Lima, Peru
May 5, 1998

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. This letter describes the economic policies of the Government of Peru for 1998. Real GDP grew by 7.4 percent in 1997, reflecting sharp increases in investment of the private sector and exports. Inflation was reduced from 11.8 percent in 1996 to 6.5 percent, its lowest level in 25 years, and the external current account deficit narrowed substantially, from 5.9 percent of GDP in 1996 to 5.2 percent in 1997. The net international reserves of the Central Reserve Bank increased by about US$1.6 billion, with gross reserves exceeding the equivalent of 12 months of imports of goods and nonfactor services by year-end. As in previous years, all performance criteria were observed in 1997.

2. The government's program aims at continuing to build the conditions for sustained output growth, with reduced poverty, low inflation, and external viability. The program hinges importantly on continued fiscal and monetary discipline and a deepening of structural reforms. The government will continue to make efforts to improve the efficiency and export competitiveness of the economy, and increase the efficiency and equity of public expenditure in health, education, the provision of justice, and poverty alleviation programs.

3. Strong and sustained economic growth is essential for improving the living conditions of the population. Since 1993, real GDP has grown by 42 percent, or at an average of 7.3 percent per year; GDP per capita has increased by an average of over 5 percent per year. In 1998, the economy is being adversely affected by *El Niño,* which has required the government to undertake a vast effort of preventive measures, containment of damage, emergency relief, and reconstructive work, and by the decline in prices of minerals in the international markets. In these circumstances, the program for 1998 aims at achieving a rate of real GDP growth of 4– 5 percent, with an inflation in the range of 7 ½– 9 percent, with a downward trend in the second half of the year. The program also aims at a further strengthening of the net international reserve position of the Central Reserve Bank, and an external current account deficit not exceeding of 5.9 percent of GDP. It is envisaged that the external current account deficit will decline significantly in 1999, and a further reduction is projected over the medium term.

4. Total investment is projected to increase from 24.6 percent of GDP in 1997 to 24.7 percent in 1998 reflecting continued private investment in the mining, communications, and energy sectors, as well as by the reconstructive effort being undertaken in the aftermath of *El Niño*. Investment in 1998 will also benefit from the measures adopted by the government to improve competitiveness, such as the reduction in tariff rates and the lowering of several other tax rates implemented in 1997. Following a significant increase in 1997, domestic savings are projected to decline slightly in 1998, reflecting the consequences of *El Niño* and the decline in the international prices of minerals.

5. The Government of Peru places high priority on fiscal consolidation. In the period 1996-97, the overall deficit of the combined public sector , excluding privatization proceeds, has declined by 2.8 percentage points of GDP to a position of equilibrium. In 1998, the government intends to maintain this position of overall equilibrium and, consistent with this objective, the primary surplus of the combined public sector, excluding privatization proceeds, will remain at 1.7 percent of GDP. The fiscal targets of the program will be monitored on the basis of the quarterly ceilings on the net domestic financing of the combined public sector, as presented in the attached table.

6. Current revenue of the central government in terms of GDP is projected to increase from 14 percent of GDP in 1997 to 14.1 percent in 1998, despite the full-year impact of tax rate reductions implemented in 1997. To achieve this level of revenue, tax administration efforts will be further stepped up. Central government current expenditure will continue to be kept strictly under control, taking into account the necessary spending associated with *El Niño*. Wage policy will remain prudent and consistent with the objectives of the program.

7. Efforts to broaden the tax base and reduce tax evasion are being intensified in 1998. In particular, efforts are being made to diminish the gap between the number of registered and actual taxpayers and between tax amounts declared and paid. Since October 1997, notices are being sent to registered taxpayers who have not filed their tax returns as well as to those taxpayers whose payments are below the amounts filed, asking them to regularize amounts due. The tax arrears regularization program will continue to be implemented and the enhanced monitoring programs that currently apply to large taxpayers will be extended to medium and small taxpayers. In June 1998 the tax administration agency SUNAT will also start collecting information on personal wealth of large taxpayers and this information will be cross-checked with that on tax payments. In the value-added tax area, the system of cross–checking the tax returns of large companies with those of their suppliers will be broadened to include information on purchases made by public sector entities, and two half-yearly audits for the 1997 tax returns will be carried out. To reduce tax evasion further, SUNAT will continue the practice of integral audits in sectors of the economy where tax evasion is high, and strengthen its enforcement capacity, including through exchange information arrangements with risk assessment bureaus, as well as giving publicity to cases of tax non-compliance. During 1998 SUNAT will develop a collection system for social security and pension contributions on behalf of the Social Security Institute (IPSS) and the National Pension Bureau (ONP), which is expected to become operational in 1999 and which will permit reductions in the collection costs of SUNAT, IPSS and ONP.

8. The implementation of an integrated expenditure information management system (SIAF) is at an advanced stage. Since mid-1997 spending units have started registering their payment operations with the SIAF, reaching 80 per cent of all units by March 1998, with the remaining units expected to be included by year end. Starting with the 1997 budget, the government introduced reforms in the budget formulation and execution processes and in the registry system of public treasury operations, with technical assistance from the Fund. Concurrently, a new functional classification of the budget structure was introduced and centralized information on treasury operations will be available later this year. Treasury cash management will continue to be improved in close coordination with the Banco de la Nación and the Central Reserve Bank.

9. The Central Reserve Bank will continue to promote the objective of reducing inflation. With this purpose, the Central Reserve Bank will continue to keep developments in the money market under close review, and if needed it will be ready to tighten its monetary policy. In this context, it will continue to ensure that its rediscount window remains a source of liquidity of last resort. To monitor the monetary program, which assumes a growth in the monetary base consistent with money demand, quarterly targets on the net international reserves and ceilings on the net domestic assets of the Central Reserve Bank have been established, as presented in the attached table. In 1998, the Central Reserve Bank has started a modernization program of the payment system in order to introduce a real-time gross-settlement system with limited and collateralized intra-day credit.

10. The government will continue to pursue a flexible exchange rate policy and central bank interventions will be aimed at smoothing out temporary fluctuations in the exchange rate. The Central Reserve Bank will monitor developments in the exchange market closely and if circumstances were to suggest the need for a further improvement in external competitiveness, the government will be ready to strengthen its fiscal position.

11. The government believes that the prudential ratios of financial intermediaries should continue to be strengthened. To that effect, in 1997 the Superintendency of Banks and Insurance (SBS) issued new regulations for the classification of bank borrowers and provisioning requirements, introduced a generic provision equivalent to 0.2 percent of performing loans, and established a timetable for a progressive increase in this provision to 1 percent by June 2000. To strengthen provisions, the SBS also removed the deduction for collateral while adjusting the provisioning requirements for collateralized loans. New norms for consolidated supervision became operational in March 1998, and recently issued SBS regulations aimed at preventing money laundering will become effective on July 1, 1998. In order to foster a new culture in the administration of risks by banks and to introduce capital requirements weighted by market risk as mandated in the Banking Law, the SBS will introduce before end-June 1998 new prudential regulations for market risks, which will become fully operational by end-1998. Also, in March 1998, the coverage of its risk assessment unit was broadened, with the inclusion of information on loans of less than S/. 13,000.

12. The program for 1998 is fully financed, and the Government of Peru intends to continue to treat the extended arrangement as precautionary. Peru’s balance of payments has

strengthened substantially in recent years, in part because of the agreements signed in 1996 and 1997 with official and commercial creditors which have helped further put the Peruvian economy on the path of fiscal solvency and external viability. The government will continue to pay close attention to debt-management policy, and the program for 1998 includes limits on the contracting or guaranteeing of nonconcessional medium and long–term public external debt and on the increase in the outstanding short–term debt of the nonfinancial public sector, as presented in the attached table. The Government of Peru has been taking steps to normalize relations with the few foreign creditors with whom small payments arrears remain, and intends to service its debt to all other creditors punctually.

13. The Government of Peru will continue implementing its privatization program, which is projected to generate US$0.7 billion in receipts to the treasury in 1998. The government intends to privatize enterprises in the energy sector, and to continue the sale of the assets of the mining complexes Centromin and Mineroperu. It also intends to sell the insurance and cement companies. To promote private ownership and investment in the agricultural sector, in 1997 the government sold 12,700 hectares of large plots of irrigated public land in the coastal region and in 1998 it intends to sell an additional 24,000 hectares. In 1998, the government will continue its program of contracting new areas for petroleum exploration and exploitation rights with the private sector; 36 such projects were in operation by the end of 1997 and the number is expected to rise to about 50 by the end of 1998.

14. In December 1996 the government enacted new legislation setting up the Commission for the Promotion of Private Concessions (PROMCEPRI), a public agency in charge of evaluating and awarding concessions to the private sector for the provision of public services and infrastructure. The areas covered by the concessions include the production and distribution of electricity, petroleum processing and distribution, the construction and operation of tourism facilities, forestry management, highways, railways, sea and air ports, and telecommunication licenses. In 1997 and early 1998, the government granted several concessions for electricity generation and transmission projects, and the construction of an electricity transmission line in the southern region of the country. During the remainder of the year, the government plans to finalize concessions for at least two major road projects, a cellular telephone band outside Lima, and for the management of some seaports, airports and the use of railways. Earlier this year the specialized regulatory agency for energy, OSINERG, became operational, and the government established a specialized regulatory agency, OSITRAN, to supervise compliance with concession contracts in public transportation infrastructure.

15. During 1998 the government will continue implementing the reform of the pension system initiated in 1993. In December 1997 the ONP issued pension bonds (*bonos de reconocimiento)* with a face value of S/. 687 million to some 36,900 former contributors of the public pension system who transferred to the private system. By end-1998 an additional S/. 700 million in pension bonds will be issued to 40,000 former contributors. Last year, the government established the Consolidated Pension Reserve Fund, an autonomous fund with earmarked resources, to meet public pension obligations falling due over the medium and long-term. Part of the 1998 privatization proceeds will be placed in an investment fund, the yield of

which will be earmarked to improve pensions. To promote portfolio diversification of private pension fund investments, the government will continue to broaden the range of instruments in which these funds can invest.

16. The government will seek to complement its efforts in the education and health sectors by facilitating private investment in these areas. In 1997, the government issued a new law allowing private companies to provide health services (EPS) within the social security system and the Superintendency of Health Services Providers, the regulatory body for the EPS, was established. During the first semester of 1998, the government will issue all necessary regulations for EPS to start operations.

17. The government has been improving the regulatory framework to encourage private sector investment in agriculture and fishing. To improve the definition and enforceability of property rights in land ownership, the government will continue implementing its land titling program and intends to issue 160,000 new land titles in urban areas and 200,000 new land titles in rural areas in 1998. In 1998, the government will continue improving regulations and supervision systems aimed at ensuring the long-term sustainability of the fishing industry and the preservation of fish species.

18. The government remains firmly committed to open trade, capital, and exchange regimes. In April 1997 the government reduced the import tariff rates to strengthen Peru's integration in the world economy and enhance its external competitiveness. At the same time, a 5 percent temporary import surcharge was introduced on certain agricultural and agro–industrial products. In 1998, Peru will join the Asia Pacific Economic Cooperation Forum (APEC).

19. The main priority of the government program is to reduce poverty and to create equal opportunity among all Peruvians. Already, significant improvement has been achieved: the share of the population living in extreme poverty has been reduced from 24.2 percent in 1991 to 18.7 percent in 1996 and access to basic services has increased significantly, with availability of drinking water and electricity in rural households having increased by 26 percent and 14 percent, respectively, between 1994 and 1996. To further reduce poverty as well as develop Peru's human capital, the government will continue to devote an increasing proportion of the budget to social spending, health and education particularly. Efforts also will be made to improve access and quality of health and education services, particularly outside Lima. To achieve this goal, the share of educational resources devoted to primary education will be increased, coordination among spending agencies in the social sectors will be strengthened and the targeting of poverty alleviation programs will continue to be improved.

20. The government believes that the policies described in this letter are adequate to achieve the objectives of the economic program, and will take any further measures that may become appropriate for this purpose. The Government of Peru and the Fund will consult periodically, in accordance with the policies on such consultations, as specified in our letter of June 4, 1996. A midterm review with the Fund will be completed prior to November 30, 1998,

to assess progress under the program, including in the area of structural reforms. The performance criteria of the program are presented in the attached table.

Sincerely yours,

Jorge Camet Minister of Economy and Finance	Germán Suárez, President Central Reserve Bank of Peru

Peru: Quantitative Performance Criteria, 1998

	March 31 Indicative	June 30	Sept. 30	Dec. 31
Cumulative changes from January 1, 1998				
(In millions of new soles)				
Net domestic financing of the combined public sector 1/ 2/ 3/ 4/	-265	-635	-922	-615
Net domestic assets of the Central Reserve Bank 1/ 2/ 3/ 4/	-8	704	-22	-353
(In millions of U.S. dollars)				
Net international reserves of the Central Reserve Bank 1/ 2/ 3/ 4/	-75	-330	-63	256
Contracting or guaranteeing of nonconcessional external public debt maturity of at least one year	100	300	700	900
Of which: 1- 12 years maturity	100	200	250	300
Short-term net external debt of the nonfinancial public sector	50	50	50	50
End-of-period stocks				
(In millions of U.S. dollars)				
External payments arrears of the public sector	– –	– –	– –	– –

1/ The limits on the net domestic financing of the combined public sector and the net domestic assets of the Central Reserve Bank will be adjusted downward, and the target for the net international reserves will be adjusted upward, to the extent that actual external disbursements to the nonfinancial public sector net of payments of principal and interest exceed US$-432 million at end-June, US$-544 million at end-September, and US$-815 million at end-December. These amounts will be deposited in a treasury account at the Central Reserve Bank.

2/ The limits on the net domestic financing of the combined public sector and the net domestic assets of the Central Reserve Bank will be adjusted upward, and the target for the net international reserves will be adjusted downward as follow: (a) by any amount in excess of US$16 million used to finance debt- and debt-service reduction operations, or to prepay external debt, including equity swaps in the privatization process; and (b) by up to a maximum of US$238 million if actual cumulative project loan disbursements to the nonfinancial public sector are below US$229 million by end-June, US$400 million by end-September, and US$574 million by end-December. The adjustments specified in this footnote will only apply to the extent that actual external disbursements to the