REPUBLICA DEL PERU

MINISTERIO DE ECONOMIA Y FINANZAS

BANCO CENTRAL DE RESERVA DEL PERÚ

Memorandum on Economic and Financial Policies of the Government of Peru for the Period April 1, 1999 to March 31, 2002

I. BACKGROUND

1. **Over the last several years Peru has made major progress through sound economic management in creating the conditions for sustained economic growth and the restoration of external viability.** Hyperinflation was stopped, and a sharp drop in output in the late 1980s was reversed. Supported initially by a Fund-monitored rights accumulation program (1991–92), and subsequently by two extended arrangements up until end-March 1999, inflation fell from over 7,650 percent in 1990 to 6 percent in 1998, while real GDP grew by 5.0 percent a year on average from 1991 to 1998. Prudent fiscal policies reduced the combined public sector deficit from 8.7 percent of GDP in 1990 to 0.5 percent of GDP in 1998. The net international reserves of the Central Reserve Bank rose from US$0.5 billion at end-1990 to about US$9 billion at end-1998 (with gross reserves equivalent to 11 months of imports of goods and services).

2. **In support of its macroeconomic policy, Peru implemented an ambitious structural reform program in the 1990s to enhance economic efficiency and improve social conditions.** The government sold major public enterprises in the telecommunications, energy, financial, fishing and mining sectors and reduced its participation in the electricity and petroleum sectors through the award of concessions and sales to the private sector. In the financial sector, the authorities introduced a new banking law in 1996 to strengthen the Superintendency of Banks and Insurance (SBS), and have since continued to improve the soundness of the banking system. A private pension system, based on individual capitalization, was created in 1993 as an alternative to the public pension system, and workers are encouraged to switch from the public to the private pension system. Fiscal reforms have simplified the tariff system, revamped customs procedures, strengthened tax administration, and reduced bureaucratic procedures. Regulations have been simplified in order to establish clear guidelines for fostering private sector investment, particularly in the areas of telecommunications, energy, agriculture, and mining. The government has implemented reform programs in education and health, and poverty levels have declined through the combined effect of more rapid economic growth and targeted efforts to alleviate poverty, especially in the poorest regions of the country. The incidence of extreme poverty declined from 26.8 percent in 1991 to 14.7 percent in 1997, and the government intends to reduce it to no more than 10 percent by end-2000.

3. The government has taken a series of major steps to normalize relations with external creditors and restructure external debt, thereby facilitating the return to external viability. These actions started with the regularization of relations with Paris Club creditors in 1991, followed by the clearance of all arrears to international financial institutions in 1993. Official external debts to the Paris Club creditors were renegotiated in 1996, with a rescheduling agreement that provided relief of US$1.3 billion in the period 1996–98. Peru graduated from Paris Club rescheduling at the end of 1998, and a re-profiling of the stock of debt became effective on January 1, 1999. In early 1997, Peru successfully concluded a debt and debt-service reduction operation with commercial creditors.

4. The economy was weakened in 1998 by the combined effects of *El Niño*, a sharp drop in export commodity prices, and a liquidity crunch stemming from turbulence in international financial markets. Growth of real GDP slowed to 0.7 percent and the external current account deficit widened, while the overall fiscal position deteriorated from balance to a deficit of 0.5 percent of GDP. The economic program for 1999–2001 is thus framed against the need to regain the momentum of sustained growth and consolidate progress toward a sustainable external position and lower inflation, while the government also perseveres in its efforts to improve social conditions and reduce poverty.

II. MACROECONOMIC PROGRAM

5. The government intends to direct its economic policies toward promoting sustainable growth of output and employment, consolidating progress toward external viability, and continuing efforts to reduce inflation. Our policies for sustained growth, which are central to our anti-poverty strategy, are complemented by focused efforts to address priority social needs.The government's strategy for growth envisages policies that will foster a thriving private sector, which must be the main source for generating employment, including in sectors such as construction and agriculture that are labor-intensive.

6. The macroeconomic program will aim at restoring real GDP growth in 1999 to 3–4 percent and raising it to 6 percent by 2001, while maintaining inflation at 5–6 percent in 1999 and lowering it to about 3 percent by 2001. An increase in net international reserves of US$0.4 billion is envisaged for 1999, followed by further increases in 2000–01 that will keep international reserves fairly stable in relation to imports.

7. Gross domestic investment and national savings will be strengthened through a deepening of structural reforms that will further increase private sector participation in

the economy, reduce the role of the public sector in economic activity, and lessen the reliance on external saving. Total investment is projected to increase from 22.9 percent of GDP in 1999 to 23.8 percent in 2001 on the strength of private investment, especially in the energy, mining, construction, and telecommunications sectors. Over this period, national savings are projected to grow from 17.8 percent to 19.0 percent of GDP, with public savings accounting for more than half of this increase. Reliance on foreign savings would decline from 6 percent of GDP in 1998 to 5 percent of GDP in 1999, and the longer-term objective is to bring the external current account deficit below 3 percent of GDP. However, large foreign-financed investment projects in the mining and energy sectors will boost import requirements over the period 2000–02, so that by the end of the program period (2001) the current account deficit is expected to be just under 5 percent of GDP.

8. Over the medium term, the government will continue to raise public savings and make room for private investment. The combined public sector primary surplus (excluding privatization proceeds) is projected to decline from 1.3 percent of GDP in 1998 to 0.9 percent of GDP in 1999, before improving to 1.6 percent of GDP in 2001, when the overall position is expected to be in approximate balance. The decline in the primary surplus in 1999, to 0.9 percent of GDP, reflects a moderately lower level of tax collections (resulting from the lagged effect of the slowdown in economic activity in 1998) and higher outlays for public sector wages and pensions following the first increase since August 1997. These changes could not easily be offset in view of the need to continue with the reconstruction of public infrastructure damaged by *El Niño*. The fiscal objectives of the program for 1999 will be monitored on a quarterly basis through a ceiling on the combined public sector borrowing requirement as set out in Table 1. Also, this ceiling will be adjusted downwards in the event that central government revenue exceeds programmed levels, up to the point where the primary surplus reaches 1.3 percent of GDP, so as to save the additional revenue and thus strengthen the fiscal position. However, if revenues fall short of programmed levels, the government will take additional measures that may be needed to achieve the fiscal targets for 1999. Looking ahead to the fiscal program for 2000, the government will adopt the measures needed to achieve the revenue objectives, in particular to offset the scheduled elimination of the special solidarity tax (IES). These measures will be approved prior to completion of the first program review.

9. The government will seek to enhance the efficiency and equity of the tax system. To improve the yield performance of the tax system by broadening the tax base and reducing evasion, eliminating distortions, and enhancing its equity, the government will seek technical assistance from the Fund in the area of tax policy in 1999. The government will evaluate the recommendations and start to implement in 2000 those reforms that it considers desirable.

Meanwhile, the government will refrain from expanding the scope of sectoral or regional tax preferences or exemptions and, more generally, it will avoid further discretionary revenue-reducing actions.

10. The government will continue its efforts to strengthen tax administration. In 1999, the tax administration agency SUNAT will continue its work to reduce tax evasion. By August 1999, it will start collecting social security and pension contributions on behalf of the public health care agency (ESSALUD) and the National Pension Bureau (ONP), which will contribute to the modernization of the state and is expected to lower collection costs and reduce evasion. SUNAT has started to gradually introduce mechanisms that will permit the filing and payment of taxes by electronic means, thus facilitating tax compliance; it is expected that at least 90 percent of tax revenue will be collected in this way by 2000. SUNAT also will establish an integrated control system by mid-2000, which will permit close monitoring of tax compliance. In addition, in 2000 SUNAT will improve the identification system for individual taxpayers on the basis of their national identity document, which will facilitate cross-checking of data. In 1999, it will finalize the audits of the fishing and construction sectors initiated in late 1998 and it will also carry out an audit of the mining sector, including close examination of drawback claims; subsequently it will conduct other audits concentrated in specific sectors. SUNAT also will examine carefully the tax exemptions claimed under the recently enacted Amazon Law in order to minimize tax avoidance and evasion in this area.

11. The peace treaty with Ecuador will permit a reallocation of central government resources away from military expenditure and toward the social sectors. The reduction in arms purchases in 1999 will provide room for increased spending in the areas of health and education, including to improve the wages of teachers and health care workers. The government will pursue a results-oriented approach to reducing poverty by improving the targeting of poverty alleviation programs. Focus will be placed on the poorer segments of the population in both urban and rural areas (see paras. 27–29).

12. An integrated system of financial administration and expenditure control for the central government budget (SIAF) is well advanced. Since end-1998, almost all units of the central government are registering their payment operations in this system regularly. With effect from January 1999, the system is being used also for expenditure management and control purposes. The budget directorate communicates monthly expenditure allocations to spending units through the SIAF, and this is the basis for the subsequent steps from expenditure commitment to cash payment, each of which is subject to verification in the system as it is taking place. By September 1999 the SIAF's operation as an instrument of expenditure management and control will be evaluated.

13. The monetary program is based on the inflation objective for 1999, for which the central bank will continue to utilize base money as its intermediate target. To ensure that the growth in private sector credit is in line with the program objectives, the central bank will keep credit developments under close review, and will continue to utilize prudent policies with respect to reserve requirements and open market operations as needed. A ceiling on the expansion of net domestic assets and a floor on the accumulation of net international reserves of the central bank have been established as indicated in Table 1. For program monitoring purposes, the calculation of net international reserves treats banks' foreign currency deposits in the central bank as a reserve liability. Thus, in Table 1 international reserves are broadly stable in 1999, compared with an increase of US$0.4 billion on an unadjusted basis.

14. The government recognizes that the maintenance of a healthy banking system and its efficient operation require a sound macroeconomic environment, and vice versa. Several actions have been taken in recent years to enhance the soundness of the system and the SBS's ability to detect bank problems and pursue appropriate remedies. Most recently, a banking reform was enacted in May 1999 that will: (i) permit the SBS to step in sooner by clarifying trigger points for surveillance and intervention; (ii) increase the efficiency of liquidation procedures and reduce the cost of bank liquidation (transferring the "good" assets to another financial institution and liquidating the rest); (iii) strengthen the SBS's ability to pursue appropriate remedies by providing a proper legal framework for its activities; (iv) give the deposit insurance fund (FSD) an active role in supporting and monitoring bank restructuring and allow the FSD to take temporary control of a bank under exceptional circumstances; and (v) tighten the limits on connected lending.

15. In the area of prudential regulations for the banking sector, the SBS is proceeding with scheduled increases in provisioning requirements, and is strengthening capital requirements so as to take appropriate account of market risk. Also, simplified money laundering regulations will be issued by December 1999. The SBS will continue to rely on forward-looking supervisory processes, by improving the existing risk-based supervision approach, which includes an analysis of credit, market, liquidity, operational and contagion risk. To have access to accurate and timely information on the financial institution's exposure to the above risks, the SBS will take steps to modernize the credit risk bureau with an updated information system.

16. In view of the virtual halt of bank lending in late 1998 and early 1999, the government is taking steps to facilitate the resumption of lending by channeling public sector resources for the restructuring of private sector debt to domestic banks. The aim of this program is to

lengthen the maturity of bank loans and provide the banking system with additional liquidity that does not entail a fiscal subsidy. To this end, public sector resources are being onlent to banks by COFIDE, a second-tier public sector financial institution. It is intended that this credit program not be used to support insolvent borrowers or unsound banks. Accordingly, the credits for this purpose will be subject to COFIDE's prudential lending limits for individual banks; banks will bear the credit risk on the refinanced loans; and banks will not be allowed to refinance debts of related parties. It is intended that the refinancing program, as with all of COFIDE's lending activities, not impede the process of bank restructuring or consolidation that may be needed in some cases. COFIDE's operations will remain second-tier only, i.e., it will refrain from direct lending to the corporate sector. Since the debt restructuring program will be limited in size and duration, COFIDE's lending for this restructuring will be limited to US$1.0 billion, which we expect to be fully disbursed by end-1999. We estimate that no further lending for debt restructuring will be needed beyond this amount.

17. The government will continue to implement a flexible exchange rate policy, permitting the economy to adapt to terms-of-trade and other external shocks. During the period of the arrangement, central bank interventions in the foreign exchange market will be aimed at smoothing out temporary fluctuations in the exchange rate, and the central bank will continue the practice of not intervening in the forward foreign exchange market.

18. The government aims at consolidating the recent gains in Peru's external debt position over the next three years. To continue improving the terms of Peru's debt, the program places a ceiling on the contracting or guaranteeing of nonconcessional medium- and long-term external public debt and on the outstanding short-term debt of the nonfinancial public sector as described in Table 1. The servicing of all public sector debt will continue to be made as scheduled.

III. STRUCTURAL REFORMS

19. In the period 1999–2001, the government will intensify the structural reform program that was started in the early 1990s. The areas to be covered will include privatization and concessions, the regulatory framework, financial sector reform, and social programs including for education, health, and poverty alleviation. To facilitate the monitoring of progress with this program, selected elements will be subject to structural benchmarks as shown in Table 2.

20. The government will take steps to reinvigorate its privatization and concession program. To enhance the efficiency of the economy, the government has implemented a program of privatization since the early 1990s that has successfully transferred numerous enterprises to the private sector. In 1999, the government will make greater inroads in this area. First, the government will sell its remaining equity in previously privatized enterprises. Second, it will privatize the remaining publicly owned mine and some small manufacturing enterprises. Third, as part of the government's reform program aimed at raising potential growth in the agricultural sector, it will sell 25,000 hectares of agricultural land. This program also includes additional titling of private lands, including the issue of at least 80,000 rural land titles in 1999. Fourth, the government will also make available for sale a list of fixed assets that would include major office buildings. In 2000, all remaining public enterprises in the mining sector will be offered for sale. The government, as shareholder in a number of sugar plantations, will encourage the injection of capital and transfer of management control of these former sugar cooperatives to strategic partners. Further steps in the privatization program, to be implemented in 2000 and 2001, will be discussed prior to the completion of the second review under the extended arrangement.

21. The increased use of concessions will complement the privatization program in reducing public sector participation in activities that are best left to the private sector. The government will award concessions for: the management of a number of forests, starting with Biabo in 1999; the Lima-Pativilica and Lima-Canta-Unish highways in 1999 and the Lima-Ica highway in 2000; the Ilo and Matarani seaports in 1999, and three other port concessions, including Callao, in 2000; the Lima airport in 1999 and airports in Arequipa, Cusco, Trujillo, and Iquitos in 2000; three fields for mining exploration owned by Centromin in Quicay, Toromocho, and Michiquillay in 1999; six fields for mining exploration owned by Mineroperu in 1999, and 11 other mine prospects in 2000–01; and five oil prospecting sites in 1999 and a similar number of sites in 2000–01; and all state railway lines in 1999. It also will auction the licenses in 1999 for new wireless communications systems. As long as the public sector continues to participate in the petroleum sector, it will follow sound business practices in the setting of domestic prices of refined petroleum products. The tender for the Camisea natural gas project has been announced for mid-1999 and should be adjudicated by end-1999. Total receipts from the privatization and concession programs are expected to yield at least US$800 million for the Treasury in 1999.

22. In the context of the privatization and concession agenda, the government will continue to strengthen the regulatory framework for economic activities, particularly for agricultural and rural development. To provide adequate regulation of recent legislation on land rights, including the legal framework for sales and transfers of agricultural land, revised norms will be issued by end-1999. These regulations will provide for an updated rural land registry that will, in conjunction with the rural land titling program, help secure the property rights of rural landowners. To promote growth in rural areas through more efficient use of agricultural resources, a draft law on water rights will be prepared for presentation to congress in 2000. This reform would allow for the transfer of water rights and establish a framework for tariffs on water usage based on the cost of providing the necessary infrastructure, and would modify regulations for associations of water users. With a view to fostering growth in the economy more generally, the government will review its policies on the promotion of technological innovation, and will assess whether it properly supports research and development activities undertaken by the private sector.

23. The program of privatization and concessions is part of the government's effort to redefine the role and appropriate dimensions of the public sector. Over the next year we will undertake preliminary studies regarding government functions (current and prospective) and assess our manpower needs in the various branches of government. These studies will form part of our continuing efforts to ensure a high quality of government expenditure.

24. To consolidate recent pension reform efforts, the government will introduce additional measures to strengthen the private pension system (SPP) and ensure the actuarial soundness of the public National Pension System (SNP). With respect to the SPP: (i) the pension supervisory authority (SAFP) will be granted access to personnel records of employers in payment arrears; (ii) the SBS and SAFP will improve coordination in the supervision of interlinked banks, insurance companies, and privately administered pension funds (AFPs); (iii) the SAFP will identify an expanded set of permissible investments for the AFPs; (iv) a study will be completed, under a World Bank loan, on the steps needed to reduce administrative costs and will develop specific targets for their reduction; and (v) the government will issue 40,000 recognition bonds for an estimated S/. 700 million (0.35 percent of GDP) in 1999, and 40,000 in each of the following two years.

25. For the SNP, the government: (i) will improve accounting controls and the cost-efficiency of the system by permitting SUNAT to collect pension contributions, register contributors to the SNP, and resolve disputes on behalf of the SNP; and (ii) will ensure that adequate funding of future obligations of the SNP is put in place by transferring additional resources to the FCR (Fondo Consolidado de Reservas) and establishing a solid, long-term investment

program for the FCR. Conservative portfolio management practices will be followed for this fund, as well as for the supplementary pension fund (FONAHPU).

26. To strengthen domestic capital markets, the government will focus on two key areas. First, to improve the effectiveness of capital market regulation, it will establish a mechanism to enhance coordination among the SBS, the SAFP, and the Superintendency of Companies and Securities (CONASEV). Second, the government will seek to promote a deepening of the domestic capital markets over the medium term, initially by studying the feasibility and appropriateness of a program of issuing long-term government securities for the purpose of establishing a yield curve. By end-1999 it is expected that tax legislation will be adapted as needed to be consistent with the development of new financial instruments and markets, including for the development of a secondary mortgage market.

27. In the social sector, the government attaches high priority to reducing poverty and improving the overall impact of social programs through better coordination among the various ministries and agencies involved. With support from the World Bank, the government will identify key social programs that, beginning this year, will be protected from budget cuts, including basic education and basic health. At the same time, the government will continue to improve the targeting of existing poverty alleviation programs and will strengthen them through better design and closer coordination among ministries, based in part on a new poverty map that will be published by December 1999. In addition, the government will develop a set of core social indicators to measure improvements and track progress in its programs, and will develop a monitoring and evaluation plan by December 1999.

28. To make spending on education more efficient and equitable, **the government will provide teachers with methodological guidance materials and training based on the analysis of school performance by October 1999.** The government will progressively allocate more resources for basic education in 2000 and 2001 to boost investment in the education of children in poverty as well as to improve teaching standards in rural areas. To achieve a better balance in the use of public sector resources for education, the government will gradually shift its budget in this area toward basic education for both equity and efficiency reasons. In addition, the teacher payroll will be verified and updated, and a unified registry established by June 2000.

29. In the area of health care, the government will improve primary care for the poor, and broaden access to publicly provided health care for the non-poor. On primary health care, the government will raise the current funding level progressively starting in 2000. The government will introduce programs to encourage community management of health care establishments, and introduce 600 more establishments of this kind by January 2000. The government will enhance access to basic services by establishing maternal-infant health insurance in six health regions by December 1999. Regarding access to health care, early this year the government implemented a fee-based plan to expand insurance coverage by ESSALUD and private insurers for the self-employed, the unemployed, and their dependents.

30. As an important part of the overall strategy to strengthen the social safety net, the government will improve the targeting of social spending, including for the provision of basic infrastructure and food and nutrition programs to the poorest segment of the population, and it will take steps to increase the cost-effectiveness of such programs. The government will make explicit the nutritional objectives and targeted population for each program and design entry and exit criteria for program beneficiaries by June 2000. In addition, the government will develop a system of control that would permit external monitoring, supervision, and evaluation of its programs, including the administrative control of food distribution by June 2000. For basic infrastructure, the government will undertake projects in water and sewage systems, roads and electrification in the poorest regions of the country.

31. The government remains firmly committed to open trade, capital, and exchange regimes, and it will continue to deepen trade and customs reforms. It is firmly committed not to introduce nontariff barriers for protectionist purposes or in a manner that is otherwise inconsistent with Peru's obligations as a member of the WTO. In 2000, it will narrow the tariff dispersion by 2 percentage points. Peru will continue to participate in regional trade agreements aimed at expanding the benefits of liberal trading systems.

32. The government has launched a comprehensive program to deal with the Y2K problem, coordinated through a central office in the National Statistics Institute (INEI). SUNAT's data system for tax administration and the financial sector's payments system are Y2K compliant, while a plan is being put in place to prepare the banking system for this contingency. By November 1999 it is expected that the utilities sector will be in full compliance, and tests of compliance for the treasury's expenditure management system will be completed.

Table 1. Peru: Quantitative Performance Criteria, 1999

	Prel. March 31	June 30	Sept. 30	Dec. 31
	(Cumulative amounts from December 31, 1998, in millions of new soles)			
Borrowing requirement of the combined public sector[1,2]	869	1,750	2,255	2,340
	(Cumulative change from December 31, 1998, in millions of new soles)			
Net domestic assets of the Central Reserve Bank[3,4,5,6]	1,180	2,511	1,050	13
	(Cumulative change from December 31, 1998, in millions of U.S. dollars)			
Net international reserves of the Central Reserve Bank[3,4,5,6,7]	-434	-733	-313	53
Short-term external debt of the nonfinancial public sector	50	50	50	50
External payments arrears of the public sector[8]	0	0	0	0
	(Cumulative amounts from December 31, 1998, in millions of U.S. dollars)			
Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year	270	1,780	2,590	2,600
Of which: 1-12 years' maturity	30	670	1,060	1,060

[1]Including the operating balance of the central bank; privatization proceeds are included below the line.
[2]The limits on the borrowing requirement of the combined public sector will be adjusted downward to the extent that revenue of the central government exceeds S/. 12,625 million at end-June, S/. 19,670 million at end-September, and S/. 27,265 million at end-December. The downward adjustment to the borrowing requirement will not exceed S/. 400 million at end-June, S/. 600 million at end-September, and S/. 800 million at end-December 1999.
[3]The limits on net domestic assets will be adjusted downward, and the targets for the net international reserves will be adjusted upward, to the extent that privatization proceeds in foreign currency exceed the assumed amounts of US$141 million by end-June, US$336 million by end-September, and US$800 million by end-December 1999. The amounts in excess will be deposited at the Central Reserve Bank.
[4]The limits on net domestic assets will be adjusted downward, and the targets for net international reserves will be adjusted upward, to the extent that net foreign borrowing of the nonfinancial public sector exceeds US$355 million at end-June, US$886 million at end-September, and US$1,038 million at end-December 1999. These amounts will be deposited at the Central Reserve Bank.
[5]The targets for net international reserves will be adjusted downward, with commensurate upward adjustments to the limits on net domestic assets, for shortfalls from programmed amounts of privatization proceeds in foreign currency, of net foreign borrowing, and of 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 end-June, US$500 million at end-September, and US$600 million at end-December 1999, and within the total the downward adjustment for shortfalls in privatization proceeds will not exceed US$100 million at end-June, US$200 million at end-September, and US$200 million at end-December 1999.
[6]The limits on net domestic assets will be adjusted upward, and the targets for net international reserves will be adjusted downward, by the amount used to prepay external debt, including debt equity swaps in the privatization process.
[7]For the purpose of the program, the definition of net international reserves includes, as a reserve liability, the financial system's deposits in foreign currency that are held in the Central Reserve Bank.
[8]Excluding arrears associated with nonrescheduled debt to foreign creditors outstanding as of end-1998.

Table 2. Peru: Structural Benchmarks

To be completed by June 30, 1999

1. Open bidding process on Camisea natural gas project

To be completed by Sept. 30, 1999

1. Bring one public enterprise in the mining sector to the point of sale
2. Sale of remaining shares in privatized enterprises in the telecommunications sector
3. Award concessions for mining exploration of 3 fields

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To be completed by Dec. 31, 1999

1. Award concession for operating Lima airport
2. Award concession for Ilo and Matarani seaports
3. Award concession for all railway lines
4. Award contract on Camisea natural gas project
5. Sale of remaining shares in privatized enterprises in the energy sector
6. Sale of agricultural land: 25,000 hectares
7. Issue 80,000 rural land titles in 1999
8. Establish set of social indicators to improve the targeting of social expenditure