July 2007
IMF Country Report No. 07/241

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

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

- the staff report for the First Review Under the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on May 15, 2007, 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 June 13, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff statement of June 27, 2007 updating information on recent developments;

- a Press Release summarizing the views of the Executive Board as expressed during its June 27, 2007 discussion of the staff report that completed the review; and

- a statement by the Executive Director for Peru.

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

Letter of Intent sent to the IMF by the authorities of Peru*

*Also be included in Staff Report

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

PERU

First Review Under the Stand-By Arrangement

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

Approved by Jose Fajgenbaum and G. Russell Kincaid

June 13, 2007

- **Stand-By Arrangement (SBA).** A 25-month SBA for SDR 172.37 million (27 percent of quota) was approved on January 26, 2007. The authorities intend to treat this arrangement as precautionary.

- **Performance under the program.** All performance criteria for end-March have been observed and all structural benchmarks have been implemented, except the clarification of the tax treatment for financial securitization transactions. The authorities have continued to implement sound macroeconomic policies and reforms toward achieving program objectives.

- **Review Issues.** The review focused on the implementation of the 2007 program and the policies to: i) to sustain strong fiscal performance and to strengthen the credibility of inflation targeting; ii) enhance the fiscal framework, the effectiveness of the tax system, and the quality of public spending; iii) implement the new plan to enhance the effectiveness of social assistance programs; iv) deepen financial intermediation and reduce dollarization; and v) promote higher sustainable growth.

- **Mission.** The team comprised M. Cerisola (head), M. Gonzalez, E. Jenkner (all WHD), Messrs. Adedeji (FAD), Breuer (PDR), and Gasha (MCM), visited Lima during May 2–15, 2007. The mission was assisted by Ms. Batini (resident representative).

- **Discussions.** In Lima, during May 2-15, the mission met with Prime Minister del Castillo, Minister of Finance Carranza, Central Bank President Velarde, Superintendent of Banks Fox, other senior public officials, and representatives from the private sector. The mission liased with the World Bank offices in Lima. Mr. Silva Ruete (OED) participated in some of the meetings.

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EXECUTIVE SUMMARY

Background

The economy is performing remarkably well. Real GDP growth is at record-highs; inflation is well-contained; fiscal prudence continues; external creditworthiness has solidified, and the financial system has strengthened. The program is on track, with significant progress on the structural front.

Key Issues

Sustaining a strong performance under the program should help Peru secure the benefits of prudent policies and reforms. Implementing sound macroeconomic policies and reforms would reduce vulnerabilities, entrench sustainable growth and reduce poverty, setting the stage for a strong exit from Fund-supported programs and for achieving investment grade.

Outlook and Risks. The economic outlook remains favorable, with risks largely dependent on external conditions, most notably related to commodity prices and global financial conditions.

Policies. The authorities remain committed to:

- ***Consolidate macroeconomic stability,*** by maintaining fiscal discipline and reducing vulnerabilities; and by advancing reforms, enhancing the inflation targeting framework, while maintaining an appropriate monetary stance.

- ***Preserve and improve the quality of public spending,*** by implementing a sound decentralization of the National System of Public Investment; strengthening the Fiscal Responsibility and Transparency Law; preserving a proper accreditation system for decentralizing spending functions; enhancing existing public financial management systems; and establishing an adequate framework for Private-Public Partnerships.

- ***Enhance the effectiveness of the tax regime,*** by streamlining it and broadening the tax base, including through a new framework for tax incentives and exemptions.

- ***Tackle high poverty levels,*** by implementing the action plan to enhance the effectiveness of social assistance programs and reforming universal programs.

- ***Strengthen the financial system,*** by reducing dollarization, particularly of mortgage loans; improving the regulatory and supervisory framework for public banks, and advancing reforms to deepen domestic capital markets.

- ***Advance growth-enhancing reforms,*** by further opening the economy, increasing labor formality and improving the business environment.

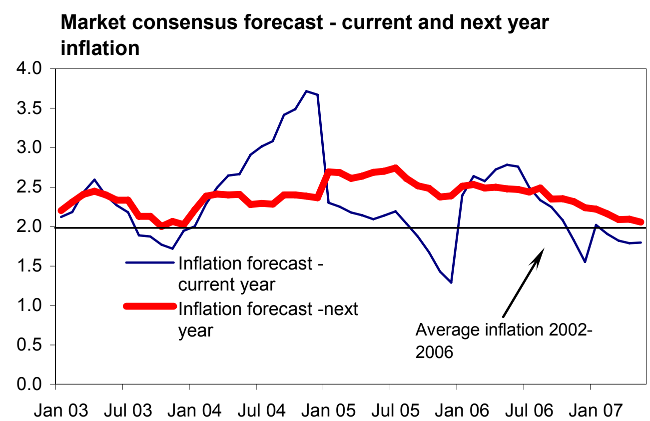
I. Developments and Performance under the Program

1. **Peru's sound macroeconomic policies are being sustained.** The Fund-supported program aims at consolidating macroeconomic stability, improving the quality of spending and the efficiency of the tax regime, tackling high poverty levels, and advancing other reforms in the financial system and the business environment to boost sustainable growth and bring Peru to a higher level of economic and social development.

2. **The economy is performing remarkably well.**

- ***Real GDP growth is at record-highs.*** In 2006, growth reached 8 percent—an eleven-year high—supported by very favorable terms of trade, and reflected in a steady rise in private consumption and investment, formal employment levels, and rising confidence (Figure 1). Real GDP grew 7½ percent (y/y) in the first quarter of 2007.

- ***Inflation is well-contained***. After becoming slightly negative in April 2007, 12-month inflation turned positive, at 0.9 percent in May, as the impact of large increases in food prices during 2006 and other transitory factors have begun to wane. Core inflation has been stable at 1½ percent and the central bank has kept policy interest rates unchanged since May 2006. In early February 2007, the central bank reduced its inflation target from 2.5 percent to 2 percent, keeping the tolerance range at +/- 1 percent. This aligned the target with the inflation expectations and the average inflation rate observed in Peru and its major trading partners since adopting inflation targeting in 2002.



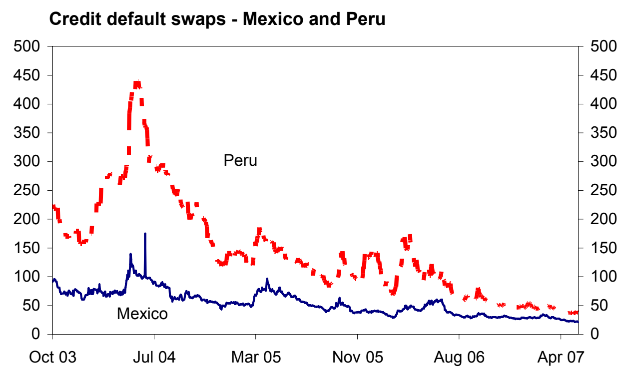
- ***Fiscal prudence is being preserved.*** The consolidated public sector posted an overall surplus of 2.2 percent of GDP in 2006 (Figure 2). General government spending rose by about 2½ percent in real terms, partly reflecting an 8 percent rise in the GDP deflator, which helped bring spending within the 3 percent limit under the *Fiscal Responsibility and Transparency Law* (FRTL). In the first quarter of 2007, the consolidated government posted a preliminary surplus of 4.9 percent of GDP, well above program targets. The authorities issued two supplementary budgets in February and May for about 1 percent of GDP, to allow for social and infrastructure spending not executed in 2006.

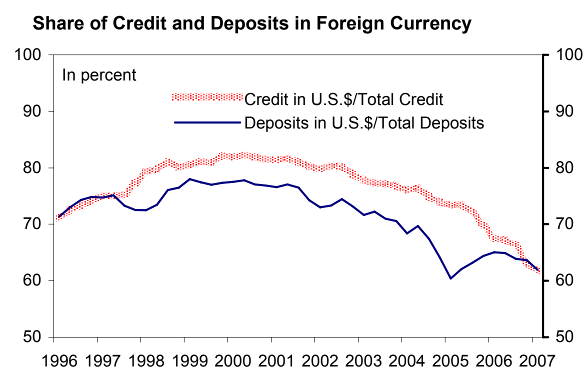
Fiscal Outcome in 2006 and 2007

Combined Public Sector	2006 Country Report 07/54	2006 Prel.	2007 Q1 Country Report 07/54	2007 Q1 Prel.
	(In percent of GDP)			
Total revenue	20.1	20.4	18.6	20.9
Total expenditure	17.3	16.5	14.4	14.0
Central bank operating balance	0.1	0.2	0.0	0.1
Primary balance	3.0	4.1	4.2	7.0
Interest payments	2.0	1.9	2.4	2.1
Overall balance	1.0	2.2	1.8	4.9

Sources: Fund Staff estimates and Peruvian authorities.

- ***Peru's external creditworthiness has solidified steadily*** (Figure 3). Fiscal prudence and active debt management have reduced public debt and improved its cost, currency mix, and maturity structure,[1] leading to credit rating upgrades and record low sovereign bond spreads.[2] Peru faced limited pressure during the most recent turbulence in global capital markets, and central bank purchases in the foreign exchange market brought official reserves to about 175 percent of FX deposits as of end-May 2007.





- ***Financial intermediation has deepened and the system's resilience strengthened.*** Credit to the private sector increased by around 25 percent over the past 18 months (Figure 4), with sol-denominated credit (led by consumer and mortgage loans)

[1] In February 2007, the government swapped $2.3 billion of external debt, extending the average maturity of public debt from 8½ years to 9½ years. In May, the authorities reached agreement to prepay about $2.5 billion in Paris Club nonconcessional debt maturing during 2007–15.

[2] Recently, Fitch upgraded the rating outlook to positive, while Moody's placed Peru for a review of its rating. Fitch and Moody's ratings for Peru are one and three notches below investment grade, respectively.

increasing at annual rates of around 30 percent. Dollarization is declining steadily, but remains high. With buoyant growth in corporate profits and high confidence, equity prices have tripled since early 2006, and price-earnings ratios are at high levels.

Financial Soundness Indicators of the Banking System 1/

	2005	2006	2007
Regulatory Capital to Risk Weighted Assets	12.0	12.5	12.5
Nonperforming Loans to Total Loans	2.1	1.6	1.6
Provisions to:			
Nonperforming loans	235.3	251.4	246.5
Nonperforming, restructured, and refinanced loans	80.3	100.3	104.1
Return on Assets	2.2	2.2	2.4
Return on Equity	22.2	23.9	25.8
Liquid Assets to Total Short Term Liabilities	45.5	44.2	44.8
Net Open Position in Foreign Exchange to Capital	23.1	17.1	30.2

Source: SBS.
1/ In percent. End of year data; for 2007, end-March data.

3. **The program is on track, with significant progress on the structural front.** All end-March 2007 performance criteria and structural benchmarks for end-March have been broadly observed (Tables 2 and 3). The tax regime has been simplified and its base broadened, while the tax treatment of financial derivatives has been clarified, except for securitized transactions. A unit to monitor fiscal performance by sub-national governments (SNGs) was established at the Ministry of Finance and a strategy to strengthen the effectiveness of social assistance programs (SAPs) has been published. Progress on a legal framework for PPP operations (an end-June structural benchmark) has been slow, partly reflecting personnel reshuffling.

4. **However, recent fiscal measures entail some risks to the program.** Two decrees were issued in mid-May to accelerate the approval of public investment projects and concessions until end-2007, by simplifying evaluation procedures under the *National System of Public Investment* (SNIP).[3] Moreover, SNGs are also allowed to use *canon minero* resources—usually earmarked for investment in infrastructure—for hiring teachers temporarily in regions. While the Ministry of Finance retains an important role in approving large sectoral projects and concessions, as well as for those by SNGs that require external borrowing or guarantees, these measures bring some risks to the level and quality of public spending.

[3] The decrees also exempt a hydrolelectric public investment project in Alto Piura (about $700 million) from SNIP procedures.

II. Policy Discussions

5. **There was broad agreement that sustaining a strong performance under the program would help Peru secure the benefits of prudent policies and reforms.** Discussions centered on how best to use the opportunity provided by favorable economic conditions to consolidate prudent policies and advance reforms to achieve key program goals by:

- Preserving a **strong fiscal stance** to entrench macroeconomic stabilization and reduce vulnerabilities faster, while ensuring that pressing social and infrastructure needs are addressed.
- Improving the **quality of public spending** and the **effectiveness of the tax system.**
- Implementing the **poverty alleviation** strategy set out in the recommendations and action plan developed by the *Inter-ministerial Committee for Social Affairs* (CIAS).
- Strengthening the **credibility of the inflation targeting framework**.
- Deepening **financial intermediation** and reducing **dollarization**.

A. Macroeconomic Framework and Risks to the Outlook

6. **The economic outlook has remained favorable.** Real GDP growth could reach 7 percent in 2007, above the 5½ percent envisaged in the program, mainly reflecting higher-than-expected commodity prices. Inflation would return gradually to its target in late 2007, as the impact of transitory factors wanes and slack in the economy is absorbed.[4] The external position is expected to remain favorable in 2007, with a current account surplus leading to further accumulation of foreign reserves. Persistently strong commodity prices, along with the expansion of investment projects in most sectors in the economy and improved prospects for the ratification of the Peru-U.S. FTA by the U.S. congress, bring upside risks to the outlook. However, a sharp decline in commodity prices, compounded by increased risk aversion and a severe correction in equity prices, could weigh heavily on the exchange rate and balance sheets in the economy, especially given the still high dollarization.[5]

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[4] The May consensus forecasts of growth and end-year inflation are 7 percent and 1.8 percent, respectively.

[5] Were terms of trade to return to 2003 levels, the trade and current account surpluses would shift into balance and into a deficit of about 2 percent of GDP, respectively, in 2007–08.

Macroeconomic Framework, 2006–08

	Country Report 07/54	Prel.	Prog.	Staff Projection	
	2006		2007	2007	2008
(Annual percentage change)					
Real GDP growth	6.5	8.0	5.5	7.0	6.0
Inflation (end-year)	1.6	1.1	2.5	2.0	2.0
(In percent of GDP)					
External current account balance	1.3	2.6	0.2	0.9	0.5
Public sector balance (excluding CRPAOs)	1.0	2.2	-0.8	0.0	-0.5
Public sector balance (including CRPAOs)	0.9	2.1	-1.2	-0.3	-0.9
Total public debt (including CRPAOs)	32.0	32.8	31.2	30.0	28.8
Gross official reserve coverage of:					
Short-term debt (residual maturity)	350	357	337	413	458

Source: Fund staff estimates and Peruvian authorities.

B. Fiscal and Poverty Alleviation Issues

7. **The authorities intend to maintain a prudent fiscal stance in 2007.** With a more favorable revenue outlook, which staff estimated could exceed program projections by 1¼ percentage points of GDP, the authorities expected that the adjusted deficit target of ½ percent of GDP would be met comfortably, in line with the program. The authorities noted that the expected revenue overperformance could also entail a higher-than-programmed level of public spending, partly related to the large mandatory transfers accruing to SNGs, their large *canon minero*-related deposits in the banking system, as well as recent measures to accelerate spending at all government levels. Nevertheless, they remained confident that program targets would not be compromised and saw scope for the consolidated public sector to overperform and achieve balance in 2007. The authorities and staff agreed that such an outturn would help limit the envisaged large fiscal impulse and assist macroeconomic stability, while helping to reduce public indebtedness further.[6]

8. **The authorities are committed to implementing several reforms to ensure the high quality of public spending.** They explained that measures to accelerate public spending needed to remain consistent with reforms underway to enhance its quality, by implementing:

[6] The fiscal impulse would be 2 percent of GDP in 2007, compared to 1½ percent of GDP previously.

- ***An effective restructuring of the SNIP.*** [7] In late May, the government announced that a high-level commission will prepare a comprehensive reform proposal of the SNIP before end-June, to make it more expeditious while ensuring the high quality of public investment.[8] In addition, the authorities intend to allocate more resources to bolster SNGs' capacity to assess and execute projects in line with SNIP procedures. Nine regional offices will be established by year-end—in addition to the six already in place—and staffing in these offices will be increased significantly. To further support SNGs' capacity, efforts will be made to continue involving the private sector, following several cooperation agreements signed with universities.

- ***An adequate use of the canon minero.*** In response to staff's concerns, the authorities explained that using *canon minero* resources would allow some SNGs to address temporarily protracted staffing bottlenecks in education, in coordination with the Ministry of Education, with the central government expected to provide financial support in 2008.

- ***A comprehensive review of the FRTL.*** Work continues on how best to balance the need to preserve fiscal discipline with more effective expenditure rules. A supplementary budget approved in May modified the 3-percent real expenditure limit, which now applies to current spending at the central government level, and removed all transfers, providing much needed room for infrastructure spending and strengthening the chances of compliance with expenditure rules.[9] Maintenance expenditures would not be excluded from the limit until a new budget classification system is established to minimize misclassification risks. With further amendments still being discussed, staff stressed that the introduction of small margins to the limits of 1 percent of GDP for the overall deficit and of 3 percent for growth in real expenditures, respectively—beyond which sanctions would apply, would not help minimize risks arising from factors beyond the authorities' control and undermine credibility. A Fiscal Coordination Committee would be established as originally envisaged.

- ***Fiscally-sound decentralization.*** With a unit established at the Ministry of Finance, the monitoring of SNGs—including compliance with the FRTL—is being

[7] Law 28802 decentralized the SNIP in early 2007, providing SNGs with full discretion for viability approval of projects that do not involve external financing or public guarantees.

[8] The commission will be chaired by the Vice Minister of Economy, and include members from other MEF and government agencies, as well as a president of a region chosen by the National Assembly of Regional Governments and the mayor of the city with the largest execution of public investment projects in 2006.

[9] To strengthen the predictability of expenditure and minimize risks of noncompliance with the FRTL, the growth in expenditure in real terms will be calculated using the inflation target of 2 percent.

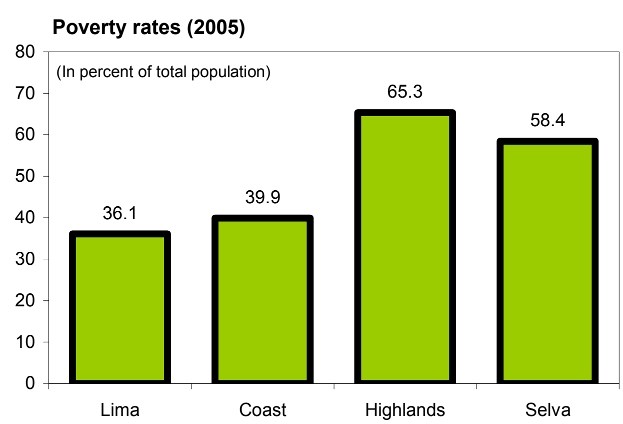
strengthened. To minimize the fiscal impact of the anticipated devolution of 185 functions to regional governments by end-2007, staff urged the authorities to preserve an adequate accreditation system in place. In transferring the ownership of three electricity companies to regional governments, the authorities intend to ensure that adequate management remains in place to preserve tight budget constraints and governance.

- ***Public financial management reforms.*** Five pilot projects on performance budgeting have been initiated, while the results of the audit of the Integrated Financial Management System (SIAF) are expected by September. The authorities intend to expedite and strengthen public procurement procedures. An FAD resident advisor is assisting the authorities in establishing a Treasury Single Account at the central government level by end-2007, in line with the program.

- ***A legal framework for PPP operations.*** The authorities intend to finalize the draft legal framework in the next few months, and expect to submit it to congress by end-September. The staff stressed the importance that all PPP projects continue to be subject to SNIP evaluation procedures. The authorities would limit the use of CRPAOs to contracts already signed, while continuing to explore alternative methods of financing to improve the risk-sharing balance between private and public sector.

9. **The authorities and staff agreed that the recent tax reforms will enhance the effectiveness of the tax regime.** The authorities were highly satisfied with the quality of the reforms, which reduce distortionary taxes and broaden the tax base (Box 1). Staff commended the authorities for rationalizing tax incentives and replacing exemptions in the Selva region with transfers earmarked for infrastructure. With pressures to grant new exemptions, staff encouraged the authorities to resist them. Efforts by the tax administration agency SUNAT remain focused on upgrading information systems, implementing well-targeted audits, and strengthening cross-checks between domestic taxes and customs.

10. **The staff welcomed the action plan to rationalize and strengthen SAPs.** Following the merger of 82 SAPs into 26, the authorities intend to finalize updating the single registry of beneficiaries and the household targeting system, critical for adequately registering beneficiaries. They agreed with staff on the importance of providing the CIAS with a permanent head and technical staff and agreed to make this measure an end-September structural benchmark. This would bolster its effectiveness and ensure the implementation of the anti-poverty plan (Box 2). In light of the success of the



conditional-cash transfer program *Juntos* in rural areas, the authorities will increase its focus on malnutrition, while enhancing its conditionality. They would also launch a pilot program aimed at reducing child malnutrition in three provinces, following the new comprehensive criteria established by the CIAS. These efforts were also being complemented by the voluntary contributions from mining companies, which were beginning to finance projects in several regions. The authorities acknowledged that the reform of some programs facing large inefficiencies may be politically difficult and agreed on the need to continue building consensus toward reform.

Box 1: Fiscal Reforms

Since late December, the authorities introduced three packages of fiscal measures aimed at:

Reducing distortionary taxes and increasing tax compliance.

- The tax rate on net assets (ITAN) was reduced from 0.6 percent to 0.5 and the threshold revised downward from S/. 5 million to S/. 1 million. The exemption of credit services from VAT is now a permanent feature of the tax system (consistent with international practice); the capitalization of interest on outstanding tax debt has been eliminated; and participation in the simplified regime has been extended.

- A timetable for reducing the financial transactions tax has been set, envisaging its gradual decline from 0.08 percent at present, to 0.07 percent in 2008, and to 0.05 percent by 2010. The ITAN rate will be reduced further to 0.4 percent by 2009.

Broadening the tax base.

- The tax treatment of financial instruments has been clarified, with capital gains and income from financial derivative instruments now taxed. Capital gains from stock trading will be taxed at an effective rate of 5 percent from 2009 on, complemented by a clear definition of the gross base for income tax purposes. The early refund of VAT payments, mainly for the mining and hydrocarbon sectors, has been extended to all sectors, specifically for firms making investments over $5 million.

- A new framework for tax incentives introduces time limits (6 years) to the granting of new exemptions, conditioning their renewal (up to 3 years) to an evaluation of whether the goals have been achieved. New exemptions for indirect taxes are also eliminated and congress will have to inform MEF before approving any new tax exemptions. Ministries have 2 years to present an assessment of existing tax exemptions to congress.

- Tax exemptions in the Selva region (except Loreto) are replaced with direct transfers for investment, maintenance of infrastructure and social expenditure. However, the elimination of certain exemptions on the VAT will be gradual.

Box 2: Strengthening the Poverty Alleviation Strategy

The CIAS has outlined the criteria and steps for the reform of social assistance programs (SAPs). The reform is centered around "three pillars" for anti-poverty efforts: i) human development, ii) promoting economic opportunities, iii) establishing a social safety net.

A Diagnosis suggests that existing SAPs have:

- ***Weak articulation and links to goal-achievement.*** SAPs are not well integrated and lack focus on achieving goals, leading to undercoverage and important leakages in terms of targeted population.

- ***Deficiencies in monitoring and assessing their social impact.*** SAPs lack adequate systems and procedures for identifying beneficiaries, as well as clearly defined exit strategies.

- ***High administrative costs.*** About 80 percent of SAPs have administrative costs that exceed 10 percent of the total spending under the program.

The Proposed Reform is based on:

- ***Reorganizing and refocusing SAPs to improve synergies.*** By providing goods and services for specific needs of beneficiaries around the strategic pillars. For example, to achieve "pillar 1", SAPs will comprise programs related to health, education, malnutrition, and housing.

- ***Institutional strengthening.*** A *Single Beneficiary Registry* and *Household Focalization System* will be developed to avoid duplications and integrate beneficiary registries, building on the one existing under the successful conditional cash transfer program *Juntos*.

- ***Drive for Performance.*** Performance budgeting will be underpinned by the use of indicators to allocate resources based on expected outcomes and for comparing performance with goals. The Ministry of Finance will provide training on performance budgeting and priority will be given to the poorest municipalities to reduce undercoverage and leakages.

The Action Plan

- **Phase I: Targeted Programs.** About 82 programs are being streamlined and consolidated into 26 enhanced programs in 13 programmatic areas. Legal decrees to merge the SAPs are being issued and should be completed by end-June.

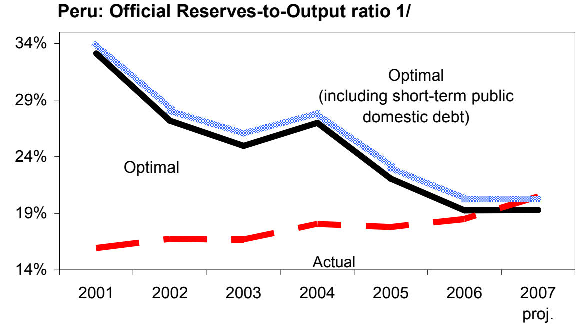
- **Phase II: Universal Programs.** The reform of universal programs will begin in the second half of 2007.

C. Strengthening the Inflation Targeting Framework

11. **The central bank is confident that inflation will remain within the target range.** With 12-month inflation declining below the 0.5 percent inner band in March, a consultation with staff was triggered under the program. The authorities and staff agreed that in light of the temporary decline in inflation, the current stance of monetary policy remained appropriate (Box 3). Nevertheless, a key challenge for monetary policy would be to gauge the point at which monetary conditions would need to be tightened as slack in the economy is absorbed without compromising the inflation target. The authorities and staff agreed that the new inflation target would help entrench price stability and declining dollarization. The inflation consultation mechanism under the program remains unchanged for the rest of 2007 (Table 2).

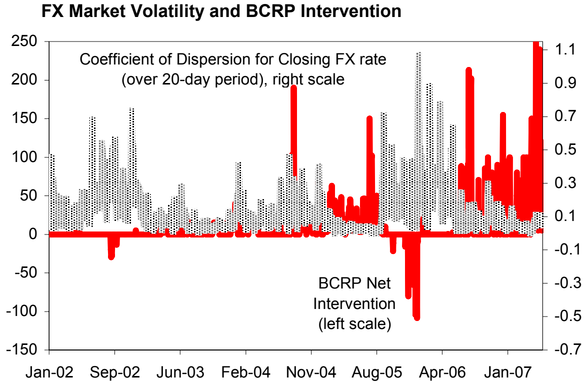
12. **Plans to build up official reserves further need to be supported by greater exchange rate flexibility.** There was agreement on the need to continue building up reserves, which are reaching levels broadly consistent with risks of high dollarization, to help avoid large swings in the real exchange rate, were the external environment to deteriorate sharply. A gradual but steady appreciation of the *Nuevo Sol* over the past year has been consistent with improved fundamentals, while helping remove perceptions of "floors" in the market. However, appreciation pressures have intensified markedly in recent months and could prove increasingly difficult to resist, given the intrinsic limits to sterilization notwithstanding the support from a strong fiscal position. The staff encouraged the authorities to allow for greater exchange rate flexibility, to avoid one-way bets and promote the use of financial hedges in the economy, building on the increased resilience of the banking system to exchange rate shocks.

Peru: Official Reserves-to-Output ratio 1/

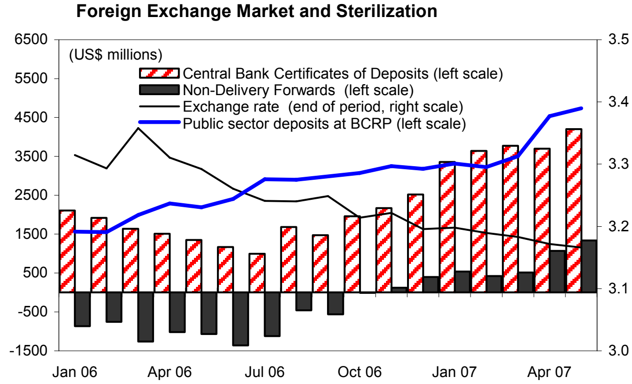


1/ Optimal reserves calculated based on methodology as in Jeanne and Ranciere (2006).

FX Market Volatility and BCRP Intervention

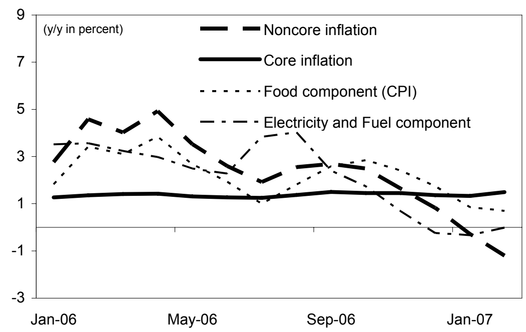


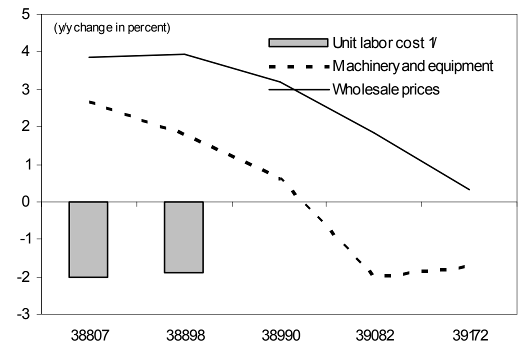
Foreign Exchange Market and Sterilization



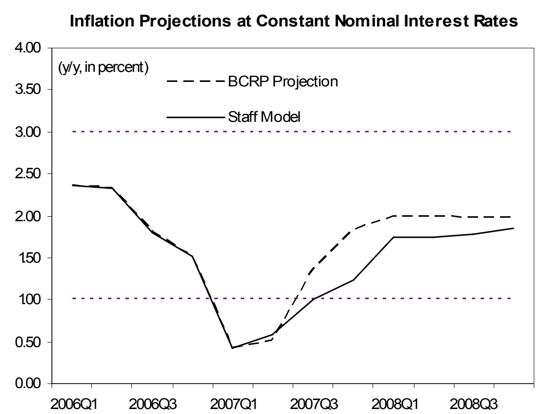
Box 3: Inflation Developments and Outlook

Inflationary pressures remain subdued. Headline inflation has decelerated, mainly reflecting reductions in the prices of public utilities, fuel, and selected food items. Formal sector wages and capacity utilization levels in the manufacturing sector have risen, but strong productivity gains have reduced unit labor costs, and increased competition appears to have compressed margins. Declining inflation expectations and a gradual exchange rate appreciation have also helped contain pressures from rapid domestic demand growth.





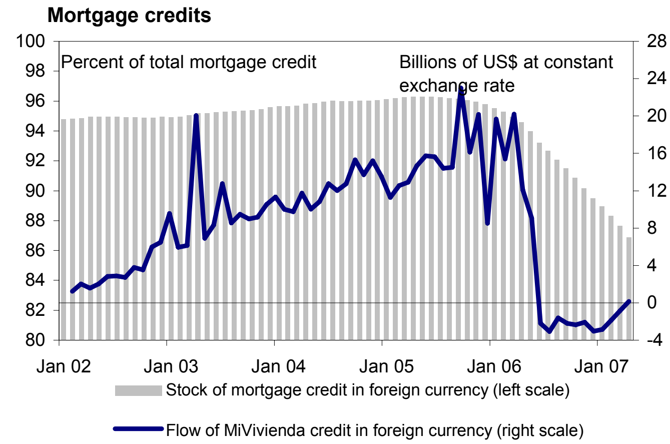
Uncertainty about the extent to which output is close to potential brings risks to the outlook. With a positive output gap of about 1 percent at end-2006, the authorities project 12-month inflation to return to the mid-point of the target range by end-2007. Measuring the level of potential output with a multivariate filter finds less evidence of a positive output gap. A structural model linking monetary policy, output and inflation, suggests that, under these circumstances, inflation could return more gradually toward the target.[1/] However, the uncertainty on the output gap, along with a potentially large fiscal impulse, could intensify inflation pressures earlier than expected.



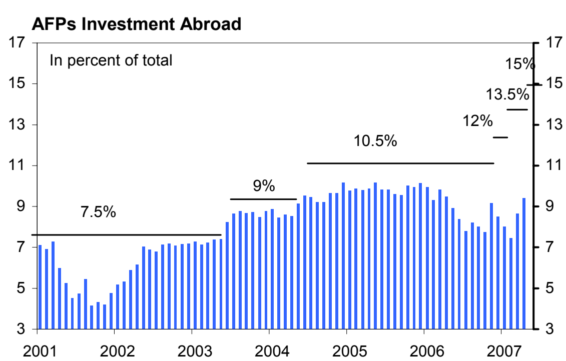
1/ See A. Berg, P. Karam and D. Laxton, "A Practical Model-Based Approach to Monetary Policy Analysis-Overview," IMF Working Paper 06/80, for a detailed description of the model.

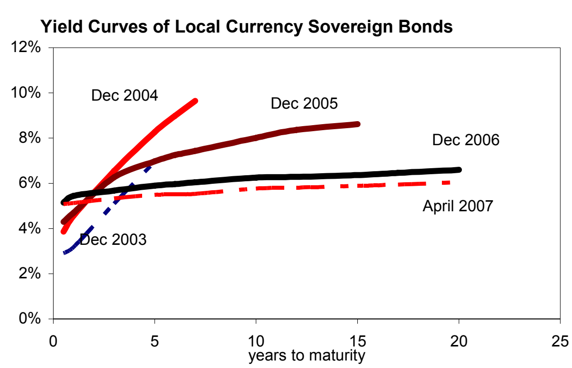
D. Strengthening the Resilience and Depth of the Financial System

13. **Progress in strengthening the financial system continues.** The authorities did not see major risks for the financial system from rapid credit growth and rising equity prices. New regulations have been issued requiring banks to constitute special provisions for credits to overexposed customers. Banks' self-assessment of foreign currency portfolios was finished last December, with the required provisioning now constituted and becoming part of the regular supervision process. Prospects for reducing the high dollarization of mortgage loans have strengthened, as large banks have started to extend mortgage loans in domestic currency with similar terms to those in foreign currency. The authorities are also in the process of exchanging part of *MiVivienda's* foreign currency portfolio into *Nuevo Soles*, and new lending programs in domestic currency have been launched. The three publicly-owned financial institutions—COFIDE, *Banco de la Nación* (BN) and *Agrobanco*—have begun to better coordinate their credit risk assessments. However, the timing of the approval by congress of draft legislation that would bring these institutions and *MiVivienda* under the supervisory framework of the Superintendency of Banks is uncertain. The staff encouraged the authorities to closely monitor the rapid growth in BN's consumer lending to ensure that it remains within the 25 percent annual limit.



14. **Several reforms continue to deepen domestic capital markets.** The limit on pension funds' investments abroad has been raised to 15 percent and the National Stock and Insurance Comission (CONASEV) has established a "fast-track" registration process for public offerings by accredited investors to simplify the issuance of securities. The authorities are assessing market conditions to potentially issue a 30-year sol-denominated bond to further extend the domestic yield curve. They expect that the share of local-currency denominated debt would reach 30 percent by end-2007.





E. Other Growth-Enhancing Reforms

15. **The authorities are confident about the prospects for a prompt ratification of the Peru-U.S. FTA by the U.S. Congress.** They explained that several changes would be needed, including on labor and environmental issues, likely to force an amendment and new ratification by Peru's Congress. The authorities did not foresee any difficulties in this regard.

16. **The authorities are assessing options to address labor market informality.** Discussions continue on a comprehensive reform of labor market legislation, which the authorities feel should be balanced with increased access to social benefits. To strengthen the business environment further, the authorities are planning to establish two additional commercial courts in Lima, as well as two more in the regions.

III. Program Issues

17. **Conditionality.** The attached letter of intent reaffirms the authorities' commitment to the program and targets. The indicative targets for September and December are being converted into performance criteria, consistent with the original program. Regarding the structural agenda, a new end-September 2007 benchmark (the appointment of a new permanent head and technical staff of the CIAS) has been added. The full clarification of the tax treatment of financial securitization transactions will be a benchmark for end-December 2007, while the submission of a legal framework for PPP operations will be a benchmark for end-September 2007.

18. **Safeguards assessment.** An off-site safeguards assessment concluded that there are no significant weaknesses in the Central Bank's safeguards framework. A few measures were proposed to address minor weaknesses related to the duration of the appointment of the external auditor and the terms of the Organic Law on recording unrealized revaluation gains.

19. **Paris Club debt.** In a recent meeting of the Secretariat, two official creditors indicated the existence of about $7.5 million in claims that needed to be reconciled. They did not foresee this standing in the way of the proposed debt repayment operation. The authorities are engaged in reconciling and resolving these disputed claims.

20. **Staff discussed with the authorities their views on an exit strategy from Fund-supported programs.** The authorities noted that strong performance under the program, along with institutional strengthening, should help reduce vulnerabilities and cement policy credibility. They noted that this should help Peru reach investment grade status and provide a natural exit from Fund-supported programs.

IV. Staff Appraisal

21. **Peru faces a good opportunity to entrench the benefits of prudent policies and ensure greater equity and poverty alleviation.** The economy enjoys the most favorable conditions of the last two decades, with broad-based and record-high growth, low inflation, and rising formal employment. Preserving sound macroeconomic policies and advancing reforms would help reduce vulnerabilities further, entrench sustainable growth and reduce high poverty levels. This will ensure steady progress toward achieving the government's goal of investment grade and help Peru reach a new level of economic and social development.

22. **The authorities are appropriately focused on achieving the program's goals.** Staff commends the authorities for the strong implementation of policies and reforms and for their intention to press ahead with a comprehensive agenda to address long-standing structural weaknesses in the fiscal and financial sectors and to reduce poverty.

23. **The reform of the social assistance programs is an important step toward reducing high poverty.** Timely implementation of the strategy to enhance the effectiveness of social assistance programs, including by bolstering the capacity of the CIAS and advancing reforms on large programs facing inefficiencies, are critical steps to begin reducing poverty effectively. The staff encourages the authorities to continue building consensus toward their reform.

24. **The authorities' commitment to maintaining a prudent fiscal strategy is pivotal to the program's success.** In light of the significant social and infrastructure needs, staff supports the authorities' decision to meet program targets, while welcoming efforts to preserve the quality of public spending. Continued fiscal prudence, including by saving part of any revenue overperformance, should also help keep public debt on a downward trend and assist macroeconomic stability.

25. **The authorities intend to preserve the credibility of the fiscal framework.** The proposed amendments to strengthen the FRTL by introducing strict sanctions for non-compliance are welcome; however, it will be important that these amendments are implemented consistently, to preserve the credibility and clarity of the FRTL. In addition, the potential inclusion of margins on the limits to the deficit and growth on real current spending should be resisted as it could undermine the hard-won credibility of fiscal policy. In this context, plans to redefine the limit to real expenditure growth seem appropriate. A prompt implementation of the new budget classification, along with improvements in public procurement, should help minimize risks associated with the misclassification of maintenance and infrastructure outlays and help preserve the quality of public spending. It is also crucial that the devolution of spending functions to subnational governments by year-end is consistent with sound accreditation criteria and does not undermine fiscal soundness.

26. **The staff commends the authorities for the recent reforms to strengthen the tax system.** A clear timetable for reducing taxes on financial transactions and net assets has been

established, while the tax treatment of financial derivatives has been clarified. The new framework rationalizing tax incentives and the required assessment of existing exemptions are commendable and should help solidify Peru's tax structure. Staff encourages the authorities to resist pressures for new exemptions. Adopting performance indicators and more focused audits would assist in sustaining the significant tax administration gains of recent years.

27. **Well-designed public investment policies would help minimize fiscal risks and support sustainable economic growth and poverty alleviation.** The recently announced temporary measures to expedite needed public investment must be balanced by sound procedures to ensure their high quality. It is essential that the decentralization process of the SNIP is improved, to retain a hard-won but more effective framework to assess the viability of public investment projects. For this, increased capacity-building efforts at the SNG level, project monitoring and ex-post evaluation are essential. It is also essential to redouble efforts to establish a comprehensive legal framework for PPPs and to continue exploring alternative financing instruments for PPP projects to ensure a balanced risk-sharing between the public and private sectors.

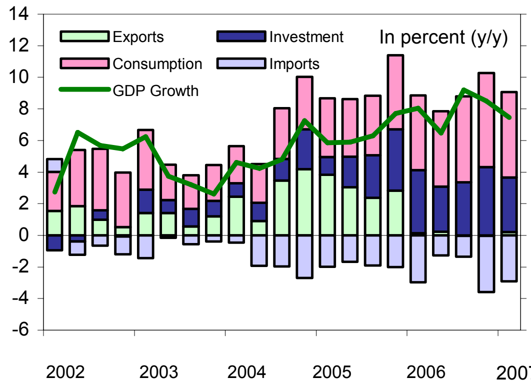
28. **Greater exchange rate flexibility would help solidify the new inflation target and help entrench declining dollarization.** To help internalize risks and further anchor expectations, the staff sees scope for greater exchange rate two-way flexibility, given the improved resilience of the banking system to exchange rate shocks, official reserves approaching more desirable levels, and the new inflation target. These efforts should be complemented by measures to reduce the dollarization of mortgage loans. Staff also supports the current stance of monetary policy and encourages continued close monitoring of underlying inflation pressures.

29. **Staff encourages the authorities to sustain efforts in enacting legislation that would effectively strengthen the regulatory oversight of public financial institutions.** The authorities should ensure the effective operation of the newly established committee of representatives of COFIDE, BN and *Agrobanco* to coordinate their overall credit assessment and lending to private financial institutions. It will also be important to continue monitoring Banco Nacion's recent expansion of consumer lending. Staff also welcomes the reforms to deepen domestic capital markets and encourages the authorities to further streamline the process of registration of securities by CONASEV.

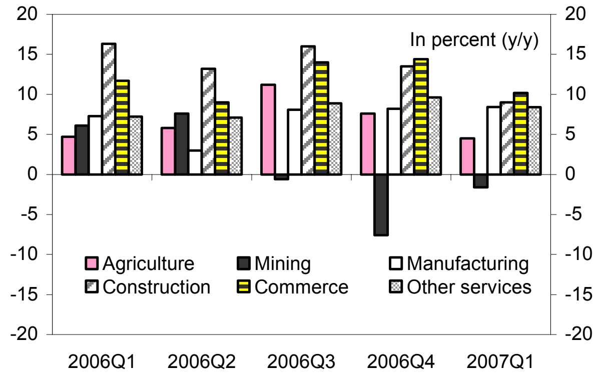
30. **The staff supports the completion of the first review under the SBA.** In light of the authorities' strong commitment to the program, and good performance, the staff supports the completion of the first SBA review.

Figure 1. Peru: Real Sector Developments

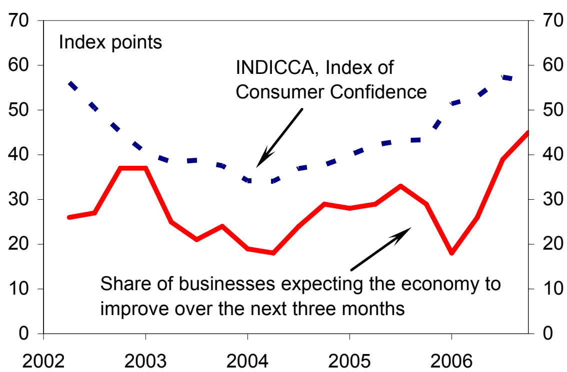
Investment and consumption have accelerated...



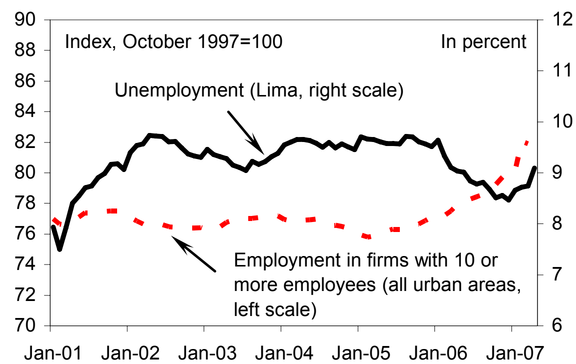
...and economic growth broadened...



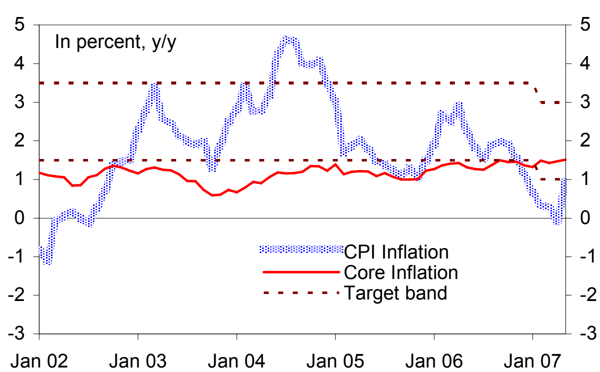
...with both consumer and business confidence rising...



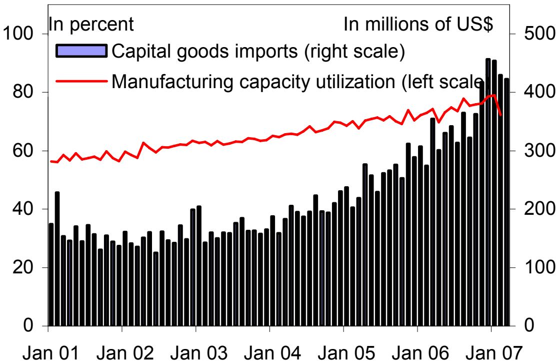
...and formal employment expanding.



Price pressures remain subdued...



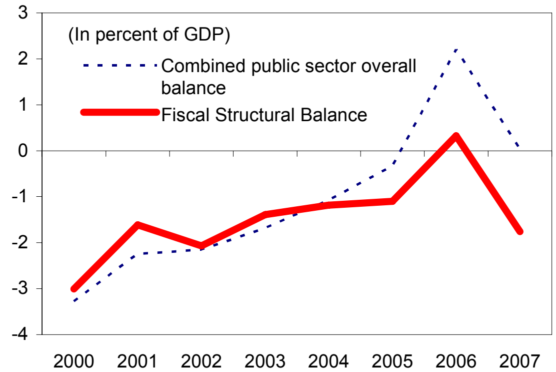
...as high capital investment coincides with a steady but gradual rise in capacity utilization.



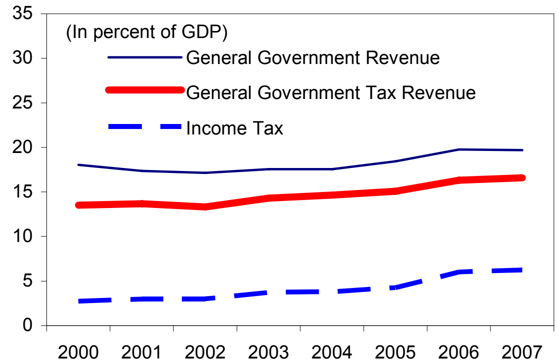
Source: Banco Central de Reserva del Peru and IMF staff estimates.

Figure 2. Peru: Fiscal Sector Developments

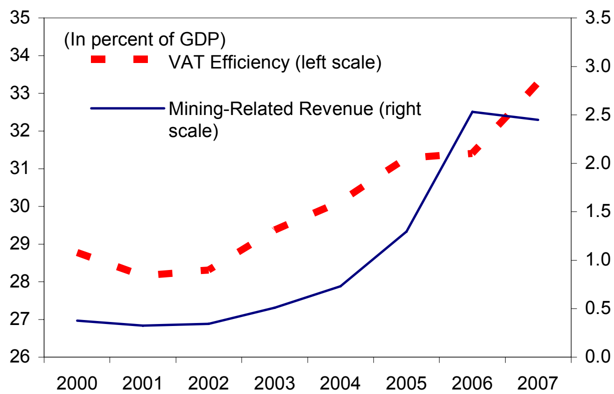
There has been a sharp improvement in the fiscal balance...



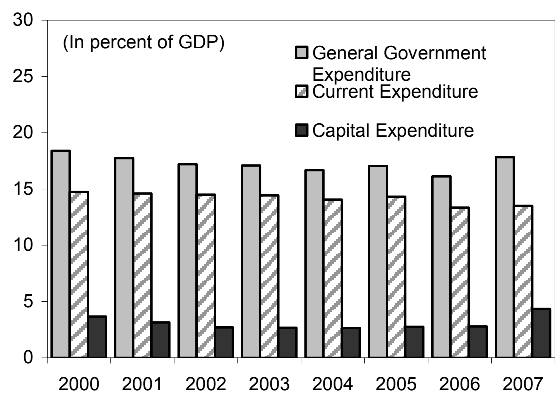
...supported by increased revenue collection.



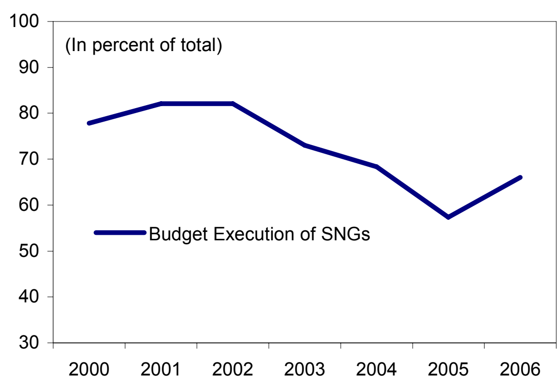
The improvement reflects better tax administration and higher commodity prices.



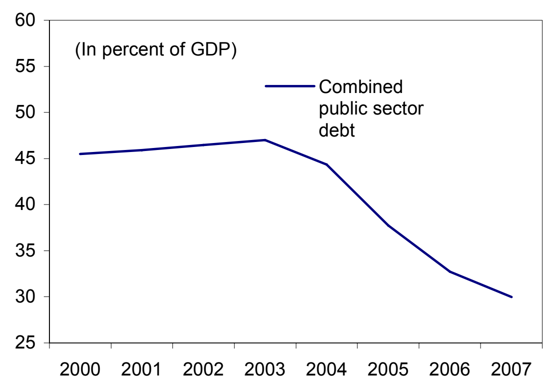
While poised for recovery, the share of expenditure to GDP has declined...



...partly reflecting low budget execution by sub-national governments.



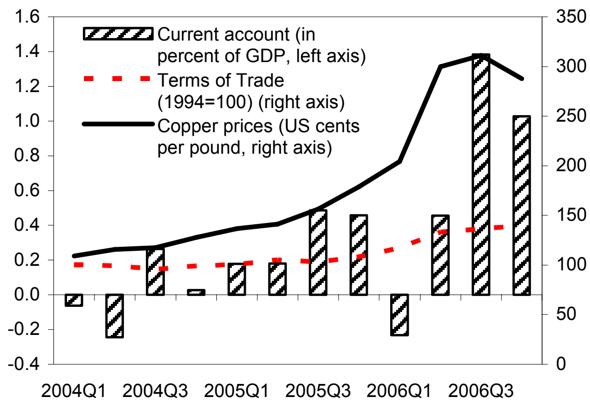
The strong fiscal performance has allowed public debt to decline markedly.



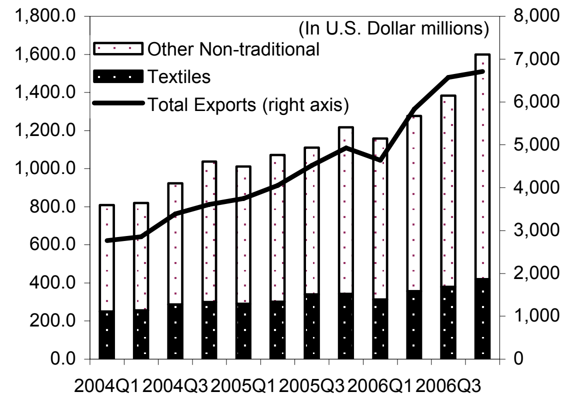
Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance and IMF staff Estimates

Figure 3. Peru: External Sector Developments

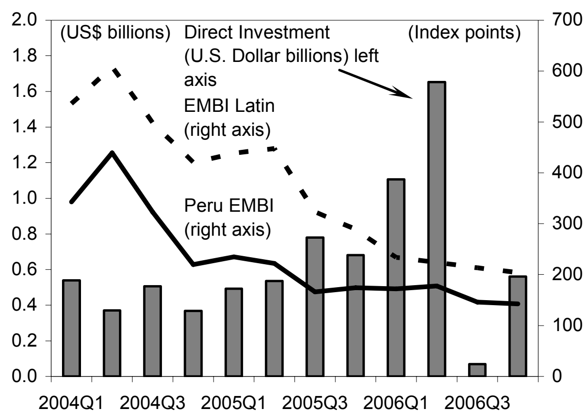
The strong balance of payments is boosted by improved terms of trade...



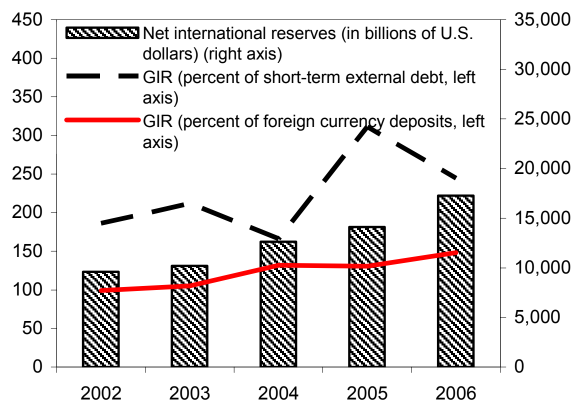
...and increasing non-traditional exports...



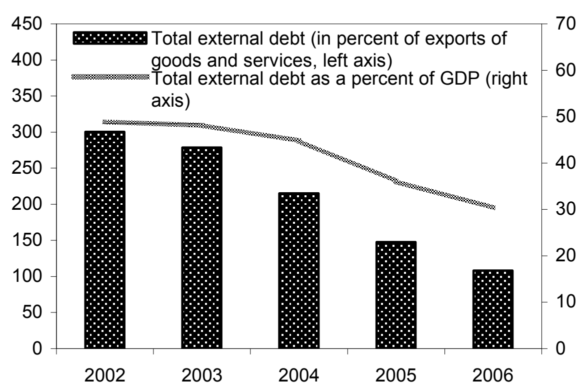
...as well as rising financial market confidence.



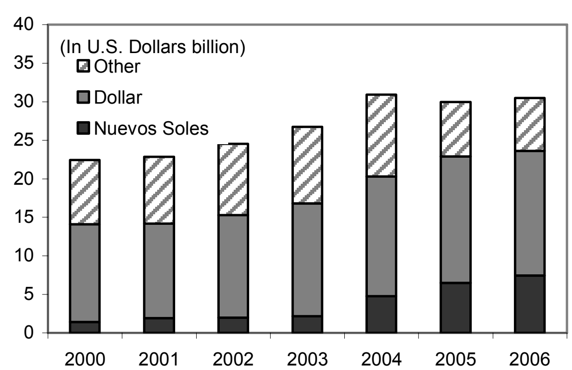
This has helped to build reserves.



External Debt has declined...



...while the domestic currency share in public debt is rising.



Source: Banco Central de Reserva del Peru, Ministry of Finance, JP Morgan and IMF staff estimates.

Figure 4. Peru: Banking and Financial System 1/

Source: Bloomberg, SBS, World Federation of Exchange Rates and Fund staff estimates.
1/ Banking sector data corresponds to December 2006.

Table 1. Peru: Selected Economic Indicators

				Prel.	Prog.	Projection	
	2003	2004	2005	2006	2007	2007	2008
Social Indicators							
Life expectancy at birth (years)	70.0	...	...	...	...	...	...
Infant mortality (per thousand live births)	26.0	...	...	...	...	...	...
Adult literacy rate	87.7	87.8	...	...	...	...	...
Poverty rate (Total) 1/	52.2	51.6	50.6	...	...	...	...
Unemployment rate	9.4	9.4	9.6	8.6	...	...	...
(Annual percentage change; unless otherwise indicated)							
Production and prices							
Real GDP	3.9	5.2	6.4	8.0	5.5	7.0	6.0
Real domestic demand	3.4	4.4	5.5	10.6	6.2	9.2	6.5
Consumer Prices (end of period)	2.5	3.5	1.5	1.1	2.5	2.0	2.0
Consumer Prices (period average)	2.3	3.7	1.6	2.0	2.0	1.1	2.0
External sector							
Exports	17.8	38.8	36.7	37.7	6.2	9.4	-1.0
Imports	11.2	19.0	23.0	23.3	16.1	20.2	12.7
Terms of trade (deterioration -)	1.3	9.2	5.9	26.1	-5.3	-0.6	-10.5
Real effective exchange rate (depreciation -) 2/	3.8	1.6	0.5	1.3	...	...	...
Money and credit 3/ 4/							
Liabilities to the private sector	2.5	8.5	13.5	12.3	9.3	13.8	9.6
Net credit to the private sector	-2.9	0.3	10.0	10.6	8.0	11.6	9.4
(In percent of GDP; unless otherwise indicated)							
Public sector							
General government current revenue	17.4	17.5	18.3	19.6	18.5	19.6	19.1
General government noninterest expenditure	17.1	16.7	17.0	16.1	17.4	17.8	17.9
Combined public sector primary balance	0.5	1.0	1.6	4.1	1.3	1.9	1.2
Interest due	2.2	2.0	1.9	1.9	2.0	1.8	1.7
Combined public sector overall balance	-1.7	-1.1	-0.3	2.2	-0.8	0.0	-0.5
External Sector							
External current account balance	-1.5	0.0	1.3	2.6	0.2	0.9	0.5
Gross reserves							
In millions of U.S. dollars 5/	10,206	12,649	14,120	17,329	16,765	21,329	21,829
Percent of short-term external debt 6/	211.9	166.3	311.4	356.6	336.9	412.6	458.3
Percent of foreign currency deposits at banks	105.2	131.9	130.6	148.2	139.6	167.0	165.2
Debt							
Total external debt	48.1	44.9	36.1	30.3	28.4	28.1	26.5
Combined public sector debt (including CRPAOs)	47.0	44.4	37.7	32.7	31.2	30.0	28.8
Domestic	10.0	9.2	9.7	9.2	8.1	8.7	9.2
External 7/	37.0	35.1	28.1	23.5	23.1	21.3	19.6
Savings and investment							
Gross domestic investment	18.8	18.9	18.6	21.0	21.2	22.5	24.3
Public sector 8/	2.8	2.8	2.9	2.8	4.3	4.8	5.2
Private sector	15.0	15.2	16.0	16.8	16.9	18.0	18.8
Inventories changes	1.0	1.0	-0.2	1.3	0.0	-0.3	0.4
National savings	17.2	18.9	19.9	23.6	21.4	23.4	24.8
Public sector 9/	1.2	1.7	2.6	5.0	3.3	4.6	4.4
Private sector	16.0	17.2	17.3	18.6	18.1	18.7	20.4
External savings	1.5	0.0	-1.3	-2.6	-0.2	-0.9	-0.5
Memorandum items:							
Nominal GDP (S/. billions)	213.9	237.8	261.6	305.8	317.9	329.2	349.0
GDP per capita (in US$)	2,330	2,599	2,917	3,379	3,496	3,672	3,834

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; ECLAC 2002-03; National Statistical Institute (INEI); and Fund staff estimates/projections.

1/ Defined as the percentage of households with total spending below the cost of a basic consumption basket. Figure for 2005 is preliminary.

2/ Based on Information Notice System.

3/ Corresponds to the banking system.

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

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

6/ Short-term debt is defined on a residual maturity basis, and includes amortization of medium- and long-term debt.

7/ Includes debt by the Central Reserve Bank of Peru.

8/ Includes CRPAOs.

9/ Excludes privatization receipts.

Table 2. Peru: Quantitative Performance Criteria and Inflation Consultation Mechanism for 2007

	Mar. 31	Jun. 30	Sept. 30	Dec. 31
(Cumulative amounts from December 31, 2006, millions of New Soles)				
Borrowing requirement of the combined public sector				
Unadjusted limits 1/ 2/ 3/ 4/	-1,396	-4,190	-2,761	2,418
Adjusted limits	-1,646			
Actual	-4,252			
Margin	2,606			
(Cumulative amounts from December 31, 2006, millions of U.S. dollars)				
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions				
Unadjusted targets 5/ 6/	-260	44	336	350
Adjusted targets	-635			
Actual	948			
Margin	1,583			
Outstanding short-term external debt of the nonfinancial public sector				
Limits	50	50	50	50
Actual	0			
Margin	50			
Contracting or guaranteeing of nonconcessional public debt with maturity of at least one year				
Unadjusted limits 7/ 8/ 9/	751	1,237	1,608	2,636
Adjusted limits	3,146			
Actual	2,742			
Margin	404			
Of which: **external debt of 1-5 year maturity**				
Limits	100	100	100	100
Actual	0			
Margin	100			
External payments arrears of the public sector (on a continuous basis)				
Limits	0	0	0	0
Actual	0			
NPV of future government payments associated with PPP operations (on a continuous basis)				
Unadjusted Limits 10/	1,500	1,500	1,500	1,500
Actual	55			
Margin	1,445			
(Consultation bands for the 12-month rate of inflation, in percent) 11/				
Outer band (upper limit)	5.5	5.5	5.5	5.5
Inner band (upper limit)	4.5	4.5	4.5	4.5
Central point	2.5	2.5	2.5	2.5
Inner band (lower limit)	0.5	0.5	0.5	0.5
Outer band (lower limit)	-0.5	-0.5	-0.5	-0.5
Actual	0.3	...	...	...

Sources: Staff estimations.

1/ PIPP proceeds are included below the line.

2/ The limit on the borrowing requirement of the combined public sector will be adjusted downwards by the amount central government revenues net of mandatory transfers exceed program estimates of S/. 10,489 million at end-March, up to a ceiling of S/. 250 million; S/. 23,359 million at end-June, up to a ceiling of S/. 500 million; S/. 32, 807 million at end-September, up to a ceiling of S/. 750 million; and S/. 44,821 million at end-December, up to a total ceiling of S/. 1,000 million.

3/ The limit on the borrowing requirement of the combined public sector will be adjusted for the operating balance of the BCRP.

4/ The limit on the borrowing requirement of the combined public sector will be adjusted upward by up to US$100 million for capital spending by Petroperu, over the $30 million already included in the program.

5/ 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$15 million at end-March, -US$138 million at end-June, -US$274 million at end-September, and -US$148 million at end-December 2007. It will be adjusted downward for shortfalls from programmed net foreign borrowing. The amounts in excess will be deposited at the BCRP.

6/ 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 2007.

7/ The limit will be adjusted upward by any amount of debt issued, and used in, debt-exchange operations, or for prefinancing of government operations.

8/ The current debt limits do not include contracting of non-guaranteed debt by Petroperu and will be adjusted upward by up to US$300 million for debt contracted by Petroperu during 2007

9/ The limit on contracting and guaranteeing of nonconcessional public debt will be adjusted upwards for guarantees contracted or extended by the government in relation to concessions, up to a ceiling of US$430 million for the year as a whole.

10/ Discount rates to calculate the NPV of the future stream of payments will be the currency-specific commercial interest reference rates (CIRRs) published by the OECD and specified in the TMU.

11/ 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: Structural Benchmarks for 2007

Measures	Date of Implementation	Current Status
Publication of the main recommendations of the CIAS on an anti-poverty strategy.	March 31, 2007	Observed.
Establishment of a unit at the Ministry of Finance to monitor the operations of subnational governments and assess their performance with respect to fiscal rules.	March 31, 2007	Observed.
Clarify the tax treatment of financial derivatives and securitized transactions.	March 31, 2007	Substantially observed. Tax treatment of securitized transactions is expected to be clarified by December 31, 2007.
Submit to congress a legal framework for PPP operations.	June 30, 2007	Reprogrammed for September 30, 2007.
Ensure that most of new mortgage loans extended by banks with the guarantee of *MiVivienda* are denominated in nuevo soles.	June 30, 2007	N/A
Full implementation of the Treasury Single Account (TSA) for the central government.	December 31, 2007	N/A
2008 Budget prepared according to the modernized budget classification system and incorporated into the charts of accounts.	December 31, 2007	N/A
Financial transactions tax rate reduced, effective January 1, 2008.	December 31, 2007	Observed. A decree was issued in March 2007.
Issue new regulations regarding new risk categories and provisions to address foreign currency risk.	December 31, 2007	N/A

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

(In percent of GDP; unless otherwise indicated)

	2003	2004	2005	Country Report 07/54 2006	Prel. 2006	Prog. 2007	Projection 2007	Projection 2008
Central government primary balance	**0.2**	**0.6**	**1.1**	**2.5**	**3.2**	**1.1**	**1.3**	**1.3**
Revenue	**14.9**	**15.0**	**15.8**	17.4	**17.4**	**16.5**	**17.3**	**16.9**
Current	14.7	14.9	15.7	17.2	17.2	16.4	17.2	16.8
Of which : Tax revenue	12.8	13.2	13.6	15.1	14.9	14.5	15.2	15.0
Of which: Financial transaction tax	...	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Capital	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Noninterest expenditure	14.7	14.4	14.7	14.9	14.1	15.4	15.9	15.6
Current 1/	12.8	12.6	12.8	13.1	12.2	12.7	13.0	12.3
Capital	1.9	1.8	1.9	1.8	2.0	2.7	3.0	3.3
Rest of the general government primary balance	**0.3**	**0.3**	**0.3**	**0.2**	**0.4**	**0.1**	**0.5**	**0.0**
Revenue	5.8	5.7	5.9	6.1	6.2	5.9	6.6	6.0
Current	5.7	5.7	5.9	5.9	5.9	5.9	6.5	5.9
Capital	0.1	0.0	0.1	0.2	0.3	0.0	0.1	0.1
Noninterest expenditure	5.5	5.4	5.7	5.8	5.8	5.8	6.0	6.0
Current	4.6	4.6	4.7	4.8	4.7	4.7	4.6	4.6
Capital	0.9	0.9	1.0	1.0	1.1	1.1	1.5	1.5
Public enterprise primary balance	**0.0**	**0.1**	**0.2**	**0.1**	**0.3**	**0.1**	**0.0**	**-0.1**
Current balance	0.3	0.4	0.5	0.4	0.5	0.5	0.3	0.3
Capital balance	-0.4	-0.2	-0.3	-0.3	-0.2	-0.4	-0.3	-0.3
Nonfinancial public sector primary balance	**0.4**	**1.0**	**1.6**	**2.8**	**3.9**	**1.3**	**1.8**	**1.2**
Central bank operating balance	0.1	0.0	0.0	0.1	0.2	0.0	0.1	0.0
Combined public sector primary balance	**0.5**	**1.0**	**1.6**	**3.0**	**4.1**	**1.3**	**1.9**	**1.2**
Interest payments	2.2	2.0	1.9	2.0	1.9	2.0	1.8	1.7
External	1.8	1.7	1.6	1.5	1.4	1.4	1.4	1.2
Domestic	0.4	0.4	0.4	0.5	0.4	0.6	0.5	0.5
Combined public sector overall balance	**-1.7**	**-1.1**	**-0.3**	**1.0**	**2.2**	**-0.8**	**0.0**	**-0.5**
Financing	**1.7**	**1.1**	**0.3**	**-1.0**	**-2.2**	**0.8**	**0.0**	**0.5**
External	1.4	1.5	-1.3	-0.2	-0.6	-0.2	0.0	-0.5
Disbursements 2/	3.4	3.6	3.4	1.1	0.7	1.0	3.2	0.9
Amortization 3/	-1.9	-1.9	-4.6	-1.3	-1.3	-1.2	-3.3	-1.5
Rescheduling/arrears (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other 4/	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.1	0.0
Domestic	0.2	-0.6	1.6	-0.9	-1.7	0.9	-0.1	1.0
Bond placements 5/	0.8	1.1	2.6	1.9	1.8	0.7	1.6	1.1
Amortization 6/	-0.9	-1.0	-1.0	-1.5	-1.5	-0.4	-1.2	-0.5
Net deposits	0.3	-0.7	0.0	-1.4	-2.1	0.6	-0.5	0.4
Privatization	0.1	0.2	0.1	0.1	0.1	0.0	0.0	0.0
Memorandum items:								
Combined public sector overall balance (including CRPAOs)	**-1.7**	**-1.1**	**-0.3**	**0.9**	**2.1**	**-1.2**	**-0.3**	**-0.9**
General government current revenue 7/	17.4	17.5	18.3	19.6	19.6	18.5	19.6	19.1
General government noninterest expenditure 7/	17.1	16.7	17.0	16.9	16.1	17.4	17.8	17.9
Public sector debt (including CRPAOs)	47.0	44.4	37.7	32.0	32.7	31.2	30.0	28.8
Nominal GDP (S/. billions)	213.9	237.8	261.6	298.9	305.8	317.9	329.2	349.0

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

1/ Revised projection for 2007 accommodates the acceleration of transfers associated with income tax payments from the extractive industries to sub-national governments.

2/ In 2004, includes placement of US$800 million euro-denominated bonds, covering part of the country's financing needs for 2005. In 2005, includes placement of US$750 million bonds to finance the Paris Club prepayment. In 2007 (the projection column), includes the swap of $2.3 billion to extend the average maturity of public debt.

3/ In 2005, includes the prepayment of US$1.55 billion to the Paris Club. In 2007 (the projection column), includes the swap of $2.3 billion to extend the average maturity of public debt.

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/ In 2005, includes the placement of US$323 and US$462 million Soles-denominated bonds to finance the Paris Club prepayment. In 2006, includes the placement of US$85 million Soles-denominated bonds to finance the Japeco prepayment.

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

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

Table 5. Peru: Fiscal Operations of the Combined Public Sector
(In billions of Soles; unless otherwise indicated)

				Country Report 07/54	Prel.	Prog.	Projection	
	2003	2004	2005	2006		2007	2007	2008
Central government primary balance	**0.5**	**1.4**	**2.9**	**7.5**	**9.8**	**3.5**	**4.4**	**4.5**
Revenue	**31.9**	**35.6**	**41.4**	**51.9**	**53.1**	**52.4**	**56.9**	**58.9**
Current	31.6	35.4	41.0	51.6	52.7	52.1	56.6	58.6
Of which : Tax revenue	27.5	31.3	35.6	45.2	45.6	46.0	50.1	52.5
Capital	0.4	0.2	0.4	0.3	0.4	0.3	0.3	0.3
Noninterest expenditure	31.5	34.2	38.5	44.4	43.3	48.9	52.5	54.4
Current 1/	27.4	29.9	33.6	39.1	37.3	40.3	42.7	42.9
Capital	4.1	4.3	4.9	5.3	6.0	8.5	9.8	11.5
Rest of the general government primary balance	**0.6**	**0.7**	**0.7**	**0.7**	**1.3**	**0.3**	**1.7**	**0.0**
Revenue	12.4	13.6	15.6	18.2	18.9	18.7	21.6	21.1
Current	12.2	13.5	15.3	17.7	18.1	18.6	21.3	20.7
Capital	0.2	0.1	0.2	0.5	0.8	0.1	0.3	0.3
Noninterest expenditure	11.8	12.9	14.8	17.5	17.6	18.4	19.9	21.1
Current	9.9	10.8	12.3	14.3	14.3	14.8	15.0	16.0
Capital	1.9	2.1	2.5	3.1	3.3	3.6	4.9	5.1
Public enterprise primary balance	**-0.1**	**0.3**	**0.6**	**0.2**	**0.9**	**0.2**	**-0.1**	**-0.3**
Current balance	0.7	0.9	1.3	1.2	1.4	1.4	1.0	0.9
Capital balance	-0.8	-0.5	-0.7	-1.0	-0.6	-1.2	-1.1	-1.2
Nonfinancial public sector primary balance	0.9	2.4	4.2	8.4	12.0	4.0	6.0	4.1
Central bank operating balance	0.1	-0.1	0.0	0.4	0.5	0.0	0.2	0.1
Combined public sector primary balance	**1.0**	**2.3**	**4.2**	**8.8**	**12.4**	**4.0**	**6.2**	**4.2**
Interest payments	4.6	4.9	5.1	5.9	5.7	6.4	6.1	6.0
External	3.8	4.0	4.2	4.4	4.3	4.5	4.5	4.2
Domestic	0.9	0.9	0.9	1.4	1.4	2.0	1.6	1.8
Of which: Pension recognition bonds	0.2	0.3	0.1	0.2	0.3	0.2	0.4	0.4
Combined public sector overall balance	**-3.6**	**-2.6**	**-0.9**	**3.0**	**6.7**	**-2.4**	**0.1**	**-1.8**
Financing	**3.6**	**2.6**	**0.9**	**-3.0**	**-6.7**	**2.4**	**-0.1**	**1.8**
External	2.9	3.7	-3.5	-0.6	-1.8	-0.6	0.0	-1.7
Disbursements 2/	7.3	8.4	9.0	3.3	2.0	3.2	10.5	3.3
Amortization 3/	-4.1	-4.6	-12.1	-4.0	-3.9	-3.8	-10.8	-5.1
Rescheduling/arrears (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other 4/	-0.2	-0.2	-0.4	0.0	0.1	0.0	0.3	0.1
Domestic	0.5	-1.5	4.2	-2.6	-5.2	2.9	-0.2	3.4
Bond placements 5/	1.8	2.6	6.8	5.7	5.5	2.3	5.4	3.8
Amortization 6/	-1.9	-2.5	-2.7	-4.4	-4.5	-1.3	-3.8	-1.7
Net deposits	0.7	-1.7	0.0	-4.2	-6.3	1.8	-1.8	1.3
Privatization	0.2	0.4	0.2	0.3	0.3	0.1	0.1	0.1
Memorandum items:								
Combined public sector overall balance (including CRPAOs)	**-3.6**	**-2.6**	**-0.8**	**2.7**	**6.4**	**-3.7**	**-3.1**	**-2.3**
General government current revenue 7/	37.3	41.6	47.9	58.6	60.2	58.8	64.7	66.7
General government noninterest expenditure 7/	36.6	39.7	44.5	50.6	49.3	55.2	58.7	62.4
Public sector debt (including CRPAOs)	100.5	105.5	98.7	95.8	100.1	99.2	98.7	100.5
Nominal GDP (S/. billions)	213.9	237.8	261.6	298.9	305.8	317.9	329.2	349.0

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

1/ Revised projection for 2007 accommodates the acceleration of transfers associated with income tax payments from the extractive industries to sub-national governments.
2/ In 2004, includes placement of US$800 million euro-denominated bonds, covering part of the country's financing needs for 2005. In 2005, includes placement of US$750 million bonds to finance the Paris Club prepayment. In 2007 (the projection column), includes the swap of $2.3 billion to extend the average maturity of public debt.
3/ In 2005, includes the prepayment of US$1.55 billion to the Paris Club. In 2007 (the projection column), includes the swap of $2.3 billion to extend the average maturity of public debt.
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/ In 2005, includes the placement of US$323 and US$462 million Soles-denominated bonds to finance the Paris Club prepayment. In 2006, includes the placement of US$85 million Soles-denominated bonds to finance the Japeco prepayment.
6/ Includes in 2005 the amortization of US$390 million U.S. dollar denominated domestic bonds for the restructuring of the financial sector.
7/ Net of transfers among non-financial public institutions.

Table 6. Peru: Financing of the Combined Public Sector

				Prel.	Prog.	Projection	
	2003	2004	2005	2006	2007	2007	2008
	(In millions of U.S. dollars)						
Combined balance	**-1,037**	**-748**	**-262**	**2,056**	**-746**	**32**	**-565**
Financing	**1,037**	**748**	**262**	**-2,056**	**746**	**-32**	**565**
Net External	843	1,078	-1,067	-560	-174	-9	-533
Disbursements	2,101	2,474	2,728	609	1,000	3,294	1,020
Bonds 1/ 2/	1,245	1,295	1,682	0	0	2,290	0
Multilaterals	519	863	595	315	400	404	420
Bilaterals and other	337	315	451	294	600	600	600
Amortization 3/ 4/	-1,187	-1,348	-3,678	-1,195	-1,174	-3,392	-1,592
Other 5/	-71	-48	-117	27	0	89	40
Privatization	52	114	56	94	24	40	25
Net Domestic financing	142	-443	1,273	-1,590	897	-62	1,073
Bonds 6/	508	759	2,071	1,701	723	1,675	1,200
Amortization	-556	-719	-811	-1,372	-387	-1,190	-544
Of which : Pension recognition bonds	-170	-215	-188	-145	-95	-158	-170
Net deposits	190	-483	13	-1,919	561	-548	417
Of which: Central government	299	-335	348	-1,227	582	-81	213
	(In percent of GDP)						
Combined balance	**-1.7**	**-1.1**	**-0.3**	**2.2**	**-0.8**	**0.0**	**-0.5**
Financing	**1.7**	**1.1**	**0.3**	**-2.2**	**0.8**	**-0.0**	**0.5**
Net External	1.4	1.5	-1.3	-0.6	-0.2	-0.0	-0.5
Disbursements 1/	3.4	3.6	3.4	0.7	1.0	3.2	0.9
Bonds	2.0	1.9	2.1	0.0	0.0	2.2	0.0
Multilaterals	0.8	1.2	0.7	0.3	0.4	0.4	0.4
Bilaterals and other	0.5	0.5	0.6	0.3	0.6	0.6	0.5
Amortization	-1.9	-1.9	-4.6	-1.3	-1.2	-3.3	-1.5
Other	-0.1	-0.1	-0.1	0.0	0.0	0.1	0.0
Privatization	0.1	0.2	0.1	0.1	0.0	0.0	0.0
Net Domestic financing	0.2	-0.6	1.6	-1.7	0.9	-0.1	1.0
Bonds	0.8	1.1	2.6	1.8	0.7	1.6	1.1
Amortization	-0.9	-1.0	-1.0	-1.5	-0.4	-1.2	-0.5
Of which: Pension recognition bonds	-0.3	-0.3	-0.2	-0.2	-0.1	-0.2	-0.2
Net deposits	0.3	-0.7	0.0	-2.1	0.6	-0.5	0.4
Of which: Central government	0.5	-0.5	0.4	-1.3	0.6	-0.1	0.2
Memorandum items:							
Net external financing (including CRPAOs)	843.5	1,077.7	-1,066.5	-459.5	226.0	389.5	-51.4
Nominal GDP (S/. billions)	213.9	237.8	261.6	305.8	317.9	329.2	349.0

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 financing needs for 2005. In 2007 (the projection column), includes the swap of $2.3 billion to extend the average maturity of public debt.

2/ In 2005, includes placement of US$750 million bonds to finance the Paris Club prepayment. In 2007 (the projection column), includes the swap of $2.3 billion to extend the average maturity of public debt.

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

4/ In 2005, includes the prepayment of US$1.55 billion to the Paris Club. In 2007 (the projection column), includes a swap of $2.3 billion to extend the average maturity of debt.

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

6/ In 2005, includes the placement of US$323 and US$462 million Soles-denominated bonds to finance the Paris Club prepayment. In 2006, includes the placement of US$85 million Soles-denominated bonds to finance the Japeco prepayment.

Table 7. Peru: Public Sector Social Expenditure

	2002	2003	2004	2005	Prel. 2006	Proj. 2007
(In millions of New Soles)						
Total social expenditure and pensions	**20,698**	**21,613**	**23,578**	**25,764**	**27,736**	**29,379**
Universal coverage (Education and Health) 1/	8,197	8,916	10,396	10,954	12,689	13,822
Education	5,759	6,366	7,289	7,718	8,341	9,048
Health	2,438	2,550	3,107	3,235	4,348	4,774
Targeted programs (Extreme Poverty)	2,840	2,988	2,994	3,447	3,185	3,455
Non-Targeted Social Programs	9,661	9,710	10,187	11,364	11,862	12,102
(In percent of general government expenditure)						
Total social expenditure and pensions	**53.5**	**52.6**	**53.0**	**52.0**	**50.5**	**45.5**
Universal coverage (Education and Health) 1/	21.2	21.7	23.4	22.1	23.1	21.4
Education	14.9	15.5	16.4	15.6	15.2	14.0
Health	6.3	6.2	7.0	6.5	7.9	7.4
Targeted programs (Extreme Poverty) 2/	7.3	7.3	6.7	7.0	5.8	5.3
Non-Targeted Social Programs	25.0	23.6	22.9	22.9	21.6	18.7
(In percent of GDP)						
Total social expenditure and pensions	**10.3**	**10.1**	**9.9**	**9.8**	**9.1**	**8.9**
Universal coverage (Education and Health) 1/	4.1	4.2	4.4	4.2	4.1	4.2
Education	2.9	3.0	3.1	3.0	2.7	2.7
Health	1.2	1.2	1.3	1.2	1.4	1.5
Targeted programs (Extreme Poverty)	1.4	1.4	1.3	1.3	1.0	1.0
Non-Targeted Social Programs	4.8	4.5	4.3	4.3	3.9	3.7
Memorandum items:						
Total social expenditure and pensions (annual percentage change, deflated by CPI)	8.4	2.2	5.9	7.6	5.3	4.9
General government expenditure (in millions of New Soles)	38,721	41,098	44,475	49,565	54,915	64,636

Source: Ministry of Economy and Finance.

1/ Net of spending on education and health already included in the extreme poverty programs.
2/ Includes expenditures for the targeted poverty-reduction program Juntos in 2006.

Table 8. Peru: Monetary Survey

	2003	2004	2005	Prel. 2006	Prog. 2007	Projection 2007	Projection 2008
I. Central Reserve Bank (In millions of New Soles at program exchange rate)							
Net international reserves 1/	**36,393**	**43,111**	**46,594**	**56,566**	**54,260**	**68,930**	**69,536**
(In millions of U.S. dollars)	10,194	12,631	14,097	17,275	16,747	21,275	21,775
Net domestic assets	**-30,023**	**-35,075**	**-36,478**	**-44,770**	**-41,689**	**-55,219**	**-54,389**
Net credit to nonfinancial public sector	-10,709	-12,974	-13,888	-20,061	-15,907	-23,224	-22,782
Rest of banking system	-14,757	-19,146	-21,384	-21,906	-23,916	-27,216	-27,796
Other	-4,557	-2,955	-1,206	-2,802	-1,867	-4,779	-3,810
Currency	**6,370**	**8,036**	**10,116**	**11,796**	**12,571**	**13,711**	**15,147**
II. Banking System (In millions of New Soles at program exchange rate)							
Net foreign assets	**36,186**	**42,562**	**45,851**	**57,359**	**58,657**	**68,746**	**69,355**
Net domestic assets	**17,597**	**15,809**	**20,404**	**17,075**	**22,414**	**15,940**	**23,438**
Net credit to nonfinancial public sector	-10,664	-13,437	-14,307	-21,290	-17,342	-26,274	-25,115
Net credit to private sector	44,876	44,990	49,504	54,736	63,173	61,095	66,809
Other	-16,615	-15,744	-14,793	-16,371	-23,417	-18,881	-18,257
Net credit to COFIDE	-1,018	-1,087	-850	-850	-850	-850	-850
Other	-15,597	-14,657	-13,943	-15,521	-22,567	-18,031	-17,407
Liabilities to the private sector	**53,783**	**58,371**	**66,255**	**74,434**	**81,071**	**84,686**	**92,792**
(12-month percentage change)							
Base money	10.1	25.3	25.7	18.3	10.0	15.4	10.8
Broad money	2.5	8.5	13.5	12.3	9.3	13.8	9.6
Domestic currency	10.5	28.1	19.5	18.0	15.9	21.4	15.3
Foreign currency 2/	-1.8	-3.1	8.8	7.5	3.0	6.6	3.4
Net credit to private sector	-2.9	0.3	10.0	10.6	8.0	11.6	9.4
Domestic currency	5.1	11.9	34.8	29.0	23.7	28.6	20.2
Foreign currency 2/	-5.0	-3.2	1.6	2.3	0.0	2.0	1.6
III. Financial System (In millions of New Soles at program exchange rate)							
Net foreign assets	**35,928**	**42,425**	**45,775**	**57,336**	**61,674**	**65,936**	**67,255**
Net domestic assets	**38,820**	**41,818**	**54,504**	**66,982**	**53,695**	**80,393**	**95,493**
Net credit to the public sector	-8,976	-10,442	-7,599	-10,927	-6,911	-13,113	-11,802
Net credit to private sector	62,666	65,914	73,377	87,626	86,777	99,832	108,803
Other	-14,871	-13,655	-11,274	-9,716	-26,171	-6,327	-1,508
Liabilities to the private sector	**74,748**	**84,243**	**100,278**	**124,318**	**115,369**	**146,329**	**162,748**
(12-month percentage change)							
Liabilities to the private sector	13.5	12.7	19.0	24.0	8.0	17.7	11.2
Domestic currency	24.3	23.5	28.9	30.6	12.0	24.0	15.0
Foreign currency 2/	3.7	0.9	6.0	13.4	1.0	6.0	3.0
Net credit to private sector	3.7	5.2	11.3	19.4	7.5	13.9	9.0
Domestic currency	18.0	17.9	26.6	37.6	15.0	25.0	15.0
Foreign currency 2/	-1.9	-0.9	2.7	6.8	1.5	4.0	2.5
Memorandum item:							
Program exchange rate (S/. per US$)	3.48	3.41	3.31	3.27	3.24	3.24	3.19

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, as well as Corporacion 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: Financial Soundness Indicators 1/

(In percent; unless otherwise indicated)

	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Mar-07
Capital Adequacy							
Equity capital to risk-weighted assets	12.8	12.5	13.3	14.0	12.0	12.5	12.5
Regulatory Tier I capital to risk-weighted assets 2/	12.4	13.0	12.1	13.1	11.2	10.6	10.7
Nonperforming loans net of provisions to capital	-11.1	-17.2	-15.2	-17.3	-21.7	-18.0	-17.2
Asset Quality							
Nonperforming loans to total gross loans 3/	9.0	7.6	5.8	3.7	2.1	1.6	1.6
In domestic currency	5.2	5.2	4.0	3.0	2.1	1.9	1.9
In foreign currency	9.9	8.2	6.3	3.9	2.2	1.5	1.5
Nonperforming loans to total gross loans 4/	17.0	14.6	12.2	9.5	6.3	4.1	3.9
In domestic currency	9.9	8.8	6.6	6.1	4.2	3.2	3.1
In foreign currency	19.0	16.4	14.1	10.6	7.1	4.6	4.3
Refinanced and restructured loans to total gross loans 5/	8.0	7.0	6.4	5.8	4.1	2.4	2.2
Provisions to nonperforming loans 3/	118.9	133.2	141.1	176.5	235.3	251.4	246.5
Provisions to nonperforming, restructured, and refinanced loans 4/	63.0	69.1	67.1	68.7	80.3	100.3	104.3
Sectoral distribution of loans to total loans							
Consumer loans	8.6	9.4	11.6	13.4	14.4	16.5	17.0
Mortgage loans	9.6	10.7	12.9	14.2	14.8	14.0	14.0
Commercial loans	79.2	77.6	72.6	68.1	65.8	64.2	63.6
Small business loans	2.5	2.3	2.9	4.3	5.0	5.3	5.4
Earnings and Profitability							
ROA	0.4	0.8	1.1	1.2	2.2	2.2	2.4
ROE	4.3	8.3	10.7	11.6	22.2	23.9	25.8
Gross financial spread to financial revenues	51.9	66.1	71.2	71.9	70.5	67.6	69.2
Financial revenues to total revenues	78.7	72.7	70.6	69.1	76.3	76.6	80.2
Annualized financial revenues to revenue-generating assets	11.6	9.9	9.2	9.0	10.3	10.6	11.0
Liquidity							
Total liquid assets to total short-term liabilities	39.2	41.9	40.4	44.5	45.5	44.2	44.9
In domestic currency	22.6	23.5	32.9	44.8	38.6	43.1	48.1
In foreign currency	46.0	49.3	43.9	44.3	49.2	45.0	42.6
Foreign Currency Position and Dollarization							
Global position in foreign currency to regulatory capital 6/	37.6	37.0	31.8	24.2	23.1	17.1	30.2
Share of foreign currency deposits in total deposits	71.9	71.6	69.7	67.1	67.2	62.7	60.7
Share of foreign currency loans in total credit	80.5	79.7	77.9	75.7	71.5	65.5	64.7
Foreign currency deposits at commercial banks (in millions of U.S. dollars)	9,357	9,658	9,210	9,596	10,913	11,855	11,993
Commercial banks' short-term foreign assets (in millions of U.S. dollars)	748	779	601	547	796	878	758
Commercial banks' short-term foreign liabilities (in millions of U.S. dollars)	1,161	763	702	733	1,085	754	712
Operational efficiency							
Financing to related parties to capital 7/	...	20.1	18.7	14.3	17.9	15.5	16.6
Nonfinancial expenditure to total revenues 8/	32.1	36.2	37.7	35.9	33.3	31.3	29.8
Nonfinancial expenditure to total revenue-generating assets 8/	4.7	4.9	4.9	4.7	4.6	3.4	4.6
Memorandum items:							
Number of Banks	16	16	16	16	14	13	13
Private commercial	15	14	14	14	12	11	11
Of which: Foreign-owned	10	9	9	9	9	7	7
State-owned	1	2	2	2	2	2	5
Banks' credit card loans to total loans	2.4	3.3	4.6	6.4	6.9	8.1	8.2
Bank loans' 12 month increase (in real terms)	-3.3	1.0	-8.3	-1.9	19.0	14.0	17.2
Stock market index (U.S. dollars)	342.1	396.0	700.6	1,131.6	1,400.1	4,032.0	5,390.2
Foreign currency debt rating (Moody's)	Ba3	Ba3	Ba3	Ba3	Ba3	Ba3	Ba3
Spread of Peruvian Brady bonds, basis points	521	610	312	220	257	118	129

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 merger 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 10. Peru: Balance of Payments
(In millions of U.S. dollars)

				Prel.	Prog.	Projection	
	2003	2004	2005	2006	2007	2007	2008
Current account	**-935**	**-11**	**1,033**	**2,456**	**151**	**877**	**551**
Merchandise trade	836	2,793	5,163	8,853	7,080	8,066	5,524
Exports	9,091	12,617	17,247	23,750	24,705	25,974	25,705
Traditional	6,356	9,028	12,839	18,332	18,867	19,766	18,616
Nontraditional and others	2,734	3,589	4,408	5,417	5,838	6,208	7,089
Imports	-8,255	-9,824	-12,084	-14,897	-17,625	-17,908	-20,181
Services, income, and current transfers (net)	-1,771	-2,803	-4,130	-6,397	-6,929	-7,189	-4,973
Services	-854	-843	-912	-932	-1,233	-1,296	-1,508
Investment income	-2,144	-3,421	-5,009	-7,649	-7,934	-8,522	-6,223
Current transfers	1,227	1,460	1,791	2,184	2,239	2,630	2,759
Financial and capital account	**1,414**	**2,337**	**495**	**270**	**971**	**2,969**	**-90**
Public sector	684	988	-1,440	-639	150	135	-148
Disbursements 1/	2,161	2,535	2,656	708	1,405	3,689	1,589
Amortization 1/	-1,229	-1,389	-3,718	-1,222	-1,205	-3,460	-1,641
Other medium- and long-term Public sector flows 2/	-248	-158	-378	-125	-50	-94	-97
Capital transfers (net)	0	0	0	0	0	0	0
Privatization	10	31	31	79	10	0	39
Private sector	720	1,318	1,905	831	811	2,834	19
Foreign direct investment (FDI) excluding privatization	1,265	1,785	2,489	3,388	2,233	2,893	2,849
Other private capital	-1,233	-557	-878	-1,884	-1,421	-59	-2,829
Medium- and long-term loans	-166	-411	-741	114	-122	262	27
Portfolio investment	-1,214	-376	75	-1,444	-910	-1,717	-1,545
Short-term flows 3/	147	231	-213	-554	-390	1,395	-1,311
Net Errors and Omissions	688	90	295	-674	0	0	0
Balance	**479**	**2,326**	**1,528**	**2,726**	**1,122**	**3,846**	**461**
Financing	**-479**	**-2,326**	**-1,528**	**-2,726**	**-1,122**	**-3,846**	**-461**
NIR flow (increase -)	-477	-2,353	-1,628	-2,753	-1,150	-3,925	-500
Change in NIR (increase -)	-596	-2,437	-1,466	-3,178	-1,150	-4,000	-500
Valuation change	-119	-84	162	-425	0	-75	0
Exceptional financing	-2	27	100	27	28	79	39
Debt relief 4/	70	27	100	27	28	79	39
Change in arrears	-72	0	0	0	0	0	0
Rescheduling	0	0	0	0	0	0	0
Memorandum items:							
Current account balance (in percent of GDP)	**-1.5**	**0.0**	**1.3**	**2.6**	**0.2**	**0.9**	**0.5**
Capital and financial account balance (in percent of GDP	2.3	3.4	0.6	0.3	1.0	2.9	-0.1
Export value (US$), percent change	17.8	38.8	36.7	37.7	6.2	9.4	-1.0
Volume growth	10.0	12.8	15.4	1.5	7.5	5.9	8.0
Price growth	7.1	23.0	18.4	35.7	-1.2	3.3	-8.3
Import value (US$), percent change	11.2	19.0	23.0	23.3	16.1	20.2	12.7
Volume growth	5.4	7.5	11.1	14.6	11.3	15.7	10.0
Price growth	5.5	10.7	10.7	7.5	4.4	3.9	2.5
GDP (in billions of US$)	61.5	69.7	79.4	93.2	98.1	103.1	109.3
Average exchange rate (S/. per US$)	3.48	3.41	3.30	3.27	3.24	3.19	3.19

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

1/ Includes debt swap operations.
2/ Includes portfolio flows of the pension reserve fund and subscription payments into international funds.
3/ Includes COFIDE and Banco de la Nación.
4/ Debt relief under existing operations.

Table 11. Peru: External Financing Requirements and Sources

(In millions of U.S. dollars)

				Prel.	Prog.	Projection	
	2003	2004	2005	2006	2007	2007	2008
Gross financing requirements	**6,008**	**7,125**	**8,440**	**5,265**	**5,459**	**9,855**	**5,076**
External current account deficit (excluding official transfers)	**935**	**11**	**-1,033**	**-2,456**	**-151**	**-877**	**-551**
Debt amortization	4,524	4,761	7,845	4,969	4,460	6,807	5,127
Medium- and long-term debt	1,954	2,247	5,094	1,783	1,808	3,901	2,264
Public sector	1,229	1,389	3,718	1,222	1,205	3,460	1,641
Multilateral 1/	486	571	628	647	707	705	696
Bilateral	686	742	2,159	394	382	411	379
Bonds and notes	44	67	90	90	113	2,340	544
Other	13	9	842	92	4	4	22
Private sector	725	858	1,376	561	602	441	623
Short-term debt 2/	2,570	2,514	2,751	3,186	2,652	2,906	2,863
Rescheduling and repayment of arrears	72	0	0	0	0	0	0
Accumulation of NIR (flow)	477	2,353	1,628	2,753	1,150	3,925	500
Change in gross reserves	513	2,440	1,470	3,177	1,150	4,000	500
Payments of short-term liabilities incl. IMF	84	-3	-4	1	0	0	0
Other	-119	-84	162	-425	0	-75	0
Available financing	**6,008**	**7,125**	**8,440**	**5,265**	**5,459**	**9,855**	**5,076**
Foreign direct investment (net)	1,275	1,816	2,519	3,467	2,243	2,893	2,888
Privatization	10	31	31	79	10	0	39
FDI	1,265	1,785	2,489	3,388	2,233	2,893	2,849
Portfolio (net)	-1,214	-376	75	-1,444	-910	-1,717	-1,545
Short-term assets (flow)	870	102	-209	-940	-390	1,438	-1,311
Of which: Errors and omissions	688	90	295	-674	0	0	0
Debt financing from private creditors	4,346	4,474	5,359	3,673	3,532	6,256	4,013
Medium- and long-term financing	1,811	1,742	2,316	775	880	3,393	1,150
To public sector 3/	1,252	1,295	1,682	100	400	2,690	500
To private sector	559	447	635	675	480	703	650
Short-term financing	2,535	2,732	3,042	2,898	2,652	2,863	2,863
Official creditors 4/	909	1,240	974	608	1,005	999	1,089
Multilateral 1/	699	1,049	762	484	690	725	737
Of which: Balance of payments financing	527	863	581	300	350	404	400
Bilateral	210	191	212	123	315	274	287
To public sector	210	191	212	123	315	274	287
To private sector	0	0	0	0	0	0	0
Other medium- and long-term public sector flov	-178	-131	-278	-98	-22	-15	-58
IMF	0	0	0	0	0	0	0
Accumulation of arrears (exceptional)	0	0	0	0	0	0	0

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

1/ Excluding IMF.
2/ Original maturity of less than one year. Equals stock at the end of the previous period.
3/ Based on projections of no placements in external markets over the program period. Projections exclude possible external issuance for debt prepayments.
4/ Includes both loans and grants. Breakdown not available as of 2008.

Table 12. Peru: Medium-Term Macroeconomic Framework

	2005	Prel. 2006	Staff Projection 2007	2008	2009	2010	2011	2012
(Annual percentage change)								
GDP at constant prices	6.4	8.0	7.0	6.0	5.5	5.5	5.5	5.5
Consumer prices (end of period)	1.5	1.1	2.0	2.0	2.0	2.0	2.0	2.0
GDP deflator	3.4	8.2	0.6	0.0	1.0	1.5	1.8	2.0
Merchandise trade								
Exports, f.o.b.	36.7	37.7	9.4	-1.0	0.1	3.1	5.5	4.6
Imports, f.o.b.	23.0	23.3	20.2	12.7	7.5	6.0	8.2	6.4
Terms of trade (deterioration -)	5.9	26.1	-0.6	-10.5	-7.6	-4.7	-1.1	-0.9
(In percent of GDP; unless otherwise indicated)								
External current account balance	1.3	2.6	0.9	0.5	0.1	-0.2	-0.3	-0.5
External current account, excluding interest obligations	3.4	4.6	2.8	2.2	1.8	1.4	1.0	0.7
Total external debt service	8.5	3.9	5.7	3.8	3.3	3.3	3.2	3.9
Medium- and long-term	8.3	3.7	5.5	3.6	3.1	3.2	3.0	3.8
Nonfinancial public sector	6.2	2.7	4.7	2.7	2.3	2.4	2.3	3.1
Private sector	2.0	0.9	0.8	0.9	0.8	0.8	0.7	0.7
Short-term 1/	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1
Nonfinancial public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1
External debt service 2/	8.5	3.9	5.7	3.8	3.3	3.3	3.2	3.9
Interest	2.1	2.0	1.9	1.7	1.7	1.5	1.4	1.2
Amortization (medium-and long-term)	6.4	1.9	3.8	2.1	1.6	1.8	1.8	2.7
Combined public sector primary balance 3/	1.6	4.0	1.5	0.8	1.0	1.1	1.4	1.3
General government current revenue	18.3	19.6	19.6	19.1	19.4	19.6	19.9	20.2
General govt. non-interest expenditure 3/	17.0	16.2	18.2	18.3	18.3	18.5	18.4	18.8
Combined public sector interest due	1.9	1.9	1.8	1.7	1.6	1.6	1.5	1.4
Combined public sector overall balance 3/	-0.3	2.1	-0.3	-0.9	-0.7	-0.5	-0.1	-0.1
Public sector debt 3/	37.7	32.7	30.0	28.8	27.4	25.7	23.7	21.8
Gross domestic investment	18.6	21.0	22.5	24.3	25.2	25.7	26.0	26.8
Public sector 3/	2.9	2.8	4.8	5.2	5.5	5.8	5.9	6.4
Private sector	16.0	16.8	18.0	18.8	19.4	19.8	20.1	20.3
Inventories changes	-0.2	1.3	-0.3	0.4	0.3	0.1	0.0	0.0
National savings	19.9	23.6	23.4	24.8	25.3	25.5	25.7	26.2
Public sector 4/	2.6	5.0	4.6	4.4	5.0	5.5	6.1	6.6
Private sector	17.3	18.6	18.7	20.4	20.3	20.0	19.6	19.6
External savings	-1.3	-2.6	-0.9	-0.5	-0.1	0.2	0.3	0.5
Memorandum items:								
Nominal GDP (billions of New Soles)	261.6	305.8	329.2	349.0	371.8	398.2	427.6	460.2
Gross international reserves (billions of U.S. dollars)	14,120	17,329	21,329	21,829	22,229	22,579	22,829	22,829
Gross international reserves to broad money	73.1	74.4	80.6	75.0	71.2	68.3	65.8	63.1
External debt service (percent of exports of GNFS)	34.8	14.0	20.6	14.7	13.6	14.3	13.9	17.7
Short-term external debt service (percent of exports of GNFS)	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7
Public external debt service (percent of exports of GNFS)	25.5	9.7	17.1	10.5	9.4	10.3	10.0	14.0

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

1/ Includes interest payments only.
2/ Includes the financial public sector.
3/ Includes CRPAOs.
4/ Excludes privatization receipts.

Table 13. Peru: Financial and External Vulnerability Indicators

(In percent; unless otherwise indicated)

				Prel.	Prog.	Projection	
	2003	2004	2005	2006	2007	2007	2008
Financial indicators							
Public sector debt/GDP	47.0	44.4	37.7	32.8	31.2	30.0	28.8
Of which: in domestic currency (percent of GDP)	3.8	6.9	8.2	8.0	7.2	7.4	7.3
90-day prime lending rate, domestic currency (end of period)	3.3	3.8	4.4	5.2	...	...	...
90-day prime lending rate, foreign currency (end of period)	1.7	2.6	5.5	6.1	...	...	...
Velocity of money 1/	4.0	4.1	3.9	4.1	3.9	3.9	3.8
Net credit to the private sector/GDP 2/	29.3	27.7	28.0	28.7	27.3	30.3	31.2
External indicators							
Exports, U.S. dollars (percent change)	17.8	38.8	36.7	37.7	6.2	9.4	-1.0
Imports, U.S. dollars (percent change)	11.2	19.0	23.0	23.3	16.1	20.2	12.7
Terms of trade (percent change) (deterioration -)	1.3	9.2	5.9	26.1	-5.3	-0.6	-10.5
Real effective exchange rate, (end of period, percent change) 3/	3.8	1.6	0.5	1.3	...	...	...
Current account balance (percent of GDP)	-1.5	0.0	1.3	2.6	0.2	0.9	0.5
Capital and financial account balance (percent of GDP)	2.3	3.4	0.6	0.3	1.0	2.9	-0.1
Total external debt (percent of GDP)	48.1	44.9	36.1	30.3	28.4	28.1	26.5
Medium- and long-term public debt (in percent of GDP) 4/	37.0	35.1	28.1	23.7	23.1	21.6	20.4
Medium- and long-term private debt (in percent of GDP)	7.0	5.8	4.0	3.5	2.7	3.7	3.5
Short-term public and private debt (in percent of GDP)	4.1	4.0	4.0	3.1	2.7	2.8	2.6
Total external debt (in percent of exports of goods and services) 4/	274.3	215.0	147.5	107.9	102.5	101.6	102.5
Total debt service (in percent of exports of goods and services) 5/	31.0	25.4	34.8	14.0	13.8	20.6	14.7
Gross official reserves							
In millions of U.S. dollars	10,206	12,649	14,120	17,329	16,765	21,329	21,829
In percent of short-term external debt 6/	211.9	166.3	311.4	356.6	336.9	412.6	458.3
In percent of short-term external debt, foreign currency deposits, and adjusted CA balance 6/ 7/	70.2	73.5	92.0	104.7	98.7	118.9	121.4
In percent of broad money 8/	65.9	71.1	73.1	74.4	67.0	80.6	75.0
In percent of foreign currency deposits at banks	105.2	131.9	130.6	148.2	139.6	167.0	165.2
In months of next year's imports of goods and services	9.7	10.0	9.8	9.7	8.5	10.6	10.1
Net international reserves (in millions of U.S. dollars)	10,194	12,631	14,097	17,275	16,747	21,275	21,775
Net international reserves (program definition; in millions of U.S. dollars) 9/	6,906	9,304	9,748	12,981	11,835	...	...
Net foreign exchange position (in millions of U.S. dollars) 10/	4,583	6,936	7,450	11,086	9,467	15,086	15,586

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. Source: Information Notice System, IMF.
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, including debt swaps.
7/ Current Account deficit adjusted for 0.75*net FDI inflows; if adjusted CA balance>0, set to 0.
8/ At end-period exchange rate.
9/ Includes financial system's foreign currency deposits in central bank as reserve liability.
10/ Includes public sector foreign currency deposits in central bank (e.g. pension reserve funds) as reserve liability.

Table 14. Peru: Millennium Development Goals

	1995	2001	2002	2003	2004	2005	2006	Target 2015
Goal 1: Eradicate extreme poverty and hunger								
Population below $1 a day (in percent of population)	...	18.1	12.8	10.5	...	...	...	9.1
Poverty gap at $1 a day (in percent of total population,)	...	9.1	4.4	2.9	...	...	...	4.6
Percent of income or consumption held by poorest 20 percent	...	2.9	3.1	3.7	...	...	...	1.5
Prevalence of child malnutrition (in percent of children under 5)	7.8	7.1	...	...	...	...	...	5.4
Pop. below min. of dietary energy consumption (in percent of total)	18.0	11.0	13.0	12.0	...	...	...	20.0
Goal 2: Achieve universal primary education								
Net primary enrollment ratio (in percent of relevant age group)	90.8	97.9	97.9	97.3	97.1	...	...	100.0
Percentage of cohort reaching grade 5 (in percent)	...	87.4	...	89.7	...	...	...	100.0
Youth literacy rate (in percent of ages 15-24)	95.7	96.9	96.8	...	97.0	...	...	100.0
Goal 3: Promote gender equality and empower women								
Ratio of girls to boys in primary and secondary education (in percent)	96.0	97.0	97.1	99.8	100.0	...	...	100.0
Ratio of young literate females to males (in percent of ages 15-24)	96.0	97.1	97.8	97.8	97.8	...	97.8	100.0
Share of women employed in the nonagricultural sector (in percent)	30.5	34.6	35.0	37.2	34.6	...	...	...
Proportion of seats held by women in national parliament (in percent)	10.0	20.0	18.0	18.0	18.0	18.3	29.2	...
Goal 4: Reduce child mortality								
Under 5 mortality rate (per 1,000)	60.0	42.0	39.0	34.0	29.2	22.8	...	53.3
Infant mortality rate (per 1,000 live births)	46.0	40.0	30.0	26.0	24.2	27.3	...	...
Immunization, measles (in percent of children under 12 months)	98.0	97.0	95.0	95.0	89.0	80.0	...	...
Goal 5: Improve maternal health								
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	410.0	...	...	...	...	...	307.5
Births attended by skilled health staff (in percent of total)	56.4	59.3	...	...	73.4	...	...	...
Goal 6: Combat HIV/AIDS, malaria and other diseases								
Prevalence of HIV, total (in percent of ages 15-24)	...	0.2	0.2	0.5	..	0.6	...	0.1
Contraceptive prevalence rate (in percent of women ages 15-49)	64.0	68.9	...	...	...	...	...	...
Number of children orphaned by HIV/AIDS	...	17000	...	...	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	196.7	196.0	202.4	187.6	178.4	171.5	...	...
Tuberculosis cases detected under DOTS	99.0	94.0	84.5	80.6	83.1	86.0	...	...
Goal 7: Ensure environmental sustainability								
Forest area (in percent of total land area)	...	50.9	...	...	...	53.7	...	...
Nationally protected areas (in percent of total land area)	2.7	2.7	6.1	6.1	...	...	...	...
GDP per unit of energy use (PPP $ per kg oil equivalent)	8.9	10.4	10.7	11.0	10.9	...	...	...
CO2 emissions (metric tons per capita)	1.0	1.1	...	1.0	...	...	...	...
Access to an improved water source (in percent of total population)	...	80.0	81.0	83.0	83.0	...	...	87.0
Access to improved sanitation (in percent of total population)	...	71.0	62.0	63.0	63.0	...	...	...
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)	11.4	13.2	15.2	19.2	19.1	20.9	...	...
Fixed line and mobile telephones (per 1,000 people)	50.3	136.7	152.3	175.6	222.9	280.1	...	...
Personal computers (per 1,000 people)	14.9	47.9	43.0	64.7	97.6	100.1	...	...

Sources: United Nations, Report 2006 and World Development Indicators, 2007.

Table 15. Peru: Proposed Schedule of Purchases Under the Stand-By Arrangement, 2007–09 1/

Amount of Purchase	Availability Date	Conditions Include
1. SDR 159.6 million 2/	January 26, 2007	Board approval of SBA.
2. SDR 1.596 million	June 27, 2007	Completion of the First Review and observance of end-March 2007 performance criteria.
3. SDR 1.596 million	August 15, 2007	Observance of end-June 2007 performance criteria.
4. SDR 1.596 million	November 15, 2007	Completion of the Second Review and observance of end-September 2007 performance criteria.
5. SDR 1.596 million	February 15, 2008	Observance of end-December 2007 performance criteria.
6. SDR 1.596 million	May 15, 2008	Completion of the Third Review and observance of end-March 2008 performance criteria.
7. SDR 1.596 million	August 15, 2008	Observance of end-June 2008 performance criteria.
8. SDR 1.596 million	November 15, 2008	Completion of the Fourth Review and observance end-September 2008 performance criteria.
9. SDR 1.596 million	February 15, 2009	Observance of end-December 2008 performance criteria.

1/ Total access under the Stand-By Arrangement is SDR 172.4 million (27 percent of quota).

2/ This amount is required to exhaust the first credit tranche which is not subject to phasing.

Table 16. Peru: Capacity to Repay the Fund as of March 29, 2007 1/

(In millions of SDRs; unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	Total
Obligations from existing drawings									
Principal (repurchases)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Charges and interest									
GRA charges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR charges	2.9	3.7	3.7	3.7	3.7	3.7	3.7	3.7	28.6
Credit outstanding	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
(percent of quota)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Obligations from prospective drawings									
Principal (repurchases)	0.0	0.0	0.0	20.4	83.4	65.6	2.8	0.2	172.4
Charges and interest 2/									
GRA charges	2.5	9.1	9.4	9.4	6.5	1.9	0.1	0.0	38.8
Service and commitment charges	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.9
Credit outstanding	164.4	170.8	172.4	152.0	68.6	3.0	0.2	0.0	...
(percent of quota)	25.8	26.8	27.0	23.8	10.8	0.5	0.0	0.0	...
Cumulative (existing and prospective)									
Principal (repurchases)	0.0	0.0	0.0	20.4	83.4	65.6	2.8	0.2	172.4
Charges and interest 2/									
GRA charges	2.5	9.1	9.4	9.4	6.5	1.9	0.1	0.0	38.8
SDR and Service charges	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	29.4
Credit outstanding	164.4	170.8	172.4	152.0	68.6	3.0	0.2	0.0	...
Percent of quota	25.8	26.8	27.0	23.8	10.8	0.5	0.0	0.0	...
Percent of GDP	0.2	0.2	0.2	0.2	0.1	0.0	0.0	0.0	...
Percent of exports of goods and services	0.9	0.9	0.9	0.8	0.3	0.0	0.0	0.0	...
Percent of public sector debt service	6.9	6.4	7.7	6.0	3.7	0.1	0.0	0.0	...
Percent of external public debt	1.1	1.2	1.1	1.0	0.5	0.0	0.0	0.0	...
Percent of external public debt service	9.6	8.8	10.8	8.5	3.8	0.1	0.0	0.0	...
Percent of gross foreign reserves	1.5	1.2	1.2	1.0	0.5	0.0	0.0	0.0	...
Memorandum item:									
Purchases	164.4	6.4	1.6	0.0	0.0	0.0	0.0	0.0	172.4

Sources: Fund staff estimates/projections.

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

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

Appendix 1. Peru: Debt Sustainability Analysis[1]

Peru's debt-to-GDP ratio is projected to decline significantly under the baseline debt sustainability scenario. Economic growth would average about 5½ percent a year with the overall deficit of the combined public sector averaging ½ percent of GDP. Public sector revenue would increase by 1 percent of GDP during 2007-2012. Under these assumptions, Peru's public sector debt stock would decline from 33 percent of GDP at end-2006, to about 22 percent of GDP by 2012.

Given that nearly 80 percent of total external debt is public, in the baseline scenario the projected drop in public debt largely determines the path of Peru's total external debt. Following a decline during 2004-05, as companies took advantage of favorable market conditions to pay down their external debt, private sector external debt is projected to decline slightly over the medium term, from already low levels. As a result, total external debt is projected to decline from 30 percent of GDP at end-2006 to 20 percent by 2012 (public external debt would decline from 24 percent to 17 percent over the same period).

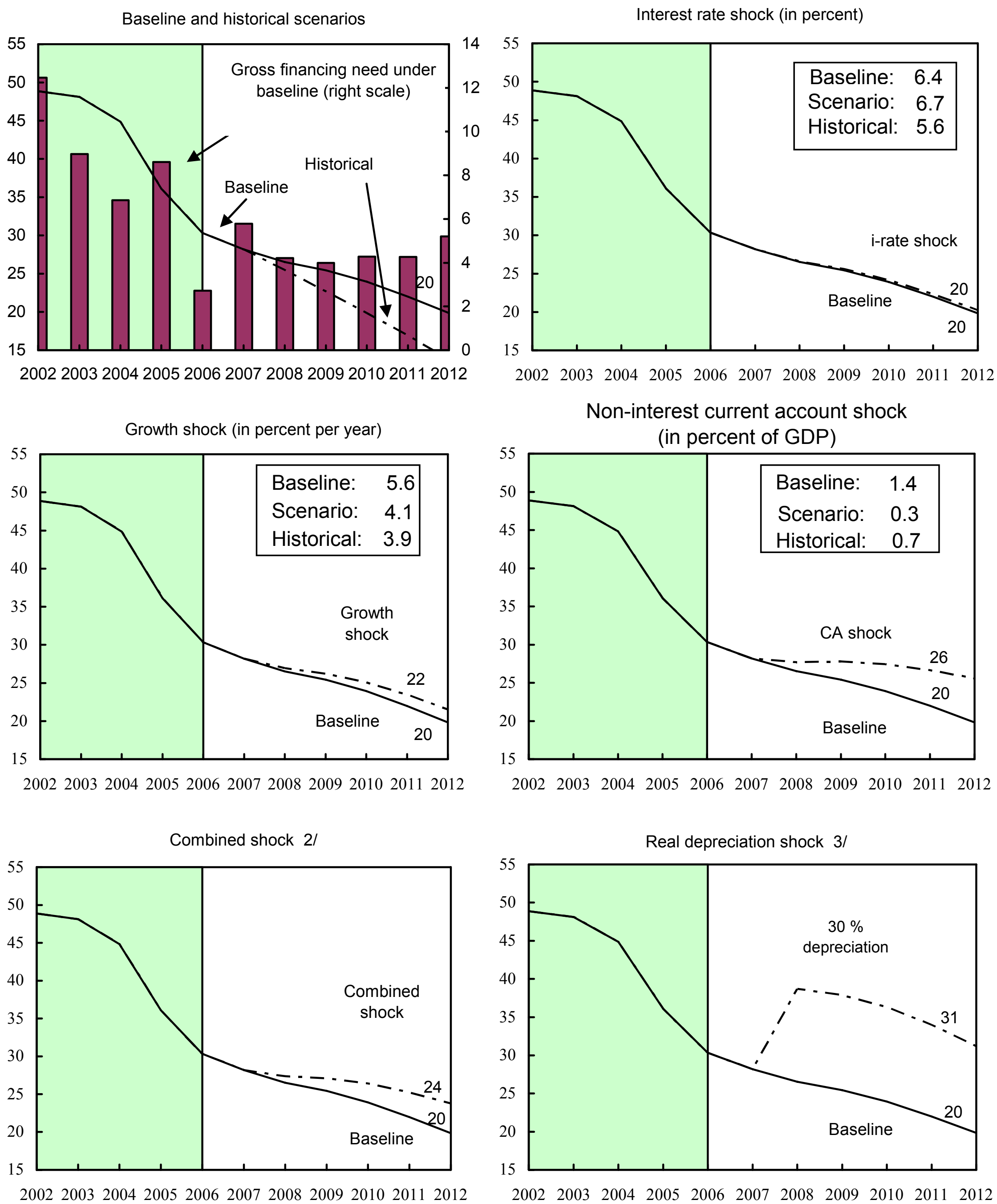
Peru's external and public sector debt ratios are robust to alternative assumptions about underlying macroeconomic variables. Sensitivity tests based on 10-year historical standard deviations to form alternative medium-term assumptions for real GDP growth and interest rates show that Peru's debt dynamics are only moderately vulnerable to such changes.

In contrast, external and public debt ratios are sensitive to changes in exchange rate changes, given the high foreign currency share of Peru's debt. Specifically, under a one-off 30 percent depreciation of the exchange rate, the external debt-to-GDP ratio would shift by about 11 percentage points above the baseline projections in the medium term. This test assumes that the exchange rate would remain at its depreciated level permanently—a scenario that could only occur in case of the current exchange rate being significantly overvalued. Available data, however, do not point to such an overvaluation. Non-interest current account shocks (such as in the terms of trade) would have a moderate adverse impact on external indebtedness.

A similar pattern is observed under a 10 percent of GDP shock to the contingent liabilities of the public sector: The public debt-to-GDP ratio would rise sharply in the short run and, while declining over the medium term, would remain 9 percentage points above the debt levels projected under the baseline scenario.

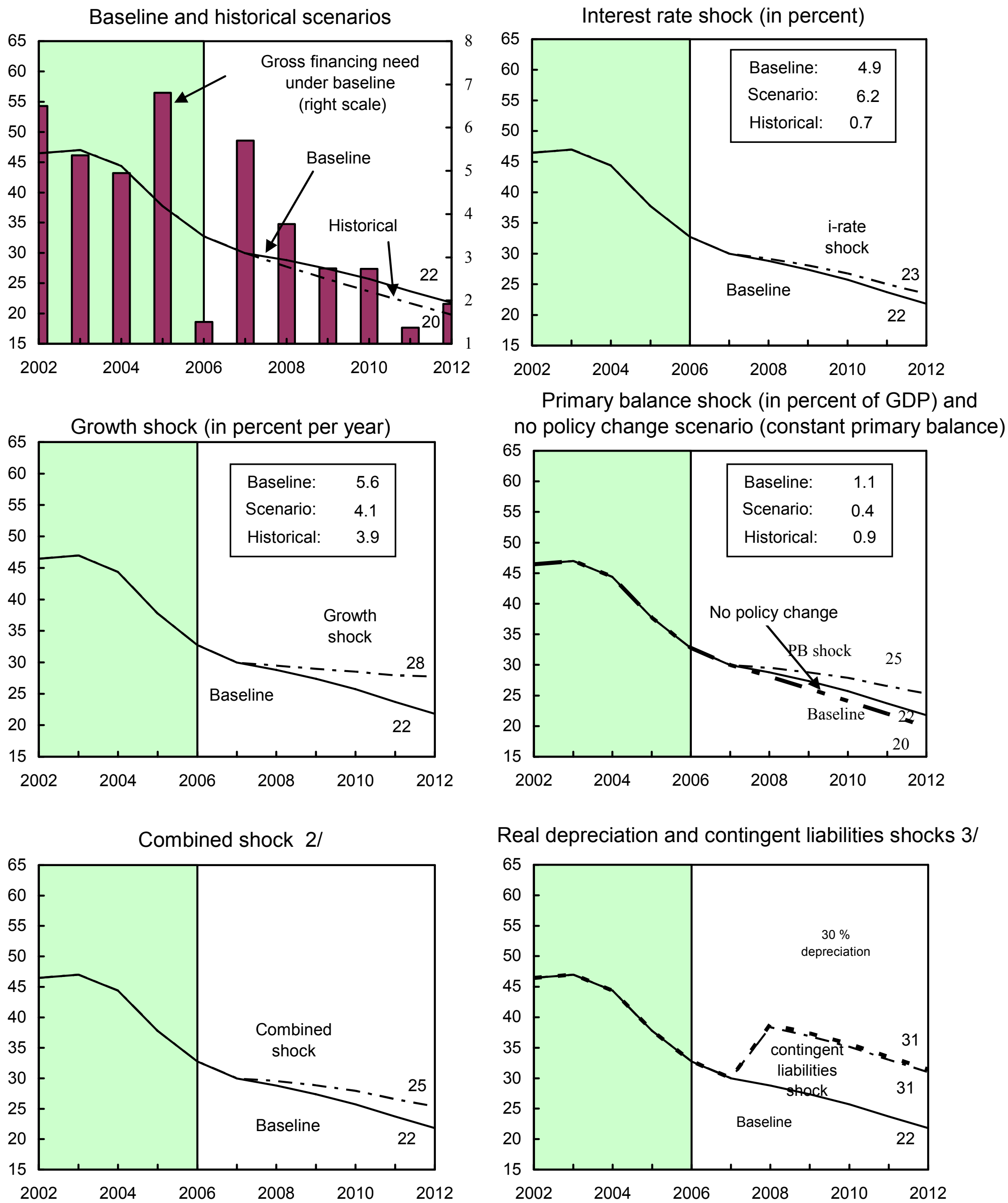
[1] The DSA includes standard sensitivity tests around the baseline medium-term scenario.

Figure 1. Peru: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

Figure 2. Country: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 1 Peru: External Debt Sustainability Framework, 2002-2012
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	48.9	48.1	44.9	36.1	30.3	**28.2**	**26.5**	**25.4**	**23.9**	**22.0**	**19.8**	**-1.4**
Change in external debt	-1.6	-0.7	-3.3	-8.8	-5.8	-2.2	-1.7	-1.1	-1.5	-1.9	-2.2	
Identified external debt-creating flows (4+8+9)	-3.5	-2.0	-7.5	-8.8	-9.7	-4.1	-2.0	-1.2	-1.4	-1.7	-1.7	
Current account deficit, excluding interest payments	-0.5	-0.7	-2.1	-3.4	-4.6	-2.8	-2.2	-1.8	-1.4	-1.1	-0.7	
Deficit in balance of goods and services	1.1	0.0	-4.0	-5.4	-8.5	-6.6	-3.7	-2.0	-1.2	-0.6	-0.1	
Exports	16.2	17.5	20.9	24.5	28.1	27.7	25.9	24.3	23.4	22.8	22.1	
Imports	17.3	17.6	16.8	19.1	19.6	21.2	22.2	22.4	22.2	22.3	22.1	
Net non-debt creating capital inflows (negative)	-2.7	0.0	-1.9	-2.0	-1.7	-1.3	0.1	0.3	-0.3	-0.8	-1.1	
Automatic debt dynamics 1/	-0.4	-1.3	-3.6	-3.4	-3.4	0.0	0.1	0.3	0.2	0.2	0.1	
Contribution from nominal interest rate	2.4	2.2	2.1	2.1	2.0	1.9	1.7	1.7	1.5	1.4	1.2	
Contribution from real GDP growth	-2.5	-1.8	-2.2	-2.5	-2.5	-1.9	-1.6	-1.4	-1.3	-1.2	-1.1	
Contribution from price and exchange rate changes 2/	-0.3	-1.8	-3.4	-3.0	-2.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	2.0	1.3	4.2	0.0	4.0	1.9	0.4	0.1	-0.1	-0.2	-0.4	
External debt-to-exports ratio (in percent)	301.5	274.3	215.0	147.5	107.9	101.6	102.5	104.5	102.5	96.3	89.6	
Gross external financing need (in billions of US dollars) 4/	7.1	5.5	4.8	6.8	2.5	6.0	4.6	4.6	5.3	5.7	7.5	
in percent of GDP	12.5	9.0	6.9	8.6	2.7	5.8	4.2	4.0	4.3	4.3	5.2	
Scenario with key variables at their historical averages 5/						**28.2**	**25.5**	**22.7**	**19.8**	**16.9**	**13.8**	**-2.4**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.2	3.9	5.2	6.4	8.0	7.0	6.0	5.5	5.5	5.5	5.5	
GDP deflator in US dollars (change in percent)	0.6	3.8	7.7	7.1	8.7	3.1	0.1	0.9	1.5	1.8	2.0	
Nominal external interest rate (in percent)	5.0	4.9	4.9	5.3	6.5	6.9	6.5	6.7	6.5	6.2	6.0	
Growth of exports (US dollar terms, in percent)	8.1	16.7	34.7	33.7	34.9	8.9	-0.9	0.1	2.8	5.0	4.2	
Growth of imports (US dollar terms, in percent)	3.4	9.2	8.5	29.5	20.5	19.1	11.4	7.2	6.1	7.9	6.5	
Current account balance, excluding interest payments	0.5	0.7	2.1	3.4	4.6	2.8	2.2	1.8	1.4	1.1	0.7	
Net non-debt creating capital inflows	2.7	0.0	1.9	2.0	1.7	1.3	-0.1	-0.3	0.3	0.8	1.1	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth
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 [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (b

3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ 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.

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

Table 2. Country: Public Sector Debt Sustainability Framework, 2002-2012
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	46.5	47.0	44.4	37.7	32.7	**30.0**	**28.8**	**27.4**	**25.7**	**23.7**	**21.8**	**-0.3**
o/w foreign-currency denominated	42.7	43.2	37.5	29.6	24.8	22.3	21.2	19.8	18.4	16.7	15.2	
Change in public sector debt	0.6	0.5	-2.6	-6.6	-5.0	-2.8	-1.2	-1.4	-1.6	-2.0	-1.9	
Identified debt-creating flows (4+7+12)	-1.1	-1.0	-4.5	-5.0	-7.8	-2.0	-0.8	-1.1	-1.3	-1.7	-1.6	
Primary deficit	0.0	-0.4	-1.0	-1.6	-4.0	-1.5	-0.8	-1.0	-1.1	-1.4	-1.3	
Revenue and grants	17.5	18.0	18.0	18.9	20.4	20.1	19.5	19.7	20.0	20.3	20.5	
Primary (noninterest) expenditure	17.5	17.6	17.0	17.3	16.5	18.6	18.7	18.7	18.9	18.8	19.2	
Automatic debt dynamics 2/	-0.3	-0.5	-3.4	-3.3	-3.8	-0.5	0.0	-0.1	-0.2	-0.3	-0.3	
Contribution from interest rate/growth differential 3/	-0.5	-0.8	-2.7	-2.1	-3.6	-0.5	0.0	-0.1	-0.2	-0.3	-0.3	
Of which contribution from real interest rate	1.8	0.9	-0.5	0.5	-1.0	1.7	1.7	1.4	1.2	1.0	0.9	
Of which contribution from real GDP growth	-2.2	-1.7	-2.2	-2.6	-2.6	-2.1	-1.7	-1.5	-1.4	-1.3	-1.2	
Contribution from exchange rate depreciation 4/	0.1	0.3	-0.7	-1.2	-0.2	...	...	...	...	...	...	
Other identified debt-creating flows	-0.7	-0.1	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.7	-0.1	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	1.6	1.5	1.9	-1.6	2.8	-0.7	-0.4	-0.3	-0.3	-0.3	-0.3	
Public sector debt-to-revenue ratio 1/	265.3	261.7	247.0	199.2	160.3	149.3	148.0	138.9	128.9	117.0	106.5	
						-0.3	-0.6	0.2	0.3	0.3	0.2	
Gross financing need 6/	6.5	5.4	4.9	6.8	1.5	5.7	3.8	2.7	2.7	1.4	1.9	
in billions of U.S. dollars	3.7	3.3	3.4	5.4	1.4	5.9	4.1	3.2	3.4	1.8	2.8	
Scenario with key variables at their historical averages 7/						**30.0**	**27.7**	**25.7**	**23.6**	**21.7**	**19.8**	**-0.6**
Scenario with no policy change (constant primary balance) in 2007-2012						**30.0**	**28.1**	**26.1**	**24.1**	**22.0**	**19.9**	**-0.3**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.2	3.9	5.2	6.4	8.0	7.0	6.0	5.5	5.5	5.5	5.5	
Average nominal interest rate on public debt (in percent) 8/	4.9	4.8	4.8	4.8	5.8	6.1	6.1	6.1	6.2	6.2	6.2	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.1	2.1	-0.8	1.5	-2.4	5.5	6.1	5.1	4.7	4.4	4.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-0.3	-0.6	1.9	3.6	0.6	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	0.8	2.6	5.6	3.4	8.2	0.6	0.0	1.0	1.5	1.8	2.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	1.7	4.2	1.8	8.6	2.7	20.7	6.6	5.8	6.3	5.2	7.5	
Primary deficit	0.0	-0.4	-1.0	-1.6	-4.0	-1.5	-0.8	-1.0	-1.1	-1.4	-1.3	

1/ Combined public sector. Gross debt is used.
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; α = share of foreign-currency denominated debt; and ε = 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/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

ANNEX 1. PERU: FUND RELATIONS
(As of April 30, 2006)

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

II.	**General Resources Account**	**SDR Million**	**Percent Quota**
	Quota	638.40	100.00
	Fund holdings of currency	638.43	100.01

III.	**SDR Department**	**SDR Million**	**Percent Allocation**
	Net cumulative allocation	91.32	100.00
	Holdings	2.58	2.82

IV. Outstanding Purchases and Loans None

V. Financial Arrangements

Type of Arrangement	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	1/26/07	2/25/09	172.37	0.00
Stand-By	6/09/04	8/16/06	287.28	0.00
Stand-By	2/01/02	2/29/04	255.00	0.00

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

	2007	2008	2009	2010	2011
Principal					
Charges/interest	2.85	3.76	3.76	3.76	3.76
Total	2.85	3.76	3.76	3.76	3.76

VII. Safeguards Assessments

An off-site safeguards assessment of the central bank is being finalized and has found that safeguards at the *Banco Central de Reserva del Perú* (BCRP) meet the requirements of the safeguards policy.

VIII. Exchange Arrangements

Peru maintains a unified, managed floating exchange rate. On April 30, 2007, the average of interbank buying and selling rates was 3.17 *Nuevo Sol* per U.S. dollar. The exchange system is free of restrictions, except for those maintained solely for the preservation of national or international security, and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51). Those restrictions are maintain pursuant to UN Security Council Resolutions 1267 (October 15, 1999) and 1373 (September 28, 2001). 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 2006 Article IV consultation was concluded on January 26, 2007 (Country Report No. 07/54).

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 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	June 2005, March 2006, November 2006	Public Financial Management
	May 2005, February, September, and November 2006, February 2007	Tax policy and administration
	September 2003	
	September 2002	
	August 2004	Public investment and fiscal policy, including issues related to PPPs.
	November 1999	Fiscal rules
MFD	April 2006	Financial sector supervision
	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 October 1999	National account statistics, new base year for the national account series

XII. Resident Representative

Ms. Nicoletta Batini has been Resident Representative in Peru since January 2006.

ANNEX 2. PERU: WORLD BANK RELATIONS

Bank Group strategy

A World Bank Group Country Partnership Strategy (CPS) was approved by the Board on December 19, 2006. The strategy has been designed to support the government's poverty reduction agenda with programs addressing fiscal, national competitiveness, and social-sector needs. The program supported by the Bank emphasizes partnerships, flexibility and results orientation in public expenditure. The new CPS projects financial assistance of up to US$3.5 billion between July 2007 and June 2011 and envisages a lending program that will include a combination of two fast disbursing loans and three investment projects per fiscal year. The strategy includes development policy lending operations in the fiscal and social sectors, and possibly one to support policy reforms in the environmental sector.

The ongoing investment portfolio consists of 17 operations for a net commitment of $536 million and one Guarantee Facility for US$200 million. Two development policy loans (DPLs) have been approved in FY07: the *Fiscal Management and Competitiveness DPL and* the *Results and Accountability DPL,* in the amount of $200 and US$150 million respectively. In addition, two investment loans have been approved in FY07, including the Sierra Rural Development project for $20 million and the Decentralized Rural Transport project for $50 million. The FY08 pipeline comprises 7 operations for a commitment amount of approximately $400 million. Bank support has and will continue to focus on three areas: (i) strengthening public sector management and decentralization; (iii) maintaining macro stability and accelerating growth; and (iii) fostering equity and quality of social services, particularly in rural areas.

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 FSAP update was completed in June 2005.

- *Fiscal Management.* A joint IMF-World Bank-IDB mission took place in September 2004 for a pilot study on Public Investment and Fiscal Policy. Most recently, Bank-Fund collaboration has focused in the area of results budgeting, the implementation of a Treasury Single Account and other issues related to financial management.

- *Country Partnership Strategy preparation and design of Programmatic Loans* (i.e. first Programmatic Fiscal Management and Competitiveness DPL). Dialogue has concentrated on the evaluation of the macroeconomic framework, the program supported under the DPL, including the setting of triggers, and risks and estimation of the fiscal implications of policy programs under Bank operations.

Statement of World Bank Loans
(As of May 2007)

Loan Number	Year approved	Borrower	Purpose	In millions of U.S. dollars Total (Net of Cancellation)	Undisbursed
Ninety-four loans fully disbursed[1]					
Partially disbursed or undisbursed loans:					
46140	2001	Republic of Peru	Second Rural Roads Project	50.0	1.9
71760	2003	Republic of Peru	Rural Education Project	52.5	30.1
71770	2003	Republic of Peru	Trade Facilitation and Productivity Improvement Technical Assistanc	20.0	12.6
72090	2003	Republic of Peru	Lima Urban Transport Project	45.0	39.6
71600	2003	Republic of Peru	Additional Financing Lima Water Rehabilitation and Management Pr	20.0	13.0
71420	2003	Republic of Peru	National Rural Water Supply and Sanitation Project	50.0	39.9
72190	2004	Republic of Peru	Justice Services Improvement	12.0	8.8
72570	2004	Republic of Peru	Vilcanota Valley Rehabilitation Program	5.0	4.6
72550	2004	Republic of Peru	Institutional Capacity for Sustainable Fiscal Decentralization	8.8	7.4
73080	2005	Republic of Peru	Irrigation Subsector Project	10.3	4.9
72540	2005	Republic of Peru	Accountability for Decentralization in the Social Sectors	7.8	5.3
72850	2005	Republic of Peru	Agricultural Research and Extension	25.0	19.4
73220	2005	Republic of Peru	Regional Transport Infrastructure Decentralization	50.0	49.3
73680	2006	Republic of Peru	Real Property Rights	25.0	22.9
73660	2006	Republic of Peru	Rural Electrification	50.0	49.3
Total disbursed:				5,181.8	
Of which : amount repaid				2,568.7	
Total outstanding 1				2,534.2	
Total undisbursed					309.0

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

Statement of IFC Investments
(As of May 2007)
In millions of U.S. dollars

	Loans	Equity	Quasi	Participation Loans	Total
Total commitments held by IFC	309.9	51.5	54.1	13.2	428.7
Total disbursed	202.1	50.8	54.1	13.2	320.1

Source: World Bank

ANNEX 3. PERU: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

Country Strategy

The key objectives of the 2002-2006 strategy for Peru are poverty reduction and equity promotion, within a context of high economic growth needed to make these goals sustainable. Toward this end, the Bank supports government's efforts to: (i) raise economic productivity and competitiveness; (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.

The Bank and the authorities have started the dialogue for the preparation of the new strategy for 2007–2011, which is projected for approval in August.

Lending

As of June 6th , 2007, the country's active portfolio consists of 26 loans for a total amount of US$1,230.5 million. These resources are distributed among 25 investment loans (US$930.5 million) and one policy-based loan (US$300.0 million).

The lending program for 2007 comprises seven investment loans for US$124.5 million and three programmatic loans for US$600.0 million. A high-case scenario forecasts total 2007 disbursements at US$874.9 million, of which US$750.0 is for policy-based lending.

To assist government efforts to de-dollarize the public sector debt, negotiations are currently underway to convert US$200.0 million of a previously disbursed loan into local currency.

The Private Sector Department (PRI) is completing due diligence on the Peru – Liquefied Natural Gas project for US$400.0 million, expected to be approved in the second quarter 2008.

Finally, the Bank's portfolio with Peru includes non-reimbursable technical cooperation totaling US$28.3 million.

IDB Loan Portfolio by Sector, as of June 6th, 2007
(US$ million)

	Commitments	Disbursements	Percent Disbursed (%)
Agriculture	30.0	8.6	28.5
Education	87.0	86.2	99.1
Environment	5.0	3.8	76.9
Public Sector Management	59.4	12.1	20.3
Sanitation	50.8	0.0	0.0
Science and Techonology	25.0	0.0	0.0
Social Investment	403.3	219.0	54.3
Transportation	510.0	203.0	39.8
Urban Development	60.0	18.6	31.1
Grand Total	**1,230.5**	**551.3**	**44.8**

ANNEX 4. PERU: STATISTICAL ISSUES

Macroeconomic statistics are broadly adequate for policy formulation, surveillance, and program monitoring. Peru has been in observance of the Special Data Dissemination Standard (SDDS) since August 1996 and meets the specifications for coverage, periodicity, and timeliness of the data categories. An advance release calendar and the metadata for Peru are posted on the Fund's Dissemination Standards Bulletin Board. A data ROSC was prepared and published in 2003.

Despite progress in recent years, there is scope for improvement in the following areas: (i) coordination among the agencies that compile official statistics to avoid duplication of efforts and confusion among users; (ii) implementing a new benchmark and base year for GDP; (iii) expanding the coverage of the wholesale price index to include mining, oil and gas extraction, electricity and water, public transportation, and communication; (iv) finalizing the migration to the standardized report forms for monetary data, with the introduction of report forms for other depository corporations and other financial corporations; and (v) expanding the scope of data sources for compiling financial flows of individual residents.

I. Real Sector and Prices

The authorities published a revised GDP series in 2000. The series used the 1994 benchmark estimates as the base year, and included input-output tables. However, due to limited availability of periodic source data, estimates after 1994 are largely based on extrapolation techniques. The lack of current detailed tables for supply and use hampers the reconciliation of discrepancies. As a result, changes in inventories are mainly determined as a residual. Although the quarterly accounts have benefited from some improvements in the timeliness of monthly production indices, 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 statistical techniques used to compile the WPI follow generally accepted international standards.

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

II. Fiscal Sector

The government finance statistics (GFS) for the general government 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 coverage of published national budget data is narrower than the fiscal statistics prepared for program purposes. The authorities have recently prepared a plan to migrate to the *GFS Manual 2001,* but the schedule for migration has yet to be defined. The authorities report annual GFS data using the *GFSM 2001* analytical framework for publication in the *Government Finance Statistics Yearbook (GFSY)* and monthly data for the *International Financial Statistics (IFS)*.

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 excluded in the depository corporations survey, but following the recommendations of the 2003 data ROSC mission, the BCRP began incorporating them. Monetary statistics are disseminated only in a summary form. At the request of the authorities, in January 2007 a mission visited the country to assist with the migration to the new standardized report forms. The mission finalized the report form for the central bank, recommending improvements in the classification and sectorization of some accounts. A follow-up mission, planned for FY 2008, should complete the work with standardized data for other depository corporations and other financial corporations.

IV. External Sector

The BCRP prepares quarterly data on the balance of payments and international investment position largely in line with the recommendations of the fifth edition of the *Balance of Payments Manual (BPM5).* 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.

The BCRP has been reporting since August 2001 weekly data on international reserves in accordance with the *Operational Guidelines for Data Template on International Reserves and Foreign Currency Liquidity.* Since August 2006, the BCRP is including the full amount of the liquidity requirements in the reserve template both under official reserve assets and as a contingent net drain (as specified in Section III of the Data Template). Peru disseminates quarterly data on external debt with a one-quarter lag in the BCRP website with a hyperlink to the Fund's website. External debt data are not fully compiled on an accrual basis, which contrast with the recommendations of the *BPM5* and the *External Debt Statistics: Guide for Compilers and Users.*

Peru: Table of Common Indicators Required for Surveillance

As of May 30, 2007

	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	Apr. 2007	5/17/2007	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2007	5/29/2007	D	W	W		
Reserve/Base Money	Feb. 2007	4/18/2007	W	W	W	O, LO, LO, LO	O, O, O, O, O
Broad Money	Feb. 2007	4/18/2007	W	W	W		
Central Bank Balance Sheet	Feb. 2007	4/18/2007	W	W	W		
Consolidated Balance Sheet of the Banking System	Feb. 2007	4/18/2007	W	W	W		
Interest Rates[2]	Mar. 2007	4/18/2007	D	D	D		
Consumer Price Index	Apr. 2007	5/21/2007	M	M	M	O, LO, LO, LO	LO, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar. 2007	5/21/2007	Q	Q	Q	O, LO, O, O	O, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing3– Central Government	Mar. 2007	5/21/2007	M	M	M		
Stocks of Central Government Debt[5]			Q	Q	Q		
External Current Account Balance	Q4. 2006	4/13/07	Q	Q	Q	O, LO, LO, LO	LO, LO, O, O, O
Exports and Imports of Goods and Services	Q4. 2006	4/13/07	M	M	M		
GDP/GNP	Q1 2007	5/21/07	M	M	M	LO, LO, LO, LO	LNO, LNO, LNO, LO, LO
Gross External Debt	Dec. 2006	5/21/07	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), not observed (NO), or not available (NA).

[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, Peru
June 12, 2007

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. de Rato,

1. This letter updates our letter of January 3, 2007, which presented the policies of our economic program supported by a Stand-By Arrangement (SBA), approved by the Fund's Executive Board on January 26, 2007. This letter reiterates our commitment to advancing reforms that will help reinforce the basis for high and sustained growth and decisively tackle high poverty levels. It also informs you of performance and policy intentions in 2007.

2. The Fund-supported program is off to an excellent start and is enabling Peru to continue benefiting from a formidable economic performance. Led by private investment and consumption, output and employment growth have remained strong and we now expect the economy to expand by about 7 percent during 2007. Inflation has remained quiescent and the Central Bank has aligned the inflation target more closely with average inflation rates in Peru and its major trading partners, by reducing the target to 2 percent, while keeping the tolerance band at ±1 percent. The external position is envisaged to remain strong, although the current account surplus would narrow to just 1 percent of GDP and net international reserves are projected to reach a level above $20 billion (equivalent to almost 75 percent of total liquidity) by end-2007. All quantitative performance criteria for end-March were observed (Table 1) and we are proposing that the September 30, 2007 and December 31, 2007 indicative targets be set as performance criteria in accordance with the attached table 1, which are the same as in our letter of January 3, 2007. A revision of the structural benchmarks for 2007 is presented in table 2. All definitions and understandings specified in the January 3, 2007 Technical Memorandum of Understanding remain the same and apply to the performance criteria.

3. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Peru will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

A. Fiscal Issues

4. Fiscal prudence has been pivotal in underpinning the strong economic performance. The consolidated public sector posted an overall surplus of 2.2 percent of GDP in 2006, above earlier expectations and mostly reflecting strong revenue and lower-than-expected

expenditure execution at all levels of government. In 2007, we will continue addressing pressing social and infrastructure needs while preserving prudent fiscal targets under the program. To this end, we have issued two supplementary budgets, and have begun to implement reforms to the *Government Procurement System* (CONSUCODE), in consultation with multilateral institutions, and to the *National Public Investment System* (SNIP). An urgency decree has also been issued that simplifies and expedites approval procedures for public bidding and investment projects for all levels of government until end-2007. All these efforts will help ensure that much needed public investment at all levels of government takes place. Against this backdrop and with economic growth and commodity prices stronger than envisaged last year, we expect to meet the adjusted deficit of 0.5 percent of GDP for the consolidated public sector, as envisaged under the program. Despite our efforts to accelerate budget execution, the consolidated public sector could be close to balance in 2007, in light of potentially higher revenues.

5. We expect Congress to amend the *Fiscal Responsibility and Transparency Law* (FRTL) in the next few months to create room for infrastructure spending and to entrench fiscal discipline. Legislation has been approved by which the current 3-percent limit on the real growth of general government's expenditure will be applicable to the central government and exclude investment expenditure, as well as transfers. At the same time, we are evaluating the possibility of better aligning the new limit on current expenditure with the economy's increased productive potential and social needs. To preserve the transparency and quality of expenditure under the new rule, work is underway to modernize the budget classification system.

6. Further, we have continued to simplify and enhance the effectiveness of the tax regime. The tax code has been reformed to strengthen taxpayers' rights by removing the capitalization of interest on outstanding tax obligations and by extending participation in the simplified tax regime. A timetable for reducing the financial transactions tax (FTT) and the tax on net assets (ITAN) has been set: indeed, the FTT rate has been reduced, effective January 1, 2008 (end-December 2007 benchmark). As part of SUNAT's (the tax administration agency) medium-term strategy, indicators are being developed to monitor performance, including for VAT compliance, and tax audits will be more focused on massive and selective audits. Audit procedures are being simplified and we will improve the coordination between domestic taxes and customs obligations in the municipality of Lima and other large cities.

7. The new framework rationalizing tax exemptions is a major step forward in broadening the tax base. New tax exemptions will be allowed for six years and be subject to a technical assessment, which could extend them for three more years. In addition, all ministries are now required to present an assessment of existing tax exemptions to congress by April 2009, at which date a decision will be taken on whether to eliminate or bring them into the new framework. The Ministry of Finance will issue regulations by end-June 2007 outlining the criteria to be followed in preparing such assessments. In addition, a new framework for

tax exemptions on indirect taxes has been enacted for the *Selva* region (except *Loreto*), that will gradually replace such exemptions with direct transfers for infrastructure and social expenditure. Regulations to limit the adverse impact on tax collections in the free economic zone of *Puno* were issued in April.

8. The government is implementing several reforms to improve the quality of public spending:

- A high-level commission has been established to restructure the SNIP to expedite project viability approval while ensuring a high-quality of spending. In addition, to support the decentralization of the SNIP and assist SNGs, six regional offices have been established, and nine more are expected to be opened before year-end. We intend to allocate significant resources to boost the capacity of regional offices, with support from the IADB; and we also intend to involve the private sector to continue to assist SNGs in strengthening their capacity during the second half of 2007. Ensuring adequate monitoring of project selection, viability, prioritization, and ex-post evaluations by the MEF remain important priorities.

- With the assistance of an FAD resident advisor, full implementation of the central government TSA is envisaged for December 2007 (structural benchmark). The independent assessment of the government's Integrated Financial Management System (SIAF) will be available by end-September 2007. In consultation with the World Bank, UNDP and IADB, the government is reforming government procurement procedures, and a new law will be presented to congress in June. In the meantime, alternative mechanisms have been introduced to expedite procedures, in line with those in other countries in the region.

- A new unit to monitor the operations of SNGs is now operating at MEF (end-March benchmark). We have also taken steps towards establishing a subnational debt registry and recording the compliance of fiscal rules by SNGs by year-end. SNGs' capacities in fiscal management will continue to be strengthened. In line with our plan to complete the devolution of 82 functions and 153 responsibilities by end-2007, resources needed by SNGs to execute these functions and responsibilities are being quantified and will be transferred accordingly, upon satisfactory compliance with the established accreditation system.

9. Work towards introducing a permanent and comprehensive framework for PPPs has been initiated. A new methodology for valuing contingent liabilities of the public sector in relation to PPP projects has been finalized, and application guidelines will soon be developed. We have also begun to coordinate the work towards preparing a legal framework for PPP projects, which we now expect to submit to congress by September 2007. We will continue to limit the use of CRPAOs to already signed PPP projects in light of the fiscal risks they entail, and are looking into alternative financing instruments to facilitate PPP operations that provide a better risk sharing between the government and the private sector.

B. Poverty Alleviation

10. In line with the government's objective of alleviating poverty, the Interministerial Committee for Social Affairs (CIAS) has completed a wide-ranging assessment of the existing social assistance programs (SAPs), and published an action plan to strengthen their effectiveness (end-March benchmark). Implementation of this plan has already started, as 82 SAPs were merged into 26 in May. In an effort to ensure adequate integration of SAPs into the 2008 budget, the government will adopt institutional and operational arrangements in the second half of 2007. Priority will be given to providing the CIAS with a permanent head and technical staff (end-September structural benchmark). This would ensure the implementation of a uniform targeting methodology across SAPs.

11. The efforts at rationalizing social programs will be assisted by the development of a Single Beneficiary Registry and a Household Targeting System (SISFOH), which we expect to have in place within the next few months. These systems should help to systematically reduce leakages across SAPs. We will also continue to strengthen the effectiveness and focus of the program *Juntos*, in consultation with the World Bank, with the number of participating families expected to rise from 170,000 as of end-2006 to 350,000 by end-2007. Following the new criteria for reorganizing programs, we are also launching a pilot program in the *Huánuco* Region, to tackle malnutrition with a multi-sector approach, financed with resources from the *Fondo para la Igualdad,* and intend to replicate it across 631 districts starting in 2008. This pilot program will also incorporate our first efforts to implement performance budgeting of social programs, which we aim to expand to all public spending over the medium term. As part of our action plan, we will aim to prepare a comprehensive evaluation of universal social programs in the second half of 2007 in order to improve the quality and coverage of public education and health care.

C. Financial Sector Issues

12. To strengthen the coordination of lending practices by public financial institutions, representatives of COFIDE, *Banco de la Nacion* and *Agrobanco* have held meetings to determine which financial institutions qualify, according to strict financial criteria, to enter into lending and infrastructure-support agreements with *Banco de la Nacion*. As an important step towards strengthening the oversight of public financial institutions, *Banco de la Nacion*, *Agrobanco*, and *MiVivienda* will be fully incorporated under the regulatory and supervisory framework of the Superintendency of Banks, and our expectation is that congress will approve such amendment in the next few months. Technical work on the legal and regulatory framework for empowering the central bank to oversee and regulate the entire payments system continues.

13. To support the dedollarization process, the guarantees and the provision of the "good payer bonus" on mortgages in foreign currency are being discontinued to ensure that by end-June most new mortgage loans guaranteed by *MiVivienda* are denominated in Nuevo Soles (end-June structural benchmark). New lending programs in domestic currency, such as *Mi*

Hogar and *Techo Propio* have been initiated to assist lower income groups. We are also finalizing technical discussions with private banks to exchange part of *MiVivienda*'s foreign currency portfolio into Nuevo Soles. We also intend to securitize the rest of *MiVivienda*'s foreign currency portfolio before end-2007.

14. The tax treatment of certificates of deposit, repurchase agreements, financial derivatives, and other financial instruments has been clarified (end-March structural benchmark). However, the clarification of the tax treatment of securitized transactions has been more complex than originally foreseen and we now intend to complete it, with technical assistance from the Fund, before end-December 2007. Also, the limit on pension funds' investments abroad has been raised to 15 percent, and cross-limits have been eased.

15. We continue to conduct debt management operations to improve its profile and extend the yield curve to provide a deep and liquid benchmark. We have recently reached agreement toward a prepayment of part of our nonconcessional obligations with the Paris Club due in 2007–2015 and remain engaged in resolving the issue of some disputed claims that have arisen in this context.

D. Other Growth-Enhancing Reforms

16. We remain committed to increasing the openness of the economy. We have recently reduced the average tariff level from 10 percent to 8.3 percent and are evaluating the possibility of additional measures to foster competitiveness. Further steps have been taken to improve the business environment. One-stop windows for importers and exporters and microenterprises are expected to be fully operational by year-end. We are extending the capacity of commercial courts in Lima and remain committed to establishing commercial courts in Trujillo and Arequipa by end-2007.

17. In light of the strong performance under the program and the important progress being made in growth enhancing reforms, we hereby request the completion of the First Review under the Stand-By Arrangement.

Sincerely yours,

/s/
Luis Carranza
Minister of Economy and Finance

/s/
Julio Velarde
President Central Reserve Bank of Peru

Table 1. Peru: Quantitative Performance Criteria and Inflation Consultation Mechanism for 2007

	Program			
	Mar. 31	Jun. 30	Sept. 30	Dec. 31
(Cumulative amounts from December 31, 2006, millions of New Soles)				
Borrowing requirement of the combined public sector				
Unadjusted limits 1/ 2/ 3/ 4/	-1,396	-4,190	-2,761	2,418
Adjusted limits	-1,646			
Actual	-4,252			
Margin	2,606			
(Cumulative amounts from December 31, 2006, millions of U.S. dollars)				
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions				
Unadjusted targets 5/ 6/	-260	44	336	350
Adjusted targets	-635			
Actual	948			
Margin	1583			
Outstanding short-term external debt of the nonfinancial public sector				
Limits	50	50	50	50
Actual	0			
Margin	50			
Contracting or guaranteeing of nonconcessional public debt with maturity of at least one year				
Unadjusted limits 7/ 8/ 9/	751	1,237	1,608	2,636
Adjusted limits	3146			
Actual	2742			
Margin	404			
Of which: **external debt of 1-5 year maturity**				
Limits	100	100	100	100
Actual	0			
Margin	100			
External payments arrears of the public sector (on a continuous basis)				
Limits	0	0	0	0
Actual	0			
NPV of future government payments associated with PPP operations (on a continuous basis)				
Unadjusted Limits 10/	1,500	1,500	1,500	1,500
Actual	55			
Margin	1,445			
(Consultation bands for the 12-month rate of inflation, in percent) 11/				
Outer band (upper limit)	5.5	5.5	5.5	5.5
Inner band (upper limit)	4.5	4.5	4.5	4.5
Central point	2.5	2.5	2.5	2.5
Inner band (lower limit)	0.5	0.5	0.5	0.5
Outer band (lower limit)	-0.5	-0.5	-0.5	-0.5
Actual	0.3	...	...	...

Sources: Staff estimations.

1/ PIPP proceeds are included below the line.
2/ The limit on the borrowing requirement of the combined public sector will be adjusted downwards by the amount central government revenues net of mandatory transfers exceed program estimates of S/. 10,489 million at end-March, up to a ceiling of S/. 250 million; S/. 23,359 million at end-June, up to a ceiling of S/. 500 million; S/. 32, 807 million at end-September, up to a ceiling of S/. 750 million; and S/. 44,821 million at end-December, up to a total ceiling of S/. 1,000 million.
3/ The limit on the borrowing requirement of the combined public sector will be adjusted for the operating balance of the BCRP.
4/ The limit on the borrowing requirement of the combined public sector will be adjusted upward by up to US$100 million for capital spending by Petroperu, over the $30 million already included in the program.
5/ 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$15 million at end-March, -US$138 million at end-June, -US$274 million at end-September, and -US$148 million at end-December 2007. It will be adjusted downward for shortfalls from programmed net foreign borrowing. The amounts in excess will be deposited at the BCRP.
6/ 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 2007.
7/ The limit will be adjusted upward by any amount of debt issued, and used in, debt-exchange operations, or for prefinancing of government operations.
8/ The current debt limits do not include contracting of non-guaranteed debt by Petroperu and will be adjusted upward by up to US$300 million for debt contracted by Petroperu during 2007
9/ The limit on contracting and guaranteeing of nonconcessional public debt will be adjusted upwards for guarantees contracted or extended by the government in relation to concessions, up to a ceiling of US$430 million for the year as a whole.
10/ Discount rates to calculate the NPV of the future stream of payments will be the currency-specific commercial interest reference rates (CIRRs) published by the OECD and specified in the TMU.
11/ Should inflation fall outside the inner band, the authorities will discuss with the Fund staff the appropriate policy response. Should inflation fall outside the outer band, the authorities will also complete a consultation with the Executive Board of the Fund on the proposed policy response before requesting further purchases under the arrangement.

Table 2. Peru: Structural Measures for 2007

Structural Benchmarks

June 30

Ensure that most of new mortgage loans extended by banks with the guarantee of *MiVivienda* are denominated in nuevo soles

September 30

Submit to congress a legal framework for PPP operations

Appoint a new head of *CIAS* and technical staff

December 31

Clarify the tax treatment of securitized transactions

Full implementation of the Treasury Single Account (TSA) for the central government

2008 Budget prepared according to the modernized budget classification system and incorporated into the charts of accounts

Issue new regulations regarding new risk categories and provisions to address foreign currency risk.

Statement by the IMF Staff Representative
June 27, 2007

1. This statement provides additional information that has become available since the circulation of the staff report. It does not alter the thrust of the staff appraisal.

2. **Recent indicators suggest that macroeconomic performance remains strong:**

- Real GDP is estimated to have grown by about 7½ percent on average during the first four months of 2007. Recent surveys show business and consumer confidence still at record-high levels and expectations of further improvement in economic conditions.

- The external current account posted a surplus of 2.8 percent of GDP as of end-2006, some 0.2 percent of GDP larger than previously estimated. Appreciation pressures on the *Nuevo Sol* have subsided in recent weeks, partly reflecting strong import growth. While there has been limited intervention by the central bank in the foreign exchange market, net international reserves have reached US$21.7 billion (close to 180 percent of foreign currency deposits) as of mid-June. Financial market conditions remain favorable, with Peru's sovereign bond spread declining to a record-low of around 100 basis points.

3. **Progress on structural reforms has been mixed:**

- The rationalization of social assistance programs is progressing, with the government issuing decrees to initiate their consolidation.

- The end-June structural benchmark on ensuring that most new mortgage loans extended by banks with the guarantees of *MiVivienda* are denominated in local currency is expected to be missed. The authorities explained that commercial banks have requested an extension for discontinuing such guarantees for foreign currency mortgage loans. *MiVivienda* has now established a timetable for fully discontinuing the issuance of such guarantees by January 1, 2008. The staff is of the view that this delay will not compromise achieving the program's objectives.

- Congress recently passed a law allowing the public bank *Agrobanco* to begin accepting deposits and expand its direct lending, while lessening its regulatory oversight. The authorities have strongly opposed this measure and President Garcia has stated his intention to veto the most controversial aspects of this law. In addition, consumer loans by *Banco de la Nación* have risen by about 40 percent (y/y) in May. The authorities noted that a significant part of the rise was related to payroll-linked loans to public sector employees, with limited credit risk. In the staff's view, increased presence in the financial system by public banks could crowd-out the activities of private institutions and potentially entail fiscal costs over the medium term.

Press Release No. 07/145
FOR IMMEDIATE RELEASE
June 27, 2007

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review under Peru's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Peru's economic performance under a 25-month Stand-By Arrangement in the amount equivalent to SDR 172.4 million (about US$261 million).

The authorities have indicated that they are treating the arrangement as precautionary. The arrangement was approved on January 26, 2007 (see Press Release No. 07/15).

Following the Executive Board discussion, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, said:

"Over the past several years, Peru has benefited from record high and broad-based economic growth, a strong external position, low inflation, and declining vulnerabilities, owing to the implementation of sound macroeconomic policies and a favorable external environment. Continued commitment to sound policies and structural reforms will be crucial to entrench economic growth, strengthen the economy's resilience to shocks, and alleviate poverty.

"The authorities' strategy to improve the targeting and effectiveness of social assistance programs will help intensify their poverty alleviation efforts, which should be based on a broad consensus. The authorities intend to buttress the capacity of the Interministerial Committee for Social Assistance to ensure that the strategy is well coordinated and implemented in a timely manner.

"Sound fiscal policies to underpin stability remain the backbone of the program, which aims to address critical social and infrastructure needs by ensuring high-quality public spending. The restructuring of the National System of Public Investment will expedite approval of public investment projects while protecting their quality. Measures are being taken to bolster the capacity of subnational governments to evaluate and execute projects, including with private sector support. Prompt establishment of a comprehensive legal framework for public-private partnerships will help ensure that public investment remains of high quality, and that there is an equitable sharing of risks between the public and private sectors.

“In amending the Fiscal Responsibility and Transparency Law, the authorities’ intention to introduce strict sanctions for noncompliance with the Law’s fiscal goals is welcome. To support fiscal prudence, a unit has been established in the Ministry of Finance to monitor subnational governments’ compliance with the Law, and efforts will be made to ensure that the devolution of fiscal functions to subnational governments preserves effective accreditation mechanisms and fiscal prudence.

“Tax incentives have been rationalized, certain regional exemptions have been replaced with budgetary transfers, and a timetable has been set to reduce distortionary taxes. It is important to resist pressures to grant new exemptions. Tax administration will be strengthened, building on recent gains.

“Monetary policy has been prudent. The new inflation target should further entrench price stability and help reduce dollarization. In light of the comfortable level of official reserves and the increased resilience of the banking system to exchange rate shocks, some greater exchange rate flexibility should be possible, to promote awareness of currency risks and further develop the domestic financial markets.

“Financial sector reforms have helped reduce the risks associated with financial system dollarization, but further measures are needed to reduce the dollarization of mortgage loans. Envisaged legislation to strengthen regulatory oversight of public financial institutions is welcome, and there is a need to ensure that public banks do not undermine financial sector competition,” Mr. Portugal said.

Statement by Javier Silva-Ruete, Executive Director for Peru
June 27, 2007

1. The Peruvian economy continues to perform well, supported by sound macroeconomic policies and a favorable international environment. Work on poverty alleviation and structural reform geared to achieve sustainable and equitable growth —a priority under the program— is proceeding with determination. All end-March performance criteria were met. In view of the progress under the Stand-By Arrangement, the authorities request completion of the First Review. They consent to the publication of the staff report.

2. Led by non-primary sectors linked to domestic demand, GDP growth reached 8 percent in 2006 and is forecasted at around 7 percent in 2007. Investment, consumption, and employment are expanding steadily thanks to solid market confidence. The external position remains sound, with international reserves equal to 3.7 times short-term debt (residual basis) and 77 percent of total liquidity as of the end of the first quarter.

3. In 2006, the consolidated public sector posted a surplus of 2.1 percent of GDP, due to strong revenue performance and lower-than-expected expenditure execution. In 2007, the priorities on the fiscal front are: to continue to address pressing social needs and bridge the significant infrastructure gap; to implement plans to improve the quality of expenditure; and to strengthen the tax system. In this regard:

- The authorities intend to move ahead with budget execution at all government levels, especially for much-needed public investment. Legislation has been issued to expedite public bidding and approval of investment projects; and efforts continue to decentralize the National System of Public Investment and enhance sub-national capacities with the Inter-American Development Bank's (IADB) support and private sector involvement. The authorities thus expect to meet the adjusted fiscal deficit of 0.5 percent of GDP for 2007, as envisaged under the program, although they recognize that it could be close to balance, in light of potentially higher revenues. To further press ahead with the government's ambitious investment program, an amendment to the Fiscal Responsibility and Transparency Law has been proposed whereby the current 3-percent limit on the real growth of general government's expenditure would be applicable only to central government consumption expenditure.

- At the same time, the authorities are committed to safeguarding the transparency and quality of expenditure. In particular, ensuring adequate selection and monitoring of investment projects is at the top of the agenda. Furthermore, the budget classification is being modernized, and implementation of the central government's Treasury Single Account is envisaged for December 2007. The independent assessment of the government's Integrated Financial Management System (SIAF) will be available by end-September 2007. In consultation with the World Bank, the United Nations Development Plan (UNDP) and the IADB, the government is reforming government procurement procedures. Follow-up of sub-national government operations — essential to underpin the decentralization process— continues to be reinforced. Measures in this field include the establishment of a new monitoring unit for sub-national governments at the Ministry of Economy and Finance (already functioning). Work on a legal framework for PPP operations is underway, and submission to Congress is now expected for end-September. Furthermore, a recently developed methodology to estimate contingent obligations associated with PPP projects has been published.

- Revenues continue to be buoyant thanks to strong growth and still positive external conditions. In addition, the authorities persist in their efforts to strengthen the tax system. Steps are being taken to further simplify the tax structure —especially by reducing distortionary taxes—; and administrative improvements continue to be introduced, especially for auditing procedures. Notably, the recent passage of legislation providing a strict timeframe for tax exemptions is a major step towards broadening the tax base. In this context, existing exemptions will be assessed to decide whether to eliminate or bring them into the new framework.

4. In order to further diminish exposure to foreign currency-denominated public debt and extend the yield curve, the authorities recently reached an agreement to prepay part of Peru's commercial obligations with the Paris Club due in 2007-2015. As a result of active debt-management policies, fiscal discipline, and high economic activity, the public debt burden is expected to diminish from 32.6 percent of GDP in 2006 to around 24 percent of GDP by 2010.

5. Inflation has remained subdued, and in February the authorities reduced the inflation target from 2.5 per cent to 2 percent to align it more closely with average inflation rates in Peru's main trade partners and help to entrench de-dollarization, while keeping the tolerance band at ±1 percent. Towards the end of 2006, twelve-month inflation dropped below the previous target range due to supply shocks, and continued to decline during the first four months of the year. However, this trend started to reverse in May, as temporary factors have begun to recede, and 12-month inflation is expected to converge towards the 2 percent target over the remainder of the year. In the longer run, economic drive is expected to remain consistent with the target range as productivity continues to improve across sectors. Also, the authorities commit to continue limiting interventions in the foreign exchange market to those needed to confront excessive exchange rate volatility or abrupt fluctuations, without an explicit or implicit commitment to any given exchange rate level.

6. As a matter of priority, the authorities continue their plans to promote rapid poverty alleviation. The Interministerial Committee for Social Affairs (CIAS) completed an assessment of existing social assistance programs (SAPs) and published an action plan. In

line with it, the authorities recently consolidated 82 SAPs into 26 and will adopt institutional and operational arrangements to increase their effectiveness —i.e., providing the CIAS with sound technical staff and implementing a consistent targeting methodology. Focus and coverage of the conditional cash transfer program *Juntos* will be further improved with World Bank assistance. In line with policy priorities, conditionality under this program will focus on the prevention of children malnutrition. Resolute steps are being taken to upgrade education standards: after successfully completing an evaluation of teachers in January, the authorities are setting out to improve their capabilities through continuous training. The quality and coverage of public health care is also being given due priority.

7. In May, Peru secured U.S. Congress support for a free-trade agreement (FTA), pending amendments to include labor and environmental standards. The FTA with the U.S., Peru's main trading partner, will further encourage export growth and diversification, increase employment, catalyze structural reform, and facilitate investment flows.

8. On the financial sector:

- The financial system continues to strengthen. Financial intermediation is expanding, and regulation and supervision are constantly being reinforced —including through adequate provisioning against currency risks— to preserve resilience. As part of the authorities' de-dollarization strategy, work is proceeding to shift MiVivienda's (the state-sponsored housing program) portfolio to domestic currency and ensure that new mortgage loans are likewise denominated. Additionally, new lending programs in domestic currency have been launched. Importantly, to ensure asset quality, the authorities expect, in the next months, congressional approval of legislation that will bring Banco de la Nación (the government's financial agent), Agrobanco (the state agricultural development bank), and MiVivienda under supervision by the Superintendency of Banks.

- In addition: (i) work on the legal and regulatory and supervisory framework for enabling the central bank to oversee the payments system continues; (ii) due to technical complexities, the clarification of the tax treatment of securitized transactions is now expected to be completed before end-December; and (iii) the limit on pension funds' investments abroad has been raised to 15 percent to improve profitability and facilitate risk diversification.

9. The authorities stand ready to take the necessary steps to meet their commitments under the program and pledge to maintain the usual close dialogue with the Fund.