EXCERPT

PERU Staying the Course of Economic Success

EDITORS

Alejandro Santos and Alejandro Werner

INTERNATIONAL MONETARY FUND

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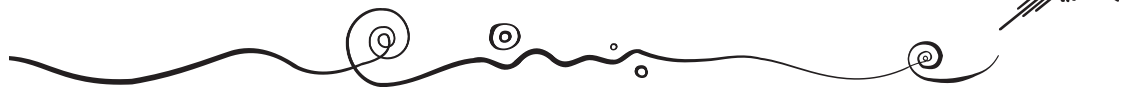

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Note to Readers

This is an excerpt from *Peru, Staying the Course of Economic Success*. Peru stands out among Latin American countries as an example of successful economic reforms over the past decade. This comprehensive look at Peru's economy traces the country's journey from a debt crisis in the 1980s to having buffers in place that allowed it to emerge unscathed from the global financial crisis. The book examines the steps Peru undertook to achieve these results, including a fiscal transparency law passed in 1999 that is generally regarded as the cornerstone of Peru's fiscal turnaround. It paved the way for a modern fiscal framework that is simpler, more transparent, and able to accommodate adjustments in Peru's economic structure.

Peru, Staying the Course of Economic Success explores in depth the roles in this success story of fiscal and monetary policies, tax administration, public financial management, and public-private partnerships. The volume then turns to a discussion of the challenges ahead, examining the work that remains to be done in the areas of fiscal and monetary policy, as well as social policies to ensure inclusive growth. Chapters are written by IMF staff and Peruvian economists.

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Foreword

"Success depends on effort."—Sophocles

This book is a timely look at a very important Latin American economic success story: Peru. When pondering the factors behind the country's recent economic achievements, many casual observers may think only of the strong uptick in the demand for commodities and, consequently, high commodity prices over the last decade. With this information in hand, they could easily conclude that Peru's economic success came without much exertion or its own unique challenges. That it was easily realized, with only minor difficulties. However, when I think of Peru and its accomplishments, I am reminded of the old adage by Sophocles that "success depends on effort."

Indeed, the narrative of Peru's economic transformation over the last three decades as contained in this book clearly demonstrates the validity of this well-worn proverb. The one constant that is woven throughout this volume is that the real story behind Peru's success is one of persistent and consistent effort—to structurally reform the economy and to construct and implement solid macroeconomic frameworks and policies. These were not easy labors, particularly given Peru's sociopolitical and economic struggles through the 1970s, 1980s, and 1990s. In this regard, I find this book to be a must read for anyone interested in understanding the real challenges in successfully transforming an emerging market economy, particularly one that depends so heavily on natural resources. In sum, I believe many lessons can be gleaned from this success story.

Finally, on a personal note, I fondly remember that Peru was the starting point of my first visit to Latin America as Managing Director of the IMF back in 2011. Since that inaugural trip, I have immensely enjoyed returning to Peru and the region in general. I, like many others, find Peru, and Latin America as a whole, to be a vibrant and dynamic region with a rich cultural heritage. I am delighted that the World Bank-IMF Annual Meetings are being held in Lima this year. I think you will all agree it is a great opportunity to showcase the country and the region, and to discuss its remaining challenges while highlighting its many successes.

Christine Lagarde
Managing Director
International Monetary Fund

Abbreviations

ARG	Argentina
BGR	Bulgaria
BOL	Bolivia
BRA	Brazil
CHL	Chile
COL	Colombia
CRI	Costa Rica
DOM	Dominican Republic
ECU	Ecuador
GTM	Guatemala
HTI	Haiti
HND	Honduras
MYS	Malaysia
MEX	Mexico
NIC	Nicaragua
PAN	Panama
PER	Peru
PRY	Paraguay
POL	Poland
ROU	Romania
SLV	El Salvador
THA	Thailand
TUR	Turkey
URY	Uruguay
VEN	Venezuela
ZAF	South Africa

About the Authors

Adrian Armas, a Peruvian national, is the Manager of the Department of Economic Studies at the Central Reserve Bank of Peru, where he developed his full professional career. Previously, he was the Head of the Monetary Sector of the Economic Studies Department (Central Reserve Bank of Peru). Mr. Armas actively participated in the implementation of the inflation targeting scheme in Peru and wrote various papers and articles on this topic published by the IMF, the European Central Bank, and the Bank for International Settlements. Mr. Armas studied Economics at Universidad del Pacífico in Peru and earned a master's degree in Economics from Boston University. He is currently a professor of Monetary Policy at Universidad del Pacífico.

Laura Calderon, a Peruvian national, is the principal advisor to the Minister of Economy and Finance of Peru. Before her current position, she was Deputy Minister of Economy and Finance. She has held several important positions in the public sector and international organizations including Superintendent of the Tax and Customs Authority of Peru, Technical Advisor on tax issues in the Fiscal Affairs Department of the IMF, Director of the Investment Promotion Agency of Peru, and Director of the National Institute of Intellectual Property. Ms. Calderon holds an MA and Licentiate in Economics from Pontificia Universidad Católica del Peru, as well as an MSc in Development Economics from Oxford University. Ms. Calderon has taught college- and graduate-level courses in economics at Pontificia Universidad Católica del Perú, Universidad del Pacífico, Universidad San Ignacio de Loyola, Universidad San Martin de Porres, and Universidad ESAN in Peru.

Marco Camacho, a national of Peru, is the General Director of the General Directorate of Public Income Policy at the Ministry of the Economy and Finance of Peru. Mr. Camacho holds a BA degree in Economics from Pontificia Universidad Católica in Peru, an MA in Economics from ILADES/Georgetown University (Santiago) in Chile, and has completed other graduate studies in Tax Administration and Public Finance Management. He also worked at the National Superintendence of Customs and Tax Administration as National Intendent of Tax Research and Planning and at the Metropolitan Municipality of Lima as Head of Municipal Tax Administration.

Patricio M. Castro, an Argentinean, holds a doctoral degree in engineering from the University of Buenos Aires in Argentina and a postgraduate degree from Stanford University. Mr. Castro worked in the private sector and in the Argentine central administration, where he held the position of Under-Secretary of the Public Function. He was a consultant to the World Bank and the Inter-American Development Bank prior to joining the Fiscal Affairs Department of the IMF as Technical Assistance Advisor with expertise in customs, social security, and tax administration. He retired from the IMF in 2014 as a Senior Economist in the Fiscal Affairs Department. During his career, he worked in tax and customs reform in many countries in Africa, Asia, and in most countries in Latin America. He has participated in numerous regional and international events and conferences on tax and customs issues, has published numerous papers on the subject, and is a contributor to the book *Changing Customs: Challenges and Strategies for the Reform of Customs Administration* (IMF 2003).

Adrienne Cheasty, from Ireland, is Deputy Director of the IMF's Western Hemisphere Department, where she has oversight of Peru, Ecuador, and Caribbean countries, program

financing, and debt issues. She was previously Deputy Director of the IMF's Fiscal Affairs Department, responsible for fiscal policy design and country advice, with specific responsibility for Latin America. Earlier, she worked on numerous IMF-supported crisis programs in emerging markets and fragile states. Her research areas include measurement of the fiscal deficit, fiscal and financial issues, and natural resource management. She is a member of the World Economic Forum's Global Agenda Council on Fiscal Sustainability and has taught at Harvard University, Yale University, and Johns Hopkins University.

Israel Fainboim, a national of Colombia, holds an MA in Economics from the University of Pennsylvania. He is a Senior Economist in the Fiscal Affairs Department of the IMF. He has provided technical assistance on Public Financial Management to almost all Latin American countries and to China and Vietnam, and has been a consultant to the Inter-American Development Bank and the World Bank. He was a member of the Council on Fiscal Policy at the Ministry of Finance of Colombia, Secretary of Finance of Bogota, Research Associate at *Fedesarrollo*, and Professor of Public Finance at the Universidad de los Andes and La Pontificia Universidad Javeriana. He has published articles on treasury management, public investment, performance budgeting, public-private partnerships, and fiscal federalism, among other topics.

Ricardo Fenochietto, an Argentine national, is Senior Economist in the Tax Policy Division of the Fiscal Affairs Department at the IMF. Before joining the IMF, he was Professor of Public Finance at the Universidad Torcuato Di Tella in Argentina and a private consultant to multinational corporations. He has published extensively on taxation issues; his recent work focused on tax capacity, tax effort, and financial sector taxation. He is also peer reviewer for a number of public finance journals.

Almudena Fernández Benito holds bachelor's degrees in Law and in Economics and Business Administration from the Complutense University in Madrid, Spain, and is a Senior Controller and Certified Public Auditor for the Spanish government. She joined the IMF as Advisor on public financial management in the Fiscal Affairs Department. Before joining the IMF, she worked as Senior Advisor at the Budget Directorate in Spain.

Mercedes García-Escribano is Deputy Division Chief in the Expenditure Policy Division of the Fiscal Affairs Department at the IMF. Ms. García-Escribano holds a PhD in Economics from the University of Chicago. At the IMF, she has worked on the teams for Brazil, Peru, Colombia, Mexico, Austria, Spain, and Malta, and has published papers on fiscal (with emphasis on decentralization), financial sector, and labor market issues.

Fei Han, a Chinese national, is currently an Economist in the Monetary and Capital Markets Department at the IMF. His research interests focus primarily on macro-financial linkages, macroeconometric models, and financial interconnectedness and spillovers. Since joining the Monetary and Capital Markets Department, he has worked on banking analysis and stress testing for Asian and European countries, and market liquidity for the IMF's *Global Financial Stability Report*. His previous assignments at the IMF included country surveillance work on Latin American emerging markets in the Western Hemisphere Department, including Brazil, Peru, and Venezuela. He holds a PhD in Economics and an MA in Statistics from the University of California, Berkeley. He also holds an MA in International Finance and a BA in Finance from Peking University.

César Liendo, a Peruvian national, is the General Director of Macroeconomic Policy and Fiscal Decentralization at the Ministry of the Economy and Finance in Peru. He holds a BA in

Economics from Pontificia Universidad Católica del Perú and an MA in Economics from Universitat Pompeu Fabra in Barcelona, Spain. Before joining the Ministry of the Economy and Finance, Mr. Liendo worked for the Inter-American Development Bank, Scotiabank, and APOYO Consultoría. He also teaches at Universidad del Pacífico and Universidad San Ignacio de Loyola. He is in charge of the design of the Multiannual Macroeconomic Framework, which forms the basis for the public sector budget, as well as the analysis on developments, outlook, and risks to the Peruvian economy; fiscal revenues; and observance of fiscal rules, proposing fiscal measures if needed.

Manuel Luy is the Head of the Research Department at the Superintendency of Banking, Insurance and Private Pension Funds of Peru. Mr. Luy holds a BA in Economics from the Universidad del Pacífico in Peru. He has an MA in Development Economics from the University of Sussex in the United Kingdom and a master's degree in Finance from the Universidad del Pacífico. Mr. Luy has also worked as a consultant at the World Bank and the IMF, and lectures at the Universidad del Pacífico and in specialized programs at the Central Reserve Bank of Peru and the Superintendency of Banking, Insurance and Private Pension Funds.

Giancarlo Marchesi is the Director General for Private Investment Policy and Promotion at the Ministry of the Economy and Finance in Peru. Mr. Marchesi holds bachelor's and Licenciate degrees in Economics from the Universidad del Pacífico in Peru and a master's degree in Public Affairs from Princeton University. He has been a Manager in the Corporate Strategy Division and Deputy Manager in the Economic Studies and Investment Strategy Area at Banco de Crédito del Perú. Mr. Marchesi has also been a consultant for the World Bank's Independent Evaluation Group and the Ministry of the Economy and Finance's Directorate General of Economic and Social Affairs, as well as an independent consultant for Peruvian corporations in the fields of risk, corporate strategy, and mergers and acquisitions.

Juan Alonso Peschiera, a national of Peru, is an Economist in the Resident Representative Office of the IMF for Peru and Paraguay. Mr. Peschiera holds a BA in Economics from Pontificia Universidad Católica del Perú in Peru and an MSc in Finance from Universidad del Pacífico in Peru. Prior to joining the IMF, he worked at the Peruvian consultancy Macroconsult.

Mario Pessoa, a national of Brazil, holds a Master of Economics and Social Science degree from the University of Wales in the United Kingdom. He is Deputy Division Chief of the Public Financial Management Division II of the IMF's Fiscal Affairs Department. He has provided technical assistance on public financial management to countries in the Western Hemisphere, Africa, and Asia in treasury and debt management, medium-term fiscal frameworks, fiscal risks, and government accounting. Previously, he worked in Brazil at the National Treasury, Economic Policy Department, and Internal Control Office of the Ministry of Finance.

Juan Pichihua, a Peruvian national, is Director of the Directorate of Fiscal Decentralization Policy and Subnational Finances at the Ministry of the Economy and Finance. Mr. Pichihua holds a BA in Economics from the Universidad Nacional Agraria La Molina in Peru and an MA in Economics from ILADES/Georgetown University (Santiago) in Chile. He is a board member of the National Superintendence of Health Insurance in representation of the Ministry of the Economy and Finance and Principal Professor of Economics at the Universidad Nacional Agraria La Molina. He was General Director of Fiscal Decentralization and Social Affairs (Ministry of the Economy and Finance), Chief of Household Targeting System, and Consultant of Health Economics and Social Affairs.

Javier Poggi is the Chief Economist at the Superintendency of Banking, Insurance and Private Pension Funds of Peru. Mr. Poggi holds a BA in Economics from the Pontificia Universidad Católica del Perú. He has a Master of Science degree in both Economics and Banking, Finance and Investments from the University of Wisconsin-Madison. Currently, he presides over the Superintendency of Banking, Insurance and Private Pension Funds, special committee for the implementation of Basel II-III and Solvency II standards. He was a member of the Board of Directors of the Comisión Nacional Supervisora de Empresas y Valores (now, Superintendencia del Mercado de Valores). Prior to joining the Superintendency of Banking, Insurance and Private Pension Funds, he worked for the World Bank as an economic development consultant, covering a variety of issues.

Zenón Quispe, a national of Peru, is Advisor to the General Manager of the Central Reserve Bank of Peru. Mr. Quispe holds a BA in Economics from the Universidad Nacional San Cristobal de Huamanga in Peru, an MA in Political Economy from Boston University, and a PhD candidate in Economics from Oxford University. After working as Senior Economist in the External Sector Analysis Division, the Macroeconomic Analysis Division, and in the Macroeconomic Models Division, he has been the Head of the Monetary Program Section in the Monetary Policy Design Division of the Central Reserve Bank of Peru. Mr. Quispe is Professor of Monetary Theory and Policy at the Pontificia Universidad Católica del Perú and the Universidad de Piura in Peru. He also teaches Advanced Topics in Monetary Theory and Policy in the Summer Course in Economics of the Central Reserve Bank of Peru and in the Centro de Capacitación del Banco de Guatemala.

Donita Rodriguez, a national of Peru, is the Head of the Balance of Payments Statistics Division of the Central Reserve Bank of Peru. Miss Rodriguez holds a BA in Economics from Pontificia Universidad Católica del Perú and an MSc in Economics from the London School of Economics and Political Science in the United Kingdom. She also has been a Senior Analyst in the Macroeconomic Modeling Division and Junior Analyst in the Monetary Program Division of the Central Reserve Bank of Peru. She is a Lecturer in International Economics and International Finance—for undergraduate and graduate levels, respectively—at Pontificia Universidad Católica del Perú.

Lucía Romero is the Head of the Financial System Analysis Department at the Superintendency of Banking, Insurance and Private Pension Funds of Peru. Ms. Romero holds a BA in Economics from the Pontificia Universidad Católica del Perú and a master's degree in Economics from the Pontificia Universidade Catolica do Rio de Janeiro in Brazil. Prior to joining the Superintendency of Banking, Insurance and Private Pension Funds, she worked as an Assistant Professor in the Economics Department of the Pontificia Universidad Católica del Perú and as a researcher at the Instituto de Estudios Peruanos.

Kevin Ross is a Senior Economist in the IMF's Western Hemisphere Department. Prior to that, he was the IMF's Regional Representative for Peru and Paraguay. He has worked in the European Department on a number of advanced and transition economies. His research has mainly focused on monetary and exchange rate policies, banking sector competition, and investment.

Renzo Rossini is the General Manager of the Central Reserve Bank of Peru. In this capacity, he reports to the Governor and to the Board of the Central Reserve Bank of Peru, and is responsible for proposing changes to the monetary policy, the management of international reserves, and other aspects of the central bank. Prior to this, Mr. Rossini was the Manager of the Department of Economic Studies. His responsibilities included directing the collection of macroeconomic

statistical data, the forecasting process, and the elaboration of monetary policy proposals. Mr. Rossini studied Economics at the Universidad del Pacífico in Peru and holds a master's degree in Economics from the London School of Economics. He is the author of several papers on monetary policy and is currently also a Professor of Economic Policy at the Universidad del Pacífico in Peru.

Alejandro Santos, a national of Mexico, is the IMF Senior Resident Representative for Peru and Paraguay. Mr. Santos holds a BA in Economics from Universidad Autónoma de Nuevo Leon in Mexico and a PhD in Economics from Yale University. He has been Advisor and Division Chief in the Western Hemisphere Department, as well as Mission Chief to many countries in the region. Mr. Santos has also been IMF Resident Representative in Russia and Bolivia. Prior to joining the Western Hemisphere Department, he worked in the European Department and the Policy Development and Review Department of the IMF, where he worked on many emerging market economies with IMF-supported programs (including Argentina, Brazil, Georgia, Korea, Indonesia, Russia, Turkey, Ukraine, and Uruguay).

Alonso Segura is the Minister of Economy and Finance of Peru, where he previously was Chief of Staff. He has been Chief Economist and Head of Strategy at Banco de Crédito del Perú, Peru's largest bank; Chief Economist at Banco Wiese Sudameris (now Scotiabank Peru); and Advisor to the Executive Director for the Southern Cone and Economist in the Fiscal Affairs Department at the IMF; among other positions. Mr. Segura has a BA in Economics from the Catholic University of Peru and holds a master's degree in Economics from the University of Pennsylvania, where he also pursued doctoral studies (PhD[ABD]). He holds international certificates in investments (Chartered Financial Analyst) and risk management (Financial Risk Manager). He has held teaching positions at the University of Pennsylvania, the Catholic University of Peru, and the Universidad del Pacífico in Peru. He is a Fulbright Scholar.

Narda Sotomayor is the Head of the Microfinance Analysis Department at the Superintendency of Banking, Insurance and Private Pension Funds of Peru. Ms. Sotomayor received her training as an Economist from the Pontificia Universidad Católica del Perú and holds a Master of Science degree in Agricultural Economics from The Ohio State University and a PhD from the University of Illinois at Urbana-Champaign. Before joining the Superintendency of Banking, Insurance and Private Pension Funds, she was a Research Fellow at the Center for Farm and Rural Business Finance of the University of Illinois at Urbana-Champaign and had worked as a consultant for diverse international organizations, including the World Bank, the U.S. Agency for International Development, and the Inter-American Development Bank. She has also worked as an Assistant Professor in the Economics Department of the Pontificia Universidad Católica del Perú.

Melesse Tashu, a national of Ethiopia, is an Economist in the Western Hemisphere Department of the IMF, where he covers Eastern Caribbean countries, Peru, and Ecuador. Mr. Tashu holds a BS in Statistics and an MS in Economics from Addis Ababa University, Ethiopia, and an MA in International Development from Harvard University. Before joining the IMF, Mr. Tashu worked for the National Bank of Ethiopia and World Vision International.

Carolina Trivelli currently serves as Project Manager for the Electronic Money Project of the Association of Banks in Peru. She has been Principal Researcher for the Institute of Peruvian Studies and Latin American Center for Rural Development. She is a former Minister of Development and Social Inclusion of Peru. She was Director General of the Institute of Peruvian Studies, President of the Consortium for Development of the Andean Ecoregion, and Board Member of the Network for the Development of Social Sciences in Peru and the Peruvian Society

for Environmental Law. She is currently a Board Member of the Permanent Seminar on Agricultural Research, a member of the Board of Innova Schools, and a member of the Technical Advisory Committee on Measuring Poverty (Instituto Nacional de Estadística e Informática). She is currently President of the Board of Fundación Backus. Ms. Trivelli specializes in social policy issues, rural poverty, agricultural and rural finance, and rural development. She has taught at the Pontifical Catholic University of Peru and the University of the Pacific. She is currently a columnist for the newspaper *Perú 21*. Ms. Trivelli is an Economist; she holds an MSc in Agricultural Economics from Pennsylvania State University and a bachelor's degree in Social Science, majoring in Economics, from the Pontifical Catholic University of Peru.

Alvaro Valencia works as a consultant at the Directorate-General of Private Investment Policy and Promotion at the Ministry of the Economy and Finance in Lima, Peru. Mr. Valencia holds a BS in Economics from Universidad del Pacífico in Peru and a master's degree in Economics from Syracuse University in the United States. He has been Chief Executive Officer and President of American Power Corporation, a U.S.-based mining exploration company. Previously, Mr. Valencia has held several positions working for the equity research departments at CLSA Global Emerging Markets and BBVA Securities in New York and the Inter-American Development Bank. He has also worked as an investment banker specializing in corporate finance and mergers and acquisitions at the consulting company Macroconsult in Peru.

Julio Velarde, a Peruvian national, holds a BA in Economics from the Universidad del Pacifico in Peru, an MA in Economics from Brown University in the United States, and is a PhD candidate in Economics at Brown University. He has been the Governor of the Central Reserve Bank of Peru since 2006. He was also Chairman of the Latin American Reserve Fund, Member of the Board of Governors of the Central Reserve Bank of Peru, Dean of the Department of Economics at the Universidad del Pacífico, and Senior Full Professor in the Department of Economics also at Universidad del Pacífico. Mr. Velarde has been a member of the board of several commercial banks and nonfinancial corporations and advisor to international organizations. He is the author of several books and many articles on macroeconomics and economic policy.

Mercedes Vera Martin, a national of Spain, is Deputy Division Chief in the Middle East and Central Asia Department of the IMF. Ms. Vera Martin holds a dual bachelor's degree in Law and in Business Administration and Management from Universidad Pontificia Comillas in Spain, and a PhD in Economics from the London School of Economics. She has been IMF Mission Chief for Ecuador and Mauritania. Ms. Vera Martin has also worked in the Western Hemisphere Department, the Policy Development and Review Department, and the Monetary and Capital Markets Department during her career at the IMF has been engaged in a variety of issues across countries (including Argentina, Colombia, Dominican Republic, Haiti, Mexico, Peru, Romania, and Uzbekistan).

Svetlana Vtyurina, a national of Russia, is a Senior Economist in the Western Hemisphere Department of the IMF. She holds BA and MA degrees from the George Washington University in the United States. As an IMF economist, she covered emerging market economies and low-income countries in Central Asia, Africa, and Central and South America. Prior to that, she was an Advisor to the Executive Director for the Russian Federation at the IMF and a project consultant in the private sector.

Alejandro Werner, a Mexican citizen, is the Director of the Western Hemisphere Department of the IMF. Mr. Werner has had distinguished careers in the public and private sectors as well as in academia. Before joining the IMF, he served as Undersecretary of Finance and Public Credit of

Mexico; he was also Professor of Economics at the Instituto de Empresa in Spain, and Head of Corporate and Investment Banking at BBVA-Bancomer. Previously, he was Director of Economic Studies at the Bank of Mexico and Professor at Instituto Tecnológico Autónomo de México in Mexico. He has published widely. Mr. Werner was named Young Global Leader by the World Economic Forum in 2007. Mr. Werner received his PhD from the Massachusetts Institute of Technology.

Yu Ching Wong, a national of Singapore, is the IMF Resident Representative for Myanmar. Ms. Wong holds a BSocSci (Honors) in Economics from the National University of Singapore and a PhD in Economics from Keio University in Japan. Before taking up her position in Myanmar, she worked in the Western Hemisphere Department of the IMF as Desk Economist on Peru, Ecuador, and the Eastern Caribbean Currency Union; in the Finance Department, where she worked on concessional financing and debt relief; and at the IMF's Regional Office for Asia and the Pacific, on regional surveillance of emerging Asia. Prior to joining the IMF, Ms. Wong was Principal Economist working on China at the Japan Center for International Finance in Japan and Economist at Singapore's Ministry of Trade and Industry.

CHAPTER 1

Overview

ALEJANDRO WERNER

Peru has been one of Latin America's main success stories for over a decade. Strengthened by solid macro policies and favorable external conditions, the country has enjoyed high growth and employment and low inflation amid gains in financial and social inclusion. Given that these achievements came on the heels of a turbulent economic past, it stands to reason that there are lessons to be learned from examining the policies and actions that contributed to these results. What challenges did the authorities confront in reforming the economy, particularly once Peru's growth momentum accelerated? What future challenges do the authorities foresee? This volume attempts to answer these questions, with chapters authored by notable Peruvian economists and IMF staff.

Part I sets the stage by providing a review of Peru's economic history over the last 30 years. Like many countries, Peru implemented misguided policies in response to the oil price shocks of the 1970s, resulting in a profound debt crisis in the 1980s. By 1989–90, the country was mired in hyperinflation, large internal and external imbalances, a multiple exchange rate system, rapid economic decline, and domestic terrorism. But fast-forward 25 years and a completely different picture emerges. In 2014, the Peruvian economy was considered one of the strongest performers in the region. In Chapter 2, Renzo Rossini and Alejandro Santos relate how this transformation was accomplished, describing how the authorities implemented their stabilization programs and reform agenda. The authorities' efforts turned the economy around and continue to bear fruit today. For example, during the commodity price boom and favorable external financial conditions over the past decade, Peru was able to successfully absorb a surge in investment flows without overheating or experiencing financial sector problems. Similarly, when the global financial crisis broke out, Peru had ample buffers and policy space to maneuver around the turbulence, and emerged unscathed. Since then, the economy has continued to grow despite weakening commodity prices.

The chapters in Part II report on the changes in Peru's macroeconomic policies. Chapter 3 on growth and Chapter 4 on investment highlight how the implementation of structural reforms, coupled with a favorable external environmental, drove the country's economic performance. In addition to describing the evolution of these structural reforms, Kevin Ross and Juan Alonso Peschiera explicitly measure the impact that terms-of-trade gains had on domestic incomes, which then spilled over into the rest of the economy. Using traditional growth accounting exercises, the authors also find that Peru enjoyed sizable gains in total factor productivity above the regional average. The next chapter, by Kevin Ross and Melesse Tashu, provides a detailed description of the policies and actions that fostered the investment boom, and how that boom has been closely aligned with developments in commodity prices and the mining sector. The authors' empirical results show that the increase in private investment was directly linked to macro stability, terms-of-trade gains, structural reforms, public investment, and global interest rates.

Improvements in fiscal policy and fiscal institutions played a critical role in Peru's transformation. In Chapter 5, Svetlana Vtyurina describes the policy decisions taken during a fiscal consolidation process that played out over the last 40 years as the high deficits of the 1970s and 1980s gradually evolved into the fiscal surpluses of more recent years. Interestingly, Peru has not recorded a primary deficit since 2003 and saw its debt ratio fall to around 20 percent of GDP in 2014.

Many observers have noted that the cornerstone of Peru's fiscal turnaround was the passing of a fiscal transparency law in 1999. As discussed by Cesar Liendo in Chapter 6, the law introduced a modern macro-fiscal framework and a fiscal rule, both of which have been gradually modified. These second-generation reforms have made the macro-fiscal framework simpler, more transparent, and more able to accommodate adjustments in the structure of the economy.

The discussion on fiscal rules is complemented by Svetlana Vtyurina's analysis in Chapter 7 of alternative fiscal stability frameworks for countries rich in natural resources. With pressing societal needs, there is a natural political desire to view resource revenues as permanent and to spend them immediately. The reality, however, suggests that these flows may be temporary and volatile, disrupting prudent budgetary planning. Thus, the permanent income hypothesis would imply that these revenues should only be used to smooth out consumption over generations, with current surplus funds invested in financial assets as savings. In this context, Vtyurina presents the choices confronting Peru and provides simulations under various approaches. She concludes that given Peru's long resource horizon, pressing infrastructure needs, and low public investment, a fiscal sustainability framework that efficiently invests these flows today in infrastructure would be optimal.

Reforms in tax policy and in public financial management have helped Peru achieve solid fiscal accounts. In Chapter 8, Ricardo Fenochietto, Laura Calderón, Marco Camacho, and Patricio Castro describe the Peruvian authorities' efforts to broaden the tax base, simplify tax rates, and reduce evasion and avoidance in an environment plagued by noncompliance and informality issues. Key components include the ongoing modernization of the tax collection agency (*Superintendencia Nacional de Administración Tributaria*) and mining taxation reform. Although much still needs to be done, these efforts have improved tax efficiency and overall revenue inflows. From the expenditure side, Chapter 9 on public financial management by Mario Pessoa, Israel Fainboim, and Almudena Fernández report on various improvements, including implementation of a medium-term budgeting and expenditure framework, results-based budgeting, state-of-the-art treasury and debt management, and improved information systems. Many of these reforms resulted from IMF technical assistance and an ongoing close technical dialogue between IMF staff and the Peruvian authorities.

Chapter 10, by Adrienne Cheasty and Juan Pichihua, reports on how fiscal decentralization has created its own challenges. Reallocating mineral revenues back to resource-producing regions has created a divide between the haves and have-nots in Peru's fragmented local regions. It has also made the regions important players in infrastructure investment and in education and health spending. However, local governments' pervasive problems with management capacity and the volatility of resource revenues continue to burden the country's overall budgeting system and complicate investment spending. In addition, under this decentralized system revenue flows toward mining communities, which may or may not be where the greatest social needs are. Both investment and social spending challenges are critical development issues for Peru that need to be addressed promptly.

A perennial question in emerging market countries centers on the most efficient way to fill infrastructure gaps. In Chapter 11, Giancarlo Marchesi and Alvaro Valencia review the Peruvian experience in addressing this crucial issue, stressing the country's heavy reliance on private sector involvement. The authorities initially focused on privatizations in the mid-1990s, given the nationalization of key industries in the 1970s and 1980s. These privatizations dramatically improved the efficiency of the economy and kick-started the growth renaissance in Peru. In the early 2000s, the focus shifted toward greater use of concessions and, by the end of the decade, more reliance on public-private partnerships. The current public-private partnership framework is considered to be well designed and efficient.

Three chapters on monetary policy provide a look at Peru's inflation-targeting framework. Two characteristics of the Peruvian economy—high dollarization and volatile credit cycles—have affected the formulation of the policy framework. As is well known, dollarization heightens the

exposure of the real and financial sectors to exchange rate and liquidity shocks. Given its impact on balance sheets, dollarization also reduces the effectiveness of monetary policy. As a result, an economy can be prone to boom-bust credit cycles associated with volatile foreign currency credit flows. Dollarization also affects the transmission of monetary policy and increases the liquidity and solvency risks to the financial system. To address these risks, the Peruvian central bank (*Banco Central de Reserva del Perú* [BCRP]) has implemented a "hybrid" inflation-targeting framework that incorporates conventional monetary policy instruments with nonstandard policy tools (for example, sterilized foreign exchange interventions and frequent use of reserve requirements).

The BCRP policy framework has worked well. As documented by Adrián Armas, Alejandro Santos, and Melesse Tashu in Chapter 12, the inflation-targeting framework has helped reduce the level of inflation and anchored price expectations, while limiting exchange rate and foreign interest rate pass-through effects. Despite Peru's high rate of dollarization, the deviation of actual inflation outcomes from the midpoint of the BCRP's 1–3 percent target range has been small, comparing well with other LA6 countries.[1] Moreover, this stability has helped to gradually lower dollarization, with the rate declining from about 70 percent on introduction of the inflation-targeting framework in 2002, to under 40 percent today. Moreover, the functioning of the monetary policy transmission mechanism has improved, and shifting capital flows have not negatively affected financial stability.

Spillovers from the global financial crisis posed a major challenge to Peru's monetary policy. To combat the recessionary effects of the global slowdown, developed-country central banks implemented expansionary monetary policies that lowered interest rates to near zero and triggered quantitative easing policies. Within this context, Renzo Rossini, Adrián Armas, and Zenón Quispe in Chapter 13 describe how the BCRP confronted the spillover effects from these developed-country policies, which led to large capital inflows seeking higher yields. Their work offers a particularly close look at how the BCRP formulated a set of reserve requirements in response to shifts in credit and capital flows. In a similar vein, Chapter 14 by Renzo Rossini, Zenón Quispe, and Donita Rodríguez focuses on the BCRP's sterilized intervention policies, providing background information on their rationale and on their impact on financial markets.

Peru's financial sector performance has strengthened, along with financial supervision. In Chapter 15, Javier Poggi, Lucia Romero, Manuel Luy, and Narda Sotomayor provide a review of how the authorities used these good economic times to modernize and reinforce financial sector supervision and regulation. In Chapter 16, Mercedes García-Escribano investigates how macroeconomic stabilization and other policies have helped to gradually reduce dollarization.

Overall, Peru's financial sector regulation and supervision are considered to be among the best in the region. Chapter 17 by Kevin Ross and Juan Alonso Peschiera reveals how the profitability and cost-efficiency of the banking sector have improved since the banking crisis in the early 2000s. Although bank concentration and effective margins remain relatively high, the sector still appears to enjoy marked competition. In Chapter 18, Mercedes Vera-Martin describes Peru's set of macroprudential tools and policies and contrasts them with the regional experience.

The external sector contributions in this volume report on how trade liberalization and free trade agreements have transformed Peru's economy. The country opened its doors to international trade and financial flows in the early 1990s as part of the broader macroeconomic stabilization and structural reform agenda. Chapter 19 by Yu Ching Wong examines the evolution of Peru's trading boom and increase in foreign direct investment flows.

Chapters 20 and 21 on exchange rate movements by Melesse Tashu show that exchange rate smoothing through foreign exchange intervention has helped insulate Peru's real exchange rate from the effects of commodity price shocks, and that the exchange rate is broadly in line

[1]The LA6 are Brazil, Chile, Colombia, Mexico, Peru, and Uruguay.

with fundamentals. Nevertheless, continuing the policy of increasing flexibility would enhance the economy's ability to absorb external shocks and reduce the incentives to undertake unhedged risks.

Although the increase in openness described in Chapter 19 had enormous benefits for Peru, it also exposed the economy to the risks of external shocks. Chapter 22 by Fei Han empirically estimates the linkages between Peru's economy and two growth drivers—Chinese investment and U.S. monetary policy. These linkages are large and important in understanding how growth and investment will evolve.

Chapter 23 turns to social issues. Yu Ching Wong outlines how Peru has achieved reductions in poverty and inequality. Over the course of 10 years, the poverty rate in Peru declined by more than half: from 59 percent in 2004 to 23 percent in 2014. This means about half the population has moved into the middle class since the mid-2000s. Similarly, the extreme poverty rate fell to about 4 percent in 2014 from 20 percent in 2004. Income distribution has also improved, with the Gini coefficient declining from above 60 in 2002 to 44 by 2014. Although a large part of these improvements can be attributed to Peru's growth, the social and cash transfer programs undertaken by various government administrations also played a role. Despite these gains, Wong notes that social spending remains low in comparison to regional peers, and much more needs to be done in the areas of education, health, and gender inequality.

Part III presents three viewpoints on Peru's future challenges. The fiscal policy agenda will need to remain focused on strengthening institutions and frameworks. In Chapter 24, Alonso Segura, Peru's Minister of the Economy and Finance, outlines how the gradual evolution of Peru's frameworks and policies imparted a degree of stability and predictability to fiscal policy. Those frameworks and policies also helped create fiscal buffers that were useful in mitigating the negative effects of the global financial crisis and the current slowdown in metal prices. In the near term, the fiscal sustainability of many emerging marketing economies, including Peru, will again be tested by higher international interest rates, persistent depreciation pressures, lower permanent fiscal revenues, and lower potential growth. As in the past, Peru will need to diligently implement stable and sound fiscal policies that will promote the credibility necessary to attract foreign investment flows, lower financing costs for both the private and public sectors, and help sustain economic growth. In Minister Segura's view, the best way to create this virtuous circle is by strengthening the current macrofiscal framework in ways that optimize the functioning of fiscal policy. In particular, future reforms need to focus on tax policy, public expenditure management, and intergovernmental transfers.

Peru has significant space to increase permanent revenues and fortify the tax system, and Minister Segura indicates this could be accomplished mainly by widening the tax base by reducing informality. Measures could focus on reducing tax evasion and avoidance through the use of risk-based enforcement systems, tax and customs controls, and new information management systems. At lower levels of government, revenue-raising incentives could be provided to expand municipal taxation, particularly in the area of property taxation. Tax exemptions and excise taxation need to be harmonized, with tax regulations brought further in line with international best practices. If all of these measures were to be fully implemented, the overall equity, efficiency, and transparency of tax administration would improve, further contributing to a reduction of informality—and higher growth.

Much work needs to be done to improve the efficiency of public spending and intergovernmental transfers. Public expenditures need to be better prioritized through a thorough evaluation of prior outcomes and these results better communicated to the public. The rigidities and other biases in expenditure design that restrict timely countercyclical spending should be eliminated. In particular, Minister Segura floats the idea of establishing a separate fund or bank for public or public-private investment projects. This entity could lie outside of the budget and be swiftly activated in a countercyclical fashion. In addition, intergovernmental transfers from all financing

sources need to be based on the predictability of public spending and on the capacity to absorb, measure, and evaluate the use of the transferred resources. Transfers based solely on the location of mining activity, and that do not take into account local authorities' ability to implement spending projects, have had a negative impact on public investment, development, and growth.

In Chapter 25, Julio Verlarde, the President of the BCRP, outlines a number of monetary policy challenges. He stresses that to implement an inflation-targeting regime in a highly dollarized economy, the BCRP needed to explicitly account for the financial cycle. Since real and financial cycles rarely coincide, and financial cycles tend to be longer in duration, the central bank had to lengthen the time horizon for monetary policy and adapt its nonconventional policy instruments. Looking ahead, it will be crucial to properly calibrate these policy instruments such that financial intermediaries internalize the financial risks, thus helping the financial system absorb shocks. If not implemented correctly, these instruments can be a source of inefficiencies that hinder capital market development.

The monetary policy framework will also need to be adjusted to developments in capital markets. As capital markets develop, it will become increasingly difficult for the BCRP to fully sterilize their interventions and control exchange rate movements. On the other hand, more developed financial markets are needed to hedge risky positions, blocking the source of shocks in the first place and eliminating the necessity of BCRP intervention. This predicament underscores the central bank's drive to dedollarize the economy with an array of reserve requirements. Then again, increased reliance on nonbank financing in Peru, such as bond issuance, weakens the effectiveness of reserve requirements and creates possible currency mismatches. It is also important to calibrate the monetary policy stance and the set of macroprudential measures with the microprudential regulations of financial system supervisors. This may not be an easy task.

The changing external environment will continue to affect monetary policy decisions. President Velarde notes that the gradual reversal of quantitative easing in the United States could imply a prolonged readjustment of dollar exchange rates. Thus, exchange rate pass-through effects could be nonlinear and asymmetric, with larger inflationary effects on depreciations than on appreciations. This is a problem because many countries in the region are already above or near their inflation targets. Given the importance of low inflation to central bank credibility, monetary transmission, and dedollarization efforts, the BCRP will need to continue to intervene to tame depreciations, with cyclical adjustments in reserve requirements to promote credit expansion. Finally, slower growth in China, the end of the commodity super-cycle, and investment bottlenecks indicate that potential growth will falter without structural reforms. Understanding the evolution of the Peruvian economy's potential output given this uncertainty will be crucial to the formulation of optimal policy.

The main social policy challenge going forward is to eradicate persistent pockets of poverty and social exclusion. Although Peru's social indicators have improved over the past decade in line with rapid economic growth and improvements in public policies, there are still high rates of poverty and malnutrition among the country's rural population, female-headed households, and native language speakers. As Carolina Trivelli notes in Chapter 26, the existence of these gaps in social inclusion was the catalyst behind the establishment of the Ministry of Social Development and Inclusion in 2011. Although prior attempts had been made to create a coordinated national strategy, most social programs and policies tended to be somewhat ad hoc and dispersed among various ministries and regions. Thus, the task confronting the Ministry of Social Development and Inclusion was to establish a clear road map of coordinated policy and program interaction among all levels of government to address these enduring gaps. The authorities' national strategy—"Inclusion for Growth" (*Incluir para Crecer*)—addresses that challenge by detailing an intergovernmental agenda that incorporates the country's five main social programs.

A concerted broad-based effort will be needed to continue to make progress above and beyond existing social inclusion gains. Trivelli stresses that authorities need to build wide-ranging public

support for social inclusion programs by effectively communicating their importance for societal growth and development. Besides creating awareness of the issues, good communication will also help sustain and build budgetary financial support. Another issue is that, at present, not all citizens who qualify for social assistance are able to access it due to funding or logistical constraints. Finally, in implementing their national strategy, the authorities will need to continue to identify and track vulnerable populations, as well as develop and test new innovative programs against measurable benchmarks. Given the dispersion of rural locations, this will require that the Peruvian government establish an effective presence throughout Peru—something that has proven difficult in the past.

In conclusion, this volume presents a multifaceted look at Peru's economic accomplishments and future challenges. Each contribution, in its own way, explains how the country has been transformed into one of the better economic performers in Latin America, and examines what needs to be done to sustain future growth and development. The common thread throughout the volume—and its essential takeaway—is that structural reforms have provided good payoffs for Peru over the last 30 years. With the external environment now turning slightly less favorable than in the recent past, the authorities will need to revisit this lesson and redouble structural reform efforts as they confront the tasks ahead.

PART I

Context

CHAPTER 2

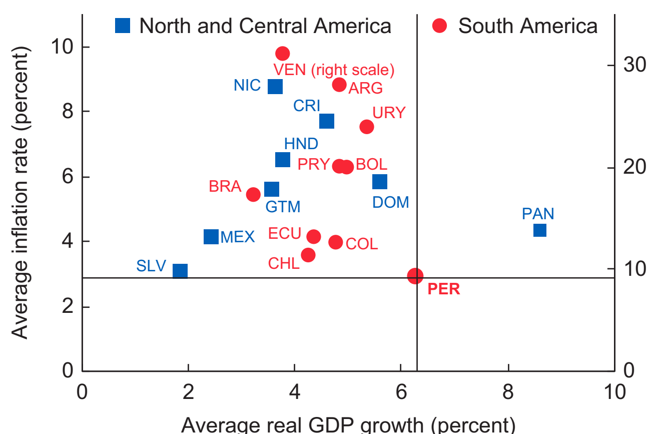
Peru's Recent Economic History: From Stagnation, Disarray, and Mismanagement to Growth, Stability, and Quality Policies

RENZO ROSSINI AND ALEJANDRO SANTOS

Peru represents one of the best examples in Latin America of how a stabilization program and structural reform agenda should be implemented. Like most countries in the region, Peru suffered through the debt crisis of the 1980s, with its situation exacerbated by misguided policies. By 1989–90, the economy was mired in hyperinflation, external debt default, sharp economic decline, a large fiscal imbalance, an unsustainable public debt, a multiple exchange rate system, countless economic distortions, and domestic terrorism. The result was an unparalleled level of economic dislocation. The ambitious economic program of the mid-1990s addressed all of these problems and began a long process of structural reform that established the basis for achieving the highest growth rates in South America over the past two decades. The reform process included two macroeconomic milestones that cemented stability: the introduction of a Fiscal Responsibility Law in 1999 (modified in 2013) and the formal introduction of inflation targeting in 2002. The economy's growth path endured the Asian and Russian crises of 1997–98 and the global financial crisis of 2008–09. The adjustment and reform process was accompanied by a number of successful IMF arrangements and significant technical assistance.

Despite the economic deceleration of 2014, economic growth in Peru over 2005–14 averaged 6.3 percent, the highest level in South America and the second highest in Latin America (after Panama, where the canal is being expanded) (Figure 2.1). This is not a small accomplishment, especially compared with the country's poor economic performance and relative stagnation during part of the 1970s and most of the 1980s. The rise of Peru as an economic star among emerging markets came as a surprise to many economic observers, analysts, and investment bankers, but not to economic historians. Peru had a long history of high growth in the post–World War II period, growing at 5 percent in the 1950s, 6 percent in the 1960s, and 5½ percent in the first half of the 1970s. By the mid-1970s, it is estimated that income per capita in Peru was broadly similar to that of Brazil, Chile, and Uruguay, and a third higher than Colombia (but still lower by about a quarter than Mexico). In that sense, Peru simply returned in the 1990s to a well-known growth path after 15 years of volatile stagnation in the second half of the 1970s and the 1980s.

The malaise of the economy came after the oil shocks of the 1970s and Peru's poor policy response (Table 2.1). Peru was not the only one; most advanced and emerging market economies at the time did not know how to respond to a large supply shock, and what is more, some may not even have been aware that their sluggish economic performance was due to that supply shock. This lack of awareness led to active demand management policies that in turn led to stagflation. Peru went through a cycle of expansionary policies and failed programs to address them (Pastor 2012). The United States suffered its own stagflation, experiencing double-digit inflation in the late 1970s, and then endured a painful disinflation process in the early 1980s that pushed interest



Source: IMF staff calculations.
Note: See page vii for a list of three-letter country codes used in this volume.

Figure 2.1 Latin America: Real GDP Growth and Inflation, 2005–14 (*Percent*)

TABLE 2.1

Peru: Economic Indicators, 1985–2014 (*Percent*)

	Instability	The Great Stabilization	Poststabilization	Average
	1985–90	1991–92	1993–2014	1985–2014
		(Annual Percentage Change)		
Real GDP	–0.9	0.8	5.3	3.7
Inflation (end of period)	2,080	98.0	6.1	427.1
Base Money	1,358	79.2	19.1	290.8
Real Exchange Rate (average)[1]	18.6	–1.9	0.2	3.8
Terms of Trade (deterioration –)	–5.0	–3.6	2.2	0.3
		(Percent of GDP)		
Domestic Investment	19.1	16.0	21.4	20.6
National Savings	14.0	11.0	18.3	17.0
External Current Account	–5.1	–5.0	–3.1	–3.6
Gross International Reserves	7.7	8.4	21.7	18.0
Fiscal Balance[2]	–8.9	–3.5	–0.7	–2.5
Public Debt[2]	71.3	67.6	40.1	48.2

Sources: Peruvian authorities; and IMF staff estimates.
[1]Effective, (–) = real depreciation.
[2]Nonfinancial public sector.

rates to record high levels. To complicate matters, Mexico, having enjoyed the oil shock as a producer, led the way in economic mismanagement in the region. Ultimately, unable to afford the higher interest payments, Mexico declared default on its external debt in August 1982. Peru suspended payments to commercial creditors seven months later in March 1983. Most countries in the region followed, as they suffered contagion from Mexico, and as banks became reluctant to renew credit lines in the region. This gave rise to the debt crisis in Latin America in the 1980s, which came to be known as the region's "lost decade."

The bad policies of the 1980s created the highest recorded inflation in Peru's history (over 7,600 percent in 1990) and its steepest economic decline (the economy contracted by about one-quarter between 1987 and 1990). It is estimated that the size of the economy by 1990 was similar to that in 1975. It took almost a decade to regain the peak (and overheated) level of GDP of 1987 (Ministry of the Economy and Finance 2003). The successful stabilization of the early 1990s stopped inflation, put public finances in order, reduced the debt burden, gave freedom and authority to the central bank to conduct monetary policy, implemented ambitious reforms, and set the foundation for sustained economic growth that continues to this day (Polastri 2007).

This chapter analyzes the economic performance of Peru and its policies from 1985–2014 by identifying six distinct periods (Table 2.2): (1) the instability of the second half of the 1980s, (2) the titanic stabilization of the early 1990s, (3) the sustained recovery during most of the 1990s, (4) the deepening reforms during most of the 2000s, (5) the global financial crisis of 2008–09, and (6) the postcrisis period of the last five years. During the entire period, Peru had almost uninterrupted IMF-supported (or monitored) programs and arrangements. These programs were some of the most successful operations in the IMF's history (Box 2.1).

INSTABILITY AND MISMANAGEMENT (1985–90)

Desperate to find solutions to the country's macroeconomic problems, the Peruvian authorities undertook some of the most unique experiments in economic policy during the mid-1980s with disastrous results. By then, Peru was experiencing declining growth rates, debt service problems, and accelerating inflation fueled by large fiscal and quasi-fiscal deficits (Table 2.3). Government intervention in pricing, interest rates, credit allocation, and labor markets resulted in major distortions of relative prices and the deepening of the large informal economy. Inefficient import substitution was encouraged by means of quantitative import restrictions and high tariffs, and a generally overvalued exchange rate favored urban consumers, discouraged exports and agricultural production, and induced large-scale migration from rural to urban areas. In the late 1980s, this migration was given additional impetus by terrorist activities, which also affected production in mining, energy, and agriculture. Drug trafficking also became a problem. It is estimated that real GDP per capita declined by about 30 percent during the late 1980s.

Social indicators were no better. It is estimated that in the mid-1980s nearly 60 percent of the Peruvian population lived in poverty (that is, their basic human needs for food, shelter, education, and medical services were not met; World Bank 2015). That figure subsequently increased. Political violence claimed over 20,000 lives in the 1980s. Peru was then stricken by a cholera epidemic, largely as a result of the deterioration of social services and widespread lack of access to safe water supplies.

The administration that took office in mid-1985 attempted to address these problems by boosting domestic demand through credit expansion, tax reduction, increases in public sector employment, and government-mandated wage increases. At the same time, the administration sought to contain inflation through price and interest rate controls, subsidies, and delays in adjusting public sector prices, and attempted to protect the balance of payments through a complex multiple exchange rate system, higher tariffs, and quantitative restrictions on imports.[1] The hallmark government policy was to limit public sector external debt service payments to 10 percent of exports of goods and nonfactor services, and to service debt only to creditors expected to provide a positive net flow of resources to Peru.[2]

These policies generated a short-lived boom in 1986–87 that was followed by hyperinflation and a deep recession. The budget deficit rose sharply, domestic savings fell, and the external current account swung from approximate balance to a deficit of 7½ percent of GDP. By late 1987, financial disintermediation was accelerating, international reserves were depleted, and the public

[1]Other measures included fixing the exchange rate at a 12 percent lower (depreciated) level, a freeze on publicly administered prices after a mild increase, a lowering of the interest rate from 280 percent to 45 percent, a salary increase of 18 percent and a subsequent adjustment to increase real wages, conversion to local currency of foreign-currency-denominated bank certificates, and a private sector price freeze. See Velarde and Rodriguez (1992a).

[2]The limit did not cover short-term debt, payments in kind, debts to Latin American governments and regional organizations, or debts incurred after mid-1985. Peru did not allow the IMF to conduct Article IV Consultations in 1985 or 1986. Debt service payments to the IMF were suspended as of early 1986 (except for charges from the Special Drawing Rights Department), and in August 1986 Peru was declared ineligible to use the IMF's General Resources. Loan disbursements from the World Bank were suspended in May 1987. While Peru was initially able to avoid arrears to the IDB, loans were halted because of failure to meet agreed-upon conditions, and eventually Peru also ran arrears to the IDB.

TABLE 2.2

Peru: Basic Institutional Information (1985–2014)

Years: 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014

	Periods (chronological, 1985–2014)
Presidents	Alan Garcia; Alberto Fujimori; VP[1]; Alejandro Toledo; Alan Garcia; Ollanta Humala
Economic Periods	Instability and Mismanagement; Great Stabilization; Sustained Recovery; Deepening Reforms; Global Crisis; Post-Global Financial Crisis
IMF Arrangements	No IMF Arrangement; RAP; EFF_1; EFF_2; EFF_3; SBA_1; SBA_2; SBA_3; SBA_4; No IMF Arrangement
Currency	Inti; Nuevo Sol
Fiscal Regime	Annual Budgets; Fiscal Rules with Multi-Annual Budgets
Monetary Regime	Accommodative Policy; Monetary Targeting; Inflation Targeting

Source: Authors' calculations.

Note: EFF = Extended Fund Facility; RAP = Rights Accumulation Program; SBA = Stand-By Arrangement.

[1]After President Alberto Fujimorii was ousted by Congress in November 2000, Congress appointed Valentin Paniagua (VP) as Interim President for eight months.

BOX 2.1. Peru: A Brief History of IMF Arrangements

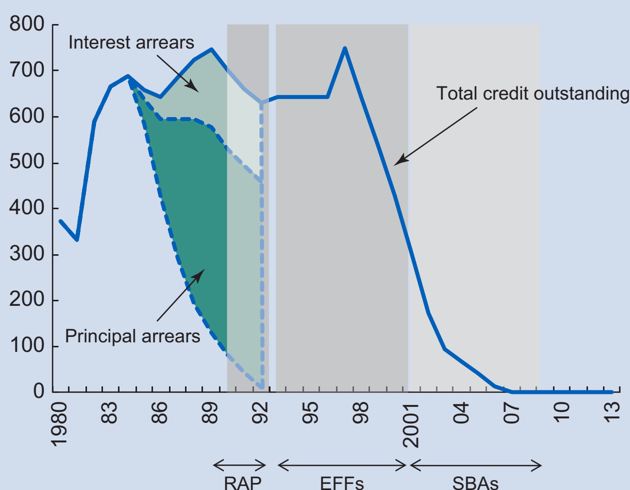
Peru has a long history of IMF-supported programs. In 1954, Peru became the third country in the world to have a Stand-By Arrangement (SBA) with the IMF (after Belgium and Finland, both in 1952). The arrangement marked the first time a Latin American country used IMF funds.

Over the past 60 years, there have been a total of 24 IMF-supported or monitored programs in Peru. Of particular note, however, are the eight very successful IMF programs with Peru from 1991 to 2009. These included one IMF-monitored program under the Rights Accumulation Program (RAP) (1991–93); three Extended Fund Facilities (EFF) (1993–2001); and four SBAs (2001–09). Peru has no credit outstanding to the IMF, as the debt was fully repaid on time by 2007.

An unfortunate episode of protracted arrears to the IMF was resolved in the early 1990s. Following the Latin American debt crisis of the 1980s, Peru had trouble adjusting to additional external shocks and adopted an inadequate macroeconomic policy mix that precipitated a severe balance of payments crisis. By 1985, Peru was running arrears to the IMF, as the first administration of Alan Garcia (1985–90) unilaterally imposed a ceiling on external debt payments equivalent to 10 percent of foreign exchange earnings. These arrears were cleared in 1993, during the first administration of Alberto Fujimori (1990–95) following completion of the IMF-monitored RAP.

The IMF has supported the economic renaissance of Peru over the past two decades. The transformation of Peru's economy was accompanied by a sequence of virtually uninterrupted IMF programs, monitorings, and arrangements, along with a massive technical assistance program. The IMF arrangements were mostly precautionary: after clearing arrears to the IMF in 1993, Peru made only one purchase in 1997 associated with the debt and debt-service reduction operation with private creditors. Below is a brief description of IMF programs and arrangements in Peru since the 1990s.

- *Rights Accumulation Program*. This program (1991–93) supported the economic policies of the newly elected government of Albert Fujimori (1990–95), which included macroeconomic adjustment and structural reforms. The program met its main objectives of reducing inflation, creating conditions for sustained growth, gradually returning to external viability, and reestablishing relations with external creditors.[1]
- *Extended Fund Facilities.* These facilities (1993–2001) supported a strong stabilization effort as well as the first generation of reforms, including the Fiscal Responsibility Law (1999). During this eight-year period, the IMF approved three EFFs for a total amount of special drawing rights (SDR)[2] 1.7 billion. Under those arrangements, Peru made purchases totaling SDR 0.8 billion, and its outstanding credit peaked at SDR 0.75 billion (161 percent of quota) at end-1997 (Figure 2.1.1). No drawing was made in the last EFF (1999–2001).
- *Stand-By Arrangements*. These arrangements (2001–09) also favored economic stabilization and a continuation of structural reforms, including the introduction of inflation targeting (2002). During this eight-year period, the IMF approved four SBAs totaling SDR 0.84 billion, all of them precautionary, as no purchase was made.



Sources: Boughton (2012); and IMF, *International Financial Statistics*.
Note: As of end-December 2013. Credit outstanding includes interest arrears. EFF = Extended Fund Facilities; RAP = Rights Accumulation Program; SBA = Stand-By Arrangement; SDR = special drawing rights.

Figure 2.1.1 Peru: IMF Credit Outstanding, 1980–2013 (*Millions of SDRs*)

[1] During this RAP (1991–93), the authorities accumulated "rights" equivalent to the amount of IMF arrears, but no money was disbursed. Japan and the United States provided a bridge loan to Peru in March 1993 to settle its arrears to the IMF. Once the arrears were cleared, the amounts accumulated under the RAP were disbursed upon approval of the successor EFF (1993–96) and served to repay the bridge loan from Japan and the United States.

[2] Special drawing rights (SDR) are the unit of account for IMF transactions. SDR value is based on a basket of four international currencies (euro, Japanese yen, pound sterling, and U.S. dollar).

TABLE 2.3

Peru: Economic Indicators, 1985–90 (*Percent*)

	1985	1987	1990	Average 1985–90
		(Annual Percentage Change)		
Real GDP	2.1	9.7	–5.0	–0.9
Inflation (end of period)	158.3	114.5	7,650	2,080
Base Money	227.8	153.7	5,094	1,370
Real Exchange Rate (average)[1]	–18.0	37.8	41.0	18.6
Terms of Trade (deterioration –)	–5.4	–0.2	–8.4	–5.0
		(Percent of GDP)		
Domestic Investment	18.9	20.4	13.9	19.1
National Savings	18.4	12.8	8.9	14.0
External Current Account	–0.5	–7.5	–5.0	–5.1
Gross International Reserves	15.7	4.1	6.1	7.7
Fiscal Balance[2]	–3.7	–10.1	–8.9	–8.9
Public Debt[2]	79.8	60.6	69.0	71.3

Sources: Peruvian authorities; and IMF staff estimates.
[1]Effective, (–) = real depreciation.
[2]Nonfinancial public sector.

sector deficit was generating strong inflationary pressures that could no longer be repressed through price controls and subsidies. The fiscal difficulties were mainly attributable to the drop in central government revenues, which fell by almost one-half as a ratio of GDP (from 15 percent of GDP in 1985 to about 8 percent in 1989), reflecting the impact on excise tax collections of lags in adjusting public sector prices, reductions in tax rates, the erosion of tax revenues through inflation, and increasing tax evasion. This was only partly offset by cuts in expenditure, including public investment. In addition, a substantial quasi-fiscal deficit emerged as a result of the central bank's exchange rate losses and subsidized lending to the agricultural bank. By 1988, the deficit of the nonfinancial public sector, at almost 12 percent of GDP, was considerably larger than the money supply (M2) in local currency, a relationship that became even more adverse the following year as the process of financial disintermediation accelerated.

Measures taken in late 1988 and early 1989 temporarily reduced the fiscal deficit, but did not address the underlying structural problems. Economic activity continued to decline and inflationary pressures remained unabated. Real GDP fell by 20 percent in 1988–89 and prices rose 1,700 percent in 1988 and 2,800 percent in 1989. The recession and collapse of investment resulted in a decline in aggregate demand well in excess of the decline in GDP, reducing the external current account deficit and reconstructing international reserves. In the run-up to the April 1990 national elections, the authorities once more relaxed fiscal and monetary policies, permitted public enterprise prices to lag even further behind the general price level, and increased subsidies through the multiple exchange rate system. As a result, during the first half of 1990 consumer prices rose by 34 percent a month (an annual rate of over 3,000 percent) before accelerating to 63 percent in July, by which time the central bank's liquid international reserves once again were virtually exhausted. By mid-1990 more than two-thirds of Peru's US$22 billion external debt (about 75 percent of GDP) was in arrears, including about US$2.2 billion in arrears to the IMF, World Bank, and Inter-American Development Bank (IDB).

THE GREAT STABILIZATION (1990–92)

In the early 1990s, the Peruvian economy faced a severe economic crisis characterized by hyperinflation and a sharp drop in output resulting from large fiscal imbalances, negative real interest rates, widespread wage and price controls and subsidies, and a highly distorted exchange rate system. In addition, the social environment had deteriorated due to increasing terrorism. Real

TABLE 2.4

Peru: Economic Indicators, 1991–92 (*Percent*)

	Average 1985–90	1991	1992	Average 1991–92
		(Annual Percentage Change)		
Real GDP	–0.9	2.2	–0.5	0.8
Inflation (end of period)	2,080.0	139.2	56.7	98.0
Base Money	1,357.7	96.2	62.1	79.2
Real Exchange Rate (average)[1]	18.6	–7.6	3.8	–1.9
Terms of Trade (deterioration –)	–5.0	–4.5	–2.6	–3.6
		(Percent of GDP)		
Domestic Investment	19.1	16.0	15.9	16.0
National Savings	14.0	11.4	10.6	11.0
External Current Account	–5.1	–4.5	–5.4	–5.0
Gross International Reserves	7.7	7.9	8.9	8.4
Fiscal Balance[2]	–8.9	–2.9	–4.0	–3.5
Public Debt[2]	71.3	68.9	66.3	67.6

Sources: Peruvian authorities; and IMF staff estimates.
[1]Effective, (–) = real depreciation.
[2]Nonfinancial public sector.

GDP in 1990 was 25 percent lower than three years before (30 percent in per capita terms) and similar to the level observed in 1975 (1965 in per capita terms).

The stabilization program that was implemented in the second half of 1990 and lasted through end-1992 drastically reformed the structure of the economy and created the basis for the solid and sustained growth in the two decades that followed (Table 2.4). The program was responsible for a number of achievements, including (1) sharply reducing the budget deficit through increases in the prices of government-provided services and by streamlining the tax system, strengthening tax administration, reducing the civil service, and liquidating some public development banks; (2) abolishing price controls, capital controls, and quantitative trade restrictions, unifying and floating the exchange rate, and liberalizing labor and financial markets; (3) opening up areas of economic activity previously reserved for the public sector (including the provision of public services) to private and foreign participation; and (4) strengthening the framework for the implementation of monetary policy and the institutional autonomy of the central bank (*Banco Central de Reserva del Perú* [BCRP]) and the superintendency of banks (*Superintendencia de Bancas, Seguro, y AFP* [SBS]); and (5) bolstering financial supervision and prudential regulation.

The government that took office in mid-1990 immediately implemented a program of macroeconomic and structural adjustment aimed at drastically reducing inflation and establishing conditions for sustained growth. The initial package of economic measures adopted in August 1990 focused mainly on eliminating the domestic financing requirements of the nonfinancial public sector, removing distortions, and opening the economy to foreign competition.[3] The measures included:

- *Price adjustments*. A 3,000 percent increase in fuel prices and an increase of about 1,000 percent in electricity, water, and telephone rates.
- *Tax exemptions*. Elimination of some exemptions to the value-added tax and reduction in its rate from 18 percent to 14 percent.

[3]The international community's reaction to the program was quite positive. Japan and the United States took the lead in organizing a donors' group that included nine European countries and Canada to provide financing. Separately, four Latin American countries (Chile, Colombia, Mexico, and Venezuela) offered short-term loans. In 1991, the Paris Club (a grouping of 17 nations) rescheduled maturities falling due in 1991–92 on official debt for US$4.6 billion under Houston terms (i.e., longer grace and repayment periods than in a traditional rescheduling).

- *New taxes*. Imposition of temporary taxes of 10 percent on exports and 1 percent each on net wealth and insured assets.
- *Foreign exchange market reform*. Unification of the exchange rate and allowing it to float.
- *Import tariffs and restrictions*. Abolition of virtually all quantitative import restrictions, abolition of some import tariff exonerations, and consolidation of the complex tariff system (with rates running to almost 120 percent) into three rates (15 percent, 25 percent, and 50 percent).
- *External payments*. Liberalization of restrictions on payments for current international transactions.
- *Financial liberalization*. Reduction in the marginal reserve requirements on banks' domestic currency liabilities from 80 percent to 40 percent, and increases in interest rate ceilings for domestic currency lending to nonbinding levels, thereby allowing interest rates to be determined by market forces.

As an integral part of the initial adjustment effort, the government created the Social Emergency Program to help offset the impact of the reduction of food subsidies and increased transportation costs on the most disadvantaged, as well as to improve basic health services. The program was a mechanism for coordinating and channeling public sector resources to the disadvantaged, primarily through existing nongovernmental organizations. It was initially expected that program expenditures would amount to 2 percent of GDP on an annual basis, financed by resources from the Treasury and from external donors, with food aid targeted at 7½ million people. In practice, however, the amount of available resources turned out to be less than expected. In 1991, the Social Emergency Program was replaced by the National System for Social Compensation and Development, which continued most of the initial program's activities.

After the initial stabilization measures, the authorities continued to pursue tight monetary and fiscal policies while broadening and deepening the structural changes in the Peruvian economy. In the area of prices and wages, discipline was maintained on public sector wages while prices and wages in the private sector were allowed to find their own level. Price controls were lifted and in August 1990 the government mandated a one-time cost-of-living bonus for all employees in the public and private sectors equivalent to 100 percent of their July 1990 wage, but with a floor equivalent to 200 percent of the minimum wage. It also announced that wages would be increased again once the magnitude of the initial price shock was clear, and a further 100 percent increase was decreed for all workers in the public sector in late August 1990, while the minimum wage was raised by 300 percent. In September 1990, the government announced that private sector wages would be determined freely, abolished wage indexation in public enterprises, and made wage increases subject to government approval. Subsequently, public sector salaries and the minimum wage were reduced significantly in real terms, while average real wages in the private sector increased. Public sector prices were raised again in December 1990 (fuel prices were raised by 50 percent and water and electricity tariffs by 30 percent). A policy of smaller and more frequent adjustments in these prices was instituted during the second quarter of 1991.

Incentives for voluntary retirement were offered in a bid to reduce public sector employment, resulting in a reduction of 50,000 employees, or about 8 percent of the civil service (excluding defense and police) in the first four months of 1991. The tax system was simplified in November 1990 by eliminating some exemptions to the income and value-added tax, and by abolishing a number of taxes with negligible yield. In March 1991, an initial list of 23 public enterprises was identified for privatization, and public sector monopolies for basic foods, fishmeal, gold, salt, advertising, and reinsurance were eliminated.

All in all, the largest fiscal adjustment in the recent history of Peru took place in 1990–91. During these two years, the primary balance of the nonfinancial public sector (NFPS) adjusted cumulatively by about 6 percent of GDP (from a primary deficit of 4 percent of GDP in 1989 to a primary surplus of 2 percent in 1991), whereas interest payments fell by about 2 percent of

GDP, leading to a reduction in the overall fiscal balance of the NFPS of some 8 percent of GDP (from a deficit of around 11 percent to 3 percent of GDP). This adjustment took place against a backdrop of deteriorating terms of trade of some 15 percent, which was a drag on tax collection. Remarkably, real GDP contracted by only 3 percent during this two-year period, and there were early signs of a recovery by late 1991 (Velarde and Rodriguez 1992b).

The central bank further reduced marginal reserve requirements on domestic currency liabilities in stages to 15 percent by February 1991. Interest rates on domestic currency deposits and loans continued to be freely determined in the market and interest rate ceilings on foreign currency loans were raised to nonbinding levels in 1991. The central bank's rediscount rate was linked to the average deposit rate in the banking system. To facilitate transactions and signal the change in the monetary regime, the central bank introduced a new currency, the nuevo sol, in July 1991 at the rate of 1 nuevo sol per 1,000,000 intis. To reduce the quasi-fiscal deficit, subsidized lending by the agriculture bank was eliminated in September 1990 and the bank was restricted to financing farms of 10 hectares or less and those in the jungle and mountain regions. To facilitate commercial bank lending to the agricultural sector, measures were taken to simplify the registry of land titles and reduce restrictions on the use of land for loan guarantees.

The 1987 law nationalizing the banking system, which could not be fully implemented, was repealed in December 1990. A new financial system law adopted in April 1991 included reorganization of the SBS, extension of the supervisory regulatory framework to include nonbank financial intermediaries, and development of a system of deposit insurance.

To reduce labor market rigidities, legislation was adopted in March 1991 to widen grounds and speed procedures for dismissal of workers under Peru's restrictive labor laws. The legislation established a system of semiannual payment of retirement contributions designed to eliminate the need for retroactive increases in contributions following a general salary increase.

The exchange rate system was further liberalized in October 1990 with the replacement of the system of export surrender certificates by a requirement of export surrender through the banking system, along with a broadening of the range of transactions that could be effected in the interbank market. In March 1991, all remaining restrictions on private sector current and capital transactions were eliminated (except for restrictions on the amortization of frozen working capital loans). The previously frozen foreign currency deposits in the banking system were freed and the opening of accounts abroad was authorized. Limitations on remittances of direct investment income and capital were removed, although foreign subsidiaries in the extractive sectors remained subject to contractual limitations. In April 1991, the export surrender requirement and the system of official registry of exchange transactions were eliminated. Taken together, these measures represented a major reform of the external payments regime.

In the area of international trade, following the elimination of quantitative restrictions and the initial tariff reduction of August 1990, the process of tariff reform was accelerated in March 1991. The maximum tariff was reduced to 25 percent, and most transactions were made subject to a 15 percent rate. In addition, a special tariff rate of 5 percent was introduced on imports of scrap iron by the then state steel company (Siderperu) and a variable surcharge was adopted for some 18 basic food imports to protect the agricultural sector. The temporary export tax was eliminated in March 1991 for all exporters other than large mining companies, and the system of temporary duty-free admission of imported inputs was extended to include all export industries. Subsidized pre-export credits (FENT) were eliminated, as was the granting of subsidies for nontraditional exports (CERTEX) for new operations.

From the outset of the program, the government announced its intention to normalize relations with the international financial community and began discussions with the IMF on an economic program that could serve as a framework for this process and for an appeal to external donors for balance of payments support. As further steps in this process, the government resumed debt service payments to the World Bank in October 1990 and the IDB in November 1990, although some payment delays reemerged after March 1991. By June 1991,

arrears to the World Bank and the IDB were about US$90 million higher than they had been when payments were resumed.

In support of these policy efforts, the authorities requested in September 1991 that Peru's economic program (which went through end-1992) be presented to the IMF Executive Board for endorsement as an IMF-monitored Rights Accumulation Program (RAP) within the framework of the enhanced collaborative approach to overdue financial obligations to the IMF. Peru became the second country in the world (after Zambia) to embark on an RAP. The proposed access was special drawing rights (SDR)[4] 624 million, equivalent to the arrears Peru had with the IMF as of June 1991, with an initial amount of SDR 104 million being accumulated upon Executive Board endorsement of the program and the rest in five equal quarterly installments, upon the observance of the performance criteria and completion of the program reviews. The accumulated rights were to be available for purchase in connection with a subsequent upper credit tranche IMF arrangement that was to be submitted to the IMF board for approval following (1) satisfactory performance under the RAP, (2) settlement of overdue obligations to the IMF, and (3) appropriate assurances regarding the financing of the subsequent program supported by the IMF arrangement.

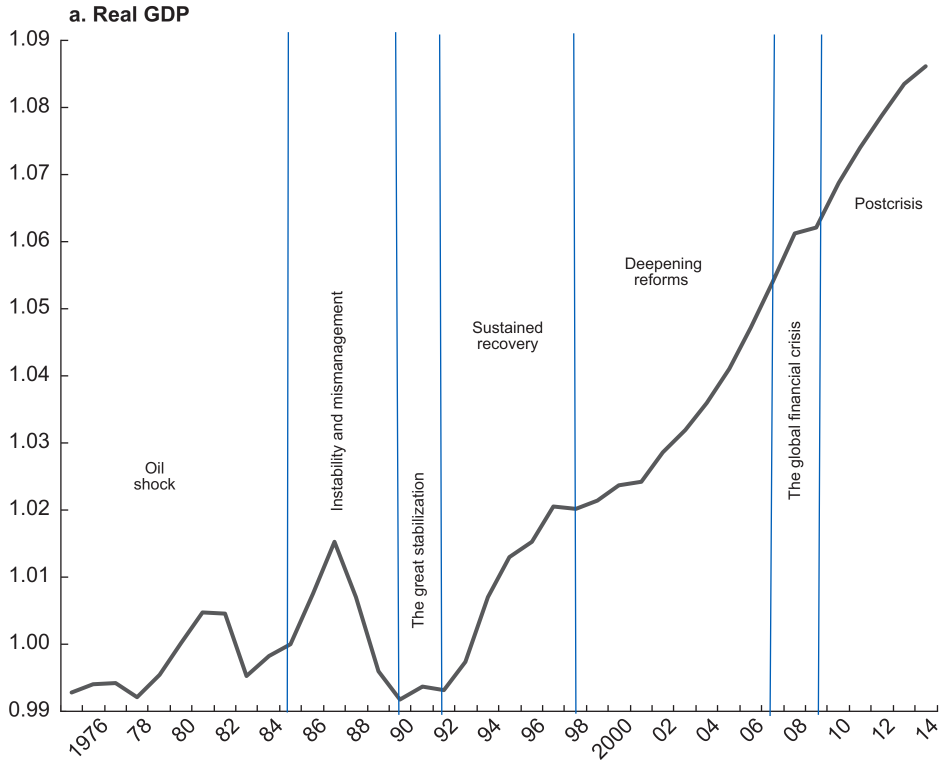
The RAP was designed to consolidate the progress already made in reducing inflation and advance the structural transformation of the economy. Specific objectives were to (1) reduce inflation to low single-digit monthly rates by end-1991 and to international levels by end-1992, (2) make progress toward a viable external payment position and reestablish relations with external creditors, and (3) increase economic growth to 2½–3 percent in 1991 and 3½ percent in 1992 (Figure 2.2). To achieve these objectives, the authorities were to continue to pursue tight monetary and fiscal policies (by sharply reducing the pace of expansion of the central bank's net domestic assets and adjusting the public accounts by 2 percent of GDP a year with almost no domestic financing), and to allow the exchange rate to be determined by market forces (but allowing the accumulation of some international reserves), while deepening the process of structural reform. Structural measures included further liberalization of labor and financial markets; relaxation of restrictions on private (domestic and foreign) participation in petroleum, mining, and other sectors; major reforms in the tax system and tax administration; a reduction in public employment and the establishment of a more progressive public sector salary structure; and the restructuring and in some cases privatization of public enterprises, including official banks.

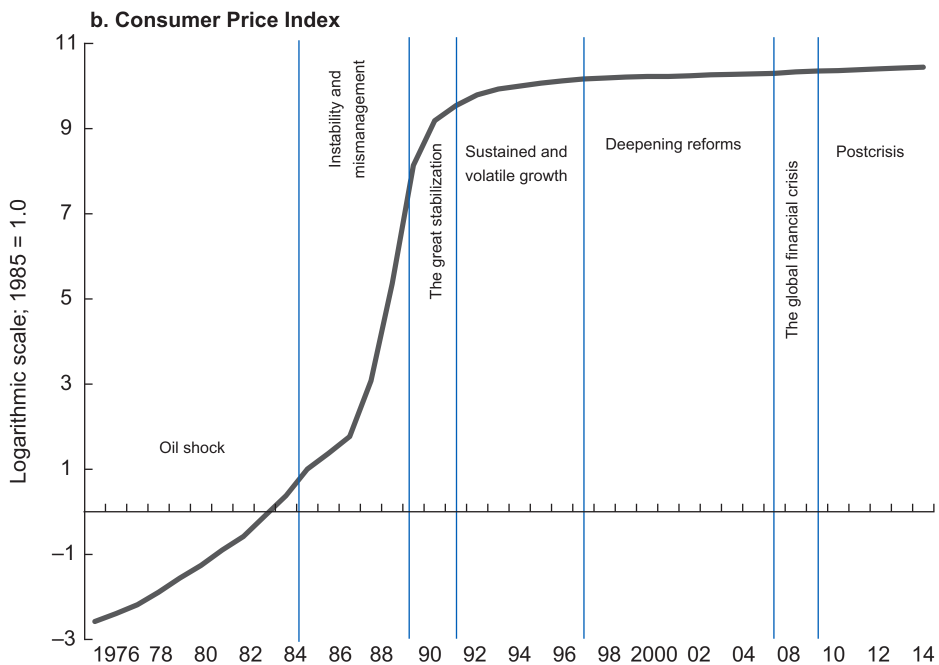
Peru's successful completion of the RAP in December 1992 was key to the normalization of relations with the IMF and all other creditors. More importantly, the successful implementation of the 1990–92 economic program (supported by the RAP) set the stage for sustained growth and price stability in the following decades. While the RAP did not achieve all the ambitious objectives set out from the beginning, the program managed to reduce inflation by more than half in 1992, and it considerably strengthened Peru's external position, although the economy actually contracted. The program was considered to be quite successful and all performance criteria and indicative targets under the RAP for 1992 were attained (with the exception of the target of eliminating arrears to international organizations, which was actually achieved in the first quarter of 1993).

SUSTAINED RECOVERY (1993–98)

The period from 1993–98 marked the resumption of sustained growth of the Peruvian economy, something that had not been seen since the 1960s and the first half of the 1970s. However, the period also included 1998, the only year of economic contraction in the poststabilization period, and a reminder of the vulnerabilities of the economy to external shocks. The strong economic performance was a reflection of positive external conditions, the closing of a negative output gap,

[4]Special drawing rights (SDR) are the unit of account for IMF transactions. SDR value is based on a basket of four international currencies (euro, Japanese yen, pound sterling, and U.S. dollar).





Source: Peruvian authorities.

Figure 2.2 Peru: Real GDP and Consumer Price Index

and a strong record of policy implementation. Real GDP grew at an average rate of about 7 percent in 1993–97 (and contracted by half a percent in 1998), surpassing the level of real GDP of the previous peak in 1987. Economic policy aimed at promoting economic stability while implementing structural reforms that laid the foundation for high, sustainable growth and a reduction of vulnerabilities.

Peru cleared its arrears to the IMF in March 1993 with a bridge loan from Japan and the United States, which paved the way to lifting Peru's ineligibility for IMF resources (ending almost seven years of ineligibility). Following the successful completion of the RAP, the IMF Board approved the request for an Extended Fund Facility (EFF) covering March 1993–March 1996 for SDR 1,018 million. Upon approval of the EFF, Peru made the first drawing (or purchase, as the IMF calls it) in the amount of SDR 643 million (of which SDR 624 million corresponded to the rights accumulated under the RAP). The first drawing was mostly used to repay Japan and the United States for their bridge loans provided to clear the IMF arrears (Boughton 2012, Chapter 6).[5] Also in March 1993, Peru eliminated US$867 million in arrears to the World Bank following the successful completion of an accumulation procedure similar to that under the IMF. (Peru had cleared its arrears to the IDB in September 1991.)

The fiscal position was brought under control, with the combined public sector accounts reaching balance in 1997 (Table 2.5). Fiscal policy focused on adjustment and limiting domestic financing to the public sector. After several years of fiscal consolidation, the primary surplus of the NFPS reached over 2 percent of GDP in 1997. The public sector borrowing requirements were covered with privatization receipts, multilateral lending, and debt rescheduling (public and private creditors), with no need for borrowing in international capital markets.

The institutional framework for an independent monetary policy established by the Central Bank Charter (1992) was further enhanced by the Constitution of Peru (1993), which states that the BCRP is independent and carries out its duties to ensure monetary stability as its single aim.

Monetary policy was guided by controlling monetary aggregates to achieve preannounced inflation objectives (but not yet an inflation-targeting scheme), although inflationary expectations were entrenched due to lack of clarity on the nominal anchor (Velarde and Rodriguez 1994). A major challenge was the management of high private capital inflows, which produced rapid growth in credit to the private sector and appreciation pressures on the exchange rate. The central bank reacted by partially sterilizing the resulting reserve accumulation and increasing reserve requirements on dollar deposits to reduce credit expansion.

A number of structural fiscal reforms were implemented during this period:

- *Tax reform*. The tax system was revamped to simplify the income tax, broaden the basis of the value-added and excise taxes, and increase taxes on petroleum products. Tax revenue peaked at 14½ percent of GDP in 1996–97, up from 11 percent in 1990.
- *Pension system restructuring*. The pension system was reformed by putting in place a fully funded, defined-contribution private capitalization system of individual accounts. The government partially financed the transition to the private pension system with privatization receipts. However, the public pension system was maintained, with its preferential and general plans, and the constitutional reform needed to correct the large imbalances in the preferential system was delayed.
- *Public enterprise divesture*. Most public enterprises were transferred to the private sector, leading to substantial government receipts and investment flows.

[5] In addition to this EFF with the IMF, Peru had a second EFF in this period covering 1996–99 for SDR 300 million, including augmentation to finance the debt and debt service reduction operation. Both arrangements were concluded successfully, although the authorities decided to draw only about half of the resources available, preferring to treat the arrangements mostly as precautionary.

TABLE 2.5

Peru: Economic Indicators, 1993–98 (*Percent*)

	Average 1991–92	1993	1996	1998	Average 1993–98
		(Annual Percentage Change)			
Real GDP	0.8	5.2	2.8	–0.4	5.6
Inflation (end of period)	98.0	39.5	11.8	6.0	14.9
Base Money	79.2	33.6	9.2	5.5	25.4
Private Credit	190.6	74.0	48.2	21.0	46.8
Real Exchange Rate (average)[1]	5.0	–10.3	–0.4	0.2	0.2
Terms of Trade (deterioration –)	–3.6	–10.2	–3.6	–2.6	0.5
		(Percent of GDP)			
Output Gap[2]	–1.9	–5.1	0.8	0.6	0.7
Domestic Investment	16.0	17.6	20.7	21.8	20.8
National Savings	11.0	10.4	13.9	15.7	14.0
External Current Account	–5.0	–7.2	–6.8	–6.1	–6.9
Gross International Reserves	8.4	11.3	17.9	18.4	16.4
Fiscal Balance[3]	–3.5	–3.1	–1.1	–1.0	–1.9
Public Debt[3]	67.6	71.0	53.9	44.8	54.9

Sources: Peruvian authorities; and IMF staff estimates
[1]Effective, (–) = real depreciation.
[2]Percent of potential.
[3]Nonfinancial public sector.

- *Financial system strengthening*. Important reforms of the financial system were also put in place. Institutional autonomy, prudential regulations, and the supervisory powers of the SBS were strengthened, and provisioning and capital requirements were raised. The process of closing official development (first-tier) banks was completed.

Reforms were also undertaken to impart flexibility in labor markets. Regulations on labor contracts, hiring practices, layoff clauses and related compensations, and collective bargaining were eased. Employment in Lima grew on average by 6½ percent a year during this period.

Peru finally normalized relations with all external creditors after difficult negotiations during this period:

- *Paris Club*. There were two additional reschedulings, the first in May 1993 covering maturities falling due in 1993–94 for US$1.9 billion on Houston terms, and the second in July 1996 covering maturities falling due in 1996–98 for US$6.7 billion, also on Houston terms. After these reschedulings, Peru graduated from Paris Club financing.
- *London Club*. A large debt and debt service reduction operation was conducted under the Brady initiative in March 1997. Peru offered four options in exchange for its defaulted loans (from March 1983): (1) a debt buyback at a deep discount, (2) a discount bond with a lower face value, (3) a par bond at below-market interest rates, and (4) a front-loaded interest reduction bond. Past due interest was exchanged for 20-year bonds (with 5-year grace periods). The upfront cost of the operation was US$1.4 billion, and it is estimated that it generated debt reduction of about one-half on a stock of US$10.6 billion in claims. There was overwhelming participation (over 99 percent).[6] Most creditors (about 78 percent) chose

[6]However, there were small holdouts. After the deal was announced, one creditor, Elliott Associates, bought about US$21 million in commercial claims on Peru in the secondary market, and did not participate in the Brady deal of 1997, instead filing a lawsuit in New York for recovery of the full value plus past due interest. Elliott Associates obtained a judgment against Peru in June 2000 for US$56 million and an attachment order against Peru's assets. It sought to attach the interest on Brady bonds and obtained a restraining order against Chase Manhattan Bank (the fiscal agent in charge

the frontloaded interest reduction bond, which had a 20-year maturity and 8 years of grace. IMF resources under the EFF (set-asides and augmentation) were used for this purpose; no IMF purchases were made after this operation. This was also graduation on rescheduling with commercial creditors.

- *Bilateral*. Peru repurchased the entire stock of its debt to the former Soviet Union (a non–Paris Club country) for about US$1.1 billion (inherited by Russia under the zero option, whereby Russia got all assets and liabilities of the Soviet Union) for about US$130 million.

Notwithstanding the economic progress achieved in many areas, Peru was reminded of its vulnerabilities in 1998. Two external shocks severely affected macroeconomic performance: (1) the withdrawal of foreign lines of credit worldwide in the wake of the Asian, Russian, and Long-Term Capital Management crisis of 1998; and (2) the El Niño weather phenomenon, which practically shut down the fishing industry and severely reduced agricultural output.[7] It is estimated that the cost of El Niño (including preventive measures and reconstruction) was close to 1 percent of GDP. As a result of these external and supply shocks, real GDP contracted by about half a percent in 1998.

The Russian crisis of 1998 highlighted financial dollarization as the main vulnerability of the Peruvian economy. As a result of the crisis, the domestic currency depreciated 13 percent in real terms, the balance sheet of nonbanking firms weakened and induced an increase of nonperforming loans in foreign currency from 5 to 10 percent, credit in foreign currency declined (with an annual decrease of –4 percent), and the number of banks declined from 26 to 14.

DEEPENING REFORMS (1999–2007)

The period from 1999–2007 is associated with a transitory slowdown in growth, a swing in the fiscal accounts (deteriorating at the beginning and strengthening at the end), improvements in external conditions, and a widespread deepening of reforms (Table 2.6).[8] The economy grew on average at an annual rate of 4½ percent (compared to 5½ percent during the previous five years), while inflation was finally brought down to levels similar to those in advanced economies, averaging 2½ percent (compared to an average of almost 15 percent during the previous five years). The NFPS balance switched from a deficit of 3¼ percent of GDP in 1999 to a surplus of 3 percent in 2007. To put these developments in perspective, the swing in the fiscal accounts during this eight-year period is similar to the massive adjustment undertaken during the great stabilization of 1990–92, with the difference being that this improvement in the fiscal accounts was facilitated by a massive improvement in the terms of trade, which increased

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of distributing the payments). Elliott Associates argued that the payment of interest to Brady bondholders violated a clause in its loan agreement that provided that the loan ranked equally with all other external debt (the *pari passu* clause). Facing this difficult trade-off, Peru decided to settle with Elliott Associates in order to avoid default on the Brady bond interest payments (IMF 2001). Argentina faced a similar situation in mid-2014 and took a different approach.

[7] El Niño is a weather disturbance that occurs every six or seven years and consists of rising ocean temperatures off the Pacific coast, which deprives the supply of plankton, resulting in lower availability of fish. Warmer temperatures also bring heavy rainfall and mudslides in the Andean and coastal regions, affecting agriculture and disrupting transportation. El Niño also affects the manufacturing sector involved in the processing of primary products.

[8] During the 1999–2007 period, Peru had one EFF and four Stand-By Arrangements (SBA) with the IMF, all of them precautionary (i.e., no money was used). The EFF was for SDR 383 million and covered the period 1999–2001. The first SBA was for SDR 128 million and covered 2001–02; the second was for SDR 255 million and covered 2002–04; the third was for SDR 287 million and covered 2004–06; and the fourth was for SDR 172 million and went beyond this period, covering 2007–09. The first SBA was requested by the Peruvian authorities during the interim government of President Valentin Paniagua to demonstrate continuity, despite the political turbulence associated with the resignation of President Alberto Fujimori.

TABLE 2.6

Peru: Economic Indicators, 1999–2007 (*Percent*)

	Average 1993–98	1999	2003	2007	Average 1999–2007
			(Annual Percentage Change)		
Real GDP	5.6	1.5	4.2	8.5	4.6
Inflation (end of period)	14.9	3.7	2.5	3.9	2.4
Interest Rate	11.1	11.8	3.1	3.2	5.2
Base Money	25.4	17.0	10.1	28.2	15.5
Private Credit	46.8	6.7	–4.5	33.3	5.0
Real Exchange Rate (average)[1]	0.2	–8.3	–2.6	–0.8	–1.6
Terms of Trade (deterioration –)	0.4	–6.6	1.6	4.3	5.3
			(Percent of GDP)		
Output Gap[2]	0.7	–0.6	–0.7	0.8	–0.6
Domestic Investment	20.8	19.3	17.9	22.3	18.3
National Savings	14.0	16.4	16.4	23.8	17.7
External Current Account	–6.9	–2.8	–1.6	1.5	–0.6
Gross International Reserves	16.4	18.3	17.3	27.1	19.1
Fiscal Balance[3]	–1.9	–3.4	–1.7	3.1	–1.1
Public Debt[3]	54.9	51.1	48.7	29.9	43.7

Sources: Peruvian authorities; and IMF staff estimates.
[1]Effective, (–) = real depreciation.
[2]Percent of potential.
[3]Nonfinancial public sector.

metal-related taxation. The terms of trade improved a staggering 70 percent in this period as copper prices soared.

On the structural side, the 1999–2007 period is marked by two landmarks in macroeconomic management: (1) the introduction of fiscal rules (Ministry of the Economy and Finance, various years), and (2) the formal implementation of an inflation-targeting scheme. Both frameworks were very successful in containing fiscal imbalances, reducing public debt, and bringing inflation down to the lowest level in Latin America. In addition, Peru returned to international capital markets after an absence of almost three-quarters of a century.

The Fiscal Responsibility and Transparency Law, approved by Congress in December 1999, was perhaps the most important piece of legislation on the fiscal side in modern Peruvian history. It ensured fiscal sustainability and a rapid recline in public debt as a ratio of GDP and encouraged fiscal savings, improving the fiscal position and creating large fiscal space and buffers. The law set prudential fiscal rules, introduced a Fiscal Stabilization Fund (FSF), and promoted fiscal transparency. The rules were simple: (1) a deficit of the NFPS (excluding municipalities) was not to exceed 2 percent in 2000, 1½ percent in 2001, and 1 percent thereafter; (2) the growth of noninterest expenditures of the general government in real terms was capped at 2 percent per year; and (3) in an election year, noninterest expenditures in the first seven months of the year were not to exceed 60 percent of the annual budget and the deficit could not exceed 50 percent in the first six months. The rule could be suspended if a national emergency was declared.

The FSF was designed to smooth budgetary revenue over the business cycle. When current revenue as a percent of GDP exceeded the previous three-year average by more than 0.3 percent of GDP, the excess (over 0.3 percent of GDP) was to be saved in the FSF. Savings in the FSF were also supposed to include 75 percent of cash receipts from privatizations and 50 percent from concession projects. Initially, balances in the FSF were not supposed to exceed 3 percent of GDP.

Transparency was enhanced by requiring budget discussions to be based on a rolling three-year macroeconomic framework, including targets for the main fiscal aggregates (revenue, expenditure, deficit, public debt), the long-term path of debt service, and a statement by the finance minister on the objectives and guidelines of fiscal policy for the period. The central bank was expected to com-

ment on the macroeconomic program, with its comments published along with the program. The finance minister was expected to present semiannual performance reports to Congress and an annual statement certifying ex post compliance with the law (and explanations in cases of deviations).

The Fiscal Responsibility and Transparency Law was modified several times (2003, 2007, and 2009). The Fiscal Management Responsibility Act was introduced in 2003 with the objective of achieving debt consolidation. Under this modification, the cap on real noninterest expenditures was increased to 3 percent per year (and later to 4 percent). It also increased the limit on the NFPS deficit to 2 percent in 2003 before reverting to 1 percent by 2005. In 2007, the definition of spending changed to central government consumption. These fiscal laws were eventually substituted by the new fiscal framework introduced in 2013.

The successful disinflation of the 1990s was conducted within a framework of monetary aggregate targeting. In practice, this took the form of controlling the net domestic assets of the central bank and achieving a net international reserve target. As disinflation unfolded in the 1990s, the behavior of monetary aggregates became more volatile and this measure was deemed unsuitable for communicating the stance of monetary policy (Rossini 2001). Against this backdrop, the central bank decided to formally adopt an inflation-targeting framework in January 2002 as the basis for conducting monetary policy (see Chapter 13). This was perhaps the most important monetary measure taken in the poststabilization period to cement stability and ensure low inflation rates. In July 2002, the central bank announced a medium-term inflation target of 2½ percent with a range of ±1 percentage point around the target.[9] An important milestone was the seminar organized in Lima by the BCRP and the IMF in 2001 to assess the conditions to adopt an inflation-targeting scheme for Peru.

Comprehensive inflation reports were to be issued initially three times a year (and then four times) to explain inflation performance, the considerations that guided monetary policy in the preceding months, and the central bank's inflation forecast. This forecast was to be based on a range of indicators (including market expectation surveys), inflation forecasting models, and other relevant factors such as the exchange rate, the fiscal policy stance, and aggregate demand conditions. The central bank changed from controlling monetary aggregates to controlling interest rates to achieve the inflation objective. The operational target for monetary policy was to be the policy interest rate, and the central bank continued intervening in the foreign exchange market. The inflation target was subsequently reduced from 2½ to 2 percent in February 2007 (with the same range of ±1 percentage point).

Inflation targeting turned out to be very successful and Peru became the country with the lowest inflation rate in Latin America over the next decade. However, implementation of the regime was not without problems. This was the first case of an inflation-targeting regime in the context of relatively large financial dollarization and starting with indicators of deflationary pressures (Armas, Ize, and Levy 2006). To make the nuevo sol competitive against the U.S. dollar in the eyes of depositors, the central bank decided to implement the inflation-targeting framework with a relatively low inflation target, the lowest to date in Latin America. The decision paid off: inflation was roughly on target and financial dollarization has gradually been reduced.

From the virtual financial autarky and default of the 1980s and the normalization of relations with creditors in the 1990s, Peru moved to having access to international capital markets in the 2000s. In February 2002, Peru issued a sovereign bond for the first time since 1928 (almost 70 years before). The transaction involved issuing a fixed-coupon, 10-year, global bond for US$1.42 billion, of which US$920 million was used to buy back existing Brady bonds (issued during the 1997 debt and debt service reduction operation) with a face value of US$1.2 billion. The strategic goal of the operation was to broaden the government's sources of financing, while extending the maturity profile of the public debt. At the time, the government relied on credits from official external sources (mainly multilaterals) and privatization receipts to finance the deficit, which were not a sustainable source of

[9]Later, starting in 2007, the inflation target was reduced to 2 percent with a range of ±1 percentage point around the target in order to align it to the median of inflation targets of other central banks.

financing because most state-owned enterprises had been sold by then, and Peru was expected to graduate from official lending.

In addition, the global bond provided a useful benchmark instrument for future bondholders and Peruvian firms. Until the global issue, Brady bonds were the only traded sovereign Peruvian debt, but they were difficult to price because of the complexities of the collaterals, and thus were poor benchmarks. The market of Brady bonds was known for pricing inefficiencies (again due to the collateral); Peru took advantage of this mispricing, and the exchange reduced the stock of public debt (about US$300 million) and generated a small saving in net present value terms. The exchange also provided some hedge against future interest rate hikes and increased somewhat the duration of Peru's debt. Access to international capital markets has been uninterrupted since, with successive improvements in the country's credit rating.

The government began a decentralization process in 2002. While the government recognized the risks associated with this policy, the objective was to promote a more responsive government structure to address local concerns. A sound legal framework was built for decentralization, including a plan for the distribution of government revenue and a timetable for the transfer of expenditure responsibilities, as well as the establishment of reporting requirements and fiscal rules for subnational governments.

A constitutional amendment that mandated political and fiscal decentralization was passed in 2002. The process was promoted by the general view that decentralization would help improve governance and public service delivery through enhanced accountability at subnational levels. Decentralization also aimed to ensure broader access to basic public services and reduce high poverty rates and regional income inequalities.

A key objective was to implement the decentralization process in a fiscally neutral manner. To that end, laws were enacted to guide the sequencing and procedures for the devolution of responsibilities, transfers of resources, and reporting provisions and fiscal rules for subnational governments. Five pieces of legislation were enacted for this purpose: (1) the Framework Decentralization Law of 2002, which mandated a clear, gradual, and fiscally neutral devolution of expenditures; (2) the Organic Law for Regional Governments of 2002, which detailed regional government expenditure responsibilities; (3) the Organic Law for Municipalities of 2003, which did the same for municipal expenditures; (4) the Accreditation System Law of 2004, which established a system to assess whether regional and local governments meet standards to qualify for the transfers; and (5) the Fiscal Decentralization Law of 2004, which established the sequence of transfers to regional governments and set fiscal rules and reporting provisions for subnational operations.

Other structural reforms were also deepened after 1999. Reform areas included privatization and economic concessions, sales and regulation of agricultural land, and efficiency of social protection programs. Reforms initially focused on ensuring a sustainable fiscal situation and more efficient provision of public services.

The authorities also announced plans during this period for comprehensive tax reform. The reform aimed at widening the tax base of the income and value-added taxes through the elimination of regional and sectoral exemptions, a rationalization of excise taxes, and improvements in tax administration. The tax reform was implemented in various stages, and by end-2003 the authorities had made progress in several areas. However, many sectoral and regional exemptions remained and a small tax on financial transactions was introduced.

Further efforts were also made to improve the finances of the pension system. These efforts concentrated on reducing the government subsidy in the preferential public pension plan, which the government subsidized at more than 90 percent. Contribution rates were raised substantially, pensions above a certain threshold became subject to income taxes, and future pensions were capped. This put pension benefits for contributors on an actuarial sound basis and generated some savings in net present value terms. However, a large gap remained for the preferential public pension plan.

GLOBAL FINANCIAL CRISIS (2008–09)

Nothing on the horizon suggested that Peru's economy was about to endure the sharpest economic deceleration in the poststabilization period. Although there were signs of trouble in the world economy (especially in the United States), almost no one was predicting the worst global financial crisis since the Great Depression of the 1930s. In 2008, Peru was booming and the economy was growing by midyear beyond capacity at close to 11 percent. There were signs of overheating, with inflation running at almost 6 percent (partly due to higher food and fuel prices, and clearly above the inflation range), although the fiscal surplus was one of the highest in recorded history, reflecting high natural resource–related taxation and a strong economy, with public debt on a continuing downward path. Giving an even greater sense of security, Fitch and Standard & Poor's granted Peru investment grade in the first half of 2008 (the third country in the region to get such a grading after Chile and Mexico).[10]

However, the world changed in September 2008 with the collapse of the U.S. investment bank Lehman Brothers and the onset of the global financial crisis. Peruvian sovereign spreads immediately tripled to over 600 basis points, although they eased back to close to more normal levels by end-2009, while equity prices were still 60 percent lower than at end-2007. Following large foreign exchange purchases earlier in the year, the central bank intervened in the aftermath of the Lehman crisis by selling foreign exchange to limit market volatility and contain pressures on the nuevo sol, which had depreciated by about 6 percent against the U.S. dollar.

Fortunately, there was limited financial contagion from the global financial crisis thanks to a quick policy response. Fearing a credit crunch similar to that in the United States, and facing tight liquidity, reduced capital inflows, and a steepening of the government yield curve, the BCRP eased reserve requirements and placed repos and swaps in nuevos soles and U.S. dollars to provide additional liquidity. At the same time, the central bank signaled its intention to repurchase government fixed-income securities in the secondary market. Banks remained resilient, and a credit crunch was avoided, as the interbank market continued operating normally and credit channels were preserved. Large official reserves, which stood at $31 billion at end-2008, along with banks' limited reliance on external funding, helped to maintain stable liquidity conditions. However, dollarization rebounded (after declining markedly over the previous two years), reflecting concerns about the global financial crisis.

The authorities entered 2009 with the concern that a sharp and sudden deceleration in domestic private demand—which could be precipitated by a sharp fall in commodity prices, declining domestic confidence, or potential disruptions in the financial system—could compromise the "soft landing" they were trying to achieve following exceptionally high growth in 2008 and emerging signs of overheating. As a result of the continuing global financial crisis, Peru's growth declined substantially in 2009, with a few months in negative territory. The downturn was primarily linked to the collapse in global trade and uncertainty about global growth, temporarily amplified by a large inventory correction in Peru (Table 2.7).

The signs of a weak economy were evident. Inflation fell to near zero in the second half of 2009 (partly due to a decline in food and fuel prices). The external current account shifted from a deficit to a small surplus as the decline in exports was more than offset by the slowdown in import growth. Private investment fell by 30 percent in real terms but consumption proved more resilient thanks to sustained employment.

A timely policy response involving monetary easing and fiscal stimulus prevented a further deterioration of economic activity in 2009. In terms of monetary easing, the BCRP acted proactively to reduce the policy rate by 525 basis points in early 2009 to a historic low of 1¼ percent. Lending rates to the private sector also declined in line with the policy rate, fostering private investment. To provide a fiscal impulse, the authorities announced an anticrisis plan to shield the economy from

[10] By then, Peru had a precautionary SBA with the IMF for SDR 172 million covering the period 2007–09.

TABLE 2.7

Peru: Economic Indicators, 2008–09 (*Percent*)

	Average 1999–2007	2008	2009	Average 2008–09
	(Annual Percentage Change)			
Real GDP	4.6	9.1	1.0	5.1
Inflation (end of period)	2.4	6.7	0.2	3.4
Policy Rate	3.5	5.9	3.3	4.6
Private Credit	5.0	33.8	1.3	17.6
Real Exchange Rate (average)[1]	–1.6	4.1	2.3	3.2
Terms of Trade (deterioration –)	5.3	–10.9	–2.4	–6.8
	(Percent of GDP)			
Output Gap[2]	–0.6	3.0	–2.1	0.5
Domestic Investment	18.3	27.5	20.9	24.2
National Savings	17.7	23.1	20.4	21.7
External Current Account	–0.6	–4.3	–0.5	–2.4
Gross International Reserves	19.1	25.6	27.3	26.4
Fiscal Balance[3]	–1.1	2.5	–1.4	0.6
Public Debt[3]	43.7	26.9	27.2	27.0

Sources: Peruvian authorities; and IMF staff estimates.
[1]Effective, (–) = real depreciation.
[2]Percent of potential.
[3]Nonfinancial public sector.

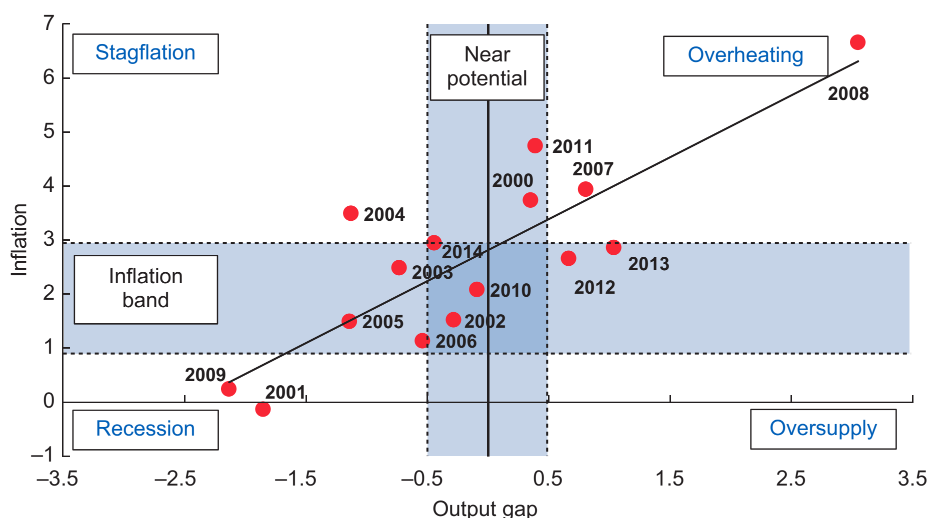
the global crisis and improve investor confidence. The fiscal stimulus was largely financed with fiscal savings. It entailed a positive fiscal impulse of about 2½ percent of GDP in 2009 concentrated on higher public investment (1¼ percent of GDP) and support to the construction sector (¾ percent of GDP). This translated into an increase in real general government primary spending of 14 percent. The fiscal plan also included contingency measures, including guarantees (which in the end were not used) to support corporations, exporters, and smaller financial institutions.

The situation with the capital account normalized rapidly. A quick recovery of net foreign direct investment (FDI) flows and strong public sector flows compensated for portfolio outflows, partly driven by domestic pension funds. The public sector took advantage of improving global market conditions during 2009 and issued debt (US$2 billion) to prefinance operations and fully repay Paris Club debt. The nuevo sol recovered its pre-Lehman level against the U.S. dollar by end-2009, and started to appreciate in nominal and real effective terms. Appreciation pressures were associated with portfolio reallocation of domestic agents, including pension funds, and some foreign portfolio inflows. These pressures were intermittent, with temporary respites during episodes of heightened global volatility linked to sovereign risk developments in other regions prompting significant purchases by the central bank. As conditions stabilized, the central bank began to reverse some of the unconventional measures. After the second quarter of 2009, the central bank reduced the stock of foreign exchange swaps, repo operations, and foreign-exchanged indexed certificates of deposit.

Although Peru's economy contracted briefly during two quarters in 2009, growth resumed rapidly thanks to a skillful countercyclical policy response. All things considered, Peru came through this relatively large external shock relatively unscathed. The moral of the story is that it pays to have large buffers and significant policy space to react to unexpected shocks. When external credit markets were in distress, Peru had the resources and the macroeconomic room to implement a timely fiscal impulse and to loosen monetary policy.

POSTCRISIS PERIOD (2010–14)

The effectiveness of the countercyclical response and the rapid economic recovery soon turned the policy debate from macroeconomic impulses to the optimal speed of stimulus withdrawal. Real GDP grew on average by 6¾ percent in the period 2010–13 (closing the negative output gap of



Source: IMF staff estimates.

Figure 2.3 Peru: Inflation and Output Gap (*Percent*)

TABLE 2.8

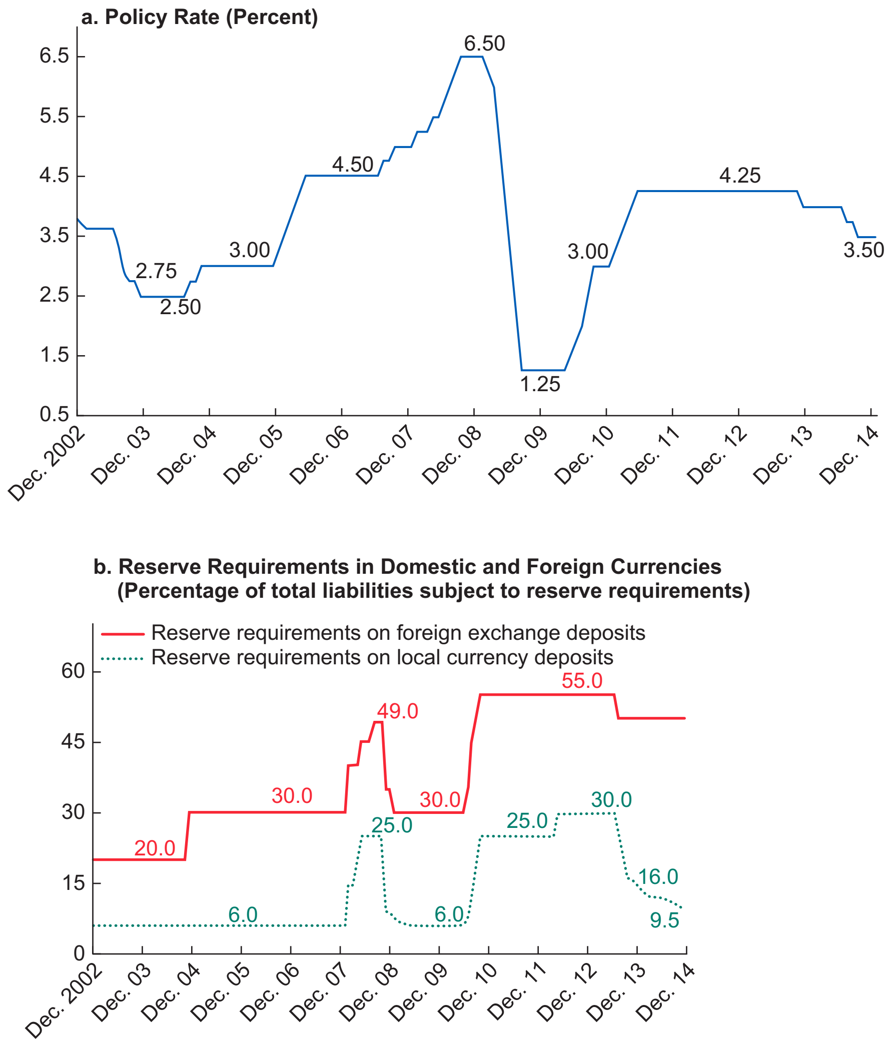
Peru: Economic Indicators, 2010–14 (*Percent*)

	Average 2008–09	2010	2012	2014	Average 2010–14
			(Annual Percentage Change)		
Real GDP	5.1	8.5	6.0	2.4	5.8
Inflation (end of period)	3.4	2.1	2.6	3.2	3.1
Policy Rate	4.6	2.1	4.3	3.8	3.7
Private Credit	17.6	14.3	12.4	13.4	16.3
Real Exchange Rate (average)[1]	3.2	2.5	7.8	–2.0	1.2
Terms of Trade (deterioration –)	–6.8	21.0	–2.1	–5.8	2.7
			(Percent of GDP)		
Output Gap[2]	0.5	–0.1	0.7	–2.0	0.0
Domestic Investment	24.2	25.2	26.7	27.3	26.6
National Savings	21.7	22.8	23.5	22.3	23.2
External Current Account	–2.4	–2.4	–3.3	–5.2	–3.4
Gross International Reserves	26.4	29.7	33.2	30.7	30.9
Fiscal Balance[3]	0.6	–0.2	2.3	–0.1	1.0
Public Debt[3]	27.0	24.3	20.4	19.7	21.2

Sources: Peruvian authorities; and IMF staff estimates.
[1]Effective, (–) = real depreciation.
[2]Percent of potential.
[3]Nonfinancial public sector.

2009), while core inflation—excluding food and fuel prices—remained under control (although headline inflation was temporarily outside the inflation range in 2011 and 2014 due to supply shocks) (Figure 2.3). However, the economy decelerated in 2014 as external conditions deteriorated, exports declined, and confidence eroded, leading to a contraction in private investment.

The signs of a recovery were clear by mid-2010 (Table 2.8). The economy was growing at almost 10 percent, driven by private domestic demand. For the year as a whole, real GDP expanded by 8½ percent. The inflation rate picked up to 2 percent (from almost zero the year before), whereas the current account deficit widened to some 2½ percent of GDP (from half a



Source: IMF staff calculations.

Figure 2.4 Peru: Policy Rate and Reserve Requirement

percent the year before). To prevent overheating risks, the authorities began the tightening cycle in 2010–11:

- *Monetary tightening*. The central bank was quick in tightening its stance; the policy rate was raised by 175 basis points in the second half of 2010 to 3 percent by year end (Figure 2.4a). The rate was further increased by 125 basis points in the first half of 2011 to 4¼ percent. Monetary policy was also tightened with restoration of a reserve requirement of 35 percent on short-term (less than two years) foreign credit lines (Figure 2.4b). Credit growth stayed at about 16 percent.

- *Fiscal consolidation*. The overall fiscal deficit fell from 1⅓ percent of GDP in 2009 to one-third of a percent in 2010, although its impact on demand was limited because real spending continued growing above potential and better terms of trade generated higher revenues. By 2011, the fiscal position strengthened further to a surplus of almost 2 percent

of GDP as a result in part of expenditure restrictions imposed by the political process (presidential elections in April–June 2011) and the limited implementation of investment projects by the incoming administration in August 2011.

Subsequently, policies were geared toward modulating the business cycle while supporting growth. As policies were tightened after the stimulus, economic growth moderated. Real GDP grew 6½ percent in 2011 and about 6 percent in 2012–13.[11] The effective macroeconomic management of the global financial crisis and the proper withdrawal of the stimulus created a problem of its own, however, as Peru became an attractive destination for FDI and a magnet for capital inflows. By 2012, the financial account of the balance of payments recorded a surplus of over 10 percent of GDP (the largest in recorded history) and nonresident holdings of domestically issued public debt increased to over half of the total stock. In order to deter external financing, in May 2012 the authorities extended the 60 percent reserve requirement on foreign liabilities to those with maturity up to three years (from two years) and imposed a 20 percent reserve requirement on foreign liabilities with a maturity longer than three years.

Fearful that the inflows could be temporarily reverted, the central bank pursued a policy of foreign exchange intervention/sterilization while allowing some exchange rate flexibility as dictated by economic fundamentals. In the end, the central bank purchased about 6½ percent of GDP in foreign exchange in 2012 to prevent unsustainable credit expansion and undue appreciation of the currency while allowing the nuevo sol to strengthen by 8½ percent in real effective terms, according to the BCRP Annual Report. Foreign exchange intervention prevented large currency fluctuations, and indeed the nuevo sol remained the most stable currency among the financially integrated economies of Latin America (i.e., Brazil, Chile, Colombia, Mexico, Peru, Uruguay). International reserves reached over 30 percent of GDP in 2012.

To prevent a large monetary injection, the foreign exchange purchases had to be sterilized. The central bank controlled the liquidity generated by these purchases by placing its own securities with domestic financial institutions and relying heavily on reserve requirements policy in nuevos soles (increasing them by some 225 basis points) to supplement the sterilization efforts. It is estimated that these operations sterilized about 70 percent of the liquidity generated by the intervention. The remaining amount was absorbed by the fiscal surplus and the increase in the demand for money.

Fiscal policy played a key role in supporting monetary policy. The fiscal surplus increased from 2 percent of GDP in 2011 to 2⅓ percent of GDP in 2012. However, the fiscal effort was greater than suggested by the overall fiscal balance, as it is estimated that the structural fiscal position was strengthened by 1 percent of GDP in 2012. In any case, the higher fiscal surplus acted as a form of fiscal sterilization, as the public sector significantly increased its deposits at the central bank.

Despite a widening current account deficit, external stability risks were contained. The current account deficit widened from 2 percent of GDP in 2011 to about 3⅓ percent in 2012, mostly due to a deteriorating terms of trade, weak volume growth in mineral exports, and strong growth in import volume. It was more than financed by strong FDI flows.

The capital inflow problem came to an abrupt end following the announcement by the U.S. Federal Reserve in May 2013 of a potential "tapering" of its unconventional monetary policy. The news created confusion and uncertainty in the markets, and the magnitude of capital inflows declined significantly. The surplus of the financial account of the balance of payments dropped from over 10 percent of GDP in 2012 to about 5½ percent in 2013. The nuevo sol was under pressure and depreciated about 8½ percent against the U.S. dollar. For the first time in a long while, the BCRP intervened by selling foreign exchange.

[11] GDP data were revised and calculated under a new base (2007). The data were released in 2014. Under the old base (1994), real GDP growth declined to about 5 percent in 2013.

The external position deteriorated in 2013 mostly due to weak export performance and higher interest rates abroad, leading to a current account deficit of 4½ percent of GDP. However, the current account deficit continued to be easily financed despite lower private capital inflows. While demand for external financing fell following the U.S. announcement in May 2013, international bond issuance by Peruvian firms already had reached historic highs above US$6.5 billion in 2013.

Under the old GDP statistics (base year 1994), there were some signs of a slowing in the economy in the second half of 2013. The concern was strong enough for the public sector to reduce its fiscal surplus from 2⅓ percent of GDP in 2012 to merely three-quarters of a percent in 2013. Primary spending was increased to achieve social goals and cover higher wages following a civil service reform, and mining-related revenues fell due to weak metal prices. After having kept the policy rate unchanged for 2½ years, the central bank reduced its rate by a quarter of a percentage point to 4 percent in November 2013, citing slower domestic and global growth and declining inflationary expectations. Concerns over an economic slowdown turned out to be unfounded, however. The revised GDP statistics showed robust growth in the second half of 2013, with the economy growing at 5¾ percent for the year as a whole.

Important reforms were also introduced in 2013. These included a far-reaching civil service reform that standardized workplace regulations and salary scales, increased training for staff, and instituted performance evaluations. A private pension system reform was directed toward generating greater public access and lower fees. The fiscal framework was revamped by Congress in October 2013 to introduce structural fiscal rules. The new framework aimed to (1) introduce a countercyclical component to budget formulation, (2) strengthen accountability by establishing a fiscal council, and (3) better delineate the relationship and fiscal practices between the national and subnational governments. The law became binding for the 2015 budget.

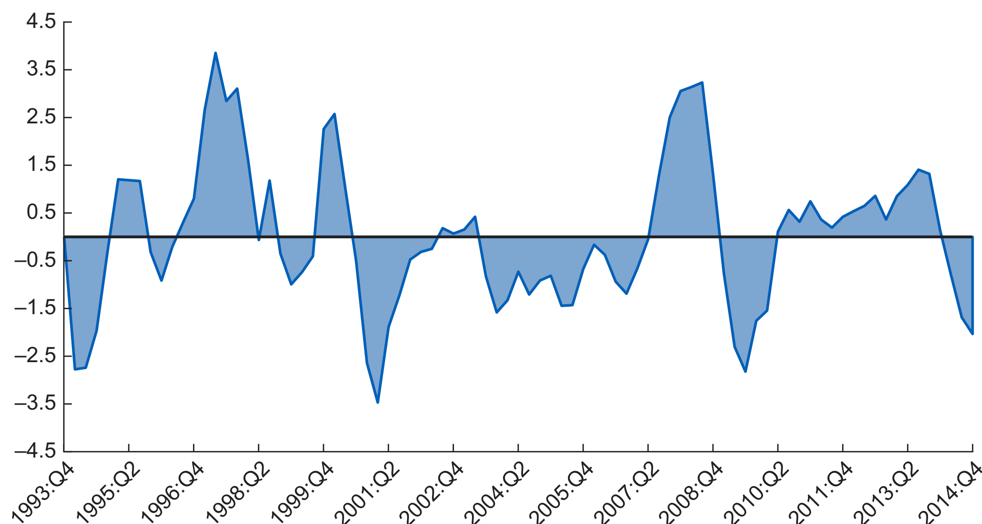
In the first half of 2014, Peru's economy experienced its sharpest deceleration since the global financial crisis of 2008–09. Real GDP grew 2.5 percent in 2014. Key factors in the deceleration were lower exports and lower private investment given uncertainties about external conditions in a world economy with mediocre growth. Current and capital outlays by regional governments were also down, reflecting lower natural resource income and regional corruption scandals. Supply factors related to extraction problems in a few large mines, and a crackdown on illegal gold mining, also contributed to the poor economic performance.

This generated a quick policy response. The central bank relaxed monetary conditions by reducing reserve requirements and reducing its policy rate by a quarter of a point in July and then by another quarter point in August 2014 to 3½ percent. In June–July, the government announced a number of measures, amounting to some 1 percent of GDP, to support aggregate demand and increase potential output. The measures involved additional capital and social spending, a write-down of unpaid interest on old tax obligations, and a one-time small wage bonus to all public employees to support private consumption.

CONCLUSIONS

Peru's strong economic performance over the past two decades can be attributed to solid macroeconomic stabilization and strong economic fundamentals. These achievements were consolidated during the great stabilization of the early 1990s and the period of continuous structural reforms in the late 1990s and early 2000s. A quick look at the output gap over the past three decades shows that the business cycle was tamed and Peru achieved its aim of high growth and low inflation after the great stabilization of 1990–92 (Figure 2.5).

While the magnitude of the adjustment achieved during the great stabilization period of the early 1990s was large, the actual size of the primary fiscal balance consistent with stabilization and growth was not that large. The primary balance adjusted by some 6 percent of



Source: Central Reserve Bank of Peru.
Note: Estimated using the Hodrick-Prescott filter.

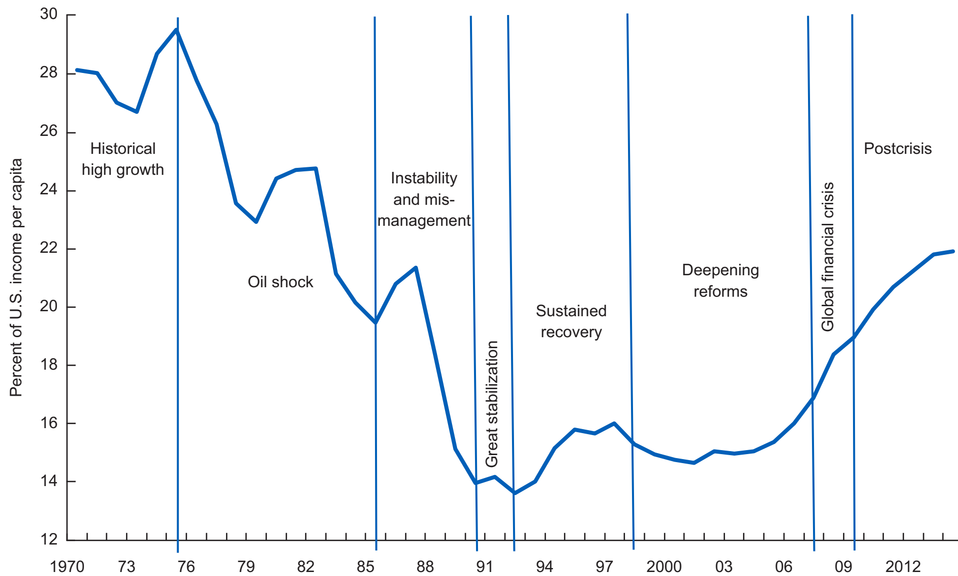
Figure 2.5 Peru: Output Gap (*Percent of potential output*)

GDP when it moved from a deficit of about 4 percent of GDP in 1989 to a surplus of about 2 percent of GDP in 1991, which is an average adjustment of 3 percent per year. However, the average level of the primary balance for the rest of the 1990s and the 2000s was close to 1½ percent of GDP, which in itself is not a particularly large surplus, but was enough to secure long-lasting stabilization.

The importance of effective macroeconomic management can never be overemphasized. The volatile stagnation of the period from 1975–90 was a major setback for Peru's economic aspirations. With the experience of the economy having grown at about 5½ from 1950–75, and at 5¼ percent from 1993–2014, the question is, what would be the level of per capita income today if the volatile stagnation of 1975–90 had never taken place? The answer is that Peru's economy would be more than 2½ times bigger than it is today (assuming the economy had grown at the constant rate of 5½ percent since 1975). This translates into income per capita (in purchasing power terms) of about US$32,000, which is similar to the level of income per capita of Italy, Spain, Korea, or New Zealand.

Although macroeconomic performance over the past two decades has been stellar and prospects look very good, much remains to be done in Peru. Using the United States as a comparative benchmark, income per capita in Peru declined from almost 30 percent in the mid-1970s to 14 percent in the early 1990s, and it is currently at about 22 percent (Figure 2.6). In the mid-1970s, Peru had a level of income per capita similar to the average of the region. But today it has fallen behind: its income level per capita is similar only to that of Colombia and is 20 percent lower than that of Brazil, 30 percent lower than Mexico, 40 percent lower than Uruguay, and 50 percent lower than Chile. Achieving the level of income of resource-rich advanced economies like Australia or Canada would require that Peru grow at a sustained rate of 5½ percent for a quarter of a century.

The lesson, then, is simple and clear. To achieve a more advanced stage of development, Peru needs to preserve macroeconomic stability and deepen its structural reforms to secure and sustain high levels of growth in the years ahead.



Source: IMF, World Economic Outlook Database.

Figure 2.6 Peru: Income per Capita (*Percent of U.S. income per capita*)

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PART III

Challenges Ahead

CHAPTER 24

Some Thoughts on Fiscal Policy and the Unfinished Agenda

ALONSO SEGURA

Peru has achieved a positive fiscal policy track record over the past 25 years thanks to an ongoing process of strengthening the macrofiscal framework. This first involved taking steps to correct existing distortions, such as the tendency to run fiscal deficits, the volatility of the main fiscal aggregates that reduced the predictability and credibility of fiscal management, and the haphazard approach to budgetary decision making, which lacked a clear, single objective. Once macroeconomic stability and credibility were restored, the authorities continued their efforts to consolidate the macrofiscal framework and institutionalize fiscal policy through binding rules governing the preparation of the budget. In an international setting that in coming years may pose challenges for the medium-term growth of economies such as Peru, there is room to consolidate the current macrofiscal framework and to maintain fiscal sustainability through action on three fronts: increasing permanent revenues through measures to broaden the tax base, seeking greater efficiency in public spending and prioritizing expenditures on the basis of an ex post evaluation of results, and reforming the system of intergovernmental transfers based on the principles of predictability in public spending, limitations on the capacity to absorb the resources transferred, and accountability.

The prudent management of fiscal policy that has been consistently applied in recent decades in Peru is one of the pillars of the country's current economic success. This is reflected in the credibility of the Peruvian economy, as recognized through its solid credit ratings, as well as its fiscal indicators, which are even better than those of countries with the same or higher credit ratings. This confidence has translated into lower costs for investing and persistent high rates of growth, both in investment and in national output. Responsible management of fiscal policy, together with other reforms, has created a climate that encourages the private sector to take medium- and long-term decisions with greater confidence and thereby improve economic productivity, a vital ingredient for growth over the long term.

Thus, what Peru has achieved today is part of an ongoing strengthening process that began some 25 years ago. The process included correcting the glaring distortions at that time, such as the persistent tendency to run fiscal deficits and the marked volatility of the main fiscal aggregates—which reduced the predictability and credibility of fiscal management—as well as the haphazard approach to budgetary decision making, which lacked a clear, single objective. In fact, during the 1980s, fiscal policy was characterized by a steady series of large fiscal deficits and an economy that was unable to obtain financing except through monetary issuance, with the attendant high inflation. Subsequently, the 1990s saw the initial reforms that made it possible to stabilize the macroeconomy and earn credibility among economic agents. In the last 10 years, the policies pursued have allowed Peru to consolidate its fiscal policy with a focus on balanced management of public finances over the economic cycle, and the strengthening of fiscal institutions, so as to impart predictability and stability to the existing macrofiscal framework. The country must now be careful not to undo all that effort and must focus on building upon what has been achieved, keeping an eye on the goals that have been established and taking nothing for granted.

In particular, the international setting that is expected to prevail in coming years will pose challenges for the medium-term growth of economies such as Peru. With a view to boosting the growth potential in the next few years and responding to the looming international context, the government has recently proposed actions within a framework along three fronts geared to ensuring greater investment and gains in productivity and competitiveness: (1) strengthening human capital and reducing informality, (2) reducing the infrastructure gap, and (3) cutting red tape and reducing excess costs.

Peruvian fiscal policy is being conducted within a macrofiscal framework that will have to be maintained and consolidated in the coming years. Indeed, in the macroeconomic setting that the world is likely to witness over the next few years, the current macrofiscal framework can be supplemented so as to optimize the functioning of fiscal policy in terms of sustainability and its stance vis-à-vis the economic cycle.

Fiscal sustainability is an essential condition for promoting needed structural reforms which take years or even decades to achieve. The last 25 years of Peru's economic history are evidence of this, because without prudent management of fiscal policy it would never have been possible to construct the macrofiscal cushions for dealing with the 2008–09 global financial crisis or with the current external shock. Empirical evidence reveals countless examples of countries that abandoned their commitment to responsible fiscal policy, even if only temporarily, thereby losing credibility and consistency over time, and making fiscal imbalances a self-fulfilling prophecy. Peru must eschew this route, especially because the economy has a propensity toward sharp swings in its terms of trade and the country is prone to natural disasters.

The unfinished agenda that will allow Peru to cope more effectively with the new challenges in the years ahead could in fact be quite lengthy. This chapter, however, will focus on the following items that are a good point of departure for continuing with a fiscal reform process that was launched nearly 25 years ago, and that is still yielding good results: (1) boosting permanent tax revenues, which requires broadening the tax base and making further efforts to reduce informality, which is one of the main factors constraining economic growth; (2) significantly improving the efficiency of public spending and setting spending priorities in light of an ex post evaluation of results, together with mechanisms to minimize the time needed to design and implement a timely and time-bound fiscal response to mitigate the situation in a countercyclical manner; and (3) reforming the system of intergovernmental transfers for all types of financing sources on the basis of the principles of predictability in public spending, limitations on the capacity to absorb the transferred resources, accountability, and ex post evaluations.

Table 24.1 and Figure 24.1, as well as the sections that follow, outline the phases of fiscal policy in Peru since the 1980s.

FIRST PHASE: FISCAL AUTARKY WITH HIGH RECURRING DEFICITS AND A CONSEQUENT LACK OF CREDIBILITY

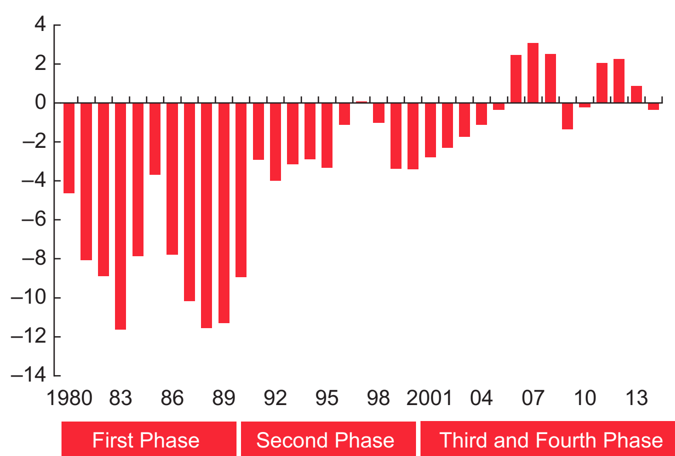
During the 1970s and 1980s, the government believed that it could stimulate the economy through state-sponsored investment by making use of the international financial facilities that were available at the time. Yet this approach was both inefficient and failed to consider the vagaries of the international economy. Thus growth fell substantially when the international setting turned less favorable, with sharp drops in prices for the commodities that Peru was exporting, slow growth in the world economy, and rising international interest rates. This was accompanied by an approach to macroeconomic management that was uncertain and unpredictable, and also by idiosyncratic shocks such as the El Niño phenomenon of 1983. As a result, average growth in GDP per capita from 1980–89 fell to about 1.5 percent, hyperinflation reached 7,481 percent in 1990, the current account deficit averaged about 5.5 percent of GDP a year, net international

TABLE 24.1

Phases of Fiscal Policy in Peru

Phase 1: Fiscal Austerity, Recurrent Deficits, and Scant Credibility	Phase 2: Fiscal Stabilization and the Quest for Credibility	Phase 3: Institution Building and Fiscal Consolidation	Phase 4: Strengthening of Institutions
1980s	1990s	2000s	2010 to date
Setting			
1980: End of the boom in export prices (1980) 1983: El Niño phenomenon	Crises: Asia (1997), Russia (1990), Brazil (1999) 1998: El Niño phenomenon	2002: Boom in export prices	2008–09: Global financial crisis 2011: End of the boom in export prices
Policy			
1985–87: Reduction in the general sales tax; increase in the payroll at the expense of public investment	1991: Tax reform; resumption of payment on the debt	2003: Decentralization; administrative systems for the general sales tax	2011: New mining regime
	1993: New Constitution; creation of the "Cash Committee"	2008: Results-based budgeting	2013: Promulgation of the Law to Strengthen Fiscal Responsibility and Transparency
1986–89: Distortionary taxes introduced; financing through monetary emission	1999: Promulgation of the Fiscal Prudence and Transparency Act; creation of the Fiscal Stabilization Fund		

Source: Author's compilation.



Source: Central Reserve Bank of Peru.

Figure 24.1 Peru: Economic Outcome of the Nonfinancial Public Sector *(Percent of GDP)*

reserves turned negative, and there were recurrent and growing fiscal deficits that amounted to 9 percent of GDP, while payments on the public debt were suspended.

In this context, the country's productive system came to a virtual standstill, as reflected in public sector revenues. Moreover, the tax system had serious distortions (with the attendant economic costs for society), such as an excessive and growing number of taxes and tax rates, and a virtual loss of control and oversight by the authorities.

During this period there were six different general taxes (income tax, wealth tax, import duties, export duties, production taxes, and consumption taxes), and these in turn contained multiple subclassifications and different regimes. In addition, there were many taxes imposed on specific transactions, with the result that the effective number of taxes exceeded 100. This showed

the weakness of a tax system that, in practice, was unworkable. The units responsible for the administration and supervision of taxes and customs duties were extremely weak, and there was no effective compliance with tax and customs obligations. In general terms, the tax system was complex, distortive, inefficient, and unfair, and did nothing to contribute to the sound management of fiscal policy.

As a result of this situation, it was difficult to collect greater revenues when the Peruvian economy fell victim to a major external shock and a prolonged period of slow growth. Thus, current revenues shrank from 20.5 percent of GDP in 1982 to 9 percent in 1989.

Despite the scant capacity to finance the public budget through tax revenues, public spending was the equivalent of 13.5 percent of GDP in 1989, and there was significant budgetary rigidity. This was reflected in wage and salary increases, pension outlays, and price controls that were introduced to alleviate the impact of hyperinflation on people's real incomes. Thus, for example, public payroll expenditures rose on average by 10.5 percent in real terms during 1985 and 1987. Prices were fixed during this period for such goods as gasoline, public services, and basic food items, including cooking oil, pasta, and sugar, in some cases entailing state subsidies. As a result, current expenditure (primarily on payrolls and pensions) represented more than 75 percent of nonfinancial public spending. Another characteristic that shows the rigidity and inefficiency of spending during the period was the many state-owned enterprises in most sectors of the economy. In 1980, there were at least 23 state-owned enterprises, operating in most economic sectors, including food (Epsa), tourism (Entur), commerce (Enci), and mining (MineroPerú).

By contrast, public investment served as the adjustment variable in spending policy during this period. Public investment declined by as much as 30 percent in some years until by the end of the 1980s it stood at about 3 percent of GDP. The low revenue collection capacity, combined with inefficient and rigid public spending, led to recurrent fiscal deficits that had to be financed. At the same time, however, external financing dried up in the wake of the decision by the authorities to declare a moratorium on payment of the public debt, a move that effectively cut Peru off from the international financial community. Consequently, the fiscal deficits were financed by internal borrowing, primarily in the form of monetary emissions by the central bank. For example, in 1987 financing provided by the central bank to the public treasury amounted to nearly 4 percentage points of GDP. This internal financing through the central bank merely increased the already high inflation rate and exacerbated macroeconomic imbalances. Moreover, the payments that were actually made lagged well behind those authorized, reflecting the financing problems facing the authorities.

By the end of the 1980s, the fiscal situation was dire and a series of reforms were needed to eliminate distortions, regain credibility in financial markets, and initiate a process of macroeconomic stabilization.

SECOND PHASE: STABILIZATION AND THE QUEST FOR CREDIBILITY

At the beginning of the 1990s, in the midst of the crisis then gripping the Peruvian economy, an in-depth program of macroeconomic stabilization was launched to correct the macroeconomic imbalances, including the high and recurrent fiscal deficits, hyperinflation, shortage of foreign exchange, and other problems noted above. The program also aimed to liberalize the economy, restore the country's access to international financial markets, and lay the foundation for a domestic capital market.

On the fiscal front, an important reform was implemented on the revenue side based on the principles of efficiency, neutrality, simplicity, and fairness in the tax system. Accordingly, 41 tax exemptions were suspended and 64 taxes were eliminated at the beginning of the decade. At the same time, a system was introduced based on only four taxes—the income tax, value-added tax,

excise tax, and customs duties—together with a special regime for small taxpayers designed to reduce tax informality. The strengthening of the tax system also included a move to modernize and reinforce the National Superintendency of Tax Administration and the Superintendency of Customs Administration, an initiative undertaken with the technical support of international agencies and drawing upon experience in developed economies. It should be noted that these two supervisory bodies were merged in 2003. This set of measures soon began to bear fruit: tax revenues rose from 9 percent of GDP in 1989 to nearly 16 percent in 1995.

Another set of reforms that served to make the economy more efficient and generate additional tax revenues involved the program to privatize money-losing public enterprises and free up external trade. A legal framework was established to effect the sale of state-owned enterprises, and agencies were created to handle both the regulatory and promotional aspects of privatizations and concessions. As a result of these moves, the government was able to sell enterprises that were showing losses, such as Peruana de Teléfonos, AeroPerú, and ElectroLima. In terms of liberalizing foreign trade, customs duties were simplified and reduced, with the result that the average tariff was brought down from 66 percent to 16 percent, and the enormous array of rates and provisions was cut to three simple rates in 1993.

The rationalization of the tax system had to be accompanied by strict control over public spending. Accordingly, the Ministry of the Economy and Finance (MEF) was reinforced as the central body for making decisions with budgetary impact, thus doing away with the scattering of responsibilities that had prevailed until then. A Cash Committee (*Comité de Caja*) was created to set expenditure ceilings based on the availability of public funds, as well as to make decisions on cash management and debt service. In addition, all tax legislation that included any type of tax exemption was to be accompanied by a report from the MEF, and emergency decrees could no longer be used to amend taxation provisions. These changes remain in place today.

Along with the internal corrections to the tax system and the budget process, a plan was launched to restore the Peruvian economy's access to the international financial market through an orderly process for refinancing payment of the external debt. This reintegration process was achieved with the assistance of a group of Latin American economies as well as advanced economies, led by Japan and the United States, accompanied by specific commitments with international agencies, which supplied the financing needed for the stabilization programs. Subsequently, amounts owed to the Paris Club were renegotiated in a way that would not exert pressure on the fiscal accounts.

This marked the launch of the process of macroeconomic stabilization. Thanks to that process the fiscal deficit, which stood at 8.9 percent of GDP during the 1980s, was reduced to an average of 1 percent in the 1990s (with primary surpluses). As a result, inflation fell sharply to less than 4 percent in 2000, and annual economic growth averaged 1.5 percent in per capita terms. This macroeconomic situation, together with the renegotiation of the public debt, succeeded in restoring Peru's credibility with economic agents. The next step was to consolidate these gains and make them sustainable and consistent over time.

THIRD PHASE: INSTITUTION BUILDING AND FISCAL CONSOLIDATION

The macrofiscal framework was institutionalized in 1999 with promulgation of the Fiscal Prudence and Transparency Act (*Ley de Prudencia y Transparencia Fiscal* [LPTF]). The general principle underlying that law was "to establish a commitment to a balanced fiscal outcome over the cycle, building up fiscal surpluses in favorable periods and allowing only moderate and nonrecurrent fiscal deficits in times of slower growth." To make the law operational, macrofiscal rules were incorporated into the framework, with the objective of diminishing the room for discretion and more solidly institutionalizing macrofiscal policy.

In the same vein, escape clauses or rules of exception (Article 5) were included to allow for more flexible fiscal management in the event of a national emergency or an international crisis that might seriously affect the national economy (provisions that could be invoked only upon a request from the executive branch to the Congress) or when there was sufficient evidence of a fall in GDP in real terms (as confirmed in a report to the legislative branch from the MEF).

Finally, a countercyclical tool known as the Fiscal Stabilization Fund (*Fondo de Estabilización Fiscal* [FEF]) was included, making it possible for public funds saved during "good" years to be set aside for use in "bad" years through a temporary boost in public spending. It is important to note that specific clauses were established for the use of funds from the FEF.

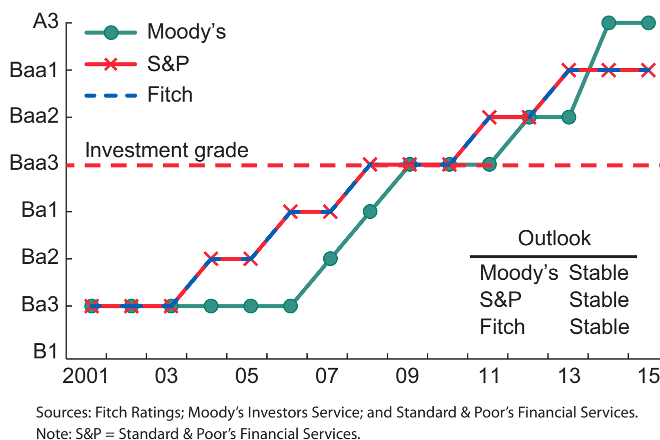
The LPTF also included a mechanism to govern formulation of the public budget following a two-stage procedure. The first stage involved approval by the Council of Ministers of the Multiyear Macroeconomic Framework (*Marco Macroeconómico Multianual* [MMM]), a document containing the guidelines for fiscal policy and establishing limits on overall expenditure and borrowing consistent with the fiscal rules and the country's macroeconomic situation. In the second stage, the annual budget was to be approved, disaggregating expenditures for each category in each section to reflect the policy debate on government priorities, while respecting the fiscal rules and limits set out in the MMM.

In addition, the LPTF made provision for more transparent management of public finances in the form of a Statement of Fiscal Policy Principles spelling out in advance the guidelines and the medium-term objectives to be pursued in fiscal policy. This document was accompanied by monitoring and evaluation reports and an ex post statement on compliance with fiscal responsibility, with a view to verifying not only the observance of the fiscal rules but also the degree of any deviation from the macrofiscal targets spelled out in the MMM, thereby making for greater accountability. If there are any significant deviations between the projections in the MMM and the results observed in practice, they must be explained and corrective measures must be adopted.

In 2003, the LPTF was revised and renamed the Fiscal Responsibility and Transparency Act (*Ley de Responsabilidad y Transparencia Fiscal*). The principal amendments included a change in the coverage of the national fiscal rules, the introduction of rules for subnational levels of government, and an improved definition of the rules of exception. In 2003 and in subsequent years as well, the expenditure ceiling was increased to reflect the potential for growth in the economy, and the scope of the ceiling was confined to current spending by the central government.

This bolstering of the institutions for fiscal policy, together with a highly favorable international setting characterized by rising commodity prices, strong growth in trading partners, and lower financing costs, has contributed to the extraordinary performance of the Peruvian economy. Between 2000 and 2014, the economy averaged annual growth of 5.3 percent, sustained by private investment that rose from 13 percent of GDP in 2000 to 22 percent in 2014. In contrast to previous episodes, this rapid growth went hand in hand with macroeconomic stability, including annual inflation of 2.7 percent (within the target range of the central bank), fiscal accounts in balance, a public debt reduced to the equivalent of 20 percent of GDP, a slight deficit on the current account averaging 1.5 percent of GDP, the accumulation of net international reserves equivalent to 30 percent of GDP, and an improvement in the country's credit rating to investment grade (Figure 24.2). Taken together, these figures made Peru, together with Mexico, the second best-rated economy in the region, behind only Chile.

The decade was also marked by other reforms that complemented the improvement in the macrofiscal framework. In 2002, the government introduced a program of withholdings and a special system for tax collection with a view to combating evasion. The value-added tax (IGV) targeted the informal sectors and other sectors of the economy that are difficult to supervise and have high evasion levels. In the case of the corporate ("legal persons") income tax, the Temporary Tax on Net Assets (*Impuesto Temporal a los Activos Netos*) was introduced. It involved withholding ½ percent of the net assets of the firm, an amount that could be used as an offsetting credit against income tax due.



Sources: Fitch Ratings; Moody's Investors Service; and Standard & Poor's Financial Services.
Note: S&P = Standard & Poor's Financial Services.

Figure 24.2 Peru: Credit Rating

Similarly, a tax reform in 2007 expanded the tax base by dismantling tax exemptions and benefits and reducing customs duties. With respect to the IGV, the reform was targeted at tax exemptions for specific geographic areas of the country (Amazonia), while in the case of the income tax it was targeted at exemptions applicable to interest and capital gains. As for customs duties, the rates were reduced gradually over the course of the decade with a view to promoting external trade and opening up the economy. Thus, the average tariff rate, which stood at 13.5 percent in 1998, fell to 3.2 percent by the end of 2013.

The process of strengthening the taxation framework continued in 2011 with the Law for Strengthening the National Superintendency of Customs and Tax Administration and a change in the mining tax regime to make it more progressive in order to ensure its neutrality and enhance competitiveness in the sector. As stated in the 2015–17 MMM (MEF 2015–17, p. 62):

> the reform strengthening the [Law for Strengthening the National Superintendency of Customs and Tax Administration] has given it greater operating, economic, financial, and budgetary autonomy in order to facilitate its task of combating tax evasion and avoidance, smuggling, and illicit trafficking in goods, stimulate foreign trade, and broaden the tax base. In the context of the legislative powers granted to the executive branch by means of Law 29884 to amend the tax rules with a view to enhancing the efficiency and effectiveness of the national taxation system, 19 legislative decrees were approved in July 2012, dealing with: (a) amendments to the tax code, (b) amendments to the Income Tax Act, (c) the Law on the General Sales Tax and the Selective Consumption Tax, (d) systems for paying the General Sales Tax, (e) improvements to the tax regulations intended to simplify taxpayers' compliance with their obligations, (f) reinforcement of the Tax Court, and (g) repeal of Law 29707, which allowed the cancellation of debts using means of payment.

On the public expenditure side, the reforms focused on improving the efficiency of spending and optimizing the use of public funds. Thus, in 2000 the National Public Investment System (SNIP) was created as a state administrative system that seeks, through a set of principles, methods, procedures, and standards, to improve the quality, efficiency, and sustainability of public spending and ensure the prompt and efficient delivery of goods and services to the population. In the context of public investment projects, the SNIP calls for identifying a given problem in society, analyzing the alternative solutions, and selecting the one that is most efficient and evaluating its implications.[1] Thus, public investment as a proportion of GDP has risen from 3.2 percent in 2001 to the present level of about 5.5 percent.

[1] This is done over what is called the "investment project lifecycle," as the SNIP provides for three differentiated phases in the preparation of a project: (1) preinvestment (where the profile and the feasibility of the project are evaluated), (2) investment (technical and execution report), and (3) postinvestment (maintenance, operation, and ex post evaluations).

In line with the objective indicated earlier, a performance-based budgeting system was introduced in 2008, with plans for its gradual implementation in all entities of public administration and at all levels of government across the country. As indicated in the 2015–17 MMM (MEF 2015–17, p. 63):

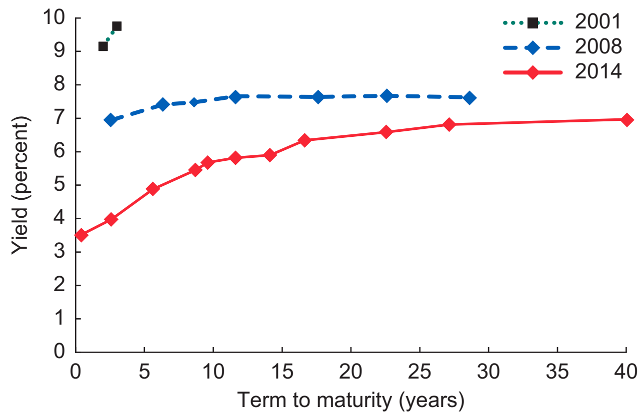
> the performance-based budgeting system constitutes a new approach to budget preparation, in which the interactions to be financed with public funds are designed, implemented and evaluated in light of the changes they promote in favor of the population, particularly the most vulnerable segments.

The system has produced some important achievements, including the Integrated National Program, which seeks to reduce chronic malnutrition among children under five years old, and the Neonatal Health Program, which aims to reduce maternal and neonatal mortality. Currently, 58 percent of the government budget, excluding pensions and debt service, is allocated under the principles of performance-based budgeting, and this proportion will continue to rise in coming years.

In terms of pension reform, the government has moved to eliminate certain unfair systems that were created on the basis of pension regimes that posed a significant risk to the sustainability of public finances. This is the case with the pension regimes under the regulatory framework of Decree Laws 19990 and 20530 (the latter known as the *Cédula viva*). Those systems were characterized by very low contributions by beneficiaries that bore no relation to the benefits they would receive upon retirement. In the case of the pension regime under Legislative Decree 20530, at retirement the beneficiary was entitled to a pension equal to the last salary earned. In addition, a reduced number of qualifying years of service was required to qualify for a pension, and there was no minimum age for retirement. It is estimated that the elimination of those schemes as part of the pension reform has produced fiscal savings in excess of US$5 billion in present-value terms.

A reform of the civil service was undertaken in 2012 with a view to providing better public services and enhancing the human capital of the public sector through an ongoing training program and ex post evaluation of performance. This is a key reform, as it took place in a context in which the responsibilities of public servants were increasing faster than their capacity to carry them out. Thus, between 2003 and 2011, while the funds administered in public investments grew by a factor of 4.4, payroll spending went up by only 1.8 times. With these reforms, it is expected that average payroll expenditure over the period 2016–18 will return to levels at the beginning of this century, but under a new regime of ongoing training and ex post performance evaluation.

Some important steps have also been taken to integrate the country into the international debt market and develop the domestic capital market, including that for public debt. Having concluded programs for restructuring the debt, which in aggregate terms ended with the Brady-type agreement of 1997 on commercial debt, Peru was in a position to pursue a more active public borrowing program. In 2002, the government successfully placed $500 million on the international market, and was thereafter able to float progressively larger issues at longer terms and under better conditions (including the issuance of a 50-year bond), as the market's perception of the country improved. In 2003, Peru began to issue bonds in local currency through the Market Makers Program (*Programa de Creadores de Mercado*), the objective of which was to develop a domestic market for public debt and strengthen the Peruvian capital market. The good reception accorded these issues could be attributed to the consolidation of domestic institutional investors, particularly private pension fund administrators, and the development of banks, which supported demand for these products, as well as to renewed confidence among both foreign and local investors. Thanks to an active and fiscally responsible approach to debt management, the profile of public debt has been improving: public debt in foreign currency fell from more than 80 percent in 2000 to 46.1 percent in March 2015, the average term to maturity of public debt has risen and today stands at 12.6 years, and the proportion of public debt at fixed rates is 84.3 percent. In addition, the liquidity of sovereign bonds has been gradually increasing, thereby generating a sovereign yield curve that serves as a benchmark for domestic currency issuances by private firms and institutions (Figure 24.3). At present, Peru has debt instruments outstanding with maturities



Source: Ministry of the Economy and Finance.

Figure 24.3 Sovereign Yield Curve

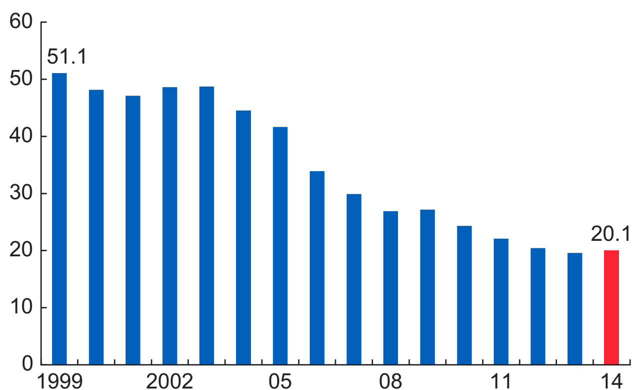
extending as far out as 2050 for global bonds, and to 2042 for sovereign bonds, and the yield curve for comparable tranches is lower than that in 2008.

A crosscutting feature of fiscal policy as a whole in recent years has been the move to decentralize resources and responsibilities to the regions and municipalities. The objective is to have the regions set priorities for using the funds transferred so that they can meet the principal demand for goods and services in their area, which by definition will differ from one area to the next. The decentralization process was launched in 2002 using intergovernmental transfers as the main sources of funds. A portion of these transfers is made at the discretion of the government for the purpose of financing payroll expenses, goods and services, and public investment in line with local needs. However, there is also a predetermined or statutory component, which is significant in some localities. It is linked to the income tax collected on local extractive activities, and is to be used by the subnational authorities to finance public investment. As an illustration of the importance of these authorities, it may be noted that their share in total investment rose from 44 percent in 2004 to 63 percent in 2014.

FOURTH PHASE: STRENGTHENING INSTITUTIONAL ARRANGEMENTS

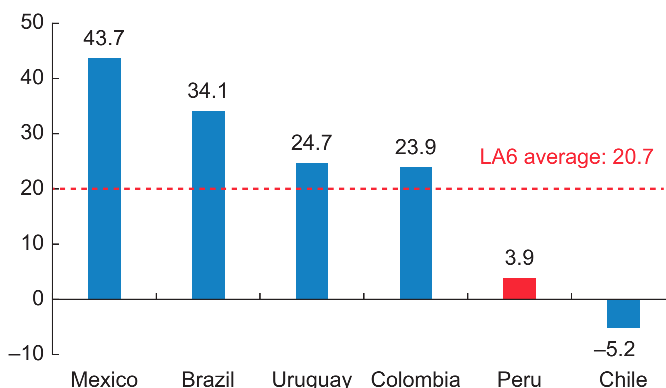
Notwithstanding the success of Peru's macrofiscal framework, it must be borne in mind that the structural characteristics of the country's economy have changed since the start of the 2000s, thereby presenting the need to design a new macrofiscal framework consistent with those new features. Such considerations include:

- *Consolidation of public debt.* At the beginning of the past decade, public finances were in an early phase of stabilization, with public debt amounting to close to 50 percent of GDP (Figure 24.4) and little in the way of public assets. At present, public finances are in a consolidation phase, with public debt of about 20 percent of GDP and public assets representing about 16 percent of GDP. Thus, on a net basis, Peru's public debt is one of the lowest in the region (Figure 24.5).
- *Importance of public investment for economic growth over the medium term.* At the beginning of the past decade, the ratio of public investment to GDP was only 2.8 percent, while it currently stands at nearly 6 percent of GDP, above the levels in Uruguay (4 percent), Colombia (4 percent), Chile (3 percent), and Brazil (2 percent).



Source: Central Reserve Bank of Peru.

Figure 24.4 Public Debt *(Percent of GDP)*



Sources: Central Reserve Bank of Peru; Ministries of Finance; and IMF staff estimates.
Note: Nonfinancial public sector for Peru. LA6 = Brazil, Chile, Colombia, Mexico, Peru, and Uruguay.

Figure 24.5 LA6: Net Public Debt Balance of General Government, 2014 *(Percent of GDP)*

- *Higher levels of spending by regional and local governments.* At present, investment by those levels of government represents 67 percent of total public investment. A macrofiscal framework has been designed for these levels of government but, as indicated in the report of the Commission for Strengthening the Macro-Fiscal Framework (MEF 2014), "there are still shortcomings that must be corrected with respect to design, transparency, recording, monitoring and compliance."
- *Greater impact of the natural resource sectors on public finances.* At the beginning of the past decade, tax revenues derived from the natural resource sectors amounted to 2.4 percent of total tax revenues of the general government, while that proportion has now risen to 12.4 percent. As well, the volatility of tax revenues derived from the natural resource sectors over the same period was 1.5, more than double the rate for other tax revenues (0.6). Although raw material prices in the years to come will be lower than those in the recent past, a series of mining projects are expected to come on stream by 2017, with the result that copper production will double from its level in 2013.

- *A more open trading regime that is having an impact on the effectiveness of fiscal policy.* The degree of commercial openness, measured as the ratio of exports plus imports to GDP, was 34 percent at the beginning of the past decade and is now 50 percent.

Against this backdrop, the macrofiscal framework, based as it was on rigid numerical rules, was not sufficiently flexible to adapt to the economic and institutional shifts mentioned above. As a result, there have been continuous amendments to the Fiscal Responsibility and Transparency Act over the past decade, affecting its predictability, simplicity, and transparency.

On the other hand, the introduction of the macrofiscal framework spelled out in the Fiscal Responsibility and Transparency Act did not eliminate or even reduce the procyclical bias of fiscal policy. A fiscal deficit rule (procyclical, by definition), together with an expenditure rule with coverage confined solely to current spending, could not ensure a fiscal policy response that was neutral or countercyclical. On this point, the IMF noted in 2013 that while the macrofiscal framework contained some important countercyclical components (such as the FEF), it did not provide for a fully countercyclical response to shocks to output or to commodity prices.

In this context, Law 29854 was passed, creating a technical entity known as the Commission for Strengthening the Macro-Fiscal Framework, which was assigned responsibility for evaluating and preparing a proposal to improve the existing macrofiscal framework, in particular with respect to the mechanisms for responsibility and transparency, and for fiscal rules.

Acting on the recommendations of that commission, the MEF subsequently prepared a draft law governing the macrofiscal framework, the Law for Strengthening Responsibility and Fiscal Transparency, Law 30099, which was approved on October 31, 2013, and came into effect with the preparation of the government budget for fiscal year 2015.

This new fiscal framework represents a continuation of the process of institutional change that began at the beginning of the past decade with the Fiscal Responsibility and Transparency Act. The process of strengthening the macrofiscal framework was intended to serve the following objectives, which were to be achieved under a more flexible and predictable regime that would also reinforce the commitment to fiscal responsibility:

- To lend greater predictability to public spending by de-linking it from the most volatile source of public revenues, that is, revenues flowing from the natural resource sectors. As indicated in the Statement of Fiscal Policy Principles in the 2015–17 MMM (MEF 2015–17, p. 11), "public spending must not be volatile, as this generates costs in terms of sector policy efficiency and management capacity; consequently, the management of public finances must be insulated from the high volatility of revenues derived from the main commodities that we export." Historically, commodity prices have been volatile and erratic, and thus difficult to project.
- To ensure fiscal solvency by keeping public debt at a low level that makes it possible to cope with negative shocks such as severe natural disasters, contingencies, international financial crises, etc.
- To avoid macroeconomic crises through countercyclical measures that will be triggered in a timely manner and only in settings in which the economy deviates sharply from its medium-term trend. To the extent that the fiscal rule insulates public spending from the temporary effects of output, commodity prices, and other similar factors, the stance of fiscal policy is by definition cyclically neutral (acyclical).

However, the fiscal rule does provide for countercyclical responses in a discretionary manner, but only for events of low probability and high impact. The factors that limit fiscal policy to this context alone (and not to fine-tuning) are the following: (1) fiscal policy operates with significant lags; (2) it is impossible to exert full control over the entire range of fiscal stimulus (spending by regional and local governments financed with statutory resource revenue transfers, compensation

funds, and tax revenues of local governments); (3) the current system of transfers to regional and local governments is procyclical and finances a significant percentage of spending, especially for public investment; (4) there is uncertainty as to the size of the fiscal multipliers; and (5) there is ex ante uncertainty as to the origin of the shock (supply or demand). Given the impossibility of controlling all these factors, fiscal policy may in the end have the unfortunate effect of increasing the volatility of output over the short term. Because of this, the Law for Strengthening Responsibility and Fiscal Transparency seeks to:

- Simplify the fiscal rules for regional and local governments. The main problems arise from the heterogeneity of these governments' public finances, their weak observance of fiscal rules, and the scarcity of corrective measures. This in turn reflects the absence of efficient measures for information, monitoring, and follow-up, as well as the lack of incentives.
- Strengthen the institutional framework of the FEF, providing it with a technical secretariat that, among other functions, would propose investment guidelines to the board for generating greater returns.
- Strengthen the institutional arrangements for fiscal policy by creating a Fiscal Council. The new macrofiscal framework does away with the old, rigid regime of fiscal rules, but this new degree of discretion must be restricted in the sense that there must be an independent entity to audit or validate it.

The objectives mentioned above will be achieved with the new macrofiscal rule covering the level of nonfinancial spending by the national government, which is based on an ex ante exercise of cyclical adjustment for the nonfinancial public sector. This fiscal rule limits the spending over which the national government has discretion, and it is more comprehensive in comparison with the previous spending rule.[2] Taking the figures for 2014, the new spending rule for the national government covers 85.9 percent of its nonfinancial spending, whereas the previous consumption rule covered only 47.8 percent. As well, it is important to note that the spending rule for the national government includes both current and capital spending, with the objective of achieving greater consistency between the increase in the stock of public capital and the amount spent on equipment and maintenance of that stock. On this point, the report of the Commission for Strengthening the Macro-Fiscal Framework (MEF 2014) declares that "it is important to note that the distinction between public investment and current spending in the public sector is weak and in part artificial, and consequently some public investments do not generate any substantial social return, while many components of current spending, such as maintenance of public infrastructure and expenditures on health and education, may produce a higher return."

A new element of this macrofiscal framework is the use of structural variables (public revenues and GDP) and the announcement of a structural balance indicative target, which is linked to budgetary programming and formulation through the expenditure limits imposed by the rules. Thus, in determining the binding expenditure rules for budgetary formulation, an incoming administration must first (within 90 days after taking office) define and announce its fiscal policy objectives (through a Macro-Fiscal Policy Statement) for the term of its mandate, and the impact of those objectives on the structural economic outcome of the nonfinancial public sector (structural balance indicative target). That indicative balance is in fact binding for the formulation of public budgets, but the ex post evaluation relates to the spending limit that flows from the structural balance target.

[2]The nonfinancial spending rule for the national government covers the sum of nonfinancial spending by the national government and transfers to entities of the nonfinancial public sector, with the exception of funds deriving from the *canon, sobrecanon* and royalties, the *Fondo de Compensación Municipal*, the *Fondo de Desarrollo Socioeconómico de Camisea*, and the share of regional and local governments in customs revenues.

With respect to the ex post analysis of fiscal rules, this requires corrective measures in case there are any deviations, something that strengthens the commitment in the macrofiscal framework to responsible management of public finances. Thus, Ter-Minassian (2010, p. 15) notes that "[t]o be effective, rules need also to be supported by appropriate enforcement mechanisms, including provisions for correction of past deviations that do not call for a permanent revision of the rule."

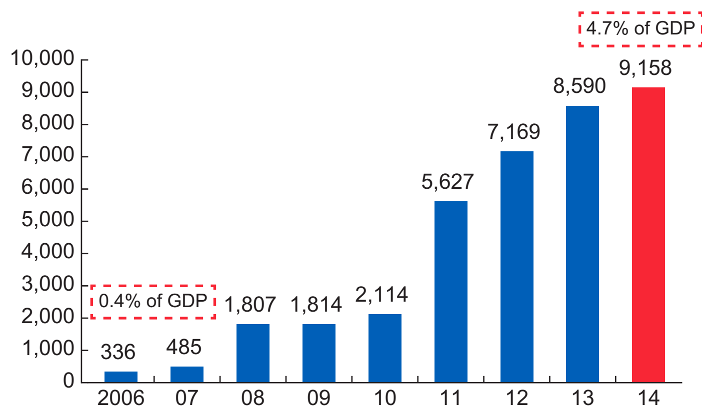
This new macrofiscal framework provides for two types of corrective measures. The first involves the creation of an account for compensation and correction of deviations (referred to in the economic literature as the "notional account"). In the case where accrued spending by the national government exceeds the limit established by the fiscal rule for a given year, this deviation will be added to that account. If the cumulative balance on the account is less than ½ percent of GDP, the nonfinancial spending limit of the national government will be reduced, at least proportionately, over the following two years, provided a negative gap exceeding 2 percent of potential GDP is not projected. On the other hand, if the cumulative balance on this account is ½ percent of GDP or greater, the nonfinancial spending limit of the national government will be immediately cut. In this way, the account for compensation and correction of deviations plays the role of an automatic enforcer in the case of breaches of the fiscal rules. In addition, to minimize the perverse incentive to postpone the task of correction to a future administration, there is a provision that the balance on the notional account must not exceed 0.3 percent of GDP at the end of the current administration's mandate.

The second corrective measure, in line with the objective of ensuring fiscal sustainability, requires that, if the debt of the public sector is found or expected to be greater than 30 percent of GDP in the following three years, the Macro-Fiscal Policy Statement and the structural balance target for the nonfinancial public sector must be amended, incorporating measures deemed appropriate to restrict expenditures or to boost revenues in order to return the debt to a level below that limit within a period of no more than seven years.

The objective of this latter measure is to correct the projected path both of expenditure and revenues in accordance with the structural balance target for the nonfinancial public sector in the case of a macrofiscal scenario that would put fiscal sustainability at risk. Economies are subject to unexpected shocks of low probability but high impact. For example, in 2007 the general government debt in Spain and Ireland stood at 36.3 percent and 20 percent of GDP, respectively. Those levels were considered low, as reflected in the solid scores granted by the credit rating agencies. Yet within five years (by 2012), those countries' debt levels had risen to 69.2 percent and 117.1 percent of GDP, respectively. In the context of a new, more flexible macrofiscal framework that can be adjusted to the medium-term potential of the economy, a low public debt level is proposed as a signal of the government's commitment to prudent management of public finances. A level of debt no higher than 30 percent will ensure sustainability, even under shock scenarios, and will make it possible to maintain an investment-grade sovereign credit rating that translates into lower financing costs for the public and private sectors alike.

On the other hand, because the proposed macrofiscal framework is supposed to be more flexible than the previous one, as it can be adjusted to the economy's medium-term potential and is based on the ex ante application of a cyclical adjustment methodology, it was deemed necessary to enhance transparency in the management of the public finances through the creation of a Fiscal Council. The purpose of this council is to conduct an independent technical analysis of macrofiscal policy and to issue opinions on the MMM, the short- and medium-term evolution of public finances, and proper application of the methodology for calculating the structural accounts and potential GDP. The reports issued by the Fiscal Council—which is comprised of at least three independent professionals with broad fiscal experience—are to be published and made known to the general public.

Lastly, when it comes to the management of assets, it is important to note that the new macrofiscal framework strengthens the institutional framework and the financial administration of the FEF,



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

Figure 24.6 Cumulative Savings in the Fiscal Stabilization Fund *(Millions of U.S. dollars)*

in line with the Santiago Principles,[3] and provides it with a technical secretariat that, among other functions, will propose investment guidelines to the board designed to increase the return on the FEF, as part of the Global Strategy for Management of the Assets and Liabilities of the Public Treasury.

Thus, the present institutional framework for fiscal policy represents to some extent a continuation of current policy, but with improvements. Peruvian fiscal policy is in effect based on a system of fiscal rules governing the level of spending, determined by a cyclically adjusted fiscal balance exercise consistent with a structural balance target, and is designed to bring greater predictability and stability to public spending. In a complementary manner, the FEF serves as a countercyclical tool that allows savings to be built up during "good" years so as to provide a cushion that can be used in "bad" years in the form of a temporary fiscal stimulus (Figure 24.6). In this way, it follows the state of the art in countries with characteristics similar to those of Peru, such as an open trading system and a concentration on commodity exports.

The public budget, which is financed by a simple, transparent, and equitable tax system, is formulated in two stages. The first stage involves preparation of the MMM, which contains fiscal policy guidelines and sets limits on overall spending and indebtedness in observance of the existing fiscal rules and in a manner consistent with a projected macroeconomic scenario for the year of the budget and the two following years. In the second stage, the annual budget is approved. It reflects the government's priorities, and it complies with the fiscal rules set forth in the MMM. In addition to this detailed budgetary formulation, there are other tools, such as the SNIP and the results-based budgeting system, that are designed to maximize efficiency in the allocation and use of public funds.

CHALLENGES AND THE UNFINISHED AGENDA

The international environment over the next few years will be characterized by slower growth in the advanced economies than that recorded in the years preceding the 2008–09 global financial crisis. There will also be higher financing costs and a permanent fall in commodity prices. All of this poses challenges over the medium term for the growth of economies such as Peru. For example, in its *World Economic Outlook* of April 2015, the IMF suggests that output growth in emerging countries will decline from around 7 percent from 2001–07 to 5.2 percent from 2015–20, with the prospect that this downward trend may continue in the absence of structural

[3]Santiago Principles are a set of 24 voluntary guidelines that assign best practices for the operations of sovereign wealth funds.

reforms. The IMF also points out that this reduction in the potential output of emerging economies can be explained in large part by a deterioration in productivity.

With a view to boosting the growth potential in the next few years and responding to the looming international context, the Peruvian government has over the last two years been proposing actions within a framework along three fronts geared to ensuring greater investment and gains in productivity and competitiveness: (1) strengthening human capital and reducing informality, (2) reducing the infrastructure gap, and (3) cutting red tape and reducing excess costs.

For its part, Peruvian fiscal policy is being conducted within a recent macrofiscal framework that must be maintained and consolidated in the coming years. And in the global macroeconomic setting that is likely to prevail for the next few years, the current macrofiscal framework can be supplemented in ways that will optimize the functioning of fiscal policy in terms of fiscal sustainability and the stance vis-à-vis the economic cycle.

Fiscal sustainability is a necessary condition for promoting any type of structural reform that may be needed. The last 25 years of Peru's economic history are evidence of this, for without responsible and prudent management of fiscal policy, it would not have been possible to build the macrofiscal cushions to cope with the 2008–09 global financial crisis or with the current external shock. During the 2008–09 crisis, Peru undertook a fiscal stimulus equal to 3.5 percent of GDP (MEF 2011–13), and between 2014 and 2015, it has been pursuing a further fiscal stimulus of 3.1 percent of GDP (MEF 2016–18), in contrast to other countries of the region that, despite a negative output gap, are still making budget cuts this year.

Similarly, the complex international environment can have a direct impact on the sustainability of countries' public finances in the form of higher financing costs, downward pressures on the exchange rate, falling tax revenues, and lower potential growth. It is essential, then, that Peruvian fiscal policy continue to distance itself from that of other emerging countries, as it has in recent years. Only in this way can the country maintain high credibility among economic agents and thereby attract capital, reduce financing costs for the public and private sectors alike, and achieve high and sustained economic growth. Empirical evidence reveals countless examples of countries that abandoned their commitment to responsible fiscal policy, even if only temporarily, and thereby lost credibility and consistency over time, making fiscal imbalances a self-fulfilling prophecy. Peru must eschew this route.

When it comes to the taxation system, as noted earlier, while it is in line with international principles, there is room to increase permanent revenues; strengthen the system in terms of its fairness, efficiency, and transparency; and broaden the tax base to reduce informality, which is one of the main problems constraining back growth. Measures must be geared to reducing tax evasion and avoidance, applying risk management systems in tax and customs supervision and enforcement, and taking further steps to automate the corresponding processes and procedures and allow them to be handled online.

Similarly, in the context of decentralization, Peru must establish incentives to boost municipal taxation, where there is still much room for improvement. According to De Cesare (2012), property taxes collected by subnational levels of government in Peru represent 0.17 percent of GDP, barely one-quarter of their level in Colombia, where the institutional structure is similar to that of Peru, and far below the level in Chile, which is the regional leader.

Peru also needs to step up efforts to rationalize and eliminate tax exemptions, and to review excise taxes in light of the negative externalities they generate. As part of Peru's efforts to join the Organisation for Economic Co-operation and Development, the country must bring its tax regulations into line with international standards and improve fiscal transparency so as to facilitate the sharing of information among tax administrations.

In a context of a permanent fall in tax revenues and a public budget that has seen a 140 percent cumulative increase in the last 10 years, the challenge is to make public spending more efficient and to set spending priorities based on an ex post evaluation of results. From an economic policy

viewpoint, it is important not to overlook the need to "sell" these priority-setting policies to society, and to strengthen the institutional underpinnings of fiscal policy. The crisis of 2008–09 showed that, for the world in general, fiscal policy can play a more important stabilization role than had previously been recognized. Yet in the case of Peru, experience with the 2008–09 crisis and with the current shock shows that there are rigidities that impede implementation of a timely and time-bound discretionary, countercyclical fiscal response. Consequently, to minimize delays in the design and implementation of this fiscal response, Peru will need to evaluate various measures such as establishing a fund or bank for public or public-private investment projects that are outside the public budget and can be activated swiftly and executed over a short time.

Last, but of no less importance, is the process of decentralization, which Peru must continue to improve. While decentralization implies a broader institutional reform that embraces concepts of political reform and reform of the state, on the fiscal front it must surely be a priority to reform the intergovernmental transfer system for all types of financing sources, based on the principles of predictability in public spending, the capacity to absorb the transferred resources, accountability, and ex post evaluations.

In conclusion, the unfinished agenda toward a fiscal policy that will allow Peru to cope more effectively with the new global context in the coming years could in fact be quite lengthy. However, the elements mentioned here are a good point of departure for pursuing a process of gradual strengthening that began nearly 25 years ago and that is still producing good results today.

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CHAPTER 25

The Future of Monetary Policy

JULIO VELARDE

The global financial crisis demonstrated the need to provide financial stability and stability in terms of inflation in order to preserve the transmission mechanism of monetary policy. The Central Reserve Bank of Peru (Banco Central de Reserva del Perú [BCRP]) has achieved these twin goals through the use of conventional and nonconventional instruments (e.g., reserve requirements and foreign exchange intervention). Looking ahead, monetary policy will need to properly calibrate nonconventional policy instruments to the financial cycle and ensure that financial intermediaries fully internalize financial risks. The Peruvian authorities will also need to adapt policies to developments in capital markets and as macroprudential measures are implemented. Also, the macroprudential framework may need to be strengthened.

The way in which monetary policy is implemented in most countries has undergone a considerable transformation over the past 10 years. The consensus as to what central banks can and should do is moving rapidly from price stability as the sole objective of monetary policy toward a broader definition of macroeconomic stability in which central banks also address financial stability concerns. In addition, the use of multiple policy instruments besides the short-term interest rate is now more widely accepted as a necessary condition to effectively implement monetary policy, especially when financial markets become dysfunctional.

Are these changes in the monetary policy framework permanent? Or are they just transitory responses to a more volatile world where global financial markets tend to overreact more frequently than in normal times? Should the time horizon for monetary policy be extended in order to properly accommodate financial cycles within the monetary policy design?

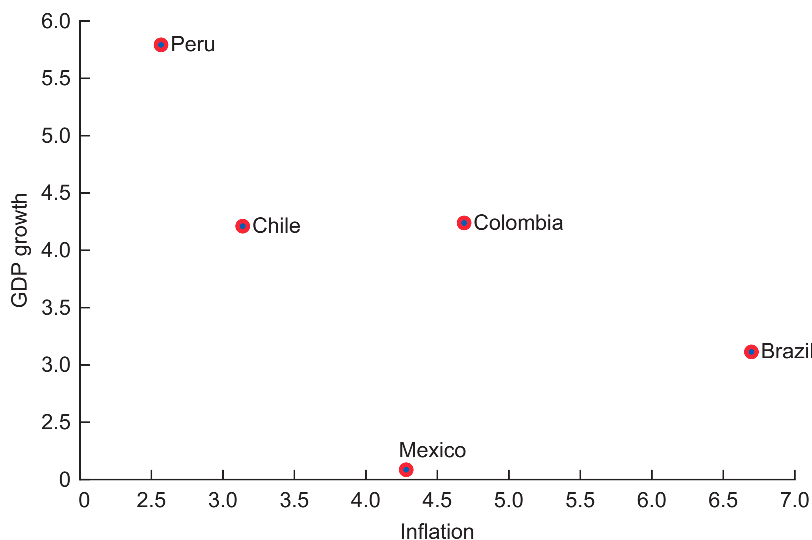
This chapter addresses these questions by looking at Peru as an illustrative example of how monetary policy can achieve price stability and at the same time reduce financial vulnerabilities associated with financial dollarization. The Peruvian experience is interesting not only because it shows the perils of implementing monetary policy in a dollarized economy, where financial vulnerabilities are tightly linked to macroeconomic developments, but also because it illustrates how monetary policy instruments can be constantly adapted to maintain their effectiveness within different macroeconomic scenarios.

The chapter first examines the policy instruments that can be deployed within the inflation-targeting design adopted by the BCRP. It then looks at how these instruments have been adapted to address a more demanding external scenario. The chapter provides an overview of aspects that future monetary policy design might need to take into account to be able to provide both financial stability and stability in terms of inflation.

THE CURRENT STATE OF PERUVIAN MONETARY POLICY

Inflation targeting started in Latin America after the 1997–99 financial crisis that spread across emerging market economies. Peru was relatively late in adopting inflation targeting,[1] although

[1] Brazil adopted inflation targeting in June 1999, while Colombia and Chile adopted the regime in September 1999.



Source: IMF staff calculations.

Figure 25.1 Inflation and GDP Growth in the Five Larger Inflation-Targeting Countries, 2001–14 *(Percent)*

it was the first highly dollarized economy to adopt the regime. By the time Peru implemented inflation targeting, its economy was in recession and facing mild deflation. In sharp contrast to other emerging economies that adopted inflation targeting, Peru needed to put in place an expansionary monetary policy to move inflation to a credible target. Inflation targeting was not intended for inflation convergence from above but to anchor a credible rate of inflation from below.

It was clear by then that inflation targeting had to be complemented by additional instruments to address financial risks in a broadly dollarized economy. This is related to widespread concerns about financial stability for monetary policy in developed economies as a result of the 2008–09 global financial crisis. Both the adoption of inflation targeting after the financial crisis that hit emerging economies (and Peru in particular) and the successful use of a managed floating exchange rate regime paved the way for the design of the inflation-targeting regime in Peru.

Also fundamental for implementation of the inflation-targeting regime in Peru were the reforms introduced during the early 1990s that granted independence to the central bank and assigned monetary stability as its single objective, as well as the establishment of the floating exchange rate regime.

Since 2001, average annual inflation in Peru has been 2.6 percent while the country's average annual growth rate has been 5.8 percent (Figure 25.1). In the group of the five largest Latin American inflation targeters[2]—which share somewhat similar economic structures and are subject to the same types of external shocks—Peru achieved the lowest inflation and the highest growth rate.

Theory suggests that full dollarization provides a strong inflation anchor. However, Table 25.1 suggests that inflation targeting in Peru has delivered lower and even more stable inflation compared with countries that have officially dollarized, such as Ecuador, El Salvador, and Panama.

[2]Brazil, Chile, Colombia, Mexico, and Peru.

TABLE 25.1

Inflation in Peru and in Fully Dollarized Economies *(Percent)*

Annual Inflation (2001–14)[1]	Average	Standard Deviation[2]
Ecuador	5.7	3.4
Panama	2.6	2.5
El Salvador	3.0	2.4
Peru	2.6	1.6

Source: IMF staff calculations.
[1] Ecuador officially dollarized in 2000, and El Salvador officially dollarized in 2001. Figures for El Salvador figures correspond to 2002–04.
[2] Standard deviation of year-on-year inflation.

Policy Rate

The outstanding results in delivering price stability have helped consolidate the BCRP's credibility as a successful implementer of inflation targeting. The keys to achieving these results were the active use of a short-term interest rate to anchor inflation expectations and the proper calibration of complementary instruments to preserve financial stability and the transmission of monetary policy. Indeed, the policy rate path can be rationalized within a Taylor-type rule that considers inflation expectations and GDP growth as its determinants:

$$i_t = \bar{i} + a_\pi\left(\pi^e_{t-1} - \pi^{target}_t\right) + a_y\left(\Delta y_{t-2} - \overline{\Delta y}\right), \tag{25.1}$$

where π^e_{t-1} is defined as the inflation expectation for the next calendar year (a proxy for medium-term inflation expectations) taken in the month prior to the policy decision.[3] Likewise, Δy_{t-2} refers to the year-over-year monthly growth of two lagged months of GDP.[4] In addition, $\bar{i}$ stands for the neutral interest rate, and π^{target}_t is the target inflation rate that was set to 2.5 percent in 2002 and changed to 2 percent in 2007. Finally, $\overline{\Delta y}$ is the average rate of GDP growth during the inflation-targeting period.

The fact that this policy rule depends on the GDP growth rate and not on an estimated output gap is because of the imprecise nature of the gap (Orphanides and Van Norden 2002) and because the growth rate in the rule may be even better in terms of welfare than a gap-based rule (Sims 2013). Estimation of a simple equation such as equation (25.1) can help directly identify how, on average, the central bank changes its monetary policy stance in terms of relevant variables available in the information set at the moment of the decision. The estimated rule is depicted in equation (25.2):

$$\underset{(0.00)^*}{i_t = 3.2} + \underset{(0.2)^*}{1.3}(\pi^e_{t-1} - \pi^{target}_t) + \underset{(0.05)^*}{0.2}(\Delta y_{t-2} - 6.1). \tag{25.2}$$

A key feature of this estimation[5] is that the policy rate always changes more than proportionally to changes in observed inflation expectations, a feature called the Taylor principle (Figure 25.2).

[3] Inflation expectation surveys are gathered and published by the BCRP at the end of each month, while policy decisions are made within the first two weeks of each month.
[4] GDP figures are published with a two-month lag around mid-month by the national statistical agency (*Instituto Nacional de Estadística e Informática*). Even if GDP publication dates sometimes fall after monetary policy decisions, the staff at the central bank provides close estimates of the $t-2$ growth rate at the time of monetary policy meetings.
[5] The estimation uses the generalized method of moments to guarantee that the equation residuals are not correlated with information available at the time of decisions such as observed inflation and core inflation rates, credit growth, and past interest rate levels. In equation (25.1), standard errors are in parentheses and the asterisks denote significance at the 1 percent level.

Sources: Central Reserve Bank of Peru; and author's calculations.

Figure 25.2 Observed Reference Interest Rate and Interest Rate Implied by Estimated Taylor Rule (*Percent*)

Also, the rule conforms to a flexible inflation-targeting framework, as policy takes into account changes in economic activity.

A particular feature of inflation targeting in Peru is that it departs from textbook implementation and relies on a number of instruments in addition to the standard policy interest rate. These complementary instruments aim to reduce the vulnerabilities that financial dollarization generates and contribute to preserving the transmission mechanism of monetary policy during periods of financial stress associated with the global financial crisis in 2009, and after the implementation of policy responses in advanced economies. The additional instruments used by the BCRP, commonly known as unconventional policies,[6] come in two sets: (1) reserve requirement policies differentiated by currency, and (2) foreign exchange market intervention policies.

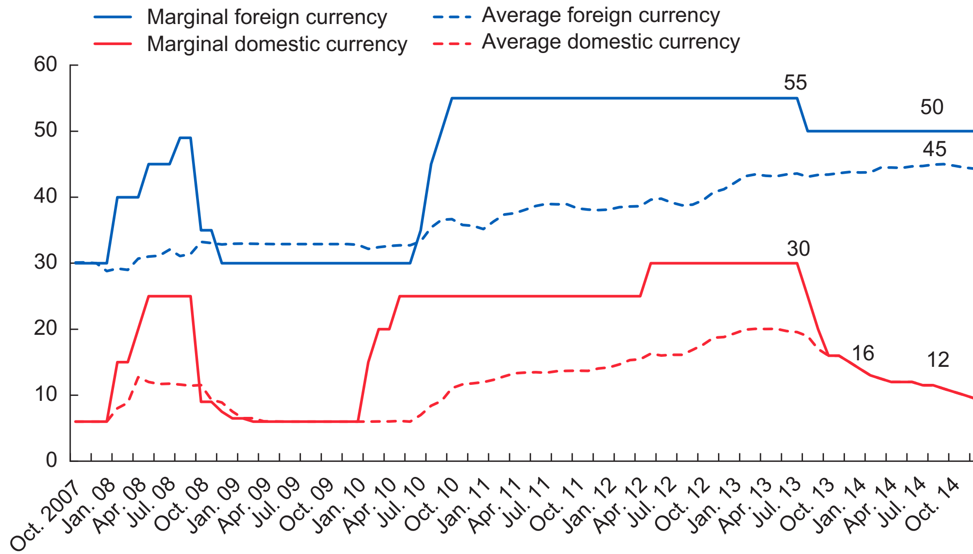
Reserve Requirement Policies

The BCRP uses reserve requirements mainly for monetary control, the mitigation of dollarization risks, and the lengthening of the maturity of the banking system's external leverage. High reserve requirements in dollars help banks to internalize dollarization risks and, by increasing banks' liquidity in foreign currency, enhance the financial system's capacity to absorb shocks, particularly those associated with capital flow fluctuations.

In addition, since 2008 the BCRP has used reserve requirements in a more cyclical fashion by raising their average and marginal levels during periods of capital flow surges and cutting them during capital reversal episodes. By increasing reserve requirements in foreign currency during periods of intense capital inflows, the BCRP reduces banks' incentives to lend in dollars. At the same time, it creates a foreign currency buffer to reduce banks' vulnerability to capital reversals.

The 2008–09 global financial crisis put the inflation target cum financial risk control to the test. Inflation was running above target during the first half of 2008. High inflation called for higher domestic policy interest rates and the widening of the spread against foreign interest rates. In turn, higher interest rate spreads against the U.S. federal funds rate induced more carry trades and short-term capital inflows in the run-up to the crisis. The important bank liquidity levels originated by capital inflows hindered the conduct of monetary policy and intensified

[6]In fact, since the beginning of the 1990s, the BCRP has used these two sets of policies.



Source: Central Reserve Bank of Peru.

Figure 25.3 Reserve Requirement in Domestic and Foreign Currency (*Percentage of total liabilities*)

appreciation pressures. In this context, in addition to raising the reference rate (from 4.5 percent in July 2007 to 6.5 percent in August 2008) in response to inflation pressures, the BCRP increased reserve requirements on domestic and foreign currency deposits to ensure an orderly expansion of liquidity and credit. The BCRP also accumulated a significant amount of international reserves, mainly by foreign exchange intervention sterilized with fiscal savings.

In September 2008, the BCRP responded immediately to the turbulence caused by the collapse of Lehman Brothers by injecting liquidity up to 9.3 percent of GDP through a wide range of instruments, including the reduction of reserve requirements to end-2007 levels, the use of foreign exchange sales of $6.8 billion during September 2008–February 2009, and the provision of liquidity trough repo operations and currency swaps.

These measures cushioned the domestic financial system from the impact of the crisis and facilitated a swift and sustained recovery of credit and growth starting in the second half of 2009. During the worst episode of the crisis (October 2008–March 2009), access to credit was preserved and nonperforming bank loans remained low.

The 2008–09 global financial crisis provided policymakers worldwide with an important lesson: monetary policy needs to and can take greater account of financial stability concerns. During the crisis, central banks in developed economies made innovative policy moves that included explicit guidance to steer expectations of future interest rates and quantitative easing. These policies spilled over into emerging market economies, which had to face unprecedented levels of capital inflows. Under these circumstances, monetary policy in Peru had to maneuver to sail against the wind and apply a sort of quantitative tightening (Armas, Castillo, and Vega 2014). This implied raising reserve requirements, as depicted in Figure 25.3. The surges in capital flows that followed the implementation of quantitative easing by the U.S. Federal Reserve had a significant impact on monetary and credit conditions in Peru, which required more active use of complementary policy instruments such as reserve requirements. As shown in Figure 25.3, the BCRP increased not only the marginal reserve requirement rate several times, but also the average rate, which has a stronger impact on banks' intermediation costs in foreign currency, limiting credit expansion in foreign currency.

By more rapidly increasing reserve requirements during this period, the BCRP tightened monetary conditions in foreign currency, reducing the need for further increases in the domestic interest rate to manage inflation. At the same time, higher reserve requirements reduced deposits rates and the incentives for short-term capital flows to the banking system. Additionally, higher reserve requirements in foreign currency generated a faster accumulation of international liquidity in the banking system, strengthening banks' liquidity buffers.

In 2013, with the U.S. recovery under way and the consequent tapering announcements, Peru sharply reversed the course of it reserve requirement policy. In sum, the cyclical use of reserve requirements by the BCRP illustrates how a policy instrument can be adapted to more effectively address a challenging external scenario.

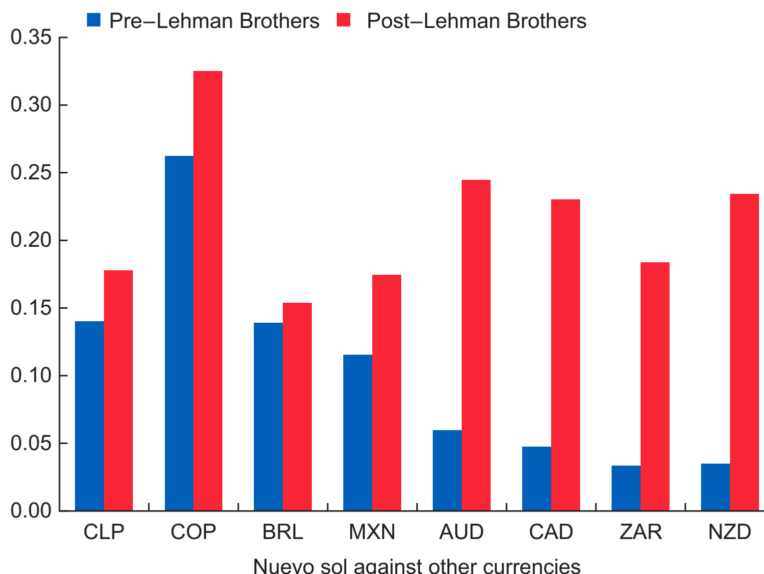
An additional nonconventional tool used by the BCRP to limit dollarization risks is the accumulation of international reserves, which are used as a buffer to increase the BCRP's capability to inject liquidity in the presence of adverse external shocks (such as capital flow reversals and drastic falls in the terms of trade). In a world with incomplete international financial markets, the accumulation of international reserves is a self-insurance mechanism against negative balance of payments shocks, such as sudden reversals in capital flows or falls in the terms of trade. This is particularly relevant for emerging market economies, which have experienced these kinds of shocks more frequently. These shocks have caused large output losses and banking credit disruptions in several emerging market economies, as occurred during the Asian and Russian crises at the end of the 1990s. As a result, emerging market economies have developed a greater risk aversion to external shocks, which has prompted them to accumulate more international reserves. In the case of Peru, most economic crises experienced during the past century had their roots in balance of payments shocks.

Foreign Exchange Market Intervention Policies

The main purpose of foreign exchange intervention in Peru is to reduce the volatility of the exchange rate and accumulate international reserves in order to prevent balance sheet effects on the partially dollarized financial position of the domestic private sector. There is no implied level, ceiling, or floor. No announcement regarding the amount of the interventions is made beforehand, because having to adjust this amount could have a high cost and because the volatile nature of foreign exchange flows requires a more discretionary approach to central bank intervention. Therefore, the exchange rate reacts to whatever shock hits its value, but extreme jumps are avoided.

As a result, daily percentage changes of the nuevo sol against the U.S. dollar correlate well with changes in other exchange rates, as shown in Figure 25.4, reflecting the fact that currencies in small open economies tend to move in the same directions when common shocks arise. Foreign exchange interventions do not preclude flexibility of exchange rates in the form of necessary adjustments, which are the fundamental mechanism in place to absorb external shocks such as capital flow reversals or lower terms of trade. The interventions aim only to avoid excessive volatility.

Excess exchange rate volatility emerges as a natural consequence of noisy information and imperfectly informed traders. The excess volatility of exchange rates, caused by the flow of private heterogeneous information, has real effects on the economy, particularly in a situation where agents are not hedged adequately. The reasons include the low state of development of the financial markets, the "original sin" documented by Eichengreen and Hausmann (1999), and the country's habits such as invoicing, holding assets, and transaction technologies in foreign currency. Thus, in a country like Peru, which has a relatively high degree of financial dollarization (currently around 40 percent), balance sheet effects are an important channel to consider in the monetary and foreign exchange intervention policy design.



Sources: Quandl; and author's estimates.
Note: AUD = Australian dollar; BRL = Brazilian real; CAD = Canadian dollar; CLP = Chilean peso; COP = Colombian peso; MXN = Mexican peso; NZD = New Zealand dollar; ZAR = South African rand.

Figure 25.4 Correlations of Peru's Exchange Rate with Other Countries

TABLE 25.2

Variance of Daily Nominal Exchange Rate Changes, 2000–14

	CLP	PEN	MXN	COP	BRL
Total Variance	0.50	0.28	0.43	0.47	0.66
Precrisis	0.49	0.23	0.41	0.45	0.70
Postcrisis	0.50	0.37	0.48	0.52	0.58

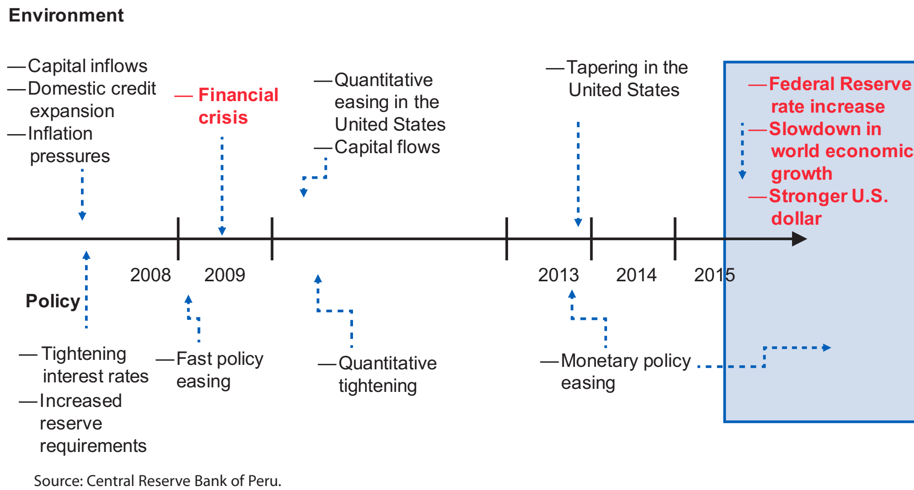
Sources: Quandl; and author's estimates.
Note: BRL = Brazilian real; CLP = Chilean peso; COP = Colombian peso; MXN = Mexican peso; PEN = Peruvian nuevo sol.

Interventions are implemented by purchases or sales of U.S. dollars in the spot market and by carrying out swaps with the issuance of certificates of deposits linked to the exchange rate. In 2014, the BCRP started using derivatives-based intervention instruments. Swaps are used mainly when there are pressures from the nondeliverable forward market that could force banks to transfer this pressure into the spot market. A swap operation with the central bank can provide temporary coverage against the risks involved in a nondeliverable forward market without affecting the availability of the bank's liquidity in domestic currency.

Indicators of relative volatility of the exchange rate among peer economies are a simple measure of the effectiveness of foreign exchange interventions. In Latin America, despite different levels of foreign exchange intervention, exchange rate trends are similar. However, in the case of Peru, volatility is lower.

Table 25.2 shows the variance of daily nominal exchange rate changes for five Latin American countries since 2000. The variance of the Peruvian exchange rate is lower than that of peer countries. After the global financial crisis, the variance of the Peruvian exchange rate increased in relation to the precrisis period.

In sum, Peru's inflation-targeting framework has considered conventional monetary policy instruments as well as nonconventional policies that have also played the role of macroprudential policies. Standard conventional monetary instruments work according to best practices in central



Source: Central Reserve Bank of Peru.

Figure 25.5 Broad Timing of Monetary Policy Actions and the Environment

banking, while nonconventional policies use (1) discretionary foreign exchange interventions to support a managed floating exchange rate regime envisaged to reduce dollarization risks, and (2) reserve requirement policies to control undue credit expansion and differentiated reserve requirement policies according to the currency denomination of bank liabilities to fight credit-induced dollarization risks. All in all, the framework has delivered macroeconomic and financial stability.

CHALLENGES FOR FUTURE MONETARY POLICY

One of the key lessons from the global financial crisis and from the Peruvian experience is that to deliver both price stability and an effective monetary policy transmission mechanism, central banks need to take into account the financial cycle in the design and implementation of the monetary framework. This poses several challenges for central banks. First, it requires lengthening the time horizon of monetary policy, particularly to properly calibrate nonconventional policy instruments. In contrast to typical business cycles that last between 8 and 32 quarters, financial cycles tend to last longer, which prompts the need to fine-tune the set of policy instruments to different time horizons.

In the case of Peru, most of the nonconventional policy instruments were tailored to accumulate international reserves and limit banks' exposure to the surge of capital flows generated by quantitative easing policies. In this way, the risks for the financial sector during the reversal of the Federal Reserve's expansionary policies were reduced (Figure 25.5).

Second, it is fundamental to maintain an appropriate balance in using different types of nonconventional instruments. These instruments can induce financial intermediaries to internalize ex ante financial risks, and if properly calibrated can also help reduce the probability of spreading the impact of shocks within the financial system. Consequently, the instruments can increase the capability of the central bank and the financial system to absorb this shock. However, if not properly calibrated, such instruments can also generate efficiency costs that can delay the development of financial markets.

The development of financial markets can also contribute to the resilience of the financial system to future external shocks, although it may also generate further challenges for implementing nonconventional policy instruments that may need to be adapted in the future to the way monetary policy is implemented.

Going forward, deeper integration of local financial markets with global financial markets will make the domestic market largely visible and open, a trend that may increase the size of foreign exchange markets relative to what the central bank can potentially intervene. This may in turn reduce the scope for an effective foreign exchange intervention. Under such circumstances, as Chinn (2014) notes, it may be hard for any central bank, let alone the BCRP, to perform sterilized foreign exchange interventions and remain in the center of the trilemma triangle as has been the case to date (Aizenman and Ito 2012).

More developed foreign exchange markets have to be accompanied by more developed financial markets that allow more economic agents to hedge risky positions. This would eliminate exchange rate movements as a source of shock and instead turn them into shock absorbers.

This particular feature of financial development is even more important for a financially dollarized economy like Peru. To foster dedollarization and minimize instances of credit riskiness due to dollar-denominated liabilities, the BCRP has introduced conditional reserve requirements for banks' dollar liabilities based on their performance in reducing outstanding dollar credits relative to starting values. In a healthy economy, only firms that generate income in dollars should resort to dollar credit and still hedge their positions to smooth their expected income profile.

Further development of capital markets would be welcome in Peru. However, several possible challenges loom. First, if more firms resort to bond issuance as a substitute for bank credit, reserve requirement policies would likely be weakened, while the conventional interest rate policy may still be effective.

Second, in terms of the issuance of bonds denominated in dollars, potential mismatches may cause problems for nonfinancial companies, as noted by Avdjiev, Chui, and Shin (2014). Although the current magnitude of this latter risk seems to be limited up until now in Peru, it serves as a warning in terms of possible future trends, and regulatory measures by the Superintendency of Security Markets may be desirable.

Third, the instruments and technological platforms of financial flows are becoming more sophisticated and change with the pace of technology. Transaction recording and official statistics rely on manuals that do not keep pace. The problem is that good financial information is necessary in the day-to-day management of monetary policy. In the foreseeable future, the fine-tuning of policy will likely have to be carried out with more noise. Investing heavily in technological improvements and platforms to gather information from the different available sources that can be quickly updated could be effective in reducing this potential information gap. The experiences of more advanced countries are valuable in this respect.

Fourth, the macroprudential framework may need to be strengthened. The BCRP's stance in terms of monetary and macroprudential measures ought to be in line with the microprudential regulation and macroprudential measures of other regulatory and financial service authorities. For example, reserve requirement policies need to go hand in hand with liquidity regulation proposed by Basel III and implemented by local financial service authorities.

Maintaining price stability will continue to be an important challenge for the region's central banks in the coming years, particularly in the case of a prolonged period of U.S. dollar adjustment. The recent experience in addressing the effects of the tapering episode illustrates that exchange rate pass-through might be nonlinear, particularly when the adjustment in the exchange rate is rapid and sizable. Indeed, Pérez-Forero and Vega (2015) show that exchange rate pass-through to prices may be twice as large in a depreciation phase than in an appreciation phase. In sharp contrast to the low inflation and even deflation levels observed in advanced economies, the current picture in the major Latin American economies is that of high inflation relative to the target, as shown in Table 25.3.

Price stability is essential for monetary policy not only because it fosters central bank credibility, which in turns strengthens the transmission mechanism of monetary policy, but also because it can improve the economy's ability to absorb external shocks. In the case of dollarized

TABLE 25.3

Year-over-Year Inflation Rates in the Larger Latin American Inflation-Targeting Countries *(Percent)*

Date	Brazil	Colombia	Chile	Mexico	Peru
July 2014	6.5	2.9	4.5	4.1	3.3
August 2014	6.5	3.0	4.5	4.2	2.7
September 2014	6.8	2.9	4.9	4.2	2.7
October 2104	6.6	3.3	5.7	4.3	3.1
November 2014	6.6	3.7	5.5	4.2	3.2
December 2014	6.4	3.6	4.6	4.1	3.2
January 2015	7.1	3.8	4.5	3.1	3.1
February 2015	7.7	4.4	4.4	3.0	2.8
March 2015	8.1	4.6	4.2	3.1	3.0

Source: Bloomberg, L.P.

economies, it can promote a decline in dollarization by increasing the confidence in the domestic currency.

The BCRP continues intervening in the foreign exchange market through outright sales of U.S. dollars in the spot market or other exchange rate intervention instruments to tame exchange rate depreciations. Foreign exchange intervention to avoid undue exchange rate depreciation is geared toward reducing financial vulnerabilities associated with highly dollarized and currency-mismatched liabilities. In turn, lower reserve requirements are meant to allow expansion of the domestic-currency credit supply.

Finally, potential GDP growth is slowing for emerging market economies. Diminishing potential growth rates may be a widespread trend in emerging economies as a whole, perhaps because of China's deceleration, the so-called secular stagnation hypothesis due to global demographic factors, or the hypothesized end of the commodity price supercycle. The potential slowdown can also be attributed to domestic bottlenecks in investment spending due to still-unsolved structural problems, which require speeding up structural reforms in order to increase potential GDP growth.

In the case of Peru, the potential output growth rate is now estimated to be about 5 percent. Monetary policy cannot do much to speed up growth above potential growth, and authorities need to remain vigilant in order to provide the appropriate amount of monetary stimulus. Other types of policies—particularly structural reforms in education, health services, and the provision of infrastructure—are urgently needed to prevent a further decline in the potential output growth rate.

CONCLUSIONS

Since the early 1990s, monetary policy in Peru has emphasized the importance of containing inflation and maintaining financial stability. In turn, the stability of the financial system has allowed for safeguarding the transmission mechanism channels of monetary policy. Based on this experience, this chapter has provided an overview of the current monetary policy strategy of the Central Reserve Bank of Peru and highlighted possible challenges for the future of monetary policy.

The chapter has emphasized the policy instruments that the central bank can deploy within the inflation-targeting design. To limit system-wide credit risk induced by high dollarization, the conventional interest rate monetary policy operational target is complemented by additional unconventional instruments such as reserve requirements and foreign exchange market

intervention policies. The chapter has also highlighted the importance of adapting these instruments to more challenging external scenarios.

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CHAPTER 26

Making Growth Inclusive: Establishment of the Ministry of Social Development and Inclusion

CAROLINA TRIVELLI

Peru has a long history of uncoordinated and not necessarily effective social policies. Only recently has the government recognized the need to adapt social policies to achieve inclusion objectives and coordinate policies within different time horizons. Against this backdrop, the government created the Ministry of Social Development and Inclusion (MIDIS) in 2011 with an ambitious agenda to accelerate poverty reduction and achieve inclusive growth. While progress has been uneven, preliminary evidence suggests that the government is on the right track to achieve objectives set for 2016. For the future, it will be important to redouble efforts to continue implementing the National Strategy for Social Development and Inclusion, which will reduce chronic child malnutrition, strengthen early childhood development, enhance programs for children of school age, promote innovative economic inclusion, and broaden protection for the elderly.

At the start of President Ollanta Humala's administration in 2011, the government undertook a wide-ranging initiative to achieve social inclusion by targeting the most vulnerable segments of the Peruvian population. To that end, a decision was made to reform the entire set of government social initiatives and establish a unified strategy to ensure mutually reinforcing public sector efforts to reduce poverty, thereby boosting the impact of those initiatives and achieving a shared, fundamental, and broad-based social protection floor for all Peruvians.

The commitment to social inclusion is based not just on considerations of justice and fairness, but also reflects a conscious resolve to ensure that all Peruvians, male or female, can contribute to the development of their family and community and thereby to the growth of the country as a whole. The task is to make sure that the Peruvian State has the tools, strategies, and resources to ensure that all citizens—no matter where they reside, what language they speak, what their parents do, or what resources are at their disposal—can get ahead in life and achieve their goals, thus contributing to Peru and its development.

STARTING POINT

Social policies, and especially policies targeting excluded segments of the population, have been around for a long time. In the specific case of Peru, one of the oldest social programs—the Drops of Milk (*Gotas de Leche*) Program dates to the administration of President Augusto B. Leguía in the early twentieth century.[1] Social policy has obviously changed significantly since then, to the

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This chapter is based on a number of papers written in 2014 about the experience of establishing the Ministry of Social Development and Inclusion (Trivelli 2014a, 2014b; Trivelli and Vargas 2014; Vargas 2014). The author would like to thank Jhonatan Clausen for his support during the writing of this chapter.

[1] *Gotas de Leche* reflected the Leguía administration's concern with lowering the infant mortality rate and setting up health clinics, day nurseries, and so on. A reference to these governmental initiatives can be found in President Leguía's speech to the National Congress in October 1924. http://www4.congreso.gob.pe/museo/mensajes/Mensaje-1924-1.asp.

point where there are now coordinated programs to address specific segments of the population and specific needs.

During Peru's more recent history of social policy, the interest in improving coordination among programs can be traced to the government of Alejandro Toledo (2001–06), when initial efforts were undertaken to achieve some degree of coordination of social policies through the Inter-Ministerial Committee on Social Affairs (CIAS), headed by the Office of the President of the Council of Ministers. In 2003, the CIAS published the Guidelines for the National Strategy to Overcome Poverty,[2] followed a year later by adoption of the National Plan for Overcoming Poverty 2004–06.[3] The strategy encompassed the entire set of programs and interventions associated with poverty reduction and put forth overall objectives to achieve that reduction. It also proposed that each sector align its own plan for overcoming poverty with the national strategy. As often happens, each entity complied with its obligation to draw up a plan and at that point coordination of the strategy ceased, despite the emphasis in the strategy itself on dovetailing and coordinating efforts.

During the administration of Alan García (2006–11), CIAS devised the CRECER (Growth) National Strategy as a fresh attempt to foster coordinated actions to tackle the main problems associated with poverty. CRECER made headway in particular with efforts to combat child malnutrition. Chapter IV of the CRECER National Strategy's Work Plan (*Plan de Operaciones*) specifically established operational procedures for both horizontal and vertical functional coordination of the various public sector interventions targeting that problem.[4] Although the CRECER strategy set three objectives, coordination improved only with respect to the first (combating malnutrition). Specifically, consensus was achieved regarding a model for complementary sectoral interventions that together would work to reduce malnutrition. Regional processes for implementing the CRECER strategy proved to be especially valuable, particularly in areas where efforts were reinforced by social coalitions and local authorities, supported by joint interventions by international and donor agencies. Good examples were in Ayacucho, with CRECER Wari,[5] Puno (in Carabaya, in particular), and Huancavelica.

The start of President Humala's administration in July 2011 triggered a debate over the need to organize social policy, direct it to overcome the country's major social challenges, and coordinate it with other national policies. The objective was to ensure that universal social services (health, education, and civil identity) in fact reach all citizens. President Humala proposed mobilizing resources for social policies to promote inclusion and, at the same time, ensuring that that enhanced inclusion sustained the country's growth. To that end, the MIDIS was established in October 2011 to manage the principal targeted social policies in a coordinated manner and to serve as the social development and inclusion policymaking body. The president assigned the new ministry the dual challenge of ensuring universal access to public services and incorporating more Peruvians into the fabric of those services as a strategy for ensuring Peru's ongoing growth.

In addition, the MIDIS was assigned responsibility for coordinating policies targeting the population in situations of poverty and vulnerability and for directly executing five social programs, four of which already existed and one that was still being developed. The five programs

[2]The guidelines (*Las Bases para la Estrategia Nacional de Superación de la Pobreza*) were adopted through Supreme Decree No. 002-2003-PCM. http://www.congreso.gob.pe/comisiones/2002/discapacidad/ds/002-2003-pcm.htm.

[3]The plan (*Plan Nacional para la Superación de la Pobreza 2004–2006*) was adopted through Supreme Decree No. 064-2004-PCM. http://www.mesadeconcertacion.org.pe/documentos/legislacion/leg_00371.pdf.

[4]The work plan (*Plan de Operaciones de la Estrategia Nacional CRECER*) was adopted through Supreme Decree No. 080-2007-PCM. http://www.observatorioseguridadalimentaria.org/sites/default/files/politicas_publicas/archivos/PlanOperaciones_CRECER.pdf.

[5]Section 1.5.1 of the CRECER Strategy Work Plan for Wari establishes general guidelines for horizontal and vertical coordination of the strategy. http://goo.gl/TNgxc6.

are (1) *Juntos*, a conditional cash transfer program; (2) FONCODES, the remnant of what was once the social investment fund set up during the structural adjustment of the 1990s; (3) *Wawawasi*, a day care center program, which would expand its services and coverage and eventually become today's *Cuna Más* program; (4) PRONAA, the government food procurement/logistics body for distributing food to various vulnerable groups; and (5) *Pensión65*, the social program that was to start delivering noncontributory pensions (as of 2012) to persons over the age of 65 living in extreme poverty.

The MIDIS thus began with the challenge not only to expand, improve, and coordinate those five programs, but also to coordinate their activities among the programs themselves and with actions undertaken by other government entities.

THE IDEA BEHIND THE MIDIS

The establishment of the MIDIS reflects the need for more effective and coordinated policies to address the challenges posed by still-high poverty rates, especially in rural areas. Although the poverty rate has declined significantly in Peru (from 58 percent in 2001 to 26 percent in 2012), the country still suffers from stark divides. Extreme poverty is virtually nonexistent in the big cities, while it exceeds 30 percent in the most remote rural areas. The child malnutrition rate in rural areas is more than double the national average.[6] For these reasons, the MIDIS has largely focused since its inception on closing gaps associated with poverty and marginalization.

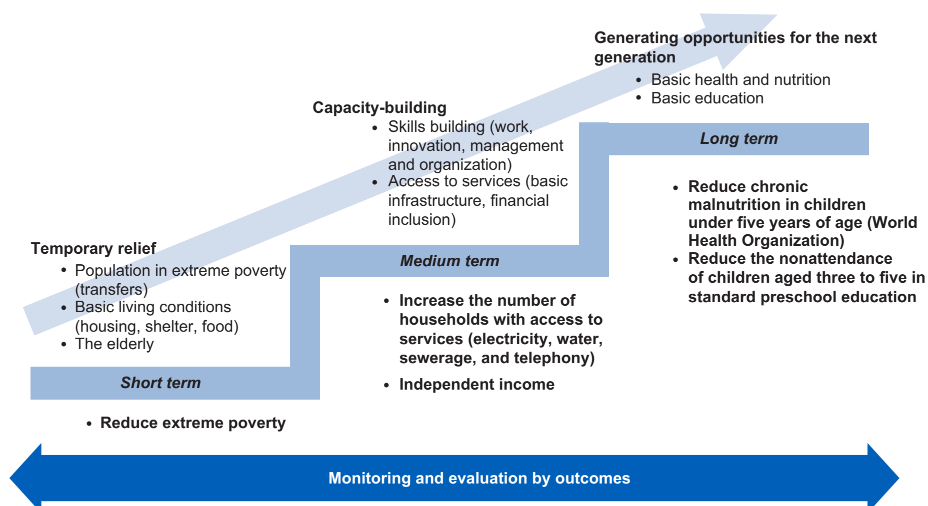
The establishment of the MIDIS was opposed by some because there were concerns that it might become an instrument of government patronage or another government bureaucracy put in place just to meet electoral promises. Fortunately, in the three years since the ministry was established, neither of those problems has materialized. However, given those concerns, it is important to clarify the role of the MIDIS and the scope of its actions.

The MIDIS was shaped by a particular context that justified its establishment and proactively facilitated its implementation (Vargas 2014). First, Peru had been experiencing a period of sustained economic growth, associated with substantial increases in the government budget and in investment, along with a significant decline in poverty rates. However, those positive circumstances disguise the existence of gaps that are not being closed by higher economic growth, lower aggregate poverty, or greater investment. In other words, while the country as a whole is doing well, there are many Peruvians who not only fail to perceive improvements in their standard of living, they also feel disconnected from the activities bringing about the overall improvement. They are being left behind, or are falling further behind, and for that reason there is a need to target specific policies toward them so that they can catch up and, ideally, progress at the pace of the country as a whole, both for their own well-being and for the well-being of the nation.[7] The MIDIS was established to find new ways to meet that challenge, to build on existing efforts, and to ensure that the fruits of growth translate into enhanced capacity and opportunity for all.

One of the MIDIS's first tasks was to clarify the term "social inclusion," which it defined as "circumstances in which everyone can exercise his or her rights, use their skills and make the most of the opportunities available to them" (MIDIS 2013a).

[6] Section 1.3 of the National Social Development and Inclusion Strategy, "Making Growth Inclusive," emphasizes the need to narrow poverty gaps (whereby poverty is defined as multidimensional) between urban and rural areas. One of the criteria for defining the population encompassed by the social development and inclusion process precisely cites belonging to a rural household, defined as households located in settlements of 400 or fewer homes. The strategy is available at http://www.MIDIS.gob.pe/files/estrategianacionaldedesarrolloeinclusinsocialincluirparacrecer.pdf.

[7] Urban-rural divides and those between certain social groups highlight the groups that are lagging behind: the rural population, indigenous groups, poorly educated households, and, clearly, the poorest households. For example, the rural poverty rate is more than triple the urban rate, and chronic malnutrition in the most excluded group is more than double the national average.



Source: Ministry of Social Development and Inclusion (2013a).

Figure 26.1 Operational Approach of the Ministry of Social Development and Inclusion

Once a consensus was reached on the definition, the ministry had to be made operational. To that end, based on the human development approach, the MIDIS devised a model with three complementary time frames: short, medium, and long term (Figure 26.1).

- In the short term, through direct assistance programs, the focus is on providing temporary relief from conditions causing households to suffer exclusion and poverty. The idea is to enable families to overcome day-to-day challenges by providing them with the minimum resources needed to exercise their rights and access the public services to which they are entitled.
- In the medium term, the focus is on developing the capacity that will enable households to pursue, in a sustained and dignified manner, paths to overcome the conditions of poverty and exclusion that beset them. Thus the main thrust here is on broadening access to a basic services and infrastructure package and increasing autonomy with respect to the provision of sustainable livelihoods by generating better living conditions (healthy homes, food security, etc.) and incomes through higher productivity, financial inclusion processes, and so on.
- Longer-term efforts will focus on pursuing policies to generate next-generation opportunities, with particular emphasis on human capital factors: nutrition, health, and quality education. Here, the idea is to reduce the intergenerational transmission of poverty so that the children of families suffering poverty and exclusion today are not condemned to be poor and excluded as well, and to find paths to inclusion for them.

These three time frames should not be understood as consecutive stages; rather, the MIDIS is committed to simultaneously mobilizing resources for all three. The challenge for development and inclusion policy is to design and promote complementary interventions that address short-, medium-, and long-term needs at the same time.

However obvious as it may seem, not all sectors have a set of established indicators, much less clearly defined targets. Being a multisectoral ministry, the MIDIS set out to define indicators and targets, but at the same time it proposed that those indicators and targets reflect progress in social development and inclusion more broadly—that is to say, the entire set of intergovernmental and

TABLE 26.1

Ministry of Social Development and Inclusion: Policy Indicators and Targets *(Percent)*

	National		Population Encompassed by the Social Development and Inclusion Process	
	Baseline 2010	Target by 2016	Baseline 2010	Target by 2016
Poverty Gap	7.9	6.0	28.6	16.3
Extreme Poverty	8.3	5.0	38.2	20.0
Extreme Poverty Based on Households' Independent Income	11.0	7.0	50.5	26.7
Households with an Integrated Services Package	59.4	70.0	13.2	46.9
Attendance of Children Aged Three to Five Years in Standard Preschool Education	73.8	85.0	60.6	78.4
Chronic Malnutrition in Children Under Five Years	23.2	10.0	50.7	23.8

Source: Ministry of Social Development and Inclusion (2012b).

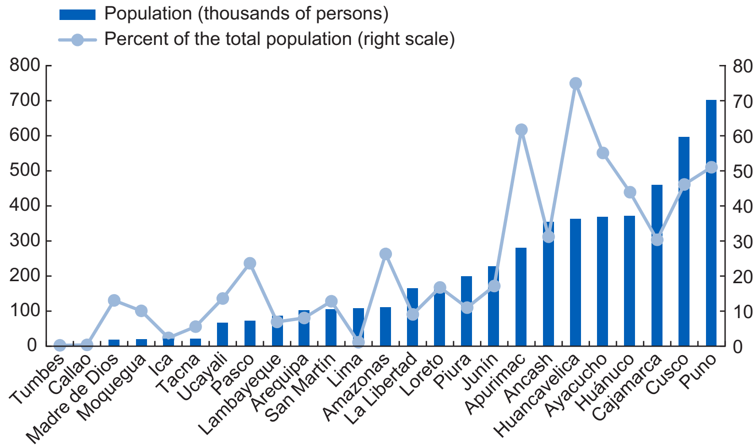
intersectoral interventions aimed at producing the prioritized outcomes. Along those same lines, it was agreed that it should be possible to calculate the indicators using national statistics, so as to ensure independence and transparency in their measurement.

Given that the MIDIS assigned priority to addressing social disparities, six indicators were proposed both for the national aggregate and the most excluded segment of the population (Table 26.1). To that end, the ministry began by defining this group, which was called the "population encompassed by the social development and inclusion process." The criteria used to define this population stemmed from a multidimensional approach to poverty that includes both monetary and nonmonetary criteria. Operationally, the population encompassed by the social development and inclusion process is comprised of households that have at least three of the four characteristics associated with the exclusion process, which are the following: rural households, that is, those located in settlements of 400 or fewer dwellings (2,000 people); households with a female head of household or spouse who never completed primary school; households with a head or spouse whose mother tongue is an indigenous language (Quechua, Aymara, or Amazonian); and households in the lowest quintile of national distribution of expenditure per capita.

As for the territorial distribution of the population encompassed by the social development and inclusion process, when the MIDIS was established the regions with the largest share of this population as a percentage of their total population were Huancavelica, Apurímac, Ayacucho, Huánuco, and Puno. The regions with the lowest share were Tumbes, Callao, Ica, and Lima, where this group accounts for 2 percent or less of the respective populations (MIDIS 2013b). In absolute terms, as shown in Figure 26.2, the population encompassed by the social development and inclusion process amounted to almost 5 million Peruvians, a little over 16 percent of Peru's total population.

The six indicators established by the MIDIS correspond to the short-, medium- and long-term time frames identified in the operational approach of the social development and inclusion policy. As shown in Table 26.1, the indicators are the poverty gap, extreme poverty, extreme poverty based on households' independent income, households with an integrated services package, attendance of children ages three to five years in standard preschool education, and chronic malnutrition in children under five years.

While establishing social sector targets and indicators might seem an obvious step, the fact is that in Peru's case it was far from self-evident. When a Ministry of the Economy is asked about its performance, everyone knows what indicators will be used (inflation, growth, the fiscal deficit,



Source: Ministry of Social Development and Inclusion (2013b).

Figure 26.2 Regional Distribution of the Population Encompassed by the Social Development and Inclusion Process

and so on), so it is the targets that are of most interest. In the social sectors, on the other hand, there is still not always agreement even on the indicators. Therefore, the MIDIS set out to establish both indicators and targets from the outset and to set the targets through to the end of President Humala's term in office (in 2016).

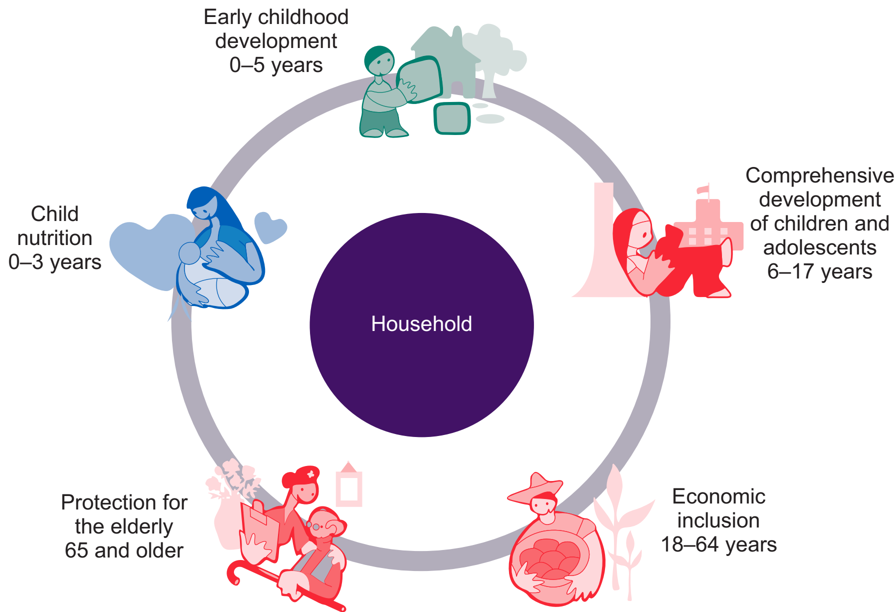
Outcomes to date show that the MIDIS has made headway toward the targets established. As discussed below, by the halfway point of the administration, indicators showed progress, but there were also some warning signs that have since enabled the MIDIS to redouble its efforts in certain areas. The warning signs demonstrate the importance of having a set of timely indicators that can help the ministry stay on track. The most notable outcome thus far is that the extreme poverty reduction target for 2016 (5 percent) was already achieved in 2013.

ESTABLISHING A SECTOR STRATEGY: A KEY TOOL FOR MANAGEMENT, COORDINATION, AND INCLUSION

The key to achieving these outcomes is to have a clear road map, know what to do and how to do it, and know who the participants are. That is why, once the MIDIS was established, targets set, and all available instruments assessed,[8] it was essential for the ministry to generate a feasible and workable strategy to guide its actions and coordinate efforts with other government entities and agencies.

The National Strategy for Social Development and Inclusion (ENDIS) was thus adopted in May 2013. Based on person-centered and coordinated interaction throughout the life cycle, the strategy makes it possible to address the principal disadvantages faced by poor families and at the same time provide them with the new services and tools they need to make progress in life.

[8] As discussed earlier in the chapter, after the MIDIS was established, it was assigned five social programs in January 2012. A decision was made to adopt a plan to evaluate each program and prepare adjustment measures for each one. That process was complicated and had to be done quickly, but it did help bring order to the programs, clarify their modus operandi, and set a clear road map for each program. The main findings of the program evaluations can be found at http://goo.gl/0XB9Wz.



Source: Ministry of Social Development and Inclusion (2013a).

Figure 26.3 The Five Pillars of the National Strategy for Social Development and Inclusion

Figure 26.3 presents the five pillars of the strategy. In some areas, the strategy builds on what is already in place by incorporating previous advances, such as the decision to make fighting malnutrition a pillar of the strategy. In other areas, it posits new types of action and new objectives, as in the economic inclusion pillar, where it is not just a question of helping families with isolated public interventions, but rather of providing them with a whole package of measures that increases their resource base of public and private assets, their productivity, and the return on their assets. This economic inclusion pillar probably represents the area in which social protection efforts have dovetailed most effectively with attempts to foster independent development for the poorest families.

The ENDIS also serves as a two-pronged instrument for the MIDIS. On the one hand, it sets the agenda for coordination with other sectors and levels of government in each of the five pillars. On the other, it establishes the road maps for the five programs executed by the MIDIS in order to ensure that each program performs a function in the pillars in which the program intervenes. These programs play a vital part in ensuring that the recipients (mainly women) gain access to and use basic public services. For many, access and use of these services represents an acknowledgment of full citizenship.

PRINCIPLES AND STRATEGIES COMPLEMENTING THE ENDIS

Ever since the MIDIS was established, the idea has been to attain a highly professional, results-oriented social sector that makes efficient use of the public resources allocated to it. To that end, a number of principles and strategies were adopted to complement the ENDIS and ensure transparent, efficient, and person-centered management geared toward bringing about substantive changes in the living conditions and opportunities of the population living in poverty and vulnerability.

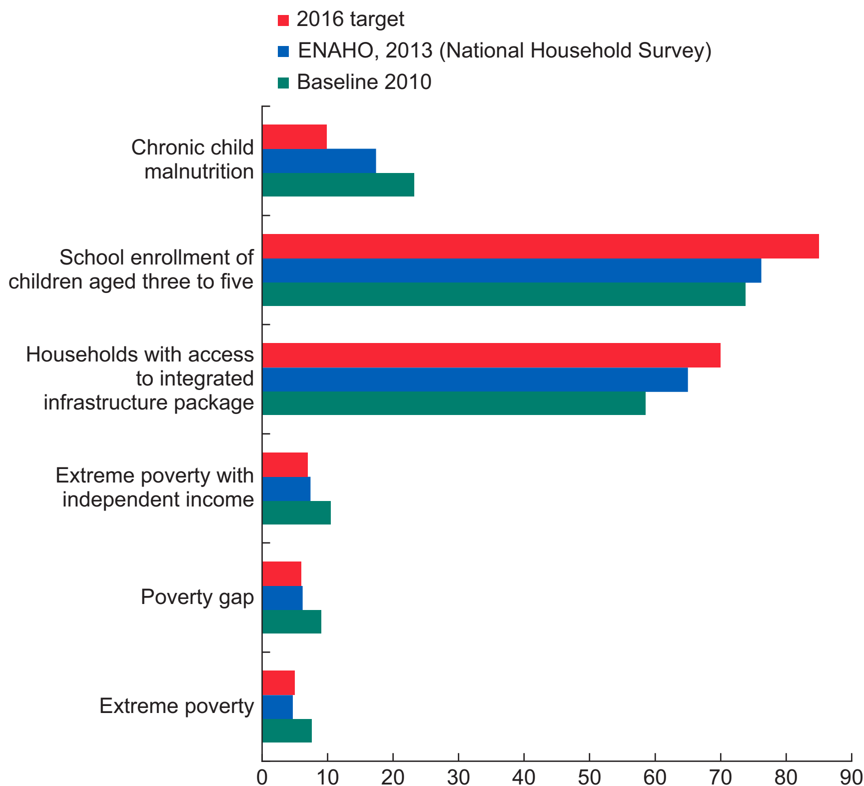
Some of the principles and strategies adopted were very simple, but had direct implications for management. Five are worth noting here:

- First, the goal is not so much to dream up solutions, but rather to build on experience. Hence, the objectives of the ENDIS include achieving progress through a cumulative process, joining forces with other sectors, building on previous experiences, and pooling efforts with other levels of government. The aim is to forge collective and coordinated efforts and build on progress already made.
- Second, actions need to be results oriented, which is why it is important that the five MIDIS programs are now governed by results-based program budgets. More than 90 percent of the ministry's budget is now performance-based.[9] What is more, this principle forced all the programs to clarify what they expected to achieve through their actions and thereby rationalize their efforts.
- Third, policy formulation and evaluation had to be evidence based. The only way to make progress toward effective and efficient interventions is to evaluate what is done, propose and promote improvements, and then reevaluate what is achieved. Evaluation of impacts, results, and processes is also vital to determine what initiatives need to be discontinued because they are not producing the desired results. Thanks to this principle, the MIDIS in 2012 closed a social program—for the first time ever in Peru—that was failing to deliver results (the PRONAA).
- Fourth, it was clearly established that effective and inclusive policies require a thorough understanding of the beneficiaries, communities, families, and markets involved. The establishment of the MIDIS revealed how little information there was about which programs were underway across Peru, the populations groups served by them, and the challenges that needed to be overcome. Moreover, gaining knowledge to achieve inclusiveness introduced transparency with respect to the rules under which programs operate and in their territorial distribution (for instance, through InfoMIDIS, on the ministry's website). At the same time, that information has shed light on the living conditions of beneficiaries of MIDIS programs and on the coordinated actions undertaken within each pillar of the ENDIS.
- Fifth, achieving results means moving away from business as usual in the operation of social programs, so it is critical that the MIDIS remain receptive to social innovation. Inclusiveness through innovation is a must if the government wants to promote services and programs more swiftly and effectively identify better ways of touching the lives of beneficiaries. This approach has enabled the MIDIS to venture into areas such as the financial inclusion of beneficiaries of MIDIS transfer programs. It has also tested the creativity of both businesspersons and public administration officials in seeking ways to reach more than 3 million children with school meals based on decentralized purchases.

HAS PROGRESS BEEN MADE SINCE THE MIDIS WAS ESTABLISHED?

As mentioned above, the MIDIS has made progress both at the institutional level and in terms of the prominence of social inclusion issues on the policy agenda. It is now widely recognized that the government cannot abdicate its responsibility to protect and include all citizens. There is also

[9] When the MIDIS was assigned the five social programs in January 2012, only one of them operated with a results-based budget.



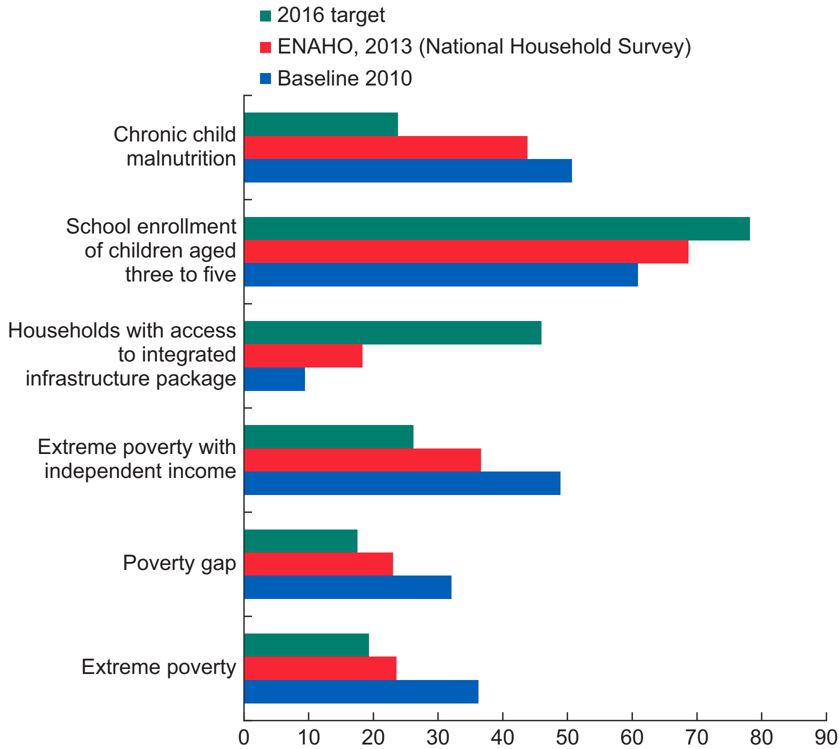
Sources: Household and Health Survey (ENAHO), 2013; Ministry of Social Development and Inclusion (2012a); and author's calculations.

Figure 26.4 Ministry of Social Development and Inclusion Indicators at the National Level (*Percent*)

clear progress in the indicators that the MIDIS developed: halfway through the current presidential term, the government is well on track to meet targets set by the MIDIS for 2016. The findings are based on official statistics from the national household and health survey known as ENAHO. Some indicators are advancing slowly, but as a result of early warning signs, steps are being taken to create new policy instruments (such as the Performance Incentive Fund) and undertake new social policy actions. As was to be expected, more progress is being made at the aggregate level than with respect to the population encompassed by the social development and inclusion process, which is where the major challenges lie and where, despite some progress, meeting targets will prove more elusive.

Predictably, the first targets met (or that are close to being met) are those related to short-term actions to relieve the plight of the poor and vulnerable. This is due to the expansion in coverage (and resources) of the principal relief programs. The extreme poverty rate in 2013 was 4.7 percent and the poverty gap ratio was slightly over 6 percent (Figure 26.4).[10] There has been major progress with respect to the medium-term indicators, where the goal is to boost people's autonomy and capacity to access opportunities to get ahead. Likewise, as a result of efforts coordinated with

[10] Peru's social sector budget remains one of the lowest in Latin America, although the budget has increased considerably under the Humala administration. The MIDIS budget (essentially concentrated in its five programs) increased significantly between 2012 (the first year in which the ministry operated) and 2014 (the amended budget for 2014 was almost 46 percent larger than in 2012). See the User-Friendly Consultation on the Economic Transparency site of the Ministry of the Economy and Finance at http://apps5.mineco.gob.pe/transparencia/Navegador/default.aspx?y=2012&ap=ActProy.



Sources: Household and Health Survey (ENAHO), 2013; Ministry of Social Development and Inclusion (2012a); and author's calculations.

Figure 26.5 Ministry of Social Development and Inclusion Indicators for the Population Encompassed by the Social Development and Inclusion Process (*Percent*)

the health, education, and housing sectors and with local and regional governments, significant progress is being made with respect to a key long-term indicator: the reduction in chronic child malnutrition. Peru has met the Millennium Development Goal target in that area and is close to achieving the goal of reducing chronic child malnutrition to 10 percent or less (in 2010 it stood at 23.1 percent) (Figure 26.5).

It is vital that the indicators and targets put in place by MIDIS for measuring social progress continue, and the hope is to add additional indicators going forward. Ideally, all national, regional, and local government entities should identify the indicators and targets by which their progress can be evaluated. Such a step would mark a milestone in the way that public administration and policymaking are conducted and perceived.

THE CHALLENGE: PRESERVE AND BUILD ON THE RESULTS ACHIEVED

Progress on the five pillars of the ENDIS has been uneven. The starting points differed and only limited tools were available for implementing policies and programs under several pillars. The ENDIS can be used to pinpoint where efforts need to focus going forward in order to consolidate social policies such that they transition to becoming full-fledged public policies.

For the first pillar, the administration set an ambitious target of reducing chronic child malnutrition to 10 percent by 2016 from 23.1 percent in 2010. By mid-2014, chronic child malnutrition

was at 14 percent. That signaled substantial progress, but much remains to be done because it is not just a question of reducing the problem at the national level, but also of lowering it in the regions where it is most prevalent. What the progress has shown is that a method and set of tools have been identified to effectively tackle chronic child malnutrition. Two factors explain that progress. First, a decision was taken to continue programs inherited from the previous government under the CRECER strategy such as *Juntos* and investments in safe water and infrastructure. Second, a clear diagnostic assessment was carried out to identify what was not working properly and which mechanisms were needed to resolve those issues. Those mechanisms included improving local investments to install safe water connections, encouraging regional governments to allocate budgetary resources to such projects, and generating useful information for timely decision making. The Peruvian government needs to commit to consolidating processes, keeping the package of policies and instruments up and running, and maintaining regional monitoring indicators as the basis for ongoing efforts.

Under the second pillar, early childhood development, a multisectoral comprehensive strategy is about to be adopted, which is essential to ensure that work continue in this area. The expansion of Comprehensive Health Insurance (*Seguro Integral de Salud*), to which every Peruvian child under three years of age is now entitled, is a major step forward for this pillar. From the standpoint of the MIDIS, external evaluation of programs such as *Cuna Más*, and above all its new services serving rural communities, will yield information as to how to best proceed in those areas. Clearly, however, the immediate priority is to prepare and implement the pending strategy.

The third pillar, regarding children of school age, is breaking new ground because of the coordination of MIDIS activities with the Ministries of Education and Health in public schools. Today, children attending public preschools and primary schools have health insurance and a health evaluation and screening plan, and receive food supplements to enhance their concentration. In addition, children from poorer households that receive conditional cash transfers under the *Juntos* program are required to maintain certain school attendance levels. This coordinated plan, known as Healthy Learning (*Aprende Saludable*), is a pilot program whose achievements need to be expanded to consolidate institutional coordination mechanisms among the three sectors, as well as among the national, regional, and local governments. The role of the different sectors and governmental levels in developing this new way of working with public schools needs to be formalized.

The MIDIS also needs to continue its efforts to consolidate the *Qali Warma* school food program to ensure that it remains on a sound footing and that parents, school directors, and teachers know how to keep it running. It is worth noting that this program serves twice as many children as the previous program (PRONAA) and does so on twice the number of days.[11]

The fourth pillar, economic inclusion, is the most innovative area for a socially oriented ministry such as the MIDIS. It requires that those involved continually identify practices and interventions that generate economic opportunities for the poorest families. The MIDIS has two such initiatives that need to be consolidated: FONCODES' *Haku Wiñay* program, which serves more than 60,000 families by providing them with assets and resources for technical assistance, investment, and training; and *Haku Wiñay,* which coordinates with *Juntos* and encourages rural families to improve their living standards, dwellings, food security, and opportunities to earn incomes autonomously. Initial (independent) evaluations of *Haku Wiñay* show that it is proceeding well but is still in its early stages of achieving its objectives.

Within that same pillar, MIDIS' efforts to advance financial inclusion reflect the emergence of a number of successful initiatives. Today, more than 1.2 million recipients of social programs have a savings account under their own name where they receive government transfers via the

[11] In 2014, *Qali Warma* served over 3 million pupils in the public preschool and primary education system, reaching over 57,000 schools.

MIDIS. More than 400,000 recipients of *Juntos* already have a debit card that they can use at automatic teller machines accessible through an extensive network of points of sale at banks, stores, and pharmacies. A financial inclusion strategy is in place, methodologies and materials have been developed to provide financial education, and the MIDIS has entered into partnerships with public and private stakeholders to consolidate this process and provide more economic opportunities for the beneficiaries of social programs. These innovations need to be further developed, scaled up, and consolidated.

The fifth pillar, protection for the elderly, is an area in which Peru is just beginning to develop policies. The pillar revolves around *Pensión65*. Today, more than 400,000 older persons receive a cash transfer and have a national identity card, savings account, and health insurance. In more than 80 districts, they can take part in the Productive Knowledge (*Saberes Productivos*) Program. However, much remains to be done to ensure that the final years of life are always dignified and secure, regardless of where one lives or how much money one has. Clearly, the challenge is to combine the effort to achieve good outcomes with the discussion about pensions, protection, and retirement. However, perhaps the most appropriate approach would be for the MIDIS to focus on expanding services that complement the transfers and leave the rest to the other entities involved, notably the Ministry of the Economy and Finance and the Superintendency of Banks, Insurance and Pensions.

CONCLUSIONS

Social program coverage has increased in Peru as a result of the establishment of the Ministry of Social Development and Inclusion and the formulation of a clear results-oriented policy. That policy is based partly on a bold approach to partnerships with other sectors, levels of government, and other institutions (for example, the *Banco de la Nación*), but also on much more substantial funding. *Juntos* has so far almost doubled its coverage under the current administration. *Pensión65* and *Haku Wiñay* did not exist in 2010. *Cuna Más* has maintained its services and developed new services for rural areas, while *Qali Warma* has quadrupled the size of the school food program.

Despite these advances, the challenges still facing Peru in terms of social inclusion are enormous. As a country, Peru needs to set the goal of guaranteeing that any Peruvian eligible for a social program can access it, which means eliminating undercoverage in targeted social programs. Today, this is only true of *Pensión65.*

As has been shown in this chapter, there are different challenges for each pillar of the ENDIS. To those challenges three additional key tasks need to be added:

- *Consolidating the transition from ad hoc initiatives to policies that are coordinated and guaranteed by the state.* The government stills needs to reach all those who need (and qualify for) social programs, not just with programs here and there, but with the basic package of services to which every Peruvian is entitled purely by virtue of having been born in Peru.
- *Innovating, testing, and evaluating new (smart) mechanisms for intersectoral and intergovernmental coordination to achieve agreed-upon social objectives.* The government must continue to search for the best ways to achieve a well-coordinated and consistent presence of the State throughout Peru, with a useful and comprehensive set of policies for citizens, especially the poorest and most vulnerable.
- *Ensuring that all Peruvians are aware that these social policies are investments in the sustainability of the country's development process, and that they represent Peru's commitment to recognizing itself as a country of equals where growth is inclusive.*

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