MINISTERIO DE ECONOMÍA Y FINANZAS

BANCO CENTRAL DE RESERVA DEL PERÚ

Lima, Peru
February 6, 2001

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Köhler:

1. This letter describes the economic policies that the Government of Peru intends to follow during the period January 1, 2001 to December 31, 2001. Through a prudent management of fiscal and monetary policies and further progress in structural reforms, the program seeks to ensure a solid economic situation in the transition to a new government that will take office at end-July 2001.

2. The Government of Peru seeks support from the International Monetary Fund for its economic program and hereby requests a stand-by arrangement for 2001 in an amount equivalent to SDR 128 million. It is not expected that purchases under the arrangement will be necessary. The successful implementation of the economic program supported by the Fund should generate the required external resources to meet our external debt-service obligations as scheduled while allowing an increase of net international reserves. Accordingly, the government intends to treat the arrangement as precautionary.

BACKGROUND

3. Since 1997, the Peruvian economy has been beset by a combination of severe external shocks (El Niño, deterioration in the terms of trade following the Asian crisis, and international financial turmoil) and by serious political difficulties leading up to and after the change of government in July 2000. These political difficulties resulted in the removal from office of the previous president and the appointment by congress of an interim constitutional government on November 22, 2000, headed by President Valentín Paniagua-Corazao. Elections will be held on April 8, 2001, with a change of government on July 28. In this environment, the recovery in economic activity that began in the first half of 2000 lost momentum, and private investment and economic activity slowed down in the second half of the year. Preliminary estimates for 2000 suggest that real GDP grew by 3.6 percent, the external current account deficit narrowed to 3 percent of GDP, and inflation ended the year at 3.7 percent.

4. The fiscal deficit is estimated to have ended the year at about 3 percent of GDP, above the limit of 2 percent of GDP established under our Law on Fiscal Responsibility and Transparency, mainly owing to a deterioration in revenue performance. Expenditure grew faster than originally planned in the run-up to the elections of 2000, but was scaled back beginning in August to offset the earlier expansion. Government deposits in the central bank fell substantially in 2000 mainly due to the overrun in the deficit, as well as to lower-than-envisaged privatization receipts and net external disbursements to the public sector.

5. Bank credit to the private sector declined for a second straight year in 2000, reflecting the continued reluctance by banks, despite ample liquidity, to increase their exposure to a highly-indebted corporate sector. Bank loan quality has deteriorated in the last two years, in part associated with the recent external shocks, and bank profitability has remained weak. On the positive side, the banking system has undergone significant consolidation in the last two years: six weak banks were closed, six banks merged, and two banks are in the process of seeking new investors. About half of the banking system is presently foreign-owned and four of the 15 banks in the system hold over 75 percent of total deposits. Bank provisioning stood at above 80 percent of nonperforming loans as of end-November 2000.

6. Notwithstanding the political upheavals of last year, progress was made in implementing structural policies aimed at improving the efficiency and competitiveness of the economy. During its first month, the new government completed the awarding of the operating concession for the large natural gas project, Camisea, and will complete the Lima airport concession in February 2001. These concessions have a combined investment commitment of roughly US$ 4 billion. During 2000, remaining government shares in two previously privatized electricity firms were sold, as were frequency bands for specialized telecommunications services. To foster private sector development in the agricultural sector, state-owned land was sold and the program of titling and registration of privately-held agricultural land continued to be implemented.

MACROECONOMIC PROGRAM AND STRUCTURAL REFORMS IN 2001

7. The government's goal in the transition to a new administration is to support economic recovery and set the conditions for sustained growth of output and employment. This will be achieved through responsible management of fiscal and monetary policies and further progress in structural reforms. Real GDP is projected to grow between 2 and 3 percent in 2001, with inflation declining to between 2.5 and 3.5 percent, and the external current account deficit falling further to 2.4 percent of GDP. Net international reserves, which remain at a comfortable level, would increase by US$215 million.

8. Fiscal policy in 2001 will aim at bringing the fiscal situation back in line with the Law on Fiscal Responsibility and Transparency, which will help enhance the credibility of the government's commitment to prudent policies. In this regard, the deficit of the combined public sector will be limited to 1.5 percent of GDP, which would also reduce the government's need to tap into domestic savings and alleviate pressure on domestic interest rates. To monitor the fiscal objectives, the program includes as performance criteria quarterly ceilings on the public sector borrowing requirement as set out in Table 1.

9. To meet the fiscal target, general-government, noninterest expenditure will be cut by 1.4 percent of GDP (a decline in real terms of 5 percent), most of which comes from a freeze on current expenditures for most sectors of the budget. Priority social program spending will be protected, while outlays of the Ministries of Defense and Interior will be cut by 0.3 percent of GDP. In 2001, the level of general government current revenue plus transfers from public enterprises will remain at its 2000 level of 17.4 percent of GDP. To

attain the revenue objective in the context of the projected slowdown in economic activity, excise taxes on petroleum products, alcoholic beverages, cigarettes, and bottled water have been increased and the special payroll tax (IES) was extended for an additional year. The government will stand ready to take additional revenue-enhancing measures that may be needed to ensure that the fiscal deficit targets are observed.

10. Upon taking office, the government saw the need to reform the tax system in order to spur tax compliance, broaden the tax base, reduce distortions, and encourage economic efficiency. As a first step toward meeting these objectives, in early 2001 it enacted a tax package that reduces income tax rates; closes a tax loophole on foreign-source income; and accelerates the payment of rescheduled tax obligations while penalizing those who fail to comply. In addition, the government introduced an automatic adjustment mechanism for specific excise taxes to maintain their real value and has sent to congress draft legislation that would eliminate the special tax regime for rice. The government, recognizing that further reform of the tax system is needed to improve efficiency and that the recent changes in the income tax may weaken revenues starting next year, has asked congress for authorization to legislate on the removal of certain tax exemptions and on the elimination or reduction in the scope of the sectoral and regional tax regimes. Moreover, the government will prepare a comprehensive study on tax policy that will be published, including by posting it on the Ministry of Economy and Finance's (MEF) web page, and presented to the newly elected authorities by June 2001. In this regard, the government is seeking the assistance from the Fund's Fiscal Affairs Department. More generally, to protect tax revenue in the near term, the government will not introduce measures that imply lower tax collections, including through the widening of the scope for rescheduling of tax liabilities and the granting of tax relief to particular sectors or regions. Also, it will not modify the withholding system or change the regulations and formulas used to calculate tax advance payments for the corporate income tax.

11. The tax collection agency (SUNAT) will seek to recover the public's trust by emphasizing honesty and fairness in its relationship with taxpayers by improving information and consultation services and regulating auditing procedures. SUNAT will step up its efforts to identify and combat tax evasion, using objective criteria aided by new information systems. The information system that will form the basis for the auditing of VAT and income tax returns, as well as an excise-tax auditing task force for large taxpayers will be set up by March 2001. Mass audits will be carried out using the new information system, and by midyear some 5,000 taxpayers will have been reviewed. SUNAT will step up its efforts to minimize tax avoidance by lowering the rates of late-payers from 3 to 1 percent for large taxpayers and from 25 to 10 percent for medium-sized taxpayers by end-2001. Late payments will also be monitored closely to avoid an increase in tax debt in real terms. In addition, the government will issue new regulations to consolidate the normative and operational responsibilities of the SUNAT to streamline auditing and collection procedures. To improve the performance of the income tax, in early 2001, the government has limited the waiver for income-tax and special wage tax (IES) withholding for service-contract workers and, by June 2001, SUNAT will adopt a new system of cross-checking information to audit professionals and the self-employed to ensure that these individuals shoulder a fair share in tax payments in accordance with their income level. SUNAT will continue developing a system to simplify filing and tax

payments using telematic technology that will reach a higher number of taxpayers. In its efforts, the SUNAT will be given the strongest support by the government.

12. To improve the quality, control, and transparency of public expenditure, the government is working with the Inter-American Development Bank (IDB) and the World Bank. Under the IDB supported program, the financial administration and control system (SIAF) will be extended to all executing units in the budget (including the Ministries of Defense and Interior), payroll and inventory control systems will be introduced, periodic financial reporting will be required of public enterprises, and a tax and financial administration module for municipalities will be developed. The program also aims at improving the transparency of fiscal policy. In this regard, the MEF will publish in the first quarter of every year a report on the performance of the economy in the previous year and prospects for compliance with the multi-annual macroeconomic plan, which is published annually in accordance with the Law on Fiscal Responsibility and Transparency. Moreover, the MEF will begin to publish a monthly fiscal bulletin in the second quarter of 2001 that will contain detailed information on revenue and spending (including tax expenditures) performance of budgetary units that will allow the general public to monitor closely the use of public resources and fiscal developments.

13. Social policies--supported by the World Bank--seek to improve the efficiency of programs in nutrition, health, and education, including through periodic evaluation and monitoring of priority programs. The targeting of expenditure on health, education, and rural infrastructure projects and the tracking of the effectiveness of the main social programs will be improved through the use of a set of social indicators developed last year. In the health care area, the government will seek to improve public access to health services, particularly for women, children, and lower-income families. In the area of education, efforts will be focused on enhancing the quality of primary education, while maintaining access rates at around 90 percent.

14. In the area of pensions, the government is committed to improving the efficiency of the private pension system, while maintaining the basic elements of the current two-tier system, such as the full-funding of the private pension fund with individual capitalization accounts, the minimum retirement ages, the prohibition of movement from the private to the public system, and restrictions on early withdrawal of funds. Further, the government intends to implement measures to reduce the operating costs of private pension funds (AFPs) by lowering their contributions to the Superintendency of Banks and Insurance (SBS) and streamlining information requirements. This will allow AFPs to reduce commissions, which will continue to be market-determined.

15. Monetary policy for 2001 aims at reducing inflation to a rate between 2.5 and 3.5 percent. The central bank (BCRP) will continue to utilize base money as its intermediate target, and interest rates and exchange rates will continue to be market determined. The program envisages a modest recovery in credit to the private sector and in the net international reserves. To ensure that the growth in private sector credit is in line with the program objectives, the BCRP 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. The program will include ceilings on the expansion of net domestic assets and floors on the accumulation of net international reserves of the central bank as

performance criteria (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, the increase in international reserves in 2001 of US$ 95 million is compatible with an increase of US$ 215 million on an unadjusted basis.

16. During 2001, the BCRP will maintain the floating exchange rate system, which has permitted the economy to adapt to terms-of-trade and other external shocks. During the program period, central bank intervention in the foreign exchange market will be aimed at smoothing out temporary and large fluctuations in the exchange rate, and there will continue to be no official intervention in the forward foreign exchange market.

17. To improve oversight of the financial system, coordination among the MEF, SBS and BCRP has been strengthened by scheduling weekly meetings of the heads of these institutions where the main financial risks, trends and plans are discussed. The government will seek to minimize fiscal costs in its efforts to strengthen the banking system by encouraging market-based solutions, including through mergers and the capitalization of banks by the private sector. In promoting a strong banking system, the SBS will maintain the current liquidity requirements and introduce regulations limiting maturity mismatches and requiring liquidity contingency planning for financial institutions. The SBS will apply strictly its current prudential norms and standards, and will continue with its efforts to strengthen consolidated supervision by visiting at least two financial institutions abroad related to Peruvian banks and by improving information sharing with offshore centers and other domestic supervisors. The government will not use public resources for the establishment or maintenance of specialized banking institutions, for the promotion of lending to specific sectors of the economy or regions in the country. The government will also refrain from using public resources (additional to those already committed under current programs) to promote the restructuring of enterprise debts with financial institutions. The government has sent to congress a draft law that would strengthen the fight against money laundering. Lastly, the government will seek to strengthen legal and judicial mechanisms for enforcing financial contracts.

18. To foster private investment, improve efficiency, generate employment, boost international reserves, and reduce public sector domestic borrowing in 2001, the government will reinvigorate efforts in structural reform. It will privatize and/or award concessions of state-owned enterprises, and will sell its remaining shares in previously privatized firms, including electricity and mining companies by mid-2001. In infrastructure, the government will accelerate the transfer to the private sector of the operation of state-owned assets, including seaports and major highway projects. The government will promote competition in the telecommunications sector by selling a broadband telecommunication system. To promote private sector activity in the forestry and agricultural sectors, the government will award forest concessions, sell additional agricultural land, and accelerate the titling and registering of rural land holdings. Proceeds from asset sales and concessions are expected to exceed US$500 million in 2001.

19. For most of 2000, Petroperu's fuel prices were not in line with international prices, which resulted in operating losses for the company. Since November, domestic

prices of the state oil company's products have been at parity with their international benchmark equivalent, and Petroperu will maintain the petroleum price parity.

20. Peru maintains a relatively open trading system with the absence of any non-tariff barriers to trade. The government 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. As a step in rationalizing the trade system, the fixed percentage import surcharge on meat products of 10 percent was reduced to 5 percent (the same rate as for other agricultural products) in January 2001. In February 2001, a decree will be issued to update and insure future automatic biannual adjustment of the reference price table used for calculating the variable surcharge on several agricultural imports.

21. The government is undertaking efforts to improve domestic and external debt management. The Office of Public Sector Credit in the Ministry of Economy and Finance is being strengthened and a plan is being elaborated for the orderly placement of public debt. To monitor external debt developments, the program includes as performance criteria ceilings 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. Also, the Treasury will develop a cash management system that would involve periodic auctions of short-term Treasury instruments in domestic currency to improve the management of the government's cash flow and avoid recourse to higher-cost borrowing in the inter-bank market.

22. The Government of Peru believes that the policies described in this letter are adequate for meeting the objectives of its program, and will take additional measures that may be necessary for this purpose. For the period of the arrangement, we will maintain the customary policy dialogue with the Fund, and take any further steps that may be needed to promote the achievement of the government's economic policy objectives in light of evolving circumstances. A midyear program review with the Fund, to be completed prior to September 30, 2001, will cover the implementation of the macroeconomic and structural programs described in this letter, including in particular the specification of an appropriate fiscal framework for 2002-2004 and progress made in the area of privatization and concessions. The performance criteria for the second half of 2001 will be set at the time of the midyear review.

Sincerely yours,

Javier Silva Ruete Minister of Economy and Finance	Germán Suárez Chávez President of the Central Reserve Bank of Peru

TABLE 1. PERU: QUANTITATIVE PERFORMANCE CRITERIA, 2001

	Mar. 31	Jun. 30	Sep. 30	Dec. 31
			Indicative	
(Cumulative amounts from December 31, 2000, millions of new soles)				
Borrowing requirement of the combined public sector [1/]	500	1 310	2 350	3 100
Net domestic assets of the Central Reserve Bank [2/ 3/ 4/ 5/]	-1 325	-645	-940	70
(Cumulative change from December 31, 2000, in millions of U.S. dollars)				
Net international reserves of the Central Reserve Bank [2/ 3/ 4/ 5/ 6/]	280	90	180	95
Short-term external debt of the nonfinancial public sector	50	50	50	50
External payments arrears of the public sector (on a continuous basis) [7/]	0	0	0	0
Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year	1 180	1 400	1 730	2 080
Of which: 1-12 years' maturity	50	100	400	425

1/ Including the operating balance of the central bank; privatization proceeds are included below the line.

2/ 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$ 185 million by end-March, US$ 215 million by end-June, US$ 365 million by end-September and US$ 550 million by end-December 2001. The amounts in excess will be deposited at the Central Reserve Bank.

3/ 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$ 370 million at end-March, US$ 470 million at end-June, US$ 735 million at end-September and US$ 700 million at end-December 2001. These amounts will be deposited at the Central Reserve Bank.

4/ 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-March, US$ 140 million at end-June, US$ 255 million at end-September and US$ 215 million at end-December 2001; and within the total the downward adjustment for shortfalls in privatization proceeds will not exceed US$ 75 million at end-March, US$ 85 million at end-June, US$ 145 million at end-September and US$ 215 million at end-December 2001**.**

5/ 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.

6/ 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.

7/ Excluding arrears associated with nonrescheduled debt to foreign creditors outstanding as of end-2000.