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IMF Concludes Article IV Consultation with Peru

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On June 24, 1999, the Executive Board concluded the Article IV consultation with Peru and approved a three-year extended arrangement in an amount equivalent to SDR 383 million (for further details, see Press Release number 99/24).[1]

Background

During the period 1991-97, Peru made major progress in eliminating large disequilibria that beset the economy at the beginning of the decade-through economic stabilization, structural reforms, and normalization of the external debt situation, all with support from the Fund.

In 1998 economic activity weakened under the influence of the *El Niño* weather disturbance, a sharp drop in export commodity prices, and a liquidity squeeze stemming from turbulence in international financial markets. *El Niño* caused severe disruptions to output and exports, as it damaged infrastructure and led to a sharp fall in fishing and a slowdown in agriculture. A pronounced reduction in foreign lines of credit to the banking system after August 1998 led to a slowdown in credit and higher interest rates, which in turn exacerbated a drop in domestic demand and put some strain on the banking system. Real GDP growth slowed to 0.7 percent, and the fiscal position shifted from balance to a deficit of 0.5 percent of GDP, as weak economic activity restrained tax revenue. The external current account deficit increased to 6 percent of GDP, and net international reserves declined by US$1 billion. However, by end-1998 international reserves still remained at a comfortable level.

In late 1998 and early 1999, the authorities took steps to ease liquidity and, in response to the weakening of the banking system, they also broadened the coverage of deposit insurance and designed a program for channeling public sector resources through the second-tier public bank for onlending to finance bank debt restructuring. Bank liquidity eased in early 1999 but, in view of the weak outlook for the business sector, banks remained cautious in their lending.

The program for 1999 assumes a 3 percent growth in real GDP and envisages inflation during the year of 6 percent, a decline in the external current account deficit, and a moderate accumulation of net international reserves that would keep gross international reserves in the range of 11-12 months of imports of goods and services, and at around 72 percent of broad money. The growth projection for 1999 assumes that a recovery will gradually build momentum during the year, initially through a rebound of output in the primary sectors and exports, and in the second half of the year from a more broadly based recovery of economic activity and domestic demand.

Executive Board Assessment

Executive Directors welcomed the authorities' overall strong record of prudent economic management throughout this decade, which had been reflected in the impressive strides made toward the creation of conditions for sustained noninflationary growth and current account viability, as well as progress in poverty alleviation. Directors noted that, over the last 12 to 18 months, a number of external shocks, including the El Niño weather phenomenon, had adversely affected economic performance. But Directors were encouraged by, and commended the authorities on, their continued efforts to maintain macroeconomic stability and pursue structural reforms, even in the face of the deteriorating external environment. Nevertheless, they observed that the recent events had highlighted the economy's continuing vulnerability to external shocks, and urged the authorities to press ahead with planned measures to consolidate the hard-won gains in policy credibility and to further strengthen the economy.

Directors endorsed the fiscal program for 1999, which provided for a modest decrease in the primary surplus. They generally agreed that it struck an appropriate balance between the need to adapt fiscal policy at a time of sluggish economic activity and the need for further fiscal consolidation over the medium term, especially in view of the recent widening of the external current account deficit. Directors agreed that monetary policy should continue to be geared to reducing inflation.

Directors acknowledged the authorities' preference for limiting the size of the government, and welcomed the emphasis being placed on more efficient, higher-quality fiscal expenditure, as well as on further improvements in tax administration. Directors supported a shift of fiscal expenditure-including by drawing on the recent "peace dividend"-toward the social sectors. Pointing to the relatively low revenue ratio, several Directors underscored the importance of examining the various options for increasing the yield and efficiency of the tax system, as a means of mobilizing resources for priority expenditures. A strengthening of the revenue base, with the support of Fund technical assistance, was also essential to enable the budget to better absorb contingent liabilities of the government vis-à-vis the banking system.

Directors endorsed the authorities' two-pronged approach to poverty alleviation that stressed both macroeconomic policies that foster strong and sustainable growth, and targeted social programs aimed at helping lift individuals and families out of poverty. Directors noted the importance for Peru's longer-term growth prospects and for the wider distribution of growth benefits of boosting investment in human capital through education programs and the provision of adequate primary health care. A number of Directors expressed concern about the performance of employment over the last several years, and suggested that labor market issues figure more prominently in future consultations.

Several Directors observed that there had been a deterioration in banks' performance since early 1998, and stressed the importance of closely monitoring the soundness of banks. In this regard, they cautioned that the quality of assets and risk management skills of banks needed to be strengthened substantially, and provisioning for bad loans significantly increased. Directors therefore welcomed the recently approved reform of banking legislation, which in their view should improve the ability of the bank supervisory agency (SBS) to address bank problems at an early stage, and give a better chance of resolving them before a state of insolvency is reached. Several Directors expressed concern that inadequate legal protection for the staff of the SBS could diminish the effectiveness of the planned financial sector reforms. Directors encouraged the authorities to press ahead with reforms of the capital market, which would also be necessary for pension reform.

Directors welcomed the authorities' intention to give renewed emphasis to the government's structural reform agenda. They recommended accelerating the process of privatization, so as to complete without undue delay those actions that were still pending. A few Directors emphasized the importance of assessing the size of the government's contingent liabilities, including in the social security sector, and recommended that plans for meeting them be drawn up.

Directors observed that the flexible exchange rate system had helped the economy adjust to external shocks, and supported the authorities' intention to continue with such asystem. They welcomed the authorities' commitment to keeping the trade system transparent and open, and their intention to make further progress with trade liberalization.

Directors welcomed the authorities' commitment to the timely provision of economic statistics that is indicated by their subscription to the Special Data Dissemination Standard.

Directors also commended the authorities for their decision to discuss publicly the memorandum of economic and financial policies before formalizing it with the Fund in order to broaden ownership and acceptance for the program.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Peru: Selected Economic Indicators

	1995	1996	1997	Prel. 1998	Proj. 1999
	(Annual percentage change, unless otherwise indicated)				
	Real economy				
Real GDP	7.3	2.5	7.2	0.7	3.0-4.0
Inflation[1]	10.2	11.8	6.5	6.0	5.0-6.0
Real effective exchange rate (depreciation -)[1 2]	-3.3	0.9	7.4	-11.1	...
Money and credit					
Broad money[3]	24.2	28.0	15.0	0.4	7.3
Credit to private sector[3]	37.6	35.6	27.4	8.4	10.8
	(In percent of GDP, unless otherwise indicated)				
Savings and investment					
Gross domestic investment	24.4	23.3	24.5	24.6	22.9
National savings	17.1	17.4	19.2	18.5	17.9
External savings	7.3	5.9	5.2	6.0	5.1
Balance of payments					
Current account	-7.3	-5.9	-5.2	-6.0	-5.0
Capital and financial account	8.9	9.0	7.8	4.3	5.7
Gross official reserves (in months of imports of goods and services)[1]	9.2	11.2	12.0	11.0	11.8

Gross official reserves (in percent of broad money)[1]	74.7	75.6	78.2	73.4	72.3
Public finances					
Combined public sector primary balance[4]	0.4	1.3	1.7	1.3	0.9
Combined public sector overall balance[4]	-2.8	-1.0	0.0	-0.5	-1.2
Public sector medium- and long-term external debt	45.1	42.8	30.2	32.3	37.4

Sources: Central Reserve Bank of Peru; and IMF staff estimates.

[1]At end of period.
[2]Based on Information Notice System.
[3]Flows in foreign currency are valued at program exchange rate.
[4]Revenue excludes privatization receipts.

[1]Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.