MINISTERIO DE ECONOMÍA Y FINANZAS

BANCO CENTRAL DE RESERVA DEL PERÚ

Lima, Peru
January 18th, 2002

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, 2002 to December 31, 2003. Through prudent macroeconomic policies and a step-up of structural reforms, the government aims at supporting a sustained recovery in economic activity and employment, maintaining low inflation, limiting external vulnerability, and laying the basis for a marked reduction in poverty over the medium term.

2. The Government of Peru seeks support from the International Monetary Fund for its economic program and hereby requests a stand-by arrangement for the period February 1, 2002 through February 29, 2004 in a total amount of SDR 255 million (20 percent of quota on an annual basis). The successful implementation of the economic program supported by the Fund should generate the required external resources for a moderate accumulation of international reserves while meeting our external debt-service obligations as scheduled. Accordingly, the government intends to treat the arrangement as precautionary.

BACKGROUND

3. While Peru made significant progress during 1991-97 in stabilizing the economy and implementing structural reforms that helped boost economic growth, this performance then deteriorated in the context of adverse external shocks, which included the *El Niño* weather phenomenon, a weakening in the terms of trade following the Asian crisis, and a liquidity squeeze stemming from international financial turmoil. Importantly, the economy was also affected by serious domestic political difficulties that led to the removal from office of the president and the

appointment by congress of an interim government in late-2000 and new presidential elections in the first half of 2001.

4. In this environment, real economic activity grew at an annual rate of only 1 percent between 1998 and 2000, while the 12-month rate of inflation declined to 3.7 percent by end-2000. Concurrently, the banking sector weakened, as the share of non-performing loans doubled, profitability fell, and bank credit to the private sector stagnated (despite various measures to support the banking system and promote lending). The fiscal situation also deteriorated, as the combined public sector position moved from balance in 1997 to a deficit of 3.2 percent of GDP in 2000, above the limit of 2 percent of GDP established under the Law on Fiscal Responsibility and Transparency. Owing to weaker domestic demand, the external current account deficit fell to 3 percent of GDP by 2000, despite a deterioration in the country's terms of trade. During 1998-2000, the central bank's international reserves declined by US$2 billion, but still remained at comfortable levels. The structural reform effort slowed considerably over this period, particularly in the area of privatization.

5. The interim government that took office in November 2000 implemented an economic program, supported by a stand-by arrangement with the Fund, that aimed at ensuring macroeconomic stability in the transition to a new government. In the first half of 2001, inflation continued to decline, international reserves increased, and all program performance criteria were observed. Some progress was made in the structural reform area, including the awarding of the operating concessions for the Camisea natural gas project, the Lima airport, and specialized telecommunications services. Notwithstanding these developments, in the first half of the year, real GDP contracted 1.6 percent (year-on-year), mainly as a result of a weakening in domestic demand that included a sharp fall in private investment, and several measures were introduced that had negative fiscal implications (particularly for the medium-term). These included a reduction in personal and corporate income tax rates; a lowering of selected import duties; a widening of the duty drawback system; the elimination of

the value-added tax on certain tourism services; a reduction in the rate of excise taxation on cigarettes; the elimination of import duties on public transportation vehicles; and an increase in the rate of revenue-sharing with the provinces and local governments (Ley del Canon) without any parallel transfer of spending responsibilities.

6. The government that took office in July 2001 inherited a situation of depressed economic activity and a weakened medium-term fiscal outlook. In response, the government implemented a fiscal stimulus package to spur economic growth, which focused on improving the domestic labor market situation by reducing from 5 to 2 percent the special payroll tax (IES), starting a temporary jobs program in areas of the country hardest hit by the recession, and moderately hiking public sector pensions and wages by 9 percent (the first pensionable wage increase in a quarter century). At the same time, to improve the fiscal outlook over the medium term, the government reversed most of the tax reduction measures introduced during the interim government and introduced new measures to strengthen revenue collections (including raising fuel taxes). Notwithstanding the impact of the fiscal stimulus implemented in the second half of this year and the continued sluggishness in economic activity for most of the year, the deficit of the combined public sector in 2001 is estimated at 2.4 percent of GDP, close to one percentage point of GDP lower than in 2000.

MACROECONOMIC PROGRAM

7. In order to effect a steady reduction in poverty, the government's strategy for the next two years is to lay the basis for sustainable high growth over the medium term through the implementation of sound macroeconomic policies and structural reforms, including a substantive program of privatization and private-sector operating concessions and a strengthening of the country's legal framework, which will spur private investment. To ensure that the fiscal finances are placed on a sustainable basis over the medium term and that adequate resources are available to

address pressing social needs, a tax reform will be implemented during the program period. Monetary policy will continue to be geared at maintaining low inflation.

8. Over the program period, real GDP is projected to grow between 3.5-4 percent in 2002 and by about 5 percent in 2003, while the 12-month rate of inflation is envisaged at 2.5 percent in 2002 and 2 percent in 2003. The external current account deficit would widen temporarily in 2002-2003, owing to the pick-up in economic activity, but would stay below 3 percent of GDP. International reserves would remain at sound levels, with gross reserves covering about 10 months of imports of goods and services and close to one and a half times the stock of short-term external debt on a residual maturity basis.

9. The combined public sector deficit is targeted to fall to 1.9 percent of GDP in 2002 and to 1.4 percent of GDP in 2003. These levels would be consistent with the availability of multilateral and bilateral funding, receipts from privatization, and a limited placement of government debt in the domestic market. In 2002, should privatization receipts exceed the baseline projection of US$ 700 million (1.2 percent of GDP), the fiscal deficit target would be raised by the excess, up to 0.3 percent of GDP, to allow for additional expenditure on infrastructure. The fiscal objectives of the program through end-2002 will be monitored on a quarterly basis through ceilings on the public sector borrowing requirement as set out in Table 1. The government will stand ready to take additional measures that may be needed to ensure that the fiscal deficit targets are observed.

10. The fiscal program envisages an increase in general government tax revenue from 12.1 percent of GDP in 2001 to 12.6 percent of GDP by 2003. This increase will result from measures already adopted, tax reform measures (described below) to be introduced in 2002 that would have full effect in 2003, and the elimination of the excise tax exemption for automobile imports in special trade zones (Ceticos) in early 2002.

11. During the program period, consistent with the projection for revenue and the fiscal deficit targets, general government non-interest expenditure is projected to grow by an average of 3 percent a year in real terms. The quality and composition of these outlays would improve, owing in large part to reforms being supported by the World Bank, the Inter American Development Bank and the Andean Development Corporation (CAF) that would focus on eliminating the duplication of government social services and a reduction in real outlays on defense and national security of about 14 percent in 2002.

12. Monetary policy will be consistent with the objectives of GDP growth, inflation, and the balance of payments of the program. In the near term, the intermediate target for monetary policy will continue to be base money; however, the Central Reserve Bank of Peru (BCRP) is considering the possibility of introducing a formal inflation targeting framework. The BCRP will continue to manage prudently reserve requirements on U.S. dollar deposits in a manner consistent with the monetary program and the maintenance of a sound level of international reserves. The program will include quarterly ceilings on the expansion of net domestic assets and floors on the accumulation of net international reserves of the central bank as performance criteria during 2002 (as indicated in Table 1).

13. The BCRP will maintain the floating exchange rate system that has served Peru well in helping the economy adapt to terms-of-trade and other external shocks. Moreover, it will continue to intervene 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.

STRUCTURAL REFORMS

14. In the program period, the Government of Peru will intensify the structural reform agenda in order to improve economic production efficiency, foster private investment, and reduce public sector borrowing needs. The areas to be covered will include tax system reform, privatizations and concessions, strengthening banking

supervision, revamping the nation's fiscal responsibility law, helping local governments achieve self-sufficiency in their finances, reforming the public and private pension systems, initiating adjustments to the trade regime for Peru's eventual entry into the western hemisphere free trade area, raising the efficiency of the public sector, and promoting private-sector activity. Selected elements of the government's program will be subject to structural benchmarks as shown in Table 2.

15. The centerpiece of the government's structural reform effort will be the introduction of a tax reform in 2002 that will improve the system's neutrality and equity and will put the fiscal finances on a sustainable basis over the medium term, while generating the necessary resources to address the country's pressing social and infrastructure needs. The reform will cover both tax policy and tax administration measures. Regarding tax policy, the government will reduce the dispersion of excise tax rates on alcoholic products, work with local governments to strengthen their real estate tax regimes, eliminate special sectoral tax exemptions, narrow the list of allowable deductions under the corporate income tax, and allow the expiration of certain tax exemptions and benefits, for both direct and indirect taxes, which are up for renewal by end-2002. With the support of the Inter-American Development Bank (IDB), the government will introduce a system of mining royalties that takes into account Peru's competitive position in commodity markets. Furthermore, the government will seek congressional approval for the elimination of the IES, the implementation of an alternative minimum income tax mechanism on corporations, the inclusion of tax expenditures in the 2003 budget, and the elimination of regional tax exemptions and tax benefits. The elimination of these exemptions and benefits will help reduce tax evasion and will generate additional resources needed for the provision of infrastructure and social services in those regions. Consistent with this reform, the government will grant no further tax relief to particular sectors or regions nor introduce any measures to widen the scope for rescheduling of tax liabilities beyond the current legislation being considered in congress. More generally, it will not introduce further tax measures that imply lower collection of tax revenue.

16. The tax collection agency (SUNAT) will be vigorously supported in its efforts to improve tax administration. With the support of the IDB, SUNAT will take steps to strengthen the tax collection unit, implement a system of private-sector collection agents (basically larger-scale firms in the chain of production) for value-added taxes, improve the control of tax rebates to avoid refunds to firms with tax debts, intensify audits, including with the use of an electronic information system, and streamline auditing and collection procedures. Auditing will focus on VAT and income tax collections, especially for corporations and independent professionals, and the SUNAT will carry out 17,000 audits of corporations and independent professionals in 2002.

17. An essential element to generate investor confidence and to help finance the fiscal deficits in 2002 and 2003 will be the implementation of a sizable program of privatization and granting of operating concessions to the private sector. Privatizations will focus in the energy sector, particularly in the generation, transmission and distribution of electricity. In infrastructure, the government will accelerate the transfer to the private sector of the operation of several state-owned assets, including regional seaports and airports and highway projects. Proceeds from asset sales and concessions are expected to be at least US$700 million a year in 2002 and 2003.

18. With support of the IDB, the government will complete a draft revision of the Law on Fiscal Responsibility and Transparency by March 2002 (that will be submitted to congress by June 2002). The revised law will establish a path for the evolution of the fiscal balance following a recession and will strengthen compliance incentives by requiring the immediate implementation of measures (in periods of positive growth) to address revenue shortfalls or expenditure overruns. The fiscal targets under the program are consistent with the path specified by the law.

19. The government aims at reducing the public-sector debt (as a percentage of GDP) over the medium term and, with the support of the World Bank, is undertaking

efforts to improve domestic and external debt management. In this context, the Treasury has established a periodic auction of domestic currency bonds that has broadened the choice of investment vehicles for domestic capital market participants and has lowered the Treasury's exposure to exchange rate risk. Also, the Ministry of Economy and Finance (MEF) is elaborating a plan for the issuance of sovereign debt in international capital markets (the first such emission in decades), which would establish a benchmark for the evaluation of country risk, thereby facilitating Peruvian firms' access to international capital markets. To monitor external debt developments in 2002, the program places ceilings on the contracting or guaranteeing of non-concessional medium- and long-term external public debt and on the outstanding short-term debt of the non-financial public sector as described in Table 1.

20. With respect to the banking sector, the Superintendency of Banks and Insurance (SBS) will continue to apply strictly its current prudential norms and standards, will maintain its policy of strengthening capital requirements, will continue with its efforts to strengthen consolidated supervision of financial conglomerates, and will begin to introduce standards for the banking system's management of country risk. In support of the SBS, the government will continue to grant it budgetary independence, and in the first year of the program, will submit legislation to congress to: (i) provide legal protection to SBS staff in the discharge of their responsibilities; (ii) strengthen banks' capital requirements by deducting goodwill items from regulatory capital; and (iii) reduce banks' single credit exposure limits by lowering the legal limit on leasing operations. The SBS will continue to seek ways for further improving the supervisory framework, including its ability to take timely action to resolve banking system issues.

21. The government has begun to introduce legislation to congress for a phased reform of the public and private pension systems (the costs of which are included in the fiscal program). The first phase, already implemented, aims at: (i) standardizing survivor benefits across the two principal plans (D.L.19990 and D.L. 20530-*Cédula*

Viva) by reducing the generous provisions in the Cédula Viva for new beneficiaries; (ii) raising the minimum pension in D.L.19990, which is well below the standard consumption basket; and (iii) ensuring a minimum pension for a group of workers older than 55 years who moved into the private system and did not have sufficient time to accumulate an adequate pension. The second phase, will focus on lowering the operating costs of private pension administrators and expanding their investment options.

22. The government is formulating plans to streamline the trade tax regime that would aim at a gradual reduction in the level and dispersion of import tariff rates in order to reach an average rate below 10 percent over time. Furthermore, the government will not create new free trade zones or expand existing ones.

23. The World Bank, IDB, and the CAF are supporting the government's efforts to strengthen poverty alleviation programs, modernize infrastructure, and improve the efficiency of the public sector. Reform programs that aim at poverty alleviation include: strengthening social protection programs, expanding rural education services and improving rural infrastructure, and focalizing social services in urban areas. Infrastructure programs concentrate on an overhaul and expansion of the national highway system. Finally, to improve the efficiency of the public sector, the government is undertaking a public sector expenditure review, developing a fiscal decentralization strategy, and reforming the public education system.

24. In November 2001, the state-owned Banco de la Nación (BN) created a temporary consumer-lending program (Multired) to aid low-income public sector employees and pensioners that would also help to spur economic activity. As this program is viewed as an exceptional measure, it will be closed, as announced, by end-2002. Furthermore, the program's original lending ceiling, prudent eligibility requirements and lending terms will be maintained, and the BN will not create any new lending programs to the public. The limit on the net-lending of the Multired operation will constitute a performance criterion under the program (as indicated in Table 1).

25. With the aim of improving the financial and social situation in the agriculture sector, in late 2001 the government created an agrarian bank that will oversee the management of financial assistance programs to agricultural producers. For small-scale producers, it will provide technical assistance and undertake direct lending using, exclusively, funds allocated in the budget for this purpose. For other producers, the bank will channel international lines of credit through financial institutions regulated by the Superintendency of Banks and Insurance (SBS), to which it will apply prudent lending standards and customary procedures in this type of on-lending operation. Apart from this institution for agricultural support, the government will not use public resources for the establishment of new financial institutions for direct lending to the public, leaving financial intermediation activities to the private sector.

26. In order to address the scarcity of affordable low-income housing, the government will establish an insurance program for mortgage securities, to be backed by deposits in the banking system of the MIVIVIENDA program. The design of the program (e.g., percentage of the guarantee, foreclosure procedures, and eligibility rules) will aim at limiting moral hazard problems; nevertheless, the government intends to contain its contingent liabilities by limiting the stock of government guarantees for housing support programs in 2002 to no more than US$ 150 million (about 0.3 percent of GDP). This limit would constitute a performance criterion under the program (as indicated in Table 1).

27. The Government of Peru believes that the policies described in this letter are adequate for meeting the objectives of the 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 will take any steps that might be needed to promote the achievement of the government's economic policy objectives in light of evolving circumstances. The first review with the Fund, to be completed by August 31, 2002, will cover the implementation of the economic program described in this letter, including in particular an assessment of:

(i) progress made in the implementation of a tax reform; (ii) advances in the privatization and concession program; (iii) the timing for submitting legislation to strengthen banking supervision; and (iv) the operations and impact of the government's plans to aid specific sectors, including: agriculture, housing, and lending to government employees. At the time of the second review with the Fund, to be completed by February 28, 2003, the quarterly performance criteria and structural benchmarks for the program in 2003 and the timing of the third review will be established.

Sincerely yours,

Pedro Pablo Kuczynski Minister of Economy and Finance	Richard Webb, President Central Reserve Bank of Peru

Table 1. Peru: Quantitative Performance Criteria, 2002

	Mar. 31	Jun. 30	Sep. 30	Dec. 31
(Cumulative amounts from December 31, 2001, millions of new soles)				
Borrowing requirement of the combined public sector 1/ 2/	750	1,800	2,850	3,915
Net domestic assets of the Central Reserve Bank 3/ 4/ 5/ 6/ 7/ 8/ 9/	-690	-920	-1,535	180
Net consumer lending of Banco de la Nación 10/	200	340	430	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/	55	125	315	30
Stock of government guarantees for housing support programs	150	150	150	150
Outstanding short-term external debt of the nonfinancial public sector 11/	50	50	50	50
Contracting or guaranteeing of non-concessional external public debt with maturity of at least one year 12/	1,100	1,400	1,700	1,950
Of which: [1-5] years' maturity	200	200	200	200
External payments arrears of the public sector (on a continuous basis) 13/	0	0	0	0

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 upward, to the extent that privatization proceeds exceed US$ 110 million by end-March, US$ 490 million by end-June, US$ 680 million by end-September, and US$ 700 million by end-December 2002. The maximum adjustment will be the equivalent in local currency to US$ 40 million by end-March, US$ 90 million by end-June, US$ 130 million by end-September, and US$ 170 million by end-December 2002.

3/ The targets for the net international reserves will be adjusted upward, with commensurate downward adjustments to the limits on net domestic assets, by the amount of privatization proceeds in foreign currency in excess of US$150 million by end-March, US$580 million by end-June, US$810 million by end-September and US$870 million by end-December 2002. The amounts in excess will be deposited at the BCRP.

4/ The targets for the net international reserves will be adjusted upward, with commensurate downward adjustments to the limits on net domestic assets, by the amount that net foreign borrowing of the nonfinancial public sector exceeds US$180 million at end-March, US$150 million at end-June, US$420 million at end-September and US$410 million at end-December 2002. The amounts in excess wil1 be deposited at the BCRP.

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. This downward adjustment will not exceed US$45 million at end-March, US$150 million at end-June, US$110 million at end-September and US$70 million at end-December 2002.

6/ 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 net foreign borrowing. This downward adjustment will not exceed US$125 million at end-March, US$125 million at end-June, US$275 million at end-September and US$200 million at end-December 2002.

7/ The targets for net international reserves will be adjusted downward, with commensurate upward adjustments to the limits on net domestic assets, for 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$200 million at any time in 2002.

8/ The targets for the net international reserves will be adjusted downward, with commensurate upward adjustments to the limits on net domestic assets, by the amount used to prepay external debt, including debt equity swaps in the privatization process.

9/ This limit will be changed, accordingly, should the monetary authorities adopt a full-fledged inflation targeting regime.

10/ This operation will be closed by end-2002, as indicated in paragraph 24.

11/ The term "debt" has the meaning set forth in point No. 18 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 (Board Decision No: 12274-(00/85).

12/ The limit would be adjusted upwards by any amount of debt issued for, and used in, a debt-exchange operation.

13/ Excluding arrears associated with non-rescheduled debt to foreign creditors outstanding as of end-2001.

Table 2. Peru: Structural Benchmarks

To be completed by March 31, 2002

1. Carry out 3,400 tax audits of corporations and independent professionals
2. Completion of draft legislation of a revision to the Law on Fiscal Transparency and Responsibility consistent with the objectives stated in paragraph 18 of the Letter of Intent

To be completed by June 30, 2002

1. Submission to congress of a revision to the Law on Fiscal Transparency and Responsibility consistent with the objectives stated in paragraph 18 of the Letter of Intent
2. Submission to congress of legislation eliminating regional tax exemptions[1]
3. Submission to congress of legislation to include tax expenditures in the 2003 budget
4. Privatization of the electricity transmission company Etecen
5. Privatization of the electricity distribution company Jorbsa
6. Carry out 6,800 tax audits of corporations and independent professionals

To be completed by September 30, 2002

1. Privatization of the electricity generation company Egasa
2. Carry out 11,900 tax audits of corporations and independent professionals
3. Submission to congress of legislation to provide the necessary statutory protection to SBS staff in the discharge of their responsibilities

To be completed by December 31, 2002

1. Carry out 17,000 tax audits of corporations and independent professionals

[1] It is expected that approval of this legislation would provide additional resources for infrastructure and social spending for those regions.