PD-ABJ-683
91293

UNCLASSIFIED

USAID/PERU

ECONOMIC STABILIZATION AND RECOVERY PROGRAM, PHASE TWO

"Stabilization, Trade and Marketing Program"

527-0367

USAID/Peru
March 1994

UNCLASSIFIED

CLASSIFICATION: UNCLASSIFI...

PROGRAM ASSISTANCE

APPROVAL DOCUMENT

(PAAD)

1. PAAD NO.

2. COUNTRY Peru

3. Category Cash Transfer

4. Date

5. To AA/LAC:Mark Schneider

6. OYB Change Number N/A

7. From USAID/Peru:George Wachtenheim
LAC/DR:Peter Bloom

8. OYB Increase N/A
To be taken from:

9. Approval Requested for Commitment of

$37,000,000

10. Appropriation Budget Plan Code

11. Type Funding

___ Loan X Grant

12. Local Currency Arrangement

___ Informal X Formal ___ None

13. Estimated Delivery Period

N/A

14. Transaction Eligibility

N/A

15. Commodities Financed

16. Permitted Source

U.S. only

Limited F.W.

Free World

Cash $37,000,000

17. Estimated Source

U.S. $37,000,000

Industrialized Countries

Local

Other

18. Summary Description

The purpose of the proposed ESF program is to strengthen Peru's commitment and efforts to establish a sound economic policy framework and to carry out structural reforms that serve as the foundation for economic stability with sustained economic growth. The U.S. dollar funds will be used to finance servicing of official Government of Peru (GOP) debt to the IMF, the World Bank and the Inter-American Development Bank, as consistent with the ESF Cash Transfer Assistance amplified Policy Guidance. Local currency deposits associated with this program ($3 million) will be used to fund A.I.D. OE Trust Fund.

This authorization covers the full $37.0 million cash transfer amount. The resources will be provided in two tranches: $22 million and $15 million. The disbursement of these funds will be conditioned upon continued progress in the counternarcotics and economic reform programs as proposed in the PAAD and as may further be defined in Program Operation Letters issued pursuant to the Agreement.

19. Clearances: Date

20. Action

__ APPROVED __ DISAPPROVED

Authorized Signature Date
Title

P A A D
Stabilization, Trade and Marketing Program -- 1994

ANNEXES

LIST OF TABLES AND FIGURES IN THE TEXT

I. SUMMARY OF THE FY 1994 STMP: STABILIZATION, TRADE AND MARKETING PROGRAM

A. Background and Recommendation

USAID/Peru recommends authorization of an Economic Support Fund grant of $37 million to Peru, hereafter referred to as the FY 1994 Stabilization, Trade and Marketing Program, or STMP. The STMP constitutes phase two of the USAID/Peru Economic Stabilization and Recovery Program (ESRP), a balance of payments program approved in FY 1991 with initial planned life of program (LOP) value of up to $400 million. However, the LOP value will only be $87 million: the sum of the $50 million FY 1991 ESRP and the $37 million FY 1994 STMP.[1] This USAID balance of payments program is a key element of Support Group assistance to Peru, to help the country return to economic stability and membership in the international financial community after years of exclusion.

B. Description of the Proposed STMP

1. Objectives of STMP

The fundamental objective of the proposed STMP is to strengthen Peru's commitment and efforts to establish a sound economic policy framework and to carry out structural reforms that serve as the foundation for economic stability with sustained economic growth, one of USAID/Peru's three strategic objectives. The economic reforms supported by STMP will help Peru bring inflation down further, but will place equal emphasis on helping Peru reactivate growth in the economy by improving incentives to the private productive sectors. The STMP is also intended to demonstrate U.S. Government support and approval for the large number and profound nature of past and ongoing economic policy implementation successes.

Finally, the program supports USG counternarcotics, democracy and human rights concerns in Peru. Conditions relating to the latter are being submitted and will be negotiated separately. Given their sensitive nature, they are not discussed in this public document.

2. Purpose -- Continuation of Reforms

STMP supports the achievement of further progress in economic reform and contains conditionality which will help to assure it. The importance of the ongoing program should not be underestimated. Nor should the Fujimori administration's record of adherence to economic policy conditions. This record has been lauded by the international financial institutions and major bilateral donors. Under Fujimori, the GOP has met 82 of 83 World Bank conditions in three adjustment loans. Peru earned 623 million SDR "rights" under the Rights Accumulation Program which ended in December 1992. Peru has satisfied over 50 conditions of IDB loans, and kept current with payments. The GOP has met the economic policy conditions of A.I.D.'s FY 1991 ESRP, with no backsliding. These are remarkable achievements, which merit support.

---

[1] Of the $50 million ESRP cash transfer obligated in FY 1991, $20 million was disbursed prior to the auto golpe of April 5, 1992 which triggered suspension of most non-humanitarian assistance to Peru through the remainder of 1992. Disbursement of the second and third tranches has been held up by Washington for reasons relating to democracy and human rights issues. This $30 million is scheduled for disbursement by the time of signing the FY 1994 STMP. All economic and counternarcotics conditions for ESRP were satisfied in early 1992. The STMP proposes to obligate $37 million of ESP approved in FYs 1992 and 1993 for Peru, but never obligated. These funds have been carried over to FY 1994. More than this amount was originally approved for Peru in FYs 1992 and 1993, but a rescission reduced the ESP funding level available to Peru. Of this $37 million, $34 million is the true budget support transfer in economic terms because $3 million will be returned to USAID in the form of a trust fund for expenditures not otherwise in the GOP budget.

External support for sound economic policies is particularly critical at this juncture in Peru's economic recovery program because the stabilization process is fragile and in some danger of being derailed by an appreciating real exchange rate, a delay in institutionalizing recent reforms, and the potential unravelling of the political consensus. Exports were stagnant from 1992 to 1993 and may actually decline in 1994 as the real exchange rate continues to appreciate (as depreciation of the nominal exchange rate lags behind inflation). And the many sound reforms put into law since July 1990 must be made to work "on the ground." Three-and-one-half years of rapid economic reform have created a feeling of "adjustment fatigue" that is palpable among certain sectors of Peruvian society, especially among those in the Sierra and other remote provinces, who feel frustrated because the promised higher incomes and increased employment opportunities have been so slow in coming. The fact is, experience from other countries, e.g. Chile, indicate that these benefits often take ten years or more to be felt. With little more one year to go until Presidential elections, scheduled for early 1995, the GOP has reacted to this widespread frustration with an intensified plan of expenditures on social programs, especially short-term programs. However, this focus on short-term social programs runs the risk of diverting attention from the reforms still necessary to assure growth over the long term. Compounding this risk, Peru's experience with earlier liberalization programs that could not be carried through to completion, or were perceived to involve an unacceptable amount of austerity and meddling by international financial institutions, still today lead many Peruvians to be skeptical and to mistrust economic reform programs. Special interest groups within the Peruvian economy will exploit this situation to intensify pressure on the GOP to relax or backtrack on past reforms.

Evidence of these pressures became public in the January 1993 letter of resignation of then-Minister of Economy and Finance, Carlos Boloña, in which he cited the many special interest groups that increasingly petition the Peruvian Government for special favors. One can easily imagine that he was referring to pressures to grant special exemptions from high taxes, reintroduce subsidies and provide "relief" from the much lower tariffs on imported goods that compete with local production. These pressures must be resisted. In sum, the STMP is designed to provide complementary support to the program of policy reforms negotiated with the IMF, IDB and World Bank, where that support is closely linked to A.I.D.'s priority areas of concern in Peru. USAID/Peru believes that these reforms are viable in the Peruvian political economic context.

3. <u>USG Support Group Pledge</u>

To achieve these goals, international cooperation and financial assistance are absolutely essential. A key aspect of this assistance is balance of payments support. In January 1993, the IMF estimated a $410 million public sector funding gap for Peru in 1993. As noted in Table IV.2, however, bilateral donor disbursements fell short of filling the gap in 1993 ($210 million instead of $410 million). To compensate for this shortfall in bilateral support, the Paris Club rescheduling was more concessional than had been planned. The USG pledged $105 million towards meeting this gap at the June 1993 Support Group Meeting in Paris, but that pledge was not fully met during 1993. <u>Cash grants totalling $67 million are schedule to be provided in FY 1994: $37 million from STMP plus the assumed disbursement of $30 million under the 1991 ESRP</u>, although the true budget support transfer value, for purposes of meeting the financing requirement, is less than $67 million by the amount of the required trust fund deposits. The STMP is critical to fulfill the Peru Support Group pledge. Table IV.2 also details the financing gap analysis for 1994. USG cash grant assistance provided under STMP will indirectly strengthen the GOP negotiating position in the context of a Brady Plan agreement with its commercial bank creditors.

In addition to registering U.S. approval for the establishment of a sound economic policy framework over the period since mid-1990, there are <u>two additional economic policy objectives of the STMP</u>: (a) to support Peru's continued adherence to the sound policy framework the GOP has worked out with the multilateral financial institutions (MFIs) -- that it not backtrack on these past reforms -- and (b) to support the elimination or reduction of remaining economic distortions in the areas of trade and agricultural marketing, in order to consolidate past successes.

4. USG Policy Interests in Counternarcotics, Democracy and Human Rights

Policy conditions in these areas will be submitted and negotiated separately. It is important to place STMP in the context of USG counternarcotics strategy in Peru and the Andean region. STMP is financed with ESF funds made available for the National Andean Counternarcotics Strategy elaborated under National Security Directive 18 (NSD-18) of 1989. As defined thereunder, macroeconomic reform -- creating an adequate policy framework -- is directly relevant to vital USG narcotics interests because sound policies must be in place for alternative coca income programs to be effective. In November 1993, by Presidential Decision Directive 14 (PDD-14), the President approved a refined and modified approach to USG efforts against cocaine production and trafficking in Latin America. PDD-14 continues to recognize that a stable and growing national economy is an imperative context for an effective effort to reduce production of cocaine in the Andean source countries, and that USG programs to promote sustainable economic development on a national basis thus also serve USG counternarcotics policy objectives. It further recognizes that in a period of more limited resources than in the past, U.S. counternarcotics efforts will be an element of more comprehensive multi-donor support for national counternarcotics efforts by source countries.

STMP is consistent with the strategic counternarcotics approach defined in PDD-14, and will contain particular counternarcotics conditions, as did ESRP, that are consistent with the specific counternarcotics programs and activities developed in accordance with it. Both programs highlight the importance of GOP action to rehabilitate the Selva/Coastal road, which links the Huallaga Valley to the coast, as well as other road infrastructure that is equally essential to counternarcotics alternative development and national sustainable development goals. STMP includes conditionality requiring that the GOP budget for, solicit support from multilateral and bilateral donors for, and make progress on repair of these roads. Given GOP extreme budget shortages, USAID/Peru believes that the combination of balance of payments support and conditionality will most effectively assure that the Selva/Coastal road is repaired in the foreseeable future.

C. Reform Progress of the GOP

The ESRP has assisted, and STMP will continue to assist, the GOP in pursuing important macro-economic reform efforts. The Fujimori administration's economic reform program is ambitious and has achieved very significant progress in little more than three years. GOP accomplishments include:

- Greatly reduced fiscal deficit that is covered without recourse to Central Bank financing, and with only minimal domestic financing.

- Victory over hyperinflation, with tight fiscal and monetary policies that have cut inflation in 1993 to its lowest level in 15 years (40 percent).

- Cleared over $2 billion in arrears to the IMF, IDB and World Bank. Peru is the first country, and the only one so far, to have successfully cleared arrears with the IMF and the World Bank under their Rights Accumulation and Debt Workout Programs.

- Restrictive labor laws and regulations made more flexible to permit productivity to increase and remove disincentives to employ workers in the formal sector.

- Virtual elimination of price controls and subsidies and the abolishment of most public sector monopolies, with remaining "public" prices (electricity, water, telephones and fuel) rising faster than inflation to prepare for privatization.

- Overhaul of national tax administration and tax reform, which increased Central Government revenues to 10 percent of GDP, from about 4 percent in mid-1990, and greatly simplified the tax code for small businesses.

- Significantly liberalized foreign trade regulations: all import quotas and virtually all non-tariff barriers were jettisoned and import tariffs were slashed from an average 80 percent to 17 percent.

- Capital account liberalized and all exchange controls abolished.

- Wholesale restructuring of public sector begun: government employment has been slashed by half since 1990 and an aggressive plan to privatize or liquidate all major state-owned firms by the end of 1995 has been in place since 1992, with privatizations valued at over $500 million completed through 1993.

- The modified investment laws mean that foreign investment is guaranteed national treatment; Peru now has perhaps the most liberal foreign investment regime in the region. One result has been an increase in direct foreign investment in Peru from $125 million in 1992 to almost $550 million in 1993.

- Broadened and strengthened rules regarding private ownership and use of land.

The GOP reform program is attempting to correct some thirty years of skewed economic policies, and to revive an economy badly hit by recession and the effects of narcotics trafficking and terrorism. Still more needs to be done. Priority attention should be given to the following:

- Inflation needs to be lowered toward a single digit annual rate, requiring continued tight fiscal and monetary policies.

- Structural reforms must be deepened, including rapid progress in privatization, continued financial sector reform, clear rules for setting of public sector tariffs, a streamlined land titling process, further measures to improve labor mobility, and holding the line on trade liberalization. Strengthening of the state role in selected activities is critical to promoting growth, such as ensuring adequate and effective legal, regulatory, and judicial controls.

- The tax base must be further broadened to boost revenues and to permit the reduction and elimination of taxes which discourage private investment, with prospects good of increasing tax revenues to 12% of GDP in 1994.

- Adequate non-distortionary incentives must be provided the export sector -- either a reversal of real appreciation, 'drawback' of taxes on inputs, access to financing, etc.

- A poverty alleviation strategy that is well targeted and cost-effective needs to be developed and implemented and the GOP's long-term capacity to meet the enormous unsatisfied demand for social services needs to be expanded.

- Steady effort must be maintained to seek reduction and rescheduling of the debt owed foreign commercial bank creditors and forgiveness of debt owed bilateral donors.

D. Proposed Tranching

The $37 million in program funds will be disbursed in two tranches. The first tranche, in an amount of $22 million, will be disbursed without specific new economic policy conditions, as a demonstration of USG support for the success Peru has already achieved in implementing one of the most rapid economic reform efforts on record. Delegates of the MFIs and more than a dozen bilateral donors at the March 4, 1993 meeting of the Support Group, applauded the Fujimori government's extraordinary economic reform program (see Section C above for details).

The second tranche disbursement, the remaining $15 million, will hinge on GOP compliance with two sets of economic conditions: (a) Peru's continued adherence to the sound policy framework the GOP has worked out with the MFIs -- specifically, that the GOP not backtrack on these past reforms -- and (b) Peru's elimination or reduction of key remaining economic distortions in the areas of trade and agricultural marketing, distortions the GOP should remove in order to consolidate its recent advances in trade liberalization. Non-economic conditionality will be in the areas of counternarcotics, democracy and human rights.

E. Proposed Conditionality

First tranche conditionality will include non-economic conditions in the areas of counternarcotics, democracy and human rights, but no additional economic conditions will be imposed. The non-economic conditions will be contained in a classified annex to this PAAD.

Second tranche conditionality will include both economic and non-economic conditions. Again, the non-economic conditions to the second tranche will be detailed in a classified annex. In general terms, the first set of economic policy conditions for disbursement of the second tranche requires the GOP to:

(i) continue its tight fiscal and monetary policy to further reduce inflation and stabilize the external current and capital accounts;

(ii) sustain import reforms achieved so far, in the areas of tariff reduction, elimination of non-tariff barriers, and overall simplification of the tariff regime;

(iii) keep the economy free of export taxes, refrain from introducing any new export subsidies and reduce surcharges on imported food commodities; and

(iv) limit public sector development banking to second-tier institutions.

The second set of economic policy conditions focuses on trade and marketing reforms and on rehabilitation of the Selva/Coastal road and other important market access roads to the coast. These are designed to:

(i) improve the competitive environment for private sector entry into the marketing of agricultural products, now being opened up by the removal of ECASA and the downsizing of ENCI, the two major parastatal marketing firms that used to monopolize much of the marketing of agricultural products;

(ii) improve the competitiveness of Peru's export sector by working with the GOP to consider extending the tax drawback system for indirect taxes on exports; and

(iii) restore road access by the coca producing zones (notably the Huallaga Valley) to coastal markets, now largely disrupted, to strengthen incentives for licit economic activities.

F. Proposed Use of the Dollars and Host Country Owned Local Currency

The dollars will be used by the GOP to repay debt owed to the three major multilateral financial institutions (MFIs) -- the IMF, IDB and World Bank -- to help Peru reintegrate itself with the international financial community. Although the GOP will be required to deposit $3 million in HCOLC to cover a portion of the in-country administrative costs of the USAID Mission in Peru, no additional HCOLC deposits will be required.

G. Coordination With Other Donors

The STMP is closely linked to multilateral stabilization, structural adjustment, trade reform and agriculture sector reform programs in Peru. The IMF has taken the lead in stabilization, the World Bank in structural adjustment, and the IDB in trade and agriculture marketing reform, although the World Bank also had a trade adjustment program. USAID/Peru, as a bilateral donor with a broad project portfolio and long history of assistance to Peru, has taken a lead in many aspects of the reform program, applying both "program" (BoP) and project resources (technical assistance, studies). STMP, as designed, is part of this integrated assistance effort. In conformity with PDD-14 emphasis on multilateralism in counternarcotics efforts in source countries, counternarcotics aspects of STMP and other USG support for counternarcotics activities are coordinated with other bilateral donors and the United Nations Drug Control Program (UNDCP) bilaterally and through the donor consultative group ("Dublin Group") on narcotics matters.

II. PERU'S ECONOMIC SITUATION

A detailed description of Peru's economic situation is contained in Annex A. Following is a summary descripton.

A. Secular Economic Decline

Peru has experienced a long period of secular economic decline going back as far as the late 1960s. This decline reached crisis proportions in the late 1980s when efforts to stimulate aggregate demand through large fiscal and quasi-fiscal deficits led to hyperinflation, the massive build-up of arrears on Peru's external debt, a worsening of inequality, and a collapse of the state apparatus for policy making and providing economic infrastructure and social services. The arrears build-up left Peru completely isolated from the international financial community, with the multilateral financial institutions (MFIs) and commercial banks no longer lending to Peru and the latter threatening to slap Peru with lawsuits for failure to service debt. Further, the growth of narcotics production and trafficking helps maintain an overvalued exchange rate, the vast profits corrupt political and economic institutions, abuse of the drug magnifies social problems, while the location and outlaw nature of production activities aggravate environmental degradation.

B. On the Road to Recovery

The new Government that came into office in July 1990 was faced with a collapsing economy and took immediate remedial action. The first phase of Peru's economic stabilization and recovery program focused on short-term stabilization of inflation and began negotiations with the three main MFIs -- IMF, IDB and World Bank -- to develop a coherent economic program to deal with the short- and long-term economic problems facing Peru.

1. Financial Reinsertion with the Multilateral Financial Institutions

By mid-1991, these negotiations had led to basic agreement among the parties on the outlines of a plan of action regarding stabilization, structural adjustment and reintegration of Peru into the international financial community. This agreement was formalized when Peru became one of the "pioneer" countries in the new approaches developed by the IMF and World Bank to deal with countries that have accumulated large arrears with these institutions, but are preparing to repay these arrears by implementing extensive reform programs to deal with their underlying economic imbalances. In July 1991 Peru signed a Debt Workout Program with the World Bank and in September 1991 a Rights Accumulation Program with the IMF. The "performance period" for these debt arrears programs ran through December 1992, during which time Peru agreed to implement a wide-ranging series of macroeconomic, structural and sectoral reforms.

The problem with such "shadow" programs is that, while Peru would have to begin servicing the debt it owed to the World Bank and the IMF as of the signing dates, no new money would flow to Peru from these institutions during the performance period. Therefore, Peru chose to first clear its arrears with the IDB in September 1991 (arrears to the IDB were small compared to those with the IMF and World Bank) so that the IDB could begin disbursing funds during the performance period. But even after arrears were cleared with the IMF and World Bank, and these institutions began to disburse project funds, net flows between Peru and the three MFIs remained negative through 1993. [[Something on net flows for 1994.]]

The structural and sectoral reform program was worked out in cooperation with the IDB and the World Bank, while the IMF consulted on overall macroeconomic reforms. The World Bank approved a structural adjustment loan and sectoral adjustment loans for reform of the trade and financial sectors. The IDB

\\

also approved two sectoral adjustment loans for the trade and financial sectors. As a result, the IDB and World Bank were lending their joint weight to the same set of trade and financial reforms.

2. Peru's Anti-Inflationary Policy

The portions of Peru's macro stabilization program of greatest concern to A.I.D. relate to the maintenance of strict fiscal and monetary policy; these are the necessary conditions for Peru to stabilize inflation. Continued fiscal restraint is the first priority because small deficits can be financed externally, but not large ones. Monetary restraint is as important, but is impossible to achieve in Peru without fiscal restraint. Trying to maintain monetary restraint while the budget run fiscal deficits, even small ones, is difficult in the Peruvian context. The high degree of "dollarization" of the Peruvian economy (70% of M2 is in dollar, not sol deposits) means that a small increase in domestic currency can yield large percentage increases in the domestic currency money supply. This makes the issue of whether or not to require the GOP to deposit host country owned local currency (HCOLC) counterpart for joint programming such a sensitive issue. HCOLC associated with the STMP and half of $30 million final tranche under the FY 1991 ESRP (a total of $50 million in HCOLC) intended for disbursement to Peru in 1994 would have amounted to 11% of the actual increase in domestic currency money supply (M2) for the entire calendar year 1993, a not insignificant amount. (See Annex B, Section D.1. for an analysis of the GOP stabilization program.)

3. Peru's Trade and Marketing Reforms

In addition to macroeconomic stabilization, trade reform, especially export promotion and continued reduction of the tariff surcharges on selected food imports, is of deep concern to A.I.D., as is agricultural marketing, because they relate directly to A.I.D. programs in Peru.

Reactivating the export sector is critical to Peru's ability to reactivate growth in the economy, and is the objective of USAID/Peru's Export, Trade and Development Project. The debate regarding extension of the tax drawback system for exporters to include other indirect taxes besides the IGV (Peru's value added tax), involves important questions of legality within the GATT and the impact such an extension would have on tax collections, in addition to others such as the incentive effect it would have on Peru's exports. Therefore, a definitively objective study of these issues would serve a positive contribution to the national debate on the tax drawback system.

GOP compliance with the schedule to reduce the tariff surcharges over a four-year period, agreed to with the IDB in mid-1993, will reduce the incentives for Peruvian farmers to continue producing non-competitive food crops and induce them to redirect production toward export and other crops where Peru has a comparative advantage (see Annex B, Section D.5. for a more detailed discussion of the agreement reached with the IDB on reducing tariff surcharges). And like the policy to reduce tariff surcharges, improving agricultural marketing policies dovetails with policy conditions attached to Peru's multi-year Title III program, approved by AID/W in April 1993 (see Annex B, Section D.4. for a more detailed discussion of needed improvements in agricultural marketing). Rehabilitation of the Selva/Coastal road will improve the marketing of licit products from Peru's main coca growing areas.

4. Peru's Medium-Term Economic Program

The medium-term economic program Peru has developed which will run through 1995, has been designed with a view to reduce inflation to single digit annual rates by the end of the program period, provide the conditions to accelerate GDP growth to 4-5% a year, alleviate extreme poverty and restore external viability. The GOP also proposes to establish an effective approach to enhancing human capital through increased expenditure in education and health and for strengthening the safety net that protects the poorer segments of the population. And the program will provide a framework for debt agreements with Peru's bilateral and commercial creditors, having already cleared arrears and continued servicing debt to the MFIs and rescheduled its bilateral debt in Paris.

5. Conclusion

As emphasized above, in Peru's effort to stabilize inflation, the primary policy concern must focus on fiscal stringency, but the need for infrastructure and the demands of the social sectors are real and the voices of public sector workers are loud. Improved tax administration and enforcement, and perhaps some innovate tax reform, hold the key to increasing revenues over the medium-term to satisfy these demands. Over the short-term, expenditure restraint is the only way to keep fiscal deficits low. A warning is in order here: the 1992 recession, when real GDP fell by 3% over the entire year, led the GOP to increase fiscal expenditures in the latter half of 1992. Compounded by the large monetary emission in December 1992 and the 60% devaluation of the sol with respect to the $US between March and October 1992, this helped trigger the 1992-93 upturn in Peruvian inflation, which the GOP dealt with by intensifying monetary restraint. This should be a lesson for the future on the likely consequences of relaxing fiscal restraint.

Figure II.1 INFLATION, NOMINAL EXCHANGE RATE DEPRECIATION AND REAL EXCHANGE RATE

January 1992 - December 1993

(monthly figures)

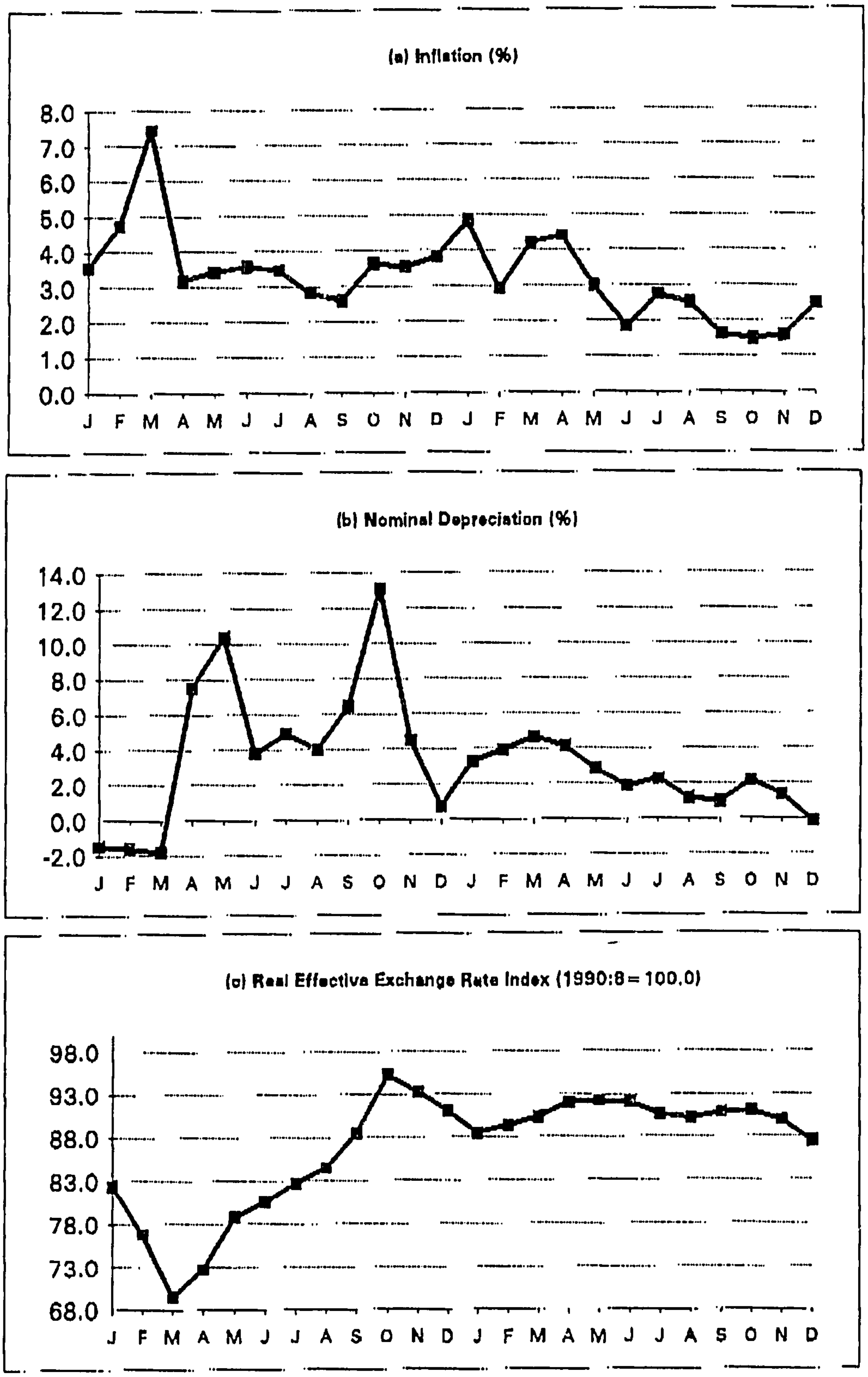
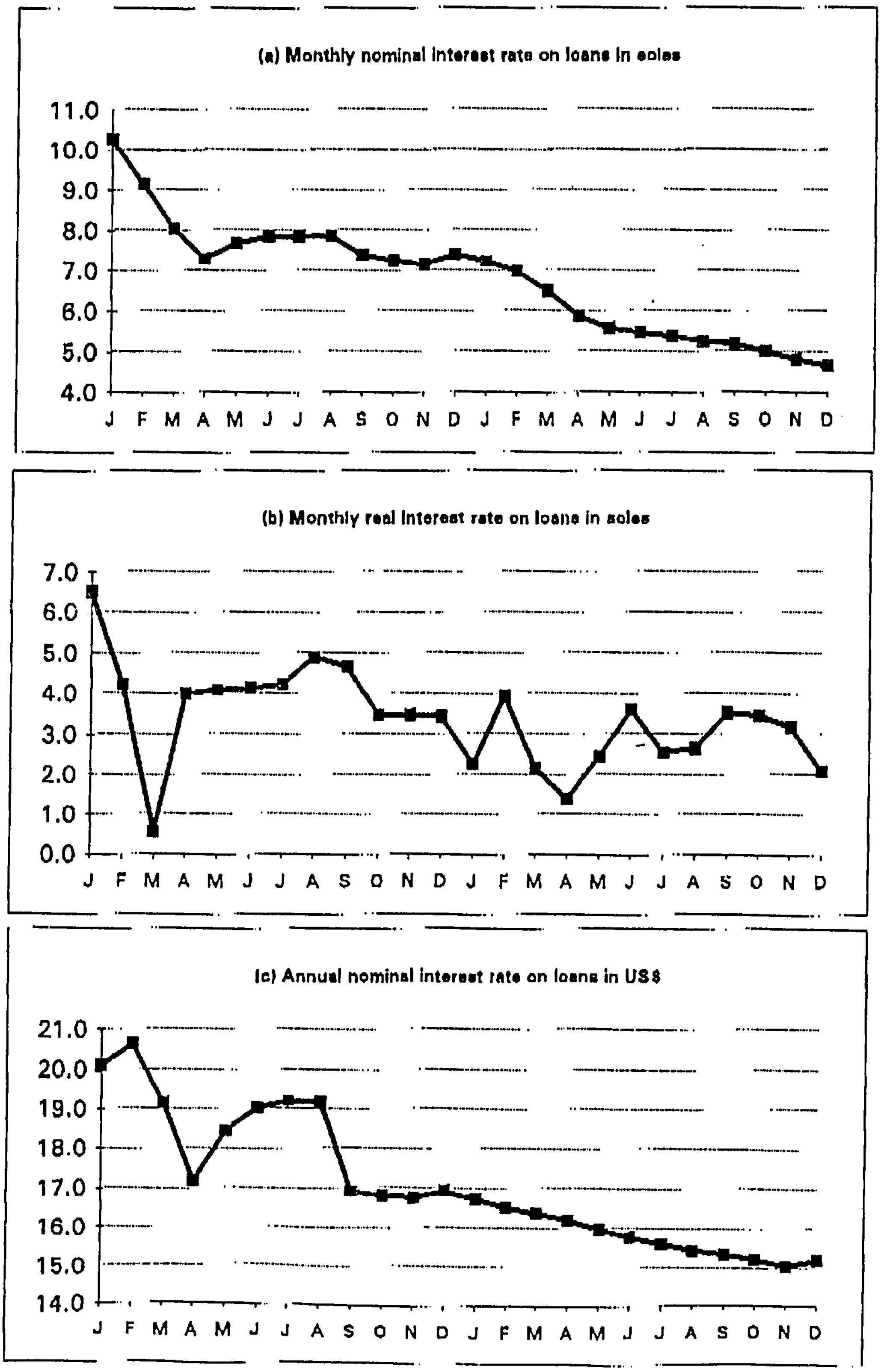


Figure II.2 NOMINAL AND REAL INTEREST RATES
January 1992 - December 1993
(%)



5

III. THE A.I.D. STABILIZATION, TRADE and MARKETING PROGRAM (STMP)

A. Multiple Objectives of the STMP

The objective of the proposed STMP is to strengthen Peru's commitment and efforts to establish a sound economic policy framework and to carry out structural reforms that serve as the foundation for economic stability with sustained economic growth, one of USAID/Peru's three strategic objectives. The economic reforms supported by STMP will help Peru bring inflation down further, but will place even greater emphasis on helping Peru reactivate growth in the economy by improving incentives to the private productive sectors. The STMP is also intended to demonstrate U.S. Government support and approval for the large number and profound nature of past and ongoing economic policy implementation successes. Finally, the program supports USG counternarcotics, democracy and human rights concerns in Peru. Conditions relating to the above are being submitted and will be negotiated separately. Given their sensitive nature, they are not discussed in this public document.

The basic strategy is to provide $34 million in balance of payments assistance (of total $37 million program)[2] in direct support of the implementation of the GOP's medium-term economic program, especially the stabilization, trade and marketing elements of the program, and ensure that budgetary resources are made available to rehabilitate the Selva/Coastal road and other essential road infrastructure, without which products from the central Sierra and alternative crops grown in the Upper Huallaga Valley cannot hope to become profitably sold in coastal towns and export markets.

B. Counternarcotics Element of the Program

For centuries Peru's coca production was oriented towards domestic demand. But, as cocaine consumption expanded abroad, narcotics traffickers found Peru's Upper Huallaga Valley to be an ideal environment for the production of high-quality coca. Peru now supplies 60-70% of the world's production of coca leaf, and is a major cocaine base producer. The expansion of illegal coca production and trafficking has caused serious economic, political, social and environmental harm to Peru. Narco-dollar liquidity has distorted exchange rates and has swung the cost/returns structure against legitimate crop and other productive activities. A symbiotic relationship between narco-traffickers and terrorists has diluted civil governmental authority in the coca growing areas (though major inroads were made against terrorists during the past two years), making control and alternative development efforts risky. Deforestation, erosion and the disposal of toxic chemicals associated with narcotics are causing significant ecological damage in these areas.

Reducing and ultimately eliminating the production of cocaine in Peru that is available for export to the U.S. is a key USG foreign policy objective. NSD-18 of 1989 established the National Andean Strategy, under which funds for STMP were requested and appropriated. PDD-14 of 1993 defined and refined a modified USG approach that emphasizes activities to reduce cocaine production in source countries, and development of host government institutional capabilities to act against cocaine production and trafficking. It recognizes that resources available to the USG to support counternarcotics activities are more limited than in the past, and thus places increased importance on coordination of USG activities with those of other multilateral and bilateral donors to support comprehensive host government national counternarcotics plans. The U.S. counternarcotics approach in Peru is developed to provide selective support, with other donors, for appropriate elements of the developing Peruvian national counternarcotics plan for a comprehensive and

---

[2] Of the $37 million cash transfer, $3 million is to be returned to USAID/Peru for use in a trust fund, and therefore is not, in economic terms, true budget support.

16

integrated national effort to reduce cocaine production, trafficking and abuse through alternative development, law enforcement and interdiction, demand reduction, prevention and treatment programs.

Reducing the amount of drugs produced and processed in Peru is a key U.S. foreign policy objective, as reflected in the Presidential signing of National Security Directive 18 (NSD-18). This Directive established the blueprint for the U.S. strategy to reduce, and if possible eliminate, the flow of illegal narcotics from the Andean region to the United States. The strategy is built upon two basic premises. The first is that the destruction of the narcotics incubus in the Andean region will require effective law enforcement against narco-traffickers combined with economic assistance to help cushion the negative economic effects of the suppression of the drug trade. The second premise is that an effective counternarcotics program needs to be based on a solid U.S. partnership with the Andean countries.

C. STMP Conditionality and Rationale

1. Objectives of STMP Conditionality

The conditionality for the assistance provided through the STMP program will follow NSD-18 guidance which establishes that recipient countries must have in place, or be taking steps to put in place, a sound economic policy environment. Although a large number of policy reforms have already been implemented and Peru's policy environment is sound, it is not fully consolidated.

a. What kind of conditionality should be sought through the STMP?

From an economic perspective, STMP conditionality should encourage GOP efforts to articulate and implement sound economic policies in 1994 that support its medium-term strategy: in essence, to help the GOP maintain the momentum for reform. From a political economic perspective, the STMP should support economic policies which Peruvians perceive to be beneficial to their country, and that are built upon a political consensus that makes them viable in the Peruvian social and political context. From a more purely political perspective, conditionality should also address issues of democracy and human rights.

b. A.I.D. programming concerns

From A.I.D.'s programmatic perspective, the STMP should link its policy dialogue to sectoral areas of concern to USAID/Peru -- export promotion, marketing of agricultural products, the social safety net and counternarcotics. A number of USAID/Peru programs embrace activities in these areas: Titles II and III food aid, health sector projects, and the project to promote exports, especially agroexports.

c. Economic Conditionality

The first economic objective of STMP is to register U.S. approval for the establishment of a sound economic policy framework over the period since mid-1990. But beyond that, STMP has two additional economic objectives:

(a) to support Peru's continued adherence to the sound policy framework the GOP has worked out with the MFIs -- that Peru not backtrack on these past reforms -- and

(b) to support the elimination or reduction of remaining economic distortions in the areas of trade and agricultural marketing, that the GOP must resolve in order to consolidate its past successes.

With these objectives, the STMP is designed to provide complementary support to the program of policy reforms negotiated with the IMF, IDB and World Bank, where that support is closely linked to A.I.D.'s priority areas of concern in Peru. USAID/Peru believes that these reforms are viable in the Peruvian political economic context.

As demonstrated elsewhere in this document, external support for sound economic policies is particularly critical at this juncture in Peru's economic recovery program because the stabilization process is fragile and in some danger of being derailed by renewed appreciation of the real exchange rate and the potential unravelling of the political consensus. Continued efforts in democracy/human rights need to accompany economic reforms. Hence, the inclusion of specific conditions for release of the dollar transfers.

d. Counternarcotics conditionality

Counternarcotics conditionality is also important, and needs to be viewed in context of progress to date. Peru has implemented, with significant and increasing contributions from its own resources, an active counternarcotics program, including enforcement, alternative development, coca eradication, drug awareness and demand reduction, activities exceeding measures that would have been required to fully satisfy counternarcotics conditionality applicable to the second and third tranches of the FY 1991 ESRP and FMF programs. Conditionality will require GOP budgetary allocation, action to solicit multilateral and bilateral donor support, and spending this year for essential repairs to the main road linking the Huallaga Valley to the Sierra and the Coast and other roads deemed essential to provide market access for licit crops or economic activities in coca producing areas.

2. Conditionality Strategy

Total STMP resources of $37 million will be disbursed in two separate tranches. The first tranche of $22 million is scheduled for disbursement in the second quarter of 1994, after Peru has met the non-economic conditions detailed in the classified annex. From the economic perspective, disbursement of the first tranche will demonstrate U.S. Government support for the significant market-based economic reforms implemented since August 1990, in particular for those designed and implemented after the development of the ESRP program in 1991, and for progress in counternarcotics efforts, as stated above.

The second tranche of $15 million is scheduled for disbursement in the fourth quarter of 1994, after a USAID/Peru review of GOP compliance with policy conditionality. This review will be timed to coincide with an IMF review of GOP performance with respect to conditions contained in the medium-term program (November 1994). Proposed conditionality on counternarcotics, democracy and human rights issues (see annexes) will be reviewed following the same schedule.

3. The Economic Policy Basis for Second Tranche Conditionality

STMP conditionality for the second tranche will provide critically needed support to a sound economic policy framework through a two-fold approach.

First, it will require continued adherence to a set of macroeconomic policies that the Peruvian Government has already introduced over the past 40 some months, policies deemed by USAID/Peru to be the most critical to successful stabilization and structural reform.

Second, it will identify an additional set of trade and agricultural marketing reforms, issues of privatization and critical budgetary expenditures that the Peruvian Government may want to implement during 1994, as part of its medium-term plan, but needs additional resources to be able to do so.

a. Support for continued implementation of past policy measures

By supporting the first group of policies, the STMP will help the GOP continue its commitment to the macroeconomic policy reforms implemented since August 1990. The most critical of these include the following: continued adherence to a unified, market-based exchange rate; maintenance of no more than two tariff rates on imports; agreement not to reintroduce any non-tariff barriers; agreement to continue reducing the tariff surcharge on selected food imports according to the schedule agreed to with the IDB in July 1993; agreement not to introduce any export subsidies which contravene GATT regulations and similar agreement not to raise or increase the number of current export taxes or extend them to other products; and agreement to continue to limit public sector development banking to second-tier institutions.

These policies are indeed important, but GOP commitment to maintain the current austere fiscal and monetary policies is what will really determine whether Peru will succeed in stabilizing inflation over the medium-term. This is so because the GOP has chosen to use restrictive monetary policy to "anchor" its efforts to stabilize the Peruvian economy, instead of using a fixed exchange rate "anchor". Therefore, for 1994, the GOP will maintain a primary surplus (excluding revenues from privatization) on the consolidated public sector budget, and the Central Bank will continue to refrain from financing any part of the consolidated public sector deficit.

b. Support for new policy initiatives in trade and marketing

Beyond these macroeconomic policies, however, the STMP will help the GOP implement additional trade and marketing reforms and ensure critical budgetary expenditures. By the end of the program the GOP will have improved the marketing of agricultural products in Peru and will have improved the tax drawback system for exporters. The former involves improving the capacity of private sector firms to market agricultural products as well as the capacity of governmental regulatory bodies to efficiently regulate the private sector marketers; it also involves limiting the scale and type of activities that ENCI will be allowed to engage in and rehabilitating the Selva/Coastal Road that runs from Lima on the Coast to Tingo Maria in the Selva as well as other road infrastructure important for marketing licit crops from coca growing areas. The latter involves improving the comprehensiveness and effectiveness of the existing tax drawback system for exported goods as it relates to the IGV and considering expansion of the tax drawback system to other indirect taxes.

4. <u>Implementing Studies to Support GOP Policy Achievement</u>

To implement these conditions effectively, a number of studies must be carried out by the GOP. They include the following:

- Recommend how to improve the marketing system for agricultural products by the private sector. The study should identify the appropriate role for government regulation of, but not direct participation in, the marketing process, and develop a training program in agricultural marketing for the private sector.

- Identify the short-term measures that could be introduced to reduce transport costs from the Sierra to Lima and other coastal urban markets and/or ports.

- Analyze the conceptual, operational, legal and revenue implications of extending the tax drawback scheme to cover tariff duties and other indirect taxes (a drawback system does exist for the value added tax) that impinge on exported goods. The IMF is skittish about reducing taxes, so the case has to be well substantiated.

5. <u>Program Monitoring and Evaluation</u>

The principal economic variables that will be monitored are the fiscal, monetary and balance of payments accounts, along with a set of key economic indicators identified below. In addition to monitoring GOP performance using these quantitative indicators, USAID/Peru will undertake a detailed review of GOP policy implementation prior to the second disbursement. A positive IMF review of GOP performance against

1994 benchmarks will satisfy this requirement for category (a) conditions detailed in Section C.3.b. of this chapter. USAID/Peru will use the results of this review as the basis to justify the disbursement and/or to engage the GOP in policy dialogue with a view toward encouraging corrective measures.

Figure III.1
Key Economic Indicators
Used to Monitor STMP

Indicator	Target
GDP growth rate (average increase over same period in 1993)	4%
Inflation rate (annualized rate of inflation over the period)	15-25%
Annual change in net international reserves ($ million)	300
External debt owed to MFIs	remain current
External debt owed to commercial creditors	complete negotiations
Central Government primary balance (surplus or deficit)	surplus
Tax effort (as % of GDP)	10%
Domestic financing of fiscal deficit (as % of GDP)	< = zero
Direct private investment in BoP ($ million)	800
Primary emission, nominal (average increase over same period in 1993)	15-20%
Primary emission, real (average increase over same period in 1993)	< = zero
Net domestic credit to the public sector	< = zero

D. Coordination with Other Donor Programs

The STMP is linked closely to past, current and future programs of the IMF, IDB and World Bank, the three main MFIs working in Peru. The $37 million in foreign exchange provided under the STMP will be used by the GOP to repay debt obligations owed to the three MFIs. During the last three quarters of 1993, after Peru had cleared its arrears with the IMF and World Bank and these institutions, in turn, had disbursed the funds earned under the IMF's Rights Accumulation and World Bank's Debt Workout Programs, Peru continued to experienced a net outflow of funds to the three MFIs in the aggregate. Although MFI net flows to Peru are projected to be positive for the entire year 1994, negative net flows are projected for the first and fourth quarters and disbursements are projected to equal repayments during the second quarter (see Table IV.1 for the details).

Furthermore, STMP policy conditionality for disbursement of the second tranche requires the GOP to continue to adhere to a set of critical macroeconomic policies that it has already introduced since August 1990. They are:

(i) key policies Peru implemented under the IMF's Rights Accumulation Program and continues to implement under the Medium-term Program with the Fund -- the ones on fiscal and monetary discipline and a floating exchange rate;

(ii) several policies Peru implemented under the IDB and World Bank Trade Reform Loans -- the ones on tariff rates, non-tariff barriers, the tariff surcharge system and export taxes and subsidies; and

(iii) a policy Peru implemented under the World Bank Structural Adjustment Loan -- the one on second-tier development banks.

Second tranche conditionality also requires the GOP to implement, or consider implementing, additional trade and marketing reforms. The agricultural marketing reform conditionality that relates to limitations on the level of operations of ENCI was also a condition in the IDB's Trade Sector Loan (fully disbursed) and the Agricultural Sector Loan now being negotiated. The condition related to study of the tax drawback system on all indirect taxes paid by exporters (related to goods actually exported) is not linked to any MFI program. Indeed, it runs somewhat counter to the position of the IMF; for the IMF, increasing tax revenues is top priority so that Peru can maintain fiscal discipline. USAID recognizes the importance of fiscal discipline, but also believes that exporters must be given a fair chance to compete in the world market, especially under the current overvalued exchange rate that is biased against exporters. That is why the study is being done, to make the case to the GOP and to the IMF of the feasibility of expanding the tax drawback system.

Two additional aspects of IMF and World Bank policy loans should also be mentioned, although they do not relate directly to STMP conditionality. The World Bank is preparing a second Structural Adjustment Loan for Peru which will have policy conditions in four areas of institutional reform: labor markets, land titling, capital markets, and trade reform vis-a-vis anti-dumping regulation. The IMF, in conjunction with its three-year extended fund facility, will be helping Peru implement its poverty alleviation program by providing technical assistance in the area of public expenditure policy. The goal is to increase the efficiency of expenditure programs and focus them on services for the poor.

E. Relationship to Other USAID/Peru Programs

The STMP is an integral part of USAID/Peru efforts to support Peru's economic program and important U.S. democracy and counternarcotics objectives in Peru. STMP economic policy conditions also respond to gaps in the Peru Medium-Term Program, and to problems identified in other USAID activities in agriculture, Title III food aid and non-traditional export promotion. USAID/Peru's humanitarian programs in health and food aid complement the STMP focus on reactivating income growth and generating new employment opportunities. In addition, the Policy Analysis, Planning and Implementation (PAPI) Project is closely linked to ESRP and STMP, as it provides funding for studies and technical assistance for the public and private sectors, relating to macro and sectoral economic reform.

The STMP is a direct descendent of the FY 1991 ESF Program, the Economic Stabilization and Recovery Program (ESRP). Whereas the ESRP focused policy dialogue on stabilization and recovery in a broad approach and HCOLC uses on alternative development activities, the STMP has limited its focus to key policy issues in the area of stabilization and has focused the major share of its attention on reactivating growth in the economy through trade and marketing reforms.

Originally, the HCOLC to be generated from the second and third tranches of the 1991 ESRP (a total $15 million) was to be programmed for use in rehabilitating the Selva/Coastal road, also known as the Central Highway, that goes from Lima on the Coast to Tingo Maria in the Selva. The road then continues on down the Huallaga Valley, as the Marginal Highway. At this juncture, however, USAID proposes to use conditions precedent in STMP to ensure the repair of the highway in question as well as other important Selva/Coastal market access roads (and to amend ESRP to eliminate HCOLC programming, when dollars are ready to be released). As described in other sections, this approach conforms to current A.I.D. guidance (PD-18), is economically preferable, and is more manageable than when HCOLC is "generated."

The policy focus of the multi-year (1993-95) Title III Program relates to agricultural trade, both the promotion of exports and the reduction of tariff surcharges on food imports, and to agricultural marketing, including privatization of ENCI. The Mission's Export, Trade and Development (ETD) Project focuses on the promotion of Peru's non-traditional export sector, with a strong emphasis on agricultural exports. The trade and marketing component of STMP also focuses on agricultural marketing and export promotion. In the area of agricultural marketing, both Title III and STMP seek to improve the incentives for private sector participation in marketing agricultural products. USAID/Peru's PAPI Project has funded a study of agricultural marketing policy options. In the area of export promotion, the STMP focus on improving the tax drawback system for exporters directly supports ETD efforts to promote non-traditional exports. The study of the tax drawback system referred to in Section C.4 (as condition b.2) is being conducted with funding under the ETD Project, while PAPI has funded a study to identify a broader array of the major bottlenecks to improved export performance.

The Title II (and USDA-managed Section 416) food aid programs are focused on direct efforts to alleviate the extreme poverty and inequality of nutritional status that exist in Peru. This poverty and inequality comes from a long historical disparity between the Coast and the Sierra and Selva, the secular decline in the economy since the mid-1960s, the dramatic economic collapse of the late 1980s and the human crisis brought by terrorism in the Sierra. These humanitarian food aid programs deliver food directly to hungry people and use monetized resources to support labor-intensive community development projects to generate temporary employment. They are critical to tide the Peruvian poor over the transition to a more vibrant free market economy supported under the STMP. Proceeds from the sale of Title III commodities are used to support food security in Peru, with a large proportion of funds directed at child survival, agriculture and temporary employment creation programs.

Analogously, USAID/Peru's health programs also play a similar role of alleviating poverty during this transition through their primary concern for issues of child survival and family planning. But these health programs are not primarily geared to short-term concerns of the transition period. Instead, their longer-term focus is on strengthening Peru's health sector institutions, both public and private, with cost-recovery becoming a more important issue so these institutions will be able to improve child survival outcomes well into the future, with less dependence on scarce funds from government budgets. A.I.D.'s health program will constitute an integral part of the GOP's emerging poverty alleviation strategy, being developed with assistance from the IDB, World Bank and other donors.

IV. USE OF GRANT FUNDS

The program dollars will be used by the GOP to service external public sector debt. When program dollars are used for this purpose, according to A.I.D. regulations (see PD-18), host country owned local currency need not be "generated." A.I.D. will, however, require the Grantee to transfer $3 million to the A.I.D. Mission in Peru for an OE Trust Fund.

A. Justification for Using the Dollars to Repay External Debt

Refer to Annex B, Section B.4., for a detailed discussion of Peru's efforts to reintegrate with the international financial community, which includes the three major multilateral financial institutions (MFIs), bilateral creditors and commercial banks.

1. Reinsertion into the International Financial Community

Peru must complete the process of reinsertion into the international financial community if it is to have any hope of obtaining significant inflows of long-term private capital in the future. To do so, Peru will have to continue to service large debts owed to the three MFIs -- IMF, IDB and World Bank -- over the period of the medium-term plan (1993-95). During last three quarters of 1993, Peru actually experienced net outflows to the MFIs and this situation will repeat itself during some quarters of 1994-95 (see Table IV-1 below). Helping Peru reintegrate with the world financial community will indirectly promote U.S. exports to Peru by increasing Peru's capacity to import during 1994. Since a large share (over 30%) of Peruvian imports come from the United States, the U.S. will be the main foreign beneficiary of Peru's increased import capacity. But U.S. exporters will also be the main losers if Peru's economy does not recover; more so if a lack of financial support now pushes Peru back into economic chaos like that of the late 1980s.

This is the best way to use STMP dollars because Peru's external debt burden is among the highest in the world. At over $1000 per capita and equal to the World Bank estimate of GDP, Peru's external debt is twice the average of countries acknowledged by the MFIs to have severe debt service problems. In 1990, Peru was the world's debt arrears "problem country" *par excellence.* Now, after some 40 months of tough economic reforms, Peru has established itself as a "pioneer" in successfully fulfilling all conditions of the Rights Accumulation Program with the IMF and the Debt Workout Program with the World Bank, and is so far the only one to have done so. Peru successfully completed the "performance period" in December 1992; then in March 1993, Peru cleared all outstanding arrears with both institutions. This arrears clearance is unique in size -- somewhat less than $900 million in arrears to each institution, for a total of almost $1.8 billion.

During 1994, the GOP will have to make normal interest and amortization payments on past loans from these two MFIs, as well as on past loans from the IDB, in order to remain current. Required debt service payments to the MFIs will amount to $442 million during 1994, or about $37 million per month. Therefore, STMP dollars will be used to help Peru pay its debt service obligations during 1994. Net flows are projected to be the tightest during the second and fourth quarters because MFI cash disbursements are projected to equal debt service in the second quarter and fall short by $16 million in the fourth (see Table IV.1 below).

24

Table IV.1
STMP: Programmed Dollar Disbursements
Compared to Debt Service Owed to MFIs During 1994 by Quarter
(in $ millions)

Type of Capital Flow	Calendar Year 1994 by Quarter				Total for 1994
	first	second	third	fourth	
Projected MFI Cash Disbursements	--	75	250	65	390
Debt Service Owed to MFIs	139	75	147	81	442
Net MFI Flows	-139	0	103	-16	70
STMP Cash Disbursements	--	30*	22**	15***	67

Notes: * The $30 million undisbursed portion of the FY 1991 ESRP is expected to be released during the second quarter of CY 1994, of which a portion to be determined will be returned to USAID for an OE Trust Fund.

** First tranche of STMP, of which $3 million equivalent will be returned to USAID for an OE Trust Fund.

*** Second tranche of STMP.

Source: Based on preliminary data prepared by the IMF for the Article IV Consultations with Peru, March 1994.

2. Peru's Financing Gap

Peru's financing gap for 1993 was originally estimated at $410 million, after taking into account projected MFI disbursements and repayments and the terms Peru expected to receive when it rescheduled bilateral debt at the Paris Club in May 1993. This estimate also assumed Peru would make no repayments to commercial banks in 1993. The Support Group for Peru met informally in February 1993, then formally in June, to obtain pledges of financial support for Peru from its bilateral donors. As co-leader of that Group, the U.S. promised to provide $105 million in balance of payments support; Japan followed suit with a pledge of $100 million; by June, total pledges reached some $337 million. In anticipation of this shortfall in bilateral donor pledges, the May Paris Club rescheduling was more beneficial to Peru than had been originally planned. However, a major share of the U.S. pledge was not released in 1993[3] because of additional conditions relating to Peru's democracy and human rights performance, so actual bilateral disbursements totalled approximately $210 million for the year (other bilateral pledges also went unmet).

For 1994, the IMF estimates no public sector financing gap, and assumes $65 million in bilateral cash grants ($30 million from the U.S. and $35 million from Japan). As can be seen, the IMF

[3] In FY 1993 a $32 million P.L. 480 Title III donation was provided. The remainder of the $105 million pledge is scheduled to be provided in FY 1994. This will consist of a $15 million P.L. 480 Title III donation and release of the $30 million undisbursed portion of the FY 1991 ESRP (some of which may be returned to the USG to form a small OE trust fund). With the $37 million proposed under this FY 1994 STMP ($3 million of which will be returned to the USG for the trust fund), the entire $105 million USG pledge to the Support Group will be fulfilled.

estimate assumes that the USG will only disburse the $30 million undisbursed portion of the FY 1991 ESRP. Thus, the $34 million net transfer in balance of payments support will indirectly permit Peru to either: (i) increase imports beyond the IMF program level, (ii) increase international reserves more rapidly, or (iii) speed up repayment of remaining external debt arrears. Additional imports would allow the Peruvian economy to grow faster than the IMF's moderate 4.5% GDP growth rate target for 1994; a more rapid increase in international reserves would improve Peru's ability to weather a possible future BoP crisis and would improve Peru's bargaining position when it comes time to renegotiation Peru's commercial debt under some form of Brady Plan; whereas speeding up repayment of external debt arrears outside such an overall agreement is no longer feasible (as it was in Bolivia in 1985-86) because Peru's commercial debt is now valued so close to par (around 70%) in the secondary market.

Table IV.2
Peru's External Financing Gap for 1993-94
($ millions)

	1993 Actuals	1994 Proj.
Requirements	5,620	3,770
external current account deficit 1/	1,150	1,050
of which: merchandise imports	(4,000)	(4,130)
public sector debt obligations due 2/	4,180	2,560
increase in gross international reserves	290	160
Financing Plan	5,620	3,770
private sector capital inflows 3/	1,930	1,865
multilateral institutions 4/	2,080	390
Paris Club and other bilateral donor relief	850	900
deferral of obligations due to commercial creditors	550	550
bilateral donor disbursements 5/	210	65

Notes:
1/ excludes public sector interest due on medium- and long-term debt
2/ 1993 figure includes payments of arrears to the IMF and World Bank.
3/ Includes revenues from privatization: $130 million in 1993; $250 million in 1994.
4/ 1993 figure includes $870 million accumulated under the IMF "Rights accumulation Program" and $1 billion from three World Bank adjustment programs.
5/ Includes only cash grants; thus, excluding project funding and commodity assistance.

Source: Based on preliminary data prepared by the IMF for the Article IV Consultations with Peru, March 1994.

But rather than balance of payments support, the cash transfer under STMP is more accurately understood as providing support to the GOP budget, for payment of debt service obligations (in this case, debt service owed multilateral financial institutions). Table IV.3 below illustrates the GOP budget financing gap analysis. For 1994, the IMF program assumes a primary budget surplus excluding privatization revenues of 0.6% of GDP ($250 million). Assuming privatization revenues of the same order of magnitude, the IMF projects a total primary surplus of some $500 million, which is sufficient to finance only about 20% of the GOP's amortization and interest payments. Expected external financing may not be enough to cover total budgetary financing requirements (almost $2,000 million).

Table IV.3
Financing Gap of Peru's Consolidated Public Sector
(in US$ million)

Financing Line Items	1993 Actuals	1994 Projections
Primary budget surplus (excluding privatization)	(44)	(250)
Revenues from privatization	(132)	(250)
Primary budget surplus (including privatization)	(176)	(500)
Public sector interest payments due	1,408	1,486
Public sector amortization payments due	963	1,009
Public sector repayment of arrears	867*	**
Total budgetary financing requirements	3,062	1,995
Disbursements of multilateral donors	1,161	390
Paris Club rescheduling	644	684
Other bilateral donor rescheduling	212	213
Deferral of obligations due to commercial creditors	550	550
Disbursements of bilateral donors	210	65
Total available external financing	2,777	1,902
Required domestic financing	285	93

Note: * In 1993, the GOP repaid arrears owed the World Bank; in 1994, the GOP could repay arrears owed commercial creditors (or establishment of an escrow account to simulate repayment of arrears).

Source: Based on preliminary data prepared by the IMF for the Article IV Consultations with Peru, March 1994.

When viewed from this perspective, any increase in bilateral cash grants, such as STMP, will help reduce the required domestic financing indicated in Table IV.3, given the assumptions on available external financing. This is important because domestic financing of the budget deficit creates macroeconomic problems for the GOP. If the GOP borrows from the domestic commercial banking system, in all likelihood the

Bank of the Nation, then less domestic credit is available for private sector borrowers, which puts upward pressure on interest rates that are still too high. Central Bank financing of the budget deficit is expressly forbidden under the IMF agreement, as it is by the Central Bank's own by-laws, but in times past when the GOP did resort to Central Bank financing of its deficit, inflation was always the result.

3. Future Negotiations With Peru's Commercial Bank Creditors

Also as part of its obligations under the medium-term program with the IMF, Peru has agreed to initiate negotiations with its commercial bank creditors. While Peru has remained current with monthly debt service owed to the three multinational MFIs since late 1990, Peru has continued to build up arrears with its commercial creditors. Peruvian commercial debt was selling at a very heavy discount on the secondary market in January 1993 (under 20% of par value), but largely because of Peru's success in clearing arrears with the MFIs and its announcement at mid-year that commercial debt could be used in the purchase of privatized public enterprises, the value of Peru's debt had increased four fold by the end of 1993, to over 70% of par value! Sometime during 1994, Peru plans to negotiate an agreement with its commercial bank creditors, hopefully along the lines of the Brady Plan agreements negotiated by Mexico, Costa Rica and a number of other heavily-indebted countries. However, prospects for negotiating a "good deal" with its commercial creditors has been considerably clouded by the abrupt rise in the perceived value of Peru's unpaid debt, and some foreign bankers question whether it will be feasible to negotiate any such agreement during 1994.

The bottom line is: Peru needs dollars now to stay current on its external debt obligations.

B. Justification for Not Generating Local Currency

As noted in the first paragraph of this chapter, the GOP will make available to USAID/Peru an amount of host country owned local currency (HCOLC) for the purpose of financing a portion of USAID/Peru's in-country operating expenses. The transfer for trust fund will be required prior to release of the first tranche. The question remains, however, whether the GOP should be required to generate additional HCOLC resources for joint programming on projects of special interest to A.I.D., such as rehabilitation of the Selva/Coastal road. It is recommended that, although the road rehabilitation project is a high priority investment project for USAID/Peru -- it would contribute to both counternarcotics and economic objectives by reducing transport costs for products produced in the Sierra and the Selva, whether for export through coastal ports or for sale in urban markets -- Peru should not be required to deposit HCOLC in a special account for joint programming under the STMP. There are a number of reasons why Peru should not be required to make HCOLC deposits.

1. Halting Inflation: Still the Top Priority

The main reason for not generating HCOLC is an economic one; it derives from the fact that the primary objective of Peru's medium-term program with the IMF is to stabilize inflation, permanently and sustainably, at the one-digit level. But squeezing the last bit of inflation out of an economy used to high inflation invariably proves difficult to do. The annual inflation rate for 1993 was 40%, down only slightly from the 57% registered in 1992, whereas the medium-term program with the IMF specified a target rate of inflation two-thirds that much (27%) for 1993.

Peru experienced an upturn in inflation during October 1992 through May 1993, although it has been able to significantly reduce inflation since then, achieving a monthly average inflation rate of 2% for the last seven months of 1993. If maintained over an entire year, a 2% monthly inflation rate translates into a 27% annual inflation rate, so Peru was actually on target for the last half of 1993. However, the IMF inflation target for 1994 is 15%, so Peru will have to cut this annualized rate of 27% almost in half to fully comply.

The problem with high inflation is that investor confidence will remain low, especially that of foreign investors, until the economy is effectively stabilized. This means that as long as inflation does not fall significantly below its current, still relatively high level, the private investment necessary to create future growth will not be forthcoming. And without growth in the Peruvian economy, there is absolutely no hope of alleviating poverty or of successfully waging a counternarcotics effort. Although certainly not the only objective of Peruvian economic policy, fighting inflation remains the number one economic objective over the medium term.

2. Continued Tight Fiscal and Monetary Policy is the Way to Do It

The way Peru has chosen to fight inflation is by maintaining extremely tight fiscal and monetary policy while simultaneously allowing the exchange rate to float (see Annex B, Section B and Section D.1., for a detailed discussion of Peru's stabilization program over the medium term). In addition to encouraging Peru to refrain from financing the budget deficit with Central Bank credit through program conditionality, the best way A.I.D. can help Peru stabilize inflation is to help control the deficit. Therefore, in Peru's fight against inflation, the worst thing A.I.D. can do is to require Peru to generate and make advance deposit of a significant amount of HCOLC counterpart to the STMP cash grant.

The amount of Peruvian soles that could be involved is far from insignificant when compared to Peru's domestic currency money supply. For example, assume that, after subtracting the $3 million that the GOP will be required to grant to the Mission Trust Fund, the remaining $34 million of STMP resources is fully monetized. When added to the $15 million of HCOLC that would be generated from the $30 million disbursement from the FY 1991 ESRP (if that 1991 agreement is not amended),[4] a total of $49 million in HCOLC would be generated. For purposes of illustration, compare this amount of HCOLC to the actual increase in liquidity (domestic currency M2) for 1993 -- approximately S./ 1 billion. The HCOLC equivalent of $49 million would be equivalent to S./ 106 million at the exchange rate of December 31, 1993, or almost 11% of the increase in liquidity (domestic currency M2) during the entire year. And assuming the GOP continues to enforce monetary restraint during 1994, thus further slowing inflation, the nominal increase in liquidity in 1994 is likely to be smaller than it was in 1993, which would make the HCOLC equivalent of $50 million even larger than 11% of the increase in liquidity. These estimates show that the equivalent of $50 million in Peruvian money is by no means insignificant, given the low level of "monetization" and high degree of "dollarization" that currently prevail in the Peruvian economy. Requiring Peru to add this amount of HCOLC to the budget, and therefore to monetary aggregates, could play havoc with Peru's objective of achieving further progress in bringing down inflation during 1994.

3. The Negative Impact on Growth if HCOLC Deposit is Required

Requiring HCOLC deposits, thus increasing the budget deficit, would put pressure on the Central Bank to allow domestic currency M2 to increase more rapidly than the target level. If the Central Bank resists this pressure and stays within the nominal target, this amount of HCOLC would mean that the Central Bank would have to reduce the amount of dollars it could buy by around 6%. This is because the IMF program specifies a direct one-to-one relationship between Central Bank money emission and dollar purchases, and the increase in primary emission has tended to be about half the increase in domestic currency M2 since

[4] The FY 1991 ESRP originally was designed to require generation of HCOLC in an amount equivalent to the full dollar value of the grant ($50 million). The first tranche of $20 million was disbursed in December 1991 but the GOP was reticent to use the available dollars to pay debt obligations because the GOP did not have adequate sufficient budgetary resources to deposit into the local currency account. Therefore, the ESRP agreement was amended so that no HCOLC was required from that first tranche, although the amendment did specify that $15 million in HCOLC (for use in rehabilitating the Selva/Coastal road) would have to generated and deposited when the remaining $30 million was disbursed.

1991. Buying fewer dollars means that the Central Bank will not be able to counter pressures for further appreciation of the sol as effectively as it would without the HCOLC deposit requirement. The result will be continued stagnation in export growth. Therefore, such a large HCOLC requirement would not only threaten Peru's anti-inflationary policy, but would also reduce Peru's already limited ability to reverse the 1993 trend toward real appreciation of the exchange rate.

4. Dollars-for-Debt Do Not Generate Local Currency Resources

When cash transfer dollars are used to repay external debt, they play a very different role in the economy than do cash transfer dollars used to purchase additional imports. In the latter case, local currency resources are withdrawn from the private sector and turned over to the public sector. Therefore, if the public sector uses them, even outside of the budget, they would not add directly to the money supply. They would, however, add to the budget deficit, but their impact on inflation would depend on whether this increase in the deficit is financed by the Peruvian banking system (inflationary) or is financed externally (not inflationary). If, however, the cash transfer dollars are used to repay debt, as would be the case with STMP dollars, the situation is quite different. Requiring them to generate HCOLC in this case would mean more money chasing the same amount of goods, and would unquestionably be inflationary.

5. A Practical Reason for Not Requiring HCOLC Deposits

In addition to the economic reason for not requiring the GOP to generate and deposit HCOLC -- to help the GOP bring down inflation -- an operational reason also mitigates against the desirability of requiring the GOP to do so. Our experience with the FY 1991 ESRP has been that requirement for such generation and deposit leads to problems with IMF terms and, quite simply, great difficulty with the GOP in advancing large cash payments for activities which cannot disburse quickly. The GOP is correct when it argues that it is poor budgetary management to deposit HCOLC in a separate account for a development activity before the GOP is ready to expend those funds for the appointed use.

6. An Alternative to Requiring HCOLC Deposits

The reason that A.I.D. often requires deposit of HCOLC into a special account is to help ensure that adequate funds are actually made available to high priority Mission projects. Instead of requiring HCOLC deposits, the Mission has attached a condition precedent to disbursement of the second tranche of the STMP that requires the GOP to budget for and begin to expend funds for Selva/Coastal road rehabilitation.

V. DOLLAR AND LOCAL CURRENCY PROCEDURES

A. Summary

The U.S. dollar funds will be used to finance official GOP debt service owed to the International Monetary Fund, the World Bank and the Inter-American Development Bank. This is consistent with the ESF Cash Transfer Assistance -- Amplified Policy Guidance. Service of debt incurred for military imports or other military requirements and other items A.I.D. cannot finance because of specific legal prohibitions will be ineligible. The detailed procedures for the programming and control of the dollar funds are described in the following sections.

As stated previously, a primary rationale for programming external debt service payments to the MFIs is that it is directly supportive of the financial integration effort and establishment of normal relations with those multilateral development banks, as well as economic stabilization and recovery in the context of sound, market-oriented outward looking economic policies. Support for the economic stabilization program to eliminate fiscal, monetary and trade imbalances impacts directly on increasing incentives for legitimate alternatives to coca production.

Programming dollars to service debt will fully absorb them since, payments coming due on existing debt to the MFIs during 1994 is estimated at $442 million (about $37 million per month). Allowing the use of dollars for debt service also entails minimum A.I.D. management responsibility, while offering simplicity, optimum internal control and low vulnerability. The Central Reserve Bank of Peru (BCR) will be the custodian for the separate dollar account and dollar transactions. This system was used for the FY 1991 ESRP agreement.

Programming of dollars for U.S. imports would be highly inadvisable given: a) the balance of payments justification of the program and b) the fact that Peru has open markets, making tracking and recording of such transactions extremely difficult. Opening markets to imports was a major achievement of the Fujimori reform program, which the USG lauded. Requiring the grant to be tied to U.S. imports would be an act contrary to GOP public policy. In any case, around one-third of Peru's imports do, in fact, come from the U.S., so there is no need to tie the cash transfer to U.S. exports.

B. Programming the Use of U.S. Dollars

As stated above, Program dollars will be used to service official debt of the GOP to the two multilateral development banks and the IMF. The GOP will group together eligible debt payments due in the time period in which the dollar disbursements are expected to take place. Notice will be given to the Grantee when A.I.D. is ready to disburse dollars. Disbursement of dollars to the separate account, deposit of local currency, and withdrawal of dollars from the separate account to effect payment of official debt of the GOP, in that order, should take place within several weeks. As described below, this is the simplest and least vulnerable system possible for managing dollars.

It should be noted that this schedule did not hold for the first tranche of the 1991 ESRP, which was designed prior to the issuance of current cash transfer guidance, and had a requirement for GOP local currency contributions of 100 percent of dollar value. This requirement was eventually eliminated on the advice of A.I.D./Washington. Setting up systems for transfers also proved complicated for the GOP, hence slowing transfers. This technical problem should not exist for the STMP program, although limited liquidity in the MEF may still slow down the transfer process. Procuring local currency for contribution to the program has proven to be difficult, even at a lower percentage contribution than originally required.

C. Separate Dollar Account

The following are the steps and/or provisions which relate to management of the separate dollar account:

- The GOP will establish a separate, interest bearing U.S. dollar account ("Separate Dollar Account") in the name of the BCR at the Federal Reserve Bank of New York (FRB), exclusively for this program, to be managed by the BCR as part of the GOP's official reserves.

- Upon the GOP meeting conditions precedent to disbursement, disbursement of $22 million in Tranche 1 and $15 million in Tranche 2 will be made to the separate account of the GOP in the FRB.

- The transfer of funds by the U.S. Treasury to the BCR separate dollar account in the FRB will be made within 48 hours, without any intermediary banks nor accounts.

- The funds in the separate dollar account at the FRB will be placed in U.S. Treasury Bills of short-term maturity to provide interest income while there are no public debt calls on the balance. Any interest income will become part of the principal balance.

- The Cash Management Committee chaired by the MEF will determine what debt service is to be paid by STMP dollars and will submit appropriate documentation to A.I.D.

- The BCR will make payments on GOP official debt to the International Financial Institution (i.e. IMF, IBRD or IDB) directly out of the separate account in FRB.

- The Grantee (i.e. the GOP) will submit monthly reports to support disbursements made for each payment of debt (principal and/or interest).

- The following documentation will be submitted in the reports: (1) copies of MEF/BCR authorization to the FRB (in which the separate account has been established) which authorized payment to the approved creditor and telexed confirmation from such creditor of payment; and (2) name of creditor to which payment was made and the amount involved.

- The Grantee will re-deposit into the separate dollar account at the FRB, any amounts, in dollars equivalent to payments made to service debt which have been determined to be ineligible.

D. Description of the Local Currency Program

According to the Supplemental Guidance on Programming and Managing Host Country-Owned Local Currency (issued in June 1991) and Policy Determination 18 (dated July 30, 1991), there is no requirement for local currency generation, as the dollars are used to service external public sector debt (PD-18, para. 4.3). However, A.I.D. will choose to require a GOP contribution of HCOLC ($3 million) for an A.I.D. Administrative (OE) Trust Fund. This deposit for the Trust Fund is to be made after conditions precedent to dollar disbursement have been met and dollrs have been disbursed to the separate dollar account for Tranche 1, but prior to release of dollars to service debt. This is consistent with prudent management of the money supply, which is essential given Peru's circumstances.

In lieu of requiring a counterpart contribution (generation or deposit) of HCOLC to finance counternarcotics activities of mutual interest, the GOP will be required to budget and start spend from its own resources for rehabilitation of the Selva/Coastal Road prior to release of the second tranche.

VI. CONDITIONS PRECEDENT-ECONOMIC REFORMS

A. Conditions Precedent to the First Tranche ($22 million)

1. Standard CPs (accounts, etc.)

2. Transfer of $3 million for the USAID/Peru Trust Fund

3. Non-economic conditions (as detailed in classified annex)

B. Conditions Precedent to the Second Tranche ($15 million)

1. Continued Adherence to Sound Economic Policies

First, the Government of Peru will continue to adhere to the set of sound macroeconomic policies that it has introduced over the past 40 some months, policies deemed by the USAID/Peru to be the most critical to the future success of Peru's efforts to stabilize inflation and implement needed structural adjustments. The Government of Peru:

a.1 will continue to adhere to a unified, market-based exchange rate.

a.2 will maintain no more than two tariff rates on imports, where, in the absence of full unification of tariff rates:

- o the lower rate does not exceed 15% and the higher rate does not exceed 25%,
- o no tariff position currently at 25% will be assigned a tariff any higher than 25% or different from the lower rate, and
- o no tariff position currently at 15% will be assigned a tariff any higher or lower, except as the consequence of moving the lower rate further downward as a unit.

a.3 agrees not to reintroduce any non-tariff barriers.

a.4 agrees to comply with the schedule and pattern of changes to the variable tariff surcharge system on selected food imports agreed to with the IDB in July 1993.

a.5 agrees, with regard to export promotion, not to:

- o introduce any export subsidies which contravene GATT regulations.
- o reintroduce export taxes, all of which were eliminated in January 1992.

a.6 agrees to limit public sector development banking to second-tier institutions.

37

a.7 agrees to maintain a primary surplus (excluding revenues from privatization) on the consolidated public sector budget.

a.8 agrees to ensure that the Central Bank continues to refrain from financing any part of the consolidated public sector budget deficit.

2. Additional Trade and Marketing Reforms

Second, the Government of Peru will consider implementing a set of trade reforms and making critical budgetary expenditures, as noted below. The GOP plans to carry out all of these actions during 1994 as part of its medium-term economic program, but it needs additional foreign exchange resources which will enable it to maintain an external balance, and so be able to carry out these plans. These conditions will be applied to the second tranche. The Government of Peru:

b.1 agrees to improve the marketing system of agricultural products by:

b.1.1 soliciting support of multilateral and bilateral donors to finance the Selva/Coastal road and other road infrastructure providing Selva producers improved access to markets for licit crops;

b.1.2 including sufficient funds in the Central Government's 1994 Budget (approximately the equivalent of $15 million) to complement road rehabilitation work on the Selva/Coastal road carried out by these multilateral and bilateral donors;

b.1.3 presenting a timetable of scheduled expenditures on the road rehabilitation work that shows the Government's intent to expend budgeted funds over the period of the medium-term program;

b.1.4 beginning actual rehabilitation work on the Selva/Coastal road no later than June 1994 (benchmarks will be specified by PIL for progress for 1994-95); and

b.1.5 with regard to ENCI, the parastatal agricultural marketing firm:

o ensuring that ENCI does not participate in the importation and sale of Title III wheat, neither directly nor indirectly;

o refraining from providing any direct or indirect subsidies to ENCI;

o not allowing ENCI any import or marketing monopolies;

o nor providing any other form of special treatment such as ENCI received in the past.

b.2 agrees to strengthen the tax drawback system for exported goods by:

b . 2 . 1
improving the comprehensiveness and effectiveness of the existing tax drawback system as it relates to the IGV;

b . 2 . 2
conducting a study on the tax drawback system for exported goods as regards the likely impact on the economy of extending the system to cover other indirect taxes; and

b . 2 . 3
taking the findings of the tax drawback study into account, and discussing these findings with the IMF, in an effort to refine the existing system of tax drawbacks.

VII. AUDITS AND REPORTS, COMPLIANCE WITH DOLLAR AND LOCAL CURRENCY GUIDANCE

A. Audits

The GOP will have the Dollar Separate Dollar Account and the uses of the local currency provided for the operations of the MEF special management unit audited annually in accordance with a scope of work to be provided by A.I.D.

B. Reports

As described above, the Grantee will provide implementation progress reports to A.I.D. on a quarterly basis. The BCR, as the managing entity for dollars, will report on the servicing of debt. In addition to the quarterly formal reports, the BCR will provide Separate Bank Account reports to A.I.D. on a monthly basis.

C. Compliance with Dollar and Local Currency Guidance

In designing the dollar and local currency procedures for programming, use, control and reporting, the following guidance documents were adhered to: (i) ESF Cash Transfer Assistance-Amplified Policy Guidance (HB 1, Part IV); (ii) Financial Management Guidance on Dollar Separate Accounts for ESF Cash Transfers, etc. (90 State 194322); and (iii) Supplemental Guidance on Programming and Managing Host Country-Owned Local Currency (91 State 204855), and 4) A.I.D. Local Currency Policy (PD-18, 7/30/91).

Dollar programming and procedures are in compliance with the first two documents in the following ways:

- a separate, interest-bearing dollar account will be established;
- cash transfer dollars will be "used for servicing debt owed to multilateral development banks and the IMF", as allowed in the ESF Cash Transfer Policy Guidance (No. 1, above);
- the cash transfer will be transferred in a most expeditious manner to the dollar separate account, i.e. within two business days;
- the program agreement will require reports on the status of separate account activity to be submitted to USAID/Peru on at least a quarterly basis (the BCR will provide monthly financial transaction reports);
- audits will be performed at least once a year, by independent auditing firms applying GAO standards; and
- an institutional assessment of the Host Country agency responsible for managing the separate dollar account, i.e. the BCR, was carried out by USAID's Controller Office in 1991. The results were positive.

VIII. FINANCIAL MANAGEMENT CONDITIONS AND COVENANTS

A. First Tranche: $22 million

Prior to the disbursement of the first tranche (expected to be effected in April 1993), the GOP will comply with the following financial management conditions for which evidence satisfactory in form and substance to A.I.D. will be submitted:

-- Establishment of a separate account and a special account for the deposit of the US dollar proceeds of the grant,

-- Execution of a trust account agreement, between the GOP and A.I.D., to make available local currency, from the first local currency deposit, to fund administrative expenses (OE). The Administrative Expenses Trust Agreement will provide the local currency equivalent of $2 million.

B. Second Tranche: $15 million

The conditions precedent for the second tranche, in terms of economic policy performance, are found in Chapter VI.

ANNEX A

PERU'S ECONOMIC COLLAPSE AND ROAD TO RECOVERY

38

ANNEX A

PERU'S ECONOMIC COLLAPSE AND ROAD TO RECOVERY

Annex A outlines the evolution of Peru's economy through 1993, with special attention to the period 1990-93. Specifically, the annex describes progress in fulfilling the objectives of the macroeconomic stabilization program and the structural reforms implemented by the current administration since 1990 to reactivate growth.

The annex is divided into two sections: a background summary of the secular economic deterioration of the Peruvian economy, going back at least to the 1960s, and its eventual collapse in the latter part of the 1980s; and a more detailed analysis of the first 40 months or so of Peru's economic stabilization and recovery program, through December 1993, in terms of both policy implementation and economic performance.

A. Decline and Collapse of the Peruvian Economy

1. Secular Decline of the Peruvian Economy

In the early 1960s the Peruvian economy stood out as one of the most promising in Latin America. In fact, its broad endowment of natural resources and a stable macroeconomic environment promoted a dynamic exporting sector and high rates of economic growth. Development expectations, however, were frustrated by 25 to 30 years of increasing government intervention, extreme import substitution policies and spiraling macroeconomic instability. By the end of the 1980s the Peruvian economy had retrogressed to such an extent that income and exports per capita were comparable to those of the 1950s.

Well-meaning institutions established in the early 1970s, such as employment stability laws and agrarian reform, aimed at protecting workers and farmers, respectively, proved detrimental to these objectives. (Putting land ownership firmly in the hands of small farmers and providing them with technical assistance might have worked; tying land ownership to communal institutions with little or no services was doomed.) In parallel, the overexpansion of the State's economic activities led to resource waste and stagnation. Government intervention in pricing, interest rates, credit allocation, and labor markets resulted in major distortions of relative prices and the emergence of a large informal economy. Inefficient import substitution was encouraged by means of quantitative import restrictions and high tariffs, and a generally overvalued exchange rate favored urban consumers and discouraged export and agricultural production. Chronic macroeconomic imbalances and market distortions -- aggravated by the particularly expansionary and interventionist economic policies implemented from 1985 to 1990 -- led ultimately to hyperinflation, deep recession, and a sharp decline in most social indicators.

The secular deterioration of the economy is further evidenced in the near total collapse of the Peruvian state. Although this collapse of the state was especially precipitous during 1988-90, it is more accurately characterized as a gradual decay of effective state control, over several decades. The GOP has lost the ability to raise revenues, and therefore the ability to maintain adequate expenditures for salaries, public investment and public services. The role of public enterprises within the Peruvian economy, including state banks, was greatly reduced, ironically, during the last few years of the Garcia government. The GOP lost regulatory control over the economy as reflected in the dramatic growth of the informal, i.e. extra-legal, economy. And finally, it is no longer able to maintain social order.

The most obvious case is the collapse of GOP control over fiscal policy -- budgetary revenues and expenditures. By 1990, per capita government expenditures and revenues (not including public enterprises) had fallen to $200 and $160, respectively, from 1975 figures of $1000 and $710, respectively. The greater decline in expenditures is due to the fact that by 1990, the GOP was no longer able to finance much of its expenditures with credit -- no one was willing to lend money to the GOP.

The role of the public enterprise sector in the Peruvian economy declined dramatically -- by about one-third in terms of gross sales, where public enterprises accounted for around 25% of total gross sales in 1975, but only about 9% in 1990. In addition, the state banking system declined in importance during 1985-90; even though the Garcia government had nationalized the banking system, the national development banking system all but disappeared, replaced by rapid growth of informal credit. State banks accounted for 64% of credit issued in 1985, but only 48% by 1990, despite Garcia's overt nationalization of the banking system. The collapse of GOP control over monetary policy and exchange and trade policy reached crisis proportions by 1990; the GOP has not yet regained effective control of the financial system -- money supply and interest rates -- nor the exchange rate.

Peruvian society had lost respect for government authority and public institutions had lost their legitimacy in the eyes of Peruvian citizens. This is witnessed by such phenomena as the recent collapse of the political parties, the growth of terrorism over the decade of the 1980s, and the gradual increase in the role of informals as the private sector responded to intensified bureaucratic controls imposed during 1960-90 by evading those controls. How? By getting small, or by bigger firms subcontracting with smaller ones. This defensive strategy of the private sector, through evasion of bureaucratic controls, was especially intense during the last years of the Garcia regime.

Finally, Peru has suffered from one of the most unequal income distributions in the developing world, and it has probably gotten even more unequal as the Peruvian economy deteriorated. Some figures demonstrate this: labor income has fallen from 34% to 24% from 1975 to 1990 due to a compression of labor incomes and a decrease in regional inequalities; whereas income inequality within the remaining sector -- between profits and income of informals -- increased; and the spread between profits and labor income also increased.[1]

2. ... And Eventual Collapse

From July 1985 to July 1990, economic policies attempted to raise the rate of economic growth by boosting domestic demand through credit expansion, tax reductions, increased public sector employment, and government-mandated wage increases. Following a short-lived boom with GDP real growth rates averaging nearly 7% a year in 1985-87, real GDP contracted on average by over 8% a year on average in 1988-90; inflation climbed steadily from 100% during 1987 to 1,700% for 1988, eventually reaching 12,000% for the twelve-month period up to August 1990. Inflation was caused by budget deficits in excess of 8% a year (on average) during 1987-90 and Central Bank losses which hit 3% of GDP in 1988. Domestic savings fell and the external current account swung from approximate balance in 1985 to a deficit of nearly 5% of GDP in 1990. Moreover, Peru's extremely distorted and highly unstable relative price structure consisted of as many as 11 exchange rates, widespread price controls, and 15 import tariff levels, ranging up to 160%.

---

[1] Figures provided in a lecture by Richard Webb, ex-Governor of Peru's Central Bank during 1980-85, given at Inter-American Development Bank, Washington, D.C., November 30, 1992.

Public sector deficits were the result of widespread subsidies (through low public sector tariffs and prices) and of reductions in tax revenues (largely promoted by the Government's own policy of tax exemptions). In turn, Central Bank quasi-fiscal losses stemmed from multiple exchange rates,[2] financial subsidies, and outright monetary transfers to development banks, in particular to the Agrarian Bank. The consolidated public sector deficit, including the Central Bank's foreign exchange and financial losses, surpassed 10% of GDP in 1987 and 1988.

Policy during the latter half of the 1980s reversed financial liberalization: convertibility of domestic currency deposits into foreign currency deposits was suspended; interest rate ceilings were reduced; legal reserve requirements were increased to finance subsidized public sector credit, primarily to agriculture; and monetary expansion spiraled out of control. The result, by the end of the decade, was a dramatic reduction in financial intermediation in the formal banking system: broad money (M2) and credit to the private sector in real terms were only 27% and 20%, respectively, of their 1985 levels.

B. Peru on the Road to Recovery

1. Overview

The new Government which took office in July 1990, immediately adopted a firm economic stabilization program aimed at bringing inflation down to world standards. This has been accompanied by structural reforms designed to turn the resource allocation process back over to competitive and efficient markets. Through these reforms, the GOP hopes to establish the framework for sustained economic growth, with the private sector playing the dominant role in allocating resources. By general consensus, Peru has implemented more reforms, more deeply, in a shorter time, than any other country in Latin America.

There have been three clearly differentiated phases in the program's implementation: first, the period July 1990 to February 1991, during which Juan Carlos Hurtado Miller was the Minister of Economy and Finance; and second, the period from February 1991 through December 1992, during which Carlos Boloña was the Minister of Economy and Finance. In the first period, a short-run stabilization program was designed and implemented and the first structural adjustment measures were taken. Economic policy during the second period continued to hold down aggregate demand, but focused on extending and deepening the structural reforms and began to deal with the massive arrears on external debt.

A third phase of Peru's economic stabilization and recovery program began in January 1993 when Peru developed and began to implement a medium-term economic program. The program will run through 1995 and is intended to finish the job of stabilizing and reactivating the Peruvian economy. The new Minister, Jorge Camet, has guided economic policy through the first year of this third phase. In March, Peru's medium-term program got a dramatic send-off: the Support Group of bilateral donors met and approved the program in early March, and later that month Peru took a huge step toward reintegrating itself into the international financial community by clearing its arrears with the IMF and world bank. Peru's medium-term program will be outlined and analyzed in Chapter IV.

---

[2] Central Bank losses on exchange rate transactions under a multiple exchange rate system arise when the Central Bank buys dollars from exporters at a higher price in soles than it sells dollars to importers.

The economic measures taken through 1992 have included tight monetary and fiscal policies and the removal of price controls and subsidies aimed at correcting the fiscal deficit; market- determination of the exchange rate and interest rates; opening the economy to external trade and international finance by lowering tariffs and eliminating most barriers to the flow of goods and financial resources. Domestic markets have been deregulated, and the legal frameworks of the labor, land and investment markets have been freed of distortions produced by government intervention. Important institutional and judiciary changes have also been made, including: simplification of the tax system and strengthening of the tax collecting institutions; reduction in public employment; removal of state monopolies, among them those in agricultural marketing; and commencement of a process to privatize public enterprises.

Since August 1990, Peru's stabilization program has overcome hyperinflation. Major relative prices have been realigned, such as the exchange rate and utility prices, and structural reforms designed to allow markets to behave more competitively have been introduced, but the positive impact of these policies will take longer to be felt. The GOP's economic policy reform program has won the support of the three international financial institutions (MFIs) -- IMF, IDB and World Bank. This, in turn, enabled Peru to reschedule its official debt in 1991 at the Paris Club -- and again in 1993 -- on generous terms reflecting confidence in Peru's policies.

By 1993, the economic program's achievements are impressive: the monthly inflation rate fell to 2% in the last half of 1993, from over 60% just before the stabilization program began; the annual fiscal deficit has been lowered to around 2% of GDP, down from 7-8%; market distortions have been removed; the privatization program began with some success; and success in 1993 in reestablishing ties with the international financial institutions and its bilateral creditors (with stated plans to negotiate, later this year, a debt rescheduling agreement with its commercial bank creditors). On top of this sound economic performance, growth of nearly 7% appeared, once external factors softened their touch.

Serious economic problems still remain, however. Although the deep economic recession of 1992 seems to be over, employment has yet to grow. The exchange rate remains overvalued by 10-25%. Tax revenue, currently at around 9% of official GDP, is significantly below the level that will be required to finance public sector services in a market-oriented economic policy environment. Only a full-fledged tax reform will provide a solid revenue base. Privatization efforts need to be completed. Many important laws which have already been promulgated, such as the reform of land ownership, need to be implemented more thoroughly. The policy-making governmental institutions -- Ministry of Economy and Finance, Bank of the Nation, Central Reserve Bank, National Superintendency of Tax Administration -- need to coordinate their policy design and implementation more closely. There is a need for more managerial capacity in different public institutions. The private sector may be able to help in this regard.

The political events associated with the April 5, 1992 suspension of the Constitution made it easier for the Fujimori Government to introduce important economic reforms but clouded economic prospects in other areas. Public international reaction to the dissolution of Congress was negative and the United States, Germany, France, Belgium, and Spain announced the temporary suspension of aid, excepting only humanitarian assistance. Some countries belonging to the Support Group reduced their funding after April 5. Following the election of a Constituent Assembly (CCD) in November 1992, Municipal Elections in January 1993, and the referendum on the new Constitution in October 1993, the situation has returned to the status prior to April 5.

2. Stabilizing the Peruvian Economy

a) Inflation

The annual inflation rate for 1993 was 40% (for an average monthly rate of 2.8%), down somewhat from the 57% registered in 1992. Even though this represents a substantial reduction compared to the hyperinflationary levels of the recent past, and is less than a third the 139% inflation rate in 1991, a 40% annual rate of inflation still constrains sustainable economic recovery. GOP deflationary strategy has relied on tight monetary and fiscal policies -- money supply was chosen as the nominal anchor for prices instead of the exchange rate. Using a monetary anchor may have tended to draw out the stabilization process, and a drawn-out process of bringing down inflation places greater strain on the government's ability to maintain credibility in the stabilization on the part of the public.

The problem is that the task of squeezing the last dregs of inflation out of the economy gets more difficult: inflation in 1993 was only slightly down from the 57% registered in 1992 because of an upturn in inflation at the end of 1992 that continued five months into 1993. The good news is that monthly inflation since June 1993 has averaged 2% per month. If this pace of inflation can be maintained through 1994, that would yield an annual inflation rate of 27%, so only a slight improvement over recent performance will enable Peru to reach the 15-25% range targeted by GOP for 1994. Four main factors have contributed to Peru's stubborn inflation in Peru.

<u>Fiscal policy</u>. To the extent that Peru's stabilization effort lacks credibility, it derives largely from the fragile fiscal equilibrium. Fiscal expenditures, currently approaching 12% of GDP, are insufficient to cover minimum needs. Therefore, economic agents expect fiscal spending to increase. Indeed, the loosening of fiscal restraint in response to these pressures late in 1992 contributed to an upturn in monthly inflation rates. This danger is especially acute over the next year, as Peru heads for Presidential elections in early 1995.

<u>Overvalued exchange rate</u>. Economic agents expect that the current overvaluation of the exchange rate will be reversed sometime in the near future. This introduces more inflationary expectations and further questions whether the GOP will have the political will to enforce the even greater fiscal and monetary restraint that will be necessary to hold down inflation when the Peruvian sol is finally devalued. The 60% nominal devaluation of the sol with respect to the $US over the period March to November of 1992 validated these expectations, while the 7% appreciation since then will build up expectations for another devaluation.

<u>Indexation schemes</u>. Several indexation mechanisms were reestablished after the August 1990 stabilization package was introduced. For instance, the GOP initially encouraged wage indexation, but changed its stance in 1992 by enacting a law to forbid automatic indexation rules in private wage increases. Public price increases, such as for gasoline and electricity, have an important inflationary impact on several items of the consumer price basket. Early in the stabilization process, the GOP indexed these prices to past inflation in order to maintain fiscal revenues. These backward-looking indexation schemes introduce inertia into the price system, causing inflation to be downward sticky. Forward-looking indexation, tied to projected future inflation, would eliminate this inertial effect of indexation on inflation.

<u>Inconsistent monetary policy</u>. Erratic monetary policy, that persisted to one degree or another through the first quarter of 1993, also affected the GOP's effort to stop inflation, largely because the monetary authorities have attempted to pursue two objectives with monetary policy. On the one hand, they try to use monetary policy as the nominal anchor to restrain inflation by strictly limiting growth of the money supply, but on the other, they by dollars to push up the

exchange rate and reduce the large overvaluation. In response to the October 1992 upturn in inflation, but with a six-month lag, the Central Bank intensified its anti-inflationary policy in the second quarter of 1993 by applying a consistently restrictive monetary policy, limiting monetary emission to an average of 1% per month, yet allowing for higher seasonal money demand in July and December.

b) From Recession to Growth

After three consecutive years of large declines in real GDP, the economy temporarily recovered in 1991 with positive GDP growth of 2.6%, but entered into recession again in early 1992 and real GDP declined by 2.8% for the year, wiping out the previous year's gains. The largest sectoral declines were registered in:

electricity	-10%
manufacturing	-6%
agriculture	-6%
fishing	-5%
and mining	-5%

In order to help reverse this situation, the GOP put together a reactivation package for the second half of 1992, consisting basically of higher public expenditures and some relief for the financial situation of banks. This package contributed to the upturn in the rate of inflation in late 1992 and early 1993, but had little impact on growth. The 1993 surge in growth (6.8% for the year) was largely supply driven, and was concentrated in the primary sectors like fishing (37%), mining (8%), and industrial processing of primary products (15%). Good weather also enabled rapid growth in electricity output (14%) and respectable growth in agriculture (6%). Construction also grew rapidly (14%) because of highway projects financed by the IDB and World Bank.

The employment picture remains discouraging. At the national level, open unemployment declined significantly in 1991, but so did the number of fully employed as the number of underemployed increased by 5 percentage points of the total labor force. Underemployment has more than doubled since 1987 as a share of the total labor force. Better data is available for the Lima metropolitan area (which covers formal sector firms with 100 employees or more); they show a moderate secular decline in aggregate employment during 1988-91, with a sharp drop in 1992 because of the recession. The cumulative decline in Lima employment during 1988-92 was 15%, with half of that decline occurring in 1992! Employment in manufacturing and commerce declined more than this while employment in services declined only slightly. This leaves no doubt that (under)employment in the informal sector has burgeoned over the past four years. It is doubtful that the 1993 recovery improved this situation much because mining and electricity do not employ many and the fishing and manufacturing sector increased productivity rather than increase employment levels, but growth in construction and agriculture may have increased urban and rural employment somewhat. The situation with wages and salaries is more heartening. Although they fell dramatically right after the new Government came into office, they have risen significantly since then, such that by mid-1993 they were 50-60% of their 1988 level.

As for the 1992 recession, it had a variety of causes: tight fiscal and monetary policy have kept a lid on aggregate demand; overvaluation of the exchange rate has held back any potential boom in exports; trade liberalization led to an import boom that hurt (inefficient) import substituting manufactures; intensified terrorism during 1991-92 hit agriculture and mining hard in the Sierra; and the "El Niño" phenomenon hurt all of the declining industries. The impact of the latter was significant in several ways: by causing a drought and warming the Humboldt current, it had a direct negative affect on agriculture and fishing; and indirectly, it hurt manufacturing and mining activities by causing a shortage of hydroelectricity. The year 1993 was free of such natural causes of economic

44

downturn, and the intensity of terrorist attacks also declined, with the capture in late 1992 of most of the leadership of Sendero Luminoso.

The tight monetary and credit policy has raised interest rates in real terms to extremely high levels, generating growing financial costs for firms and at the same time increasing the fragility of the financial sector. High interest rates also led to large short-term capital inflows that helped to appreciate the currency in real terms. Tight fiscal policy not only has meant a cutback in expenditures, but has increasingly replaced the inflation tax with an increase in taxes on the business sector. In addition, although public utility prices, such as those on electricity, water and fuel, remain well below their 1985 levels in real terms, they have been raised in real terms since 1990, causing supply shocks.

The negative effects of a depressed real exchange rate have hurt tradable sectors and encouraged the non-traded sectors, i.e, construction and services. On the demand side, the combined effects of real appreciation and trade liberalization cheapened imports in real terms, producing a strong rise in imports through 1992.

c) Fiscal Balance

In 1992, the non-financial public sector deficit stood at 1.7% of GDP, compared to 2.6% in 1991. Although it was in approximate balance over the first six months of 1993, expenditures increased over the second half of 1993 and a deficit somewhat greater than 1992 is expected. Part of the 1992 deficit was financed domestically (probably by the public sector Bank of the Nation), but the budget deficits for the years 1990 and 1991 were totally financed by external borrowing. Even with the new tax measures and major improvements in tax administration and tax structure, Central Government tax revenues accounted for only 8.7% of GDP in 1992, up from 4% in the late 1980s but barely enough to cover minimum levels of essential public services and domestic security. In 1993, tax collections continued to disappoint, with preliminary figures indicating a figure slightly above 9% of GDP. Simultaneously, Central Government expenditures were reduced from nearly 13% of GDP in 1990 to 11% in 1992, and to 10% for the first half of 1993. However, interest payments on public sector debt added another 2% of GDP to the 1992 and 1993 budgets.

In the first semester of 1992, the GOP tightened its fiscal stance through greater restraint of public expenditures, which reduced the Central Government deficit to near balance -- an estimated 0.5% of GDP. This "over-adjustment" in the public sector accounts had a negative impact on aggregate demand and deepened the 1992 recession. Other public institutions and funds also cut spending during the first months, accumulating a slight surplus of around $400 million on the consolidated public sector budget balance. This surplus was used to stimulate growth in the second semester of the year, but was too little.

The primary balance of the consolidated public sector budget has improved dramatically during the first year of Peru's stabilization and recovery program, going from <u>a deficit of 2%</u> of GDP in 1990 <u>to a surplus of 0.5%</u> in 1991. In 1992 the primary surplus fell back to a minimal 0.1% of GDP, but is likely to increase to near 1% of GDP in 1993. The quasi-fiscal deficit was reduced from 1.1% of GDP in 1990 to 0.3% in 1991 and in 1992 declined further to 0.1% of GDP. These improvements came about because the exchange rate was unified and the Central Bank stopped channeling subsidized credit to public sector banks. The last bit of quasi-fiscal deficit was eliminated in late 1993 when the Central Bank reduced the high interest rate it had been paying commercial banks on their foreign exchange reserve deposits with the Central Bank, bringing that rate in line with the return it obtains by reinvesting these deposits in world capital markets.

Appreciation of the real exchange rate also has a negative effect on the fiscal situation. Appreciation depresses the value added tax base on traded activities -- imports, exports and import-substitutes -- and lowers revenues from import duties. Although real appreciation increases the tax base for non-traded activities, tax collection on these activities -- mostly services and informal commerce -- still lags behind that on the more easily observed traded activities. And appreciation increases fiscal expenditures: almost all fiscal expenditures are for non-traded goods and services and an overvalued exchange rate makes these more expensive.

d) Monetary Policy and Banking

Since 1990, the GOP has remained committed to a tight monetary and credit policy, in order to stabilize inflation and achieve external balance, and further tightening this policy in 1993 to intensify its anti-inflationary stance. The shift into foreign currency deposits that started in 1988 -- what is termed the "dollarization of the economy" -- continued during the period 1989-93. The share of foreign currency deposits in broad money increased from 22% in 1989 to 60% by the end of 1991 and exceeded 70% by December 1993. And the share of foreign currency loans in total lending was even higher, at 80%. The shift toward foreign currency operations took place despite a deliberate Central Bank policy aimed at increasing intermediation in domestic currency by lowering marginal reserve requirements on domestic currency deposits.[3]

Partly as a result of this reduction in reserve requirements, partly because of the tax on interest was eliminated in late 1992, and partly because of reduced uncertainty as a result of lower inflation, real interest rates have continued to fall. The monthly real interest rate on domestic currency loans was 4% in 1992, but fell to below 3% in 1993. On dollar loans, the annual interest rate had fallen to 16.3% by December 1993. Furthermore, loan rates have fallen faster than deposit rates, thus reducing the spread and indicating greater banking system efficiency. Nevertheless, Peruvian interest rates remain high compared to depressed rates elsewhere in the world, in order to attract capital inflows to pay for the large current account deficit. And one recent policy change threatens to stall further interest rate declines. The 1993 Banking Law allowed the Central Bank to reduce the interest rate it pays commercial banks on the reserves they hold with the Central Bank on their dollar deposits. Although this was accompanied by a slight reduction in the marginal reserve requirement on dollar deposits with commercial banks (from 50% to 45%) the latter threatened to significantly raise interest rates. Interest rate data for December 1993 do indicate a slight upward movement in the loan rate for dollar loans (about 0.4%), but most predictions are that interest rates will resume their decline into 1994.

Four development banks -- used by the GOP to channel public funds to agriculture, industry, mining and housing -- had played an important role in providing credit to the private sector; indeed, credit through the Agrarian Bank was provided at highly subsidized rates of interest and with high default rates. Because they were financed by Central Bank credit, they were one of the main causes of the large quasi-fiscal deficits that existed through 1990. But all four development banks ceased operations during the first half of 1992. Those lending activities directed to assist small farmers and enterprises will be covered by COFIDE, which was scaled down and transformed into a second-tier development bank. COFIDE channels long-term external loan funds (from sources like Aladi, CAF, the Japanese Exim Bank, the IDB and the World Bank) to commercial banks for onlending to private business. At present, COFIDE is about the only source of long-term loans funds for private business.

As a temporary solution to the problem of providing credit to small-scale farmers, the GOP authorized the channeling of $50 million to FONDEAGRO (not to be confused with

[3] Average reserve requirements on domestic currency liabilities fell from 57% in 1988 to 15% in June 1992, and have remained unchanged since the, while average reserve requirements on foreign currency liabilities fell from 50% in 1988 to 35% in June 1992, with marginal requirements on the latter remaining at 50% until they were reduced to 45% in late 1993.

the NGO FUNDEAGRO), to be applied to crop financing of small farms. In addition, the Ministry of Agriculture uses a portion of the $60 million in annual revenues from the tariff surcharges on imported food commodities, revenues earmarked for the MOA budget, to finance rotating credit funds for the agriculture sector. In an effort to find a more permanent way to fill the vacuum created by the absence of the Agrarian Bank, the GOP plans to create a system of Cajas Rurales, unitary banks in rural areas that have had little success elsewhere in the world.

Nevertheless, the banking and financial sector is still suffering, at least temporarily, as a result of the stabilization process. The prolonged period of high real interest rates has had two pernicious effects on banking and financial activities: they hurt the repayment capacity of borrowers because of the high financial cost involved, and they led to a riskier group of clients as a consequence of an adverse selection process. The 1992 recession in traded activities also hurt the repayment capacity of borrowers. All three factors help create a large stock of non-performing loans in commercial bank portfolios. And the program to sell treasury bonds to banks, in return for a portion of their portfolio of such bad loans, has been slow to get off the ground.

e) Exchange Rate Overvaluation

The present authorities implemented a floating exchange rate system in August 1990, albeit a managed float where the Central Bank intervenes to buy dollars in an attempt to keep the rate from appreciating in real terms. Nevertheless, the real exchange rate has appreciated significantly since the stabilization program began, largely because, in the face of monetary contraction, the price adjustment in asset markets (higher interest rates) is faster than it is in goods markets. In 1992, this trend was temporarily reversed from April through October, when the real exchange rate depreciated some 30% with respect to the $US, and was accompanied by a simultaneous decline in inflation.

Reduced capital inflows in the wake of the events of April 5 and a restrictive fiscal policy were mainly responsible for this win-win situation with regard to lower inflation and real exchange rate depreciation. But in November 1992, the trend changed again: inflation turned up and nominal devaluation did not keep pace, resulting in real appreciation since then.

In response, the Central Bank intensified its anti-inflationary policy in the second quarter of 1993: a very restrictive monetary policy, limiting monetary emission to an average of 1% per month, has been accompanied by a new exchange rate policy designed to stabilized the nominal exchange rate. Under the latter, the Central Bank maintains the weekly nominal exchange rate within a band around the average rate of the previous week. As a result, the nominal exchange rate has, indeed, been more stable. But in the face of continued though slower inflation, the real exchange rate appreciated some 7% against the US dollar during the 15-month period from October 1992 to December 1993. Thus, severe monetary restraint and a policy to stabilize the nominal exchange rate has kept inflation down to its new, lower level, but at the expense of continued overvaluation.

The real appreciation is in open contradiction to the long-term goal of trade liberalization, which is to raise the real exchange rate to make the traded sectors profitable. As long as the exchange rate is below its equilibrium level, expectations remain strong that the situation will be reversed. As real appreciation persists (estimated in the range of 5-25%), the costs in lowered output mount.

The tight monetary policy also explains the high real interest rates since August 1990, whereby tight monetary policy creates a monetary disequilibrium which is being adjusted through higher real interest rates. Moreover, interest rates above international levels generate an enormous short-term capital inflow, of around $200 million a month, which depresses the exchange rate even more. Another factor that contributes to overvaluation is the supply of dollars derived from illegal drug trafficking. However, coca prices have, in general, declined over the past seven years, so the inflow of drug-dollars should be down from levels of the mid-1980s.

f) Balance of Payments

The 1993 trade deficit remained the same as in 1992, at around 1.3% of GDP ($565 million), as both exports and imports fell slightly by 1.5% and 1% respectively. Mining accounted for 43% of exports and fishing another 24%. The improvement in non-factor services, due to an increase in tourism revenues, was more than offset by an increase in interest payments, resulting in a 1993 current account deficit of 6% of GDP, up from 5.4% in 1992. Peru's stagnating exports is to be expected, given the real appreciation of the exchange rate during 1993. Continued real appreciation projected for 1994, combined with the elimination of the drawback on fuel taxes in December 1993, threaten to prolong the stagnation in Peru's export sector. Continued poor export performance constitutes a real threat to continued growth in 1994 and to economic recovery over the medium term.

Developments in the capital account of the balance of payments, however, were much more positive: direct foreign investment in 1993 was over four times what it was in 1992 ($550 million compared to $125 million). This demonstrates the high level of investor confidence in the new Peru. As a result, 1993 short-term capital inflows were well below their 1992 levels, which is no doubt partly due to the sharp decline in the price of cocaine on world markets.

3. Peru's Program of Structural Reforms

A set of structural economic reforms was implemented parallel to the stabilization program. One set of reforms was designed to change the State's role in the economy both in the central government as well as public enterprise activities. A second set of reforms was aimed at deregulating the economic functioning of goods, factor, asset and capital markets. In spite of the strong GDP growth experienced in 1993 and projected for 1994, it is still too early to judge the long-term net benefits of structural reforms so early in the process of their implementation. Nevertheless, the direction and sequencing of the economic liberalization process will be described.

Price controls and subsidies have been virtually eliminated since the start of Peru's economic program in 1990. In the first half of 1992, the GOP liberalized fuel prices and electricity tariffs have been adjusted to reflect cost of production. During 1993, prices of all "public" prices -- electricity, water and telephone tariffs and fuel prices -- were increased faster than the rate of inflation, in order to reduce the remaining gap between revenues and costs, in preparation for privatization of the parastatal firms that dominate these sectors.

Exchange system. The foreign exchange system, which was segmented into four different rates during the period 1988-89, was unified and allowed to float in early 1991, albeit a "dirty" float in that the Central Bank continued to intervene in minor way. This change was accompanied by the elimination of virtually all exchange controls and the reestablishment of convertibility for the Peruvian sol. Then, in mid-1993, the Central Bank introduced a new exchange rate policy designed to stabilized the nominal exchange rate. Under the latter, the Central Bank maintains the weekly nominal exchange rate within a band around the average rate of the previous week.

Foreign Trade Liberalization. In September 1990, the number of ad-valorem tariff rates was reduced from 56 to three -- 15%, 25% and 50% -- and a temporary surcharge of 10% was applied to all imports entering at the top two rates. In March 1991, the GOP deepened trade liberalization by reducing to just two tariff rates -- 15% and 25% -- aside from a few inputs to the metal industry subject to a 5% rate. About 80% of all inputs were assigned to the lower rate and the average tariff declined from 26% to 17%, then rose to 18% when the 5% rate was eliminated. The non-tariff barriers such as quotas were almost totally removed. Other measures enhancing trade liberalization included: customs and ports reform; enhancement of the temporary admission system for imports to be processed into exports; creation of a tax drawback scheme for domestic indirect taxes paid by exporters; and elimination of all taxes on exports. Indeed, the liberalized trading regime under which Peru now operates is much more liberal than its partners in the Andean Pact. This is the principal reason why Peru has postponed reentry into the Andean Pact; it would probably have to raise tariffs on imports from non-Andean Pact countries in order to harmonize them with other members of the Pact such as Colombia, Ecuador and Venequela. The tariff surcharge system applied to the main importable foodstuffs is the one remaining major "illiberal" trade policy. This tariff surcharge system on selected foodstuffs was introduced in March 1991 and after a number of *ad hoc* changes over the two years that followed an agreement was reached with the IDB on a four-year program to reform (but not eliminate) the system: all rates are now variable and the Central Bank ensures transparency of the system by providing data on world price movements. Over time, the agreement requires that the floor price be progressively lowered -- eventually to between 60-80% (depending on the foodstuff) of the average world price over the previous 60 months. For a more detailed description of the evolution of the tariff surcharge system, see Annex B, Section D.5. and the Methodological Appendix.

Capital Account Liberalization. Parallel to the trade liberalization, the capital account of the balance of payments was fully opened in two steps: the first in September 1990 and the second in March 1991. Foreign exchange requirements for exporters were abolished and the right to transfer foreign currency deposits abroad was legally established. The simultaneity of liberalizing trade and capital markets and freeing interest rates, rather than waiting to liberalize the financial sector after trade liberalization, caused balance of payments problems for the Southern Cone countries in the late 1970s/early 1980s; it also helps explain Peru's exchange rate appreciation.

Financial reform. Restrictions on interest rates and portfolio requirements have been removed. The GOP has privatized state holdings in commercial banks and liquidated public sector credit institutions. It also enacted several important banking laws that have promoted competition, defines the role of the monetary authority in a system of market-based monetary policy and allowed for closer monitoring and prudential regulation of the financial system. The Bank of the Nation lost its monopoly of public sector deposits in 1992 and is undergoing major restructuring under the IDB/World Bank financial restructuring loans, but the pace and extent of this restructuring remains a sticking point in GOP relations with these two lending institutions. Reform of the social security system is also underway, alongside the introduction of private companies to compete with the public pension systems. Both reformed systems became operational in 1993.

Land Reform. Private ownership of land has been broadened and strengthened. Land has been made freely transferable and can now be used as collateral for credit. To make this reform effective, however, the land must be titled. Effective implementation of land ownership reform is key to developing a dynamic private sector agriculture. The GOP has begun this long and tedious land titling process.

Labor Market. There have been major changes in labor legislation which introduced more flexibility in labor regulations. This includes temporary employment categories to soften the job stability law, provisions that permit lay-offs for economic causes, transformation of the legal minimum wage into a non-binding reference wage, and introduction of a more efficient regime of severance payment funds. In July 1992 the GOP enacted a law regulating collective bargaining. All aspects of labor contracts will now be subject to negotiation every year and collective bargaining in the private sector will proceed without government interference.

Monopolies and Deregulation. Monopoly rights of 12 public enterprises have been abolished, including transportation, telecommunications, electricity, and grain marketing. And in early 1992, the GOP ended the State monopoly for the exploitation and distribution of oil derivatives. An Anti-Trust law was enacted in order to punish monopolistic behavior. INDECOPI, the autonomous public agency responsible for promoting free competition, consumer protection and intellectual property rights, enforces the anti-trust laws and has so far successfully beat back appeals for tariff protection under the guise of dumping charges.

Privatization. Virtually no activity maintains restrictions against private investment. In September 1991 four different modalities for privatization were developed and codified, and the privatization process was strengthened after April 5, 1992. An efficient institutional framework for privatization was established, and a sweeping program of privatization has been initiated, with assistance from the World Bank. By the end of 1993, the total value of 23 privatized companies was approximately $525 million, with revenues to the GOP Treasury of $218 million. Early success in the sale of the state-owned iron ore company, the retail gasoline outlets owned by Petro Peru, and the national airline was followed by less progress in 1993. Total revenues actually received by the GOP Treasury from 1992 privatizations equaled $160 million, out of total value of $210 million, whereas in 1993 the GOp received less than $60 million from privatizations valued at $315 million because the purchasers of two large ones -- the off-shore petroleum company leased to a U.S. firm over 20 years and a copper mined sold to another U.S. firm -- have not yet begun making payments to the GOP. The pace of privatization will accelerate markedly in 1994, with the major electricity, water and telecommunications utilities scheduled for privatization.

State Reforms. State sector reforms consist of a dramatic reduction in public sector employment and continuing efforts at tax reform. During the first half of 1992, public employment reduction at the Ministry of Economy and Finance reduced employment from 1,100 at the end of 1991 to about 400 and the National Planning Institute was abolished in June 1992. However, the latter's functions were absorbed by various GOP entities, most notably the new Ministry of the Presidency. The Central Reserve Bank has been restructured, including the voluntary departure of 850 employees. Although the number of public sector jobs has been greatly reduced -- by over half -- salaries have not been increased for those civil servants that remain. December 1993 witnessed the most recent GOP effort at tax reform. The income tax was simplified and now contains only two rates; a tax drawback for exporters on fuel taxes was eliminated (it was never effectively implemented anyway); while a Congressional proposal to reduce the value added tax (IGV) on certain types of agricultural products and products sold by small businesses was successfully resisted by the Executive.

Tax Administration. Improved tax administration is included among the structural reforms because of its impact on private sector incentives, which are in addition to its impact on fiscal policy. The GOP has strengthened substantially the tax administration (SUNAT), which has already developed credibility and improved tax compliance based on improvements in professional standards, administrative procedures and control systems. To facilitate tax collection, commercial banks have been authorized to act as collecting agents for the taxes administered by SUNAT. Unfortunately, tax revenues have responded slowly so far. The customs administration (SUNAD) also has made substantial progress in implementing a restructuring program. SUNAD has started to implement a comprehensive plan to effectively fight smuggling, which entails limitations on the list of available products and in the amounts purchased at free trade zones. And the GOP has privatized all customs warehouses.

4. Reintegrating Peru into the International Financial Community

One of the most critical tasks the new Government faced when it came into office in July 1990 was to reintegrate Peru into the international financial community. The GOP recognized that it could not get out from under the crushing effects of a hyperinflationary recession by continuing the confrontational external debt policies of the previous administration. Those policies had only succeeded in isolating Peru from further lending from the commercial banks and the three Multilateral Financial Institutions (MFIs) -- IMF, IDB and World Bank -- as well as most bilateral creditors.

The GOP was determined to open the economy to international trade and to depend on an export-led development strategy to reactivate growth in income and employment, so that a broad-base of Peruvian society would benefit this time around. It knew, however, that this strategy would have no chance to succeed unless Peru could become a convincingly reliable trading partner in the eyes of the rest of the world, and for this to occur, a clean bill of economic health from the MFIs would be necessary. But the accumulation of truly massive arrears with all of its creditors stood firmly in the way.

In 1990 the accumulated external debt approached $22 billion, two-thirds of which was in arrears. This amount of external debt was five times the value of exports while public debt service obligations were 85% of exports. Both figures were twice the average for all countries with debt service difficulties. By the end of 1992 the external debt had climbed above $24 billion, or more than $1000 for every Peruvian man, woman and child.

So in 1991, the GOP began to pay current obligations to the MFIs and initiated a debt rescheduling exercise, both with the MFIs and its bilateral creditors. More recently, Peru has initiated preliminary negotiations with its commercial bank creditors. The dollars provided Peru under this cash grant will be used to help Peru continue to remain current with its debt obligations to the MFIs during 1993.

a) Dealing with the MFIs

When the new Government took office in mid-1990, arrears with the MFIs exceeded $2 billion. Although Peru had begun to service IMF obligations in September 1989 (in response to a threat of expulsion from membership in the Fund), thereby "freezing" the stock of arrears with the IMF, arrears with the IDB and World Bank continued to mount. None of these arrears could be cleared immediately, but by the end of 1990 Peru had also begun to service its debt obligations with the two multilateral development banks. Ten more months would pass, however, before the Government signed the agreements that eventually led to clearing its arrears with the three MFIs.

In September 1991 Peru used a $325 million bridge loan from the Latin American Reserve Fund to clear its arrears with the IDB. Within a few days, the IDB disbursed the first tranche ($325 million) of its Trade Reform loan. Peru chose to clear its arrears with the IDB first because arrears with that institution ($347 million) were significantly less than its arrears with the IMF ($875 million) and the World Bank ($927 million). Another motive for first clearing arrears with the IDB was that the latest replenishment of overall IDB resources had given it considerable capacity to increase its lending. However, as history would have it, the political events of April 5, 1992, when elected President Fujimori disbanded the elected Peruvian Congress, would significantly slow IDB disbursements (just as they would slow the disbursements of bilateral donors like the U.S.), compared to expectations prior to April 1992.

At the same time it was clearing arrears with the IDB, Peru negotiated a Debt Workout Program with the World Bank and a Rights Accumulation Program (RAP) with the IMF. Although these agreements were not formally signed until July and September 1991, respectively, Peru had been implementing reforms according to a timetable worked out with the three MFIs since late 1990. The "performance period" of both programs was scheduled to run through December 1992, by which time all conditions were to be met. Peru's "shadow" programs with the World Bank and IMF were among the earliest examples of a new approach developed by these institutions to deal with countries with large arrears and strong adjustment programs.

It is important to note in all this that neither the RAP nor the Debt Workout involve actual disbursements of funds during the performance period. Indeed, through 1992, Peru was only servicing World Bank and IMF debt; it received no new money. These net capital outflows severely compressed budgetary expenditures, no doubt contributing to the 1992 recession.

Under the IMF's RAP, Peru accumulated "rights" to draw on IMF resources in the future. The RAP was designed to allow Peru to earn these "rights" by meeting the program's macroeconomic targets during the performance period, where the total amount of such "rights" Peru could earn was approximately equal to Peru's accumulated arrears with the Fund. Similarly, under the World Bank's Debt Workout Program, the Bank developed and processed three adjustment loans, and Peru built a track record of implementing the policy conditions attached to the three loans during the performance period. In this way, Peru accumulated claims to future disbursements under the three adjustment loans. The three World Bank loans so developed -- for structural adjustment and for trade and financial sector reforms -- amounted to a total of about $1 billion. Of this amount, $900 million was scheduled for disbursement once Peru cleared its arrears with the World Bank. The initial disbursement amount of $900 million was chosen to coincide with the approximate amount of Peru's accumulated arrears with the World Bank.

Peru successfully completed both programs in December 1992 by meeting all the targets. Indeed, Peru has the distinction of being the first country to successfully complete RAP[4] and Debt Workout Programs, and so far the only one. (Note: one of the conditions specified in the Workout Program is not yet complete -- the one relating to restructuring the Bank of the Nation. The Bank of the Nation is the largest public sector commercial bank and holds over 30% of all commercial bank deposits. Restructuring it is taking longer than expected and the two parties have renegotiated the timetable for doing so. As of early 1994, it is still not clear how this issue will be resolved, but it is clear that the Bank of the Nation still lives.)

On March 18, 1993, Peru cleared its arrears with both MFIs, first with the IMF, then minutes later with the World Bank, by arranging for a joint bridge loan from the U.S. and the Japanese. Peru used the "rights" it had earned as security for the bridge loan. Clearance of arrears with the Fund then triggered formal IMF Board approval of a three-year Extended Fund Facility (EFF), where the first tranche disbursement was equal to the amount of "rights" Peru had accumulated during the performance period. Peru, in turn, used the initial disbursement of the EFF to clear its arrears with the World Bank. Clearing the arrears with the World Bank then triggered disbursement of the $900 million, equal to the accumulated disbursement claims of the structural adjustment and trade sector loans and the first disbursement of the financial sector loan. The lion's share of these disbursement funds were used to repay the bridge loan.[5]

---

[4] Michel Camdessus, Managing Director of the IMF, was quoted in an IMF News Brief dated March 18, 1993 as follows: "Peru is the first country to regain access to the international financial community through the IMF's rights accumulation approach to eliminate payments arrears with the institution."

[5] On March 18, 1993, Peru cleared its arrears with both the IMF ($850 million) and the World Bank ($878 million). This was accomplished with a joint bridge loan from the U.S. Treasury and the Japanese Export-Import Bank (JEXIM), in the amount of $900 million. The first drawing of $860 million, funded half-and-half from Treasury and JEXIM accounts at the Federal Reserve Bank of New York (FRBNY), combined with $10 million from the Peruvian Central Bank, was deposited into the IMF Account at the FRBNY to clear Peru's arrears with the Fund. The IMF then approved a three-year Extended Fund Facility (EFF) for Peru. The first disbursement under the EFF equaled approximately $880 million, a figure which included the "rights" Peru

Clear, the GOP has, over the past 40 some months, implemented an impressive economic stabilization and structural adjustment program. Although major problems remain, much has been accomplished in a relatively short time. The breadth and depth of the policy reforms that comprise the government's program are discussed in Sections B.2 and B.3 above: the former details those taken to stabilize inflation and attain external balance while the latter details the structural reforms implemented to improve resource allocation and reactivate growth.

Approval of Peru's policy performance by the multilateral development community (the MFIs) is evidenced by Peru's successful completion, in December 1992, of the IMF's Rights Accumulation Program and the World Bank's Debt Workout Program. According to the IMF assessment of Peru's policy performance, "performance under the RAP during 1991 and 1992 was satisfactory and ... all quantitative performance criteria through September 1992 (the last performance date) were observed."[6] These IMF quantitative performance criteria included limits on the following: net domestic borrowing of the consolidated public sector; net domestic assets of the Central Bank; net international reserves of the Central Bank; external payment arrears of the public sector; and the contracting or guaranteeing of new short- and long-term external public debt by the non-financial public sector. Similarly, quoting the World Bank, "all of the 83 loan-specific conditions (the Trade, Structural Adjustment and Financial Sector Loans that constituted the Debt Workout Program) ... have been met during the performance period, with one modification."[7] That one modification relates to restructuring the Bank of the Nation, as noted above. During 1993, Peru continued to meet IMF conditions under the Extended Fund Facility, began negotiating a new structural adjustment loan with the World Bank, and will sign later this year an agricultural sector adjustment loan with the IDB.

b) Dealing with Bilateral Creditors

In 1990, nearly half of Peru's outstanding external debt obligations were owed to bilateral creditors and suppliers, including Eastern European countries. In September 1991, the magnitude of accumulated arrears with bilateral creditors ($5.8 billion) approached three times that with the MFIs, and the debt service falling due to these bilateral creditors ($2.4 billion during 1991-92) exceeded by several fold that owed the MFIs over the same period. Right after negotiating the RAP with the Fund, in late 1991, Peru rescheduled its official bilateral debt through the Paris Club, including the arrears.

---

had accumulated during its rights accumulation program with the Fund plus an additional $30 million. The portion of this initial disbursement corresponding to the accumulated "rights" was deposited into Peru's Special Funds Account at the FRBNY, along with funds the IMF had received from the first drawing in excess of Peru's arrears with the Fund. The $30 million in additional funds disbursed under the EFF was deposited directly into Peru's General Account at the FRBNY. The FRBNY then transferred all funds in Peru's Special Funds Account to the World Bank's account at the FRBNY. Together with a second GOP drawing on the U.S. Treasury of $40 million, also deposited into the World Bank's account, these funds cleared Peru's arrears with the World Bank. The World Bank then transferred $900 million to a special Treasury account at the FRBNY, along with funds it had received from the second drawing in excess of Peru's arrears. The $900 million corresponded to the disbursement of three World Bank policy loans for Peru, approved in advance by the Executive Board of the World Bank, and included full disbursement of the Trade Sector and Structural Adjustment Loans and the first tranche of the Financial Sector Loan. The FRBNY used funds in the special Treasury account to repay the Treasury and JEXIM shares of the bridge loan, including interest on the JEXIM loan, then transferred the balance to Peru's General Account.

[6] IMF, Staff Report for the 1992 Article IV Consultation and Economic Program for 1993-95, EBS/93/12, January 28, 1993, p.2.

[7] World Bank, Peru: Final Review of the Bank's Workout Program, R92-226, December 10, 1992.

Peru received extremely generous terms in Paris. A consolidation period was defined for October 1991 through December 31, 1992. All maturities on debt contracted before the cut-off date, defined as the 1983 Paris Club rescheduling, and coming due during the consolidation period, as well as all arrears on pre-cutoff debt, were rescheduled on terms corresponding to heavily indebted lower middle income countries. Moratorium interest payments due during the consolidation period were deferred. Arrears on post-cutoff debt were deferred contingent on continued performance under the IMF's program. Support Group disbursements for the period 1991-92 amounted to $448 million, short of the $700 million pledged, because some donors suspended disbursements after the April 5th political events. However, higher than expected private capital inflows, estimated at $1,700 million for 1992, ensured that the program was adequately financed.

In May 1993, Peru negotiated another Paris Club rescheduling of its bilateral debt, on even more generous terms than those it received in 1991. The consolidation period of 39 months covers the period January 1993 through March 31, 1996, which coincides with the period of Peru's Extended Fund Facility with the IMF. Peru's debt service to its bilateral creditors falling due during this period was reduced by 60%, debt relief in the amount of $1.9 billion, or around $600 million per year over the consolidation period. Also rescheduled was the interest on the debt rescheduled in 1991, in spite of the fact that the 1991 Paris Club accord explicitly stated that these interest payments would not be reprogrammed again. However, this Paris Club agreement is good only so long as Peru continues to perform under the IMF program: by April 1994, the IMF must notify the Paris Club that the Fund has approved the second year of the EFF with Peru, and similarly by April 1995 for the third year. Finally, if Peru meets all the conditions of this agreement, Peru's bilateral creditors agreed to meet again in 1996 to consider another rescheduling.

Leading up to the May 1993 Paris Club, the Support Group of Peru's major bilateral creditors agreed to fill most of the 1993 financing gap, estimated by the IMF at $410 million, of which the U.S. pledged $105 million and Japan a similar sum. The June 1993 meeting of the Support Group yielded total pledges in excess of $900 million in support for Peru's program of social development. However, only $327 million corresponded to bilateral pledges, still more than $80 million short of the $410 million financing gap. And some of these pledges have yet to be fulfilled. In truth, the magnitude of official bilateral debt is so imposing that Peru should seek to negotiate long-term debt reduction. Without long-term debt reduction, Peru will have to seek such Paris Club rescheduling year after year. A first *ad hoc* step in this direction was the decision by the Swiss Government to forgive past loans to Peru if Peru agreed to use the "proceeds" (an equivalent amount of local currency) to support the social development fund it had presented at the June Support Group meeting.

c) Initiating Negotiations with Commercial Banks

At present, Peru's debt with commercial banks approaches $6 billion, of which over 90% is in arrears. The conciliatory approach to commercial creditors on the part of the current administration contrasts sharply with the confrontational approach of the previous one. Together with the implementation of sound economic policies, this has led the commercial banks to drop legal actions they had begun against Peru. As part of the medium-term program, Peru will seek to normalize relations with its commercial bank creditors through voluntary market-based debt and debt service reduction operations. Peru began active negotiations with the commercial banks in 1993 and expects to conclude a rescheduling agreement sometime in mid-1994. Financing is expected to come from international institutions, bilateral donors, Peru's own resources, and additional access to Fund resources (provisions for which are contained in the IMF's disbursement schedule over the next three years). However, the four-fold increase in the price of Peru's debt in the secondary market during the 1993 -- from 18% of par value in January 1993 to over 70% by the end of 1993 -- will make it more difficult for Peru to negotiate a "good deal" with the commercial banks, similar to the one Costa Rica was able to negotiate in 1992. This dramatic increase in debt valuation by the international financial community was mainly the result of Peru's decision to allow commercial debt to be used in the privatization process, a tactical mistake in its debt renegotiating strategy.

As a further cautionary note, Peru's current and foreseeable limited ability to pay would not appear to provide room for the resumption of debt service payments to commercial banks during the medium-term program. Peru will, however, be a suitable candidate for schemes to exchange policy reforms for debt and debt service reduction (e.g. buy-back schemes and/or outright debt reduction with enhancements). Unlike the cases of Argentina, Brazil and Mexico, however, where commercial debt accounts for the lion's share of total debt, Peru's debt with commercial creditors is only one-quarter of total external debt.

d) Dealing with Debt Over the Medium-term

This is where Peru finds itself at present: Peru has completed the RAP and the Debt Workout Program; it has negotiated bridge loans to clear its arrears with the World Bank and the IMF; it has received the disbursements on the Fund's EFF and the three World Bank policy loans to repay the bridge loans; and it has rescheduled official debt with bilateral creditors in Paris. Peru is now eligible to receive project and policy-based lending from the World Bank on a normal basis, continued lending from the IDB and subsequent tranches of the EFF. Even so, disbursements from the three MFIs were not sufficient to cover the debt service payments due these MFIs over the last three quarters of 1993; that is, net capital flows from the MFIs were negative. The hope for 1994 is that the clean bill of economic health Peru earned by reintegrating with the MFIs, and continues to earn with further reforms, will elicit additional fast disbursing aid from bilateral donors that will strengthen Peru's hand as it attempts to negotiate an agreement with its commercial bank creditors. Refer to Table IV.1 for a breakdown of net flows from the MFIs to the GOP.

ANNEX B

PERU'S MEDIUM-TERM ECONOMIC PROGRAM FOR 1993-95

56

ANNEX B

PERU'S MEDIUM-TERM ECONOMIC PROGRAM FOR 1993-95

The Government of Peru reached agreement on a three-year Extended Fund Facility with the IMF in March 1993, which established the economic program Peru will follow during 1993-95. Sections A through C below are edited versions of the material contained in the GOP's January 1993 Letter of Intent to the IMF, outlining the economic program it will follow during the medium-term period 1993-95. Section D contains Mission analyses of five major elements of the program: stabilizing inflation, reactivating growth, alleviating poverty, improving agricultural marketing, and removing the final impediments to liberalized trade.

A. Overview of the Program

Peru's economic program for 1993-1995 has been designed with a view to reduce inflation to single digit rates by the end of the program period, provide the conditions to accelerate GDP growth to 4-5 percent a year, alleviate extreme poverty and restore viability in the external trade and capital accounts. In particular, the objectives of the program for 1994 are to limit the rate of inflation to 20% during the year, to increase the net international reserves of the Central Bank by $180 million, and to achieve real GDP growth of 5%. To this end, the GOP will continue to pursue market-oriented policies, apply prudent fiscal and monetary policies, and deepen structural reforms and privatization, in order to stimulate private investment. The GOP also is determined to establish an effective approach to enhancing human capital through increased expenditure in education and health and for strengthening the safety net that protects the poorer segments of the population. And the program will provide a framework for debt agreements with Peru's external creditors, having already cleared arrears and service debt to the MFIs.

B. Program to Stabilize Inflation and External Balances

1. Fiscal policy

Fiscal policy for 1993-95 will be based on no use of domestic financing by the combined public sector, stepped up efforts to increase tax revenues, and management of public expenditure so as to emphasize increases in investment in infrastructure and the social sectors. The consolidated public sector deficit will continue its downward trend, while public sector investment will be allowed to nearly double as a share of GDP. The consolidated deficit is projected to decline only marginally, in spite of a large increase in the primary surplus, because of a growing portion of debt service payments due (especially once commercial bank debt is renegotiated. Thus, sustained progress toward external viability and fiscal solvency would require substantial debt reduction from official and private creditors that would supplement Peru's domestic adjustment efforts.

The slight increase in the consolidated public sector deficit for 1993 was almost entirely financed from abroad, with no domestic financing projected for 1994. The increase over 1992 reflects stepped up social expenditure and an increase in interest due. The fiscal goals will be monitored on the basis of quarterly ceilings on the net domestic borrowing of the consolidated public sector through December 1994.

2. Tax policy

The GOP's objective is to raise tax revenues of the Central Government. Efforts to raise tax revenues will be based mainly on the substantive tax reforms that were introduced in 1992, combined with substantial further strengthening of the tax and customs administrations in late 1993. The GOP has extended the IGV (value added) tax to the mining and agricultural sectors, and has started to design mechanisms that would ensure effectiveness in the collection of the tax. It also is actively pursuing elimination of special regimes that discriminate in favor of geographical areas or firms, and the dismantling of tax stability contracts granted in the past. Finally, it will continue to strengthen the tax (SUNAT) and customs (SUNAD) administrations.

To promote private sector investment, the tax structure will be based increasingly on income and value added taxes. During the program period the GOP will continue improving the structure of the tax system with a view to having a system that is based on five core taxes: income taxes, taxes on wealth, value added tax, selective consumption taxes, and import duties. Any change introduced in the tax system will be consistent with the revenue objectives of the program, and no changes are to be made until recommendations of IMF technical assistance are available.

Revenue from privatization will be substantial throughout the period, but will peak in 1994 as major public utilities are sold off. This revenue will be used to finance the GOP's social investment programs and structural reforms -- a case of temporary revenues for temporary expenditure requirements. Additional revenue from privatization would be reserved for nonrecurring expenditure connected with additional investment in social sectors, further public sector restructuring, or for debt reduction operations.

3. Monetary policy

Monetary and credit policy will continue to have as its central objective the control of inflation and the attainment of the balance of payment targets. The Central Bank will limit the extension of rediscounts to temporary liquidity needs and will resist calls to reduce reserve requirements. There will be no credit to the nonfinancial public sector as a whole, and monetary creation will be limited to intervention in the foreign exchange market. The Central Bank has targeted the exchange rate, as well as inflation and the balance of payments, in determining its emission policy.

The program contemplates a gradual remonetization of the economy. During 1994, currency in circulation is projected to rise faster than inflation, as is broad money in domestic currency. Credit to the private sector as a share of GDP is projected to increase substantially during the program period, supporting the economic recovery. Monthly interest rates on domestic currency deposits followed the sharp decline in inflation over 1990-93, and are expected to continue as inflation declines further. The spread between lending and deposit rates remained high, with monthly lending rates on domestic currency loans still twice the rate of inflation. In order to facilitate a reduction of the spreads, the GOP will promote competition in the banking system through privatization and will require increased provisioning and recapitalization of weak financial institutions.

4. External Sector

The GOP will continue to pursue a floating exchange rate policy, with Central Bank intervention being guided by the achievement of the program's international reserve and monetary targets. The Central Bank will continue developing open market operations to facilitate a more active intervention in the foreign exchange market without fueling inflationary pressures, and will begin to emit Treasury bonds to absorb some of the savings being generated by the new private pension plans.

The external current account deficit (before debt and debt service reductions) is projected to oscillate in the range 5-6% of GDP during 1993-95. The 1993 increase in the deficit reflects a rise in public sector interest due. Average growth in export volume is projected to exceed 5% a year during 1993-95, reflecting the expected improvement in competitiveness, while only moderate growth is projected for imports because of the stock accumulation that took place after the 1990-91 trade liberalization. Private capital inflows (including foreign direct investment and errors and omissions) are estimated at $1.6 billion a year reflecting the substantial support for private investment in Peru from foreign sources. Taking into account disbursements from external loans already approved or in process, financing gaps of $1,450 million a year on average in the period 1993-95 will obtain. These gaps are expected to be covered by debt relief from private and official creditors (the latter through the Paris Club) and additional disbursements from official sources. Peru's projected 1993-94 financing gap is detailed in Table IV.1.

The GOP has continued to pay its current obligations to international institutions, after clearing arrears to these institutions in March 1993. The country is seeking normalization of relations with its commercial bank creditors through a voluntary market-based debt and debt service reduction operation. Negotiations are to start soon, and the operation is expected to be financed with a combination of resources from international institutions, bilateral donors and Peru's own resources. Peru may request additional access to Fund resources if needed once an appropriate restructuring arrangement has been agreed with these commercial creditors. The GOP also intends to approach non-guaranteed suppliers and other official creditors outside the Paris Club to explore means (in a cooperative framework) to facilitate the achievement of balance of payments viability in the context of adequate economic growth. Pending the conclusion of negotiations with these creditors, arrears to commercial bank creditors will continue to increase.

C. Medium-Term Program of Structural Reforms

1. Privatization

The GOP is committed to deepening structural reforms. In early 1993 it developed a comprehensive plan aimed at transferring to the private sector most pubic enterprises by 1995. This program is receiving technical assistance and financial support from the World Bank. The GOP is putting in place the appropriate regulatory framework, tax regime and pricing policies for hydrocarbons, electricity, telecommunications, mining, sewage, and fisheries, for privatization in 1994. In particular, public sector tariffs will need to be determined so as to promote efficiency and set clear rules of the game to attract private investors.

In November 1991, legislation was enacted enabling the formation of private pension funds. In mid-1993, the GOP implemented the transition from a pay-as-you-go, benefit-oriented, public pension system to a fully funded, contribution-determined, private capitalization system of individual accounts. The reform of the pension system is expected to foster the development of capital markets in Peru. The Treasury will have to cover the unfunded liabilities of the Social Security Institute (IPSS) by issuing bonds which will be cashed by retirees at the time of their retirement, the costs of which are estimated at $150 million in 1993 and are incorporated in the fiscal plan. A Superintendency of pension funds administrators was created in December 1992.

2. Trade reform

The GOP will continue liberalization of the trade system. ECASA, a rice trading company, has ceased operations, all its personnel has been laid off, and it is in the process of liquidating all assets of confirmed property. ENCI, an input and food products trading firm, has been radically downsized. The annual trading volume has been reduced from about 1 million metric tons in 1991 to 300,000 metric tons by the end of 1992. The process of rationalization will continue, and by the end of 1994 ENCI will not conduct operations on its own account.

The authorities have suspended temporarily Peru's membership in the Andean Pact. A free trade agreement has been signed with Bolivia, a country with macroeconomic policies similar to Peru's, and the GOP is negotiating trade agreements with other regional partners. To promote further liberalization, the GOP will continue eliminating non-tariff barriers and shifting products to the lower of two tariff levels (25% to 15%) with the objective of reaching a unified 15 percent rate by the end of the program period. The GOP will continue to ensure that reference prices, sanitary regulations, and anti-dumping mechanisms are not used for unwarranted protection. In July 1993, the formula to calculate the variable surcharge was modified to reduce effective protection progressively through 1997.

3. Financial sector reform

The reform of the financial system will continue. The development banks have ceased operations and the disposition of the residual assets and liabilities toke place in 1993. The monopoly over public sector deposits and tax collections by Bank of the Nation has been removed. A high level commission has been appointed to prepare a detailed restructuring plan for Bank of the Nation by April 1993, which would involve limiting the operations of the Bank to those areas where private commercial banking is not present. The restructuring plan will be implemented by September 1993.

Following the approval of the law of the Superintendency of Banks (SBS) and Insurance in December 1992, the personnel and system reorganization of SBS was completed in early 1993. Before the end of December 1992 and based on a review finished in November 1992, undercapitalized banks were required to present programs of recapitalization and reinvestment of dividends (except for newly issued shares), and to accept the new prudential rules. The SBS will require capitalization or increased provisioning where needed within a reasonable period of time, which will be set up case by case, but no later than December 1993.

The Central Bank law, also enacted in December 1992, defines the role of the monetary authority in a system of market-based monetary policy, provides for the continued solvency of the Bank, and establishes strict limits on the credit it can provide to the public sector. Restructuring of the Central Bank was carried forward in 1993. The quasi-fiscal deficit has been reduced substantially in recent years; the 0.1% of GDP deficit incurred in 1993 will be completely eliminated by 1994 through the replacement of the Central Bank's non-performing portfolio and reduction of the interest paid on dollars reserves of the commercial banks.

4. Labor law flexibility

Reforms to the labor law during 1991-92 have facilitated the reallocation of resources that is a necessary and desirable result of the profound restructuring wrought by Peru's economic recovery program. Further measures aimed at increasing flexibility in labor contracts to improve labor mobility were introduced in 1993, along with measures to streamline approval of employment reductions and widen the scope for temporary contracts.

5. Poverty alleviation

Poverty remains widespread despite the recent efforts at alleviation and the substantial increase in social spending. The GOP, in collaboration with the World Bank and the Inter-

American Development Bank, has defined a new poverty alleviation strategy that was implemented in 1993. The focus is on nutrition, health and education; these programs will target the rural poor, clarify the role of the various institutions, and stress the collaborative approach with donors and non-governmental agencies. Health programs are to focus on primary health care for mothers and children. Special efforts will be made to increase vaccination coverage and the supply of basic drugs in the Sierra.

The GOP initiated a major reform of the primary and secondary education system in 1993, aimed at: increasing coverage for primary education, reducing illiteracy rates, and improving the quality of education received. These objectives are to be achieved through the creation of competitive conditions in the provision of education by means of a system of budgetary allocations to schools based exclusively on the number of students, regardless of a school's ownership. All schools will be subject to the same operating, financing, administration, and supervision rules. Public schools will be transferred to community education councils which will assume full responsibility for their operation, subject only to across-the-board technical requirements established by the Ministry of Education.

The pacification of Peru is a fundamental objective of GOP policy and a basic condition for sustained economic growth. In this context, the economic program requires a massive program of social investment and employment generation projects in the impoverished zones which have been dominated by terrorists and narcotics trafficking and are in the process of pacification.

To support these programs, the GOP is planning to devote over 1% of GDP a year to social sectors through an enhanced program to alleviate extreme poverty. A substantial part of these outlays will be utilized to finance, through the Social Fund (FONCODES), small-scale investment projects in health, education, rural access roads, sewage facilities and agriculture in targeted areas of the poorest segments of the population. In order to finance the pacification effort without affecting the thrust of the economic program, the GOP will actively seek grants and concessional loans from friendly governments and organizations.

61

Table B.1
Macroeconomic Targets of
Peru's Medium-Term Economic Program
(% of GDP Unless Otherwise Indicated)

Indicator	Actuals		Medium-Term Targets		
	1992	1993	1993	1994	1995
GDP growth rate (%)	-3.1	6.8	3.5	4.5	5
inflation rate (%)	57	40	27	20	9
domestic invest (% of GDP)	24.2	23.6	16.8		19
national savings (% of GDP)	19.1	16.7	10.8		13.5
consolidated deficit (% of GDP)	-2.5		-2.9		-1.8
primary surplus (% of GDP)	0.5	0.1	0.8	0.6	2
quasi-fiscal deficit (% of GDP)	-0.1		-0.1		zero
domestic financing of budget deficit (% of GDP)	0.1	0.6	zero		
tax revenues (% of GDP)	9.2	10.1	10.3	12	13.5
privatize revenue (% of GDP)	0.1	0.3	0.6	0.6	0.3
growth rate of currency (%)	71	40	36		
growth rate of domestic currency M2 (%)	60	41	35		
Central Bank net domestic assets	-6.7		level		
change in international reserves of the Central Bank ($ mil)	697	700	178	160	110
external current account deficit (% of GDP)	5	6.0	6	5.6	5.5
export volume growth rate (%)	1.6	-2.0	3.0		6.5
private capital inflows ($ billion)	1.9	1.2	1.4		1.7
debt payments to MFIs	current		remain current		
number of tariff rates (units)	2	2	2	2	1
surcharge system (# of products)	20	20	20	20	0
wheat & products surcharge (%)	> 45	28	10		0
ENCI trading limit ('000 mt)	300		food donations only (not AID)		

D. USAID Analysis of Peru's Medium-Term Program

1. Stabilizing Inflation and External Balances

Inflation is now within reach of being brought under control. But why is stabilization so important to economic activity in Peru? Because it amplifies uncertainty. Predicting costs, prices and profitability becomes nearly impossible. Protecting the value of assets becomes very costly. This uncertainty breeds an intricate web of financial institutions and financial advisors whose sole purpose is to predict costs and protect values under extreme uncertainty, unnecessary functions under conditions of low inflation. The costs of everyday business transactions, and even personal savings and spending transactions, become very costly. Variable inflation, and certainly hyperinflation, grossly distort economic reality. As a result, the existing set of rules that guide the economy in normal times get way out of touch with economic reality. This disconnect between economic reality and the existing set of rules designed to guide the economy heightens the temptation to circumvent the rules and leads to corruption. Wasteful transactions costs and a greater tendency toward corruption are the legacy of high and variable inflation.

Fortunately, after three-and-one-half years of economic stabilization and structural adjustment policies, Peru has put a halt to hyperinflation. Peru achieved this success by adopting a stabilization policy based on a "nominal money supply anchor" to fight inflation.[8] Under this form of stabilization policy, Peru has allowed the exchange rate to float freely, with only moderate Central Bank intervention, and maintained very tight control of fiscal and monetary policy.

Other countries -- Israel, Argentina and Mexico to name three -- are using a fixed exchange rate as the nominal anchor to bring inflation down. But nowhere has fixing the nominal exchange rate succeeded over the medium-term, because the real exchange invariably becomes overvalued -- Israel and Mexico have since adopted a moving peg, but it has not moved up fast enough to avoid real appreciation. The irony, of course, is that Peru's currency has also become overvalued, even though it maintains what is basically a freely floating rate subject to market forces. In Peru's case, real appreciation is the result of other systemic causes related to high interest rates and large inflows of dollars (see the next section for a more detailed analysis of the real exchange rate).

Inflation has not yet been expunged from the Peruvian economy, in spite of the considerable success achieved so far. The annual rate of inflation in 1993 still stood at 40%, or just under a 3% monthly rate. Indeed, this was good compared to the <u>monthly</u> rates of inflation of 30% and up during the first eight months of 1990. But during the eight-month period October 1992 through May 1993, the downward trend in inflation temporarily reversed itself, requiring the GOP to further tighten monetary policy.

As a lesson for the next few years of anti-inflationary policies, it is important to understand what caused inflation to reignite in late 1992-early 1993. Four factors were primarily responsible. One is the moderately expansionary fiscal policy during the second half of 1992, which "burned up" the 2% of GDP surplus built up during the first half of the year. Another was the 60% nominal devaluation of the sol in comparison to the US dollar from March to October 1992, amounting

---

[8] Through early 1993, the GOP did not use a monetary anchor in the strict sense of the term because they did not rigidly stick to a preset rate of increase in the monetary base; rather, they established a range for the rate of increase in the monetary base while simultaneously trying to avoid large fluctuations in the real exchange rate. Since April 1993, however, monetary policy has been more consistently restrictive, with the result that the real exchange rate has again begun to appreciate. It is, of course, difficult to pursue two objectives with one policy tool.

63

to about 30% in real terms. A third related to increases in public utility prices -- gas, water, electricity -- which must be increased further to enhance prospects for privatization. And finally, the more-than-10% decline in agricultural output, a main cause of the 1992 recession, no doubt contributed to an increase in food prices. It was difficult to keep inflation under control with all this going on. This made meeting the IMF target of a 27% rate of inflation for 1993 impossible to attain until the last half of the year. Several factors make anti-inflationary possible more difficult.

One is the heavy dollarization of the Peruvian economy -- by the end of 1993, over 70% of the total money supply was held in dollar deposits. Peruvian soles are, at the moment, only held to meet the transactions demand for money; dollars serve as the store of value, and speculative demand would tend to favor the dollar, not the sol. Whereas total liquidity, which includes M2 and dollar deposits, is around 10% of GDP, M2 in domestic currency is only 3%. This means that even a slight increase in nominal M2 can cause a large percentage increase in M2. A contributing cause would be if a bilateral donor required HCOLC to be generated as part of a dollar grant used to repay debt, as opposed to, say a food aid commercial sales program that naturally generates HCOLC.

Continued anti-inflationary policies are still required, but should be designed to gradually push the inflation rate down toward one-digit annual levels. Inflation is not yet under control, but control over inflation is within reach. But wait! One might ask, why is an inflation rate of 40% so bad? Hyperinflation is obviously a problem, but "moderate" inflation may not be. The point is, 40% is not moderate inflation. Although Colombia may get along marvelously with 20% inflation, year after year, Colombia's economy has historically been better managed. Investors have confidence in the Colombian Government's continued ability to manage it, and therefore are able to feel comfortable with 20% inflation.

Increased investment expenditures is necessary to ignite and maintain strong growth in output. After having dramatically adjusted its incentive structure, new investment in physical capital is especially important to Peru because of the need to reallocate resources within the Peruvian economy to take advantage of the new incentives. But high inflation holds back private investment. Investor decisions in Peru are constrained because high inflation (and in Peru's case, a history of not being able to control it) makes future returns more uncertain; input costs, especially utility prices, and financial costs (the loan rate of interest divided by the inflation rate) unpredictable; and in general, increases the risk premium to investment decisions. As a result, investors demand a higher expected rate of return, so they invest less.

High inflation also makes it much more difficult to implement other reforms, including trade reform and reform of public utility pricing. In the latter, administrative decisions to change prices must be made frequently, and if they are not, distortions arise between easily adjusted private sector prices and more rigid public sector prices. But use of an automatic adjustment clause would build in an institutional basis toward inflationary expectations.

The question is, what can the GOP do to complete the stabilization process, given all the constraints discussed above? The key is tight fiscal policy, so that the domestic economy is not forced to finance a budget deficit. Given Peru's poorly developed capital market and lack of long-term financial instruments, open market policy familiar to Americans is not likely to work in Peru, on more than a very small scale. One objective of IDB and World Bank financial sector loans is to develop the capacity to conduct open market operations in the future. But at present, the only option left is to either borrow from the banking system, which would push up interest rates even further and squeeze out private borrowing, or borrow from the Central Bank, which means printing more money. These options risk another spate of inflation, especially the latter. Therefore, Peru must maintain and tighten fiscal discipline, as the IMF program requires and as Peru has done successfully since 1991. In technical terms, this means that Peru must maintain a primary budget surplus (revenues minus expenditures but excluding interest payments), so that it can pay an increasing share of its interest obligations from own resources. And these interest payments will increase if Peru is successful in negotiating a rescheduling agreement with its foreign commercial bank creditors.

Besides tight fiscal policy, the final stage of tariff reduction, including the reduction of tariff surcharges, will provide a downward "push" on inflation by reducing the price of imported goods. If the surcharge system had been eliminated abruptly, the impact would also have been abrupt -- a one-time downward "shock" to food prices. To be sustainable, however, the GOP will have to follow such tariff reduction with attempts to manage inflationary expectations, a task easier said than done.

As hard as it is to get there, once inflation has been reduced to one-digit levels, or at least when the economy begins to believe in the likely success of the stabilization process and believes that the policy will continue, then dollarization trends can begin to be reversed as more Peruvians become willing to use soles as a store of value. And when dollarization declines, the demand for soles will increase, replacing to an ever greater extent the demand for dollars. This will allow the Central Bank to significantly "monetize" the economy by increasing the money supply much faster than GDP growth.

2. Reactivating Growth in the Peruvian Economy

While success in stabilizing inflation is the most immediate objective of the medium-term program, a number of actions can simultaneously be taken to help reactivate growth in the economy. This is important because, on the one hand, the 1992 recession represented a 3% decline in GDP, accompanied by public sector layoffs and stagnant employment growth in the private sector, and on the other, the sharp recovery in 1993, with growth of almost 7%, was largely due to good weather and can be reversed with a change in external factors. Reactivating growth in the economy is USAID's top economic priority for a number of reasons:

- it is the only way to generate productive employment opportunities on a sustainable basis;

- it is the most painless way to generate tax revenues so that the GOP can increase public investment in infrastructure and human capital and support social safety-net programs -- otherwise the GOP will have to introduce new taxes, raise tax rates, or further improve tax administration; and

- it is a *sine qua non* in the struggle against narco-trafficking because without growth in alternative employment opportunities, Peruvians will continue to resort to illegal activities related to the drug trade.

Growth is critical. But where will growth come from? To find the answer all one need do is analyze the internal logic of Peru's economic program, the basic premise of which is the adoption of an outward-looking strategy of economic development. Therefore, the success of Peru's program will hinge on sustained and rapid export growth. This will require investment by the private sector on a much larger scale than at present. But as yet, the incentives are inadequate to stir the private sector into aggressive action. At least seven factors combine to limit investment incentives. They are:

- a renewed trend toward overvaluation of the real exchange rate since the fourth quarter of 1992;

65

- high taxes, along with a few remaining anti-technical taxes, are now more likely than ever to be collected by a strengthened SUNAT (the Peruvian IRS);

- high (though declining) interest rates, mainly a result of high margins between loan and deposit rates;

- some remaining rigidty in labor laws that imposes high fixed labor costs on firms and reduces workers' productivity;

- persistence of public sector involvement in activities where it does not belong; contrasted with

- the profoundly weakened capacity of the State to do what it should do well; and finally,

- the as yet incomplete stabilization of inflation and external debt.

How can these factors constraining investment incentives be turned around to favor investment?

a) Depreciating the real exchange rate

The overvalued real exchange rate obviously constrains the incentive to export, and given the dramatic decline in tariff rates, it puts an added strain on import competing industries. One way to effect a real devaluation is by reducing domestic interest rates on dollar deposits to slow short-term capital inflows. (Higher interest rates in the world economy would accomplish the same thing, but Peru has no control over these rates.) Another is to maintain an even tighter fiscal policy, and use the budgetary surplus to buy dollars. This has the added advantage that it will work without threatening the stabilization effort. However, tightening fiscal policy even further will require intensified effort to raise tax revenues from the major taxes on income, value added, imports, and some excises, while reining in public spending ever more tightly (no fiscal stimulus here), which will mean reductions in public sector employment and tight control of public investment and social expenditures. These policies are difficult to implement, especially in a year leading up to Presidential elections. But no matter what happens to the real exchange rate, some room for manoeuver does exist to affect changes in the other factors listed above.

b) Reducing "anti-technical" taxes

A body of opinion in Peru believes that taxes are too high -- that they are so severely eating into formal sector firms' profitability that new investment is constrained. Special attention has been directed at two taxes on assets: one on gross assets and another on net assets (after accounting for debt). Fortunately, the latter was eliminated in the December 1993 tax reform. Evidence of the tax burden on exporters, in particular, is contained in a paper by Jorge Vega titled "Incidencia Tributaria Sobre las Exportaciones no Tradicionales en el Peru." In addition, the draft World Bank Economic Memorandum (still unavailable officially) concludes that the IGV (valued added) tax rate to optimize revenues is 15%, rather than the current 18%. But a very real danger attaches to efforts to reduce taxes now, on anything approaching a large scale. The public revenue base is still recovering from an extremely low level -- Central Government revenues amounted to less than 10% of GDP last year, much lower than the 14% average for countries at Peru's level of development.

Therefore, any effort to reduce taxes will come up against the GOP's strong efforts to increase tax revenues, and will have to overcome opposition from the IMF which places top priority on increasing GOP tax revenues. That means that focus is critical, and the focus should be on tax reduction to favor savings and investment, especially tax relief for exporters. Primary attention should focus on the possibility of reducing indirect taxes on exported goods. Peru should be in the business of exporting goods and services, not taxes! One way to do this is to expand and streamline the tax drawback system for exporters. First, implementation of the existing drawback system as applied to the IGV (Peru's value added tax) should be improved and streamlined so that more, eventually all, exporters have *de facto* access to it. Second, consideration should be given to make other indirect taxes on exports and on all inputs used in producing exports also eligible for drawback. That would include tariff duties, excise taxes (ISC) and municipal taxes. Important issues to consider with regard to the latter include: legality within the GATT, the impact of an expansion of the drawback system on tax collections and the incentive effect such an expansion would have on Peru's exports.

But to be fair to the Treasury's need to increase revenues, and to dilute IMF opposition to expanding the drawback system, the tax bases of the five major taxes would have to simultaneously be broadened to compensate for extending the drawback. This would mean incorporating more informal sector businesses into the tax system. For this broadening of the tax base to be successful, representatives of the informal sector will have to be brought into the policy process, which includes the process of designing the policy studies to identify and choose among options. It will also be necessary to make sure that tax rates are not be so high that they encourage informals to evade taxes by remaining informal.

c) Reducing interest rate margins

How can interest rates be brought down? The only way do so, while maintaining a free-market in interest rates, is to reduce the margins between loan and deposit rates. Three courses of action are open to the GOP, but two of them would threaten to undermine stabilization -- lowering reserve requirements and having the Central Bank buy more dollars -- so they should be carefully handled or avoided all together for the present. And in any case, the only high reserve requirement left in the system is that on dollar accounts, with a marginal rate of 45%, reduced from 50% in late 1993 to compensate for the Central Bank decision to reduce the interest rate it pays commercial banks on the reserves they are required to hold on dollar deposits. However, this marginal reserve requirement can be lowered further, without causing inflation, only when short-term capital inflows slow.

The third option -- expanding the secondary market for long-term financial instruments -- will not undermine the fight against inflation and should be pursued over the medium-term program. The recent privatization of the social security and pension programs will create long-term savings that can be mobilized to provide funds for capital investment at lower interest rates. Through USAID's Policy Analysis, Planning and Implementation Project, the GOP is conducting a study to evaluate the feasibility of five such long-term financial instruments.

d) Making labor laws more flexible

The GOP has made important reforms to the labor laws over the past two years, but more flexibility is needed. During a period of transition to an outward-looking free market system like the one Peru is passing through now, the incentive structure is in a state of flux. Industries that were profitable no longer are, whereas new ones have become more profitable. Businesses that are moving out of the former industries need the flexibility to let go of workers simply because of business conditions, not solely for fraud or malfeasance. Similarly, businesses moving into the newly profitable industries will be hesitant to hire large numbers of workers because of the difficulty they will encounter later in letting those workers go, when business conditions change. Inflexible labor laws slow down markedly the economy's "response time" to changed incentives.

Labor law reform, however, carries a risk of being too ambitious from a political economy perspective. A political backlash to further changes in labor laws, especially if the administration elected in 1995 does not share the vision of the current administration, could lead to a return to 1990's anachronistic labor laws could result. This would be worse than no reform at all. Balancing political with economic objectives is difficult in this area.

e) Eliminating inappropriate public sector involvement in the economy

Now that the GOP's economic program is based on an outward-looking, free market approach, the GOP has already stopped such counterproductive *dirigiste* activities as price controls and subsidies and excessive public employment, but more needs to be done with regard to the latter. The GOP is also in the process of selling or liquidating most of its public enterprises. In the case of state-owned enterprises in sectors where natural monopolies exist, privatization should be delayed to first establish an appropriate regulatory framework. This regulatory framework is well advanced, with technical assistance from the World Bank. But continued public enterprise involvement in agricultural marketing (through ENCI) presents a problem for potential private sector entrants into the agricultural marketing business: it is urgently important that the private sector move in as fast as possible, so that the remaining privileged position of ENCI in agricultural marketing may be eliminated.

Likewise, the remnants of special tariff protection for certain agricultural producers means that privileged groups can earn economic rents at the expense of the rest of the sector. It also means that the desired redirection of investment in the agricultural sector, toward the production of crops in which Peru has a comparative advantage in world markets, will be stymied. Of course, some highly targeted subsidies for all non-coca production in the Huallaga Valley and other remote coca-growing regions may be a cost-effective way to promote alternative development programs, but will be feasible only so long as the profits to coca production stay at what are relatively lower levels compared to the mid-1980s.

In general, it is important to remain vigilant in opposing GOP moves to reinstate the kind of sectoral policies that seek to identify future dynamic industries and then use public policy to subsidize them. Although this has worked in Southeast Asia and Japan, it will not work in Peru because GOP institutions are weak. A government that lacks qualified personnel and offers very low salary levels is fair game for rent seekers. Public employees find it difficult to resist the pressure from groups that, once privileged with subsidies, will try to keep them forever, long after their usefulness has passed. As a rule of thumb, sectoral policies are unnecessary when outward-looking free-market macro policies are put into place, and counterproductive when weak governments try to over-manage the economy. For example, in the case mentioned above, of providing targeted subsidies for alternative crops to coca, eliminating the subsidies to the use of irrigation water along the coast would be an even better way to provide incentives to water-intensive production of crops in the Selva region (rice immediately comes to mind), thus avoiding the need to introduce new price distortions.

f) Strengthening what the Peruvian public sector <u>should</u> do

The Peruvian state was in total collapse by 1990. Although the collapse of the state was especially precipitous during 1988-90, it is more accurately characterized as a gradual decay of effective state control over several decades. What are the main dimensions of state collapse? The decimation of public finance is perhaps the most critical. The others are: the near absence of effective public sector regulatory control of production, marketing, banking, etc.; loss of control of economic policy; and the loss of respect for and power of Peru's political institutions.

Not enough emphasis is now being placed on reestablishing those elements of the state apparatus that will help the private sector revitalize the economy. Of course, the GOP should continue to eliminate the functions discussed in the section above, but simultaneously it must strengthen the state role in (i) formulating economic policy and decision-making; (ii) public investment, both more and better quality investment; (iii) the legal, regulatory, and judicial controls needed to make an economy run smoothly; and (iv) maintaining social order. Especially important is the need for the GOP to expand its capacity to meet the enormous unsatisfied demand for social services: more and better investment in human capital, especially education. Returning to the experience of East Asian economic growth success stories, much of their success resulted from early investments in human capital, which created a well-trained and healthy labor force able to respond to the outward-looking development policies that followed. But all this will require more government revenues.

The need for more revenues has already been discussed above, as has the need to reduce civil service employment and divest the public enterprises. But the other points need elaboration. The GOP is nearly irrelevant in what should be its two principal economic policy areas: exchange and credit policy. The collapse of GOP control over monetary policy and exchange and trade policy has been secular over time, since 1970, and is reflected in the dramatic growth of the informal (i.e. extra-legal) economy. Loss of effective GOP control has come about because the GOP has established overburdensome bureaucratic controls; yet even the public enterprises have not felt constrained by these burdensome controls. The private sector has responded to the burdensome controls by getting small, or by the bigger firms subcontracting with smaller, informal ones. This defensive strategy of the private sector to evade bureaucratic controls was especially intense during the last years of the Garcia regime, but continues today.

The GOP also lost the capacity to maintain social order. Peruvian society has lost respect for government authority and public institutions have lost their legitimacy in the eyes of Peruvian citizens. This is witnessed by such phenomena as the collapse of the political parties in 1990 and by the growth of terrorism over the decade of the 1980s.

But Peru is now undergoing a slow process of "reestatización" (reestablishing the authority of the state in areas where it is needed) to reverse these secular trends of the past. Success in this effort will increasingly enable the GOP to carry out those functions that are critical to growth. Public investment in infrastructure, education/training and social support services plays a critical supporting role in promoting growth, but GOP capacity to determine which projects are the most economically beneficial is weak, and the budgetary resources are still inadequate. GOP legal and regulatory bodies need to be overhauled, downsized, and then the remaining personnel trained to carry out their jobs better. And the GOP's capacity to carry out economic policy analysis, using modern equipment and requiring new and often sophisticated skills, must also be strengthened. Efforts to pacify the rural areas in the Sierra and Selva must be stepped up so that public institutions can reestablish a presence and provide needed services, and local producers can get back to work producing legal crops. But this will be a slow process that will extend beyond the medium-term program because the revenues will simply not be sufficient to do everything that soon. "Reestatización" is a top priority for growth.

g) Doing no harm to the stabilization effort

In Peru's efforts to reactivate growth, the GOP and the donor community must be ever mindful of the need for fiscal and monetary discipline. Every effort should be made to eliminate those remaining distortions that hold back investment, but that do not threaten fiscal and monetary discipline. Tax reductions must be carefully balanced with efforts to broaden the base of less distortionary taxes. Public investment in economic and social infrastructure must remain within the limits imposed by revenue collections and donor budgetary support. And donors need to restrain their demands that additional GOP budgetary expenditures be directed to their own projects. This a doable task.

3. Poverty Alleviation

Peru suffers from chronic poverty and one of the most unequal income distributions in the developing world; the extent and depth of this poverty and inequality have increased significantly over the decade of the 1990s. In Lima alone, in 1990, it was estimated that 44 percent of the population was living in poverty (defined by consumption below the cost of a basic food basket). The available data also confirm that Peru's child and infant mortality rates (119 and 84 per thousand live births, respectively) are more than double and its life expectancy rate (62 years) is ten percent lower than those of neighboring countries (Ecuador, Chile, and Colombia) save for Bolivia. Half of all children under age five are chronically malnourished.

There is a sharp disparity in the availability and quality of health, nutrition, and education services within the country. Activities are not well-integrated or targeted to the most vulnerable groups: infants, pregnant and lactating mothers, and children under five. A secular worsening of the income distribution during the period 1970-90 can also be demonstrated: although regional income inequalities have decreased, labor income has fallen from 36% to 24% of GDP over the period, due to a compression of labor incomes; income inequality within the remaining sector -- profits and income from informal sector activity -- has increased, and the spread between profits and labor income has also increased. Inflation is clearly implicated in increasing income inequality, because it tends to fall heaviest on the poor (a study of Brazil[9] shows a clear relationship between periods of high inflation and worsening income distribution during the 1980s).

Poverty alleviation in Peru must be addressed from both a long-term and a short-term perspective. The details of a viable long-term growth strategy were detailed in Section 2 above, but can be outlined again for emphasis. Two objectives are paramount over the long term: rapid, broad-based and sustainable increases in income and employment and a focusing of (increased) expenditures on human capital development toward the poor. This can be achieved only by stabilization policies to bring down inflation and bring imports into line with exports; structural adjustments to eliminate price distortions, reduce the public sector's direct role in productive activities, along with other distortions that constrain Peru from taking advantage of its international comparative advantages, including that of cheap labor; public expenditure policies that direct scarce budgetary resources toward investments in the human capital of poor people and into focused safety net programs for those few who will always remain outside the dynamic growth economy; and sectoral adjustments that eliminate distortions at the sector level that run counter to reforms at the macro level and that improve the state's capacity to manage an economy dominated by private sector activity. Among the most critical positive sectoral reforms are improvements in the legal, regulatory and judicial framework designed to provide the mass of Peruvian society with access to the formal economy, such as land titling, simplification of business licensing, and regulation of newly privatized public enterprises in sectors with a tendency toward natural monopoly.

Over the short-term, the objective is to manage the political economy of these long-term reform policies so that public support can be maintained long enough for them to bear the promised fruit. The idea here is to create alliances among those who will be the eventual winners from stabilization and adjustment, while diffusing the opposition of those who will be worse off from the elimination of their privileges and subsidies. Emergency social safety net programs are critical to keep the lid on social unrest and provide needed income sources, health and nutritional services to tide the poor over the period of transition. Also, care must be taken to avoid excessively alienating powerful

---

[9] Cardoso, Eliana, Ricardo Paes de Barros, Andre Urani, "Inflation and Unemployment as Determinants of Inequality in Brazil: the 1990s," Conference on Stabilization, Economic Reform and Growth sponsored by the National Bureau of Economic Research and the Inter-American Development Bank, December 17-18, 1992.

groups who have benefitted from the privileges and distortions developed over the years. But it is important to remember that these are temporary measures, necessary only until sustainable growth sets in. Over time, emergency welfare programs should be transformed into more sustainable income-generating and of social support programs.

The present GOP has made impressive progress in restoring macroeconomic stability and establishing a more efficient incentive structure for broad-based growth. Making the labor laws more flexible will play a role here too. Labor reform not only allows businesses more flexibility to move in and out of industries made more profitable or less profitable by the new outward-oriented, free market policies, it also means that businesses will increase employment over the medium-term because they will no longer have the worry of becoming locked into that higher level of employment when business conditions change and they have to downsize. Although increased labor flexibility will clearly hurt unionized labor -- the privileged class among laboring groups -- it will be beneficial to the poorest and will allow more transition from informal to formal sector labor.

But no matter how effective these adjustment programs are in the long run, the GOP needs to attack Peru's deep-rooted poverty more vigorously and directly over the short-term, through the provision of social services, nutrition programs and financing of small-scale, labor-intensive projects to generate temporary employment. The Fujimori administration should do so both to ensure that the poor benefit from the increased economic opportunities and to increase the likelihood that Peruvians will "keep the faith" long enough to see the adjustment process through to its completion, and the long-term growth benefits begin to accrue.

The necessity for fiscal austerity will, however, continue to severely limit GOP resources available for social programs in the medium-term. Although this might seem like a perfect opportunity for the donor community to play a large role, efforts to improve social services involves primarily local currency costs, not foreign exchange costs. This means that the donor community may actually be less able to help. But interestingly, support for social services may present an opportunity for monetized food aid, where it is actually better than dollar-funded programs. In sum, the broad-based income and employment growth that is the objective of stabilization and adjustment will inevitably be delayed longer than we would like (look how long it took Chile to finally get going -- 10-15 years); therefore, carefully targeted improvements in social services will be the most cost-effective way to alleviate poverty over the short-term.

The World Bank's structural adjustment program calls for concerted actions to define and implement a series of social measures to enable the poor to respond to income-earning opportunities arising from economic growth and to improve living conditions. Under the program, the GOP is committed to:

(a) developing a poverty alleviation strategy;

(b) developing profiles for priority projects in health, nutrition, and education;

(c) preparing a national nutrition policy based on a review of the existing food assistance program; and

(d) implementing reforms in food assistance, based on the recommendations of the above mentioned national nutrition policy.

Actions in these areas will be strengthened by the preparation of a poverty assessment report, and have already been aided by an update of the 1985/86 Living Standard Measurement Survey (including selected rural areas). The latter constructed a poverty profile to monitor changes in living standards over the past five years and establish a base for evaluating the effect of the GOP's economic program on poverty. The Japanese and German technical assistance grants have supported much of this effort. In addition, the International Monetary Fund will be providing technical assistance in support of Peru's poverty alleviation strategy, right at the heart of it in the area of public expenditure policy.

4. Agricultural Sector Policy: Credit and Marketing

It is not entirely true that the GOP should ignore sectoral policy. What is true is that agricultural sector policy should reflect the macro policy framework, indeed mimic it. Agricultural policy should seek to eliminate distortions to the incentive structure within agriculture, just like macro policy is seeking to eliminate them among sectors. The current set of stabilization and adjustment programs attempt to do that.

Of the distortions that remain operative in the agricultural sector, many relate to agricultural credit and marketing. Some result from too much direct GOP intervention -- public enterprise marketing firms that cling to handling (non-USAID) food aid shipments and special tariff protection for selected agricultural products -- while others derive from a government too weak to provide the incentives necessary to hasten the entry of private firms into what are for them new credit and marketing functions, and also too weak to develop and implement effective regulatory procedures to oversee the credit and marketing activities that will now have to be carried out by the private sector. Free markets don't just come about by themselves: simple, fair rules must be established and compliance must be meticulously enforced.

One of the great challenges to agriculture policy over the coming decade will be to develop private sector institutions that provide credit and marketing services, not to mention appropriate technology packages, to the large number of rural peasants with new ownership rights to their land. Land ownership should play a critical role by creating the opportunity for peasants to benefit personally from their own labors. This will be a powerful force pushing them to seek credit in order to buy inputs so they can increase production to sell in commercial markets. Care must be taken, however, to create an agricultural credit system that is self-sustaining and free of subsidy elements that undermine efficiency and promote corruption.

With specific reference to agricultural marketing: What is needed to get private firms to aggressively enter the market? and next, What is needed to make the system work efficiently once private sector involvement is fully underway? One obvious need is transport infrastructure, where the first order of priority is to rehabilitate the run-down roads and develop the resources and the will to maintain them. Road links between the Selva and the Coast are absolutely critical for any hopes of increasing export production in the Sierra and Selva.

Storage facilities are another important element to effective marketing operations; the storage facilities still owned by parastatal marketing firms should be put in the hands of private sector farmers' associations and marketing firms as soon as possible. The object is to increase competition and help break the stranglehold which monopsonistic buyers in regional markets in the Sierra and Selva are able to exert (oligopolistic markets in food products also exist in Lima). Low tariffs are an important tool for curtailing monopoly power in food markets, especially at the retail level in coastal towns where imports are easily accessible. But Peru's agricultural sector still maintains the last vestiges of trade restrictions. The next section will discuss why the tariff surcharge system is counterproductive and what has been done to modify it.

The continued involvement of ENCI, the parastatal marketing firm that refuses to wither away, remains a drag on private sector involvement in the marketing business. Although

12

ENCI's operations have been severely curtailed since 1991, so long as it continues to play even a small role in marketing -- ENCI currently markets imports, including other donor food aid shipments -- the private sector fears that a reinvigorated ENCI could present unfair competition, because of its privileged position, at some time in the future.

Training is also important. Because the private sector has been kept out of the agricultural marketing business to a great extent, potential entrants lack the appropriate skills. And because the public sector has spent the last 20 years trying to directly execute agricultural development programs and institutions, they lack the knowledge and experience in regulatory functions that will be necessary to monitor and coordinate and provide the right incentives to private sector actors. But before any form of effective rural development in much of the Sierra and Selva can have a chance to succeed, these areas must be pacified of terrorist activity.

All of this will be difficult to achieve. A.I.D. financial and technical assistance, in collaboration with other donors, must be maintained to help the GOP make these hard choices.

5. Peru's Tariff Surcharge System on Major Food Imports

a. A Brief Description of the Evolution of the System

In March 1991, Peru introduced a system of tariff surcharges on a number of agricultural products (wheat, corn, sorghum, rice, milk, sugar, and wheat products such as flour and pasta) to compensate for the dramatic reduction in levels of protection for domestic agriculture that resulted when Peru moved to a simplified and much lower tariff rate structure, eliminated most other trade restrictions and found itself plagued with an overvalued exchange rate that, even today, continues to be a central outcome of the macroeconomic stabilization program. Although the formal design of the surcharge system gives the impression of being a transparent, rule-based, price band mechanism, in practice this was not always the case. Indeed, during the first 20 months of its existence, rates were changed on an *ad hoc* basis, in response to classic rent-seeking behavior on the part of influential agricultural producer and processing groups.

Peru's surcharge system started out as one of fixed ad valorem rates (e.g. the surcharge on wheat products which importers of wheat would have to pay, in addition to the standard tariff rates, was 57% of the declared FOB value). The system was later changed to one of variable ad valorem rates. Then late in 1992, the surcharge on several commodities (corn and sorghum) was fixed at 10%, a partial reversal to a fixed rate system, to help the struggling chicken industry. The latest modification to the surcharge system occurred in July 1993 after a long negotiation period between the Ministry of Agriculture (MOA) and the Ministry of Economy and Finance (MEF). While the MOA argued for a continuation of the scheme then in effect, the MEF, supported by the multilaterals and USAID, pressed for a progressive phasing out of surcharges, starting with a gradual conversion from variable to fixed rates and leading eventually to elimination of the system. The final outcome, which favored the MOA position, was put in place with the D.S. 014-93-EF of July 27, 1993. It contains the following changes to the tariff surcharge system:

- Twenty imported food products are included under the system, the same 20 initially established in 1991.
- All the imported food products are under a variable surcharge system, including dairy products, maize and sorghum.

73

- A schedule has been established, covering the period July 1993 to July 1997, during which the formulas for calculating the surcharge for each product are updated periodically.

- However, in converting the fixed surcharge for dairy products to a variable surcharge, the floor price is set above the average price, rather than below it, as is the case for all other products included in the surcharge system.

This latest modification of the Peruvian tariff surcharge system has established a gradual reduction in the surcharges through 1997, but no agreement has been reached on elimination of the system.

b. Major Elements of the Debate Regarding Surcharges

<u>Ministry of Agriculture</u>

Ever since the 1991 introduction of the surcharge system, the Ministry of Agriculture (MOA) and the Ministry of Economics and Finance (MEF) have held divergent views on whether Peru benefits from the surcharge system. Under the leadership of the MOA, the variable surcharge system was introduced in 1991, and the MOA has successfully resisted pressures to eliminate the system ever since, using the following arguments:

1) Prices should be stabilized around their international "trend" values, thereby reducing price uncertainty to producers and consumers. This is the objective of a true price band system.

2) A countervailing mechanism should be available that can offset the subsidization of agricultural commodity exports in OECD countries. This developed country subsidization of agricultural exports harms import-competing production in the Peruvian domestic market (Note: recourse to existing Peruvian anti-dumping legislation would seem to be more appropriate as a way of dealing with this problem.)

3) A mechanism should be created to offset the real appreciation of the exchange rate resulting from the macro-stabilization program. (Note: real appreciation affects all tradable sectors of the economy, not just agriculture.)

4) And finally, lying just below the surface of these technical economic justifications, the surcharge system serves an important revenue-raising function for the MOA (surcharge revenues are earmarked for that Ministry's budget), during a period when the GOP budget is particularly hard-pressed financially.

<u>Ministry of Finance</u>

The MEF has consistently questioned MOA arguments in favor of surcharges because of its belief in a uniform trade liberalization process with no exemptions to specific sectors, the need to remove all non-tariff barriers, and the need to move toward a low, flat tariff system. Nevertheless, the theoretical argument that the system would reduce price variability and hence generate net benefits for the economy as a whole was theoretically appealing, especially during the period leading up to implementation of the surcharge system in 1991. However, when the system's performance was evaluated, a year and a half after full implementation of the surcharge system, the evidence suggested that costs exceeded benefits. The most thoughtful study evaluating the performance of the surcharge system[10] found that by reducing price variability, a variable scheme has, in theory, the potential to increase Peru's welfare, and the gains would be even larger if the scheme incorporated a true price band, rather than only a price floor. However, the study's empirical findings told a different story.

1) The variability of the surcharge system over the period 1991-93 has led to an important efficiency loss to the economy. This variability, involving frequent changes in the methodology by which the surcharges were calculated and in the list of commodities covered by the system, indicates that the system has proven very prone to political manipulation by rent seeking groups within the economy.

2) For most of the food products included in the surcharge system, domestic price stability has been achieved more through lower inflation and less variability in the real exchange (i.e. macro stability), than because of the presence of the variable surcharge system.

3) Moreover, the surcharge system has largely failed to increase farm gate prices because the benefits of increased protection primarily accrue to middlemen, millers and traders rather than to farmers, or because the presence of close substitutes not subject to the surcharge led to increased imports of substitutes.

4) The surcharge system has been very costly for Peruvian society as a whole. For instance, during 1991-92 the system generated the following costs, benefits and net losses:

(i) Consumers suffered a loss of $380 million.

(ii) The Central Government (i.e. the Ministry of Agriculture) received $180 million as tax revenue.

(iii) Middlemen, millers and (to a lesser extent) farmers benefitted to the tune of $160 million.

(iv) However, society as a whole incurred a deadweight loss of $40 million, which is an indicator of the degree of economic inefficiency.

<u>World Bank, IDB and USAID</u>

The three MFI support the conclusions and recommendations contained in the Escobal and Briceño study. MFI loans and programs highlighted how inconvenient the surcharge system was and recommended that it be phased out. As noted above, the MOA strongly opposed this effort on the part of the MFIs, while the MEF supported it.

It is U.S. Government (USG) policy to discourage the use of price band mechanisms to stabilize agricultural prices. If a country has not already introduced such a system, the USG prefers that it not do so. For those countries that have such systems already in place, the USG expects them to be operated in the most transparent and least trade-distorting manner possible. Any such existing system should:

---

[10] Escobal, Javier, Arturo Briceño, Una Alternativa al Actual Sistema de Sobretasas Agricolas in el Peru, GRADE, Lima, Peru, 1992.

15

1) be entirely transparent and stable (because a transparent distortion, where the decision rules are simple, mechanical and/or subject to public scrutiny, is hard to manipulate to the benefit of one group or another);

2) be limited to only a few products to avoid "rent-seeking" by producers of close substitutes;

3) be clearly temporary in duration, with a timetable for their elimination.

With particular reference to Peru, in addition to the empirical evidence cited above that clearly calls the Peruvian surcharge system into question, A.I.D. is especially concerned with the negative impact the system has on food security -- it significantly increases the food prices that poor Peruvian consumers face.[11] Thus, A.I.D. supported the IDB and World Bank position with regard to this issue. In January 1993, A.I.D. called for the modification of the Peruvian import surcharge system by recommending that conditionality to this effect be included in the FY 1993-95 Title III program. A.I.D.'s principal objection was the adverse effect the system had on consumers of wheat and wheat product, which are a major commodity in Peruvian consumption, in the context of a proposed Title III program with wheat as the commodity to be imported. Bread and pasta bulk large in the diets and budgets of poor urban consumers in Peru, and potatoes, a close substitute to wheat products, are even more commonly found in the Peruvian diet. Therefore, the imposition of surcharges on imported wheat is contrary to the objective of improving food security for vulnerable groups.

METHODOLOGICAL APPENDIX
Methodology of the Current Tariff Surcharge System

With the passage of D.S. 014-93-EF in July 1993, a variable surcharge was applied to all 20 imported food products, some of which had been converted to fixed surcharges in late 1992, and a schedule was established to reduce the surcharges over time. Information on weekly reference prices for wheat, rice, sugar and maize in the world market is provided by an external consultant company, contracted by MEF. For dairy products, the Central Bank takes the prices directly from GATT publications, but the reference price is updated every three months because no weekly nor monthly sources of price data for dairy products are available, as exist for the other imported food products. Thus, although the surcharge system remains in force, its new pattern largely conforms to the three conditions specified in Section (b) above.

Calculation of the Effective Floor Price

The effective "floor" price for grains and sugar is calculated as the difference between the average international price of the given product (deflated by the Consumer Prices Index in the U.S.) over the previous 60 months, minus a specified proportion of the standard deviation of those 60 monthly price observations. The effective floor price under this new system was first calculated in July 1993 and will be revised once or twice a year, according to the schedule contained in Table B.2.

---

[11] Escobal, Javier, Evaluación del Sistema de Sobretasas a la Importación de Trigo y Harina en el Peru, GRADE, Lima, Peru, April 1993.

1b

$$P_f = [(1/60) \sum_{t=1}^{t=60} (P_t \,/\, CPI_t)\,] - \alpha\sigma$$

Where: P_f = effective floor price for product

P_t = international nominal price of product in month t

CPI_t = Consumer Price Index in the United States in month t

α = adjustment parameter that increases over time according to the schedule specified in Table B.2

σ = standard deviation of the 60 monthly price observations

As of July 1993, the floor price was 10 percent below the 60-month average. The adjustment parameter increases over time, reaching 100 percent by July 1997, the end of the agreement with the IDB. Thus, as the adjustment parameter increases over time, the floor price for grains and sugar declines.

For dairy products, the equation is as follows:

$$P_f = [(1/60) \sum_{t=1}^{t=60} (P_t \,/\, CPI_t)\,] + \alpha\sigma$$

Where: all variables are the same as for grains and sugar, except that

α = adjustment parameter that <u>decreases</u> over time according to the schedule specified in Table B.2

As can be seen, in the case of dairy products, the adjustment factor ($\alpha\sigma$) is added to, not subtracted from the 60-month average, yielding a floor price higher than the 60-month average. According to the schedule in Table B.2, the adjustment parameter, which presently stands at 50 percent of the standard deviation <u>above</u> the 60-month average, will diminish over time to zero by July 1997. From that point on, the floor price will equal the 60-month average.

Table B.2
Schedule for Updating the Adjustment Parameter
Used to Calculate the Floor Price, as Specified in DS 114-93-EF

Period	Grains and Sugar	Dairy Products
July 1993	Average less 10.00% S. D.(*)	Average plus 50% S. D.
July 1994	Average less 20.00% S. D.	Average plus 45% S. D.
July 1995	Average less 30.00% S. D.	Average plus 40% S. D.
January 1996	Average less 47.50% S. D.	Average plus 30% S. D.
July 1996	Average less 65.00% S. D.	Average plus 20% S. D.
January 1997	Average less 82.50% S. D.	Average plus 10% S. D.
July 1997	Average less 100% S. D.	Average

(*) S. D. = Standard Deviation

78

Determination of the margin between the floor price and the reference price

To establish the amount of the actual surcharge, an additional margin (1 + B) is introduced. This margin is multiplied by the difference between the calculated floor price and the reference price (determined weekly for grains and sugar and once every three months for dairy products) to establish the amount of the surcharge:

$$s = (1 + B) * (P_f - P_r)$$

Where **s** is the surcharge in dollars per metric ton and $\mathbf{P_r}$ and $\mathbf{P_f}$ are the FOB reference price and the FOB effective floor price, respectively. The term B is supposed to represent the costs associated with import expenses. For the case of sugar and wheat, B has been established as 18 percent; for maize, rice and dairy products it has been established as 20 percent. Thus the formulas to calculate the surcharges for each of the food products are the following:

Wheat	$s = (1 + 0.18)(\$159 - P_r)$
Wheat Flour	$s = 1.4 *$ Wheat Surcharge
Milled rice	$s = (1 + 0.20)(\$251 - P_r)$
Paddy rice	$s = 0.7 *$ Milled rice surcharge
Sugar	$s = (1 + 0.18)(\$344 - P_r)$
Maize products	$s = (1 + 0.20)(\$116 - P_r)$
Powered Whole Milk	$s = (1 + 0.20)(\$2006 - P_r)$
Nonfat Powered Milk	$s = (1 + 0.20)(\$2009 - P_r)$
Dehydrated Milk Fat	$s = (1 + 0.20)(\$2186 - P_r)$

19

ANNEX C

PERU'S COUNTERNARCOTICS PERFORMANCE

A. Overview of Peru's Cocaine Industry
B. GOP Cooperation in the Counternarcotics Program
C. U.S. Foreign Policy Interest

ANNEX C

PERU'S COUNTERNARCOTICS PERFORMANCE

A. Overview of Peru's Cocaine Industry

For centuries Peru's coca production was oriented towards domestic demand. But, as cocaine consumption expanded abroad, narcotics traffickers found Peru's Upper Huallaga valley to be an ideal environment for the production of high-quality coca. Peru now supplies 60-70% of the world's production of coca leaf, and is a major cocaine base producer. Illegal production has spread outward from the Upper Huallaga, where the USG estimate of area in cultivation dropped by nearly half in 1993, to the Central and Lower Huallaga, and the Aguaytía-Ucayali and Apurímac valleys. The USG estimates that there were about 108,000 hectares in coca production in 1993, somewhat less than a third of which was in the Upper Huallaga Valley (intensified enforcement and the spread of a fungus that attacks coca plants were primarily responsible for the decline in coca cultivation in the Upper Huallaga valley). More than 120,000 farmers are engaged in coca cultivation throughout the country, with perhaps 5,000 more involved in related processing, trafficking and financial operations. The industry brings $500-900 million in foreign exchange into the country each year, depending on the price of cocaine base.

The expansion of illegal coca production and trafficking has caused serious economic, political, social and environmental harm to Peru. Narco-dollar liquidity has distorted exchange rates and has swung the cost/returns structure against legitimate crop and other productive activities. A symbiotic relationship between narco-traffickers and terrorists has diluted civil governmental authority in the coca growing areas (though major inroads were made against terrorists during the past two years), making control and alternative development efforts risky. Deforestation, erosion and the disposal of toxic chemicals associated with narcotics are causing significant ecological damage in these areas. Drug abuse is expanding with serious consequences to an already weakened social fibre.

Constraints to the reduction of illicit coca in Peru include persistent market distortions caused by faulty economic policies of the past, which made legal crops unprofitable. The current period can be described as one of structural readjustment as the coca growing zones try to recover from decapitalization of the past seven years and adjust to the market driven realities of an open economy. The deterioration of infrastructure and government services restricts the marketing of legal crops from coca-growing areas. The management and level of police and military resources currently engaged in counter-narcotics enforcement efforts are inadequate to disrupt narcotics trafficking enough to make alternatives more attractive. And the lack of security inhibits legitimate private sector investment in the region.

B. GOP Cooperation in the Counternarcotics Program

Under President Fujimori, the Government of Peru has clearly demonstrated the political will to act against cocaine production and trafficking. In 1990, President Fujimori declined to accept U.S. assistance he considered unbalanced toward military aid, and called for a "Fujimori Doctrine" of an integrated approach to eliminate coca cultivation by alternative development assistance to growers combined with police and armed forces action against drug traffickers. In 1991, the U.S. concluded an overall framework agreement for a counternarcotics program including military, police, coca eradication and economic assistance. USAID involvement in counternarcotics efforts has included balance of payments support under ESRP, alternative development activities, administration of justice, demand reduction through prevention and treatment, and trade development activities.

The alternative development element of Peru's counternarcotics program progressed well through the end of 1993. Pilot activities begun under the Upper Huallaga Area Development Project (community development, agricultural development and river basin programs tied to future coca eradication, and road rehabilitation) were successful beyond expectations. The period witnessed increased support and participation by the President, national, regional and local governments. Funding in cash and in kind was made available by the GOP from its own resources for the first time, even though the GOP was engaged in a major austerity program, and 10 million soles ($5.46 million) was committed by the GOP's Social Emergency Fund. Also, for the first time the Army began civic action programs, including significant road rehabilitation in areas where security considerations impeded civilian construction activity. Security has improved steadily and a number of agribusiness projects began in 1993.

Other donor interest is apparent, reflecting increased donor awareness of and response to counternarcotics interests, the success and leadership of the USAID Program, increased GOP committment to and participation in counternarcotics efforts, and decreasing risk in working in coca producing areas. Major complementary road construction and rehabilitation of the nation's highway system will come from the World Bank and the IDB (Tingo María to Pucallpa). At the end of 1993, the GOP initiated a systematic effort to define a comprehensive national narcotics control plan, whose central coca control element is alternative development. Counternarcotics activity is now well positioned to attain significant limitation and reduction of drug production, if USG, other donor and host government funding remains available at appropriate levels over an appropriate period of time.

C. U.S. Foreign Policy Interest

Reducing and ultimately eliminating Peru's production of cocaine available for export to the U.S. is an essential element of the U.S. national counternarcotics strategy and a key U.S. foreign policy objective. NSD-18 of 1989 established and Andean Counternarcotics Strategy that sought to reduce the flow of illegal drugs from the Andean region to the United States. That initiative was approved by the Congress with enactment of the International Narcotics Control Act of 1990. At the Cartagena (1990) and San Antonio (1992) Summits, and in the bilateral counternarcotics agreement of May 1991, the U.S. and Peru committed themselves to an effort to reduce, and ultimately eliminate, coca production in Peru through an integrated set of law enforcement, economic development, coca eradication, demand reduction and associated programs. In November 1993, by Presidential Decision Directive 14 (PDD-14), the President approved a refined and modified approach to USG efforts against cocaine production and trafficking in Latin America. PDD-14 places increased emphasis on efforts to control drug production in source countries, while recognizing that in a period of limited resources, U.S. counternarcotics efforts will be an element of more comprehensive multi-donor support. It emphasizes developing host government institutional capabilities to act against cocaine production and trafficking, and places increased importance on coordination of USG activities with those of other bilateral and multilateral donors to support comprehensive host government national counternarcotics plans.

Counternarcotics conditionality is also important, but must be viewed in context of progress to date. Peru is party to the 1988 UN Convention on Illicit Trafficking in Drugs (Vienna Convention), the central element of U.S. international narcotics policy. It cooperated closely with the United States, and made significant commitments from its own resources, to implement an active counternarcotics program including enforcement and interdiction, alternative development, coca eradication, drug awareness and demand reduction. It has concluded bilateral agreements with the U.S. pertinent to control of narcotics trafficking, including the bilateral agreement on chemical control signed at the Cartagena Summit and brought into force in February 1992, and the Tax Information Exchange Agreement (which can also apply to narcotics crimes) brought into force in March 1993.

Peruvian Police and armed forces have collaborated in an increasing number and variety of counternarcotics activities during the past year. In particular, the Peruvian Air Force and Police have established permanent detachments to control use of numerous legal airports in coca growing areas for drug trafficking purposes. The Air Force, Navy and Police seized or destroyed 17 aircraft engaged in drug trafficking in 1993.

All of the foregoing activities exceed measures that would have been required to fully satisfy counternarcotics conditionality applicable to the second and third tranches of the FY 1991 and FMF programs, and more. Those programs however, were never delivered; the FY 1991 ESF program for Peru has been reduced, while funding for most of the second and all of the third tranche of FY 1991 FMF has been rescinded. During the past year and a half, therefore, the GOP has taken an extensive range of actions which respond to U.S. desires on the full specturm of counternarcotics policy, which in effect were self-motivated since the earlier U.S. assistance was frozen or rescinded. In recognition of this state of affairs, counternarcotics conditions applying to this ESF program are oriented primarily to: encourage integration of GOP narcotics control planning at national strategic level; ensure that specific narcotics control activities are planned and implemented to provide mutually reinforcing support of an integrated national strategic concept; and ensure that GOP efforts in infrastructure improvement, particularly road repair and rehabilitation, take account of participation by other multilateral and bilateral donors, and explicitly recognize the essential character of these activities to counternarcotics as well as national sustainable economic development goals.