



MINISTERIO DE ECONOMÍA Y FINANZAS



BANCO CENTRAL DE RESERVA DEL PERÚ

Lima, March 17, 2003

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

Dear Mr. Köhler:

1. In our letters of January 18 and November 26, 2002, the Government of Peru described its economic program supported under the current Stand-By Arrangement. This letter describes performance under the program in 2002 and discusses the economic policies that will be pursued during 2003 in order to achieve the program's objectives. Continued prudent macroeconomic policies and structural reforms will sustain the recovery in economic activity that began in the second half of 2001, maintain low inflation, limit external vulnerability, and lay the basis for a marked reduction in unemployment and poverty over the medium term.

2. In 2002, the Peruvian economy experienced a broad-based recovery in economic activity, weathering well the turmoil in the region. Macroeconomic performance was strong, and all end-December and continuous performance criteria were observed. GDP growth in 2002 exceeded program expectations, coming in at around 5 percent. Inflation ended the year at 1.5 percent, at the low end of the inflation target range of 1.5–3.5 percent. The combined public sector deficit was 2.2 percent of GDP. The external position was robust, with the current account deficit remaining at 2 percent of GDP and official reserves rising by some US\$1 billion (owing to substantial public and private capital inflows). Interest rates were at historical low levels for most of the year, and the exchange rate was relatively stable during the year (with the *Nuevo Sol* depreciating by 2.3 percent). In the banking system, both local and foreign currency deposits rose, and prudential indicators improved.

3. Progress was made in implementing the Government's structural reform agenda, including the initiation of a comprehensive reform of the tax system. Administrative measures were implemented in mid-2002 that have improved the collection of value-added taxes by using large private firms as tax retention agents, strengthening control of taxpayer registries and paperwork, expanding the tax agency's auditing rights, and improving the monitoring of taxpayer transactions with government agencies. Tax measures were also introduced last year that rationalized excise taxes on petroleum products, expanded the income tax base (including through the elimination of certain deductions from the corporate income tax), raised the maximum marginal personal income tax rate from 27 to 30 percent, and created a new minimum income tax advance payment scheme for larger taxpayers. These measures yielded around 0.4 percent of GDP (on an annual basis) in 2002 and are expected to yield 0.8 percent of GDP in 2003.



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4. Further, Peru embarked on an important decentralization process. In July 2002, the legal framework for decentralization was established that set specific principles on fiscal decentralization, including that the process be carried out in a gradual and fiscally-neutral manner, that external borrowing by regional administrations requires a state guarantee, and that 60 percent of the proceeds raised through the Private Investment Promotion Program (PIPP) be earmarked for the regional development fund (FONCOR) and the decentralization fund (FIDE). The framework called for additional implementing legislation, the first of which was approved in the last quarter of 2002 that details the exclusive and shared responsibilities of regional governments and grants the central government authority to oversee the fiscal situation of regional governments. On November 17, 2002 elections were held for the regional governments that took office on January 1, 2003.

5. Significant progress was made in implementing other structural fiscal reforms. The tax audit program of corporations and independent professionals exceeded the program goal of carrying out 17,000 audits in 2002, and tax expenditures were incorporated in the 2003 budget. Reform of the public pension system (which aims at equalizing benefits across the various public pension plans over the medium term) continued in 2002—survivor benefits were standardized across the two principal plans, replacement rates were lowered and the pensionable base standardized under the general pension plan; the minimum pension was raised to protect the poorest pensioners; and a minimum pension was established for certain older workers who moved to the private pension system. Draft legislation was submitted to congress (and approved by the Budget Commission) to revise the Law on Fiscal Prudence and Transparency that establishes a realistic path for the evolution of the fiscal balance following a recession (allowing a three year adjustment to the medium term deficit limit of 1 percent of GDP), strengthens compliance incentives by requiring the immediate implementation of measures (in periods of positive economic growth) to address revenue shortfalls or expenditure overruns, and sets prudent fiscal rules on regional and local governments. On the other hand, the PIPP was reoriented away from outright sale of assets to focus on operating concessions and joint ventures. In 2002, PIPP receipts reached US\$420 million.

6. Further steps were taken to strengthen bank supervision in 2002. Draft legislation was submitted to congress that would provide the necessary statutory protection to the staff of the Superintendency of Banks (SBS) in the discharge of their responsibilities. Regulations were introduced on country and operational risk and to increase competition in the financial system, and prudential requirements were applied on a consolidated basis. Also a Financial Intelligence Unit to prevent money laundering in the financial sector was created, and the SBS promoted the transparency in banks' publication of interest rates.



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2003 Program

7. The near-term outlook for 2003 points to continued economic growth, low inflation, and a robust external position. For 2003, real GDP growth is projected in the range of 4–5 percent, and inflation is projected at 2½ percent. The external current account deficit is expected to decline slightly to under 2 percent of GDP on the basis of continued strength in traditional and nontraditional exports. Capital inflows are projected to slow somewhat from last year, but would still result in an accumulation of official reserves.

8. In this context, the program for 2003 will aim at maintaining prudent macroeconomic policies, including a moderate fiscal adjustment that would be a first step in our medium-term plan of fiscal consolidation. The overall public sector deficit is to decline from 2.2 percent in 2002 to 1.9 percent in 2003, reflecting the tax reform measures taken in 2002. Tax revenue is projected to rise from 12.2 percent of GDP in 2002 to 12.7 percent of GDP in 2003. To enhance taxpayer compliance, the government will not introduce any tax amnesty schemes. Current expenditure will remain under strict control, with no generalized wage increase planned for 2003, while general government non-interest expenditure is projected to grow by only 2 percent in real terms in 2003. The fiscal objectives of the program through end-2003 will be monitored on a quarterly basis as set out in Table 1 through ceilings on the combined public sector borrowing requirement, the contracting or guaranteeing of medium and long-term external public debt, and on the stock of short-term external public debt; and a continuous performance criterion will prohibit the accumulation of external payment arrears. The government stands ready to take additional measures that may be needed to ensure that the fiscal deficit targets are observed.

9. The government's gross financing requirement in 2003 of US\$ 2.6 billion has been basically secured, with US\$1.8 billion coming from external sources. The World Bank, the Inter-American Development Bank, the Andean Development Corporation, and bilateral creditors are expected to make disbursements in 2003 of around US\$1.1 billion (a similar amount to that in 2002) in support of the government's efforts to improve the delivery of social programs, key structural reforms, and public investment projects. Building upon the successful reentrance into the international private capital market in 2002, the government has placed so far this year US\$750 million of sovereign debt in international markets. Financing for 2003 would be complemented by issuing bonds in the local market for around US\$400 million (resulting in a small net placement) and proceeds from the PIPP projected at US\$400 million. The government will not 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.



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10. The central bank (BCRP) will continue its prudent management of monetary policy under the inflation-targeting framework. The BCRP will maintain the current consultation mechanism on inflation, as described in Table 1, and quarterly performance criteria (floors) have been established for the net international reserves of the central bank. The BCRP will continue to maintain the floating exchange rate system, intervening in the spot foreign exchange market only to limit volatility in the exchange rate. It will also continue the practices of not intervening directly in the forward foreign exchange market and of limiting the use of exchange rate-indexed certificates of deposit to cases of unusual volatility in the spot exchange rate. 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.

11. In 2003, the Government of Peru will press ahead with its structural reform agenda. The agenda will focus on continuing to reform the tax system, implementing a sound fiscal decentralization plan, reactivating the domestic government bond market, strengthening the legal framework for fiscal policy, continuing with the PIPP, fortifying governance and the transparency of government operations, raising the efficiency of public expenditure, strengthening bank supervision, and continuing to open the economy. Key elements of the government's structural reform program will be subject to structural benchmarks as shown in Table 2.

12. In 2003, the government will continue working cautiously on a legal framework for decentralization that will ensure that the process is implemented in an orderly manner to protect the public finances over the medium term. The introduction of a fiscal decentralization law is a key element of this strategy. Draft legislation is being prepared that would define the allowable revenue collections at each level of government, coordinate the transfer of expenditure assignments and revenue consistent with local and regional governments' institutional capacity, introduce criteria for inter-governmental transfers, include provisions on full and uniform reporting (along the lines of those for the central government) for all regional and local governments, and place controls on regional and local government borrowing. In 2003, we will work toward implementing the reporting requirements for all regional and local governments.

13. Tax reform in 2003 will aim at phasing out regional and sectoral tax exemptions (in exchange for investment in infrastructure) and reducing tax evasion by broadening the coverage of the retention and withholding schemes implemented in 2002 and continuing to implement tax audits. The key step in the introduction of the phasing out of regional and sectoral tax exemptions is the fiscal decentralization law noted above (to be approved by congress) that will define this process and will be consistent with the government's objectives in the area of tax reform. The current estimate in the 2003 budget of the cost of the exemptions (on an annual basis) to be phased out by end-2004 is 0.7 percent of GDP, with



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exemptions costing 0.3 percent of GDP to be phased out by end-2003. Full implementation of the comprehensive tax reform introduced during 2002–2004 is expected to yield around 2 percent of GDP on an annual basis over the medium term.

14. The 2004 budget and the revamped law on fiscal prudence and transparency will be key signals of the government's commitment to its medium-term goal of fiscal consolidation. In this context, the 2004 budget will be consistent with the government's plans noted above in the areas of fiscal decentralization and tax reform, as well as with the medium-term macro framework

15. The government will embark on a reform of the state that in 2003 will concentrate on rationalizing spending to reverse the recent trend of declining capital expenditure as a percentage of total outlays. Toward this end, an inter-ministerial team has been established to identify nonessential outlays and to recommend a restructuring of government spending. In addition, the team will formulate medium-term strategic guidelines for each government program that will also aid in prioritizing the allocation of government expenditure.

16. Bank supervision will continue to be strengthened in 2003. The SBS is working toward strengthening exchange rate risk management and monitoring for dollar lending to clients whose operations generate income streams in local currency. Norms were issued in March requiring banks to increase their information base and their analytical internal risk models so that they can explicitly incorporate an evaluation of exchange rate risk in their overall credit risk calculation. The SBS is also consolidating and rationalizing regulations on provisioning and loan classification, with a view to improving the transparency and consistency of the regulations. Legislation has been passed that increases the penalties for intent to destabilize the financial system, and statutory protection to SBS staff in the discharge of their responsibilities will be granted.

17. The government will refrain from creating new sectoral support programs and continue to manage prudently existing programs. The government has extended for two years the consumer-lending program (*Multired*) of the *Banco de la Nación* (BN) in order to support the continued recovery in economic activity. However, the program will continue to be managed under the same prudent regulations as last year. The limit on the net lending of the *Multired* operation will constitute a performance criterion under the program (as indicated in Table 1). The agriculture bank, *Banco Agropecuario*, will continue to limit direct lending to small-scale producers with funds exclusively allocated in the budget and for other producers will channel international lines of credit through SBS-regulated institutions. Cofide will maintain its operations as a second-tier development bank, channeling officially-borrowed resources through private financial institutions. The government will not use public resources to establish new financial institutions for direct lending to the public.



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18. An important element of the government's structural program for 2003 is to improve the functioning of the domestic market for government securities in local-currency, and in particular, the auction system. In March 2003 a system of primary dealers for auctioning government paper will begin operating. Moreover, to best ensure a well-functioning market, a calendar of scheduled domestic bond auctions will be published in March 2003.

19. The government will continue to implement its trade policy strategy of reducing the average level of import tariffs, always with a view to ensuring that such reductions are consistent with the fiscal program. In 2002, the average tariff level was reduced from 11.8 percent to 10.9 percent, and the government intends to lower this further. Negotiations to reduce tariff barriers with our Andean Community partners and bilaterally with Mexico and Brazil will continue. The government's longer-term objective is to enter into a hemispheric free-trade arrangement by 2006.

20. The government will continue to work toward strengthening governance. In 2003, the government intends to continue in its efforts to root out corruption in all levels of government (having passed last year important anti-corruption legislation), and work toward strengthening the independence and efficiency of the judiciary.

21. 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, and to this end, the program will have two more reviews. The third review with the Fund, to be completed by August 31, 2003, will cover the implementation of the economic program described in this letter and our letters of January 18, 2002 and November 26, 2002 and will establish the timing of the fourth review. The third 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,

Javier Silva Ruete
Minister of Economy and Finance

Richard Webb
President
Central Reserve Bank of Peru



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Table 1. Peru: Quantitative Performance Criteria and Inflation Consultation Mechanism, 2003

	Mar. 31	Jun. 30	Sep. 30	Dec. 31
(Cumulative amounts from December 31, 2002, millions of new soles)				
Borrowing requirement of the combined public sector 1/ 2/	780	1,400	2,595	4,130
Net consumer lending of Banco de la Nación	-15	40	30	75
(Cumulative change from December 31, 2002, in millions of U.S. dollars) 3/				
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions 4/ 5/ 6/ 7/	98	-50	-146	-148
Outstanding short-term external debt of the nonfinancial public sector	50	50	50	50
Contracting or guaranteeing of nonconcessional external public debt with maturity of at least one year 8/	950	1,680	2,015	2,200
Of which: [1-5] years' maturity	250	250	250	250
External payments arrears of the public sector (on a continuous basis) 9/	0	0	0	0
(Consultation bands for the 12-month rate of inflation, in percent) 10/				
Outer band (upper limit)	5.5	5.5	5.5	5.5
Inner band (upper limit)	4.5	4.5	4.5	4.5
<i>Central point</i>	2.5	2.5	2.5	2.5
Inner band (lower limit)	0.5	0.5	0.5	0.5
Outer band (lower limit)	-0.5	-0.5	-0.5	-0.5

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

2/ The limits on the borrowing requirement of the combined public sector will be adjusted upward, by a maximum amount of S/. 200 million, for completion of a public investment project financed with concessional lending under the PIPP.

3/ The quantitative performance criterion on government guarantees for housing support programs has been deleted as these programs will not be put into place.

4/ The target for net international reserves will be adjusted upward by the amount of PIPP proceeds in foreign currency in excess of US\$15 million by end-March, US\$57 million by end-June, US\$157 million by end-September and US\$400 million by end-December 2003. The amounts in excess will be deposited at the BCRP.

5/ The target for net international reserves will be adjusted upward by the amount that net foreign borrowing of the nonfinancial public sector exceeds US\$380 million at end-March, US\$510 million at end-June, US\$660 million at end-September and US\$720 million at end-December 2003. The amounts in excess will be deposited at the BCRP.

6/ The target for net international reserves will be adjusted downward for shortfalls from the combined program amounts of PIPP proceeds and net foreign borrowing. This downward adjustment will not exceed US\$100 million at end-March, US\$320 million at end-June, US\$500 million at end-September and US\$400 million at end-December 2003.

7/ The target for the net international reserves will be adjusted downward 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\$300 million at any time in 2003.

8/ The limit would be adjusted upwards by any amount of debt issued for, and used in, a debt-exchange operation, and by up to US\$375 million for prefinancing of government operations in 2004.

9/ Excluding arrears associated with nonrescheduled debt to foreign creditors outstanding as of end-2002.

10/ 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 arrangement.



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Table 2. Peru: Structural Benchmarks

To be completed by June 30, 2003

1. Submission to congress of fiscal decentralization legislation consistent with the objectives for decentralization stated in paragraph 12 and with the objectives for tax reform stated in paragraph 13.
2. Implementation of the revised rules on fiscal prudence and transparency.
3. Granting statutory protection to SBS staff in the discharge of their responsibilities.

To be completed by September 30, 2003

1. Submission to congress of a 2004 budget consistent with the objectives for decentralization stated in paragraph 12 and with the objectives for tax reform stated in paragraph 13 and the revised rules on fiscal prudence and transparency.
2. Identification of regional and sectoral tax exemptions to be phased out by end-2004 that in the 2003 budget are estimated to have an annualized cost of 0.4 percent of GDP.