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Peru: 2006 Article IV Consultation and Request for Stand-By Arrangement—Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Peru

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2006 Article IV consultation with Peru and request for a Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the combined 2006 Article IV Consultation and Request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on October 20, 2006, with the officials of Peru on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 4, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff statement of January 26, 2007 updating information on recent economic developments;

- a Press Release, summarizing the views of the Executive Board as expressed during its January 26, 2007, discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively; and

- a statement by the Executive Director for Peru.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Peru*
Memorandum of Economic and Financial Policies by the authorities of Peru*
Technical Memorandum of Understanding*

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

PERU

Staff Report for the 2006 Article IV Consultation and Request for Stand-By Arrangement

Prepared by the Western Hemisphere Department
(in consultation with other departments)

Approved by Jose Fajgenbaum and G. Russell Kincaid

January 4, 2007

- **Discussions:** They were held during October 4–20 in Lima, with Prime Minister del Castillo; Ministers Carranza (Economy and Finance), Araoz (Foreign Trade and Tourism), Salazar (Agriculture), Valdivia (Mining and Energy); and Zavala (Justice); Central Reserve Bank of Peru President Velarde; and other senior officials.

- **Team:** Messrs. Terrier (head) and Cerisola, Ms. Jenkner (all WHD), Ms. Alexandraki (PDR), Mr. Adedeji and Ms. Garcia-Escribano (FAD), and Mr. Gasha (MCM). Messrs. Fajgenbaum (WHD) and Silva Ruete (OED) participated in the final discussions. The mission was assisted by Ms. Batini (Resident Representative).

- **Outreach**: Meetings with financial institutions, labor union organizations, the business community and research institutes. A half-day seminar was organized at the central bank to present the Selected Issues Papers: (1) Growth and Reforms in Peru Post-1990: A Success Story?; (2) Toward a Sound Fiscal Decentralization in Peru; (3) Peru's Experience with Partial Dollarization and Inflation Targeting; and (4) The Performance and Prospects of the Peruvian Textiles and Clothing Exports.

- **Relations with the Fund.** At end-November 2006, Peru's outstanding Fund credit was SDR 13.4 million (2 percent of quota). In support of their 2007–08 program, the authorities have requested a Stand-By arrangement (SBA), which they intend to treat as precautionary. Access under the 25–month SBA would be equivalent to 27 percent of quota (SDR 172.37 million). Peru has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement (Appendix 1). Peru has subscribed to the SDDS, and its statistics are broadly adequate for policy formulation, surveillance, and program monitoring.

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EXECUTIVE SUMMARY

Background

While currently reaping the benefits of sound policies, Peru still faces significant and pressing challenges. Supported by a favorable external environment, the economy is enjoying its longest expansion on record, with low inflation, a solid external position, and declining indebtedness and dollarization ratios. However, half of the population is still below the poverty line, and lingering vulnerabilities and structural weaknesses need to be addressed to improve sustainability and boost economic growth further.

The outlook remains favorable. Growth is expected to decelerate from 6½–7 percent in 2006 to 5–5½ percent in 2007–08, with risks balanced and largely dependent on global conditions. Over the medium term, the economy should expand at around 5 percent a year.

Key Issues

Medium-Term Challenges. Discussions focused on the need for sustained and stronger growth, to boost employment and lower poverty. A prudent overall policy framework, including with respect to foreign investment, should help promote nontraditional labor intensive sectors. This, together with more flexible labor regulations, would help reduce high informality. In addition, improving access to public services by the poor will enhance the effectiveness and sustainability of policies.

The 2007–08 Program. The program aims at entrenching macroeconomic stability, enhancing the anti-poverty strategy, strengthening the resilience and depth of the financial system, and pressing ahead with growth-enhancing reforms. Specifically:

- ***Consolidating macroeconomic stability.*** Fiscal targets for 2007–08 are to remain below the 1 percent deficit ceiling in the Fiscal Responsibility and Transparency Law (FRTL). Measures to lower distortionary taxes and exemptions and to improve the quality of public spending will also be adopted (paragraph 14–19). Greater exchange rate flexibility would help solidify the inflation targeting framework.

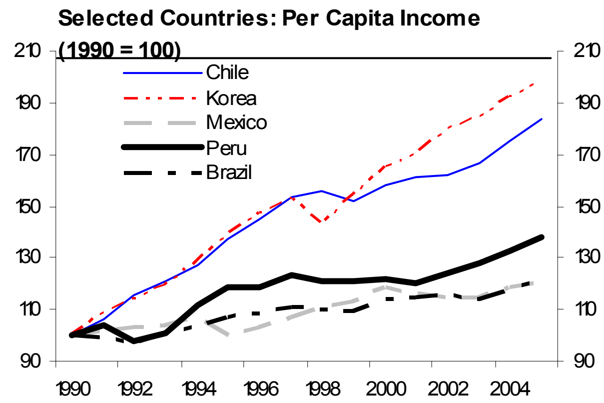
- ***Tackling high poverty.*** An action plan to restructure and enhance the effectiveness of social assistance programs is a key component of the program (paragraph 21–23).

- ***Financial system.*** Reducing dollarization, particularly of mortgage loans is a critical objective, as this will help to fortify the resilience of the banking system (Paragraph 30). These efforts will be assisted by measures to allow for a better internalization of risks and to deepen domestic capital markets (paragraph 32–33).

- ***Growth-enhancing reforms.*** The authorities will continue advancing reforms to simplify regulatory requirements, enhance labor market flexibility, and further open the economy (paragraph 34–37).

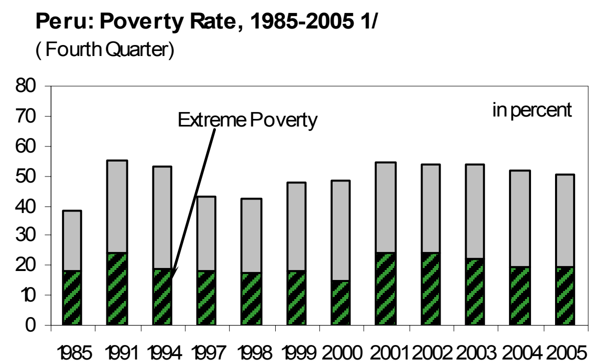
I. Introduction

1. ***Peru is reaping the benefits of the sound policies implemented over the last decade-and-a-half, in the context of a favorable global environment.*** The economy is enjoying its longest expansion on record, with low inflation, a solid external position, and declining indebtedness. This performance owes much to the policy efforts that have advanced fiscal consolidation and built on the structural reforms introduced during the 1990s. Inflation expectations have become well anchored which, along with regulatory reforms in the financial system, has contributed to some reduction in financial dollarization.



Comparison based on purchasing-power parity. Source: IFS and staff estimates.

2. ***The challenges faced by Peru are, however, still significant and pressing.*** The results of the presidential election in 2006 unveiled deep social tensions, which could threaten the sustainability of Peru's hard-won financial stability. Macroeconomic stabilization and reforms have helped augment capital accumulation and total factor productivity growth, but structural weaknesses still need to be addressed to boost growth further and reduce poverty decisively. While the asset quality and profitability of the financial system have improved significantly in recent years, intermediation remains low and the economy is still exposed to significant exchange rate risks. The tax base is narrow, reflecting broad exemptions and weak overall tax compliance, while the limited technical capabilities of subnational governments have delayed the execution of infrastructure projects. Informality in the labor market is high, and regulatory requirements for closing businesses are above the average in Latin America.



Sources: Instituto Cuanto (1985-1994); INEI (1997-2000 and 2005) and World Bank (2001-2004).

1/ Figures not comparable across series.

3. ***The new administration faces the difficult challenge of addressing these weaknesses while consolidating the foundations for sustained growth.*** President Garcia has appointed a politically diversified and technically strong cabinet, and reassured markets that the sound economic policy framework will remain in place. He has also promised to swiftly tackle poverty, while advancing structural reforms that would help raise medium-term growth and achieve investment grade status. President Garcia's approval ratings are high

and, given the complex socio-political scene, the government will need to build a strong consensus for these policies to sustain progress with reforms.

4. ***The Article IV consultation discussions focused on the policies needed to address Peru's key challenges and on how a new Fund-supported program could best help buttress the authorities' policy intentions.*** Discussions with government officials and private sector representatives highlighted a broad consensus on the need to consolidate macroeconomic stability and reduce vulnerabilities further—poverty in particular. The authorities considered that, although the last Stand-By Arrangement (SBA) was designed to signal an exit from Fund-supported programs, a new arrangement would help anchor policies and send appropriate signals to the markets (Box 1). Accordingly, they have requested a low-access 25–month SBA, which they intend to treat as precautionary, in support of their policies for 2007–08. The authorities' objectives are presented in the Letter of Intent and Memorandum of Economic and Financial Policies (MEFP).

BOX 1. PERU: PAST FUND POLICY RECOMMENDATIONS AND IMPLEMENTATION

In past Article IV consultations and program reviews, Directors called for reforms to solidify the macroeconomic policy framework, address social and infrastructure needs, enhance the resilience of the economy, and boost medium-term growth prospects.

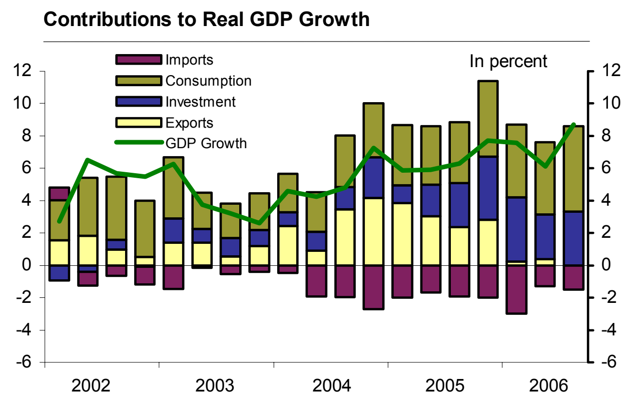
Macroeconomic policy. Directors viewed fiscal consolidation as essential to maintaining public debt on a downward path, endorsing the authorities' approach to keep deficits below the 1 percent limit in the FRTL. Directors have also called for eliminating regional and sectoral exemptions, bolstering the tax revenue effort, and improving the quality of public spending. They supported the authorities' plans to enhance budget flexibility, limit the growth in public sector wages, and provide scope for increased public investment and for assisting the poor. Directors supported the inflation targeting framework, underscoring the need to limit intervention to events of excessive exchange rate volatility.

Growth-enhancing measures. Directors emphasized the need to ensure flexible labor market conditions and to strengthen the business environment, including through trade liberalization. With high dollarization, Directors agreed with the importance of strengthening the prudential framework of the financial system and of developing capital markets.

Longer-term Fund engagement. An ex-post assessment of Fund longer-term engagement with Peru was discussed during the 2004 Article IV consultation. A number of Directors considered that exiting from Fund support would enhance confidence. Others considered that precautionary arrangements could be helpful to further entrench consensus for sound policies and reforms, particularly in challenging political conditions. Directors noted that programs should be with low-access and with measures paving the way for an exit.

II. The current Setting

5. ***The economy has continued to expand briskly during 2006, with inflation well within the 1.5–3.5 percent target range*.** The current expansion is in its twenty-first consecutive quarter, the longest on record. During January-September 2006, real GDP grew by 7½ percent year-on-year, propelled by a sharp increase in the terms of trade and strong domestic demand—supported by growing investment as well as higher incomes and rising employment. After peaking at 2.9 percent in April, 12–month inflation abated to around 1½ percent in November, reflecting a tightening in monetary policy and the unwinding of food supply shocks.[1] Core inflation remains at the lower end of the inflation target range.



6. ***The conduct of fiscal policy has been prudent, but expenditure growth has been strong.*** The deficit of the combined public sector was reduced from 2½ percent of GDP in 2001 to ⅓ percent of GDP in 2005 (Tables 2–5). Performance during the first three quarters of 2006 was significantly stronger than anticipated, and the combined public sector registered a surplus equivalent to about 3 percent of GDP. General government revenue was boosted by higher than anticipated corporate income tax payments, while expenditure of the consolidated public sector increased by about 11 percent in real terms (year-on-year) during January-September. Expenditure is estimated to have picked up further in the last quarter of the year, reflecting in part seasonal patterns in budget execution,[2] the adoption of a supplementary budget focusing on capital spending, and plans to advance some outlays initially planned for 2007. For 2006 as a whole, the combined public sector would register a surplus of 1 percent of GDP, compared with a deficit of ½ percent of GDP initially envisaged.

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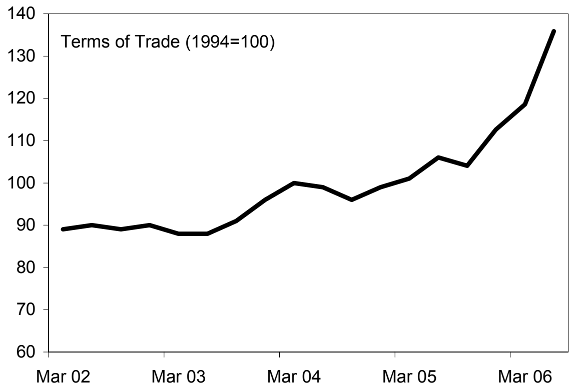
[1] The authorities have lowered excise taxes on petroleum products on several occasions since mid–2004 to offset the full pass-through of higher international prices. Currently, domestic retail fuel prices are broadly aligned to international levels.

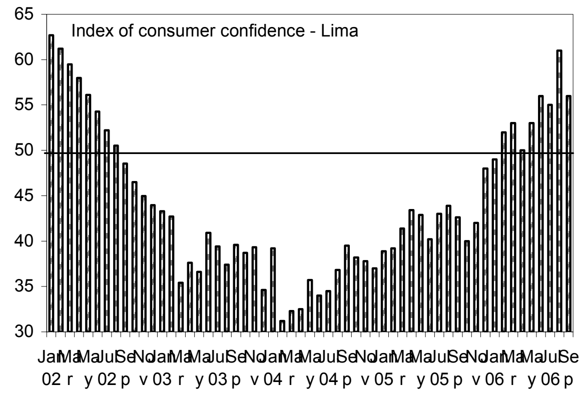
[2] In 2005, the combined public sector balance showed a surplus of 1.4 percent of GDP during January-September and a deficit of 0.3 percent of GDP for the whole year.

Figure 1. Peru: Indicators of Economic Activity

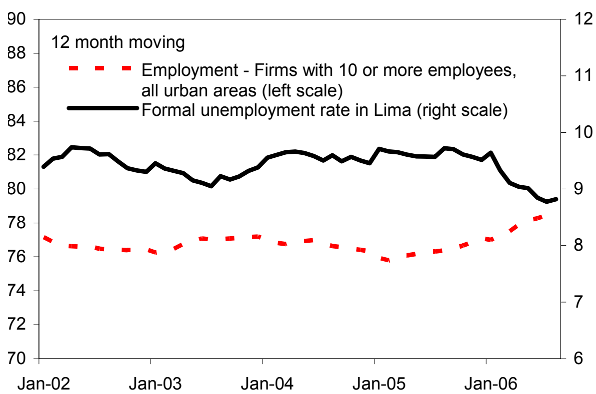
Commodity prices have reached record highs...



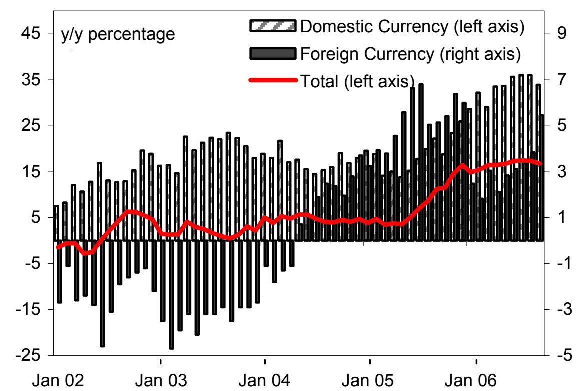
...and consumer confidence has strenghtened.



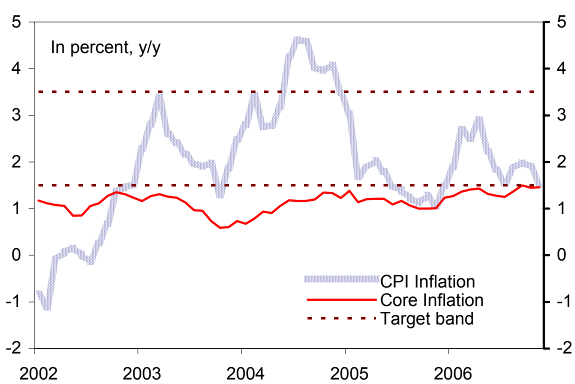
Employment growth has broadened...



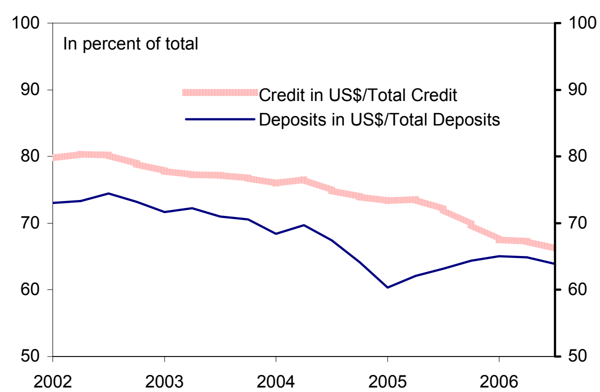
...while financial sector credit growth has accelerated.



Inflation and core inflation remain well under control.



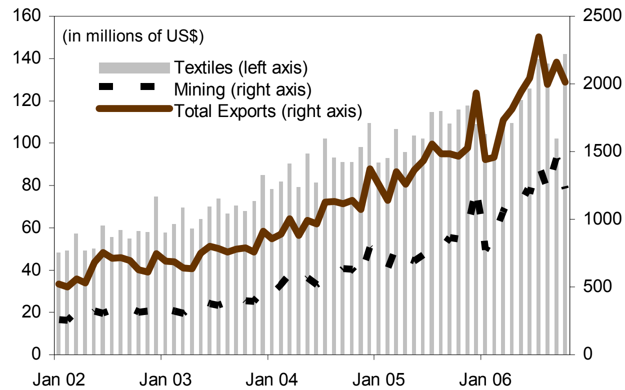
Shares of credit and deposits in foreign currency have declined.



Source: Banco Central de Reserva del Peru.

7. ***Peru's external position is strong and external vulnerabilities have declined.*** In 2006, record-high gains in commodity prices and higher nontraditional export receipts are estimated to have boosted the current account surplus to 1⅓ percent of GDP, despite a significant rise (estimated at 26 percent) in imports, particularly of capital goods. Foreign direct investment has remained strong, at around 4 percent of GDP, partly driven by reinvested earnings. At end-November, net international reserves stood at US$16.2 billion, equivalent to over 325 percent of short-term debt and 135 percent of foreign currency deposits with the banking system. Public sector debt is expected to have declined to 32 percent of GDP by end–2006, or 14 percentage points below its 2002 level; the structure of the debt has also improved, with the share of local currency-denominated debt now equivalent to one-fifth of the total.

Peru - Textiles, Mining and Total Exports



8. ***Financial market sentiment is favorable.*** In recent months, Fitch and S&P upgraded Peru's sovereign rating to BB+ (one notch below investment grade) and Moody's changed its outlook from neutral to positive.[3] Sovereign bond spreads have hovered close to all-time lows (around 135 basis points) and equity prices have increased sharply, largely reflecting higher mineral prices. The central bank has continued to intervene in the foreign exchange market, with net purchases of US$2¼ billion during the first eleven months of this year. The *Nuevo Sol* has been fluctuating within a narrow margin against the U.S. dollar.

9. ***Progress has been made in advancing structural reforms.*** In the financial sector, bank regulations to better internalize foreign currency risks have been advanced, and consolidated supervision has continued to be strengthened. New concessions for Peru's largest port facility (*Callao*) and nine regional airports were awarded in recent months, and two commercial courts are now operating in Lima, greatly expediting the resolution of disputes.[4] In June, the Free Trade Agreement (FTA) with the United States was ratified by the Peruvian congress, and is now pending ratification by the U.S. congress.

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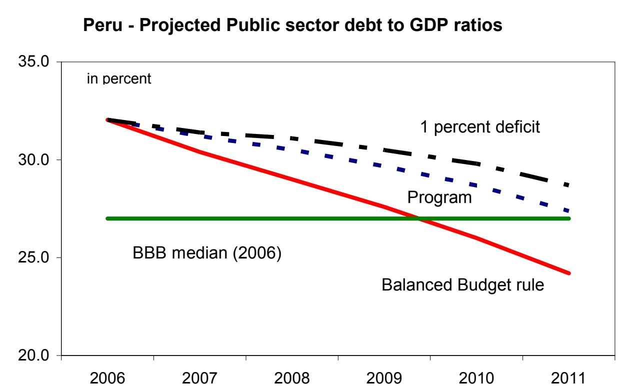
[3] Moody's rates Peru's sovereign credit three notches below investment grade, with a positive outlook.

[4] Peru ranks 65th in the 2007 World Bank Doing Business Report, up from 78th in 2005, reflecting a reduction in the burden of starting new businesses and improvements in contract enforcement.

III. Outlook

10. ***The short-term outlook remains strong, with relatively balanced risks.*** Growth is conservatively projected to abate from 6½–7 percent in 2006 to 5–5½ percent in 2007–08, partly reflecting a slowdown in world demand and declining terms of trade. The external position would remain robust and inflation is expected to return closer to the middle of the official target range (2.5 percent), in line with consensus forecasts, driven in part by fiscal expansion. While commodity prices are expected to ease from recent record-highs, large ongoing investment projects in extractive industries, together with an expected pickup in government capital expenditure, suggest some upside risks to growth. A less benign *El Niño* phenomenon than currently envisaged could also have a negative impact on output.[5] A disorderly unwinding of global imbalances could exert sharp downward pressures on commodity prices and heighten global risk aversion, with potentially adverse consequences for exports and public finances.[6]

11. ***Over the medium term, the economy is expected to expand by around 5 percent a year.*** This performance takes into account a gradual decline in commodity prices, which would bring the external current account balance back into small deficits. With fiscal policy expected to continue to overperform relative to the 1 percent deficit limit set in the FRTL, Peru's public indebtedness would decline steadily, from an estimated 32 percent of GDP in 2006 to around 27½ percent in 2011. The authorities and staff agreed that the debt dynamics remain fragile, with stress tests indicating that a sharp depreciation of the currency could potentially reverse most of the envisaged decline (Appendix 4). In the staff's view, this risk underscores the importance of further dedollarization and fiscal overperformance over the medium term compared to the overall deficit ceiling under the FRTL. An illustrative scenario (text chart) shows that balance in the accounts of the consolidated public sector would help public debt converge to the debt ratios of investment grade emerging market economies by 2009.



Source: IMF staff

[5] The *El Niño* cyclical climatic phenomenon, which recurs periodically, is expected to return in early 2007. Officials expect a limited impact on economic activity.

[6] A 10 percent decline in mining export prices would reduce central government revenue by around 0.4 percentage points of GDP.

IV. POLICY DISCUSSIONS AND THE 2007–08 PROGRAM

12. ***The discussions focused on the critical challenges that Peru faces over the medium term.*** Sustained and strong economic growth, together with a broadening of the export base, will be needed to boost employment and reduce high informality. Maintaining an environment favorable to foreign direct investment and trade openness will be critical to growth prospects in the mining sector and to help diversify the productive structure toward nontraditional labor-intensive sectors. Enhancing the provision and quality of services to the poorest areas of the country is needed to tackle poverty decisively, while more flexible labor regulations would help absorb a growing labor force into the formal sector and strengthen anti-poverty efforts.

Macroeconomic Framework: Main Elements 2006–09

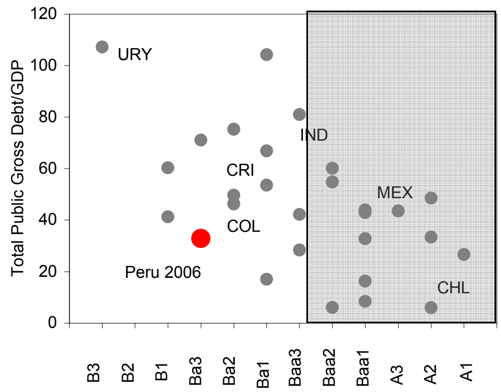
		Staff Projection		
	2006	2007	2008	2009
(Annual percentage change)				
Real GDP growth	6.5	5.5	5.0	5.0
Inflation (end-year)	1.6	2.5	2.5	2.5
(In percent of GDP)				
External current account balance	1.3	0.2	0.1	-0.1
Public sector primary balance	3.0	1.3	1.2	1.0
Public sector balance	1.0	-0.8	-0.7	-0.7
Public sector balance (including CRPAOs)	0.9	-1.2	-1.2	-1.1
Total public debt	32.0	31.2	30.5	29.7
Gross official reserve coverage of:				
Short-term debt (residual maturity)	350	337	385	370

Source: Fund staff estimates and Peruvian authorities' Macroeconomic Multiyear Framework.

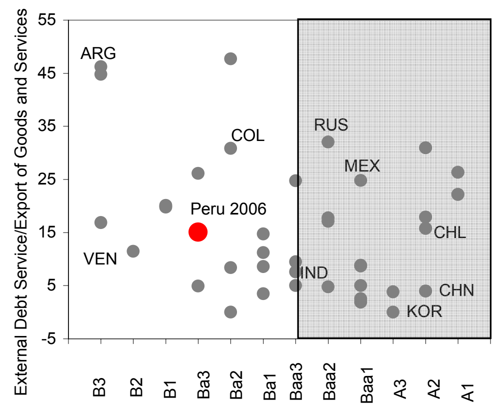
13. ***The authorities' program for 2007–08 focuses on maintaining macroeconomic stability and reducing poverty, while consolidating medium-term growth prospects.*** The program aims at entrenching macroeconomic stability through fiscal consolidation, while providing scope for addressing pressing social and infrastructure needs. A strategy is being prepared to strengthen poverty alleviation, including by stepping up the effectiveness of social assistance programs combined with institutional strengthening. Together with a prudent macroeconomic stance, efforts to lessen vulnerabilities—particularly dollarization—and to deepen the domestic capital markets should be conducive to achieving investment grade status (Figure 2). In turn, these reforms would set the stage for a virtuous cycle of sound policies with more equitable economic growth.

Figure 2. Peru: Comparison of Vulnerabilities with Investment Grade Countries, 2006

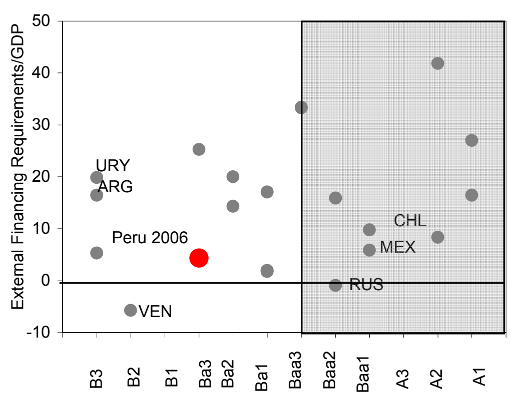
Public indebtedness is now within the range of investment grade countries.



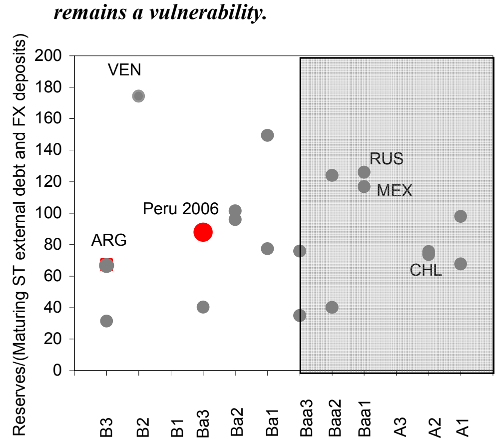
The debt service burden has declined due to high commodity prices, export volume growth and liability management operations.



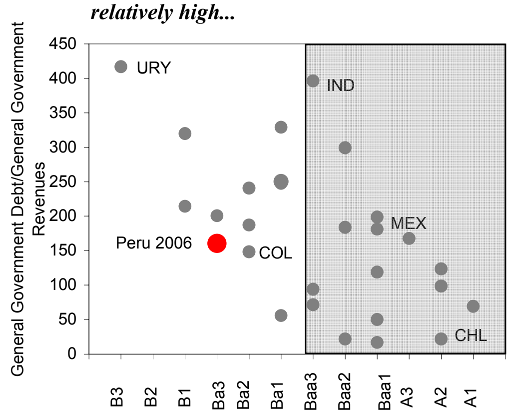
Fiscal consolidation, an improved debt profile and a surging trade surplus have led to low external financing requirements.



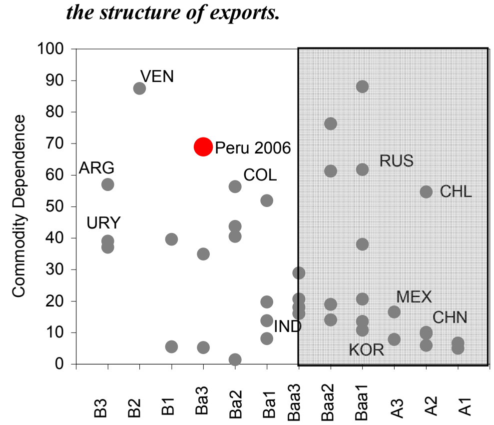
Reserves coverage has risen, but high dollarization, especially relative to investment grade economies, remains a vulnerability.



The public debt to fiscal revenue ratio remains relatively high...



... and efforts are needed to continue to diversify the structure of exports.



Source: WEO, IMF Staff Forecasts. Comparisons are based on Moody's credit ratings and refer to the general government.

A. Entrenching Fiscal Consolidation

The fiscal targets for 2007–08

14. ***While committed to maintaining fiscal discipline, the authorities consider that fiscal policy needs to play a more active and effective role in alleviating poverty***. They have reaffirmed their commitment to comply with the 1 percent limit on the overall deficit of the FRTL. Within that framework, they considered that boosting infrastructure and maintenance spending was the most appropriate means to help address pressing poverty issues in the short run. In the authorities' view, this would reduce the economic isolation of some regions due to Peru's difficult geography and help them take advantage of increased trade openness and market access. At the same time, they agreed with staff on the advisability of sustaining fiscal overperformance relative to the deficit limit to help public debt decline faster.

- ***Overall balance***. The overall public sector deficit has been set at 0.8 percent of GDP in 2007 and 0.7 percent in 2008.[7] Moreover, should central government revenues net of mandatory transfers exceed programmed amounts, the government would save them to reduce the overall deficit to 0.5 percent of GDP or less.[8] The revenue projections built in the 2007 Budget are relatively conservative, and assume a moderate drop in commodity prices and the elimination of custom duties associated with the FTA with the United States.

- ***Infrastructure spending***. A key priority of the 2007 budget is to increase spending in infrastructure and maintenance, to stimulate job creation and address social needs, particularly in poor regions. To this end, the authorities will amend the FRTL so as to remove capital expenditure and maintenance outlays from the 3 percent limit on expenditure growth in real terms. Under the 2007 budget, the growth in total expenditure excluding maintenance and investment will be submitted to the 3 percent limit in real terms, while capital expenditure would register a sizeable increase.[9]

- ***Civil servant wages***. Wage outlays included in the 2007 budget reflect the austerity policy initiated by the new administration. Under this policy, relatively low ceilings have also been set on civil servant wages and salaries. Staff expressed concern about

[7] Staff estimates that the structural fiscal deficit of the consolidated public sector would increase by about 1½ percentage points of GDP in 2007.

[8] Revenue overperformance above 0.3 percent of GDP would likely result in additional savings, in light of the limit of 3 percent real growth in central government expenditure (excluding maintenance and capital outlays) and the historical track record on the execution of capital outlays.

[9] Increased capital expenditure for 2007 focuses mainly on projects relating to roads, education, basic health, and rural electrification, reflecting significant infrastructure gaps in these sectors.

implementing such low ceilings, because they could lead the most qualified personnel to leave the civil service.

15. ***Staff supported the authorities' fiscal stance, while emphasizing the need to improve the quality of spending.*** In particular, given that the deficit target for 2007 would entail a significant fiscal easing at a time when the economy was expected to continue sustaining strong momentum, staff welcomed the authorities' commitment to save part of the unanticipated additional revenue. It also noted the importance of continuing to save as much as possible to help contain inflationary pressures in the economy. Indeed, with corporate profits on the rise, tax revenue could turn out to be quite higher than envisaged in the budget. Staff also encouraged the authorities to proceed with the increase in infrastructure and social spending—within the agreed-upon overall deficit limits—but emphasized the need to press ahead with well-targeted programs and to guard against unproductive spending.

Strengthening the effectiveness of the tax regime

16. ***There was agreement that a comprehensive reassessment of tax incentives was essential to strengthening the effectiveness of the tax system.*** In view of the complexity of existing tax exemptions, which already complicates the task of tax administration, staff expressed concern about the numerous proposals to introduce new regional and sectoral tax incentives.[10] The authorities agreed and indicated that they would submit a draft law to congress aimed at rationalizing fiscal exemptions by March 2007 (MEFP, paragraph 6). They expected this new framework to introduce time limits to the granting of exemptions, while conditioning their renewal to an evaluation of whether the initial goals had been achieved.[11] The authorities also intended to continue promoting the replacement of existing regional tax exemptions with direct central government transfers earmarked for investment and social spending.

17. ***Reform efforts will also focus on lessening the burden from distortionary taxes and strengthening compliance.*** Staff recommended transforming the temporary tax on assets (ITAN) into a minimum corporate income tax when it expires at end–2006, while allowing the exemption on capital gains in the stock market to lapse; this would ensure comparable treatment for capital and labor income. Congress recently approved gradually decreasing the rates of ITAN and reinstating the tax on capital gains in the stock market in 2009. Congress also approved a gradual decrease in the rate of the financial transactions tax (FTT), in line

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[10] A law was recently passed granting the government the powers to issue tax reform laws. This delegation will last 90 days and the government will not be able to use it to create new taxes, raise the rates of existing taxes, introduce tax exemptions, or tax savings.

[11] In November 2006, an FAD technical assistance mission helped the authorities with these reforms. The mission favored the use of accelerated depreciation, rather than tax exemption, as a means of stimulating investment.

with the authorities' policy intention (MEFP, paragraph 7).[12] Staff emphasized the need to strengthen tax administration through the intensification of audits, stepping up the collection of arrears, and introducing performance indicators, particularly for customs and the value-added tax. To this end, it stressed the importance of providing adequate resources to the tax administration agency SUNAT.

Improving the quality of public spending

18. ***The authorities intend to press ahead with modernizing the budgetary process, including by introducing performance budgeting*** (MEFP, paragraphs 8–9). Performance indicators are expected to pave the way for a gradual move toward performance budgeting by 2010. As a first step, and with assistance from the World Bank, performance budgeting for public investment will be introduced in the 2008 budget. Critical steps toward improving the quality of public spending involve strengthening the fiscal framework, the Financial Management Information System (SIAF), the National System of Public Investment (SNIP), and the framework for Public-Private Partnerships:

- ***Fiscal framework.*** New legislation approved in mid–2006 has freed the state-oil company PetroPeru from budgetary oversight and from the annual limits on non-publicly guaranteed borrowing imposed by the Ministry of Finance. The authorities shared staff's concerns that this new legislation could weaken the public finances framework and make it difficult for the government to comply with the fiscal objectives of the program. To address this problem, a new law was introduced to congress, proposing the creation of a Committee for Fiscal Policy Coordination under the authority of the Minister of Economy and Finance. In addition, congress has approved a law subjecting all non-publicly guaranteed borrowing by PetroPeru under the requirements and standards set in the General Indebtedness Law. The authorities also intend to gradually strengthen the commercial orientation of PetroPeru.

- ***Public Financial Management.*** In recent years, the authorities have continued to strengthen the Financial Management Information System (SIAF) and begun rolling it out to sub-national governments. They have also initiated an independent audit to assess whether the SIAF should be further enhanced or replaced by a different system. The results of this audit, which is financed by the Inter-American Development Bank, are expected to be available by September 2007. Efforts are underway to adopt a Treasury Single Account in 2007 and to align the budget classification with *GFSM 2001* (MEFP, paragraph 8). This would bring needed improvements in fiscal recording and reporting, and facilitate international comparisons.

[12] Revenues from the FTT and ITAN are included in the 2007 budget.

- ***National System of Public Investment (SNIP).*** Staff and the authorities agreed that the SNIP had been critical in strengthening the assessment of projects, although at times at the cost of delays in project approval. There was also agreement that the weak capacity of subnational governments in evaluating and executing projects was the most critical constraint to a full and effective decentralization. To help expedite project approval, the government has begun to decentralize the SNIP. Regional offices will be established and be responsible for assessing and approving public investment projects, in accordance to guidelines issued by the Ministry of Finance (MEFP, paragraph 11). To reduce unnecessary delays in the execution of public projects, particularly for small maintenance projects, staff encouraged the authorities to reassess the classification of investment under the purview of the SNIP to ensure that its assessment remained primarily focused on larger-sized projects.

- ***Public Private Partnership (PPP) framework.*** Given the increasing importance of PPP operations and the need for a framework law that provides guidelines on all aspects of these operations, the authorities intend to submit to congress a draft of such a law by June 2007 (MEFP, paragraph 17). At end–2006, government commitments in terms of future expenditure or minimum revenue guarantees related to PPP projects were estimated at close to 2 percent of GDP in NPV terms. To introduce more transparency in reporting, the proposed program includes performance criteria on all commitments associated with new PPPs signed in 2007 (MEFP, Table 1 and TMU, paragraph 14). For transparency purposes, the program will also monitor the issuance of PAO Entitlement Recognition Certificates (CRPAOs) and adjust the overall deficit and public debt for the consolidated public sector accordingly.[13]

19. ***The authorities and staff agreed that it was critical for the decentralization process to remain orderly and fiscally-neutral***. Political pressure has mounted to rapidly transfer functions to subnational governments, in line with the 2004 Fiscal Decentralization Law. In October 2006, an urgency decree brought forward the devolution of 185 functions to regional governments to end–2007. Staff emphasized the importance of ensuring that the transfer of the functions and corresponding resources is undertaken only once appropriate capabilities are in place at the subnational level; developing pilot projects will also help ensure a smooth process of decentralization. Staff stressed the need to preserve and, if necessary, strengthen the accreditation system, under which subnational governments are assessed with respect to their capacity to qualify for the transfers. The Ministry of Finance has also been conducting workshops to train subnational governments on how to report on their financial performance,

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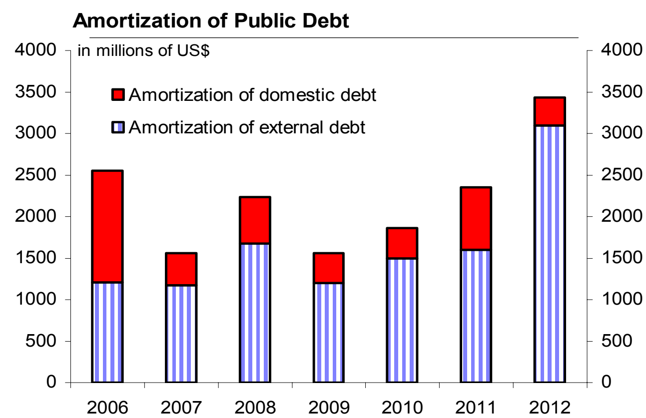
[13] CRPAOs can be issued by the government when a concessionaire completes a stage of the PPP project. They entitle their holder to a stream of future government payments committed under the original PPP contract. CRPAOs can be transferred to third parties and contain *pari-pasu*, acceleration, and cross-default clauses with all other CRPAOs issued in relation to any PPP project. The government expects to issue US$2 billion of such certificates during 2006–10, including US$0.1 billion in 2006 and US$0.4 billion in 2007.

including with respect to compliance under fiscal rules, and a unit will be established at the Ministry of Finance to monitor financial developments at the sub-national level. Staff also cautioned that the management of regional public companies should only be transferred to those subnational governments that have demonstrated their capacity to administer them soundly.

Further improving the structure of public debt

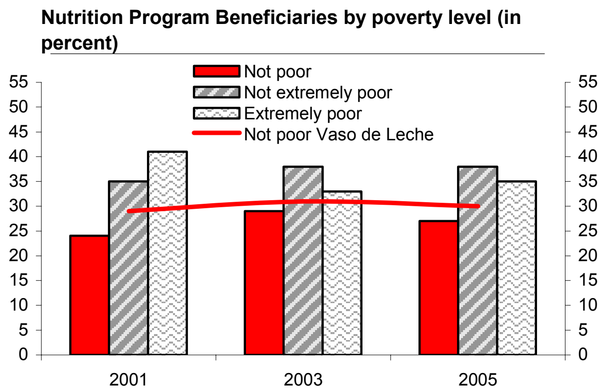
20. ***Debt management remains focused on improving the structure of public debt.*** The authorities' efforts continue to aim at increasing the share of local-currency denominated and fixed-rate debt in total debt. The amortization profile has been smoothed out in recent years, and the authorities are contemplating new private market and official debt operations to that effect. They noted that, with about one-fourth of the sovereign domestic bond debt held by non-residents, they did not consider the placement of sol-denominated bonds abroad a priority. Staff considered that the CRPAO instruments issued to facilitate the financing of PPP projects signed in 2005 needed to be treated as debt under the Fund's definition, despite the fact they were not given such a treatment under Peruvian law. Accordingly, it was agreed that the issuance of such papers would be included in the measurement of Peru's debt stock, for the purpose of the Fund's debt sustainability analysis and in the performance criteria for the contracting and guaranteeing of public debt. The authorities plan to explore alternative financial mechanisms for PPP projects with a view to minimizing the risks to the government from such operations (MEFP, paragraph 12).



B. Tackling High Poverty

21. ***A major challenge is how best to reduce poverty and ensure that all segments of the population share in the benefits of growth.*** Lack of significant progress in alleviating poverty in recent years has brought to the fore the need to improve the quality of public spending and to enhance the effectiveness of social assistance programs. Serious shortcomings are evident in a number of areas, including in education, where test scores place Peru near the bottom of countries in Latin America. Also, social programs are numerous (122 in total), and a large share of the resources available does not reach the

targeted population.[14] Discussions with civil society highlighted the effectiveness of the program *Juntos* which, by conditioning cash transfers on compliance with administrative, health, and educational requirements, has helped restore a sense of inclusion among its beneficiaries. Given the wide dispersion of access to benefits among the poor, the authorities plan to establish a registry of beneficiaries for all programs (MEFP, paragraph 14).



22. ***The authorities and staff agreed that a major effort was needed to better articulate the fight against poverty.*** With plans largely focused on increasing public spending and expanding programs, staff emphasized the need to streamline, consolidate, and better coordinate existing programs so as to avoid duplications and other inefficiencies. The authorities agreed and requested the Interministerial Committee for Social Assistance (CIAS), placed under the auspices of the Prime Minister, to prepare a strategy and corresponding action plan by March 2007.[15] Such an action plan will be a key component of the economic program, and specific actions based on the recommendations of the CIAS will be made explicit at the time of the first review. To the extent that the Committee's recommendations involve an expansion of social expenditure programs, there may be a need to rebalance the government's poverty strategy from capital to current spending.

23. ***Staff noted the need to complement the anti-poverty strategy with fiscal reforms in order to lessen regional disparities.*** A wide dispersion of poverty rates across regions, along with the limited capacity of subnational governments to carry out investment projects, highlight the need for improving the system of transfers in Peru (Box 2). At present, half of the corporate tax paid by the mining sector accrues to the regions where mining takes place (*canon minero).* Staff encouraged the authorities to press ahead with the introduction of mechanisms under which part of this revenue would be shared with the poorest regions where there is no mining activity. Although a recent initiative to allocate 20 percent of the *canon minero* to such regions was unsuccessful in congress, staff encouraged the authorities to persevere in this area.

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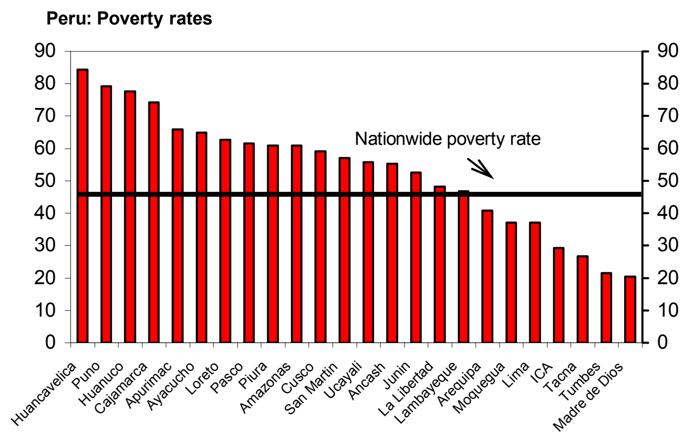
[14] For instance, a 2004 report by the *Contraloria General de la Nación* (CGN) noted that only about half of resources allocated under the *Vaso de Leche (Glass of Milk* program) actually reached the targeted population of young children and expecting and nursing mothers.

[15] The work of the CIAS is expected to be supported by 11 governmental agencies involved with social assistance programs.

BOX 2: PERU: REGIONAL POVERTY AND PUBLIC RESOURCES

- ***Regional disparities.*** Significant differences exist in poverty across regions and departments. The poverty rate is higher in the *Sierra* (68 percent) and the *Selva* (60 percent) regions than on the coast (41 percent). Similarly, poverty rates vary remarkably across departments, and are highest in Huancavelica (88 percent) and lowest in Madre de Dios (20 percent). A 2005 World Bank poverty assessment indicates that regional variations in poverty rates are closely related to access to basic services and road infrastructure.



- ***Resources for poverty reduction.*** The *canon minero* provides the bulk of public resources available at subnational government levels. They are estimated at US$1 billion (around 1 percent of GDP) in 2006 (up from US$150 million in 2002), and are to be used mainly for investment in infrastructure. These resources are concentrated in a few regions, with seven departments accounting for close to 80 percent of the total**.** Revenue from mining royalties, introduced in 2004 with a graded scale of rates (1–3 percent, according to gross sales), mostly benefits subnational governments. Mining royalty collections are expected to amount to US$0.1 billion in 2006. The effective use of resources has been constrained by the limited capacity of subnational governments to identify and execute productive investment projects. At end-September 2006, they had accumulated US$0.5 billion in bank deposits. The creation of SNIP offices at the regional level should help assist with the approval procedures and accelerate the pace of implementation of projects.

24. ***Mining regions are also set to benefit from part of the windfall gains of extractive industries.*** In the context of buoyant mineral prices, private mining companies operating in Peru have agreed to voluntary contributions to help increase social and infrastructure spending in the regions in which they operate.[16] The agreement with the government, which was finalized in December, is expected to lead to disbursements of some US$0.8 billion over

[16] FAD has provided TA in the area of the taxation of mining resources. Peru's mining tax regime compares favorably by international standards, but there is scope for making it more progressive in the future. FAD recommended avoiding the introduction of ad hoc windfall taxes or an abrogation of stability contracts, as these would significantly undermine prospects for investment.

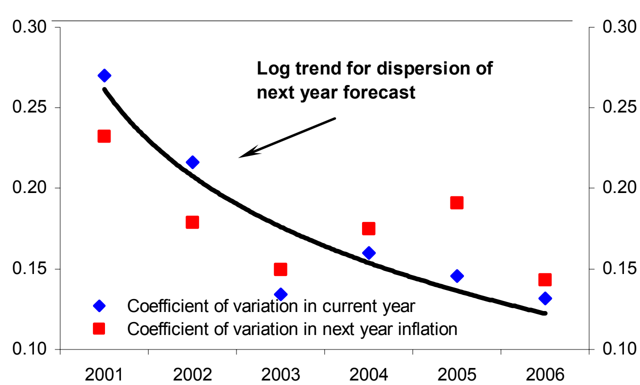
the next five years. The contributions are a function of commodity prices and are computed as a proportion of companies' after-tax profits. They will remain outside of the budget framework and will be managed by the companies themselves. The selection of projects would be decided by committees comprised of representatives from contributing corporations and subnational governments. Staff emphasized that close attention would need to be paid to the nature of projects and spending to minimize disruption risks in case of a decline in mineral prices.

C. Strengthening the Inflation Targeting Framework

25. ***Despite the strong momentum in the economy, inflationary pressures are quiescent.*** Over the past year, the increase in policy rates, together with upward pressure on the currency, has helped keep underlying pressures in check. The authorities noted that, although some areas of the country were operating at close to full capacity, wage pressures had not materialized, reflecting in part the large number of new entrants to the labor force and the size of the informal sector. However, there was agreement that increased public spending could put additional pressure on resources, and that the resulting impact on monetary conditions would require close scrutiny in the coming months.

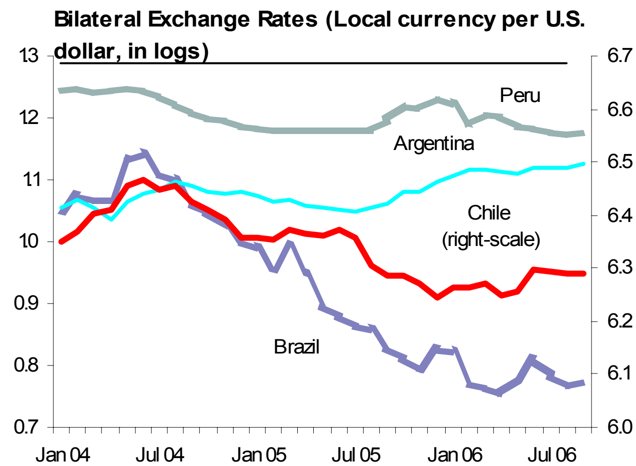
26. ***Staff noted that reforms could help further solidify the credibility of the inflation targeting framework.*** There was agreement that the inflation targeting framework had successfully helped anchor inflation expectations around the official target. However, staff noted that a continuation of the authorities' intervention policy, which had limited exchange rate flexibility in recent years, could undermine the achievement of inflation targets going forward. To raise the effectiveness and credibility of the inflation targeting framework, staff suggested increasing exchange rate flexibility. On the institutional front, the authorities concurred that the de-linking of future appointments of the central bank president and board members from the political cycle would further enhance the independence of monetary policy, but noted that such a reform would be difficult, as it would require a constitutional amendment.

Dispersion of Consensus Inflation Forecast



27. ***The authorities agreed on the need for greater exchange rate flexibility, but emphasized that any change in policies would be implemented gradually.*** The authorities noted that it was important to lean against temporary appreciation pressures, to avoid large corrections if the global environment were to turn less favorable. They pointed out that, in a highly dollarized economy, a significant and sudden depreciation of the currency could lead

to sharp changes in banks' balance sheets. On the other hand, the authorities and staff agreed that greater flexibility in exchange rate management would help avoid one-way bets in the economy, promote the use of financial hedges by economic agents, and increase the overall resilience of the economy. In turn, a higher degree of currency matching would help reduce vulnerability to exchange rate fluctuations and promote dedollarization in the financial sector. Central bank officials considered that the process needed to be gradual, to avoid generating new uncertainties in the economy and hurting the competitiveness of non-traditional exports. They stated that their intervention policy would become less frequent, and would primarily aim at limiting excessive volatility in the exchange rate. The authorities preferred discretionary intervention over a rules-based one, arguing that the limited size of the foreign exchange market might not be able to absorb occasional mismatches of a technical nature, causing undue swings in the exchange rate.



28. ***The program aims at a further modest buildup of official reserves.*** In recent years, net official international reserves have risen to comfortable levels but vulnerabilities remain, stemming from Peru's high foreign currency public debt, the dollarization of the financial system, and the exposure of the external position to commodity price shocks. The program contemplates a further, although modest, reserves buildup of US$350 million (net of banks' deposits at the central bank) in 2007. The authorities noted that the quasi-fiscal costs of the central bank had remained low. Staff concurred, but noted that these costs were artificially contained by the low rate of remuneration paid by the central bank on banks' legal reserves on foreign currency liabilities. Staff encouraged the authorities to raise this rate to help reduce distortions in financial intermediation. In early December, the rate was increased from 2.5 percent to 2.75 percent.[17]

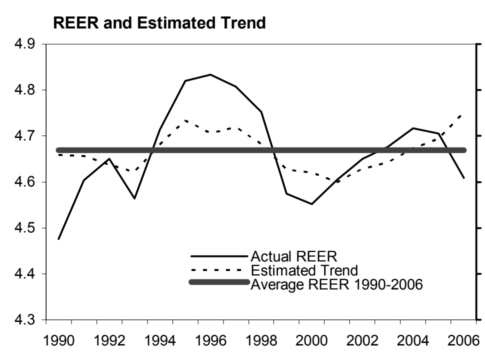
29. ***There was agreement that the level of external competitiveness remained broadly appropriate.*** Since 2000, Peruvian exports have more than tripled in U.S. dollar terms, reflecting both the surge in commodity prices and a sharp increase in volume (10 percent a year on average). Over the same period, growth in the volume of nontraditional exports has averaged 12 percent a year, suggesting that competitiveness is adequate, although such

[17] Previously, the rate of remuneration had been raised from 2.25 percent to 2.5 percent in July 2006, after having remained unchanged since June 2005. Prior to that date, it floated at the equivalent of Libor minus 0.75 percentage points.

growth in exports has also benefited from trade preferences in major markets. The authorities and staff agreed that recent trends in fundamental determinants, such as commodity prices and productivity growth, suggested that the currency may be slightly undervalued in real effective terms, while recognizing that such an assessment was inherently difficult and subject to considerable uncertainty (Box 3). There was agreement that infrastructure development and reductions in customs procedures would help further improve the competitiveness of Peruvian exports.

BOX 3: PERU: EXCHANGE RATE REGIME

- ***Exchange rate regime.*** Peru maintains a unified, managed floating exchange rate. The exchange system is free of restrictions on purchases of goods and services as well as capital account transactions.
- ***Appreciation pressures***. Strong appreciation pressures have emerged since 2002, driven by a surge in commodity prices, an increasingly stable macroeconomic framework, continued productivity improvements, and a benign global environment that has helped attract steady inflows of foreign capital.
- ***Intervention.*** Appreciation pressures have been contained by central bank intervention, partly out of concern that balance of payments improvements may be temporary. Net central bank purchases in the foreign exchange market have amounted to US$5.7 billion since end-2002. Over the past three years, the Nuevo Sol has fluctuated within a narrow margin (less than 5 percent) against the U.S. dollar.
- ***Foreign exchange market.*** The foreign exchange market is small, with daily turnover of US$40–100 million. Market participants expressed the view that frequent central bank intervention had prevented a deepening of the foreign exchange market.
- ***Real effective Exchange Rate***. Peru's real effective exchange rate (REER) stands slightly below its 10-year average, while a model based on commodity prices, net foreign assets, and relative economic growth suggests the REER is slightly undervalued. Peru's share in U.S. imports has nearly doubled since 2000, though some of this growth is thought to reflect the benefits of the ATPDEA trade preferences.



D. Strengthening the Resilience and Depth of the Financial System

30. ***The banking system is generally sound, and the authorities have continued to address balance sheet vulnerabilities associated with the high degree of dollarization.*** In a supportive macroeconomic environment, banks have experienced improved asset quality, profitability, and capitalization levels. Although financial intermediation remains low, with net credit to the private sector equivalent to 27 percent of GDP, access to banking services has increased significantly, with an additional 1½ million of new borrowers over the past five years. General growth of bank credit to the private sector was around 12.5 percent in the 12–month period through September 2006, with consumer credit expanding by 28 percent. The authorities and staff shared the concern that strong consumer credit growth may have been accompanied by weakened lending standards which could eventually impact asset quality during an economic downturn. To address the risk of over-borrowing, the authorities have issued new regulations requiring banks to constitute provisions equivalent to 20 percent of credit lines for overexposed customers. The authorities did not expect a sharp decline in commodity prices to entail major direct risks in the corporate sector, which is in a strong financial position and has reduced its leverage in recent years, but were more concerned about its impact on households and small businesses.

Peru: Indicators of Corporate Sector Vulnerability 1/

	2002	2005
Debt Service to Sales, Total	**4.0**	**3.4**
Fisheries	8.0	5.1
Tourism	7.5	5.9
Mining	2.3	1.7
Debt to Net Worth, Total	**1.7**	**1.5**
Fisheries	2.1	1.8
Commerce	2.0	1.9
Textiles	1.8	1.8
Mining	1.2	1.0

Source: SBS.
1/ Figures as of December, in percent.

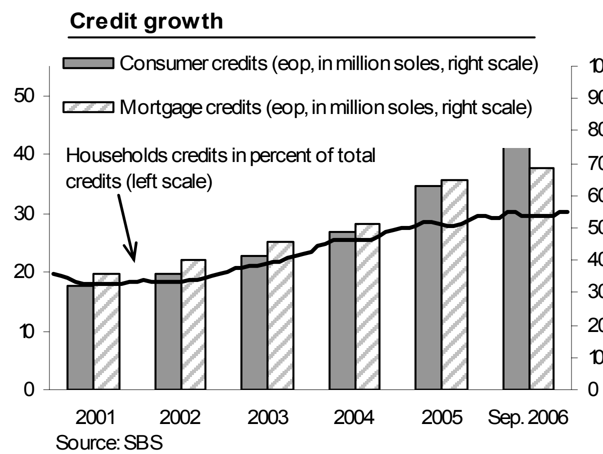
Peru. Financial Soundness Indicators of the Banking System, 2002-2006 1/

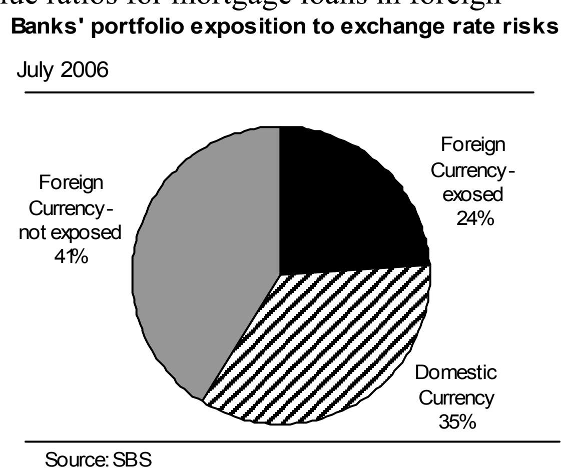
	2002	2003	2004	2005	2006
Regulatory capital to risk weighted assets	12.5	13.3	14.0	12.0	12.4
Non-performing loans to total loans	7.6	5.8	3.7	2.1	1.9
Provisions to:					
Nonperforming loans	133.2	141.1	176.5	235.3	223.3
Nonperforming, restructured, and refinanced loans	69.1	67.1	68.7	80.3	89.6
Return on assets	0.8	1.1	1.2	2.2	2.2
Return on equity	8.3	10.7	11.6	22.2	23.5
Liquid assets to total short term liabilities	41.9	40.4	44.5	45.5	43.0
Net foreign exchange open position to capital	37.0	31.8	24.2	23.1	22.4

Source: SBS.
1/ End of year data; for 2006, end-September data.

31. ***Reducing dollarization, particularly for mortgage loans, would be critical to bolstering the resilience of the banking system.*** The authorities agreed that the banking system remained highly exposed to foreign currency-related credit risk, as shown in the stress tests of the 2005 FSAP update. Staff called for strengthening provisioning requirements for the foreign currency loans that are pending a risk assessment, to increase

banks' incentives for prompt assessment and adequate provisioning. The authorities did not consider this necessary, as the share of loans pending an assessment was small. Furthermore, they intended to move within the next two years toward the adoption of capital requirements for foreign currency related credit risk for all financial institutions, in line with Basel II (MEFP, paragraph 22). They recognized that mortgage lending in foreign currency represented an important risk, and planned to introduce lower loan-to-value ratios for mortgage loans in foreign currency to unhedged borrowers. They also intended to press ahead with dedollarizing mortgage loan operations with the guarantee of *MiVivienda* (MEFP, paragraph 23). At the same time, they were exploring options to securitize *MiVivienda*'s portfolio with a view to inducing mortgage holders to voluntarily swap their dollar loans into domestic currency loans. They noted, however, that an obstacle to this process was the lack of standardization of mortgage contracts.





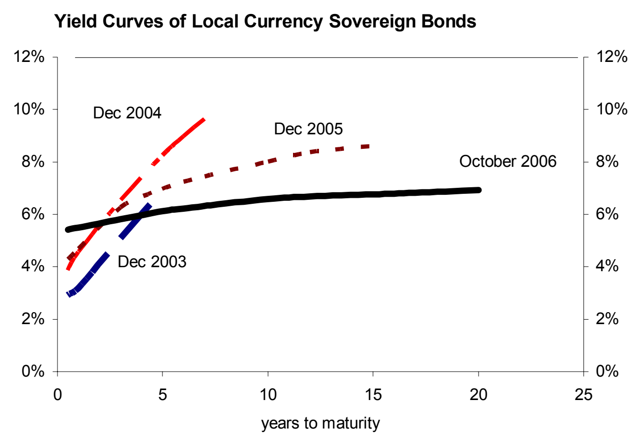
32. ***The authorities considered that public banks should continue to play a critical role as second-tier financial institutions.*** The three major public financial institutions—Banco de la Nación, COFIDE, and Agrobanco—are boosting their lending operations to small and medium-sized firms, in part through microfinance institutions. Given that microfinance institutions have still relatively low capitalization and weak management practices, the authorities plan to raise their minimum capital requirements while strengthening the selection process for their management (MEFP, paragraph 26).[18] To ensure that public bank lending through microfinance institutions is extended on the basis of sound risk practices, coordination among public banks and with the Superintendency of Banks (SBS) will be enhanced (MEFP, paragraph 25). The authorities noted that the subsidiary role of the General

[18] Microfinance institutions account for about 15 percent of total credit, or about 4 percent of GDP. The current minimum capital requirement is $250,000, and Directors have tended to be appointed on the basis of their political affiliation, particularly in municipal credit unions.

Banking Law for public banks made their supervision by the Superintendency of Banks more complicated.[19] Staff urged the authorities to ensure adequate governance and full-fledged supervision for these public financial institutions.

33. ***As a follow-up to the 2005 FSAP update, the authorities and staff discussed how to deal with systemic risks during periods of financial stress.*** There was agreement that the lender of last resort framework should be strengthened, particularly to establish the seniority status of the central bank as a creditor, which is currently left to the SBS to decide (MEFP, paragraph 24). To avoid large shifts in assets, staff suggested narrowing the net open foreign exchange position of banks and setting limits on the levels of the foreign exchange position of private pension funds.[20] The authorities were of the view that current bank regulations were appropriate, and that there was no immediate need for minimum hedging requirements for private pension funds. They noted that these funds adjust profitability for risks, and thereby limit incentives for large open positions. The authorities also agreed that such an adjustment may not work well during times of stress, and undertook to explore the merits of minimum hedging requirements (MEFP, paragraph 27).

34. ***Several complementary reforms are being advanced to deepen domestic capital markets.*** Peru's domestic capital markets have expanded markedly in recent years, particularly with respect to long-term bond issues and the market capitalization of listed shares. These improvements have been supported by active government debt management and increased global investor interest, which have helped extend the domestic yield curve for public securities. The authorities considered that the development of the capital markets was very important and planned to take further steps to deepen them. These steps included removing regulatory impediments to issuing securities, publishing a yield curve for private securities, unifying the tax treatment of securitized transactions, and clarifying the tax treatment of financial derivatives while aligning it with that for securitization transactions. In their view, the latter would encourage bank participation in the markets for these instruments and expand the set of instruments



[19] Banco de la Nación, COFIDE, and Agrobanco are governed by their own statutes, which can be amended by the Ministry of Finance.

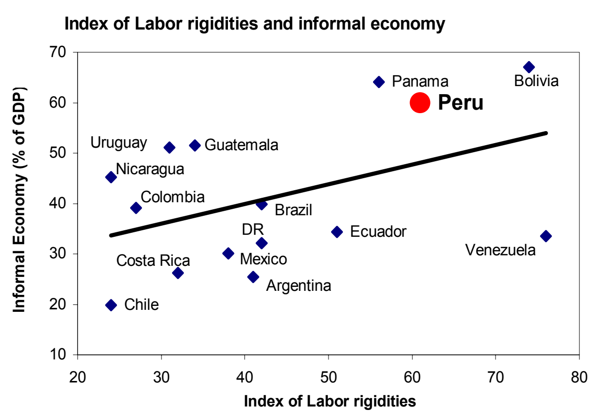
[20] For banks, the limits of the short and long net open foreign position are equivalent to 10 percent and 100 percent of capital, respectively. Staff suggested that the limit on the long position be reduced to around the level of dollarization of assets, so that the capital of banks remain protected.

used by the central bank for the conduct of monetary policy (MEFP, paragraph 24). These efforts, along with other reforms to the payments system, would also help promote trading in the secondary market.[21] The authorities planned to request technical assistance from the Fund in the capital market area. With assets held by private pension funds rapidly rising (US$12.7 billion at end-September), they have recently raised from 10.5 percent to 12 percent the limit on pension fund investments abroad. To help diversify risks, staff encouraged them to continue to raise gradually these limits.

E. Other Growth-Enhancing Reforms

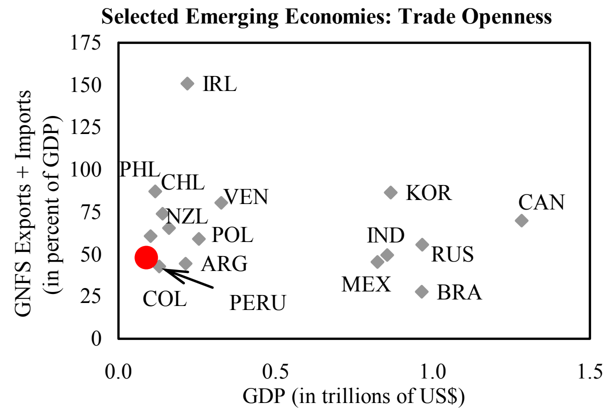
35. ***The authorities are taking steps to improve the business environment.*** Progress has been made in recent years in the areas of investor protection and contract enforcement. The establishment of two commercial courts has been an important first step to improve dispute resolution, and the authorities intend to proceed with their extension nationwide. In November, the authorities introduced a draft law in congress that would aim at simplifying business licensing and eventually shortening approval processes from an average of close to 100 days to 15 days; a "one-stop window" would also be established for exporters and importers.

36. ***The labor market remains characterized by a very high degree of informality***. Official data show that three fourths of active workers are employed in the informal sector, reflecting in part high severance payments and legal impediments to dismissals in the formal sector. The authorities noted that political pressure to intensify rigidities had risen, but saw some room for increasing flexibility and reducing severance payments, while providing a safety net to dismissed workers. Staff recommended that the labor regime governing micro-enterprises, which is due to expire by end–2008, be made permanent. There is evidence that non-wage costs are significantly higher in Peru than in other countries in the region. Employers also often report a deficit of skills, partly due to a mismatch between academic programs and the needs of dynamic industries. Investment in human capital and workers' training program would help ensure higher productivity.



[21] Under the current law, the tax treatment of repurchase agreements entails a transfer of property and is therefore subject to capital gains tax. This treatment differs for certificates of deposit. The tax treatment of financial derivatives has yet to be defined by SUNAT.

37. ***The authorities remain committed to opening the economy further.*** The significant reduction in the average level and dispersion of tariff rates since the mid-1990s, the dismantling of nontariff barriers, and the introduction of bilateral free trade agreements have contributed to a significant opening of the economy. However, at close to 50 percent of GDP, trade openness remains relatively low. The authorities and staff agreed that further unilateral tariff reductions, particularly of high tariff rates, would help further integrate Peru with the global economy while boosting competitiveness. In late December, the authorities lowered average tariff rates from 10.1 percent to 8.3 percent, effective January 1, 2007.



38. ***The uncertainty regarding the ratification of the U.S. FTA may pose some risks to certain sectors of the economy.*** Nearly 60 percent of Peru's total textile exports and one quarter of agricultural exports enjoy duty-free access to the U.S. market as a result of ATPDEA preferences. In the absence of a timely ratification of the FTA by the U.S. congress, investment in these sectors might be curtailed due to uncertainties over the long-term conditions for access to the U.S. market (Box 4). In late December 2006, trade preferences under the ATPDEA were extended through end-June 2007, with an option for another six-month extension. Negotiations for new bilateral trade agreements are expected to be initiated with Singapore and Mexico in the near future.

V. Program Modalities and Other Issues

39. ***The proposed low-access SBA covers the period through end-February 2009, and the risks to the Fund are small.*** Total access would be equivalent to SDR172.37 million (27 percent of quota or close to 13 percent on an annual basis). The authorities have indicated that they plan to treat the arrangement as precautionary. Given the low access, risks to the Fund are minimal, even if Peru were to draw the full amount available (Tables 14–15).

40. ***The program envisages semi-annual reviews, with the first one associated with performance at end-March 2007.*** The first review will concentrate on reforms to enhance the fiscal policy framework, including the effectiveness of the tax system, notably exemptions, and proposals to strengthen the effectiveness of social assistance programs. Monitoring is based on quantitative performance criteria, an inflation consultation mechanism, and structural benchmarks (Table 1 of the MEFP).

41. ***An off-site safeguards assessment of the Central Reserve Bank of Peru is expected to be completed by end-January 2007.*** All recommendations of the last safeguards assessment, completed in October 2004, have been implemented.

BOX 4. PERU: FREE TRADE AGREEMENT (FTA) WITH THE UNITED STATES

- ***Andean Trade Promotion and Drug Eradication Act (ATPDEA).*** The ATPDEA, a unilateral scheme of trade preferences extended by the United States to Peru and other countries of the region, has been in place since 2002. Peruvian Exports to the U.S. have increased from less than 26 percent of total exports in 2001 to 31 percent in 2005.

- ***Free Trade Agreement***. The FTA would offer a permanent framework and thus provide a more secure environment for trade and investment decisions. It is broader in scope than the ATPDEA, with reciprocal commitments on, *inter alia,* trade in goods and services, investment, government procurement, labor legislation, and intellectual property rights. The FTA was ratified by the Peruvian congress in June 2006 and is pending ratification by the U.S. congress.

- ***Goods trade.*** Ratification of the FTA would immediately expand the list of industrial goods that can be exported duty-free to the United States and establish a 10–year period for the removal of tariffs on 20 additional industrial products. In the textiles sector, additional products would become eligible for duty-free treatment. Some flexibility would be introduced in the rules of origin. On its part, Peru would eliminate tariffs immediately on around 80 percent of its imports from the United States, with tariffs on more sensitive products eliminated gradually, in stages of 5, 7, and 10 years.

- ***Investments.*** The coverage of types of investment is very comprehensive, ranging from securities to direct investment. The FTA includes dispute settlement mechanisms and provides for compensation if the state were to renege from its commitments under the FTA or from its obligations under existing or future contracts, including in the area of exploitation of natural resources.

42. ***Peru's statistics are adequate for policy formulation, surveillance, and program monitoring.*** An updated business register has been established, but efforts should be made to implement a new base year for the GDP. Also, better labor cost indices and indicators of household indebtedness need to be developed. The need to improve coordination among agencies that compile official statistics remains significant. A technical assistance mission to enhance the reporting of monetary data is scheduled for January 2007.

VI. Staff Appraisal

43. ***Supported by a favorable external environment, Peru is reaping the benefits of the sound policies and reforms implemented over the past 15 years.*** The economy is enjoying its longest expansion on record, with strong broad-based growth and rising employment, while inflation remains well contained. Vulnerabilities have been reduced markedly, as reflected in a strong foreign reserves position, a declining public debt-to-GDP ratio, and an improved debt maturity structure. Sovereign bond spreads are close to record lows.

44. ***The sustainability of these hard-won gains critically hinges on consolidating macroeconomic stability and addressing long-standing structural and social weaknesses***. The authorities' commendable commitment to enhance the conditions for strong and sustained economic growth and to ensure that its benefits are shared with all segments of the population is welcome. Toward these objectives, the proposed Fund-supported program aims at strengthening the macroeconomic framework while effectively addressing social and infrastructure needs; fostering long-term growth; and strengthening the resilience of the financial system to adverse shocks.

45. ***A stable and predictable policy framework will be key to helping ensure a business environment conducive to high investment and economic growth.*** The authorities' strong commitment to respect contracts is critical toward ensuring sustained foreign direct investment inflows and strong economic growth. Recent measures aimed at reducing red tape and simplifying procedures for businesses, together with plans to extend commercial courts beyond Lima, are also noteworthy.

46. ***The government's determination to address high poverty rates is being framed in a comprehensive anti-poverty strategy.*** The government has appointed an Interministerial Committee—under the authority of the Prime Minister—in charge of defining a strategy and drawing up an action plan to combat poverty. The main task of this group will be to identify how best to reach those who need immediate assistance, rationalize existing programs, improve targeting, and develop an action plan that will be a critical part of the government's program.

47. ***Fiscal prudence should remain the backbone of the authorities' program.*** In 2007, the combined public sector is projected to register a modest deficit, reflecting lower projected revenue and increased spending on infrastructure maintenance and development. Moreover, the authorities' intention to lower the deficit in case revenue collections turn out to be higher than contemplated in the program underscores their prudent fiscal policy. Staff encourages the authorities to go beyond the program commitment in order to contain the possible inflationary impact of the fiscal expansion, and to entrench the limits on spending growth through the approval of the amended FRTL. Moreover, it would be important for the authorities to redouble their efforts to broaden the tax base and avoid introducing new tax exemptions, as these would complicate the tax system and lead to an erosion in revenue. It

will also be critical for the newly-established Committee for Fiscal Policy Coordination to ensure that the operations of all public sector entities, including PetroPeru, are in full compliance with program objectives. These policy efforts, together with active debt management, are consistent with further declines in the public debt-to-GDP ratio.

48. ***To avoid posing risks to the soundness of public finances, the authorities' ambitious plans for decentralization will need to be implemented with caution.*** The political will to advance decentralization should be carefully balanced against weaknesses in the administrative and fiscal management capacity of subnational governments. Specific tasks should only be transferred to subnational governments that meet the accreditation system criteria. It would be important that the plans to decentralize the National System of Public Investment are closely coordinated and monitored with subnational governments, so as to ensure that the evaluation of investment projects remains adequate, especially in light of the envisaged sizeable increase in capital spending. Care should also be taken to ensure that the management of regional public companies is transferred to subnational governments only if these governments have demonstrated the capacity to administer them soundly.

49. ***Ensuring high quality investment in infrastructure will be best served by establishing a legal framework for public-private partnerships.*** The adoption of a legal framework is essential to provide clear guidelines for project selection and approval, conflict resolution procedures, as well as to adopt international accounting standards. Staff encourages the authorities to minimize future fiscal commitments under the PPP program and, to further enhance transparency, the program includes a ceiling on any new commitments. It will also be critical that the authorities monitor closely the issuance of securities associated with PPP projects and explore new instruments aimed at minimizing potential financial risks to the government.

50. ***The favorable external environment provides a formidable opportunity to move to greater exchange rate flexibility.*** Efforts are needed to introduce more flexibility in exchange rate management and limit interventions to avoiding excessive exchange rate volatility. Greater flexibility would help economic agents better internalize currency risks and would provide more incentives for hedging, thus helping reduce dollarization.

51. ***Further progress toward dedollarization in the financial system will help enhance the resilience of the economy.*** Staff welcomes progress made in identifying foreign exchange-related credit risks in the banking system and encourages the authorities to continue adopting steps aimed at reducing risks from financial dollarization. The proposed changes to the *MiVivienda* mortgage lending program are important steps in this regard, and the authorities' program includes important measures to discourage mortgage bank lending in foreign currency to unhedged borrowers.

52. ***Enhancing the resilience and depth of the financial system remains an important priority.*** Peru's financial system has strengthened markedly in recent years and, at present, banks are profitable, well capitalized, and with low impaired assets. Staff welcomes plans to

strengthen the payments system and to reform the frameworks supporting repurchase operations and derivatives. It will also be important to continue strengthening the bank resolution and lender-of-last-resort frameworks. The authorities would be well advised to continue gradually raising the limits on private pension fund investments abroad.

53. ***With three fourths of workers employed in the informal sector, reducing informality in the labor market is imperative***. A comprehensive reform of labor market legislation should aim at lowering high severance payments, better aligning non-wage benefits with job tenure, and removing legal restrictions that prevent dismissals for economic, technological, and structural reasons.

54. ***The openness of Peru's economy is still relatively low, and the authorities' commitment to further trade liberalization is commendable***. Staff encourages them to continue their efforts towards the successful conclusion of the Doha Round negotiations. Ratification of the FTA with the United States would help bolster private investment and employment generation, including by promoting institutional strengthening and reducing investor uncertainty associated with the temporary nature of existing preferential trade agreements. There is also scope for Peru to reduce its maximum tariff rates and tariff dispersion.

55. ***The authorities' program for 2007–08 embodies a coherent set of policies to consolidate macroeconomic stability, reduce poverty, and boost the conditions for sustained economic growth***. Successful implementation of the program will reinforce confidence in the continuity of prudent policies and help pave the way for broad-based and sustainable growth. Risks to the program include adverse terms-of-trade shocks and possible policy slippages, particularly if the global environment were to turn less favorable. Lower commodity prices and higher global risk aversion could exert considerable pressure on the exchange rate and public finances, with potentially disruptive balance-sheet effects. However, the authorities' commitment to maintaining macroeconomic stability and reducing poverty mitigates concerns. On this basis, the staff supports the authorities' request for a new Stand-By Arrangement.

56. It is recommended that the next Article IV consultation with Peru be held on the 24-month consultation cycle, in accordance with the provisions of the July 15, 2002 decision on consultation cycles for countries with Fund arrangements.

Table 1. Peru: Selected Economic Indicators

	2002	2003	2004	Prel. 2005	Projection 2006	2007	2008
Social Indicators							
Life expectancy at birth (years)	69.8	70.0	...	...	...	...	...
Infant mortality (per thousand live births)	30.0	26.0	...	...	...	...	...
Adult literacy rate	87.3	87.7	87.8	...	...	...	...
Poverty rate (Total) 1/	53.8	52.2	51.6	50.6	...	...	...
Unemployment rate	9.4	9.4	9.4	9.6	...	...	...
(Annual percentage change; unless otherwise indicated)							
Production and prices							
Real GDP	5.2	3.9	5.2	6.4	6.5	5.5	5.0
Real domestic demand	4.4	3.4	4.4	5.5	8.8	6.2	6.7
Consumer Prices (end of period)	1.5	2.5	3.5	1.5	1.6	2.5	2.5
Consumer Prices (period average)	0.2	2.3	3.7	1.6	2.0	2.0	2.5
External sector							
Exports	9.8	17.8	38.8	36.7	34.9	6.2	-3.7
Imports	2.8	11.2	19.0	23.0	25.6	16.1	11.2
Terms of trade (deterioration -)	3.1	1.3	9.2	6.9	23.7	-5.3	-10.4
Real effective exchange rate (depreciation -) 2/	-1.2	-6.8	1.9	-3.9	0.2	...	...
Money and credit 3/ 4/							
Liabilities to the private sector	4.4	1.9	11.5	15.2	9.5	9.3	9.2
Net credit to the private sector	-1.5	-3.5	3.6	12.0	12.1	8.0	6.3
(In percent of GDP; unless otherwise indicated)							
Public sector							
General government current revenue	17.0	17.4	17.5	18.3	19.6	18.5	18.6
General government noninterest expenditure	17.2	17.1	16.7	17.0	16.9	17.4	17.4
Combined public sector primary balance	0.0	0.5	1.0	1.6	3.0	1.3	1.2
Interest due	2.1	2.2	2.0	1.9	2.0	2.0	1.9
Combined public sector overall balance	-2.2	-1.7	-1.1	-0.3	1.0	-0.8	-0.7
External Sector							
External current account balance	-1.9	-1.5	0.0	1.3	1.3	0.2	0.1
Gross reserves							
In millions of U.S. dollars 5/	9,690	10,206	12,649	14,115	15,615	16,765	17,465
Percent of short-term external debt 6/	214.2	214.4	161.2	288.5	350.1	336.9	385.5
Percent of foreign currency deposits at banks	100.6	107.3	128.3	129.4	135.6	139.6	140.5
Debt							
Total external debt	48.9	48.1	44.9	36.1	30.7	28.4	26.7
Combined public sector debt (including CRPAOs)	46.6	47.0	44.4	37.7	32.0	31.2	30.5
Domestic	10.1	10.0	9.2	9.7	7.4	8.1	8.7
External 7/	36.5	37.0	35.1	28.1	24.6	23.1	21.8
Savings and investment							
Gross domestic investment	18.9	18.8	18.9	18.6	19.6	21.2	21.8
Public sector 8/	2.8	2.8	2.8	2.9	2.9	4.3	4.6
Private sector	14.7	15.0	15.2	16.0	16.6	16.9	17.2
Inventories changes	1.4	1.0	1.0	-0.2	0.1	0.0	0.0
National savings	17.0	17.2	18.9	19.9	21.0	21.4	21.9
Public sector 9/	0.8	1.2	1.7	2.6	3.9	3.3	3.6
Private sector	16.2	16.0	17.2	17.3	17.1	18.1	18.3
External savings	1.9	1.5	0.0	-1.3	-1.3	-0.2	-0.1
Memorandum items:							
Nominal GDP (S/. billions)	200.6	213.9	237.8	261.6	298.9	317.9	337.2
GDP per capita (in US$)	2,194	2,330	2,599	2,917	3,297	3,496	3,685

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; ECLAC 2002-03; National Statistical Institute (INEI); and Fund staff estimates/projections.

1/ Defined as the percentage of households with total spending below the cost of a basic consumption basket.

2/ Based on Information Notice System. Data for 2006 reflect the 12-month change of the REER up to September.

3/ Corresponds to the banking system.

4/ Foreign currency stocks are valued at program exchange rate.

5/ Gross international reserves exceed net international reserves by the stock of Fund credit outstanding.

6/ Short-term debt is defined on a residual maturity basis, and includes amortization of medium- and long-term debt.

7/ Includes debt by the Central Reserve Bank of Peru.

8/ Includes CRPAOs.

9/ Excludes privatization receipts.

Table 2. Peru: Fiscal Operations of the Combined Public Sector

(In percent of GDP; unless otherwise indicated)

				Prel.	Projection		
	2002	2003	2004	2005	2006	2007	2008
Central government primary balance	**-0.2**	**0.2**	**0.6**	**1.1**	**2.5**	**1.1**	**1.1**
Revenue	14.5	**14.9**	**15.0**	**15.8**	**17.4**	**16.5**	**16.6**
Current	14.4	14.7	14.9	15.7	17.2	16.4	16.5
Of which : Tax revenue	11.9	12.8	13.2	13.6	15.1	14.5	14.6
Of which: Financial transaction tax	...	...	0.3	0.3	0.3	0.3	0.2
Capital	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Noninterest expenditure	14.7	14.7	14.4	14.7	14.9	15.4	15.6
Current	12.7	12.8	12.6	12.8	13.1	12.7	12.6
Capital	2.0	1.9	1.8	1.9	1.8	2.7	2.9
Rest of the general government primary balance	**0.2**	**0.3**	**0.3**	**0.3**	**0.2**	**0.1**	**0.1**
Revenue	5.7	5.8	5.7	5.9	6.1	5.9	5.9
Current	5.7	5.7	5.7	5.9	5.9	5.9	5.8
Capital	0.1	0.1	0.0	0.0	0.2	0.0	0.0
Noninterest expenditure	5.6	5.5	5.4	5.6	5.8	5.8	5.7
Current	4.8	4.6	4.6	4.7	4.8	4.7	4.7
Capital	0.8	0.9	0.9	0.9	1.0	1.1	1.1
Public enterprise primary balance	**-0.1**	**0.0**	**0.1**	**0.2**	**0.1**	**0.1**	**0.0**
Current balance	0.2	0.3	0.4	0.5	0.4	0.5	0.4
Capital balance	-0.3	-0.4	-0.2	-0.3	-0.3	-0.4	-0.4
Nonfinancial public sector primary balance	**-0.2**	**0.4**	**1.0**	**1.6**	**2.8**	**1.3**	**1.2**
Central bank operating balance	0.2	0.1	0.0	0.0	0.1	0.0	0.0
Combined public sector primary balance	**0.0**	**0.5**	**1.0**	**1.6**	**3.0**	**1.3**	**1.2**
Interest payments	2.2	2.2	2.0	1.9	2.0	2.0	1.9
External	1.8	1.8	1.7	1.6	1.5	1.4	1.3
Domestic	0.4	0.4	0.4	0.3	0.5	0.6	0.6
Of which: Pension recognition bonds	0.1	0.1	0.1	0.0	0.1	0.1	0.1
Combined public sector overall balance	**-2.2**	**-1.7**	**-1.1**	**-0.3**	**1.0**	**-0.8**	**-0.7**
Financing	2.2	1.7	1.1	0.3	-1.0	0.8	0.7
External	2.1	1.4	1.5	-1.5	-0.2	-0.2	-0.1
Disbursements 1/	5.1	3.4	3.6	3.3	1.1	1.0	1.5
(In millions of U.S. dollars)	2,863	2,101	2,474	2,628	1,019	1,000	1,611
Amortization 2/	-3.2	-1.9	-1.9	-4.6	-1.3	-1.2	-1.6
(In millions of U.S. dollars)	-1,837	-1,187	-1,348	-3,678	-1,204	-1,174	-1,673
Rescheduling/arrears (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other 3/	0.3	-0.1	-0.1	-0.1	0.0	0.0	0.0
Domestic	-0.7	0.2	-0.6	1.7	-0.9	0.9	0.7
Bond placements 4/	0.5	0.8	1.1	2.6	1.9	0.7	0.8
(In millions of U.S. dollars)	267	508	759	2,090	1,814	723	800
Amortization 5/	-0.3	-0.9	-1.0	-1.0	-1.5	-0.4	-0.5
(In millions of U.S. dollars)	-193	-556	-719	-779	-1,346	-387	-563
Of which: Pension recognition bonds	-55	-170	-215	-192	-105	-95	-95
Net deposits	-0.8	0.3	-0.7	0.1	-1.4	0.6	0.5
(In millions of U.S. dollars)	-443	190	-483	50	-1,268	561	473
Privatization	0.8	0.1	0.2	0.1	0.1	0.0	0.1
(In millions of U.S. dollars)	421	52	114	56	84	24	84
Memorandum items:							
Overall fiscal deficit (including CRPAOs)	**-2.2**	**-1.7**	**-1.1**	**-0.3**	**0.9**	**-1.2**	**-1.2**
General government current revenue 6/	17.0	17.4	17.5	18.3	19.6	18.5	18.6
General government noninterest expenditure 6/	17.2	17.1	16.7	17.0	16.9	17.4	17.4
Public sector debt (including CRPAOs)	47.1	47.0	44.4	37.7	32.0	31.2	30.5
Nominal GDP (S/. billions)	200.6	213.9	237.8	261.6	298.9	317.9	337.2

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and Fund staff estimates/projections.

1/ In 2004, includes placement of US$800 million euro-denominated bonds, covering part of the country's financing needs for 2005. In 2005, includes placement of US$750 million bonds to finance the Paris Club prepayment.
2/ In 2005, includes the prepayment of US$1.55 billion to the Paris Club.
3/ Includes condonations, plus the net increase in short-term external credit to the NFPS and the net decrease in foreign assets of the NFPS.
4/ In 2005, includes the placement of US$323 and US$462 million Soles-denominated bonds to finance the Paris Club prepayment. In 2006, includes the placement of US$85 million Soles-denominated bonds to finance the Japeco prepayment.
5/ Includes in 2005 the amortization of US$390 million U.S. dollar denominated domestic bonds for the restructuring of the financial sector.
6/ Net of transfers among non-financial public institutions.

Table 3. Peru: Financing of the Combined Public Sector

	2002	2003	2004	Prel. 2005	Projection 2006	2007	2008
	(In millions of U.S. dollars)						
Combined balance	**-1,227**	**-1,037**	**-748**	**-250**	**902**	**-746**	**-733**
Financing	**1,227**	**1,037**	**748**	**250**	**-902**	**746**	**733**
Net External	1,169	843	1,078	-1,167	-186	-174	-62
Disbursements	2,863	2,101	2,474	2,628	1,019	1,000	1,611
Bonds 1/ 2/	1,886	1,245	1,295	1,682	0	0	591
Multilaterals	807	519	863	595	515	400	420
Bilaterals and other	170	337	315	350	504	600	600
Amortization 3/ 4/	-1,837	-1,187	-1,348	-3,678	-1,204	-1,174	-1,673
Other 5/	143	-71	-48	-117	0	0	0
Privatization	421	52	114	56	84	24	84
Net Domestic financing	-363	142	-443	1,361	-800	897	710
Bonds 6/	267	508	759	2,090	1,814	723	800
Amortization	-193	-556	-719	-779	-1,346	-387	-563
Of which : Pension recognition bonds	-55	-170	-215	-192	-105	-95	-95
Net deposits	-437	190	-483	50	-1,268	561	473
Of which: Central government	-396	299	-335	364	-970	582	499
	(In percent of GDP)						
Combined balance	**-2.2**	**-1.7**	**-1.1**	**-0.3**	**1.0**	**-0.8**	**-0.7**
Financing	**2.2**	**1.7**	**1.1**	**0.3**	**-1.0**	**0.8**	**0.7**
Net External	2.0	1.4	1.5	-1.5	-0.2	-0.2	-0.1
Disbursements 1/	5.0	3.4	3.6	3.3	1.1	1.0	1.5
Bonds	3.3	2.0	1.9	2.1	0.0	0.0	0.6
Multilaterals	1.4	0.8	1.2	0.7	0.6	0.4	0.4
Bilaterals and other	0.3	0.5	0.5	0.4	0.6	0.6	0.6
Amortization	-3.2	-1.9	-1.9	-4.6	-1.3	-1.2	-1.6
Other	0.3	-0.1	-0.1	-0.1	0.0	0.0	0.0
Privatization	0.7	0.1	0.2	0.1	0.1	0.0	0.1
Net Domestic financing	-0.6	0.2	-0.6	1.7	-0.9	0.9	0.7
Bonds	0.5	0.8	1.1	2.6	2.0	0.7	0.8
Amortization	-0.3	-0.9	-1.0	-1.0	-1.5	-0.4	-0.5
Of which: Pension recognition bonds	0.1	0.3	0.3	0.2	0.1	0.1	0.1
Net deposits	-0.8	0.3	-0.7	0.1	-1.4	0.6	0.5
Of which: Central government	-0.7	0.5	-0.5	0.5	-1.1	0.6	0.5
Memorandum item:							
Net external financing (including CRPAOs)	1,169.0	843.5	1,077.7	-1,166.9	-85.6	225.1	281.1
Nominal GDP (S/. billions)	200.6	213.9	237.8	261.6	298.9	317.9	337.2

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and Fund staff estimates/projections.

1/ In 2004, includes placement of US$800 million euro-denominated bonds, covering part of the financing needs for 2005.
2/ In 2005, includes placement of US$750 million bonds to finance the Paris Club prepayment.
3/ Includes in 2005 the amortization of US$390 million U.S. dollar denominated domestic bonds for the restructuring of the financial sector.
4/ In 2005, includes the prepayment of US$1.6 billion to the Paris Club.
5/ Includes condonations, net increase in short-term external credit to the NFPS, and net decrease in foreign assets of the NFPS.
6/ In 2005, includes the placement of US$323 and US$462 million Soles-denominated bonds to finance the Paris Club prepayment. In 2006, includes the placement of US$85 million Soles-denominated bonds to finance the Japeco prepayment.

Table 4. Peru: Fiscal Operations of the Central Government
(In percent of GDP)

				Prel.	Projection		
	2002	2003	2004	2005	2006	2007	2008
Current primary balance	**1.6**	**2.0**	**2.3**	**2.8**	**4.2**	**3.7**	**3.9**
Current revenue	14.2	14.7	14.9	15.7	17.2	16.4	16.5
Tax revenue	11.8	12.8	13.2	13.6	15.1	14.5	14.6
Income tax	3.2	3.9	4.0	4.3	6.1	5.6	5.6
Other tax revenue	8.6	8.9	9.2	9.3	9.0	8.8	9.0
Of which: Financial transaction tax	...	...	0.3	0.3	0.3	0.3	0.0
Other current revenue 1/	2.4	1.9	1.7	2.1	2.1	1.9	1.9
Current noninterest expenditure	12.6	12.8	12.6	12.8	13.1	12.7	12.6
Labor services 2/	6.6	6.7	6.4	6.3	6.0	6.0	6.1
Goods and nonlabor services	3.4	3.4	3.5	3.4	3.7	3.3	3.2
Transfers and other	2.6	2.7	2.7	3.1	3.3	3.3	3.3
Capital balance	**-1.8**	**-1.7**	**-1.7**	**-1.7**	**-1.7**	**-2.6**	**-2.9**
Capital revenue	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Capital expenditure	2.0	1.9	1.8	1.9	1.8	2.7	2.9
Gross capital formation	1.7	1.6	1.6	1.7	1.5	2.5	2.8
Other	0.2	0.3	0.2	0.2	0.3	0.2	0.2
Primary balance	**-0.2**	**0.2**	**0.6**	**1.1**	**2.5**	**1.1**	**1.1**
Interest payments	2.0	2.0	1.8	1.8	1.9	1.9	1.8
External	1.7	1.7	1.6	1.6	1.5	1.4	1.3
Domestic	0.2	0.2	0.2	0.3	0.4	0.5	0.5
Overall balance	**-2.2**	**-1.7**	**-1.3**	**-0.7**	**0.7**	**-0.8**	**-0.7**
Memorandum items:							
General government tax revenues 2/	12.0	12.9	13.4	13.9	15.4	14.7	14.8
Primary balance before transfers	2.0	2.8	3.3	4.0	5.7	4.1	4.0
Overall balance before transfers	0.0	0.9	1.4	2.2	3.9	2.2	2.2

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and Fund staff estimates/projections.

1/ Decline in 2003 reflects lower collections on the recovery of illicit funds from officials of the previous administration and special large fines paid by mining companies in 2002. Includes mining royalties since 2005.

2/ Includes wages, salaries, and employer contributions to social security.

Table 5. Peru: Public Sector Social Expenditure

	2002	2003	2004	Prel. 2005
(In millions of New Soles)				
Total social expenditure and pensions	**19,032**	**20,249**	**22,516**	**24,888**
Universal coverage (Education and Health) 1/	8,491	9,016	10,541	10,994
Education	5,646	6,247	7,166	7,599
Health	2,846	2,769	3,376	3,395
Targeted programs (Extreme Poverty)	2,377	2,678	2,483	3,033
Non-Targeted Social Programs	8,164	8,555	9,492	10,861
(In percent of general government expenditure)				
Total social expenditure and pensions	**49.2**	**49.3**	**50.6**	**50.4**
Universal coverage (Education and Health) 1/	21.9	21.9	23.7	22.3
Education	14.6	15.2	16.1	15.4
Health	7.3	6.7	7.6	6.9
Targeted programs (Extreme Poverty) 2/	6.1	6.5	5.6	6.1
Non-Targeted Social Programs	21.1	20.8	21.3	22.0
(In percent of GDP)				
Total social expenditure and pensions	**9.5**	**9.5**	**9.5**	**9.5**
Universal coverage (Education and Health) 1/	4.2	4.2	4.4	4.2
Education	2.8	2.9	3.0	2.9
Health	1.4	1.3	1.4	1.3
Targeted programs (Extreme Poverty)	1.2	1.3	1.0	1.2
Non-Targeted Social Programs	4.1	4.0	4.0	4.2
Memorandum items:				
General government expenditure (in millions of New Soles)	38,721	41,098	44,475	49,401

Source: Ministry of Economy and Finance.

1/ Net of spending on education and health already included in the extreme poverty programs.

Table 6. Peru: Monetary Survey

				Prel.	Projection		
	2002	2003	2004	2005	2006	2007	2008
I. Central Reserve Bank (In millions of New Soles at program exchange rate)							
Net international reserves 1/	**32,954**	**35,361**	**42,125**	**45,639**	**50,224**	**53,325**	**55,078**
(In millions of U.S. dollars)	9,309	9,905	12,342	13,808	15,308	16,458.3	17,158.3
Net domestic assets	**-27,339**	**-28,991**	**-34,090**	**-35,524**	**-38,834**	**-40,754**	**-41,247**
Net credit to nonfinancial public sector	-10,147	-10,709	-12,974	-13,888	-17,047	-15,906.5	-15,906.5
Rest of banking system	-14,338	-14,757	-19,146	-21,384	-20,347	-23,915.8	-24,606.8
Other	-2,854	-3,525	-1,970	-252	-1,440	-931.6	-733.8
Currency	**5,615**	**6,370**	**8,035**	**10,115**	**11,390**	**12,571**	**13,831**
II. Banking System (In millions of New Soles at program exchange rate)							
Net foreign assets	**33,300**	**35,010**	**42,976**	**47,610**	**54,769**	**58,657**	**63,793**
Net domestic assets	**18,407**	**17,699**	**15,805**	**20,089**	**19,385**	**22,414**	**24,762**
Net credit to nonfinancial public sector	-10,532	-10,664	-13,437	-14,307	-17,748	-17,342.0	-17,042.0
Net credit to private sector	46,621	44,994	46,632	52,208	58,502	63,172.9	67,172.9
Other	-17,682	-16,631	-17,390	-17,812	-21,369	-23,417.1	-25,369.1
Net credit to COFIDE	-1,340	-1,018	-1,087	-850	-850	-850.0	-850.0
Other	-16,342	-15,613	-16,303	-16,962	-20,519	-22,567.1	-24,519.1
Liabilities to the private sector	**51,707**	**52,709**	**58,781**	**67,699**	**74,154**	**81,071**	**88,555**
(12-month percentage change)							
Base money	11.0	10.1	25.3	25.7	11.5	10.0	10.0
Broad money	4.4	1.9	11.5	15.2	9.5	9.3	9.2
Domestic currency	11.5	10.0	28.1	26.3	14.6	15.9	15.4
Foreign currency 2/	1.1	-2.3	1.7	6.8	5.0	3.0	2.5
Net credit to private sector	-1.5	-3.5	3.6	12.0	12.1	8.0	6.3
Domestic currency	7.0	5.1	11.9	34.8	28.3	23.7	16.4
Foreign currency 2/	-3.6	-5.7	1.2	4.6	5.3	0.0	0.0
III. Financial System (In millions of New Soles at program exchange rate)							
Net foreign assets	**37,354**	**45,003**	**52,416**	**53,714**	**57,639**	**61,674**	**65,991**
Net domestic assets	**28,499**	**29,745**	**31,828**	**45,114**	**49,218**	**53,695**	**58,631**
Net credit to the public sector	-9,697	-8,976	-10,442	-7,595	-6,911	-6,911	-6,911
Net credit to private sector	60,422	62,666	65,913	73,395	80,702	86,777	92,113
Other	-22,226	-23,946	-23,644	-20,687	-24,573	-26,171	-26,571
Liabilities to the private sector	**65,854**	**74,748**	**84,243**	**98,827**	**106,857**	**115,369**	**124,622**
(12-month percentage change)							
Liabilities to the private sector	9.0	13.5	12.7	17.3	8.1	8.0	8.0
Domestic currency	17.5	24.3	23.5	25.7	12.0	12.0	12.0
Foreign currency 2/	2.3	3.7	0.9	6.1	2.0	1.0	0.4
Net credit to private sector	2.1	3.7	5.2	11.4	10.0	7.5	6.1
Domestic currency	18.9	18.0	17.9	26.2	20.0	15.0	12.0
Foreign currency 2/	-3.3	-1.9	-0.9	3.0	3.0	1.5	0.8
Memorandum item:							
Program exchange rate (S/. per US$)	3.54	3.57	3.41	3.31	3.29	3.24	...

Sources: Central Reserve Bank of Peru; and Fund staff estimates/projections.

1/ Excludes subscriptions to the IMF and the Latin American Reserve Fund (FLAR), Pesos Andinos, credit lines to other central banks, as well as Corporacion Andina de Fomento (CAF) bonds, and foreign assets temporarily held by the BCRP as part of swap operations.

2/ Flows in foreign currency are valued at the program exchange rate.

Table 7. Peru: Financial Soundness Indicators 1/
(In percent; unless otherwise indicated)

	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Jun-06	Sep-06
Capital Adequacy							
Equity capital to risk-weighted assets	12.8	12.5	13.3	14.0	12.0	12.6	12.4
Regulatory Tier I capital to risk-weighted assets 2/	12.4	13.0	12.1	13.1	11.2	9.0	11.1
Nonperforming loans net of provisions to capital	-11.1	-17.2	-15.2	-17.3	-21.7	-17.9	-16.8
Asset Quality							
Nonperforming loans to total gross loans 3/	9.0	7.6	5.8	3.7	2.1	2.0	1.9
In domestic currency	5.2	5.2	4.0	3.0	2.1	2.2	2.0
In foreign currency	9.9	8.2	6.3	3.9	2.2	1.9	1.8
Nonperforming loans to total gross loans 4/	17.0	14.6	12.2	9.5	6.3	5.3	4.6
In domestic currency	9.9	8.8	6.6	6.1	4.2	3.8	3.5
In foreign currency	19.0	16.4	14.1	10.6	7.1	6.0	5.2
Refinanced and restructured loans to total gross loans 5/	8.0	7.0	6.4	5.8	4.1	3.3	2.8
Provisions to nonperforming loans 3/	118.9	133.2	141.1	176.5	235.3	223.7	223.3
Provisions to nonperforming, restructured, and refinanced loans 4/	63.0	69.1	67.1	68.7	80.3	84.8	89.6
Sectoral distribution of loans to total loans							
Consumer loans	8.6	9.4	11.6	13.4	14.4	15.1	16.0
Mortgage loans	9.6	10.7	12.9	14.2	14.8	14.3	14.4
Commercial loans	79.2	77.6	72.6	68.1	65.8	65.6	64.6
Small business loans	2.5	2.3	2.9	4.3	5.0	5.0	5.1
Earnings and Profitability							
ROA	0.4	0.8	1.1	1.2	2.2	2.3	2.1
ROE	4.3	8.3	10.7	11.6	22.2	24.6	23.5
Gross financial spread to financial revenues	51.9	66.1	71.2	71.9	70.5	68.0	67.4
Financial revenues to total revenues	78.7	72.7	70.6	69.1	76.3	77.0	76.2
Annualized financial revenues to revenue-generating assets	11.6	9.9	9.2	9.0	10.3	10.5	10.5
Liquidity							
Total liquid assets to total short-term liabilities	39.2	41.9	40.4	44.5	45.5	42.3	43.0
In domestic currency	22.6	23.5	32.9	44.8	38.6	20.0	34.3
In foreign currency	46.0	49.3	43.9	44.3	49.2	55.7	48.3
Foreign Currency Position and Dollarization							
Global position in foreign currency to regulatory capital 6/	37.6	37.0	31.8	24.2	23.1	27.1	22.4
Share of foreign currency deposits in total deposits	71.9	71.6	69.7	67.1	67.2	65.1	64.4
Share of foreign currency loans in total credit	80.5	79.7	77.9	75.7	71.5	68.7	67.3
Foreign currency deposits at commercial banks (in millions of U.S. dollars)	9,357	9,658	9,210	9,596	10,913	11,251	11,306
Commercial banks' short-term foreign assets (in millions of U.S. dollars)	748	779	601	547	796	889	870
Commercial banks' short-term foreign liabilities (in millions of U.S. dollars)	1,161	763	702	733	1,085	684	518
Operational efficiency							
Financing to related parties to capital 7/	...	20.1	18.7	14.3	17.9	15.0	17.1
Nonfinancial expenditure to total revenues 8/	32.1	36.2	37.7	35.9	33.3	31.2	30.1
Nonfinancial expenditure to total revenue-generating assets 8/	4.7	4.9	4.9	4.7	4.6	4.3	4.3
Memorandum items:							
Number of Banks	16	16	16	16	14	13	13
Private commercial	15	14	14	14	12	11	11
Of which: Foreign-owned	10	9	9	9	9	7	7
State-owned	1	2	2	2	2	2	2
Banks' credit card loans to total loans	2.4	3.3	4.6	6.4	6.9	7.4	7.7
Bank loans' 12 month increase (in real terms)	-3.3	1.0	-8.3	-1.9	19.0	17.4	16.7
Stock market index (U.S. dollars)	342.1	396.0	700.6	1,131.6	1,400.1	2,502.2	3,197.5
Foreign currency debt rating (Moody's)	Ba3	Ba3	Ba3	Ba3	Ba3	Ba3	Ba3
Spread of Peruvian Brady bonds, basis points	521	610	312	220	257	169	171

Sources: Superintendency of Banks and Insurance of Peru; Central Bank of Peru; and Fund staff estimates/projections.

1/ These indicators correspond to private commercial banks.
2/ Tier I regulatory capital is equivalent to share capital and reserves. Risk-weighted assets include market risk exposure. In year 2002, the Tier I considers a reduction on Banco Santander Central Hispano capital due to the valorization before its merger with Banco de Crédito.
3/ Nonperforming loans are overdue loans after 15 days since the due date for commercial loans, after 30 days for small bussines loans. In the case of mortgage, consumer and leasing loans, they are considered overdue after 30 days since the due date only for the non paid portion and after 90 days, for all the credit. The overdue loans include credits under judicial resolution.
4/ Includes restructured loans, refinanced loans, and arrears.
5/ Refinanced loans refer to those loans subjected either term and/or principal modifications with respect to the initial debt contract. Restructured loans refer to those loans whose payments have been restructured according to the "Ley General del Sistema Concursal."
6/ Global position in foreign currency corresponds to those items in the balance sheet subject to exchange rate risk.
7/ Financing to related parties corresponds to those loans to individuals and firms owning more than 4 percent of the bank.
8/ Nonfinancial expenditures do not consider provisions nor depreciations.

Table 8. Peru: Balance of Payments

(In millions of U.S. dollars)

	2002	2003	2004	Prel. 2005	Projection 2006	2007	2008
Current account	**-1,063**	**-935**	**-11**	**1,033**	**1,222**	**151**	**91**
Merchandise trade	292	836	2,793	5,163	8,086	7,080	4,205
Exports	7,714	9,091	12,617	17,247	23,262	24,705	23,795
Traditional	5,369	6,356	9,028	12,839	18,109	18,867	17,528
Nontraditional and others	2,345	2,734	3,589	4,408	5,153	5,838	6,267
Imports	-7,422	-8,255	-9,824	-12,084	-15,176	-17,625	-19,590
Services, income, and current transfers (net)	-1,355	-1,771	-2,803	-4,130	-6,865	-6,929	-4,114
Services	-941	-854	-843	-912	-1,038	-1,233	-1,542
Investment income	-1,457	-2,144	-3,421	-5,009	-7,892	-7,934	-4,854
Current transfers	1,043	1,227	1,460	1,791	2,065	2,239	2,281
Financial and capital account	**1,881**	**1,414**	**2,337**	**495**	**-112**	**971**	**583**
Public sector	1,096	684	988	-1,440	-309	150	231
Disbursements 1/	2,902	2,161	2,535	2,656	1,066	1,405	2,002
Amortization 1/	-1,843	-1,229	-1,389	-3,718	-1,234	-1,205	-1,721
Other medium- and long-term Public sector flows 2/	37	-248	-158	-378	-141	-50	-50
Capital transfers (net)	0	0	0	0	0	0	0
Privatization	186	10	31	31	62	10	62
Private sector	599	720	1,318	1,905	135	811	290
Foreign direct investment (FDI) excluding privatization	1,970	1,265	1,785	2,489	3,575	2,233	2,180
Other private capital	-1,412	-1,233	-557	-878	-3,440	-1,421	-1,890
Medium- and long-term loans	-146	-166	-411	-741	-307	-122	-122
Portfolio investment	-472	-1,214	-376	75	-1,565	-910	-952
Short-term flows 3/	-794	147	231	-213	-1,567	-390	-817
Net Errors and Omissions	41	688	90	295	0	0	0
Balance	**818**	**479**	**2,326**	**1,528**	**1,109**	**1,122**	**673**
Financing	**-818**	**-479**	**-2,326**	**-1,528**	**-1,109**	**-1,122**	**-673**
NIR flow (increase -)	-832	-477	-2,353	-1,628	-1,167	-1,150	-700
Change in NIR (increase -)	-985	-596	-2,437	-1,466	-1,500	-1,150	-700
Valuation change	-153	-119	-84	162	-334	0	0
Exceptional financing	14	-2	27	100	57	28	27
Debt relief 4/	14	70	27	100	57	28	27
Change in arrears	0	-72	0	0	0	0	0
Rescheduling	0	0	0	0	0	0	0
Memorandum items:							
Current account balance (in percent of GDP)	**-1.9**	**-1.5**	**0.0**	**1.3**	**1.3**	**0.2**	**0.1**
Capital and financial account balance (in percent of GDP)	3.3	2.3	3.4	0.6	-0.1	1.0	0.6
Export value (US$), percent change	9.8	17.8	38.8	36.7	34.9	6.2	-3.7
Volume growth	5.7	10.0	12.8	15.4	1.0	7.5	6.2
Price growth	3.9	7.1	23.0	18.4	33.5	-1.2	-9.3
Import value (US$), percent change	2.8	11.2	19.0	23.0	25.6	16.1	11.2
Volume growth	1.7	5.4	7.5	11.1	16.4	11.3	9.8
Price growth	1.1	5.5	10.7	10.7	7.8	4.4	1.2
GDP (in billions of US$)	57.0	61.5	69.7	79.4	91.1	98.1	105.0
Average exchange rate (S/. per US$)	3.52	3.48	3.41	3.30	3.28	3.24	3.21

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and Fund staff estimates/projections.

1/ In 2002, includes the Brady Bond swap. For details of the swap, see IMF Country Report No. 03/72, Box 3.

2/ Includes portfolio flows of the pension reserve fund and subscription payments into international funds.

3/ Includes COFIDE and Banco de la Nación.

4/ Debt relief under existing operations.

Table 9. Peru: External Financing Requirements and Sources

(In millions of U.S. dollars)

				Prel.	Projection		
	2002	2003	2004	2005	2006	2007	2008
Gross financing requirements	**7,768**	**6,008**	**7,125**	**8,440**	**5,108**	**5,459**	**5,585**
External current account deficit (excluding official transfers)	**1,063**	**935**	**11**	**-1,033**	**-1,222**	**-151**	**-91**
Debt amortization	5,873	4,524	4,761	7,845	5,163	4,460	4,976
Medium- and long-term debt	2,664	1,954	2,247	5,094	1,977	1,808	2,324
Public sector	1,843	1,229	1,389	3,718	1,234	1,205	1,721
Multilateral 1/	399	486	571	628	649	707	712
Bilateral	496	686	742	2,159	404	382	375
Bonds and notes	940	44	67	90	90	113	613
Other	8	13	9	842	92	4	21
Private sector	821	725	858	1,376	743	602	602
Short-term debt 2/	3,209	2,570	2,514	2,751	3,186	2,652	2,652
Rescheduling and repayment of arrears	0	72	0	0	0	0	0
Accumulation of NIR (flow)	832	477	2,353	1,628	1,167	1,150	700
Change in gross reserves	852	513	2,440	1,470	1,499	1,150	700
Payments of short-term liabilities incl. IMF	133	84	-3	-4	1	0	0
Other	-153	-119	-84	162	-334	0	0
Available financing	**7,768**	**6,008**	**7,125**	**8,440**	**5,108**	**5,459**	**5,585**
Foreign direct investment (net)	2,156	1,275	1,816	2,519	3,637	2,243	2,242
Privatization	186	10	31	31	62	10	62
FDI	1,970	1,265	1,785	2,489	3,575	2,233	2,180
Portfolio (net)	-472	-1,214	-376	75	-1,565	-910	-952
Short-term assets (flow)	-163	870	102	-209	-1,007	-390	-817
Of which: Errors and omissions	41	688	90	295	0	0	0
Debt financing from private creditors	5,179	4,346	4,474	5,359	3,161	3,532	3,632
Medium- and long-term financing	2,560	1,811	1,742	2,316	536	880	980
To public sector 3/	1,886	1,252	1,295	1,682	100	400	500
To private sector	675	559	447	635	436	480	480
Short-term financing	2,619	2,535	2,732	3,042	2,625	2,652	2,652
Official creditors 4/	1,016	909	1,240	974	966	1,005	1,502
Multilateral 1/	807	699	1,049	762	754	690	0
Of which: Balance of payments financing	625	527	863	581	500	350	0
Bilateral	209	210	191	212	212	315	0
To public sector	209	210	191	212	212	315	0
To private sector	0	0	0	0	0	0	0
Other medium- and long-term public sector flows 5/	51	-178	-131	-278	-84	-22	-23
IMF	0	0	0	0	0	0	0
Accumulation of arrears (exceptional)	0	0	0	0	0	0	0

Sources: Central Reserve Bank of Peru; and Fund staff estimates/projections.

1/ Excluding IMF.
2/ Original maturity of less than one year. Equals stock at the end of the previous period.
3/ Based on projections of no placements in external markets over the program period. Projections exclude possible external issuance for debt prepayments.
4/ Includes both loans and grants. Breakdown not available as of 2008.
5/ Includes debt relief and subscription payments to international organizations and changes in Banco de la Nación's long-term assets.

Table 10. Peru: Medium-Term Macroeconomic Framework

		Staff Projection					
	2005	2006	2007	2008	2009	2010	2011
	(Annual percentage change)						
GDP at constant prices	6.4	6.5	5.5	5.0	5.0	5.0	5.0
Consumer prices (end of period)	1.5	1.6	2.5	2.5	2.5	2.5	2.5
GDP deflator	3.4	7.3	0.8	1.0	1.5	1.9	1.9
Merchandise trade							
Exports, f.o.b.	36.7	34.9	6.2	-3.7	1.2	3.8	5.7
Imports, f.o.b.	23.0	25.6	16.1	11.2	7.3	5.7	6.7
Terms of trade (deterioration -)	6.9	23.7	-5.3	-10.4	-6.3	-3.7	-0.9
	(In percent of GDP; unless otherwise indicated)						
External current account balance	1.3	1.3	0.2	0.1	-0.1	-0.2	-0.4
External current account, excluding interest obligations	7.6	3.4	2.1	1.9	1.5	1.3	0.9
Total external debt service	8.5	4.2	3.8	4.0	3.3	3.4	3.2
Medium- and long-term	8.3	4.0	3.6	3.8	3.2	3.2	3.0
Nonfinancial public sector	6.2	2.8	2.7	3.0	2.4	2.5	2.4
Private sector	2.0	1.2	0.9	0.9	0.8	0.7	0.7
Short-term 1/	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Nonfinancial public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	0.2	0.2	0.2	0.2	0.2	0.1	0.1
External debt service 2/	8.5	4.2	3.8	4.0	3.3	3.4	3.2
Interest	2.1	2.1	2.0	1.8	1.7	1.5	1.3
Amortization (medium-and long-term)	6.4	2.2	1.8	2.2	1.7	1.9	1.8
Combined public sector primary balance 3/	1.6	3.0	1.3	1.2	1.0	0.9	0.7
General government current revenue	18.3	19.6	18.5	18.6	18.6	18.5	18.6
General govt. non-interest expenditure	17.0	16.9	17.4	17.4	17.6	17.7	17.9
Combined public sector interest due	1.9	2.0	2.0	1.9	1.8	1.6	1.4
Combined public sector overall balance	-0.3	1.0	-0.8	-0.7	-0.7	-0.7	-0.7
Public sector debt 4/	37.7	32.0	31.2	30.5	29.7	28.7	27.4
Gross domestic investment	18.6	19.6	21.2	21.8	22.0	22.2	22.0
Public sector 4/	2.9	2.9	4.3	4.6	4.7	4.7	4.4
Private sector	16.0	16.6	16.9	17.2	17.4	17.5	17.6
Inventories changes	-0.2	0.1	0.0	0.0	0.0	0.0	0.0
National savings	19.9	21.0	21.4	21.9	21.9	22.0	21.6
Public sector 5/	2.6	3.9	3.3	3.6	3.7	3.7	3.9
Private sector	17.3	17.1	18.1	18.3	18.2	18.3	17.7
External savings	-1.3	-1.3	-0.2	-0.1	0.1	0.2	0.4
Memorandum items:	71.5	68.4	67.0	63.3	62.1	60.5	
Nominal GDP (billions of New Soles)	261.6	298.9	317.9	337.2	359.3	384.4	411.2
Gross international reserves (billions of U.S. dollars)	14,115	15,615	16,765	17,465	18,065	18,515	18,765
Gross international reserves to broad money	68.7	68.4	67.0	63.3	62.1	60.6	58.3
External debt service (percent of exports of GNFS)	34.8	15.1	13.8	16.1	14.1	14.8	14.2
Short-term external debt service (percent of exports of GNFS)	0.8	0.8	0.8	0.8	0.7	0.7	0.6
Public external debt service (percent of exports of GNFS)	25.5	10.0	9.6	11.9	10.1	10.9	10.6

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; and Fund staff estimates/projections.

1/ Includes interest payments only.
2/ Includes the financial public sector.
3/ Exludes CRPAOs.
4/ Includes CRPAOs.
5/ Excludes privatization receipts.

Table 11. Peru: Financial and External Vulnerability Indicators
(In percent; unless otherwise indicated)

	2002	2003	2004	Prel. 2005	Projection 2006	2007	2008
Financial indicators							
Public sector debt/GDP	46.6	47.0	44.4	37.7	32.0	31.2	30.5
Of which: in domestic currency (percent of GDP)	6.9	7.1	6.9	8.2	7.3	7.2	6.9
90-day prime lending rate, domestic currency (end of period)	5.1	3.3	3.8	4.4	...	...	...
90-day prime lending rate, foreign currency (end of period)	2.4	1.7	2.6	5.5	...	...	...
Velocity of money 1/	3.9	4.1	4.0	3.9	4.0	3.9	3.8
Net credit to the private sector/GDP 2/	30.1	29.3	27.7	28.1	27.0	27.3	27.3
External indicators							
Exports, U.S. dollars (percent change)	9.8	17.8	38.8	36.7	34.9	6.2	-3.7
Imports, U.S. dollars (percent change)	2.8	11.2	19.0	23.0	25.6	16.1	11.2
Terms of trade (percent change) (deterioration -)	3.1	1.3	9.2	6.9	23.7	-5.3	-10.4
Real effective exchange rate, (end of period, percent change) 3/	-1.2	-6.8	1.9	-3.9	0.2	...	...
Current account balance (percent of GDP)	-1.9	-1.5	0.0	1.3	1.3	0.2	0.1
Capital and financial account balance (percent of GDP)	3.3	2.3	3.4	0.6	-0.1	1.0	0.6
Total external debt (percent of GDP)	48.9	48.1	44.7	35.8	30.7	28.4	26.7
Medium- and long-term public debt (in percent of GDP) 4/	36.4	37.0	35.1	28.1	24.6	23.1	21.8
Medium- and long-term private debt (in percent of GDP)	7.9	7.0	5.6	3.9	3.1	2.7	2.4
Short-term public and private debt (in percent of GDP)	4.5	4.1	4.0	3.9	2.9	2.7	2.5
Total external debt (in percent of exports of goods and services) 4/	301.5	274.3	214.1	146.5	109.0	102.5	107.2
Total debt service (in percent of exports of goods and services) 5/	45.1	31.0	25.4	34.8	15.1	13.8	16.1
Gross official reserves							
In millions of U.S. dollars	9,690	10,206	12,649	14,115	15,615	16,765	17,465
In percent of short-term external debt 6/	214.2	214.4	161.2	288.5	350.1	336.9	385.5
In percent of short-term external debt, foreign currency deposits, and adjusted CA balance 6/ 7/	68.3	71.6	71.4	88.0	97.8	98.7	103.0
In percent of broad money 8/	65.9	67.2	70.6	68.7	68.4	67.0	63.3
In percent of foreign currency deposits at banks	100.6	107.3	128.3	129.4	135.6	139.6	140.5
In months of next year's imports of goods and services	10.8	9.7	10.0	9.8	8.8	8.5	8.3
Net international reserves (in millions of U.S. dollars)	9,598	10,194	12,631	14,097	15,597	16,747	17,447
Net international reserves (program definition; in millions of U.S. dollars) 9/	5,830	6,906	9,304	9,748	11,485	11,835	...
Net foreign exchange position (in millions of U.S. dollars) 10/	3,341	4,583	6,936	7,380	9,117	9,467	10,967

Sources: Central Reserve Bank of Peru; and Fund staff estimates/ projections.

1/ Defined as the inverse of the ratio of end-period broad money to annual GDP.
2/ Corresponds to the financial system.
3/ End of period. Source: Information Notice System, IMF.
4/ Includes Central Reserve Bank of Peru debt.
5/ Includes debt service to the Fund. For 2002, excludes US$923 million of Brady bonds that were amortized in a debt exchange operation.
6/ Short-term debt includes amortization of medium- and long-term loans falling due over the following year.
7/ Current Account deficit adjusted for 0.75*net FDI inflows; if adjusted CA balance>0, set to 0.
8/ At end-period exchange rate.
9/ Includes financial system's foreign currency deposits in central bank as reserve liability.
10/ Includes public sector foreign currency deposits in central bank (e.g. pension reserve funds) as reserve liability.

Table 12. Peru: Millennium Development Goals

	1995	2001	2002	2003	2004	2005	Target 2015
Goal 1: Eradicate extreme poverty and hunger							
Population below $1 a day (in percent of population)	...	18.1	...	...	...	...	9.1
Poverty gap at $1 a day (in percent of total population,)	...	9.1	...	...	...	...	4.6
Percent of income or consumption held by poorest 20 percent	...	2.9	...	...	...	...	1.5
Prevalence of child malnutrition (in percent of children under 5)	7.8	7.1	...	...	...	...	5.4
Pop. below min. of dietary energy consumption (in percent of total)	18.0	11.0	13.0	12.0	...	...	20.0
Goal 2: Achieve universal primary education							
Net primary enrollment ratio (in percent of relevant age group)	90.8	99.9	...	99.7	...	...	100.0
Percentage of cohort reaching grade 5 (in percent)	...	87.4	...	...	...	...	100.0
Youth literacy rate (in percent of ages 15-24)	95.7	96.9	96.8	...	97.0	...	100.0
Goal 3: Promote gender equality and empower women							
Ratio of girls to boys in primary and secondary education (in percent)	96.0	97.0	97.1	99.8	100.0	...	100.0
Ratio of young literate females to males (in percent of ages 15-24)	96.0	97.1	97.8	97.8	97.8	...	100.0
Share of women employed in the nonagricultural sector (in percent)	30.5	34.6	35.0	37.2	...	...	...
Proportion of seats held by women in national parliament (in percent)	10.0	...	...	18.0	18.0	...	...
Goal 4: Reduce child mortality							
Under 5 mortality rate (per 1,000)	60.0	42.0	39.0	34.0	29.2	...	53.3
Infant mortality rate (per 1,000 live births)	46.0	40.0	30.0	26.0	24.2	...	...
Immunization, measles (in percent of children under 12 months)	98.0	97.0	95.0	95.0	87.0	...	...
Goal 5: Improve maternal health							
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	410.0	...	...	...	...	307.5
Births attended by skilled health staff (in percent of total)	56.4	59.3	...	...	71.1	...	...
Goal 6: Combat HIV/AIDS, malaria and other diseases							
Prevalence of HIV, total (in percent of ages 15-24)	...	0.2	0.2	0.5	...	...	0.1
Contraceptive prevalence rate (in percent of women ages 15-49)	64.0	68.9	...	...	...	...	...
Number of children orphaned by HIV/AIDS	...	17000	...	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	196.7	196.0	202.4	187.6	178.4	...	...
Tuberculosis cases detected under DOTS	99.0	94.0	84.5	80.6	83.1	...	...
Goal 7: Ensure environmental sustainability							
Forest area (in percent of total land area)	...	50.9	...	...	...	53.7	...
Nationally protected areas (in percent of total land area)	2.7	2.7	6.1	6.1	...	...	...
GDP per unit of energy use (PPP $ per kg oil equivalent)	8.9	10.4	10.7	11.0	...	...	...
CO2 emissions (metric tons per capita)	1.0	1.1	...	1.0	...	...	...
Access to an improved water source (in percent of total population)	...	80.0	81.0	83.0	...	...	87.0
Access to improved sanitation (in percent of total population)	...	71.0	62.0	63.0	...	...	...
Access to secure tenure (in percent of total population)	...	...	...	...	...	...	...
Goal 8: Develop a Global Partnership for Development							
Youth unemployment rate (in percent of labor force ages 15-24)	11.4	13.2	15.2	19.2	...	...	...
Fixed line and mobile telephones (per 1,000 people)	50.3	136.7	152.3	175.6	222.9	...	...
Personal computers (per 1,000 people)	14.9	47.9	43.0	64.7	97.6	...	...

Source: United Nations, Report 2006.

Table 13. Peru: Quantitative Performance Criteria and Inflation Consultation Mechanism, 2005 and 2006

	2005	2006	
	Dec. 31	Mar. 31	Jun.30
	(Cumulative amounts from December 31, 2004, millions of New Soles)	(Cumulative amounts from December 31, 2005, millions of New	
Borrowing requirement of the combined public sector 1/			
Unadjusted limits	2,605	-596	-2,090
Adjusted limits 2/	2,605	-596	-2,090
Actual	339	-2,983	-6,905
Margin	2,266	2,387	4,815
	(Cumulative amounts from December 31, 2004, millions of U.S. dollars)	(Cumulative amounts from December 31, 2005, millions of U.S.	
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions			
Unadjusted targets	-300	-387	-804
Adjusted targets 2/	-1,541	-654	-1176
Actual	444	-732	-561
Margin	1,985	-78	615
Outstanding short-term external debt of the nonfinancial public sector			
Limits	50	50	50
Actual	0	0	0
Margin	50	50	50
Contracting or guaranteeing of nonconcessional public debt with maturity of at least one year			
Unadjusted limits	3,100	960	1,101
Adjusted limits 2/	5,776	1198	2,623
Actual	4,343	900	2,290
Margin	1,433	299	333
***Of which:* external debt of 1-5 year maturity**			
Limits	100	100	100
Actual	0	0	0
Margin	100	100	100
External payments arrears of the public sector (on a continuous basis)			
Limits	0	0	0
Actual	0	0	0
Margin			
	(Consultation bands for the 12-month rate of inflation, in percent) 3/		
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**
Actual	1.5	2.5	1.8

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; IMF Country Report No. 07/110; and IMF Country Report No. 06/47.

1/ PIPP proceeds are included below the line.

2/ The targets and limits were adjusted in accordance with the tables attached to the letters of intent dated May 20, 2005 (IMF Country Report No. 07/100) for 2005, and December 20, 2005 (IMF Country Report No. 06/47) for 2006.

3/ 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 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 14. Peru: Proposed Schedule of Purchases Under the Stand-By Arrangement, 2007–09 1/

Amount of Purchase	Availability Date	Conditions Include
1. SDR 159.6 million 2/	January, 2007	Board approval of SBA.
2. SDR 1.596 million	May 15, 2007	Completion of the First Review and observance of end-March 2007 performance criteria.
3. SDR 1.596 million	August 15, 2007	Observance of end-June 2007 performance criteria.
4. SDR 1.596 million	November 15, 2007	Completion of the Second Review and observance of end-September 2007 performance criteria.
5. SDR 1.596 million	February 15, 2008	Observance of end-December 2007 performance criteria.
6. SDR 1.596 million	May 15, 2008	Completion of the Third Review and observance of end-March 2008 performance criteria.
7. SDR 1.596 million	August 15, 2008	Observance of end-June 2008 performance criteria.
8. SDR 1.596 million	November 15, 2008	Completion of the Fourth Review and observance end-September 2008 performance criteria.
9. SDR 1.596 million	February 15, 2009	Observance of end-December 2008 performance criteria.

1/ Total access under the Stand-By Arrangement is SDR 172.4 million (27 percent of quota).
2/ This amount is required to exhaust the first credit tranche which is not subject to phasing.

Table 15. Peru: Capacity to Repay the Fund as of November 30, 2006 1/

(In millions of SDRs; unless otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total
Obligations from existing drawings										
Principal (repurchases)	0.0	13.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	13.4
Charges and interest 2/										
GRA charges	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2
SDR charges	0.0	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	29.4
Credit outstanding	13.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
(percent of quota)	2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Obligations from prospective drawings										
Principal (repurchases)	0.0	0.0	0.0	0.0	60.5	83.4	25.5	2.8	0.2	172.4
Charges and interest 3/										
GRA charges	0.0	6.9	9.1	9.4	8.5	4.3	0.6	0.1	0.0	38.7
Service and commitment charges	0.0	2.4	1.1	0.2	0.0	0.0	0.0	0.0	0.0	3.7
Credit outstanding	0.0	164.4	170.8	172.4	111.9	28.5	3.0	0.2	0.0	...
(percent of quota)	0.0	25.8	26.8	27.0	17.5	4.5	0.5	0.0	0.0	...
Cumulative (existing and prospective)										
Principal (repurchases)	0.0	13.4	0.0	0.0	60.5	83.4	25.5	2.8	0.2	185.8
Charges and interest 3/										
GRA charges	0.0	7.1	9.1	9.4	8.5	4.3	0.6	0.1	0.0	38.9
SDR and Service charges	0.0	6.1	4.8	3.9	3.7	3.7	3.7	3.7	3.7	33.1
Credit outstanding	13.4	164.4	170.8	172.4	111.9	28.5	3.0	0.2	0.0	...
Percent of quota	2.1	25.8	26.8	27.0	17.5	4.5	0.5	0.0	0.0	...
Percent of GDP	0.0	0.2	0.2	0.2	0.1	0.0	0.0	0.0	0.0	...
Percent of exports of goods and services	0.1	0.9	1.0	1.0	0.6	0.1	0.0	0.0	0.0	...
Percent of public sector debt service	0.5	6.9	6.0	7.3	4.4	1.0	0.1	0.0	0.0	...
Percent of external public debt	0.1	1.1	1.1	1.1	0.7	0.2	0.0	0.0	0.0	...
Percent of external public debt service	0.8	9.6	8.4	10.2	6.0	1.5	0.1	0.0	0.0	...
Percent of gross foreign reserves	0.1	1.5	1.5	1.4	0.9	0.2	0.0	0.0	0.0	...
Memorandum items:										
Purchases	0.0	164.4	6.4	1.6	0.0	0.0	0.0	0.0	0.0	172.4

Sources: Fund staff estimates/projections.

1/ Assuming all purchases are made. Repurchases assumed to be made under obligations schedule.

2/ For 2006, they show charges and interest for September–December.

3/ Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the GRA. The current SDR interest rate is assumed for net use of SDRs.

ANNEX 1. PERU: DEBT SUSTAINABILITY ANALYSIS[1]

Peru's debt-to-GDP ratio is projected to decline significantly under the baseline debt sustainability scenario. Economic growth would average close to 5 percent a year with the overall deficit of the combined public sector averaging 0.9 percent of GDP. Public sector revenue would remain broadly unchanged as a percent of GDP. Under these assumptions, Peru's public sector debt stock would decline from 38 percent of GDP at end-2005, to about 27½ percent of GDP by 2011.

Given that 80 percent of total external debt is public, in the baseline scenario the projected drop in public debt largely determines the path of Peru's total external debt. Following a decline during 2004-05, as companies took advantage of favorable conditions to pay down their external debt, private sector external debt is projected to decline slightly over the medium term, from already low levels. As a result, total external debt is projected to decline from 36 percent of GDP at end-2005 to 22 percent by 2011 (public external debt would decline from 28 percent to 19 percent over the same period).

Peru's external and public sector debt ratios are robust to alternative assumptions about underlying macroeconomic variables. Sensitivity tests based on 10-year historical standard deviations to form alternative medium-term assumptions for real GDP growth and interest rates show that Peru's debt dynamics are only moderately vulnerable to such changes.

In contrast, external and public debt ratios are sensitive to changes in exchange rate changes, given the still high foreign currency share of Peru's debt. Specifically, under a one-off 30 percent depreciation of the sol, the external debt-to-GDP ratio would shift by 14 percentage points above the baseline projections in the medium term. This test assumes that the currency would remain at its depreciated level permanently—a scenario that could only occur in the case the sol were currently significantly overvalued. Available data, however, do not point to such an overvaluation. Non-interest current account shocks (such as in the terms of trade) would have a moderate adverse impact on external indebtedness.

A similar pattern is observed under a 10 percent of GDP shock to the contingent liabilities of the public sector: The public debt-to-GDP ratio would rise sharply in the short run and, while declining over the medium term, would remain 10 percentage points above the debt levels projected under the baseline scenario.

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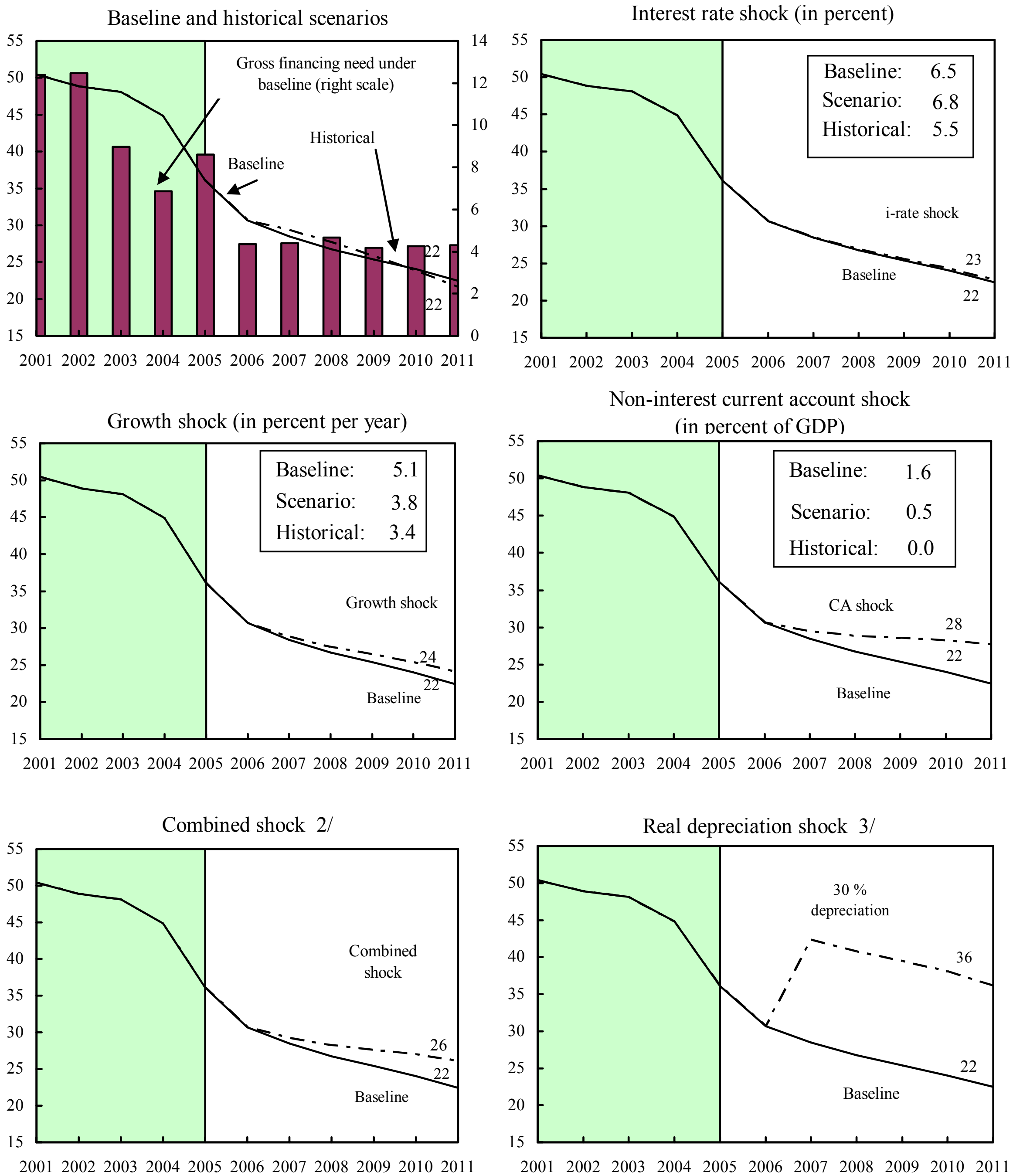
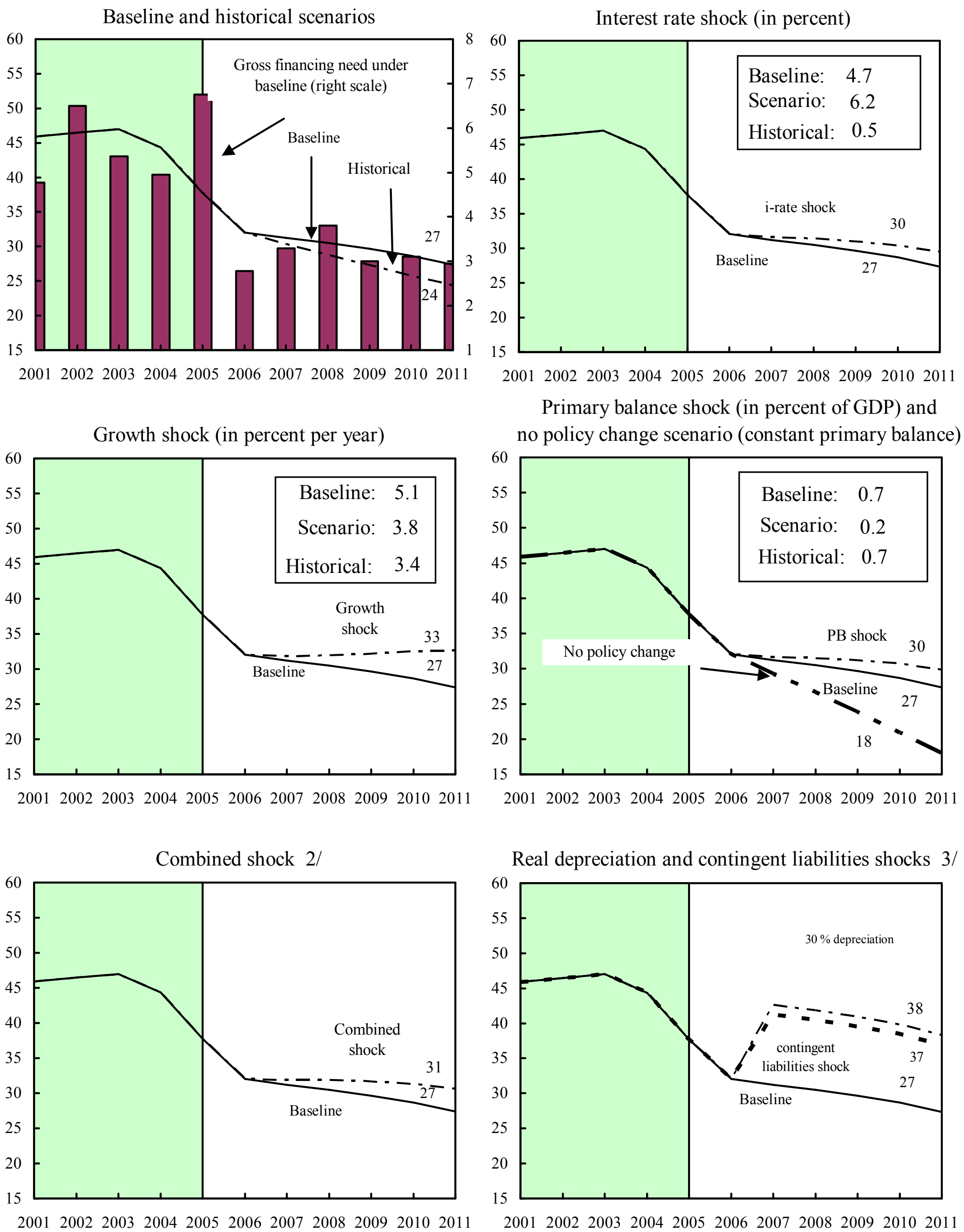
[1] The DSA includes standard sensitivity tests around the baseline medium-term scenario. The methodology used is in line with that endorsed in "Information Note on Modification to the Fund's Debt Sustainability Assessment framework for market Access Countries" (www.imf.org).

Figure 1. Peru: External Debt Sustainability: Bound Tests 1/
(In percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

Figure 2. Peru : Public Debt Sustainability: Bound Tests 1/
(In percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 1 Peru: External Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	50.4	48.9	48.1	44.9	36.1	**30.7**	**28.4**	**26.7**	**25.4**	**24.0**	**22.5**	**-0.8**
Change in external debt	-1.7	-1.6	-0.7	-3.3	-8.8	-5.4	-2.2	-1.7	-1.3	-1.4	-1.6	
Identified external debt-creating flows (4+8+9)	0.3	-3.5	-2.0	-7.5	-8.8	-4.4	-2.6	-1.8	-1.3	-1.2	-1.3	
Current account deficit, excluding interest payments	-0.8	-0.5	-0.7	-2.1	-3.4	-3.4	-2.1	-1.9	-1.5	-1.3	-0.9	
Deficit in balance of goods and services	1.9	1.1	0.0	-4.0	-5.4	-7.7	-5.9	-2.5	-1.1	-0.6	-0.3	
Exports	15.9	16.2	17.5	20.9	24.5	28.2	27.6	24.9	23.5	22.7	22.3	
Imports	17.7	17.3	17.6	16.8	19.1	20.4	21.7	22.4	22.4	22.1	22.0	
Net non-debt creating capital inflows (negative)	-1.5	-2.7	0.0	-1.9	-2.0	-1.0	-0.9	-0.4	-0.2	-0.2	-0.5	
Automatic debt dynamics 1/	2.6	-0.4	-1.3	-3.6	-3.4	0.0	0.4	0.5	0.4	0.3	0.2	
Contribution from nominal interest rate	3.0	2.4	2.2	2.1	2.1	2.1	2.0	1.8	1.7	1.5	1.3	
Contribution from real GDP growth	-0.2	-2.5	-1.8	-2.2	-2.5	-2.0	-1.6	-1.3	-1.2	-1.2	-1.1	
Contribution from price and exchange rate changes 2/	-0.1	-0.3	-1.8	-3.4	-3.0	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-2.0	2.0	1.3	4.2	0.0	-1.0	0.4	0.1	0.0	-0.1	-0.3	
External debt-to-exports ratio (in percent)	317.9	301.5	274.3	215.0	147.5	109.0	103.0	107.2	107.9	105.7	100.7	
Gross external financing need (in billions of US dollars) 4/	6.7	7.1	5.5	4.8	6.8	4.0	4.3	4.9	4.7	5.1	5.5	
in percent of GDP	12.4	12.5	9.0	6.9	8.6	4.4	4.4	4.7	4.2	4.3	4.3	
Scenario with key variables at their historical averages 5/						**30.7**	**29.4**	**27.7**	**25.9**	**23.9**	**21.6**	**-2.5**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.4	5.2	3.9	5.2	6.4	6.5	5.5	5.0	5.0	5.0	5.0	
GDP deflator in US dollars (change in percent)	0.2	0.6	3.8	7.7	7.1	7.8	2.1	1.9	2.0	2.0	2.1	
Nominal external interest rate (in percent)	5.7	5.0	4.9	4.9	5.3	6.6	6.9	6.8	6.6	6.4	6.0	
Growth of exports (US dollar terms, in percent)	0.8	8.1	16.7	34.7	33.7	32.1	5.6	-3.4	1.1	3.5	5.2	
Growth of imports (US dollar terms, in percent)	-0.4	3.4	9.2	8.5	29.5	22.6	14.6	10.4	7.2	5.8	6.7	
Current account balance, excluding interest payments	0.8	0.5	0.7	2.1	3.4	3.4	2.1	1.9	1.5	1.3	0.9	
Net non-debt creating capital inflows	1.5	2.7	0.0	1.9	2.0	1.0	0.9	0.4	0.2	0.2	0.5	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP de

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 2. Peru: Public Sector Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	45.9	46.5	47.0	44.4	37.7	**32.0**	**31.2**	**30.5**	**29.7**	**28.7**	**27.4**	**-0.5**
o/w foreign-currency denominated	38.8	39.6	39.9	37.5	29.6	25.0	24.0	23.5	22.8	22.1	21.1	
Change in public sector debt	0.4	0.6	0.5	-2.6	-6.6	-5.7	-0.8	-0.7	-0.8	-1.0	-1.3	
Identified debt-creating flows (4+7+12)	0.0	-1.1	-1.0	-4.5	-5.0	-5.7	-0.8	-0.7	-0.8	-1.0	-1.3	
Primary deficit	0.0	0.0	-0.4	-1.0	-1.6	-2.9	-0.9	-0.7	-0.6	-0.6	-0.8	
Revenue and grants	18.1	17.5	18.0	18.0	18.9	20.2	19.0	19.0	19.0	19.0	18.9	
Primary (noninterest) expenditure	18.1	17.5	17.6	17.0	17.3	17.4	18.1	18.2	18.4	18.4	18.1	
Automatic debt dynamics 2/	0.5	-0.4	-0.6	-3.4	-3.3	-2.7	0.1	0.1	-0.1	-0.3	-0.4	
Contribution from interest rate/growth differential 3/	1.5	-0.5	-0.8	-2.7	-2.1	-2.7	0.1	0.1	-0.1	-0.3	-0.4	
Of which contribution from real interest rate	1.6	1.8	0.9	-0.5	0.5	-0.6	1.8	1.6	1.3	1.0	0.9	
Of which contribution from real GDP growth	-0.1	-2.2	-1.7	-2.2	-2.6	-2.1	-1.7	-1.5	-1.4	-1.4	-1.3	
Contribution from exchange rate depreciation 4/	-0.9	0.1	0.3	-0.7	-1.2	...	...	...	...	...	...	
Other identified debt-creating flows	-0.6	-0.7	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	
Privatization receipts (negative)	-0.6	-0.7	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	0.4	1.6	1.6	1.9	-1.6	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	253.6	265.3	261.7	247.0	199.9	158.6	164.6	160.7	156.0	151.3	144.5	
Gross financing need 6/	4.8	6.5	5.4	4.9	6.8	2.8	3.3	3.8	3.0	3.1	2.9	
in billions of U.S. dollars	2.6	3.7	3.3	3.4	5.4	2.5	3.2	4.0	3.4	3.7	3.8	
Scenario with key variables at their historical averages 7/						**32.0**	**30.4**	**28.8**	**27.3**	**25.8**	**24.4**	**-0.8**
Scenario with no policy change (constant primary balance) in 2005-2010						**32.0**	**29.3**	**26.6**	**23.8**	**20.9**	**18.0**	**-0.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.2	5.2	3.9	5.2	6.4	6.5	5.5	5.0	5.0	5.0	5.0	
Average nominal interest rate on public debt (in percent) 8/	5.0	4.9	4.8	4.8	4.8	6.0	6.7	6.5	6.1	5.7	5.3	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.6	4.1	2.1	-0.8	1.4	-1.3	5.9	5.5	4.6	3.8	3.4	
Nominal appreciation (increase in US dollar value of local currency, in percent)	2.4	-0.3	-0.6	1.9	3.6	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	1.4	0.8	2.6	5.6	3.4	7.3	0.8	1.0	1.5	1.9	1.9	
Primary deficit	0.0	0.0	-0.4	-1.0	-1.6	-2.9	-0.9	-0.7	-0.6	-0.6	-0.8	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

APPENDIX 1. PERU: FUND RELATIONS
(As of November 30, 2006)

I. Membership Status: Joined 12/31/1945; accepted Article VIII obligations on February 15, 1961.

II.

General Resources Account	SDR Million	Percent Quota
Quota	638.40	100.00
Fund holdings of currency	651.81	102.1

III.

SDR Department	SDR Million	Percent Allocation
Net cumulative allocation	91.32	100.00
Holdings	0.61	0.66

IV.

Outstanding Purchases and Loans	SDR Million	Percent Quota
Extended arrangements	13.38	2.1

V. Financial Arrangements

Type of Arrangement	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	6/09/04	8/16/06	287.28	0.00
Stand-By	2/01/02	2/29/04	255.00	0.00
Stand-By	3/12/01	1/31/02	128.00	0.00

VI. Projected Obligations to the Fund (SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue 12/31/05	2006	2007	2008	2009	2010
Principal	0	0	13.38	0.00	0.00	0.00
Charges/interest	0	0	3.88	3.68	3.67	3.67
Total	0	0	17.26	3.68	3.67	3.67

VII. Safeguards Assessments

Under the Fund's safeguards assessment policy, the Central Reserve Bank of Peru is subject to an update of the 2004 assessment. The previous assessment concluded that some risks existed in the bank's safeguards framework, and recommendations made to address them have since been implemented.

VIII. Exchange Arrangements

Peru maintains a unified, managed floating exchange rate. On November 30, 2006, the average of interbank buying and selling rates was 3.22 *Nuevo Soles* per U.S. dollar. The exchange system is free of restrictions, except for those maintained solely for the preservation of national or international security, and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51). Those restrictions are maintained pursuant to UN Security Council Resolutions 1267 (October 15, 1999) and 1373 (September 28, 2001). The central government maintains external payments arrears to unguaranteed suppliers, some of whom are in discussions with the government, while the rest have not been located. Peru has maintained a clearing arrangement with Malaysia since 1991.

IX. Last Article IV Consultation

The 2003 Article IV consultation was concluded on February 23, 2004 (Country Report No. 04/155).

X. FSAP and ROSCs

Several joint Fund-Bank missions visited Lima in the period September 2000–January 2001 to conduct an FSAP for Peru. The corresponding Financial System Stability Assessment Report dated February 28, 2001 (www.imf.org) was discussed by the Executive Board on March 12, 2001. A follow-up FSAP was concluded in June 2005. In October 2002, an FAD mission conducted a Fiscal ROSC for Peru, while an STA mission conducted a Data ROSC for Peru in February 2003.

XI. Technical Assistance

Department	**Date**	**Purpose**
FAD	June 2005, March 2006, November 2006	Public Financial Management
	May 2005, February 2006, September and November 2006	Tax policy and administration
	August 2004	Public investment and fiscal policy, including issues related to PPPs.
	November 1999	Fiscal rules
MFD	April 2006	Financial sector supervision
	April 2005	Consumer protection in the banking system
	March, 2005	Central bank organization
	April, December 2002	Inflation targeting
	October 2002	Foreign exchange operations
	August 2002	Accounting and organizational issues
	May 2002	Inflation targeting
	March 2002	Monetary operations and government securities market
STA	January 1998 and October 1999	National account statistics, new base year for the national account series

XII. Resident Representative

Ms. Nicoletta Batini has been Resident Representative in Peru since January 2006.

APPENDIX 2. PERU: WORLD BANK RELATIONS

Bank Group strategy

A new World Bank Group Country Partnership Strategy (CPS) is under preparation and will cover the five year period of the new administration, corresponding to the Bank's fiscal years 2007 to 2011. This CPS will provide the Bank's framework to support the implementation of the government's poverty reduction strategy with programs addressing fiscal, national competitiveness, and social-sector needs. The program supported by the Bank under the new CPS emphasizes partnerships, flexibility and results orientation. The CPS under preparation envisages a lending program that will include a combination of two fast disbursing loans and three investment projects per year. The new CPS will explore development policy lending possibilities in the fiscal and social sectors, including the first one to support policy reforms in the environmental sector. The previous Country Assistance Strategy discussed by the IBRD Board on September 17, 2002 came to an end in July 2006.

To date, in FY06 four operations have been approved, the Regional Transport Decentralization project for $50 million; the Decentralization and Competitiveness Development Policy Loan for $150 million; the Real Property Rights Consolidation Project for 25 million; and the Rural Electrification Project for $50 million. Peru's current portfolio amounts to 15 loans for US$431 million and one Guarantee Facility for US$200 million. A development policy loan supporting fiscal management and competitiveness for US$200 million will be discussed at the Board on December 19th, 2006. By end-FY06 the disbursement level should hover around US$200 million.

Bank-Fund collaboration in specific areas

- *Tax Reform and Fiscal Decentralization*. Fund staff has taken the lead in assisting in the design of tax reform. Jointly with the World Bank and IDB, staff has worked on drafting laws and regulations for fiscal decentralization. The World Bank has also focused on the design and implementation of decentralization of the social sectors and pro-poor spending policies.

- *Financial Sector.* A joint FSAP was completed in May 2001. Follow up technical assistance to implement FSAP recommendations has been given by both institutions. A joint FSAP update was completed in June 2005.

- *Public expenditure review (PER).* In a joint effort with the IDB, and close collaboration with the IMF, the Bank completed in June 2002 a comprehensive diagnosis of, and made policy recommendations for, Peru's public expenditure management. A social sector expenditure review, with support of the Fund, is being prepared to assess fiscal trends in the social sector under decentralization, review the quality of social spending, and fine-tune the on-going budgetary protection policy of priority social programs.

- *Fiscal reforms.* In March 2002, the Bank and the Fund supported an international seminar on proposals for revising the law on fiscal prudence and transparency. A joint IMF-World Bank-IaDB mission took place in September 2004 for a pilot study on Public Investment and Fiscal Policy.

- *CAS follow-up and preparation of the Programmatic Loans* (Social Reform Loans I, II, III, and IV, and Decentralization and Competitiveness Loan I, II, and III). The World Bank and the government have engaged in an interactive and continuous dialogue on CAS implementation and preparation of the subsequent programmatic loans. Dialogue has concentrated on the macroeconomic background, setting of triggers, overall loan conditionality, and risks and estimation of the fiscal implications of Bank operations.

Statement of World Bank Loans
(As of October 2006)

Loan Number	Year approved	Borrower	Purpose	In millions of U.S. dollars: Total (Net of Cancellation)	Undisbursed
Ninety-four loans fully disbursed[1]				5,692.4	
Partially disbursed or undisbursed loans:					
46140	2001	Republic of Peru	Second Rural Roads Project	50.0	2.5
71760	2003	Republic of Peru	Rural Education Project	52.5	35.1
71770	2003	Republic of Peru	Trade Facilitation and Productivity Improvement Technical Assistance Project	20.0	14.3
72090	2003	Republic of Peru	Lima Urban Transport Project	45.0	42.6
71600	2003	Republic of Peru	Additional Financing Lima Water Rehabilitation and Management Project	20.0	16.5
71420	2003	Republic of Peru	National Rural Water Supply and Sanitation Project	50.0	41.7
72190	2004	Republic of Peru	Justice Services Improvement	12.0	10.9
72570	2004	Republic of Peru	Vilcanota Valley Rehabilitation Program	5.0	4.8
72550	2004	Republic of Peru	Institutional Capacity for Sustainable Fiscal Decentralization	8.8	7.8
73080	2005	Republic of Peru	Irrigation Subsector Project	10.3	6.2
72540	2005	Republic of Peru	Accountability for Decentralization in the Social Sectors	7.8	5.6
72850	2005	Republic of Peru	Agricultural Research and Extension	25.0	21.1
73220	2005	Republic of Peru	Regional Transport Infrastructure Decentralization	50.0	49.9
73680	2006	Republic of Peru	Real Property Rights	25.0	25.0
73660	2006	Republic of Peru	Rural Electrification	50.0	49.9
Total disbursed:				5,157.8	
Of which : amount repaid				2,421.4	
Total outstanding 1				2,718.1	
Total undisbursed					333.7

1/ Includes exchange rate adjustments and loans sold to third parties.

Statement of IFC Investments
(As of October 2006)
In millions of U.S. dollars

	Loans	Equity	Quasi	Participation Loans	Total
Total commitments held	178.2	17.2	30.5	13.6	225.9
Total disbursed	148.1	16.6	30.5	13.6	208.8

Source: World Bank.

APPENDIX 3. PERU: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

Country Strategy 2002–06

The key objectives for the 2002–06 strategy for Peru are poverty reduction and equity promotion, within the context of high economic growth, which is needed to make these goals sustainable. Toward this end, the Bank will support the government's efforts to: (i) raise the economy's productivity and competitiveness, by removing institutional obstacles to increased productivity and investment and making structural investments in human capital; (ii) improve the efficiency of social policy while implementing measures to mitigate poverty and protect vulnerable groups; and (iii) create a modern, decentralized and efficient state.

The Bank and the authorities have started the dialogue for the preparation of the new strategy for 2007–11.

Lending

As of November 1st, 2006, the country's portfolio consists of **27 loans for a total amount of US$1,434.0 million**. These resources are distributed among 25 investment loans (US$834.0 million) and two policy-based loans (US$600.0 million). The lending program for 2006 relies on the approval of four investment loans for US$215.0 million and a programmatic loan for US$200.0 million.

In addition, the country portfolio with Peru includes 45 non-reimbursable technical cooperation grants (US$7.5 million) and six small projects (US$3.4 million). The Multilateral Investment Fund (MIF) has 28 non-reimbursable technical cooperation grants under execution (US$15.2 million).

IDB Loans Portfolio By Sector as of November 1, 2006
(In millions of US$)

	Commitments	Disbursements	Percent Disbursed
Agriculture	53.3	24.6	46.2%
Education	87.0	78.6	90.4%
Environment	5.0	3.3	66.9%
Health	28.0	26.7	95.2%
Public sector management	65.9	8.9	13.5%
Sanitation	50.8	0.0	0.0%
Science and technology	325.0	200.0	61.5%
Social investment	404.1	202.6	50.1%
Transportation	355.0	181.7	51.2%
Urban development	60.0	16.6	27.7%
Total	**1,434.00**	**743.0**	**51.8%**

APPENDIX 4. PERU: STATISTICAL ISSUES

Macroeconomic statistics are broadly adequate for policy formulation, surveillance, and program monitoring. Peru has been in observance of the Special Data Dissemination Standard (SDDS) since August 1996 and meets the specifications for coverage, periodicity, and timeliness of the data categories. An advance release calendar and the metadata for Peru are posted on the Fund's Dissemination Standards Bulletin Board. A data ROSC was prepared and published in 2003.

Despite progress in recent years, there is scope for improvement in the following areas: (i) coordination among the agencies that compile official statistics to avoid duplication of efforts and confusion among users; (ii) implementing a new benchmark and base year for GDP; (iii) expanding the coverage of the wholesale price index to include mining, oil and gas extraction, electricity and water, public transportation, and communication; (iv) preparing sectoral breakdowns of depository corporations and financial surveys in accordance with the *MFSM* methodology; and (v) expanding the scope of data sources for compiling financial flows of individual residents.

I. Real Sector and Prices

In 2000, the authorities published a revised GDP series using the 1994 benchmark estimates, which includes detailed input-output tables, as the base year. However, due to limited availability of periodic source data, estimates after 1994 are largely based on extrapolation techniques. The lack of current detailed tables for supply and use hampers the reconciliation of discrepancies. As a result, changes in inventories are mainly determined as a residual. Although the quarterly accounts have benefited from some improvements in the timeliness of monthly production indices, coverage is still very limited. The National Statistics Office (INEI) is working on a new national account series using 2001 as the base year.

The weight structure for the CPI is derived from a 1993–94 household expenditure survey. Except for weights, source data are timely and consistent with the technical requirements for producing the index. The coverage of owner-occupied housing, however, was eliminated from the Metropolitan Lima index through the exclusion of imputed rent, a deviation from international practices. Imputed rent is included in the indices of the other 24 cities in the CPI. Thus, the national index is a weighted average of indices that have different coverage. The weights for the WPI are also outdated. INEI derived the weights from the 1994 input-output table and other reports and publications of relevant ministries. The statistical techniques used to compile the WPI follow generally accepted international standards.

The authorities monitor labor market developments using four indicators: open unemployment, underemployment, employment, and remunerations. The quality of the indicators has improved over the last two years. However, wage data comes with a relatively long delay; the nationwide unemployment and underemployment situation is surveyed only once a year; and labor productivity data is published only at the time of adjustments to electricity and telecommunications tariffs.

II. Fiscal Sector

The government finance statistics (GFS) for the general government are compiled using the analytical framework of the *GFS Manual 1986*. For the consolidated central government, revenues are compiled on a cash basis, while expenditures are compiled on an accrual basis. The authorities have sent to the Fund information on the components of consolidated central government expenditures by function. The coverage of published national budget data is narrower than the fiscal statistics prepared for program purposes. The authorities have recently prepared a plan to migrate to the *GFS Manual 2001,* but the schedule for migration has yet to be defined. The authorities report annual GFS data using the *GFSM 2001* analytical framework for publication in the *Government Finance Statistics Yearbook (GFSY)* and monthly data for the *International Financial Statistics (IFS)*.

III. Monetary Sector

The BCRP prepares and publishes the analytical accounts of the banking system and of the central bank broadly in line with the methodology recommended by the Fund's *Monetary and Financial Statistics Manual*. The main discrepancy is the valuation of some financial instruments at cost rather than at market prices. Until early-2003, nonbank deposit-taking institutions were excluded in the depository corporations survey, but following the recommendations of the 2003 data ROSC mission, the BCRP began incorporating them. Monetary statistics are disseminated only in a summary form. At the request of the authorities, in January 2007 a mission will visit the country to assist them in migrating to the new standardized report forms.

IV. External Sector

The BCRP prepares quarterly data on the balance of payments and international investment position largely in line with the recommendations of the fifth edition of the *Balance of Payments Manual (BPM5).* Data are reported to the Fund for publication in the *IFS* and the Balance of Payments Statistics Yearbook. Some departures from *BPM5* include the lack of coverage of assets held abroad and land acquisition abroad by residents; lack of separate identification of liabilities to affiliated enterprises; and the recording of some external debt transactions that are not on an accrual basis.

The BCRP has been reporting since August 2001 international reserves weekly data in accordance with the *Operational Guidelines for Data Template on International Reserves and Foreign Currency Liquidity.* Since August 2006, the BCRP is including the full amount of the liquidity requirements in the reserve template both under official reserve assets and as a contingent net drain (as specified in Section III of the Data Template). In September 2003, Peru started to disseminate quarterly data on external debt with a one-quarter lag in the BCRP website with a hyperlink to the Fund's website. External debt data are not compiled on an accrual basis, as recommended by *BPM5* and the *External Debt Statistics: Guide for Compilers and Users.*

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/	/s/
Luis Carranza Minister of Economy and Finance	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 though 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)				
Borrowing requirement of the combined public sector				
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)				
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions				
Unadjusted limits 5/ 6/	-260	44	336	350
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/	751	1,237	1,608	2,636
***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/	1,500	1,500	1,500	1,500
(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

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

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.

TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

This technical memorandum sets out the understandings between the Peruvian authorities and the Fund relating to the monitoring of the program for 2007. It defines the concepts used to assess compliance with quantitative performance criteria specified in the letter of the Government of Peru dated January 3, 2007. It also sets the frequency of the data to be provided to the Fund for monitoring the program. For purposes of the program for 2007, operations in foreign currency will be converted into *Nuevos Soles* at the average program exchange rate of S/. 3.24 per U.S. dollar.

I. DEFINITIONS OF CONCEPTS

1. The nonfinancial public sector (**NFPS)** includes the central government, the autonomous agencies, the local and regional governments, and the nonfinancial public enterprises.

2. **The borrowing requirement of the combined public sector (PSBR)** will be measured as: (a) net domestic financing of the NFPS; plus (b) net external financing of the NFPS; plus (c) proceeds from the Private Investment Promotion Program (PIPP); and less (d) the operating balance of the Central Reserve Bank of Peru (BCRP). The PSBR will be adjusted to exclude the impact of data revisions that do not represent a change of its flows during 2007. The components of the PSBR (see Table 1), will be defined and measured as follows:

(a) **The net domestic financing of the NFPS** is defined as the *sum* of: (i) the increase in net claims of the domestic **financial system**[1] on the nonfinancial public sector, excluding Peruvian Brady bonds and other government bonds initially sold abroad; (ii) the net increase in the amount of public sector bonds[2] held outside the domestic financial system and the nonfinancial public sector, excluding Peruvian Brady bonds and other bonds initially sold abroad; and (iii) the increase in the floating debt of the nonfinancial public sector due to expenditure operations and tax refund arrears; *less* (iv) the accumulation of stocks, bonds, or other domestic financial assets by the nonfinancial public sector and (v) the amortization of pension related bonds. In the case of enterprises that are divested after December 31, 2006, the net credit of the financial system to these enterprises will be recorded, for the remainder of the program period, as unchanged from their level at the time of the PIPP.

[1] The financial system comprises the banking system, the Corporación Financiera de Desarrollo (COFIDE), *MiVivienda* and all other nonbank financial intermediaries. The banking system includes the BCRP, the commercial banks, *Banco de la Nación* (BN), and *AgroBanco*.

[2] Excluding the new issuances of pension related bonds.

(b) **The net external financing of the NFPS** comprises (i) disbursements of loans; plus (ii) receipts from the issuance of government bonds abroad; minus (iii) cash payments of principal (current maturities of both loans and bonds); minus (iv) cash payments of arrears (principal and interest); plus/minus (v) the net increase/decrease in short-term external debt; minus (vi) debt buy-backs or other prepayments of debt (at market value) not included in the following item (including repayments of short-term external debt assumed by the government at the time of the divestiture of public enterprises, net of the proceeds from the sale of inventories of such enterprises); minus (vii) debt-equity swaps used in the PIPP accounted at the market value of these papers as defined by *ProInversion*; minus/plus (viii) the net increase/decrease in foreign assets of the nonfinancial public sector (including those held abroad by the *Fondo Consolidado de Reservas* (FCR), and any other fund managed by the *Oficina de Normalización Previsional* (ONP)) (see Table 2).

(c) **PIPP proceeds** are defined as (i) the cash payments received by the Treasury from the sale of state-owned assets (including proceeds transferred to the FCR, and any other specialized funds) valued at the program exchange rate, plus (ii) debt equity swaps used in the PIPP, accounted at market values as defined by *ProInversion*. PIPP proceeds also include up-front payments received by the Treasury for the granting of concessions for public services but exclude the annual payments under the concession program, which are part of nontax revenue.

(d) **The operating balance of the BCRP** includes: (i) cash interest earnings of the BCRP minus cash interest payments by the BCRP, in both domestic and foreign currency; (ii) the administrative expenses of the BCRP; and (iii) any realized cash losses or gains from activities in currencies, financial instruments, and derivatives.

3. **The quarterly limits on the borrowing requirement of the combined public sector (PSBR) for 2007 will be reduced** by the amount to which revenues of the central government 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. Mandatory transfers are earmarked central government expenditures that are linked to revenue. These include *canon and sobrecanon*, *fondo de Camisea, regalía minera, renta de aduanas,* and *Impuesto de Promoción Municipal (IPM).*

4. **The consultation bands for inflation** are based on the 12-month rate of change in consumer prices as measured by the *Indice de Precios al Consumidor (IPC)* at the level of Metropolitan Lima by the *Instituto Nacional de Estadística e Informática* (INEI). Should inflation fall outside an inner band of 2 percentage points around the central point of 2.5 percent, the authorities will discuss with the Fund staff on an appropriate policy response. Should inflation fall outside an outer band of 3 percentage points around the central point of 2.5 percent, the authorities will discuss with Fund staff on a policy response and complete a

consultation with the Executive Board of the Fund on the proposed policy response before requesting further purchases under the program.

5. **The net consumer lending of the *Banco de la Nación*** will be defined as disbursements of all consumer loans, including these under the "*Multired Program*" (established in November 2001) and "*Prestamos a 60 Quotas*" (established in September 2004) less cash amortizations under the loan programs. Interest payments on these loans are excluded from the definition of net lending.

6. **The net international reserves of the BCRP, excluding foreign-currency deposits of financial institutions,** are defined for the purpose of the program as: (a) the foreign assets of the BCRP (excluding subscriptions to the IMF and the Latin American Reserve Fund (FLAR), *Pesos Andinos*, credit lines to other central banks, *Corporación Andina de Fomento* (CAF) bonds, and foreign assets temporarily held by the BCRP as part of swap operations); less (b) reserve liabilities, defined as the sum of: (i) the BCRP's external liabilities with an original maturity of less than one year, and (ii) its liabilities to the IMF, to the Inter-American Development Bank (IADB) and to the FLAR; less (c) deposits in foreign currency by the banking system, other financial intermediaries and the private sector, net of repos of Treasury bonds with the financial system.

7. **BCRP's silver holdings** will be included as net domestic assets and excluded from the net international reserves.

8. **BCRP's gold holdings** will be accounted at US$516.53 per troy ounce (the average book value as of June 30, 2006), SDRs at US$1.429 per SDR, and foreign currency assets and liabilities of the BCRP in other currencies than US$ at the exchange rate of June 30, 2006. Net international reserves will be adjusted to exclude any valuation gains or losses resulting from net sales or deliveries of gold by the BCRP. The end-September 2006 level of net international reserves is shown in Table 3.

9. The flows of the **short-term external debt of the NFPS** are defined as the net change in the NFPS's outstanding external indebtedness with a maturity of less than one year (including instruments with put options that would be triggered within one year of the contracting date), measured, in part, on the basis of the operations of a selected sample of public enterprises comprising *Petroperú*, and *Electroperú*. These limits exclude normal import financing but include forward commodity sales. In the case of companies sold to the private sector under the PIPP, the short-term debt of these entities will be recorded, for the remainder of the program period, as unchanged from their level at the time of the PIPP. The [end-September 2006] stock of short-term external debt of the NFPS is shown in Table 4.

10. **The contracting or guaranteeing of nonconcessional public debt with a maturity of at least one year** refers to all domestic and external obligations of the NFPS contracted or guaranteed by the government, COFIDE, the BCRP, the BN, and any other public financial entity, except for loans classified as reserve liabilities of the BCRP. The program limits on

nonconcessional debt will exclude: (i) any new loans extended in the context of a debt rescheduling or debt reduction operation; (ii) any lending at concessional terms; and (iii) certificates (BCRPCD) issued by the BCRP for conducting monetary policy. The program limits will be adjusted upward by up to US$300 million for debt contracted by Petroperu during 2007 that is not guaranteed by the central government.

11. **For the purpose of the performance criterion on the contracting or guaranteeing of public debt,** external public debt applies also to commitments contracted or guaranteed for which value has not been received. In this regard, the term “debt” has the meaning set forth in point No.9 of the Guidelines on Performance Criteria with respect to Foreign Debt adopted on August 24, 2000 (Board Decision No. 12274-(00/85)). Thus, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time: these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers’ credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers’ credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property; (iv) PAO Entitlement Recognition Certificates (CRPAOs) used to facilitate the financing of Public-Private Partnership (PPP) projects by concessionaires.[3] For the purpose of the performance criterion, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property. Under the definition of debt set out above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt. Foreign currency public debt to be contracted or guaranteed will be converted based on the program exchange rate, with cross rates for non-dollar foreign currencies set based upon the rate on the day of the transaction, published by REUTERS.

[3] Under Peruvian law, the CRPAOs are not treated as sovereign debt.

12. For program purposes, **a debt is concessional** if it includes a grant element of at least 35 percent, calculated as follows: the grant element of a debt is the difference between the net present value (NPV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt (i.e., grant element) is equal to nominal value minus NPV divided by nominal value. The NPV of debt at the time of its disbursement is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the currency specific commercial interest reference rates (CIRRs), published by the OECD. For debt with a maturity of at least 15 years, the ten-year average CIRR will be used to calculate the NPV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. For the purposes of the program through end-June 2007, the CIRRs published by the OECD in October 2006 will be used (see Table 5).

13. **The concessionality of loans in currency baskets** will be assessed on the basis of U.S. dollar interest rate tables. For loans with interest rates based on the internal policy of the creditors, the relevant interest rate to define concessionality will be the interest rate for each creditor at the time of the commitment. Loans or portions of loans extended in the context of a debt rescheduling or a debt reduction operation will be excluded from the ceiling.

14. **The NPV of the future government payments associated with PPP operations** will include all payments, firm and contingent, committed by the government in relation to new PPP projects signed during the program period. Specifically, such payments will include, *inter alia*, annual payments for the coverage of the investment made by the concessionaire (*Pagos anuales por Obra*, or PAOs); annual payments for the maintenance and operation of the project (*Pagos Anuales por Mantenimiento y Operación* or PAMOs); and the minimum annual revenues guaranteed to a concessionaire by the government (*Ingresos Minimos Anuales Garantizados*, or IMAGs). For those projects where the government's payment commitments have yet to be defined in terms of PAOs and PAMOs, the target also includes the estimated aggregate annual payments for the project (*Pagos Anuales por Servicio*, or PAS). The discount factor used in the calculation of the NPV of the payments will be the 10-year commercial interest reference rate (CIRR). For purposes of the program through end-June 2007, the CIRRs published by the OECD in October 2006 will be used (Table 5).

15. **The external payments arrears of the public sector** include arrears to multilateral financial institutions, to Paris Club creditors, and to other foreign creditors with whom debt restructuring agreements have been concluded. They exclude arrears outstanding at end-2005 that were not covered under restructuring agreements. The public sector will be defined to include the NFPS, COFIDE, the BCRP, the BN, and any other state development bank.

16. **Definitions used in Table 1 of the letter of intent dated January 3, 2007 for the calculation of adjusters, limits and targets for net international reserves:**

a. **Net foreign borrowing** (Table 2) is defined as the sum of disbursements of loans (I.2.b.i); plus receipts from the issuance of government bonds abroad (I.2.b.ii); minus cash payments of principal (I.2.b.iii); minus cash payments of arrears (principal and interest) (I..b.iv); plus/minus the net increase/decrease in short-term external debt (I.2.b.v).

b. **The withdrawals for portfolio management purposes** of deposits held at the BCRP by the FCR and any other fund managed by the ONP, mentioned in footnote 4 of Table 1 attached to the letter of intent dated January 3, 2007 refer to placements of funds that are in accord with an investment plan approved by the Board of the FCR, excluding deposits in public financial institutions and government securities.

II. Periodic Reporting

17. Periodic reporting includes:

(a) The latest *Nota Semanal* published by the BCRP;
(b) Report of BCRP daily operations;
(c) Daily exchange rate statistics.
(d) Monthly Report of:

(i) **Performance criteria**
Data on the program's quarterly quantitative performance criteria.

(ii) **Financial sector**
(a) Balance sheets of the consolidated financial system, consolidated banking system, BCRP, BN, commercial banks, *AgroBanco*, *MiVivienda* and development banks in liquidation.
(b) Disaggregation of the net domestic assets of the BCRP and BN with details of the other net accounts.
(c) Balance sheet of COFIDE and data on COFIDE guarantees.
(d) Balance sheet of the private pension system.
(e) Evolution of gross disbursements and cash amortizations of consumer loans under the *"Multired Program"* of *Banco de la Nación*.
(f) The stock of government guarantees for housing support programs.

(iii) **Fiscal sector**
(a) PSBR as defined in Table 1.
(b) List of domestic and external debt instruments contracted or guaranteed by the public sector, including data on the amount, lender, grace period, maturity, and interest rate (refinancing credits should be labeled as such), collateral guarantees, any instrument enhancements (such as but not limited to put or call options) that affect the price or maturity of the debt instrument.

(c) Summary of disbursements and interest and amortization due and paid (identifying the payments of arrears) of loans included in the records of the General Directorate of Public Credit by creditor and debtor, indicating foreign origin (distinguishing between financial and nonfinancial public sector debt) and domestic origin (Table 6).

(d) Cash operations of the treasury (which includes floating debt, with a memorandum item on tax refund arrears).

(e) Data on PIPP revenue, which will include gross receipts, costs of the PIPP, use of debt-for-equity swaps, commissions received by *ProInversion* and the resulting cash receipts received by the Treasury and the FCR. In addition, the report will include debts assumed by the government in connection with the PIPP.

(f) Operations of the Central Government, Central Government Current Revenue (SUNAT Format); Central Government Noninterest Expenditure; and Transfers from the Central Government to the Rest of the General Government.

(g) Fuel prices of *Petroperu* and *Relapasa*, and international prices of products commercialized by *Petroperu* including tariffs, indirect taxes and distribution margins (prices would be listed for all grades of gasoline, diesel fuel, kerosene and fuel oils).

(h) Stocks of the central government PIPP accounts in the BCRP and the BN.

(iv) **External sector**

(a) Summary of imports by products (volume and prices); and

(b) Summary of exports by products (volume and price).

(d) **Quarterly data of fiscal and external accounts, and public sector debt,** distinguishing between external and domestic total public sector debt and total NFPS.

(f) **Other**

(a) Summary of legislative changes pertaining to economic matters.

(b) BCRP circulars.

(c) BCRP inflation report.

Table 1 Peru: Public Sector Borrowing Requirement 2006
(In millions of nuevos soles)

	Stock as of Dec. 31 2005 1/	Stock as of Sep. 30 2006 1/	Flow Jan-Sep
a. Net domestic financing of the nonfinancial public sector	**4 470**	**-1 143**	**-5 612**
i. Net claims of the financial system (1+2+3)	-6 440	-10 513	-4 073
1. Net credit of the banking system on the NFPS, COFIDE and MiVivienda	-14 559	-20 817	-6 258
Credits	6 811	5 150	-1 661
Liabilities	21 370	25 968	4 597
2. Net credit of COFIDE and MiVivienda on the banking system	2 854	3 056	201
Credits	3 084	3 117	33
Liabilities	230	62	- 168
3. Net credit of nonbanking financial institutions on the NFPS	5 265	7 248	1 984
Credits	5 954	7 787	1 833
Liabilities	689	538	- 151
ii. Stock of NFPS bonds in circulation	11 496	10 760	- 736
(excluding bonds held by NFPS and of the financial system)			
1. Total	20 665	21 354	689
2. Less: holdings of the financial system (including COFIDE and MiVivienda)	8 662	10 271	1 609
3. Less: holdings of nonfinancial public sector entities	507	323	- 184
iii. Floating debt	2 810	2 173	- 637
iv. Less: Accumulation of stocks, bonds, or other domestic financial assets by the NFPS	2 444	2 513	70
v. Less: Issuance of pension recognition bonds in program period	952	1 049	96
b. Net external financing			**-2 454**
(Millions of US dollars)			-$ 757
c. Privatization			**240**
(Millions of US dollars)			$ 74
d. Operating balance of the BCRP			**402**
PSBR (a+b+c-d)			**-8 228**

1/ Foreign currency valued at US$ 1 = S/. 3,24

Table 2. Peru: Public External Debt
Net External Financing N.F.P.S. 2007
(In millions of dollars)

		Jan - Mar	Jan - Jun	Jan - Sep	Jan - Dec
		Programmed	Programmed	Programmed	Programmed
i.	**Loan Disbursements**	294	440	592	1000
	-Projects	144	290	442	600
	-Non Projects	150	150	150	400
ii.	**Bonds**	0	0	0	0
iii.	**Cash payments on amortization**	309	578	866	1148
	- Loans	252	521	753	1035
	- Bonds	56	56	113	113
	- Prepayments	0	0	0	0
iv.	**Cash payments to settle arrears**	0	0	0	0
v.	**Change in short term debt (increase+)**	0	0	0	0
A.	**NET FOREIGN BORROWING (i+ii-iii-iv+v)**	**-14**	**-138**	**-274**	**-148**
vi.	**Debt equity swaps**	0	0	0	0
vii.	**Change in foreign assets held by the NFPS**	3	6	8	11
viii.	**Investment project under the PIPP**	0	0	0	0
B.	**NET EXTERNAL FINANCING (A-vi-vii+viii)**	**-17**	**-143**	**-282**	**-159**

1/ Excludes balance of payments support loans to the Central Reserve Bank of Peru.
Source: Central Reserve Bank of Peru

Table 3 Peru: Net International Reserves of the Central Reserve Bank of Peru excluding foreign currency deposits of financial institutions as defined in the Technical Memorandum of Understanding (TMU)
(In millions of US dollars)

		Stocks as of September 30, 2006
a.	**Assets**	**14,755**
	Deposits abroad	5,926
	Securities	8,225
	Gold 1/	576
	Holdings of SDR 2/	9
	Reciprocal credit agreement	9
	Cash	10
	Others	0
b.	**Liabilities**	**26**
	Reciprocal credit agreement	2
	Liabilities with international organizations	**23**
	IMF 2/	0
	IADB	23
	FLAR	0
c.	**Foreign currency deposits of financial institutions at the Central Bank**	**3,693**
	Banking enterprises	3,522
	Banco de la Nación	75
	COFIDE	18
	Financial enterprises	78
d.	**Treasury bond repos**	**0**
e.	**Swaps**	**0**
f.	**Valuation US$/other currencies**	**179**
g.	**Net international Reserves - Program definition (a-b-c+d-e-f)**	**10,858**
Memorandum items:		
1.	Subscription to the IMF and FLAR	331
2.	Pesos andinos	20
3.	CAF bonds	0
4.	Valuation change by BCRP's gold holdings	91
5.	Valuation change by BCRP's SDR holdings	0
6.	Net international reserves, official definition (g+c-d+e+f+1+2+3+4+5)	15,172

Source: Central Reserve Bank of Peru.

1/ Gold valued at US$ 516,53330
2/ Valued at US$ 1,42927 per SDR.

Table 4. Peru: Short-Term External Debt Owed by the Nonfinancial Public Sector
as of September 30, 2006
(In millions of US$)

	Export Financing	Working Capital	Import Financing	Total
Total	0	0	73	73
Petroperu	0	0	73	73
Electroperu	0	0	0	0
General government	0	0	0	0
Memorandum item:				
Total of export financing plus working capital loans				0

Source: Central Reserve Bank of Peru and state companies.

Table 5. Peru: Commercial Interest Reference Rates (CIRRs)

	Average CIRRs		Previous rates for loans with maturity =>15 years contracted in							
	Six-month	**Ten-year**	**before 1999**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
	02/15/06-08/14/06	1/96 - 12/05 1/	1/86-12/95	1/89-12/98	1/90-12/99	1/91-12/00	1/92 - 12/01	1/93 - 12/02	1/94 - 12/03	1/95 - 12/04
Australian Dollar	6.51%	6.85%	12.15%	10.15%	9.28%	8.55%	7.98%	7.68%	7.48%	7.24%
Austrian Schiling 2/	n.a.	5.45%	8.35%	7.73%	7.65%	7.43%	6.72%	6.34%	6.03%	5.76%
Belgian Franc 2/	n.a.	5.68%	9.25%	8.60%	8.45%	8.13%	7.21%	6.80%	6.44%	6.07%
Canadian Dollar > 8.5 years	5.22%	6.25%	9.83%	8.90%	6.07%	6.78%	7.41%	7.34%	7.05%	6.69%
Danish Krone	4.71%	5.65%	10.37%	8.88%	8.33%	7.80%	7.29%	6.81%	6.37%	6.09%
Finnish Markkaa 2/	n.a.	5.55%	10.64%	9.32%	9.15%	8.72%	7.56%	6.92%	6.43%	6.02%
French Franc 2/	n.a.	5.51%	9.62%	8.42%	8.19%	7.82%	6.95%	6.50%	6.16%	5.89%
German Mark 2/	n.a.	5.45%	7.91%	7.62%	7.54%	7.27%	6.58%	6.23%	5.96%	5.73%
Irish Punt 2/	n.a.	5.70%	10.37%	7.59%	8.36%	8.44%	7.44%	6.97%	6.50%	6.16%
Italian Lira 2/	n.a.	5.81%	11.50%	10.38%	10.06%	9.71%	8.30%	7.61%	6.94%	6.47%
Japanese Yen	2.49%	2.08%	5.53%	4.65%	4.30%	3.75%	3.17%	2.77%	2.45%	2.24%
Korean Won	6.10%	8.59%	n.a.	n.a.	n.a.	11.57%	10.74%	10.19%	9.55%	9.04%
Netherlands Guilder >8.5 years	n.a.	5.74%	8.08%	5.24%	5.81%	6.52%	6.95%	6.75%	6.43%	6.11%
New Zealand dollar	6.87%	7.46%	12.17%	9.62%	8.90%	8.33%	7.97%	7.94%	7.80%	7.68%
Norwegian Krone	4.81%	6.36%	11.27%	8.93%	8.36%	7.94%	7.60%	7.28%	7.04%	6.74%
Spanish Peseta 2/	n.a.	5.91%	12.99%	11.35%	10.89%	10.31%	8.65%	7.92%	7.20%	6.65%
Swedish Krona	4.50%	5.98%	11.67%	10.10%	9.42%	8.61%	8.04%	7.52%	7.08%	6.67%
Swiss Franc	3.40%	4.01%	6.68%	3.78%	5.97%	5.67%	5.26%	4.85%	4.55%	4.31%
U.K. Pound	5.34%	6.53%	10.37%	9.53%	8.99%	8.38%	7.85%	7.41%	7.16%	6.91%
U.S. Dollar > 8.5 years	5.78%	6.09%	8.62%	7.93%	7.59%	7.35%	7.06%	6.85%	6.63%	6.36%
Euro (ECU for ten-year avg)	4.62%	5.39%	8.56%	7.99%	7.82%	7.13%	6.79%	6.40%	6.07%	5.80%
Memorandum:										
SDR 3/	4.97%	5.46%	8.22%	7.51%	7.21%	6.85%	6.49%	6.17%	5.90%	0.00%

1/ Estimates based on actual CIRRs for 1/95 to 12/04.
2/ For the current 10-year averages, rates for Euro are used from 1/99.
3/ The 10-year SDR denominated CIRR rate was constructed based on the weighted average of the five

Previous six-month rates

		loans with maturity <15 years, contracted between:														
		2/15/99 and **8/14/99**	8/15/99 and **2/14/00**	2/15/00 and **8/14/00**	8/15/00 and **2/14/01**	2/15/01 and **8/14/01**	8/15/01 and **2/14/02**	2/15/02 and **8/14/02**	8/15/02 and **2/14/03**	2/15/03 and **8/14/03**	8/15/03 and **2/14/04**	2/15/04 and **8/14/04**	8/15/04 and **2/14/05**	2/15/05 and **8/14/05**	8/15/05 and **2/14/2006**	2/15/06 and **8/14/2006**
based on rates:	2/15 thru 8/14/98	8/15/98-2/14/99	2/15 thru 8/14/99	8/15/99-2/14/00	2/15 thru 8/14/00	8/15/00-2/14/01	2/15 thru 8/14/01	8/15/01-2/14/02	2/15 thru 8/14/03	8/15/02-2/14/03	2/15/03-8/14/03	8/15/03-2/14/04	2/15/04 - 8/14/04	08/15/04-2/14/05	2/15/05-8/14/05	8/15/05-2/14/2006
Australian Dollar	6.42%	6.01%	6.34%	7.20%	7.47%	6.99%	6.27%	6.18%	6.83%	6.23%	5.83%	6.45%	6.6%	6.34%	6.36%	6.24%
Austrian Schiling	5.59%	4.99%	n.a	n.a	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Belgian Franc	5.99%	5.24%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Canadian Dollar > 8.5 years	6.27%	6.12%	6.20%	6.88%	7.26%	6.80%	6.24%	6.17%	6.21%	5.69%	5.50%	5.24%	5.0%	5.23%	4.85%	4.79%
Danish Krone	5.77%	5.44%	4.72%	5.71%	6.46%	6.55%	6.01%	5.66%	6.15%	5.48%	4.85%	5.02%	5.0%	4.75%	4.13%	3.99%
Finnish Markkaa	5.52%	5.04%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
French Franc	5.71%	5.03%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
German Mark	5.57%	4.86%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Irish Punt	5.69%	4.93%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Italian Lira	5.31%	5.22%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Japanese Yen	2.32%	2.28%	2.13%	2.05%	1.98%	2.02%	1.58%	1.55%	1.95%	1.64%	1.45%	1.92%	2.0%	2.08%	1.87%	2.05%
Korean Won	n.a.	n.a.	n.a.	10.51%	10.18%	8.85%	7.91%	7.42%	7.95%	7.00%	6.11%	5.94%	5.9%	4.80%	5.10%	5.94%
Netherlands Guilder >8.5 years	6.12%	5.43%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
New Zealand dollar	8.17%	6.76%	6.64%	7.74%	8.08%	7.57%	7.16%	7.10%	7.51%	7.00%	6.45%	6.36%	6.9%	7.10%	7.02%	6.87%
Norwegian Krone	6.11%	6.58%	5.97%	6.82%	7.51%	7.98%	7.96%	7.46%	7.75%	7.34%	5.97%	5.27%	4.7%	4.45%	4.21%	4.35%
Spanish Peseta	5.68%	4.98%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Swedish Krona	6.04%	5.38%	4.78%	6.19%	6.46%	6.03%	5.63%	5.89%	6.42%	5.85%	5.22%	5.31%	5.4%	5.15%	4.33%	4.01%
Swiss Franc	4.07%	3.91%	3.81%	4.50%	5.24%	5.17%	4.17%	3.89%	4.05%	3.06%	2.88%	3.39%	3.4%	3.30%	2.85%	2.84%
U.K. Pound	7.15%	6.53%	5.79%	6.97%	7.03%	6.59%	6.11%	5.96%	6.17%	5.60%	5.22%	5.69%	5.9%	5.82%	5.54%	5.26%
U.S. Dollar > 8.5 years	6.63%	5.92%	6.37%	7.18%	7.54%	6.86%	6.09%	5.67%	5.86%	4.75%	4.38%	4.75%	4.9%	4.89%	5.04%	5.27%
ECU/Euro	5.36%	4.72%	4.72%	5.82%	6.27%	6.15%	5.73%	5.53%	5.91%	5.27%	4.73%	4.85%	4.8%	4.61%	4.17%	4.05%
SDR	5.59%	5.01%	5.02%	5.80%	6.07%	5.88%	5.31%	5.04%	5.32%	4.53%	4.13%	4.46%	5.64%	4.49%	4.37%	4.50%

Table 6. Peru: Stock of Domestic Debt of the NFPS (September-30-2006)

	Legal Norm	Gross placements		Stock (estimated)
		Currency	Amount	(Millions of Nuevos Soles)
Credits from BN				**2,584**
Credit to central government		US$ / S/. / Y		2,554
Credit to local governments		US$ / S/.		29
Net public treasury overdraft		S/.		0
Bonds				**12,075**
Capitalización BCRP	D.S.066-94-EF	S/.	614	0
Serie A			239	0
Serie B			375	0
Bonos TP - Financial system strengthening	D.U. 041-99	US$	175	171
Bonos TP - Temporal suscription of stocks	D.U. 034-99	US$	52	169
Bonos TP - Temporal portfolio exchange	D.S. 114-98-EF	US$	136	0
Bonos TP - Debt exchange bonds	D.S. 068-99-EF	US$	259	347
Bonos TP - RFA and FOPE programs	D.S. 059-2000-EF / D.U. 050-2002	US$	109	383
Bonos TP - Financial system consolidation	D.U. 108-2000 / D.U. 099-2001	US$	392	0
Bonos TP - Sovereign bonds 1/		S/.	11 481	11,005
Bonos TP - Caja de Pensiones Militar Policial Bonds	D.U. 030-2001	US$	34	0
Total				**14,659**
Memorandum item:				
Pension Reform Bonds	D.S. 096-95-EF and DS 097-54-EF	S/.		9,002
Floating debt		S/.		1,402

1/ Include public debt operations to exchange Bonds Financial system consolidation for Sovereign Bonds (S/. 851 millions in May and S/. 393 millions in September of 2005), and the Bonds to prepay external public debt with Paris Club (S/. 2 619 millions in July and August of 2005) and Japeco (S/. 811 millions in November of 2005)

Source: Central Reserve Bank of Peru

Statement by the IMF Staff Representative
January 26, 2007

1. This statement provides additional information that has become available since the circulation of the staff report. It does not alter the thrust of the staff appraisal.

Macroeconomic developments

2. **Recent economic indicators suggest that economic performance remains strong.**

- Real GDP is estimated to have grown by about 7½ percent (year-on-year) during January-November 2006, underpinned by strong private consumption and investment. In December, 12-month inflation fell to 1.1 percent, below the 1.5–3.5 percent target range, largely reflecting lower gasoline prices and a one-off decline in telephone rates. Core inflation remained stable, at 1.4 percent.

- The external current account surplus is estimated to reach close to 2 percent of GDP in 2006, about ¾ percentage point of GDP above staff projections. This development primarily reflects higher prices of metals and lower-than-projected imports during the fourth quarter.

- Net international reserves stood at US$17.4 billion at end-2006. The exchange rate has continued to appreciate moderately against the U.S. dollar, by 1½ percent since November.

Policy developments

3. **Preliminary data suggest that the consolidated public sector balance would record a surplus of 1½ percent of GDP in 2006.** This outcome would exceed projections in the staff report by about ½ percentage points of GDP, largely as a result of lower expenditures, most notably related to investment, at all government levels.

4. **The authorities have adopted several measures, in line with their Letter of intent and Memorandum of Economic and Financial Policies.** Specifically:

- The draft law amending the Fiscal Responsibility and Transparency Law was presented to congress and approved on first reading (MEFP, ¶5). The draft law will have to go through a second reading before final approval by congress.

- Legislation to reinstate the tax on casinos and slot machines was passed on December 21, 2006 (MEFP, ¶7).

- The regulations governing the agreement with mining sector companies for a voluntary contribution to support poverty alleviation and infrastructure needs were issued on December 21, 2006 and are broadly in line with what has been described in the staff report (¶ 24).

- The regulatory framework designed to help establish a one-step window for exporters and importers was approved by Congress in early January (MEFP, ¶19).

- Banks have completed the assessment of their portfolios to identify unhedged borrowers (MEFP, ¶22). Preliminary information confirms that about 18 percent of banks' foreign currency denominated loans have been extended to unhedged borrowers. It is expected that banks will continue to reclassify these loans and build additional provisioning requirements.

- The Superintendency of Banks has further liberalized the regulations affecting private pension funds' investments abroad (MEFP, ¶27). In particular, private pension funds would now be allowed to invest in non-investment grade instruments, as well as in mutual funds that invest in private equity, venture capital, real estate, and hedge funds. The new regulations also ease the limit for investing in a single mutual fund (from 1 percent to 2 percent), and eliminate the maximum limit (3 percent) on investments in a mutual fund management company.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 07/12
FOR IMMEDIATE RELEASE
January 29, 2007

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with Peru

On January 26, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the 2006 Article IV consultation with Peru.[1]

Background

The Peruvian economy has been reaping the benefits of sound policies, in the context of a favorable external environment. The economy is enjoying its longest expansion on record, with low inflation, a solid external position, and declining indebtedness ratios. During the first 11 months of 2006, real GDP grew by about 7½ percent year-on-year, propelled by strong exports and domestic demand—supported by growing investment as well as higher incomes and rising employment (Table 1). After peaking at 2.9 percent in April, 12-month inflation abated to 1.1 percent in December, reflecting tightening monetary conditions, a favorable food supply shock, and a decline in domestic fuel prices. Core inflation has remained at the lower end of the inflation target range and inflation expectations are well anchored.

The external position has strengthened, vulnerabilities have declined, and financial market conditions have been favorable. The current account surplus is estimated to have risen to 2 percent of GDP in 2006, while foreign direct investment remained strong. At end-2006, net international reserves stood at US$17.3 billion, equivalent to 390 percent of short-term debt and 150 percent of foreign currency deposits with the banking system. Public sector debt is

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

estimated to have declined to 31½ percent of GDP by end-2006, or 15 percentage points below its end–2002 level. The structure of this debt has also improved, with the share of local currency-denominated debt now equivalent to one-fifth of total. In recent months, two credit ratings agencies upgraded Peru's sovereign rating to BB+ (one notch below investment grade) and Moody's changed its outlook from neutral to positive. Sovereign bonds have hovered close to all-time low levels and stock market prices have increased sharply. The *Nuevo Sol* has been fluctuating within a narrow margin against the U.S. dollar and the real effective exchange rate has remained broadly stable, close to the average of the past five years.

This favorable performance reflects to a large extent the prudent conduct of fiscal policy in recent years. The deficit of the combined public sector was gradually reduced, from 2½ percent of GDP in 2001 to ⅓ percent of GDP in 2005. During the first three quarters of 2006, the combined public sector balance achieved a surplus equivalent to about 3 percent of GDP, partly reflecting rising central government revenue, which was boosted by higher than anticipated corporate income tax payments. However, expenditure grew by 11 percent in real terms during this period, compared with the same period in 2005. Expenditure is expected to pick up in the last quarter of the year, reflecting the adoption of a supplementary budget focusing on capital outlays and government plans to advance outlays initially planned for 2007. For 2006 as a whole, the combined public sector is expected to register a surplus of 1½ percent of GDP compared with a deficit of ½ percent of GDP initially envisaged under the 2004-06 program.

The new government remains committed to sustaining fiscal consolidation to entrench macroeconomic stability, while boosting infrastructure and social spending to decisively reduce poverty, as well as advancing other reforms to enhance medium-term growth prospects. To support their policies for 2007–08, the authorities have requested a new 25-month Stand-by arrangement, which they intend to treat as precautionary.

Executive Board Assessment

Executive Directors commended the Peruvian authorities' commitment to sound economic policies and structural reforms, which has contributed to high rates of economic growth, low inflation, and declining external vulnerabilities. The favorable external environment, particularly high commodity prices, has also helped drive exports and Peru's longest economic expansion on record.

At the same time, Directors noted that major challenges remain, including the high rate of poverty, regional income disparities, and the still-high dollarization of the economy. These call for further efforts to strengthen the macroeconomic policy framework, address social and infrastructure needs, and promote structural reforms.

Directors underscored the critical importance of decisively tackling high poverty levels, to strengthen social cohesion and ensure the sustainability of economic policies. They welcomed the creation of a high-level committee to develop a strategy to combat poverty, and called for more effective targeting of social assistance programs.

Directors underscored the crucial role of fiscal policy, and supported the authorities' intention to continue saving part of central government revenue that exceeds the budgeted amount, as part of the strategy to contain demand pressures, accelerate the pace of public debt reduction, and achieve investment grade status for Peru. Directors supported the steps being taken to improve tax policy and administration, including reducing tax exemptions and simplifying the tax regime to broaden the tax base. They welcomed plans to introduce performance-based budgeting and improve public financial management, and the emphasis on increased spending on infrastructure and social assistance programs without compromising the fiscal consolidation goals.

Directors stressed that fiscal decentralization should be implemented cautiously to minimize risks to public finances. In this regard, the administrative and technical capacity of subnational governments needs to be strengthened, and shared expenditure responsibilities clearly specified. In decentralizing the National System of Public Investment, close coordination with subnational governments would help ensure selection of high-quality investment projects, especially in light of the envisaged sizable increase in capital spending.

Directors underscored the importance of establishing a legal framework for public-private partnerships (PPPs), to provide clear guidelines for project selection and conflict resolution. They stressed that the issuance of new securities associated with PPP projects should be monitored closely to minimize future fiscal commitments and risks, and that all public sector obligations associated with PPPs should be clearly recorded.

While Directors felt that the current exchange rate system has served Peru well, a number of Directors encouraged the authorities to manage the exchange rate more flexibly. They considered that this would help economic agents better internalize currency risks and provide more incentives for hedging, thus assisting to reduce dollarization and develop domestic capital markets. Other Directors stressed that any increased flexibility should be introduced gradually, given the risks that depreciation poses for sectoral balance sheets and the external debt in a highly dollarized economy like Peru.

Directors welcomed the strengthening of Peru's financial system in recent years. They commended the progress made in identifying foreign exchange-related credit risks in the banking system, and encouraged the authorities to implement their reform agenda aimed at reducing the risks from dollarization. The proposed changes to the MiVivienda mortgage lending program would aim at discouraging mortgage lending in foreign currency to unhedged borrowers. These efforts, along with plans to strengthen the payments system and the regulatory framework would help lessen vulnerabilities. Directors welcomed reforms being implemented to deepen the domestic capital market.

Directors were encouraged by the progress made in improving Peru's business environment, but stressed that much more needs to be done. In particular, they urged the authorities to take steps to reduce the high level of informality in the labor market, including the reduction of high severance payments, the better alignment of non-wage benefits with job tenure, and the removal of other legal restrictions that prevent dismissals. Directors also commended Peru's growing integration into the global economy.

The proposed stand-by arrangement is expected to provide a welcome policy anchor for the new authorities. Several Directors also noted that continued strong implementation of policies and improvement in economic performance should lay the basis for Peru's eventual exit from the use of Fund resources.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Peru: Economic and Financial Indicators

	2002	2003	2004	Prel. 2005	Projection 2006	2007
Social Indicators						
Life expectancy at birth (years)	69.8	70.0	...	...	...	...
Infant mortality (per thousand live births)	30.0	26.0	...	...	...	...
Adult literacy rate	87.3	87.7	87.8	...	...	...
Poverty rate (Total) 1/	53.8	52.2	51.6	50.6	...	...
Unemployment rate	9.4	9.4	9.4	9.6	...	...
(Annual percentage change; unless otherwise indicated)						
Production and prices						
Real GDP	5.2	3.9	5.2	6.4	6.5	5.5
Real domestic demand	4.4	3.4	4.4	5.5	8.8	6.2
Consumer Prices (end of period)	1.5	2.5	3.5	1.5	1.1	2.5
Consumer Prices (period average)	0.2	2.3	3.7	1.6	2.0	1.5
External sector						
Exports	9.8	17.8	38.8	36.7	37.2	4.4
Imports	2.8	11.2	19.0	23.0	23.9	17.7
Terms of trade (deterioration -)	3.1	1.3	9.2	6.9	26.1	-5.3
Real effective exchange rate (depreciation -) 2/	-1.2	-6.8	1.9	-3.9	2.3	...
Money and credit 3/ 4/						
Liabilities to the private sector	4.4	1.9	11.5	15.2	9.5	9.3
Net credit to the private sector	-1.5	-3.5	3.6	12.0	12.1	8.0
(In percent of GDP; unless otherwise indicated)						
Public sector						
General government current revenue	17.0	17.4	17.5	18.3	19.6	18.5
General government noninterest expenditure	17.2	17.1	16.7	17.0	16.4	17.4
Combined public sector primary balance	0.0	0.5	1.0	1.6	3.5	1.3
Interest due	2.1	2.2	2.0	1.9	2.0	2.0
Combined public sector overall balance	-2.2	-1.7	-1.1	-0.3	1.5	-0.8
External Sector						
External current account balance	-1.9	-1.5	0.0	1.3	2.0	0.2
Gross reserves						
In millions of U.S. dollars 5/	9,690	10,206	12,649	14,115	17,329	18,479
Percent of short-term external debt 6/	214.2	214.4	161.2	288.5	388.6	371.4
Percent of foreign currency deposits at banks	100.6	107.3	128.3	129.4	150.5	153.9
Debt						
Total external debt	48.9	48.1	44.9	36.1	30.7	28.4
Combined public sector debt	46.6	47.0	44.4	37.7	31.5	30.7
Domestic	10.1	10.0	9.2	9.7	7.4	8.1
External 7/	36.5	37.0	35.1	28.1	24.6	23.1
Savings and investment						
Gross domestic investment	18.9	18.8	18.9	18.6	19.0	21.2
Public sector	2.8	2.8	2.8	2.9	2.4	4.3
Private sector	14.7	15.0	15.2	16.0	16.6	16.9
Inventories changes	1.4	1.0	1.0	-0.2	0.0	0.0
National savings	17.0	17.2	18.9	19.9	21.0	21.4
Public sector 8/	0.8	1.2	1.7	2.6	3.9	3.3
Private sector	16.2	16.0	17.2	17.3	17.1	18.1
External savings	1.9	1.5	0.0	-1.3	-2.0	-0.2
Memorandum items:						
Nominal GDP (S/. billions)	200.6	213.9	237.8	261.6	298.9	317.9
GDP per capita (in US$)	2,194	2,330	2,599	2,917	3,297	3,496

Sources: Central Reserve Bank of Peru; Ministry of Economy and Finance; ECLAC 2002-03; National Statistical Institute (INEI); and IMF staff estimates/projections.

1/ Defined as the percentage of households with total spending below the cost of a basic consumption basket.
2/ Based on Information Notice System. Data for 2006 reflect the 12-month change of the REER up to October.
3/ Corresponds to the banking system.
4/ Foreign currency stocks are valued at program exchange rate.
5/ Gross international reserves exceed net international reserves by the stock of Fund credit outstanding.
6/ Short-term debt is defined on a residual maturity basis, and includes amortization of medium- and long-term debt.
7/ Includes debt by the Central Reserve Bank of Peru.
8/ Excludes privatization receipts.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 07/15
FOR IMMEDIATE RELEASE
January 26, 2007

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US$258 Million Stand-By Arrangement for Peru

The Executive Board of the International Monetary Fund (IMF) today approved a 25-month SDR 172.4 million (about US$257.7 million) Stand-By Arrangement for Peru to support the country's economic program. The Peruvian authorities have indicated their intention to treat the arrangement as precautionary.

The main objectives of the Fund-supported program are to consolidate macroeconomic stability, tackle high poverty levels, strengthen the resilience and depth of the financial system, and press ahead with growth-enhancing reforms.

Following the Executive Board discussion, Murilo Portugal, Deputy Managing Director and Acting Chair, said:

"Over the past several years, Peru has implemented sound economic policies which, in the context of a favorable external environment, have resulted in the longest economic expansion on record, low inflation, a robust external position, and declining vulnerabilities. The new authorities are taking measures to further improve this excellent performance during 2007-08.

"At the same time, Peru still faces important challenges. Half of the population lives in poverty, and structural weaknesses continue to constrain growth. To address these challenges, the authorities' program for 2007-08 aims at consolidating macroeconomic stability and implementing reforms to boost growth prospects, while tackling high poverty. To support the program, the authorities have requested a successor 25-month Stand-By Arrangement.

"Fiscal prudence remains the backbone of the authorities' program. Following a strong surplus in 2006, the public sector result in 2007-08 is expected to remain below the deficit ceiling set out in the Fiscal Responsibility and Transparency Law. This will help ensure that pressing social and infrastructure needs are addressed while the public-debt-to-GDP ratio remains on a downward path.

"Monetary policy continues to be guided by the inflation targeting framework, aimed at keeping inflation within the 1½-3½ percent official range. The authorities intend to gradually introduce more flexibility in exchange rate management in order to further enhance the credibility of the inflation targeting framework, help economic agents better internalize currency risks, and provide more incentives for hedging. This will reduce dollarization and help develop the domestic capital market.

"Structural reforms remain an important building block of the authorities' program. Reforms will aim, inter alia, at strengthening the effectiveness of the tax system, improving the quality of public spending, and providing a legal framework for public-private partnerships. The effectiveness of social assistance programs is to be enhanced in the context of a comprehensive anti-poverty strategy. Decentralization would proceed in a manner consistent with the implementation of high-quality investment projects under the auspices of the National System of Public Investment and with sound public finances. Other reforms will aim at reducing risks associated with financial dollarization, strengthening the financial regulatory framework, improving the business environment, reducing the size of the informal labor market, and sustaining trade liberalization," Mr. Portugal said.

ANNEX

Recent Developments

Supported by a favorable external environment, the Peruvian economy has continued to expand at a rapid pace during 2006, with inflation well contained and an improved external position. During January-November 2006, real GDP grew by 7½ percent year-on-year, propelled by a sharp increase in the terms of trade and strong domestic demand, which has been underpinned by growing investment as well as higher incomes and rising employment. After peaking at 2.9 percent in April, 12–month inflation abated to around 1.1 percent in December 2006. Strong export performance, including for nontraditional exports, has boosted the current account surplus, while net international reserves have reached US$17.3 billion at end-2006, about 150 percent of foreign currency deposits at commercial banks.

Fiscal policy has continued to strengthen, and the combined public sector is estimated to have recorded a surplus of about 1½ percent of GDP in 2006. On the back of buoyant revenues, expenditure growth has been strong, estimated to have risen by 9 percent in real terms. Public sector debt is estimated to have declined to 31½ percent of GDP by end-2006, about 15 percentage points below its 2002 levels.

Notwithstanding this strong economic performance, the challenges faced by Peru are significant and pressing. Half the population lives in poverty and structural weaknesses need to be addressed to lower underemployment and continue to boost employment creation in the formal sector, as well as economic growth, while reducing poverty decisively. To achieve these objectives, maintaining an environment favorable to foreign direct investment and trade openness will be critical to growth prospects in the mining sector and to help diversify the productive structure toward nontraditional labor-intensive sectors. Enhancing the provision and quality of services to the poorest areas of the country would be fundamental to tackle poverty decisively, while more flexible labor regulations would help absorb a growing labor force into the formal sector and strengthen anti-poverty efforts.

Program Summary

The 2007–08 program is based on the policies needed to address Peru’s key challenges and aims at consolidating macroeconomic stability, reducing poverty swiftly, strengthening the resilience and depth of the financial system, and advancing other reforms to enhance the business environment.

The most important objectives of the authorities’ new program are:

Consolidation of macroeconomic stability. Fiscal targets for 2007–08 are well within the 1 percent of GDP deficit ceiling in the Fiscal Responsibility and Transparency Law, helping entrench macroeconomic stability and keep the public debt-to-GDP ratio on a downward path. The government intends to adopt measures to lower distortionary taxes and exemptions and to improve the quality of public spending. Greater exchange rate flexibility will solidify the credibility of the inflation targeting framework.

Tackling high poverty. An action plan to strengthen current efforts at poverty alleviation will be elaborated, mainly to enhance the effectiveness and scope of social assistance programs, as these programs are numerous and to ensure that the resources reach the targeted population.

Strengthening and deepening the financial system. Reducing dollarization, particularly of mortgage loans is a critical objective, as this will help to fortify the resilience of the banking system. These efforts will be assisted by measures to allow for a better internalization of risks and to further develop domestic capital markets.

Growth-enhancing reforms. Reforms will focus on continuing to improve the business environment, including by simplifying regulatory requirements and extending commercial courts nationwide. Efforts will also be made to enhance labor market flexibility and to further liberalize external trade, critical for boosting competitiveness. In late December, the authorities lowered average import tariff rates from 10.1 percent to 8.3 percent, effective January 1, 2007.

Peru: Economic and Financial Indicators

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Adult literacy rate	87.3	87.7	87.8	...	...	...
Poverty rate (Total) 1/	53.8	52.2	51.6	50.6	...	...
Unemployment rate	9.4	9.4	9.4	9.6	...	...
(Annual percentage change; unless otherwise indicated)						
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Real GDP	5.2	3.9	5.2	6.4	6.5	5.5
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Consumer Prices (end of period)	1.5	2.5	3.5	1.5	1.1	2.5
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6/ Short-term debt is defined on a residual maturity basis, and includes amortization of medium- and long-term debt.
7/ Includes debt by the Central Reserve Bank of Peru.
8/ Excludes privatization receipts.

Statement by Javier Silva-Ruete, Executive Director for Peru
January 26, 2007

1. Over the last years Peru has posted solid growth, responsible fiscal and monetary policies have been implemented, external and financial vulnerabilities have diminished considerably, and progress has been made in structural reform. Nevertheless, the authorities that took office in July 2006 are not complacent and recognize the need to lay firmer foundations for sustained medium-term growth and, crucially, reduce the still high poverty level by ensuring a more equitable distribution of the benefits of growth. They intend to make a decisive contribution to meeting these challenges by putting in place a set of wide-ranging policies aimed at locking-in macroeconomic stability and deepening the reform process —mainly enhancing the country's physical and human capital, promoting employment, improving the business climate, and further limiting financial vulnerabilities.

2. From past experience with Fund-supported arrangements, the authorities acknowledge the value of close collaboration with the Fund in resolving the problems facing the nation. In particular, they attach great importance to the sound advice provided by the staff, to whom they explicitly express their recognition, and believe that the greater credibility associated with Fund endorsement will facilitate their goal of achieving investment grade status. In view of these considerations, they request a Stand-By Arrangement (SBA), covering the period through end-February 2009, in support of their policy agenda. The government intends to treat the requested arrangement as precautionary, keeping the Fund's financial exposure in Peru at a minimum —currently only 2.1 percent of quota.

Macroeconomic Policies

3. The Peruvian economy continues to show robust growth supported by a sound macroeconomic framework and a favorable international environment. Preliminary estimates suggest that GDP growth in 2006 was 7.5 percent, well above initial expectations. The economy experiences persistent growth —its longest expansion on record. This growth was achieved despite electoral uncertainties and after four years of annual expansion of more than 5 percent. In 2006, private investment and consumption were the main engines of growth, reflecting high market confidence. Export growth —roughly 35 percent in dollar terms— was underpinned by favorable commodity prices and by a continuous expansion in the volume of industrial exports, mainly textiles and agricultural goods. The external position has improved as well: at end-2006 the level of reserves reached 3.8 times short-term debt (residual basis) and around 100 percent of foreign currency-denominated deposits in the banking system. Meanwhile, sovereign spreads hit historic lows. Although the outlook for 2007 is one of soft deceleration, in line with expectations of a cooling-down of the global

economy, macroeconomic policies and structural reforms will aim at sustaining growth and stability.

4. On the fiscal front:

- The authorities will further strengthen debt sustainability, with public debt falling to almost 30 percent of GDP by end-2008 —from around 32 percent at end-2006 and 37½ percent at end-2005. They will continue to increase the share of local currency instruments to reduce exchange rate risks and extend the maturity of new placements abroad.

- The overall public sector balance is foreseen to shift from a surplus of 1.6 percent of GDP in 2006, the highest in decades, to deficits not to exceed 0.8 percent in 2007 and 0.7 percent in 2008, due significantly to urgent increases in social and infrastructure spending. In particular, public investment would rise from around 3 percent of GDP currently to 4.5 percent over the next five years. To reinforce this strategy, the National System of Public Investment (SNIP), which has been instrumental in ensuring the quality of public investment, will be decentralized.

- To remain consistent with fiscal discipline, the authorities will strive to create fiscal space by further improving tax collections and enhancing expenditure restraint, quality, and focus. In this regard, recently the authorities were granted temporary fiscal powers, which will facilitate their plans to enhance the efficiency and transparency of the tax structure and end several tax exemptions. Also, performance budgeting will be phased in; at least half of any excess central government revenue over programmed amounts will be saved; sanctions for noncompliance will be enforced under the Fiscal Responsibility and Transparency Law (FRTL); and the operations of subnational governments will be closely monitored.

5. The inflation targeting scheme adopted in 2002 aims at a 2.5 percent medium-term inflation target within a ±1 percent range, in the context of a floating exchange rate regime. Interventions in the foreign exchange market are limited to those needed to confront excessive exchange rate volatility or abrupt fluctuations, without an explicit or implicit commitment to any given exchange rate level (the domestic currency has appreciated around 1.5 percent in the last three months). In 2006, to improve its accountability, the central bank moved from a year-end basis to a rolling twelve-month inflation target, which was met until November. Towards the end of the year, supply shocks with a one-off effect brought twelve-month inflation below the target range, to 1.14 percent. Given the temporary nature of these shocks, inflation would start to converge towards the target range by mid-2007, and there is no reason so far to loosen the monetary stance. It should also be noted that core inflation, which provides a better picture of the true inflation trend, was heading towards the lower limit of the target range as of year-end, although it has been gradually increasing since December 2005.

Poverty Reduction and Structural Reform

6. The authorities aim at promoting rapid poverty alleviation and structural transformation to achieve high, sustainable, and balanced growth. To better target social expenditure, the Interministerial Committee for Social Affairs (CIAS) will present in March 2007 a plan for consolidating the existing social programs and optimizing their functioning. Also, the significant resources generated through austerity measures and voluntary private sector contributions will be applied to programs aimed at resolving the most pressing social needs —mainly child malnutrition, access to clean water, and housing— and the cash transfer program launched in 2005 will be expanded. Critically, social recognition of the role of improved education standards in empowering the population is reflected in the strong support given by the National Accord —a multiparty assembly for the discussion of matters of national interest— to the government's initiative to evaluate teachers and improve their skills through continuous training.

7. Peru's infrastructure deficit continues to be an important bottleneck for industrial growth and the development of the rural economy. To help resolve it, the authorities plan to engage more actively in Public-Private Partnerships (PPPs). During 2007, the government envisages to initiate PPPs for a total of US$3 billion, especially in the areas of ports, highways, and sanitation. To keep these operations in line with transparency and international best practice, a framework law —to be submitted to Congress by June 2007— will propose guidelines for project selection and approval, reporting requirements, conflict resolution, and adherence to accounting standards. Importantly, to ensure fiscal sustainability, a limit has been established on the net present value of future payments, firm and contingent, associated with PPPs.

8. The authorities are placing heavy emphasis on private sector growth to ensure sustained formal employment generation. In order to improve the business environment, they will press ahead with administrative simplification for new businesses and exporters and, after a successful pilot program in the capital, will establish commercial courts in several other cities to expedite the resolution of business disputes. The fiscal regime will continue to be consistent with attracting investment, notably into the important mining and hydrocarbon sectors. In this regard, the authorities will not introduce measures that would result in the unilateral cancellation or modification of tax stability contracts. At the same time, they will aim at gradually reducing the persistently high number of informal jobs and developing a more comprehensive social protection net.

9. The authorities are engaged in pursuing regional and bilateral free-trade agreements (FTAs). In particular, an FTA with the U.S. —currently pending ratification by the U.S. Congress— would make permanent the special access to the U.S. market currently enjoyed under the Andean Trade Promotion and Drug Eradication Act (ATPDEA). The FTA with the

U.S. is expected to further encourage export growth and diversification, as well as accelerate critical reforms that will attract investment into the country.

10. Financial system indicators remain sound as a result of a consistent strengthening of financial supervision and regulation. Going forward:

- Measures to accelerate de-dollarization —including mortgage lending in domestic currency under the state-sponsored housing program— will be complemented by strengthened norms on loan classification, provisioning, and capital requirements to face foreign currency credit risks.

- Regarding the payments system, modified legislation will be introduced to entrust its surveillance and regulation to the central bank, and to ensure the latter's seniority as a lender of last resort among creditors.

- As part of the government's strategy to promote small and medium-size enterprises, public banks will operate as second tier institutions. To facilitate access to the financial system in remote areas, Banco de la Nación —the government's financial agent— will enter into infrastructure agreements with selected financial institutions. Also, it will continue to comply with a 25 percent annual growth limit on its consumer lending operations.

- The authorities will implement additional measures aimed at improving the financial soundness and corporate governance of microfinance institutions and, recognizing the importance of private pension funds in the economy, they will seek to enhance their operating environment, including by gradually raising the limits on their investments abroad.

11. Finally, the authorities believe that the policies described in their Memorandum of Economic and Financial Policies (MEFP) are adequate for meeting the objectives of the program, but stand ready to take any additional measures that may be needed for this purpose. They commit to maintaining the usual close and proactive dialogue with the Fund.