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Peru: Staff Report for the 2008 Article IV Consultation, Fourth Review and Inflation Consultation Under the Stand-By Arrangement and Request for Waiver of Applicability of Performance Criteria—Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Peru

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2008 Article IV consultation with Peru and the fourth review and inflation consultation under the Stand-By Arrangement and request for waiver of applicability of performance criteria, the following documents have been released and are included in this package:

- The staff report for the combined 2008 Article IV consultation and Staff Report for the 2008 Article IV Consultation, Fourth Review and Inflation Consultation Under the Stand-By Arrangement and Request for Waiver of Applicability of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on December 13, 2008, with the officials of Peru on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 14, 2009. 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 January 30, 2009 updating information on recent economic developments.

- A Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its January 30, 2009, discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

- A statement by the Executive Director for Peru.

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

Selected Issues Paper

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

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PERU

Staff Report for the 2008 Article IV Consultation, Fourth Review and Inflation Consultation Under the Stand-By Arrangement and Request for Waiver of Applicability of Performance Criteria

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

Approved by José Fajgenbaum and Dominique Desruelle

January 14, 2009

- ***Context and recent developments.*** Peru's economic expansion is the longest on record and inflation remains among the lowest in the region. The impact from the global crisis has been moderate, but high dollarization poses risks. The outlook for 2009 is favorable, but with heightened downside risks.
- ***Key policy recommendations and authorities' views.*** There was broad agreement on the need to preserve prudent policies in light of the deteriorating external environment and on advancing reforms to sustain high growth and poverty alleviation. Fiscal policy would allow for automatic stabilizers to operate and public expenditure would continue addressing infrastructure and social needs. Monetary policy would aim at ensuring that inflation converges within the target range of 1–3 percent by end-2009. A deeper impact from the global crisis would allow for cautious countercyclical policies, consistent with the authorities' recently announced plan. Recent prudential measures and financial sector reforms should promote orderly financial deepening and crisis preparedness. Broadening the tax base, enhancing the quality of public spending, and further strengthening of the policy framework are also priorities. Further trade liberalization and administrative simplification would help reduce informality and enhance labor productivity, essential to entrench poverty alleviation.

Relations with the Fund

- **Arrangement.** A 25-month SBA for SDR 172.37 million (27 percent of quota) was approved on January 26, 2007. The authorities treat it as precautionary. The Executive Board approved the third review of the SBA on July 23, 2008. Peru's has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement and its exchange rate regime is classified as a managed float.
- **Program implementation.** All performance criteria for end-June and end-September 2008, as well as the continuous ones, were observed. Inflation exceeded the upper limit of the program's consultation band mechanism in September and December. Structural benchmarks have been met, except for the issuance of guidelines to assess tax exemptions (end-June), the implementation of the Treasury Single Account, and the submission to Congress of amendments to the Decentralization Law to reconcile subnational government spending (both end-September).

Discussions. Conducted by M. Cerisola (Head), M. Gonzalez, M. Garcia-Escribano, M. Kaufman (all WHD), M. Goretti (SPR), G. Gasha (MCM), and D. Leigh (FAD) in Lima (December 2–13, 2008), and assisted by L. Breuer, resident representative. Staff met with Central Bank President Velarde, Minister of Finance Valdivieso, and Prime Minister Simon. O. Hendrick (OED) participated in the discussions.

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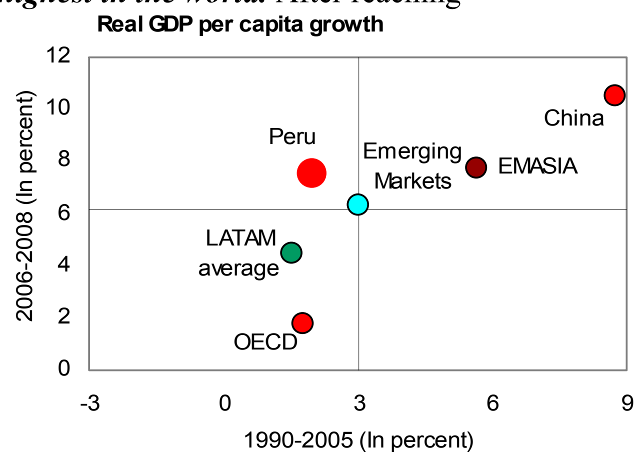
Attachments

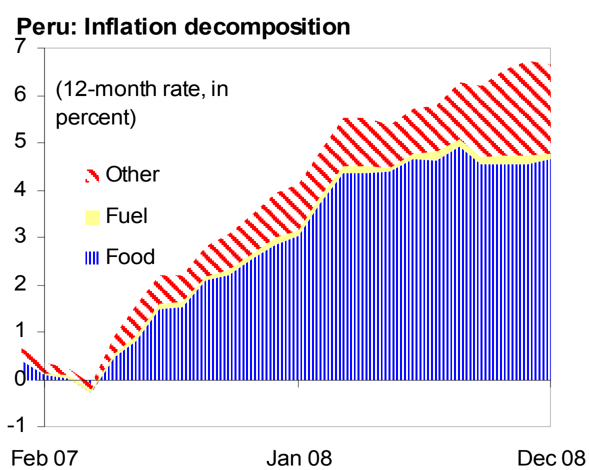
I. Background

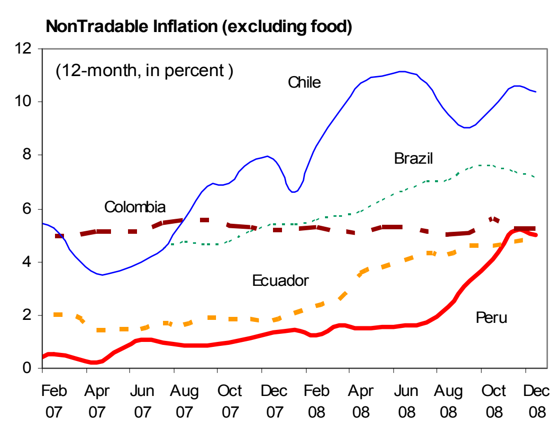
1. **The 2008 Article IV Consultation and Fourth (and final) review under the SBA takes place against a backdrop of strong macroeconomic performance but sharply deteriorating global conditions.** With the Fund-supported program coming to an end, the consultation provided a good opportunity to highlight accomplishments in recent years, as well as the policy challenges and risks going forward.

- ***Economic growth has been among the highest in the world.*** After reaching 10 percent in the first three quarters of 2008, recent indicators suggest that real GDP growth could decelerate to 7½ percent in the fourth quarter of 2008, and would end at around at 9.4 percent for the year as a whole. Growth has been led by private investment and consumption, as well as by a significant recovery of public investment.



- ***Inflation has risen but remains low by regional standards*.** Headline inflation was 6.7 percent in 2008, above the 2 percent target (+/- 1 percent band), mostly driven by higher food and fuel prices. However, pressures broadened, with core inflation (excluding food and fuels) rising from 1.5 percent at end-2007 to 4¼ percent at end-2008.





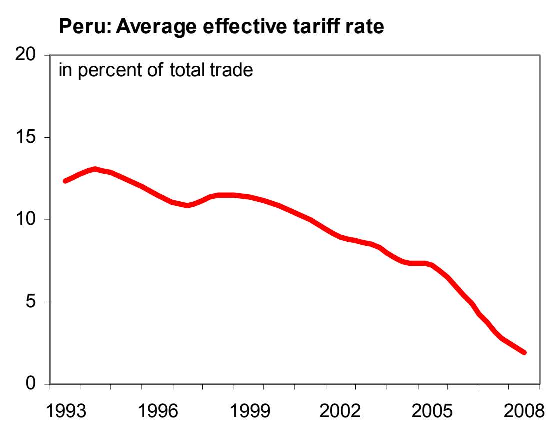
- ***Steady fiscal surpluses and declining public debt vulnerabilities.*** The nonfinancial public sector surplus is projected at 2.1 percent of GDP by end-year—entailing an expansionary fiscal stance, largely as a result of a significant increase in public investment and 0.6 percent of GDP in repayment of liabilities under the *Fuel Price Stabilization Fund* (FEPC). Fuel subsidies have been eliminated through adjustments to the band price and the sharp decline in imported fuel prices, while excise taxes on selected domestic fuel prices have been raised markedly (Box 1). Public debt has been reduced from about 33 percent of GDP in 2006 to 25 percent of GDP in 2008. The share of foreign currency denominated public debt has declined to almost 60 percent, the public sector has become a net external creditor, and the sovereign was granted investment grade by Fitch and Standard & Poor's in April and July 2008, respectively (Box 2).

Peru: Fiscal Performance 2007-08

	2007	2008	
	Prel.	CR 08/258	Proj.
Total revenue of general government[1]	20.8	19.6	20.8
Total primary expenditure of general government[1]	16.0	16.0	17.1
Current expenditure	12.9	12.2	13.0
Capital expenditure	3.0	3.8	4.2
Public enterprises primary balance	0.1	-0.1	-0.1
Overall balance of NFPS	**3.1**	**2.0**	**2.1**
Central bank operating balance	0.2	0.0	-0.1
Overall balance of CPS	**3.3**	**2.0**	**2.0**
Overall balance (including CRPAOs)	2.2	1.4	1.3

Source: Peruvian authorities and Fund staff estimates.
[1] Net of transfers to non-financial public sector (NFPS)

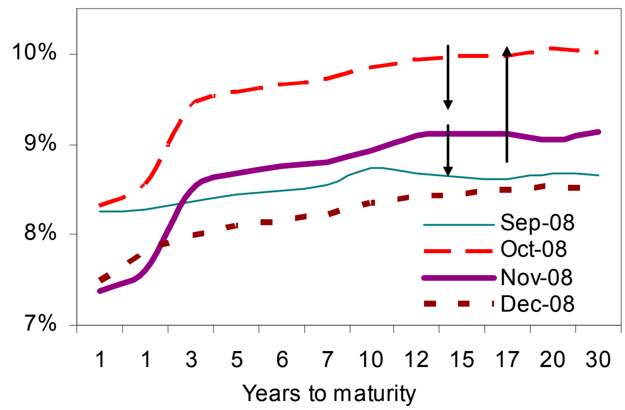
- ***The economy is more open, with a better business climate and declining poverty***. Peru has been liberalizing external trade through tariff reductions in recent years and has also been seeking enhanced market access through new bilateral agreements. To complement the approval of the Peru-U.S. FTA earlier this year, the authorities have continued negotiations with the EU and China, among others. There has been progress in simplifying administrative procedures and in enacting legislation to reduce labor market informality. Over the past two years, urban employment has risen by 9–10 percent, and poverty rates have declined from 44½ percent in 2006 to 39⅓ percent in 2007.



2. **The economy has been moderately affected by the global financial crisis thus far.** Strong fundamentals, along with several measures implemented have helped limit the contagion from the global financial crisis, preserve adequate liquidity conditions in domestic financial and capital markets, and bolster domestic confidence in the economy. In particular:

- ***Limited financial contagion.*** After tripling to above 620 basis points in late October, sovereign spreads have eased to around 455 basis points more recently and equity prices have recovered somewhat, but are still 60 percent lower than at end-2007. Following US$8.5 billion in foreign exchange purchases earlier this year, the central bank sold US$6 billion since September, to limit market volatility and contain pressures on the *Nuevo Sol*, which has depreciated by 5.8 percent against the U.S. dollar. Facing tight liquidity, reduced capital inflows, and a steepening of the government yield curve, the central bank has held policy rates unchanged since October, but eased reserve requirements and placed *repos* and *swaps* in *Nuevo Soles* and U.S. dollars. At the same time, the state-owned *Banco de la Nación* signaled its intention to repurchase government fixed-income securities in the secondary market. As a result of these measures, interbank and prime corporate rates in U.S. dollars, and the government yield curve are close to pre-crisis levels.

Peru. Domestic Sovereign Yield Curve: Impact and Response to Crisis



Peru: Changes to Reserve Requirements (RR) in 2008-09

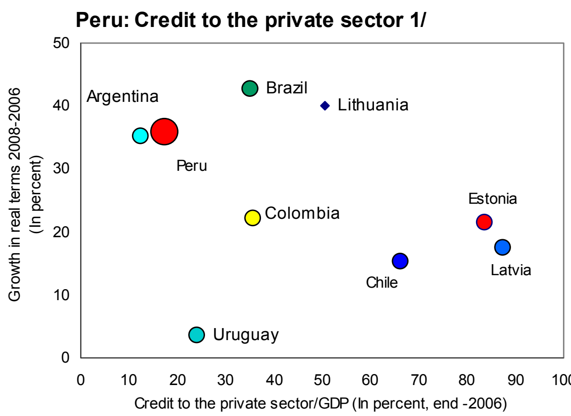
	2008				2009
	January	July	October 1/	December 2/	January
Minimum nonremunerated RR (both currencies)	6	9	9	7.5	6.5
Marginal RR for FX deposits	30	49	35	30	30
Marginal RR for NS deposits (residents)	0	25	0	0	0
Marginal RR for NS deposits (non residents)	0	120	120	35	35

1/ The RR of 9 percent on long-term (more than 2 years) credit lines from foreign institutions established in August was eliminated in October. The marginal RR for foreign credit lines in both currencies were also removed in October.
2/ Regarding local banks' short-term USD-denominated obligations, the BCRP established a 35 percent ceiling to the average RR.

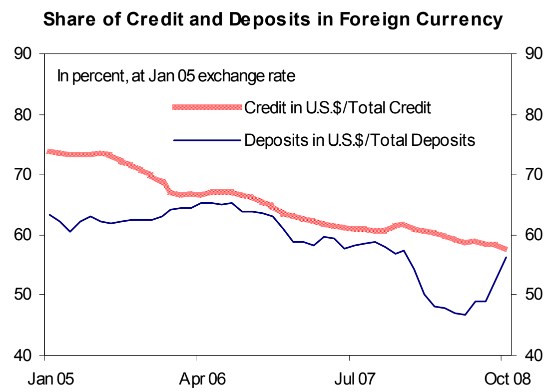
- ***Banks have remained resilient, and a "credit crunch" is being avoided.*** After growing at about 30 percent in the year to September, credit to the private sector accelerated in October, particularly for the corporate sector, partly as a result of tighter financing faced abroad and in domestic capital markets. Large official reserves—which stood at $31 billion at end-December and strong financial soundness indicators for the banking system, along with banks' limited reliance on external funding (at about 15 percent of total assets and two-thirds of long-term nature) have helped preserve stable liquidity conditions.

- ***Dollarization has rebounded in recent months after declining markedly over the past two years***. The share of dollar denominated deposits has risen markedly since

September, reflecting portfolio shifts associated with concerns on the global financial crisis. Stress tests suggest that banks are better prepared to face a currency depreciation, while corporates and households also seem less exposed to currency-related risks (Box 2). Nonetheless, a potentially sudden and sharp depreciation could still bring strains to balance sheets and confidence, and revert the trend in dedollarization.



1/ Based on latest available monthly data for 2008 for each country



- ***The authorities announced an "anti-crisis" plan to shield the economy from the global crisis and buttress business confidence.*** The government announced a "Plan for Sustaining Economic Growth, Employment, and Poverty Alleviation in a Global Crisis", which presents a set of fiscal measures—equivalent to nearly 2½ percent of GDP—that could be ready for implementation as conditions warrant. These include measures targeted to maintain a program of public investment and support construction,

The Anti-Crisis Plan: Fiscal Measures

	S/ million	Percent of GDP
Total	**10,032**	**2.43**
Support to construction sector	3,120	0.75
Mortgage financing guarantees	2,920	0.71
Access to drinking water	200	0.05
Support to SMEs and export sector	1,360	0.33
Public investment	5,002	1.21
Investment continuity initiative	1,500	0.36
Key new or accelerated projects (68)	1,008	0.24
FONIPREL	2,294	0.55
Other	200	0.05
Social programs and targeted support to workers	550	0.13
Memorandum items		
Spending already in 2009 budget	550	0.13
Spending in baseline staff forecast	1,700	0.41
Nominal GDP	413,550	...

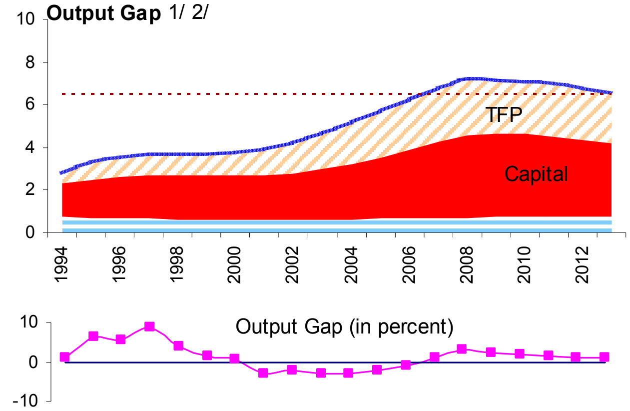
micro and small enterprises, exporters, and social programs, to be financed with public sector deposits. The government has also lined up access to contingent lines from official creditors that could amount up to $9¼ billion dollars.

- ***Peru's performance under the SBA has been good.*** All quantitative performance criteria for end-September were met, but inflation exceeded the upper limit of the program's consultation band for end-September and end-December (see attached letter from the authorities). With data yet to be released and no evidence that the performance criteria will not be met, the authorities are requesting a waiver of applicability for the end-December 2008 quantitative performance criteria. End-June and end-September structural benchmarks were also met, except for the issuance of methodological guidelines to assess tax exemptions, the implementation of the Treasury Single Account (TSA) and the submission to Congress of amendments to the Decentralization Law to reconcile subnational government spending limits with those for the central government as presented in the Fiscal Responsibility and Transparency Law (FRTL). The timing of implementation of these reforms is uncertain.

II. The Medium-Term Outlook and Risks for 2008–2010

3. **Medium-term prospects are favorable and require preserving prudent macroeconomic policies and dealing with long-standing structural challenges.** With heightened risks stemming from the global economy, preserving the high quality of macroeconomic policies is necessary to sustain high growth, low inflation, external stability, and poverty alleviation. Peru has become a more open economy, and continued capital deepening should enhance productivity and potential output growth—estimated by staff at 6–6½ percent, to generate strong employment growth and higher real wages. These efforts need to be further complemented by reducing high labor market informality and improving the quality of public investment and social spending across all government levels to alleviate infrastructure and social gaps, and thus support ongoing export diversification and poverty alleviation. Strengthening public institutions, advancing administrative simplification and education attainment, would also help boost human capital and entrench high total factor productivity growth.

Peru: Contributions to Potential Output Growth and Output Gap 1/ 2/



1/ Calculations based on a labor share of 32.3 percent, and a smoothed capital stock series
2/ Output gap expresed as a share of potential output.

Macroeconomic Framework, 2007–2013

		Prog. CR/08/28	Proj. CR/08/258 1/	Proj.	Proj.				
	2007	2008			2009	2010	2011	2012	2013
	(Annual percentage change)								
Real GDP growth	8.9	6.5	8.2	9.4	6.0	6.8	6.5	6.5	6.5
Inflation (end-year)	3.9	2.5	4.3	6.7	2.8	2.2	2.0	2.0	2.0
	(In percent of GDP)								
External current account balance	1.4	-0.7	-0.6	-3.3	-3.0	-2.9	-2.6	-2.0	-1.6
Public sector balance (excluding CRPAOs	3.3	2.0	3.0	2.0	0.6	0.6	0.5	0.3	0.1
Public sector balance (including CRPAOs)	2.2	1.4	2.4	1.3	0.2	0.5	0.5	0.3	0.1
Total public debt (including CRPAOs)	30.9	26.2	22.0	24.8	21.7	18.9	16.7	14.9	13.6
Gross official reserve coverage of:									
Short-term debt (residual maturity)	456	489	582	443	358	363	317	383	397

Source: Fund staff estimates and Peruvian authorities.
1/ The public sector balance (excluding CRPAOs) equals 2 percent of GDP under the program CR/08/258.

4. **Against the backdrop of sharply deteriorating external conditions, the domestic economic outlook for 2009 still remains favorable, but with risks on the downside.** The pace of economic growth is expected to slow to 6 percent in 2009—owing to the impact of the global slowdown, lower terms of trade, and tighter financial conditions on net exports and private investment. With global price disinflation already underway and imported food prices expected to decline by 3½ percent in 2009, inflation would decelerate to 2¾ percent by end-2009, within the 1–3 percent target range. While the economy is above potential, there is considerable uncertainty on these estimates and how domestic demand translates into inflation—particularly given the prominent role of private investment and surge in capital goods imports in recent years, as well as the still high levels of labor market informality.

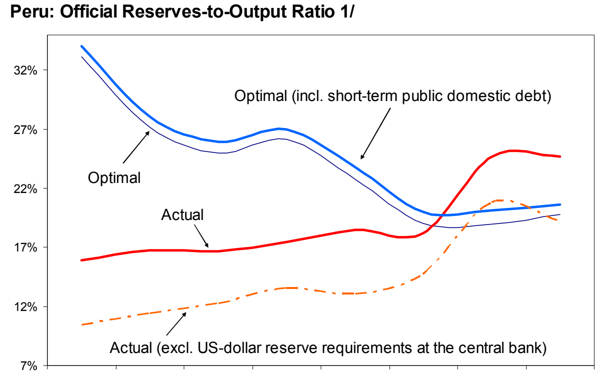
Peru: Contribution to real GDP growth (y/y)

	2008	2009
GDP	**9.4**	**6.0**
Domestic demand	13.0	7.1
Private Consumption	5.9	3.7
Public Consumption	0.3	0.2
Gross investment	6.8	3.2
of which: private	5.1	2.5
of which: public	1.7	0.7
Net exports	-3.6	-1.1
Exports	0.9	0.4
Imports	-4.5	-1.5

Source: Staff estimates

5. **A more severe and prolonged global slowdown could also extend downside risks into 2010.** With almost 50 percent of exports to the United States, Europe, and Japan, a deeper and more protracted global slowdown—especially if accompanied by a sharp deceleration in large emerging market economies in Asia, brings further downside risks. An illustrative staff scenario suggests that Peru would be vulnerable to a sharper-than-anticipated fall in external demand and

Peru: Official Reserves-to-Output Ratio 1/



1/ Optimal reserves calculated based on the methodology as in Jeanne and Rancierre (2006) commodity prices accompanied by a further tightening of financing conditions, lower foreign direct investment, and higher risk aversion. This could bring real GDP growth down to 4–5 percent. Moreover, under such scenario, a marked depreciation of the currency, could promote dollarization, strain the economy's balance sheets and lower official reserves below comfortable levels. In these circumstances, the current adequate level of official reserves and the recently announced government plan would provide an important buffer to preserve significant economic growth, external stability, and poverty alleviation (Annex 1).

III. Policy Discussions

6. **Discussions took place against a backdrop of heightened global uncertainty and with the economy showing incipient signs of deceleration.** Discussions focused on the policies that could help shield the economy from a further deterioration in the global environment, while helping to preserve the strong economic performance over the medium term. In particular:

- ***Achieving a "soft-landing".*** *The policies to respond to the global crisis and risks of a sudden and sharp slowdown to preserve macroeconomic stability.*

- ***Strengthening the financial system and sustaining an orderly deepening.*** *The key reforms to ensure that financial deepening proceeds in an orderly manner and markets improve their resilience to external shocks.*

- ***Further solidifying the policy framework.*** *Reforms to consolidate the fiscal framework, minimize fiscal risks, and strengthen the inflation targeting framework.*

- ***The poverty alleviation strategy and other structural reforms.*** *Reforms to strengthen the effectiveness of social programs and further steps simplify business procedures and lessen regional disparities.*

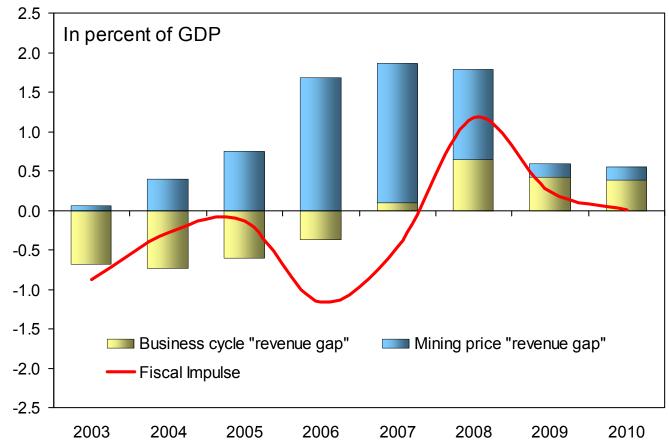
A. Achieving a Soft-Landing

7. **The authorities stressed the need to preserve the prudent policy strategy of recent years.**[1] They recognized that the still strong economic underlying momentum provided an important buffer to face the global slowdown and financial crisis. However, they remained concerned that a sharp and sudden deceleration in domestic private demand—that could be precipitated by a sharp fall in commodity prices, domestic confidence, and potential disruptions in the financial system—could compromise a "soft landing". Therefore, the conduct of fiscal policy in 2009 would be geared toward allowing for automatic stabilizers to operate in full, while several of the measures contemplated in the anti-crisis plan would be

[1] A *Selected Issues Paper* presents an analysis of the role of fiscal policy in contributing to macroeconomic stability.

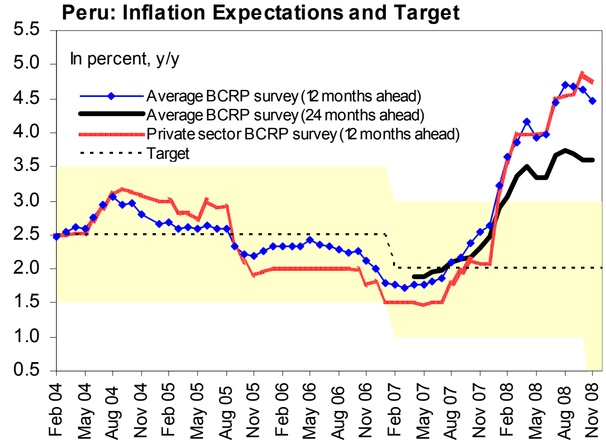
immediately implemented. Most notably, the authorities have extended the execution of public investment projects budgeted in 2008 through March 2009 and boosted resources under the Fund for Regional and Local Public Investment (FONIPREL), while public investment execution would be phased more evenly through the year to sustain some of the fiscal impulse during the first half of the fiscal year. As a result, the nonfinancial public sector surplus could reach 0.4 percent of GDP. This would still entail a tight rein on current spending (4 percent growth in real terms), while public investment would expand by about 20 percent in real terms. Staff noted that preserving a better balance between achieving a soft landing and addressing infrastructure and social needs would imply a more prudent expansion of public spending. This would entail achieving a neutral fiscal stance for the year as a whole—equivalent to an overall surplus of 0.7 percent of GDP. The authorities expected that some of the intrinsic difficulties in executing spending would likely bring fiscal policy close to a neutral stance.

Peru: Structural Fiscal Balance



8. **In coordination with fiscal policy, monetary policy would continue to balance the disinflationary effects from the deteriorating external environment with the need to preserve adequate liquidity conditions.** In the context of the inflation consultation (see attached letter), central bank authorities indicated their expectation that inflation would converge within the 2 percent target (+/- 1 percent band) by end-2009. They noted that inflation had begun to decelerate and that this trend was likely to intensify in the coming months, as declining global food and fuel prices had yet to be fully passed onto domestic prices.[2] The authorities were confident that recent reductions in reserve requirements would preserve stable liquidity conditions and ward off the economy from a sharp and sudden slowdown in domestic demand. They also noted that disinflation dynamics

Peru: Inflation Expectations and Target



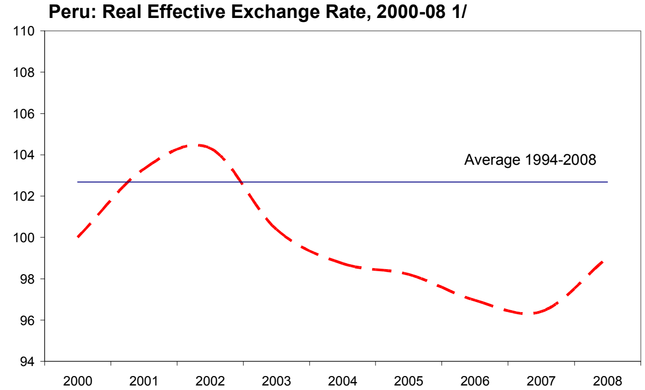
[2] Domestic fuel prices remained 23 percent on average above their import parity as of mid-December 2008, in line with the FEPC mechanism, as its liabilities still amount to about ⅓ percent of GDP.

could prove more severe, given some inventory build-up in specific sectors. Therefore, the authorities were committed to continue monitoring closely the path of domestic demand and inflation expectations, noting that, if needed, there could be scope for further easing of monetary policy by lowering reserve requirements. Staff agreed with this assessment and policy approach, and emphasized the importance of taking advantage of the expected global disinflation to bring domestic inflation promptly to the target. Staff also noted the risk that, with strong credit growth, the path of domestic demand could prove more resilient in the near term and delay somewhat the disinflation process.

9. **Were the impact of the global crisis to intensify, the authorities and staff agreed that there would be some scope for cautious countercyclical policies**. Staff stressed that the still strong underlying economic momentum and several of the measures implemented by the authorities seemed sufficient to buffer the economy from the global slowdown. However, should downside risks intensify and materialize, further reductions in reserve requirements and policy interest rates, along with further fiscal easing, reflecting automatic stabilizers, should be the first line of defense. The authorities and staff agreed that a prudent fiscal stimulus should be carefully considered and paced, if the impact of the crisis were to extend to 2010, and provided it could be financed with government savings accumulated in recent years.[3] The authorities agreed with the need to proceed cautiously, as the scope for implementing countercyclical fiscal policy has traditionally been limited, and despite improved fundamentals in recent years, it could otherwise compromise the hard-won fiscal credibility. They stressed that such course of action would be consistent with the measures announced in the anti-crisis plan.

10. **The authorities and the staff agreed that the *Nuevo Sol* was fairly valued in real effective terms, posing no risks to external stability.**[4]

Peru: Real Effective Exchange Rate, 2000-08 1/



1/ An increase denotes appreciation. Last observation: September 2008.

- ***Assessment***. Cross country panel estimates from the macroeconomic balance, external stability, and equilibrium exchange rate approaches suggest that the *Nuevo Sol* is undervalued by 2–7 percent (Annex 2). The underlying current account balance for 2009 would be a deficit of 2.8 percent of GDP, in line with the projected deficit of

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[3] Government deposits amounted to 7¼ percent of GDP at end-October 2008.

[4] Peru's exchange system is free of restrictions on the making of payments and transfers for current international transactions.

3 percent of GDP adjusted for relative output gaps and commodity prices.

- ***Discussions.*** The authorities stressed the uncertainty of these estimates associated with the considerable structural changes in the economy—such as the recent trade liberalization and labor market reform—and their implications for external stability going forward. Their own time series estimates suggested that the *Nuevo Sol* would be close to equilibrium, but ranging on average from an undervaluation of 4 percent to an overvaluation of 6 percent, reflecting the different impact of changes in terms of trade and labor productivity under different methodologies.

B. Strengthening the Financial System and Sustaining an Orderly Financial Deepening

11. **Financial soundness indicators show that banks are well-capitalized, liquid, and with provisions exceeding nonperforming loans for all credit segments**.[5] Recent stress tests conducted by the Superintendency of Banks (SBS) also confirmed that the banking system has gained resilience to market, credit, and exchange rate-related risks. Nonetheless, indicators vary between large (and stronger) banks compared to those for the small (and generally weaker) banks and microfinancial institutions, which would be potentially more vulnerable to a sharp deterioration of the economy and market risks.[6] The authorities and staff agreed that banks' provisions—at about $1 billion (25 percent of their capital) provided an important buffer to a potential significant slowdown in the economy and deterioration in asset quality, without significantly jeopardizing the comfortable level of capitalization.[7]

Financial Sector Indicators: Banks and Microfinance Institutions
As of October 2008 (in percent)

	Banks	Cajas Municipales	Cajas Rurales
Capital Adequacy Ratio	11.9	19.1	18.7
Nonperforming Loans/Total Loans	1.2	4.1	4.4
Provisions/NPLs	263.1	142.3	136.3
Nonperforming Loans/Total Loans 1/	2.1	5.3	6.3
Provisions/NPLs 1/	147.0	111.4	95.4
Return on Equity	30.7	24.6	13.7
Return on Assets	2.6	4.2	2.1
Liquidity Ratio in Domestic Currency	36.0	19.9	23.8
Liquidity Ratio in Foreign Currency	53.9	40.6	62.2
Net Foreign Asset Position/Capital	9.9	2.0	1.3

1/ Including refinanced and restructured loans
Source: SBS

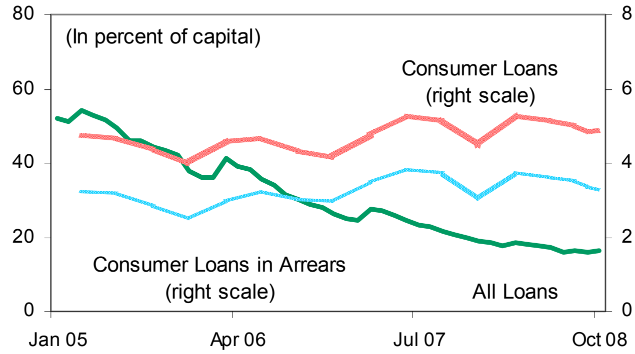
[5] Fitch's October 2008 *Banking System Risk Report*, assessed the banking system potential vulnerability to macro-prudential risks as low (similar to Panama), with its intrinsic quality—which is derived from Fitch's individual bank ratings—also deemed to be low, but typical of emerging markets.

[6] Microfinance institutions account for 6 percent of total assets of the financial system and have a CAR of about 23 percent.

[7] As of end-October, microfinance institutions provisions represented 29.6 percent, and 32.0 percent of capital for Cajas Municipales and Cajas Rurales, respectively.

12. **The authorities have also been implementing prudential measures to rein in buoyant credit growth.** Staff noted that new entrants to the system—from the supply and demand side—posed unchartered risks to macroeconomic stability. Some had begun to manifest in rapidly growing nonperforming consumer and microenterprise loans, including in banks with stronger credit risk management practices.[8] The authorities noted that banks had already begun to tighten lending standards, while the SBS established—effective 2009—more restrictive rules for granting credit card loans, as well as provisioning requirements for all consumer loans, and introduced procyclical provisioning effective December 1.[9] As a result, they felt that risks to asset quality would be contained, particularly as banks were also expected to add most of their high profits expected for 2008 to their provisions. Staff welcomed these measures, noting that it would be important to continue monitoring the rapid expansion of nonperforming loans for consumer and microenterprise loans, particularly as the pace of economic growth slows.[10]

Peru: Banking System Non-performing loans, 2005-2008 1/



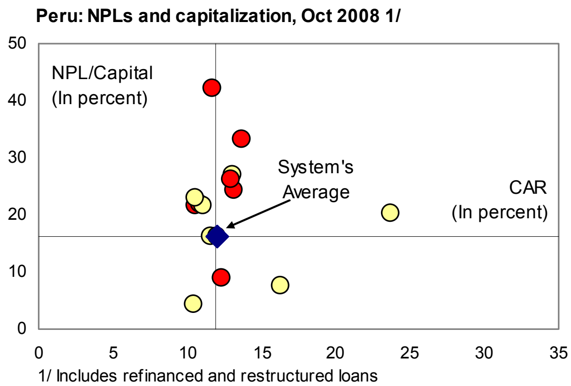
1/ Includes refinanced and restructured loans

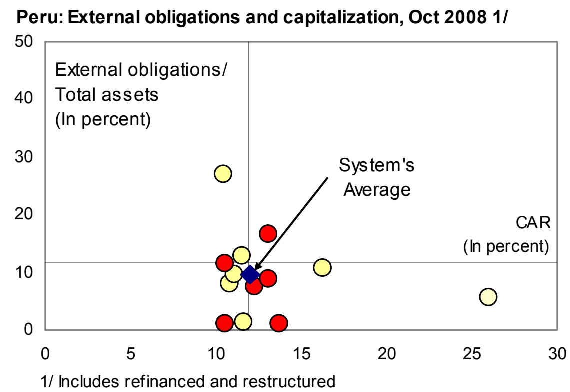
13. **The authorities noted that foreign-owned banks posed no systemic risks.** They noted that while foreign banks represented almost half of the banking system's assets, they continued to rely mostly on domestic funding. In addition, the SBS continued to monitor closely—through the provisions provided by memoranda of understanding with foreign supervisory agencies—the offshore operations of domestic financial conglomerates that could be more exposed to the global financial crisis. To address this risk and others related to large exposure to riskier operations (such as consumer and retail activities), staff encouraged the authorities to consider requiring financial institutions to increase their capital base, preferably with Tier-I contributions, as needed. The close monitoring of smaller banks and larger microfinancial institutions was also important, given their weaker risk management practices and potential contagion on other small financial institutions.

[8] In Peru, commercial loans past due 15 days are treated as nonperforming, compared with 30 days in most countries. In addition, the treatment of restructured loans—which payments have been rescheduled—has been aligned with international accepted practices in 2007.

[9] With the implementation of procyclical provisioning, the authorities amended the accounting rules for financial institutions to avoid incompatibilities with the international accounting standards (IAS 39).

[10] A *Selected Issues Paper* discusses the recent developments in private sector credit and policy options to ensure an orderly financial deepening.





14. **The authorities and staff agreed that the ongoing reform agenda should enhance the economy's resilience to global financial shocks**:

- ***Crisis Preparedness***. Intervention rules in cases where a bank experiences losses of 50 percent of capital have been clarified, with intervention triggered when such losses occur within a 12-month period. A Coordination Committee comprising senior officials from the Ministry of Finance, the Central Bank, and the SBS has been established to strengthen the framework for providing liquidity to all financial entities. The group has been exploring several mechanisms, including the possibility of establishing a trust fund that would allow private financial institutions to exchange high quality portfolio for a new credit-enhanced instrument issued by the trust fund, and potentially funded by the central bank. The authorities emphasized that such an instrument would facilitate access of smaller financial institutions to the central bank's safety net. The authorities were also exploring the possibility of relying on the Deposit Insurance Fund (FSD) as a complementary mechanism of liquidity provision—via the acquisition of portfolio. For solvency issues, the legal framework of the FDS already allows the provision of assistance through credit lines from the Ministry of Finance. Staff noted that these measures would help minimize systemic risks, and needed to be complemented by a well-established mechanism to protect the central bank's balance sheet. It would be important to recapitalize the FDS over the coming years through contributions by financial institutions.

- ***Proceeding with the gradual implementation of Basel II as envisaged***. Amendments to the General Banking Law and Organic Law of the SBS were approved by Congress on June 22, 2008. As a result, minimum capital requirements for credit, market, and operational risks will be introduced in line with Basel II. The minimum regulatory capital adequacy ratio will be raised from 9.1 percent to 9.5 percent in June 2009 and to 10 percent by 2011. Requirements for treating subordinated debt as Tier 2 capital have also been strengthened relative to standard international practice. Diagnostic

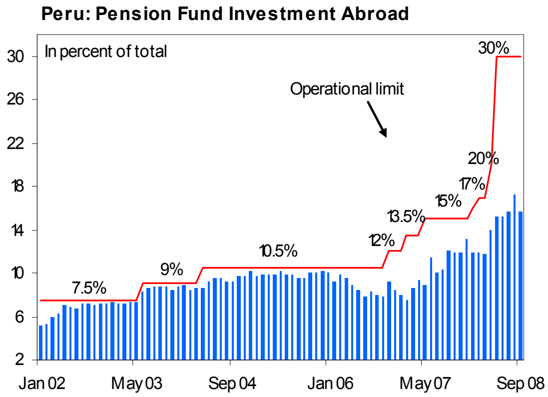
Fund-World Bank missions confirmed that the authorities are well placed to implement Basel II gradually.

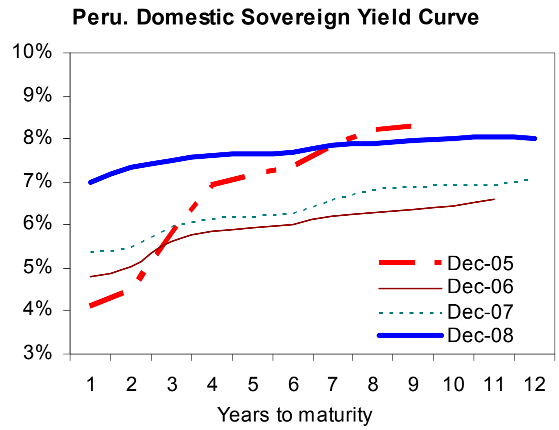
- ***Strengthening and expanding the operations of micro-finance institutions (MFIs)***. The authorities submitted legislation to Congress in late August 2008 to increase minimum capital requirements for microfinance institutions (end-June structural benchmark).[11] The new legislation was approved by Congress' Banking Commission in mid-September and now awaits plenary approval. The authorities have recently passed legislation that allows these institutions to engage in securitization and fixed-income product operations, including the purchase of central bank securities (which could be used as collateral for LOLR support) permitting their direct participation in the payments system (subject to central bank approval). The authorities emphasized that they had enough flexibility to accommodate the expansion of these operations with minimal risk.

- ***Aligning the supervisory framework of public banks with that of private banks.*** The market share of Peru's public financial institutions has remained contained—mostly as a result of the growth of private sector participants. Staff encouraged the authorities to give full priority to bringing all public financial institutions fully under the supervisory umbrella of the SBS, as envisaged by draft legislation currently stalled in Congress.

15. **The authorities agreed that promoting competition and strengthening the regulatory framework for domestic capital markets should help consolidate recent reforms.** New financial instruments have begun to emerge—such as long-term, fixed-rate mortgage lending in domestic currency and mortgage securitization—while issuance of private fixed-income instruments in *Nuevos Soles* has increased. The authorities also raised the limits of pension funds' investment abroad to 30 percent of total investments last May, paving the way for further diversification. Opening competition to other institutions, further streamlining their investment limits, and improving the coordination among public agencies, would best serve these goals. The authorities intend to continue implementing reforms related to the pension funds' minimum return guarantee and investment limits, and capital market supervision, with MCM TA during 2009.

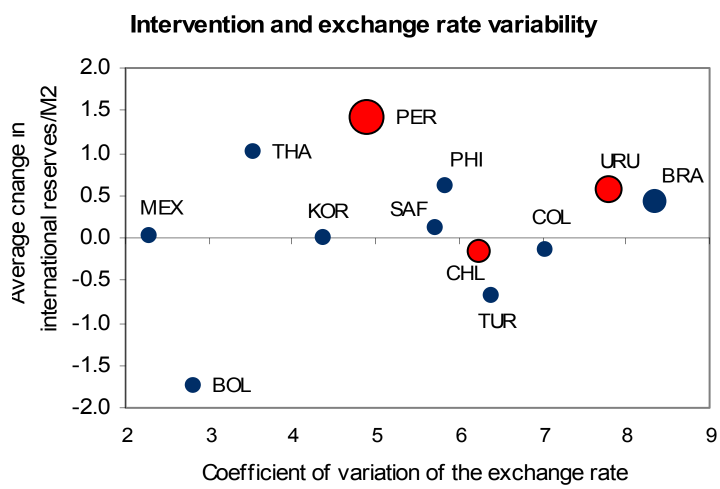
[11] Minimum capital for Cajas Rurales y Municipales would be raised to US$1.3 million (from US$0.3 million), and to US$ 0.8 million (from US$0.3 million) for Edpymes. All existing institutions will have 2 years to increase their capital to the new minimums once the law is approved by Congress.





C. Solidifying the Policy Framework

16. **The authorities and staff agreed that the inflation targeting framework should remain focused on preserving low and stable inflation**. They noted that their strategy in dealing with strong short-term capital inflows through higher reserve requirements earlier this year had been appropriate in buffering the inflation targeting framework from the risks to financial stability posed by large short-term capital inflows. The authorities felt that current global financial conditions were now more propitious to reduce reserve requirements and to rely on the policy interest rate as an instrument to control inflation. However, they stressed that they would not hesitate in relying on such instrument again, to contain excessive credit growth and risks posed by dollarization. Staff also encouraged them to prioritize Congressional approval of the constitutional amendment delinking the appointment of the central bank president and board members from the presidential cycle.



17. **Some reforms would help establish conditions for greater exchange rate flexibility to help absorb shocks and better anchor expectations.** Staff emphasized that stronger macroeconomic fundamentals, more resilient public and private sector balance sheets to exchange rate risks have provided more scope for exchange rate flexibility to act as a shock buffer. Staff and the authorities agreed that intervention has helped both build an adequate reserve buffer and contain the risks associated with large swings in the exchange rate. There was also agreement that in the current context of heightened global uncertainties, the timing for greater flexibility was less favorable given

the risks of stimulating excessive volatility and dollarization.[12] Staff encouraged the authorities to issue regulations for the tax treatment of derivatives, critical to bolster market incentives for hedging and to support a gradual increase in exchange rate flexibility.

18. **The authorities agreed on the need to strike a better balance between medium-term fiscal sustainability and cyclical factors**. Staff encouraged the authorities to begin preparing for a structural fiscal rule that would formalize the broadly neutral fiscal stance of recent years and strengthen the credibility of fiscal policy by ensuring a balanced budget over the economic cycle. The formal adoption of such a rule could be gradual and brought explicitly into the budget process before it is formalized. Staff suggested establishing and independent expert panel to help alleviate the authorities' concern on the difficulties in assessing the stage of the economic cycle when implementing such rule. Going forward, they agreed on the need to adopt a medium-term expenditure framework and remained committed to introducing multiannual budgeting in 2010.

19. **Several reforms would also help strengthen the fiscal policy framework, particularly to minimize fiscal risks in the face of external shocks.** Specifically:

- ***Higher public expenditure quality.*** Staff emphasized the importance of maintaining an appropriate balance of risks between the public and private sector in initiatives involving private sector participation in the provision of public services, including infrastructure. In this context, staff highlighted the risks posed by the new *Build and Transfer* program[13] and suggested close monitoring. Regional SNIP offices have been established (end-December 2008 benchmark), to provide further impulse to public investment in regions and municipalities. These efforts are being complemented with the expansion of performance budgeting to 9 sectors in 2009—from 5 in the 2008 budget. The authorities also agreed that further reforms to the FEPC—including an automatic price band—would help minimize fiscal risks of renewed subsidies. Staff also suggested the possibility of liberalizing fuel prices over the medium term.

- ***Enhancing the budget coverage and accounting.*** It was agreed that new extrabudgetary funds, while still small in size, have proliferated in recent years and could be better integrated into the budget documents. Also, the new fiscal accounting rules for the PPPs have yet to be fully implemented. The fiscal accounting rules for the recently approved *Build and Transfer* program have yet to be defined as well.

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[12] A *Selected Issues Paper* explores empirically the central bank's motives for intervention.

[13] The program allows the subnational government to contract private companies for investment projects in exchange for credit certificates against future income tax liabilities. The ceiling for project contracts by each SNG is roughly equal to the aggregated *canon* transfers for concept of mining revenues of the last two years.

- ***Improving the consistency of the Fiscal Responsibility and Transparency Law (FRTL).*** There is a need to reconcile expenditure limits with those for subnational governments (SNGs) in the Decentralization Law (DL) (end-September structural benchmark), as well as to ensure that the granting of specific-exemptions to such limits are prohibited under the law and not subject to Congressional discretion. The authorities did not see scope to amend the DL in the near term and preferred to do so once a well-defined timetable for decentralization is agreed upon.

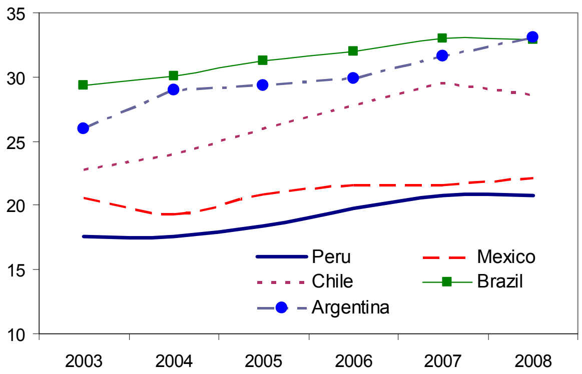
20. **Despite significant progress, broadening the tax base remains a key challenge**:

- ***Tax revenue-to-GDP is at its highest since 1980.*** At 18.3 percent of GDP in 2007, this ratio remains below many countries in the region—and is still largely dependent on mining-related revenue, which represents a quarter of total central-government revenue. The authorities were in the process of implementing the 2007 tax reform, to begin taxing capital income and gains in 2009, although they did not rule out some delays. They recognized that recent reforms to simplify VAT procedures for small tax payers may undermine efficiency gains.[14] The authorities agreed that it was also important to continue enhancing tax administration.[15] The new Customs Law preserves its administrations at SUNAT, critical for exploiting synergies between customs and domestic tax collection. They also agreed that it was important to restore fuel excise taxes to 2004 levels in the period ahead, particularly for the most environmentally noxious.

[14] In particular, the new regime loosens the requirements to apply for VAT credit, while expanding the registration period to one year. These changes may create an incentives to request increased VAT devolutions and drawbacks during a economic slowdown, while delaying VAT receipts accruing to SUNAT.

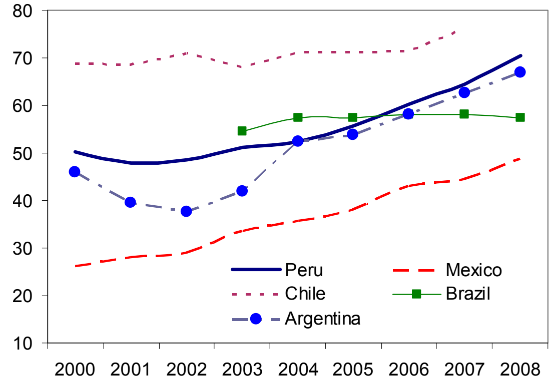
[15] Efforts should focus on streamlining audit procedures and quality, and setting noncompliance targets for tax audit and arrears collection.

Tax-to-GDP ratio for selected Latin American Countries 1/



1/ For the General Government

VAT Efficiency for selected Latin American Countries



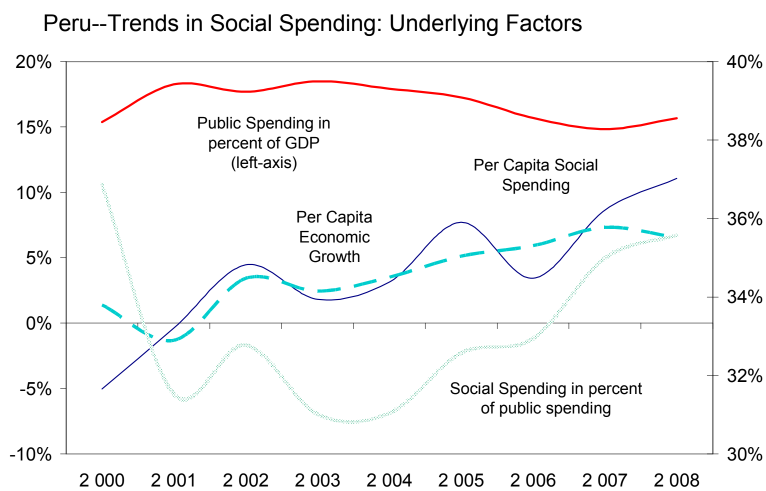
- ***Staff encouraged the authorities to proceed with the reform of tax exemptions planned for March 2009***. Draft methodological guidelines for the assessment of all existing tax exemptions (end-June 2008 benchmark) under the new regime had been approved and the authorities intended to issue them shortly. However, they noted that advancing this reform may prove politically challenging. One particular example was the recent Congressional passage of a two-year-delay (to 2013) of the replacement of exemptions of VAT and fuel and excises with direct budget transfers in the *Selva* region.

21. **The authorities and staff agreed that decentralization needs to proceed while carefully assessing fiscal risks**. The authorities continued to assess the fiscal decentralization process, initiated in 2002. The devolution of functions to subnational governments proceeded in 2008 and pilot programs had been initiated for decentralizing primary health and primary education. However, the laws that would clarify responsibilities across government levels had yet to be issued to avoid duplication or loopholes in the provision of services.[16] Staff stressed the need to evaluate the quality of public spending under the new National System of Public Investment (SNIP)

[16] The Organic Law of the Executive Power of December 2007 did not address the expenditure assignments among levels of governments, but instead, indicated that the shared responsibilities would be determined in the laws of organization and functions of each ministry.

D. The Way Forward on Poverty Alleviation

22. **While satisfied with the progress made in alleviating poverty, the authorities recognized the need to persevere with their efforts.** They stressed that the strong economic performance and rising formal employment, along with more prioritized spending on social assistance programs, have been important contributing factors to the important gains on poverty alleviation. In this regard, they emphasized that continuing with the implementation of the strategy *Crecer*, and expanding the conditional cash-transfer program *Juntos* in the 2009 budget to more rural areas, would provide the basis for expanding the coverage and effectiveness of social assistance efforts.



23. **Other important reforms are needed to sustain poverty alleviation.** Despite the progress, social assistance programs—including those related to education and health (universal programs)—continued to face significant targeting challenges. The authorities were well aware of these problems, and noted that their effectiveness was also impaired by difficulties in ensuring an adequate supply of public services. Therefore, they decided to link 2009 budgetary allocations to concrete improvements in several large targeted social programs. For this, and to strengthen their effectiveness, they intend to finalize comprehensive reviews of such programs, including *Glass of Milk*, by March 2009. The conditional cash transfer program *Juntos* would also be subject to a review, with assistance from the Interamerican Development Bank and the World Bank, to better articulate its capacity to deliver public services. Staff encouraged the authorities to also assess and reform universal programs on health and education, in line with the strategy presented in the March 2007 poverty reduction strategy. While the authorities agreed with the need to reform universal programs, they indicated that it would be politically difficult, and emphasized that their efforts would continue to be focused on improving their quality through performance budgeting.

Peru: Beneficiaries of social programs, 2006-07
(in percent)

Program	2006 poor	2006 non poor	2006 total	2007 poor	2007 non poor	2007 total	Targeting Performance 1/ 2006	Targeting Performance 1/ 2007
Glass of milk	67.9	32.1	100	61.1	38.9	100	1.5	1.6
Public meals	58.5	41.5	100	53.8	46.2	100	1.3	1.4
School breakfast	75.4	24.6	100	73.3	26.7	100	1.7	1.9
Primary education	66.1	33.9	100	62.6	37.4	100	1.5	1.6
Preventive health	56.0	44.0	100	52.8	47.2	100	1.3	1.3
Curative health	16.6	83.4	100	14.7	85.3	100	0.4	0.4

Source: Staff estimates based on National Household Survey (ENAHO), 2006-2007.
1/ Targeting performance of a social program is calculated as the ratio of poor beneficiaries to total beneficiaries divided by the percentage of poor in the total population. Poor includes extreme poor and non-extreme poor households. Poverty rates were 44.5 in 2006 and 39.2 in 2007.

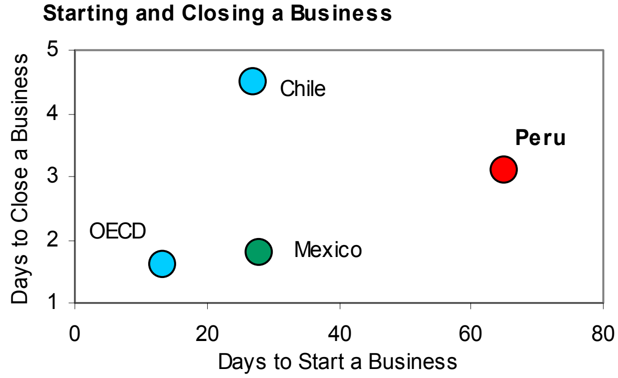
24. **The authorities were also well aware of the risks posed by increasing regional disparities**. Despite declining poverty, regional disparities were likely to increase, reflecting different resource endowments (in terms of economic structure and mining-related revenues) and ability to deliver public services. The authorities viewed the need to begin laying the ground for some form of equalization. As a first step, the 2009 budget increased the resources in the Fund for Regional and Local Public Investment (FONIPREL) by 0.5 percentage points of GDP so that the poorest regions could bid for resources to close their infrastructure gaps. Based on international experience, staff noted that further reforms would be needed to better help fill the gap between the subnational governments' expenditure needs, their revenue capacities, and the central government's transfers.[17]

E. Enhancing the Business Environment, Institutions, and Competitiveness

25. **Considerable progress has been made to enhance the business environment**. The authorities recognized that, according to World Bank indicators, Peru continues to lag other investment grade economies on establishing a conducive business environment, particularly in view of existing costly procedures for opening and closing businesses and for construction permits, for tax payments, and external trade. They noted that, therefore, efforts have and will remain focused on advancing reforms in key three areas:

[17] A *Selected Issues Paper* discusses the impact of public transfers in regional disparities and the international experience in establishing equalization schemes.

- ***Promoting formal employment***. The recently approved *Micro and Small Business Law* is an important step forward in reducing costs of formalization for small firms,[18] while providing progressive access to social security and health benefits (Box 3). The authorities expected that the new law would begin to have considerable effects on formalization, helping entrench the rise in formal employment of recent years.

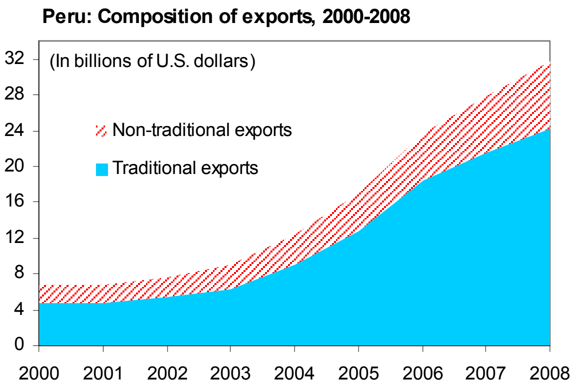


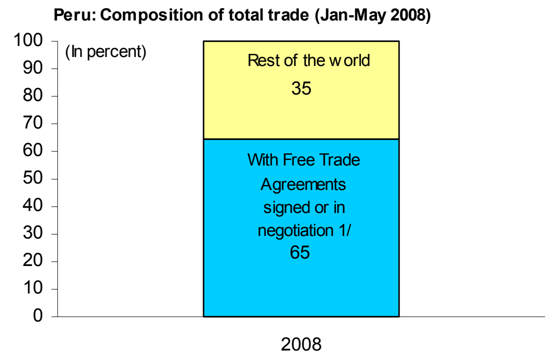
Source: Doing Business, World Bank

- ***Modernizing and simplifying procedures***. The *Positive Administrative Silence Law* has been in effect since 2008, and a one-step window for external trade is being implemented to facilitate the Peru-U.S. Free Trade Agreement. In addition, an e-government pilot project has been established that would allow the six more demanded procedures (including opening new businesses) to be completed electronically. Twelve commercial courts have been established across regions that have helped simplify and expedite conflict resolution.

- ***Further trade liberalization***. The authorities stressed that significant progress has been made in recent years in adding new external markets, with about two-thirds of external trade (exports) to be covered under bilateral free trade agreements. They stressed that these agreements should continue to provide the private sector with an important window to continue diversifying exports, particularly in light of the weakening global conditions.

[18] Labor informality remains very high, partly reflecting still high costs of hiring and firing, notwithstanding labor force unionization of less than 10 percent.





Source: IMF - DOTS
1/ Includes: USA, EU, China, Chile, Canada, Mexico, EFTA

IV. Staff Appraisal

26. **Peru's strong economic performance owes much to prudent macroeconomic policies and reforms under the favorable external environment of recent years.** Sustained fiscal surpluses have been the backbone of this success, supported by a prudent conduct of monetary policy, which while underpinned by inflation targeting, has also aimed at carefully balancing risks associated with high dollarization. Important structural reforms have been advanced to expedite public investment, reduce fiscal risks, enhance the resilience and depth of the financial system and capital markets, enhance the business environment and reduce poverty. These efforts have helped establish the basis for low inflation, reduced vulnerabilities, sustained high economic growth and a sustainable improvement in living standards, all of which have been recognized by the achievement of investment grade status.

27. **Macroeconomic policies need to remain prudent and focused on achieving a soft-landing.** This will entail the need to balance the risks associated with the global slowdown and the economy's underlying growth momentum. In the staff's view, achieving a neutral fiscal stance in 2009 would enhance macroeconomic stability and would provide room for implementing key elements of the authorities' anticrisis plan, such as the decision to extend the execution of ongoing projects through March 2009, phase investment projects more evenly throughout the year and boost resources under the Fund for Regional and Local Public Investment (FONIPREL). This, along with the recent reductions in reserve requirements and steady growth in credit to the private sector, should help buttress business confidence and ward off the economy from a sharp and sudden deterioration in private investment and net exports. It will be important for monetary policy to re-anchor expectations and reduce inflation to the 1–3 percent range during 2009. At present, a more aggressive discretionary set of countercyclical policies risks delaying some needed slowdown in domestic demand and a potentially sharper deceleration later on, with an ensuing weakening of credibility and more limited progress in reducing inflation.

28. **Were the global slowdown to be more severe and prolonged, the authorities would be in a position to implement cautious countercyclical measures in the second**

half of 2009. In particular, further reductions in reserve requirements and policy interest rates, along with some fiscal easing reflecting the use of automatic stabilizers, could be the first line of defense. The need for additional fiscal stimulus should be carefully considered and paced, and in the staff's view, a prudent stimulus could be financed with government savings accumulated in recent years. This policy response would be consistent with the authorities' intentions, as presented in their anticrisis plan.

29. **The authorities' focus on strengthening the financial system and sustaining an orderly financial deepening is timely.** Given the risks stemming from still buoyant credit growth, staff welcomes the authorities' decision to tighten prudential regulations on consumer loans and the implementation of new procyclical provisioning rules. Reforms to enhance the bank surveillance and intervention regimes, and to implement enhanced capitalization requirements in line with Basel II are also welcome. Going forward, it will be important to continue monitoring the growth in nonperforming loans, which may increase as a consequence of the slowdown in economic activity. Priority should be given in 2009 to enacting the increase in minimum capital requirements for microfinance institutions to protect their strong capitalization, including for new entrants. The continued close monitoring of foreign operations of domestic financial conglomerates is important in light of the recent experiences and risks posed by the global financial crisis. To address risks related to the large exposure of banks to riskier operations (such as consumer and retail activities), there may be a need to requiring financial institutions to increase their capital base, preferably with Tier-I contributions.

30. **Staff welcomes the coordinated action among government entities to strengthen the framework for crisis preparedness.** The ongoing actions and plans to ensure adequate liquidity to the financial sector and capital markets constitute a key step to minimize systemic risks. In the staff's view, these actions need to be complemented by a well-established mechanism to protect the central bank's balance sheet. Staff encourages the authorities to recapitalize the Deposit Insurance Fund over the coming years through contributions by financial institutions. In addition, the supervisory framework for public financial institutions should be aligned with that of private entities. It will be important to continue with reforms to enhance the depth and resilience of the domestic capital markets, including by improving the coordination for their oversight and enhancing competition for private pension funds.

31. **There is scope to further solidify the policy framework and the economy's ability to buffer shocks.** To bolster the credibility of the inflation targeting framework further, priority could be given to enacting legislation that delinks the appointment of the central bank president and board members from the presidential cycle. In addition, the authorities' decision to reduce reserve requirements to inject liquidity in the system would also help strengthen the signaling of the policy interest rate. Staff is of the view that the stronger macroeconomic fundamentals and improved balance sheets in the economy provide scope for greater exchange rate flexibility ahead, as external conditions permit. For this, it will also be

critical to advance reforms that facilitate hedging in the economy, such as the issuance of regulations regarding the tax treatment of derivatives.

32. **Efforts to strengthen the fiscal policy institutional framework have been significant and need to continue.** Reforms to minimize fiscal risks, including through the issuance of a legal framework for Public-Private Partnerships (PPPs), and aligning the budget classification with international standards are to be commended. Going forward, it will be important to finalize the implementation of the TSA, implementing the recently approved fiscal accounting rules for PPPs and issue the pertinent accounting norms for the *Build & Transfer* program. It will also be important that the PPP framework and other initiatives involving the private sector maintain an adequate balance of risks between private and public sectors. Staff encourages the authorities to prioritize the alignment of the expenditure limits in the FRTL and the Decentralization Law, in line with commitments under the program. At the same time, the adoption of a structural fiscal rule would formalize the broadly neutral fiscal stance of recent years and strengthen the credibility of fiscal policy by ensuring a balanced budget over the economic cycle. The formal adoption of such a rule could be gradual and brought explicitly into the budget process before it is formalized. In addition, consideration should be given to making the price-band adjustment and settlement of liabilities of the Fuel Price Stabilization Fund automatic, or even liberalizing fuel prices over the medium term.

33. **Broadening the tax base remains an important challenge ahead.** With Peru's tax system highly exposed to commodity revenues, it will be key to press ahead with reforms that broaden the tax base, including the taxation of capital gains. It is also critical to proceed with the 2007 reform of the tax exemptions planned for March 2009, including by issuing the recently completed methodological guidelines for the assessment of such exemptions, in line with program commitments. Staff supports the authorities' intention to unwind fully the reduction in fuel excise taxes implemented since 2004 in line with environmental considerations. Efforts to protect the integrity of the tax administration and to strengthen procedures need to be sustained.

34. **Sustaining poverty alleviation would require continued efforts to improve the effectiveness of social programs.** Staff welcomes the commitment in the 2009 Budget to link allocated spending to concrete improvements in social programs, as well as the intention to assess the successful cash transfer program Juntos and other large social programs, to strengthen their effectiveness further. It will also be important to garner support to assess universal programs, in line with the poverty strategy of March 2007. Regional disparities remain a challenge, and the expansion of the Fund for Regional and Local Public Investment (FONIPREL) and the methodological changes to the allocation coefficients of Regional Compensation Fund (FONCOR) are welcome steps that need to be complemented by reforms toward institutionalizing an equalization scheme.

35. **Much has been accomplished in enhancing the business environment, and further efforts are underway.** Staff welcomes the implementation of the Micro and Small Business law, an important step towards reducing informality. Efforts to promote trade liberalization, could be complemented with further administrative simplification and reduced costs for the business environment.

36. **Staff recommends completion of the fourth (and final) review and inflation consultation under the SBA,** as well as the authorities' request for a waiver of applicability of end-December performance criteria, given Peru's strong performance under the program.

37. It is expected that the next Article IV Consultation will take place on the standard 12-month cycle.

Box 1. Fuel-Price Stabilization—Fiscal Cost and Social Distribution

With persistently rising international fuel prices, the Fuel-Price Stabilization Fund (FEPC) has stabilized domestic fuel prices over the past two years. Firms that keep prices within an official wholesale price band set by the authorities receive compensation for the gap between the band and an import-parity reference price formula. The authorities also reduced specific fuel excises to limit the pass-through to domestic retail prices.

Table 1. Price Gaps: Required Fuel-Price Increases, July and December 2008
(Percent)

	July 2008	December 2008	Volume Share
Diesel	43	-15	50
LPG	69	-19	20
Gasolines	9	-39	16
Industrial Petroleum	60	-43	13
Kerosene	33	-2	1
Weighted Average	45	-23	100

Source: Peruvian authorities and IMF staff calculations. Note: Table reports increase in official price band required to eliminate subsidy. Negative numbers indicate official price band above international reference price. Volume shares based on annual sales.

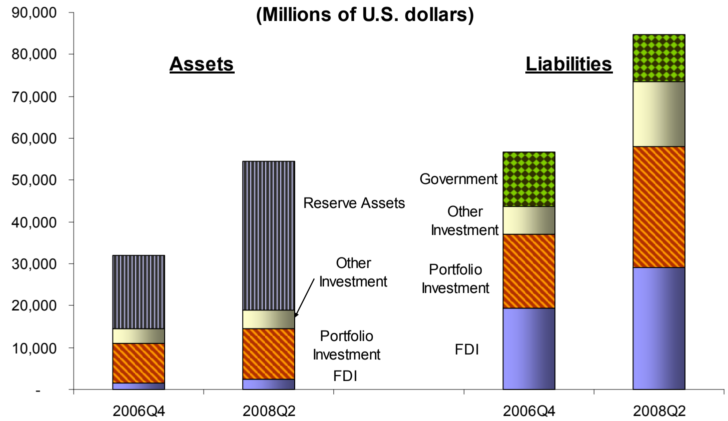
The fiscal cost of the fuel-price subsidies reached a peak in July 2008, when the cost for the year was projected at 1.4 percent of GDP. Of this cost, 1.2 percentage points of GDP corresponded to the pure fuel-price subsidy, and 0.2 percentage points to ad-valorem tax revenue foregone due to lower retail prices. In addition, the annual fiscal cost of fuel excise tax cuts during 2004–08 was estimated at 0.5 percent of GDP, bringing the total 2008 cost of fuel-price stabilization policies to 1.9 percent of GDP. The average fuel-price increase required to eliminate the subsidy peaked at 45 percent (Table 1).

The rising cost of fuel subsidies and their poor targeting led the authorities to implement several measures. A Poverty and Social Impact Analysis (PSIA) concluded that fuel-price subsidies in Peru were poorly targeted, with the richest 20 percent of households receiving over eight times the subsidies received by the poorest 20 percent. The intuition for this finding was that richer households tend to consume a large share of fuel and final goods that use fuel as an intermediate good. In response, the authorities increased the official FEPC price band under in January, March, June and August 2008 by a cumulative 28 percent. They also made adjustments to the import-parity price formula to ensure that it did not overstate true import costs, and began unwinding the specific excise tax cuts in November, when these taxes were more than doubled. However, the weighted average of fuel excises would need to increase by a further 26 percent to reach end-2004 levels. With these measures, and the 50-percent fall in fuel import prices from their peak, subsidies have been eliminated, and the FEPC price band is now about 23 percent *above* the reference international price. With the FEPC now collecting payments from domestic firms, the cost of the pure fuel-price subsidies is projected at 0.7 percent of GDP in 2008, of which 0.6 percentage points of GDP has already been paid by the government.

Box 2. Balance Sheet Vulnerabilities

Peru's overall external position has strengthened, but improvements differ across sectors. Between end-2006 and mid-2008, the economy's net international liabilities fell from 26¼ percent of GDP (US$24.8 billion) to 23¼ percent of GDP (US$30.3 billion). Improvements were not uniform across all sectors—with the combined public sector recording the largest net increase in its international net asset position (by 17¼ percent of GDP), while private investment positions—other than FDI—experienced and increase in net liabilities of 13 percent of GDP.

Peru: International Investment Position, 2006:Q4-2008:Q2
(Millions of U.S. dollars)



The public sector became a net creditor. The authorities' strategy involved public debt repayments, an increase in public debt maturity, and a decline in the share of FX denominated debt has fallen to about 60 percent. Potential vulnerabilities would be associated with the undercoverage of FX-denominated deposits protected under the Deposit Insurance Fund (DIF)—some US$9.2 billion—as DIF resources represent only 2 percent of total insured deposits.

Banks can better withstand currency-related shocks, but remain subject to dollarization risks. While credit dollarization remains high at 56 percent, the de-dollarization process has contributed to a reduction of the FX induced credit risk stemming from unhedged borrowers. However, with banks having reduced their net FX asset positions over the past year, a depreciation of the Nuevo Sol would have a slightly higher impact on the system's capitalization than it would have had a year ago. Nevertheless, banks' position is significantly stronger than at end-2005.

Table 1. Peru: Banking sector stress test to currency-related risks

	Market Exchange Rate Risk			Foreign-Exchange Induced Credit Risk		
	2005 FSAP Update 1/	June 2007	August 2008	2005 FSAP Update 1/	June 2007	August 2008
Initial Banking System CAR	13.5	12.1	12.4	13.5	12.1	12.4
New Banking System CAR	11.8	12.0	12.2	9.9	10.2	11.2
Change in CAR (in percent)	-12.6	-0.8	-1.5	-26.7	-15.7	-9.9
Memorandum Items						
Share of Loans in Foreign Currency (percent)	75.7	65.0	58.9			
Net Foreign Exchange Open Position / Capital	24.2	28.6	10.8			
Stress Scenario 2/	20 percent depreciation					

Source: Staff Estimates
1/ Data as of December 2004.
2/ Both the 2005 FSAP Update and the SBS methodology determined the 20 percent depreciation by the 99 percent confidence level of the normalized distribution of the monthly changes in the exchange rate in the period January 1997 to December 2004, and January 1991 to February 2006 respectively.

The corporate sector has improved its net foreign position in recent years, particularly at the short-end. Available data on 120 nonfinancial firms suggest that as of end-2006, the average firm held net total short-term FX-denominated assets for about US$3 million, compared to net short-term liabilities for US$6 million in 2003. Improvements were also reflected in the case of nonexporting firms.

The vulnerability of households' balance sheets to exchange-rate shocks seems contained. Stress tests on mortgage-market debtors based on end-2006 data (latest available) suggested that a depreciation 20 percent of the *Nuevo Sol* against the U.S. dollar would have raised the amortization burden on low-income household by 5–6 percentage points—to nearly 35 percent.

Box 3. The Micro and Small-Sized Business Law

Peru's strong economic performance has been accompanied by high levels of informality and limited access to social benefits among micro and small-sized enterprises (MSEs). Data from ENAHO 2006 shows that 60 percent of the Peruvian labor force works in enterprises with less than 50 workers, and many of these operate informally. High nonwage labor costs have been identified as one of the key factors driving the informal economy in Peru. Nonwage labor costs, which include mandated health and pension contributions, holiday bonuses, family assignments, and tenure bonuses amount to 72 percent of the basic wage in the general labor regime, compared to less than 30 percent in Chile and Mexico. Informality hinders competition, productivity and economic growth since informal enterprises do not benefit from trade liberalization or access to financing to invest in physical or human capital. Further, workers operating in the informal sector are excluded from the benefits and rights incorporated in the labor contracts and social systems.

Peru: Labor rights and access to benefits by workers across enterprises

Size of the enterprise	Lacking labor contract (in percent)	Affiliation to health insurance (in percent)	Affiliation to a pension system (in percent)
1–10 workers	57.9	9.8	13
10–50 workers	53.3	32.4	34
More than 50 workers	25 for medium- and 14 for big-sized enterprises	69.4	69

Source: MEF based on ENAHO 2006.

The law for the promotion and formalization of MSEs approved in 2003 has not yielded the expected results. In particular, this law established a special labor regime that lowers nonwage labor costs of enterprises with less than 10 workers to 14 percent. However, this regime has not been attractive to workers or employers since the health contribution is compulsory and fully financed by the employer, while the pension affiliation is voluntary.

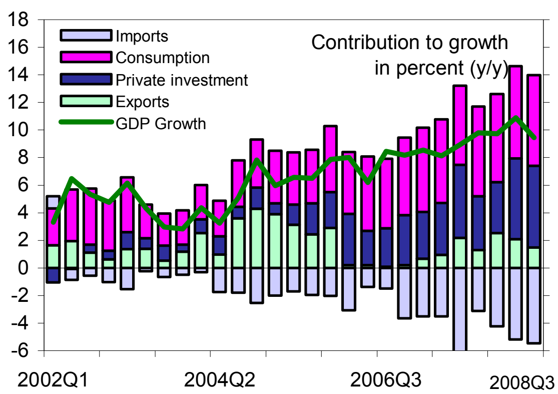
A legal reform to enhance the competitiveness, formalization and development of the small and medium-sized enterprises was approved in June. Although the reform entails a fiscal cost—S/. 1,987 millions per year (equivalent to 0.5 percentage points of GDP) according to the authorities' estimates, it is expected that through formalization it raises the economy potential growth and lowers poverty. Key features of the reform are as follows:

- *More labor incentives for micro-enterprises* (those with less than 10 workers). In particular, (i) affiliation to a health system will continue to be compulsory but cofinanced in equal amounts by the employer and the government; and (ii) it establishes a volunteer pension contribution to a portable individual pension account that will be managed by a private pension fund. Worker contributions into the individual accounts will be matched by government contributions up to a maximum, creating an incentive for voluntary savings. Affiliation to this pension scheme will also grant the right to a disability pension and a pension for survivors.

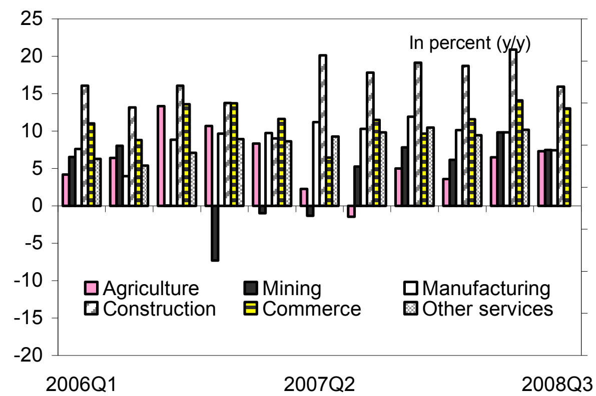
- *Reduced nonwage labor costs for small-enterprises* (those with less than 100 workers). Small-enterprises will benefit from reduced nonwage costs of about 41 percent. Social security and pension affiliation are kept as compulsory, and other benefits such as life insurance, holiday bonuses, tenure bonuses, and the right to union are also maintained.

Figure 1. Peru: Real Sector Developments

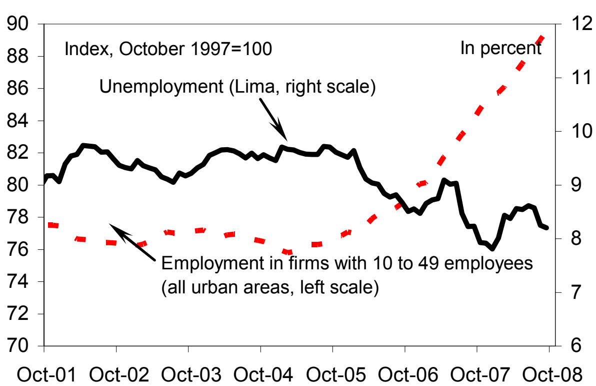
Investment and consumption remain strong...



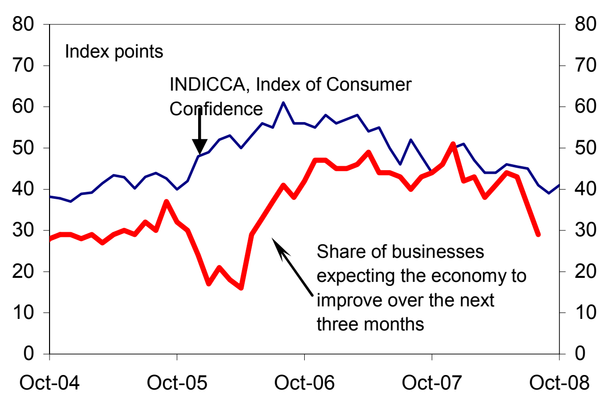
...and economic growth broad-based...



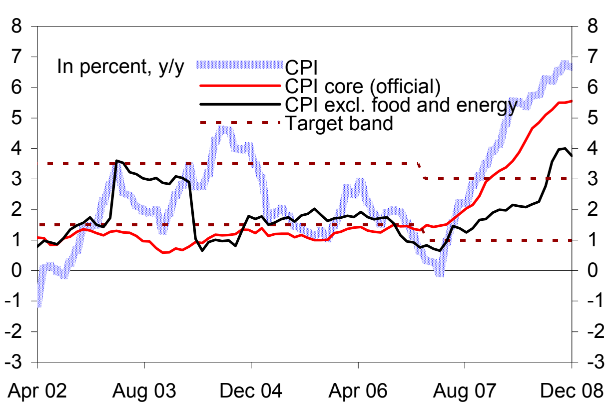
...with formal employment expanding...



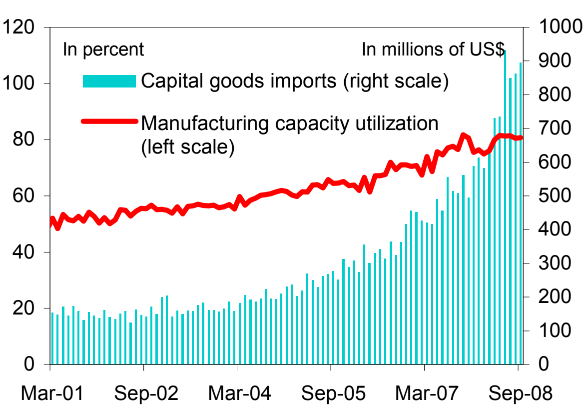
...but business and consumer confidence indicators softening.



Inflation has surpassed the upper limit of the target range mainly due to imported inflation...



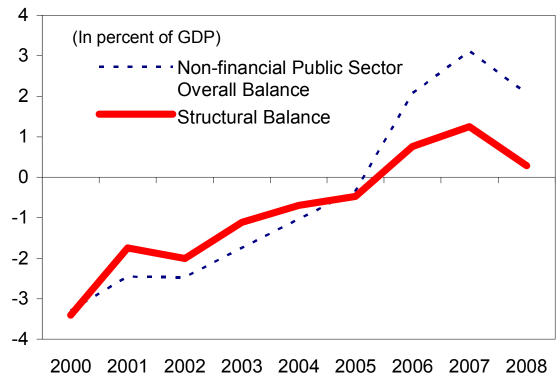
...as high capital investment contains a steady but gradual rise in capacity utilization.



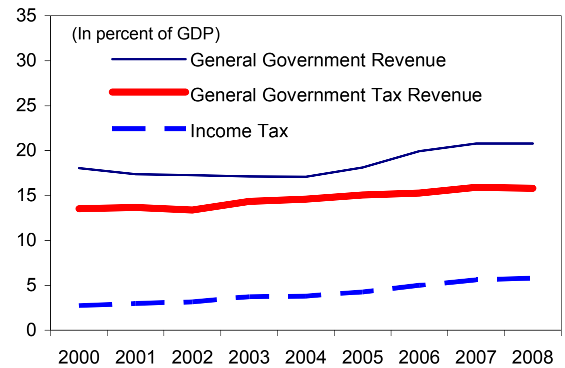
Sources: Banco Central de Reserva del Peru and IMF staff estimates.

Figure 2. Peru: Fiscal Sector Developments

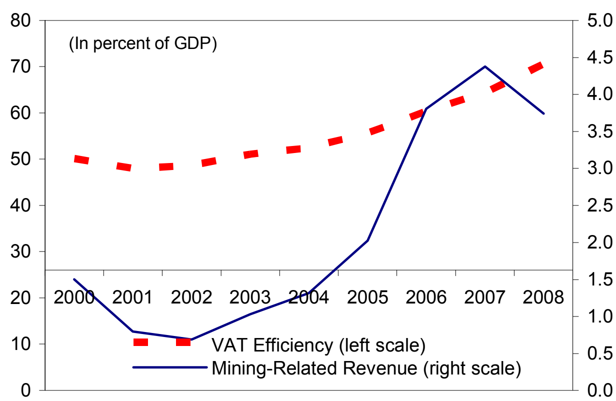
There has been a sharp improvement in the fiscal balance...



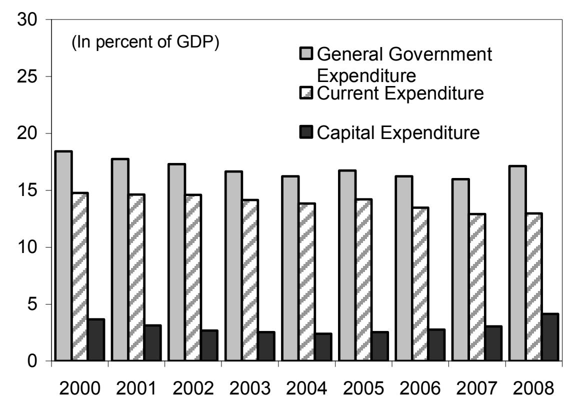
...supported by increased revenue collection.



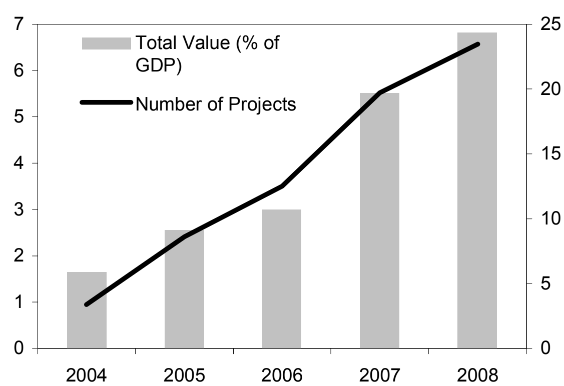
The improvement reflects better tax administration and higher commodity prices.



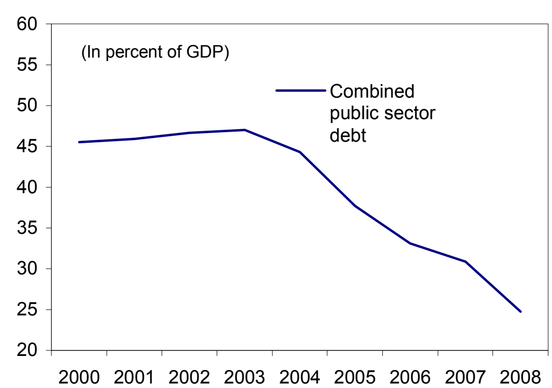
While the share of current expenditure to GDP has declined, the share of capital spending has increased in recent years...



... partly reflecting the increase in public investment projects authorized.



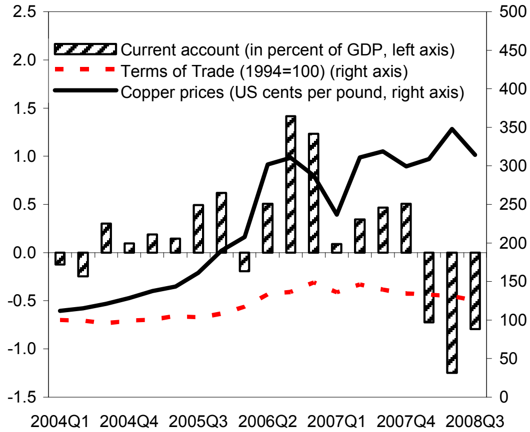
The strong fiscal performance has allowed public debt to decline markedly.



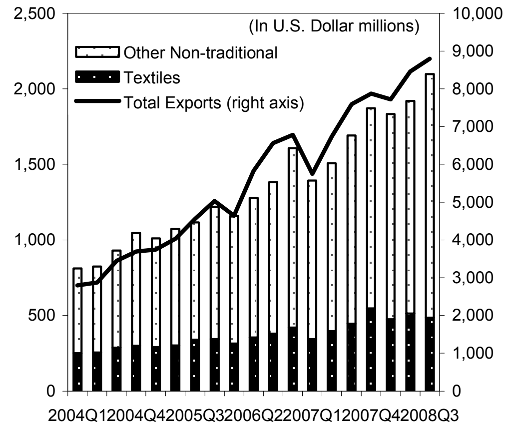
Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance and IMF staff Estimates

Figure 3. Peru: External Sector Developments

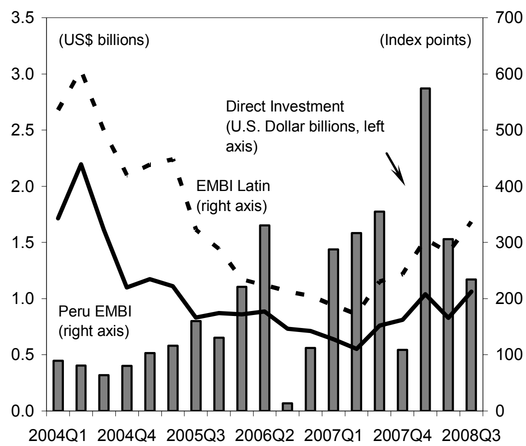
The strong current account position has deteriorated in 2008 due to worsening terms of trade.



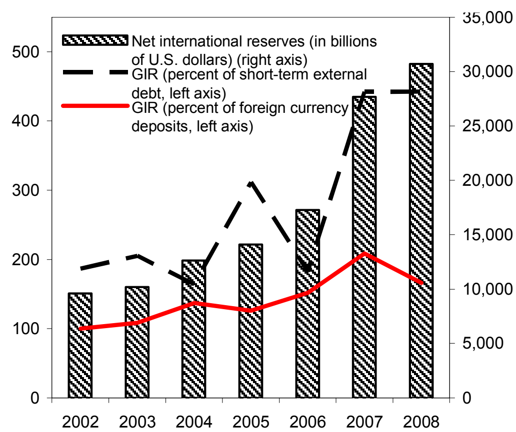
Nevertheless, non-traditional exports have kept rising...



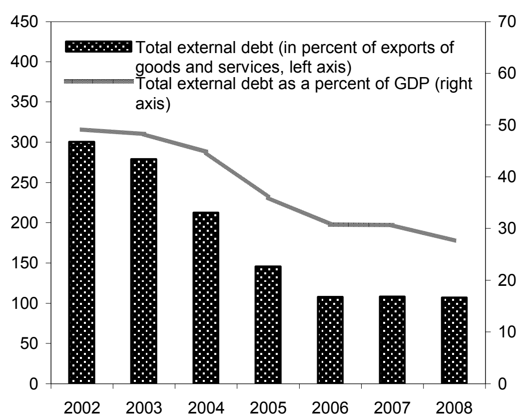
...and foreign direct investment has remained relatively strong, despite the global market turmoil.



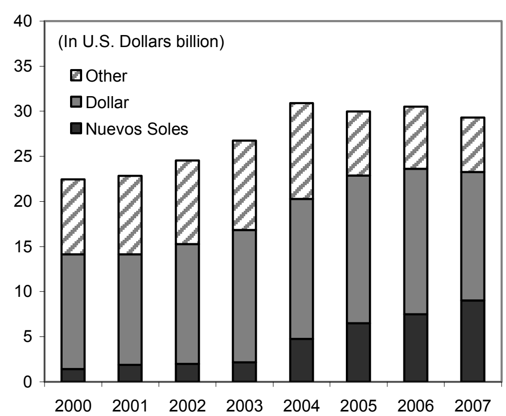
This has allowed some build-up of reserves, although not sufficient to avoid a decline in the ratio to FX deposits.



External debt has declined...



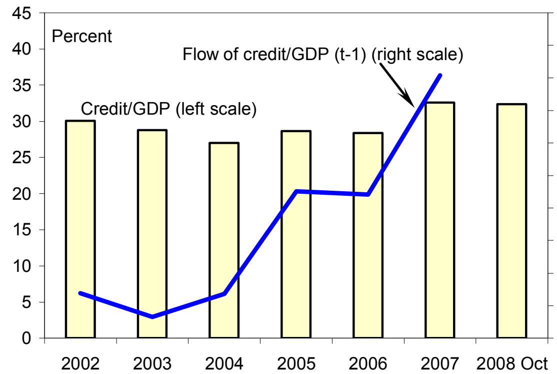
...and the domestic currency share in public debt has been rising.



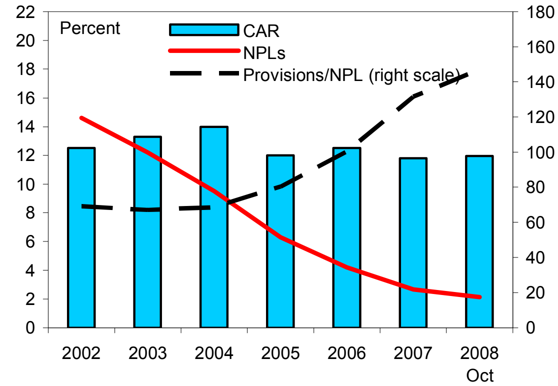
Sources: Banco Central de Reserva del Peru, Ministry of Finance, JP Morgan and IMF staff estimates.

Figure 4. Peru: Banking and Financial System 1/

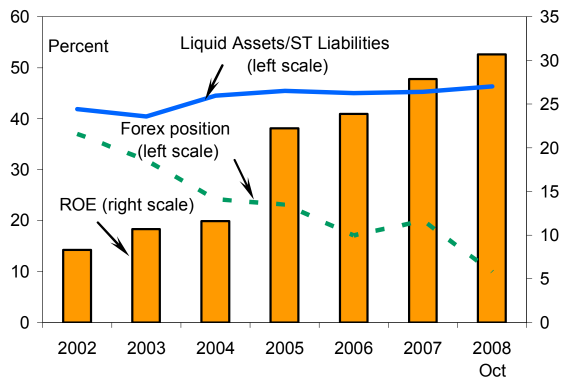
Credit continues to grow steadily...



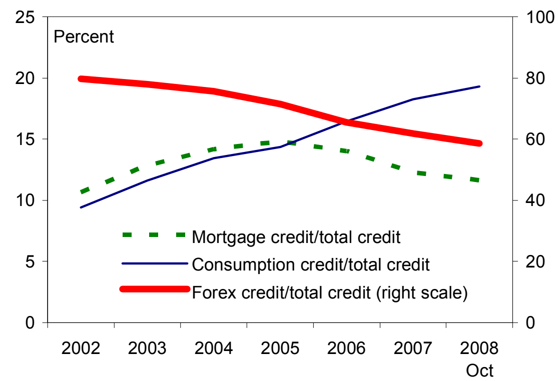
The banking system is enjoying strong capitalization ratios, declining non-performing loans, and adequate privisioning...



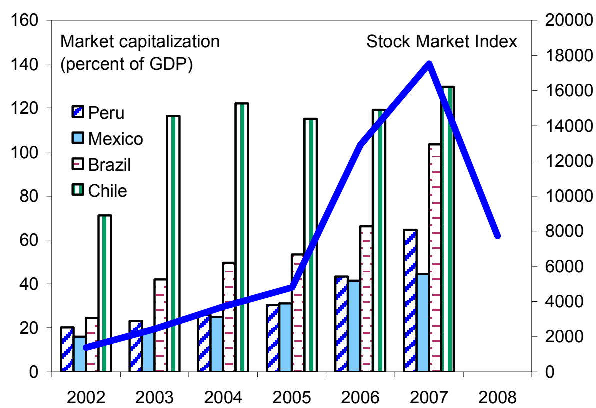
...increasing profitability, and comfortable levels of liquidity and foreign exchange positions.



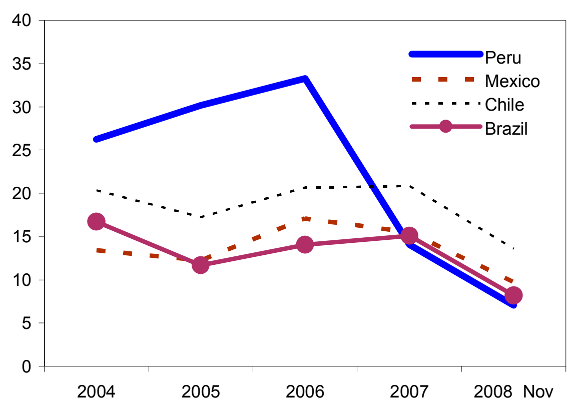
However, dollarization remains high and consumer credit is growing at a fast pace.



Equity prices and market capitalization have increased in recent years...



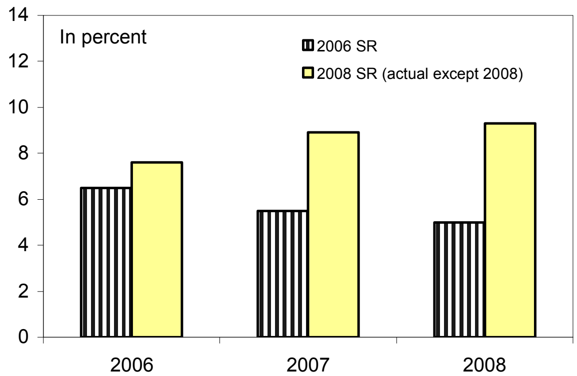
...but with the global financial crisis, equity prices and price-earning ratios have declined.



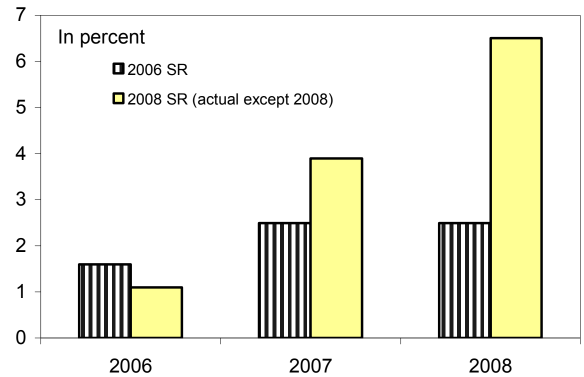
Sources: Bloomberg, SBS, World Federation of Exchange Rates and Fund staff estimates.
1/ Banking sector data corresponds to October 2008.

Figure 5. Peru: SBA Objectives and Outcomes, 2006–2008 [1/]

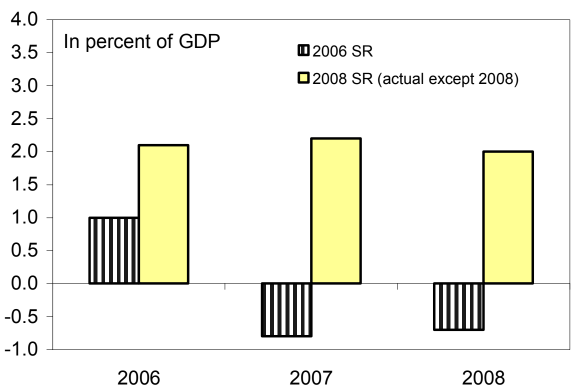
Growth has far exceeded program expectations



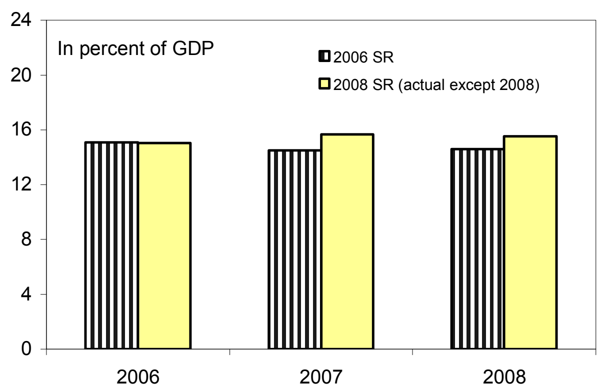
Inflation has been higher, largely due to external developments



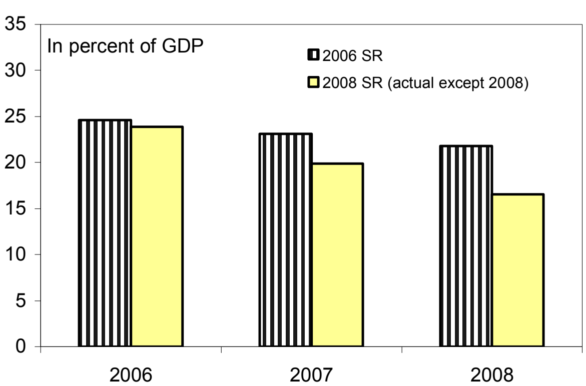
Fiscal policy has significantly outperformed program targets



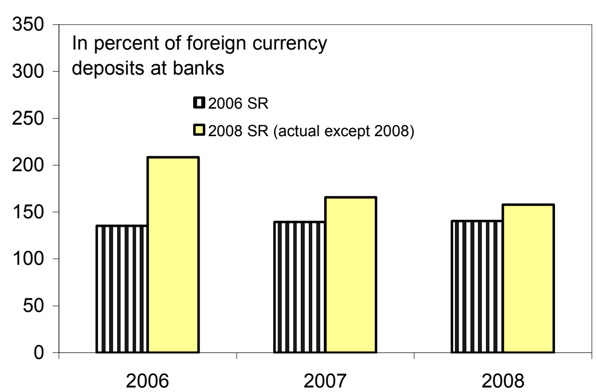
Progress has been made in broadening the tax base



The strong fiscal performance has resulted in a significant decline in public debt



The buildup in foreign official reserves has been much larger than programmed.



1/ Program performance in line with the fourth review under the SBA.

Table 1. Peru: Selected Economic Indicators

	2004	2005	2006	2007	Prog. CR/08/258 2008	Proj. 2008	Proj. CR/08/258 2009	Proj 2009
Social Indicators								
Life expectancy at birth (years)	...	70.7	...	...	...	...	...	...
Infant mortality (per thousand live births)	...	22.8	...	...	...	...	...	...
Adult literacy rate	87.8	87.9	...	...	...	...	...	...
Poverty rate (Total) 1/	48.6	48.7	44.5	39.3	...	...	...	...
Unemployment rate	9.4	9.6	8.5	8.4	...	...	...	...
(Annual percentage change; unless otherwise indicated)								
Production and prices								
Real GDP	5.1	6.7	7.7	8.9	8.2	9.4	6.5	6.0
Real domestic demand	4.0	5.7	10.3	11.8	11.0	12.8	7.1	6.8
Of which: Private sector	4.4	5.9	9.0	11.4	11.2	12.4	6.4	7.7
Consumer Prices (end of period)	3.5	1.2	1.1	3.9	4.3	6.7	2.8	2.8
Consumer Prices (period average)	3.7	1.6	2.0	1.8	4.8	5.8	3.0	4.7
External sector								
Exports	40.9	35.6	37.0	17.4	18.5	12.8	3.5	-17.7
Imports	19.5	23.2	23.0	31.8	35.0	44.7	11.7	-4.1
Terms of trade (deterioration -)	9.2	5.9	28.3	3.6	-1.8	-9.5	-5.8	-10.6
Real effective exchange rate (depreciation -) 2/	-1.6	-0.5	-1.3	-0.6	...	...	...	...
Money and credit 3/ 4/								
Liabilities to the private sector	8.3	18.4	8.8	22.7	14.9	26.6	12.4	10.3
Net credit to the private sector	-0.3	16.3	6.2	30.8	13.4	31.1	10.3	11.6
(In percent of GDP; unless otherwise indicated)								
Public sector								
General government current revenue	17.0	18.0	19.8	20.7	20.3	20.7	19.2	19.6
General government noninterest expenditure	16.2	16.7	16.2	16.0	16.0	17.1	16.2	17.3
Combined public sector primary balance	1.0	1.6	4.1	5.1	4.5	3.5	2.9	2.0
Interest due	2.0	1.9	1.9	1.8	1.5	1.5	1.3	1.5
Combined public sector overall balance	-1.1	-0.3	2.2	3.3	3.0	2.0	1.6	0.6
Combined public sector overall balance (including CRPAOs)	-1.1	-0.3	2.1	2.2	2.4	1.3	1.2	0.2
External Sector								
External current account balance	0.0	1.4	3.0	1.4	-0.6	-3.3	-0.7	-3.0
Gross reserves								
In millions of U.S. dollars	12,649	14,120	17,329	27,743	37,243	30,743	41,243	30,243
Percent of short-term external debt 5/	163.9	311.4	182.4	456.1	582.4	442.8	503.9	358.1
Percent of foreign currency deposits at banks	137.3	125.9	151.7	208.5	264.4	165.8	258.2	158.0
Debt								
Total external debt	44.8	36.1	30.5	31.5	25.1	29.2	22.4	28.9
Combined public sector debt (including CRPAOs)	44.3	37.7	33.1	30.9	22.0	24.8	19.0	21.7
Domestic	9.2	9.7	9.2	11.0	7.3	8.2	6.5	7.4
External 6/	35.1	28.0	23.9	19.9	14.7	16.5	12.6	14.4
Savings and investment								
Gross domestic investment	18.1	17.9	20.2	22.9	25.8	28.0	27.7	30.1
Public sector 7/	2.8	2.9	2.8	3.1	4.1	4.4	4.9	4.8
Private sector	15.3	15.1	17.4	19.8	21.7	23.6	22.8	25.3
National savings	18.1	19.4	23.2	24.3	25.2	24.8	27.0	27.0
Public sector 8/	1.7	2.6	5.1	6.4	7.2	6.3	6.4	5.4
Private sector	16.4	16.8	18.1	17.9	18.0	18.5	20.5	21.6
External savings	0.0	-1.4	-3.0	-1.4	0.6	3.3	0.7	3.0
Memorandum items								
Nominal GDP (S/. billions)	238.0	261.9	302.8	335.7	382.9	379.0	414.3	413.5
GDP per capita (in US$)	2,602	2,920	3,346	3,826	4,868	4,550	5,505	4,723

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.

2/ Based on Information Notice System.

3/ Corresponds to the banking system.

4/ Foreign currency stocks are valued at end-of-period exchange rates.

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

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

7/ Includes CRPAOs.

8/ Excludes privatization receipts.

Table 2. Peru: Quantitative Performance Criteria and Inflation Consultation Mechanism for 2007-2008

	2007				2008		
	Mar. 31	Jun. 30	Sept. 30	Dec. 31	Mar. 31	June. 30	Sept. 30
(Cumulative amounts from December 31, millions of Nuevos Soles)							
Borrowing requirement of the combined public sector							
Unadjusted limits 1/ 2/ 3/ 4/	-1,396	-4,190	-2,761	2,418	-2,036	-5,555	-6,302
Adjusted limits	-1,646	-4,690	-3511	1,418	-2,486	-6,455	-6,302
Actual	-4,194	-11,749	-14,181	-13,176	-3,001	-8,320	-10,983
Margin	2,548	7,059	10,670	14,594	515	1,865	4,681
(Cumulative amounts from December 31, 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	-645	-404	-437
Adjusted targets	-635	-478	-8	-1,691	-1,446	-1,185	-1,310
Actual	948	4,126	4,761	8742	6,042	6,642	4,779
Margin	1,583	4,604	4,769	10,433	7,488	7,827	6,089
Outstanding short-term external debt of the nonfinancial public sector							
Limits	50	50	50	50	50	50	50
Actual	0	0	0	0	0	0	0
Margin	50	50	50	50	50	50	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	1,568	1,673	2,354
Adjusted limits	3,146	3,632	5,506	6,935	1,568	1,673	2,354
Actual	2,741	3,028	4,627	5,630	254	745	857
Margin	405	604	879	1,305	1,314	928	1,497
Of which: **external debt of 1-5 year maturity**							
Limits	100	100	100	100	100	100	100
Actual	0	0	1	1	0	0	0
Margin	100	100	99	99	100	100	100
External payments arrears of the public sector (on a continuous basis)							
Limits	0	0	0	0	0	0	0
Actual	0	0	0	0	0	0	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	1,860	1,860	1,860
Actual	58	58	58	680	0	0	0
Margin	1,442	1,442	1,442	820	1,860	1,860	1,860
(Consultation bands for the 12-month rate of inflation, in percent) 11/							
Outer band (upper limit)	5.5	5.5	5.5	5.5	5.0	5.0	5.0
Inner band (upper limit)	4.5	4.5	4.5	4.5	4.0	4.0	4
Central point	2.5	2.5	2.5	2.5	2.0	2.0	2.0
Inner band (lower limit)	0.5	0.5	0.5	0.5	0.0	0.0	0
Outer band (lower limit)	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Actual	0.3	1.6	2.8	3.9	5.6	5.7	6.2

Sources: Staff estimations.

1/ PIPP proceeds are included below the line.
2/ In 2007, 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. In 2008, 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/. 12,767 million at end-March, up to a ceiling of S/. 450 million; S/. 26,493 million at end-June, up to a ceiling of S/. 900 million. No adjustors will be applied to the end-September 2008 nor to the end-December 2008 data when assessing the performance of the PSBR.
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 Petroper 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 June–December 2008

Measure	Implementation	Status
Clarify the tax treatment of securitization transactions in line with para. 11, bullet 4 of the LOI of December 5, 2007.	June 30, 2008	Not observed. As reported to the Executive Board at the time of the Third Review, the reform was put on hold, as it would entail amendments to the VAT law and a suspension of income tax withholding difficult to justify with Congress, as the authorities have been resisting introducing other tax exemptions in the recent period.
Issue methodological guidelines for ministries and public entities to assess tax exemptions in line with the new regime for tax exemptions.	June 30, 2008	Not observed. Draft methodological guidelines have not yet been issued by the authorities, although they have been approved by the Council of Ministers.
Submit to Congress amendment to the General Banking Law to allow the SBS the introduction of capital requirements for exchange-related risk in line with Basel II.	June 30, 2008	Observed.
Submit to Congress amendment to the General Banking Law to raise the minimum capital requirement for microfinance institutions.	June 30, 2008	Observed with some delay. The draft law was submitted to Congress in August.
Submit to Congress amendment to the Law of Pension Funds that would significantly raise the limit for foreign investment by private pension funds.	June 30, 2008	Observed.
2009 Budget to be prepared according to modernized budget classification system and incorporated into the chart of accounts.	September 30, 2008	Observed.
Implement the TSA, as described in para. 7 of the Letter of Intent of December 5, 2007.	September 30, 2008	Not observed. Earmarked funds (e.g., transfers of mining taxes to SNG, etc.) included in TSA but inclusion of revenues generated by agencies are still pending. The authorities are working on modifying the SIAF to generate outputs in a format that replicates that of a Treasury-General-Ledger.
Submit to Congress amendments to the Decentralization Law to reconcile subnational government spending with that for the central government as presented in the FRTL.	September 30, 2008	Not observed. Authorities are undertaking comprehensive review of decentralization process.
Expand the number of Technical Assistance Regional Offices from 16 to 28.	December 31, 2008	The authorities have established 24 regional offices, one per each region in the country.

Table 4. Peru: Fiscal Operations of the Combined Public Sector
(In percent of GDP; unless otherwise indicated)

	2006	2007	2008 Proj. CR/08/258	2008 Proj	2009 Proj. CR/08/258	2009 Proj.
Central government primary balance	**3.2**	**3.4**	**3.4**	**3.5**	**2.6**	**2.4**
Revenue	17.5	18.3	17.6	18.2	17.0	17.2
Current	17.4	18.2	17.5	18.1	16.9	17.1
Of which : Tax revenue	15.0	15.7	15.3	15.5	14.8	14.8
Of which : Financial transaction tax	0.3	0.4	0.4	0.3	0.3	0.3
Capital	0.1	0.1	0.1	0.1	0.1	0.1
Noninterest expenditure	14.3	14.9	14.2	14.8	14.3	14.8
Current 1/	12.3	12.7	11.7	12.3	11.3	12.0
Wages and salaries	4.1	3.9	3.7	3.7	3.5	3.6
Goods and services	3.4	3.3	3.2	3.0	3.1	2.9
Transfers	4.8	5.5	4.9	5.6	4.6	5.4
Capital	2.0	2.2	2.6	2.5	3.0	2.8
General government primary balance	**3.7**	**4.8**	**4.4**	**3.7**	**3.0**	**2.4**
Revenue	19.9	20.8	20.4	20.8	19.2	19.7
Current	19.8	20.7	20.3	20.7	19.2	19.6
Capital	0.1	0.1	0.1	0.1	0.1	0.1
Noninterest expenditure	16.2	16.0	16.0	17.1	16.2	17.3
Current	13.5	12.9	12.2	13.0	11.8	12.9
Capital	2.8	3.1	3.8	4.2	4.5	4.5
Public enterprise primary balance	0.3	0.1	0.1	-0.1	0.0	-0.2
Nonfinancial public sector primary balance	3.9	4.9	4.5	3.6	3.0	2.2
Overall balance	2.1	3.1	...	2.1	...	0.7
Central bank operating balance	0.2	0.2	0.0	-0.1	0.0	-0.2
Combined public sector primary balance	4.1	5.1	4.5	3.5	2.9	2.0
Interest payments	1.9	1.8	1.5	1.5	1.3	1.5
External	1.4	1.3	0.9	0.9	0.8	0.9
Domestic	0.4	0.5	0.6	0.6	0.6	0.6
Combined public sector overall balance	**2.2**	**3.3**	**3.0**	**2.0**	**1.6**	**0.6**
Financing	-2.2	-3.3	-3.0	-2.0	-1.6	-0.6
External	-0.5	-0.9	-1.0	-0.3	0.5	0.7
Domestic	-1.9	-2.5	-2.0	-1.7	-2.1	-1.3
Privatization	0.1	0.1	0.0	0.0	0.0	0.0
Memorandum items						
Combined public sector overall balance (incl. CRPAOs	**2.1**	**2.2**	**2.4**	**1.3**	**1.2**	**0.2**
Public sector debt (incl. CRPAOs)	33.1	30.9	22.0	24.8	19.0	21.7
Nominal GDP (S/. millions)	302,834	335,730	382,867	378,997	414,278	413,550

Source: Peruvian authorities and staff estimates.

1/ Figures since 2007 reflect the acceleration of transfers associated with income tax payments from the extractive industries to sub-national governments.

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

	2006	2007	2008 Proj. CR/08/258	2008 Proj	2009 Proj. CR/08/258	2009 Proj.
Central government primary balance	**9,816**	**11,536**	**12,980**	**13,203**	**10,963**	**9,949**
Revenue	53,076	61,498	67,510	69,153	70,284	70,949
Current	52,715	61,113	67,131	68,741	69,900	70,520
Of which : Tax revenue	45,552	52,569	58,606	58,824	61,429	61,323
Of which : Financial transaction tax	843	1,486	1,667	1,147	1,406	1,191
Capital	361	385	379	412	384	429
Noninterest expenditure	43,260	49,962	54,530	55,950	59,320	61,000
Current	37,252	42,613	44,738	46,523	46,784	49,487
Wages and salaries	12,553	13,020	13,986	14,052	14,685	15,064
Goods and services	10,192	10,994	12,140	11,237	12,869	11,911
Transfers	14,506	18,599	18,612	21,234	19,230	22,513
Capital	6,008	7,349	9,791	9,427	12,536	11,513
General government primary balance	11,099	16,190	16,881	14,170	12,413	9,758
Revenue	60,303	69,842	77,992	78,808	79,715	81,372
Current	60,056	69,456	77,723	78,397	79,438	80,943
Capital	247	386	269	411	278	429
Noninterest expenditure	49,204	53,651	61,111	64,924	67,303	71,613
Current 1/	40,833	43,407	46,743	49,180	48,793	53,172
Capital	8,372	10,244	14,367	15,745	18,509	18,441
Public enterprise primary balance	858	285	299	-505	-186	-653
Nonfinancial public sector primary balance	11,957	16,475	17,181	13,665	12,227	9,106
Overall balance	6,264	10,445	...	7,829	...	3,040
Central bank operating balance	474	632	11	-249	-144	-694
Combined public sector primary balance	12,431	17,107	17,192	13,417	12,083	8,412
Interest payments	5,692	6,030	5,706	5,837	5,503	6,066
External	4,337	4,440	3,502	3,547	3,166	3,706
Domestic	1,355	1,590	2,204	2,290	2,336	2,359
Combined public sector overall balance	**6,738**	**11,077**	**11,486**	**7,580**	**6,580**	**2,346**
Financing	-6,738	-11,077	-11,486	-7,580	-6,580	-2,346
External	-1,371	-3,079	-3,776	-1,073	2,221	3,034
Domestic	-5,671	-8,448	-7,746	-6,544	-8,829	-5,409
Privatization	304	450	37	37	28	28
Memorandum items						
Combined public sector overall balance (incl. CRPAOs)	**6,330**	**7,483**	**9,097**	**6,551**	**5,139**	**669**
Public sector debt (incl.CRPAOs)	100,245	103,610	84,055	86,602	78,888	89,924
Nominal GDP (S/. millions)	302,834	335,730	382,867	377,899	414,278	413,550

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

1/ Figures since 2007 reflect the acceleration of transfers associated with income tax payments from the extractive industries

Table 6. Peru: Public Sector Social Expenditure

	2004	2005	2006	2007	Proj. 3/ 2008
	(In millions of Nuevos Soles)				
Total social expenditure and pensions	**23,528**	**25,708**	**27,711**	**31,905**	**33,041**
Universal coverage (Education and Health) 1/	10,263	10,892	12,285	14,685	14,123
Education	7,251	7,682	8,244	9,648	9,409
Health	3,011	3,210	4,041	5,037	4,714
Targeted programs (Extreme Poverty)	3,078	3,453	3,565	5,027	6,024
Non-Targeted Social Programs	10,187	11,363	11,861	12,193	12,894
	(In percent of general government expenditure)				
Total social expenditure and pensions	**60.9**	**58.6**	**56.3**	**59.5**	**50.9**
Universal coverage (Education and Health) 1/	26.6	24.8	25.0	27.4	21.8
Education	18.8	17.5	16.8	18.0	14.5
Health	7.8	7.3	8.2	9.4	7.3
Targeted programs (Extreme Poverty) 2/	8.0	7.9	7.2	9.4	9.3
Non-Targeted Social Programs	26.4	25.9	24.1	22.7	19.9
	(In percent of GDP)				
Total social expenditure and pensions	**9.9**	**9.8**	**9.2**	**9.5**	**8.7**
Universal coverage (Education and Health) 1/	4.3	4.2	4.1	4.4	3.7
Education	3.0	2.9	2.7	2.9	2.5
Health	1.3	1.2	1.3	1.5	1.2
Targeted programs (Extreme Poverty)	1.3	1.3	1.2	1.5	1.6
Non-Targeted Social Programs	4.3	4.3	3.9	3.6	3.4
Memorandum items					
Total social expenditure and pensions (annual percentage change, deflated by CPI)	5.7	7.5	5.7	13.1	-2.1
General government expenditure (S/. million)	38,641	43,845	49,204	53,651	64,924

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.
3/ As per the 2008 approved budget.

Table 7. Peru: Monetary Survey 1/

	2004	2005	2006	2007	2008 Prog. CR/08/258	2008 Proj.	2009 Proj. CR/08/258	2009 Proj
				I. Central Reserve Bank (In millions of New Soles)				
Net international reserves 2/	**41,430**	**48,353**	**55,279**	**83,017**	**96,691**	**94,828**	**107,091**	**89,647**
(In millions of U.S. dollars)	12,631	14,097	17,275	27,689	37,189	30,689	41,189	30,389
Net domestic assets	**-33,394**	**-38,237**	**-43,483**	**-68,032**	**-77,686**	**-77,208**	**-85,148**	**-69,894**
Net credit to nonfinancial public sector	-12,930	-13,770	-19,925	-28,933	-34,821	-35,376	-44,260	-38,143
Rest of banking system	-19,191	-21,585	-22,158	-39,175	-54,243	-35,841	-56,481	-33,199
Other	-1,273	-2,881	-1,400	75	11,378	-5,991	15,593	1,447
Currency	**8,036**	**10,116**	**11,796**	**14,985**	**19,005**	**17,620**	**21,943**	**19,753**
				II. Banking System (In millions of Nuevos Soles)				
Net foreign assets	**40,903**	**47,582**	**56,057**	**78,993**	**91,701**	**98,389**	**103,141**	**94,816**
Net domestic assets	**16,191**	**20,017**	**17,505**	**11,234**	**11,947**	**15,866**	**13,407**	**31,255**
Net credit to nonfinancial public sector	-12,970	-14,254	-20,601	-34,822	-41,422	-42,937	-50,456	-45,796
Net credit to private sector	43,683	50,799	53,948	70,574	80,019	92,546	88,287	103,320
Other	-14,522	-16,528	-15,842	-24,518	-26,650	-33,744	-24,424	-26,269
Net credit to COFIDE	-1,087	-850	-850	-850	-850	-850	-850	-850
Other	-13,435	-15,678	-14,992	-23,668	-25,800	-32,894	-23,574	-25,419
Liabilities to the private sector	**57,094**	**67,599**	**73,562**	**90,227**	**103,648**	**114,254**	**116,548**	**126,071**
				(12-month percentage change)				
Base money	25.3	25.7	18.3	28.2	29.0	21.8	14.7	12.0
Broad money	8.3	18.4	8.8	22.7	14.9	26.6	12.4	10.3
Domestic currency	28.1	19.5	18.0	34.5	30.2	23.5	14.5	13.5
Foreign currency	-3.9	17.5	1.2	11.2	-3.0	30.3	9.2	6.8
Net credit to private sector	-0.3	16.3	6.2	30.8	13.4	31.1	10.3	11.6
Domestic currency	11.9	34.8	29.0	43.1	31.2	44.1	14.5	22.0
Foreign currency	-4.0	9.8	-3.7	23.7	1.5	22.4	6.7	3.5
				III. Financial System (In millions of Nuevos Soles)				
Net foreign assets	**40,771**	**47,504**	**56,032**	**78,610**	**88,043**	**88,043**	**95,086**	**95,086**
Net domestic assets	**42,060**	**54,322**	**67,296**	**79,528**	**101,672**	**110,546**	**119,680**	**126,100**
Net credit to the public sector	-10,121	-8,908	-10,746	-17,777	-19,463	-19,848	-21,585	-20,509
Net credit to private sector	64,271	74,945	86,575	111,218	128,428	146,417	141,864	164,929
Other	-12,090	-11,715	-8,533	-13,913	-7,293	-16,024	-599	-18,320
Liabilities to the private sector	**82,831**	**101,825**	**123,329**	**158,138**	**189,715**	**198,589**	**214,766**	**221,187**
				(12-month percentage change)				
Liabilities to the private sector	12.5	22.9	21.1	28.2	20.0	25.6	13.2	11.4
Domestic currency	23.5	29.1	30.4	35.5	30.2	23.5	14.5	13.5
Foreign currency	0.1	14.4	6.7	14.4	-3.0	30.3	9.2	6.8
Net credit to private sector	4.7	16.6	15.5	28.5	15.5	31.6	10.5	12.6
Domestic currency	17.9	26.0	38.2	40.1	28.3	40.1	13.2	20.0
Foreign currency	-1.7	11.1	0.4	17.8	1.5	22.4	6.7	3.5
Memorandum item								
End-of-period exchange rate (S/. per US$	3.28	3.43	3.20	3.00	...	3.09	...	2.95

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

1/ Stocks in foreign currency are valued at the end-of-period exchange rate.

2/ 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.

Table 8. Peru: Financial Soundness Indicators 1/

(In percent; unless otherwise indicated)

	Dec-04	Dec-05	Dec-06	Dec-07	Oct-08
Capital Adequacy					
Equity capital to risk-weighted assets	14.0	12.0	12.5	11.7	11.8
Regulatory Tier I capital to risk-weighted assets 2/	13.1	11.2	10.6	8.8	8.4
Nonperforming loans net of provisions to capital	-17.3	-21.7	-18.0	-17.3	-14.7
Asset Quality					
Nonperforming loans to total gross loans 3/	3.7	2.1	1.6	1.3	1.2
In domestic currency	3.0	2.1	1.9	1.6	1.6
In foreign currency	3.9	2.2	1.5	1.1	0.9
Nonperforming loans to total gross loans 4/	9.5	6.3	4.1	2.7	2.1
In domestic currency	6.1	4.2	3.2	2.5	2.4
In foreign currency	10.6	7.1	4.6	2.8	1.9
Refinanced and restructured loans to total gross loans 5/	5.8	4.1	2.4	1.4	0.9
Provisions to nonperforming loans 3/	176.5	235.3	251.4	278.4	263.1
Provisions to nonperforming, restructured, and refinanced loans 4/	68.7	80.3	100.3	131.6	146.7
Sectoral distribution of loans to total loans					
Consumer loans	13.4	14.4	16.5	18.3	19.3
Mortgage loans	14.2	14.8	14.0	12.3	11.6
Commercial loans	68.1	65.8	64.2	63.9	63.1
Small business loans	4.3	5.0	5.3	5.5	5.9
Earnings and Profitability					
ROA	1.2	2.2	2.2	2.5	2.6
ROE	11.6	22.2	23.9	27.9	30.7
Gross financial spread to financial revenues	71.9	70.5	67.6	66.6	66.5
Financial revenues to total revenues	69.1	76.3	76.6	79.6	81.3
Annualized financial revenues to revenue-generating assets	9.0	10.3	10.6	11.6	11.7
Liquidity					
Total liquid assets to total short-term liabilities	44.5	45.5	44.2	45.3	46.3
In domestic currency	20.7	19.9	43.1	57.3	36.0
In foreign currency	44.3	49.2	45.0	37.0	53.9
Foreign Currency Position and Dollarization					
Global position in foreign currency to regulatory capital 6/	24.2	23.1	17.1	16.8	25.9
Share of foreign currency deposits in total deposits	67.1	67.2	62.7	59.3	57.2
Share of foreign currency loans in total credit	75.7	71.5	65.5	61.8	58.6
Foreign currency deposits at commercial banks (in millions of U.S. dollars)	9,596	10,913	11,855	14,857	18,353
Commercial banks' short-term foreign assets (in millions of U.S. dollars)	547	796	878	822	2,342
Commercial banks' short-term foreign liabilities (in millions of U.S. dollars)	733	1,085	754	2,238	2,105
Operational efficiency					
Financing to related parties to capital 7/	14.3	17.9	15.5	14.4	14.2
Nonfinancial expenditure to total revenues 8/	35.9	33.3	31.3	30.1	28.4
Nonfinancial expenditure to total revenue-generating assets 8/	4.7	4.6	3.4	4.5	4.3
Memorandum items					
Number of Banks	16	14	13	15	18
Private commercial	14	12	11	13	16
Of which: Foreign-owned	9	9	7	9	12
State-owned	2.0	2.0	2.0	2.0	2.0
Banks' credit card loans to total loans	6.4	6.9	8.1	9.2	9.6
Bank loans' 12 month increase (in real terms)	-1.9	19.0	14.0	27.7	30.7
Stock market index (U.S. dollars)	1132	1400	4032	5849	2284
Foreign currency debt rating (Moody's)	Ba3	Ba3	Ba3	Ba2	Ba1
EMBI+ PERU spread, basis points	236	186	131	175	475

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 bussineses 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 9. Peru: Balance of Payments
(In millions of U.S. dollars)

	2004	2005	2006	2007	2008 Prog. CR/08/258	2008 Proj.	2009 Proj. CR/08/258	2009 Proj.
Current account	**19**	**1,149**	**2,757**	**1,511**	**-821**	**-4,229**	**-1,181**	**-4,159**
Merchandise trade	3,004	5,286	8,934	8,353	6,670	3,163	4,744	-1,244
Exports	12,809	17,368	23,800	27,952	33,124	31,525	34,290	25,950
Traditional	9,199	12,950	18,374	21,490	24,966	23,618	24,656	18,200
Nontraditional and others	3,611	4,418	5,426	6,463	8,159	7,907	9,634	7,751
Imports	-9,805	-12,082	-14,866	-19,599	-26,454	-28,362	-29,546	-27,195
Services, income, and current transfers (net)	-2,985	-4,137	-6,177	-6,842	-7,491	-7,392	-5,924	-2,914
Services	-732	-834	-781	-928	-1,538	-1,727	-2,160	-1,234
Investment income	-3,686	-5,074	-7,581	-8,409	-8,534	-8,439	-6,441	-4,393
Current transfers	1,433	1,772	2,185	2,495	2,581	2,774	2,676	2,713
Financial and capital account	**2,155**	**141**	**847**	**8,909**	**10,282**	**7,431**	**5,154**	**3,632**
Public sector	988	-1,440	-599	-1,272	-1,512	-534	704	829
Disbursements 1/	2,535	2,656	747	4,588	2,173	2,261	1,786	2,272
Amortization 1/	-1,389	-3,718	-1,222	-5,691	-3,588	-2,699	-981	-1,342
Other medium- and long-term Public sector flows 2/	-158	-378	-125	-169	-97	-97	-101	-101
Capital transfers (net)	0	0	0	0	0	0	0	0
Privatization	31	31	79	0	0	0	39	0
Private sector	1,288	1,788	491	10,181	11,794	7,966	4,411	2,803
Foreign direct investment (FDI) excluding privatization	1,568	2,548	3,388	5,343	6,791	6,525	6,205	5,111
Other private capital	-432	-997	-2,020	4,838	5,003	1,441	-1,794	-2,308
Medium- and long-term loans	-285	-840	148	3,335	1,932	1,937	27	564
Portfolio investment	-377	79	-1,540	323	1,640	480	296	-1,323
Short-term flows 3/	231	-237	-628	1,180	1,431	-977	-2,117	-1,548
Net Errors and Omissions	151	238	-877	-852	0	-117	0	0
Balance	**2,326**	**1,528**	**2,726**	**9,567**	**9,461**	**3,085**	**3,973**	**-527**
Financing	**-2,326**	**-1,528**	**-2,726**	**-9,567**	**-9,461**	**-3,084**	**-3,973**	**527**
NIR flow (increase -)	-2,353	-1,628	-2,753	-9,654	-9,500	-3,128	-4,000	500
Change in NIR (increase -)	-2,437	-1,466	-3,178	-10,414	-9,500	-3,000	-4,000	500
Valuation change	-84	162	-425	-760	0	128	0	0
Exceptional financing	27	100	27	86	39	44	27	27
Debt relief 4/	27	100	27	86	39	44	27	27
Change in arrears	0	0	0	0	0	0	0	0
Rescheduling	0	0	0	0	0	0	0	0
Memorandum items								
Current account balance (in percent of GDP)	**0.0**	**1.4**	**3.0**	**1.4**	**-0.6**	**-3.3**	**-0.7**	**-3.0**
Capital and financial account balance (in perce	3.1	0.2	0.9	8.3	7.4	5.7	3.2	2.7
Export value (US$), percent change	40.9	35.6	37.0	17.4	18.5	12.8	3.5	-17.7
Volume growth	13.9	15.0	-0.1	3.1	11.5	6.6	7.8	2.0
Price growth	23.7	17.9	37.2	13.9	6.2	5.8	-4.0	-19.3
Import value (US$), percent change	19.5	23.2	23.0	31.8	35.0	44.7	11.7	-4.1
Volume growth	7.9	10.8	15.0	19.9	24.7	23.8	9.6	6.2
Price growth	10.7	11.3	7.0	9.9	8.2	16.9	1.9	-9.7
GDP (in billions of US$)	69.7	79.5	93.0	107.4	138.8	129.7	159.3	136.7

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 10. Peru: External Financing Requirements and Sources

(In millions of U.S. dollars)

	2004	2005	2006	2007	2008 Prog. CR/08/258	2008 Proj.	2009 Proj. CR/08/258	2009 Proj
Gross financing requirements	**7,247**	**8,434**	**4,965**	**17,475**	**19,569**	**15,495**	**12,744**	**12,020**
External current account deficit (excluding official transfers)	**-19**	**-1,149**	**-2,757**	**-1,511**	**821**	**4,229**	**1,181**	**4,159**
Debt amortization	4,914	7,956	4,969	9,332	9,248	8,138	7,563	8,362
Medium- and long-term debt	2,400	5,205	1,783	6,310	4,456	3,252	1,604	2,058
Public sector	1,389	3,718	1,222	5,691	3,588	2,699	981	1,342
Multilateral 1/	571	628	647	974	1,859	960	564	894
Bilateral	742	2,159	394	2,200	320	329	269	307
Bonds and notes	66	90	90	2,513	1,338	1,338	0	0
Other	10	842	92	4	71	71	148	141
Private sector	1,011	1,486	561	619	868	553	623	716
Short-term debt 2/	2,514	2,751	3,186	3,022	4,792	4,886	5,960	6,304
Rescheduling and repayment of arrears	0	0	0	0	0	0	0	0
Accumulation of NIR (flow)	2,353	1,628	2,753	9,654	9,500	3,128	4,000	-500
Change in gross reserves	2,443	1,471	3,177	9,547	9,500	1,900	4,000	-500
Payments of short-term liabilities incl. IMF	-6	-5	1	867	0	1,100	0	0
Other	-84	162	-425	-760	0	128	0	0
Available financing	**7,247**	**8,434**	**4,965**	**17,475**	**19,569**	**15,495**	**12,744**	**12,020**
Foreign direct investment (net)	1,599	2,579	3,467	5,343	6,791	6,525	6,244	5,111
Privatization	31	31	79	0	0	0	39	0
FDI	1,568	2,548	3,388	5,343	6,791	6,525	6,205	5,111
Portfolio (net)	-377	79	-1,540	323	1,640	480	296	-1,323
Short-term assets (flow)	163	-434	-1,276	-1,536	262	-2,512	-2,117	-1,048
Of which: Errors and omissions	151	238	-877	-852	0	-117	0	0
Debt financing from private creditors	4,753	5,513	3,790	12,280	9,625	9,663	7,164	8,288
Medium- and long-term financing	2,021	2,328	834	7,394	3,666	3,359	1,204	2,484
To public sector 3/	1,295	1,682	125	3,440	866	869	554	1,204
To private sector	726	647	709	3,955	2,800	2,491	650	1,280
Short-term financing	2,732	3,185	2,956	4,886	5,960	6,304	5,960	5,804
Official creditors 4/	1,240	974	623	1,148	1,308	1,393	1,231	1,067
Multilateral 1/	1,049	762	499	1,005	1,018	1,202	822	915
Of which: Balance of payments financing	863	581	315	854	691	887	462	713
Bilateral	191	212	123	143	290	191	409	152
To public sector	191	212	123	143	290	191	409	152
To private sector	0	0	0	0	0	0	0	0
Other medium- and long-term public sector flows 5/	-131	-278	-98	-83	-58	-54	-74	-74
IMF	0	0	0	0	0	0	0	0
Accumulation of arrears (exceptional)	0	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.

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

Table 11. Peru: Medium-Term Macroeconomic Framework

			Proj.					
	2006	2007	2008	2009	2010	2011	2012	2013
(Annual percentage change)								
GDP at constant prices	7.6	8.9	9.4	6.0	6.8	6.5	6.5	6.5
Consumer prices (end of period)	1.1	3.9	6.7	2.8	2.2	2.0	2.0	2.0
GDP deflator	8.1	1.8	3.2	2.9	2.3	2.0	2.0	2.0
Merchandise trade								
Exports, f.o.b.	37.0	17.4	12.8	-17.7	11.7	6.6	6.0	5.7
Imports, f.o.b.	23.0	31.8	44.7	-4.1	13.0	8.6	7.7	7.2
Terms of trade (deterioration -)	28.3	3.6	-9.5	-10.6	-1.4	-0.6	0.0	-0.2
(In percent of GDP; unless otherwise indicated)								
External current account balance	3.0	1.4	-3.3	-3.0	-2.9	-2.6	-2.0	-1.6
External current account, excluding interest obligations	5.0	3.4	-1.6	-1.7	-1.7	-1.3	-0.8	-0.5
Total external debt service	3.9	7.8	4.1	2.8	2.6	2.9	3.3	2.2
Medium- and long-term	3.7	7.6	3.9	2.7	2.4	2.6	3.1	2.0
Nonfinancial public sector	2.7	6.6	3.0	1.9	1.6	1.8	2.3	1.4
Private sector	0.9	1.0	0.9	0.8	0.8	0.9	0.7	0.6
Short-term 1/	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2
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	0.3	0.2	0.2	0.2	0.2	0.2
External debt service 2/	3.9	7.8	4.2	2.9	2.6	2.9	3.3	2.2
Interest	2.0	2.0	1.7	1.4	1.2	1.4	1.2	1.1
Amortization (medium-and long-term)	1.9	5.9	2.5	1.5	1.4	1.5	2.1	1.2
Combined public sector primary balance 3/	4.0	4.0	2.9	1.6	1.9	1.9	1.6	1.3
General government revenue	19.9	20.8	20.8	19.7	19.9	19.6	19.3	19.2
General govt. non-interest expenditure 3/	16.2	16.0	17.1	17.3	17.6	17.3	17.4	17.5
Combined public sector interest due	1.9	1.8	1.5	1.5	1.4	1.4	1.3	1.2
Combined public sector overall balance 3/	2.1	2.2	1.3	0.2	0.5	0.5	0.3	0.1
Public sector debt 3/	33.1	30.9	24.8	21.7	18.9	16.7	14.9	13.6
Gross domestic investment	20.2	22.9	28.0	30.1	29.5	28.4	26.9	26.5
Public sector 3/	2.8	3.1	4.4	4.8	4.8	4.9	5.0	5.0
Private sector	17.4	19.8	23.6	25.3	24.7	23.5	22.0	21.5
National savings	23.2	24.3	24.8	27.0	26.6	25.7	25.0	24.9
Public sector 4/	5.1	6.4	6.3	5.4	6.3	5.4	5.3	5.1
Private sector	18.1	17.9	18.5	21.6	20.3	20.3	19.7	19.8
External savings	-3.0	-1.4	3.3	3.0	2.9	2.6	2.0	1.6
Memorandum items								
Nominal GDP (billions of Nuevos Soles)	302.8	335.7	379.0	413.5	451.9	490.9	533.3	579.3
Gross international reserves (billions of U.S. dollars)	17,329	27,743	30,743	30,243	30,343	30,993	31,743	32,593
Gross international reserves to broad money	75.3	92.2	83.1	72.6	63.3	63.5	64.2	65.5
External debt service (percent of exports of GNFS)	13.8	26.9	15.4	12.9	11.8	13.8	16.7	11.9
Short-term external debt service (percent of exports of GNFS)	0.8	0.9	1.0	0.8	0.7	1.0	1.0	1.0
Public external debt service (percent of exports of GNFS)	9.6	22.6	10.9	8.4	7.4	8.5	11.8	7.5

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 12. Peru: Financial and External Vulnerability Indicators

(In percent; unless otherwise indicated)

	2004	2005	2006	2007	2008 Prog. CR/08/258	2008 Proj.	2009 Proj. CR/08/258	2009 Proj.
Financial indicators								
Public sector debt/GDP	44.3	37.7	33.1	30.9	22.0	24.8	19.0	21.7
Of which: in domestic currency (percent of GDP)	6.9	8.2	9.2	11.0	8.0	8.2	7.5	7.4
90-day prime lending rate, domestic currency (end of period)	3.8	4.4	5.2	5.6	...	...	...	...
90-day prime lending rate, foreign currency (end of period)	2.6	5.5	6.1	6.4	...	...	...	...
Velocity of money 1/	4.2	3.9	4.1	3.7	3.7	3.3	3.6	3.3
Net credit to the private sector/GDP 2/	27.0	28.6	28.6	33.1	33.5	39.9	34.2	40.5
External indicators								
Exports, U.S. dollars (percent change)	40.9	35.6	37.0	17.4	18.5	12.8	3.5	-17.7
Imports, U.S. dollars (percent change)	19.5	23.2	23.0	31.8	35.0	44.7	11.7	-4.1
Terms of trade (percent change) (deterioration -)	9.2	5.9	28.3	3.6	-1.8	-9.5	-5.8	-10.6
Real effective exchange rate, (end of period, percent change) 3/	-1.6	-0.5	-1.3	-0.6	...	...	...	...
Current account balance (percent of GDP)	0.0	1.4	3.0	1.4	-0.6	-3.3	-0.7	-3.0
Capital and financial account balance (percent of GDP)	3.1	0.2	0.9	8.3	7.4	5.7	3.2	2.7
Total external debt (percent of GDP)	44.8	36.1	30.5	31.5	25.1	29.2	22.4	28.9
Medium- and long-term public debt (in percent of GDP) 4/	35.1	28.0	23.8	19.9	14.8	16.1	13.3	16.5
Medium- and long-term private debt (in percent of GDP)	5.7	4.0	3.6	6.2	6.1	6.6	5.3	6.7
Short-term public and private debt (in percent of GDP)	4.0	4.0	3.2	5.4	4.3	6.4	3.8	5.7
Total external debt (in percent of exports of goods and services) 4/	212.2	145.8	107.4	108.1	94.5	106.9	93.2	130.5
Total debt service (in percent of exports of goods and services) 5/	26.1	35.0	13.8	26.9	17.5	15.4	9.4	12.9
Gross official reserves								
In millions of U.S. dollars	12,649	14,120	17,329	27,743	37,243	30,743	41,243	30,243
In percent of short-term external debt 6/	163.9	311.4	182.4	456.1	582.4	442.8	503.9	358.1
In percent of short-term external debt, foreign currency deposits, and adjusted CA balance 6/ 7/	74.7	89.6	82.8	143.1	181.8	120.6	170.7	110.9
In percent of broad money 8/	72.7	71.6	75.3	92.2	99.1	83.1	98.7	70.8
In percent of foreign currency deposits at banks	137.3	125.9	151.7	208.5	264.4	165.8	258.2	158.0
In months of next year's imports of goods and services	10.0	9.3	8.7	9.8	12.5	11.3	12.9	9.8
Net international reserves (in millions of U.S. dollars)	12,631	14,097	17,275	27,689	37,189	30,689	41,189	30,189
Net international reserves (program definition; in millions of U.S. dollars) 9/	9,304	9,748	13,963	23,292	31,283	25,816	...	...
Net foreign exchange position (in millions of U.S. dollars) 10/	6,936	8,564	11,317	20,970	30,470	24,098	34,470	23,598

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 13. Peru: Proposed Schedule of Purchases Under the Stand-By Arrangement, 2008–09 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	December 19, 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	July 7, 2008	Completion of the Third Review and observance of end-June 2008 performance criteria.
7. SDR 1.596 million	August 15, 2008	Observance of end-June 2008 performance criteria.
8. SDR 1.596 million	January 28, 2009	Completion of the Fourth Review and observance of 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 172.368 million (27 percent of quota).

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

Table 14. Peru: Capacity to Repay the Fund as of November 30, 2008 1/
(In millions of SDRs; unless otherwise indicated)

	Oct-Dec 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
Charges and interest								
GRA charges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR charges	0.0	0.9	0.9	0.9	0.9	0.9	0.9	5.4
Credit outstanding	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	...
Obligations from prospective drawings								
Principal (repurchases)	0.0	0.0	0.0	0.0	64.6	86.2	21.6	172.4
Charges and interest 2/								
GRA charges	0.0	2.8	3.7	3.7	3.3	1.6	0.1	15.1
Service charge	0.0	0.9	0.0	0.0	0.0	0.0	0.0	0.9
Credit outstanding	0.0	172.4	172.4	172.4	107.7	21.5	0.0	...
(percent of quota)	0.0	27.0	27.0	27.0	16.9	3.4	0.0	...
Cumulative (existing and prospective)								
Principal (repurchases)	0.0	0.0	0.0	0.0	64.6	86.2	21.6	172.4
Charges and interest 2/								
GRA charges	0.0	2.8	3.7	3.7	3.3	1.6	0.1	15.1
SDR and Service charges	0.0	1.8	0.9	0.9	0.9	0.9	0.9	6.3
Credit outstanding	0.0	172.4	172.4	172.4	107.7	21.5	0.0	...
Percent of quota	0.0	27.0	27.0	27.0	16.9	3.4	0.0	...
Percent of GDP	0.0	0.2	0.2	0.2	0.1	0.0	0.0	...
Percent of exports of goods and services	0.0	0.8	0.7	0.9	0.5	0.1	0.0	...
Percent of public sector debt service	0.0	5.3	7.8	7.7	4.7	0.8	0.0	...
Percent of external public debt	0.0	1.2	1.2	1.1	0.7	0.1	0.0	...
Percent of external public debt service	0.0	7.0	11.5	10.3	6.2	1.1	0.0	...
Percent of gross foreign reserves	0.0	0.9	0.6	0.9	0.5	0.1	0.0	...
Memorandum item								
Purchases	0.0	172.4	0.0	0.0	0.0	0.0	0.0	172.4

Sources: Fund staff estimates/projections.

1/ Assuming all purchases are made when available. 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.

ATTACHMENT I. INFLATION CONSULTATION LETTER

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund

January 7, 2009

Dear Mr. Strauss-Kahn,

During 2008 inflation was considerably influenced by international food and fuel supply shocks. In consequence, annual inflation reached 6.65 percent, above the upper limit of the target range (1–3 percent). It should be noted that the joint price increase for food, fuels, and electricity was 8.6 percent.

To prevent inflation expectations from affecting nonfood items, particularly in a context of robust domestic demand, the Central Bank reinforced its anti-inflationary stance to ensure a gradual return of inflation and inflation expectations to the target range. Accordingly, the Central Bank increased the reference interest rate by 200 basis points, from 4.5 percent in June 2007 to 6.5 percent in September 2008. This decision was complemented by increases in reserve requirements on obligations in both domestic and foreign currency.

The global financial crisis worsened in the second half of September, creating high volatility in international markets. Metal, fuel, and food prices dropped significantly; stock markets plunged in a context of deteriorating market expectations; and emerging market currencies experienced depreciation pressures. The resulting downward pressure on imported inflation is expected to translate into lower domestic prices over the next months.

As the main developed economies fall deeper into recession, the Peruvian economy is expected to decelerate. Growth is envisaged to decline from 9.3 percent in 2008 to 6.0 percent in 2009. At the same time, inflation expectations have started to ease, with a clear downward trend expected over the next two years.

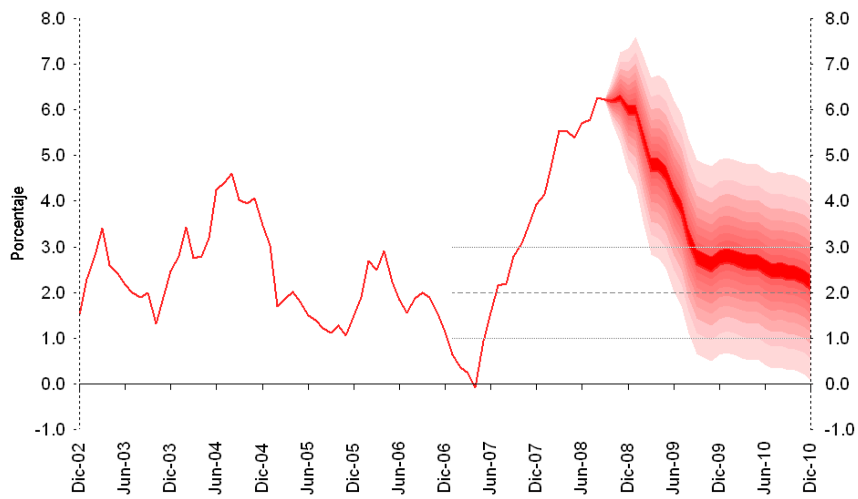
Under these circumstances, the Central Bank has kept its policy interest rate at 6.5 percent. Additionally, in response to the financial system's greater preference for liquidity in a context of considerable market uncertainty, the Central Bank has provided adequate liquidity through open market operations and reductions in reserve requirements. Official interventions in the foreign exchange market have continued to be confined to smoothing excessive exchange rate fluctuations in a context of financial dollarization.

The last Inflation Report envisages that inflation will return to the target range in 2009. Inflation is expected to drop from 6,65 percent in 2008 (one of the lowest of the region) to 2,8 percent (within the target range) in 2009, driven by lower imported inflation, GDP growth below potential (around 7 percent), and declining inflation expectations, in line with the Central Bank's commitment to the 1–3 percent target range.

Sincerely,

/s/

Julio Velarde
President, Central Reserve Bank of Peru



Note: The fan chart shows the probability of various outcomes for inflation over the forecast horizon. The darkest band around the central forecast represents a 10 percent probability of occurrence, and all bands together represent a 90 percent probability of occurrence.

ATTACHMENT II. IMPACT OF A SHARPER AND MORE PROLONGED GLOBAL SLOWDOWN

- ***Real sector.*** Real GDP growth declines to 4 percent and 5 percent in 2009 and 2010, respectively (compared to 6 and 6.8 percent in 2009 and 2010 in the baseline). Real domestic demand growth decelerates by about 2 percentage points during 2009–2010 compared to the baseline, driven by weaker consumption and investment. Real GDP growth is expected to rebound to 7 percent in 2011, stabilizing at its potential level of 6.5 percent of GDP in 2012–13, as in the baseline.

- ***Exchange rate and prices.*** The average nominal exchange rate is assumed to depreciate by an additional 6.2 and 8.4 percent in 2008 and 2009, respectively, relative to the baseline. Prices of major mineral commodities decline by 10 percent compared to the baseline, implying a reduction on traditional export prices of 25 percent. This contrast with a reduction of 19 percent in the baseline, which is in line with the WEO and authorities' projections. End-of-year inflation is projected at 2.2 percent in 2009, reflecting a limited pass-through of commodity prices and the exchange rate depreciation. By 2010, inflation declines to 2 percent, at the mid-point of the inflation targeting range.

- ***Fiscal policy.*** The decline in growth and the fall in mineral commodity prices lower government revenue by 0.8 percent of potential GDP relative to the baseline. Nominal government spending is assumed to remain unchanged, consistent with a neutral fiscal policy stance. The overall combined public sector fiscal balance-to-GDP ratio deteriorates by 0.8 percentage points from 0.6 percent of GDP in the baseline to -0.2 percent of GDP. The public debt-to-GDP ratio declines to 22.3 percent of GDP, versus 21.7 percent of GDP in the baseline.

- ***Current account.*** The current account deficit narrows from 3.3 percent in 2008 to 3.2 percent of GDP in 2009–10, led by a strong decline in exports as a result of the decline in the price of mineral commodities, and significantly lower global real GDP growth and domestic demand compared to the baseline scenario. Imports decline in line with lower real GDP growth and oil prices. Foreign demand remains low in 2010 with a slow recovery towards the end of the year. The current account recovers to 2.5 percent in 2011, due to a rebound in foreign demand and despite a rebound in imports, led by the implementation of delayed expansion projects in the traditional sector.

- ***Foreign direct investment.*** FDI is reduced on behalf of previously retained earnings now being repatriated to their home countries. Retained earnings are assumed to account for 60 percent of total FDI. In 2009, the crisis scenario assumes retained earnings to fall by 80 percent compared to the baseline. This drop would bring reinvested FDI in 2009 to about two times the 2001–03 average (which includes episodes of negative retained earnings). In the hard-lending scenario, the remainder is assumed to drop by 40 percent in 2009. FDI remain low in 2010 to recover to the baseline levels in 2011. The lower reinvested earnings and corresponding returns partly offset the decline in the trade balance during 2009–10.

- ***Banks' external medium- and long-term borrowing.*** It is assumed that US$200 million of the amortizations coming due in 2009 and 2010 are not rolled over.

- ***Portfolio investment***. In 2009, the crisis scenario includes around US$500 million in outflows compared to the baseline. This includes outflows in investment by private pension funds following the raise in their external investment limits. In 2010, portfolio outflows decline but remain $150 million higher than in the baseline.

- ***Other short-term capital flows***. In 2009, US$2.1 billion are withdrawn, including US$443 million of maturing CDs not rolled over; US$663 million of foreign deposits (5 percent of total FX deposits), and US$1 billion of other liabilities. Continued outflows for US$ 1 billion are assumed in 2010.

Table 1. Peru: Medium-Term Macroeconomic Framework under Alternative Scenario

			Proj.					
	2006	2007	2008	2009	2010	2011	2012	2013
(Annual percentage change)								
GDP at constant prices	7.6	8.9	9.4	4.0	5.0	7.0	6.5	6.5
Consumer prices (eop)	1.1	3.9	6.5	2.2	2.0	2.0	2.0	2.0
Consumer prices (average)	2.0	1.8	5.8	3.8	2.3	2.0	2.0	2.0
GDP deflator	8.1	1.8	3.2	2.5	2.5	1.5	1.9	2.0
Exchange rate (eop)	3.2	3.0	3.1	3.3	3.1	2.8	2.8	2.8
Exchange rate (average)	3.3	3.1	2.9	3.2	3.1	2.9	2.8	2.8
Merchandise trade								
Exports, f.o.b.	37.0	17.4	12.8	-25.5	9.5	14.0	8.2	5.8
Volume growth	-0.1	5.9	6.6	-1.0	4.7	7.2	4.7	4.2
Price growth	37.2	3.3	5.8	-24.7	4.6	6.4	3.3	1.5
Imports, f.o.b.	23.0	31.8	44.7	-9.6	10.1	14.3	8.8	8.1
Volume growth	15.0	15.7	23.8	3.9	4.7	7.1	6.5	6.3
Price growth	7.0	3.9	16.9	-13.0	5.1	6.7	2.1	1.7
Terms of trade (deterioration -)	28.3	3.6	-9.5	-13.5	-0.4	-0.3	0.0	-0.2
(In percent of GDP; unless otherwise indicated)								
External current account balance	3.0	1.4	-3.3	-3.2	-3.0	-2.5	-2.0	-1.7
External current account, excluding interest obligations	5.0	3.4	-1.6	-1.7	-1.7	-1.1	-0.7	-0.6
Combined public sector overall balance	2.2	3.3	2.0	-0.2	-0.1	0.0	0.0	0.0
Public sector debt 3/	33.1	30.9	24.8	22.3	19.7	17.4	15.5	14.2
Gross domestic investment	20.2	22.9	28.0	29.6	29.2	28.8	27.3	27.3
Public sector 3/	2.8	3.1	4.4	4.9	5.0	5.1	5.2	5.2
Private sector	17.4	19.8	23.6	24.7	24.2	23.7	22.1	22.0
National savings	23.2	24.3	24.8	26.4	26.2	26.2	25.3	25.5
Public sector 4/	5.1	6.4	6.3	4.7	5.8	5.1	5.2	5.2
Private sector	18.1	17.9	18.5	21.7	20.4	21.1	20.1	20.3
External savings	-3.0	-1.4	3.3	3.2	3.0	2.5	2.0	1.7
Memorandum items								
Nominal GDP (billions of Nuevos Soles)	302.8	335.7	379.0	404.1	434.6	472.0	512.0	556.2
Gross international reserves (billions of U.S. dollars)	17,329	27,743	30,743	27,693	25,743	26,393	27,143	27,993
External debt service (percent of exports of GNFS)	13.8	26.9	15.4	14.0	13.1	14.3	17.0	12.1
Short-term external debt service (percent of exports of GNFS)	0.8	0.9	1.0	0.9	0.8	1.1	1.0	1.0

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/ Excludes CRPAOs.
4/ Excludes privatization receipts.

ATTACHMENT III. SURVEILLANCE DECISION—EXTERNAL SUSTAINABILITY ISSUES

In real effective terms, the *Nuevo Sol* has been recovering from its low level in recent years. In October, the real effective exchange rate (REER) was 3 percent below its 1991–2008 average. During 2004–07 the *Nuevo Sol* had been at its lowest level since it was introduced in 1991 following Peru's recovery from the crisis of the late 1980s. This decline had been accompanied by a large accumulation of reserves. Nonetheless, since September, as a result of market pressures from the global financial crisis, reserves have declined by US$4 billion as the exchange rate depreciated by about 5 percent.

CGER-type analysis suggests that the exchange rate is undervalued (by about 2–7 percent). In particular, the ***macroeconomic balance approach*** shows an undervaluation of 7 percent in the real effective exchange rate, while the ***external sustainability approach*** suggests the *Nuevo Sol* is undervalued by about 6 percent. Finally, estimates under the ***equilibrium real exchange rate*** approach suggests an undervaluation of 2 percent.

CGER-type estimates are subject to considerable uncertainty. A sensitivity analysis shows the sensitivity of the misalignment measure to various assumptions in the macroeconomic balance approach. For instance, if the underlying medium-term current account deficit were underestimated by 1 percentage point of GDP in the baseline, Peru's undervaluation would fall by 6 percentage points to only 1 percent. By contrast, if the current account norm were overestimated by 1 percentage point, the undervaluation would increase by 6 percentage points to 13 percent. The measure of misalignment is less sensitive to variances in the medium-term real exchange rate path underlying baseline projections and the current account elasticity to the real exchange rate.

Sensitivity of RER Gap to Assumptions

	RER Gap	Change from baseline
Baseline	-7	0
MT current account balance		
-1 p.p.	-1	6
+1 p.p.	-13	-6
Current account norm		
-1 p.p.	-13	-6
+1 p.p.	-2	5
Elasticity (CA to RER)		
+0.1	-7	0
-0.1	-8	-1
Change in RER through 2013		
+3%	-10	-3
-3%	-4	3

Calculations based on an alternative methodology for countries with large stocks of nonrenewable resources confirm the CGER-type results. Using a stock approach (Thomas, Kim, Aslam, 2008) for Peru based on copper as the sole nonrenewable resources suggests an undervaluation of 7 percent. Uncertainties in this approach are linked to the estimate of the stock of copper reserves, assumptions on the return on investment and the discount rate, and the exclusion of other nonrenewable resources in the country.

Under the 2007 Surveillance Decision, the underlying current account balance is defined as the medium-term level of the current account stripped of temporary factors influencing the trade and income balances. The projected current account may differ from the underlying current account for several reasons, including:

- ***Domestic output gap***. Peru's output above potential currently entails a higher level of imports—and lower trade and current account balances—than a closed gap.

- ***Trading partner's output gap.*** With output below potential abroad, Peru's exports—and trade and current account balances—are lower than at a closed gap.

- ***Commodity prices.*** Being a commodity exporter, if prices were to fall back to a smoothed average, Peru's trade and current account balances would deteriorate.

- ***Hydrocarbon prices.*** Being a net importer of hydrocarbon products, if prices did not fall back to a smoothed average, Peru's current account would be higher.

Peru's underlying current account deficit is estimated at 2.8 percent of GDP compared to a projection of 3 percent of GDP in 2009. With mining products representing two-thirds of goods exports, lower longer-term commodity prices have the strongest effect on Peru's current account—some 0.9 percent of GDP. Nonetheless, this is more than offset by the closing of trading partner's negative output gap and Peru's positive output gap. Peru's misalignment vanishes if this adjusted current account is used as the underlying current account in the macroeconomic balance approach.

Peru: Estimating the Underlying Current Account Balance in 2009

Current account		Adjustment		Concept	Explanation
(billions of US$)	(in percent of GDP)	(billions of US$)	(in percent of GDP)		
Projection 2009					
-4.16	-3.04	0.68	0.50	Output gap in Peru	Output is above potential. Reducing it to potential would lower imports.
		0.60	0.44	Output gap trading partner	Foreign demand is growing below potential. Assuming the gap will be closed will benefit Peruvian exports.
		-0.88	-0.65	Mineral Prices	Mineral prices are estimated above their long term level. If they fall, exports will be lower.
		-0.09	-0.06	Hydrocarbon Prices	Oil are estimated slightly below their long term level. If they increase, net imports will be higher.
Underlying current account					
-3.85	-2.81				

ATTACHMENT IV. DEBT SUSTAINABILITY ANALYSIS[19]

Peru's debt-to-GDP ratio is projected to decline considerably under the baseline debt sustainability scenario. Economic growth would average close to 7 percent a year in 2008–13 underpinned by a moderate fiscal surplus position. The public sector revenue-to-GDP ratio is expected to decline by a cumulative 1.6 percentage points, reflecting the decline in growth and mining government revenues. Under these assumptions, Peru's public sector debt stock (including CRPAOs) would decline from 30.9 percent of GDP at end-2007, to 13.6 percent of GDP by 2013.

Given that nearly two thirds 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. Private external debt rose in 2007 as banks sought long term loans abroad to expand their domestic business, but is projected to decline over the medium term as more financing becomes available domestically. Given the recent declines in public external debt, total external debt is projected to decline from 32 percent of GDP at end-2007 to 20 percent by 2013 (public external debt would decline from 20 percent to 10 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.

Despite the increasing share of domestic currency in public sector debt, external and public debt ratios remain sensitive to changes in exchange rate changes, given the high foreign currency share of Peru's debt. Specifically, under a one-off 30 percent real depreciation of the exchange rate, the external debt-to-GDP ratio would shift by 6 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. Noninterest 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, by 2013 remain 9.3 percentage points above the debt levels projected under the baseline scenario.

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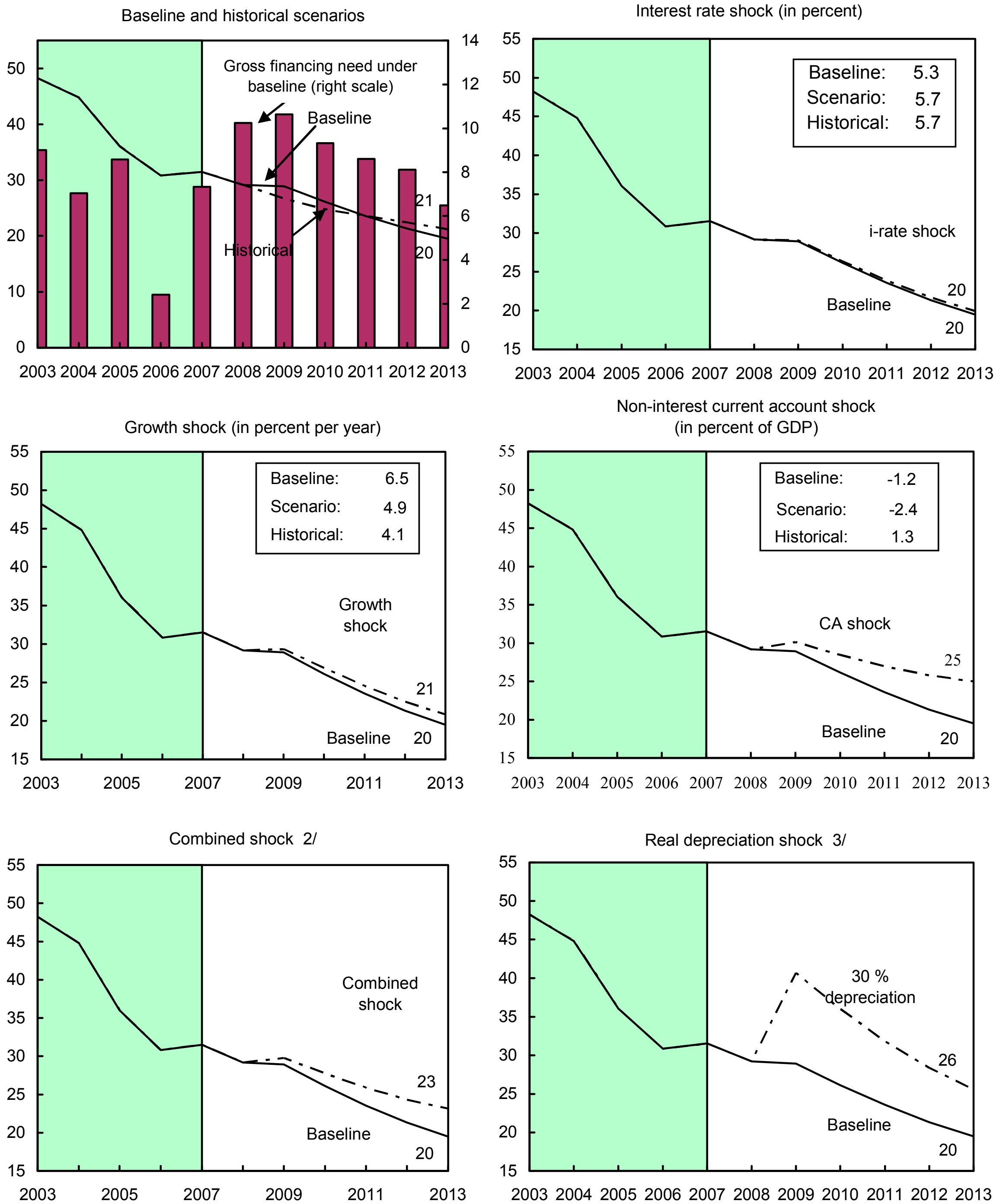
[19] The DSA includes standard sensitivity tests around the baseline medium-term scenario. The methodology used is in line with that endorsed in the Information Note on Modifications to the Fund's Debt Sustainability Assessment Framework for Market Access Countries, dated July 5, 2005.

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



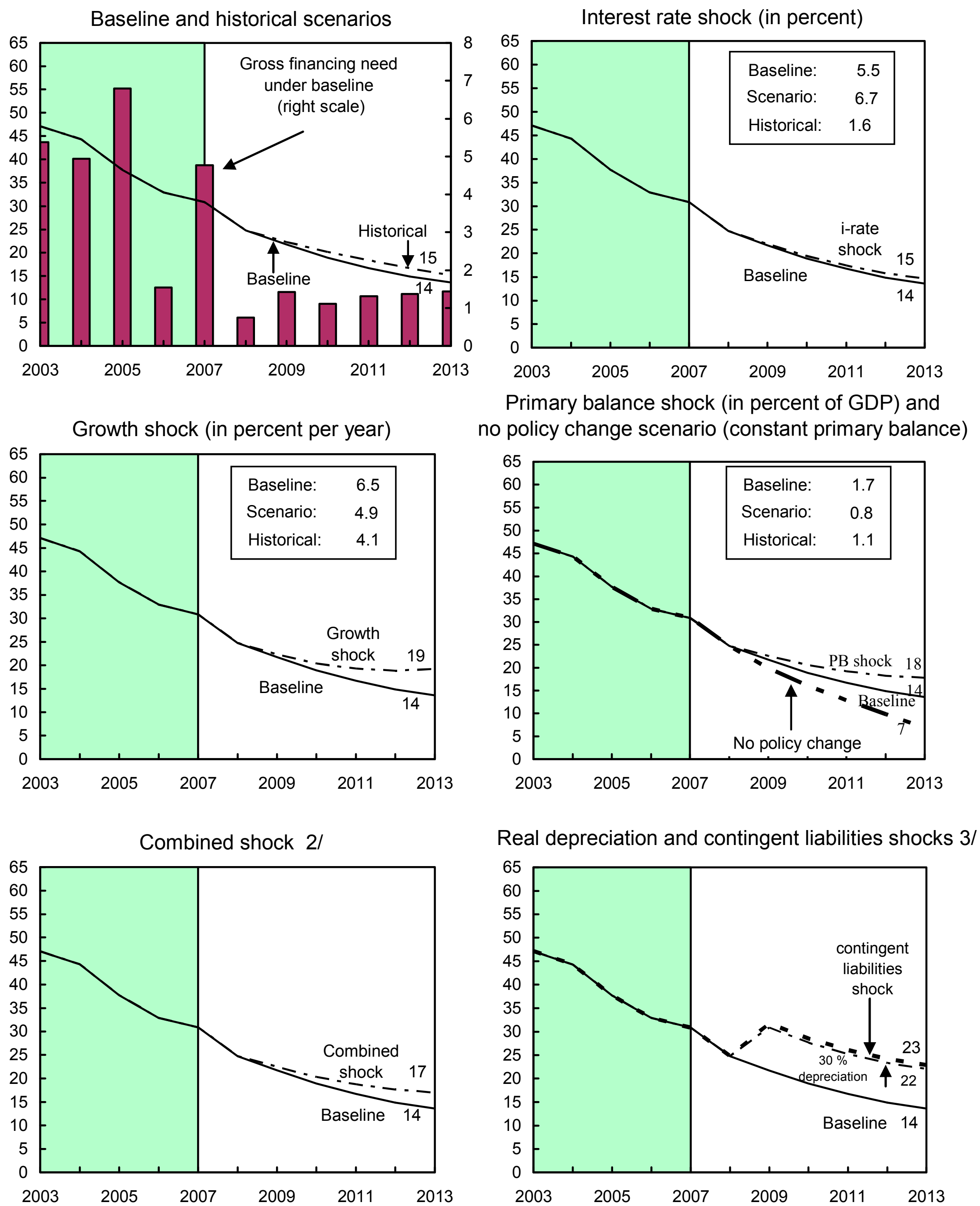
Sources: International Monetary Fund, Country desk data, and staff estimates.

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 2009.

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 2009, 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, Baseline, 2003-2013
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	48.2	44.8	36.1	30.8	31.5	**29.2**	**28.9**	**26.1**	**23.6**	**21.3**	**19.5**	**-3.4**
Change in external debt	-0.9	-3.4	-8.8	-5.2	0.7	-2.3	-0.3	-2.8	-2.6	-2.2	-1.8	
Identified external debt-creating flows (4+8+9)	-2.1	-7.4	-9.0	-9.6	-10.2	-2.7	-0.6	-1.6	-2.6	-2.5	-2.3	
Current account deficit, excluding interest payments	-0.7	-2.1	-3.5	-5.0	-3.4	1.6	1.7	1.7	1.3	0.8	0.5	
Deficit in balance of goods and services	-0.1	-3.1	-5.6	-48.4	-51.4	-53.5	-46.1	-45.5	-43.5	-41.6	-40.2	
Exports	17.6	21.1	24.7	28.6	29.1	27.3	22.2	21.8	20.6	19.6	18.8	
Imports	17.5	18.0	19.1	-19.8	-22.2	-26.2	-24.0	-23.7	-22.9	-22.0	-21.4	
Net non-debt creating capital inflows (negative)	0.0	-1.5	-2.0	-1.5	-4.5	-3.5	-1.9	-2.8	-3.7	-3.1	-2.6	
Automatic debt dynamics 1/	-1.5	-3.7	-3.4	-3.0	-2.3	-0.8	-0.3	-0.5	-0.1	-0.2	-0.2	
Contribution from nominal interest rate	2.2	2.1	2.1	2.0	2.0	1.7	1.4	1.2	1.4	1.2	1.1	
Contribution from real GDP growth	-1.8	-2.2	-2.7	-2.4	-2.4	-2.4	-1.7	-1.7	-1.5	-1.4	-1.3	
Contribution from price and exchange rate changes 2/	-1.8	-3.6	-2.8	-2.7	-1.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	1.2	3.9	0.2	4.3	10.8	0.3	0.3	-1.2	0.0	0.3	0.5	
External debt-to-exports ratio (in percent)	274.3	212.2	145.8	107.8	108.1	106.9	130.5	119.8	114.1	108.9	103.9	
Gross external financing need (in billions of US dollars) 4/	5.5	4.9	6.8	2.2	7.9	13.3	14.5	14.5	15.0	15.6	13.6	
in percent of GDP	9.0	7.0	8.6	2.4	7.3	10.2	10.6	9.3	8.6	8.1	6.5	
Scenario with key variables at their historical averages 5/						**29.2**	**26.7**	**24.8**	**23.6**	**22.4**	**21.2**	**-1.2**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.0	5.1	6.7	7.7	8.9	9.4	6.0	6.8	6.5	6.5	6.5	
GDP deflator in US dollars (change in percent)	3.9	8.2	6.8	8.0	6.7	10.4	-0.6	6.7	4.7	4.0	2.7	
Nominal external interest rate (in percent)	4.9	4.9	5.3	6.5	7.4	6.5	4.9	4.8	5.9	5.7	5.4	
Growth of exports and services (US dollar terms, in percent)	16.7	36.5	33.5	34.5	18.3	13.1	-14.4	12.2	5.5	5.1	4.9	
Growth of imports and services (US dollar terms, in percent)	8.7	16.8	21.0	-220.3	30.5	42.3	-3.5	12.8	7.5	6.8	6.3	
Current account balance, excluding interest payments	0.7	2.1	3.5	5.0	3.4	-1.6	-1.7	-1.7	-1.3	-0.8	-0.5	
Net non-debt creating capital inflows	0.0	1.5	2.0	1.5	4.5	3.5	1.9	2.8	3.7	3.1	2.6	

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

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

3/ 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, 2003-2013
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	47.1	44.3	37.7	32.9	30.9	**24.8**	**21.7**	**18.9**	**16.7**	**14.9**	**13.6**	**0.0**
o/w foreign-currency denominated	43.3	37.5	29.5	25.0	22.3	17.6	14.8	12.5	10.7	9.2	8.2	
Change in public sector debt	0.4	-2.8	-6.6	-4.8	-2.0	-6.1	-3.0	-2.8	-2.2	-1.8	-1.3	
Identified debt-creating flows (4+7+12)	-1.1	-4.7	-5.0	-7.6	-7.4	-4.9	-2.2	-2.3	-2.0	-1.6	-1.3	
Primary deficit	-0.4	-1.0	-1.6	-3.9	-4.0	-2.9	-1.6	-1.9	-1.9	-1.6	-1.3	
Revenue and grants	18.0	17.9	18.9	20.5	20.8	20.8	19.7	19.9	19.6	19.3	19.2	
Primary (noninterest) expenditure	17.6	17.0	17.3	16.5	16.8	17.9	18.0	18.0	17.7	17.8	17.9	
Automatic debt dynamics 2/	-0.7	-3.6	-3.3	-3.6	-3.3	-2.0	-0.6	-0.4	-0.1	0.0	0.0	
Contribution from interest rate/growth differential 3/	-0.9	-2.8	-2.1	-3.4	-1.3	-2.0	-0.6	-0.4	-0.1	0.0	0.0	
Of which contribution from real interest rate	0.8	-0.7	0.6	-1.0	1.4	0.6	0.8	0.9	1.0	1.0	0.9	
Of which contribution from real GDP growth	-1.8	-2.2	-2.7	-2.4	-2.7	-2.6	-1.4	-1.4	-1.1	-1.0	-0.9	
Contribution from exchange rate depreciation 4/	0.3	-0.7	-1.2	-0.2	-2.0	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	-0.2	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.1	-0.2	-0.1	-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/	1.5	1.9	-1.6	2.8	5.4	-1.2	-0.8	-0.5	-0.2	-0.2	0.0	
Public sector debt-to-revenue ratio 1/	261.7	247.0	199.2	160.7	148.4	119.0	110.5	94.9	85.4	76.9	71.0	
Gross financing need 6/	5.4	4.9	6.8	1.5	4.8	0.7	1.4	1.1	1.3	1.4	1.4	
in billions of U.S. dollars	3.3	3.4	5.4	1.4	5.1	1.0	1.9	1.7	2.3	2.7	3.0	
Scenario with key variables at their historical averages 7/						**24.8**	**22.3**	**20.2**	**18.4**	**16.6**	**15.2**	**-0.4**
Scenario with no policy change (constant primary balance) in 2008-2013						**24.8**	**19.9**	**16.1**	**12.8**	**9.8**	**6.9**	**0.0**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.0	5.1	6.7	7.6	9.0	9.4	6.0	6.8	6.5	6.5	6.5	
Average nominal interest rate on public debt (in percent) 8/	4.8	4.8	4.8	5.8	6.0	5.6	6.5	7.1	8.0	8.4	8.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.0	-1.3	1.7	-2.4	4.9	2.4	3.6	4.8	6.0	6.4	6.6	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-0.6	1.9	3.6	0.6	9.2	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.8	6.1	3.1	8.1	1.1	3.2	2.9	2.3	2.0	2.0	2.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	4.1	1.3	8.9	2.8	10.6	16.9	6.8	6.7	4.3	7.1	7.1	
Primary deficit	-0.4	-1.0	-1.6	-3.9	-4.0	-2.9	-1.6	-1.9	-1.9	-1.6	-1.3	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or 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 - π (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.

INTERNATIONAL MONETARY FUND

PERU

**Staff Report for the 2008 Article IV Consultation,
Fourth Review and Inflation Consultation Under the Stand-By Arrangement and
Request for Waiver of Applicability of Performance Criteria—Informational Annex**

Prepared by the Western Hemisphere Department

January 14, 2009

Annexes

Tables

Annex I. Peru: Fund Relations
(As of November 30, 2008)

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	5.82	6.37
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	2/28/09	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):

	2008	2009	2010	2011	2012
Principal					
Charges/interest		0.92	0.90	0.90	0.90
Total		0.92	0.90	0.90	0.90

VII. **Safeguards Assessments**

An off-site safeguards assessment of the central bank in 2007 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 November 5, 2008, the average of interbank buying and selling rates was 3.07 *Nuevos Soles* 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 (IMF 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 (dated February 28, 2001) 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, May 2007–present	Public Financial Management
	May 2005, February, September, and November 2006, February, June and August 2007, April, June and October 2008	Tax policy and administration, customs administration.
	September 2002, September 2003 and August 2004	Public investment and fiscal policy, including issues related to PPPs.
	November 1999	Fiscal rules
MFD/MCM	September 2008	Supervision of Capital Markets.
	March 2008	Implementation of Basel II
	April, July and October 2007	Strengthening the Capital Markets
	April 2006	Financial sector supervision
	April 2005	Consumer protection in the banking system
	March, 2005	Central bank organization
	April, May, December 2002, February 2003, March and September 2004	Inflation targeting
	October 2002	Foreign exchange operations
	August 2002	Accounting and organizational issues
	March 2002	Monetary operations and government securities market
STA	January 1998, October 1999, and March, September and November 2008	National account statistics, new base year for the national account series; and Government Finance Statistics 2001.

XII. Resident Representative

Mr. Luis Breuer has been Resident Representative in Peru since January 2008.

ANNEX II. PERU: WORLD BANK RELATIONS

Bank Group strategy

The World Bank Group support to Peru is defined in the Country Partnership Strategy (CPS) approved by the Board on December 19, 2006. The strategy supports the government's developmental goals with emphasis on inclusive growth and poverty reduction. The agenda includes programs addressing fiscal, national competitiveness, infrastructure and social-sector needs. The country strategy underscores partnerships, flexibility and results orientation in public expenditure. The CPS projects financial assistance of up to US$3.5 billion between July 2007 and June 2011 and envisages a flexible 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, social, and environmental sectors. The Bank is currently preparing a Progress Report for the CPS. While this Progress Report takes into account the current financial crisis and adapts the Program accordingly, the overall medium term vision continues to be relevant for Peru.

FY09 pipeline comprises five operations for a total of $1,405 million. It includes three DPLs-DDOs in the fiscal, environmental, and social sectors for $1,370 million and two investment lending operations for $35 million. The program for FY10–FY11 is being discussed with the government in the context of the Country Strategy Progress Report, the global financial crisis, and Peru's new financing needs.

In addition, the Bank has an extensive program of analytical and advisory activities for FY09, including both economic and sector work and nonreimbursable technical assistance. The economic and sector work covers areas such as public expenditure, labor markets, infrastructure, gas development strategy, decentralization, social sectors, and housing and municipal financing. Several multi-year nonlending technical assistance are currently in progress, covering areas such as decentralization, governance and governability enhancement, poverty monitoring, and performance informed budgeting. Additional nonlending technical assistance in education and nutrition are planned for delivery in FY10.

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.

- *Public Sector Management.* Bank-Fund collaboration has focused in the area of results based budgeting, the implementation of a Treasury Single Account and modernization of budget processes, institutions and information systems.

- *Customs Administration Modernization:* A needs assessment mission was undertaken together with the IMF to develop an action plan for modernizing customs administration. The joint team presented a technical report to SUNAT.

- *Reform of the National Public Investment System (SNIP).* The Bank has been working in close collaboration with the authorities in reducing the institutional bottlenecks of the public investment system. A joint WB-IADB mission took place in March 2007 to revise current government procurement regulations. The Bank is also providing technical assistance in the design of the framework law for Public-Private Partnerships as well as in the implementation of FONIPREL.

Statement of World Bank Loans
(As of December 18, 2008)

				In millions of U.S. Dollars	
Loan Number	Year Approved	Borrower	Purpose	Total (Net of Cancellation)	Undisbursed
Sixty six loans have been fully repaid.					
Partially disbursed or undisbursed loans:					
73080/40760	1997	Republic of Peru	Irrigation Subsector Project	95.26	1.07
71420	2003	Republic of Peru	National Rural Water Supply and Sanitation Project	50.00	27.17
71600	2003	Republic of Peru	Additional Financing Lima Water Rehabilitation and Management Project	20.00	0.95
71770	2003	Republic of Peru	Trade Facilitation and Productivity Improvement Technical Assistance	20.00	2.18
72090	2004	Republic of Peru	Lima Transport Project	45.00	20.37
72190	2004	Republic of Peru	Justice Services Improvement	12.00	2.26
72540	2005	Republic of Peru	Accountability for Decentralization in the Social Sectors	6.90	2.23
72550	2005	Republic of Peru	Institutional Capacity for Sustainable Fiscal Decentralization	8.80	6.31
72570	2005	Republic of Peru	Vilcanota Valley Rehabilitation and Management Project	4.98	3.24
72850	2005	Republic of Peru	Agricultural Research and Extension - APL II	25.00	10.20
B1220	2005	Republic of Peru	PE (CRL) Guarantee Facility	200.00	200.00
73220	2006	Republic of Peru	Regional Transport Infrastructure Decentralization	50.00	46.23
73660	2006	Republic of Peru	Rural Electrification	50.00	34.99
73680	2006	Republic of Peru	Real Property Rights II Project	25.00	19.80
74230	2007	Republic of Peru	Decentralized Rural Transport Project	50.00	45.92
74430	2007	Republic of Peru	Sierra Rural Development Project	20.00	20.00
75880	2008	Republic of Peru	Second Programmatic Fiscal Mgmt and Competitiveness Development Policy Loan	370.00	370.00
Total disbursed:				5637.4	
	Of which: amount repaid			2918.8	
Total Outstanding:				2651.8	
Total Undisbursed					812.9

Statement of IFC Operations in Peru
(As of November, 2008)

	Total	
	Commitments held	Disbursed
Loans	620.1	249.1
Equity	130.9	118.4
Quasi	54.0	54
Particip Loans	230.0	230
Total	1035.0	651.5

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

Country Strategy

The Country Strategy for 2007–2011 continues the thrust of Bank assistance in areas relating to competitiveness, social development, and modernization of the State, and reflects wide-ranging discussions of policies with the Government and with Peruvian society to identify the constraints the country faces in achieving its development objectives.

The IDB supports Peru's development agenda by deepening the country's sustainable economic growth and generating greater opportunities for the majority of Peruvians, through efforts grouped into the following three strategic pillars: (i) strengthening Peru's participation in the global economy and enhancing competitiveness; (ii) promoting social development and economic inclusion; and (iii) deepening the reform of the State and improving public sector management.

Lending

As of November 30, 2008, the Bank's portfolio of active, public sector operations consisted of 25 loans for a total amount of US$833.8 million, of which US$197.7 million (23.7%) had been disbursed. The public sector lending program for 2008 comprises a policy based loan for US$130.0 million, an investment loan for US$25.0 million already approved and an investment loan for US$ 15.00 million pending approval.

IDB's Structured Corporate Finance Department's portfolio in execution consists of eight A-loans for a total amount of US$799.6 million, and five credit guarantee operations for US$165 million. These operations are focused primarily in the financial and natural gas sectors. Private sector lending for 2008 includes two projects for US$75.0 million, which have been already approved.

To assist Government efforts to de-dollarize the public sector debt, the Bank successfully converted US$131.0 million of previously disbursed loans into local currency.

Considering recent financial market developments, the Government has requested to modify 18 loan contracts, converting their interest rates from variable LIBOR-based to fixed rates. This change would capture currently available low long term rate, and a unique opportunity to reduce volatility and debt service payments. This process is in its final step.

Peru: IDB Loan Portfolio by Sector
As of November 30, 2008
US$ million

Sector	Commitments	Disbursements	Disbursed (in percent of total)
Agriculture	53.4	18.8	35.2
Environmental	0	0	0
Science and Technology	25.0	3.0	11.9
Urban Development	60.0	39.3	65.5
Social Investment	103.3	90.7	87.8
Modernization of the State	47.6	17.2	36.2
Water and Sanitation	235.6	0.1	0.0
Transportation	308.9	28.7	9.3
Total	**833.8**	**197.7**	**23.7**

ANNEX IV. PERU: STATISTICAL ISSUES

Data provision has some shortcomings, but is broadly adequate for policy formulation, surveillance, and program monitoring. Certain shortcomings occur in the datasets for national accounts, prices and the external sector. Peru subscribed to the Special Data Dissemination Standard (SDDS) in August 1996, and a data ROSC was prepared and published in 2003.

Real Sector and Prices

National Accounts: The accuracy and reliability of estimates are limited by the use of an outdated base year for national accounts compilation and lags with the implementation of methodological recommendations stemming from the *System of National Accounts 1993*. The National Statistics Office (INEI), in consultation with international experts and STA, have developed an action plan to update the base year to 2007 and address various other shortcomings with data sources and statistical techniques to produce annual and quarterly national accounts; the timeframe for implementation is 2008–11.

Prices Statistics: The national consumer price index (CPI) is affected by different consumer basket coverage among its regional components. However, a number of new initiatives are underway to address such methodological weakness. A new national Household Expenditure Survey is scheduled for completion by April 2009, and will permit updating the base year for the compilation of the CPI as well as more robust estimates of household final consumption for national accounts' purposes.

The wholesale price index (WPI) also has problems of limited coverage which should be expanded to include mining, oil and gas extraction, electricity and water, public transportation, and communication.

As with the CPI, the WPI is currently compiled with outdated weights derived from the 1994 input-output table and other reports and publications of relevant line ministries.

Labor market statistics: The authorities monitor labor market developments using four indicators: open unemployment, underemployment, employment, and remuneration. The quality of these indicators has improved over recent years. Nevertheless, 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 of electricity and telecommunications tariffs.

Fiscal Sector

Government finance statistics (GFS) for 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*. In 2008, the authorities have aligned budgetary classifications to the *GFSM 2001* framework. Also, some activities have been started to align the Chart of Account to the international standards. The authorities report annual GFS data using the *GFSM 2001* presentational framework for publication in the *Government Finance Statistics Yearbook (GFSY)* and monthly data for the *International Financial Statistics (IFS)*.

Monetary Sector

The central bank (BCRP) compiles and publishes the analytical accounts of the central bank, depository corporations, and financial corporations broadly in line with the methodology recommended by the *Monetary and Financial Statistics Manual*. The main discrepancies being the exclusion of the deposits of other financial corporations, state and local governments, and public nonfinancial corporations from the definition of broad money. At the request of the authorities, a mission visited the country in January 2007 to assist with the migration to the new standardized report forms (SRFs) for reporting monetary data to the IMF. The mission finalized the SRF for the central bank, recommending improvements in the classification and sectorization of some accounts. A follow-up mission took place in September 2008 to complete the work on the SRF for other depository corporations and other financial corporations. The BCRP is currently in the process of revising historical data on the basis of the report forms developed by the mission.

External Sector

Despite recent improvements, external statistics continue to be affected by shortcomings. These 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 not recording on an accrual basis some external debt transactions.

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: Table of Common Indicators Required for Surveillance
(As of December 17, 2008)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality Accuracy and reliability[9]
Exchange Rates	Nov. 2008	12/12/08	D	M	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Nov. 2008	12/16/08	D	M	W		
Reserve/Base Money	Sep. 2008	12/8/08	W	M	W	O, LO, LO, LO	O, O, O, O, O
Broad Money	Sep. 2008	12/8/08	W	M	W		
Central Bank Balance Sheet	Sep. 2008	12/8/08	W	M	W		
Consolidated Balance Sheet of the Banking System	Sep. 2008	12/8/08	W	M	W		
Interest Rates[2]	Oct. 2008	12/8/08	D	M	D		
Consumer Price Index	Nov. 2008	12/16/08	M	M	M	O, LO, LO, LO	LO, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2004	9/21/2005	Q	Q	Q	O, LO, O, O	O, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing3– Central Government	Feb. 2008	4/16/08	M	M	M		
Stocks of Central Government Debt[5]							
International investment Position[6]	Q2 2008	9/18/08	Q	Q	Q		
External Current Account Balance	Q2 2008	9/18/08	Q	Q	Q	O, LO, LO, LO	LO, LO, O, O, O
Exports and Imports of Goods and Services	Q2 2008	9/18/08	Q	Q	Q		
GDP/GNP	Q2 2008	10/21/08	Q	Q	Q	LO, LO, LO, LO	LNO, LNO, LNO, LO, LO
Gross External Debt	June 2006	Sep. 2006	Q	Q	Q		

1/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
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.

Statement by the IMF Staff Representative
January 30, 2009

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. **Minister of Finance Valdivieso was replaced by former Minister Carranza, who has pledged policy continuity.** Minister Carranza indicated that he will ensure the implementation of the government's anti-crisis plan, particularly by seeking a steady pace of public investment spending in line with projections assumed for 2009.

3. **In line with projections, signs of an economic slowdown are emerging.** Real GDP growth decelerated to 5.1 percent in November (y/y)—the lowest rate recorded in 2008—due to temporary factors related to the APEC meetings (less number of working days) and a suspension of operations by some local firms. Excluding these factors, the growth rate stood at 7 percent (y/y) for the month, compared with 9.5 percent during the first 11 months of the year.

4. **Financial market conditions have remained stable.** With some US$0.5 billion in central bank securities held by non-residents falling due in January, pressures in the foreign exchange rate market in recent days have been met by central bank intervention for about US$440 million, helping to contain the depreciation of the *Nuevo Sol* to around 1 percent since end-2008. The interbank market has also been stable, as interbank interest rates in domestic currency have remained unchanged from end-year levels, while dollar-denominated rates have dropped below 1 percent, resembling the trend of the U.S. policy rate.

5. **At its January meeting, the central bank maintained its policy interest rate unchanged at 6.5 percent, while reducing minimum reserve requirements by 1 percent, to 6.5 percent.** The central bank reiterated that it continues to monitor closely the path of domestic demand and the global economic conditions, and their prospective impact on inflation. It also reiterated its commitment to ensuring the gradual convergence of the inflation rate to its target range, while providing adequate liquidity levels.

6. **There has been progress on key pending items of the structural agenda under the program.** In particular, the methodological manual on assessing tax incentives (end-June 2008 benchmark) was published on January 16, 2009.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/12
FOR IMMEDIATE RELEASE
February 3, 2009

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

IMF Executive Board Concludes Article IV Consultation with Peru

On January 30, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Peru.[1]

Background

Peru has enjoyed an impressive economic performance against the backdrop of a favorable external environment in recent years. Led by consumption and investment, real GDP is estimated to have grown above 9 percent in 2008, marking the country's longest expansion on record (Table 1). On the back of high food and fuel prices, headline inflation reached 6.7 percent in 2008, exceeding the 1–3 percent target range, but remaining one of the lowest by regional standards.

The sound policy framework put in place in recent years and the build up of a solid international reserves position have contributed to reduce vulnerabilities significantly, lower poverty, and enhance the business environment. The strong fiscal surpluses achieved in recent years are the backbone of this success, as they have supported a significant reduction in public debt, improved maturity structure, and the build up of important fiscal buffers. A sound monetary policy, entrenched on an inflation targeting framework, has also been instrumental in helping to maintain macroeconomic stability and reduce dollarization. Structural reforms have reduced fiscal and financial vulnerabilities, while reforms to open new trade destinations, lower

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

informality, streamline procedures, and improve the business climate have helped improve long-term growth prospects and support poverty reduction.

These achievements have placed Peru on a strong position to weather the expected deterioration in external conditions. Building on Peru's strong fundamentals, including a resilient financial system, several measures have been appropriately implemented by the authorities that would help to limit spillovers, preserve adequate liquidity conditions in the domestic markets, and bolster domestic confidence. As a result, orderly liquidity conditions in the financial system have been preserved, and despite some increase in deposit dollarization between September and November 2008, preliminary data to December suggests that it has renewed its downward trend of recent years.

The authorities have been implementing reforms to further strengthen the financial system. Large official reserves—currently at around US$30 billion—and strong financial soundness indicators, along with the banks' limited financial reliance on external funding have helped preserve the system's stability. The authorities have recently introduced prudential measures—including more restrictive rules for consumer credit; new dynamic provisioning made effective last December, and strengthened banks' minimum capital requirements as Basel II is gradually implemented.

On the fiscal area, the authorities have announced several measures to shield the economy from the global crisis and enhance confidence. These include measures to maintain a program of public investment and support construction, as well as to support micro and small enterprises, exporters, and social programs. To further boost confidence, the authorities have also lined up access to contingent credit lines from official creditors.

As a result, the near term domestic economic outlook still remains favorable, but with risks on the downside. The pace of economic growth is expected to decelerate to 6 percent in 2009, reflecting the global slowdown, lower terms of trade, and tighter financial conditions that would affect net exports and private investment. With the global price disinflation underway, inflation would decelerate toward the 1–3 percent target range. A more severe and prolonged global slowdown could also extend the downside risks into 2010. Nevertheless, Peru's medium-term prospects are favorable and require preserving prudent macroeconomic policies and dealing with long-standing structural challenges.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They praised the Peruvian authorities for their sustained implementation of sound macroeconomic policies and structural reforms, which—supported by favorable external conditions—have fostered the country's longest economic expansion. Sustained fiscal surpluses, supported by a prudent conduct of monetary policy, have been the backbone of this success, while important structural reforms have enhanced the resilience and depth of the financial system and capital markets and improved the business environment. These policies have yielded an impressive economic performance with robust economic growth, relatively low inflation, reduced vulnerabilities, and important gains in poverty alleviation.

Despite the adverse impact of the global economic downturn and financial crisis, a soft landing for Peru's economy seems likely, owing to its strong fundamentals and the authorities' sound policy framework. Nevertheless, with downside risks increasing, Directors endorsed as timely and appropriate the authorities' preparedness plan, and welcomed as well the authorities' commitment to make further advances in tackling structural challenges. If the global slowdown were to prove more severe and prolonged than expected, Directors concurred with the authorities' intention to implement prudent countercyclical measures.

Directors supported the authorities' target of a neutral fiscal stance in 2009, geared to allowing automatic stabilizers to operate fully and phasing public investment execution evenly, while boosting resources for subnational governments to increase their investment. Directors emphasized the importance of broadening Peru's tax base and proceeding with the reform of tax exemptions planned for March 2009. They welcomed the recent issuance of the methodological guidelines for assessing tax exemptions.

Directors encouraged the authorities to further strengthen the institutional framework for fiscal policy, most notably by gradually developing a structural fiscal rule to enhance the credibility of fiscal policy. Reforms to minimize fiscal risks, including from Public-Private Partnerships, will be important, as will their proper fiscal accounting. Other key priorities are aligning the expenditure limits for subnational governments with the Fiscal Responsibility and Transparency Law and the Decentralization Law, fully implementing the Treasury Single Account, and reforming the Fuel Stabilization Fund to make its price-band adjustment mechanism automatic.

Directors welcomed the efforts to make further advances on poverty reduction, by improving the effectiveness and targeting of social programs, and strengthening large social programs. They also supported the authorities' plans to tackle the challenges posed by existing regional disparities.

Directors considered that Peru's inflation targeting framework should remain focused on preserving low and stable inflation. They welcomed the central bank's commitment to ensure a gradual convergence to the inflation target range in 2009, while providing adequate liquidity to support domestic demand. In this context, Directors supported the authorities' intention to continue to monitor closely the path of domestic demand, inflation, and inflation expectations, and to adjust policies as warranted. Delinking the appointment of the central bank's president and board members from the presidential cycle would further bolster the credibility of the inflation-targeting framework.

Directors noted the staff assessment that the real effective exchange rate is broadly aligned with fundamentals. Peru's exchange rate policy has appropriately balanced exchange rate flexibility and dollarization risks. Directors supported the authorities' foreign exchange intervention, which has reduced exchange rate volatility and increased official reserves. They generally agreed that Peru’s improved fundamentals provide scope for greater exchange rate flexibility but considered that such a transition should await more stable external conditions.

Directors commended the progress made in strengthening the financial system. Continuing steady implementation of Basel II, as well as enactment of minimum capital requirements for microfinance institutions, remain key priorities. The authorities have taken important steps by establishing new procyclical provisioning rules and tightening prudential regulations on consumer loans. Directors welcomed the authorities’ efforts to enhance their crisis preparedness, underscoring the need to strengthen the framework for providing adequate liquidity to all financial entities and to gradually recapitalize the Deposit Insurance Fund.

Directors congratulated the authorities on Peru’s highly successful Stand-By Arrangement with the Fund and welcomed warmly Peru’s inclusion in the Fund’s Financial Transaction Plan.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Peru: Selected Economic Indicators

	2004	2005	2006	2007	Prog. CR/08/258 2008	Proj. 2008	Proj. CR/08/258 2009	Proj 2009
Social Indicators								
Life expectancy at birth (years)	...	70.7	...	...	...	...	...	...
Infant mortality (per thousand live births)	...	22.8	...	...	...	...	...	...
Adult literacy rate	87.8	87.9	...	...	...	...	...	...
Poverty rate (Total) 1/	48.6	48.7	44.5	39.3	...	...	...	...
Unemployment rate	9.4	9.6	8.5	8.4	...	...	...	...
(Annual percentage change; unless otherwise indicated)								
Production and prices								
Real GDP	5.1	6.7	7.7	8.9	8.2	9.4	6.5	6.0
Real domestic demand	4.0	5.7	10.3	11.8	11.0	12.8	7.1	6.8
Of which: Private sector	4.4	5.9	9.0	11.4	11.2	12.4	6.4	7.7
Consumer Prices (end of period)	3.5	1.2	1.1	3.9	4.3	6.7	2.8	2.8
Consumer Prices (period average)	3.7	1.6	2.0	1.8	4.8	5.8	3.0	4.7
External sector								
Exports	40.9	35.6	37.0	17.4	18.5	12.8	3.5	-17.7
Imports	19.5	23.2	23.0	31.8	35.0	44.7	11.7	-4.1
Terms of trade (deterioration -)	9.2	5.9	28.3	3.6	-1.8	-9.5	-5.8	-10.6
Real effective exchange rate (depreciation -) 2/	-1.6	-0.5	-1.3	-0.6	...	...	...	...
Money and credit 3/ 4/								
Liabilities to the private sector	8.3	18.4	8.8	22.7	14.9	26.6	12.4	10.3
Net credit to the private sector	-0.3	16.3	6.2	30.8	13.4	31.1	10.3	11.6
(In percent of GDP; unless otherwise indicated)								
Public sector								
General government current revenue	17.0	18.0	19.8	20.7	20.3	20.7	19.2	19.6
General government noninterest expenditure	16.2	16.7	16.2	16.0	16.0	17.1	16.2	17.3
Combined public sector primary balance	1.0	1.6	4.1	5.1	4.5	3.5	2.9	2.0
Interest due	2.0	1.9	1.9	1.8	1.5	1.5	1.3	1.5
Combined public sector overall balance	-1.1	-0.3	2.2	3.3	3.0	2.0	1.6	0.6
Combined public sector overall balance (including CRPAOs)	-1.1	-0.3	2.1	2.2	2.4	1.3	1.2	0.2
External Sector								
External current account balance	0.0	1.4	3.0	1.4	-0.6	-3.3	-0.7	-3.0
Gross reserves								
In millions of U.S. dollars	12,649	14,120	17,329	27,743	37,243	30,743	41,243	30,243
Percent of short-term external debt 5/	163.9	311.4	182.4	456.1	582.4	442.8	503.9	358.1
Percent of foreign currency deposits at banks	137.3	125.9	151.7	208.5	264.4	165.8	258.2	158.0
Debt								
Total external debt	44.8	36.1	30.5	31.5	25.1	29.2	22.4	28.9
Combined public sector debt (including CRPAOs)	44.3	37.7	33.1	30.9	22.0	24.8	19.0	21.7
Domestic	9.2	9.7	9.2	11.0	7.3	8.2	6.5	7.4
External 6/	35.1	28.0	23.9	19.9	14.7	16.5	12.6	14.4
Savings and investment								
Gross domestic investment	18.1	17.9	20.2	22.9	25.8	28.0	27.7	30.1
Public sector 7/	2.8	2.9	2.8	3.1	4.1	4.4	4.9	4.8
Private sector	15.3	15.1	17.4	19.8	21.7	23.6	22.8	25.3
National savings	18.1	19.4	23.2	24.3	25.2	24.8	27.0	27.0
Public sector 8/	1.7	2.6	5.1	6.4	7.2	6.3	6.4	5.4
Private sector	16.4	16.8	18.1	17.9	18.0	18.5	20.5	21.6
External savings	0.0	-1.4	-3.0	-1.4	0.6	3.3	0.7	3.0
Memorandum items								
Nominal GDP (S/. billions)	238.0	261.9	302.8	335.7	382.9	379.0	414.3	413.5
GDP per capita (in US$)	2,602	2,920	3,346	3,826	4,868	4,550	5,505	4,723

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

1/ Defined as the percentage of households with total spending below the cost of a basic consumption basket.
2/ Based on Information Notice System.
3/ Corresponds to the banking system.
4/ Foreign currency stocks are valued at end-of-period exchange rates.
5/ Short-term debt is defined on a residual maturity basis, and includes amortization of medium- and long-term debt.
6/ Includes debt by the Central Reserve Bank of Peru.
7/ Includes CRPAOs.
8/ Excludes privatization receipts.

Press Release No. 09/20
FOR IMMEDIATE RELEASE
January 30, 2009

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth and Final Review Under Peru's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) today completed the fourth and final review of Peru's economic performance under a 25-month Stand-By Arrangement in the amount equivalent to SDR 172.4 million (about US$257.2 million). The arrangement, which was approved on January 26, 2007 (see Press Release No. 07/15), is being treated by the Peruvian authorities as precautionary.

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

"Peru has been enjoying its longest expansion on record, one of the lowest inflation rates in the region, declining vulnerabilities, and poverty reduction. These achievements owe much to the authorities' strong commitment to prudent macroeconomic policies and steady implementation of reforms.

"Despite the adverse impact of the global economic downturn and financial crisis, a soft landing for Peru's economy seems likely, owing to its strong fundamentals and the authorities' sound policy framework. Nevertheless, with downside risks increasing, the authorities' "anti-crisis" preparedness plan is timely and appropriate, as is their commitment to make further advances in tackling structural challenges. Were the downside external risks to intensify, carefully paced countercyclical policies could be contemplated, in line with the authorities' anti-crisis plan.

"The authorities have targeted a broadly neutral fiscal stance, geared to allowing the automatic stabilizers to operate fully and phasing public investment execution evenly. It will be important to enhance the fiscal framework and strengthen the tax base, including by establishing a fiscal rule to formalize the prudent fiscal policy of recent years.

"Monetary policy will remain focused on achieving a gradual convergence to the inflation target range, while ensuring adequate liquidity in the financial system. Peru's exchange rate policy has appropriately balanced exchange rate flexibility and dollarization risks. Going forward, Peru's improved fundamentals provide scope for allowing greater flexibility, which should await more stable external conditions.

"Significant progress has been made in further strengthening the financial system and enhancing the framework for crisis preparedness. The authorities have taken important steps to establish new procyclical provisioning rules and tighten prudential regulations on consumer loans. There is scope to further enhance the framework for liquidity provision to the financial system, including by gradually recapitalizing the Deposit Insurance Fund.
To strengthen poverty reduction, the authorities are assessing their existing programs, improving targeting, and linking expenditure to efficiency. A review of reforms to tackle decisively the existing regional disparities would reinforce these efforts.

"Directors congratulated the authorities on Peru's highly successful Stand-By Arrangement with the Fund," Mr. Portugal said.

Statement by Messrs. Pablo A. Pereira, Executive Director for Peru
and Oscar Hendrick, Advisor
January 30, 2009

INTRODUCTION

1. On behalf of our Peruvian authorities, we would like to convey our appreciation to Mr. Cerisola and his team for a constructive and candid policy dialogue during the Article IV Consultation and final review of the precautionary Stand-By Arrangement. They would also like to express their gratitude to the Executive Board and Management for their support and quality advice during close to 20 years of continued Fund-supported programs. The staff report and selected issues paper provide an in-depth analysis of the strong economic performance of the Peruvian economy and the challenges ahead. Our authorities are in broad agreement with the staff's assessment and policy recommendations. We are pleased to inform the Board that Peru does not intend to seek an additional arrangement with the Fund.

2. The resilience of the Peruvian economy has been successfully tested once again. Despite the lingering effects of the worst financial crisis in recent history and adverse external shocks, Peru's economic growth has been among the highest in the world and inflation remains among the lowest in the region. All end-September 2008 performance criteria were met with ample margins and most structural benchmarks have also been met. Given the strong performance under the Stand-By Arrangement, the authorities request completion of the fourth and final review. They consent to the publication of the staff report.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

3. ***The Peruvian economy continues to perform well, supported by strong economic fundamentals and the authorities' commitment to sound macroeconomic policies.*** Consolidating the longest economic expansion on record, real GDP growth is expected to have reached 9.1 percent in 2008, the highest since 1994, with almost every economic activity showing a good pace, in particular the construction and commerce sectors. While private consumption is broadly growing at the same pace as GDP, private investment continues to grow for a third consecutive year, above 20 percent in real terms. The strong economic growth has contributed to a further reduction in the unemployment rate to 8.4 percent, while the poverty rate has continued to decline to 39.3 percent, reflecting the improvement in the standard of living of the population. The external position remains solid with a level of net international reserves equivalent to more than four times the short-term external debt on a residual maturity basis. The consolidated fiscal sector had a surplus for the third consecutive year, about 2.0 percent of GDP in 2008, while public debt declined further to 24.0 percent of GDP.

4. ***The Central Bank's anti-inflationary stance has limited the pass-through from significant increases in international food and oil prices into domestic inflation.*** In 2008,

mostly driven by higher international food and oil prices. The monetary authority reinforced its anti-inflationary stance to ensure a gradual return to inflation and inflation expectations to the target range. Accordingly, the Central Bank increased the policy interest rate several times by an accumulated 200 bps, from 4.5 percent in June 2007 to 6.5 percent in September 2008. These decisions were complemented by increases in reserve requirements on obligations in both domestic and foreign currency. The authorities are committed to taking additional actions if required and will continue to closely monitor the evolution of international prices and domestic demand.

5. ***The Free Trade Agreement with the United States will come into effect shortly and similar arrangements with China, the European Union, and other countries are underway.*** Presidents George W. Bush and Alan Garcia put the trade deal into effect on February 1, 2009, concluding a long process of trade negotiations and good will. The free trade agreement makes the special access to the U.S. market currently enjoyed under the Andean Trade Promotion and Drug Eradication Act permanent. The current two-way trade is about US$ 10.9 billion annually. The free trade agreement is expected to encourage higher export growth and diversification, as well as accelerate reforms that will further enhance the investment climate in Peru, already benefiting from foreign direct investment at historic highs. During the 2008 APEC Summit, important progress was made towards the free trade agreements with China.

6. ***Looking forward, the outlook for the Peruvian economy remains favorable, despite the heightened risks stemming from the global economic slowdown.*** Real GDP growth is expected to reach 6.0 percent in 2009, one of the highest in the world according to the latest revised WEO. Inflation is expected to decline below 3.0 percent, returning to the Central Bank's target range. The consolidated public sector balance will be in surplus, albeit at a lower level than previous years to allow for the automatic stabilizers to operate in full. The financial system has not been affected by the global financial crisis, as underscored by very strong financial soundness indicators, including bank liquidity and capital adequacy ratios. The authorities concur with the staff's assessment that the current level of official reserves provides an important buffer to preserve economic growth, external stability, and poverty alleviation.

7. ***Nonetheless, to protect the hard-earned gains, the government has announced an "anti-crisis" plan to avoid the risk of a sudden and sharp slowdown of economic activity.*** The main objective of the plan is to achieve a "soft landing" by maintaining the growth momentum—within long-term sustainable levels—and ensuring an adequate liquidity level in the financial system. The Ministry of Finance has already taken actions, extending the execution of public investment projects budgeted in 2008 through March 2009 and increasing resources to the Fund for Regional and Local Public Investment. The Central Bank, in coordination with the Ministry of Finance and the Superintendency of Banks and Insurance (SBS), is evaluating policies to strengthen the framework for providing adequate liquidity to all financial entities. Additionally, actions to strengthen the prudential and regulatory

framework have already been implemented. The authorities are confident that the fiscal savings allocated to finance the anti-crisis plan, equivalent to 2.5 percent of GDP, should be adequate. However, should the crisis be worse than envisaged, they are ready to take additional actions to stimulate the economy. If the fiscal savings are not enough, the government will access available financing from multilateral organizations.

TAKING STOCK OF THE LAST TWO DECADES

8. ***Peru continues to be a success story, but it is fair and important to recognize that many challenges remain ahead.*** It has taken almost two decades of continued implementation of sound economic policies—despite temporary setbacks—and a strong political commitment to modernize the country and improve the standard of living of the population. Peru's strong macroeconomic performance was underpinned by wide-ranging structural reforms to improve the functioning of markets, foster private sector participation, and modernize the role of the state. In the early 1990s, Peru was one of the first emerging countries to undertake a simultaneous trade and capital account liberalization, accompanied by a flexible exchange rate regime and a deep reform of the financial system. Among several important transformations aimed at enhancing external competitiveness and investor confidence, Peru modernized the civil service, reformed the labor market, strengthened the rule of Law, and revamped the judiciary system. Our authorities remain committed to prudent financial policies to preserve the hard-earned macroeconomic stability and a further deepening of structural reforms to sustain growth and entrench poverty reduction.

9. ***In the 1990s, while most other financially-dollarized economies chose an exchange rate anchor, Peru was the only highly-dollarized country that enforced an independent monetary policy.*** The strategy was based on (i) legal and effective Central Bank autonomy; (ii) enhanced monetary policy credibility through an annual inflation target—in place since 1994 and currently 2 percent, the lowest in the region; (iii) policies to address financial dollarization risks, including high reserve requirements for foreign currency deposits, preemptive reserve requirements on dollar liabilities, and foreign exchange intervention to smooth excessive exchange rate volatility without affecting the trend.

10. ***In the course of the current decade, inflation has been 2.3 percent on average, one of the lowest in the region***. The low inflation has helped to regain confidence in the domestic currency, which has been reflected in a clearly voluntary dedollarization process. Thus, dollarization has decreased from 71 percent in 2000 to 46 percent in 2008. In addition, Peru and Mexico's nominal bonds in domestic currency have the longest maturities in the region (up to 30 years) and provide a benchmark for private sector issuances. Access to financial markets has been enhanced by the investment grade rating received from Fitch and Standard & Poor's last year.

POLICY ISSUES AND OBJECTIVES GOING FORWARD

A. Surviving the Worst Global Economic Crisis Since the Great Depression

11. ***Financial sector contagion has been limited.*** Initially, Peru's sovereign spread increased to 620 bps in late October 2008, but in December 2008 the sovereign yield curve returned to the "pre-crisis" level. The Central Bank's decisive actions to limit market and exchange rate volatility included: (i) easing reserve requirements—previously increased to contain speculative capital inflows; (ii) the placement of repos and swaps in nuevos soles and U.S. dollars; and (iii) the use of international reserves accumulated during the first half of the year. The Central Bank held the policy rate unchanged during this period. In 2009, economic growth will be driven by a still strong domestic demand, which will compensate for the substantial expected decline in external demand.

B. Policies to Face Current and Prospective Challenges

12. ***The authorities' main priority in the short term is to maintain the growth momentum and help the economy to transition in an orderly fashion to a lower level of economic activity.*** To this end, monetary policy will continue to ensure the gradual return to the inflation target range in 2009 and it will only ease reserve requirements and reduce the policy rate when clear evidence of a declining trend in prices is in place. Fiscal policy will be aimed at achieving a neutral fiscal stance for the year as a whole, but the balance between achieving a soft landing and addressing infrastructure and social needs would be biased towards the second goal. As clearly indicated in the Debt Sustainability Analysis, public debt is on a solid declining path, the fiscal position is strong, and government deposits amounted to 7 percent of GDP by end-December 2008. This provides a strong buffer to manage different levels of "fiscal stimulus", as needed, without resorting to public debt.

13. ***Strengthening and closely monitoring the Financial System remains a priority.*** The authorities have permanently updated prudential regulations and the regulatory framework and the banks have learned to be conservative and prudent in their financing and lending activities. The banking system has a relatively low dependence of external credit lines, higher liquidity, and lower ratios of non-performing loans and a high level of provisions. The SBS has recently updated credit risks and exchange risk stress tests and the system remains resilient to most foreseeable shocks, even under extreme adverse assumptions. The SBS has recently begun to tighten lending standards (effective as of January 2009); issued more restrictive rules for granting credit card loans; introduced provisioning requirements for all consumer loans; and established procyclical provisioning (effective as of December 1, 2008). Foreign banks account for about half of total assets. They are in a solid position and continue to rely mostly on domestic funding. No banks pose any systemic risks.

C. The Fund Program and Future Fund Relations

14. ***Peru has maintained a long relationship with the Fund under "program mode".*** Peru has benefited significantly from Fund advice and the "seal of approval" from Fund-

supported programs, and it has also one of the best records of compliance with original program targets. The other side of the coin is that after almost two decades of continuing in program mode, it requires a certain creativity from the staff and the authorities to envisage every year for almost two consecutive decades, new structural reforms and suitable benchmarks. Perhaps Peru was one of the cases that inspired the need for streamlined conditionality and Management's recommendation to distinguish desirable from essential structural conditionality. It is also worth mentioning that in all these years, all arrangements with the Fund were precautionary, with the exception of the initial Right Accumulation Program back in 1991.

15. ***The current Stand-By Arrangement was completed with flying colors, but a few structural benchmarks were missing.*** On January 16, 2009, legislation was passed for the issuance of methodological guidelines to assess tax exemptions. The authorities remain committed to delivering on the remaining benchmarks as soon as it is feasible. Regarding the Single Treasury Account (STA), it is worth mentioning that more than 85 percent of public sector transactions are already in the STA and a higher percentage is managed in a centralized manner by the Treasury, although it is not formally recorded in the TSA. Finally, regarding the benchmark to reconcile subnational government spending limits with those for the central government—the difference is only one percentage point, as indicated by the staff—, the authorities now believe that it would be better to address this issue within a comprehensive review of the decentralization process; and that this is perhaps not the right time for submitting such a proposal to Congress.

16. ***Looking ahead, Peru will maintain a close dialogue with the Fund and it will continue to engage in the policy discussions and institutional changes through the relevant internal channels and other international fora.*** The authorities would like to share their experience with other countries, help shape future Fund conditionality and lending activities, and contribute to the Fund's operational budget. Taking into account Peru's strong external position, it has been included for the upcoming February–April 2009 Financial Transaction Plan.