February 2002
IMF Country Report No. 02/27

Peru: Request for Stand-By Arrangement—Staff Report; Staff Supplement; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Peru

In the context of the Request for Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the Request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **November 20, 2001,** with the officials of Peru on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on January 23, 2002**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **January 30, 2001** and a staff statement of **February 1, 2002** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its February 1, 2002 discussion** of the staff report that completed the review.

- a statement by the Executive Director for Peru.

The documents listed below have been separately released.

Letter of Intent sent to the IMF by the authorities of Peru*
Technical Memorandum of Understanding by the authorities of Peru*

*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

PERU

Request for a Stand-By Arrangement

Prepared by Western Hemisphere and
Policy Development and Review Departments

(In consultation with the Fiscal Affairs, International Capital Markets, Legal,
Monetary and Exchange Affairs, Statistics, and Treasurer's Departments)

Approved by Claudio M. Loser and Liam P. Ebrill

January 23, 2002

Contents Page

Figures

Appendices

Executive Summary

Background

After several years of strong performance Peru's economy weakened starting in the late 1990s mainly as a result of adverse external shocks and domestic political difficulties. The interim government that took office in November 2000 was successful in maintaining a stable macroeconomic situation through the end of its term in office, July 2001, in the context of a program supported by the Fund. Economic activity, however, continued to weaken. In response, the new authorities provided a fiscal stimulus in the second half of the year, while at the same time introducing measures to improve the medium-term fiscal outlook.

In 2001, real GDP is estimated to have remained constant and inflation fell to zero by year-end. The fiscal deficit is estimated at 2.4 percent of GDP, above the limit in the country's Law on Fiscal Transparency and Responsibility, but still 0.8 percent of GDP lower than in 2000. The external current account deficit declined to 2.1 percent of GDP, and international reserves continued at comfortable levels. Credit to the private sector remained stagnant, reflecting banks' concerns about the creditworthiness of their clients, but some indicators of bank soundness improved during the year and measures were taken to continue strengthening the banking system. Adverse developments in other countries in the region had little effect on Peru's financial indicators, which were more influenced by domestic political events.

The program for 2002–3

The authorities' program seeks to set the basis for sustained high growth of output and employment and a steady reduction in poverty. The authorities are requesting Fund support for their program through a Stand-By Arrangement to emphasize their commitment to sound policies, and thereby enhance market confidence and catalyze financing for the public sector, including adjustment lending by multilateral institutions.

The program envisages a recovery of output growth to 3.7 percent in 2002 and 5 percent in 2003 as a result of an improved investment climate, in large part reflecting a more stable political environment and the authorities' structural reform agenda. Inflation is targeted at around 2–2.5 percent and international reserves would increase moderately over the program period. Fiscal policy will aim at a gradual reduction of the combined public sector deficit, to 1.9 percent of GDP in 2002 and 1.4 percent of GDP in 2003, while monetary policy will continue to focus on maintaining low inflation, under a floating exchange rate system.

The reform agenda includes a revision of the Law on Fiscal Transparency and Responsibility, a tax reform that would help put the public finances on a sustainable basis over the medium term, an ambitious privatization and concessions program, a strengthening of banking supervision, a reform of the public and private pension systems, and an improvement in the efficiency of social safety net programs. The authorities are also committed to ensure that certain state-supported lending programs that they introduced recently will be managed in a way that limits the risks for public resources.

I. Introduction

1. Discussions on an economic program that could be supported by a Fund arrangement were held in Lima during August 28–September 4 and November 12–20, 2001, and concluded from headquarters.[1] In a letter to the Managing Director dated January 18, 2002, the authorities describe the policies they intend to follow during 2002–3 and request a two-year Stand-By Arrangement in an amount equivalent to SDR 255 million, equal to 20 percent of quota on an annual basis (Attachment I).[2] The authorities intend to treat the arrangement as precautionary. A recent safeguards assessment of the Central Reserve Bank of Peru conducted by the Treasurer's Department concluded that the safeguard controls in place at the bank are generally adequate and the bank is implementing most of TRE's recommendations (Appendix I).

II. Background and Recent Developments

2. **During 1991–97, Peru made significant progress in stabilizing the economy and implementing structural reforms that helped boost economic growth, but subsequently performance deteriorated mainly as a result of adverse external shocks and domestic political difficulties.** In 1991–97, real GDP growth averaged 5.3 percent a year, inflation was brought down from hyperinflation levels to single digits, and poverty levels fell significantly. Between 1998 and 2000, however, economic growth averaged only 1 percent a year (Figure 1) and unemployment and poverty rose, reflecting the adverse effects of the *El Niño* weather phenomenon, a weakening in the terms of trade, a liquidity squeeze stemming from international financial turmoil, and domestic political upheaval.[3] During this period, the fiscal position deteriorated sharply, moving from balance in 1997 to a deficit of 3.2 percent of GDP in 2000, and the banking sector weakened, with a doubling in nonperforming loans and a stagnation in credit to the private sector. In this environment, stock prices fell significantly.

---

[1] The staff team consisted of Mr. Lizondo (Head-WHD), Ms. Albino (FAD), Mr. Keller (PDR), and Messrs. Rodriguez, Villafuerte, and Wolfe (all-WHD). The missions were assisted by Mr. Velloso, the Resident Representative in Lima. Mr. Hendrick, Advisor to the Executive Director, participated in the policy discussions.

[2] In a letter dated January 18, 2002, the authorities have informed management of their decision to cancel the one-year Stand-By Arrangement that was approved on March 12, 2001 for the equivalent of SDR 128 million (EBS/01/25), which was treated as precautionary.

[3] Salient political events include: (April and May 2000) controversial general elections; (July 2000) Mr. Fujimori begins a third term as President; (November 2000) Mr. Fujimori is removed from office by congress and Mr. Paniangua is appointed interim President; (April and June 2001) new general elections; and (July 2001) Mr. Toledo assumes the presidency.

On the positive side, inflation continued to decline and international reserves remained at comfortable levels.

3. **In a context of high political uncertainty, the interim government that took office in November 2000 introduced an economic program supported by the Fund which aimed at maintaining a stable macroeconomic situation in the transition to the new government that would enter in July 2001.** The program envisaged real GDP growth of 2.5 percent in 2001 and a slight decline in inflation to 3 percent by year-end (Table 1). The external current account deficit was projected to narrow moderately to 2.4 percent of GDP, and international reserves to increase modestly. Consistent with these objectives, and with a view to keeping confidence in the authorities' commitment to macroeconomic stability, the combined public sector deficit was targeted to fall to 1.5 percent of GDP, the limit for 2001 in Peru's Law on Fiscal Transparency and Responsibility. The authorities were to continue implementing a flexible exchange rate policy and maintaining an open trade regime. The reform agenda, which took into account the government's short transition period and lack of a majority in congress, included some privatizations and the granting of operating concessions, and enhancing fiscal transparency and the targeting of social programs.

4. **The interim government was successful in maintaining macroeconomic stability during its tenure, but economic activity in the first half of 2001 was lower than expected and some measures introduced during this period weakened the medium-term outlook for the public finances.** All end-June performance criteria under the program were observed (Table 2).[4] The fiscal target for the first half of the year was met with a margin of 0.8 percent of the period's GDP (mostly reflecting lower-than-programmed expenditure), international reserves increased, and inflation declined. Some progress was made in the structural reform area, including the awarding of operating concessions for the Camisea gas field and Lima airport, initiating the sale of an electricity company, and setting up a website with extensive information on the public finances that significantly enhanced fiscal transparency. However, real GDP fell by 1.6 percent (year-on-year) in the first half of 2001, mainly owing to a fall in domestic demand, and several measures were introduced with negative implications for the fiscal accounts.[5]

---

[4] Performance criteria for the second half of the year were to be established at the time of the first program review, which was to be completed by end-September 2001. However, the government that came into office in July 2001 preferred to negotiate a new arrangement.

[5] Most significant was the reduction in personal and corporate income tax rates (introduced at end-2000, but with main effect starting in 2002). Other measures included a lowering of selected import duties; a widening of the duty drawback system; the elimination of the value-added tax on certain tourism services; a reduction in the rate of excise taxation on cigarettes; the elimination of import duties on public transportation vehicles; and an increase in the rate of revenue-sharing with the provinces and local governments (Ley del Canon) without any parallel transfer of spending responsibilities.

5. **Faced with continued weakness in economic activity, the new administration of President Toledo provided a fiscal stimulus in the second half of 2001, while monetary policy was gradually loosened in light of a persistent decline in inflation. At the same time, steps were taken to improve the medium-term outlook for fiscal revenue**. The fiscal stimulus included reducing the special payroll tax (IES), hiking public sector wages and pensions (by 9 percent), and starting a temporary jobs program in areas of the country hardest hit by the recession.[6] To improve the medium-term prospects for the fiscal accounts, personal and corporate income tax rates were increased (effective in 2002), thus preventing most of the revenue loss that would have resulted from the income tax changes introduced during the previous government. Also, some of the revenue-reducing measures introduced earlier in the year were reversed and excise taxes on fuels were increased.

6. **For 2001 as a whole**, real GDP is estimated to have remained constant (with part of the recovery in the second half of the year reflecting the initial operations of a mining mega-project, Antamina), and annual inflation fell to zero by year-end. Employment during the first nine months of the year was down by 1.5 percent with respect to its level in the same period a year earlier (Figure 2). The deficit of the combined public sector is estimated at 2.4 percent of GDP, above the limit under the Law on Fiscal Transparency and Responsibility (but still 0.8 percent of GDP lower than in 2000), mainly reflecting a shortfall in government revenue. Owing to the weakness in domestic demand, the trade balance strengthened (Figure 3), and the external current account deficit is estimated to have fallen to 2.1 percent of GDP, despite some deterioration in the country's terms of trade. Credit to the private sector remained stagnant (Figure 4), as banks continued to have concerns about the creditworthiness of their clients, and thus concentrated their lending on preferential clients, paid down lines of credit from abroad, and accumulated remunerated dollar deposits (other than reserves requirements) at the central bank.[7]

7. **Some indicators of bank soundness improved during 2001 and the authorities continued in their efforts to strengthen the banking system**, in line with suggestions from FSAP missions of late 2000 and early 2001. Nonperforming loans remained stable at about 11 percent of total loans, while loan provisioning and the risk-adjusted capital-assets ratio increased during the year for the system as a whole (Figure 5).[8] The FSAP missions

---

[6] The new government's poverty relief efforts (including the jobs program) received donors' support at a meeting held in October 2001. Official creditors pledged new funding of about US$150 million a year (for the next three years), about two thirds of it comprising grants and the rest coming in the form of debt swaps.

[7] The banking system is highly dollarized, with about 80 percent of deposits and loans denominated in U.S. dollars.

[8] Published official figures show nonperforming loans at around 10 percent of total loans because they exclude past-due loans that have been temporarily exchanged for government bonds (under a program that was open during the second half of 1999).

concluded that systemic risks were limited and that the authorities' strategy for resolving banking system problems was broadly appropriate, but that the system would continue to face pressures. Since then, the authorities have concentrated their efforts on improving consolidated supervision of financial conglomerates, strengthening the supervision of money laundering prevention practices, and limiting maturity mismatches.

8. **During 2001, the authorities continued to implement a floating exchange rate system, with infrequent interventions in the foreign exchange market, and by year-end international reserves remained at a comfortable level.** The currency weakened early in the year mainly reflecting growing political uncertainty in the period leading to the general elections, but subsequently strengthened despite a decline in domestic-currency interest rates relative to dollar interest rates (Figure 6). In the last quarter of the year, the central bank intervened in the foreign exchange market by purchasing foreign exchange (in modest amounts), as the authorities considered that prevailing pressures for appreciation were of a temporary nature. The currency appreciated in real effective terms by 3 percent through November (the latest data available), continuing a trend initiated the previous year (Figure 7). Net international reserves increased moderately in 2001, and by end-year gross reserves were equivalent to 1.5 times the stock of short-term external debt on a residual maturity basis (Table 3).[9]

9. **Adverse developments in other countries in the region during 2001 had little effect on Peru's financial indicators, which were more influenced by domestic political events.** The spread on sovereign bonds rose early in the year, but subsequently subsided when the political outlook improved following the general elections. By end-2001 the spread on Peruvian Brady bonds was lower than at end-2000 by 166 basis points. Peru's international credit ratings were unchanged in 2001; its long-term foreign currency sovereign risk is rated Ba3 by Moody's and BB- by Standard and Poor's (both noninvestment grade).

III. THE PROGRAM FOR 2002-3 AND POLICY DISCUSSIONS

10. The government's program aims at creating the conditions for sustained high growth of output and employment and a steady reduction in poverty, through the implementation of prudent macroeconomic policies, a comprehensive program of structural reforms, and enhanced efforts at addressing priority social needs. The authorities are seeking Fund support for their program in order to foster investor confidence and catalyze financing for the public sector, including adjustment lending of the multilateral institutions.

---

[9] International reserves may change for reasons other than intervention, even under a floating exchange rate. Those reasons include changes in foreign-currency deposits held by banks and by the government at the central bank, foreign exchange transactions between the central bank and the government, interest receipts on international reserves, and valuation changes.

11. On fiscal policy, the program envisages a gradual reduction of the combined public sector deficit, which would be supported by a tax reform that would help to put the public finances on a sustainable basis over the medium term and by a revision to the Law on Fiscal Transparency and Responsibility (both of which require legislative approval). Monetary policy will continue to be geared towards maintaining low inflation, in the context of a floating exchange rate system. The reform agenda includes, in addition to the actions in the fiscal area mentioned above, an ambitious privatization and concessions program, a strengthening of banking supervision, a reform of the public and private pension systems, and an improvement in the efficiency of social safety net programs.

12. The program for 2002–3 is based on an expected recovery of real GDP growth to 3.7 percent in 2002 and to 5 percent in 2003. Economic activity is envisaged to pick up mainly as a result of an improved investment climate generated by a more stable political environment and the authorities' privatization and concession program, with growth in 2002 also reflecting the full-year operation of the Antamina project. Inflation is targeted at around 2–2.5 percent and international reserves would increase moderately over the program period. The external current account deficit is projected to widen somewhat, in line with the pick up in economic activity, to 2.3 percent of GDP in 2002 and 2.7 percent of GDP in 2003.

A. Fiscal Policies

13. **Seeking an appropriate balance between the need for further fiscal consolidation and the risk of jeopardizing the incipient recovery in economic activity, the combined public sector deficit is targeted to decline gradually, to 1.9 percent of GDP in 2002 and 1.4 percent of GDP in 2003** (Tables 4 and 5).[10] To provide further room for addressing unemployment problems, while simultaneously ensuring that the fiscal program is properly financed, the target on the fiscal deficit for 2002 would be adjusted upward to allow for additional government capital projects (for up to 0.3 percent of GDP) to the extent that privatization receipts for the year exceed the baseline projection of US$700 million (1.2 percent of GDP).[11]

14. **The reduction of the fiscal deficit in 2002 would come mainly from expenditure restraint, particularly in the areas of defense and national security** (Table 6). The positive impact of the tax reform (explained below) on revenue in 2002 will be largely offset by the negative effect of the tax measures taken in 2001 that were not reversed (0.3 percent of GDP); thus general government current revenue is projected to remain at about 17 percent of

[10] Thereafter, the authorities intend to maintain a fiscal deficit of around 1 percent of GDP, which would allow for a significant reduction of the public-sector-debt-to-GDP ratio over the medium term.

[11] The adjustor would allow for a maximum additional expenditure of about US$45 million per quarter to the extent that privatization receipts exceed the cumulative quarterly projection.

GDP.[12] On the expenditure side, the authorities' program focuses on a reduction in nonproductive outlays and a general wage and pension freeze (overall, real spending on defense and national security would be cut by 14 percent). The authorities are confident that the programmed level of general government noninterest expenditure for 2002 of 17.3 percent of GDP is adequate to ensure that the most vulnerable of the population are properly protected. They will continue to work with multilateral institutions to streamline government programs in the area of social protection to improve the efficiency and targeting of social programs.[13]

15. **The fiscal effort in 2003 would include a significant increase in government revenue and continued expenditure restraint.** The full effect of the tax reform is projected to result in a rise in general government current revenue to 17.5 percent of GDP. Government expenditure would grow somewhat less than GDP, but there would be room for a moderate wage and pension increase.[14]

16. **A key element of the authorities' fiscal program is a comprehensive reform of the tax system to be introduced in 2002, which would include new tax measures and a strengthening of tax administration** (along the lines of the recommendations of the June 2000 FAD technical assistance mission). The reform aims at increasing revenue and improving the system's neutrality and equity through a widening of the tax base by: (i) eliminating tax exemptions and tax benefits for specific sectors and regions of the country (with a portion of the increased revenue to be allocated to poverty relief programs in these same regions); (ii) mitigating the impact of previously granted generous depreciation allowances through the creation of an alternative minimum corporate tax (that would take the form of a modified income tax); (iii) abolishing the IES; (iv) requiring the inclusion of tax expenditures in the budget (starting in 2003); (v) creating a system of mining royalties; (vi) closing corporate income tax loopholes that have been used to hide personal income of executives (e.g., provisioning of automobiles); and (vii) strengthening of local government

---

[12] The effect of the tax reform on revenue will be significantly higher in 2003 partly because some of the important measures are related to income taxation, and changes in income taxes in Peru can only take effect in the year following the change in legislation.

[13] A joint Inter-American Development Bank (IDB) and World Bank (IBRD) public expenditure review mission in late 2001 recommended that spending on essential social protection programs continue at its current level of 2 percent of GDP. The authorities are also developing plans with the support of the IDB, the IBRD, and the Andean Development Corporation (CAF) to establish a program for the decentralization of government services and reform of the public education system. For details of the IBRD and IDB programs, see Appendices II and III.

[14] In both 2002 and 2003 the deficit is envisaged to be financed essentially by privatization receipts and by external borrowing, including disbursements of about US$800 million (1.4 percent of GDP) each year in adjustment lending from the multilateral institutions.

real estate tax regimes. The reform will also incorporate measures to improve the efficiency of the tax collection agency (SUNAT), including by establishing a system that uses large-firms in the production chain to act as tax-retention agents. The full revenue effect of the tax reform is projected at 0.8 percent of GDP (see Appendix IV for details).

17. The mission urged the authorities to give tax reform the highest priority in their legislative agenda, given some indications of political opposition to the reform and the government's lack of a majority in congress. The authorities indicated that the government is fully committed to seeking legislative approval of the reform. The staff also noted that congress was considering a plan to provide relief to taxpayers in arrears (by expanding the coverage of previous tax amnesty programs, lowering the interest rate on rescheduled tax debts, and lowering the penalty rate on unpaid installments), and indicated that the implementation of such plan could reduce the incentives for tax compliance and hamper tax administration. The authorities explained that they would present to congress an alternative plan, with limited relief, which would prevent a negative effect on tax collections. They also gave assurances that they would not introduce further measures to widen the scope for rescheduling of tax liabilities, nor grant tax relief to particular sectors or regions.

18. **The authorities are committed to revising the country's Law on Fiscal Transparency and Responsibility to allow for a gradual fiscal adjustment and to strengthen compliance incentives**. The current law, approved in late 1999, imposed limits on the fiscal deficit of 2 percent of GDP in 2000, 1.5 percent of GDP in 2001, and 1 percent of GDP thereafter.[15] The law also established that in the event of actual or projected recession the deficit limit may be increased to 2 percent of GDP. The law's deficit limits were breached in 2000 and 2001, and would be breached in 2002 as well (formally, the limits for 2001 and 2002 were suspended by congress). A revised law, being drafted with support from the IDB, will be submitted to congress before mid-2002. In broad terms, the revision would allow for a transitional period to reach the medium-term deficit target following a recession, and would require the immediate implementation of measures (in periods of positive growth) when the fiscal program goes off-track.

19. **The authorities intend to undertake an ambitious program of privatization and granting of operating concessions that should aid in their efforts to attract private investment and provide financing for the fiscal deficits during the program period.** Receipts are expected to reach about 1.2 percent of GDP in each year of the program (in the

[15] These limits apply to the *nonfinancial public sector excluding municipalities*, which is different from the concept of *combined public sector* (which includes municipalities and the operating balance of the central bank) used in the program; however, for practical purposes the difference in coverage is negligible. In addition to setting limits on the deficit, the law sets limits on the growth of noninterest general government expenditure, establishes a fiscal stabilization fund to smooth government revenue over the business cycle, and introduces measures to increase fiscal transparency (see EBS/00/47, Box 1).

baseline projection), with privatization focusing on the electricity sector and operating concessions to be granted for seaports, airports, road maintenance, and petroleum refining.

20. **The authorities are contemplating a reform of the public and private pension systems that over time would seek to reduce current inequities, improve somewhat the longer-term outlook of the public finances, and enhance the performance of private pension funds.** As a first step, congress approved legislation, in late 2001, that: (i) begins to reduce preferential benefits for certain beneficiaries under the privileged public system (Cédula Viva-DL 20530);[16] (ii) raises the minimum pension in the general public pension system (DL 19990), which is well below the cost of the standard family consumption basket; and (iii) guarantees a minimum pension in the private system, aimed mainly at those who have not had sufficient time to accumulate an adequate pension. In a second phase, to be introduced this year, the reform would: (i) make more flexible the investment options for the private pension plans; (ii) reduce the operating costs of the private pension administrators partly by limiting the number of times in a year that one can switch between pension funds; and (iii) close the Cédula Viva to new entrants.[17] The mission supported this plan but stressed that further steps to bring the benefit structure of the Cédula Viva in line with the general public pension plan would be needed for markedly improving equity across public pension plans and lowering the long-term fiscal cost of the public pension system.

B. Monetary and Financial Sector Policies

21. **Monetary policy will be guided by the inflation objective of the program**, and the central bank will continue to manage liquidity mainly through open market operations. The monetary program for 2002 assumes that base money, the intermediate target, will increase broadly in step with nominal GDP, while credit to the private sector is expected to pick up in line with the anticipated recovery in economic activity (Table 7). Interest rates and the exchange rate will continue to be market determined. The central bank is considering moving to a formal inflation-targeting framework for monetary policy, but no decision has been reached. The mission considered that adopting such a framework would help strengthen further public confidence in the authorities' commitment to low inflation, provide a firm

---

[16] Specifically, the benefit that was reduced was the generous pension for widowers and daughters. However, the most costly aspect of the scheme results from its very high replacement rates (which average 85 percent of the current salary for the position the beneficiary held at retirement).

[17] The system was closed to most public sector workers in the early 1990s and remains open only to judges and magistrates with more than 10 years of service, diplomats, and congress members.

anchor for inflation expectations, and further enhance transparency in the design and implementation of monetary policy.[18]

22. The authorities were considering whether to reduce reserve requirements on U.S. dollar deposits as a way of stimulating bank lending. The mission was of the view that a generalized reduction in average reserve requirements on U.S. dollar deposits (now at 33 percent) was unlikely to help spur bank credit given the ample liquidity in the banking system (interbank interest rates are at historically low levels, and banks hold sizable dollar deposits—other than reserve requirements—at the central bank), and that such a policy would more likely result in a loss of international reserves (bank reserve requirements plus other deposits held at the central bank constitute about 40 percent of official international reserves). The authorities agreed with the mission on the need to manage prudently reserve requirements on U.S. dollar deposits so as to maintain an adequate level of international reserves.

23. **The authorities will continue to strengthen the Superintendency of Banks' (SBS) oversight of the financial system.** They indicated that the system remained sound, and noted that: (i) there had been no further deterioration in the performance of bank loan portfolios since July 2000; (ii) one large bank recently received a sizable capital injection from its foreign owners; and (iii) the situation of two small banks with problems had recently been resolved (in one case through closure, and in the other through merger). To strengthen SBS oversight of the financial system, the government plans to submit draft legislation to congress to provide statutory protection to SBS staff in the discharge of their duties and will continue to grant the agency budgetary independence. Regarding regulatory issues, the SBS is continuing in its efforts to improve consolidated supervision of financial conglomerates, and during the program period, the government will propose legislation to strengthen capital requirements and reduce single credit exposure limits. The mission urged the authorities to follow the FSAP recommendations of broadening the use of explicit time limits for the capitalization of weak banks, and improving the SBS's power to take remedial action in cases of persistent bank liquidity problems. The authorities were not ready to specify the steps they might take in these areas.

24. **The authorities recently created a state-supported "agrarian bank" to aid the agriculture sector, introduced a scheme for the state-owned Banco de la Nacion to provide credit to low-income public sector employees and pensioners, and are developing a state-supported program to facilitate lending to the housing sector**. The mission argued against the introduction of specialized state-supported lending programs in general, pointing that these programs usually create contingent fiscal costs and generate political pressure for government support to other sectors, and that previous programs of sector-specific state development banks (including an agrarian bank) had failed in Peru. The

[18] The central bank increased transparency in 2001 through the publication of a monthly report that outlines recent monetary developments and sets the monetary target for the month.

authorities were of the view that these programs were needed to help generate activity in the agricultural and housing sector, and more generally to help jump-start the economy. It was agreed that these programs would be implemented in a way that limits their potential fiscal costs. In particular, the size of the programs for public sector employees and pensioners and for the housing sector would be subject to limits which would constitute performance criteria under the program.

25. The creation of the **agrarian bank** had broad political support, including from the president, as it was perceived that private banks were providing insufficient financing to small and medium-size agricultural producers. The mission expressed the view that a more effective means of promoting adequate bank lending to the agricultural sector was through improving the legal framework for loan collateral, in part by accelerating the titling and registration of land (small producers could continue to be helped through existing farm-aid programs in the budget). The authorities, however, considered that a new state-supported financial institution was needed to help the agricultural sector. They also noted that, although the bank was initially being capitalized only by the government, the law allows for private capital and eventual majority private ownership. In order to protect public resources, the authorities agreed that: (i) the bank's first-tier operations would be strictly limited to providing loans to small-scale farmers, funded through resources already identified in the budget for agricultural support; and (ii) the bank's on-lending operations would involve the channeling of resources from external credit lines to other agricultural producers through financial institutions regulated by the SBS and under strict lending standards.

26. The authorities considered that **Banco de la Nacion's program** would induce private banks to lower their own interest rates on consumer loans, thereby providing a broad-based stimulus to the economy, and that the program would not put fiscal resources at risk because loan repayments would be automatically deducted from payrolls and pension deposits. The mission considered that, given current pressures from congress for private banks to refinance their consumer loans, Banco de la Nacion could also be pressured to weaken the conditions on its loans and to extend eligibility to a wider set of borrowers. It was agreed that under the program: (i) net lending of the scheme would be limited to the authorities' proposed path (which reach a maximum of 0.2 percent of GDP); (ii) the lending terms and lending limits under the program would not be altered; and (iii) the program would not be extended beyond its original closing date of end-2002.

27. For **housing loans**, the authorities plan to establish a mortgage security insurance program, along the lines of the United States Federal Housing Administration (FHA), but the exact conditions of the program (e.g., the percentage of mortgage guarantee) are still being developed. The mission cautioned the authorities that the FHA model (and its 100 percent mortgage guarantee) might not be appropriate for Peru, owing to the country's relatively weaker systems of judicial review and bankruptcy workout procedures, and encouraged the authorities to consider a relatively low rate of mortgage guarantee. The authorities were not ready to take a position in this area, but agreed to limit the size of contingent losses for housing lending to the equivalent of 0.3 percent of GDP.

C. External Sector Policies

28. **The authorities intend to maintain the floating exchange rate system**, undertaking exchange market intervention only to the extent that it is needed to avoid excessive short-term exchange rate volatility, and to continue the practice of not intervening in the forward foreign exchange market. The authorities and the mission shared the view that exchange rate flexibility has served Peru well in helping the economy adjust to external shocks.

29. The external current account deficit is projected to widen somewhat in 2002–3 on the basis of a recovery in imports in line with the envisaged economic upturn, but would remain under 3 percent of GDP (Table 8). Export values are projected to show solid growth on the strength of full-year operations of Antamina and some improvement in export prices. Net private capital inflows are projected to rise during the program, mainly owing to increased political stability and the privatization program, while net public sector inflows would decline somewhat, primarily reflecting lower financing needs. These projections are consistent with a targeted modest increase (about US$ 110 million a year) in net international reserves during the program period (Table 9).[19]

30. **The authorities are aiming to reduce gradually the average level and dispersion of import tariffs, but feel they need more time to develop a political consensus before committing to a specific plan.** The authorities' stated objective is to reach an average tariff rate below 10 percent (compared with around 12 percent at present). There is strong opposition among the business community and certain political groups to this plan, and in fact, there are demands for increased protection. The mission and the authorities agreed that these pressures must be resisted. While the government tries to build support for its plan, it is committed to not introducing new trade barriers in a manner that is inconsistent with Peru's obligations as a member of the WTO.[20]

31. **The authorities indicated that they were considering a debt exchange with private creditors.** Although the specifics of the operation were still to be defined, it would presumably involve the exchange of new government 10-year bonds with bullet payment at maturity for front-loaded interest reduction Brady bonds (FLIRBs), the stock of which is

---

[19] Net international reserves as defined for monitoring purposes, with the financial system's foreign currency deposits in the central bank as a reserve liability, would remain broadly constant.

[20] Peru has a low level of trade restrictiveness, as reflected in its rating of 2 on the 1–10 scale of trade restrictiveness developed by the Fund (EBS/97/163), owing to its moderate level of tariff protection and the absence of nontariff barriers of major significance. There are four basic tariff rates: 0, 4, 12, and 20 percent, and a 5 percent import surcharge on certain agricultural products. A few agricultural products are also subject to variable-rate import surcharges based on world reference prices.

about US$1.7 billion. The mission indicated that such an operation was likely to worsen the maturity profile of debt payments.[21] The authorities considered however that the exchange would serve to reduce the present value of Peru's debt. The authorities were also considering an additional placement of sovereign bonds that would help provide a benchmark for private Peruvian firms seeking access to international capital markets. The mission agreed that there seemed to be scope for a moderate debt issuance in international markets, and that the proceeds could serve as a source of financing should there be delays or shortfalls in the privatization program.

D. Medium-Term Outlook and Capacity to Repay the Fund

32. **Projections prepared by the authorities and discussed with staff point to a favorable medium-term outlook for the economy**, with low inflation, and real GDP growth of about 5 percent a year on the basis of a sustained growth in private sector investment and increasing productivity (Table 10).[22] This scenario is conditional on sound macroeconomic policies, including the gradual reduction in the fiscal deficit, and the implementation of further structural reforms that enhance productivity and provide the necessary incentives for the envisaged increase in investment.

33. **The projections suggest limited external vulnerability over the medium term**. The external current account deficit would remain under 3 percent of GDP over the projection period, with both exports and imports of goods and nonfactor services exhibiting strong growth (in average over 7 percent a year). Net capital inflows are projected at around 3 percent of GDP a year, mainly reflecting a steady growth in foreign direct investment. This would allow for moderate annual accumulations of international reserves. Gross international reserve coverage of short-term debt on a residual-maturity basis would remain at around 150 percent throughout the projection period, and while the reserve coverage of imports and broad money would decline, it would stay at comfortable levels (5.6 months of imports and 41 percent of broad money by 2011). External debt indicators would improve significantly between 2001 and 2011, with total external debt falling from 52 percent to 34 percent of GDP, and external debt service declining from 43 percent to 26 percent of exports of goods and services.

[21] The FLIRBs, which at end-2001 were selling at a discount of 28.5 percent, carry low interest rates and the principal is to be amortized gradually from 2005 to 2017.

[22] A preliminary analysis suggest that this scenario would lead to a reduction in the poverty rate from 54 percent in 2001 to about 40 percent in 2011, using a methodology that applies sectoral growth assumptions for the medium-term to household income in each sector and then compares the increased per capita income levels with a constant real poverty line.

34. A sensitivity analysis shows that if the prices of fishmeal, copper, and gold, Peru's most important commodities, were 25 percent lower than in the baseline scenario, the external current account deficit would be larger on average by about 0.5 percent of GDP, 0.8 percent of GDP, and 0.6 percent of GDP, respectively.[23] Also, if international interest rates were 2 percentage points higher than expected during the projection period, the current account deficit would be higher by 0.6 percent of GDP on average. Compared with the baseline scenario, in either of these simulations the external-debt-to-GDP ratio would be higher by at most 6.4 percentage points at the end of the projection period, and debt service as a percentage of exports of goods and services higher by at most 3.3 percentage points (on average over the period). Also, a simulation assuming real GDP growth of 3 percent over the medium-term, and the baseline fiscal deficit path (as a percentage of GDP), indicates that the public-debt-to-GDP and external-debt-to-GDP ratios would still decline over the program period, although at a slower pace than in the baseline scenario. Maintaining the same fiscal deficit path (as a percentage to GDP), however, implies that the authorities would need to scale down their expenditure plans with respect to the baseline scenario.

35. If the prospects for capital flows to Peru were to weaken significantly with respect to the baseline scenario (for instance owing to financial contagion), monetary policy would need to be tightened to limit the depreciation of the currency, as a sharp depreciation could have a significant adverse effect on banks' balance sheets given their indirect exposure to exchange rate risk. Fiscal policy may also need to be tightened to the extent that the outlook for public sector financing (either through privatization or borrowing) deteriorates.

36. Notwithstanding the envisaged decline in the ratio of public-debt-to-GDP over the medium term, the mission encouraged the authorities to work closely with the World Bank in: (i) strengthening the finance ministry's capacity for public debt management; and (ii) developing a strategy to minimize the costs of debt service and better manage risks over the medium term, as financing sources are likely to shift away from multilateral lenders towards private capital markets. The mission supported the current strategy of issuing Sol-denominated Treasury securities and encouraged the authorities to do so in accordance with a preannounced calendar in order to improve the government's cash and debt management. The mission noted that these instruments would provide benchmarks that would help the development of the domestic capital market.

37. **Peru should not have difficulties in discharging its obligations to the Fund, assuming a continuation of sound economic policies** (Table 11). As noted earlier, the Peruvian authorities intend to treat the Stand-By Arrangement as precautionary. However, if

[23] Changes in petroleum prices have a much smaller net effect; Peru exports oil but is a small net importer of petroleum products.

Peru decided to purchase all available resources under the requested arrangement (Table 12), its obligations to the Fund would peak in 2002 at SDR 144.7 million, or 0.3 percent of GDP. Fund credit outstanding to Peru would rise from 48.2 percent of quota in November 2001 to 50.4 percent of quota in 2004 and then fall to virtually zero by 2008.

E. Program Monitoring

38. The **quantitative performance criteria** for 2002 are presented in the letter of intent (Attachment I, Table 1), and comprise *ceilings* on the combined public sector borrowing requirements (with an upward adjustment for privatization receipts in excess of program projections for up to 0.3 percent of GDP), the expansion in net domestic assets of the central bank, the outstanding stock of short-term external debt of the nonfinancial public sector; the contracting or guaranteeing of external public debt, the net lending of the Banco de la Nacion's consumer-loan program, the stock of government guarantees for housing support programs, and the accumulation of external payments arrears (which applies on a continuous basis); and a *floor* on the accumulation of net international reserves of the central bank.[24] **Structural benchmarks** for 2002 (Attachment I, Table 2, and Box 1) include actions in the area of tax reform, tax administration, and a new law on fiscal transparency and responsibility; the privatization of key state electricity enterprises; and submission to congress of legislation to provide the necessary statutory protection to SBS staff. The program envisages three **reviews**. The first review, to be completed by August 30, 2002, will focus on: (i) progress in the implementation of a tax reform, and, if needed, the design of contingency measures; (ii) advances in the privatization and concession program; (iii) the status of submitting legislation to congress to strengthen banking supervision; and (iv) ensuring that the implementation of the state-supported lending schemes for specific sectors (agriculture, housing, and government employees and pensioners) is consistent with the program's objectives. The second review, to be completed by February 27, 2003, will establish the quarterly performance criteria and structural benchmarks for 2003, as well as the timing of the third review.

[24] This floor would be adjusted upward to the extent that net foreign borrowing exceeds the program projection and privatization proceeds exceed the baseline projection plus the 0.3 percent of GDP allowed for additional spending in the adjustor to the fiscal target. In the event of shortfalls in these inflows, the target would be adjusted downward, but with a limit.

Box 1. Peru: Structural Conditionality

1. Coverage of Structural Conditionality in the Current Program

Structural conditionality in the program for 2002 includes benchmarks related to: (i) the privatization of important state electricity companies; (ii) the submission of draft legislation to congress regarding tax reform, a revision of the country's fiscal responsibility law, and statutory protection for SBS staff in the discharge of their duties; and (iii) targets for the tax collection agency's tax audit program (see Attachment I, Table 2). The mission and the authorities agreed that these benchmarks covered policy actions that were essential for ensuring a sustainable fiscal situation and a strengthening of financial system oversight. There are no structural performance criteria nor specific structural conditions for the completion of program reviews.

2. Status of Structural Conditionality from Earlier Programs

The most recent Fund-supported program in Peru (2001) did not include structural conditionality in view of the interim administration's short period in office and lack of a majority in congress. Prior to this arrangement and to the political turmoil in 2000, in June 1999 the Executive Board approved an extended arrangement in support of Peru's economic program. The program included structural benchmarks in the areas of privatization, the granting of operating concessions, sale of state-owned agricultural land, titling and registration of private landholdings, and efforts to improve the efficiency of social protection programs (there were no structural performance criteria nor specific structural conditions for the completion of program reviews). By end-June 2000 (the last target date under the program) all benchmarks were observed, albeit some after their initial target date, with one exception. The granting of a forestry operating concession has been complicated by delays in passage of the forestry law and subsequent legal challenges to the law's regulations. This concession has marginal macroeconomic relevance and, thus, was not included in the conditionality for the current program.

3. Structural Areas Covered by World Bank Lending

The World Bank (in coordination with the IDB) is working in the area of public sector reform that covers: tax reform, improving the efficiency of social expenditures, reform of the pension system, decentralization, and budget reform. To support these reforms, the World Bank would extend a second loan under the existing Public Sector Reform Loan, while the IDB is preparing a new reform loan (Institutional, Social and Fiscal Reform Program). It is expected that the IDB would make disbursements in the first and fourth quarters of 2002, while the World Bank would disburse in the second half of the year. The Andean Development Corporation (CAF) is also supporting the authorities' efforts to improve the efficiency of social expenditures.

IV. STAFF APPRAISAL

39. Peru's economic performance in 2001 was affected by the lingering effects of previous adverse external shocks and by domestic political developments. The interim government that was in office through midyear was successful in maintaining a stable macroeconomic situation, within the context of a program supported by the Fund, but economic activity declined in the first half of the year mainly owing to a drop in domestic demand. The administration that took office in July introduced some expansionary fiscal measures, and monetary policy was relaxed in view of a persistent decline in inflation. In the event, output picked up slowly late in the year, partly reflecting the activities of a new large mining project. For the year as a whole, the fiscal deficit exceeded the limit in the country's Law on Fiscal Transparency and Responsibility, although the deficit was still significantly lower than in the previous year. On the positive side, international reserves continued at comfortable levels, and the external current account deficit and inflation fell to their lowest levels in many years.

40. **The program being proposed for 2002–3 includes sound macroeconomic policies and a comprehensive structural agenda to lay the basis for sustained high growth of output and employment and a steady reduction in poverty levels.** The authorities are seeking Fund support for this program through a Stand-By Arrangement to emphasize their commitment to sound policies, and thereby enhance market confidence and catalyze financing for the public sector, including adjustment lending by multilateral institutions.

41. **The authorities' fiscal program aims at a gradual reduction of the fiscal deficit, to 1.9 percent of GDP in 2002 and 1.4 percent of GDP in 2003, allowing for a limited increase in the deficit target for 2002 to the extent that privatization proceeds exceed the level envisaged in the baseline scenario.** The staff sees merit in this strategy and supports the authorities' intention to revise the Law on Fiscal Transparency and Responsibility, with the support of the IDB, to allow for a gradual fiscal adjustment following a recession. The revised law would also require that the authorities take immediate corrective action (in times of positive growth) in the event of revenue shortfalls or expenditure overruns; this would help enhance credibility in the commitment to the new legal deficit limits following the noncompliance with the current law in its first two years.

42. **The key element in the authorities' economic program is a comprehensive tax reform that would lay the basis for a sustainable fiscal position over the medium term.** The reform would increase tax revenue and improve the efficiency and equity in the tax system through a widening of the tax base and elimination of distortionary taxes. Numerous existing tax exemptions and tax benefits would be eliminated; new taxes would be created; and tax administration would be strengthened. To help prevent hidden subsidies to particular industries or regions, all tax benefits and exemptions would be explicitly incorporated in the budget as tax expenditure. The staff strongly supports the authorities' intentions in these areas and urges them to make all efforts to ensure that the tax reform is approved by congress. It would also be important to prevent further tax amnesties and the relaxation of

conditions for the rescheduling of tax arrears in order to avoid eroding the incentives for tax compliance. Staff agrees with the authorities' plans to divert a portion of the increased revenue from the tax reform to anti-poverty programs and regional development projects, particularly in the Amazon region, and to continue working with multilateral institutions to improve the efficiency and targeting of the social safety net.

43. **The staff supports the authorities' program of divestiture of state assets in the energy sector and the granting of concessions in the management and maintenance of seaports, airports, roads, and petroleum refining.** Successful implementation of this program would leave almost all utilities in the hands of the private sector, and would help ensure that adequate capital investment is carried out in important infrastructure sectors.

44. **The authorities' efforts to reform the public and private pension systems are welcome**. The first phase of such a reform, approved by congress in late 2001, begins to reduce the preferential benefits under the privileged public pension system and improves the social safety net by raising the minimum pension in the public system and providing a minimum pension for certain older workers in the private system. The second phase in the reform would be equally important, and would aim at increasing the flexibility for private pension plan operators' investment choices and close the privileged public system to new entrants. The staff urges the authorities to continue in their efforts to eliminate other preferential benefits of the privileged public system.

45. **The authorities' intention to continue focusing monetary policy on keeping low inflation is appropriate**. The staff also welcomes the intention to manage prudently reserve requirements on U.S. dollar deposits so as to maintain a sound level of international reserves.

46. **The staff urges the authorities to move forcefully with their plans to continue strengthening the banking supervisory framework.** While there has been a significant and orderly consolidation of the banking system in recent years and systemic risk appears to be limited, the authorities should remain vigilant and move rapidly to obtain legislation to provide appropriate legal protection to staff of the Superintendency of Banks (SBS), strengthen bank capital requirements, and reduce single credit exposure limits. Also, the staff welcomes the authorities' commitment to maintain the budgetary independence of the SBS.

47. **The staff supports the official plans to continue with the floating exchange rate system and to garner a consensus for reducing the average level and dispersion of import tariffs**. The floating rate system, with its limited interventions, has served Peru well in helping the economy adjust to external shocks. The authorities' objective of reaching an average tariff rate below 10 percent would enhance resource allocation, but time is needed to achieve broad political support for this issue. In the meantime, the staff urges the authorities to maintain Peru's relatively open trade regime and resist protectionist pressures.

48. **The staff shares the authorities' view that a moderate issuance of sovereign bonds in international markets would be useful** in helping provide a benchmark for Peruvian firms seeking foreign financing. The authorities, however, should move cautiously

regarding their intention to enter into a Brady debt exchange, as this operation may result in a worsening of the maturity profile of debt payments.

49. **It would be important that the authorities implement their specialized state-supported lending programs in a way that limits the risk to public resources**. The consumer loan program for lower-income public sector workers and pensioners should be operated under strict lending standards and be closed at end-2002 as originally envisaged, and the mortgage insurance scheme should cover only a moderate percentage of the mortgage contracts under the program. Also, the newly created agrarian bank should operate prudently, providing loans to small-scale farmers from resources identified in the budget, and channeling resources from external credit lines to other agricultural producers through on-lending operations that follow strict lending standards. In addition, over the next few years, the government should strengthen the legal framework for loan collateral in the agricultural sector in order to promote sustainable private bank lending to the sector, which would obviate the need for state support to the agrarian bank.

50. **The medium-term prospects for the economy look favorable**, assuming a continued implementation of sound macroeconomic policies, including the gradual reduction of the fiscal deficit through the introduction of a comprehensive tax reform, and structural reforms that would encourage investment and enhance productivity. Peru has a comfortable level of international reserves, but a relatively high external debt and debt service obligations. Under the aforementioned policy framework, the country should be able to maintain a prudent reserve coverage and reduce its external debt burden.

51. In sum, the staff is of the view that the authorities' program is consistent with the objective of creating the conditions for sustained high rates of economic growth that would support a steady reduction in poverty. There are risks to the program, mainly reflecting the lack of a legislative majority, which could jeopardize the introduction of the proposed tax reform and more generally the overall direction of policies envisaged in the program. The authorities recognize these risks and believe that with the support of the Fund they can bring about a resumption of growth that will in turn strengthen political support for their policies. Moreover, they stand ready to take any appropriate corrective action that may be needed. The staff, therefore, supports Peru's request for a two-year Stand-By Arrangement from the Fund.

Table 1. Peru: Selected Economic Indicators

	1998	1999	2000	2001 Prog.	2001 Est.	Program 2002	Program 2003
(Annual percentage change)							
Production, prices, and trade							
Real GDP	-0.5	0.9	3.1	2.5	0.0	3.7	5.0
Real domestic demand	-0.8	-2.7	2.4	1.9	-1.0	3.5	5.4
Of which : private consumption	-0.8	-0.4	3.9	3.4	1.2	2.9	5.2
Consumer prices							
End of period	6.0	3.7	3.7	3.0	-0.1	2.5	2.0
Period average	7.3	3.5	3.8	3.3	2.0	1.8	2.3
Exports (U.S. dollars)	-15.7	6.3	14.8	8.9	1.5	11.0	7.7
Imports (U.S. dollars)	-3.9	-17.9	8.9	3.4	-0.6	6.3	8.0
Terms of trade	-13.6	-5.6	-0.4	2.0	-2.4	1.3	2.0
Real effective exchange rate (depreciation -) 1/	-10.8	-2.4	7.2	...	3.0	...	...
Money and credit							
Broad money 2/	0.2	4.3	1.7	4.2	5.3	4.2	6.1
Credit to the private sector 2/	7.8	-2.3	-3.6	3.0	-1.5	5.4	8.2
(In percent of GDP)							
Public sector							
Combined public sector primary balance	1.2	-0.8	-0.9	0.8	-0.2	0.1	0.6
Interest due	2.0	2.2	2.3	2.4	2.2	2.0	2.1
Combined public sector overall balance	-0.6	-3.0	-3.2	-1.5	-2.4	-1.9	-1.4
Balance of payments							
Current account	-6.4	-3.7	-3.0	-2.4	-2.1	-2.3	-2.7
Capital and financial account	4.0	2.2	2.8	2.8	2.8	2.5	2.9
Net international reserves (increase -)	1.8	1.5	0.4	-0.4	-0.8	-0.2	-0.2
Savings and investment							
Gross domestic investment	23.6	21.5	20.1	20.0	18.4	18.8	19.4
Public sector	4.5	4.8	4.0	3.4	3.4	3.1	3.0
Private sector	19.1	16.7	16.1	16.6	15.0	15.7	16.4
National savings	17.2	17.8	17.1	17.6	16.3	16.5	16.7
Public sector 3/	4.0	1.8	0.9	1.9	1.0	1.1	1.5
Private sector	13.2	16.0	16.2	15.7	15.3	15.4	15.2
External savings	6.4	3.7	3.0	2.4	2.1	2.3	2.7
Memorandum item:							
Nominal GDP (S/. billions)	166.5	174.7	186.8	200.2	189.8	201.0	216.3

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

1/ End of period. Based on Information Notice System. Data for 2001 correspond to November 2001.
2/ Flows in foreign currency are valued at program exchange rate.
3/ Excludes privatization receipts.

Table 2. Peru: Quantitative Performance Criteria, January-June 2001

	March 31	June 30
(Cumulative amounts from December 31, 2000; in millions of soles)		
Borrowing requirement of the combined public sector		
Unadjusted limits	500	1,310
Adjusted limits 1/	500	1,310
Actual	-496	580
Margin	996	730
(Cumulative change from December 31, 2000; in millions of soles)		
Net domestic assets of the central reserve bank		
Unadjusted limits	-1,325	-645
Adjusted limits 1/	-251	-144
Actual	-725	-851
Margin	474	707
(Cumulative change from December 31, 2000; in millions of U.S. dollars)		
Net international reserves of the central reserve bank		
Unadjusted targets	280	90
Adjusted targets 1/	-20	-50
Actual	52	104
Margin	72	154
Short-term net external debt of the public sector		
Limits	50	50
Actual	0	0
Margin	50	50
External payments arrears of the public sector (on a continuous basis) 2/		
Limits	0	0
Actual	0	0
Margin	0	0
(Cumulative amounts from December 31, 2000; in millions of U.S. dollars)		
Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year		
Total		
Limits	1,180	1,400
Actual	127	727
Margin	1,053	673
Of which: 1- to 12-year maturity		
Limits	50	100
Actual	0	0
Margin	50	100

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and EBS/01/25.

1/ The targets and limits have been adjusted in accordance with the table attached to the letter of intent dated February 6, 2001, which is appended to the staff report (EBS/01/25).

2/ Excluding arrears associated with nonrescheduled debt to foreign creditors outstanding as of end-2000.

Table 3. Peru: Financial and External Vulnerability Indicators
(In percent; unless otherwise indicated)

	1998	1999	2000	2001 Prog.	2001 Est.	Program 2002	Program 2003
Financial indicators							
Public sector debt/GDP	42.7	48.0	45.9	45.5	46.5	45.1	43.1
90-day prime lending rate, domestic currency 1/	24.2	21.2	18.2	...	15.2	...	...
90-day prime lending rate, foreign currency 1/	14.4	11.8	10.7	...	9.0	...	...
Velocity of money 2/	4.1	3.9	3.9	4.1	3.8	3.9	3.9
Credit to the private sector/GDP	28.0	27.9	26.0	25.1	25.0	24.6	25.1
Share of foreign currency deposits in total deposits	76.5	77.3	77.9	76.9	75.9	74.6	73.5
Share of foreign currency loans in total credit	80.0	82.3	81.5	81.5	81.1	80.3	79.8
Nonperforming loans/total loans 3/	6.5	9.4	11.2	...	11.0	...	...
Loan-loss provisions/nonperforming loans 3/	81.1	79.4	78.5	...	98.1	...	...
Risk-based capital-assets ratio 4/	11.2	12.0	12.9	...	13.7	...	...
Commercial banks' short-term foreign assets (in millions of U.S. dollars)	613	981	824	649	861	861	861
Commercial banks' short-term liabilities (in millions of U.S. dollars)	2,879	1,835	1,519	967	1,239	1,239	1,239
External indicators							
Exports, U.S. dollars (percent change)	-15.7	6.3	14.8	8.9	1.5	11.0	7.7
Imports, U.S. dollars (percent change)	-3.9	-17.9	8.9	3.4	-0.6	6.3	8.0
Terms of trade (percent change)	-13.6	-5.6	-0.4	2.0	-2.4	1.3	2.0
Real effective exchange rate, (end-period, percent change) 1/	-10.8	-2.4	7.2	...	3.0	...	...
Current account balance (percent of GDP)	-6.4	-3.7	-3.0	-2.4	-2.1	-2.3	-2.7
Capital and financial account balance (percent of GDP)	4.0	2.2	2.8	2.8	2.8	2.5	2.9
Total external debt (percent of GDP)	53.0	55.2	53.0	49.6	52.3	50.2	47.9
Medium- and long-term public debt (percent of GDP) 5/	35.6	38.7	36.5	35.9	36.4	34.9	33.2
Medium- and long-term private debt (percent of GDP)	6.4	7.8	9.1	7.7	9.2	9.1	8.7
Short-term public and private debt (percent of GDP)	10.9	8.7	7.4	6.0	6.7	6.1	6.0
Total external debt (percent of exports of goods and services) 5/	400.0	372.3	329.7	294.1	323.1	302.8	284.6
Total debt service (percent of exports of goods and services) 6/	53.1	54.7	52.6	41.6	43.3	38.6	39.8
Gross official reserves (in millions of U.S. dollars)	10,036	9,057	8,613	8,684	8,891	8,853	8,904
Gross official reserves, percent of short-term external debt 7/	115.1	122.8	130.0	157.6	154.7	156.0	146.3
Gross official reserves, percent of broad money 8/	77.4	68.4	64.0	64.6	61.9	60.3	57.5
Gross official reserves (in months of imports of goods and services)	13.1	10.8	10.9	9.7	10.6	9.8	9.0
Net international reserves (in millions of U.S. dollars)	9,183	8,404	8,180	8,395	8,613	8,713	8,833
Net international reserves (program definition; in millions of U.S. dollars) 9/	5,880	5,195	4,891	4,989	5,056	5,092	5,116
Financial market indicators							
Stock market index (U.S. dollars)	422.3	523.4	342.8	...	342.1	...	...
Foreign currency debt rating (Moody's)	Ba3	Ba3	Ba3	...	Ba3	...	...
Spread of Peruvian Brady bonds, basis points 10/	655	443	687	...	521	...	...

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

1/ At end of period. Data for 2001 correspond to November 2001.
2/ Defined as the inverse of the ratio of end-period broad money to annual GDP.
3/ Annual average. Since 2000, includes adjustment for nonperforming loans that were temporarily exchanged for government bonds. Data for 2001 correspond to September 2001.
4/ Data for 2001 correspond to October 2001.
5/ Includes Central Reserve Bank of Peru debt.
6/ Includes debt service to the Fund.
7/ Short-term debt includes amortization of medium- and long-term loans falling due over the following year.
8/ At end-period exchange rate.
9/ Includes financial system's foreign currency deposits in central bank as reserve liability.
10/ Over U.S. Treasury bond yields of comparable maturity.

Table 4. Peru: Fiscal Operations of the Combined Public Sector

(In percent of GDP)

	1998	1999	2000	2001 Prog.	2001 Est.	Program 2002	Program 2003
Central government primary balance	**0.8**	**-1.0**	**-0.5**	**0.7**	**-0.6**	**-0.3**	**0.3**
Revenue	16.0	14.8	15.0	14.6	14.2	14.4	14.7
Current	15.7	14.4	14.7	14.4	14.1	14.1	14.4
Of which: tax revenue 1/	13.8	12.3	12.0	12.3	11.8	11.9	12.4
Capital	0.4	0.4	0.3	0.2	0.1	0.3	0.3
Noninterest expenditure	15.2	15.7	15.5	13.9	14.8	14.7	14.5
Current	11.8	12.4	12.7	11.5	12.5	12.4	12.2
Capital	3.4	3.4	2.8	2.4	2.3	2.2	2.2
Rest of the general government primary balance	**0.5**	**0.1**	**0.1**	**0.4**	**0.1**	**0.2**	**0.2**
Revenue	5.2	5.4	5.6	5.4	5.6	5.6	5.6
Current	5.2	5.3	5.4	5.3	5.5	5.6	5.6
Capital	0.0	0.0	0.1	0.1	0.1	0.1	0.0
Noninterest expenditure	4.7	5.3	5.5	5.0	5.4	5.4	5.4
Current	3.8	4.3	4.5	4.2	4.5	4.5	4.5
Capital	0.9	0.9	1.0	0.9	0.9	0.9	0.9
Public enterprise primary balance	**-0.1**	**0.0**	**-0.5**	**-0.2**	**0.2**	**0.2**	**0.1**
Current balance	0.7	0.9	0.2	0.3	0.6	0.4	0.3
Capital balance	-0.8	-0.9	-0.7	-0.5	-0.4	-0.3	-0.2
Central bank operating balance	**0.1**	**0.1**	**0.0**	**0.0**	**0.1**	**0.0**	**0.0**
Combined public sector primary balance	**1.2**	**-0.8**	**-0.9**	**0.8**	**-0.2**	**0.1**	**0.6**
Interest payments	2.0	2.2	2.3	2.4	2.2	2.0	2.1
External	1.8	2.0	2.0	2.1	1.9	1.7	1.7
Domestic	0.2	0.2	0.3	0.3	0.3	0.3	0.4
Combined public sector overall balance	**-0.6**	**-3.0**	**-3.2**	**-1.5**	**-2.4**	**-1.9**	**-1.4**
Financing	**0.6**	**3.0**	**3.2**	**1.5**	**2.4**	**1.9**	**1.4**
External	0.4	-0.0	1.3	1.3	1.0	0.7	0.3
Disbursements	1.1	1.6	2.5	2.6	2.5	2.2	2.1
(In millions of U.S. dollars)	650	812	1,299	1,475	1,360	1,250	1,250
Amortizations	-1.4	-1.7	-1.2	-1.4	-1.5	-1.5	-1.8
(In millions of U.S. dollars)	-800	-873	-636	-788	-794	-862	-1,091
Domestic	-0.2	2.3	1.2	-0.7	0.9	0.0	-0.0
Central government	0.3	2.5	0.8	-0.3	0.9	0.3	0.3
Rest of general government	-0.4	-0.0	-0.1	-0.2	-0.1	-0.2	-0.2
Public enterprises	-0.0	-0.2	0.5	-0.2	0.0	-0.1	-0.1
Privatization	0.4	0.7	0.8	1.0	0.6	1.2	1.2
(In millions of U.S. dollars)	263	363	409	550	334	700	700
Memorandum items: 2/							
General government current revenue	19.0	17.8	17.6	18.1	17.1	17.0	17.5
Of which: tax revenue 3/	14.1	12.9	12.7	12.6	12.0	12.2	12.6
General government noninterest expenditure	17.8	18.7	18.4	17.4	17.6	17.3	17.1
Military expenditure	1.8	1.9	2.0	1.6	1.8	1.5	...
General government cyclically adjusted balance 4/	-1.3	-3.2	-2.7	-1.3	-2.1	-1.6	-1.4
Public sector debt	42.7	48.0	45.9	45.5	46.5	45.1	43.1

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and Fund staff estimates and projections.

1/ Net of tax on assets of public enterprises and of central government payroll tax (IES) payments.

2/ Net of transfers among nonfinancial public institutions.

3/ Net of social security and other contributions

4/ Trend GDP is computed using a Hodrick-Prescott filter.

Table 5. Peru: Fiscal Operations of the Central Government

(In percent of GDP)

	1998	1999	2000	2001 Prog.	2001 Est.	Program 2002	Program 2003
Current primary balance	**3.8**	**2.0**	**2.0**	**2.9**	**1.6**	**1.7**	**2.2**
Current revenue	15.7	14.4	14.7	14.4	14.1	14.1	14.4
Tax revenue 1/	13.8	12.3	12.0	12.3	11.8	11.9	12.4
Direct taxes	4.3	3.5	3.3	3.2	3.4	3.1	3.2
Indirect taxes	9.5	8.8	8.7	9.2	8.4	8.8	9.2
Other current revenue	1.9	2.1	2.8	2.1	2.3	2.2	2.1
Current noninterest expenditure	11.8	12.4	12.7	11.5	12.5	12.4	12.2
Labor services 2/	6.2	6.7	6.6	6.1	6.6	6.4	6.4
Goods and nonlabor services	3.6	3.0	3.3	2.8	3.7	3.6	3.5
Transfers and other	2.0	2.7	2.8	2.6	2.2	2.4	2.3
Capital balance	**-3.0**	**-3.0**	**-2.5**	**-2.2**	**-2.2**	**-1.9**	**-1.9**
Capital revenue	0.4	0.4	0.3	0.2	0.1	0.3	0.3
Capital expenditure	3.4	3.4	2.8	2.4	2.3	2.2	2.2
Gross capital formation	2.5	2.7	2.5	1.8	2.1	2.1	2.1
Other	0.9	0.7	0.3	0.6	0.3	0.2	0.1
Primary balance	**0.8**	**-1.0**	**-0.5**	**0.7**	**-0.6**	**-0.3**	**0.3**
Interest payments	1.9	2.1	2.2	2.3	2.1	1.9	2.0
External	1.8	2.0	1.9	2.0	1.9	1.7	1.6
Domestic	0.1	0.1	0.3	0.3	0.2	0.3	0.4
Overall balance	**-1.0**	**-3.1**	**-2.7**	**-1.6**	**-2.8**	**-2.2**	**-1.7**
Memorandum items:							
Primary balance before transfers	2.4	0.6	0.9	2.1	1.3	1.9	2.4
Overall balance before transfers	0.5	-1.5	-1.3	-0.2	-0.9	-0.1	0.4

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and Fund staff estimates and projections.

1/ Net of tax on assets of public enterprises and of central government payroll tax (IES) payments.
2/ Includes wages, salaries, and employer contributions to social security.

Table 6. Peru: Functional Classification of Budget Expenditure 1/

	1998	1999	2000	Prel. 2001	Budget 2002
	(In percent of GDP)				
Total	**17.3**	**19.0**	**18.9**	**18.4**	**17.8**
Planning and administration	4.0	4.7	5.0	4.7	4.7
Debt service	3.0	3.4	3.9	3.7	3.9
Administration	0.9	1.2	1.1	1.0	0.8
Pensions and social assistance	3.5	4.1	4.1	4.3	4.1
Pensions	2.7	3.0	3.3	3.4	3.2
Other social assistance	0.8	1.0	0.8	0.9	0.9
Education	2.7	3.0	2.9	2.9	3.0
Preprimary	0.2	0.3	0.2	0.2	0.3
Primary	1.0	1.1	1.0	1.0	1.0
Secondary	0.7	0.7	0.7	0.8	0.8
Tertiary	0.5	0.6	0.5	0.5	0.5
Other	0.3	0.3	0.5	0.4	0.4
Defense and national security	2.9	2.8	2.9	2.5	2.1
Health and water	1.5	1.5	1.6	1.6	1.7
Water and sewage	0.2	0.2	0.2	0.1	0.1
Healthcare services	1.3	1.4	1.4	1.5	1.6
Transportation	0.9	1.0	0.7	0.7	0.7
Agriculture	0.7	0.7	0.7	0.6	0.5
Justice	0.4	0.4	0.4	0.4	0.4
Energy and natural resources	0.2	0.2	0.1	0.1	0.1
Foreign relations	0.2	0.2	0.2	0.2	0.2
Legislative	0.1	0.1	0.1	0.1	0.1
Housing and urban development	0.1	0.1	0.1	0.1	0.1
Industry, commerce, and services	0.1	0.1	0.1	0.1	0.1
Fishing	0.0	0.1	0.1	0.1	0.1
Communications	0.0	0.0	0.0	0.0	0.0
Employment	0.0	0.0	0.0	0.0	0.0
Memorandum items:					
Total social expenditure	6.5	7.0	6.8	6.9	6.9
Budgetary social expenditure 2/	5.0	5.5	5.3	5.4	5.6
ESSALUD 3/	1.2	1.4	1.5	1.4	1.3
Fonavi 4/	0.3	0.1	0.0	0.0	0.0

Source: Ministry of Economy and Finance.

1/ Budget coverage includes central government and some autonomous agencies (i.e. ONP, FCR, FONAHPU).
2/ Includes education, health and sanitation, and other social assistance.
3/ Total expenditure by Essalud, the public health insurance administration.
4/ Net operations of the national housing fund (Fonavi), loan disbursements and amortizations received.

Table 7. Peru: Monetary Survey

	1998	1999	2000	2001 Prog.	2001 Est.	Program 2002	Program 2003
	I. Central Reserve Bank (In millions of new soles at program exchange rate)						
Net international reserves 1/	**25,643**	**28,149**	**28,739**	**28,966**	**29,664**	**29,690**	**30,625**
(In millions of U.S. dollars)	8,935	8,159	7,983	8,091	8,286	8,387	8,507
Net domestic assets	**-21,693**	**-23,518**	**-24,201**	**-23,999**	**-24,719**	**-24,450**	**-25,041**
Net credit to nonfinancial public sector	-10,853	-9,966	-9,390	-9,806	-8,790	-8,874	-9,092
Rest of banking system	-10,091	-11,462	-12,488	-12,648	-13,694	-13,401	-13,588
Other	-749	-2,090	-2,323	-1,545	-2,235	-2,175	-2,361
Currency	**3,950**	**4,631**	**4,537**	**4,967**	**4,945**	**5,240**	**5,584**
	II. Banking System (In millions of new soles at program exchange rate)						
Net foreign assets	**19,681**	**25,630**	**26,415**	**27,923**	**28,358**	**29,249**	**30,680**
Net domestic assets	**18,670**	**19,801**	**21,183**	**21,736**	**21,624**	**22,441**	**24,811**
Net credit to nonfinancial public sector	-15,017	-13,291	-11,697	-13,090	-10,007	-11,542	-13,097
Credit to private sector	43,423	49,166	49,112	51,221	48,149	50,305	55,163
Other	-9,737	-16,074	-16,232	-16,394	-16,518	-16,322	-17,255
Net credit to COFIDE	-2,095	-3,074	-1,996	-2,442	-1,709	-1,692	-1,718
Other	-7,642	-13,000	-14,236	-13,952	-14,809	-14,630	-15,537
Liabilities to the private sector	**38,351**	**45,431**	**47,598**	**49,659**	**49,982**	**51,690**	**55,491**
	(12-month percentage change) 2/						
Base money	5.5	17.0	-4.0	6.0	7.9	4.8	5.8
Broad money	0.2	4.3	1.7	4.2	5.3	4.2	6.1
Domestic currency	-2.1	11.5	1.3	9.0	11.9	7.7	10.1
Foreign currency	1.4	1.7	2.2	2.1	2.5	2.5	4.1
Credit to private sector	7.8	-2.3	-3.6	3.0	-1.5	5.4	8.2
Domestic currency	6.6	-5.3	0.9	5.8	1.9	9.1	12.2
Foreign currency	8.1	-1.6	-4.5	2.3	-2.3	4.6	7.2
Memorandum item:							
Program exchange rate (S/. per US$)	2.87	3.45	3.60	3.58	3.58	...	...

Source: Central Reserve Bank of Peru; and Fund staff projections.

1/ Excludes subscriptions to the IMF and the Latin American Reserve Fund (FLAR), Pesos Andinos, credit lines to other central banks, Corporacion Andina de Fomento (CAF) bonds, and foreign assets temporarily held by the BCRP as part of swap operations. Gold holdings are valued at the price of gold assumed in the program for each particular year.

2/ Flows in foreign curency are valued at program exchange rate.

Table 8. Peru: Balance of Payments

	1998	1999	2000	2001 Prog.	2001 Est.	Program 2002	Program 2003
(In millions of U.S. dollars)							
Current account	**-3,634**	**-1,919**	**-1,627**	**-1,352**	**-1,144**	**-1,334**	**-1,643**
Merchandise trade	-2,466	-631	-321	21	-173	151	142
Exports	5,757	6,119	7,028	7,642	7,132	7,915	8,525
Traditional	3,712	4,142	4,817	5,161	4,740	5,411	5,809
Nontraditional	2,045	1,977	2,212	2,481	2,392	2,505	2,716
Imports	-8,222	-6,749	-7,349	-7,621	-7,306	-7,764	-8,383
Services, income, and current transfers (net)	-1,173	-1,291	-1,306	-1,373	-968	-1,486	-1,787
Services	-658	-701	-783	-542	-587	-789	-892
Investment income	-1,488	-1,581	-1,542	-1,817	-1,408	-1,682	-1,949
Current transfers	978	994	1,018	986	1,024	985	1,057
Financial and capital account	**2,263**	**1,116**	**1,496**	**1,554**	**1,519**	**1,412**	**1,739**
Public sector	-57	383	277	644	445	323	134
Disbursements	790	1,237	1,485	1,621	1,410	1,300	1,300
Amortization	-859	-971	-1,045	-925	-933	-941	-1,131
Other medium- and long-term public sector flows 1/	12	117	-163	-52	-33	-36	-35
Capital transfers (net)	0	0	0	0	0	0	0
Privatization	60	219	229	507	270	665	665
Private sector	2,260	514	990	403	804	423	940
Foreign direct investment (FDI) excluding privatization	1,782	2,044	452	741	720	537	1,066
Other private capital	478	-1,530	538	-338	84	-114	-126
Medium- and long-term loans	677	435	792	256	191	240	88
Portfolio investment	-355	-299	-273	-238	-45	-189	-179
Short-term flows to the financial system 2/	9	-1,424	-99	-250	-209	-245	-40
Other short term flows (incl. errors and omissions)	255	-242	118	-106	147	80	5
Financing	**1,371**	**803**	**132**	**-202**	**-375**	**-78**	**-96**
Change in central bank reserves (increase -)	1,006	775	190	-215	-433	-100	-120
Exceptional financing	365	28	-58	13	58	22	24
Debt relief 3/	383	55	0	13	117	22	24
Change in arrears	-18	-27	-58	0	-59	0	0
(In percent of GDP unless otherwise specified)							
Memorandum items:							
Current account balance	**-6.4**	**-3.7**	**-3.0**	**-2.4**	**-2.1**	**-2.3**	**-2.7**
FDI and private MLT capital (percent of CA deficit)	67.7	129.2	76.4	73.7	79.6	58.2	70.2
Capital and financial account balance	4.0	2.2	2.8	2.8	2.8	2.5	2.9
Export value (US$), percent change	-15.7	6.3	14.8	8.9	1.5	11.0	7.7
Volume growth	2.8	12.6	9.5	6.8	7.9	9.9	3.7
Price growth	-18.0	-5.6	4.9	2.0	-6.0	1.0	3.9
Import value (US$), percent change	-3.9	-17.9	8.9	3.4	-0.6	6.3	8.0
Volume growth	1.3	-17.9	3.4	3.4	3.2	6.6	6.0
Price growth	-5.1	0.0	5.3	0.0	-3.7	-0.3	1.8
External arrears of public sector (end of period, $US mn) 4/	166	155	108	108	43	43	43
GDP (millions of US$)	57,080	51,962	53,513	55,965	53,983	56,817	60,072

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and Fund staff estimates and projections.

1/ Includes medium- and long-term flows of the financial public sector, as well as subscription payments into international funds.

2/ Includes COFIDE and Banco de la Nacion.

3/ Debt relief for 2002-2003 from Paris Club creditors.

4/ Most of the external arrears are owed to unguaranteed suppliers, some of which are in discussions with the government, while the rest have not been located.

Table 9. Peru: External Financing Requirements and Sources

(In millions of U.S. dollars)

	1998	1999	2000	2001 Prog.	2001 Est.	Program 2002	Program 2003
1. Gross financing requirements	**11,199**	**9,762**	**8,659**	**7,313**	**7,699**	**7,208**	**7,733**
External current account deficit (exc. official transfers)	3,634	1,919	1,627	1,352	1,144	1,334	1,643
Debt amortization	8,553	8,591	7,164	5,746	6,063	5,774	5,970
Medium- and long-term debt	2,203	2,455	2,667	2,066	2,140	2,184	2,495
Public sector	859	971	1,045	925	933	941	1,131
Multilateral 1/	254	272	532	354	324	410	470
Bilateral	562	365	389	70	513	472	588
Bonds and notes	16	319	109	501	83	50	67
Other	27	15	15	0	13	9	6
Private sector	1,344	1,484	1,622	1,141	1,207	1,243	1,364
Short-term debt 2/	6,350	6,136	4,497	3,680	3,923	3,590	3,475
Repayment of arrears 3/	18	27	58	0	59	0	0
Accumulation of NIR	-1,006	-775	-190	215	433	100	120
Change in gross reserves	-1,196	-954	-362	31	271	-55	41
Payments of short-term liabilities of the Central Bank	190	179	172	184	162	155	79
IMF repurchases and repayments	190	179	172	184	162	155	79
Other	0	0	0	0	0	0	0
2. Available financing	**10,473**	**9,600**	**8,273**	**7,300**	**7,374**	**7,185**	**7,709**
Foreign direct investment (net)	1,842	2,263	681	1,248	990	1,202	1,731
Privatization	60	219	229	507	270	665	665
FDI	1,782	2,044	452	741	720	537	1,066
Portfolio (net)	-355	-299	-273	-238	-45	-189	-179
Short-term assets (flow)	108	-37	206	0	64	-50	-135
Debt financing from private creditors	8,156	6,343	6,372	4,721	4,988	4,958	5,027
Medium- and long-term financing	2,020	1,846	2,449	1,397	1,398	1,483	1,452
To public sector	80	24	35	0	0	0	0
To private sector	1,940	1,822	2,414	1,397	1,398	1,483	1,452
Short-term financing	6,136	4,497	3,923	3,324	3,590	3,475	3,575
Official creditors 4/	710	1,213	1,450	1,621	1,410	1,300	1,300
Multilateral 1/	603	960	794	1,026	1,208	1,071	1,040
Bilateral	107	253	656	595	202	229	260
To public sector	107	253	656	595	202	229	260
To private sector	0	0	0	0	0	0	0
Other medium- and long-term public sector flows 5/	12	117	-163	-52	-33	-36	-35
IMF	0	0	0	0	0	0	0
Accumulation of arrears (exceptional)	0	0	0	0	0	0	0
3. Financing gap	**726**	**162**	**387**	**13**	**323**	**22**	**24**
Other flows 6/	726	162	387	13	323	22	24
Errors and omissions	343	107	387	0	206	0	0
Debt relief	383	55	0	13	117	22	24

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

1/ Excluding the IMF.

2/ Original maturity of less than one year. Equals stock at the end of the previous period. Excludes BCRP short-term debt (US$16mn

3/ Most of the external arrears are owed to unguaranteed suppliers, some of which are in discussions with the government, while the rest have not been located.

4/ Includes both loans and grants.

5/ Includes subscription payments to international organizations (mainly CAF, also IBRD's FOE) and changes in Banco de la Nation's long-term as

6/ Includes all other net financial flows (incl. exceptional financing), and errors and omissions.

Table 10. Peru: Medium-Term Outlook

	Est.	Projections									
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
I. Balance of Payments and Other External Indicators											
(In billions of U.S. dollars)											
Current account	**-1.14**	**-1.33**	**-1.64**	**-1.75**	**-1.77**	**-1.91**	**-2.04**	**-2.19**	**-2.33**	**-2.37**	**-2.55**
Merchandise trade	-0.17	0.15	0.14	0.23	0.55	0.78	0.83	1.01	1.00	1.08	1.06
Exports	7.13	7.92	8.53	9.33	10.55	11.83	13.11	14.57	15.98	17.40	18.96
Imports	-7.31	-7.76	-8.38	-9.10	-10.00	-11.05	-12.27	-13.56	-14.98	-16.32	-17.90
Services	-0.59	-0.79	-0.89	-0.94	-0.96	-1.02	-1.19	-1.21	-1.21	-1.12	-1.01
Investment income	-1.41	-1.68	-1.95	-2.21	-2.62	-3.02	-3.13	-3.52	-3.78	-4.41	-4.41
Current transfers	1.02	0.99	1.06	1.18	1.26	1.35	1.44	1.55	1.66	1.80	1.80
Capital and financial account	**1.52**	**1.41**	**1.74**	**1.92**	**1.99**	**2.24**	**2.39**	**2.53**	**2.68**	**2.66**	**2.80**
Public sector	0.44	0.32	0.13	0.16	0.45	0.50	0.52	0.46	0.42	0.38	0.27
Disbursements 1/	1.41	1.30	1.30	1.44	1.79	1.92	2.08	2.10	2.18	2.14	2.16
Amortization due	-0.93	-0.94	-1.13	-1.24	-1.34	-1.42	-1.56	-1.65	-1.76	-1.76	-1.89
Other medium- and long-term public flows 2/	-0.03	-0.04	-0.04	-0.04	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Private sector	1.08	1.09	1.61	1.76	1.54	1.73	1.87	2.07	2.26	2.28	2.53
Privatization receipts from direct investment	0.27	0.67	0.67	0.40	0.05	0.05	0.05	0.04	0.04	0.04	0.03
Direct investment, excluding privatization	0.72	0.54	1.07	1.31	1.30	1.41	1.65	1.86	1.98	2.05	2.30
Other 3/	0.09	-0.11	-0.12	0.05	0.20	0.28	0.17	0.17	0.24	0.19	0.21
Overall balance	**0.38**	**0.08**	**0.10**	**0.17**	**0.22**	**0.33**	**0.35**	**0.34**	**0.35**	**0.30**	**0.25**
Change in central bank reserves	-0.44	-0.10	-0.12	-0.20	-0.25	-0.35	-0.35	-0.35	-0.35	-0.30	-0.25
Exceptional financing 4/	0.06	0.02	0.02	0.02	0.02	0.02	0.00	0.00	0.00	0.00	0.00
(In percent of exports of goods and services)											
Total external debt service	43.3	38.6	39.8	38.4	36.0	34.2	32.3	30.4	28.8	27.2	26.1
Public external debt service	23.3	20.7	21.4	21.7	21.4	21.2	20.8	19.8	19.1	17.9	17.2
(In months of next year's imports of goods and services)											
Gross reserves	10.6	9.8	9.0	8.5	7.9	7.4	6.9	6.5	6.3	5.9	5.6
(In percent of short-term external debt on a residual-maturity basis)											
Gross reserves	154.7	156.0	146.3	144.8	146.9	150.1	151.4	152.4	152.9	154.0	151.9
(In percent of broad money)											
Gross reserves	61.9	60.3	57.5	56.7	54.5	52.2	50.2	48.1	45.8	43.6	41.2
(In percent of GDP)											
Current account deficit	-2.1	-2.3	-2.7	-2.7	-2.6	-2.6	-2.6	-2.6	-2.6	-2.5	-2.5
Merchandise exports	13.2	13.9	14.2	14.6	15.4	16.1	16.7	17.3	17.7	17.7	18.3
Merchandise imports	13.5	13.7	13.9	14.2	14.6	15.1	15.7	16.1	16.6	16.9	17.3
Total external debt	52.3	50.2	47.9	45.6	43.8	42.1	40.6	39.0	37.5	35.9	34.2
Total medium- and long-term public external debt 5/	36.4	34.9	33.2	31.5	30.1	28.8	27.6	26.3	25.0	23.7	22.3

Table 10. Peru: Medium-Term Outlook

	Est.	Projections									
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
				II. Output and Prices							
				(Annual percentage change)							
Real GDP	0.0	3.7	5.0	5.5	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Real domestic demand	-1.0	3.5	5.4	5.5	4.7	4.8	5.1	4.8	5.0	4.9	5.0
Of which:											
Private consumption	1.2	2.9	5.2	5.5	4.5	4.4	4.4	4.4	4.4	4.4	4.4
Private investment	-4.4	5.1	9.3	8.5	7.6	7.5	7.5	7.5	7.5	7.5	7.5
Consumer prices (end of period)	-0.1	2.5	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
				(In percent of GDP)							
				III. Savings and Investment							
Gross domestic investment	**18.4**	**18.8**	**19.4**	**19.7**	**20.0**	**20.3**	**20.8**	**21.1**	**21.5**	**21.9**	**22.3**
Public sector	3.4	3.1	3.0	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Private sector	15.0	15.7	16.4	16.8	17.1	17.4	17.9	18.2	18.6	19.0	19.4
National savings	**16.3**	**16.5**	**16.7**	**17.0**	**17.4**	**17.7**	**18.2**	**18.5**	**18.9**	**19.4**	**19.8**
Public sector 6/	1.0	1.1	1.5	1.9	1.9	1.9	1.9	2.0	2.1	2.1	2.3
Private sector	15.3	15.4	15.2	15.1	15.5	15.8	16.3	16.5	16.9	17.3	17.5
External savings	**2.1**	**2.3**	**2.7**	**2.7**	**2.6**	**2.6**	**2.6**	**2.6**	**2.6**	**2.5**	**2.5**
				IV. Combined Public Sector							
Combined public sector primary balance	**-0.2**	**0.1**	**0.6**	**1.1**	**1.3**	**1.4**	**1.4**	**1.5**	**1.5**	**1.5**	**1.7**
Of which											
General government current rev	17.1	17.0	17.5	17.6	17.6	17.6	17.6	17.7	17.7	17.8	17.9
General govt. non-interest expe	17.6	17.3	17.1	16.6	16.3	16.2	16.2	16.2	16.2	16.2	16.2
Interest due	2.2	2.0	2.1	2.1	2.2	2.4	2.4	2.4	2.3	2.3	2.3
Combined public sector overall balance	**-2.4**	**-1.9**	**-1.4**	**-1.0**	**-1.0**	**-1.0**	**-1.0**	**-0.9**	**-0.8**	**-0.7**	**-0.6**
Net external financing	1.0	0.7	0.3	0.3	0.7	0.7	0.6	0.5	0.5	0.4	0.3
Net domestic financing 7/	0.9	0.0	0.0	0.1	0.2	0.1	0.3	0.3	0.3	0.3	0.2
Privatization receipts	0.6	1.2	1.2	0.6	0.1	0.2	0.1	0.1	0.0	0.0	0.0
Public sector debt	46.5	45.1	43.1	40.9	39.1	37.5	36.0	34.4	32.9	31.3	29.6
Memorandum item:											
Poverty rate	54.3	52.9	50.9	49.1	48.3	47.1	45.7	43.7	42.5	40.8	39.1

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

1/ Includes bonds.

2/ Includes medium- and long-term flows of the financial public sector, as well as subscription payments into international funds.

3/ Includes errors and omissions.

4/ Includes debt relief from Paris Club creditors, and debt forgiveness.

5/ Includes Central Reserve Bank of Peru debt.

6/ Excludes privatization receipts.

7/ Includes statistical discrepancy.

Table 11. Peru: Projected Payments to the Fund as of December 31, 2001 1/

(In millions of SDRs)

	Over-due	2002	2003	2004	2005	2006	2007	2008	2009	2010	Beyond	Total
Obligations from existing drawings												
Principal (repurchases)	0	133.9	80.3	26.8	26.8	26.8	13.4	0.0	0.0	0.0	0.0	308.0
Charges and interest 2/												
On Fund credit	0	7.1	3.5	2.2	1.5	0.8	0.1	0.0	0.0	0.0	0.0	15.2
On use of SDRs	0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	20.0
Total obligations	0	143.0	85.8	31.0	30.3	29.5	15.5	2.0	2.0	2.0	2.0	343.1
(percent of quota)	0	22.4	13.4	4.8	4.7	4.6	2.4	0.3	0.3	0.3	0.3	53.7
Obligations from prospective drawings												
Principal (repurchases)	0	0.0	0.0	0.0	22.5	78.7	101.6	48.8	3.5	0.0	0.0	255.0
Charges and interest 2/												
On Fund credit	0	1.7	4.7	6.9	6.9	5.7	3.2	0.9	0.0	0.0	0.0	30.0
On use of SDRs	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations	0	1.7	4.7	6.9	29.4	84.4	104.8	49.7	3.5	0.0	0.0	285.0
(percent of quota)	0	0.3	0.7	1.1	4.6	13.2	16.4	7.8	0.5	0.0	0.0	44.6
Cumulative (existing and prospective)												
Principal (repurchases)	0	133.9	80.3	26.8	49.3	105.5	115.0	48.8	3.5	0.0	0.0	563.1
Charges and Interest 2/												
On Fund credit	0	8.8	8.2	9.2	8.4	6.5	3.3	0.9	0.0	0.0	0.0	45.3
On use of SDRs	0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	20.0
Total obligations	0	144.7	90.5	38.0	59.7	114.0	120.3	51.7	5.5	2.0	2.0	628.4
(percent of quota)	0	22.6	14.2	5.9	9.3	17.8	18.8	8.1	0.9	0.3	0.3	98.3
(percent of GDP)	0	0.3	0.2	0.1	0.1	0.2	0.2	0.1	0.0	0.0	0.0	1.2
(percent of exports of goods and services)	0	2.0	1.2	0.4	0.6	1.1	1.0	0.4	0.0	0.0	0.0	6.8
Memorandum items:												
Purchases		115.6	111.5	27.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	255.0
Fund credit outstanding												
(end period)		289.7	320.9	322.0	272.7	167.2	52.2	3.4	-0.1	-0.1	-0.1	...
(percent of quota)		45.3	50.2	50.4	42.6	26.1	8.2	0.5	0.0	0.0	0.0	...
(percent of GDP)		0.7	0.7	0.7	0.5	0.3	0.1	0.0	0.0	0.0	0.0	...

Sources: Treasurer's Department; and Fund staff estimates and projections.

1/ Assuming all scheduled purchases are made.

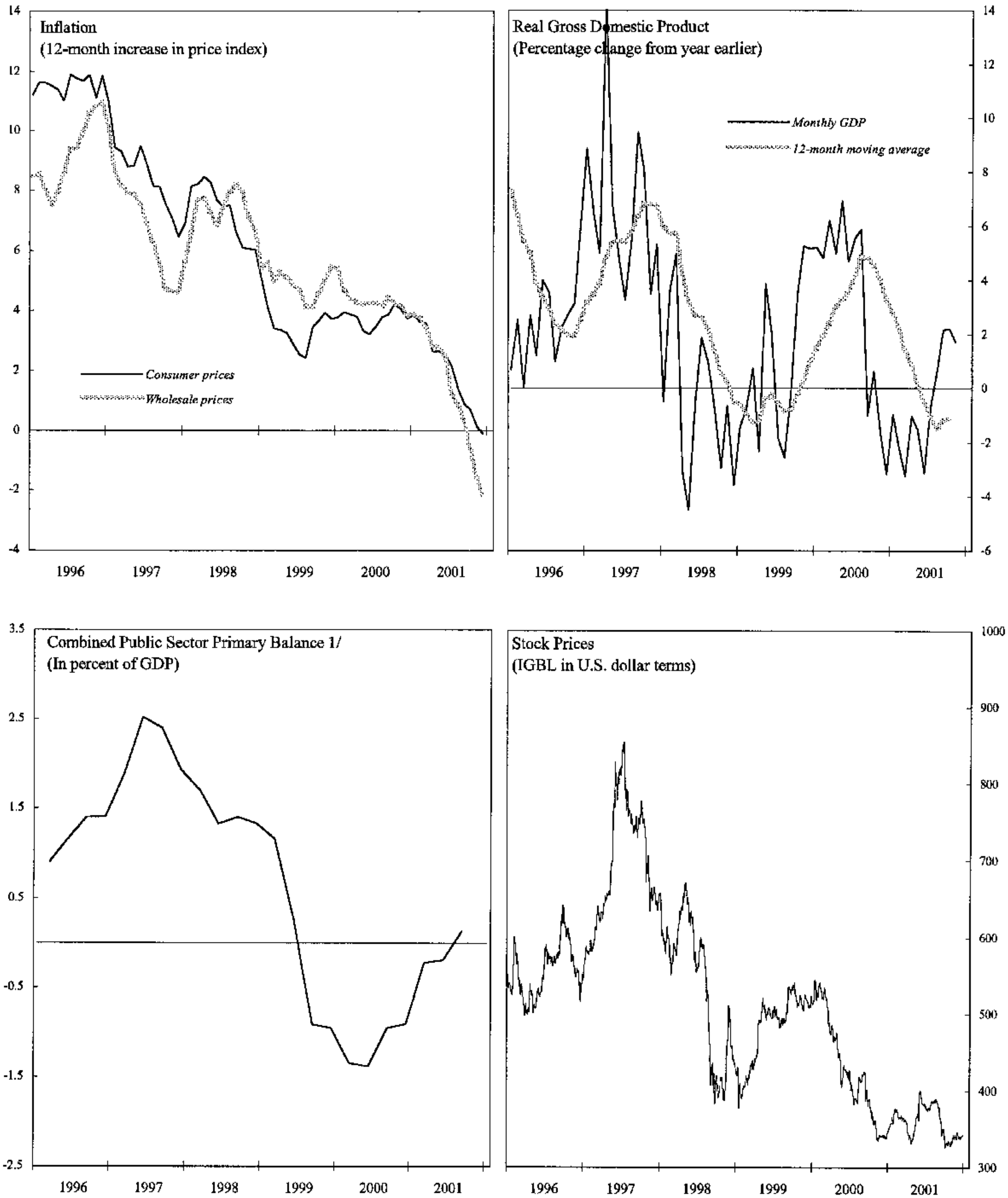
2/ Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the GRA, and on current interest rates for SAF, PRGF, and Trust Fund. The current SDR interest rate is assumed for net use of SDRs.

Table 12. Peru: Proposed Schedule of Purchases
Under the Stand-By Arrangement, 2002–4 1/

Amount of Purchase	Availability Date	Conditions Include
1. SDR 32.0 million	February 1, 2002 (tentative Board date)	Board approval of SBA.
2. SDR 27.875 million	May 15, 2002	Observance of end-March 2002 performance criteria.
3. SDR 27.875 million	August 31, 2002	Completion of the first review and observance of end-June 2002 performance criteria.
4. SDR 27.875 million	November 15, 2002	Observance of end-September 2002 performance criteria.
5. SDR 27.875 million	February 28, 2003	Completion of the second review and observance of end-December 2002 performance criteria.
6. SDR 27.875 million	May 15, 2003	Observance of end-March 2003 performance criteria.
7. SDR 27.875 million	August 31, 2003	Completion of the third review and observance of end-June 2003 performance criteria.
8. SDR 27.875 million	November 15, 2003	Observance of end-September 2003 performance criteria.
9. SDR 27.875 million	February 15, 2004	Observance of end-December 2003 performance criteria.

1/ Total access under the Stand-By Arrangement is SDR 255 million (20 percent of quota on an annual basis).

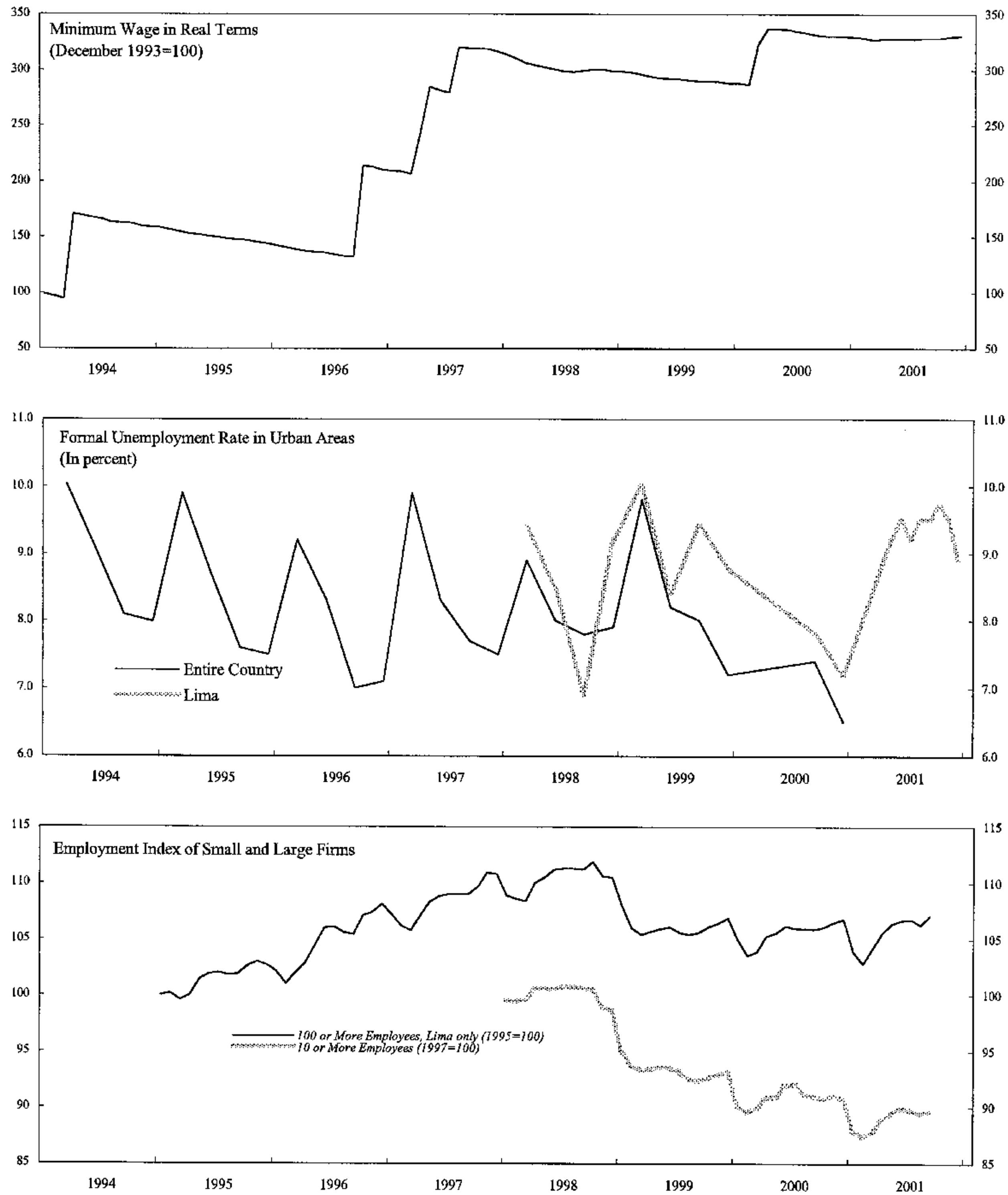
Figure 1. Peru:
Selected Economic Indicators, 1996-2001



Source: Central Reserve Bank of Peru.

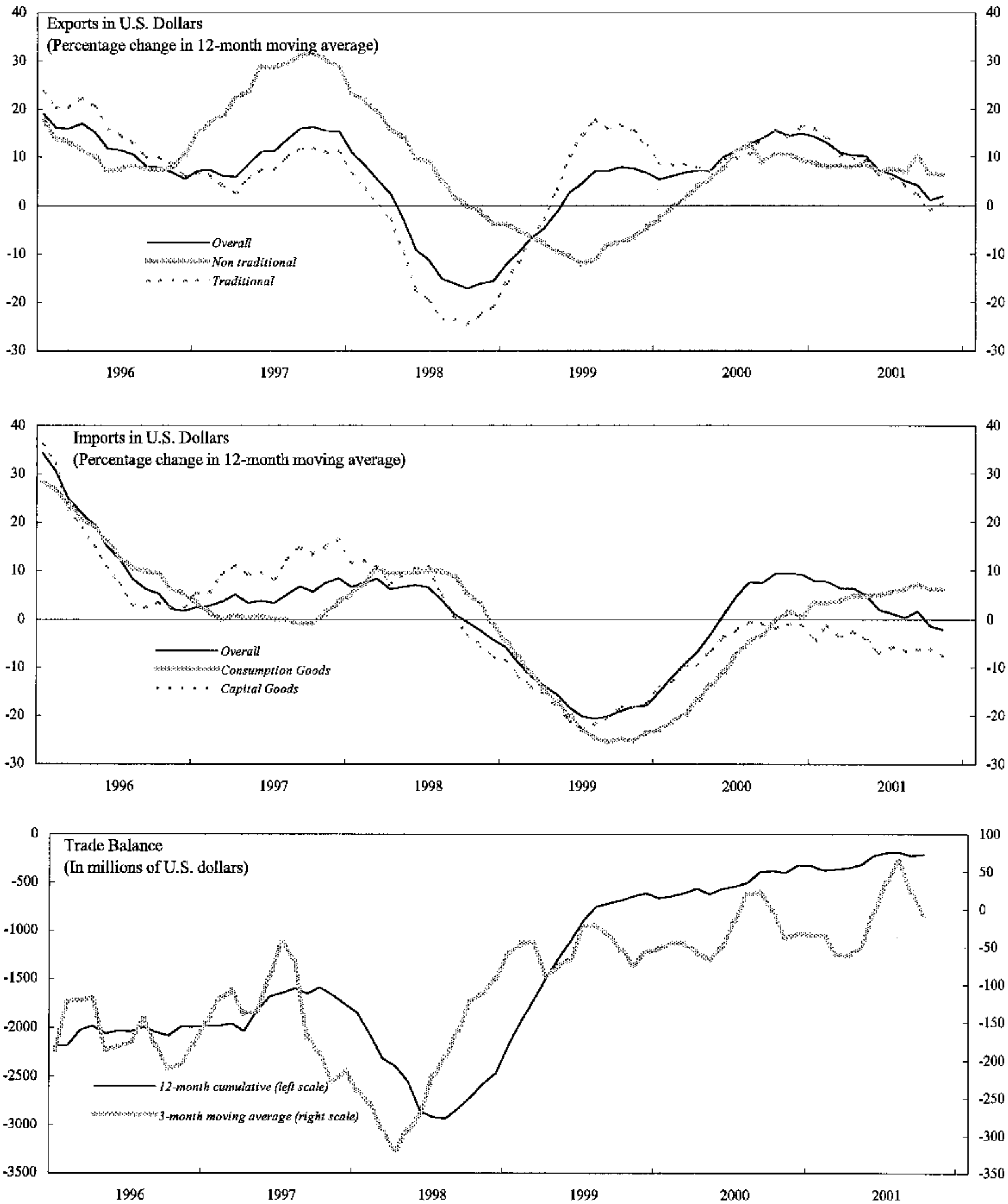
1/ 12-month cumulative.

Figure 2. Peru:
Labor Market Indicators, 1994-2001



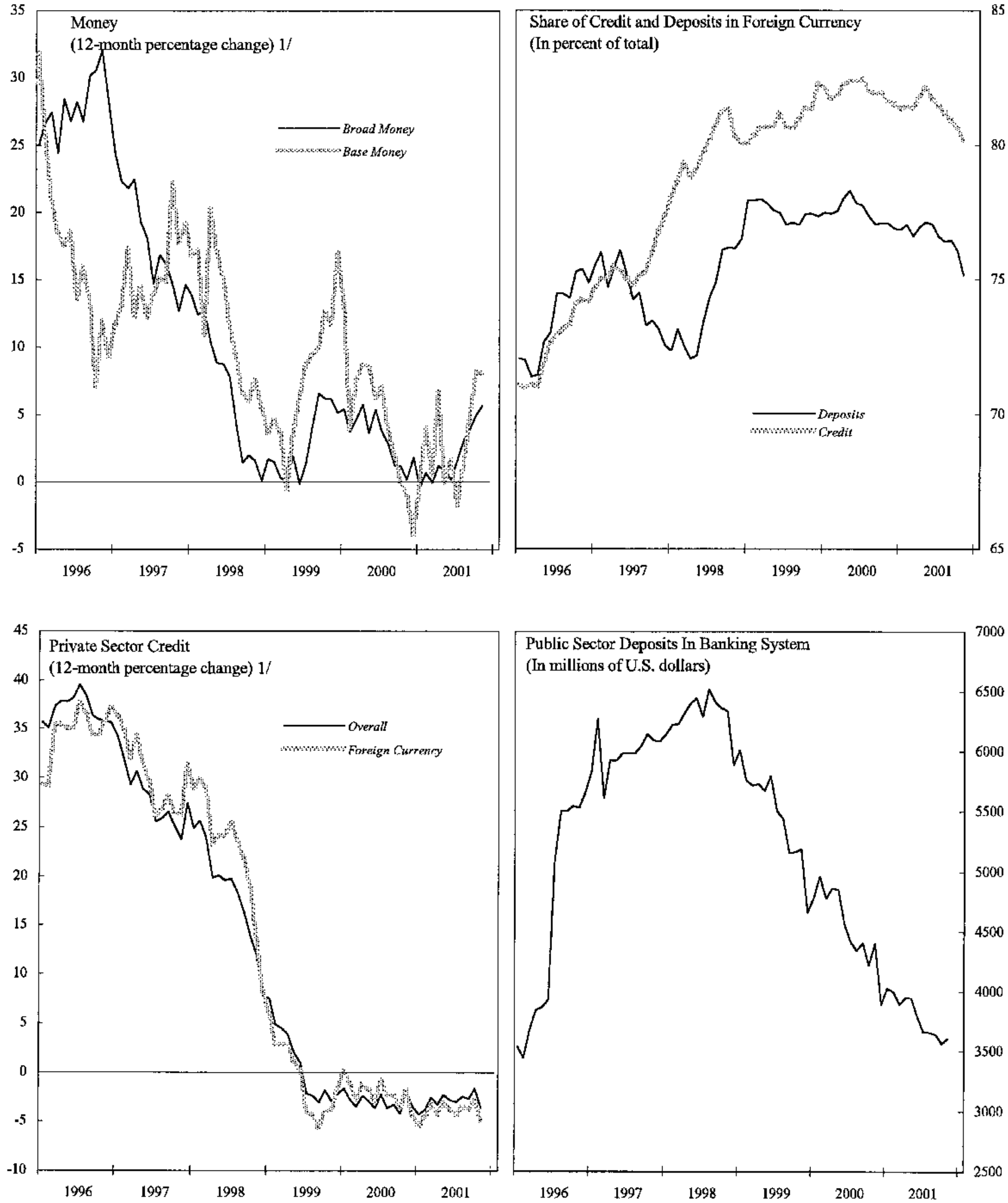
Sources: Ministry of Labor; Central Reserve Bank of Peru; and Fund staff estimates.

Figure 3. Peru:
Trade Indicators, 1996-2001



Source: Central Reserve Bank of Peru.

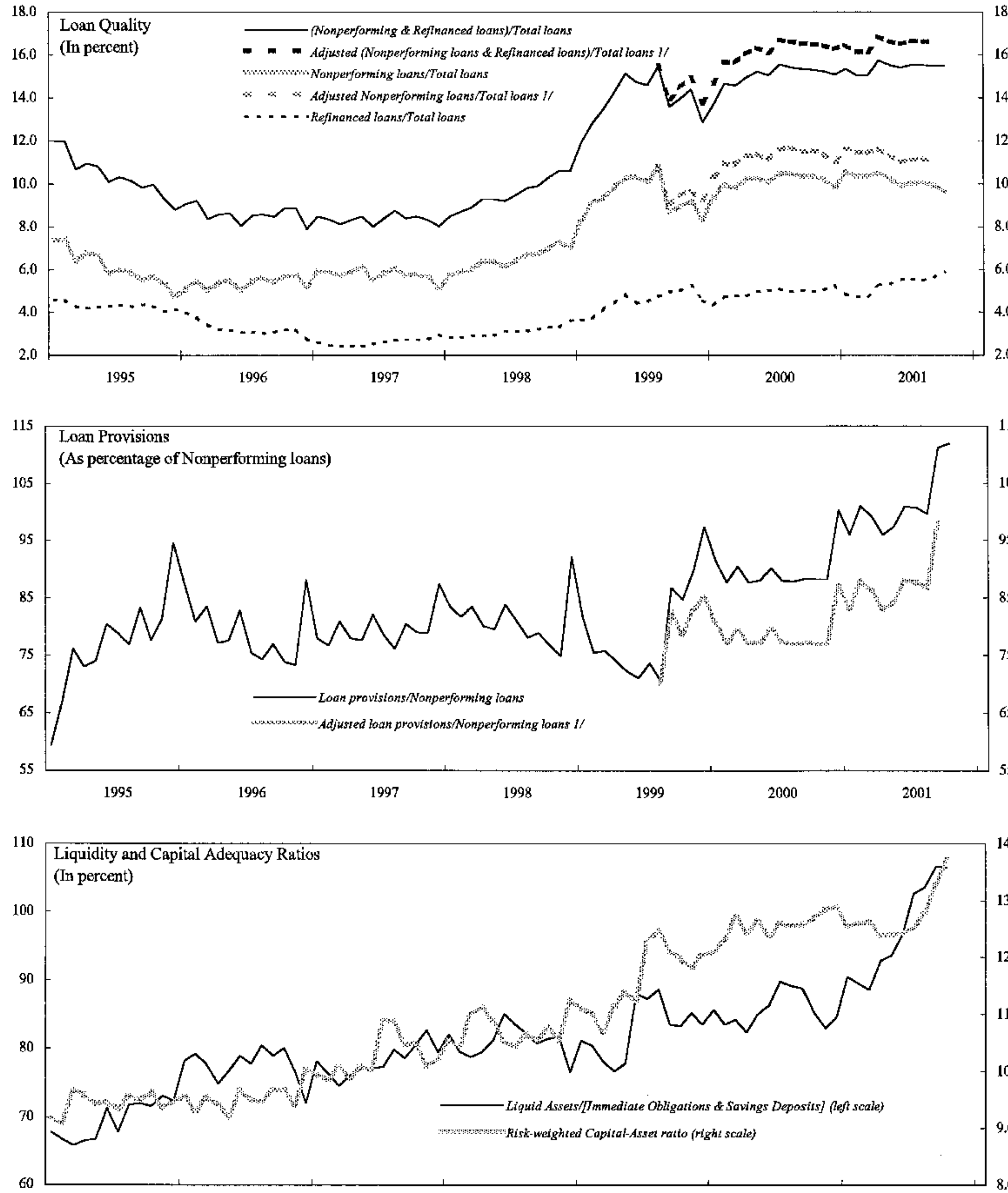
Figure 4. Peru:
Monetary Indicators, 1996-2001



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

1/ U.S. dollar stocks are valued at program exchange rates.

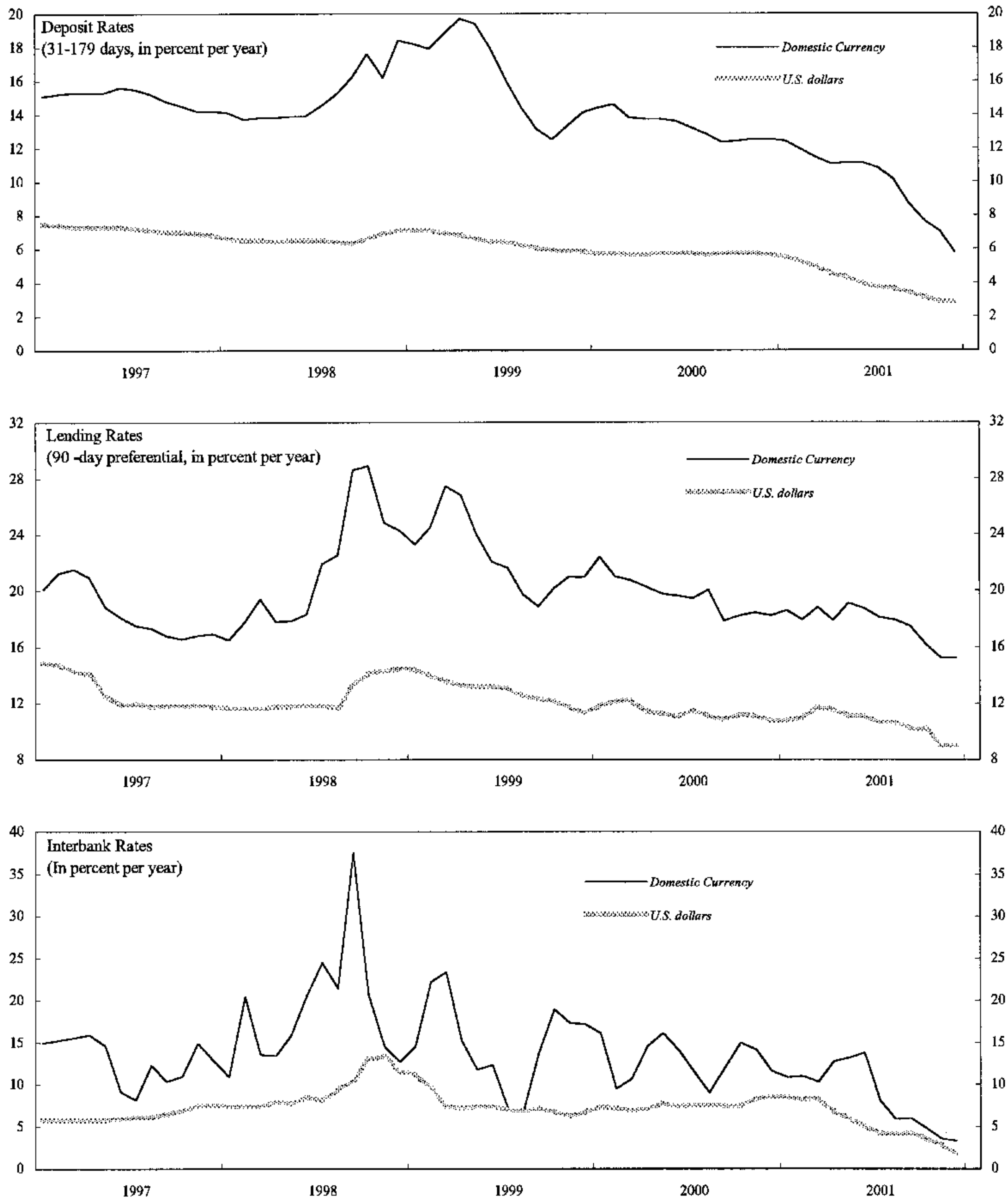
Figure 5. Peru: Banking Indicators, 1995-2001



Source: Superintendency of Banks and Insurance.

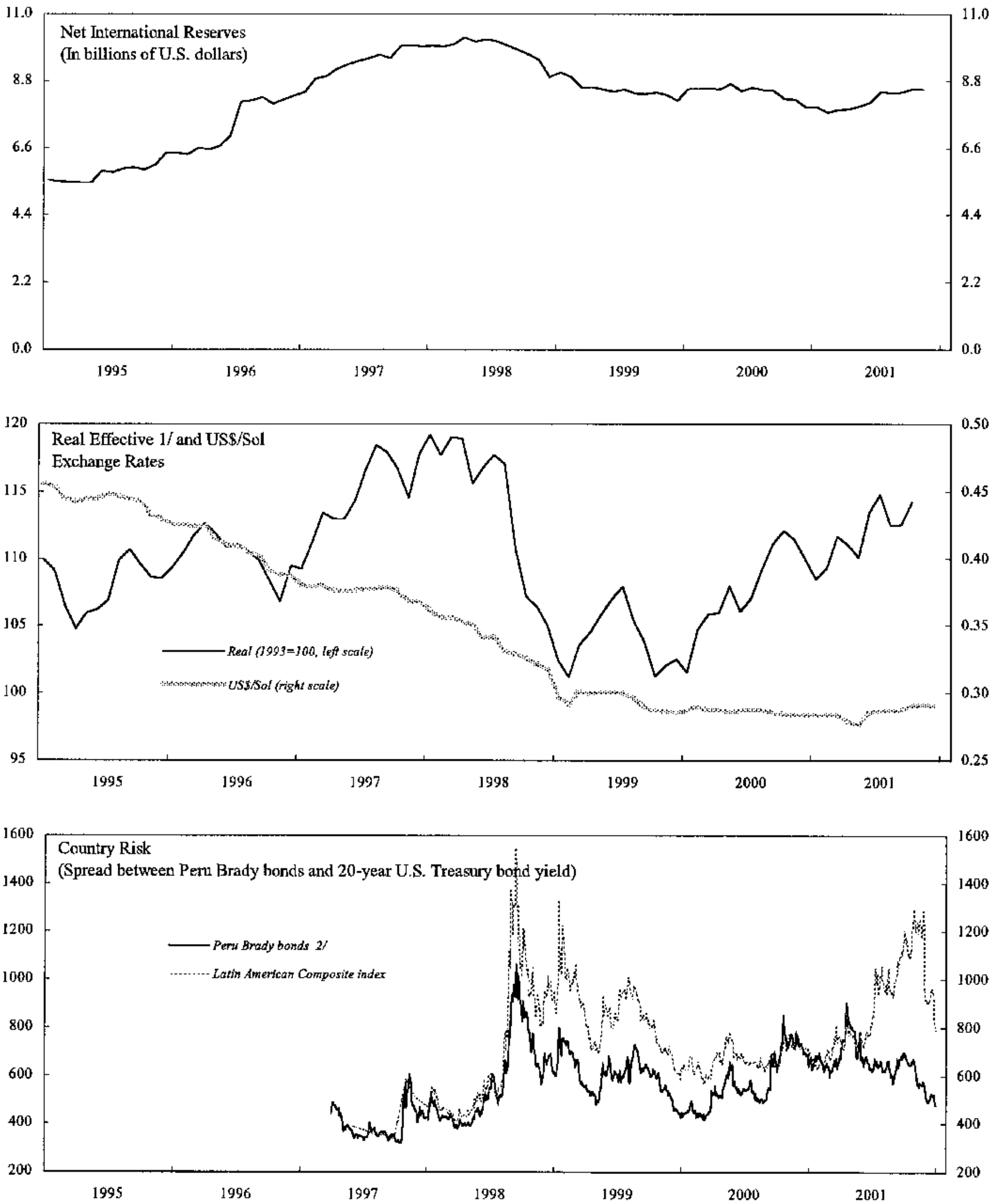
1/ Adjusted for the bond for loan swap programs from August 1999. Staff estimates for January 2001 through August 2001.

Figure 6. Peru:
Interest Rates, 1997-2001



Source: Central Reserve Bank of Peru.

Figure 7. Peru:
External Indicators, 1995-2001



Sources: Central Reserve Bank of Peru; J.P. Morgan; and Fund staff estimates.

1/ Trade weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices. An increase (decrease) indicates appreciation (depreciation).

2/ Peruvian Brady bonds were first issued on March 31, 1997.

Peru: Fund Relations
(As of November 30, 2001)

I. Membership Status: Joined 12/31/1945; accepted Article VIII status on February 15, 1961.

II.	**General Resources Account**	**SDR Million**	**Percent Quota**
	Quota	638.4	100.0
	Fund holdings of currency	946.2	148.2

III.	**SDR Department**	**SDR Million**	**Percent Allocation**
	Net cumulative allocation	91.3	100.0
	Holdings	1.4	1.5

IV.	**Outstanding Purchases and Loans**	**SDR Million**	**Percent Quota**
	Extended arrangements	307.8	48.2

V. Financial Arrangements

Type of Arrangement	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	3/12/01	3/11/02	128.0	0.0
EFF	6/24/99	2/08/01	383.0	0.0
EFF	7/01/96	3/31/99	300.2	160.5
EFF	3/18/93	3/17/96	1,018.1	642.7

VI. Projected Obligations to Fund (SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	11/30/01	2001	2002	2003	2004	2005
Principal	0	0.0	133.9	80.3	26.8	26.8
Charges/interest	0	0.0	9.1	5.5	4.3	3.5
Total	0	0.0	143.0	85.8	31.0	30.3

VII. Safeguard Assessments

Under the Fund's safeguards assessment policy, the Central Reserve Bank of Peru is subject to a full Stage One safeguards assessment with respect to the stand-by arrangement approved on March 12, 2001, which is scheduled to expire on March 11, 2002.

A Stage One safeguards assessment of the Central Reserve Bank of Peru was completed on July 26, 2001. The assessment concluded that a Stage Two (on-site) visit was unnecessary, but identified certain weaknesses (most notably with the bank's implementation of International

Accounting Standards) and provided recommendations to address them. The Central Reserve Bank of Peru is proceeding to implement most of the recommendations.

VIII. Exchange Arrangements

Peru maintains a unified, floating exchange rate. On January 18, 2002, the average of official buying and selling rates was 3.46 new soles per U.S. dollar. The central government maintains external payments arrears. Peru maintains a clearing arrangement with Malaysia.

IX. Last Article IV Consultation

The 2000 Article IV consultation was concluded on March 12, 2001 (EBS/01/25).

X. FSAP Participation

Several joint Fund-Bank missions visited Peru in the period September 2000–January 2001 to conduct an FSAP for Peru. The corresponding FSSA report (SM/01/75 dated February 28, 2001) was discussed by the Executive Board on March 12, 2001.

XI. Technical Assistance

Department	Date	Purpose
FAD	November 1999	Fiscal rules.
	June 2000	Tax policy and administration.
MAE	April 1998	Modernization of the payments system.
	January 2000	Forward foreign exchange markets.
	September, October, November 2000, January 2001	Financial sector assessment.
STA	January 1998 and October 1999	National account statistics, new base year for the national account series.
TRE	March 1999	Central bank accounting.

XII. Resident Representative

Mr. Ricardo Velloso started his assignment as the Fund Resident Representative in Peru in July 2001.

PERU: RELATIONS WITH THE WORLD BANK GROUP

I. Objectives

The last full Country Assistance Strategy (CAS) for Peru was discussed by the Executive Board on July 22, 1997. The overriding objective of the World Bank's assistance program for Peru is to support the government's effort to achieve a sustained, continuous reduction in poverty. The lending program focuses on increasing human capital, developing market-integrating infrastructure, strengthening private property ownership and public institutions, improving the efficiency and targeting of social expenditure programs, and enhancing macroeconomic stability. A Country Assistance Strategy Progress Report (CAS PR) was discussed by the Board on June 19, 2001 as an interim Bank assistance strategy for the next 9 to 12 months, to bridge the transition to a new administration.

II. Lending

Since FY00 was an election year for Peru (presidential and congressional elections in April 2000), the Bank limited the lending program to three operations in the total of US$ 94.6 million, two of which were accelerated and approved in the first half of FY00 at the request of the government. It included an Agricultural Research and Extension Project (APL) of US$ 9.6 million, a Health Sector Reform Program (APL) of US$ 80 million and an Indigenous and Afro-Peruvian Peoples Development Project (LIL) of US$ 5 million. The government requested the Bank to reduce the loan amount of the Health Sector Reform APL from US$ 80 million to US$ 27 million, while preserving the project's key development objectives and components.

The CAS PR of 2001 proposed a lending program for FY 2001–2 of US$ 217 million per year on average, which is slightly above the lending levels in FY 1998–2000, and about one half the lending levels in FY 1995–98. Taking into account the lack of counterpart funds and the political uncertainties at that time, lending in FY 2001 comprised only two operations, totaling US$ 160 million: (i) an investment project—the Rural Roads Rehabilitation II Project (US$ 50 million)—which expands on a previous operation that demonstrated the large positive impact of rural road and bridle path construction (in combination with community and micro-enterprise participation) on rural development and poverty reduction; and (ii) a quick disbursing operation—the first loan under the Programmatic Social Reform Loan (PSRL, US$ 100 million)—which aimed at safeguarding important social programs during the political transition period.

The proposed lending program in the CAS PR for FY 2002 included four operations for a total of US$ 260 million, focusing on social programs and the rehabilitation and maintenance of infrastructure. This program is under discussion with the current administration as part of the preparation of the full CAS. The proposed operations included: (i) the second loan under the PSRL (US$ 100 million), which would focus on institutional reform; (ii) a new project on Rural Education and Human Resources Reform (US$ 30 million), which builds on the findings of an education study and will address the inequality of learning outcomes of rural and urban children; (iii) a Transport Rehabilitation II (US$ 80 million) project, which will be followed by a Lima Urban Transport project in FY 2003; and (iv) a new project for Rural Water and Sanitation (US$

50 million), which will help raise rural water supply coverage to 60 percent by 2005 and will aim at increasing the sustainability of water supply systems by involving communities at every step.

III. Non-lending Services (NLS)

While the transition period was marked by major political uncertainties, significant studies were carried out in FY 2001-2, including work to engage the incoming economic team in a policy dialogue. In FY 2001: (i) the Bank aided in a plan for the first 100 days of the new government, by bringing together a wide-spectrum of Peruvian professionals to design a series of policy papers (Carta de Navegacion); (ii) the Institutional and Governance Review (IGR), which provided a broad overview of Peru's institutional and governance problems, presented a set of policy recommendations on priority institutional reform agenda. The Bank also carried out a country financial accountability assessment and supported an anti-corruption initiative of the transition government, including a survey to assess corruption. For FY 2002, the Bank will undertake: (i) a study on micro-constraints to growth, which will suggest specific measures to facilitate private sector activities; (ii) a review of public expenditures, jointly with the IDB; (iii) work on decentralization, building on the findings of the IGR; and (iv) analytical work on an integrated rural strategy, including issues in labor markets and rural financing. Also, as preparation for the CAS, the Bank is undertaking an assessment of poverty in Peru.

IV. World Bank Technical Assistance (TA)

The Bank has secured a number of grants from Japan, Canada, and other bilateral donors to support project preparation, economic and sector work, supervision, and implementation issues.

Statement of World Bank Loans
(As of December 12, 2001)

Loan Number	Fiscal Year Approved	Borrower	Purpose	In millions of U.S. dollars: Total (net of cancellation)	Undisbursed
eighty (80) loans fully disbursed 1/				3,957.6	
Partially disbursed or undisbursed loans					
38110	1995	Republic of Peru	Lima water rehabilitation and management project (SEDAPAL)	150.0	15.5
46140	2001	Republic of Peru	Second Rural roads rehabilitation and maintenance	50.0	50.0
40760	1997	Republic of Peru	Irrigation rehabilitation	85.0	35.2
41300	1997	Republic of Peru	Sierra national resource management	51.0	8.5
43840	1999	Republic of Peru	Urban property rights	38.0	17.0
45190	2000	Republic of Peru	Agricultural research and extension	9.6	8.0
45360	2000	Republic of Peru	Indigenous people development	5.0	4.7
45270	2000	Republic of Peru	Health reform	27.0	26.7
Total				**4,373.2**	
Of which: amount repaid				1,864.8	
Total outstanding				**2,508.4**	
Total undisbursed					**165.6**

1/ Includes the 1979 program loans (US$115 million), 1992 Financial Sector Adjustment Loan (US$400 million), 1992 Trade Policy Loan (US$300 million), and 1992 Structural Adjustment Loan (US$150 million), 1993 Privatization Adjustment Loan (US$250 million), 1997 Pension Reform Adjustment Loan (US$100 million), 1997 DDSR Loan (US$183 million), and 1999 Financial Sector Adjustment Loan (US$300 million), and 2001 Programmatic Social Reform Loan (US$100 million).

Statement of IFC Investments
(As of July 31, 2001)

In millions of U.S. dollars

	Loans	Equity	Quasi-equity	Participation loans	Total
Total commitments held by IFC	137.34	16.69	28.50	111.12	293.65
Total disbursed	112.53	16.26	28.50	111.12	278.40

Source: World Bank.

PERU: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

I. Background

Since 1991 the Inter-American Development Bank (IDB) has played a major role in supporting economic stabilization, structural reforms, and poverty reduction in Peru. Currently, the Bank is financing programs aimed at reforming public finance management and the country's fiscal institutions, expanding physical infrastructure, modernizing the public sector, reducing poverty, creating the conditions for growth in agriculture, protecting the environment, strengthening the health sector, and improving the quality of secondary education. The Bank is also lending directly to the private sector to build infrastructure projects.

II. Lending

Peru's total outstanding debt with the IDB as of December 11, 2001 amounted to about US$2.8 billion and current commitments (undisbursed balance) amounted to about US$690 million, corresponding to 18 loans currently in execution. The lending program for 2002–3 is currently under discussion with the Peruvian authorities. Tentatively, the lending program will include ten loan operations for an estimated amount of up to US$ 750 million.

III. Recent economic and sector work

A comprehensive review of major economic, social, and institutional issues is being carried out in order to prepare the country paper for Peru, the document that will lay out the Bank's strategy for the 2002–4 period. In addition, a Public Expenditure Review (PER) is also being carried out, as a joint effort with the World Bank.

IV. Nonreimbursable technical cooperation

In the last several years, the IDB has extended a number of grants for institutional building programs through the following institutions: SUNAT (tax administration), SUNAD (customs), FONCODES (social programs), Congress, the Ministry of Finance and the Economy, the Republic's General Comptroller, the Institute for the Defense of Competition and Intellectual Property, municipal savings banks, and financial institutions. Peru has also received grants to establish an environmental authority, for studies on pollution in the Mantaro Valley, and for a number of social programs. In addition, the Bank has provided resources to the Multilateral Investment Fund (MIF) to finance private sector projects.

PERU: FINANCIAL RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

I. IDB Loans By Sector

(In millions of US dollars)

Sector	Commitments	Disbursements	Undisbursed amounts
Agricultural and rural development	418.9	56.5	362.4
Education	187.0	64.1	122.9
Multi sector	380.9	256.4	124.5
Population, health and nutrition	56.8	12.4	44.4
Public sector management	20.7	16.6	4.1
Urban development	252.0	246.1	5.9
Water supply and sewerage	140.0	134.9	5.1
Grand total	**1456.3**	**787.0**	**669.3**

II. IDB Loan Transactions

(In millions of US dollars)

	1997	1998	1999	2000	2001	Total (1997-2001)
a. Disbursements	585.3	287.9	485.5	350.7	372.0	2.081.4
b. Amortization	107.5	106.5	104.2	310.8	62.7	691.7
c. Net disbursements (a-b)	**477.8**	**181.4**	**381.3**	**39.9**	**309.3**	**1.389.3**

Peru: Tax Reform

(In percent of GDP)

Measure	Revenue Impact 2002	Revenue Impact 2003
I. Tax policy	**0.17**	**0.59**
Income		
Introduce an alternative minimum corporate tax		0.40
Narrow allowable deductions under the corporate income tax		0.05
Eliminate special payroll tax (IES)		-0.20
Eliminate exemption for agricultural producers below 50 UIT 1/		0.01
Value added		
Eliminate tax benefits on importation of inputs for agriculture		0.04
Excises		
Reduce the dispersion on alcoholic products	--	--
Eliminate the exemption for automobile imports in Ceticos	0.03	0.03
Increase ad valorem for cigarette from 100 percent to 125 percent	0.01	0.01
Increase fuel excises	0.11	0.11
Eliminate exemption on fuel excise in Amazon region		0.12
Trade		
Eliminate tax benefits on importation of buses and taxis	0.02	0.02
Other		
Inclusion of tax expenditures in the 2003 budget	--	--
Introduce a system of mining royalties		...
Eliminate special regime for domestic producers of machinery and equipment 2/	--	--
II. Tax administration	**0.17**	**0.17**
Implement a system of private-sector collection agents for VAT	0.07	0.07
Introduce mechanisms to avoid refunds to firms with tax debts	0.05	0.05
Implement presumptive methods to audit independent professionals	0.05	0.05
Carry out 17,000 audits of corporations and independent professionals	...	...
Total impact	**0.35**	**0.76**

1/ The UIT (Unidad Impositiva Tributaria) is a tax index unit. For 2002 it is equivalent to S/. 3,100.
2/ To be accompanied by a tariff reduction on capital goods imports.

INTERNATIONAL MONETARY FUND

PERU

Request for a Stand-By Arrangement
Supplementary Information

Prepared by Western Hemisphere and
Policy and Development Review Departments

Approved by Claudio M. Loser and Liam P. Ebrill

January 30, 2002

This supplement updates the information on economic developments and policy announcements presented in the staff report (EBS/02/12).

1. Despite adverse developments in Argentina, financial market indicators in Peru have continued to be stable. Last week, Moody's raised its ratings outlook on foreign-currency ceilings for Peru's sovereign bonds and notes from *negative* to *stable*, and Standard and Poor's raised its outlook on Peru's long-term local and foreign-currency sovereign credit ratings from *stable* to *positive*. Both agencies cited an improved political situation and the authorities' commitment to sound policies and structural reforms.

2. On January 18, congress approved a tax amnesty scheme that would provide substantial tax relief. The scheme permits the rescheduling of tax liabilities incurred through end-2001, reduces penalties charges on these unpaid tax liabilities, sets interest rates on rescheduled tax obligations at subsidized levels, requires no downpayment, and allows the cancellation of the full tax debt with a cash payment of 80 percent. The Ministry of Finance estimates that, if implemented, this program could lead to a loss of revenue of up to 0.3 percent of GDP in 2002, as a result of lower compliance with current and pending tax obligations and lower receipts from previous tax-debt repayment plans. The authorities informed staff that they intend to veto the law and work with congress on a revised scheme that would minimize the cost to the public finances, and stressed that any such cost would be offset through a hike in fuel excises and other measures if necessary. They reiterated their commitment to take any steps that might be needed to achieve the program's objectives.

3. On January 29, and in the context of presenting its monetary program for 2002 to Congress, the central bank announced it had decided to adopt a formal inflation targeting framework, effective immediately. For 2002, the inflation target range would be centered on the inflation rate envisaged in the program of 2.5 percent, with a margin of 1 percentage point on each side of the midpoint. The central bank will abandon base money as its intermediate target, but will continue using banks' deposits in Soles at the central bank as the operational target for monetary policy. To enhance transparency, the bank will issue (in

January, May and September of each year) a comprehensive inflation report that would include a discussion of inflation developments and prospects within a medium-term horizon, and would explain monetary policy decisions. Other elements usually associated with a successful implementation of inflation targeting have been present in Peru for several years, including an independent central bank, a mandate for the central bank to maintain low inflation, the prohibition of central bank lending to the public sector, and a floating exchange rate.

Staff Appraisal

4. Staff strongly supports the authorities' intention to seek a revision of the tax amnesty scheme to minimize its adverse impact on revenue collections. It will be important that the authorities be ready to act promptly in introducing measures to offset the fiscal costs of the scheme that is finally introduced in order to ensure achieving the objectives of the program.

5. Staff is of the view that the announced move to a formal inflation targeting framework is consistent, in general, with the stance of monetary policy envisaged in the program and, more specifically, with the program's monetary projections and inflation target. As the operational target of monetary policy remains unchanged, this move to a formal inflation targeting framework does not represent a marked departure from past practices. Also, staff considers that this strategy would help to further strengthen public confidence in the authorities' commitment to low inflation and enhance transparency in the design and implementation of monetary policy. This said, based on the policy discussions that had been held with the authorities, staff understood that adoption of an inflation targeting framework was not likely to occur so soon. In light of this development, at the time of the first program review the staff will hold detailed discussions with the authorities on the design challenges that they will be facing under the new policy framework.

Statement by the IMF Staff Representative
February 1, 2002

1. This statement provides an update of information that has become available since the release of the staff report and its supplement.

2. The Government of Peru has authorized an issue of up to US$1.5 billion in 10-year Global bonds in international markets, of which up to US$1 billion will be in exchange for existing Brady bonds and US$500 million for cash. The proposed issue will be Peru's first sovereign bond issue since the late 1920s. The operation aims to reestablish Peru's presence in international markets, increase the liquidity of outstanding debt instruments, achieve cash flow savings, and release collateral. The new bond will be offered to investors between January 31, 2002 and February 6, 2002. The actual impact of the operation on Peru's external debt will depend on the terms of the exchange and investor participation rates. Staff will be conducting a thorough assessment of the swap operation once it is completed.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 02/6
FOR IMMEDIATE RELEASE
February 1, 2002

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves Two-Year Stand-By Credit for Peru

The International Monetary Fund (IMF) today approved a two-year stand-by credit for Peru for SDR 255 million (about US$316 million) to support the government's economic program for 2002–2003. The government of Peru will treat the stand-by credit as precautionary and does not intend to make any drawings.

In commenting on the Executive Board discussion, Eduardo Aninat, Deputy Managing Director and Acting Chairman, said:

"The Executive Board welcomed the Peruvian authorities' commitment to maintain macroeconomic stability and pursue a comprehensive structural reform agenda. The successful implementation of the authorities' program should lay the basis for sustained high growth of output and employment and a steady reduction in poverty. The program supported by the Fund should also strengthen public confidence and catalyze financing for the public sector, including adjustment lending by the multilateral institutions.

"The centerpiece of the economic program for 2002–2003 is the implementation of a broad-based tax reform that would improve the neutrality and equity of the tax system through a widening of the tax base. This reform, together with government expenditure restraint, would enable the combined public sector deficit to decline gradually over the program period. Attainment of the program's fiscal targets is critical for achieving the program's objectives of a recovery in economic activity, low inflation, a moderate external current account deficit, and a modest increase in net international reserves. The revision of the Law on Fiscal Transparency and Responsibility will facilitate fiscal policy over the medium term.

"The fiscal adjustment in the first year of the program falls, appropriately, on the side of expenditure restraint, before shifting to the revenue side following the full implementation of the tax reform. Expenditure restraint in 2002 comes mainly from a stricter control of current outlays, and from cuts in the areas of defense and security that in turn would protect spending on priority social programs. In 2003, the tax reform combined with continued improvement in the efficiency of government expenditure—supported by the World Bank, the Inter-American Development Bank, and the Andean Development Corporation—should create room for a moderate increase in wages and pensions.

"The ambitious privatization and concession program should aid in efforts to attract private investment in important infrastructure sectors and provide financing for the fiscal deficits during the program period. To allow for additional spending on infrastructure needs in the country, the fiscal deficit target for 2002 could be increased moderately to the extent that privatization receipts in the year exceed the baseline projection.

"Systemic risk in the financial sector appears to be limited, but the authorities should continue to strengthen oversight of the banking system. This would include granting adequate legal protection to the staff of the Superintendency of Banks (SBS), strengthening bank capital requirements, limiting credit risk, and maintaining the budgetary independence of the SBS.

"The newly-created state-supported financial institution should be operated prudently, with an eye to containing any potential future costs. More broadly, the authorities should guard against committing additional public resources to support specialized regional or sectoral financial institutions," Mr. Aninat said.

ANNEX

Program summary

During 1991–1997, Peru made significant progress in stabilizing the economy and implementing structural reforms that helped boost economic growth. Real GDP growth in the period averaged 5.3 percent a year, inflation was brought down from hyperinflation levels to single digits, and poverty levels fell significantly. Subsequently, performance deteriorated mainly as a result of adverse external shocks and domestic political difficulties. Between 1998 and 2000 economic growth averaged only one percent a year, and unemployment and poverty rose.

The interim government that took office in November 2000 was successful in maintaining a stable macroeconomic situation through the end of its term of office in July 2001, in the context of a program supported by the IMF. Economic activity, however, continued to weaken. The deficit of the combined public sector for 2001, estimated at 2.4 percent of GDP, is above the limit under the Law of Fiscal Transparency and Responsibility, and reflects a shortfall in government revenue. Despite some deterioration in the country's terms of trade, the external current account deficit is estimated to have fallen to 2.1 percent of GDP, owing to the weakness in domestic demand. Adverse developments in other countries in the region had little effect on Peru's financial indicators, which were more influenced by domestic events.

The authorities' program for 2002–2003 seeks to lay the basis for a sustained high expansion of output and employment and a steady reduction in poverty. The program envisages a recovery of output **growth,** which is estimated at zero in 2001, to 3.7 percent in 2002 and 5 percent in 2003 as a result of an improved investment climate, reflecting a more stable political environment, and the authorities' ambitious privatization program.

Annual **inflation** under the program is targeted at 2.5 percent in 2002 and 2 percent in 2003, international reserves are envisaged to increase moderately over the program period. The **external current account deficit** is projected to widen somewhat in 2002–2003, in line with the envisaged recovery in economic activity, but would remain under 3 percent of GDP.

The program seeks an appropriate balance between the need for further fiscal consolidation and the risk of jeopardizing the incipient recovery in economic activity. The combined **public sector deficit** is targeted to decline gradually, to 1.9 percent of GDP in 2002 and 1.4 percent of GDP in 2003. The fiscal target for 2002 would be adjusted upward to the extent that privatization receipts for the year exceed US$700 million (with a maximum adjustment of 0.3 percent of GDP). The reduction of the fiscal deficit in 2002 will come mainly from expenditure restraint, particularly in the areas of defense and national security. For 2003 the fiscal effort would include a significant increase in government revenue and continued expenditure restraint. A key element of the authorities' fiscal program is a comprehensive reform of the tax system to be introduced in 2002, which will include new tax measures and a strengthening of tax administration.

Peru joined the IMF on December 31, 1945, and its current quota[1] is SDR 638.4 million (about US$791 million). Its outstanding use of IMF financing currently totals SDR 307.8 million (about US$381 million).

[1] A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of SDRs.

Peru: Selected Economic Indicators

	1999	2000	Est. 2001	Proj. 2002	Proj. 2003
(Annual percentage change, unless otherwise indicated)					
Real economy					
Real GDP	0.9	3.1	0.0	3.5 - 4.0	5.0
Inflation 1/	3.7	3.7	-0.1	2.5	2.0
Terms of trade	-5.6	-0.4	-2.4	1.3	2.0
Real effective exchange rate (depreciation -) 1/ 2/	-2.4	7.2	3.0	...	...
Nominal exchange rate (in soles per U.S. dollar) 1/	3.51	3.53	3.44	...	...
Money and credit					
Base money	17.0	-4.0	7.9	4.8	5.8
Broad money 3/	4.3	1.7	5.3	4.2	6.1
Credit to private sector 3/	-2.3	-3.6	-1.5	5.4	8.2
(In percent of GDP, unless otherwise indicated)					
Savings and investment					
Gross domestic investment	21.5	20.1	18.4	18.8	19.4
National savings	17.8	17.1	16.3	16.5	16.7
External savings	3.7	3.0	2.1	2.3	2.7
Balance of payments					
Current account	-3.7	-3.0	-2.1	-2.3	-2.7
Capital and financial account	2.2	2.8	2.8	2.5	2.9
Gross official reserves (in months of imports of goods and services) 1/	10.8	10.9	10.6	9.8	9.0
Gross official reserves (in percent of broad money) 1/	68.4	64.0	61.9	60.3	57.5
Public sector					
Combined public sector primary balance 4/	-0.8	-0.9	-0.2	0.1	0.6
Combined public sector overall balance 4/	-3.0	-3.2	-2.4	-1.9	-1.4
Public sector medium- and long-term external debt	38.7	36.5	36.4	34.9	33.2

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

1/ At end of period.
2/ Based on Information Notice System. Data for 2001 correspond to November 2001.
3/ Flows in foreign currency are valued at program exchange rate.
4/ Revenue excludes privatization receipts.

Statement by A. Guillermo Zoccali, Executive Director and Oscar A. Hendrick, Advisor to Executive Director for Peru
February 1, 2002

Key Points

- The resilience of the Peruvian economy has been successfully tested once again.
- Even though Peru faced one of its most severe political crises in recent history, a slowdown of the world economy, lower commodity prices and a weak domestic economic activity, the authorities managed to maintain macroeconomic stability, while attaining a smooth and orderly political transition.
- All quantitative and performance criteria under the previous one-year Stand-by Arrangement, requested by the transition government, were met with ample margins.
- Despite null economic growth in 2001, and the fiscal stimulus provided in the second half of the year, the fiscal deficit was reduced by 0.8 percent of GDP relative to 2000, to 2.4 percent of GDP. It is worth mentioning that the fiscal stance remained contractionary, with a fiscal negative impulse of 0.8 per cent.
- In 2001 inflation was zero, the current account deficit was further reduced, the exchange rate remained relatively stable, international reserves increased up to the equivalent of 10 months of imports, and progress was made on the structural front.
- The new administration of President Toledo, which took office last July, designed a sound macroeconomic program for 2002-03, aimed at setting the basis for a significant reduction of poverty in the medium term.
- The medium-term outlook for the Peruvian economic is positive. The international rating agencies such as Moody's and Standard & Poor's have changed their rating outlook from stable to positive and from negative to stable, respectively. In this context, the government has authorized an issuance of sovereign bonds for up to US$ 1.5 billion, aimed at establishing a benchmark for Peruvian papers and swapping for Peruvian Brady bonds. To further strengthen monetary stability, the Central Bank announced on Tuesday 29 the decision to adopt a formal inflation-targeting scheme.

Introduction

1. At the outset, on behalf of our authorities we would like to express our gratitude to staff for the excellent work done. The report (EBS/02/12) provides a fair and well-balanced description and analysis of recent economic developments and policy discussions. Our authorities are in broad agreement with the staff's assessment and policy recommendations. Therefore, we will focus on a few salient points that merit further emphasis or clarification.

The 2001 Macroeconomic Program

2. We wish to highlight, as indicated in table 2 of the staff report, that ***all end-June 2001 performance criteria under the previous Stand-by Arrangement were observed with ample margin***. This performance was attained despite the difficult economic and political environment faced by the interim government that took office in November 2000, following the removal of the former President by Congress. Notwithstanding a "wait and see" attitude by private investors, progress was also made on the structural front, including the awarding of operating concessions for the Camisea natural gas project (representing some US$ 3.0 billion in FDI over the next few years), the Lima airport (US$ 1.2 billion); and the divestiture of an electricity company. Additionally, fiscal transparency was substantially enhanced by establishing a hyperlink to the Integrated System of Financial Administration (SIAF), which consolidates the budget management, accounting, and treasury operations of the Government.

3. In the first half of 2001, real GDP fell by 1.6 percent (year-on-year), domestic demand weakened further, commodity prices continued to fall and clear signs of the slowdown of the world economy became apparent. Against this background, the new administration, which took office at end-July 2001, changed the macroeconomic policy mix. The shift to a more expansionary fiscal stance was aimed at providing some stimulus to the economy in the context of a somewhat less restrictive monetary policy given the declining inflation. The authorities also took measures to improve the medium-term fiscal outlook. These included an increase in personal and corporate income tax rates and the reversal of some revenue-reducing measures implemented by the previous administration.

4. The authorities' commitment to fiscal discipline was also reflected in the revision of the 2002 Budget submitted to Congress at end-2001, which contains a 14 percent reduction in real terms in defense expenditure, a cut in non-priority capital expenditure, and an important increase in education and health expenditure to improve the quality of the social safety net. The new monetary authorities maintained the floating exchange rate system and reaffirmed their commitment to prudent monetary policy with the aim of safeguarding price stability and a high level of international reserves.

5. Overall, macroeconomic performance in 2001 was satisfactory. The scenario was very different from that envisaged in the Stand-by Arrangement, with two different administrations, difficult political conditions, null economic growth and a more adverse external environment. However, the authorities succeeded in reducing the fiscal deficit by 0.8 percent of GDP, and net international reserves remained at a very comfortable level, equivalent to about 10 months of imports of goods and services and to 1.5 times the external debt obligations maturing in the following year. In addition, despite the deterioration in the terms of trade, the external current account deficit narrowed at a faster rate than envisaged in the program. This was partially explained by the weakness in domestic demand, but was also accompanied by a 7.9 percent growth in the volume of exports, as indicated in table 8 of the staff report. FDI —excluding privatization proceeds— and medium- and long-term private flows financed about 80 percent of the current account deficit in 2001. The exchange rate

remained relatively stable and end-year inflation was approximately zero. The challenges ahead are to preserve the hard-won gains and to revitalize the economy to provide much needed employment and reduce poverty in the medium term.

Recent Economic Developments and Policy Issues

6. The resilience of the Peruvian economy is not only rooted in its strong economic fundamentals, but also in the ability of the institutional framework to operate under conditions of severe strain. In only 12 months, Peru has gone through two general election processes, both with run-off elections, and a transitional government in between. This resilience has been acknowledged by the international capital markets, as reflected in a lower spread on Peruvian Brady Bonds at end-2001, and in the stable credit rating by international rating agencies, like Standard & Poor's and Moody's during 2001.

7. Moreover, both agencies recently visited Peru and changed their rating outlook from stable to positive and from negative to stable, respectively. The authorities' renewed commitment to sound macroeconomic policies, and their request for a new Stand-by Arrangement with the Fund in support of their program, provides reassurances to the international financial community about the willingness to preserve the hard-won gains of the last decade. Interest rates in domestic and foreign currency are steadily decreasing, and the country risk, measured by the spread on the Brady Bonds, on January 22 was 470 basis points, or 50 basis points lower that at end-2001. Early economic activity indicators such as cement sales, electricity consumption and retail sales in December 2001/January 2002 point to an incipient recovery of economic activity.

8. Under this improved outlook, and to lock into current low international interest rates, the government has authorized an issuance of sovereign bonds for up to US$ 500 million. This is intended to serve as a benchmark for the private sector, to improve the profile of external debt service, and to help reduce the country risk premium. In addition, there will be an issuance of bonds for up to US$ 1 billion, to be swapped for Peruvian Brady Bonds. It is worth underscoring that Peru has not issued sovereign bonds since 1928.

9. Political stability facilitates good governance and to that end, a working coalition in Congress is expected to facilitate passage of pending reforms. In this regard, even though the Executive Branch lacks a majority in Congress, there seems to be general agreement on the need to proceed with market-oriented policies as the best way to sustain economic growth and address the pressing social needs.

10. Although macroeconomic performance is solid, our authorities are aware of the risks associated with a tense social situation. Despite steady implementation of stabilization and structural reform policies under Fund-supported programs over the last ten years, the most vulnerable segments of society still do not see a substantial improvement in their living standards. Consequently, the current administration faces daunting pressures to create employment, reduce poverty and increase social spending. The economic model is also

under scrutiny, pointing the importance of being able to maintain a pragmatic and flexible approach to preserve public support for a market-oriented economy.

The Economic Program of the New Administration

11. The government's strategy for 2002-2003 aims at creating the conditions for a rapid recovery of the economy, while laying the basis for sustainable high growth over the medium term. Employment creation and poverty reduction are the authorities' highest priorities, in a framework where the private sector continues to drive the process of economic growth, while the government focuses its scarce resources on providing basic services and on improving the quality of public expenditure, particularly in the health and education sectors, which have the highest rate of social return. To that end, our authorities are committed to completing pending structural reforms and to take any necessary actions to attain the objectives of the program described in the LOI.

12. The requested twenty-five month Stand-by Arrangement is seen as providing the framework for macroeconomic stability and a clear signal to the markets regarding the new administration's commitment to sound policies. In the current circumstances, the program for 2002-03 is based on an expected recovery of real GDP growth to between 3.5 - 4.0 percent in 2002 and around 5.0 percent in 2003. Owing to the pickup in economic activity, the 12-month rate of inflation is envisaged at 2.5 percent in 2002 and 2.0 percent in 2003, the current account deficit is expected to temporarily widen in 2002-03, but stay below 3 percent of GDP, and the comfortable level of international reserves should continue to increase over the program period.

Fiscal Policy, Tax and Pension Reform

13. The combined public sector deficit is targeted to fall to 1.9 percent of GDP in 2002 and to 1.4 percent in 2003. Thereafter, our authorities intend to maintain a fiscal deficit of around 1 percent of GDP, which would allow for a significant reduction of the public sector debt-to-GDP ratio, as shown in the medium-term outlook table of the staff report. These levels are consistent with the availability of multilateral and bilateral funding, receipts from privatization, and a limited placement of government debt in the domestic market. The privatization schedule for 2002 agreed in the arrangement with the Fund, expected to generate about US$ 700 million, are considered, in our authorities' view, a minimum. In order to increase capital expenditure, mainly in infrastructure projects aimed at providing additional economic impulse and contributing to the creation of new employment, they are confident that privatization receipts will be larger than envisaged in the program.

14. To achieve the fiscal targets under the program, the government is committed, on the expenditure side, to reducing real spending on defense and national security by around 14 percent. With the latter, Peru would be helping to lead a coordinated reduction in military outlays in the Latin American region. In addition, to improve the quality and composition of social expenditure, the government is receiving technical assistance from the World Bank, the IADB and the Andean Development Corporation (CAF) to formulate a program for the

decentralization of government services and the reform of the public education system. As importantly, to mitigate procyclical rigidities, the Law on Fiscal Transparency and Responsibility is being revised, with support from the IADB, to include a transitional period for reaching medium-term balance. Additionally, the revision would give consideration to actions to be taken in periods of cyclical expansion, when fiscal discipline begins to wane. Revised draft legislation is expected to be submitted to Congress before mid-2002, as indicated in table 2 of the LOI.

15. On the revenue side, in addition to the measures already taken by the new administration in the second half of 2001, our authorities are working on a comprehensive tax reform to be introduced in 2002, with the aim of increasing revenue and improving equity through a widening of the tax base. These measures are described in detail in the LOI, and would produce a full year revenue effect of around 0.8 percent of GDP, as reflected in Appendix IV of the staff report.

16. To further improve the longer-term outlook of the public finances and reduce current inequities, at end-2001 Congress also passed government-sponsored legislation to reform the public and private pension systems. The first phase of this reform is intended to reduce the unfunded pension liabilities under the pay-as-you-go system by 7.5 percent of GDP according to preliminary estimates. This reform includes the equalization of benefits across pension systems, a new minimum pension in the public system —that is currently well below the cost of the standard family consumption basket— and a minimum pension in the private pension system. These changes are expected to have a significant positive impact on the lowest wage earners, and on the development of the domestic capital market.

17. Our authorities would like to stress that they stand ready to take any measures needed to fulfill their fiscal program objectives, including the Presidential veto, should attainment of program objectives be put at risk.

Monetary Policy and the Banking System

18. Monetary policy led to international inflation levels and a relatively stable exchange rate. To further strengthen monetary stability, and to build on low inflation, a consistent fiscal framework, and institutional credibility, the Central Bank announced on Tuesday 29, the decision to adopt a formal inflation-targeting scheme, which would be guided by a wide set of indicators including: (i) polls about inflation expectations, (ii) the increase in monetary aggregates, (iii) the evolution of economic activity and (iv) the behavior of forward exchange rates.

19. The floating exchange rate system that has served Peru well in helping the economy to adapt to terms-of-trade and other external shocks will be maintained. The credibility of the Central Reserve Bank has contributed significantly to the resilience and stability of the Peruvian economy. Despite domestic difficulties and turmoil in regional financial markets, the real exchange rate appreciated by 3 percent at end-November 2001. The Central Bank's

foreign exchange position remained strong at about US$ 3 billion, while the net international reserves as of January 22 amounted to US$ 9.1 billion.

20. Financial stability has contributed to a steady reduction in deposit, lending and interbank interest rates, both in domestic and foreign currency, as clearly shown in figure 6 of the staff report, and to the deepening of the financial markets. In this regard, in addition to Central Bank open market instruments, the Treasury has established a periodic auction of domestic-currency bonds that has broadened the choice of investment instruments for domestic capital market participants and has lowered Treasury exposure to exchange risk.

21. As discussed in the previous Board meeting, the FSAP mission that visited Peru in late 2000 and early 2001, concluded that the current strategy for the banking system was broadly appropriate, that systemic risk is limited and that international standards and best practices are generally being observed. At end-2001, the banking system remains sound, despite the weak economic activity and domestic demand. Non-performing loans (NPLs) remain stable at around 11 percent of total loans. Loan provisions as percentage of NPLs have, nevertheless, increased substantially from 78.5 percent in 2000 to 98.1 percent in 2001, while the risk-based capital-assets ratio strengthened from 12.9 to 13.7 percent in the same period, as shown in table 3 of the staff report. The Superintendence of Banks (SBS) has reaffirmed its efforts to strengthen supervisory capacity by first submitting legislation to Congress to provide statutory protection to SBS staff in the discharge of their duties, and to proceed with legislation to address cases of persistent bank liquidity problems.

22. Regarding the recently created agrarian bank, the Banco de la Nacion temporary consumer-lending program, and the planned mortgage security insurance program, suffice it to note that avoidance of moral hazards and contingent fiscal liabilities has been paramount and, in general, that the actions taken have sought to ensure that these programs fulfill their objectives in an efficient way.

Concluding remarks

23. Peru's strong economic fundamentals and a solid track record of policy performance are the bases for the favorable medium-term outlook of the economy. Staff projections suggest limited external vulnerability over the medium term. Similarly, the sensitivity analysis provided on the basis of lower prices for the main export commodities and lower rates of economic growth over the next decade, shows that the Peruvian economy can deal with a variety of negative external and domestic shocks. The approval of the requested precautionary Stand-by Arrangement by the Executive Board will be key to help Peru move closer to its potential for higher non-inflationary sustained economic growth, and hence to successfully reduce poverty over time.