REPUBLICA DEL PERU

MINISTERIO DE ECONOMIA Y FINANZAS **BANCO CENTRAL DE RESERVA DEL PERÚ**

Lima, Peru
March 13, 2000

Mr. Stanley Fischer
Acting Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Fischer:

1. The Peruvian economy has begun to recover from three severe exogenous shoc*ks* *(El Niño*, the deterioration in the terms of trade that followed the Asian crisis, and the international financial market turbulence), thanks to a robust expansion in agriculture, fishing, and mining. Real GDP rose by an estimated 3.8 percent in 1999, despite a reduction in domestic demand that was larger than contemplated in our memorandum on economic and financial policies (letter of intent) dated June 7, 1999. In this context, the external current account deficit declined to 3.6 percent of GDP (compared with 5 percent of GDP in the program), and inflation declined to 3.7 percent (compared with a target range of 5–6 percent in the program).

2. The weakness in domestic demand led to a significant reduction in tax collections, and central government current revenue declined to 12.8 percent of GDP in 1999, compared with a projection of 13.6 percent. In view of the adverse impact of low domestic demand on many sectors of the economy, the government decided to avoid a reduction in public expenditure. The fiscal deficit rose to an estimated 2.5 percent of GDP, compared with 1.2 percent of GDP in the program. The larger fiscal deficit and lower privatization receipts did not entail larger external disbursements than programmed, but resulted in a drawdown of government deposits in the central bank. Consequently, the performance criteria for December 1999 relating to the public sector borrowing requirement, net international reserves, and net domestic assets of the central bank were not observed, and we are hereby requesting waivers for the nonobservance of these performance criteria.

3. The responsible management of fiscal and monetary policies and the adoption of a wide range of structural reforms have helped to consolidate the economic stabilization and raised potential output. The government is convinced that these policies provide the most appropriate framework for an effective strategy to combat poverty. To solidify this framework by ensuring a continuation of prudent fiscal conduct over the medium and long term, Congress approved a law on fiscal responsibility in December 1999. It sets limits to the deficit, the growth of general government expenditure, and the increase in public debt. In addition, it provides for the creation of a fiscal stabilization fund to generate savings during boom periods that would be utilized in times of recession or emergency. Also, the law requires that the public sector budget be prepared within a three-year macroeconomic framework, and it contains other features aimed at fostering fiscal transparency. For the purpose of fiscal transparency, plans for assisting individual sectors will avoid contingent fiscal costs, and so will channel fiscal support through the budgetary accounts.

4. In light of the developments in 1999, it is expected that real GDP will grow by 4–5 percent in 2000, with inflation remaining in the range of 3.5–4 percent, the external current account deficit reaching about 4 percent of GDP, and net international reserves increasing by US$300 million. Fiscal policy has been designed so as to strike a balance between making progress toward fiscal consolidation and not jeopardizing the economic recovery. Consistent with the Law on Fiscal Responsibility, the government intends to limit the deficit of the consolidated public sector in 2000 to 1.9 percent of GDP, with general government noninterest expenditure in real terms growing by less than 2 percent. To help achieve the deficit objective , the special payroll tax (IES) has been renewed for one year. However, the tax on net assets was allowed to expire at end-1999 out of concern that its burden would fall disproportionately on firms facing large decreases in demand. If necessary, the government will take additional measures to ensure that the deficit targets are observed. Also, there will be no widening of the scope for rescheduling tax liabilities or of tax relief, including for individual sectors or regions, and more generally no new tax measures that imply lower collections. In the event that fiscal revenue exceeds programmed levels, most of the additional revenue will be used to reduce the deficit. As part of the current program to improve tax administration, the tax collection agency SUNAT will conclude tax audits in the mining sector which are underway and will conduct audits for other sectors.

5. Bank liquidity returned to normal levels during the first half of 1999, but bank credit to the private sector declined during the year, reflecting banks' reluctance to increase their exposure to a highly indebted corporate sector in a context of weak economic activity. The changes in banking legislation that took effect in May 1999 and the increases in provisioning requirements that are being implemented are aimed at improving the soundness of the banking system. The government will continue to promote market-based solutions in the banking sector, including mergers, capitalization of banks by the private sector, and strengthening banks' risk management and internal controls, which have been giving positive results. We are confident that the banking system is not facing systemic risks, and note that the deterioration of loan quality has slowed down.

6. The government has introduced a new program for enterprise debt restructuring. This program widens access to formal restructuring procedures by eliminating requirements based on the size of the debt and net worth of the firm, makes it easier for banks to capitalize claims on enterprises, and establishes streamlined procedures which would allow debtors and creditors to reach an agreement faster. To encourage these agreements, the tax liabilities—which in the absence of a restructuring agreement would be difficult to collect—will be subject to the same repayment periods and interest rates that are applicable for most other liabilities of the enterprise being restructured; to protect public resources, the tax liabilities would not be capitalized or written off. We believe that this program will facilitate market solutions for dealing with the problems of highly indebted, but solvent, enterprises and thus will contribute to a sustained economic recovery.

7. The government made progress during 1999 in implementing policies aimed at enhancing efficiency and competitiveness of the economy, and it met a majority of the structural benchmarks presented in the June 1999 policy memorandum. However, for various

reasons ranging from legal issues related to limits on market concentration to ensure competition, to requests from firms for additional time to make bids, some projects and plans were postponed, such as the Camisea natural gas project, the operating concession for the Lima airport, and the sale of agricultural lands and of shares in a previously privatized electricity company. To foster private investment and generate employment, the government will promote the transfer of public agricultural land to the private sector by selling 5,000 hectares of arable land, issuing 250,000 land titles, and registering 250,000 land titles during the first half of the year; it will also promote the Camisea natural gas project as well as the concessions in the telecommunications sector and the Biabo forest. The proceeds from asset sales and concessions are expected to reach US$650 million in 2000.

8. The government continues to give priority to the social sectors and its poverty reduction strategy, including through a better targeting of health, education, and projects for rural infrastructure. In 1999, 600 local Health Committees (CLAS) were formed for providing primary health care, and steps were taken to introduce maternal-infant health insurance in seven regions. In 2000 this insurance will be widened, and the CLAS will be expanded to include the creation of support units. The aim is to improve access to health care for the poorer sectors of the population, particularly those most vulnerable, women and children. In education, the objective of providing teacher training and developing teaching guides in 1999 was met. In 2000 the government will develop a plan to improve the quality of education based on performance indicators. Also, it will seek to improve equity in the school system, initially by evaluating alternative mechanisms for attracting and retaining qualified teachers in rural areas. In addition, to combat poverty more efficiently, by end-June 2000 the government expects to have developed a set of social indicators that can be used to measure the effectiveness of the main social programs, and to have completed a study aimed at improving the targeting of social investment on the basis of a new poverty map.

9. The other elements of our economic program, which are not described in this letter, will continue to be guided by our memorandum on economic and financial policies (letter of intent) of June 7, 1999. The Government of Peru and the Fund will consult periodically, in accordance with the usual policies on such consultations, as specified in the letter just mentioned. The second review under the extended arrangement will be completed no later than September 30, 2000. As before, Peru does not intend to make purchases under this arrangement from the Fund. The quantitative performance criteria and structural benchmarks through June 2000 are specified in Tables 1 and 2, respectively.

Sincerely yours,

Efraín Goldenberg
Minister of Economy and Finance

Germán Suárez
President of the Central Reserve Bank of Peru

Table 1. Peru: Quantitative Performance Criteria, 2000

	March 31	June 30
(Cumulative amounts from December 31, 1999, in millions of new soles)		
Borrowing requirements of the combined public sector 1/2/	1,060	1,820
(Cumulative change from December 31, 1999, in millions of new soles)		
Net domestic assets of the Central Reserve Bank 3/4/5/6	-368	-245
(Cumulative change from December 31, 1999, in millions of U.S. dollars)		
Net international reserves of the Central Reserve Bank 3/4/5/6/7/	-45	-71
Short-term external debt of the nonfinancial public sector	50	50
External payments arrears of the public sector 8/	0	0
(Cumulative amounts from December 31, 1999, in millions of U.S. dollars)		
Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year	715	985
Of which: 1–12 year's maturity	75	225

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/. 6,416 million at end-March and S/. 13,330 million at end-June 2000. The downward adjustment to the borrowing requirement will not exceed S/. 200 million at end-March and S/. 400 million at end-June 2000.

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$100 million at end-March and US$300 million at end-June 2000. 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$300 million at end-March and US$400 million at end-June 2000. 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$115 million at end-March and US$125 million at end-June 2000, and within the total the downward adjustment for shortfalls in privatization proceeds will not exceed US$50 million at end-March and US$120 million at end-June 2000.

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-1999.

Table 2. Peru: Structural Benchmarks

To be completed by March 31, 2000

1. Announce results of bidding on gas extraction for the Camisea project.
2. Bring to the point of sale the remaining shares in two privatized enterprises in the energy sector.

To be completed by June 30, 2000

1. Announce results of bidding on the concession for management of the Biabo forest.
2. Announce results of bidding on two concessions in telecommunications.
3. Announce results of bidding on the concession on gas transportation and distribution for the Camisea project.
4. Bring to the point of sale 5,000 hectares of arable land.
5. Issue 250,000 land titles.
6. Register 250,000 land titles.
7. Construct set of indicators for an improved evaluation of social programs.
8. Conclude a study for improved targeting of social investment at the district level.