



MINISTERIO DE ECONOMÍA Y FINANZAS



BANCO CENTRAL DE RESERVA DEL
PERÚ

Lima, Peru
December 5, 2007

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Strauss-Kahn,

1. This letter reiterates our commitment to the economic reform agenda supported by the Stand-By Arrangement (SBA), approved by the Fund's Executive Board on January 26, 2007, and informs you of performance under the program in 2007 and our policy intentions for 2008. It supplements our letters of January 3, 2007, and of June 12, 2007.
2. Peru's economic performance has been strong during the first year of the Fund-supported program and we expect this to continue during 2008. All performance criteria for end-June and end-September 2007 were observed with a comfortable margin. New performance criteria and structural benchmarks for 2008 are set out in Tables 1 and 2.
3. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of its program, but stands ready to take any further measures that may become appropriate or needed for this purpose. We will maintain a close and proactive policy dialogue with the Fund, in accordance with Fund policies on such matters.

A. Fiscal Issues

4. Following an overall public sector surplus of 2¼ percent of GDP expected for 2007, the program for 2008 maintains a prudent fiscal strategy. The 2008 budget envisages a balanced fiscal position, significantly below the deficit limit of 1 percent of GDP under the Fiscal Responsibility and Transparency Law (FRTL). Central government current expenditure growth (net of transfers excluding pensions) would be limited to 4 percent in real terms, while public investment not executed during 2007 would be carried forward into 2008 in order to



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continue addressing social and infrastructure needs. Were revenues net of mandatory transfers—as defined in the Technical Memorandum—to exceed the level envisaged under the program, the public sector borrowing requirement would be reduced up to a ceiling of 0.5 percent of GDP to assist macroeconomic stability. The public debt ratio is projected to decline from 47 percent of GDP in 2003 to an estimated 26 percent of GDP at end-2008.

5. To enhance budget execution, the government has simplified the National System of Public Investment (SNIP) procedures and is aiming at streamlining procurement processes. Subnational governments (SNGs) can now use part of their canon-related resources and revenues for maintenance and pre-evaluation of investment projects. To further enhance the capacity of SNGs to implement timely and high-quality investment projects, the government intends to strengthen existing regional Technical Assistance Offices supporting the SNIP by allocating additional staff and providing more training for evaluation of investment projects. The government will also increase the number of Technical Assistance offices from 16 to 28 by end-December 2008 (structural benchmark).

6. To strengthen the fiscal framework and minimize long-term risks, the government intends to:

- Submit to Congress a draft amendment to the Decentralization Law (DL) to ensure that limits to subnational government spending are consistent with those for the central government as prescribed in the FRTL (an end-September 2008 structural benchmark). The government will continue with its efforts to amend the FRTL to strengthen compliance and its consistency, including for better aligning the limit on real growth of consumption expenditure for all government levels with the economy's medium-term growth capacity.
- Finalize and submit a draft law to Congress to establish a comprehensive framework for PPPs by end-December (end-September 2007 structural benchmark that will be proposed to be set as a structural performance criterion for end-March 2008 otherwise).

7. Progress with modernizing the budget classification system has not been timely enough to incorporate it into the 2008 budget and into the charts of accounts (end-December 2007 benchmark). However, the new classification will be rolled out at the start of the 2009 budget cycle at all government levels (end-September 2008 structural benchmark). Delays in the external evaluation of the Integrated Financial Management System (SIAF) have complicated the full implementation of a Treasury Single Account (TSA) for the central government by end-2007 (structural benchmark). To implement this reform, the Ministry of



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Finance intends to take the following steps by end-September 2008: i) submit to Congress a new draft Treasury Law to include all general government resources in the TSA; ii) adopt the new budget classification, as noted above; and iii) establish a Treasury General Ledger (TGL) or modify the SIAF to ensure it provides TGL-type information.

8. Broadening the tax base is essential to meeting social and infrastructure needs. To this end, the government will issue methodological guidelines that should be used by ministries and other public entities for evaluating existing tax exemptions by end-June (structural benchmark), as contemplated in the new framework for tax exemptions enacted in December 2006 (Legislative Decree No 977).

B. Poverty Alleviation

9. In 2007, the government rationalized social assistance programs (SAPs) and integrated several of them into the strategy Crecer, to address chronic child malnutrition. A new permanent head and staff were assigned to the Interministerial Committee for Social Affairs (CIAS) in July (end-September 2007 structural benchmark). In 2008, efforts will be bolstered further:

- The conditional cash-transfer program Juntos will be extended from 360,000 beneficiaries at end-2007 to at least 500,000 beneficiaries by end-2008. The strategy Crecer, which currently attends 638 rural districts in extreme poverty, will be expanded into a second phase to reach 880 districts. To provide complementary basic infrastructure, a new social strategy Progresar will be launched soon. The recently completed Household Targeting Database (SISFOH) will assist in improving the quality of social expenditures and enhancing targeting of social programs.
- A prompt approval by Congress of the Executive Power Organic Law (LOPE) will strengthen budgetary resources for the CIAS.
- To further assist the poorest SNGs—especially those without access to canon resources--the Fondo para la Inversion Regional y Local (FONIPREL) will be expanded once its initial allocation of S/. 650 million is used. The government will also submit to Congress amendments to the SNIP Law, to allow for the outsourcing of the studies required for the formulation and approval of investment projects; which will help assist those SNGs with low capacity (end-March 2008 structural benchmark).



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- In addition, the government intends to ensure that the canon-related cash transfers to households remain limited and well-targeted.

C. Monetary and Financial Sector Issues

10. The authorities remain fully committed to its inflation targeting framework. The bands of the inflation consultation mechanism have been adjusted to reflect our new inflation target of 2 percent introduced in early 2007, while minimizing deflationary risks (Table 1). To further strengthen central bank independence, the Economics Commission in Congress has approved a draft constitutional amendment for de-linking future appointments of board members from the political cycle after 2011. We will continue with our efforts to ensure a prompt ratification by Congress in the year ahead.

11. The government will also continue implementing reforms aimed at enhancing the resilience of the financial sector, by sustaining dedollarization, strengthening the regulation and supervision of banks, and advancing reforms to deepen capital markets. Specifically:

- The government will submit to Congress amendments to the General Banking Law (GBL) to allow the Superintendency of Banks (SBS) the introduction of capital requirements for foreign-currency-induced credit risks via regulations (end-June structural benchmark, reset from end-December 2007), in line with our roadmap to fully adopt Basel II. In addition, financial institutions requested MiVivienda an extension of the deadline to discontinue the provision credit risk guarantees and the Bono al Buen Pagador for new foreign currency mortgages (end-June 2007 structural benchmark) and MiVivienda has agreed that this will be implemented by end-December 2007.
- Public banks should remain properly supervised and not undermine competition in the financial system. To that effect, Banco de la Nación (BN) will again comply with the 25 percent growth limit on its consumer lending during 2008. The government will ensure that the interest rates associated with BN's handling of the TSA are transparent and aligned to reflect BN's administrative costs for management services of public sector accounts. Also, we have submitted to Congress a draft law to align the regulatory and supervisory framework for BN and COFIDE with that for private financial institutions. With this reform, the GBL will have precedence over BN's and COFIDE's statutes.



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- Amendments to the GBL to increase the minimum capital required to established microfinance institutions will also be submitted to Congress by end-June 2008 (structural benchmark). The central bank intends to submit to congress legal changes to empower the central bank to oversee and regulate the entire payments system.
- The clarification of the tax treatment of securitized transactions (an end-December 2007 benchmark, reset from end-March 2007) will now be completed by end-June, 2008 (structural benchmark), through: (i) eliminating the application of VAT to collection of receivables used by Trusts and SPVs when originators are exempt; (ii) allowing the possibility of offsetting the effect of income taxes withheld at the Trust or SPV level in the case of future capital losses from equities or in the case of losses posted by the ultimate beneficiary on a consolidated basis. Regulation related to the tax treatment of financial derivatives will be issued by end-December 2007 (Legislative Decree No. 970).
- The government will submit to Congress an amendment to the Law of Pension Funds to significantly increase the 20 percent limit of private pension funds (AFPs) investment abroad by end-June 2008 (structural benchmark), redefine investment limits on public sector assets, broaden the set of investible domestic securities for AFPs, and ease limits on the use of forwards as hedges. The minimum return guarantee will be reformed in order to minimize herding behavior.
- The supervision of capital markets will be enhanced by strengthening the coordination between CONASEV and the SBS, including by signing a Memorandum of Understanding by end-March 2008.
- Debt management operations will be conducted to improve its profile, including by resolving the issue of some disputed claims following the prepayment in October of part of our nonconcessional obligations with the Paris Club in October 2007.

D. Other Growth-Enhancing Reforms

12. With regard to the business environment, a one-stop window for external trade transactions is now operational and the implementing rules of the rules of the “Positive Administrative Silence” law will be issued in the coming months. New commercial courts have been established in Lambayeque, Junin, and Tacna during 2007, and more courts are on the way to be implemented in 2008.



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13. In light of the strong performance under the program and the important progress being made in the structural reform agenda, we hereby request the completion of the Second Review under the Stand-By Arrangement.

Sincerely yours,

Luis Carranza
Minister of Economy and Finance

Julio Velarde
President Central Reserve Bank of Peru



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Table 1. Peru: Quantitative Performance Criteria and Inflation Consultation Mechanism for 2008

	Mar. 31	Jun. 30	Sept. 30	Dec. 31
(Cumulative amounts from December 31, 2007, millions of New Soles)				
Borrowing requirement of the combined public sector				
Unadjusted limits 1/ 2/ 3/ 4/	-2,036	-5,555	-5,254	0
(Cumulative amounts from December 31, 2007, millions of U.S. dollars)				
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions				
Unadjusted targets 5/ 6/	-645	-404	-437	0
Outstanding short-term external debt of the nonfinancial public sector				
Limits	50	50	50	50
Contracting or guaranteeing of nonconcessional public debt with maturity of at least one year				
Unadjusted limits 7/ 8/ 9/	1,568	1,673	2,354	2,680
Of which: external debt of 1-5 year maturity				
Limits	100	100	100	100
External payments arrears of the public sector (on a continuous basis)				
Limits	0	0	0	0
NPV of future government payments associated with PPP operations (on a continuous basis)				
Unadjusted Limits 10/	1,860	1,860	1,860	1,860
(Consultation bands for the 12-month rate of inflation, in percent) 11/				
Outer band (upper limit)	5.0	5.0	5.0	5.0
Inner band (upper limit)	4.0	4.0	4.0	4.0
Central point	2.0	2.0	2.0	2.0
Inner band (lower limit)	0.0	0.0	0.0	0.0
Outer band (lower limit)	-0.5	-0.5	-0.5	-0.5

Sources: Staff estimations.

1/ PIPP proceeds are included below the line.

2/ The limit on the borrowing requirement of the combined public sector will be adjusted downwards by the amount central government revenues net of mandatory transfers exceed program estimates of S/. 12,767 million at end-March, up to a ceiling of S/. 450 million; S/. 26,493 million at end-June, up to a ceiling of S/. 900 million; S/. 40,471 million at end-September, up to a ceiling of S/. 1350 million; and S/. 54,751 million at end-December, up to a total ceiling of S/. 1,800 million.

3/ The limit on the borrowing requirement of the combined public sector will be adjusted for the operating balance of the BCRP.

4/ The limit on the borrowing requirement of the combined public sector will be adjusted upward by up to US\$100 million for capital spending by Petroperu, over the \$30 million already included in the program.

5/ The target for net international reserves will be adjusted upward by the amount by which net foreign borrowing of the nonfinancial public sector exceeds -US\$600 million at end-March, -US\$394 million at end-June, -US\$497 million at end-September, and -US\$41 million at end-December 2008. It will be adjusted downward for shortfalls from programmed net foreign borrowing. The amounts in excess will be deposited at the BCRP.

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 2008.

7/ The limit will be adjusted upward by any amount of debt issued, and used in, debt-exchange operations, or for prefinancing of government operations.

8/ The current debt limits do not include contracting of non-guaranteed debt by Petroperu and will be adjusted upward by up to US\$300 million for debt contracted by Petroperu during 2008.

9/ The limit on contracting and guaranteeing of nonconcessional public debt will be adjusted upwards for guarantees contracted or extended by the government in relation to concessions, up to a ceiling of US\$293 million for the year as a whole.

10/ Discount rates to calculate the NPV of the future stream of payments will be the currency-specific commercial interest reference rates (CIRRs) published by the OECD and specified in the TMU.

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 arrangement.



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Table 2: Structural Benchmarks for 2008

End-March

Submit to Congress an amendment to the SNIP law to allow for the outsourcing of the studies required for the formulation and approval of investment projects

End-June

Clarify the tax treatment of securitization transactions in line with parag. 11, bullet 4 of the Letter of Intent

Issue methodological guidelines for ministries and public entities to assess tax exemptions in line with new regime for tax exemptions

Submit to Congress amendment to the General Banking Law to allow the SBS the introduction of capital requirements for exchange-rate related risk in line with Basel II

Submit to Congress amendment to General Banking Law to raise the minimum capital requirement for microfinance institutions

Submit to Congress amendment to the Law of Pension Funds that would significantly raise limit for foreign investments by private pension funds

End-September

2009 Budget to be prepared according to modernized budget classification system and incorporated into the chart of accounts

Implement the TSA, as described in paragraph 7 of the Letter of Intent

Submit to Congress amendments to the Decentralization Law to reconcile subnational government spending with that for the central government as presented in the FRTL

End-December

Expand the number of Technical Assistance Regional Offices from 16 to 28
