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MEMORANDUM FOR THE RECORD

Visit of Ambassador Berckemeyer of Peru, accompanied by Mr. Santistevan, Alternate Executive Director, February 9, 1972

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The Ambassador said that Mr. Morales Bermudez, Minister of Finance of Peru, would not be able to visit Washington before the meeting of the Consultative Group for Peru in Paris. He had therefore asked the Ambassador to convey the message to Mr. McNamara that he was thankful for the recent visit of Bank officials to Peru and that he hoped Mr. McNamara would do all he could to make the Peru meeting a success. The Ambassador said he had also spoken to the U.S. State Department on the subject.

Mr. McNamara said that he sincerely hoped the meeting would be a success and that he was pleased that it would take place.

Anders Ljungh

President has seen

8



September 28, 1972

3. General Marco del Pont commented on the reorganization of the Bank and was given an account by Mr. McNamara of the underlying concept for the reorganization: the new regional system, Mr. McNamara said, should enable the Bank to serve its constituents more rapidly and effectively in the future.

4. The meeting concluded with General Marco del Pont's complimenting Mr. McNamara on his continuing concern with social equity as an integral element of economic development, expressed by him in his speeches at Copenhagen, at the recent UNCTAD meeting, and again at the General Session of the present Annual Meeting. This concern, the General added, is shared by the present Peruvian Government.

cc: Messrs. Knapp  
Alter  
Gutierrez  
Ljungh

SSKapur:ub

9.

## OFFICE MEMORANDUM

TO: Memorandum for the Record

DATE: October 2, 1973

FROM: John A. Holsen

SUBJECT: Meeting of Mr. McNamara with the Peruvian Delegation in Nairobi on Tuesday, September 25, 1973

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1. The Peruvian delegation met with Mr. McNamara at 2:10 p.m. on September 25. General Marco del Pont, Director of the National Planning Institute, was accompanied by Luis Barua (COFIDE's President) and Carlos Santistevan (Alternate Executive Director). Those present for the Bank included Messrs. Knapp, Alter, Holsen, and the translator.
2. General Marco del Pont began by noting the coincidence between the points emphasized by Mr. McNamara in his opening speech and Peru's own development objectives. Both income distribution and agrarian reform were priority concerns of his Government. He said that Peru is carrying out the only agrarian reform that hasn't hurt production. He mentioned recent changes in the agrarian reform legislation to benefit small farmers. (Note: Medium-sized commercial farmers even more than small farmers will be beneficiaries of the stability of tenure provisions of the new decree.)
3. The General noted that the recent agricultural credit loan from the Bank would strengthen the Government's program for small farmers and cooperatives. Likewise, the education loan (for which negotiations had just been completed) would support this most important part of the Government's reform program. He expressed his hope that the flow of funds from the Bank would continue, mentioning the proposed highway loan in particular. He hoped that the next Consultative Group meeting would be even more successful than the last, based in part upon the Bank's lending.
4. In conclusion, General Marco del Pont invited Mr. McNamara to visit Peru next year. He also expressed the Finance Minister's regrets at being unable to attend the meetings in Nairobi and emphasized the keen interest which the President of Peru takes in Mr. McNamara's speeches.
5. Mr. McNamara indicated his satisfaction that the lending program had been reinstated and that the initial projects would assist small farmers and the educational sector. He said an agreement on the approach to highways financing should be reached at the next day's meeting with Mr. Alter. Regarding the Consultative Group, he indicated he thought another meeting should be held next year; its scheduling should also be discussed with Mr. Alter. Mr. McNamara thanked General Marco del Pont for the invitation to visit Peru; he said he had never been there and would make an effort to find the time to visit Peru.

October 2, 1973

6. In conclusion, Mr. McNamara referred to his interest in the status of the measures (discussed at the last Consultative Group meeting) to provide an additional S/3 billion in budgetary revenues in 1974 and also the steps to be taken to close the financing gap that may exist even after these measures are taken. He asked that these matters be discussed with Mr. Alter and that the latter report back to him on what the Government will be doing to increase revenues and control expenditures.

cc: Mr. Alter  
Mr. Knox, LAC, Projects  
Mr. Lerdau, Acting Director, LAC I  
Mr. Nelson, Division Chief, LAC I  
Mr. Pfeffermann, Proj. LAC  
Mr. Goffin, Proj. LAC  
Mr. Thint, Pro. LAC

JAHolsen<sup>pa:</sup>/acn

10

## OFFICE MEMORANDUM

TO: Memorandum for the Record

DATE: October 2, 1974

FROM: Roger Nelson, Division Chief, LAC I

SUBJECT: Meeting with Mr. McNamara and the Peru Delegation

10/24

The Peru Delegation met with Mr. McNamara at 2:30 p.m. on Monday, September 30. General Amilcar Vargas Gavilano, Minister of Economy and Finance, was accompanied by Mr. Carlos Santistevan, Alternate Executive Director. Those present for the Bank included Messrs. Chenery, Alter, Krieger and Nelson. General Vargas began by expressing satisfaction about the \$75 million of Bank loans to Peru last year and his expectation of about \$100 million of Bank loans annually. He then pointed out that Peru's economic and financial situation is well known to the Bank and that the situation is good.

Mr. McNamara then expressed concern about the low level of public savings in relation to investment and high level of external debt and future service on it. In response, the Minister indicated that Peru has positive public savings and is taking additional measures which are expected to increase Government revenues by 6 to 7 billion soles annually. He cited specifically three measures now being taken: (a) an extension of the sales tax from the producer to the wholesale level; (b) the revaluation of the assets on which the property tax is assessed; and (c) increases in prices charged for some basic commodities.

Referring to Peru's external debt, Minister Vargas pointed out that this problem is being eased by the exports of both non-traditional types and of basic materials, particularly minerals and petroleum. He also mentioned that the preparation of the Government's financial program for the next two years will be completed during December and suggested that this will provide a basis for considering further Peru's external borrowing plans and its implications for Peru's external debt. He also pointed out that the various measures now being taken are designed to have an anti-inflationary effect without producing a recession.

In conclusion, General Vargas and Mr. McNamara expressed a mutual interest in close cooperation in Peru's future development.

RNelson:scg

cc: Messrs. Alter

Krieger, Director, LAC I

Avramovic, Chief Economist, LAC

Blaxall, LCP

Pfeffermann, Sr. Economist, LAC I

Chaparro/Mendoza, LC1DD

Perez, LAC

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## OFFICE MEMORANDUM

TO: MEMORANDUM FOR THE RECORD

FROM: Roger Nelson, Division Chief, LAC I

SUBJECT: PERU: Meeting of Mr. Elespuru with Mr. McNamara

DATE: January 24, 1975

1. Mr. Elespuru, head of the Legal Department of the Ministry of Finance, accompanied by Mr. Santistevan, met briefly with Mr. McNamara at 6:30 p.m. on January 15. The main purpose was to deliver an invitation on behalf of the Government for Mr. & Mrs. McNamara to visit Peru. In response, Mr. McNamara expressed appreciation for the invitation and his keen interest in visiting Peru. He then mentioned that his travel plans for the year currently are uncertain until a schedule of visits to OPEC countries is worked out, referring to their priority at the present time. He then indicated that, when these plans are worked out, he hoped to be able to schedule a visit to Peru at a time convenient for the Peruvian Government.

2. A copy of the incoming letter together with a translation is attached.

Attachment

cc: Messrs. Alter  
Burmester  
Krieger, Director, LAC I  
Mendoza, Loan Officer, LAC I

RNelson:eg



DE ECONOMIA Y FINANZAS

Lima, 8 de Enero de 1975

OFICIO N° 001-75-EF/10-01

Señor  
Robert S. McNamara, Presidente del  
Banco Internacional de Reconstrucción y Fomento  
Washington, D.C. 20433  
U.S.A.-

Estimado señor Presidente y amigo:

Para mí es especialmente grato dirigirle la presente, que me permite expresarle mi simpatía por la línea de constructiva cooperación que el Banco mantiene hacia el Perú, cooperación que traduce, evidentemente, el espíritu que usted, señor Presidente, imprime a la política de esa institución financiera mundial.

En la actual circunstancia económica, resulta muy alentador saber que los criterios del más alto funcionario del Banco Internacional de Reconstrucción y Fomento, respecto a los problemas que confrontan los países en desarrollo, se caracterizan por su realismo, y sentido humanista, en relación a las necesidades de inmensas masas humanas desplazadas de los mínimos requerimientos vitales.

El propósito de mi comunicación es, señor McNamara, renovarle en nombre de mi Gobierno, la cordial invitación para que visite el Perú en la fecha que tenga a bien señalar, invitación que haremos extensiva a su digna esposa. Su visita a mi país ofrecería una favorable ocasión para que, en forma personal, pueda apreciar la gestión transformadora que realiza el Gobierno Revolucionario de la Fuerza Armada. Personalmente, me será muy grato brindarle la especial hospitalidad que usted merece.

/..

Quedo a la espera de su estimable decisión; en tanto me complace, señor Presidente y amigo, renovarle el testimonio de mi distinguida consideración.

Cordialmente,



General de Brigada E.P.  
AMILCAR VARGAS GAVILANO  
Ministro de Economía y Finanzas

FREE TRANSLATION

Dear Mr. President and friend:

I wish to take this opportunity to express my sincere appreciation for the policy of constructive cooperation which the Bank has implemented towards Peru and which obviously reflects the spirit with which you, Mr. President, guide that world-wide financial institution.

At the present economic juncture, it is a source of comfort to know that the thinking of the highest officer of the World Bank with respect to the problems which are now facing the developing countries, is characterized by a realistic and humanitarian approach when dealing with the urgent needs of immeasurable masses of people who are presently lacking the most elementary means of subsistence.

The purpose of this communication, Mr. President, is to renew in the name of my Government, our most cordial invitation for you and Mrs. McNamara to visit Peru at a time when it would be most convenient to you both. Your visit to our country would give us the opportunity to show you personally the efforts towards change which are being carried out by the Revolutionary Government of the Armed Forces. Personally, it will be a pleasure for me to be able to offer you our most special hospitality as you deserve.

Looking forward to hearing your comments as to the feasibility of accepting our most sincere invitation, I remain,

Very truly yours,

12

## OFFICE MEMORANDUM

TO: Files

DATE: April 22, 1975

FROM: E. Lerdau

SUBJECT: PERU - Visit of Minister of Finance to Mr. McNamara

1. On April 21 the Minister of Finance and Economy of Peru, General Amilcar Vargas Gavilano, accompanied by Mr. Santistevan, called on Mr. McNamara and Mr. Knapp. The writer was also present.
2. The Minister expressed his gratification for the way the recent Consultative Group meeting on Peru had gone and, in particular, commended the Bank staff for the economic report.
3. The Minister reiterated the Government's invitation for Mr. McNamara to visit Peru. Mr. McNamara said that if the Government would let him choose a convenient date within the next twelve months, he would be glad to accept the invitation. The Minister said that this was entirely acceptable.
4. The Minister referred to the discussion that he had had with Mr. McNamara at the time of the 1974 Annual Meeting and recalled that Mr. McNamara at that time had asked him a number of questions regarding savings in Peru. He said that he was glad to report that a number of substantial actions had already been taken and that some more would be taken, because the Government shared the Bank's view that more domestic resources had to be mobilized to finance needed investments. Mr. McNamara expressed his pleasure and said that he had been informed of the Minister's concern lest the low level of Bank lending to Peru in FY75 represent a lasting reduction in the Bank's programmed lending for FY75 and FY76. He said that he wanted to assure the Minister that the Bank realized that whether a project fell into one fiscal year or another was to some extent fortuitous, and that the Bank was primarily concerned whether the projects that it was asked to finance were fully prepared and sound. Consequently he could assure the Minister that there was no need to be concerned, i.e. that the slippage of some projects from FY75 to FY76 would not lead to a reduction in the Bank's total lending to Peru for the two years. The Minister expressed his appreciation for this assurance.
5. The Minister gave Mr. McNamara some details of petroleum prospects, mentioning that Petroperu and the Ministry of Mines were working with several hypotheses, of which the most optimistic was that by early 1977 there would be total production of some 200,000 barrels per day, of which some 60,000 would be exportable, while in 1978 exports might reach 160,000 barrels per day. The financial authorities, wishing to be as cautious as possible, were basing their balance of payments and public finance projections on estimates which were only 50 to 75 percent of those mentioned above, but that every day seemed to produce more evidence in support of the higher projections. Mr. McNamara said that these were impressive figures, which according to his calculation would mean some \$150 million per year of petroleum export earnings to Peru.

cc: Mr. Santistevan

Cleared with and cc: Mr. Knappcc: Messrs. Krieger, de Vries, Nelson, Pfeiffermann  
ELerdau/jd

## OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara  
(through Mr. J. Burke Knapp)

DATE: April 21, 1975

FROM: Enrique Lerda

SUBJECT: PERU - Your Meeting with Finance Minister

1. You will meet the Minister of Economy and Finance, General Amilcar Vargas (biodata sheet attached), on April 21 at 6.30 p.m., during his stopover on his return from the Consultative Group on Peru (CGP) meeting in Paris. The meeting was quite successful; both the Peruvian Delegation and those of the participating countries seemed genuinely pleased. The expressions of interest by governments in the financing of individual projects included in the list - prepared by the Government with Bank help - submitted to the CGP, greatly exceeded those of previous meetings. This undoubtedly reflects in part a much more relaxed political atmosphere: this was the first CGP meeting in which the investment dispute with the United States was absent, so that the U.S. could participate fully, rather than attend as observer. It also reflects a much improved project list and an excellently briefed Peruvian Delegation. Mr. Santistevan was most helpful. A copy of the Chairman's introductory remarks, and of the final Press Release are attached.

2. As far as I know the Minister intends to raise the following points with you:

a. Invitation to visit Peru

He will reiterate the Government's invitation to you to visit Peru. Almost any time would be acceptable; if you accept, I suggest that you go before November, which is when the rainy season in the mountains begins and field visits to rural areas become more cumbersome and more difficult to schedule with precision. I also suggest you exclude from consideration the two weeks following July 27, because of national holidays. The Government genuinely hopes that you will accept and, given our present state of good relations, I think that your visit would be very fruitful.

b. Lending FY75-FY76

The Minister will wish to obtain confirmation that the fact that we have not made any loans in FY75 will not reduce the cumulative total for FY75-76. Two major operations - the \$68 million Transandean Corridor (road and river ports) and the \$30 million DFC (COFIDE) loan, scheduled for FY75, have slipped to FY76. The Minister asked me this question in Paris, and, following Mr. Knapp's guidance, I gave him a categorical answer to the effect that we would, in this case, treat the two years together so that Peru's total would not be affected by the slippage of the highway project. Whether this also applies to the COFIDE slippage was left fuzzy. Since he attributes importance to the lending totals it would be good if you could confirm my answer to him if he raises the question.

c. Cofinancing

Several of the projects in the list presented at the CGP meeting are very large and costly with a foreign exchange component exceeding the amount any single lender is likely to be willing or able to put up. The Minister is likely to ask that the Bank sponsor cofinancing arrangements for one or more of these. He may mention, in particular, the \$1 billion expansion of the Chimbote iron and steel plant (foreign exchange component \$689 million). We have had no opportunity to assess, even informally, the merits of the project (although on grounds of location, raw material availabilities and scale, I would assume that viability can be established) and we do not have this item in our operations program. As far as the lending involved is concerned, there are enough weak spots in our present program to make it likely that this project could be accommodated without a great expansion in total lending. You might give a guardedly positive answer on our willingness to look at the project, if our project staff resources permit it.

In addition, you might indicate our readiness to cooperate in the cofinancing of the large copper projects of CENTROMIN and MINEROPERU, the two Government mining companies. The amounts that we have in the lending program for these projects (\$50 million in FY76, 78 and 80) would leave room for substantial participation by other lenders.

3. As far as the economic discussions of the CGP are concerned, you may wish to comment favorably both on the fiscal measures already taken in CY 1975 and on the Government's intention - reiterated unambiguously by the Minister during the debate - to raise domestic petroleum product prices appreciably very soon. (The present retail price of premium gasoline in Peru is approximately \$0.20.) The measures already taken - which also include a reduction in consumption subsidies - plus the petroleum product price increase are substantial: together they should raise public sector savings from 1.5 to 3.3 percent of GDP.

cc: Mr. A. Krieger  
Mr. H. Fuchs  
Mr. R. Nelson

*per gallon*

Attachments

Annex I Biodata sheet on General Vargas  
Annex II CGP: Opening Statement by Chairman  
Annex III CGP: Press Release

ELerdau:jd

Biodata Sheet

General Amilcar Vargas Gavilano - Minister of Finance

General Vargas was appointed Minister on July 18, 1974 following the resignation of General Guillermo Marco del Pont. The new Minister has ample experience in financial matters. He was Director of the Budget in 1970-71 under Minister Morales Bermudez and, up to his appointment, continued serving in the Ministry as a special advisor to both Morales Bermudez and Marco del Pont.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

RESTRICTED

April 16, 1975

MEETING OF THE CONSULTATIVE GROUP FOR PERU

Paris, Wednesday and Thursday, April 16 and 17, 1975

Opening Statement by the Chairman

Ladies and Gentlemen:

1. It is a special privilege for me to welcome to this meeting of the Consultative Group for Peru the delegates representing the member countries of the Consultative Group, the Ministry of Economy and Finance and his colleagues representing the Government of Peru, and the representatives of institutions attending as participants or as observers.

2. Since the last time this Group met in June 1973, the Peruvian Government has continued carrying out the basic structural and institutional reforms initiated six years ago, especially in the agricultural and industrial fields. Over-all planning and the project preparation and execution capacity in the public sector have improved. At the same time a relatively satisfactory level of growth has been maintained in spite of the fishmeal industry crisis in 1972-73 and the serious deterioration in the terms of trade suffered in 1974. On the whole, the Government has continued to demonstrate its capacity to manage the Peruvian economy soundly and pragmatically, combining structural reforms of a far-reaching nature with financial prudence and realism. Moreover, it has succeeded to accelerate considerably the capacity of the public sector to mobilize and use effectively financial resources from abroad for use on development projects.

3. The recent Bank economic report supports the targets of the Peruvian Government in the next few years to sustain economic growth and accelerate investment to mobilize the exportable mineral resources while at the same time consolidating and deepening the structural reforms initiated. However, the report also underlines some important issues which in our opinion are critical in the attainment of these objectives.

4. I propose to summarise these issues very briefly, as I have no doubt that the Chief of the Peruvian Delegation, General Vargas Gavilano will want to address them in detail. Fundamentally, we are concerned with four major issues, namely domestic savings, debt management, exports, and agriculture. Singling out these issues for discussion does not mean, however, that we fail to recognise the important progress that has already been made in each of these fields; rather it signifies that it is our understanding that the Government shares our view that continued attention will have to be devoted to them if the over-all Government objectives are to be achieved.

5. The first issue is related to the increased mobilization of domestic financial resources. During 1973-74 although the Government was successful in sharply increasing the level of investment, this was not matched by a sufficient flow of additional savings and a sizeable resource gap developed. Gross national savings, which in 1972 had been 15.5 per cent of Gross Domestic Income, by 1974 had declined to 12.0 per cent, while in the same period Gross Domestic Investments rose from 14.2 to 16.0 per cent. The Bank's projections suggest that in future years the resource gap will have to be gradually reduced to ensure that foreign debt service and/or inflationary pressures remain within manageable levels. The Peruvian Government agrees with this and has started to implement a series of measures aimed at increasing savings of both the public and non-public sectors. The measures approved early in 1975 will increase the tax burden and substantially reduce consumption subsidies on foodstuffs. In addition the Government is in the final stages of consideration of a sharp increase in domestic petroleum products prices, intends to limit further consumption subsidies to the most essential products consumed by the poorest segments of the population and is about to implement a program to increase gradually the level of interest rates in the financial system which in real terms became increasingly negative during the last two years. The magnitude of these efforts is illustrated by the fact that the measures already taken are estimated to raise public sector savings on current account from 1.5 to 2.8 per cent of Gross Domestic Product, while the expected oil price increase would raise this total further to 3.3 per cent.

6. The willingness already demonstrated to mobilize domestic savings should also make it easier for Peru to obtain the sizable inflows of external capital needed to complete the financing of the Government's ambitious investment program. Governments and international institutions will be called upon to participate, and certainly the World Bank expects to play a constructive role in this. But other sources, too, will have to be tapped and the Government has already had notable successes in this respect. The resources mobilized from commercial banks and suppliers in 1974 - some \$595 million - are an impressive testimony to the confidence of

the international community in the Government's policy. To ensure a continuation of this favorable atmosphere, we would urge a strengthening of the machinery for financial planning, the better to ensure that priority projects always find the most favorable types of financing and that the over-all levels of debt service obligations do not exceed the capacity of the economy to generate the required resources. In addition, lenders will want to be reassured that the Government will continue to tailor its investment decisions to its financing possibilities, i.e. that shortfalls in resources would be matched by deferral or reduction of some investments, to protect the viability of the public finances.

7. The capacity to service external debt depends, of course, primarily on the dynamism of export earnings. Our economic report is rather optimistic about the medium-term outlook, in spite of the serious deterioration in export prices which Peru is presently experiencing. The main growth element here is petroleum, and it will be particularly interesting to hear the views of the Peruvian delegation regarding the realism of this projection.

8. Increasing agricultural output to lower the country's dependence on imported foodstuffs and reduce the acute poverty and underemployment in the rural areas is vital for Peru's social and economic development. In the last few years a large part of the Government's efforts has been concentrated on achieving a rapid redistribution of land ownership in the coastal areas. For the future it seems to us that there are two sets of issues that require attention. On one side, investment priorities in the sector should be more clearly defined. If food output and employment are to be rapidly increased in the coastal areas, then more emphasis should be given to relatively low-cost irrigation rehabilitation schemes. But the bulk of Peru's agricultural population lives in the Sierra, and a large-scale effort to improve productivity and incomes there can only be achieved if more human and financial resources are dedicated to the identification and preparation of suitable projects. On the latter point, various experimental schemes in increasing yields in potato production, dairy farms and forestry among others, have shown some success, but few large-scale projects or programs have been developed. On the other side, there is room for improvement in the management, investment levels and project preparation capacity in the established co-operatives. Of overriding importance in the short run, however, is a rapid definition of responsibilities between the Ministry of Agriculture and the newly-created Ministry of Food; it will be most useful to spend some time on this issue in the discussions of the next two days.

9. I would like to emphasize that in Peru, as in most other countries in Latin America, the financial problems confronting the Government are greatly aggravated by the sharp deterioration of the terms of trade and the hardening of lending terms in the international commercial capital markets. The efforts which the Peruvian Government is now making to develop and exploit the country's natural resources and to distribute more evenly the nation's income and wealth should lay the basis for the long-term viability of the

Peruvian economy and society. We, therefore, think that as long as Peru continues taking sufficient measures that guarantee a reasonably stable internal and external financial position, it is only proper that its efforts be complemented by an expanded level of technical and financial support from abroad, including some at concessionary terms.

10. Concerning the List of Projects for External Financing prepared by the Peruvian Government for consideration by members of the Consultative Group, we hope that our subsequent discussions will throw further light on the investment priorities of the Peruvian Government, and thus enable Group members to indicate their interest in the individual sectors and projects in which they wish to support the Peruvian program. In this connection, we see a need for a more concerted effort from all parties concerned to match systematically the available technical and financial assistance resources on the one hand, and the projects requiring external financing on the other. Several lenders have indicated that they have budgeted government funds or would be prepared to do so, but apparently have difficulty in attaching these funds to projects of a type they prefer, mostly projects with a direct social content. Some of the agencies financing exports of capital goods appear to be prepared to expand the volume of their loans if projects were offered. It should be recognized that, as the number of investment projects, as well as their size, increases, the complexity of matching finance with project also grows and calls for additional efforts. We do not doubt that by confronting this problem directly, we should be able to record substantial progress during and subsequent to these meetings.

11. I trust our deliberations will contribute to these objectives.

12. Before asking the head of the Peruvian delegation to present his statement, I would like to suggest that, in line with the Annotated Agenda which was distributed to you on April 31, following the Peruvian statement we devote this morning's session to the discussion of Peru's economic performance and prospects and its external financial requirements. Discussion of the project list would be initiated this afternoon and continued, if needed, tomorrow morning. It is during the discussion of the project list that delegates will have an opportunity to indicate their interest in providing support for the Peruvian program.

13. Does any delegation wish to suggest a modification in the agenda?

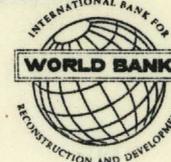
14. I now should like to invite General Amilcar Vargas Gavilano, Minister of Economy and Finance, and Chief of the Peruvian delegation, to present his statement.

European Office  
Paris.

International Bank for  
Reconstruction and Development

66, AVENUE D'ENNA, 75116 PARIS - TÉL. : 720.25.10 - TELEX : INBAFRAD 62164 F

ANNEX III



*As from March 15, 1975  
new telephone number :  
723.54.21*

PRESS RELEASE  
for Immediate Publication  
April 17, 1975

SUBJECT: Meeting of Consultative  
Group for Peru

A meeting of the Consultative Group for Peru, sponsored by the World Bank was held in Paris on April 16 and 17, 1975, with the purpose of coordinating external financing of the development efforts of Peru. The meeting was chaired by Mr. Enrique Lerdaу, Director of Country Programs Department, Latin America and the Caribbean Regional Office of the Bank.

The delegation of the Government of Peru was headed by General Amilcar Vargas Gavilano, Minister of Economy and Finance, and included the Head of the Planning Office, General José Loayza Amezquita and several other high officials of the administration.

The meeting was attended by the representatives of the Governments of Belgium, Canada, Finland, France, Federal Republic of Germany, Italy, Japan, the Netherlands, Spain, the United Kingdom and the United States. Representatives of the International Monetary Fund, the Inter-American Development Bank, the Permanent Executive Commission of the Economic and Social Inter-american Council (CEPCIES), the United Nations Development Programme, and observers from Switzerland and the Organization for Economic Cooperation and Development also attended.

The Group discussed the development prospects of Peru and its needs for foreign financing, on the basis of a report prepared by the World Bank. The Head of the Peruvian delegation made a comprehensive presentation setting forth the objectives of Government development strategy and the policies which will be pursued during the next several years. He emphasized the twin goals of increasing domestic food production and rural incomes, and developing at an accelerated pace basic industries, petroleum, mining and

essential infrastructure. The Minister described the recent measures for reducing non-essential consumption and for increasing domestic savings, in the fields of taxation and curtailment of consumption subsidies. He indicated that the Government was considering measures to mobilize additional domestic resources in the near future, including readjustment of the domestic price of petroleum products.

The Group agreed that Peru had made substantial progress in achieving the objectives of structural socio-economic change and laying foundations for rapid economic growth. The Group noted the increase in Peru's capacity to generate development projects. It noted Peru's efforts to diversify its production and export structure and its success in expanding non-traditional exports. The Group noted the progress in the implementation of agrarian reform, and indicated its readiness to support investment programs in the rural areas, particularly in the depressed Andean highlands. The Group expressed its readiness to cooperate with the Peruvian authorities in the preparation of feasibility studies in the rural sector, considered of high priority for economic and social development.

The Group reviewed Peru's external capital requirements and agreed that to achieve the necessary disbursement levels, project loan commitments of the order of US\$950 million annually would be needed in the three-year period 1975-77, compared to an average of \$530 million achieved in the two years 1973-74. It was of particular importance to assure that the required commitment level be reached in 1975 and 1976. The Group discussed the list of projects prepared by the Government, amounting to \$3.5 billion for 1975-77, an amount which should enable the project loan commitments to reach the desirable level. The Group further agreed that some local cost financing of projects was needed. The Group also agreed that it was important that suitable technical assistance be provided to enable the project financing to be used to maximum advantage. In addition, financing not tied to specific projects will continue to be necessary.

The Group noted that Peru was successful in mobilizing financing from the commercial markets, despite the deterioration in the world financial situation. It agreed, however, that the cost of this borrowing was such that it could only be relied upon as a supplementary source of finance, and emphasized the need for intensification of efforts at domestic resource mobilization.

The Group noted the hardening in Peru's average terms of borrowing, and recommended that external financing should be provided on as favorable terms as possible including assistance on concessional terms. It was suggested that efforts should be made to blend government-to-government assistance with the credits made available under the export credit guarantee arrangements. The Group also agreed that for several of the large projects included in the project list, cofinancing would be desirable. The Group noted the Government's determination to pursue a careful debt management policy, and supported the Government's intention to ensure that borrowing decisions are consistent with project priorities and sound financial planning.

A noteworthy feature of the meeting was the lively interest expressed by Group members in many of the projects included in the project list.

It was agreed that the Group would meet again in approximately eighteen months.

BANK LENDING PROGRAM FOR PERU FY1975-76  
(in millions of dollars)  
FY1975 FY1976

	GPP	Revised	CPP	Revised	
Irrigation Rehabilitation I			20.0	20.0	Appraisal scheduled for late April. Issues concerning project implementation (water tariffs collection, administration of project, etc.) may cause delays.
DFC I - COFIDE	30.0	30.0			Prospects of project being ready for Board presentation in FY75 are low.
Mining I - CENTROMIN			50.0	50.0	In line with Mr. Knapp's suggestion co-financing for this project is being explored.
Power V - Empresas Electricas			25.0	35.0	Recent tariff action has improved prospects of bringing this project to fruition, but effect of tariff increase has not been analysed yet. Amount revised because of larger price increases than foreseen earlier.
Power VI - Electroperu			35.0	-	Project postponed to FY77 in view of status of project preparation and time required to deal with institutional issues in Electroperu.
Andean Corridor	55.0	68.0			Amount includes \$11.5 mil. interest during construction, as is being recommended to Loan Committee in a few days.
Ports V - (Ocean Ports)			10.0	15.0	Projects staff constraints and delays in current investment plan for the related iron and steel mill expansion in Chimbote may postpone this project to FY77. Amount revised because of larger price increases than foreseen earlier.
Operations Program	$\frac{85}{2}$	$\frac{98.5}{2}$	$\frac{140.0}{5}$	$\frac{120.0}{4}$	
Lending Program	$\frac{85}{2}$	$\frac{68.0}{1}$	$\frac{120.0}{4}$	$\frac{135.0}{4}$	Lending program for FY76 assumes one project slipping into FY77 & addition of \$30 million carryover from FY75.

March 5, 1975



VISIT TO SOUTH AMERICA, March 2-12, 1976

<u>DATE</u>	<u>TIME</u>	<u>GMT</u>		<u>REMARKS</u>
Mar. 2	1746	2246	Depart Washington (National)	EA197 (DC9) nonstop coach
Tues.	2014	2514	Arrive Miami	Airport Hotel (double room)
Mar. 3	0115	0615	Depart Miami	Aeroperu 601 (DC8) nonstop
Wed.	0650	1150	Arrive Lima	first
	0800		Rest in hotel	Sheraton Lima (small suite)
	1100		Meeting with Finance Minister, President of Central Bank, and President of COFIDE	
	1300		Lunch hosted by President Central Bank	
	1500		Meeting with COFIDE, Chief of Planning Office, and Presidents of selected public enterprises	
	<del>1700</del> 1730		Meeting with Prime Minister <i>of Peru</i>	
	<del>1830</del>		Courtesy visit to Minister Foreign Affairs	
	2000		Reception hosted by Finance Minister (with wives)	
Mar. 4				
Thurs.	0900		Meeting with Minister of Housing and field visit to site of proposed "Sites and Services project" in Lima area (Villa El Salvador)	
	1330		Private meeting with President of Republic	
	1400		Working lunch with President, Ministers of Agriculture, Food, Industry, Energy & Mines, Transport, and Planning	
			<u>Following meetings will take place at the hotel</u>	
	1630		UNDP ResRep	
	1700		Mr. Keller, President of ADELA until recent retirement	
	1730		Mr. L. Paredes, President of Peruvian Institute for Business Administration (IPAE); Mr. P. Reyser, Industrialist and President of ENTURPERU; Mr. G. Lanatta, Industrialist; and Mr. A. Villalobos, President of Chamber of Commerce	
	1800		Mr. C. Mariotti, Industrialist and former President of Empresas Electrical (Lima Power Company)	
	1830		Mr. E. Jaworski, Director of "El Comercio" (daily newspaper); Mr. L. Chiappo, Editor of "El Expreso" (weekly magazine); and Mr. J. Matos Mar, Director of Institute for Political Studies	
	1900		Mr. N. Asheshov, Editor of "The Andean Report"	
	2000		Informal dinner by COFIDE (with wives)	
Mar. 5				
Fri.	0700		Depart to Trujillo	by special plane
	0820		Arrival in Trujillo and visit to Sugar Cooperative "Casagrande"	
	1100		Depart for Tarapoto	
	1300		Arrive in Tarapoto	
	1315		Lunch at Hotel De Turistas with explanation on development program of Huallaga Region	
	1430		Visit Huallaga and Alto Mayo areas, where new developments in agriculture have taken place and more are being planned	
	1600		Depart for Lima	
	1730		Arrival in Lima	

<u>DATE</u>	<u>TIME</u>	<u>GMT</u>		<u>REMARKS</u>
Mar. 6	0730	1230	Depart for Cuzco	Aeroperu arranged by COFIDE
Sat.	0830	1330	Arrive Cuzco	
	1000		Depart for Machu Picchu	Special autowagon
	1230		Visit to Machu Picchu and lunch	
	1700		Return to Cuzco	Autowagon
Mar. 7	0900		Visit Cuzco and its surroundings	
Sun.	1200	1700	Depart for La Paz	Special plane
	1415	1815	Arrive La Paz	Hotel La Paz (small suite)
	1500--1800		Tour of city	
	2000		Small informal "get acquainted" dinner by Finance Minister, Carlos Calvo, at his home. About nine couples will be present plus six Bank participants	
Mar. 8				
Mon.	0800--1000		Meeting with Economic Group at Presidential Palace to be attended by: Minister of Finance, Carlos Calvo Minister Planning & Coordination, Lechin Presidential Advisor, Violand Undersecretary of Planning, Valdes Executive Director of External Financing Institute, Ormachea	
	1010--1030		Meeting with President Banzer	at Presidential Palace
	1035--1310		Visit by car to Ingavi Rural Development project (at Jalsuri)	
	1315--1340		Signing (in Jalsuri) of Loan Agreement for Ingavi Rural Development Project by Mr. McNamara and President Banzer and Minister of Finance Carlos Calvo on behalf of Government	
	1345--1540		Lunch at Jalsuri with President Banzer	
	1755		Arrive at Hotel Evening free	
Mar. 9				
Tues.	0800--0930		Meeting with top representatives from private sector (banking, mining and industry)	
	0935--1000		Briefing about urban development of La Paz	
	1005--1200		Tour of urban development sites in La Paz	by car
	1250	1650	Depart for Santa Cruz with President Banzer	Govt. plane (lunch served)
	1425	1825	Arrive Santa Cruz	Holiday Inn or Govt. accommodation
	1425--1445		Introduction to welcoming party of local leaders	
	1455--1800		Tour to see agricultural areas in Santa Cruz, with briefing by President Banzer Evening free	by helicopter
Mar. 10				
Wed.	0540	0940	Depart for Asuncion	Govt. plane
	0800	1100	Arrive President Stroessner Airport	Hotel Ita Enramada
	0900		Meeting with President Stroessner	
	1000		Visit rural and eastern areas of Paraguay (area of Small Farmer Credit and Rural Development Project)	by plane to Coronel Oviedo by car to Caaguazu
	1400		Trip to Itapua Department (southeastern Paraguay). Flyover Parana River and sites of future hydroelectric schemes. Lunch during flight. Visit cooperatives at Hohenau, Obligado, Capitan Meza, etc.	

<u>DATE</u>	<u>TIME</u>	<u>GMT</u>	<u>REMARKS</u>
	1800		Return to Asuncion
	2000		Cocktail party hosted by Finance Minister, General Cesar Barrientos--guests will include other Ministers and some prominent members of private sector
Mar. 11			
Thurs.	0700		Meeting with economic team
	1000		Field trip to El Chaco, Western Paraguay visit to Mennonite colonies and cooperatives of Loma Plata and Filadelfia
	1500		Depart for Asuncion
	1630		Arrive Asuncion
	1700--1800		Open (after visitors have had chance to see the country, President Stroessner usually likes to have wrap-up meeting to exchange ideas on policies and programs that will improve their development efforts)
	2115	0015	Depart Asuncion
	2345	0445	Arrive Lima
Mar. 12			
Fri.	0110	0610	Depart Lima
	0830	1330	Arrive Washington (Dulles)

by plane  
Club Centenario

Presidential plane

Presidential plane

Braniff 974 (D8S) one stop  
(La Paz) coach

Braniff 978 (DC8) nonstop  
(coach)

SB  
March 1, 1976

Peru

64-68	129
69-73	38
74-78	458
74	8
75	0
76	172
78	90

Excessive consumption (high subsidies food & gas)  
 Low savings (low taxes, neg. int. rates, losses of state enter.)  
 Stagnation of food prod. (inadeq. supply & high price of fert. etc)  
 World recession (low vol. & price of copper; & other exports)  
 adverse weather  
 Low fish catch  
 Strikes

Adv. Stage of prof  
 Sectors & Service  
 mining  
 Agri  
 Others

∴ Inter. res. fell from 1/1 to 1/3 in 1975 650m to 150m = 4.6% exports

∴ '76 Govt must reduce resource gap

1/10/76 austerity measures:

- inc. in petrol & food prices
- inc in taxes
- 5% cut in govt. spend.
- decreasing exports

330m pa

Proposed to take add'l measures if necessary

∴ '77: effort goes to be effective  
 by end yr: petrol self-suffic.

Topics for conversation:

1. Causes of crises '75 80% prod & res. crisis
2. Action to prevent (& prospects for preventing in '76)
3. Further action that may be needed
4. Outlook for: copper export in '77  
petrol self-suffic in '77
5. Extent & future of land reform
6. Progress & future plans for integrating the Indians, & raising productivity (characterized 5-6% rate by dual economy)
7. Plans for tackling urban slums (40% of Lima)
8. Plans to increase present low-level of int. rates
9. What is Morales New Plan for long-term Govt obj
10. How is economic planning working: state enterprise; industrial community; social enterprise; agri. coop;

Itinerary for Mr. McNamara's Visit to Peru

Wednesday, March 3

6:50 a.m. Arrival in Lima in Aeroperu, Flight 601  
8:00 a.m. Rest in Sheraton Hotel  
11:00 a.m. Meeting with Minister of Finance, President of Central Bank  
and President of COFIDE  
1:00 p.m. Lunch hosted by President of Central Bank  
3:30 p.m. Meeting with COFIDE, Technical Director of the Planning  
Office, and Presidents of selected public enterprises  
5:30 p.m. Meeting with Prime Minister and Minister of Foreign Affairs  
8:00 p.m. Reception hosted by Minister of Finance (with wives)

Thursday, March 4

7:30 a.m. Visit to International Potato Center and meeting with  
Deputy Director  
9:00 a.m. Meeting with Minister of Housing and field visit to the  
site of a proposed "Sites and Services project" in the  
Lima area (Villa El Salvador)  
1:30 p.m. Private meeting with President of the Republic  
2:00 p.m. Working lunch with President of the Republic and Ministers  
of Agriculture, Food, Industry, Energy and Mines, Trans-  
port, and Planning

The following meetings will take place at the hotel:

4:30 p.m. UNDP Resident Representative  
5:00 p.m. Mr. Keller, President of ADELA until recent retirement  
5:30 p.m. Mr. L. Paredes, President of the Peruvian Institute for  
Business Administration (IPAE); Mr. P. Reyser, Industrialist  
and President of ENTURPERU; Mr. G. Lanatta, Industrialist;  
and Mr. A. Villalobos, President of the Chamber of Commerce  
6:00 p.m. Mr. Mariotti, Industrialist and former President of  
Empresas Electricas (Lima Power Company)  
6:30 p.m. Mr. E. Jaworski, Director of "El Comercio" (daily newspaper);  
and Mr. J. Matos Mar, Director of the Institute for  
Political Studies  
7:00 p.m. Miss Michelle Proud, co-editor of "The Andean Report"  
8:00 p.m. Informal dinner offered by COFIDE (with wives).

Friday, March 5

7:00 a.m. Departure from hotel to take special plane to Trujillo  
8:20 a.m. Arrival in Trujillo and visit to Sugar Cooperative  
"Casagrande" in the area  
11:00 a.m. Departure to Tarapoto  
1:00 p.m. Arrival in Tarapoto  
1:15 p.m. Visit to the construction site of the Transandean oil  
pipeline  
5:00 p.m. Return to Lima  
7:00 p.m. Arrival in Lima.

Saturday, March 6

7:30 a.m. Departure by plane to Cuzco  
8:30 a.m. Arrival in Cuzco  
10:00 a.m. Departure in special autowagon to Machu Picchu  
1:30 p.m. Lunch and visit to Machu Picchu  
5:00 p.m. Return to Cuzco in special autowagon  
10:00 p.m. Dinner offered by President of COFIDE

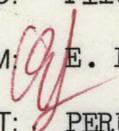
Sunday, March 7

9:00 a.m. Visit to Cuzco and its surroundings  
12:00 noon Departure to La Paz in special plane.

## OFFICE MEMORANDUM

TO: Files

DATE: April 5, 1976

FROM:  E. LerdauSUBJECT: PERU - Mr. McNamara's Visit, March 3-7

1. Mr. and Mrs. McNamara visited Peru on the dates indicated. They were accompanied by Messrs. Adalbert Krieger, William Clark, and Sven Burmester, as well as by E. Lerdau, F. Mendoza and E. Chaparro. The visit was in response to repeated invitations by the Peruvian Government, the first of which had been extended some years ago by President Morales Bermudez when he was Minister of Economy. In the Peruvian Government, Mr. Oscar Espinosa, President of COFIDE, handled the arrangements for the Minister of Economy, Mr. Luis Barua, and the President of the Central Bank, Mr. Carlos Santistevan also played a central role.
2. The minutes of the principal meetings with public officials are attached. Mr. McNamara also made field trips to Trujillo (sugar cooperative of Casa Grande), Tarapoto (overflight of jungle area and visit to oil pipeline camp site of San Lorenzo), Agricultural University of La Molina (International Potato Institute) and Villa El Salvador (after an overflight of Lima's pueblos jovenes) site of a Bank urban project.
3. The meetings with public officials took place in an atmosphere of cordiality and frankness. Especially the economic team was very forthcoming as far as discussing its evaluation of the present situation was concerned, and in Mr. McNamara's discussion of this situation with the President, the latter seemed well aware of the difficulties enumerated by his associates. While he had little to say with respect to specific measures, he seemed confident that he had the situation well in hand and that the present difficulties would not overwhelm him.
4. Mr. McNamara's visit closely followed visits by Secretary of State Kissinger and Lic. Ortiz Mena, and a number of Peruvian officials commented positively on the difference in style and attitude of the World Bank and its President. In terms of strengthening relations between Peru and the Bank, the visit was a considerable success.
5. It also put in evidence that Peru is going through a period of transition in which a number of central policy issues remain to be defined. The role of the private sector, the nature of the "social property" sector and of the "industrial communities", the role and attitudes of the labor movement, the setting of priorities in public investment planning, the role and nature of short term financial management are all issues on which there clearly is more than one view in this Government, and while it would be sanguine to expect quick resolutions on any of them, Mr. McNamara's visit

April 5, 1976

had the useful result of provoking some well-focused articulations of the different points of view. 1/

Attachments (4)

cc.: Mr. McNamara  
Mr. Knapp  
Mr. Krieger  
Mr. Clark  
Mr. Chenery  
Mr. Nelson

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1/ For example, I was told that the meeting with the heads of the principal public enterprises was the first occasion on which these officials had all met together and confronted the sum of their investment programs.

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10:00 p.m. Dinner offered by President of COFIDE

Sunday, March 7

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12:00 noon Departure to La Paz in special plane.

OFFICE MEMORANDUM Attachment 1

TO: Files

FROM: *EL* E. Lerdau

SUBJECT: PERU - Meeting with President Morales Bermudes

DATE: March 17, 1976

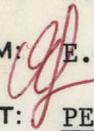
1. On March 4 Mr. McNamara met with President Morales Bermudes. Also present were Messrs. Krieger and Lerdau.
2. After some courtesy exchanges and personal reminiscences about their previous contacts, Mr. McNamara expressed his great interest that the objectives of the present Government - the objectives of the Revolution of 1968 - be achieved. He stated that it was for this reason that he was particularly concerned that the present financial difficulties be overcome, for if they were not, the objectives of the Revolution would be imperilled.
3. He acknowledged that part of the difficulties were the result of external factors, outside the control of the Government, but he thought that others were not. Among the latter he cited the deficit of the public sector, with particular reference to the public enterprises, and the growth in public and private consumption with the consequent pressure on the balance of payments. He noted that one of the by-products of recent developments abroad was that private lenders were becoming increasingly cautious, and that without evidence of decisive action to attack the fiscal and balance of payments gaps, they might become much more reluctant than in recent years to finance Peru on the scale required.
4. The President said that Mr. McNamara's diagnosis was entirely accurate and that he shared both his concerns and the reason for them. He assured Mr. McNamara that action would be taken, as needed, and he expressed his appreciation for the Bank's objective and sympathetic attitude during difficult periods.
5. At a subsequent lunch with a large part of the Cabinet, the President repeated to his Ministers - and in particular to the Prime Minister - practically all of Mr. McNamara's statements, and reiterated his agreement with the diagnosis and with the need for corrective action.

cc: Mr. McNamara  
Mr. Knapp  
Mr. Krieger  
Mr. Chenery  
Mr. Nelson  
ELerdau:jd

OFFICE MEMORANDUM Attachment 2

TO: Files

DATE: March 17, 1976

FROM:  E. LerdaSUBJECT: PERU - Meeting with Prime Minister and Foreign Minister

1. On March 3 Mr. McNamara met with Prime Minister General Fernandes Maldonado and General Miguel de la Flor, Foreign Minister. Present were Messrs. Krieger, Clarke and Lerda, and Sr. Faura (Interpreter).
2. After some courtesy exchanges, Mr. McNamara referred to the enormous resource requirements implied by the investment programs of the major public enterprises - of which he had become especially conscious during his meeting at COFIDE - and of the difficult choices that the Government confronted, both in setting investment priorities and in choosing between present and future consumption. He expressed his awareness that Peru's problems were made more acute by the international economic recession and related problems, as well as his concern with the evident difficulty of persuading the public that present sacrifices were needed if future income levels were to be raised. The news of strikes and other labor disputes underlined this difficulty.
3. Minister Fernandes Maldonado agreed that the problem existed, but said that (a) previous governments also had demanded sacrifices without being able to offer future benefits for them, and (b) the people already identified themselves sufficiently with the Revolutionary Government to accept the burden of necessary measures. He noted that twice in less than six months had painful austerity measures been taken and accepted by the country because it was sure that the Government had made the interests of the people its own; under other governments the political consequences would have been serious. There were strikes, but the opposition magnified their importance out of proportion, for political reasons.
4. As far as the concern with the short term situation was concerned, which Mr. McNamara had also voiced, he acknowledged that it was valid, mainly because of foreign developments, but expressed confidence that Peru would overcome them with the help of such factors as the coming on-stream of the Cuajone mine and of the petroleum pipeline.
5. He noted that his previous post (Minister of Energy and Mines) had given him a certain bias, consisting of the conviction that without rapid and continuous growth of energy production, development was impossible. Therefore, he asked Mr. McNamara to ensure that the Bank continue to help finance the power sector, both in generation - especially hydro - and in distribution - especially to the pueblos jovenes. Mr. McNamara agreed on both counts, noting especially Peru's rich endowment with hydro potential, the Bank's interest in contributing with its sectoral experience both to the traditional power sector and to participate in Peru's effort to tackle the improvement of conditions in pueblos jovenes.

March 17, 1976

6. Mr. McNamara then asked the Foreign Minister for support, both for the IBRD and for regional development banks, in international forums. The Minister explained Peru's international policy in the Third World and agreed that the Bank was an institution that it was in Peru's interest to defend. He mentioned that he had told Secretary Kissinger that certain U.S. legislative amendments were unacceptable pressure tools, and that it would be best to work for their repeal. Mr. McNamara pointed out that this was precisely one reason for protecting international organizations, and the Minister agreed.

cc: Mr. McNamara  
Mr. Knapp  
Mr. Krieger  
Mr. Clarke  
Mr. Chenery  
Mr. Nelson  
ELerdau:jd

## OFFICE MEMORANDUM

Attachment 3

TO: Files

DATE: April 6, 1976

FROM: Fernando Mendoza, LAC I, 1D SUBJECT: PERU - Mr. McNamara's Visit to COFIDE

1. On March 3, 1976, Mr. McNamara visited COFIDE's headquarters in Lima and met with the President and Director General of COFIDE, the Technical Director of the National Planning Institute, and the Presidents of several public enterprises. A list of the attendants is attached.

2. Mr. Van Oordt started the meeting by explaining the financial system and institutions of Peru. Following Mr. Van Oordt exposé, Mr. A. Seminario, Head of the Projects Department of the National Planning Institute explained the major features of the economic plan and the objectives on the basis of which specific investment priorities were determined. These objectives by order of importance were: increasing the production of basic goods and services like food, clothing, education, health, housing, and recreation; the creation of an integrated productive structure by new investments in agriculture, fisheries, mining, and industry; and the promotion of extraction industries like mining and oil which generate or save foreign exchange. He also explained that the selection of specific investments was made in accordance with the following criteria: finishing projects under execution, selecting projects with short periods of maturity and favoring projects which would tend to decentralize economic activity in the country. He noted, however, that so far the planning mechanism to select investments had had limited use because to a large extent they were bound by the availability of prepared projects and, therefore, the selection as such was not all the times possible. He thought, however, that as more investment alternatives are becoming available a greater degree of selectivity could be applied. To the question of Mr. McNamara as to whether the peruvians were now using relative rates of return at international prices to choose between alternative investments, the answer was in the affirmative.

3. Following these two general discussions, the Presidents of CENTROMIN, MINEROPERU, INDUPERU, PETROPERU, SIDERPERU, and ELECTROPERU made a quick run down of their investments projects for the near future. These projects were basically the same as described in the Project List distributed to the Consultative Group Meeting on April 1975. The questions raised by Mr. McNamara as the projects were described showed generally a concern with the volume of investment under consideration and the rates of return of the individual investment projects.

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4. In closing, Mr. Espinosa said that the run down of the investment projects that had just been done by the Presidents of the public enterprises showed clearly the project preparation effort which had been made in Peru in the last few years; he also mentioned that the preparatory work for the meetings of the Consultative Group had contributed to stimulate such efforts and to make them more productive.

5. Mr. McNamara's closing remarks were that he was very much interested in the changes through which the country was going institutionally, socially, and in terms of regional decentralization, that he was also interested in learning how the bulk of the people would increase its participation in the development process and in how all these changes could be translated in an increase of productivity. He further said that the Bank was ready to help the peruvian efforts by providing financing for investment projects which were economically justified and stressed the importance of establishing economically sound investment priorities particularly in view of the huge investment possibilities in the country and its limited financial resources.

RELACION DE ASISTENTES

BANCO MUNDIAL

Sr. Robert Mc Namara	Presidente
Sr. Adalbert Krieger	Vice Presidente Regional para América Latina y el Caribe
Sr. William Clark	Vice Presidente de Relaciones Exteriores
Sr. Enrique Lerdaú	Director de Programas para América Latina y el Caribe
Sr. Sven Burmeester	Asistente del Presidente
Sr. Elwyn Chaparro	Economista Encargado del Perú
Sr. Fernando Mendoza	Oficial de Préstamos para el Perú

SECTOR ECONOMIA Y FINANZAS

Ing. Oscar Espinosa	Presidente del Directorio de COFIDE
Ing. Guillermo van Oordt	Gerente General de COFIDE
Dr. Ulises Montoya	Director Técnico de la Dirección de Crédito Público - MEF
Dr. Marco Antonio Pajuelo	Director Ejecutivo de la Dirección General de Asuntos Financieros

INSTITUTO NACIONAL DE PLANIFICACION

Ing. Alejandro Vera	Director Técnico
Ing. Alejandro Seminario	Coordinador del Area de Proyectos de Inversión

EMPRESAS PUBLICAS

General de Brigada EP Máximo León Velarde	Presidente de PETROPERU
Crnel. EP Jorge Luna Salinas	Gerente General de PETROPERU
Ing. Alberto Bruce	Sub-Gerente Técnico
Ing. Antonio Tord	Presidente de MINERO PERU
Ing. Luis Briceño	Gerente General de MINERO PERU
Ing. Guillermo Flores	Presidente de CENTROMIN
Ing. Behram Wadia	Gerente General Ejecutivo de CENTROMIN
Dr. Otoniel Velasco	Presidente de ELECTROPERU
Ing. Jorge Ratto	Gerente General de ELECTROPERU
Dr. Gil Indacochea	Presidente de INDUPERU
Dr. Adrián Fajardo	Gerente General de INDUPERU
Ing. Jorge Cárcamo	Asesor del Presidente de INDUPERU
Cmdte. AP Eduardo Barragán	Presidente de SIDERPERU

## OFFICE MEMORANDUM

Attachment 4

TO: Files

DATE: April 6, 1976

FROM: Elkyn A. Chaparro, LAC I, 1D

p.p. FRANK

SUBJECT: PERU - Mr. McNamara's Meeting with the Minister of Finance

1. On March 3 Mr. McNamara met with the Minister of Finance, the President of the Central Bank and the President of COFIDE. Present at the meeting were Messrs. Krieger and Lerdaud of the Bank, and Messrs. Salaverry, Director General of Financial Affairs; Alban, Director General of Economic Affairs; and Pajuelo, Head of the Division of Financial Affairs.
2. The Minister greeted Mr. McNamara and told him that this meeting would concentrate on a frank and open discussion of the present short-term economic problems. He explained that when the present Government took power last August they found that the financial position of the economy was rapidly deteriorating. Savings were falling, inflation was rising, production expansion was slowing and the balance of payments current account balance was widening. In part the problems were caused by the international recession; however, internal factors also contributed. The fall in savings was principally caused by the consumption subsidies while labor problems and inadequate price policies affected the productive sectors. Since then, they had taken measures to reduce subsidies, stimulate production and reduce the balance of payments gap. He emphasized that labor peace was a vital prerequisite for improvement.
3. Mr. McNamara said that he was alarmed since on the one hand economic decision making was constrained by the political impasse while on the other there were little international reserves left. Moreover, given the changing conditions in the international markets, there was little chance that Peru would obtain foreign commercial financing on the required scale. He said that the Bank wanted to support Peru's interesting development efforts, but only if a viable financial position could be restored. The Minister agreed and asked Mr. McNamara to make the same point to the President of the Republic and to explain to the commercial banks the Government's efforts to overcome the crisis.
4. Mr. McNamara also asked if interest rates were going to be increased. The Minister said that he did not think interest rates had much impact on increasing savings, but he knew his closest advisers disagreed. Messrs. Santistevan and Espinosa both stressed that unless interest rates were increased there was little chance of reducing the rise in velocity of circulation of money and stopping the fall in financial savings.

14

## OFFICE MEMORANDUM

TO: Memorandum for the Record

DATE: July 15, 1976

FROM: E. Lerdau

SUBJECT: PERU : Mr. McNamara's Meeting with Mr. Santistevan

1. On July 14 Mr. McNamara was visited by Mr. Carlos Santistevan, President of the Central Bank of Peru. Mr. Santistevan gave Mr. McNamara a brief account of his conversations with the IMF and with the group of New York banks which he had been visiting during the past two days. He stated that Mr. Witteveen and the Fund staff had been very understanding and helpful and that he was optimistic that his attempt to borrow some \$300 million from the banks would be successful, although he acknowledged that the amount may be somewhat less. He also stated his conviction that the measures taken reflected a new policy orientation which the Government would adhere to; indeed he felt that having paid the heavy political price of taking inevitably unpopular measures the Government had no option but to stick to them until they showed the expected results.

2. Mr. McNamara stated that he had been very gratified to learn of the measures taken which he felt were impressive in the courage and determination which they demonstrated. He had told the Government quite frankly during his visit how concerned he was about the deteriorating financial situation and he was greatly relieved to see that the Government was now addressing these problems so vigorously. He quite appreciated how difficult measures of this scope were politically, but he was also convinced that they were absolutely necessary. Mr. Santistevan asked Mr. McNamara to state these views to the banking community if the occasion arose and Mr. McNamara said that he was quite prepared to do so.

3. Mr. Santistevan expressed the hope that the greater volume of Bank lending in FY76 would be continued and Mr. McNamara responded that if the economic management continued along the lines just initiated, he, too, was optimistic that an active program could be carried out.

cc: Mr. McNamara's office  
Mr. Knapp  
Mr. Krieger  
Mr. Nelson

ELerdau:jd

15.

## OFFICE MEMORANDUM

LAC - Andean Group

TO: Memorandum for the Record

DATE: July 30, 1976

FROM: Carlos N Quijano, SR-IAO

SUBJECT: Andean Group - Visit of General (R) Barandiaran, Coordinator of  
the Andean Common Market Technical Secretariat

1. On July 26, the Coordinator of the Andean Common Market Technical Secretariat, General (R) Luis Barandiaran, called briefly on Mr. McNamara. He was accompanied by Messrs. Barberena, Vice President of the Andean Development Corporation; Winston Temple, IMF Alternate Executive Director; Jose Nuñez, from the IDB's Integration Studies Unit and Mr. Ernesto Franco-Holguin, IBRD Executive Director.

2. General Barandiaran gave a short and general description of the Andean Common Market accomplishments. He conceded that the Group recently had serious difficulties in reaching an agreement on the Common External Tariff and that they have only completed negotiations on 3 of the original 8 regional industrial sector programs targeted to be completed by the end of 1975. He observed, however, that the differences have been largely resolved, particularly those with regard to appropriate tariff levels and that agreement on a Minimum Common External Tariff is expected soon. He added that the Group was now giving an increasing importance to the agricultural development of the region and that the Junta is now preparing a series of projects to increase the region's production of agricultural inputs including fertilizer and agricultural machinery. General Barandiaran also reported on the Junta staff estimates of future financial requirements to carry out the investments in the fertilizer, petrochemical and metallurgical sector. He added that the requirements for external funds were so large that the Andean Development Corporation was not in a position to raise the funds necessary to carry out the Group's investment program. For this reason he was requesting the Bank's financial assistance. He then stressed that Bank technical assistance was also welcome since the proposed projects were very complex and the Group did not have the expertise to handle such complex and large projects while the Bank had already demonstrated its ability to do so.

3. Mr. McNamara replied that, first, in principle the Bank was very much interested in supporting the Andean integration scheme as we have done in other areas like in the East African and West African Community, as well as in the Caribbean. Secondly, that in order to do so we have to place ourselves in the position to know the financial situation and investment program of the Group. He then said that of course we would have to solve the problem of guarantees but this, in his opinion, was not a difficult problem. Mr. McNamara stressed that even though we were anxious to help we would have to know also what specific form of financial or technical assistance was required. He suggested that General Barandiaran discuss further this matter with Mr. Krieger.

cc: Messrs. Krieger, Lerda, Wiese

CNQuijano:bg

## OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara

DATE: July 23, 1976

FROM: Adalbert Krieger *AK*

SUBJECT: ANDEAN GROUP - Your July 26, 6:30 p.m. Meeting with General Barandiaran,  
Coordinator of the Technical Secretariat of the Andean  
Common Market

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Please find attached a memorandum from Mr. Quijano, dated July 22, regarding recent developments in the Andean Common Market. Mr. Quijano makes certain recommendations about the prospects for Bank activities with the Andean Group. Since Bank staff and myself are meeting earlier with General Barandiaran on the same day, I propose that I brief you shortly before your meeting with him about the results of our conversation.

### Attachments

Memorandum dated July 22, 1976  
General Barandiaran's curriculum vitae

## OFFICE MEMORANDUM

TO: Mr. Adalbert Krieger

DATE: July 22, 1976

FROM: C. N. Quijano, Special Representative for Inter-American Organizations

SUBJECT: Andean Group - Briefing for the Meetings with Lt. General Barandiaran,  
Coordinator of the Andean Group Technical Secretariat1. Background

The Andean Common Market (ACM) was formed in 1969 by Bolivia, Chile, Colombia, Ecuador and Peru, and joined by Venezuela in 1973. The ACM is a subregional integration agreement within the framework of the Latin American Free Trade Association (LAFTA). The agreement aims at a faster and more comprehensive integration process than the one achieved by the Andean countries since the creation of LAFTA. The Andean Common Market is probably the most ambitious integration scheme among less developed countries as it includes provisions for establishing a common external tariff, freeing internal trade, jointly programing new industries and coordinating economic policies. The agreement includes deadlines which attempt to force the member countries into an automatic integration process. The treaty also guarantees special treatment for the "relatively less developed countries" Bolivia and Ecuador.

Three main institutions were created to provide a framework for the integration process: the Commission, the Junta and the Andean Development Corporation (CAF). The Commission is the political institution comprising a direct representative of each member government. The Junta, an independent technical secretariat, consists of three members appointed by the Commission, and their staff which is chosen by the members of the Junta. General Barandiaran is the newly appointed coordinator of the Junta. The Junta provides the analytical economic base for the integration policy proposal to the Commission. The Andean Development Corporation is the financial institution principally created to obtain funds for the development of industries to be programed by the Junta and the Commission. In addition, an Andean Reserve Fund with a capital of US\$400 million was recently established. The Fund's principal function is to help finance balance of payments deficits between the Andean countries and third countries.

2. Current Developments and Issues

Before the creation of the ACM, trade among the respective countries was small. While in 1969 intra-regional exports, excluding Venezuela, amounted to US\$86 million, by 1974 the figure had risen to US\$468 million. This represents an annual growth rate of intra-regional trade of about 40% compared with an annual growth rate of 19% for total exports of the Andean region during the same period. As a percentage of total exports, regional trade increased from 3% to about 7%. If Venezuela is included, however, intra-regional export participation in total exports of the Andean region merely increased to about 4% by 1974 from the 3%

registered in 1969. This is explained by the unusually high increase in the value of Venezuelan oil exports on account of rising oil prices. A more detailed analysis of the trade data will reveal that the ACM is an important factor in the promotion of industrial production of the region. Intra-regional manufactured exports represent about one third of the region's total manufactured exports.

Despite an apparent success in trade and industrial development, the Andean Common Market went through a severe crisis in 1975. The crisis began when sector plans for the regional industries (Programas Industriales) started to run seriously behind schedule. By late 1975, it was obvious that the deadline for completion of all regional industries' sector plans and the common external tariff would not be met. This impasse was the consequence of the most complex and important problem currently facing the Common Market authorities: a basic disagreement over development policies. One group of countries represented by Chile and Colombia favors a relatively low common external tariff and relatively open economies. A second group--Peru, Ecuador and Bolivia--with some support and encouragement from the staff of the Junta, favors a development policy which places a greater reliance on import substitution policies even if this entailed high-industrial protection. Venezuela, in spite of its oil wealth, follows an intermediate course since its weak industrial sector considers the market provided by the ACM an important factor for its industrial development.

The impasse was recently solved by reaching a compromise which basically provides for an extension of two years of a series of deadlines, principally for the final drafting and adoption of the regional industries' sector plans and the common external tariff which had originally been fixed for the end of last year. The extension hopefully will provide a breathing space for the regional industries' sector plans. Moreover, at the same time that an extension was granted for the regional industries' sector plans and the common external tariff, the original integration pact (El Acuerdo de Cartagena) was amended to prevent the reoccurrence of a deadlock in negotiations in the future. One change is that if the countries cannot agree on any particular proposal to establish a new regional industry and its corresponding tariff protection level, it can be adopted by the approval of a minimum of four countries. The second change allows for maximum and minimum levels in the common external tariff for each product, taking into account the effect on tariffs of different monetary and trade policies. In short, flexibility will be maintained in the common external tariff by having varying degrees of tariff levels to compensate for the use of trade related mechanisms, such as prior import deposit, import subsidies and foreign exchange policies which may nullify the effect of a common external tariff.

Other major areas of dispute between the Andean countries have been the group's rigid rules on foreign investments and the effect of Common Market policies on the two least developed members, Bolivia and Ecuador. Chile for some time has been pressing for the amendment of the rules on

foreign investments, particularly as regards profit remittances limitations and reinvestments. The Commission has now agreed to set up a working group to study the proposed amendments. Important changes making more flexible the original rules are likely to be introduced this year. A study has been undertaken also to recommend measures which will give more effective support to the development problems of Bolivia and Ecuador. The study is expected to be finished by the end of this year.

### 3. Bank Activities in Relation to the Andean Common Market

#### a. Recent Developments

Our support to the Andean Common Market scheme has been limited to some general technical assistance to the Junta on the methodology for establishing a common external tariff. Contrary to other regional economic integration schemes, where we have given specific technical advice through special studies and through comprehensive economic reports on the integration experience and prospects, or where we have expanded our lending activities to include projects specifically designed to promote economic integration, we have not carried out any of these activities in the Andean area. Moreover, our present five-year lending program does not include a single project whose essential element is the promotion of integration activities in the Andean Common Market area.

Since 1969, there have been several contacts between our staff and the staff of the Junta and the CAF. Our conversations with CAF staff have not resulted in any concrete action. Discussions with CAF and its top level staff, including its previous president, revolved mainly around two topics: (a) development of jointly financed projects, and (b) the possibility of a Bank/DFC type project. As regards a jointly financed project, it has been difficult to identify any project suitable to both institutions. On negotiations for a Bank/DFC loan to CAF--which from our point of view would be a better vehicle to channel our funds for further promoting and strengthening the integration process--we have encountered two types of problems. On the one hand, the previous CAF administration was never fully forthcoming in enabling our staff to determine whether they really needed Bank funds, and on the other hand, we have not been able to solve the difficulties of obtaining necessary guarantees from ACM member countries.

#### b. Future Prospects and Recommendations

Recently the Colombian authorities have suggested the possibility of a Bank study on the Proposal for a Common External Tariff of the Andean Group. The study would consider the appropriate level of tariff and structures on a few products with emphasis on export development, and the consequence of low and high-tariff strategies on income distribution and, in particular, their impact on the poorest sector of the population. I have informally explored the possibility of such a study with the Chilean and

Venezuelan authorities, as well as with General Barandiaran, and have met with a favorable response. General Barandiaran offered the cooperation of the Technical Secretariat staff in the event we went ahead with such a study (if we do we will have to approach management for a supplementary budget appropriation).

On the lending activities General Barandiaran may express once more the Andean Group's interest in obtaining Bank support for their operations. I suspect that he will give us a list of possible projects with a particular emphasis on the metallurgical and petrochemical sectors. Our information is that most of those projects are in a very early stage of preparation, probably at the pre-feasibility stage. I understand that Antonio Barbarena, Vice President of the Andean Development Corporation (CAF) will accompany General Barandiaran and that a request for Bank support to CAF activities will also be made. I have also learned that Mr. Sanjines, the new President of CAF, is planning to visit us some time in August.

As you know, General Barandiaran will meet with Mr. Lerdaу and the Division chiefs dealing with the countries in the Andean Group before he meets with you and with Mr. McNamara. We assume that the meeting with Mr. McNamara will be primarily for protocol and that during the meeting with our staff, General Barandiaran will inform on the present status of the Andean Group and on its prospects, and will go into some aspects of the Group's capital requirements as indicated previously. Given the importance the Andean Group countries assigns to their integration program, I suggest we use the opportunity to strengthen our contacts with the Andean Common Market authorities and explore the possibility of a Bank/DFC type operation with the Andean Development Corporation.

What needs to be established at this stage is whether CAF is positively interested in allowing the Bank to review in detail their overall need for, and purpose, amount, and timing of a possible Bank/DFC type credit line. Needless to say, that any credit transaction to CAF will involve difficult problems in obtaining necessary guarantees from ACM member countries.

cc: Messrs. Lerdaу, Director, CPD I, LAC  
Wiese, Director, CPD II, LAC  
Holsen, Assistant Director, Econ. Analysis & Projections  
Renger, Division Chief, DFC, LAC  
Nelson, Division Chief, CPD I, LAC  
Gonzalez-Cofiño, Division Chief, CPD I, LAC o/r  
Favilla, Division Chief, CPD II, LAC  
Lehbert, Division Chief, CPD II, LAC

CNQuijano:bg

LUIS BARANDIARAN PAGADOR  
Coordinator of the Technical Secretariat  
of the Andean Common Market

Peruvian, Air Force, Lt. General (R)

Education

Air Force Academy, Peru  
Air Force University, USA  
Graduated from Chief Command and Chief of Staff  
courses and Academic Instructor course  
Center of Advanced Military Studies (CAEM), Peru  
Master of Economics, Escolatina College,  
University of Chile

Previous Activities

Director, School of Public Administration (ESAP), Peru  
Chief, Office of Integration (ONIT), Peru  
Peru's Representative to the Andean Common Market  
Commission and President of the Commission during 1973  
Director and President of the Board of Directors,  
Andean Development Corporation (CAF)  
Minister of Commerce, 1974

16

## OFFICE MEMORANDUM

TO: MEMORANDUM FOR THE RECORD

DATE: December 7, 1976

FROM: E. Lerdau

SUBJECT: PERU : Visit to Mr. McNamara by the President of COFIDE

1. On December 7 Mr. Oscar Espinosa, President of COFIDE, and Mr. Winston Temple, Peruvian Executive Director in the IMF, called on Mr. McNamara.
2. Mr. Espinosa informed Mr. McNamara on the positive results of the various economic measures that had been taken since Mr. McNamara's visit and expressed optimism about their success. He indicated that the difficulties of moving toward stability, while at the same time maintaining the investments most urgently needed to assure growth and welfare, were being overcome. In this the Bank's willingness to support the Government's policies with a substantial lending program had been particularly helpful.
3. In this context, he also expressed his pleasure that the loan negotiations between COFIDE and the Bank had been successfully completed and he asked Mr. McNamara whether it would not be possible to get Board approval of this loan in calendar year 1976, indicating that this was of some importance to himself. Mr. McNamara said that the Board of Directors had been quite concerned about the inordinate delays between loan approval and loan signature, not only in Peru but also in some other countries, and that therefore special efforts were being made to reduce such lags by encouraging countries to take all possible procedural steps prior to Board presentation. However, he said, that if Mr. Espinosa could give him his personal assurance that it would be possible to sign the loan in January, he would be prepared to release the documents now so that December approval could take place. Mr. Espinosa said that he was in a position to give such an assurance since good progress had already been made and since the Government, especially the Minister of Finance, was eager to resolve the internal procedural problem and he had already alerted all concerned levels of Government of its urgency. In this he referred to the vigorous representations of Bank staff over the past few months. Mr. McNamara said that on the basis of this personal assurance he authorized the release of the documents.
4. Mr. Espinosa also confirmed that the Minister of Finance had signed loans with commercial banks in Europe, Canada and the United States for \$330 million, and said that some further loans from Japanese and Swiss banks would probably be signed after Christmas. He reiterated that in future Peru would look increasingly to institutions like the World Bank for its capital requirements and would try to reduce its dependence on commercial banks. He therefore wanted to express to Mr. McNamara once again the Peruvian Government's full support for efforts to increase the Bank's capital, since it was clear that only with growing Bank resources could Peru count on a growing lending program. Mr. McNamara said that he was aware and appreciative of Peru's support in this matter and hoped that he would be able to continue to count

December 7, 1976

on it. He also said that he saw some ground for optimism for an improvement in the attitudes of the OECD countries in this respect, although obviously there were major difficulties.

cc: Mr. McNamara's office (2)  
Mr. Knapp  
Mr. Krieger  
Mr. Broches  
Mr. van der Meer  
Mr. Mendoza

ELerdau:jd

## OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara (through Mr. J. Burke Knapp) DATE: December 6, 1976

FROM: E. Lerdau

SUBJECT: PERU : Your Meeting with Mr. Oscar Espinosa

1. You are scheduled to meet with Mr. Espinosa, President of COFIDE and Alternate Governor of the Bank for Peru, on Tuesday, December 7 at 6 p.m. You may recall that during your visit to Peru Mr. Espinosa was one of your principal hosts and that COFIDE handled most of the arrangements. A biographical sketch is attached.

2. I am not aware of major issues that Mr. Espinosa is likely to bring up. Negotiations of a first loan of \$35 million to COFIDE took place November 15 - 19 and are substantially completed. Mr. Espinosa may urge you to have the loan approved before the end of the calendar year. Logistically this would be possible but we have been postponing distribution of the documents to the Board until further progress is made with the procedural actions required in Peru to permit signature, so as to avoid the long delays between Board approval and loan signing that have plagued some of our recent loans. If you agree to have the documents distributed immediately, it would be possible to have the loans signed in January if the Government continues to act as expeditiously as they have in recent months, but there is no assurance that they will.

3. The other principle obstacle which had prevented our submitting the documents to the Board has now been removed. You may recall that it had been decided to postpone Board presentation until the Government's negotiations with European and North American commercial banks had been successfully concluded. This has now happened; Finance Minister Barua has signed loans of \$90 million in Europe, \$30 million in Canada and \$210 million in the U.S. in the course of last week.

Attachment

cc: Mr. Krieger, o/r  
Mr. Broches  
ELerdau:jd

Oscar ESPINOSA

President of COFIDE

1. From 1965 through 1970 Mr. Espinosa held executive positions in regional organizations in the southern part of the country and taught at the Universities of the Altiplano and Santa Maria de Arequipa. In 1970-71 he studied at Harvard and obtained a Master's Degree. Subsequently he held high positions in the National Planning Institute until 1973 when Dr. Barúa appointed him as General Manager of COFIDE. Upon the appointment of Dr. Barúa as Minister of Economy and Finance in August 1975, Mr. Espinosa was appointed as President of COFIDE; as such he is Alternate Governor of the Bank for Peru.
2. Mr. Espinosa is the prototype of the young, aggressive and well educated manager. He has an exuberant personality, always full of enthusiasm and a capacity to express his views clearly. He combines a good technical background with a sense of political constraints.
3. He speaks English fluently.

17

## OFFICE MEMORANDUM

TO: Memorandum for the Record

DATE: October 6, 1978

FROM: Francisco J. Aguirre-Sacasa, <sup>FAS</sup> Division Chief, LAC ISUBJECT: PERU: Meeting with the Peruvian Delegation with  
Mr. McNamara on September 27 at the 1978 Annual MeetingsDelegation - Messrs.:

Javier Silva Ruete, Finance Minister  
Oscar Espinosa, IBRD Alternate  
Executive Director  
Julio Vega, Counselor at Peru's  
Washington Embassy

Bank - Messrs.:

Robert S. McNamara  
Nicolas Ardito Barletta  
Eugenio Lari, Director, LAC I  
John Holsen, Chief Economist  
Francisco Aguirre-Sacasa,  
Division Chief, LAC I  
C. Koch-Weser, Personal Assistant  
to the President

- 10/17
1. The Minister briefed Mr. McNamara on the economic crisis facing Peru and on the measures which the Government was taking to deal with this situation. These included (i) naming a new, strengthened economic team in May; (ii) enacting tough and unpopular stabilization measures; and (iii) entering into a standby with the IMF. Mr. Silva Ruete added that Peru intended to seek a rescheduling of its medium- and long-term external public debt and that the French Government had agreed to chair a Paris Club meeting on November 2 and 3. At this meeting, Peru would seek to reschedule 90 percent of the principal due in 1979 and 1980 on debts owed to governments, and suppliers insured by governments. Peru hoped to repay the rescheduled debt over 8 years including a 3-year grace period.
  2. The Minister then mentioned that the Government was in the process of preparing --with Bank staff assistance-- a medium-term recovery program covering the next 2-1/2 years. This program would, he hoped, serve as a satisfactory basis for a \$100 million program loan from the Bank. Mr. Silva Ruete indicated that the purpose of his visit to Mr. McNamara was to seek his support for this program loan. He added that President Morales Bermudez had specifically asked him to raise this matter personally with Mr. McNamara.
  3. Mr. McNamara indicated that he was aware of the serious economic problems which Minister Silva Ruete had inherited. He went on to add that the Bank would be willing to consider a program loan but that our approval of such an operation would depend on Peru (i) adhering to the terms of the standby; (ii) arranging a successful rescheduling of its debt; (iii) drawing up and starting implementation of a medium-term economic recovery program which included a sound public investment program for the next five years; and (iv) improving execution of the nine Bank-financed projects for which a total of about \$245 million in Bank loans was still undisbursed.

October 6, 1978

4. Minister Silva Ruete took note of these four conditions and expressed confidence regarding satisfactory progress on the standby and the restructuring of Peru's debt. He added that the Government would be submitting to the Bank a medium-term recovery program before the end of the week and that the Government was also working on accelerating disbursements of Bank loans. The Minister then mentioned that the timing of a program loan was important to Peru since it was President Morales Bermudez' intention to return the country to democratic rule by 1980 and to have made significant progress before then in solving Peru's economic difficulties. Mr. McNamara assured the Minister that the Bank would process the application as quickly as possible, provided Peru met the four conditions that he had outlined earlier.

FJAguirreSacasa:sh

Cleared with and cc: Mr. Lari, LAC I. ~~Mr. Stern~~ cc: Mr. Stern

cc: Messrs.: Ardito Barletta  
Holsen  
van der Meer, o/r  
Glaessner  
Goffin  
Wyss  
Nowicki  
Koch-Weser  
Landau  
Weissman

18

## OFFICE MEMORANDUM

CONFIDENTIAL

DECLASSIFIED

MAY 09 2013

DATE: March 28, 1979

WBG ARCHIVES

TO: Memorandum for the Record  
FROM: Eugenio F. Lariviere, Director LAC I  
SUBJECT: PERU - Meeting Between Mr. McNamara and Minister Javier Silva Ruete.

- 3/30
1. Peru's Finance Minister, Mr. Javier Silva Ruete, met with Mr. McNamara on March 26. He was accompanied by Messrs. Ricardo Saettone (Vice Minister of Energy and Mines), Luis Guiulfo (Advisor to the Minister of Energy and Mines), Julio Vega (Counselor of the Peruvian Embassy) and Oscar Espinoza (Alternate Executive Director in the Bank). For the Bank, Messrs. Ardito Barletta, Koch-Weser and myself were also present.
  2. The Minister thanked Mr. McNamara for the collaboration received from the Bank during a very difficult period for the country. He then gave Mr. McNamara a letter of intent formally requesting the Program Loan. He outlined, in this connection, the steps taken by his Government over the past few months and the stabilization and recovery programs which had been adopted. He briefly indicated the first signs of recovery which have recently appeared in Peru and repeated his appreciation for the Bank's assistance in putting together both the Program Loan and the recovery program.
  3. The Minister went on to express interest in Bank assistance for an oil project which would have a quick gestation and very beneficial fiscal and balance of payments effects. The required Bank loan would be relatively small, of the order of \$10 to \$15 million. The Minister expressed the hope that the Bank would provide assistance in preparing and evaluating a new list of projects which would form the basis for sustained financial assistance from the Bank, in the order -- he said -- of \$150 million per year. He then requested that the Bank open in the next few months an office in Lima, which would be very beneficial in accelerating disbursements, identifying and preparing new projects, and would also give policy advice. The Minister then thanked Mr. McNamara for the increasingly active role the IFC is playing in Peru. Mr. Silva Ruete concluded by telling Mr. McNamara of Peru's intention to participate in the capital increase and to continue to support strongly the Bank. Peru, he said, intended to increase its position in the Bank so as to have the same relative position that it has now in the Fund.
  4. Mr. McNamara responded point by point. He said that according to his information the Program Loan was in very good shape and negotiations should be swift. He gave the Minister recognition for his Government's great efforts to stabilize and revitalize the economy under very difficult circumstances. Concerning the proposed petroleum project, he had been told that it was indeed a good project but that PETROPERU needed to be

strengthened financially, managerially and technically. He, too, was anxious to keep the pipeline filled with good projects; but any new lending program was predicated on the Government's ability to accelerate disbursements of present projects and to continue to execute successfully its economic program. Regarding the office in Lima, Mr. McNamara noted that the Bank would seriously consider it and that he would support it, provided it could really have a major positive impact and that this could not be achieved otherwise. He mentioned to the Minister the high cost to the Bank and, in the ultimate analysis, to the member countries of field offices; thus the need for a careful benefit/cost analysis in each case. Mr. McNamara confirmed that the IFC was anxious to play an active role in Peru.

5. Concluding the meeting, Mr. McNamara expressed appreciation for Peru's support for the capital increase, said that he very much needed such a support, and outlined the difficulties he was encountering in his efforts to maintain and strengthen the role of the Bank as the main international development agency.

EFLari:nsp

Cleared with and cc: Mr. Ardito Barletta  
Mr. Koch-Weser

cc: Mr. Stern  
Mr. Aguirre-Sacasa, LAC I  
Mr. Nowicki, LAC I

## OFFICE MEMORANDUM

CONFIDENTIAL

TO: Mr. Robert S. McNamara  
 (through Mr. Nicolas Ardito Barletta) *AB*  
 FROM: Eugenio *AB* Lari, Director, LAC I

DATE: March 26, 1979

SUBJECT: PERU - Briefing for your Meeting with  
Minister Javier Silva Ruete

DECLASSIFIED

MAY 09 2013

WBG ARCHIVES

1. Peru's Finance Minister, Mr. Javier Silva Ruete, will be in Washington, New York and San Francisco the week of March 26 to report on Peru's improving economic situation to the international financial community, private business interests and commercial banks. The minister is particularly interested in encouraging a revival of private foreign investment in Peru.
2. While in Washington, Mr. Silva Ruete will be meeting, inter alia, with Messrs. de Larosiere and Ortiz Mena and with Secretary Blumenthal and yourself. Your meeting with the minister will take place in your office at 6:30 p.m. on March 26. I expect that the minister will be accompanied by Mr. Luis Guiulfo, an advisor, and by Oscar Espinosa. Bio-sketches of the minister --whom you met privately at the last annual meetings-- and of Mr. Guiulfo are attached for your ready reference.

The Program Loan and Peru's Economic Situation

3. During his meeting with you, the minister will likely thank you for the Bank's willingness to consider a \$115 million program loan for Peru and for our assistance in helping the Government to draw up an economic program (ERP) on which the loan would be based. The program loan will be negotiated at the end of this week and is now scheduled for Board action on May 1.
4. I expect that Mr. Silva Ruete will also deliver to you a letter of intent which formally requests the program loan and spells out the actions which the Government has already taken, or plans to take in 1979, to put the country's economic house in order. These include measures which would emphasize efficiency and open up the economy. Among the ERP's principal features are steps to (i) strengthen the tax system; (ii) cut back on superfluous public sector expenditures, particularly for defense outlays, and rationalize public investment; (iii) improve Peru's balance of payments; (iv) liberalize imports and lower levels of tariff protection; and (v) reduce inflation. An advance text of the letter of intent which I expect Minister Silva Ruete to hand you is also attached.
5. The minister will also probably briefly review with you Peru's improving economic situation. He may report that the Government is complying with the stand-by approved by the IMF in September 1978 and that last November and December it successfully restructured 90 percent of its 1979-80 foreign debt with bilateral lenders and commercial banks. The minister will likely state that although Peru's performance and prospects have improved markedly since the new economic team was appointed in mid 1978, it is still passing through a difficult period; the program loan would greatly help the country overcome the present situation.

New Project Lending

6. I expect that the minister will also urge the Bank to continue identifying and preparing projects for Peru in order to maintain a pipeline that can be reactivated as Peru's creditworthiness improves. In this connection, Mr. Silva Ruete may specifically request that the Bank consider making a \$10 million loan before the end of this calendar year to PETROPERU --the state-owned oil company-- for a petroleum rehabilitation and pre-investment project. The financing would help cover the cost of urgently needed equipment to reverse declining production in PETROPERU's oil fields and for studies expected to lead to further secondary recovery and exploration work. The project has already been looked at by Bank staff and appears to be a very good and most urgently needed one, with a very quick payback. It would result in increased oil production of about 8,000-10,000 barrels a day, with most of this output being exported. The Government and PETROPERU, however, must promptly take measures to restore PETROPERU's seriously weakened financial, managerial and technical capabilities.

7. Should the point of future Bank project lending come up, you may want to confirm to the minister that the Bank is continuing to prepare projects in Peru. Amongst the most advanced of these operations are an irrigation rehabilitation scheme in the Chira-Piura valley (\$55 million for FY81S) and a rural development operation in the Puno area (\$10 million in FY81S). These projects, as well as the PETROPERU project which we are also prepared to process --with the proviso expressed at the end of the previous paragraph-- could result in a resumption of project lending in the last quarter of this calendar year, provided that Peru's economic management remains sound and that the country's creditworthiness continues to improve.

Field Office in Peru

8. The minister may suggest that the Bank open a field mission in Lima. A Bank representative could assist the Government on economic policy matters, particularly since the IMF does not have an office in Lima. He could also help expedite ongoing Bank projects including the proposed program loan. You may want to advise the minister that his request will receive favorable consideration at the Bank. X

Capital Increase

9. The minister may indicate that he fully supports the Bank's proposed capital increase. At the same time he may express concern about a possible erosion of Peru's representation at the Board as a result of the realignment in voting power currently taking place.

Mr. Robert S. McNamara  
(through Mr. N. Ardito Barletta)

March 26, 1979  
Page 3

Disbursement of Ongoing Loans

10. I suggest that at this meeting you may wish to remind the minister of the importance of accelerating Bank disbursements to Peru. We currently have approximately \$240 million committed but undisbursed to the country. While the Bank is taking steps to better tailor some of the projects to Peru's present needs and expedite their execution, the Government will have to diligently follow-up to ensure that counterpart funds are available and that other administrative and procedural bottlenecks to project execution are quickly resolved. 

Attachments

FJAguirreSacasa: SJWeissman:sh

cc: Messrs.: Stern  
Holsen  
van der Meer  
Nowicki, o/r  
Landau  
McCarthy

BIO-SKETCHES

Javier SILVA RUETE

Minister of Economy and Finance

1. In order to strengthen Peru's economic team, President Morales Bermudez named Mr. Silva Ruete Minister of Economy and Finance in May. By virtue of his position, he is also Peru's Governor for the Bank. The minister, who is 43 years old, is an economist by training. He is also credited with having a keen political sense and served as Minister of Agriculture under ex-President Belaunde in the late sixties. He is a Christian Democrat.
2. In the six years prior to being named to the Economy and Finance portfolio, Mr. Silva Ruete occupied several senior posts in the Andean Pact and related organizations. Most recently, he was Vice President of the Andean Development Corporation (CAF).
3. The Minister's command of English is weak.

Luis GUIULFO Zender

Advisor to the Minister of Economy and Finance

1. Mr. Guiulfo, 36, is one of the original architects of the economic and social programs of the 1968 Revolutionary Government. He studied economic and social development in France and was previously Vice-Minister of Economy and Finance and President of the Industrial Bank. During the past year, Mr. Guiulfo has been employed by the U.N. but has actually spent most of his time advising Minister Silva Ruete.
2. Mr. Guiulfo's command of English is fair.

Lima, March 21, 1979

Mr. Robert S. Mc Namara  
President  
International Bank for  
Reconstruction and Development  
Washington D.C.

Dear Mr. Mc Namara:

1. Peru has suffered, over the last few years, the effects of a severe economic crisis which has caused social and political difficulties.
2. As a consequence of this crisis, the present level of production of goods and services is barely similar to that attained in 1975; real income of wage earners is lower than 1970 levels; the rates of open unemployment as well as underemployment, are higher than in previous years; and the rate of inflation in 1978 was the highest ever registered in Peruvian statistics.
3. Further, in the external sector, the country faced an acute lack of foreign exchange and was unable to meet the domestic demand for imported goods, mainly inputs for industry and other productive sectors. These problems reached a crisis peak during the first half of 1978, when the probability of stopping repayment of international debt was faced, together with loss of Government's control over public finance deficit, the exchange rate, and the inflation rate.
4. To cope with this situation, Peruvian economic authorities formulated and begun to implement an integrated economic program designed to control and over-come the crisis. This Program, which has already been published, applies to the period: June 1978-December 1980 (Public Investment is programmed through 1982). During the preparation

of the Program views were exchanged with and suggestions were received from members of several World Bank technical missions, for whose assistance and comments I should like to express my appreciation.

5. The main objective of the Program is to restore basic equilibrium to the economy, permitting a selective reactivation of economic activity which, together with an improvement in the efficiency of the public and private productive sectors, should lay the basis for an adequate solution of the acute employment and wealth distribution problems.
6. The global Program is made up of four elements, as follows:
  - a) Economic and Financial Stabilization Program;
  - b) Refinancing of External Public Debt Program;
  - c) Selective Reactivation of the Economy Program; and
  - d) Public Investment Program.

A. Economic and Financial Stabilization Program

7. This Program, which served as a basis for negotiations with the International Monetary Fund, is reflected in the current Stand-By Arrangement. Its two fundamental objectives are to revert the negative trend of the Balance of Payments and to reduce the rate of inflation. Up to now, all objectives have been met, through the implementation of a series of measures which include: the restructuring of the 1978 Central Government budget; the increase of some taxes; the reestablishment of the policy of continuous adjustment of the exchange rate; the periodical increases of interest rates; the reformulation of the Monetary Program and of the Legal Cash Reserve Requirements System, and the periodical adjustments of prices of the products subject to control. The Government of Peru has the intention of continuing to comply with the Stand-By Arrangement.

B. Refinancing of External Public Debt

8. Projections of exports and of external public debt service before refinancing showed debt service to exports ratios of 56.3 per cent for 1978; 57.7 per cent for 1979; and of 48.4 per cent for 1980. Thus shows that the percentage of exports needed for payment of external public debt service was far too high and it would not have permitted an imports level adequate to sustain economic activity. Because of this, four external public debt refinancing arrangements were made for the amounts that would have been paid over 1978, 1979 and 1980. These arrangements were arrived at: (i) with the Soviet Union; (ii) with private international banks; (iii) with the countries that participate in the Club of Paris; and (iv) with some Latin American and Eastern European Socialist countries.
9. Total debt relief is of approximately US\$1,800 million, of which the greater part shall be paid over a 4 to 5 year period, with three years of grace.
10. These refinancing operations have reduced considerably the percentage of foreign exchange earnings necessary for foreign external debt service, to levels of 34 per cent for 1979 and of 25 per cent for 1980.

C. Selective Reactivation of the Economy Program

11. Keeping in mind the resource constraints, the Economic Program for 1978-1980 includes measures leading to the reactivation of the economy, giving priority to agriculture, export industries, energy, and mining. Policies and specific action to be implemented have been divulged by the Government and also transmitted to the World Bank.
12. Of the policies and measures contained in this Program, some have already been approved and are being applied and others are in process

of study or implementation; general objectives of some of these have been jointly analyzed with members of World Bank technical missions.

13. The Program's main objective is to start again the economic growth process, based upon the priority sectors mentioned (paragraph eleven) and directly related to the comparative advantages the Peruvian economy has for international trade, mainly based on its natural and human resources and on an improved efficiency of its production capacity. To achieve this, among other measures, the protection of industry shall be reduced, exports diversification shall be stimulated, administrative controls over economic activities shall be reduced, the price system shall be made more flexible, and economic analysis of Government investments shall be strengthened.

- a. Reduction of protection of industry

14. This reform includes the following specific measures: (i) gradual elimination of the National Register of Manufacturers, which played the role of an imports restriction tool. Early this year such protection has been eliminated for a total of approximately 50 per cent of the products included in the Register, and half-yearly reductions of the interim List of Imports Prohibitions shall be made for the other 50 per cent, towards its total elimination in late 1980; (ii) gradual elimination of customs duties exonerations. This process should also be ended by late 1980, at the latest; (iii) formulation of a new customs tariffs system, substantially reducing the levels of tariff protection with a view to the improvement of efficiency in the industrial sector. This reduction shall be made from time to time, and should be totally accomplished in 1983. The new tariff should result in effective protection not exceeding a maximum of 90 per cent and its structure and levels shall be approved during July, 1979, within the protection limits fixed in the Decision 96 of the Cartagena Convention Commission.

b. Exports Promotion

15. A Law for the Promotion of Non Traditional Exports has recently been passed. Among other things, it guarantees the maintenance, in the future, of tax incentives, and eliminates bureaucratic controls and legal obstacles for these exports.

c. Tax policies

16. A special effort is being made to update tax rates, eliminate marginal taxes with high collection costs, and to broaden the tax base. To this end, exceptions and exonerations will continue to be reduced, independent professionals incomes shall be fully analyzed for tax purposes, and external wealth indicators shall be considered in ascertaining taxable income. A Program for the improvement of tax administration has been undertaken, and, to achieve this, the necessary resources shall be made available to the Dirección General de Contribuciones. To meet all these objectives we have requested financing, through the Program Loan, of technical assistance from the World Bank.

d. Exchange Rate Policy

17. The Exchange Rate shall be constantly readjusted, by means of mini-devaluations, so that approximate real relative parity is maintained.

e. Interest Rates Policy

18. Adjustments of the interest rate are foreseen, insofar as periodic assessments should show that they are necessary in order to achieve, in 1979, and maintain in the future, effective positive interest rates in real terms.

f. Monetary Policy

19. Monetary and Credit expansion will be related to stabilization objectives. However, selective assignment of available credit will favor productive sectors according to priorities set forth in the Economic Program.

g. Prices and Incomes Policies

20. For those goods whose prices are subject to control, equilibrium prices that reflect production costs are planned; this will be achieved through gradual and periodic adjustments. Furthermore, for these and other goods, administrative requirements will be made more flexible. Wages and salaries shall be also readjusted, taking into account inflation rates and the need to protect the purchasing power of low-income population.

D. Public Investment Program

21. The Public Investment Program, over the 1978-1982 period, constitutes a serious effort aiming mainly at the increase of public investment and its concentration on projects with higher economic returns. Over the past few years a slowdown in execution of some projects has become apparent, parallel to a general reduction in capital expenditures, which has taken place as a result of budgetary cuts reflected in thus limiting available funds. These factors have been affecting many projects which benefited from external financing but where internal counterpart funds were insufficient.
22. The Government will in future give priority to ongoing projects which contribute to economic recovery. To this end, Peru has taken action to facilitate a faster execution of projects. Those that are externally financed-including World Bank loans- shall benefit from such action.
23. Important technical help has been received from the World Bank in determination of economic criteria for the selection of projects included in the Public Investment Program. We expect to continue benefitting from the help of the Bank's professional staff in this field.
24. It must be noted that the investment levels set forth in the Government Budget and in the Public Investment Program for 1979 are specifically

and partly based upon financing we expect to obtain through the Program Loan. This financing is also included in the terms of the Stand-By Arrangement with the International Monetary Fund, and in the Agreement signed with private commercial bankers to refinance 1977 debt service.

25. The attached schedule includes the essentials of the Economic Program and the specific measures actually undertaken or considered.

### CONCLUSION

26. The above outlines the existence of a consistent Global Economic Program, with clear priorities, upon which the Peruvian Government bases all actions aiming at the stabilization of our economy and the recovery of its levels of economic activity and, in the final account of the standard of living of its population. This Program has been scrupulously adhered to up to now. Within this context the Program Loan has an important role to play of two reasons: a) It makes foreign exchange resources available to the productive sectors of the economy, necessary for the import of basic inputs for industry and for other productive sectors. Considering present under-utilization of installed capacity, this should result in a direct and positive effect upon the rate of growth of Gross Domestic Product; and, b) its proceeds converted into soles shall be used to finance counterpart funds for high priority investment projects, and will provide increased resources to export financing.
27. Taking into consideration all facts set forth above, I should like to reiterate the Peruvian Government's interest in the prompt approval of a Program Loan for US\$ 115 million.

Yours sincerely,

JAVIER SILVA RUETE  
Minister of Economy and Finance

MAIN PARAMETERS OF THE ECONOMIC PROGRAM AND ITS SPECIFIC MEASURES

MAIN TOPICS		SOLUTIONS AND MEASURES		ESTIMATED RESULTS	
Problems Identified	Magnitude	Measures	Schedule	Qualitative or Quantitative	Scheduled Impact
Public Finance Deficit	Current Account Balance	<ol style="list-style-type: none"> <li>Tax System Restructuring and Rationalization</li> <li>Tax Administration Reform</li> <li>Price Policies for Public Enterprises</li> <li>Control of current expenditures</li> </ol>	Variable	1979 5.3% GDP	Effects on income should be appreciated mainly in 1980-1981
	1977 - 2.5% GDP		Permanent		
	1978 - 1.02% GDP		Permanent		
	Overall Balance		Permanent		
B. Balance of Payments Deficit	1977 - 9.6% GDP	<ol style="list-style-type: none"> <li>Law for the Promotion of Non-Traditional Exports</li> <li>Exchange Policies</li> <li>Reduction of Mandatory Foreign Financing Terms for Imports</li> <li>Refinancing of External Public Debt</li> <li>Rationalization of new external indebtedness</li> </ol>	Done; Decree Law 22342, Regulations contained in S.D.001-79-ICTI-CO-CE	Non Traditional Exports: 1979 = US\$ 450 million 1980 = US\$ 520 million	Main effects to be appreciated in 1980-1981
	1978 - 4.9% GDP		Permanent	Maintenance of the Exchange Rate Real Parity	
	Basic Balance		To be eliminated 1980		
	1977 = US\$ - 252'400		Agreements arrived at	1979=US\$778.1 million <sup>b/</sup> 1980=US\$731.7 million <sup>b/</sup>	
C. Inflation	1978 = US\$ -229'500 <sup>a/</sup>	<ol style="list-style-type: none"> <li>Control of the economic deficit of the public Sector</li> <li>Interest Rates Policies</li> </ol>	Adopted, Decree Law 22149	US\$300 million if reimbursement period should be less than 10 years	Limits set for new public indebtedness are referred 1978/1981
	Cost of living Increase		Permanent	Cost of living increase: 1979=40% Decrease of GDP 1979 = 2.6% Effective Positive interest rate, in real terms in 1979	
	1977 = 32.4%			- Credit to the private Sector \$/.87,500 <sup>d/</sup> - Liquidity \$/.118,000 <sup>d/</sup>	
	1978 = 73.7%				
D. Economic Recession		<ol style="list-style-type: none"> <li>Selective support to priority sectors in credit availability of foreign exchange and tax treatment.</li> <li>Public Investment Program:                             <ol style="list-style-type: none"> <li>Minimum annual expenditure levels for priority sectors, highways conservation and construction, and health services</li> <li>Project implementation according to approved Public Investment Program.</li> </ol> </li> <li>Industrial Policies                             <ul style="list-style-type: none"> <li>National Registry of Manufactures</li> <li>Customs duties</li> <li>Customs duties exemptions</li> </ul> </li> <li>World Bank Program Loan</li> </ol>	Permanent	1979 = \$/.94,159 <sup>a/</sup>	
			Gradual reduction		
			Gradual reduction		
			Gradual reduction		
E. Agrarian Capitalization Decrease		<ol style="list-style-type: none"> <li>Minimum Public Investment Program for the Sector</li> <li>Credit Support</li> </ol>		1979=\$/.19,614.1 million <sup>a/</sup>	

NOTES:

- a/ Includes refinancing effects.
- b/ Includes estimated relief, due to refinancing with international private banks, Club of Paris, socialist and Latin American countries.
- c/ December to December.
- d/ Exchange Rate = S/. 200.00 per US\$ 1

19

35

1-10

January 7, 1980

Mr. Robert S. McNamara

Dear Bob,

Regarding Mr. Carlos Alzamora's request, it may be worth your while to see him briefly, say ten minutes. He is the new Secretary General of the Latin American Economic System, the only purely Latin American body created basically to:

1. Coordinate Latin American positions for world-wide economic negotiations, i.e. UNCTAD, North-South, South-South, etc.; and
2. Coordinate intra-regional economic efforts for integration through very flexible action committees made up by subjects and by interested group of countries.

SELA was created in 1975 (in fact, I presided over the organization meetings which took place in Panama). It has not functioned yet as well as we expected since it has not had any major breakthrough in four years. However, a good deal of technical effort has been done in many fields, even though sometimes the approach taken has not been very realistic.

The SELA Council is made up of the Ministers of Finance, Planning or Economics of all Latin American countries, including Cuba. It was not easy at the creation to bring together to the same negotiating table such countries as Cuba, Brazil, Argentina and Chile, but they all signed at the end, thus establishing a quasi "non-political", developmental approach. It has a small Secretariat, headed now by Mr. Alzamora, for coordination and for contracting out specialized analysis.

My impression is that they would like now to work a little closer with the international and regional development institutions. We could initially establish a good dialogue, which eventually could lead to our supporting some sensible and realistic multinational development projects which they may sponsor. We have nothing to lose by establishing a dialogue. Many people, including myself, are skeptical of that forum's ability to do much toward tangible achievements related to their second objective, unless they adopt realistic approaches.

The creation of BLADEX (Latin American Export Bank) was done under the spirit of SELA; however, I managed it away from the Secretariat and directly with the Latin American Central Banks until I had it all structured and approved, and then brought it to SELA as an accomplished fact.

If you decide to have a brief meeting with Mr. Alzamora, I will be glad to accompany you.

*NB*  
Nicolás Ardito Barletta

cc: Mr. Stern

1/7  
we will meet at 6 PM Thursday 1/10  
Lm

*Pem*



## OFFICE MEMORANDUM

TO: Memorandum for the Record

DATE: October 15, 1980

FROM: Francisco J. Aguirre-Sacasa, <sup>JAS</sup> Division Chief, LC1DSUBJECT: PERU: Meeting of the Peruvian Delegation with  
Mr. McNamara on September 30 at the 1980 Annual MeetingsDelegation:

Manuel Ulloa, Prime Minister and  
Minister of Economy, Finance  
and Commerce  
Pedro Pablo Kuczynski, Minister  
of Energy and Mines  
Richard Webb, President of  
Central Reserve Bank of Peru

Bank:

Robert S. McNamara  
Ernest Stern  
Nicolas Ardito Barletta  
Eugenio Lari, Director, LAC 1  
Guy Pfeffermann, Chief Economist, LCNVP  
Francisco Aguirre-Sacasa,  
Division Chief, LC1D  
Olivier Lafourcade, Personal Assistant  
to the President

10/17

1. After being welcomed by Mr. McNamara, Minister Ulloa briefly described the economic situation inherited by the Belaunde Administration and the measures that the Government intended to take. He explained that the economic team would continue with the recovery program launched in mid-1978 and that it would emphasize bringing inflation under control. The Government would stress social programs in the area of health, nutrition and housing while pursuing employment generation schemes. Attention would also be given to stimulating agricultural production, increasing expenditures in the energy and petroleum sectors and to redesigning incentives to encourage private sector participation in mining and petroleum exploration/exploitation. In addition, the Government would launch road and irrigation rehabilitation projects. Minister Ulloa went on to say that some of the measures which the economic team was considering would be unpopular, particularly with leftist factions in Peru. While President Belaunde had received a clear mandate in the recent presidential election and his "Acción Popular" party had effective control of Congress, the economic team would have to proceed cautiously and would very much welcome receiving World Bank backing for their programs in the form of a structural adjustment loan (SAL).

2. Minister Ulloa then mentioned that his Government was putting together a public investment program and hoped to have it ready in early 1981. This program would be made up of sound development projects and could serve as the basis for a Bank-sponsored consultative group meeting in mid-1981.

3. Mr. McNamara congratulated Mr. Ulloa on the thrust of his policies and took note of the Minister's plans with regard to the consultative group meeting. He added that the Bank would find it difficult to make a SAL to Peru because of the country's relatively favorable balance of payments situation. Mr. McNamara went on to emphasize, however, that the Bank

October 15, 1980

supported the measures which Minister Ulloa was taking and that we would show our backing by significantly increasing Bank lending to Peru over the next 5 years. Mr. McNamara stated he was particularly pleased about the emphasis which the new Government was giving to poverty projects and he urged that Dr. Evans (Director of Population, Health and Nutrition Department) be brought in to help accelerate processing a health project. Messrs. Ardito Barletta and Webb noted that extensive discussions on a possible health project were already under way and that they had, in fact, been launched prior to the new Government's inauguration.

4. Mr. McNamara then asked Minister Ulloa to comment on measures being contemplated to strengthen the Government's finances. In response, Minister Ulloa stated that the Government intended to continue eliminating subsidies. At this point Mr. Kuczynski interjected that the Government was aware of its commitment to the Bank to increase the domestic prices of petroleum derivatives by 40 percent during the course of 1980 and he confirmed that this commitment would be honored. Minister Ulloa also endorsed this statement.

5. Turning to interest rates, Minister Ulloa mentioned that the Government was considering increasing passive rates by 8 to 10 points which would stimulate savings. The tax system would also be studied with an eye towards making tax administration more effective. Finally, on the expenditure side the Minister mentioned that the Government would resist pressure to embark on large but economically unjustified projects. With regard to the Majes irrigation scheme, Peru's largest ongoing "white elephant", the Government hoped to minimize the harm being done to public finances by following the recommendations of an ongoing optimization study financed under the program loan.

7. Mr. McNamara concluded the meeting by touching upon the disbursement of Bank loans to Peru. In this regard he reminded the Minister that the Bank could deliver on a greatly increased lending program only if the Government succeeded in stepping up execution and, therefore, disbursement of ongoing loans. He also briefed the Peruvian delegation on the difficulties that the idea of a proposed Bank energy affiliate was encountering in some OECD countries. Mr. McNamara suggested that the energy affiliate was the quickest way for the Bank to mobilize the level of funds required by developing countries and he requested Peruvian support for this initiative. Both Ministers Ulloa and Kuczynski pledged to support the energy affiliate.

F.AguirreSacasa:gw

Cleared with and cc: Mr. Lari, LAC1

cc. Messrs. Stern  
Ardito Barletta  
van der Meer, LCP  
Glaessner, LCP  
Wessels, LCP  
Goffin, LCP  
Doyen, LCP  
Lafourcade, EXC

Messrs. Pfeiffermann, LCNVP  
Quijano, LCNVP  
Nowicki, LCI  
Aguirre Sacasa, LC1D  
Weissman, LC1D  
Thumm, LC1D  
Chaparro, LC1D, Peru

CONFIDENTIAL



## OFFICE MEMORANDUM

TO: MEMORANDUM FOR THE RECORD

FROM: Francisco Aguirre Sacasa, Division Chief, LC1D *FAS*

SUBJECT: PERU - Minutes of Minister Kuczynski's meeting with Mr. McNamara  
on February 13, 1981

DATE: February 20, 1981

1. Mr. Pedro Pablo Kuczynski, Peru's Minister of Energy and Mines, met with Mr. McNamara at 6:00 p.m. on February 13, 1981. The Minister was accompanied by Mr. Fernando Schwalb, Peru's Ambassador to the United States and its Vice President. Besides Mr. McNamara, Messrs. Stern, Ardito Barletta, Lafourcade and Aguirre-Sacasa attended the meeting on behalf of the Bank.

03/06  
2. Mr. McNamara open the meeting by welcoming Minister Kuczynski to the Bank. The Minister then proceeded to summarize Peru's economic situation and the economic measures taken recently by the Belaunde Government. More specifically, Minister Kuczynski mentioned that while the economy was recovering from the severe recession of 1978-79, Peru still faced a high debt service ratio and low commodity prices for some of its principal exports (e.g., silver and copper). To bring Peru's public sector deficit down from about 5 percent of GDP in 1980 to more manageable levels in 1981 (2-2.5 percent of GDP), the Belaunde Government had announced significant increases in food and domestic petroleum prices as well as water and power rates; the largest hikes took place in January of this year. The Government had also cut back on the CERTEX, a much abused tax rebate scheme set up to stimulate non-traditional exports.

3. Taking these actions had not been easy. President Belaunde himself has been reluctant to authorize the measures because of their unpopular nature. Moreover, many Peruvian industrialists, who had grown accustomed to protection, opposed the general opening-up of the economy being pushed by the economic team. Finally, the Government had come under attack for these economic measures from the left.

4. Mr. McNamara congratulated Minister Kuczynski for the courage the economic team had shown, particularly on the pricing front. He reminded the Minister that realistic pricing for domestic petroleum products was especially important in order to curb demand for petroleum and to help finance exploration efforts. In response to a query from Mr. McNamara, Mr. Kuczynski mentioned that Peru was a marginal producer of petroleum with 1981 production in the 220,000 b/d range. About 70,000 b/d of this amount was available for export. The Minister added that recent changes in Peru's petroleum legislation--a more favorable tax credit scheme and the opening up of secondary recovery to foreign contractors--would create a more favorable investment climate for foreign oil firms. Several important multinationals, including Shell, had already expressed an interest in playing a more active role in Peru's petroleum development. If their involvement materialized, Peru could conceivably be

producing as much as 300,000 b/d by the mid-1980s. Because of the growth of domestic consumption, however, the amount available for export would still be about 70,000 b/d.

5. The discussion then turned to agriculture. The Minister reported that the outlook for the 1981 crop year was considerably improved over the past year (when production actually dropped by 4-5 percent) thanks to an end to Peru's drought. To stimulate agriculture further, the Government intended to raise farmgate prices and had entered into a consolidation phase in the agrarian reform. Important institutional problems still persisted, however, particularly in BAP, Peru's national agricultural bank. Feeder roads were also deficient, extension services were virtually non-existent and Government involvement in marketing of agricultural products was a hindrance.

6. Minister Kuczynski then indicated that President Belaunde attached top priority to the Bank's proposed eighth highway project. The Government was also interested in going ahead with the Sheque Hydroelectric Project. In this regard, he reported that--at the Bank's suggestion--the Government had proceeded to hire a consultant to reconcile two conflicting studies on the water availability needs of Lima and the Mantaro water transfer scheme. Mr. McNamara took note with satisfaction of this progress and urged that this issue be resolved quickly for Peru to minimize investments in thermal power at a time when the price of fuel was rising. In a country like Peru, hydropower was an obvious way of reducing dependence on oil. Mr. McNamara then returned to the issue of pricing for petroleum derivatives and remarked that even the 90 cents per gallon price introduced in January was too low. He recommended that the Government raise these prices gradually and mentioned that recent experience around the world suggested that the demand for petroleum products was more elastic than had originally been thought.

7. The meeting concluded with a brief discussion of the Bank Group's future in view of the growing austerity of several important Part I countries. Mr. McNamara stated that the Bank was facing a serious situation but that he anticipated that we would be able to go ahead with about \$145 million in new lending to Peru in FY81 and with \$200+ million in FY82. The countries that would likely be hardest hit were those that were IDA recipients. Minister Kuczynski offered to help mobilize support for IDA and the energy affiliate. More specifically, he indicated that he would take this matter up with the US Government and particularly with the Treasury Department.

cc. Mr. Stern  
Mr. Ardito Barletta  
Mr. Lafourcade  
Mr. Lari

FAguirreSacasa,gw

## OFFICE MEMORANDUM

STRICTLY CONFIDENTIAL

TO: Messrs. Francisco Aguirre-Sacasa, Division Chief, LAC-DATE: November 8, 1977  
and Alexandre Nowicki, Senior Economist

FROM: Elwyn A. Chaparro, Economist, LAC I ~~XXXXXXXXXX~~

SUBJECT: PERU - Recent Economic Developments and the IMF Stabilization Program

DECLASSIFIED

MAY 09 2013

WBG ARCHIVES

I. SUMMARY AND CONCLUSIONS

1. The economic situation which had started to improve during the second half of 1976 once again deteriorated during January-September, 1977. The economic team was changed twice and negotiations with the IMF towards a stand-by credit failed twice. Faced by a desperate scenario of depleted cash reserves and a high risk of default on external payments, President Morales personally assumed ultimate responsibility for economic management and decided on the necessity of agreeing with the IMF on a stabilization program. On September 21, an agreement at a technical level was finally reached with the IMF on a program for the October 1977-December 1979 period. Because of earlier false starts, the IMF imposed two conditions before it would formally consider a request for a stand-by agreement: (i) the adoption of a realistic and flexible exchange rate policy; and (ii) increases in the price of petroleum derivatives other than gasoline. The Government approved measures satisfying both conditions on October 10-11. The exchange has been allowed to float and quantitative controls on merchandise imports were relaxed. The rate, which was S/.81 dollar on October 10, had risen to S/.103.5/dollar by November 4. The IMF is now finalizing the documents for the stand-by agreement that are to be presented to its Board on November 18. The IMF assistance would amount to about \$103 million (SDR 90 million equivalent to the second and third credit tranches) to be disbursed during the next two years.

2. The IMF program essentially aims at cutting both inflation and the loss of international reserves by reducing aggregate demand. In formal terms, the IMF would put ceilings on domestic credit and on foreign borrowing with maturities of less than 10 years. In substantive terms, key elements of the program are slashing the public sector overall deficit from 8.6 percent of GDP this year to 3.2 percent in 1978, reducing in real terms both wages and credit to the private sector, and maintaining a realistic exchange rate policy. As a result, imports in 1978 are targetted to contract by around 7 percent in nominal terms. Since exports are expected to grow by some 15 percent the trade balance is to become positive by some \$50 million compared to negative balances of \$740 million in 1976 and \$370 million in 1977. <sup>1/</sup> However, since public debt service will reach over \$1 billion (or at least 40-41 percent of exports of goods and non-factor services), over \$210 million of fiscal and balance of payments support loans will still be required to balance the accounts.

3. For 1979 the program envisages a further small cut in the public sector overall deficit to 3 percent of GDP and a continued tight monetary and credit policy. The compression of wages in real terms would probably have to continue. Imports are to remain at 1978 levels in nominal terms while exports are to grow by 10 percent widening the trade surplus to \$300 million. However, around \$275 million of balance of payments support loans would be required since the service on foreign public debt will rise again to

<sup>1/</sup> Interest payments on medium and long-term public debt will rise from \$268 million in 1977 to \$332 million in 1978, but the current account balance will fall from \$860 million to \$500 million.

\$1.2 billion (or around 45 percent of exports of goods and non-factor services).

4. During the 1978-79 stabilization period overall real economic growth will probably be zero or negative (compared to a negligible growth this year and an annual 3 percent attained in 1975-76). The debt service burden in the next two years is so heavy and the present resource gap so wide, however, that even after two years of no growth and austerity and almost \$500 million of new balance of payments support loans, net international reserves will not have improved from the negative \$700 million of August 1977.

5. The commercial banks will continue to play a key role in Peru's short-term future providing the bulk of the balance of payments support loans required. An important point to highlight is the mutual interdependence between Peru and the banks. If the banks do not provide large amounts of additional financing, Peru will be unable to service its foreign debt, but the last thing the commercial banks want is the default by an important LDC at the present time when the wisdom of their foreign operations is being widely questioned and the U.S. Government is threatening to impose stiff controls. However, the banks have repeatedly stated their reluctance to provide any further loans without a stand-by agreement with the IMF.

6. The precarious political conditions and the weakness of the present economic team raise serious doubts whether the program will be successfully implemented. Political and economic leadership is seriously lacking at a time when Peru needs it the most. The present military government remains in power principally because no other group --military or civilian-- wants to carry the burden of a stabilization program. Its goal is to somehow hold the economy together until the elections of 1980. In this vacuum of direction and purpose, the Government has no strong support from any political group in the country. Moreover, even if the political will can be maintained, it is doubtful whether the present economic team is capable of effecting the fine tuning that the implementation of the stabilization program will require. It was my distinct impression that the program was put together by the IMF while few in Peru have understood its ramifications. The inevitable adjustments that will have to be made to the program during the next two years will require continued heavy IMF intervention. This, in turn, may debilitate the already weak political backing of the program.

7. Another worrisome aspect is that the program is exclusively focussed on closing the resource gap in the short run through compression of aggregate demand. If the recurrence and intensity of these financial crisis are to be reduced, the Government will have to tackle the basic causes which include inadequate savings, inefficient use of resources and excessive concentration of exports in primary commodities. To enhance the long-term prospects of the economy, the Government should also make more efforts at stimulating employment creation.

8. In conclusion, the future prospects of the Peruvian economy are at best uncertain. After much hesitation and zig-zaging of policies and faced by totally depleted cash reserves and the drying up of foreign financing sources, the Government seems to be willing to take serious compression action to

stabilize the economy in the next two years, under the guidance and supervision of the IMF. Although the first concrete steps have been taken, only after the program is well underway (during 1978) can any tentative conclusions on its success be advanced. A major element in this assessment will be the Government's determination to carry out the program. In the recent past, similar good starts by the Government were abandoned shortly thereafter. Unless concrete evidence of continuity in sound economic policies is forthcoming, Peru cannot be considered creditworthy for further normal project Bank lending. In addition, it would be advisable for the Bank to continue impressing upon the Peruvians the urgent need for tackling the causes of the present problems and of trying to remove them within the framework of the stabilization program so as to reduce the recurrence of crises and put the medium and long-term prospects of the economy on more solid ground.

## II. DEVELOPMENTS UP TO AUGUST 1977

9. In 1975 the Government claimed repeatedly that it intended to reverse the worsening economic situation. A series of mild austerity measures were approved but had little effect in counteracting the otherwise expansionary policies. Public sector savings collapsed from a low 2.9 percent of GDP in 1974 to a negative 0.9 percent of GDP and the overall public sector deficit widened from 6.3 percent to an all-time high 10.3 percent of GDP (see Table 1). The principal causes were the inadequate pricing policies and the excessive investment of the public enterprises whose overall deficit (excluding Central Government subsidies) reached 8 percent of GDP. Although in absolute terms the bulk of this deficit was accounted for by PETROPERU, PESCAPERU and food subsidies, weak financial management and performance was a general problem in most public enterprises. At the same time, Central Government finances also weakened noticeably. (See Annex Tables 1 to 3). Total expenditures rose from 21 to almost 24 percent of GDP fueled by a 32 percent real growth of military expenditures and a 61 percent real growth of transfers to the rest of the public sector. Revenues, on the other hand, rose only 7 percent in real terms and the overall deficit of the Central Government widened from 3.2 to 5.5 percent of GDP. Excluding taxes on exports (which were increased in 1975) and on imports (merchandise imports rose by almost 30% in 1975), other tax revenues as a share of GDP declined from 10.8 to 10.1%. The monetary accounts also suffered serious disadjustments in 1975: net domestic assets grew by 21% in real terms (mainly because of a 57% real growth of credit to the public sector) while liabilities to the private sector contracted by over 5% in real terms (see Annex Tables 4 and 5). This increase in velocity of circulation was the logical result of an increase in inflationary expectations combined with a policy of fixed and increasingly negative interest rates in real terms. Besides accelerating inflation, the excessive aggregate demand that resulted spilled over into imports in a year when exports contracted by over 7% (see Annex Table 6). The trade deficit tripled to 1.1 billion and the current account deficit widened to the 11.3% of GDP mentioned above. In spite of the continued massive borrowing, almost \$580 million of net international reserves were lost during 1975.

10. In June 1976, a first serious attempt was made to compress aggregate demand. The measures approved included new taxes, budget cuts, increases in petroleum and food prices and a large devaluation (from S/.45 to S/65 per US dollar). Then in September a crawling peg exchange rate policy was adopted. In aggregate terms, the financial figures for the second semester of 1976 showed a sharp improvement over the recent past. The overall balance of payments gap was reduced from \$670 million in the first semester of the year to \$200 million in the second semester (of which \$165 million were financed with emergency balance of payments support loans from commercial banks) (see Annex Tables 6 and 8). Inflation which totalled 44% for the whole year was down to 1% per month in November and December. The principal source of the improvement were the public enterprises. The increase in prices of petroleum products and foodstuffs, the reduction in overstaffing at PESCAPERU, and general reductions in the levels of investment resulted in a halving of the overall deficit of the public enterprises (excluding Central Government subsidies) to less than 4% of GDP. Also contributed to the financial improvement, the tight credit policy that was followed: in real terms, overall banking system credit contracted at an annual rate of almost 15% in the second semester. The sharpest contraction in real terms was absorbed by the private sector to which credit fell at an annual rate of 42%. Against these achievements, performance was less satisfactory in three areas: Central Government finances, external debt management and banking system deposits. In the first place, the Central Government finances continued deteriorating (see Table 1). Tax revenues decreased from 14.5 to 13.1% of GDP and if the yields of the large gasoline tax introduced in June 1976 are excluded, other tax revenues contracted by 16% in real terms (see Annex Table 2). Although the austerity program did make very substantial cuts in most expenditures (in real terms payments of wages and salaries fell 10% and fixed investment expenditures fell 14%), the overall deficit of the Central Government widened from 5.5 to 6.2% of GDP in 1976. The expansionary element was defense expenditures, which amounted to 5% of GDP in 1976 (compared to 3.5% two years earlier). Moreover, these figures do not give the full magnitude of the defense spending-spree that occurred in 1976 since only a small share of the around \$700 million of hardware purchased abroad was delivered in that year. Arms purchases were the principal cause of the second area of weakness in 1976 performance: new public sector foreign loan commitments almost doubled from \$984 million in 1975 to \$1,712 in 1976 and the external debt outstanding and disbursed rose over 20% to \$3.7 billion. The third area of poor performance was that banking system liabilities to the private sector in real terms contracted by an additional 20% during the year, partly due to the continued negative level of real interest rates.

11. By the end of 1976 the political determination necessary to pursue an austerity program wavered, mainly because of doubts within the military cabinet on the seriousness of the economic crisis and the fear of popular unrest. For most of 1977, indecision characterized economic management and the financial deterioration resumed its course. Despite the insistence by the then Minister of Finance (Mr. Barúa), the Cabinet refused to trim the 1977 budget to realistic levels and by the end of June the overall deficit was 10% larger in real terms than in the first semester of 1976 (see Annex Table 1). Revenues, other than the taxes on exports and on gasoline introduced in June 1976,

continued to fall in real terms (see Annex Table 2). A conspicuous example of the weakening of tax administration is that the average import duty actually collected fell from 22% in 1976 to 17% in January-June 1977, without any reduction in nominal tariffs. The Ministry of Finance struggled to administratively keep a lid on expenditures by authorizing expenditures on a month-to-month basis and trying to keep them at 1976 levels. However, expenditures in debt service and defense rose in real terms by 33 and 20% respectively from the levels reached in the first semester of 1976 (see Annex Table 3). At the same time, the lag in adjustment of prices once again affected negatively the finances of the public enterprises. Since most of the growth of the public sector deficit was financed with foreign loans, credit to the public sector did not grow much during the semester. However, as liabilities to the private sector in real terms contracted an additional 11% in the December 1976-June 1977 period, around \$85 million of net international reserves were lost in spite of \$222 million of balance of support loans received by the Central Bank. (See Annex Tables 5, 6 and 8).

12. After a first round of negotiations for an IMF stand-by agreement failed in April 1977, a new Minister of Finance, Mr. Piazza was appointed in May 1977. He made a new attempt to structure a stabilization program and to reach agreement with the IMF. He succeeded in getting approval for increases in the prices of gasoline and foodstuffs. However, serious disturbances in many areas of the country protesting the price increases and wage controls resulted in clashes with the police and the army and climaxed in a general strike in mid-July. Because of this and the fact that Mr. Piazza's program called for sharp cuts in military expenditures, the Cabinet refused to accept the program negotiated with the IMF and removed Mr. Piazza from the Ministry in July.

13. Since mid-July the financial situation has deteriorated to desperate levels. The new economic team (headed by Gen. Sáenz Barsallo, Minister of Economy and Finance, and Mr. De la Melena, President of the Central Bank) began to act in the direction opposite to that of the preceding team. They granted some wage increases, partially rolled back the increases in food prices approved in June, stopped the crawling devaluation of the Sol, and tightened the physical control of imports except for military purchases abroad which reportedly continued at high levels. These measures widened the resource gap, worsened inflationary pressures and allowed the exchange rate to once again become overvalued. In July and August credit to the public sector was growing at a real annual rate of 32% and an additional \$56 million of net international reserves were lost. Since August a default in external debt payments has been averted only through emergency swaps with the Central Banks of Venezuela, Brazil and Colombia and through commercial bank roll-overs of maturities due with short-term loans.

14. In this untenable scenario, President Morales has personally assumed ultimate responsibility for economic management and decided on the imperative necessity of agreeing with the IMF on a stabilization program. An IMF mission visited Lima in early September and drew up a two-year stabilization program on which to base a stand-by agreement. President Morales followed closely the negotiations with the IMF and on September 21 agreement was reached at a technical level.

15. Because of the difficulties encountered in implementing earlier agreements, the IMF established two pre-conditions to consideration of the negotiated documents by their Board: adopting a realistic exchange rate policy and increasing the prices of petroleum derivatives other than gasoline. On October 10-11 the Government satisfied both conditions. A floating exchange rate has been adopted and some of the restrictions on merchandise imports dropped. The rate, which was S/. 80.88/dollar on October 10 had risen to S/.103.5/dollar by November 4. The prices of petroleum products other than gasoline were raised by around 25% and are expected to yield additional revenue of around S/. 4 billion per year at 1977 consumption levels.

#### IV. THE IMF PROGRAM 1/

16. The program negotiated between the IMF and the Government had to face four facts: (i) net international reserves were negative by \$700 million at the end of August and there were no foreign exchange cash reserves left; (ii) the burden of the service from the debt already contracted by June 1977 would mushroom from \$654 million in 1977 to \$976 million in 1978 and \$1076 million in 1979; (iii) under the best of circumstances and with better policies during the October-December 1977 period, the overall public sector deficit would be a staggering 8.6% of GDP in 1977, comparable to that in 1976; and (iv) inflation was expected to exceed 40% for a second year and was liable to accelerate further unless drastic action was taken. Therefore, with very little room for maneuver left, the program had to last at least until the end of 1979 and had to aim at a massive contraction of resource use in the economy, that would slowdown inflation and stop the loss of international reserves. The alternative was a certain default on foreign debt service payments and a galloping inflation.

17. The centerpiece of the stabilization program is reducing the overall public sector deficit as a share of GDP from the 8.6% expected this year to not more than 3.2% in 1978 and 3% in 1979 (see Table 1). 2/ The contraction effort needed is large but the remaining deficit will still be sizeable since it will have to be financed almost in its entirety with domestic financing; net direct foreign financing to the public sector will be negligible because of the huge amortization payments due. It could be argued that if the contraction of the public sector deficit could have been distributed more evenly throughout the two-year period instead of aiming at achieving most of the cut in 1978. However, this would have resulted in highly unrealistic foreign financing requirements. The largest burden will fall on the Central Government which will have to shave its overall deficit between 1977 and 1978 from 6.5 to 2.3% of GDP (see Table 1 and Annex Tables 1 to 3). According to the hopes of the Government, 2/3 of the reduction in the deficit is to come from expenditure cuts. The aim is to maintain public fixed investment at 2.4% of GDP but cut transfers to the rest of the public sector and defense outlays, and allow wages to increase only

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1/ This section was put together from conversations with the IMF and Peruvian officials. However, since the IMF has not shown us the details of the agreement, there may be minor errors.

2/ The formal agreement with the IMF will specify only the ceilings for domestic and foreign borrowing by the public sector: The discussion in this paragraph refers to the pattern of behavior projected by the Peruvians to remain within these ceilings. However, alternative patterns (such as more defense and less fixed investment) would not violate the agreement.

half as fast as prices. On the revenue side, the plans are to increase them from 13.7% of GDP in 1977 to 15% of GDP in 1978 with minor increases in the rates of excise and sales taxes and with a tightening of tax administration. The rest of the public sector as a whole would have to cut by about half its overall deficit through realistic price policies that reflect costs and through further cuts in fixed investments.

**Table 1 : INDICATORS OF PUBLIC SECTOR FINANCES, 1974-78**  
 (percent of GDP)

	Estimated		Prelim.	Targets supplied in IMF Program 2/	
	1974	1975	1976	1977	1978
<b>PUBLIC SECTOR 1/</b>					
Savings	2.9	-0.9	0.9	-1.1	4.0
Capital expenditures	9.2	9.4	9.4	7.5	7.2
Fixed investment	8.2	8.4	8.0	6.5	6.2
Other	1.0	1.0	1.4	1.0	1.0
Overall balance	-6.3	-10.3	-8.5	-8.6	-3.2
External financing, net	5.7	5.6	3.1	4.5	0.2
Domestic financing, net	0.6	4.7	5.4	4.1	3.0
<b>CENTRAL GOVERNMENT</b>					
Current revenues	15.3	15.8	14.5	13.7	15.0
Current expenditures	14.0	16.3	15.9	16.3	14.2
National defense	(3.5)	(4.6)	(5.0)	(n.a.)	(n.a.)
Interest payments	(1.7)	(1.7)	(1.7)	(n.a.)	(n.a.)
Other	(8.8)	(10.0)	(9.2)	(n.a.)	(n.a.)
Current acct. Balance	1.3	-0.5	-1.4	-2.6	-0.8
Capital expenditures	4.5	5.0	4.8	3.9	3.1
Fixed capital form.	(2.9)	(2.9)	(2.6)	(2.4)	(2.4)
Other	(1.6)	(2.1)	(2.2)	(1.5)	(0.7)
Overall balance	-3.2	-5.5	-6.2	-6.5	-2.3

1/ For 1977-78 figures for the overall deficit and fixed investment are firm; the other numbers are rough estimates.

2/ The IMF program conditions only the size of the overall deficit and its financing.

18. A key feature of the monetary program proposed for next year is that banking system liabilities with the private sector will increase at almost the same rate as prices. 1/ This would be a reversal of what has been occurring in the last three years when liquidity has been shrinking rapidly in real terms. However, the program envisages that this can be achieved without an increase in interest rates because the program targets inflation to drop rapidly. The agreement does have a clause that if inflation has not fallen to the targetted level by the end of the first quarter of 1978, interest rate policy would be reviewed, but there is no commitment on the Peruvian side to raise the rates to positive levels in real terms. Even if this target on liquidity is achieved, given the credit requirements of the public sector, the growth of credit to the private sector will have to be

1/ More specifically the elasticity to changes in prices of banking system liabilities with the private sector will be 0.75 in the first semester and 1 in the second semester.

kept at less than half that of prices to avoid further losses in net international reserves. Although specific monetary targets for 1979 have not yet been set, they will certainly maintain a tight credit policy.

19. The above fiscal, exchange rate and monetary targets are expected to reduce inflation within the year from around 40-45% in 1977 to 20% in 1978 and to less in 1979, and to shrink merchandise imports from \$2.15 billion in 1977 to \$2 billion in 1978 and \$1.95 billion in 1979. (See Annex Table 6). Assuming an annual international inflation of 6% over the next two years, the fall in volume implied by these targets would amount to about 12% in 1978 and 8% in 1979. A large share of the import contraction will be accounted for by targetted cuts in purchases of military goods and oil products.

20. Assuming that with somewhat better mineral prices and a recovery in the growth of non-traditional exports, merchandise exports can grow by about 12% annually over the next two years, the trade balance would turn from a negative \$370 million in 1977 to a positive \$50 million in 1978 and \$300 million in 1979. (See Annex Table 6). With growing tourism inflows, with less imports and with less direct investment income remitted abroad, the deficit in the balance of services other than interest payments on public debt is projected to decline from around \$280 million in 1977 to \$235 million in 1979. The targets also assume that private long-term capital inflows will almost double in 1978-79 from the \$69 million expected this year and that, with the import financing requirements imposed, short-term capital inflows will become positive in 1978 (but become negative in 1979 when the import financing requirements are to be phased out). Consistent with the targets on public investment in Table 1 and adding the loans for military, food and petroleum purchases, gross disbursements of foreign loans to the public sector are projected to total \$800 million in 1978 and \$825 million in 1979 (see Table 2). <sup>1/</sup> However, even if all the above targets are met and assuming that net internal reserves do not improve during 1978-79 from the negative \$700 million of August 1977, an unfinanced balance of payments gap of around \$490 million would remain over the two years because of the jump in public debt service payments from \$660 million this year to \$1 billion in 1978 and \$1.2 billion in 1979. The debt service ratio would rise from 30% in 1977 to at least 41% in 1978 and 45% in 1979. The unfinanced gap would probably have to come predominantly from foreign commercial banks, although the Peruvians have a hope of obtaining a program loan from the World Bank and large assistance from the U. S. Government.

<sup>1/</sup> The agreement however imposes the following ceilings on foreign borrowing (excluding borrowing for balance of payments support purposes) between June 1977 and December 1978: (ceilings in millions of dollars):

	Maturity	
	1-5	5-10
June 1977-June 1978	115	185
June 1978-Dec. 1978	60	90

**Table 2 : FOREIGN CAPITAL FLOWS TO THE PUBLIC SECTOR AND EXTERNAL DEBT INDICATORS, 1976-1980**

	1976	1977	1978	1979	1980
----- A. CAPITAL FLOWS (in millions of dollars) -----					
a. <u>GROSS DISBURSEMENTS</u>	<u>963</u>	<u>1215</u>	<u>1011</u>	<u>1101</u>	
Balance of Payments support loans	165	222	211	276	
Other	798	993	800	825	
b. <u>AMORTIZATION</u>	<u>284</u>	<u>391</u>	<u>686</u>	<u>836</u>	<u>937</u>
1976-77 BOP support loans	-	47	111	111	111
1978 BOP support loans	-	-	-	-	70
1979 BOP support loans	-	-	-	-	-
Other	284	344	575	725	756
c. <u>NET DISBURSEMENTS (a - b)</u>	<u>679</u>	<u>824</u>	<u>325</u>	<u>265</u>	
1976-79 BOP support loans	165	175	100	155	
Other	514	649	225	100	
<u>INTEREST</u>	<u>205</u>	<u>268</u>	<u>332</u>	<u>382</u>	<u>324</u>
1976-77 BOP support loans	-	24	32	26	17
1978 BOP support loans	-	-	14	18	12
1979 BOP support loans	-	-	-	18	25
Other	205	244	286	382	270
e. <u>NET TRANSFERS (c - d)</u>	<u>474</u>	<u>556</u>	<u>-7</u>	<u>-127</u>	
1976-79 BOP support loans	165	151	54	103	
Other		405	-61	-230	
f. <u>TOTAL DEBT SERVICE (b + d)</u>	<u>489</u>	<u>659</u>	<u>1018</u>	<u>1218</u>	<u>1261</u>
1976-79 BOP support loans	-	71	157	173	235
Other	489	588	861	1055	1026
g. <u>DEBT OUTSTANDING AND DISBURSED</u>	<u>3734</u>	<u>4558</u>	<u>4883</u>	<u>5148</u>	
1976-79 BOP support loans	165	340	440	605	
Other	3569	4218	4443	4543	
----- B. RELATIVE MAGNITUDE OF FLOWS (in percent) -----					
Disbursements/Imports of goods	46	57	51	56	
Net Disbursements/Imports of goods	32	38	16	14	
Net transfers/ Imports of goods	23	26	-	-7	
----- B. INDICATORS OF BURDEN OF DEBT (in percent) -----					
Debt service/Export of goods + NFS	<u>28.1</u>	<u>29.7</u>	<u>40.7</u>	<u>44.3</u>	
Debt outstanding/ Export of goods + NFS	<u>2.15</u>	<u>2.06</u>	<u>1.95</u>	<u>1.87</u>	
Interest/Debt outstanding	5.5	5.9	6.8	7.4	
Amortization/Debt outstanding	7.6	8.6	14.0	16.2	
Debt service/Debt outstanding	13.1	14.5	20.8	23.6	

#### IV. CHANCES OF SUCCESS OF THE IMF PROGRAM

21. At present it is impossible to predict whether the program agreed with the IMF will be successfully carried out. The fact that the pre-conditions to the agreement were executed by the Government is encouraging. There are, however, three aspects that, in my view, diminish the chances of success of the program: (i) the political weakness of the Government; (ii) the ambitious targets in the program with little room for mistakes; and (iii) the low technical competence of the present economic team.

22. The stability of the present regime is uncertain and its political ability to carry through any strong program is precarious. Gen. Morales remains in power mainly because no other group -- military or civilian -- wants to carry the burden of a stabilization program. At the same time the aims of the Revolution of 1968, which justified the military government, have been either achieved or dropped. The Government's present goal is to somehow hold the economy together until the elections of 1980. In this vacuum of direction and purpose, the Government has no support from (nor any desire to antagonize) any political group in the country. Against this background a consensus on economic policy within the Cabinet was reached only sporadically during the past two years. Programs were initiated only to be abandoned a few months later. There is a school of thought that this time, since Peru is on the brink of default, the Cabinet is serious about carrying through the stabilization program. Only after the program has been implemented for at least 6 months and tangible results appear can this judgment be tentatively confirmed.

23. At the same time, there are various targets in the stabilization program which have a low probability of being attained. These include:

- a. Raising Central Government revenues from 13.7% to 15% of GDP without taking major action to revamp tax administration and/or expand the taxable base by eliminating tax loopholes. This seems unlikely given the record of the last five years.
- b. Cutting Central Government expenditures sufficiently since this necessarily implies a sharp reduction in defense expenditures. The past austerity programs initiated by the Government have been characterized by ever-growing defense expenditures. There is little basis on which to trust that arms purchases will be cut in the future. Although it is probably true that Peru now has more military hardware than any of its neighbors except, possibly, Brazil, the cost of maintaining this equipment will be high. Moreover, it is not clear that achieving a superiority in military hardware was the real justification for the massive military purchases. If expenditures on defense and wages and salaries cannot be cut, the only alternative to attain the public sector's targetted deficit will be to cut fixed investment. However, this will most probably imply a parallel fall in disbursements of foreign medium- and long-term loans that finance the fixed investments; this would widen the balance of payments gap, if the foreign loans finance local expenditures.

- c. Stopping the increase in velocity of circulation of money so as to allow a growth of banking system liquidity at almost the same rate as prices, without taking action to increase interest rates now. For this to occur, the inflationary expectations would have to dramatically drop and confidence in the Government's economic management capability increase, which seems unlikely.
- d. Doubling private long-term capital inflows and eliminating private capital flight next year.

24. Keeping in mind that the "bottom line" of the program -- mainly on international liquidity -- allows for no margin of error, if one or more of the above targets are not met strictly throughout 1978 and 1979, the Government will have to move quickly to make up shortfalls with alternative measures. This brings us to the third reason for pessimism on the prospects of success of the program: the low technical quality of the economic team. The problem exists in top management -- which was evident during the Annual Meetings of the Bank -- and at the staff level. The economic team has no one with experience in these types of problems and less than a handful of middle level technicians have understood the ramifications of the program. It is difficult to see who is going to work out viable solutions if the program gets out of track. One alternative would be for the IMF to give continuous substantive advice to the Government on how to proceed. But at present the Fund does not have a resident representative in Lima and heavy IMF advice might, in any event, exacerbate the already strong political sensitivity to foreign intervention.

EChaparro/mlb

Cleared with and cc. Messrs: Lari, Holsen, Aguirre-Sacasa and Nowicki

c.c. Messrs: Krieger  
Calika  
Mendoza  
von Stauffenberg

## OFFICE MEMORANDUM

TO: Mr. Francisco Aguirre-Sacasa  
 Mr. Alexandre Nowicki  
 FROM: Luis Landau *by hand*  
 SUBJECT: PERU - Economic Situation

DATE: March 22, 1978

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1. This note is based on my findings during a mission to Peru on January 24 - February 3, 1978, and developments since then.

Political Background

2. The political situation is unstable. Constituent Assembly elections are scheduled for June and 13 parties of all shades (including the communists) have registered. President Morales Bermúdez has recently received a strong statement of support from the Armed Forces. There are, however, expectations of important changes in the Government. Conservative segments of the business community predict that a coup - whose probability is difficult to assess - will lead to a new government and an indefinite postponement of the elections. Others, including some bankers, expect that after the elections President Morales Bermúdez will appoint a civilian cabinet. On the other hand, recent changes in key military command posts have raised some of the original leftist military supporters of former President Velasco to important positions.

3. The picture is also mixed on the labor front. A general strike, called by the leftist CGT for February 27-28, resulted in partial compliance and isolated acts of violence. Unions affiliated with center parties, such as APRA and the Christian Democrats, did not join the strike. The Government appears to have been able to ride out this storm without making major concessions to essentially political demands (release of some jailed union leaders, return of other exiled leaders, and reinstatement of workers fired for having joined previous illegal strikes). Labor unrest is likely to continue, however, and demands for wage increases in excess of those already granted by the Government in January (about 12 per cent) can be expected to grow with inflation.

Economic Developments

4. In this unstable political climate, the authorities find it extremely difficult to formulate and implement the tough policies needed to overcome a deepening financial and economic crisis. This is aggravated by the growing weakness of an economic team that was not strong to begin with, as competent technicians continue to leave the Government. Also, the attention of the authorities is fully absorbed by urgent day-to-day matters, and there is little time to think in terms of correcting the underlying problems of the Peruvian economy or to outline a medium-term development strategy.

5. The dark economic picture that was presented in Mr. Chaparro's memo to you (dated November 8, 1977 -- copy attached) has further deteriorated. Real economic growth, which was barely in line with population growth in 1975-76, became negative in 1977. This GDP drop (1%) was more intense in urban areas, as industrial value added fell by 4.5 percent and construction by 15 percent. Urban unemployment most likely is increasing, fed by migration from the Sierra. In addition, real wages are being eroded by rapidly rising inflation. The consumer price index, which rose by 38.5 percent in 1977, soared at 7.5 percent in January and 5 percent in February of this year. Furthermore, net international reserves fell by a further \$296 million in 1977, to reach a negative value of \$830 million.

External Payments

6. The most urgent issue facing the Government is how to meet the large financial obligations of the public and private sectors. I estimate the country's total foreign debt at approximately \$8,120 million, distributed as follows:

Peru's External Debt - Disbursed Only  
(\$ million)

	<u>As of Year-end</u>	
	<u>1976</u>	<u>1977</u>
I. <u>Long-Term</u>	<u>5,495</u>	<u>6,120</u>
Public Sector	4,195	4,820
- Central Government and Entities	(3,495)	(4,170)
- Central Bank and others	(700)	(650)
Private Sector	1,300	1,300
II. <u>Short-Term</u>	<u>2,000</u>	<u>2,000</u>
Banking System <sup>a/</sup>	750	830
Private Business	1,250	1,170
III. <u>TOTAL</u>	<u>7,495</u>	<u>8,120</u>
IV. MEMO - GNP at Market Prices	12,610	13,114
- Debt as Percent of GNP	59.4%	61.9%

a/ Private and Public

7. Debt service obligations payable in 1978 on this debt can be estimated to range between \$1,370 million and \$2,000 million, depending on the extent to which the short-term and private long-term debt can be rolled over (See Annex Table I). These magnitudes are gigantic in relation to the country's projected earnings. Taking into account the recent completion of the Cujone copper mine, as well as the northern branch of the oil pipeline, exports of goods and non-factor services could at best reach \$2,400 million in 1978, resulting in an aggregate debt-service ratio that would range between 57 and 83 percent. The conventional debt-service ratio used by the Bank (which excludes service on the private and the short-term debt) would be around 42 percent. It seems at present that it will not be possible for Peru to meet even the minimum projected total debt service, and the country could only avoid default with a major debt-relief operation. This possibility is further discussed in para. 18 below.

8. In the circumstances, the Government has been attempting to meet its immediate external obligations by various means. It has arranged to receive swap deposits from other regional central banks and the Andean Development Corporation. The Central Bank has so far given priority to servicing the financial obligations of the public sector, allocating close to two-fifths of all the country's merchandise exports for this purpose. The remaining three-fifths is available to commercial banks for servicing all other external payments. With the Central Bank's share of export revenues (expected to reach \$740 million in 1978) plus projected new disbursements on existing loans and other foreign earnings (some \$170 million, including the IMF standby) added to the initial cash holdings of the Central Bank (\$123 million as of February 1, 1978) the Central Bank will continue to strive hard to avoid a default. The struggle, however, could not last much longer, unless Peru succeeds in its current efforts to obtain a \$250 million refinancing loan from a syndicate of U.S., European and Japanese banks. Unfortunately, the prospects for this loan are, at best, uncertain at present.

9. Turning to the country's private debt, commercial banks are unlikely to have enough foreign exchange to meet their own obligations and those of private business firms. At present, the bulk of foreign exchange receipts of commercial banks is derived from export earnings. Only about 60 percent of the value of merchandise exports plus the proceeds from services is available to commercial banks to meet foreign payments for all merchandise imports (except capital goods imports, which are financed with medium or long-term credits), invisibles and private debt service. Without additional foreign loans, commercial banks and private business firms could face a total foreign exchange gap of between \$455 million and \$1,140 million in 1978 depending on the extent to which the private sector debt can be rolled over (See Annex Table II).

10. It is not clear what the consequences of the private sector foreign exchange gap will be. Private capital inflows are not likely to make a significant net contribution, beyond the full rollover of the long and short-term debt. Consequently, private sector imports will likely have to contract sharply, perhaps by even more than the 10 percent reduction (in real terms) assumed in the projections presented in Annex Table II. Fortunately, stocks of imported intermediate goods are believed to be large; this provides a certain cushion for a reduction in imports in 1978.

#### The Foreign Exchange Market

11. Since the Sol was floated in October, 1977, the Central Bank does not intervene in the foreign exchange market. Commercial banks are free to buy and sell foreign exchange at any price. In practice, however, the commercial banks have agreed to peg the exchange rate at S/.130 to the US\$ (up from S/.85 in October). The banks reached this agreement because they felt that a free float would have further depreciated the Sol to such an extent that many local firms with foreign liabilities could not have survived. Since the new rate does not clear the market, the banks are rationing foreign exchange. They apparently give priority to the payment of debts that cannot be postponed, and stimulate their clients to roll over other debts or to take new foreign loans. Foreign banks have reported that their Peruvian correspondents owe unauthorized overdrafts for an aggregate total of more than \$50 million. On the other hand, there are indications that some Peruvian firms still have access to additional foreign borrowing or lines of credit, but the drawdown of these credits is obviously hampered by the private sector's reluctance to directly assume new obligations involving a foreign exchange risk.

12. A legal parallel market is emerging through the use of Certificates of Deposit (CDs). An individual or firm receiving a bank remittance from abroad for any service other than payment of merchandise exports may use the foreign funds to buy, through any commercial bank, a CD denominated in US\$, with maturities ranging from 90 to 360 days, and annual yields up to nine percent. CDs are payable to the bearer and freely negotiable. They are reportedly being traded at around Soles 160 - 170 for 180-day maturities. This would imply an expected rate of domestic currency depreciation of about 50 percent per year. An illegal market in foreign currency is reportedly developing as well.

The Standby Program

13. Last November, the IMF approved a stabilization program as part of a standby arrangement. The program, which assumed a target inflation rate of 20 percent for 1978, established ceilings on the expansion of domestic credit to the public sector (39 percent) on the unlikely assumption that the public sector's overall deficit would be reduced from 8.6 percent of GDP in 1977 to 3.3 percent of GDP in 1978. The standby also restricted foreign borrowing operations by the public sector. It further implied a severe contraction in real domestic credit to the private sector, as it only allowed a 10.9 percent expansion in current terms for 1978. Other provisions of the program would have limited the loss in net international reserves of the banking system to \$150 million in 1978 (compared to \$296 million in 1977), committed the Government to raise the gasoline price by at least 20 percent and to liberalize the system of import controls. In addition, the Government indicated its intention to carry out other measures including first, allowing the Sol to float freely (except for limited interventions to counteract erratic or seasonal movements); second, limiting general wage increases in 1978 to a single across-the board increase averaging ten percent for public and non-unionized private workers; third, moving towards relaxing price controls on certain consumer goods and reducing Government subsidies; and fourth, moving towards real positive interest rates on loans and deposits by March, 1978.

14. While on paper the standby program might have seemed feasible, its chances of success were minimal for the reasons indicated in Mr. Chaparro's memo to you dated November 8, 1977 which still remain valid:

" The precarious political conditions and the weakness of the present economic team raise serious doubts whether the program will be successfully implemented. Political and economic leadership is seriously lacking at a time when Peru needs it the most. The present military government remains in power principally because no other group -- military or civilian -- wants to carry the burden of a stabilization program. Its goal is to somehow hold the economy together until the elections of 1980. In this vacuum of direction and purpose, the Government has no strong support from any political group in the country. Moreover, even if the political will can be maintained, it is doubtful whether the present economic team is capable of effecting the fine tuning that the implementation of the stabilization program will require. It was my distinct impression that the program was put together by the IMF while few in Peru have understood its ramifications. The inevitable adjustments that will have to be made to the program during the next two years will require continued heavy IMF intervention. This, in turn, may debilitate the already weak political backing of the program. "

15. Developments since the above was written unfortunately confirm our pessimism. In January the authorities obtained from the IMF a waiver on the gasoline price increase. 1/ In mid-January a general wage increase was announced, broadly in line with the program guidelines. At the same time, however, the Minister of Economy raised inflationary expectations by encouraging unions to negotiate larger increases with individual firms and by announcing that in April the authorities would reconsider the adequacy of salaries in the light of trends in the cost of living.

16. The 1978 budget for the Central Government (adjusted to reflect recent policy decisions) is prima facie in line with the program, but only in the sense that the budgeted bottom line (net borrowing) conforms to the program. Closer analysis, however, suggests that this objective may not be attained. The budget is, for example, excessively optimistic in projecting that current revenues will increase by 57.4 percent in 1978 over 1977 (in current prices). The specific revenue measures thus far taken are inadequate to bring about such an increase in revenues at a time when real GDP will probably contract. On the expenditure side, the Government's apparent program still includes a large outlay on imported non-productive hardware (US\$304 million) only one-fourth below these outlays in 1977. The 1978 budget, revised as of late February, allows for a 40 percent current expansion in fixed investment, a 120 percent rise in current transfers to public sector entities (reflecting a continued high level of subsidies) and a 28 percent rise in wages and salaries. These figures may well be exceeded, since inflation in January/February alone was higher than 12 percent.

17. Pegging the US\$ at 130 Soles might not be considered a clear violation of the standby for two reasons. First, as indicated above, floating the US\$ was not a legally binding commitment. Second, the Government apparently played no formal role in the commercial bank's decision to stop the float. This decision, by the way, was sound, because little would have been gained at this time by allowing the Sol to depreciate further. From now on, however, it would be desirable to maintain the real exchange rate unchanged by adjusting the nominal exchange rate in line with the excess of Peruvian inflation over international inflation.

18. An IMF standby review mission returned to headquarters around March 10. Since then, some mission members have gone back to Lima. We understand that the mission found that Peru was not in compliance with the program, although no final decision has yet been taken. If Peru were not authorized to make the \$10 million drawing due in April, 1978, the foreign commercial banks would find it difficult to grant further refinancing loans, and default might follow soon. On the other hand, even if the Fund were to authorize

1/ This means that regular gasoline will continue to sell at S/.75/gallon, or about US\$0.57.

the April drawing the outlook for the rest of the year, as well as for 1979-80, would remain critical. Peru could only avoid default with the help of an urgent major debt-relief operation, to encompass most of the debt-service due in 1978-80. This in turn would clearly require the formulation of a sound medium-term economic program, involving both policy measures to induce structural changes and some development-oriented capital investments.

#### Conclusions

19. Because of the gravity of the economic situation, lack of a political definition and weakness of the economic team, there is a substantial possibility of default on the foreign debt, hyperinflation and continued decline of economic activity. To delay such an outcome, it would be necessary for the major foreign commercial banks to assist Peru by urgently granting refinancing loans. Furthermore, to achieve a medium-term solution, a concomitant step would be the formulation of a plan to correct the underlying causes of the present crisis. These include the weakness of public revenues, inadequate attention to economic and financial considerations in the priorities for public expenditures, and lack of incentives to stimulate private sector savings and their investment in socially productive activities, including non-traditional exports.

20. For the reasons analyzed above, Peru cannot be considered, at present, creditworthy for normal Bank project lending. However, if the Government were to seek our assistance to formulate or implement an economic recovery program, it would be advisable for us to be prepared to assist the Government in the preparation of a medium-term program. Simultaneously, and assuming that the authorities prove to be determined to carry out the reforms, there would be a need for quick-disbursing, presumably non-project, loans. This activity should be undertaken with a view of finding solutions to a generalized excess capacity in manufacturing, agriculture, mining and infrastructure. The urgent need is for working capital and intermediate-goods imports to put that capacity to work. With appropriate policies, part of the additional output could be channelled into exports which, in turn, would contribute to solving the balance-of-payments crisis. This action could prove effective only if institutional and organizational improvements take place including more efficient management of publicly-owned enterprises, better project preparation, etc. Such a program would, in turn, help to rebuild private sector confidence and should reverse the capital flight of recent years.

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#### Attachments

Cleared with: Mr. F. Aguirre-Sacasa  
Mr. A. Nowicki

ANNEX TABLE I

Estimated Debt-Service Payments Due in 1978 (\$ Million)

	<u>Interest</u>	<u>Amortization</u>		<u>Total</u>	
		Max. <u>a/</u>	Min. <u>b/</u>	Max. <u>a/</u>	Min. <u>b/</u>
On the Public Long-Term Debt (of which: commercial banks)	318 (155)	686 (306)	686 (306)	1,004 (461)	1,004 (461)
On the Private Long-Term Debt	130	185	-	315	185
On the Private and Public Short-Term Debt	<u>180</u>	<u>500</u>	<u>-</u>	<u>680</u>	<u>180</u>
<b>TOTAL DEBT SERVICE</b>	<u>628</u>	<u>1,371</u>	<u>686</u>	<u>1,999</u>	<u>1,369</u>

a/ "Max" assumes full repayment of the private long-term debt due in 1978 and of 25% of the outstanding debt outstanding, plus all interest due in 1978.

b/ "Min" assumes full rollover of the short-term debt and of the private long-term debt due in 1978, but full payment of interest due in 1978.

NOTE: Both versions assume the meeting of full service obligations on public long-term debt.

## ANNEX TABLE II

## Peruvian Private Sector (Including Commercial Banks)

## Sources and Uses of Foreign Exchange, 1978

(\$ million)

<u>Sources</u>			<u>1,600</u>
Merchandise Exports (60% of \$2,000)	1,200		
Service Exports	<u>400</u>		
Uses - Max. <u>b/</u>			<u>2,740</u>
Uses - Min. <u>a/</u>			<u>2,055</u>
Current Imports <u>a/</u>		<u>1,175</u>	
- Consumer Goods	175		
- Raw Materials, Spare Parts and Intermediate Goods	1,000		
Invisibles (Excluding Interest)		570	
Service on Private Debt - Max. <u>b/</u>		<u>995</u>	
Long-term; Amortization	185		
Interest	<u>130</u>	315	
Short-term; Amortization	500		
Interest	<u>180</u>	<u>680</u>	
GAP Max. <u>b/</u>			<u>1,140</u>
Interest on Private Debt - Min. <u>c/</u>		<u>310</u>	
Long-term	130		
Short-term	<u>180</u>		
GAP Min <u>c/</u>			<u>455</u>

a/ Average of actual 1977 imports and those projected for 1978. The projection assumes that real imports in 1978 will be 10% below the 1977 level. Imports of capital goods are not included in this table because they are required to have long-term financing. Thus, they do not imply a use of foreign exchange in 1978.

b/ "Max." assumes full repayment of the private long-term debt due in 1978, and of 25% of the short-term outstanding, plus all interest due in 1978.

c/ "Min." assumes full rollover of the short-term debt and of the private long-term debt due in 1978, but full payment of interest due in 1978.

NOTE: The debt-service projections include an undetermined amount (believed to be small) of short-term debt of the public sector. To this extent, they overstate the private sector gap.