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Peru at the Brink of Economic Collapse: Current Problems and Policy Options

by Uwe Corsepius

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für

CONTENTS

- Since 1988 Peru has plunged into a deep economic crisis which has already caused severe social strife and threatens to uproot the young democratic system. The present government seems to be unable to arrest the precipitous decline of per capita income of the Peruvian population. Therefore, the result of the next presidential elections in early 1990 will hinge on the credibility of the candidates' economic reform programmes.
- The Peruvian economy is suffering from large government deficits, a declining international competitiveness, an outdated and underutilised capital stock, and substantial arrears on the high debt burden. These structural deficiencies have resulted in an economic quandary which is characterized by hyperinflation, a drain of foreign exchange reserves, a dramatic decline of output, and mass unemployment.
- The economic plight of Peru can largely be attributed to a long history of policy failures. Adverse external developments such as low commodity prices or high interest rates were of minor importance. A comprehensive and consistent policy reform programme accompanied by foreign financial support would go a long way in bringing Peru back to a sustained and socially acceptable growth path.
- Priority areas for policy reform are to stop hyperinflation by public expenditure cuts and a tax reform, to improve domestic resource mobilisation by dismantling financial sector regulations, and to regain international competitiveness by exchange rate adjustment and lower import protection.
- Successful adjustment of the Peruvian economy will require an internationally-agreed temporary suspension of debt service payments and a supply of fresh funds to finance restructuring. Domestically, social hardship caused by adjustment has to be eased by targeted food subsidies to the poor.

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I. Introduction

While Peru is preparing for the presidential elections in mid-1990, it faces the second economic crisis within six years. In 1988, real gross domestic product (GDP) fell by 9 percent, outstanding external debt amounted to US\$ 16.3 billion (Table 1) and the economy was on the road to hyperinflation; in June 1989, the annualised inflation rate reached 5835 per cent. The economic recession has impoverished the Peruvian people and a substantial part of the population is already starving. Per capita income in real terms has declined by roughly 15 per cent since 1980. Furthermore, declining real incomes and increasing unemployment have caused social unrest and have prepared the ground for the growing terrorism. In view of this situation, the survival of Peru's democratic system heavily depends on whether the presidential candidates can offer a credible strategy to overcome the mounting crisis. For designing future policy reforms a critical assessment of current problems is necessary. It is the aim of this paper to provide such an analysis. The basic hypothesis is that the economic malaise in Peru can not be attributed to adverse international developments, such as low commodity prices or high interest rates, but rather results from a long history of policy failures.

In order to derive useful policy conclusions the following analysis starts from the most pressing problems. In Chapter II, an overview of economic development in the 1980s is followed by an evaluation of the inflationary process. Subsequently, possible measures to improve Peru's domestic resource mobilisation are discussed. Chapter III contains an analysis of the external account. The causes of the persistent trade deficit are investigated and alternative strategies for the external debt problem are evaluated. Chapter IV deals with sectoral issues. An attempt is made to confirm the hypothesis that government policies hinder the functioning of the labour market and discriminate against the agricultural sector. The final chapter summarises the main findings and provides an agenda for medium and long-term policy reforms required to reactivate economic and social development in Peru.

This is a revised version of a paper written for a seminar on economic policy in Lima, Peru, 29-31 May 1989. Financial support from the Konrad-Adenauer-Stiftung and helpful comments by Ulrich Hiemenz are gratefully acknowledged.

Table 1 - Main Economic Indicators for Peru, 1980-88

	1980	1981	1982	1983	1984	1985	1986	1987(a)	1988(a)
	Indices (1980 = 100)								
Basic economic indicators									
GDP at market prices	100.0	104.4	104.7	92.4	96.8	99.0	107.8	115.7	105.3
Population (mill. of inhabitants)	17.3	17.8	18.2	18.7	19.2	19.7	20.2	20.7	21.3
Per capita GDP	100.0	101.7	99.4	85.4	87.2	86.9	92.3	96.6	85.7
	Percentage change								
Short-term economic indicators									
GDP	4.5	4.4	0.4	-11.7	4.8	2.3	8.9	7.3	-9.0
Per capita GDP	1.8	1.7	-2.3	-14.1	2.1	-0.3	6.2	4.7	-11.3
Rate of unemployment(b)(c)	10.9	10.4	10.6	9.2	10.9	11.8	8.2	12.5	20.6
Consumer prices									
December-December	60.8	72.7	72.9	125.1	111.5	158.3	62.9	114.5	1722.3
Variation between annual averages	59.2	75.4	64.5	111.1	110.2	163.4	77.9	85.8	666.9
Public sector deficit/GDP (b)(d)	3.9	6.7	7.3	9.8	6.1	2.4	4.9	6.5	4.9
	Millions of dollars								
External Sector									
Trade balance (goods and services)	661.0	-869.0	-743.0	39.0	787.0	995.0	-307.0	-858.0	-454.0
Current account balance	-247.0	-1889.0	-1776.0	-1091.0	-379.0	-19.0	-1113.0	-1627.0	-1046.0
Variation in international reserves	607.0	-618.0	-57.0	10.0	317.0	83.0	-397.0	-785.0	-428.0
Total external debt	9595.0	9606.0	11465.0	12445.0	13338.0	13721.0	14477.0	15406.0	16332.0
(a) Preliminary figures. - (b) Percentage. - (c) Non-agricultural sector only. - (d) Consolidated non-financial public sector.									

Source: CEPAL [var. iss.; unpubl. data].

II. Domestic Developments

1. Performance and Policy Background

Peru covers an area of 1.23 million square kilometres and its population was estimated to be 21.3 million in 1988. In comparison, the Federal Republic of Germany has only one fifth of Peru's size but roughly three times as many people. Nevertheless, in 1985, 68 per cent of all Peruvians lived in urban areas while the average urbanisation ratio for all middle-income developing countries¹ was only 48 per cent. The strong annual population growth rate of 2.3 per cent was, however, not matched by a similar performance of GDP. In 1988, GDP per capita was roughly 1000 US-dollars, about 86 per cent of what it had been in 1980 (Table 1). The decline resulted from two deep economic recessions in 1983 and 1988, in which GDP dropped by 11.7 and 9.0 per cent, respectively. Between both recessions, economic performance had recovered and due to a consumption boom GDP expanded by 8.9 and 7.3 per cent in 1986 and 1987.

The fluctuations in the performance of the Peruvian economy reflect erratic changes and inconsistencies in macro-economic policy. The first democratically elected government under President Belaúnde started its five-year term in 1980, partially reversing the previous import substitution strategy. Some trade barriers were removed and the financial sector was liberalised, although incompletely. Since the currency was overvalued, exports stagnated while imports soared. At the same time, efforts to control the public sector deficit proved to be unsuccessful as infrastructure investments and arms purchases abroad were increased. The resource gap was financed by foreign capital inflows and government borrowing from the Central Bank. Increasing rates of inflation and crowding out of private borrowers were the consequences.

Following the 1983 recession, the Belaúnde government undertook efforts to reactivate the economy. Imports were restricted again and the exchange rate was actively devalued. Public finance improved since taxes and tariffs of state enterprises were adjusted upwards and foreign debt service payments were partially suspended. While these measures corrected the external and internal imbalances, economic growth remained low and the inflation rate could not be brought down. In

¹ According to the definition of the World Bank.

this situation the APRA government¹ with President Alan García took up its responsibilities in July 1985. It applied the so-called heterodox model to reactivate the Peruvian economy. Real wage increases to expand domestic demand were coupled with reductions in indirect taxes and real interest rates to encourage the business sector. Balance of payments problems were thought to be solved by introducing a multiple exchange rate system and limiting debt service payments to 10 per cent of Peru's exports. These measures were complemented by a temporary price and exchange rate freeze. While this set of policies stimulated economic growth in the short run, it also led to severe imbalances: the public sector deficit widened intensifying inflationary pressures and the current account deteriorated. By the end of 1987, the situation had become unsustainable so that the government allowed drastic price increases and devaluations. Subsidies were curtailed and exchange rates unified. However, the policy changes could not prevent Peru from running into a deep economic recession. The starting hyperinflation and the scarcity of domestic resources seriously narrowed growth prospects. Therefore, the causes of the inflationary process and issues in domestic resource mobilisation deserve special attention.

2. The Inflation Trap

Rates of inflation as high as in Peru are a major obstacle to a stable economic development. They affect economic growth negatively in several ways. Empirical evidence documents that high rates of inflation are unstable [cf. Logue, Willet, 1976; Blejer, 1979; Corsepius, 1988]. The volatility of inflation rates, however, causes uncertainty for holders of financial and real assets:

- In the absence of a fully indexed financial sector unstable inflation rates increase the uncertainty with respect to the real return of financial assets. Hence, saving in real assets such as precious metals and durable consumer goods is favoured. Financial intermediation is reduced and domestic resource mobilisation weakened. This weighs heavily in highly indebted developing countries since they have to finance their growth mostly internally.
- Volatile inflation rates lower real capital formation as investors will only realise highly profitable short-term projects. As regards investments with long pay-off periods, firms will demand a substantial risk premium which makes these projects

¹ Alianza Popular Revolucionaria Americana.

unprofitable. Empirical evidence for Peru confirms the negative relationship between real capital formation and inflation rates even for inflation rates substantially below those in 1987-88 [Corsepius, 1988].

Other negative effects of high inflation rates include a redistribution of wealth in favour of borrowers and the rich who tend to have better opportunities to hedge against inflation losses than the poor. Furthermore, in developing countries the real tax revenue of the government is inversely related to the inflation rate due to time lags in tax collection (Tanzi-Oliviera effect).

Peru's record inflation rate of 1988 is not an unprecedented inflationary attack but rather the preliminary peak of a long inflation experience. Consecutive policy failures intensified the inflationary process so that Peru now faces hyperinflation. When the Belaúnde government came into office in 1980 the annual inflation rate was already 61 per cent (Table 1). According to this government the inflation was of demand pull origin [EIU, 1988]. The main reasons were thought to be the monetisation of reserves having been accumulated in the commodity boom 1979-80 and the fiscal deficit. Consequently, subsidies were curtailed and a half-hearted import liberalisation implemented. The latter was intended to reduce prices by increasing competitive pressure. In addition, a restrictive monetary policy was followed to reduce demand further.

However, the government failed to realise that the way of financing its deficit is more important than its absolute size. Thus, inflation may result from deficit financing by Central Bank credit which increases the money supply. In the case of Peru, the deficit financing by the inflation tax led even to increasing rates of inflation as it was clearly incompatible with the growing dollarisation of the economy: the existence of financial assets denominated in US-dollar with yields superior to those in national currency induced savers to shift into dollar assets. In 1984, deposits in foreign currency accounted already for 50 per cent of broad money (M2) (Table 2). This reduced the quantity of money the government could tax through seignorage. For a given deficit more inflationary finance and more rapid inflation was necessary. This in turn raised the rate of devaluation required to maintain the real exchange rate, increasing the expected return of dollar assets in national currency. The subsequent shift into dollar assets reinitialised the entire process [Hanson, Neal, 1985].

In addition to the policy inconsistencies, the public sector deficit did not shrink as envisaged and when Peru was hit by adverse weather conditions in 1983, the inflation rate reached 125 per cent. Thereafter, the upward adjustments of prices and tariffs of state enterprises and the active exchange rate devaluation

Table 2 - Monetary Indicators, 1980-88 (per cent of GDP)

	1980	1981	1982	1983	1984	1985	1986	1987 (a)	1988 (a)
Monetary Base(b)	10.8	9.3	6.5	6.9	6.0	11.1	9.9	9.9	8.2
Money (M1)	10.4	9.4	7.7	7.9	7.7	7.5	8.2	9.5	8.8
Quasimoney	16.7	16.3	19.3	20.7	24.8	13.9	10.4	9.3	10.5
national currency	9.0	8.5	8.8	8.1	8.9	7.4	8.2	7.4	4.3
foreign currency	7.7	7.8	10.5	12.6	16.0	6.5	2.1	1.9	6.2
Money plus									
quasimoney	27.1	25.8	27.0	28.6	32.6	21.3	18.5	18.8	19.3
Domestic credit	20.7	23.5	23.7	26.0	28.3	15.1	16.8	19.8	25.4
to the public sector	10.2	9.1	6.7	8.9	8.8	2.2	3.5	6.8	4.9
to the private sector	18.8	18.6	21.9	23.8	27.3	16.6	15.3	14.9	13.1
other accounts	-8.3	-4.2	-4.9	-6.8	-7.8	-3.7	-2.1	-1.9	7.4
Coefficient of dollarisation(c)	46	48	54	61	64	47	20	20	59

(a) Preliminary figures. - (b) Known as primary issue in Peru's monetary accounts. - (c) Share of quasimoney in foreign currency in total quasimoney.

Source: BCRP [1985]; CEPAL [var. iss.; unpubl. data]; own calculations.

improved the external account and lowered the public sector deficit but resulted in an annualised inflation rate of almost 200 per cent in mid-1985.

The new APRA government of Alan García took a different view of the inflationary process and attributed it to cost-push factors. The government changed several times its strategy to fight inflation. Initially, in the period July 1985 to December 1986 most prices in the Peruvian economy were frozen: the two benchmark exchange rates after the July devaluation, domestic prices and tariffs of state enterprises, and all industrial products and most services.¹ In addition, saving and lending interest rates were lowered to one third of their early 1985 level and then maintained till the end of 1986 (Table 3). The convertibility of foreign currency deposits was suspended to stop the dollarisation of the financial sector. These measures were complemented by a restrictive monetary policy. Because of high reserve requirements for commercial banks broad money grew considerably less than the monetary base.

¹ The functioning of the price freezes relied mainly on the credibility of the incoming government and the voluntary adherence of the people to the limits, since at least initially the government was even lacking the administrative capacity of monitoring prices.

Table 3 - Selected Interest Rates of the Commercial Banking System, 1980-88

	Loans (a)			Deposits (nominal)				Inflation rate	
	nominal (b)	effective (c)		90-180 days		720 days and more			in foreign currency
	average	average	end of period	average	end of period	average	end of period		
1980	32.5	73.6		33.0		-		45.2	60.8
1981	48.3	86.7		51.4		-		66.9	72.7
1982	47.5	69.6		55.0		-		140.5	72.9
1983	51.7	78.4		56.7		-		139.5	125.1
1984	60.3	97.3		60.3		-		136.5	111.5
1985	-	114.5		56.8		57.9		706.0	158.3
1986	-	40.0		25.5		39.5		7.2	62.9
1987									
I	-	40.0		25.5		39.5		20.0	67.4
II	-	40.0		25.5		39.5		42.9	77.6
III	-	32.0		23.0		32.0		116.7	93.5
IV	-	32.0		23.0		32.0		171.6	114.5
1988									
I	-	35.8	55.0	25.3	36.5	34.4	46.5	253.3	129.8
II	-	65.8	120.0	42.7	73.5	53.1	86.0	225.4	229.7
III	-	165.0	255.0	89.5	121.5	101.3	132.0	301.0	816.8
IV	-	433.9	791.6	326.2	210.0	388.6	228.0	704.1	1722.3
					(d)		(d)		

(a) Up to 360 days. - (b) Since August 1985 the Central Bank publishes effective rates only. The interest rate is charged for credits up to one year. - (c) Includes effects of capitalisation. - (d) Annualised rates, based on monthly ceilings. Daily capitalisation yields for 90-180 days: 735.6 per cent; for 720 days or more: 901.8 per cent.

Source: BCRP [var. iss.; unpubl. data]; CEPAL [unpubl. data].

The results of this strategy were economic reactivation and disinflation. In 1986, the annual inflation rate dropped to 63 per cent after 158 per cent in 1985 and real GDP expanded by 9 per cent. The GDP growth was mainly a consumption boom; firms used idle capacity while investment in plant and equipment remained sluggish. Actually, GDP grew mostly in the second half of 1986 when monetary and fiscal policies had become expansionary. Adverse effects on the inflationary process remained small as García inherited a relatively balanced public sector budget and a high level of international reserves.

In 1987 and 1988, however, the inflationary financing of the public sector deficit fuelled inflation which was suppressed temporarily. In 1987, the government pursued a more flexible price strategy and most prices as well as the multiple

exchange rate system were periodically adjusted. At the same time the level of government expenditures was kept constant while current revenue declined due to tax cuts and an erosion of the tax base (Table A1). The Central Bank provided inflationary finance for the widening public deficit. Furthermore, the Banco Central de Reserva del Perú expanded the money supply to cover its exchange and interest rate subsidies.¹ The inflationary process was further fuelled by real wage increases, so that the annual inflation rate reached 115 per cent. Finally, in the first eight months of 1988 the government tried to stop the economic decline by a series of ad-hoc measures: periodic price increases at first, a 120-day price freeze later on, tax increases and expenditure cuts. However, the measures were neither taken in a co-ordinated fashion nor were the deficit reduction and the price increases sufficient to correct the underlying imbalances. Thus, in September the government abolished price controls and devalued the inti substantially. This resulted in a monthly inflation rate of 119 per cent in September alone, bringing Peru to the beginning of hyperinflation. In addition, the measures could not prevent Peru from running into a deep recession: real GDP contracted by 9 per cent.

In view of the negative effects of high inflation rates and the critical situation in Peru a stabilisation of the inflationary process is absolutely essential for economic recovery. As the Peruvian experience reveals, this implies to reduce the public sector's financing needs drastically and/or switch to non-inflationary financing of the deficit. The former calls for revenue raising measures and expenditure cuts, while the latter requires an improvement in the domestic resource mobilisation as new foreign funds are not available. These issues are discussed in the next chapter. Nevertheless, further measures are necessary to reduce inflation rates in Peru. In particular, widespread backward-looking indexation of wages needs to be modified in order to avoid current inflation rates from being automatically translated into future inflation rates.

3. Domestic Resource Mobilisation

Any analysis of domestic resource mobilisation in Peru needs to focus on two different issues. Firstly, it has to be evaluated whether the financial sector

¹ The Central Bank payed commercial banks a higher interest rate on reserves than it charged the government on debt.

efficiently mobilises savings and finances those investments, which are most productive from an economic perspective. Secondly, domestic resource mobilisation can be improved if public expenditures are brought into line with public revenue, thereby reducing the deficit which is to be financed by the Central Bank.

a. The Financial Sector

Although a strong causal relationship between economic growth and financial development is difficult to prove empirically,¹ there is a strong theoretical reasoning that differences in economic growth can be attributed to the size, structure, and development of the financial sector in the countries in question. According to the concept of financial deepening [Shaw, 1973] an expansion of the financial sector can reduce the transaction costs within the economy by equating maturities of savings with those of credits, by exploiting economies of scale in gathering information and by risk diversification. However, in order to achieve these benefits of financial intermediation, financial institutions have to act as efficient intermediaries. The performance of financial intermediaries can be evaluated from three perspectives. Firstly, financial intermediaries must offer instruments to savers which satisfy the various needs of depositors with respect to risk, return and maturity. Secondly, efficient intermediation requires that financial institutions provide funds for those investments which are most profitable for both the banks and from an economic perspective. Thirdly, the resources involved in the process of intermediation between savers and investors have to be minimised.

Since financial institutions in developing countries mainly rely on savings and time deposits in providing long-term credits, the ratio of quasimoney to GDP is used to assess financial deepening in Peru. Judging from this indicator, Peru's financial sector expanded markedly between 1980 and 1984: the ratio of quasimoney to GDP grew from 16.7 to 24.8 per cent (Table 2). The growth of foreign currency deposits was particularly strong, their share in total quasimoney rose from 46 to 64 per cent in the 1980-84 period. Nevertheless, these figures over-represent the development of Peru's financial sector. Effective reserve requirements for foreign currency deposits were at average 60 per cent and thus much higher than for deposits in national currency. The shift in favour of dollar

¹ For a discussion of this issue, see Fischer [1982, pp. 9-14; 117-124] and the literature cited therein.

deposits increased the loanable funds with which banks could finance investments by much less than the growth in quasimoney seemed to indicate.

Under García, the financial sector contracted significantly. In 1987, the dollarisation was reduced to 20 per cent and the ratio of quasimoney to GDP dropped to 10 per cent. In 1988, a further disintermediation could only be avoided because foreign currency deposits jumped up again.

These developments may be explained by variations in the Peruvian interest rate policy.¹ Both governments used ceilings to regulate nominal interest rates. These allowed real ex-post returns on deposits in national currency only to be negative. In the Belaúnde period, however, foreign currency deposits with positive attractive real yields were available to hedge against inflation losses. The García government suspended the convertibility of foreign currency deposits and held the exchange rate constant. Consequently, foreign currency deposits lost their attraction. Instead, savers hoarded dollars outside the financial sector since the changes in the black market exchange rate compensated them for the inflation losses.² Hoarded dollars are, however, not available for investment finance so that financial disintermediation took place. Only in 1988, the exchange rate was more frequently devalued so that the return to foreign currency deposits increased again (Table A2).

Judging from the other two performance criteria, intermediation costs and efficient allocation, the Peruvian financial sector also faces major problems. Efficient intermediation involves minimising transaction costs in transferring funds from depositors to borrowers. This implies that operating costs are kept low and profits in the banking industry do not exceed levels in competitive situations. According to available data for the 1978-80 period, Peruvian banks were relatively inefficient from a macro-economic perspective (Table 4). Operating costs and profits were much higher than in industrialised countries or South Korea, Malaysia and Thailand. Furthermore, figures for 1985 indicate that the performance became worse as compared to the early eighties. While the oligopolistic structure of the banking industry may have contributed to costly intermediation in Peru, the temporary nationalisation of the banking industry under García could not solve the problem either. The extensive branch systems of banks, overstaffing and non-

¹ The positive relationship between the level of interest rates and the volume of financial savings is well-documented empirically. For an overview, see Corsepis, Fischer [1987].

² Significant amounts of US-dollars are available in Peru because of illegal drug exports which are estimated to be worth some 1 billion US-dollars.

Table 4 - Indicators for the Costs of Financial Intermediation in Selected Industrial and Developing Countries, 1978-80 (percentage share of total assets)

	Concentration ratio(a)	Gross earnings margins(b)	Operating costs	Profits before tax
Colombia(c)	0.52	6.0	4.0	1.3
Germany, Fed. Rep. of	n.a.	2.6	2.1	0.5
Korea, Rep. of(d)	n.a.	4.8	2.0	1.1
Malaysia(e)	0.42(f)	3.6	1.3	1.9
Peru(e) 1980	0.51	5.7	3.7	1.1
1985	0.56	12.6	6.0	1.7
Spain	n.a.	4.9	3.2	0.8
Thailand(e)	0.59	4.2	2.4	1.5
Turkey(c)	0.50	7.6	6.8	0.8
United States(g)	n.a.	3.9	2.6	0.8(h)

(a) Share of the largest three banks in the assets of all banks in 1982/83. -
 (b) Interest received and other income (net) less interest paid. - (c) Domestic commercial banks. - (d) Nationwide commercial banks. - (e) Commercial banks. -
 (f) Deposits instead of assets used. - (g) FDIC insured banks. - (h) 1977-79.
 n.a. = not available.

Source: Rezende Rocha [1986]; Superintendencia de Banca y Seguros [var. iss.]; own calculations.

price competition of banks which are subject to interest rate controls are major impediments to efficient intermediation.

As concerns the allocation of the mobilised funds indirect evidence points to severe bottlenecks. The existence of a flourishing informal financial sector indicates credit rationing in the formal financial sector. Obviously, many firms do not have access to subsidised credits from commercial banks and have to pay higher rates in the informal sector.¹ These differences in borrowing costs can cause inefficiencies as less productive firms may crowd out more productive ones because of lower interest rate payments. In addition, credit restrictions were imposed in 1987. Accordingly, banks have to relend certain shares of their deposits to the region where they raised them. Furthermore, depending on the type of bank a varying share of the funds has to be lent to agriculture. The restrictions limit the flow of mobilised savings to the most productive investment opportunities.

¹ Interest rates are much higher in the informal than in the formal financial sector. For an overview, see Thorne et al. [1988].

In view of the importance of an efficient financial sector for economic development a major reform of the financial sector in Peru is warranted.¹ While lifting interest rate ceilings and reducing inflation rates are necessary measures to improve the efficiency, they do not suffice. In particular, credit restrictions have to be abolished and the integration of the informal and formal financial sector has to be fostered. At the same time, the supervisory authorities are to be strengthened to ensure solid bank management and competitive behaviour in the industry.

b. Public Finance

The inflationary financing of the public sector deficit has been identified as main determinant of the inflation process in Peru. A detailed analysis of the Peruvian public sector is beyond the scope of this paper. However, some salient features indicating the major problems on the revenue and expenditure side can be presented:

- While current expenditures of the non-financial public sector declined from 51 to 40 per cent of GDP in the 1980-87 period (10 per cent in 1988), the real expenses for remunerations remained relatively stable around 11 per cent of GDP (Table 5). Hence, in 1987, wages and salaries already accounted for 31 per cent of current expenditures.
- In the second half of the eighties, Central Bank losses due to subsidisation of exchange and interest rates became a major source of the monetary expansion.
- In the late eighties, the policies of low prices and tariffs of public enterprises eroded their income. In spite of reduced capital expenditures their financing needs grew (Table 5).
- Tax cuts and García's policies towards foreign trade led to a significant reduction in tax revenue. The ratio of the revenues of the central government to GDP fell from 21 per cent in 1980 to 7 per cent in 1988 (Table A1).
- In comparison to other developing countries the level of tax revenues in Peru is very low. Especially, revenues from income and foreign trade taxes are below average (Table 6).

Reducing the wage bill could lower current public expenditures significantly in Peru. This implies reversing García's high-wage policy to speed up consumption. A wage freeze may be a first step. Nevertheless, in order to achieve a substantial reduction in expenditures a structural reform of government pay and em-

¹ Cf. Corsepius [1989] for a detailed analysis of the Peruvian capital market and possible reforms.

Table 5 - Operations of the Consolidated Non-Financial Public Sector, 1980-88 (percentage of GDP)

	1980	1981	1982	1983	1984	1985	1986	1987	1988 (a)
Current revenues	54.3	48.2	49.6	53.3	48.1	53.8	41.3	36.3	9.1
Taxes	19.1	16.3	16.0	12.9	13.7	16.0	11.3	8.6	n.a.
Current expenditures	51.3	47.7	49.7	56.0	47.0	49.9	41.3	39.7	9.8
Remunerations	9.8	10.8	11.7	11.7	11.0	10.1	8.5	8.7	n.a.
Current account balance	3.0	0.6	-0.1	-2.7	1.1	3.9	0.1	-3.4	-0.7
Capital income	0.6	0.9	1.4	1.0	0.8	0.6	0.4	0.4	0.0
Capital expenditures	8.4	9.8	10.7	10.5	9.5	7.5	6.8	6.1	1.7
Overall deficit	-4.7	-8.4	-9.3	-12.1	-7.6	-3.0	-6.3	-9.1	-5.8
Memo:									
Deficit of public enterprises	n.a.	3.4	5.1	2.2	1.9	0.5	1.8	1.1	2.8

(a) Preliminary figures.

Source: BCRP [var. iss.; unpubl. data].

Table 6 - Tax Revenues in Peru and Other Selected Developing Countries (percentage of GDP)

	Other countries(a)	Peru	
	1981	1980	1987
Income taxes	5.8	6.0	1.6
Wealth and property taxes	0.5	0.7	0.4
Domestic taxes on production and consumption	4.7	7.6	3.9
Foreign trade taxes	5.3	5.7	1.8
Other	0.7	0.6	0.2
Total	17.0	18.9	7.3

(a) Average for countries with an average per capita income of US\$ 1195.

Source: Table A1; Tanzi [1987].

ployment policies is necessary, which also considers the possibility of cutting the work force in the public sector. The argument that high wages in the public sector are necessary to support the poor is not valid. The recent Peru Living

Standard Survey shows that the poor are mostly self-employed and do not profit from wage increases in the public sector [Glewwe, 1987]. The need for inflationary finance will also be reduced if multiple exchange rates are unified and adjusted. Subsidies being provided through preferential exchange rates would disappear and automatically lower the monetary expansion of the Central Bank.

With respect to public sector revenues a comprehensive tax reform seems most promising. The current system of unco-ordinated taxes and selective exemptions has to be simplified. This would be more in line with the administrative capacity of the tax office, so that coverage and collection could be improved. In particular, a reform of income taxes provides scope for raising revenues. However, as long as the huge informal sector cannot be integrated into the formal economy, revenue gains from the tax reform will remain insufficient to finance development expenditures.¹ Finally, upward adjustments of the prices and tariffs of public enterprises could diminish financing requirements and increase efficiency. Charging less than marginal cost may lead to excess demand and the need for additional finance. An efficient allocation of resources cannot be assured. The scope for raising prices and tariffs of public sector enterprises in Peru is substantial. In 1988, real prices for public goods and services accounted on average only for 40 per cent of their 1985 levels, due to price freezes and selective adjustments implemented by the APRA government.

III. The External Sector

The development of the external accounts of Peru is a major source of concern. Peru has experienced a deterioration of the balance of payments in the last three years which points to the necessity of structural reforms for economic reactivation:

- In 1988, the trade balance showed a substantial deficit for the third consecutive year (Table 1).
- External debt obligations increased to US\$ 16.3 billion or 613 per cent of exports and arrears had amounted to US\$ 9.4 billion.
- The Central Bank ran out of international reserves.

In order to formulate policies to overcome the crisis, major problems with respect to international trade and foreign finance are analysed next in separate sections.

¹ According to de Soto [1987], the informal sector accounted for 39 per cent of the GDP as registered in the national accounts.

1. International Trade

In the 1980s, changes in Peru's trade balance have not revealed a stable development but rather a sequence of ups and downs. Due to high prices of its traditional exports such as minerals and petroleum in 1980, exports exceeded imports by US\$ 661 million (Table 1). However, in 1981, when prices and volume of exports declined while imports continued to expand (Table 7) the trade balance turned into deficit. It remained negative in spite of increasing exports in 1982. Only in 1983, when imports fell more than exports a small trade surplus was achieved. Similarly in 1984 and 1985, the trade surplus resulted mainly from the contraction of imports. Finally, in 1986, the situation was reversed again as imports started to expand vigorously.

The reasons for these fluctuations and the poor performance of exports can mostly be found in Peruvian trade policies. To a lesser extent, international price changes and domestic production difficulties are relevant too. Among the policies affecting Peruvian trade, exchange rate management figures prominently. Since Peru experienced inflation rates well above those of its major trading partners in the 1980-88 period, devaluations were necessary to keep the real effective exchange rate constant. During most of the years the government devalued the sol (since 1985 the inti), though not sufficiently, thus causing a real appreciation of its currency (Table 7). Hence, Peruvian exports became more expensive for foreign buyers while foreign goods could be imported cheaper. The devaluations of 1985 brought only a temporary correction of the real exchange rate. As a result of García's policy to freeze nominal exchange rates, the real exchange rate appreciated again in 1986 to levels similar to those in 1982/83.

More recently, in late 1986, the introduction of multiple exchange rates further distorted international trade (Table A2). In order to reform the economy according to national priorities and to lower the price of important imports, traditional exports were given a less favourable exchange rate than manufactured exports and priority imports. Consequently, important exporting activities were discouraged and imports soared. Besides, multiple exchange rates distorted the domestic price system by implicit subsidies and penalties. Inefficient resource allocation was likely to result. Furthermore, inconsistencies between tariffs, exchange rates and export incentives were difficult to avoid. Thus, production and export decisions were negatively affected by differing price signals.

The exchange rate management influenced international trade also by increasing uncertainty for exporters. As Peruvian exchange rate policies were changed

Table 7 - Main Indicators of Foreign Trade in Goods, 1980-87

	1980	1981	1982	1983	1984	1985	1986	1987(a)
	Growth rates							
Exports (fob)								
value	12.2	-17.0	1.3	-8.4	4.3	-5.4	-15.7	3.9
volume	-9.5	-9.8	17.3	-20.8	16.2	-3.8	-2.0	-3.1
unit value	24.1	-8.0	-13.6	15.6	-10.2	-1.7	-14.1	7.2
Imports								
value	58.4	23.0	-2.1	-26.8	-21.4	-15.5	38.9	22.1
volume	38.6	18.8	2.5	-24.3	-14.8	-9.7	40.7	19.0
unit value	14.3	3.6	-4.5	-3.4	-7.7	-6.4	-1.2	2.6
Terms of trade (fob/cif)	9.1	-11.5	-10.0	19.2	-4.0	5.0	-13.0	4.3
	Percentages							
Composition of exports								
traditional	78.7	78.7	76.9	81.6	76.9	76.0	74.5	72.5
mining	44.9	43.8	38.2	50.0	41.3	39.0	40.9	44.2
non-traditional	21.3	21.3	23.1	18.4	23.1	24.0	25.5	27.5
Composition of imports								
consumer goods	12.5	15.9	13.3	12.8	11.2	6.2	14.6	13.2
intermediate goods	37.9	36.2	34.7	37.7	44.3	46.6	47.8	47.3
other	49.6	47.9	52.0	49.5	44.5	46.8	37.6	39.5
	Indices (1980 = 100)							
Real effective exchange rate(b)								
exports(c)								
A	100	85.5	89.2	92.9	89.3	102.6	90.5	91.7
B	100	85.8	85.6	94.0	95.2	113.3	92.2	78.9
imports(c)								
A	100	83.8	87.1	89.9	86.8	99.4	87.9	83.7
B	100	84.1	83.5	90.9	92.5	109.7	89.4	72.2
<p>(a) Preliminary figures. - (b) Average real exchange rate indices for the sol (inti) vis-à-vis the currencies of Peru's main trading partners, weighted according to the relative size of its bilateral exports or imports. Since 1988 these weightings correspond to the average for the 1982-1985 period. Preference was given to wholesale prices in the calculations. For the methodology and sources used, see the technical appendix of CEPAL [1981]. - (c) A: The sub-index for domestic products of the wholesale price index was adopted. B: The consumer price index was adopted.</p>								

Source: CEPAL [1988].

repeatedly and in an unforeseeable manner, the future path of the real exchange rate was difficult to project. Unstable exchange rates did not induce firms to enlarge their capacity for exports, since uncertain export revenues and import prices increase the risk of unprofitable investments. Paredes [1987] confirmed empirically the negative influences of real appreciations and exchange rate uncertainty on Peruvian manufactured exports.

In sum, improvements in Peru's trade performance require reforms which stabilise and unify the exchange rates at a competitive level. However, exchange rate management cannot fully explain the shifts in the trade balance. The use of quantitative restrictions and tariff policy was also decisive. Changes in the structure and level of both import restrictions followed a similar time path. The Belaúnde government initially pursued a trade liberalisation course, continuing the reductions in tariffs and quantitative restrictions which had been started under the last military government (Table 8). In late 1983, this policy was turned around, as import restrictions were used to improve the deteriorating trade balance. García intensified the protectionist measures. In 1987, the average tariff reached 67 per cent with a maximum rate of 123 per cent. As concerns the tariff structure, it is noteworthy that the highest rates were applied to manufacturing and the lowest to agricultural products. Within the manufacturing sector consumer products received much more protection than intermediate imports. In addition, the number of items whose import was prohibited was raised from 8 (1985) to 535 in 1987. All other items required import licenses, whereas in July 1985, 4757 items could still be imported freely.

Severe efficiency losses have emerged from Peru's extensive use of import restrictions and their combined effect with multiple exchange rates. The first set of problems stems from the inefficient administration of protective measures while the second is due to the effects of protection on production decisions. Granting protection through quantitative restrictions is more costly than using tariffs exclusively. The government foregoes the tariff revenue if licenses are not auctioned off but just given away to importers. Furthermore, the bureaucratic costs of administering quantitative restrictions is much higher than in the case of tariffs. The arbitrary distribution of import licenses cannot assure that the most efficient importers receive licenses and changing approval procedures create uncertainty for importers. However, in Peru the administration of tariffs causes also problems. The customs office is not capable of controlling tariffs tightly and exonerations are widespread. Consequently, within the same category different importers may be

Table 8 - Quantitative Restrictions and Tariff Rates, 1979-87 (a)

	Number of tariff positions					Tariffs		
	free from restrictions	import licence required	import prohibited	temporarily prohibited	total	average rate (b)	maximum rate	sur-charge
Dec. 1979	3,745	1,258	9	-	5,012	40	155	1
July 1980	4,745	348	9	-	5,102	39	94	1
Dec. 1980	4,990	107	7	-	5,104	34	60	1
Dec. 1981	5,088	112	7	-	5,207	32	60	15
Dec. 1982	5,075	144	7	-	5,226	36	60	10
Dec. 1983	5,136	118	8	-	5,262	41	70	15
July 1984	5,120	116	8	51	5,295	n.a.	n.a.	n.a.
Dec. 1984	4,996	126	7	172	5,301	57	76	15
July 1985	4,757	350	8	188	5,303	n.a.	n.a.	n.a.
Dec. 1985	3,259	1,553	525	-	5,337	63	102	16
Feb. 1986	3,220	1,557	562	-	5,339	63	102	17
April 1986	3,224	1,574	541	-	5,339	63	102	17
June 1987	1,744	2,975	535	-	5,254	n.a.	n.a.	n.a.
Dec. 1987	0	4,719	535	-	5,254	67	102	21

(a) The month mentioned in the table is always the last one in which the respective measure was in force. Up to April 1986 includes tariff positions and subpositions. - (b) Includes surcharges.

Source: BCRP [1987].

confronted with different rates. In addition, information costs rise as the existence of exonerations further complicates the already wide dispersion of tariff rates.

More important than administrative problems are efficiency losses which result from production decisions being based on distorted price signals. The combined effect of overvalued exchange rates and import protection supports import substitution at the expense of exports. The production of consumer goods for the Peruvian market is favoured since competition from imports is restricted. Furthermore, protection raises selling prices in the domestic market while expensive imports and unfavourable exchange rates lower the profitability of exporting activities. Thus, it does not surprise that the manufacturing sector has specialised in consumption goods, and intermediate inputs with low protection still have to be imported. The distorted pattern of production incentives and lacking integration in the world economy have caused considerable welfare losses for Peru. Furthermore, its low level of exports and its dependency on imports makes Peru particularly

susceptible for external shocks which increase import prices. As export revenues currently cannot compensate higher import expenditures, foreign reserves become a binding constraint. In the absence of fresh foreign funds, a crisis is likely to emerge when foreign exchange reserves are exhausted, because domestic production will drop due to the lack of essential imports.

This situation seems to call for external liberalisation and improvement in Peru's international competitiveness. However, up to now Peru opted for strengthening its export subsidy schemes instead. Currently, CERTEX¹ and FENT² are most important. Under CERTEX exporters receive a tax-free certificate which can be used to pay taxes. Its value depends on the type of export product and may amount to as much as 25 per cent of the fob value. FENT is a promotional credit line which supplies credits at rates below those prevailing in the market. In 1987, the difference in rates was about 17.5 percentage points. Despite the substantial amounts being extended through the subsidy schemes, CERTEX and FENT cannot correct the policy-induced distortions in the economy. First of all, these measures only offset the anti-export bias for exporters. The distortions affecting the domestic market remain. In addition, both subsidies are costly to administer and put a strain on the Treasury and the Central Bank. Increasing subsidies thus conflicts with the aim to control public financing requirements and to fight inflation. Finally, the schemes cause additional inefficiencies as some exports are subsidised unnecessarily while the subsidies are too small to promote other products effectively.

Summing up, the review of Peru's trade performance underscores the necessity of lowering protection by abolishing quantitative restrictions and reducing tariffs. Subsidies cannot serve as a substitute for liberalisation and can be cut back as liberalisation proceeds. This lowers also the danger of further retaliation which an increased use of CERTEX and FENT is likely to provoke.

2. External Debt

Peru's high and increasing external debt obligations are another major problem any economic reform has to deal with. In 1988, total foreign debt outstanding

¹ Certificado de Reintegro Tributario a la Exportación No Traditional.

² Fondo de Promoción de Exportaciones No Tradicionales.

amounted to US\$ 16.3 billion (Table 9). About 90 per cent were medium and long-term commitments of which 84 per cent accrued to the public sector. On the creditor side, international organisations, such as the World Bank, and commercial banks figure most prominently, each group accounting for some US\$ 3.5 billion.

While Peru shares this type of debt burden with other Latin American countries with debt service problems, Peru's situation is unique due to its accumulation of arrears. In 1984, the Belaúnde government suspended partly interest and amortisation payments to avoid a deepening of the recession. This policy was further aggravated by García who announced in his inaugural speech that debt service payments were limited to 10 per cent of Peru's export value.¹ As a consequence, Peru has been declared ineligible by the IMF.

It is not advisable for Peru to continue with its confrontation with foreign creditors since this strategy entails significant costs. Although future economic growth will have to be financed mostly domestically, the necessary structural reforms in the trade regime and the domestic capital market require initially foreign funds, too. Otherwise adjustment costs are difficult to cushion and strong resistance against the reforms is to be expected. However, fresh money will not be available as long as no agreement on current obligations is reached. Therefore, Peru has to enter into negotiations with its creditors. Any solution has to take into account that Peru's ability to service its foreign debt will remain rather limited over the next couple of years. Nevertheless, if Peru commits itself in a credible way to future payments, significant reductions in its debt service burden should be possible. As the secondary market value of Peruvian debt is below 10 per cent of its face value [Cohen, 1988], creditors currently do not seem to expect significant service payments. Peru's commitment to future service payments may thus increase the willingness of foreign creditors to make new money available. This applies to multinational organisations in the first place. The use of the credits for a well-defined adjustment programme would increase Peru's ability to service its debt and thus raise the expected return to the debt already outstanding.

¹ One year later, this policy was modified and excluded payments in kind and payments to Latin American countries and entities [Kisic, 1988].

Table 9 - Evolution of External Indebtedness, 1980-88 (mill. of dollars; end of period)

	1980	1981	1982	1983	1984	1985	1986	1987 (a)	1988 (a)
Total external debt(b)	9595	9606	11465	12445	13338	13721	14377	15406	16332
medium and long-term	8126	8090	9197	10925	11976	12629	13200	14050	14713
public sector(c)	6043	6127	6825	8256	9648	10462	11068	11732	12325
Central Reserve Bank	710	455	707	1089	862	825	788	870	843
private sector	1373	1508	1665	1580	1466	1342	1344	1448	1545
Short-term	1469	1516	2268	1520	1362	1092	1277	1356	1619
public and private enterprises(d)	902	920	1842	1134	978	760	789	836	753
banking system	567	596	426	386	384	332	488	520	866
Central Reserve Bank	25	24	39	23	66	63	148	217	n.a.
Banco de la Nación	450	457	178	255	212	143	157	169	n.a.
other banks	92	115	209	108	106	126	183	134	n.a.
Medium and long-term external public debt by source									
total	6043	6127	6825	8256	9648	10462	11068	11732	12325
public agencies & government	1849	1346	1195	1321	1508	1793	1942	2060	2236
international agencies	1536	1524	1986	2406	2972	3110	3262	3386	3466
socialist countries	610	784	949	1106	1305	1426	1530	1724	1884
suppliers	985	930	925	1076	1070	1026	987	1020	1018
international banks	1063	1543	1770	2347	2793	3107	3347	3542	3721
Memo:									
Total debt service attended	1709	2358	2107	1336	2889	2708	2616	2692	2354
not attended	0	0	0	0	1685	1677	1872	2124	2018

(a) Preliminary figures. - (b) Up to 1982, includes adjustments due to variations in the exchange rates of foreign currencies. - (c) Central government and public enterprises. - (d) Commercial and financial credits with and without guarantee of the banking system.

Source: BCRP [var. iss.]; CEPAL [unpubl. data].

IV. Sectoral Issues

Within the Peruvian economy three sectors merit special attention: agriculture, mining, and the labour market. Since in 1986 50 per cent of the work force were estimated to be underemployed and the work force is growing at rates above 3 per cent, a functioning labour market is of vital importance. The mining sector traditionally generated a large part of Peru's export earnings. Its reactivation could lower the stress on the balance of payments. As concerns agriculture the production record has been far from being satisfactory. Peru is still dependent on food imports. In addition, the poorest part of the population lives on agriculture so that improvements in productivity are socially desirable, too.

1. Labour Market Rigidity and the Informal Sector

The success of trade reforms is contingent on whether market participants can adjust to the new incentive structure. Some production activities being oriented to the domestic market mainly will become unprofitable and have to be closed down. On the other hand, new opportunities for exports emerge and require new investments. A necessary precondition for structural changes is that capital and labour markets are flexible and allow for shifts of workers and savings. There are, however, clear indications that the Peruvian labour market and its economic legislation lack the necessary flexibility.

The existence of the huge informal sector supports this view. De Soto [1987] estimated that 48 per cent of the work force are employed in the informal sector producing 39 per cent of measured GDP.¹ Besides manifold bureaucratic procedures which increase the costs of setting up formal businesses, several government policies, in fact, work out as barriers of entry into the formal labour market. As most Peruvians cannot afford to remain unemployed, they are forced into self-employment in the informal sector.² Particularly under García's administration, negative real interest rates and high real wages limited the number of possible jobs in the formal sector because firms preferred capital-intensive rather than labour-intensive

¹ De Soto's estimates are questioned by other researchers on econometric grounds. They conclude that the size of the informal sector should be significantly lower [Rossini, Thomas, 1987].

² For data on the informal sector in Metropolitan Lima, see Carbonetto [1987].

Table 10 - Evolution of Real Average Remunerations, 1980-88 (Index 1979 = 100)

	Private sector in Metropolitan Lima(a)			Unionised workers (b)		Central government
	salaries (c)	wages (d)	legal minimum income (e)	salaries	wages	
1980	107.4	106.1	124.1	93.0	103.2	136.4
1981	109.2	104.1	105.2	87.1	103.7	127.0
1982	117.8	105.1	78.4	84.6	105.2	116.5
1983	101.0	87.8	80.2	65.6	83.8	84.2
1984	93.2	74.5	62.3	54.7	70.0	74.0
1985	85.9	64.3	54.7	48.1	59.5	58.9
1986(f)	107.2	85.7	56.3	59.7	80.9	61.3
1987	112.4	93.9	60.8	61.8	85.8	69.4
1988(g)	102.8	82.8	52.9	55.1	74.2	56.2

(a) Survey of establishments with 10 and more workers. - (b) Does not include unilateral rises on behalf of the employer. - (c) Intis per month. - (d) Intis per day. - (e) Annual average in Metropolitan Lima. Since August 1985, the legal minimum income applies for the whole country. - (f) The information up to 1986 has been adjusted for changes in the methodology of the survey. - (g) Preliminary figures.

Source: CEPAL [var. iss.; unpubl. data].

projects. After real wages had dropped to 50 per cent of the 1980 level in July 1985, the government achieved dramatic increases by decreeing national minimums and avoiding inflationary erosion with quarterly adjustments (Table 10). Labour in the formal sector was further discriminated against capital since, by legislation, fringe benefits in the order of 25 per cent of the basic wage were required.

Initially, the flexibility of the formal labour market was also reduced by the Labour Stability Law. Accordingly, firms are not allowed to fire workers unless those are convicted of having committed crimes.¹ In addition, employees which leave the company voluntarily are to be paid one month's salary for every year employed in addition to accumulated vacation pay. Since the costs of dismissing employees grow rapidly, firms may be unable to adjust to changing market conditions by reducing their work force. Consequently, firms are reluctant to fill up their vacancies and the transfer of workers from declining firms to booming ones is hampered. In addition, firms had to employ at least 90 per cent of their employees

¹ This applies to workers having passed the three-months probation period only.

on a permanent basis. Since July 1986, the negative effects of the restrictive legislation have been mitigated by the employment programme PROEM. The latter allows firms to appoint temporarily an unlimited number of employees for a period up to two years.

The deficiencies of the formal labour market cannot be compensated by self-employment in the informal sector. Firstly, the existence of the informal sector does not provide flexibility for firms operating in the formal sector. Since most larger firms being involved in international trade operate in the formal sector, the flexibility for a trade liberalisation is still missing. Secondly, informality entails significant costs for both individual workers and the economy as a whole. Incomes in the informal sector are generally low, since firms operate with low productivity. Due to credit rationing and scarce know-how the businesses are often confined to commerce and services. More importantly, informality implies that contracts are difficult to enforce as the basic legal certainty granted by the state does not apply. Furthermore, as the informal sector avoids taxation payments, public finances are weakened. At the same time, macro-economic management, such as the control of the money supply, is complicated because little statistical information exists on informal transactions.

Summing up, the Peruvian labour market does not provide the mobility of workers being required by major structural reforms. While the informal sector mitigates the negative effects of bureaucratic regulations and lacking jobs in the formal sector, it cannot serve as a substitute for an efficient formal labour market. Instead of promoting informal activities, reforms should rather aim at eliminating the causes of the informal sector. This involves greater flexibility in the labour legislation and a correction of the bias in favour of capital-intensive projects.

2. Mining

The mining sector which traditionally generated 40 per cent of Peru's export revenues performed particularly poor. Its contribution to GDP dropped from 10 per cent in 1980 to 7.8 per cent in 1988 (Table A3). Peru is well equipped with mineral resources. Besides producing lead and zinc, the country ranked as the seventh largest world copper producer in 1987 and was among the world's three major producers of silver. In addition, considerable unexploited copper reserves are known. Hence, the contraction of the sector does not result from exhausted reserves.

Similarly, the sluggish performance cannot be blamed only on low world mineral prices, since in 1988 the price of Peru's major export product, copper, exceeded the 1980 price (Table A5). The reasons are rather the heavy taxation of exports and production difficulties due to labour disputes. When García introduced multiple exchange rates, minerals were given a less favourable exchange rate than other exports (Table A2). Thus, in the first quarter of 1987, the difference in exchange rates between traditional and priority exports was 28 per cent. Labour disputes in the mining sector affected domestic production severely because the strong unions took care that many workers participated in strikes. Mainly in the last quarter of 1988, strikes brought production practically to a standstill. Consequently, the sum of man-hours lost due to labour disputes was three times larger in the mining than in the manufacturing sector, though the latter employed about five times as many people (Table A6).

3. Agriculture

Agriculture is still an important sector in the Peruvian economy, contributing on average 14 per cent to GDP (Table A3). Furthermore, in 1987, 36 per cent of the work force were still employed in agriculture. The performance of the sector has, however, been far from being satisfactory and has enhanced the migration into urban areas. Production expanded slowly over the last 17 years; the increase in production is mainly due to the expansion in the cultivated area (Table 11). Particularly food production could not keep pace with population growth. Even heavy food imports which turned the agricultural trade balance into deficit did not raise the food supply: in 1987, the daily per capita supply of calories was below its 1961 level and below the average of all low middle-income developing countries. In addition, it is not likely that larger food imports would benefit the poor. In 1985, two fifths of the poorest 30 per cent were self-employed peasants [Glewwe, 1987]. They lack the financial means of buying imported food. Instead, improvements in nutrition require real income growth in agriculture.

Table 11 - Main Indicators of the Agricultural Sector, 1961-87

	Unit	1961	1970	1980	1985	1986	1987(a)
Land use							
arable and permanent crops land	100 ha	1956	2813	3520	3696	n.a.	n.a.
irrigated land	dto	1016	1106	1160	1210	n.a.	n.a.
Agricultural labour force as percentage of total	per cent	52	47	40	37	37	36
Production							
total agriculture	1979-81=100	81	104	94	114	112	116
food production	dto	82	101	94	112	109	113
food production per capita	dto	137	136	94	100	96	96
Food supply							
daily supply per capita	calories	2272	2299	2154	2163	2246	n.a.
External trade							
agricultural exports as percentage of total exports	per cent	37	17	10	11	17	14
agricultural imports as percentage of total imports	dto	17	20	20	17	22	n.a.
Total agricultural exports							
value	1979-81=100	59	57	94	100	129	n.a.
volume	dto	314	238	74	99	73	n.a.
Total agricultural imports							
value	dto	16	25	106	59	114	n.a.
volume	dto	39	52	102	90	155	n.a.
Agricultural trade balance	US\$ 100000	n.a.	542	-2033	267	-1461	-4133

(a) Preliminary figures.

Source: FAO [a; b]; CEPAL [unpubl. data].

Agricultural policy as well as the import substitution strategy have been major hindrances to agricultural expansion. Traditionally, Peruvian governments have controlled consumer prices for agricultural products to keep them low. In the period 1981-85 for example, wholesale prices for agricultural products of national origin grew much less than wholesale prices for domestically produced manufactures (Table A4). Price responsive farmers were discouraged and production was low.

García maintained the policy of low consumer prices for food products but changed the measures. Consumers received heavy subsidies for certain domestically-produced food products and imports were subsidised with favourable exchange rates, since they were classified as priority imports (Table A2). Furthermore, guaranteed producer prices were introduced.¹ In addition, production costs were kept low, due to subsidised credits and fertiliser. As a result of these policies production boomed in 1986/87. Nevertheless, output expansion could only be achieved at the expense of huge transfers from the Treasury and the Central Bank. The policy mix became unsustainable in late 1988, so that prices were freed and the inti devalued. Consequently, the subsidisation of agriculture disappeared.

Peruvian policies also discriminated agricultural exports against imports and manufactured products. In the 1981-85 period, nominal rates of protection for food products such as maize and wheat exceeded protection rates for export products like coffee and cotton by 85 percentage points [Herrmann, 1989]. Hence, agricultural export products were more exposed to competing imports. More important were, however, indirect effects due to an overvalued currency and an import substitution strategy. The overvaluation of the exchange rate at which agricultural products had to be exported raised the price for foreign buyers and made Peruvian exports less competitive. Furthermore, Herrmann confirmed empirically that import protection measures which raised wages and import prices lowered agricultural exports. Consequently, agricultural production for exports declined while imports grew and the agricultural trade deficit widened (Table 11).²

All in all, policies towards agriculture were costly and contradictory. The Peruvian experience shows that farmers respond to price signals and that the change of relative prices according to national priorities may become very expensive. Policy reforms should aim at reducing the bias against export products and try to bring national prices in line with world market prices. This could assure an efficient allocation within the agricultural sector and avoid costly subsidies. At the same time, imports would be reduced and exports promoted. However, as far as consumer prices are raised for basic agricultural goods, compensatory measures are necessary to soften the effects on the poor. Nevertheless, well-targeted subsidies would be more effective and less costly than an unspecified subsidisation through overvalued exchange rates and price controls.

¹ The price system is administered by two public enterprises, ECASA for rice and ENCI for wheat as well as other food.

² Only in 1985, the drastic devaluation depressed imports temporarily so that the agricultural trade balance showed a small surplus.

V. Agenda for Medium and Long-Term Policy Reforms

A short-term stabilisation programme and long-term structural reforms are required to reactivate the Peruvian economy. Contrary to traditional policy-making in Peru, a few ad-hoc measures to stabilise the economy will not suffice. However, in view of Peru's development potential a rapid economic recovery is most likely once the necessary policy changes are implemented. Peru is well-endowed with natural resources, notably minerals which could provide an important source of export revenues. A largely underemployed but well-educated labour force is available. In addition, the potential for domestic food production has not been fully realised so far.

A comprehensive and coherent policy reform is necessary to exploit Peru's development potential. Experience from other countries shows that correcting macro policies is of pivotal importance in this respect. Stopping inflation contributes more to economic reactivation than simplifying bureaucratic procedures. Therefore, successful overall reforms have to focus on abolishing distortions at the macro-economic level in the first place. In the context of this paper only the general policy guidelines can be outlined. The implementation of the reforms has to take into account the existing network of political relationships and pressure groups.¹

Lowering inflation has been identified as major prerequisite for sustained economic growth. Some authors [Stein, 1980] have emphasised gradualism in this respect to avoid a major decline of production and employment due to contractionary monetary policy. In the case of Peru, a gradual approach to eliminate inflation is not warranted for several reasons. Firstly, monetary fine-tuning is impossible when the economy has already run into hyperinflation. Secondly, small reductions in the public sector deficit do not necessarily translate into small reductions in inflation. Kiguel [1986] has shown that hyperinflationary pressures can mostly be stopped only if public sector financing requirements are drastically curtailed. Thirdly, the success of any disinflationary policy depends heavily on its credibility. Otherwise, the public will not adjust prices and wages to keep the recessionary impact of the stabilisation policy small. In a country with a long inflation experience such as Peru, drastic measures bound to achieve improvements promptly are more likely to produce the necessary confidence. The example of the successful stabilisation in Germany after 1923 is a case in point [Sargent, 1982].

¹ For a careful analysis of the political economy of a trade liberalisation, see Amelung [1988].

As the inflationary financing of the public sector deficit has been identified as major cause of the inflation spiral in Peru, expenditure cuts and revenue raising measures are required. Food subsidies and remunerations are obvious candidates for savings. However, food subsidies should not be abolished altogether. Reforms should aim at targeting subsidies at the poor only. Furthermore, transfers to public enterprises can be lowered, where prices and tariffs of public enterprises are brought into line with marginal costs. In the long run, the privatisation of some public enterprises must be considered also. This could be combined with debt-equity swaps as the Chilean experience shows. Revenues could be increased with a comprehensive tax reform, which unifies existing taxes and improves receipts from income taxation, but foreign budgetary support may be needed during a transition period.

A reform of the domestic capital market can help to finance remaining public sector deficits in a non-inflationary manner. Lifting interest rate ceilings and credit controls enable financial institutions to offer savers attractive saving instruments. Measures which increase the competition among banks will prevent them from increasing intermediation costs above competitive levels. One such measure is the opening of the capital account so that foreign banks can compete with domestic ones.

However, a substantial body of literature [Edwards, 1984; Frenkel, 1983] has argued that capital flows should only be liberalised after free trade has been introduced. Accordingly, asset markets adjust more quickly than goods markets to new policy regimes. Capital inflows following the capital market liberalisation would push up the real exchange rate to levels which impede the structural transition of the real sector.¹ In fact, exchange rate movements have created distortions in previous liberalisation attempts. Nevertheless, it can be shown that these were due to inconsistent policies rather than the sequence of liberalisation [Donges, Hiemenz, 1985; Sjaastad, 1984]. Mismanagement of nominal exchange rates particularly, has caused major problems.

In view of these experiences and Peruvian exchange rate policies possible distortions from "false" exchange rates are to be avoided. Therefore, the exchange rate should be allowed to float freely. This implies that the trade and the capital account are to be liberalised simultaneously.² Specifically, quantitative restrictions

¹ The liberalisation programmes in the Southern Cone countries - Argentina, Chile, Uruguay - are often-cited examples.

² As the African experience shows, the technical prerequisites for free floating are often overestimated [Mussa, 1987].

should be abolished while tariffs are unified and reduced. Since many Peruvians are well aware of their disastrous economic situation, the necessity of major structural reforms is known. Hence, a shock treatment trying to achieve an overall liberalisation of the economy will be even more credible than in previous years. In addition, recent developments in agriculture and the informal sector have demonstrated that Peruvians adjust quickly to changing price signals. This suggests that economic reactivation will take less time than in other countries.

A stabilisation programme along the aforementioned lines will reactivate the Peruvian economy and especially speed up the development of those sectors which have been discriminated hitherto. Notably, minerals will become important exports. Labour-intensive projects can be expected to provide additional jobs and agricultural production, particularly export crops, will increase. The positive effects on economic growth can be supported by complementary reforms in the labour market and the public bureaucracy. To increase flexibility in the labour market, the temporary employment programme PROEM should be extended and the costs of the Labour Stability Law cut back. In addition, simplifying public authorisation procedures can help to integrate the formal and the informal sector.

Nevertheless, these reforms may not provide sufficient employment and an income distribution which is socially acceptable. Additional measures can be considered. Landownership in Peru is extremely skewed [Glewwe, 1987]: only 10 per cent of the population own 86.3 per cent of the land. Furthermore, starting in 1980, the restructuring of co-operatives has resulted in an organisational crisis. A land reform accompanied by measures normalizing land tenure may help to improve the living conditions of the poor. In the long run, public investment in education of the poor is also likely to have an equalising effect on welfare in Peru. It can be shown that education and income are highly correlated [ibid., 1987].

However, the prevailing analyses do not allow a final judgement on the costs and benefits of a land reform and other complementary measures. Further investigations are required for designing these strategic policies.

Statistical Appendix

Table A1 - Central Government Operations, 1980-88 (percentage of GDP) (a)

	1980	1981	1982	1983	1984	1985	1986	1987(b)	1988(b)
A.Total income	20.5	18.0	18.1	14.3	13.6	14.1	12.0	8.7	7.7
1.Current income	20.5	18.0	18.0	14.3	13.5	14.0	12.0	8.7	7.7
tax revenue	18.9	16.3	16.3	12.9	11.2	12.4	10.8	8.2	7.3
income tax	6.0	3.6	3.5	2.5	2.0	1.7	2.6	1.7	1.6
property tax	0.7	0.7	0.7	0.5	0.4	0.3	0.5	0.4	0.4
tax on external trade	5.7	5.2	4.2	2.6	2.6	3.1	2.5	1.9	1.8
production & consumer tax	7.6	7.4	8.5	5.7	6.4	7.7	5.6	4.6	3.9
other tax revenue	0.6	0.6	0.6	0.5	0.8	0.6	0.3	0.3	0.2
less credit documents(c)	-1.6	-1.2	-1.2	-1.1	-0.9	-1.1	-0.8	-0.6	-0.6
Non-tax revenue(d)	1.5	1.6	1.7	1.5	2.3	1.6	1.2	0.6	0.4
2.Capital income	-	-	0.1	-	0.1	0.1	0.0	0.0	0.0
B.Total expenditure	23.4	22.9	22.0	23.2	17.9	16.2	15.5	14.3	9.7
1.Current expenditure	18.1	17.8	17.9	19.4	14.6	13.6	12.6	12.0	8.3
wages & salaries	4.8	5.3	5.2	3.9	4.1	3.7	3.9	3.9	2.1
goods & services	0.7	0.8	0.7	0.6	0.8	0.9	0.9	0.7	0.3
transfer	3.3	2.8	2.2	2.2	2.4	1.7	2.7	2.8	1.5
Interest payments	4.3	4.5	4.0	5.3	4.3	4.1	2.3	1.7	1.7
internal debt	1.9	2.4	1.9	1.9	1.0	1.1	0.5	0.9	0.7
external debt	2.5	2.1	2.2	3.4	3.3	2.9	1.8	0.9	1.0
Defence	4.9	4.4	5.9	7.5	2.9	3.3	2.8	2.9	2.7
2.Capital expenditure	5.3	5.1	4.0	3.8	3.3	2.5	2.9	2.2	1.4
gross capital formation	3.6	4.1	3.0	2.4	2.9	2.3	2.2	1.4	0.2
transfers	1.7	1.0	1.0	1.4	0.4	0.2	0.7	0.7	1.1
other	-	0.0	0.1	-	0.0	0.0	0.0	0.2	0.1
Saving on current account (A.1 - B.1)	2.4	0.2	0.1	-5.1	-1.1	0.4	-0.7	-3.3	-0.6
Economic deficit (A - B)	-2.8	-4.9	-3.9	-9.0	-4.3	-2.0	-3.5	-5.3	-2.0

(a) GDP series of the Instituto Nacional de Estadística. - (b) Preliminary figures. - (c) Primarily tax reimbursement certificates for non-traditional exports, capitalisation of taxes, tax payment promissory notes. - (d) Mainly property income, taxes and deductions from pensions.

Source: BCRP [var. iss.]; CEPAL [unpubl. data].

Table A2 - Exchange Rate Structure for Trade Transactions, 1986-88 (a)

	1986				1987				1988			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Exchange rates for exports												
average	14.3	14.3	14.6	15.2	17.0	18.7	22.1	29.4	44.1	74.0	152.4	357.1
hydrocarbons	13.9	13.9	13.9	14.0	15.6	17.3	18.9	26.7	43.4	73.7	152.1	357.1
traditional exports	14.1	14.1	14.3	14.8	15.6	17.1	19.4	28.4	43.4	73.7	152.1	357.1
small and medium mining firms	14.2	14.3	15.0	15.4	16.6	18.2	22.5	29.3	43.4	73.7	152.1	357.1
non-traditional												
non-priority exports	14.8	14.9	15.4	16.8	19.8	21.8	26.4	32.8	45.5	73.9	152.1	357.1
non-traditional												
priority exports	14.8	14.9	15.4	17.4	21.5	23.8	28.6	33.4	53.7	92.0	174.9	357.1
Exchange rates for imports												
average	14.1	14.2	14.5	15.5	16.9	18.2	19.8	26.5	36.8	44.5	141.4	484.3
Memo:												
Mercado único de cambio (MUC)	13.9	13.9	13.9	13.9	14.4	15.4	15.9	21.6	33.0	33.0	92.2	357.1
Financial market rate (MF)(b)	17.4	17.4	17.5	17.5	20.1	24.0	36.4	45.7	68.4	75.0	140.4	353.2

(a) Intis per dollar; quarterly average. - (b) Equals the quotation of foreign currency certificates since August 1987.

Source: BCRP [var. iss.]; CEPAL [unpubl. data].

Table A3 - Industrial Origin of GDP, 1980-88 (per cent of total; constant 1970 prices)

	1980	1984	1985	1986	1987	1988(a)
Agriculture & livestock	11.4	13.8	13.9	13.3	13.4	15.5
Fishing	1.2	1.2	1.3	1.3	1.1	1.4
Mining & quarrying	9.3	9.8	10.2	9.2	8.6	7.8
Manufacturing	24.5	21.5	21.6	23.4	24.3	23.0
Construction	5.1	4.8	4.1	4.6	4.6	4.9
Government	7.5	8.4	8.1	7.7	7.0	7.2
Services & utilities	41.0	40.8	40.8	40.5	40.7	41.2

(a) Preliminary figures.

Source: BCRP [var. iss.]; CEPAL [unpubl. data]; own calculations.

Table A4 - Price Ratios between Rural and Urban Areas, 1980-88 (Indices 1979 = 100)

	1980	1981	1982	1983	1984	1985	1986	1987	1988
1. Prices of agricultural products(a)	165	294	436	913	1905	4386	10003	17322	61337
2. Prices of industrial products(a)	145	254	411	949	2170	6362	8821	12984	108131
3. Terms of exchange (1/2)	114	116	106	96	88	69	113	133	57

(a) Monthly average of the wholesale price index for goods of national origin.

Source: CEPAL [var. iss.; unpubl. data].

Table A5 - Value, Volume and Prices of Main Export Products, 1980-88 (a)

	1980	1981	1982	1983	1984	1985	1986	1987(b)	1988(b)
Coffee									
value	140	107	114	116	126	151	275	143	133
volume	44	46	43	55	52	60	74	71	52
price(e)	146.9	107.4	119.4	96.8	112.7	115.9	170.8	92.7	115.6
Copper									
value	750	529	460	442	442	476	449	516	649
volume	350	324	335	292	337	363	347	351	291
price(f)	97.4	74.1	62.3	68.8	59.5	59.3	58.7	66.5	101.3
Cotton									
value	72	63	85	44	23	51	39	19	21
volume(d)	702	685	1287	670	246	624	474	190	139
price(e)	102.8	92.8	66.1	66.4	92.5	82.6	81.5	103.2	148.6
Fish meal									
value	195	141	202	80	137	118	206	229	368
volume	417	315	616	205	401	508	716	742	839
price(c)	469.4	448.0	328.5	386.7	342.4	232.6	287.7	308.2	438.9
Iron									
value	95	93	108	75	58	76	60	58	61
volume(g)	6	5	6	4	4	5	4	4	5
price(h)	16.5	17.7	19.1	17.5	13.9	14.6	14.4	13.7	12.9
Lead									
value	384	218	215	294	234	202	172	251	169
volume	152	146	177	191	181	174	136	146	100
price(f)	114.4	68.0	55.2	69.6	58.7	52.7	57.4	78.3	77.2
Petroleum and derivatives									
value	792	690	719	544	618	645	232	274	151
volume(k)	22.4	19.9	22.8	20.5	23.5	27.1	21.6	17.8	14.4
price(l)	35.2	34.6	31.6	26.6	26.3	23.9	10.8	15.4	10.5
Refined silver									
value	315	312	205	391	227	140	107	93	61
volume(i)	16	28	26	33	27	23	19	14	9
price(j)	19.7	11.1	7.9	11.9	8.5	6.3	5.6	6.7	6.6
Sugar									
value	13	-	20	35	49	23	22	15	16
volume	53	-	59	89	116	64	55	33	36
price(e)	11.4	-	15.2	17.9	19.4	16.8	18.4	20.6	20.3
Zinc									
value	211	267	268	307	340	268	246	234	254
volume	468	477	491	522	511	459	477	427	390
price(f)	20.4	25.4	24.8	26.7	30.2	26.4	23.4	24.9	29.5

(a) Values in millions of dollars and volumes in thousands of tons, unless otherwise indicated; prices as indicated. - (b) Preliminary figures. - (c) Dollars per ton. - (d) Thousands of quintals. - (e) Dollars per quintal. - (f) US cents per pound. - (g) Millions of long tons. - (h) Dollars per long ton. - (i) Millions of troy ounces. - (j) Dollars per troy ounce. - (k) Millions of barrels. - (l) Dollars per barrel.

Source: BCRP [var. iss.]; CEPAL [unpubl. data].

Table A6 - Evolution of Labour Disputes, 1981-88 (a)

	1981		1982		1983		1984(b)		1985		1986		1987		1988(b)	
	Work- ers af- fected	Man- hours lost	Work- ers af- fected	Man- hour lost	Work- ers af- fected	Man- hours lost	Work- ers af- fected	Man- hours lost	Work- ers af- fected	Man- hours lost	Work- ers af- fected	Man- hours lost	Work- ers af- fected	Man- hours lost	Work- ers af- fected	Man- hours lost
Total	857	19974	572	22751	786	20300	697	13968	238	12228	249	16867	312	9068	657	35023
By economic activity:																
agriculture and fishing	6	600	5	405	34	885	2	101	14	2443	10	362	4	103	8	1227
mining	90	5403	61	3646	84	7853	92	4353	31	2482	68	5583	61	3136	118	18816
manufacturing industry	93	6414	95	6680	63	2602	31	1788	43	2769	75	7196	57	3156	59	5800
construction	5	203	155	7557	32	1514	13	674	10	200	6	351	11	431	10	725
transport, storage and communication	65	1234	27	376	60	1407	37	1105	36	1589	13	662	25	286	24	836
commerce and banks	94	1067	82	1567	69	1350	56	1194	48	1130	41	1267	20	512	67	2593
others	504	5053	147	2702	444	4689	466	4483	56	1615	36	1447	134	1444	372	5025
By causes:																
remunerations	176	9446	248	14631	161	11280	103	6197	101	5075	119	9127	76	4242	133	20693
reinstatement to work economic and financial policy of the enter- prise	58	2792	65	2766	27	468	10	553	13	941	15	619	7	192	25	250
non-fulfilment of collective agreements	9	453	16	207	63	1004	8	205	15	2097	3	102	9	363	127	2077
solidarity	20	479	22	667	63	2500	50	1725	24	1533	52	5513	46	1298	56	3347
rise in the cost of living	23	882	58	1470	12	474	8	175	42	968	9	204	6	173	7	238
regional or local reasons	459	3593	-	-	380	3036	393	3143	6	138	-	-	105	843	89	711
others	77	1358	50	545	33	542	105	935	4	237	2	30	-	-	13	138
	35	971	113	2465	47	996	20	765	33	923	49	1272	63	1954	227	7468

(a) All values are expressed in thousands. - (b) Preliminary figures.

Source: CEPAL [var. iss.]; unpubl. data].

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