"DECADE OF PEOPLE WITH DISABILITIES IN PERU"
"YEAR OF THE PROMOTION OF RESPONSIBLE INDUSTRY AND CLIMATE COMMITMENT"

MINISTRY OF ECONOMY AND FINANCE

STRATEGY FOR GLOBAL ASSET AND LIABILITY MANAGEMENT *

2014 - 2017

* Document approved by the Ministerial Resolution N° 245-2014-EF/52 according to the Asset and Liability Management Committee created by Act N° 30116 as the authority that will define the actions to be taken in order to manage the financial assets and liabilities that are part of the Public Treasury. It includes the Annual Debt and Debt Management Program, referred to in Article 14 of Law No. 28563, specifying its policies, objectives and goals, from a long term perspective, which is compatible with the fiscal targets and the debt sustainability.

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Message from the Minister of Economy and Finance

The management of the Peruvian economy in year 2013 and 2014 so far has become a major challenge because, as many emerging countries, we face the materialization of global risks affecting the expected economic performance. On one hand, China, Brazil, Russia, India and South Africa's economic slowdown had an impact on the prices of commodities we export and, on the other hand, we had to face the effects of uncertainty due the withdrawal of monetary stimulus in the U.S.

In this context, on the macroeconomic side, the GDP did not reach the level of growth we expected, however we are confident that it surpasses 5% between 2013 and 2014, which will be one of the highest in the region, and we will effort to adopt measures to return to previous growth levels. The principal macro financial impact resulted in a high volatility of the sovereign curve yields and the exchange rate. These variables lost the minimum level reached during the unusual international liquidity scenario.

The Global Asset and Liability Management Strategy 2014-2017 was elaborated consistently with the general aim of a responsible and sustainable management of public finance and with the fiscal policies and projections of the Multiannual Macroeconomic Framework.

Within this framework, the Public Treasury is aimed at minimizing the cost of financial liabilities and maximizing the return of financial assets subject to the maximum level of risk established in the guidelines for global asset and liability management. To this end, the development of the public debt securities market should be considered as the fundamental pillar of the local financial market development. Thus, innovations in the periodic issuance of short and long-term Public Treasury securities in nominal and real soles will be developed, which will be complemented with the implementation of the repo operations market, a key instrument for the public savings to increase return responsibly and transparently, and at the same time, it will help the securities market and the whole financial system to deepen development and liquidity.

In accordance with the foregoing, and in order to consolidate a responsible management of public financial assets and liabilities according to the best international practices, a high level technical committee has been formed which will define and follow the approved guidelines and actions for an adequate global management of all financial assets and liabilities that are part of the Public Treasury, under a long-term vision and oriented to the modernization and efficiency of the public finance management.

Finally, I would like to point out that we are fully convinced that the measures we are planning and implementing in terms of financial policy will lead to new improvements in Peru's sovereign risk rating and that the Peruvian economy would accede to lower financing costs.

Luis Miguel Castilla Rubio
Minister of Economy and Finance

Message from the General Director of Public Debt and Treasury

I am pleased to introduce you the updated version of the Global Asset and Liability Management Strategy which shares the same vision, direction and long-term goals than the Strategy published on 2013 but, at the same time, it shows the new challenges the institutional entities and units that are part of the Public Treasury will face in regard to the management of national finance and also the policy guidelines taken to overcome them.

Last year the principal reforms to develop the public debt securities market in local currency were implemented. The new bills, bonds and market makers regulations came into force in order to establish a modern framework for action according to the best international practices. This year, the regulations of Repo operations using treasury securities will come into force which will complete the relevant normative framework that will help the market to become more competitive, liquid, transparent and diversified.

In the same way, periodic bonds and bills auctions started, following the established schedule, and it helped to fulfill the aims established in this stage for each market segment. Bill auctions completed the short segment of the sovereign curve and retail investors could accede to these auctions, benchmark bonds were issued periodically supporting interest rate stability and, after many years, the Public Treasury paved the way for the issuance of inflation-indexed bonds (VAC bonds) in order to attend this market segment with specific needs. This year, we plan to enhance this type of auctions that transmit more confidence to the market participants and produced very satisfactory results.

In terms of debt, savings and treasury management, this year the Committee of Assets and Liabilities Management of the Ministry of Economy and Finance will start its term of office after the compliance of some norms. The Committee is the authority in charge of investment and finance decision-making, and has adopted a structural balance sheet risk approach, in order to fulfill long-term financial goals.

The principal actions in the Strategy are divided into four fundamental points: i) asset management, designed to constitute and manage liquidity reserves to face temporary maturity mismatches or contingencies, and manage the investment of public treasury savings, ii) Liability management, designed to increase the number of periodic issuances of real and nominal benchmark bonds, iii) treasury management, directed at making profitable the temporary excess of funds, principally using public treasury securities and, iv) Market structure, designed to lead infrastructure improvements for the functioning of the local public debt securities market according to the highest international standards as soon as possible.

Finally, I would like to ratify our commitment to keep working hard in order to accomplish our long-term aims and goals in the interest of guaranteeing the sustainability of public finance and the financial stability in our country.

Carlos Linares Peñaloza
General Director of Public Debt and Treasury

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EXECUTIVE SUMMARY

Performance in 2013

Following the adoption of the Strategy for Global Asset and Liability Management 2013-2016, several actions have been taken in order to accomplish the financial policy guidelines, the goals and the main objective of the Strategy. This process was key to strengthening the Treasury's reputation regarding its commitment to deepen the development of government securities market and to help to maintain financial stability, despite financial markets volatility. As will be recalled, the year 2013 was marked by the end of monetary stimulus and by political crisis over fiscal negotiations and the debt ceiling in the United States, while in China, the problems in its financial system and the fears of an economic slowdown generated high volatility in the international financial markets.

In line with the clear long-term vision of the Strategy, important regulatory and normative changes have been made, mainly related to the structure of government securities market in local currency. New regulations for government securities (bills and bonds) and new auction rules for these instruments (hybrid auction) were approved, meanwhile new eligible auction participants (brokerage firms, pension funds, insurance companies, financial municipality entities, etc.) were incorporated; the Stock Exchange Supervisor (SMV) approved the new regulation for centralized trading of public debt and for related derivative instruments; the legal constitution of the Asset and Liability Management Committee was formalized; decisions on the investment of the Stabilization Fiscal Fund (FEF) were assumed by this Committee in accordance with the Treasury's Strategy; the Repo Law was enacted; and, after several years, all International Accounting Standards for the Public Sector (IPSAS) became official in Peru. We expect all public entities -including regional and local governments- to incorporate these standards uniformly and progressively, and consistently with the IMF's Government Finance Statistics Manual 2001/2014.

At the same time, most of the actions announced in the Strategy for 2013-2016 have started to be implemented. The weekly schedule of the new Regular Treasury Auctions was strictly followed and, after many years, we have again issued Treasury bills and Inflation-linked bonds. For the first time, we have held quarterly meetings with all eligible entities for Treasury auctions; public entities began to use an internet-based platform for the auction of their short-term funds; we avoided issuing public debt abroad in order to reduce the pro-cyclicality of external debt as a source of macro-financial vulnerability; prepayments to international organizations were made, with replacement bonds being issued in the local market, promoting its development; and we have continued to implement further improvements in investor relations, which were recognized by the Institute of International Finance in its annual evaluation.

Most importantly, despite the complicated outlook for the financial markets, the local demand for Peruvian Treasury securities continued to grow strongly during 2013, in line with our forecasts. According to the figures of sovereign bond holdings, between the end of 2012 and the end of 2013, the additional demand in face value from banks was S/. 1.39 billion, from the insurance companies was S/. 737 million, from the pension funds was S/. 387 million and from public funds was S/. 729 million. The total increase in holdings by local institutions was a face value of S/. 3.25 billion, which at market value reached S/. 3.44 billion by the end of 2013, similar to our local structural

demand projections made last year, when S&P and Fitch upgraded Peru's sovereign rating in local currency from "BBB +" to "A-".

In 2013, Central Government gross debt reached 16.4% of GDP and its net debt (gross debt, represented by financial liabilities, less gross savings, represented by financial assets) reached 5.5% of GDP, less than the 6.8% of end 2012. It is pertinent to point out that the Central Government is considered as the most relevant institutional unit from an economic point of view, whose creditworthiness is subject to evaluation by sovereign risk rating agencies.
The lower net debt was mainly due to an increase in savings, whose main components are the FEF's financial assets and the liquidity buffers accumulated to handle stress situations that could affect the Treasury's cash flows. However, as a result of the high dollarization of financial liabilities, their total annual cost, measured in soles, increased from 2.6% to 10.7%, whereas, as a result of lower elasticity on asset yields, their total annual yield, measured in soles, went from -0.9% to +4.9%. Therefore, the higher asset performance did not offset the higher liability costs; neither would it have compensated if the overall foreign currency position had been zero– because of the difference in elasticities – in a context of the rising dollar exchange rate and interest rates. Thus, the net annual cost of net debt increased from 3.5% to 5.8%, therefore the Treasury should improve the management of the following aspects: (i) the return on assets, keeping a countercyclical position against interest rate risk and reducing concentration risk, and (ii) the cost of liabilities, reducing the overall foreign currency positions and diversifying them without affecting the management of liquidity risk.

Financial Strategy for 2014-2017

According to the commitments made and the goals achieved, the Strategy for Global Asset and Liability Management 2014-2017 outlines the main actions that the Government will continue to implement, maintaining the flexibility to face future circumstances. The strategy has been formulated and disclosed to the market in order to communicate, under a long-term vision, the policies, objectives and relevant targets for the Treasury's financial strategy. It also details the financial guidelines and actions to be followed from now on by all institutions or institutional units that are part of the Treasury, and whose financial management will be evaluated and monitored by the Asset and Liability Management Committee, which is chaired by the Minister of Economy and Finance. Among the most important guidelines approved there are four basic principles for an adequate global financial management:

- Centralization of liquidity flows and fund balances
- Optimizing the relationship between risk and return /cost;
- Comparison on the same comparable basis; and
- Prioritizing the highest level of competition in all sectors.

Other mandatory guidelines to be taken into account are the financial policies for asset and liability management, which were also approved by the Strategy for Global Asset and Liability Management 2013-2016. In this regard, the relevant financial policies are:

- Deepening government securities market by increasing public debt in soles
- Maintain liquidity reserves to face situations of instability,
- Making public funds profitable and reducing the costs of their liquidity
- Maintaining a healthy financing structure in the indirect debt

- Reducing foreign debt pro-cyclicality as a possible source of vulnerability, and
- Ensuring the sustainability of the net public debt.

Thus, according to these policies, we will continue developing the securities market in local currency by reducing the dollarization of both public debt and external public debt, maintaining enough reserves to deal with liquidity stress scenarios, increasing profitability of accumulated assets (savings) through collateralized deposits and repo operations with Treasury securities, maintaining a healthy structure of indirect debt by adopting international best practices in concessions (PPP), encouraging domestic savings, helping to ensure net debt sustainability, and developing sovereign yield curves with high liquidity– in nominal and real soles – as the main reference provided by the Treasury to deepen financial development across the country. In addition to that, we will avoid systemic vulnerabilities such as currency or financial crises; therefore the exposure of public funds to counterparties with high credit dollarization will also be limited.

In order to manage the structural balance sheet risk and the market risk associated with global asset and liability management, four tactical guidelines will be followed to achieve the goals and targets. To this end, according to international best practices, the assessment of the Government's financial operation should be based on a long-term vision, taking into account the fundamentals of economic theory (from a social point of view) and not just on a short-term vision mainly supported by financial theory (from a private perspective). Governments have specific interests; therefore, the traditional tools for financial analysis will be used differently than would any private agent who only aims at reducing the debt cost subject to a prudent level of risk. Thus, tactical guidelines to be considered are:

- Optimizing the management of liquidity risk,
- Countercyclical position against interest rate risk,
- Diversification of foreign exchange risk, and
- Control of concentration risk.

Therefore, the Strategy's objective will continue to be oriented to maintaining a responsible and sustainable management of public finances, by minimizing liability costs and maximizing the return on assets, subject to the level of risk established by the Strategy's guidelines. To this end, it is necessary to develop the government securities market in local currency as the principal vehicle to meet the temporal financial requirements of the Government resulting from debt, asset and cash management. This objective is strengthened by the new Rules of Organization and Functions (ROF) of the Ministry of Economy and Finance, which establish that one of the ministry's functions is to develop, propose, implement and evaluate policies, standards, and technical guidelines in order to develop the government securities market as part of global asset and liability management. Thus, the Strategy has been designed incorporating the best international standards, so that the Republic is able to reduce its long-term financial vulnerability, in line with the national strategic plans; this will continue to be reflected in further improvements in the sovereign ratings. To this end, the Strategy has incorporated key recommendations for financial de-dollarization, de-dollarization of public debt and, development of local credit and securities markets.

The Strategy for Global Asset and Liability Management seeks to reduce Peru's weaknesses in some financial development indicators in order to define its policies and guidelines. From this perspective, the Strategy indicates specific actions

for asset management, liability management, cash flow management, and for the development of the market structure:

- In asset management, the strategy aims to maintain liquidity reserves to deal with financial instability; to implement a counter-cyclical investment management by providing liquidity to holders of government securities; to implement an active asset management with more competition, diversification and transparency; to optimize direct public credit and to evaluate the sustainability of contingent public credit granted. To this end, it is necessary to strengthen the role of the government securities market in local currency, as a base for determining transfer pricing or the opportunity costs of various funding sources and investment alternatives.
- In liability management, the strategy aims to increase the diversification of debt holders; to issue nominal and inflation-indexed bonds more frequently at key points on the yield curve as a good signal to market; to generate attractive debt volumes for each type of investor; to avoid interest rate instability; to stabilize debt interest payments over time; to reduce gross debt dollarization; to increase the market size of domestic public debt in order to reduce external debt; to mitigate the possible liquidity risk arising from the excessive concentration of debt maturities; and to reduce the financial cost associated with interest rate risk which could unnecessarily generate a higher volume of refinancing in the financial markets.
- In cash management, the strategy aims to collect tax obligations directly on the Treasury's account; to earn a return from the cash flows that are not used on the day they are collected; to minimize the impact on the financial system's liquidity caused by the Treasury's auctions; and to ensure liquidity of Treasury securities before they are auctioned.
- In the market structure, the strategy mainly aims to optimize the functioning of the infrastructure of the government securities market in local currency; to renew the role of market makers; to increase the level of competition, transparency and liquidity in pricing of contestable markets; to facilitate access to the public debt market for retail investors; to establish a sovereign index fund – as a reference – for investment and pension funds; and to improve the delivery versus payment (DVP) system for the clearing and settlement of government securities in general.

Expected Results

To forecast the results for 2014, we developed four deterministic scenarios consistently with the projections for the 2014-2017 Multiannual Macroeconomic Framework. The forecasts take into account compliance with the financial policies and the relevant targets set in the Multiannual Strategic and Sectoral Plan for the Public Sector, 2012-2016 (PESEM) and Institutional Strategic Plan (PEI). The purpose of these projections is to measure the impact of the main actions that will be carried out as part of the implementation of asset, debt, and cash management policies. These forecast assumptions take into account the economic environment, the financial needs that will be required to meet fiscal requirements and some debt management operations. In the same way, we consider local and international financial markets perspectives that could affect the access and conditions for new debt issuance.

The baseline scenario corresponds to projections in which economic growth will reach 6% annually, with a positive impact on Central Government revenue. For the year 2015 onwards, we expect economic growth to maintain a similar level. Debt management operations are planned for the next four years in line with the actions that will help to accomplish the principles, policies, and tactics considered in the Strategy and to achieve the objective of deepening the government securities market in local currency.

	2013	2014	2015	2016	2017
Baseline scenario					
Central Government Debt /GDP	15.3%	15.8%	16.0%	15.7%	13.9%
Central Government service/GDP	1.5%	1.6%	1.6%	1.6%	1.2%
Central Government amortization/ GDP	0.6%	0.7%	0.7%	0.8%	0.4%
Central Government Interest/GDP	0.9%	0.9%	0.9%	0.8%	0.7%

An optimistic scenario estimates that the Peruvian economy will register a 6.7% growth per year until 2017, while a pessimistic scenario estimates a 4.5% annual growth. In the first case, we may achieve a fiscal surplus of 0.9% for this period, while in the second case, it is expected that the international context could affect the dynamism of the economy, especially external demand, through a sharp decline in export volumes and a fall in international prices. This would affect the expectations of economic agents which would generate lower private spending, mainly reflecting fewer and delayed investments. Therefore, if we consider the optimistic and pessimistic scenarios in which the economy would perform until 2017, we obtain the following estimates:

Concept	Pessimistic - Optimistic at the end of 2017
Percentage in soles in the portfolio	57.2% - 72.1%
Percentage of fixed rate debt in the portfolio	76.9% - 79.4%
Percentage of internal debt in the portfolio	56.2% - 71.1%
Average term to maturity(years)	12.9 - 16.2
Average term to re-pricing (years)	11.9 - 15.5
Accumulated amortization over the next 12 months	6.9% - 6.0%
Percentage of financing flows in local currency	70.5% - 84.4%

Finally, we include the 2014-2015 Schedule for the Regular Auction of Treasury Securities. It sets out the new schedule of regular T-bill auctions (first and third Tuesday of each month) and bond auctions (four Thursdays each month), with issuance of new nominal and inflation-indexed securities. In a context of high market volatility, we will try to avoid auctions being declared null in order to give the government debt market more prices frequently, and to improve liquidity to generate sufficient local economies of scale. These actions will contribute to develop the repo market and subsequently the derivative market, as in other countries of the region.

1. INTRODUCTION

The Strategy for global asset and liability management is a multiannual plan that comprises the main guidelines and the framework of action for financial asset and liabilities management with enough flexibility to meet the new circumstances in the future. It has been formulated and published to the public in order to reveal the most relevant policies and objectives for the financial management strategy in a long-term vision, as well as the general guidelines and actions that should be observed by the institutional entities or units that are part of the Public treasury.

The publication of the strategy – which is also a reference for the Annual Debt Program and Debt Management, see appendix N° 1 –is aimed at becoming a planning instrument that improves the communication and transparency of the Government's strategy to develop the public debt securities market and promote a diverse and sound investment of public funds. In this way, any debt, investment and treasury management requirement could be covered and, at the same time, the sustainability of the total net public debt will be ensured, within the framework of a responsible and sustainable management of public finance.

Due to the merger of the former National Directorate of Public Debt and the former National Directorate of Public Treasury, the new General Directorate of Public Debt and Treasury is implementing the new framework for global financial asset and liability management for the Central Government[1] as well as the entities or institutional units that conform the Public treasury[2] in order to manage more efficiently the balance sheet mismatches during the economic cycle. This will not only determine the opportunity to improve the debt profile, but also the investment or the divestment of savings and liquidity reserves in a counter-cyclical manner to support the implementation of the fiscal policy.

This new framework, which will strengthen the management of the net public debt according to the guidelines of the macroeconomic policy and especially to the fiscal policy described in the Multiannual Macroeconomic Framework 2015-2017. Likewise, this will become the central point to reduce the vulnerability of the public finances against adverse external shocks in financial markets, to strength the State's net worth and to consolidate the development of the domestic securities market in soles. Securities are a key government property whose cost of provision is a necessary condition to achieve the financial development in any country.

This document has not only the intention to present a transparent accountability concerning to the progress made in public finances in 2013, the analysis of the current situation and the strategy planned for the next four years, but also that the implementation of the strategy contributes to a better development of capital markets. Thus, Peruvian economic agents could access to these instruments easily and with lower costs, and the Republic of Peru could consolidate the improvements in sovereign risk ratings, preparing for the equilibrium of the financial markets and the monetary flow come back.

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1 According to international standards of fiscal statistics and in order to ease a comparison with other countries, the definition of Central Government used to determine the extension of financial assets and liabilities for the analysis corresponds to the definition of the FMI'S Government Finance Statistics Manual 2015-2017 without the social security, this is, without the assets and liabilities of the entity in charge of the contributory health provision (EsSalud) or the entity in charge of contributory retirement pensions (ONP) or the rest of institutional entities or units that are part of the Central Government.

2 In general, it refers to the Public Sector, this is, all institutional entities or units that are part of the General Government Sector and the financial and non-financial public companies in the three levels of government.

In this sense, the implementation of the new strategy is designed to increase the public debt composition, reducing vulnerabilities caused by external debt and the exposition to currency fluctuations in the Government balance, improving the strength of the economy against possible financial or currency crisis and, at the same time, contributing to promote the financial inclusion throughout the country.

The document is divided into seven sections and considers four big topics. In the first two sections, there is a review of the context considered in the formulation and observance of the guidelines of the asset and liability management. In the following two sections, an analysis of the Central Government's assets and liabilities and the balance sheet structural risk is made. In the two subsequent sections the strategy implemented in 2013 and the strategy for 2014-2017 are evaluated. In the last section, the results of the implementation of the strategy concerning the main indicators that are reported to the Congress annually are forecasted.

2. CONTEXT

2.1 Relevant conceptual framework

This document updates the Strategy for Global Asset and Liability Management 2013-2016, uses the same conceptual framework for converging the best practices and standards in the different aspects of finance applying international consistent principles. The conceptual framework for the internal control[3] is also consistent with these principles.

In this sense, the conceptual frameworks of the International Financial Reporting Standards (IFRS) and the International Public Sector Accounting Standards (IPSAS) are particularly important for the Government's asset and liability management. Provide useful financial information for present and potential investors and creditors so they could make decisions to provide resources to the reporting institutional entity or unit. This enhances a transparent accountability in favor of the taxpayer and Peruvians.

A useful financial information is any relevant information that represents exactly what it pretends to represent and its usefulness is bigger if it is opportune and understandable and if it can be compared and verified. The information will be relevant for people if they use it to evaluate past, present and future events or to confirm or correct past assessments, where the relevancy of the materialization of these events will be determined according to each reporting entity. The information should consider not only the legal aspect but also the economic aspect of transactions and other events in order to represent them accurately; in addition, the economic aspect must be complete, neutral and without mistakes in order to avoid an incorrect analysis or obtain wrong conclusions.

To formulate this document we have taken into account the conceptual framework of the different basic principles and key standards published by the Bank for International Settlements (BIS), the International Association of Deposit Insurers (IADI), the International Organization of Securities Commission (IOSCO) and the International Monetary Fund (IMF), in the context of a more interdependent global economy in which Peru, as a small and open economy, exposed to a higher mobility of capital, has taken in consideration. In Peru, the Public treasury is not only a key agent of the financial security network but also the issuer of securities that sustain one of the main pillars of the whole financial system.

Finally, and not less important, we have considered all the legal norms and regulations that direct or indirectly mention the goals that this document must fulfill for the management of public finance in Peru, which could be checked in Appendix N° 2.

[3] The internal control is an integral process made by civil servants and officials. It is designed to face risk and reasonably ensure that, to achieve the mission of the entity, the following objectives will be attained: (i) Promote efficiency, effectiveness, transparency and economy in the operations made by the entity, as well as the quality of the public services; (ii) to look after and protect resources and properties of the State against any loss, deterioration, inappropriate use and illegal actions, irregular incidents or harmful situations that may affect them; (iii) obey the regulations applicable to the entity and its operations; (iv) Guarantee the reliability and opportunity of the data (v) encourage and boost the practice of institutional values; and (vi) Promote the accountability of public funds, properties, missions or objectives in charge of civil servants or officials.

2.2 Coverage and scope

All general guidelines[4] and actions[5] discussed below are valid and should be followed by all institutional units or entities that are part of the Public treasury, as long as it does not affect the constitutional or legal mandates.

Although, while the public entities[6] at the three levels of Government adopt the International Public Sector Accounting Standards (IPSAS) that were official in 2013, the subsequent analysis of assets and liabilities in this document are limited initially to the Central Government's financial assets and liabilities which will be broaden in the future (see Box N° 1), regardless of the analysis each entity has been implementing[7].

Thus, the asset and liability global management is the group of techniques and procedures that ensure a correct and opportune financial decision-making for investment, deb and treasury management altogether. To this end, it is necessary to consider useful financial information about favorable and unfavorable relations, accrued or not, between the different components of the financial assets and liabilities accrued or not which are in and out of the balance sheet of the institutional entity or unit which define the profile of the structural balance sheet risk and its exposure to market risk.

Box N° 1: Registration of the information of the public institutions' assets and liabilities

The Ministry of Economy and Finance will consolidate the current registration of the public funds and debt in one centralized registration of asset and liability information in order to unify and standardize the criteria for the registration of financial asset and liability information of the public entities at the three levels of government.

All entities should report all financial assets and liabilities at the end of each established period end date using this registration, regardless of the fiscal year, or the legal form, or if there was budget allocation, according the international standards of accountability, financial information and fiscal statistics.

The chief of each entity will be in charge of the veracity of the information; the information sent by each entity will be considered as a sworn statement, without prejudice of being contacted by the person responsible for treasury or accountability to clarify or answer any question if necessary.

Public entities should send the quarterly historical information of the financial asset and liability management since the first quarter of 2000 until the last quarter of 2010 and, the monthly historical information since the first month of 2011 until the prior month to the start date for the periodic sending of information. For this purpose, the schedule with the final dates to send the information will be issued according to the recommendations of the Asset and Liability Management Committee.

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4 The guidelines are general characteristics for certain subject; they include the behavior and performance in a certain direction or their own direction, trend, guidance or style.

5 The actions are necessary initiatives to attain goals or fulfil objectives or to prioritize the fulfilment of policies, which may be planned systematically and shape a strategy.

6 The public companies are already governed by the International Financial Reporting Standards.

7 The General Directorate of Public Debt and Treasury (DGETP) is in charge of proposals for policies and design of norms and procedures to implement the global Financial Asset and Liability Management. In 2012, the main actions to implement this new strategic vision was: (i) the approval of the guidelines for the Global Asset and Liability Management according to Directorial Resolution N° 016-2012-EF/52.03, which states that the Public sector's companies and entities whose financial assets are higher than S/. 10 million should form an Asset and Liability Committee and approve a Policies Manual; (ii) the development of informatics tools that help public financial companies and entities to quantify their risk exposure, which are published in the website www.mef.gob.pe/tesoro/activos-y-pasivos.php where biblioGraph information that help treasurers to improve their knowledge about financial asset and liability management can also be found and (iii) training for the main officers of the non-financial public entities and companies related to the implementation of their asset and liability committee and the formulation of its policies manual.

According to international norms, an institutional entity or unit is considered as an institutional unit from an economic point of view that has the capacity to own assets, incur liabilities and develop economic activities and transactions with other similar entities, such as public companies from any of the three levels of Government, public universities, welfares, regulatory and supervisor organizations and the decentralized public organizations such as social security organizations, among others.

Thus, every institutional entity or unit has (or will have, because it is possible and significant from an economic and legal point of view) a complete group of accounts, including an asset, liability and net worth balance sheet. Every institutional entity or unit is subject to an analysis of its management, performance and individual ability to pay; therefore, they will be subject to credit risk rating, as any company or individual.

Although in the beginning the global assets and liabilities of every institutional entity or unit should focus on all direct financial assets and liabilities that are part of the balance sheet because they are under the entities control and generate income and risks, later, the scope of the analysis will extend progressively. First, revenues and expenses on the income statement should be also included, as well as indirect financial assets and liabilities that could affect the balance sheet's risk profile. Secondly, non-financial assets and liabilities that are part of the balance sheet of every institutional entity or unit should be included. Afterwards, it is necessary an analysis of the exposure to other entities' risk because the financial or economic situation of each of them have an effect on other entities and vice versa.

2.3 National strategic plans, objectives and goals

The Multiannual Sectorial Strategic Plan for 2012-2016[8] (PESEM) and the Institutional Strategic Plan for 2012-2016[9] (PEI) are the main instruments that guide the actions of the Ministry of Economy and Finance (MEF) within the framework of the big development and policies plans of the State, among which stand out the Bicentennial Plan: Peru 2021, the State's Policies of National Agreement and the National Policies of Mandatory Compliance.

According to these instruments, the new framework for the implementation of a global asset and liability management in the different levels of the public sector has four principal policies guidelines and associated sectorial strategic actions:

a) To maintain fiscal balance and financial efficiency:

- Ensure the financing for the public policies by increasing tax collection.
- Incorporate public debt management as part of the State's global financial asset and liability management.
- Enhance the normative and legal framework to allow and promote a global asset and liability management in all levels of the public sector.
- Reduce the cost of the Public Treasury' liquidity management through active management of the treasury with public debt securities.

b) To maintain macroeconomic and financial stability:

- Increase the de-dollarization of the public debt in order to reduce macroeconomic vulnerability to credit crises and currency crisis.

[8] Approved by Ministerial Resolution N° 807-2011-EF/41

[9] Approved by Ministerial Resolution N° 880-2011-EF/41

- Design and implement a liquidity contingency plan that will help to prevent eventual situations of systematic liquidity crisis.
- Diversify markets and investors in order to improve debt sustainability and the negotiating ability of the State.
- Increase the liquidity of benchmark bonds in soles in order to reduce the uncertainty of the investor's portfolio management.

c) To enhance the development of the securities market:

- Strengthen transparency and competitiveness of the public debt securities market operations according international standards.
- Identify and minimize the asymmetry in financing and investment between credit and securities institution.
- Promote more investment alternatives in the financial markets.
- Promote financing and investment structures that include the small and medium-sized enterprises in the securities market.

d) To develop the financial system with a greater financial inclusion:

- Consolidate the growth of microfinance institutions, through the participation in public debt securities for a better treasury management.
- Promote the access to credit in times of incomplete markets.
- Boost corporate governance and the technologic support of the municipal and rural funds.
- Development of money market through repo operations with public debt securities and other financial instruments backed by financial collateral arrangements.

Thus, within the framework of the main guidelines of policies and sectoral strategic actions, there are objectives and related goals to reduce the dollarization levels of public debt and increase the public debt securities market in soles (see Box N° 1).

However, without prejudice of the above mentioned, and as part of the constant improvement process, we also consider the opinion of third independent parties such as contracted and non-contracted risk agencies, as well as a periodical analysis of internal evaluation, in order to act with transparency with the different market agents (See appendix N° 3).

Table Nº 1
Objective and Goals Approved in the PESEM and the PEI

General objectives	Indicators	Base 2012	Goal 2016
Responsible fiscal and financial policy	Public debt as percentage of Gross Domestic Product (GDP).	21%	15%
Integral development of the financial system	Trading frequency of referential public debt securities under normal conditions.	70%	80%
Specific objectives	**Indicators**	**Base 2012**	**Goal 2016**
Strengthen liquidity of the public debt market in order to maintain the financial stability	Issues with a minimum amount of S/. 3 billion above the total benchmark issues for non-residents.	57%	75%
Efficient public debt management as part of a global asset and liability management.	Percentage of local currency in the public debt.	48%	70%

Improvement of the treasury management conditions of non-bank institutions.	Number of treasury auctions.	12	48
Strengthen the modernization process of the treasury management	Participation of institutions in centralized mechanisms for public funds auctions	20%	80%
Institutional strengthening of financial management ability	Number of treasurers that received at least 8-hour training per year.	300	500

Source: MEF – DGETP

3. GLOBAL ASSET AND LIABILITY MANAGEMENT GUIDELINES

3.1 Economic and financial fundamentals

The purpose of the merger of the former National Directorate of Public Treasury and the former National Directorate of Public Debt – guiding organisms of the National Treasury System and the National Public Debt System respectively –is to implement the Government's global financial asset and liability management, regardless of the budget allocation. Since 2013, the main goal is not only to cover the financial needs resulting from debt, savings and treasury management but also to develop the public debt securities market as the backbone of the local financial system. This meant a paradigm shift in the guidelines for the execution of asset and liability financial operations.

The international experience show that the assessment process of the financial operations of the asset and liability management of the Government's balance sheet should be based in a long-term vision, especially considering the fundamentals of the economic theory (from a social point of view) with an accurate accountability according to international regulations, and not only in a short term vision based on the financial theory (from a private sector point of view). The lifeline of this idea is that the Government has peculiar characteristics that restrain it from using the traditional instruments of financial analysis as if it was any business economic agent that only aims at reducing the debt cost with low risk[10].

On the other hand, during the execution of the annual budgeting, the size of the Government's income and outgoings flows clearly can optimize the financial structure of the Government's balance sheet. The size, nature and composition of the public securities allow the Government to influence on the prices and consequently on the cost and risk of its financial strategy as opposed to the rest of economic agents that basically act as price takers.

Therefore, unlike the financial evaluation (from a private point of view) where the analysis instrument is the same than any other economic agent or counterparty of the market, the economic evaluation (from a social point of view) assess the main positive and negative externalities that derive from the Government's actions on the country's well-being and the financial stability that all Peruvians need in the long term[11].

Finally, the financial assets and liabilities of the Government could have different opportunity costs which would make that all asset operations (investments and granting

[10] Otherwise, for instance, in most of the cases, Government debt should be only granted in foreign currency with international financial organizations, which capital structure is formed to obtain better risk grades than the member countries, in order to access to lower debt costs, especially in stress situations.

[11] In some circumstances, from a financial (private) point of view, new public debt in dollars may be cheaper (not considering the short-term) but from an economic (social) point of view (long-term) an increase in dollarization means higher vulnerability to financial or currency crisis and a huge cost which is not incorporated in the financial evaluation. In addition to this potential higher cost, we should add the higher cost of public and private debt due to the lower sovereign risk rating of the Republic of Peru caused by the high dollarization. On the other hand, from the financial (private) point of view, convert foreign currency debt to national currency may seem cheaper than the issuance of public debt securities in national currency but this ex ante decision is based on a theory that do not assure the effective result of the ex post operations. Moreover, this decision does not consider that the Republic's great demand of derivatives is not only pushing the derivatives cost up for the local private sector but also easing the entry of foreign capital, see Du and Schreger (2013) "Local Currency Sovereign Risk", pushing the exchange rate up, which reduces the competitive position of the tradable sector of the economy, and also restrain the development of the public debt securities market and stops foreign debt decrease, that's why these costs will be reflected in a (social) economic evaluation. This is especially important when there is deficit in the checking account, because the foreign debt capacity is not unlimited as assumed in traditional flow models; the performance of the most affect by the recent international financial crisis, see Orpiszewski (2012) "What drives investors' demand for sovereign bonds in developed and emerging economies: fundamentals or market sentiment?".

of public credit) do not optimize as well as liability operations (debt and public debt securities issuance). Therefore, for instance, to finance public works within the framework of a global asset and liability management, the decision analysis should not only choose the cost of the different debt operations (liabilities) but also to contrast it with the return of current or future investment operations (assets). In this line, the following guidelines seek to ensure an optimal decision-making in a long-term vision, from an economic (social) and transparent point of view, in order to ease the subsequent rendering of account.

3.2 Basic principles for financial management

The basic principles are certain referential criteria or opinions that all institutional entities or units, regardless of its condition, should consider as methodological guidelines to plan permanently all the analysis process prior to decision- making.

Considering the international standards on financial management, the basic principles for an accurate global asset and liability management in all institutional entities or units that are part of the public treasury are:

a) Optimization of the risk and return/cost relationship

To optimize systematically the relationship between risk and return/cost in all possible operations that can be done or undone, it is important to prioritize: (i) the highest return or the lower cost in relation to the same level of risk and, (ii) the lower level of risk in relation to the same return or cost.

From this principle, we deduce that we should not look for the absolute highest return of assets or the absolute lower cost of liabilities without considering the involved risk but, on the contrary, we should maximize the net return or minimize the net cost between assets and liabilities with the same level of risk, exchange rate, interest rate and maturity date.

b) Centralize the liquidity of flows and fund balance

The liquidity of every institutional entity or unit should be managed on the basis of a centralization of all fund flows and considering not just incomes and outlays but also all flows generated or not by assets and liabilities in local currency, regardless of budget allocation.

The implementation of this principle will avoid that different groups of financial assets and liabilities (which are immobilized) with different opportunity costs that may be subject to arbitration on behalf of third parties, which may cause unfavorable and important transfers of net wealth, opposite to tax collection.

c) Comparison of alternatives over a same base

In order to choose between two or more alternative operations, regardless of its legal form, it is necessary to compare them including all relevant economic effects, even tax, regulatory or normative purpose (tax shield, tax credit, financial transaction tax, reserves requirements, margin calls and similar).

This key principle will ensure that the correction of the effects of monetary illusion that could generate different tax treatments, different treatments of financial supervision or

monetary regulation and different level of compliance of agreed safeguards in contracts or similar agreements creates value.

d) Prioritize competition in all levels

Competition in equal conditions between all possible alternatives and substitutes should be encouraged as the most effective and transparent mechanism in order to obtain the best financial conditions of asset and liabilities operations to be executed, in or off-balance sheet.

This principle not only facilitates accountability but also promotes a more dynamic and competitive environment in all levels, in the public sector and in the different economic sectors the public sector interacts with.

Box N° 2: Optimum profile of the Peruvian debt by market

The estimation of the optimal composition of internal and external debt results from the foreign exchange exposure equation presented by Calvo, Izquierdo and Talvi (2003) whom calculated the impact on the mismatches between the public debt and GDP's negotiable and non-negotiable sector during the crisis of the 1990s in many South American countries:

$$\text{Real exchange rate exposure} = \frac{\frac{B}{B+B^{*}e}}{\frac{Y}{Y+Y^{*}e}},$$

In this equation, "B" is the level of public debt in terms of non-negotiable prices; "B*" is the level of public debt in terms of negotiable prices; "Y" is the non-negotiable GDP, "Y*" is the negotiable GDP and "e" is the multilateral real exchange rate. The numerator represents the percentage of domestic public debt to total public debt and the denominator represents the percentage of non-negotiable GDP to the total production. When the compositions of public debt and GDP match with this indicator, it equals to 1 or 100% so it does not affect the fiscal sustainability.

	Multilateral Real Exchange Rate (B = 71% GDP)	
	Current	Optimal
Domestic Debt	42%	78%
Foreign Debt	58%	22%
Mismatch	0.53	
	(B = 65% GDP)	
Domestic Debt	42%	76%
Foreign Debt	58%	24%
Mismatch.	0.55	

Source: MEF - DGETP

To perfectly match the public debt and GDP with a constant production, it is necessary a 78% and 22% of domestic and external debt, opposite to the current structure of domestic and external debt which are 42% and 58% respectively. Likewise, a second scenario for the approximate variable of the non-negotiable GDP was analyzed and as a result an optimal profile of 76% and 24% for domestic and external public debt was obtained.

Finally, the exposure of the real exchange rate variation is approximately 53% - 55%, which is a low exposure because it is closer to 100% than the 10% obtained during the crisis of the 1990s thanks to the higher issuance of public debt in soles in the last decade. However, this indicator could improve even more by reducing external debt in 34% - 36%, eliminating 38.8 billion soles of external debt and increasing the same amount of public debt securities in soles.

3.3 Financial policies for the asset and liability management

In general, policies are long-term orientations or guidelines that should be considered in the decisions of particular subjects and, therefore, they formulate risk appetite and tolerance. These policies may include the definition of objectives[12] and goals[13] or alarms[14] and limits[15] depending on the established flexibility degree to obtain the most favorable structures to avoid or confront the worst crisis scenarios.

All actions that will be executed or not in the global financial asset and liability management of institutional entities or units that are part of the Public Treasury, should consider the following main financial policies:

a) Develop the securities market increasing the public debt in soles

The public debt securities market in local currency is one of the most important pillars for the development of any domestic financial system, comprised of financial entities and the three most important markets: stock, exchange and bond market. A developed financial system creates more value to the country because the real sector companies become more competitive internationally. However, in spite of the efforts to decrease direct public debt in dollars, it still reaches approximately 50% and, the size of the public debt securities market in soles barely surpasses 6% GDP; more than 50% of the public debt in soles has not been traded on a centralized trading system without using the delivery versus payment principle, which favors market dominance and fragmentation.

To reduce these gaps, the Government will increase the number of regular public debt securities auctions and transparent trading will be encouraged through authorized centralized systems with definite settlement using the delivery versus payment principle, where Public Treasury will participate with the specific purpose of developing the market as the principal means to obtain domestic savings and financial inclusion. Thus, in 2017 we expect to reduce the public debt dollarization to 30% and to increase the size of the public debt market in soles up to 10% of GDP, with a 100% of settlements using the delivery versus payment principle, supervised and competitive trading and at least an 80% of trading frequency. This effort also shows our will to reduce financial dollarization of credit granted to the private sector, which does not only represent an important systemic vulnerability for the country's financial stability, but also an obstacle to achieve higher risk rating levels[16].

b) Maintain liquidity reserves to face situations of instability

To strength the development of the public debt securities market allows the Public Treasury to reduce the costs of the Public Treasury's savings and liquidity management

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12 The objectives are the aims of the operational actions that are executed by the entities, considering the guidelines and political framework.

13 The goals are quantitative signs that show or monitor how we are reaching the planned objectives, according to the principles, policies and other guidelines.

14 Warnings are minimum or maximum magnitudes of certain indicators, as part of a periodic surveillance. When these warnings are temporally violated, certain procedures or reaction activities are executed.

15 Limits are minimum or maximum sides of certain indicators as part of a periodic surveillance, which if violated, will jeopardize the internal control system.

16 Unlike the decade of the 90's, in the decade of 2000, worldwide governments have been reducing the issuance of foreign currency debt in favor of local currency debt, which has made the EMBI+ lose consistency as a sovereign risk indicator. The sovereign risk spread of many countries' debt in foreign currency, especially in periods of economic crisis as the last years, has showed a higher correlation than the debt issued by these countries in local currency, which gives a lower or higher diversification, respectively. See Du and Schreder (2013) "Local Currency Sovereign Risk".

and the financial system in general, because it will reduce the uncertainty of the securities holders about the future liquidity and price risk of those securities. This also will generate an improvement in the State's funding and refinancing capacity, minimizing the related costs. However, there are situations of instability that could jeopardize this virtuous circle.

Therefore, the best international practices suggest not only the maintenance of a basic cushion of liquid financial assets or a primary liquidity reserve for regular times and an active management of financial liabilities to maintain the interest of the financial markets, but also the constitution of an additional cushion or secondary liquidity reserve to face stress situations that are not considered as severe situations which would make necessary to use the savings of the Fiscal Stabilization Fund. Government should be able to use to this reserve when collected income is temporally insufficient or in the case of closed markets, in order that Government can meet all the budgetary obligations, as part of a consistent liquidity contingency plan.

c) Make profitable the public funds and reduce the cost of its liquidity

To ensure fiscal balance in the long-term –in addition to the liquidity reserves - it is necessary to accumulate surplus savings of the favorable periods of the economic and financial cycle in order to use them later in periods of slower growth, instead of procyclically turning to a probable closed market. However, in order to maintain the purchase capacity of these savings and reduce the cost of liquidity, it is necessary to implement appropriate mechanisms so that these funds generate return according to its opportunity cost on the market principally through treasury securities derivatives, diversifying the systemic risk through the elimination of counterparty concentration, from the day in which they are paid by each taxpayer.

In this regard, the Government is taking all the necessary steps in order to collect tax revenue through index-linked deposits directly on bank accounts in the name of the Public Treasury. Through these deposits, the tax agent can automatically identify the nature of the income, as well as all the taxpayer characteristics. Thus, it will be easier to implement an active cash management in the market, with regular auctions of funds collaterized with the Public treasury securities, just as public treasuries of many countries do, without affecting the financial stability and generating significant additional revenues that will enable the Public Treasury to accelerate its modernization process and reduce the difference in the level of infrastructure between the State and the private sector.

d) Reduce the procyclicality of the external debt as a cause of vulnerability

The procyclical evolution of the total external debt (private and public), could be one of the vulnerability factors that may cause financial or credit crisis in the future, as it has happened in past decades in Peru and recently in some developed countries, even though they did not have problems with financial dollarization[17]. The empirical evidence shows that countries with important levels of domestic savings were not in crisis or it was not severe, in spite of having a higher total debt, domestic and external, public and private debt than countries that were in crisis.

In a context in which the Peruvian private sector has increased rapidly its external debt in recent years, maintaining the current account deficit financed with foreign savings, the

[17] Relevant foreign debt may cause vulnerability even if it is not denominated in foreign currency. If the concessional and refinancing conditions are established in foreign markets, the sustainability will not depend only in the local market conditions, unlike domestic debt which is determined basically by internal macroeconomic policies.

institutional units that are part of the Public Treasury will help to promote that private and public financing should rely on domestic savings rather than foreign savings in order to reduce the vulnerability that may affect the financial stability of Peru. By doing so, we expect to reduce the external public debt to 30% in 2017, an optimal level for Peru to face a crisis, when probably all savings will be used. (See chart 2).

e) Maintain a sound financing structure of the indirect debt

In a country such as Peru, with a big infrastructure deficiency and a fiscal policy goal to stabilize the indirect and direct debt ratio to GDP, public works concessions with the private sector becomes inevitable. However, in cases of self-sustaining or co-financed concession projects, indirect debt- that includes guarantees, bonds or other Government financial guarantee to third parties - must be limited to those projects that ensure a sound economic and financial balance during the time each operation last, according to the best international practices.

From the financial concept of each project, the goal is to count with effective contractual and structural mechanisms that allow to reestablish an adequate distribution of incentives and risks over the project life, ensuring an average return to the private participation based on the risk associated with the sector involved, only if the private sector meet all the responsibilities. Also, they will ensure that the indirect public debt could transform into direct public debt according to the guidelines, policies, goals and targets of the current financial strategy. In addition, in order to enhance transparency, it is necessary to accelerate the process that units control and equity accounting of all public works concessions, following the best international practices and the current international standards with the adoption of the International Public Sector Accounting Standards Board (IPSASB)[18] and the MEFP 2001-2014 (Government Finance Statistics Manual 2001-2014).

f) Ensure the sustainability of the net public debt

In an environment of high export prices and fiscal surpluses, the maintenance of at least an optimal amount of gross public debt is mainly justified by the greater need to maintain a yield curve free of risks as a reference. This will facilitate the access of local firms to the local securities market in order to obtain financing and also will support the development of the financial system in national currency.

The savings that are derived from accumulated surplus decreased the net public debt stock and will ensure fiscal sustainability, even in future severe stress scenarios, because we will anticipate the ability to pay the advance gross debt so we avoid increasing debt in the worst moments to look for financing in the markets; this is, when

[18] Accumulation (or accrual basis accounting) describes the effects of transactions and other events or circumstances on economic resources and the rights of the creditors of the entity that provides information, even if payments and receipts are paid in a different period. This is important because the information of economic resources and the rights of the creditors of the institution that provides information and its changes during a period of time gives a better basis to evaluate past and future yields of the institution than just the information about payments and receipts in the period. The information concerning the financial yield of the institution that informs during certain period, reflected the changes in its economic resources and the rights of the creditors which are different than obtaining additional resources directly from investors and creditors helps to evaluate the past and future capacity of the institution to generate net effective incomings. This information shows how much the institution that provides information has increased its disposable economic resources and, in this way, its capacity to generate net effective incomings through operations instead of obtaining additional resources directly from investors and creditors. The information about the financial yield of the institution that provides information during a certain period can also show how much the changes in market prices or interest rates have increased or reduced the economic resources and the creditor's rights and, in this way, affect the institution's capacity to generate net effective incomings. See IFRS Foundation (2010) "The conceptual framework for financial information".

the risk premium soars, as it happened in the recent international financial crisis, even in many industrialized countries. In a countercyclical way, we expect to count with large available credit lines granted by multilateral agencies, as part of the liquidity contingency plans.

Box N° 3: Best practices in public works concessions

Over two decades, public-private partnership (PPP) has promoted investments in public works and services, as well as the infrastructure development, which were exclusively managed by the public sector in the past. According to international experience, there is a consensus on recommendations for the basis of tender procedures for construction, financing and operation of infrastructures.

a) Equal distribution of risks between the Government and the concessionaire:
- To maintain the economic-financial balance and to count with contractual mechanisms to correct imbalances that may cause detrimental to the parties during the time the concession lasts.

b) Fair determination of the minimum and average return:
- The minimum return for the concessionaire should not exceed the risk-free rate.
- The average return should include the risk premium related to a specific investment sector.
- An agreement to obtain returns in the functional currency of the Government, in nominal or real terms (linked to inflation).

c) Compensation for demand risk:
- Concessionaires should be compensated when there is no minimum demand.
- Government should participate in the profit distribution when the return of the concessionaire is above the average.

d) Ensure an efficient system to evaluate the compliance of the commitments :
- Reward or punish the profits of the concessionaire, following assessable criteria, according to the state of preservation and the availability of the infrastructure.
- High technical qualified staff is required to guarantee quality monitoring.

e) Investments made by concessionaires with high technical and economic standards:
- Provide optimal services, which should be the result of a continuing improvement program according to people's needs during the time the concession lasts.
- Government should be able to redefine the obligations of the concessionaire in order to keep high service standards.

f) A sound and sustainable financial structure:
- 30% of the capital contributions by the concessionaire in order to avoid asset devaluation as it happened in the countries in crisis.
-Capital expenditure: at least 75% in the first year and 25% within two years after the contract has been signed.
- The periods for financing should be shorter than the life of real assets in order to guarantee the financial sustainability.
- Government's guarantees and deposits should use the same currency than the incomes resulting from the infrastructure service; in this way, future currency mismatches that could affect fiscal sustainability are avoided.

g) Ensure the real transfer of risks to the concessionaire:
- Ensure the real transfer of construction, demand and availability risk so that the concessions debts do not affect public debt or the credit rating.

3.4 Tactical guidelines for structural risk management

In general, tactics are methods that are planned to execute or achieve specific goals or a specific order of things; for instance, to implement a section of a strategy and reach some goals and targets, meeting the basic principles and financial policies. In this way, tactics help to monitor the improvements in the decision-making, without using any theory that had not been put into practice. (See chart N° 4).

In that sense, key tactic guidelines for an accurate structural balance sheet risk management which affect the assets and liabilities of the institutions that are part of the Public Treasury are the following:

a) Optimize the liquidity risk management

Sufficient liquidity reserves are necessary in order to avoid losses due to failure to pay or difficulties to reach higher accounts receivable financing and to prove that the Government counts with enough liquidity to meet stress situations. However, as a higher liquidity means a higher cost, a continuing optimization to minimize the opportunity cost of liquidity and not to affect the monetary policy is necessary.

b) Countercyclical position to face interest rate risk

In order to avoid systematic losses due to interest rates variations in reasonable asset and liability values or in future financial revenues and outgoings flows, it is necessary to identify periodically the phase of the interest rate cycle. For instance, if the inflation rate has been reducing systematically under the inflation targets, then, the nominal interest rates will tend to fall, and vice versa.

c) Exchange rate risk diversification

To prevent losses due to exchange rate risk variations, the first option is to avoid currency mismatches and get into debt or save money with the same currency indexed to revenues or outlays. However, if avoiding this exchange rate position is not possible, to adopt decisions based on a periodical long-term and cost-benefit analysis; this is, to choose between diversifying exchange rate risk with currencies that have low or negative correlation considering the cyclical position of the interest rates, or to hedge using derivatives or not to hedge considering the cyclical position of the exchange rate trend and the implicit and explicit costs.

d) Concentration risk control

The probabilities of loss due to concentration risk are high: by counterparty, product, guarantee, sector, country, market, etc. Thus, to minimize the possible systemic losses due to concentration, the most effective is diversification with appropriate alerts and limits or coupons. In partially dollarized economies, the systemic losses are caused principally by the credit risk derived from exchange rate risk, so that it is necessary to count with exchange rate credit risk ratings.

Box N° 4: Main theories of interest rates and exchange rates

Theories are hypothesis whose consequences may apply to a science or a part of it; they are also a group of laws that relate diverse phenomena. We can resort to these theories which are a complement to establish the decision-making as long as empirical evidence can corroborate it. The main theories of interest and exchange rate behavior and the recent empirical results are:

a) Expectations hypothesis: Long-term profitability of securities are related to future expectations of risk-neutral agents.
- Empirical evidence: implicit forward rates do not predict in practice future spot rates.

b) Preferred habitat hypothesis: Investors are risk-averse and demand an attractive risk premium to leave their habitat.
- Empirical evidence: The differential between the implicit forward rate and future spot interest rate expectations include risk premium.

c) Stochastic-process models: the evolution of temporary interest rate structure responds to an stochastic process with no possibilities of arbitrage.
- Empirical evidence: Financial variables such as interest rates tend to revert to the average in front of the impossibility of grow or decreasing indefinitely.

d) Purchasing power parity: In the long term, the prices of goods in different countries establish the exchange rate between two currencies.
- Empirical evidence: The transaction of all goods and services is not possible, factor productivity, tariff and non-tariff barriers, transportation costs and price rigidity in the short term affect the PPP.

e) Traditional flow models: Exchange rate variations results from the supply and demand of currencies which results from international flows that come from imports and exports.
- Empirical evidence: It is possible to find an equilibrium exchange rate even when a current account deficit persists because a very high domestic interest rate could allow net capital inflows, which is not sustainable in the long term.

f) Uncovered interest rate parity: The law of one price applied to the financial markets states that the difference in interest rates between two countries is equal to the expected change in exchange rates between the countries' currencies.
- Empirical evidence: The hypothesis of efficiency in the foreign exchange market is rejected as well as the hypothesis that agents use all information and that they are risk neutral without showing any preference for specific assets.

g) Interest rate parity: The rate of return in foreign assets investments is similar to investments in local currency assets with the same characteristics considering the foreign exchange hedge.
- Empirical evidence: After the transaction costs are covered, only in the short-term there is a relationship between forward currency and the difference in interest rates when there is no risk aversion.

h) Real interest rate parity: The inflation-adjusted return should be equal across countries.
- Empirical evidence: Real interest rates are not stable and equal in all countries because an expected inflation measure is necessary and this is not always possible.

i) Assets or balance sheet model: The capital account of the balance of payments is essential for the international demand of assets fund. There is no perfect substitutability between financial assets with different currencies; there is a risk premium.
- Empirical evidence: Exchange rate volatility is bigger than fundamentals.

j) Models with new information: The empirical regularities of the variables are the base of the model. The exchange rate is defined as the price of an asset that changes according to relevant information
- Empirical evidence: These models use latent variables. It is impossible to realize predictions because these models are based on information that agents cannot predict.

k) Speculative bubbles: Variables take different long-term values. Agent's wrong perceptions are widespread until reality shows the contrary and the bubble burst
- Empirical evidence: Models cannot distinguish speculative bubbles from changes in fundamental exogenous variables of the model.

l) Models with heterogeneous expectations: Agents do not always use rational expectations because there are different valuations: i) technical analysis and ii) fundamental analysis.
- Empirical evidence: The same levels of economic fundamentals could generate multi-market equilibrium.

3.5 Main objective of the Strategy

Once that the referential framework of the guidelines for the asset and liability management is established to be observed permanently by all institutional entities or units that are part of the Public Treasury in order to execute all its operations, the main objective of the Strategy is:

A responsible and sustainable management of public finance, minimizing the cost of liabilities, maximizing the yield of assets, subject to the maximum risk level established by the guidelines for the global asset and liability management. To achieve this goal, it is necessary to develop the public debt securities market in local currency in order to cover temporary financial requirements that derive from the management of debt, savings and treasury.

In this sense, the participation of the Public Treasury in the market looks for reaching an equilibrium between the predictability that any issuer of sovereign benchmark bond needs in order to develop the market by increasing the number of regular auctions and, the flexibility to face volatile and integrated financial markets with the periodic ad of special auctions of temporary or permanent repurchase or resale of bonds.

4. FINANCIAL ASSETS AND LIABILITIES OF THE CENTRAL GOVERNMENT

The direct financial assets and liabilities that are part of the Central Government's financial balance sheet constitute the basis to determinate the Government's gross and net debt. The Central Government is an institutional unit from an economic point of view which is relevant for the elaboration of financial statements according to the International Public Sector Accounting Standards Board and whose creditworthiness is subject to evaluation and sovereign risk rating.

According to the international standards for fiscal statistics, the definition of Central Government to determine the coverage of relevant financial assets and liabilities above mentioned belong to the definition of budgetary Central Government[19] of the Government Finance Statistics Manual 2001-2014 of the IMF, excluding the assets and liabilities of the entity in charge of providing deducible health care (EsSalud) or the entity in charge of providing deductible pensions (ONP)[20].

In addition, following the principles established in the International Accounting Standards and the International Financial Reporting Standards, the measurement is made in national currency because it is the functional currency of the Central Government, of the budget and most of tax and non-tax revenues.

4.1 Financial assets (gross savings)

On December 31st, 2013, the total financial assets[21] of the Central Government reached S/. 58.3 billion, of which S/. 27.4 billion are assets in national currency and S/. 31.05 billion in foreign currency, which are made up with funds of regular resources and the Stabilization Fund, respectively. (See Chart N° 2)[22].

When we revise the group of accounts that constitute assets, we note that term deposits are the main instrument that make the funds profitable. At the fourth quarter, 67.6% of the total assets belongs to term deposits of the Central Reserve Bank of Peru. The concentration of these deposits in the CRB currently does not respond to an optimization of risk/return, but to the lack of agreements with other institutions inside and outside the country that would allow the Public Treasury to diversify its assets just as other countries do. This is especially relevant if we consider the excess liquidity after the treasury complies with its financial obligations.

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19 The definition of central government involves all the units that are part of the executive, legislative and judicial powers but do not include entities that are different institutional units such as universities, welfares, monitoring organizations or other autonomous units that, along with Central Government and other institutional entities or units that belong to this government level, are part of the Central Government sector.

20 Assets (like savings managed by the Consolidated Fund of Reserves) or liabilities (such as the "recognition bonds" that are managed by the ONP) are not included in order to ease the comparison with other countries that do not include their assets (savings) neither their liabilities (debt) related to the contributory social security.

21 In stricto sensu, the Central Government' equity share in the public companies was not added to the total financial assets of the Central Government because there was not audited information at the end of 2012. Obviously, this total does not include financial assets of the Regional and Local Governments, neither the financial or not financial public companies, nor the entities that are part of the extra budgetary Central Government.

22 The Regular Resources funds represents the 69% of the total balance of the Disposable account and the Fiscal Stabilization Fund equals to the 83.5% of the total restricted funds at the end of 2013.

Table N° 2
Financial asset position

	Balance Dec2012 (B S/.)	Part. (%)	Balance Sep2013 (B S/.)	Part. (%)	Balance Dic2013 (B S/.)	Part. (%)	Quarterly changes (%)
By availability							
Disposable income	**27.69**	**53.2%**	**26.18**	**44.0%**	**26.16**	**44.8%**	**-0.1%**
Demand deposits	12.92	24.8%	11.88	19.9%	10.76	18.4%	-9.2%
Term deposits	14.76	28.4%	14.34	24.1%	15.40	26.4%	7.4%
Accounts receivables	**3.67**	**7.1%**	**3.92**	**6.6%**	**3.41**	**5.8%**	**-12.9%**
Transfers	3.66	7.0%	3.90	6.6%	3.41	5.8%	-12.7%
Derivatives	0.006	0.0%	0.016	0.0%	0.006	0.0%	-65.2%
Restricted funds	**20.68**	**39.7%**	**29.40**	**49.4%**	**28.78**	**49.3%**	**-2.1%**
Demand deposits	2.41	4.6%	5.58	9.4%	476	8.2%	-14.6%
Term deposits	18.26	35.1%	23.82	40.0%	24.02	41.2%	0.8%
TOTAL	**52.04**	**100.0%**	**59.50**	**100.0%**	**58.35**	**100.0%**	**-1.9%**

Source: MEF-DGETP

On the other hand, if the Public Treasury would have received the market interest rates that financial institutions with better risk rating pay to other public institutions for term deposits and demand deposits then, the Public Treasury would have obtained an additional financial income of S/. 270.4 million in the last 12 months. Although, in the present context of inflow foreign flight capital, the need for more sterilization policies would have been higher, which would meant bigger capital contributions to the Central Reserve Bank.

4.2 Financial liabilities (gross debt)

At the end of 2013, the Central Government's financial liabilities[23] reached S/. 88.61 billion, 2.0 % higher than the previous year (See Table N° 3).

By jurisdiction, the external debt[24] represents 54.1% of the total debt, a 5.5% less than the previous year, while 73.0% are outstanding securities in the markets, compared with 67.5% the last year.

In the last 12 months, outstanding securities increased in 10.4% and credit and loans reduced in -13.9%. In the last quarter of year, S/.526 million[25] in bonds and bills were issued under the regular auction program in order to support regional and local governments. They helped to increase the participation of outstanding securities in national currency on the total debt. Likewise, in the first and second quarter of the year, the prepayment of loans to the World Bank and the International Development Bank reached S/. 4. 42 billion, S/. 994 million in March and S/. 3. 42 billion in April. These loans were replaced with new obligations in local currency with more favorable conditions for Peru; to do so, the Peruvian Government issued sovereign bonds maturing in 2023 and 2042 for S/. 3.09 billion: S/. 1.90 billion in February and S/. 1.18 million in April. The remaining position of the prepayment was cancelled with accumulated resources of the

[23] Traditionally, the Public Debt Annual Report submitted to the Congress includes not only the domestic and foreign gross debt, but also includes the foreign debt of the Regional and Local Governments and financial/non-financial public companies, as well as the projected reserve liabilities of the ONP that are related to guarantees for the recognition of the contribution made by workers that changed their retirement pension system from the public system to the private system.

[24] The foreign debt responds to the legal jurisdiction of the market in which the debt contract was made before the residence of the creditors or debt holders.

[25] S/. 457 million in regular auctions and S/. 69 million to support the Regional and Local Governments.

Public Treasury. This operation increased the securities debt in the second quarter in 4.8% and reduced loans in -9%.

Table N°3
Financial liability position

	Balance Dec 12 (B S/.)	Part. (%)	Balance Sep 13 (B S/.)	Part. (%)	Balance Dec 13 (B S/.)	Part. (%)	Quarterly variation (%)
Securities	**58.63**	**67.5%**	**63 88**	**73.0%**	**64.72**	**73.0%**	**1.3%**
Public Treasury bills	0	0.0%	0.12	0.1%	0.28	0.3%	127.0%
Global bonds	24.12	27.8%	26.31	30.0%	26.47	29.9%	0.6%
Sovereign bonds	32.24	37.1%	35.35	40.4%	35.87	40.5%	1.5%
Other bonds	2.26	11.4%	2.10	2.4%	2.11	2.4%	0.1%
Credit and loans	**27.21**	**31.3%**	**23.16**	**26.4%**	**23.42**	**26.4%**	**1.1%**
Multilaterals	19.21	22.1%	15.70	17.9%	15.75	17.8%	0.3%
Paris Club	6.19	7.1%	5.82	6.6%	5.46	6.2%	-6.1%
Others	1.82	2.9%	1.64	1.9%	2.20	2.5%	34.5%
Payables	**1.06**	**1.2%**	**0.53**	**0.6%**	**0.47**	**0.5%**	**-10.8%**
Derivatives	1.06	1.2%	0.53	0.6%	0.47	0.5%	-10.8%
TOTAL	**86.90**	**100.0%**	**87.57**	**100.0%**	**88.61**	**100.0%**	**1.2%**

Source: MEF-DGETP

It is important to highlight that the Regular Treasury Auctions Program includes the weekly issue of bills, nominal bonds and real bonds (inflation-indexed bonds) that begun in the third quarter of the year. The main objective of the program is to inform periodically to the market participants about the benchmark bonds in the sovereign curve. These auctions have made a small change in the structure of the Central Government's funding because the amounts issued were not big enough to develop the market, even in an adverse international scenario.

4.3 Net public debt

At the end of 2013, the gross debt (financial liabilities) of the Central Government was reduced thanks to the accumulated savings (financial assets); and this gap determines the exposition to the structural balance sheet risk.

Table N° 4
Central Government's Net debt

Currencies	Financial assets		Financial liabilities		Net debt	
	Balance Dec2012 (B S/.)	Balance Dec2013 (B S/.)	Balance Dec2012 (B S/.)	Balance Dec2013 (B S/.)	Balance Dec2012 (B S/.)	Balance Dec2013 (B S/.)
Soles	27.52	27.36	37.54	40.57	10.03	13.21
Dollars	21.83	28.61	42.18	41.34	20.35	12.73
Euros	0.271	0.30	2.43	2.92	2.16	2.62
Yen	2.42	2.08	4.44	3.64	2.02	1.57
Others	0	0	0.307	0.13	0.307	0.132
Total	**52.04**	**58.35**	**86.90**	**88.61**	**34.86**	**30.26**
Position / GDP(base year 1994)	9.9%	10.5%	16.5%	15.9%	6.6%	5.4%
Position / GDP(base year 2007)	10.2%	10.8%	17.1%	16.4%	6.8%	5.6%

Source: MEF-DGETP

In this sense, net debt represents about 34.2% of gross debt, and last year represented 40.1%. At the end of 2013, net debt equaled 5.6% GDP (see Table N°4) showing a 1.2% decrease regarding last year, but a quarterly increase and a trend shift since the second

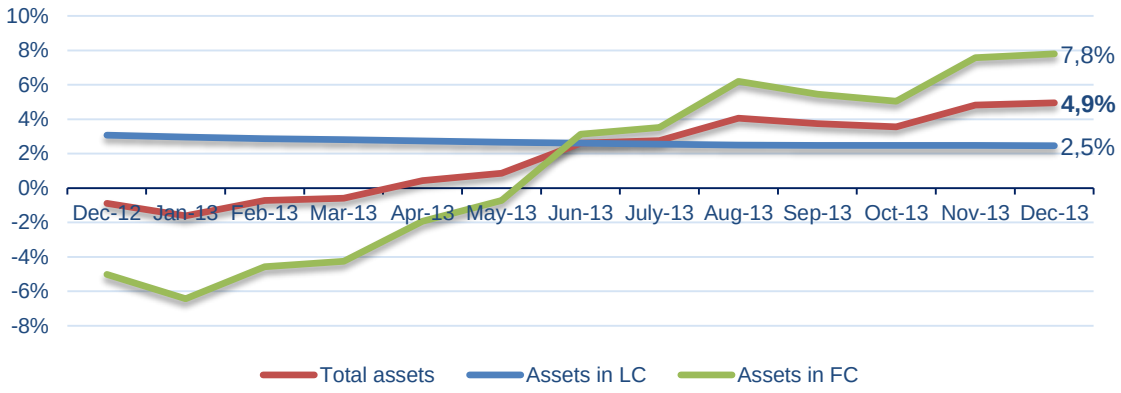
half of the year. This is due to the seasonal decrease of the total assets, because of the reduction of the disposable income due to lower tax collection and budgetary expenses. Net debt would be lower if the financial assets that are part of the Central Government's equity participation in public companies and entities would be included[26].

4.4 Return and costs

The equivalent return and cost presented below have been calculated considering cash in local currency that the Central Government obtained and disbursed in the last 12 months for their investments and obligation agreements, taking into account the effect of the exchange rate variation on the return and the cost of foreign currency operations, as well as variable interest rate and indexed instruments.

In the case of financial assets, the effect of exchange rate adjustment during 2013 -mainly the US dollar- due to the market expectations on quantitative stimulus, has increased the return of financial assets in foreign currency expressed in soles, despite the Public Treasury's interest rates are still low. (See Table N° 5)

Graph N° 1
Performance of Financial Assets expressed in local currency



Source: MEF-DGETP

At the end of 2013, the annual percentage rate of the total financial assets in soles was 4.9%, the previous year was -0.9%. We note that assets in foreign currency adds volatility to the return of the total assets.

Table N° 5
Performance of Financial Assets 2013

	Dec 2012		Sep 2013		Dec 2013	
	In soles (%)	Country's currency (%)	In soles (%)	Country's currency	In soles (%)	Country's currency (%)
Disposable income	**2.1%**		**2.9%**		**2.9%**	
Soles	3.1%	2.8%	2.5%	2.5%	2.4%	2.4%
Dollars	-5.3%	0.1%	7.0%	0.1%	9.3%	0.0%
Euros	-4.9%	0.1%	11.5%	0.0%	12.4%	0.0%
Accounts receivable	**-2.8%**		**-5.0%**		**-2.8%**	
Soles	4.5%	4.4%	4.2%	4.2%	3.6%	3.6%
Dollars	-3.4%	2.2%	9.1%	2.2%	11.5%	2.1%

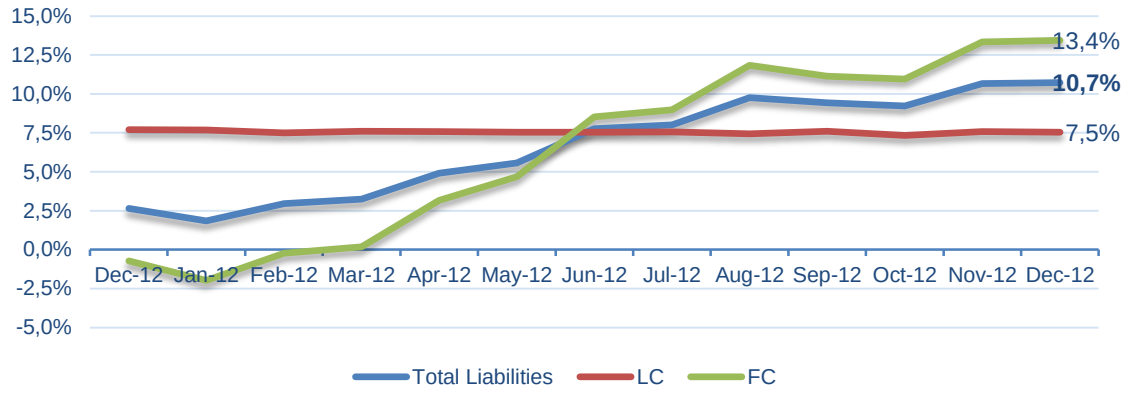
[26] At the end of 2012, the net worth of the institution and financial/non-financial companies that are part of the Central Government, equaled to approximately 3.1% GDP at the end of 2012 (to calculate, we considered the 2011 net worth of Osinerming, Ositran, Indecopi and Sunat because we did not count with information at the end of 2012).

Euros	3.2%	2.3%	14.1%	2.3%	14.5%	1.9%
Yen	-4.4%	1.9%	-13.5%	1.6%	-11.7%	1.6%
SCP	-2.5%	2.9%	9.4%	3.0%	11.2%	3.1%
Restricted funds	**-4.4%**		**6.2%**		**8.2%**	
Soles	3.0%	2.7%	2.4%	2.4%	2.5%	2.5%
Dollars	-5.4%	0.1%	7.0%	0.04%	9.2%	0.0%
Euros	-4.9%	0.1%	11.5%	0.00%	12.4%	0.0%
Total	**-0.9%**		**3.7%**		**4.9%**	

Source: MEF-DGETP

The effect of the exchange rate has had an impact on the liability cost, because most of foreign debt is expressed in US Dollar. Thus, at the end of December 2013, the average equivalent annual cost of the total financial liabilities (see Table N° 6) in soles was 10.7%, which showed a considerable rise compared to 2.6% of the previous year.

Graph N° 2
Performance of the financial liabilities in national currency



Source: MEF-DGETP

The increase in the annual cost of liabilities is bigger than the increase in the annual return on assets because of: (i) the higher dollarization of total liabilities compared with the total assets; (ii) the volume of liabilities is bigger than the volume of assets and (iii) interest-inelastic assets are greater than interest-inelastic liabilities.

Table N° 6
Financial liability cost

	Dec 2012		Sep 2013		Dec 2013	
	In soles (%)	Country's currency (%)	In soles (%)	Country's currency (%)	In soles (%)	Country's currency (%)
Securities	**5.4%**		**10.5%**		**11.4%**	
Public Treasury bills			**4.2%**		**4.0%**	
Soles			4.2%		4.0%	
Sovereign bonds	**7.9%**		**7.8%**		**7.7%**	
Soles	7.9%	7.9%	7.7%	7.7%	7.7%	7.8%
Global bonds	**2.3%**		**14.5%**		**16.9%**	
Dollars	2.1%	7.6%	14.4%	7.4%	16.7%	7.4%
Euros	8.1%	7.5%	18.9%	7.5%	19.9%	7.5%
Public Treasury bonds	**5.7%**		**7.8%**		**8.2%**	
Soles	6.3%	6.3%	6.2%	6.2%	6.2%	6.2%
Dollars	2.4%	8.0%	15.0%	8.0%	17.3%	8.0%

Brady bonds	**-2.0%**		**11.0%**		**13.3%**	
Dollars	-2.0%		11.0%	4.1%	13.3%	4.1%
Credit and loans	**-2.7%**		**7.3%**		**9.1%**	
Soles	6.6%	6.6%	6.2%	6.2%	6.3%	6.2%
Dollars	-2.9%	2.6%	11.9%	4.9%	13.7%	4.9%
Euros	3.2%	2.6%	14.2%	2.6%	15.0%	2.6%
Yen	-4.2%	2.1%	-13.2%	2.1%	-11.2%	2.1%
Others	-2.5%		9.2%		11.9%	
Total	**2.6%**		**9.4%**		**10.7%**	

Source: MEF-DGETP

Therefore, the equivalent annual cost, which is the difference between the average equivalent annual cost and the average equivalent annual return, showed a growing trend during the year (see Table N° 7).

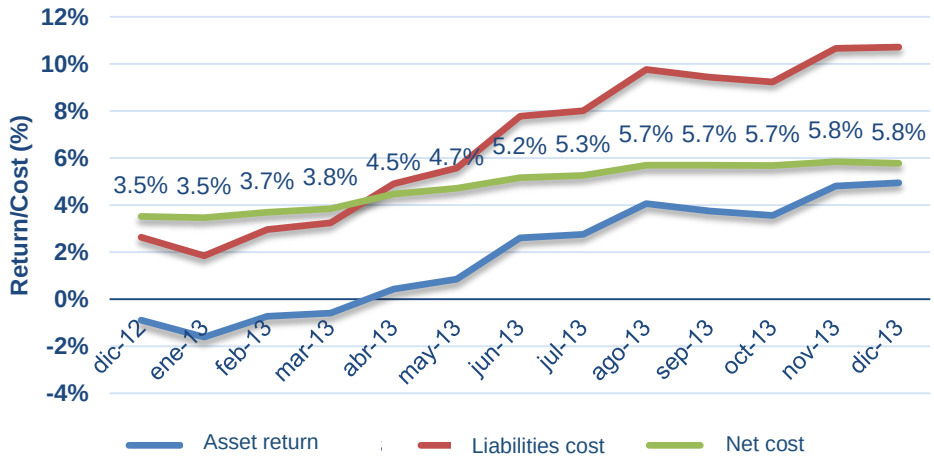
The growing trend of the net cost is mainly due to a greater dollarization in the liability structure than the asset structure. Therefore, the exchange rate has a bigger impact on the total cost of debt than the total return on assets. In addition, liabilities in foreign currency have a longer maturity than assets, increasing the financial cost related to the financial income that the Public Treasury receives.

Table N° 7
Central Government's net cost per currency

Currencies	Financial assets		Financial liabilities		Net debt	
	Yield Dec2012 (%)	Yield Dec2013 (%)	Cost Dec2012 (%)	Cost Dec2013 (%)	Net cost Dec2012 (%)	Net cost Dec2013 (%)
Soles	3.1%	2.5%	7.7%	7.5%	4.6%	5.1%
Dollars	-3.7%	7.2%	-0.1%	15.6%	3.6%	6.0%
Euros	-2.0%	14.2%	5.2%	17.1%	7.2%	2.9%
Yen	-4.4%	-11.7%	-4.2%	-11.2%	0.2%	0.4%
Other	-2.5%	11.2%	-2.5%	11.9%	0.1%	0.7%
Total	**-0.9%**	**4.9%**	**2.6%**	**10.7%**	**3.5%**	**5.8%**

Source: MEF-DGETP

Graph N° 3
Performance of the net cost of debt expressed in national currency



Source: MEF-DGETP

Therefore, net debt in dollars should be equal to zero (0) and the elasticity of returns and cost should be equal in order that the net cost will not increase before the exchange rate shifts. It implies that the length of assets and liabilities should be the same so there will not be differences due to shifts in the curve slope, and also assets and liabilities should be traded in the same market or markets with a lower basis risk.

5. STRUCTURAL BALANCE SHEET RISK

The structural balance sheet risk is defined as the possibility of suffering potential losses derived from adverse movements in the interest rate curves, exchange rates, or in the relative liquidity of the markets due to interest rate, currency, and maturity mismatches in the asset and liability management. It is also due to mismatches in asset and liability concentrations that cannot offset before sudden changes in financial conditions in different markets, such as credit risk derived from exchange rate risk.

In this sense, we will continue monitoring using different tools according to the level of complexity of the Central Government's financial assets and liabilities in order to take necessary measures to manage risk in a market movement situation.

5.1 Liquidity risk

The liquidity risk is the possibility of incurring losses when it is not possible to finance an increase in the volume of assets (such as an increase or replenishment of liquidity reserves), or to meet obligations (reduce liabilities that will mature and cannot be refinanced) through cash or another financial asset.

For measuring and monitoring the liquidity risk, we have used: a liquidity gap table (matching), that includes the financial assets and liabilities[27] and shows the gaps generated by maturities distributed in time periods, and the Liquidity Coverage Ratio (LCR)[28] which includes available, liquid and high quality assets to meet cash outflows.

a. Asset-liability matching according to the residual term

Considering the analysis of the liquidity gap, we note that the total mismatch of assets and liabilities in national and foreign currency is positive until a time period of 2 years, whereas the time period last year was 3 years (see Graph N° 4). It means that, despite the Central Government has enough money to cover its financial obligations (principal and interest) for the next two years by using its liquid assets[29], there is a slight decrease in the liquidity volume compared to last year.

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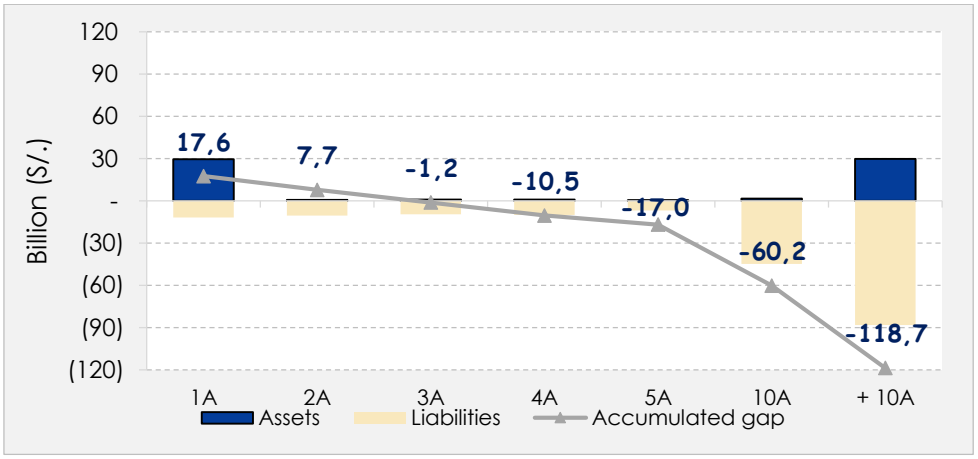
27 We include the balance of assets/liabilities and the flows of future interest receivable and payable under a conservative criteria.

28 Measure recommended by the Basel Committee on Banking Supervision to monitor and control the liquidity risk of the financial entities.

29 In the liquidity analysis per periods of time, the resources of the Fiscal Stabilization Fund can be found in the last period in order to measure the Central Government's capacity to deal with its liabilities with the most liquid resources, even though this Fund may be used in a crisis scenario.

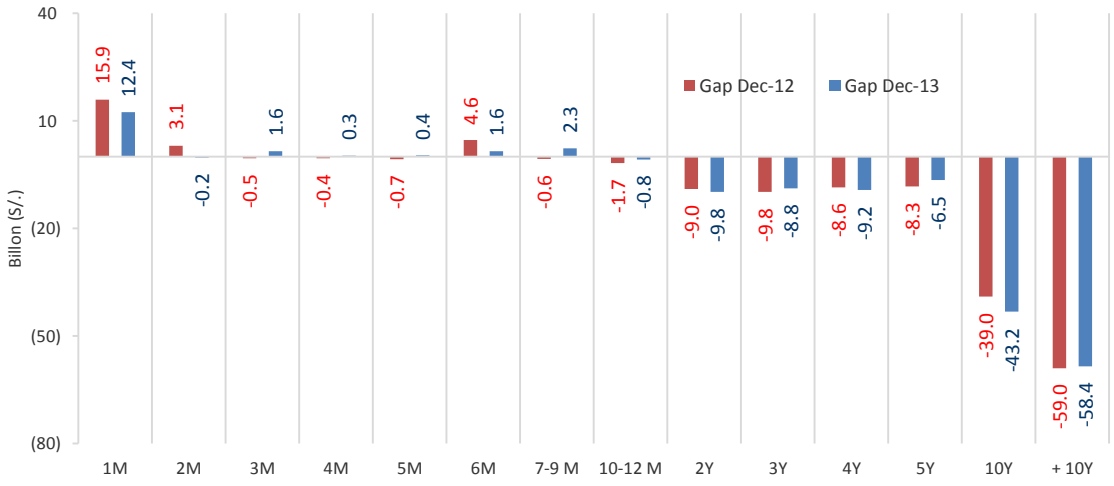
Graph N° 4
Table of liquidity gap



Source: MEF-DGETP

It shows a positive mismatch in the time period of 2 years with S/. 7.7 billion, whereas last year it was in the time period of 3 years with S/. 0.9 billion.

Graph N° 5
Gaps considering periods of time



Source: MEF-DGETP

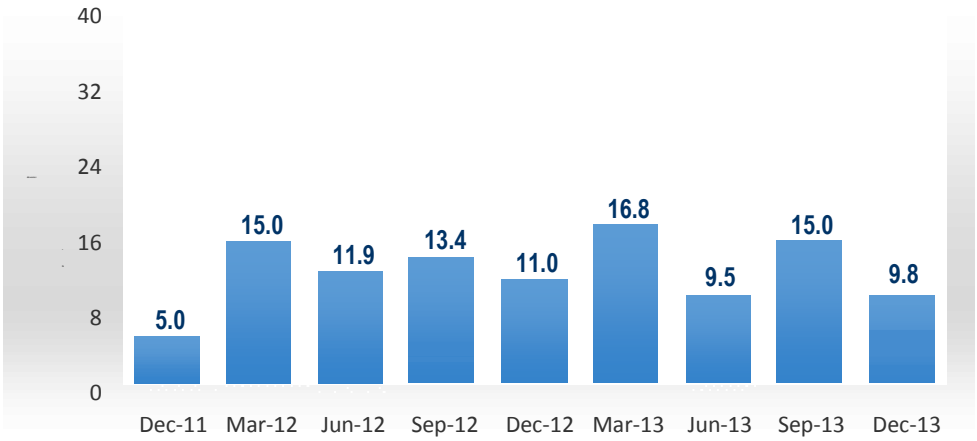
A detailed analysis of gaps shows that most of assets focus on one month period in 2012 and 2013 (see Graph N°5). Even though there is a better allocation of short-term assets (2 months, 3 months, 4 months, 5 months, 6 months and 9 months) than last year, in which there were only positives gaps in the 2 months and 6 months period, this is still insufficient. There are not important obligations in the short term that justify so significant balances with one month term or less, which impedes that such excess could generate profits without risk for the Public Treasury.

While the objective is to diversify assets by terms, counterparties and currencies, this has a limitation because, currently, the Banco de la Nación (Nation Bank) and the Central Reserve Bank of Peru (CRBP) are the only counterparties to make deposits. Moreover, the CRBP delimits the maximum terms for deposits in foreign currencies.

b) Liquidity coverage ratio (LCR)[30]

At the end of December 2013, the LCR was greater than 1, with a value of 9.8, showing a considerable decrease compared to the end of last year, which was 11,0 (see Graph N° 6). This decrease shows a lower level of liquid assets compared to last year. In spite of this decrease, the result shows a liquidity level that gives enough margin to the Central Government, to deal with some short-term unexpected event, and enough capacity to establish and manage an important secondary reserve of liquidity that may reduce the high cost of liquidity.

Graph N° 6
Liquidity coverage ratio (LCR)



Source: MEF-DGETP

5.2 Interest rate risk

From a short-term perspective, shifts in the market interest rates have an effect on the Central Government results and, from a long-term perspective, it affects the economic or equity value, becoming a significant risk in the Central Government financial activity, and at the same time, an opportunity to create value.

The main source of risk is the time lag between the interest rate rise and the Central Government's financial asset and liability maturities that are exposed to interest rate shifts, which may generate favorable or unfavorable impacts. As an initial approach to the time lag of assets and liabilities, we consider the indicator of their durations[31]. The total duration is approximately 0.59 years in the last year, which is a slightly increase of 0.01 years considering the high levels of disposable income and term deposits for less than 1 year, approximately 2.5 months[32] (see Table N°8).

Table N° 8
Financial asset duration

	Balance Dec 2012 (B S/.)	Duration (years)	Balance Sep 2013 (B S/.)	Duration (years)	Balance Dec 2013 (B S/.)	Duration (years)
Disposable income	**27.69**	**0.2**	**26.18**	**0.2**	**26.16**	**0.2**

30 The high quality disposable funds are the numerator of the ratio and the short-term cash outflows are the denominator. When the indicator is higher or equal to 1, there is enough liquidity.

31 It equals to the average term for the redemption of the principal and interests at present value.

32 If the term of deposits in the Central bank were longer, the yield rate will not be essentially higher and, on the contrary, it will expose the government to a higher reinvestment risk.

Demand deposits	12.92	0.0	11.85	0.0	10.76	0.0
Term deposits	14.77	0.3	14.34	0.3	15.40	0.4
Accounts receivable	**3.67**	**5.2**	**3.92**	**4.7**	**3.41**	**4.8**
Transfers	3.66	5.2	3.90	4.7	3.41	4.8
Derivatives	0.01		0.02		0.01	
Restricted funds	**20.68**	**0.5**	**29.40**	**0.5**	**28.78**	**0.4**
Demand deposits	2.41	0.0	5.58	0.0	4.76	0.0
Term deposits	18.27	0.6	23.82	0.6	24.02	0.5
TOTAL	**52.04**	**0.58**	**59.50**	**0.64**	**58.35**	**0.59**

Source: MEF-DGETP

On the other hand, the duration of the assets has had a decrease equaled to 1.23 years over the last year (See Table N° 9). Shifts in interest rates, principally at the long term of the curve in soles and dollars, have affected the total financial liabilities during the year, due to a greater uncertainty in the second quarter of the year worldwide. This has been reflected in the constant reduction of the duration of securities.

Table N° 9
Duration of financial liabilities

	Balance Dec2012 (B S/.)	Duration (years)	Balance Sep2013 (B S/.)	Duration (years)	Balance Dec2013 (B S/.)	Duration (years)
Securities	**58.63**	**9.08**	**63.89**	**8.09**	**64.72**	**7.58**
Treasury bills			0.12	**0.49**	0.28	**0.44**
Global bonds	24.12	**9.57**	26.31	**8.26**	26.47	**7.84**
Sovereign bonds	32.24	**8.80**	35.35	**8.08**	35.87	**7.53**
Other bonds	2.26	**7.76**	2.10	**6.55**	2.11	**6.19**
Credit and loans	**27.21**	**5.15**	**23.16**	**4.99**	**23.42**	**4.81**
Multilaterals	19.21	**5.32**	15.70	**5.29**	15.75	**5.13**
Paris Club	6.19	**5.35**	5.82	**4.90**	5.46	**4.81**
Others	1.82	**2.71**	1.64	**2.46**	2.20	**2.54**
Payables	**1.06**		**0.53**		**0.47**	
TOTAL	**86.90**	**8.08**	**87.57**	**7.26**	**88.61**	**6.85**

Source: MEF-DGETP

We have calculated the duration of the net debt based on the duration of financial assets and liabilities (see Table N° 10). The duration of the net debt has decreased in 1.28 years compared to last year. Net debt in dollars and soles have the greatest duration levels, because assets in dollars and soles are invested at very short terms and funding is made with long-term operations.

Table N° 10
Duration of the net debt

Currencies	Financial assets		Financial liabilities		Net debt	
	Duration Dec 2012 (years)	Balance Dec 2013 (years)	Duration Dec 2012 (years)	Duration Dec 2013 (years)	Duration Dec 2012 (years)	Duration Dec 2013 (years)
Soles	0.34	0.26	8.49	7.21	8.24	7.03
Dollars	0.53	0.54	8.19	7.12	7.92	6.74
Euros	4.93	5.16	4.38	3.53	3.92	2.95
Yen	5.88	4.85	5.01	4.48	2.2	1.70

Others	0.00	0.00	1.41	2.91	1.39	2.91
Total	**0.58**	**0.59**	**8.08**	**6.85**	**7.74**	**6.46**

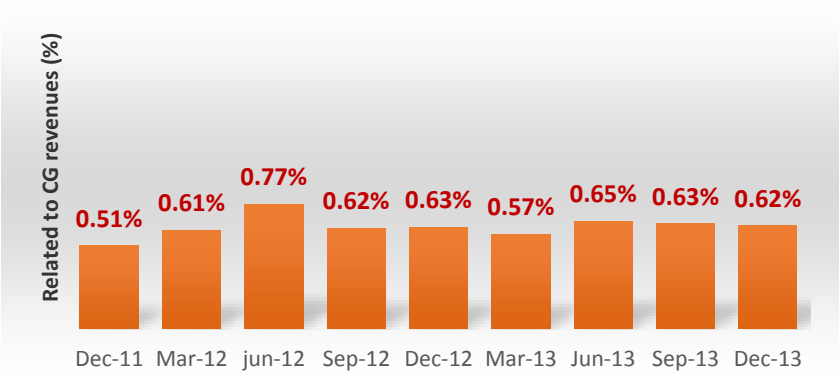
Source: MEF-DGETP

In addition, we have been monitoring the interest rate risk exposure in the short-term using the earnings at risk indicator and the interest rate risk exposure in the long-term, we used the equity value indicator at Risk, using in both cases, a standard deviation of interest rate of + / -200 basis points, as well as the periodic stress testing simulation.

a. Earnings at Risk (EAR)

At the end of 2013, the Earnings at Risk indicator showed that, the standard variation of the interest rate used (+200bp), would generate an impact on the financial margin of the Central Government (Earnings at Risk) equal to S/. -637 million equivalent to 0.62% of Central Government Revenue, or 0.11% of GDP[33] (see Graph N°7). The previous year, the EaR indicator was S/. -611 million.

Graph N° 7
Earnings at risk (EaR)



Source: MEF-DGETP

b. Equity's interest rate sensitivity

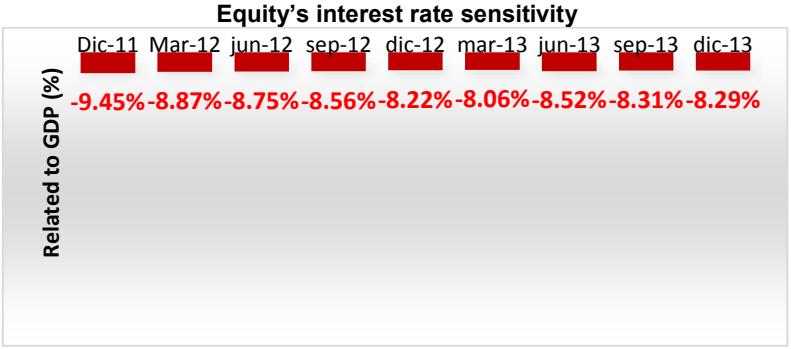
The measurement and monitoring of the structural interest rate risk in the long term is based on the analysis shifts in the present value of assets and liabilities when there are movements in the interest rate curve. Such variation will be reflected in the market value of Central Government's equity.

At the end of 2013, with a negative variation of 200 basis points in the interest rate curve (risk scenario), equity's interest rate sensitivity was S/. -44.83 billion, equivalent to 8.29% of GDP, which was slightly higher than last year's indicator result of 8.22%[34] (see Graph N° 8). The Central Government's balance sheet structure would be exposed to a decrease in the interest rate level. However, in the last quarter of 2013, since the interest rate of instruments belonging to emerging economies has been rising and one of the main powers is expected to change its expansionary monetary policy, there are few possibilities that risks could materialize.

[33] The revenue and GDP used are the numbers projected at the end of 2013 according to the MMF 2015-2017.

[34] The VAR for the net wealth regarding the Central Government revenue rose from 43% to 43.4% between Dec 12 and Dec 13.

Graph N° 8
Equity's interest rate sensitivity



Source: MEF-DGETP

5.3 Exchange rate risk

The structural exchange risk occurs when the Central Government suffers losses because of changes in the value of national currency in relation to other currencies in the financial markets. It exists when there are gaps between the maturity of assets operations and liabilities operations in different foreign currencies.

According to the currency composition of assets, until the third quarter of 2013 most assets are denominated in Soles, this is, 50.2% of the total amount. At the end of the year, the participation of the Sol was 46.9%, losing ground to assets in dollars, which had a 49.0% participation. From the second quarter of 2013, asset participation in local currency reduced in relation to the total assets, and assets in foreign currency expressed in local currency increased because of currency appreciation and the increase in balance (see Table N°11).

Table N° 11
Currency composition of financial assets

Currency	Participation Dec 2012 (%)	Participation Sep 2013 (%)	Participation Dec 2013 (%)
Assets	**S/. 52.04 B**	**S/. 59.48 B**	**S/. 58.34 B**
Disposable income	**53.2%**	**44.0%**	**44.8%**
Soles	50.2%	41.0%	39.9%
Dollars	2.9%	3.0%	4.9%
Euros	0.1%	0.0%	0.0%
Accounts receivable	**7.0%**	**6.6%**	**5.8%**
Soles	0.3%	0.8%	0.4%
Dollars	1.6%	1.5%	1.5%
Euros	0.4%	0.4%	0.4%
Yen	4.6%	3.9%	3.6%
Others	0.0%	0.0%	0.0%
Restricted funds	**39.7%**	**49.4%**	**49.3%**
Soles	2.4%	8.4%	6.6%
Dollars	37.4%	41.0%	42.6%
Euros	0.0%	0.0%	0.1%
Total	**100.0%**	**100.0%**	**100.0%**

Source: MEF-DGETP

The dollar is the main component of the currency composition of liabilities with a 46.7% participation, slightly higher than the Sol, which had a 46.0% at the end of the year (see

Table N° 12). The amount of dollars has reduced during the year (at the end of 2012, was 49.1%), and liabilities in soles increased. This reduction is part of the policies approved in the Global Asset and Liability Management Strategy 2013-2016.

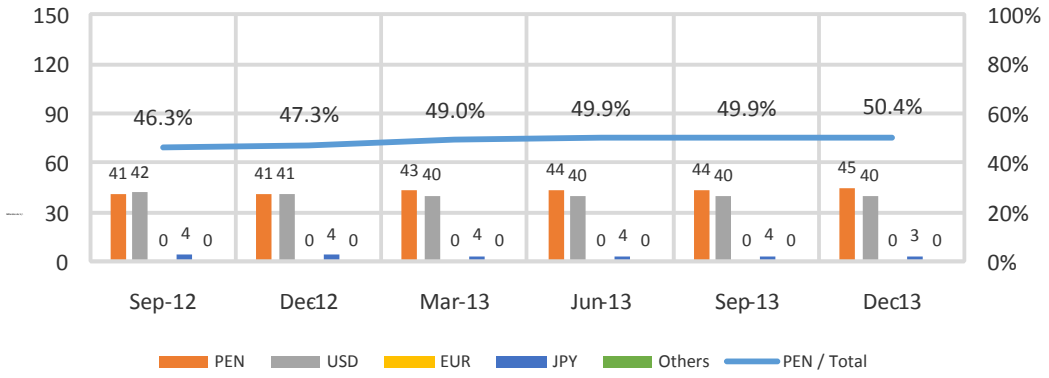
Table N° 12
Currency composition of financial liabilities

	Composition Dec 2012 (%)	Composition Sep 2013 (%)	Composition Dec 2013 (%)
Liabilities	**S/. 85.84 B**	**S/. 87.05 B**	**S/. 88.14 B**
Securities	**68.3%**	**73.4%**	**73.4%**
Soles	39.6%	42.6%	42.8%
Dollars	27.5%	29.5%	29.3%
Euros	1.2%	1.3%	1.3%
Credit and loans	**31.7%**	**26.6%**	**26.6%**
Soles	2.9%	2.6%	3.2%
Dollars	21.7%	17.5%	17.4%
Euros	1.6%	1.7%	1.7%
Yen	5.2%	4.6%	4.1%
Others	0.4%	0.2%	0.1%
Total	**100.0%**	**100.0%**	**100.0%**

Source: MEF-DGETP

Including operations with derivatives made before 2011, the Sol composition in the liability structure is 50.4% and the US Dollar diminishes to 45.1%. However, these operations have meant a higher cost for the Republic of Peru than an uncovered position or a public debt securities issue in soles (see Graph N° 9).

Graph N° 9
Composition of liabilities with derivatives



Source: MEF-DGETP

During 2012, Sol boosted due to the expansionary monetary policies in developing countries but, in the second quarter of 2013, uncertainty emerged because of market expectations that the US FED could back-away from monetary stimulus. This situation has led to a depreciation on the currencies of emerging countries; the Sol was one of the currencies that suffered less damage. During 2013, the exchange rate for US Dollar to Sol fell 9.6%[35].

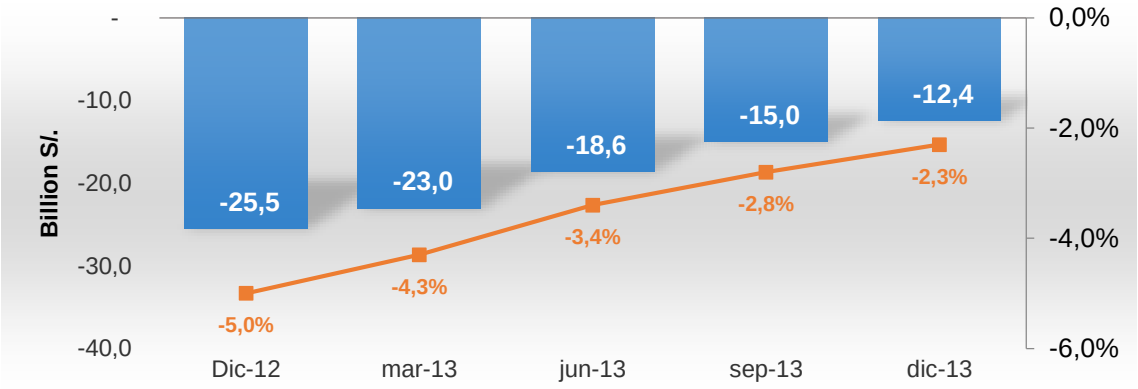
[35] Shadow exchange rate according to the SBS between 12/28/2012 and 12/28/2013.

In this context, we will monitor the exchange rate market and its impact on the Central Government's balance using stochastic tools, such as Value at Risk and stress scenarios.

a. Global foreign exchange

At the end of 2013, the Central Government had an oversold foreign exchange position that equaled to S/. 16.52 billion, compounded mainly by US Dollars, which is S/. 9.31 billion lower than the previous year. This is due to an increase in assets and a decrease in liabilities in foreign currency during the year. In addition, the forward foreign exchange position includes the present value of the derivatives and of the interest generated by asset and liability operations. In this way, at the end of 2013, the Central Government has a global foreign exchange position (which is the sum of cash and forward foreign exchange position) that was oversold (net liabilities) that equaled to S/. 12.39 billion (2.3% GDP) –compounded principally by US Dollars –and has diminished compared to the end of the previous year, which ended in S/. 25.53 billion, equaled to 5.0 GDP[36] (see Graph N° 10).

Graph N° 10
Global foreign exchange position



Source: MEF-DGETP

b. Value at risk for foreign exchange risk

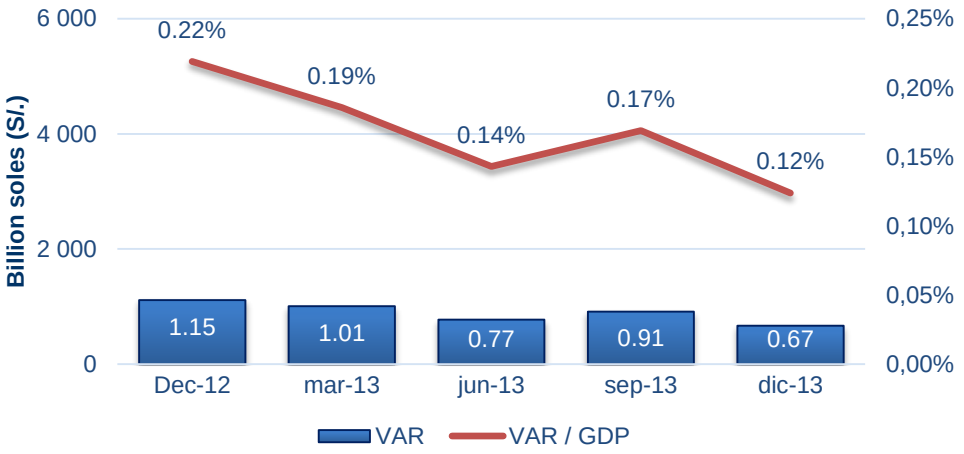
To measure and monitor the foreign exchange risk we will use a model of Value at Risk (VaR) model, which calculates the maximum loss expected from the volatility of returns of the currencies that make up the balance, in a period of 90 days, using the Monte Carlo simulation. This model is based on a sample of 10 years and a confidence level of 99%.

According to the analysis, the maximum expected loss caused by the exchange rate is S/. 670 million at the end of 2013, equivalent to 0.12% of GDP, a 0.9% lower than the previous year[37], and the dollar was the currency that most contributed to the level of VaR, due to its superiority in the global position (see Graph N° 11). Based on the previous results, policies that prioritize the local currency debt over the long term have been established. It is important that institutions that are part of the Government consider these policies of de-dollarization and foreign debt reduction to diminish financial vulnerability.

[36] The global foreign exchange position with regard to the Central Government revenue was 26.2% and 12.0% at the end of 2012 and 2013, respectively.

[37] The VaR in relation to the Central Government revenue was 1.1% and 0.6% at the end of 2012 and 2013, respectively.

Graph N° 11
Performance of the VaR for the foreign exchange risk



Source: MEF-DGETP

5.4 Concentration risk

The concentration risk implies many aspects with different effects on asset and liability management, which can be measured through the mismatches in market concentration, counterparties concentration, exposure to credit risk arising from currency risk, among others. The common denominator is not only the loss of the ability to diversify, but also the possible generation of a potential systemic vulnerability, which eventually might also affect the strength of the public finances or stimulate moral hazard. Concentration also generates less flexibility and especially, less negotiating skills for debtors to obtain higher returns of assets, as well as for creditors which will not obtain lower costs.

Currently, we are monitoring the concentration of debtors in asset operations, and monitoring the concentration of creditors in liability operations, in order to increase the diversification to face all risk factors. In this regard, as part of the investment strategy, it is essential to generate sufficient and diversified competition to maintain an attractive return and liquidity.

To date, the Central Reserve Bank of Peru and the Banco de la Nación are the only counterparties for assets operations, and their regulations for deposits restrict the access to more competitive market interest rates (see Table N° 13).

Table N° 13
Liabilities concentration based on debtors

Counterparty	Dec 2012		Sep 2013		Dec 2013	
	Amount (B S/.)	Part. %	Amount (B S/.)	Part. %	Amount (B S/.)	Part. %
Disposable income	**27.69**	**53.2%**	**26.18**	**44.0%**	**26.16**	**44.8%**
Central Reserve Bank of Peru	23.98	46.1%	22.41	37.7%	21.15	36.2%
Banco de la Nación	3.71	7.1%	3 75	6.3%	4.98	8.5%
Others		0.0%	0.03	0.0%	0.03	0.0%
Accounts receivable	**3.67**	**7.1%**	**3 92**	**6.6%**	**3.41**	**5.8%**
Non-financial public institutions	3.66	7.0%	3 90	6.6%	3.41	5.8%
Investment institutions	0.01	0.0%	0.02	0.0%	0.01	0.0%
Restricted funds	**20.68**	**39.7%**	**29.40**	**49.4%**	**28.78**	**49.3%**
Central Reserve Bank of Peru	20.53	39.5%	29.33	49.3%	28.67	49.1%

Banco de la Nación	0.15	0.2%	0.07	0.1%	0.11	0.2%
Total	**52.04**	**100.0%**	**59.50**	**100.0%**	**58.35**	**100.0%**

Source: MEF-DGETP

Additionally, as part of the debt strategy, it is essential to count with an adequate diversification of funding sources, and have permanent access to international financial markets for the benefit of the Republic. Therefore, we monitor the structure of the Central Government's creditors in order to make changes to strengthen the structure of the public debt and trading capacity, if necessary.

Table N° 14
Liability concentration based on creditors

Creditors	Dec 2012		Sep 2013		Dec 2013	
	Amount (B S/.)	Part. %	Amount (B S/.)	Part. %	Amount (B S/.)	Part. %
Outstanding securities	**58.63**	**67.5%**	**63.89**	**73.0%**	**64.72**	**73.0%**
Resident holders	16.24	18.7%	17.09	19.6%	19.49	22.0%
Non-resident holders	42.39	48.8%	46.80	53.4%	45.23	51.0%
Debt	**28.27**	**32.5%**	**23.69**	**27.0%**	**23.89**	**27.0%**
Multilaterals	19.21	22.1%	15.70	17.9%	15.75	17.8%
Paris Club	6.19	7.1%	5.82	6.6%	5.46	6.2%
Other organizations	1.82	2.1%	1.64	1.9%	2.20	2.5%
Investment institutions	1.06	1.2%	0.53	0.6%	0.47	0.5%
Total	**86.90**	**100.0%**	**87.57**	**100.0%**	**88.61**	**100.0%**

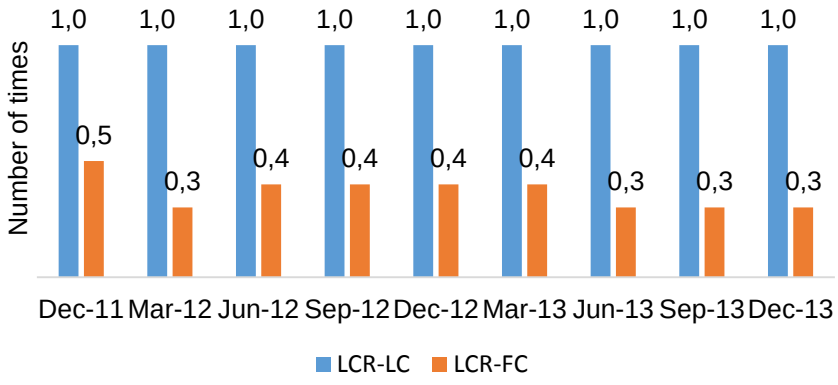
Source: MEF-DGETP

5.5 Stress scenarios and risk balances

a. Liquidity coverage ratio (LCR)

To reduce the probabilities of the activation of the acceleration and cross-default clauses established in the prospectus for global bond issuance, it is necessary to meet these obligations progressively using excess liquidity in local currency –without jeopardizing obligations in this currency –or issuing bonds in local currency. Graph N° 12 shows that the cover in the stress scenario was reduced since the second quarter of 2013.

Graph N° 12
Liquidity coverage ratio –Stress scenario

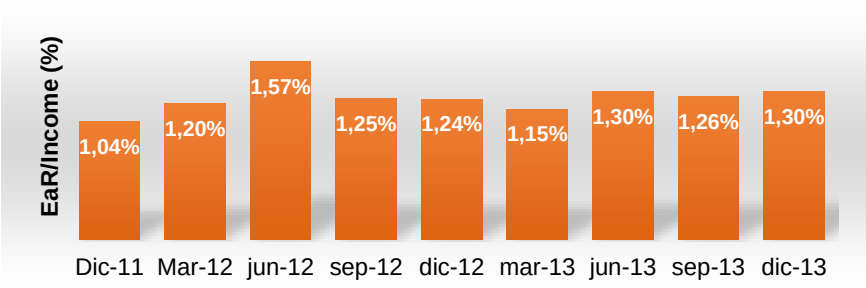


Source: MEF-DGETP

b. Earnings at risk (EaR)

In the third quarter of the year, the benchmark rate of the CRBP lowered in 25 basis points, and was 4.0% in the last quarter of the year. The CRBP could diminish the benchmark rate during the year if the economic conditions are appropriate. This diminishment along with the positive gap that indicates that assets excess will re-price in the short term, implies that a negative impact, due to an adverse shift in interest rates (interest rate fall), could occur. Therefore, the opportunity cost of short-term assets should be optimized through the diversification of counterparties and investments at market prices.

Graph N° 13
Earnings at risk (EaR) – Stress scenario



Source: MEF-DGETP

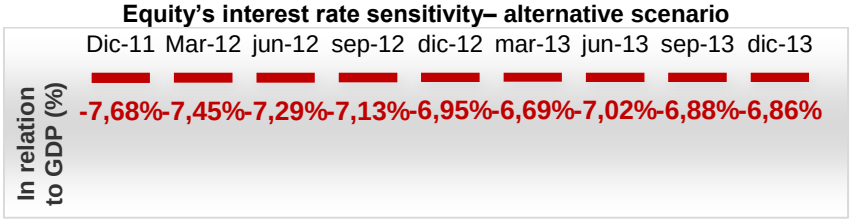
However, if interest rates change as in September and October 2008, as a result of the deterioration of the financial crisis (Lehman Brothers bankrupt, 6.98% Dow Jones slump and the rescue package of US FED/Treasury of US 700 billion), then, Earnings at Risk will be S/. – 1.31 billion, with an interest rate variation of +3.31% in local currency and +5.27% in foreign currency[38], equal to -1.30% of the Central Government revenue (see Graph N° 13). Such a variation, considering the interest rates of the Central Reserve Bank of Peru for the Public Treasury, will led to negative interest rates.

c. Equity's interest rate sensitivity

In case the interest rate variation of the financial crisis (2008-2009) repeats, then the equity's interest rate sensitivity will be S/. 37.16 billion with a 99% confidence level, equaled to 6.86% GDP[39] (Graph N° 14).

Using a standard variation, this indicator would be lower because most of the mismatches are long term and movements in the long end of the curve have been historically lower than in the short end of the curve.

Graph N° 14
Equity's interest rate sensitivity– alternative scenario



Source: MEF-DGETP

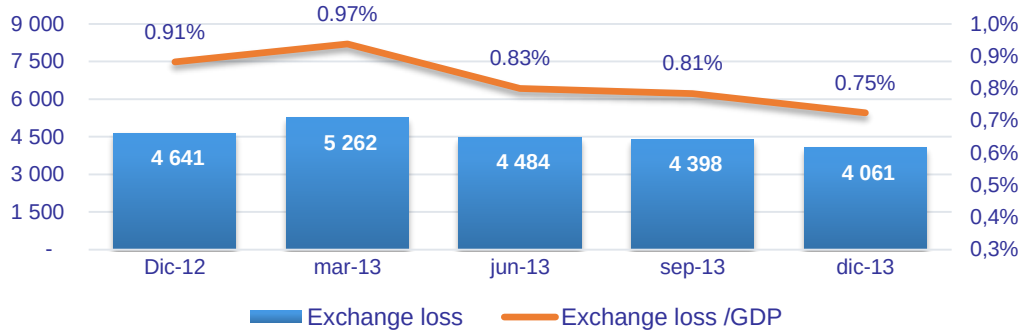
[38] The EaR in relation to GDP was 0.24% at the end of 2013.

[39] The equity's interest rate sensitivity in relation to the Central Government revenue was 36% at the end of 2013.

d. Value at foreign exchange risk

If a depreciation in local currency against foreign currency occurs , as it happened during the 1997-1998 crisis (the Asian and Russian crisis) in which the US Dollar appreciated in 19.86%, the Euro in 33.87% and the Yen in 41.18%, then, the exchange rate loss would be S/. 4.06 billion, which equals to 0.75%GDP[40] (Graph N° 15).

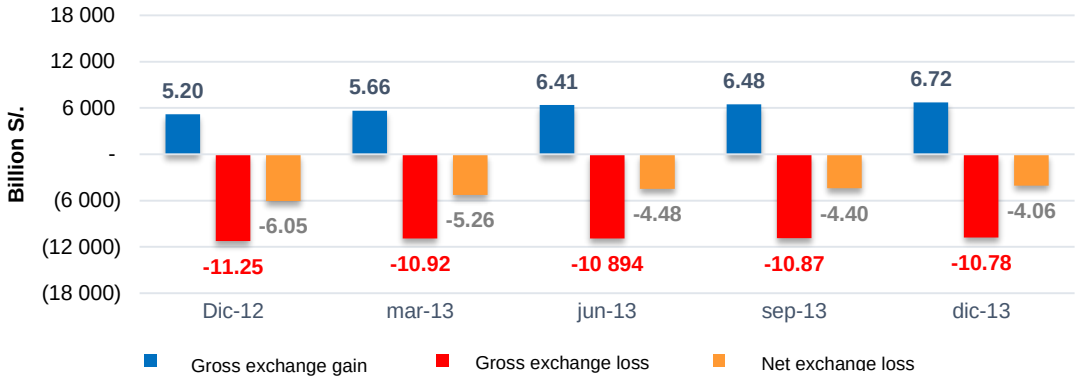
Graph N° 15
Stress scenario – Foreign exchange risk



Source: MEF-DGETP

However, the Fiscal Stabilization Fund do not necessarily compensate the total exchange loss generated by the gross debt in foreign currency[41]; therefore, we estimate the gross loss in the stress scenario will mean a S/. 10.78 billion loss, equal to -1.99% GDP[42] (see Graph N° 16).

Graph N° 16
Stress scenario – Gross exchange gain and loss



Source: MEF-DGETP

Instead, if 30% of total gross debt was expressed in foreign currency as indicated in the approved polices, then, the exchange loss would decrease to S/. -724 million, equal to 0.14%GDP.

In addition, if the participation of total assets in local currency increases to 55% and the total Fiscal Stabilization Fund remains in foreign currency and, the participation of liabilities in local currency would increase in 0.05%, then, position of foreign currency will

40 The exchange loss in relation to the Central Government revenue was 3.9% at the end of 2013.

41 In a stress scenario, the Fiscal Stabilization Fund may have been used totally or partially to confront any national emergency situation or an international crisis as described in the law.

42 The gross loss in relation to the Central Government revenue was 10.4% at the end of 2013.

be close to zero (0) and the impact of exchange rate shifts will be just S/. -270 million, about 0.05%GDP and the exchange rate risk would be very low.

e. Risk assessment

Table N° 15 summarizes the severity and probabilities associated to the main risk factors that the Central Government is exposed to, based on information and reviewed indicators. In this sense, the foreign exchange risk is the Central Government's main risk factor in a stress scenario.

Table N° 15
Assessment of the impact of the main risk factors.

Type of risk	Exposure in balance sheet structure	Severity	Probability
Exchange rate	Exchange rate depreciation	High	High
Short-term interest rate	Interest rate depreciation	Medium	Medium
Long-term interest rate	Interest rate depreciation	Medium	Low
Liquidity	Activation of cross-default clauses of Global bonds	High	Low

Source: MEF-DGETP

6. ASSESSMENT OF THE STRATEGY 2013

After the Strategy for Global Asset and Liability Management 2013-2016 was approved and published, a series of actions to comply with the approved political guidelines and with the main objective of the Strategy were implemented as well as the guidelines approved after the merger of the National Direction of Public Treasury and the National Direction of Public Debt.

In this context, in 2013, sovereign bonds were issued in order to finance a part of the financial requirements and to execute debt management operations: bonds were issued for S/. 4.12 billion in the domestic market. Additionally, Public Treasury bills auctions were made in order to establish benchmarks in the short end of the curve and develop the public debt securities market and, the public funds auctions were centralized in the Public Treasury's informatics platform.

6.1. Compliance with the financial policy guidelines

A crucial aspect to achieve a successful implementation of any strategy is to build a reputation based on trust and credibility of the parties involved which, in this case, is based on a consistent compliance of six guidelines for the approved financial policies and on the materialization of the strategic actions.

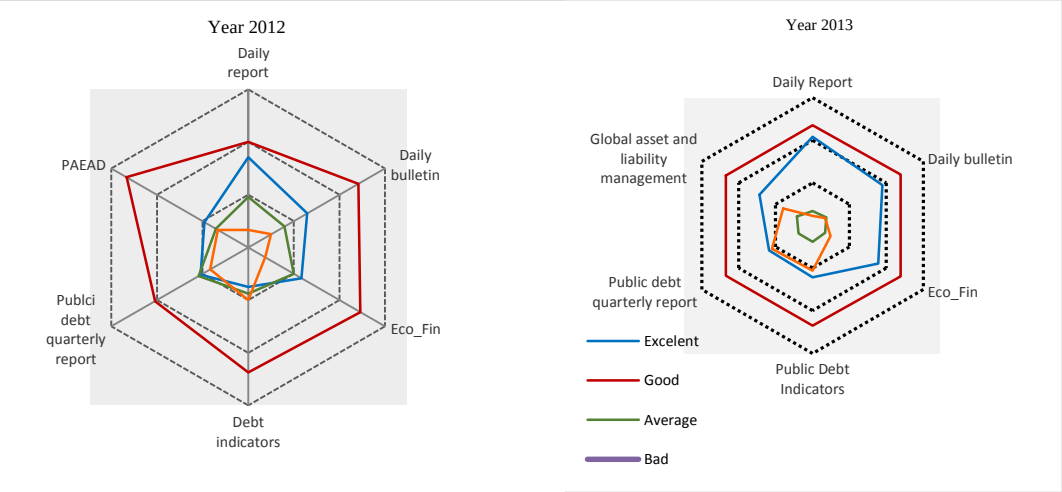
a. Develop the securities market by increasing the public debt in soles

Regulations of bills, bonds and market makers were approved in order to comply with this policy. Likewise, weekly regular auctions of bills and bonds started in July 2013. In the last 6 months of 2013, the total issuance of Public Treasury bills was S/. 322.6 million and the nominal and real bond issuance reached S/. 878.8 million. The new regulation and strategy allowed to diversify bonds (with regard to previous issuances) and to initiate a diversification process of the public debt market participants: per instance, in the last 6 months of 2012, sovereign bonds were issued for S/. 891.5 million of which the 75% was composed by the nominal bond 2023 and 25% by nominal bond 2042 while in 2013 the total issuance of nominal bonds was composed by 41.5% nominal bond 2017, 7.7% nominal bond 2029, 17.6% nominal bond 2023, 9.2% nominal bond 2042, 13.4% real bond 2018 and 10.5% real bond 2046.

Box N° 5: Improvement in the investor relations satisfaction survey

The Investor Relations Survey was made for the second consecutive year between July and August 2013 for the period of June-2013 / June-2012 to gather relevant information in order to improve the quality of information services that have been reported regularly to the market. To this end, we used a database with more than 1200 contacts such as credit institutions, pension and investment funds, insurance companies, stockbrokers, global portfolio managers and others.

During this period, the Investor Relations Office website (www.mef.gob.pe/inversionistas.php and www.mef.gob.pe/investor.php) in Spanish and English experienced a number of changes such as: frequently asked questions, which provide important details for investors that participate in the public debt securities market for the first time, presentations for the market participants, to improve the communication with the Republic of Peru, the Schedule of the Regular Treasury Auctions Program, the Investor Relations link to facilitate online participation and others.
Additionally, the response time for the questions received in the e-mails (inversionistas@mef.gob.pe and investor@mef.gob.pe) is shorter.



Source: MEF-DGETP

The results of the survey were more favorable than 2012. 32% of the 6 reports sent periodically were considered as "excellent" compared to 23% last year, and the "good" response also had a better score, which reflects a better global perception of the main reports.

The Ministry of Economy and Finance welcomes the results of the assessment about Peru's investor relations made by the Institute of International Finance (IIF) within the framework of the "2013 Annual Report of the Consultative Group for the implementation of the Principles for Stable Capital Flows and Fair Debt Restructuring" that points out that Peru has improved its rating and it is just one rating behind the highest rating.

The chapter "V" of the 2013 Annual Report points out that Peru obtained a 37 points rating of a total of 38 (97.4% compliance) in terms of "Evaluation of Investor Relations Practices and Data Transparency". This means an improvement compared to the 2012 rating in which Peru obtained 36 points (94.7% compliance).

The annual report contains the contribution of 46 global financial leaders with great experience and international credibility, who meet every year in order to review the progress of the implementation of the principles, measure the performance of the investor relations management and evaluate financial data transparency and dissemination practices.

Also, the new regulation allowed the financial institutions that were not considered as Market Makers to participate directly in the auctions of Public treasury bills and bonds. The total number of institutions that showed interest in participating in sovereign bond auctions by sending the participation application were 32[43]: 12 stockbroker agencies, 8 insurance companies, 5 pension fund administrators, 2 banks, 2 municipal funds, 2 financial companies and 1 mutual fund management company.

Likewise, periodic meetings were held with all market participants in order to inform in detail the range of the 2013-2016 Global Asset and Liability Management Strategy and the results of the auctions made and encourage them to participate in the public debt securities market as an alternative way to invest. To monitor the level of receptiveness of the first meetings, the annual investor relations survey was made and showed a favorable performance, which was recognized internationally.

b. To maintain liquidity reserve to face instability situations

The minimum amount of the secondary liquidity reserve has been updated to S/. 22 389 million. This reserve has been design to achieve 2 purposes: maintain the annual budget

[43] Without taking into account the entities considered as market makers.

spending in situations where revenues may be reduced temporarily and stabilize the sovereign yield curve in extreme volatility situations, with the participation of the Public Treasury in the secondary market. Currently, we are working on the regulations.

On the other hand, we have been monitoring the contingent credit lines that Peru has received in case of international financial crisis in order to agree new lines of credit or use them if necessary. Currently we can access to US$ 1.50 billion from lines of credit of multilateral organizations that may be used as an alternative funding in a financial crisis event.

c. To make public funds profitable and reduce the liquidity cost

Normative changes will facilitate the Public Treasury's decision-making related to asset and liability management. Law N° 30099 "Law on fiscal responsibility and transparency strength" establishes that the investment guidelines of the Fiscal Stabilization Fund will consider the guidelines of the Global asset and liability management strategy and that the General Directorate of Public Debt and Treasury, as the Technical Secretariat of the FSF, will propose the investment guidelines and directives.

Law N° 30116 "Law on Debt for the Public Sector for 2014" formalized the creation of the Asset and Liability Management Committee as the authority that will define the actions to be taken in order to manage a correct management of financial assets and liabilities that are part of the Public Treasury. In this sense, we have been supervising the compliance of the guidelines for the global asset and liability management and the Regulations of Deposits approved by Director's Resolution N° 016-2012-EF/52.03, which involves the public companies of the Fondo Nacional de Financiamiento de la Actividad Empresarial del Estado (FONAFE) and other public institutions, such as the regional and local governments. In addition, the Public Treasury carried out the on-line auctions module for public companies and institutions to develop auctions using a systematized informatics mechanism (see Box N°6).

Box N° 6: Auctions module of public funds

The application designed for the auctions of the public entities funds during the first semester of 2013 concluded the stage of development and production at the end of 2013, after an arduous process of adaptation and tests made by the operators in the Public Treasury and the representatives of public institutions and financial institutions.

The auction module started to operate the 1rst working day of 2014, with the participation of public companies and institutions such as Electroperú, Osiptel, Sedapal, Sunat and others, which used to auction their excess liquidity separately, providing little access to information. More than 20 financial institutions were constantly and actively demanding for a portion of these funds in a competitive way and, on average, 16 public entities make their surplus more profitable each month.

This platform has made more transparent the process of participation and allocation of auctions of the public entities' funds and helps to create benchmark yield curves of the funds of the financial institutions, considering an amount of risk. This develops a healthy competition and, at the same time, facilitates the access to information, which will improve the risk/return relationship of institutions while managing their liquidity excess.

The on-line auctions module and the orientation and training given to public companies and institutions concerning to the profitability of their funds have helped to increase progressively the deposits that have been auctioned in relation to the total assets. Total assets grew from 45.3% at the end of 2012 to 49.9% at the end of 2013 and the balance of current accounts reduced from 43.0% at the end of 2012 to 36.6% at the end of 2013

and will continue reducing in 2014. It will reduce because, the guidelines of asset and liability management establish that no public entity can have a total balance greater than S/. 100,000 in current accounts for operative needs, in order to maintain the purchasing power of the public funds.

In 2013, the General Directorate of Public Debt and Treasury finished the elaboration of the repo operation regulations of public debt securities, within the framework of Law N° 30052, "Law on Repo operations" approved on June 27th, 2013. Repo operations will stimulate the development of the public debt market in soles, establish the basis for the future development of the derivatives market and will make profitable the liquidity excess of the Public Treasury.

d. Maintain a healthy indirect debt structure

In April 2013, as part of an adaptation process of international standards, an IMF technical mission visited Peru to diagnose the advances and the necessary steps for the Peruvian Government to adopt the IMF's Government Finance Statistics Manual 2001 (GFSM 2001) and to adopt to the Special Data Dissemination Standard Plus (SDDS+). In addition, in September 2013, the Director's Resolution N° 011-2013-EF/51.01 formalized the adoption of the International Public Sector Accounting Standards issued by the International Public Sector Accounting Standards Board of the International Federation of Accountants (IFAC). Currently, with the support of an IMF's technical assistance mission –financed by the State Secretariat for Economic Affairs (SECO) –the procedures and examples to record the provision for indirect debt and contingent liabilities in the accounting are finishing.

e. Reduce the procyclicality of the external debt as a cause of vulnerability

In 2013, in accordance with the Government policies and the periodic analysis of risk, the Republic of Peru has avoid foreign funds because of the fast grow of the private sector's foreign debt, which has prevented the vulnerability indicators from getting worse, which are monitored by credit risk agencies in order to elaborate Peru's sovereign risk rating. Despite the market turmoil, we have issued securities in local currency, increasing the amount of sovereign bonds in S/. 3.62 billion, which reduced the gross debt dollarization from 52.7% in 2012 to 49.3% in 2013, and helped to develop the local public debt securities market.

f. Ensure the sustainability of the net public debt

In the first semester of 2013, the Republic of Peru made two prepayment operations in foreign currency to the World Bank and the Inter-American Development Bank for a total S/. 4, 418 billion, which were replaced by new obligations in local currency: sovereign bonds maturing in 2023 and 2042, with better conditions.

Likewise, in the last year, the amount of credits and loans has reduced from S/. 28.01 billion to S/. 23.16 billion. According to the approved Global Asset and Liability Management Strategy, the Government considered funding important projects by issuing local public debt securities instead of using lines of credits with multilaterals organizations, because it encourages the development of the local securities market and reduces the great levels of foreign public debt quickly. Also, the gross and net public debt ratios to GDP were reduced.

6.2 Development of the public debt securities market

a. Issue of public debt securities

In 2013, the regular bills and bonds auctions started, observing the periodicity established in the schedule approved in the Strategy 2013-2016. To date, the results show great progress in the development of the bills retail market as well as the bonds wholesale market.

In this way, in 2013, S/. 4.12 billion in bonds were issued, from which S/. 3.24 billion correspond to debt management and S/. 878.8 million to debt operations. Likewise, since July 2013, Public Treasury bills maturing in 3, 6, 9 and 12 months were issued, for an amount of S/. 322.6 million.

Bills were auctioned in the first and third week of each month, with a referential amount of S/. 15 million per each basis point are having an increasing demand because of the bigger acknowledgement about this instrument, which had not been issued since 2004. Bonds auctions made in the second and fourth week of each month have given predictability and confidence to agents, even if 2013 was a year of high volatility in the markets as a result of the announcements of ease stimulus withdrawal in the U.S. and the constant uncertainty about the world recovery after the financial crisis.

The demand and yields are related to the context in which the auctions take place and the investor appetite, according to the type of currency (nominal or real) and the maturity of bonds. It establishes valid references for the sovereign yield curve.

b. Trading of Public Treasury's securities

At the end of 2013, according to the information supplied by Datatec and GFI trading platforms, the total amount traded in the general and special level of the secondary market of sovereign bonds was S/. 34.36 billion, which represents a 1.6% increase in relation to the amount traded in 2012, which was S/. 33.83 billion. The average trading amount in the centralized trading mechanism was above S/. 2.7 billion monthly during the last five years, except in 2011. (See Box N° 7).

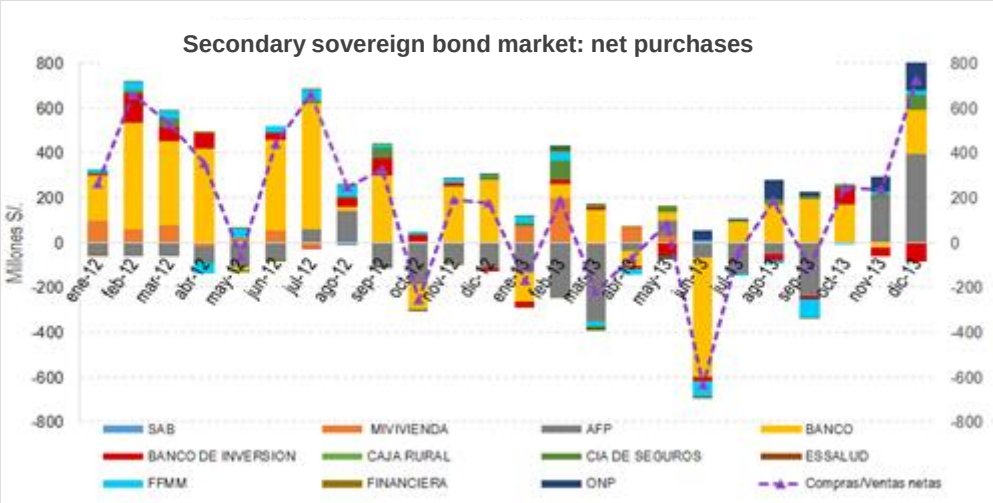
Box N° 7: Development of government bonds traded in the secondary market

One of the Government efforts to consolidate the government securities market is the greater development of the secondary market as the central point to obtain the market prices of the traded securities. Its liquidity and diversification depends on the turnover and the number of investors that participate in the markets.

In 2013, S/. 34 billion securities were traded in the government secondary market and in the fourth quarter of 2012 and 2013 it increased in 60%, according to the information provided by DATATEC and GFI trading platforms. However, these numbers only represent 50% of total securities traded according to CAVALI.

The development of purchase and selling bids as well as the development of the balance of net purchase shows the dynamic evolution of the secondary market. Purchase bids happen when a market participant makes a selling bid and another participant accepts it (purchase), and selling bids mean that a participant makes a purchase bid and another accepts it (sell). The net difference between both bids is denominated net purchase and it shows the appetite development of investors for government securities.

When it comes to purchase, the majority of market participants have increased the demand in the last months of 2013, highlighting that stock agencies and the ONP (Retirement Pension Office) have entered to the secondary market. When it comes to selling, we observe decreasing sales volumes, in some participants such as stock agencies, pension and mutual funds.



Source: DATATEC, GFI Made by: MEF-DGETP

Since August 2012, we observed a downward trend in net purchases, which reaches the minimum at the end of June 2013 with a S/. 636 million balance, where sell-off is greater than the securities purchase (net selling). This is related to an announcement of a future withdrawal of monetary stimulus from the U.S. economy, which generated a massive wage of sell-off by banks, pension and mutual funds.

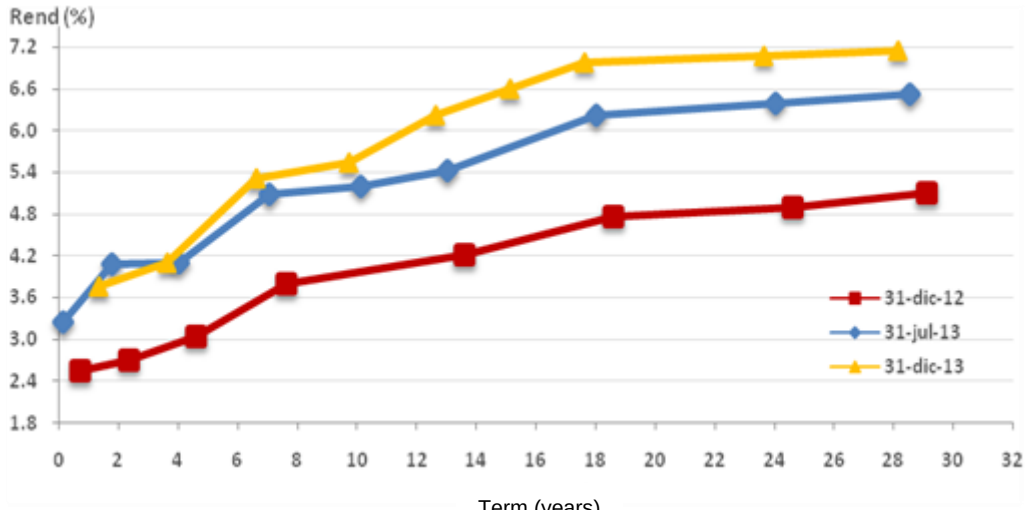
The increase of net purchase began with the implementation of the Schedule of the Regular Treasury Auctions Program in July 2013, in December 2013, purchases represented S/. 722 million. The participants were the pension funds, banks, ONP and insurance companies and the more demanded bonds were bond 2017, 2020 and 2023. We also highlight the progressive participation of financial companies and rural funds.

The secondary market of Public Treasury bills is not liquid yet, because bills issuance recently started on July 2013; however, the trading made with these securities increased gradually from S/. 2.5 million in July to S/. 50.5 million in November, the highest trading month in 2013. The total traded amount in the second semester reached S/. 172.4 million and the monthly average trading was S/. 28.7 million.

c. Yield curve of nominal sovereign bonds

The lower demand of sovereign bonds increased the yield curve in 132 bp between December 2012 and July 2013. In the second half 2013, rates continued increasing but at a slower pace than the first semester, as a consequence of the international turmoil due to the market reaction to the future FED's monetary policy. Between July and December 2013, the yield curve increased around 62 bp, principally at the long end of the curve and more than 170 bp during 2013.

Graph N° 17
Yield curve of nominal sovereign bonds



Source: MEF-DGETP

d. Public Treasury's bondholders

At the end of 2013, the number or units of sovereign bonds[44] held by banks changed, banks increased its position in 1,392,926 bonds, followed by insurance companies and public funds which increased their position in 736,892 and 728,835 bonds, respectively.

Even when foreign investors did not lead the purchase of sovereign bonds in 2013, and reduced its relative position compared to 2012, from 56.2% to 51.9% of the total amount of outstanding sovereign bonds, these investors have the highest percentage of participation of the total amount of outstanding bonds, followed by pension funds and banks, with 28.0% and 8.6%, respectively.

Table N° 16
Sovereign bond holding (in units)

Institutions	December 2012	December 2013	Variation units	Variation %
AFP	9,473,970	9,861,130	387,160	4.1%
Banks	1,625,814	3,018,740	1,392,926	85.7%
Non Residents	17,841,998	18,291,245	449,247	2.5%
Private funds	633,293	476,446	-156,847	-24.8%
Public funds	636,112	1,364,947	728,835	114.6%
People	796	14,380	13,584	1,706.5%
Others	155,357	134,599	-20,758	-13.4%
Insurance	1,355,281	2,092,173	736,892	54.4%
Total	**31,722,621**	**35,253,660**	**3,531,039**	**11.1%**

6.3 Forecast assessment

In 2013, unfavorable events for emerging countries' financial markets took place, such as the ones caused by the announcement and then the beginning of the easy money reduction and the politic crisis regarding the fiscal policy and debt ceiling in the U.S. and possible complications of the financial system in China and the fears of a downturn in its economy. These situations lead to a high volatility for financial markets. However, public

[44] The face value of each bond is S/.1000 which is the value of the principal which will be paid at the maturity date, regardless of the selling price, while the face value of each public treasury bill is S/. 100.

debt management could observe all the basic guidelines established in the Strategy for Global Asset and Liability Management 2013-2016.

Table N° 17
Assessment of the projections for the Central Government's gross debt in the PAEAD 2013

Indicator	Range at the end of December [1./]	Final result at the end of 2013
Percentage of soles in the gross balance	51.1% - 58.1%	50.4%
Percentage of nominal fixed-rate debt in the gross balance	82.1% - 83.3%	81.8%
Percentage of domestic debt in the gross balance	46.5% - 53.2%	45.4%
Average life (years)	13.0 - 13.5	12.7
Average time to re-fixing (years)	11.9 - 12.5	11.7
Concentration of amortizations over the next 12 months	4.6% - 4.5%	4.2%
Percentage of the flow of local currency funding	80.4% - 83.7%	83.2%

Source: MEF-DGETP

In the first semester 2013, two debt management operations replaced past obligations to the World Bank and the Inter-American Development Bank in U.S. dollars with floating interest rate in exchange for sovereign bonds issued in the local market in soles with a fixed interest rate. In the second semester, regular auctions of sovereign bonds and Public Treasury bills started with a schedule of biweekly issue of benchmark bonds and bills maturing in 3, 6, 9 and 12 months was approved, therefore. These actions improved the structure of maturity dates, currency and costs of the Central Government's gross debt.

The results of debt management indicators at the end of 2013 are close to the lower limit range forecasted in the pessimistic scenario of the Annual Debt Program and Debt Management 2013 (PAEAD 2013) at the beginning of 2013, when there were favorable expectations regarding to the development of world economy, but surpassing the forecast for the stress scenario. In part, the results are the product of not implementing some management operations that were planned for 2013, principally due to the high volatility in interest rate and the exchange rate in emerging countries (Table N° 17).

However, debt structure was improving, especially in regards to the Central Government's gross debt proportion in soles, which increased from 47.3% in December 2012 to 50.4% at the end 2013, in spite of the depreciation of the sol.
Likewise, the percentage of funding paid in soles increased in 2013 and was closed to the upper limits of the forecasted range, reaching 83.2% and the level of fixed interest rate is still high and shows a low risk position when facing potential fluctuations of interest rates. The value of the indicator that establishes interest rates supports our estimation.

7. STRATEGY 2014-2017

Some of the most relevant public actions of the Strategy 2014-2017 are the following:

7.1 Asset management

The goal is to constitute and keep liquidity reserves to face financial volatility, implement a countercyclical investment management to provide liquidity to government securities holders, implement a more active, competent, diversified and transparent cash management, optimize direct public credit and continuously evaluate the sustainability of future indirect public credit and its counter guarantee, regardless of debt or funds that finance it. In this way, it will consolidate the role of government securities market in local currency as the basis for the determination of the transfer rate or opportunity cost of different funding sources and the investment management.

The strategy for asset management considers the following lines of action:

a) To constitute and keep the liquidity reserve to ensure the solvency and liquidity even in financial volatility situations

Within the framework of a global asset and liability management, to keep the solvency of the public finances necessarily involves ensuring its liquidity before eventual stress situations that could become into an individual or systemic liquidity crisis.
There are two types of liquidity reserves: the primary liquidity reserve, basically made of deposits to face seasonal variations of cash flow in normal situations and the secondary liquidity reserve, which is invested in liquidity assets to face stress situations that may generate crisis situations if they are not appropriately handled (see Box N° 8). A liquidity contingency plan approved by the Asset and Liability Management Committee will determinate the use of both reserves in case regular incomes are temporarily insufficient or when it is not possible to raise funds from markets so that Government could fulfill all the budgetary commitments. In this way, we avoid a procyclical fiscal policy and we will use the savings of the Fiscal Stabilization Fund in case of more severe scenarios.

Box N° 8: Estimation of the secondary liquidity reserve

According to Article No 6º of Law No. 28693, The General Law on the National Treasury, two components were estimated for the secondary liquidity reserve. The first aims at hedging the cash flows of the Public Treasury, ensuring a normal operation in a situation of economic contraction. The second is intended to provide liquidity to the market in a context of financial instability where financing channels may have closed.
The first component was calculated on the basis of an estimate of the tax gap that would be generated in a stress scenario during a year, for which were necessary projections of expenses and revenues. In the case of expenditure, since it is a variable of macroeconomic policy decision, we have used the MMM (multiannual macroeconomic framework) projections.
With respect to the revenues, two different techniques were applied. For the first one, the collection was estimated on the basis of its main determinants, which are then simulated under a stress scenario. In the second one, a simulation of the monthly variations of seasonally adjusted collection was made through a random process.

Reserves (in billion S/.)	LSM	MCE	Monte Carlo Simulation
Estimate of regular resources revenues	14.24	10.65	11.14
Estimate of illiquidity in the secondary market		11.39	
Secondary liquidity reserve	25.63	22.03	22.53
Secondary liquidity reserve/GDP	4.24%	3.65%	3.73%

For the second component, it was necessary to estimate the amount necessary to stabilize the public debt market in an eventual crisis. The behavior of the number of transactions and the amount of money traded daily in the bonds secondary market were analyzed. A distribution function that can adjust better to the data for a representative period was built, and a 95% confidence interval was calculated using a Monte Carlo simulation. Based on the results of the confidence interval, the "normal" referential values for the number of daily transactions and the "average" amount traded that was used to adjust all the observations that move away from the referential values were analyzed.

Considering both components, the total amount of the secondary liquidity reserve ranges from S/. 22.03 billion to S/. 25.63 billion which are covered by the total financial assets of the Central Government at the end 2013.

b) To manage the savings in the Fiscal Stabilization Fund using a strategic basis, according to the global asset and liability management

According to the new regulation changes, the investment guidelines and directives of the Fiscal Stabilization Fund and its modifications must be in tune with the strategy for global asset and liability management. Due to the amount of savings of the Fiscal Stabilization Fund, it is necessary a long-term investment, a strategic segmentation according to the expected use of the savings and a diversification of currencies and foreign markets in order to keep its purchasing power and profitability in the future. Therefore, it is preferable to obtain low correlations between the investment alternatives and a passive management to reduce management costs and to develop a more transparent and easier financial accountability. To contrast its optimal composition it is necessary to prepare a study, according to the international experience, in harmony with the others guidelines already established.

c) A counter cyclical management of investments and supply of minimum liquidity to security holders to reduce risk aversion

Government will repurchase and resale government securities as another market participant to help to reduce the yield curve volatility and make profitable the savings generated in the favorable periods of the economic cycle. It will provide greater liquidity to the government securities market in a countercyclical way to ensure the financial stability. Special repurchase and resale auctions will be made or trading modules of the trading centralized mechanisms of Government securities will be used when the trading frequency of government securities keeps a diminishing trend below the goals and the yield curve is out of the equilibrium dynamic range. It will ensure a periodic benchmark of the market prices and a periodic permanent minimum level of liquidity for the securities' holders. The repurchased securities could also be resold in the market as part of the Public Treasury's operations, with or without resale auction, unless that they could be part of an exchange offer with a public or private bid, without the high outsourcing costs, to soft the maturities date profile. Every quarter, the Public Treasury will inform about its market analysis and will publish its intention to participate in order to develop the market.

d) More competition, diversification and transparency in the auctions of public fund deposits

The new deposit regulations allowed that more credit and security entities that could not participate in auctions of public funds in the past, now can access to the auctions of funds of public companies and entities. To reduce the concentration risk and avoid interest rate distortions, we will rebalance the maximum counterparty limits based on the capital adequacy ratio and we will apply an adjustment to the credit risk rating due to the exchange risk; this is, an adjustment based on the level of dollarization of the credit

entities that can issue financial instruments. In this way, funds would be less exposed to a systemic risk related to credit dollarization (see Box N° 9), whenever the limits for collateralized deposits are implemented. The increasing profits of these funds means an additional income caused by the transfer of wealth form the private sector to the public sector, as other countries do. The Public Treasury's electronic auction system ensures the strengthening of transparency, competency and diversification.

Box N° 9: Downward adjustment to the credit risk rating due to the exchange risk

The Director's Resolution N° 016-2012-EF/52.03, Appendix 1 "Guidelines for Global Asset Management", item 12 (eligibility and counterparty limits), states that, to determine the maximum portfolio limit for each credit entity it is necessary to use a downward adjustment to the credit risk rating due to the exchange risk and the capital adequacy ratio published on the Superintendencia de Banca, Seguros y AFP.

In case the level of dollarization of a credit entity's portfolio is greater than the level established on the financial policy guidelines of the Strategy for Global Asset and Liability Management, the credit risk rating will be adjusted downwards. It directly discourages dollar credits, which is one of the main vulnerabilities that impedes a better sovereign risk rating. In the chart, we show the factors we used to measure credit risk rating:

Factors used to measure the credit risk rating

Dollarization of the credit portfolio of financial institutions	Calibration factor
Up to 15,0%	0
Up to 30,0%	-1
Up to 45,0 %	-2
More than 45%	-3

To get the credit risk rating adjusted downwards we need to consider the current credit risk ratings made by Apoyo, Equilibrium, PCR and Class Rating for local financial entities. A quantitative value (from 1 to 9) will be assigned to each credit risk rating, and the higher value will be assigned to the highest rating:

Qualitative and quantitative scale for credit risk rating

Score on a qualitative scale	Score on a quantitative scale
A+	9,0
A	8,0
A-	7,0
B+	6,0
B	5,0
B-	4,0
C+	3,0
C	2,0
C-	1,0

In this way, to obtain the adjusted credit risk rating, the measure factor is deduced from the financial entity's credit risk rating according to the dollarization level of its credit portfolio. For example, if a financial entity's credit risk rating is A+ and the dollarization level of its credit portfolio is higher than 45.0%, then, the credit risk rating will be 3 sub-categories lower (because the measure factor is -3) and the credit risk rating adjusted to the exchange risk will be B+.

e) To improve direct and public credit granting financed with debt of financial organizations according to the economic cycles

Financing offered by international financial organizations through public credit granted by the Central Government to public institutions is used to develop the local securities market and to promote domestic savings just as other countries do. We will give priority to financing through local securities issues in order to reduce foreign debt and to free up credit lines that were granted to the Republic of Peru so they could be used in periods of financial instability. These contingent credit lines will be used in periods of liquidity constraints or financial market turmoil according to the particular needs of public institutions because one of the main objectives of multilaterals organizations is to encourage a countercyclical funding to its members. Likewise, public sector institutions could hire specialized technical consulting on development banking to implement projects and public credit programs approved in the Public Treasury's budget, without using public debt.

f) Prioritize the direct public credit grant in local currency for infrastructure development projects

Within the framework of the goals and performance of the Mandatory Fulfilling of National Policies, most public credits will be set aside for national infrastructure and the average credit terms will be shorter than the average useful life of real assets calculating depreciation, to ensure their sustainability[45]. To execute these projects, we will use bridge loans from the local development banks[46] or public debt funds obtained from international financial organization that could be paid executing debt administration operations issuing any national bonds either a public or a private bond issue, according to the current strategy. Infrastructure works and public investment projects will be financed through the issuance of benchmark bonds or using our temporary free-availability surplus, optimizing the opportunity cost.

g) Continuous assessment of indirect public credit sustainability granted or to be granted through deposits and other financial guarantees

We will assess and monitor the credit risk implied in different guarantees, as well as the counter-guarantees necessary to support the counterparty's ability to pay. This counterparty cannot belong to the private sector except when participates in public-private investments and licenses. The amount and validity period of all operations should have a limit and have to be covered by counter-guarantees. Additionally, the currency of the new indirect credits should mismatch with the same currency with which the users pay for the use of the infrastructure or the currency of the Regional and Local Government's revenues, in nominal or real soles, according to the best international practices (see Box N° 3).

7.2 Liability management

The strategy's goal is: to diversify the debt holders, to generate frequent signs of key vertex on the yield curve, to generate attractive debt volumes for each segment, that

[45] In stricto sensu, if the golden rule prohibits the use of debt to finance the current services provided by the Government and if the accrued expenses are considered the best accounting indicator of the cost of current services, then, it seems logical that the golden rule should require the equilibrium of the accrual budget during the economic cycle. In other words, the golden rule will allow that only the "net" investment (in contrast to the "gross" investment) will be financed using debt. In the same manner, the depreciation of investment should be covered with revenues and not debt. See Khan and Mayes (2009) "Transition to accrual accounting".

[46] COFIDE (Corporación Financiera de Desarrollo) and Banco de la Nación

auctions do not create interest rate instability, to stabilize the payment of interest of the whole debt, to reduce the level of dollarization of gross debt, to increase the government securities market in soles to reduce foreign debt, to mitigate the future liquidity risk that may be caused by the concentration of maturity dates and to flexibly reduce the financial cost related to interest rate risk that may cause a higher volume of refinancing for financial markets.

The strategy for global asset and liability management will consider the following lines of action:

a) To increase the number of financial institutions that can access to the regular auctions of the primary market in order to diversify the pool of investors.

The new regulations of bills and bonds allow the stockbrokers, insurance companies, pension, mutual, investment, trust and municipal funds to participate directly in the regular auctions of the primary market with competitive bids (including the minimum yield). It gives them for the first time the opportunity to develop more competition and to dinamize the segments or niches of this government securities market in local currency. In addition, public companies and public institutions could participate in the bills and bonds auctions, but with non-competitive bids that individually cannot be higher than 5% of the referential amount of each security. For this purpose, they should have sent the authorization request with the corresponding powers and signatures, specifying how they will sent the bids (electronically, using envelopes or fax).

b) Offer of Public Treasury bills to complete the short end of the sovereign curve in soles and to encourage national savings of the professional retail market

The maintenance of the short end of the sovereign curve in local currency is key for the real and financial sector companies to count with a frequent periodic reference to develop the access to local private debt securities market, which makes easier the issuance of certificates, bills, promissory notes and commercial papers.

Currently, the maximum amount of Public Treasury bills is still little; therefore, it does not exist a liquid secondary market for investors to buy these securities in each auction (each type of bill has been auctioned once a month) because most of investors hold the bills to maturity. We plan to increase progressively the amount and frequency of regular auctions with the same periods of 3,6,9 and 12 months (4 vertex, 2 vertex per week, first once a week, then twice a week) with a referential amount up to S/. 20 million each auction and a maximum S/. 600 million total balance at the end of 2014 (this balance will increase in the next years). Low amounts of bills will be issued in order to encourage domestic savings of the professional retail market through instruments with low exposure to market risk and that are considered free-risk assets in a market that was fragmented and could not access to the government securities market until mid-2013. Each participant can allocate up to S/. 500,000 per each type of bill in each auction (See Appendix N° 6).

Box N° 10: New regulations on Public Treasury bills

The Public Treasury bills Regulation was approved on March 14th, 2013 with the Supreme Decree Nº 051-2013-EF; it was one of the most important initiatives of the Public Treasury to develop the government securities market in local currency. This regulation encourages the participation of the different market segments, specially, the retail investor segment. It introduces good practices for auctions in the primary market, encouraging competition, equity and transparency, which are key factors to build a solid and well-structured market.

The main characteristics of this regulation are: i) the low nominal denominations of S/. 100 instruments, ii) the election of representative terms of 3, 6, 9 and 12 month, iii) the mixed allocation auctions, half auctions with unique price and the other half with multiple price, iv) the allocation limits per counterparty, up to 10% on behalf of each credit or security entity, and up to 2.5% on behalf of a third party, v) the use of centralized trading mechanisms, principally, Lima Stock Market and vi) the supervision of operations made by the Superintendencia del Mercado de Valores, to guarantee the good behavior of the market.

The measures to develop this market look for two objectives. On one hand, they look for setting the basis for the reference yields of the local sovereign curve with terms shorter than one year, in order to incentive the development of a market of short-term private issuances, which helps to develop the securities market. On the other hand, the development of the government bills market is part of the reform made by the Government in terms of financial inclusion, because small investor now can access to government instruments, which helps them to build their portfolio accurately, especially in high volatility contexts.

c) A new message for the private debt securities market through benchmark bonds in the sovereign curve in real or inflation-indexed soles

For the private sector, the advantages of the inflation-indexed securities is that they match their financial cost with their sale prices and the real value of their fixed assets in the long term. For the public sector, the advantage of these securities is that they ease the stabilization of debt to GDP ratio and debt service to GDP ratio and also give useful information about market inflation expectations because they are correlated with the long-term performance of tax collection. However, due to the lack of these instruments, it is difficult that indexed bonds in the primary market can be traded in the secondary market because the few inflation-indexed bonds are purchased in order to match maturities gaps and are not large-scale neither they have enough liquidity to be part of a portfolio. In this way, the number of auctions and bonds will increase in order to obtain more frequent signals of valid prices and a more liquid yield curve in real soles, whereas the inflation-indexed bond market reactivates. For this reason, 10, 15, 25 and 40 years bonds (4 vertex, 2 vertex per week, twice a month) with a referential amount not lesser than S/. 20 million per each bond will be issued in the regular auctions. In this way, every eligible participant that is not considered a market maker, will be able to award until S/. 3 million per one out of two bonds auctioned each week, unless the Ministry announce something different. These bonds will be also issued in quarterly special auctions to reduce the growing deficit of investment instruments of the big retirement and life pension market. It will also help to create opportunities for diversification in the local government securities market for issuers and investors, without looking for the massive indexation of government debt.

d) Bids of benchmark bonds for the middle and long end of the sovereign curve in nominal soles

In the long and middle end of the curve, 3,9,15 and 40 years (4 vertex, 2 vertex per week, twice a month) benchmark bonds in nominal soles will be issued weekly with a referential amount above S/. 20 million each, in the regular Public Treasury auctions. In this way, every eligible participant that is not considered a market maker, will be able to award until S/. 3 million per one out of two bonds auctioned each week, unless the Ministry announce something different. The increase in the frequency of bond issuance also responds to the need of maintaining the market development, to the highest demand of liquid assets to comply with the regulation requirements and to avoid void auctions even in times of high volatility, which will probably continue in the short term. Also, international experience suggest that there is a positive correlation between a greater frequency of regular auctions and a more developed securities market, in contrast with the limited

development and higher vulnerability when bond auctions are based only in market opportunity. Notwithstanding, regular auction's benchmark bonds will be issued in the quarterly special auctions. In any case, benchmark bonds will be issued in regular and special auctions as well as its amount do not exceed S/. 4 billion. In case the balance is greater than S/. 4 billion, future 5 and 7 years benchmark bonds will be issued. Current and future benchmark bonds may be used for debt management, as long as the amount of each bond does not exceed S/. 4 billion.

Box N° 11: New regulations on Sovereign bonds

The local sovereign debt market has increased gradually in the last years, catching the interest of local and foreign investors which requires the adoption of more standards. To achieve this, it has been necessary to introduce a series of qualitative improvement in the current regulations on sovereign debt securities that will allow to reduce gaps with more developed debt markets.

In this framework, recognizing the importance of the government market as the base for the financial market development, the new regulations of bonds was approved in order to develop the government market and guarantee the stability of the sovereign yield curve.

The changes in the bonds regulations are:

- Regular auctions under an annual schedule and special auctions, according to the market opportunities.
- Trading of government debt securities using centralized trading platforms, under the supervision of the Securities Market Regulator (SMV).
- The obligatory settlement of operations under the delivery vs payment system.

New characteristics for auctions:

- Authorized firms, not necessarily market makers firms, can participate in the auctions. In this sense, stock brokers, insurance companies, pension, mutual and rural funds can participate.
- Entities can present competitive and non-competitive bids. In the first case, the participant presents the bid yield but may not award the bond. In the second case, the participant accepts to award the bond with the average yield of the auction.
- The auction combines elements of a single uniform price auction and a discriminatory auction (multiple prices). Different prices allocations favors the secondary market of securities.
- Limits for counterparties are established to avoid the concentration of securities in few participants: up to 15% of the referential amount with competitive bids for each eligible entity.

With these measures the Public Treasury reaffirms its commitment of promoting and guarantying a more accessible, transparent, liquid and competitive government securities market in local currency.

e) Stabilization of payments of debt interests through the standardization of coupons

In order to obtain the macroeconomics forecasts and accomplish the debt service schedule, the principal of all bonds issued for the first time will not be redeemed and their coupon rates will be 6% for nominal soles and 4% for inflation-indexed soles, unless exceptional cases. These rates correspond to average implicit yields expected in the long term in the government securities market in a situation of market equilibrium. They are in tune with the current inflation target for the Peruvian sol, which is similar to the implicit or explicit inflation targets of countries whose currencies are the dollar, euro and yen. The new bonds in nominal soles will mature in odd years and inflation-indexed soles will mature in even years. This standardization will also help to the future coupon stripping and the dynamic debt service profile, reducing transaction costs.

Box N° 12: Average structural demand of sovereign bonds 2014-2017

The demand of the main institutional investors (pension funds, mutual funds and banks) for sovereign bonds in the 2014-2017 period has been estimated according to the regulations for the government market until 2013, based on the growth of their investment portfolio and the average percentage of sovereign bonds in these portfolios.

To quantify the sovereign bond demand is important because it makes clear the real viability of financing the public sector´s financial needs in local currency as well as it allows to anticipate the time for modifying or increasing the debt composition in soles for the new issuances and some debt management operations, if important changes does not occur. In the next chart the average annual structural demand for the period 2014-2017 is showed and the maximum amount if the confidence level were 80%, 90% and 95%:

Years	Average amount	80%	90%	95%
2014	**2.72**	**3.44**	**3.90**	**4.31**
2015	3.73	4.41	4.60	4.83
2016	3.09	3.89	4.07	4.32
2017	4.72	5.67	5.84	6.12

On the other hand, we can observe the participations of local sovereign bonds in the portfolios of the main institutional investors in Brazil, Mexico and Colombia at the end of 2012, showing an evident gap:

Institutions	Brazil	Mexico	Colombia	Peru
Banks	28%	12%	34%	**2%**
Pension Funds Schemes	15%	44%	17%	**13%**
Insurance Companies	30%	31%	15%	**11%**
Mutual Funds	40%	37%	7%	**4%**

Consequently, if the participation of government sovereign bonds in the portfolios of the main local institutional investors would be equal to the participation in the abovementioned countries, the structural demand for sovereign bonds will be more than three times the average, which means that there is plenty of room to increase the participation of public debt securities in soles, without increasing the public debt balance.

Years	Average base amount	Similar to Colombia	Similar to Brazil	Similar to Mexico
2014	2.72	10.06	10.33	14.54
2015	3.73	12.47	12.71	17.39
2016	3.09	12.82	12.95	18.07
2017	4.72	15.33	15.41	20.98

f) Mitigate the profile of debt maturities through periodic exchange of debt to avoid excessive concentration of maturities

Special auctions for government securities exchange in local currency will be announced quarterly in order to soft the profile of gross debt maturities. It will increase the balance on benchmark bonds and, at the same time, reduce the balance on bonds with maturity dates over S/. 4 billion or bonds with maturity dates over two years. These operations will be flexible, using competitive and non-competitive bids, in order to provide to each investor an opportunity to realigning the weightings according to the objectives or profiles of their portfolios. In the future, when the amortized cost of the securities that will be exchanged is lower than the market price of the new securities and, if the long-term economic analysis and the fulfilling of objectives, goals, policies and tactics justify it, bonds will be issued with the same amount that Government will receive. In this way, if the Asset and Liability Management Committee authorizes it, the difference will be paid in cash as part of a debt management operation considered as debt service.

g) Reduce gradually the foreign debt through complementary special auctions, separated from regular auctions

To achieve the approved policies, objectives and goals, the foreign debt (debits and securities) will be exchanged gradually by domestic debt in soles issued in periodical and complementary special auctions in one or more issuances, separated from regular auctions. The priority will be the most expensive and highest relative risk foreign debt, using benchmark government securities issuance in soles for prepayment. To obtain flexibility to execute prepayment operations when market conditions are unfavorable to issue bonds in the domestic market to obtain the necessary funding, the Public Treasury will use its funds provisionally without incurring in high financial expenses, which will be paid back with special auctions, in one or more parts. In the future, when the amortized cost of the securities or loans that will be prepaid is lower than the market price of the new securities in soles, bonds will be issued with the prepaid value, if the long-term economic analysis and the fulfilling of objectives, goals, policies and tactics justify it. In this way, the difference will be paid in cash as part of a debt management operation considered as debt service, as long as this difference will be compensated with the exchange rate profits from the original bookkeeping.

7.3 Treasury management

In treasury management, the Strategy aims at collecting tax revenue directly from contributors make profitable the cash flows that were not spent from day one, reduce the impact on the liquidity of funds obtained by the Public Treasury auctions and provide the liquidity of Public Treasury securities before auctions.

In this way, the Strategy considers the following lines of action.

a) Progressive and direct collection of public funds through tax or non-tax collection in the Public Treasury's account

Internationally, the Public Treasury role is to pay all the Government's obligations and collect all its revenues, and to be in charge of the treasury, savings and debt management. Consequently, tax and non-tax collections should be deposited directly in the Public Treasury accounts (in banks, municipal savings, etc.). This collection should be reflected in the financial statement directly and in detail, according to the international accountability standards, which will ease the control and monitoring the collecting process in the Central Government, without affecting the budget allocation. To this end, we count with the experience and advice of civil servants of other countries that are members of the Foro de Tesorerías Gubernamentales de América Latina (FOTEGAL) (Peru is a charter member and a current member) and the periodic technical assistance of the International Monetary Fund and the support of the Swiss Cooperation (SECO).

b) Implement an active management of the temporary differences between revenues and expenses, using government securities as collaterals

An active cash management will be implemented to improve the profitability of public funds and, at the same time, create a "derivative" demand for the Public Treasury securities that will be used as collateral, using the liquidity excess that is caused by the time difference between revenue collection and budget expenses during the year. In this way, in the banking system, there will be just one change in the ownership of the funds (from the public to the Public Treasury and vice versa) deposited in bank and mutual fund accounts, reducing the unfavorable impact that such mismatches generate on the

liquidity of the financial system during the year, according to the best international practices that were already implemented in more developed countries. In these countries, there are auctions of the participation of any surplus that the Public Treasury has not spent until certain hour each day.

c) A temporary offer of liquidity to the buyers of treasury bills and benchmark bonds through repo operations

Financial institutions that can participate in Public Treasury auctions in a competitive manner and contribute to maintain the stability of interest rates will be able to obtain funds with repo operations using bills and benchmark bonds issued in regular and special auctions as collaterals. A down payment will allow financial entities to allocate Public Treasury securities financed in instalments up to 24 months, with the option to pay off in advance under certain conditions, with competitive and non-competitive bids. As soon as Government counts with the technical facilities, repo operations to allocate funds will be offered progressively after regular and special auctions in order to soften the unfavorable impacts that the Public Treasury securities generate on the liquidity of the financial system the day the funds are settled against issued securities, especially in big issuances and when foreign investors participate, according to the best international practices already implemented in developed countries.

d) Temporary offers of benchmark bonds through repo operations that can be offered permanently

The repo operations regulations will allow financial institutions that can participate in the Public Treasury auctions could raise any benchmark bonds through securities repo with cash collateral, so they will obtain the ownership and temporary free availability of Public Treasury securities. Additionally, the institutions have the option of buying bonds to the Public Treasury if they decide not to return the bonds before the final date. These repo operations will be offered immediately after the regular auctions of bonds with the same benchmark amounts and for 2 or 4 weeks before the next auctions under certain conditions, with competitive or non- competitive bids.

Box N° 13: Regulations on repo operations

Repo operations are a key instrument to develop the financial market of any country, because it helps to increase the liquidity flow of the financial system agents. The advantage is that it softens the credit, market and operative risk if repos are made with 3 agents, a centralized settlement, delivery vs payment system and an accurate level and management of collaterals.

Within this framework, and considering that Law N° 30052, Repo Operations Law came into effect, the Repo Operations Regulations with Public Treasury Securities is in process to be approved. This regulation will contribute to a more efficient development of the local sovereign debt market and securities market.

In economic terms, repo operations are equal to a money lending backed by a financial guarantee agreement which lays in a temporary transfer of securities ownership (money repo using securities as a collateral) or, alternatively, they will equal to securities loan backed with a financial guarantee agreement which lays in a temporary transfer of money ownership (securities repo using money as a collateral). Therefore, the main characteristics of these instruments are:

- Initial prices that will reduce the call margins up to 99% confidence level.
- Final prices that will include the profitability of the operation and the eventual coupon payments.
- Exposure calculus that will protect to the money or broker in case of default.
- Secondary repos that will allow changing the broker position, temporally or totally.

- Securities repos using securities as collaterals with the same or other counterparty.
- Partial or total synthetic bailout option.
- Synthetic and permanent bailout and outright option, either total or partial.
- Only spot and forward operations are allowed, with fixed or variable rate.
- Only government securities registered in CAVALI are allowed.
- The Public Treasury will act as a counterparty in repo operations with or without auctions.
- Operations made in centralized trading systems monitored by the SMV.
- Operations with centralized settlement following the best practices recommended by IOSCO.
- Institutions with the most competitive position have permanent access to bond auctions

The development of the repo market will make the temporary excess liquidity under the Public Treasury administration more profitable, and will give more fluency to trading and will establish the basis for the future derivatives market.

7.4 Market structure

The Strategy main goal is to optimize the infrastructure of the government securities market in local currency, enhance the role of Market Makers institutions, increase the level of competition, transparency and liquidity for price formation in a more contestable market, give access to individuals, constitute a fund as a sovereign risk benchmark for mutual and pension funds, increase coverage and to apply the delivery vs payment principle in settlement and clearing of government securities.

The market structure strategy considers the following actions:

a) Enhance transparency, competition and liquidity for the price formation of the government securities market

The new bonds and bills regulations establish the minimum requirements for the centralized trading systems where government securities operations are traded or recorded; these trading operations are monitored by the SMV considering the best international practices on financial market infrastructure. Repo operations with bonds and bills will be offered in order to increase the structural demand of these securities by local investors, ensuring a minimum liquidity of funds and securities. With repo operations of government securities, the securities holder may obtain free availability money funds and, with repo operations of money, the money holder may obtain free-availability securities. Both operations will be offered through a centralized trading system, which will give more transparency to price formation in equal conditions.

Box N° 14: Benefits of the registration modules for financial operations

According to the Bank for International Settlements (BIS) and the International Organization of Securities Commissions (IOSCO), one of the major benefits of the financial operation register, which is a consequence of the centralization and quality of data, is the better transparency of the market and the supply of data to authorities and the public related to their information needs. An opportune and reliable access to data storage improves the capacity of the authorities and the public to determinate and evaluate possible risks of the financial system. In particular, authorities need an efficient and practical access to data storage, including data of participants, in order to comply with the regulatory framework and legal responsibilities.

A registration module can render services to parties that need an efficient access to operation registration services for data submission and retrieval. Besides authorities and the public, the parties involved can also be markets, electronic negotiation platforms, confirmation platforms or comparison operation platforms and independent services suppliers that use the operations registration data to provide complementary service. Therefore, the policies for access and instructions for use of the operations registration module should facilitate a fair and open access to its services and data. Another important benefit of this module is to provide a common technical platform that needs coherence in the

formats and data representation. The result is a centralized data repository of operations that are more usefulness and reliable than scattered data.

The central banks, supervised institutions and other institutional authorities involved in trading operations registration have the responsibility of enhancing data access within the framework of regulation, supervision and monitoring responsibilities. Whenever market infrastructures keep developing, it is possible to establish the operation registration for different instruments and securities and also the cooperation between authorities will be more important. Efforts must be made to eliminate any obstacle or legal limitations that avoid authorities from an appropriate, effective and practical access to data, keeping the confidentiality.

b) Prepare a study to increase the technologic infrastructure of the operative systems of the government securities market

The project's objective is to make an international and independent diagnosis to identify competitive opportunities to develop technology and regulations for the current operative systems of the government securities market, based on the best international models and practices that promote a greater competition in equal conditions and, at the same time, reduce the incentives for market fragmentation. The objectives of the project are: (i) protect investors and preserve the integrity of the market and (ii) encourage equity, transparency, effectiveness and integration of the financial markets. To this end, the consultancy will focus on study and diagnose the performance of the operative process of securities issuances (primary market), intermediation and execution of orders (secondary market), communication, registration, compensation and operations settlement, deposit and securities custody. This study comprehends the framework of goals and indicators of performance of the Mandatory Fulfilling of National Policies, approved by Supreme Decree N° 027-2007-PCM and will receive the support of the Swiss Cooperation – SECO.

Box N° 15: New regulations on the market makers program

The new market makers regulations, approved by Supreme Decree N° 096-2013-EF, arises to adapt the mechanism of participation of the entities in charge of boosting the development of the government bonds market to modern times, identifying the main changes and risks of the global financial environment nowadays.

The guidelines previous to the current Regulation contributed to the initial boost and position of government securities in local currency for great, local and international investors. However, in this new phase, we need a renewed boost to this modality of distribution of government securities, according to the best international practices, ensuring the participation of market participant within a competition and transparency framework for sovereign debt operations.

One of the main novelties of the Regulation is that it allows securities institutions to be considered as market makers just ensuring a minimum S/. 3 million net worth. The most important advantages for market makers are:

- Submit bids until 30 minutes after the auction ends.
- 100% award of the benchmark amount of securities.
- Access to the special module of the centralized trading mechanisms.
- Access to the repo operations, syndicated loans, and others.
- Participate in the periodical meetings arranged by the Responsible Unit.
- Receive the official recognition if institutions obtain the first place in the assessment.

On the other hand, the main obligations of market makers are:

- At least, to submit bids for each security according: i) credit institutions: 10.0% of benchmark amount, and ii) securities entities: 5.0% of benchmark amount.
- Minimum allocations should be a proportion of the benchmark amount that has been auctioned in the last quarter: i) for credit institutions: 5.0%, and ii) for securities institutions: 2.5%.
- Establish prices in the platforms of the centralized trading mechanisms in pre-established hours (between 9:30 am and 10:30 am and between 12:30 pm and 1:30 pm).

c) Boost the role of the financial entities that are considered as market makers of government securities

To this end, a new Market Makers Regulations with requirements, privileges and obligations that are more aligned with the interests of the Republic of Peru, obtaining more liquidity and a wider base of investors, according to the best international practices and experiences. Net worth and bid and allocations are different for credit institutions and securities institutions and, in order to promote a greater competition, the scores as well as the level of compliance of each obligation will be published weekly. We hope this will represent a new opportunity for a greater participation of local and foreign stock brokers in the government securities market, looking for a future and active integration of the fixed income markets of Peru, Chile, Colombia and Mexico in the next stages of MILA and the consolidation of capital mobility in the Pacific Alliance.

d) Government securities sales for the non-professional retail market in order to increase domestic savings

The project's main goal is that people can save money using special government securities other than bonds and bills, buying them online, like other countries in the region with similar credit rating do. This initiative will be favorable to the financial inclusion of the Public Treasury, will promote the domestic savings of national small savers and also will establish the bases for a greater diversification of the investor base and a long-term growth for the future domestic holding of bills and bonds in order to increase the financial inclusion. The project is included in the framework of goals and indicators of performance of the Mandatory Fulfilling of National Policies, approved by Supreme Decree N° 027-2007-PCM and has the support of the Swiss Cooperation – SECO.

Box N° 16: Website for government securities sale

One of the goals of the Public Treasury, which encourages the financial inclusion and education for the population, is the creation and implementation of a website for government securities sales, which is included in the Mandatory Fulfilling of National Policies. It is a mechanism that will allow the average citizens to save money safely, regardless of its geographic location or social status.

During 2014, this website will be build, thanks to the Swiss Cooperation – SECO, and it will offer low nominal denomination instruments and will be designed exclusively for a massive public nationally, whom will be able to invest their money on these securities in a simple and transparent way, obtaining attractive yields, without costs nor commissions, enjoying the security and guarantee of the Peruvian government. This initiative complements a plan that started in 2013, in which citizens could access to government securities, principally through the Public Treasury bids up to one year-term.

In order to democratize the access to the services provided by the Peruvian Government, this project will be considered as a key instrument of the National Strategy of Financial Inclusion which has been promoted by the Executive Power, leaded by the Ministry of Economy and Finance along with the main institutions and agents related to the subject.

e) Constitution of the Sovereign Debt Fund as a risk-free reference for the pension and mutual funds market

The Public Treasury was authorized to constitute the Sovereign Debt Fund that will operate as a benchmark index fund for the credit risk-free yield, for participants and members, mutual funds administrators and pension funds from the local market. It will directly help to order the market and will create a greater competition and will indirectly help to increase the structural demand for government securities in the institutional

investor market. In the future, the public will access to this fund just as any mutual fund does, similar to the way that other Public Treasuries do.

Box N° 17: Methodology of the Public Treasury Index

The index will be calculated on a daily basis estimating the total rate of return of a portfolio composed of all government bonds denominated in today's nominal soles (RTP(t)) multiplied by the index value of the previous day.

$$Vindex_{(t)} = Vindex_{(t-1)} \times (1 + RTP_{(t)})$$

Where:

$Vindex_{(t)}$: Index value in period t

$Vindex_{(t-1)}$: Index value in period t-1

$RTP_{(t)}$: Total Return of the portfolio, consisting of bonds denominated in nominal soles, which is obtained from:

$$RTP_{(t)} = \sum_{i=1}^{N} P_{i\,(t-1)} \times RTB_{i(t)}$$

Where:

$P_{i(t-1)}$: Participation percentage of each bond in the portfolio in period t-1.

$RTB_{i(t)}$: The overall performance of a particular bond.

The total return of each bond ($RTB_{i(t)}$) is obtained from the sum of five components:

- Price return: for market movements
- Coupon return: for the coupons received.
- Amortization return: for amortizations of the principal.
- Prepayment return: for prepayments made.
- Extraordinary return: for extraordinary payments (payment protection or similar).

The participation of each bond in the bond portfolio is obtained from:

$$\boldsymbol{P_i(t) = \frac{VMB_i(t)}{Cash\ balance_{(t)} + \sum_{i=1}^{n} VMB_i(t)}}$$

Where:

$P_{i(t)}$: Participation percentage of each bond in the portfolio in the period t-1.

VMBi(t): market value of a bond in the moment t.

Cash balance(t): accumulated cash in the moment t.

∑VMBi(t): Summation of the market values of the current bonds.

f) Increase the coverage and the application of the delivery vs payment system principle in the clearing and settlement of government debt

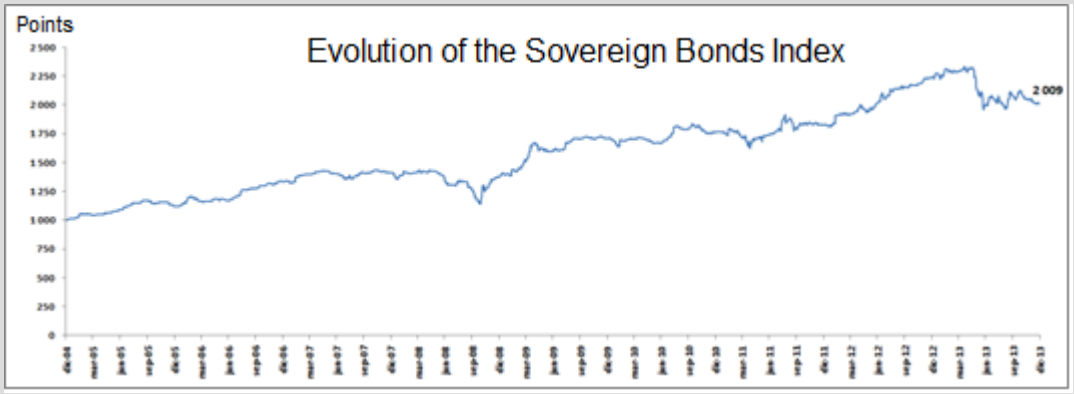
The government securities market will adopt the delivery vs payment principle in the same way the private debt equity market and securities market do, in order to reduce the operative fragmentation of the government securities market and promote a greater competition between market participants in equal conditions. The government securities market will also adopt a multilateral settlement of funds and securities with deferred transfers in net terms at the end of the settlement date or in specific moments of this date, in order to develop the repo market and the derivatives market. Currently, the bilateral real-time transaction-by-transaction settlement is not the most efficient for the Peruvian market because not all institutions can access to the real-time gross settlement system, neither to its intraday liquidity and also this system is not available 24hrs a day 365 days of the year.

To reduce the credit risk and liquidity risk the period between liquidations should be reduced and consider the possible constitution of margin calls due to the differences between the traded price and the market value. In this way, the future cost of any default

on credit events will reduce, including the settlement cases, without incurring in foreign abodes and laws, especially for derivatives with and between local counterparties.

Box N° 18: Return performance of the Public Treasury index

Based on December 2004 (base=1000), the index of bonds in soles issued by the Republic of Peru was calculated, using the methodology in the previous box. The results showed that the index behavior during the period was growing and that demonstrates a good performance of the public sovereign debt instruments.



Source: MEF

In addition, we can see the performance of the annual return of the fund during the period from January 2006 to December 2013 and the historic average return during this period is 9.27% annual cash, better than other local investors with similar risk profile and investment term. For instance, the performance of the index return in the last year has been superior to the return of some debt mutual funds in soles.

Investment options	Historical return
BCP	4,49%
BBVA	4,17%
Interfondos	4,56%
Fund 1 of a Pensions Fund Manager (AFP)	8,06%
Sovereign Debt Fund Index	**9,27%**

Source: MEF

8. PROJECTIONS 2014-2017

To quantify the fulfillment of the financial policies in a prospective manner established in the Strategy for Global Asset and Liability Management that are assembled to the public debt management and to some goals established in the PESEM and PEI, leads to an estimation of a referential rank of the projections of the Central Government's gross debt indicators at the end of 2017. These projections have been consistent with the preliminary estimations of the Multiannual Macroeconomic Framework 2015-2017 and its fiscal goals and regulations. The aim of these projections is to quantify the impact of the main tactical actions that will be part of the implementation of the debt, savings and treasury management.

The rank of projections is based on four alternative deterministic scenarios, which consider the economic performance, the funding amounts to cover the fiscal needs and the execution of some debt management operations, as well as the perspectives for the local and international financial markets because they will define the access and conditions for the new debt.

8.1 Current context and perspectives

In 2013, the Peruvian economy reached 5.82% growth with base year 2007, its lowest growth in the last 3 years, considering the numbers from 2010 (8.45%), 2011 (6.45%) and 2012 (5.95%). The economic performance was principally due to the domestic demand that reached 7.0% boosted by the private consumption (5.4%), government consumption (6.7%) and domestic gross investment (10.5%). On the other hand, the external demand suffered a 0.9% downturn, principally due to the lower exportation volumes as a consequence of the main world economies' downturn.

The performance of the economy locally and internationally is relevant for the public debt management because the recovery of the first world countries to the conditions before the crisis may impact equities flow and their cost.

In line with the lower GDP growth and the inflationary expectations included in the target rank of the monetary policy, the benchmark interest rate of the Central Reserve Bank of Peru keeps unchanged at 4.0%. On the other hand, in the last quarter of 2013 and at the beginning of 2014, the international financial markets were affected due to events caused principally by the U.S. and China and its effects had direct repercussions on some emerging economies that lift its interest rates because of the imbalances in their external accounts and inflationary pressures.

One of the markets' main worries is that the U.S. Fed will raise the short-term benchmark rate. The impact of the interest rate lift worldwide may lead to a global portfolios rearrangement and emerging markets may overreact and pressure to increase the sovereign debt yields and Peru will not be exempt from this situation. However, from a long-term perspective, we expect that the sovereign curve will adopt the average values according to its credit rating and economic fundamentals.

On the other hand, the Sol depreciated in 9.52% at the end of the year, and the average exchange rate sale was S/. 2.798 per dollar, because of the demand of dollars by corporative companies in the spot market, by pension fund administrators in the forward market and by banks that increased their portfolio in dollars. Since April 2013, the Peruvian currency suffered a continuous depreciation that started with the first

statements of the FED about the removal of the quantitative expansion measures sooner than expected.

In 2013, there was a high volatility in the sovereign yield curve, especially in the last months of the year, and also a relative reduction of foreign investors' debt holdings; however, the overall picture shows a slight increase. The trend of the yield curve in soles slopes upward along with global yields, raising as investors overweighted very short-term bonds in order to evade the effects of an eventual interest rate increase.

The financing cost of Peru's sovereign debt in U.S. dollars raised strongly between May and June and sloped downward since August 2013 because of a higher risk aversion, which was reflected in the fall of 5 years Certificates of Deposits and the EMBI+ Peru, anchored inflationary expectations and the performance of the U.S. bond yields.

According to the expectations and assumptions related to the shift in the yield curves and the differentials between currency for the short and long term in 2014, the expected behavior of the sovereign curve of the Republic in soles and U.S. dollars is shown in the following Graph (see Table N° 18).

Table N° 18
Expected perform of the yield curve for Peru in 2014

Concept	Short-term	Long-term	Slope of the curves
Sovereign curve in soles	⇧	⇧	⇧
Sovereign curve in dollars	⇧	⇧	⇧
Differential between soles and dollars	⇩	⇧	

Source: MEF-DGETP

As indicated in the table, in the base scenario the sovereign curve in soles might show an upward correction, which might not be uniform in all its segments. We expect the short-term vertex register a lower volatility because of its shorter duration and lower market risk exposure and the important number of foreign investors in this segment that may limit the upward trends.

In the long term, yields may be more sensitive to interest rates shifts, which will be aligned to the gradual adjustments of the FED monetary police. In the long term, we expect global bond yields to grow as a result of the best perspectives of the U.S. economy and the monetary stimulus cuts promoted by the FED.

8.2 Scenarios to quantify the projections range

The projections range of monitoring indicators of the Central Government's gross debt was determined using four scenarios. Each scenario responds to different assumptions of economic and financial variables and debt management operations that will be executed in the next four years.

The base scenario responds to the current context which projects a better economic grow than 2013 of approximately 6% annual, and it will have a positive impact in the Central Government income. For 2015 and forwards, we expect the consolidation of this growth at similar levels to 2014. The debt management operations for the next four years are aligned with the planned actions to comply with the main goal of the Strategy for Global Assets and Liability Management, which is related to the development of the government securities market in local currency.

In the optimistic scenario, the Peruvian economy will have an economic growth of approximately 6.7% annually from 2014 to 2017, which will make possible to obtain higher tax revenues and therefore, the average economic result will be 0.9% for that period. We expect a greater dynamic in the economy principally due to a better performance of the domestic demand through the private consumption and investment.

Table N° 19
Referential projections of the indicators of the Central Government's gross debt at the end of 2017

Concept	Expected rank at the end of December 2017
Percentage in soles of the gross balance	57.2% - 72.1%
Debt percentage at nominal fixed rate in the gross balance	76.9% - 79.4%
Domestic debt proportion in the gross balance	56.2% - 71.1%
Average life (years)	12.9 - 16.2
Average re-pricing (years)	11.9 - 15.5
Concentration of amortizations in the next 12 months 1_/	6.9% - 6.0%
Percentage of the financing flows in local currency 2_/	70.5% - 84.4%

Source: MEF-DGETP

1_/ Indicator that measures the immediate payment pressures.
2_/ Includes the financing of debt management operations.

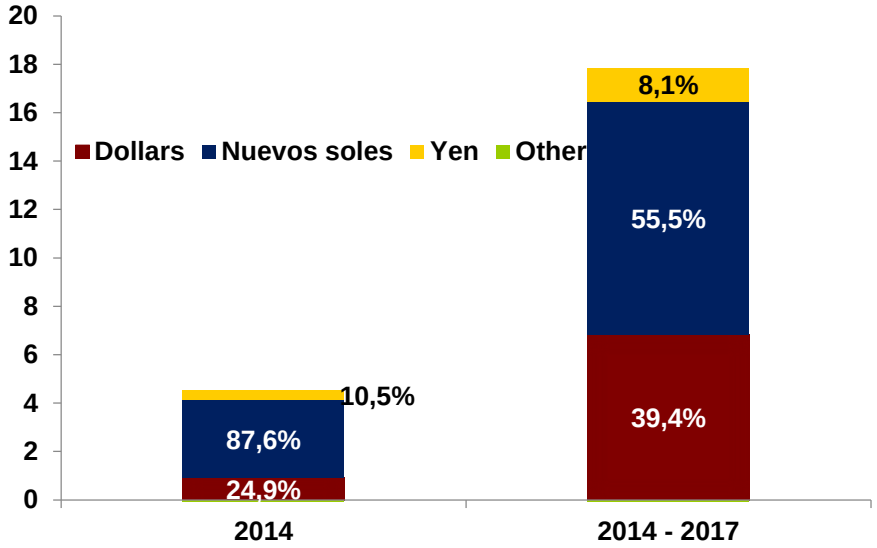
The pessimistic and stress scenarios show a less favorable performance of the GDP which, in average, will remain at levels of 4.5% and 2.5% annually, respectively. The international context would be contrary to the economy dynamism especially on the external demand, with a strong reduce of the exportation volumes and the fall of international prices. It would affect the expectations of economic agents, and will mean a lower rotation of the private spending caused by less investments or investment delays. Based on the optimist and pessimistic scenarios, the referential rank of projections for the end of 2017 was established, as indicated in Table N° 19.

8.3 Projections of gross debt service and composition

a. Projection of the gross debt service

Considering the base scenario, in 2014, the amortizations service represents 4.2% of the total debt (S/. 3.68 billion) and the annual amortizations until 2017 represent a slightly growing in the payment levels, as the average amortizations for this period represent approximately 5%. Therefore, the Public treasury can support the Central Government's debt service because the budget pressure of the Republic will diminish, as it has happened in previous year.

Graph N° 17
Debt maturities of the Central Government in currencies
(Billion soles)

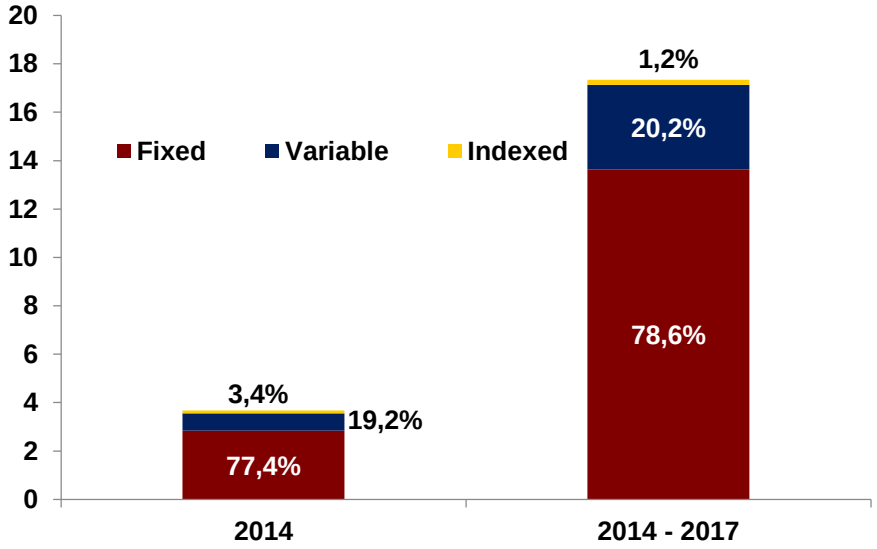


Source: MEF-DGETP

In 2014, payments made with currencies different to the sol represent approximately 35% and 47% of accumulated maturities in the next four years (Graph N° 17). The higher participation of the local currency reflects the efforts we have made to modify the structure of the Central Government's gross debt, aimed at reducing the impact of exchange risk.

On the other hand, Graph N° 18 shows that the 77.4% of maturities in 2014 of the interest rate structure belong to fixed rate obligations. We have a similar low risk proportion in the period 2014-2017, which favors a true programming of the budget for debt service payment.

Graph N° 18
Debt maturities related to the Central Government's interest rate
(Billion soles)

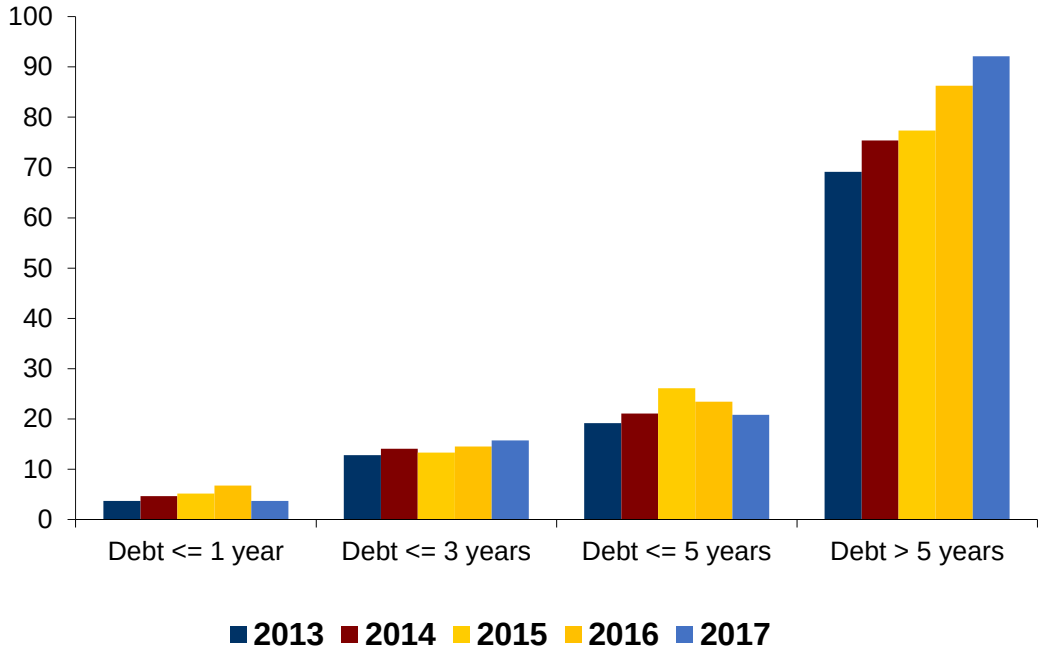


Source: MEF-DGETP

b. Projection of the debt composition related to maturity term

A big part of the structure of the maturities of current and future loans belongs to debt over five year maturity and, in 2017, this concentration will grow (see Graph N° 19). The effect of this structure is the de-concentration of the maturity profiles of public debt, which leads to a lower fiscal pressure.

Graph N° 19
Term to maturity of the Central Government's gross debt
(Billion soles)



Source: MEF-DGETP

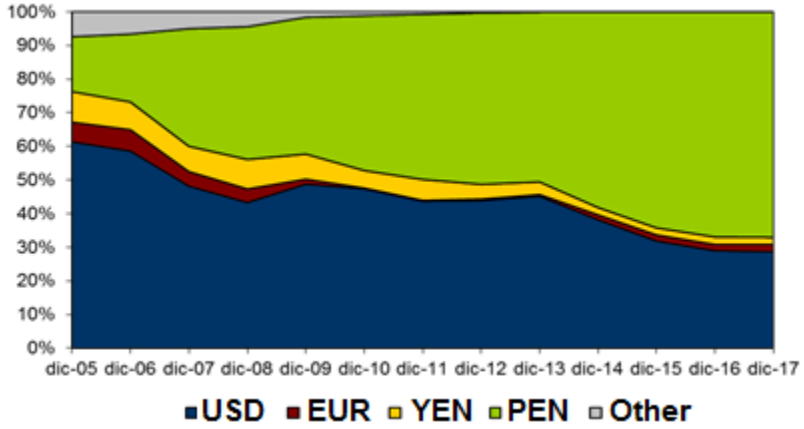
In the base scenario, the percentage of debt maturities over 5 years until December 2017 is 82.0%, and on December 2013 was 78.0% approximately. The factors that explain this shift are related to debt management operations, which will be financed with the long-term sovereign bonds issuance. The average life indicator hold this position and is expected that, in the base scenario at the end of 2017, it will reach 14.4 years.

c. Projection of the debt composition using currencies

The participation of the local currency in the total gross debt would be 67% at the end of 2017, close to the goal established in the PEI, that is, 70% (See Graph N° 20). At the end of 2013, this indicator was 50.4%.

It is very important to achieve the 70% in this indicator, because it creates a beneficial circle in which a higher income taking in the local market will mean a greater participation of the sol in the gross debt structure (reducing the exchange rate risk) and a lower financial vulnerability and, therefore, a potential improving of the credit rating made by credit rating agencies which will lead to a lower debt cost for the public and private sector.

Graph N° 20
Performance of the Central Government's gross debt composition per currencies

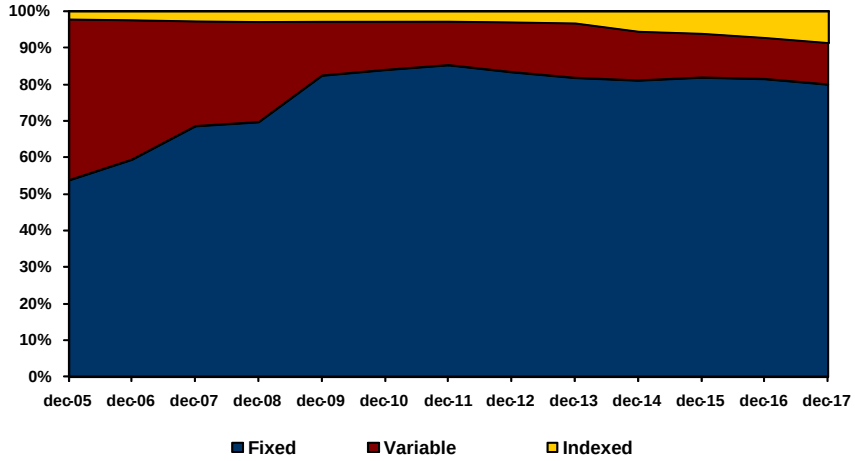


d. Projection of the debt composition per interest rate

Over the last years, the position of fixed rate in the gross debt structure has been 70%, which has helped to count with predictable flows to elaborate the corresponding budget.

The projection for the next years deepens this behavior: according to the calculations made in the base scenario we expect that this indicator will increase up to 80% at the end of 2017 (see Graph N° 21).

Graph N° 21
Performance of the composition of the Central Government's gross debt per interest rate



Source: MEF-DGETP

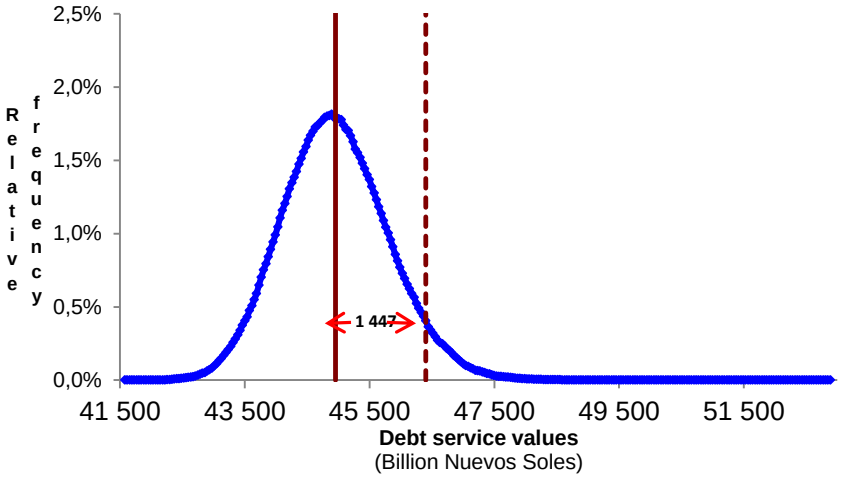
8.4 Gross debt service and cost at risk

The debt service at risk[47] analysis shows that an estimated debt service for the next four years (from 2014 to 2017), with a 95% confidence level, reaches S/. 44.95 billion. The risk due to interest and exchange rate fluctuations, which may imply additional outgoings for the expected debt service, (measured by the difference between 95% percentile and

[47] This model assumes that each variable interest rate and exchange rate are related to a variance of the geometric Brownian motion and are correlated with each other. Under this premise, an adequate number of Monte Carlo simulations with possible joint paths of these variables is generated and it makes possible to distribute the accumulated debt service in the chosen period.

the average) reaches S/. 1.45 billion, an additional 3.2% for the estimated debt service (see Graph N° 22)

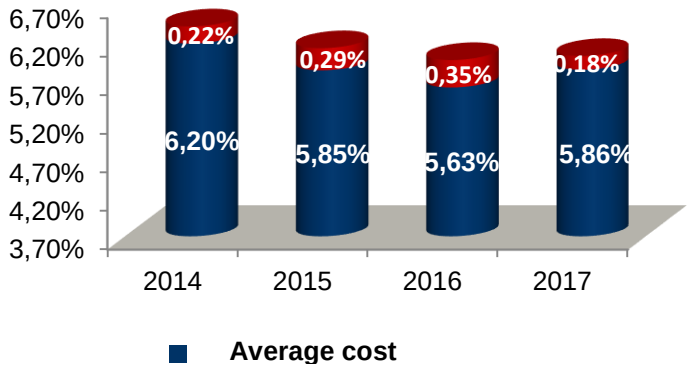
Graph N° 22
The Central Government's debt service at risk for the next 4 years



Source: MEF-DGETP

The annual average cost of the Central Government's gross debt in soles equals to the payment of debt interests plus an additional amount as the result of the exchange and interest rate volatilities[48]. This additional amount, which we define as risk, was established considering the stochastic performance of the interest and exchange rate, as well as its joint correlation[49]. The probable cost increase due to interest and exchange rate variations represents 26 bp in average for the analyzed 4 years (see Graph N° 23).

Graph N° 23
Cost and risk of the Central Government's gross debt for the period 2014-2017



Source: MEF-DGETP

8.5 Deterministic sustainability of the gross debt

The estimations of some Debt-to-GDP indicators (base year 1994) for the following years shows that it will slightly increase until 2015, reversing since 2016, according to the level

[48] This financial cost considers an interest rate increase in the variable rate loans (liabilities) and in the fixed rate of the new financing as well as the expected exchange rate stability, which would increase the cost of debt in the next years.
[49] The risk of financial cost in soles is the difference between the maximum cost (95% confidence) and the average cost.

of economic growth rate estimated in the Multiannual Macroeconomic Framework and the planned debt management operations for the period (Table N° 20).

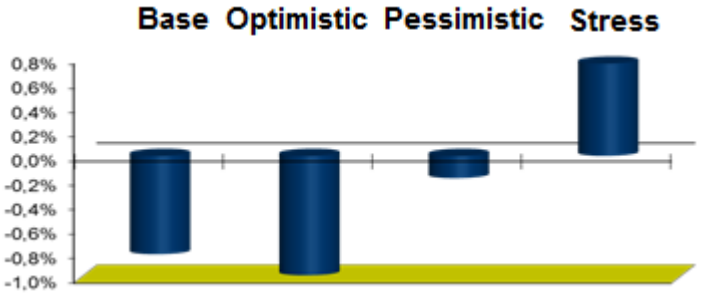
Table N° 20
Central Government's gross debt ratio
(In GDP percentage)

	2013	2014	2015	2016	2017
Base scenario					
Debt to GDP	15.3%	15.8%	16.0%	15.7%	13.9%
Debt Service to GDP	1.5%	1.6%	1.6%	1.6%	1.2%
C.G. Amortizations/GDP	0.6%	0.7%	0.7%	0.8%	0.4%
C.G. interests/PBI	0.9%	0.9%	0.9%	0.8%	0.7%

Source: MEF-DGETP

The analysis of the Central Government's debt ratio behavior using the sustainability indicator[50], shows that the debt is sustainable in the base and optimistic scenario and even in the pessimistic scenario, even though the assumptions for this scenario are adverse. This is the result of the favorable perspective of growth of Peru and a good management of the fiscal policy which will allow to keep reducing the financing needs and, therefore, the relative weight of the public debt. In the stress scenario, the debt would not be sustainable (see Graph N° 24).

Graph N° 24
Indicator of the Central Government's gross debt sustainability
(Percentage of GDP)

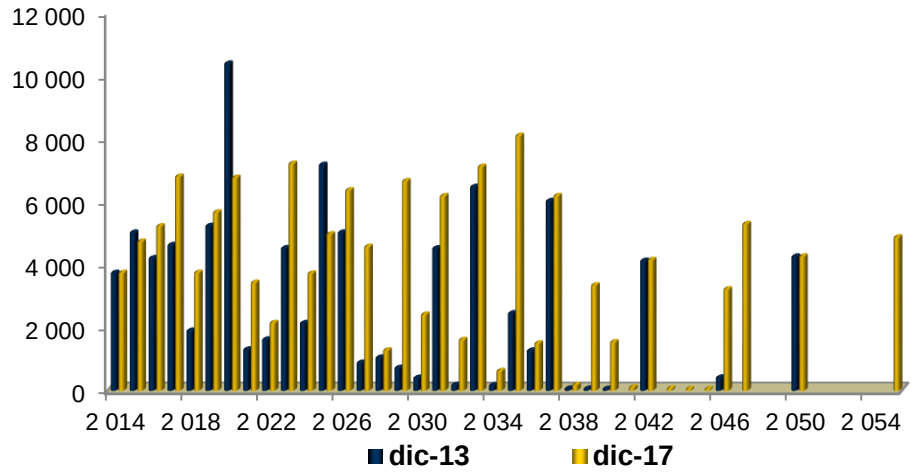


Source: MEF-DGETP

One of the objectives of the Strategy is to improve the debt maturities profile of the Central Government to avoid excessive concentrations of payments. The Graph N° 25 shows the C.G. debt maturities profile that includes the flows of the projected debt, generated by the new debt expected for the period 2014-2017 to finance the financial needs and the operations of liability management during this period.

[50] This indicator is the difference between the sustainable fiscal burden and the weighted average of the projected primary surplus as GDP ratios. The sustainable fiscal burden ensures that the debt ratio is constant over time. If the indicator has a negative sign, it means the public debt is sustainable (and eventually decreasing).

Graph N° 25
Projections of amortizations of the Central Government's gross debt
(In million soles)



Source: MEF-DGETP

One of the most relevant aspects is the reduction of the payment concentrations in the year 2020 as well as a redistribution of the long-term maturities in return for a stronger stability in the next year. The issuance of some sovereign securities in the long-end of the curve has become in order to provide them with more liquidity or to satisfy the needs of some institutional investors, such as insurance companies, which may mismatch their assets and liabilities with new securities.

APPENDICES

APPENDIX 1:

2014 Annual Public Debt and Debt Management Program

In accordance with the article 14° of the Single Consolidated Text of the Act N° 28563, General Act on the National Public Debt System, approved by Supreme Decree N° 008-2014-EF, The Annual Public Debt and Debt Management Program for the fiscal year 2014 was elaborated. From a long term perspective, the policies, objectives and quantitative goals of this program are part of the Strategy for Global Asset and Liability Management 2014-2017, consistent with the fiscal goals in the Multiannual Macroeconomic Framework.

One of the main objectives of the public debt management is to reduce the vulnerability of the public finances and enhance the investor confidence regarding the soundness of Peru's macroeconomic fundamentals. In the last years, progress towards this objective has been achieved by a continuous modification of the structure of the government liabilities portfolio with a greater position of the domestic debt in local currency and lower payment concentrations in the amortization profile for the next years that led to the consolidation of Peru's investment grade designated by sovereign risk agencies.

Since M.R. N° 157-2013-EF/52 of 05.23.13, which approved the 2013-2016 Strategy for Global Asset and Liability Management, the room for improvement in the composition of the gross public debt was the basis to define the main objective of the 2013-2016 Strategy "Enhance the development of the government securities market in local currency and cover the financial needs resulting from the debt and treasury management, within the framework of a responsible and sustainable management of public finances".

To reach this new main objective, the 2013-2016 Strategy for Global Asset and Liability Management approved six financial policies guidelines under a long-term vision to improve the debt and treasury management.

- Enhance the securities market by increasing the government debt in soles.
- Keep liquidity buffers to face volatility situations.
- Make profitable the public funds and reduce the liquidity cost.
- Keep a financing structure of the indirect debt.
- Reduce the procyclicality of the foreign debt as a source of vulnerability.
- Ensure the sustainability of the net public debt.

The first and the last three guidelines are closely related to the public debt management and the common denominator is related to the increase of the participation of the local currency in the gross and net public debt structure. The priority is to unite accurately these guidelines with the current regulation in order to reach a qualitative level of public debt according to the international standards.

Considering articles 17.3 and 28.1 of the Single Consolidated Text of the Act N° 28563, General Act on the National Public Debt System, that establish the procedures to set the maximum amounts for concertation of debt operations and the annual program of disbursements respectively, considering that one of the main parameters are the objectives, policies and goals of the Annual Public Debt and Debt Management Program, the actions below should be done during this fiscal year in order to reach the goals established in the indicators that measure the vulnerability level of the public finance, the development of the government securities' local market, the debt service

concentration, and others, which are compatible with the policies and objectives set in the 2014-2017 Strategy for Global Asset and Liability Management:

- At least 85% of the financing for the fiscal needs that are established in the Multiannual Macroeconomic Framework will be obtained from the government securities market in soles.

- 100% of the financing needed for the execution of the debt management operations will be obtained from the government securities market in soles.

- The number of weekly auctions of the Public Treasury bills and nominal and real (inflation-indexed) sovereign bonds will increase according with the regular auctions schedule published in the Appendix N° 6 of the 2014-2017 Strategy for Global Asset and Liability Management. The referential amounts are also detailed in this document.

- The new nominal and real benchmark sovereign bonds are defined in the Appendix N° 6 of the 2014-2017 Strategy and becomes effective for the next 12 months.

- The coupons of the new non-amortizing bonds issued for the first time will be 6% for nominal securities and 4% for real (inflation-indexed) securities, except in individual cases.

- Special auctions of nominal or real sovereign bonds considered as benchmark bonds according to the Strategy for Global Asset and Liability Management 2014-2017 will be announced at least once every three months. These auctions will be made when the market conditions are favorable to the interests of the Republic after the quarterly meetings with the market participants.

- Special auctions of government securities exchange in local currency will be announced at least once every three months, as long as the market conditions are favorable to the interests of the Republic in order to improve the gross debt profile. The objective of these operations is to facilitate the rebalancing of its holdings based on the profile or objectives of their investment portfolio.

- The settlement of the nominal and real sovereign bonds and the Public Treasury bills will be made under the delivery vs payment scheme and the multilateral net settlement will be implemented, just as the rest of the securities market.

- The Treasury Index is the benchmark to manage the Sovereign Debt Fund in order to democratize the access of the public to funds with yields based on securities issued by the Republic of Peru.

- Repo operations using nominal or real sovereign bonds and Public Treasury securities will be executed. The goal is to increase the demand for Public Treasury Securities and, therefore, the liquidity in the government securities market in local currency.

- Communication channels with credit risk agencies and local and foreign investors will enhance in order to keep them informed about the performance of the debt indicators and the intentions of future actions and operations.

To quantify the quantitative effect of these strategic actions for the Central Government's debt management, some monitoring indicators have been projected and defined based on the alternative deterministic scenarios (pessimistic and optimistic),which determine the projected referential range for the end of 2014:

Referential projections of indicators of the Central Government's gross debt at the end of 2014

Indicator	Range at the end of December of 2014
Percentage of soles in the gross balance	53.5% - 62.9%
Percentage of fixed-rate debt in the gross balance	80.3% - 81.1%
Percentage of domestic debt in the gross balance	51.4% - 60.8%
Average life (years)	12.9 - 14.2
Average time to re-fixing (years)	11.9 - 13.4
Concentration of amortizations over the next 12 months 1_/	4.2% - 4.2%
Percentage of the flow of local currency funding 2_/	82.2% - 88.1%

Source: MEF- DGETP
1_/ Indicator that measures the immediate pressure of payments.
2_/ Includes the funding of debt management operations.

APPENDIX 2:

Outstanding legal norms for the Strategy

- Act. N° 28112, Framework Act on the Public Sector's Financial Management
- Act. N° 28563, General Act on the National Public Debt System and its amendments
- Act N° 28693, General Act on the National Treasury System
- Act N° 30116, Act on the Public Sector's Debt for 2014 (6th y 7th final complementary provision)
- Act N° 28716, Act on Internal Control of the State's Entities
- Legislative Decree N° 1012, Framework Act on Public-Private Partnership
- Act N° 27245, Act on Fiscal Responsibility and Transparency and its amendments and Act N° 30099, Act on Strengthening of Fiscal Responsibility and Transparency
- Supreme Decree N° 051-2013-EF, Public Treasury bills Regulations
- Supreme Decree N° 096-2013-EF, Market Makers Program Regulations and Sovereign Bonds Regulations
- Supreme Decree N° 117-2014-EF, Organization and Duties Regulations of the MEF
- Ministerial Resolution N° 807-2011-EF/41, Multiannual Strategic Sectorial Plan 2012-2016
- Ministerial Resolution N° 880-2011-EF/41, Institutional Strategic Plan 2012-2016
- Ministerial Resolution N° 009-2013-EF/41, Performance Goals and Indicators of the Economy and Finance Sector 2013
- Ministerial Resolution N° 157-2013-EF/52 2013-2016 Global Asset and Liability Management
- Ministerial Resolution N° 172-2014-EF/52, Operative Regulations of the Asset and Liability Management Committee
- Director's Resolution N° 016-2012-EF/52.05, Guidelines for the Asset and Liability Management and Deposits Regulations
- Director's Resolution N° 011-2013-EF/51.01, Formalization of IPSASB
- Resolution of the Comptroller General N° 320-2006-CG, Internal Control Rules

According to articles 7° and 8° of the Act N° 28112, the Framework Act on Financial Management of the Public Sector, the Public Treasury centralizes, guards and channels the funds and securities of the Public Finance Sector and the Public Debt obtains external and internal financing to fulfill part of the requirement established in the Public Sector Budget, according to the corresponding payment capacity. In this sense, according to article 3 of the Organization and Duties Regulations of the MEF, approved by Supreme Decree N° 117-2014-EF, one of the general functions of the Ministry of the Economy and Finance is to formulate, propose, execute and evaluate the policies, rules and technical guidelines to develop the government securities market, within the framework of a global financial asset and liability management. Likewise, according to article 95, the Direction-General of Public Debt and Treasury is the governing body of the MEF in charge of proposing policies and to make the rules and procedures for the global financial asset and liability management, as well as the regulation and management of public funds and public debt.

According to article 14° of Act 28563, General Act on the National Public Debt System, the Direction General of Public Debt and Treasury, as part of its powers, formulates the Annual Public Debt and Debt Management Program of the Central Government,

specifying the policies, objectives and goals compatible with the fiscal goals and debt sustainability, from a long-term perspective. According to article 17° and article 28° of this Act, in order to determine the maximum amount of debt operations to arrange and pay out in each fiscal year, we must consider the policies and objectives of the approved Annual Public Debt and Debt Management Program, as well as the goals of the Multiannual Macroeconomic Framework.

According to the article 36° of this Act, the Ministry of Economy and Finance is authorized to make debt management operations following the guidelines of the Strategy for Global Asset and Liability Management, without budget implications. It must be considered that, according to the complementary and transient disposition 23ª, The Direction General of Public Debt and Treasury can be authorized by Supreme Decree to fulfill the debt service using the funds that should be managed in case of mismatches in new debt operations or total or partial implementation of debt management operations that are approved according to Law.

Also, in virtue of literals p), q) and r) of article 6° of Act N° 28693, General Act on National Treasury System, the Direction-General of Public Debt and Treasury has, as an exclusive attribution, the execution of all type of operations that contribute to the development of the securities market, the constitution of a secondary reserve to face financial instability situations that affect the liquidity of the ordinary resources assigned for budget execution or the securities market liquidity or the credit market liquidity and the establishment of policies and standards to manage funds of non-financial companies and public sector institutions through deposits and all type of investments, within the framework of a global asset and liability management. For this purpose, according to article I of this act, the most important regulatory principle is cash unit, this is, the centralized management of public funds en each entity, whatever the budgetary financing source may be, regardless of its purpose.

According to the final complementary disposition 6 and 7 of Act N° 30116, Act on the Public Sector's Debt for the Fiscal Year 2014, the Asset and Liability Management Committee was created to define the guidelines and actions for an appropriate management of global financial assets and liabilities that are part of the Public Finance Sector; also, the Sovereign Debt Fund was constituted with the objective of contributing to a greater dynamism of the secondary market of government' securities in local currency. In that regard, the Ministerial Resolution N° 172-2014-EF/52 approved the operational regulations for this Committee, and one of its functions is to propose the Strategy for Global Asset and Liability Management for a three-year period.

And, according to article 9° of the Legislative Decree N° 1012, Framework Act on Public-Private Partnership, investment projects classified as co-financed should fulfill the Act on the National System of Public Investment, the Act on National Public Debt System and its amendments and other norms, as well as to count with the favorable opinion of the Ministry of Economy and Finance respecting to the fiscal responsibility and budget capacity. In this sense, the last paragraph of article 54° of Act N° 28563 establishes that, the auction bases of a project or program that will be concede and have Government guarantees need to count with a favorable opinion from the Direction-General of Public Debt and Treasury about the financing structure before its approval. To classify a project as self-sustainable instead of co-financed: (i) it should not demand a financial guarantee over the 5% of the total investment cost, without including operation and maintenance costs and, (ii) the probabilities of using public resources of non-financial guarantees should be lower than 10% in each year of the first 5 years of the project execution.

Moreover, according to article 2° of Act N° 27245, Act on Fiscal Responsibility and Transparency, as a general principle, the Government must ensure the long-term fiscal equilibrium or surplus, accumulating fiscal surplus in favorable periods and allowing only moderate and non-recurring fiscal deficits only in periods of lower growth. Since 2015, the article 3° of Act N° 30099, Act on Strengthening of Fiscal Responsibility and Transparency, the structural fiscal deficit should represent at the most 1% GDP, consistent with fiscal sustainability. In addition, according to article 11°, the investment guidelines for the Fiscal Stabilization Fund and its amendments should be part of the framework of the Public Treasury' Strategy for Global Asset and Liability Management.

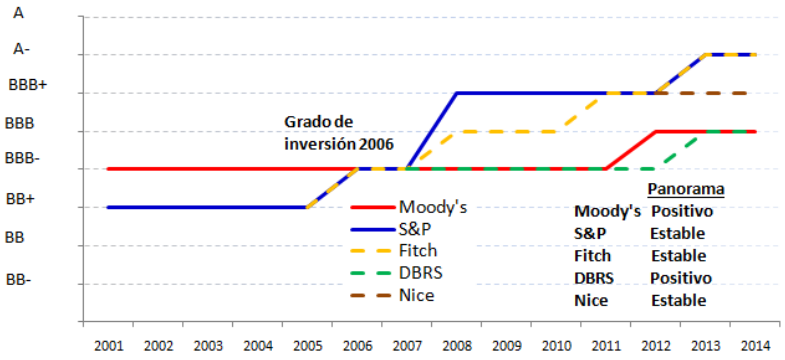
Finally, the 2014 Strategy has considered that, according to Act N° 28716, Act on Internal Control of the State's Institutions, the internal control system is the group of actions, activities, plans, policies, rules, registers, organization, procedures and methods, including the attitude of the authorities and staff, organized and instituted in each institution of Government, in order to achieve the institutional objectives. The Act points out that is composed by: (i) The control environment, which is the favorable organizational environment for the execution of practices, values, behavior and appropriate rules for the functioning of the internal control and a meticulous management, (ii) risk assessment, it identifies, analyses and manage factors or events that may affect the fulfillment of institutional targets, goals, objectives, activities and operations, (iii) management control activities, which are the control policies and procedures provided by the designated principal or civil servants, the manager and competent executive authorities, related to the functions assigned to the staff in order to ensure the objectives are fulfilled, (iv) the prevention and monitoring activities, these actions should be implemented while the staff is carrying out its duties in order to look after and assure the suitability and quality of these duties, (v) the information and communication systems, with which the registration, processing, integration and dissemination of information with data bases and accessible modern informatics solutions provides reliability, transparency and efficiency to the process of institutional internal control and management, (vi) the monitoring of results, consisting in the updated review and verification of attention and achievements of the internal control measures, including the implementation of the recommendations made in the reports of the bodies that belong of the SNC (Quality National System), (vii) the improvement compromises; the institutional bodies and staff of the administration make self-assessments to develop the internal control and communicate any deficiency that may be corrected, fulfilling the dispositions or recommendations formulated to improve or optimize their work. The administration as well as the Institutional Control Body are part of the internal control system according to their competence field.

APPENDIX 3:

Sovereign risk rating and internal assessment

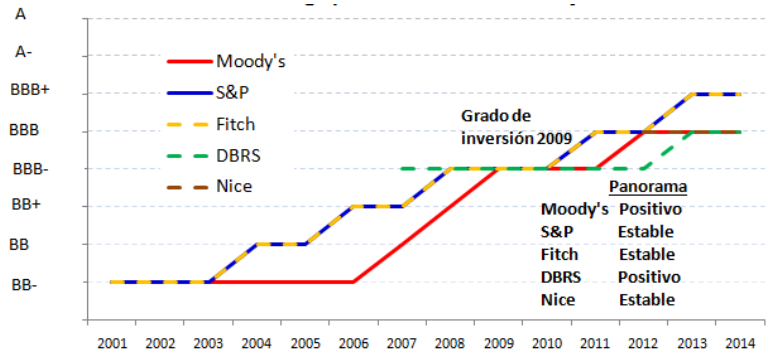
Among the opinions of independent third parties we find the opinions of credit risk agencies on strengthens and main vulnerability gaps or disadvantages of the Republic of Peru as a country subject to sovereign credit. If these disadvantages are not reverted, it is going to be more difficult to obtain a better risk rating in the short term.

Peru: performance of long-term credit ratings in local currency



The long-term credit rating in national and foreign currency of the Republic of Peru has improved notoriously during the period 2001-2013 due to the economic growth, more private investment, low levels of inflation, fiscal equilibrium, and debt reduction among other factors. At the end of 2013, the Republic of Peru had A- credit rating for long-term debt in local currency and BBB+ for long-term debt in foreign currency, according to S&P and Fitch Ratings.

Peru: performance of long-term credit ratings in foreign currency

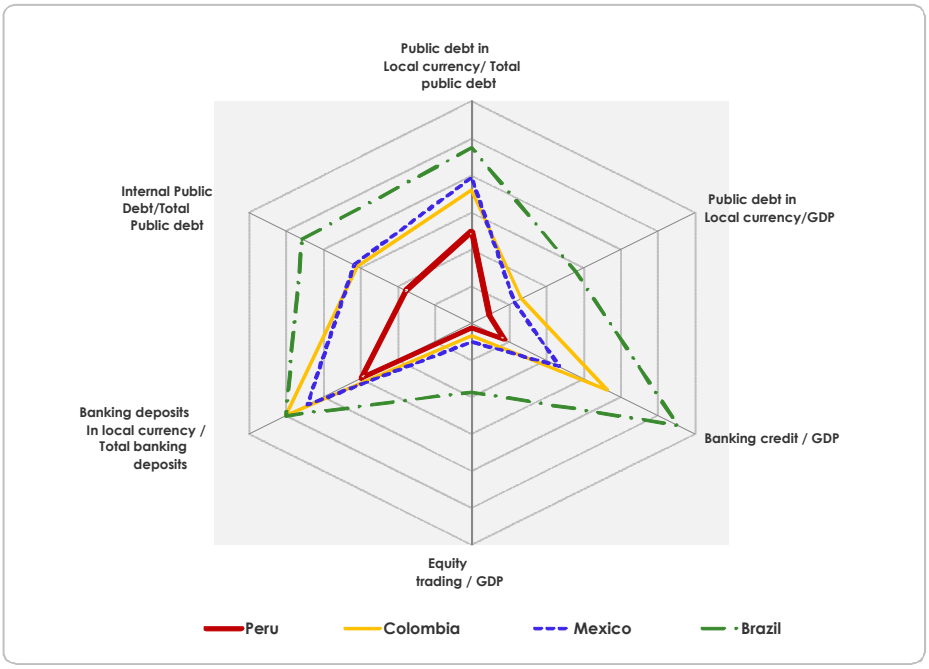


Among the main quantitative factors of negative perceptions expressed in the risk agencies' reports, including the contracted and non-contracted risk agencies, they focus on the financial area and its impact on the structure of the economic growth: the financial dollarization, public debt dollarization, low development of the local credit and securities market and dependence on the commodities' price cycle, which is related to the vulnerability of capital flows and weakness of foreign accounts.

	Standard & Poor's	Fitch Ratings	Moody´s	Nice Investor Services	DBRS Inc	Coincidence factors
Institutional structures deficiencies/ Political factors	x	x	x		x	4/5
Dependence on the commodities' cycle/Capital flows / weakness of foreign accounts	x	x	x	x	x	5/5
Financial dollarization	x	x	x		x	4/5
Dollarization of the public debt		x	x			2/5
Development of the local credit and securities market	x		x	x	x	4/5

Source: Peru sovereign risk rating reports from Fitch Ratings, Moody's, Nice, S&P and DBRS

Even though Fitch Ratings and Standard & Poor's already graded the public debt in local currency of Peru with A-, Peru is still under the average of countries with BBB sovereign risk grade in most of these type of financial factors. For instance, the average of these countries have a 65% government debt in local currency, 63% of internal government debt and a 62% financial de-dollarization level.



Another key legitimacy criteria to consider are the main disadvantages or vulnerability sources of Peru in matters of financial development and government securities market, especially in contrast to countries in the region with similar credit risk rating. This aspect is very important especially in the context of the regional integration between Chile, Colombia, Mexico and Peru through the Pacific Alliance, which began in April 28, 2011 thirty days before the Mercado Integrado Latinoamericano - MILA (Latin American Integral Market) started its operations. The MILA resulted from the agreement signed between stock markets and securities depository of Chile, Colombia and Peru with the participation of the governments of these countries.

In this sense, Peru still has some deficiencies compared to the optimal levels reached by countries in the region. When it comes to government debt de-dollarization, Colombia reaches 72%, Mexico 80% and Brazil 95%. Moreover, Peru also has deficiencies regarding domestic government debt, as Colombia reaches 62%, Mexico 63% and Brazil 91%. Also, Mexico reaches a 94% in financial de-dollarization and Brazil and Colombia reaches 100%. In this way, the main financial indicators that Peru must improve are exposed, and its future favorable performance will permit to diminish vulnerabilities caused by exchange or financial crisis.

APPENDIX 4:

Interaction between the Public treasury's objectives and the monetary policy

The typical objectives of the monetary policies are very well-known: the preservation of the monetary stability (prices), the support the sustainable growth (GDP, employment), ensure the good functioning of (internal and external) payment systems, support the financial system development (financial institutions and markets) and maintain the transmission mechanisms of the monetary policy. The importance of these objectives varies in each country.

On the other hand, the objectives of the fiscal policy (fiscal means Treasury) are also very well-known: the good performance of the economy (GDP, prices, employment), the allocation of resources for production of goods and public services, a fair redistribution of the national income and keep the macroeconomic stability (moderating the fluctuations of the demand). However, these objectives are not related with the assets and liabilities of the Public Treasury, they are only related to the management of the Public Treasury's revenues and outgoings.

The monetary and fiscal policies manage their assets and liabilities with their own instruments and dynamics, that interact sometimes and, under some circumstances, they could damage each other instead of strengthen mutually. For instance, a poor fiscal management of revenues and outgoings may affect the expectations of inflation and, therefore, the interest rates or exchange rates or the opposite, a high and volatile inflation can affect the economic activity of the private sector and reduce the Public Treasury's income.

In addition, the monetary policy affects the exchange rate and interest rates directly, and they affect the cost and yield of debt and public savings. To the contrary, a poor development of the government securities market affects the capacity of the monetary policy to influence in the interest rates and exchange rates in all sectors of the economy.

Finally, there are also other sources of interaction. A permanent policy of sterilization may generate losses equal to almost fiscal deficits that the Public Treasury must assume, either increasing debt, reducing savings or reducing the budgetary payment capacity. To the contrary, when the monetary policy finances the Public Treasury's debt or when it raises money from savings, the monetary base is damaged and it causes instability in the interest rates of the financial system and, if interest rates are not market interest rates, it generates implicit subsidy that disfavors and adequate and transparent accountability.

APPENDIX 5:

Glossary

Public savings: funds, wealth or other financial asset that is kept to prevent future needs.

Public debt: Financial assets in securities or contracts with implicit accrued interests, with amortization or not and explicit interests or not.

Credit institution: Regardless of its legal denomination, it is the intermediary whose typical activity is to receive resources through deposits or other redeemable funds (including funds obtained with the issuance of securities), which must be returned. The funds can be used to grant credits and similar operations. In this category are included banks, finance companies, municipal and rural funds and EDPYME (Development entity for the small and micro-enterprise) authorized by the SBS, as well as COFIDE, Banco Agropecuario, Fondo Mivivienda and Banco de la Nación.

Investment institution: Regardless of its legal denomination, it is any special purpose entity constituted as an independent net worth without legal status and managed by a securities institution. Usually, they are constituted as open-end or closed-end (investment, securitization, foreign currency, etc.) funds managed by a manager (securities administrator) and its net worth is composed by shares or securities that may – or not –have tranches with subordination. In this category are included pension, mutual, investment and trust funds that are managed by administrators or a fiduciary, authorized by the SBS or SMV or by law.

Insurance institution: Regardless of its legal denomination, it is the intermediary whose main function is the issuance of insurance policy or similar contracts; a policy's premium is charge to compensate (indemnify) a beneficiary with a specific amount of money or an equivalent benefit in one or two parts when an expected (covered) event (disaster) happens during a specified period. In this category are included the life insurance companies and other insurance companies authorized by the SBS.

Securities institution: Regardless of its legal denomination, it is the intermediary whose main function is to participate as a securities intermediary and similar activities. These institutions negotiate orders on behalf of third parties, guard securities or manage portfolios, other manage funds through special purpose entities (investment entities) and also intermediate securities on their own behalf and even may grant loans to their investor clients. In this category are included the stockbroker agencies authorized by the SMV.

APPENDIX 6:

Schedule of the Regular Treasury Auctions Program

August 2014 (1)

D	L	M	M	J	V	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

September 2014 (2)

D	L	M	M	J	V	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30				

October 2014 (3)

D	L	M	M	J	V	S
			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30	31	

November 2014 (4)

D	L	M	M	J	V	S
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30						

December 2014 (5)

D	L	M	M	J	V	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31			

January 2015 (6)

D	L	M	M	J	V	S
				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	31

February 2015 (7)

D	L	M	M	J	V	S
1	2	3	4	5	6	7
8	9	10	11	12	13	14
15	16	17	18	19	20	21
22	23	24	25	26	27	28

March 2015 (8)

D	L	M	M	J	V	S
1	2	3	4	5	6	7
8	9	10	11	12	13	14
15	16	17	18	19	20	21
22	23	24	25	26	27	28
29	30	31				

April 2015 (9)

D	L	M	M	J	V	S
			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30		

May 2015 (10)

D	L	M	M	J	V	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

June 2015 (11)

D	L	M	M	J	V	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30				

July 2015 (12)

D	L	M	M	J	V	S
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29				

First Tuesday of each month: Bills auction with a maximum referential amount of S/. 20 million for the referential period of 3 months and 9 months.

Second Tuesday of each month: Bills auction with a maximum referential amount of S/. 20 million for the referential period of 6 months and 12 months.

First and third Thursday of each month: Bonds auction with a minimum referential amount of S/. 20 million, for the nominal benchmark bonds 12SET2023 and 12FEB2055 real bonds (VAC) 12FEB2030 and 12FEB2054.

Second and fourth Thursday of each month: Bonds auction with a minimum referential amount of S/. 20 million for the nominal benchmark bonds 12AGO2017 and 12FEB2029 and real bonds (VAC) 13OCT2024 and 12FEB2040.

Announcement of possible special auctions and exchange of nominal bonds 12AGO2020 and 04ENE2026A and real bonds (VAC) 08JUN2016 y 13JUL2019 and other bonds in exchange of any current or future benchmark bond.

Terms and conditions of the information contained in this appendix: Should any of the regular auction dates coincide with a holiday, the auction will be held the next business day. When any benchmark bond reaches a maximum S/. 4 billion, the new benchmark will be any of the nominal bonds 12FEB2019 y 12FEB2021 or real bonds (VAC) 12FEB2018 and 12AGO2046. The frequency and maximum referential amount of bills auctions may increase from January 2015. Competitive bids will be received from 9:30 am to 10:30 am using different means, unless the announcement indicates

the opposite. The bills will be redeemed the second Wednesdays of each month. In any case, the General Directorate of Public Debt and Treasury has the authority to modify the schedule of the Regular Treasury auctions Program.