 March 2007
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Peru—Second Review Under the Stand-By Arrangement and Requests for Establishment of Performance Criteria, Wavier of Nonobservance of Performance Criteria, and Rephasing of Future Disbursements—2005 Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Peru

In the context of the sixth review under the Stand-By Arrangement and requests for establishment of performance criteria, waiver of nonobservance of performance criteria, rephasing of future disbursements, the following documents have been released and are included in this package:

- the staff report for the Sixth Review Under the Stand-By Arrangement and Requests for Establishment of Performance Criteria, Wavier of Nonobservance of Performance Criteria, and Rephasing of Future Disbursements prepared by a staff team of the IMF, following discussions that ended on February 22, 2005, with the officials of Peru on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 24, 2005. 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 Press Release summarizing the views of the Executive Board of the staff report that completed the review and requests; and

- statement by the Executive Director for Peru.

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

Letter of Intent sent to the IMF by the authorities of Peru*
Memorandum of Economic and Financial Policies by the authorities of Peru*
Technical Memorandum of Understanding*

*Also included in Staff Report

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

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PERU

Second Review Under Stand-By Arrangement and Requests for Establishment of Performance Criteria, Waivers of Nonobservance of Performance Criteria, and Rephasing of Future Disbursements

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

Approved by José Fajgenbaum and Juha Kähkönen

May 23, 2005

Discussions. Discussions on the second review under the Stand-By Arrangement were held in Lima during February 10–22, 2005. The staff team met with President Toledo; Economy and Finance Minister Kuczynski; Acting Central Bank President Dancourt; the Ministers of Labor and Women and Social Development; other senior officials; and private sector representatives. The staff team comprised G. Terrier (Head), A. López-Mejía, M. Perez dos Santos (all WHD), M. García-Escribano (FAD), and M. Shannon (PDR). J. Guzmán (Senior Resident Representative) assisted the mission. Mr. Silva Ruete, Alternate Executive Director, participated in the policy discussions.

Program. A 26–month Stand-By Arrangement in the amount of SDR 287.279 million (21 percent of quota on an annual basis) was approved by the Executive Board on June 9, 2004. The first review was completed on November 19, 2004. The authorities are treating the arrangement as precautionary and, with completion of this review, a total of SDR 149.093 million would be available for drawing.

Review. The review focused on the implementation of macroeconomic policies and reforms of the 2005 program. The Peruvian economy continues to perform well. Real GDP grew by 5.1 percent in 2004 and inflation was 2.0 percent in April 2005. In addition, progress has been made in key areas of structural reform, particularly with respect to public pensions.

Letter of Intent. In their Letter of Intent dated May 20, 2005, the authorities describe progress made in 2004 and their economic program for 2005. They request a waiver for nonobservance of the end-December 2004 structural performance criterion on the establishment of a commercial court in Lima, which became operational in April 2005. The authorities also request a waiver for nonobservance of the end-April structural performance criterion on the awarding in concession or entering into Public Private Partnerships for the construction and maintenance of two major roads, a modification of this criterion, and a resetting of the criterion for end-September 2005. In addition, they request that future disbursements under the arrangement be rephased into five equal amounts of SDR 27.6372 million.

Relations with the Fund. Peru’s outstanding Fund credit is SDR 53.5 million (8.4 percent of quota). The last Article IV consultation was concluded on February 23, 2004. Peru has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Peru’s economic statistics are adequate for surveillance and policy formulation. The authorities have indicated that they do not favor publishing the last staff report and, at this stage, they have not indicated if they consent to the publication of this report.

Content Page

Executive Summary 4

I. Background 5

II. Recent Developments 5

III. The 2005 Program and Outlook 8
- A. Economic Outlook 8
- B. Fiscal Policy 10
- C. Public-Private Partnerships 13
- D. Monetary, Exchange Rate, and Debt Management Policies 14
- E. Financial Sector Policies 16
- F. Other Growth-Enhancing Reforms and Poverty Reduction Efforts 20
- G. Other Issues 21

IV. Program Modalities 23

V. Staff Appraisal 23

Text Boxes
1. Developments in 2004 and Early 2005 6
2. Sensitivity to External Exchange Rate and Interest Rate Developments 9
3. Strengthening the Legal Fiscal Framework 12
4. Summary of Findings of the Follow-up FSAP Mission 19
5. Poverty and the Millennium Development Goals 22

Tables
1. Selected Economic Indicators 27
2. Quantitative Performance Criteria, 2004 28
3. Status of Structural Performance Criteria and Benchmarks, 2004 29
4. Fiscal Operations of the Combined Public Sector 30
5. Financing of the Combined Public Sector....................31
6. Fiscal Operations of the Central Government 32
7. Public Sector Social Expenditure 33
8. Monetary Survey 34
9. Balance of Payments 35
10. External Financing Requirements and Sources 36
11. Medium-Term Macroeconomic Framework 37
12. Financial Soundness Indicators....................38
13. Financial and External Vulnerability Indicators 39
14. Proposed Schedule of Purchases Under the Stand-By Arrangement, 2004–06....................40
15. Capacity to Repay the Fund as of March 31, 2004....................41
16. Millennium Development Goals 42

Figures

1. Contributions to Real GDP Growth 7
2. Inflation 7
3. Net International Reserves 7
4. Current Account Balance 8
5. EMBI 9
6. Money 15
7. Exchange Rate 15
8. AFPs Portfolio Composition 16
9. Total Public Debt by Currency 16
10. Liquidity and Capital Adequacy Ratios 16
11. Bank Credit to the Private Sector 17
12. Share of Credit and Deposits in Foreign Currency 17
13. *MiVivienda* Mortgage Lending in US dollars 17
14. Consumer Credit by Institution 18

Appendices

I. Debt Sustainability Analysis 43
II. Fund Relations 47
III. World Bank Relations 49
IV. Relations with the Inter-American Development Bank 51
V. Statistical Issues 52

Attachments

I. Letter of Intent 56
II. Memorandum of Economic and Financial Policies for 2005 59

Annex

Technical Memorandum of Understanding (TMU) 65

Executive Summary

Background

- ***The economy continued to perform well in 2004.*** Real GDP grew by 5.1 percent, inflation was 3.5 percent at end-December, and the fiscal deficit of the combined public sector narrowed to 1.1 percent of GDP. However, poverty remains high.
- ***Some progress has been made in structural reforms.*** The reform of the preferential public pension regime was approved in mid-December and the authorities are making progress toward awarding transportation infrastructure in concession to the private sector. The establishment of a commercial court (end-December structural performance criterion) was delayed by a few months, but became operational in April.
- ***The domestic political and social situation remains a challenge.*** Recent polls suggest that the main institutions are discredited with the population and social disturbances have continued to take place sporadically in several regions of the country.

Policy discussions and staff appraisal

- ***Preserving macroeconomic stability continues to be at the core of the authorities' policies.*** Although achieving the fiscal target will be a challenge, the authorities are committed to reducing the fiscal deficit to 1 percent of GDP in 2005. Monetary policy is being set to keep inflation within the year-end target band (1.5−3.5 percent).
- ***The authorities reaffirmed their commitment to further progress in implementing structural reforms.*** In 2005, the reform program will focus on improving fiscal transparency, promoting de-dollarization, and enhancing the business environment. The end-April structural performance criterion on the awarding in concession of two roads to the private sector was not met. However, one road was awarded in concession in May and a second one is to be awarded before end-September (structural performance criterion). Staff supports the authorities' request for a waiver of the end-December criterion on the establishment of a commercial court and for a waiver of the end-April criterion on the awarding in concession of the construction and maintenance of two major roads, modifying this criterion to better specify it, and resetting it for end-September 2005. Staff also supports the authorities' request to rephase into five equal amounts future disbursements under the arrangement.
- ***The medium term outlook is favorable.*** Assuming sound macroeconomic policies and progress in structural reforms, growth could well exceed 4½ percent a year in 2005-06.
- ***The political and social situation continues to be the main risk to the program.*** In recent months pressure to increase fiscal spending has been very strong but, so far, the government has been able to preserve consensus for prudent policies and reform.

I. Background

1. ***The authorities' program, supported by the current Stand-By Arrangement, aims at reinforcing confidence and supporting the continued implementation of prudent policies through the election period.*** The first round of the presidential and congressional elections is scheduled to take place in April 2006, with a new administration taking office in July 2006. Within a challenging social and political situation, the authorities view the program as an instrument to maintain consensus for prudent economic policies. Despite strong rates of economic growth in recent years, the trickle down effects of the economic recovery on the general population have been limited and discontent is still high. Poverty rates remain above 50 percent.[1]

2. ***A 26–month Stand-By Arrangement in the amount of SDR 287.279 million (21 percent of quota on an annual basis) was approved on June 9, 2004.*** The authorities are treating this arrangement as precautionary. When completing the first review on November 19, 2004, Directors welcomed the authorities' commitment to prudent policies and growth-enhancing reforms, and stressed the importance of further strengthening the national consensus for adjustment and reform. They observed that sustained implementation of the authorities' program would further strengthen the basis for Peru's strategy for exiting from Fund financial support.

3. ***In the attached letter of intent to the Managing Director, the authorities specify their economic policies for 2005.*** These policies aim at preserving macroeconomic stability and implementing a broad set of reforms, focusing on improving fiscal transparency, promoting de-dollarization, and enhancing the business environment. The authorities also request a waiver for nonobservance of the end-December criterion on the establishment of a commercial court and a waiver for nonobservance of the end-April criterion on the awarding in concession of the construction and maintenance of two roads, modifying this criterion, and resetting it to end-September 2005. In addition, they request that future disbursements under the arrangement (excluding the disbursement that will become available upon completion of this review) be rephased into five equal amounts of SDR 27.6372 million.

II. Recent Developments

4. ***Economic performance in 2004 was strong.*** Real GDP growth exceeded 5 percent, driven by net exports and a recovery in private investment in the manufacturing and construction sectors. Private consumption also continued to increase, reflecting in part higher disposable income associated with positive terms of trade and strong remittances. The external current account balance shifted from a deficit of close to 2 percent of GDP in 2003 to equilibrium in 2004, and gross international reserves continued to grow (Box 1).

[1] The poverty rate is defined as the percentage of households whose total spending is below the cost of a basket of basic consumption goods.

BOX 1. PERU: DEVELOPMENTS IN 2004 AND EARLY 2005

Despite a decline in agriculture output due to a severe drought, real GDP grew by about 5 percent during 2004. Economic growth was broad based and particularly strong in the fishing, manufacturing, and mining sectors.

Inflation declined to 2 percent in April 2005. At end-December 2004, inflation was 3.5 percent, at the upper end of the central bank inflation target band.

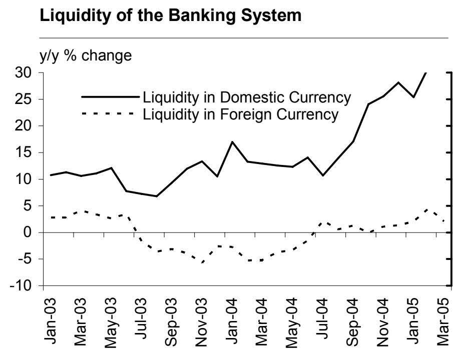
Driven by a sharp increase in exports in U.S. dollar terms (40 percent), the external current account deficit shifted to virtual equilibrium in 2004. Export growth was led by volume increases of mineral products, a revival of fishing exports, and strong growth in non-traditional goods (partly spurred by preferential access to the U.S. market). Completion at mid-year of the first phase of the Camisea gas project, directed at the domestic market, has reduced Peru's demand for energy imports and helped mitigate the impact of higher oil prices on the balance of payments.

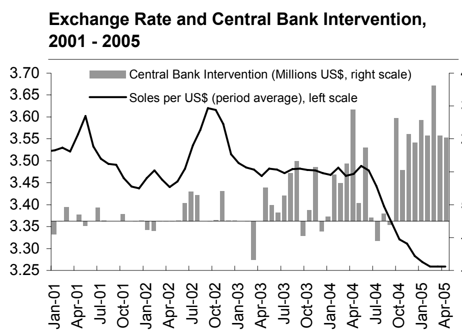
The overall deficit of the combined public sector was reduced from 1.7 percent of GDP in 2003 to 1.1 percent in 2004. The overperformance in comparison with the program target (1.4 percent of GDP) was primarily due to lower interest payments driven by currency appreciation and a better-than-anticipated performance at the subnational level, reflecting higher shared tax revenues from mining.

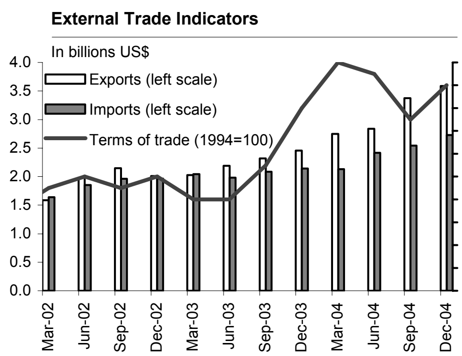
Following 18 months with little nominal movement, the Nuevo Sol has appreciated by about 7 percent against the U.S. dollar since June 2004. This appreciation has reflected the improvement in the external current account balance, capital inflows, and ongoing domestic financial de-dollarization.

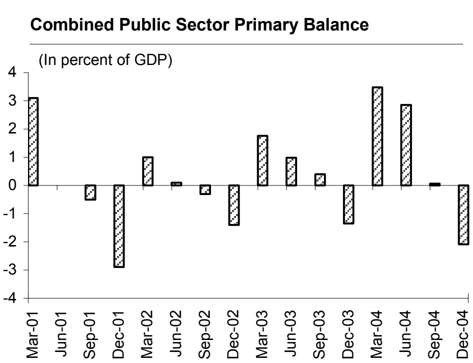
The level of net official international reserves is comfortable. At end-April 2005, net reserves amounted to US$13.6 billion, covering more than 100 percent of bank dollar deposits. Central bank intervention has remained high, with net foreign exchange purchases of US$1.9 billion in 2004 and US$1.2 billion so far this year.

Peru's sovereign spreads remain among the lowest in the region. In November 2004, Fitch upgraded Peru's sovereign credit rating to BB—two levels below investment grade—and, in mid-May 2005, Peru's sovereign spread was at about 220 basis points.









Inflationary pressures have moderated in recent months, with 12–month inflation at 2 percent in April 2005. Monetary policy was tightened somewhat in the second half of 2004, to preempt a rise in inflationary expectations (the central bank policy interest rate was raised 50 basis points, to 3 percent), but it remains accommodative. In 2004, the overall deficit of the combined public sector was reduced to 1.1 percent of GDP compared with 1.4 percent of GDP in the program. All quantitative performance criteria for end-December 2004 under the program were met.

Figure 1. Contributions to Real GDP Growth

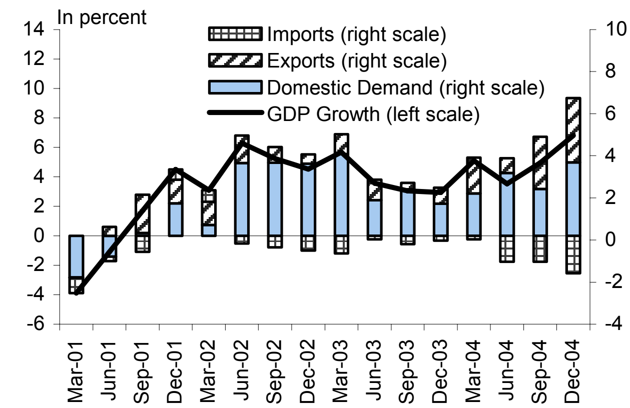


Figure 2. Inflation

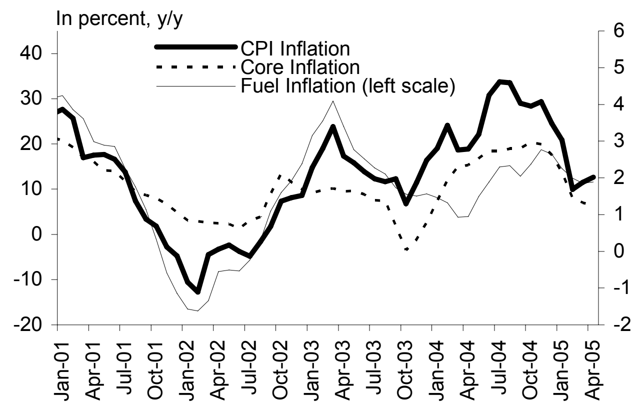
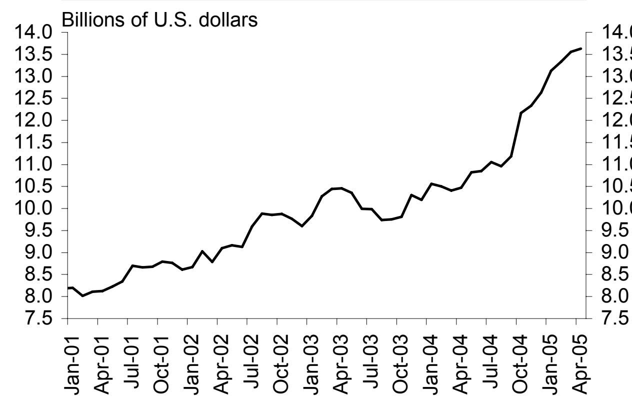


Figure 3. Net International Reserves



5. ***Although the authorities have stepped up their efforts in the implementation of structural reforms, some of the reforms have been delayed.*** In December, congress approved the law reforming the *Cédula Viva* public pension regime (end-December benchmark) and the government completed an action plan to reform the pension regimes of the military and police (end-September benchmark). The establishment of a commercial court (end-December structural performance criterion) was delayed by a few months because of administrative bottlenecks, but it became operational in April. A new bank regulation, which is key to making operational a system within the Superintendency of Banks to measure risks associated with foreign currency denominated loans, was issued in mid-January (end-December benchmark). The law on the certification of subnational governments' administrative capacity was implemented (end-December benchmark) and the law clarifying functional responsibilities among different levels of government was not passed due to lack of support in Congress (end-December benchmark). Instead, a plan to devolve certain sectoral responsibilities to regional governments in 2005 will be issued by end-June and the government is preparing a devolution plan for the medium term. Because of delays in congressional consideration of associated legislation, the government has not yet announced plans to centralize information on collateral registries (end-June 2004 benchmark) but intends to do so by September 2005.

III. The 2005 Program and Outlook

6. ***The program for 2005 seeks to consolidate macroeconomic stability and implement a broad set of structural reforms.*** Discussions on the second year of the program took place against the backdrop of mounting pressures to increase fiscal spending, particularly public sector wages. The authorities reaffirmed their commitment to reduce the overall deficit of the consolidated public sector to 1 percent of GDP in 2005, as envisaged under the program, and to keep inflation within the central bank's target band. Structural reforms will focus on improving fiscal transparency, promoting de-dollarization, and further enhancing the business environment. To help meet Peru's large infrastructure needs, the program includes—as in 2004—flexibility for government guarantees associated with investment projects undertaken under the public-private partnership (PPP) program. The quantitative performance criteria for the 2005 program are presented in Table 1 attached to the Letter of Intent and the structural performance criteria and benchmarks in Table A attached to the Memorandum of Economic and Financial Policies.

Table 1. Macroeconomic Framework

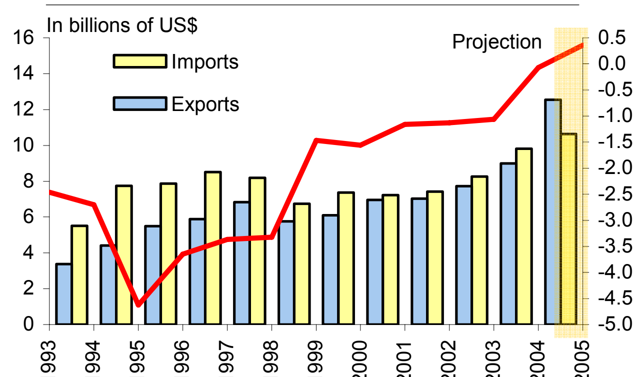
	2004		Proj.	
	Prog.	Proj.	2005	2006
	(In percent of GDP, unless otherwise indicated)			
Real GDP growth (in percent)	4.0	5.1	4.5	4.5
Inflation (in percent, end of period)	2.5	3.5	2.3	2.5
External current account	-0.7	-0.1	0.5	0.2
Public sector overall balance	-1.4	-1.1	-1.0	-1.0
Public sector debt	44.6	45.2	42.2	40.5

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

A. Economic Outlook

7. ***Economic growth is projected to remain strong in 2005.*** With the global outlook remaining favorable, real GDP is projected to grow by at least 4½ percent. The external current account balance is forecast to register a surplus of ½ percent of GDP in 2005, with official international reserves covering about 250 percent of short term and maturing external debt by year-end. Mineral product export growth would remain strong, while the rate of growth of textile exports would moderate, reflecting in part the removal of world quotas on textile imports. Textile exports during the first quarter of 2005 were 16 percent above their level a year earlier.

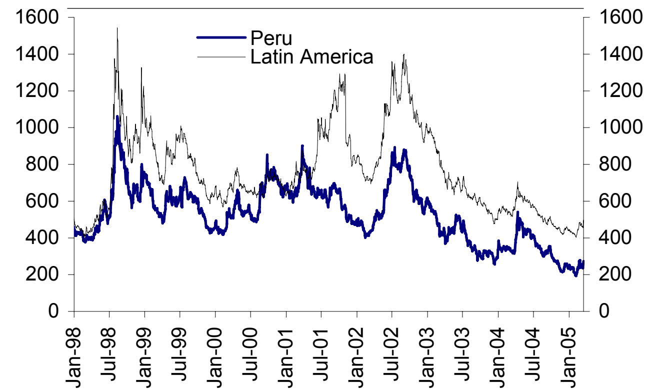
Figure 4. Current Account Balance



8. ***The risks to the external short-term outlook stem in part from existing global imbalances.*** If these imbalances were to be corrected by abrupt adjustments in the exchange rate of the major currencies or a sharp rise in interest rates, this could lead to reduced global growth, lower commodity prices, and higher debt service payments (Box 2). However, Peru has built important buffers against these risks. Its level of official reserves is comfortable, the banking system is well-capitalized, and the debt sustainability analysis indicates that debt

dynamics are relatively robust to shocks. In addition, the government has completed its external market financing plans for 2005.

Figure 5. EMBI



9. ***In the political area, the authorities' commitment to the program will be tested in the run-up to the 2006 elections.*** Public surveys show that the main institutions—including the presidency, the main political parties, congress, the press, and the judiciary—are largely discredited with the general population. In addition, episodes of social disturbances have taken place in some areas of the country and there is a risk that growing drug-trafficking influence could contribute to institutional weakening. Frequent ministerial cabinet changes could also disrupt progress in the area of structural reform, and pressures to increase government spending and narrow the tax base could lead to a relaxation of the fiscal stance. At present, however, the consensus for prudent policies and selected economic reforms has been maintained, with a majority in congress and the main civil society organizations supporting institutional continuity and adherence to the electoral calendar.

BOX 2. PERU: SENSITIVITY TO EXTERNAL EXCHANGE RATE AND INTEREST RATE DEVELOPMENTS

Assuming relatively benign global conditions, external and public sector debt service levels are manageable. Over the period 2005-09, total external debt servicing requirements are projected to average 5.2 percent of GDP a year, including 3.8 percent of GDP in public sector external debt servicing requirements.

With about 85 percent of Peru's public sector debt denominated in foreign currency, debt dynamics are sensitive to exchange rate changes. Approximately 60 percent of foreign currency debt is denominated in U.S. dollars, 16 percent in euros, 15 percent in yen, and the rest in other foreign currencies. A one percent depreciation of the *Nuevo Sol* against the U.S. dollar would increase debt servicing requirements by 0.1 percent of GDP (and the debt stock by about 0.2 percent of GDP).

An increase in global interest rates to recent historic levels would remain manageable. Virtually all of Peru's external public debt is long term, and about half at fixed rates, mitigating the impact of interest rate changes. An increase in rates by 200 basis points above current projections would increase public sector interest payments by roughly 0.3 percentage points of GDP in 2005.

The authorities are working proactively to improve the profile of public debt through market-based operations. These efforts are directed at reducing currency risk, including through a gradual increase in local currency issuance in the domestic market. They are also working to lower interest rate and roll-over risks through hedging instruments, swap transactions, and extension of the average maturity of their market debt in both the local and external markets.

B. Fiscal Policy

10. ***The 2005 program aims at reducing the overall deficit of the combined public sector to 1 percent of GDP, in accordance with the Fiscal Responsibility and Transparency Law (FRTL).***[2] Achievement of this objective is expected to further reduce the public debt-to-GDP ratio and, thus, help pave the way for additional upgrades by credit rating agencies. Most of the government's gross financing requirements in 2005 (US$3.1 billion) have been secured, including US$1.2 billion in placements in the international markets. The remainder is expected to be covered by official creditors and domestic sources.

11. ***Achievement of the fiscal target in 2005 will be a challenge.*** The program targets an improvement in the central government primary balance of 0.4 percent of GDP. On the revenue side, collections stemming from higher royalties, a new temporary corporate tax on net assets, and increased direct and VAT taxes are expected to be partly offset by the revenue loss associated with the removal of the payroll tax, reductions in the excise tax rate on petroleum products, the elimination of minimum advanced corporate income tax payments, and the cut in the rate of the financial transactions tax.[3] Accordingly, meeting the fiscal targets in the program will require a strong control of government expenditures.

12. ***Faced with pressure to increase spending above budgeted amounts, the government is making efforts to limit and prioritize new demands.*** Staff encouraged the authorities to adhere to the fiscal target for 2005 and welcomed their efforts to prioritize spending. A supplementary budget is expected to be submitted to congress in coming weeks, comprising additional spending of about ⅓ percent of GDP, financed by higher tax collections. The additional spending would include increases in public sector wages (the 2005 budget did not contemplate any new wage increases) and the introduction—on a small scale—of a targeted program of transfers to the poor (*Juntos*).[4] On the basis of strong tax collections in the first four months of the year, the authorities and staff are confident that the increase in expenditure would be fully covered by revenue over-performance in 2005. Taking into account the supplementary budget, primary spending of the general government would however exceed the 3 percent limit on real expenditure growth in the Fiscal Responsibility and Transparency Law (FRTL). Staff therefore encouraged the authorities to use any additional revenue to reduce the fiscal deficit below programmed levels. The breach of the

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[2] The 1 percent of GDP limit in the FRTL applies to the deficit of the nonfinancial public sector. To provide some flexibility while ensuring consistency with the FRTL, the program has an adjustor on the deficit of the combined public sector equivalent to 0.15 percent of GDP for quasi-fiscal losses of the central bank.

[3] A tax on net assets, scheduled to be in force until end–2006, with a 0.6 percent rate applying only to firms with net assets exceeding S/. 5 million (about 2,500 firms) was introduced in late-2004 to partially compensate for the revenue losses of eliminating the minimum advanced corporate income tax payments, declared unconstitutional in November 2004.

[4] The small temporary fund aimed at avoiding excessive volatility in domestic petroleum prices was recently extended until end-September 2005 and its resources increased by about US$8 million, up to a total amount of US$25 million, computed against the 2006 budget.

expenditure growth limit under the FRTL, the second in three years, raises issues about the fiscal framework, which staff plans to discuss in the context of future reviews.

13. ***The authorities are committed to deepening their tax administration reform efforts.*** They reaffirmed their intentions to broaden the tax base, but noted that legislation phasing out exemptions in at least two regions has not yet received needed support from Congress. The authorities stressed their commitment to renew work with Congress to advance these reforms, but noted that potential resources from the removal of exemptions would not affect the primary balance, as they would be used to increase regional infrastructure spending. The authorities concurred with staff that existing legislative proposals to introduce multiple VAT rates would have a negative impact on tax collection and on the efficiency of the tax system. They are working with congress to help avoid the adoption of such a measure, which would result in a weakening of the tax base. The Fund recently provided technical assistance on tax policy and administration and found significant scope for reducing VAT evasion through improvements in tax administration. The authorities have indicated that they plan to implement most of the recommendations of the technical assistance mission.

14. ***To further enhance prudent fiscal management, the authorities plan to strengthen the legal and institutional framework*** (Box 3)***.*** They are seeking approval of an amendment to the FRTL aimed at strengthening procedures for reporting compliance to congress and implementing sanctions on public officials for noncompliance with the law's fiscal deficit limit. The authorities are also working with Congress to ensure the prompt enactment of a law on public indebtedness to help improve the administration of public borrowing and debt. Regulations are to be issued in September on the implementation of the Fiscal Decentralization Law, which sets out fiscal rules on subnational governments and reporting provisions. The Fund is providing technical advice in these areas, including with a forthcoming mission on budget legislation and information systems.

15. ***The authorities are committed to a comprehensive reform of the state.*** The reform is expected to help further improve resource management in the public sector with a view to creating more room for social and infrastructure spending. The main areas of the reform include:

- ***Pension reform.***[5] The authorities estimate that the recently-approved reform of the *Cédula Viva* public pension regime reduces pension liabilities by 24 percent in net present value terms and will generate fiscal savings of ½ percent of GDP a year over 2006-09. The reform, however, has a fiscal cost of close to 0.1 percent of GDP in 2005, reflecting the increase of all pensions below US$225 a month. Work is proceeding toward centralizing and improving the administration of this regime. In addition, the authorities will submit draft legislation to congress by end-September to reform the pension regime of the police and the military.

[5] For a description of the reform, see IMF Country Report No. 07/99, Box 4, page 16.

BOX 3. PERU: STRENGTHENING THE LEGAL FISCAL FRAMEWORK

Peru has a comprehensive legal framework for fiscal management, which has been significantly strengthened since late 2003. The Fund has been providing technical advise in this area to help address shortcomings in the legal frameworks for financial management, debt, and decentralization.

Financial Administration

In November 2003, the authorities enacted a Public Sector Financial Administration Framework Law. Under this framework, general laws governing the budgetary process, treasury operations, accounting, and debt management have been submitted to Congress. These laws aim to lay down a permanent set of regulations, replacing the practice of fiscal management through annual directives. In particular:

- ***The general budget law,*** approved in December 2004, will serve as the legal framework for the preparation of the budget. It strengthens budget procedures and reduces the line-ministries' flexibility to shift their spending between allocations during budget execution (for instance, it prohibits using the capital budget for current outlays).
- ***The general law on public indebtedness***. A draft law, submitted to Congress in November 2004, aims at providing a legal framework for enhanced and transparent liability management. The draft law sets annual limits on debt and guarantees contracted by the central government as well as on guarantees provided/contracted by the central government in the context of Public-Private Partnerships (PPPs). The law assigns to the Ministry of Economy and Finance the responsibility for registering, programming, and ensuring compliance with government's financial commitments, including in the context of PPPs.

Fiscal Responsibility and Transparency Law (FRTL)

- The FRTL, which was amended in 2003, contains the ***fiscal rules for the nonfinancial public sector,*** including in reference to subnational governments. Implementing regulations were issued in November 2004, but some provisions are still to be regulated, including on sanctions and corrective measures for subnational governments that do not comply with the fiscal rules.
- A ***supplementary FRTL*** is being prepared, with a view to strengthening procedures for reporting to Congress and to establishing sanctions on public officials responsible for noncompliance with the law's fiscal deficit limit.

Fiscal Decentralization

- Completion of the ***fiscal decentralization legal framework*** is proceeding gradually. The Fiscal Decentralization Law, approved in early 2004, sets additional fiscal rules on subnational governments, as well as budgeting, reporting, and revenue provisions. The law's implementing regulations are expected to be issued in September.
- Two additional laws were approved in 2004 establishing: (i) requirements for the ***certification of subnational governments' administrative capacity*** to deliver public services effectively; and (ii) ***incentives for the voluntary merger of regional governments.*** However, the allocation of expenditure responsibilities among levels of government needs further clarification. A plan to devolve certain sectoral responsibilities in 2005 is expected to be issued in June and the authorities are committed to provide additional clarification through implementation of a multi-annual devolution plan.

- ***Civil service.*** The authorities are working with congress toward the passage of legislation needed to implement the framework law on public sector human resource management. The authorities' plans to gradually implement the reform of the public sector wage structure are consistent with the envisaged fiscal consolidation. Preliminary estimates indicate that the total fiscal cost of the reform would be about 0.7 percent of GDP over the expected five-year implementation period.

- ***Fiscal management.*** An administrative structure is to be established in the near future at the Ministry of Economy and Finance to improve expenditure control and help secure FRTL compliance. Budget procedures will be reviewed to help prioritize budgetary line-items and reduce the flexibility of line ministries to shift spending between allocations. The authorities plan to unify the central government budget formulation and execution systems and the Integrated Financial Management System (SIAF) to strengthen budget management and transparency, and to gradually extend the SIAF budget execution and property registration modules at the local level. In addition, the Ministry of Economy and Finance will establish a pilot program to strengthen capacity-building at the subnational government level. With World Bank support, the authorities are developing a pilot program within the Management Control and Evaluation System at the Ministry of Economy and Finance to evaluate and improve the quality of priority social programs.

C. Public-Private Partnerships

16. ***The authorities are moving forward with the program of Private-Public Partnerships in infrastructure.*** Although this program is still in its early stages, the authorities expect to award in concession to the private sector investment commitments of up to US$4–5 billion (about 6 percent of annual GDP) over the next few years. About half of these concessions would be in the area of transportation infrastructure, including three major highways, several roads connecting the coast with the highlands, and regional airports. In addition, recent cabinet approval of the National Port Development Plan has paved the way for the concession of a modern terminal in Peru's largest port (Callao).[6] A large regional integration highway in the northern part of the country was awarded in concession in early May, but the awarding in concession of a second major highway had to be postponed because only one bid was presented. Given that the delays in this area reflect a temporary deviation from the original schedule, the authorities are requesting a waiver for the nonobservance of the end-April performance criterion on awarding two major roads in concession and resetting it to end-September 2005.

17. ***The mission noted that there was a risk that the Private-Public Partnership (PPP) program could be misused to undertake infrastructure projects that are not commercially viable.*** The staff cautioned against using the PPP program to implement politically-motivated projects. In particular, it urged the authorities to proceed in a cautious and fiscally-sound manner with the large, politically motivated *InterOceánica* road project, and expressed

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[6] Concessions are also planned in the area of mining and hydrocarbons (US$1.5 billion), rehabilitation of water and sewerage facilities (US$0.6 billion), and irrigation (US$0.2 billion).

concern regarding its exemption by decree from SNIP viability assessment earlier this year. It is estimated that this project will entail a commitment by the government to extend sizable subsidies for its entire duration, which is a source of rigidity in expenditure over the medium term.[7] More broadly, the staff emphasized the importance of avoid engaging in new infrastructure projects that would require large future subsidies from the government.

18. ***In the discussions, the authorities agreed with the staff that the institutional framework to assess investment projects needed to be strengthened.*** In this context, the National System of Public Investment (SNIP)—which assesses the viability of public investment projects based on their social rate of return—is being strengthened to improve its effectiveness in weeding out non-viable projects. The staff concurred with the authorities on the need to speed up the project's approval process and to put in place monitoring systems and ex-post evaluating mechanisms. In addition, all major projects undertaken via concessions and PPPs, will henceforth be required to meet SNIP's viability requirements, and guidelines will be established for deciding whether projects can be implemented as PPPs.[8] The authorities agreed with the mission that, in coordination with debt management officials, the assessments undertaken by the SNIP should be broadened to cover the project's costs to the government, including through commitments of future expenditure and guarantees of minimum revenue streams.

19. ***The 2005 program envisages a transparent recording of contingent liabilities, including those associated with PPP operations.*** The authorities are working on the design of a comprehensive reporting system of the stock of public sector liabilities (including guarantees and other contingent liabilities) resulting from PPPs, and will issue a regulation requiring the annual publication of such liabilities (end-September structural performance criterion). Such information will begin to be published in the Multiyear Macroeconomic Framework in 2006.

D. Monetary, Exchange Rate, and Debt Management Policies

20. ***The monetary authorities reaffirmed their commitment to the inflation targeting framework.*** In recent months, inflation has moved toward the lower end of the inflation target band, as the impact of temporary and weather-related bottlenecks that caused food prices to rise in the second half of 2004 have dissipated. The authorities and staff agreed that the central bank's interest rate was consistent with the sterilization of most foreign exchange purchases through the issuance of central bank certificates, while accommodating a higher demand for local currency. Although the rapid increase in the monetary base observed in 2004 continued in 2005 (25 percent at end-March, on a yearly basis), this has primarily reflected the ongoing process of de-dollarization in the economy. Pressures on prices and wages have remained relatively light, and 12–month projections show inflation well-

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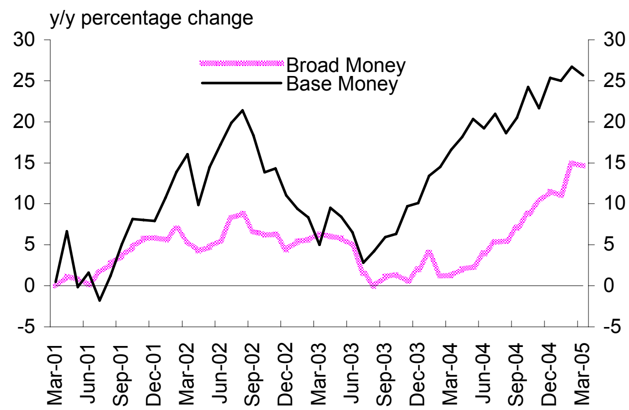
[7] The total cost of this project is estimated at about US$900 million. The contract for the first stage (US$700) of the project is expected to be awarded in mid-2005.

[8] Small projects (below US$2.5 million) can be exempted from meeting the SNIP viability requirements assessed at the Ministry of Economy and Finance.

anchored near the middle of the inflation target band. The monetary authorities stated that they were ready to raise rates promptly if inflationary pressures were to develop.

Figure 6. Money 1/

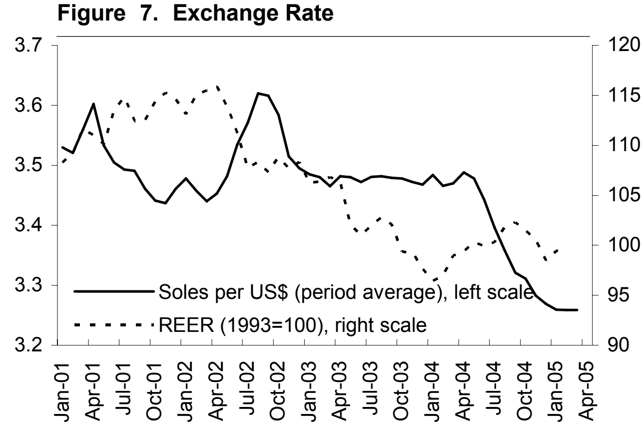


1/ U.S. dollar stocks are valued at market exchange rates.

21. ***The staff encouraged the authorities to take steps to further enhance the transparency of the inflation targeting regime.*** In particular, the mission suggested a shift from a year-end to a continuous inflation target and publication of the minutes of Board policy meetings. The authorities agreed that such reforms would help improve transparency, but noted that the inflation-targeting framework was still relatively young (it was introduced in 2002), and that it was preferable to avoid introducing new measures early on, particularly in the pre-electoral period.

22. ***The transparency of the inflation targeting regime would also be increased by allowing the exchange rate to move more freely, particularly given the present favorable economic conditions.*** The staff encouraged the authorities to limit central bank intervention in the foreign exchange market to smoothing out excess volatility. This would help avoid the risks associated with providing the conditions for one-way bets and help contain potential quasi-fiscal losses associated with a growing stock of central bank certificates. The authorities acknowledged benefits to greater exchange rate volatility but noted that a sharp appreciation of the currency might push inflation below the lower limit of the inflation target band. They observed that an exchange rate appreciation could provide perverse incentives on loan dollarization, because economic agents would be faced with lower loan installments in domestic currency terms. The authorities also expressed concern that a sharp appreciation might hamper the competitiveness of nontraditional exports and stressed that further reserve accumulation was warranted by potential external shocks and uncertainties in the run up to the 2006 elections.[9]

Figure 7. Exchange Rate



[9] At present, external competitiveness appears adequate, as evidenced by the external current account position, strong export volume growth, and a real effective exchange rate that still remains at historically low levels.

23. ***A variety of measures to reduce appreciation pressures were explored in the discussions.*** Staff continued to encourage the authorities to gradually increase the limit on private pension fund investments abroad, which would also help diversify the risks of these funds and avoid the development of asset bubbles in the domestic financial market. While agreeing on the advantages of this policy over time, the central bank continued to stress the importance of supporting the development of domestic capital markets. The authorities also noted that the debt management strategy of the government would help reduce appreciation pressures, with net borrowing abroad projected to be close to zero in 2005. More broadly, the government intends to reduce currency and interest rate exposure through increased government placements in local currency at lengthened maturities, along with swap transactions to increase the local currency composition of existing debt. The authorities are continuing discussions with Paris Club creditors on possible prepayments of Peru's official bilateral debt, in order to address relatively high debt servicing obligations through the end of the decade. They intend to continue including collective action clauses in foreign sovereign debt placements.

Figure 8. AFPs Portfolio Composition

In percent of total

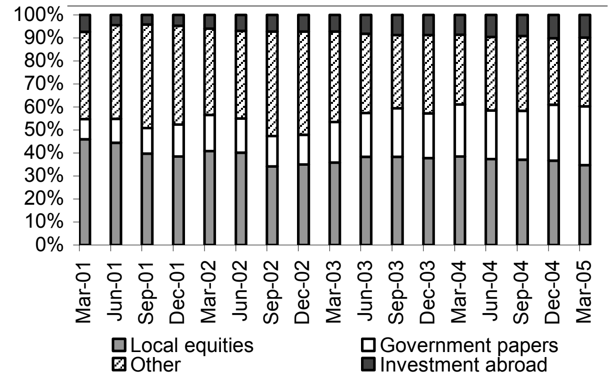
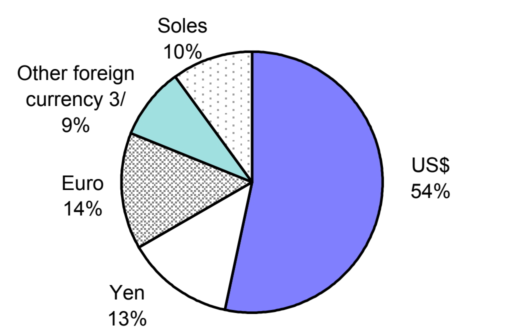


Figure 9. Total Public Debt by Currency

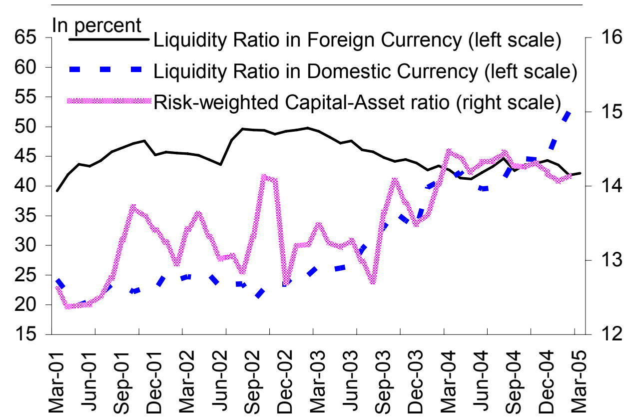
December, 2004



E. Financial Sector Policies

24. ***Staff welcomed the continued progress toward strengthening the resilience of the financial sector.*** Bank capitalization and profitability have increased, the quality of the loan portfolio has improved, and liquidity conditions have been enhanced. Bank credit for housing, consumption, and small- and medium-sized enterprises has continued to grow, while commercial credit has fallen further, as corporations are increasingly financing their operations by issuing bonds in the domestic capital market. Partly

Figure 10. Liquidity and Capital Adequacy Ratios



reflecting higher commodity prices, the Lima stock exchange index rose by 12 percent in the first quarter of 2005, on top of the 75 percent surge registered in 2004.

25. ***There was agreement, however, that financial dollarization continues to be a key source of economic vulnerability.*** In recent months dollarization has continued to decline, particularly on the deposit side. On the lending side, dollarization has declined somewhat less rapidly, as appreciation pressures have enticed economic agents to take loans in foreign currency. Lending in foreign currency to unhedged economic agents remains an important risk to the banking system. As a first step to reducing this risk, the authorities and staff concurred on the need to reduce the rapid growth of dollar-denominated mortgage lending to unhedged borrowers, particularly those funded by the government program *MiVivienda*.[10] Rather than prohibiting mortgage lending in foreign currency, the authorities favored restructuring the subsidies granted under the *MiVivienda* program, with a view to encouraging mortgage lending in domestic currency. Staff also welcomed the authorities' commitment to implement the recent norm putting into operation a system of provisions for risks associated with foreign currency denominated loans. The authorities are also committed to issuing inspections guidelines clarifying key aspects of the norm (end-September 2005 performance criterion). The authorities noted that their efforts to promote de-dollarization also included promoting the use of the inflation-indexed unit of account

Figure 11. Bank Credit to the Private Sector

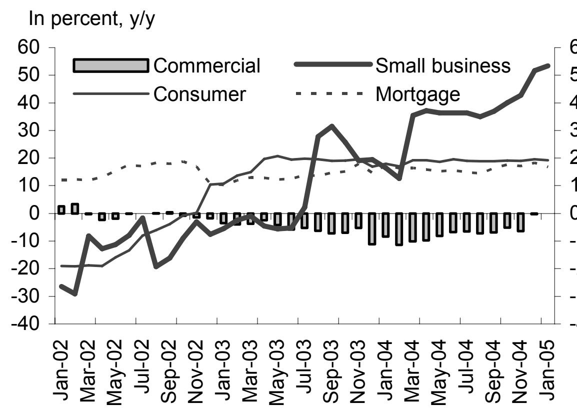


Figure 12. Share of Credit and Deposits in Foreign Currency

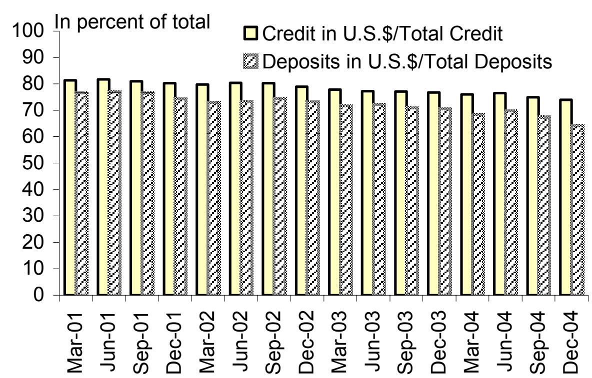
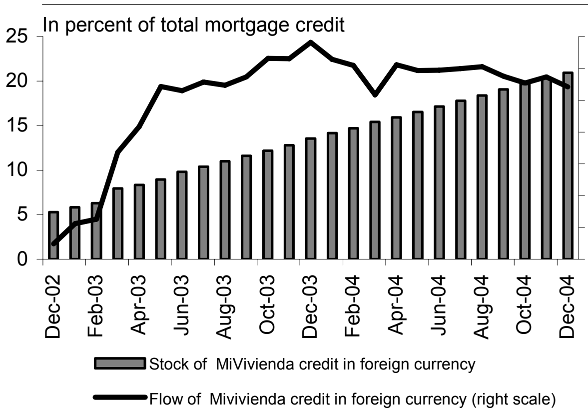


Figure 13. *MiVivienda* Mortgage Lending in US$



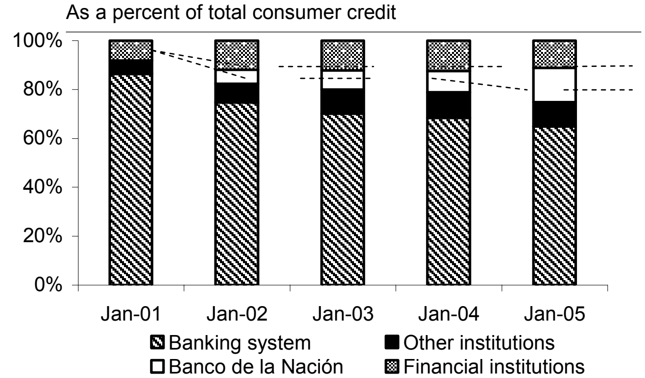
[10] Two thirds of the recent expansion of US-dollar denominated mortgage lending has been funded by *MiVivienda*, which absorbs most of the credit risk by giving the lending bank preferred credit status on the first two-thirds of the net recoveries on any mortgage default.

(VAC) and a gradual reduction in the rate of remuneration of U.S. dollar- denominated reserve requirements.[11]

26. ***The authorities plan to step up their efforts to strengthen the banking system.*** The recent follow-up FSAP mission noted that progress had been made with banking reform and strengthening of supervision in recent years, and also identified areas for improvement (Box 4). In particular, there is a need to improve the legal protection for bank supervisors, strengthen prudential regulations for foreign-exchange risk, tighten regulations governing restructured loans, and improve the supervision of offshore subsidiaries. Regarding consolidated supervision, the mission welcomed the authorities' intention to strengthen capital reserves or provisions on financial intermediaries' risky offshore operations, including on loans for which information is not available. The staff also encouraged the authorities to continue strengthening ongoing bank restructuring programs, amend regulations governing restructured loans, and fully align them with best international practices accounting procedures on past-due loans and provisions. In addition, staff urged the authorities to keep working closely with Congress to ensure prompt enactment of legislation aimed at granting legal protection to bank supervisors.

27. ***The authorities are promoting efficiency in financial intermediation, including through a deepening of the domestic capital market.*** Progress is being made to enhance competition among private pension fund administrators, with a view to reducing fees and commissions charged on contributors. Recent regulatory changes also ease the transfer of funds between administrators, and a new pension fund administrator is scheduled to enter the market in July 2005, which is expected to boost competition. Moreover, a system allowing pension funds to offer investment portfolios with different risk-return characteristics is to become fully operational by year-end. In an effort to improve financial market transparency and efficiency, in the third quarter of 2005 the Superintendency of Banks will publish a new methodology to price nontraded financial assets and encourage the use of the new reference prices by all financial intermediaries.

Figure 14. Consumer Credit by Institution
As a percent of total consumer credit



28. ***Staff urged the authorities to reduce the size of government participation in the financial system.*** Credit extended in 2004 under the subsidized consumer-lending program of the state bank *Banco de la Nación* to public sector employees rose significantly faster than initially envisaged under the program. As a result, at end-2004 *Banco de la Nación* accounted for close to 15 percent of the total stock of consumer lending of the financial system. The staff recommended strictly limiting its growth

[11] At present, the remuneration rate of reserve requirements kept by financial institutions at the central bank is equivalent to 3-month LIBOR minus ¾ percentage points.

BOX 4. PERU: SUMMARY OF FINDINGS OF THE FOLLOW-UP FSAP MISSION

- ***The resilience of the Peruvian banking sector has strengthened, but further efforts are needed to address remaining vulnerabilities.*** Financial indicators are improving—nonperforming loan ratios have declined, return on assets has risen, bank profitability and capitalization have improved, and the liquidity ratio has increased. Remaining vulnerabilities include:

  ➢ ***High financial dollarization.*** Banks remain exposed to significant credit risk from lending in dollars to unhedged borrowers.

  ➢ ***Consolidated supervision***. A few banks are exposed to the risks associated with activities of offshore entities and a weak capital structure. Corrective steps in these banks are underway.

  ➢ ***Public banks***. Public banks need to be placed on a level playing field with commercial banks and made subject to the same supervision. The recent sharp expansion of the activities of *Banco de la Nación* is cause for concern.

  ➢ ***Micro financing institutions.*** Micro credit has grown rapidly and, while not presenting systemic risk, is being increasingly monitored by the supervisory agency. Improvements in titling and execution of collateral are needed to spur the availability of financial services, particularly in rural areas.

- ***Although substantial progress has been made in improving the legal, regulatory, and supervisory frameworks for banking, further efforts are needed***. Areas of progress include the approval of the AML Law (2002), the law on large credit exposure (2004), and regulations aimed at enhancing consolidated supervision, including offshore supervision. Banks need to improve risk management, especially for dollar-denominated loans. Further progress is desirable in the legal protection to supervisors, regulations on restructured loans, abolition of accounting practices not in line with International Accounting Standards (IAS), and information gathering from some offshore centers on the activity of Peruvian banks' branches and subsidiaries.

- ***Private pension funds have grown rapidly and are the dominant institutional investor in the narrow domestic capital market.*** Current efforts to encourage competition and reduce high commissions should be intensified, including through changes in the overly narrow band around the required rate of return and the formula for calculating commissions. Gradually easing restrictions on private pension funds' investment abroad would reduce risks of asset price bubbles.

- ***Development of the domestic market for government bonds in domestic currency needs to be consolidated.*** Institutional strengthening of the debt office to reduce "key person" risk and a more explicit annual debt strategy are desirable. The Ministry of Finance and the central bank need to coordinate closely the issuance of new public debt. Better coordination between the SBS and the Supervisory Agency of the Capital Market (CONASEV) in developing repos, securities lending, and a forward market would also enhance the liquidity and growth of the market.

in 2005 while expressing concern about the creation of new consumer-lending programs at subsidized interest rates.[12] The authorities agreed that lending by this bank should be strictly based on sound commercial criteria to avoid hampering the development of private financial institutions, including those involved in micro financing. Accordingly, during 2005, the Ministry of Economy and Finance will closely monitor the development of all consumer-lending extended by *Banco de la Nación* through quarterly targets, and the increase in lending is not to exceed 20 percent for the year as a whole. The staff urged the authorities to take all necessary steps to ensure that this objective is strictly implemented. The authorities also indicated that *AgroBanco* will continue to limit its lending operations to channeling foreign lines of credit to agricultural producers, and its quasi-fiscal operations with small-scale farmers will continue to be recorded transparently in the budget.

29. ***Progress has been made toward improving the AML/CFT legal and regulatory frameworks.*** Peru is a member of—and has, since recently, been presiding over—the Financial Action Task Force against Money Laundering in South America (GAFISUD), which is expected to produce a report on Peru by mid-year. A Financial Intelligence Unit was created in 2002 as an autonomous body reporting to the Prime Minister, to ensure compliance with the 2002 Law on money laundering. The Unit began operations in mid-2003 with regulatory powers for all financial entities not already supervised by another regulatory body (such as the Superintendency of Banks). Reporting requirements became effective in September 2003, and its functions were expanded in 2004 to analyze reports related to terrorism financing. The Unit is expected to become a member of the Egmont group of International Financial Intelligence Units in mid–2005. In addition, the Superintendency of Banks has updated its manual of on-site inspections to include a special section on AML procedures, and findings are now reported in each bank inspection report.

F. Other Growth-Enhancing Reforms and Poverty Reduction Efforts

30. ***The authorities considered that further improvements in the business climate were key to enhancing the competitiveness of the Peruvian economy.*** Although the establishment of the first specialized commercial court in Lima (end-December 2004 performance criterion) was delayed by a few months, it became fully operational in April 2005. The establishment of additional courts would further accelerate the settlement of business-related legal disputes. Implementation of a plan to centralize collateral registries, expected to be announced by end-September, should also help support the development of domestic capital markets to increase the access and quality of credit, thus fostering robust growth.

31. ***Peru is actively pursuing trade liberalization through both bilateral and multilateral negotiations, including in the context of the Doha Round.*** The authorities aim at completing discussions on a Free Trade Agreement with the United States by mid–2005. This agreement would be key to making permanent Peru's temporary preferential access to the U.S. market for nontraditional products and to accelerating investor-friendly structural and institutional reforms. The authorities are also planning to extend to services and transfers

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[12] *Banco de la Nación* was authorized late last year to issue bonds to fund its lending operations. The issuance of bonds requires prior authorization by the Ministry of Economy and Finance. So far, however, no such approvals have been given.

the existing agreement on goods with Chile, and are continuing to explore free trade negotiations with Singapore and a cooperation agreement with China. The authorities have also held discussions with the European Union on the possibility of free trade negotiations in the future. Temporary restrictions on textile imports, which had been renewed in October 2004, were eliminated at end-April 2005, based on a technical report that found no harm to domestic production from imports. In May, however, a decree was issued to subject 38 textile import items to a procedure by which duties would be applied on the export value of the commodity computed on the basis of existing market information rather than the declared value at customs.

32. ***Consensus still needs to be built on a set of reforms that would promote formal employment.*** Although the government is aware of the need to lower labor market rigidities, consensus has not yet been reached on proposals that would extend the more flexible regulations that are in place for micro-enterprises to larger firms and/or to new workers in all firms. Discussions continue in congress on a general labor law, which would consolidate existing labor legislation into a code, which could possibly result in the introduction of additional labor rigidities. In view of the high levels of informal employment, the authorities concurred with the mission on the importance of avoiding increases in the minimum wage during 2005 (it was last raised by 12 percent in September 2003).

33. ***Achieving Peru's millennium development goals will be challenging.*** To reduce poverty by half between 2002 and 2015, a key component of authorities' strategy is the maintenance of sound macroeconomic policies and the implementation of structural reforms aimed at ensuring high and sustained growth. In addition, their strategy aims at improving the efficiency of government spending and implementing well-focused poverty-reducing programs (Box 5). They noted that improvements had been made in the food and social infrastructure programs (PRONAA and FONCODES) following their transfer from the central government to the regions in 2003. The authorities also planned to go ahead with a new assistance program (*Juntos*) targeted to households in extreme poverty, with transfers to households conditional on keeping children in school and providing them with health care. To increase the program's probability of success, the mission advised that a pilot program be established with technical assistance in its design, monitoring, and evaluation.

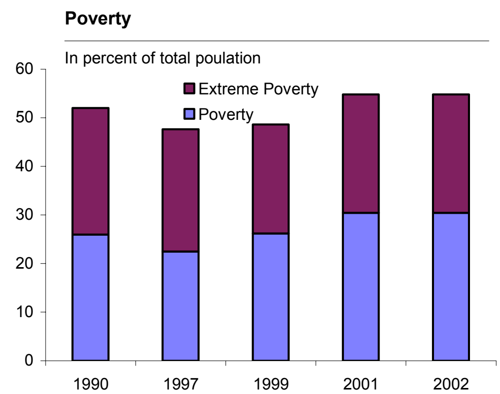
G. Other Issues

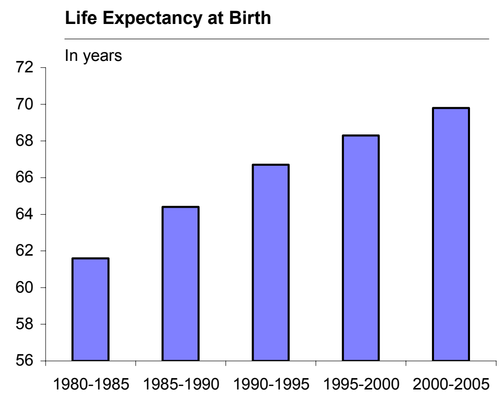
34. ***Safeguards Assessment.*** The authorities have continued working toward implementing the main recommendation of the on-site safeguards assessment completed on October 26, 2004. This recommendation strongly encouraged the central bank and the Comptroller General's Office to reach formal understandings clarifying their respective responsibilities in the areas of internal and external audits. The mission urged the authorities to reach such understandings by the completion of the third review.

35. ***Statistical Issues.*** Peru's statistics are adequate for policy formulation, surveillance, and program monitoring. Progress is being made to address some shortcomings identified in the statistical annex, particularly regarding migration to the GFSM 2001 manual.

Box 5. Peru: Poverty and the Millennium Development Goals

Despite strong economic growth in recent years, poverty remains high. Growth has helped stop the worsening trend in poverty observed during the recession of the late 1990s, but has been unable to reduce it. The poverty rate increased by 7 percentage points between 1999 and 2002, and has since declined slightly to 52 percent in 2003. From 2001 to 2003, the extreme poverty rate declined from 24.4 percent to 21.6 percent.[1]





Meeting the millennium development goals will be challenging. Poverty and extreme poverty would need to be reduced to 27.3 percent and 11.5 percent, respectively, by 2015. This would require sustaining average annual rates of growth of over 4 percent. Key to this effort is the consolidation of sound macroeconomic policies and the implementation of structural reforms.

Poverty reduction also depends on improving the efficiency of government spending. Spending on extreme poverty has remained low, at about 1½ percent of GDP, and inefficient. A key priority should be to strengthen ongoing efforts to reduce large leakages in existing programs through their consolidation and improvements in managerial deficiencies.

Significant progress has been made toward achieving some other millennium developments goals. Illiteracy rates have declined and life expectancy has increased; infant mortality rates were reduced, and gender equality and the proportion of births attended by qualified personnel has risen; access to several basic services has also increased, including to safe water.

Sources: The World Bank, Country Assistance Strategy Progress Report for the Republic of Peru, October, 2004; and UNDP, "*Hacia el Cumplimiento de los Objetivos de Desarrollo del Milenio en el Perú*", 2004.

[1] The poverty rate is defined as the percentage of households whose total income is below the costs of a basket of basic consumption goods, while extreme poverty is based on a consumpton basket of basic food items only.

36. ***G8 Anti-corruption and Transparency Initiative.*** During the June 2004 G-8 Summit, Peru announced its intention to cooperate with G-8 partners in promoting transparency in public management and in combating corruption. The authorities' efforts under this initiative center on six core areas: citizens and information; transparency and fiscal management; procurement; decentralization, efficiency and transparency; transparency in extractive industries; and asset recovery. A technical action plan to reinforce existing initiatives in these areas is expected to be finalized in coming months. Consultations with the World Bank and the Department for International Development of the United Kingdom (DFID) have also continued regarding the Extractive Industry Transparency Initiative. A local coordinator was appointed in December 2004 to lead a working team representing government agencies, industries, and civil society. The initial focus of this team will be publication of national extractive industry revenues and a pilot-based examination of regions benefiting from these revenues.

IV. Program modalities

37. ***Program monitoring in 2005 will remain similar to that in 2004.*** The program includes quarterly quantitative performance criteria for 2005, the inflation consultation mechanism, and structural performance criteria and benchmarks through end-year (Table 1 of the LOI, and Table A of the MEFP). The third review has been postponed to take place by mid-November 2005. In 2005, the reform program will focus on improving fiscal transparency, concessions and PPP monitoring, promoting de-dollarization, and enhancing the business environment.

38. ***Peru's capacity to repay the Fund is strong.*** Even if Peru were to draw the full amount available under the program, Fund credit outstanding would peak in 2006 at SDR 314 million, representing 0.6 percent of GDP and 3.8 percent of gross foreign reserves. At its peak in 2009, debt service to the Fund would be equivalent to 4.5 percent of Peru's total public debt service and 1.0 percent of exports of goods and services. Fund credit outstanding would rise from 10.5 percent of quota in December 2004 to 49.2 percent of quota in 2006 and then decline to zero by 2011.

V. Staff Appraisal

39. ***The Peruvian economy continues to perform strongly and there has been some progress in the structural reform area.*** The sustained implementation of sound macroeconomic policies, in the context of a very favorable external environment, led to strong growth and a sharp improvement in the external position while inflationary pressures remained low. Some progress was also made in the structural reform area, particularly in advancing public pension reform and private investment in infrastructure. However, due to administrative bottlenecks, the establishment of the first commercial court (end-December structural performance criterion) only took place in April 2005. While the end-April performance criterion on the concession for two roads was not observed, one of these roads was awarded in concession in early May and the delay in concessioning the second road is expected to be temporary.

40. ***The authorities' commitment to the fiscal targets is commendable***. The program target for 2004 was met with some margin and the program aims at a further reduction in the combined public sector deficit in 2005, in line with the Fiscal Responsibility and Transparency Law (FRTL). On the basis of strong tax collections in the first four months of the year, the contemplated supplementary budget appears consistent with projected revenue over-performance in 2005. However, the additional spending will result in a regrettable breach of the expenditure growth limit in the FRTL, an issue that will be discussed in future reviews. Staff therefore encourages the authorities to use any additional revenue to reduce the fiscal deficit below programmed levels. Achievement of this objective would help further reduce Peru's still high public debt-to-GDP ratio. Staff supports the steps being taken in the area of tax policy, including the elimination of the payroll tax and the reduction in the rate of the tax on financial transactions. It will also be important to deepen efforts to broaden the tax base by further improving tax administration and curtailing tax exemptions.

41. ***The authorities' efforts to prioritize and limit expenditure demands are appropriate.*** Although pressure to raise government spending above budgeted amounts has been strong in recent months, the room for maneuver is limited. In that context, the staff welcomes the authorities' intentions to establish priorities in the granting of any additional expenditure increases above budgeted allocations. The authorities need to move decisively in improving the efficiency of existing social assistance programs, while implementing carefully the new program of targeted income transfers to indigent families to ensure its effectiveness in reducing poverty.

42. ***Improvements in the legal and institutional fiscal framework will be key to consolidating prudent fiscal management.*** The authorities' efforts to enhance the budgetary framework will help strengthen central government budget management and control. Improving the procedures for reporting to congress and implementing sanctions on public officials for noncompliance with the law will help further institutionalize the Fiscal Responsibility and Transparency Law. In addition, approval of the Public Indebtedness Law would create a legal framework for effective monitoring and control of government liabilities, including contingent obligations. In the area of decentralization, issuance of the regulation in implementation of the Fiscal Decentralization Law will help strengthen prudent fiscal management at the subnational government levels. In this area, it is important to note that, in addition to specifying sectoral devolution responsibilities to regional governments for 2005, the government will need to develop a comprehensive sectoral devolution plan for the medium-term to clarify shared responsibilities among different levels of government. This would help avoid reversals in the decentralization process while helping ensure that this process proceeds in a cautious and fiscally-neutral manner.

43. ***Efforts aimed at implementing a comprehensive reform of the state are commendable.*** These efforts should help improve resource management in the public sector over the medium-term while creating additional room for social and infrastructure spending. The staff welcomes the enactment of the reform of the preferential *Cédula Viva* public pension regime and encourages the authorities to speed up their efforts to centralize its administration. Plans to gradually implement a comprehensive and fiscally prudent reform of civil service employment conditions are also commendable. However, the financial cost of the reform could be high, and care will have to be taken to ensure that it proceeds at a pace that does not place an undue burden on the budget. Staff welcomes recent progress in the area of transparent fiscal management, including the expected unification of the central government budget formulation system and the Integrated Financial Management System.

44. ***There is a need to broaden the institutional framework for PPP operations and strengthen ongoing efforts to transparently record these operations.*** The authorities need to coordinate efforts to improve the effectiveness of administrative processes aimed at weeding out projects that do not best lend themselves to the PPP framework. In particular, these efforts need to include a comprehensive assessment of all fiscal costs involved, including future expenditure commitments from the government and guarantees of minimum revenue streams. The exemption from SNIP procedures of a large road project is regrettable, and staff welcomes the authorities' commitment to avoid by-passing these procedures for all major projects undertaken via concessions and PPPs. Staff urges the authorities to avoid engaging in new infrastructure projects that would require sizable future subsidies from the

government and to establish transparent reporting and effective control over public sector obligations associated with PPPs.

45. ***Peru's inflation targeting framework has helped anchor inflationary expectations***. The appreciation of the *Nuevo Sol* since mid-2004, in the context of increased nominal exchange flexibility, has helped contain inflation in the face of adverse supply shocks. In 2005, inflation is expected to remain well within the inflation target range. Given the comfortable level of international reserves, staff encourages the authorities to limit intervention in the foreign exchange market to minimize short-term volatility in the exchange rate and increase the transparency of the inflation targeting framework. This would also avoid the risks associated with providing one-way bets to capital flows and help contain the losses of the central bank. To reduce appreciation pressures on the currency, staff continues to encourage the authorities to gradually raise the limits on pension funds' investments abroad and welcomes their intention to increase the share of public debt denominated in local currency. More broadly, staff commends the authorities' debt management strategy, which focuses on reducing currency and rollover risks, including by seeking opportunities to reprofile existing debt.

46. ***The authorities plan to further strengthen and modernize financial regulation and supervision and improve intermediaries' efficiency.*** Progress is being made in increasing the resilience of the financial sector, and staff welcomes the authorities' commitments to implement high risk-based capital requirements on financial intermediaries' risky offshore operations, including on loans for which comprehensive information is not available. They are also well advised to continue implementing ongoing bank strengthening programs and fully align accounting procedures with best international practices. Staff would also encourage the authorities to continue working closely with congress to ensure prompt enactment of legislation aimed at granting legal protection to bank supervisors. The staff urges the authorities to ensure that the limit on the expansion of *Banco de la Nación's* lending operations to the private sector in 2005 is strictly observed.

47. ***Staff concurs with the authorities on the need to strengthen de-dollarization efforts.*** Despite a gradual decline in dollarization, lending in foreign currency to unhedged economic agents remains an important risk to the banking system. In this regard, the authorities' intention to encourage mortgage lending in domestic currency under the *MiVivienda* program is a step in the right direction. It would also be important for the Superintendency of Banks to proceed decisively with issuing inspection guidelines to strengthen key aspects of the recently-issued regulations on foreign currency credit risks and step up bank supervision in this area.

48. ***The authorities' efforts to further integrate Peru in the global economy are commendable, but efforts to promote flexibility in the economy will need to be further enhanced.*** The staff encourages the authorities to continue pursuing further trade liberalization through bilateral and multilateral negotiations, and welcomes the decision to eliminate the temporary restrictions on textile products. Efforts to improve the investment climate need to be stepped-up, including by establishing new commercial courts and implementing the plan to centralize collateral registries. Staff also urges the authorities to

continue working toward lowering labor market rigidities and promoting formal employment.

49. ***The baseline medium-term outlook continues to be favorable.*** The authorities' commitment to consolidate sound macroeconomic policies and rekindle the reform effort will be key to boosting economic growth over a sustained period of time, thus helping reduce poverty. Risks to the program continue to stem from existing global imbalances, high debt and dollarization, and policy slippages associated with a challenging political situation. However, a consensus for prudent policies and reform has been preserved and Peru has important buffers, including a comfortable level of reserves and a well-capitalized banking system.

50. ***In summary, Peru has continued to perform well under the program supported by the Stand-By Arrangement, and the staff recommends completion of the second review.*** The staff supports the authorities' request for a waiver for the nonobservance of the end-December 2004 structural performance criterion on the establishment of a commercial court in Lima given that the delay was temporary and the court is now fully operational. Regarding concessions, one highway was awarded in concession in early May and delays for the second road are expected to be temporary. Accordingly, the staff also supports the authorities' request for a waiver of the structural performance criterion on the granting in concession of two major roads, a modification to further specify it, and a resetting of the criterion for end-September 2005. In addition, taking into account the delays registered in completing the present review, staff supports the authorities' request that future disbursements under the arrangement (excluding the disbursement that will become available upon completion of this review) be rephased into five equal amounts of SDR 27.6372 million.

Table 1. Peru: Selected Economic Indicators

				2004		Proj.	
	2001	2002	2003	Prog.	Prel.	2005	2006
Social Indicators							
Life expectancy at birth (years)	...	69.8	...	...	...	...	...
Infant mortality (per thousand live births)	...	30.0	...	...	...	...	...
Adult literacy rate	90.2	85.0	...	...	...	...	...
Poverty rate 1/	54.8	54.3	52.0	...	...	...	...
Unemployment rate	9.3	9.4	9.4	...	9.4	...	...
(Annual percentage change; unless otherwise indicated)							
Production, prices, and trade							
Real GDP	0.2	4.9	3.8	4.0	5.1	4.5	4.5
Real domestic demand	-0.6	4.0	3.3	3.5	4.3	4.6	4.8
Consumer Prices (end of period)	-0.1	1.5	2.5	2.5	3.5	2.3	2.5
Consumer Prices (period average)	2.0	0.2	2.3	3.2	3.7	2.1	2.4
External Sector							
Exports	1.0	9.9	16.4	22.9	39.6	8.8	0.9
Imports	-2.0	2.7	11.3	8.0	18.9	8.4	6.9
Terms of trade (deterioration -)	-1.8	2.8	1.4	9.1	8.1	-2.6	-3.3
Real effective exchange rate (depreciation -) 2/	4.4	-5.5	-10.7	...	0.8	...	...
Money and credit 3/ 4/							
Liabilities to the private sector	4.0	4.4	1.9	5.5	11.3	5.3	5.4
Net credit to the private sector	-2.6	-1.5	-3.5	4.3	3.7	3.2	3.3
(In percent of GDP, unless otherwise indicated)							
Public sector							
General government current revenue	17.3	17.2	17.7	17.4	17.8	17.8	17.7
General government noninterest expenditure	17.9	17.4	17.3	16.8	16.9	16.7	16.5
Combined public sector primary balance	0.0	0.0	0.5	0.8	1.0	1.2	1.4
Interest due	2.2	2.2	2.2	2.2	2.1	2.2	2.4
Combined public sector overall balance	-2.3	-2.2	-1.7	-1.4	-1.1	-1.0	-1.0
External Sector							
External current account balance	-2.2	-2.0	-1.8	-0.7	-0.1	0.5	0.2
Gross reserves							
in millions of U.S. dollars	8,838	9,690	10,206	10,306	12,643	12,343	12,443
percent of short-term external debt 5/	149.9	217.2	214.0	225.5	257.0	243.3	238.4
percent of foreign currency deposits at banks	92.5	100.6	107.3	107.3	133.4	122.7	124.0
Debt							
Total external debt	50.7	49.3	49.1	45.9	45.8	41.8	40.8
Combined public sector debt	46.6	47.1	47.7	44.6	45.2	42.2	40.0
Domestic	10.8	10.3	10.1	9.3	9.4	8.8	8.6
External 6/	35.8	36.9	37.6	35.4	35.8	33.4	31.4
Savings and investment							
Gross domestic investment	18.8	18.8	18.8	18.2	18.6	19.0	19.5
Public sector	3.1	2.8	2.9	2.9	2.7	2.9	3.0
Private sector	15.7	15.9	15.9	15.4	15.9	16.1	16.5
National savings	16.6	16.8	17.0	17.5	18.5	19.5	19.7
Public sector 7/	1.1	0.8	1.3	1.4	1.7	1.9	2.0
Private sector	15.5	16.0	15.8	16.1	16.9	17.5	17.7
External savings	2.2	2.0	1.8	0.7	0.1	-0.5	-0.2
Memorandum item:							
Nominal GDP (S/. billions)	188.3	198.7	210.7	231.6	233.4	249.3	265.7
GDP per capita (in US$)	2,037	2,111	2,231	2,563	2,483	2,699	2,782

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; ECLAC 2002-03; and Fund staff estimates/projections.

1/ Defined as the percentage of households whose total spending is below the cost of a basket of basic consumption goods.
2/ End of period. Based on Information Notice System.
3/ Corresponds to the banking system.
4/ Foreign currency stocks are valued at program exchange rate.
5/ Short-term debt includes amortization of medium- and long-term loans falling due over the following year.
6/ Includes Central Reserve Bank of Peru debt.
7/ Excludes privatization receipts.

Table 2. Peru: Quantitative Performance Criteria, 2004

	2004		
	June 30	Sept. 30	Dec. 31
(Cumulative amounts from December 31, 2003, in millions of *Nuevos Soles*)			
Borrowing requirement of the combined public sector 1/			
Unadjusted limits	200	1,590	3,300
Adjusted limits 2/	223	1,646	3,401
Actual	-1,057	-280	2,345
Margin	1,280	1,926	1,056
(Cumulative amounts from December 31, 2003, in millions of U.S. dollars)			
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions			
Unadjusted targets	286	-44	-157
Adjusted targets 2/	18	-512	232
Actual	529	741	2,313
Margin	511	1,253	2,081
Outstanding short-term external debt of the nonfinancial public sector			
Limits	50	50	50
Actual	0	0	0
Margin	50	50	50
Contracting or guaranteeing of nonconcesional public debt with maturity of at least one year			
Unadjusted limits	2,050	2,675	3,200
Adjusted limits 2/	2,050	2,675	3,999
Actual	1,495	1,807	3,343
Margin	555	868	656
Of which: **external debt of 1-5 year maturity**			
Limits	100	100	100
Actual	0	0	0
Margin	100	100	100
External payments arrears of the public sector (on a continuous basis) 3/			
Limits	0	0	0
Actual	0	0	0
Margin	0	0	0
(Consultation bands for the 12-month rate of inflation, in percent) 4/			
Outer band (upper limit)	5.5	5.5	5.5
Inner band (upper limit)	4.5	4.5	4.5
Central point	2.5	2.5	2.5
Inner band (lower limit)	0.5	0.5	0.5
Outer band (lower limit)	-0.5	-0.5	-0.5
Actual	4.3	4.0	3.5

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and IMF Country Report No. 04/226.

1/ PIPP proceeds are included below the line.
2/ The targets and limits were adjusted in accordance with the table attached to the letter of intent dated May 25, 2004 (IMF Country Report No. 04/226).
3/ Excluding arrears associated with nonrescheduled debt to foreign creditors outstanding as of end-2003.
4/ 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 3. Peru. Status of Structural Performance Criteria and Benchmarks, 2004

Measures	Original Program (IMF Country Report No. 04/226)	Revised Program (IMF Country Report No. 07/99)	Status
I. Performance Criteria			
1. Begin operations of a commercial court in Lima.	September 30, 2004	December 31, 2004	Not observed. Action completed in early-April 2005.
2. Grant concessions or enter into Public Private Partnerships for the construction and maintenance of at least two major roads.	December 31, 2004	April 30, 2005	Not observed. Expected for end-September.
II. Benchmarks			
1. Announce a plan to centralize the information on collateral registries.	June 30, 2004		Not observed. Benchmark for end-September 2005.
2. Submit to Congress legislation to eliminate by end-December the special wage tax (IES).	September 30, 2004		Not observed. Action completed in early October.
3. Complete a census of government employees and pensioners.	September 30, 2004		Observed.
4. Develop a satisfactory action plan for reforming the pension regimes for the police and the military.	September 30, 2004		Not observed. Action completed in December 2004.
5. Introduce in congress a constitutional amendment and, once approved, introduce in Congress draft laws to allow a comprehensive reform of the *Cédula Viva*, as described in paragraph 11 of the May 25, 2004 MEFP.	December 31, 2004	December 31, 2004	Observed.
6. Implementation of a satisfactory law clarifying shared functional responsibilities among the national, regional, and local governments.	December 31, 2004	December 31, 2004	Not observed.
7. Implementation of a satisfactory law providing objective criteria for certifying that regional governments have the administrative capacity to take on devolved expenditure (*Ley del Sistema Nacional de Acreditación*).	December 31, 2004	December 31, 2004	Observed.
8. Put in full operation a system within the SBS to measure currency risks.	December 31, 2004	December 31, 2004	Not observed. Action completed in mid-January.

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

(In percent of GDP; unless otherwise indicated)

				2004		Proj.	
	2001	2002	2003	Prog.	Prel.	2005	2006
Central government primary balance	**-0.7**	**-0.2**	**0.2**	**0.6**	**0.6**	**1.0**	**1.1**
Revenue	14.5	14.5	15.1	15.2	15.2	15.4	15.3
Current	14.3	14.4	15.0	15.1	15.2	15.3	15.2
Of which : tax revenue	12.2	11.9	13.0	13.3	13.4	13.3	13.4
Of wich: net financial transaction tax 1/	...	...	...	0.3	0.3	0.2	0.1
Capital	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Noninterest expenditure	15.2	14.7	14.9	14.6	14.6	14.4	14.3
Current	12.8	12.7	13.0	12.7	12.8	12.6	12.4
Capital	2.4	2.0	1.9	1.9	1.9	1.8	1.9
Rest of the general government primary balance	**0.3**	**0.2**	**0.3**	**0.2**	**0.3**	**0.2**	**0.2**
Revenue	5.7	5.7	5.9	5.5	5.7	5.7	5.7
Current	5.6	5.7	5.8	5.5	5.7	5.7	5.7
Capital	0.1	0.1	0.1	0.0	0.0	0.0	0.1
Noninterest expenditure	5.4	5.6	5.6	5.4	5.4	5.5	5.5
Current	4.5	4.8	4.7	4.6	4.6	4.6	4.6
Capital	0.9	0.8	0.9	0.8	0.8	0.9	0.9
Public enterprise primary balance	**0.2**	**-0.1**	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**
Current balance	0.6	0.2	0.3	0.4	0.4	0.4	0.5
Capital balance	-0.4	-0.3	-0.4	-0.3	-0.2	-0.4	-0.4
Nonfinancial public sector primary balance	**-0.2**	**-0.2**	**0.4**	**0.8**	**1.0**	**1.2**	**1.4**
Central bank operating balance	0.2	0.2	0.1	0.0	0.0	-0.1	0.0
Combined public sector primary balance	**0.0**	**0.0**	**0.5**	**0.8**	**1.0**	**1.2**	**1.4**
Interest payments	2.2	2.2	2.2	2.2	2.1	2.2	2.4
External	2.0	1.8	1.8	1.8	1.7	1.8	1.8
Domestic	0.3	0.4	0.4	0.4	0.4	0.4	0.6
Of which: pension recognition bonds	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Combined public sector overall balance	**-2.3**	**-2.2**	**-1.7**	**-1.4**	**-1.1**	**-1.0**	**-1.0**
Financing	2.3	2.2	1.7	1.4	1.1	1.0	1.0
External	0.9	2.1	1.4	1.0	1.6	0.1	0.5
Disbursements 2/	2.5	5.1	3.5	3.0	3.6	2.0	2.4
(In millions of U.S. dollars)	*1,319*	*2,863*	*2,101*	*1,961*	*2,476*	*1,496*	*1,889*
Amortization 3/	-1.4	-3.2	-2.0	-2.0	-2.0	-2.0	-2.0
(In millions of U.S. dollars)	*-768*	*-1,837*	*-1,187*	*-1,335*	*-1,348*	*-1,529*	*-1,551*
Rescheduling/arrears (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other 4/	-0.1	0.3	-0.1	0.0	-0.1	0.1	0.0
Domestic	0.8	-0.7	0.2	0.2	-0.6	0.8	0.5
Bond placements	0.6	0.5	0.8	0.8	1.1	0.8	0.9
(In millions of U.S. dollars)	*348*	*267*	*508*	*552*	*732*	*625*	*700*
Amortization 3/	-0.4	-0.3	-0.9	-0.9	-1.1	-1.1	-0.6
(In millions of U.S. dollars)	*-197*	*-193*	*-556*	*-587*	*-755*	*-805*	*-436*
Of which: pension recognition bonds	-52	-55	-170	-235	-212	-193	-68
Net deposits	0.5	-0.8	0.3	0.3	-0.6	1.1	0.2
(In millions of U.S. dollars)	*252*	*-443*	*190*	*193*	*-414*	*807*	*130*
Privatization	0.6	0.8	0.1	0.2	0.2	0.1	0.0
(In millions of U.S. dollars)	*327*	*421*	*52*	*111*	*113*	*87*	*24*
Memorandum items:							
Overall fiscal deficit (old definition) 5/	-2.4	-2.2	-1.9	-1.6	-1.3	-1.2	-1.0
General government current revenue 6/	17.3	17.2	17.7	17.4	17.7	17.8	17.7
General government noninterest expenditure 6/	17.9	17.4	17.3	16.8	16.9	16.7	16.5
Public sector debt-to-GDP 2/	46.6	47.1	47.7	44.6	45.2	42.2	40.0
Nominal GDP (S/. billions)	188.3	198.7	210.7	231.6	233.4	249.3	265.7

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

1/ The FTT is deductible from income tax payments of the following fiscal year. This deduction, estimated at 0.1 percent of GDP in 2005 and 2006, is taken into account to compute the net FTT.

2/ In 2004, includes placement of US$800 million euro-denominated bonds, covering part of the country's financing needs for 2005.

3/ Includes in 2005 the amortization of US$390 million U.S. dollar denominated domestic bonds for the restructuring of the financial sector.

4/ Includes condonations, plus the net increase in short-term external credit to the NFPS and the net decrease in foreign assets of the NFPS.

5/ Adjusted by adding the amortization (previously booked as a current transfer) and subtracting the accrued interest payments of CPI-indexed pension recogniton bonds.

6/ Net of transfers among nonfinancial public institutions.

Table 5. Peru: Financing of the Combined Public Sector

	2001	2002	2003	2004 Prog.	2004 Prel.	Proj. 2005	Proj. 2006
			(In millions of U.S. dollars)				
Combined balance	**-1,209**	**-1,227**	**-1,037**	**-927**	**-761**	**-787**	**-783**
Financing	**1,209**	**1,227**	**1,037**	**927**	**761**	**787**	**783**
Net External	479	1,169	843	657	1,085	73	365
Disbursements	1,319	2,863	2,101	1,961	2,476	1,496	1,889
Bonds 1/	0	1,886	1,245	500	1,299	400	1,000
Multilaterals	1,105	807	519	1,012	862	596	389
Bilaterals and other	214	170	337	449	315	500	500
Amortization	-768	-1,837	-1,187	-1,335	-1,348	-1,529	-1,551
Other 2/	-72	143	-71	31	-43	106	28
Privatization	327	421	52	111	113	87	24
Net Domestic financing	403	-363	142	159	-437	628	393
Bonds	348	267	508	552	732	625	700
Amortization 3/	-197	-193	-556	-587	-755	-805	-436
Of which : pension recognition bonds	-52	-55	-170	-235	-212	-193	-68
Net deposits	252	-436	190	193	-414	807	130
Of which: Central government	228	-396	299	221	-254	829	232
			(In percent of GDP)				
Combined balance	**-2.3**	**-2.2**	**-1.7**	**-1.4**	**-1.1**	**-1.0**	**-1.0**
Financing	**2.3**	**2.2**	**1.7**	**1.4**	**1.1**	**1.0**	**1.0**
Net External	0.9	2.1	1.4	1.0	1.6	0.1	0.5
Disbursements	2.5	5.1	3.5	3.0	3.6	2.0	2.4
Bonds	0.0	3.3	2.1	0.8	1.9	0.5	1.3
Multilaterals	2.1	1.4	0.9	1.5	1.3	0.8	0.5
Bilaterals and other	0.4	0.3	0.6	0.7	0.5	0.7	0.6
Amortization	-1.4	-3.3	-2.0	-2.0	-2.0	-2.0	-2.0
Other 2/	-0.1	0.3	-0.1	0.0	-0.1	0.1	0.0
Privatization	0.6	0.7	0.1	0.2	0.2	0.1	0.0
Net Domestic financing	0.8	-0.6	0.2	0.2	-0.6	0.8	0.5
Bonds	0.6	0.5	0.8	0.8	1.1	0.8	0.9
Amortization 3/	-0.4	-0.3	-0.9	-0.9	-1.1	-1.1	-0.6
Of which: pension recognition bonds	0.1	0.1	0.3	0.4	0.3	0.3	0.1
Net deposits	0.5	-0.8	0.3	0.3	-0.6	1.1	0.2
Of which: Central government	0.4	-0.7	0.5	0.3	-0.4	1.1	0.3
Memorandum item:							
Nominal GDP (S/. billions)	188.3	198.7	210.7	231.6	233.4	249.3	265.7

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

1/ In 2004, includes placement of US$800 million euro-denominated bonds, covering part of the country's financing needs for 2005.
2/ Includes condonations, plus the net increase in short-term external credit to the NFPS and the net decrease in foreign assets of the NFPS.
3/ Includes in 2005 the amortization of US$390 million U.S. dollar denominated domestic bonds for the restructuring of the financial sector.

Table 6. Peru: Fiscal Operations of the Central Government
(In percent of GDP)

	2001	2002	2003	2004 Prog.	2004 Prel.	Proj. 2005	Proj. 2006
Current primary balance	**1.5**	**1.6**	**2.0**	**2.4**	**2.4**	**2.7**	**2.8**
Current revenue	14.3	14.4	15.0	15.1	15.2	15.3	15.2
Tax revenue	12.2	11.9	13.0	13.3	13.4	13.3	13.4
Direct taxes	3.4	3.2	4.0	3.9	4.1	3.7	3.7
Indirect taxes	8.8	8.7	9.0	9.4	9.3	9.5	9.6
Of which: net financial transaction tax 1/	...	...	...	0.3	0.3	0.2	0.1
Other current revenue 2/	2.2	2.5	1.9	1.8	1.8	2.0	1.9
Current noninterest expenditure	12.8	12.7	13.0	12.7	12.8	12.6	12.4
Labor services 3/	6.7	6.7	6.8	6.5	6.5	6.4	6.3
Goods and nonlabor services	3.8	3.4	3.5	3.4	3.5	3.3	3.3
Transfers and other	2.3	2.6	2.7	2.8	2.8	2.9	2.8
Capital balance	**-2.2**	**-1.9**	**-1.8**	**-1.8**	**-1.8**	**-1.7**	**-1.8**
Capital revenue	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Capital expenditure	2.4	2.0	1.9	1.9	1.9	1.8	1.9
Gross capital formation	2.1	1.8	1.7	1.7	1.6	1.7	1.7
Other	0.3	0.2	0.3	0.2	0.2	0.2	0.2
Primary balance	**-0.7**	**-0.2**	**0.2**	**0.6**	**0.6**	**1.0**	**1.1**
Interest payments	2.2	2.0	2.0	2.0	1.9	2.0	2.2
External	1.9	1.8	1.8	1.8	1.7	1.8	1.8
Domestic	0.2	0.2	0.2	0.2	0.2	0.3	0.4
Overall balance	**-2.8**	**-2.2**	**-1.8**	**-1.5**	**-1.3**	**-1.1**	**-1.1**
Memorandum items:							
General Government Tax Revenues	12.5	12.2	13.1	13.6	13.7	13.5	13.6
Primary balance before transfers	1.3	2.0	2.9	3.2	3.3	3.8	3.9
Overall balance before transfers	-0.8	0.0	0.9	1.2	1.4	1.8	1.7
Tax compliance rate 4/	83	87	...	...	...	...	...
Nominal GDP (S/. billions)	188.3	198.7	210.7	231.6	233.4	249.3	265.7

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

1/ The FTT is deductible from income tax payments of the following fiscal year. This deduction, estimated at 0.1 percent of GDP in 2005 and 2006, is taken into account to compute the net FTT.

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

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

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

Table 7. Peru: Public Sector Social Expenditure

	2001	2002	2003	Prel. 2004	Proj. 2005
	(In millions of *Nuevos Soles*)				
Total social expenditure and pensions	**19,056**	**20,670**	**21,573**	**23,463**	**24,308**
Universal coverage (Education and Health) 1/	7,135	8,169	8,875	10,328	10,326
Education	5,165	5,730	6,326	7,256	7,213
Health	1,970	2,439	2,549	3,071	3,114
Targeted programs (Extreme Poverty)	2,986	2,840	2,988	2,948	3,311
Non-Targeted Social Programs	8,935	9,661	9,710	10,187	10,671
ESSALUD	2,775	2,961	3,023	3,156	3,248
Pensions	6,108	6,644	6,671	7,030	7,421
Housing Development Program (FONAVI)	52	56	16	1	1
	(In percent of general government expenditure)				
Total social expenditure and pensions	**50.7**	**53.4**	**52.5**	**53.0**	**51.8**
Universal coverage (Education and Health) 1/	19.0	21.1	21.6	23.3	22.0
Education	13.7	14.8	15.4	16.4	15.4
Health	5.2	6.3	6.2	6.9	6.6
Targeted programs (Extreme Poverty)	7.9	7.3	7.3	6.7	7.1
Non-Targeted Social Programs	23.8	25.0	23.6	23.0	22.7
ESSALUD	7.4	7.6	7.4	7.1	6.9
Pensions	16.2	17.2	16.2	15.9	15.8
Housing Development Program (FONAVI)	0.1	0.1	0.0	0.0	0.0
	(In percent of GDP)				
Total social expenditure and pensions	**10.1**	**10.4**	**10.2**	**10.1**	**9.8**
Universal coverage (Education and Health) 1/	3.8	4.1	4.2	4.4	4.1
Education	2.7	2.9	3.0	3.1	2.9
Health	1.0	1.2	1.2	1.3	1.2
Targeted programs (Extreme Poverty)	1.6	1.4	1.4	1.3	1.3
Non-Targeted Social Programs	4.7	4.9	4.6	4.4	4.3
ESSALUD	1.5	1.5	1.4	1.4	1.3
Pensions	3.2	3.3	3.2	3.0	3.0
Housing Development Program (FONAVI)	0.0	0.0	0.0	0.0	0.0
Memorandum items:					
General government expenditure (in billions of *Nuevos Soles*)	37.6	38.7	41.1	44.3	46.9
Nominal GDP (in billions of *Nuevos Soles*)	188.3	198.7	210.7	233.4	249.3
Defense and national security (in percent of GDP)	2.5	2.2	2.2	2.1	2.0
Justice (in percent of GDP)	0.4	0.4	0.4	0.5	0.4

Source: Ministry of Economy and Finance.

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

Table 8. Peru: Monetary Survey

	2001	2002	2003	2004 Prog.	2004 Prel.	Proj. 2005	Proj. 2006
I. Central Reserve Bank (In millions of *Nuevos Soles* at program exchange rate)							
Net international reserves 1/	**29,800**	**32,954**	**35,361**	**34,968**	**42,125**	**39,802**	**40,906**
(In millions of U.S. dollars)	8,324	9,309	9,905	10,005	12,342	12,042	12,142
Net domestic assets	**-24,855**	**-27,339**	**-28,991**	**-28,120**	**-34,090**	**-30,993**	**-31,426**
Net credit to nonfinancial public sector	-8,758	-10,147	-10,709	-9,865	-12,974	-10,291	-10,182
Rest of banking system	-13,695	-14,338	-14,757	-15,495	-19,146	-20,208	-19,984
Other	-2,402	-2,854	-3,525	-2,760	-1,970	-494	-1,260
Currency	**4,945**	**5,615**	**6,370**	**6,848**	**8,035**	**8,809**	**9,480**
II. Banking System (In millions of *Nuevos Soles* at program exchange rate)							
Net foreign assets	**28,503**	**33,300**	**35,010**	**35,709**	**50,088**	**49,757**	**50,768**
Net domestic assets	**21,004**	**18,407**	**17,699**	**19,924**	**8,589**	**12,050**	**14,384**
Net credit to nonfinancial public sector	-9,351	-10,532	-10,664	-9,997	-13,783	-11,321	-10,377
Net credit to private sector	47,343	46,621	44,994	46,831	46,656	48,129	49,722
Other	-16,988	-17,682	-16,631	-16,910	-24,284	-24,758	-24,962
Net credit to COFIDE	-1,732	-1,340	-1,018	-1,018	-903	-904	-904
Other	-15,256	-16,342	-15,613	-15,892	-23,381	-23,854	-24,058
Liabilities to the private sector	**49,507**	**51,707**	**52,709**	**55,633**	**58,677**	**61,807**	**65,152**
(12-month percentage change)							
Base money	7.9	11.0	10.1	8.0	25.3	10.0	8.0
Broad money	4.9	4.4	1.9	4.1	11.3	5.3	5.4
Domestic currency	13.7	11.5	10.0	12.0	26.4	9.7	10.2
Foreign currency 2/	1.1	1.1	-2.3	-0.5	2.4	2.2	1.6
Net credit to private sector	-2.6	-1.5	-3.5	4.3	3.7	3.2	3.3
Domestic currency	2.9	7.0	5.1	22.9	12.3	10.0	10.0
Foreign currency 2/	-3.8	-3.6	-5.7	-1.1	1.2	0.9	0.9
III. Financial System (In millions of *Nuevos Soles* at program exchange rate)							
Net foreign assets	**30,931**	**37,354**	**44,893**	**45,592**	**45,994**	**48,844**	**52,414**
Net domestic assets	**29,503**	**28,499**	**30,212**	**32,438**	**32,724**	**36,171**	**39,419**
Net credit to the public sector	-8,581	-9,697	-8,976	-8,309	-8,382	-7,209	-6,560
Net credit to private sector	59,191	60,422	62,666	64,635	64,872	68,829	72,996
Other	-21,106	-22,226	-23,478	-23,888	-23,766	-25,450	-27,017
Liabilities to the private sector	**60,435**	**65,854**	**75,105**	**78,029**	**78,717**	**85,015**	**91,833**
(12-month percentage change)							
Liabilities to the private sector	7.8	9.0	14.0	3.9	4.8	8.0	8.0
Domestic currency	18.0	17.5	24.9	11.7	12.7	12.2	12.0
Foreign currency 2/	1.0	2.3	4.2	-4.6	-3.8	2.7	2.5
Net credit to private sector	-2.0	2.1	3.7	3.1	3.5	6.1	6.1
Domestic currency	5.6	18.9	18.0	18.3	18.8	14.8	13.6
Foreign currency 2/	-4.2	-3.3	-1.9	-4.1	-3.7	1.0	1.0
Memorandum item:							
Program exchange rate (S/. per US$)	3.51	3.52	3.48	3.49	3.41	...	...

Sources: Central Reserve Bank of Peru; and Fund staff estimates/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 9. Peru: Balance of Payments

	2001	2002	2003	2004 Prog.	2004 Prel.	Proj. 2005	Proj. 2006
(In millions of U.S. dollars)							
Current account	**-1,157**	**-1,127**	**-1,062**	**-453**	**-70**	**365**	**194**
Merchandise trade	-194	306	731	2,103	2,729	3,011	2,400
Exports	7,026	7,723	8,986	11,009	12,547	13,652	13,776
Traditional	4,730	5,369	6,267	7,982	8,886	9,583	9,211
Nontraditional and others	2,296	2,354	2,719	3,027	3,507	4,068	4,565
Imports	-7,220	-7,417	-8,255	-8,906	-9,818	-10,641	-11,376
Services, income, and current transfers (net)	-963	-1,433	-1,793	-2,556	-2,800	-2,646	-2,206
Services	-881	-986	-931	-1,053	-957	-919	-818
Investment income	-1,124	-1,490	-2,082	-2,711	-3,307	-3,313	-3,037
Current transfers	1,042	1,043	1,220	1,208	1,464	1,586	1,649
Financial and capital account	**1,606**	**1,945**	**1,476**	**521**	**2,353**	**-770**	**-122**
Public sector	425	1,096	684	543	1,027	-106	263
Disbursements 1/	1,343	2,902	2,161	2,037	2,534	1,573	1,904
Amortization 1/	-886	-1,843	-1,229	-1,375	-1,389	-1,571	-1,590
Other medium- and long-term public sector flows 2/	-32	37	-248	-119	-118	-108	-51
Capital transfers (net)	0	0	0	0	0	0	0
Privatization	267	186	10	10	35	10	10
Private sector	914	663	782	-32	1,291	-674	-395
Foreign direct investment (FDI) excluding privatization	803	1,970	1,307	1,100	1,766	483	839
Other private capital	102	-1,412	-1,089	-912	-534	-1,157	-1,235
Medium- and long-term loans	204	-146	-22	200	-379	220	201
Portfolio investment	-291	-472	-1,214	-1,012	-386	-794	-1,156
Short-term flows 3/	189	-794	147	-100	231	-583	-280
Net Errors and Omissions	9	105	564	-220	59	0	0
Financing	**-449**	**-818**	**-414**	**-68**	**-2,282**	**405**	**-72**
NIR flow (increase -)	-448	-832	-478	-100	-2,309	300	-100
Change in NIR (increase -)	-433	-985	-596	-100	-2,437	300	-100
Valuation change	15	-153	-118	0	-128	0	0
Exceptional financing	-1	14	64	32	27	105	28
Debt relief 4/	1	14	64	32	27	105	28
Rescheduling	53	0	0	0	0	0	0
Change in arrears	-56	0	0	0	0	0	0
Memorandum items:							
Current account balance	**-2.2**	**-2.0**	**-1.8**	**-0.7**	**-0.1**	**0.5**	**0.2**
Capital and financial account balance (in percent of GDP)	3.0	3.4	2.4	0.8	3.4	-1.0	-0.2
Export value (US$), percent change	1.0	9.9	16.4	22.9	39.6	8.8	0.9
Volume growth	6.0	5.8	8.6	9.0	19.2	8.9	4.0
Price growth	-4.7	3.9	7.1	13.0	17.1	0.4	-3.0
Import value (US$), percent change	-2.0	2.7	11.3	8.0	18.9	8.4	6.9
Volume growth	1.1	1.6	5.5	4.3	9.8	5.2	6.5
Price growth	-3.0	1.1	5.5	3.6	8.3	3.0	0.4
GDP (in billions of US$)	53.7	56.5	60.6	66.3	68.4	75.4	78.9
Average exchange rate (S/. per US$)	3.51	3.52	3.48	3.49	3.41	...	...

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

1/ In 2002, includes the Brady Bond swap. For details of the swap, see IMF Country Report No. 03/72, Box 3.
2/ Includes portfolio flows of the pension reserve fund and subscription payments into international funds.
3/ Includes COFIDE and *Banco de la Nación* . Outflows in 2002 reflect a further reduction in the financial system's short-term debt.
4/ Debt relief under existing operations.

Table 10. Peru: External Financing Requirements and Sources

(In millions of U.S. dollars)

	2001	2002	2003	2004 Prog.	2004 Prel.	Proj. 2005	Proj. 2006
Gross financing requirements	**7,061**	**7,855**	**6,002**	**5,155**	**7,149**	**4,255**	**4,980**
External current account deficit (excluding official transfers)	1,157	1,127	1,062	453	70	-365	-194
Debt amortization	5,454	5,896	4,462	4,602	4,770	4,920	5,074
Medium- and long-term debt	1,714	2,664	1,873	2,075	2,244	2,151	2,273
Public sector	886	1,843	1,229	1,375	1,389	1,571	1,590
Multilateral 1/	335	399	486	573	571	612	663
Bilateral	456	496	686	724	742	856	791
Bonds and notes	83	940	50	68	67	93	90
Other	12	8	7	10	9	10	46
Private sector	828	821	644	700	855	580	683
Short-term debt 2/	3,740	3,232	2,589	2,527	2,526	2,769	2,801
Rescheduling and repayment of arrears	2	0	0	0	0	0	0
Accumulation of NIR (flow)	448	832	478	100	2,309	-300	100
Change in gross reserves	279	852	512	100	2,439	-320	99
Payments of short-term liabilities incl. IMF	154	133	84	0	-2	20	1
Other	15	-153	-118	0	-128	0	0
Available financing	**7,061**	**7,855**	**6,002**	**5,155**	**7,149**	**4,255**	**4,980**
Foreign direct investment (net)	1,070	2,156	1,317	1,100	1,801	493	849
Privatization	267	186	10	10	35	10	10
FDI	803	1,970	1,307	1,100	1,766	483	839
Portfolio (net)	-291	-472	-1,214	-1,012	-386	-794	-1,156
Short-term assets (flow)	706	-46	780	-211	45	-615	-339
Of which: errors and omissions	9	105	564	-220	59	0	0
Debt financing from private creditors	4,264	5,150	4,393	3,827	4,540	4,028	4,744
Medium- and long-term financing	1,032	2,561	1,867	1,400	1,771	1,227	1,884
To public sector	0	1,886	1,245	500	1,295	427	1,000
To private sector	1,032	675	622	900	476	800	884
Short-term financing	3,232	2,589	2,526	2,427	2,769	2,801	2,860
Official creditors 3/	1,343	1,016	909	1,538	1,240	1,146	904
Multilateral 1/	1,105	807	699	1,307	1,049	919	775
Of which: balance of payments financing	877	625	527	1,011	863	581	389
Bilateral	238	209	210	231	191	227	129
To public sector	238	209	210	231	191	227	129
To private sector	0	0	0	0	0	0	0
Other medium- and long-term public sector flows 4/	-31	51	-184	-87	-91	-3	-23

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

1/ Does not include IMF.
2/ Original maturity of less than one year.
3/ Includes both loans and grants.
4/ Includes debt relief and subscription payments to international organizations and changes in *Banco de la Nación's* long-term assets.

Table 11. Peru: Medium-Term Macroeconomic Framework

					Staff Projections					
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
(Annual percentage change)										
GDP at constant prices	0.2	4.9	3.8	5.1	4.5	4.5	4.5	4.5	4.5	4.5
Consumer prices (end of period)	-0.1	1.5	2.5	3.5	2.3	2.5	2.5	2.5	2.5	2.5
GDP deflator	1.4	0.6	2.2	5.4	2.0	2.7	2.1	2.4	2.4	2.4
Merchandise trade										
Exports, f.o.b.	1.0	9.9	16.4	39.6	8.8	0.9	2.0	4.8	4.8	5.1
Imports, f.o.b.	-2.0	2.7	11.3	18.9	8.4	6.9	6.7	7.4	7.1	6.3
Terms of trade (deterioration -)	-1.8	2.8	1.4	8.1	-2.6	-3.3	-2.9	-0.6	-0.3	-0.1
(In percent of GDP; unless otherwise indicated)										
External current account balance	-2.2	-2.0	-1.8	-0.1	0.5	0.2	-0.6	-0.6	-0.7	-0.8
External current account, excluding interest obligations	-0.1	0.6	1.7	4.7	4.9	4.1	3.1	2.9	2.5	2.3
Total external debt service 1/	6.4	7.4	5.4	5.4	5.2	5.3	5.2	5.5	4.7	4.4
Medium- and long-term	6.0	7.1	5.2	5.2	5.0	5.1	5.0	5.3	4.5	4.2
Nonfinacial public sector	3.7	5.1	3.8	3.7	3.9	3.8	3.8	4.1	3.4	3.1
Private sector	2.4	2.1	1.4	1.5	1.1	1.3	1.2	1.1	1.1	1.0
Short-term 2/	0.4	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Nonfinacial public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	0.4	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
External debt service	6.4	7.4	5.4	5.4	5.2	5.3	5.2	5.5	4.7	4.4
Interest	3.1	2.4	2.2	2.1	2.3	2.4	2.4	2.3	2.2	2.1
Amortization (medium-and long-term)	3.4	5.0	3.2	3.3	2.9	2.9	2.8	3.2	2.6	2.3
Combined public sector primary balance	0.0	0.0	0.5	1.0	1.2	1.4	1.3	1.3	1.2	1.0
General government current revenue	17.3	17.2	17.7	17.8	17.8	17.7	17.5	17.5	17.5	17.4
General govt. non-interest expenditure	17.9	17.4	17.3	16.9	16.7	16.5	16.4	16.4	16.4	16.5
Combined public sector interest due	2.2	2.2	2.2	2.1	2.2	2.4	2.3	2.3	2.2	2.1
Combined public sector overall balance	-2.3	-2.2	-1.7	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Public sector debt 1/	46.6	47.1	47.7	45.2	42.2	40.0	38.5	36.9	35.5	34.2
Gross domestic investment	18.8	18.8	18.8	18.6	19.0	19.5	19.8	20.2	20.2	20.3
Public sector	3.1	2.8	2.9	2.7	2.9	3.0	3.0	3.0	3.1	3.1
Private sector	15.7	15.9	15.9	15.9	16.1	16.5	16.8	17.1	17.1	17.1
National savings	16.6	16.8	17.0	18.5	19.5	19.7	19.2	19.6	19.4	19.5
Public sector 3/	1.1	0.8	1.3	1.7	1.9	2.0	2.1	2.2	2.3	2.3
Private sector	15.5	16.0	15.8	16.9	17.5	17.7	17.1	17.3	17.2	17.2
External savings	2.2	2.0	1.8	0.1	-0.5	-0.2	0.6	0.6	0.7	0.8
Memorandum items:										
Nominal GDP (billions of Nuevos Soles)	188.3	198.7	210.7	233.4	249.3	265.7	283.4	303.3	324.5	347.2
Gross international reserves (billions of U.S. dollars)	8,838	9,690	10,206	12,643	12,343	12,443	12,543	12,643	12,743	12,843
Gross international reserves to broad money	62.6	65.9	67.4	77.0	68.7	67.0	64.3	61.4	58.7	53.8
External debt service (percent of exports of GNFS)	40.1	45.0	30.6	25.6	25.0	26.3	26.8	28.6	24.9	23.4
Short-term external debt service (percent of exports of GNFS) 4/	2.3	1.3	0.8	0.7	0.9	1.1	1.1	1.1	1.1	1.1
Public external debt service (percent of exports of GNFS)	22.8	30.8	21.7	17.8	18.7	18.9	19.4	21.5	18.0	16.7

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

1/ Spikes in 2008-09 reflect bullet-payment amortizations of international bond issues of 2002 and 2003.

2/ Includes interest payments only.

3/ Excludes privatization receipts.

4/ Interest only.

Table 12. Peru: Financial Soundness Indicators 1/
(In percent; unless otherwise indicated)

	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04
Capital Adequacy					
Equity capital to risk-weighted assets	12.8	12.8	12.5	13.3	14.0
Regulatory Tier I capital to risk-weighted assets 2/	12.7	12.4	12.4	12.1	13.1
Nonperforming loans net of provisions to capital	-4.6	-11.1	-17.2	-15.2	-17.3
Asset Quality					
Nonperforming loans to total gross loans 3/	9.7	9.0	7.6	5.8	3.7
In domestic currency	7.0	5.2	5.2	4.0	3.0
In foreign currency	10.3	9.9	8.2	6.3	3.9
Nonperforming loans to total gross loans 4/	16.8	17.0	14.6	12.2	9.5
In domestic currency	11.5	9.9	8.8	6.6	6.2
In foreign currency	17.9	19.0	16.4	14.1	10.8
Refinanced and restructured loans to total gross loans 5/	6.1	8.0	7.0	6.4	5.8
Provisions to nonperforming loans	107.4	118.9	133.2	141.1	176.5
Sectoral distribution of loans to total loans					
Consumer loans	6.7	8.6	9.4	11.6	13.4
Mortgage loans	7.8	9.6	10.7	12.9	14.2
Commercial loans	84.7	79.2	77.6	72.6	68.1
Small business loans	0.9	2.5	2.3	2.9	4.3
Earnings and Profitability					
ROA	0.3	0.4	0.8	1.1	1.2
ROE	3.0	4.5	8.4	10.8	11.3
Gross financial spread to financial revenues	47.9	51.9	66.1	71.2	71.9
Financial revenues to total revenues	80.3	78.8	72.7	70.6	69.1
Annualized financial revenues to revenue-generating assets	14.7	11.6	9.9	9.2	9.0
Liquidity					
Total liquid assets to total short-term liabilities	...	39.2	41.9	40.4	44.5
In domestic currency	19.4	22.6	23.5	32.9	44.8
In foreign currency	37.7	46.0	49.3	43.9	44.3
Foreign Currency Position and Dollarization					
Global position in foreign currency to regulatory capital 6/	35.7	37.6	37.0	31.8	24.2
Share of foreign currency deposits in total deposits	73.5	71.9	71.6	69.7	67.1
Share of foreign currency loans in total credit	81.9	80.5	79.7	77.9	75.7
Foreign currency deposits at commercial banks (in millions of U.S. dollars)	8,729	9,357	9,658	9,210	9,596
Commercial banks' short-term foreign assets (in millions of U.S. dollars)	824	748	779	601	547
Commercial banks' short-term foreign liabilities (in millions of U.S. dollars)	1,519	1,161	763	702	733
Operational efficiency					
Financing to related parties to capital 7/	...	...	20.1	18.7	14.3
Nonfinancial expenditure to total revenues 8/	29.8	32.1	36.2	37.7	35.9
Nonfinancial expenditure to total revenue-generating assets 8/	5.5	4.7	4.9	4.9	4.7
Memorandum items:					
Number of Banks	17	16	16	16	16
Private commercial	16	15	14	14	14
Of which: Foreign-owned	10	10	9	9	9
State-owned	1	1	2	2	2
Banks' credit card loans to total loans	0.0	2.4	3.3	4.6	6.4
Bank loans' 12 month increase (in real terms)	-11.7	-3.3	1.0	-8.3	-1.9
Stock market index (U.S. dollars)	342.8	342.1	396.0	700.6	1,131.6
Foreign currency debt rating (Moody's)	Ba3	Ba3	Ba3	Ba3	Ba3
Spread of Peruvian Brady bonds, basis points	687	521	610	312	220

Sources: Superintendency of Banks and Insurance of Peru; Central Bank of Peru; and Fund staff estimates/projections.

1/ These indicators correspond to private commercial banks.

2/ Tier I regulatory capital is equivalent to share capital and reserves. Risk-weighted assets include market risk exposure. In year 2002, the Tier I considers a reduction on *Banco Santander Central Hispano* capital due to the valorization before its merge with *Banco de Crédito* .

3/ Nonperforming loans are overdue loans after 15 days since the due date for commercial loans, after 30 days for small bussines loans. In the case of mortgage, consumer and leasing loans, they are considered overdue after 30 days since the due date only for the non paid portion and after 90 days, for all the credit. The overdue loans include credits under judicial resolution.

4/ Includes restructured loans, refinanced loans, and arrears.

5/ Refinanced loans refer to those loans subjected either term and/or principal modifications with respect to the initial debt contract. Restructured loans refer to those loans whose payments have been restructured according to the "*Ley General del Sistema Concursal"*.

6/ Global position in foreign currency corresponds to those items in the balance sheet subject to exchange rate risk.

7/ Financing to related parties corresponds to those loans to individuals and firms owning more than 4 percent of the bank.

8/ Nonfinancial expenditures do not consider provisions nor depreciations.

Table 13. Peru: Financial and External Vulnerability Indicators
(In percent; unless otherwise indicated)

	2001	2002	2003	2004 Prog.	2004 Prel.	Proj. 2005	Proj. 2006
Financial indicators							
Public sector debt/GDP	46.6	47.1	47.7	44.6	45.2	42.2	40.0
Of which: in domestic currency (percent of GDP)	7.2	7.0	7.2	7.2	7.0	6.8	6.4
90-day prime lending rate, domestic currency (end of period)	5.0	5.1	3.3	...	3.8	...	...
90-day prime lending rate, foreign currency (end of period)	3.1	2.4	1.7	...	1.7	...	...
Velocity of money 1/	3.8	3.8	4.0	4.0	4.0	4.0	4.1
Net credit to the private sector/GDP 2/	31.4	30.4	29.7	27.3	26.0	25.9	25.8
External indicators							
Exports, U.S. dollars (percent change)	0.8	9.9	16.4	22.9	39.6	8.8	0.9
Imports, U.S. dollars (percent change)	-1.8	2.7	11.3	8.0	18.9	8.4	6.9
Terms of trade (percent change)	-1.8	2.8	1.4	9.1	8.1	-2.6	-3.3
Real effective exchange rate, (end of period, percent change) 3/	4.4	-5.5	-10.7	...	0.8	...	...
Current account balance (percent of GDP)	-2.2	-2.0	-1.8	-0.7	-0.1	0.5	0.2
Capital and financial account balance (percent of GDP)	3.0	3.4	2.4	0.8	3.4	-1.0	-0.2
Total external debt (percent of GDP)	50.7	49.3	49.1	45.9	45.8	41.8	40.8
Medium- and long-term public debt (in percent of GDP) 4/	35.7	36.8	37.6	35.4	35.8	32.4	31.4
Medium- and long-term private debt (in percent of GDP)	8.9	7.9	7.3	6.9	6.0	5.7	5.8
Short-term public and private debt (in percent of GDP)	6.0	5.7	4.3	3.7	3.7	3.7	3.6
Total external debt (in percent of exports of goods and services) 4/	315.1	300.4	278.8	239.9	217.6	201.7	201.7
Total debt service (in percent of exports of goods and services) 5/	40.1	45.0	30.6	28.3	25.6	25.0	26.3
Gross official reserves, in							
millions of U.S. dollars	8,838	9,690	10,206	10,306	12,643	12,343	12,443
percent of short-term external debt 6/	149.9	217.2	214.0	225.5	257.0	243.3	238.4
percent of broad money 7/	62.6	65.9	67.4	64.8	77.0	68.7	67.0
percent of foreign currency deposits at banks	92.5	100.6	107.3	107.3	133.4	122.7	124.0
months of imports of goods and services	11.0	11.7	11.3	10.6	12.0	10.9	10.4
Net international reserves (in millions of U.S. dollars)	8,613	9,598	10,194	10,294	12,631	12,331	12,431
Net international reserves (program definition;							
in millions of U.S. dollars) 8/	5,056	5,830	6,906	7,064	9,304	9,005	8,985
Net foreign exchange position (in millions of U.S. dollars) 9/	2,914	3,341	4,583	4,683	6,892	6,592	6,692

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

1/ Defined as the inverse of the ratio of end-period broad money to annual GDP.
2/ Corresponds to the financial system.
3/ End of period.
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.

Table 14. Peru: Proposed Schedule of Purchases
Under the Stand-By Arrangement, 2004–06 1/

Amount of Purchase	Availability Date	Conditions Include
1. SDR 80.00 million 2/	June 9, 2004	Board approval of SBA.
2. SDR 23.031 million	August 31, 2004	Observance of end-June 2004 performance criteria.
3. SDR 23.031 million	October 31, 2004	Completion of the First Review and observance of end-September 2004 performance criteria.
4. SDR 23.031 million	February 28, 2005	Completion of the second review and observance of end-December 2004 performance criteria.
5. SDR 27.6372 million	August 31, 2005	Observance of end-June 2005 performance criteria.
6. SDR 27.6372 million	November 15, 2005	Completion of the third review and observance of end-September 2005 performance criteria.
7. SDR 27.6372 million	February 28, 2006	Completion of the fourth review and observance of end-December 2005 performance criteria.
8. SDR 27.6372 million	May 15, 2006	Observance of end-March 2006 performance criteria.
9. SDR 27.6372 million	July 31, 2006	Completion of the fifth review and observance of end-June 2006 performance criteria.

1/ Total access under the Stand-By Arrangement is SDR 287.279 million (21 percent of quota on an annual basis).
2/ Amount required to bring total disbursements outstanding to above 25 percent of quota.

Table 15. Peru: Capacity to Repay the Fund as of March 31, 2005 1/

(In millions of SDRs; unless otherwise indicated)

	2005 2/	2006	2007	2008	2009	2010	2011	Total
Obligations from existing drawings								
Principal (repurchases)	13.4	26.8	13.4	0.0	0.0	0.0	0.0	53.5
Charges and interest 2/								
GRA charges	1.3	1.0	0.1	0.0	0.0	0.0	0.0	2.4
SDR charges	1.7	2.3	2.3	2.3	2.3	2.3	2.3	15.2
Credit outstanding	40.1	13.4	0.0	0.0	0.0	0.0	0.0	...
(percent of quota)	6.3	2.1	0.0	0.0	0.0	0.0	0.0	...
Obligations from prospective drawings								
Principal (repurchases)	0	0	0	40.7	122.9	102.9	20.7	287.3
Charges and interest 3/								
GRA and service charges	3.3	8.7	9.9	9.8	7.4	2.9	0.4	42.4
Credit outstanding	244.5	300.7	287.3	246.6	123.6	20.7	0.0	...
(percent of quota)	38.3	47.1	45.0	38.6	19.4	3.2	0.0	...
Cumulative (existing and prospective)								
Principal (repurchases)	13.4	26.8	13.4	40.7	122.9	102.9	20.7	...
Charges and interest 3/								
GRA charges	4.6	9.6	10.1	9.8	7.4	2.9	0.4	...
SDR charges	1.7	2.3	2.3	2.3	2.3	2.3	2.3	...
Credit outstanding	284.6	314.0	287.3	246.5	123.6	20.7	0.0	...
percent of quota	44.6	49.2	45.0	38.6	19.4	3.2	0.0	...
percent of GDP	0.6	0.6	0.5	0.4	0.2	0.0	0.0	...
percent of exports of goods and services	2.8	3.0	2.7	2.2	1.0	0.2	0.0	...
percent of public sector debt service	10.8	12.4	10.6	8.1	4.5	0.8	0.0	...
percent of external public debt	1.8	1.9	1.7	1.5	0.7	0.1	0.0	...
percent of external public debt service	15.1	16.0	13.8	10.2	5.8	1.0	0.0	...
percent of gross foreign reserves	3.5	3.8	3.5	3.0	1.5	0.2	0.0	...
Memorandum items:								
Purchases	204.4	82.9	0.0	0.0	0.0	0.0	0.0	...

Sources: Fund staff estimates/projections.

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

2/ All figures for obligations are based on remainder of 2005.

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

Table 16. Peru: Millennium Development Goals

	1990	1995	2000	2001	2002	2003	2015 Target
Goal 1: Eradicate extreme poverty and hunger							
Population below $1 a day (in percent of population)	...	...	...	18.1	...	...	9.05
Poverty gap at $1 a day (in percent of total population,)	...	...	...	9.1	...	...	4.55
Percent of income or consumption held by poorest 20 percent	...	...	...	2.9	...	...	1.45
Prevalence of child malnutrition (in percent of children under 5)	10.7	7.8	...	7.1	...	...	5.35
Pop. below min. of dietary energy consumption (in percent of total)	40	18	...	11	...	...	20
Goal 2: Achieve universal primary education							
Net primary enrollment ratio (in percent of relevant age group)	...	90.8	...	99.9	...	...	100
Percentage of cohort reaching grade 5 (in percent)	...	...	...	87.4	...	...	100
Youth literacy rate (in percent of ages 15-24)	94.5	95.7	...	96.9	96.9	...	100
Goal 3: Promote gender equality and empower women							
Ratio of girls to boys in primary and secondary education (in percent)	96.1	96	...	...	...	...	100
Ratio of young literate females to males (in percent of ages 15-24)	95.1	96	...	97.1	97.3	...	100
Share of women employed in the nonagricultural sector (in percent)	28.9	30.5	...	34.6	...	...	...
Proportion of seats held by women in national parliament (in percent)	...	10	...	...	...	...	...
Goal 4: Reduce child mortality							
Under 5 mortality rate (per 1,000)							
Infant mortality rate (per 1,000 live births)	80	60	...	42	39	...	53.3
Immunization, measles (in percent of children under 12 months)	58	46	...	40	30	...	...
	64	98	...	97	95	...	...
Goal 5: Improve maternal health			...				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	410	...	...	307.5
Births attended by skilled health staff (in percent of total)	...	56.4	...	59.3	...	...	
Goal 6: Combat HIV/AIDS, malaria and other diseases							
Prevalence of HIV, female (in percent of ages 15-24)	...	...	0.26	0.2	0.21	...	0.1
Contraceptive prevalence rate (in percent of women ages 15-49)	54.7	64.0	...	68.9	...	...	...
Number of children orphaned by HIV/AIDS	...	...	...	17000	...	...	...
Incidence of tuberculosis (per 100,000 people)	183.3	196.7	133.6	196	202.4	...	...
Tuberculosis cases detected under DOTS		99		94	84.5	...	...
Goal 7: Ensure environmental sustainability							
Forest area (in percent of total land area)	53	...	...	50.9	...	...	...
Nationally protected areas (in percent of total land area)	...	2.7	...	2.7	6.1	...	...
GDP per unit of energy use (PPP $ per kg oil equivalent)	6.8	8.9	...	10.4	...	...	...
CO2 emissions (metric tons per capita)	1	1	...	1.1	...	...	...
Access to an improved water source (in percent of total population)	74	...	...	80	...	...	87
Access to improved sanitation (in percent of total population)	60	...	...	71	...	...	...
Access to secure tenure (in percent of total population)	...	...	...	...	...	...	...
Goal 8: Develop a Global Partnership for Development							
Youth unemployment rate (in percent of labor force ages 15-24)	15.8	11.4	...	13.2	15.2	...	...
Fixed line and mobile telephones (per 1,000 people)	26.2	50.3	...	136.7	152.3	...	...
Personal computers (per 1,000 people)	...	14.9	...	47.9	43	...	...

Sources: United Nations, Report 2004.

Peru—Debt Sustainability Analysis[1]

Under the baseline debt sustainability scenario, Peru's debt-to-GDP ratios would decline to moderate levels over the medium term. Economic growth would average 4½ percent a year and the overall deficit of the combined public sector would be kept at the equivalent of 1 percent of GDP, in line with the requirements of the Fiscal Responsibility and Transparency Law. Medium-term fiscal projections assume that government revenue would remain broadly unchanged over the medium term, which implies that new tax measures will have to be implemented to compensate for the revenue loss associated with the elimination by end-2006 of several temporary taxes, including the tax on financial transactions. Under these assumptions, Peru's public sector debt stock would decline from 45 percent of GDP at end-2004 to about 34 percent of GDP by 2010.

Peru's external and public sector debt ratios are robust to alternative assumptions about underlying macroeconomic variables. Debt dynamics are only moderately vulnerable to a decline in real GDP growth. Standard sensitivity tests suggest resiliency, as the introduction of shocks on key variables (using 10-year historical standard deviations) do not significantly alter medium-term projections. Even under more severe stress tests, e.g. two-standard-deviation shocks, the debt ratios generally decline once conditions normalize.

External and public debt ratios are sensitive to changes in real growth and, given the high foreign currency composition of Peru's debt, to exchange rate changes. Peru's debt dynamics are resilient to short-term real exchange rate shocks of magnitudes experienced by Peru in the recent past.

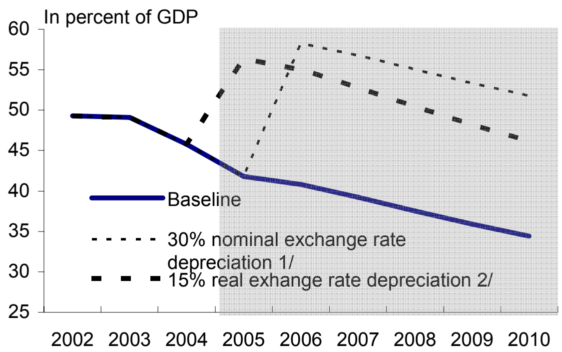
- A country-specific scenario, assuming a shock to Peru's terms of trade, leading to a sustained 15 percent real depreciation and a reduction in projected output by 4 percentage points in 2005 would result in a sharp increase in external and public debt ratios. However, with the subsequent recovery in output and the exchange rate, those ratios would decline somewhat, supported by the strong fiscal primary balance. By 2010, the public debt-to-GDP ratio would be around 46 percent of GDP.

- A sustained 30–percent real depreciation of the *sol* would lead to a protracted period of higher debt ratios. Although these ratios would evidence a declining trend after the initial shock, the public debt-to-GDP ratio would still remain equivalent to 50 percent of GDP and the external debt-to-GDP ratio about 54 percent of GDP by 2010.

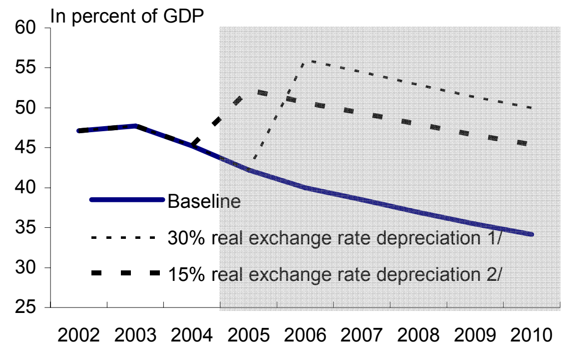
[1] The DSA includes standard sensitivity tests around the baseline medium-term scenario. The methodology used is in line with that endorsed in the assessing sustainability (See www.imf.org).

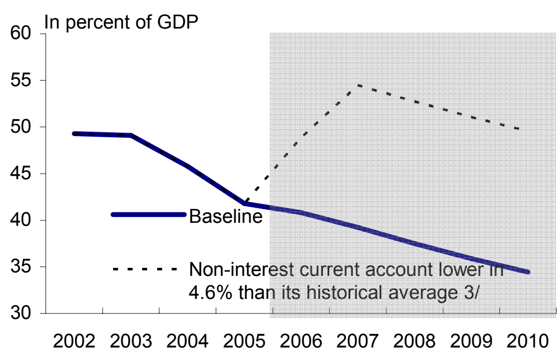
External Debt and Public Sector Debt Sustainability

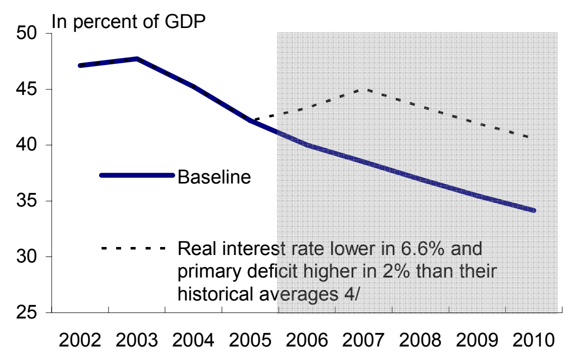
External Debt

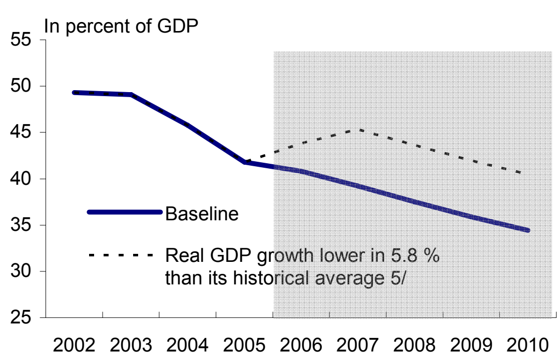


Gross Public Sector Debt









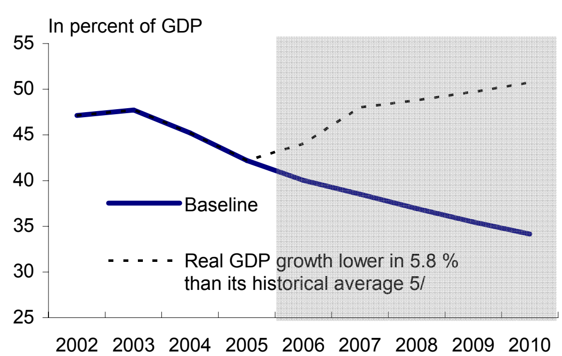


Chart Notes:
1/ Effect of one time 30 percent depreciation of the *Nuevo Sol* in 2006.
2/ Effect of one time 15 percent real depreciation of the *Nuevo Sol i* n 2005, and endogenous current account adjustment.
3/ Effect of a decrease by two standard deviations in 2006-07 of historical average (-0.9 percent) of non-interest current account.
4/ Effect of combination of an increase by two standard deviations in 2006-07 of historical average (0.5 percent) of interest rates and a decrease by two standard deviations in 2006-07 of historical average of primary balance (0.5 percent).
5/ Effect of a decrease by two standard deviations in 2006-07 of historical average (3.5 percent) of real GDP growth.

Table 1. Peru. External Debt Sustainability Framework, 1999-2010
(In percent of GDP, unless otherwise indicated)

	Actual 2001	2002	2003	2004			Projections 2005	2006	2007	2008	2009	2010	
									I. Baseline Projections				**Debt-stabilizing non-interest current account 6/**
1 **External debt**	50.7	49.3	49.1	45.8			**41.8**	**40.8**	**39.2**	**37.5**	**35.9**	**34.4**	**0.3**
2 Change in external debt	-1.5	-1.4	-0.2	-3.3			-4.0	-1.0	-1.6	-1.7	-1.6	-1.5	
3 Identified external debt-creating flows (4+8+9)	0.7	-3.6	-1.3	-7.4			-4.2	-1.6	-1.4	-1.4	-1.1	-1.0	
4 Current account deficit, excluding interest payments	-0.9	-0.4	-0.5	-2.0			-2.8	-2.7	-1.8	-1.7	-1.4	-1.3	
5 Deficit in balance of goods and services	1.8	1.2	0.3	-2.6			-2.8	-2.0	-1.0	-0.8	-0.5	-0.2	
6 Exports	16.1	16.4	17.6	21.0			20.7	20.2	19.4	19.3	19.0	18.7	
7 Imports	17.9	17.6	17.9	18.5			18.0	18.2	18.4	18.4	18.5	18.5	
8 Net non-debt creating capital inflows (negative)	-1.4	-3.0	0.2	-1.9			0.5	0.5	0.4	0.4	0.4	0.4	
9 Automatic debt dynamics 1/	3.0	-0.1	-1.1	-3.5			-1.9	0.6	0.0	-0.1	-0.1	-0.1	
10 Contribution from nominal interest rate	3.1	2.4	2.2	2.1			2.3	2.4	2.4	2.3	2.2	2.1	
11 Contribution from real GDP growth	-0.1	-2.3	-1.7	-2.2			-1.9	-1.8	-1.7	-1.7	-1.6	-1.5	
12 Contribution from price and exchange rate changes 2/	0.1	-0.2	-1.6	-3.4			-2.4	0.0	-0.6	-0.7	-0.7	-0.7	
13 Residual, incl. change in gross foreign assets (2-3)	-2.2	2.2	1.1	4.1			0.2	0.6	-0.2	-0.3	-0.5	-0.5	
External debt-to-exports ratio (in percent)	315.1	300.4	278.8	217.6			201.7	201.7	202.1	194.8	189.2	183.8	
Gross external financing need (in billions of US dollars) 3/	6.7	7.2	5.6	4.8			4.6	4.9	5.7	6.3	6.0	6.0	
in percent of GDP	12.5	12.7	9.2	7.1			6.1	6.2	6.8	7.0	6.3	5.9	
Key Macroeconomic Assumptions					10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	0.2	4.9	3.8	5.1	3.5	2.9	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Exchange rate appreciation (US dollar value of local currency, change in percent)	-1.5	-0.3	1.1	1.9	-4.2	5.1	3.3	-1.9	-0.5	-0.5	-0.5	-0.5	-0.1
GDP deflator in US dollars (change in percent)	-0.1	0.3	3.4	7.5	1.0	5.5	5.5	0.1	1.5	1.9	1.9	1.9	2.1
Nominal external interest rate (in percent)	5.9	5.0	4.9	4.9	5.6	0.8	5.6	6.1	6.2	6.2	6.1	6.1	6.0
Growth of exports (US dollar terms, in percent)	0.9	7.4	15.1	34.9	10.4	12.0	8.6	2.1	1.8	5.6	4.9	5.2	4.7
Growth of imports (US dollar terms, in percent)	-0.9	3.5	9.2	16.2	6.5	13.0	7.3	6.2	7.1	6.7	7.0	6.4	6.8
Current account balance, excluding interest payments	0.9	0.4	0.5	2.0	-0.9	2.3	2.8	2.7	1.8	1.7	1.4	1.3	1.9
Net non-debt creating capital inflows	1.4	3.0	-0.2	1.9	2.7	2.0	-0.5	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4
A. Alternative Scenarios													**Debt-stabilizing non-interest current account 6/**
A1. Key variables are at their historical averages in 2006-10 4/							**41.8**	**41.1**	**39.5**	**37.8**	**35.9**	**34.0**	**-2.3**
A2. Country-specific shock in 2005, with real depreciation of 15 percent 5/							**56.3**	**55.0**	**52.8**	**50.4**	**48.2**	**46.2**	**0.3**
B. Bound Tests													
B1. Nominal interest rate is at historical average plus two standard deviations in 2006 and 2007							**41.8**	**41.3**	**40.1**	**38.4**	**36.8**	**35.3**	**0.3**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007							**41.8**	**43.8**	**45.3**	**43.6**	**42.0**	**40.5**	**0.3**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2006 and 2007							**41.8**	**45.7**	**50.1**	**48.3**	**46.7**	**45.1**	**0.4**
B4. Non-interest current account is at historical average minus two standard deviations in 2006 and 2007							**41.8**	**48.9**	**54.5**	**52.7**	**51.1**	**49.5**	**0.2**
B5. Combination of B1-B4 using one standard deviation shocks							**41.8**	**50.7**	**59.5**	**57.4**	**55.4**	**53.6**	**0.3**
B6. One time 30 percent nominal depreciation in 2006							**41.8**	**58.3**	**56.8**	**55.0**	**53.3**	**51.8**	**0.4**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in 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 $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) 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/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

5/ The implied change in other key variables under this scenario is discussed in the text.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 2. Peru. Public Sector Debt Sustainability Framework, 1999-2010
(In percent of GDP, unless otherwise indicated)

	Actual 2001	2002	2003	2004			Projections 2005	2006	2007	2008	2009	2010	
									I. Baseline Projections				**Debt-stabilizing primary balance 10/**
1 **Public sector debt 1/**	46.6	47.1	47.7	45.2			**42.2**	**40.0**	**38.5**	**36.9**	**35.5**	**34.2**	**-0.1**
o/w foreign-currency denominated	39.4	40.1	40.6	38.3			35.4	33.6	30.8	29.5	28.4	27.3	
2 Change in public sector debt	0.7	0.6	0.6	-2.5			-3.0	-2.2	-1.5	-1.6	-1.5	-1.3	
3 Identified debt-creating flows (4+7+12)	0.4	-0.8	-0.9	-4.4			-3.1	-1.0	-1.3	-1.4	-1.3	-1.2	
4 Primary deficit	0.0	0.0	-0.4	-1.0			-1.2	-1.4	-1.3	-1.3	-1.2	-1.0	
5 Revenue and grants 11/	18.2	17.7	18.2	18.2			18.2	18.3	18.1	18.1	18.0	17.9	
6 Primary (noninterest) expenditure	18.2	17.7	17.9	17.2			17.0	16.9	16.8	16.8	16.8	16.9	
7 Automatic debt dynamics 2/	1.0	-0.1	-0.4	-3.2			-1.8	0.4	0.0	-0.1	-0.1	-0.1	
8 Contribution from interest rate/growth differential 3/	1.9	-0.2	-0.7	-2.5			-0.7	-0.2	-0.2	-0.3	-0.3	-0.2	
9 Of which contribution from real interest rate	2.0	1.9	1.0	-0.3			1.3	1.5	1.5	1.4	1.3	1.3	
10 Of which contribution from real GDP growth	-0.1	-2.1	-1.7	-2.2			-1.9	-1.8	-1.7	-1.6	-1.6	-1.5	
11 Contribution from exchange rate depreciation 4/	-0.9	0.1	0.3	-0.7			-1.1	0.6	0.2	0.2	0.1	0.1	
12 Other identified debt-creating flows	-0.6	-0.7	-0.1	-0.2			-0.1	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	-0.6	-0.7	-0.1	-0.2			-0.1	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3)	0.3	1.4	1.5	1.9			0.1	-1.2	-0.2	-0.2	-0.1	-0.1	
Public sector debt-to-revenue ratio 1/	255.9	266.1	261.8	248.5			231.9	219.0	212.9	204.1	196.7	190.6	
Gross financing need 5/	4.8	6.2	4.5	4.0			3.9	3.7	3.7	4.1	3.4	3.3	
in billions of U.S. dollars	2.6	3.5	2.7	2.7			3.0	2.9	3.1	3.6	3.2	3.4	
Key Macroeconomic and Fiscal Assumptions					10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	0.3	4.9	3.7	5.1	3.5	2.9	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Average nominal interest rate on public debt (in percent) 6/	4.9	4.9	4.7	4.9	5.3	1.0	5.2	6.0	6.2	6.3	6.3	6.3	6.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent) 12/	4.4	4.3	2.3	-0.5	0.5	3.3	3.1	4.0	4.2	3.9	3.9	3.9	3.8
Nominal appreciation (increase in US dollar value of local currency, in percent)	2.4	-0.3	-0.6	1.9	-4.4	5.6	3.2	-1.8	-0.5	-0.5	-0.5	-0.5	-0.1
Inflation rate (GDP deflator, in percent)	0.5	0.6	2.4	5.4	5.4	4.1	2.2	2.0	2.1	2.4	2.4	2.4	2.2
Growth of real primary spending (deflated by GDP deflator, in percent)	-2.8	2.0	4.6	1.1	2.9	3.8	3.4	3.6	4.0	4.6	4.7	4.8	4.2
Primary deficit	0.0	0.0	-0.4	-1.0	-0.5	1.0	-1.2	-1.4	-1.3	-1.3	-1.2	-1.0	-1.2
A. Alternative Scenarios									**II. Stress Tests for Public Debt Ratio**				**Debt-stabilizing primary balance 10/**
A1. Key variables are at their historical averages in 2006-10 7/							**42.2**	**39.8**	**38.1**	**36.4**	**34.7**	**33.1**	**-0.9**
A2. Country-specific shock in 2005, with real depreciation of 15 percent 8/							**52.2**	**50.6**	**49.4**	**47.9**	**46.6**	**45.4**	**0.4**
B. Bound Tests													
B1. Real interest rate is at historical average plus two standard deviations in 2006 and 2007							**42.2**	**41.2**	**40.9**	**39.3**	**37.8**	**36.5**	**-0.1**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007							**42.2**	**44.0**	**48.0**	**48.8**	**49.7**	**50.8**	**-0.2**
B3. Primary balance is at historical average minus two standard deviations in 2006 and 2007							**42.2**	**42.8**	**44.0**	**42.4**	**40.9**	**39.6**	**-0.1**
B4. Combination of B1-B3 using one standard deviation shocks							**42.2**	**43.3**	**45.1**	**43.4**	**41.9**	**40.6**	**-0.1**
B5. One time 30 percent real depreciation in 2006 9/							**42.2**	**56.0**	**54.5**	**52.9**	**51.3**	**50.0**	**-0.2**
B6. 10 percent of GDP increase in other debt-creating flows in 2006							**42.2**	**50.0**	**48.5**	**46.9**	**45.4**	**44.1**	**-0.1**

1/ Gross debt of the public sector including debt of public enterprises and the central bank.
2/ 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; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ The implied change in other key variables under this scenario is discussed in the text.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.
11/ Net of transfers among non-financial public institutions.
12/ Calculated for period 1995-2003 to exclude the effect of recovery from hyperinflation during early 1990s.

Peru: Fund Relations

(As of March 31, 2005)

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

		SDR Million	Percent Quota
II.	**General Resources Account**	**SDR Million**	**Percent Quota**
	Quota	638.40	100.00
	Fund holdings of currency	691.93	108.39
III.	**SDR Department**	**SDR Million**	**Percent Allocation**
	Net cumulative allocation	91.32	100.00
	Holdings	0.20	0.22
IV.	**Outstanding Purchases and Loans**	**SDR Million**	**Percent Quota**
	Extended arrangements	53.50	8.38

V. **Financial Arrangements**

Type of Arrangement	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	6/09/04	8/16/06	287.28	0.00
Stand-By	2/01/02	2/29/04	255.00	0.00
Stand-By	3/12/01	1/31/02	128.00	0.00

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

	Overdue 12/31/03	2005	2006	2007	2008
Principal	0	13.38	26.75	13.38	0.00
Charges/interest	0	2.97	3.22	2.39	2.26
Total	0	16.34	29.97	15.77	2.26

VII. **Safeguard Assessments**

The safeguards assessment of the central bank was completed on October 26, 2004. The assessment found that, with few exceptions, safeguards at the *Banco Central de Reserva del Peru* (BCRP) meet the requirements of the safeguards policy. The assessment recommended that by end-January 2005 the BCRP and the Comptroller General's Office agree on a Memorandum of Understanding, already under discussion, which would harmonize the respective organic laws in the area of oversight of the external and internal audit mechanisms.

VIII. **Exchange Arrangements**

Peru maintains a unified, managed floating exchange rate. On March 23, 2005, the average of interbank buying and selling rates was 3.26 *Nuevo Sol* per U.S. dollar. The central government maintains external payments arrears to unguaranteed suppliers, some of whom are in discussions with the government, while the rest have not been located. Peru has maintained a clearing arrangement with Malaysia since 1991.

IX. Last Article IV Consultation

The 2003 Article IV consultation was concluded on February 23, 2004 (IMF Country Report No. 04/155).

X. FSAP and ROSCs

Several joint Fund-Bank missions visited Lima in the period September 2000–January 2001 to conduct an FSAP for Peru. The corresponding FSSA report (dated February 28, 2001, see www.imf.org) was discussed by the Executive Board on March 12, 2001. A follow-up FSAP mission was concluded in February 2005. In October 2002, an FAD mission conducted a Fiscal ROSC for Peru, while an STA mission conducted a Data ROSC for Peru in February 2003.

XI. Technical Assistance

Department	Date	Purpose
FAD	May 2005	Tax policy and administration
	September 2003	
	September 2002	
	June 2000	
	August 2004	Public investment and fiscal policy, including issues related to PPPs.
	November 1999	Fiscal rules
MFD	April 2005	Consumer protection in the banking system
	March, 2005	Central bank organization
	March, September 2004	
	February 2003	
	April, December 2002	Inflation targeting
	October 2002	Foreign exchange operations
	August 2002	Accounting and organizational issues
	May 2002	Inflation targeting
	March 2002	Monetary operations and government securities market
STA	January 1998 and	National account statistics, new
	October 1999	base year for the national account series

XII. Resident Representative

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

Peru: World Bank Relations

Bank Group strategy

The World Bank Group Country Assistance Strategy (CAS), discussed by the IBRD Board on September 17, 2002, supports the implementation of the government's poverty reduction strategy with programs addressing fiscal, national competitiveness, and social-sector needs. In November 2003, the Bank decided to move Peru to a CAS high-case lending scenario with a total envelope of around US$300–400 million a year over FY04–06. New lending includes quick-disbursing programmatic loans investment projects for an additional US$200 million a year.

In FY 2004, following the additional priorities outlined in the CAS, the Bank approved operations for US$357 million (See Appendix IV, IMF Country Report No. 04/155). As of December 2004 in FY 2005, the Bank had approved six loans: two programmatic adjustment loans for US$200 million, two technical assistance loans for US$16.4 million to support the programmatic loans, a technical assistance loan for US$20 million to support improvement of justice services, and a loan for US$5 million to foster sustainable development initiatives in the Vilcanota Valley.

Bank-Fund collaboration in specific areas

- *Tax Reform and Fiscal Decentralization*. Fund staff has taken the lead in assisting in the design of tax reform. Jointly with the World Bank and IDB, staff has worked on drafting laws and regulations for fiscal decentralization. The World Bank has also focused on the design and implementation of decentralization of the social sectors and pro-poor spending policies.
- *Financial Sector.* A joint FSAP was completed in May 2001. Follow up technical assistance to implement FSAP recommendations has been given by both institutions. A joint follow-up FSAP mission visited Peru in February 2005.
- *Public expenditure review (PER).* In a joint effort with the IDB, and close collaboration with the IMF, the Bank completed in June 2002 a comprehensive diagnosis of, and made policy recommendations for, Peru's public expenditure management. A social sector expenditure review, with support of the Fund, is being prepared to assess fiscal trends in the social sector under decentralization, review the quality of social spending, and fine-tune the on-going budgetary protection policy of priority social programs
- *Fiscal reforms.* In March 2002, the Bank and the Fund supported an international seminar (organized by the Ministry of Economy and Finance) on proposals for revising the law on fiscal prudence and transparency. A joint IMF-World Bank-IaDB mission took place in September 2004 for a pilot study on Public Investment and Fiscal Policy.
- *CAS follow-up and preparation of the Programmatic Loans* (Social Reform Loans I, II, III, and IV, and Decentralization and Competitiveness Loan I,II and III). The World Bank and the Fund have engaged in an interactive and continuous dialogue on CAS implementation and preparation of the subsequent programmatic loans. Dialogue has concentrated on the macroeconomic background, setting of triggers, overall loan conditionality, and risks and estimation of the fiscal implications of Bank operations.

Statement of World Bank Loans
(As of February, 2005)

Loan Number	Year approved	Borrower	Purpose	In millions of U.S. dollars: Total (Net of Cancellation)	Undisbursed
One hundred ten (116) loans fully disbursed[1]				4,942.6	
Partially disbursed or undisbursed loans:					
45190	1999	Republic of Peru	Agricultural Research and Extension	9.6	1.2
45270	1999	Republic of Peru	Health Reform Program	27.0	10.8
45360	2000	Republic of Peru	Indigenous People Development	5.0	4.0
46140	2001	Republic of Peru	Second Rural Roads Rehabilitation and Maintenance	50.0	20.5
71420	2002	Republic of Peru	Rural Water and Sanitation	50.0	47.4
71760	2003	Republic of Peru	Rural Education Project	52.5	48.5
71770	2003	Republic of Peru	Trade Facility and Productivity Improvement TA	20.0	19.0
72090	2003	Republic of Peru	Lima Transport Project	45.0	43.0
71600	2003	Republic of Peru	Lima Water Rehabilitation Additional Financing	20.0	19.3
72190	2004	Republic of Peru	Justice Services Improvement	12.0	12.0
72570	2004	Republic of Peru	Vilcanota Valley Rehabilitation Program	5.0	5.0
72550	2004	Republic of Peru	Institutional Capacity for Decentralization and Management	8.8	8.8
72540	2005	Republic of Peru	Accountability for Decentralization Soc.Sector	7.8	7.8
Total disbursed:				4,942.6	
of which : amount repaid				2,028.1	
Total outstanding [3]				2,896.2	
Total indisbursed					247.2

1/ Includes exchange rate adjustments and loans sold to third parties.

Statement of IFC Investments
(As of February, 2005)
In millions of U.S. dollars

	Loans	Equity	Quasi	Participation Loans	Total
Total commitments held by IFC	260.6	28.3	30	37.7	356.6
Total disbursed	172.1	27.7	30	37.7	267.5

Source: World Bank.

Peru: Relations with the Inter-American Development Bank

Country Strategy 2002-2006

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

Lending

As of March 1st, 2005, the country's portfolio consists of 25 loans for a total amount of US$1,514.3 million. These resources are distributed among 23 investment loans (US$914.3 million) and two policy-based loans (US$600 million). The lending program for 2005 relies on the approval of fourteen investment loans for US$412.8million.

In addition, the country portfolio with Peru includes 25 non-reimbursable technical cooperation grants (US$5.2 million) and six small projects (US$1.9 million). The Multilateral Investment Fund (MIF) has 34 non-reimbursable technical cooperation grants under execution (US$16.6 million).

IDB Loans Portfolio By Sector as of March 1st, 2005
(In millions of US$)

	Commitments	Disbursements	Percent Disbursed
Agriculture	83.9	53.3	63.5%
Education	87.0	32.4	37.2%
Environment	5.0	1.8	35.4%
Health	28.0	12.9	46.2%
Industry	200.0	190.6	95.3%
Public sector management	371.8	208.7	56.1%
Sanitation	0.8	0.0	0.0%
Social investment	432.9	194.5	44.94%
Transportation	245.0	137.4	56.1%
Urban development	60.0	0.7	1.2%
Total	**1,514.3**	**832.2**	**55.0%**

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. The dissemination of the advance release calendars and the metadata has been posted on the Fund's Dissemination Standards Bulletin Board. A data ROSC module was completed in 2003.

I. Real Sector

In June 2000, the authorities published a revised GDP series using the 1994 benchmark estimates, which includes detailed input-output tables, as the base year. However, due to limited availability of periodical source data, estimates after the year 1994 are largely based on extrapolation techniques. The lack of current detailed tables for supply and use hampers the reconciliation of discrepancies in the data. As a result, changes in inventories are mainly determined as a residual. Even though the quarterly accounts have benefited from some improvements in the timeliness of monthly production indices, their coverage is still very limited. The National Statistics Office (INEI) is working on a new national account series using 2001 as the base year.

The weight structure for the CPI is derived from a 1993–94 household expenditure survey. Except for weights, source data are timely and consistent with the technical requirements for producing the index. The coverage of owner-occupied housing, however, was eliminated from the Metropolitan Lima index through the exclusion of imputed rent, a deviation from international practices. Imputed rent is included in the indices of the other 24 cities in the CPI. Thus, the national index is a weighted average of indices that have different coverage. The weights for the WPI are also outdated. INEI derived the weights from the 1994 input-output table and other reports and publications of relevant ministries. The WPI statistical techniques follow generally accepted international standards.

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

II. Fiscal Sector

For the general government, GFS data are compiled using the analytical framework of the *GFS Manual 1986*. For the consolidated central government, revenues are compiled on a cash basis, while expenditures are compiled on an accrual basis. The authorities have sent to the Fund information on the components of consolidated central government expenditures by function. The authorities have recently prepared a plan to migrate to the *GFS Manual 2001,* but the schedule for migration is yet to be defined.

The authorities report annually GFS data for publication in the *Government Finance Statistics Yearbook (GFSY)* (on a cash basis only) and monthly for the *International Financial Statistics (IFS)*.

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

III. Monetary Sector

The BCRP prepares and publishes the analytical accounts of the banking system and of the central bank broadly in line with the methodology recommended by the Fund's *Monetary and Financial Statistics Manual*. The main discrepancy is the valuation of some financial instruments at cost rather than at market prices. Until early 2003, nonbank deposit-taking institutions were not included in the depository corporations' survey. However, following the recommendations of the February 2003 data ROSC mission, the BCRP expanded the coverage of the survey to incorporate them. Monetary statistics are disseminated only in summary form.

IV. External Sector

The BCRP is responsible for the compilation and dissemination of balance of payments and international investment position statistics. The BCRP prepares quarterly data on the balance of payments and international investment position largely in line with the recommendations of the *Balance of Payments Manual, Fifth Edition (BPM5).* These data are reported to the Fund for publication in the *IFS* and the Balance of Payments Statistics Yearbook. Some departures from *BPM5* include the lack of coverage of assets held abroad and land acquisition abroad by residents; lack of separate identification of liabilities to affiliated enterprises; and the recording of some external debt transactions that are not on an accrual basis.

Regarding international reserves, the BCRP has been reporting data weekly since August 2001, in accordance with the *Operational Guidelines for Data Template on International Reserves and Foreign Currency Liquidity.* The BCRP includes the full amount of the liquidity requirements in the reserve template under official reserve assets, but does not register the contingent net drain (as specified in Section III of the Data Template). Peru started to disseminate quarterly data on external debt with a one-quarter lag in end-September 2003. External debt data are not compiled on an accrual basis, as recommended by *BPM5* and the *External Debt Statistics: Guide for Compilers and Users.*

V. Findings of the Data ROSC Mission

A ROSC data module mission visited Lima during February 12–26, 2003. Although Peru's macroeconomic statistics are largely adequate for effective surveillance, the mission identified important shortcomings mainly in national accounts and price statistics. Most of the recommendations made by the mission have been implemented. However, the areas that still need to be improved include: (i) coordination among the agencies that compile official statistics to avoid duplication of efforts and confusion among users; (ii) establishing an updated business register that provides the basis for sample surveys; (iii) implementing a new benchmark and base year for GDP; (iv) expanding the coverage of the wholesale price index to include mining, oil and gas extraction, electricity and water, public transportation, and communication; (v) preparing sectoral breakdowns of depository corporations and financial surveys in accordance with the *MFSM* methodology; and (vi) expanding the scope of data sources for compiling financial flows of individual residents.

PERU: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF MARCH 25, 2005

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality Accuracy and reliability[8]
Exchange Rates	03/24/2005	03/25/2005	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	04/30/2005	05/06/2005	D	W	W		
Reserve/Base Money	03/21/2005	03/25/2005	W	W	W	O, LO, LO, LO	O, O, O, O, O
Broad Money	02/28/2005	04/15/2005	W	W	W		
Central Bank Balance Sheet	03/21/2005	03/25/2005	W	W	W		
Consolidated Balance Sheet of the Banking System	03/21/2005	03/25/2005	W	W	W		
Interest Rates[2]	03/24/2005	03/25/2005	D	D	D		
Consumer Price Index	Mar 2005	Apr 2005	M	M	M	O, LO, LO, LO	LO, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4/2004	02/21/2004	Q	Q	Q	O, LO, O, O	O, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	2/2005	03/25/2005	M	M	M		
Stocks of Central Government Debt[5]	Q4/2004	02/21/2004	Q	Q	Q		
External Current Account Balance	Q4/2004	02/21/2004	Q	Q	Q	O, LO, LO, LO	LO, LO, O, O, O
Exports and Imports of Goods and Services	01/2005	03/14/2005	M	M	M		
GDP/GNP	12/2005	02/18/2005	M	M	M	LO, LO, LO, LO	LNO, LNO, LNO, LO, LO
Gross External Debt	Q4/2004	02/21/2004	Q	Q	Q		

[1] Every Friday the Central Bank disseminates daily net international reserves, and weekly International Reserve Assets and Reserve Liabilities.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including type of instrument, maturity and type of creditor.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on October 4, 2003 and based on the findings of the mission that took place during February 12-26, 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Lima, May 20, 2005

Dr. Rodrigo de Rato y Figaredo
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. de Rato,

1. This letter and the attached Memorandum of Economic and Financial Policies (MEFP) present the policies that the Government of Peru intends to pursue during 2005 under its economic program, supported by the current Stand-By Arrangement from the Fund. It supplements the letter from the Minister of Economy and Finance and the President of the Central Reserve Bank of Peru dated May 25, 2004 and the letter from the Minister of Economy and Finance dated November 4, 2004. We believe that this program will help maintain macroeconomic stability, foster robust growth and employment, and further reduce financial vulnerabilities, particularly those associated to financial dollarization and public debt.

2. During 2004, Peru made further progress in stabilizing its economy and implementing measures aimed at sustaining a strong rate of economic growth. Economic growth rose to about 5 percent, inflation remained low within the inflation targeting framework, and Peru's external position strengthened substantially, reflecting strong export performance. The government also made significant progress in advancing its growth-enhancing reform program, particularly in areas related to public pension reform and the granting of privately-operated concessions for public asset management. All quantitative performance criteria for end-December 2004 were met.

3. In light of the strong performance under the program and our commitment to continue fostering macroeconomic stability and economic growth, we hereby request the completion of the Second Review under the Stand-By Arrangement. We also request (i) a waiver for non-observance of the structural performance criterion at end-December 2004 on the establishment of a commercial court in Lima, which became fully operational in April, 2005; (ii) a waiver for non-observance of the structural performance criterion at end-April, 2005 on the granting of concessions or entering into Public Private Partnerships for the construction and maintenance of at least two major roads, on the grounds that this deviation was temporary; a modification of this criterion in order to further specify it; and a resetting of its completion date to September 30, 2005; and (iii) that, due to the fact that there is one less set of performance criteria than initially envisaged under the program, future disbursements under the arrangement (excluding the disbursement that will become available upon completion of this review) be rephased into five equal amounts of SDR 27.6372 million, to be disbursed according to the original timetable. The quantitative performance criteria for the 2005 program are presented in attached Table 1 and the structural performance criteria and structural benchmarks in Table A attached to the Memorandum of Economic and Financial

Policies. In addition to the policies described in this letter and the attached MEFP, the Government of Peru stands ready to take additional measures as appropriate to ensure the achievement of its program's objectives. During the period covered by the Stand-By Arrangement, the authorities of Peru will maintain the usual close policy dialogue with the Fund. To this end, the program will have three more reviews, with the next review to be completed by mid-November, 2005. During this review, Peru's strategy to exit from Fund Arrangements at the end of the current Stand-By Arrangement will continue to be discussed.

Sincerely yours,

__________/s/_______________	___________/s/___________
Pedro Pablo Kuczynski	Oscar Dancourt, Acting President
Minister of Economy and Finance	Central Reserve Bank of Peru

Table 1. Peru: Quantitative Performance Criteria and Inflation Consultation Mechanism, 2005

	2005		
	Prog.		
	June 30	Sept. 30	Dec. 31
(Cumulative amounts from December 31, 2004, millions of New Soles)			
Borrowing requirement of the combined public sector 1/ 2/	-850	270	2,605
(Cumulative amounts from December 31, 2004, in millions of U.S. dollars)			
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions 3/4/5/	-232	-483	-300
Outstanding short-term external debt of the nonfinancial public sector	50	50	50
Contracting or guaranteeing of nonconcesional public debt with maturity of at least one year 6/ 7/	1,627	2,296	3,100
Of which: external debt of 1-5 year maturity	100	100	100
External payments arrears of the public sector (on a continuous basis)	0	0	0
(Consultation bands for the 12-month rate of inflation, in percent) 8/			
Outer band (upper limit)	5.5	5.5	5.5
Inner band (upper limit)	4.5	4.5	4.5
Central point	2.5	2.5	2.5
Inner band (lower limit)	0.5	0.5	0.5
Outer band (lower limit)	-0.5	-0.5	-0.5

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

1/ The borrowing requirement of the combined public sector will be adjusted upward by up to S./400 million for any negative operating financial result of the BCRP.
2/ PIPP proceeds are included below the line.
3/ The target for net international reserves will be adjusted upward by the amount by which net foreign borrowing of the nonfinancial public sector exceeds US$202 million at end-June, US$41 million at end-September, and US$97 million at end-December 2005. It will be adjusted downward for shortfalls from programmed net foreign borrowing. The amounts in excess will be deposited at the BCRP.
4/ The target for 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 2005.
5/ The target of net international reserves will be adjusted downward by up to US$400 million for the amortization of US-dollar denominated bonds issued under the Program of Consolidation of the Financial System that are paid in 2005 and have not been swapped into domestic currency instruments by the government during 2005.
6/ The limit will be adjusted upward by any amount of debt issued for, and used in, debt-exchange operations, or for prefinancing government operations in 2006.
7/ The limits will be adjusted upward by up to US$400 million for guarantees provided by or contracted by the government, including with multilaterals, in context of Private Public Partnerships (PPPs) and concessions.
8/ 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 discuss with the Fund staff the appropriate policy response and complete a consultation with the Executive Board of the Fund on the proposed policy response before requesting further purchases under the arrangement.

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2005

1. Peru's macroeconomic performance in 2004 was strong, reflecting close adherence by the government to its macroeconomic program. Led by private investment and exports, output grew by about 5 percent, formal employment in firms with 10 or more employees increased by 2.7 percent, and 12-month inflation was within the inflation target range of the Central Bank. Driven by a sharp increase in exports, the external current account balance shifted from a deficit of close to 2 percent of GDP in 2003 to virtual equilibrium and net international reserves rose to US$12.6 billion at end-2004. The overall deficit of the combined public sector was reduced from 1.7 percent of GDP in 2003 to 1.1 percent in 2004.

2. Progress was also made under the program in the area of structural reforms. In the area of public pensions, the reform of the *Cédula Viva* regime (end-December benchmark) was adopted ahead of the program timetable. In November, Congress gave the second-round approval to the constitutional amendment needed for the reform and, in early December, it approved the law reforming the regime. In December, the government also agreed on a plan to reform the pension regimes of the police and the military (end-September benchmark). In the area of decentralization, the law on the certification of regional governments' administrative capacity was implemented (end-December benchmark) but, due to a lack of political consensus, the law clarifying shared functional responsibilities among different levels of government (end-December benchmark) was not approved by Congress.

3. In the Judiciary, although the establishment of a commercial court module in Lima wasdelayed by a few months because of administrative bottlenecks, the court module became fully operational in April 2005. The announcement of a plan to centralize the information of collateral registries has also been delayed, but the government will announce its plan by end-September 2005. In the area of financial sector regulation, a system to measure and regulate foreign currency-induced credit risks was put into operation within the Superintendency of Banks (SBS) in mid-January 2005 (end-December benchmark); implementation of the regulatory requirements by banks is being gradually phased in over a period of 18 months.

4. The government's economic program for 2005 aims at consolidating the gains made in recent years and promoting sustained economic growth through the continued implementation of prudent macroeconomic policies and a deepening of its growth-enhancing reform program. Real GDP is projected to grow by 4½ percent in 2005 (with an upward bias), supported by strong investment and export growth. Year-end inflation is projected at 2.3 percent. Gross official international reserves are expected to continue to cover more than 100 percent of the banking system's dollar-denominated liabilities and close to 250 percent of short-term and maturing external debt, helping Peru deal with possible adverse shocks.

5. The government is committed to preserving the institutional framework upon which the Central Bank's independence is based, and to ensuring, within its constitutional competencies, that modifications to the Central Bank charter or any other norm that could undermine that autonomy will not be approved. Monetary policy will continue to be guided by the inflation targeting framework, with the Central Bank's target set at 2.5 percent, within a band of plus or minus 1 percent. Central Bank intervention in the foreign exchange market

will be limited to smoothing out excess volatility. The payment system under ALADI will continue to be used only for short-term trade operations.

6. The overall deficit of the combined public sector is targeted to decline to 1 percent of GDP in 2005. Central government tax revenue would remain broadly unchanged at about 13½ percent of GDP. Revenue losses associated with the elimination of the advanced corporate income tax payments, the removal of the payroll tax, and the reduction of the excise tax rate on petroleum products are expected to be offset by the introduction of the temporary corporate tax on net assets, improvements in tax administration, and an increase in value added tax collections. The government will continue to seek the removal of regional and sectoral tax exemptions and strictly avoid granting tax preferences to specific sectors of the economy.

7. To ensure adherence to the deficit target expenditure growth will be restrained. Selective expenditure increases will only be granted if they are consistent with the fiscal targets of the program. Public sector capital spending is projected to remain broadly stable at 3 percent of GDP.

8. The government will undertake public liability management operations with a view to further reducing fiscal vulnerabilities. The debt management strategy will aim at reducing rollover and market risks (currency and interest rate) and increasing gradually the share of long-term local currency instruments. The government will continue to explore the possibility of reprofiling existing debt through market-based operations. All external bond issues will continue to have collective action clauses.

9. The government will continue to reinforce the legal and institutional fiscal framework, consistent with a strong fiscal stance while allowing for counter-cyclical policies. To that effect, the main policy actions will be as follows:

- ***Fiscal Responsibility and Transparency Law (FRTL)***. The government will work with Congress to enact complementary FRTL legislation, with a view to strengthening procedures for compliance, monitoring, and requirements for reporting to Congress and the public. The legislative proposal will be submitted to Congress by June 2005.

- ***Public indebtedness.*** The government is working closely with Congress to enact a General Law on Public Indebtedness, which aims at providing an integral and stable legal framework that will contribute to an orderly and efficient administration of the public sector indebtedness. This draft law establishes rules on annual limits on debt and guarantees contracted through the central government, as well as on contingent liabilities contracted under concessions and private-public partnership programs. The Ministry of Economy and Finance is also working on a framework for transparent reporting of regional and local governments' debt, which will contribute to the sustainability of public finances. In addition, it is working on the design of a reporting system of public sector liabilities (including guarantees and other contingent liabilities).

- ***Public sector assets and investment projects.*** The government will begin building a database of the public sector assets and investment projects.

- ***Central government budget management.*** The government will continue to strengthen central government budget management and transparency, with Fund technical assistance. The central government budget formulation system and the Integrated Financial Management System (SIAF) will be unified by June 2005 and a system for prioritizing budget items will be introduced by December 2005.

- ***Public investment prioritization.*** The government will strengthen the National System of Public Investment (SNIP) to bolster its capacity to ensure efficient and sustainable public investment. This system will reinforce its project monitoring, ex-post evaluation, and pre-investment analysis. In the context of the 2006 Budget preparation, the government will strengthen budget procedures to ensure adequate maintenance of existing infrastructure and to prioritize public investment projects, taking into account their social, economic and financial returns, and their environmental and institutional sustainability. Coordination within the Ministry of Economy and Finance will be strengthened, with a view to enhancing and prioritizing the assessment of investment projects on the basis of all their components, including the costs to the government through commitments of future expenditure and guarantees of minimum revenue streams.

10. Peru's growth-enhancing reform program will focus on supporting well-prioritized investment, furthering Peru's integration into the regional and world economy, and fostering the business climate and competitiveness. To help expedite the judicial resolution of business-related disputes and bolster contract enforcement, a first commercial court module in Lima was established in April 2005. The government will continue establishing additional commercial courts in Lima and in the rest of the country.

11. The government will strengthen investment and maintenance of infrastructure in a fiscally sound manner, including through the Private Investment Promotion Program (PIPP), which includes concessions and Private-Public Partnership (PPP) operations. By end-September 2005, the government aims to have awarded in concession the stretch of the Pan-American highway between Pucusana and Ica and a major regional integration highway in the north. Other concessions/PPPs expected to be granted in 2005 include a major regional integration highway in central Peru, eleven regional airports, water and sewerage facilities in two cities, and a fourth band of cellular telephone operations.

12. The government will ensure that concessions and PPP operations are fiscally prudent and transparent. In this context, there will be no exemptions for any new concession/PPP projects involving government financial guarantees or subsidies to meet SNIP viability requirements. Also, by end-September 2005 the Ministry of Economy and Finance will establish guidelines and institutional procedures for deciding what projects could be implemented as private concessions/PPPs. To increase the transparency of fiscal commitments under concessions/PPP projects, the government will establish a reporting system of public sector liabilities (including contingent) associated with PPPs and

concessions, and issue a norm requiring the annual publication of such liabilities in the Multiyear Macroeconomic Framework beginning in 2006.

13. Steps also are being taken to consolidate the implementation of the decentralization process in a fiscally-neutral manner, while improving service delivery. Consistent with the decentralization legislation, the government will issue by end-June the plan for 2005 to devolve certain sectoral responsibilities to regional governments; in addition, it will work to prepare a devolution plan for the medium term by 2006. This multi-year plan will help clarify shared responsibilities among different levels of government and introduce well-specified criteria to ensure that program service delivery is maintained as devolution proceeds. To improve financial management at the municipal government level, the budget execution module of the SIAF will be extended to 170 municipalities during 2005, including most of the largest. Also, a pilot program will be established in 2005 to foster regional and local government financial management capacity. This program will include the development of multi-annual fiscal frameworks consistent with the Fiscal Decentralization Law and capacity-building in project pre-investment procedures, consistent with the SNIP. With World Bank support, the implementation of a SIAF cadastre module will be gradually extended during 2005 to support property tax collections by municipalities. The government will also issue by September 2005 the regulations implementing the Fiscal Decentralization Law, which aims at reinforcing prudent budgetary decisions and practices of regional and local governments.

14. Further efforts will be made to improve resource management in the public sector, with a view to creating more room for priority social spending. Following the adoption of the reform of the *Cédula Viva* (CV) public pension regime, low pensions under this regime have been raised, funded in part by a reduction in the highest pensions, and the administration of the CV regime will be centralized. Also, by end-September 2005 the government will submit to Congress a draft law to reform the pension regime of the police and the military. The Ministry of Economy and Finance will introduce by September 2005 a pilot program within the Management Control and Evaluation System to help improve the quality of spending in priority social programs. The government will continue to work with Congress to enact legislation for a fiscally prudent reform of the civil service employment.

15. The government will seek to improve targeting in the implementation of new and existing social programs. To that effect, a pilot program of well-targeted monthly transfers to the poor will be gradually implemented. The program aims at providing transfers to heads of households that meet child education, health, and nutritional requirements.

16. The government will enhance coordination of its policy and regulatory actions with a view to reducing further the vulnerabilities of the financial system and improving its efficiency. Efforts to reduce financial dollarization risks will be strengthened. By end-2005, the government will develop an operational plan to ensure that at least 50 percent of the mortgage loans financed by the *MiVivienda* program during the period January-June 2006 are denominated in domestic currency. The SBS will continue to strengthen supervision to ensure effective implementation of the recently-issued regulation in the area of foreign currency-induced credit risks. In this context, it will develop detailed actions to strengthen both off-site and on-site supervision, and will establish minimum standards for identifying and quantifying these risks and for implementing a satisfactory reporting system. The SBS

will ensure that consolidated supervision is effectively implemented, including for off-shore operations. In this regard, it will continue to implement high risk-based capital requirements on financial intermediaries' risky offshore operations, including those on which comprehensive information is not available. More specifically, actions will be taken so that all high-risk offshore loans, as well as loan for which comprehensive information is not available, will be covered by capital reserves or provisions.

17. The government will promote greater efficiency in financial intermediation, including through development of the domestic capital market. Actions will be taken to deepen the securities' secondary market, reduce administrative barriers to securitization and standardize financial contracts, including on mortgages. Also, competition among private pension fund administrators (PPFAs) is being enhanced, which should significantly reduce costs to contributors and enhance investment returns. In particular, recent regulatory changes facilitate the transfer of funds to the more efficient administrators and a fifth administrator is expected to enter in the market by end-July 2005. In addition, a system to allow each PPFA to offer investment portfolios with different risk return characteristics will become operational by end-November. Competition also should be fostered by a widening of the permissible band around the required rate of return. Moreover, the PPFAs will be encouraged to limit market risks, including those associated to stock market prices, currency, and interest rates. To help improve financial market transparency and efficiency, the SBS is developing a new methodology to price nontraded financial assets. The new methodology and set of reference prices will be published in July 2005 with a view to promoting their wider use in the banking system and institutional investors.

18. Public bank lending to the private sector will be closely monitored. During 2005, all of *Banco de la Nación*'s consumer lending programs will be monitored by the Ministry of Economy and Finance through quarterly targets. The operations of *Agrobanco* will continue to be in the form of channeling foreign lines of credit to agricultural producers, and its quasi-fiscal operations associated with lending to small-scale farmers will continue to be recorded in the budget.

Table A. Peru: Growth Enhancing Policy Actions for 2005

1. Structural Performance Criteria	
Grant concessions or enter into Public Private Partnerships for the construction and maintenance of the portion of the Pan-American highway from Pucusana to Ica, and a large regional integration highway in the north of Peru.	September 30
The Ministry of Economy and Finance will establish a reporting system of public sector liabilities (including contingent) associated with PPPs and concessions, and will issue a norm requiring the annual publication of such liabilities in the Multiyear Macroeconomic Framework beginning in 2006.	September 30
The Superintendency of Banks will issue inspection guidelines strengthening the implementation of the norms on foreign currency-induced credit risk, including at a minimum the concepts of unhedged borrowers and significant impact on the repayment capacity of economic agents.	September 30
2. Structural Benchmarks	
Unify the Central government budget formulation system and the Integrated Financial Management System (SIAF).	June 30
The Superintendency of Banks will publish and disseminate the new pricing methodology and reference prices of nontraded financial assets.	July 30
Announce a plan to centralize the information on collateral registries.	September 30
Issue the implementing regulations of the Fiscal Decentralization Law that support prudent budget decisions and management of the regional and local governments.	September 30
Start implementing a law on public indebtedness, as specified in paragraph 9 of this MEFP.	December 31
The government will develop an operational plan to ensure that at least 50 percent of the mortgage loans financed by the *MiVivienda* program during the period January-June 2006 are denominated in domestic currency.	December 31

TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

This technical memorandum sets out the understandings between the Peruvian authorities and the Fund relating to the monitoring of the program for 2005. It defines the concepts used to assess compliance with quantitative performance criteria specified in the letter of the Government of Peru dated May 20, 2005. It also sets the frequency of the data to be provided to the Fund for monitoring the program. For purposes of the program for 2005, operations in foreign currency will be converted into *Nuevos Soles* at the average program exchange rate of S/. 3.31 per U.S. dollar.

I. DEFINITIONS OF CONCEPTS

1. The nonfinancial public sector (**NFPS)** includes the central government, the autonomous agencies, the local and regional governments, and the nonfinancial public enterprises.

2. **The borrowing requirement of the combined public sector (PSBR)** will be measured as: (a) net domestic financing of the NFPS; plus (b) net external financing of the NFPS; plus (c) proceeds from the Private Investment Promotion Program (PIPP); and less (d) the operating balance of the Central Reserve Bank of Peru (BCRP). The PSBR will be adjusted to exclude the impact of data revisions that do not represent a change of its flows during 2005. The components of the PSBR (see 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**[14] 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[15] 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 and (v) the amortization of pension recognition bonds. In the case of enterprises that are divested after December 31, 2004 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); plus/minus (v) the net increase/decrease in short-term external debt;

[14] The **financial system** comprises the banking system, the *Corporación Financiera de Desarrollo* (COFIDE), and all other nonbank financial intermediaries. The banking system includes the BCRP, the commercial banks, the *Banco de la Nación* (BN), and *Agrobanco*.

[15] Excluding the new issuances of pension recognition bonds.

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/plus (viii) the net increase/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)) (see 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 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.

3. **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 2 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 3 percentage points around the central point of 2.5 percent, the authorities will discuss with Fund staff on a policy response and complete a consultation with the Executive Board of the Fund on the proposed policy response before requesting further purchases under the program.

4. **The net consumer lending of the *Banco de la Nación*** will be defined as disbursements of all consumer loans, including these under the "*Multired Program*" (established in November 2001) and "*Préstamos a 60 Cuotas*" (established in September 2004) less cash amortizations under the loan programs. Interest payments on these loans are excluded from the definition of net lending.

5. **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; 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.

6. **BCRP's silver holdings** will be included as net domestic assets and excluded from the net international reserves.

7. **BCRP's gold holdings** will be accounted at US$438.35 per troy ounce (the average book value as of December 31, 2004), SDRs at US$1.55301 per SDR, and foreign currency assets and liabilities of the BCRP in other currencies at the exchange rate of December 31, 2004. 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 2004 level of net international reserves is shown in Table 3.

8. 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*, and *Electroperú*. These limits exclude normal import financing but include forward commodity sales. 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 2004 stock of short-term external debt of the NFPS is shown in Table 4.

9. **The contracting or guaranteeing of nonconcessional public debt with a maturity of at least one year** refers to all domestic and external obligations as specified under the 2005 fiscal year Public Sector Debt Law (*Ley Nro. 28423*) of the NFPS contracted or guaranteed by the central government, COFIDE, the BCRP, the BN, and any other public financial entity, 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; (ii) any lending at concessional terms; and (iii) certificates (BCRPCD) issued by the BCRP for conducting monetary policy.

10. **For the purpose of the performance criterion on the contracting or guaranteeing of public debt,** external public debt applies also to commitments contracted or guaranteed for which value has not been received. In this regard, 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. Foreign currency public debt to be contracted or guaranteed will be converted based on the program exchange rate, with cross rates for non-dollar foreign currencies set based upon the rate on the day of the transaction, published by REUTERS.

11. 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 end-December 2005, the CIRRs published by the OECD in December 2004 will be used (see Table 5).

12. **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.

13. **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–2004 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.

14. **Definitions used in Table 1 of the letter of intent dated May 20, 2005 for the calculation of adjusters, limits and targets for net international reserves:**

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

b. **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 4 of Table 1 attached to the letter of intent dated May 20, 2005 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.

II. Periodic Reporting

15. Periodic reporting includes:

(a) The latest *Nota Semanal* published by the BCRP;
(b) Report of BCRP daily operations;
(c) Daily exchange rate statistics.
(d) Monthly Report of:

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

(ii) **Financial sector**
(a) Balance sheets of the consolidated financial system, consolidated banking system, BCRP, BN, commercial banks, *AgroBanco,* 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) Balance sheet of COFIDE and data on COFIDE guarantees.
(d) Balance sheet of the private pension system.
(e) Evolution of gross disbursements and cash amortizations of consumer loans under the "*Multired Program*" of *Banco de la Nación*.
(f) The stock of government guarantees for housing support programs and the 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).

(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 Noninterest Expenditure; and Transfers from the Central Government to the Rest of the General Government.

(g) Fuel prices of *Petroperú* and *Relapasa*, and international prices of products commercialized by *Petroperú* including tariffs, indirect taxes and distribution margins (prices would be listed for all grades of gasoline, diesel fuel, kerosene and fuel oils).

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

(iv) **External sector**

(a) Summary of imports by products (volume and prices); and

(b) Summary of exports by products (volume and price).

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

(f) **Other**

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

(b) BCRP circulars.

(c) BCRP inflation report.

Table 1 Peru: Public Sector Borrowing Requirement 2004
(In millions of nuevos soles)

	Stock as of Dec. 31 2003 1/	Stock as of Dec. 31 2004 1/	Flow
a. Net domestic financing of the nonfinancial public sector	**-116**	**-1,896**	**-1,780**
i. Net claims of the financial system (1+2+3)	-8,491	-10,175	-1,684
1. Net credit of the banking system on the NFPS and COFIDE	-11,298	-14,147	-2,849
Credits	7,302	6,708	-593
Liabilities	18,600	20,856	2,256
2. Net credit of COFIDE on the banking system	1,064	1,134	70
Credits	1,142	1,265	123
Liabilities	78	131	53
3. Net credit of nonbanking financial institutions on the NFPS	1,743	2,838	1,096
Credits	2,688	3,524	837
Liabilities	945	686	-259
ii. Stock of NFPS bonds in circulation	9,824	9,775	-49
(excluding bonds held by NFPS and of the financial system)			
1. Total	15,705	16,024	319
2. Less: holdings of the financial system (including COFIDE)	5,538	5,796	258
3. Less: holdings of nonfinancial public sector entities	344	453	110
iii. Floating debt	1,326	1,715	389
iv. Less: Accumulation of stocks, bonds, or other domestic financial assets by the NFPS	2,190	2,431	241
v. Less: Issuance of pension recognition bonds in program period	584	780	196
b. Net external financing			**3,572**
(Millions of US dollars)			1,079
c. Privatization			**377**
(Millions of US dollars)			114
d. Operating balance of the BCRP			**-89**
PSBR (a+b+c-d)			**2,257**

1/ Foreign currency valued at US$1 = S/. 3.31

Table 2. Peru: Net External Financing NFPS: 2004-2005 1/
(In millions of US$)

	2004	2005 Prog.			
		Jan.-Mar.	Jan.-Jun.	Jan.-Sep.	Jan.-Dec.
i. Loan disbursements	1,149	275	482	643	1,096
-Projects	286	110	236	397	500
-Nonprojects	862	165	246	246	596
ii. Bonds	1,295	427	427	427	427
iii. Cash payments on amortization	-1,323	-319	-707	-1,029	-1,425
- Loans	-1,256	-275	-662	-939	-1,336
- Bonds	-67	-45	-45	-90	-90
iv. Cash payments to settle arrears	0	0	0	0	0
v. Change in short term debt (increase+)	-11	0	0	0	0
A. Net foreign borrowing (i+ii-iii-iv+v)	**1,110**	**382**	**202**	**41**	**97**
vi. Prepayments	0	0	0	0	0
vii. Debt equity swaps	0	0	0	0	0
viii. Change in foreign assets held by the NFPS	60	50	50	50	50
ix. Investment project under the PIPP 2/	29	0	0	0	0
B. Net external financing (A-vi-vii-viii+ix)	**1,079**	**332**	**152**	**-9**	**47**

Source: Central Reserve Bank of Peru

1/ Excludes balance of payments support loans to the Central Reserve Bank of Peru.
2/ Includes disbursements for the project "Yuncán" since April 2004.

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 dollars)

		Stocks as of December 31, 2004
a.	**Assets**	**12,306**
	Deposits abroad	4,305
	Securities	7,485
	Gold 1/	489
	Holdings of SDR 2/	10
	Reciprocal credit agreement	7
	Cash	10
	Others	0
b.	**Liabilities**	**18**
	Reciprocal credit agreement	8
	Liabilities with international organizations	**10**
	IMF 2/	0
	IADB	10
	FLAR	0
c.	**Foreign currency deposits of financial institutions at the Central Bank**	**2,984**
	Banking enterprises	2,811
	Banco de la Nación	45
	COFIDE	70
	Financial enterprises	58
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/**	**9,304**
Memorandum items:		
1.	Subscription to the IMF and FLAR	320
2.	Pesos andinos	20
3.	CAF bonds	3
4.	Net international reserves, official definition (g+c+1+2+3)	12,631

Source: Central Reserve Bank of Peru.

1/ Gold valued at US$438.350
2/ Valued at US$1.55301 per SDR
3/ As defined in I.5.

Table 4. Peru: Short Term External Owed by the Non Financial Public Sector (as of December 31, 2004)

(In millions of US$)

	Export Financing	Working Capital	Import Financing	Total
Total	**0**	**0**	**88**	**88**
Petroperu	0	0	88	88
Electroperu	0	0	0	0
General government	0	0	0	0
Memorandum item:				
Total of export financing plus working capital loans	0	0	0	0

Sources: Central Reserve Bank of Peru and state companies.

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

	Average CIRRs (updated Dec 10, 2004)		Previous rates for loans with maturity =>15 years contracted in						
	Six-month	**Ten-year**	**before 1999**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
	08/15/04-02/14/05	1/95 - 12/04 1/	1/86-12/95	1/89-12/98	1/90-12/99	1/91-12/00	1/92 - 12/0	1/93 - 12/0	1/94 - 12/03
Australian Dollar	6.34%	7.24%	12.15%	10.15%	9.28%	8.55%	7.98%	7.68%	7.48%
Austrian Schiling 2/	n.a.	5.76%	8.35%	7.73%	7.65%	7.43%	6.72%	6.34%	6.03%
Belgian Franc 2/	n.a.	6.07%	9.25%	8.60%	8.45%	8.13%	7.21%	6.80%	6.44%
Canadian Dollar > 8.5 years	5.23%	6.69%	9.83%	8.90%	6.07%	6.78%	7.41%	7.34%	7.05%
Danish Krone	4.75%	6.09%	10.37%	8.88%	8.33%	7.80%	7.29%	6.81%	6.37%
Finnish Markkaa 2/	n.a.	6.02%	10.64%	9.32%	9.15%	8.72%	7.56%	6.92%	6.43%
French Franc 2/	n.a.	5.89%	9.62%	8.42%	8.19%	7.82%	6.95%	6.50%	6.16%
German Mark 2/	n.a.	5.73%	7.91%	7.62%	7.54%	7.27%	6.58%	6.23%	5.96%
Irish Punt 2/	n.a.	6.16%	10.37%	7.59%	8.36%	8.44%	7.44%	6.97%	6.50%
Italian Lira 2/	n.a.	6.47%	11.50%	10.38%	10.06%	9.71%	8.30%	7.61%	6.94%
Japanese Yen	2.08%	2.24%	5.53%	4.65%	4.30%	3.75%	3.17%	2.77%	2.45%
Korean Won	4.80%	9.04%	n.a.	n.a.	n.a.	11.57%	10.74%	10.19%	9.55%
Netherlands Guilder >8.5 year	n.a.	6.11%	8.08%	5.24%	5.81%	6.52%	6.95%	6.75%	6.43%
New Zealand dollar	7.10%	7.68%	12.17%	9.62%	8.90%	8.33%	7.97%	7.94%	7.80%
Norwegian Krone	4.45%	6.74%	11.27%	8.93%	8.36%	7.94%	7.60%	7.28%	7.04%
Spanish Peseta 2/	n.a.	6.65%	12.99%	11.35%	10.89%	10.31%	8.65%	7.92%	7.20%
Swedish Krona	5.15%	6.67%	11.67%	10.10%	9.42%	8.61%	8.04%	7.52%	7.08%
Swiss Franc	3.30%	4.31%	6.68%	3.78%	5.97%	5.67%	5.26%	4.85%	4.55%
U.K. Pound	5.82%	6.91%	10.37%	9.53%	8.99%	8.38%	7.85%	7.41%	7.16%
U.S. Dollar > 8.5 years	4.89%	6.36%	8.62%	7.93%	7.59%	7.35%	7.06%	6.85%	6.63%
Euro (ECU for ten-year avg	4.61%	5.80%	8.56%	7.99%	7.82%	7.13%	6.79%	6.40%	6.07%
Memorandum:									
SDR 3/	4.49%	5.64%	8.22%	7.51%	7.21%	6.85%	6.49%	6.17%	5.90%

1/ Estimates based on actual CIRRs for 1/95 to 12/04.
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.

Previous six-month rates

	loans with maturity <15 years, contracted between:											
based on rates:	2/15 thru 8/14/98	8/15/98- 2/14/99	2/15 thru 8/14/99	8/15/99- 2/14/00	2/15 thru 8/14/00	8/15/00- 2/14/01	2/15 thru 8/14/01	8/15/01- 2/14/02	2/15 thru 8/14/03	8/15/02- 2/14/03	2/15/03- 8/14/03	8/15/03- 2/14/04
Australian Dollar	6.42%	6.01%	6.34%	7.20%	7.47%	6.99%	6.27%	6.18%	6.83%	6.23%	5.83%	6.45%
Austrian Schiling	5.59%	4.99%	n.a	n.a	n.a.	n.a.	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.	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%	6.21%	5.69%	5.50%	5.24%
Danish Krone	5.77%	5.44%	4.72%	5.71%	6.46%	6.55%	6.01%	5.66%	6.15%	5.48%	4.85%	5.02%
Finnish Markkaa	5.52%	5.04%	n.a.	n.a.	n.a.	n.a.	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.	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.	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.	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.	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%	1.95%	1.64%	1.45%	1.92%
Korean Won	n.a.	n.a.	n.a.	10.51%	10.18%	8.85%	7.91%	7.42%	7.95%	7.00%	6.11%	5.94%
Netherlands Guilder >8.5 year	6.12%	5.43%	n.a.	n.a.	n.a.	n.a.	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%	7.51%	7.00%	6.45%	6.36%
Norwegian Krone	6.11%	6.58%	5.97%	6.82%	7.51%	7.98%	7.96%	7.46%	7.75%	7.34%	5.97%	5.27%
Spanish Peseta	5.68%	4.98%	n.a.	n.a.	n.a.	n.a.	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%	6.42%	5.85%	5.22%	5.31%
Swiss Franc	4.07%	3.91%	3.81%	4.50%	5.24%	5.17%	4.17%	3.89%	4.05%	3.06%	2.88%	3.39%
U.K. Pound	7.15%	6.53%	5.79%	6.97%	7.03%	6.59%	6.11%	5.96%	6.17%	5.60%	5.22%	5.69%
U.S. Dollar > 8.5 years	6.63%	5.92%	6.37%	7.18%	7.54%	6.86%	6.09%	5.67%	5.86%	4.75%	4.38%	4.75%
ECU/Euro	5.36%	4.72%	4.72%	5.82%	6.27%	6.15%	5.73%	5.53%	5.91%	5.27%	4.73%	4.85%
SDR	5.59%	5.01%	5.02%	5.80%	6.07%	5.88%	5.31%	5.04%	5.32%	4.53%	4.13%	4.46%

Sources: OECD and Funf staff calculations.

Table 6. Peru: Stock of Domestic Debt of the NFPS (as of Dec-31-2004)

	Legal Norm	Gross placements		Stock (estimated)
		Currency	Amount	(Millions of *Nuevos Soles*)
Credits from BN				**3,915**
Credit to central government		US$ / S/. / Y		2,856
Credit to local governments		US$ / S/.		191
Net public treasury overdraft		S/.		869
Bonds				**6,511**
Capitalización BCRP	D.S.066-94-EF	S/.	614	39
Serie A			239	39
Serie B			375	0
Bonos TP - Financial system strengthening	D.U. 041-99	US$	175	288
Bonos TP - Temporal suscription of stocks	D.U. 034-99	US$	52	171
Bonos TP - Temporal portfolio exchange	D.S. 114-98-EF	US$	136	0
Bonos TP - Debt exchange bonds	D.S. 068-99-EF	US$	259	500
Bonos TP - RFA and FOPE programs	D.S. 059-2000-EF / D.U. 050-2002	US$	108	357
Bonos TP - Financial system consolidation	D.U. 108-2000 / D.U. 099-2001	US$	392	1,276
Bonos TP - Sovereign bonds	D.S. 007-2002-EF / D.S. 041-2003-EF / D.S. 079-2003-EF D.S.162-2003-EF / D.S.015-2004-	S/.	6,720	3,770
Bonos TP - Caja de Pensiones Militar Policial Bonds	D.U. 030-2001	US$	34	111
Total				**10,426**
Memorandum items:				
Pension Reform Bonds (Bonos de Reconocimiento)	D.S. 096-95-EF	S/.		9,508
Floating debt		S/.		1,715

Source: Central Reserve Bank of Peru.

Press Release No. 05/137
FOR IMMEDIATE RELEASE
June 9, 2005

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Second Review Under Peru's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) has completed the second review of Peru's economic performance under a 26-month Stand-By Arrangement (see Press Release No. 04/112). The completion of the review makes available a total amount equivalent to SDR 149.1 million (about US$219.8 million), but the Peruvian authorities intend to continue treating the arrangement as precautionary.

In completing the review, the Executive Board also approved Peru's request for a waiver of the nonobservance of a performance criterion and the modification and resetting of another performance criterion. In addition, the Board also approved a rephasing of the country's future disbursements into five equal amounts of SDR 27.6 million (about US$40.7 million).

Following the Executive Board discussion, of Peru on June 8, 2005, Mr. Agustín Carstens, Deputy Managing Director and Acting chair, said:

"Peru's economic performance has continued to be strong in 2004 and the first half of 2005. Inflation remains low and official reserves are at a comfortable level. The outlook is positive, as the economy is expected to continue to benefit from the global recovery. In addition, Peru has built important buffers to mitigate vulnerabilities associated with public debt and financial dollarization. In the context of the national elections scheduled for early 2006, it will be important to maintain the consensus for policies aimed at promoting sustained growth and reducing poverty over the medium-term.

"Prudent fiscal management is at the core of the authorities' economic strategy, and fiscal policies are consistent with further consolidation in 2005. Given that part of the revenue increase projected for 2005 is expected to be temporary, the authorities need to avoid boosting expenditures on a permanent basis. They are also encouraged to keep expenditure in the supplementary budget to a minimum, and to use part of any excess tax revenue to reduce the fiscal deficit below program levels. This will help reduce Peru's public debt-to-GDP ratio and further bolster investor sentiment. The authorities are committed to strengthening the institutional framework to ensure efficient and transparent use of scarce resources for public investment. In this context it is important that procedures to identify projects eligible under the Private-Public Partnerships program be strictly observed.

"The central bank remains committed to keeping inflation low. Allowing the exchange rate to move more freely will be important to help insulate the economy against external shocks and speculative capital flows. It is also important that the central bank continues to gradually raise the limit on pension funds' investments abroad and further strengthen domestic capital markets in order to help diversify the risks of these funds.

"The authorities are making progress in increasing the resilience and efficiency of the financial sector. They are strengthening prudential regulations on lending to unhedged economic agents and improving the supervision of offshore bank subsidiaries. The authorities also intend to discourage mortgage lending in foreign currency, and are promoting greater efficiency in financial intermediation, including through the development of the domestic capital market. It will be important that the authorities strictly observe the limit on consumer lending by the state-owned bank, *Banco de la Nación*.

"Progress is continuing in the implementation of growth-enhancing reforms. In recent months, the authorities' focus has been on reforming the *Cédula Viva* public pension regime and on bolstering private investment by awarding infrastructure transportation in concession under transparent and fiscally-responsible procedures. The establishment of a commercial court in April 2005 and the centralization of collateral registries by end-September are expected to further enhance the business climate. Progress has also been made in strengthening the legal framework for prudent fiscal management, and the authorities have continued to actively pursue trade liberalization through bilateral and multilateral negotiations," Mr. Carstens said.

Statement by Javier Silva-Ruete, Alternate Executive Director for Peru
June 8, 2005

1. Adherence to the SBA continues to result in solid economic performance. Growth has accelerated, inflation is expected to stay within the annual target, and the external position is sound. The authorities' program for 2005 will help maintain macroeconomic stability, foster robust growth and employment, and further reduce financial vulnerabilities. Especially, the growth-enhancing reform program aims at ensuring sustainable growth and poverty reduction in the longer term by supporting well-prioritized investment, improving the business climate, and enhancing competitiveness. All quantitative performance criteria (PCs) for end-December 2004 were met, and delayed structural PCs are being implemented satisfactorily. Despite political noise, growth momentum remains strong. Moreover, the authorities continue to prove their ability to press ahead with key policies, and confirm their commitment to taking the necessary steps to ensure achievement of the program's objectives.

Macroeconomic Developments

2. Peru continues to show a healthy growth pattern, free from inflationary and balance-of-payments pressures, led by private investment and exports. In 2004, output grew by 4.8 percent, exceeding program projections. As of the beginning of 2005, the Peruvian economy had expanded for fifteen consecutive quarters. High growth in the first quarter (5.4 percent yoy) confirmed the upward bias in the original GDP growth forecast for 2005 (4.5 percent). As a result, the annual growth rate is now expected to be close to 5 percent. Private investment (which has grown steadily since the second half of 2002) posted a 7.7 percent increase yoy in the first quarter. Favorable international conditions, increasing corporate profits, and improving expectations fostered a further development of mining and energy projects, as well as higher investment in the manufacturing, electricity, commerce, hotel, and services sectors. Booming export growth (19.9 percent yoy in the first quarter) has resulted in commercial surpluses for eight consecutive quarters. High international prices continue to boost commodity exports, mainly mining products; and industrial exports, in particular textile, chemical, and agricultural goods, grew by 25 percent yoy in the first quarter (in dollar terms). In 2004, employment in firms with ten or more employees increased by 2.7 percent, and shows a growing trend (3.9 percent yoy in the first quarter).

3. Net international reserves continue to cover more than 100 percent of the banking system's dollar-denominated liabilities and around 250 percent of short-term external debt on a residual maturity basis, helping Peru deal with possible adverse shocks. Forex intervention has contributed to increasing international reserves, thus providing protection against the risks associated with the *de facto* partial dollarization of the financial system, considering the possibility of sharp movements in international interest rates or uncertainties in the run-up to the 2006

elections. As a result of economic expansion, good fiscal performance, and a solid external position, sovereign spreads reached historic lows in the first quarter of the year, and maintain a decreasing trend.

4. In 2004, the combined public sector deficit narrowed to 1.1 percent of GDP, compared to 1.7 percent in 2003. A good revenue performance —associated with a growing economy, favorable commodity prices, administrative policies aimed at expanding the tax base, and tax measures introduced since the second half of 2003—helped reduce the budget gap beyond the original fiscal target (1.4 percent of GDP). Central government non-financial expenditures decreased as a percentage of GDP, partially due to lower than authorized capital spending by local governments. In this regard, the authorities are taking measures to enhance implementation capacities at the sub-national level.

5. In 2005, the fiscal program considers a further reduction of the deficit to 1 percent of GDP. The temporary corporate tax on net assets and greater VAT collections are projected to offset losses associated with the reduction or elimination of other taxes—notably, the Special Payroll Tax (IES), at a fiscal cost of 0.2 percent of GDP. Reflecting continuing administrative improvements and growth, the annual filing for the corporate income tax in March-April reached a record high and generated a fiscal surplus of 2 percent of GDP in the first quarter. The authorities will continue to seek the removal of regional and sectoral tax exemptions, in coordination with Congress, and avoid granting new tax breaks. Due to pressing needs in priority sectors (education, health, security, and infrastructure), expenditure growth will exceed the limit of 3 percent in real terms established by the Fiscal Responsibility and Transparency Law (FRTL). However, the authorities will ensure that additional expenses are consistent with the annual deficit target. The medium-term macroeconomic framework envisages a deficit as a percentage of GDP of 1.0 percent in 2006 and 0.6 percent in 2007; and a decrease in public debt to around 40 percent of GDP in 2006 and 38 percent in 2007, from 45 percent in 2004.

6. In 2004, inflation was 3.48 percent, within the target range set by the Central Bank (1.53.5 percent). In spite of adverse supply shocks (mainly increases in world oil prices and weak agricultural crops), which generated a temporary rise in inflation, the monetary authorities met the announced inflation goal for the third consecutive year since the adoption of the inflation-targeting framework. The monetary policy setting has been instrumental in maintaining a stable interbank rate and promoting bank intermediation. In 2005, accumulated inflation as of end-May was 0.76 percent, in line with the year-end projection of 2.3 percent. Regarding the foreign exchange market, favorable balance of payments developments, a weaker dollar associated with the U.S. current account deficit, and improving investor sentiment towards emerging markets resulted in appreciatory pressures since mid-2004. In this context, forex intervention will continue to be limited to smoothing out excess volatility. As a consequence of

monetary and exchange rate conditions, financial dollarization decreased significantly, from 62 percent at end-2003 to 55 percent at end-2004. In addition, bank profits continue to improve due to the quality of the loan portfolio, reflected in the persistent drop in the ratio of non-performing loans, and provisioning has further strengthened.

Structural Reforms

7. In addition to the reform of the *Cédula Viva* public pension regime, approved in November, by end-September the authorities will submit to Congress a draft law to reform the pension regime of the police and the military. Also, they will continue to work with Congress to enact legislation for a fiscally prudent reform of the civil service.

8. With the aim of reinforcing transparency, accountability, and efficiency in the fiscal framework, the authorities will:

- Enact complementary FRTL legislation, in coordination with Congress, with a view to strengthening procedures for compliance, monitoring, and reporting to Congress and the public.

- Enact a General Law on Public Indebtedness (end-December benchmark), in coordination with Congress, to provide a policy framework for an orderly and efficient administration of public sector indebtedness. The draft law includes annual limits on debt and guarantees contracted through the central government, as well as on contingent liabilities. The authorities are also working on a reporting framework for sub-national debt.

- Unify the central government budget formulation system and the register and follow-up system for public sector operations (Integrated Financial Management System, SIAF) (end-June benchmark) and introduce a system for prioritizing budget items.

- Introduce a pilot program within the Management Control and Evaluation System to improve the quality of spending in priority social programs. Among the latter, the government is creating a conditional cash transfer system (*Juntos*) aimed at encouraging heads of poor households to meet child schooling, health, and nutrition goals. The program will be phased in gradually, and a pilot program will be launched to define implementation issues.

- Strengthen the system for pre-investment analysis, monitoring, and ex-post evaluation of public investment projects (National System of Public Investment, SNIP) to ensure efficient and sustainable public investment. Also, for 2006 the government will strengthen budget procedures to ensure maintenance of existing infrastructure and prioritize public investment projects.

- Ensure that all concessions/PPPs are fiscally prudent and transparent. Along these lines, all concessions/PPPs involving government financial guarantees or subsidies will be required to meet SNIP requirements. The authorities will also establish a reporting system of public sector liabilities (including contingent) associated with concessions/PPPs, and issue a norm requiring the annual publication of the stock of such liabilities in the Multiyear Macroeconomic Framework starting in 2006 (end-September structural PC).

9. The authorities attach importance to enhancing competitiveness, improving the business climate, and fostering private sector participation through the Private Investment Promotion Program (PIPP). They will strengthen investment and maintenance of infrastructure in a fiscally sound manner, including through concessions/PPPs. This year the government has awarded in concession to the private sector a phosphate deposit, a fourth band of cellular telephone operations and a major regional integration highway in northern Peru. Other concessions/PPPs to be granted in 2005 include a stretch of the Pan-American Highway (end-September structural PC), a major regional integration highway in central Peru, eleven regional airports, and water and sewage facilities in two cities.

10. Debt management policy will aim at further reducing rollover and market risks and increasing gradually the share of long-term local currency instruments. In this regard, the authorities are succeeding in extending maturities for nominal and inflation-indexed domestic currency-denominated bonds. Additionally, they will continue to explore ways to reprofile existing debt through market-based operations. Particularly, discussions are underway with the Paris Club on a proposal to prepay principal due between 2005 and 2009. The operation would be financed through the placement of longer-term commercial debt on international and local capital markets. All external bond issues will continue to include collective action clauses.

11. Steps are also being taken to consolidate the implementation of the decentralization process in a prudent and fiscally neutral manner. A law on the certification of regional governments' administrative capacity was implemented, but a law clarifying shared functional responsibilities among different levels of government was not approved. Instead, such responsibilities will be established in the context of a medium-term devolution plan currently being prepared by the government. The latter will also include specific criteria to ensure service delivery. In order to enhance management capacities at the sub-national level, the authorities will: (i) extend the budget execution module of the SIAF to municipalities starting this year; and (ii) establish a pilot program to develop sub-national multiyear fiscal frameworks consistent with decentralization legislation,

and to build capacity in project pre-investment procedures in line with the SNIP. The government will also issue the by-laws for the Fiscal Decentralization Law, which will reinforce prudent practices in sub-national governments (end-September benchmark).

12. To help expedite the judicial resolution of business-related disputes and facilitate contract enforcement, in April a first commercial court module became fully operative in Lima. The government intends to continue establishing such courts throughout the country.

13. The following policy and regulatory actions will be taken to further reduce the vulnerabilities of the financial system and improve its efficiency:

- The authorities will announce their plan for centralizing the information on collateral registries (end-September benchmark).

- In mid-January 2005, the Superintendency of Banks (SBS) put in place a system for quantifying and reporting foreign currency-induced credit risks. To strengthen implementation, the SBS will publish inspection guidelines touching on issues such as hedging and repayment capacity (end-September structural PC).

- As part of their strategy to reduce dollarization risks, the authorities will issue a plan to ensure that at least 50 percent of the mortgage loans financed by the *MiVivienda* housing program in January-June 2006 are denominated in domestic currency (end-December benchmark).

- The SBS will ensure that all high-risk offshore loans, as well as loans for which comprehensive information is not available, are covered by capital reserves or provisions.

- The authorities will persist in promoting the development of the domestic capital market, including through actions to deepen the secondary market for securities, reduce administrative barriers to securitization, and standardize financial contracts.

- Competition among private pension fund administrators (PPFAs) is expected to be enhanced by the entry of a new one by end-July. Also, the authorities will allow a wider range of permissible investment portfolios and rates of return, with the aim of reducing costs to contributors and enhancing investment gains. They continue to have reservations about raising again the limits for PPFAs' investments abroad, and remain convinced, based on international experience, that at this stage the PPFAs' pool of resources can play a critical role in developing the domestic capital market. The authorities also emphasize that the suggestion to increase further the limit for investments abroad has become less relevant since, as a consequence of current exchange rate conditions, the share of domestic currency-denominated assets—notably government paper—in the PPFAs' portfolio has increased considerably. Moreover, these assets show no signs of over-valuation, and therefore concerns about the creation of an asset bubble do not seem warranted.

- To help improve financial market transparency and efficiency, the SBS will publish a new methodology for pricing non-traded financial assets (end-July benchmark).

- Public bank lending to the private sector will be subject to close follow-up. *Banco de la Nación* consumer lending will be monitored through quarterly targets, and *Agrobanco* will continue to limit its operations to channeling foreign credit lines to agricultural producers.

14. The authorities are engaged in actively pursuing regional and bilateral free-trade agreements (FTAs). In particular, negotiations for an FTA with the U.S. are progressing. Finally, the authorities and the staff continue to discuss Peru's strategy to exit from Fund arrangements at the end of the current SBA.