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

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

- the staff paper for the third review under the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **September 5, 2003,** 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 October 17, 2003**. 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 **October 29, 2003** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its November 3, 2003 discussion** of the staff report that completed the review.

- a statement by the Executive Director for Peru.

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.

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INTERNATIONAL MONETARY FUND

PERU

Third Review Under the Stand-By Arrangement

Prepared by Western Hemisphere Department
(In collaboration with other departments)

Approved by Markus Rodlauer and Juha Kähkönen

October 17, 2003

Stand-By Arrangement. A two-year arrangement for SDR 255 million (20 percent of quota on an annual basis) was approved on February 1, 2002; the authorities are treating the arrangement as precautionary. The second program review was completed on March 28, 2003. SDR 199.25 million will become available upon completion of the third review and observance of end-September performance criteria, which will be reported in a supplement to the staff report (along with a proposed decision) prior to the Board meeting. The fourth, and last, review is to be completed by February 27, 2004.

Economic Developments. Robust growth continues, inflation remains low, and the external position is strong. Financial and banking indicators have improved, with increased demand for local-currency assets. Wage increases granted after a series of public-sector strikes have been compensated by tax increases and spending cuts.

Review. Discussions focused on the outlook for continuing gradual fiscal consolidation, implementation of key structural reforms on fiscal decentralization and taxation, and monetary policy management. Congress approved legislation delegating power to the executive branch to carry out a comprehensive tax reform and enact legislation on fiscal decentralization. Since performance has been good and no changes have been made to the program, there is no updated letter of intent at this review.

Program Status. The macroframework is on track, and all structural benchmarks under the program but one have been carried out. In particular, fiscal rules have been revised and legislation has been sent to congress on: (i) fiscal decentralization; (ii) a timetable for the phasing out of regional and sectoral tax exemptions; and (iii) a draft 2004 budget consistent with decentralization and tax reform. A draft law giving legal protection to bank supervisors has yet to be passed.

Mission. Discussions took place in Lima during August 20–September 3. The mission met with Finance Minister Quijandría, Central Bank President Silva Ruete and other senior officials. The team comprised Andrew Wolfe (Head), Marco Rodríguez, Delia Velculescu, and Mauricio Villafuerte (all WHD); Teresa Dabán (FAD), Christian Keller (PDR), Andrei Kirilenko (ICM), and Jorge Guzmán (Senior Resident Representative). Markus Rodlauer (WHD) and Carlos Pereyra (OED) attended the final meetings. Subsequent to the mission, an FAD technical assistance mission visited Lima in mid-September to advise on tax reform, and Deputy Managing Director, Mr. Carstens, visited Lima in mid-October.

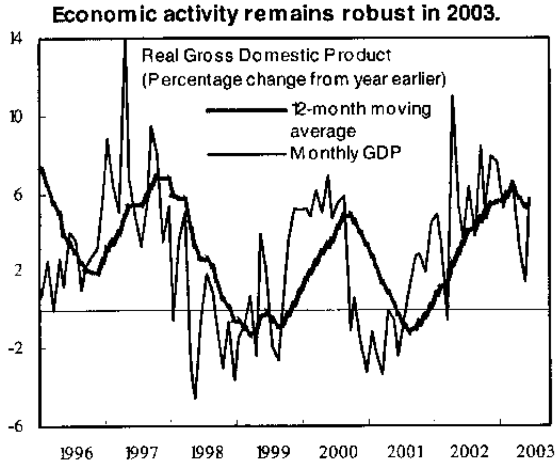
Contents | Page

I. Background

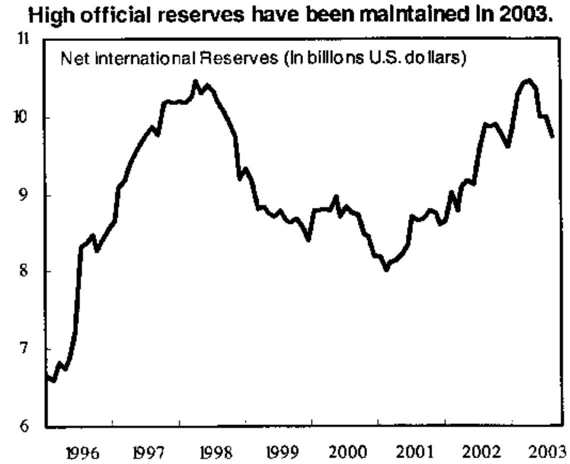
1. **The Peruvian economy has weathered regional turbulence well and continues to perform solidly in 2003.**

- Economic activity expanded by over 4 percent (y/y) in the first eight months of 2003, led by exports and private investment; however, employment has risen only moderately.
- Inflation was 2 percent in September (y/y) and trending downward, within the central bank's target range of 1.5–3.5 percent.
- The external current account has been in line with program projections (a deficit of 1.9 percent of GDP in 2003). Private capital inflows (including errors and omissions) have resulted in a modest increase of official reserves.

Economic activity remains robust in 2003.



High official reserves have been maintained in 2003.



Selected Economic Indicators, 2001-03

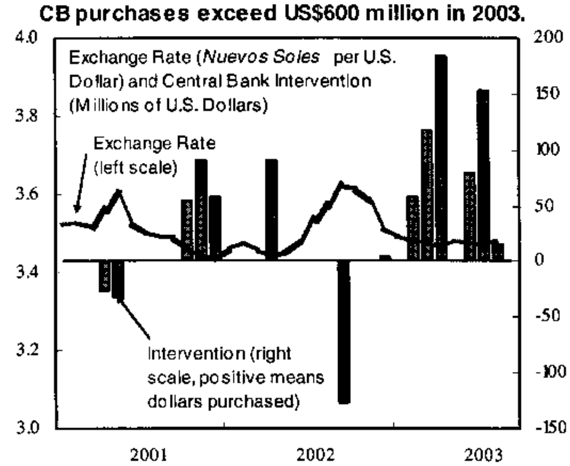
			2003	
	2001	2002	Q1	Q2
(Percent change from equivalent period of previous year; unless otherwise indicated)				
Real GDP	0.6	5.3	5.8	3.4
Real domestic demand	-0.1	4.7	5.8	2.4
Exports (contribution to growth)	1.1	1.1	1.2	1.2
Export volume	5.9	5.0	17.2	7.5
Import volume	1.3	1.0	12.6	1.5
Consumer Price Index (average)	2.0	0.2	2.8	2.4
Current account balance (percentage of GDP)	-2.2	-2.1	-3.2	-1.1

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

2. **Financial and banking indicators have strengthened further.**

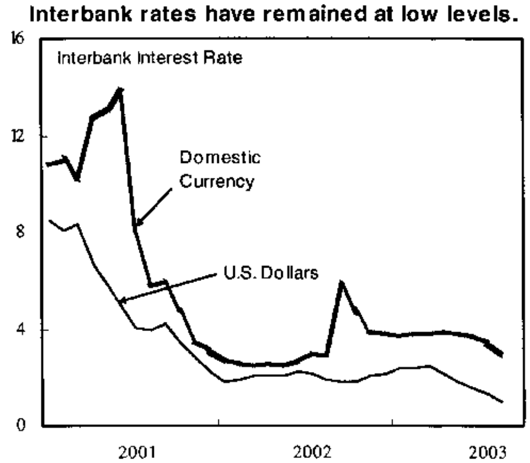
- **Domestic capital markets.** Bond and stock markets have performed well in 2003, including the market for local-currency government bonds. Monthly auctions in this market have been oversubscribed and interest rates have remained low reflecting favorable inflation and exchange rate expectations.

CB purchases exceed US$600 million in 2003.



- **Money and credit.** There has been a modest shift in the composition of broad money and credit toward the local currency in 2003, with broad money growing moderately. Bank credit for housing and consumer lending has picked up significantly this year, but lending to businesses has remained stagnant as firms have opted to finance their operations through bond placements and use of higher retained earnings. Overall, credit has remained below programmed levels.

Interbank rates have remained at low levels.



- **Banking sector indicators.** Most prudential indicators have improved, including for the third-largest bank, which had come under pressure in late 2002. The bank's foreign owners have made substantial capital injections, reaffirming their commitment to the bank. The lack of credit growth, however, is resulting in relatively low rates of bank profitability.

3. **Macroeconomic policies have been in line with the program.**[1]

- **Fiscal policy.** The combined public sector deficit in the first half of 2003 was 1 percent of GDP, consistent with the program target through June of 1.3 percent of GDP. Financing for the year has been secured, with lower-than-programmed privatization receipts being offset by increased debt placements in the local market

[1] All end-June performance criteria were observed, and staff will provide an update on end-September performance prior to the Board meeting.

and use of public sector deposits.[2] In June-July, measures were approved to cover the cost of public-sector wage settlements and increased security outlays (equivalent to 0.6 percent of GDP on an annual basis) for this year and next.[3]

- **Monetary and exchange rate policies**. Monetary conditions have been eased moderately this year, consistent with the inflation targeting framework. In response to pressures for the *Nuevo Sol* to appreciate, the central bank at first intervened significantly in the foreign exchange market, but then gradually lowered interest rates as inflation moved below the mid-point of the inflation target band. As a result, upward pressure on the *Nuevo Sol* has eased somewhat in recent weeks.

4. **Progress has been made on structural reforms.**

- **Tax reform**. A draft law has been submitted to congress to begin phasing out regional and sectoral tax exemptions in 2003 and 2004 (a key element of tax reform in Peru), in line with the program. In late September, congress approved legislation granting the executive branch 90 days to enact a comprehensive tax reform (paragraph 13).

- **Fiscal decentralization**. An appropriate framework law on decentralization has been approved by congress, establishing a timetable for expenditure devolution and subnational fiscal rules. The recent delegation of legislative authority on tax reform also grants the executive branch the authority to enact two important laws on specific aspects of fiscal decentralization, which include a cautious revenue transfer plan, monitoring and reporting requirements on subnational government operations, and regulations on the allocation and monitoring of disbursements from special funds for infrastructure and social programs. The authorities intend to enact the laws by year's end.

- **Fiscal rules**. Revised rules on fiscal responsibility and transparency have been implemented, in line with FAD recommendations.

- **2004 budget**. The draft budget submitted to congress is consistent with the framework for decentralization; it will likely be revised in light of congress' approving the executive branch's request for legislative authority on tax reform.

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[2] Strong public opposition to the privatization program led to its reorientation toward operating concessions in mid–2002.

[3] The value-added tax rate was raised by one-percentage point to 19 percent (through end–2004); some excise taxes were increased; and spending was reduced by cutting wages for high-income civil servants—including the President—and restricting goods and services purchases (with key social programs remaining protected).

- **Bank supervision**. The regulatory environment for banks continues to be strengthened.[4] However, draft legislation to grant legal protection to bank supervisors in the discharge of their responsibilities (submitted last November) has not yet been approved by congress.

II. Outlook and Vulnerabilities

5. **The near-term outlook is for continued economic growth, low inflation, and a robust external position**. The main macroeconomic projections for 2003–04 are as follows:

Near-Term Macroeconomic Framework

	2003 (program)	2003 (projection)	2004 (projection)
Real GDP Growth (in percent)	4.0	4.0	4.0
End-of-period inflation (in percent)	2.5	1.5	2.5
External current account deficit (in percent of GDP)	1.9	2.0	1.9
Overall fiscal deficit (in percent of GDP)	1.9	1.9	1.4
Primary fiscal balance (in percent of GDP)	0.2	0.1	0.7
NIR accumulation (in millions of US$)	40	350	100
Gross official reserve coverage of:			
U.S. dollar deposits in the banking system	100.1	104.1	103.0
Short-term external debt	198.2	215.5	211.8
Public sector debt-to-GDP (in percent)	45.6	45.6	45.1

6. **There are important economic vulnerabilities, but these are cushioned by solid buffers**. Key economic vulnerabilities in Peru include the high level of dollarization in the banking system and the relatively high public debt. However, vulnerability indicators have improved somewhat over the last few years, with substantial buffers in the form of high official reserves, a well-capitalized banking system, a flexible exchange rate system, diversified trade links, limited dependence on international capital markets, and a moderate debt service burden reflecting the large proportion of public debt owed to official creditors (71 percent).

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[4] In 2003, the Superintendency of Banks (SBS): (i) consolidated and rationalized norms on provisioning and loan classification, incorporating borrowers' currency mismatches as explicit criteria for these purposes; (ii) introduced the use of Value at Risk models for the measurement of exchange rate risk in financial institutions; and (iii) submitted legislation to congress to implement FSAP recommendations on credit exposure limits and the definition and measurement of capital.

Vulnerability Indicators, 2000–2004
(In percent; unless otherwise indicated)

	2000	2001	2002	Proj. 2003	Proj. 2004
Public sector debt (percent of GDP)	45.9	46.2	46.7	45.6	45.1
Of which: in domestic currency (percent of GDP)	5.9	6.8	6.9	6.8	6.7
Share of foreign currency deposits in total deposits	76.9	74.3	73.2	70.7	...
Share of foreign currency loans in total credit	81.5	80.3	78.9	77.2	...
Total external debt (percent of GDP)	52.3	50.3	49.0	47.2	47.1
Total external debt (percent of exports of goods and services)	327.1	319.3	302.9	280.9	270.0
Total debt service (percent of exports of goods and services)	44.2	35.0	35.0	31.6	32.9
Gross official reserves					
in percent of short-term external debt (residual maturity basis)	155.6	147.2	217.2	215.5	211.8
in percent of foreign currency deposits at banks	92.5	93.5	101.3	104.1	103.0
Risk-based capital asset ratio (in percent)	12.9	13.4	12.7	13.0 1/	...

Sources: Central Reserve Bank of Peru; and Fund staff estimates.
1/ As of July 2003, month of latest observation.

7. **The political situation poses an important risk to the program, but the government has been able to move forward with its economic agenda** (Box 1). In June, Ms. Beatriz Merino, an independent politician and former head of the tax agency, was appointed prime minister, as part of a cabinet reshuffle aimed at improving the administration's ability to move its agenda in congress.[5] The direction of economic policy has remained largely unchanged, and the government has been able recently to win important support in congress for its tax and pension reform initiatives. Nonetheless, it remains to be seen if the government can sustain such support in the face of the President's continued low approval ratings, the lack of a stable majority in congress, and pressures to raise government spending (especially from regions). These pressures could undermine the government's objectives of steady fiscal consolidation, including a cautious decentralization process.

8. **The uncertain political environment could dampen investment and growth prospects over the medium-term, especially in the run up to the national elections in early 2006.** Baseline medium-term growth is projected at 4 percent,[6] with low inflation and a continued strong official reserve position. This growth path projected by the staff is slightly

[5] In August, Finance Minister Silva Ruete was appointed central bank president (replacing Mr. Webb, who resigned in July), and former Minister of Mining and Energy, Mr. Jaime Quijandría, was named Minister of Finance.

[6] Growth would peak at 4.5 percent in 2005 due to the impact of the large *Camisea* natural gas project, which is on schedule for completion by that year.

lower than that in the previous review, as the political situation is likely to remain difficult, potentially dampening prospects for continued robust investment growth.[7]

9. **Peru's medium-term debt dynamics are sustainable and fairly resilient to possible shocks, although the government's ability to run countercyclical fiscal policy will remain limited until the level of public debt is brought down.** Appendix I presents the standard debt sustainability analysis (DSA), together with two additional simulations that include partial adjustments in key macroeconomic variables in response to relevant shocks for Peru.[8] The analysis shows that, assuming continued maintenance of prudent macroeconomic policies, the outlook for external and public sector debt is quite robust; however, concerns could arise should a permanent economic slowdown be accompanied by higher and persistent fiscal deficits.

III. Policy Discussions

10. **Overall aims.** The 2003 program aims at keeping inflation low, promoting growth, and reducing economic vulnerabilities. Discussions focused on the outlook for continuing fiscal consolidation through key reforms on fiscal decentralization and taxation, monetary policy, bank supervision, and debt management.

A. Fiscal Policy

11. **The authorities remain committed to the goal of declining deficits under their fiscal consolidation plan.** The combined public sector (CPS) deficit is projected at 1.9 percent of GDP in 2003 and 1.4 percent of GDP in 2004, consistent with the limits established under the recently revised law on fiscal responsibility and transparency (LFRT, described in EBS/03/34). The reduction in the deficit envisaged in the 2004 budget recently submitted to congress reflects a ½-percent-of-GDP improvement in the primary balance

[7] An additional downside risk over the medium term is the likely increase in competition in global textile markets beginning in 2005; lately, this sector has been one of Peru's most dynamic. On the other hand, there are upside risks arising from the authorities' interest in pursuing a free-trade agreement with the United States and the development of a large gas export project.

[8] The shocks include an exchange rate depreciation similar to that experienced during the 1998 financial crisis (with the external current account adjusting based on export and import exchange rate elasticities) and a low-growth scenario stemming from an export shock (which the authorities would attempt to counter by running higher fiscal deficits).

stemming from increased tax revenue,[9] limited real growth in spending (3 percent, in line with the LFRT), and safeguards for fiscal decentralization, such as strict limits on regions' hiring of additional personnel.[10]

12. **Discussions with multilateral creditors and private market analysts suggest that the authorities' preliminary financing plan for 2004 is realistic.** About one-fifth of the gross financing requirement is to come from domestic bond placements, and the remainder from external sources (about half from official creditors and half from debt placements in international capital markets). Staff noted that there would be scope to substitute a part of the planned foreign bond placement by additional domestic debt issues.[11] The authorities saw merit in the staff's proposal and agreed to consider it as they finalize their financing strategy. Staff welcomed the authorities' continued commitment not to use the resources of the pension reserve fund held at the central bank (as part of official reserves) for financing the fiscal deficit.

13. **The authorities intend to implement a comprehensive tax reform package that would durably strengthen the public finances over the medium term.** The main elements of the package include: (i) broadening the corporate and personal income tax bases by eliminating exemptions and tightening rules on deductions; (ii) raising the progressiveness of the personal income tax; [12] (iii) strengthening tax administration; (iv) simplifying the tax regime for small-sized taxpayers; (v) improving municipal real estate tax systems; (vi) eliminating sectoral exemptions; [13] and (vii) a tax on financial transactions (FTT) that

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[9] The higher revenue reflects mainly: (i) the full-year impact of the mid–2003 increases in excises and the VAT; and (ii) a small hike in the corporate income tax rate, to align it with the highest marginal personal income tax rate, which congress is expected to approve shortly.

[10] Such safeguards are enforced through the legal framework for decentralization that authorizes central government oversight of subnational governments (see Box 2).

[11] While current international market conditions are favorable, shifting the country's financing reliance toward the domestic market is prudent since spread changes can be abrupt and, even if country-specific factors are sound, emerging debt markets remain highly sensitive to volatility in rates on U.S. Treasuries and to developments in other important emerging market economies.

[12] Staff recommended that personal income tax reform center on addressing the high exemption threshold.

[13] The authorities' strategy for phasing out regional exemptions includes seeking approval of a general framework law on these exemptions sent to congress earlier this year (which sets a timetable for their phase out), coupled with bilateral negotiations with regional governments for additional revenue transfers to finance infrastructure projects. So far, three of the five main beneficiaries of regional tax exemptions have agreed to this scheme.

would allow for a rollback of the recent VAT rate increase or elimination of the highly-distortive special payroll tax (IES).[14] The authorities explained that the package is aimed at strengthening the tax effort by some 3 percent of GDP over the medium term, taking it to about 16 percent of GDP.

14. **Most of the tax measures being considered are appropriate, but an FTT would run counter to the objective of promoting financial intermediation and growth.**

- Staff urged that the tax not be adopted as it would foster financial disintermediation (and perhaps capital outflows), complicate tax administration, and reduce collections of other taxes as economic activity is pushed into the informal sector. Staff noted the experience in other countries in the region that have implemented an FTT, where collections were adversely affected over time as evasion of the tax increased. Staff also stressed that an FTT is likely to be more regressive than the VAT, as the wealthy were better placed to avoid it while the VAT does not cover agricultural products heavily consumed by the poor. Staff urged the authorities to maintain the current VAT rate and focus on eliminating highly-distortive taxes, such as the IES.

- The authorities viewed the FTT (along with a companion law that would require transactions above a certain threshold to be made through the banking system) as an important tool to combat tax evasion, through the information it would provide on financial transactions of taxpayers. They acknowledged that an FTT carries risks and were receptive to staff's recommendations that if the tax is adopted, the rate should be set very low and on a wide base of debit transactions to minimize any adverse impact on growth and financial intermediation.[15] The authorities are also considering staff's suggestion to maintain the current VAT rate and instead accelerate the elimination of the special payroll tax (the draft 2004 budget already includes a modest reduction in this tax). They pointed out, however, that the recent VAT hike placed a high burden on socially vulnerable groups, despite the fact that most agricultural products are exempted. A final decision on the tax package is expected in November 2003.

15. **The authorities indicated that the draft 2004 budget would likely be amended to channel additional revenue from the tax reform to spending on social programs and infrastructure, but that the overall deficit target of 1.4 percent of GDP would be maintained.** Staff welcomed the decision not to include additional spending in the budget

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[14] The authorities have announced that the VAT rate would not be lowered until the tax reform is in place and generating sufficient revenue to cover the rollback.

[15] The authorities' latest internal discussions are pointing to a broad-based tax with a rate of 0.1 percent that would expire after three years. To ensure that the information benefit of the tax continues after its elimination, staff will work with the authorities to identify other mechanisms to follow financial transaction flows.

until the tax reform was adopted. Staff noted that using part of the revenue from tax reform to cover the elimination of distortonary taxes, such as the IES, should still leave room for additional social and infrastructure spending.

16. **The medium-term fiscal outlook will depend critically on how fiscal decentralization is implemented.** While commending the progress that has been made on the legal framework for fiscal decentralization (Box 2), staff highlighted the importance of enacting the two pending laws on fiscal decentralization. Staff urged the authorities to continue resisting pressures to accelerate the decentralization process, as adequate controls and capacity of subnational governments are not yet in place. Moreover, to ensure that decentralization will bring efficiency gains and is consistent with medium-term fiscal consolidation, staff recommended:

- Preparing estimates of expenditures to be devolved to subnational governments, to minimize the risk of revenue/expenditure mismatches.
- Timely approval of legislation to specify the distribution of expenditure responsibilities among different levels of government, especially for education and health (which could be devolved to the regions as early as 2005).
- Establishing minimum standards for delivery of certain social services by subnational governments.

The authorities broadly agreed with these recommendations, and noted that they were receiving on-going support from multilateral institutions in implementing decentralization.

17. **Reducing the currency and rollover risk of public debt is an important element of the authorities' debt management strategy.** The authorities agreed with the mission's advice to gradually shift the composition of public debt toward local-currency instruments, and to reprofile growing amortization payments over the medium term.[16] The authorities also agreed with staff that future foreign debt placements should include CACs. The mission recommended increasing debt management flexibility by setting an overall debt ceiling in the annual budget legislation, instead of the current practice of separate ceilings for domestic and foreign currency debt. The authorities agreed, but noted that it was too late to change the legal framework for the 2004 budget.

18. **The authorities are embarking on reforms to improve public sector operations.** Staff welcomed the authorities' intention to move ahead with plans to restructure public wages and streamline government programs, and emphasized the need to strengthen the operations of public enterprises, including through renewed efforts to grant operating concessions. The authorities added that public-private partnerships (PPPs) also would play an

[16] The authorities requested ICM assistance in debt management modeling and policy design.

important role in addressing the infrastructure deficit, and that PPPs would continue to be treated under the program in a transparent manner.[17]

19. **The authorities continue in their efforts to reform the preferential public pension system (*Cédula Viva, CV*), but a comprehensive reform requires amending the constitution.** Congress has approved a series of measures aimed at establishing a benefit structure that would fully fund *future* CV retirees' pensions.[18] To address the large financial gap for *existing* CV retirees, the government has created a commission that would propose a reform of current constitutional provisions (acquired-rights clauses) that preclude an effective long-term reform of the CV.[19] Staff supported these efforts and the authorities' plan to centralize CV payments and collections at the Ministry of Finance to improve control over the system's finances.

B. Monetary and Exchange Rate Policies, and the Banking System

20. **Monetary policy has been managed prudently under the inflation targeting framework.** Staff noted that there might be scope for further reductions in interest rates in light of the low inflation outlook (as evidenced by surveys showing inflation expectations near the bottom of the target band). The authorities agreed, but were reluctant to ease policy further at this stage until an appropriate tax reform has been adopted.

21. **The authorities reaffirmed their commitment to a flexible exchange rate.** Staff queried whether recent sustained large foreign exchange purchases were consistent with the central bank's stated policy of limiting intervention to smoothing excessive fluctuations in the exchange rate. The authorities noted that exchange rate appreciation could generate a further reduction in the already low inflation expectations and, thus, would be inconsistent with the inflation target. Therefore, while they remain committed to the flexible exchange rate regime, some (temporary) intervention might be needed to prevent a further appreciation of the *Nuevo Sol*, until such time that it would be prudent to move ahead with a further round of interest rate reductions.

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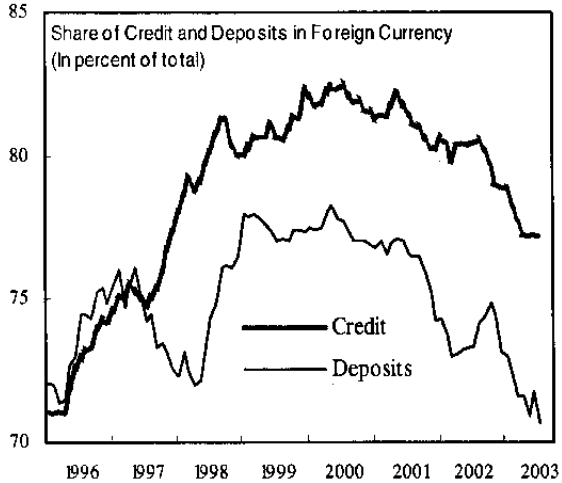
[17] Cash outlays related to PPP operations are recorded in the government's budget, and any government guarantees for private-sector debt are included in the stock of government debt.

[18] The measures raise contribution rates, cap pensions for future retirees, and subject existing CV pensions (above a certain threshold) to income taxes. The CV, which is closed to new entrants (except judges and magistrates), provides pensions to long-serving civil servants, congresspersons, and certain former employees of public enterprises.

[19] In April of this year, the constitutional court overruled (partially) previous reforms of the public pension system to limit survivors' benefits.

22. **The authorities remain committed to achieving a durable reduction in financial dollarization.** Fully aware that dollarization is an important vulnerability, they believe it can only be permanently reduced through establishing a track record of macroeconomic stability, sound banking system oversight, and further development of domestic capital markets. The mission concurred and welcomed the authorities' continued commitment to prudent management of reserve requirements on dollar deposits (which form about one-third of official reserves).

Dollarization ratios have been falling since 2000.



23. **Bank supervision continues to be strengthened.** Staff welcomed the authorities' efforts in improving the regulatory environment for banks. On the draft law granting legal protection to bank supervisors, the authorities said they were continuing to work with congress for swift passage, although the timetable had to be extended as the issue was politically contentious. They noted that, in the interim, a general law had been passed that protects public sector officials from frivolous lawsuits. The authorities suggested a follow-up FSAP mission to evaluate the current regulatory framework and to assist them in implementing Basel II criteria.

C. Other Issues

24. **The authorities agreed with the main recommendations made by the recent Fiscal Transparency and Data ROSCs** (Box 3). The authorities intend to publish the fiscal and data ROSC reports and have begun working on implementing many of the recommendations. They pointed out, however, that the recommendations involving congressional action would require consensus building and take longer to implement.

25. **The various sectoral support programs have been managed prudently, but political pressures could undermine this record in the agriculture bank.**[20] The mission advised against plans to recapitalize this bank noting that its limited lending was not due to a lack of funds, but a lack of eligible and creditworthy clients. Staff suggested that the resources for recapitalizing the bank would be better spent on social and infrastructure needs. The authorities agreed that a key problem in agriculture was lack of profitability, but

[20] The consumer-lending program of the *Banco de la Nación* (BN) continues to be managed in line with the limits set in the program. Both the BN and the agriculture bank are subject to regulations and supervision by the Superintendency of Banks (see Country Report No. 02/27).

indicated that there was scope for expanding the bank's operations in aiding the sector, which is a priority for the government.

26. **In mid-September, the minimum wage was raised by 12 percent; any further increase could begin to have a negative impact on formal employment.** While the adjustment is consistent with inflation and productivity growth since the last change to the wage (more than three years ago),[21] staff expressed concern that any additional increase would likely encourage informal sector activity, especially in light of the recent tightening of certain labor market rules.[22] The authorities explained that no further changes in the minimum wage are planned and that they are committed to flexible labor markets with appropriate protections for workers.

27. **The authorities expressed interest in a successor arrangement after the current SBA expires in February 2004.** The mission explained that prior to discussions on a successor arrangement, an assessment of the Fund's extended financial engagement with Peru needs to be prepared. [23] Such a study is underway, and the findings will be discussed with the authorities in the context of the fourth review.

IV. Staff Appraisal

28. **Peru's economic performance under the program continues to be favorable, based on strong fundamentals, prudent macropolicies, and progress with structural reforms.** Growth has been strong, inflation low, and the external position robust. Preliminary data suggest that all end-September performance criteria are likely to have been observed, and all structural benchmarks under the program but one were met.

29. **The near-term outlook remains favorable, but medium-term growth prospects could be dampened by the political environment.** The macroeconomic framework for 2003 and 2004 foresees continued robust growth with low inflation and a sound external position. The baseline medium-term outlook is for a continuation of these trends, although there are risks from the relatively high public debt, dollarization, and the difficult political situation. To manage these risks, the authorities need to be steadfast in implementing their

[21] Staff estimates that, over this three-year period, labor productivity in Peru has grown about 6 percent and inflation has risen 4 percent.

[22] These ILO-supported changes included: (i) requiring biannual bonuses for all private sector workers; (ii) limiting labor outsourcing; (iii) raising overtime pay; and (iv) tightening work schedule rules (see Country Report No. 03/72).

[23] This assessment would follow the Operational Guidance for Assessments of Countries with a Longer-Term Program Engagement.

program and, in particular, continue to build the necessary domestic consensus for sound fiscal policies and reforms.

30. **Fiscal consolidation is at the heart of the authorities' medium-term economic strategy.** The envisaged deficit reduction path is appropriate to ensure a sustained decline in public debt without undermining growth. Staff welcomes the approval of a strengthened law on fiscal responsibility and transparency as well as the steps taken in the areas of tax reform and fiscal decentralization.

31. **Staff supports the authorities' plans for comprehensive tax reform, but urges that a tax on financial transactions (FTT) not be introduced.** The delegation of legislative power on taxation to the executive constitutes a good opportunity to rationalize the tax system, eliminate sectoral exemptions, improve tax administration, and raise revenues that would strengthen the public finances and help address pressing social and infrastructure needs. Staff advises the authorities to refrain from introducing an FTT, as such a tax would likely create significant economic distortions that could undermine growth prospects and, over time, complicate the collection of other taxes. Should the authorities go forward with an FTT, it should be set at a very low rate and on a wide base to minimize the adverse effects of the tax. The specific outcome of the tax reform will be a principal focus of the fourth review.

32. **Implementation of a careful and fiscally-neutral decentralization process is crucial for ensuring fiscal sustainability**. Staff welcomes the progress made in establishing a sound legal framework regulating the decentralization process and looks forward to the timely enactment by year's end of the draft laws on fiscal decentralization. Staff also encourages the authorities to continue working with the World Bank and IDB to further strengthen the decentralization process, especially in the assignment of expenditure responsibilities.

33. **Reducing the currency and rollover risk of public debt is a key element of debt management**. Staff recommends gradually shifting the composition of public debt toward local-currency instruments and spreading out amortization payments over the medium term. Staff supports the authorities' efforts to strengthen debt management and diversify the public sector's sources of financing, and welcomes their intention to include CACs in future sovereign debt placements.

34. **Staff encourages the authorities' plans to improve the performance of public sector operations and reform the preferential public pension plan.** Rationalizing public salaries and spending programs should help increase budget flexibility and create room for additional productive expenditure. Staff encourages the authorities to renew efforts to grant operating concessions for public works and pursue privatizations where feasible, and push ahead with reforms to secure the long-term financial viability of the public pension system.

35. **Staff sees scope for a further easing of monetary policy, but concurs with the central bank's cautious monetary policy stance until tax reform is settled.** The favorable inflation outlook provides scope for a further reduction of interest rates, although the still

uncertain shape of the tax reform argues for caution. Once this issue is settled and barring a change in the inflation outlook, the authorities should stand ready to ease monetary policy further.

36. **The flexible exchange rate system has served Peru well in adjusting to external shocks**. Staff supports the authorities' announced policy of limiting intervention in the foreign exchange market to smooth excessive fluctuations in the exchange rate, but notes that sustained foreign exchange market intervention is not consistent with this policy.

37. **Staff supports the policy of maintaining a high level of official reserves as a key buffer against external shocks and the vulnerability from dollarization.** Staff welcomes the authorities' continued commitment to maintain reserve requirements on U.S. dollar deposits at their current level, and to avoid recourse to dollar deposits of the pension reserve fund held at the central bank to finance fiscal operations.

38. **The financial situation of banks continues to improve, and bank oversight is being strengthened especially in the area of dollar lending**. Staff welcomes the rationalization of norms on provisioning and loan classification, the strengthening of the regulatory framework associated with dollar lending by domestic banks, and steps underway toward implementation of Basel II criteria. Given the importance of sound supervision, staff urges swift passage of the draft law to grant legal protection to bank supervisors in the execution of their duties.

39. **In summary, Peru has performed well under the program supported by the Stand-By Arrangement, and staff recommends completion of the third review**. The overall stance of macroeconomic policy is appropriate, and progress is being made in implementing structural reforms. Although there are risks to the program, the authorities recognize those risks, are working to address them, and stand ready to take additional actions if needed. The authorities continue to treat the Stand-By Arrangement as precautionary.

Box 1. Political Situation and Capacity for Program Implementation

Political pressures continue for adopting a more populist agenda. The government's success in continuing to implement their economic program will depend on sustaining support in congress on key economic measures.

Maintaining the course of economic policy has been challenging.

- In late May, strikes by public sector workers and protests by agricultural producers seeking increased state support led to the imposition of a nationwide state of emergency. The labor situation was settled following agreement on pay increases for teachers and police.
- Regional governments continue to press for additional transfers, and some remain opposed to eliminating regional tax benefits that foster tax evasion.
- Initiatives continue to be floated in congress (often proposed by members of the president's party) that would reduce tax revenue and increase government spending.

Nevertheless, the administration has maintained legislative support for keeping the economic program on track. In particular, congress has:

- passed a revised Law on Fiscal Responsibility and Transparency, (April);
- approved tax and spending measures (June/July) that cover the increased wages for teachers and the police in 2003 and 2004;
- adopted laws to contain the costs of the preferential public pension plan (July); and
- ratified the government's request for 90-day authority to implement a comprehensive tax reform and enact laws to guide fiscal decentralization (September).

Box 2. Fiscal Decentralization in Peru

Important steps have been taken toward building a sound legal framework for decentralization in Peru.

A cautious plan for the distribution of government revenue is being defined.

- Taxing power has been limited to the central government and municipalities.
- The fiscal decentralization law pending in congress establishes that through 2006 regions will be funded through discretionary central government transfers. After 2006, transfers will complement a 30-percent share in indirect taxes collected in each region (60 percent for merged regions).

A timetable for the transfer of expenditure responsibilities has been set.

- Sub-national governments will assume full responsibility for specific public investment projects and social programs in 2004 (as established in the decentralization framework law), and will share responsibility for cultural, regional tourism, and sectoral economic support activities in 2005, and health and education programs in 2005 or beyond.
- Defense, internal security, and judicial services, along with regulation of public services, will remain the exclusive responsibility of the national government.

Reporting requirements and fiscal rules are in place.

- An oversight committee (the National Council for Decentralization) has been created. Regions and municipalities must provide the central government with information on their annual and quarterly fiscal performance. The Financial Management Information System, SIAF, has been extended to regions for all budgetary stages and to municipalities for the budget formulation stage. Subnational governments must observe the central government budgetary legal framework.
- The central government is authorized to oversee the fiscal situation of subnational governments, including the power to intervene regional governments that endanger the country's fiscal sustainability. In addition, access to regional and municipal funds will be denied to delinquent subnational governments.
- The decentralization framework law prohibits the national government from covering non-guaranteed debts of the subnational governments.
- Subnational governments require a central government guarantee for contracting external debt (which can only be used to finance infrastructure).
- Fiscal rules are established for subnational governments, including:
    - Limits on ratios of: total debt to current revenue (100 percent); non-guaranteed debt to current revenue (40 percent); annual debt service to current revenue (25 percent); and interest payments to current revenue (10 percent).
    - A region's three-year average primary balance must be positive.

Box 3. Main Recommendations of the Fiscal and Data ROSCs

The main fiscal ROSC recommendations were to:

- Introduce transparent regulations for the civil service;
- Establish a stable legal framework for the budget, treasury operations, and debt management;
- Publish regular reports on quasi-fiscal operations, contingent liabilities, and fiscal sustainability;
- Widen the coverage of the SIAF;
- Reconcile institutional coverage of fiscal statistics; and
- Establish a disciplined legislative process for taxes by requiring Ministry of Finance approval of tax-related congressional proposals (congress cannot make new expenditure proposals).

The main data ROSC recommendations were to:

- Strengthen technological and manpower capacity of the national statistics institute;
- Disseminate terms and conditions for published data;
- Reduce wage and earnings data lags; and
- Replace the wholesale price index with a producer price index.

Table 1. Peru: Proposed Schedule of Purchases
Under the Stand-By Arrangement, 2003–04 1/

Amount of Purchase	Availability Date	Conditions Include
1. SDR 27.875 million (cumulative available: SDR 199.25 million) 2/	October 31, 2003	Completion of the third review and observance of end-September 2003 performance criteria. 3/
2. SDR 27.875 million	November 17, 2003	Observance of end-September 2003 performance criteria.
3. SDR 27.875 million	February 15, 2004	Completion of the fourth review and 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).
2/ The authorities have treated the SBA as precautionary.
3/ The original conditions were completion of the third review and observance of end-June performance criteria, and the availability date was September 2, 2003. However, the end-September 2003 performance criteria became controlling as completion of the third review was delayed beyond end-September 2003.

Table 2. Peru: Quantitative Performance Criteria and Structural Benchmarks, 2003

	March 31	June 30	Sept. 30	Dec. 31
(Cumulative amounts from December 31, 2002; in millions of Nuevos Soles)				
Borrowing requirement of the combined public sector				
Unadjusted limits	780	1,400	2,595	4,130
Adjusted limits 1/	780	1,400	...	...
Actual	596	1,262	...	...
Margin	184	138	...	...
Net consumer lending of the Banco de la Nación				
Limit	-15	40	30	75
Actual	-8	8	...	...
Margin	-7	32	...	...
(Cumulative amounts from December 31, 2002; in millions of Nuevos Soles)				
Net international reserves of the central reserve bank				
Unadjusted targets	98	-50	-146	-148
Adjusted targets 1/	335	-293	...	...
Actual	646	338	...	...
Margin	311	631	...	...
Short-term net external debt of the public sector				
Limits	50	50	50	50
Actual	0	0	...	...
Margin	50	50	...	...
External payments arrears of the public sector (on a continuous basis) 2/				
Limits	0	0	0	0
Actual	0	0	...	...
Margin	0	0	...	...
(Cumulative amounts from December 31, 2002; in millions of Nuevos Soles)				
Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year				
Total				
Unadjusted limits	950	1,680	2,015	2,200
Adjusted limits 1/	950	1,680	...	...
Actual	763	831	...	...
Margin	187	849	...	...
Of which: 1- to 5-year maturity				
Limits	250	250	250	250
Actual	8	8	...	...
Margin	242	242	...	...
(Consultation band for the 12-month rate of inflation, in percent) 3/				
Outer band range	-0.5 - 5.5	-0.5 - 5.5	-0.5 - 5.5	-0.5 - 5.5
Actual	3.4	2.2	2.0	...
Inner band range	0.5 - 4.5	0.5 - 4.5	0.5 - 4.5	...

Structural Benchmarks 2003	Target Date	Current Status
Submission to congress of fiscal decentralization legislation consistent with the objectives for decentralization and for tax reform stated in the letter of intent dated March 17, 2003 (EBS/03/34).	June 30	Completed
Implementation of the revised rules on fiscal prudence and transparency.	June 30	Completed
Granting statutory protection to SBS staff in the discharge of their responsibilities.	June 30	Pending
Submission to congress of a 2004 budget consistent with the objectives for decentralization and for tax reform stated in the letter of intent dated March 17, 2003 and the revised rules on fiscal prudence and transparency.	Sept. 30	Completed
Identification of regional and sectoral tax exemptions to be phased out by end-2004 that in the 2003 budget are estimated to have an annualized cost of 0.4 percent of GDP.	Sept. 30	Completed

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and Country Report No. 03/104.

1/ The targets and limits were adjusted in accordance with the table attached to the letter of intent dated March 17, 2003 (Country Report

2/ Excluding arrears associated with nonrescheduled debt to foreign creditors outstanding as of end-2002.

3/ Should inflation fall outside the inner band, the authorities will discuss with Fund staff the appropriate policy response. Should inflation fall outside the outer band, the authorities will also complete a consultation with the Executive Board of the Fund on the proposed policy response. The central bank's inflation target range is 1.5 - 3.5 percent.

Table 3. Peru: Selected Economic Indicators

	2000	2001	Rev. Prog. 2002	2002	Rev. Prog. 1/ 2003	Proj. 2003	Proj. 2004
(Annual percentage change)							
Production, prices, and trade							
Real GDP	3.1	0.6	3.7	5.3	4.0	4.0	4.0
Real domestic demand	2.4	-0.1	3.3	4.7	3.6	3.6	3.8
Consumer prices							
End of period	3.7	-0.1	2.0	1.5	2.5	1.5	2.5
Period average	3.8	2.0	0.4	0.2	2.5	2.1	1.8
Exports (U.S. dollars)	14.2	0.8	8.5	9.1	11.1	13.1	8.3
Imports (U.S. dollars)	9.0	-1.8	3.1	2.3	6.9	9.9	5.2
Terms of trade	-2.1	-1.8	3.2	2.5	0.8	-0.4	1.6
Real effective exchange rate (depreciation -) 2/	7.2	4.4	...	-5.5	...	...	...
Money and credit							
Broad money 3/	2.3	4.9	4.2	4.4	5.5	4.9	5.0
Credit to the private sector 3/	-3.6	-2.6	0.6	-1.3	6.4	0.5	4.5
(In percent of GDP, unless otherwise indicated)							
Public sector							
General government current revenue	17.7	17.0	17.2	17.0	16.9	17.1	17.4
Of which : Central government tax revenue	12.0	12.1	11.8	11.8	12.4	12.7	13.0
General government noninterest expenditure	18.4	17.7	17.6	17.3	17.0	17.2	16.9
Of which : capital expenditure	3.8	3.4	3.1	2.8	2.8	2.6	2.6
Combined public sector primary balance	-0.9	-0.1	-0.2	-0.1	0.2	0.1	0.7
Interest due	2.3	2.2	2.1	2.1	2.1	2.1	2.1
Combined public sector overall balance	-3.2	-2.4	-2.3	-2.2	-1.9	-1.9	-1.4
Balance of payments							
Current account	-2.9	-2.2	-2.2	-2.1	-1.9	-2.0	-1.9
Capital and financial account	2.7	3.0	4.4	3.5	1.9	2.5	2.1
Gross reserves							
in millions of U.S. dollars 4/	8,562	8,837	9,942	9,690	9,658	9,960	10,060
percent of short-term external debt 5/	155.6	147.2	189.8	217.2	198.2	215.5	211.8
percent of foreign currency deposits at banks	92.5	93.5	103.0	101.3	100.1	104.1	103.0
Debt							
Total external debt	52.3	50.3	51.0	49.0	48.6	47.2	47.1
Public debt	45.9	46.2	47.7	46.7	45.6	45.6	45.1
Domestic	9.4	10.7	11.0	10.2	9.6	9.8	9.5
External 6/	36.5	35.5	36.7	36.6	36.0	35.8	35.6
Savings and investment							
Gross domestic investment	20.1	18.5	18.0	18.5	18.3	18.5	18.8
Public sector	4.0	3.1	3.2	2.8	2.9	2.7	2.8
Private sector	16.1	15.4	14.8	15.7	15.4	15.7	16.0
National savings	17.2	16.3	15.8	16.4	16.4	16.4	16.8
Public sector 7/	0.8	0.7	0.9	0.6	0.9	0.9	1.4
Private sector	16.4	15.6	14.9	15.8	15.4	15.5	15.4
External savings	2.9	2.2	2.2	2.1	1.9	2.0	1.9
Memorandum item:							
Nominal GDP (S/. billions)	186.8	189.9	196.9	200.0	212.6	212.5	225.7

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

1/ Program numbers revised during the second program review, Country Report No. /03/104.

2/ End of period. Based on Information Notice System.

3/ Foreign currency stocks are valued at program exchange rate.

4/ Gross international reserves exceed net international reserves, basically by the stock of Fund credit outstanding.

5/ Short-term debt includes amortization of medium- and long-term loans falling due over the following year.

6/ Includes Central Reserve Bank of Peru debt.

7/ Excludes privatization receipts.

Table 4. Peru: Balance of Payments

	2000	2001	Rev. Prog. 2002	2002	Rev. Prog. 1/ 2003	Proj. 2003	Proj. 2004
	(In millions of U.S. dollars)						
Current account	**-1,558**	**-1,183**	**-1,239**	**-1,206**	**-1,134**	**-1,246**	**-1,230**
Merchandise trade	-456	-267	289	207	585	466	754
Exports	6,951	7,007	7,713	7,647	8,530	8,646	9,361
Traditional	4,821	4,742	5,269	5,312	5,776	6,099	6,422
Nontraditional and others	2,130	2,265	2,444	2,335	2,754	2,547	2,939
Imports	-7,407	-7,273	-7,424	-7,440	-7,945	-8,180	-8,607
Services, income, and current transfers (net)	-1,101	-916	-1,528	-1,414	-1,718	-1,712	-1,984
Services	-691	-835	-860	-948	-850	-1,020	-1,018
Investment income	-1,409	-1,123	-1,572	-1,509	-1,807	-1,807	-2,091
Current transfers	999	1,042	904	1,043	939	1,115	1,125
Financial and capital account	**1,426**	**1,601**	**2,434**	**1,987**	**1,142**	**1,546**	**1,305**
Public sector	280	394	1,081	1,051	670	503	725
Disbursements 2/	1,485	1,344	2,941	2,902	1,878	1,942	2,100
Amortization 2/	-1,042	-918	-1,889	-1,888	-1,152	-1,183	-1,316
Other medium- and long-term public sector flows 3/	-163	-32	29	37	-56	-256	-59
Capital transfers (net)	0	0	0	0	0	0	0
Privatization	229	267	245	186	214	10	10
Private sector	917	940	1,110	750	158	1,033	570
Foreign direct investment (FDI) excluding privatization	581	803	1,677	2,205	471	948	531
Other private capital	336	137	-567	-1,455	-313	85	39
Medium- and long-term loans	962	197	-339	-173	60	37	341
Portfolio investment	-314	-300	-321	-495	-177	-529	-376
Short-term flows to the financial system 4/	-9	-358	0	-474	0	-35	0
Other short term flows (including errors and omissions)	-303	598	93	-313	-96	612	74
Financing	**132**	**-418**	**-1,195**	**-781**	**-8**	**-300**	**-75**
NIR flow (increase -)	190	-448	-1,250	-832	-40	-333	-100
Change in NIR (increase -)	224	-433	-1,250	-985	-40	-350	-100
Valuation change (increase -)	34	15	0	-153	0	-17	0
Exceptional financing	-59	30	55	51	33	33	25
Debt relief 5/	0	33	55	52	33	33	25
Rescheduling	0	53	0	0	0	0	0
Change in arrears	-59	-56	0	0	0	0	0
	(In percent of GDP unless otherwise specified)						
Memorandum items:							
Current account (CA) balance	**-2.9**	**-2.2**	**-2.2**	**-2.1**	**-1.9**	**-2.0**	**-1.9**
FDI and private MLT capital (percent of CA deficit)	66.1	76.3	108.0	168.5	46.8	79.0	71.0
Capital and financial account balance	2.7	3.0	4.4	3.5	1.9	2.5	2.1
Export value (US$), percent change	14.2	0.8	8.5	9.1	11.1	13.1	8.3
Volume growth	10.5	5.9	6.5	5.0	7.7	7.6	7.0
Price growth	3.4	-4.7	1.9	3.7	3.4	5.2	1.2
Import value (US$), percent change	9.0	-1.8	3.1	2.3	6.9	9.9	5.2
Volume growth	3.3	1.3	2.8	1.0	4.4	4.1	5.7
Price growth	5.6	-3.0	0.3	1.2	2.5	5.7	-0.4
GDP (millions of US$)	53,513	54,025	55,943	56,870	59,535	60,971	63,427
Average exchange rate (S/. per US$)	3.49	3.52	3.52	3.52	3.57	3.49	3.55

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

1/ Program numbers revised during the second program review, Country Report No. /03/104.

2/ In 2002, includes the Brady Bond swap (not envisaged in the original program). For details of the swap, see Country Report No. 03/72, Box 3.

3/ Includes portfolio flows of the pension reserve fund and subscription payments into international funds.

4/ Includes COFIDE and Banco de la Nación. Outflows in 2002 reflect a further reduction in the financial system's short-term debt.

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

Table 5. Peru: External Financing Requirements and Sources

(In millions of U.S. dollars)

	2000	2001	Rev. Prog. 2002	2002	Rev. Prog. 1/ 2003	Proj. 2003	Proj. 2004
1. Gross financing requirements	**8,137**	**7,135**	**8,385**	**8,042**	**5,814**	**6,040**	**5,952**
External current account deficit (excluding official transfers)	1,558	1,183	1,239	1,206	1,134	1,246	1,230
Debt amortization	6,712	5,502	5,896	6,002	4,639	4,461	4,622
Medium- and long-term debt	1,980	1,762	2,794	2,770	1,992	1,871	2,139
Public sector	1,042	918	1,889	1,888	1,152	1,183	1,316
Multilateral 2/	531	334	397	399	479	485	560
Bilateral	388	489	544	541	617	640	679
Bonds and notes	108	83	940	940	50	50	68
Other	14	12	8	8	6	8	8
Private sector	938	844	905	882	840	688	823
Short-term debt 3/	4,732	3,740	3,102	3,232	2,647	2,590	2,483
Repayment of arrears 4/	58	2	0	0	0	0	0
Accumulation of NIR (flow)	-190	448	1,250	832	40	333	100
Change in gross reserves	-440	275	1,105	853	-32	270	100
Payments of short-term liabilities incl. IMF	216	158	138	132	72	80	0
Valuation adjustment	34	15	7	-153	0	-17	0
2. Available financing	**7,714**	**7,051**	**8,012**	**7,983**	**5,781**	**5,449**	**5,927**
Foreign direct investment (net)	810	1,070	1,922	2,391	685	958	531
Privatization	229	267	245	186	214	10	10
FDI	581	803	1,677	2,205	471	948	531
Portfolio (net)	-314	-300	-321	-495	-177	-529	-376
Short-term assets (flow)	257	697	-423	-151	-200	127	74
Debt financing from private creditors	5,674	4,273	5,755	5,185	4,351	3,958	4,647
Medium- and long-term financing	1,934	1,041	2,457	2,595	1,600	1,475	2,164
To public sector	34	0	1,891	1,886	700	750	1,000
To private sector	1,900	1,041	566	709	900	725	1,164
Short-term financing	3,740	3,232	3,298	2,590	2,751	2,483	2,483
Official creditors 5/	1,450	1,343	1,050	1,016	1,178	1,191	1,100
Multilateral 2/	794	1,104	822	807	895	959	833
Of which: balance of payments financing	471	876	617	625	674	750	600
Bilateral	656	239	228	209	283	232	267
To public sector	656	239	228	209	283	232	267
Of which: balance of payments financing	300	0	0	0	0	0	0
To private sector	0	0	0	0	0	0	0
Other medium- and long-term public sector flows 6/	-163	-32	29	37	-56	-256	-59
IMF	0	0	0	0	0	0	0
Accumulation of arrears (exceptional)	0	0	0	0	0	0	0
3. Financing gap	**423**	**84**	**373**	**59**	**33**	**591**	**25**
Other flows 7/	423	84	373	59	33	591	25
Errors and omissions	423	51	318	7	0	558	0
Debt relief	0	33	55	52	33	33	25

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

1/ Program numbers revised during the second program review, Country Report No. /03/104.

2/ Excluding IMF.

3/ Original maturity of less than one year. Equals stock at the end of the previous period. Excludes BCRP short-term debt.

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.

5/ Includes both loans and grants.

6/ Includes subscription payments to international organizations and changes in Banco de la Nación's long-term assets.

7/ Includes all other net financial flows (including exceptional financing) and errors and omissions.

Table 6. Peru: Monetary Survey

	1999	2000	2001	Rev. Prog. 2002	2002	Rev. Prog. 1/ 2003	Proj. 2003
I. Central Reserve Bank							
(In millions of Nuevos Soles at program exchange rate)							
Net international reserves 2/	**28,149**	**28,739**	**29,803**	**33,368**	**32,214**	**32,627**	**34,243**
(In millions of U.S. dollars)	8,159	8,022	8,324	9,426	9,100	9,139	9,592
Net domestic assets	**-23,518**	**-24,201**	**-24,858**	**-27,771**	**-26,602**	**-26,498**	**-28,123**
Net credit to nonfinancial public sector	-9,966	-9,390	-8,758	-10,217	-10,003	-9,579	-9,162
Rest of banking system	-11,462	-12,488	-13,695	-14,996	-14,286	-14,373	-15,243
Other	-2,090	-2,323	-2,405	-2,558	-2,313	-2,546	-3,718
Currency	**4,631**	**4,537**	**4,945**	**5,597**	**5,612**	**6,129**	**6,120**
II. Banking System							
(In millions of Nuevos Soles at program exchange rate)							
Net foreign assets	**25,630**	**26,555**	**28,503**	**31,824**	**32,141**	**32,552**	**34,518**
Net domestic assets	**19,801**	**21,043**	**21,004**	**20,112**	**19,257**	**22,009**	**18,988**
Net credit to nonfinancial public sector	-13,291	-11,297	-9,351	-10,400	-10,464	-10,290	-9,959
Credit to private sector	49,166	49,112	47,611	47,458	46,550	49,841	47,117
Other	-16,074	-16,772	-17,256	-16,946	-16,829	-17,542	-18,170
Net credit to COFIDE	-3,074	-2,395	-1,732	-1,367	-1,265	-1,275	-1,202
Other	-13,000	-14,377	-15,524	-15,579	-15,564	-16,267	-16,968
Liabilities to the private sector	**45,431**	**47,598**	**49,507**	**51,936**	**51,398**	**54,561**	**53,506**
(12-month percentage change) 3/							
Base money	17.0	-4.0	7.9	11.0	11.0	8.0	8.5
Broad money	4.6	2.3	4.9	4.2	4.4	5.5	4.9
Domestic currency	11.4	2.5	13.7	10.1	10.2	11.9	12.1
Foreign currency	1.7	2.2	1.1	1.2	1.5	2.1	1.1
Credit to private sector	-2.3	-3.6	-2.6	0.6	-1.3	6.4	0.5
Domestic currency	-5.3	0.9	2.7	3.0	7.2	11.3	12.4
Foreign currency	-1.6	-4.5	-3.8	0.0	-3.4	5.1	-2.6
Memorandum item:							
Program exchange rate (S/. per US$)	3.45	3.60	3.58	3.54	3.54	3.57	3.57

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

1/ Program numbers revised during the second program review, Country Report No. /03/104.

2/ Excludes subscriptions to the IMF and the Latin American Reserve Fund (FLAR), Pesos Andinos, credit lines to other central banks, Corporación Andina de Fomento (CAF) bonds, and foreign assets temporarily held by the BCRP as part of swap operations.

3/ Flows in foreign currency are valued at the program exchange rate.

Table 7. Peru: Fiscal Operations of the Combined Public Sector
(In percent of GDP)

	2000	2001	Rev. Prog. 2002	2002	Rev. Prog. 1/ 2003	Proj. 2003	Proj. 2004
Central government primary balance	**-0.5**	**-0.7**	**-0.3**	**-0.2**	**0.0**	**0.1**	**0.6**
Revenue	15.0	14.2	14.5	14.3	14.3	14.6	14.8
Current	14.7	14.1	14.4	14.2	14.2	14.5	14.7
o/w tax revenue 2/	12.0	12.1	11.8	11.8	12.4	12.7	13.0
Capital	0.3	0.2	0.2	0.1	0.1	0.1	0.1
Noninterest expenditure	15.5	14.9	14.8	14.5	14.3	14.5	14.2
Current	12.7	12.6	12.6	12.5	12.3	12.7	12.4
Capital	2.8	2.4	2.2	2.0	2.0	1.8	1.9
Rest of the general government primary balance	**0.1**	**0.2**	**0.0**	**0.1**	**-0.1**	**-0.1**	**-0.1**
Revenue	5.6	5.6	5.7	5.7	5.5	5.6	5.6
Current	5.4	5.5	5.6	5.6	5.5	5.6	5.6
Capital	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Noninterest expenditure	5.5	5.5	5.6	5.6	5.6	5.7	5.7
Current	4.5	4.6	4.8	4.8	4.8	4.9	5.0
Capital	1.0	1.0	0.9	0.8	0.8	0.8	0.7
Public enterprise primary balance	**-0.5**	**0.2**	**0.0**	**-0.1**	**0.2**	**0.1**	**0.1**
Current balance	0.2	0.6	0.4	0.2	0.5	0.5	0.5
Capital balance	-0.7	-0.4	-0.4	-0.3	-0.4	-0.3	-0.4
Nonfinancial public sector primary balance	-0.9	-0.3	-0.3	-0.3	0.1	0.1	0.6
Central bank operating balance	0.0	0.2	0.1	0.2	0.1	0.1	0.1
Combined public sector primary balance	**-0.9**	**-0.1**	**-0.2**	**-0.1**	**0.2**	**0.1**	**0.7**
Interest payments	2.3	2.2	2.1	2.1	2.1	2.1	2.1
External	1.9	1.9	1.8	1.8	1.8	1.8	1.8
Domestic	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Combined public sector overall balance	**-3.2**	**-2.4**	**-2.3**	**-2.2**	**-1.9**	**-1.9**	**-1.4**
Financing	3.2	2.4	2.3	2.2	1.9	1.9	1.4
External	1.2	0.9	2.1	2.1	1.2	1.0	1.2
Disbursements 3/	2.4	2.5	3.7	5.0	3.0	3.1	3.2
(In millions of U.S. dollars)	1,299	1,319	2,056	2,863	1,800	1,910	2,050
Amortizations	-1.2	-1.5	-1.7	-3.2	-1.9	-1.9	-2.0
(In millions of U.S. dollars)	-636	-768	-925	-1,837	-1,111	-1,141	-1,279
Rescheduling/arrears (net)	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Condonations	0.1	-0.1	0.1	0.3	0.1	-0.2	0.0
Domestic	1.2	0.8	-0.5	-0.7	0.1	0.6	0.1
o/w bonds	...	0.6	0.5	0.5	0.7	0.8	0.9
(In millions of U.S. dollars)	...	346	267	267	430	517	555
Amortizations	-0.3	-0.2	-0.2	-0.2	-0.6	-0.6	-0.5
(In millions of U.S. dollars)	-161	-130	-125	-138	-370	-371	-354
Net deposits	1.5	0.4	-0.8	-0.9	0.0	0.4	-0.2
(In millions of U.S. dollars)	798	139	-447	-482	0	223	-112
Privatization	0.8	0.6	0.7	0.8	0.7	0.3	0.0
(In millions of U.S. dollars)	409	327	400	421	400	157	20
Memorandum items:							
Adjusted overall fiscal deficit (pension recognition bonds) 4/	-3.2	-2.2	-2.4	-2.2	-1.8	-1.7	-1.3
Tax on assest on public enterprises	...	0.3	0.3	0.2	0.0	0.0	0.0
General government current revenue 5/	17.7	17.0	17.2	17.0	16.9	17.1	17.4
General government noninterest expenditure 5/	18.4	17.7	17.6	17.3	17.0	17.2	16.9
Public sector debt-to-GDP	45.9	46.2	47.7	46.7	45.6	45.6	45.1

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

1/ Program numbers revised during the second program review, Country Report No. /03/104.

2/ Net of tax on assets of public enterprises and of central government IES payment (0.2 percent of GDP in 2002 and 0 percent in 2003 as the tax on assests of public enterprises has been phased out).

3/ Includes the Brady bond swap of US$923 million carried out in early 2002.

4/ Adjusted by substracting the amortization (currently recorded as a current transfer) and adding the accrued interest payments of CPI-indexed pension recognition bonds.

5/ Net of transfers among non-financial public institutions.

Table 8. Peru: Fiscal Operations of the Central Government
(In percent of GDP)

	2000	2001	Rev. Prog. 2002	2002	Rev. Prog. 1/ 2003	Proj. 2003	Proj. 2004
Current primary balance	**2.0**	**1.5**	**1.8**	**1.7**	**1.9**	**1.8**	**2.4**
Current revenue	14.7	14.1	14.4	14.2	14.2	14.5	14.7
Tax revenue 2/	12.0	12.1	11.8	11.8	12.4	12.7	13.0
Direct taxes	3.3	3.4	3.2	3.2	3.5	4.0	3.8
Indirect taxes	8.7	8.7	8.6	8.6	8.9	8.7	9.1
Other current revenue	2.8	2.0	2.6	2.3	1.8	1.8	1.8
Current noninterest expenditure	12.7	12.6	12.6	12.5	12.3	12.5	12.4
Labor services 3/	6.6	6.6	6.7	6.7	6.4	6.6	6.4
Goods and nonlabor services	3.8	3.7	3.5	3.4	3.4	3.4	3.3
Transfers and other	2.3	2.2	2.4	2.5	2.6	2.6	2.7
Capital balance	**-2.5**	**-2.2**	**-2.0**	**-1.8**	**-1.8**	**-1.7**	**-1.8**
Capital revenue	0.3	0.2	0.2	0.1	0.1	0.1	0.1
Capital expenditure	2.8	2.4	2.2	2.0	2.0	1.8	1.9
Gross capital formation	2.5	2.1	1.9	1.8	1.8	1.6	1.7
Other	0.3	0.3	0.3	0.2	0.1	0.2	0.1
Primary balance	**-0.5**	**-0.7**	**-0.3**	**-0.2**	**0.0**	**0.1**	**0.6**
Interest payments	2.2	2.2	2.0	2.0	2.0	2.0	2.0
External	1.9	1.9	1.8	1.7	1.8	1.7	1.8
Domestic	0.3	0.2	0.3	0.2	0.3	0.2	0.2
Net lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**-2.7**	**-2.8**	**-2.3**	**-2.2**	**-2.0**	**-1.9**	**-1.4**
Memorandum items:							
General government tax revenue 2/	12.2	12.4	12.1	12.1	12.7	13.0	13.3
Primary balance before transfers	0.9	1.2	1.8	1.9	2.4	2.6	3.1
Overall balance before transfers	-1.3	-1.0	-0.3	-0.1	0.4	0.7	1.1
Tax compliance rate 4/	78.6	82.8	...	87.2	...	...	...

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

1/ Program numbers revised during the second program review, Country Report No. /03/104.
2/ Net of tax on assets of public enterprises and of central government IES payments.
3/ Includes wages, salaries, and employer contributions to social security.
4/ Measured as the ratio between paid tax obligations and total tax obligations. Obligations covered are VAT and income taxes for large taxpayers only.

Table 9. Peru: Financial and External Vulnerability Indicators

(In percent; unless otherwise indicated)

	2000	2001	Rev. Prog. 2002	2002	Rev. Prog. 1/ 2003	Proj. 2003	Proj. 2004
Financial indicators							
Public sector debt/GDP	45.9	46.2	47.7	46.7	45.6	45.6	45.1
Of which: in domestic currency (percent of GDP)	5.9	6.8	7.1	6.9	6.5	6.8	6.7
90-day prime lending rate, domestic currency 2/	15.4	5.0	...	5.1	...	3.7	...
90-day prime lending rate, foreign currency 2/	8.2	3.1	...	2.4	...	1.8	...
Velocity of money 3/	3.9	3.8	3.9	3.9	3.9	4.0	4.0
Credit to the private sector/GDP	26.0	25.0	24.1	23.1	23.5	21.2	21.4
Share of foreign currency deposits in total deposits	76.9	74.3	74.1	73.2	71.9	70.7	...
Share of foreign currency loans in total credit	81.5	80.3	80.1	78.9	78.1	77.2	...
Nonperforming loans/total loans 4/ 5/	11.2	11.0	...	9.1	...	8.6	...
Loan-loss provisions/nonperforming loans 4/ 5/	78.5	91.1	...	112.2	...	113.4	...
Risk-based capital-assets ratio 5/	12.9	13.4	...	12.7	...	13.0	...
Foreign currency deposits at commercial banks (in millions of U.S. dollars)	9,260	9,451	9,655	9,562	9,646	9,565	9,765
Commercial banks' short-term foreign assets (in millions of U.S. dollars)	824	748	977	779	789	779	779
Commercial banks' short-term foreign liabilities (in millions of U.S. dollars)	1,519	1,161	1,451	763	827	763	763
External indicators							
Exports, U.S. dollars (percent change)	14.2	0.8	8.5	9.1	11.1	13.1	8.3
Imports, U.S. dollars (percent change)	9.0	-1.8	3.1	2.3	6.9	9.9	5.2
Terms of trade (percent change)	-2.1	-1.8	3.2	2.5	0.8	-0.4	1.6
Real effective exchange rate, (end-period, percent change) 2/	7.2	4.4	...	-5.5	...	-5.1	...
Current account balance (percent of GDP)	-2.9	-2.2	-2.2	-2.1	-1.9	-2.0	-1.9
Capital and financial account balance (percent of GDP)	2.7	3.0	4.4	3.5	1.9	2.5	2.1
Total external debt (percent of GDP)	52.3	50.3	51.0	49.0	48.6	47.2	47.1
Medium- and long-term public debt (percent of GDP) 6/	36.5	35.5	36.7	36.6	36.0	35.8	35.6
Medium- and long-term private debt (percent of GDP)	8.8	8.9	8.4	7.8	8.0	7.3	7.5
Short-term public and private debt (percent of GDP)	7.0	6.0	5.9	4.6	4.6	4.1	3.9
Total external debt (percent of exports of goods and services) 6/	327.1	319.3	309.3	302.9	284.5	280.9	270.0
Total debt service (percent of exports of goods and services) 7/	44.2	35.0	35.5	35.0	34.7	31.6	32.9
Gross official reserves (in millions of U.S. dollars)	8,562	8,837	9,942	9,690	9,658	9,960	10,060
Gross official reserves, percent of short-term external debt 8/	155.6	147.2	189.8	217.2	198.2	215.5	211.8
Gross official reserves, percent of broad money 9/	64.0	62.1	68.0	65.2	62.4	64.4	63.2
Gross official reserves, percent of foreign currency deposits at banks	92.5	93.5	103.0	101.3	100.1	104.1	103.0
Gross official reserves (in months of imports of goods and services)	10.7	10.7	11.5	10.8	10.3	10.6	10.1
Net international reserves (in millions of U.S. dollars)	8,180	8,613	9,863	9,598	9,638	9,948	10,048
Net international reserves (program definition; in millions of U.S. dollars) 10/	4,891	5,056	5,593	5,674	5,526	6,206	6,116
Net international position (in millions of U.S. dollars) 11/	2,624	2,915	3,110	3,341	3,341	3,841	3,751
Financial market indicators							
Stock market index (U.S. dollars) 12/	342.8	342.1	...	396.0	...	566.3	...
Foreign currency debt rating (Moody's) 12/	Ba3	Ba3	...	Ba3	...	Ba3	...
Spread of Peruvian Brady bonds, basis points 12/ 13/	687	521	...	610	...	355	...

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

1/ Program numbers revised during the second program review, Country Report No. /03/104.
2/ At end of period. For 2003, interest rates correspond to August information for 90-day prime corporate rates, and real effective exchange rate corresponds to August.
3/ Defined as the inverse of the ratio of end-period broad money to annual GDP.
4/ Annual average. Since 2000, includes adjustment for an estimate of nonperforming loans that were temporarily exchanged for government bonds.
5/ Preliminary data for 2003 correspond to July.
6/ Includes Central Reserve Bank of Peru debt.
7/ Includes debt service to the Fund. For 2002, excludes US$923 million of Brady bonds that were amortized in a debt exchange operation.
8/ Short-term debt includes amortization of medium- and long-term loans falling due over the following year.
9/ At end-period exchange rate.
10/ Includes financial system's foreign currency deposits in central bank as reserve liability.
11/ Includes public sector foreign currency deposits in central bank (e.g. pension reserve funds) as reserve liability.
12/ For 2003, data correspond to end-September.
13/ Over U.S. Treasury bond yields of comparable maturity.

Table 10. Peru: Medium-Term Outlook

			Projections									
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
I. Balance of Payments and Other External Indicators												
(In billions of U.S. dollars)												
Current account	**-1.2**	**-1.2**	**-1.2**	**-1.2**	**-1.2**	**-1.3**	**-1.2**	**-1.3**	**-1.3**	**-1.3**	**-1.2**	**-1.1**
Merchandise trade	-0.3	0.2	0.5	0.8	1.1	1.3	1.5	1.7	2.0	2.3	2.6	3.0
Exports	7.0	7.6	8.6	9.4	10.3	11.2	12.2	13.3	14.5	15.8	17.2	18.8
Imports	-7.3	-7.4	-8.2	-8.6	-9.2	-9.9	-10.7	-11.6	-12.5	-13.5	-14.6	-15.8
Services	-0.8	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0	-1.1	-1.1	-1.1	-1.1	-1.1
Investment income	-1.1	-1.5	-1.8	-2.1	-2.5	-2.8	-2.8	-3.2	-3.4	-3.6	-3.9	-4.2
Current transfers	1.0	1.0	1.1	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Capital and financial account	**1.6**	**2.0**	**1.5**	**1.3**	**1.4**	**1.4**	**1.4**	**1.5**	**1.4**	**1.4**	**1.3**	**1.2**
Public sector	0.4	1.1	0.5	0.7	0.7	0.2	0.5	0.3	0.2	0.2	0.0	0.1
Disbursements 1/	1.3	2.9	1.9	2.1	2.1	1.6	2.0	2.6	2.0	2.0	2.0	3.5
Amortization due 1/	-0.9	-1.9	-1.2	-1.3	-1.4	-1.4	-1.5	-2.3	-1.7	-1.8	-1.9	-3.4
Other medium- and long-term public flows 2/	0.0	0.0	-0.3	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	1.2	0.9	1.0	0.6	0.6	1.1	0.8	1.2	1.1	1.2	1.3	1.1
Privatization receipts from direct investment	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, excluding privatization	0.8	2.2	0.9	0.5	0.5	1.2	0.5	0.7	1.1	1.2	1.3	1.1
Other 3/	0.1	-1.5	0.1	0.1	0.1	-0.1	0.3	0.4	0.0	0.0	0.0	0.0
Overall balance	**0.4**	**0.8**	**0.3**	**0.1**	**0.1**	**0.1**	**0.2**	**0.2**	**0.1**	**0.1**	**0.1**	**0.1**
Change in central bank reserves	-0.4	-0.8	-0.3	-0.1	-0.1	-0.1	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1
Exceptional financing 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(In percent of exports of goods and services)												
Total external debt service 1/ 5/	35.0	35.0	31.6	32.9	33.8	33.1	32.4	35.8	30.0	28.0	26.6	30.8
Public external debt service 1/ 5/	23.6	31.7	22.1	22.6	22.3	21.0	20.7	24.5	19.8	18.7	18.2	23.4
(In months of next year's imports of goods and services)												
Gross reserves	11.5	11.4	10.8	10.0	9.5	9.4	9.0	8.6	8.3	7.9	7.4	7.2
(In percent of short-term external debt on a residual-maturity basis)												
Gross reserves	147.2	217.2	215.5	211.8	208.3	192.9	173.0	194.0	199.6	200.2	163.5	160.0
(In percent of broad money)												
Gross reserves	62.1	65.2	64.4	63.2	62.1	60.9	58.4	55.7	53.0	50.3	47.5	44.7
(In percent of GDP)												
Current account deficit	-2.2	-2.1	-2.0	-1.9	-1.8	-1.8	-1.6	-1.6	-1.5	-1.4	-1.3	-1.1
Merchandise exports	13.0	13.4	14.2	14.8	15.3	15.7	16.1	16.5	16.9	17.3	17.7	18.2
Merchandise imports	-13.5	-13.1	-13.4	-13.6	-13.7	-13.9	-14.1	-14.3	-14.6	-14.8	-15.0	-15.3
Total external debt	50.3	49.0	47.2	47.1	45.2	43.8	42.1	40.6	39.8	37.7	35.7	33.6
Total medium- and long-term public external debt 6/	35.5	36.6	35.8	35.6	34.7	33.0	31.7	30.2	28.7	27.2	25.7	24.2

Table 10. Peru: Medium-Term Outlook

	2001	2002	Projections 2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
II. Output and Prices												
(Annual percentage change)												
Real GDP	0.6	5.3	4.0	4.0	4.5	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Real domestic demand	-0.1	4.7	3.6	3.8	4.3	3.9	3.9	3.9	3.9	3.8	3.8	3.8
Of which:												
Private consumption	1.8	4.4	3.6	3.6	4.2	4.0	3.9	3.9	3.9	3.8	3.8	3.8
Private investment	-5.9	0.5	5.0	5.7	6.3	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Consumer prices (end of period)	-0.1	1.5	1.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
(In percent of GDP)												
III. Savings and Investment												
Gross domestic investment	**18.5**	**18.5**	**18.5**	**18.8**	**19.1**	**19.1**	**19.0**	**19.0**	**18.9**	**18.9**	**18.8**	**18.8**
Public sector	3.1	2.8	2.7	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Private sector	15.4	15.7	15.7	16.0	16.3	16.3	16.2	16.2	16.1	16.1	16.0	16.0
National savings	**16.3**	**16.4**	**16.4**	**16.8**	**17.2**	**17.3**	**17.5**	**17.4**	**17.4**	**17.5**	**17.6**	**17.7**
Public sector 7/	0.7	0.6	0.9	1.4	1.9	2.2	2.2	2.4	2.4	2.5	2.7	2.7
Private sector	15.6	15.8	15.5	15.4	15.3	14.8	17.5	17.4	17.4	17.5	17.6	17.7
External savings	**2.2**	**2.1**	**2.0**	**1.9**	**1.8**	**1.8**	**1.6**	**1.6**	**1.5**	**1.4**	**1.3**	**1.1**
IV. Combined Public Sector												
Combined public sector primary balance	**-0.1**	**-0.1**	**0.1**	**0.7**	**1.3**	**1.7**	**1.9**	**2.1**	**2.1**	**2.1**	**2.2**	**2.1**
Of which												
General government current rev. 8/	17.0	17.0	17.1	17.4	17.6	17.6	17.7	17.7	18.0	18.1	18.3	18.3
General govt. non-interest exp. 9/	17.7	17.3	17.2	16.9	16.8	16.7	16.6	16.8	16.9	17.0	17.0	17.1
Interest due	2.2	2.1	2.1	2.1	2.2	2.3	2.3	2.3	2.3	2.3	2.2	2.1
Combined public sector overall balance	**-2.4**	**-2.2**	**-1.9**	**-1.4**	**-0.9**	**-0.5**	**-0.4**	**-0.2**	**-0.2**	**-0.2**	**0.0**	**0.0**
Net external financing	0.9	2.1	1.0	1.2	0.8	0.4	0.3	0.1	0.1	0.1	0.0	0.0
Net domestic financing 10/	0.8	-0.7	0.6	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Privatization receipts	0.6	0.8	0.3	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt	46.2	46.7	45.6	45.1	42.8	40.6	38.5	36.2	34.1	32.0	30.0	28.2

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

1/ In 2002, includes the Brady Bond swap (not envisaged in the original program). For details of the swap, see Country Report No. /03/72, Box 3.

2/ Includes portfolio flows of the pension reserve fund and subscription payments into international funds.

3/ Includes errors and omissions.

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

5/ Spikes in 2008 and 2012 reflect bullet-payment amortizations of international bond issues from 2002 and 2003.

6/ Includes Central Reserve Bank of Peru debt.

7/ Excludes privatization receipts.

8/ Reflects government's 2003 tax reform objective of raising tax revenues by 3-percentage points of GDP over the medium term (which would allow room, in part, for the elimination of distortionary taxes).

9/ Real expenditure growth is limited to 3 percent a year under the nation's fiscal responsibility law.

10/ Includes statistical discrepancy.

Table 11. Peru: Financing of the Combined Public Sector

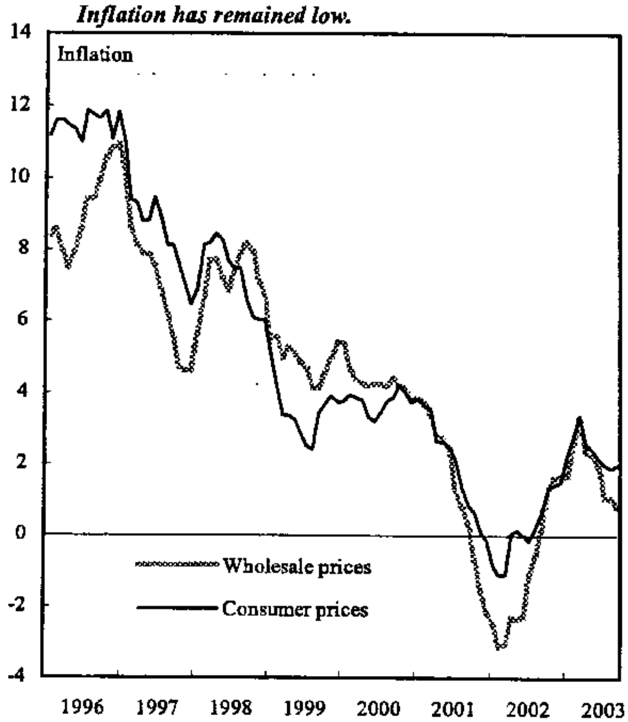
	2001	Rev. Prog. 2002	2002	Rev. Prog. 1/ 2003	Proj. 2003	Proj. 2004
	(In millions of U.S. dollars)					
Combined balance	**-1,266**	**-1,281**	**-1,243**	**-1,183**	**-1,161**	**-902**
Financing	**1,266**	**1,281**	**1,243**	**1,183**	**1,161**	**902**
	479	1,186	1,169	722	635	796
Net External	479	1,179	1,169	722	635	796
Disbursements 2/	1,319	2,056	2,863	1,800	1,910	2,050
Bonds	0	989	1,886	750	750	1,000
Multilaterals	1,105	774	807	895	958	833
Bilaterals and other	214	293	170	155	202	217
Amortizations 2/	-768	-925	-1,837	-1,111	-1,141	-1,279
Condonation	-72	55	143	33	-134	25
Privatization	327	400	421	400	157	20
Net Domestic financing	461	-298	-347	61	369	86
Bonds	346	267	267	430	517	555
Amortizations	-130	-125	-138	-370	-371	-354
Other	245	-440	-475	0	223	-109
Of which: Central government	228	-424	-471	43	246	-76
	(In percent of GDP)					
Combined balance	-2.4	-2.3	-2.2	-1.9	-1.9	-1.4
Financing	2.3	2.3	2.2	1.9	2.0	1.4
Net External	0.9	2.1	2.1	1.2	1.0	1.2
Disbursements 2/	2.5	3.7	5.0	3.0	3.1	3.2
Bonds	0.0	1.8	3.3	1.2	1.2	1.6
Multilaterals	2.1	1.4	1.4	1.5	1.6	1.3
Bilaterals and other	0.4	0.5	0.3	0.3	0.3	0.3
Amortizations 2/	-1.5	-1.7	-3.2	-1.9	-1.9	-2.0
Condonation	-0.1	0.1	0.3	0.1	-0.2	0.0
Privatization	0.6	0.7	0.8	0.7	0.3	0.0
Net Domestic financing	0.8	-0.5	-0.7	0.1	0.6	0.1
Bonds	0.6	0.5	0.5	0.7	0.8	0.9
Amortizations	-0.2	-0.2	-0.2	-0.6	-0.6	-0.6
Other	0.5	-0.8	-0.9	-0.0	0.4	-0.2
Of which: Central government	0.4	-0.8	-0.8	0.1	0.4	-0.1

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

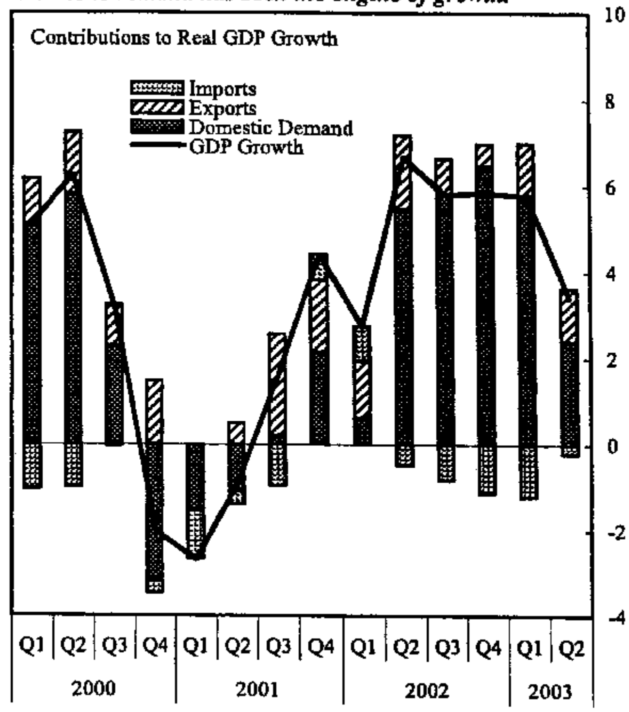
1/ Program numbers revised during the second program review, Country Report No. /03/104.
2/ Includes the Brady bond swap of US$923 million carried out in early 2002.

Figure 1. Peru: Selected Economic Indicators, 1996–2003

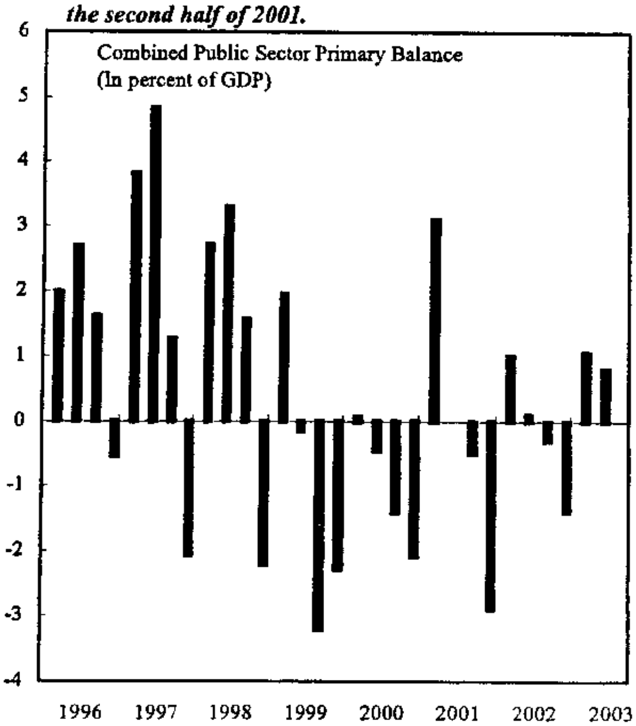
Inflation has remained low.



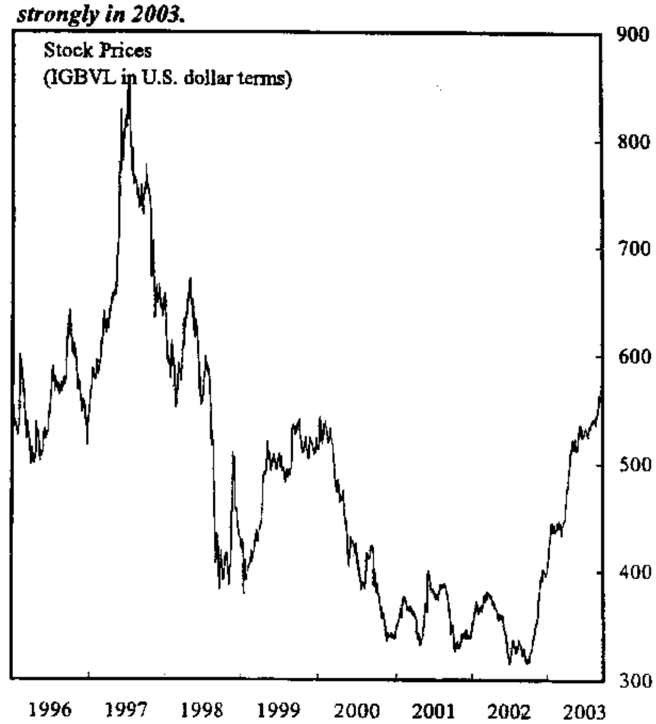
Domestic demand has been the engine of growth.



The public sector primary balance has improved since the second half of 2001.



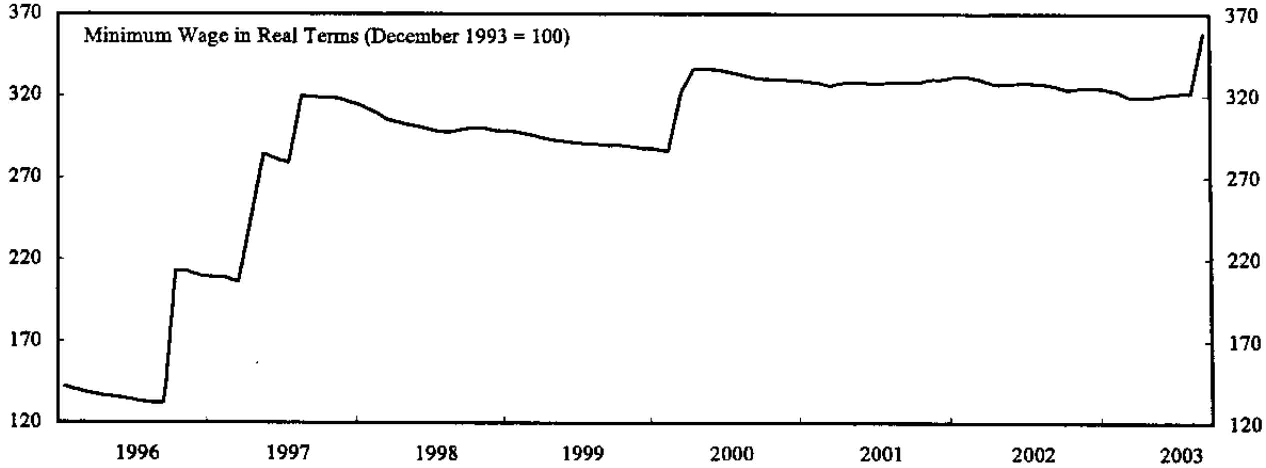
Stock prices in U.S. dollar terms have recovered strongly in 2003.



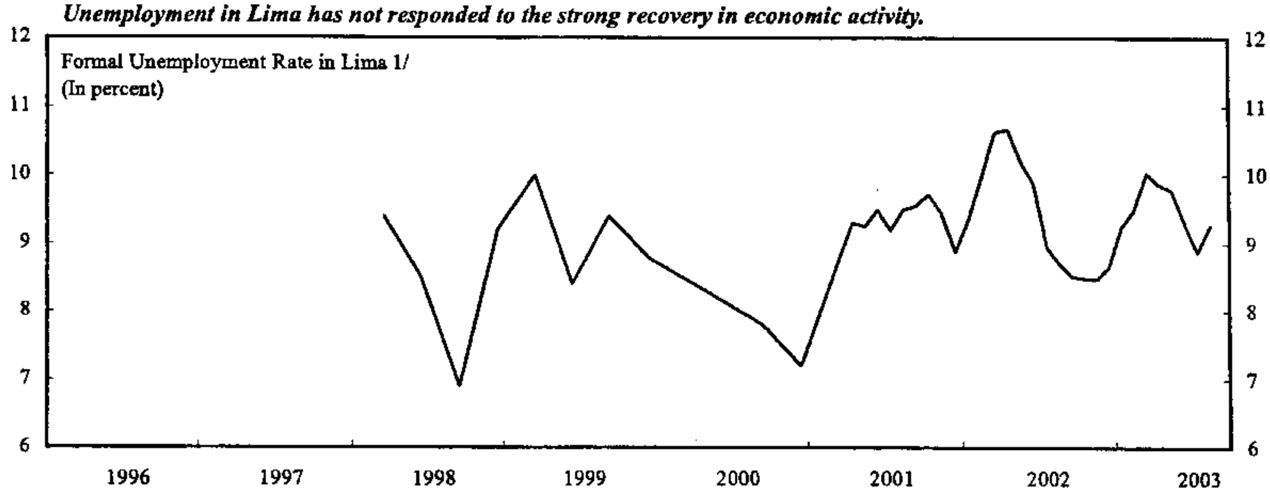
Sources: Central Reserve Bank of Peru; and Yahoo Finance.

Figure 2. Peru: Labor Market Indicators, 1996–2003

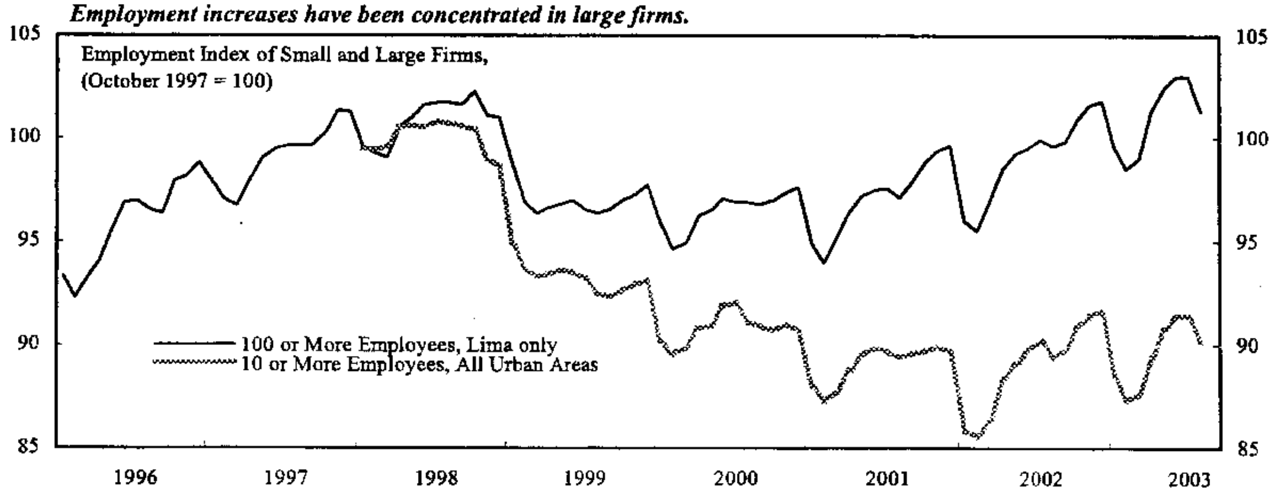
The minimum wage was recently adjusted for the first time since 2000.



Unemployment in Lima has not responded to the strong recovery in economic activity.



Employment increases have been concentrated in large firms.

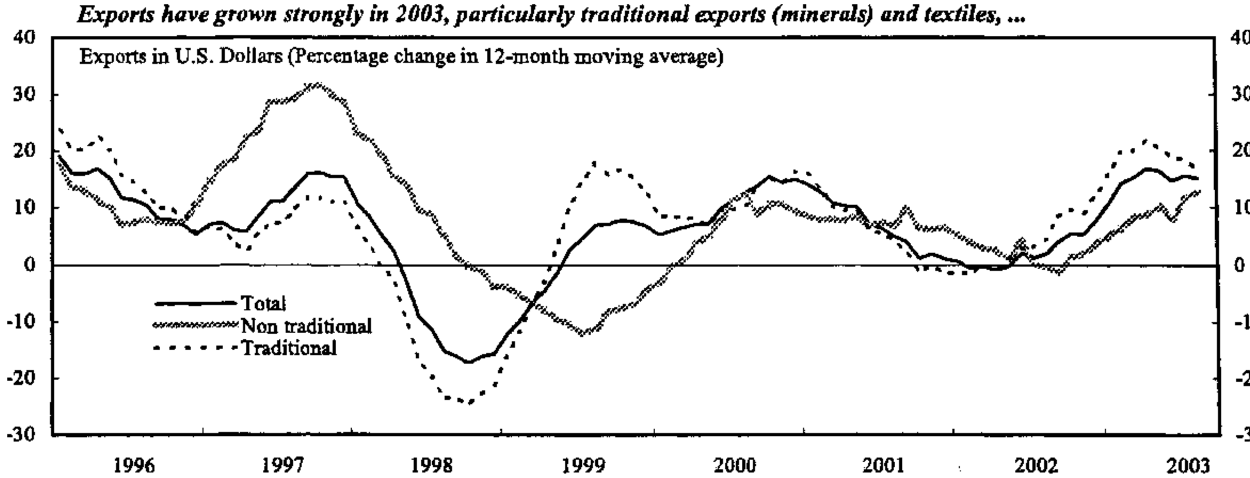


Sources: Ministry of Labor; and Central Reserve Bank of Peru.

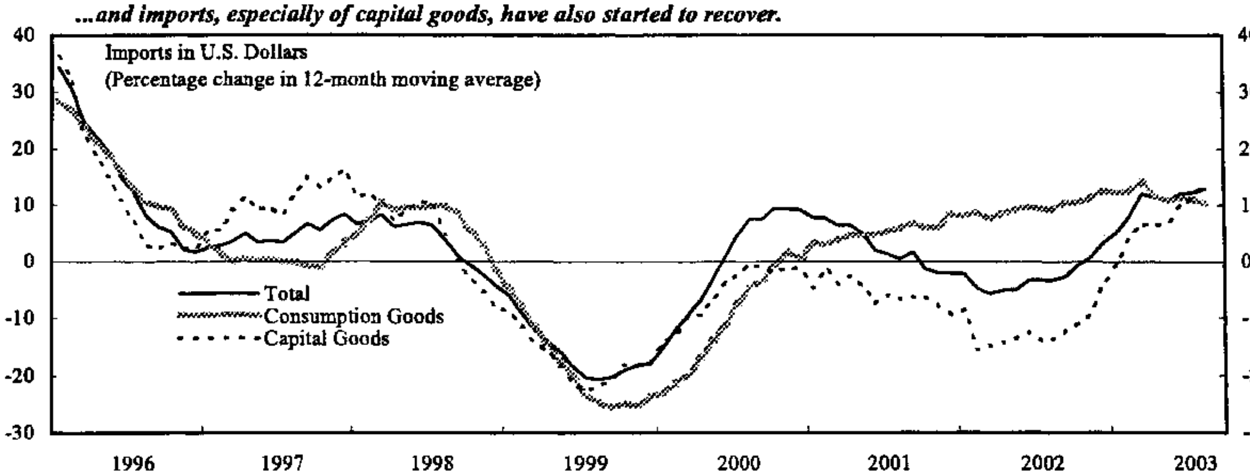
1/ Series begins in 1998; quarterly through 2000; three-month moving average since 2001.

Figure 3. Peru: Trade Indicators, 1996–2003

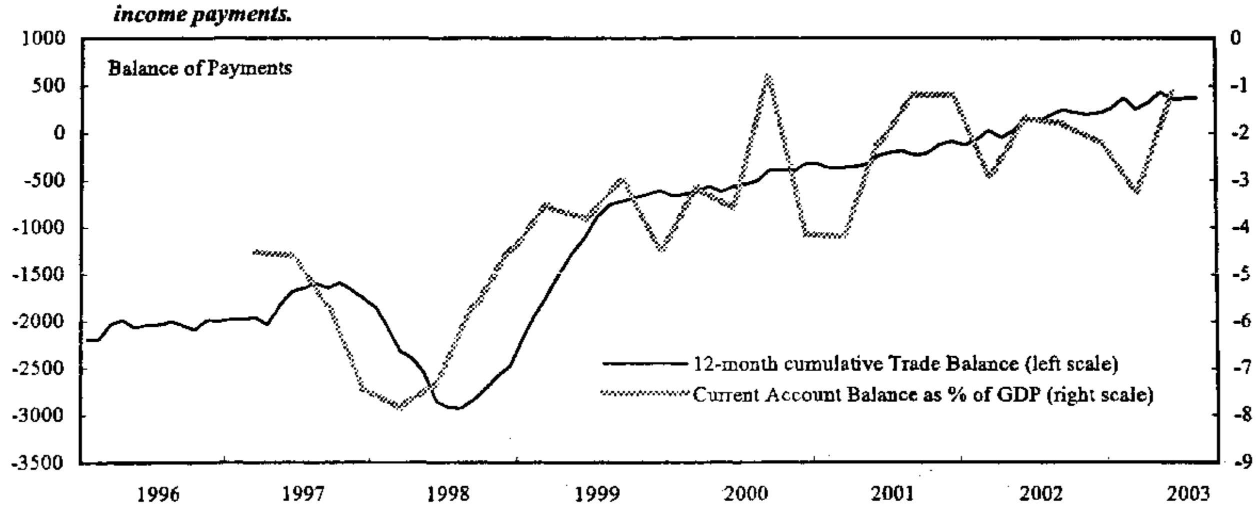
Exports have grown strongly in 2003, particularly traditional exports (minerals) and textiles, ...



...and imports, especially of capital goods, have also started to recover.



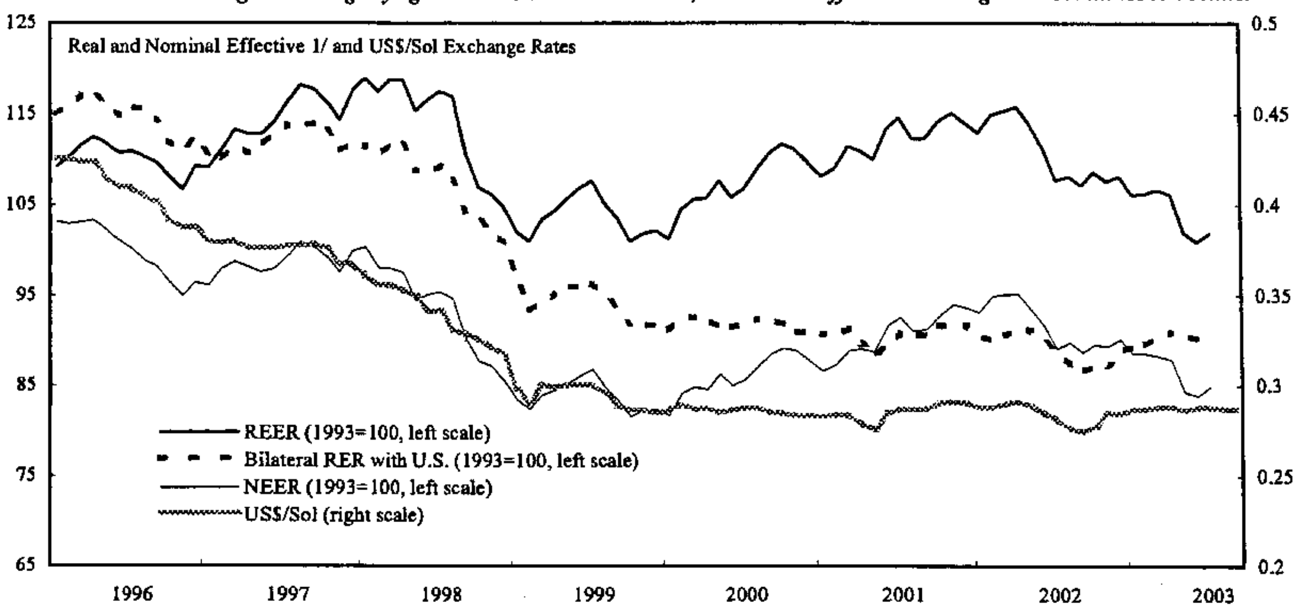
The current account deficit remains stable, with a growing trade surplus offsetting higher investment-income payments.



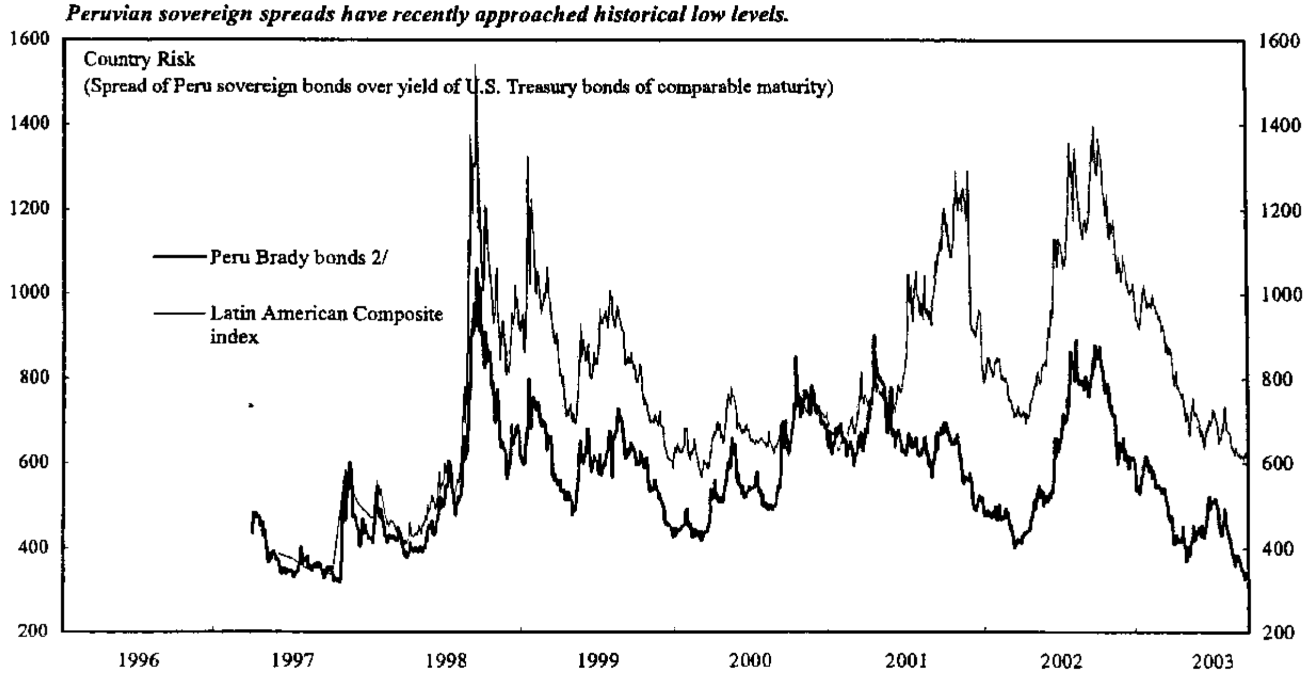
Source: Central Reserve Bank of Peru.

Figure 4. Peru: External Indicators, 1996–2003

The Sol has strengthened slightly against the U.S. dollar in 2003, but the real effective exchange rate continues to decline.

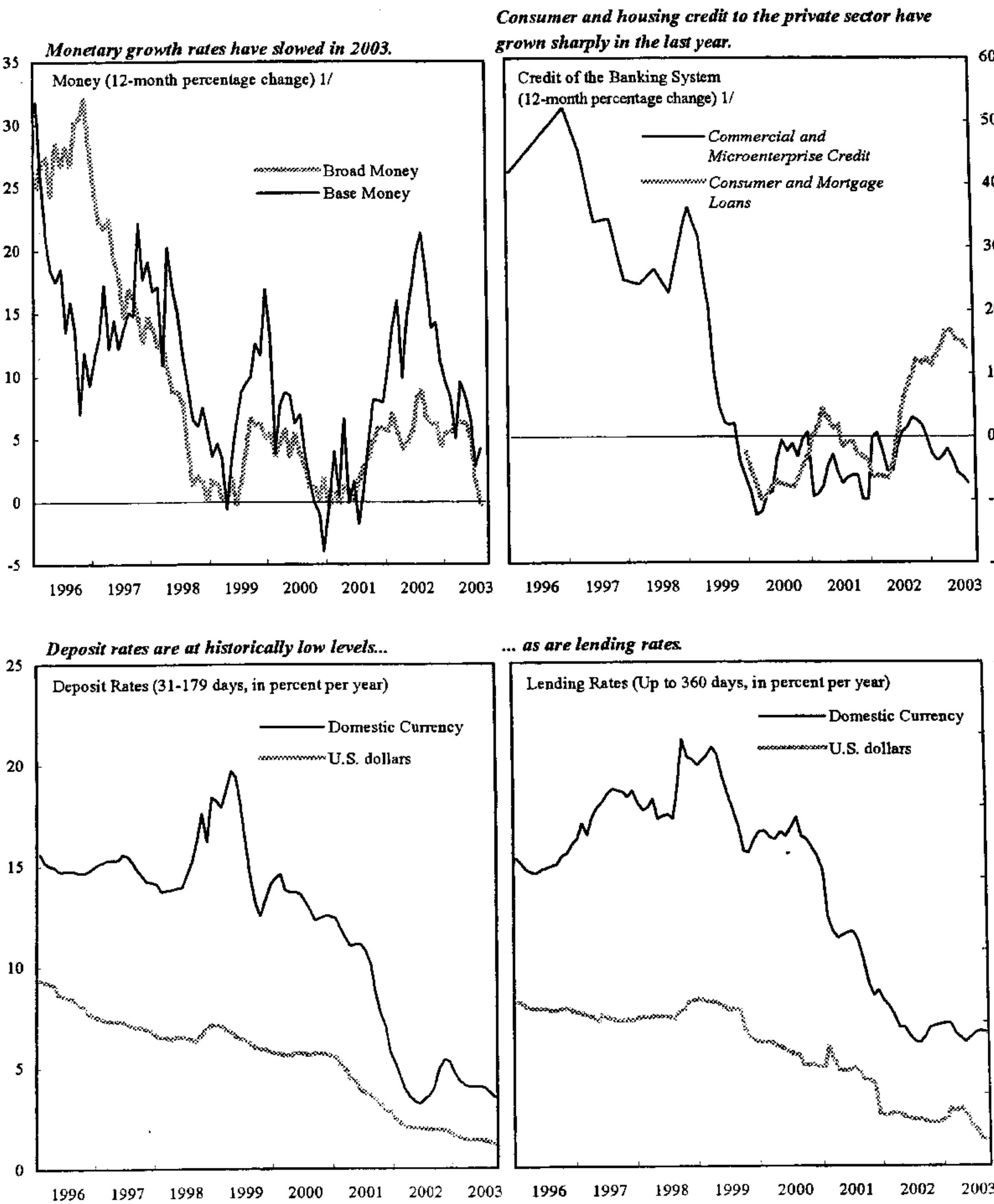


Peruvian sovereign spreads have recently approached historical low levels.



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.

Figure 5. Peru: Monetary Indicators, 1996–2003

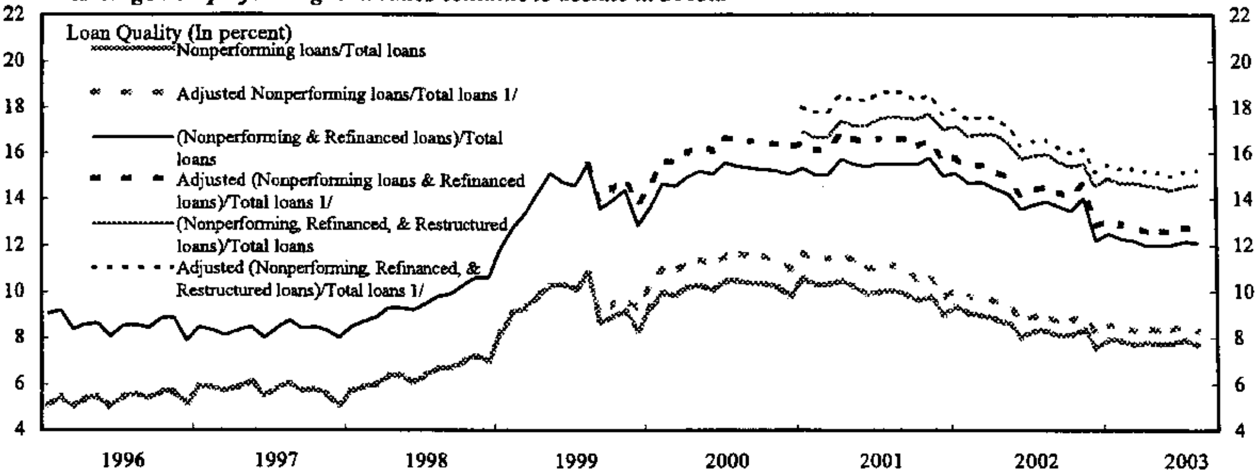


Sources: Central Reserve Bank of Peru; Superintendency of Banks; and Fund staff estimates.

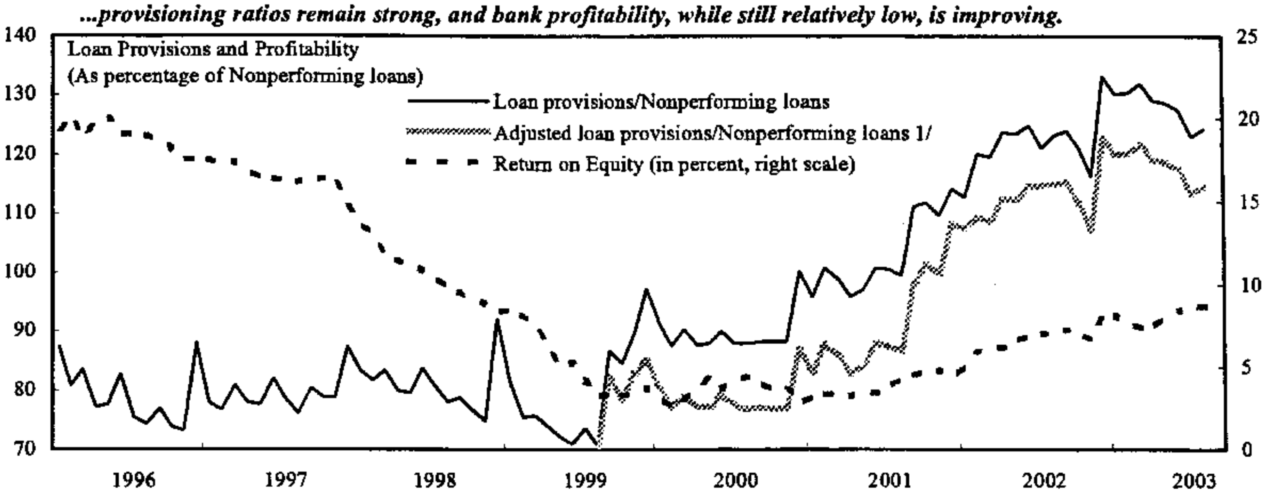
1/ U.S. dollar stocks are valued at market exchange rates.

Figure 6. Peru: Banking Indicators, 1996–2003

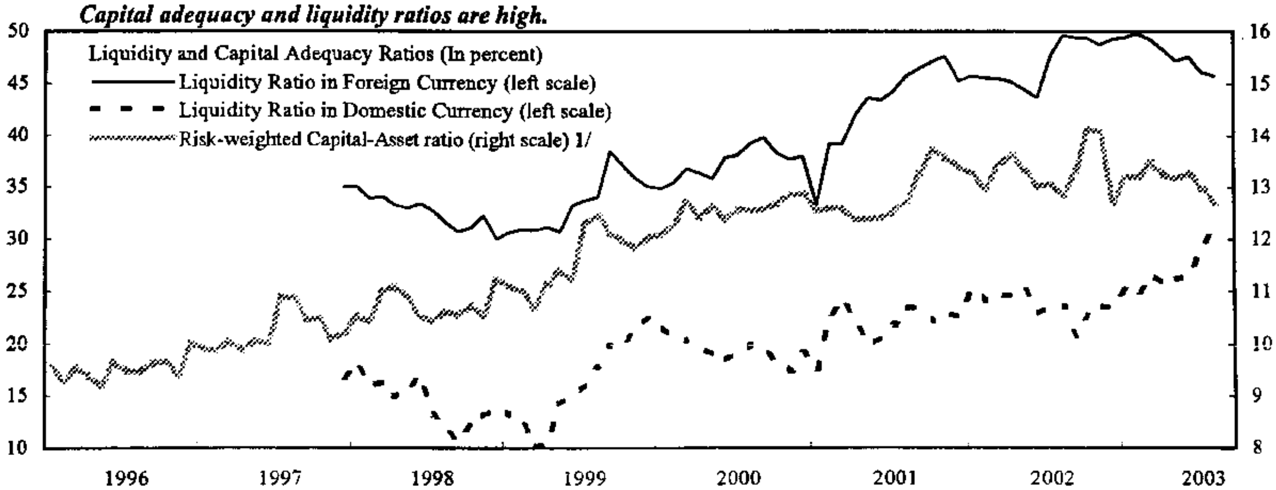
Average non-performing loan ratios continue to decline in 2003...



...provisioning ratios remain strong, and bank profitability, while still relatively low, is improving.



Capital adequacy and liquidity ratios are high.

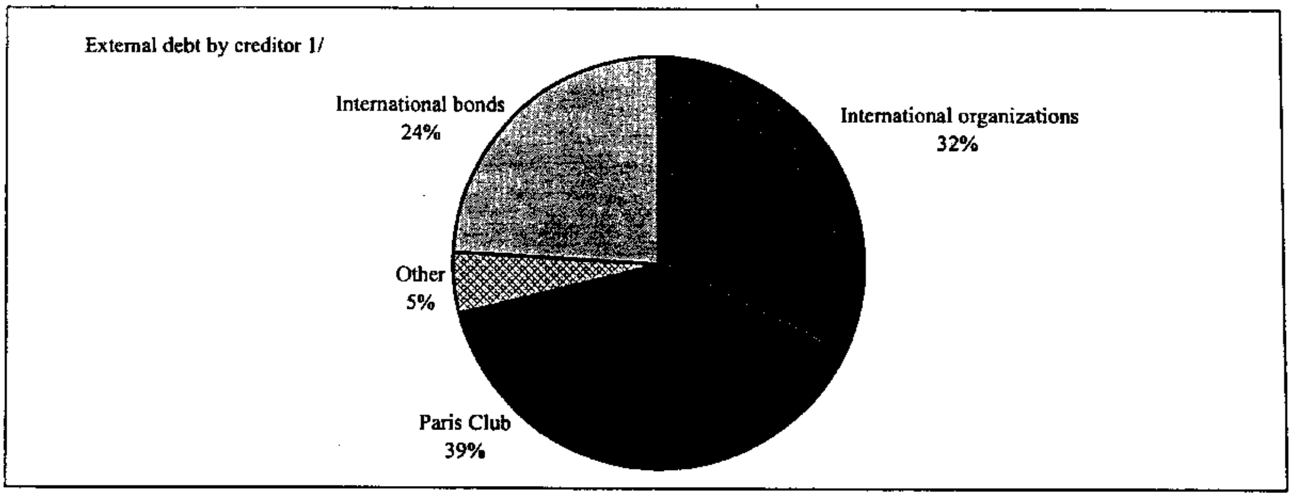


Source: Superintendency of Banks and Insurance.

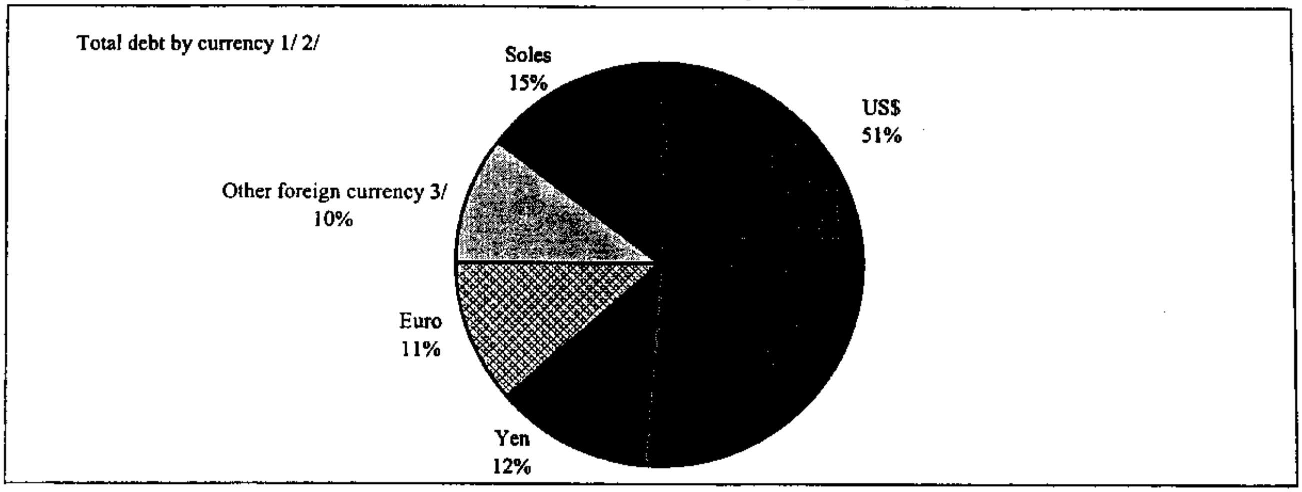
1/ Adjusted for the bond-for-loan swap programs from August 1999.

Figure 7. Peru: Composition of Public Debt, June 2003

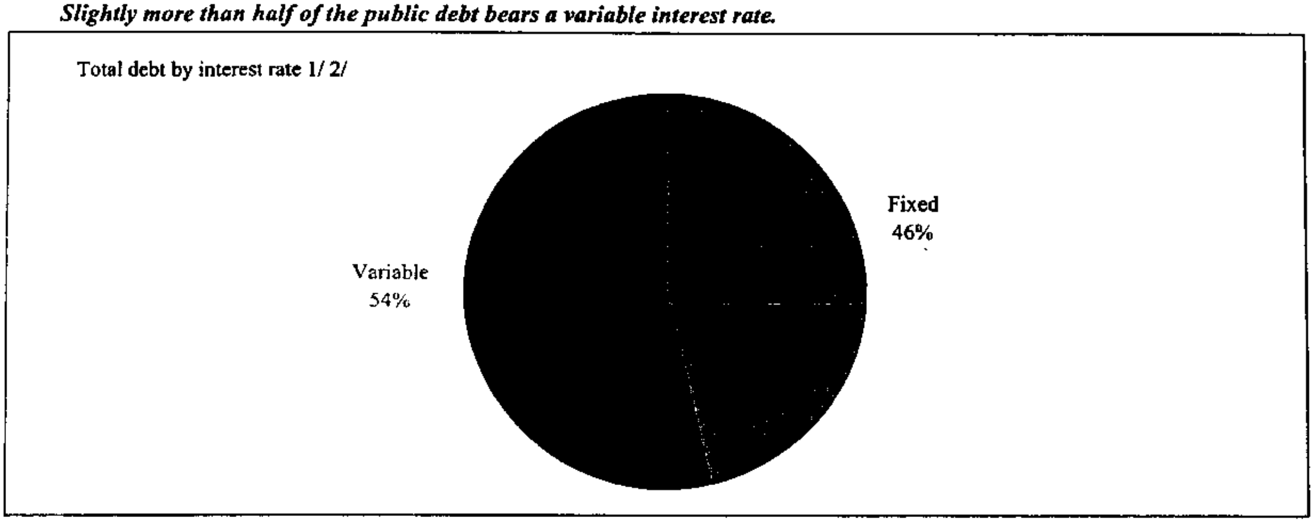
Three-fourths of the US$21 billion public external debt is owed to official creditors.



85 percent of the US$27.3 billion total public debt is denominated in foreign currency.



Slightly more than half of the public debt bears a variable interest rate.



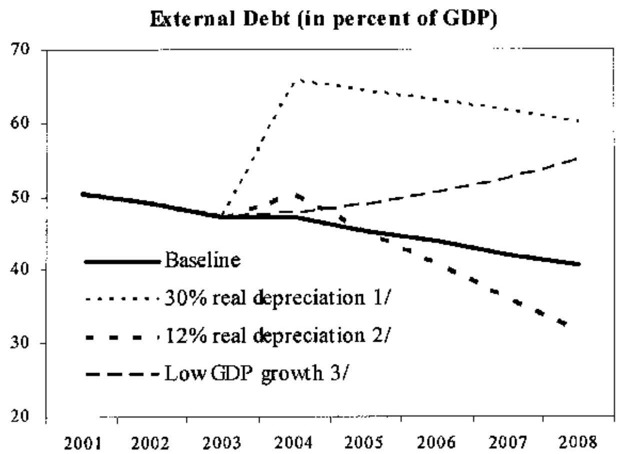
Source: Ministry of Economy and Finance.

1/ Millions of U.S. dollars.
2/ Domestic debt includes floating debt.
3/ Includes loans expressed as a currency basket, comprised mostly of Euro, Yen, and U.S. dollars.

Peru: Debt Sustainability Analysis[1]

External and public sector debt in the baseline projections are quite robust to alternative assumptions about the underlying macroeconomic variables. Using ten-year historical averages of the key assumptions does not significantly alter the medium-term projection. Additional temporary negative shocks to key variables, such as interest rates and real GDP growth, would lead to some increase in the level of public and external debt, but the ratios would return to a declining trend once conditions normalize.

External and public debt are also resilient to real exchange rate shocks of magnitudes experienced by Peru in the recent past and in which there is a corresponding current account adjustment, but appear vulnerable to a very large decline in the real exchange rate as assumed in the standard DSA. A 12-percent permanent real depreciation that leads to a contraction in domestic demand and an improvement in the external current account would result initially in somewhat higher external and public debt-to-GDP ratios, but thereafter those ratios would decline rapidly.



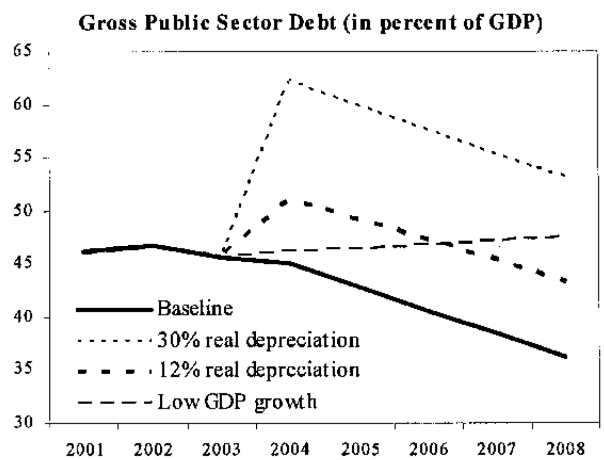


Chart Notes:
1/ Effect of a sustained 30 percent real depreciation of the Nuevo Sol.
2/ Effect of a sustained 12 percent real depreciation of the Nuevo Sol, and endogenous current account adjustment.
3/ Effect of a reduction in the baseline growth path from 4 to 2 percent.

External debt appears vulnerable to a situation of a sustained reduction in demand for Peru's exports, and public debt would also be vulnerable should the government try to offset the economic slowdown by running higher fiscal deficits. A reduction in baseline growth from 4 to 2 percent, owing to an export shock, countered by increasing the fiscal deficit to 2 percent of GDP (the limit established under the country's fiscal responsibility law during recessionary periods), leads to moderately rising ratios of external and public sector-debt-to-GDP.

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[1] The DSA includes standard sensitivity tests around the baseline medium-term scenario. The methodology used is in line with that endorsed in (http//www.IMF.Org).

Table 1a. Peru: External Standard Debt Sustainability Framework, Baseline Scenario, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
External debt	53.1	55.6	52.3	50.3	49.0	47.2	47.1	45.2	43.8	42.1	40.6
Change in external debt	3.9	2.4	-3.3	-2.0	-1.4	-1.8	-0.1	-1.9	-1.4	-1.7	-1.5
Identified external debt-creating flows (4+8+11)	5.7	5.4	0.0	0.5	-4.4	-2.7	-0.8	-1.5	-1.5	-1.8	-1.7
Current account deficit, excluding interest payments	2.8	-0.5	-0.5	-0.8	-0.3	-0.2	-0.4	-0.9	-1.0	-1.3	-1.1
Deficit in balance of goods and services	5.5	2.5	2.1	1.8	1.0	0.9	0.4	-0.4	-0.6	-0.8	-1.0
Exports	13.2	14.9	16.0	15.8	16.2	16.8	17.4	18.0	18.4	18.9	19.3
Imports	18.7	17.4	18.1	17.6	17.2	17.7	17.8	17.6	17.8	18.1	18.3
Net non-debt creating capital inflows (negative)	-1.9	-2.9	-1.0	-1.4	-3.8	-1.5	-0.8	-0.7	-0.7	-0.7	-0.7
Net foreign direct investment, equity	2.8	3.5	1.1	1.5	3.9	1.5	0.8	0.7	0.7	0.7	0.7
Net portfolio investment,equity	-0.8	-0.6	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Automatic debt dynamics 1/	4.8	8.8	1.4	2.8	-0.3	-1.1	0.5	0.1	0.2	0.2	0.2
Contribution from nominal interest rate	3.1	3.4	3.4	3.0	2.4	2.2	2.4	2.7	2.8	2.8	2.7
Contribution from real GDP growth	0.3	-0.6	-1.7	-0.3	-2.5	-1.8	-1.8	-2.0	-1.7	-1.7	-1.6
Contribution from price and exchange rate changes 2/	1.4	6.0	-0.3	0.0	-0.2	-1.5	-0.1	-0.6	-0.9	-0.9	-0.9
Residual, incl. change in gross foreign assets (2-3)	-1.7	-2.9	-3.3	-2.5	3.0	1.0	0.7	-0.4	0.1	0.1	0.1
External debt-to-exports ratio (in percent)	401.5	371.9	327.1	319.3	302.9	280.9	270.6	251.4	237.8	223.3	209.9
Gross external financing need (in billions of U.S. dollars) 3/	11.4	9.5	8.3	6.7	7.2	5.7	5.9	6.1	6.3	6.3	7.3
In percent of GDP	20.1	18.3	15.5	12.4	12.9	9.4	9.3	9.0	8.8	8.3	9.0
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	-0.5	0.9	3.1	0.6	5.3	4.0	4.0	4.5	4.0	4.0	4.0
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-8.7	-13.5	-3.0	-1.1	0.4	0.9	-1.9	-1.6	-0.5	-0.4	-0.3
GDP deflator in U.S. dollars (change in percent)	-2.8	-10.1	0.5	0.0	0.3	3.1	0.1	1.3	2.0	2.2	2.3
Nominal external interest rate (in percent)	6.1	5.8	6.3	5.9	5.0	4.9	5.2	6.2	6.5	6.9	6.9
Growth of exports (U.S. dollar terms, in percent)	-10.2	2.4	10.9	-0.4	7.9	11.4	8.0	9.3	8.8	9.0	9.0
Growth of imports (U.S. dollar terms, in percent)	-2.2	-15.4	7.7	-2.2	3.2	10.3	4.9	4.4	7.8	7.8	7.9
Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2008					49.0	48.7	48.2	46.6	45.5	44.4	43.2
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004					49.0	48.4	49.5	47.6	46.2	44.6	43.1
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					49.0	51.6	56.4	54.5	53.2	51.6	50.1
4. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004					49.0	52.6	58.3	56.4	55.1	53.5	52.0
5. Combination of 2-4 using one standard deviation shocks					49.0	53.9	61.2	59.3	57.9	56.4	54.9
6. One time 30 percent nominal depreciation in 2004					49.0	47.2	66.2	64.3	63.0	61.5	60.0
7. One time 15 percent nominal depreciation in 2004					49.0	47.2	54.4	52.5	51.2	49.6	48.1

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2003-08
Current account deficit, excluding interest payments	1.5	1.9	-0.8
Net non-debt creating capital inflows	3.8	2.3	0.9
Nominal external interest rate (in percent)	6.0	0.8	6.1
Real GDP growth (in percent)	4.5	4.1	4.1

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in USdollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Table 1b. Peru: Public Sector Standard Debt Sustainability Framework, Baseline Scenario, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Public sector debt 1/	42.1	48.0	45.9	46.2	46.7	**45.6**	**45.1**	**42.8**	**40.6**	**38.5**	**36.2**
Change in public sector debt	3.5	5.9	-2.1	0.3	0.5	-1.2	-0.5	-2.3	-2.2	-2.2	-2.3
Identified debt-creating flows (4+7+12)	3.5	4.6	-0.2	0.0	-0.7	-0.7	-0.5	-1.7	-2.0	-2.0	-2.2
Primary deficit	-1.3	0.8	0.9	0.1	0.1	-0.1	-0.7	-1.3	-1.7	-1.9	-2.1
Revenue and grants 2/	19.9	18.8	18.0	18.0	17.5	17.7	18.1	18.3	18.6	18.7	18.8
Primary (noninterest) expenditure 2/	18.6	19.6	18.9	18.1	17.6	17.5	17.4	17.0	16.9	16.8	16.7
Automatic debt dynamics 3/	5.2	4.4	-0.4	0.5	-0.1	-0.3	0.2	-0.3	-0.3	-0.1	0.0
Contribution from interest rate/growth differential 4/	-0.2	0.2	-0.8	1.5	-0.3	-0.6	-0.5	-0.9	-0.4	-0.2	-0.1
Of which contribution from real interest rate	-0.4	0.6	0.6	1.7	2.1	1.1	1.2	1.0	1.2	1.3	1.3
Of which contribution from real GDP growth	0.2	-0.4	-1.4	-0.3	-2.3	-1.8	-1.7	-1.9	-1.6	-1.5	-1.5
Contribution from exchange rate depreciation 5/	5.3	4.2	0.4	-1.0	0.1	0.4	0.7	0.6	0.2	0.1	0.1
Other identified debt-creating flows	-0.4	-0.7	-0.8	-0.6	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	-0.4	-0.7	-0.8	-0.6	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	0.0	1.3	-1.9	0.4	1.3	-0.4	0.0	-0.6	-0.2	-0.1	-0.1
Public sector debt in percent of revenues 1/	211.6	255.3	255.3	257.2	267.0	256.9	249.0	234.3	218.8	205.9	192.7
Overall deficit	-0.7	-3.0	-3.2	-2.4	-2.2	-1.9	-1.4	-0.9	-0.5	-0.4	-0.2
Interest payment	2.0	2.2	2.3	2.2	2.1	2.1	2.1	2.2	2.3	2.3	2.3
Gross financing 6/	3.3	6.1	6.2	4.8	6.2	4.6	4.4	3.8	3.3	3.0	3.6
in billions of U.S. dollars	1.9	3.2	3.3	2.6	3.5	2.8	2.8	2.6	2.4	2.3	2.9
Additional Macroeconomic and Fiscal Assumptions											
Nominal GDP (local currency)	166.5	174.7	186.8	189.9	200.0	212.5	225.7	242.8	259.0	276.3	294.9
Average nominal interest rate on public debt (in percent) 7/	5.4	5.4	5.1	4.9	4.7	4.8	5.0	5.4	5.6	6.2	6.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.1	1.5	1.4	3.8	4.7	2.7	2.9	2.4	3.1	3.6	3.8
Interest rate on new market external financing (in percent)	...	...	...	...	...	11.0	11.0	10.0	10.0	10.0	10.0
Gross market external financing in percent of total external financing	...	...	...	...	...	38.9	38.9	38.9	38.9	38.9	38.9
Exchange rate (LC per U.S. dollar)	3.1	3.5	3.5	3.4	3.5	3.5	3.6	3.6	3.6	3.6	3.7
Nominal appreciation (increase in U.S. dollar value of local currency, in percent) 8/	-13.4	-10.0	-1.0	2.4	-0.3	-0.9	-1.9	-1.6	-0.5	-0.4	-0.3
Inflation rate (GDP deflator, in percent)	6.4	3.9	3.6	1.1	0.0	2.2	2.1	2.9	2.5	2.6	2.6
Growth of real primary spending (deflated by GDP deflator, in percent)	4.0	6.3	-0.7	-3.7	2.7	3.2	3.3	2.0	3.3	3.5	3.6
Stress Tests											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007					**46.7**	**43.6**	**41.6**	**39.0**	**36.5**	**34.1**	**31.8**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004					**46.7**	**47.6**	**49.1**	**46.8**	**44.7**	**42.5**	**40.2**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					**46.7**	**49.3**	**52.6**	**50.1**	**47.6**	**45.1**	**42.5**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004					**46.7**	**47.4**	**49.1**	**46.8**	**44.6**	**42.5**	**40.2**
5. Combination of 2-4 using one standard deviation shocks					**46.7**	**48.3**	**51.0**	**47.3**	**43.8**	**40.2**	**36.6**
6. 30 percent real depreciation in 2004 9/					**46.7**	**45.6**	**62.2**	**59.8**	**57.5**	**55.3**	**53.1**
6a. 15 percent real depreciation in 2004 9/					**46.7**	**45.6**	**52.1**	**49.8**	**47.6**	**45.4**	**43.2**
7. 10 percent of GDP increase in other debt-creating flows in 2003					**46.7**	**55.6**	**55.1**	**52.8**	**50.5**	**48.4**	**46.1**
8. Impact on **debt-to-GDP ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04					**46.7**	**47.3**	**48.8**	**46.6**	**44.4**	**42.2**	**39.9**
8a. Impact on **debt-to-revenue ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04					**267.0**	**294.9**	**304.6**	**254.8**	**238.9**	**225.8**	**212.4**

Historical Statistics for Key Variables (1993-2002)	Historical Average	Standard Deviation
Primary deficit	-0.6	1.1
Real GDP growth (in percent)	4.5	4.1
Nominal interest rate (in percent) 7/	5.7	1.3
Real interest rate (in percent) 10/	-0.4	3.9
Inflation rate (GDP deflator, in percent)	11.9	14.5
Revenue to GDP ratio	18.6	1.3

1/ Gross debt of the public sector including debt of public enterprises and the central bank.
2/ Net of transfers among non-financial public institutions.
3/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by the increase in local currency value of U.S. dollar).
4/ The real interest rate contribution is derived from the denominator in footnote 3/.
5/ The exchange rate contribution is derived from the denominator in footnote 3/.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ Based on end of period exchange rate.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ Calculated for period 1995-2001 to exclude the effect of recovery from hyperinflation during early 1990s.

Table 2a. Peru: External Endogenized Debt Sustainability Framework, Real Exchange Rate Scenario, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
External debt	53.1	55.6	52.3	50.3	49.0	**47.2**	**50.2**	**45.2**	**40.8**	**36.1**	**31.6**
Change in external debt	3.9	2.4	-3.3	-2.0	-1.4	-1.8	3.0	-5.0	-4.3	-4.7	-4.6
Identified external debt-creating flows (4+8+11)	5.7	5.4	0.0	0.5	-4.4	-2.7	2.8	-5.2	-4.5	-4.8	-4.7
Current account deficit, excluding interest payments	2.8	-0.5	-0.5	-0.8	-0.3	-0.2	-3.7	-4.2	-4.3	-4.8	-4.9
Deficit in balance of goods and services	5.5	2.5	2.1	1.8	1.0	0.9	-3.0	-3.6	-3.8	-4.2	-4.7
Exports	13.2	14.9	16.0	15.8	16.2	16.8	19.7	20.3	21.0	21.6	22.2
Imports	18.7	17.4	18.1	17.6	17.2	17.7	16.7	16.7	17.2	17.3	17.5
Net non-debt creating capital inflows (negative)	-1.9	-2.9	-1.0	-1.4	-3.8	-1.5	-1.0	-0.8	-0.8	-0.8	-0.8
Net foreign direct investment, equity	2.8	3.5	1.1	1.5	3.9	1.5	1.0	0.8	0.8	0.8	0.8
Net portfolio investment,equity	-0.8	-0.6	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Automatic debt dynamics 1/	4.8	8.8	1.4	2.8	-0.3	-1.1	7.5	-0.1	0.6	0.8	1.0
Contribution from nominal interest rate	3.1	3.4	3.4	3.0	2.4	2.2	2.7	3.1	3.2	3.2	3.1
Contribution from real GDP growth	0.3	-0.6	-1.7	-0.3	-2.5	-1.8	0.2	-2.1	-1.7	-1.5	-1.4
Contribution from price and exchange rate changes 2/	1.4	6.0	-0.3	0.0	-0.2	-1.5	4.6	-1.1	-0.9	-0.9	-0.8
Residual, incl. change in gross foreign assets (2-3)	-1.7	-2.9	-3.3	-2.5	3.0	1.0	0.2	0.2	0.2	0.1	0.1
External debt-to-exports ratio (in percent)	401.5	371.9	327.1	319.3	302.9	280.9	255.0	221.9	194.5	167.5	142.3
Gross external financing need (in billions of U.S. dollars) 3/	11.4	9.5	8.3	6.7	7.2	5.7	4.1	4.2	4.3	4.0	4.8
in percent of GDP	20.1	18.3	15.5	12.4	12.9	9.4	7.4	7.1	6.9	6.1	6.7

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Table 2b. Peru: Public Sector Endogenized Debt Sustainability Framework, Real Exchange Rate Scenario, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
1 Public sector debt 1/	42.1	48.0	45.9	46.2	46.7	**45.6**	**51.1**	**49.3**	**47.3**	**45.4**	**43.4**
2 Change in public sector debt	3.5	5.9	-2.1	0.3	0.5	-1.2	5.6	-1.9	-1.9	-1.9	-2.0
3 Identified debt-creating flows (4+7+12)	3.5	4.6	-0.2	0.0	-0.7	-0.7	5.5	-1.9	-1.9	-2.0	-2.0
4 Primary deficit	-1.3	0.8	0.9	0.1	0.1	-0.1	-0.5	-1.1	-1.7	-1.8	-2.0
5 Revenue and grants 2/	19.9	18.8	18.0	18.0	17.5	17.7	18.0	18.2	18.6	18.7	18.8
6 Primary (noninterest) expenditure 2/	18.6	19.6	18.9	18.1	17.6	17.5	17.5	17.1	16.9	16.8	16.8
7 Automatic debt dynamics 3/	5.2	4.4	-0.4	0.5	-0.1	-0.3	6.1	-0.7	-0.3	-0.1	0.0
8 Contribution from interest rate/growth differential 4/	-0.2	0.2	-0.8	1.5	-0.3	-0.6	0.7	-1.0	-0.5	-0.2	-0.1
9 *Of which* contribution from real interest rate	-0.4	0.6	0.6	1.7	2.1	1.1	0.6	1.1	1.4	1.5	1.6
10 *Of which* contribution from real GDP growth	0.2	-0.4	-1.4	-0.3	-2.3	-1.8	0.2	-2.1	-1.8	-1.8	-1.7
11 Contribution from exchange rate depreciation 5/	5.3	4.2	0.4	-1.0	0.1	0.4	5.4	0.3	0.2	0.1	0.1
12 Other identified debt-creating flows	-0.4	-0.7	-0.8	-0.6	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	-0.4	-0.7	-0.8	-0.6	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	0.0	1.3	-1.9	0.4	1.3	-0.4	0.0	0.0	0.0	0.0	0.0
Public sector debt in percent of revenues 1/	211.6	255.3	255.3	257.2	267.0	256.9	283.4	271.2	254.6	243.1	231.3
Overall deficit	-0.7	-3.0	-3.2	-2.4	-2.2	-1.9	-1.6	-1.4	-0.9	-0.9	-0.7
Interest payment	2.0	2.2	2.3	2.2	2.1	2.1	2.2	2.5	2.6	2.7	2.7
Gross financing 6/	3.3	6.1	6.2	4.8	6.2	4.6	4.9	4.4	3.8	3.5	4.3
in billions of U.S. dollars	1.9	3.2	3.3	2.6	3.5	2.8	2.7	2.6	2.4	2.3	3.0

1/ Gross debt of the public sector including debt of public enterprises and the central bank.

2/ Net of transfers among non-financial public institutions.

3/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by the increase in local currency value of U.S. dollar).

4/ The real interest rate contribution is derived from the denominator in footnote 3/.

5/ The exchange rate contribution is derived from the denominator in footnote 3/.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

Table 3a. Country: External Endogenized Debt Sustainability Framework, Low Growth Scenario, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
External debt	53.1	55.6	52.3	50.3	49.0	**47.2**	**47.6**	**48.8**	**50.5**	**52.4**	**54.7**
Change in external debt	3.9	2.4	-3.3	-2.0	-1.4	-1.8	0.5	1.2	1.7	1.8	2.3
Identified external debt-creating flows (4+8+11)	5.7	5.4	0.0	0.5	-4.4	-2.7	0.3	1.1	1.6	1.7	2.2
Current account deficit, excluding interest payments	2.8	-0.5	-0.5	-0.8	-0.3	-0.2	0.3	0.6	1.0	1.1	1.8
Deficit in balance of goods and services	5.5	2.5	2.1	1.8	1.0	0.9	0.9	1.1	1.4	1.6	1.9
Exports	13.2	14.9	16.0	15.8	16.2	16.8	16.5	16.2	15.8	15.5	15.2
Imports	18.7	17.4	18.1	17.6	17.2	17.7	17.4	17.3	17.2	17.2	17.1
Net non-debt creating capital inflows (negative)	-1.9	-2.9	-1.0	-1.4	-3.8	-1.5	-0.8	-0.8	-0.7	-0.8	-0.8
Net foreign direct investment, equity	2.8	3.5	1.1	1.5	3.9	1.5	0.8	0.8	0.7	0.8	0.8
Net portfolio investment,equity	-0.8	-0.6	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Automatic debt dynamics 1/	4.8	8.8	1.4	2.8	-0.3	-1.1	0.9	1.2	1.3	1.4	1.3
Contribution from nominal interest rate	3.1	3.4	3.4	3.0	2.4	2.2	2.4	2.8	2.9	3.1	3.1
Contribution from real GDP growth	0.3	-0.6	-1.7	-0.3	-2.5	-1.8	-0.9	-0.9	-1.0	-1.0	-1.0
Contribution from price and exchange rate changes 2/	1.4	6.0	-0.3	0.0	-0.2	-1.5	-0.6	-0.7	-0.7	-0.7	-0.7
Residual, incl. change in gross foreign assets (2-3)	-1.7	-2.9	-3.3	-2.5	3.0	1.0	0.1	0.1	0.1	0.1	0.1
External debt-to-exports ratio (in percent)	401.5	371.9	327.1	319.3	302.9	280.9	289.1	302.2	318.9	337.0	359.0
Gross external financing need (in billions of U.S. dollars) 3/	11.4	9.5	8.3	6.7	7.2	5.7	6.3	7.1	7.7	8.0	9.5
in percent of GDP	20.1	18.3	15.5	12.4	12.9	9.4	10.1	10.9	11.4	11.5	13.1

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Table 3b. Peru: Public Sector Endogenized Debt Sustainability Framework, Low Growth Scenario, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Public sector debt 1/	42.1	48.0	45.9	46.2	46.7	**45.6**	**46.1**	**46.4**	**46.8**	**47.1**	**47.5**
Change in public sector debt	3.5	5.9	-2.1	0.3	0.5	-1.2	0.5	0.4	0.4	0.3	0.3
Identified debt-creating flows (4+7+12)	3.5	4.6	-0.2	0.0	-0.7	-0.7	0.5	0.3	0.4	0.3	0.3
Primary deficit	-1.3	0.8	0.9	0.1	0.1	-0.1	-0.2	-0.4	-0.5	-0.8	-0.9
Revenue and grants 2/	19.9	18.8	18.0	18.0	17.5	17.7	18.1	18.2	18.4	18.5	18.6
Primary (noninterest) expenditure 2/	18.6	19.6	18.9	18.1	17.6	17.5	17.9	17.8	17.9	17.7	17.7
Automatic debt dynamics 3/	5.2	4.4	-0.4	0.5	-0.1	-0.3	0.7	0.8	0.9	1.2	1.2
Contribution from interest rate/growth differential 4/	-0.2	0.2	-0.8	1.5	-0.3	-0.6	0.5	0.6	0.7	1.0	1.1
Of which contribution from real interest rate	-0.4	0.6	0.6	1.7	2.1	1.1	1.4	1.5	1.6	1.9	2.0
Of which contribution from real GDP growth	0.2	-0.4	-1.4	-0.3	-2.3	-1.8	-0.9	-0.9	-0.9	-0.9	-0.9
Contribution from exchange rate depreciation 5/	5.3	4.2	0.4	-1.0	0.1	0.4	0.2	0.2	0.2	0.2	0.2
Other identified debt-creating flows	-0.4	-0.7	-0.8	-0.6	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	-0.4	-0.7	-0.8	-0.6	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	0.0	1.3	-1.9	0.4	1.3	-0.4	0.0	0.0	0.0	0.0	0.0
Public sector debt in percent of revenues 1/	211.6	255.3	255.3	257.2	267.0	256.9	255.0	255.4	254.4	255.0	255.7
Overall deficit	-0.7	-3.0	-3.2	-2.4	-2.2	-1.9	-2.0	-2.0	-2.0	-2.0	-2.0
Interest payment	2.0	2.2	2.3	2.2	2.1	2.1	2.2	2.4	2.5	2.8	2.9
Gross financing 6/	3.3	6.1	6.2	4.8	6.2	4.6	4.5	4.4	4.2	4.1	5.0
in billions of U.S. dollars	1.9	3.2	3.3	2.6	3.5	2.8	2.9	2.9	2.8	2.9	3.6

1/ Gross debt of the public sector including debt of public enterprises and the central bank.

2/ Net of transfers among non-financial public institutions.

3/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π= growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by the increase in local currency value of U.S. dollar).

4/ The real interest rate contribution is derived from the denominator in footnote 3/.

5/ The exchange rate contribution is derived from the denominator in footnote 3/.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

Peru: Fund Relations
(As of August 31, 2003)

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

II. General Resources Account	SDR Million	Percent Quota
Quota	638.40	100.00
Fund holdings of currency	732.06	114.67

III. SDR Department	SDR Million	Percent Allocation
Net cumulative allocation	91.32	100.00
Holdings	0.44	0.48

IV. Outstanding Purchases and Loans	SDR Million	Percent Quota
Extended arrangements	93.63	14.67

V. Financial Arrangements

Type of Arrangement	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	2/01/02	2/29/04	255.00	0.00
Stand-By	3/12/01	1/31/02	128.00	0.00
EFF	6/24/99	2/08/01	383.00	0.00
EFF	7/01/96	3/31/99	300.20	160.50
EFF	3/18/93	3/17/96	1,018.10	642.70

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

	Overdue	Forthcoming				
	8/31/03	2003	2004	2005	2006	2007
Principal	0	0.00	26.75	26.75	26.75	13.38
Charges/interest	0	0.85	3.12	2.54	1.98	1.48
Total	0	0.85	29.87	29.29	28.73	14.85

VII. Safeguard Assessments

Under the Fund's safeguards assessment policy, the Central Reserve Bank of Peru is subject to a full safeguards assessment with respect to the Stand-By Arrangement approved on February 1, 2002, and scheduled to expire on February 29, 2004.

A safeguards assessment was completed on July 26, 2001. The assessment identified certain weaknesses (most notably with the central bank's implementation of International Accounting Standards) and provided recommendations to address them. The Central Reserve Bank of Peru has proceeded to implement all of the recommendations.

VIII. Exchange Arrangements

Peru maintains a unified, floating exchange rate. On September 30, 2003, the average of interbank buying and selling rates was 3.48 *Nuevo Sol* per U.S. dollar. The central government maintains external payments arrears to unguaranteed suppliers, some of whom are in discussions with the government, while the rest have not been located. Peru maintains a clearing arrangement with Malaysia.

IX. Last Article IV Consultation

The 2002 Article IV consultation was concluded on December 13, 2002.

X. FSAP and ROSCs

Several joint Fund-Bank missions visited Lima in the period September 2000–January 2001 to conduct an FSAP for Peru. The corresponding FSSA report dated February 28, 2001(http//www.IMF.Org) that was discussed by the Executive Board on March 12, 2001. In October 2002, an FAD mission conducted a Fiscal ROSC for Peru, while an STA mission conducted a Data ROSC for Peru in February 2003.

XI. Technical Assistance

Department	Date	Purpose
FAD	November 1999	Fiscal rules
	June 2000, September 2002, September 2003	Tax policy and administration
MFD	April 1998	Modernization of the payments system
	January 2000	Forward foreign exchange markets
	September, October, November 2000, January 2001	Financial sector assessment
	March 2002	Monetary operations and government securities market
	May 2002	Inflation targeting
	August 2002	Accounting and organizational issues
	October 2002	Foreign exchange operations
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. Jorge Guzmán is the Fund Senior Resident Representative in Peru since August 2003.

Peru: World Bank Relations

Bank Group strategy

The World Bank Group FY03 Country Assistance Strategy (CAS), discussed by the IBRD Board on September 17, 2002, aims at helping the government implement its poverty reduction strategy by providing support to its fiscal, national competitiveness, and social-sector programs. **The CAS lending program is for US$180 to US$250 million a year in new lending that would include quick-disbursing programmatic loans (such as the US$100 million approved for FY 03 and two adjustment operations for US$300 million scheduled for 2004).** Such loans would depend on the achievement of a set of targets (triggers) related to the tax revenue effort and the implementation of key actions and reforms in public sector management, decentralization, and competitiveness. The lending program would also include lending for specific investment projects for about US$120 million a year.

The principal strategic elements of the CAS include programmatic loans (in the high-lending case) to support a reform program covering the areas of: public sector management and decentralization, barriers to competitiveness, social sectors, and financing investment programs that have a direct impact on the productive lives of the poor.

Following the priorities outlined in the CAS in FY03 the Board approved five operations accounting for a total of US$242 million in loans and one GEF grant for US$14 million. In particular the Bank approved one adjustment operation for the social sector and four investment projects to support Peru's efforts to increase its competitiveness, water supply and rural education.

Bank-Fund collaboration in specific areas

- Fund staff has taken the lead in assisting in the design of tax reform and has worked with World Bank (and IDB) staff on fiscal decentralization.
- *Financial Sector.* A joint FSAP was completed in May 2001. Follow up technical assistance to implement FSAP recommendations has been given by both institutions.
- *Public expenditure review (PER).* In an effort with the IDB, and close collaboration with the IMF, the Bank completed in June 2002 a comprehensive diagnosis of, and made policy recommendations for, Peru's public expenditure management.
- *Fiscal reforms.* In March 2002, in Lima, the Bank and the Fund supported jointly an international seminar (organized by the Ministry of Economy and Finance) on proposals for revising the law on fiscal prudence and transparency.
- *CAS and preparation of the Programmatic Social Reform Loans (PSRL-I and II).* The Bank and the Fund have engaged in an interactive and continuous dialogue on the CAS, implementation of PSRL-I, and preparation of PSRL II. Dialogue has concentrated on the macroeconomic background, setting of triggers, overall loan conditionality, risks, and estimation of the fiscal implications of both operations.

Statement of World Bank Loans
(As of June 30, 2003)

Loan Number	Fiscal Year Approved	Borrower	Purpose	In millions of U.S. Dollars: Total (Net of Cancellation)	Undisbursed
One hundred and ten (110) loans fully disbursed 1/				4,057.6	
Partially disbursed or undisbursed loans:					
38110	1995	Republic of Peru	Lima water rehabilitation and management project (SEDAPAL)	170.0	20.5
40760	1997	Republic of Peru	Irrigation rehabilitation	85.0	16.1
41300	1997	Republic of Peru	Sierra natural resource management	51.0	4.9
43840	1999	Republic of Peru	Urban property rights	38.0	8.3
45190	2000	Republic of Peru	Agricultural research and extension	9.6	4.2
45360	2000	Republic of Peru	Indigenous people development	5.0	4.1
45270	2000	Republic of Peru	Health reform	27.0	20.1
46140	2001	Republic of Peru	Second rural roads rehabilitation and maintenance	50.0	35.7
71420	2003	Republic of Peru	Rural Water and Sanitation	50.0	49.5
77788	2003	Republic of Peru	Trade facility and productivity improvement TA	20.0	20.0
55232	2003	Republic of Peru	Rural Education project	52.5	52.5
Total disbursed:				**4,379.7**	
Of which: amount repaid				1,725.4	
Total outstanding 2/				**2,549.2**	
Total undisbursed					**235.9**

1/ Includes 1997 Pension Reform Adjustment Loan (US$100 million), 1997 DDSR Loan (US$183 million), 1999 Financial Sector Adjustment Loan (US$300 million), 2001 Programmatic Social Reform Loan I (US$100 million), and the 2003 Programmatic Social Reform Loan II (US$100 million).
2/ Includes exchange adjustments and loans sold to third parties.

Statement of IFC Investments
(As of June 30, 2003)
In millions of U.S. dollars

	Loans	Equity	Participation Loans	Total
Total commitments held by IFC	265.7	35.9	68.1	301.6
Total disbursed	231.6	35.8	68.1	290.4

Source: World Bank.

Prepared by World Bank staff. Questions may be addressed to Mr. José López-Cálix, Senior Country Economist; or Mr. Oscar Avalle, Senior Operations Officer.

Peru: Relations with the Inter-American Development Bank

Country Strategy 2002–2006

The key objectives for the 2002–2006 strategy for Peru are poverty reduction and equity promotion, within the context of high economic growth, which is needed to make these goals sustainable. Toward this end the Bank will support the government's efforts to: (i) raise the economy's productivity and competitiveness, by removing institutional obstacles to increased productivity and investment and making structural investments in human capital; (ii) improve the efficiency of social policy while implementing measures to mitigate poverty and protect vulnerable groups; and (iii) create a modern, decentralized and efficient state.

Lending

As of June 30, 2003 the country's portfolio consists of 22 loans for a total amount of US$1,589.4 million. These resources are distributed among 21 investment loans (US$1,289.4 million) and a policy-based loan (US$300 million). The lending program for 2003 foresees the approval of five loans for US$420.8 million, two of which have been approved.

In addition, the country portfolio with Peru includes 33 non-reimbursable technical cooperation grants (US$11 million) and six small projects (US$2.4 million). Through the Multilateral Investment Fund (MIF), which finances private sector investment projects, Peru has contracted one loan and received 28 non-reimbursable technical cooperation grants.

Peru: Financial Relations with the Inter-American Development Bank
IDB Loans by Sector as of June 30, 2003
(In millions of U.S. dollars)

	Commitments	Disbursements	Percent Disbursed
Agriculture	68.9	34.1	49.5
Education	187.0	90.1	48.2
Social investment	589.6	314.2	53.3
Public sector management	360.9	212.8	58.9
Environment	5.0	0.0	0.0
Health	28.0	2.7	9.6
Transportation	350.0	74.3	21.2
Total	**1,589.4**	**728.2**	**45.8**

INTERNATIONAL MONETARY FUND

PERU

Third Review Under the Stand-By Arrangement

Supplementary Information

Prepared by Western Hemisphere
(In consultation with other departments)

Approved by Markus Rodlauer and Juha Kähkönen

October 29, 2003

This supplement updates the information presented in the staff report. It does not change the thrust of the staff appraisal.

Data provided by the Peruvian authorities has confirmed that all end-September performance criteria were met. Table 2 of the staff report has been revised accordingly.

Table 2. Peru: Quantitative Performance Criteria and Structural Benchmarks, 2003

	March 31	June 30	Sept. 30	Dec. 31
(Cumulative amounts from December 31, 2002; in millions of Nuevos Soles)				
Borrowing requirement of the combined public sector				
Unadjusted limits	780	1,400	2,595	4,130
Adjusted limits 1/	780	1,400	2,595	...
Actual	357	1,184	2,473	...
Margin	423	216	122	...
Net consumer lending of the Banco de la Nación				
Limit	-15	40	30	75
Actual	-8	8	15	...
Margin	-7	32	15	...
(Cumulative amounts from December 31, 2002; in millions of Nuevos Soles)				
Net international reserves of the central reserve bank				
Unadjusted targets	98	-50	-146	-148
Adjusted targets 1/	335	-289	-757	...
Actual	646	338	228	...
Margin	311	627	985	...
Short-term net external debt of the public sector				
Limits	50	50	50	50
Actual	0	0	0	...
Margin	50	50	50	...
External payments arrears of the public sector (on a continuous basis) 2/				
Limits	0	0	0	0
Actual	0	0	0	...
Margin	0	0	0	...
(Cumulative amounts from December 31, 2002; in millions of Nuevos Soles)				
Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year				
Total				
Unadjusted limits	950	1,680	2,015	2,200
Adjusted limits 1/	950	1,680	2,015	...
Actual	793	861	1,362	...
Margin	157	819	653	...
Of which: 1- to 5-year maturity				
Limits	250	250	250	250
Actual	8	8	8	...
Margin	242	242	242	...
(Consultation band for the 12-month rate of inflation, in percent) 3/				
Outer band range	-0.5 - 5.5	-0.5 - 5.5	-0.5 - 5.5	-0.5 - 5.5
Actual	3.4	2.2	2.0	...
Inner band range	0.5 - 4.5	0.5 - 4.5	0.5 - 4.5	...

Structural Benchmarks 2003	Target Date	Current Status
Submission to congress of fiscal decentralization legislation consistent with the objectives for decentralization and for tax reform stated in the letter of intent dated March 17, 2003 (EBS/03/34).	June 30	Completed
Implementation of the revised rules on fiscal prudence and transparency.	June 30	Completed
Granting statutory protection to SBS staff in the discharge of their responsibilities.	June 30	Pending
Submission to congress of a 2004 budget consistent with the objectives for decentralization and for tax reform stated in the letter of intent dated March 17, 2003 and the revised rules on fiscal prudence and transparency.	Sept. 30	Completed
Identification of regional and sectoral tax exemptions to be phased out by end-2004 that in the 2003 budget are estimated to have an annualized cost of 0.4 percent of GDP.	Sept. 30	Completed

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and Country Report No. 03/104.

1/ The targets and limits were adjusted in accordance with the table attached to the letter of intent dated March 17, 2003 (Country Report

2/ Excluding arrears associated with nonrescheduled debt to foreign creditors outstanding as of end-2002.

3/ Should inflation fall outside the inner band, the authorities will discuss with Fund staff the appropriate policy response. Should inflation fall outside the outer band, the authorities will also complete a consultation with the Executive Board of the Fund on the proposed policy response. The central bank's inflation target range is 1.5 - 3.5 percent.

Press Release No. 03/181
FOR IMMEDIATE RELEASE
November 3, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Third Review of Peru's Stand-By Arrangement, Approves US$40 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third review of Peru's performance under a two-year, SDR 255 million (about US$367 million) Stand-By Arrangement that was approved on February 1, 2002 (see Press Release No. 02/6). This decision enables the release of SDR 27.87 million (about US$40 million) to Peru, which brings the total amount available to SDR 199.25 million (about US$287 million). So far the country has not made any drawings under the arrangement.

Following the Executive Board review of Peru, Agustín Carstens, Deputy Managing Director and Acting Chairman, said:

'Peru's economic performance under the program continues to be favorable. Real GDP is projected to grow by 4 percent in 2003, with inflation around 2 percent and a robust external position. The outlook for next year and the medium term is also positive, assuming continued implementation of prudent macroeconomic policies and structural reforms. At the same time, it will be important to sustain a broad domestic consensus on key reforms to promote growth, keep inflation low, and continue to reduce economic vulnerabilities originated in the current levels of public debt and financial dollarization.

'Good progress has been made with the structural reform agenda under the program. The law on fiscal prudence and transparency has been strengthened; a sound legal framework for fiscal decentralization is being put in place, with two key laws expected to be passed by the end of the year. The authorities intend also to implement a comprehensive tax reform, improve the performance of public sector operations, and reform the preferential public pension plan. These reforms, together with increased flexibility on expenditures, concessions, and prudent debt management, will support continued medium-term fiscal consolidation, promote growth, and improve the quality of public services. It will be relevant though, for the authorities to limit as much as possible the distortionary effects of new taxes.

'Monetary policy has kept inflation low, consistent with the inflation targeting framework. The floating exchange rate system will continue to serve Peru well in adjusting to external shocks and limiting external vulnerability. In line with the authorities' announced policy, intervention in the foreign exchange market should be limited to smoothing excessive volatility in the exchange rate.

'Banking sector indicators continue to improve, although the high degree of financial dollarization, while declining, remains a source of vulnerability. To address this risk, the authorities intend to maintain a high level of official international reserves and to further strengthen prudential oversight. New regulations recently adopted on dollar lending and foreign-currency risk management by banks, as well as a draft law currently in congress to provide adequate legal protection to bank supervisors, are welcome steps to this end," Mr. Carstens said.

Statement by Guillermo Le Fort, Executive Director for Peru, and Carlos E. Pereyra, Senior Advisor to the Executive Director November 3, 2003

Recent Developments

1. We would like to thank the staff for a concise and well-written report. Peru has continued to perform well under the Stand-by Arrangement (SBA), with rapid growth, low inflation, and limited external vulnerabilities. All end-September performance criteria were observed, and the authorities' commitment to implementing prudent macroeconomic policies and structural reforms is expected to further improve investor confidence, ensure sustained growth, and pave the way for significant poverty reduction. In particular, specific steps have been taken to deepen the reform process, and the new cabinet appointed in mid-year has shown the ability to muster political support for the authorities' agenda.

2. The Peruvian economy has been undergoing a sustained recovery over the past twenty-six months, and the projected GDP growth rate of 4 percent for 2003 is among the highest in Latin America. It is important to highlight the more balanced sectoral growth registered in 2002 and the first half of 2003, with the more labor-intensive sectors, like non-primary manufacturing, construction and services, showing important expansions. Furthermore, after two years of slowdown, private investment picked up vigorously, growing at a 4 percent annual rate in the second half of 2002, with a 5 percent increase projected for 2003. The recovery in private investment is mostly associated with the dynamic behavior of the construction sector, the expansion of corporate profits, and a positive shift in business sentiment.

3. In 2002, Peru's trade balance moved into surplus for the first time since 1990 based on the dynamism of exports, which are projected to increase further in 2003. Several large-scale mining projects implemented in recent years and the growth of non-traditional exports are at the center of this process. In particular, apparel exports, Peru's fourth largest export item, has increased 25 percent in the first eight months of this year, a direct effect from the Andean Trade Promotion and Drug Eradication Act (ATPDEA) agreement with the U.S. Additionally, FDI prospects, associated mainly with the mining sector and the Camisea gas project, remain promising. Regarding the latter, an agreement concluded in September to export gas destined to the U.S. market will result in further growth of investment and exports.

4. The floating exchange rate regime and a sound international reserve level — $9.8 billion as of end-September, equivalent to 2.1 times short-term external obligations and 15 months of imports—place Peru in a good position to weather external shocks. This has been recognized by international markets, as evidenced in recent debt issues and by the reduction in sovereign bond spreads to historically low levels.

Macroeconomic Policies

5. The authorities are committed to fiscal sustainability and the continuation of economic reforms. Achievement of the deficit target of 1.9 percent of GDP for the overall

public sector in 2003 will be underpinned by the administrative enhancements and tax measures introduced in 2002. They also put in place a set of austerity and rationalization measures; and additional reforms were introduced in the state pension system to level the two existing regimes. The authorities will persevere in their efforts to reduce tax evasion by broadening the coverage of the withholding schemes introduced in 2002 and intensifying tax audits. These actions will be supported by increased use of computing systems and streamlined auditing and collection processes. Control operations will emphasize the VAT and the income tax.

6. Moreover, with the aim of strengthening public sector finances, responding to pressing social needs—mainly in the areas of education, health, and domestic security—and enhancing the equity, efficiency, and collection potential of the tax system, a comprehensive tax reform was launched in October. This reform, which figured prominently in the new cabinet's agenda, was expedited by the special powers granted by Congress to legislate on tax matters, reflecting a finer coordination between the government and the legislative branch. The reform would include administrative improvements, a widening of the tax base of the corporate and personal income taxes, the elimination of sectoral tax benefits, and a financial transactions tax (FTT). Since the FTT would be complemented with the obligation to perform financial operations above a threshold through the banking system, the authorities argue it would be instrumental in improving tax control. At the same time, they are giving due consideration to the staff's suggestions in this regard. The authorities' decision will be announced shortly.

7. The authorities emphasize that, together with enhanced revenues, strict expenditure control is crucial to ensure medium-term fiscal sustainability. They also underscore that fiscal discipline would create room for priority spending aimed at raising the living standards of the population and improving productivity performance, thus providing a favorable environment for growth and facilitating the continuation of the reform process. The fiscal deficit is expected to decline from 2.2 percent in 2002 to 0.4 percent of GDP in 2006, and the debt-to-GDP ratio from 47 percent in 2002 to 41 percent in 2006.

8. The authorities continue to strengthen the conduct of monetary policy within the inflation targeting scheme. The low inflation forecast—close to the lower band of the target range—has allowed the Central Bank to adopt a more accommodative monetary stance. Since July, the Board of the Central Bank has reduced its policy interest rate, which has been followed by market-determined interest rates. Thus, both the level and volatility of the interbank interest rate have continued their falling trend.

9. The new primary dealer system, launched in March to improve debt management, reduce the exchange rate risk, and promote de-dollarization through the development of a fixed-income market in domestic currency, has been very successful, with demand exceeding supply by over 100 percent in all auctions. Maturities have become longer, reaching up to five years, and yields have decreased significantly, reflecting greater confidence in the domestic currency and providing a reference for longer-term financial instruments. This context has also favored a reduction of dollarization in the banking system, from 67 percent of deposits in 2001 to 65 percent in 2002 and to 63 percent in September 2003. In addition,

the quality of the loan portfolio is improving, past-due loans have been decreasing in the past months, and provisioning has strengthened.

Structural Reforms

10. As informed in previous reviews, the authorities are working in a gradual elimination of regional and sectoral tax exemptions, and continue to coordinate with the regional authorities the phasing out of exemptions in exchange for investment in infrastructure and social programs. Concerning the legal framework for decentralization, by year's end the authorities intend to enact the draft fiscal decentralization law, and another law will further regulate the devolution process, with emphasis on social programs and infrastructure. Additionally, the draft budget law for 2004 is consistent with the decentralization process and considers a greater participation of regional and local governments in the distribution of fiscal resources, notably for investment.

11. Bank supervision continues to be strengthened, with stress on exchange rate risk management and monitoring of dollar lending. Also, a new regulatory body, effective since October, was introduced to unify previous legislation on bank debtor evaluation and classification, refine provisioning with the aim of reducing the cost of credit, and make banks' boards of directors more accountable for credit risk management. Furthermore, the authorities intend to press forward for an early passage of legislation granting legal protection to bank supervisors in the discharge of their duties.

12. Trade policy aims at increasing openness and widening export markets. In August, Peru signed an agreement with Mercosur, which allows bilateral negotiation of a free-trade list of products with each member of that trade bloc. Additionally, in October, Thailand and Peru signed an agreement to set up a free trade area, and the authorities have expressed their interest in negotiating trade agreements with the U.S. and the E.U. At the same time, the authorities remain committed to participating in the FTAA initiative.

Relations with the Fund

13. The current SBA, which will expire in end-February 2004, has served Peru well in providing an adequate policy framework for its longer-term objectives. In particular, (i) it has helped to better define the commitment to fiscal sustainability, evidenced in Peru's medium-term fiscal consolidation plans; (ii) it constitutes an invaluable endorsement with the international community and has proved helpful in greatly improving investor sentiment, as reflected in the significant decrease in Peru's country-risk and the ability to regain access to international capital markets, floating sovereign bonds for the first time in several decades; (iii) it provides comfort to the other multilateral organizations—the World Bank and the Inter-American Development Bank—whose disbursements are an essential financing component geared to support key reform initiatives, especially poverty alleviation, the reform of the state, and the decentralization process.

14. At the same time, despite Peru's ability to deliver under the SBA, the authorities are far from complacent, and acknowledge that substantial work remains to be done to fulfill their reform plans and, in particular, to reinforce investor confidence. The authorities believe

that this process can be substantially underpinned by Fund endorsement. As previously underscored by this chair, the Fund is in a unique position to inform international markets about member countries' economic performance, and therefore plays a crucial role in promoting investor discrimination.

15. Our Peruvian authorities are giving strong consideration to requesting a successor arrangement in the form of a precautionary SBA. As explained in the staff report, such possibility would have to be discussed on the basis of an assessment of the Fund's extended financial engagement with Peru, in accordance with the recently approved policy on prolonged use of Fund resources. We take the opportunity to recall that this and other chairs have expressed the view that precautionary arrangements should be excluded from that definition. In particular, Peru would not fall into the classification of "prolonged user" since it has not relied continuously on Fund resources, having generally treated arrangements as precautionary (that is, mainly as a framework for consistent macroeconomic and reform policies), with a Fund exposure continuously falling to less than 15 percent of quota. Also, the Operational Guidance for Assessments of Countries with Longer-Term Program Engagement includes considerations regarding precautionary arrangements, namely that they should not be evaluated as if they were indistinct from a standard program, and that the framework should not entail a new bias against them. Quite importantly, the authorities also see the desirability of seeking a smooth transition to a successor arrangement to ensure continuous investor confidence and access to multilateral financing through Fund endorsement.

16. Following past practice, the authorities consent to the publication of the staff report.