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Peru: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

May 20, 2005

The following item is a Letter of Intent of the government of Peru, which describes the policies that Peru intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Peru, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

Lima, May 20, 2005

Dr. Rodrigo de Rato y Figaredo
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. de Rato,

1. This letter and the attached Memorandum of Economic and Financial Policies (MEFP) present the policies that the Government of Peru intends to pursue during 2005 under its economic program, supported by the current Stand-By Arrangement from the Fund. It supplements the letter from the Minister of Economy and Finance and the President of the Central Reserve Bank of Peru dated May 25, 2004 and the letter from the Minister of Economy and Finance dated November 4, 2004. We believe that this program will help maintain macroeconomic stability, foster robust growth and employment, and further reduce financial vulnerabilities, particularly those associated to financial dollarization and public debt.

2. During 2004, Peru made further progress in stabilizing its economy and implementing measures aimed at sustaining a strong rate of economic growth. Economic growth rose to about 5 percent, inflation remained low within the inflation targeting framework, and Peru's external position strengthened substantially, reflecting strong export performance. The government also made significant progress in advancing its growth-enhancing reform program, particularly in areas related to public pension reform and the granting of privately-operated concessions for public asset management. All quantitative performance criteria for end-December 2004 were met.

3. In light of the strong performance under the program and our commitment to continue fostering macroeconomic stability and economic growth, we hereby request the completion of the Second Review under the Stand-By Arrangement. We also request (i) a waiver for non-observance of the structural performance criterion at end-December 2004 on the establishment of a commercial court in Lima, which became fully operational in April, 2005; (ii) a waiver for non-observance of the structural performance criterion at end-April, 2005 on the granting of concessions or entering into Public Private Partnerships for the construction and maintenance of at least two major roads, on the grounds that this deviation was temporary; a modification of this criterion in order to further specify it; and a resetting of its completion date to September 30, 2005; and (iii) that, due to the fact that there is one less set of performance criteria than initially envisaged under the program, future disbursements under the arrangement (excluding the disbursement that will become available upon completion of this review) be rephased into five equal amounts of SDR 27.6372 million, to be disbursed according to the original timetable. The quantitative performance criteria for the 2005 program are presented in attached Table 1 and the structural performance criteria and structural benchmarks in Table A attached to the Memorandum of Economic and Financial

Policies. In addition to the policies described in this letter and the attached MEFP, the Government of Peru stands ready to take additional measures as appropriate to ensure the achievement of its program's objectives. During the period covered by the Stand-By Arrangement, the authorities of Peru will maintain the usual close policy dialogue with the Fund. To this end, the program will have three more reviews, with the next review to be completed by mid-November, 2005. During this review, Peru's strategy to exit from Fund Arrangements at the end of the current Stand-By Arrangement will continue to be discussed.

Sincerely yours,

_____/s/_____
Pedro Pablo Kuczynski
Minister of Economy and Finance

_____/s/_____
Oscar Dancourt, Acting President
Central Reserve Bank of Peru

Table 1. Peru: Quantitative Performance Criteria and Inflation Consultation Mechanism, 2005

	2005		
	Prog.		
	June 30	Sept. 30	Dec. 31
(Cumulative amounts from December 31, 2004, millions of New Soles)			
Borrowing requirement of the combined public sector 1/ 2/	-850	270	2,605
(Cumulative amounts from December 31, 2004, in millions of U.S. dollars)			
Net international reserves of the Central Reserve Bank, excluding foreign-currency deposits of financial institutions 3/4/5/	-232	-483	-300
Outstanding short-term external debt of the nonfinancial public sector	50	50	50
Contracting or guaranteeing of nonconcesional public debt with maturity of at least one year 6/ 7/	1,627	2,296	3,100
<i>Of which:</i> external debt of 1-5 year maturity	100	100	100
External payments arrears of the public sector (on a continuous basis)	0	0	0
(Consultation bands for the 12-month rate of inflation, in percent) 8/			
Outer band (upper limit)	5.5	5.5	5.5
Inner band (upper limit)	4.5	4.5	4.5
<i>Central point</i>	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

Sources: Central Reserve Bank of Peru; and Ministry of Economy and Finance.

1/ The borrowing requirement of the combined public sector will be adjusted upward by up to S./400 million for any negative operating financial result of the BCRP.

2/ PIPP proceeds are included below the line.

3/ 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\$202 million at end-June, US\$41 million at end-September, and US\$97 million at end-December 2005. It will be adjusted downward for shortfalls from programmed net foreign borrowing. The amounts in excess will be deposited at the BCRP.

4/ 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 2005.

5/ The target of net international reserves will be adjusted downward by up to US\$400 million for the amortization of US-dollar denominated bonds issued under the Program of Consolidation of the Financial System that are paid in 2005 and have not been swapped into domestic currency instruments by the government during 2005.

6/ The limit will be adjusted upward by any amount of debt issued for, and used in, debt-exchange operations, or for prefinancing government operations in 2006.

7/ The limits will be adjusted upward by up to US\$400 million for guarantees provided by or contracted by the government, including with multilaterals, in context of Private Public Partnerships (PPPs) and concessions.

8/ 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 discuss with the Fund staff the appropriate policy response and complete a consultation with the Executive Board of the Fund on the proposed policy response before requesting further purchases under the arrangement.

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2005

1. Peru's macroeconomic performance in 2004 was strong, reflecting close adherence by the government to its macroeconomic program. Led by private investment and exports, output grew by about 5 percent, formal employment in firms with 10 or more employees increased by 2.7 percent, and 12-month inflation was within the inflation target range of the Central Bank. Driven by a sharp increase in exports, the external current account balance shifted from a deficit of close to 2 percent of GDP in 2003 to virtual equilibrium and net international reserves rose to US\$12.6 billion at end-2004. The overall deficit of the combined public sector was reduced from 1.7 percent of GDP in 2003 to 1.1 percent in 2004.
2. Progress was also made under the program in the area of structural reforms. In the area of public pensions, the reform of the *Cédula Viva* regime (end-December benchmark) was adopted ahead of the program timetable. In November, Congress gave the second-round approval to the constitutional amendment needed for the reform and, in early December, it approved the law reforming the regime. In December, the government also agreed on a plan to reform the pension regimes of the police and the military (end-September benchmark). In the area of decentralization, the law on the certification of regional governments' administrative capacity was implemented (end-December benchmark) but, due to a lack of political consensus, the law clarifying shared functional responsibilities among different levels of government (end-December benchmark) was not approved by Congress.
3. In the Judiciary, although the establishment of a commercial court module in Lima was delayed by a few months because of administrative bottlenecks, the court module became fully operational in April 2005. The announcement of a plan to centralize the information of collateral registries has also been delayed, but the government will announce its plan by end-September 2005. In the area of financial sector regulation, a system to measure and regulate foreign currency-induced credit risks was put into operation within the Superintendency of Banks (SBS) in mid-January 2005 (end-December benchmark); implementation of the regulatory requirements by banks is being gradually phased in over a period of 18 months.
4. The government's economic program for 2005 aims at consolidating the gains made in recent years and promoting sustained economic growth through the continued implementation of prudent macroeconomic policies and a deepening of its growth-enhancing reform program. Real GDP is projected to grow by 4½ percent in 2005 (with an upward bias), supported by strong investment and export growth. Year-end inflation is projected at 2.3 percent. Gross official international reserves are expected to continue to cover more than 100 percent of the banking system's dollar-denominated liabilities and close to 250 percent of short-term and maturing external debt, helping Peru deal with possible adverse shocks.
5. The government is committed to preserving the institutional framework upon which the Central Bank's independence is based, and to ensuring, within its constitutional competencies, that modifications to the central bank charter or any other norm that could

undermine that autonomy will not be approved. Monetary policy will continue to be guided by the inflation targeting framework, with the Central Bank's target set at 2.5 percent, within a band of plus or minus 1 percent. Central Bank intervention in the foreign exchange market will be limited to smoothing out excess volatility. The payment system under ALADI will continue to be used only for short-term trade operations.

6. The overall deficit of the combined public sector is targeted to decline to 1 percent of GDP in 2005. Central government tax revenue would remain broadly unchanged at about 13½ percent of GDP. Revenue losses associated with the elimination of the advanced corporate income tax payments, the removal of the payroll tax, and the reduction of the excise tax rate on petroleum products are expected to be offset by the introduction of the temporary corporate tax on net assets, improvements in tax administration, and an increase in value added tax collections. The government will continue to seek the removal of regional and sectoral tax exemptions and strictly avoid granting tax preferences to specific sectors of the economy.

7. To ensure adherence to the deficit target expenditure growth will be restrained. Selective expenditure increases will only be granted if they are consistent with the fiscal targets of the program. Public sector capital spending is projected to remain broadly stable at 3 percent of GDP.

8. The government will undertake public liability management operations with a view to further reducing fiscal vulnerabilities. The debt management strategy will aim at reducing rollover and market risks (currency and interest rate) and increasing gradually the share of long-term local currency instruments. The government will continue to explore the possibility of reprofiling existing debt through market-based operations. All external bond issues will continue to have collective action clauses.

9. The government will continue to reinforce the legal and institutional fiscal framework, consistent with a strong fiscal stance while allowing for counter-cyclical policies. To that effect, the main policy actions will be as follows:

- ***Fiscal Responsibility and Transparency Law (FRTL)***. The government will work with Congress to enact complementary FRTL legislation, with a view to strengthening procedures for compliance, monitoring, and requirements for reporting to Congress and the public. The legislative proposal will be submitted to Congress by June 2005.
- ***Public indebtedness***. The government is working closely with Congress to enact a General Law on Public Indebtedness, which aims at providing an integral and stable legal framework that will contribute to an orderly and efficient administration of the public sector indebtedness. This draft law establishes rules on annual limits on debt and guarantees contracted through the central government, as well as on contingent liabilities contracted under concessions and private-public partnership programs. The Ministry of Economy and Finance is also working on a framework for transparent

- reporting of regional and local governments' debt, which will contribute to the sustainability of public finances. In addition, it is working on the design of a reporting system of public sector liabilities (including guarantees and other contingent liabilities).
- **Public sector assets and investment projects.** The government will begin building a database of the public sector assets and investment projects.
 - **Central government budget management.** The government will continue to strengthen central government budget management and transparency, with Fund technical assistance. The central government budget formulation system and the Integrated Financial Management System (SIAF) will be unified by June 2005 and a system for prioritizing budget items will be introduced by December 2005.
 - **Public investment prioritization.** The government will strengthen the National System of Public Investment (SNIP) to bolster its capacity to ensure efficient and sustainable public investment. This system will reinforce its project monitoring, ex-post evaluation, and pre-investment analysis. In the context of the 2006 Budget preparation, the government will strengthen budget procedures to ensure adequate maintenance of existing infrastructure and to prioritize public investment projects, taking into account their social, economic and financial returns, and their environmental and institutional sustainability. Coordination within the Ministry of Economy and Finance will be strengthened, with a view to enhancing and prioritizing the assessment of investment projects on the basis of all their components, including the costs to the government through commitments of future expenditure and guarantees of minimum revenue streams.
10. Peru's growth-enhancing reform program will focus on supporting well-prioritized investment, furthering Peru's integration into the regional and world economy, and fostering the business climate and competitiveness. To help expedite the judicial resolution of business-related disputes and bolster contract enforcement, a first commercial court module in Lima was established in April 2005. The government will continue establishing additional commercial courts in Lima and in the rest of the country.
11. The government will strengthen investment and maintenance of infrastructure in a fiscally sound manner, including through the Private Investment Promotion Program (PIPP), which includes concessions and Private-Public Partnership (PPP) operations. By end-September 2005, the government aims to have awarded in concession the stretch of the Pan-American highway between Pucusana and Ica and a major regional integration highway in the north. Other concessions/PPPs expected to be granted in 2005 include a major regional integration highway in central Peru, eleven regional airports, water and sewerage facilities in two cities, and a fourth band of cellular telephone operations.
12. The government will ensure that concessions and PPP operations are fiscally prudent and transparent. In this context, there will be no exemptions for any new concession/PPP

projects involving government financial guarantees or subsidies to meet SNIP viability requirements. Also, by end-September 2005 the Ministry of Economy and Finance will establish guidelines and institutional procedures for deciding what projects could be implemented as private concessions/PPPs. To increase the transparency of fiscal commitments under concessions/PPP projects, the government will establish a reporting system of public sector liabilities (including contingent) associated with PPPs and concessions, and issue a norm requiring the annual publication of such liabilities in the Multiyear Macroeconomic Framework beginning in 2006.

13. Steps also are being taken to consolidate the implementation of the decentralization process in a fiscally-neutral manner, while improving service delivery. Consistent with the decentralization legislation, the government will issue by end-June the plan for 2005 to devolve certain sectoral responsibilities to regional governments; in addition, it will work to prepare a devolution plan for the medium term by 2006. This multi-year plan will help clarify shared responsibilities among different levels of government and introduce well-specified criteria to ensure that program service delivery is maintained as devolution proceeds. To improve financial management at the municipal government level, the budget execution module of the SIAF will be extended to 170 municipalities during 2005, including most of the largest. Also, a pilot program will be established in 2005 to foster regional and local government financial management capacity. This program will include the development of multi-annual fiscal frameworks consistent with the Fiscal Decentralization Law and capacity-building in project pre-investment procedures, consistent with the SNIP. With World Bank support, the implementation of a SIAF cadastre module will be gradually extended during 2005 to support property tax collections by municipalities. The government will also issue by September 2005 the regulations implementing the Fiscal Decentralization Law, which aims at reinforcing prudent budgetary decisions and practices of regional and local governments.

14. Further efforts will be made to improve resource management in the public sector, with a view to creating more room for priority social spending. Following the adoption of the reform of the *Cédula Viva* (CV) public pension regime, low pensions under this regime have been raised, funded in part by a reduction in the highest pensions, and the administration of the CV regime will be centralized. Also, by end-September 2005 the government will submit to Congress a draft law to reform the pension regime of the police and the military. The Ministry of Economy and Finance will introduce by September 2005 a pilot program within the Management Control and Evaluation System to help improve the quality of spending in priority social programs. The government will continue to work with Congress to enact legislation for a fiscally prudent reform of the civil service employment.

15. The government will seek to improve targeting in the implementation of new and existing social programs. To that effect, a pilot program of well-targeted monthly transfers to the poor will be gradually implemented. The program aims at providing transfers to heads of households that meet child education, health, and nutritional requirements.

16. The government will enhance coordination of its policy and regulatory actions with a view to reducing further the vulnerabilities of the financial system and improving its

efficiency. Efforts to reduce financial dollarization risks will be strengthened. By end-2005, the government will develop an operational plan to ensure that at least 50 percent of the mortgage loans financed by the *MiVivienda* program during the period January-June 2006 are denominated in domestic currency. The SBS will continue to strengthen supervision to ensure effective implementation of the recently-issued regulation in the area of foreign currency-induced credit risks. In this context, it will develop detailed actions to strengthen both off-site and on-site supervision, and will establish minimum standards for identifying and quantifying these risks and for implementing a satisfactory reporting system. The SBS will ensure that consolidated supervision is effectively implemented, including for off-shore operations. In this regard, it will continue to implement high risk-based capital requirements on financial intermediaries' risky offshore operations, including those on which comprehensive information is not available. More specifically, actions will be taken so that all high-risk offshore loans, as well as loan for which comprehensive information is not available, will be covered by capital reserves or provisions.

17. The government will promote greater efficiency in financial intermediation, including through development of the domestic capital market. Actions will be taken to deepen the securities' secondary market, reduce administrative barriers to securitization and standardize financial contracts, including on mortgages. Also, competition among private pension fund administrators (PPFAs) is being enhanced, which should significantly reduce costs to contributors and enhance investment returns. In particular, recent regulatory changes facilitate the transfer of funds to the more efficient administrators and a fifth administrator is expected to enter in the market by end-July 2005. In addition, a system to allow each PFFA to offer investment portfolios with different risk return characteristics will become operational by end-November. Competition also should be fostered by a widening of the permissible band around the required rate of return. Moreover, the PPFAs will be encouraged to limit market risks, including those associated to stock market prices, currency, and interest rates. To help improve financial market transparency and efficiency, the SBS is developing a new methodology to price nontraded financial assets. The new methodology and set of reference prices will be published in July 2005 with a view to promoting their wider use in the banking system and institutional investors.

18. Public bank lending to the private sector will be closely monitored. During 2005, all of *Banco de la Nación's* consumer lending programs will be monitored by the Ministry of Economy and Finance through quarterly targets. The operations of *Agrobanco* will continue to be in the form of channeling foreign lines of credit to agricultural producers, and its quasi-fiscal operations associated with lending to small-scale farmers will continue to be recorded in the budget.

Table A. Peru: Growth Enhancing Policy Actions for 2005

1. Structural Performance Criteria

Grant concessions or enter into Public Private Partnerships for the construction and maintenance of the portion of the Pan-American highway from Pucusana to Ica, and a large regional integration highway in the north of Peru. September 30

The Ministry of Economy and Finance will establish a reporting system of public sector liabilities (including contingent) associated with PPPs and concessions, and will issue a norm requiring the annual publication of such liabilities in the Multiyear Macroeconomic Framework beginning in 2006. September 30

The Superintendency of Banks will issue inspection guidelines strengthening the implementation of the norms on foreign currency-induced credit risk, including at a minimum the concepts of unhedged borrowers and significant impact on the repayment capacity of economic agents. September 30

2. Structural Benchmarks

Unify the Central government budget formulation system and the Integrated Financial Management System (SIAF). June 30

The Superintendency of Banks will publish and disseminate the new pricing methodology and reference prices of nontraded financial assets. July 30

Announce a plan to centralize the information on collateral registries. September 30

Issue the implementing regulations of the Fiscal Decentralization Law that support prudent budget decisions and management of the regional and local governments. September 30

Start implementing a law on public indebtedness, as specified in paragraph 9 of this MEFP. December 31

The government will develop an operational plan to ensure that at least 50 percent of the mortgage loans financed by the *MiVivienda* program during the period January-June 2006 are denominated in domestic currency. December 31

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 2005. It defines the concepts used to assess compliance with quantitative performance criteria specified in the letter of the Government of Peru dated May 20, 2005. It also sets the frequency of the data to be provided to the Fund for monitoring the program. For purposes of the program for 2005, operations in foreign currency will be converted into *Nuevos Soles* at the average program exchange rate of S/. 3.31 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 2005. 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 bonds² 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 recognition bonds. In the case of enterprises that are divested after December 31, 2004 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), and all other nonbank financial intermediaries. The banking system includes the BCRP, the commercial banks, the *Banco de la Nación* (BN), and *Agrobanco*.

² Excluding the new issuances of pension recognition 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 *ProInversión*; 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 *ProInversión*. 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 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.

4. **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 “*Préstamos a 60 Cuotas*” (established in September 2004) less cash amortizations under the loan programs. Interest payments on these loans are excluded from the definition of net lending.

5. **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.

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

7. **BCRP's gold holdings** will be accounted at US\$438.35 per troy ounce (the average book value as of December 31, 2004), SDRs at US\$1.55301 per SDR, and foreign currency assets and liabilities of the BCRP in other currencies at the exchange rate of December 31, 2004. 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-December 2004 level of net international reserves is shown in Table 3.

8. 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-December 2004 stock of short-term external debt of the NFPS is shown in Table 4.

9. **The contracting or guaranteeing of nonconcessional public debt with a maturity of at least one year** refers to all domestic and external obligations as specified under the 2005 fiscal year Public Sector Debt Law (*Ley Nro. 28423*) of the NFPS contracted or guaranteed by the central 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.

10. **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. 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.

11. 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-December 2005, the CIRRs published by the OECD in December 2004 will be used (see Table 5).

12. **The concessional 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 concessional 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.

13. **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-2004 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.

14. Definitions used in Table 1 of the letter of intent dated May 20, 2005 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.2.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 3 of Table 1 attached to the letter of intent dated May 20, 2005 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

15. 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*, 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 and the balance sheet of *Mi Vivienda*.

(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 *ProInversión* 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 *Petroperú* and *Relapasa*, and international prices of products commercialized by *Petroperú* 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).

(e) **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 2004
(In millions of nuevos soles)

	Stock as of Dec. 31 2003 1/	Stock as of Dec. 31 2004 1/	Flow
a. Net domestic financing of the nonfinancial public sector	-116	-1,896	-1,780
i. Net claims of the financial system (1+2+3)	-8,491	-10,175	-1,684
1. Net credit of the banking system on the NFPS and COFIDE	-11,298	-14,147	-2,849
Credits	7,302	6,708	-593
Liabilities	18,600	20,856	2,256
2. Net credit of COFIDE on the banking system	1,064	1,134	70
Credits	1,142	1,265	123
Liabilities	78	131	53
3. Net credit of nonbanking financial institutions on the NFPS	1,743	2,838	1,096
Credits	2,688	3,524	837
Liabilities	945	686	-259
ii. Stock of NFPS bonds in circulation (excluding bonds held by NFPS and of the financial system)	9,824	9,775	-49
1. Total	15,705	16,024	319
2. Less: holdings of the financial system (including COFIDE)	5,538	5,796	258
3. Less: holdings of nonfinancial public sector entities	344	453	110
iii. Floating debt	1,326	1,715	389
iv. Less: Accumulation of stocks, bonds, or other domestic financial assets by the NFPS	2,190	2,431	241
v. Less: Issuance of pension recognition bonds in program period	584	780	196
b. Net external financing (Millions of US dollars)			3,572 1,079
c. Privatization (Millions of US dollars)			377 114
d. Operating balance of the BCRP			-89
<u>PSBR (a+b+c-d)</u>			2,257

1/ Foreign currency valued at US\$1 = S/. 3.31

Table 2. Peru: Net External Financing NFPS: 2004-2005 1/
(In millions of US\$)

	2004	2005 Prog.			
		Jan.-Mar.	Jan.-Jun.	Jan.-Sep.	Jan.-Dec.
i. Loan disbursements	1,149	275	482	643	1,096
-Projects	286	110	236	397	500
-Nonprojects	862	165	246	246	596
ii. Bonds	1,295	427	427	427	427
iii. Cash payments on amortization	-1,323	-319	-707	-1,029	-1,425
- Loans	-1,256	-275	-662	-939	-1,336
- Bonds	-67	-45	-45	-90	-90
iv. Cash payments to settle arrears	0	0	0	0	0
v. Change in short term debt (increase+)	-11	0	0	0	0
A. Net foreign borrowing (i+ii-iii-iv+v)	1,110	382	202	41	97
vi. Prepayments	0	0	0	0	0
vii. Debt equity swaps	0	0	0	0	0
viii. Change in foreign assets held by the NFPS	60	50	50	50	50
ix. Investment project under the PIPP 2/	29	0	0	0	0
B. <u>Net external financing (A-vi-vii-viii+ix)</u>	<u>1,079</u>	<u>332</u>	<u>152</u>	<u>-9</u>	<u>47</u>

Source: Central Reserve Bank of Peru

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

2/ Includes disbursements for the project "Yuncán" since April 2004.

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 December 31, 2004
a. <u>Assets</u>	<u>12,306</u>
Deposits abroad	4,305
Securities	7,485
Gold 1/	489
Holdings of SDR 2/	10
Reciprocal credit agreement	7
Cash	10
Others	0
b. <u>Liabilities</u>	<u>18</u>
Reciprocal credit agreement	8
Liabilities with international organizations	10
IMF 2/	0
IADB	10
FLAR	0
c. <u>Foreign currency deposits of financial institutions at the Central Bank</u>	<u>2,984</u>
Banking enterprises	2,811
Banco de la Nación	45
COFIDE	70
Financial enterprises	58
d. <u>Treasurv bond repos</u>	<u>0</u>
e. <u>Swaps</u>	<u>0</u>
f. <u>Valuation USS/other currencies</u>	<u>0</u>
g. <u>Net international Reserves - Program definition (a-b-c+d-e-f) 3/</u>	<u>9,304</u>
<u>Memorandum items:</u>	
1. Subscription to the IMF and FLAR	320
2. Pesos andinos	20
3. CAF bonds	3
4. Net international reserves, official definition (g+c+1+2+3)	12,631

Source: Central Reserve Bank of Peru.

1/ Gold valued at US\$438.350

2/ Valued at US\$1.55301 per SDR

3/ As defined in I.5.

**Table 4. Peru: Short Term External Owed by the
Non Financial Public Sector (as of December 31, 2004)**

(In millions of US\$)

	Export Financing	Working Capital	Import Financing	Total
<u>Total</u>	<u>0</u>	<u>0</u>	<u>88</u>	<u>88</u>
Petroperu	0	0	88	88
Electroperu	0	0	0	0
General government	0	0	0	0
Memorandum item:				
Total of export financing plus working capital loans	0	0	0	0

Sources: Central Reserve Bank of Peru and state companies.

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

	Average CIRRs (updated Dec 10, 2004)		Previous rates for loans with maturity =>15 years						
	Six-month	Ten-year	contracted in						
	08/15/04-02/14/05	1/95 - 12/04 1/	before 1999	1999	2000	2001	2002	2003	2004
			1/86-12/95	1/89-12/98	1/90-12/99	1/91-12/00	1/92 - 12/01	1/93 - 12/01	1/94 - 12/03
Australian Dollar	6.34%	7.24%	12.15%	10.15%	9.28%	8.55%	7.98%	7.68%	7.48%
Austrian Schiling 2/	n.a.	5.76%	8.35%	7.73%	7.65%	7.43%	6.72%	6.34%	6.03%
Belgian Franc 2/	n.a.	6.07%	9.25%	8.60%	8.45%	8.13%	7.21%	6.80%	6.44%
Canadian Dollar > 8.5 years	5.23%	6.69%	9.83%	8.90%	6.07%	6.78%	7.41%	7.34%	7.05%
Danish Krone	4.75%	6.09%	10.37%	8.88%	8.33%	7.80%	7.29%	6.81%	6.37%
Finnish Markkaa 2/	n.a.	6.02%	10.64%	9.32%	9.15%	8.72%	7.56%	6.92%	6.43%
French Franc 2/	n.a.	5.89%	9.62%	8.42%	8.19%	7.82%	6.95%	6.50%	6.16%
German Mark 2/	n.a.	5.73%	7.91%	7.62%	7.54%	7.27%	6.58%	6.23%	5.96%
Irish Punt 2/	n.a.	6.16%	10.37%	7.59%	8.36%	8.44%	7.44%	6.97%	6.50%
Italian Lira 2/	n.a.	6.47%	11.50%	10.38%	10.06%	9.71%	8.30%	7.61%	6.94%
Japanese Yen	2.08%	2.24%	5.53%	4.65%	4.30%	3.75%	3.17%	2.77%	2.45%
Korean Won	4.80%	9.04%	n.a.	n.a.	n.a.	11.57%	10.74%	10.19%	9.55%
Netherlands Guilder >8.5 year	n.a.	6.11%	8.08%	5.24%	5.81%	6.52%	6.95%	6.75%	6.43%
New Zealand dollar	7.10%	7.68%	12.17%	9.62%	8.90%	8.33%	7.97%	7.94%	7.80%
Norwegian Krone	4.45%	6.74%	11.27%	8.93%	8.36%	7.94%	7.60%	7.28%	7.04%
Spanish Peseta 2/	n.a.	6.65%	12.99%	11.35%	10.89%	10.31%	8.65%	7.92%	7.20%
Swedish Krona	5.15%	6.67%	11.67%	10.10%	9.42%	8.61%	8.04%	7.52%	7.08%
Swiss Franc	3.30%	4.31%	6.68%	3.78%	5.97%	5.67%	5.26%	4.85%	4.55%
U.K. Pound	5.82%	6.91%	10.37%	9.53%	8.99%	8.38%	7.85%	7.41%	7.16%
U.S. Dollar > 8.5 years	4.89%	6.36%	8.62%	7.93%	7.59%	7.35%	7.06%	6.85%	6.63%
Euro (ECU for ten-year avg)	4.61%	5.80%	8.56%	7.99%	7.82%	7.13%	6.79%	6.40%	6.07%
Memorandum:									
SDR 3/	4.49%	5.64%	8.22%	7.51%	7.21%	6.85%	6.49%	6.17%	5.90%

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 10-year CIRR averages for the underlying currencies.

Previous six-month rates

based on rates:	loans with maturity <15 years, contracted between:											
	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
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%
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.
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.
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%
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%
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.
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.
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.
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.
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.
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%
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%
Netherlands Guilder >8.5 year	6.12%	5.43%	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%
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%
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.
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%
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%
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%
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%
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%
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%

Sources: OECD and Funf staff calculations.

Table 6. Peru: Stock of Domestic Debt of the NFPS (as of Dec-31-2004)

	Legal Norm	Gross placements		Stock (estimated) (Millions of Nuevos Soles)
		Currency	Amount	
Credits from BN				3,915
Credit to central government		US\$ / S/. / Y		2,856
Credit to local governments		US\$ / S/.		191
Net public treasury overdraft		S/.		869
Bonds				6,511
Capitalización BCRP	D.S.066-94-EF	S/.	614	39
Serie A			239	39
Serie B			375	0
Bonos TP - Financial system strengthening	D.U. 041-99	US\$	175	288
Bonos TP - Temporal suscription of stocks	D.U. 034-99	US\$	52	171
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	500
Bonos TP - RFA and FOPE programs	D.S. 059-2000-EF / D.U. 050-2002	US\$	108	357
Bonos TP - Financial system consolidation	D.U. 108-2000 / D.U. 099-2001	US\$	392	1,276
Bonos TP - Sovereign bonds	D.S. 007-2002-EF / D.S. 041-2003-EF / D.S. 079-2003-EF D.S.162-2003-EF / D.S.015-2004.	S/.	6,720	3,770
Bonos TP - Caja de Pensiones Militar Policial Bonds	D.U. 030-2001	US\$	34	111
Total				10,426
Memorandum items:				
Pension Reform Bonds (Bonos de Reconocimiento)	D.S. 096-95-EF	S/.		9,508
Floating debt		S/.		1,715

Source: Central Reserve Bank of Peru.