



MINISTERIO DE ECONOMÍA Y FINANZAS



BANCO CENTRAL DE RESERVA DEL  
PERÚ

Lima, November 26th, 2002

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

Dear Mr. Köhler:

1. In our letter of January 18, 2002, the Government of Peru described its economic program supported under the current two-year Stand-By Arrangement. This letter describes performance under the program in 2002, discusses additional policies and prospects for 2003 in order to achieve the objectives of our economic program, and describes our revised structural reform strategy. Macroeconomic performance in 2002 has been in line with the program, and significant progress has been made in implementing the program's structural reform agenda. In this letter we request the modification of the fiscal performance criterion and all privatization-related adjusters for end-2002, and the replacement of the performance criterion on net domestic assets of the central bank by a consultation mechanism based on inflation.
2. **The Peruvian economy has weathered the turmoil in the world economy in 2002, and our program has been successful in minimizing contagion.** Economic growth has resumed and is projected to be in line with the program projection for the year of 3.7 percent. Inflation has remained in check and should end the year at around 2 percent. The balance of payments position has stayed strong all year, and the net international reserves of the central bank are expected to increase by some US\$1.25 billion in 2002.

Deposits in the banking system have been growing throughout the year, interest rates (particularly in local currency) have fallen, and the exchange rate has been in line with program projections. Vulnerability indicators have remained strong as well, and by year-end gross international reserves of the central bank are expected to continue to exceed the stock of dollar deposits in the banking system and cover close to 190 percent of short-term debt on a residual-maturity basis.

3. **Notwithstanding these positive developments, external and domestic factors have been challenging the recovery in economic activity.** Continued difficulties in the external environment, in particular in the region, and, to some extent, certain domestic political developments, have adversely affected private investment, including the transfer to the private sector of state enterprises under the Government's Private Investment Promotion Program (PIPP). For 2003, real GDP is projected to grow around 3.5–4 percent, slower than originally forecasted.
  
4. **In this context, the Peruvian authorities, in consultation with Fund staff, have revised slightly the fiscal deficit targets for this year and the next.** We are requesting that the performance criterion on the fiscal deficit for end-December 2002 be modified from S/.3,915 million to S/.4,520 million. The latter, equivalent to 2.3 percent of GDP, is equal to the maximum fiscal deficit target that would have been allowed under the program adjustor in the event of higher-than-programmed receipts from the PIPP (and equivalent to an upward adjustment of 0.3 percent of GDP). For next year, we are now targeting a fiscal deficit of 1.9 percent of GDP (which reflects a planned primary balance adjustment from a deficit of 0.2 percent of GDP to a surplus of 0.4 percent of GDP).

5. **The primary balance adjustment in 2003 would mainly reflect an anticipated increase in tax revenue**, which is projected to rise from 12.2 percent in 2002 to 12.7 percent of GDP in 2003. Tax reform measures and tax rate increases introduced in 2002 are projected to more than compensate for expected lower revenue collections from taxes on public enterprise assets and exceptional fines. Current expenditure will remain under strict control, while general government non-interest expenditure is projected to grow by only 2 percent in real terms in 2003.
6. **The government will continue to carry out social programs and important structural reforms** with the support of the World Bank, the Inter-American Development Bank, and the Andean Development Corporation, which together are expected to make disbursements in 2003 in a similar amount to that in 2002. Moreover, we intend to build upon the successful reentrance into the international private capital market in 2002 and place additional sovereign bonds in 2003. The financing of the deficit in 2003 would be closed by placing local currency bonds, prefinancing arranged in 2002, and proceeds from the PIPP. The government will not seek to cover its financing needs with resources of the pension reserve fund (FCR) that are held at the central bank and that form part of its international reserves.
7. **As indicated in our letter of January 18, 2002, the program envisaged a modification of performance criteria in the event that the BCRP adopted a full-fledged inflation-targeting framework for monetary policy. Such a framework has been implemented**, with the operational target of monetary policy being the monthly average stock of banks' local currency deposits at the BCRP. In July, the first inflation report was issued, and the BCRP Board announced a medium-term inflation target range of plus or minus 1 percentage point around the midpoint of 2.5 percent. Accordingly, we request that the end-December 2002 performance criterion on the net domestic assets

of the central bank be replaced with the consultation mechanism described in Table 1. The BCRP will continue to maintain the floating exchange rate system, intervening in the spot foreign exchange market to limit volatility in the exchange rate, while continuing the practice of not intervening in the forward foreign exchange market. Reserve requirements on U.S. dollar deposits will continue to be managed prudently to ensure that the high level of coverage of dollar deposits in the banking system by the international reserves of the BCRP is maintained.

8. **Our structural reform agenda is being implemented mainly as planned.** In the fiscal area, the tax audit program of corporations and independent professionals is ahead of schedule, and as of end-September, 15,318 audits have been carried out; tax expenditures have been incorporated in the 2003 budget submission to congress; and draft legislation has been submitted to congress to revise the Law on Fiscal Transparency and Responsibility. Progress has been made in strengthening bank supervision, including the submission to congress of draft legislation to provide the necessary statutory protection to the staff of the Superintendency of Banks in the discharge of their responsibilities. All performance criteria pertaining to special public lending programs have been observed; and measures have been put in place to begin reforming the public pension system.
  
9. **In 2003, the government will continue to implement its structural reform agenda.** Bank supervision will continued to be strengthened, including through the tightening of regulations on credit risk derived from foreign-currency lending by banks (and the associated exposure to exchange rate changes). Cofide will maintain its operations as a second-tier development bank. We will continue to:  
(i) strengthen the public and private pension systems; (ii) maintain our trade policy strategy; and (iii) not use public resources to establish new financial institutions for direct lending to the public.

10. **As part of the government's decentralization program, elections are to be held on November 17 for new regional administrations (at the same time as municipal elections). Congress approved in July the legal framework for decentralization.** The law sets specific principles on fiscal decentralization that call for an orderly process of decentralizing government services to ensure that the impact on the consolidated public finances is neutral and that any external borrowing carried out by the new regional administrations require approval of the MEF. Also, the law earmarks 60 percent of the proceeds from the PIPP to the regional development fund (FONCOR) and the decentralization fund (FIDE).
11. **The design of the PIPP is being refined to address domestic considerations and reduced interest by foreign investors in the region.** The less favorable environment adversely affected the process of transferring the operations of two public enterprises to the private sector (which constituted structural benchmarks under the program for end-June and end-September). Receipts from the PIPP are expected to reach US\$400 million in 2002. In light of this outlook, the government is requesting a modification to the adjustor on the end-December 2002 performance criterion on the net international reserves of the central bank for shortfalls in PIPP receipts. For 2003, proceeds from the PIPP are expected to yield US\$400 million.
12. **As part of our economic program, a comprehensive reform of the tax system is being implemented,** albeit over a longer time horizon than originally envisaged in the program. Measures have been adopted to lower evasion, enhance equity, and reduce distortions, that are expected to yield 0.2 percent of GDP this year and 0.8 percent of GDP in 2003. Other measures will be introduced in 2003 that will aim at strengthening tax administration, rationalizing tax rates, and increasing income tax rates and widening the income tax base. In addition, we will begin to phase out certain regional and

sectoral tax exemptions by end-June 2003. Full implementation of this process is expected to occur by end-2004, as it involves reaching agreements with the incoming regional administrations on the phasing out of these exemptions (to be ratified by congress) in exchange for investment in infrastructure in the affected regions. The current estimated cost on an annual basis of the exemptions to be phased out by end-2004 is 0.9 percent of GDP, with exemptions costing 0.4 percent of GDP to be phased out by end-2003. In total, the comprehensive tax reform introduced from 2002-2004 is expected to yield around 2 percent of GDP on an annual basis over the medium term.

13. **An important element of the Government of Peru's structural program for 2003 is to improve the functioning of the domestic market** for government securities, and in particular, the auction system. We aim to introduce in January/February 2003 a system of primary dealers for auctioning government paper. To best ensure a well-functioning domestic bond market auctions will follow an established calendar to allow market participants to better account for government issues in their cash-flow plans. At the same time, to ensure transparency in the auction process, government entities could voluntarily buy government bonds only through direct placements at the prices determined in the auctions or in the secondary market.
  
14. In addition to the policies outlined in this letter, the Government of Peru stands ready to take additional measures as appropriate to ensure the achievement of its program's objectives. During the period of the Stand-By Arrangement, the authorities of Peru will maintain the usual close policy dialogue with the Fund. The second review with the Fund, to be completed by March 15, 2003, will establish the quarterly performance criteria and structural benchmarks for the program in 2003, set the timing of the third review, and cover the implementation of the economic program described in this letter and our letter of January 18, 2002. The review will focus, in particular, on: (i) progress in implementing the tax

reform and fiscal responsibility law; (ii) developments in the decentralization process; (iii) the functioning of the domestic bond market; (iv) steps being undertaken to strengthen banking supervision; and (v) the operations and impact of government initiatives to aid specific sectors.

Sincerely yours,

\_\_\_\_\_/s/\_\_\_\_\_  
Javier Silva Ruete  
Minister of Economy and Finance

\_\_\_\_\_/s/\_\_\_\_\_  
Richard Webb, President  
Central Reserve Bank of Peru

**Table 1. Peru: Quantitative Performance Criteria and Inflation Consultation Mechanism, 2002**

	December 31
(Cumulative amounts from December 31, 2001, millions of new soles)	
Borrowing requirement of the combined public sector 1/	4,520
Net consumer lending of Banco de la Nación 2/	360
(Cumulative change from December 31, 2001, in millions of U.S. dollars)	
Net international reserves of the Central Reserve Bank excluding foreign-currency deposits of financial institutions 3/ 4/ 5/ 6/ 7/ 8/	30
Stock of government guarantees for housing support programs	150
Outstanding short-term external debt of the non financial public sector	50
Contracting or guaranteeing of non-concessional external public debt with maturity of at least one year 9/	1,950
<i>Of which: [1-5] years' maturity</i>	200
External payments arrears of the public sector (on a continuous basis) 10/	0
(Consultation bands for the 12-month rate of inflation, in percent) 11/	
Outer band (upper limit)	5.5
Inner band (upper limit)	4.5
<i>Central point</i>	2.5
Inner band (lower limit)	0.5
Outer band (lower limit)	-0.5

- 1/ Including the operating balance of the central bank; Private Investment Promotion Program (PIPP) proceeds are included below the line.
- 2/ This operation will be closed by end-2002, as indicated in the letter of intent dated January 18, 2002.
- 3/ The target for net international reserves will be adjusted upward by the amount of PIPP proceeds in foreign currency in excess of US\$870 million by end-December 2002. The amounts in excess will be deposited at the BCRP.
- 4/ The target for net international reserves will be adjusted upward by the amount that net foreign borrowing of the non financial public sector exceeds US\$410 million at end-December 2002. The amounts in excess will be deposited at the BCRP.
- 5/ The target for net international reserves will be adjusted downward for shortfalls of PIPP proceeds in foreign currency below US\$870 million. This downward adjustment will not exceed US\$470 million at end-December 2002.
- 6/ The target for net international reserves will be adjusted downward for shortfalls from programmed amounts of net foreign borrowing. This downward adjustment will not exceed US\$200 million at end-December 2002.
- 7/ The target for net international reserves will be adjusted downward for withdrawals for portfolio management purposes of deposits held at the BCRP by the Consolidated Pension Reserve Fund (FCR) and any other funds managed by the ONP. This downward adjustment will not exceed US\$200 million at any time in 2002.
- 8/ The target for net international reserves will be adjusted downward by the amount used to prepay external debt, including debt equity swaps in the PIPP process.
- 9/ The limit would be adjusted upwards by any amount of debt issued for, and used in, a debt-exchange operation.
- 10/ Excluding arrears associated with non rescheduled debt to foreign creditors outstanding as of end-2001.
- 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 program.