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

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

- the staff report for the second review under the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **February 7, 2003,** 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 March 17, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **March 28, 2003** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its March 28, 2003 discussion** of the staff report that completed the review.

- a statement by the Executive Director for Peru.

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

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

*May also be included in Staff Report

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

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

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INTERNATIONAL MONETARY FUND

PERU

Second Review Under the Stand-By Arrangement

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

Approved by Markus Rodlauer and Liam P. Ebrill

March 17, 2003

- Discussions were held in Lima during January 27–February 6 for the second review under the current two-year Stand-By Arrangement (SBA).[1] The SBA was approved on February 1, 2002, for an amount equivalent to SDR 255 million (20 percent of quota on an annual basis), and is being treated as precautionary. SDR 143.5 million would be available for drawing upon completion of the second review (Appendix I).

- In their Letter of Intent (Attachment I), the authorities describe their economic program for 2003. Performance criteria and structural benchmarks have been set for the year, and the program will have two more reviews.

- At the last Article IV consultation and first program review (December 13, 2002), Directors supported the overall policy framework centered on medium-term fiscal consolidation, inflation targeting and a floating exchange rate. However, they also noted the vulnerabilities of the Peruvian economy associated with financial dollarization and the high public debt. Directors stressed the need to complete the tax reform, implement decentralization in a fiscally-neutral manner, continue to strengthen bank supervision, and improve the financial position of the public pension system.

- 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 broadly adequate for effective surveillance and policy formulation. It has subscribed to the SDDS, and its metadata is posted on the Fund's external web page. A ROSC data mission (STA) visited Lima in February 2003. Appendix II reviews data issues in more detail.

[1] The staff team comprised Messrs. Wolfe (Head), Rodriguez and Villafuerte (all WHD), Ms. Dabán (FAD), and Mr. Keller (PDR). Mr. Velloso (resident representative) assisted the mission, and Mr. Pereyra, Advisor to the Executive Director, participated in the policy discussions. Ms. Cheasty (FAD) joined the mission during January 30–31.

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EXECUTIVE SUMMARY

Background

- **Peru has weathered regional turbulence relatively well, but significant vulnerabilities remain.** Reserves are high, fiscal and external current account deficits are moderate, and the banking system is well-capitalized. The main risks are from the high level of financial dollarization, the relatively large public debt, continued uncertainty in the external environment, and the difficult political situation, which could undermine implementation of the program.

- **Economic performance in 2002 was favorable.** GDP growth in 2002 was 5.2 percent, and inflation was at the low end of the authorities' target range (1.5–3.5 percent). The external position improved further, with reserves up by almost US$1 billion.

- **Progress was made on structural reforms, but key reforms remain to be implemented,** including the completion of tax reform and implementation of a fiscally-neutral decentralization. Both are crucial to fiscal sustainability over the medium term, but face considerable risks in the current political environment.

The 2003 program

- **The 2003 program aims at maintaining prudent macroeconomic policies, including moderate fiscal adjustment, and pressing ahead with structural reforms.** The economic outlook is for continued strong growth (4–5 percent), low inflation, and a robust external position.

- **Moderate fiscal adjustment is needed to give credibility to the authorities' medium-term deficit target** (1 percent of GDP). The combined public sector (CPS) deficit is to be reduced to 1.9 percent of GDP, down from 2.2 percent of GDP in 2002. The targeted decline is largely based on tax reform measures already taken last year.

- **Monetary and exchange rate policies will continue to operate under inflation targeting and the floating exchange rate framework.** Intervention will be limited to "smoothing" operations.

- **The structural reform agenda focuses on issues critical to medium-term fiscal sustainability and the banking system.** In particular, the program includes key steps in tax reform, fiscal decentralization, a revised law on fiscal prudence and transparency, and strengthening legal protection of bank supervisors.

I. Background

1. **The Peruvian economy has weathered regional turbulence relatively well.** The economy's resilience can be attributed to sound fundamentals, including high official reserves, a well-capitalized banking system, globally diversified trade links, and limited dependence on financing from international capital markets. Growth has been robust, and the government's program provides an adequate framework for economic policies.

2. **Nonetheless, the Peruvian economy has important vulnerabilities.** Key vulnerabilities include the high level of dollarization in the banking system (73 percent of private sector deposits are in dollars); the relatively high public debt (47 percent of GDP, with about 85 percent denominated in foreign currency, Figure 1); continued uncertainty in the external environment; and a difficult political situation that could potentially undermine the government's capacity to implement its program (Box 1).

3. **In 2002, economic activity picked up strongly, inflation remained low, and the external position strengthened.** GDP grew by 5.2 percent, compared with 3.7 percent assumed in the program (Table 1 and Figure 2). Growth was led by exports, mainly related to the full-year operation of a large mining project, and consumption, reflecting the fiscal stimulus package implemented in the second half of 2001 and a pick up in consumer and housing lending by banks.[2] Private investment began to recover in the third quarter, and employment has also picked up (Figure 4). Inflation was 1.5 percent in December (y/y), at the lower end of the authorities' inflation target range (1.5–3.5 percent). On the external side, a small current account deficit (2 percent of GDP) was more than matched by sizeable public and private capital inflows, resulting in an increase of official reserves by almost US$1 billion (Tables 2 and 3, and Figures 5 and 6).[3] By year's end, gross official reserves stood at US$9.7 billion, covering 103 percent of dollar deposits in the banking system and 206 percent of short-term external debt.

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[2] While there was a recovery of bank lending in these areas, particularly in the second half of the year (Figure 3), overall bank credit to the private sector declined again in 2002 (Table 1).

[3] In 2002, the *Nuevo Sol* depreciated 5.5 percent in real effective terms. Competitiveness is unlikely to be adversely affected by the large currency depreciations in some neighboring countries as trade with those countries and competition in third markets is limited.

Box 1. Political Situation and Capacity for Program Implementation

The political situation has been difficult. President Toledo took office in July 2001 with high popularity ratings, and his party had 46 of the 120 seats in the unicameral congress that, in coalition with a smaller party, gave him a small voting majority. Over the following 15 months, the President's approval ratings in the polls slid to very low levels owing to unfulfilled electoral promises regarding employment opportunities and concerns of a personal matter. Moreover, discipline within the President's party weakened, and the President lost stability in his voting bloc in congress. Since late 2002, the President's approval ratings have been rising following the pick up in economic growth (which began in the second half of last year) and the resolution of the personal matter.

The government continues to face significant opposition in congress, which raises concerns regarding program implementation capacity. The President is without a stable voting majority, and there remains significant public opposition (including in congress) to the government's economic policies. The poor showing by the President's party in the November 2002 regional elections has emboldened the new regional authorities to press for a faster pace of decentralization and higher spending in the regions. This situation could complicate the introduction of key structural measures to reform the tax system, including the phase-out of regional and sectoral tax exemptions, and to implement a fiscally-neutral decentralization. Also, debate on a new constitution has begun, and while most economic provisions of the current constitution are likely to be preserved, there are a few problematic initiatives (including giving congress the authority to create spending initiatives and expanding the government's right to intervene in private sector activity).

The authorities, however, are of the view that there is sufficient support for their economic program. They point to the passage of key legislation in 2002 that established a sound legal framework for regional governments and put in place several tax reform measures. They note that several presidential vetoes have led to the reconsideration of laws that ran counter to the government's program. In the area of constitutional reform, the authorities are committed to working with congress toward an appropriate final draft.

4. **Financial and banking indicators improved in 2002.** Interest rates and the exchange rate were relatively stable in the first half of the year, but in August-September the currency came under pressure amid growing regional uncertainty. The central bank responded by tightening monetary policy and intervening modestly in the foreign exchange market, and the exchange rate subsequently stabilized (Figure 6). In the banking system, both local and foreign currency deposits rose, and prudential indicators for most banks improved (Table 4 and Figures 7–8).

5. **Macroeconomic policies have been broadly in line with the Fund-supported program, and progress has been made on structural reforms.** All end-December performance criteria were met (Table 5). The 2002 CPS deficit was 2.2 percent of GDP, in line with the revised fiscal program (Tables 6 and 7). Monetary and exchange rate policies have been conducted appropriately under inflation targeting and the float. Structural benchmarks on the inclusion of regional and sectoral tax exemptions as tax expenditures in the 2003 budget, the submission of legislation to congress to revise the law on fiscal prudence and transparency and to grant legal protection to bank supervisors, and tax audits were observed.[4] Tax policy and tax administration measures were introduced as a first phase in the authorities' strategy for a comprehensive tax reform, aimed at improving the efficiency of the tax system (see EBS/02/12, paragraph 16).[5] In addition, the public pension system was reformed, resulting in a modest net present value savings and improving the equity of the system (by reducing certain benefits under the preferential public pension scheme—further reforms of this scheme require constitutional changes). However, the elimination of regional and sectoral tax exemptions, a key element of tax reform in Peru, was delayed owing to political considerations, and strong public opposition led to the reorientation of the privatization program (from asset sales to operating concessions).

II. Outlook and Policy Discussions

6. **The near-term outlook is for continued economic growth, low inflation, and a robust external position.** Real GDP growth is projected in the 4–5 percent range (with the financial program based on 4-percent growth). Exports are expected to continue to perform well, and the recovery in private investment should continue; however, consumption is likely to slow as the impact of the 2001 fiscal stimulus wanes.[6] Inflation is projected at 2½ percent, the mid-point of the central bank's inflation target range. The external current account deficit should decline to under 2 percent of GDP, but capital inflows are projected to slow from last

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[4] The tax audit program has helped raise compliance rates, and collection rates on tax debts doubled in 2002.

[5] Appendix III contains the details on the measures put in place in 2002.

[6] Nontraditional exports will benefit from the full-year effect of the United States preferential trade arrangement for Andean countries; traditional exports should continue to show robust growth (especially for gold, copper, and fishmeal); and several planned investment projects in the mining and transportation sectors should sustain the recovery in private investment that began in the second half of last year.

year; official reserves are targeted to rise modestly.[7] The main economic assumptions and targets for 2003 are as follows:

2003 Macroeconomic Framework

	2002 (preliminary)	**2003**
Real GDP growth (in percent)	5.2	4.0 – 5.0
Inflation (in percent)	1.5	2.5
External current account deficit (percent of GDP)	2.0	1.9
Overall fiscal deficit (percent of GDP)	2.2	1.9
Primary fiscal balance (percent of GDP)	-0.1	0.2
NIR accumulation (in millions of U.S. dollars)	985	40
Gross official reserves (in millions of U.S. dollars)	9,690	9,658
Coverage of bank dollar deposits (in percent)	103	100
Coverage of short-term external debt (in percent)	206	198
Public sector debt-to-GDP (in percent)	46.8	45.6

7. **The economic program for 2003 aims at maintaining prudent macroeconomic policies, including moderate fiscal adjustment, and pressing ahead with structural reforms.** Given the favorable growth outlook for 2003, moderate fiscal consolidation is appropriate. Monetary and exchange rate policies will continue to operate under the inflation targeting and floating exchange rate frameworks. More challenging, given the domestic political situation, will be the planned elimination of regional and sectoral tax exemptions (the key element of tax reform in Peru) and ensuring that fiscal decentralization remains fiscally neutral over the medium term. In the banking system, although financial conditions improved notably last year, both continued vigilance and further strengthening of the prudential framework are needed to contain the vulnerabilities from dollarization (Table 8).

A. Fiscal Policies

8. **Moderate fiscal consolidation in 2003 is in line with the authorities' medium-term fiscal deficit target (1 percent of GDP).** The CPS deficit is to decline from 2.2 percent in 2002 to 1.9 percent in 2003.[8] The programmed adjustment (of about ½-percent of GDP primary balance improvement) is based on the tax reform measures taken in 2002 and strict

[7] However, in the event of adverse developments in the external environment, it is likely that growth would slow and a financing gap could emerge.

[8] The deficit target is adjustable upward by up to 0.1 percent of GDP for on-lending of concessional loans to the private sector for public investment projects.

control on current expenditure.[9] The authorities intend to continue their efforts to strengthen tax administration, especially through the tax audit program and by expanding the VAT withholding schemes introduced last year. They also committed to refrain from any tax amnesty schemes, and will not grant a general wage increase this year.[10] In the event that revenue collections exceed program projections, owing to more robust economic activity than envisaged under the program, staff encouraged the authorities to use part of the higher revenue to further reduce the deficit. However, the authorities were reluctant to commit to further deficit reduction in 2003, given Peru's substantial infrastructure needs and the risk that greater fiscal consolidation could undermine the recovery.

9. **The government's gross financing need for 2003 has been largely secured**. Of the total need of US$2.6 billion, about US$1.1 billion will come from official sources (Table 9).[11] Building on Peru's successful return to international private capital markets in 2002, the government placed in the first quarter of 2003 US$750 million of 12-year bonds.[12] In addition, about US$400 million are expected from quota payments for past privatizations and the granting of new operating concessions in 2003. The residual need of about US$350 million will be met by placements of local-currency bonds in a reactivated domestic market.[13] For this purpose, the authorities are implementing a system of primary dealers, with a published calendar of domestic bond auctions. The staff welcomed these steps and encouraged the issuance of bonds with progressively longer maturities, while concentrating the placement of Treasury bills (for cash management operations) with maturities in the one-to-three month range. The authorities believe that a temporary market closure (owing to adverse external circumstances) should not necessitate a change in their

[9] The tax reform measures taken in 2002 are expected to yield 0.8 percent of GDP, which would compensate for lower exceptional revenues in 2003 (which last year amounted to 0.4 percent of GDP) and the elimination of the special assets tax on state enterprises.

[10] There will be an increase in the wage bill for teachers, as contractual workers are being incorporated in the civil service.

[11] The main lending programs and expected disbursements in 2003 of the World Bank (IBRD) and Inter-American Development Bank (IDB) are described in Appendices IV and V, respectively.

[12] US$500 million were placed in January at a yield of 10.1 percent (610 basis points over comparable U.S. Treasury bonds), and another US$250 million were placed in March at a yield of 9.43 percent (575 basis points over comparable U.S. Treasury bonds). Both auctions were oversubscribed.

[13] The 2003 fiscal program relies on a bond placement rate in the domestic market similar to that in early 2002, when the market was functioning well. After that time, investors lost confidence in the transparency of the auction system, as auction amounts were cut and interest rates did not rise in line with market conditions.

fiscal strategy since contingency financing would be available, but that a longer-term reduction in market access would lead them to tighten the medium-term fiscal framework. They reaffirmed their commitment not to use the resources of the pension reserve fund held at the central bank (as part of official reserves) for financing the fiscal deficit.

10. **Looking to the medium-term, the authorities recognized the need for further reforms on both the revenue and expenditure sides to underpin fiscal sustainability.** Key items on the reform agenda are the completion of tax reform, fiscal decentralization (Box 2), and a comprehensive reform of the state that would rationalize current spending and reverse the decline in capital expenditure as a percentage of total outlays. The authorities will also continue to work with the IBRD and IDB to improve the effectiveness of social spending and thus to ensure that the most vulnerable of the population are well protected.

11. **The planned phase out of regional and sectoral tax exemptions (to be completed by end–2004) is a key element of Peru's comprehensive tax reform.** The authorities explained that this phase out is being integrated into the ongoing fiscal decentralization process in order to improve prospects for reaching a political consensus on this measure. The draft fiscal decentralization law requires that sub-national tax responsibilities be assigned in the context of the comprehensive tax reform, and that increased tax collections in the regions (owing to the phase out of exemptions) be channeled for investment in regional infrastructure.[14] Consistent with the decentralization draft law, so far in 2003 three important exemptions have been eliminated. The authorities agreed with the staff on the importance of measures to mitigate the impact of the phasing out of exemptions on the poor and pointed to an IBRD-supported pilot project in this area. The 2004 budget, which (by law) is to be submitted to congress by end-August, will be consistent with the authorities' objectives on decentralization and tax reform, as well as with strengthened rules on fiscal prudence and transparency.

12. **A strengthened Law on Fiscal Prudence and Transparency is expected to be in place by mid–2003.** A draft law was submitted to congress in November 2002 that would: (i) set a medium-term deficit limit of 1 percent of GDP, with transitional targets of 2.0 and 1.5 percent of GDP for 2003 and 2004, respectively; (ii) establish prudent fiscal rules for sub-national levels of government, including penalties for their non-compliance; (iii) require automatic adjustments in response to revenue shortfalls or expenditure overruns in times of positive economic growth; (iv) establish a realistic path for returning to the medium-term deficit target following a recession (during which the deficit limit is 2.5 percent of GDP); and (v) strengthen fiscal reporting requirements.

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[14] Regional and sectoral tax exemptions to be phased out have relatively small direct costs, but are important sources of tax evasion nationwide. Exemptions needed to compete for foreign investment in the natural resource sector and standard exemptions for the financial sector will not be phased out.

Box 2. Decentralization in Peru

Backed by a strong grassroots movement to decentralize decision-making, a constitutional amendment was approved in early 2002 to decentralize the structure of government. Despite the 1993 constitution's mandate for decentralization, Peru's fiscal management has remained highly centralized: in 2001, the national government carried out 89 percent of expenditure and collected 87 percent of revenue of the general government. The 2002 constitutional amendment mandated the creation of three levels of government (national, regional, and local) with economic and political autonomy, and the implementation of a gradual and orderly decentralization process to ensure an adequate allocation of expenditure responsibilities and resource transfer to local governments. Regional elections were held in November 2002, and the new administrations took office on January 1, 2003.

In 2002, congress approved two key laws that represented important steps forward for a sound decentralization process (the Organic Framework Law on Decentralization, approved in July, and the Law on Regional Governments, approved in November). The Organic Law mandated key principles to be followed in the design of implementing legislation for decentralization, including: (i) promoting accountability of government officials; (ii) requiring a transparent intergovernmental transfer mechanism; (iii) ensuring a neutral fiscal impact of decentralization; (iv) subjecting regional and local government external borrowing to Ministry of Economy and Finance (MEF) approval; and (v) setting fiscal rules for regional and local governments compatible with fiscal rules of the national government. The Law on Regional Governments details their exclusive and shared responsibilities and grants the central government authority to oversee the fiscal situation of regional governments.

A draft law on fiscal decentralization, to be approved in 2003, is to ensure that the medium-term impact of decentralization on the public finances is broadly neutral. The draft law has been prepared with assistance of the Fund, IBRD, and IDB and is to be submitted to congress by late-May. The law:

- sets criteria for the allocation of central government transfers to lower levels of government;
- defines sub-national government taxing powers;
- establishes fiscal rules at the sub-national levels in line with those in the draft law on fiscal prudence and transparency;
- regulates sub-national government borrowing; and
- defines the remaining elements of the comprehensive tax reform (initiated in 2002), including the phasing out of regional and sectoral exemptions (Appendix VI).

Staff supports the authorities' strategy to carry out decentralization in a gradual and ordered manner. In particular, pressures to accelerate the decentralization process in advance of having a sound legal framework in place should be resisted. In moving ahead with decentralization, financing should not precede the devolution of expenditure functions, transfers should be allocated according to a composite index of need, size, and local tax mobilization capabilities, a system of full and uniform reporting requirements (along the lines of those for the central government) should be implemented for all sub-national levels of government, and all regulations (such as debt ceilings) should be strictly observed.

B. Monetary, Exchange Rate, and Financial Sector Policies

13. **The authorities remain committed to continued prudent management of monetary policy under the inflation-targeting framework.** The current monetary stance appears consistent with keeping inflation within the target range over the next 12 months (the central bank's policy horizon), and the authorities are prepared to tighten monetary policy (as they did last year) if necessary to ensure achievement of the target.[15] The authorities felt that the width of the target band (two percentage points) was appropriate, as a wider band could bring into question their commitment to maintaining low inflation.

14. **The authorities recognized that financial dollarization is an important vulnerability, but believed that reducing it will take time**. They explained that dollarization was the result of past episodes of hyperinflation and confiscation of savings and noted that the sound regulatory environment for dollar lending and the high level of official reserves were key factors in mitigating the risks posed by dollarization. In this context, staff welcomed the authorities' continued commitment to manage prudently the reserve requirements on dollar deposits (which form about one-third of official reserves). Looking ahead, the authorities stressed that restoring confidence in the local currency requires a track record of macroeconomic stability, continued prudence in banking system oversight, and the further development of domestic capital markets. However, direct measures to reduce dollarization (such as limits on dollar lending) would be counterproductive (leading banks to shift operations off-shore).

15. **The floating exchange rate system will be maintained.** The authorities' policy is to limit intervention in the spot exchange market to smoothing excessive fluctuations in the exchange rate. Staff welcomed their continued commitment not to intervene directly in the forward foreign exchange market and to limit the use of exchange rate-indexed certificates of deposit (CDRs) to situations of unusual volatility in the spot exchange rate.

16. **Bank supervision will continue to be strengthened in 2003**. The Superintendency of Banks (SBS) issued norms in March 2003 requiring banks to better identify the exchange rate risk of dollar lending to clients with income streams mainly in local currency, and to include it in banks' overall credit risk calculation. In addition, the SBS is in the final stages of consolidating and rationalizing its norms on provisioning and loan classification, with a view to improving their transparency and consistency. Staff cautioned—and the authorities agreed—that any changes should not lead to a relaxation of provisioning requirements. Staff welcomed the authorities' plan to grant statutory protection to SBS staff in the discharge of their responsibilities and encouraged implementation of pending FSAP recommendations to include in the banking law the "least-cost" principle for bank resolution and to establish a

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[15] Starting January 2003, the central bank is reporting its lending and deposit rates as its headline indicator of monetary policy (replacing the previous monetary indicator).

time limit for required capital increases. However, the authorities felt that current regulations are adequate (Appendix VII describes progress in implementing FSAP recommendations).

17. **The authorities will continue to manage prudently existing sectoral support programs and will not create new ones.** The authorities reaffirmed their commitment not to use public resources to establish new financial institutions for direct lending to the public, as well as to continue prudent policies for the agriculture bank (*Banco Agropecuario*) and the second-tier development bank *Cofide*. Staff expressed concern, however, about the recent extension for two years of the consumer-lending program of the *Banco de la Nación* (BN). The authorities explained that this was needed to continue supporting the recovery in economic activity and assured staff that the program would be managed under the same prudent regulations as last year (see EBS/02/12, paragraph 26).

C. Medium-Term Outlook and Debt Sustainability

18. **The medium-term outlook remains favorable** (broadly unchanged from the assessment presented at the last Article IV consultation, Table 10). Continued prudent macropolicies, implementation of the current structural reform agenda, and increasing international trade opportunities should sustain a recovery in private investment and increasing productivity. Under this scenario, real GDP growth would average about 5 percent a year over the medium term, inflation would remain low, and external vulnerability would be limited. Peru should not have difficulties in discharging its obligations to the Fund, even if all available resources were purchased under the arrangement (Tables 11 and 12).

19. **Peru's medium-term debt dynamics are sustainable and fairly resilient to possible shocks.** Appendix VIII presents the staff's debt sustainability analysis (DSA), which follows the methodology established in SM/02/166. It shows that the external and public sector debt outlook is quite robust, but with some vulnerability to a large and sustained decline in the real exchange rate. The authorities questioned the mechanical and static nature of the exercise, especially the lack of any endogenous adjustment to the shocks. They noted that the 30-percent exchange rate shock seemed more appropriate for a fixed-rate exchange rate system and that, in 1998, a time of severe climatic and financial shocks to the Peruvian economy, the *Nuevo Sol* had depreciated by only 11 percent in real terms. Staff and the authorities agreed to work together in refining the DSA model to incorporate dynamic interactions and examine more realistic shocks for Peru.

D. Program Monitoring

20. The quantitative performance criteria and structural benchmarks for 2003 are presented in Attachment I, Tables 1 and 2, respectively. The program envisages two more reviews. The third review, to be completed by August 31, 2003, will focus on: (i) progress in implementing the tax reform and the law on fiscal prudence and transparency; (ii) fiscal decentralization; (iii) the functioning of the domestic bond market; (iv) banking supervision; and (v) government initiatives to aid specific sectors. The timing of the fourth review will be determined at the time of the third review.

III. Staff Appraisal

21. **Peru's economic performance under the program has been favorable, based on strong fundamentals, prudent macropolicies, and progress with structural reforms.** Despite a turbulent external environment and a difficult domestic political situation, growth has been strong, inflation low, and the external position robust. All end-December performance criteria were observed, as were most structural benchmarks. However, domestic political considerations led to a reorientation of the privatization agenda under the PIPP and a change of strategy for eliminating regional and sectoral tax exemptions.

22. **Although the economic outlook remains favorable, it is not without risks**. The macroeconomic framework for 2003 foresees continued robust growth with low inflation and a sound external position. Nonetheless, the relatively high public debt and financial dollarization remain sources of vulnerability, as are the uncertain external environment and the domestic political situation. Given these risks, the authorities will need to be particularly vigilant in implementing the program and stand ready to take additional measures if needed.

23. **Moderate fiscal consolidation in 2003 balances the need to begin reducing the deficit while supporting the recovery**. Deficit reduction is needed to give credibility to the authorities' medium-term fiscal goal, while gradual adjustment is appropriate to avoid the risk of undermining growth. However, should growth exceed program projections and revenue collections prove more buoyant than expected, staff would recommend using part of the excess revenue to lower the deficit. The major fiscal reforms on the agenda, including tax reform, fiscal decentralization, and strengthening the law on fiscal prudence and transparency will be key signals of the authorities' commitment to medium-term fiscal consolidation.

24. **A fiscally-neutral decentralization is crucial for ensuring medium-term fiscal sustainability**. Staff welcomes the recent approval of the Law on Regional Governments, and urges adoption of a fiscal decentralization law this year that is consistent with the goal of keeping decentralization fiscally-neutral over the medium term.

25. **Completing the tax reform begun in 2002, including the phasing out of regional and sectoral tax exemptions, is also key to the health of public finances over the medium term**. Staff sees merit in linking the phase-out of regional and sectoral tax exemptions to the process of decentralization, as a means of building consensus for the reform. Nonetheless, with the phase-out of exemptions to take place over the next two years, the authorities will need to persist in pursuing this key reform to avoid any loss of momentum.

26. **Staff welcomes the authorities' plans to rationalize public expenditure.** Timely implementation of these plans is important to increase budget flexibility and create room for additional productive expenditure. Staff supports the ongoing work, with assistance from the IBRD and the IDB, to improve the quality of social expenditure to ensure that the most vulnerable of the population are well-protected.

27. **Reactivating the domestic bond market is an important step in diversifying public sector sources of financing.** Staff recommends issuing bonds only in local currency and at longer maturities, while placing Treasury bills (to be used for cash management purposes) at maturities in the one-to-three month range.

28. **Staff supports the inflation-targeting framework for monetary policy** and is of the view that the monetary policy stance is consistent with the achievement of the inflation target. Staff commends the authorities' commitment to reducing dollarization and agrees with the authorities that reducing it will depend mainly on continued prudent macroeconomic policies, strong bank supervision, and domestic capital market development. Staff welcomes the improved transparency on the monetary policy stance that will result from the use of central bank interest rates as the headline monetary policy indicator.

29. **The high level of official reserves has been a key factor in Peru's ability to avoid the contagion that has affected other highly-dollarized economies in the region.** Staff welcomes the authorities' continued commitment to maintain reserve requirements on U.S. dollar deposits at their current level and to avoid recourse to dollar deposits of the pension reserve fund held at the central bank to finance fiscal operations.

30. **The flexible exchange rate system has served Peru well in adjusting to external shocks.** Staff supports the policy of limiting intervention in the spot market to smooth excessive fluctuations in the exchange rate. The policy of not intervening directly in the forward exchange market should continue, and the use of exchange rate-indexed certificates of deposit should be strictly limited to relatively low amounts and to cases of unusual spot market volatility.

31. **The financial situation of banks has strengthened over the past year, and the authorities plan to further improve bank oversight.** Staff welcomes the authorities' plan to grant legal protection to bank supervisors and the steps to improve banks' management of risk arising from foreign-currency lending. Staff commends the authorities' stance of leaving financial intermediation to private sector institutions under SBS supervision.

32. **The baseline medium-term outlook is favorable, but not without risks.** Continued prudent macroeconomic policies and implementation of structural reforms should allow Peru to attain high rates of growth that would support poverty reduction and employment growth. However, the high degree of dollarization and the relatively large public debt are important vulnerabilities that need to be addressed, in line with the authorities' medium-term program.

33. **In summary, Peru has performed well under the program supported by the Stand-By Arrangement, and staff recommends completion of the second review.** The overall stance of macroeconomic policy and the structural reform agenda are appropriate. Although there are risks to the program, the authorities recognize those risks, are working to address them, and stand ready to take additional actions if needed.

Table 1. Peru: Selected Economic Indicators

	1999	2000	2001	Prog. 2002	Prel. 2002	Prog. 2003	Rev. Prog. 2003
(Annual percentage change)							
Production, prices, and trade							
Real GDP	0.9	3.1	0.2	3.7	5.2	5.0	4.0
Real domestic demand	-3.1	2.4	-0.7	3.5	4.7	5.4	3.6
Consumer prices							
End of period	3.7	3.7	-0.1	2.5	1.5	2.0	2.5
Period average	3.5	3.8	2.0	1.8	0.2	2.3	2.5
Exports (U.S. dollars)	6.3	15.0	1.1	11.0	8.0	7.7	11.1
Imports (U.S. dollars)	-17.9	8.9	-2.0	6.3	3.3	8.0	6.9
Terms of trade	-8.3	-2.1	-2.0	1.3	2.6	2.0	0.8
Real effective exchange rate (depreciation -) 1/	-2.4	7.2	4.4	...	-5.5	...	...
Money and credit							
Broad money 2/	4.6	2.3	4.9	4.2	4.4	6.1	5.5
Credit to the private sector 2/	-2.3	-3.6	-2.6	5.4	-1.3	8.2	6.4
(In percent of GDP, unless otherwise indicated)							
Public sector							
General government current revenue	17.5	17.7	17.1	16.9	17.2	17.5	16.8
Of which: Central government tax revenue	12.3	12.0	11.9	11.9	11.7	12.4	12.4
General government noninterest expenditure	18.9	18.4	17.8	17.3	17.4	17.1	17.0
Of which: capital expenditure	4.3	3.8	3.2	3.2	2.8	3.1	2.8
Combined public sector primary balance	-0.8	-0.9	-0.1	0.1	-0.1	0.7	0.2
Interest due	2.2	2.3	2.2	2.0	2.1	2.1	2.1
Combined public sector overall balance	-3.0	-3.2	-2.3	-1.9	-2.2	-1.4	-1.9
Balance of payments							
Current account	-2.9	-2.9	-2.0	-2.3	-2.0	-2.7	-1.9
Capital and financial account	1.3	2.7	2.8	2.5	3.4	2.9	1.9
Gross reserves							
in millions of U.S. dollars 3/	9,003	8,563	8,838	8,853	9,690	8,904	9,658
percent of short-term external debt 4/	122.1	154.3	140.5	156.0	206.3	146.3	198.2
percent of foreign currency deposits at banks	98.6	92.5	94.8	92.6	102.6	89.4	100.1
Debt							
Total external debt	55.6	52.6	50.9	50.2	49.9	47.9	48.6
Public debt	48.0	45.9	46.2	45.1	46.8	43.1	45.6
Domestic	9.2	9.4	10.7	10.2	10.0	9.9	9.6
External 5/	38.8	36.5	35.5	34.9	36.8	33.2	36.0
Savings and investment							
Gross domestic investment	21.5	20.1	18.4	18.8	18.3	19.4	18.3
Public sector	4.8	4.0	3.2	3.1	2.8	3.0	2.9
Private sector	16.7	16.1	15.2	15.7	15.5	16.4	15.4
National savings	18.6	17.2	16.4	16.5	16.3	16.7	16.4
Public sector 6/	1.8	0.9	1.0	1.1	0.6	1.5	0.9
Private sector	16.8	16.3	15.4	15.4	15.7	15.2	15.4
External savings	2.9	2.9	2.0	2.3	2.0	2.7	1.9
Memorandum item:							
Nominal GDP (S/. billions)	174.7	186.8	189.5	201.0	199.0	216.3	212.6

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

1/ End of period. Based on Information Notice System.
2/ Foreign currency stocks are valued at program exchange rate.
3/ Gross international reserves exceed net international reserves, basically by the stock of Fund credit outstanding. At end-2002, net international reserves were US$9,598 million.
4/ Short-term debt includes amortization of medium- and long-term loans falling due over the following year.
5/ Includes Central Reserve Bank of Peru debt.
6/ Excludes privatization receipts.

Table 2. Peru: Balance of Payments

	1999	2000	2001	Prog. 2002	Prel. 2002	Prog. 2003	Rev. Prog. 2003
	(In millions of U.S. dollars)						
Current account	**-1,478**	**-1,568**	**-1,094**	**-1,334**	**-1,137**	**-1,643**	**-1,134**
Merchandise trade	-630	-317	-90	151	246	142	585
Exports	6,120	7,034	7,108	7,915	7,679	8,525	8,530
Traditional	4,143	4,821	4,743	5,411	5,313	5,809	5,776
Nontraditional and others	1,977	2,213	2,364	2,505	2,366	2,716	2,754
Imports	-6,750	-7,351	-7,198	-7,764	-7,433	-8,383	-7,945
Services, income, and current transfers (net)	-847	-1,252	-1,004	-1,486	-1,384	-1,787	-1,718
Services	-666	-793	-800	-789	-806	-892	-850
Investment income	-1,146	-1,452	-1,203	-1,682	-1,477	-1,949	-1,807
Current transfers	964	993	999	985	899	1,057	939
Financial and capital account	**673**	**1,437**	**1,511**	**1,412**	**1,919**	**1,739**	**1,142**
Public sector	383	280	394	323	1,050	134	670
Disbursements 1/	1,237	1,485	1,344	1,300	2,901	1,300	1,878
Amortization 1/	-971	-1,042	-918	-941	-1,888	-1,131	-1,152
Other medium- and long-term public sector flows 2/	117	-163	-32	-36	37	-35	-56
Capital transfers (net)	-54	-69	0	0	0	0	0
Privatization	219	229	267	665	186	665	214
Private sector	126	997	850	423	683	940	158
Foreign direct investment (FDI) excluding privatization 3/	1,593	433	796	537	2,046	1,066	471
Other private capital	-1,467	564	54	-114	-1,363	-126	-313
Medium- and long-term loans 4/	350	603	358	240	-346	88	60
Portfolio investment	-297	-300	-271	-189	-402	-179	-177
Short-term flows to the financial system 5/	-1,424	-86	-325	-245	-452	-40	0
Other short term flows (including errors and omissions)	-96	347	292	80	-163	5	-96
Financing	**805**	**131**	**-417**	**-78**	**-782**	**-96**	**-8**
Change in central bank reserves (increase -)	775	190	-448	-100	-832	-120	-40
Change in NIR (increase -)	780	223	-433	-200	-985	-120	-40
Valuation change	6	34	15	0	-153	0	0
Exceptional financing	30	-58	31	23	50	24	32
Debt relief 6/	38	0	33	23	50	24	32
Change in arrears	-8	-58	-2	0	0	0	0
	(In percent of GDP unless otherwise specified)						
Memorandum items:							
Current account (CA) balance	**-2.9**	**-2.9**	**-2.0**	**-2.3**	**-2.0**	**-2.7**	**-1.9**
FDI and private MLT capital (percent of CA deficit)	131.5	66.1	105.5	58.2	149.5	70.2	46.8
Capital and financial account balance	1.3	2.7	2.8	2.5	3.5	2.9	1.9
Export value (US$), percent change	6.3	15.0	1.1	11.0	8.0	7.7	11.1
Volume growth	14.8	11.5	6.3	9.9	4.1	3.7	7.7
Price growth	-7.4	3.1	-4.9	1.0	3.8	3.9	3.4
Import value (US$), percent change	-17.9	8.9	-2.0	6.3	3.3	8.0	6.9
Volume growth	-18.5	3.4	1.0	6.6	2.1	6.0	4.4
Price growth	0.7	5.3	-3.0	-0.3	1.1	1.8	2.5
GDP (millions of US$)	51,628	53,513	54,024	56,817	56,459	60,072	59,535

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; 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 EBS/02/199, Box 3.

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

3/ The 2002 program did not envisage a $600 million sale of a local brewery, nor a US$300 million capital injection by foreign owners of a Peruvian bank. Also, several investments expected to take place in 2003 were advanced to 2002.

4/ In 2002, the negative net figure mainly reflects the substitution of FDI for new credit disbursements (see Footnote 3).

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

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

Table 3. Peru: External Financing Requirements and Sources

(In millions of U.S. dollars)

	1999	2000	2001	Prog. 2002	Prel. 2002	Prog. 2003	Rev. Prog. 2003
1. Gross financing requirements	**8,639**	**8,144**	**6,995**	**7,208**	**8,233**	**7,733**	**5,814**
External current account deficit (excluding official transfers)	1,478	1,568	1,094	1,334	1,137	1,643	1,135
Debt amortization	7,933	6,742	5,466	5,774	6,111	5,970	4,639
Medium- and long-term debt	2,039	2,487	1,797	2,184	3,009	2,495	1,992
Public sector	971	1,042	918	941	1,888	1,131	1,152
Multilateral 1/	273	531	335	410	399	470	479
Bilateral	365	389	490	472	541	588	617
Bonds and notes	319	108	83	50	940	67	50
Other	15	12	10	9	8	6	6
Private sector	1,068	1,445	879	1,243	1,121	1,364	840
Short-term debt 2/	5,894	4,255	3,669	3,590	3,102	3,475	2,647
Repayment of arrears 3/	8	58	2	0	0	0	0
Accumulation of NIR	-780	-224	433	100	985	120	40
Change in gross reserves	-954	-362	275	-55	852	41	-32
Payments of short-term liabilities of the central bank	174	138	158	155	133	79	72
IMF repurchases and repayments	179	172	143	155	129	79	72
Other	-5	-34	15	0	4	0	0
2. Available financing	**8,505**	**7,632**	**6,508**	**7,185**	**8,129**	**7,709**	**5,781**
Foreign direct investment (net)	1,812	662	1,063	1,202	2,232	1,731	685
Privatization	219	229	267	665	186	665	214
FDI	1,593	433	796	537	2,046	1,066	471
Portfolio (net)	-297	-300	-271	-189	-402	-179	-177
Short-term assets (flow)	-37	231	68	-50	-61	-135	-200
Debt financing from private creditors	5,697	5,752	4,338	4,958	5,308	5,027	4,351
Medium- and long-term financing	1,442	2,083	1,236	1,483	2,661	1,452	1,600
To public sector	25	35	0	0	1,886	0	700
To private sector	1,418	2,048	1,236	1,483	775	1,452	900
Short-term financing	4,255	3,669	3,102	3,475	2,647	3,575	2,751
Official creditors 4/	1,213	1,450	1,343	1,300	1,015	1,300	1,178
Multilateral 1/	960	794	1,105	1,071	807	1,040	895
Of which: balance of payments financing	414	471	848	850	586	819	674
Bilateral	253	656	238	229	208	260	283
To public sector	253	656	238	229	208	260	283
Of which: balance of payments financing	0	300	0	0	0	0	0
To private sector	0	0	0	0	0	0	0
Other medium- and long-term public sector flows 5/	117	-163	-33	-36	37	-35	-56
IMF	0	0	0	0	0	0	0
Accumulation of arrears (exceptional)	0	0	0	0	0	0	0
3. Financing gap	**134**	**512**	**487**	**23**	**104**	**24**	**33**
Other flows 6/	134	512	487	23	104	24	33
Errors and omissions	96	512	456	0	52	0	0
Debt relief	38	0	31	23	51	24	33

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

1/ Excluding IMF.

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

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

4/ Includes both loans and grants.

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

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

Table 4. Peru: Monetary Survey

	1999	2000	2001	Prog. 2002	Prel. 2002	Prog. 2003	Rev. Prog. 2003
			I. Central Reserve Bank				
			(In millions of Nuevos Soles at program exchange rate)				
Net international reserves 1/	**28,149**	**28,739**	**29,803**	**29,690**	**32,214**	**30,625**	**32,627**
(In millions of U.S. dollars)	8,159	8,022	8,324	8,387	9,100	8,507	9,139
Net domestic assets	**-23,518**	**-24,201**	**-24,858**	**-24,450**	**-26,602**	**-25,041**	**-26,498**
Net credit to nonfinancial public sector	-9,966	-9,390	-8,758	-8,874	-10,003	-9,092	-9,579
Rest of banking system	-11,462	-12,488	-13,695	-13,401	-14,286	-13,588	-14,373
Other	-2,090	-2,323	-2,405	-2,175	-2,313	-2,361	-2,546
Currency	**4,631**	**4,537**	**4,945**	**5,240**	**5,612**	**5,584**	**6,129**
			II. Banking System				
			(In millions of Nuevos Soles at program exchange rate)				
Net foreign assets	**25,630**	**26,555**	**28,503**	**29,249**	**32,141**	**30,680**	**32,552**
Net domestic assets	**19,801**	**21,043**	**21,004**	**22,441**	**19,257**	**24,811**	**22,009**
Net credit to nonfinancial public sector	-13,291	-11,297	-9,351	-11,542	-10,464	-13,097	-10,290
Credit to private sector	49,166	49,112	47,611	50,305	46,550	55,163	49,841
Other	-16,074	-16,772	-17,256	-16,322	-16,829	-17,255	-17,542
Net credit to COFIDE	-3,074	-2,395	-1,732	-1,692	-1,265	-1,718	-1,275
Other	-13,000	-14,377	-15,524	-14,630	-15,564	-15,537	-16,267
Liabilities to the private sector	**45,431**	**47,598**	**49,507**	**51,690**	**51,398**	**55,491**	**54,561**
			(12-month percentage change) 2/				
Base money	17.0	-4.0	7.9	4.8	11.0	5.8	8.0
Broad money	4.6	2.3	4.9	4.2	4.4	6.1	5.5
Domestic currency	11.4	2.5	13.7	7.7	10.2	10.1	11.9
Foreign currency	1.7	2.2	1.1	2.5	1.5	4.1	2.1
Credit to private sector	-2.3	-3.6	-2.6	5.4	-1.3	8.2	6.4
Domestic currency	-5.3	0.9	2.7	9.1	7.2	12.2	11.3
Foreign currency	-1.6	-4.5	-3.8	4.6	-3.4	7.2	5.1
Memorandum item:							
Program exchange rate (S/. per US$)	3.45	3.60	3.58	3.54	3.54	3.60	3.57

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

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

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

Table 5. Peru: Quantitative Performance Criteria, 2002

	March 31	June 30	Sept. 30	Dec. 31
(Cumulative amounts from December 31, 2001; in millions of Nuevos Soles)				
Borrowing requirement of the combined public sector				
Unadjusted limits	750	1,800	2,850	4,520
Adjusted limits 1/	750	1,800	2,850	4,520
Actual	373	1,299	2,357	4,195
Margin	377	501	493	325
Net consumer lending of the Banco de la Nación				
Limit	200	340	430	360
Actual	106	145	207	218
Margin	94	195	223	142
Net domestic assets of the central reserve bank (change) 2/				
Unadjusted limits	-690	-920	-1,535	...
Adjusted limits 1/	-1,455	-1,334	-1,800	...
Actual	-1,371	-1,022	-1,707	...
Margin	-83	-312	-93	...
(Cumulative change from December 31, 2001; in millions of U.S. dollars)				
Net international reserves of the central reserve bank				
Unadjusted targets	55	125	315	30
Adjusted targets 1/	271	242	390	213
Actual	324	273	523	618
Margin	53	31	133	405
Stock of government guarantees for housing support programs				
Limit	150	150	150	150
Actual	0	0	0	0
Margin	150	150	150	150
Short-term net external debt of the public sector				
Limits	50	50	50	50
Actual	0	0	0	0
Margin	50	50	50	50
External payments arrears of the public sector (on a continuous basis) 3/				
Limits	0	0	0	0
Actual	0	0	0	0
Margin	0	0	0	0
(Cumulative amounts from December 31, 2001; in millions of U.S. dollars)				
Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year				
Total				
Unadjusted limits	1,100	1,400	1,700	1,950
Adjusted limits 1/	2,023	2,323	2,623	2,873
Actual	1,423	1,973	2,273	2,779
Margin	600	350	350	94
Of which: 1- to 5-year maturity				
Limits	200	200	200	200
Actual	0	0	0	2
Margin	200	200	200	198
(Consultation band for the 12-month rate of inflation, in percent)				
Outer band range				-0.5 - 5.5
Actual				1.5
Inner band range				0.5 - 4.5

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; EBS/02/12, and EBS/02/199.

1/ The targets and limits were adjusted in accordance with the tables attached to the letters of intent dated January 18, 2002 (EBS/02/12) and November 26, 2002 (EBS/02/199).

2/ This performance criterion was replaced by a consultation mechanism on inflation, as approved by the Executive Board on December 13, 2002.

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

Table 6. Peru: Fiscal Operations of the Combined Public Sector
(In percent of GDP)

	1999	2000	2001	Prog. 2002	Rev. Prog. 2002	Prel. 2002	Prog. 2003	Rev. Prog. 2003
Central government primary balance	**-1.0**	**-0.5**	**-0.7**	**-0.3**	**-0.3**	**-0.3**	**0.3**	**0.0**
Revenue	14.9	15.0	14.3	14.4	14.5	14.3	14.7	14.3
Current	14.5	14.7	14.1	14.1	14.4	14.2	14.4	14.2
Of which: tax revenue 1/	12.3	12.0	11.9	11.9	11.8	11.7	12.4	12.4
Capital	0.4	0.3	0.2	0.3	0.2	0.1	0.3	0.1
Noninterest expenditure	15.9	15.5	14.9	14.7	14.8	14.6	14.5	14.3
Current	12.5	12.7	12.6	12.4	12.6	12.6	12.2	12.3
Capital	3.4	2.8	2.4	2.2	2.2	2.0	2.2	2.0
Rest of the general government primary balance	**0.1**	**0.1**	**0.2**	**0.2**	**0.0**	**0.1**	**0.3**	**-0.1**
Revenue	5.4	5.6	5.6	5.6	5.7	5.8	5.7	5.5
Current	5.4	5.4	5.5	5.6	5.6	5.7	5.7	5.5
Capital	0.0	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Noninterest expenditure	5.3	5.5	5.5	5.4	5.6	5.6	5.4	5.6
Current	4.4	4.5	4.6	4.5	4.8	4.9	4.5	4.8
Capital	1.0	1.0	0.9	0.9	0.8	0.8	0.9	0.8
Public enterprise primary balance	**0.0**	**-0.5**	**0.2**	**0.2**	**0.0**	**-0.1**	**0.1**	**0.2**
Current balance	0.9	0.2	0.6	0.4	0.4	0.2	0.3	0.5
Capital balance	-0.9	-0.7	-0.4	-0.3	-0.4	-0.3	-0.2	-0.4
Nonfinancial public sector primary balance	-0.5	-0.9	-0.4	0.0	-0.2	-0.4	0.5	0.2
Central bank operating balance	0.1	0.0	0.2	0.0	0.1	0.2	0.0	0.1
Combined public sector primary balance	**-0.8**	**-0.9**	**-0.1**	**0.1**	**-0.2**	**-0.1**	**0.7**	**0.2**
Interest payments	2.2	2.3	2.2	2.0	2.1	2.1	2.1	2.1
External	2.0	1.9	1.9	1.7	1.8	1.8	1.7	1.8
Domestic	0.2	0.3	0.3	0.3	0.3	0.3	0.4	0.3
Combined public sector overall balance	**-3.0**	**-3.2**	**-2.3**	**-1.9**	**-2.3**	**-2.2**	**-1.4**	**-1.9**
Financing	3.0	3.2	2.3	1.9	2.3	2.2	1.4	1.9
External	-0.1	1.2	0.9	0.7	2.1	2.1	0.3	1.2
Disbursements	1.6	2.4	2.4	2.2	3.7	5.0	2.1	3.0
(In millions of U.S. dollars)	812	1,299	1,319	1,250	2,056	2,863	1,250	1,800
Amortizations	-1.7	-1.2	-1.4	-1.5	-1.7	-3.2	-1.8	-1.9
(In millions of U.S. dollars)	-873	-636	-768	-862	-925	-1,837	-1,091	-1,111
Rescheduling/arrears (net)	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Condonations	0.1	0.1	-0.1	0.0	0.1	0.3	0.0	0.1
Domestic	2.3	1.2	0.9	0.0	-0.5	-0.7	-0.1	0.1
Of which: bonds	...	...	0.6	0.8	0.5	0.5	1.1	0.7
(In millions of U.S. dollars)	...	...	348	452	267	266	667	420
Amortizations	...	-0.3	-0.2	-0.3	-0.2	-0.2	-0.6	-0.6
(In millions of U.S. dollars)	...	-161	-131	-147	-125	-138	-381	-361
Net deposits	2.3	1.5	0.5	-0.5	-0.8	-0.9	-0.6	0.0
(In millions of U.S. dollars)	1,203	798	244	-306	-436	-497	-357	-20
Privatization	0.7	0.8	0.6	1.2	0.7	0.8	1.2	0.7
(In millions of U.S. dollars)	363	409	327	700	400	421	700	400
Memorandum items:								
Tax on assets on public enterprises	...	...	0.3	0.3	0.3	0.2	0.2	0.0
General government tax revenues 1/	12.6	12.2	12.1	12.2	0.0	12.0	12.6	12.7
General government current revenue 2/	17.5	17.7	17.1	16.9	17.2	17.2	17.5	16.8
General government noninterest expenditure 2/	18.9	18.4	17.8	17.3	17.6	17.4	17.1	17.0
Public sector debt-to-GDP 3/	48.0	45.9	46.2	45.1	47.7	46.8	43.1	45.6

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

1/ Net of tax on assets of public enterprises and of central government IES payment.

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

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

Table 7. Peru: Fiscal Operations of the Central Government
(In percent of GDP)

	1999	2000	2001	Prg. 2002	Rev. Prog. 2002	Prel. 2002	Prg. 2003	Rev. Prg. 2003
Current primary balance	**2.0**	**2.0**	**1.5**	**1.7**	**1.8**	**1.6**	**2.2**	**1.9**
Current revenue	14.5	14.7	14.1	14.1	14.4	14.2	14.4	14.2
Tax revenue 1/	12.3	12.0	11.9	11.9	11.8	11.7	12.4	12.4
Direct taxes	3.5	3.3	3.4	3.1	3.2	3.2	3.2	3.5
Indirect taxes	8.9	8.7	8.5	8.8	8.6	8.5	9.2	8.9
Other current revenue	2.2	2.8	2.2	2.2	2.6	2.5	2.1	1.8
Current noninterest expenditure	12.5	12.7	12.6	12.4	12.6	12.6	12.2	12.3
Labor services 2/	6.7	6.6	6.6	6.4	6.7	6.7	6.4	6.4
Goods and nonlabor services	3.0	3.8	3.7	3.6	3.5	3.4	3.5	3.4
Transfers and other	2.7	2.3	2.2	2.4	2.4	2.5	2.3	2.6
Capital balance	**-3.0**	**-2.5**	**-2.2**	**-1.9**	**-2.0**	**-1.9**	**-1.9**	**-1.8**
Capital revenue	0.4	0.3	0.2	0.3	0.2	0.1	0.3	0.1
Capital expenditure	3.4	2.8	2.4	2.2	2.2	2.0	2.2	2.0
Gross capital formation	2.7	2.5	2.1	2.1	1.9	1.8	2.1	1.8
Other	0.7	0.3	0.3	0.2	0.3	0.2	0.1	0.1
Primary balance	**-1.0**	**-0.5**	**-0.7**	**-0.3**	**-0.3**	**-0.3**	**0.3**	**0.0**
Interest payments	2.1	2.2	2.1	2.0	2.0	2.0	2.0	2.0
External	2.0	1.9	1.9	1.7	1.8	1.7	1.6	1.8
Domestic	0.1	0.3	0.2	0.3	0.3	0.2	0.4	0.3
Net lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**-3.1**	**-2.7**	**-2.8**	**-2.2**	**-2.3**	**-2.2**	**-1.7**	**-2.0**
Memorandum items:								
Primary balance before transfers	0.6	0.9	1.2	1.9	1.8	1.9	2.4	2.4
Overall balance before transfers	-1.5	-1.3	-0.9	-0.1	-0.3	-0.1	0.4	0.4
Tax compliance rate 3/	...	78.6	82.8	...	...	87.2	...	...

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

1/ Net of tax on assets of public enterprises and of central government IES payment.

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

3/ Measured as the ratio between paid tax obligations and total tax obligations. Obligations covered are VAT and income taxes for large taxpayers only.

Table 8. Peru: Financial and External Vulnerability Indicators

(In percent; unless otherwise indicated)

	1999	2000	2001	Prog. 2002	Prel. 2002	Prog. 2003	Rev. Prog. 2003
Financial indicators							
Public sector debt/GDP	48.1	45.9	46.2	45.1	46.8	43.1	45.6
Of which: in domestic currency (percent of GDP)	5.7	5.9	6.8	...	6.9	...	6.5
90-day prime lending rate, domestic currency 1/	21.2	15.4	5.0	...	5.1	...	...
90-day prime lending rate, foreign currency 1/	11.8	8.2	3.1	...	2.4	...	...
Velocity of money 2/	3.9	3.9	3.8	3.9	3.9	3.9	3.9
Credit to the private sector/GDP	27.9	26.0	25.0	24.6	23.4	25.1	23.5
Share of foreign currency deposits in total deposits	77.3	76.9	73.9	...	73.0	...	71.9
Share of foreign currency loans in total credit	82.3	81.5	80.1	...	78.8	...	78.1
Nonperforming loans/total loans 3/	9.4	11.2	11.0	...	8.2	...	...
Loan-loss provisions/nonperforming loans 3/	79.4	78.5	90.0	...	122.8	...	...
Risk-based capital-assets ratio	12.0	12.9	13.4	...	12.7	...	...
Foreign currency deposits at commercial banks (in millions of U.S. dollars)	9,133	9,260	9,321	9,561	9,446	9,960	9,646
Commercial banks' short-term foreign assets (in millions of U.S. dollars)	981	824	750	861	789	861	789
Commercial banks' short-term foreign liabilities (in millions of U.S. dollars	1,835	1,519	1,188	1,239	827	1,239	827
External indicators							
Exports, U.S. dollars (percent change)	6.3	15.0	1.1	11.0	8.0	7.7	11.1
Imports, U.S. dollars (percent change)	-17.9	8.9	-2.0	6.3	3.3	8.0	6.9
Terms of trade (percent change)	-8.3	-2.1	-2.0	1.3	2.6	2.0	0.8
Real effective exchange rate, (end-period, percent change) 1/	-2.4	7.2	4.4	...	-5.5	...	...
Current account balance (percent of GDP)	-2.9	-2.9	-2.0	-2.3	-2.0	-2.7	-1.9
Capital and financial account balance (percent of GDP)	1.3	2.7	2.8	2.5	3.4	2.9	1.9
Total external debt (percent of GDP)	55.6	52.6	50.9	50.2	49.9	47.9	48.6
Medium- and long-term public debt (percent of GDP) 4/	38.8	36.5	35.5	34.9	36.8	33.2	36.0
Medium- and long-term private debt (percent of GDP)	8.4	9.1	9.7	9.1	8.3	8.7	8.0
Short-term public and private debt (percent of GDP)	8.3	6.9	5.8	6.1	4.7	6.0	4.6
Total external debt (percent of exports of goods and services) 5/	371.9	326.8	320.0	302.8	305.3	284.6	284.5
Total debt service (percent of exports of goods and services) 5/	54.4	50.2	39.4	38.6	35.5	39.8	34.7
Gross official reserves (in millions of U.S. dollars)	9,003	8,563	8,838	8,853	9,690	8,904	9,658
Gross official reserves, percent of short-term external debt 6/	122.1	154.3	140.5	156.0	206.3	146.3	198.2
Gross official reserves, percent of broad money 7/	68.0	64.0	62.1	60.3	65.7	57.5	62.4
Gross official reserves, percent of foreign currency deposits at banks	98.6	92.5	94.8	92.6	102.6	89.4	100.1
Gross official reserves (in months of imports of goods and services)	11.1	10.8	10.8	9.8	11.1	9.0	10.3
Net international reserves (in millions of U.S. dollars)	8,404	8,180	8,613	8,713	9,598	8,833	9,638
Net international reserves (program definition; in millions of U.S. dollars) 8/	5,195	4,891	5,056	5,094	5,674	5,116	5,526
Net international position (in millions of U.S. dollars) 9/	2,538	2,624	2,915	...	3,341	...	3,341
Financial market indicators							
Stock market index (U.S. dollars)	523.4	342.8	342.1	...	396.0	...	...
Foreign currency debt rating (Moody's)	Ba3	Ba3	Ba3	...	Ba3	...	...
Spread of Peruvian Brady bonds, basis points 10/	443	687	521	...	610	...	...

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

1/ At end of period.
2/ Defined as the inverse of the ratio of end-period broad money to annual GDP.
3/ Annual average. Since 2000, includes adjustment for an estimate of nonperforming loans that were temporarily exchanged for government bonds.
4/ Includes Central Reserve Bank of Peru debt.
5/ Includes debt service to the Fund. For 2002, excludes US$923 million of Brady bonds that were amortized in a debt exchange operation.
6/ Short-term debt includes amortization of medium- and long-term loans falling due over the following year.
7/ At end-period exchange rate.
8/ Includes financial system's foreign currency deposits in central bank as reserve liability.
9/ Includes public sector foreign currency deposits in central bank (e.g. pension reserve funds) as reserve liability.
10/ Over U.S. Treasury bond yields of comparable maturity.

Table 9. Peru: Financing of the Combined Public Sector

	Prog. 2002	Prel. 2002	Prog. 2003	Rev. Prog. 2003
	(In millions of U.S. dollars)			
Combined public sector balance	**-1,060**	**-1,219**	**-770**	**-1,154**
Financing	**1,060**	**1,219**	**770**	**1,154**
Net External	**410**	**1,176**	**183**	**722**
Disbursements 1/	1,250	2,863	1,250	1,800
Bonds	0	1,886	0	750
Multilaterals	1,025	807	992	895
Bilaterals and other	225	170	258	155
Amortizations 1/	-862	-1,837	-1,091	-1,111
Condonation	22	150	24	33
Privatization	**700**	**421**	**700**	**400**
Net Domestic financing	**-50**	**-378**	**-113**	**32**
Bonds	452	266	667	420
Amortizations	-147	-138	-381	-361
Net deposits	-354	-507	-398	-27
Of which: Central government	-121	-410	-114	42
	(In percent of GDP)			
Combined public sector balance	**-1.9**	**-2.2**	**-1.4**	**-1.9**
Financing	**1.9**	**2.2**	**1.4**	**1.9**
Net External	**0.7**	**2.1**	**0.3**	**1.2**
Disbursements 1/	2.2	5.1	2.1	3.0
Bonds	0.0	3.3	0.0	1.3
Multilaterals	1.8	1.4	1.7	1.5
Bilaterals and other	0.4	0.3	0.4	0.3
Amortizations 1/	-1.5	-3.3	-1.8	-1.9
Condonation	0.0	0.3	0.0	0.1
Privatization	**1.2**	**0.8**	**1.2**	**0.7**
Net Domestic financing	**-0.1**	**-0.7**	**-0.2**	**0.1**
Bonds	0.8	0.5	1.1	0.7
Amortizations	-0.3	-0.2	-0.6	-0.6
Net deposits	-0.6	-0.9	-0.7	-0.0
Of which: Central government	-0.2	-0.7	-0.2	0.1

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

1/ Includes the Brady bond swap carried out in early 2002, which was not envisaged in the program.

Table 10. Peru: Medium-Term Outlook

		Prel.	Projections									
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
	I. Balance of Payments and Other External Indicators											
	(In billions of U.S. dollars)											
Current account	**-1.1**	**-1.1**	**-1.1**	**-1.3**	**-1.4**	**-1.3**	**-1.4**	**-1.5**	**-1.5**	**-1.6**	**-1.8**	**-1.9**
Merchandise trade	-0.1	0.2	0.6	0.9	1.1	1.4	1.7	2.1	2.4	2.7	3.1	3.5
Exports	7.1	7.7	8.5	9.4	10.4	11.6	13.0	14.4	15.8	17.2	18.7	20.2
Imports	-7.2	-7.4	-7.9	-8.5	-9.3	-10.1	-11.2	-12.3	-13.4	-14.5	-15.5	-16.7
Services	-0.8	-0.8	-0.9	-0.9	-0.9	-0.9	-1.0	-1.0	-1.1	-1.1	-1.2	-1.2
Investment income	-1.2	-1.5	-1.8	-2.3	-2.6	-2.8	-3.1	-3.5	-3.8	-4.2	-4.7	-5.1
Current transfers	1.0	0.9	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Capital and financial account	**1.5**	**1.9**	**1.1**	**1.6**	**1.7**	**1.6**	**1.7**	**1.8**	**1.8**	**1.9**	**2.1**	**2.2**
Public sector	0.4	1.1	0.7	0.6	0.5	0.5	0.4	0.3	0.2	0.2	0.1	0.5
Disbursements 1/	1.3	2.9	1.9	1.8	1.8	1.8	1.8	2.5	1.8	1.8	1.8	3.7
Amortization due	-0.9	-1.9	-1.2	-1.2	-1.3	-1.3	-1.4	-2.2	-1.6	-1.6	-1.7	-3.2
Other medium- and long-term public flows 2/	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	0.7	0.8	0.6	1.0	1.1	1.2	1.3	1.5	1.6	1.7	2.0	1.7
Privatization receipts from direct investment	0.3	0.2	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, excluding privatization	0.8	2.0	0.5	1.0	0.7	0.7	0.7	0.9	1.0	1.1	1.4	1.1
Other 3/	-0.4	-1.4	-0.1	-0.1	0.4	0.4	0.6	0.6	0.6	0.6	0.6	0.5
Overall balance	**0.4**	**0.8**	**0.0**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Change in central bank reserves	-0.4	-1.1	0.0	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Exceptional financing 4/	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	(In percent of exports of goods and services)											
Total external debt service 5/	39.4	35.5	34.7	33.3	32.7	31.5	29.7	32.1	26.5	24.5	23.4	28.1
Public external debt service 5/	23.4	31.6	22.0	22.0	21.3	20.1	19.0	22.0	17.2	16.1	15.7	21.0
	(In months of next year's imports of goods and services)											
Gross reserves	10.8	11.1	10.3	9.8	9.2	8.6	8.1	7.6	7.3	6.9	6.6	6.3
	(In percent of short-term external debt on a residual-maturity basis)											
Gross reserves	140.5	206.3	198.2	203.3	202.8	202.6	179.3	204.6	212.5	213.4	172.7	177.0
	(In percent of broad money)											
Gross reserves	62.1	65.7	62.4	61.2	58.9	56.6	54.1	51.7	49.1	46.4	43.8	41.2
	(In percent of GDP)											
Current account deficit	-2.0	-2.0	-1.9	-2.0	-2.0	-1.8	-1.8	-1.8	-1.7	-1.7	-1.7	-1.7
Merchandise exports	13.2	13.6	14.3	14.9	15.3	15.9	16.6	17.2	17.6	17.9	18.1	18.2
Merchandise imports	-13.3	-13.2	-13.3	-13.5	-13.6	-14.0	-14.4	-14.7	-15.0	-15.0	-15.0	-15.1
Total external debt	50.9	49.9	48.6	47.0	45.4	43.2	40.9	38.6	36.3	34.2	32.2	30.6
Total medium- and long-term public external debt 6/	35.5	36.8	36.0	34.8	33.2	31.6	30.0	28.3	26.6	25.0	23.4	22.2

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

	2001	Prel. 2002	Projections 2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
II. Output and Prices												
(Annual percentage change)												
Real GDP	0.2	5.2	4.0	4.5	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Real domestic demand	-0.7	4.7	3.6	4.2	4.9	4.8	4.9	4.9	5.0	5.0	5.0	5.1
Of which:												
Private consumption	1.3	4.4	4.0	4.5	4.6	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Private investment	-5.6	0.7	5.4	7.5	7.2	7.0	7.0	7.0	7.5	7.5	7.5	7.5
Consumer prices (end of period)	-0.1	1.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
(In percent of GDP)												
III. Savings and Investment												
Gross domestic investment	**18.4**	**18.3**	**18.3**	**18.1**	**18.4**	**18.7**	**19.0**	**19.3**	**19.6**	**20.0**	**20.4**	**20.8**
Public sector	3.2	2.8	2.9	2.8	2.7	2.8	2.8	2.9	2.9	3.0	3.0	3.1
Private sector	15.2	15.5	15.4	15.3	15.6	15.9	16.1	16.4	16.7	17.1	17.4	17.8
National savings	**16.4**	**16.3**	**16.4**	**16.1**	**16.4**	**16.9**	**17.2**	**17.5**	**17.9**	**18.3**	**18.7**	**19.1**
Public sector 7/	1.0	0.6	0.9	1.3	1.7	1.9	2.0	2.2	2.2	2.3	2.5	2.5
Private sector	15.4	15.7	15.4	14.8	14.6	14.9	15.1	15.3	15.7	16.0	16.3	16.6
External savings	**2.0**	**2.0**	**1.9**	**2.0**	**2.0**	**1.8**	**1.8**	**1.8**	**1.7**	**1.7**	**1.7**	**1.7**
IV. Combined Public Sector												
Combined public sector primary balance	**-0.1**	**-0.1**	**0.2**	**0.7**	**1.3**	**1.4**	**1.5**	**1.5**	**1.5**	**1.5**	**1.5**	**1.5**
Of which:												
General government current revenue	17.1	17.2	16.8	17.3	17.6	17.6	17.7	17.7	17.8	17.8	17.9	17.9
General government non-interest expenditure	17.8	17.4	17.0	16.8	16.5	16.4	16.4	16.5	16.5	16.6	16.6	16.7
Interest due	2.2	2.1	2.1	2.2	2.3	2.3	2.3	2.2	2.2	2.1	2.1	2.0
Combined public sector overall balance	**-2.3**	**-2.2**	**-1.9**	**-1.5**	**-1.0**	**-0.9**	**-0.8**	**-0.7**	**-0.7**	**-0.7**	**-0.6**	**-0.6**
Net external financing	0.9	2.1	1.2	0.9	0.8	0.7	0.5	0.3	0.2	0.2	0.1	0.4
Net domestic financing 8/	0.9	-0.7	0.1	0.5	0.1	0.2	0.3	0.3	0.5	0.4	0.5	0.1
Privatization receipts	0.6	0.8	0.7	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Public sector debt 9/	46.2	46.8	45.6	43.9	41.7	39.4	37.4	35.5	33.8	32.1	30.4	28.8

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

1/ Includes bonds.

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

3/ Includes errors and omissions.

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

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

6/ Includes Central Reserve Bank of Peru debt.

7/ Excludes privatization receipts.

8/ Includes statistical discrepancy.

9/ Domestic debt includes floating debt.

Table 11. Peru: Capacity to Repay the Fund as of December 31, 2002 1/

(In millions of SDRs)

	Over-due	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total
Obligations from existing drawings												
Principal (repurchases)	0	80.3	26.8	26.8	26.8	13.4	0.0	0.0	0.0	0.0	0.0	174.1
Charges and interest 2/												
On Fund credit	0	3.3	2.1	1.4	0.7	0.1	0.0	0.0	0.0	0.0	0.0	7.6
On use of SDRs	0	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	17.1
Total obligations	0	85.4	30.6	29.9	29.2	15.2	1.7	1.7	1.7	1.7	1.7	198.8
(percent of quota)	0	13.4	4.8	4.7	4.6	2.4	0.3	0.3	0.3	0.3	0.3	31.1
Obligations from prospective drawings												
Principal (repurchases)	0	0.0	0.0	64.3	124.0	63.2	3.5	0.0	0.0	0.0	0.0	255.0
Charges and interest 2/												
On Fund credit	0	3.9	6.4	6.2	4.0	1.0	0.0	0.0	0.0	0.0	0.0	21.5
On use of SDRs	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations	0	3.9	6.4	70.5	128.0	64.2	3.5	0.0	0.0	0.0	0.0	276.5
(percent of quota)	0	0.6	1.0	11.0	20.0	10.0	0.5	0.0	0.0	0.0	0.0	43.2
Cumulative (existing and prospective)												
Principal (repurchases)	0	80.3	26.8	91.1	150.8	76.6	3.5	0.0	0.0	0.0	0.0	429.1
Charges and interest 2/												
On Fund credit	0	7.2	8.6	7.6	4.7	1.1	0.0	0.0	0.0	0.0	0.0	29.2
On use of SDRs	0	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	17.1
Total obligations	0	89.3	37.1	100.4	157.2	79.4	5.2	1.7	1.7	1.7	1.7	475.4
(percent of quota)	0	14.0	5.8	15.7	24.6	12.4	0.8	0.3	0.3	0.3	0.3	74.4
(percent of GDP)	0	0.2	0.1	0.2	0.3	0.1	0.0	0.0	0.0	0.0	0.0	0.9
(percent of exports of goods and services)	0	1.2	0.5	1.1	1.6	0.7	0.0	0.0	0.0	0.0	0.0	5.1
(percent of public sector debt service)	0	5.4	2.0	5.2	7.7	3.7	0.2	0.1	0.1	0.1	0.0	24.5
Memorandum items:												
Purchases		227.1	27.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	370.6
Fund credit outstanding (end period)		320.7	321.8	230.7	79.9	3.3	-0.2	-0.2	-0.2	-0.2	-0.2	...
(percent of quota)		50.2	50.3	36.1	12.5	0.5	0.0	0.0	0.0	0.0	0.0	...
(percent of GDP)		0.7	0.7	0.5	0.1	0.0	0.0	0.0	0.0	0.0	0.0	...
(percent of total public debt)		1.6	1.6	1.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0	...

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

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

Table 12. Peru: Proposed Schedule of Purchases
Under the Stand-By Arrangement, 2003–04 1/

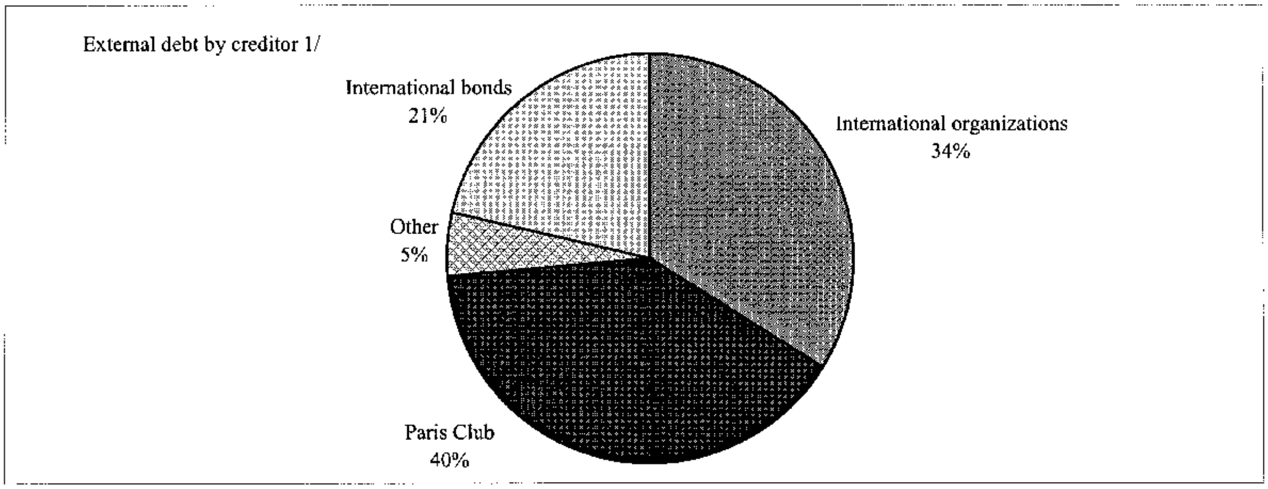
Amount of Purchase	Availability Date	Conditions Include
1. SDR 27.875 million (cumulative available: SDR 143.5 million) 2/	March 31, 2003	Completion of the second review and observance of end-December 2002 performance criteria.
2. SDR 27.875 million	May 15, 2003	Observance of end-March 2003 performance criteria.
3. SDR 27.875 million	September 2, 2003	Completion of the third review and observance of end-June 2003 performance criteria.
4. SDR 27.875 million	November 17, 2003	Observance of end-September 2003 performance criteria.
5. SDR 27.875 million	February 16, 2004	Observance of end-December 2003 performance criteria.

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

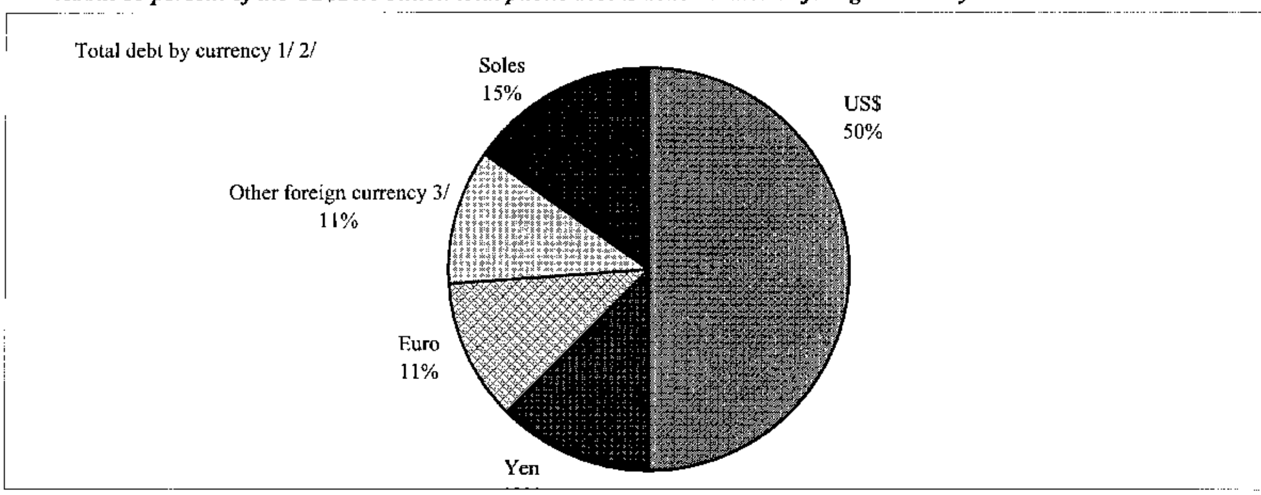
2/ The authorities have treated the SBA as precautionary.

Figure 1. Peru: Composition of Public Debt, December 2002

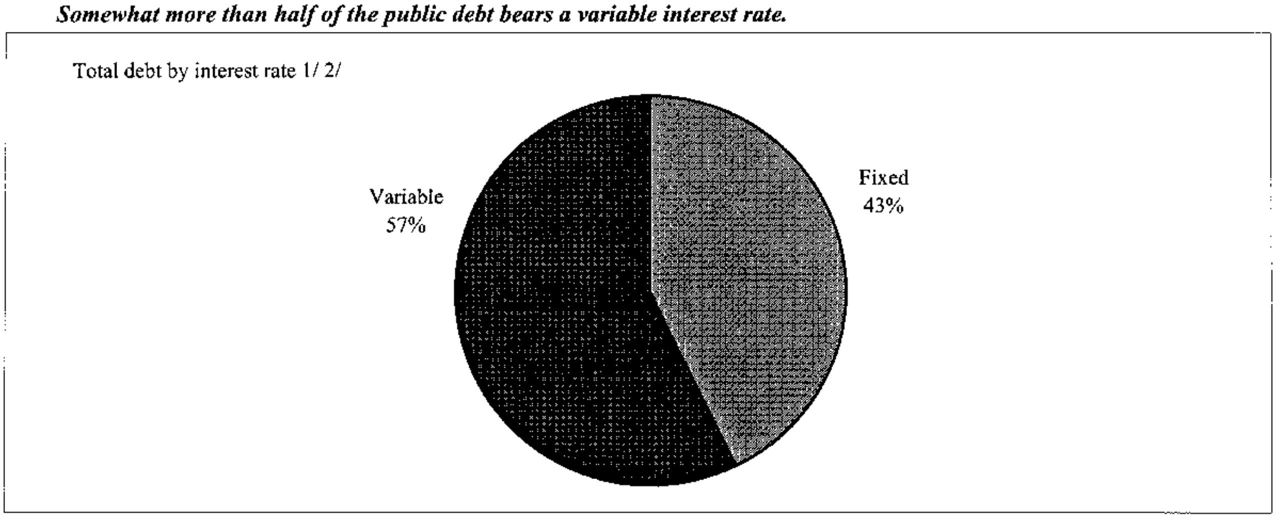
Three-fourths of the US$21 billion public external debt is owed to official creditors.



About 85 percent of the US$26.6 billion total public debt is denominated in foreign currency.



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



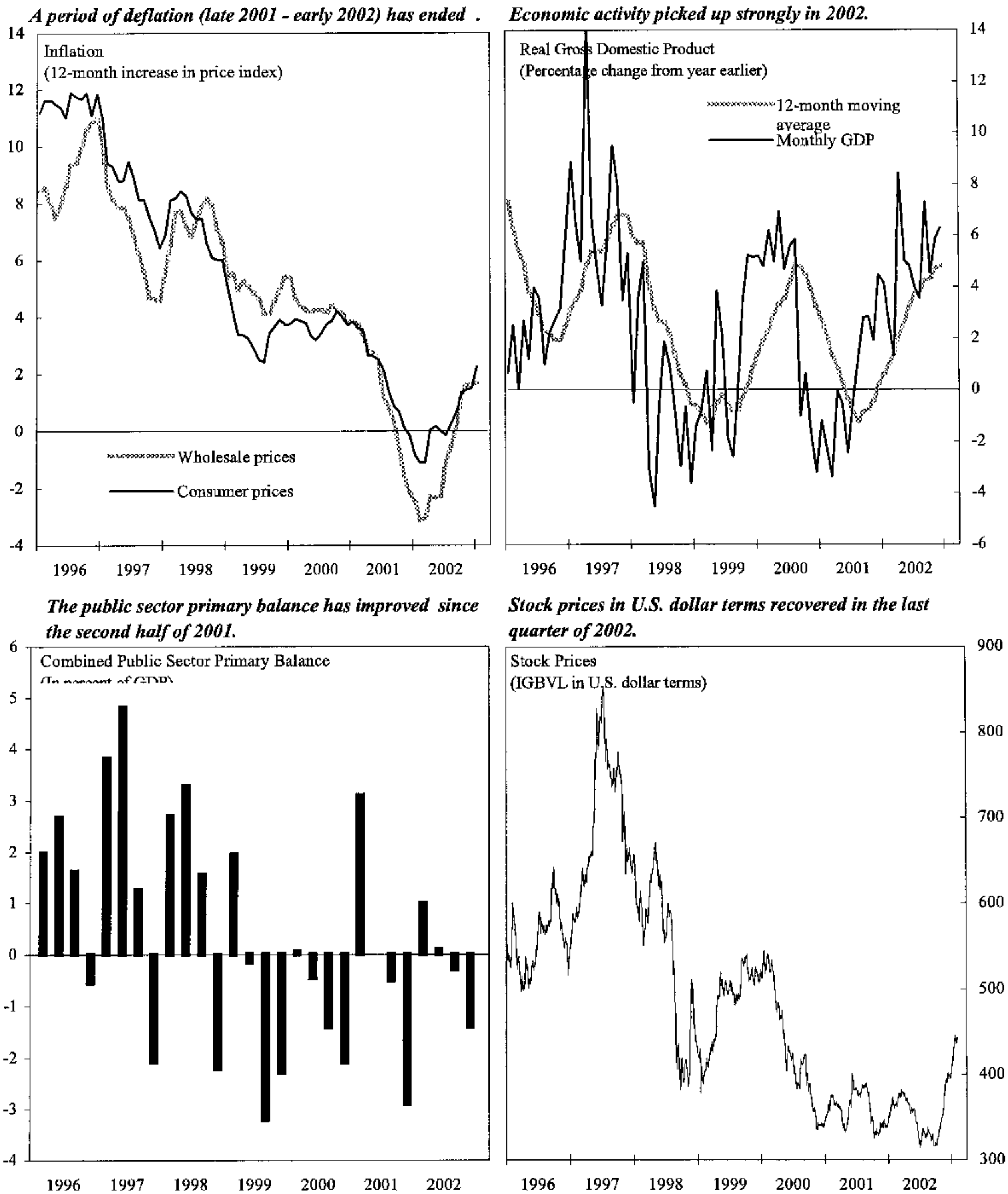
Source: Ministry of Economy and Finance.

1/ Millions of U.S. dollars.

2/ Domestic debt includes floating debt.

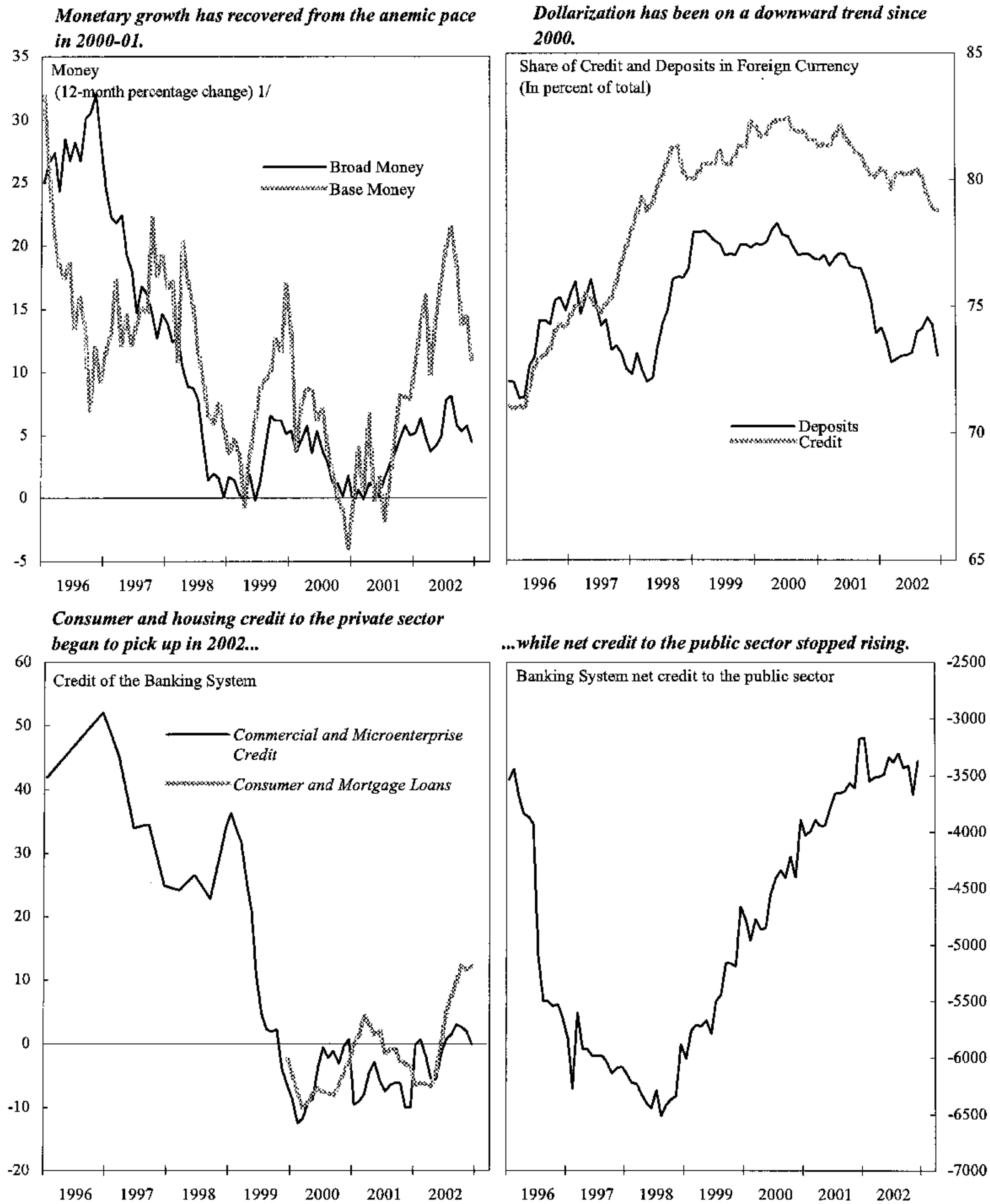
3/ Includes loans expressed as a currency basket, comprised mostly of Euro, Yen, and U.S. dollars.

Figure 2. Peru: Selected Economic Indicators, 1996-2003



Source: Central Reserve Bank of Peru.

Figure 3. Peru: Monetary Indicators, 1996-2003

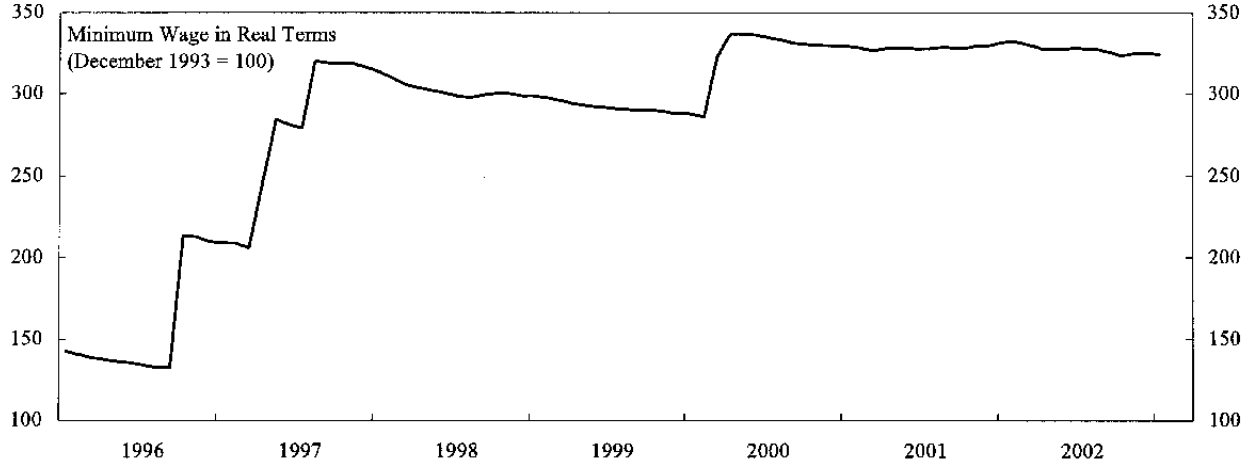


Sources: Central Reserve Bank of Peru; Superintendency of Banks; and Fund staff estimates.

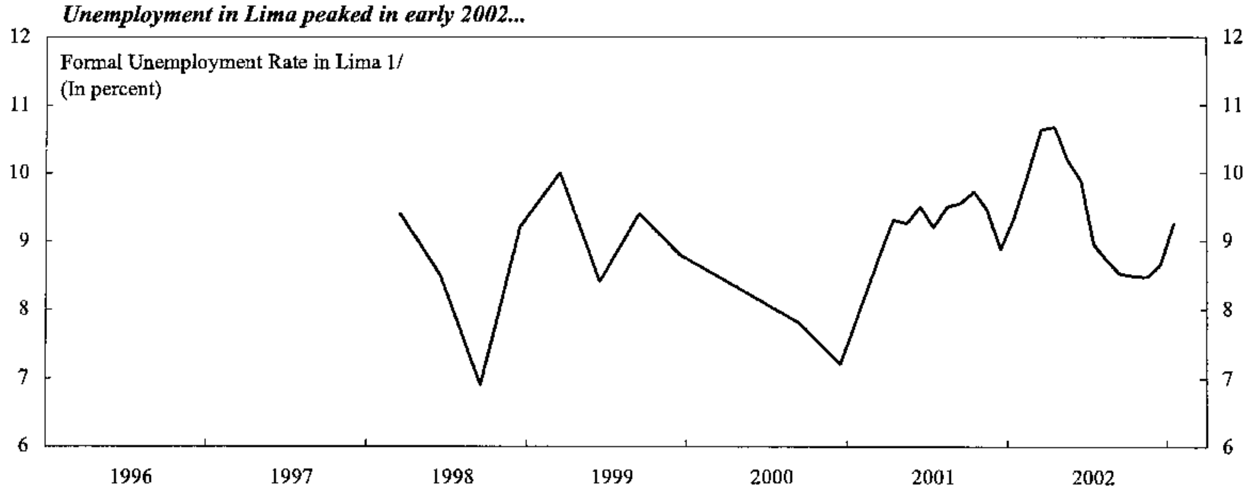
1/ U.S. dollar stocks are valued at market exchange rates; data source, Superintendency of Banks.

Figure 4. Peru: Labor Market Indicators, 1996-2003

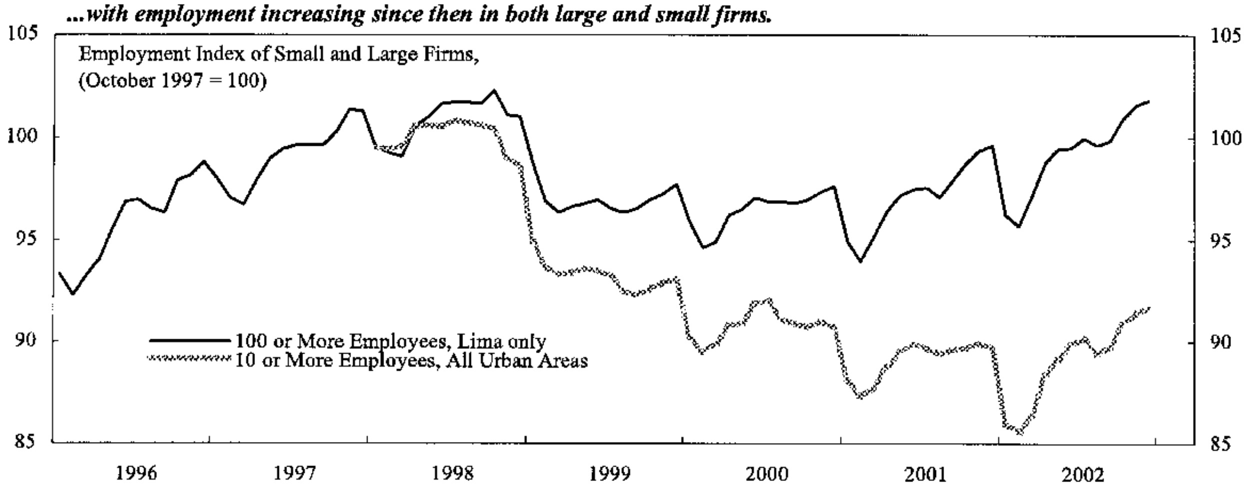
The minimum wage has not been adjusted since 2000.



Unemployment in Lima peaked in early 2002...



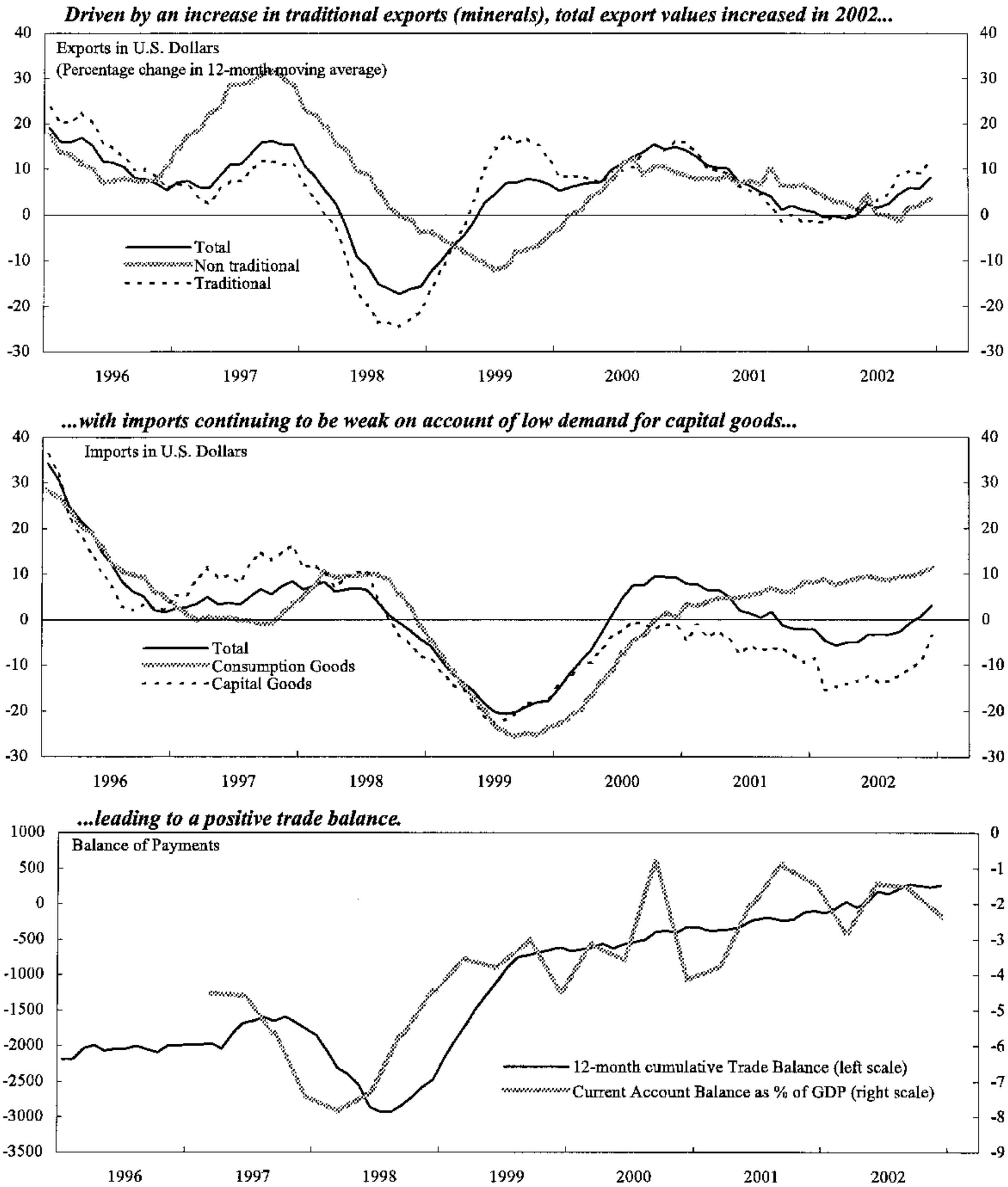
...with employment increasing since then in both large and small firms.



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

1/ Series begins in 1998. Quarterly through 2000. Three-month moving average since 2001.

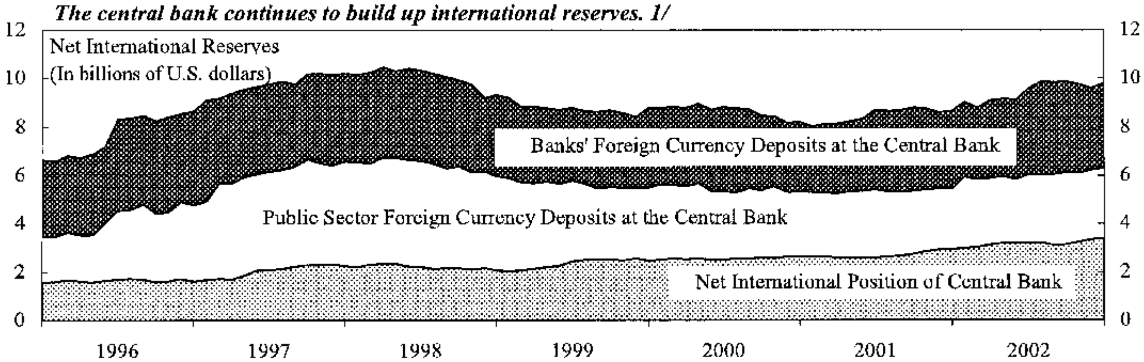
Figure 5. Peru: Trade Indicators, 1996-2003



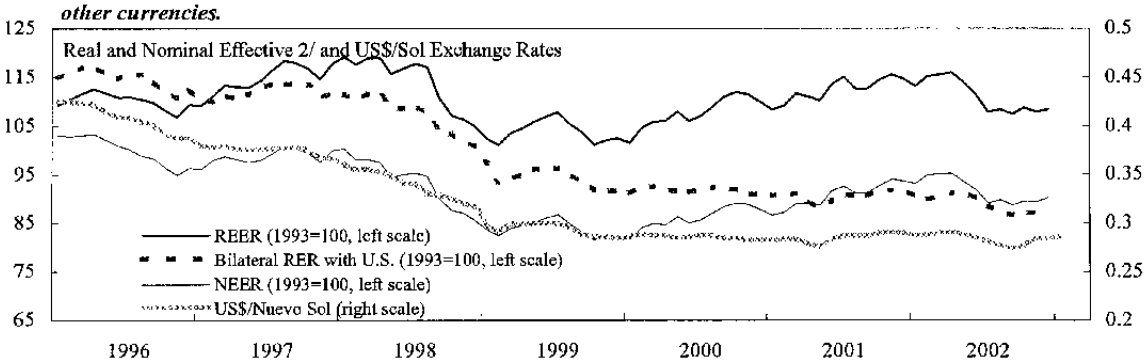
Source: Central Reserve Bank of Peru.

Figure 6. Peru: External Indicators, 1996-2003

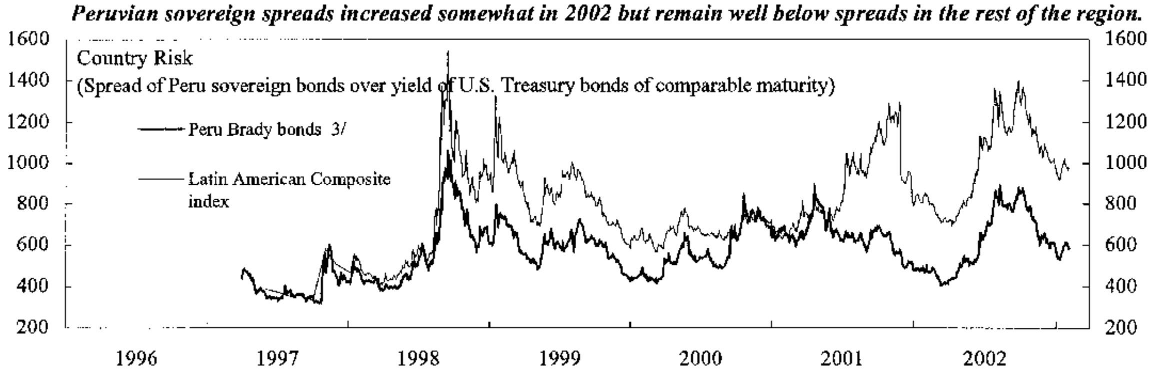
The central bank continues to build up international reserves. 1/



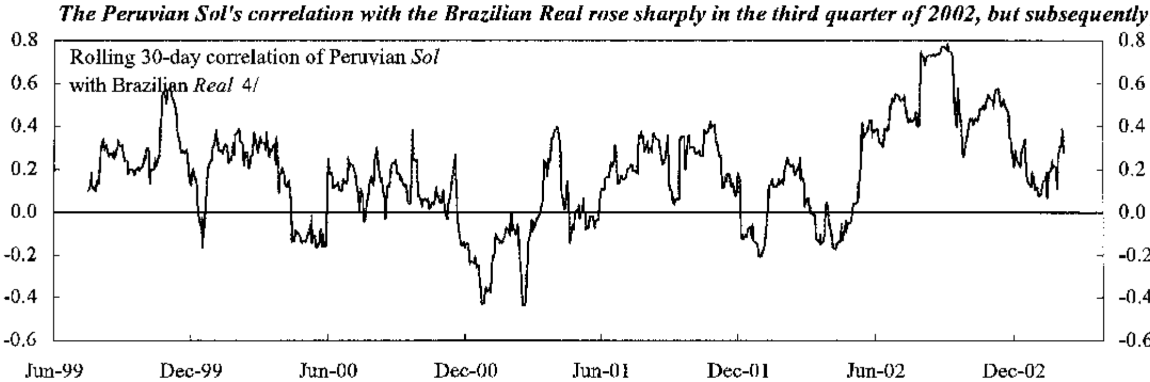
The real effective exchange rate of the Sol declined in 2002, driven by the decline of the U.S. dollar against other currencies.



Peruvian sovereign spreads increased somewhat in 2002 but remain well below spreads in the rest of the region.



The Peruvian Sol's correlation with the Brazilian Real rose sharply in the third quarter of 2002, but subsequently fell.



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

1/ Data is up to January 2003.

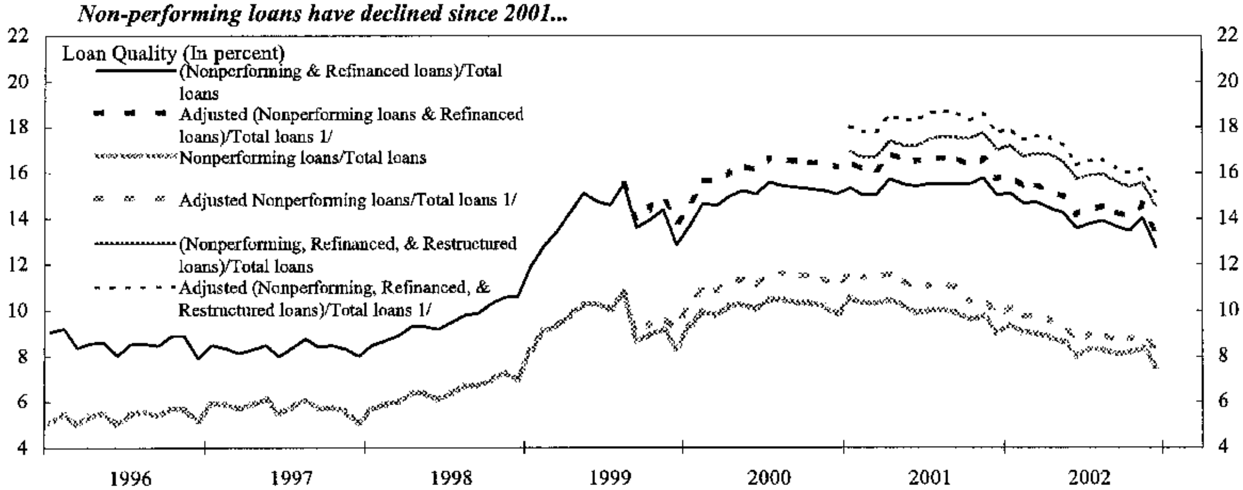
2/ Trade weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices. An increase (decrease) indicates appreciation (depreciation).

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

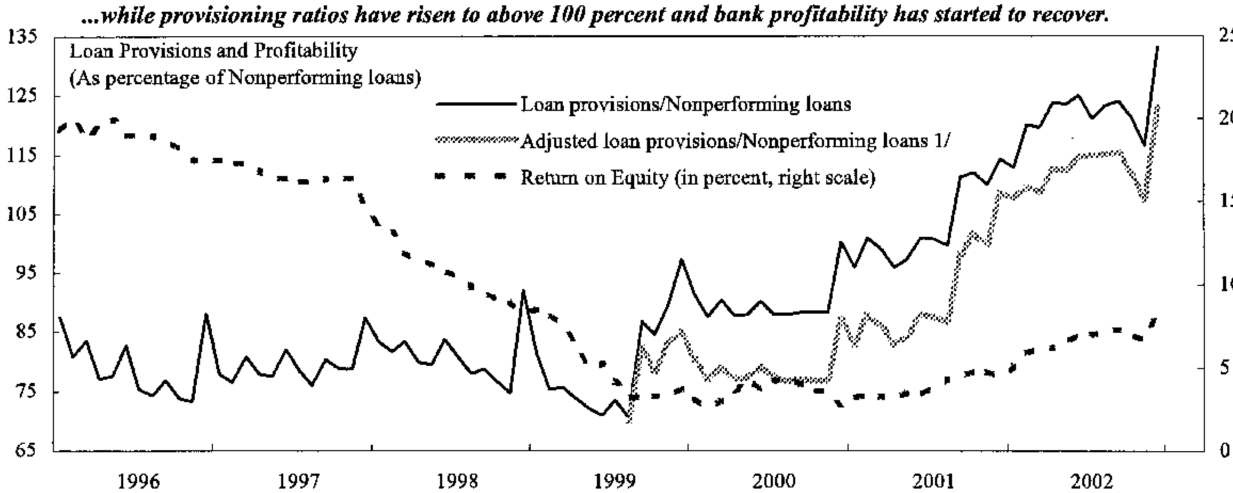
4/ Correlation of standardized first difference of the natural log of the exchange rate.

Figure 7. Peru: Banking Indicators, 1996-2003

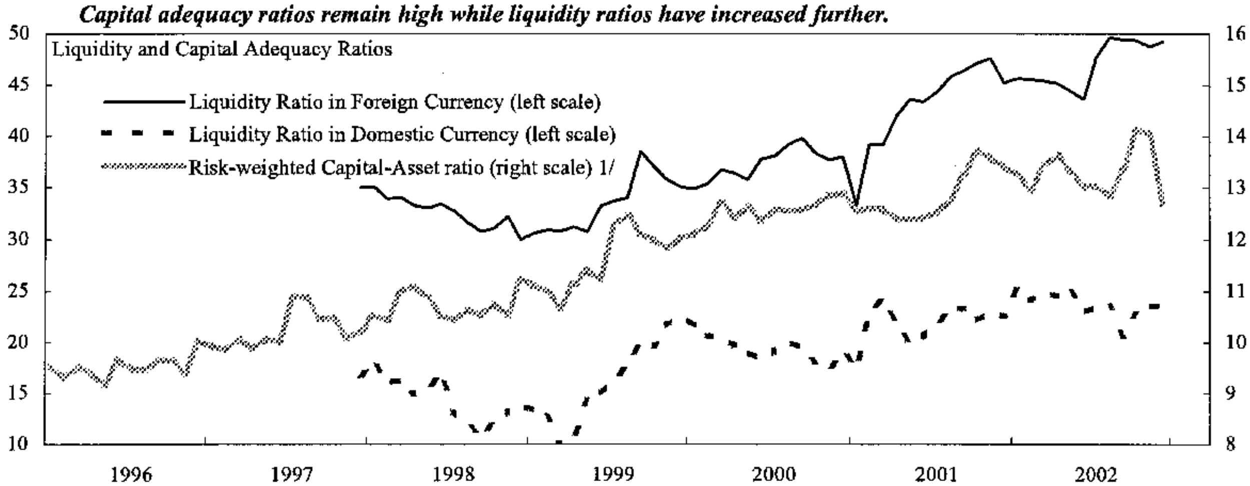
Non-performing loans have declined since 2001...



...while provisioning ratios have risen to above 100 percent and bank profitability has started to recover.



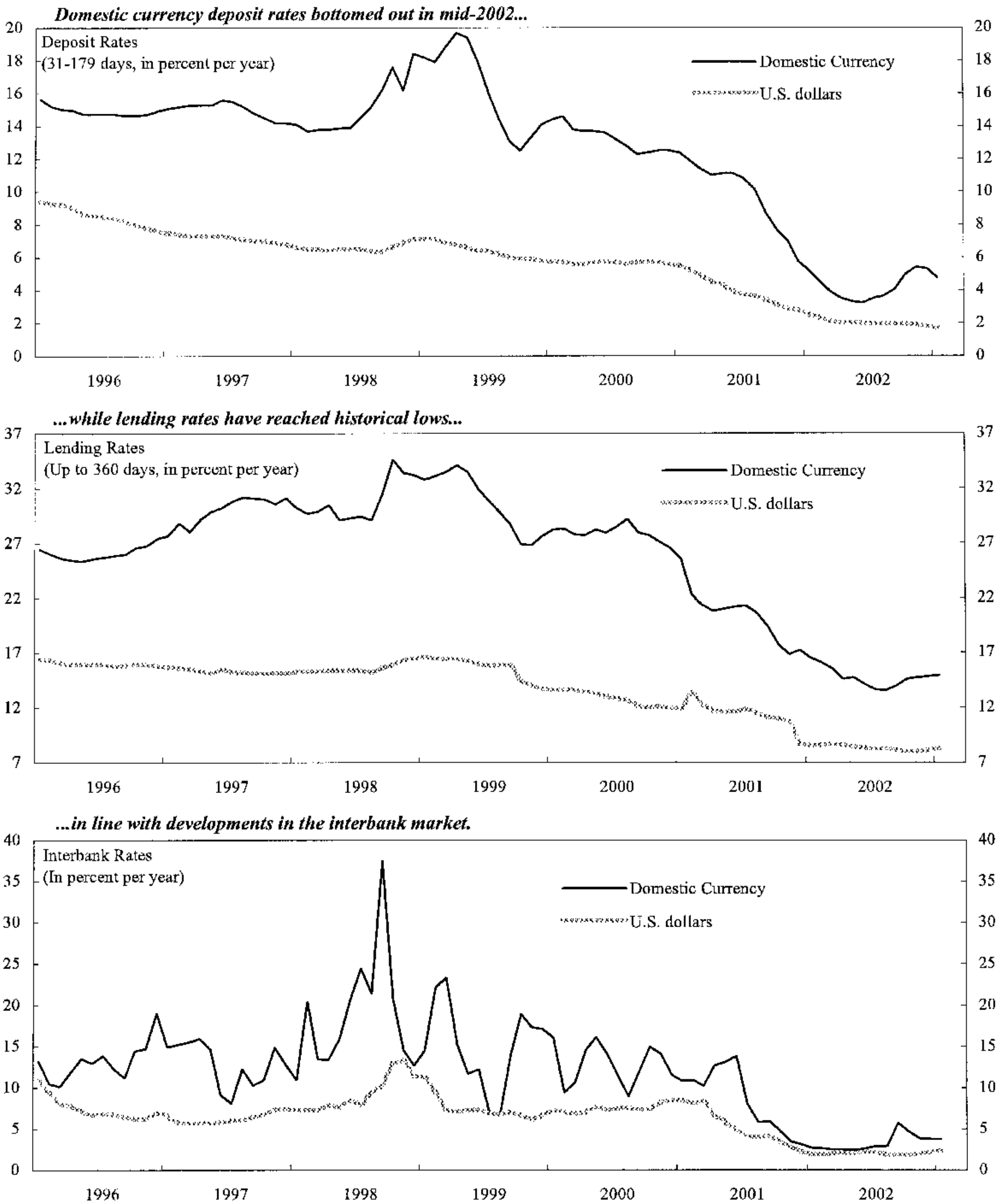
Capital adequacy ratios remain high while liquidity ratios have increased further.



Source: Superintendency of Banks and Insurance.

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

Figure 8. Peru: Interest Rates, 1996-2003



Source: Central Reserve Bank of Peru.

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

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

II. **General Resources Account**	**SDR Million**	**Percent Quota**
Quota	638.40	100.00
Fund holdings of currency	812.37	127.25

III. **SDR Department**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	91.32	100.00
Holdings	2.45	2.68

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

V. **Financial Arrangements**

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

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

	Overdue	**Forthcoming**				
	1/31/03	**2003**	**2004**	**2005**	**2006**	**2007**
Principal	0	80.31	26.75	26.75	26.75	13.38
Charges/interest	0	4.95	3.72	3.05	2.38	1.78
Total	0	85.26	30.47	29.80	29.13	15.15

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 January 31, 2003, the average of interbank buying and selling rates was 3.48 *Nuevo Sol* per U.S. dollar. The central government maintains external payments arrears to unguaranteed suppliers, some of whom are in discussions with the government, while the rest have not been located. Peru maintains a clearing arrangement with Malaysia.

IX. Last Article IV Consultation

The 2002 Article IV consultation was concluded on December 13, 2002 (EBS/02/199).

X. FSAP Participation

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

XI. Technical Assistance

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

XII. Resident Representative

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

Peru: Statistical Issues

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

I. Real Sector

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

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

II. Fiscal Sector

For the consolidated central government data, revenues are reported on a cash basis, while expenditures are reported on an accrual basis. The authorities have reported data on the operations of the consolidated central, regional and local governments and debt up to 2001 for publication in the *Government Finance Statistics Yearbook (GFSY)*. The authorities 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 August 2002.

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

III. Monetary Sector

The central bank of Peru (BCRP) is responsible for the compilation and dissemination of monetary 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. It prepares quarterly data largely in line with the recommendations of the *Balance of Payments Manual, Fifth Edition (BPM5).*

Import and export data are provided by Customs. Import data is recorded on the date on which the customs documents are numbered (which is close to the date of clearance), while exports are recorded on the shipment date. The export data are also supplemented by the value of goods (mainly fuel and food) sold to nonresident transport enterprises (BCRP surveys). Import data are supplemented by data on imports into the Tacna Special Processing Area, purchases of goods (primarily fuel and food) abroad by resident transport companies, and ship repairs by nonresidents (BCRP surveys).

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

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

Data is preliminary when first released and is revised every quarter, becoming final after six months of being published. Definitive statistics of other services, direct investment, and other private sector investment are available 18 months after the end of the referred period.

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

Peru: 2002 Tax Reform

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

Tax policy

Income tax

- *A new minimum income tax advance payment scheme* for taxpayers with net assets above approximately US$135,000 requires advance payments based on the greater of the past year's earnings or a percentage of net assets (which rises with the level of net assets and ranges from 0.25 percent to 1.5 percent). In 2003, the tax advance payment is reduced by 30 percent for those taxpayers with net assets below US$4.5 million, and not applicable to taxpayers that can prove that they are running losses in the first semester of 2003.
- *Eliminate from allowable deductions* under the corporate income tax automobile purchases for executives.
- *Collect taxes from* profits made by *mutual-fund investors.*
- *Increase the maximum marginal income tax rate* from 27 to 30 percent.
- *Revamp the strategy in granting tax-stability contracts* to exclude tax benefits and incentives and to charge a 2 percent premium for such contracts.[2]

VAT

- *Eliminate VAT exemption on fertilizers* (for 57 out of 60 agricultural inputs).

Fuel excise

- Raise *kerosene excise* by 80 percent to partially reduce the differential with the excise on diesel.

---

[1] Tax administration measures yielded 0.2 percent of GDP in 2002 and are expected to yield 0.4 percent of GDP in 2003. Tax policy measures are projected to yield 0.4 percent of GDP in 2003; by law, changes in income taxes take effect in the following calendar year.

[2] This measure has not yet been approved by Congress.

Tax administration

Various VAT withholding mechanisms were established to reduce evasion on VAT collection. Retention agents can hold for one month the resources they collect. Specifically, a portion of the VAT is being withheld by:

- *Large buyers in transactions of agricultural products characterized by a high level of informality (rice, sugar, fishing and alcohol).* Suppliers are to open a bank account—exclusively used for tax payments—in the state-owned Banco de la Nación. Prior to delivery, buyers must deposit 10 percent of the sale price into these accounts (products cannot be delivered without the bank deposit receipt). This system is to be extended in 2003 to other agriculture products, such as cotton, sugarcane and corn.
- *Large taxpayers (1,200 in total) in transactions with their suppliers.* These large taxpayers must withhold 6 percent at the payment stage of every purchase, when transactions exceed a minimum amount (of around US$200). The system applies to suppliers not classified by the tax agency (SUNAT) as "good taxpayers". Suppliers can ask for a tax refund only after having withholdings in excess of their tax obligations during six consecutive months.
- *Central government spending units (240 public entities out of those linked to the Financial Management Information System—SIAF) withhold taxes for government purchases.*
- *Large fuel sellers in transactions with fuel retailers* withhold 1 percent of the sale price.

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

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

The collection of tax debts from government's suppliers and private companies is being enforced by:

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

Impact of the 2002 Tax Reform

(In millions of *Nuevo Sol*)

	Initial Projection: Second Half 2002	Outturn: Second Half 2002	Projection 2003
TAX POLICY	**50**	**48**	**904**
(In percent of GDP)	*0.0*	*0.0*	*0.4*
Income tax	**0**	**0**	**654**
Introduce new minimum advance payment scheme			550
Eliminate allowable deductions under the corporate income tax			25
Increase the maximum marginal income tax rate from 27 to 30 percent			40
Collect tax on mutual-fund investors' profits			39
VAT	**25**	**25**	**110**
Partial elimination of VAT exemption on fertilizers 1/	25	25	100
Fuel excises	**25**	**23**	**140**
Increase kerosene excise	25	23	140
TAX ADMINISTRATION	**324**	**454**	**964**
(In percent of GDP)	*0.2*	*0.2*	*0.4*
Withholding mechanisms and tax debt collection	**259**	**454**	**964**
Large buyers in transactions of main agricultural products (rice, sugar and alcohol; extended to fishing in 2003)	40	50	170
Large taxpayers in transactions with their suppliers	185	381	695
Central government spending units in government purchases 1/	7	2	36
Large fuel sellers in transactions with fuel retailers 1/	12	6	48
From central government's suppliers through SIAF	15	15	15
Other	**65**		
Prohibiting firms with tax debts to distribute profits			
Better control of nonexistent taxpayers			
Introduce expiration date on purchase invoices			
Allow the auditing of tax years prior to a year in which a taxpayer is in compliance			
2002 REFORM	***374***	***502***	***1,868***
(In percent of GDP)	*0.2*	*0.2*	*0.8*

1/ These measures were implemented in the fourth quarter of 2002, the remainder were implemented in the third quarter of 2002.

Peru: World Bank Relations

Partnership in Peru's development strategy

The government's strategy focuses on attacking poverty through: employment generation, access to health, education, culture and other basic services; and creating a state that serves the people. A national accord, signed in July 2002, organizes the government's tasks into four areas: democracy and the rule of law; competitiveness of the country; equity and social justice; and an efficient, transparent and decentralized state.

Bank Group strategy

The World Bank Group FY03 Country Assistance Strategy (CAS), discussed by the IBRD Board on September 17, 2002, aims at helping the government implement its strategy by providing support to its fiscal program, national competitiveness program, and social sector program. **The CAS lending program is for US$180 to US$250 million a year in new lending that would include quick-disbursing programmatic loans (US$100 million programmed for 2003)**. Such loans would depend on the achievement of a set of targets (triggers) related to the tax revenue effort and the implementation of key actions and reforms in public sector management, decentralization, and competitiveness. The lending program would also include lending for specific investment projects for about US$120 million a year.

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

Bank-Fund collaboration in specific areas

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

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

Statement of World Bank Loans
(As of January 31, 2003)

Loan Number	Fiscal Year Approved	Borrower	Purpose	In millions of U.S. Dollars: Total (Net of Cancellation)	Undisbursed
Eighty-one (81) loans fully disbursed 1/				4,057.6	
Partially disbursed or undisbursed loans:					
38110	1995	Republic of Peru	Lima water rehabilitation and management project (SEDAPAL)	150.0	2.8
40760	1997	Republic of Peru	Irrigation rehabilitation	85.0	18.9
41300	1997	Republic of Peru	Sierra natural resource management	51.0	5.9
43840	1999	Republic of Peru	Urban property rights	38.0	10.8
45190	2000	Republic of Peru	Agricultural research and extension	9.6	5.0
45360	2000	Republic of Peru	Indigenous people development	5.0	4.1
45270	2000	Republic of Peru	Health reform	27.0	21.7
46140	2001	Republic of Peru	Second rural roads rehabilitation and maintenance	50.0	39.6
71420	2003	Republic of Peru	Rural Water and Sanitation	50.0	50.0
Total				**4,523.2**	
Of which: amount repaid				1,643.1	
Total outstanding				**2,613.2**	
Total undisbursed					**158.9**

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

Statement of IFC Investments
(As of August 12, 2002)

In millions of U.S. dollars

	Loans	Equity	Quasi-Equity	Participation Loans	Total
Total commitments held by IFC	161.6	36.3	34.0	95.1	327.0
Total disbursed	126.7	36.1	32.5	95.1	290.4

Source: World Bank.

Peru: Relations with the Inter-American Development Bank

I. Background

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

II. 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.

III. Lending

As of January 31, 2003 the country's portfolio consists of 21 loans for a total amount of US$1,542 million. These resources are distributed among 14 investment loans (US$1,200.7 million), a policy-based loan (US$300 million), an emergency loan (US$20 million), three reimbursable technical-cooperation loans (US$20.1 million) and two preparation program facility loans (US$1.6 million). The lending program for 2003 foresees the approval of six loans for US$415.5 million.

In addition, the country portfolio with Peru includes 31 non-reimbursable technical cooperation grants (US$11 million) and six small projects (US$1.4 million). Through the Multilateral Investment Fund (MIF), which finances private sector investment projects, Peru has contracted seven loans and received 24 non-reimbursable technical cooperation grants.

Peru: Financial Relations with the Inter-American Development Bank

I. IDB Loans By Sector as of January 31, 2003
(In millions of U.S. dollars)

	Commitments	Disbursements	Percent Disbursed
Agriculture	68.9	30.4	44.1
Education	187.0	85.1	45.5
Social investment	549.6	321.6	58.5
Public sector management	353.9	211.2	59.7
Environment	5.0	0.0	0.0
Health	28.0	1.5	5.0
Transportation	350.0	59.6	17.0
Total	**1,542.4**	**709.3**	**46.0**

II. IDB Loan Transactions as of January 31, 2003
(In millions of U.S. dollars)

	1997	1998	1999	2000	2001	2002
Approval	210.3	560.3	274.4	293.5	342.2	488.8
Disbursements (a)	585.3	299.6	485.5	350.7	378.0	307.8
Amortization, interest and contributions (b)	239.2	249.1	262.9	558.3	286.1	307.9
c. **Net Cash flow (a-b)**	**346.1**	**50.5**	**222.6**	**-207.6**	**91.9**	**-0.1**

Peru: Tax Exemptions and Benefits 1/
(In millions of Soles)

Sector	Type	Description of the Exemption	Annual Cost	Percent GDP
Agriculture	VAT exemption	Certain fertilizers.	146.5	0.07
	VAT exemption	For agricultural goods included in Appendix I of the VAT law.	1,437.4	0.68
	VAT exemption	For agricultural producers whose sales do not exceed 50 UIT (tax account unit, currently S/. 3,100).	62.6	0.03
	Income tax exemption	For agricultural producers whose sales do not exceed 50 UIT.	17.6	0.01
	Income tax benefit	Agricultural sector: rate 15 percent.	20.2	0.01
	Income tax benefit	Agricultural sector: up to 20 percent of depreciation for hydraulic infrastructure and irrigation can be deferred.	33.8	0.02
Amazon region	VAT exemption	In jungle regions of Loreto, San Martin, Ucayali, Madre de Dios, and Amazon (except construction).	412.8	0.19
	VAT exemption	Construction and activities inside the Amazon but outside the ancient jungle region.	225.5	0.11
	ISC and VAT exemption 2/	For fuel sales in the Amazon.	169.6	0.08
	VAT benefit	Tax refund mechanism.	82.9	0.04
	VAT benefit	Special fiscal credit mechanism.	15.1	0.01
	Income tax benefit	Amazon-5 percent and 10 percent rate.	19.9	0.01
	Income tax benefit	Amazon-deduction for third party investors.	0.0	0.00
Education	VAT exemption	For educational, cultural and sports organizations.	243.2	0.11
	Income tax benefit	Credit for donations.	2.8	0.00
Energy	ISC and VAT exemption	For electricity-generation companies and for the consumption of diesel.	23.6	0.01
Financial	VAT exemption	Services rendered by private pension fund administration companies.	63.3	0.03
	VAT and income tax exemption	For financial institutions.	250.0	0.12
	VAT and income tax exemption	For life insurance contracts.	105.5	0.05
Manufacturing	General tax benefit	3 percent tax credit for intermediary sales of capital goods.	3.0	0.00
CETICOS	ISC and VAT benefit	0 percent rate in the ISC for reparing and renovating used vehicles in special trade zones (CETICOS).	228.6	0.11
Mining	VAT and trade tax exemption	For importing input goods for the exploration of hydrocarbon.	4.5	0.00
	Income tax benefit	Accelerated depreciation.	44.4	0.02
Tourism	Income tax benefit	Accelerated depreciation.	6.6	0.00
Other	VAT benefit	Anticipated tax rebates.	198.4	0.09
	Income tax benefit	Refund for donations from overseas—technical international cooperation.	40.0	0.02
	Income tax exemption	For interest on deposits.	184.9	0.09
		Total	**4,047.5**	**1.91**

Source: SUNAT.

1/ The fiscal cost recorded in this table is in agreement with the notion of tax expense and is the same as that listed in the 2003-05 Marcroeconomic Framework (MMM).

2/ ISC refers to selected excise tax.

Peru: Update on FSAP Main Recommendations

Reform Measures	Specific Actions	Current Status and Comments
Strengthen the autonomy of the Superintendency of Banks (SBS).	Provide legal protection for the SBS staff.	Legislation sent to congress in November 2002.
	Establish an independent SBS budget mechanism.	SBS budget not included in annual budget law sent to congress.
	Eliminate the coincidence of the term of the appointment of the Superintendent with the political cycle (Constitutional reform).	No action taken to date.
Improve the corrective action and bank exit framework.	Strengthen the Financial Instability regime by: - creating explicit time frames for any capital contribution that the SBS may deem necessary. - making application of the Special Surveillance regime mandatory if the measures required under the Financial Instability Regime are not met. - conferring explicit powers on the SBS for taking actions in instances of chronic liquidity problems.	No action taken to date. The authorities argue 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 argue that an SBS norm already includes this provision, and, therefore, its explicit inclusion in the banking law is not necessary.
Improve the financial system's regulatory framework.	Reduce the limits on single credit exposure by lowering the legal limit on leasing operations.	The SBS submitted to congress a proposal to modify the banking law.
	Reduce the limits on lending to connected parties.	A phase-out period of adaptation to a lower limit has been established.
	Improve the definition and measurement of capital: - requiring capital on a consolidated basis. - deducting goodwill from regulatory capital.	 Effective since end-December 2001. Proposed change to banking law sent to congress by SBS.
	Improve regulations on money laundering.	A law was passed in April 2002 establishing an anti-money laundering unit, and operational norms are being formulated.
Streamline corporate debt restructuring process.	- Simplify procedures. - Strengthen debtor disclosure requirements. - Limit the precedence of labor claims of managers and shareholders on companies under restructuring, as well as the withdrawal of shareholders from the restructuring process.	A new bankruptcy procedure law effective since October 2002 has dealt with these specific issues.

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

Peru: Debt Sustainability Analysis [1]

Baseline projections of external and public sector debt are quite robust to alternative assumptions about the underlying macroeconomic variables. Using ten-year historical averages of the key assumptions does not significantly alter the medium-term projection in Table 10. Additional temporary negative shocks to key variables, such as interest rates and real GDP growth, would lead to some initial increase in the level of public and external debt, but the debt ratios would return to a declining trend once conditions normalize.

External debt is also resilient to sustained declines in the real exchange rate that are consistent with actual exchange rate developments over the last ten years, but appears vulnerable to a very large and sustained decline in the real exchange rate. A sustained 30-percent real depreciation would lead to a rise in the debt-to-GDP ratio from 50 percent in 2002 to 69 percent in 2003, with the ratio declining thereafter. Other simulated shocks, including a 15-percent sustained real depreciation, would push the external debt-to-GDP ratio to a peak of 62 percent of GDP in 2004, with the ratio declining to under 53 percent of GDP by 2008.

External Debt (in percent of GDP)

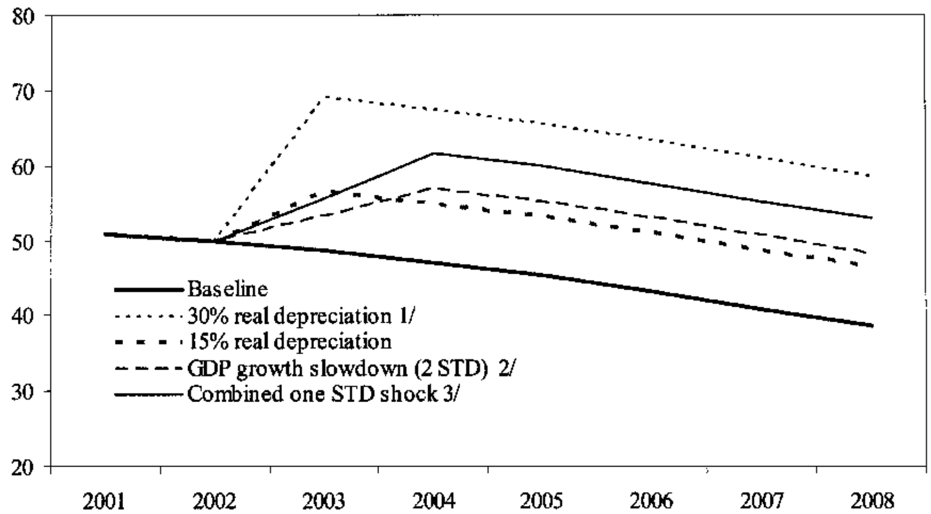


Chart Notes:

1/ Effect of a sustained 30 percent real depreciation of the Nuevo Sol.

2/ Effect of a two standard deviation shock of real GDP growth lasting two years.

3/ Combined effect of a one standard deviation shock of interest rates, real GDP and the non-interest external current account.

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[1] The DSA includes standard sensitivity tests (Tables 1 and 2 of this Appendix) around the baseline medium-term scenario (Table 10). The methodology used is in line with that endorsed in SM/02/166.

As in the case of external debt, public sector debt appears most vulnerable to a very large sustained decline in the real exchange rate (a sustained 30-percent real depreciation in 2003 would lead to a rise in the public debt-to-GDP ratio from 47 percent in 2002 to 64 percent in 2003, with the ratio declining thereafter). Other simulated shocks would push the public debt-to-GDP ratio to a peak of 56 percent of GDP in 2003, with the ratio declining to under 50 percent of GDP by 2006 in all cases.

Gross Public Sector Debt (in percent of GDP) 1/

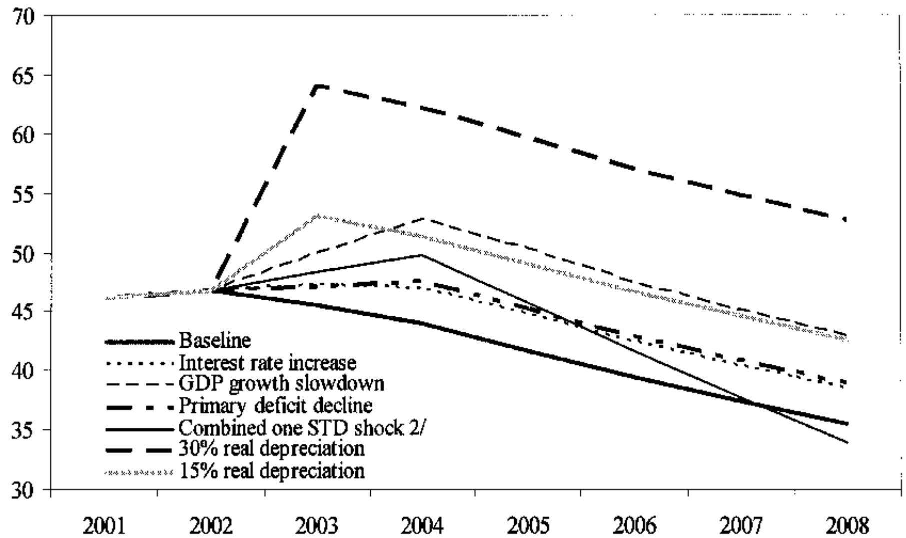

Chart Notes:

1/ Effect of two-year two-standard deviations shock of each variable, unless otherwise indicated.

2/ Effect of combined two-year shock equal to one standard deviation on interest rate, real GDP growth, and the primary deficit.

Table 1. Peru: External Debt Sustainability Framework, 1997-2008
(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
						I. Baseline Medium-Term Projections						
1 **External debt**	49.2	53.1	55.6	52.6	50.9	**49.9**	**48.6**	**47.0**	**45.4**	**43.2**	**40.9**	**38.6**
2 Change in external debt	-11.6	3.9	2.4	-3.0	-1.7	-1.0	-1.3	-1.7	-1.6	-2.2	-2.3	-2.3
3 Identified external debt-creating flows (4+8+11)	-1.0	5.7	5.4	-0.1	-0.3	-4.1	-1.6	-2.5	-2.2	-2.2	-2.0	-2.0
4 Current account deficit, excluding interest payments	3.0	2.8	-0.5	-0.5	-0.9	-0.4	-0.5	-0.7	-0.8	-1.0	-1.0	-0.9
5 Deficit in balance of goods and services	4.3	5.5	2.5	2.1	1.6	1.0	0.4	0.0	-0.3	-0.6	-0.9	-1.2
6 Exports	14.2	13.2	14.9	16.1	15.9	16.3	17.1	17.7	18.2	19.0	19.8	20.5
7 Imports	18.5	18.7	17.4	18.2	17.6	17.3	17.5	17.7	17.9	18.3	18.9	19.3
8 Net non-debt creating capital inflows (negative)	-3.6	-1.9	-2.9	-1.1	-1.9	-3.9	-0.9	-1.6	-1.1	-1.0	-0.9	-1.1
9 Net foreign direct investment, equity	3.5	2.8	3.5	1.2	2.0	4.0	1.0	1.7	1.1	1.0	1.0	1.1
10 Net portfolio investment,equity	0.1	-0.8	-0.6	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
11 Automatic debt dynamics 1/	-0.4	4.8	8.8	1.4	2.4	0.2	-0.2	-0.2	-0.3	-0.2	-0.2	-0.1
12 Contribution from nominal interest rate	2.8	3.1	3.4	3.4	2.9	2.4	2.4	2.7	2.8	2.8	2.8	2.7
13 Contribution from real GDP growth	-3.9	0.3	-0.6	-1.7	-0.1	-2.5	-1.9	-2.1	-2.2	-2.1	-2.0	-1.9
14 Contribution from price and exchange rate changes 2/	0.7	1.4	6.0	-0.3	-0.4	0.3	-0.7	-0.8	-1.0	-0.9	-0.9	-0.9
14 Residual, incl. change in gross foreign assets (2-3)	-10.6	-1.7	-2.9	-2.8	-1.3	3.0	0.4	0.8	0.6	0.0	-0.2	-0.2
External debt-to-exports ratio (in percent)	345.4	401.5	371.9	326.8	320.0	305.3	284.5	265.1	248.8	227.5	206.0	188.0
Gross external financing need (in billions of US dollars) 3/	10.6	11.4	9.5	8.3	6.6	7.3	5.8	6.1	6.3	6.4	6.6	7.6
in percent of GDP	18.0	20.1	18.3	15.5	12.3	12.9	9.7	9.7	9.3	8.8	8.5	9.1
Key Macroeconomic and External Assumptions												
Real GDP growth (in percent)	6.7	-0.5	0.9	3.1	0.2	5.2	4.0	4.5	5.0	5.0	5.0	5.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	-8.1	-8.7	-13.5	-3.0	-0.5	-0.5	-1.3	-0.8	-0.4	-0.4	-0.4	-0.4
GDP deflator in US dollars (change in percent)	-1.1	-2.8	-10.1	0.5	0.7	-0.6	1.4	1.7	2.1	2.1	2.1	2.1
Nominal external interest rate (in percent)	4.8	6.1	5.8	6.3	5.6	5.0	5.1	5.8	6.4	6.7	6.9	7.0
Growth of exports (US dollar terms, in percent)	14.7	-10.2	2.4	11.7	-0.2	7.3	10.3	10.1	10.2	11.6	12.2	11.0
Growth of imports (US dollar terms, in percent)	9.2	-2.2	-15.4	7.9	-2.4	3.2	6.7	7.3	8.5	9.7	10.7	9.4
						II. Stress Tests for External Debt Ratio						
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2007						**49.9**	**49.0**	**48.5**	**47.8**	**46.5**	**44.9**	**43.4**
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						**49.9**	**49.9**	**49.1**	**47.4**	**45.2**	**42.9**	**40.6**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						**49.9**	**53.3**	**56.8**	**55.1**	**52.9**	**50.6**	**48.3**
4. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						**49.9**	**54.4**	**58.7**	**57.0**	**54.8**	**52.4**	**50.1**
5. Combination of 2-4 using one standard deviation shocks						**49.9**	**55.7**	**61.6**	**59.8**	**57.6**	**55.2**	**52.9**
6. One time 30 percent nominal depreciation in 2003 4/						**49.9**	**69.0**	**67.3**	**65.5**	**63.2**	**60.9**	**58.5**
6a. One time 15 percent nominal depreciation in 2003 4/						**49.9**	**56.6**	**55.0**	**53.3**	**51.0**	**48.7**	**46.4**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2002-07
Current account deficit, excluding interest payments	1.6	1.9	-0.7
Net non-debt creating capital inflows	3.4	2.6	1.6
Nominal external interest rate (in percent)	6.2	0.8	6.0
Real GDP growth (in percent)	3.9	4.4	4.8

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

2/ The contribution from price and exchange rate changes is defined as [-ρ(1 +g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε> 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/ Over the medium term, inflation forecasts for Peru are in line with world inflation such that nominal exchange rate shocks are equivalent to real exchange rate shocks.

Table 2. Peru: Public Sector Debt Sustainability Framework, 1997-2008

(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline Medium-Term Projections											
Public sector debt 1/	42.1	48.0	45.9	46.2	**46.8**	45.6	**43.9**	**41.7**	**39.4**	**37.4**	**35.5**
Of which foreign-currency denominated	37.9	43.2	41.3	41.6	**41.1**	**40.1**	**36.9**	**35.0**	33.1	**29.9**	**28.4**
Change in public sector debt	3.5	5.9	-2.1	0.3	0.5	-1.2	-1.7	-2.2	-2.2	-2.0	-1.9
Identified debt-creating flows (4+7+12)	3.5	4.6	-0.2	0.0	-0.5	-0.6	-1.6	-2.1	-2.1	-1.9	-1.8
Primary deficit	-1.3	0.8	0.9	0.1	0.1	-0.2	-0.7	-1.3	-1.4	-1.5	-1.5
Revenue and grants 2/	19.9	19.2	18.4	18.4	18.1	17.8	18.2	18.6	18.6	18.5	18.6
Primary (noninterest) expenditure 2/	18.6	20.0	19.3	18.5	18.1	17.6	17.5	17.3	17.2	17.0	17.1
Automatic debt dynamics 3/	5.2	4.4	-0.4	0.6	0.1	0.3	-0.8	-0.7	-0.7	-0.4	-0.3
Contribution from interest rate/growth differential 4/	-0.2	0.2	-0.8	1.6	0.0	-0.9	-0.9	-0.8	-0.8	-0.5	-0.4
Of which contribution from real interest rate	-0.4	0.6	0.6	1.7	2.1	0.9	1.0	1.2	1.3	1.4	1.4
Of which contribution from real GDP growth	0.2	-0.4	-1.4	-0.1	-2.2	-1.7	-1.9	-2.0	-2.2	-1.9	-1.8
Contribution from exchange rate depreciation 5/	5.3	4.2	0.4	-1.0	0.1	1.2	0.1	0.1	0.1	0.1	0.1
Denominator = 1+g+π+gπ	1.1	1.0	1.1	1.0	1.0	1.1	1.1	1.1	1.1	1.1	1.1
Other identified debt-creating flows	-0.4	-0.7	-0.8	-0.6	-0.7	-0.7	-0.1	-0.1	-0.1	-0.1	0.0
Privatization receipts (negative)	-0.4	-0.7	-0.8	-0.6	-0.7	-0.7	-0.1	-0.1	-0.1	-0.1	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	0.0	1.3	-1.9	0.3	1.1	-0.6	-0.1	-0.1	-0.1	-0.1	-0.1
Public sector debt in percent of revenues 1/	211.6	249.8	249.4	251.2	258.9	255.4	240.8	224.3	212.4	202.4	190.9
Gross financing 6/	3.3	6.1	6.2	4.8	6.4	4.6	4.4	3.7	3.5	3.3	4.0
in billions of U.S. dollars	1.9	3.2	3.3	2.6	3.6	2.7	2.8	2.5	2.6	2.6	3.4
Additional Macroeconomic and Fiscal Assumptions											
Nominal GDP (local currency)	166.5	174.7	186.8	189.5	198.6	212.1	227.4	244.8	264.4	284.2	305.2
Average nominal interest rate on public debt (in percent) 7/	5.4	5.4	5.1	4.9	4.7	4.8	5.1	5.6	5.8	6.2	6.3
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.1	1.5	1.4	3.7	4.8	2.1	2.5	3.1	3.6	4.0	4.1
Interest rate on new market external financing (in percent)	...	...	...	...	...	11.0	11.0	10.0	10.0	10.0	10.0
Gross market external financing in percent of total external financing	...	...	...	...	...	38.9	38.9	38.9	38.9	38.9	38.9
Exchange rate (LC per US dollar)	3.1	3.5	3.5	3.4	3.5	3.6	3.6	3.6	3.6	3.6	3.6
Growth of real primary spending (deflated by GDP deflator, in percent)	4.0	8.5	-0.5	-4.2	3.2	0.8	4.0	3.5	5.1	4.2	5.5
II. Stress Tests											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007					**46.8**	**43.6**	**40.6**	**37.7**	**35.0**	**32.5**	**30.0**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004					**46.8**	**47.2**	**47.0**	**44.7**	**42.4**	**40.4**	**38.5**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					**46.8**	**49.9**	**52.8**	**50.2**	**47.5**	**45.1**	**42.8**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004					**46.8**	**47.2**	**47.5**	**45.2**	**42.9**	**40.9**	**38.9**
5. Combination of 2-4 using one standard deviation shocks					**46.8**	**48.3**	**49.8**	**45.7**	**41.6**	**37.7**	**34.0**
6. 30 percent real depreciation in 2003 8/					**46.8**	**64.1**	**62.1**	**59.6**	**57.0**	**54.8**	**52.8**
6a. 15 percent real depreciation in 2003 8/					**46.8**	**53.1**	**51.3**	**49.0**	**46.6**	**44.5**	**42.6**
7. 10 percent of GDP increase in other debt-creating flows in 2003					**46.8**	**55.6**	**53.7**	**51.3**	**48.9**	**46.8**	**44.8**
8. Impact on **debt-to-GDP ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04					**46.8**	**47.8**	**48.7**	**46.4**	**44.1**	**42.1**	**40.1**
8a. Impact on **debt-to-revenue ratio** if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04					**260.4**	**306.6**	**312.5**	**249.9**	**237.6**	**227.4**	**215.6**

Historical Statistics for Key Variables (1992-2001)	Historical Average	Standard Deviation
Primary deficit	-0.8	1.1
Real GDP growth (in percent)	3.9	4.4
Nominal interest rate (in percent) 7/	6.1	1.5
Real interest rate (in percent) 9/	-1.2	3.5
Inflation rate (GDP deflator, in percent)	18.9	22.4
Revenue to GDP ratio	18.6	1.5

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

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

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

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

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

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

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

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

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

Lima, March 17, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Köhler:

1. In our letters of January 18 and November 26, 2002, the Government of Peru described its economic program supported under the current Stand-By Arrangement. This letter describes performance under the program in 2002 and discusses the economic policies that will be pursued during 2003 in order to achieve the program's objectives. Continued prudent macroeconomic policies and structural reforms will sustain the recovery in economic activity that began in the second half of 2001, maintain low inflation, limit external vulnerability, and lay the basis for a marked reduction in unemployment and poverty over the medium term.

2. In 2002, the Peruvian economy experienced a broad-based recovery in economic activity, weathering well the turmoil in the region. Macroeconomic performance was strong, and all end-December and continuous performance criteria were observed. GDP growth in 2002 exceeded program expectations, coming in at around 5 percent. Inflation ended the year at 1.5 percent, at the low end of the inflation target range of 1.5–3.5 percent. The combined public sector deficit was 2.2 percent of GDP. The external position was robust, with the current account deficit remaining at 2 percent of GDP and official reserves rising by some US$1 billion (owing to substantial public and private capital inflows). Interest rates were at historical low levels for most of the year, and the exchange rate was relatively stable during the year (with the *Nuevo Sol* depreciating by 2.3 percent). In the banking system, both local and foreign currency deposits rose, and prudential indicators improved.

3. Progress was made in implementing the Government's structural reform agenda, including the initiation of a comprehensive reform of the tax system. Administrative measures were implemented in mid–2002 that have improved the collection of value-added taxes by using large private firms as tax retention agents, strengthening control of taxpayer registries and paperwork, expanding the tax agency's auditing rights, and improving the monitoring of taxpayer transactions with government agencies. Tax measures were also introduced last year that rationalized excise taxes on petroleum products, expanded the income tax base (including through the elimination of certain deductions from the corporate income tax), raised the maximum marginal personal income tax rate from 27 to 30 percent, and created a new minimum income tax advance payment scheme for larger taxpayers. These measures yielded around 0.4 percent of GDP (on an annual basis) in 2002 and are expected to yield 0.8 percent of GDP in 2003.

4. Further, Peru embarked on an important decentralization process. In July 2002, the legal framework for decentralization was established that set specific principles on fiscal decentralization, including that the process be carried out in a gradual and fiscally-neutral

manner, that external borrowing by regional administrations requires a state guarantee, and that 60 percent of the proceeds raised through the Private Investment Promotion Program (PIPP) be earmarked for the regional development fund (FONCOR) and the decentralization fund (FIDE). The framework called for additional implementing legislation, the first of which was approved in the last quarter of 2002 that details the exclusive and shared responsibilities of regional governments and grants the central government authority to oversee the fiscal situation of regional governments. On November 17, 2002 elections were held for the regional governments that took office on January 1, 2003.

5. Significant progress was made in implementing other structural fiscal reforms. The tax audit program of corporations and independent professionals exceeded the program goal of carrying out 17,000 audits in 2002, and tax expenditures were incorporated in the 2003 budget. Reform of the public pension system (which aims at equalizing benefits across the various public pension plans over the medium term) continued in 2002—survivor benefits were standardized across the two principal plans, replacement rates were lowered and the pensionable base standardized under the general pension plan; the minimum pension was raised to protect the poorest pensioners; and a minimum pension was established for certain older workers who moved to the private pension system. Draft legislation was submitted to congress (and approved by the Budget Commission) to revise the Law on Fiscal Prudence and Transparency that establishes a realistic path for the evolution of the fiscal balance following a recession (allowing a three year adjustment to the medium term deficit limit of 1 percent of GDP), strengthens compliance incentives by requiring the immediate implementation of measures (in periods of positive economic growth) to address revenue shortfalls or expenditure overruns, and sets prudent fiscal rules on regional and local governments. On the other hand, the PIPP was reoriented away from outright sale of assets to focus on operating concessions and joint ventures. In 2002, PIPP receipts reached US$420 million.

6. Further steps were taken to strengthen bank supervision in 2002. Draft legislation was submitted to congress that would provide the necessary statutory protection to the staff of the Superintendency of Banks (SBS) in the discharge of their responsibilities. Regulations were introduced on country and operational risk and to increase competition in the financial system, and prudential requirements were applied on a consolidated basis. Also a Financial Intelligence Unit to prevent money laundering in the financial sector was created, and the SBS promoted the transparency in banks' publication of interest rates.

2003 Program

7. The near-term outlook for 2003 points to continued economic growth, low inflation, and a robust external position. For 2003, real GDP growth is projected in the range of 4–5 percent, and inflation is projected at 2½ percent. The external current account deficit is expected to decline slightly to under 2 percent of GDP on the basis of continued strength in traditional and nontraditional exports. Capital inflows are projected to slow somewhat from last year, but would still result in an accumulation of official reserves.

8. In this context, the program for 2003 will aim at maintaining prudent macroeconomic policies, including a moderate fiscal adjustment that would be a first step in our medium-term plan of fiscal consolidation. The overall public sector deficit is to decline from 2.2 percent in 2002 to 1.9 percent in 2003, reflecting the tax reform measures taken in 2002. Tax revenue is projected to rise from 12.2 percent of GDP in 2002 to 12.7 percent of GDP in 2003. To enhance taxpayer compliance, the government will not introduce any tax amnesty schemes. Current expenditure will remain under strict control, with no generalized wage increase planned for 2003, while general government non-interest expenditure is projected to grow by only 2 percent in real terms in 2003. The fiscal objectives of the program through end–2003 will be monitored on a quarterly basis as set out in Table 1 through ceilings on the combined public sector borrowing requirement, the contracting or guaranteeing of medium and long-term external public debt, and on the stock of short-term external public debt; and a continuous performance criterion will prohibit the accumulation of external payment arrears. The government stands ready to take additional measures that may be needed to ensure that the fiscal deficit targets are observed.

9. The government's gross financing requirement in 2003 of US$ 2.6 billion has been basically secured, with US$1.8 billion coming from external sources. The World Bank, the Inter-American Development Bank, the Andean Development Corporation, and bilateral creditors are expected to make disbursements in 2003 of around US$1.1 billion (a similar amount to that in 2002) in support of the government's efforts to improve the delivery of social programs, key structural reforms, and public investment projects. Building upon the successful reentrance into the international private capital market in 2002, the government has placed so far this year US$750 million of sovereign debt in international markets. Financing for 2003 would be complemented by issuing bonds in the local market for around US$400 million (resulting in a small net placement) and proceeds from the PIPP projected at US$400 million. The government will not cover its financing needs with resources of the pension reserve fund (FCR) that are held at the central bank and that form part of its international reserves.

10. The central bank (BCRP) will continue its prudent management of monetary policy under the inflation-targeting framework. The BCRP will maintain the current consultation mechanism on inflation, as described in Table 1, and quarterly performance criteria (floors) have been established for the net international reserves of the central bank. The BCRP will continue to maintain the floating exchange rate system, intervening in the spot foreign exchange market only to limit volatility in the exchange rate. It will also continue the practices of not intervening directly in the forward foreign exchange market and of limiting the use of exchange rate-indexed certificates of deposit to cases of unusual volatility in the spot exchange rate. Reserve requirements on U.S. dollar deposits will continue to be managed prudently to ensure that the high level of coverage of dollar deposits in the banking system by the international reserves of the BCRP is maintained.

11. In 2003, the Government of Peru will press ahead with its structural reform agenda. The agenda will focus on continuing to reform the tax system, implementing a sound fiscal decentralization plan, reactivating the domestic government bond market, strengthening the

legal framework for fiscal policy, continuing with the PIPP, fortifying governance and the transparency of government operations, raising the efficiency of public expenditure, strengthening bank supervision, and continuing to open the economy. Key elements of the government's structural reform program will be subject to structural benchmarks as shown in Table 2.

12. In 2003, the government will continue working cautiously on a legal framework for decentralization that will ensure that the process is implemented in an orderly manner to protect the public finances over the medium term. The introduction of a fiscal decentralization law is a key element of this strategy. Draft legislation is being prepared that would define the allowable revenue collections at each level of government, coordinate the transfer of expenditure assignments and revenue consistent with local and regional governments' institutional capacity, introduce criteria for inter-governmental transfers, include provisions on full and uniform reporting (along the lines of those for the central government) for all regional and local governments, and place controls on regional and local government borrowing. In 2003, we will work toward implementing the reporting requirements for all regional and local governments.

13. Tax reform in 2003 will aim at phasing out regional and sectoral tax exemptions (in exchange for investment in infrastructure) and reducing tax evasion by broadening the coverage of the retention and withholding schemes implemented in 2002 and continuing to implement tax audits. The key step in the introduction of the phasing out of regional and sectoral tax exemptions is the fiscal decentralization law noted above (to be approved by congress) that will define this process and will be consistent with the government's objectives in the area of tax reform. The current estimate in the 2003 budget of the cost of the exemptions (on an annual basis) to be phased out by end–2004 is 0.7 percent of GDP, with exemptions costing 0.3 percent of GDP to be phased out by end-2003. Full implementation of the comprehensive tax reform introduced during 2002–2004 is expected to yield around 2 percent of GDP on an annual basis over the medium term.

14. The 2004 budget and the revamped law on fiscal prudence and transparency will be key signals of the government's commitment to its medium-term goal of fiscal consolidation. In this context, the 2004 budget will be consistent with the government's plans noted above in the areas of fiscal decentralization and tax reform, as well as with the medium-term macro framework.

15. The government will embark on a reform of the state that in 2003 will concentrate on rationalizing spending to reverse the recent trend of declining capital expenditure as a percentage of total outlays. Toward this end, an inter-ministerial team has been established to identify nonessential outlays and to recommend a restructuring of government spending. In addition, the team will formulate medium-term strategic guidelines for each government program that will also aid in prioritizing the allocation of government expenditure.

16. Bank supervision will continue to be strengthened in 2003. The SBS is working toward strengthening exchange rate risk management and monitoring for dollar lending to

clients whose operations generate income streams in local currency. Norms were issued in March requiring banks to increase their information base and their analytical internal risk models so that they can explicitly incorporate an evaluation of exchange rate risk in their overall credit risk calculation. The SBS is also consolidating and rationalizing regulations on provisioning and loan classification, with a view to improving the transparency and consistency of the regulations. Legislation has been passed that increases the penalties for intent to destabilize the financial system, and statutory protection to SBS staff in the discharge of their responsibilities will be granted.

17. The government will refrain from creating new sectoral support programs and continue to manage prudently existing programs. The government has extended for two years the consumer-lending program (*Multired*) of the *Banco de la Nación* (BN) in order to support the continued recovery in economic activity. However, the program will continue to be managed under the same prudent regulations as last year. The limit on the net lending of the *Multired* operation will constitute a performance criterion under the program (as indicated in Table 1). The agriculture bank, *Banco Agropecuario*, will continue to limit direct lending to small-scale producers with funds exclusively allocated in the budget and for other producers will channel international lines of credit through SBS-regulated institutions. Cofide will maintain its operations as a second-tier development bank, channeling officially-borrowed resources through private financial institutions. The government will not use public resources to establish new financial institutions for direct lending to the public.

18. An important element of the government's structural program for 2003 is to improve the functioning of the domestic market for government securities in local-currency, and in particular, the auction system. In March 2003 a system of primary dealers for auctioning government paper will begin operating. Moreover, to best ensure a well-functioning market, a calendar of scheduled domestic bond auctions will be published in March 2003.

19. The government will continue to implement its trade policy strategy of reducing the average level of import tariffs, always with a view to ensuring that such reductions are consistent with the fiscal program. In 2002, the average tariff level was reduced from 11.8 percent to 10.9 percent, and the government intends to lower this further. Negotiations to reduce tariff barriers with our Andean Community partners and bilaterally with Mexico and Brazil will continue. The government's longer-term objective is to enter into a hemispheric free-trade arrangement by 2006.

20. The government will continue to work toward strengthening governance. In 2003, the government intends to continue in its efforts to root out corruption in all levels of government (having passed last year important anti-corruption legislation), and work toward strengthening the independence and efficiency of the judiciary.

21. In addition to the policies outlined in this letter, the Government of Peru stands ready to take additional measures as appropriate to ensure the achievement of its program's objectives. During the period of the Stand-By Arrangement, the authorities of Peru will maintain the usual close policy dialogue with the Fund, and to this end, the program will

have two more reviews. The third review with the Fund, to be completed by August 31, 2003, will cover the implementation of the economic program described in this letter and our letters of January 18, 2002 and November 26, 2002 and will establish the timing of the fourth review. The third review will focus, in particular, on: (i) progress in implementing the tax reform and fiscal responsibility law; (ii) developments in the decentralization process; (iii) the functioning of the domestic bond market; (iv) steps being undertaken to strengthen banking supervision; and (v) the operations and impact of government initiatives to aid specific sectors.

Sincerely yours,

/s/	/s/
Javier Silva Ruete Minister of Economy and Finance	Richard Webb, President Central Reserve Bank of Peru

Table 1. Peru: Quantitative Performance Criteria
and Inflation Consultation Mechanism, 2003

	Mar. 31	Jun. 30	Sep. 30	Dec. 31
(Cumulative amounts from December 31, 2002, millions of new soles)				
Borrowing requirement of the combined public sector 1/ 2/	780	1,400	2,595	4,130
Net consumer lending of Banco de la Nación	-15	40	30	75
(Cumulative change from December 31, 2002, in millions of U.S. dollars) 3/				
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions 4/ 5/ 6/ 7/	98	-50	-146	-148
Outstanding short-term external debt of the nonfinancial public sector	50	50	50	50
Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year 8/	950	1,680	2,015	2,200
Of which: [1-5] years' maturity	250	250	250	250
External payments arrears of the public sector (on a continuous basis) 9/	0	0	0	0
(Consultation bands for the 12-month rate of inflation, in percent) 10/				
Outer band (upper limit)	5.5	5.5	5.5	5.5
Inner band (upper limit)	4.5	4.5	4.5	4.5
Central point	2.5	2.5	2.5	2.5
Inner band (lower limit)	0.5	0.5	0.5	0.5
Outer band (lower limit)	-0.5	-0.5	-0.5	-0.5

1/ Including the operating balance of the central bank; PIPP proceeds are included below the line.

2/ The limits on the borrowing requirement of the combined public sector will be adjusted upward, by a maximum amount of S/. 200 million, for completion of a public investment project financed with concessional lending under the PIPP.

3/ The quantitative performance criterion on government guarantees for housing support programs has been deleted as these programs will not be put into place.

4/ The target for net international reserves will be adjusted upward by the amount of PIPP proceeds in foreign currency in excess of US$15 million by end-March, US$57 million by end-June, US$157 million by end-September and US$400 million by end-December 2003. The amounts in excess will be deposited at the BCRP.

5/ The target for net international reserves will be adjusted upward by the amount that net foreign borrowing of the nonfinancial public sector exceeds US$380 million at end-March, US$510 million at end-June, US$660 million at end-September and US$720 million at end-December 2003. The amounts in excess will be deposited at the BCRP.

6/ The target for net international reserves will be adjusted downward for shortfalls from the combined program amounts of PIPP proceeds and net foreign borrowing. This downward adjustment will not exceed US$100 million at end-March, US$320 million at end-June, US$500 million at end-September and US$400 million at end-December 2003.

7/ The target for the net international reserves will be adjusted downward for withdrawals for portfolio management purposes of deposits held at the Central Reserve Bank by the Consolidated Pension Reserve Fund (FCR) and any other funds managed by the ONP. This downward adjustment will not exceed US$300 million at any time in 2003.

8/ The limit would be adjusted upwards by any amount of debt issued for, and used in, a debt-exchange operation, and by up to US$375 million for prefinancing of government operations in 2004.

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

10/ Should inflation fall outside the inner band, the authorities will discuss with the 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 before requesting further purchases under the arrangement.

Table 2. Peru: Structural Benchmarks

To be completed by June 30, 2003

1. Submission to congress of fiscal decentralization legislation consistent with the objectives for decentralization stated in paragraph 12 and with the objectives for tax reform stated in paragraph 13.

2. Implementation of the revised rules on fiscal prudence and transparency.

3. Granting statutory protection to SBS staff in the discharge of their responsibilities.

To be completed by September 30, 2003

1. Submission to congress of a 2004 budget consistent with the objectives for decentralization stated in paragraph 12 and with the objectives for tax reform stated in paragraph 13 and the revised rules on fiscal prudence and transparency.

2. 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.

Technical Memorandum of Understanding (TMU)

This memorandum includes definitions of concepts and the format for periodic reporting to the Fund on performance under the program for 2003 described in the letter of the Government of Peru dated March 17, 2003.

I. Definitions of Concepts[1]

1. **The borrowing requirement of the combined public sector (PSBR)** will be measured as: (a) net domestic financing of the nonfinancial public sector, plus (b) net external financing of the nonfinancial public sector, plus (c) proceeds from the Private Investment Promotion Program (PIPP), less (d) the operating balance of the BCRP. The PSBR will be adjusted to exclude the impact of data revisions that do not represent a change of its flows during 2003. **The nonfinancial public sector (NFPS)** comprises the central government, the autonomous agencies, the local and regional governments, fiduciary trusts (Fideicomisos) overseeing the concessions program such as Fonfide-Vial, and the nonfinancial public enterprises. The components of the PSBR (Table 1), will be defined and measured as follows:

(a) **The net domestic financing of the NFPS** is defined as the sum of: (i) the increase in net claims of the domestic **financial system**[2] on the nonfinancial public sector (excluding Peruvian Brady bonds and other government bonds initially sold abroad); (ii) the net increase in the amount of public sector bonds held outside the domestic financial system and the nonfinancial public sector, excluding Peruvian Brady bonds and other bonds initially sold abroad; and (iii) the increase in the floating debt of the nonfinancial public sector due to expenditure operations and tax refund arrears; less (iv) the accumulation of stocks, bonds, or other domestic financial assets by the nonfinancial public sector. In the case of enterprises that are divested after December 31, 2002, the net credit of the financial system to these enterprises will be recorded, for the remainder of the program period, as unchanged from their level at the time of the PIPP.

(b) **The net external financing of the NFPS** comprises (i) disbursements of loans; plus (ii) receipts from the issuance of government bonds abroad; minus (iii) cash payments of principal (current maturities of both loans and bonds); minus (iv) cash payments of arrears, principal and interest (as defined for program purposes); plus (v) the net increase (or, minus

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[1] For purposes of the program for 2003, operations in foreign currency will be valued at S/. 3.57 per U.S. dollar.

[2] **The financial system** comprises the banking system, the Corporación Financiera de Desarrollo (COFIDE) and all other nonbank financial intermediaries. The banking system comprises the Central Reserve Bank of Peru (BCRP), the commercial banks, the Banco de la Nación (BN); Banco Agropecuario, and any development bank in liquidation.

the decrease) in short-term external debt; minus (vi) debt buy-backs or other prepayments of debt (at market value) not included in the following item (including repayments of short-term external debt assumed by the government at the time of the divestiture of public enterprises, net of the proceeds from the sale of inventories of such enterprises); minus (vii) debt-equity swaps used in the PIPP accounted at the market value of these papers as defined by ProInversión; minus (viii) the net increase (or, plus the decrease) in foreign assets of the nonfinancial public sector (including those held abroad by the Fondo Consolidado de Reservas (FCR), and any other fund managed by the Oficina de Normalización Previsional (ONP)) (Table 2).

(c) **PIPP proceeds** are defined as (i) the cash payments received by the Treasury from the sale of state-owned assets (including proceeds transferred to the FCR, and any other specialized funds) valued at the program exchange rate, plus (ii) debt equity swaps used in the PIPP, accounted at market values as defined by ProInversión. PIPP proceeds also include up-front payments received by the Treasury for the granting of concessions for public services but exclude the annual payments under the concession program, which are part of central government nontax revenue.

(d) **The operating balance of the BCRP** includes: (i) cash interest earnings of the BCRP minus cash interest payments by the BCRP, in both domestic and foreign currency; (ii) the administrative expenses of the BCRP; and (iii) any realized cash losses or gains from activities in currencies, financial instruments, and derivatives.

2. **The consultation bands for inflation** are based on the 12-month rate of change in consumer prices as measured by the *Indice de Precios al Consumidor (IPC)* at the level of Metropolitan Lima by the *Instituto Nacional de Estadística e Informática* (INEI). Should inflation fall outside an inner band of two percentage points around the central point of 2.5 percent, the authorities will discuss with the Fund staff on an appropriate policy response. Should inflation fall outside an outer band of three percentage points around the central point, the authorities will also complete a consultation with the Executive Board of the Fund on the proposed policy response before requesting further purchases under the arrangement.

3. **The net consumer lending of the BN** will be defined as disbursements of loans under the "Multired Program", established in November 2001 and extended in December 2002, less cash amortizations under the loan program. Interest payments on these loans are excluded from the definition of net lending.

4. **The net international reserves of the BCRP, excluding foreign-currency deposits of financial institutions,** are defined for the purpose of the program as: (a) the foreign assets of the BCRP (excluding 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); less (b) reserve liabilities, defined as the sum of: (i) the BCRP's external liabilities with an original maturity of less than one year, and (ii) its liabilities to the IMF, to the Inter-American Development Bank (IADB) and to the FLAR; and less (c) deposits in foreign currency by the

banking system, other financial intermediaries and the private sector, net of repos of Treasury bonds with the financial system.

5. BCRP's silver holdings will be excluded from the net international reserves. The gold holdings of the BCRP will be accounted at US$346.8667 per troy ounce (the average book value as of December 31, 2002), SDRs at US$1.35458 per SDR, and foreign currency assets and liabilities of the BCRP in other currencies at the exchange rate of December 31, 2002. Net international reserves will be adjusted to exclude any valuation gains or losses resulting from net sales or deliveries of gold by the BCRP. The end-December 2002 level of net international reserves is shown in Table 3.

6. The flows of the **short-term external debt of the NFPS** are defined as the net change in the NFPS's outstanding external indebtedness with a maturity of less than one year (including instruments with put options that would be triggered within one year of the contracting date), measured, in part, on the basis of the operations of a selected sample of public enterprises comprising Petroperú, Centromín Perú, and Electroperú. These limits exclude normal import financing but include forward commodity sales. For the purposes of this performance criterion, the term "debt" has the meaning set forth in point number 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt, which is defined in detail in 6 below. In the case of companies sold to the private sector under the PIPP, the short-term debt of these entities will be recorded, for the remainder of the program period, as unchanged from their level at the time of the PIPP. The end-December 2002 stock of short-term external debt of the NFPS is shown in Table 4.

7. **The contracting or guaranteeing of nonconcessional external public debt with a maturity of at least one year** refers to all external obligations of the NFPS, COFIDE, the BCRP, the BN, and any other state development bank, except for loans classified as reserve liabilities of the BCRP. The program limits on nonconcessional debt will exclude: (i) any new loans extended in the context of a debt rescheduling or debt reduction operation; and (ii) any lending at concessional terms.

8. The performance criterion on the contracting or guaranteeing of external public debt applies also to commitments contracted or guaranteed for which value has not been received. For the purpose of this performance criterion, the term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with respect to Foreign Debt adopted on August 24, 2000 (Board Decision No. 12274-(00/85)). Thus, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time: these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans

under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the performance criterion, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property. Under the definition of debt set out above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

9. For program purposes, **a debt is concessional** if it includes a grant element of at least 35 percent, calculated as follows: the grant element of a debt is the difference between the net present value (NPV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt (i.e., grant element is equal to (nominal value minus NPV) divided by nominal value). The NPV of debt at the time of its disbursement is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the currency specific commercial interest reference rates (CIRRs), published by the OECD. For debt with a maturity of at least 15 years, the ten-year average CIRR will be used to calculate the NPV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. For the purposes of the program through December 2003, the CIRRs published by the OECD in December 2002 will be used (Table 5).

10. The concessionality of loans in currency baskets will be assessed on the basis of U.S. dollar interest rate tables. For loans with interest rates based on the internal policy of the creditors, the relevant interest rate to define concessionality will be the interest rate for each creditor at the time of the commitment. Loans or portions of loans extended in the context of a debt rescheduling or a debt reduction operation will be excluded from the ceiling.

11. The **external payments arrears of the public sector** include arrears to multilateral financial institutions, to Paris Club creditors, and to other foreign creditors with whom debt restructuring agreements have been concluded. They exclude arrears outstanding at end-2002 that were not covered under restructuring agreements. The public sector will be defined to include the NFPS, COFIDE, the BCRP, the BN, and any other state development bank.

12. Definitions used in Table 1 of the letter of intent dated March 17, 2003 for the calculation of adjustments to limits and targets for net international reserves:

a) **PIPP proceeds in foreign currency** are calculated as (a) PIPP proceeds as defined above in Section I.1.c, less (b) domestic currency PIPP proceeds from citizens (Participación Ciudadana) and from Administradoras Privadas de Fondos de Pensiones (AFPs).

b) **Net foreign borrowing** (Table 2) is defined as the sum of disbursements of loans (I.1.b.i), plus receipts from the issuance of government bonds abroad (I.1.b.ii); minus cash payments of principal (I.1.b.iii); minus cash payments of arrears (principal and interest) (I.1.b.iv); plus the net increase (or minus the decrease) in short-term external debt (I.1.b.v).

c) The **withdrawals for portfolio management purposes** of deposits held at the BCRP by the FCR and any other fund managed by the ONP, mentioned in footnote 7 of Table 1 attached to the letter of intent refer to placements of funds that are in accord with an investment plan approved by the Board of the FCR, excluding deposits in public financial institutions and government securities.

d) **Prefinancing** mentioned in footnote 8 is understood as the portion of nonproject related external public debt, contracted or guaranteed, that is issued in 2003 but will be used in 2004 or later.

II. Periodic Reporting

13. The regular reporting will include the following:

a) The latest **Nota Semanal** of the BCRP.
b) Monthly Report.

(i) **Performance criteria**
Data on the program's quarterly performance criteria.

(ii) **Financial sector**
(a) Balance sheets of the consolidated financial system, consolidated banking system, BCRP, BN, commercial banks, Banco Agropecuario, and development banks in liquidation.
(b) Disaggregation of the net domestic assets of the BCRP and BN with details of the other net accounts.
(c) Monthly balance sheet of COFIDE and data on COFIDE guarantees.
(d) BCRP daily operations.
(e) Monthly balance sheet of the private pension system.
(f) Evolution of gross disbursements and amortizations of consumer loans made under the "Multired Program".
(g) The stock of any government guarantees for housing support and the monthly balance sheet of Mivivienda.

(iii) **Fiscal sector**

(a) PSBR as defined in Table 1.

(b) List of domestic and external debt instruments contracted or guaranteed by the public sector, including data on the amount, lender, grace period, maturity, and interest rate (refinancing credits should be labeled as such), collateral guarantees, any instrument enhancements (such as but not limited to put or call options) that affect the price or maturity of the debt instrument.

(c) Summary of disbursements and interest and amortization due and paid (identifying the payments of arrears) of loans included in the records of the General Directorate of Public Credit by creditor and debtor, indicating foreign origin (distinguishing between financial and nonfinancial public sector debt) and domestic origin (Table 6). Cash operations of the treasury (which includes floating debt, with a memorandum item on tax refund arrears).

(d) Cash operations of the treasury (which includes floating debt, with a memorandum item on tax refund arrears).

(e) Data on PIPP revenue, which will include gross receipts, costs of the PIPP, use of debt-for-equity swaps, commissions received by ProInversión and the resulting cash receipts received by the Treasury and the FCR. In addition, the report will include debts assumed by the government in connection with the PIPP.

(f) Operations of the Central Government, Central Government Current Revenue (SUNAT Format); Central Government Non-interest Expenditure; and Transfers from the Central Government to the Rest of the General Government.

(g) Fuel prices of PETROPERU and RELAPASA, and international prices of products commercialized by PETROPERU including tariffs, indirect taxes and distribution margins (prices would be listed for all grades of gasoline, diesel fuel, kerosene and fuel oils.) Stocks of the central government PIPP accounts in the BCRP and the BN.

(h) Stocks of the central government PIPP accounts in the BCRP and the BN.

(i) Fideicomisos for operating concessions—balance sheet; summary of operations, including revenue, outlays, and guarantees; and copies of contracts engaged in for operating concessions.

(iv) **External sector**

(a) Summary of imports and exports by product (volume and price).

(b) Daily exchange rate statistics.

(v) **Quarterly data of fiscal and external accounts, and public sector debt,** distinguishing between total public sector debt and total NFPS.

(vi) **Other**

(a) Summary of legislative changes pertaining to economic matters.

(b) BCRP circulars.

(c) BCRP inflation report.

Table 1. Peru: Public Sector Borrowing Requirement (PSBR)
(In millions of nuevos soles)

	Stock as of Dec. 31 2001 1/	Stock as of Dec. 31 2002 1/	Flow
a. Net domestic financing of the nonfinancial public sector	**-9,205**	**-10,350**	**-1,145**
i. Net claims of the financial system (1+2+3)	-8,472	-9,380	-908
1. Net credit of the banking system on the NFPS and COFIDE	-11,214	-11,998	-784
Credits	7,869	8,060	191
Liabilities	19,082	20,058	975
2. Net credit of COFIDE on the banking system	1,880	1,473	-407
Credits	2,009	1,679	-330
Liabilities	129	206	77
3. Net credit of nonbanking financial institutions on the NFPS	861	1,145	284
Credits	1,342	1,831	489
Liabilities	481	686	205
ii. Stock of bonds of NFPS in circulation (excluding bonds held by NFPS and of the financial system)	270	132	-138
a. Total	4,753	5,389	637
b. Less: holdings of the financial system (including COFIDE)	4,278	5,040	762
c. Less: holdings of nonfinancial public sector entities	204	217	12
iii. Floating debt	902	957	55
iv. Less: Accumulation of stocks, bonds, or other domestic financial assets by the NFPS	1,905	2,059	154
b. Net external financing			**4,184**
(Millions of US dollars)			$1,172
c. Privatization			**1,499**
(Millions of US dollars)			$420
d. Operating balance of the BCRP			**309**
PSBR (a+b+c-d)			**4,230**

1/ Foreign currency valued at US$ 1 = S/. 3.57.

Table 2. Peru: Net External Financing NFPS: 2002-2003

(In millions of US$)

		2002	2003			
		Prel.	Jan.-Mar. Prog.	Jan.-Jun. Prog.	Jan.-Sep. Prog.	Jan.-Dec. Prog.
i.	Loan disbursements	977	130	334	734	1,100
	-Projects	352	130	234	334	450
	-Nonprojects	625	0	100	400	650
ii.	Bonds	1,886	492	700	700	700
iii.	Cash payments on amortization	-1,735	-243	-524	-779	-1,081
	- Loans	-810	-221	-501	-735	-1,036
	- Bonds	-924	-22	-22	-44	-44
iv.	Cash payments to settle arrears	0	0	0	0	0
v.	Change in short term debt (increase+)	27	0	0	0	0
A.	**Net foreign borrowing (i+ii-iii-iv+v)**	**1,155**	**379**	**510**	**655**	**719**
vi.	Prepayments	54	0	0	0	0
vii.	Debt equity swaps	0	0	0	0	0
viii.	Change in foreign assets held by the NFPS	-72	0	0	0	0
B.	**Net external financing (A-vi-vii-viii)**	**1,172**	**379**	**510**	**655**	**719**

Source: BCRP.

Table 3. Peru: Net International Reserves of the Central Reserve Bank of Peru excluding Foreign Currency Deposits of Financial Institutions as Defined in the Technical Memorandum of Understanding (TMU)

(In millions of US$)

		Stocks as of December 31, 2002
a.	**Assets**	**9,349**
	Gold 1/	387
	Deposits abroad	3,131
	Holdings of SDR 2/	9
	Reciprocal credit agreement	3
	Cash	50
	Others (Bonds)	5,769
b.	**Liabilities**	**92**
	Reciprocal credit agreement	13
	Liabilities with international organizations	**80**
	IMF 2/	73
	IADB	7
	FLAR	0
c.	**Foreign currency deposits of financial institutions at the Central Bank**	**3,426**
	Banking enterprises	3,048
	Banco de la Nación	291
	COFIDE	46
	Financial enterprises	42
d.	**Treasury bond repos**	**0**
e.	**Swaps**	**0**
f.	**Valuation US$/other currencies**	**0**
g.	**Net international Reserves - Program definition (a-b-c+d-e-f)** 3/	**5,830**
Memorandum items:		
1.	Subscription to the IMF and FLAR	304
2.	Pesos andinos	20
3.	CAF bonds	18
4.	Net international reserves, official definition (g+c+1+2+3)	9,598

Source: Central Reseve Bank of Peru.

1/ Gold valued at US$ 346.8667.

2/ Valued at US$ 1.35458 per SDR.

3/ As defined in I.4.

Table 4. Peru: Short-term External Debt of the NFPS (as of December 31, 2002) [1/]

(In millions of US$)

	Export Financing	Working Capital	Import Financing	Total
Total	**0**	**0**	**34**	**34**
Petroperu	0	0	34	34
Centromin	0	0	0	0
Electroperu	0	0	0	0
General government	0	0	0	0
Memorandum item:				
Total of export financing plus working capital loans				0

Sources: BCRP and state companies.

1/ Preliminary.

Table 5. Peru: Commercial Interest Reference Rates (CIRRs)

Note: the latest six-month CIRRs averages are to be used for loans whose maturity is less than 15 years. For all others use 10-year averages.

Average CIRRs (updated Nov. 26, 2002)			Rates for Loans with Maturity =>15 years Contracted in				
	Six-month	Ten-Year	Before 1999	1999	2000	2001	2002
	2/15/-8/14/2001*	1/92-12/01 1/	1/86-12/95	1/89-12/98	1/90-12/99	1/91-12/00	1/92-12/01 1/
Australian Dollar	6.83%	7.68%	12.15%	10.15%	9.28%	8.55%	7.98%
Austrian Schilling 2/	n.a.	6.34%	8.35%	7.73%	7.65%	7.43%	6.72%
Belgian Franc 2/	n.a.	6.80%	9.25%	8.60%	8.45%	8.13%	7.21%
Canadian Dollar > 8.5 years	6.21%	7.34%	9.83%	8.90%	6.07%	6.78%	7.41%
Danish Krone	6.15%	6.81%	10.37%	8.88%	8.33%	7.80%	7.29%
Finnish Markkaa 2/	n.a.	6.92%	10.64%	9.32%	9.15%	8.72%	7.56%
French Franc 2/	n.a.	6.50%	9.62%	8.42%	8.19%	7.82%	6.95%
German Mark 2/	n.a.	6.23%	7.91%	7.62%	7.54%	7.27%	6.58%
Irish Punt 2/	n.a.	6.97%	10.37%	7.59%	8.36%	8.44%	7.44%
Italian Lira 2/	n.a.	7.61%	11.50%	10.38%	10.06%	9.71%	8.30%
Japanese Yen	1.95%	2.77%	5.53%	4.65%	4.30%	3.75%	3.17%
Korean Won	7.95%	10.19%	n.a.	n.a.	n.a.	11.57%	10.74%
Netherlands Guilder >8.5 years 2/	n.a.	6.75%	8.08%	5.24%	5.81%	6.52%	6.95%
New Zealand dollar	7.51%	7.94%	12.17%	9.62%	8.90%	8.33%	7.97%
Norwegian Krone	7.75%	7.28%	11.27%	8.93%	8.36%	7.94%	7.60%
Spanish Peseta 2/	n.a.	7.92%	12.99%	11.35%	10.89%	10.31%	8.65%
Swedish Krona	6.42%	7.52%	11.67%	10.10%	9.42%	8.61%	8.04%
Swiss Franc	4.05%	4.85%	6.68%	3.78%	5.97%	5.67%	5.26%
U.K. Pound	6.17%	7.41%	10.37%	9.53%	8.99%	8.38%	7.85%
U.S. Dollar > 8.5 years	5.86%	6.85%	8.62%	7.93%	7.59%	7.35%	7.06%
Euro (ECU for ten-year avg)	5.91%	6.40%	8.56%	7.99%	7.82%	7.13%	6.79%
Memorandum:							
SDR 3/	5.32%	6.17%	8.22%	7.51%	7.21%	6.85%	6.49%

1/ Estimates based on actual CIRRs for 1/92 to 12/01.

2/ For the current 10-year averages, rates for Euro are used from 1/99.

3/ The 10-year SDR denominated CIRR rate was constructed based on the weighted average of the five 10-year CIRR averages for the underlying currencies.

Loans with Maturity <15 years, Contracted Between

Previous six-month rates	2/15 thru 8/14/1998	8/15/98 thru 2/14/1999	2/15 thru 8/14/1999	8/15/99 thru 2/14/2000	2/15 thru 8/14/2000	8/15/00- 2/14/01	2/15 thru 8/14/2001	8/15/01 2/14/02
Australian Dollar	6.42%	6.01%	6.34%	7.20%	7.47%	6.99%	6.27%	6.18%
Austrian Schilling	5.59%	4.99%	n.a	n.a	n.a.	n.a.	n.a.	n.a.
Belgian Franc	5.99%	5.24%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Canadian Dollar > 8.5 years	6.27%	6.12%	6.20%	6.88%	7.26%	6.80%	6.24%	6.17%
Danish Krone	5.77%	5.44%	4.72%	5.71%	6.46%	6.55%	6.01%	5.66%
Finnish Markkaa	5.52%	5.04%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
French Franc	5.71%	5.03%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
German Mark	5.57%	4.86%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Irish Punt	5.69%	4.93%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Italian Lira	5.31%	5.22%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Japanese Yen	2.32%	2.28%	2.13%	2.05%	1.98%	2.02%	1.58%	1.55%
Korean Won	n.a.	n.a.	n.a.	10.51%	10.18%	8.85%	7.91%	7.42%
Netherlands Guilder >8.5 years	6.12%	5.43%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
New Zealand dollar	8.17%	6.76%	6.64%	7.74%	8.08%	7.57%	7.16%	7.10%
Norwegian Krone	6.11%	6.58%	5.97%	6.82%	7.51%	7.98%	7.96%	7.46%
Spanish Peseta	5.68%	4.98%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Swedish Krona	6.04%	5.38%	4.78%	6.19%	6.46%	6.03%	5.63%	5.89%
Swiss Franc	4.07%	3.91%	3.81%	4.50%	5.24%	5.17%	4.17%	3.89%
U.K. Pound	7.15%	6.53%	5.79%	6.97%	7.03%	6.59%	6.11%	5.96%
U.S. Dollar > 8.5 years	6.63%	5.92%	6.37%	7.18%	7.54%	6.86%	6.09%	5.67%
ECU/Euro	5.36%	4.72%	4.72%	5.82%	6.27%	6.15%	5.73%	5.53%
SDR	5.59%	5.01%	5.02%	5.80%	6.07%	5.88%	5.31%	5.04%

Sources: OECD; and Fund staff calculations.

Table 6. Peru: Stock of Domestic Debt of the NFPS (as of December 31, 2002)

	Legal Norm	Gross placements		Stock (estimated)
		Currency	Amount	(Millions of Nuevos Soles)
Credits from BN				**4,163**
Credit to central government		US$ / S/. / Y		3,202
Credit to local governments		US$ / S/.		91
Net public treasury overdraft		S/.		870
Bonds				**5,693**
Capitalización BCRP	D.S.066-94-EF	S/.	614	327
Serie A			239	239
Serie B			375	88
Bonos TP - Financial system strengthening	D.U. 041-99	US$	175	429
Bonos TP - Temporal suscription of stocks	D.U. 034-99	US$	52	183
Bonos TP - Temporal portfolio exchange	D.S. 114-98-EF	US$	136	241
Bonos TP - Debt exchange bonds	D.S. 068-99-EF	US$	259	750
Bonos TP - RFA and FOPE programs	D.S. 059-2000-EF / D.U. 050-2002	US$	95	335
Bonos TP - Financial system consolidation	D.U. 108-2000	US$	392	1,376
Bonos TP - Sovereign bonds	D.U. 015-2001 / D.U. 106-2001	S/.	1,934	1,934
Bonos TP - Caja de Pensiones Militar Policial Bonds	D.U. 030-2001	US$	34	119
Total				**9,856**
Memorandum item:				
Pension Reform Bonds (Bonos de Reconocimiento)	D.S. 096-95-EF	S/.		9,519
Floating debt		S/.		957

Statement by the IMF Staff Representative
March 28, 2003

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.

- Real GDP grew by 4.6 percent in January (y/y), and the 12-month inflation rate (CPI) rose to 2.8 percent in February; core inflation was 1.7 percent.

- Gross reserves have increased by US$867 million since end-2002 (to US$10.6 billion as of March 21), mainly reflecting two international government bond issues (US$750 million). In addition, the central bank has purchased some US$145 million in the foreign exchange interbank market.

- On March 13, 2003, the government issued a decree aimed at capping retail fuel prices by adjusting fuel excise taxes in the event of a substantial further increase in international crude prices. The decree, effective for 90 days, reduces the specific excise tax on fuels if West Texas Intermediate (WTI) crude prices exceed US$40 per bbl over any 10-day period.[1] The tax would be unchanged if WTI prices are between US$30-40/bbl, and would be raised if they drop below US$30/bbl (to recover any previous revenue loss). So far in 2003, the state-owned petroleum refinery has raised prices by 12 percent on average (with the private refinery following suit). The authorities have told staff that they remain committed to the fiscal targets under the program and would absorb any temporary revenue loss through delays in certain investment projects and cuts in current outlays. In light of this commitment and given the likely small size of the potential impact of the measure on the budget,[2] staff's assessment is that the authorities' fiscal program remains intact and appropriate.

- On March 21, 2003, the authorities issued regulations to establish a system of primary dealers of domestic government bonds, selected five banks as primary dealers, and announced the bond placement calendar for 2003.

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[1] On March 25, the benchmark WTI crude price closed at $29.3 per bbl.

[2] Should WTI crude prices remain US$10 per bbl above the threshold of US$40 per bbl for a three-month period, it is estimated that the price stabilization mechanism would lead to a revenue loss of about 0.1 percent of annual GDP.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 03/44
FOR IMMEDIATE RELEASE
March 31, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Second Review of Peru's Stand-By Arrangement, Approves US$38 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the second review of Peru's performance under a two-year SDR 255 million (about US$347 million) Stand-By Arrangement, approved on February 1, 2002 (see Press Release No. 02/6). The completion of this review enables the release of SDR 27.87 million (about US$38 million) to Peru, bringing the total amount available to SDR 143.5 million (about US$196 million). So far the country has not made any drawings under the arrangement.

Following the Executive Board review of Peru on March 28, 2003, Eduardo Aninat, Deputy Managing Director and Acting Chairman, said:

"Peru's economic performance under the program has been strong, despite the difficult external environment. The outlook for 2003 and the medium term is also favorable, assuming continued implementation of sound economic policies.

"The authorities' economic program for 2003 aims at supporting the recovery in economic activity while keeping inflation low. Real GDP is projected to grow by 4 percent, with inflation around 2 ½ percent and the external position remaining robust. The fiscal deficit is targeted to decline moderately, in line with the authorities' medium-term fiscal consolidation goals.

"The structural reform agenda for 2003 includes introducing a sound fiscal decentralization law, beginning to phase out regional and sectoral tax exemptions in exchange for investment in regional infrastructure, and strengthening the law on fiscal prudence and transparency. The authorities also intend to rationalize public expenditure and improve the quality of social spending, with the assistance of the World Bank and the Inter-American Development Bank. These reforms will contribute importantly to medium-term fiscal sustainability, growth, and poverty reduction, and it will be crucial to ensure a broad political consensus for their effective implementation.

"The continuing improvement in the financial performance of banks is encouraging, although the high degree of dollarization remains a source of vulnerability. To address this risk, the authorities intend to maintain a high level of official international reserves and to continue strengthening oversight of the banking system. New regulations recently adopted on foreign-currency risk management and the draft law in congress to provide adequate legal protection to bank supervisors are also important in this regard.

"The inflation targeting framework and the stance of monetary policy are consistent with the goal of maintaining low inflation. The floating exchange rate system, with intervention limited to smoothing operations, will continue to serve Peru well in adjusting to external shocks and limiting external vulnerability," Mr. Aninat said.

Statement by Guillermo Le Fort, Executive Director for Peru and Carlos Pereyra, Advisor to Executive Director March 28, 2003

Recent Developments

1. In 2002, Peru's macroeconomic performance was strong, with rapid growth, low inflation and limited external vulnerabilities, thus weathering well the international and regional turmoil. All end-December and continuous performance criteria under the Stand-By Arrangement were observed, and the authorities' commitment to continued prudent macroeconomic policies and structural reforms is expected to sustain the recovery in economic activity that began in the second half of 2001, opening the way for a marked reduction in unemployment and poverty over the medium term.

2. GDP growth in 2002 exceeded program expectations (originally 3.7 percent), closing at 5.2 percent according to the latest national account figures, one of the highest in the western hemisphere. The rise in private consumption (4.4 percent) and exports (5.7 percent) contributed significantly to this result. GDP growth in 2003 is forecasted in the range of 4-5 percent. Continued expansion of exports and private consumption and the foreseen improvement in corporate profitability —as well as their effect on private investment— would contribute to achieving the forecasted growth. However, the authorities are aware of the risks associated with a weak global recovery, including the possible consequences of the conflict in Iraq, that could result in increased uncertainty and lower domestic growth.

3. The upturn in private consumption in 2002 resulted from prospects of an improvement in income, the expansion of consumption credit, and higher employment (the year-on-year increase in the latter was 3.7 percent in Metropolitan Lima). Copper and gold exports experienced substantial increases (25.2 and 10.6 percent, respectively). In addition, the value of non-traditional exports is also growing at a fast pace (estimated roughly at 15 percent in 2003), spurred by the extended Andean Trade Promotion and Drug Eradication Act, which enables Peruvian textile and agricultural goods to enter the U.S. market free of tariffs.

4. Private investment gathered a significant pace since mid-2002. Real growth rates in the third and fourth quarters were 4.5 and 4.3 percent, respectively, after eight quarters of continuous decline, and the increase envisaged for 2003 is approximately 5 percent. Investment growth has resulted, in particular, from greater dynamism in construction and higher capital imports, and has been reinforced by improvements in corporate profitability.

5. The robust external position —with official reserves rising by $985 million in 2002, and amounting to around twice short-term debt— as well as favorable growth prospects and confidence in policy continuity, contributed to greater investor discrimination, as evidenced by Peru's ability to tap international capital markets. It is also worth emphasizing that in 2002 the trade balance turned to positive after several years. In the

banking system, both local and foreign currency deposits rose, and prudential indicators improved. Progress was made in implementing the authorities' structural reform agenda, including the continuation of a comprehensive reform of the tax system and of the Private Investment Promotion Program.

Macroeconomic Policies

6. The program for 2003 will aim at maintaining prudent macroeconomic policies, including a moderate fiscal adjustment that would be a first step in the medium-term plan of fiscal consolidation. The 2004 budget and the revamped law on fiscal prudence and transparency will be key signals of the government's commitment to its medium-term goal of fiscal consolidation. In this context, the 2004 budget will be consistent with the government's plans in the areas of fiscal decentralization and tax reform, as well as with the medium-term macro framework. The overall public sector deficit is to decline from 2.2 percent in 2002 to 1.9 percent in 2003, reflecting the tax reform measures taken in 2002. To enhance taxpayer compliance, the government has stated its intention not to introduce any tax amnesty schemes. Current expenditure will remain under strict control, with no generalized wage increase planned for 2003, and the government stands ready to take additional measures that may be needed to ensure that the fiscal deficit targets are observed.

7. Programmed disbursements by the World Bank, the Inter-American Development Bank, the Andean Development Corporation, and bilateral creditors are expected to be similar to those in 2002, in support of the government's efforts to improve the delivery of social programs, key structural reforms, and public investment projects. The government's gross financing requirements for 2003 have been basically secured before the end of the first quarter after tapping international markets. Building on a successful reentrance into the international private capital market in 2002, Peru has placed a total of \$750 million of sovereign debt this year, thereby covering its financing needs from external sources for 2003. On January 30, Peru sold \$500 million in 12-year global bonds with a yield of 10.10 percent. The operation was well received by investors, as reflected by a healthy performance in the secondary market. On March 3, Peru carried out an additional issue for \$250 million as a reopening of the previous one. The 9.43 percent yield on the new operation —which drove the total cost of the sale to 9.88 percent— compares favorably with the yield paid by some higher-rated emerging economies. In this way, Peru has consolidated its presence in the international capital market and protected its financing plans for 2003 from the possibility of unfavorable developments in international markets.

8. In 2003 the authorities will move forward with the phasing out of regional and sectoral tax exemptions, in accordance with their objectives in the area of tax reform. A key step in this field is the fiscal decentralization law, which will regulate coordination with the sub-national governments, and is expected to be submitted to congress in May. In particular, it will introduce mechanisms for the exchange of tax exemptions for investment in infrastructure and social programs, as an incentive to encourage the process. Additionally, the authorities will persist in their efforts to reduce tax evasion by broadening the coverage of the retention and withholding schemes introduced in 2002 and continuing to implement tax audits. Steps will also be taken to further enhance the

Superintendence of Tax Administration's human resources and computing processes associated with the merging of the internal tax and customs administration agencies, and to continue to improve taxpayer services. Full implementation of the comprehensive tax reform introduced during 2002–2004 is expected to yield around 2 percent of GDP on an annual basis over the medium term.

9. The central bank will continue to pursue a prudent monetary policy under the inflation-targeting framework and a floating exchange regime. In 2002, the monetary policy aimed at preventing the development of deflationary pressures by providing adequate liquidity so as to lower interbank interest rates. The annual inflation target —2.5 percent plus or minus one percent— was attained: at end-2002, the 12-month inflation rate stood at 1.52 percent, just above the lower limit of the target range. In addition, maturities for central bank certificates of deposit have been extended, to 9 months in 2002, and to 18 months and two years in 2003, reflecting lower inflation and greater stability and confidence.

10. With the normalization of financial market conditions after the regional turbulence experienced in the second half of 2002, the interbank interest rate returned to low levels (3.8 percent as of end-2002, similar to its present level). Additional liquidity, together with improvements in the banks' loan portfolios and profitability indicators, fostered an increase in bank credit to the private sector at a rate of 1.7 percent in 2002, which compares favorably with the 3.5 percent decline registered in 2001, and an even greater dynamism is expected in 2003. It should be stressed that the currency composition of bank credit is changing, with an increase in credit in domestic currency of 10.6 percent in 2002, while credit in foreign currency continued to fall (-2.9 percent).

11. For 2003, inflation is projected at the center of the target range, 2.5 percent, and monetary policy will continue to be administered flexibly to ensure the attainment of the target in a context of favorable growth prospects. At the same time, risks associated with the evolution of international oil prices will be properly taken into consideration to avoid any second-round effects or the generalization of inflationary pressures. Furthermore, starting this year, the central bank's monthly policy announcements are placing additional emphasis on the interest rates used in its operations with the banking system, as a way to strengthen the guidance of market interest rates as an operational target of monetary policy, and to further reducing their variability.

Structural Reforms

12. In 2003, the government will continue working on a legal framework for fiscal decentralization that will ensure that the process is implemented in an orderly, gradual and fiscally neutral manner to protect the public finances over the medium term, as already stated in the legislation enacted so far. The introduction of the fiscal decentralization law, mentioned above, is a main element of this strategy. In addition to facilitating the phasing out of tax exemptions, the law would propose the following policies:

- Define the scope of revenue collections for sub-national governments, with the aim of ensuring the resources necessary to fulfill their functions. This will be a step-by-step process, consistent with local and regional governments' institutional capacity.
- Introduce criteria for central government transfers to local and regional governments, notably provisions on full and uniform reporting (along the lines of those for the central government).
- Place further controls on regional and local government borrowing, in addition to those proposed in the draft law on fiscal prudence and transparency. In particular, it is stipulated that debt can be contracted only to finance capital expenditures.
- Specify fiscal rules, in accordance with the principle of fiscal responsibility, mainly: (i) limits on expenditure; (ii) accountability mechanisms (multi-year performance reports); and (iii) sanctions for noncompliance.

13. The development of a fixed-income market in domestic currency will favor a process of financial de-dollarization. In this regard, an important element of the government's structural program for 2003 is to improve the functioning of the domestic market for local-currency denominated government securities, and in particular, the auction system. Recently, the authorities issued regulations on the placement of sovereign bonds in the domestic market, and announced the creation of a system of primary dealers. Furthermore, to best ensure a well-functioning market, a calendar of scheduled domestic bond auctions has been published.

14. Bank supervision will continue to be strengthened in 2003. Significant attention is given to the strengthening of exchange rate risk management and monitoring for dollar lending to clients whose operations generate income streams in local currency. In this respect, legislation has been passed to require banks to increase their information base and their analytical internal risk models, so that they can explicitly incorporate an evaluation of exchange rate risk in their overall credit risk calculation. Legislation has also been approved that increases the penalties for actions resulting in or involving an intent to destabilize the financial system, and draft legislation to provide statutory protection to SBS staff in the discharge of their responsibilities has been submitted to congress.

15. The government will continue to implement its trade policy strategy of reducing the average level of import tariffs, always with a view to ensuring that such reductions are consistent with the fiscal program. In 2002, the average tariff level was reduced from 11.8 percent to 10.9 percent, and the government intends to lower this further. The government's longer-term objective is to enter into a hemispheric free-trade arrangement by 2006.

16. Regarding governance issues, in 2003 the authorities intend to continue their efforts to root out corruption in all levels of government —having passed last year important anti-corruption legislation— and work toward strengthening the independence and efficiency of the judiciary.

17. Our Peruvian authorities remain committed to their reforms plans, and are confident in their ability to press forward with them. In this regard, coordination with congress has

been satisfactory, as reflected in the passing of essential legislation for the authorities' initiatives. The enhanced political sustainability of the reform program is also a major element bearing on investor sentiment, that has contributed to Peru's narrowing yield spreads and increased access to international markets, thus reinforcing a virtuous circle of good performance, political support and reform implementation.