

Lima, Peru  
January 3, 2007

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

Dear Mr. de Rato:

1. Peru's economy has performed well in recent years: economic growth has been relatively strong, inflation has remained low, and most financial indicators have improved. However, large social deficits persist, as half of the population still lives below the poverty line and one-fourth of all Peruvian children are affected by malnutrition. Access to basic public services, notably education, health, and security remains largely inadequate.
2. The Government is determined to implement a comprehensive strategy aimed at boosting Peru's economic growth while ensuring that its benefits are shared by all. Our program seeks to consolidate macroeconomic stability, alleviate poverty decisively, and address structural weaknesses to enhance medium-term growth prospects. Long-standing vulnerabilities related to a narrow tax base, poor infrastructure, high dollarization and low financial intermediation, and high labor informality are being addressed to support growth.
3. The attached Memorandum of Economic and Financial Policies (MEFP) presents the plans of the Government of Peru for 2007–08. In support of its program, the government requests a Stand-By Arrangement (SBA) from the Fund totaling SDR 172.37 million (27 percent of quota), covering the period through February 28, 2009. The requested SBA would help bolster market confidence and provide an important anchor to policies to entrench macroeconomic stability, decisively tackle poverty, and enhance medium-term growth. The government intends to treat the requested arrangement as precautionary.
4. The Government of Peru believes that the policies described in the attached MEFP are adequate for meeting the objectives of the program, but stands ready to take any additional measures that may be needed for this purpose. We will maintain a close and proactive policy dialogue with the Fund, in accordance with Fund policies on such consultations. There will be four semi-annual reviews under the program, and the first review

will be completed by May 15, 2007. Performance criteria and structural benchmarks under the program are set out in Tables 1 and 2 of the MEFP.

Sincerely yours,

/s/

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Luis Carranza

Minister of Economy and Finance

/s/

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Julio Velarde

President Central Reserve Bank of Peru

## MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2007–08

1. Over the past several years, Peru has made progress in consolidating macroeconomic stability and in implementing important reforms. Supported by a favorable external environment, the economy has been experiencing its longest expansion on record, with growth averaging 4¼ percent a year since 2001. Inflation has remained well contained in the context of the inflation targeting framework, and the external position has strengthened significantly. Progress was also made in strengthening the medium-term underpinnings of fiscal policy, consolidating the prudential and supervisory frameworks for the financial system, and in taking steps to improve the business environment.
2. Notwithstanding this strong performance, the Government of Peru is aware of the critical and pressing challenges facing the nation and is committed to addressing them. Moreover, it will implement the policies needed to help secure investment grade status while ensuring a more equal distribution of the benefits associated with growth. Accordingly, the government intends to consolidate macroeconomic stability and establish the conditions to reduce poverty decisively, enhance medium-term growth prospects, help promote employment growth, improve basic public services, and diminish incentives for informality. Critical to achieving these objectives is the implementation of reforms that strengthen the effectiveness of public institutions.
3. Macroeconomic policies for 2007–08 aim at sustaining economic growth, low inflation, and a strong external position. The economy is expected to grow by 5.5–6 percent, led increasingly by a strong domestic demand, and twelve-month inflation is projected to remain at around 2.5 percent. The external current account surplus would narrow to ¼ percent of GDP in 2007-08, and net international reserves are projected to grow by at least US\$400 million in 2007, with some further increase in 2008. To achieve these objectives, we will maintain prudent fiscal and monetary policies, while implementing growth-enhancing reforms.

### A. Consolidating Macroeconomic Stability

4. In the public sector, emphasis is being placed on prudent policies, while making room for needed increases in social and infrastructure spending. The overall balance of the combined sector is targeted to shift from a surplus of 1.0 percent of GDP in 2006 to a deficit of 0.8 percent in 2007, and 0.7 percent of GDP in 2008. The program includes an adjustor under which any central government revenue (net of mandatory transfers) exceeding programmed amounts will be saved to reduce the overall deficit to no more than 0.5 percent of GDP in 2007. Public sector debt is expected to fall from 37½ percent of GDP at the end of 2005 to close to 30 percent by end–2008. The fiscal objectives of the program will be monitored on a quarterly basis through ceilings on the borrowing requirement of the combined public sector; the contracting or guaranteeing of nonconcessional medium- and long-term public debt; and the outstanding short-term external debt of the nonfinancial public

sector. The program also includes a ceiling on the future stream of government obligations associated with new concessions and public-private partnerships awarded by the government.

5. To provide room for needed infrastructure spending while preserving fiscal discipline, the Fiscal Responsibility and Transparency Law (FRTL) is expected to be amended. A mechanism of sanctions is to be introduced in case of noncompliance with this law, and the 3-percent annual limit on the real growth in government spending was redefined, to exclude maintenance and investment spending. These changes would allow the government to increase public investment to 4.5 percent of GDP over the next five years.

6. The government is committed to broadening the tax base by reducing tax exemptions. To that effect, following the completion of a study on regional and sectoral tax exemptions, by March 2007 it will submit to congress a draft law that would rationalize fiscal exemptions. Steps will be taken to limit the adverse impact on tax collections from the creation of the tax free zone in *Puno*. With the same objective, tax exemptions for companies effectively operating in the high altitude regions of the country will only apply to a limited number of taxes. During 2007, the government will seek to finalize arrangements aimed at replacing regional tax exemptions with government transfers earmarked for infrastructure for other regions, similar to the agreement reached in July 2005 with the *San Martín* region.

7. The government intends to simplify, broaden, and enhance the effectiveness of the tax regime. In the area of tax policy, the Financial Transactions Tax rate will be gradually reduced beginning in January 2008. Prior to end-March 2007, MEF will specify the tax treatment of financial derivative instruments and financial securitization transactions. It will harmonize the tax treatment of repurchase agreements and certificates of deposits by end-2007. Legislation will be introduced in congress by end-December 2006 to reinstate the recently-eliminated tax on casinos and slot machines. The fiscal regime will continue to be consistent with enhancing the relative competitiveness of Peru in attracting investment into the mining and hydrocarbon sectors. In this regard, the government will not impose any new measures that would result in the unilateral cancellation of tax stability contracts. In the area of tax administration, performance indicators will be established at SUNAT to strengthen its effectiveness, particularly at customs. Administrative measures will be taken to avoid misuse of the duty drawback for exports, make the process of advanced VAT refunds more efficient, and simplify the system for small taxpayers (RUS).

8. Modernizing the budgetary process is critical to strengthening fiscal management and the effectiveness of public spending. The 2008 budget will be prepared following a budget classification aligned with international standards and incorporated into the charts of accounts. A comprehensive reform is under way to move gradually to performance budgeting in the accounts of the public sector, with the aim of completing this process by 2010. With assistance from the World Bank, performance indicators will be identified with a view to introducing performance budgeting for public investment by 2008. To improve transparency and facilitate supervision over public resources, the government will establish fully

functioning Treasury Single Accounts for the central government by end-December 2007 and for subnational governments by end-December 2008. The independent assessment of the government's Financial Management Information System (SIAF) will be completed by September 2007 and its recommendations will start to be implemented soon thereafter.

9. A transparent and effective fiscal framework constitutes the backbone of macroeconomic stability. To that effect, a Committee for Fiscal Policy Coordination will be created to ensure that all nonfinancial public sector entities continue to abide by the guidelines and goals established in the FRTL. To take into account the need to undertake long-delayed investments, the proposed program incorporates adjustors in the ceilings for contracting and guaranteeing of nonconcessional public debt (US\$300 million) and in the overall deficit of the public sector (up to US\$100 million) for additional capital expenditure undertaken by PetroPeru, in order to comply with environmental requirements.

10. The decentralization process will proceed in a fiscally sound manner. Efforts to strengthen the administrative capacity of subnational governments will be deepened during 2007-08, and functions devolved to subnational governments upon their satisfactorily meeting all the Accreditation System criteria. The government will monitor the quality of public expenditure for devolved functions and establish a registry of subnational debt at the Ministry of Finance. To this end, by March 2007 the Ministry of Finance will establish a unit to monitor the operations of subnational governments and their performance relative to the fiscal rules. It will also request that all regional governments and large municipalities comply with reporting rules by end-2007.

11. To simplify and expedite the approval of public investment projects, the government will reform the National System of Public Investment (SNIP). In accordance with a recently-approved law, its operations will be decentralized, with steps taken in close coordination between the Ministry of Finance and the regions to ensure that the quality of project assessments is preserved, and that SNIP procedures are better aligned with existing regional budget procedures. In this context, the limit on projects not subject to SNIP approval has been revised upward from S/. 4 million to S/. 10 million. Efforts will be made to develop and strengthen project assessment capacity of regional and local governments.

12. The Government of Peru intends to continue pursuing active debt management operations to deepen the domestic capital market further. It will continue to increase the share and duration of local currency instruments, to reduce exchange rate risks and extend the yield curve; it will also lengthen the maturity of new placements abroad in order to smooth out the amortization profile of external public debt. The Ministry of Finance will finalize a methodology for valuing the contingent liabilities of the public sector in relation to PPP projects. The Ministry of Finance also intends to enhance the design of the financing instruments used in the PPP projects.

13. The authorities are fully committed to preserving price stability and further strengthening the inflation targeting framework. Toward these objectives, the Central Reserve Bank of Peru stands ready to adjust interest rates as required to meet the inflation target. The Central Bank will limit its intervention in the foreign exchange market to avoid excessive volatility and build international reserves, thus helping economic agents to better internalize foreign exchange risks.

### **B. Reducing Poverty**

14. The sustainability of Peru's economic development critically hinges on a prompt and significant reduction in poverty levels. To effectively address social problems, including the critical issue of chronic malnutrition among children less than five years old, the government has established several new programs and is expanding and reforming existing ones:

- Child nutrition programs are being consolidated and strengthened to bring malnutrition down by five percentage points by 2011. Access to health insurance is being facilitated, particularly for those living in conditions of extreme poverty.
- The newly-created *Fondo para la Igualdad*, funded with the savings associated with recently-introduced austerity measures and transfers authorized by the Ministry of Finance, will be effectively used to address social needs. A registry of beneficiaries from all social programs will also be established.
- The *Agua para Todos* program is designed to help reduce by half the share of the population without access to potable water over the next five years. The government is also stepping up its housing efforts for the poor through the *Techo Propio* program and strengthening Cofopri's efforts to issue property titles. The number of families benefited under the conditional cash-transfer program *Juntos* will be raised from 180,000 in 2006 to 300,000 by end-2007.
- In the area of education, the accreditation system for teachers will be strengthened and their skills improved through continuous training.

15. To help design better policies in the fight against poverty and, in general, with respect to all social expenditures, the government will entrust the Secretary of Social Affairs (CIAS) to prepare reforms in this area. Social assistance programs have become extensive and are in need of streamlining and consolidation. By March 2007, the CIAS will have completed a comprehensive stocktaking of all social programs and prepared an action plan aimed at optimizing their functioning. Completion of the report by March 2007 will be a structural benchmark under the program. In implementing the poverty alleviation strategy, efforts will focus, with the support of multilateral institutions, on strengthening the indicators for monitoring and assessing key social programs.

16. The government has recently reached agreement with mining sector companies to make voluntary contributions toward a privately managed fund to support poverty alleviation and infrastructure needs. A committee, comprising subnational governments and mining sector companies, has been established to select the specific projects that will be financed with these contributions.

### **C. Promoting Long-Term Growth**

17. To help overcome existing deficiencies in public infrastructure, the Government is promoting the use of Public-Private Partnerships (PPPs). To that effect, a framework law will be submitted to congress by June 2007, which will provide guidelines on all aspects of PPP operations, including project selection and approval, reporting requirements, conflict resolution procedures, and adherence to international accounting standards. During 2007, the government plans to initiate PPP operations for a total amount of US\$3 billion, with large projects in the areas of ports, highways, and sanitation. All PPPs will continue to be evaluated by the SNIP and, to ensure that the increased reliance on PPPs is consistent with fiscal sustainability, the program has established a limit on the net present value of future government payments, firm and contingent, associated with new PPP operations.

18. The government is firmly committed to ensuring sustained formal employment generation in the private sector while aiming at a gradual reduction in labor market informality. Steps will be taken to further improve employment generation while developing a more comprehensive social protection net and providing progressive access to benefits to informal sector workers. The Government also plans to renew the current labor regime governing micro-enterprises before its expiration by end-2008.

19. Fostering the conditions for the growth of private sector activity is a core government objective. Steps have been taken to press ahead with administrative simplification and a one-step window is being implemented for new businesses and exporters. The positive results of the pilot program of commercial courts in Lima have helped expedite the resolution of business disputes, and the Judiciary intends to establish such courts in several other cities by end-2008.

20. The government intends to increase the openness of the economy further. The ratification of the Free Trade Agreement (FTA) with the United States will represent an important step in this area. Upon ratification of this agreement, the government will provide temporary compensation to affected producers for a limited period of time, without compromising the fiscal targets. The government will continue reducing tariff protection at the MFN level but also seek new bilateral FTAs, with a view to increasing further Peru's insertion in the world economy and boosting exports.

#### **D. Strengthening the Resilience of the Financial Sector**

21. The government will continue to strengthen financial sector regulation and supervision in order to enhance the resilience of the financial system. In this aspect, regulations were recently issued, aimed at preventing over-indebtedness by households and ameliorating foreign-currency-induced credit risks. In the period ahead, efforts will be focused on sustaining financial de-dollarization, improving the reliability of the payments system, expanding the role of public banks in promoting access to financial markets, and enhancing the development of the capital market.
22. To sustain the de-dollarization process, sound macroeconomic policies are being complemented by prudential regulations aimed at mitigating foreign-currency induced credit risks. The Superintendency of Banks (SBS) is ensuring that banks complete their assessment of unhedged borrowers by end-2006 and that, as required, reclassify their loans and build the associated provisioning requirements if needed. By December 2007, the SBS will strengthen the regulations on classification of loans and provisioning to fully take into account foreign-currency induced credit risks. The SBS will also issue norms to introduce lower loan-to-value ratios for mortgage loans in foreign currency to unhedged borrowers. In line with the Basel II Accord, the government will also seek to modify the General Banking Law with a view to introducing specific capital requirements for exposure to foreign currency credit risks.
23. The government will continue to promote mortgage lending in domestic currency under the *MiVivienda* program. To that effect, steps will be taken to ensure that, by end-June 2007, most new mortgage loans guaranteed by *MiVivienda* are denominated in nuevo soles. *MiVivienda*'s guarantee and provision of the "good payer bond" on mortgages in foreign currency will be discontinued for any new loan signed after that date. *MiVivienda* will also gradually increase its resources through issuance of long-term bonds in soles.
24. With respect to the payments system, the authorities will complete the DVP for fixed-income and will establish oversight of over-the-counter trading platforms. The legal framework for empowering the central bank to oversee and regulate the entire payment system will be defined by June 2007. To further strengthen the payments system, the authorities will also modify the banking law to ensure the seniority of the central bank as a lender of last resort among creditors.
25. Public banks will operate as second tier institutions. Agrobanco was recently recapitalized and mechanisms are being established to ensure that Banco de la Nación assists small and medium-size regional businesses more effectively. To that effect, it has started channeling its new lending operations to micro enterprises primarily through nonbank financial institutions. A coordinating committee comprised of representatives of the *Corporación Financiera de Desarrollo* (COFIDE), Banco de la Nación, and Agrobanco will be established by March 2007, to determine, according to strict financial criteria, which financial institutions should be allowed to enter into infrastructure agreements with Banco de

la Nación. Banco de la Nación will also continue to comply with a 25 percent annual growth limit on its consumer lending operations in 2007 and 2008. Steps will be taken to strengthen the oversight of the SBS over Banco de la Nación.

26. The government will implement additional measures aimed at improving the financial soundness and corporate governance of microfinance institutions. In particular, the minimum capital requirements for establishing such institutions will be raised. To enhance the transparency of credit operations and enforce consumer protection, the SBS will ensure that information on interest rates charged by financial intermediaries are presented in a transparent manner to the public.

27. Recognizing the increased importance of private pension funds in the economy, the government will seek to enhance their operating environment. The limits on private pension funds abroad will be gradually raised, while other cross-limits will be eased. The authorities will also assess whether minimum hedging requirements for foreign exchange investments of AFPs should be introduced. In order to promote the development of capital markets, an assessment will be undertaken to evaluate existing methods of infrastructure finance and determine whether the legal and regulatory frameworks should be modified, with a view to improving investor demand and reducing transaction structuring costs. A calendar for the issuance of infrastructure bonds in domestic currency will be developed by June 2007. The government also plans to strengthen the role and administrative capacity of the *Comisión Nacional Supervisora de Empresas y Valores* (CONASEV), to better align it with the development of new instruments and the increase in trading volumes.

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

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

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**Structural Benchmarks*****March 31***

Publication of the main recommendations of the CIAS on an anti-poverty strategy

Establishment of a unit at the Ministry of Finance to monitor the operations of subnational governments and assess their performance with respect to fiscal rules

Clarify the tax treatment of financial derivatives and securitized transactions

***June 30***

Submit to congress a legal framework for PPP operations

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

***December 31***

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

Financial transactions tax rate reduced, effective January 1, 2008

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

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