

Lima, Peru
June 12, 2007

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. de Rato,

1. This letter updates our letter of January 3, 2007, which presented the policies of our economic program supported by a Stand-By Arrangement (SBA), approved by the Fund's Executive Board on January 26, 2007. This letter reiterates our commitment to advancing reforms that will help reinforce the basis for high and sustained growth and decisively tackle high poverty levels. It also informs you of performance and policy intentions in 2007.

2. The Fund-supported program is off to an excellent start and is enabling Peru to continue benefiting from a formidable economic performance. Led by private investment and consumption, output and employment growth have remained strong and we now expect the economy to expand by about 7 percent during 2007. Inflation has remained quiescent and the Central Bank has aligned the inflation target more closely with average inflation rates in Peru and its major trading partners, by reducing the target to 2 percent, while keeping the tolerance band at ± 1 percent. The external position is envisaged to remain strong, although the current account surplus would narrow to just 1 percent of GDP and net international reserves are projected to reach a level above \$20 billion (equivalent to almost 75 percent of total liquidity) by end-2007. All quantitative performance criteria for end-March were observed (Table 1) and we are proposing that the September 30, 2007 and December 31, 2007 indicative targets be set as performance criteria in accordance with the attached table 1, which are the same as in our letter of January 3, 2007. A revision of the structural benchmarks for 2007 is presented in table 2. All definitions and understandings specified in the January 3, 2007 Technical Memorandum of Understanding remain the same and apply to the performance criteria.

3. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Peru will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

A. Fiscal Issues

4. Fiscal prudence has been pivotal in underpinning the strong economic performance. The consolidated public sector posted an overall surplus of 2.2 percent of GDP in 2006, above earlier expectations and mostly reflecting strong revenue and lower-than-expected

expenditure execution at all levels of government. In 2007, we will continue addressing pressing social and infrastructure needs while preserving prudent fiscal targets under the program. To this end, we have issued two supplementary budgets, and have begun to implement reforms to the *Government Procurement System* (CONSUCODE), in consultation with multilateral institutions, and to the *National Public Investment System* (SNIP). An urgency decree has also been issued that simplifies and expedites approval procedures for public bidding and investment projects for all levels of government until end-2007. All these efforts will help ensure that much needed public investment at all levels of government takes place. Against this backdrop and with economic growth and commodity prices stronger than envisaged last year, we expect to meet the adjusted deficit of 0.5 percent of GDP for the consolidated public sector, as envisaged under the program. Despite our efforts to accelerate budget execution, the consolidated public sector could be close to balance in 2007, in light of potentially higher revenues.

5. We expect Congress to amend the *Fiscal Responsibility and Transparency Law* (FRTL) in the next few months to create room for infrastructure spending and to entrench fiscal discipline. Legislation has been approved by which the current 3-percent limit on the real growth of general government's expenditure will be applicable to the central government and exclude investment expenditure, as well as transfers. At the same time, we are evaluating the possibility of better aligning the new limit on current expenditure with the economy's increased productive potential and social needs. To preserve the transparency and quality of expenditure under the new rule, work is underway to modernize the budget classification system.

6. Further, we have continued to simplify and enhance the effectiveness of the tax regime. The tax code has been reformed to strengthen taxpayers' rights by removing the capitalization of interest on outstanding tax obligations and by extending participation in the simplified tax regime. A timetable for reducing the financial transactions tax (FTT) and the tax on net assets (ITAN) has been set: indeed, the FTT rate has been reduced, effective January 1, 2008 (end-December 2007 benchmark). As part of SUNAT's (the tax administration agency) medium-term strategy, indicators are being developed to monitor performance, including for VAT compliance, and tax audits will be more focused on massive and selective audits. Audit procedures are being simplified and we will improve the coordination between domestic taxes and customs obligations in the municipality of Lima and other large cities.

7. The new framework rationalizing tax exemptions is a major step forward in broadening the tax base. New tax exemptions will be allowed for six years and be subject to a technical assessment, which could extend them for three more years. In addition, all ministries are now required to present an assessment of existing tax exemptions to congress by April 2009, at which date a decision will be taken on whether to eliminate or bring them into the new framework. The Ministry of Finance will issue regulations by end-June 2007 outlining the criteria to be followed in preparing such assessments. In addition, a new framework for

tax exemptions on indirect taxes has been enacted for the *Selva* region (except *Loreto*), that will gradually replace such exemptions with direct transfers for infrastructure and social expenditure. Regulations to limit the adverse impact on tax collections in the free economic zone of *Puno* were issued in April.

8. The government is implementing several reforms to improve the quality of public spending:

- A high-level commission has been established to restructure the SNIP to expedite project viability approval while ensuring a high-quality of spending. In addition, to support the decentralization of the SNIP and assist SNGs, six regional offices have been established, and nine more are expected to be opened before year-end. We intend to allocate significant resources to boost the capacity of regional offices, with support from the IADB; and we also intend to involve the private sector to continue to assist SNGs in strengthening their capacity during the second half of 2007. Ensuring adequate monitoring of project selection, viability, prioritization, and ex-post evaluations by the MEF remain important priorities.
- With the assistance of an FAD resident advisor, full implementation of the central government TSA is envisaged for December 2007 (structural benchmark). The independent assessment of the government's Integrated Financial Management System (SIAF) will be available by end-September 2007. In consultation with the World Bank, UNDP and IADB, the government is reforming government procurement procedures, and a new law will be presented to congress in June. In the meantime, alternative mechanisms have been introduced to expedite procedures, in line with those in other countries in the region.
- A new unit to monitor the operations of SNGs is now operating at MEF (end-March benchmark). We have also taken steps towards establishing a subnational debt registry and recording the compliance of fiscal rules by SNGs by year-end. SNGs' capacities in fiscal management will continue to be strengthened. In line with our plan to complete the devolution of 82 functions and 153 responsibilities by end-2007, resources needed by SNGs to execute these functions and responsibilities are being quantified and will be transferred accordingly, upon satisfactory compliance with the established accreditation system.

9. Work towards introducing a permanent and comprehensive framework for PPPs has been initiated. A new methodology for valuing contingent liabilities of the public sector in relation to PPP projects has been finalized, and application guidelines will soon be developed. We have also begun to coordinate the work towards preparing a legal framework for PPP projects, which we now expect to submit to congress by September 2007. We will continue to limit the use of CRPAOs to already signed PPP projects in light of the fiscal risks they entail, and are looking into alternative financing instruments to facilitate PPP operations that provide a better risk sharing between the government and the private sector.

B. Poverty Alleviation

10. In line with the government's objective of alleviating poverty, the Interministerial Committee for Social Affairs (CIAS) has completed a wide-ranging assessment of the existing social assistance programs (SAPs), and published an action plan to strengthen their effectiveness (end-March benchmark). Implementation of this plan has already started, as 82 SAPs were merged into 26 in May. In an effort to ensure adequate integration of SAPs into the 2008 budget, the government will adopt institutional and operational arrangements in the second half of 2007. Priority will be given to providing the CIAS with a permanent head and technical staff (end-September structural benchmark). This would ensure the implementation of a uniform targeting methodology across SAPs.

11. The efforts at rationalizing social programs will be assisted by the development of a Single Beneficiary Registry and a Household Targeting System (SISFOH), which we expect to have in place within the next few months. These systems should help to systematically reduce leakages across SAPs. We will also continue to strengthen the effectiveness and focus of the program *Juntos*, in consultation with the World Bank, with the number of participating families expected to rise from 170,000 as of end-2006 to 350,000 by end-2007. Following the new criteria for reorganizing programs, we are also launching a pilot program in the *Huánuco* Region, to tackle malnutrition with a multi-sector approach, financed with resources from the *Fondo para la Igualdad*, and intend to replicate it across 631 districts starting in 2008. This pilot program will also incorporate our first efforts to implement performance budgeting of social programs, which we aim to expand to all public spending over the medium term. As part of our action plan, we will aim to prepare a comprehensive evaluation of universal social programs in the second half of 2007 in order to improve the quality and coverage of public education and health care.

C. Financial Sector Issues

12. To strengthen the coordination of lending practices by public financial institutions, representatives of COFIDE, *Banco de la Nación* and *Agrobanco* have held meetings to determine which financial institutions qualify, according to strict financial criteria, to enter into lending and infrastructure-support agreements with *Banco de la Nación*. As an important step towards strengthening the oversight of public financial institutions, *Banco de la Nación*, *Agrobanco*, and *MiVivienda* will be fully incorporated under the regulatory and supervisory framework of the Superintendency of Banks, and our expectation is that congress will approve such amendment in the next few months. Technical work on the legal and regulatory framework for empowering the central bank to oversee and regulate the entire payments system continues.

13. To support the dedollarization process, the guarantees and the provision of the "good payer bonus" on mortgages in foreign currency are being discontinued to ensure that by end-June most new mortgage loans guaranteed by *MiVivienda* are denominated in Nuevo Soles (end-June structural benchmark). New lending programs in domestic currency, such as *Mi*

Hogar and *Techo Propio* have been initiated to assist lower income groups. We are also finalizing technical discussions with private banks to exchange part of *MiVivienda*'s foreign currency portfolio into Nuevo Soles. We also intend to securitize the rest of *MiVivienda*'s foreign currency portfolio before end-2007.

14. The tax treatment of certificates of deposit, repurchase agreements, financial derivatives, and other financial instruments has been clarified (end-March structural benchmark). However, the clarification of the tax treatment of securitized transactions has been more complex than originally foreseen and we now intend to complete it, with technical assistance from the Fund, before end-December 2007. Also, the limit on pension funds' investments abroad has been raised to 15 percent, and cross-limits have been eased.

15. We continue to conduct debt management operations to improve its profile and extend the yield curve to provide a deep and liquid benchmark. We have recently reached agreement toward a prepayment of part of our nonconcessional obligations with the Paris Club due in 2007–2015 and remain engaged in resolving the issue of some disputed claims that have arisen in this context.

D. Other Growth-Enhancing Reforms

16. We remain committed to increasing the openness of the economy. We have recently reduced the average tariff level from 10 percent to 8.3 percent and are evaluating the possibility of additional measures to foster competitiveness. Further steps have been taken to improve the business environment. One-stop windows for importers and exporters and microenterprises are expected to be fully operational by year-end. We are extending the capacity of commercial courts in Lima and remain committed to establishing commercial courts in Trujillo and Arequipa by end-2007.

17. In light of the strong performance under the program and the important progress being made in growth enhancing reforms, we hereby request the completion of the First Review under the Stand-By Arrangement.

Sincerely yours,

/s/

Luis Carranza

Minister of Economy and Finance

/s/

Julio Velarde

President Central Reserve Bank of Peru

Table 1. Peru: Quantitative Performance Criteria and Inflation Consultation Mechanism for 2007

	Program			
	Mar. 31	Jun. 30	Sept. 30	Dec. 31
(Cumulative amounts from December 31, 2006, millions of New Soles)				
Borrowing requirement of the combined public sector				
Unadjusted limits 1/ 2/ 3/ 4/	-1,396	-4,190	-2,761	2,418
Adjusted limits	-1,646			
Actual	-4,252			
Margin	2,606			
(Cumulative amounts from December 31, 2006, millions of U.S. dollars)				
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions				
Unadjusted targets 5/ 6/	-260	44	336	350
Adjusted targets	-635			
Actual	948			
Margin	1583			
Outstanding short-term external debt of the nonfinancial public sector				
Limits	50	50	50	50
Actual	0			
Margin	50			
Contracting or guaranteeing of nonconcessional public debt with maturity of at least one year				
Unadjusted limits 7/ 8/ 9/	751	1,237	1,608	2,636
Adjusted limits	3146			
Actual	2742			
Margin	404			
Of which: external debt of 1-5 year maturity				
Limits	100	100	100	100
Actual	0			
Margin	100			
External payments arrears of the public sector (on a continuous basis)				
Limits	0	0	0	0
Actual	0			
NPV of future government payments associated with PPP operations (on a continuous basis)				
Unadjusted Limits 10/	1,500	1,500	1,500	1,500
Actual	55			
Margin	1,445			
(Consultation bands for the 12-month rate of inflation, in percent) 11/				
Outer band (upper limit)	5.5	5.5	5.5	5.5
Inner band (upper limit)	4.5	4.5	4.5	4.5
Central point	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
Actual	0.3

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/. 10,489 million at end-March, up to a ceiling of S/. 250 million; S/. 23,359 million at end-June, up to a ceiling of S/. 500 million; S/. 32,807 million at end-September, up to a ceiling of S/. 750 million; and S/. 44,821 million at end-December, up to a total ceiling of S/. 1,000 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\$15 million at end-March, -US\$138 million at end-June, -US\$274 million at end-September, and -US\$148 million at end-December 2007. 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 2007.

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 2007.

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\$430 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.

Table 2. Peru: Structural Measures for 2007

Structural Benchmarks***June 30***

Ensure that most of new mortgage loans extended by banks with the guarantee of *MiVivienda* are denominated in nuevo soles

September 30

Submit to congress a legal framework for PPP operations

Appoint a new head of *CIAS* and technical staff

December 31

Clarify the tax treatment of securitized transactions

Full implementation of the Treasury Single Account (TSA) for the central government

2008 Budget prepared according to the modernized budget classification system and incorporated into the charts of accounts

Issue new regulations regarding new risk categories and provisions to address foreign currency risk.
