

Peru: 2002 Article IV Consultation, First Review Under the Stand-By Arrangement, and Request for Modification and Waiver of Performance Criteria—Staff Report; Staff Statement; Public Information Notice and News Brief on the Executive Board Discussion; and Statement by the Executive Director for Peru

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2002 Article IV consultation with Peru, First Review Under the Stand-By Arrangement, and Request for Modification and Waiver of Performance Criteria, the following documents have been released and are included in this package:

- the staff report for the combined 2002 Article IV consultation, first review under the Stand-By Arrangement, and request for modification and waiver of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **September 20, 2002**, 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 November 27, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **December 13, 2002** updating information on recent economic developments.
- a Public Information Notice (PIN) and News Brief, **summarizing the views of the Executive Board as expressed during its December 13, 2002 discussion** of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.
- a statement by the Executive Director for Peru.

The document(s) listed below have been or will be separately released.

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

*May also be included in Staff Report

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

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PERU

Staff Report for the 2002 Article IV Consultation, First Review Under the Stand-By Arrangement, and Request for Modification and Waiver of Performance Criteria

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

Approved by Markus Rodlauer and Liam P. Ebrill

November 27, 2002

- Discussions were held in Lima during September 4–20 for the 2002 Article IV consultation and the first review under the current two-year stand-by arrangement (SBA). The staff team met with Minister of Finance Silva Ruete, Central Bank President Webb, senior officials in the government and the central bank, and private sector representatives.¹ The SBA was approved on February 1, 2002, for an amount equivalent to SDR 255 million (20 percent of quota on an annual basis), and is being treated as precautionary.
- At the last Article IV consultation (March 12, 2001), Directors welcomed the government's intention to pursue sound macroeconomic policies and reduce vulnerabilities. They expressed concern, however, that recent tax exemptions had narrowed the tax base, and stressed the need for a broad-based tax reform to ensure a sustainable medium-term fiscal position and adequate resources for the social safety net. Directors also recommended strengthening bank supervision and improving debt management. Structural reforms in the authorities' economic program are addressing these concerns.
- Peru has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system free of restrictions on current international transactions. Relations with the Fund are presented in Appendix I.
- Peru's economic statistics are broadly adequate for effective surveillance and policy formulation (Appendix II). It has subscribed to the SDDS, and its metadata is posted on the Fund's external web page. Two ROSC Modules (on fiscal transparency and data) will further strengthen economic statistics. Technical assistance has concentrated in the fiscal, monetary, and statistical areas. The authorities have agreed to publish the staff report.

¹ The staff team comprised Messrs. Wolfe (Head), Rodriguez and Villafuerte (all WHD), Ms. Albino (FAD), and Mr. Keller (PDR). Mr. Velloso (resident representative) assisted the mission. Mr. Pereyra, Advisor to the Executive Director, took part in the policy discussions.

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Abbreviations and Acronyms

ATPDEA	Andean Trade Promotion and Drug Eradication Act
BCRP	Central Reserve Bank of Peru
BN	Banco de la Nación
CAF	Andean Development Corporation
CAN	Andean Economic Community
CAS	Country Assistance Strategy
CIRR	Commercial Interest Reference Rates
COFIDE	Development Finance Corporation
CTS	Service Time Compensation Scheme
ESSALUD	Social Health Insurance Agency
FONAHPU	National Public Savings Fund
FCR	Pension Reserve Fund
FIDE	Decentralization Investment Fund
FLAR	Latin America Reserve Fund
FRL	Fiscal Responsibility Law
FONAVI	National Housing Fund
FONCOMUN	Municipal Compensation Fund
FONCOR	Regional Compensation Fund
IDB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IES	Special Wage Tax
INEI	National Statistics Office
MEF	Ministry of Finance
NPL	Non-Performing Loans
ONP	Public Pension System Agency
PER	Public Expenditure Review
PETROPERU	Peruvian State Petroleum Company
PIPP	Private Investment Promotion Program
PSBR	Public Sector Borrowing Requirement
PSRL	Programmatic Social Reform Loan
RFE	Special Payment Agreements Regime
REFT	Special Tax Agreement Regime
RESIT	Tax Recovery Through Debt Recognition Regime
ROSC	Report on Standards and Codes
SBS	Superintendency of Banks and Insurance
SCT	Selected Consumption Tax
SDDS	Special Data Dissemination Standard
SEAP	Special Payment System of Tax Debts
SIAF	Financial Management Information System
SUNAD	Customs Agency
SUNAT	Tax Administration Agency
UIT	Tax Index Unit

EXECUTIVE SUMMARY

Background

- The Peruvian economy has so far resisted contagion from developments in the region relatively well. Real GDP growth in 2002 is projected at 3.7 percent, inflation remains low, and the external position is sound. High international reserve coverage of dollar bank deposits and of short-term external debt has helped shield Peru.
- Fiscal policy was tightened in early 2002 from the expansionary stance in the second half of last year. The original end-year fiscal target is likely to be missed by a modest amount, and staff supports the authorities' request for modification of that target. Monetary and exchange rate policies have been conducted appropriately under the (newly adopted) inflation-targeting framework and the floating exchange rate regime.
- Banking system indicators have improved, prudential oversight has been strengthened, and deposits in the banking system have risen in 2002.

Main vulnerabilities

Peru remains vulnerable given its high degree of financial dollarization, the relatively large public debt, and the difficult political situation that could undermine fiscal discipline (particularly in the context of ongoing decentralization) and hinder tax reform.

Policy discussions

- The discussions focused on policies to lay the basis for sustained growth and poverty reduction, by maintaining macroeconomic stability and creating a sound investment climate. The authorities' economic program for 2003, including a primary fiscal adjustment of 0.6 percent of GDP, should ensure continued economic recovery, keep inflation at low levels, and sustain a robust external position.
- The targeted reduction in the overall fiscal deficit in 2003 makes a credible step toward medium-term fiscal consolidation without jeopardizing the recovery in economic activity. Monetary policy will be guided by the inflation-targeting framework adopted this year, and the exchange rate will continue to float, with intervention only to smooth excessive market volatility. Structural reforms will focus on the tax and pension systems, bank supervision, and public debt management.
- The baseline medium-term outlook is favorable, albeit not without risks. Assuming sound macropolicies and structural reforms continue, Peru should be able to achieve medium-term growth of 5 percent. However, the domestic political situation contains clear risks, potentially holding up tax reform and undermining fiscal discipline. If the external environment were to deteriorate, growth would be affected as private investment would probably not recover, and the highly dollarized banking system is vulnerable to currency depreciation.

I. BACKGROUND

A. A Brief Perspective

1. **After several years of rapid growth, Peru's economy weakened in 1998–2001, with real GDP growth averaging only 1 percent a year.** The weakening resulted from adverse external shocks, little progress in structural reforms, and domestic political events. In comparison, during 1993–97, real GDP growth averaged 7 percent a year and employment growth averaged almost 6 percent a year, supported by the implementation of important structural reforms, and buoyant private investment. Inflation declined progressively since the early 1990s and was slightly negative by end-2001. Soon after taking office in July 2001, President Toledo's government introduced a fiscal stimulus package while, at the same time, formulating a program to strengthen the medium-term fiscal outlook.

2. **The Peruvian economy has so far weathered developments in the region relatively well.** This can be attributed to several factors:

- Improving fundamentals—fiscal and external current account deficits are moderate, inflation is low, and official reserves are high (covering more than 100 percent of dollar bank deposits and 190 percent of short-term external debt).
- The financial situation of banks has also improved significantly over the last few years, and their short-term foreign liabilities are relatively small.
- Peru's limited trade links to countries in the region allow it to resist contagion from the current account.
- Public sector financing is not dependent on international capital markets and could be largely covered by official creditors.
- Private firms' foreign borrowing is mainly carried out by subsidiaries of multinational corporations.

3. **Nonetheless, the Peruvian economy has important vulnerabilities:**

- The banking system is highly dollarized, with around 80 percent of loans and 70 percent of deposits denominated in U.S. dollars. Although banks themselves have a long foreign-exchange position, they are exposed to significant credit risk as only 40–50 percent of bank clients have dollar earnings (see Section B below).
- Public debt is relatively high at 48 percent of GDP, with about 85 percent of it denominated in foreign currency.
- A major decentralization of government is underway. While the intention is to implement it in a phased and fiscally neutral way, the experience in other countries has been that decentralization poses risks to the public finances.

These vulnerabilities are compounded by the difficult domestic political situation. The president's approval ratings have declined to low levels since taking office in July 2001, and there is significant opposition (including in congress) to the government's economic policies. Such opposition could increase after the recent regional elections (held on November 17, 2002, with the new regional governments to take office January 1, 2003),² possibly complicating the decentralization process as well as the planned elimination of regional and sectoral tax exemptions, the key plank of the government's tax reform.

B. Developments in 2002

4. **Economic activity has picked up in 2002, but private investment has not recovered and the economy remains vulnerable to further external shocks.** Real GDP is projected to grow by 3.7 percent in 2002, with the 12-month rate of inflation remaining low at 2 percent (Table 1 and Figure 1). Growth has been led by exports, mainly related to the full-year operation of a large mining project; consumption has also risen following the fiscal stimulus package implemented last year. With the pickup in economic activity, labor market indicators have improved (Figure 2). On the other hand, private investment has fallen for eight consecutive quarters (although most recent data suggest that this might be bottoming out), reflecting investor concerns about the impact on Peru of the deteriorating external environment and a difficult domestic political situation.

Fiscal developments

5. **After sizeable fiscal stimulus in the second half of last year, fiscal policy was tightened in 2002 (EBS/02/12).** The combined public sector deficit (CPSD) in July–December last year was 4 percent of GDP, reflecting mainly a boost to public spending (including a generalized wage hike). In 2002, the CPSD is projected at 2.3 percent of GDP, somewhat higher than the original program target (1.9 percent of GDP, Tables 2 and 3).³ The higher-than-programmed deficit reflects mainly spending overruns by the state healthcare agency and court rulings that require (one-off) compensation to certain workers laid-off during past privatizations. Revenues are on track, however, as an increase in excise tax rates and tax administration improvements (described below) broadly offset the impact of lower trade-related revenue and a tax amnesty approved by congress in March (Appendix III). The

² Of the 25 regional contests, former President Alan Garcia's (center-left) *APRA* party won twelve and non-traditional parties (mainly independent regional movements) won ten. These two groups took the majority of the local elections as well. The (center-right) *Unidad Nacional* gained the important post of mayor of Lima (where one third of the population lives). President Toledo's *Peru Posible* won one region.

³ Preliminary data suggest that the end-September 2002 fiscal performance criterion on the combined public sector deficit was observed (Table 4 and Box 1).

Box 1. Modalities of the Review

In a letter to the Managing Director, dated November 26, 2002 (Attachment I), the authorities describe developments under the program and the policies they intend to follow in 2003 and request completion of the first review under the stand-by arrangement.

The authorities are seeking **modifications** to the program regarding: (i) the performance criterion on the fiscal deficit for end-December 2002, consistent with the revised fiscal target for 2002; (ii) the adjustor to the performance criterion on the net international reserves of the central bank for shortfalls in privatization receipts for end-December 2002, in line with the lower-than- envisaged outturn for such receipts in 2002; and (iii) the replacement of the performance criterion on the net domestic assets of the central bank by a consultation mechanism based on inflation, consistent with their adoption of an inflation-targeting framework (see also the Technical Memorandum of Understanding, Attachment II).

The authorities are also requesting a **waiver** for the nonobservance of the end-September performance criterion on the NDA of the central bank, as at that point the NDA ceiling was not consistent with the annual inflation target under the inflation-targeting framework.

Performance criteria and structural benchmarks for 2003 will be set at the time of the second program review, to be completed by March 15, 2003 (phasing under the arrangement is summarized in Table 5). The review will focus in particular on: (i) progress with tax reform and the fiscal responsibility law; (ii) developments in the decentralization process; (iii) the functioning of the domestic bond market; (iv) steps being taken to strengthen banking supervision; and (v) the operations and impact of the government's support to specific sectors.

2002 deficit is being financed mostly from external sources (mainly official),⁴ while privatization receipts and domestic debt placements have been lower than programmed. The public sector debt-to-GDP ratio will rise somewhat in 2002, in part reflecting the effective depreciation of the Sol (Figures 3 and 4).

6. Progress has been made with fiscal reforms, although the key step of eliminating regional and sectoral tax exemptions has been delayed.

- A number of **tax reforms** were implemented (with IMF/World Bank technical assistance) and are expected to yield 0.8 percent of GDP on an annual basis. These reforms include steps to broaden the income tax base, rationalize excise taxes on petroleum products, narrow the scope of future tax-stability contracts, eliminate certain VAT exemptions, and strengthen tax audit programs (see Appendix VI).
- A draft amendment of the **fiscal responsibility law** (FRL) has been sent to congress (a prior action for this review) that would, inter alia, allow a more realistic adjustment period to the medium-term fiscal target following a recession (three years rather than one), require automatic adjustments in fiscal policy in years of economic growth, and extend rules of fiscal discipline to all levels of government.

⁴ Relations with the World Bank and the Inter-American Development Bank (IDB) are summarized in Appendices IV and V, respectively.

- To improve *transparency*, the cost of tax exemptions has been explicitly incorporated (as tax expenditure) in the 2003 budget proposal.⁵
- *Pension reforms* implemented have (i) standardized the pension base, lowered replacement rates, and raised the minimum pension in the general public pension system; (ii) reduced preferential survivor benefits under the special public pension system (*Cédula Viva*); and (iii) established a minimum pension guarantee for certain beneficiaries under the private pension system. These measures are expected to reduce the net present value of government pension liabilities by around 15 percent over the medium term (or by about 5 percent of GDP).
- On the other hand, **eliminating regional tax exemptions**, a key reform in the program, was delayed as explained in paragraph 29 below. Also, the most recent **tax amnesty** approved earlier in the year (see EBS/02/12, Supplement 1) again risks undermining tax compliance by fostering expectations of repeat amnesties in the future.

7. **Public opposition to the sale of state assets has shifted the authorities' focus to other forms of private sector participation in state enterprise operations.**⁶ The Private Investment Promotion Program (PIPP), which had concentrated on the sale of state enterprises, has been reoriented toward the granting of operating concessions, management contracts, and joint ventures. As a result, receipts from the PIPP are projected at US\$400 million in 2002, around half the amount envisaged under the program.⁷

8. **Backed by a strong grassroots movement to decentralize decision-making, a constitutional amendment was approved in early 2002 to decentralize the structure of government.**⁸ The amendment established three levels of government (national, regional, and municipal) and mandated an orderly decentralization of resources and expenditure responsibilities. An omnibus decentralization law, approved in July 2002, provides an organized framework for the decentralization process.⁹ Key principles set out in the law

⁵ Steps taken regarding tax audits, the FRL, and fiscal transparency were structural benchmarks under the program (Appendix VII). Structural conditionality in Fund-supported programs with Peru is described in EBS/02/12.

⁶ In mid-2002, following the announced sale of two power plants, violent protests led to the suspension of the sale (the legality of the sale is being reviewed by the constitutional court).

⁷ The program had three structural benchmarks on privatization; one was met.

⁸ In 2001, the national government carried out 89 percent of expenditures and collected 87 percent of revenues of the general government.

⁹ Implementing legislation is expected to be approved before year-end (Appendix VIII).

include: (i) promoting accountability of government officials; (ii) requiring a transparent intergovernmental transfer mechanism; (iii) ensuring a neutral fiscal impact of decentralization; (iv) subjecting regional and local government external borrowing to Ministry of Economy and Finance (MEF) approval; and (v) setting fiscal rules for regional and local governments compatible with fiscal rules of the national government.

Monetary and financial system developments

9. **In January 2002, the authorities announced the implementation of an inflation-targeting framework for monetary policy.** In July, the BCRP Board announced a medium-term inflation target range of plus/minus one percentage point around a midpoint of 2.5 percent.¹⁰ Comprehensive inflation reports, along the lines of those issued in July and November, will be issued three times a year to explain inflation performance, the considerations that guided monetary policy in the preceding months, and the BCRP inflation forecast. The inflation forecast, which continues to be refined,¹¹ is based on (i) a range of indicators (including market expectation surveys); (ii) inflation forecasting models; and (iii) other relevant factors such as the exchange rate, the stance of fiscal policy, and aggregate demand conditions. The operational target of monetary policy continues to be the monthly average stock of banks' local currency deposits at the BCRP.

10. **The stance of monetary policy has been tightened somewhat since midyear.** After interest rates fell to record lows in early 2002 (reflecting the mild deflation), the central bank raised its rediscount rate by 150 basis points since September in response to heightened regional uncertainties, pressures in the foreign exchange market, and indicators of a pickup in inflation. Bank credit to the private sector has been flat in 2002, except for some increase in consumer and housing lending (Table 6 and Figures 5 and 6).

11. **Financial dollarization remains pervasive and is a source of vulnerability** (Box 2). Dollarization in Peru has been high since the late 1970s (except for a brief period in the late 1980s), with some 70–80 percent of the financial system now denominated in dollars. However, considerable risks arise because the real economy is much less dollarized (only about 40–50 percent of bank clients' earnings are estimated to be in dollars). As a result, even though banks carry long positions in foreign currency, they are indirectly exposed to credit risk in case of a sharp depreciation of the currency. There were some signs of de-dollarization between the second half of 2001 and mid-2002 (with low inflation and a stable exchange rate), but this has since been reversed reflecting political uncertainty and regional concerns.

¹⁰ This is the lowest target range compared with other countries in the region that have adopted an inflation-targeting framework (Brazil, Chile, Colombia, and Mexico).

¹¹ MAE has made specific recommendations to further improve the inflation forecast and the way it feeds into monetary policy decisions.

Box 2. Dollarization

The banking system is highly dollarized, very liquid, and with indirect exposure to exchange rate risk in its credit portfolio. *Liquidity risk* is limited given banks' high reserves in foreign currency, relatively low and declining short-term external liabilities, small maturity mismatches, and potential access to U.S. dollar credit facilities from the BCRP (supported by the BCRP's sizable net international reserves). Direct risk of an exchange rate depreciation is mitigated by the banks' long net position in foreign currency. The average *non-performing loan ratio* in U.S. dollars has declined from 10.3 percent at end-2000 to 8.6 percent at end-September 2002, and is slightly higher than that in local currency. However, some estimates suggest that 50–60 percent of credit to the private sector in foreign currency is to clients that could be affected by a large depreciation (given the currency composition of their balance sheets and income and expenditure streams). Banks consider that in case of a sharp devaluation the sizable long position in foreign currency would generate resources to help provision against any rise in nonperforming loans.

There is comprehensive prudential regulation of banks' operations in foreign currency, and the Superintendency of Banks (SBS) is considering additional norms to strengthen the management of associated risks. Current norms include: (i) capital requirements on market risk (3.2 percent), including foreign exchange risk; (ii) a minimum foreign-exchange liquidity requirement (20 percent) coupled with an average effective reserve requirement by the BCRP of just over 30 percent; and (iii) limits on the net foreign-exchange position relative to capital (2.5 percent for short positions and 100 percent for long positions). The SBS is considering the possibility of: (i) reinforcing the use of internal models of exchange-rate risk used by banks, including the banks' stress-test assumptions; and (ii) requiring that a debtor's exposure and capacity to generate foreign currency be included in credit documentation.

While forward exchange market operations have increased substantially in 2002, this hedging instrument continues to be a limited alternative for most debtors. The market continues to be small and one-sided, as most exporters do not sell foreign exchange forward; thus, banks make up almost all of the supply side of the market. To cover these open forward positions, banks purchase foreign exchange in the spot market; hence, stepped up demand for forward dollars introduces volatility in the spot exchange rate.

Peru: Dollarization in Commercial Banks

(In percent, unless otherwise indicated)

	1998	1999	2000	2001	Q3 2002
FX- denominated loans to total loans	80.2	82.6	82.6	80.6	80.8
FX- denominated deposits to total deposits	77.3	78.5	78.7	76.1	76.3
Liquid FX assets to short-term FX Liabilities	30.6	35.1	38.0	45.2	49.5
FX-denominated NPLs to total FX-denominated loans	7.2	8.7	10.3	9.9	8.6
Net FX position to capital	49.2	38.1	37.0	37.6	41.5
Short-term foreign liabilities (millions of U.S. dollars)	2,879	1,835	1,519	1,188	1,224

Source: BCRP and SBS.

12. **Other banking system indicators have generally improved in 2002, and the SBS has taken several steps recently to strengthen bank supervision** (in line with FSAP 2000 recommendations, see Appendix IX). As noted, average nonperforming loan ratios have declined; loan provisioning is up; and the profitability of most banks has risen (Figure 7). A large foreign-owned bank recently experienced deposit outflows related to the owner's

publicly stated intention to withdraw from the region. The owner has since announced a substantial capital injection, scheduled to occur in early December. In 2002, the SBS introduced regulations on country and operational risk, and prudential requirements were applied on a consolidated basis. Draft legislation has been submitted to congress to grant legal protection to bank supervisors (a prior action for this review). In 2002 an anti-money laundering unit in the MEF was established, and its operational norms are being formulated.

13. Special lending programs have been implemented in a prudent manner, and steps have been taken to strengthen corporate governance and restructuring procedures. The consumer lending program of *Banco de la Nación* has been kept below the ceilings in the program, with repayment conditions fully respected. The agrarian bank has limited its first-tier lending operations to small-scale agricultural producers (from resources in the budget); it will lend to larger producers by channeling foreign credit lines through financial institutions supervised by the Superintendency of Banks (SBS). A new bankruptcy procedure law was approved in August, which limits court intervention and better balances the rights of creditors and debtors. In addition, regulations were issued to strengthen corporate governance and increase the transparency of domestic securities markets.

External developments

14. The external position has strengthened in 2002, both in the current and capital accounts (Table 7 and Figure 8). Exports are projected to grow by around 8.5 percent (in U.S. dollar terms), while imports are growing more slowly given weak private investment growth. Net capital inflows have been strong (Table 8), mainly reflecting Peru's recent return to the private international capital market (Box 3). As a result, official reserves are expected to increase by some US\$1.25 billion, to around US\$10 billion, more than covering the stock of bank dollar deposits and equivalent to 190 percent of short-term external debt.

15. The exchange rate has continued to float, with intervention limited to smoothing short-term volatility. After being relatively stable since mid-2001, the exchange rate came under pressure in August–September 2002 amid growing regional uncertainties. The central bank responded by tightening monetary policy and intervening modestly in the foreign-exchange market. The exchange rate has since stabilized.¹² In real effective terms, the Sol has depreciated by 5 percent so far this year, partially reversing the appreciating trend over the last few years (following the U.S. dollar, to which most Peruvian exports and financial transactions are linked). The current level of the exchange rate does not seem to be a problem for the competitiveness of Peruvian exports; rather, exports would benefit most from improvements in road and port infrastructure, which would lower transportation costs and allow for expanded export volumes.

¹² The Peruvian Sol and the Brazilian Real showed a strong correlation during August–September of this year, but this relationship started to weaken in October (see Figure 4).

Box 3. Peru's Brady Bond Swap and Global Bond Issue

In February 2002, Peru accessed international capital markets through a sovereign bond issue (the first such placement since 1928). The transaction involved the issuing of fixed-coupon, 10-year, global bonds for US\$1,423 million, of which US\$923 million were exchanged for existing Brady bonds with a face value of US\$1,204 million.

The strategic goal of the operation was to broaden the government's sources of financing, while extending the maturity profile of the public debt. In recent years, the Peruvian government has relied on credits from official external sources—mainly multilaterals—and privatization receipts to finance its fiscal deficits. Neither of these are sustainable sources of financing, as most state enterprises have been sold and Peru should graduate soon from official development programs. At the same time, grace periods on some of the Brady bonds and other loans are beginning to expire, increasing the governments' amortization payments in the near term.

In addition, the global bond provides a useful benchmark instrument for Peruvian firms. For international corporate bond issuers, sovereign bonds typically serve as a reference price. Until the global issue, Brady bonds had been the only traded sovereign Peruvian debt, but because of their complexity they are difficult to price and, thus, are poor benchmarks.

The exchange reduced the stock of public debt and, by taking advantage of pricing inefficiencies associated with Bradys, generated a small net-present-value saving. The swap reduced the nominal debt stock by US\$280 million and freed US\$50 million of collateral.

The exchange also provided some hedge against future interest rate hikes and increased slightly the duration of Peru's debt. Since three of Peru's Brady bonds carry floating rates (or will soon switch from fixed to floating rates), their exchange for a fixed coupon instrument helped to reduce the interest rate risk of the public-debt portfolio. Low international interest rates at the time of the swap provided the additional advantage of allowing Peru to lock-in these favorable rates. The swap extended the modified duration from 6.1 years for the existing Bradys to 6.4 years for the new combined Brady-Global bond portfolio.

At the same time, the exchange does have some costs and risks. The duration gain comes at the cost of higher interest coupon payments on the global bond (at least in the near term), and the gradual amortization of the exchanged Bradys posed a lower rollover risk than the bullet payment on the global bond.

16. **The impact of political uncertainty and regional sentiment on financial developments has been limited** (Table 9). Both dollar- and Sol-denominated bank deposits have grown throughout most of the year, and official reserves have risen. Sovereign spreads on Peruvian debt were at 742 basis points (bps) at end-October, some 220 bps above their end-2001 level (compared with an average rise in spreads for countries in the region of about 420 bps).

II. OUTLOOK

17. **The 2003 program outlook is based on maintaining growth at about its 2002 rate and continued low inflation.** Growth will be slower than the 5 percent originally assumed in the program, reflecting weaker private investment, and would be led by exports. Inflation is projected to be at the mid-point of the central bank's inflation target range. Key economic objectives for 2003 are as follows:

Macroeconomic Framework 2002–03

(In percent)	2002	2003
Real GDP growth	3.7	3.5
Inflation	2.0	2.5
External current account deficit (percent of GDP)	2.2	1.9
NIR accumulation (in millions of U.S. dollars)	1,250	70
Gross official reserve coverage of:		
Dollar deposits in the banking system	103	102
Short-term external debt	190	185

18. **The external position is expected to strengthen somewhat further in 2003.** The current account deficit is projected to fall below 2 percent of GDP in 2003 as exports benefit from new mining projects coming on line, firming mineral prices, and the full-year effect of expanded U.S. trade preferences for Andean countries (ATPDEA).¹³ Private capital inflows should pick up gradually in 2003 assuming increased political stability, and net public sector inflows would be around the same as in 2002. These projections are consistent with a modest increase in net international reserves.

19. **The baseline medium-term outlook is favorable.** Assuming that sound macroeconomic policies and structural reforms continue, Peru should be able to achieve real GDP growth rates of 5 percent over the medium term with low inflation (Table 10 and Box 4).¹⁴ Key policies include bringing the fiscal deficit under 1 percent of GDP, thereby lowering the public debt-to-GDP ratio to 30 percent by 2012. The external current account deficit would rise temporarily in the near term as investment picks up, but would return to below 2 percent of GDP over the medium term, with the potential for both exports and imports of goods and services to grow relatively rapidly. The baseline assumes an improving external environment that would allow net capital inflows to increase over the medium term in line with the projected rise in foreign direct investment. This scenario maintains solid

¹³ The main Peruvian export products added to the list of eligible products are certain apparel and garment items, footwear, and prepared tuna.

¹⁴ Growth would be led by exports, both traditional (particularly from new mining projects) and non-traditional (many of which are labor-intensive). Non-traditional exports should benefit from the envisaged hemispheric free-trade arrangement. Growth would also be bolstered by the development of a domestic natural gas industry starting in 2004 when a large project (Camisea) is to begin operations.

Box 4. Sources of Growth: The 1990s and Beyond

Peru should be able to achieve average growth of around 5 percent a year over the medium term provided that prudent macroeconomic policies continue and needed structural reforms are implemented. Standard growth accounting methodology suggests that the assumed medium-term growth path is consistent with realistic projections for productivity and factor growth.

GDP growth in Peru during the period 1991–2001 averaged 3.7 percent. Much of the growth was driven by capital accumulation. However, performance varied significantly during the subperiods 1993–97 and 1998–2001.

- During 1993–97, Peru benefited from favorable external conditions and an ambitious program of first-generation structural reforms, including privatization, pension reform, and trade liberalization. This environment created conditions for a high rate of investment and rising productivity, which allowed the economy to grow at an annual rate of 7.1 percent. Factor productivity explained more than 40 percent of growth during this period.
- The period 1998–2001 was marked by adverse external shocks, little progress in structural reforms, and political events. These factors combined to deter private investment (which contracted in each year) and limited growth to an average rate of 0.9 percent. The decline of total factor productivity reduced growth by 2.8 percentage points on average during this period.

Continuation of sound macroeconomic policies and a revitalized structural reform agenda, along with increased international trade opportunities, should provide a favorable environment for private investment and factor productivity growth over the medium term. On this basis, the Peruvian economy should be able to sustain growth rates of around 5 percent over the medium term. Expanding opportunities in the export sector, both traditional and nontraditional (many of which are labor-intensive), together with structural reforms (especially the PIPP initiative), and investment in infrastructure and human capital should promote private investment, spur employment of the growing labor force, and raise factor productivity. Ongoing efforts to strengthen the institutional and legal environment should also contribute to improving the investment climate.

Peru: Contribution to Growth
(In percent)

	GDP	Capital	Labor	Productivity	Primary	Secondary	Tertiary
1991-2001	3.7	2.1	1.0	0.6	0.7	0.8	2.2
1993-1997	7.1	2.6	1.5	3.0	1.0	1.8	4.2
1998-2001	0.9	1.8	1.9	-2.8	0.8	-0.2	0.4
2002-2012	4.8	1.9	1.1	1.8	...	...	...

Sources: Jose Valderrama, et al. (2001). "Productividad y Crecimiento Economico en el Peru"; and Fund staff estimates.

1/ The computations are based on a standard growth accounting methodology. The production function is Cobb-Douglas (with a labor coefficient of 0.36), and the estimates for the 2002-12 period are based on the medium-term projections underlying Table 10. For this period, an annual rate of 3 percent is assumed for labor growth, and the construction of the capital series assumes a 5 percent depreciation rate.

levels of reserve coverage,¹⁵ with debt indicators improving over the medium term.¹⁶ In this context, Peru should be able to comfortably meet its obligations to the Fund (Table 11).

20. **There are, nevertheless, important risks to the medium-term outlook.** In particular:

- A deepening of regional and other external difficulties would likely affect growth, as capital inflows and the assumed recovery in private investment could stall. This could put pressure on the authorities to carry out a countercyclical fiscal policy, undermining fiscal consolidation. It could also put pressure on the exchange rate, which would affect the (partly unhedged) corporate sector and, in turn, erode the quality of bank loan portfolios.
- The high degree of financial dollarization will expose banks to credit risk in the event of a sharp depreciation of the currency.
- Fiscal sustainability requires completion of tax reform and fiscally neutral implementation of decentralization, both of which could be at risk if the domestic political situation were to deteriorate.
- Sensitivity analysis of the medium-term balance of payments and debt projections suggest that the outlook is quite robust to shocks to key parameters, although debt ratios would rise significantly in case of a large and sustained depreciation of the Sol (given the high share of debt denominated in foreign currency).

III. POLICY DISCUSSIONS

21. **The authorities considered that their economic policy framework will maintain macroeconomic stability, reinforce an already solid financial system, and provide a basis for sustained rapid growth.** The framework centers on medium-term fiscal consolidation, inflation targeting with a floating exchange rate, and supporting structural reforms. The authorities noted that Peru's sound fundamentals, led by high official reserves, had helped shield the country from regional contagion. Looking forward, they considered that solid growth would continue in 2003 and accelerate thereafter, given the completion of major natural resource projects and the prospects for increased trade opportunities under the hemispheric free-trade area envisaged to begin in 2006.

¹⁵ Official reserves would cover over 180 percent of short-term external debt for most of the projection period and would decline only slightly relative to imports and broad money (to 6½ months and 40 percent, respectively) by 2012.

¹⁶ External debt-to-GDP would fall from 51 percent in 2002 to 31 percent in 2012, with debt service-to-exports declining from 39 percent to 32 percent.

22. **The staff supported the authorities' overall policy framework, in particular their focus on financial sector soundness and high official reserve coverage as key elements of strength of the Peruvian economy.** There was broad agreement that medium-term growth prospects depended importantly on the continuation of prudent macroeconomic policies and structural reforms to create a sound investment climate. Given the economy's vulnerabilities and the uncertain regional outlook, the staff underscored the importance of containing the risks of financial dollarization and maintaining sustainable public-debt dynamics. Staff also emphasized that policies should also aim at reversing dollarization of the banking system, and that this should be a key objective for the medium term.

A. Fiscal Policies

23. **The authorities firmly plan that the fiscal deficit decline next year, to give credibility to their medium-term fiscal deficit target.** They considered that the moderate consolidation should not jeopardize economic recovery. Thus, the overall public sector deficit in 2003 is targeted to decline by about ½ percent of GDP, to 1.9 percent of GDP, with a similar adjustment in the primary balance (Table 2). The adjustment reflects mainly an increase in tax revenue, on the strength of the tax reform measures put in place in 2002 (Appendix VI).¹⁷ Primary spending-to-GDP is to fall marginally, as current expenditure will remain under strict control with no generalized wage or pension increase.

24. **Protecting the most vulnerable of the population remains high on the authorities' agenda.** The authorities are working with multilateral institutions to improve the efficiency and targeting of social programs (Appendices IV and V). Social expenditure (as a percentage of total budget outlays) is to rise for the second year in a row (Table 12).

25. **The fiscal deficit in 2003 will be financed mainly from external sources** (Table 13). World Bank, IDB, and Andean Development Corporation (CAF) disbursements are projected at about the same levels as in 2002, as is the amount of debt to be placed in international capital markets (excluding the impact of the debt swap). Total net external financing in 2003 is projected at US\$750 million, or 1.3 percent of GDP. The remaining financing (0.6 percent of GDP) would come from receipts for past privatizations, operating concessions granted under the government's PIPP, and bond placements in the domestic market.

26. **The staff cautioned that in the current international capital market environment and given Peru's relatively high public debt-to-GDP ratio, the authorities should have a well-defined contingency strategy for potential shortfalls in external financing.** Such a strategy might need to include measures to reduce the fiscal deficit further. The authorities

¹⁷ To ensure achievement of the revenue target, the authorities plan to extend the special wage tax (IES) through end-2003 and would only eliminate it once it is clear that the tax reform is generating the expected revenues.

noted that Peru had maintained access to international capital markets, pointing to their recent US\$500 million bond placement.¹⁸ They added that, if markets were temporarily closed, they could make up the shortfall by tapping emergency lending facilities at the World Bank and IDB, additional access to CAF funds, and by using part of government deposits built-up in 2002 (mainly at the central bank).¹⁹ They believed that a temporary market closure should not necessitate a change in their fiscal strategy, since contingency financing was available, but noted that a longer-term reduction in market access would lead them to tighten the medium-term fiscal framework. The authorities reaffirmed their commitment not to use resources of the pension reserve fund held at the central bank (as part of official reserves) for financing the fiscal deficit.

27. **Reactivating the domestic government bond market is essential for improving public debt management over the medium term.** When spreads on Peruvian paper began to rise in the second quarter of this year, the authorities took actions that raised perceptions among market participants that they were trying to manipulate the market.²⁰ As a result, the market has been dormant since May. The staff stressed that, with significant domestic debt coming due next year, restoring market confidence was critical. The authorities explained that the actions taken were aimed at addressing collusive behavior of market participants and demands for interest rates that were not in line with market conditions. Nevertheless, they agreed with the staff on the need to reactivate the market and, to this end, will introduce a system of primary dealers and other steps described in the attached letter of intent (LOI, paragraph 13).²¹

28. **The staff supported the authorities' continuing efforts to encourage private sector participation in the operations of state enterprises,** through the granting of operating concessions, management contracts, and strategic partnerships. A broad effort has been made to ensure that such a program has popular support (LOI, paragraph 11). The staff noted that in terms of improving economic efficiency, operating concessions were good substitutes for outright privatization, but that they generally yielded less up-front revenue.

¹⁸ On November 25, 2002, the authorities placed US\$500 million of global bonds maturing in January 2008, with a coupon rate of 9.125 percent and an effective yield of 9.35 percent (with a spread of 612 basis points over comparable U.S. Treasuries).

¹⁹ The authorities stated that, even under this scenario, they would continue to treat the SBA as precautionary.

²⁰ Such as abandoning the auction schedule, cutting the auctions below the auction target, and allowing government agencies to participate in the auctions.

²¹ The LOI is shown in Attachment I.

For 2003, proceeds from the PIPP are expected to yield US\$400 million, about the same as in 2002.²²

29. **In 2003–04, the authorities intend to introduce the key element of their comprehensive tax reform plan—elimination of certain regional and sectoral tax exemptions.** The objectives are to increase efficiency, facilitate tax administration, and raise close to 1 percent of GDP in annual tax revenues over the medium term. The authorities intend to eliminate those exemptions which are not needed to match tax incentive schemes in neighboring countries and which are not important for low-income households (see Appendix X for a list of existing exemptions). The staff urged the authorities to move quickly with eliminating most exemptions, but the authorities felt that in the current political circumstances, they could not take unilateral actions that would have important repercussions for the regions. Rather, they were aiming at phasing out regional and sectoral tax exemptions in consultation with the incoming regional administrations (LOI, paragraph 12). Increased tax collections in the affected regions (resulting from the phase-out of exemptions) would be earmarked for those regions to spend on infrastructure. Full implementation of the reform is envisaged by end-2004, with about half of the targeted exemptions (in terms of their revenue cost) to be eliminated by end-2003. Staff also urged the authorities to resist any future pressures for tax amnesties, as their history in Peru (and other countries) clearly demonstrates their long-term costs of reduced taxpayer compliance.

30. **The staff advised the authorities to carry out the decentralization program in a cautious and fiscally neutral manner.** Staff encouraged them to work closely with IDB and World Bank experts and noted the usefulness of pilot programs to test the transfer of expenditure responsibilities. The authorities agreed and explained that they would first transfer social programs to the regions and, once the transfer mechanism was functioning in a fiscally neutral manner, transfer the larger health and education programs. They noted that fiscal discipline in the regions would be aided by the revised fiscal responsibility law, which restricts sub-national governments' external borrowing and applies to them the national fiscal rules.

31. **The staff supported the authorities' plans to continue pension reform in 2003.** To improve the finances of the public pension plans the authorities intend to streamline further the benefit structure of the *Cédula Viva* preferential pension system, with a view to eventually unifying the main public pension systems. They also intend to expand investment opportunities of private pension funds, while working with those funds to lower operating costs.²³ There was agreement that a current proposal in congress to lower the retirement age

²² About half of those receipts would come from previous privatizations, and the other half from operating concessions in the energy sector.

²³ The authorities intend to seek technical assistance from the Fund in the area of regulation of private pension funds.

in the public pension system would undermine the public pension system's finances and imply substantial fiscal costs, and the authorities said they were working with congress to prevent such a reduction.

B. Monetary and Financial Sector Policies

32. **The staff supported the current stance of monetary policy and the authorities' inflation-targeting framework.** The staff viewed the 1.5–3.5 percent target band as an appropriate medium-term objective and welcomed the recent tightening of monetary policy in response to exchange market pressures and the resulting risks to the inflation target.

33. **Falling interest rates in 2002 have not translated into a noticeable increase in bank credit.** The authorities attributed this mainly to banks' continuing reluctance to lend to other than the most high-quality borrowers, as the banks had just gone through a difficult period of strengthening their balance sheets. They pointed out that improving bank profitability should soon allow banks to start widening their client base.

34. **The authorities agreed with the staff that reducing dollarization is an important medium-term goal.** They noted that this could only be achieved gradually and in the context of continued prudent macroeconomic policies. In the meantime, containing the risks associated with dollarization was a priority, and they noted the importance of high official reserves to this end. In addition, they explained that reducing dollarization would be aided by their plans to develop domestic capital markets (supported by the World Bank) and stressed the importance of maintaining a sound regulatory environment for dollar lending. The staff concurred, noting that about one-third of official reserves reflected reserve requirements on dollar deposits, and recommended that earlier plans to restructure those reserve requirements (which would likely have led to a reduction in total reserve requirements) not be implemented at this time. The authorities assured the staff that reserve requirements would continue to be managed prudently to ensure a high level of reserve coverage of dollar deposits.

35. **The staff welcomed the authorities' intention to continue strengthening bank supervision.** The SBS is analyzing the credit risk from foreign-currency lending by banks and the associated exposure to exchange rate changes and, if necessary, stands ready to issue norms to strengthen the management of those risks. The staff welcomed the planned legislation to grant legal protection to bank supervisors, and urged the authorities to implement other FSAP recommendations (Appendix IX) on reinforcing capital requirements and strengthening the system of prompt corrective actions. The authorities explained that the SBS had recently proposed to congress an increase in capital requirements, but felt that current regulations on corrective actions were more than adequate. The staff welcomed the authorities' commitment not to use public funds to create new lending institutions (leaving financial intermediation to private institutions supervised by the SBS) and to close the consumer lending program of *Banco de la Nación* at end-2002. The authorities also pointed out that the second-tier development bank, *Cofide*, would continue limiting its lending

operations to channeling financial resources to banks for on-lending to the private sector (LOI, paragraph 9).

C. External Sector Policies and Issues

36. **The exchange rate will continue to float, with intervention only in the spot market to smooth volatility.** The authorities and the staff agreed that exchange rate flexibility has served the economy well in adjusting to external shocks and maintaining competitiveness. The staff supported the moderate intervention and monetary tightening used to combat the exchange rate pressures in August/September, but questioned the recent decision by the central bank to issue exchange-rate indexed certificates as a means of providing a hedge for banks in their forward operations. This, the staff pointed out, was functionally very similar to intervention in the forward exchange market.²⁴ The authorities noted that the purpose of the indexed certificates was to reduce pressures in the spot exchange market, and that they would only be issued at appropriate times. MAE provided technical assistance (in mid-October) on the optimal use of these certificates. While noting the instrument's potential to smooth volatility in the spot exchange market, it was recommended to strictly limit their use to ensure that they do not become a general investment vehicle. In line with staff recommendations, these instruments have been included in the statistics of net international reserves.

37. **The authorities pointed out that Peru's vulnerability to external shocks had been well-contained so far.** They attributed this to sound macroeconomic fundamentals, the high level of official reserve coverage of dollar deposits and short-term external debt (reflecting in part the sharp reduction in bank's short-term foreign liabilities since 1998, see Box 2), and limited regional trade links. Furthermore, they noted that the public sector's external financing needs could be largely covered by official creditors, and that many of the private firms that had access to foreign financing were subsidiaries of large multinational corporations.

38. **The staff agreed with the authorities that Peru's exposure to sudden shifts in market sentiment toward the region had been limited so far, but noted that a further deterioration in the regional situation would not leave it unaffected.** In particular, growth would suffer as private investment (both foreign and domestic) would likely fail to recover if capital inflows dried up. The authorities explained that part of the adjustment to any reduction in private capital inflows would come through the exchange rate, but a tightening of the monetary policy stance and some limited use of international reserves would also likely be required. They saw the high level of reserves as providing some room for such action. As noted, the government would likely adhere to its fiscal plan in the short term, but would be prepared to tighten the fiscal stance in case of a prolonged shock.

²⁴ As noted in Box 2, banks typically hedge their open forward positions through spot purchases of foreign exchange.

39. **The staff welcomed the authorities' commitment to continuing trade liberalization and urged them to support HIPC assistance for Nicaragua.** Peru has an open trading regime (rated 2 on the 1–10 scale of the Fund's trade restrictiveness index), with a trade-weighted average tariff rate of 10.7 percent²⁵ and a trading system free of quantitative restrictions. Peru is presently negotiating with members of the Andean Economic Community (CAN) on a common external tariff. The staff cautioned the authorities that the trade negotiations within the CAN might lead to a rise in trade protection. The authorities explained that their medium-term trade priority was to participate in a hemispheric free trade area, and in this context it would be best if Peru was part of the CAN negotiating bloc. On HIPC assistance, the authorities did not believe that the current political and economic environment in Peru would allow them to garner the support necessary to grant HIPC assistance to Nicaragua.

D. Labor Markets Issues

40. **The staff expressed concern that some recent changes in labor market regulations would reduce flexibility and that there no longer existed an effective unemployment safety net.** Conditions have been tightened on firms' abilities to outsource labor needs, standardize overtime and bonus pay rules, and lay off workers. The staff pointed out that a less flexible labor market would reduce the growth elasticity of employment, which would make reducing the high level of unemployment and underemployment more difficult.²⁶ Moreover, the staff noted that since late-2000 workers had been left with no protection in the event of job loss as a result of legal norms that effectively shifted funding for the unemployment protection scheme to direct payments to workers.²⁷ The authorities said that labor-market flexibility had not been compromised, noting that the measures on outsourcing and pay rules aimed at protecting workers and had the support of the International Labor Organization. In their view, a recent constitutional court ruling against collective dismissals was case-specific, and an omnibus labor bill presently in congress was likely to reaffirm the relatively flexible labor market situation. In addition, the authorities informed the staff that they were considering proposals to provide unemployment insurance protection, including a return to the original CTS, but that no final decision had been taken.

²⁵ In 2002, tariffs on certain capital and intermediate goods were lowered from 12 to 4 and 7 percent.

²⁶ Those underemployed work less than 35 hours a week or (working more than 35 hours) earn less than half the cost of the standard family consumption basket. At end-2001, the rates of underemployment and unemployment were 47.6 and 7.9 percent, respectively.

²⁷ Previously, the Service Time Compensation Scheme (CTS) provided a form of unemployment insurance. Firms paid one half a salary every six months into an interest-earning account for workers (from which up to 50 percent could be withdrawn at any time).

IV. STAFF APPRAISAL

41. **Peru's economic performance in 2002 has been encouraging.** Despite a deteriorating external environment and a difficult political situation at home, growth is recovering, inflation is low, and the external position is robust. Macroeconomic performance has been broadly in line with the program, and progress has been made with structural reforms. All but one end-September quantitative performance criteria were observed, as were most structural benchmarks. Domestic political considerations led to a reorientation of the privatization agenda under the Private Investment Promotion Program (PIPP) and of the strategy for eliminating regional and sectoral tax exemptions.

42. **Continued implementation of sound macroeconomic policies and structural reforms should allow Peru to continue to resist adverse regional and other external developments.** Maintaining a sound macroeconomic framework would keep public-debt dynamics under control and international reserves at comfortable levels, creating the conditions for sustained rapid growth and a recovery in private investment. Although external debt and debt-service obligations are relatively high, they should decline progressively under the policy framework described above.

43. **While the baseline medium-term outlook is favorable, there are risks.** In particular, the high degree of dollarization and the relatively large public debt imply that Peru will remain vulnerable to adverse shocks for some time. A severe but short-term financial shock would affect growth as the anticipated recovery in private investment would likely be delayed; such a shock would probably require some tightening of monetary policy, but contingency financing plans could allow the fiscal program to proceed without abrupt changes. A more permanent financial shock would require a tightening of the fiscal stance. Given the external environment, and the risk that the domestic political situation poses to tax reform and decentralization (and thus to medium-term sustainability), the authorities should develop a contingency plan for fiscal measures that could be implemented if needed.

44. **The revised fiscal program balances the need to reduce the deficit while supporting the recovery.** Reducing the deficit is needed to impart credibility to the country's medium-term fiscal deficit target and avoid an increase in the public debt-to-GDP ratio. This is being done in a gradual manner so as not to adversely impact economic growth. It is important that the authorities continue to work with the World Bank and IDB to improve the quality of public expenditure, to ensure that the most vulnerable of the population are well protected, and to increase budget flexibility to absorb unanticipated expenditure shocks (such as those related to recent court rulings).

45. **Comprehensive tax reform is key to putting the public finances on a sustainable basis.** Tax policy and administration measures implemented in 2002 will improve the overall efficiency and equity of the tax system, although the recent tax amnesty again risks undermining future tax discipline. The reform is to be completed over the next two years by the elimination of regional and sectoral tax exemptions. The staff hopes that the authorities' phased approach to eliminating those exemptions will help them reach agreements with

regional authorities. However, there is also a risk that the reform will lose momentum under this approach, and the authorities will need to be persistent in pursuit of this key reform.

46. **The domestic bond market needs to be reactivated by improving the transparency and efficiency of the auction process.** The 2003 fiscal program relies on an increase in the placement of government bonds in the domestic market, consistent with rates of placement made in early 2002 when the market was functioning well.

47. **The decision to seek alternatives to privatization should not necessarily mean less efficiency gains.** The reorientation of the PIPP from asset sales toward operating concessions and other forms of private-sector participation in state enterprise operations was a pragmatic response to growing protests against privatization. Operating concessions could generate similar investment commitments to privatization, but will generally result in lower immediate receipts for the government.

48. **Decentralization needs to be carried out cautiously to ensure that its impact is fiscally neutral.** While the authorities' strategy, supported by the World Bank and IDB, appears to be sound, the experience in other countries has shown that there are considerable fiscal risks in decentralization. Pilot programs could serve as useful tests of the fiscal impact. In addition, swift passage of the revised fiscal responsibility law is important, as it contains important regulations on regional and local government finances. Maintaining a political consensus with the regions will be crucial for an orderly implementation of decentralization.

49. **The authorities' intention to continue reforming public and private pension systems is welcome.** Measures taken to date, and continued efforts to streamline benefits under the *Cédula Viva* system with a view toward unifying the main public pension systems, will serve to reduce the net present value of the pension system's liabilities and improve its equity. In contrast, a proposal to lower the retirement age in the public pension system would have significant negative consequences for the fiscal finances and should be resisted.

50. **Staff supports the inflation-targeting framework for monetary policy,** with a target band of 1.5–3.5 percent over the medium term, and encourages the authorities to continue refining the inflation forecast and to strengthen its integration with the monetary policy decision-making process. The staff agrees with the authorities that reducing dollarization is a key goal that, while likely requiring time, will depend on continued pursuit of prudent macroeconomic policies, aided by strong bank supervision and development of the domestic capital market.

51. **The high level of official reserves is a key factor in Peru's ability to avoid the contagion that has affected other highly-dollarized economies in the region.** The staff welcomes the decisions to maintain reserve requirements on U.S. dollar deposits at the present level and to avoid recourse to dollar deposits of the pension reserve fund held at the central bank to finance fiscal operations.

52. **The position of most banks has strengthened over the past year, and the authorities' commitment to further enhance prudential oversight is welcome.**

Particularly important are plans to evaluate the credit risk of banks derived from foreign-currency lending and to grant legal protection to bank supervisors. The staff commends the authorities' continued intention to leave financial intermediation activities to private sector institutions under SBS supervision.

53. **The flexible exchange rate system has served Peru well in adjusting to external shocks.** The response in August/September to pressures in the foreign exchange market, combining monetary tightening and modest intervention in the foreign exchange market, was appropriate. The policy of not intervening directly in the forward exchange market should continue, and use of the new exchange rate-indexed Sol-denominated central bank certificates should be strictly limited.

54. **The staff commends the authorities' continuing commitment to an open trade and payments regime.** The authorities should resist proposals in the trade negotiations within the Andean Community that might lead to a rise in trade protection.

55. **The authorities' intention to maintain the current relatively flexible system of labor market norms is welcome.** In light of the high level of underemployment and unemployment, it is important that the new legal framework for labor markets maintain flexibility, as any reduction would be detrimental to employment growth and poverty reduction. In addition, the authorities should implement as soon as possible an adequate unemployment insurance system.

56. **Economic statistics are timely and broadly adequate for program monitoring and surveillance purposes.** The authorities have improved banking data, and the inflation targeting framework adopted in January 2002 has increased the transparency of monetary policy. The ROSC fiscal transparency module and planned ROSC data module are welcome steps to improve information dissemination, but fiscal decentralization will require efforts to compile and report additional fiscal data. The recent decision by the National Statistics Office to rebase GDP figures to 2001 should not pose a problem in monitoring or surveillance, as the authorities will continue to publish quarterly and annual GDP data.

57. **In summary, Peru has performed well under the program supported by the Stand-By Arrangement, and the staff recommends completion of the first review.** The overall stance of macroeconomic policy is appropriate, and staff is confident that the authorities will continue to adjust policies as needed to achieve the objectives of the program. Because monetary policy has been consistent with the central bank's inflation-targeting framework and in line with the program, the staff supports the authorities' request for a waiver for the nonobservance of the end-September performance criterion on NDA and the replacement of the performance criterion on NDA by a consultation mechanism based on inflation. In addition, the staff supports the authorities' request to modify the fiscal performance criterion and all privatization-related adjusters for end-2002.

58. It is recommended that the next Article IV consultation with Peru will be held on a 24-month consultation cycle in accordance with the Board decision DEC/12794 adopted on July 15, 2002.

Table 1. Peru: Selected Economic Indicators

	1999	2000	Prel. 2001	Prog. 2002	Rev. Prog. 2002	Prog. 2003	Proj. 2003
(Annual percentage change)							
Production, prices, and trade							
Real GDP	0.9	3.1	0.2	3.7	3.7	5.0	3.5
Real domestic demand	-3.1	2.4	-0.7	3.5	3.3	5.4	3.1
<i>Of which</i> : private consumption	-0.4	3.9	1.3	2.9	3.6	5.2	3.1
Consumer prices							
End of period	3.7	3.7	-0.1	2.5	2.0	2.0	2.5
Period average	3.5	3.8	2.0	1.8	0.2	2.3	2.2
Exports (U.S. dollars)	6.3	15.0	1.1	11.0	8.5	7.7	10.8
Imports (U.S. dollars)	-17.9	8.9	-2.1	6.3	3.1	8.0	6.0
Terms of trade	-8.3	-2.1	-2.0	1.3	3.2	2.0	2.3
Real effective exchange rate (depreciation -) 1/	-2.4	7.2	4.4	...	-4.8	...	...
Money and credit							
Broad money 2/	4.6	2.3	4.9	4.2	4.2	6.1	5.7
Credit to the private sector 2/	-2.3	-3.6	-2.6	5.4	0.6	8.2	2.9
(In percent of GDP, unless otherwise indicated)							
Public sector							
General government current revenue	17.8	17.5	17.2	17.0	17.2	17.5	17.6
General government noninterest expenditure	18.7	18.4	17.7	17.3	17.6	17.1	17.2
Combined public sector primary balance	-0.8	-0.9	-0.1	0.1	-0.2	0.7	0.4
Interest due	2.2	2.3	2.2	2.0	2.1	2.1	2.4
Combined public sector overall balance	-3.0	-3.2	-2.3	-1.9	-2.3	-1.4	-1.9
Balance of payments							
Current account	-2.9	-2.9	-2.0	-2.3	-2.2	-2.7	-1.9
Capital and financial account	1.4	2.5	2.8	2.5	4.4	2.9	2.0
Change in net international reserves (in millions of U.S. dollars, increase -)	775	190	-448	-100	-1,250	-120	-70
Savings and investment							
Gross domestic investment	21.5	20.1	18.4	18.8	18.0	19.4	18.2
Public sector	4.8	4.0	3.2	3.1	3.2	3.0	3.2
Private sector	16.7	16.1	15.2	15.7	14.8	16.4	15.0
National savings	18.6	17.2	16.4	16.5	15.8	16.7	16.3
Public sector 3/	1.8	0.9	1.0	1.1	0.9	1.5	1.3
Private sector	16.8	16.3	15.4	15.4	14.9	15.2	15.0
External savings	2.9	2.9	2.0	2.3	2.2	2.7	1.9
Memorandum item:							
Nominal GDP (S/. billions)	174.7	186.8	189.5	201.0	196.9	216.3	208.8

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

1/ End of period. Based on Information Notice System. Data for 2002 correspond to September.

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

3/ Excludes privatization receipts.

Table 2. Peru: Operations of the Combined Public Sector
(In percent of GDP)

	1999	2000	Prel. 2001	Prog. 2002	Rev. Prog. 2002	Prog. 2003	Rev. Prog. 2003
Central government primary balance	-1.0	-0.6	-0.7	-0.3	-0.3	0.3	0.2
Revenue	14.8	15.0	14.3	14.4	14.5	14.7	14.8
Current	14.5	14.7	14.1	14.1	14.3	14.4	14.7
<i>Of which: tax revenue 1/</i>	12.3	12.0	11.9	11.9	11.8	12.4	12.6
Capital	0.4	0.3	0.2	0.3	0.2	0.3	0.1
Noninterest expenditure	15.9	15.5	14.9	14.7	14.8	14.5	14.5
Current	12.5	12.7	12.6	12.4	12.6	12.2	12.3
Capital	3.4	2.8	2.4	2.2	2.2	2.2	2.2
Rest of the general government primary balance	0.1	0.1	0.2	0.2	0.0	0.3	0.0
Revenue	5.4	5.6	5.6	5.6	5.7	5.7	5.5
Current	5.4	5.4	5.5	5.6	5.6	5.7	5.5
Capital	0.0	0.1	0.1	0.1	0.1	0.0	0.0
Noninterest expenditure	5.3	5.5	5.5	5.4	5.6	5.4	5.5
Current	4.4	4.5	4.6	4.5	4.8	4.5	4.7
Capital	0.9	1.0	0.9	0.9	0.8	0.9	0.8
Public enterprise primary balance	0.0	-0.5	0.2	0.2	-0.0	0.1	0.1
Current balance	0.9	0.2	0.6	0.4	0.4	0.3	0.4
Capital balance	-0.9	-0.7	-0.4	-0.3	-0.4	-0.2	-0.3
Nonfinancial public sector primary balance	-0.9	-1.0	-0.3	0.1	-0.3	0.7	0.3
Central bank operating balance	0.1	0.0	0.2	0.0	0.1	0.0	0.1
Combined public sector primary balance	-0.8	-0.9	-0.1	0.1	-0.2	0.7	0.4
Interest payments	2.2	2.3	2.2	2.0	2.1	2.1	2.4
External	2.0	1.9	1.9	1.7	1.8	1.7	2.0
Domestic	0.2	0.3	0.3	0.3	0.3	0.4	0.3
Combined public sector overall balance	-3.0	-3.2	-2.3	-1.9	-2.3	-1.4	-1.9
Financing	3.0	3.2	2.3	1.9	2.3	1.4	1.9
External	-0.1	1.2	0.9	0.7	2.1	0.3	1.3
Disbursements 2/	1.6	2.4	2.4	2.2	3.7	2.1	3.1
(In millions of U.S. dollars)	812	1,299	1,319	1,250	2,056	1,250	1,800
Amortizations 2/	-1.7	-1.2	-1.4	-1.5	-1.7	-1.8	-1.9
(In millions of U.S. dollars)	-873	-636	-768	-862	-925	-1,091	-1,074
Condonations	0.1	0.1	-0.1	0.0	0.1	0.0	0.0
Privatization	0.7	0.8	0.6	1.2	0.7	1.2	0.7
(In millions of U.S. dollars)	363	409	327	700	400	700	400
Domestic	2.4	1.2	0.8	-0.0	-0.5	-0.1	-0.1
<i>Of which: bonds</i>	...	...	0.6	0.8	0.5	1.1	0.6
(In millions of U.S. dollars)	...	...	349	452	267	667	345
Amortizations	...	-0.3	-0.3	-0.3	-0.2	-0.6	-0.6
Net deposits	2.3	1.5	1.1	-0.5	-0.8	-0.6	0.0
Memorandum items: 3/							
General government current revenue	17.8	17.5	17.2	17.0	17.2	17.5	17.6
General government noninterest expenditure	18.7	18.4	17.7	17.3	17.6	17.1	17.2
Public sector debt-to-GDP 4/	48.0	45.9	46.2	45.1	47.7	43.1	47.8

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

1/ Net of government IES payment and tax on assets of public enterprises (0.3 and 0.1 percent of GDP in 2002 and 2003).

2/ Excludes the Brady bond swap of US\$923 million carried out in early 2002.

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

4/ About half the deterioration in the ratio by end-2003 relative to the original program is explained by lower GDP growth and effective depreciation of the Sol. The rest reflects higher deficits and lower privatization receipts.

Table 3. Peru: Operations of the Central Government
(In percent of GDP)

	1999	2000	Prel. 2001	Prog. 2002	Rev. Prog. 2002	Prog. 2003	Rev. Prog. 2003
Current primary balance	2.0	2.0	1.5	1.7	1.8	2.2	2.3
Current revenue	14.5	14.7	14.1	14.1	14.3	14.4	14.7
Tax revenue 1/	12.3	12.0	11.9	11.9	11.8	12.4	12.6
Direct taxes	3.5	3.3	3.4	3.1	3.2	3.2	3.6
Indirect taxes	8.8	8.7	8.5	8.8	8.6	9.2	9.0
Other current revenue	2.2	2.8	2.2	2.2	2.6	2.1	2.1
Current noninterest expenditure	12.5	12.7	12.6	12.4	12.6	12.2	12.3
Labor services 2/	6.7	6.6	6.6	6.4	6.7	6.4	6.4
Goods and nonlabor services	3.6	3.8	3.7	3.6	3.5	3.5	3.4
Transfers and other	2.2	2.3	2.2	2.4	2.4	2.3	2.5
Capital balance	-3.0	-2.5	-2.2	-1.9	-2.0	-1.9	-2.1
Capital revenue	0.4	0.3	0.2	0.3	0.2	0.3	0.1
Capital expenditure	3.4	2.8	2.4	2.2	2.2	2.2	2.2
Gross capital formation	3.2	2.5	2.1	2.1	1.9	2.1	2.0
Other	0.2	0.3	0.3	0.2	0.3	0.1	0.1
Primary balance	-1.0	-0.6	-0.7	-0.3	-0.3	0.3	0.2
Interest payments	2.1	2.2	2.1	2.0	2.0	2.0	2.3
External	2.0	1.9	1.9	1.7	1.8	1.6	2.0
Domestic	0.1	0.3	0.2	0.3	0.3	0.4	0.3
Overall balance	-3.1	-2.7	-2.8	-2.2	-2.3	-1.7	-2.0
Memorandum items:							
Primary balance before transfers	0.6	0.9	1.2	1.9	1.8	2.4	2.5
Overall balance before transfers	-1.5	-1.3	-0.9	-0.1	-0.3	0.4	0.2

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

1/ Net of government IES payment and tax on assets of public enterprises (0.3 and 0.1 percent of GDP in 2002 and 2003, respectively).

2/ Includes wages, salaries, and employer contributions to social security.

Table 4. Peru: Quantitative Performance Criteria, January-September 2002

	March 31	June 30	Prel. Sept. 30
(Cumulative amounts from December 31, 2001; in millions of soles)			
Borrowing requirement of the combined public sector			
Unadjusted limits	750	1,800	2,850
Adjusted limits 1/	750	1,800	2,850
Actual	348	1,316	2,641
Margin	402	484	209
Net consumer lending of the Banco de la Nación			
Limit	200	340	430
Actual	106	139	142
Margin	94	201	288
Net domestic assets of the central reserve bank (change)			
Unadjusted limits	-690	-920	-1,535
Adjusted limits 1/	-1,453	-1,333	-1,801
Actual	-1,371	-1,024	-1,711
Margin	-82	-309	-90
(Cumulative change from December 31, 2001; in millions of U.S. dollars)			
Net international reserves of the central reserve bank			
Unadjusted targets	55	125	315
Adjusted targets 1/	271	242	390
Actual	324	273	523
Margin	53	31	133
Stock of government guarantees for housing support programs			
Limit	150	150	150
Actual	0	0	0
Margin	150	150	150
Short-term net external debt of the public sector			
Limits	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
Actual	0	0	0
Margin	0	0	0
(Cumulative amounts from December 31, 2001; in millions of U.S. dollars)			
Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year			
Total			
Unadjusted limits	1,100	1,400	1,700
Adjusted limits 1/	2,023	2,323	2,623
Actual	1,423	1,973	2,273
Margin	600	350	350
<i>Of which: 1- to 5-year maturity</i>			
Limits	200	200	200
Actual	0	0	0
Margin	200	200	200

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and EBS/02/12.

1/ The targets and limits have been adjusted in accordance with the table attached to the letter of intent dated January 18, 2002 (EBS/02/12).

2/ Excluding arrears associated with nonrescheduled debt to foreign creditors outstanding as of end-2001.

Table 5. Peru: Proposed Schedule of Purchases
Under the Stand-By Arrangement, 2002-04 1/

Amount of Purchase	Availability Date	Conditions Include
1. SDR 115.625 million	December 13, 2002	Completion of the first review and observance of end-September 2002 performance criteria.
2. SDR 27.875 million	March 16, 2003	Completion of the second review and observance of end-December 2002 performance criteria.
3. SDR 27.875 million	May 15, 2003	Observance of end-March 2003 performance criteria.
4. SDR 27.875 million	August 31, 2003	Completion of the third review and observance of end-June 2003 performance criteria.
5. SDR 27.875 million	November 15, 2003	Observance of end-September 2003 performance criteria.
6. SDR 27.875 million	February 15, 2004	Observance of end-December 2003 performance criteria.

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

Table 6. Peru: Monetary Survey

	1999	2000	2001	Prog. 2002	Rev. Prog. 2002	Prog. 2003	Rev. Prog. 2003
I. Central Reserve Bank							
(In millions of new soles at program exchange rate)							
Net international reserves 1/	28,149	28,739	29,803	29,690	33,368	30,625	34,168
(In millions of U.S. dollars)	8,159	8,022	8,324	8,387	9,426	8,507	9,491
Net domestic assets	-23,518	-24,201	-24,858	-24,450	-27,771	-25,041	-28,082
Net credit to nonfinancial public sector	-9,966	-9,390	-8,758	-8,874	-10,217	-9,092	-9,931
Rest of banking system	-11,462	-12,488	-13,695	-13,401	-14,996	-13,588	-15,639
Other	-2,090	-2,323	-2,405	-2,175	-2,558	-2,361	-2,512
Currency	4,631	4,537	4,945	5,240	5,597	5,584	6,086
II. Banking System							
(In millions of new soles at program exchange rate)							
Net foreign assets	25,630	26,555	28,503	29,249	31,824	30,680	32,598
Net domestic assets	19,801	21,043	21,004	22,441	20,112	24,811	22,928
Net credit to nonfinancial public sector	-13,291	-11,297	-9,351	-11,542	-10,400	-13,097	-9,781
Credit to private sector	49,166	49,112	47,611	50,305	47,458	55,163	49,482
Other	-16,074	-16,772	-17,256	-16,322	-16,946	-17,255	-16,773
Net credit to COFIDE	-3,074	-2,395	-1,732	-1,692	-1,367	-1,718	-1,388
Other	-13,000	-14,377	-15,524	-14,630	-15,579	-15,537	-15,385
Liabilities to the private sector	45,431	47,598	49,507	51,690	51,936	55,491	55,526
(12-month percentage change) 2/							
Base money	17.0	-4.0	7.9	4.8	11.0	5.8	6.6
Broad money	4.6	2.3	4.9	4.2	4.2	6.1	5.7
Domestic currency	11.4	2.5	13.7	7.7	10.1	10.1	12.6
Foreign currency	1.7	2.2	1.1	2.5	1.2	4.1	2.1
Credit to private sector	-2.3	-3.6	-2.6	5.4	0.6	8.2	2.9
Domestic currency	-5.3	0.9	2.7	9.1	3.0	12.2	7.0
Foreign currency	-1.6	-4.5	-3.8	4.6	0.0	7.2	1.9
Memorandum item:							
Program exchange rate (S/. per US\$)	3.45	3.60	3.58	3.54	3.54	3.60	3.60

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

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

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

Table 7. Peru: Balance of Payments

	1999	2000	Prel. 2001	Prog. 2002	Rev. Prog. 2002	Prog. 2003	Rev. Prog. 2003
(In millions of U.S. dollars)							
Current account	-1,478	-1,568	-1,094	-1,334	-1,239	-1,643	-1,120
Merchandise trade	-630	-317	-90	151	289	142	674
Exports	6,120	7,034	7,108	7,915	7,713	8,525	8,545
Traditional	4,143	4,821	4,743	5,411	5,269	5,809	5,746
Nontraditional	1,977	2,213	2,333	2,505	2,444	2,716	2,798
Imports	-6,750	-7,351	-7,198	-7,764	-7,424	-8,383	-7,871
Services, income, and current transfers (net)	-847	-1,252	-1,004	-1,486	-1,528	-1,787	-1,793
Services	-666	-793	-800	-789	-860	-892	-915
Investment income	-1,146	-1,452	-1,203	-1,682	-1,572	-1,949	-1,832
Current transfers	964	993	999	985	904	1,057	954
Financial and capital account	673	1,437	1,511	1,412	2,434	1,739	1,165
Public sector	383	280	393	323	1,081	134	709
Disbursements	1,237	1,485	1,344	1,300	2,941	1,300	1,878
Amortization	-971	-1,042	-918	-941	-1,889	-1,131	-1,113
Other medium- and long-term public sector flows 1/	117	-163	-33	-36	29	-35	-56
Capital transfers (net)	-54	-69	-68	0	0	0	0
Privatization	219	229	267	665	245	665	340
Private sector	126	997	919	423	1,110	940	116
Foreign direct investment (FDI) excluding privatization	1,593	433	796	537	1,677	1,066	219
Other private capital	-1,467	564	123	-114	-567	-126	-103
Medium- and long-term loans	350	603	358	240	-339	88	80
Portfolio investment	-297	-300	-271	-189	-321	-179	-184
Short-term flows to the financial system 2/	-1,424	-86	-325	-245	0	-40	0
Other short term flows (including errors and omissions)	-96	347	360	80	93	5	1
Financing	805	131	-417	-78	-1,195	-96	-45
Change in central bank reserves (increase -)	775	190	-448	-100	-1,250	-120	-70
Exceptional financing	30	-58	31	23	55	24	26
Debt relief 3/	38	0	33	23	55	24	26
Change in arrears	-8	-58	-2	0	0	0	0
(In percent of GDP unless otherwise specified)							
Memorandum items:							
Current account (CA) balance	-2.9	-2.9	-2.0	-2.3	-2.2	-2.7	-1.9
FDI and private MLT capital (percent of CA deficit)	131.5	66.1	105.5	58.2	108.0	70.2	26.7
Capital and financial account balance	1.3	2.7	2.8	2.5	4.4	2.9	2.0
Export value (US\$), percent change	6.3	15.0	1.1	11.0	8.5	7.7	10.8
Volume growth	14.8	11.5	6.3	9.9	6.5	3.7	8.0
Price growth	-7.4	3.1	-4.9	1.0	1.9	3.9	2.6
Import value (US\$), percent change	-17.9	8.9	-2.1	6.3	3.1	8.0	6.0
Volume growth	-18.5	3.4	1.0	6.6	2.8	6.0	5.0
Price growth	0.7	5.3	-3.1	-0.3	0.3	1.8	1.0
GDP (millions of US\$)	51,628	53,513	54,023	56,817	55,943	60,072	57,686

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

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

2/ Includes COFIDE and Banco de la Nación.

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

Table 8. Peru: External Financing Requirements and Sources
(In millions of U.S. dollars)

	1999	2000	Prel. 2001	Prog. 2002	Rev. Prog. 2002	Prog. 2003	Rev. Prog. 2003
1. Gross financing requirements	8,639	8,144	6,995	7,208	8,385	7,733	6,421
External current account deficit (excluding official transfers)	1,478	1,568	1,094	1,334	1,239	1,643	1,120
Debt amortization	7,933	6,742	5,466	5,774	5,896	5,970	5,231
Medium- and long-term debt	2,039	2,487	1,797	2,184	2,794	2,495	1,933
Public sector	971	1,042	918	941	1,889	1,131	1,113
Multilateral 1/	273	531	334	410	397	470	479
Bilateral	365	389	490	472	544	588	578
Bonds and notes	319	108	83	50	940	67	50
Other	15	12	10	9	8	6	6
Private sector	1,068	1,445	879	1,243	905	1,364	820
Short-term debt 2/	5,894	4,255	3,669	3,590	3,102	3,475	3,298
Repayment of arrears 3/	8	58	2	0	0	0	0
Accumulation of NIR	-780	-224	433	100	1,250	120	70
Change in gross reserves	-954	-362	289	-55	1,105	41	1
Payments of short-term liabilities of the central bank	174	138	144	155	145	79	69
IMF repurchases and repayments	179	172	160	155	138	79	69
Other	-5	-34	-16	0	7	0	0
2. Available financing	8,505	7,632	6,523	7,185	8,012	7,709	6,395
Foreign direct investment (net)	1,812	662	1,063	1,202	1,922	1,731	559
Privatization	219	229	267	665	245	665	340
FDI	1,593	433	796	537	1,677	1,066	219
Portfolio (net)	-297	-300	-271	-189	-321	-179	-184
Short-term assets (flow)	-37	231	81	-50	-423	-135	0
Debt financing from private creditors	5,697	5,752	4,339	4,958	5,755	5,027	4,898
Medium- and long-term financing	1,442	2,083	1,237	1,483	2,457	1,452	1,600
To public sector	25	35	0	0	1,891	0	700
<i>Of which: balance of payments financing 3/</i>	0	0	0	0	0	0	0
To private sector	1,418	2,048	1,237	1,483	566	1,452	900
Short-term financing	4,255	3,669	3,102	3,475	3,298	3,575	3,298
<i>Of which: balance of payments financing 3/</i>	0	0	0	0	0	0	0
Official creditors 4/	1,213	1,450	1,344	1,300	1,050	1,300	1,178
Multilateral 1/	960	794	1,104	1,071	822	1,040	895
<i>Of which: balance of payments financing</i>	414	471	876	850	617	819	650
Bilateral	253	656	239	229	228	260	283
To public sector	253	656	238	229	228	260	283
<i>Of which: balance of payments financing</i>	0	300	0	0	0	0	0
To private sector	0	0	0	0	0	0	0
Other medium- and long-term public sector flows 5/	117	-163	-33	-36	29	-35	-56
IMF	0	0	0	0	0	0	0
Accumulation of arrears (exceptional)	0	0	0	0	0	0	0
3. Financing gap	134	512	472	23	373	24	26
Other flows 6/	134	512	472	23	373	24	26
Errors and omissions	96	512	441	0	318	0	0
Debt relief	38	0	31	23	55	24	26

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

1/ Excluding IMF.

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

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

4/ Includes both loans and grants.

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

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

Table 9. Peru: Financial and External Vulnerability Indicators
(In percent; unless otherwise indicated)

	1999	2000	Prel. 2001	Prog. 2002	Proj. 2002	Prog. 2003	Proj. 2003
Financial indicators							
Public sector debt/GDP	48.0	45.9	46.2	45.1	47.7	43.1	47.8
<i>Of which:</i> in domestic currency (percent of GDP)	5.7	5.9	6.8	...	7.1	...	7.1
90-day prime lending rate, domestic currency 1/	21.2	18.2	15.2	...	8.4	...	...
90-day prime lending rate, foreign currency 1/	11.8	10.7	9.0	...	2.7	...	...
Velocity of money 2/	3.9	3.9	3.8	3.9	3.9	3.9	3.8
Credit to the private sector/GDP	27.9	26.0	25.0	24.6	24.1	25.1	23.7
Share of foreign currency deposits in total deposits	77.3	77.9	75.9	74.6	74.1	73.5	72.0
Share of foreign currency loans in total credit	82.3	81.5	81.1	80.3	80.1	79.8	79.6
Nonperforming loans/total loans 3/ 4/	9.4	11.2	11.0	...	8.7	...	...
Loan-loss provisions/nonperforming loans 3/ 4/	79.4	78.5	90.0	...	115.3	...	...
Risk-based capital-assets ratio 4/	12.0	12.9	13.4	...	13.3	...	...
Foreign currency deposits at commercial banks (in millions of U.S. dollars)	9,133	9,260	9,321	9,561	9,655	9,960	9,855
Commercial banks' short-term foreign assets (in millions of U.S. dollars)	981	824	750	861	977	861	977
Commercial banks' short-term foreign liabilities (in millions of U.S. dollars)	1,835	1,519	1,188	1,239	1,451	1,239	1,451
External indicators							
Exports, U.S. dollars (percent change)	6.3	15.0	1.1	11.0	8.5	7.7	10.8
Imports, U.S. dollars (percent change)	-17.9	8.9	-2.1	6.3	3.1	8.0	6.0
Terms of trade (percent change)	-8.3	-2.1	-2.0	1.3	3.2	2.0	2.3
Real effective exchange rate, (end-period, percent change) 1/	-2.4	7.2	4.4	...	-4.8	...	...
Current account balance (percent of GDP)	-2.9	-2.9	-2.0	-2.3	-2.2	-2.7	-1.9
Capital and financial account balance (percent of GDP)	1.4	2.5	2.8	2.5	4.2	2.9	2.0
Total external debt (percent of GDP)	55.2	52.5	50.9	50.2	51.0	47.9	50.8
Medium- and long-term public debt (percent of GDP) 5/	38.7	36.5	35.5	34.9	36.7	33.2	36.8
Medium- and long-term private debt (percent of GDP)	7.8	9.0	9.7	9.1	8.4	8.7	8.2
Short-term public and private debt (percent of GDP)	8.7	6.9	5.8	6.1	5.9	6.0	5.7
Total external debt (percent of exports of goods and services) 5/	372.3	326.2	320.0	302.8	309.3	284.6	288.6
Total debt service (percent of exports of goods and services) 6/	54.4	50.2	39.4	38.6	35.5	39.8	34.7
Gross official reserves (in millions of U.S. dollars)	9,003	8,563	8,838	8,853	9,942	8,904	9,941
Gross official reserves, percent of short-term external debt 7/	122.1	154.3	149.3	156.0	189.8	146.3	184.8
Gross official reserves, percent of broad money 8/	68.0	64.0	62.1	60.3	68.0	57.5	65.2
Gross official reserves, percent of foreign currency deposits at banks	98.6	92.5	94.8	92.6	103.0	89.4	100.9
Gross official reserves (in months of imports of goods and services)	11.1	10.8	10.8	9.8	11.5	9.0	10.7
Net international reserves (in millions of U.S. dollars)	8,404	8,180	8,613	8,713	9,863	8,833	9,933
Net international reserves (program definition; in millions of U.S. dollars) 9/	5,195	4,891	5,056	5,094	5,593	5,116	5,461
Net international position (in millions of U.S. dollars) 10/	2,538	2,624	2,915	...	3,110	...	3,110
Financial market indicators							
Stock market index (U.S. dollars) 11/	523.4	342.8	342.1	...	342.4	...	...
Foreign currency debt rating (Moody's) 11/	Ba3	Ba3	Ba3	...	Ba3	...	...
Spread of Peruvian Brady bonds, basis points 11/ 12/	443	687	521	...	742	...	...

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

1/ At end of period. For 2002, interest rates correspond to October prime corporate rates, and the REER to September.

2/ Defined as the inverse of the ratio of end-period broad money to annual GDP.

3/ Annual average. Since 2000, includes adjustment for an estimate of nonperforming loans that were temporarily exchanged for government bonds.

4/ Preliminary data for 2002 correspond to September.

5/ Includes Central Reserve Bank of Peru debt.

6/ Includes debt service to the Fund. For 2002, excludes US\$923 million of Brady bonds that were amortized in a debt exchange operation.

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

8/ At end-period exchange rate.

9/ Includes financial system's foreign currency deposits in central bank as reserve liability.

10/ Includes public sector foreign currency deposits in central bank (e.g. pension reserve funds) as reserve liability.

11/ For 2002, data correspond to end-October.

12/ 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	-1.1	-1.2	-1.1	-1.3	-1.4	-1.0	-0.9	-1.2	-1.5	-1.7	-1.8	-2.0
Merchandise trade	-0.1	0.3	0.7	0.9	1.1	1.7	1.9	2.0	1.9	1.9	2.0	2.1
Exports	7.1	7.7	8.5	9.4	10.5	12.0	13.5	14.8	16.0	17.3	18.8	20.3
Imports	-7.2	-7.4	-7.9	-8.5	-9.3	-10.3	-11.6	-12.8	-14.2	-15.4	-16.8	-18.3
Services	-0.8	-0.9	-0.9	-0.9	-1.0	-1.0	-1.1	-1.1	-1.2	-1.2	-1.3	-1.3
Investment income	-1.2	-1.6	-1.8	-2.2	-2.6	-2.8	-2.9	-3.2	-3.4	-3.7	-4.0	-4.2
Current transfers	1.0	0.9	1.0	1.0	1.0	1.1	1.2	1.2	1.3	1.4	1.4	1.5
Capital and financial account	1.5	2.4	1.2	1.5	1.6	1.3	1.2	1.5	1.8	2.0	2.1	2.3
Public sector	0.4	1.1	0.7	0.6	0.5	0.5	0.4	0.3	0.2	0.1	0.0	-0.1
Disbursements 1/	1.3	2.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	3.8
Amortization due	-0.9	-1.9	-1.1	-1.3	-1.3	-1.3	-1.5	-1.5	-1.7	-1.7	-1.9	-3.8
Other medium- and long-term public flows 2/	0.0	0.0	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	1.1	1.4	0.5	1.0	1.1	0.8	0.8	1.2	1.6	1.8	2.1	2.4
Privatization receipts												
from direct investment	0.3	0.2	0.3	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, excluding privatization	0.8	1.7	0.2	0.9	0.7	0.4	0.2	0.5	1.0	1.2	1.5	1.8
Other 3/	0.1	-0.6	-0.1	0.0	0.4	0.4	0.6	0.6	0.6	0.6	0.6	0.5
Overall balance	0.4	1.2	0.0	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Change in central bank reserves	-0.4	-1.3	-0.1	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Exceptional financing 4/	0.0	0.1	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 5/	39.4	35.5	34.7	34.7	33.6	31.6	30.1	28.8	27.7	25.9	24.8	31.8
Public external debt service 5/	23.4	21.9	22.6	23.2	22.1	20.4	19.5	18.7	18.3	17.4	16.9	24.5
(In months of next year's imports of goods and services)												
Gross reserves	10.8	11.5	10.7	10.1	9.5	8.8	8.2	7.7	7.3	6.9	6.5	6.7
(In percent of short-term external debt on a residual-maturity basis)												
Gross reserves	149.3	189.8	184.8	187.8	188.2	187.3	188.1	188.7	194.2	195.3	151.8	155.5
(In percent of broad money)												
Gross reserves	62.1	68.0	65.2	62.9	60.6	58.3	55.8	53.3	50.7	48.0	45.3	42.6
(In percent of GDP)												
Current account deficit	-2.0	-2.2	-1.9	-2.0	-2.0	-1.4	-1.2	-1.4	-1.7	-1.8	-1.8	-1.8
Merchandise exports	13.2	13.8	14.8	15.3	15.8	16.9	17.6	18.1	18.3	18.5	18.7	18.9
Merchandise imports	13.3	13.3	13.6	13.8	14.1	14.5	15.2	15.7	16.2	16.5	16.7	16.9
Total external debt	50.9	51.0	50.8	48.7	47.2	45.0	42.8	40.7	38.5	36.5	33.6	32.1
Total medium- and long-term public external debt 6/	35.5	36.7	36.8	35.4	33.9	32.3	30.6	29.0	27.4	25.6	23.4	22.2

Table 10. Peru: Medium-Term Outlook (Concluded)

	Projections											
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
II. Output and Prices												
(Annual percentage change)												
Real GDP	0.2	3.7	3.5	4.6	4.9	5.7	5.3	5.1	5.0	5.0	5.1	5.0
Real domestic demand	-0.6	3.3	3.1	4.4	4.8	4.9	4.9	5.0	5.0	5.1	5.0	5.1
<i>Of which:</i>												
Private consumption	1.3	3.6	3.1	3.9	4.6	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Private investment	-5.6	1.0	4.5	7.5	7.0	7.0	7.0	7.0	7.5	7.5	7.5	7.5
Consumer prices (end of period)	-0.1	1.5	2.5	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	18.4	18.0	18.2	18.6	18.8	19.1	19.4	19.8	20.3	20.7	21.2	21.6
Public sector	3.2	3.0	3.1	3.1	3.0	3.1	3.1	3.2	3.2	3.3	3.4	3.4
Private sector	15.2	15.0	15.1	15.5	15.8	16.0	16.3	16.6	17.1	17.4	17.8	18.2
National savings	16.4	15.8	16.3	16.6	16.8	17.6	18.2	18.4	18.6	19.0	19.4	19.8
Public sector 7/	1.0	0.9	1.3	1.7	2.0	2.1	2.2	2.3	2.4	2.6	2.8	2.8
Private sector	15.4	14.9	15.0	14.9	14.8	15.6	16.0	16.1	16.2	16.4	16.6	17.0
External savings	2.0	2.2	1.9	2.0	2.0	1.4	1.2	1.4	1.7	1.8	1.8	1.8
IV. Combined Public Sector												
Combined public sector												
primary balance	-0.1	-0.2	0.4	0.9	1.4	1.4	1.4	1.4	1.5	1.5	1.5	1.5
<i>Of which:</i>												
General government												
current revenue	17.2	17.2	17.4	17.7	17.9	17.9	17.9	17.9	18.1	18.1	18.1	18.1
General government												
non-interest expenditure	17.7	17.6	17.2	17.0	16.7	16.7	16.7	16.8	16.8	16.8	16.8	16.7
Interest due	2.2	2.1	2.4	2.4	2.4	2.5	2.5	2.5	2.5	2.5	2.5	2.2
Combined public sector												
overall balance	-2.3	-2.3	-1.9	-1.4	-1.0	-1.0	-0.9	-0.9	-0.8	-0.7	-0.6	-0.6
Net external financing	0.9	2.1	1.3	1.0	0.9	0.7	0.5	0.4	0.2	0.2	0.1	0.0
Net domestic financing 8/	0.8	-0.5	-0.1	0.4	0.0	0.2	0.4	0.5	0.5	0.4	0.5	0.5
Privatization receipts	0.6	0.7	0.7	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Public sector debt 9/	46.2	47.7	47.8	46.2	43.9	41.7	39.6	37.7	35.8	33.8	31.8	29.9

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

1/ Includes bonds.

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

3/ Includes errors and omissions.

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

5/ For 2002, excludes US\$923 million in Brady bonds that were amortized through a debt exchange operation.

6/ Includes Central Reserve Bank of Peru debt.

7/ Excludes privatization receipts.

8/ Includes statistical discrepancy.

9/ Domestic debt includes floating debt.

Table 11. Peru: Projected Payments to the Fund as of December 13, 2002 1/

(In millions of SDRs)

	Over- due	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
Obligations from existing drawings												
Principal (repurchases)	0	0.0	80.3	26.8	26.8	26.8	13.4	0.0	0.0	0.0	0.0	174.1
Charges and interest 2/												
On Fund credit	0	0.0	3.7	2.4	1.6	0.8	0.1	0.0	0.0	0.0	0.0	8.6
On use of SDRs	0	0.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	18.0
Total obligations	0	0.0	86.0	31.1	30.3	29.5	15.5	2.0	2.0	2.0	2.0	200.4
(percent of quota)	0	0.0	13.5	4.9	4.7	4.6	2.4	0.3	0.3	0.3	0.3	31.3
Obligations from prospective drawings												
Principal (repurchases)	0	0.0	0.0	0.0	0.0	78.7	124.0	48.8	3.5	0.0	0.0	255.0
Charges and interest 2/												
On Fund credit	0	0.6	4.6	7.3	7.4	6.8	4.1	1.0	0.0	0.0	0.0	31.8
On use of SDRs	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations	0	0.6	4.6	7.3	7.4	85.5	128.1	49.8	3.5	0.0	0.0	286.8
(percent of quota)	0	0.1	0.7	1.1	1.2	13.4	20.0	7.8	0.5	0.0	0.0	44.9
Cumulative (existing and prospective)												
Principal (repurchases)	0	0.0	80.3	26.8	26.8	105.5	137.4	48.8	3.5	0.0	0.0	429.1
Charges and interest 2/												
On Fund credit	0	0.6	8.3	9.8	9.0	7.6	4.2	1.0	0.0	0.0	0.0	40.5
On use of SDRs	0	0.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	18.0
Total obligations	0	0.6	90.6	38.6	37.8	115.1	143.6	51.8	5.5	2.0	2.0	487.6
(percent of quota)	0	0.1	14.2	6.0	5.9	18.0	22.5	8.1	0.9	0.3	0.3	76.3
(percent of GDP)	0	0.0	0.2	0.1	0.1	0.2	0.3	0.1	0.0	0.0	0.0	1.0
(percent of exports of goods and services)	0	0.0	1.2	0.5	0.4	1.1	1.2	0.4	0.0	0.0	0.0	4.8
Memorandum items:												
Purchases		115.6	111.5	27.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	255.0
Fund credit outstanding												
(end period)		289.7	320.9	322.0	295.2	189.7	52.3	3.5	0.0	0.0	0.0	...
(percent of quota)		45.3	50.2	50.4	46.2	29.7	8.2	0.5	0.0	0.0	0.0	...
(percent of GDP)		0.7	0.7	0.7	0.6	0.4	0.1	0.0	0.0	0.0	0.0	...

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

1/ Assuming all scheduled purchases are made. Repurchases assumed to be made under obligation schedule.

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

Table 12. Peru: Functional Classification of Budget Expenditure 1/ 2/

	1999	2000	2001	Budget 2002	Prel. Budget 2003
(In percent of GDP)					
Total	19.0	18.9	18.2	17.8	21.1
Planning and administration	4.7	5.0	4.7	4.7	5.4
Debt service	3.4	3.9	3.6	3.8	4.6
Administration	1.2	1.1	1.1	1.0	0.8
Pensions and social assistance	4.1	4.1	4.2	4.1	5.0
Pensions	3.0	3.3	3.2	3.1	3.0
Other social assistance	1.0	0.8	1.0	1.0	2.0
Education	3.0	2.9	2.8	3.0	3.1
Preprimary	0.3	0.2	0.2	0.3	0.2
Primary	1.1	1.0	1.0	1.0	1.0
Secondary	0.7	0.7	0.8	0.8	0.9
Tertiary	0.6	0.5	0.5	0.5	0.6
Other	0.3	0.5	0.4	0.3	0.4
Defense and national security	2.8	2.9	2.5	2.1	2.1
Health and water	1.5	1.6	1.6	1.7	2.2
Water and sewage	0.2	0.2	0.1	0.1	0.7
Healthcare services	1.4	1.4	1.5	1.6	1.5
Transportation	1.0	0.7	0.7	0.7	1.2
Agriculture	0.7	0.7	0.6	0.5	0.7
Justice	0.4	0.4	0.4	0.4	0.4
Energy and natural resources	0.2	0.1	0.1	0.1	0.3
Foreign relations	0.2	0.2	0.2	0.2	0.2
Legislative	0.1	0.1	0.1	0.1	0.1
Housing and urban development	0.1	0.1	0.1	0.1	0.0
Industry, commerce, and services	0.1	0.1	0.1	0.1	0.0
Fishing	0.1	0.1	0.1	0.1	0.0
Communications	0.0	0.0	0.0	0.0	0.0
Employment	0.0	0.0	0.0	0.0	0.1
Memorandum items:					
Total social expenditure	7.0	6.8	6.9	7.2	8.9
Budgetary social expenditure 3/	5.5	5.3	5.4	5.7	7.3
ESSALUD 4/	1.4	1.5	1.5	1.5	1.5
Fonavi 5/	0.1	0.0	0.0	0.0	0.0

Source: Ministry of Economy and Finance.

1/ Budget coverage includes central government and some autonomous agencies (i.e. ONP, FCR, FONAHPU).

2/ The 2003 budget includes for the first time an estimate of tax expenditure (1.7 percent of GDP).

3/ Includes education, health and sanitation, and other social assistance.

4/ Total expenditure by Essalud, the public health insurance administration.

5/ Net operations of the national housing fund (Fonavi), loan disbursements and amortizations received.

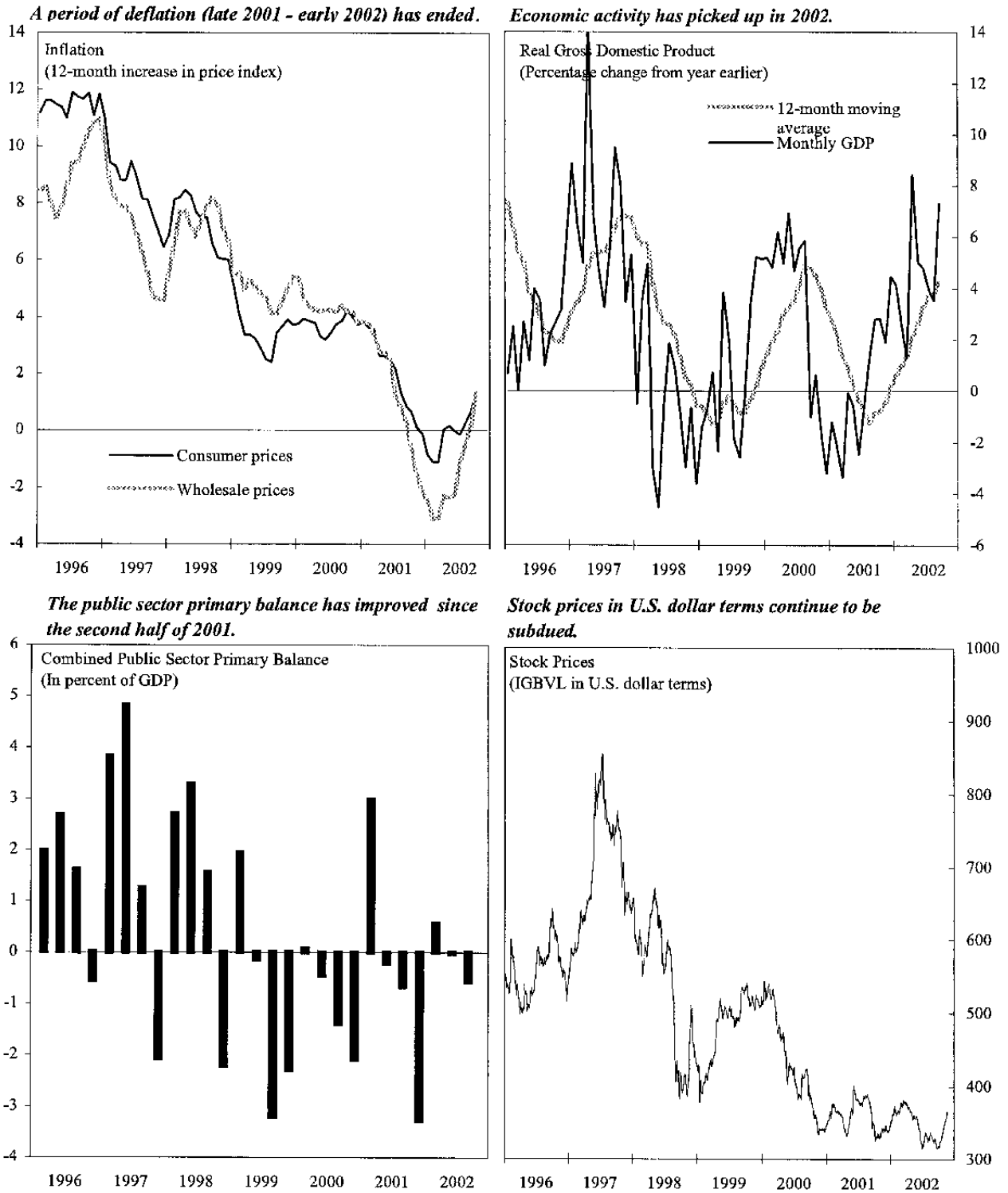
Table 13. Peru: Financing of the Combined Public Sector

	Prog. 2002	Rev. Prog. 2002	Prog. 2003	Rev. Prog. 2003
(In millions of U.S. dollars)				
Combined balance	-1,060	-1,284	-770	-1,118
Financing	1,060	1,284	770	1,118
Net External	410	1,186	183	753
Disbursements 1/	1,250	2,056	1,250	1,800
Bonds 1/	0	989	0	700
Multilateral	1,025	774	992	817
Bilaterals and other	225	293	258	283
Amortizations 1/	-862	-925	-1,091	-1,074
Condonations	22	55	24	27
Privatization	700	400	700	400
Net Domestic financing	-50	-302	-113	-35
Bonds	452	267	667	345
Amortizations	-147	-125	-381	-357
Net deposits	-355	-452	-398	-23
<i>Of which: Central government</i>	-121	-424	-114	45
(In percent of GDP)				
Combined balance	-1.9	-2.3	-1.4	-1.9
Financing	1.9	2.3	1.4	1.9
Net External	0.7	2.1	0.3	1.3
Disbursements 1/	2.2	3.7	2.1	3.1
Bonds 1/	0.0	1.8	0.0	1.2
Multilateral	1.8	1.4	1.7	1.4
Bilateral and other	0.4	0.5	0.4	0.5
Amortizations 1/	-1.5	-1.7	-1.8	-1.9
Condonations	0.0	0.1	0.0	0.0
Privatization	1.2	0.7	1.2	0.7
Net Domestic financing	-0.0	-0.5	-0.1	-0.1
Bonds	0.8	0.5	1.1	0.6
Amortizations	-0.3	-0.2	-0.6	-0.6
Net deposits	-0.5	-0.8	-0.6	-0.0
<i>Of which: Central government</i>	-0.2	-0.7	-0.2	0.1

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

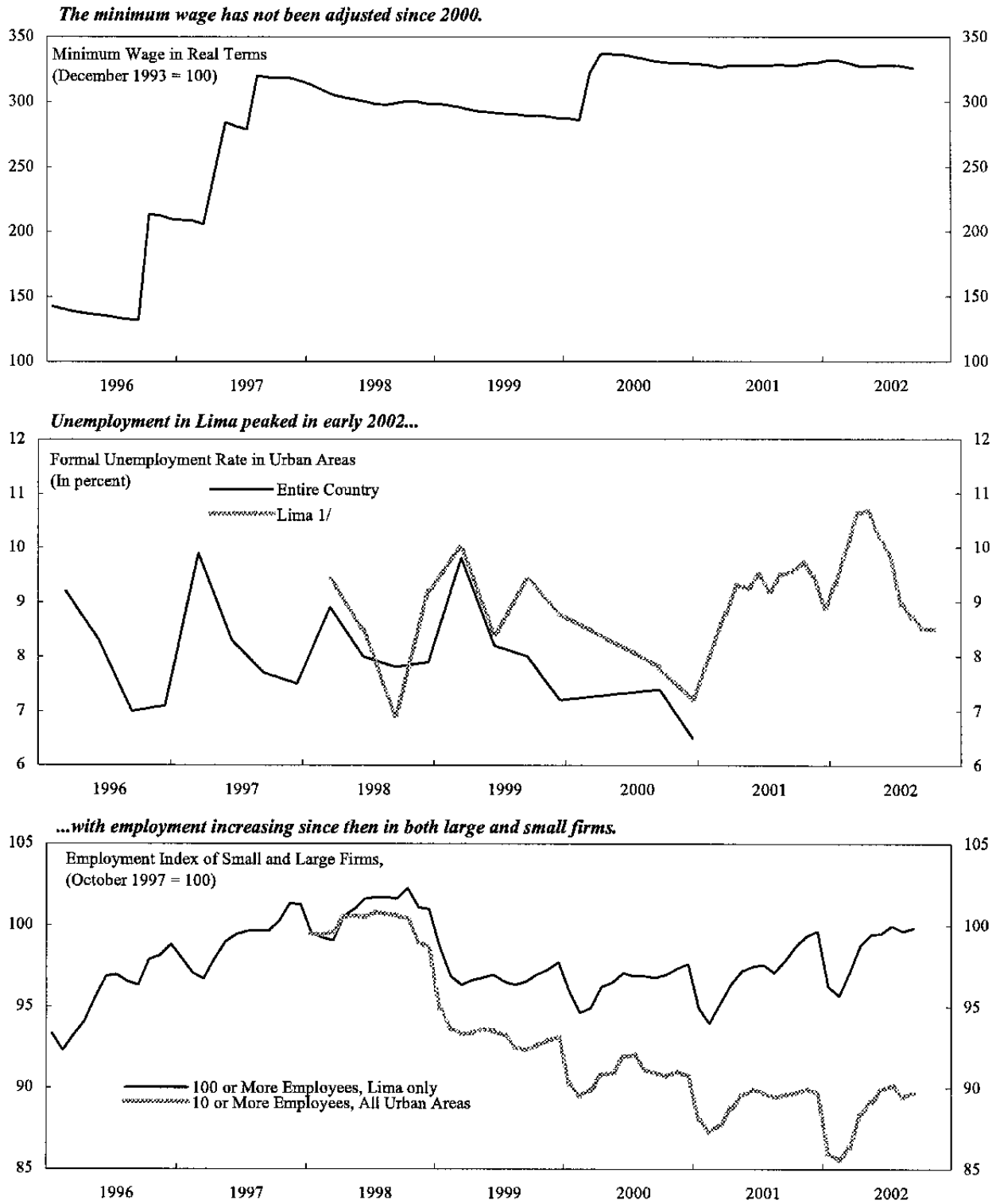
1/ Excludes the Brady bond swap of US\$923 million carried out in early 2002.

Figure 1. Peru: Selected Economic Indicators, 1996-2002



Source: Central Reserve Bank of Peru.

Figure 2. Peru: Labor Market Indicators, 1996-2002

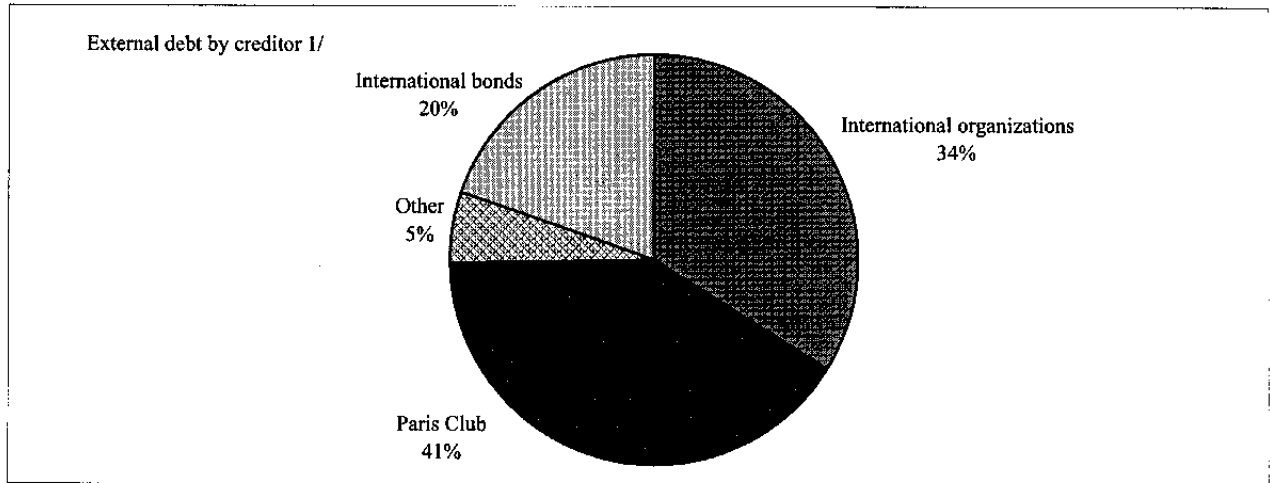


Sources: Ministry of Labor; and Central Reserve Bank of Peru.

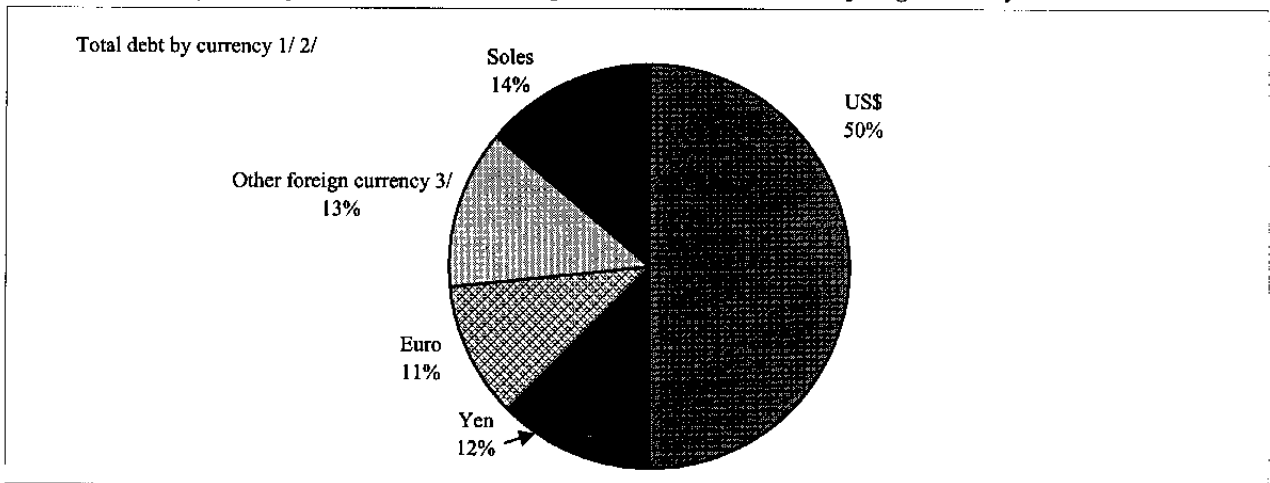
1/ Quarterly through 2000. Three-month moving average since 2001.

Figure 3. Peru: Composition of Public Debt, June 2002

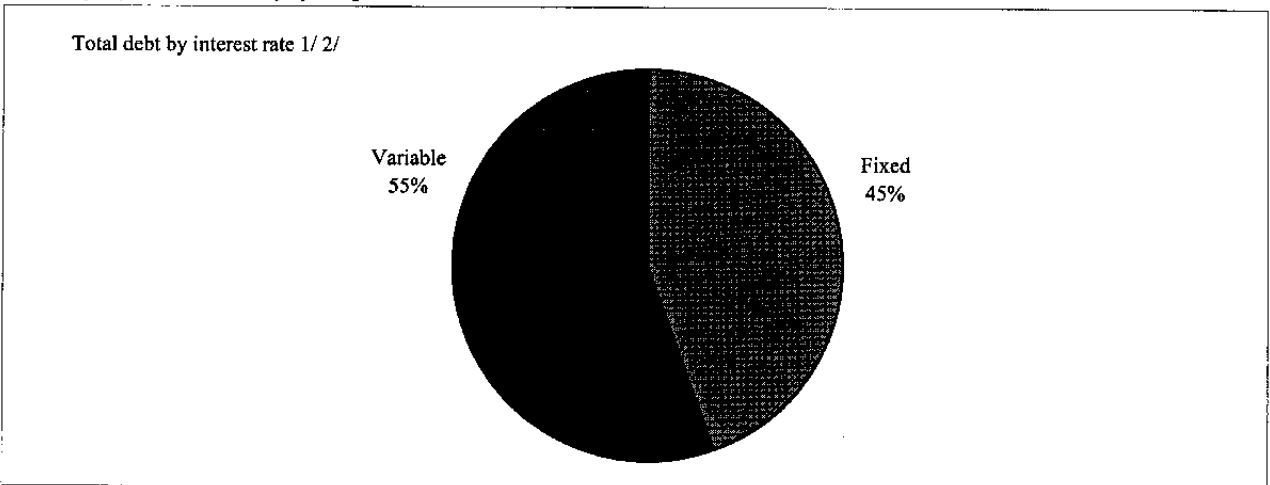
Three quarters of the US\$20 billion public external debt is owed to official creditors.



More than 85 percent of the US\$25.5 billion total public debt is denominated in foreign currency.



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



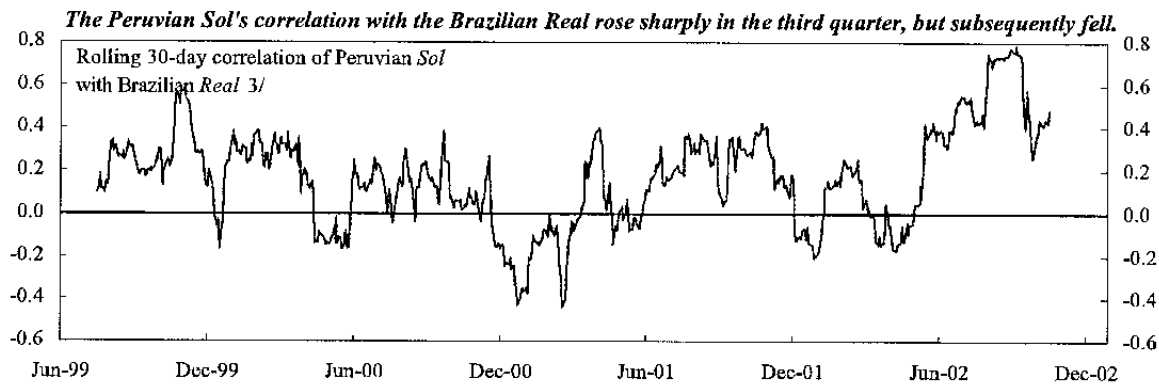
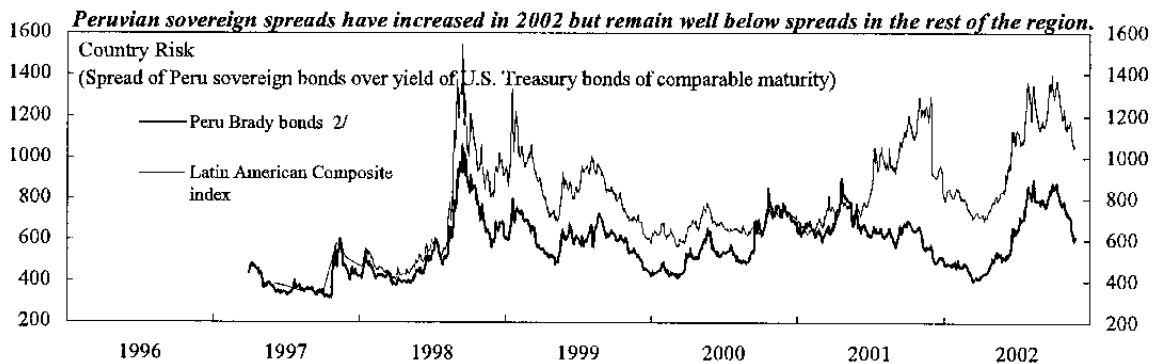
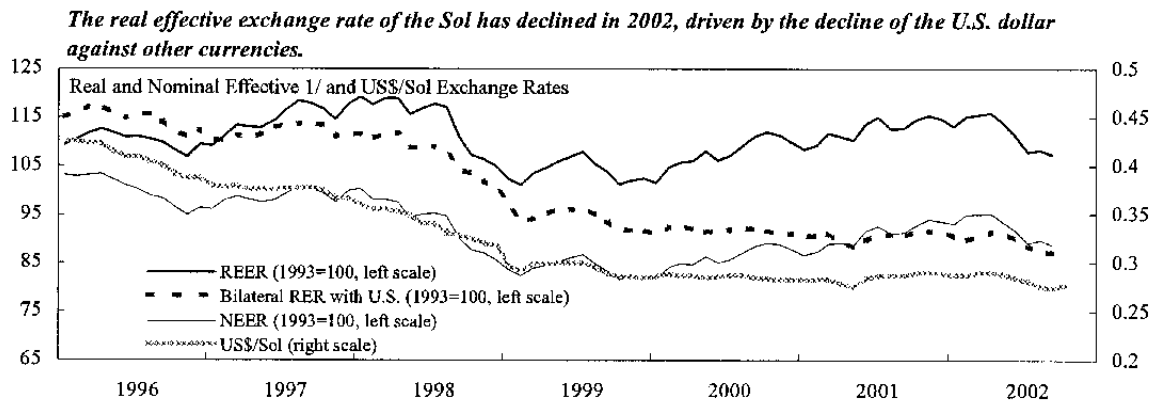
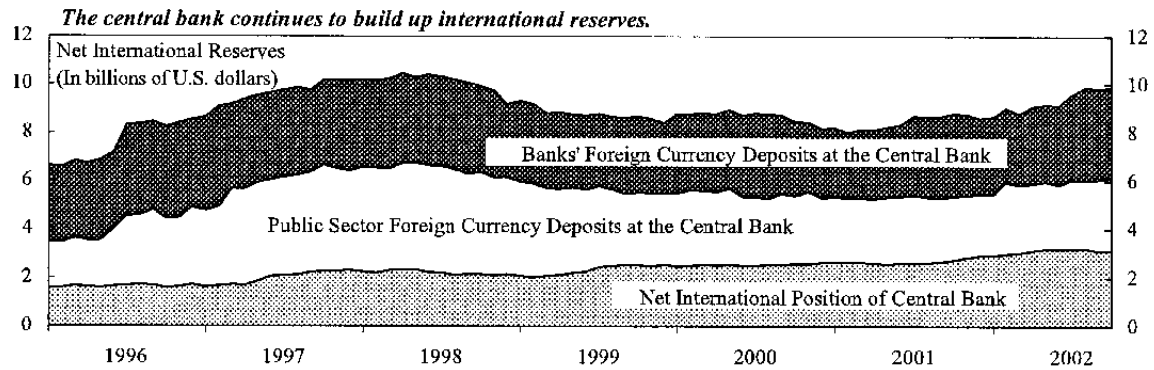
Source: Ministry of Economy and Finance.

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.

Figure 4. Peru: External Indicators, 1996-2002



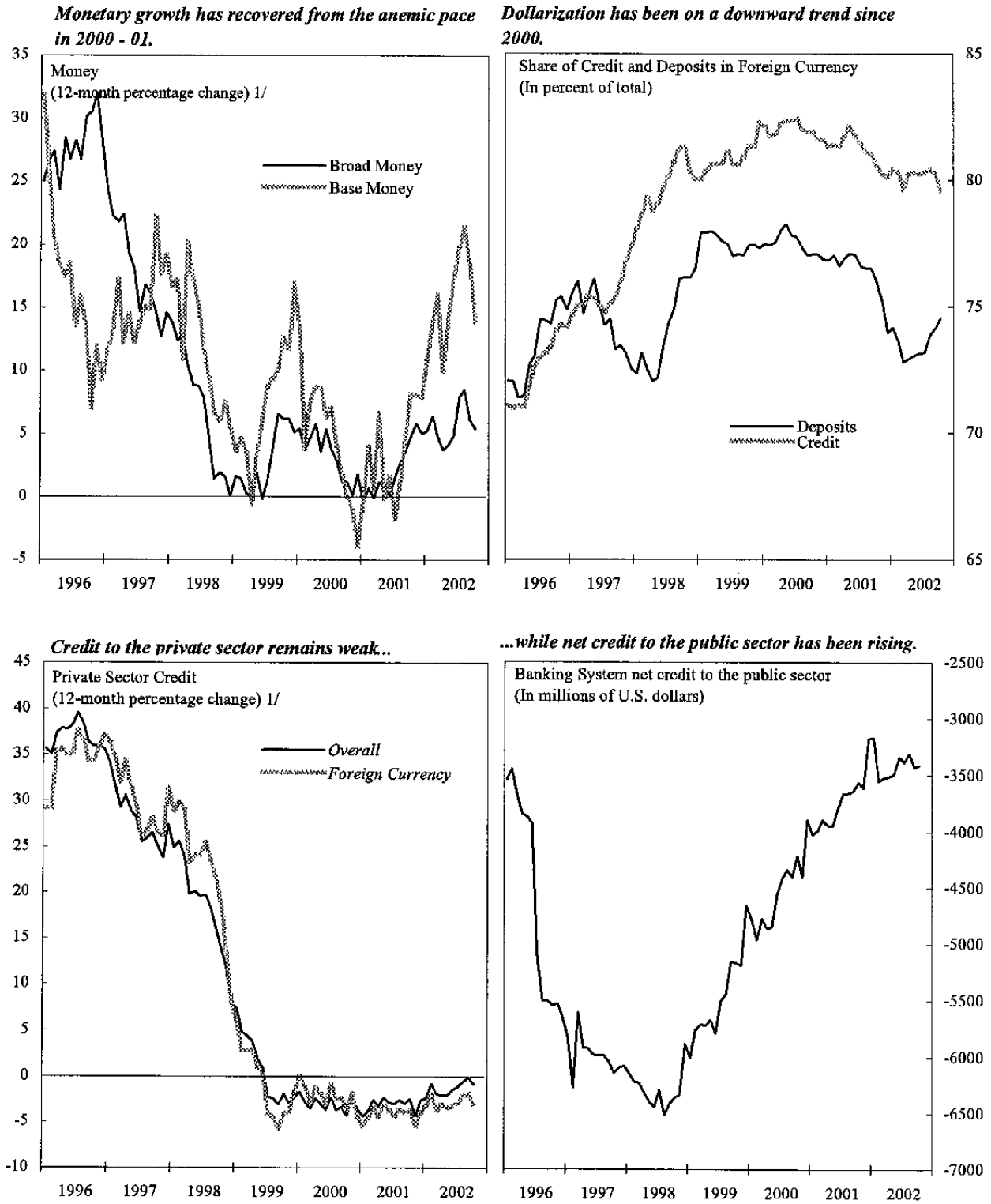
Sources: Central Reserve Bank of Peru; J.P. Morgan; and Fund staff estimates.

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.

3/ Correlation of standardized first difference of the natural log of the exchange rate.

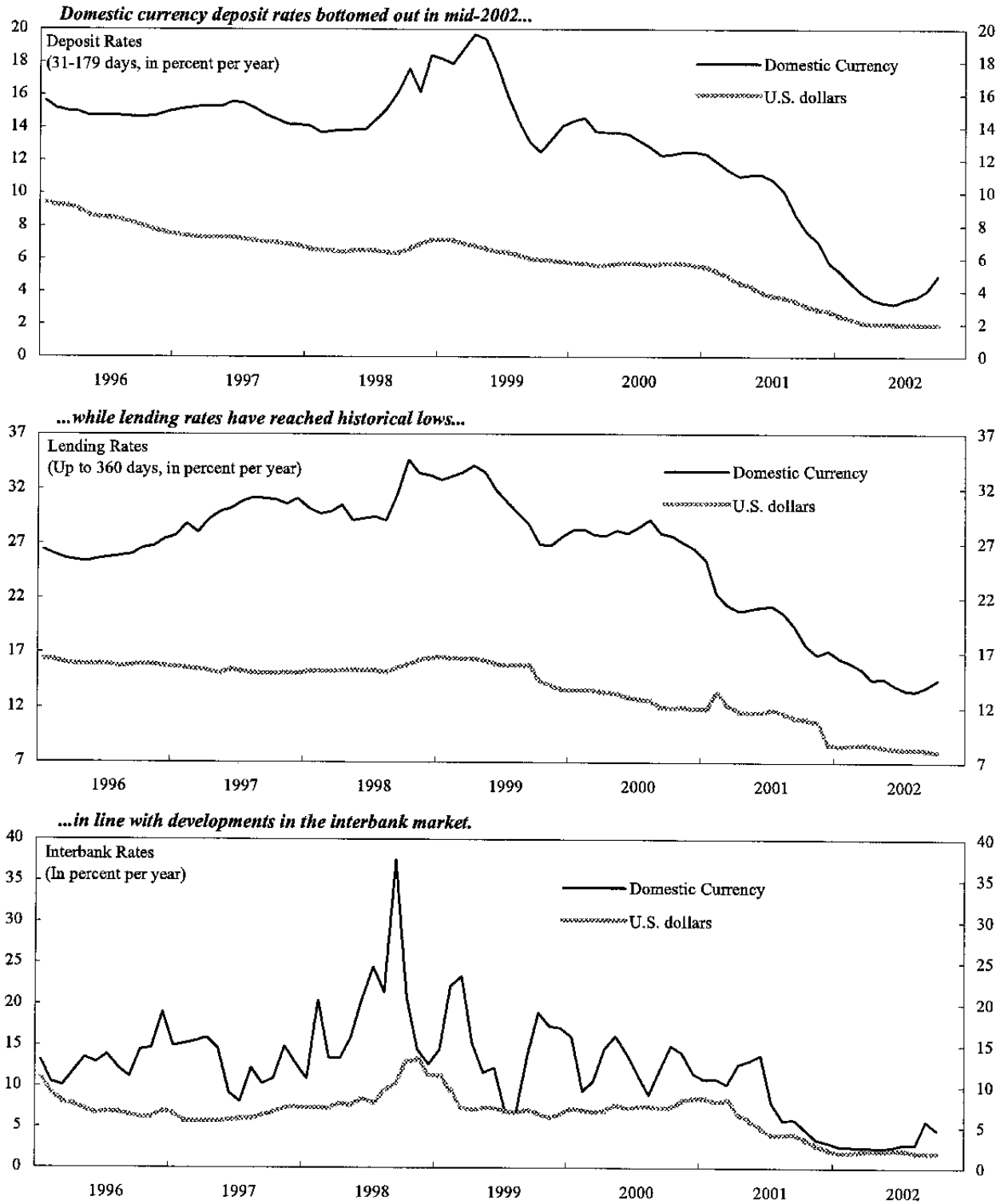
Figure 5. Peru: Monetary Indicators, 1996-2002



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

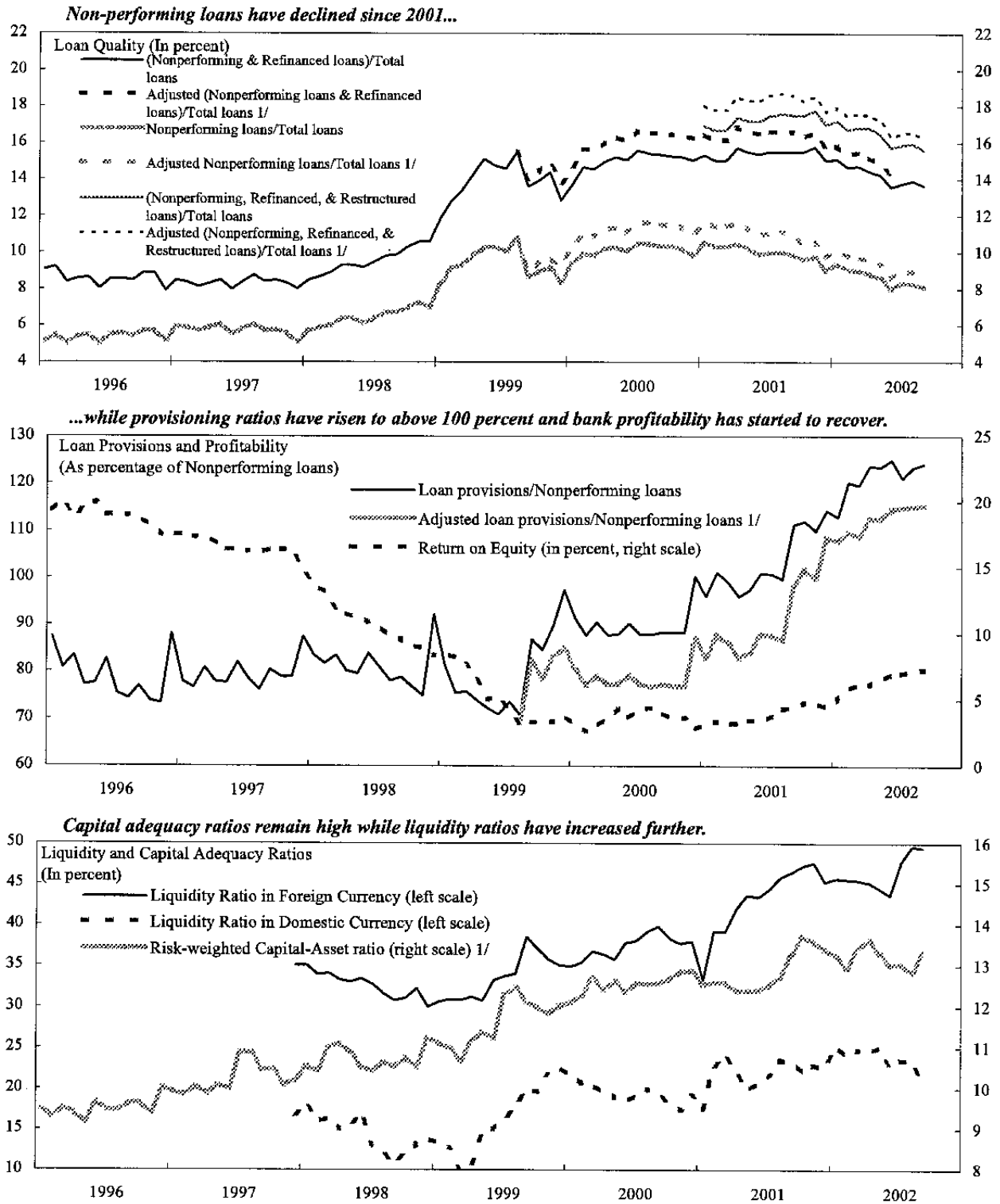
1/ U.S. dollar stocks are valued at program exchange rates.

Figure 6. Peru: Interest Rates, 1996-2002



Source: Central Reserve Bank of Peru.

Figure 7. Peru: Banking Indicators, 1996-2002

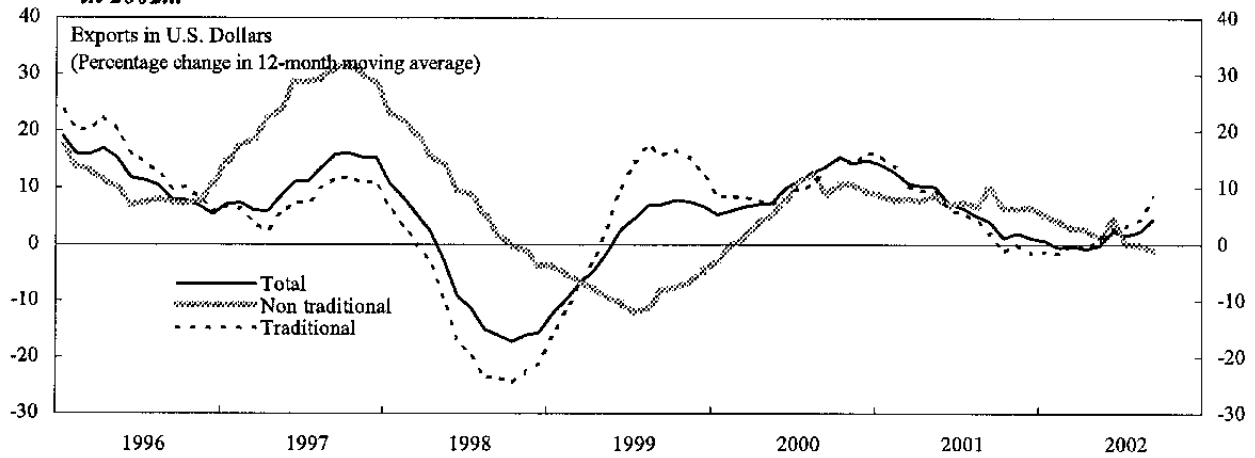


Source: Superintendency of Banks and Insurance.

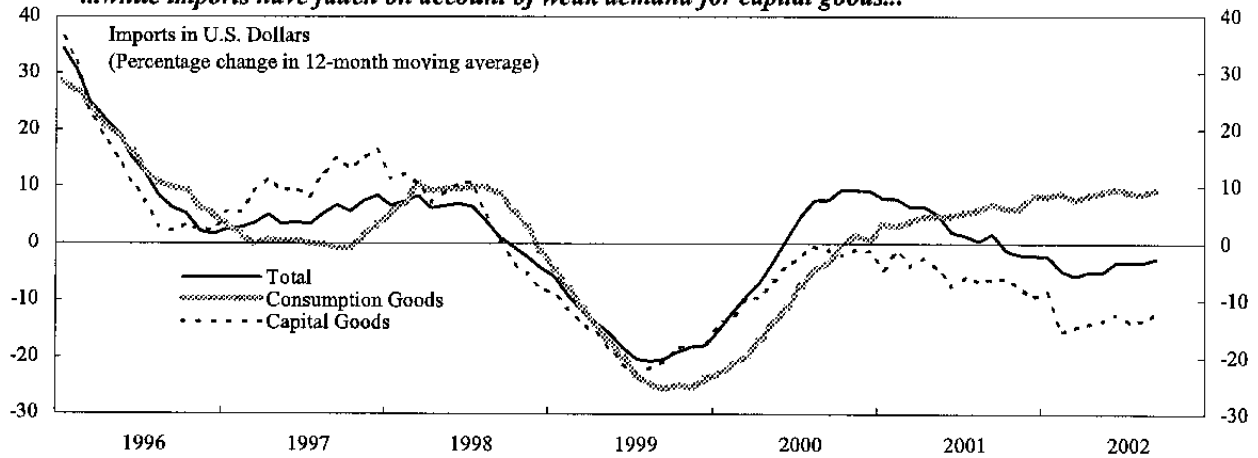
1/ Adjusted for the bond-for-loan swap programs from August 1999.

Figure 8. Peru: Trade Indicators, 1996-2002

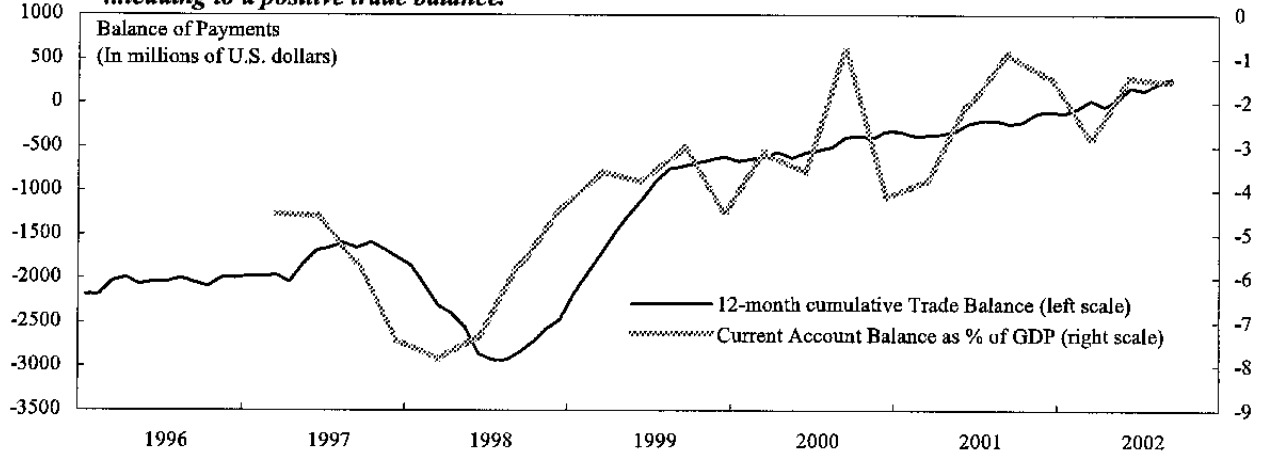
Driven by an increase in traditional exports (minerals), total export values have increased slightly in 2002...



...while imports have fallen on account of weak demand for capital goods...



...leading to a positive trade balance.



Source: Central Reserve Bank of Peru.

Peru: Fund Relations
(As of October 31, 2002)

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	812.37	127.25

III. SDR Department	SDR Million	Percent Allocation
Net cumulative allocation	91.32	100.00
Holdings	2.55	2.80

IV. Outstanding Purchases and Loans	SDR Million	Percent Quota
Extended arrangements	173.93	27.25

V. Financial Arrangements	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Type of Arrangement				
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				
	8/31/02	2002	2003	2004	2005	2006
Principal	0	0	80.31	26.75	26.75	26.75
Charges/interest	0	2.01	5.69	4.33	3.55	2.78
Total	0	2.01	86.00	31.08	30.30	29.53

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 most of the recommendations.

VIII. Exchange Arrangements

Peru maintains a unified, floating exchange rate. On November 22, 2002, the average of interbank buying and selling rates was 3.58 new soles 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 2000 Article IV consultation was concluded on March 12, 2001 (EBS/01/25).

X. FSAP Participation

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

XI. Technical Assistance

Department	Date	Purpose
FAD	November 1999	Fiscal rules
	June 2000, September 2002	Tax policy and administration
	October 2002	Fiscal ROSC
MAE	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. Ricardo Velloso started his assignment as the Fund Resident Representative in Peru in July 2001.

Peru: Statistical Issues

Peru is in observance of the Special Data Dissemination Standard (SDDS) and meets the specifications for coverage, periodicity, and timeliness of the data categories and the dissemination of the advance release calendars, and the metadata have been posted on the Fund's Dissemination Standards Bulletin Board.

I. Real Sector

In June 2000, the authorities published a revised GDP series using 1994 as the base year. However, the National Statistics Office (INEI) recently announced its intention to produce a new GDP series using 2001 as the base year, which would become available in mid-2003. In the meantime, INEI will carry on with the publication of base-year 1994 GDP data.

The authorities monitor labor market developments through four indicators: open unemployment, underemployment, employment, and remunerations. The quality of these indicators has improved over the last two years. However, wage data comes with a relatively long delay; the nationwide unemployment and underemployment situation is surveyed only once a year; and labor productivity data is only published at the time of adjustments to electricity and telecommunications tariffs.

II. Fiscal Sector

For the consolidated central government data, revenues are reported on a cash basis, while expenditures are reported on an accrual basis. The authorities have reported data on the operations of the consolidated central, regional and local governments and debt up to 2001 for publication in the *Government Finance Statistics Yearbook (GFSY)*. The authorities are preparing information on the components of consolidated central government expenditures by function. The *International Financial Statistics (IFS)* has published fiscal data through July 2002.

The coverage of national budget accounting is narrower than the fiscal accounting carried out in the program.

III. Monetary Sector

The central bank of Peru (BCRP) is responsible for the compilation and dissemination of monetary sector statistics. The BCRP prepares and publishes the analytical accounts of the banking system and of the central bank in line with international standards in terms of coverage and periodicity.

IV. External Sector

The central bank of Peru (BCRP) is responsible for the compilation and dissemination of balance of payments and international investment position statistics. The BCRP prepares quarterly data largely in line with the framework of the *Balance of Payments Manual, Fifth Edition (BPM5)*.

Trade data are provided by Customs. Import data is recorded on the date on which the customs documents are numbered (which is close to the date of clearance), while exports are recorded on the shipment date. Data on exports and imports from Customs are supplemented by other reports. For example, import data is supplemented by imports into the Tacna Special Processing Area.

Data on services are mostly based on the BCRP's quarterly surveys reported by resident operators (e.g. transporters, insurance companies, and telecommunications). Data on other services is mostly based on the Annual Services, Foreign Investment and External Debt Survey (SFIED).

For income, the BCRP mostly relies on the quarterly Foreign Investment and External Debt Survey (QFIED), which also provides information used to calculate direct investment, portfolio investment, and other private nonfinancial investment. In addition, portfolio investment liabilities are obtained from the Lima Stock Exchange. Financial investment data are calculated from quarterly-position data reports on commercial bank transactions with nonresident correspondents and from the monetary authority. Data on short-term loans to the private sector are provided by financial institutions. Information for the private financial accounts and income accounts is supplemented by the annual SFIED. The Ministry of Economy and Finance provides information on general-government external debt (disbursements, repayments, and interest payments).

Quarterly statistics are considered preliminary until final annual data is available. Definitive statistics of other services, direct investment and other private sector investment are available 18 months after the end of the referred period.

Regarding international reserves, Peru has been reporting since August 2001 weekly data in accordance with the *Operational Guidelines for Data Template on International Reserves and Foreign Currency Liquidity*. For the external-debt data category, the SDDS transition period ends on March 2003. As an SDDS subscriber, Peru will disseminate quarterly data on external debt with a one-quarter lag by end-September 2003.

Peru: Core Statistical Indicators

As of October 31, 2002

	Exchange Rate	International Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 2/	GDP/ GNP	External Debt 3/	Debt Service 3/
Date of Latest Observation	10/31/2002	10/30/2002	10/22/2002	10/22/2002	9/30/2002	10/31/2002	9/2002	8/2002	Q2/2002	Q2/2002	8/2002	Q2/2002	Q2/2002
Date Received	10/31/2002	10/31/2002	10/25/2002	10/25/2002	10/25/2002	10/31/2002	10/4/2002	10/11/2002	8/23/2002	8/23/2002	10/11/2002	8/23/2002	8/23/2002
Frequency of Data 4/	D	D	W	W	W	D	M	M	Q	Q	M	Q	Q
Frequency of Reporting 4/	D	D	W	W	W	D	M	M	Q	Q	M	Q	Q
Source of Update 5/	B	B	B	B	B	B	B	B	B	B	B	B	B
Mode of Reporting 6/	E	E	M	E	E	E	M	M	M	M	M	M	M
Confidentiality 7/	C	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication 4/	D	D	W	W	W	D	M	M	Q	Q	M	Q	Q

1/ Data refer to net international reserves. Reserve template data are reported weekly, with a lag of 1 week, and are in full compliance with template standards.

2/ Refers to combined public sector deficit, including general government, public enterprises, and the operating balance of the central bank.

3/ Data are reported quarterly with a lag of 2 months, and cover private and public sector debt and debt-service.

4/ D=Daily; W=Weekly; M=Monthly; Q=Quarterly; and A=Annual.

5/ B=Central bank; F=Ministry of Finance; O=other official agency.

6/ E=Electronic, and M=mail.

7/ C=For unrestricted use.

Peru: Recent Tax Amnesties

In recent years, the Peruvian authorities have approved four general tax amnesties (including special payment agreements—*fraccionamientos*). The broad scope of the amnesties, their high frequency and easing conditions over time, have signaled to taxpayers that amnesties are not “one-time events” and that non-compliance can be advantageous. The amnesties (Table 1) have covered taxpayers with tax obligations under previous amnesties or tax obligations under civil tax litigation. Penalties have been abated as have interest payments. Tax liabilities have been reduced considerably through frequent re-determination and discounts for full payment. Table 2 compares two such amnesties and shows that over time more taxpayers have benefited from successive amnesties, while repayments have been extended over longer periods of time.

Table 1

Tax Amnesty Program	Special Payment Agreements Regime-RFE¹	Special Regimen of Tax Payment Agreements - REFT²	Special Payment System of Tax Debts- SEAP³	Recovery Through Tax Debt Recognition- RESIT⁴
Scope of the amnesty	Tax obligations <i>as of end-Aug. 1996</i> with the tax agency (SUNAT), customs (SUNAD), social security (ONP), the housing national fund (FONAVI), and the state commercial bank (Banco de la Nación) (irrespective of one’s tax obligation status).	Originally: tax obligations <i>as of end-July 2000</i> with SUNAT, SUNAD, ONP, FONAVI, Banco de la Nación. Debt due to enterprises under restructuring. Date later modified to <i>end-Aug. 2000</i> .	Tax obligations <i>as of end-Aug. 2000</i> with SUNAT, SUNAD, ONP, FONAVI, Banco de la Nación. Debt due to enterprises under restructuring.	Tax obligations <i>as of Dec. 2001</i> with SUNAT, SUNAD, ONP, FONAVI, Banco de la Nación. Debt due to enterprises under restructuring.
Benefits	Re-determination of tax liability by indexing the original debt to inflation. Elimination of all penalties, surcharges or interest.	Re-determination of the liability by indexing the original debt to inflation or a rate of 6 percent per annum (whichever is lower). Elimination of all penalties, surcharges or interest.	Re-determination of the liability by indexing the original debt to inflation or a rate of 6 percent per annum (whichever is lower). Elimination of all penalties, surcharges or interest.	Re-determination of the liability by indexing the original debt to inflation or a rate of 6 percent per annum (whichever is lower). Elimination of all penalties, surcharges or interest.
Guarantees	Required for debt over S./100,000.	Not required	Not required	Not required
Interest rate	22 percent nominal interest rate on the balance at the end of each year.	15 percent nominal interest rate on the balance at the end of each year.	15 percent nominal interest rate on the balance at the end of each year.	8 percent effective interest rate on the balance at the end of each year.
Payment schemes	Full payment or balance to be paid over a period of 7 years.	(1) Five percent discount for payment in full, later modified to 10 percent. (2) Five percent down payment and balance to be paid over a period of 10 years.	(1) 10 percent discount for payment in full. (2) 5 percent down payment and balance to be paid over a period of 10 years.	(1) 10 percent discount for payment in full. (2) 5 percent down payment and balance to be paid over a period of 10 years.

¹ Decree 848 (September 1996, with several modifications in 1998 and 1999).

² Law 27344 (September 2000).

³ Decree 914 (April 2001).

⁴ Law 27681 (March 2002).

Table 1 (Concluded)

Tax Amnesty Program	Special Payment Agreements Regime-RFE	Special Regimen of Tax Payment Agreements – REFT	Special Payment System of Tax Debts- SEAP	Recovery Through Tax Debt Recognition- RESIT
Loss of benefit	Missing payments or failing to file returns for two consecutive periods triggers use of collateral first and then interest is charged on unpaid installments. There is no loss of benefits, however, regarding the re-determination of the stock of tax debt owed.	Missing payments or failing to file returns for two consecutive periods or more. There is no loss of benefits, however, regarding the re-determination of the stock of tax debt owed.	Missing payments or failing to file returns for two consecutive periods. There is no loss of benefits, however, regarding the re-determination of the stock of tax debt owed.	Missing payments or failing to file returns for three or more consecutive periods. There is no loss of benefits, however, regarding the re-determination of the stock of tax debt owed.

Source: SUNAT-Peru.

Table 2**Comparison of RFE and RESIT Amnesties**

	RFE	RESIT
Number of participants	50,660	53,439
Percentage of new participants	68	47
Percentage of participants in two (or three) amnesties	32	53
Total tax obligations to be covered (in percent of GDP)	1.4	1.0
<i>Of which:</i> under payment agreements	93	96
Percentage of agreements to reach over 6-7 years	72	1
Percentage of agreements to reach over 9-10 years	2	80

Source: SUNAT Peru.

Peru: World Bank Relations

Partnership in Peru's development strategy

The government's strategy focuses on attacking poverty through: employment generation, access to health, education, culture and other basic services; and creating a state that serves the people. Key to achieving these goals is to have in place an economic program and institutions ready to buffer the impact of adverse shocks—and thus prevent losing ground in the fight against poverty—while addressing structural sources of poverty. A national accord, signed on July 22, 2002, organizes the government's tasks into four areas: democracy and the rule of law; competitiveness of the country; equity and social justice; and an efficient, transparent and decentralized state. A group of indicators to monitor progress have been identified in the areas of competitiveness and equity, and additional indicators are expected by the end of this year.

In the area of competitiveness, the government will seek to foster a sustainable economic recovery, by bringing about greater competitiveness of Peru's private sector. On equity and social justice, it will seek to provide all Peruvians with access to quality health, education, culture and other basic services. Finally, regarding institutional quality, it will promote democracy and the rule of law through a more efficient, transparent and decentralized state.

Fifteen indicators and targets have been identified by the government to measure progress in reaching the poverty reduction and growth targets. There is a high coincidence of these indicators with the Millennium Development Goals (MDG), although the government's 2015 targets are not the same as those identified for the MDG.

Bank Group strategy

To achieve its development strategy, and in light of the high dollar indebtedness of the economy, Peru needs to increase fiscal revenue and exports, strengthen governance and institutions, and eliminate obstacles to firm development. The World Bank Group FY03 Country Assistance Strategy (CAS), discussed by the WB Board on September 17, aims at helping the government fulfill these needs by providing support to its fiscal program, national competitiveness program, and social sector program. Assistance will be provided to make safety nets more efficient and create growth opportunities targeted to the poor and to strengthen governance and institutions.

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 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 are:

- supporting policy and institutional reforms through a combination of analytical and advisory activities and technical assistance loans. Programmatic loans (in the high-lending case) would support a reform program covering the areas of: public sector management and decentralization; barriers to competitiveness; and social sectors;
- financing investment programs that have a direct impact on the productive lives of the poor, through a combination of rural and urban development programs, and financing to support the institution of reforms in the social sectors;
- renewing focus on environmental issues especially linked to health, sustainable use of natural resources, and management of biodiversity; and
- continuing emphasis on partnerships with civil society, and addressing the inclusion within WBG operations of specific groups such as youth, women, indigenous peoples, and Afro-Peruvians.

The Bank's non lending services will focus on: (i) in the competitiveness area, poverty-related studies, the development of a rural infrastructure strategy, and analysis of private sector growth issues, including a regional study of privatization and private sector participation experiences; and (ii) in the equity area, environmental health, youth and social development, indigenous learning and knowledge exchange, major sectoral studies in health and education, and activities in the water and sanitation sector, including an assessment of strategies for private sector participation. Finally, additional services will include diagnostic work and policy advice regarding institutional reforms and decentralization.

Bank-Fund collaboration in specific areas

As part of its overall assistance to Peru, the Bank has strengthened its close collaboration with the IMF. Specific examples of joint work have covered the following areas:

- *Financial Sector.* A joint FSAL was completed in May 2001, covering: the macro environment, risks and vulnerabilities, safety net, regulations and supervision, public sector asset/liability management, pension system, capital markets, microfinance, rural finance, and corporate restructuring. Follow up technical assistance to implement FSAL recommendations has been provided by both institutions.
- *Public expenditure review (PER).* In a joint effort with the IDB, and close collaboration with the IMF, the Bank completed in June a comprehensive diagnosis of, and made policy recommendations for, Peru's public expenditure management. Several key aspects of the PER underscore the importance of Bank-Fund collaboration, including the need to push forward in restoring fiscal discipline, promoting a shift toward pro-poor programs, and improving the efficiency of public

- expenditure. Among several topics, the PER developed an innovative public expenditure tracking survey for Peru. Moreover, the Bank and the Fund worked closely in the areas of: tax reform, debt sustainability, and fiscal rules. As part of the PER dissemination activities, the Bank, the IDB, and the Fund organized jointly (in August 2002) a seminar on “Restoring Fiscal Discipline and Poverty Reduction” attended by the new cabinet, the monetary authorities, think-tanks, and the media.
- *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 responsibility and transparency. The seminar was attended by panelists from Chile, Brazil, Argentina, Venezuela and Mexico and has been particularly instrumental for preparing amendments to the current fiscal framework at the onset of decentralization.
 - *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.

Prepared by World Bank staff. Questions may be addressed to Mr. José López-Cálix, Senior Country Economist at 458-1906; or Mr. Eduardo Wallentin, Senior Country Officer at 473-5600.

Statement of World Bank Loans (As of August 12, 2002)					
Loan Number	Fiscal Year Approved	Borrower	Purpose	In millions of U.S. Dollars	
				Total (Net of Cancellation)	Undisbursed
Eighty (80) loans fully disbursed 1/				3,957.6	
Partially disbursed or undisbursed loans:					
38110	1995	Republic of Peru	Lima water rehabilitation and management project (SEDAPAL)	150.0	13.8
46140	2001	Republic of Peru	Second Rural roads rehabilitation and maintenance	50.0	45.5
40760	1997	Republic of Peru	Irrigation rehabilitation	85.0	25.3
41300	1997	Republic of Peru	Sierra national resource management	51.0	7.2
43840	1999	Republic of Peru	Urban property rights	38.0	13.8
45190	2000	Republic of Peru	Agricultural research and extension	9.6	5.4
45360	2000	Republic of Peru	Indigenous people development	5.0	4.6
45270	2000	Republic of Peru	Health reform	27.0	24.5
Total				4,373.2	
<i>Of which: amount repaid</i>				<i>1,952.8</i>	
Total outstanding				2,420.4	
Total undisbursed					144.1
1/ Includes the 1979 program loans (US\$115 million), 1992 Financial Sector Adjustment Loan (US\$400 million), 1992 Trade Policy Loan (US\$300 million), and 1992 Structural Adjustment Loan (US\$150 million), 1993 Privatization Adjustment Loan (US\$250 million), 1997 Pension Reform Adjustment Loan (US\$100 million), 1997 DDSR Loan (US\$183 million), and 1999 Financial Sector Adjustment Loan (US\$300 million), and 2001 Programmatic Social Reform Loan (US\$100 million).					

Statement of IFC Investments (As of August 12, 2002)					
In millions of U.S. dollars					
	Loans	Equity	Quasi-Equity	Participation Loans	Total
Total commitments held by IFC	161.6	36.3	34.0	95.1	327.0
Total disbursed	126.7	36.1	32.5	95.1	290.4

Source: World Bank.

Peru: Relations with the Inter-American Development Bank

I. Background

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

II. Lending

Peru's total outstanding debt with the IDB as of June 30, 2002 amounted to US\$2,868 million and current commitments (undisbursed balance) amounted to US\$667 million, as of August 8, 2002, corresponding to 16 loans currently in execution. The tentative lending program for 2002 through mid-2003 includes eleven loan operations for an estimated amount of US\$687.5 million.

III. Recent economic and sector work

A comprehensive review of major economic, social, and institutional issues was carried out in the process of preparing the Strategy Paper for Peru, the document that lays out the Bank's strategy for the 2002–06 period. In addition, a Public Expenditure Review (PER) was also carried out, as a joint effort with the World Bank, and was completed in June 2002.

IV. Nonreimbursable technical cooperation

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

Peru: Financial Relations With the Inter-American Development Bank

I. IDB Loans By Sector as of August 8, 2002

(In millions of U.S. dollars)

	Commitments	Disbursements	Undisbursed Amounts
Agriculture and social development	23.3	1.2	22.1
Education	187.0	79.8	107.2
Infrastructure	50.0	5.0	45.0
Multi sector	200.0	123.9	76.1
Population, health and nutrition	226.8	181.0	45.8
Public sector management	320.9	210.0	110.8
Urban development	300.0	51.8	248.2
Water supply and sewerage	45.6	24.7	20.9
Grand total	1,353.6	677.3	676.3

II. IDB Loan Transactions as of August 8, 2002

(In millions of U.S. dollars)

	1997	1998	1999	2000	2001	2002 (p)	Total (1997-2002)
a. Disbursements	585.3	299.6	485.5	350.7	378.0	347.1	2,446.2
b. Amortization	107.5	106.5	104.2	353.2	113.5	169.5	954.5
c. Net disbursements (a-b)	477.8	193.1	381.3	-2.6	264.5	177.6	1,491.7

Peru: 2002 Tax Reform

The tax reform in 2002 included tax policy and tax administration measures. Tax policy measures were intended to improve the neutrality of the tax system and increase tax bases. Measures concentrated on: (i) income taxes (which will take effect in 2003); (ii) elimination (or restriction) of some VAT exemptions; and (iii) increase in the kerosene excise. On tax administration, measures aimed at reducing tax evasion by: (i) introducing various systems of VAT withholding; (ii) intensifying the control of tax collection, refunds and rebates; and (iii) ensuring the collection of tax debts from government's suppliers and private companies. As a result of the measures implemented, tax revenue is expected to increase by 0.2 percent of GDP in the second half of 2002 and 0.8 percent of GDP in 2003 (see attached Table).¹

Tax policy

Income tax

- *A new minimum income tax advance payment scheme* for taxpayers with net assets above approximately US\$135,000 requires advance payments based on the greater of the past year's earnings or a percentage of net assets (which would rise with the level of net assets and would range from 0.25 percent to 1.5 percent).
- *Eliminate from allowable deductions* under the corporate income tax, automobile purchases for executives and restaurant expenses.
- *Collect taxes from profits made by mutual-fund investors.*
- *Increase the maximum marginal income tax rate* from 27 to 30 percent.²
- *Introduce an income tax on pensions* above 10 tax index units (UIT), currently about US\$8,300, under the preferential public pensions plan (*Cedula Viva*, Decree 20530)²
- *Create a 6 percent income tax on presumptive rental income from second homes.*²
- *Revamp the strategy in granting tax-stability contracts* to exclude tax benefits and incentives and to charge a 2 percent premium for such contracts.²

VAT

- *Eliminate VAT exemption on fertilizers* (for 57 out of 60 agricultural inputs).
- *Restrict the VAT exemption* for cultural events. The Ministries of Finance and Culture will establish on a case-by-case basis when a public performance can be considered a cultural event and thus be exempted of the VAT.²

Fuel excise

- *Increase kerosene excise* by 80 percent to partially reduce the difference with diesel excise.

¹ Tax administration measures are expected to yield 0.2 percent of GDP in 2002 and 0.3 percent of GDP in 2003, respectively. By law, changes in income taxes take effect in the following calendar year.

² This measure has not yet been approved by Congress.

Tax administration

Various VAT withholding mechanisms are being established to reduce the evasion on VAT collection. Specifically, a portion of the VAT will be withheld by:

- *Large buyers in transactions of agricultural products characterized by a high level of informality (rice, sugar and alcohol).* Suppliers are to open a bank account—exclusively used for tax payments—in the state-owned Banco de la Nación. Prior to delivery, buyers must deposit 10 percent of the sale price into these accounts (products cannot be delivered without the bank deposit receipt).³
- *Large taxpayers (1,200 in total) in transactions with their suppliers.* These large taxpayers must withhold 6 percent at the payment stage of every purchase, when transactions exceed a minimum amount (of around US\$200). The system applies to suppliers not classified as “good taxpayers” by SUNAT. Suppliers can ask for a tax refund only after having withholdings in excess of their tax obligations during six consecutive months.
- *Central government spending units (linked to the Financial Management Information System—SIAF) will withhold taxes for government purchases.*
- *Large fuel sellers in transactions with fuel retailers would withhold 1 percent of the sale price.*

To intensify control of tax collection, refunds and rebates, specific measures have been defined to:

- *Keep better control of nonexistent taxpayers (taxpayers that cannot be located at their registered address).*
- *Introduce expiration dates on purchase invoices authorized by the tax agency.*
- *Give the tax agency the right to audit tax years prior to a year in which a taxpayer is in compliance.*

The collection of tax debts from government’s suppliers and private companies will be enforced by:

- Automatically collecting 80 percent of tax debts from central government’s suppliers through the SIAF.
- Prohibiting firms with tax debts to distribute profits.

³ The approval of congress to extend this withholding mechanism to fishing is still pending.

Impact of the 2002 Tax Reform

(In millions of New Soles)

	Second Half of 2002	2003
TAX POLICY	50	895
Income tax	0	645
Introduce new minimum advance payment scheme		550
Eliminate allowable deductions under the corporate income tax		25
Collect tax on mutual-fund investors' profits		
Increase the maximum marginal income tax rate from 27 to 30 percent ¹		50
Introduce an income tax on high pensions under the <i>Cedula Viva</i> (Decree 20530) ¹		10
Create a 6 percent income tax on presumed rental income from second homes ¹		10
VAT	25	110
Partial elimination of VAT exemption on fertilizers	25	100
Restrict the VAT exemption for cultural events ¹		10
Fuel excises	25	140
Increase kerosene excise	25	140
TAX ADMINISTRATION	324	665
Withholding mechanisms and tax debt collection	259	600
Large buyers in transactions of main agricultural products (rice, sugar and alcohol)	40	120
Large taxpayers in transactions with their suppliers	185	345
Central government spending units in government purchases	7	40
Large fuel sellers in transactions with fuel retailers	12	80
From central government's suppliers through SIAF	15	15
Other	65	65
Prohibiting firms with tax debts to distribute profits		
Better control of nonexistent taxpayers		
Introduce expiration date on purchase invoices		
Allow the auditing of tax years prior to a year in which a taxpayer is in Compliance		
2002 REFORM (In percent of GDP)	374 0.2	1,560 0.8

1/ Measure pending of congressional approval.

Peru: Status of Structural Benchmarks Under the 2002 Program		
2002 Structural Reform	Target Date	Current Status and Comments
<i>Privatization and other asset sales:</i>		
Sale of four northern electricity distribution companies (JORBSA)	June 30	Initially delayed from June 30 to July 16 and then again to August 28. Currently delayed indefinitely.
Privatization of electricity transmission company (ETECEN)	June 30	Awarded concession on June 5.
Sale of the electricity generation company (EGASA)	Sept. 30	Completed on June 14, then suspended until court ruling on its validity. Currently the judicial process is ongoing.
<i>Fiscal</i>		
Submission to congress of legislation eliminating regional tax exemptions	June 30	Delayed to after November regional elections.
Submission to congress of legislation to include tax expenditures in the 2003 budget	June 30	Sent in August, along with 2003 budget.
Completion of draft legislation of a revision to the Law on Fiscal Transparency and Responsibility	March 31	Completed in June.
Submission to congress of a revision to the Law on Fiscal Transparency and Responsibility	June 30	Sent in November (prior action for completion of the review). 4,300 tax audits completed as of March 31.
SUNAT to carry out 3,400 tax audits of corporations and independent professionals	March 31	9,500 tax audits completed as of June 30.
SUNAT to carry out 6,800 tax audits of corporations and independent professionals	June 30	15,318 tax audits completed as of September 30.
SUNAT to carry out 11,900 tax audits of corporations and independent professionals	Sept. 30	Action planned for December 31.
SUNAT to carry out 17,000 tax audits of corporations and independent professionals	Dec. 31	
<i>Financial system</i>		
Submission to congress of legislation to provide the necessary statutory protection to SBS staff in the discharge of their responsibilities	Sept. 30	Sent in November (prior action for completion of the review).

Peru: Decentralization Framework			
	National Government	Regional Governments	Municipal Governments
Exclusive Expenditure Responsibilities	Defense. National security. Foreign relations. Justice. Money and banking. Public borrowing. Regulation of public services and public infrastructure.	Approval of regional development plan (agreement with municipalities). Regional infrastructure (roads, energy, communications). Regional tourism. Approval of changes in territorial limits within the region. Modernization of small and medium enterprises.	Urban and rural municipal development. Management of local public services. Local public infrastructure.
Shared Expenditure Responsibilities	To be defined by the Organic Law of the Executive Branch (forthcoming).	Education (management of basic, primary, secondary and technical education). Public health. Economic activities (agriculture, industry, etc.). Culture.	Education. Public health. Culture, tourism and sports. Civil security. Monument restoration. Public transport. Housing. Management of social programs.
Revenue Source		Discretionary transfers from the national budget. Regional taxes approved by congress with the initiative of the executive branch. Resources from the regional compensation fund, FONCOR, (which includes: 25 percent of national privatization receipts; and 50 percent of regional infrastructure concessions). Resources from special revenue-sharing agreements in electricity generation, mining, oil, gas, and fisheries. External borrowing operations approved by the MEF.	Municipal taxes (real estate, vehicles, cultural events). New municipal taxes approved by congress with the initiative of the executive branch. Fees and fines approved by the municipal council. Resources from the municipal compensation fund, FONCOMUN, (which includes: 2 percentage points of the VAT); 8 percent tax on gasoline sales; resources from special revenue-sharing agreements in electricity generation, mining, oil, gas, and fisheries. External borrowing operations approved by the MEF.
Distribution and Use of Resources	To be defined by the Organic Law of the Executive Branch (forthcoming).	FONCOR is distributed by the MEF on the basis of poverty, population, fiscal effort, and investment performance indicators.	FONCOMUN is distributed by the MEF on the basis of poverty, population, urban development, violence, and natural resources. Resources of FONCOMUN are to be used as defined by the municipal council.

Source: Omnibus Decentralization Law, July 2002.

Peru: Update on FSAP Main Recommendations

Reform Measures	Specific Actions	Current Status and Comments
Strengthen the autonomy of the Superintendency of Banks (SBS).	Provide legal protection for the SBS staff.	Legislation sent to congress in November 2002.
	Establish an independent SBS budget mechanism.	SBS budget not included in annual budget law sent to congress.
	Eliminate the coincidence of the term of the appointment of the Superintendent with the political cycle (Constitutional reform).	No action taken to date.
Improve the corrective action and bank exit framework.	Strengthen the Financial Instability regime by: <ul style="list-style-type: none"> - creating explicit time frames for any capital contribution that the SBS may deem necessary. - making application of the Special Surveillance regime mandatory if the measures required under the Financial are not met. - conferring explicit powers on the SBS for taking actions in instances of chronic liquidity problems. 	No action taken to date. The authorities claim that current regulations to require corrective actions are more than adequate.
	Make explicit in the law the application of least cost considerations in any injections of funds from the Deposit Insurance Fund (FSD).	The authorities claim that an SBS norm includes this provision. They have not discussed its explicit inclusion in the banking law.
Improve the financial system's regulatory framework.	Reduce the limits on single credit exposure by lowering the legal limit on leasing operations.	The SBS submitted to congress a proposal to modify the banking law.
	Reduce the limits on lending to connected parties.	A phase-out period of adaptation to lower limit has been established.
	Improve the definition and measurement of capital: <ul style="list-style-type: none"> - requiring capital on a consolidated basis. - deducting goodwill from regulatory capital. 	Effective since end-December 2001. Proposed change to banking law sent to congress by SBS.
	Improve regulations on money laundering.	A law was passed in April 2002 establishing an anti-money laundering unit, and further operational norms are being formulated.
Streamline corporate debt restructuring process.	<ul style="list-style-type: none"> - Simplify procedures. - Strengthen debtor disclosure requirements. - Limit the precedence of labor claims of managers and shareholders on companies under restructuring as well as the withdrawal of shareholders from the restructuring process. 	A new bankruptcy procedure law effective since October 2002 has dealt with these specific issues.

Sources: Peru.- Financial System Stability Assessment, February/2001; and SBS.

Tax Exemptions and Benefits, 2003 1/
(In millions of Soles)

Sector	Type	Description of the Exemption	Annual Cost	Percent GDP
Agriculture	VAT exemption	Certain fertilizers.	146.5	0.07
	VAT exemption	For agricultural goods included in Appendix I of the VAT law.	1,437.4	0.68
	VAT exemption	For agricultural producers whose sales do not exceed 50 UIT.	62.6	0.03
	Income tax exemption	For agricultural producers whose sales do not exceed 50 UIT.	17.6	0.01
	Income tax benefit	Agricultural sector: rate 15 percent.	20.2	0.01
	Income tax benefit	Agricultural sector: up to 20 percent of depreciation for hydraulic infrastructure and irrigation can be deferred.	33.8	0.02
Amazon region	VAT exemption	In jungle regions of Loreto, San Martin, Ucayali, Madre de Dios, and Amazon (except construction).	412.8	0.19
	VAT exemption	Construction and activities inside the Amazon but outside the ancient jungle region.	225.5	0.11
	SCT and VAT exemption 2/	For fuel sales in the Amazon.	169.6	0.08
	VAT benefit	Tax refund mechanism.	82.9	0.04
	VAT benefit	Special fiscal credit mechanism.	15.1	0.01
	Income tax benefit	Amazon-5 percent and 10 percent rate.	19.9	0.01
Income tax benefit	Amazon-deduction for third party investors.	0.0	0.00	
Education	VAT exemption	For educational, cultural and sports organizations.	243.2	0.00
	Income tax benefit	Credit for donations.	2.8	0.00
Energy	SCT and VAT exemption	For electricity-generation companies and for the consumption of diesel.	23.6	0.01
Financial	VAT exemption	Services rendered by Private Pension Fund Administration companies.	63.3	0.03
	VAT and Income tax exemption	For financial institutions.	250.0	0.12
	VAT and Income tax exemption	For life insurance contracts.	105.5	0.05
Manufacturing	General tax benefit	3 percent tax credit for intermediary sales of capital goods.	3.0	0.00
CETICOS	SCT and VAT benefit	0 percent rate in the ISC for using CETICOS to repair and renovate used vehicles.	228.6	0.11
Mining	VAT and trade tax exemption	For importing input goods for the exploration of hydrocarbon.	4.5	0.00
	Income tax benefit	Accelerated depreciation.	44.4	0.02
Tourism	Income tax benefit	Accelerated depreciation.	6.6	0.00
Other	VAT benefit	Anticipated tax rebates.	198.4	0.09
	Income tax benefit	Refund for donations from overseas—technical international cooperation.	40.0	0.02
	Income tax exemption	For interest on deposits.	184.9	0.09
Total			4,047.5	1.91

Source: SUNAT.

1/ The fiscal cost recorded in this table is in agreement with the notion of tax expense.

2/ SCT stands for Selected Consumption Tax.

Statement by the IMF Staff Representative on Peru
December 13, 2002

1. This statement summarizes economic information that has become available since the release of the staff report as well as the preliminary findings of the recent fiscal transparency module of the Report on Observance of Standards and Codes (ROSC). This information does not change the thrust of the staff appraisal.

2. **On recent economic developments:**

- **Economic growth is somewhat stronger than assumed in the program.** The index of economic activity in September was up by 7.3 percent from a year earlier, and third quarter real GDP growth was 5.2 percent (year-on-year). It is now likely that GDP growth for the entire year 2002 will be at least 4 percent (the program assumed 3.7 percent).
- **Inflation is at the lower end of the authorities' target range.** The 12-month rate of inflation in November was 1.5 percent, at the lower end of the 1.5–3.5 percent target range under the authorities' inflation targeting framework. The authorities expect inflation in the months ahead to be comfortably within the target range.

3. **The recent ROSC module on fiscal transparency finds that Peru has launched important initiatives to increase fiscal transparency.** In particular:

- budget formulation has been strengthened and based on a medium-term macro framework;
- an integrated financial management information system is being phased-in;
- a modern public procurement process has been introduced;
- the cost of tax expenditures has been estimated and published; and
- most public entities have been mandated to disclose a large amount of important information.

4. **At the same time, the ROSC also noted remaining weaknesses in some areas,** including the need for:

- a clearer definition of the scope and functions of public sector operations;
- a more stable and unified legal framework for fiscal activities;
- greater transparency of the legislative process in taxation; and
- a strengthened capacity to carry out external audits of public sector operations.



INTERNATIONAL MONETARY FUND

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Peru

On December 13, 2002, the Executive Board concluded the 2002 Article IV consultation with Peru and completed the First Program Review Under the Stand-By Arrangement for Peru approved on February 1, 2002.¹

Background

After several years of strong performance, Peru's economy weakened in the late 1990s, mainly as a result of adverse external shocks, a weakening structural reform effort, and domestic political turmoil. Real GDP growth averaged 7 percent during 1993–97, but only 1 percent over 1998–2001. Inflation declined progressively since the early 1990s and was slightly negative by end-2001.

In 2002, economic activity is recovering and real GDP is expected to grow by 3.7 percent, and annual inflation is projected at 2 percent. Employment during the first nine months of the year rose 2.3 percent with respect to its level in the same period a year earlier. After a sizeable fiscal stimulus in the second half of last year, fiscal policy was tightened in early 2002, and the combined public sector deficit is projected at 2.3 percent of GDP for the entire year. The external position is robust, with an expected accumulation of official international reserves of over US\$1 billion. During 2002, progress was made in introducing structural reforms in the fiscal area, including on tax and pension system reform, fiscal transparency, and fiscal rules. The authorities also introduced an inflation targeting framework for monetary policy, with the

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medium-term inflation-target centered at a midpoint of 2.5 percent plus/minus 1 percentage point. Moreover, continued efforts have been made to strengthen the banking system, along the lines of suggestions from the 2000 Financial Sector Assessment Program. Bank portfolios and profitability improved, loan provisioning was high, and risk-adjusted capital-asset ratios increased for the system as a whole. Credit to the private sector has been basically flat, but there are signs that it is picking up.

The program for 2003 is based on continued economic recovery, with GDP growth projected at 3.5–4.0 percent. Economic activity is expected to pick up owing to an improved investment climate, reflecting a more stable external and domestic political environment. Inflation is targeted at 2.5 percent, and international reserves would increase moderately. The external current account deficit is projected to fall below 2 percent of GDP, with continued strong growth of traditional exports and a pick up in nontraditional exports under the expanded U.S. trade preference arrangement for Andean countries.

Continuing with their strategy of gradual medium-term fiscal consolidation, the authorities aim to reduce the combined public sector deficit to 1.9 percent of GDP in 2003 (reflecting mainly the full-year effect of tax reform measures implemented in 2002). Further tax reform measures are planned in 2003, as are continued efforts to fortify the financial position of the pension system, improve debt management, and strengthen bank supervision. Also, a phased introduction of fiscal decentralization will begin in 2003.

Executive Board Assessment

Directors commended the authorities for their skillful economic management that had facilitated a positive macroeconomic performance in 2002, despite the weakening external environment and difficult political situation. Indeed, the Peruvian economy has shown considerable resilience to adverse developments, especially compared with the region. Directors stressed that continued implementation of sound macroeconomic policies and structural reforms, including a strong effort on institution building, is essential for Peru to sustain growth, resist external shocks, and continue to successfully address the risks related to the highly dollarized banking system and the relatively large public debt.

Directors supported the authorities' overall policy framework, which aims at maintaining macroeconomic stability and reinforcing an already solid financial system. They noted that the policy framework centers appropriately on medium-term fiscal consolidation, inflation targeting with a floating exchange rate, and supporting structural reforms. Directors stressed that the authorities should garner the necessary political consensus for this policy agenda, as lack of adequate ownership could pose a serious risk to successful policy implementation. Equally, economic performance would benefit from a strengthening of governance in public sector operations.

Directors endorsed the authorities' strategy of gradual fiscal consolidation while supporting the economic recovery. They emphasized that completing the comprehensive tax reform begun in 2002 by phasing out regional and sectoral tax exemptions was key to putting the public finances

on a sustainable basis. Most Directors expressed concern that the recent tax amnesty could undermine compliance and suggested that it be clearly indicated to taxpayers that the government will not rely on tax amnesties in the future. With regard to expenditures, Directors welcomed the recent restraint on increases in wages and pensions. They also welcomed the on-going work to improve the quality of public expenditure to ensure that the most vulnerable of the population are well protected. In addition, it would be important to increase the level of social spending in order to alleviate poverty—this could also help mobilize political acceptance for the reform agenda.

Directors stressed the importance of carrying out fiscal decentralization in a cautious and fiscally neutral manner. They encouraged the authorities to work closely with the World Bank and Inter-American Development Bank in implementing decentralization and considered that pilot programs for the transfer of expenditure responsibilities could be useful vehicles to test the fiscal impact of decentralization. Directors also stressed the importance of early congressional approval of the revised fiscal responsibility law as it contains important regulations on regional and local government finances.

Directors welcomed the authorities' intention to reactivate the domestic bond market, pointing out that the development of this market would have broad positive effects for the economy and provide protection against adverse developments in international capital markets.

While noting the change in the privatization strategy in view of strong public opposition to outright privatization, Directors encouraged the authorities to continue to seek ways for private sector participation in state enterprise operations. They welcomed the authorities' plans for continued reform of the public pension system. Directors warned, however, that the proposal to lower the retirement age in the public pension system was likely to have significant negative consequences for the public finances.

Directors endorsed the authorities' inflation-targeting framework for monetary policy and commended the central bank for maintaining inflation at low levels. They recommended continued work to refine the inflation forecasting process and to strengthen its integration with the monetary policy decision-making framework.

Directors considered that the current flexible exchange rate policy has served Peru well in adjusting to external shocks, and they supported the authorities' intention to continue with the present regime.

Directors welcomed the sound financial position of the banking system, which has improved in recent years in the wake of the significant consolidation that the system has experienced. They considered it important that the supervisory agency continue to enhance prudential oversight, especially in evaluating credit risk derived from foreign-currency lending operations and in ensuring that all banks have adequate capital.

Directors considered reducing the high degree of financial dollarization as an important goal that, while requiring time, will depend mainly on continued pursuit of prudent macroeconomic

policies, aided by a strong prudential framework and development of the domestic capital market. They noted that the high level of official international reserves has been a key factor in Peru's ability to avoid the kind of contagion that has affected other highly dollarized economies in the region, and they welcomed the authorities' commitment to keep reserves at high levels.

Directors welcomed the authorities' progress with anti-money laundering and combating the financing of terrorism and encouraged them to continue their efforts in this area.

Directors supported the authorities' intention to continue to maintain both an open trade and payments regime and the current relatively flexible system of labor market norms. They encouraged the authorities to implement as soon as possible a mechanism for protecting the unemployed.

Directors noted that Peru was one of the early subscribers to the Special Data Dissemination Standard. They welcomed the improved transparency in monetary policy following the adoption of inflation-targeting and strengthened banking system data. Directors viewed the Reports on the Observance of Standards and Codes modules on fiscal transparency and data as important steps to improving information dissemination.

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

Peru: Selected Economic Indicators

	1999	2000	2001	Projections	
				2002	2003
(Annual percentage change, unless otherwise indicated)					
Real economy					
Real GDP	0.9	3.1	0.2	3.7	3.5
Inflation 1/	3.7	3.7	-0.1	2.0	2.5
Terms of trade	-8.3	-2.1	-2.0	3.2	2.3
Real effective exchange rate (depreciation -) 1/ 2/	-2.4	7.2	4.4	-4.8	...
Nominal exchange rate (in soles per U.S. dollar) 1/	3.51	3.53	3.45	...	...
Money and credit					
Base money	17.0	-4.0	7.9	11.0	6.6
Broad money 3/	4.6	2.3	4.9	4.2	5.7
Credit to private sector 3/	-2.3	-3.6	-2.6	0.6	2.9
(In percent of GDP, unless otherwise indicated)					
Savings and investment					
Gross domestic investment	21.5	20.1	18.4	18.0	18.2
National savings	18.6	17.2	16.4	15.8	16.3
External savings	2.9	2.9	2.0	2.2	1.9
Balance of payments					
Current account	-2.9	-2.9	-2.0	-2.2	-1.9
Capital and financial account	1.4	2.5	2.8	4.4	2.0
Gross official reserves (in months of imports of goods and services) 1/	11.1	10.8	10.8	11.5	10.7
Gross official reserves (in percent of broad money) 1/	68.0	64.0	62.1	68.0	65.2
Public sector					
Combined public sector primary balance 4/	-0.8	-0.9	-0.1	-0.2	0.4
Combined public sector overall balance 4/	-3.0	-3.2	-2.3	-2.3	-1.9
Public sector medium- and long-term external debt	38.7	36.5	35.5	36.7	36.8

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

1/ At end of period.

2/ Based on Information Notice System. Data for 2002 correspond to September 2002.

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

4/ Revenue excludes privatization receipts.



FOR IMMEDIATE RELEASE

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

**IMF Completes First Review of Peru's Stand-By Agreement,
Approves \$154 Million Disbursement**

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Peru's performance under the two-year SDR 255 million (about \$340 million) Stand-By Arrangement, approved on February 1, 2002 (see [Press Release No. 02/6](#)). The completion of this review enables the release of SDR 115.625 million (about \$154 million) to Peru. So far the country has not made any drawings under the arrangement.

In completing the review, the Executive Board approved the modification of the 2002 fiscal deficit target from 1.9 percent of GDP to 2.3 percent of GDP, and the replacement of the Net Domestic Asset (NDA) target by a consultation mechanism on inflation.

Following the Executive Board's review of Peru, Eduardo Aninat, Deputy Managing Director and Acting Chair, said:

"Economic performance under the program in 2002 has been encouraging. Despite a difficult environment, growth is recovering, inflation is low, and the external position is robust.

"The policy framework for 2003 aims at a further recovery in economic activity, with continued low inflation. The fiscal deficit is targeted to decline moderately, balancing the need to support the recovery while giving further credibility to the government's medium-term fiscal consolidation goals. The authorities should seek to garner the necessary political consensus for the needed policy actions.

"Achieving the fiscal target for next year will require cautious implementation of decentralization to ensure that its impact is fiscally neutral. Moreover, to put the public finances on a sustainable basis, it is essential that the comprehensive tax reform plan introduced in 2002 be completed by phasing out regional and sectoral tax exemptions. It would also be important that the government does not resort to tax amnesties in the future. The government's financing plan for 2003 requires that the domestic bond market for government securities be reactivated. Enhanced social spending would be important to help poverty alleviation efforts—and could also serve to gain broader acceptance for the authorities' reform efforts.

"The improved financial performance of most banks in 2002 is encouraging. In addressing dollarization in the financial system, the authorities appropriately focus on maintaining a high level of official international reserves, developing the local bond market, and further strengthening the prudential framework, especially in monitoring the credit risk arising from banks' foreign-currency lending operations.

"The authorities are seeking alternatives to privatization to encourage private participation in public sector operations. Other important structural reforms on the agenda include steps to enhance the efficiency of social expenditure programs and to improve the equity and strengthen the financial position of the public pension system," Mr. Aninat said.



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In 2002, economic activity is recovering and real GDP is expected to grow by 3.7 percent, and annual inflation is projected at 2 percent. Employment during the first nine months of the year rose 2.3 percent with respect to its level in the same period a year earlier. After a sizeable fiscal stimulus in the second half of last year, fiscal policy was tightened in early 2002, and the combined public sector deficit is projected at 2.3 percent of GDP for the entire year. The external position is robust, with an expected accumulation of official international reserves of over US\$1 billion. During 2002, progress was made in introducing structural reforms in the fiscal area, including on tax and pension system reform, fiscal transparency, and fiscal rules. The authorities also introduced an inflation targeting framework for monetary policy, with the

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medium-term inflation-target centered at a midpoint of 2.5 percent plus/minus 1 percentage point. Moreover, continued efforts have been made to strengthen the banking system, along the lines of suggestions from the 2000 Financial Sector Assessment Program. Bank portfolios and profitability improved, loan provisioning was high, and risk-adjusted capital-asset ratios increased for the system as a whole. Credit to the private sector has been basically flat, but there are signs that it is picking up.

The program for 2003 is based on continued economic recovery, with GDP growth projected at 3.5–4.0 percent. Economic activity is expected to pick up owing to an improved investment climate, reflecting a more stable external and domestic political environment. Inflation is targeted at 2.5 percent, and international reserves would increase moderately. The external current account deficit is projected to fall below 2 percent of GDP, with continued strong growth of traditional exports and a pick up in nontraditional exports under the expanded U.S. trade preference arrangement for Andean countries.

Continuing with their strategy of gradual medium-term fiscal consolidation, the authorities aim to reduce the combined public sector deficit to 1.9 percent of GDP in 2003 (reflecting mainly the full-year effect of tax reform measures implemented in 2002). Further tax reform measures are planned in 2003, as are continued efforts to fortify the financial position of the pension system, improve debt management, and strengthen bank supervision. Also, a phased introduction of fiscal decentralization will begin in 2003.

Executive Board Assessment

Directors commended the authorities for their skillful economic management that had facilitated a positive macroeconomic performance in 2002, despite the weakening external environment and difficult political situation. Indeed, the Peruvian economy has shown considerable resilience to adverse developments, especially compared with the region. Directors stressed that continued implementation of sound macroeconomic policies and structural reforms, including a strong effort on institution building, is essential for Peru to sustain growth, resist external shocks, and continue to successfully address the risks related to the highly dollarized banking system and the relatively large public debt.

Directors supported the authorities' overall policy framework, which aims at maintaining macroeconomic stability and reinforcing an already solid financial system. They noted that the policy framework centers appropriately on medium-term fiscal consolidation, inflation targeting with a floating exchange rate, and supporting structural reforms. Directors stressed that the authorities should garner the necessary political consensus for this policy agenda, as lack of adequate ownership could pose a serious risk to successful policy implementation. Equally, economic performance would benefit from a strengthening of governance in public sector operations.

Directors endorsed the authorities' strategy of gradual fiscal consolidation while supporting the economic recovery. They emphasized that completing the comprehensive tax reform begun in 2002 by phasing out regional and sectoral tax exemptions was key to putting the public finances

on a sustainable basis. Most Directors expressed concern that the recent tax amnesty could undermine compliance and suggested that it be clearly indicated to taxpayers that the government will not rely on tax amnesties in the future. With regard to expenditures, Directors welcomed the recent restraint on increases in wages and pensions. They also welcomed the on-going work to improve the quality of public expenditure to ensure that the most vulnerable of the population are well protected. In addition, it would be important to increase the level of social spending in order to alleviate poverty—this could also help mobilize political acceptance for the reform agenda.

Directors stressed the importance of carrying out fiscal decentralization in a cautious and fiscally neutral manner. They encouraged the authorities to work closely with the World Bank and Inter-American Development Bank in implementing decentralization and considered that pilot programs for the transfer of expenditure responsibilities could be useful vehicles to test the fiscal impact of decentralization. Directors also stressed the importance of early congressional approval of the revised fiscal responsibility law as it contains important regulations on regional and local government finances.

Directors welcomed the authorities' intention to reactivate the domestic bond market, pointing out that the development of this market would have broad positive effects for the economy and provide protection against adverse developments in international capital markets.

While noting the change in the privatization strategy in view of strong public opposition to outright privatization, Directors encouraged the authorities to continue to seek ways for private sector participation in state enterprise operations. They welcomed the authorities' plans for continued reform of the public pension system. Directors warned, however, that the proposal to lower the retirement age in the public pension system was likely to have significant negative consequences for the public finances.

Directors endorsed the authorities' inflation-targeting framework for monetary policy and commended the central bank for maintaining inflation at low levels. They recommended continued work to refine the inflation forecasting process and to strengthen its integration with the monetary policy decision-making framework.

Directors considered that the current flexible exchange rate policy has served Peru well in adjusting to external shocks, and they supported the authorities' intention to continue with the present regime.

Directors welcomed the sound financial position of the banking system, which has improved in recent years in the wake of the significant consolidation that the system has experienced. They considered it important that the supervisory agency continue to enhance prudential oversight, especially in evaluating credit risk derived from foreign-currency lending operations and in ensuring that all banks have adequate capital.

Directors considered reducing the high degree of financial dollarization as an important goal that, while requiring time, will depend mainly on continued pursuit of prudent macroeconomic

policies, aided by a strong prudential framework and development of the domestic capital market. They noted that the high level of official international reserves has been a key factor in Peru's ability to avoid the kind of contagion that has affected other highly dollarized economies in the region, and they welcomed the authorities' commitment to keep reserves at high levels.

Directors welcomed the authorities' progress with anti-money laundering and combating the financing of terrorism and encouraged them to continue their efforts in this area.

Directors supported the authorities' intention to continue to maintain both an open trade and payments regime and the current relatively flexible system of labor market norms. They encouraged the authorities to implement as soon as possible a mechanism for protecting the unemployed.

Directors noted that Peru was one of the early subscribers to the Special Data Dissemination Standard. They welcomed the improved transparency in monetary policy following the adoption of inflation-targeting and strengthened banking system data. Directors viewed the Reports on the Observance of Standards and Codes modules on fiscal transparency and data as important steps to improving information dissemination.

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

Peru: Selected Economic Indicators

	1999	2000	2001	Projections	
				2002	2003
(Annual percentage change, unless otherwise indicated)					
Real economy					
Real GDP	0.9	3.1	0.2	3.7	3.5
Inflation 1/	3.7	3.7	-0.1	2.0	2.5
Terms of trade	-8.3	-2.1	-2.0	3.2	2.3
Real effective exchange rate (depreciation -) 1/ 2/	-2.4	7.2	4.4	-4.8	...
Nominal exchange rate (in soles per U.S. dollar) 1/	3.51	3.53	3.45	...	...
Money and credit					
Base money	17.0	-4.0	7.9	11.0	6.6
Broad money 3/	4.6	2.3	4.9	4.2	5.7
Credit to private sector 3/	-2.3	-3.6	-2.6	0.6	2.9
(In percent of GDP, unless otherwise indicated)					
Savings and investment					
Gross domestic investment	21.5	20.1	18.4	18.0	18.2
National savings	18.6	17.2	16.4	15.8	16.3
External savings	2.9	2.9	2.0	2.2	1.9
Balance of payments					
Current account	-2.9	-2.9	-2.0	-2.2	-1.9
Capital and financial account	1.4	2.5	2.8	4.4	2.0
Gross official reserves (in months of imports of goods and services) 1/	11.1	10.8	10.8	11.5	10.7
Gross official reserves (in percent of broad money) 1/	68.0	64.0	62.1	68.0	65.2
Public sector					
Combined public sector primary balance 4/	-0.8	-0.9	-0.1	-0.2	0.4
Combined public sector overall balance 4/	-3.0	-3.2	-2.3	-2.3	-1.9
Public sector medium- and long-term external debt	38.7	36.5	35.5	36.7	36.8

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

1/ At end of period.

2/ Based on Information Notice System. Data for 2002 correspond to September 2002.

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

4/ Revenue excludes privatization receipts.

**Statement by Guillermo Le Fort, Executive Director for Peru
and Carlos E. Pereyra, Advisor to Executive Director
December 13, 2002**

- *The Peruvian economy has shown resilience against external disturbances, and economic growth picked up during the year.*
- *Under the new inflation targeting framework, the Central Bank has kept inflation under control and neutralized deflation risks, while the freely floating exchange rate has remained rather stable in spite of the prevailing international financial conditions.*
- *The banking system has continued to be strengthened through prudential regulation; net international reserves provide adequate coverage of financial liabilities and debt; and policies are being adopted to favor financial de-dollarization.*
- *A comprehensive fiscal reform is being pursued, new measures geared to reinforce collections have been approved, and expenditures will be kept under close control in 2003.*
- *The legal and institutional framework for the decentralization process has been designed to ensure an orderly transfer of government functions and the preservation of fiscal discipline.*
- *The authorities will continue to encourage greater private sector participation in the economy, carry out social programs with multilateral support, improve competitiveness, and reform the pension system.*

1. The Peruvian economy has proved to be quite resilient to exogenous shocks. In 2002, despite the reduced global growth and the financial turmoil that affected several countries in Latin America, GDP is estimated to grow at a rate above 4 percent, the unemployment rate has fallen by more than 2 percentage points during the year, and annual inflation is projected to close the year below 2 percent. At the same time, the level of net international reserves has increased to almost \$10 billion, covering close to 190 percent of short-term debt on a residual maturity basis.
2. These positive results have been achieved despite several years of successive adverse events such as the El Niño phenomenon and its negative impact on infrastructure and exports; the fall in terms of trade in the wake of the Asian crisis; the reduction and outflow of short-term capitals during the Russian financial crisis in 1998; the volatility caused by devaluations in Brazil and Argentina; and the domestic political crisis at the end of the 1990s. Sound fundamentals have enabled Peru to weather all these shocks and start a period of economic recovery, thus creating the conditions to reduce the poverty level.

I. ECONOMIC ACTIVITY

3. Peru's GDP growth is one of the highest in the Latin American region this year, as the recovery in economic activity continues. The latest figures show that GDP increased by 5.2 percent in the third quarter relative to the same quarter last year, thus confirming the accelerating trend initiated since the second half of 2001. It should be underscored that the stagnation in private investment was reversed by a substantial 4.5 percent pickup in the third quarter. Exports show increased dynamism, and manufacture and construction have started to lead growth, with 5.6 and 11.4 percent increases in the same period, respectively.
4. The recent extension of the Andean Trade Promotion and Drug Eradication Act, which enables Peruvian textile and agricultural goods to enter the U.S. market free of tariffs, is envisaged to have a high positive effect on exports. In particular, the arrangement increases significantly the growth potential of Peruvian textiles and apparel—currently the fourth most important export item. Additionally, the Camisea gas project, which will start operations in 2004, will imply an important reduction in energy costs and substitution of oil imports.

II. MONETARY AND EXCHANGE RATE POLICY

5. In January 2002, the Central Bank announced the adoption of an inflation targeting strategy with a target of plus or minus one percentage point around the midpoint of 2.5 percent. The launching of the new monetary framework included the dissemination of the calendar of Central Bank board meetings—in which monetary policy actions are taken—as well as the announcement of the publication of an inflation report every fourth months. Under this monetary arrangement, the Central Bank successfully neutralized deflation risks, with inflation passing from -0.1 percent in 2001 to an expected 1.8 percent in 2002.
6. Peru has been able to maintain an expansionary bias in monetary policy this year, reflected in an average interbank interest rate of 3.9 percent by end-November, vis-à-vis 8.4 percent right after the presidential election in 2001. At the same time, credit to the private sector, after falling by 4.6 percent in 2001, grew by 2.5 percent over the twelve months to October—with a 7.8 percent growth in credit denominated in domestic currency—while the banking system has shown improvements in all its indicators.
7. The freely floating exchange rate has served the economy well, acting as a cushion against external shocks and remaining quite stable, given the international financial conditions. As of November, the domestic currency showed one of the lowest accumulated depreciation rates in the region (4.3 percent).
8. In response to risks arising from the partial dollarization of deposits and credits in the financial system, since the beginning of the 1990s Peru has adopted prudential measures against the possibility of an abrupt withdrawal of dollar deposits and the potential effects

of a significant currency depreciation on loan portfolios. The banking system maintains demand deposits at the Central Bank amounting to \$3.6 billion, representing 33 percent of dollar liabilities. As for the risk of pressures on the exchange rate, it is important to note that the Central Bank's net international reserves amount to 5.8 times the monetary base and 2.1 times liquidity in domestic currency.

9. At the same time, the mismatch stemming from foreign currency loans to domestic firms and households with revenue sources in domestic currency is being addressed by the development of the foreign exchange forward market, in which they can cover open foreign exchange positions. In addition, provisioning requirements on commercial banks are helping to cover unhedged risks, and the development of a fixed income market in domestic currency is favoring a process of financial de-dollarization. In this regard, the authorities aim to introduce in 2003 a system of primary dealers for auctioning government paper in domestic currency, thus helping the development of a secondary market in these instruments that should prompt the development of bank liabilities denominated in domestic currency. In any case, the process is supported by the application of consistent macroeconomic policies and the consolidation of monetary stability through the inflation targeting framework.

III. FISCAL SECTOR

10. During the last year, the fiscal position was somewhat affected by unforeseen developments, including lower than projected grants and unanticipated judicial liabilities. In this context, the Peruvian authorities, in consultation with the Fund, have revised slightly the fiscal deficit target to 2.3 percent of GDP for 2002.
11. The authorities have succeeded in bringing revenues back on track through tax measures and administrative enhancements. General Government current revenues are estimated to remain at 17.2 percent of GDP and would increase to 17.6 percent in 2003. In the second half of 2002, several policies can explain the recovery in tax collections, mainly: (i) the introduction of new VAT withholding systems; (ii) the increase in excise taxes on fuels; and (iii) the tax audit program of corporations and independent professionals, which is ahead of schedule.
12. In addition, a set of new measures geared to reinforce collections in 2003 is being approved by Congress, among them the increase in the highest personal income tax rate from 27 percent to 30 percent; the introduction of a new collection system for the corporate income tax based on the value of companies' assets; and the extension for one year of the special 2 percent payroll tax.
13. The recently approved budget law for 2003 considers a rate of growth of one percent in real terms for non-financial expenditures, consistent with a public sector deficit of 1.9 percent of GDP. Tax expenditures have been explicitly incorporated in the 2003 budget to underscore their fiscal cost. Also, the new Law on Fiscal Responsibility and Transparency introduces a more realistic period of three years for convergence to the

limit, as well as fiscal rules for and control mechanisms on the new sub-national governments.

14. In addition, the authorities will begin to phase out certain regional and sectoral tax exemptions. Full implementation of this process, which is expected to occur by end-2004, will involve reaching agreements with the incoming regional administrations on exchanging the elimination of these exemptions for investment in infrastructure in the regions concerned, as well as approval by Congress.
15. Building on the successful reentrance into the international private capital market in February, confidence in fiscal sustainability, and isolation from regional disturbances, on November 25 the government of Peru placed \$500 million of 5-year sovereign bonds with a coupon of 9.125 percent, at a spread of 612 basis points over comparable U.S. Treasuries. Peru thus turned into one of the few Latin American economies that have been able to tap international capital markets. The placement had a demand three times higher than the amount offered, and the yield was lower than that obtained by countries with higher ratings. Peru's external public debt—which has an average maturity of 8 years—comes mainly from concessional sources, and sustainability analyses—including the one presented by staff—shows the significant soundness of Peru's debt position.

IV. PROGRESS IN STRUCTURAL REFORM

16. At the beginning of 2002, a constitutional amendment launched the decentralization process—one of the central points in the authorities' agenda—aiming at deepening the democratization process and promoting economic growth. Our authorities have taken great care in designing a legal and institutional framework intended to effectively facilitate an orderly transfer of government functions to the regions—notably the provision of government services—while preserving fiscal discipline. The process will count with technical and financial assistance from the World Bank and the IDB.
17. The principles that would guide the process—which enjoy political consensus—were approved by Congress in July: (i) responsibilities at the three levels of government—national, regional and municipal—should be clearly defined to ensure accountability; (ii) the process should be gradual, and its impact on the consolidated public finances should be neutral; (iii) any external borrowing carried out by the new regional administrations require approval from the Ministry of Economy and Finance (MEF) and should be consistent with the overall public sector's indebtedness limit; and (iv) fiscal rules should be established at the sub-national level to guarantee the financial sustainability of the decentralization process.
18. The law also establishes that the formulation, approval, and control of the annual budget at the three levels will be governed by the norms established by the MEF. Accordingly, sub-national governments will require to submit to the central government information on the implementation of their budgets. Additionally, according to the Regional

Governments Law, approved in November, sub-national governments will be subject to the fiscal sustainability mechanisms established in the Law on Fiscal Responsibility and Transparency.

19. Despite domestic developments that affected the process of transferring the operations of the electric generation companies EGASA and EGESUR to the private sector, the authorities remain committed to encouraging greater private sector participation in the economy. In order to strengthen domestic support and preserve foreign investors' interest, the Private Investment Promotion Program (PIPP) is being refined, with an increased emphasis on concession contracts and strategic partnerships. In light of this revised outlook, the government is requesting a modification to the adjustor on the end-December 2002 performance criterion on the net international reserves of the Central Bank for shortfalls in PIPP receipts. In 2003, proceeds from the PIPP are expected to yield \$400 million.
20. Measures have been put in place during 2002 to reform the public pension system: (i) differences between survivor benefits under the National Pension System's two main retirement plans were reduced; (ii) in the public pension plan encompassing most employees, the minimum pension—which was well below the standard consumption basket—was raised; (iii) a minimum pension was ensured for a group of workers older than 55 years who moved into the private system and did not have enough time to accumulate an adequate pension; and (iv) the calculation method for both the replacement rate and the pension base were modified to improve the actuarial equilibrium of the National Pension System. In the near future, the authorities will set out to further equalize the National Pension System's main plans, as well as to reduce the operating costs and expand the investment options of private pension funds.
21. The authorities will continue to carry out social programs with multilateral support. Also, they have expressed their decision to move forward in the integration and liberalization processes, and a complete action plan aimed at fostering competitiveness is being developed in cooperation with the World Bank and the Inter-American Development Bank. Furthermore, with the aim of building consensus on key governance issues, such as the rule of law, social equity, competitiveness, and efficiency in public management, the authorities promoted a National Agreement, which was signed in March with political parties and civil organizations.
22. In sum, Peru remains in a solid position to sustain high economic growth, and the policy framework has enough flexibility to resist and adequately respond to negative shocks. A fruitful combination of consistent policy implementation, active domestic debate, and international cooperation has been effective in confronting perceived risks.