MINISTERIO DE ECONOMÍA Y FINANZAS

BANCO CENTRAL DE RESERVA DEL PERÚ

Lima, May 25, 2004

Dr. Anne Krueger
Acting Managing Director
International Monetary Fund
Washington, DC 20431

Dear Dr. Krueger:

1. In recent years, the Peruvian economy has continued to strengthen, and financial indicators have further improved. The government of Peru is firmly committed to continuing to foster robust and durable growth of output and employment, keep inflation low, reduce external vulnerabilities, and lay the basis for a marked reduction in poverty through prudent macroeconomic policies and a deepening of growth-enhancing reforms.

2. Policies for 2004 aim at consolidating the gains made in 2002–03, with sustained economic growth, low inflation, and a further strengthening in external balances. The economy is envisaged to grow by 4 percent, led by strong export performance, and inflation is projected at 2.5 percent by year-end. The external current account deficit is projected to narrow from 1.8 percent of GDP in 2003 to 0.7 percent in 2004, with an increase in net international reserves of at least US$100 million. Toward this end, the program will maintain prudent fiscal and monetary policies, while adopting growth-enhancing reforms. Quantitative performance criteria are presented in Table 1.

3. The combined public sector deficit is targeted to fall from 1.7 percent of GDP in 2003 to 1.4 percent in 2004 and 1 percent in both 2005 and 2006. These levels are expected to be covered by available multilateral and bilateral financing and net placements of government debt in the domestic and external markets. On this basis, public sector debt is expected to fall from 47½ percent of GDP in 2003 to about 41 percent of GDP by end-2006. The fiscal objectives of the program through end-June 2006 will be monitored on a quarterly basis through ceilings on the public sector borrowing requirement. The program also includes ceilings on the contracting or guaranteeing of nonconcessional medium- and long-term public debt and on the outstanding short-term external debt of the nonfinancial public sector. The government will stand ready to take any additional measures that may be needed to ensure that the fiscal targets are observed.

4. The objective of monetary policy is attainment of the inflation target of 1.5-3.5 percent, according to the central bank's inflation targeting framework, in the context of a floating exchange rate regime. In recent months, weak agricultural crops, increases in world oil prices, and bottlenecks in transportation have led to a temporary rise in observed inflation, to the higher end of the inflation targeting range. However, some of these pressures are expected to subside in the near term and, by year-end, inflation is expected to fall back into the target range. Reserve requirements has been extended to all foreign exchange

liabilities, and 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. The program will include quarterly performance criteria floors on the accumulation of net international reserves by the central bank during 2004, and a consultation mechanism on inflation.

5. The attached Memorandum of Economic and Financial Policies (MEFP) presents the plans of the Government of Peru for 2004–06, which are based on an economic framework (*Hoja de Ruta*) reflecting broad-based consultation. In support of its program, the government requests a Stand-By Arrangement (SBA) from the Fund totaling SDR 287.279 million (20 percent of quota on an annual basis) and covering the period June 9, 2004 through August 16, 2006. The requested SBA would support government efforts to reduce the economy's vulnerability during the period through the change in administration in mid–2006. Accordingly, the government intends to treat the arrangement as precautionary.

6. The Government of Peru believes that the policies described in the attached MEFP are adequate for meeting the objectives of the program, but will take any steps that might may be needed for this purpose. The authorities of Peru will maintain a close and proactive policy dialogue with the Fund, in accordance with Fund policies on such consultations. There will be five semi-annual reviews under the program, and the first review will be completed by October 31, 2004. During the first review, the end-December limit on the borrowing requirement of the combined public sector may be adjusted by up to S/. 300 million, while assuring achievement of the program objectives.

Sincerely yours,

Pedro Pablo Kuczynski
Minister of Economy and Finance

Javier Silva Ruete, President
Central Reserve Bank of Peru

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Table 1. Peru: Quantitative Performance Criteria
and Inflation Consultation Mechanism, 2004

	Jun.30	Sep. 30	Dec. 31
(Cumulative amounts from December 31, 2003, millions of new soles)			
Borrowing requirement of the combined public sector 1/ 2/	200	1,590	3,300
(Cumulative amounts from December 31, 2003, 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/	286	-44	-157
Outstanding short-term external debt of the nonfinancial public sector	50	50	50
Contracting or guaranteeing of nonconcesional public debt with maturity of at least one year 7/8/	2,050	2,675	3,200
Of which: external debt [1-5] years' maturity	100	100	100
External payments arrears of the public sector (on a continuous basis) 9/	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
Inner band (upper limit)	4.5	4.5	4.5
Central point	2.5	2.5	2.5
Inner band (lower limit)	0.5	0.5	0.5
Outer band (lower limit)	-0.5	-0.5	-0.5

1/ 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./350 million for completion of two public investment projects (the Yuncan hydroelectric plant and other projects) financed with concessional lending under the PIPP.
3/ The target for net international reserves will be adjusted upward by the amount of PIPP proceeds in foreign currency in excess of US$40 million by end-June, US$70 million by end-September and US$110 million by end-December 2004. 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 the net foreign borrowing of the nonfinancial public sector exceeds US$500 million at end-June, US$585 million at end-September and US$665 million at end-December 2004. The amounts in excess will be deposited at the BCRP.
5/ 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$350 million at end-June, US$500 million at end-September and US$500 million at end-December 2004. In this case 3/ and 4/ will not apply.
6/ The target for 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 2004.
7/ 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$1 billion for prefinancing of government operations in 2005.
8/ The limit would be adjusted upwards by the total amount of private public partnerships (PPPs) where the government issues guarantees on borrowing by private firms up to a maximum of US$400 million.
9/ Excluding arrears associated with nonrescheduled debt to foreign creditors outstanding as of end-2003.
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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Memorandum of Economic and Financial Policies for 2004–06

1. Under its economic program for 2002–03, supported by the Stand-By Arrangement from the Fund, Peru made progress in stabilizing its economy and implementing growth-enhancing reforms. Economic growth averaged 4½ percent a year, inflation remained low in the context of the inflation targeting framework adopted in early 2002, and the external position strengthened significantly, reflecting strong export performance and substantial private capital inflows. The Government of Peru also made progress in advancing a series of reforms related to the tax regime, fiscal decentralization, the pension system, the introduction of fiscal rules, the granting of operating concessions of state assets, and prudential regulations and oversight of the financial system. During the program period, vulnerabilities associated with dollarization and relatively high external debt and debt service levels were reduced. However, the government is committed to further reduce vulnerabilities and bring down still high unemployment and poverty rates.

2. The government's economic program for 2004–06 is aimed at consolidating the gains made in recent years and promoting sustained economic growth and employment creation through the continuation of prudent macroeconomic policies and a deepening of the reform effort. Over the program period, real GDP is projected to grow by 4½ percent a year, supported by strong export performance, and 12-month inflation is forecast at about 2.5 percent. Gross official international reserves are targeted to continue to cover more than 100 percent of the banking system's dollar-denominated liabilities and more than twice the stock of short-term external debt on a residual maturity basis.

3. The primary surplus of the combined public sector is projected to improve significantly in 2004, from 0.4 percent of GDP in 2003 to 0.8 percent. Central Government tax revenue is projected to rise by 0.3 percentage points of GDP to 13.3 percent of GDP, reflecting the introduction of the tax on financial transactions, higher income tax collections associated with improved export prices, improvements in tax administration, and the elimination of distortionary taxes. The tax on financial transactions has been reduced from an initial rate of 1.5 per thousand to 1.0 per thousand in March 2004, and further reductions to 0.8 per thousand and to 0.6 per thousand have been approved for end-December 2004 and end-December 2005, respectively. To generate additional resources needed for the provision of infrastructure and social services in the regions, the government will work with congress to eliminate regional tax exemptions in at least two regions by end-September 2004.

4. In 2004, expenditure growth will also be restrained. The growth in general government noninterest expenditure in real terms will be limited to less than 3 percent in real terms (applying the GDP deflator). General government noninterest current outlays will be maintained below S/. 32.6 billion. Capital expenditure of the general government will be stepped up to S/. 6.2 billion (2.6 percent of GDP), with emphasis on infrastructure and roads. Further public investment in roads and other high priority infrastructure, consistent with sustainable debt dynamics and transparent fiscal accounting, will be promoted on the basis of

innovative financial mechanisms. There will be a more active promotion of private investment in infrastructure, through public-private partnerships (PPPs) and more conventional concession arrangements.

5. In order to contribute to medium term fiscal sustainability, the government will undertake public liability management. It will aim to expand placements in medium- and long-term local currency instruments, with a view to reducing rollover and currency risks. Likewise, the government will seek to lengthen the maturity of new placements abroad and to extend the maturity of existing debt through voluntary debt swap operations, among others. All external bond issues will have collective action clauses. To increase the flexibility of debt management, the government will introduce an overall ceiling on central government borrowing to replace the specific ceilings for domestic and external borrowing.

6. Monetary policy will continue to be guided by the inflation targeting framework, with the target set at 2.5 percent (within a band of ± 1 percent). The central bank will maintain a strong official international reserve position, in the context of Peru's inflation targeting framework.

7. To foster robust economic growth and employment and make room for higher priority social and infrastructure expenditure, the Government is deepening reforms aimed at increasing the cyclical stability of the economy, increasing the level and efficiency of public and private investment in infrastructure, encouraging private investment in productive capacity and housing, furthering Peru's integration into the regional and world economy, and streamlining public sector operations (Table 1 presents the growth enhancing policy actions for 2004). Toward these aims, the government will:

- ***Private investment.*** Grant privately operated concessions for public asset management, particularly in the area of transportation infrastructure; develop Public-Private Partnerships (PPPs), including for road construction and maintenance; bolster property rights by putting in place commercial courts in Lima and other cities with the purpose of expediting the settlement of business-related legal disputes.

- ***Public investment.*** Fiscal reforms aimed at protecting public investment levels and ensuring a more efficient execution of capital projects will continue to be implemented, with a view to avoiding the use of public capital expenditure as the variable that absorbs changes in the fiscal accounts. Furthermore, the government will explore the scope for innovative financial mechanisms that could be implemented to raise public investment in a noninflationary way, consistent with debt sustainability and transparent fiscal accounting.

- ***Job creation in the formal economy.*** Gradually lower the taxes on and regulatory costs of labor, which presently are equivalent to 60 percent of wages and undermine effective worker protection; and further promote trade opening and free trade agreements, including to accelerate the growth of labor intensive export industries.

- ***Public sector reform***. In order to improve resource management in the public sector, carry out a comprehensive reform of the pension regimes, including the preferential *Cédula Viva* regime; ensure that the pricing policy of state enterprises is consistent with market conditions; reinforce efforts to improve the efficiency and equity of the tax system by strengthening tax administration and eliminating distortionary taxes; and phase out sectoral and regional tax exemptions to generate additional resources needed for the provision of infrastructure and social services in the regions. Implement a comprehensive reform of the pension regimes for the police and the military. The reform would include raising individual contribution rates and improving administration.

- ***Decentralization.*** Complete the legal framework for a gradual and fiscally neutral decentralization that ensures delivery of essential public services.

- ***Poverty reduction.*** Improve the efficiency of social expenditure and strengthen the targeting of poverty reducing programs with the assistance of the Inter-American Development Bank (IADB) and the World Bank.

- ***Capital markets***. Further strengthen financial sector regulations and supervision, including in the context of the new Basle regulations, promote dedollarization, and support the development of domestic capital markets to increase the access and quality of credit, including through strengthening the basis for collateralization.

8. To promote higher investment and growth, the government of Peru has recently sold its minority shareholdings in an oil refinery, granted in concession a hydro-electrical project, and will shortly grant two important mining concessions. It will also issue the calls for bids to award in concession to the private sector the operation and maintenance of a port terminal by end-December 2004. In the area of road infrastructure, the government will seek to award concessions or PPPs by December 2004 for the construction and maintenance of at least two major roads. It will ensure that any government outlays, debt guarantees, or contingent obligations associated with concessions, PPPs, or any other financial mechanisms, are recorded transparently in the fiscal accounts and the public sector debt.

9. The Judiciary is implementing a program to strengthen property rights, with IDB support. In particular, it is establishing commercial courts modules to adjudicate commercial disputes and speed-up contract enforcement.

10. The government will continue to promote employment in the formal sector of the economy and improve effective worker protection. To reduce non-wage labor costs, the

government will submit to congress legislation to eliminate by end-December 2004 the 1.7 percent wage tax (IES).

11. In the area of public pensions, the government has already introduced in congress a constitutional amendment to allow for the submission of draft laws aimed at a comprehensive reform of the preferential public pension system (*Cédula Viva*, CV). The reform shall include centralizing the administration of the CV to improve its management and eliminate fraudulent payments, closing the CV system to new entrants, and eliminate the link between wage increases and pensions.

12. The government will undertake a reform of the civil service and improve the regulation of domestic fuel prices, with a view to improving efficiency and governance. Consistent with the recently approved general Public Employment Law, the government will submit to congress legislation that regulates employment conditions for government employees by end-December 2004. Also, government employment and payroll will be fully computerized, and a census of government employees and pensioners will be completed by end-September 2004. From June 2004, a new system will be introduced to ensure that prices of the state oil company PETROPERU are adjusted in an automatic and transparent way to keep them in line with market prices.

13. The government is pressing ahead with decentralization and related efforts to reduce poverty, with assistance from the World Bank and IDB. Consistent with the recently approved Fiscal Decentralization Law, controls on reporting, spending and borrowing by sub-national governments will be strengthened and their administrative capacity improved. The legal framework will be further enhanced to ensure that decentralization is implemented in a fiscally-neutral manner. In particular, by end-December 2004, the government will submit to congress three laws requiring: (i) specification of the criteria for central government certification of sub-national governments' administrative capacity to deliver public services effectively *(Ley del Sistema Nacional de Acreditación)*; (ii) consolidation of regions (*Ley de Incentivos para la Integración y Conformación de Regiones*); and (iii) clarification of the distribution of functional responsibilities among the different levels of government *(Ley del Poder Ejecutivo*). In addition, regulations will be issued by end-December 2004 that specify remedial measures for sub-national governments that are not compliant with fiscal rules.

14. The government will continue its efforts to further strengthen financial regulation and supervision. During 2004, the Peruvian authorities will: (i) announce a plan to improve collateral registries; (ii) enhance the supervision and regulation of operational risk of financial institutions, including insurance companies; (iii) start implementing rules requiring specific qualifications for personnel of financial institutions in charge of evaluating financial investments; and (iv) further promote the reduction of risks associated with dollarization. To develop the domestic capital market and further diversify investment opportunities of private pension funds, the government will promote the creation of alternative financial instruments in order to allow domestic savings to be allocated to private investment. To that effect the

limits on AFP investments abroad have recently been increased by 1.5 percentage points. Steps also will be taken to enhance the legal protection of employees of the Superintendency of Banks. Consistent with existing legislation, the government will maintain a unified and unrestricted exchange system, and a foreign trade regime free of import restrictions for balance of payments reasons.

15. Public bank lending to the private sector will continue to be closely monitored. Net lending under the Banco de la Nación consumer-lending program to aid low-income public sector employees and pensioners (Multired) will continue to be managed conservatively, and will not exceed S/. 700 million at the end of 2004. With respect to Banco Agrario, its operations will continue to channel foreign lines of credit to agricultural producers, and its quasi-fiscal operations associated with lending to small-scale farmers will continue to be recorded in the budget.

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Table 1. Peru: Growth Enhancing Policy Actions for 2004

1. Structural Performance Criteria	
Begin operations of a commercial court in Lima.	September 30
Grant concessions or enter into Public Private Partnerships for the construction and maintenance of at least two major roads.	December 31
2. Structural Benchmarks	
Announce a plan to centralize the information on collateral registries.	June 30
Submit to Congress legislation to eliminate by end-December the special wage tax (IES).	September 30
Complete a census of government employees and pensioners	September 30
Develop a satisfactory action plan for reforming the pension regimes for the police and the military.	September 30
Introduce in congress a constitutional amendment and, once approved, introduce in Congress draft laws to allow a comprehensive reform of the *Cédula Viva,* as described in paragraph 11 of the MEFP.	December 31
Implementation of a satisfactory law clarifying shared functional responsibilities among the national, regional, and local governments.	December 31
Implementation of a satisfactory law providing objective criteria for certifying that regional governments have the administrative capacity to take on devolved expenditure (*Ley del Sistema Nacional de Acreditación*).	December 31
Put in full operation a system within the SBS to measure currency risks.	December 31