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**Country Development  
Strategy Statement**

**FY 1989**

**Peru**

**February 1988**



**Agency for International Development  
Washington, D.C. 20523**

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*Embassy of the United States of America*

February 10, 1988

Mr. Dwight Ink  
AA/LAC  
AID/W  
Washington, D.C. 20523

Dear Dwight:

At this juncture, economic assistance planning for Peru is an uncommonly problematic exercise. To say that the current economic and political situation in Peru is dynamic is to understate the state of affairs. The country is on the brink of a grave economic crisis. The prospect of elections in 1990, combined with intra-APRA conflicts, incipient political mobilization of the center-right and new developments within the left, not to mention potential threats from the military and the political terrorists and narco traffickers, have created a highly uncertain political environment. The government's economic policies are unpredictable and its political maneuvering could take almost any form. Responses by the World Bank and other creditors remain to be determined.

Because of our strong interests in sustaining democracy and a rational approach to Peru's economic problems, I believe it would be a serious mistake to depart from our "constructive engagement" policy, especially when we want to remain in a position to effect, favorably to our interests, economic and political directions over the next few turbulent years. The USG has been a consistent development partner in Peru since the return of democracy in 1980. Current assistance levels have enabled us to play a useful role; lower levels would mean essentially, "marginal presence". They would require eliminating or slowing down, with detrimental consequences, ongoing priority programs and would be understood to represent a negative departure from what is now considered to be positive and helpful.

This document accurately describes Peru's dire economic prospects and the political and social tensions which will characterize the country during the next few years. The threat to democracy is real. That threat takes on an especially ominous edge when the evidence suggests we may be beginning to face a major Soviet challenge for influence in Peru. This is clearly no time to weaken our position here.

Mr. Dwight Ink

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I believe this CDSS successfully reconciles the uncertainties, the importance of hanging in, holding the line, and Peru's long run importance to the U.S. Our policy has worked. It would be harmful to change it. Moreover, in development terms, we are doing the right things and in a way which efficiently carries out our "constructive engagement" approach. I am pleased with the reasonable results we are obtaining, under difficult circumstances. The program is also responsive to AID and LAC priorities. The Action Plan appropriately details what the proposed strategy requires.

This CDSS Update should be approved.

Best regards.

Sincerely,

A handwritten signature in cursive script, appearing to read "Alex", written in dark ink.

Alexander F. Watson  
Ambassador

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Executive Summary

This FY 88-FY 90 CDSS Update covers the second half of the APRA government, as agreed in the 1987 Action Plan review. The decision to attenuate the normal five year CDSS period was a response to the fact of elections in 1990 and the change in government which would then occur. Notwithstanding this modification, the challenge of extraordinary uncertainty during the Update period must still be confronted. The outcome of developments affecting several critical variables will clearly effect U.S. interests, strategy and policy, across-the-board, not only the USAID program. The most important variable is the economy. That there is a crisis, worsening daily, is evident. What is uncertain is how the government will respond, whether or not and when the GOP and the World Bank will conclude their current start and stop negotiations with a meaningful stabilization-structural adjustment-growth package, what will be the response of the international financial community broadly, and what the impact of predictable dislocations will be on this fragile democracy, threatened by political terrorists and narco-traffickers.

Under these circumstances, and because our current assistance strategy and policy are achieving political and developmental objectives, the prudent approach, as we enter the Update period, is to hold the course. The Mission's judgment is that lower assistance levels and cessation or cuts in ongoing priority programs would be harmful to U.S. foreign policy and development interests. Peru's heightening vulnerability to radical political change suggests that important U.S. interests are at stake and at risk; these are sustained democracy, successful anti-narcotics efforts, effective anti-terrorism, economic and social development, dilution of Soviet presence and influence. That these concerns extend beyond the Update years underscore the long term character of U.S. interests in Peru. Peru's size (the largest among LAC-assisted countries) and its strategic location and political role in the developing world make evident the importance to the U.S. of favorable outcomes in the economic, political and developmental spheres. It is critical to avoid the situation toward which Peru could very well be heading. USAID strategy and program proposals are designed to reflect, taking into account

budget realities and the fact of other current priorities, the foregoing factors.

Proposed programs aim to achieve three of the Goals of the LAC Bureau. To achieve the goal of basic structural reforms leading to sustained economic growth, activities are proposed to support the private sector, promote exports, increase agricultural production and manage and preserve natural resources.

To achieve the goal of wider sharing of the benefits of growth, activities are proposed to alleviate malnutrition, reduce infant and child mortality, improve health and health services, and increase access to voluntary family planning. Food assistance and private sector activities are fully integrated into the range of activities directed at this goal.

To achieve the goal of strengthening democratic institutions, activities are proposed to strengthen the judicial system, support anti-narcotics efforts, and increase participant training.

To maintain the ongoing programs in the priority areas through the Update period will require at least the level of resources that has been provided in recent years, about \$20 million per year for AID projects, \$20 million per year of PL-480 Title I resources, and \$15 million per year of PL-480 Title II/Section 416 resources. A lower level of resources would result in a slowing down of project implementation or even abandonment of ongoing activities, when follow-on projects cannot be financed. Current U.S. policy in Peru cannot be sustained, if barely adequate allocations in FY 86 and FY 87 are followed with lower levels during the Update period.

Developments during the next few years may require a revised strategy. Peru's macroeconomic level problems, if attacked sensibly and supported by the World Bank and others, could lead to a consideration of higher assistance levels. This would depend, of course, on the budget situation and other priorities. The dimensions of what might be called an "indicative optimum strategy" are briefly described.

USAID/Peru recommends the preparation of an Andean Regional Strategy, to complement existing strategies for the Caribbean and Central America, and urges, to respond to the earmarking phenomenon, that the Andean countries be given priority to the maximum extent possible, in the allocation of non-earmarked resources as well as resources from central and regionally funded projects.

## Introduction

This CDSS Update for Peru covers FY 1988, FY 1989, and FY 1990, the last half of Alan Garcia's administration. This CDSS Update follows up on the CDSS of 1984 and the report "Options for USAID/Peru Program Planning in FY 1986-1987 and Recommended Strategy," of January, 1986, which was submitted in lieu of a CDSS. The Options Paper was prepared at a time when Peruvian policies on many topics of importance to the U.S. were in doubt. A policy of "constructive engagement" was adopted which has resulted in improved relationships and continuation in a collaborative and cooperative atmosphere of the Mission's assistance programs. This Update serves as the strategy document for the last half of a normal CDSS period. It reviews progress to date and proposes a strategy for the next three years.

### I. Overview of the Environment for Development in Peru

The current Peruvian government took office in the summer of 1985 in a democratic transition from the government of Fernando Belaunde, which was the first democratically elected government since the military coup of 1968. At the time the new government took over, Peru had experienced ten years of declining per capita incomes. Repeated stabilization programs, almost all with IMF Standby support, had failed to stabilize the economy and to restore satisfactory economic growth. While the outgoing administration, with AID support, had made gains in the foreign exchange and fiscal situation in its last seven months, the foreign debt problem was severe, and arrearages on interest and amortization had been building up since 1984. In the presidential election the party of outgoing President Belaunde collapsed and Alan Garcia won a big victory over the candidate of the United Left. The Peruvian people clearly wanted a change and were in no mood for new stabilization programs like those that had failed for the last ten years.

In response, President Garcia implemented the "nationalist, anti-imperialist" program he had promised, announcing a policy of restricting foreign debt service to 10 percent of export earnings (promising vaguely to service the debt when Peru could afford it), denouncing the International Monetary Fund and the international economic system, and seizing American oil companies, expropriating one of them. Economically, he gave highest priority to increasing economic output in Peru, using increased real wages to stimulate demand, exploiting the idle capacity in the economy, and financing increased

imports from the stock of foreign exchange left by the outgoing government. After initial hesitation caused by the uncertainties of the new program, production rose very rapidly, and GDP increased 16 percent from the fourth quarter of 1985 to the fourth quarter of 1986, continuing at that level, with small fluctuations through 1987. Despite the success in increasing consumption and real income in his first two years, Garcia has not been successful in charting a longer run economic program. Investment has been inadequate to increase capacity and to provide the production base for the foreign exchange earnings required to meet import needs.

Peru is one of the poorest countries in the region, with many grave development problems. Agricultural output stagnated for many years; there has been little industrial investment; new exports have not been developed on a sufficient scale; hunger and malnutrition are widespread and severe; and health conditions are poor. The division into coast, sierra, and selva has hindered political, social, and economic integration. Governments of the last twenty years with or without international support have not established a stable path for economic development.

Peru has a large area of tropical forests and, because of its many different regions, has great biological diversity. The tropical forests are being cut down rapidly in ways that are uneconomical and do not leave productive agricultural land. Techniques for economic exploitation of tropical forests on a long term maintenance basis are not yet available for widespread use and technology for long term exploitation of soils in the Amazon basin is not yet available.

Peru has long experience with donors and the international agencies. The first IMF Standby agreement anywhere was with Peru in 1954, and Peru had Standbys every year from 1954 to 1969, resuming them in 1977 to 1984. It has had a long relationship with the World Bank, the IDB, and with many donor countries. Now, however, it has cut itself off from almost all foreign assistance. Peru stopped making repurchases from the IMF in early 1986, and now is in arrears by about \$500 million. Peru stopped servicing its debt to the World Bank in the first half of 1987 and now has arrearages of about \$200

million with that institution. Peru has not serviced its debts to most of its other bilateral donors, and they have cut back on their programs. The GOP for lack of good project preparation and availability of adequate local financing has used slowly the funds that are available from prior loans. Only the IDB, as well as the US, has retained an active program in Peru. In the absence of improved GOP policy, the IDB program is likely to decline. While the GOP sees the need to restore its relationships with the World Bank and other donors in the face of impending severe economic problems and has been discussing a new stabilization and structural adjustment program with World Bank staff, the arrears to be paid will be a formidable barrier to restoration of the relationship. It will require extraordinary donor cooperation and support, along with policy reform, to restore Peru to a situation of active positive collaboration with the donors and its concomitant external assistance.

There is no doubt that Peru is facing a deepening economic crisis, with no resolution as yet in sight. Economic growth is limited by the lack of productive investment, by both the private sector and the government, to increase productive capacity, and by the lack of clear plans and policy on which to base growth. Foreign exchange reserves fell by over \$700 million in 1987, and were falling more rapidly at the end of 1987, with available reserves to pay for imports limited to about \$500 million. Net reserves were negative in January, 1988. The fiscal and credit situation was coming apart, and, in January, 1988, prices rose at an annual rate of over 200 percent per year (inflation previously dropped in 1986 to under 60 percent per year). A devaluation of 50 percent in December, 1987, was not followed by the needed complementary fiscal and credit measures in late December or January, and government planners had not made known any clear scenarios for 1988 on which to base plans and programs. The prospects are for little growth or a fall in GDP in 1988 and a worsening crisis until the balance of payments is improved to allow continuation of an adequate level of imports, the fiscal and credit situation is put on a stable basis, and a program of investment in new production facilities of adequate size is established. Even with appropriate measures and significant external assistance, Peru's economic situation will remain difficult during the Update period. A fragile political system, made even more vulnerable by a variety of destabilizing forces, complicates the

development environment and makes even more difficult the tough economic decisions which are required.

Despite the improvements in income, employment, and consumption in 1986 and 1987, the more recent evidence of economic management shortfalls has eroded the Government's support. The President's call for nationalization of the remaining private domestic banks in July 1987 has proved deeply divisive and harmed business confidence. The struggle against terrorism and subversion is not going well, with Sendero Luminoso still highly active in the Sierra, Lima and other parts of Peru. An intensified threat from the MRTA group broke out in late 1987. Despite the strains, however, Peru remains a functioning democracy, with a free press, and general respect for human rights. The situation will unfortunately deteriorate until the economic problems can be effectively dealt with. The Update period, clearly, is critical for Peru. Many U.S. interests are at stake.

Peru is the "odd man out" in many ways when it comes to development and AID strategy in Latin America and the Caribbean. There is no "Andean" or South American regional strategy in which to situate AID's Peru strategy, unlike the situation for Central American and Caribbean countries. Although the same is true of Ecuador and Bolivia, Peru can be set apart. It is much larger and more important to the world economy than any other LAC country with an AID Mission, whether measured by population, area, exports, markets, etc. Its development requirements are heroic. In many respects Peru is an Alliance for Progress country that never graduated, as did the major Alliance emphasis countries in South America--Colombia, Chile, and Brazil--and never received the major program assistance in the 60's that the other countries did. Peru is also the country with a regular AID Mission that has by far the largest foreign debt. This CDSS Update presents a strategy which reflects what is, overall, a complex, challenging and critical development environment.

## II. Problem Description and Analysis

### A. Macroeconomic Assessment - Inadequate Income Growth

(LAC Goals: Short Term Economic Stabilization, Basic Structural Reforms Leading to Rapid and Sustained Economic Growth)

#### a. Income Growth

From 1954 to 1975, despite periodic economic and balance of payments crises, per capita GDP growth was acceptable, averaging 2.1 percent per year. From 1975 to 1985, per capita GDP fell by 16.4 percent, back to the level of twenty years before. Per capita GDP grew by about 6 percent in 1986 and 4.4 percent in 1987, but growth will probably be negative in 1988 since the unused capacity and stock of foreign exchange that permitted the 1986-87 growth are not available in 1988. Per capita GDP growth will probably continue to be low or negative through 1990. While income distribution is very uneven in Peru, both by social class and by region, the increases in 1986-87 were broadly based, with real wages in both rural and urban areas increasing around 20 percent. Restoring an acceptable and sustainable rate of per capita economic growth in Peru will require the following factors, which may not be achieved during the period of this CDSS Update:

- A large increase in export earnings, based on development and marketing of new agricultural and industrial non-traditional exports, and renewed foreign investment in the petroleum sector.
- Management of the debt problem which allows Peru to service its debt and borrow abroad.
- Greatly increased productive domestic investment, both private and public.

- Reforms in the tax and public tariffs situation which will increase public revenues and savings.

b. The Balance of Payments

Peru's imports and exports (FOB basis) have been about equal over the last few years, at about \$2.6 billion in 1986 and 1987. Traditional exports account for about 75 percent of total exports, with non-ferrous metal and mineral products about 40 percent of total exports. Other important traditional exports include petroleum, fishmeal, coffee, cotton, and sugar. Except for petroleum, where foreign investment is needed, there is not much scope for further investment in traditional exports from Peru under current international market and domestic potential supply and price situations. Non-traditional exports are widely diversified. Non-traditional exports have been shown to be quite elastic to the level and stability of real exchange rates, and could be expanded rapidly under good policies, but since they form only 25 percent of exports currently, even achievable rapid rates of growth will not, in the short run, have a large effect on overall exports. Peru has a good potential to increase tourism earnings, but this will require investment in expansion and improvement of domestic transport and tourism facilities. Timing and resource availabilities argue against achieving substantial results in this sector during the Update period.

Peru is now receiving almost no new loans--in the first three quarters of 1987, only \$45 million of new long-term loans to the public sector were signed. Loan disbursements are falling rapidly, since most bilateral donors have reduced or made no loans in the last few years, and currently World Bank loans are not disbursing. Without a satisfactory approach to the debt situation--arrearages on public debt are now about \$7 billion, of which \$2.6 billion is in interest--there will be few new loans from any source. After using \$1.6 billion from its gross foreign exchange reserves in the last two years, available reserves are now at minimal levels and declining. In fact, Peru must sell gold to maintain its level of imports (it has perhaps \$400 million of gold in readily salable form). Unless there is a metals price boom in 1988, it would appear that Peru will have to cut back on the level of

imports because virtually no one, currently, will give Peru credit, and available export earnings and reserves will not be adequate to maintain import levels. Unless there is a major arrangement with some creditors, and new loans are made, no meaningful relief can be expected through the end of the Update period.

When the APRA government took office, Peru had a floating exchange rate. This allowed the GOP to devalue in real terms in 1984-1985 but at a cost of a rate of nominal devaluation and of inflation of over 200 percent per year, leading to dollarization of the economy. The system had become unsustainable. The new government immediately introduced a dual fixed exchange rate system after initial 11 percent and 38 percent devaluations. The new system did reduce inflation for a while, but at the expense of a lag in exchange rate parity. Over time, new exchange rates have been introduced, and, as of February, 1988, there were about eight different rates, ranging from 16 intis to the dollar for food imports through around 45 intis for most exports and imports, to 63 for services and up to 100 in the informal market. Although the GOP has announced its intent to reduce the number and spread of rates, this had not yet occurred by February 12, 1988. The December 1987 devaluation brought exchange rates for exports closer to exchange parity, and a further devaluation in January for exports helped to limit the drop below parity, but with inflation running at a rate of 9.5 percent to 13 percent per month (200 percent or more per year), unless drastic fiscal and credit measures are taken, it will not be easy to retain parity.

c. The Debt Problem

Peru had debt arrears of over \$1 billion at the end of 1984, and the arrears have risen rapidly since. The total public sector medium and long term foreign debt at the end of 1987 was about \$11.5 billion, about 30 percent owed to bilateral and multilateral donors, 30 percent to commercial banks, 30 percent to suppliers, and 10 percent to the socialist countries. In addition, the Central Bank has debts of \$860 million, largely to the IMF. Private sector medium and long-term debt is under \$1.5 billion. Except for a few token payments, the commercial banks and suppliers have not received payments

under the present government. Socialist countries are accepting payments in merchandise, and some commercial banks have signed arrangements to do the same. At this time the World Bank and most bilateral creditors are not receiving debt payments from the GOP. The APRA Administration has made several sporadic efforts during its period in office to enter negotiations on debt payments or reschedulings. These efforts have been unavailing. Moreover, the GOP refused to accept the Paris Club rescheduling for 1984 which had been negotiated by the outgoing government. Despite its generalized rhetoric and poor performance, the GOP has managed its FMS and AID arrearages to avoid USG sanctions and has covered its arrearages on PL-480 to enable PL-480 programs to continue. And, in fact, its debt service payments have been around 20 percent of export earnings, rather than the announced limitation of 10 percent, when service on short-term debt and debt to other Latin American countries is included.

d. Fiscal and Monetary Policy

The fiscal and monetary situation has deteriorated drastically and dramatically during the APRA Administration. The new Administration inherited a situation that was close to fiscal equilibrium and actually raised gasoline prices initially which improved matters. Since then, in its aim to increase output and private income, fiscal and monetary discipline has essentially vanished. Tax revenues, thanks to rate cuts and lack of adequate adjustment of gasoline and other specific taxes for inflation, are down from 17 percent of GDP in 1985 to around 9 percent of GDP at the end of 1987. Even taking into account the increase in GDP over this period, the drop has been dramatic. Central Bank financing of the government deficit has been running around 5 percent of GDP. Central Bank losses on foreign exchange sales, and heavy advances to government development banks that lend at negative interest rates have had a major effect in increasing the monetary base. Losses of public sector enterprises have also been heavy. By the end of 1987, the overall public sector deficit was well over 10 percent, how large it was, no one really knew, although a World Bank team was attempting to determine the actual amount. While the GOP has stated its intent to increase tax revenues by 3 percent of GDP in 1988, and has instituted a new wealth tax and

selectively increased excise taxes, as of February 12, it had yet to take other needed measures. We share the World Bank's view that even greater revenue increases than those set as a goal by the GOP will be required to restore fiscal balance.

The fiscal deficit has not been due to an increase in public investment, which has fallen under the current government. Whether or not an explicit intention, the GOP has given a low priority to implementing ongoing development projects, and, except for USAID projects, has done little to provide the local currency support needed to implement multilateral and bilateral donor projects. The National Planning Institute (INP) has been unable to adequately prepare new projects and begin their implementation. There is no backlog of new projects in the public sector which responsible donors/creditors would consider ready for financing.

Part of the GOP strategy for reactivating the economy was to cut interest rates to lower costs, so that product prices would not rise and real wages could increase. This strategy served its purpose, but interest rates are controlled at rates below 50 percent per year, when inflation is running now about 200 percent per year. While the reactivation of the economy greatly increased corporate profits through a higher level of activity, and thus corporate savings, these savings have not moved through financial markets. There are no good current estimates of private savings, since these savings do not move through organized markets. One effect has been to set off a construction boom, and a resultant scarcity of construction materials, since purchasing building supplies is one of the few ways in which the small saver can at least maintain the real value of his savings.

e. The Private Sector

There has been little change in Peru's large and very diverse private sector under the APRA government, and it is not clear that there will be many changes during the Update period. Despite all the talk about "nationalization," so far only Belco Petroleum has been nationalized and two private banks and associated financieras intervened. Now that the GOP has

admitted that the largest private bank was legitimately sold to its employees, it is not clear which banks, if any, financieras or insurance companies will be nationalized. Until the matter is settled, the uncertainty will discourage the private sector.

While the GOP has privatized five small enterprises, it has not privatized any major enterprises so far, nor announced major changes in the operations of the many large public enterprises. While announcement of the intended nationalization of the remaining private domestic banks, financieras and insurance companies last July has caused enormous problems in business confidence and the relationships between the GOP and the private sector, the direct impact on banking and credit policies has been minimal.

Through the first part of 1987, business circles found a good operating environment for increased business activity and profits, despite government controls and regulations, and were responsive to invitations to plan new investments and expansions of activities in key areas with the GOP. Now, after a number of shocks of unexpected GOP announcements that seem to threaten the autonomy and future stability of the private sector, it will take major steps to reestablish government-business confidence.

In addition to the modern business sector, Peru has a very large informal urban sector, made famous by Hernando de Soto and his Institute for Liberty and Democracy. While debate rages over how the informal sector is to be defined, and how large it is, de Soto has presented two major challenges to the political and social left in Peru, that it does not know how to rebut: first, that the informal sector is mostly composed of entrepreneurs, not proletarian wage workers, so that the natural home of the poor in Peru is with the liberals who want liberty for starting and expanding businesses, not with the left and a controlled socialist approach to life, secondly, that the formal business community in Peru is largely "Mercantilists" who earn profits from favorable arrangements with the government rather than from hard work and business efficiency, and who depend on the government for their privileges, thus, the informal sector should strive for a smaller, less controlling and less interventionist government, so that they may overcome the unfair advantages enjoyed by larger businesses. A corollary is that leftists who

favor a larger and more controlling government are the enemies of the informal sector. It is difficult to predict future developments in the fight for the ideological definition and loyalty of the informal sector.

Peru also faces problems related to the rural production enterprises resulting from the land reforms of the Velasco era. These are at least nominally in the private sector, but usually do not operate effectively, and are inefficient and unstable. The government as yet has done little to tackle the fundamental problems of these rural enterprises.

During the Velasco era the old business/land-owning oligarchy was destroyed and its organizations eliminated. Peru now is creating new organizations to represent the private sector to the government and other sectors. Opportunities exist to make them more technical, competitive and entrepreneurially oriented, minimizing the protectionist, monopolistic and favoritism tendencies found in the business community in the past.

The largest problem for the private sector at this time is the lack of a rational, predictable, and stable business environment, which is having a negative effect on business planning and investment. With the deepening of the economic crisis, this situation is likely to worsen. The GOP needs close collaboration with business to stimulate the investment and exports and rational import substitution that are needed to solve Peru's major problems, but this will not be easy to achieve.

f. Agriculture

Recent studies indicate that total agricultural production in Peru grew little, if at all, between 1970 and 1986. The downward trend in the 70's under the military government has been turned around. Agricultural production has increased in this decade, but there is still great potential for increased output. Because of the great diversity of agriculture on the coast, sierra and selva, it is no easy task to even determine what changes in total agricultural output really are. It would also appear that the acreage

of land actually cropped each year changed almost not at all from 1970 to 1986, dropping in the 70's and then increasing in the 80's.

Many different problems and policies have limited the growth of agricultural production. The military government allowed one of the best agricultural education, research and extension complexes in Latin America to deteriorate and shrink, severely limiting the development of and access to new technology. The terms of trade were turned against agriculture as part of policies to protect import-substituting industry, and to provide cheap food to urban dwellers. The large agricultural complexes taken from private owners in the land reform were not provided with adequate management, organization, or financing. There was no emphasis on developing new agricultural products for the export market, and policies were unfavorable for developing non-traditional exports. Agricultural investment was concentrated in large scale new projects designed to bring new lands under cultivation on the coast and selva, neglecting small scale projects, and incentives to make smaller scale investment in maintaining and upgrading existing agricultural areas. Agriculture in the sierra has suffered particularly from this policy.

Although fundamental reforms have not yet been undertaken, the APRA government gives a high priority to supporting increased agricultural production. It continues to provide strong support to agricultural research and extension, providing ample funding and taking steps to reorganize the programs to make them more effective. It has sharply improved the terms of trade for agriculture, partly as the result of the policies that have increased urban wages and employment and consequently demand for food and the prices of food not under price controls, and partly as a result of setting high support prices for a number of crops and providing funds to purchase the commodities. Prior to 1985, the agricultural terms of trade had been falling in line with worldwide trends, but since 1985 they have recovered sharply, rising again toward the level of the late 70's. The exact increase depends on which indices are used to calculate the terms of trade, but the improvement from the 1985 lowpoint to end 1987 is in the range of 50 percent to 100 percent. The price support program is expensive, and there is considerable question about being able to sustain it financially. Relative support prices

are not always set carefully, and at times stimulate production of crops that are not the optimum ones for a region. The government also instituted a cheap credit program for agriculture, and has lent large amounts for this purpose through its agrarian bank, but has done little to ensure that the loans increase agricultural productivity. While the government has pulled back somewhat from investments in large new irrigation projects to bring new lands into production, it has done little to promote policies to provide funds and incentives for investment to maintain and improve existing irrigation facilities. Within its complex of varying exchange rates with constant drift and abrupt changes in real exchange rates, the GOP has given a priority to the exchange rate for non-traditional agricultural exports, and has kept this rate closer to parity than other rates.

Although the GOP has given special emphasis to the sierra region because of its poverty, it has no specific strategy for Andean agriculture. It has given a high priority to rural programs in areas in the sierra threatened by violence, including many agricultural improvement projects, but it has had difficulties in developing projects and in assuring effective implementation.

g. Managing and Preserving Natural Resources

Within its coast, sierra, and selva areas Peru has an extremely large and varied number of habitats, and a tremendous diversity of flora and fauna. Many of these areas are ecologically fragile, and are threatened by population increases as existing populated areas come under increasing pressure, and new areas are opened up for settlement.

The problems are particularly severe in the selva, where the tropical forests are threatened by both spontaneous and government-sponsored colonization, and where cost-effective technologies for long term conservation of the resource base are not yet developed and available. Unless viable technologies are developed or means are found to prevent settlement of the tropical forest areas, Peru runs the risk of having vast areas of present

tropical forests changed into unusable wastelands impoverished in both flora and fauna.

Deforestation and soil erosion are serious problems in the sierra. On the coast, wetlands and dry forests are threatened by exploitation, and there are, of course, serious problems in management of the great Peruvian fishery, once the most productive in the world.

While there is widespread appreciation of the threat to natural resources and biological diversity, and both government and private organizations are active, the problems are so immense that activities to date, with a few exceptions, such as preservation of the vicuña, have been totally inadequate to provide the needed conservation and protection. The GOP has established a number of national parks, protection forests, and reserves, but to manage them effectively is a difficult task in the face of desires of local residents to exploit their resources. Work is being done on surveying and inventorying natural resources, but a tremendous job remains. Only limited efforts are underway to develop technologies for utilization of tropical forests and soils in economically productive ways that preserve these resources. Work has hardly begun on developing policies and incentives that will lead the private sector to preserve resources and biological diversity. Education, training, and institution building efforts are as yet not far advanced. It may well be that Peru is not lagging behind other countries in tackling the problems of managing and preserving its natural resources, but the challenge is great, and much needs to be done on an urgent basis at a time when financial and human resources are scarce.

B. Hunger and Malnutrition

(LAC Goal: Shared Benefits of Growth)

Peru has serious malnutrition problems. In 1984 an AID sponsored nutrition and health survey showed that nationwide, 38 percent of children under age 5 suffered from severe chronic malnutrition (weight for height, two standard deviations or more below the norm). This is well above the AID goal

of less than 20 percent. The problem is greater in rural areas, with 57 percent of children severely malnourished, compared to 24 percent in urban areas. The problem in Peru is among the most severe in the LAC region, comparable to Bolivia and Haiti. (FAO is preparing new caloric input estimates for Peru. In 1980 per capita caloric intake was estimated at a low 1,669 calories per day.) Peru is not self-sufficient in food, and imports large amounts of cereals, vegetable oil, dairy products, meat, and other foods every year.

The causes of malnutrition are many, and a multitude of actions must be taken to reduce malnutrition in Peru. A basic cause is the very unequal income distribution in Peru, and the decline in per capita income in the last decade. The stagnation in agricultural production since 1970, already referred to, has been another major cause. The unfavorable terms of trade for rural areas, benefitting urban areas at the expense of the rural population, is probably the major reason that malnutrition is worse in rural areas. State intervention in the economy and unstable policies have hindered development of efficient food marketing systems, hurting both producers and consumers. Food subsidies in urban areas have been untargeted, overly costly and unsustainable in fiscal terms, and subject to abrupt changes, particularly when foreign exchange crises have limited food imports. Poor health conditions, and poor availability of medical care, particularly in rural areas, have also contributed to the high levels of malnutrition seen in children. The measures taken by the APRA government to increase real wages and incomes for the mass of people, and to sharply improve the rural/urban terms of trade, have resulted in increased domestic food production. Increased levels of food imports have also increased food consumption, but data on the extent to which severe malnutrition has been lowered in children are lacking.

AID and other donors have had large supplementary food programs in Peru for many years. Currently there are over 950,000 mothers and children receiving AID supplied supplementary foods each year, plus over 450,000 food for work recipients, a total of almost 7 percent of the total Peruvian population. Continual efforts are being made to include the most severely malnourished in these programs and to provide growth monitoring and child

survival services. Peruvian scientists are internationally recognized for their high quality nutritional and medical research. Studies to identify the causes of infant mortality and morbidity, especially due to malnutrition, and develop effective interventions to improve the nutritional status of mothers and children are underway.

C. Health Deficiencies

(LAC Goal: Shared Benefits of Growth)

Peru has poor health conditions for what is nominally listed as a middle income country. Infant mortality rates nationwide are about 88 per 1,000 live births, and have been falling steadily. This is above the AID maximum acceptable level of 75 per 1,000 and is the third highest in the LAC region. In some rural areas in the sierra and selva, infant mortality rates are more than double the national average. About 30 percent of the population does not have access to medical care. Life expectancy only in 1987 finally exceeded 60 years, the AID minimum acceptable level. Because of the severe infant and child health problems, Peru is a Child Survival Emphasis Country, and much of health analysis and research goes into the infant health problem. Prematurity and neonatal tetanus are thought to be major causes of infant deaths. Respiratory and gastrointestinal infections resulting from poor living conditions are also major causes of infant and children deaths. They are also leading causes of morbidity. Peru has had high rates of immuno-preventable illnesses in the past.

Poor sanitation conditions, particularly in rural areas, are another cause of poor health conditions in Peru. Only 20 percent of the total rural population has access to safe drinking water, and only 15 percent have sanitary disposal facilities.

In 1985 an analysis of the Peruvian health sector was completed by private and public sector Peruvian specialists working with foreign consultants and a U.S. University under AID sponsorship. The analysis indicated the system has the same problems found in other developing

countries, as extensively analyzed by the World Bank and others. Health care in the public sector is excessively curative, and based too much on hospitals. Cost recovery on hospital care is poor, and too much of the public sector budget goes to this urban hospital based system, leaving insufficient amounts for preventive, clinic and health post based, and rural area care. Management has been overcentralized and poor, leading to underutilization of many existing facilities because of the poor quality of care offered. The validity of this analysis has been recognized by many health care professionals, and under the APRA government movements are under way to decentralize health care, emphasize preventive health care (particularly immunizations and oral rehydration therapy) and increase primarily health care budgets.

Because of the high quality of the health research centers in Lima and their staffs, they have received many centrally funded health grants from AID and other donors. Their work is not only contributing to more effective health care and management in Peru, but also is developing new treatments, methods and technologies that are important to better health care worldwide.

D. Population Pressures

(LAC Goal: Shared Benefits of Growth)

In 1987, the population growth rate in Peru was estimated to be 2.5 percent per year, down from 2.8 percent in 1970. Less than half of couples use some form of contraception, well below the AID target level of 80 percent. At this growth rate, Peru's population will double in 28 years, increasing social and economic problems, and putting greater pressure on the environment. Many couples do not have access to acceptable modern contraceptive methods, and there is a large unmet demand for such services.

The APRA government is providing strong support for expanding family planning services, under the leadership of President Alan Garcia, who has strongly supported family planning in public, and taken a number of actions to facilitate greater provision of family planning services. The government has

set a very optimistic target of a total fertility rate of 2.0 by the year 2000. Throughout the public sector expanding efforts are underway to solve organizational, technical, and funding problems and increase the provision of family planning services through public facilities.

The private sector has also been active in increasing family planning services, and under the AID Private Sector Family Planning project, the private agencies have substantially increased their coordination and efficiency in their work.

Increasingly a major problem for both the public and private sectors is funding. As other constraints are being solved and removed, the chief limitation on expanding access to family planning services is expected to be the funding required to maintain and expand both public and private sector programs.

#### E. Housing

(LAC Goal: Shared Benefits of Growth)

The USAID has had a long and innovative association with the housing sector in Peru. The Mutual Savings and Loan system was established with AID assistance, and more recently the Materials Bank has proven to be another successful innovation. Since 1972, seven HG loans to Peru, totalling \$123.8 million, have concentrated on sites and services, particularly electricity, water, and sewer services. The most recent loan in 1984 was for the regions damaged by the 1983 El Niño disaster.

During the previous administration a number of shelter sector policy problems were identified by the Mission that needed correction. The APRA government has made progress on a number of these issues. Unlike the previous government, the current GOP has a policy that public funds will be used exclusively on low income shelter. The private sector institutions, particularly the Mutualls, have been given a more favorable policy environment and have survived and reentered the mortgage market. While no formal

mechanism has been created, there have been improvements in joint public-private sector policy formulation. Less progress has been made on questions of subsidies and decapitalization, given the present environment where government credit controls require interest rates that are strongly negative in real terms. On balance though, progress has been made, and new HG loans would be productively used, provided the subsidization/decapitalization issues can be resolved.

Arrearages have been accumulating on prior HG loans since January 1985, before the APRA government took office, and at the end of 1987 they were about \$37.1 million dollars. During 1987 the USAID presented a carefully prepared proposal for resolving the arrearages problem, including renegotiation of old high interest HG loans, and negotiation of new HG loans. This was the most favorable offer that could be made to the GOP. After close consideration, the GOP reluctantly decided not to accept the offer. As a result, the Mission has not been able to go forward with new activities in the shelter sector, and improving housing is not a Mission objective at this time.

#### F. Strengthened Democratic Institutions

Democracy has faced many attacks in Peru from both the right and left. Peru was under military government from 1968, when a coup removed democratically elected President Belaunde, until 1980, when President Belaunde was reelected for a second term. Much of the debt that burdens Peru today was contracted under the military governments, and the failures of stabilization programs in the 70's were due in large part to the failure of the military government to accept the discipline of limiting military pay increases and reducing arms purchases from foreign suppliers. The threat from the left is also strong, both from leftist terrorist movements trying to overthrow the government, which are stronger now than previously, and also from the legal left, which if elected democratically might try to eliminate democracy in the future. A newer threat which has grown greatly in the 80's is narcotics trafficking, which threatens to subvert and corrupt democratic institutions for its own illegal purposes. Particularly important for the proper

functioning of a democratic government, so that it maintains its prestige and support, are equitable and effective legislative and judicial systems.

The Peruvian House and Senate operate under old and outmoded rules, have few technical resources to assist in drafting complex technical legislation, hold few hearings to allow the public and interests affected by proposed legislation to present their views, and are inefficient in considering and passing legislation. As a result, something like 90 percent of the laws and decrees issued in Peru come from the Executive Branch, are often badly drafted, done without consultation with the private sector and interested groups, set up unnecessarily complex procedures, and often cannot be implemented effectively. Many of the obstacles to the informal sector--highlighted so effectively by Hernando de Soto--are created by the failures of the legislature to pass well considered legislation and the consequent mass of executive decree laws and decrees, resulting in a loss of prestige for the legislative and executive branches, and lessened popular support for democracy.

In public opinion surveys, a majority of Peruvians say they don't expect justice from their judicial system. A majority of the population lacks access to the system and understanding of how it should work. The system has inadequate resources, human and material, for its greatly increased caseload, and makes less than efficient use of the resources it does have. There is a lack of coordination among the entities responsible for the justice system, an inadequate information system within the sector as well as lack of information on actual judicial system behavior, and general prevalence of antiquated procedures. The system is subject to grave pressures from terrorists and narcotics traffickers. Yet, there is much interest in reform by capable people within the system and the Garcia administration has given a high priority to improving the judicial system. Reform efforts are hampered by resource scarcity, and by lack of experience within the sector in planning for and managing programs of change and improvement. It will require a long period of hard work to make the needed changes in this crucial area.

G. Narcotics Eradication Support

Production of coca has expanded rapidly in Peru in recent years, and at least 100,000 hectares of land, largely in the Upper Huallaga Valley, are now in coca. Considered purely as an agricultural crop, coca leaf is now the most important in Peru in terms of farmgate value, accounting for fully 13 percent of total agricultural output value for the 84 principal crops in 1986. Coca is also a major foreign exchange earner, and the admittedly imprecise estimates put coca growing and coca paste export return value to Peru in 1986 between \$600 million and \$1 billion, making coca paste the largest export from Peru, and providing between 15 and 25 percent of total Peruvian exports of goods and services. Before May 1987, when Peruvians lost confidence in the inti, and the parallel market rate rose above the official rate, the inflow of "coca dollars" was a major source of foreign exchange income of the Central Bank, and helped finance the current increase in economic output and limit the loss of reserves. In the last half of 1987, the coca dollar inflow has helped to finance capital flight, and official foreign exchange reserves have fallen more rapidly as a result.

Interdiction of narcotics traffic, eradication of coca growing, and the provision of alternate crop and income alternatives to those who no longer grow coca are extremely difficult for the government and its forces when the opposition commands more resources than the government. The problem is complicated in Peru by terrorist movements that operate in the coca area--Sendero Luminoso moved in from the south, and now the MRTA is trying to move in from the north--setting off a confused three way, or perhaps even four-way struggle for control of the area.

The government of Peru has made fighting the drug traffic a major priority, and has increased the resources it is devoting to implementation of the national drug plan. Over 1,200 police were sent to the Upper Huallaga valley in 1987 to carry out major drug interdiction and eradication operations. However, despite the large numbers and amounts of seizures, the government has not been able to control the coca zone, and the rising level of

violence has forced the government to declare the area an emergency zone under military control.

While the APRA administration has been resolute and active in its anti-narcotics efforts, many Peruvians consider the narcotics problem as one that does not involve them and is not important for national priorities. The fact is that narcotics use is spreading in Peru and is a growing threat to society. Despite increasing awareness and concern, continuing and expanded drug education programs are needed to educate the public to the threat and expand public support for the anti-narcotics effort.

As the anti-narcotics effort registers successes, and coca paste exports drop drastically and export revenue falls, there will be significant effects on the national economy. Recognition of and a response to this fact are needed now so that Peruvian support for the anti-narcotics effort will not drop just when it is most needed, because no provision has been made to offset the negative macroeconomic effects that really effective control of coca in Peru will have on the Peruvian economy.

#### H. Natural Disasters

More than most nations, Peru has a history of natural disasters. The El Niño disaster in 1983 of devastating floods in the north and a severe drought in the south caused economic losses to Peru estimated at over \$1 billion, and GDP dropped by 12 percent that year. The great Huaraz earthquake of 1970 killed 66,000 people and caused great damage in both the coast and sierra. Peru must prepare for more giant earthquakes, droughts and floods in the future. Some disasters, such as those in 1970 and 1983, require major responses by the U.S. Others, such as the flooding of Lake Titicaca in 1986, require only a limited U.S. response. Still others, such as the landslides and floods that come every year in the sierra in the rainy season, destroying houses, roads and property and killing many, essentially receive no U.S. response. The Peruvian efforts in mitigating these disasters, while increasing in effectiveness, are still inadequate, and much more can be done to assist in their efforts to anticipate, prepare for and respond to disasters.

In cooperation with OFDA, the Mission provides support for disaster preparedness activities in Peru.

I. Lack of Education

(LAC goal: Shared Benefits of Growth)

Peru has a better record of achievement in primary education than in many other social fields. In 1982 primary school enrollment as a percentage of population in the age group was over 110 percent in Peru, far above the AID minimum standard of 90 percent. In 1980, according to the census of that year, adult literacy was 79 percent, and the rate for females was 74 percent, well above the AID minimum standard of 50 percent. While there are numerous problems and faults in Peruvian public education, including a steady decline in quality in recent years, their resolution requires working through a large and politicized educational establishment. In view of the greater problems in other areas, the Mission has not considered public primary education to be a priority area. The Mission has several training programs, including the Andean Peace Scholarship program, and supports management training in several universities as part of its private sector assistance efforts, but has no projects at this time directed specifically to the solution of problems in the education sector.

III. Strategy

A. Strategy Overview

U.S. policy in Peru is described as "constructive engagement." The phrase is difficult to define with precision but may be broadly described as a set of activities, assistance among others, which allows the U.S. to have a visible presence, to support a positive bilateral relationship, to have access to the government and other sectors of Peruvian society, to create opportunities for influence on a range of macro and micro policies, and to be identified as a friend of the country and its people.

We don't pretend to solve all Peru's economic and social problems, nor do we pretend to support Peru's balance of payments. But we do pretend to provide solid, steady, well justified program and project support for a democratic--although problematical--government. Over the long haul in Peru we need to maintain a steady, "correct" benign posture that will not associate the U.S. overly with any one Peruvian group and allow us maximum political and programmatic flexibility in the future.

One translation of the political objective of "constructive engagement" into assistance levels would be to provide enough assistance to demonstrate that it is in Peru's interest to deal positively with the U.S. in particular, and the West more broadly. Operating within the framework of the USG's foreign policy in Peru, AID's primary role, as "a" if not "the" major instrument for carrying out that policy, is to contribute effectively to Peru's economic and social development.

On balance, the "constructive engagement" policy has worked, particularly in political terms, despite difficult conditions in Peru. The bilateral relationship is generally good, we have easy, open access to the government and other sectors, issues are discussed frankly and, frequently, sympathetically, the USG is generally regarded as a long-time friend and, by most Peruvians, helpful. In development terms, the assessment contains both positive and negative elements but, overall the policy can be described as reasonably successful. We have little influence on macro-economic policy but have been associated with important sectoral policy developments in agriculture, health and family planning. We can point to discrete if limited achievements in other areas, for example, in the private sector. In narcotics, the level of our assistance has not provided opportunities for significant results to date, but has contributed to a balanced, integrated overall USG approach, helping to keep us engaged on narcotics issues with GOP decision-makers at all levels, and providing a basis for more effective results should additional resources be made available. Thus, recent past levels of assistance have made it possible to achieve a good proportion of our political objectives, program levels, and the development assistance program

itself, including the manner of its implementation, have made possible the achievement of reasonable development results.

The judgment here is that a reduction in levels during the Update period will have serious negative political and developmental consequences. Therefore, unless we foresee a basic change in GOP and/or USG policy, or in other circumstances during the Update period, it makes sense to plan now to continue our "constructive engagement" strategy. For AID, the questions are: What should be the level of resources? What should be the program's priorities and composition?

To sustain the current policy requires at least the same level of resources as has been provided during the past few years:

- At least \$20 million of DA/ESF for projects that are highest priority for Peruvian development and U.S. interests in Peru.
- At least \$20 million of PL-480 Title I to keep AID a player in the macroeconomic/sectoral policy dialogue, provide local currency for implementation of AID projects, contribute to the country's food requirements, and participate in providing support for the balance of payments, possibly as part of a donor effort to help stabilize the economy.
- About \$15 million of food aid under Title II/Section 416 for direct distribution to fight malnutrition, address income disparities and support development programs.

This provides a level of about \$55 million per year, an amount which will allow for minimum effective funding of programs to achieve U.S. objectives, including a demonstration of continued U.S. support for the democratic process in Peru. This is about the same level as was provided in the last several years and considerably less than was provided during the "El Niño" disaster.

This strategy will contribute towards achieving three kinds of U.S. objectives in Peru:

- AID's worldwide goals of alleviating hunger, preventing disease and early death (with emphasis on Child Survival), controlling unmanageable population pressures, protecting tropical forests and biological diversity, and increasing economic growth through agricultural and private sector development (70 percent of DA/ESF resources, Title II/Section 416).
- U.S. specific interests in Peru in strengthening democratic institutions, assisting in anti-narcotics programs, and increasing interchanges between Peru and the U.S. at the non-elite level (30 percent of DA/ESF resources).
- Maintaining the dialogue on sectoral and macroeconomic policy, preparing for longer run solutions to the debt problem, preparing for programs beyond the end of the CDSS Update period, participating with other donors in stabilization programs (small share of DA/ESF resources, PL-480 Title I).

The strategy proposes only follow-on new projects, except in FY 1988, for the Agribusiness and Agricultural Export project as a shelf project. Therefore, funding cuts would force slowdowns or discontinuance of ongoing priority efforts that require a number of years of effort to reach their objectives. Cutbacks would also be perceived as a change in U.S. policy by the Garcia administration, and others leading to problems in carrying out the development programs. Also, given Peruvian attitudes on debt and the difficult foreign exchange situation to be faced during the Update period, a decrease in program levels could lead Peru to conclude that the U.S. attitude and the assistance provided does not justify paying service on past U.S. debt, leading to a phase-out of the U.S. assistance program, and mounting arrearages with the U.S. It is not in our interest that this happen, restarting a U.S. development program, designed to reach U.S. goals in the future could prove to be difficult and costly.

Should additional resources become available during the CDSS Update period, the strategy proposes that they be primarily used for more adequate funding on existing projects designed to meet AID's worldwide goals in agriculture biological diversity, private sector support, health and population, and specific U.S. interests: democratic institutions, narcotics, and training. This would take priority over using increased resources for economic stabilization, unless substantial additional resources are available, since action in this field would require very large resource transfers.

Given the level of resources proposed for implementation of the strategy during the CDSS Update period, there were few options to be considered. Lower priority objectives such as education have already been dropped from the strategy. Existing projects focus on achieving priority U.S. objectives, are being implemented satisfactorily, and enjoy good support from the APRA administration. No new projects were identified for FY 1988 that are sufficiently high priority that they would justify discontinuance of existing projects, and loss of much of the progress made to date in them, in order to free up the funds needed to finance new ones.

It should also be noted that many of the Mission's activities in Peru have arisen from priorities and earmarks on expenditures which were set outside of the Mission. The Mission does not wish to propose premature completion or severe cutbacks in administration of justice, narcotics, andean peace scholarship, or child survival activities in order to finance other new initiatives as part of this strategy during the Update period.

The public/private split of obligations during the Update period would continue the trend for the last several years with between one-third to two-fifths for the private sector, and between three-fifths to two-thirds for the public sector.

As part of the Strategy Overview, three other points should be made. First, within the Update period, the situation in Peru will be characterized by extraordinary uncertainty, with a wide range of possible outcomes. The economy in February 1988 was already heading towards a major

crisis. The political scene is extremely volatile, with intra-APRA conflicts further unsettling the political picture already threatened by terrorism, narcotics and economic recession. The political structure, clearly, is fragile and vulnerable, with a fractured society not only attempting to deal with structural problems but also with powerful new economic and political challenges.

Several questions reveal how dynamic and uncertain the next few years will be. What policy course will the APRA government pursue to deal with the economic crisis? What will be the response of the World Bank, other donors and international creditors? What will the inevitable political and social tensions lead to? Authoritarianism? Of the left? The military? However this all plays out, it will be necessary for the U.S. to be flexible and to continually review its policy and strategy. It may be found appropriate, during 1988-1990, to change U.S. policy and strategy in Peru and/or to modify U.S. activities here, including economic assistance.

The second point relates to the question of U.S. policy and strategy in Peru beyond the Update period. How important Peru is and will be to the U.S. over the years will depend upon its relationship to several major issues, including the maintenance of values we uphold, narcotics affairs, terrorism, preservation of natural resources/environmental degradation, U.S. trade and investment, and U.S.-Soviet-Third World relations. On these accounts as well as Peru's high place on a scale of development needs among the countries in the region, Peru, because of its size, location, political development and national characteristics, could well be the most important country to the U.S. among those with bilateral assistance programs in the LAC region. However, the current budget situation and immediate and short-term political considerations have resulted in a U.S. assistance allocation to Peru which is not in harmony with this assessment. That is to say, USAID/Peru believes that, relatively, Peru is substantially underfunded in terms of long-term U.S. interests among the LAC countries. To prepare for a re-alignment of resource allocation more in keeping with long-run U.S. interests, the Mission proposes that, during the Update period, appropriate elements of the USG prepare a development strategy for the Andean region, reflecting Peru's place in the

region and the commonalities (e.g., narcotics, terrorism, debt, development characteristics, political development) which the Andean countries share. In the interim, because the "earmarking" process has contributed to dealing with Peru and the other Andean countries in part on a residual basis, USAID/Peru believes that AID's central bureaus and AID/LAC need to exert special efforts to optimize resource allocations to the Andean region within existing budget constraints. For example, Andean countries should be given high priority in allocating non-earmarked resources (DA, food). Central and regional programs should encourage "buy-ins" by the earmarked countries while applying central and regional resources to the extent applicable, feasible and absorbable, to the Andean countries.

The third point deals with what can be called an indicative optimum strategy. If AID's strategy in Peru were, as CDSS guidelines would have it, entirely "grounded in the development needs of the country", the program would have considerably more profile in the LAC region. Peru's development needs are among the highest in AID-assisted LAC countries. Peru is the largest of LAC recipients, with a population equal to the four core Central American countries.

But AID's strategy must also be "grounded" in other considerations. Are the country's policies "right"? Will assistance be used effectively? What are other donors doing? Because of current policy inadequacies, especially on the macro-economic side, total assistance levels, which would otherwise include a response to Peru's serious balance of payments and domestic financial situations, would be scaled down. However, given ongoing explorations with the World Bank on a reform package, the USG, conceivably, could be examining the possibilities of a reform cum assistance arrangement, on its own or in concert with the Bank and others.

On the political side, the USG has an abiding interest in strengthening democracy in Peru and in successful GOP efforts to defeat terrorism and eliminate coca production and narcotics trafficking. This combination of political factors plus the added consideration of major and expanding Soviet presence and interest in Peru add up to a significant

political rationale, short and long term, for a substantial U.S. assistance program.

One aspect of a relevant and appropriate strategy for Peru needs particular attention: narcotics. Coca production and trafficking annually generate at least \$600 million foreign exchange in Peru. Successful efforts to eradicate coca would have serious negative foreign exchange effects on an economy already in great distress. An assistance strategy for Peru should take into account the need to supplement Peru's resources if the narcotics incubus is to be eliminated and to support a development program that would contribute to making a successful anti-narcotics effort economically and politically absorbable. It is not an adequate strategy to punish Peru if its performance on narcotics is deficient. An appropriate strategy should include positive activities which increase the chances of achievement of objectives in which we have a vital stake.

Taken together, objective consideration of Peru's development needs, macro and sectoral policy performance, and the range of U.S. political and other interests, especially narcotics, points to an assistance level which would be considerably higher than the current program. The following is an indication of what additional activities such a development program would include.

An optimum strategy would respond to the structural constraints related to the balance of payments gap and its causes, and to the problem of domestic financial resource mobilization. Balance of payments and budget support, tied to reforms targeted at the structural problems, could be substantial. The ideal arrangement would be to integrate this component of an optimum strategy with a World Bank-led stabilization cum growth program. Depending upon a variety of circumstances, the magnitude could be at least equal to current program levels.

Expanded agricultural initiatives would focus primarily on activities designed to: increase agricultural exports; augment Mission programs dealing with natural resource conservation and bio-diversity, and

strengthen private institutional capacity to deliver quality agricultural analysis and policy. An Agricultural Policy Institute would be the centerpiece of this initiative. Some \$10 to \$15 million annually is contemplated.

Narcotics activities would involve, assuming government control of the Upper Huallaga and substantial success in interdiction and eradication, a doubling or tripling of the current rate of activities. Narcotics awareness operations could be doubled. If an explicit effort were made to offset, even modestly, the loss in foreign exchange from an effective eradication program, then a balance of payments component, tranching to specific achievements, would be included in an optimum strategy. About \$25 million annually would not be inappropriate.

Significant training and technical assistance, beyond current Administration of Justice levels, would require a modest increase above current programs to flesh out a program to strengthen democratic institutions. Enhanced direct private sector assistance, including expanded support to ILD and CONFIEP, could effectively use some \$5 million.

The health sector would encompass new private sector activities, expanded work in rural water and sanitation, an increase in Child Survival public sector activities (emphasizing the Peruvian Institute of Social Security--IPSS) and attention to urban environmental health. Some \$30 to \$40 million would be required. In population, there are attractive private sector opportunities to expand on effective arrangements USAID has put in place. The Social Security Institute is becoming more important and with modest additional funding could energize public sector population efforts. With decentralization on the move, it would make sense to exploit the regional development corporations infrastructure and growing financial base to intensify population activities throughout the country. A Population Policy and Planning project would be a key component of an optimum population strategy in Peru. The indicated population activities would require some \$30 million.

A Development Support Training project, aimed at private and public sector planning and management, a special Women in Development project (including a Women's banking program) and an in-country training program whose objectives, except for the Experience America component, would parallel the Andean Peace Scholarship program, would require some \$10 to \$15 million.

Expanded Title II food programs involving reforestation, soil conservation, biodiversity and rural credit, plus the possible use of food in the anti-narcotics program could amount to some \$15-20 million.

An optimum strategy, reflecting Peru's shelter requirements and an appropriate policy package, should include a HG loan program. This, of course, would depend on the GOP's taking adequate steps to deal effectively with the arrearages on past loans.

The foregoing elements of an optimum strategy would come to less than \$10 per capita per year, a lower figure than for any program now mounted in all of the LAC countries with active programs, except for Ecuador. The program would finance current AID and LAC priorities, would build on program achievements, and is consistent with USAID and GOP development strategy. It would make a difference in terms of macro-policy and would produce significant anti-narcotics results.

An optimum program would be different from the current composition of assistance activities in Peru. Currently, food is running at about 60 percent of our total program. Without denigrating in the slightest this form of aid, it is clear that an optimum development strategy would sharply increase the proportion of financial assistance to Peru. In addition to this change in form, financial assistance would embrace not only the project mode, but would likely include the possibility of conditioned cash transfers, commodity import, program and sector activities. There would also be the likelihood of moving to a relatively larger loan portfolio.

B. Strategies for Specific Goals and Objectives

1. Economic Stabilization

Performance Indicators

- Structural Adjustment/Stabilization Program agreed upon with IBRD and other donors.
- Massive Debt Rescheduling/restructuring Agreement negotiated, to enable new inflow of resources to Peru.
- Program for rapid increase in value of Peruvian exports.
- Stabilization of real exchange rate and unification of multiple exchange rates.
- Reduction of fiscal deficit and limitations on domestic credit, positive real interest rates and fewer credit controls.
- Structural and policy reforms that reduce controls and provide incentives for private initiative and efficient use of resources.
- Programs to strengthen the private sector.

Strategy

USAID balance of payments projections for 1988 in the CDSS Annex "Economic Prospects for Peru" indicate that, absent massive price increases for Peruvian exports that would raise export earnings by \$700 million or more, Peru will not be able to reach its target of 3.5 percent growth in GDP. Rather, GDP will fall or at best be constant, and in 1989 there would be a

large decrease in GDP if present policies are continued. Both the GOP and the private sector recognize that drastic measures must be taken to avoid this outcome. Currently the GOP is examining a structural adjustment program with the IBRD. Implementation of a program will require extraordinary measures by the donor community, the GOP and other creditors. The success of negotiations is by no means assured. If this effort is not successful, Peru will feel compelled to turn to other possible sources, including the Soviet Bloc countries, in an effort to find its way out of the crisis. Peru is entering a very unpredictable period where major policy changes may be made rapidly. Simple extrapolation from past Peruvian experience with balance of payments crises would lead to the prediction that it will take several failed stabilization attempts before a successful program can finally be agreed upon and put into place.

A donor supported stabilization program will be a major undertaking. The IBRD must receive payment of about \$200 million in arrearages before it can resume operations in Peru and consider new lending. Some way must be found to handle the \$500 million in arrearages that the GOP has with the IMF. There will have to be a massive rescheduling of all arrearages from past years of some \$7 billion, plus most of the debt service obligations coming due in 1988 of about \$3 billion. Bridge loans may be required before new structural adjustment loans can be disbursed. For its part, the GOP will have to take measures that will not be politically popular in a context of falling or at best constant real incomes.

AID and the U.S. Government can play a supporting but important role in stabilization and structural adjustment efforts. The USG has already played a constructive role in facilitating World Bank/GOP negotiations. Through its agricultural sector policy dialogue activities, AID can play a major role in working out structural adjustment and stabilization policies for the agricultural/food sector, which will likely play an important role in the overall program. USAID-sponsored studies by Peruvian economists on balance of payments and other macroeconomic policies can be applied to policy making. Self-help measures under Title I can be tied into the overall structural adjustment program. The Mission's economics staff can analyze, monitor and

report on program performance. This would be specially helpful given the absence of permanent economics staff in Lima from the other major donors. Mission reporting and analysis will assist Washington agencies concerned with the stabilization program.

#### Program

No additional resources are requested for implementation of the economic stabilization strategy, at this time. However, planning should go forward for higher levels of resources after the end of the Update period, when developments elsewhere may decrease the demand for funds for other countries, opening up the possibility of greater allocations to support a sound stabilization effort in Peru. Should U.S. interests and priorities dictate increasing resources to Peru to support a stabilization program, they could take the form of ESF funds for program loans, increased PL-480 Title I levels, and modest increases in DA and OE funds to provide analysis and manage the program.

#### 2. Basic Structural Reforms Leading to Sustained Economic Growth

Objectives: Strengthen the Private Sector, Promote Exports, Increase Agricultural Production, Manage and Preserve Natural Resources.

#### Overview

The four objectives are interrelated in trying to achieve this goal, which is one of the most important to the Mission. Given Peru's large size, and the limited resources available during the Update period, the approach to many goals must be modest and indirect, i.e., AID will not provide capital resources or credit, but will seek to build up Peruvian institutions that will be dedicated to achieving objectives in their own way. For example, to promote exports, the Mission will strengthen private sector groups to analyze problems of exporters and seek better policies on exporting from the GOP. The agricultural policy project will support the analysis unit which advises the Minister of Agriculture on policies needed to promote increased

exports, the agricultural technology transformation project will develop new agricultural technologies and made them available to exporters, technical assistance will be given to private sector organizations of producers and exporters.

a. Strengthen the Private Sector

Performance Indicators

- Assist Private Sector business and analysis groups in becoming effective analysts and spokesmen for the private sector in reducing controls over the private sector and securing policies that permit efficient private sector growth.
- Assist the GOP to analyze its policies affecting the private sector and to make changes that increase the dynamism of the private sector.
- Help private sector organizations train qualified management personnel.
- Provide support and assistance in privatization of government enterprises.

Strategy

The institution building strategy that the Mission is following is based on conclusions formed from our experience during the past two and one half years; despite the occasional attractiveness of elements (e.g., the financial elite) of the private sector as political targets, the APRA government realizes that it needs private sector confidence, cooperation and investment, the "nationalization" initiative is widely regarded within APRA as a major mistake and President Garcia has already retreated from his initial position on the issue; some of the measures taken which have been

adverse to private sector interests did not reflect hostility to the private sector but rather were a response to other pressures whose effects were not fully understood by policy makers; and, even in an atmosphere of some hostility in some APRA quarters, there are useful opportunities to strengthen the private sector. The need is to create, both in the private sector and in the government, organizations that can study and analyze the effects of government measures on the private sector and be effective advocates to the public, the legislature, and the government of policies that will allow the private sector to grow, invest, create jobs, increase exports, and make a strong contribution to economic growth and social development.

This strategy is proving to be effective. The Institute for Liberty and Democracy (ILD) has had a continent-wide impact on analyzing the informal sector, the constraints to its productive energies, and the policy changes needed. ILD also serves as a guide and advocate for informal sector groups in Lima and elsewhere in seeking policy changes. For the organized business sector, the National Business Confederation, CONFIEP, has established an analysis section and is creating its own economic analyses and plans for presentation to the government. It has emerged as the major and most powerful spokesman for the private sector, for example, in reacting to GOP proposals to nationalize financial institutions. Within the government, AID sponsored studies are showing how improved government organization and policies can increase private sector growth and assist the government in reaching its goals. The effort to improve management education in an important part of the institution building process. While privatization has not moved very far yet in Peru some steps have been taken and more is planned. AID will continue to assist the effort.

#### Program

During the Update period, resources will go to funding of ongoing activities with the private sector institutions and the GOP agencies so that they may continue their policy programs and not be cut back or lose the momentum gained to date.

If additional funding became available, it would be used to increase support to ILD so that it may expand its activities and have more stability in its financial support, and to CONFIEP, so that it may expand its activities related to analysis and advocacy on questions of investment, savings, exports and employment, and to expand its activities outside of Lima.

b. Promote Exports

Performance Indicators

- Increase non-traditional agricultural exports by 60 percent from 1987 to over \$140 million per year by the end of the Update period.
- Maintain an exchange rate for non-traditional exports during the Update period that is stable in real terms and at least as favorable as the real rate after the December, 1987 devaluation.
- Simplify procedures and eliminate obstacles to increased exports.

Strategy

To date, the export promotion strategy has concentrated on assisting private sector producer groups do pilot work in developing new agricultural exports. After several years of preparatory work with small grants, in 1987 a larger pilot project with asparagus producers resulted in \$2 million of exports of fresh green asparagus during the winter period, a totally new export for Peru. In the future, other non-traditional agricultural exports will be targeted, and producer and exporter groups will be assisted in creating effective export programs. These groups will also be assisted in working with the government to produce more favorable procedures and regulations for non-traditional exporters.

A secondary part of the strategy is to focus economic research on macroeconomic variables that affect exports, and assist in having these results incorporated into policies affecting non-traditional exports. Work sponsored has shown the importance of stable and adequate real exchange rates for non-traditional exports. While the government has accepted this goal, it allowed lapses that affected non-traditional exports in 1987. The non-traditional export exchange rate was restored to parity in December 1987. Additional economic/research and advocacy will be required if policies supporting a longer term increase in non-traditional exports are to be adopted.

#### Program

The Mission's export promotion effort is ready to leave the pilot effort stage and be expanded. Modest resources will be used for export promotion activities with the private sector organizations. Activities for implementing this strategy are vulnerable to cuts in Mission DA resources during the Update period, since no ongoing project was established in prior years.

If additional resources become available during the Update period, they would be used for expanded technical assistance efforts with private sector exporters of non-traditional products, and for further economic studies and policy advocacy.

#### c. Increase Agricultural Production

##### Performance Indicators

- Increase the volume of production of rice, corn, and potatoes by 8 percent to 12 percent per year through the end of the Update period through research and extension work that increases yields, and through agricultural policies favorable to increased production.

- Secure GOP agricultural policies for improved and stable terms of trade for the agricultural sector, improved marketing operations, and improved pricing policies on agricultural inputs, including water, to encourage rehabilitation of and investment in productive facilities.
  
- Develop a private sector research and extension network working separately from but in collaboration with the public sector.

### Strategy

During the period of military government, the once outstanding system of agricultural education, research, and extension in Peru was allowed to deteriorate badly. As a result, yields in Peruvian agriculture did not increase, new varieties and crops were not introduced, and Peru dropped behind other countries in the region. Starting at the beginning of the decade, a major element of strategy has been to assist the GOP to rebuild public sector agricultural education, research, and extension organizations. Good progress had been made, and the effort should be continued through the end of the Update period. A new element now being added to the strategy is to encourage producer associations, regional groups and other private sector agricultural organizations to create their own field research and extension programs, following successful pilot efforts. A more competitive research system using both private and public sector institutions is also being encouraged.

A second major element of the strategy has been to form a highly competent agricultural economic research and policy unit within the Ministry of Agriculture to analyze and advise on improved agricultural policies. This process has now progressed to the point that much better policies based on research results are being formulated, explained and advocated to the Minister of Agriculture, who relies heavily on this unit. There have been improvements in the policies actually adopted, with prospects for further changes for the better despite the highly political atmosphere in

which policy decisions are made. The strategy during the Update period is to continue to support the policy unit and its work, and to establish a private sector agricultural policy analysis capability isolated from the day-to-day pressures of a Ministry, but with close links to Ministry policymakers. If opportunity offers, the work on policy in the public sector may be extended to the Ministry of Economics and Finance and other ministries.

A third subsidiary strategy element is to use the self-help measures of PL-480 Title I agreements for policy dialogue on agricultural pricing policies and other policies with the GOP, focusing on issues where the AID sponsored policy analysis unit can formulate improved policies for implementation. Previously, self-help measures were focussed primarily on AID project-related issues.

Since the Mission will not have funding for new projects in new areas during the Update period, there are no expected resources on which to formulate a specific Andean Agriculture Strategy. There are elements of an Andean strategy in ongoing projects, however. The efforts to improve the rural/urban terms of trade and increase rural incomes are particularly important for the Andean Region. Several of the National Program crops in the Agricultural Technology Transformation (ATT) project are primarily Andean crops, (e.g., potatoes, cereals, white corn and pulses), in addition to the Andean crops program that concentrates on native Andean crop such as quinoa, kiwicha, tarwi, oca, olluco and mashua. Further, the ATT supported national livestock program focusses largely on sierra livestock production and range management. The Small Ruminants Collaborative Research Support Program also provides assistance to various Peruvian institutional and fertility problems related to alpaca, llama and sheep production. The reforestation program, emphasizing peasant economic forestry and soil conservation in the Sierra also is an important part of an Andean strategy. The Central Selva Research and Demonstration Project and the Tropical Soils Collaborative Research Support Program are seeking ways to assure sustainable profitable forestry, crop and livestock production in the Selva. These efforts are an important element of an Andean strategy, since sustainable Selva economic opportunity would open up better migration prospects from the Andean region.

Should additional funds become available, the Mission will develop a more formal Andean strategy. Projects for small irrigation construction and soil conservation in the Sierra would probably form part of this strategy.

Program

Resources will be used to fund the continuing project in agricultural technology transformation with public and private sector institutions, and to continue the support for the agricultural policy research and formulation effort.

If additional resources become available, they would be used to promote establishment of an effective private sector agricultural policy institute with links to the GOP Ministries, and increased Andean activities.

d. Manage and Preserve Natural Resources

Performance Indicators

- Develop through research and demonstration projects, viable technologies that are economically profitable for long run sustained utilization of tropical forests and of tropical soils.
  
- Stimulate greater GOP attention to technological development for sustained use of tropical forests and preservation of biological diversity in its ongoing agricultural technology transformation activities.
  
- Maintain and expand community based reforestation and soil conservation programs in the Sierra, with greater emphasis on activities that are profitable for peasants and peasant communities.

- Assist GOP in the establishment and effective management of forest and other natural resources preserves.

### Strategy

For a number of years AID has been active in Peru trying to develop new technologies that can economically exploit and preserve tropical forests and soils. These technologies must be developed and adopted widely if the current rapid destruction of Peruvian tropical forest and soils resources is to be controlled. The completion of the natural regeneration, full resource utilization, forest demonstration project now under way in the Central Selva project is of great importance. Continuance of tropical soils research at Yurimaguas is equally important. If more resources become available, the strategy would be to expand the research and demonstration efforts to new sites and to test new approaches to develop the needed technologies.

Taking advantage of the current reorganization of the Ministry of Agriculture, and within the framework of its ongoing projects with the Ministry, the USAID will seek to stimulate greater attention to forestry and natural resource research and extension activities in the Ministry.

AID has also assisted in establishing national parks and forest preserves in the Central Selva project, and is assisting the GOP in establishing the administrations for the new preserves. If more resources were available, further assistance would be given to establishment and management of other preserves.

AID has also been active for a number of years in reforestation activities in the Sierra. With the assistance of a new voluntary agency, this effort will be continued, and support will be given to having reforestation integrated into individual and peasant community activities as a profitable activity that also is helping to conserve natural resources. It is hoped to expand the program to additional areas in the

Sierra toward the end of the Update period, once the revised reforestation approach is well accepted.

The Mission recently has reviewed its tropical forest and biological diversity strategies, based on an assessment of biological diversity in Peru prepared by Mission consultants, and on its participation in the preparation of the FAO sponsored National Forestry Action Plan, which has just been completed. The following additional elements would be added to the Mission's strategy, should additional resources become available.

Prior Mission projects have demonstrated the potential for soil conservation measures and small irrigation projects in the Sierra to increase agricultural production and preserve the agricultural resource base. With additional resources, new projects for expanded soil conservation and irrigation activities could be established. Such activities would also lessen over the longer run the pressure on tropical forestry resources in the Selva from immigration from the Sierra. They would form part of the Mission's Andean agriculture strategy

There is also a need for large scale irrigation system rehabilitation and improvement on the coast, if valuable crop land is not to deteriorate and be lost and water resources are to be used effectively. Technical assistance, training, and even some capital assistance would be provided for this activity if additional resources were available.

The Mission's consultants have identified a need to support research on the flora and fauna of Peru. Until more is known about the existing flora and fauna and which of them are endangered, a strategy for their conservation will be incomplete.

Support is also needed for private sector groups, and for public education, to increase awareness of and support for greater conservation actions in Peru.

Sections 118 and 119 of the FAA require each AID CDSS to

indicate the actions necessary to achieve conservation and sustainable management of tropical forests and to conserve biological diversity, and to indicate the extent to which actions proposed for support meet the needs identified. These actions have been identified above. As pointed out, the technology for sustainable management of tropical forests in the private sector does not yet exist, and it is impossible to make the entire Amazonian tropical forest a government preserve and effectively prevent any further settlement or development. With the resources on which this Update is based, the strategy presented above will provide, at minimum levels, only the most urgent actions needed to help achieve conservation of tropical forests and biological diversity. With additional resources, a higher level of activity would be undertaken on the most urgent actions, and complementary actions of great value for conservation would be initiated.

#### Program

The Central Selva program will be carried forward in stage II with emphasis on conservation related activities, using previously obligated resources. A reforestation and conservation program in the Sierra will be carried on with food aid resources, supplemented by grant funds and local currency. The centrally funded tropical soils research project will continue.

If additional resources were available, additional R&D projects for tropical forestry would be developed as follow-on and expansion to the Central Selva program. Soil conservation and small scale irrigation programs in the Sierra and an irrigation management program would be developed. Smaller programs for establishment of natural resource reserves and for research on the flora and fauna of Peru might be developed.

### 3. Wider Sharing of the Benefits of Growth

Objectives: Alleviate Malnutrition, Reduce Infant and Child Mortality, Improve Health and Health Services, Increase Access to Voluntary Family Planning Services.

### Overview

The four objectives are closely related, both operationally in terms of project activities that are targeted at several objectives, and in the sense that achieving one objective helps to achieve others. They all represent high priority objectives of the APRA government, and have strong GOP support. Programs to achieve these objectives directly help the people of Peru to improve their welfare and wellbeing.

#### a. Alleviate Malnutrition

##### Performance Indicators

- Reduce severe chronic malnutrition in children ages 0 to 5, from 57 percent in 1984 to 47 percent in 1990 in rural areas, and from 24 percent in 1984 to 20 percent in 1990 in urban areas.
- Provide Title II/Section 416 food to 775,000 children in 1990, an increase of 12 percent from the 1987 level.
- Provide favorable rural terms of trade to increase rural incomes and provide incentives to increase food production.
- Substitute food subsidy programs targeted on the malnourished for current general food subsidies.

##### Strategy

There are three main elements in the strategy. The first is direct food distribution programs using Title II/Section 416 foods. These have been in operation for many years in Peru on a large scale. Around 20 percent of Peruvian children under age 6 receive food in these programs every year. To have a greater impact on reducing malnutrition, these programs concentrate on the age groups at greatest risk of malnutrition, in the regions

and rural areas with the highest rates of malnutrition, and on the groups in the communities who are suffering most from malnutrition. Considerable progress has been made already and the effort will continue. In addition, child survival activities to improve health and reduce malnutrition are being provided and expanded in projects carried out by the various voluntary agencies, and the Ministry of Health.

The second element is to increase rural incomes and agricultural production, both to increase the supply of food and to increase purchasing power for food in rural areas where malnutrition is most severe. In part, this is accomplished by agricultural technology transformation activities, and in part by improved agricultural policies, the agricultural policy project, supplemented by PL-480 Title I self-help measures, is the principal instrument for this.

The third element concerns the financing of agricultural programs and the provision of food through food subsidy programs. Relationships between the support prices for domestic crops, the sales prices to the public for domestic and imported food and agricultural inputs, the exchange rates used for food imports, and the amounts of food subsidized and the manner in which they are distributed, determine the amount of financial resources necessary for the system to operate. The policy project is focussing on these variables and resulting financing needs, as well as the incentives for production and the impacts on rural income that come from the system. PL-480 Title I negotiations are also an element in the strategy, since sales proceeds from commercial imports are used for price support activities, while from Title I imports they are used for development projects, unless there is mutual GOP/AID agreement to use them for price supports.

#### Program

PL-480 Title II food distribution programs will continue, with support from OPGs and local currency for increasing the development impact of the food programs, and integrating child survival activities with the feeding activities. PL-480 Title I programs will continue to emphasize

use of self-help measures and sales proceeds to secure agricultural policies to increase agricultural production, reduce malnutrition, and obtain fiscal balance in the food sector.

Should additional resources become available, there would be an expansion of food distribution activities, and greater financial support for them.

b. Reduce Infant and Child Mortality

Performance Indicators

- Reduce the infant mortality rate to 80 in 1990, from 88 in 1987.
- Achieve more than 80 percent complete immunization coverage of children 0-5 by 1990.
- Eradicate polio in Peru by 1990.
- Use prepackaged ORS in more than 10 percent of cases of diarrhea in children under 5 by 1990.
- Have a fully integrated Ministry of Health/Social Security Institute program to provide child survival services by 1990.

Strategy

One major element of the strategy is to work with the public sector health institutions--the Ministry of Health and the Social Security Institute--to improve and expand the delivery of child survival services. Whereas previously USAID support to the public sector has had an institutional development focus, now the focus is on service delivery and the support systems necessary to facilitate and sustain service delivery and management.

The Mission's efforts are integrated with those of UNICEF, PAHO and other donors, and there is mutual definition of goals and objectives by the GOP and donors and a clear division of labor among the donors in supporting the national programs.

The other major element of the strategy is working with the private sector. One part of this, providing child survival health services to beneficiaries of direct feeding programs, has already been mentioned. This activity should be extended and systematized to ensure better and more uniform coverage on a nationwide scale to complement public sector programs. A new and promising extension in the private sector would be to mining firms and other enterprises in isolated areas who must provide health services to their employees and families. These services tend to be curative, they are expensive, and they do not provide effective preventative child survival and M/Ch services to families. Opportunities exist to improve the health status of children and families without increasing health care costs, or even reducing them. A second element in the private sector strategy is operational research. The Peruvian universities and research institutions that obtain \$500,000 to \$1 million per year of centrally funded AID research grants are available to do high quality research, in collaboration with the public sector, on all aspects of child survival program effectiveness. Finally, much of the training needed for effective child survival programs can best be provided by private sector institutions.

In addition to child survival services, AID will also support activities such as research and training related to specific diseases. These include tuberculosis, diarrheal diseases, vector-borne diseases such as malaria and yellow fever, and in particular, illnesses and attendant problems associated with Acquired Immune Deficiency Syndrome (AIDS).

#### Program

The public sector strategy is being implemented by ongoing projects, which will continue during the Update period. At the forecast level of financing during this period, funds may not be adequate for proceeding as

rapidly as had been planned with implementation of the strategy. The private sector strategy has been implemented to date by individual OPGs and small grants on an ad-hoc basis as opportunities have arisen. In order to build on the structures now in place, and support successful activities in the longer run, an integrated and comprehensive approach will be developed. At expected funding levels during the Update period, however, this will not be possible. At best, only a limited number of OPGs and grants can be continued, at a level of operation below that already achieved, and even this may be at the expense of slowed implementation of the public sector program.

If additional resources become available, they would be used for more adequate and timely funding of the public sector program, including expansion of Social Security Institute activities, and for fuller implementation of the private sector strategy. If Peru is a "Child Survival Emphasis Country," the emphasis during the Update period must be on adequate program funding.

c. Improve Health and Health Services

Performance Indicators

- Complete over 1,300 water systems in rural towns of 100 to 500 residents by 1990, providing water to over 20 percent of the total number of rural towns of that size in Peru.

Strategy

Since 1980, the Mission has had a project to construct water systems and install latrines in small rural towns. After initial problems, the project has now met its initial targets and will more than double the planned achievements for water systems construction by its end in 1990. This program now has strong GOP support and is considered highly successful. An evaluation of project's impact on health, and determination of project factors significantly related to health impact, particularly community education, is needed before designing a follow-on project to construct more water systems.

If the evaluation reveals that a follow-on project is justified and of high priority, it should be funded and be ready to start before the end of the Update period.

Program

The water project will be completed during the Update period without the need for additional funding. Additional resources beyond those on which this Update is based will be required if this activity is to be continued by a new AID funded project.

d. Increase Access to Voluntary Family Planning Services

Performance Indicators

- Increase the number of women receiving family planning services through AID supported programs by 170,000 in 1987-1990, from 15.9 percent of women of reproductive age to 18 percent.

Strategy

The Mission strategy is to help the GOP implement its family planning programs, provide assistance to private sector family planning services, and establish a contraceptive social marketing system during the Update period. These activities will assist in achieving the goals for family planning that have been established by the government. The environment is very favorable for family planning activities, and past Mission and Peruvian efforts have set the stage for effective program implementation for all three aspects of the strategy.

The major problem with the strategy is the adequacy of funding. At the levels of population funding provided in the last two years, and foreseen for the Update period, the Mission's private sector family planning efforts are underfunded and face a slowdown in implementation. If

progress is made as expected with contraceptive social marketing, a new follow-on project will be required during the Update period. Yet funds for this project at the level of funding foreseen in this CDSS Update will be at the expense of other private sector activities. Public sector family planning support will also lag if there is any fall in funding from the levels of funding foreseen for the Update period.

#### Program

The program during the Update period is to implement the existing projects. If additional funds become available, they will be used to provide the level of funding planned for the existing projects so that they may proceed without slowdowns, to provide for a follow-on project for contraceptive social marketing, and for expansions to work with public sector entities on family planning service delivery.

#### 4. Strengthening Democratic Institutions

Objectives: Strengthen Democratic Institutions; Support Anti-Narcotics Programs; Increase Numbers and Improve Effectiveness of Participant Training.

#### Overview

These objectives respond to specific important U.S. interests. The programs being implemented to achieve these objectives have been formulated, in most cases, on instructions from Washington. The objectives are largely independent of each other, but all support the broad U.S. interest of strengthening and preserving an effectively functioning democratic system of government in Peru.

a. Strengthen Democratic Institutions

Performance Indicators

- Existence of GOP long-term, medium-term, and short-term plans for reform of the judicial sector by 1990. Continued multi-institution commitment to reform.
  
- Significant increases in GOP funding for the judicial system as reforms are effected and financial resources are used more effectively.

Strategy

The program for improving the administration of justice in Peru was started in 1986, as required by the 1985 FAA. Because of this, the strategy followed has been one of developing all aspects of the program simultaneously. Sector assessments are being prepared to guide the longer run development of judicial reform. Institutions are being developed to plan and implement judicial reform projects, joint projects between the Ministry of Justice, the Courts, and the Public Ministry are being planned and implemented, and specific projects are being implemented within each of the three participating components of the judicial system. A wide variety of activities are underway, from training programs, to establishment of legal information offices to give poor urban dwellers access to the judicial system, to management information systems for handling judicial cases. These activities seek wide participation within the judicial system and are designed to build support for (and the belief in the possibility of) significant improvement in the administration of justice at all levels of the judicial system. As the program advances in resolving problems, and in encouraging sector-wide long-term reforms, additional resources will be required for continuing improvement in the administration of justice.

Significant opportunities exist for assistance to the Peruvian Chamber of Deputies for improvements in its legislative systems.

In late 1987, the President of the Chamber recruited a competent technical staff to assist in reform efforts, and has requested assistance from the Mission. Given the widespread perceived need for modernization of the legislature, the need for a more productive legislature if it is to restore and maintain its prestige, the high-level commitment to change, and the quality of the technical staff, there is an excellent opportunity for the Mission to assist in strengthening a key democratic institution. Until sources of funding for such an effort have been identified, however, the Mission cannot proceed with developing a more detailed assistance strategy.

#### Program

Continue implementation of the Administration of Justice project, modifying and upgrading activities in accordance with findings and recommendations from the sector assessment and pilot activities. If additional funds become available during the Update period, project activities would be expanded into new areas, and an expansion of the project or a new project to help strengthen the legislative system would be started.

#### b. Support Anti-Narcotics Programs

##### Performance Indicators

- Increase cultivation of legitimate crops in the coca growing Upper Huallaga valley to 220,000 hectares in 1990 from 182,570 in 1986, a 20 percent increase.
- Make more than 1/3 of Peruvian citizens aware that drug abuse in Peru is a serious and growing national problem.

##### Strategy

There are two elements to the strategy. The first is to provide support and assistance in growing legitimate crops in areas where GOP agencies, supported by the U.S., have been active in their drug interdiction

and eradication efforts. This support complements, yet is dependent on, more effective eradication and enforcement programs which will in part contribute to the reduction in the price for coca paid to the farmer. Then targeted assistance will contribute to narcotics objectives, as returns to coca presently exceed those of the best substitute cash crops by at least three to one. Specifically, this assistance includes agricultural research to develop crops suitable for the area which provide good economic returns, agricultural extension to help establish profitable production of these crops, and agricultural input supply and product marketing to assure lowest possible costs and stability of production and profitability. Community development complements the agricultural orientation of the programs by promoting the organization of the local population around self-help measures to improve economic and social services.

The second element of the strategy is to increase the Peruvian public awareness that drug abuse and trafficking is a serious and growing national problem and that support for fighting this problem is in their own interest. A parallel program of drug education and information is underway which includes the creation and strengthening of a non-profit organization (CEDRO) to serve as an independent source of education and information on the drug problem, along with complementary programs with the Ministry of Education and the Ministry of Health which will develop and test a pilot drug abuse prevention curriculum in selected public schools and a pilot drug testing system for health facilities.

#### Program

A second phase program in the Upper Huallaga valley will be developed and implemented with resources targeted at breaking the principal bottlenecks to legitimate agricultural production. The focus will be on provision of agricultural services to eradicated lands where farmers volunteer to raise legitimate crops. Drug education efforts will be continued.

If more funds become available, both programs would be expanded.

- Upper Huallaga Development: Additional funds would support legitimate agricultural production complementary to eradication/interdiction activities as well as balance of payments/partial mitigation of negative economic effects associated with anti-narcotics programs.
- Public Awareness: Additional funds would be dedicated to broader narcotics awareness/education initiative with GOP and CEDRO, specifically, using the results of pilot testing as the basis for implementing national programs with the Ministry of Education and Health.

c. Increase Numbers and Improve Effectiveness of Participant Training

Performance Indicators

- Have 323 Andean Peace Scholarship participants begin training by the end of 1990.

Strategy

The Mission is a major participant in the Andean Peace Scholarship program, whose strategy has been set on a regional basis. The Peru specific aspects of the strategy are to train participants in those sectors which are identified as priority sectors in the Mission's development strategy, as well as those individuals who are leaders or potential leaders in a variety of other key development sectors where no training opportunities currently exist under other AID projects. To ensure broad geographic coverage, the strategy calls for the selection of about 50 percent of all Andean Peace Scholars from outside Lima.

Participant training is an important element of most Mission projects. It will be continued with increasing participation of women, particularly for short-term training.

Program

The Andean Peace Scholarship program will be implemented throughout the Update period. Training under the LAC Training Initiatives II project will be completed, with the last participants leaving for training in 1989. Project related training will increase from the 1987 level, rising to the levels of recent years. Expanded participant training will be particularly important in agriculture projects.

IV. Resources

A. Other Donors

Other donor activities have been declining in Peru since the start of the APRA administration, and there have been almost no new starts of true development projects. The primary reason has been the lack of payments by the GOP to service debts on prior assistance, but, despite sporadic efforts, the failure of the GOP to develop donor support for new development projects is also a very important factor.

The World Bank has not signed any new loans for projects since 1984 because of questions about Peru's creditworthiness. It continued to disburse on projects in its portfolio (with a pipeline of well over \$600 million at the start of the new government) until mid-1987, when failure of the GOP to pay service on its prior loans from the IBRD resulted in suspension of project implementation. Currently the pipeline is \$437 million for 19 loans.

The IDB has continued disbursements on its pipeline, which also was well over \$600 million in mid-1985, but the only new loans signed provide for completion of a hydroelectric plant which had received previous IDB loans. The IDB pipeline at the end of 1987 was \$278 million for 31 loans. The IDB has discussed new projects with the GOP, but little progress has been made. The IDB does not intend to sign any major new programs until important policy improvements are undertaken.

The bilateral donors have cut back greatly because of non-payment of debt service. With two exceptions, they now confine themselves to small grant social projects, PVO assistance, technical experts, and financing required to complete ongoing projects. The Canadian CIDA resolved a debt repayment problem, and is now offering C\$20 million in grants for tied imports of mining and telecommunications equipment from Canada. Italy, under its former Socialist Premier offered large grants and loans on highly concessional terms to Peru (about \$200 million at current \$/lira exchange rate). They are completely tied to Italian procurement. After long GOP-Italian discussions, agreements are being reached on using these loans for equipment imports for various projects, including, probably, rolling stock for the controversial Lima rapid transit project.

The World Bank and the IMF no longer have representatives in Lima. Although there is not much donor activity to be coordinated at this time, the function might be taken on by the UNDP. However, UNDP technicians and projects have contributed to the "heterodox" economic strategy of the Garcia government, which reduces UNDP prospects for effective leadership on donor coordination. The UNDP has played a helpful role in facilitating GOP/World Bank discussions.

B. U.S. Resources

1. Financial Resources

The decision cable for last year's Action Plan review (87 STATE 132146) instructed the Mission to prepare the CDSS Update on a straight-line projection of FY 88 CP levels, at \$52 million per year, including food aid. An alternative scenario at a level of \$70 to \$80 million per year was also allowed. The Mission has made two small adjustments to this instruction. It has lowered the combined DA/ESF level from \$24.2 million in the CP to \$20 million. This is a more realistic level and this is the level on which Mission planning for the projects included in the Action Plan had proceeded. Direct food aid has been increased from \$8.1 million for Title II in the CP to \$15 million per year of Title II/Section 416, to take into account Section 416

resources, which were not included in the FY 88 CP presentation, but which are included in this CDSS.

To carry out the strategy presented here, the AID resources would have to be allocated by functional account as follows. The objectives for which the funds would be used are indicated. The amounts indicated are average yearly amounts for 1988-1990.

ARDN (agriculture, export, natural resources, and malnutrition objectives)	\$ 5 million
Population (family planning objective)	\$ 2.5 million
Health/Child Survival (health, infant mortality, malnutrition, and family planning objectives)	\$ 4.5 million
Education and Human Resources (private sector objective)	\$ 0.8 million
SDA (private sector objective)	\$ 1.5 million
Narcotics objective (ESF, or ARDN, EHR)	\$ 2.9 million
Democratic institutions objective (ESF)	\$ 0.8 million
Participant training objective (ESF or EHR)	\$ 2.0 million
TOTAL	\$20.0 million

These funds can be obligated only if Peru is free of loan repayment sanctions (Section 620Q/Brooke) when obligations are made. The yearly amount of payments that come due on AID and DOD loans that must be paid for obligations to be made is about \$20 million during the Update period. Since there are no new military credits, the net flow of resources to Peru (not including food aid) under this CDSS would be about zero.

PL-480 Title I programs would be continued at the \$20 million level which has been the base level for the program since 1983. This program is important for the policy dialogue on agricultural policy, and for the local currency it generates for support of AID projects and other development programs. It also serves other U.S. interests in Peru, including USDA agricultural market development interests. The payments due on past PL-480 Title I agreements from the GOP will be increasing over the Update period, assuming new agreements at the \$20 million level are signed in 1988 and 1989, from \$11.4 million in FY 1987 to \$14.0 million in FY 1988. Maintaining the Title I level at \$20 million will encourage the GOP to make these payments.

Food resources for direct distribution programs from Title II/Section 416 are an integral and very important part of the total resources for the Mission program. These resources (commodity value) have averaged \$14.7 million per year during the past four years. The \$15 million proposed in this CDSS is the minimum required to continue these programs without serious cutbacks, while continuing the process of improving their targeting on the most malnourished, and integrating them with other Mission activities as effective development resources.

Should a larger amount of resources become available, and the total program rise, say, to the \$80 million per year alternate CDSS level specified by LAC, the Mission would propose to hold food aid virtually constant, and increase the DA/ESF program by \$25 million, the full amount of the increase. If this were done, the average yearly amounts by functional account allocation, and objectives would be as follows. This program would still be much smaller than the optimum strategy program discussed in the Strategy Overview section, III.A., above.

ARDN	\$10 million
Population	\$ 6 million
Health/Child Survival	\$10 million
Education and Human Resources	\$ 2 million
SDA	\$ 3 million
Narcotics (ESF or ARDN, EHR)	\$ 8 million

Democratic institutions (ESF)	\$ 2 million
Training (ESF or EHR)	\$ 4 million
TOTAL	\$45 million

2. Staffing Levels

This CDSS Update proposes to continue program levels in Peru through 1990 about constant at the non-disaster relief program levels of 1984 to 1987. Despite this, the staff reduction proposal brings the level below the staff numbers associated with the non-disaster program in those years. In this context, the Mission proposes to reduce USAID OE funded staff by 36 percent at the end of 1989 from its end 1985 levels, and total USAID staff by 28 percent in the same period. The Mission proposal and its analysis of staffing and OE was submitted to the LAC Bureau at the end of December, 1987, in the Report "USAID/Peru Proposal for Staffing and Operating Expenses for FY 1988 and FY 1989." This report, preliminarily reviewed in AID/W in early February (State 42487), will be available for consideration at the same time as this CDSS Update, and its contents are not summarized here.