

**Peru: 2004 Article IV Consultation, Fourth Review Under the Stand-By Arrangement, and Request for Waiver of Nonobservance of Performance Criterion—Staff Report; Staff Statement; Public Information Notice and Press Release 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 2004 Article IV consultation with Peru, fourth review under the Stand-By Arrangement, and request for waiver of nonobservance of performance criterion, the following documents have been released and are included in this package:

- the staff report for the combined consultation and 2004 Article IV consultation, fourth review under the Stand-By Arrangement, and request for waiver of nonobservance of performance criterion, prepared by a staff team of the IMF, following discussions that ended on **December 12, 2003**, with the officials of Peru on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on February 10, 2004.** 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 **February 23, 2004** updating information on recent economic developments.
- a Public Information Notice (PIN) and Press Release, **summarizing the views of the Executive Board as expressed during its February 23, 2004, discussion** of the staff report on issues related to the Article IV consultation and the review and request, respectively.
- a statement by the Executive Director for Peru.

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

Selected Issues Paper

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PERU

**Staff Report for the 2004 Article IV Consultation, Fourth Review Under the Stand-By Arrangement, and Request for Waiver of Nonobservance of Performance Criterion**

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

Approved by Markus Rodlauer and Juha Kähkönen

February 10, 2004

- Discussions were held in Lima during December 1–12 for the 2004 Article IV consultation and the fourth review under the two-year stand-by arrangement (SBA) approved on February 1, 2002. The SBA is for SDR 255 million (20 percent of quota on an annual basis). The authorities are treating the SBA as precautionary. The third review was completed on November 3, 2003. The staff team met with Minister of Finance Quijandría, Central Bank President Silva Ruete, other senior officials, and private sector representatives.<sup>1</sup>
- The mission also discussed with the authorities the findings of the task force on the Fund's longer-term program engagement (LTPE) with Peru. The task force found that the Fund's LTPE with Peru has had, on balance, positive results, and that it would be appropriate for the Fund to continue supporting suitably strong programs.
- Peru has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.
- Peru's economic statistics are adequate for surveillance and policy formulation. Peru subscribes to the SDDS; its metadata is posted on the Fund's external web page. Two ROSC Modules (on fiscal transparency and data) will help further strengthen economic statistics.
- Technical assistance has concentrated in the fiscal, monetary, and statistical areas.

<sup>1</sup> The staff team comprised A. Wolfe (Head), M. Rodríguez, M. Villafuerte (all WHD), T. Dabán (FAD), and M. Shannon (PDR). A. Berg (RES, Head of the Task Force on Peru's Longer-Term Program Engagement) joined the mission during Dec 8–12. J. Guzmán (Senior Resident Representative) assisted the mission. Mr. Pereyra, Advisor to the Executive Director, participated in the policy discussions.

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## EXECUTIVE SUMMARY

### Background

- The Peruvian economy has been substantially transformed over the past decade, enabling it to weather the recent regional financial turbulence relatively well. Real GDP grew 4 percent in 2003, inflation is low, and the external position is sound. High official reserves provide a buffer against vulnerabilities from dollarization and high public debt.
- Ongoing fiscal consolidation aims at ensuring sustainable debt dynamics under robust assumptions. The fiscal deficit fell below 2 percent of GDP in 2003 and is to decline further in 2004. Monetary policy is being conducted in a manner consistent with keeping inflation low under the inflation targeting framework. All end-2003 performance criteria were met, except for a small overrun on the contracting of external public debt, owing to pre-financing of 2004 budget operations.
- Banking system indicators have improved and prudential oversight has been strengthened, with focus on addressing the risks from dollar lending.
- Structural reforms have also progressed, albeit with some delays and setbacks. A cautious decentralization plan is being carried out. The tax system has been reformed, but many exemptions remain, and a (temporary) tax on financial transactions has been adopted, although its constitutionality is being challenged. Steps were taken to reform the preferential public pension system, but a complete reform requires amending the constitution. Political opposition brought the privatization program to a halt in 2002, and its reorientation toward operating concessions has been slow.

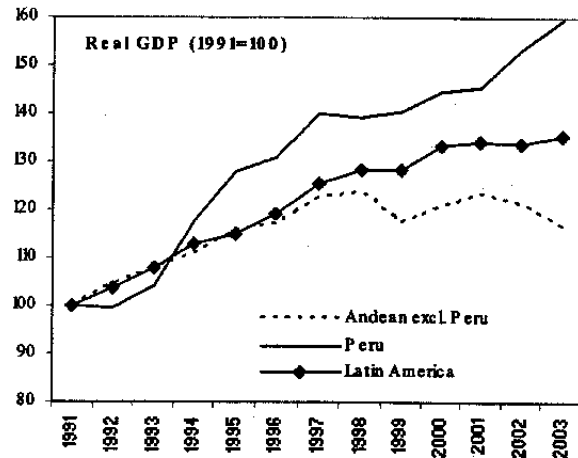
### Policy discussions

- The discussions focused on policies to maintain macroeconomic stability and create a sound investment climate to sustain growth and poverty reduction. Implementing such policies will be challenging in the run up to the 2006 national elections.
- The authorities' medium-term economic program focuses on continuing with gradual fiscal consolidation, keeping inflation low, and strengthening further official reserves in the context of the flexible exchange rate system.
- The authorities aim to further strengthen bank supervision, improve public debt management, reform the public sector, ensure labor market flexibility, pursue free trade, and strengthen the legal environment for investment.
- The baseline medium-term outlook is favorable. Assuming sound macropolicies and progress on structural reforms, growth of 4 percent should be maintained over the medium term. The main risk stems from possible policy weakening because of the difficult political situation. A free trade arrangement with the United States and a second large natural gas project are potential positive factors in the medium-term outlook.

## I. BACKGROUND

### A. Longer-Term Perspective

1. **Peru has made significant progress over the last decade in reforming its economy.** Between 1990 and 1997, Peru's economy was thoroughly transformed: hyperinflation and a debt crisis were ended, fiscal consolidation was carried out, and the economy was comprehensively liberalized and privatized. Reform efforts lost momentum starting in 1998, due to a combination of political and external shocks and policy slippages, but since mid-2001 there has been a new impetus for fiscal consolidation and other key reforms.



2. **Growth has been strong, albeit uneven.** Real per capita GDP is now about 30 percent higher than in 1990, compared with 12 percent for Peru's Andean neighbors. Growth was strong until 1997, but faltered during 1998–2001 as Peru was hit by spillover from crises in emerging markets, the El Niño weather phenomenon, and domestic political turmoil. As these factors waned, growth recovered strongly in 2002–03 (with a cumulative real GDP growth of 9 percent). Private investment followed a similar pattern, and has been mainly concentrated in the natural resource sector. As a result, growth has not been broad-based, with limited employment formation. Also, poverty remains widespread, with total poverty near 55 percent and extreme poverty at around 25 percent, and significantly higher poverty rates among the indigenous population.<sup>2</sup>

3. **Inflation fell steadily through 2000 and has been low since.** The good track record on inflation reflects in part the independence of the central bank, which was established under a new charter in the early 1990s. In 2002 the central bank adopted an inflation targeting framework, with a medium-term target of 2.5 percent, and range of plus/minus 1 percent.

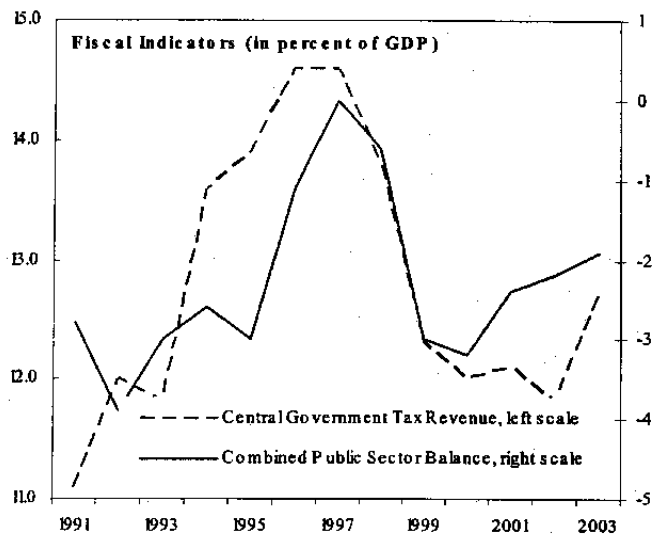
4. **The external position has moved from crisis to considerable strength.**

- Peru cleared arrears to the Fund in 1992, obtained substantial debt relief from Paris Club and private creditors in 1996–97, and graduated from Paris Club reschedulings in 1998. External debt (mostly public) fell sharply between 1990 and 1997, but then stayed at a still fairly high level (47 percent of GDP and 280 percent of exports).

<sup>2</sup> The poverty rate is defined as the percentage of households whose total spending is below the cost of a basket of basic consumption goods, while extreme poverty is based on a consumption basket of basic food items only.

- Official reserves were rebuilt through 1997, and after some decline in the late 1990s reserve coverage has risen now to over 200 percent of short-term debt and over 100 percent of dollar deposits in the banking system.
- In 2002 Peru accessed international bond markets for the first time in 70 years. Since then, it has placed US\$3.2 billion in international bonds with maturities ranging from 5 to 30 years, and spreads are now at near-historically low levels.

5. **A successful fiscal adjustment effort was interrupted in 1998.** Significant progress in fiscal consolidation was achieved through 1997, reflecting strong growth, comprehensive tax and pension reforms, and debt restructurings, which together brought the public sector accounts into balance by 1997. After that, the economic slowdown and policy slippages put renewed pressure on the public finances, with a slackening revenue effort, an inflexible fiscal expenditure structure, and a high level of public debt. A new consolidation effort, supported by the current SBA, began under the new government that took office in July 2001, returning public debt ratios onto a declining path.



6. **The fiscal deterioration in the late 1990s also reflected incomplete fiscal reforms.**

- **Tax reform.** Gains from the deep tax reform of the mid-1990s were eroded between 1998 and 2001, when the tax system and its administration were weakened through a series of tax amnesties and an expansion of tax benefits and exemptions.
- **Public expenditure reform.** Little progress was made in reducing spending rigidity, for example by curtailing non-productive public sector employment and overhauling the costly preferential public pension regime (*Cédula Viva*).<sup>3</sup>
- **Privatization.** An ambitious and initially successful privatization program stalled in 1998. Since then, operating concessions have been granted for electricity transmission, a small port and the international airport, and in mining, but much remains to be done to promote private investment in Peru's weak infrastructure.

<sup>3</sup> A major reform of the pension system took place in 1993, with the creation of a parallel *private* pension plan. However, the *public* plan still requires annual budget transfers of about 2.5 percent of GDP (see the chapter in the Selected Issues Paper (SI) on the Peruvian pension system).

**7. Progress with other structural reforms has also been uneven.**

- **Labor markets.** Laws that ruled out layoffs for economic reasons were eliminated in the early 1990s, but little progress has been made in reducing the relatively high costs of employing labor. Non-wage labor costs are equivalent to about 50 percent of wages, and dismissal costs are high.<sup>4</sup>
- **Trade policy.** Following a dramatic liberalization in the early 1990s, import tariffs have been selectively reduced, lowering average tariff rates but raising dispersion.<sup>5</sup> More recently, Peru has been actively pursuing bilateral trade agreements (with the United States, Mercosur, and Thailand, among others).
- **Investment climate.** Despite the sound macroeconomic performance over the last decade, investment remains relatively low. In the World Economic Forum's 2003 Report on Global Competitiveness, Peru ranked 54 out of 102 countries regarding the overall investment climate, well behind Chile's ranking of 26, and is at the high end of countries in the region in terms of business start-up time.<sup>6</sup>
- **Domestic capital markets** remain relatively shallow. The creation in early 2003 of a system of primary dealers for local-currency government debt has supported private sector bond activity by providing benchmark yields. In 2003, government debt placements in the domestic market grew by 44 percent, and private sector placements more than doubled; nevertheless, outstanding government local-currency debt and private-sector bonds are only 1.5 percent of GDP and 4.4 percent of GDP, respectively—notwithstanding foreign investment limits on private pension funds.<sup>7</sup>

**B. Performance Under the 2002–03 SBA**

**8. Macroeconomic performance under the program has been favorable.**

- **Growth averaged 4½ percent a year, inflation remained low, and the external position strengthened.**

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<sup>4</sup> For details on labor costs in Peru, see Country Report No. 01/51.

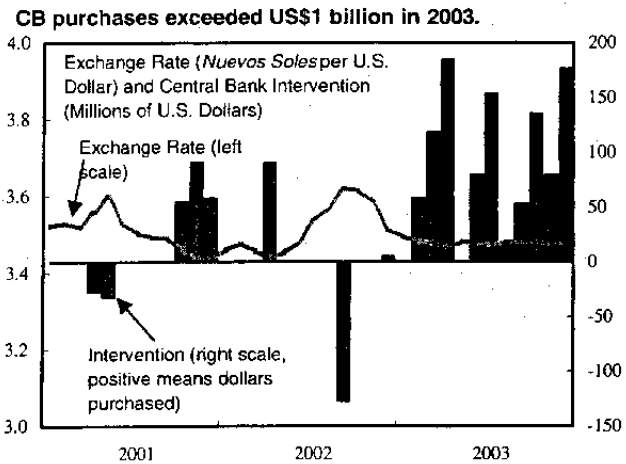
<sup>5</sup> The average tariff rate is 10.4 percent, but the effective rate of protection is higher, as the average dispersion of tariff rates between final goods and productive inputs is 6.1 percentage points.

<sup>6</sup> Box 1 reviews institutional constraints on investment in agriculture. A chapter in the SI paper discusses barriers to output and employment growth and examines the investment climate in more detail.

<sup>7</sup> Over 90 percent of government bonds are held by the financial system, including over 20 percent by private pension funds. Most bonds are not indexed, with (original) maturities ranging from 1½ to 5 years, while indexed bonds carry 7-year (original) maturities.



- **The combined public sector (CPS) deficit was reduced** from 2.4 percent of GDP in 2001 to 1.9 percent of GDP in 2003. The 2004 budget approved by congress is consistent with a further reduction in the CPS deficit to 1.5 percent of GDP.
- **Monetary policy** has followed the new inflation targeting framework. Since mid-2003, inflation expectation surveys have consistently forecasted 12-month inflation around the bottom of the target band. This has allowed the central bank to gradually reduce its reference lending rate (by 100 bps since early 2003). Interest rates in Peru are now at historically low levels.
- **International reserves were built up** as the central bank intervened, at times heavily, in the foreign exchange market amidst pressures for the *Nuevo Sol* to appreciate.<sup>8</sup> The appreciation pressure reflected strong export performance and substantial private capital inflows.<sup>9</sup>



- All continuous and end-December 2003 quantitative performance criteria (PC) were observed, except for a small deviation with respect to the limit on the contracting of external public debt, for which the authorities are requesting a waiver.

The deviation reflected the authorities' decision to take advantage of favorable market conditions and pre-finance 2004 budget operations. The proceeds from the pre-financing were deposited at the central bank, contributing to the large margin on the performance criterion for net international reserves.

9. **Progress on structural reforms was mixed.**

- **Tax reform.** The need to build domestic consensus has made for a gradual and still incomplete reform process. Many important changes have been introduced, but a consensus has not yet been achieved on the need to eliminate important regional, sectoral, and income tax exemptions (see Appendix I). As a result, the net revenue yield of the tax reform over the coming years is estimated at around 1 percent of GDP, well below the authorities' original target of 3 percent of GDP.<sup>10</sup>

<sup>8</sup> Foreign-exchange purchases exceeded US\$1 billion in 2003 (slightly more than 1½ percent of GDP), virtually all of them sterilized (at a cost of about 0.1 percent of GDP). Such purchases have continued so far in 2004.

<sup>9</sup> These inflows reflected both continued strength in foreign direct investment, as well as a reversal in 2003 of short-term capital flows.

<sup>10</sup> This estimate excludes the positive effect of certain measures on tax administration.

- Reforms through mid-2003 included steps to: (i) widen the income tax base; (ii) rationalize excise taxes; (iii) lower tariffs; (iv) eliminate certain VAT exemptions; and (v) strengthen tax administration.
- In addition, a recent package of measures: (i) eliminates the special payroll tax (IES) at end-2004; (ii) reduces import tariffs further; (iii) limits corporate income tax deductions; (iv) eliminates the capital gains exemption on property sales; (v) simplifies the regime for small taxpayers; (vi) strengthens the tax base for municipalities; and (vii) includes steps to further bolster tax administration.<sup>11</sup>
- However, the plan to eliminate regional and sectoral tax exemptions faced significant resistance by the regions and in congress. To overcome it, the authorities have, in addition to seeking across-the-board legislation, encouraged individual regions to give up exemptions in exchange for increased resources for infrastructure spending.<sup>12</sup> Draft legislation that eliminates exemptions in two of the five regions with the most exemptions is making its way through congress, and discussions are underway with two other regions. Important sectoral exemptions, however, remain.
- The recent tax package also introduced—against the advice of staff—a financial transactions tax (FTT), which would take effect in March 2004 and last for three years (at a rate of 0.15 percent on most credit and debit transactions). In part, the FTT is to cover the cost of the decision to roll back in July 2004 the recent 1-percentage point VAT rate increase.<sup>13</sup> However, the congressional Committee on Constitutional Affairs' ruled in late January that the law establishing the tax is unconstitutional, which could lead to the modification or repeal of the tax. In any event, the VAT rate reduction will proceed as scheduled.
- **Decentralization.** Following a constitutional amendment in 2002 that mandated the decentralization of government, the authorities have developed a sound legal and economic framework for decentralization (Box 2).<sup>14</sup>
- **Pension reform.** In mid-2003, congress approved a series of measures aimed at fully funding *future* retirees' pensions under the preferential public pension regime (*Cédula*

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<sup>11</sup> The package was adopted by the government in December 2003/January 2004 after congress granted legislative powers to the executive (for 90 days) to enact tax reform.

<sup>12</sup> The resources transferred would be equivalent to the additional taxes collected as a result of the elimination of the exemptions.

<sup>13</sup> The higher VAT rate was originally set to remain in place through end-2004.

<sup>14</sup> A chapter in the SI paper addresses decentralization in Peru, in a regional perspective.

*Viva, CV*).<sup>15</sup> To address the large financial gap for *existing* CV retirees, a draft constitutional reform is being finalized that would modify constitutional acquired-rights clauses.<sup>16</sup>

- **Fiscal rules.** In early 2003, the law on Fiscal Responsibility and Transparency (LFRT) was amended to: (i) allow a more realistic adjustment period to the medium-term fiscal target following a recession; (ii) require automatic adjustments in fiscal policy when it is off-track in non-recessionary years; and (iii) extend rules of fiscal discipline to all levels of government
- **Privatization.** The structural reform agenda of the program included an ambitious privatization plan, but strong public opposition in mid-2002 led to its reorientation from asset sales to operating concessions. Progress with this reorientation has been slow and limited.
- **Financial system.** Prudential regulations and oversight have been strengthened further under the program, with focus on limiting the risks of dollarization, and banks' prudential indicators continued to improve in 2003.
  - The Superintendency of Banks (SBS) has strengthened norms on provisioning and loan classification (taking into account currency mismatches); introduced Value-at-Risk models for measuring exchange rate risk; and legislation was recently approved to implement credit exposure limits and strengthen the definition and measurement of capital (by deducting goodwill), in line with recommendations of the financial sector assessment program (FSAP).
  - The composition of broad money and credit has started to shift toward the local currency, and financial system credit to the private sector has picked up during the program period. Housing and consumer lending by banks has grown significantly, while large firms have increasingly sought financing from the domestic capital market (having mainly private pension funds, mutual funds, and insurance companies as the providers of resources).
- **Sectoral support lending.** Program limits on the consumer-lending scheme of the *Banco de la Nación* were met, but the scheme was extended beyond its original duration. The agrarian bank created in 2002 has operated under strict standards to protect public resources.

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<sup>15</sup> The measures raise contribution rates, cap pensions for future retirees, and subject existing CV pensions (above a certain threshold) to income taxes. The CV provides pensions to long-serving civil servants, congresspersons, and certain former employees of public enterprises and is closed to new entrants (except judges and magistrates).

<sup>16</sup> In April 2003, the constitutional court overruled (partially) previous reforms of the public pension system to limit survivors' benefits.

## II. OUTLOOK AND RISKS

10. **The medium-term outlook is for continued robust growth, low inflation, and a strong external position.** Staff's baseline scenario projects annual growth of 4 percent, assuming continued prudent macro policies and progress with structural reforms (Box 3).<sup>17</sup> Downside risks include stronger competition in global textile markets from 2005 onward and political uncertainty in the run up to the 2006 national elections. Upside risks arise from possible trade liberalization (including the FTAA) and a large gas export project.<sup>18</sup> Inflation is projected around the mid-point of the target band, and the official reserve position should continue to be strong. The main macroeconomic projections for 2004–05 are as follows:

Macroeconomic Framework

|  | 2002  | 2003<br>(estimate) | 2004<br>(projection) | 2005<br>(projection) |
|--|-------|--------------------|----------------------|----------------------|
| Real GDP growth (in percent)                         | 4.9   | 4.0                | 4.0                  | 4.5                  |
| Private sector investment (in percent of GDP)        | 15.6  | 15.8               | 15.7                 | 16.2                 |
| End-of-period inflation (in percent)                 | 1.5   | 2.5                | 2.0                  | 2.5                  |
| External current account deficit (in percent of GDP) | 2.1   | 1.7                | 1.4                  | 1.4                  |
| Overall fiscal deficit (in percent of GDP)           | 2.2   | 1.9                | 1.5                  | 1.0                  |
| Primary fiscal balance (in percent of GDP)           | -0.1  | 0.2                | 0.6                  | 1.2                  |
| NIR accumulation (in millions of US\$)               | 985   | 600                | -500 1/              | 100                  |
| Gross official reserve coverage of:                  |       |                    |                      |                      |
| U.S. dollar deposits in the banking system           | 101.3 | 107.7              | 100.3                | 99.8                 |
| Short-term external debt                             | 216.3 | 222.6              | 209.4                | 211.1                |
| Public sector debt-to-GDP (in percent)               | 47.1  | 46.8               | 46.1                 | 44.1                 |

1/ The loss of reserves reflects the use of funds from the government's 2003 prefinancing operation.

11. **Continued implementation of prudent macroeconomic policies and structural reforms will be a challenge.** Notwithstanding the difficult political environment, the government has been able to move forward with certain key elements of its economic agenda, but the recent experience with tax reform highlights the challenges faced by the authorities. Sustaining political support of the reform program will continue to be difficult, given the President's low approval ratings, weak consensus on the course of economic policy within the governing coalition, and likely pressures to raise government spending as the 2006 elections approach (Box 4). Progress in employment creation and poverty reduction would help foster a consensus for the government's economic program.

12. **Peru's medium-term public and external debt dynamics appear sustainable and fairly resilient to possible shocks.** The debt sustainability analysis (DSA) described in

<sup>17</sup> Growth would be export-led, with consumption and investment growing at moderate rates.

<sup>18</sup> Plans for this project (Camisea II) are well-advanced. If carried out, it would lead to significant investment and a boost to exports of almost 10 percent over the medium term. It would complement the soon-to-be completed Camisea I gas project, which is geared to the domestic market (substituting petroleum product imports).

Appendix II incorporates two additional scenarios that simulate partial adjustments in key macroeconomic variables in response to relevant shocks for Peru. The DSA shows that, with continued prudent macroeconomic policies, the outlook for external and public sector debt is quite robust. However, concerns could arise if a sustained economic slowdown is accompanied by higher fiscal deficits. Thus, the government's ability to run countercyclical fiscal policy will remain limited until the level of public debt is brought down further.

13. **Although the risks from the high public debt and financial dollarization have been diminishing, they are still present.** While the debt has been declining, it is still about 47 percent of GDP, with some 85 percent of it denominated in foreign currency. About 75 percent of banking system assets is denominated in foreign currency. Substantial buffers have been built up to mitigate these vulnerabilities, including a high level of official reserves (that covers 100 percent of the banking system's dollar-denominated liabilities) and a well-capitalized banking system.<sup>19</sup>

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

|  | 2000  | 2001  | 2002  | Est.<br>2003 | Proj.<br>2004 |
|--|-------|-------|-------|--------------|---------------|
| Public sector debt (percent of GDP)                              | 45.9  | 46.6  | 47.1  | 46.8         | 46.1          |
| Of which: in domestic currency (percent of GDP)                  | 4.6   | 4.7   | 5.6   | 5.6          | 7.4           |
| Share of foreign currency deposits in total deposits             | 76.9  | 74.3  | 73.2  | 70.4         | 68.3          |
| Share of foreign currency loans in total credit                  | 81.5  | 80.3  | 78.9  | 76.2         | 74.4          |
| Total external debt (percent of GDP)                             | 52.3  | 50.7  | 49.3  | 48.3         | 46.5          |
| Total external debt (percent of exports of goods and services)   | 327.1 | 319.3 | 302.9 | 280.7        | 255.2         |
| Total debt service (percent of exports of goods and services)    | 44.2  | 39.9  | 34.8  | 30.8         | 31.0          |
| Gross official reserves  |       |       |       |              |               |
| in percent of short-term external debt (residual maturity basis) | 155.6 | 147.3 | 216.3 | 222.6        | 209.4         |
| in percent of foreign currency deposits at banks                 | 92.5  | 93.5  | 101.3 | 107.7        | 100.3         |
| Risk-based capital asset ratio (in percent)                      | 12.9  | 13.2  | 12.7  | 13.8 1/      | ...           |

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

1/ Data for November 2003.

### III. POLICY DISCUSSIONS

14. **Staff commended the authorities for the substantial progress made in implementing recommendations of recent Article IV consultations.** The Board and staff have consistently urged the authorities to continue with fiscal consolidation and fiscal reforms to ensure a durable improvement in the public finances, maintain low inflation and a flexible exchange rate policy, and strengthen bank supervision, especially regarding the risks from dollar lending. They have also stressed the need for garnering the necessary political consensus for the policy agenda and for a strengthening of institutions and governance. Most of these recommendations have been implemented, reflecting strong ownership by the government of its economic program. Shortfalls occurred mainly where strong opposition

<sup>19</sup> A chapter in the SI paper looks at the risks of dollarization from a balance sheet approach.

from affected groups prevented more decisive progress (such as in tax reform) and where more time was needed to overcome skepticism in congress (e.g., the delays with proposed legislation to provide legal protection to bank supervisors reflect in part deeply entrenched fears of limiting the accountability of government officials). Fundamental reform of the public pension plan will likely require modification of constitutional rights, a difficult undertaking in any democratic political system.

15. **In this review and consultation discussion, there was broad agreement between the authorities and staff on the overall policy framework**, which remains centered on medium-term fiscal consolidation, inflation targeting, and structural reforms to reduce vulnerabilities and boost the economy's growth potential. Against this background, the review discussions focused on the macroframework for 2003–04, details of the fiscal reforms supported by the SBA, and steps to reduce vulnerabilities in the banking system.<sup>20</sup> In addition, the Article IV discussions took a wider perspective of the economy's medium-term growth and inflation performance and its ability to create employment and reduce poverty, which would in turn help strengthen the consensus on the policy framework.

#### A. Fiscal Policy

16. **The authorities' medium-term fiscal program aims at continued fiscal consolidation to reduce public debt, keep interest rates low, and provide room for countercyclical fiscal policy.** The authorities stressed that they remain committed to reducing the CPS deficit to 1 percent of GDP or less from 2005 onwards,<sup>21</sup> consistent with a substantial reduction of the public debt-to-GDP ratio over the medium term. They also noted the importance of strengthening the tax effort (which at 13 percent of GDP is low by regional standards) to fund critical social and infrastructure spending while maintaining the overall consolidation goal. Staff supported this objective, but regretted that the recent tax reform—while bringing important improvements to the tax system—will yield only about a third of the original revenue target.

17. **Staff also regretted the introduction of an FTT, even though its final design reflected some of staff's recommendations to limit its distortionary effects.** Experience has shown that such a tax distorts financial intermediation and thus undermines investment and growth. Staff also cautioned that the revenue gains from such a tax tend to be short-lived, and that its distortive effects could adversely affect tax revenues from other taxes. The authorities stressed the overall positive impact of the recent tax reform on revenues and growth.<sup>22</sup> Regarding the FTT, they felt that its distortive effects had been limited by applying it to a broad base of financial transactions, at a rate (0.15 percent) below that originally

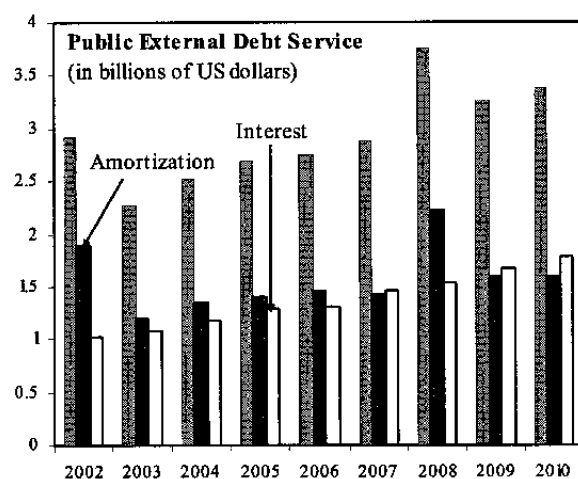
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<sup>20</sup> Box 5 summarizes the key issues for the fourth review.

<sup>21</sup> This path is in line with the recently revised LFRT that limits the fiscal deficit (in non-recessionary periods) to 1 percent of GDP.

<sup>22</sup> Regarding growth, they highlighted the importance of the reduction in the rate of the special payroll tax (IES) from 2 to 1.7 percent in 2004, and the elimination of the tax in 2005.

envisaged, and with a clear sunset provision (after three years).<sup>23</sup> They added that a key motivation for the tax was to help tax administration by providing access to bank information otherwise precluded by bank secrecy, together with a companion law requiring transactions above a certain threshold to be made through the banking system. The authorities pointed out that any additional spending from the FTT would be determined by actual revenue collections, and that such spending would be focused on non-recurring capital outlays. As a result, should the tax be repealed, this would not have implications for the fiscal deficit target.



18. **Fiscal decentralization is proceeding in a cautious and fiscally-sound manner.** Staff urged the authorities to resist pressures to accelerate the decentralization process, given the still limited capacity of subnational governments and control mechanisms. The mission recommended preparation of estimates of expenditures to be devolved to subnational governments, to minimize the risk of revenue/expenditure mismatches, and of unified legislation on the distribution, management, and monitoring of all intergovernmental transfers. The authorities agreed, noting the recent enactment of a key fiscal decentralization law,<sup>24</sup> and their commitment to minimizing fiscal risks and maximizing efficiency gains from decentralization. They explained that additional legislation is being prepared to establish performance evaluation mechanisms for regions' capacity to take on the spending responsibilities corresponding to increased transfers.

19. **The authorities' debt management strategy aims at reducing the currency and rollover risks of public debt.** The mission supported the authorities' intention to shift the structure of public debt toward local-currency instruments,<sup>25</sup> and to reduce a hump of debt service payments through longer-term foreign bond placements. Staff welcomed the

<sup>23</sup> Staff opposed the tax, but recommended that, if introduced, it should be imposed on a broad base of financial transactions, at a rate no higher than 0.05 percent, and with a sunset provision.

<sup>24</sup> The law was put in place on February 5 under the powers granted by congress to the executive to enact legislation on tax reform and decentralization.

<sup>25</sup> Although current international market conditions are favorable, shifting the financing of government toward the domestic market is prudent as those conditions can change abruptly and are sensitive to developments in other emerging market economies.

inclusion of collective-action clauses in a recent bond issue,<sup>26</sup> and supported the authorities' intention to avoid financing fiscal operations by tapping pension system reserve fund dollar deposits at the central bank, which form part of official reserves.

**20. Further progress on important public sector reforms will depend on difficult political negotiations.** Such progress is needed to create room for important social and infrastructure spending; continued efforts are also needed (with World Bank and IDB support) to improve the quality and targeting of anti-poverty programs.

- Staff supported the authorities' plan to reform the public pension system. As noted, this will likely require amending the constitution and, therefore, take time. In the meantime, the authorities are planning steps to contain costs and better control fraud in the system. They agreed with staff that some legislative proposals (e.g., allowing workers in the private system to return to the public one) risk weakening the system's finances, and noted that they are working with congress to stop them.
- Staff encouraged the authorities' efforts to develop a reform of the state, with assistance from the World Bank and IDB. A key objective is to overhaul the legal framework and remuneration scale for public sector employees. A framework law on public employment was recently passed by congress, with implementing legislation on public sector personnel management and reform of the public sector wage structure (among others) to be put in place in the next few months. In the meantime, a special commission is preparing a human resource management policy for the public sector, and the authorities plan to merge some small spending units and are undertaking a census to remove unregistered personnel from the payroll.
- Staff supported the authorities' plan to revitalize operating concessions and public-private partnerships (PPPs), to foster private-sector participation in infrastructure investments. The authorities agreed with staff on the need for continued transparent fiscal accounting of such operations, in line with that under the current program.<sup>27</sup>

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<sup>26</sup> In November 2003, the government placed a US\$500 million, 30-year global bond, at 375 basis points over comparable U.S. Treasuries. This issue prefinanced half of the envisaged international capital market placements in 2004; as a result, part of the official reserve increase in 2003 is expected to be unwound this year.

<sup>27</sup> Specifically, cash outlays related to PPPs should be recorded as expenditure in the year they occur, estimates of contingent costs should be recorded in budget documentation, and government guarantees for private-sector debt should be included in the government debt.



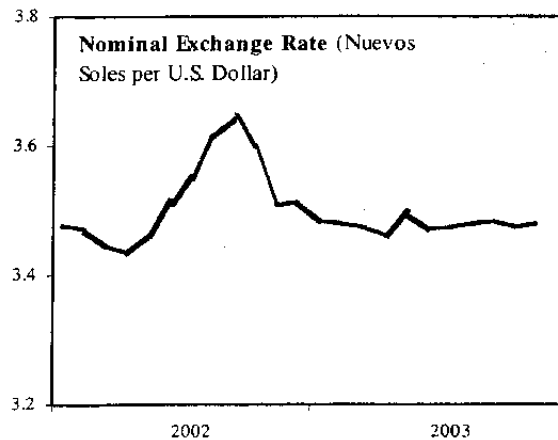
## B. Monetary and Exchange Rate Policies

21. **Monetary policy has been successful in keeping inflation within the target range.** Staff noted that there might be room for further interest rate cuts, given the favorable inflation outlook,<sup>28</sup> and the pressures for the *Nuevo Sol* to appreciate. The authorities explained that they were hesitant to reduce interest rates further due to the uncertainty surrounding the introduction of the FTT and the lags in the transmission mechanism of past interest rate cuts.

22. **The central bank's inflation target range balances the trade-off between flexibility and credibility.** In response to staff's questions on the appropriateness of the plus/minus 1-percent band around the medium-term target of 2.5 percent,<sup>29</sup> the authorities explained that the band was sufficiently wide as Peru has already achieved low inflation, and that a wider range might raise questions on their commitment to the inflation target.

23. **The central bank strongly defended its policy of intervening in the foreign exchange market during 2003.** Staff noted that the substantial purchases of foreign exchange by the central bank last year—while the dollar/*Nuevo Sol* exchange rate hardly moved—could be perceived as

establishing a floor for the exchange rate, which would be inconsistent with the stated policy of limiting intervention to smoothing excessive fluctuations in the exchange rate. The authorities argued that foreign exchange market conditions in 2003 provided a good opportunity to bolster official reserves, which was warranted given the potential external shocks and political uncertainties in the run up to the 2006 elections. They also explained that in case of a conflict between the



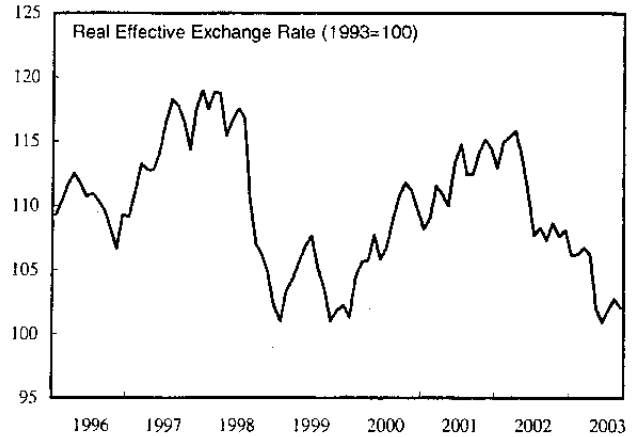
inflation target and the reserve accumulation goal, the inflation target would take precedence. Staff agreed that further reserve accumulation was a worthwhile objective; however—to be consistent with the inflation targeting framework and the flexible exchange rate regime—pursuing this objective should not be largely contingent on exchange market conditions. Staff suggested that the reserve objective be made transparent and stated in the central bank's inflation report, and the authorities agreed with these suggestions. Staff welcomed the authorities' continued commitment to prudent management of reserve requirements on dollar deposits (which form about one-third of official reserves).

<sup>28</sup> This is evidenced by core inflation in 2003 of 0.8 percent, recent survey results, and the central bank's own inflation model.

<sup>29</sup> This issue was raised by several Executive Directors in a recent Board meeting on Peru.

24. **External competitiveness appears adequate.** Staff agreed with the authorities that competitiveness does not appear to be an issue, evidenced by the decline since 2002 of the real effective exchange rate, the low current account deficit, and the strong export growth. Also, Peru competes little with other countries in the region that have experienced large real depreciations of their currencies. The medium-term outlook, which includes the opening of large mines and development of a natural gas industry, suggests that pressures could arise for appreciation of the equilibrium real exchange rate.

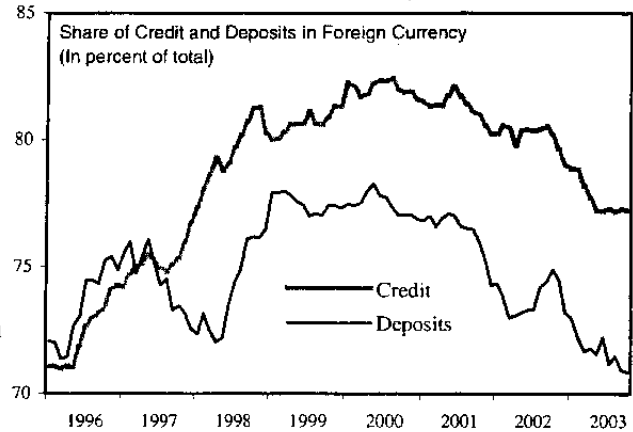
The real exchange rate has fallen to relatively low levels.



### C. Financial Sector Policies

25. **Reducing the high degree of financial dollarization is an important medium-term goal.** The authorities noted that dollarization is being gradually reduced through establishing a track record of economic stability, good bank supervision, and further development of domestic capital markets.<sup>30</sup> Staff welcomed the authorities' plan to hold an international seminar on de-dollarization in the second half of 2004. Staff also noted that the recent low volatility in the exchange rate might be discouraging further de-dollarization, by reducing the risk of holding dollar assets in terms of a consumption basket largely denominated in local currency. The authorities did not believe that this was a factor slowing the de-dollarization process, noting that there had been a significant variability of the exchange rate over the last few years.

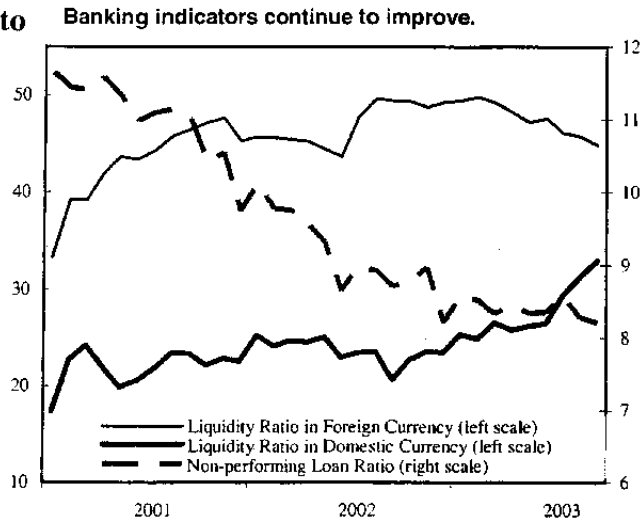
Dollarization ratios have been falling since 2000.



<sup>30</sup> They noted, in particular, the deepening public debt market in local currency and improved management of exchange rate risk by financial institutions as favoring de-dollarization.

**26. Bank supervision has continued to improve, although a few issues remain.**

The authorities explained that they will continue to work with congress toward early adoption of a law granting legal protection to bank supervisors. They noted that legislation on FSAP recommendations to strengthen the definition of regulatory capital (by excluding goodwill) and exposure limits have been approved by congress. Staff supported the authorities' intention to request a follow-up FSAP to evaluate the current regulatory framework.



**27. Domestic financial markets are deepening, but access to credit is still limited.**

Bank credit for housing, consumer loans, and small- and medium-sized enterprises has been picking up, but lending to corporate customers remains stagnant. Staff noted that access to credit remains limited and costly for most borrowers.<sup>31</sup> The authorities explained that corporates have relied increasingly on domestic capital markets, where they can borrow at longer maturities and lower interest rates than from banks. The authorities intend to address credit cost concerns by broadening collateral vehicles and strengthening the registry system; improving debt collection procedures; and setting up commercial courts and alternative commercial dispute resolution mechanisms.

**28. The private pension plan is growing, requiring continued upgrading of regulations.**<sup>32</sup> Staff welcomed recent regulatory changes designed to lower operational costs and broaden pension fund management options.<sup>33</sup> However, staff noted that the 9 percent limit on pension fund holdings of foreign assets is affecting the funds' profitability and distorting interest rates in the domestic capital market, and that an initiative to allow banks and other financial institutions to manage pension funds could complicate supervision. The authorities explained that the limit on foreign holdings (which was raised slightly last year) was needed to help develop the domestic capital market. They also explained that they are exploring ways to promote competition among private pension funds to reduce operating costs and commissions (which absorb about 30 percent of contributions). They agreed with staff that if other financial institutions are allowed to enter the market, it would require effective "firewalls" between pension fund and other operations.

<sup>31</sup> Prime lending rates are low (in both dollars and *Nuevo Soles*), but rates for consumers and small enterprises can reach as high as 40–50 percent (in *Soles*). Poor credit history registries and a weak loan recovery process are the main reasons for high rates in these sectors.

<sup>32</sup> Pension fund assets reached about 10 percent of GDP at end–2003.

<sup>33</sup> These steps include: auctions for management of survivor and disability insurance, and allowing pension funds to offer alternative investment plans with differentiated risk profiles.

29. **Government participation in the financial system should be phased out.** Staff argued that the agricultural bank (BA) and the special consumer-loan program of the state-owned commercial bank (BN) were unnecessary. BA lending has been limited by a dearth of eligible and creditworthy clients, yet there are political pressures to inject additional capital into the bank.<sup>34</sup> Also, with strong economic growth and consumer lending on the rise, the BN loan program is no longer needed. The authorities agreed with staff that the resources for recapitalizing the BA could be better spent on social and infrastructure needs, but argued that the BA and BN play useful roles for those without access to private financial institutions.

#### **D. Other Structural Reforms**

Boosting employment and reducing poverty in a lasting way will require additional structural reforms to open the economy further, reduce labor costs in the formal sector, and improve the climate for private investment.

30. **Continued trade opening will encourage investment and promote output growth.** Peru has a relatively open trade regime (rated 2 in the Fund's 1–10 trade restrictiveness index), with an average tariff of about 10 percent and no quantitative restrictions (though some agricultural products receive high levels of protection through a reference price system). Nonetheless, Peru's exports are heavily concentrated in minerals, with trade in goods and services equivalent only to about 35 percent of GDP.<sup>35</sup> Staff noted that diversification in the mining sector has buffered Peru's vulnerability to terms of trade shocks, but further diversification of the export base is critical to meeting Peru's growth and employment objectives. The authorities agreed and added that planned infrastructure improvements (e.g., through road concessions) would be important for promoting non-traditional agricultural exports. Staff welcomed Peru's ongoing participation in multilateral discussions in context of the WTO and FTAA, as well as the recent announcement that discussions will soon start on a free-trade agreement with the United States. The authorities noted that an agreement could make permanent their current favorable access to U.S. textile markets.

31. **Reducing the costs of labor market regulations is key for promoting formal employment and effectively protecting workers' rights.** Staff supported the decision to lower the special payroll tax rate in 2004 and eliminate it in 2005. Staff welcomed legislation in mid-2003 that reduced substantially non-wage labor costs (vacation and severance) for very small enterprises, and suggested to gradually extend it to larger firms. Staff also cautioned against further increases in the minimum wage, and urged swift reinstatement of the unemployment protection system that existed until end-2001—an important safeguard

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<sup>34</sup> The BA is subject to oversight by the SBS and the same regulations as other banks, and its quasi-fiscal activities are recorded in the budget.

<sup>35</sup> A chapter in the SI paper examines why trade levels in Peru are relatively low.

against the potential cost of reforms (such as further trade liberalization).<sup>36</sup> The authorities noted that tripartite discussions (workers, employers and the government) are well advanced on consolidating existing legislation in a new labor code, and that they are looking toward reinstating unemployment protection. They explained that there is flexibility in determining the size of the workforce, with relatively liberal legislation on part-time employment, temporary contracts, and work schedules, but they acknowledged that the quite high non-wage labor costs have led firms to offer fewer permanent positions and invest little in labor training.

**32. Improving the investment climate will require institutional reforms to strengthen property rights, contract enforcement, and the regulatory environment.** Staff welcomed the initiative to establish a commercial court system (with World Bank and IDB support) as a way to expedite business-related legal disputes, and encouraged the authorities to work with the World Bank and IDB to strengthen the legal framework for the independence of all regulatory agencies. The authorities also pointed to a range of other initiatives in their agenda for modernizing the state to reduce administrative barriers, particularly for establishing new firms, and to strengthen procurement procedures by state agencies.

#### **E. Other Issues**

**33. Fiscal Transparency and Data ROSCs.** Staff welcomed the authorities' commitment to implementing the main recommendations of the ROSCs (Box 6); although, the authorities noted that those requiring congressional approval could take time to implement. Staff also welcomed the authorities decision to publish the 2003 fiscal ROSC.

**34. The mission welcomed Peru's efforts to combat money laundering and the financing of terrorism.** An autonomous anti-money laundering unit, in charge of handling information on suspicious transactions related to a broad range of illegal activities (including the financing of terrorism), started operations in the second half of 2003. Peru has responded comprehensively to the Fund's voluntary anti-money laundering questionnaire.

#### **F. Ex-Post Assessment of Longer-Term Program Engagement (LTPE)<sup>37</sup>**

**35. An ex-post assessment of Peru's longer-term program engagement (LTPE) with the Fund was conducted.** It concluded that continued support of the authorities' economic program through a new (precautionary) SBA could be beneficial, given the favorable performance under the current SBA and the Fund's role in encouraging appropriate economic policy making. The authorities expressed a strong interest in a new arrangement with the

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<sup>36</sup> The minimum wage was increased by 12 percent in September 2003, in line with inflation and productivity growth since the last change more than three years ago. For details on the unemployment protection system, see Country Report No. 01/51.

<sup>37</sup> The report was prepared by a team led by Andrew Berg (RES), with representatives from FAD, PDR, and WHD, and is being sent as a background document.

Fund, agreeing with the assessment that Fund involvement had provided helpful guidance, in particular, for Peru's official and private creditors.

36. **The assessment noted, and the authorities agreed, that exiting from Fund-supported programs would take time.** Peru could benefit from Fund arrangements through the current political cycle, to support further progress on key reforms and give more time for entrenching sound economic policies. The authorities concurred that as an outside monitor, the Fund could continue to help create and sustain domestic consensus on a policy framework that ensures macroeconomic stability.

37. **The authorities stressed the benefits of the quantitative macroeconomic framework and associated conditionality, but argued against structural conditionality.** The assessment noted that Fund-supported programs over the period of engagement had featured structural benchmarks, and that in any follow-up program structural performance criteria should remain an option in case of incomplete implementation of envisaged reforms. The authorities stressed their firm commitment to structural reforms, but argued that inclusion of structural benchmarks in Fund-supported programs had been counterproductive, often focalizing opposition to the envisaged reform. They made clear, however, that while structural conditionality in Fund-supported programs sometimes created political tensions, this did not reduce their desire for a successor program.

38. **The LTPE suggests that key reforms under a successor program should include: (i) continued fiscal consolidation; (ii) policies to support further de-dollarization; and (iii) addressing key institutional weaknesses, such as those in public sector operations, labor markets, and the judicial system.** The authorities supported these principal policy conclusions. On dollarization, while they felt it was not a major vulnerability or constraint on monetary policy, they agreed that policies should aim at reducing it further. The authorities also noted that to make future technical assistance (TA) more effective, staff should include TA recommendations into program conditionality only if the recommendations were fully agreed by the authorities and were macro-critical.

#### IV. STAFF APPRAISAL

40. **Peru made significant progress in the 1990s in restoring macroeconomic stability and growth, a performance that has continued under the current SBA.** Despite a difficult political situation and an adverse external environment, growth has been strong, inflation low, and the external position robust. All but one end-December 2003 performance criteria were observed, and most structural benchmarks under the program were met. Major progress has been made in establishing a framework for decentralization and in strengthening financial regulation and supervision. There has also been broad tax reform, although the final stage of it fell short of the original goal. Domestic political considerations also led to a reorientation of the privatization agenda toward operating concessions and public-private partnerships, and progress with the revised agenda has been slow.

41. **Continued implementation of sound macroeconomic policies and structural reforms should sustain rapid growth over the medium term.** Fiscal consolidation should keep public debt dynamics under control, and monetary policy should continue to be guided

by the inflation-targeting framework and the flexible exchange rate regime. Future reforms need to concentrate on improving the efficiency of government spending, reinforcing the revenue effort, strengthening further financial system supervision, and improving the environment for private investment.

42. **The economic outlook remains favorable, although growth could be dampened by uncertainty and policy weakening in the run up to the 2006 national elections.** The baseline medium-term outlook foresees continued robust growth with low inflation and a sound external position. However, there are risks from the still relatively high public debt, the difficult political situation, and the high degree of financial dollarization—although Peru has built up important buffers against those vulnerabilities, most notably the high level of official reserves. Continued success in managing these risks will require steadfast implementation of the authorities' program, based on broad domestic consensus on the core elements of sound public finance, a strong banking sector, and outward-oriented, private-sector led growth.

43. **Fiscal consolidation is a key plank of the authorities' medium-term economic strategy.** The targeted reduction in the fiscal deficit to no more than one percent of GDP will set the public debt-to-GDP ratio on a firmly downward path. Achieving this objective would be facilitated by further actions to strengthen the tax effort and make expenditures more flexible, particularly by restraining growth in the wage bill and pensions.

44. **Although tax reform under the program has brought many improvements of the tax system, it fell short of the authorities' original objective, and staff regrets the introduction of the FTT.** Important improvements include a widening of the corporate income tax base, rationalization of excise taxes on petroleum products, tariff reductions, elimination of the special payroll tax by end-2004, and new withholding schemes to improve tax administration. However, progress on eliminating regional tax exemptions has been slow, and the authorities will need to persist in the negotiations with the regions on this issue. Staff hopes that a consensus can be found for the removal of sectoral tax exemptions and further broadening of the income tax base. The FTT risks distorting financial intermediation and thereby undermining growth, investment, and the collection of other taxes, and staff urges the authorities to eliminate this tax as soon as possible, and to monitor closely its impact on the financial system with a view to acting quickly by removing or revising the tax if needed.

45. **Careful implementation of decentralization, in a fiscally-neutral manner, is crucial for fiscal sustainability.** Staff welcomes the progress made in establishing a sound legal framework for the decentralization process, including the recent enactment of the law to guide fiscal decentralization. Staff encourages the authorities to continue working with the World Bank and IDB in implementing decentralization, in particular, the assignment of expenditure responsibilities. A close dialogue and consensus with the regions will be crucial for successful completion of this process.

46. **Reducing the currency and rollover risk of public debt is a focus of debt management.** Staff supports the authorities' intention to gradually shift the composition of public debt toward local-currency instruments and to extend amortization payments over the medium term, and welcomes the inclusion of CACs in their recent sovereign debt placement.

47. **Staff strongly encourages the authorities' plans to reform the public sector, including the preferential public pension regime.** The authorities will need to persevere in building the necessary consensus to reform this regime, which will likely require amending the constitution. Rationalizing public salaries and spending programs should help increase budget flexibility and create room for additional productive expenditure. Staff encourages the authorities to renew efforts to grant operating concessions for public works and pursue privatizations where feasible. In designing public-private partnerships for infrastructure investment, the authorities should make sure that the private sector shares appropriately in the project's risk and that these agreements are accounted for in a transparent manner.
48. **Staff supports the inflation targeting framework for monetary policy.** The benign inflation outlook should provide scope for a further moderate reduction of interest rates once the uncertainty surrounding the tax reform subsides. While the authorities' goal to raise official reserves further is appropriate, staff recommends that this goal be pursued in a transparent manner, allowing appropriate exchange-rate flexibility. Staff supports the authorities' continued commitment to avoid recourse to dollar deposits of the pension reserve fund held at the central bank to finance fiscal operations.
49. **The financial situation of banks continues to improve and bank oversight is being strengthened, with focus on managing the risks of dollar lending.** Staff welcomes the improved norms on provisioning and loan classification and the strengthened regulatory framework for dollar lending by domestic banks. Staff urges swift passage of the draft law to grant legal protection to bank supervisors in the execution of their duties.
50. **Investment restrictions for the growing private pension plan should be eased gradually.** Staff recommends that the limits on pension fund investments abroad be raised gradually to widen their investment options and remove the distorting effect these restrictions have on domestic interest rates.
51. **Staff commends the authorities' commitment to open trade.** The announcement that negotiations on a free-trade arrangement with the United States will begin in 2004 is welcomed, as is the authorities' continued support for multilateral trade discussions in the context of the WTO. Further trade liberalization will help Peru diversify its export base and encourage private investment.
52. **Flexible labor market regulations are key for promoting formal employment.** Existing labor regulations elevate non-wage labor costs and undermine formal employment, which in turn leaves a significant portion of the working population without adequate workplace and social protection. Staff supports the phased elimination of the special payroll tax rate. Staff welcomes the recent law to promote formal employment in very small enterprises by reducing regulations on vacation and severance pay, and urges the authorities to extend gradually this legislation to larger firms. Staff also recommends swift reinstatement of unemployment protection.
53. **Strengthening the investment climate requires institutional reforms to bolster the legal and regulatory environment.** Staff encourages the authorities to move forward with their plans to establish a commercial court system and to strengthen the legal framework for independent regulatory agencies.



54. **Peru's longer-term program engagement with the Fund has accompanied the restoration of macroeconomic stability, rapid growth, and important progress with structural reforms.** The authorities have expressed strong interest in continued Fund support of their economic program. Continued support through a new (precautionary) SBA could be beneficial, given the good progress made under the current SBA, the useful role that Fund support can play as an external anchor, and assuming a strong program focused on the key issues of fiscal consolidation, de-dollarization, and institutional reforms in the public sector, labor markets, and the judicial system.

55. **Economic statistics are timely and broadly adequate for program monitoring and surveillance.** Staff welcomes the recent publication of the data ROSC and the authorities' intention to publish the fiscal ROSC.

56. **In summary, Peru has performed well under the program supported by the Stand-By Arrangement, and staff recommends completion of the fourth review.** The overall stance of macroeconomic policy is appropriate, and notwithstanding the weaker-than-envisaged tax reform, significant progress has been made in implementing structural reforms under the program. Staff supports the authorities' request for a waiver for the nonobservance of the end-December 2003 performance criterion on the contracting of external public debt, as fiscal policy is on track, and the small deviation reflected the authorities' decision to take advantage of favorable capital market conditions to pre-finance 2004 budget operations.

57. It is recommended that the next Article IV consultation with Peru be held on the standard 12-month consultation cycle.

### **Box 1: Constraints on Investment: The Case of Agriculture**

**Notwithstanding natural advantages, Peru's agricultural sector is highly inefficient, attracts very little private investment, and produces almost exclusively for the domestic market.** Peru possesses a rich climate and land variety, as well as a large water supply, allowing for continuous production of different agricultural products throughout the year. These factors, together with relatively abundant labor and a liberal trade regime, are good conditions for a dynamic export-oriented agricultural sector. Nevertheless, Peru's agricultural exports (about 10 percent of total exports) are low relative to other countries with similar or even poorer resource endowments. At present, only 6 percent of arable coastal land is being used for modern agriculture.

**The poor performance of the agriculture sector, particularly exports, reflects structural and institutional problems related to poor infrastructure (ports and roads) and a weak legal and institutional framework that does not provide well-defined property rights.**

- **Infrastructure constraints.** Seaports do not have the capacity to handle a large-scale increase in agricultural exports, especially those requiring refrigeration. In addition, the road network to the ports is lacking. Both areas would benefit from private sector participation, and although the authorities are moving ahead with a PPP program for road concessions, progress has been slow.
- **Legal framework for water use.** Inefficiencies arise from the allocation of water in Peru, whereby farmers in the highlands draw water directly from natural sources at no charge. In times of low rainfalls, this can result in insufficient water supply from the mountains to the coastal growing areas, requiring more expensive irrigation methods. However, this issue involves sensitive social considerations, and governments have found it politically difficult to regulate and charge small farmers for water use. The current government is trying to build a consensus for legislation in this area.
- **Land titling and registration.** About 600,000 land holdings are in the possession of individuals and communities without properly defined ownership, especially in indigenous areas. In addition, the high fragmentation of land ownership makes it difficult, and risky, for potential investors to buy large extensions of land needed to make modern agricultural projects profitable.

**The weak institutional environment and poor infrastructure, together with political constraints, adversely affect the incentives of private investors and the financial sector to channel resources (financial, technological, and entrepreneurial) to the agricultural sector.** Until steps are taken to address these problems, production and export of agricultural goods in Peru will remain well below potential.

### **Box 2. Fiscal Decentralization in Peru**

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

#### **A cautious plan for the distribution of government revenue has been defined.**

- Taxing power has been limited to the central government and municipalities.
- The fiscal decentralization law establishes that in a first stage, regions will be funded through central government transfers earmarked for social and infrastructure spending. In a second stage, regions that agree to merge jurisdictions will receive 50 percent of the indirect taxes and personal income taxes collected in the merged region (in addition to the transfers from the center). To enter the second stage, the merged regions will need certification that they have the administrative capability to deliver public services. Subnational borrowing can only be used for infrastructure.

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

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

#### **Reporting requirements and fiscal rules are in place.**

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

### Box 3. Sources of Growth: The 1990s and Beyond

GDP growth in Peru during the period 1991–2003 averaged 3.9 percent (with GDP per capita rising by about 2 percent a year). Much of the growth was driven by capital accumulation. However, performance varied significantly during the subperiods 1993–97, 1998–2001, and 2002–03.

- 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, boosting growth to an annual rate of 7.1 percent. Factor productivity explained more than 40 percent of growth during this period.
- The period 1998–01 was marked by adverse external shocks, little progress in structural reforms, and domestic political events. These factors and a decline of total factor productivity combined to deter private investment (which contracted in each year) and limited growth to an average rate of 1.9 percent.
- In 2002–03, Peru's economy posted an important recovery in economic activity, with a moderate recovery in private investment.

**Peru should achieve continued average GDP growth of around 4 percent a year over the medium term.** This assumes that prudent macropolicies and steady progress with reforms continue. Standard growth accounting methodology suggests that the assumed medium-term growth path is consistent with historical productivity and factor growth.

**Growth could be higher if the authorities can garner the domestic support for a more ambitious structural reform agenda that would provide a more favorable environment for private investment and factor productivity growth.** Such reforms should aim at:

- Opening the economy further, which would expand opportunities in the export sector, both traditional and nontraditional (many of which are labor-intensive).
- Strengthening domestic institutions (especially the judiciary) to improve the legal climate for investment.
- Promoting greater labor market flexibility.
- Raising the efficiency of the public sector, in particular, through a revitalization of operating concessions (and privatization where possible).

#### **Box 4. Political Situation and Risks to the Authorities' Economic Program**

Political pressures continue for adopting policies that could undermine fiscal sustainability and market-oriented reforms (such as subsidizing or protecting particular sectors and regulating particular prices) and recent events in the region add to the uncertainty. The authorities' success in continuing to implement their economic program will depend on maintaining a consensus within the governing coalition, with congress, and with other stakeholders on key economic measures.

##### **Maintaining the course of economic policy has been challenging.**

- Violent protests broke out in June 2002 that led the authorities to abandon the privatization program. Strikes in May 2003 by public sector workers and protests by agricultural producers seeking increased state support led to the imposition of a nationwide state of emergency (that has since been lifted in most areas).
- Certain regional governments have resisted reforms on taxation and the decentralization process.
- The Supreme Court has issued contradictory rulings on key economic institutional issues that have made more uncertain the legal environment for investors.

**High income inequality and poverty, skewed against the indigenous population, is a potential source of instability**, as evidenced by recent events in some other countries in the region.<sup>38</sup>

- Eighty percent of the indigenous population and 50 percent of the non-indigenous population are poor.
- The rate of extreme poverty is three times higher among indigenous peoples than the rest of the population.
- Social indicators are highly disparate for these two groups (e.g., average years of schooling of indigenous peoples is only about three-fourths that of the non-indigenous population).

**Nevertheless, the authorities have been able to garner support in congress for many elements of their economic program, and at present there is no evidence of the social unrest that has affected Peru's neighbors.**

- Congress has supported key economic reform laws to: strengthen the law on fiscal responsibility and transparency (April 2003); contain the costs of the preferential public pension plan (July 2003); and delegate legislative authority to the government for a 90-day period to implement a comprehensive tax reform and enact laws to guide fiscal decentralization (September 2003).
- The indigenous population in Peru is more integrated in the economy (albeit mainly in the informal sector) and has not been as isolated politically as in some other countries in the region. President Toledo is making significant outreach efforts to the indigenous population.

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<sup>38</sup> Data sources are GRADE (*Grupo de Análisis para el Desarrollo*) and the World Bank. Indigenous people are defined as those whose first language is Quechua or Aymará.

### **Box 5. Key Issues for the Fourth Program Review**

The fourth program review focused on:

- Macroeconomic performance in 2003 and the framework for 2004.
- Completion of tax reform.
- Progress in implementing a sound decentralization process.
- Progress in implementing legal protection for bank supervisors.

Performance was generally satisfactory, although the tax reform fell short of the original program objectives.

- The macroframework is on track, and all end-December 2003 quantitative performance criteria were observed, except for a small deviation on the ceiling on the contracting of external public debt.
- The last phase tax reform was not as strong as originally envisaged. It brought important structural improvements of the tax system, but many sectoral tax exemptions remain, progress in eliminating regional tax exemptions has been slow, and the reform included a tax on financial transactions, against the staff's advice.

A key law to guide the fiscal decentralization process has been enacted.

All structural benchmarks for the review were met, except for that on legal protection for bank supervisors (recently approved by the Economic Commission in congress; with passage expected in 2004).

**Box 6. Main Recommendations of the Fiscal and Data ROSCs**

**The main fiscal ROSC recommendations were to:**

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

**The main data ROSC recommendations were to:**

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

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

| Amount of Purchase   | Availability Date | Conditions  |
|--|-------------------|---|
| 1. SDR 27.875 million<br>(cumulative available:<br>SDR 255 million) <sup>2</sup> | February 15, 2004 | Completion of the fourth review and observance of end-December 2003 performance criteria. |

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

<sup>2</sup> The authorities have treated the SBA as precautionary.



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

| Quantitative Performance Criteria   | March 31   | June 30    | Sept. 30   | Dec. 31    |
|---|------------|------------|------------|------------|
| (Cumulative amounts from December 31, 2002; in millions of Nuevos Soles)                                      |            |            |            |            |
| <b>Borrowing requirement of the combined public sector</b>  |            |            |            |            |
| Unadjusted limits   | 780        | 1,400      | 2,595      | 4,130      |
| Adjusted limits 1/  | 780        | 1,400      | 2,595      | 4,130      |
| Actual  | 302        | 1,090      | 2,042      | 3,802      |
| Margin  | 478        | 310        | 553        | 328        |
| <b>Net consumer lending of the Banco de la Nación</b>   |            |            |            |            |
| Limit   | -15        | 40         | 30         | 75         |
| Actual  | -8         | 8          | 15         | 74         |
| Margin  | -7         | 32         | 15         | 1          |
| (Cumulative amounts from December 31, 2002; in millions of U.S. dollars)                                      |            |            |            |            |
| <b>Net international reserves of the central reserve bank</b>   |            |            |            |            |
| Unadjusted targets  | 98         | -50        | -146       | -148       |
| Adjusted targets 1/   | 336        | -288       | -753       | -66        |
| Actual  | 646        | 338        | 228        | 957        |
| Margin  | 310        | 626        | 981        | 1,023      |
| <b>Short-term net external debt of the public sector</b>  |            |            |            |            |
| Limits  | 50         | 50         | 50         | 50         |
| Actual  | 0          | 0          | 0          | 0          |
| Margin  | 50         | 50         | 50         | 50         |
| <b>External payments arrears of the public sector (on a continuous basis) 2/</b>                              |            |            |            |            |
| Limits  | 0          | 0          | 0          | 0          |
| Actual  | 0          | 0          | 0          | 0          |
| Margin  | 0          | 0          | 0          | 0          |
| (Cumulative amounts from December 31, 2002; in millions of U.S. dollars)                                      |            |            |            |            |
| <b>Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year</b> |            |            |            |            |
| <b>Total</b>  |            |            |            |            |
| Unadjusted limits   | 950        | 1,680      | 2,015      | 2,200      |
| Adjusted limits 1/  | 950        | 1,680      | 2,015      | 2,575      |
| Actual  | 793        | 861        | 1,362      | 2,591      |
| Margin  | 157        | 819        | 653        | -16        |
| <i>Of which: 1- to 5-year maturity</i>  |            |            |            |            |
| Limits  | 250        | 250        | 250        | 250        |
| Actual  | 8          | 8          | 38         | 38         |
| Margin  | 242        | 242        | 212        | 212        |
| (Consultation band for the 12-month rate of inflation, in percent) 3/   |            |            |            |            |
| Outer band range  | -0.5 - 5.5 | -0.5 - 5.5 | -0.5 - 5.5 | -0.5 - 5.5 |
| Actual  | 3.4        | 2.2        | 2.0        | 2.5        |
| Inner band range  | 0.5 - 4.5  | 0.5 - 4.5  | 0.5 - 4.5  | 0.5 - 4.5  |

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

| Structural Benchmarks   | Target Date | Current Status       |
|---|-------------|----------------------|
| <b>2002</b>   |             |                      |
| Completion of draft legislation of a revision to the Law on Fiscal Transparency and Responsibility.   | March 31    | Completed            |
| SUNAT to carry out 3,400 tax audits of corporations and independent professionals.  | March 31    | Completed            |
| Submission to congress of a revision to the Law on Fiscal Transparency and Responsibility.  | June 30     | Completed            |
| Sale of four northern electricity distribution companies (JORBSA).  | June 30     | Delayed indefinitely |
| Privatization of electricity transmission company (ETECEN).   | June 30     | Completed            |
| SUNAT to carry out 6,800 tax audits of corporations and independent professionals.  | June 30     | Completed            |
| Submission to congress of legislation to include tax expenditures in the 2003 budget.   | June 30     | Completed            |
| Submission to congress of legislation eliminating regional tax exemptions.  | June 30     | Completed            |
| Sale of electricity generation company (EGASA).   | Sept. 30    | Delayed indefinitely |
| SUNAT to carry out 11,900 tax audits of corporations and independent professionals.   | Sept. 30    | Completed            |
| Submission to congress of legislation to provide the necessary statutory protection to SBS staff in the discharge of their responsibilities.  | Sept. 30    | Completed            |
| SUNAT to carry out 17,000 tax audits of corporations and independent professionals.   | Dec. 31     | Completed            |
| <b>2003</b>   |             |                      |
| Submission to congress of fiscal decentralization legislation consistent with the objectives for decentralization and for tax reform stated in the letter of intent dated March 17, 2003 (EBS/03/34).                         | June 30     | Completed            |
| Implementation of the revised rules on fiscal prudence and transparency.  | June 30     | Completed            |
| Granting statutory protection to SBS staff in the discharge of their responsibilities.  | June 30     | Pending              |
| Submission to congress of a 2004 budget consistent with the objectives for decentralization and for tax reform stated in the letter of intent dated March 17, 2003 and the revised rules on fiscal prudence and transparency. | Sept. 30    | Completed            |
| Identification of regional and sectoral tax exemptions to be phased out by end-2004 that in the 2003 budget are estimated to have an annualized cost of 0.4 percent of GDP.   | Sept. 30    | Completed            |

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

1/ The targets and limits were adjusted in accordance with the table attached to the letter of intent dated March 17, 2003 (Country Report No. 03/104).

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

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

Table 3. Peru: Selected Economic Indicators

|  | 2000  | 2001  | Rev.<br>Prog.<br>2002 | 2002  | Rev.<br>Prog. 1/<br>2003 | Est.<br>2003 | Proj.<br>2004 |
|--|-------|-------|-----------------------|-------|--------------------------|--------------|---------------|
| (Annual percentage change)                       |       |       |                       |       |                          |              |               |
| <b>Production, prices, and trade</b>             |       |       |                       |       |                          |              |               |
| Real GDP   | 2.8   | 0.3   | 3.7                   | 4.9   | 4.0                      | 4.0          | 4.0           |
| Real domestic demand                             | 2.4   | -0.5  | 3.3                   | 4.1   | 3.6                      | 3.7          | 3.7           |
| Consumer prices                                  |       |       |                       |       |                          |              |               |
| End of period                                    | 3.7   | -0.1  | 2.0                   | 1.5   | 2.5                      | 2.5          | 2.0           |
| Period average                                   | 3.8   | 2.0   | 0.4                   | 0.2   | 2.5                      | 2.3          | 2.1           |
| Exports (U.S. dollars)                           | 14.3  | 0.8   | 8.5                   | 9.1   | 11.1                     | 16.2         | 12.6          |
| Imports (U.S. dollars)                           | 9.1   | -1.8  | 3.1                   | 2.2   | 6.9                      | 10.1         | 5.2           |
| Terms of trade                                   | -2.1  | -1.8  | 3.2                   | 2.5   | 0.8                      | 1.8          | 5.1           |
| Real effective exchange rate (depreciation -) 2/ | 7.2   | 4.4   | ...                   | -5.5  | ...                      | -7.9         | ...           |
| <b>Money and credit 3/</b>                       |       |       |                       |       |                          |              |               |
| Liabilities to the private sector 4/             | 3.9   | 7.8   | ...                   | 9.3   | ...                      | 9.8          | 10.3          |
| Credit to the private sector 4/                  | -1.2  | -2.0  | ...                   | 2.9   | ...                      | 5.3          | 5.7           |
| (In percent of GDP, unless otherwise indicated)  |       |       |                       |       |                          |              |               |
| <b>Public sector</b>                             |       |       |                       |       |                          |              |               |
| General government current revenue               | 17.7  | 17.2  | 17.2                  | 17.2  | 16.9                     | 17.3         | 17.8          |
| <i>Of which</i> : Central government tax revenue | 12.0  | 12.2  | 11.8                  | 11.9  | 12.4                     | 12.8         | 13.6          |
| General government noninterest expenditure       | 18.4  | 17.9  | 17.6                  | 17.4  | 17.0                     | 17.3         | 17.4          |
| <i>Of which</i> : capital expenditure            | 3.8   | 3.3   | 3.0                   | 2.8   | 2.8                      | 2.6          | 2.9           |
| Combined public sector primary balance           | -0.9  | -0.1  | -0.2                  | -0.1  | 0.2                      | 0.2          | 0.6           |
| Interest due                                     | 2.3   | 2.2   | 2.1                   | 2.1   | 2.1                      | 2.1          | 2.1           |
| Combined public sector overall balance           | -3.2  | -2.4  | -2.3                  | -2.2  | -1.9                     | -1.9         | -1.5          |
| <b>Balance of payments</b>                       |       |       |                       |       |                          |              |               |
| Current account                                  | -2.9  | -2.2  | -2.2                  | -2.1  | -1.9                     | -1.7         | -1.4          |
| Capital and financial account                    | 2.7   | 3.0   | 4.4                   | 3.5   | 1.9                      | 2.5          | 0.5           |
| <b>Gross reserves</b>                            |       |       |                       |       |                          |              |               |
| in millions of U.S. dollars 5/                   | 8,562 | 8,837 | 9,942                 | 9,690 | 9,658                    | 10,198       | 9,698         |
| percent of short-term external debt 6/           | 155.6 | 147.3 | 189.8                 | 216.3 | 198.2                    | 222.6        | 209.4         |
| percent of foreign currency deposits at banks    | 92.5  | 93.5  | 103.0                 | 101.3 | 100.1                    | 107.7        | 100.3         |
| <b>Debt</b>                                      |       |       |                       |       |                          |              |               |
| Total external debt                              | 52.3  | 50.7  | 51.0                  | 49.3  | 48.6                     | 48.3         | 46.5          |
| Public debt                                      | 45.9  | 46.6  | 47.7                  | 47.1  | 45.6                     | 46.8         | 46.1          |
| Domestic   | 9.4   | 10.9  | 11.0                  | 10.3  | 9.6                      | 9.8          | 10.6          |
| External 7/                                      | 36.5  | 35.7  | 36.7                  | 36.8  | 36.0                     | 37.0         | 35.5          |
| <b>Savings and investment</b>                    |       |       |                       |       |                          |              |               |
| Gross domestic investment                        | 20.1  | 18.6  | 18.0                  | 18.4  | 18.3                     | 18.5         | 18.5          |
| Public sector                                    | 4.0   | 3.1   | 3.2                   | 2.8   | 2.9                      | 2.8          | 2.8           |
| Private sector                                   | 16.1  | 15.5  | 14.8                  | 15.6  | 15.4                     | 15.8         | 15.7          |
| National savings                                 | 17.2  | 16.4  | 15.8                  | 16.3  | 16.4                     | 16.9         | 17.1          |
| Public sector 8/                                 | 0.8   | 0.7   | 0.9                   | 0.6   | 0.9                      | 0.9          | 1.3           |
| Private sector                                   | 16.4  | 15.7  | 14.9                  | 15.7  | 15.4                     | 16.0         | 15.8          |
| External savings                                 | 2.9   | 2.2   | 2.2                   | 2.1   | 1.9                      | 1.7          | 1.4           |
| <b>Memorandum item:</b>                          |       |       |                       |       |                          |              |               |
| Nominal GDP (\$/ billions)                       | 186.8 | 188.2 | 196.9                 | 198.4 | 212.6                    | 211.8        | 225.8         |

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

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

2/ End of period. Based on Information Notice System. For 2003, data corresponds to November.

3/ Corresponds to the financial system. For 2003, data corresponds to November.

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

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

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

7/ Includes Central Reserve Bank of Peru debt.

8/ Excludes privatization receipts.

Table 4. Peru: Balance of Payments

|   | 2000          | 2001          | Rev.<br>Prog.<br>2002 | 2002          | Rev.<br>Prog. 1/<br>2003 | Est.<br>2003  | Proj.<br>2004 |
|---|---------------|---------------|-----------------------|---------------|--------------------------|---------------|---------------|
| (In millions of U.S. dollars)                           |               |               |                       |               |                          |               |               |
| <b>Current account</b>                                  | <b>-1,557</b> | <b>-1,183</b> | <b>-1,239</b>         | <b>-1,206</b> | <b>-1,134</b>            | <b>-1,013</b> | <b>-875</b>   |
| Merchandise trade                                       | -456          | -267          | 289                   | 207           | 585                      | 692           | 1,389         |
| Exports   | 6,951         | 7,007         | 7,713                 | 7,647         | 8,530                    | 8,886         | 10,008        |
| Traditional   | 4,821         | 4,742         | 5,269                 | 5,312         | 5,776                    | 6,284         | 7,092         |
| Nontraditional and others                               | 2,130         | 2,265         | 2,444                 | 2,335         | 2,754                    | 2,602         | 2,916         |
| Imports   | -7,407        | -7,273        | -7,424                | -7,440        | -7,945                   | -8,194        | -8,619        |
| Services, income, and current transfers (net)           | -1,101        | -916          | -1,528                | -1,414        | -1,718                   | -1,705        | -2,264        |
| Services  | -691          | -835          | -860                  | -948          | -850                     | -1,015        | -1,049        |
| Investment income                                       | -1,409        | -1,123        | -1,572                | -1,509        | -1,807                   | -1,860        | -2,339        |
| Current transfers                                       | 999           | 1,042         | 904                   | 1,043         | 939                      | 1,170         | 1,124         |
| <b>Financial and capital account</b>                    | <b>1,426</b>  | <b>1,600</b>  | <b>2,434</b>          | <b>1,987</b>  | <b>1,142</b>             | <b>1,518</b>  | <b>351</b>    |
| Public sector   | 280           | 392           | 1,081                 | 1,051         | 670                      | 901           | 202           |
| Disbursements 2/  | 1,485         | 1,343         | 2,941                 | 2,902         | 1,878                    | 2,345         | 1,600         |
| Amortization 2/   | -1,042        | -918          | -1,889                | -1,888        | -1,152                   | -1,189        | -1,339        |
| Other medium- and long-term public sector flows 3/      | -163          | -33           | 29                    | 37            | -56                      | -255          | -59           |
| Capital transfers (net)                                 | 0             | 0             | 0                     | 0             | 0                        | 0             | 0             |
| Privatization   | 229           | 267           | 245                   | 186           | 214                      | 10            | 10            |
| Private sector  | 917           | 941           | 1,110                 | 750           | 158                      | 607           | 139           |
| Foreign direct investment (FDI) excluding privatization | 581           | 803           | 1,677                 | 2,205         | 471                      | 1,187         | 912           |
| Other private capital                                   | 336           | 138           | -567                  | -1,456        | -313                     | -580          | -773          |
| Medium- and long-term loans                             | 962           | 197           | -339                  | -173          | 60                       | 57            | 331           |
| Portfolio investment                                    | -314          | -300          | -321                  | -495          | -177                     | -1,209        | -1,026        |
| Short-term flows to the financial system 4/             | -9            | -358          | 0                     | -474          | 0                        | 155           | -150          |
| Other short term flows (including errors and omissions) | -303          | 599           | 93                    | -313          | -96                      | 417           | 72            |
| <b>Financing</b>  | <b>131</b>    | <b>-417</b>   | <b>-1,195</b>         | <b>-781</b>   | <b>-8</b>                | <b>-505</b>   | <b>524</b>    |
| NIR flow (increase -)                                   | 190           | -448          | -1,250                | -832          | -40                      | -536          | 500           |
| Change in NIR (increase -)                              | 224           | -433          | -1,250                | -985          | -40                      | -600          | 500           |
| Valuation change  | 34            | 15            | 0                     | -153          | 0                        | -64           | 0             |
| Exceptional financing                                   | -59           | 31            | 55                    | 51            | 33                       | 31            | 24            |
| Debt relief 5/  | 0             | 33            | 55                    | 51            | 33                       | 31            | 24            |
| Rescheduling  | 0             | 53            | 0                     | 0             | 0                        | 0             | 0             |
| Change in arrears                                       | -59           | -56           | 0                     | 0             | 0                        | 0             | 0             |
| (In percent of GDP unless otherwise specified)          |               |               |                       |               |                          |               |               |
| <b>Memorandum items:</b>                                |               |               |                       |               |                          |               |               |
| Current account (CA) balance                            | -2.9          | -2.2          | -2.2                  | -2.1          | -1.9                     | -1.7          | -1.4          |
| FDI and private MLT capital (percent of CA deficit)     | 99.1          | 84.5          | 108.0                 | 168.5         | 46.8                     | 122.8         | 142.3         |
| Capital and financial account balance                   | 2.7           | 3.0           | 4.4                   | 3.5           | 1.9                      | 2.5           | 0.5           |
| Export value (US\$), percent change                     | 14.3          | 0.8           | 8.5                   | 9.1           | 11.1                     | 16.2          | 12.6          |
| Volume growth   | 10.5          | 5.8           | 6.5                   | 5.0           | 7.7                      | 8.3           | 7.6           |
| Price growth  | 3.4           | -4.7          | 1.9                   | 3.7           | 3.4                      | 7.3           | 4.7           |
| Import value (US\$), percent change                     | 9.1           | -1.8          | 3.1                   | 2.2           | 6.9                      | 10.1          | 5.2           |
| Volume growth   | 3.3           | 1.3           | 2.8                   | 1.0           | 4.4                      | 4.5           | 5.6           |
| Price growth  | 5.6           | -3.0          | 0.3                   | 1.2           | 2.5                      | 5.4           | -0.4          |
| GDP (millions of US\$)                                  | 53,513        | 53,636        | 55,943                | 56,423        | 59,535                   | 60,866        | 64,101        |
| Average exchange rate (S/. per US\$)                    | 3.49          | 3.51          | 3.52                  | 3.52          | 3.57                     | 3.48          | 3.52          |

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

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

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

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

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

5/ Debt relief from Paris Club creditors.

Table 5. Peru: External Financing Requirements and Sources

(In millions of U.S. dollars)

|   | 2000         | 2001         | Rev.<br>Prog.<br>2002 | 2002         | Rev.<br>Prog. 1/<br>2003 | Est.<br>2003 | Proj.<br>2004 |
|---|--------------|--------------|-----------------------|--------------|--------------------------|--------------|---------------|
| <b>1. Gross financing requirements</b>                          | <b>8,136</b> | <b>7,135</b> | <b>8,385</b>          | <b>8,040</b> | <b>5,814</b>             | <b>6,033</b> | <b>4,956</b>  |
| External current account deficit (excluding official transfers) | 1,557        | 1,183        | 1,239                 | 1,206        | 1,134                    | 1,013        | 875           |
| Debt amortization   | 6,477        | 5,502        | 5,896                 | 6,002        | 4,639                    | 4,484        | 4,581         |
| Medium- and long-term debt                                      | 1,980        | 1,762        | 2,794                 | 2,770        | 1,992                    | 1,894        | 2,159         |
| Public sector   | 1,042        | 918          | 1,889                 | 1,888        | 1,152                    | 1,189        | 1,339         |
| Multilateral 2/   | 532          | 335          | 397                   | 399          | 479                      | 486          | 564           |
| Bilateral   | 389          | 490          | 544                   | 541          | 617                      | 647          | 699           |
| Bonds and notes   | 109          | 83           | 940                   | 940          | 50                       | 50           | 67            |
| Other   | 12           | 10           | 8                     | 8            | 6                        | 6            | 9             |
| Private sector  | 938          | 844          | 905                   | 882          | 840                      | 701          | 820           |
| Short-term debt 3/  | 4,731        | 3,740        | 3,102                 | 3,232        | 2,647                    | 2,590        | 2,422         |
| Rescheduling and repayment of arrears 4/                        | 58           | 2            | 0                     | 0            | 0                        | 0            | 0             |
| Accumulation of NIR (flow)                                      | -189         | 448          | 1,250                 | 832          | 40                       | 536          | -500          |
| Change in gross reserves  | -165         | 276          | 1,105                 | 853          | -32                      | 508          | -500          |
| Payments of short-term liabilities incl. IMF                    | 92           | 158          | 138                   | 132          | 72                       | 92           | 4             |
| Other   | 34           | 15           | 7                     | -153         | 0                        | -64          | 0             |
| <b>2. Available financing</b>                                   | <b>7,713</b> | <b>7,050</b> | <b>8,012</b>          | <b>7,984</b> | <b>5,781</b>             | <b>5,629</b> | <b>4,932</b>  |
| Foreign direct investment (net)                                 | 810          | 1,070        | 1,922                 | 2,392        | 685                      | 1,197        | 922           |
| Privatization   | 229          | 267          | 245                   | 186          | 214                      | 10           | 10            |
| FDI   | 581          | 803          | 1,677                 | 2,206        | 471                      | 1,187        | 912           |
| Portfolio (net)   | -314         | -300         | -321                  | -495         | -177                     | -1,209       | -1,026        |
| Short-term assets (flow)  | 256          | 697          | -423                  | -152         | -200                     | 374          | 0             |
| Debt financing from private creditors                           | 5,675        | 4,273        | 5,755                 | 5,185        | 4,351                    | 4,424        | 4,009         |
| Medium- and long-term financing                                 | 1,935        | 1,041        | 2,457                 | 2,595        | 1,600                    | 2,002        | 1,665         |
| To public sector  | 35           | 0            | 1,891                 | 1,886        | 700                      | 1,245        | 515           |
| To private sector   | 1,900        | 1,041        | 566                   | 709          | 900                      | 757          | 1,150         |
| Short-term financing  | 3,740        | 3,232        | 3,298                 | 2,590        | 2,751                    | 2,422        | 2,344         |
| Official creditors 5/   | 1,450        | 1,343        | 1,050                 | 1,016        | 1,178                    | 1,098        | 1,085         |
| Multilateral 2/   | 794          | 1,105        | 822                   | 807          | 895                      | 895          | 833           |
| Of which: balance of payments financing                         | 461          | 876          | 617                   | 625          | 674                      | 860          | 791           |
| Bilateral   | 656          | 238          | 228                   | 209          | 283                      | 203          | 252           |
| To public sector  | 656          | 238          | 228                   | 209          | 283                      | 203          | 252           |
| Of which: balance of payments financing                         | 300          | 0            | 0                     | 0            | 0                        | 0            | 0             |
| To private sector   | 0            | 0            | 0                     | 0            | 0                        | 0            | 0             |
| Other medium- and long-term public sector flows 6/              | -163         | -33          | 29                    | 37           | -56                      | -255         | -58           |
| IMF   | 0            | 0            | 0                     | 0            | 0                        | 0            | 0             |
| Accumulation of arrears (exceptional)                           | 0            | 0            | 0                     | 0            | 0                        | 0            | 0             |
| <b>3. Financing gap</b>   | <b>423</b>   | <b>85</b>    | <b>373</b>            | <b>56</b>    | <b>33</b>                | <b>404</b>   | <b>24</b>     |
| Other flows 7/  | 423          | 85           | 373                   | 56           | 33                       | 404          | 24            |
| Errors and omissions  | 423          | 52           | 318                   | 5            | 0                        | 373          | 0             |
| Debt relief   | 0            | 33           | 55                    | 51           | 33                       | 31           | 24            |

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

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

2/ Excluding IMF.

3/ Original maturity of less than one year. Equals stock at the end of the previous period.

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

5/ Includes both loans and grants.

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

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

Table 6. Peru: Monetary Survey

|  | 2000           | 2001           | Rev.<br>Prog.<br>2002 | 2002           | Rev.<br>Prog. 1/<br>2003 | Prel.<br>2003  | 2004           |
|--|----------------|----------------|-----------------------|----------------|--------------------------|----------------|----------------|
| <b>I. Central Reserve Bank</b>                         |                |                |                       |                |                          |                |                |
| (In millions of Nuevos Soles at program exchange rate) |                |                |                       |                |                          |                |                |
| <b>Net international reserves 2/</b>                   | <b>28,739</b>  | <b>29,803</b>  | <b>33,368</b>         | <b>32,214</b>  | <b>32,627</b>            | <b>34,722</b>  | <b>34,588</b>  |
| (In millions of U.S. dollars)                          | 8,022          | 8,324          | 9,426                 | 9,100          | 9,139                    | 9,726          | 9,826          |
| <b>Net domestic assets</b>                             | <b>-24,201</b> | <b>-24,858</b> | <b>-27,771</b>        | <b>-26,602</b> | <b>-26,498</b>           | <b>-28,353</b> | <b>-27,816</b> |
| Net credit to nonfinancial public sector               | -9,390         | -8,758         | -10,217               | -10,003        | -9,579                   | -10,854        | -8,546         |
| Rest of banking system                                 | -12,488        | -13,695        | -14,996               | -14,286        | -14,373                  | -15,023        | -14,585        |
| Other  | -2,323         | -2,405         | -2,558                | -2,313         | -2,546                   | -2,476         | -4,685         |
| <b>Currency</b>  | <b>4,537</b>   | <b>4,945</b>   | <b>5,597</b>          | <b>5,612</b>   | <b>6,129</b>             | <b>6,369</b>   | <b>6,772</b>   |
| <b>II. Banking System</b>                              |                |                |                       |                |                          |                |                |
| (In millions of Nuevos Soles at program exchange rate) |                |                |                       |                |                          |                |                |
| <b>Net foreign assets</b>                              | <b>26,555</b>  | <b>28,503</b>  | <b>31,824</b>         | <b>32,141</b>  | <b>32,552</b>            | <b>34,764</b>  | <b>33,045</b>  |
| <b>Net domestic assets</b>                             | <b>21,043</b>  | <b>21,004</b>  | <b>20,112</b>         | <b>19,257</b>  | <b>22,009</b>            | <b>19,211</b>  | <b>23,179</b>  |
| Net credit to nonfinancial public sector               | -11,297        | -9,351         | -10,400               | -10,464        | -10,290                  | -11,148        | -10,204        |
| Credit to private sector                               | 49,112         | 47,611         | 47,458                | 46,550         | 49,841                   | 45,721         | 47,295         |
| Other  | -16,772        | -17,256        | -16,946               | -16,829        | -17,542                  | -15,362        | -13,912        |
| Net credit to COFIDE                                   | -2,395         | -1,732         | -1,367                | -1,265         | -1,275                   | -1,187         | -1,187         |
| Other  | -14,377        | -15,524        | -15,579               | -15,564        | -16,267                  | -14,175        | -12,725        |
| <b>Liabilities to the private sector</b>               | <b>47,598</b>  | <b>49,507</b>  | <b>51,936</b>         | <b>51,398</b>  | <b>54,561</b>            | <b>53,975</b>  | <b>56,224</b>  |
| (12-month percentage change) 3/                        |                |                |                       |                |                          |                |                |
| Base money   | -4.0           | 7.9            | 11.0                  | 11.0           | 8.0                      | 9.6            | 7.0            |
| Broad money  | 2.3            | 4.9            | 4.2                   | 4.4            | 5.5                      | 1.9            | 5.4            |
| Domestic currency                                      | 2.5            | 13.7           | 10.1                  | 10.2           | 11.9                     | 10.3           | 11.0           |
| Foreign currency                                       | 2.2            | 1.1            | 1.2                   | 1.5            | 2.1                      | -2.5           | 2.1            |
| Credit to private sector                               | -3.6           | -2.6           | 0.6                   | -1.3           | 6.4                      | -1.7           | 4.6            |
| Domestic currency                                      | 0.9            | 2.7            | 3.0                   | 7.2            | 11.3                     | 5.8            | 15.0           |
| Foreign currency                                       | -4.5           | -3.8           | 0.0                   | -3.4           | 5.1                      | -3.7           | 1.5            |
| <b>III. Financial System</b>                           |                |                |                       |                |                          |                |                |
| (In millions of Nuevos Soles at program exchange rate) |                |                |                       |                |                          |                |                |
| <b>Net foreign assets</b>                              | <b>26,708</b>  | <b>30,931</b>  | ...                   | <b>37,354</b>  | ...                      | <b>42,961</b>  | <b>48,309</b>  |
| <b>Net domestic assets</b>                             | <b>29,180</b>  | <b>29,503</b>  | ...                   | <b>27,156</b>  | ...                      | <b>30,382</b>  | <b>30,240</b>  |
| Net credit to the public sector                        | -11,600        | -8,581         | ...                   | -9,697         | ...                      | -9,594         | -12,169        |
| Credit to private sector                               | 60,374         | 59,191         | ...                   | 60,422         | ...                      | 64,027         | 67,040         |
| Other  | -19,594        | -21,106        | ...                   | -23,570        | ...                      | -24,051        | -24,631        |
| <b>Liabilities to the private sector</b>               | <b>55,888</b>  | <b>60,435</b>  | ...                   | <b>64,510</b>  | ...                      | <b>73,343</b>  | <b>78,549</b>  |
| (12-month percentage change) 3/                        |                |                |                       |                |                          |                |                |
| Liabilities to the private sector                      | 3.9            | 7.8            | ...                   | 9.3            | ...                      | 9.8            | 10.3           |
| Domestic currency                                      | 6.4            | 18.0           | ...                   | 17.2           | ...                      | 17.5           | 17.5           |
| Foreign currency                                       | 2.3            | 1.0            | ...                   | 3.2            | ...                      | 2.9            | 2.9            |
| Credit to private sector                               | -1.2           | -2.0           | ...                   | 2.9            | ...                      | 5.3            | 5.7            |
| Domestic currency                                      | 2.3            | 5.6            | ...                   | 18.9           | ...                      | 15.2           | 15.2           |
| Foreign currency                                       | -2.2           | -4.2           | ...                   | -2.2           | ...                      | 1.5            | 1.5            |
| <b>Memorandum item:</b>                                |                |                |                       |                |                          |                |                |
| Program exchange rate (S/ per US\$)                    | 3.60           | 3.58           | 3.54                  | 3.54           | 3.57                     | 3.57           | 3.52           |

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

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

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

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

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

|  | 2000        | 2001        | Rev.<br>Prog.<br>2002 | 2002        | Rev.<br>Prog.<br>2003 | 1/<br>Est.<br>2003 | Proj.<br>2004 |
|--|-------------|-------------|-----------------------|-------------|-----------------------|--------------------|---------------|
| <b>Central government primary balance</b>                      | <b>-0.5</b> | <b>-0.7</b> | <b>-0.3</b>           | <b>-0.2</b> | <b>0.0</b>            | <b>0.2</b>         | <b>0.6</b>    |
| <b>Revenue</b>   | 15.0        | 14.4        | 14.5                  | 14.4        | 14.3                  | 14.8               | 15.3          |
| Current  | 14.7        | 14.2        | 14.4                  | 14.3        | 14.2                  | 14.7               | 15.3          |
| <i>Of which: tax revenue 2/</i>                                | 12.0        | 12.2        | 11.8                  | 11.9        | 12.4                  | 12.8               | 13.6          |
| <i>Of which: financial transactions tax</i>                    | ...         | ...         | ...                   | ...         | ...                   | ...                | 1.0           |
| Capital  | 0.3         | 0.2         | 0.2                   | 0.2         | 0.1                   | 0.1                | 0.1           |
| <b>Noninterest expenditure</b>                                 | 15.5        | 15.1        | 14.8                  | 14.6        | 14.3                  | 14.6               | 14.7          |
| Current  | 12.7        | 12.7        | 12.6                  | 12.6        | 12.3                  | 12.7               | 12.7          |
| Capital  | 2.8         | 2.4         | 2.2                   | 2.0         | 2.0                   | 1.8                | 2.0           |
| <b>Rest of the general government primary balance</b>          | <b>0.1</b>  | <b>0.2</b>  | <b>0.0</b>            | <b>0.1</b>  | <b>-0.1</b>           | <b>-0.1</b>        | <b>-0.1</b>   |
| <b>Revenue</b>   | 5.6         | 5.7         | 5.7                   | 5.7         | 5.5                   | 5.6                | 5.6           |
| Current  | 5.4         | 5.5         | 5.6                   | 5.7         | 5.5                   | 5.6                | 5.6           |
| Capital  | 0.1         | 0.1         | 0.1                   | 0.1         | 0.0                   | 0.0                | 0.0           |
| <b>Noninterest expenditure</b>                                 | 5.5         | 5.5         | 5.7                   | 5.6         | 5.6                   | 5.7                | 5.7           |
| Current  | 4.5         | 4.6         | 4.8                   | 4.9         | 4.8                   | 4.9                | 4.9           |
| <i>Of which: amortization recognition pension bonds</i>        | 0.1         | 0.1         | 0.1                   | 0.1         | 0.2                   | 0.3                | 0.3           |
| Capital  | 1.0         | 0.9         | 0.8                   | 0.8         | 0.8                   | 0.8                | 0.9           |
| <b>Public enterprise primary balance</b>                       | <b>-0.5</b> | <b>0.2</b>  | <b>0.0</b>            | <b>-0.1</b> | <b>0.2</b>            | <b>0.0</b>         | <b>0.1</b>    |
| Current balance  | 0.2         | 0.6         | 0.4                   | 0.2         | 0.5                   | 0.4                | 0.5           |
| Capital balance  | -0.7        | -0.4        | -0.4                  | -0.3        | -0.4                  | -0.4               | -0.4          |
| <b>Nonfinancial public sector primary balance</b>              | <b>-0.9</b> | <b>-0.4</b> | <b>-0.2</b>           | <b>-0.4</b> | <b>0.2</b>            | <b>0.0</b>         | <b>0.0</b>    |
| <b>Central bank operating balance</b>                          | <b>0.0</b>  | <b>0.2</b>  | <b>0.1</b>            | <b>0.2</b>  | <b>0.1</b>            | <b>0.1</b>         | <b>0.1</b>    |
| <b>Combined public sector primary balance</b>                  | <b>-0.9</b> | <b>-0.1</b> | <b>-0.2</b>           | <b>-0.1</b> | <b>0.2</b>            | <b>0.2</b>         | <b>0.6</b>    |
| <b>Interest payments</b>                                       | 2.3         | 2.2         | 2.1                   | 2.1         | 2.1                   | 2.1                | 2.1           |
| External   | 1.9         | 1.9         | 1.8                   | 1.8         | 1.8                   | 1.8                | 1.8           |
| Domestic   | 0.3         | 0.3         | 0.3                   | 0.3         | 0.3                   | 0.3                | 0.3           |
| <b>Combined public sector overall balance</b>                  | <b>-3.2</b> | <b>-2.4</b> | <b>-2.3</b>           | <b>-2.2</b> | <b>-1.9</b>           | <b>-1.9</b>        | <b>-1.5</b>   |
| <b>Financing</b>   | 3.2         | 2.4         | 2.3                   | 2.2         | 1.9                   | 1.9                | 1.5           |
| External   | 1.2         | 0.9         | 2.1                   | 2.1         | 1.2                   | 1.7                | 0.4           |
| Disbursements 3/   | 2.4         | 2.5         | 3.7                   | 5.1         | 3.0                   | 3.8                | 2.4           |
| (In millions of U.S. dollars)                                  | 1,299       | 1,319       | 2,056                 | 2,863       | 1,800                 | 2,298              | 1,550         |
| Amortizations  | -1.2        | -1.4        | -1.7                  | -3.3        | -1.9                  | -1.9               | -2.0          |
| (In millions of U.S. dollars)                                  | -636        | -768        | -925                  | -1,837      | -1,111                | -1,148             | -1,301        |
| Rescheduling/arrears (net)                                     | -0.1        | 0.0         | 0.0                   | 0.0         | 0.0                   | 0.0                | 0.0           |
| Condonations   | 0.1         | -0.1        | 0.1                   | 0.3         | 0.1                   | -0.2               | 0.0           |
| <b>Domestic</b>  | 1.2         | 0.8         | -0.5                  | -0.7        | 0.1                   | 0.2                | 1.1           |
| Bond placements  | ...         | 0.6         | 0.5                   | 0.5         | 0.7                   | 0.8                | 0.9           |
| (In millions of U.S. dollars)                                  | ...         | 348         | 267                   | 267         | 431                   | 509                | 560           |
| Amortizations  | -0.3        | -0.2        | -0.2                  | -0.2        | -0.6                  | -0.6               | -0.6          |
| (In millions of U.S. dollars)                                  | -161        | -131        | -125                  | -138        | -370                  | -379               | -356          |
| Net deposits   | 1.5         | 0.4         | -0.8                  | -0.9        | 0.0                   | 0.0                | 0.7           |
| (In millions of U.S. dollars)                                  | 798         | 226         | -436                  | -504        | -20                   | -28                | 480           |
| <b>Privatization</b>   | 0.8         | 0.6         | 0.7                   | 0.8         | 0.7                   | 0.1                | 0.0           |
| (In millions of U.S. dollars)                                  | 409         | 327         | 400                   | 421         | 400                   | 54                 | 20            |
| <b>Memorandum items:</b>                                       |             |             |                       |             |                       |                    |               |
| Adjusted overall fiscal deficit (pension recognition bonds) 4/ | -3.3        | -2.3        | -2.4                  | -2.2        | -1.9                  | -1.7               | -1.3          |
| Tax on assets on public enterprises                            | ...         | 0.3         | 0.3                   | 0.2         | 0.0                   | 0.0                | 0.0           |
| General government current revenue 5/                          | 17.7        | 17.2        | 17.2                  | 17.2        | 16.9                  | 17.3               | 17.8          |
| General government noninterest expenditure 5/                  | 18.4        | 17.9        | 17.6                  | 17.4        | 17.0                  | 17.3               | 17.4          |
| Public sector debt-to-GDP                                      | 45.9        | 46.6        | 47.7                  | 47.1        | 45.6                  | 46.8               | 46.1          |

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

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

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

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

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

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

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

|  | 2000        | 2001        | Rev.<br>Prog.<br>2002 | 2002        | Rev.<br>Prog. 1/<br>2003 | Est.<br>2003 | Proj.<br>2004 |
|--|-------------|-------------|-----------------------|-------------|--------------------------|--------------|---------------|
| <b>Current primary balance</b>               | <b>2.0</b>  | <b>1.5</b>  | <b>1.8</b>            | <b>1.6</b>  | <b>1.9</b>               | <b>1.9</b>   | <b>2.6</b>    |
| Current revenue                              | 14.7        | 14.2        | 14.4                  | 14.3        | 14.2                     | 14.7         | 15.3          |
| Tax revenue 2/                               | 12.0        | 12.2        | 11.8                  | 11.9        | 12.4                     | 12.8         | 13.6          |
| Direct taxes                                 | 3.3         | 3.4         | 3.2                   | 3.2         | 3.5                      | 4.0          | 3.8           |
| Indirect taxes                               | 8.7         | 8.8         | 8.6                   | 8.7         | 8.9                      | 8.8          | 9.9           |
| <i>Of which</i> : financial transactions tax | ...         | ...         | ...                   | ...         | ...                      | ...          | 1.0           |
| Other current revenue 3/                     | 2.8         | 2.0         | 2.6                   | 2.4         | 1.8                      | 1.8          | 1.6           |
| Current noninterest expenditure              | 12.7        | 12.7        | 12.6                  | 12.6        | 12.3                     | 12.7         | 12.7          |
| Labor services 4/                            | 6.6         | 6.7         | 6.7                   | 6.7         | 6.4                      | 6.7          | 6.6           |
| Goods and nonlabor services                  | 3.8         | 3.8         | 3.5                   | 3.4         | 3.4                      | 3.4          | 3.4           |
| Transfers and other                          | 2.3         | 2.2         | 2.4                   | 2.5         | 2.6                      | 2.6          | 2.7           |
| <b>Capital balance</b>                       | <b>-2.5</b> | <b>-2.2</b> | <b>-2.0</b>           | <b>-1.9</b> | <b>-1.8</b>              | <b>-1.7</b>  | <b>-1.9</b>   |
| Capital revenue                              | 0.3         | 0.2         | 0.2                   | 0.2         | 0.1                      | 0.1          | 0.1           |
| Capital expenditure                          | 2.8         | 2.4         | 2.2                   | 2.0         | 2.0                      | 1.8          | 2.0           |
| Gross capital formation                      | 2.5         | 2.1         | 1.9                   | 1.8         | 1.8                      | 1.6          | 1.8           |
| Other  | 0.3         | 0.3         | 0.3                   | 0.2         | 0.1                      | 0.2          | 0.2           |
| <b>Primary balance</b>                       | <b>-0.5</b> | <b>-0.7</b> | <b>-0.3</b>           | <b>-0.2</b> | <b>0.0</b>               | <b>0.2</b>   | <b>0.6</b>    |
| Interest payments                            | 2.2         | 2.2         | 2.0                   | 2.0         | 2.0                      | 2.0          | 2.0           |
| External                                     | 1.9         | 1.9         | 1.8                   | 1.8         | 1.8                      | 1.7          | 1.8           |
| Domestic                                     | 0.3         | 0.2         | 0.3                   | 0.2         | 0.3                      | 0.2          | 0.2           |
| <b>Net lending</b>                           | <b>0.0</b>  | <b>0.0</b>  | <b>0.0</b>            | <b>0.0</b>  | <b>0.0</b>               | <b>0.0</b>   | <b>0.0</b>    |
| <b>Overall balance</b>                       | <b>-2.7</b> | <b>-2.8</b> | <b>-2.3</b>           | <b>-2.2</b> | <b>-2.0</b>              | <b>-1.7</b>  | <b>-1.4</b>   |
| <b>Memorandum items:</b>                     |             |             |                       |             |                          |              |               |
| General government tax revenue 2/            | 12.2        | 12.4        | 12.1                  | 12.1        | 12.7                     | 13.1         | 13.9          |
| Primary balance before transfers             | 0.9         | 1.2         | 1.8                   | 1.9         | 2.4                      | 2.7          | 3.2           |
| Overall balance before transfers             | -1.3        | -1.0        | -0.3                  | -0.1        | 0.4                      | 0.8          | 1.2           |
| Tax compliance rate 5/                       | 78.6        | 82.8        | ...                   | 87.2        | ...                      | ...          | ...           |

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

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

2/ Net of tax on assets of public enterprises and of central government IES payments.

3/ The decline in 2003 reflects lower collections on the recovery of illicit funds from officials of the previous administration and special large fines paid by mining companies in 2002.

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

5/ Measured as the ratio between paid tax obligations and total tax obligations. Obligations covered are VAT and income taxes for large taxpayers only. Preliminary estimates suggest that tax compliance further strengthened in 2003.



Table 9 . Peru: Public Sector Social Expenditure

|  | 1999        | 2000        | 2001        | 2002        | 2003<br>Est. |
|--|-------------|-------------|-------------|-------------|--------------|
| (In percent of general government expenditure) |             |             |             |             |              |
| <b>Total social expenditure and pensions</b>   | <b>48.5</b> | <b>48.9</b> | <b>50.4</b> | <b>53.0</b> | <b>53.3</b>  |
| Universal coverage (Education and Health) 1/   | 18.6        | 18.5        | 18.9        | 20.7        | 22.2         |
| Education                                      | 12.9        | 13.0        | 13.7        | 14.8        | 15.5         |
| Health   | 5.7         | 5.5         | 5.2         | 5.8         | 6.8          |
| Targeted programs (Extreme Poverty)            | 8.9         | 7.9         | 7.9         | 7.3         | 7.2          |
| Non-Targeted Social Programs                   | 20.9        | 22.5        | 23.6        | 25.0        | 23.8         |
| ESSALUD  | 6.8         | 7.4         | 7.3         | 7.7         | 7.4          |
| Pensions                                       | 13.9        | 15.2        | 16.2        | 17.2        | 16.3         |
| Housing Development Program (FONAVI)           | 0.2         | 0.0         | 0.1         | 0.1         | 0.0          |
| (In percent of GDP)                            |             |             |             |             |              |
| <b>Total social expenditure and pensions</b>   | <b>10.2</b> | <b>10.1</b> | <b>10.1</b> | <b>10.3</b> | <b>10.3</b>  |
| Universal coverage (Education and Health) 1/   | 3.9         | 3.8         | 3.8         | 4.0         | 4.3          |
| Education                                      | 2.7         | 2.7         | 2.7         | 2.9         | 3.0          |
| Health   | 1.2         | 1.1         | 1.0         | 1.1         | 1.3          |
| Targeted programs (Extreme Poverty)            | 1.9         | 1.6         | 1.6         | 1.4         | 1.4          |
| Non-Targeted Social Programs                   | 4.4         | 4.6         | 4.7         | 4.9         | 4.6          |
| ESSALUD  | 1.4         | 1.5         | 1.5         | 1.5         | 1.4          |
| Pensions                                       | 2.9         | 3.1         | 3.2         | 3.3         | 3.2          |
| Housing Development Program (FONAVI)           | 0.1         | 0.0         | 0.0         | 0.0         | 0.0          |
| <b>Memorandum items:</b>                       |             |             |             |             |              |
| (In millions of soles)                         |             |             |             |             |              |
| General government expenditure                 | 36,684      | 38,477      | 37,808      | 38,668      | 40,847       |
| Nominal GDP                                    | 174,719     | 186,756     | 188,172     | 198,436     | 211,809      |
| (In percent of GDP)                            |             |             |             |             |              |
| Defense and national security                  | 2.8         | 2.9         | 2.5         | 2.2         | 2.3          |
| Justice  | 0.4         | 0.4         | 0.4         | 0.4         | 0.4          |

Source: Peruvian authorities

1/ Net of spending on education and health already included in the extreme poverty programs.

Table 10. Peru: Financing of the Combined Public Sector

|                                     | 2001          | Rev.<br>Prog.<br>2002 | 2002          | Rev.<br>Prog. 1/<br>2003 | Est.<br>2003  | Proj.<br>2004 |
|-------------------------------------|---------------|-----------------------|---------------|--------------------------|---------------|---------------|
| (In millions of U.S. dollars)       |               |                       |               |                          |               |               |
| <b>Combined balance</b>             | <b>-1,267</b> | <b>-1,281</b>         | <b>-1,243</b> | <b>-1,185</b>            | <b>-1,184</b> | <b>-983</b>   |
| <b>Financing</b>                    | <b>1,267</b>  | <b>1,281</b>          | <b>1,243</b>  | <b>1,185</b>             | <b>1,184</b>  | <b>983</b>    |
| <b>Net External</b>                 | 479           | 1,186                 | 1,169         | 722                      | 1,029         | 274           |
| Disbursements 2/                    | 1,319         | 2,056                 | 2,863         | 1,800                    | 2,298         | 1,550         |
| Bonds                               | 0             | 989                   | 1,886         | 750                      | 1,245         | 500           |
| Multilaterals                       | 1,105         | 774                   | 807           | 895                      | 704           | 600           |
| Bilaterals and other                | 214           | 293                   | 170           | 155                      | 349           | 450           |
| Amortizations 2/                    | -768          | -925                  | -1,837        | -1,111                   | -1,148        | -1,301        |
| Condonation                         | -72           | 55                    | 143           | 33                       | -121          | 25            |
| <b>Privatization</b>                | 327           | 400                   | 421           | 400                      | 54            | 20            |
| <b>Net Domestic financing</b>       | 461           | -305                  | -347          | 63                       | 101           | 689           |
| Bonds                               | 348           | 267                   | 267           | 431                      | 509           | 560           |
| Amortizations                       | -131          | -125                  | -138          | -370                     | -379          | -356          |
| Other                               | 226           | -436                  | -504          | -20                      | -28           | 480           |
| <i>Of which: Central government</i> | 228           | -424                  | -471          | 43                       | -98           | 422           |
| (In percent of GDP)                 |               |                       |               |                          |               |               |
| <b>Combined balance</b>             | <b>-2.4</b>   | <b>-2.3</b>           | <b>-2.2</b>   | <b>-1.9</b>              | <b>-1.9</b>   | <b>-1.5</b>   |
| <b>Financing</b>                    | 2.4           | 2.3                   | 2.2           | 1.9                      | 1.9           | 1.5           |
| <b>Net External</b>                 | 0.9           | 2.1                   | 2.1           | 1.2                      | 1.7           | 0.4           |
| Disbursements 2/                    | 2.5           | 3.7                   | 5.1           | 3.0                      | 3.8           | 2.4           |
| Bonds                               | 0.0           | 1.8                   | 3.3           | 1.2                      | 2.0           | 0.8           |
| Multilaterals                       | 2.1           | 1.4                   | 1.4           | 1.5                      | 1.2           | 0.9           |
| Bilaterals and other                | 0.4           | 0.5                   | 0.3           | 0.3                      | 0.6           | 0.7           |
| Amortizations 2/                    | -1.4          | -1.7                  | -3.3          | -1.8                     | -1.9          | -2.0          |
| Condonation                         | -0.1          | 0.1                   | 0.3           | 0.1                      | -0.2          | 0.0           |
| <b>Privatization</b>                | 0.6           | 0.7                   | 0.8           | 0.7                      | 0.1           | 0.0           |
| <b>Net Domestic financing</b>       | 0.8           | -0.5                  | -0.7          | 0.1                      | 0.2           | 1.1           |
| Bonds                               | 0.6           | 0.5                   | 0.5           | 0.7                      | 0.8           | 0.9           |
| Amortizations                       | -0.2          | -0.2                  | -0.2          | -0.6                     | -0.6          | -0.6          |
| Other                               | 0.4           | -0.8                  | -0.9          | 0.0                      | -0.0          | 0.7           |
| <i>Of which: Central government</i> | 0.4           | -0.8                  | -0.8          | 0.1                      | -0.2          | 0.6           |

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

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

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

Table 11. Peru: Financial and External Vulnerability Indicators  
(In percent; unless otherwise indicated)

|   | 2000  | 2001  | Rev.<br>Prog.<br>2002 | 2002  | Rev.<br>Prog. 1/<br>2003 | Est. Proj.<br>2003 | 2004  |
|---|-------|-------|-----------------------|-------|--------------------------|--------------------|-------|
| <b>Financial indicators</b>   |       |       |                       |       |                          |                    |       |
| Public sector debt/GDP  | 45.9  | 46.6  | 47.7                  | 47.1  | 45.6                     | 46.8               | 46.1  |
| <i>Of which:</i> in domestic currency (percent of GDP)                              | 4.6   | 4.7   | 7.1                   | 5.6   | 6.5                      | 5.6                | 7.4   |
| 90-day prime lending rate, domestic currency (end of period)                        | 15.4  | 5.0   | ...                   | 5.1   | ...                      | 3.3                | ...   |
| 90-day prime lending rate, foreign currency (end of period)                         | 8.2   | 3.1   | ...                   | 2.4   | ...                      | 1.7                | ...   |
| Velocity of money 2/  | 3.9   | 3.8   | 3.9                   | 3.9   | 3.9                      | 4.0                | 4.0   |
| Credit to the private sector/GDP 3/   | 32.3  | 31.5  | ...                   | 30.4  | ...                      | 30.2               | 29.7  |
| Share of foreign currency deposits in total deposits                                | 76.9  | 74.3  | 74.1                  | 73.2  | 71.9                     | 70.4               | 68.3  |
| Share of foreign currency loans in total credit                                     | 81.5  | 80.3  | 80.1                  | 78.9  | 78.1                     | 76.2               | 74.4  |
| Nonperforming loans/total loans 4/ 5/   | 11.2  | 11.0  | ...                   | 9.1   | ...                      | 8.3                | ...   |
| Loan-loss provisions/nonperforming loans 4/ 5/                                      | 78.5  | 91.1  | ...                   | 112.2 | ...                      | 116.2              | ...   |
| Risk-based capital-assets ratio (end of period) 4/                                  | 12.9  | 13.2  | ...                   | 12.7  | ...                      | 13.8               | ...   |
| Foreign currency deposits at commercial banks (in millions of U.S. dollars)         | 9,260 | 9,451 | 9,655                 | 9,562 | 9,646                    | 9,565              | 9,675 |
| Commercial banks' short-term foreign assets (in millions of U.S. dollars)           | 824   | 748   | 977                   | 779   | 789                      | 779                | 779   |
| Commercial banks' short-term foreign liabilities (in millions of U.S. dollars)      | 1,519 | 1,161 | 1,451                 | 763   | 827                      | 763                | 763   |
| <b>External indicators</b>  |       |       |                       |       |                          |                    |       |
| Exports, U.S. dollars (percent change)  | 14.3  | 0.8   | 8.5                   | 9.1   | 11.1                     | 16.2               | 12.6  |
| Imports, U.S. dollars (percent change)  | 9.1   | -1.8  | 3.1                   | 2.2   | 6.9                      | 10.1               | 5.2   |
| Terms of trade (percent change)   | -2.1  | -1.8  | 3.2                   | 2.5   | 0.8                      | 1.8                | 5.1   |
| Real effective exchange rate, (end of period, percent change) 4/                    | 7.2   | 4.4   | ...                   | -5.5  | ...                      | -7.9               | ...   |
| Current account balance (percent of GDP)  | -2.9  | -2.2  | -2.2                  | -2.1  | -1.9                     | -1.7               | -1.4  |
| Capital and financial account balance (percent of GDP)                              | 2.7   | 3.0   | 4.4                   | 3.5   | 1.9                      | 2.5                | 0.5   |
| Total external debt (percent of GDP)  | 52.3  | 50.7  | 51.0                  | 49.3  | 48.6                     | 48.3               | 46.5  |
| Medium- and long-term public debt (percent of GDP) 6/                               | 36.5  | 35.7  | 36.7                  | 36.8  | 36.0                     | 37.0               | 35.5  |
| Medium- and long-term private debt (percent of GDP)                                 | 8.8   | 8.9   | 8.4                   | 7.9   | 8.0                      | 7.4                | 7.5   |
| Short-term public and private debt (percent of GDP)                                 | 7.0   | 6.0   | 5.9                   | 4.6   | 4.6                      | 4.0                | 3.5   |
| Total external debt (percent of exports of goods and services) 6/                   | 327.1 | 319.3 | 309.3                 | 302.9 | 284.5                    | 280.7              | 255.2 |
| Total debt service (percent of exports of goods and services) 7/                    | 44.2  | 39.9  | 35.5                  | 34.8  | 34.7                     | 30.8               | 31.0  |
| Gross official reserves (in millions of U.S. dollars)                               | 8,562 | 8,837 | 9,942                 | 9,690 | 9,658                    | 10,198             | 9,698 |
| Gross official reserves, percent of short-term external debt 8/                     | 155.6 | 147.3 | 189.8                 | 216.3 | 198.2                    | 222.6              | 209.4 |
| Gross official reserves, percent of broad money 9/                                  | 64.0  | 62.1  | 68.0                  | 65.2  | 62.4                     | 66.9               | 64.7  |
| Gross official reserves, percent of foreign currency deposits at banks              | 92.5  | 93.5  | 103.0                 | 101.3 | 100.1                    | 107.7              | 100.3 |
| Gross official reserves (in months of imports<br>of goods and services)             | 10.7  | 10.7  | 11.5                  | 10.8  | 10.3                     | 10.8               | 9.7   |
| Net international reserves (in millions of U.S. dollars)                            | 8,180 | 8,613 | 9,863                 | 9,598 | 9,638                    | 10,198             | 9,698 |
| Net international reserves (program definition;<br>in millions of U.S. dollars) 10/ | 4,891 | 5,056 | 5,593                 | 5,674 | 5,526                    | 6,486              | 5,815 |
| Net international position (in millions of U.S. dollars) 11/                        | 2,624 | 2,915 | 3,110                 | 3,341 | 3,341                    | 4,583              | 4,583 |
| <b>Financial market indicators</b>  |       |       |                       |       |                          |                    |       |
| Stock market index (U.S. dollars)   | 342.8 | 342.1 | ...                   | 396.0 | ...                      | 700.6              | ...   |
| Foreign currency debt rating (Moody's)  | Ba3   | Ba3   | ...                   | Ba3   | ...                      | Ba3                | ...   |
| Spread of Peruvian Brady bonds, basis points 12/                                    | 687   | 521   | ...                   | 610   | ...                      | 312                | ...   |

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

1/ Program numbers revised during the second program review, Country Report 03/104.

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

3/ Corresponds to the financial system.

4/ For 2003, data corresponds to November.

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

6/ Includes Central Reserve Bank of Peru debt.

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

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

9/ At end-period exchange rate.

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

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

12/ Over U.S. Treasury bond yields of comparable maturity.

Table 12. 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)   |             |       |       |       |       |       |       |       |       |       |       |       |
| <b>Current account</b>  | -1.2        | -1.2  | -1.0  | -0.9  | -0.9  | -0.9  | -0.8  | -1.0  | -1.0  | -1.0  | -1.1  | -1.1  |
| Merchandise trade   | -0.3        | 0.2   | 0.7   | 1.4   | 1.5   | 1.7   | 1.9   | 2.1   | 2.3   | 2.6   | 2.9   | 3.2   |
| Exports   | 7.0         | 7.6   | 8.9   | 10.0  | 10.7  | 11.5  | 12.4  | 13.4  | 14.4  | 15.6  | 16.8  | 18.1  |
| Imports   | -7.3        | -7.4  | -8.2  | -8.6  | -9.2  | -9.8  | -10.5 | -11.3 | -12.1 | -13.0 | -13.9 | -14.9 |
| Services  | -0.8        | -0.9  | -1.0  | -1.0  | -1.0  | -1.1  | -1.1  | -1.2  | -1.3  | -1.4  | -1.5  | -1.5  |
| Investment income   | -1.1        | -1.5  | -1.9  | -2.3  | -2.6  | -2.7  | -2.8  | -3.1  | -3.3  | -3.5  | -3.7  | -3.9  |
| Current transfers   | 1.0         | 1.0   | 1.2   | 1.1   | 1.1   | 1.2   | 1.2   | 1.2   | 1.2   | 1.2   | 1.2   | 1.2   |
| <b>Capital and financial account</b>                                  | 1.6         | 2.0   | 1.5   | 0.4   | 1.0   | 1.0   | 1.0   | 1.2   | 1.1   | 1.1   | 1.2   | 1.2   |
| Public sector   | 0.4         | 1.1   | 0.9   | 0.2   | 0.6   | 0.5   | 0.5   | 0.5   | 0.4   | 0.5   | 0.4   | 0.9   |
| Disbursements 1/  | 1.3         | 2.9   | 2.3   | 1.6   | 2.1   | 2.0   | 1.9   | 2.8   | 2.0   | 2.1   | 2.1   | 4.1   |
| Amortization due 1/   | -0.9        | -1.9  | -1.2  | -1.3  | -1.4  | -1.5  | -1.4  | -2.2  | -1.6  | -1.6  | -1.7  | -3.2  |
| Other medium- and long-term public flows 2/                           | 0.0         | 0.0   | 0.6   | -0.1  | -0.1  | -0.1  | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   |
| Private sector  | 1.2         | 0.9   | 0.1   | 0.1   | 0.4   | 0.5   | 0.5   | 0.7   | 0.7   | 0.7   | 0.8   | 0.4   |
| Privatization receipts from direct investment                         | 0.3         | 0.2   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   |
| Direct investment, excluding privatization                            | 0.8         | 2.2   | 1.2   | 0.9   | 1.2   | 1.2   | 0.8   | 0.9   | 1.1   | 1.3   | 1.5   | 1.3   |
| Other 3/  | 0.1         | -1.5  | -0.6  | -0.8  | -0.8  | -0.7  | -0.3  | -0.2  | -0.4  | -0.6  | -0.7  | -0.9  |
| <b>Overall balance</b>  | 0.4         | 0.8   | 0.5   | -0.5  | 0.1   | 0.1   | 0.2   | 0.2   | 0.1   | 0.1   | 0.1   | 0.1   |
| Change in central bank reserves                                       | -0.4        | -0.8  | -0.5  | 0.5   | -0.1  | -0.1  | -0.2  | -0.2  | -0.1  | -0.1  | -0.1  | -0.1  |
| 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 1/ 5/                                     | 39.9        | 34.8  | 30.8  | 31.0  | 32.3  | 31.3  | 31.0  | 34.6  | 29.3  | 27.4  | 26.7  | 32.1  |
| Public external debt service 1/ 5/                                    | 23.6        | 31.7  | 21.7  | 21.5  | 21.7  | 20.5  | 19.8  | 24.0  | 19.3  | 18.5  | 18.4  | 24.5  |
| (In months of next year's imports of goods and services)              |             |       |       |       |       |       |       |       |       |       |       |       |
| Gross reserves  | 10.7        | 10.8  | 10.8  | 9.7   | 9.2   | 8.6   | 8.2   | 7.8   | 7.4   | 6.9   | 6.5   | 6.1   |
| (In percent of short-term external debt on a residual-maturity basis) |             |       |       |       |       |       |       |       |       |       |       |       |
| Gross reserves  | 147.3       | 216.3 | 222.6 | 209.4 | 211.1 | 208.6 | 181.2 | 207.7 | 212.5 | 209.7 | 164.4 | 215.2 |
| (In percent of broad money)   |             |       |       |       |       |       |       |       |       |       |       |       |
| Gross reserves  | 62.1        | 65.2  | 66.9  | 64.7  | 66.0  | 66.9  | 68.5  | 70.1  | 71.0  | 71.9  | 72.8  | 73.7  |
| (In percent of GDP)   |             |       |       |       |       |       |       |       |       |       |       |       |
| Current account deficit   | -2.2        | -2.1  | -1.7  | -1.4  | -1.4  | -1.2  | -1.1  | -1.2  | -1.2  | -1.1  | -1.1  | -1.1  |
| Merchandise exports   | 13.1        | 13.6  | 14.6  | 15.6  | 15.7  | 16.1  | 16.3  | 16.6  | 16.8  | 17.0  | 17.3  | 17.5  |
| Merchandise imports   | -13.6       | -13.2 | -13.5 | -13.4 | -13.5 | -13.7 | -13.8 | -13.9 | -14.1 | -14.2 | -14.3 | -14.5 |
| Total external debt   | 50.7        | 49.3  | 48.3  | 46.5  | 45.7  | 43.8  | 41.7  | 39.8  | 37.9  | 36.2  | 34.6  | 33.6  |
| Total medium- and long-term public external debt 6/                   | 35.7        | 36.8  | 37.0  | 35.5  | 34.6  | 33.0  | 31.7  | 30.5  | 29.2  | 28.0  | 26.7  | 26.0  |

Table 12 (continued). Peru: Medium-Term Outlook

|   | 2001        | 2002        | Projections |             |             |             |             |             |             |             |             |             |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
|   |             |             | 2003        | 2004        | 2005        | 2006        | 2007        | 2008        | 2009        | 2010        | 2011        | 2012        |
| <b>II. Output and Prices</b>                  |             |             |             |             |             |             |             |             |             |             |             |             |
| (Annual percentage change)                    |             |             |             |             |             |             |             |             |             |             |             |             |
| Real GDP                                      | 0.3         | 4.9         | 4.0         | 4.0         | 4.5         | 4.0         | 4.0         | 4.0         | 4.0         | 4.0         | 4.0         | 4.0         |
| Real domestic demand                          | -0.5        | 4.1         | 3.7         | 3.7         | 4.4         | 3.8         | 3.9         | 3.9         | 3.8         | 3.8         | 3.8         | 3.8         |
| <i>Of which:</i>                              |             |             |             |             |             |             |             |             |             |             |             |             |
| Private consumption                           | 1.4         | 4.5         | 3.4         | 3.5         | 4.2         | 3.0         | 3.9         | 3.9         | 3.8         | 3.8         | 3.8         | 3.8         |
| Private investment                            | -4.5        | 0.2         | 5.4         | 5.6         | 6.6         | 3.0         | 4.0         | 4.0         | 4.0         | 4.0         | 4.0         | 4.0         |
| Consumer prices (end of period)               | -0.1        | 1.5         | 2.5         | 2.0         | 2.5         | 2.5         | 2.5         | 2.5         | 2.5         | 2.5         | 2.5         | 2.5         |
| (In percent of GDP)                           |             |             |             |             |             |             |             |             |             |             |             |             |
| <b>III. Savings and Investment</b>            |             |             |             |             |             |             |             |             |             |             |             |             |
| <b>Gross domestic investment</b>              | <b>18.6</b> | <b>18.4</b> | <b>18.5</b> | <b>18.5</b> | <b>19.0</b> | <b>19.5</b> | <b>19.5</b> | <b>19.4</b> | <b>19.4</b> | <b>19.3</b> | <b>19.3</b> | <b>19.3</b> |
| Public sector                                 | 3.1         | 2.8         | 2.8         | 2.8         | 2.8         | 2.8         | 2.8         | 2.8         | 2.9         | 2.9         | 2.9         | 2.9         |
| Private sector                                | 15.5        | 15.6        | 15.8        | 15.7        | 16.2        | 16.7        | 16.6        | 16.6        | 16.5        | 16.5        | 16.4        | 16.4        |
| <b>National savings</b>                       | <b>16.4</b> | <b>16.3</b> | <b>16.9</b> | <b>17.1</b> | <b>17.6</b> | <b>18.3</b> | <b>18.4</b> | <b>18.2</b> | <b>18.2</b> | <b>18.2</b> | <b>18.2</b> | <b>18.2</b> |
| Public sector <sup>7/</sup>                   | 0.7         | 0.6         | 0.9         | 1.3         | 1.8         | 1.8         | 1.8         | 1.8         | 1.9         | 1.9         | 1.9         | 1.9         |
| Private sector                                | 15.7        | 15.7        | 16.0        | 15.8        | 15.8        | 16.5        | 16.6        | 16.4        | 16.3        | 16.3        | 16.3        | 16.3        |
| <b>External savings</b>                       | <b>2.2</b>  | <b>2.1</b>  | <b>1.7</b>  | <b>1.4</b>  | <b>1.4</b>  | <b>1.2</b>  | <b>1.1</b>  | <b>1.2</b>  | <b>1.2</b>  | <b>1.1</b>  | <b>1.1</b>  | <b>1.1</b>  |
| <b>IV. Combined Public Sector</b>             |             |             |             |             |             |             |             |             |             |             |             |             |
| <b>Combined public sector</b>                 |             |             |             |             |             |             |             |             |             |             |             |             |
| <b>primary balance</b>                        | <b>-0.1</b> | <b>-0.1</b> | <b>0.2</b>  | <b>0.6</b>  | <b>1.2</b>  | <b>1.2</b>  | <b>1.4</b>  | <b>1.3</b>  | <b>1.3</b>  | <b>1.3</b>  | <b>1.4</b>  | <b>1.4</b>  |
| <i>Of which</i>                               |             |             |             |             |             |             |             |             |             |             |             |             |
| General government current rev. <sup>8/</sup> | 17.2        | 17.2        | 17.3        | 17.8        | 17.6        | 17.2        | 16.4        | 16.5        | 16.4        | 16.3        | 16.2        | 16.1        |
| General govt. non-interest exp. <sup>9/</sup> | 17.9        | 17.4        | 17.3        | 17.4        | 16.6        | 16.2        | 15.4        | 15.7        | 15.6        | 15.6        | 15.5        | 15.5        |
| Interest due                                  | 2.2         | 2.1         | 2.1         | 2.1         | 2.2         | 2.2         | 2.4         | 2.3         | 2.3         | 2.3         | 2.2         | 2.2         |
| <b>Combined public sector</b>                 |             |             |             |             |             |             |             |             |             |             |             |             |
| <b>overall balance</b>                        | <b>-2.4</b> | <b>-2.2</b> | <b>-1.9</b> | <b>-1.5</b> | <b>-1.0</b> | <b>-1.0</b> | <b>-1.0</b> | <b>-1.0</b> | <b>-1.0</b> | <b>-1.0</b> | <b>-1.0</b> | <b>-1.0</b> |
| Net external financing                        | 0.9         | 2.1         | 1.7         | 0.4         | 1.1         | 0.8         | 0.7         | 0.7         | 0.5         | 0.5         | 0.5         | 0.8         |
| Net domestic financing <sup>10/</sup>         | 0.8         | -0.7        | 0.2         | 1.1         | -0.1        | 0.2         | 0.3         | 0.3         | 0.5         | 0.5         | 0.5         | 0.1         |
| Privatization receipts                        | 0.6         | 0.8         | 0.1         | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         |
| Public sector debt                            | 46.6        | 47.1        | 46.8        | 46.1        | 44.1        | 42.4        | 40.7        | 39.1        | 37.6        | 36.2        | 34.7        | 33.3        |

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

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

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

3/ Includes errors and omissions.

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

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

6/ Includes Central Reserve Bank of Peru debt.

7/ Excludes privatization receipts.

8/ Assumes that the financial transactions tax expires at end-2006.

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

10/ Includes statistical discrepancy.

Table 13. Peru: Capacity to Repay the Fund as of December 31, 2003 1/

(In millions of SDRs)

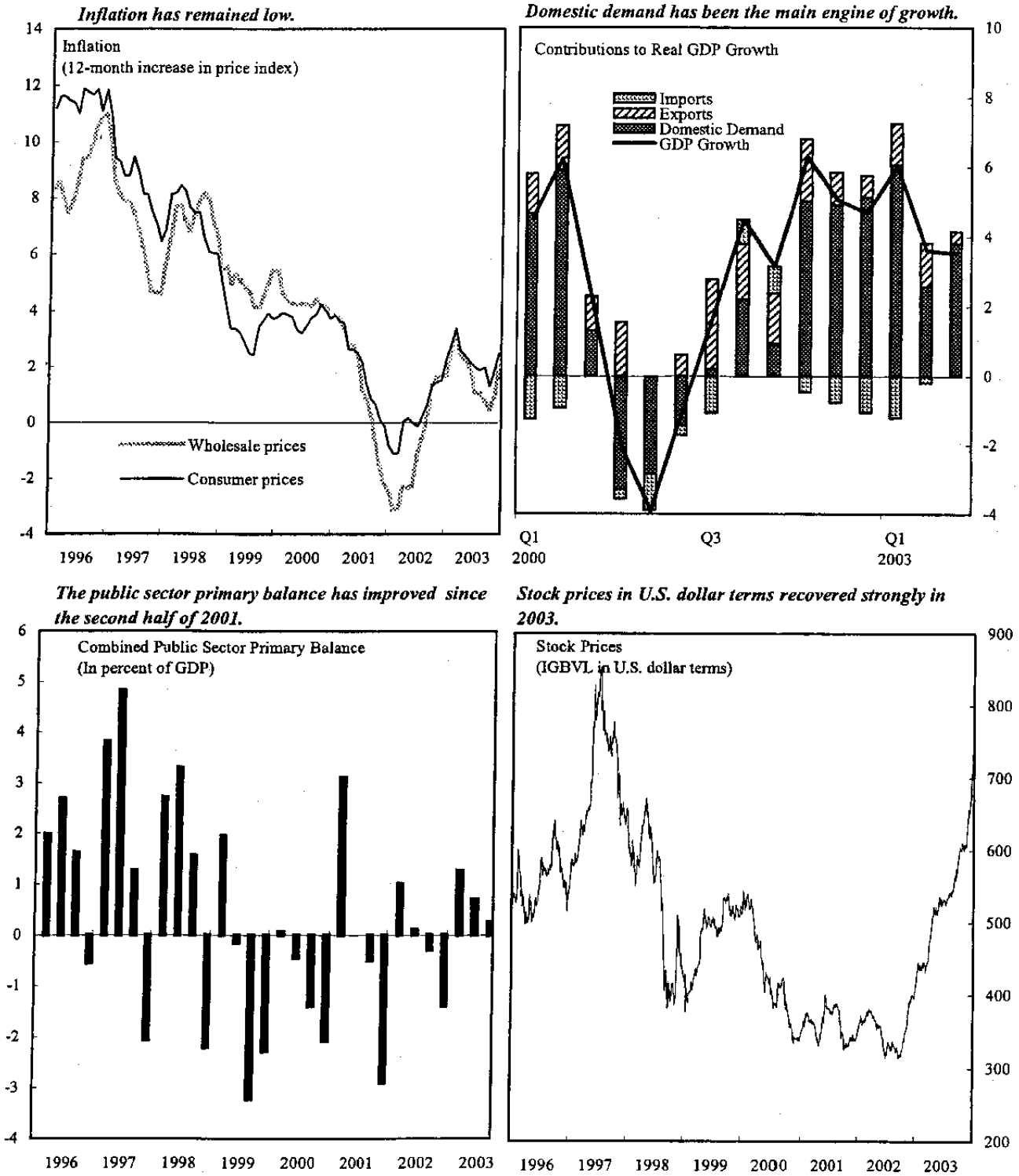
|  | 2004  | 2005  | 2006  | 2007  | 2008 | 2009 | 2010 | 2011 | 2012 | Total |
|--|-------|-------|-------|-------|------|------|------|------|------|-------|
| <b>Obligations from existing drawings</b>    |       |       |       |       |      |      |      |      |      |       |
| Principal (repurchases)                      | 26.8  | 26.8  | 26.8  | 13.4  | 0.0  | 0.0  | 0.0  | 0.0  | 0.0  | 93.6  |
| Charges and interest 2/                      |       |       |       |       |      |      |      |      |      |       |
| On Fund credit                               | 3.3   | 2.6   | 2.1   | 1.5   | 0.0  | 0.0  | 0.0  | 0.0  | 0.0  | 9.5   |
| On use of SDRs                               | 1.7   | 1.7   | 1.7   | 1.7   | 1.7  | 1.7  | 1.7  | 1.7  | 1.7  | 15.3  |
| Total obligations                            | 31.8  | 31.1  | 30.5  | 16.6  | 1.7  | 1.7  | 1.7  | 1.7  | 1.7  | 118.5 |
| (percent of quota)                           | 5.0   | 4.9   | 4.8   | 2.6   | 0.3  | 0.3  | 0.3  | 0.3  | 0.3  | 18.6  |
| <b>Obligations from prospective drawings</b> |       |       |       |       |      |      |      |      |      |       |
| Principal (repurchases)                      | 0.0   | 0.0   | 64.3  | 124.0 | 63.2 | 3.9  | 0.0  | 0.0  | 0.0  | 255.4 |
| Charges and interest 2/                      |       |       |       |       |      |      |      |      |      |       |
| On Fund credit                               | 6.4   | 6.2   | 4.0   | 1.0   | 0.0  | 0.0  | 0.0  | 0.0  | 0.0  | 17.6  |
| On use of SDRs                               | 0.0   | 0.0   | 0.0   | 0.0   | 0.0  | 0.0  | 0.0  | 0.0  | 0.0  | 0.0   |
| Total obligations                            | 6.4   | 6.2   | 68.3  | 125.0 | 63.2 | 3.9  | 0.0  | 0.0  | 0.0  | 273.0 |
| (percent of quota)                           | 1.0   | 1.0   | 10.7  | 19.6  | 9.9  | 0.6  | 0.0  | 0.0  | 0.0  | 42.8  |
| <b>Cumulative (existing and prospective)</b> |       |       |       |       |      |      |      |      |      |       |
| Principal (repurchases)                      | 26.8  | 26.8  | 91.1  | 137.4 | 63.2 | 3.9  | 0.0  | 0.0  | 0.0  | 349.0 |
| Charges and interest 2/                      |       |       |       |       |      |      |      |      |      |       |
| On Fund credit                               | 9.8   | 8.8   | 6.1   | 2.5   | 0.0  | 0.0  | 0.0  | 0.0  | 0.0  | 27.2  |
| On use of SDRs                               | 1.7   | 1.7   | 1.7   | 1.7   | 1.7  | 1.7  | 1.7  | 1.7  | 1.7  | 15.3  |
| Total obligations                            | 38.3  | 37.3  | 98.8  | 141.6 | 64.9 | 5.6  | 1.7  | 1.7  | 1.7  | 391.6 |
| (percent of quota)                           | 6.0   | 5.8   | 15.5  | 22.1  | 10.2 | 0.9  | 0.3  | 0.3  | 0.3  | 61.3  |
| (percent of GDP)                             | 0.1   | 0.1   | 0.2   | 0.3   | 0.1  | 0.0  | 0.0  | 0.0  | 0.0  | ...   |
| (percent of exports of goods and services)   | 0.5   | 0.4   | 1.1   | 1.5   | 0.6  | 0.0  | 0.0  | 0.0  | 0.0  | ...   |
| (percent of public sector debt service)      | 2.3   | 2.1   | 5.4   | 7.4   | 2.6  | 0.3  | 0.1  | 0.1  | 0.0  | ...   |
| <b>Memorandum items:</b>                     |       |       |       |       |      |      |      |      |      |       |
| Purchases                                    | 255.4 | 0.0   | 0.0   | 0.0   | 0.0  | 0.0  | 0.0  | 0.0  | 0.0  | 255.4 |
| Fund credit outstanding                      |       |       |       |       |      |      |      |      |      |       |
| (end period)                                 | 322.2 | 295.5 | 204.4 | 67.1  | 3.9  | 0.0  | 0.0  | 0.0  | 0.0  | ...   |
| (percent of quota)                           | 50.5  | 46.3  | 32.0  | 10.5  | 0.6  | 0.0  | 0.0  | 0.0  | 0.0  | ...   |
| (percent of GDP)                             | 0.7   | 0.6   | 0.4   | 0.1   | 0.0  | 0.0  | 0.0  | 0.0  | 0.0  | ...   |
| (percent of total public debt)               | 1.6   | 1.5   | 1.0   | 0.3   | 0.0  | 0.0  | 0.0  | 0.0  | 0.0  | ...   |
| (percent of external public debt)            | 2.1   | 1.9   | 1.3   | 0.4   | 0.0  | 0.0  | 0.0  | 0.0  | 0.0  | ...   |
| (percent of external public debt service)    | 19.0  | 16.4  | 11.1  | 3.5   | 0.2  | 0.0  | 0.0  | 0.0  | 0.0  | ...   |
| (percent of gross foreign reserves)          | 4.8   | 4.4   | 3.0   | 1.0   | 0.1  | 0.0  | 0.0  | 0.0  | 0.0  | ...   |

Sources: FIN Department; and Fund staff estimates and projections.

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

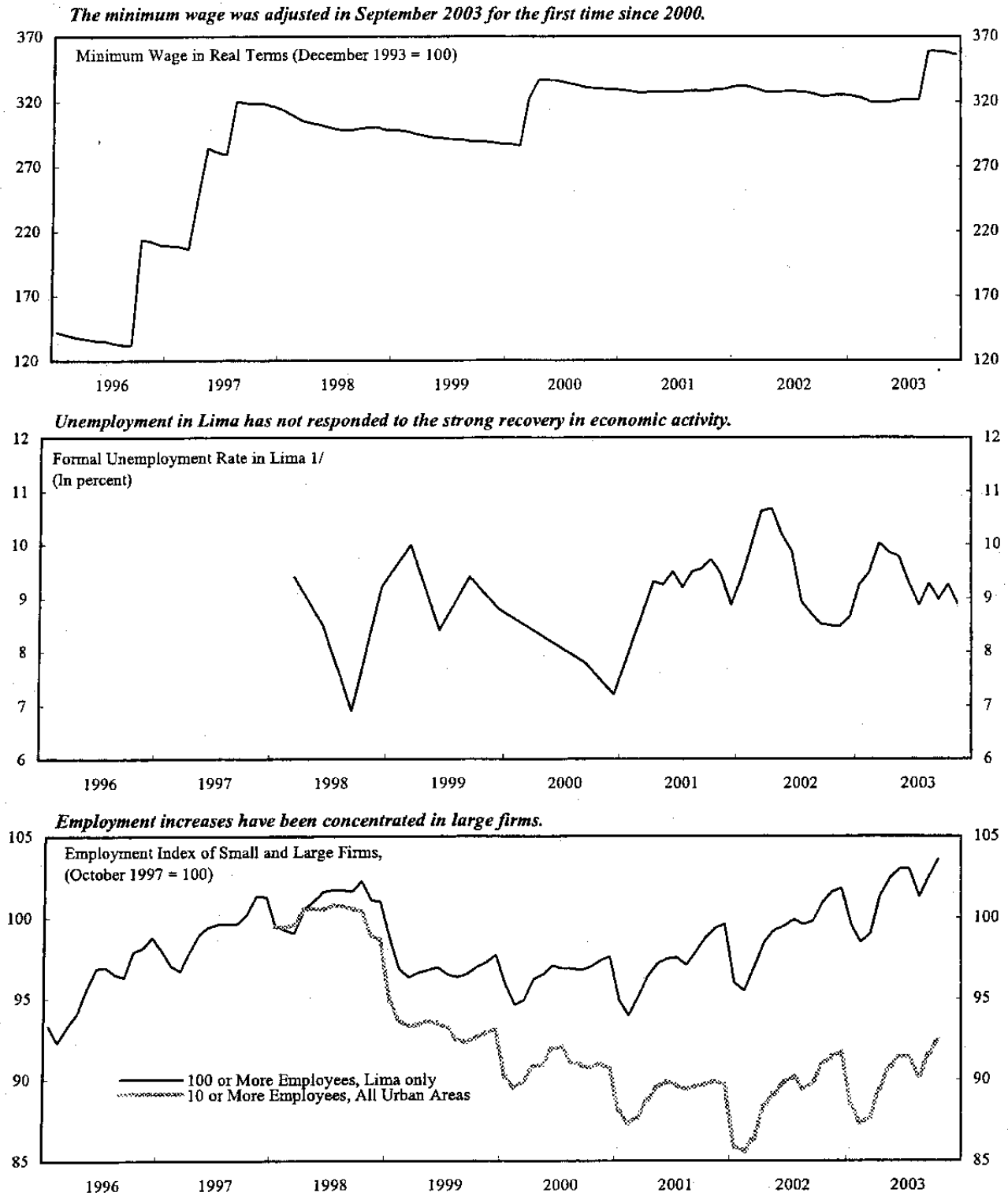
2/ Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the GRA, and on current interest rates for PRGF and Trust Fund. The current SDR interest rate is assumed for net use of SDRs.

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



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

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

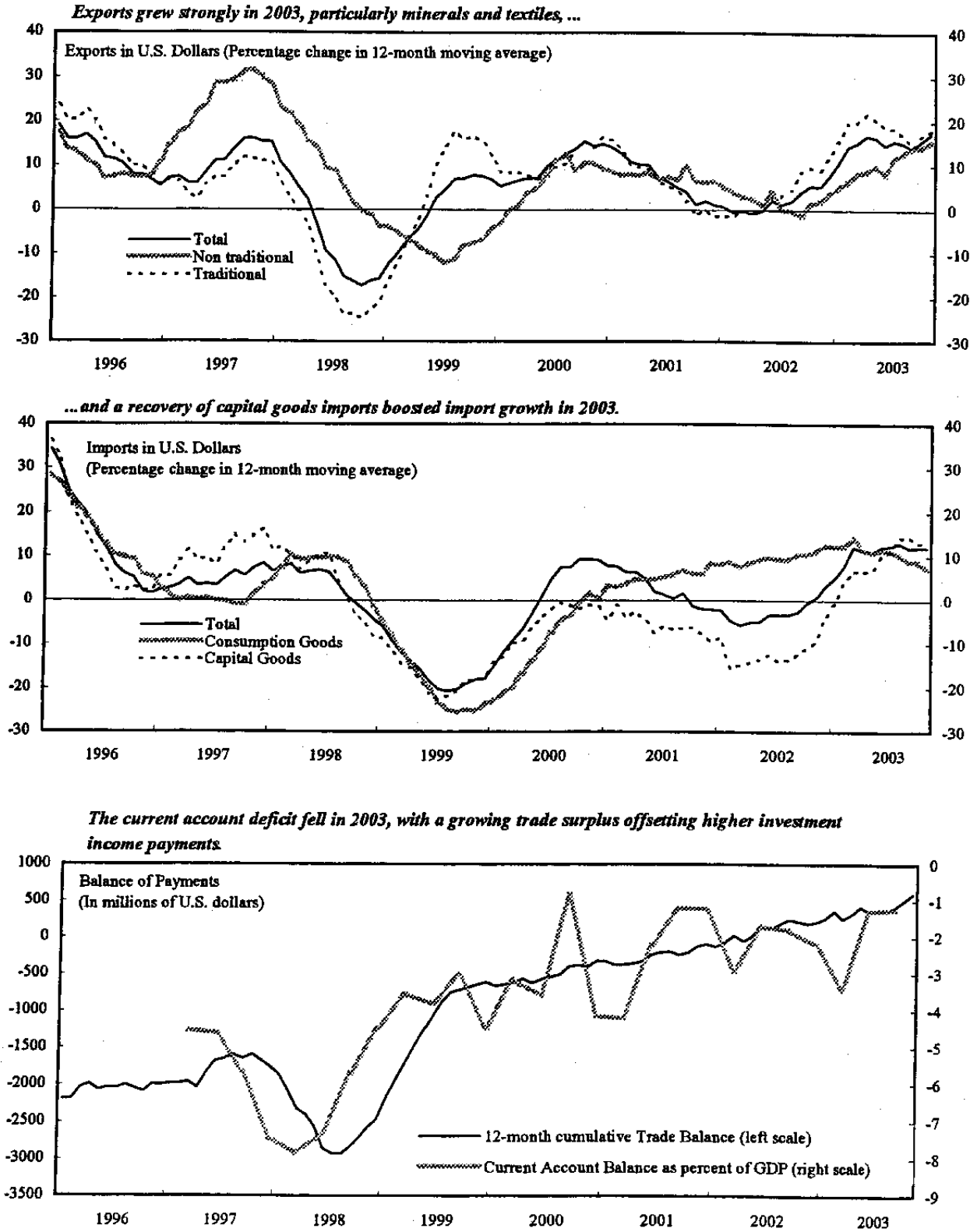


Sources: Ministry of Labor; and Central Reserve Bank of Peru.

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



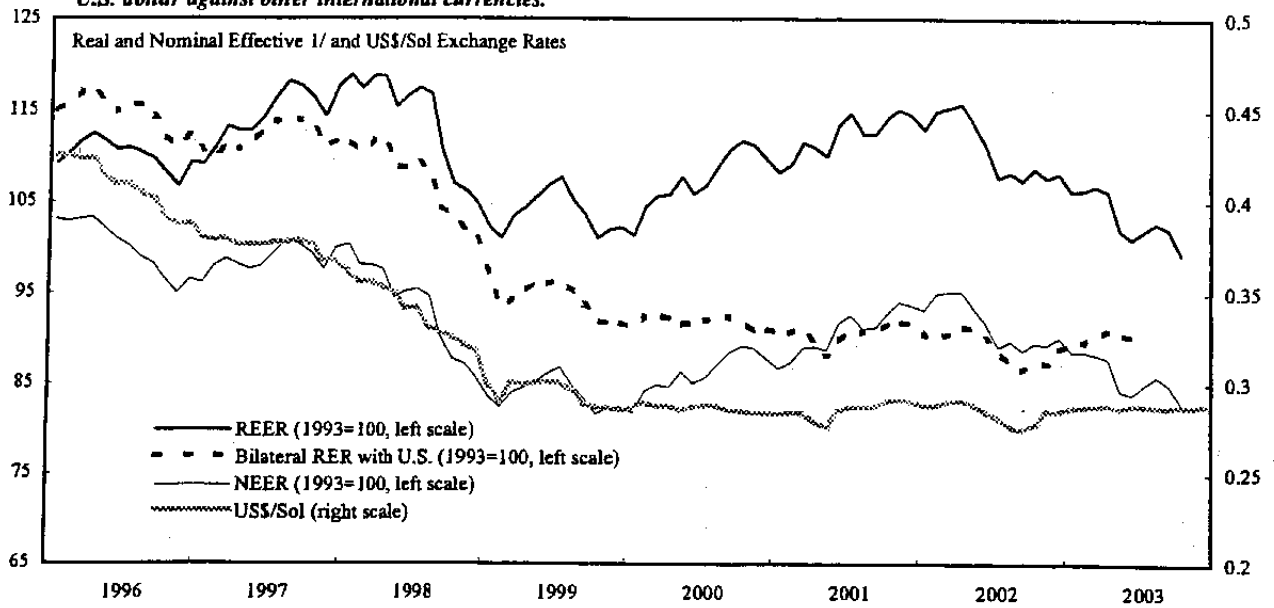
Figure 3. Peru: Trade Indicators, 1996–2003



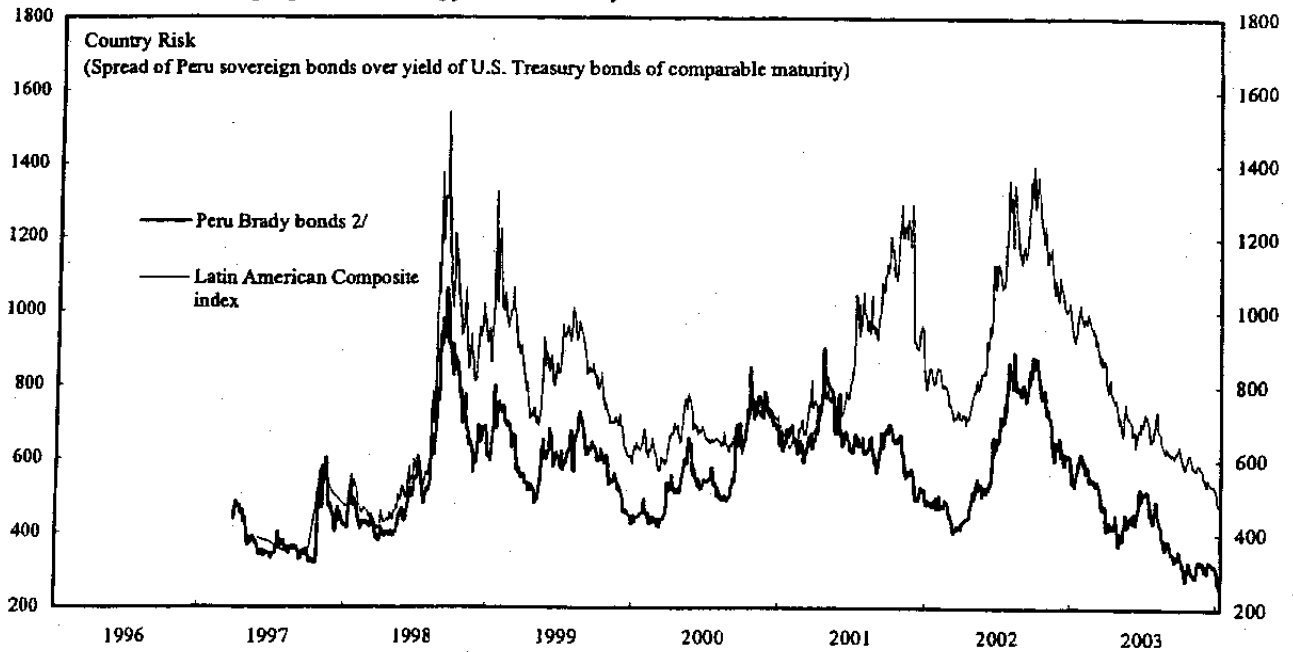
Source: Central Reserve Bank of Peru.

Figure 4. Peru: External Indicators, 1996–2003

*The Sol has been stable against the U.S. dollar, but the real effective exchange rate has declined on account of a weaker U.S. dollar against other international currencies.*



*Peruvian sovereign spreads have dropped to historically low levels.*

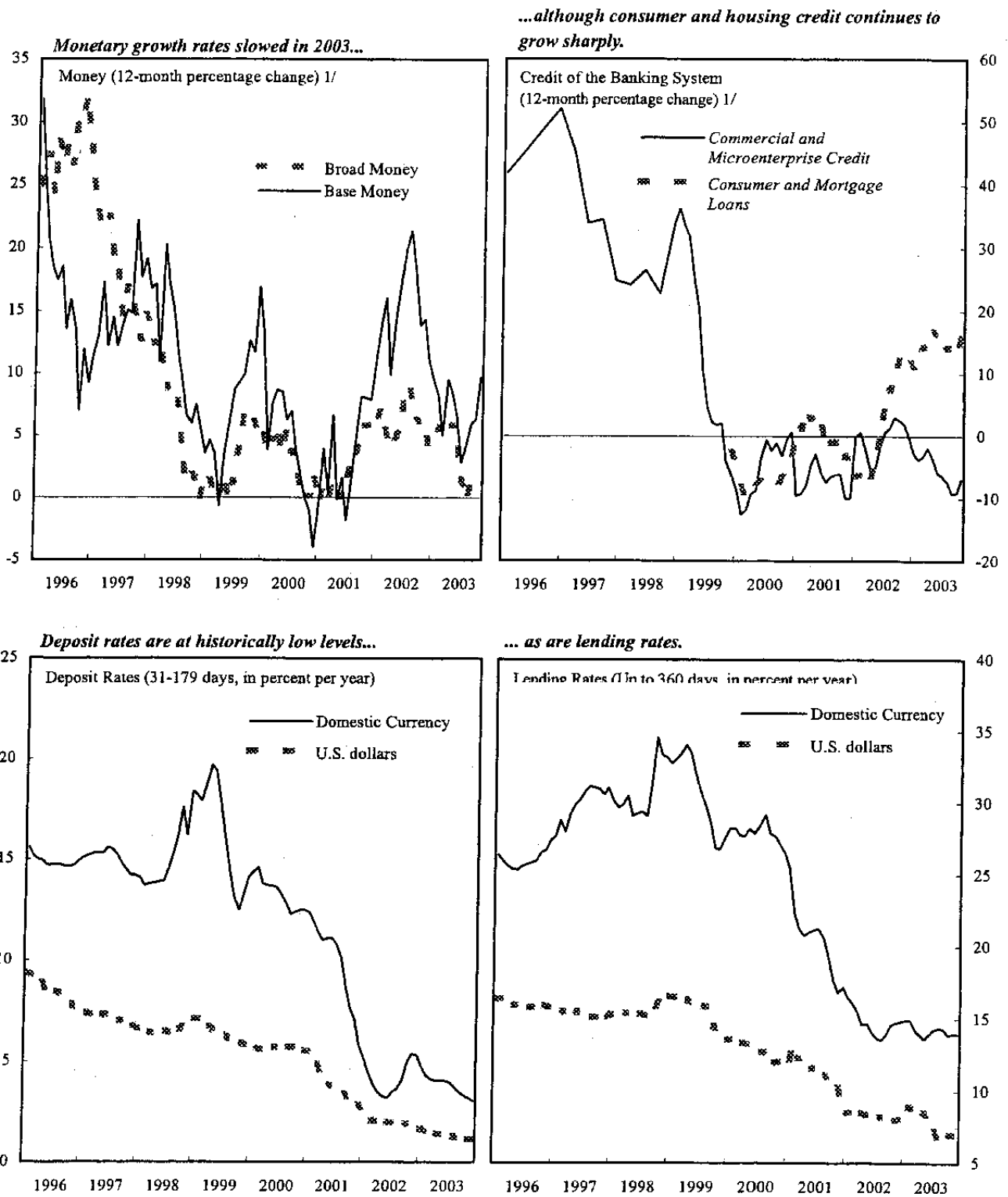


Sources: Central Reserve Bank of Peru; J.P. Morgan; and Fund staff estimates.

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

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

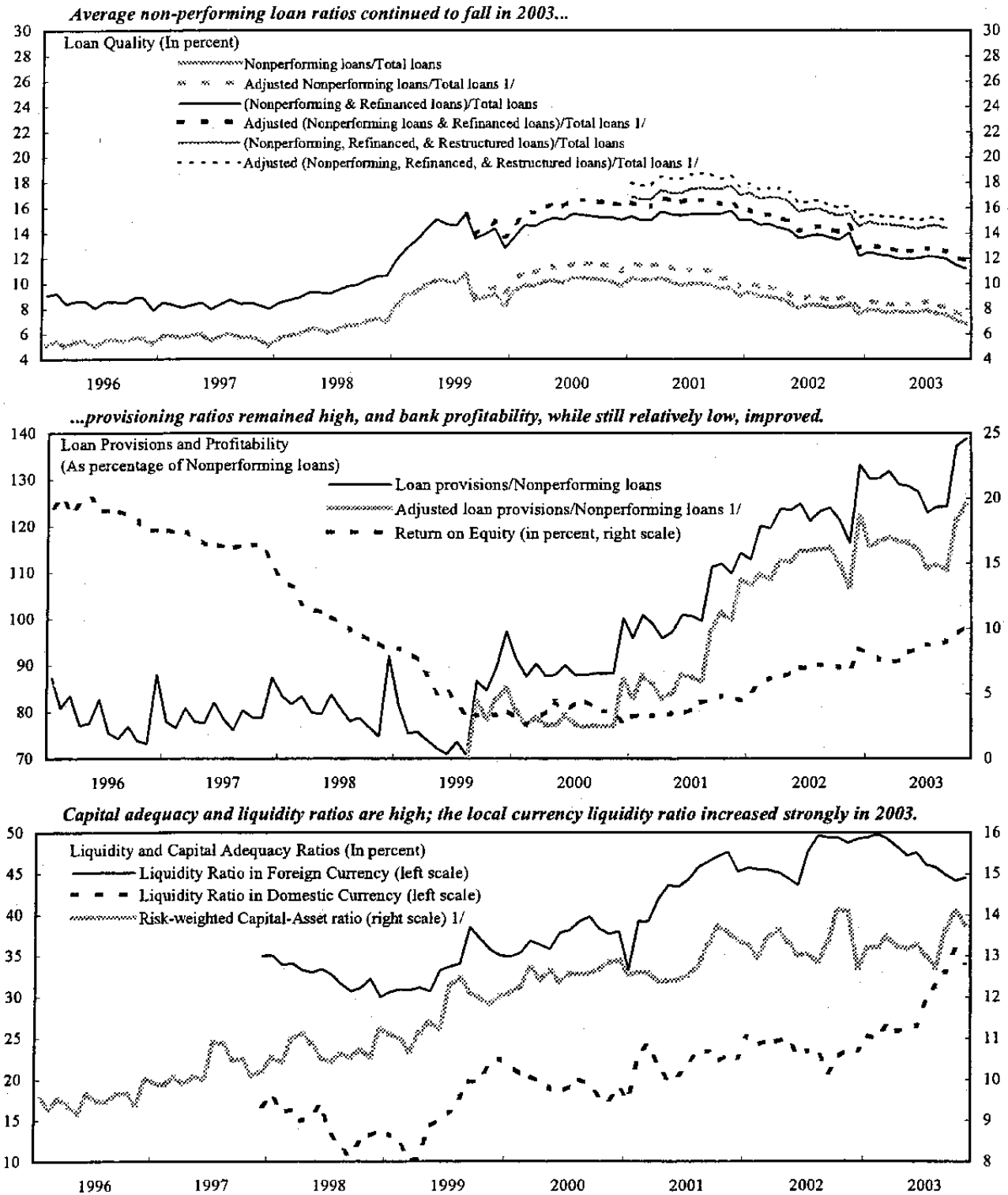
Figure 5. Peru: Monetary Indicators, 1996–2003



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

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

Figure 6. Peru: Banking Indicators, 1996–2003

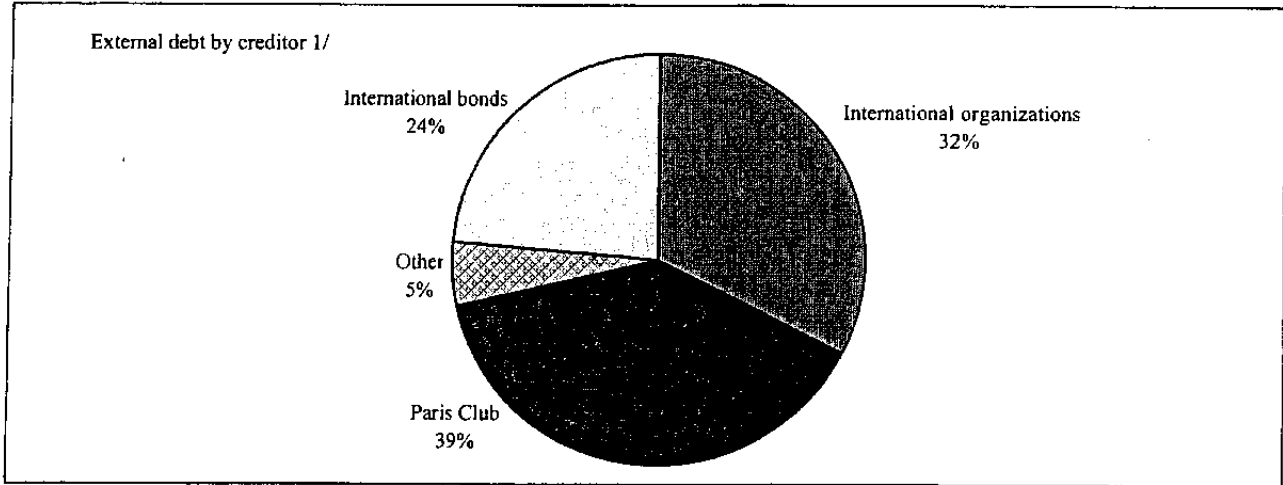


Source: Superintendency of Banks and Insurance.

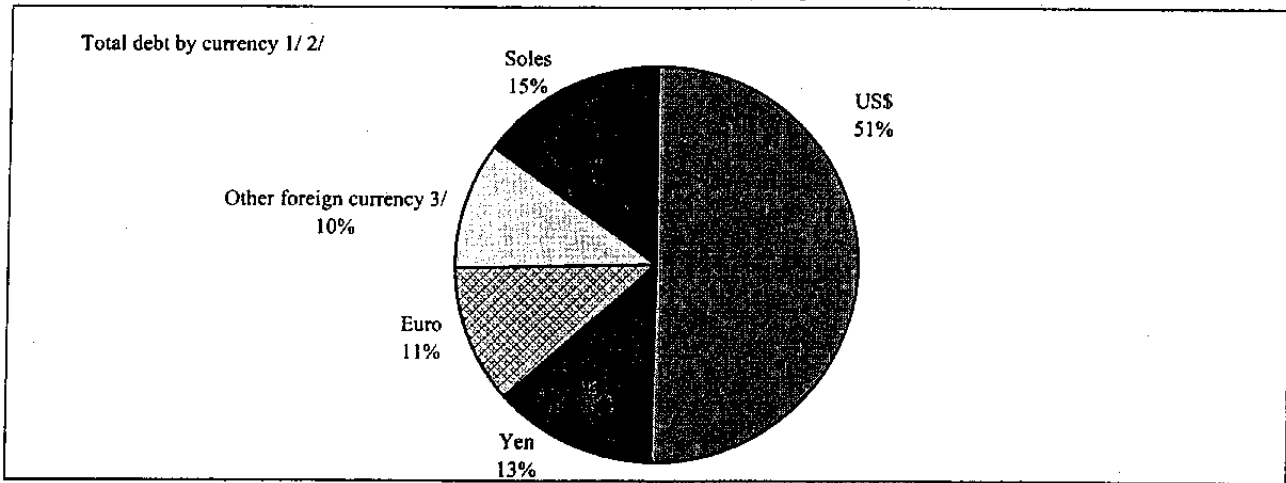
1/ Adjusted for the bond-for-loan swap programs from August 1999.

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

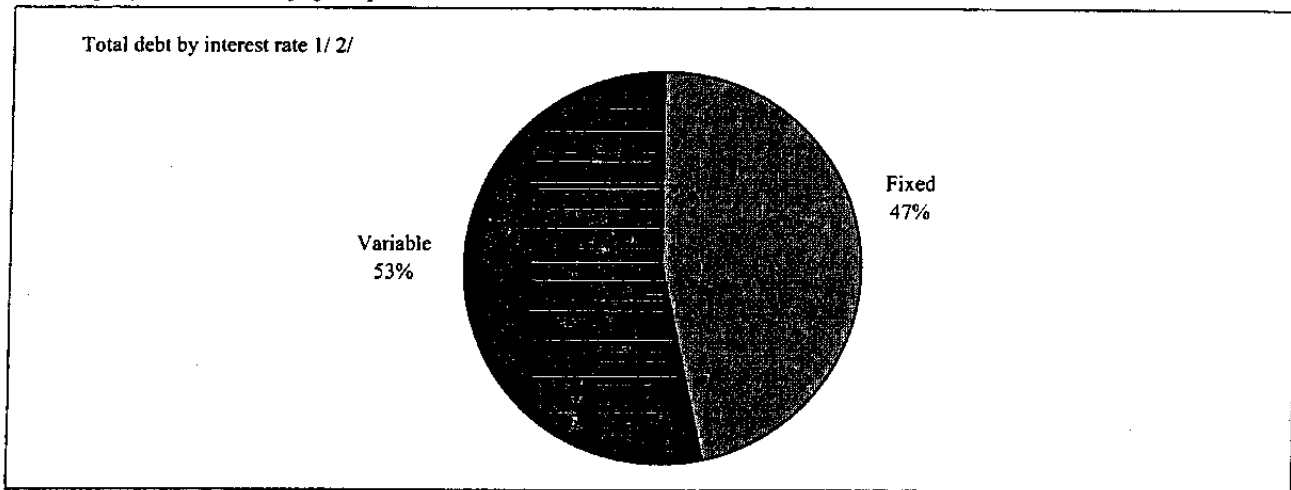
*Three-fourths of the US\$22 billion public external debt is owed to official creditors.*



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



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



Source: Ministry of Economy and Finance.

1/ Millions of U.S. dollars.

2/ Domestic debt includes floating debt.

### Peru: Tax Reform Under the Current SBA

**Tax policy and tax administration measures implemented by the current government have increased revenues, improved the neutrality of the tax system, and strengthened tax administration.** Tax policy measures included: (i) broadening the base of the corporate and personal income taxes and rationalizing their rates; (ii) eliminating or restricting certain VAT exemptions; (iii) rationalizing excise tax rates, (iv) reducing tariffs; (v) improving the efficiency of municipal tax systems; and (vi) phasing out the payroll tax. Tax administration measures included: (i) various VAT withholding schemes; (ii) control of tax refunds and rebates; (iii) collection of tax debts from government suppliers and private companies, (iv) simplification of the tax regime for small taxpayers; and (v) a strengthening of taxpayer registration systems.

**Over the medium-term, the net impact of these measures is estimated at around 1 percent of GDP** (see attached table). Collections could be somewhat higher as certain measures to reduce evasion are not quantified. However, the impact of the reform is still well below the 3 percent of GDP originally envisaged by the administration. The shortfall mainly reflects limited progress on eliminating sectoral and regional exemptions.

Details of the tax reform are as follows:

#### Corporate income tax

- **Minimum income tax advance payment scheme.** Taxpayers with net assets above approximately US\$135,000 are required to make 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).
- **Deductions.**
  - Eliminated for automobile purchases by firms for their executives.
  - Limited "loss carry-overs" to four years.
  - Eliminated for general provisions on banking activity.
- **Base broadening.** Mutual-fund investors included in the taxable base.
- **Exemptions eliminated.** Agricultural producers whose sales do not exceed 50 tax units (UIT), about US\$45,000, are now subject to the tax.
- **Rationalized tax rates.** Corporate income tax rate raised from 27 to 30 percent to equalize it with the maximum marginal personal income tax rate.

#### Personal income tax

- **Base expansion.** Annual pensions above 14 UIT, currently about US\$12,400 (all under the preferential public pension plan), are subject to income taxation.
- **Exemption elimination.** Capital gains on real estate sales included in the tax base.

### **VAT exemptions**

- Eliminated on 57 of 60 fertilizers.
- Eliminated for inter-provincial transportation.
- Strictly limited for cultural events.

### **Excise tax rates**

- Rationalized through increasing kerosene excises by 80 percent (to partially reduce the difference with diesel and other petroleum product excises).

### **External tariff reductions**

- Tariffs first reduced on 1,560 capital goods from 12 to 7 percent (with a temporary surcharge of 5 percent on 312 of these items). Tariffs further reduced on 178 capital good items from 7 to 4 percent under the trade preference arrangement with the USA (ATPA). Finally, tariffs on 1,113 capital goods items were reduced from 10 and 7 to 4 percent at end-2003. The tariff on wheat was reduced from 25 to 17 percent at end2003.

### **Payroll tax.**

- Two percent payroll tax reduced to 1.7 percent starting January 1, 2004 and eliminated at end-2004.

### **Regional Tax Benefits**

Congress is debating the elimination of tax benefits in two regions and passage is expected by late-January. Discussions are under way with two other regions.

### **Tax administration**

#### **VAT withholding mechanisms.**

- **High-evasion sectors.** Suppliers to large purchasers in sectors characterized by a high level of informality (sugar, alcohol, fishing, and construction materials) serve as retention agents. The agents open bank accounts in the state-owned Banco de la Nación, and prior to delivery of goods buyers must deposit 10 percent of the sale price (a deposit receipt is needed for delivery).
- **Large taxpayers.** They must withhold 6 percent at the payment stage of every purchase, when transactions exceed a minimum amount of around US\$200 with suppliers not classified as "good taxpayers". Suppliers can ask for a tax refund only after having withholdings in excess of their tax obligations during six consecutive months.

- **Special regime for large fuel sellers.** They must withhold 1 percent of the sale price. For 2004, this system is to be extended to large sellers in other sectors.
- **Government agencies.**
  - Customs withholds 3.5 percent of the sale price of imports by importers who do not qualify as “good taxpayers” or are retention agents. The surcharge tax is 10 percent for importers without a fiscal identification number or that are first-time importers.
  - Central government spending units withhold taxes for government purchases.

**Other administrative measures.**

- Step up control of taxpayers that cannot be located at their registered address.
- Introduce expiration dates on purchase invoices authorized by the tax agency (6 months).
- Allow audit of tax years prior to a year in which a taxpayer is in compliance.
- Collect automatically 80 percent of tax debts from central government suppliers through the Financial Management Information System (SLAF).
- Prohibit firms with tax debts to distribute profits.
- Make compulsory the use of the banking system for transactions above 2 UIT (or US\$1,771).



**Peru: Medium-Term Net Impact of Tax Reform Measures**  
(in millions of Nuevos Soles)

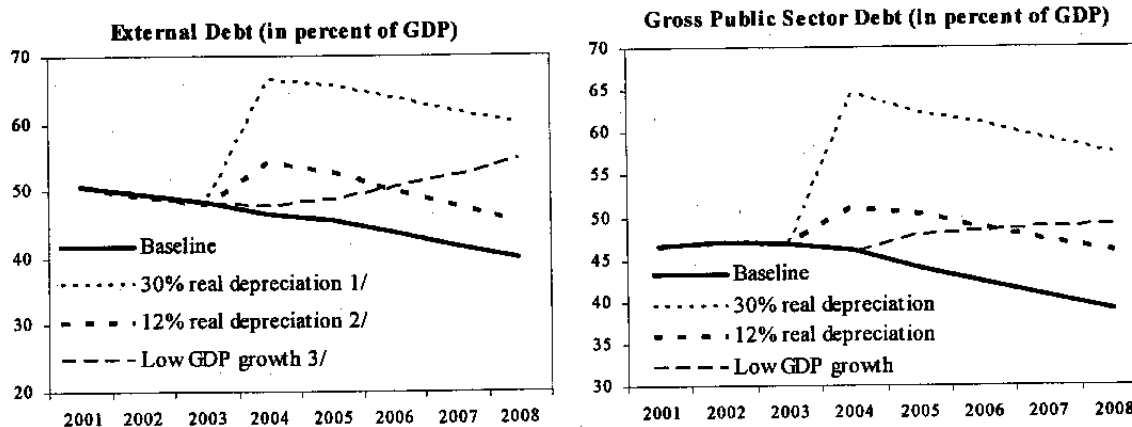
|  | 2003         | 2004         | 2005         | 2006         | 2007         | 2008         |
|--|--------------|--------------|--------------|--------------|--------------|--------------|
| <b>TAX POLICY</b>  | <b>833</b>   | <b>603</b>   | <b>920</b>   | <b>856</b>   | <b>915</b>   | <b>957</b>   |
| <i>Income tax</i>  | <b>635</b>   | <b>212</b>   | <b>499</b>   | <b>407</b>   | <b>435</b>   | <b>445</b>   |
| Introduce a new minimum advance payment scheme.  | 550          | 445          | 400          | 300          | 300          | 300          |
| Eliminate allowable deductions under the corporate income tax.   | 25           | 27           | 29           | 31           | 33           | 35           |
| Collect tax on mutual-fund investors' profits.   | ...          | ...          | ...          | ...          | ...          | ...          |
| Increase the maximum marginal income tax rate from 27 to 30 percent for individuals.                                       | 50           | 53           | 57           | 61           | 65           | 70           |
| Introduce an income tax on high pensions under the Cedula Viva (Decree 20530).   | 10           | 45           | 48           | 52           | 55           | 59           |
| Equalize the corporate income tax rate with the maximum marginal rate of the personal income tax.                          |              |              | 330          | 352          | 376          | 401          |
| Eliminate the exemption in the income tax for agricultural producers whose sales do not exceed 50 UIT.                     |              |              | 20           | 21           | 23           | 24           |
| Eliminate the exemption of capital gains in real estate.   |              |              |              |              | 20           | 21           |
| Eliminate the 2 percent tax on payrolls ( <i>Impuesto Extraordinario de Solidaridad</i> ).                                 |              | -458         | -492         | -525         | -560         | -598         |
| Limit "carry forwards" of corporate losses to 4 years and general provisions on banking activity.                          |              | 100          | 108          | 116          | 124          | 134          |
| <i>VAT</i>   | <b>110</b>   | <b>147</b>   | <b>159</b>   | <b>170</b>   | <b>182</b>   | <b>194</b>   |
| Eliminate partially the VAT exemption on fertilizers.  | 100          | 107          | 115          | 122          | 130          | 139          |
| Restrict the VAT exemption for cultural events.  | 10           | 11           | 11           | 12           | 13           | 14           |
| Eliminate the exemption of interprovincial transportation.   |              | 10           | 11           | 11           | 12           | 13           |
| Eliminate exemption for tourism services.  |              | 20           | 22           | 24           | 26           | 28           |
| <i>Excises</i>   | <b>300</b>   | <b>469</b>   | <b>505</b>   | <b>538</b>   | <b>574</b>   | <b>613</b>   |
| Increase kerosene excise.  | 140          | 149          | 160          | 171          | 183          | 195          |
| Increase petroleum excises.  | 140          | 280          | 301          | 321          | 343          | 366          |
| Increase beer and tobacco excises.   | 20           | 40           | 43           | 46           | 49           | 52           |
| <i>External Tariffs</i>  | <b>-212</b>  | <b>-226</b>  | <b>-243</b>  | <b>-259</b>  | <b>-276</b>  | <b>-295</b>  |
| Reduce tariffs on 1,560 capital goods from 12 to 7 percent and impose a temporary surcharge of 5 percent on 312 of them.   | -106         | -113         | -121         | -129         | -138         | -147         |
| Reduce tariffs on 178 capital good items from 7 to 4 percent.  | -106         | -113         | -121         | -129         | -138         | -147         |
| Reduce tariffs on 1,113 capital goods items from 10 and 7 to 4 percent, and reduced tariff on wheat from 25 to 17 percent. |              | -120         | -129         | -138         | -147         | -157         |
| <b>TAX ADMINISTRATION</b>  | <b>627</b>   | <b>1,026</b> | <b>1,103</b> | <b>1,176</b> | <b>1,255</b> | <b>1,340</b> |
| <i>Withholding mechanisms and tax debt collection</i>  | <b>627</b>   | <b>1,026</b> | <b>1,103</b> | <b>1,176</b> | <b>1,255</b> | <b>1,340</b> |
| Large buyers in transactions of main agricultural products (rice, sugar, fishing, etc).                                    | 120          | 128          | 138          | 147          | 157          | 167          |
| Large taxpayers in transactions with their suppliers.  | 345          | 485          | 521          | 556          | 594          | 633          |
| Central government spending units in government purchases.   | 40           | 43           | 46           | 49           | 52           | 56           |
| Large fuel sellers in transactions with fuel retailers.  | 80           | 85           | 92           | 98           | 104          | 111          |
| Withholding scheme for large wholesale sellers.  |              | 150          | 161          | 172          | 184          | 196          |
| Automatic collection of tax debts from central government's suppliers through SIAF.  | 15           | 15           | 16           | 17           | 18           | 20           |
| Withholding scheme for importers.  | 27           | 120          | 129          | 138          | 147          | 157          |
| <i>Other tax administration measures 1/</i>  | ...          | ...          | ...          | ...          | ...          | ...          |
| <b>REGIONAL EXEMPTIONS</b>   |              | <b>68</b>    | <b>73</b>    | <b>78</b>    | <b>83</b>    | <b>88</b>    |
| <b>TOTAL</b>   | <b>1,460</b> | <b>1,696</b> | <b>2,096</b> | <b>2,110</b> | <b>2,253</b> | <b>2,385</b> |
| <i>(In percent of GDP)</i>   | <b>0.7</b>   | <b>0.8</b>   | <b>0.9</b>   | <b>0.8</b>   | <b>0.9</b>   | <b>0.8</b>   |

1/ Includes strengthening of taxpayer registration, introducing expiration date on purchase invoices, reforming the small taxpayer regimes, improving auditing mechanisms, and making use of the banking system compulsory for transactions above a certain threshold and for expenditures claimed as tax deductible.

### Peru: Debt Sustainability Analysis<sup>1</sup>

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

**External and public debt is also resilient to real exchange rate shocks of magnitudes experienced by Peru in the recent past and to which there is a corresponding current account adjustment, but the debt dynamics appear vulnerable to a very large decline in the real exchange rate.** A 12-percent permanent real depreciation that leads to a contraction in domestic demand and an improvement in the external current account would result initially in somewhat higher external and public debt-to-GDP ratios, but thereafter those ratios would decline rapidly. A sustained 30-percent real depreciation leads to a sharper initial increase in the debt ratios, with a more protracted period of decline.



**Chart Notes:**

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

**The debt dynamics appear moderately vulnerable to a sustained reduction in demand for Peru's exports, and somewhat more so if the government tries to offset the economic slowdown by running higher fiscal deficits.** A reduction in baseline growth from 4 to 2 percent, owing to an export shock, countered by increasing the fiscal deficit to 2 percent of GDP (the limit established under the country's fiscal responsibility law during recessionary periods), leads to moderately rising ratios of external and public sector-debt-to-GDP.

<sup>1</sup> The DSA includes standard sensitivity tests around the baseline medium-term scenario.

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

|   | Actual             |                    |                 |       |       | Projections |       |       |       |       |       |
|---|--------------------|--------------------|-----------------|-------|-------|-------------|-------|-------|-------|-------|-------|
|   | 1998               | 1999               | 2000            | 2001  | 2002  | 2003        | 2004  | 2005  | 2006  | 2007  | 2008  |
| <b>1 External debt</b>  | 53.1               | 55.6               | 52.3            | 50.7  | 49.3  | 48.3        | 46.5  | 45.7  | 43.8  | 41.7  | 39.8  |
| 2 Change in external debt   | 3.9                | 2.4                | -3.3            | -1.6  | -1.4  | -1.0        | -1.8  | -0.8  | -1.9  | -2.1  | -1.8  |
| 3 Identified external debt-creating flows (4+8+11)  | 5.7                | 5.4                | 0.3             | 1.0   | -4.0  | -1.5        | -0.8  | -1.0  | -2.1  | -1.4  | -1.4  |
| 4 Current account deficit, excluding interest payments  | 2.8                | -0.5               | -0.5            | -0.9  | -0.3  | -0.5        | -0.9  | -1.3  | -1.5  | -1.7  | -1.4  |
| 5 Deficit in balance of goods and services  | 5.5                | 2.5                | 2.1             | 2.1   | 1.3   | 0.5         | -0.5  | -0.7  | -0.9  | -1.0  | -1.1  |
| 6 Exports   | 13.2               | 14.9               | 16.0            | 15.9  | 16.3  | 17.2        | 18.2  | 18.3  | 18.8  | 19.1  | 19.3  |
| 7 Imports   | 18.7               | 17.4               | 18.1            | 17.9  | 17.6  | 17.7        | 17.7  | 17.6  | 17.9  | 18.1  | 18.2  |
| 8 Net non-debt creating capital inflows (negative)  | -1.9               | -2.9               | -0.6            | -1.4  | -3.4  | 0.4         | 0.3   | 0.2   | -1.0  | 0.0   | -0.3  |
| 9 Net foreign direct investment, equity   | 2.8                | 3.5                | 1.5             | 2.0   | 4.2   | 2.0         | 1.4   | 1.7   | 2.6   | 0.7   | 0.9   |
| 10 Net portfolio investment, equity   | -0.8               | -0.6               | -0.9            | -0.6  | -0.8  | -2.4        | -1.7  | -1.9  | -1.6  | -0.7  | -0.6  |
| 11 Automatic debt dynamics 1/   | 4.8                | 8.8                | 1.4             | 3.2   | -0.3  | -1.4        | -0.2  | 0.1   | 0.3   | 0.2   | 0.3   |
| 12 Contribution from nominal interest rate  | 3.1                | 3.4                | 3.4             | 3.1   | 2.4   | 2.2         | 2.2   | 2.7   | 2.7   | 2.8   | 2.7   |
| 13 Contribution from real GDP growth  | 0.3                | -0.6               | -1.7            | 0.0   | -2.3  | -1.8        | -1.9  | -2.0  | -1.7  | -1.6  | -1.6  |
| 14 Contribution from price and exchange rate changes 2/   | 1.4                | 6.0                | -0.3            | 0.1   | -0.4  | -1.8        | -0.6  | -0.6  | -0.6  | -1.0  | -0.9  |
| 15 Residual, incl. change in gross foreign assets (2-3)   | -1.7               | -2.9               | -3.6            | -2.6  | 2.7   | 0.5         | -1.0  | 0.2   | 0.2   | -0.7  | -0.5  |
| <b>16 External debt-to-exports ratio (in percent)</b>   | 401.5              | 371.9              | 327.1           | 319.3 | 302.9 | 280.7       | 255.2 | 249.0 | 232.7 | 218.4 | 205.9 |
| <b>Gross external financing need (in billions of U.S. dollars) 3/</b>   | 11.4               | 9.5                | 8.3             | 6.7   | 7.2   | 5.5         | 5.5   | 5.5   | 5.5   | 5.6   | 6.6   |
| <b>In percent of GDP</b>  | 20.1               | 18.3               | 15.5            | 12.5  | 12.8  | 9.0         | 8.5   | 8.1   | 7.7   | 7.3   | 8.1   |
| <b>Key Macroeconomic and External Assumptions</b>   |                    |                    |                 |       |       |             |       |       |       |       |       |
| Real GDP growth (in percent)  | -0.5               | 0.9                | 3.1             | -0.1  | 4.9   | 4.0         | 4.0   | 4.5   | 4.0   | 4.0   | 4.0   |
| Exchange rate appreciation (U.S. dollar value of local currency, change in percent)   | -8.7               | -13.5              | -3.0            | -1.3  | 0.5   | 1.1         | -1.2  | -1.0  | -0.8  | -0.4  | -0.4  |
| GDP deflator in U.S. dollars (change in percent)  | -2.8               | -10.1              | 0.5             | -0.2  | 0.8   | 3.8         | 1.2   | 1.3   | 1.4   | 2.2   | 2.2   |
| Nominal external interest rate (in percent) 4/  | 6.1                | 5.8                | 6.3             | 5.9   | 5.0   | 4.8         | 4.9   | 6.1   | 6.2   | 6.9   | 7.0   |
| Growth of exports (U.S. dollar terms, in percent)   | -10.2              | 2.4                | 10.9            | -0.4  | 7.9   | 14.0        | 11.5  | 6.6   | 8.2   | 7.7   | 7.7   |
| Growth of imports (U.S. dollar terms, in percent)   | -2.2               | -15.4              | 7.7             | -0.9  | 3.3   | 8.8         | 5.0   | 5.5   | 7.2   | 7.2   | 7.2   |
| <b>Stress Tests for External Debt Ratio</b>   |                    |                    |                 |       |       |             |       |       |       |       |       |
| 1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2004-2008 | 49.3               | 48.3               | 45.7            | 44.3  | 42.0  | 40.1        | 38.2  |       |       |       |       |
| 2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005   | 49.3               | 48.3               | 47.8            | 47.8  | 45.9  | 43.8        | 41.9  |       |       |       |       |
| 3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005  | 49.3               | 48.3               | 50.5            | 54.1  | 52.3  | 50.2        | 48.3  |       |       |       |       |
| 4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005   | 49.3               | 48.3               | 52.8            | 58.5  | 56.6  | 54.5        | 52.7  |       |       |       |       |
| 5. Combination of 2-4 using one standard deviation shocks   | 49.3               | 48.3               | 53.6            | 60.2  | 58.4  | 56.3        | 54.5  |       |       |       |       |
| 6. One time 30 percent nominal depreciation in 2004   | 49.3               | 48.3               | 66.3            | 65.5  | 63.7  | 61.6        | 59.8  |       |       |       |       |
| 7. One time 15 percent nominal depreciation in 2004   | 49.3               | 48.3               | 54.3            | 53.5  | 51.6  | 49.5        | 47.7  |       |       |       |       |
| <b>Historical Statistics for Key Variables (past 10 years)</b>  |                    |                    |                 |       |       |             |       |       |       |       |       |
|   | Historical Average | Standard Deviation | Average 2003-08 |       |       |             |       |       |       |       |       |
| Current account deficit, excluding interest payments  | 1.5                | 1.9                | -1.2            |       |       |             |       |       |       |       |       |
| Net non-debt creating capital inflows   | 3.7                | 2.4                | 0.1             |       |       |             |       |       |       |       |       |
| Nominal external interest rate (in percent)   | 6.0                | 0.8                | 6.0             |       |       |             |       |       |       |       |       |
| Real GDP growth (in percent)  | 4.4                | 4.2                | 4.1             |       |       |             |       |       |       |       |       |

1/ Derived as  $[r - g - \rho(1+g) + \alpha(1+r)] / (1+g+\rho+gp)$  times previous period debt stock, with  $r$  = nominal effective interest rate on external debt;  $\rho$  = change in domestic GDP deflator in US\$ terms,  $g$  = real GDP growth rate,  $\alpha$  = nominal appreciation (increase in dollar value of domestic currency), and  $\alpha$  = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as  $[\rho(1+g) + \alpha(1+r)] / (1+g+\rho+gp)$  times previous period debt stock.  $\rho$  increases with an appreciating domestic currency ( $\alpha > 0$ ) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ Interest rate assumption for 2004-2008 reflects current market information.

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

|   | Actual             |       |                    |       |       | Projections |       |       |       |       |       |
|---|--------------------|-------|--------------------|-------|-------|-------------|-------|-------|-------|-------|-------|
|   | 1998               | 1999  | 2000               | 2001  | 2002  | 2003        | 2004  | 2005  | 2006  | 2007  | 2008  |
| <b>I. Baseline Medium-Term Projections</b>  |                    |       |                    |       |       |             |       |       |       |       |       |
| 1 Public sector debt 1/<br>o/w foreign-currency denominated   | 42.1               | 48.0  | 45.9               | 46.6  | 47.1  | 46.8        | 46.1  | 44.1  | 42.4  | 40.7  | 39.1  |
| 2 Change in public sector debt  | 3.5                | 5.9   | -2.1               | 0.7   | 0.6   | -0.3        | -0.7  | -2.0  | -1.7  | -1.7  | -1.6  |
| 3 Identified debt-creating flows (4+7+12)   | 3.5                | 4.6   | -0.2               | 0.4   | -0.8  | -0.8        | -1.3  | -2.0  | -0.5  | -1.6  | -1.5  |
| 4 Primary deficit   | -1.3               | 0.8   | 0.9                | 0.1   | 0.1   | -0.2        | -0.6  | -1.2  | -1.2  | -1.4  | -1.3  |
| 5 Revenue and grants 2/<br>Primary (noninterest) expenditure 2/   | 19.9               | 18.8  | 18.0               | 18.1  | 17.7  | 17.8        | 18.3  | 18.0  | 17.8  | 17.2  | 17.4  |
| 6 Automatic debt dynamics 3/<br>Contribution from interest rate/growth differential 4/<br>Of which: contribution from real interest rate<br>Of which: contribution from real GDP growth | 5.2                | 4.4   | -0.4               | 0.9   | -0.2  | -0.5        | -0.6  | -0.7  | 0.7   | -0.1  | 0.0   |
| 7 Contribution from exchange rate depreciation 5/<br>Other identified debt-creating flows   | -0.2               | 0.2   | -0.8               | 1.9   | -0.4  | -0.8        | -0.7  | -0.7  | -0.3  | -0.2  | -0.1  |
| 8 Privatization receipts (negative)   | -0.4               | 0.6   | 0.6                | 1.8   | 1.8   | 0.9         | 1.1   | 1.2   | 1.4   | 1.4   | 1.4   |
| 9 Recognition of implicit or contingent liabilities   | 0.2                | -0.4  | -1.4               | 0.1   | -2.1  | -1.7        | -1.8  | -1.9  | -1.7  | -1.6  | -1.5  |
| 10 Other (specify, e.g. bank recapitalization)  | 5.3                | 4.2   | 0.4                | -1.0  | 0.1   | 0.3         | 0.1   | 0.0   | 1.1   | 0.1   | 0.1   |
| 11 Residual, including asset changes (2-3)  | -0.4               | -0.7  | -0.8               | -0.6  | -0.7  | -0.1        | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   |
| 12 Public sector debt in percent of revenues 1/   | -0.4               | -0.7  | -0.8               | -0.6  | -0.7  | -0.1        | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   |
| 13 Overall deficit  | 0.0                | 0.0   | 0.0                | 0.0   | 0.0   | 0.0         | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   |
| 14 Interest payment   | 0.0                | 0.0   | 0.0                | 0.0   | 0.0   | 0.0         | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   |
| 15 Gross financing 6/<br>in billions of U.S. dollars  | 0.0                | 0.0   | 0.0                | 0.0   | 0.0   | 0.0         | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   |
| 16 Additional Macroeconomic and Fiscal Assumptions  | 1.9                | 3.2   | 3.3                | 2.6   | 3.5   | 2.8         | 2.9   | 2.6   | 2.7   | 2.8   | 3.6   |
| Nominal GDP (local currency)  | 3.3                | 6.1   | 6.2                | 4.9   | 6.3   | 4.6         | 4.4   | 3.8   | 3.8   | 3.6   | 4.4   |
| Average nominal interest rate on public debt (in percent) 7/ 8/ 9/  | 1.9                | 3.2   | 3.3                | 2.6   | 3.5   | 2.8         | 2.9   | 2.6   | 2.7   | 2.8   | 3.6   |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent)  | 166.5              | 174.7 | 186.8              | 188.2 | 198.4 | 211.8       | 225.8 | 241.6 | 257.0 | 274.2 | 292.7 |
| Interest rate on new market external financing (in percent) 9/  | 5.4                | 5.4   | 5.1                | 4.9   | 4.6   | 4.8         | 5.0   | 5.4   | 5.6   | 6.2   | 6.4   |
| Gross market external financing in percent of total external financing  | -1.1               | 1.5   | 1.4                | 4.1   | 4.1   | 2.1         | 2.5   | 2.9   | 3.4   | 3.6   | 3.8   |
| Exchange rate (LC per US dollar)  | ...                | ...   | ...                | ...   | ...   | 11.0        | 11.0  | 10.0  | 10.0  | 10.0  | 10.0  |
| Nominal appreciation (increase in US dollar value of local currency, in percent) 10/  | ...                | ...   | ...                | ...   | ...   | 38.9        | 38.9  | 38.9  | 38.9  | 38.9  | 38.9  |
| Inflation rate (GDP deflator, in percent)   | 3.1                | 3.5   | 3.5                | 3.4   | 3.5   | 3.5         | 3.5   | 3.5   | 3.6   | 3.6   | 3.6   |
| Growth of real primary spending (deflated by GDP deflator, in percent)  | -13.4              | -10.0 | -1.0               | 2.4   | -0.3  | -0.7        | -0.3  | 0.0   | -2.8  | -0.4  | -0.4  |
|   | 6.4                | 3.9   | 3.6                | 0.9   | 0.6   | 2.7         | 2.5   | 2.4   | 2.3   | 2.6   | 2.6   |
|   | 4.0                | 6.3   | -0.7               | -3.5  | 2.2   | 2.7         | 4.1   | -0.8  | 2.7   | -0.5  | 5.4   |
| <b>II. Stress Tests</b>   |                    |       |                    |       |       |             |       |       |       |       |       |
| 1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2004-2008   | 47.1               | 46.8  | 45.3               | 43.2  | 41.1  | 39.1        | 37.3  |       |       |       |       |
| 2. Real interest rate is at historical average plus two standard deviations in 2004 and 2005  | 47.1               | 46.8  | 48.2               | 48.0  | 46.3  | 44.6        | 43.0  |       |       |       |       |
| 3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005  | 47.1               | 46.8  | 49.9               | 51.9  | 50.1  | 48.1        | 46.2  |       |       |       |       |
| 4. Primary balance is at historical average minus two standard deviations in 2004 and 2005  | 47.1               | 46.8  | 48.4               | 49.2  | 47.5  | 45.8        | 44.2  |       |       |       |       |
| 5. Combination of 2-4 using one standard deviation shocks   | 47.1               | 46.8  | 49.4               | 51.4  | 48.3  | 45.2        | 42.1  |       |       |       |       |
| 6. 30 percent real depreciation in 2004 11/   | 47.1               | 46.8  | 64.6               | 62.3  | 60.9  | 59.2        | 57.6  |       |       |       |       |
| 6a. 15 percent real depreciation in 2004 11/  | 47.1               | 46.8  | 54.2               | 52.0  | 50.5  | 48.8        | 47.2  |       |       |       |       |
| 7. 10 percent of GDP increase in other debt-creating flows in 2004  | 47.1               | 46.8  | 56.1               | 53.9  | 52.4  | 50.7        | 49.1  |       |       |       |       |
| 8. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2004-05  | 47.1               | 46.8  | 48.3               | 48.1  | 46.5  | 44.8        | 43.2  |       |       |       |       |
| 8a. Impact on debt-to-revenue ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2004-05   | 267.0              | 263.3 | 299.8              | 298.7 | 260.4 | 260.3       | 247.9 |       |       |       |       |
| <b>Historical Statistics for Key Variables (1993-2002)</b>  |                    |       |                    |       |       |             |       |       |       |       |       |
|   | Historical Average |       | Standard Deviation |       |       |             |       |       |       |       |       |
| Primary deficit   | -0.6               |       | 1.1                |       |       |             |       |       |       |       |       |
| Real GDP growth (in percent)  | 4.4                |       | 4.2                |       |       |             |       |       |       |       |       |
| Nominal interest rate (in percent) 7/   | 5.7                |       | 1.3                |       |       |             |       |       |       |       |       |
| Real interest rate (in percent) 12/   | -0.5               |       | 3.8                |       |       |             |       |       |       |       |       |
| Inflation rate (GDP deflator, in percent)   | 12.0               |       | 14.4               |       |       |             |       |       |       |       |       |
| Revenue to GDP ratio  | 18.6               |       | 1.3                |       |       |             |       |       |       |       |       |

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

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

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

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

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

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

7/ Derived as nominal interest expenditure divided by previous period debt stock.

8/ Assumption on domestic interest rate for 2004-2008 reflects current market information in the context of the inflation-targeting framework.

9/ Assumption on the external interest rate for 2004-2008 reflects current market information.

10/ Based on end of period exchange rate.

11/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

12/ Calculated for period 1995-2001 to exclude the effect of recovery from hyperinflation during early 1990s.

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

|   | Actual |       |       |       |       | Projections |       |       |       |       |       |
|---|--------|-------|-------|-------|-------|-------------|-------|-------|-------|-------|-------|
|   | 1998   | 1999  | 2000  | 2001  | 2002  | 2003        | 2004  | 2005  | 2006  | 2007  | 2008  |
| <b>External debt</b>  | 53.1   | 55.6  | 52.3  | 50.7  | 49.3  | 48.3        | 54.1  | 52.7  | 50.1  | 47.8  | 45.4  |
| External debt-to-exports ratio (in percent)                           | 401.5  | 371.9 | 327.1 | 319.3 | 302.9 | 280.7       | 268.4 | 252.6 | 236.8 | 221.8 | 207.4 |
| <b>External gross financing need (in billions of U.S. dollars) 1/</b> | 11.4   | 9.5   | 8.3   | 6.7   | 7.2   | 5.5         | 5.4   | 5.6   | 5.5   | 5.8   | 6.9   |
| in percent of GDP   | 20.1   | 18.3  | 15.5  | 12.5  | 12.8  | 9.0         | 9.8   | 9.5   | 8.8   | 8.7   | 9.7   |
| <b>Public sector debt 2/</b>  | 42.1   | 48.0  | 45.9  | 46.6  | 47.1  | 46.8        | 51.0  | 50.4  | 48.7  | 47.2  | 45.8  |
| o/w foreign-currency denominated                                      | 37.9   | 43.2  | 41.3  | 41.9  | 41.5  | 41.2        | 42.8  | 42.3  | 40.9  | 37.8  | 36.7  |
| Public sector debt in percent of revenues                             | 211.6  | 255.3 | 255.3 | 256.7 | 267.0 | 263.3       | 273.9 | 277.9 | 270.9 | 272.8 | 261.7 |
| Overall deficit   | -0.7   | -3.0  | -3.2  | -2.4  | -2.2  | -1.9        | -1.2  | -1.4  | -1.3  | -1.4  | -1.4  |
| Interest payment  | 2.0    | 2.2   | 2.3   | 2.2   | 2.0   | 2.1         | 2.2   | 2.6   | 2.6   | 2.8   | 2.8   |
| <b>Public sector gross financing 3/</b>                               | 3.3    | 6.1   | 6.2   | 4.9   | 6.3   | 4.6         | 4.5   | 4.3   | 4.2   | 4.0   | 5.0   |
| in billions of U.S. dollars   | 1.9    | 3.2   | 3.3   | 2.6   | 3.5   | 2.8         | 2.5   | 2.5   | 2.6   | 2.7   | 3.5   |

1/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

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

|   | Actual |       |       |       |       | Projections |       |       |       |       |       |
|---|--------|-------|-------|-------|-------|-------------|-------|-------|-------|-------|-------|
|   | 1998   | 1999  | 2000  | 2001  | 2002  | 2003        | 2004  | 2005  | 2006  | 2007  | 2008  |
| <b>External debt</b>  | 53.1   | 55.6  | 52.3  | 50.7  | 49.3  | 48.3        | 47.7  | 48.7  | 50.4  | 52.3  | 54.6  |
| External debt-to-exports ratio (in percent)                           | 401.5  | 371.9 | 327.1 | 319.3 | 302.9 | 280.7       | 278.2 | 290.8 | 306.9 | 324.3 | 345.5 |
| <b>Gross external financing need (in billions of U.S. dollars) 1/</b> | 11.4   | 9.5   | 8.3   | 6.7   | 7.2   | 5.5         | 5.4   | 5.6   | 5.5   | 5.8   | 6.9   |
| in percent of GDP   | 20.1   | 18.3  | 15.5  | 12.5  | 12.8  | 9.0         | 8.6   | 8.5   | 8.2   | 8.2   | 9.5   |
| <b>Public sector debt 2/</b>  | 42.1   | 48.0  | 45.9  | 46.6  | 47.1  | 46.8        | 45.8  | 47.8  | 48.2  | 48.6  | 49.0  |
| o/w foreign-currency denominated                                      | 37.9   | 43.2  | 41.3  | 41.9  | 41.5  | 41.2        | 38.5  | 40.1  | 40.5  | 38.9  | 39.2  |
| Public sector debt in percent of revenues                             | 211.6  | 255.3 | 255.3 | 256.7 | 267.0 | 263.3       | 250.9 | 263.3 | 270.3 | 284.7 | 283.7 |
| Overall deficit   | -0.7   | -3.0  | -3.2  | -2.4  | -2.2  | -1.9        | -2.0  | -2.0  | -2.0  | -2.0  | -2.0  |
| Interest payment  | 2.0    | 2.2   | 2.3   | 2.2   | 2.0   | 2.1         | 2.2   | 2.4   | 2.6   | 2.9   | 3.0   |
| <b>Public sector gross financing 3/</b>                               | 3.3    | 6.1   | 6.2   | 4.9   | 6.3   | 4.6         | 4.4   | 4.4   | 4.6   | 4.9   | 5.9   |
| in billions of U.S. dollars   | 1.9    | 3.2   | 3.3   | 2.6   | 3.5   | 2.8         | 2.9   | 2.8   | 3.1   | 3.4   | 4.3   |

1/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

**Peru: Fund Relations**  
(As of December 31, 2003)

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

|                                      |                    |                      |
|--------------------------------------|--------------------|----------------------|
| <b>II. General Resources Account</b> | <b>SDR Million</b> | <b>Percent Quota</b> |
| Quota                                | 638.40             | 100.00               |
| Fund holdings of currency            | 732.06             | 114.67               |

|                            |                    |                           |
|----------------------------|--------------------|---------------------------|
| <b>III. SDR Department</b> | <b>SDR Million</b> | <b>Percent Allocation</b> |
| Net cumulative allocation  | 91.32              | 100.00                    |
| Holdings                   | 0.27               | 0.30                      |

|  |                    |                      |
|--|--------------------|----------------------|
| <b>IV. Outstanding Purchases and Loans</b> | <b>SDR Million</b> | <b>Percent Quota</b> |
| Extended arrangements                      | 93.63              | 14.67                |

|                                  |                      |                        |                                      |                                   |
|----------------------------------|----------------------|------------------------|--------------------------------------|-----------------------------------|
| <b>V. Financial Arrangements</b> | <b>Approval Date</b> | <b>Expiration Date</b> | <b>Amount Approved (SDR Million)</b> | <b>Amount Drawn (SDR Million)</b> |
| <b>Type of Arrangement</b>       |                      |                        |                                      |                                   |
| 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):

|                  | <b>Overdue</b>  | <b>Forthcoming</b> |             |             |             |             |
|------------------|-----------------|--------------------|-------------|-------------|-------------|-------------|
|                  | <b>12/31/03</b> | <b>2004</b>        | <b>2005</b> | <b>2006</b> | <b>2007</b> | <b>2008</b> |
| Principal        | 0               | 26.75              | 26.75       | 26.75       | 13.38       | 0.00        |
| Charges/interest | 0               | 3.20               | 2.61        | 2.04        | 1.52        | 1.44        |
| Total            | 0               | 29.95              | 29.36       | 28.79       | 14.90       | 1.44        |

**VII. Safeguard Assessments**

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

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

**VIII. Exchange Arrangements**

Peru maintains a unified, floating exchange rate. On December 31, 2003, the average of interbank buying and selling rates was 3.46 *Nuevo Sol* per U.S. dollar. The central government maintains external payments arrears to unguaranteed suppliers, some of whom are in discussions with the government, while the rest have not been located. Peru has maintained a clearing arrangement with Malaysia since 1991.

arrears to unguaranteed suppliers, some of whom are in discussions with the government, while the rest have not been located. Peru has maintained a clearing arrangement with Malaysia since 1991.

**I. Last Article IV Consultation**

The 2002 Article IV consultation was concluded on December 13, 2002 (IMF Country Report No. 03/72).

**II. FSAP and ROSCs**

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

**III. Technical Assistance**

| Department | Date  | Purpose  |
|------------|---|--|
| FAD        | November 1999                                   | Fiscal rules   |
|            | June 2000, September 2002, September 2003       | Tax policy and administration  |
|            |   |  |
| MFD        | April 1998                                      | Modernization of the payments system                                       |
|            | January 2000                                    | Forward foreign exchange markets   |
|            | September, October, November 2000, January 2001 | Financial sector assessment  |
|            | March 2002                                      | Monetary operations and government securities market                       |
|            | May 2002  | Inflation targeting  |
|            | August 2002                                     | Accounting and organizational issues                                       |
|            | October 2002                                    | Foreign exchange operations  |
| STA        | January 1998 and October 1999                   | National account statistics, new base year for the national account series |
| TRE        | March 1999                                      | Central bank accounting.   |

**IV. Resident Representative**

Mr. Jorge Guzmán is the Fund Senior Resident Representative in Peru since August 2003.



## Peru: World Bank Relations

### Bank Group strategy

The World Bank Group Country Assistance Strategy (CAS), discussed by the IBRD Board on September 17, 2002, supports the implementation of the government's poverty reduction strategy with programs addressing fiscal, national competitiveness, and social-sector needs. In November 2003, following a comprehensive review of the country's performance, the Bank decided to move Peru to a CAS high-case lending scenario entailing a total envelope of around US\$300–400 million a year over FY04–06. Triggers met for the high case are related to the tax ratio and satisfactory progress in the implementation of key reforms in public sector management, social sectors, decentralization, and competitiveness. New lending includes additional quick-disbursing programmatic loans and investment projects for an additional US\$200 million a year.

In 2003, following the additional priorities outlined in the CAS, the Bank approved four operations for US\$365 million for Peru—one programmatic adjustment operation for the social sectors, one programmatic adjustment operation for decentralization, and two investment projects to support Peru's efforts to increase competitiveness and improve public transportation.

### Bank-Fund collaboration in specific areas

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

| Statement of World Bank Loans<br>(As of November 30, 2003)  |                      |                  |  |                             |              |
|---|----------------------|------------------|--|-----------------------------|--------------|
| Loan Number   | Fiscal Year Approved | Borrower         | Purpose  | In millions of U.S. Dollars |              |
|   |                      |                  |  | Total (Net of Cancellation) | Undisbursed  |
| One hundred and twelve (112) loans fully disbursed 1/   |                      |                  |  | 4,351.4                     |              |
| Partially disbursed or undisbursed loans:   |                      |                  |  |                             |              |
| 40760   | 1996                 | Republic of Peru | Irrigation rehabilitation                                | 85.0                        | 3.7          |
| 41300   | 1997                 | Republic of Peru | Sierra natural resource management                       | 51.0                        | 4.4          |
| 43840   | 1998                 | Republic of Peru | Urban property rights                                    | 38.0                        | 8.3          |
| 45190   | 1999                 | Republic of Peru | Agricultural research and extension                      | 9.6                         | 2.2          |
| 45270   | 1999                 | Republic of Peru | Health reform  | 27.0                        | 20.1         |
| 45360   | 2000                 | Republic of Peru | Indigenous people development                            | 5.0                         | 3.9          |
| 46140   | 2001                 | Republic of Peru | Second rural roads rehabilitation and maintenance        | 50.0                        | 30.9         |
| 71420   | 2002                 | Republic of Peru | Rural Water and Sanitation                               | 50.0                        | 49.3         |
| 71760   | 2003                 | Republic of Peru | Rural Education Project                                  | 52.5                        | 52.5         |
| 71770   | 2003                 | Republic of Peru | Trade facility and productivity improvement TA           | 20.0                        | 20.0         |
| 72090   | 2003                 | Republic of Peru | Lima Transport Project                                   | 45.0                        | 45.0         |
| P3980   | 2002                 | Republic of Peru | Accountability for decentralization of social sectors 2/ | 1.5                         | 0.7          |
| <b>Total disbursed:</b>   |                      |                  |  | <b>4,548.2</b>              |              |
| <i>Of which: amount repaid</i>  |                      |                  |  | <i>1,808.5</i>              |              |
| <b>Total outstanding 3/</b>   |                      |                  |  | <b>2,637.3</b>              |              |
| <b>Total undisbursed</b>  |                      |                  |  |                             | <b>237.9</b> |
| 1/ Includes 1997 Pension Reform Adjustment Loan (US\$100 million), 1997 DDSR Loan (US\$183 million), 1999 Financial Sector Adjustment Loan (US\$300 million), 2001 Programmatic Social Reform Loan I (US\$100 million), and the 2003 Programmatic Social Reform Loan II (US\$100 million). Does not include the Decentralization and Competitiveness Loan (DECSAL I) for US\$150 million, which was disbursed in December 2003. |                      |                  |  |                             |              |
| 2/ Project preparation advance.   |                      |                  |  |                             |              |
| 3/ Includes exchange adjustments and loans sold to third parties.   |                      |                  |  |                             |              |

| Statement of IFC Investments<br>(As of November 30, 2003)<br>In millions of U.S. dollars |       |        |       |                     |       |
|--|-------|--------|-------|---------------------|-------|
|  | Loans | Equity | Quasi | Participation Loans | Total |
| Total commitments held by IFC  | 254.2 | 35.9   | 30.0  | 64.9                | 385.0 |
| Total disbursed  | 197.2 | 35.9   | 30.0  | 64.9                | 328.0 |

Source: World Bank.

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

## Peru: Relations with the Inter-American Development Bank

### Country Strategy 2002–2006

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

### Lending

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

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

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

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

## 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, since 1994, the statistical techniques have been largely based on extrapolation. Intermediate consumption is usually compiled as a fixed ratio of output, and the single indicator method is used to estimate GDP at constant prices. With the exception of mining, electricity, and financial and governmental services, the availability of source data is limited due to resource constraints to visit establishments. Response rates for some surveys are low owing to a collection method based on voluntary response to announcements in the press. In addition, the lack of an adequate business register limits the assessment of how representative are the samples. Also, the lack of detailed tables for supply and use hampers the reconciliation of discrepancies in the data. As a result, changes in inventories are mainly determined as a residual. Even though the quarterly accounts have benefited from some improvements in the timeliness of monthly production indices, their coverage is very limited. In order to improve the estimates, 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 the near future. In the meantime, INEI will carry on with the publication of base-year 1994 GDP data.

The weight structure for the CPI is derived from a 1993-94 household expenditure survey. Except for weights, source data are timely and consistent with the technical requirements for producing the index. The coverage of owner-occupied housing, however, was eliminated from the Metropolitan Lima index through the exclusion of imputed rent, a deviation from international practices. Imputed rent is included in the indices of the other 24 cities in the CPI. Thus, the national index is a weighted average of indices that have different coverage. The weights for the WPI are also outdated. INEI derived the weights from the 1994 input-output table and other reports and publications of relevant ministries. The WPI establishment sample could be improved. Although annual and monthly economic surveys are available, there has not been a comprehensive economic census since 1994. An updated business register does not exist, and INEI has had difficulty in obtaining measure-of-size data for a new establishment sample. With the exception of the outdated weights and small sample, the WPI statistical techniques follow generally accepted international standards.

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. Due to technical problems, the authorities were not able to meet the submission deadline to report government finance data for publication in the *2003 Government Finance Statistics Yearbook (2003 GFS Yearbook)*. Consequently, although the data for 2002 has been sent recently, the *2003 GFS Yearbook* (hardcopy) will only include information up to 2001. The data for 2002 will be processed for publication in the *GFS Yearbook-CDROM*. The authorities have prepared and sent to the Fund information on the components of consolidated central government expenditures by function. The *International Financial Statistics (IFS)* has published fiscal data through March 2003.

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 statistics. The BCRP prepares and publishes the analytical accounts of the banking system and of the central bank broadly in line with international standards. However, these statistics are disseminated only in a summary form.

## **IV. External Sector**

The 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 recommendations of the *Balance of Payments Manual, Fifth Edition (BPM5)*. These data are reported to the Fund for publication in the *IFS* and the *Balance of Payments Statistics Yearbook*. Some departures from *BPM5* include the lack of coverage of assets held abroad and land acquisition abroad by residents; lack of separate identification of liabilities to affiliated enterprises; and recording of some external debt transactions on a cash basis rather than an accrual basis.

Regarding international reserves, the BCRP has been reporting since August 2001 weekly data in accordance with the *Operational Guidelines for Data Template on International Reserves and Foreign Currency Liquidity*. The BCRP includes the full amount of the liquidity requirements in the reserve template under official reserve assets, but does not register the contingent net drain (as specified in Section III of the Data Template). Peru started to disseminate quarterly data on external debt with a one-quarter lag in end-

September 2003. External debt data are not compiled on an accrual basis, as recommended by *BPM5* and the *External Debt Statistics: Guide for Compilers and Users*.

### **Findings of the Data ROSC Mission**

A ROSC data module mission visited Lima during February 12–26, 2003. Although Peru's macroeconomic statistics are to a large extent adequate for effective surveillance, the mission identified important shortcomings mainly in national accounts and price statistics.

The report found Peru having a legal and institutional framework that is broadly adequate to support the quality of official statistics and protect the confidentiality of individual respondents' data. The terms and conditions under which statistics are collected, processed, and disseminated are available to the public, as are studies and analyses of revisions to macroeconomic statistics. The timeliness and periodicity of most data series meet or exceed SDDS requirements. The methodologies used for compiling macroeconomic statistics broadly follow international standards, with the exception of the wholesale price index.

Statistical techniques and assessment and validation of source and intermediate data are weak for national accounts and, to a lesser extent, for prices and balance of payments statistics. Response rates for surveys are low, particularly for national accounts source data. There is limited coordination between the BCRP and the Ministry of Economy and Finance (MEF) concerning fiscal statistics. The needs of nongovernmental users of official statistics are not monitored, with the exception of the consumer price index. Statistics are, in general, consistent across sectors, but there are inconsistencies within the national accounts statistics.

The report found several areas where further improvements are needed, including:

- (i) coordination among the agencies that compile official statistics to avoid duplication of efforts and confusion among users;
- (ii) simultaneous release of price and national accounts data to all interested users, without privileged access to selected government officials;
- (iii) establishing an updated business register that provides the basis for sample surveys;
- (iv) implementing a new benchmark and base year for GDP;
- (v) adopting the methodology used for annual GDP to compile quarterly GDP estimates at a more aggregated level;
- (vi) expanding the coverage of the wholesale price index to include mining, oil and gas extraction, electricity and water, public transportation, and communication;
- (vii) assigning responsibility for compiling and disseminating GFS to a single agency;
- (viii) improving the reconciliation of GFS published by the BCRP with the fiscal statistics published by the MEF and the Accountant General's Office;
- (ix) expanding the coverage of the depository corporations survey;
- (x) preparing sectoral breakdowns of depository corporations and financial surveys in accordance with the *MFSM* methodology; and
- (xi) expanding the scope of data sources for compiling financial flows of individual residents.

Since June 2003, the BCRP has fully implemented the recommendation of expanding the coverage of the depository corporations survey.

## Peru: Core Statistical Indicators

As of December 30, 2003

|                             | 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  | 12/30/2003    | 12/29/2003                | 12/24/2003                 | 12/24/2003          | 11/28/2003  | 12/30/2003     | 11/2003              | 10/2003          | Q3/2003                 | 9/2003                        | 10/2003    | Q3/2003          | Q3/2003         |
| Date Received               | 12/30/2003    | 12/30/2003                | 12/26/2003                 | 12/26/2003          | 12/26/2003  | 12/30/2003     | 12/2/2003            | 12/12/2003       | 11/21/2003              | 11/21/2003                    | 12/19/2003 | 11/21/2003       | 11/21/2003      |
| 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                       | Q                             | 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.

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: Update on Main FSAP Recommendations

| Reform Measures  | Specific Actions  | Current Status and Comments  |
|--|---|--|
| Strengthen the autonomy of the Superintendency of Banks (SBS). | Provide legal protection for SBS staff.   | Legislation sent to congress in November 2002. Approved by the relevant commission in congress in late 2003.                                       |
|  | 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"> <li>- creating explicit time frames for any capital contribution that the SBS may deem necessary.</li> <li>- making application of the Special Surveillance regime mandatory if the measures required under the Financial Instability Regime are not met.</li> <li>- conferring explicit powers on the SBS for taking actions in instances of chronic liquidity problems.</li> </ul> | 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. Approved by the relevant commission in congress in late 2003.                  |
|  | 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 by: <ul style="list-style-type: none"> <li>- requiring capital on a consolidated basis.</li> <li>- deducting goodwill from regulatory capital.</li> </ul>   | Effective since end-2001.<br>Proposed change to banking law sent to congress by SBS. Approved by the relevant commission in congress in late 2003. |
|  | 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"> <li>- Simplify procedures.</li> <li>- Strengthen debtor disclosure requirements.</li> <li>- 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.</li> </ul>  | 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.



**Peru: Summary of the Tax System**  
(as of January 2004)

| Tax  | Rate                       | Taxable Base | Exemptions | Remarks |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
|--|----------------------------|--------------|------------|---------|-----|------------|-----------|----------------------------|--------------|-----------------------|--------------|-------------------------|--------------|---------------------------|-----------|---------------------------|-------------|-----------------|
| <b>1. Income tax</b>   |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| <b>A. Corporate income tax (3<sup>rd</sup> category)</b>   |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| The following are not subject to the tax:  |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| <ul style="list-style-type: none"> <li>- The National Public Sector, except public enterprises</li> <li>- Legally established cultural, research, welfare, social assistance, and hospital foundations.</li> <li>- Mutual aid entities.</li> <li>- Communal associations of farmers and indigenous groups.</li> </ul>  |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| The following are exempt (until 12/31/2006):   |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| <ul style="list-style-type: none"> <li>- Religious institutions and nonprofit institutions dedicated to social assistance, charity, education, culture, science, arts, literature, sports, politics and housing.</li> <li>- Interest on development lending granted by international organizations or foreign governmental institutions.</li> <li>- Interest and other gains on loans granted to the National Public Sector.</li> <li>- Interest on savings in the domestic financial system.</li> <li>- Royalties for technical assistance provided from abroad by state or international agencies.</li> <li>- Capital gains from the sale of securities.</li> <li>- Interest and adjustments to principal from mortgage instruments.</li> <li>- Private (nonprofit) universities.</li> <li>- Interest collected or paid by savings and loan cooperatives.</li> </ul> |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| Agriculture is taxed at a rate of 15 percent (Agricultural Promotion Law).   |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| Payments for the 3 <sup>rd</sup> category (general regime):  |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| <ul style="list-style-type: none"> <li>- On the basis of a coefficient applied to monthly income. This coefficient is calculated yearly (and may be revised once during the year), as the quotient between the total amount of tax paid in the previous year and net income during the same period.</li> <li>- 2 percent of net income for new companies or companies that had no income in the previous year (or paid no tax).</li> </ul>   |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| Since 2003 a new advance payment scheme for the income tax is applied to all the corporations except to those starting operations or providing public services as water and utilities. Payments could be used as tax credits. The tax advance payment is applied according corporations' value of net assets; at the rates:  |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="text-align: left;">Tax</td> <td style="text-align: left;">Net assets</td> </tr> <tr> <td>0 percent</td> <td>up to 160 UIT<sup>1</sup></td> </tr> <tr> <td>0.25 percent</td> <td>between 160 - 806 UIT</td> </tr> <tr> <td>0.50 percent</td> <td>between 806 - 1,612 UIT</td> </tr> <tr> <td>0.75 percent</td> <td>between 1,612 - 3,225 UIT</td> </tr> <tr> <td>1 percent</td> <td>between 3,225 - 4,838 UIT</td> </tr> <tr> <td>1.5 percent</td> <td>above 4,838 UIT</td> </tr> </table>  |                            |              |            |         | Tax | Net assets | 0 percent | up to 160 UIT <sup>1</sup> | 0.25 percent | between 160 - 806 UIT | 0.50 percent | between 806 - 1,612 UIT | 0.75 percent | between 1,612 - 3,225 UIT | 1 percent | between 3,225 - 4,838 UIT | 1.5 percent | above 4,838 UIT |
| Tax  | Net assets                 |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| 0 percent  | up to 160 UIT <sup>1</sup> |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| 0.25 percent   | between 160 - 806 UIT      |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| 0.50 percent   | between 806 - 1,612 UIT    |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| 0.75 percent   | between 1,612 - 3,225 UIT  |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| 1 percent  | between 3,225 - 4,838 UIT  |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| 1.5 percent  | above 4,838 UIT            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| Starting in 2004, taxpayers can choose one of two systems to carry losses forward:   |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |
| <ul style="list-style-type: none"> <li>• Losses generated in a taxable year may be carried forward from year to year up to 4 fiscal years, counted from the following year after the loss was generated.</li> <li>• Losses may be carried forward from year to year until their full amount have been offset, but can only be applied up to 50 percent of the net income generated.</li> </ul>   |                            |              |            |         |     |            |           |                            |              |                       |              |                         |              |                           |           |                           |             |                 |

<sup>1</sup> One UIT was equivalent to S/3,200, as of January 1, 2004.

**Peru: Summary of the Tax System**  
(as of January 2004)

| Tax  | Rate         | Taxable Base   | Exemptions   | Remarks   |
|--|--------------|--|--|---|
| <b>b. Special Regime (RER)</b>   |              |  |  |   |
| - Industry and commerce  | 2.5 percent  | Net monthly revenue derived from the 3 <sup>rd</sup> category of income from individuals or legal entities domiciled in Peru whose net revenue in the previous fiscal year did not exceed S/. 240,000.   |  | Since 2001, allowable deductions of expenses are possible unless expenses are incurred in countries with low or no taxation (tax-havens), or paid through persons or entities domiciled in such locations.  |
| - Services   | 3.5 percent  |  |  |   |
| <b>ii. Non-residents</b>   |              |  |  |   |
| - Interest on lines of credit abroad from banks and financial institutions established in Peru     | 1 percent    | Peruvian-source income of enterprises not legally domiciled in Peru (branches, agencies, or permanent establishments).   |  | In 2000, the tax exemption on undistributed profits of mining companies was eliminated.   |
| - Interest on external loans subject to registration requirements and a preferential interest rate | 4.99 percent |  |  | Interest derived from the use of external credit lines by banks or financial institutions continue to be taxed at 1 percent. Interest derived from external loans in cash and posted as a credit to Peru's foreign currency income, loans discounted at an annual interest rate lower than the prevailing preferential interest rate in the source market plus 3 points, and import credits are taxed at a rate of 4.99 percent. Other interest payments on external loans are taxed at a rate of 30 percent. |
| - Leasing of ships and aircrafts   | 10 percent   |  |  |   |
| - Dividends  | 4.1 percent  |  |  |   |
| - Royalties and other income   | 30 percent   |  |  |   |
| <br><b>B. Individuals</b>  |              |  |  |   |
| <b>i. Residents</b>  |              |  |  |   |
| - Between 0-27 UIT   | 15 percent   | Net income results from gross income minus legally-allowed deductions. Income is classified according to 4 categories. Special deductions apply to gross income of each category.  | <p>The following are exempt (until 12/31/2006):</p> <ul style="list-style-type: none"> <li>- Income of sports and cultural representatives of foreign countries.</li> <li>- Leasing on houses of representatives of international organizations.</li> </ul> <p>Salaries of individuals employed by foreign governmental institutions or international institutions, when established by agreement.</p> | <p>Payment scheme:</p> <ul style="list-style-type: none"> <li>- 1<sup>st</sup> and 2<sup>nd</sup> categories: 15 percent per month.</li> <li>- 4<sup>th</sup> category: 10 percent per month</li> <li>- 5<sup>th</sup> category: 1/12 of the expected annual income per month.</li> </ul>   |
| - Between 27-54 UIT  | 21 percent   |  |  |   |
| - Above 54 UIT   | 30 percent   |  |  |   |
|  |              | <ul style="list-style-type: none"> <li>- 1<sup>st</sup> category: land and real estate. (20 percent deduction)</li> <li>- 2<sup>nd</sup> category: capital gains (10 percent deduction)</li> <li>- 4<sup>th</sup> category: income from independent professionals (20 percent deduction up to 24 UIT). In addition, the first 7 UIT are deductible.</li> <li>- 5<sup>th</sup> category: wages and salaries. First 7 UIT are deductible.</li> </ul> |  |   |
| <b>ii. Dividends and profits</b>   |              |  |  |   |
|  | 4.1 percent  | A tax of 4.1 percent applies on the total amount of dividends or distributed profits of both resident and nonresidents.  |  |   |
| <b>iii. Nonresidents</b>   |              |  |  |   |
| - Pensions and salaries  | 30 percent   |  |  | Since 2001, the tax exemption on gross income received by Sportmen/Sportswomen, Sport Clubs and non-resident artists has been eliminated.   |

**Peru: Summary of the Tax System**  
(as of January 2004)

| Tax                               | Rate       | Taxable Base  | Exemptions   | Remarks  |
|-----------------------------------|------------|---|--|--|
| <b>2. General sales tax (IGV)</b> |            |   |  |  |
| <b>General regime</b>             |            |   |  |  |
| Total rate                        | 19 percent | The tax is levied on:   | The following are exempt until 12/31/2004:   | Tax credit:  |
| <i>Of which:</i>                  |            | - Domestic sales of movable goods.  | a. Goods   | Tax credit is accorded for IGV paid on purchases of goods, services, and construction contracts, or paid on imported goods. The tax credit is limited to purchases representing an enterprise expense or cost, in accordance with income tax legislation, and intended for use in operations relating to taxable activities.   |
| - National Treasury               | 17 percent | - The provision or use of services in Peru.   | - South American camels  |  |
| - Municipal budgets (IPM)         | 2 percent  | - Construction contracts.   | - Fish and seafood (except when used to produce fish oil or fish flour)  |  |
|                                   |            | - The first sale of structures by builders.   | - Cochinitilla (red dye)   |  |
|                                   |            | - Imports of goods. The taxable base is the c.i.f. price plus customs duties, surcharges, and the excise tax. | - Bull semen   |  |
|                                   |            |   | - Whole raw milk   |  |
|                                   |            |   | - Potatoes and other root vegetables, vegetables, dried vegetables, and other vegetables and fruits            |  |
|                                   |            |   | - Cereal seeds   |  |
|                                   |            |   | - Rice   |  |
|                                   |            |   | - Raw coffee, tea, cocoa, and unprocessed tobacco  |  |
|                                   |            |   | - Wools and pelts, not carded or combed  |  |
|                                   |            |   | - Raw cotton   |  |
|                                   |            |   | - Nonmonetary gold, unrefined or dust  |  |
|                                   |            |   | - Vehicles for diplomatic use  |  |
|                                   |            |   | - Books for educational institutions   |  |
|                                   |            |   | - The first sale of structures valued at less than 35 UITs   |  |
|                                   |            |   | b. Services  |  |
|                                   |            |   | - Financial services   |  |
|                                   |            |   | - Public passenger terrestrial transportation  |  |
|                                   |            |   | - International cargo transport  |  |
|                                   |            |   | - Live shows declared of cultural value by the Director of National Institute of Culture (INC)                 |  |
|                                   |            |   | - Sale of beverage and food at snack bars and universities   |  |
|                                   |            |   | - Construction and repair of foreign ships   |  |
|                                   |            |   | - Interest on transferable securities issued by enterprises pursuant to the Securities Market Law              |  |
|                                   |            |   | - Life insurance policies  |  |
|                                   |            |   | - Postal services intended to complete such services originating abroad  |  |
|                                   |            |   | Exports of goods and services, as well as construction contracts performed abroad, are not subject to the IGV. |  |
|                                   |            |   |  | Treatment of exports:<br>Exporters may apply the balance of the tax credit against the income tax or other tax liabilities representing income for the National Treasury. Any residual amount may be refunded in the form of marketable tax certificates ( <i>Notas de Crédito Negociables--NCN</i> ) or cash.   |
|                                   |            |   |  | The following are regarded as exports of services:   |
|                                   |            |   |  | - Consulting and technical assistance  |
|                                   |            |   |  | - Leasing of movable property  |
|                                   |            |   |  | - Advertising, market research, and public opinion survey services   |
|                                   |            |   |  | - Personnel placement and administration   |
|                                   |            |   |  | - Commissions on the provision of credit   |
|                                   |            |   |  | - Financing, insurance, and reinsurance operations   |
|                                   |            |   |  | - Telecommunications   |
|                                   |            |   |  | - Tourism operators (only for sales abroad)  |
|                                   |            |   |  | IGV withholding schemes:<br>Law 27799 of 2002 allows SUNAT to select withholding tax agents. The withholding mechanisms adopted include: large taxpayers are required to withhold 6 percent of their purchases above US\$ 200; large fuel sellers withhold 1 percent of the sale price in transactions with fuel retailers; and large buyers of agricultural products (rice, sugar, and alcohol), fisheries and enterprises of labor intermediation withhold up to 15 percent of the sale price. Another withholding mechanism is applied on imports at the rate of 3.5 percent (and 10 percent for physical persons). |

**Peru: Summary of the Tax System**  
(as of January 2004)

| Tax   | Rate         | Taxable Base   | Exemptions   | Remarks  |
|---|--------------|--|--|--|
| <b>3. Excise tax (ISC)</b>                                |              |  |  |  |
| Ad valorem on factory sale price:                         |              |  |  |  |
| - Soft drinks, carbonated and noncarbonated mineral water | 17 percent   | For imports, the tax is levied on:   | Vehicle imports through CETICOS are not subject to ISC.  |  |
| - alcoholic beverages                                     | 20 percent   | - The value in customs determined by Customs authorities.  |  |  |
| - Vehicles (new)  | 10 percent   | The base excludes the IGV.   |  |  |
| - Vehicles (used)   | 30 percent   |  |  |  |
| - Games of chance   |              |  |  |  |
| Lotteries   | 10 percent   |  |  |  |
| Equestrian events   | 2 percent    |  |  |  |
| Ad valorem on retail sale price:                          |              |  |  |  |
| - Cigarettes  | 37.2 percent | The tax is levied on price suggested by the producer or importer, multiplied by a factor of 0.84.                    |  |  |
| - Beer  | 27.8 percent |  |  |  |
| Specific rate system:                                     |              |  |  |  |
| S/. per gallon  |              | The tax is levied on:  | The following are exempt until December 31, 2004   |  |
| - Gasoline  |              | - The volume sold or imported, expressed in units of measurement established by the Ministry of Economy and Finance. | - Imports or sales of diesel or residual fuel to enterprises engaged in the generation, marketing, and distribution of electrical power, authorized by supreme decree. |  |
| Up to 84 octane   | 2.90         |  |  |  |
| 85 – 90 octane  | 3.71         |  |  |  |
| 91 – 95 octane  | 4.02         |  |  |  |
| Over 95 octane  | 4.35         |  |  |  |
| - Kerosene  | 2.14         |  |  |  |
| - Diesel 2  | 2.29         |  |  |  |
| - LPG   | 0.27         |  |  |  |
| <b>4. Import taxes</b>                                    |              |  |  |  |
| Number of customs items affected                          |              | The c.i.f. value of imports.   | The following are exempt from this tax:  | There are four duty rates (4 percent, 7 percent, 12 percent, and 20 percent) as well as a surtax of 5 percent on certain agricultural products, which, taken together, make up the basic customs duty structure. |
| 2,644   | 4 percent    |  | - Imports by universities and by cultural and educational institutions.  |  |
| 133   | 7 percent    |  | - Imports covered by international agreements.   |  |
| 1   | 9 percent    |  | - Grants to the public sector and private charitable institutions.   |  |
| 3,072   | 12 percent   |  | - Passengers' personal baggage.  |  |
| 49  | 17 percent   |  | - Imports by diplomatic personnel and official representatives of international organizations.   |  |
| 763   | 20 percent   |  | - Imports of arms for the Armed Forces and national defense.   |  |
| 329   | 25 percent   |  | - Samples without commercial value.  |  |

**Peru: Summary of the Tax System**  
(as of January 2004)

| Tax  | Rate                       | Taxable Base   | Exemptions  | Remarks  |
|--|----------------------------|--|---|--|
| <b>5. Simplified Consolidated Regime (RUS)</b>   |                            |  |   |  |
| Category:  | Four months revenue up to: | Monthly gross tax of S/.   | Individuals domiciled in Peru who generate 3 <sup>rd</sup> category income and whose gross income in four consecutive months does not exceed S/. 80,000.  |  |
| - Special Industry and commerce  | 14,000                     | 0  |   | Taxpayers concerned pay only the amount of their monthly installment, and are not affected by the income tax, IGV and IES.<br><br>Special Regime:<br>The special regime applies to sellers of fruits, vegetables, and other items exempted under Appendix I to the law on the IGV and ISC, whose income in four consecutive months does not exceed S/. 14,000. The gross tax for this category is currently nil. |
| - 1  | 14,000                     | 20   |   |  |
| - 2  | 24,000                     | 50   |   |  |
| - 3  | 36,000                     | 140  |   |  |
| - 4  | 54,000                     | 280  |   |  |
| - 5  | 80,000                     | 500  |   |  |
| <u>Services (Independent workers)</u>  |                            |  |   |  |
| - 1  | 14,000                     | 20   |   |  |
| - 2  | 24,000                     | 50   |   |  |
| - 3  | 36,000                     | 180  |   |  |
| - 4  | 54,000                     | 380  |   |  |
| - 5  | 80,000                     | 600  |   |  |
| <b>6. Extraordinary Solidarity Tax (IES)</b>   | 1.7 percent                | Compensation to workers subject to income tax in the 4 <sup>th</sup> and 5 <sup>th</sup> income categories.  | The following are not covered:<br>- Compensation for time of service (CTS)<br>- Bonuses for national holidays and Christmas (Law 27349 of 10/4/2000).<br>- Payments to household employees<br>- Annual profit sharing allocations |  |
| <b>7. Amazon Investment Promotion Law (Law 27037 of 12/30/98)</b>  |                            |  |   |  |
| Tax benefits are granted to enterprises located in 5 departments and selected provinces or districts of another 10 departments for a period of 50 years (since 1/1/99) |                            |  |   |  |
| <b>I. Income tax:</b>  |                            |  |   |  |
| Taxpayers in the Departments of Loreto, Madre de Dios, and some districts of Ucayali.  | 5 percent                  | Income of enterprises engaged in agriculture, aquaculture, fishery, tourism, and manufacturing activities associated with the processing, transformation, and marketing of commodities from the aforementioned activities, the processing of forestry products, and forest extraction. | Taxpayers located in the Amazon region who are engaged principally in agriculture and/or the transformation or processing of products described as native and/or alternative crops in this area are exempted.                     | A taxpayer benefiting from this tax advantage must meet domicile requirements for the head office, and at least 70 percent of total assets and/or total production must take place within the Amazon region.   |
| Taxpayers in the rest of Amazonia.   | 10 percent                 |  |   |  |
| <b>II. General sales tax</b>   | Exempt                     |  | The sale of goods, services, and construction contracts within the area for own consumption.  |  |
| <b>III. ISC on natural gas, petroleum, and derivatives</b>   | Exempt                     |  | The sale of such products within the Departments of Loreto, Ucayali and Madre de Dios is exempt from IGV and ISC.   |  |
| <b>IV. Special solidarity tax</b>  | Exempt                     |  | Enterprises located in this zone are exempt.  |  |

**Statement by the IMF Staff Representative**  
**February 23, 2004**

This statement provides information that has become available since the staff report was issued. The new information does not change the thrust of the staff appraisal.

- On February 15 President Toledo replaced seven cabinet ministers. Mr. Pedro Pablo Kuczynski, Mr. Toledo's first finance minister, returns to his former post, and outgoing Minister of Finance Quijandría returns to his previous post at the Ministry of Mining and Energy. The authorities have informed staff that they intend to maintain the direction of economic policies as described in the staff report.
- On February 4, 2004, congress approved several institutional and regulatory norms for the National Port System Framework Law that sets the stage for the concessioning of port facilities. The authorities have announced that the bidding of the concession of the main port (Callao) will take place in the second half of 2004 or early 2005.
- The authorities have renewed their efforts to grant operating concessions for public works. On February 6, 2004, the Yuncán hydroelectric plant was granted in a 30-year concession to Energía del Sur (ENERSUR), a subsidiary of a foreign-owned company. The concession involves an investment commitment of US\$205 million over 17 years, about one fourth of which is to be carried out in the next 1½ years.



INTERNATIONAL MONETARY FUND

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Washington, D. C. 20431 USA

## **IMF Concludes 2004 Article IV Consultation with Peru**

On February 23, 2004, the Executive Board concluded the 2004 Article IV consultation with Peru and completed the fourth program review under the Stand-By Arrangement for Peru approved on February 1, 2002.<sup>1</sup>

### **Background**

The Peruvian economy has been significantly transformed since 1990, enabling it to weather the recent regional financial turbulence. During that period, Peru ended hyperinflation and a debt crisis, carried out fiscal consolidation with important tax and pension reforms, and comprehensively liberalized and privatized the economy. Real per capita GDP is now about 30 percent higher than in 1990. Inflation fell steadily through the 1990s and has remained low since.

In 2003, real GDP grew by 4 percent, with inflation of 2.5 percent and a further strengthening of the external position. Net international reserves rose by US\$600 million, and official reserves now cover more than 200 percent of short-term debt and over 100 percent of dollar deposits in the banking system. Inflation has been kept low under the central bank's inflation targeting framework, permitting a gradual reduction of interest rates. However, the recent rebound in economic activity has not translated into rapid job creation, reflecting weaknesses in the overall investment climate and the concentration of private investment in capital-intensive industries such as mining.

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

Fiscal reforms have progressed well over the last two years, including the creation of a sound legal framework for fiscal decentralization, strengthened fiscal rules, improved fiscal transparency, and further pension reforms. Important advances have also been made in tax reform, although the goal of eliminating regional and sectoral tax exemptions remains to be accomplished, and the latest round of tax reforms also included a new financial transactions tax. Commercial banks' prudential indicators continued to improve in 2003, and bank oversight and prudential regulations have been further strengthened, with particular focus on guarding against vulnerabilities from financial dollarization. Financial system credit to the private sector grew for the second straight year in 2003 (after contracting for several years), with the expanding domestic capital market providing firms an alternative source of financing to traditional bank lending.

The authorities' economic program for 2004 foresees continued economic growth, based on a further recovery of investment and strong export growth. Inflation is projected to remain within the central bank's target range of 1.5-3.5 percent, and the external position is expected to strengthen further, with the current account deficit falling below 1.5 percent of GDP.

In line with the authorities' strategy of gradual medium-term fiscal consolidation, the combined public sector deficit is targeted to decline to 1.5 percent of GDP in 2004 (reflecting mainly the effect of tax reform measures implemented in 2002 and 2003). Fiscal reforms are set to continue in 2004, as the authorities intend to improve the efficiency of public sector operations, proceed with their cautious plan for decentralization, and deepen tax and pension system reform. Bank supervision will be strengthened further, and the reform agenda includes important institutional reforms to improve the investment climate.

As part of the Article IV consultation, an assessment, prepared by staff, of the Fund's longer-term program engagement in Peru was discussed with the authorities.<sup>2</sup> The assessment considers this engagement as having been, on the whole, beneficial for Peru. It highlights that Peru has made significant progress in reforming its economy during the period of engagement, although it also notes that vulnerabilities remain, especially from the still relatively high levels of public debt and financial dollarization. Therefore, the assessment underscores the need for further fiscal consolidation, prudent monetary policy and a high official reserves cushion, and continued vigilance in financial sector supervision.

### **Executive Board Assessment**

Executive Directors agreed with the thrust of the staff appraisal. They commended the Peruvian authorities for their continued strong performance in achieving macroeconomic stability, solid growth, and improved economic resilience in a difficult external environment. Going forward, the economic outlook remains favorable. The authorities' strategy of continued fiscal consolidation and structural reforms is appropriately designed to manage the remaining risks associated with the still relatively large public debt and high financial dollarization, while

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<sup>2</sup> Such assessments are required for members with longer-term program engagement. Peru has had arrangements with the Fund almost continuously since 1993, including three extended arrangements (1993–95, 1996–98, and 1999–2001) and two stand-by arrangements (2001 and 2002–03).



sustaining rapid growth and progress on reducing poverty. Directors encouraged the authorities to continue to look for broad political support for the steadfast implementation of the economic program.

Directors stressed the importance of ongoing fiscal consolidation to keep the public debt dynamics under control. They recommended further action to strengthen the tax effort and make expenditure more flexible, in particular by reforming the preferential public pension regime and restraining wage bill growth. This would also create room for important social and infrastructure spending. Directors were encouraged by the authorities' renewed efforts to grant operating concessions for public works and to pursue privatization where feasible. They noted the importance of proper risk sharing and transparent accounting of public-private partnerships. They welcomed the authorities' commitment to avoid using the dollar deposits of the pension reserve fund held at the central bank to finance fiscal operations.

While welcoming the significant improvements made to the tax system, Directors saw a need for further progress in eliminating regional and sectoral tax exemptions and broadening the income tax base. They urged the authorities to work towards eliminating or revising the Financial Transaction Tax (FTT) as soon as possible to minimize the risks of financial disintermediation and negative effects on investment, growth, and the collection of other taxes.

Directors emphasized that careful implementation of decentralization will be crucial for fiscal sustainability. They welcomed the progress made in establishing a sound legal framework for the fiscal decentralization process. They encouraged the authorities to maintain a close dialogue and consensus with the regions, and to continue to collaborate closely with the World Bank and Inter-American Development Bank in assigning expenditure responsibilities to subnational governments, enhancing local implementation capacity, and ensuring proper monitoring of the implementation process.

Directors supported the authorities' plans to reduce the currency and rollover risk of public debt by gradually shifting the composition of public debt toward local-currency instruments and extending amortization payments over the medium term. They also welcomed the inclusion of collective action clauses in the recent sovereign debt placement.

Directors commended the central bank for maintaining inflation at low levels under the inflation targeting framework. They viewed as appropriate the authorities' goal of further raising official reserves, in light of the still relatively high levels of public dollar-denominated debt and financial dollarization. It will be important to pursue this goal in a manner that is transparent and consistent with appropriate exchange-rate flexibility.

Directors welcomed recent steps to further strengthen bank supervision, particularly in managing the risks of dollar lending. They looked forward to a swift passage of draft legislation to grant legal protection to bank supervisors, and to steps intended to ease credit access for borrowers. Some Directors also recommended a gradual increase in the limits on private pension fund investments abroad to widen their investment options.

Directors encouraged the authorities to make further sustained progress on a range of structural reforms that will be key to strengthening the environment for private investment, growth, and employment creation. They stressed the need to bolster the legal and regulatory framework, including by establishing a commercial court system, enhancing the legal

framework for independent regulatory agencies, and strengthening property rights. Directors underscored the importance of steps to reduce the relative cost of creating formal sector jobs. In this regard, the phased elimination of the special payroll tax rate is welcome, and Directors encouraged the authorities to extend to larger firms the recent measures to lower non-wage labor costs in very small enterprises. Swift reinstatement of unemployment protection would be an important safeguard against potential temporary costs of reforms. Directors commended the authorities' continued commitment to open trade, and welcomed the planned start of negotiations on a free trade-agreement with the United States.

Directors noted that Peru's economic statistics are timely and adequate for program monitoring and surveillance. They welcomed the recent publication of the data Reports on the Observance of Standards and Codes and the authorities' intention to publish the fiscal ROSC.

Directors welcomed the opportunity to review Peru's performance under Fund-supported programs since 1993. During this period, Peru has restored macroeconomic stability, and has achieved strong growth and important progress with structural reforms. Directors considered that Fund involvement has, on balance, been beneficial, with the Fund playing a useful creditor assessment role and providing an anchor for policy credibility. Going forward, many Directors expected that Fund engagement in support of a strong precautionary program could continue to be helpful in the coming years, in particular to further entrench the consensus for sound macroeconomic policies and structural reforms in a challenging political environment. A number of other Directors, however, while recognizing the advantages of a successor program, also considered that exiting from Fund support would further strengthen the market confidence which Peru has regained in recent years.

It is expected that the next Article IV consultation with Peru will be held on the standard 12-month consultation cycle.

**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. The Staff Report for the 2004 Article IV Consultation with Peru is also available.

## Peru: Selected Economic Indicators

|  | 2000 | 2001 | 2002 | Est.<br>2003 | Proj.<br>2004 |
|--|------|------|------|--------------|---------------|
| (Annual percentage change, unless otherwise indicated)                     |      |      |      |              |               |
| <b>Real economy</b>  |      |      |      |              |               |
| Real GDP   | 2.8  | 0.3  | 4.9  | 4.0          | 4.0           |
| Inflation 1/   | 3.7  | -0.1 | 1.5  | 2.5          | 2.0           |
| Terms of trade   | -2.1 | -1.8 | 2.5  | 1.8          | 5.1           |
| Real effective exchange rate<br>(depreciation -) 1/ 2/                     | 7.2  | 4.4  | -5.5 | -7.9         | ...           |
| Nominal exchange rate (in soles per U.S. dollar) 1/                        | 3.53 | 3.44 | 3.51 | 3.48         | ...           |
| <b>Money and credit</b>  |      |      |      |              |               |
| Base money   | -4.0 | 7.9  | 11.0 | 9.6          | 7.0           |
| Liabilities to the private sector 3/ 4/                                    | 3.9  | 7.8  | 9.3  | 9.8          | 10.3          |
| Credit to private sector 3/ 4/   | -1.2 | -2.0 | 2.9  | 5.3          | 5.7           |
| (In percent of GDP, unless otherwise indicated)                            |      |      |      |              |               |
| <b>Savings and investment</b>  |      |      |      |              |               |
| Gross domestic investment  | 20.1 | 18.6 | 18.4 | 18.5         | 18.5          |
| National savings   | 17.2 | 16.4 | 16.3 | 16.9         | 17.1          |
| External savings   | 2.9  | 2.2  | 2.1  | 1.7          | 1.4           |
| <b>Balance of payments</b>   |      |      |      |              |               |
| Current account  | -2.9 | -2.2 | -2.1 | -1.7         | -1.4          |
| Capital and financial account  | 2.7  | 3.0  | 3.5  | 2.5          | 0.5           |
| Gross official reserves (in months of imports<br>of goods and services) 1/ | 10.7 | 10.7 | 10.8 | 10.8         | 9.7           |
| Gross official reserves (in percent of broad money) 1/                     | 64.0 | 62.1 | 65.2 | 66.9         | 64.7          |
| <b>Public sector</b>   |      |      |      |              |               |
| Combined public sector primary balance 5/                                  | -0.9 | -0.1 | -0.1 | 0.2          | 0.6           |
| Combined public sector overall balance 5/                                  | -3.2 | -2.4 | -2.2 | -1.9         | -1.5          |
| Public sector medium- and long-term external debt                          | 36.5 | 35.7 | 36.8 | 37.0         | 35.5          |

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 2003 correspond to November.

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

4/ Corresponds to the financial system.

5/ Revenue excludes privatization receipts.



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FOR IMMEDIATE RELEASE  
February 23, 2004

International Monetary Fund  
Washington, D.C. 20431 USA

### **IMF Completes Fourth Review of Peru's Stand-By Arrangement and Grants Waiver**

The Executive Board of the International Monetary Fund (IMF) today completed the fourth and last review of Peru's performance under a two-year, SDR 255 million (about US\$380 million) Stand-By Arrangement that was approved on February 1, 2002 (see [Press Release No. 02/6](#)). This decision enables the release of SDR 27.87 million (about US\$41 million) to Peru, which brings the total amount available to SDR 255 million (about US\$380 million). The country has not made any drawings under the arrangement nor intends to do so.

In completing the review, the Executive Board also approved Peru's request to waive the nonobservance of the end of December 2003 performance criterion related to the contracting or guaranteeing of nonconcessional external public debt.

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

"Peru's economic performance under the 2002-03 program has been favorable. Real GDP growth averaged 4.5 percent, with inflation in the low single digits and a robust external position. The outlook for 2004 and the medium term is favorable, supported by the authorities' commitment to continue to implement prudent macroeconomic policies and structural reforms. Their efforts to maintain broad domestic consensus on key reforms will help support continued growth with low inflation, while ensuring debt sustainability and further progress on de-dollarization.

"Fiscal consolidation is a key element of the authorities' medium term strategy. In 2003, the fiscal deficit was reduced to 1.9 percent of GDP as programmed, and the medium-term objective of limiting the deficit to no more than one percent of GDP will set the public debt-to-GDP ratio on a firm downward path.

"Monetary policy under the inflation targeting framework has succeeded in meeting the target, with an annual inflation rate converging to 2.5 percent. The authorities' goal of further raising official reserves is appropriate, in view of the still relatively high public debt and dollarization, and it will be important to pursue this goal in a transparent manner that allows appropriate exchange rate flexibility.

“Progress was made with the structural agenda under the program. The recent framework law provides a sound basis for the fiscal decentralization process. It will now be important to follow through with additional legislation on the assignation of expenditure responsibilities to subnational governments, and with careful implementation to ensure broad fiscal neutrality. While many improvements have been introduced to the tax system, work should continue to broaden the consensus for the elimination of regional and sectoral tax exemptions, and the impact of the financial transaction tax will need to be monitored closely.

“Continued improvements in the prudential framework are helping to reduce the risks associated with the high degree of financial dollarization. Welcome steps in this regard are the new regulations related to managing the risks of dollar lending, and the plan to grant bank supervisors appropriate legal protection in the discharge of their duties.

“The authorities’ strategy rightly focuses on continued fiscal consolidation, de-dollarization, reforms of government operations, labor markets, the judicial system, and trade openness. The plans to improve public infrastructure, including through greater private sector participation, are also appropriate. Implementation of these reforms and continued prudent macroeconomic management will provide the foundation for sustained high growth, employment creation and poverty reduction,” Mr. Carstens stated.

**Statement by Guillermo Le Fort, Executive Director for Peru  
and Carlos E. Pereyra, Senior Advisor to Executive Director  
February 23, 2004**

***Key Points***

- *Rapid GDP growth under the program largely reflected a stable macroeconomic environment and expanding export base.*
- *Consistent policies and reduced external vulnerability have resulted in declining sovereign spreads and continuing access to international markets.*
- *Monetary policy in consistency with the inflation target has led to a declining trend in interest rates. Interventions in the foreign exchange market are a tool for monetary policy aimed at preventing deflationary pressures arising from currency appreciation.*
- *The primary dealer system for domestic public debt has been instrumental in promoting financial de-dollarization through the development of a fixed-income market in domestic currency.*
- *The tax reform and the objective of refining expenditure control underpin the authorities' commitment to fiscal sustainability.*
- *Progress in structural reform included: (i) completing the legal framework for decentralization; (ii) advancing trade negotiations both within the framework of regional trading blocs and bilaterally; (iii) relaunching the Private Investment Promotion Program (PIPP); and (iv) pursuing a reform of the state.*
- *Engagement with the Fund has strengthened program implementation through close policy collaboration, creditable performance, and almost no financial implications. Going forward, the authorities concur that a successor program should focus on further fiscal consolidation, de-dollarization, and confronting institutional weaknesses.*

1. The Peruvian authorities wish to thank the staff and management for their advice and support provided under the 2002-03 Stand-By Arrangement (SBA), which now comes to a close. During the program, growth has accelerated to one of the highest rates in the Western Hemisphere, inflation has been kept within the target, and progress has been attained in advancing structural reform. Going forward, the authorities will continue their efforts to strengthen political support for their agenda, further improve resilience against external shocks, increase competitiveness, and consolidate investor confidence to enhance growth and attain a significant reduction in the incidence of poverty. As indicated by the staff, all end-December performance criteria were met, with the exception of a small overrun on the limit for external debt contracting. This was originated by a pre-financing operation for the 2004 budget, performed to benefit from favorable financial conditions. Our authorities, therefore, request a waiver of noncompliance.

## **Real Sector and External Position**

2. Rapid GDP growth under the program —4.9 percent in 2002 and 4.0 percent in 2003— was partly based on the sustained increase in domestic aggregate demand, largely reflecting a stable macroeconomic environment. The dynamism of consumption has been sustained and private investment grew 5.2 percent in real terms in 2003, vis-à-vis 0.2 percent in 2002, mainly in response to major mining and natural gas projects. Moreover, an increasingly favorable external environment has fostered robust growth in exports —6.8 percent in 2002 and 5.0 percent in 2003 in real terms— further widening the trade surplus. It should be noted that the export base is also rapidly expanding to sectors such as textiles and agriculture. In particular, the Andean Trade Promotion and Drug Eradication Act (ATPDEA) with the U.S. has promoted a very strong expansion in textile exports, and our authorities consider regional and bilateral trade agreements as a vehicle for developing the country's productive potential, with exports as the driving force.
3. Strong fundamentals, consistent policies, and reduced external vulnerability have been recognized by international markets through a declining trend in sovereign spreads, reaching 343 basis points in end-January, from 613 one year earlier. Peru's access to international capital is secured on increasingly favorable terms. The latest bond issuance, in November 2003, was completed at a lower spread and a longer maturity than previous placements —30 years— and included collective action clauses (CACs). The authorities hope that these financial conditions will contribute to establishing a benchmark for future private sector bond operations in the international capital market. Moreover, a sound international reserve level —\$10.2 billion as of end-December, equivalent to 2.1 times short-term external obligations and 15 months of imports— places Peru in a good position to weather liquidity shocks.

## **Monetary and Exchange Rate Policy**

4. The stance of monetary policy continues to be defined within the inflation targeting regime. Inflation in 2003 closed at 2.5 percent, at the center of the target range. Since July 2003, the Board of the Central Bank has reduced its policy interest rate four times, and these actions were closely followed by market-determined rates. As a consequence, both the level and volatility of the interbank interest rate have continued their falling trend. Also, the achievement of price stability and the improvement in global economic conditions, together with a more stable regional outlook, have helped to improve the external position and to attract additional capital inflows, thus contributing to the strengthening of the local currency. The authorities underscore that their interventions in the foreign exchange market are to be considered as a tool for monetary policy, in particular to prevent deflationary pressures arising from currency appreciation, and do not reflect a commitment to any predetermined exchange rate. Furthermore, reserve accumulation through these purchases has enabled the Central Bank to underpin the country's external liquidity position.

5. The promotion of financial de-dollarization through the development of a fixed-income market in domestic currency has been enhanced through a primary dealer system for domestic public debt. Under the system, management of domestic debt has been improved, and a benchmark for the interest rates of assets denominated in domestic currency has been defined. Maturities have become longer and yields have decreased significantly, reflecting greater confidence in the domestic currency and providing a reference for longer-term financial instruments. Also, private bond issues, as well as loans in domestic currency, are gaining a larger share of financial operations. Particularly, dollarization in the banking system has diminished from 67 percent of deposits in 2001 to 65 percent in 2002 and to 62 percent as of end-2003. In addition, as of December 2003, bank profitability increased due to the greater quality of the loan portfolio, reflected in the significant drop in the ratio of non-performing loans.

### **Fiscal Policy**

6. The public sector deficit target of 1.9 percent of GDP for 2003 was achieved, to a large extent through good revenue performance. The tax measures adopted in 2002 and 2003, together with a continuing dynamism in economic activity, led to higher tax revenues, equivalent to 12.9 percent of GDP in 2003, from 12.1 percent in 2002, and to a central government primary surplus of 0.1 percent of GDP, from a 0.3 percent primary deficit. The authorities will continue to modernize processes, and enforcement operations will emphasize the VAT and the income tax.
7. Moreover, with the aim of creating room for priority spending, and to increase public investment in infrastructure to enhance the overall productive capacity, the authorities completed the comprehensive tax reform launched in October. The reform was enacted through special powers granted by Congress to legislate on tax matters, and includes a number of administrative measures intended to enhance the efficiency and collection potential of the tax system, mainly by clarifying rules to prevent evasion, enhancing control mechanisms and expanding the supervisory powers of the tax authority. Also, the corporate income tax rate was increased and deductions were narrowed, and the personal income tax base was widened. The financial transactions tax (FTT) will be complemented with the obligation to perform financial operations above a threshold through the banking system. The authorities argue that such obligation will increase financial intermediation and provide additional information that will be instrumental in improving tax control. At the same time, they are aware of the staff's advice in this regard, and have lately expressed their intention to revise it in order to minimize its distortive effects.
8. The authorities' pledge to reinforce fiscal sustainability is further underpinned by the objective of refining expenditure control within the framework of the reform of the state. Thus, they expect the deficit to decline to 1.5 percent of GDP in 2004 —with the primary surplus increasing to 0.6 percent of GDP. Furthermore, they remain committed to reducing the fiscal deficit as announced in the medium-term macroeconomic framework, to 0.5 of GDP by 2006, with the aim of bringing the



debt-to-GDP ratio towards 40 percent of GDP over the medium-term from its current level of 47 percent.

### **Structural Reforms**

9. Concerning the decentralization process, the government will continue to coordinate with the regional authorities the phasing out of exemptions in exchange for investment in infrastructure and social programs. To ensure that the process is implemented in an orderly, gradual, and fiscally neutral manner, the authorities completed the legal framework for decentralization. The Fiscal Decentralization Law, recently enacted, is geared to protect public finances over the medium term. Among other features, it (i) establishes criteria to define the revenue base for sub-national governments; (ii) indicates fiscal rules, mainly limits on the increase in expenditure in real terms and on the debt stock and debt service; and (iii) requires the elaboration of multi-year frameworks and quarterly reports as accountability mechanisms.
10. The authorities are pursuing trade agreements both within the framework of regional trading blocs and bilaterally. In August, Peru became an associate member of the Common Market of the South (MERCOSUR), and the authorities have also made initial progress in negotiating free-trade agreements with the U.S. and the European Union. Likewise, in October Peru started discussions towards a free-trade agreement with Thailand. At the same time, the authorities remain committed to participating in the FTAA initiative.
11. The authorities emphasize their determination to relaunch the Private Investment Promotion Program (PIPP), in an effort to encourage private sector investment. They are confident to be able to muster support for the program, including by involving sub-national governments in the process. A long-term management contract was recently completed for a hydroelectric plant, and near-future operations will include the sale of the remaining government's stake in electricity transmission companies and in an oil company, the exploitation of a phosphates deposit and a copper mining project, and road system concessions.
12. The reform of the state is also prominent in the authorities' agenda. A single regime for government workers—to become effective in 2005—has been enacted in an effort to further rationalize and improve expenditures control. The authorities will also persist in the modernization and transparency of procurement procedures. In addition, they have stated their intention to continue controlling and evaluating current beneficiaries of the national pension system to eliminate irregularities, and to centralize the system.

### **Relations with the Fund**

13. The Fund has provided sound policy advice and has maintained a direct and open dialogue with the authorities in the context of a series of precautionary SBA programs, and financial exposure has been maintained at a minimum (less than 15

percent of quota). This combination of close policy collaboration, creditable performance under Fund support, and almost no financial exposure, represents a deal that members do not usually offer to the institution. Furthermore, since resource implications are one of the main criteria for constructing the list of members with longer-term program engagement, the authorities continue to be of the view that consecutive precautionary arrangements, like in the case of Peru, should be excluded from such list.

14. Our authorities recognize that, despite the progress achieved, substantial work remains to be done to fulfill their reform plans aimed at further improving investor sentiment and creating the conditions for sustained growth and sizeable poverty reduction. Therefore, they have confirmed their interest to continue a close cooperation with the Fund by negotiating a successor SBA, which they also intend to treat as precautionary. The Ex-Post Assessment of Longer-Term Program Engagement (LTPE) broadly recognizes that continued support of the government's economic program through a precautionary SBA could be beneficial. At the same time, for clarification, we would like to provide the following comments:

- Engagement with the Fund has strengthened program implementation, and the compliance problems at the end of the 1990s were isolated events, owing to an institutional disruption already overcome. Under the most recent programs, the authorities have been able to deliver, thanks to their commitment to disciplined macroeconomic management and structural reform. There has been no complacency on the part of the authorities and, even though a certain degree of flexibility has been required, the program has been conducted in the clear understanding that completion of reviews was subject to attainment of the performance criteria and structural benchmarks agreed in the letters of intent.
- The authorities concur that the credibility of a successor program would hinge on addressing fiscal consolidation, de-dollarization, and remaining institutional weaknesses. The significant improvement in market perception in response to a good record of compliance under the recent program suggests that, far from wearing out, the effectiveness of Fund support has increased. Also, the use of structural performance criteria in a continuation program could be politically sensitive and prove counterproductive. Therefore, the authorities continue to be favorable to using structural benchmarks. At the same time, the authorities' approach of garnering political support for their reform agenda has been challenging, but nonetheless they have been able to deliver in crucial areas such as decentralization and the tax reform.