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BRIEF FOR MR. CLAUSEN – LATIN AMERICA & CARIBBEAN REGION: Brazil, Caribbean Region, Colombia, Mexico, Peru

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BRAZIL

BRAZIL

Political Situation and Trends

1. During the 1950s and early 1960s Brazil was governed by a series of elected regimes with a populist orientation. In 1964, after several years of increasing inflation and political confusion, the armed forces, with tacit popular support, took control of the Government. The early years of military rule were marked on the economic side by strong anti-inflationary measures, including severe wage restraints, and on the political side by severe repression. After 1967 economic policy became more expansionist, but tight political control was enforced by the military until the mid-1970s. The Geisel administration (1974-79) began a process of political "opening", which has accelerated under the present Figueiredo administration. Press censorship has been removed and amnesty for most political prisoners declared. Popular election of the federal president is scheduled for 1985, and expectations are that he will be a civilian.

Economic Situation and Trends

2. With a rich human and natural resource base, Brazil's long-term economic outlook is excellent. The "miracle years" 1968-73 demonstrated Brazil's potential for growth when conditions are favorable. Growth of some 11% per annum in those years was partly made possible by previously idle capacity, but it at the same time reflected the manifold natural advantages with which the country is endowed and its ability to modernize its institutions and mobilize resources for development. Important policies adopted during this time that have been continued to the present include a strong emphasis on agricultural development, the stimulation of manufactured exports, and the "crawling peg" exchange rate system, under which the cruzeiro is devalued frequently in accordance with the difference between domestic and foreign inflation. The Government has now launched some important programs to combat poverty.

3. The rate of growth has slowed to 7% per year since 1974, reflecting the balance-of-payments constraint introduced by high petroleum prices and, more recently, the high cost of servicing the rapidly accumulating foreign debt. The major required adjustments now are to increase the domestic savings rate, to develop alternative energy sources, and to expand exports. Both the energy substitution effort and the export drive have been successful up to now. However, under the most reasonable assumptions regarding the future course of petroleum prices, reduced oil import requirements, external borrowing costs and export growth, Brazil will need very large amounts of new external, private, financial credits at least through 1982 to sustain the projected GDP growth rate of 5-6%. Once this "hump" is

passed, however, barring unexpectedly unfavorable developments in the above variables, and assuming appropriate demand management and exchange rate policies and continued progress in oil conservation and substitution, the rate of net borrowing and the debt service burden can be expected to decline sharply. In other words, although private bank exposures in Brazil would have to grow substantially in 1981 and 1982, its relative share by 1985 would have fallen back to present levels. This scenario can only be realized, of course, if Brazil is able to retain the confidence of the international banking community. Although for domestic political reasons Brazil would prefer to avoid recourse to the IMF, it may in the end have to go to the Fund in order to assure the flow of private financing which it requires.

4. Over the past five years Brazilian governments have followed somewhat erratic monetary and fiscal policies, with periods of monetary and fiscal restraint being followed by relaxation. Since 1973, the rate of inflation has been increasing, and reached over 100% in 1980. Among the factors contributing to this pattern have been reluctance to allow growth to slow to a point where the 1-1/2 million annual new entrants to the labor force could not be employed, and institutional weaknesses affecting the economic authorities' ability to control the activities of Brazil's vast public sector. Over the past year, the Planning Ministry has greatly increased its authority over public sector expenditures and has used this power to exercise increasingly rigorous monetary and fiscal restraints. Nevertheless, agricultural subsidies are still very high (especially credit subsidies extended through interest rates that are highly negative in real terms). Partly in response to the balance-of-payments stringency, protection of domestic industry has increased. Wage policy is expansionary, and public sector prices have not been allowed to follow inflation. Finally, budgetary decisions, including those involving important long-term investments, are being taken with a short-run point of view without adequate consideration of their longer term economic and financial implications. All of these issues need to be addressed as a part of any program to adjust Brazil's economic structure to its new international situation.

World Bank Relations

5. Although Brazil was one of the earliest borrowers from the Bank, we made no loans from the late 1950s until after the 1964 revolution because Brazil was deemed to lack creditworthiness as a result of the economic policies being followed. Borrowing was resumed in 1965 and has gradually increased so that Brazil is now the Bank's largest borrower with gross commitments amounting to $5.4 billion. Loans at present disbursed and outstanding amount to $2.0 billion, and there are $2.6 billion of undisbursed commitments. In each of the past three fiscal years new loans have reached about $700 million. We expect them to exceed $800 million in the current year. The growth in our lending has been based on confidence in the country's long-term prospects together with generally high respect -- in spite of some reservation -- for the country's economic management.

6. The Brazilians have always shown themselves ready to discuss their economic problems and policies freely with the Bank. In some respects they have been influenced by the Bank's advice, and in all cases it has been possible to achieve a good degree of mutual understanding and respect, even though the Bank's economic views were not always shared.

7. The Bank has been pursuing several major objectives in its lending program. We have worked closely with the Brazilians to prepare a pipeline of projects addressing problems of poverty: rural development, urban development including water supply and sewerage, transport and sites and services, and basic education. At present over 50% of our lending program consists of projects whose main objective is to increase the incomes and well-being of low-income groups. We have also had a large number of projects designed to induce institutional and policy reform. Our lending in the electric power and transport sectors reflects this objective. Finally, we have financed a group of projects whose main purpose is to ease the balance-of-payments constraint by increasing exports or, when economically justified, creating substitutes for imports. In this category we have financed steel, fertilizers, petrochemicals, aluminum and iron ore mining projects. Over the next year or two we would like to increase the share of our lending devoted to helping Brazil resolve the energy problem and expect to make loans for fuel alcohol development, a gas pipeline, shale oil, and energy savings projects in steel and other industry.

8. There have been two chronic problems encountered in our lending, especially in the past two or three years. One of them is the Government's failure to permit adequate increases in public utility tariffs. Performance has recently improved in both the electricity and water supply and sewerage sectors but we hope to persuade the Brazilians to make further increases in electricity rates before our next loan for that sector. The other problem has been Brazil's practice of granting heavy interest rate subsidies to favored sectors of the economy, especially agriculture. Industrial interest rates have recently been reformed and in most cases are now positive in real terms, but agricultural rates remain highly negative. The prospects for new lending for agricultural credit programs are therefore not bright.

9. Now that the Government has taken some energetic measures to control public expenditures, some of the projects that we have financed in the past few years that are now in execution are encountering counterpart funding problems. We are addressing these cases one by one and are prepared to agree to a stretching out of project execution in many instances in order to cooperate with the Government's anti-inflationary program. A structural adjustment loan is not presently being considered. However, the Brazilians have expressed interest in one or a series of large, quick-disbursing sector loans.

CARIBBEAN REGION

THE CARIBBEAN REGION

1. The Caribbean Region includes all the countries which participate as actual or potential beneficiaries in the multinational consultative group formed and chaired by the Bank for this area (see para.15 below). They include the 17 English-speaking countries and territories known as the Commonwealth Caribbean (CC); the Dutch-speaking Netherland Antilles and Suriname; the Spanish-speaking Dominican Republic; and the French-speaking Haiti. Owing to its geographic and political fragmentation, small size, limited natural resources, and the seriousness of its current economic problems--emerging partly from the impact of oil price increases and, in most countries, also from past domestic mismanagement--this area poses a uniquely difficult challenge to the donor community as a whole, and, in particular, to the World Bank. This paper concentrates on issues related to the CC.

A. The Commonwealth Caribbean

2. The CC embraces a total population of about 5.3 million in 1979 with a combined GNP of about US$9.0 billion. It includes the independent countries of Bahamas, Barbados, Dominica, Grenada, Guyana, Jamaica, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago; the United Kingdom (UK) Associated States of Antigua and St. Kitts-Nevis; and the UK Crown Colonies of Anguilla, Belize, British Virgin Islands, Cayman Islands, Montserrat and the Turks and Caicos Islands. All the independent countries, except for St. Vincent and the Grenadines, are Bank members. St. Vincent and the Grenadines is expected to become a Bank member later this year, and Antigua, Belize and St. Kitts-Nevis should also become independent, and members of the Bank, by late 1982. Common practice is to distinguish between the relatively more developed and larger countries (MDCs) of Bahamas, Barbados, Guyana, Jamaica and Trinidad and Tobago, and the remaining less developed and smaller ones (LDCs).

Background and Main Characteristics

3. The CC countries have in common many characteristics. Politically, all of them used to be UK colonies. The 1960s witnessed independence for some of them, and by 1980 most of them had become independent nations. As a result of their British heritage, all of them have parliamentary traditions. Their political institutions, however, particularly in the LDCs, are still fragile as the 1979 Grenada coup illustrates. Trade unions have, in most of them, a long and strong tradition, and many of the political leaders of today have their roots in the trade union movement.

4. Economically, most of these countries are characterized by their smallness and by their heavy dependence on external trade, investment and financial assistance. Most of them depend on a few primary products--sugar, banana, bauxite--and/or on tourism. Only Trinidad and Tobago has a significant amount of hydrocarbons. Almost all, particularly the LDCs, provide an extremely difficult and challenging development problem. Their colonial heritage has left them with high levels of education, but paradoxically, relatively low levels of marketable skills in the labor force. In spite of

their sophisticated political development, many of them lack effective developmental institutions. The LDCs, when they were colonies, relied on budgetary support from the UK. Foreign assistance, properly focussed, will be needed on a continuous basis and could, over the long run, reduce the unstable conditions confronting these economies.

5. Economic development has led, in most of these countries, to improved social conditions, but has not significantly reduced the very high unemployment rates. High unemployment has contributed to different degrees of social tension and unrest but, overall, the social situation has been relatively stable. The high literacy, the democratic process, the absence on the whole of wide income disparities, the existence of a limited welfare state and the extended family system have all contributed to the relative social stability of the region. Nevertheless, social stability, as well as political democracy, cannot be taken for granted. During the second half of the 1970s, they were seriously tested in some countries. In the 1980s, effective approaches for employment generation and further improve- ments in income distribution may be needed to preserve them.

6. Building on somewhat fragile foundations and common interests, the CC countries have tried repeatedly to construct a framework of regional cooperation. An early attempt was made at integration--political and economic--with the establishment of the West Indies Federation in 1958. This experiment, however, did not survive the nationalist sentiments which dominated the Caribbean. The idea of regional economic association was revived in the mid-1960s and culminated in 1968, in the formation of the Caribbean Free Trade Association (CARIFTA). Within this free trade area, seven LDCs of the Eastern Caribbean formed the East Caribbean Common Market (ECCM). In 1970, the Caribbean Development Bank (CDB) was established, and in October 1972, CARIFTA member countries decided to strengthen the integration movement still further by forming a Caribbean Community and Common Market (CARICOM). Progress towards achieving the goals of regional economic integration has been limited, partly owing to political differences. Most of such limited progress has been made in the field of regional trade and monetary arrangements, including substantial financial assistance from oil-rich Trinidad and Tobago.

Developments during the 1970s

7. During the 1960s and up to 1973, these countries enjoyed high economic growth rates,a healthy demand for their products, relatively stable prices for their large range of consumer and capital goods imports, a growing inflow of tourist earnings, substantial inflows of foreign investment in mining, manufacturing and tourism (in the MDCs) and relatively substantial amounts of UK budgetary support (in the LDCs). The external economic environment changed drastically during the 1970s, and, with the exception of Trinidad and Tobago, economic performance deteriorated throughout the CC.

8. Among the MDCs, Bahamas and Barbados experienced low economic growth and/or stagnation through 1975/76, but performed well in subsequent years. Their relatively good performance has been assisted by political stability, an active private sector and good economic management. Jamaica and

Guyana, on the other hand, faced during the 1970s a substantial deterioration in their living standards. In these countries, internal policies compounded the effect of adverse external developments. Both engaged in ambitious and poorly managed programs to redistribute income and wealth. Unnecessary political rhetoric and varying degrees of intended--and sometimes unintended--hostility towards the private sector led to a decline of private investment, capital outflows, emigration of badly needed managerial, professional, and skilled labor, and to a substantial deterioration in labor relations. Both countries also faced increased fiscal and balance-of-payment current account deficits that led to harsh adjustment measures. By 1980, the prospects for investment, growth and balance of payments stability werediscouraging, but, in recent months, the outlook has improved with the change of leadership in Jamaica and a more positive attitude towards the private sector in Guyana.

9. Economic performance of the LDCs during the 1970s was uneven. Most of these countries had to adapt not only to a drastically changed external economic environment but also to their newly acquired independence, and to reduced levels of UK budgetary assistance. Living standards in some of them decreased in the early and mid-1970s, but have recovered since. Most of them, however, face serious problems of economic viability.

Prospects for the 1980s

10. During the 1980s, all the CC countries, must, to a greater or lesser degree, carry out a process of structural adjustment. This will be difficult and will require courage. Nevertheless, there is reason for some degree of optimism. With respect to the MDCs, Barbados and the Bahamas should be able to continue their relatively better performance. In Jamaica--and to a degree, Guyana--there is an incipient but clear trend towards more realistic and responsible economic management. In some LDCs, however, the roots of the economic problems go deeper, and their economic viability is still in question. For these LDCs, greater regional integration must be an integral part of their programs of structural adjustment.

Bank Group Lending

11. The Bank direct lending program for the MDCs totals US$311 million for FY81-85, including US$21.0 million for Bahamas, US$31.0 million for Barbados, US$85.0 million for Guyana, and US$174.0 million for Jamaica. Of these countries, only Bahamas and Barbados are clearly creditworthy. This program might be increased in the near future if the creditworthiness situation of Jamaica and Guyana continues improving. In Bahamas, the program covers urban development, education and agriculture. In Barbados, power, agriculture, and energy projects are under consideration. In Guyana and Jamaica, the recent trend towards more responsible and effective economic management has enabled the Bank to consider structural adjustment lending. An SAL was recently approved for Guyana, and one is being considered for Jamaica. A key element in Guyana's economic strategy is the development of a hydropower and related aluminum processing project, which, if feasible, might be supported by the Bank. The Bank does not have presently an active lending program in Trinidad and Tobago.

12. The current Bank lending strategy for the Commonwealth Caribbean emphasizes the role of its indirect lending through the CDB, which includes financing small projects in the MDCs and all the planned Bank Group financial assistance for the LDCs. Since its establishment in 1972, the CDB was considered a channel which should enable the Bank to assist the small Caribbean countries at a relatively low administrative cost. Up to now, the Bank Group has provided US$51 million to CDB (including US$7 million in IDA credit) and the FY81-85 program envisages assistance for US$77 million (including US$22 million from IDA). The CDB performance, however, is now below original expectations. Its technical staff is still very small, and its management is too weak to resist political pressures from the recipient countries. The recipients consider CDB too slow in processing loans--a complaint at least partly justified--and its main donor members--UK and Canada--as well as the US, believe that CDB expansion should proceed slower than previously expected. As a result, the LDCs which are becoming World Bank members, supported by Canada, UK and US, are increasingly pressing us for direct financial assistance. Since the availability of IDA resources is not likely to allow simultaneous direct and indirect lending in meaningful amounts to the LDCs of the Eastern Caribbean, and since these countries are not creditworthy for Bank lending, a decision will have to be made later this year on which of the two courses of action should be followed. Both alternatives are relatively costly for the Bank Group. Under the first one, we have been reimbursing CDB for the cost of "retailing" our IDA credits to the LDCs of the Eastern Caribbean. Under the second, such reimbursement would no longer be necessary, but substantial additional staff time would be required to handle direct lending.

B. The Caribbean Group

13. At the request of the US and Venezuela, and, subsequently, of some Caribbean countries, the Bank established in December 1977 the Caribbean Group for Cooperation in Economic Development--a multinational consultative group which by now includes as members 21 Caribbean countries, 15 donor countries (including the US, Canada, Japan, most of Western Europe and several Latin American countries), and the IMF, IDB, CDB, UNDP, the European Economic Community and about 10 other international institutions. The Group has met three times (in June of 1978, 1979 and 1980), and a fourth meeting is scheduled for June 1981. Until June 1980, it helped mobilize about US$530 million in program-type balance of payments support, as well as substantial amounts of project financing and technical assistance. The Group has also been successful in promoting some regional programs, particularly those related to private sector development, export promotion, tourism and energy. Given its success, the Group operations are now strongly supported by most donors and recipients. The Group is quite costly in terms of staff time, and demands from donors and recipients for additional technical work for the Group are increasing. Up to now, however, we have been able to limit somewhat the impact of the Group operations on our administrative budget by obtaining the technical and/or financial support of other institutions (particularly UNDP, IMF, CDB and EEC) and bilateral donors (US, UK and Canada).

COLOMBIA

COLOMBIA

I. Political Situation and Trends

1. Colombia has a long tradition of democracy, with more than 20 years of governments elected by the people. The Turbay Administration obtained a large majority in the past election. President Turbay, a consummate politician, has been able through negotiation and compromise to maintain party loyalty and cohesion, and by judicious appointments of opposition party members to cabinet posts has minimized inter-party conflict. Although successful in the political front, the President has been criticized for not providing enough leadership on economic matters. A recent cabinet reshuffle and a renewed public commitment to social and economic progress has apparently reduced discontent, for a time, at least. There is in the private sector, however, concern that the Government's decision-making process has become too politicized, and with the next Presidential election scheduled for March 1982, some of the problems confronting the economy--inflation, slowdown in real growth, growing unemployment and increasing dependence on imported energy--will remain for the next Government, which will take office after August 1982. Guerrilla activity, which was a problem in the past, has subsided considerably and illegal drug traffic has weakened, because of the Government crackdown of these activities and partly because of increased international competition. The campaign for the forthcoming election is taking shape gradually. The Liberal Party appears to continue having a considerable margin (if elected this would be its third consecutive term in office). The former Ambassador to the U.S. and for many years a Bank Executive Director, Virgilio Barco Vargas is gaining support within this party.

II. Economic Situation and Trends

2. The Colombian economy has made considerable progress over the past quarter century. It evolved to a more integrated urban-industrial and services orientation (over 68% of the population is now urban, compared with 50% in 1960), from a largely rural and agricultural base. Its productive structure was broadened appreciably as output became more diversified. Greater reliance on foreign trade allowed the external sector to grow, with non-coffee exports, particularly manufactured goods, expanding rapidly. Public sector investment and output came to play a greater role. The domestic financial market evolved *pari-passu* with the growing needs of the economy and Colombia has become an active participant in international capital markets. The foreign exchange shortages which the economy suffered from for many years because of sharp coffee price fluctuations have moderated, and the country has become more resilient to external shocks. This has been the result of the deliberate efforts of several administrations to establish an outward-looking development strategy (export promotion policies, including periodic exchange rate devaluations and export tax rebates, together with the lowering of tariffs and the freeing of products and capital markets from controls). In addition to relieving the foreign exchange constraint, this strategy stimulated economic growth. In future, more will have to be done to open the economy to imports by rationalizing and liberalizing the licensing system.

3. Between 1976 and 1979 the economy experienced both high rates of economic growth and strong inflationary pressures resulting mainly from excessive aggregate demand. Exports expanded, unemployment declined and real wages rose significantly in the rural areas, and were maintained in the urban sector. The Colombian authorities decided on economic stabilization and adopted a wide range of restrictive monetary and trade policies, including reduced public investment. This effort proved futile as unanticipated events--two coffee frosts in Brazil,

increased foreign exchange receipts from illegal (drug) exports, rising domestic gold production and large capital inflows induced by high interest rates--caused a rapid expansion of foreign exchange (at the end of 1980, net foreign exchange reserves were equal to one year's imports), thus exerting additional pressure on domestic prices. The stabilization program appears to be taking hold. Real economic growth in 1980 is estimated to have been no greater than 3-4% (down from an average growth of 6% per year during 1976-79). A recession in the construction industry caused by saturation of the high income market, a drought which affected agricultural production, and slower export growth have also contributed to deflate the economy for the whole of 1980. Inflation was reduced to 26% from 29% in 1979. The authorities, therefore, began to stimulate the economy and there are already some positive signs of recuperation.

4. Although broad improvements in economic and social welfare have occurred, poverty remains a major problem in Colombia. While all income groups have gained in absolute terms from the increases in real per capital income, in relative terms, the lower and higher income groups appear to have benefitted the most. The lower income group in particular were helped by the heavy Government outlays to provide basic needs.

5. The base of the economy is strong and its medium- and long-term growth prospects are favorable. The country has an abundance of resources, including ample arable land, minerals and primary energy resources, and its debt and debt-service burdens are low. It has a history of good economic management and exceptional entrepreneurial ability. Still, there are obstacles to growth that require prompt attention. Colombia became a net oil importer in 1976 and by 1986 petroleum imports are projected to absorb over 30% of total merchandise exports. In the absence of rapid energy development, energy shortages could become a major constraint on growth. Resolution of the energy problem depends upon the country's success in developing its abundant domestic energy resources--hydroelectricity, coal and natural gas--and also upon increasing petroleum exploration and development. For this to happen, further progress needs to be made by the Government in developing policies that promote sound energy pricing in line with rationalized consumption and resource availabilities, a least-cost program of investments, sufficient domestic and external financing for these investments, strengthened sector institutions and speedy and improved programs execution capability. Although planning and policy-making have improved substantially in recent years, overall planning and coordination in the energy sector is still weak. The Government and the Bank are working closely to strengthen the sector's performance.

6. With the heavy emphasis placed by the preceding Governments on social programs, the country's transport infrastructure has been substantially neglected. Today Colombia has high transportation costs and inadequate services. This situation could slow down economic growth, particularly that resulting from the development of the country's vast coal reserves and agriculture. The State Railway is in poor condition, the road network needs maintenance and rehabilitation and the antiquated port facilities cannot cope with increased traffic. At the same time, intermodal coordination and energy conservation efforts are deficient. The Government, therefore, proposes to allocate an important share of investment resources to the transport sector; the Bank is cooperating with the Government in finding appropriate solutions to these problems.

7. The Government is firmly committed to buttressing the elements which allow sustained economic growth. It proposes to increase public investment, while at the same time continue with the stabilization program. It is aware that it needs to mobilize substantial domestic resources to finance the investment program's

rapid execution, for which it will have to take additional fiscal measures, including appropriate pricing of public services. Making the transition to higher public spending without renewing inflationary pressures will require careful economic management. Also, to strengthen the external sector it will have to improve the competitiveness of Colombian exports through increased efficiency, timely devaluations and import liberalization. Given Colombia's good economic performance, it is reasonable to expect that the authorities will be taking all the necessary actions.

III. World Bank Relationship

8. The Bank has maintained a very close relationship with Colombia for over 30 years, with active economic dialogue and intimate involvement in the development process, particularly in the power, transport and industrial sectors. The Bank has also supported pioneering activities in rural development, nutrition, water supply and education. To date the Bank has made 90 loans and one IDA credit to Colombia, totalling US$2.9 billion equivalent.

9. Colombia is creditworthy and is expected to remain so. The Bank's program is designed to give heavy emphasis to energy development, transport infrastructure and institution building. The main thrust of the Bank's lending program will be to support Colombia's efforts to prevent energy scarcities and to upgrade the country's transport infrastructure. Continuing emphasis will be given to the productive sectors, i.e., agriculture, industry and mining. Part of the program will also aim at social programs but in lesser degree than in the past, as it is felt that the Colombians themselves are already making substantial progress in this field. The objective is to supplement this effort in areas where the Bank can contribute to institution building and thus, to the sector's absorptive capacity. The Bank's efforts will be concentrated upon rural development, nutrition, water supply and, possibly, rural education, with the objective of assisting the poor.

10. Given the task ahead, Colombia will require substantial gross external capital inflows over the next five years (about US$1.8 billion per year). To reach this target, the Bank has been encouraging co-financing from commercial banks and suppliers' credit, particularly on large projects. The Consultative Group for Colombia, which is made up of representatives from the major industrial countries, has provided a forum in which the Government has enlisted financial support for its investment progrma. Although Colombia's growing economic strength has lessened the usefulness of the Group, preparations for the meeting have helped the Government to introduce discipline in the public investment exercise. Furthermore, the Consultative Group has branched out and there are now sessions with the commercial banking community following the official Meeting.

MEXICO

MEXICO

The Political Scene

1. Mexico will be going through a sensitive political period during the next few months. President Lopez Portillo is expected to announce, sometime after September 1981, his party's candidate for the election of July 1982. Since the Partido Revolucionario Institucional (PRI) traditionally commands an overwhelming majority of the votes, Mr. Lopez Portillo is, in fact, considering who his successor to the Presidency will be. By tradition, the candidate is chosen from among cabinet members and Messrs. de la Madrid (Programming and Budgeting) and Ibarra (Treasury), who are well known to the Bank, are rumored to be on the short list of about six Secretaries.

2. It is unlikely that there will be major shifts in Government policy during the next six-year administration though, as in the past, the new President will impose his own style and emphasis on established policies. Some political issues, however, may become critical and the most important on the domestic front could be labor relations. Union leadership has supported the PRI loyally throughout successive administrations since the 1940s. However, it is now old and the change to a younger generation could result in a splintering of the labor movement and loss of control over its more militant members. There is no reason to believe, however, that the transition would result in undue disturbance in the internal political scene.

3. Mexico has traditionally adopted an independent stance internationally. The recognition that has come with its new-found oil wealth has been readily accepted by its present leadership; numerous and distinguished heads of state have visited Mexico over the past few years. Mexico now seeks to use its influence: it has proposed a world program to conserve and rationalize the use of energy at the United Nations and has become one of the principal spokesmen for the third world in international fora. This latter role is likely to be expanded, particularly if the political situation in Central America becomes the focus of world attention.

Economic Trends

4. Following the 1976 devaluation and the 1977 stabilization program, the pace of economic growth has been resumed vigorously; annual growth rates were above 7 percent between 1977 and 1980. This expansion has been made possible by (a) a reduced foreign exchange constraint as a result of oil discoveries; this has enabled the country to expand imports at more than 30 percent annually in real terms, (b) the restored confidence of the private sector, which has been increasing its investments at above 15 percent annually in real terms, and (c) an equally fast increase in public investment. The acceleration in the level of economic activity has resulted in a strong rise in employment, which has been growing at about 4 percent per annum, i.e., faster than the rate of increase of the labor force (3.7 percent per annum).

5. The Government has not been equally successful in fighting inflation; during 1980, prices rose by almost 30 percent compared to an average of 20 percent in the previous two years. No great improvement is expected for 1981. The persistence of inflationary pressures is the result of continued overheating of the economy. Domestic demand has been fueled by excessive Government public spending and by international oil sales (more than US$10 billion in 1980), while supply has faced a number of rigidities (bottlenecks in the railway and ports systems, lack of construction materials, a shortage of skilled labor, etc.). The situation has been further aggravated by expectations of continued inflation.

6. The public sector has accounted for a significant proportion of overall demand and this has resulted in increasing financial disequilibria; the overall deficit of the public sector reached almost 8 percent of GDP in 1980. While the growth of domestic resource mobilization has been impressive (domestic savings increased from 17.5 to 22 percent of GDP between 1977 and 1980), public sector current savings were due only to PEMEX; the rest of the public sector showed negative savings in 1980. The insufficiency of public savings in relation to public investment is the result of a low level of tax revenues, of substantial and increasing subsidies to cover the current account deficit of public enterprises --most of which price their goods and services at levels which do not reflect full costs--and of agricultural support prices for producers, and low consumer prices for basic consumption commodities.

7. The continued differential between the rate of inflation in Mexico and in its major trading partners has made the need for an exchange rate adjustment an urgent one. Though a policy of modest devaluations has now been adopted (expected to result in an adjustment of about 8 percent by the end of 1981) a larger adjustment is needed. The present exchange rate is gradually eroding the competitiveness of non-oil exports and increasingly cheap imports are causing a serious displacement effect in the domestic market. The apparent reluctance of the present Administration to address itself to this problem is of concern; for the coming two years, inflation in Mexico is unlikely to decline much below 25 percent annually, i.e., more than double the expected world inflation rate.

8. While growth prospects for the Mexican economy appear good in spite of the above problems, there remains the need for vigorous action to overcome income and regional disparities and to improve the living conditions of large segments of the population, especially in the rural areas. In this respect, the current strategy of the Government, which favors increasing subsidies to lower income groups, is not the appropriate way to increase productivity and income, the only effective way of eliminating social inequalities in the long run. On the contrary, by fueling inflation, these subsidies defeat their original objectives.

Bank Operations

9. The main objectives of Bank lending to Mexico have been to help overcome the country's main development problems by supporting projects which improve the distribution of the benefits of economic growth, provide additional

employment and income to low-income groups, improve the productivity of low income farmers, reduce Mexico's regional imbalances, and, in general, make directly or indirectly a significant contribution to output and employment.

10. The Government has repeatedly expressed its desire for a continued presence of the Bank in Mexico in order that we might continue a substantive dialogue on development policy and help strengthen investment programs in priority areas. Because of its oil wealth, Mexico has a manageable balance of payments problem. Nevertheless, it is likely to continue facing complex and deep-rooted problems of income distribution, of spatial concentration of economic activity and population, of sector under-development and inadequate infrastructure and of inadequate training for a large and rapidly expanding labor force. The Bank has a useful role to play in all these fields and can make a positive contribution to Mexico's development in the context of a significant lending program.

11. Mexico is now the Bank's second largest borrower (excluding IDA). As of January 31, 1981, 69 loans for a total value of US$4,799 million had been made, of which 38 loans for a total value of US$1,870 million were fully disbursed. Some 45 percent of Bank lending had been for projects in agriculture and rural development, 16 percent for industry, 15 percent for power, and 17 percent for transport; the remaining 7 percent was for water supply, tourism and urban development projects.

12. For the future, we visualize a lending program of US$640 million for FY82 (6 projects) and US$575 million for FY83 (5 projects). Thereafter, a program of about US$600 million per year is tentatively projected.

13. Our lending is to be complemented by a broad program of cooperation with the Mexican authorities to study specific development issues. Of special importance will be a Bank review of the agriculture sector in 1981, its main problems, bottlenecks and prospects. A study of the policies for, and prospects of, manufacturing industry would also be undertaken to see how Mexico could specialize along lines in which it has a comparative advantage and attain sustained growth in manufactured exports.

14. On several occasions we have discussed the possibility of cofinancing projects with Mexican officials. In the past, these officials have not been receptive to this mechanism arguing that it would result in additional conditionality to their foreign borrowing without a measurable improvement in terms. Most recently, however, they have expressed interest in exploring cofinancing possibilities with the Bank and we plan to pursue this further in the near future. The Government has also expressed interest in actively participating with the Bank in the financing of development projects in Central America and the Caribbean.

PERU

PERU

I. Political Situation and Trends

1. Fernando Belaunde Terry of the centrist Accion Popular Party (AP) was elected President of Peru in May 1980. In a country with a complex and varied political mosaic, he won an impressive 45 percent of the votes, far outdistancing his nearest rival. The AP also gained control of the Chamber of Deputies and, in a coalition with a center-right party, has a comfortable working majority in Peru's Senate. Mr. Belaunde's inauguration in July ended a dozen years of military rule which, ironically, had begun when the armed forces ousted him from power in 1968.

2. Despite the Administration's mandate, it faces a difficult political situation. President Belaunde must deal cautiously with the military and contend (i) with the strong opposition of Peru's leftist parties, which captured 26 percent of the vote in November 1980 municipal elections, up from a 15 percent showing in the general elections; and (ii) with intense pressure from Peru's trade unions, whose members' real wages have been declining for several years. In addition, there is opposition within the populist wing of AP and amongst some industrialist to the realistic pricing and austerity measures which the Government has taken recently and to its advocacy of an open economy. Finally, a small but violent terrorist movement has emerged to add to Peru's troubles.

3. The Administration has so far been able to manage the political situation. A one-day general strike called by the unions in January to protest price increases was largely ineffectual and President Belaunde's popularity was enhanced by an outpouring of national unity during border clashes with Ecuador in February. To deal with Peru's labor unrest, the Government is trying to negotiate a voluntary social pact--with labor, business interests and Government as participants. While this idea may work, a rapid improvement in the economy--with a corresponding increase in jobs--is still the best hope for social and political tranquility in Peru.

II. Economic Situation and Trends

4. During the mid-seventies, the Peruvian economy went through a serious economic and financial crisis, which culminated in mid-1978 with the country on the verge of bankruptcy. The former Government's stabilization-cum-economic recovery program, supported by an international rescue effort (including an IMF standby, a $115 million program loan from the Bank and a major rescheduling of Peru's debt), resulted in an improved balance of payments performance in 1979. Peru's reemergence as a modest petroleum exporter and high world prices for its other exports further boosted the balance of payments. At the time of the change in Government, the country's external financial position was comfortable, the public finance situation had improved and economic recovery was underway with growth during 1979-80 in the 3-4 percent range.

5. Several acute short- and medium-term problems remain: (i) a high rate of inflation of over 70 percent p.a.; (ii) urban un- and underemployment estimated at 11.2 percent and 44.1 percent, respectively, of the urban labor force in 1979; (iii) stagnating agricultural production aggravated by a drought in 1980 that caused production to drop by 4 to 5 percent; (iv) high subsidies for food and petroleum products amounting to about 6 percent of GDP in 1980 (the public sector deficit was equivalent to about 5 percent of GDP in 1980); (v) a rigid structure of Government expenditures with high outlays for the uneconomic Majes irrigation/power scheme and over 50 percent allocated to interest payments and defense; and (vi) a stagnating petroleum production/exploration effort.

6. The Government also faces severe long-term problems such as widespread poverty, skewed income distribution, poor state of health and nutrition, rapid population growth, and severe water and land resource constraints.

7. President Belaunde has named a first rate economic team headed by Mr. Manuel Ulloa, who is both Prime Minister and Minister of Economy, Finance and Commerce. The team includes technocrats and leading personalities from Peru's private sector, many of whom were drawn from the ranks of international institutions (including the Bank) and from commercial banks. Minister Ulloa is the Bank's Governor for Peru and Mr. Pedro Pablo Kuczynski--the Minister of Energy and Mines and a former Bank/IFC staff member--is the Alternate Governor.

8. This team is committed to efficiency, decontrol, promotion of the private sector and to an equitable sharing of the benefits of growth. Policies are designed to promote trade liberalization, growth of exports, and employment generation while dampening inflation. Priority is given to the (i) revival of agriculture and industry; (ii) expansion of mining, power and petroleum production; (iii) rehabilitation and expansion of the country's transport system (a particular concern of President Belaunde); and (iv) improvement of health and housing.

9. In its first months in office the Government accelerated the devaluation of the sol to an annual rate roughly in line with the differential between domestic and international inflation. In January 1981, the Central Bank revised upwards Peru's interest rate structure. Deposit and lending rates were increased by about 20 percentage points. Taking into account commissions and discounting practices, the lending rate equals roughly 75 percent p.a. and is, therefore, positive. (The expected rate of inflation for 1981 is in the 60-65 percent range).

10. The public sector deficit is being tackled through periodic upward adjustments of food and petroleum prices and of water and power rates. These price increases are expected to lead to a reduction of the overall deficit to about 2.5 percent of GDP in 1981. Improvements in Peru's tax administration should help reach this manageable level.

11. All remaining non-tariff barriers to imports were eliminated in August 1980 and tariffs have been cut to an unweighted average of 34 percent. The previous Government's export tax credit scheme has been revised to eliminate abuses and an industrial promotion law is under preparation which would simplify the structure of incentives. These measures have contributed to the strong performance of manufactured exports, which rose from $330 million in 1978 to nearly $800 million in 1980. In the petroleum sector, to slow down domestic demand the Government has increased local prices for petroleum derivatives (the price of regular gasoline is about 90 ¢ per gallon). To maintain and expand oil exploration/production efforts, which currently enable the country to produce 200,000 b/d (70,000 b/d of which is exported), the Government has taken steps to improve the investment climate. Secondary recovery--previously the exclusive preserve of the State-owned oil company--is now open to private firms. The Government has also enacted a more favorable tax credit scheme. A number of international firms, including Shell, have reacted favorably to the new climate and appear ready to invest in Peru. In the related area of power generation, the Government is gearing up to expand the country's hydropower generation capacity. Delays in preparing future hydro projects, however, will require the Government to make substantial investments in thermal plants in the early and mid-eighties.

12. Assuming a continuation of these policies and given the country's resource base, we estimate that the Peruvian economy will experience growth of about 5 percent p.a. and have a manageable balance of payments situation through the mid-eighties. International reserves (currently at about $1.3 billion) would remain at a level roughly equivalent to 3-4 months of imports and Peru's debt service ratio would hover around 30 percent. The balance of payments may, however, deteriorate in the mid-eighties if the exportable surplus of oil declines.

III. Bank Relations

13. Beginning with the preparation of the 1979 program loan, Peru and the Bank have been engaged in a close and fruitful policy dialogue. Senior Bank staff have met with President Belaunde and his closest advisors to discuss Peru's economic situation and the Bank's role in its development effort. During these meetings, Mr. Belaunde has stated his preference for financing Peru's development, to the extent possible, with the help of donors like the Bank as well as his interest in technical support from the Bank. The policy dialogue has been furthered by the recent opening of a resident mission in Peru and by an economic mission in June/July of 1980. Its findings served as the basis for an in-depth discussion with the economic team and will be published in April. The Bank has agreed to chair a Consultative Group meeting for Peru in the Spring of 1981.

14. While things could change (particularly if the economic team is replaced), there is at present broad agreement between the team and the Bank on most issues. Our dialogue has focussed, inter-alia, on the need for (i) continued regular price and exchange rate adjustments; (ii) an improvement in Peru's public investment program; (iii) restrictions on defense outlays; (iv) careful management of Peru's indebtedness, and (v) strengthening of energy planning.

15. The future Bank lending program is designed to (i) increase productive capacity, particularly in agriculture, mining and petroleum--which are the key to strengthening the balance of payments--and in industry, which can be an important source of employment generation; (ii) help meet the basic needs of the poor through health and rural/urban development projects; and (iii) help relieve serious infrastructure deficiencies, particularly in power and in transportation, where under-investment and lack of maintenance is resulting in serious deterioration of existing roads. A major aim of Bank lending would also be to strengthen public sector institutions so that they can effectively prepare and carry out investments.

16. The Bank is considering an ambitious, but achievable, lending program of $1.2 billion for FY82-86, which would provide tangible backing to the economic team. The program's level would be reviewed in a year and revised upwards if management of the economy continues to be sound. About 23 percent of the FY82-86 program would be for socially oriented projects, 39 percent for productive activities and 38 percent for infrastructure. The proposed lending program for Peru dwarfs past lending to the country which totalled slightly less than $800 million through FY80. Efforts of the Bank's Lima Office in helping to identify prospective projects and in ensuring that preparation schedules are met should assist Peru and the Bank to meet the proposed targets. A marked improvement in the disbursement of our Peru operations also suggests that the country absorptive capacity would permit the proposed lending.