

Peru: Selected Issues Paper

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PERU

Selected Issues

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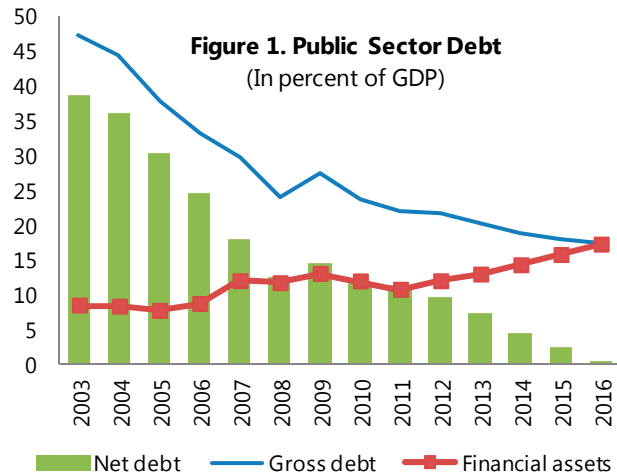
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I. TOWARDS A STRUCTURAL FISCAL FRAMEWORK¹

A. The Current Fiscal Framework

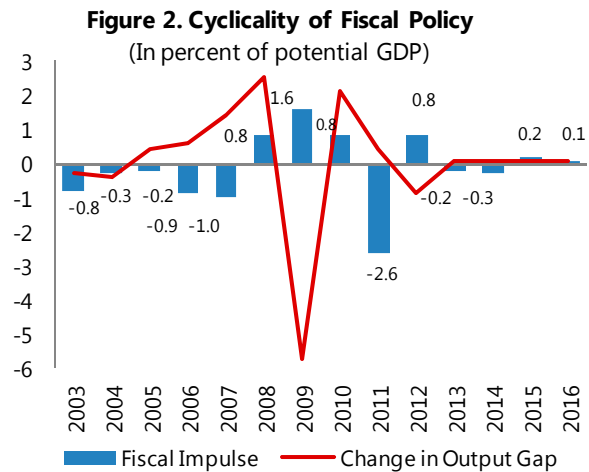
1. The current fiscal framework—embedded in the Fiscal Responsibility and Transparency Law (FRTL)—has been effective in reducing debt.

It has imposed fiscal discipline by limiting the deficit in lower phases of the cycle and curbing expenditures growth on the upside, allowing Peru to reduce its debt and accumulate significant financial assets. Public sector gross debt was reduced from 44 percent of GDP in 2004 to 24 in 2010 (Figure 1). Similarly, a sound debt management strategy successfully reduced debt vulnerabilities in terms of currency and interest rate risks. While very successful in terms of fiscal discipline, the framework can be further reviewed, particularly when debt levels are more comfortable



2. The FRTL has not prevented procyclicality in specific years.

For example, fiscal policy was pro-cyclical in 2008 due to increased spending beyond the limits imposed by the FRTL, while turning countercyclical in the following two years as a response to the financial crisis (Figure 2). In 2009, with considerable fiscal space, the government reacted to the global crisis by providing a fiscal stimulus of 3.5 percent of GDP. The stimulus—mainly based on spending measure—shifted the budget into a deficit of 1.6 percent of GDP resulting in a temporary relaxation of the FRTL targets (Box 1). However, fiscal policy was considerably expansionary in 2010, despite the rapid recovery of output and emerging signs of overheating. The procyclical bias left a large part of the burden of the macroeconomic adjustment to monetary policy.



¹ Prepared by Isabel Rial (FAD).

3. **FRTL does not rule out discretionary changes in tax rates, raising the risk of procyclical measures.** In 2011, the authorities reduced several tax rates; the most important being the reduction of one point in VAT tax rate. Despite these procyclical measures, the fiscal impulse dissipated in the second half of 2011 mainly due to expense restraining at the central government and low execution rates of capital spending at the subnational level.

4. **The FRTL embodies some countercyclical elements in response to output or commodity price shocks.** The combination of a provision for a moderate deficit on the down-side, and a current expenditure cap on the up-side, allows for some countercyclical policy. However, it still has pockets of procyclicality in the face of large shocks to output or commodity prices. In particular, it has no direct mechanism for saving high-cycle mineral revenues. Although, part of the revenues windfalls is accumulated in the Fiscal Stabilization Fund (FEF), rigidities in its withdrawal rules have prevented it to function effectively as a macroeconomic stabilization fund (see Box 2).

5. **Coverage of the FRTL has not been applied consistently, either over time or across subsectors, hindering the transparency of the rule.** Expenditures caps have changed several times since the FRTL was introduced (see Box 1). Changes include not only the use of deflators and targets for real growth rates, but most importantly, the transactional coverage used to set the cap (i.e., from current to consumption expenditures). Moreover, the institutional coverage of the rule is not applied consistently across subsectors. While expenditure caps apply only to central government, the overall deficit limit covers the nonfinancial public sector. In addition, subnational governments are constrained by a different set of rules.

6. **The use of exceptional clauses has proved to be challenging in the past.** Although the FRTL includes an "exceptional clause", authorities have had difficulties in using it on a timely manner mainly due to imprecision in the specification of the circumstances activating the emergency. During the 2009 financial crisis, the conditions triggering the use of the clause comprised: negative real GDP growth for two consecutive quarters, and increase in international interest rates. None of these conditions materialized during the crisis, delaying the policy response that was finally implemented through an urgent decree.

7. **Finally, the implementation of the FRTL at the subnational level has been problematic, with high and increasing rates of non-compliance.** This has resulted in frequent changes in the parameters of the fiscal rules to accommodate the growing spending pressures at the subnational level, hindering predictability.

8. **Going forward, there is a case for Peru's fiscal policy to limit procyclical possibilities, include more countercyclicality in case of extreme shocks, while continue generating surpluses.** As a small open natural resource-exporting economy, Peru would benefit from a comprehensive fiscal framework which converts current windfalls into higher

government savings, so they could be available to cushion the economy when growth falters, prices fall, or mineral resources are exhausted. Moreover, a cautious fiscal policy stance is warranted given the need for ensuring faster progress to reduce poverty and inequality and minimizing the threats of contingent claims and natural disasters.

Box 1. Fiscal Responsibility and Transparency Law

Legal status of the rule. The “*Ley de Responsabilidad y Transparencia Fiscal*” (FRTL) was enacted in December 1999 as a permanent institutional device to promote fiscal discipline in a credible, predictable, and transparent manner. In 2003 the *Fiscal Management Responsibility Act*, supplemented the FRTL, with a clear objective of debt consolidation.

Rationale for the fiscal rule. The FRTL included a combination of a nominal deficit target and real current expenditure ceiling for the nonfinancial public sector and central government respectively, as well as debt ceilings for subnational governments. The main features of the Peruvian FRTL can be summarized as follows:

- The government must prepare the Multi-Annual Macroeconomic Framework (MMM) containing three-year macroeconomic projections of revenue, expenditure, public investment, and public debt.
- Numerical fiscal targets are embedded in the law (see Table below).
- Escape clauses allow deviations from numerical targets during periods of low growth.
- Cyclical considerations are taken into account by establishing fiscal stabilization funds to mitigate spending cyclical variations (see Box 2).

Historical compliance with the rule. The numerical targets have been changed over time, such as in 2003, 2007 and 2009. The following table summarizes the main changes introduced to the FRTL.

	Numerical Targets of the FRTL											
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 (*)	2010 (*)	2011
Main Numerical Rules 1/												
NFPS Overall Deficit (% GDP)	2.0	1.5	1.0	2.0	1.5	1.0	1.0	1.0	1.0	2.0	2.0	1.0
Gen. Gov. Current Exp. (% real change)	2.0	2.0	2.0	3.0	3.0	3.0	3.0					
Central Gov. Consumption (% real change) 2/								3.0	3.0	4.0	4.0	4.0
Execution												
NFPS Overall Deficit (% GDP)	3.3	2.2	2.5	1.7	1.0	0.3	-2.1	-3.1	-2.3	1.6	0.5	-2.2
Gen. Gov. Current Exp. (% real change)	4.7	-0.7	4.2	3.8	4.2	9.8	3.7	7.4	6.2	6.0	7.2	4.7
Central Gov. Consumption (% real change) 2/								-0.1	4.5	11.8	4.4	3.2
Central Gov. Consumption (% real change) 3/								-0.3	3.8	11.4	6.9	6.0

Sources: Fund staff estimates.

(*) Exceptional clause in application.

1/ Numerical rules for subnational governments are not included in this table.

2/ According to the national definition, consumption comprises spending on wages and salaries, goods and services, and pensions. Deflated by GDP deflator.

3/ Deflated by inflation target of BCRP (2 percent).

Ad-hoc response to 2009 global financial crisis. The impact of the 2008-09 global financial crisis was significant, which called for countercyclical monetary and fiscal policies. Escape clauses in the law were not applicable for this particular shock. However, the FRTL includes an exceptional escape clause that allows for a temporary relaxation of the targets with Congressional approval. The relaxation of the FRTL targets was approved in May 2009 for the following two years to allow a deficit of 2 percent of GDP.

Return to the rule in 2011. The rule became bidding since May 2011, even though additional rules for the subnational levels were simplified.

Box 2. Fiscal Stabilization Fund

The FRTL comprises a fiscal stabilization fund (FEF). Resources of the FEF include any fiscal surpluses generated by the Treasury, 10 percent of privatization proceeds, and 10 percent of concessional fees. These assets are deposited at the central bank or abroad but under similar management criteria as with international reserves. The FEF is subject to a cap of 4 percent of GDP, with any excess allocated to debt reduction. FEF resources may only be used when revenues are at least 0.3 percent of GDP lower than the average ratio of the last 3 years. However, no more than 40 percent of total funds can be used in a given year, except when the escape clauses contained in the LRTF (article 5) apply.

The FEF has worked de facto as a savings fund. It accumulated 1.4 percent of GDP (at end-2010). Its rules proved too stringent for it to be used for stabilization—mainly because two quarters of declining GDP are needed before funds can be used, and they are capped. As a result, funds that were not allocated to the FEF and those deposited were barely used. The FEF was not used for the fiscal stimulus package, mainly because discretion regarding the timing of inflows to the FEF allowed the government to apply the previous year Treasury surplus to the stimulus rather than transferring it to the FEF.

The authorities recapitalized the FEF at the beginning of 2011. The authorities added up to the fund US\$3.5 billion from a combination of the Treasury surplus at end-2010, 50 percent of central government bank balances, and proceeds arising from the bank account consolidation process being undertaken to improve coverage of the treasury single account. Taken together, the fund is expected to accumulate around US\$6 billion or 3.5 percent of GDP by end-2011.

B. Structural Guidance for Peru's Fiscal Policy

9. **The current fiscal framework could be enhanced by introducing a structural measure as a reference value or “guidance” for fiscal policy.** Structural measures could provide a useful policy anchor by helping the policy discussion by identifying its discretionary component. By purging nominal fiscal balances of the cyclical and abnormal commodity price components of taxation and spending, structural measures can be used to limit procyclicality. Albeit with some institutional differences, Chile's experience is particularly relevant, given its success in applying a structural rule, taking into account both the economic cycle and the copper cycle. By focusing on a structural measure “a la Chile”, pressures for potential tax changes—as the one observed in early 2011—could be contained. Similarly, a structurally-based fiscal framework could provide better guidance regarding the level of fiscal savings that should be targeted, both in terms of revenues and commodity price booms. Finally, a structurally-based fiscal framework would also facilitate coordination of monetary and fiscal policies.

10. **Yet, benefits of incorporating structural measures into policy discussion should be carefully evaluated relative to its implementation difficulties.** While structural measures are regularly used by international organizations and national institutions,

weaknesses in their implementation have been well documented. This reflects in part the relative complexity of the techniques used for the estimation of output gaps, long-term commodity prices, and budgetary elasticities, as well as the need of some judgment. To the extent that technical difficulties in the computation of these measures affect their accuracy and reliability, discussing them is warranted.

11. There are four main concerns in estimating structural fiscal balances:

(i) different methods for estimating structural measures can yield different results, particularly for the structural balance level; (ii) forecasts and outturns of structural measures can be subject, respectively, to large errors and to significant revisions, regardless of the specific method used; (iii) structural measures require strong institutions to implement them; and (iv) selecting the right timing for introducing a structurally-based fiscal framework is crucial for its success. These issues are discussed below.

Estimation methods

12. Main difficulties regarding methodologies arise from: (i) different techniques for estimating trend output and output gap produce different results; (ii) the same concern holds for commodity prices; and (iii) accurate estimation of budgetary elasticities is not always feasible given the information requirements.

13. There are various techniques available for computing potential or trend output. Although they can provide different estimates of output gap—and related structural measures—results obtained with different methods display strong short-term correlations, although the range level estimates is wide.² When output gap is very volatile or subject to structural breaks, this problem is likely to be more acute.

14. Estimation of long-term commodity prices is particularly challenging.

Commodity prices impact the budget directly through tax income revenues and royalties, as well as indirectly through their impact on output.³ However, adjusting nominal balances for deviations from current commodity prices to their benchmark levels requires a transparent and analytically sound methodology for assessing long-term trends in such prices. This has proved to be challenging.

15. Reliable estimates of budget elasticities can be data intensive. Elasticities are often estimated econometrically using macro variables. However, its accuracy depends on adequately controlling for discretionary policy, while it requires detailed institutional

² Orphanides and Van Norden, 2002.

³ In Peru, expenditures are also affected due to the *Fondo de Estabilizacion del Precio de Combustible*.

knowledge. In the absence of detailed information, the used of international benchmarks is a common practice.

Forecasting errors and data revisions

16. **Structural measures are affected by errors in calculating the unobserved trend output and commodity prices.** While forecasts for the actual nominal balance depend on estimates of actual GDP and commodity prices, forecasts for structural balances depend on estimates of trend GDP and commodity prices. Yet, it is impossible to say a priori which of the two estimates is subject to greater error, in which case, forecasts of structural measures would be as accurate as (or no more inaccurate than) forecast of corresponding nominal balances.

17. **Estimate revisions can significantly affect structural measures.** Revisions to past structural measures are influenced by the realization of new data; whereas, nominal balances are not. This is so since, estimates of trend output and commodity prices are usually some form of weighted averages of realized data and forecasts for a number of periods ahead. As time passes, subsequent computation of structural measures for a given period can give different results. This is a significant challenge in commodity price forecasts, as there may not be consensus on its long-term values.

18. **The impact of new data on changes in structural measures—i.e., fiscal impulse indicator—is less significant.** This is primarily because the revisions generally affect estimates for contiguous years in roughly similar manner, leaving the change in trend between years relatively unaffected. Thus, focusing on changes in structural measures (fiscal impulse) would reduce the risks of an imprecise estimation of the level of trend output and commodity prices.

Institutional requirements

19. **Structural fiscal frameworks require strong institutions.** This entails strong commitment to transparency, well-established policy credibility, and good governance structure and quality of institutions. All these elements are, in various degrees, present in Peru. Recent technical assistance has identified significant progress in most of these areas, and the authorities are working to improve further.⁴

⁴ These areas include: (i) the budgetary process; (ii) the financial management information system; and (iii) treasury management.

Timing issues

20. **Selecting the appropriate timing for introducing a structurally-based framework is crucial for its success.** Adopting a structural framework requires that important economic and institutional pre-conditions be met. Caution suggests that changes should preferably be introduced when macro stability is achieved, any significant fiscal stimulus from previous periods has been withdrawn, and the output gap is close to zero. According to staff estimates, Peru seems to have achieved most of such prerequisites.

21. **Care should be taken to avoid different interpretation of data.** Given the potential debate regarding some factors entailed in the computation of these measures, it is particularly important to have transparency in the estimation procedures. This is especially so when output and commodity prices volatility complicate the task of estimating long-term trends. The authorities have taken initial steps in this direction, incorporating in the MMM an estimation of the structural fiscal position. Yet, further efforts are needed to refine the methodology for the structural calculations, as well as to agree on a medium-term target.

C. Structural Balance Estimates for Peru

22. **There are three main structural balance estimates for Peru.** Both the Ministry of Economy and Finance (MEF) and the Central Reserve Bank of Peru (BCRP) disseminate their estimates of the structural fiscal position—albeit differences in the methodologies persist. Similarly, IMF uses structural measures to assess discretionary fiscal policy, which, in turn, differ from the official figures.

23. **This section aims at outlining main features of the different methodologies.** It is not intended to be an exhaustive analysis; instead, its purpose is to explore main methodological issues that may explain discrepancies in the results obtained by the MEF, BCRP, and IMF, with information collected so far.

Main Results

24. **Because any methodology has some analytical judgment, it is not surprising that the results differ.** Table 1 presents the three different estimations. Discrepancies observed for the 2003–2010 period are fully explained by differences in methodologies; whereas, discrepancies for the 2011–2013 period are also caused by different underlying projections of the fiscal stance.

25. **Discrepancies are marginal at the beginning of the sample period, but turn to be significant from 2006 onwards** (Figure 3). For example, while the methodology used by the IMF and the BCRP suggest that a structural surplus is achieved by 2006–07, the MEF still estimates a structural deficit of around 1 percent of GDP.

Figure 3. Overall and Structural Balance
(Nonfinancial Public Sector, in percent of GDP)

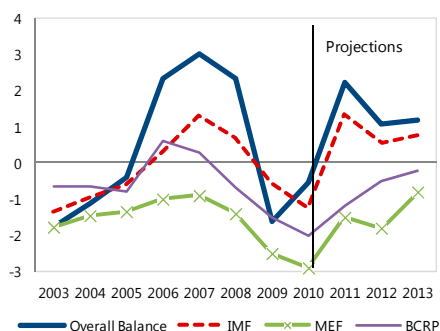
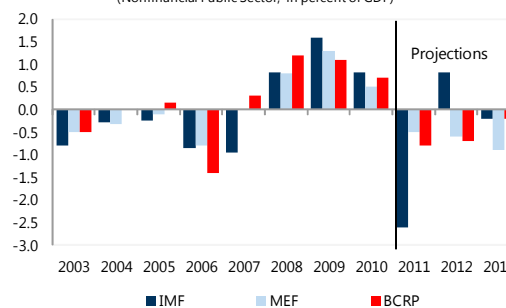


Figure 4. Fiscal Impulse
(Nonfinancial Public Sector, in percent of GDP)



26. **Discrepancies in terms of fiscal impulse are smaller** (Figure 4). As discussed in the previous section, focusing on changes in structural measures (fiscal impulse) reduces the risks of an imprecise estimation of the level of trend output and commodity prices. Yet, in 2011 results vary significantly, mainly due to differences in the underlying fiscal projections.

27. **The factors behind these discrepancies can be decomposed in three components:** (i) adjustment for the impact of the business cycle; (ii) adjustment for the impact of changes in commodity prices; and (iii) one-off adjustments. For illustrative purposes, we present below such decomposition for the staff estimates in Table 2.

Table 1. Comparison of Different Estimations of the Structural Balance
(Nonfinancial Public Sector, in percent of GDP)

Indicator	Agency	2003	2004	2005	2006	2007	2008	2009	2010	2011 1/	2012 1/	2013 1/
Overall Balance	IMF	-1.7	-1.1	-0.4	2.3	3.0	2.3	-1.6	-0.5	2.2	1.1	1.2
	MEF	-1.7	-1.1	-0.4	2.3	3.0	2.3	-1.6	-0.5	0.8	1.0	1.4
	BCRP	-1.7	-1.1	-0.4	2.3	3.0	2.3	-1.6	-0.5	1.0	1.2	1.4
Structural balance	IMF	-1.4	-1.0	-0.6	0.3	1.3	0.7	-0.5	-1.2	1.3	0.5	0.8
	MEF	-1.8	-1.5	-1.3	-1.0	-0.9	-1.4	-2.5	-2.9	-1.5	-1.8	-0.8
	BCRP	-0.7	-0.7	-0.8	0.6	0.3	-0.7	-1.5	-2.0	-1.2	-0.5	-0.2
Fiscal Impulse 2/	IMF	-0.8	-0.3	-0.2	-0.9	-1.0	0.8	1.6	0.8	-2.6	0.8	-0.2
	MEF	-0.5	-0.3	-0.1	-0.8	0.0	0.8	1.3	0.5	-0.5	-0.6	-0.9
	BCRP	-0.5	0.0	0.2	-1.4	0.3	1.2	1.1	0.7	-0.8	-0.7	-0.2

Sources: MEF, BCRP, and Fund's estimates.

1/ Projections.

2/ Change in the structural balance (+ expansionary)

Table 2. Staff Estimates of the Structural Balance

(Nonfinancial Public Sector, in percent of GDP)

Percent of GDP (unless otherwise stated)		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
A	Overall balance 1/	-1.7	-1.0	-0.3	2.1	3.1	2.3	-1.6	-0.5	2.2	1.1	1.2
B	Structural adjustments	-0.4	-0.1	0.3	1.8	1.8	1.6	-0.7	0.3	0.9	0.5	0.4
	Business cycle	-0.2	-0.3	-0.2	-0.1	0.3	0.9	-0.5	0.0	0.1	-0.1	0.0
	Commodity prices	-0.2	0.2	0.5	1.8	1.5	0.8	-0.2	0.3	0.7	0.6	0.4
C	Other adjustments	0.0	0.0	0.0	0.0	0.0	0.0	-0.4	0.4	0.0	0.0	0.0
	Accrued expenditures 2/	0.0	0.0	0.0	0.0	0.0	0.0	-0.4	0.4	0.0	0.0	0.0
A-B-C	Structural Overall Balance	-1.4	-1.0	-0.6	0.3	1.3	0.7	-0.5	-1.2	1.3	0.5	0.8
	Structural <i>primary</i> balance (% GDP)	0.8	1.1	1.3	2.2	3.1	2.2	0.8	-0.1	2.5	1.7	1.9
	Structural <i>primary</i> balance (% <i>potential</i> GDP)	0.8	1.1	1.3	2.2	3.2	2.3	0.8	-0.1	2.5	1.7	1.9
	Fiscal Impulse											
	Δ <i>primary</i> structural balance (% GDP) 3/	-0.8	-0.3	-0.2	-0.9	-1.0	0.8	1.6	0.8	-2.6	0.8	-0.2

Sources: Fund's estimates.

1/ Projections for 2011-2013

2/ Corresponds to advance accrual of expenditures in 2009 corresponding to 2010.

3/ + = expansionary.

Adjustment for the business cycle

28. **Adjusting for the business cycle entails the following steps:** (i) identifying the revenue base; (ii) estimating the elasticities; and (iii) estimating the output gap.

29. **The revenue base for the business cycle adjustment is the non-commodity related revenues for the nonfinancial public sector.** While theoretically the three methodologies use the same revenue base, in practice, differences exist. These differences derive from the definition of commodity-related revenues (see discussion below). None of the three methodologies adjusts spending for the impact of the business cycle.

30. **Assessing the impact of the business cycle requires the use of elasticities to output gap.** This can be achieved via an aggregated method (when elasticities are used to measure the sensitivity of total revenue and spending to the output gap), or via a disaggregated method (with elasticities specific to various revenue and spending components). For example, the BCRP estimates that the weighted average of the elasticities of the main revenue components is 1.09.⁵ The MEF uses a similar approach and arrives to similar results. IMF staff assumes revenue elasticity to output gap equal to one.⁶

⁵ BCRP, 2008. Elasticities are estimated econometrically for each main type of revenues of the general government.

⁶ Empirical evidence points to aggregated one-zero elasticity assumptions (for revenue and spending, respectively) as being a good approximation of the weighted average of disaggregated elasticity estimates (Girouard and Andre, 2005).

31. **Trend output estimates can take several forms.** Two main groups include: (i) statistical filters based on the properties of the GDP time serie; and (ii) a model-based approach. In measuring output gaps, the staff uses a simple statistical procedure (i.e., the Hodrick-Prescott filter). The MEF uses an average of several methods (Table 3). The BCRP uses a production-function approach assuming that the country's aggregate output can be modeled by a Cobb-Douglas function.⁷

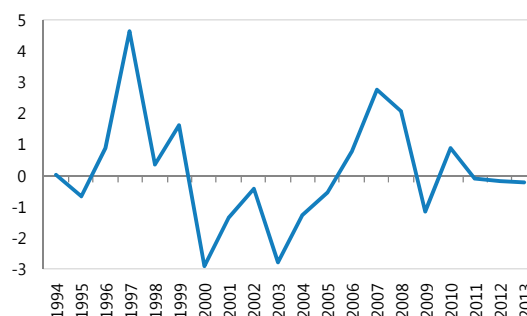
Table 3. Estimates of Potential GDP Growth
(Average real change)

Methodology	Average	
	1994-2002	2003-2011
Statistical Filters		
Baxter and King	3.9	6.3
Hodrick y Prescott	3.8	6.3
Cristiano y Fitzgerald	4.0	6.5
Kalman Univariado	3.8	6.5
Average	3.8	6.4
Model-based methods		
Kalman+Phillips curve	3.8	6.5
Production function	4.0	6.4
Average	3.9	6.4
Average	3.8	6.4

Sources: MEF estimates.

32. **There are differences on the estimates of potential growth.** The authorities use a potential GDP growth rate of 6.4 percent. This implies a considerable increase (twofold) relative to estimates for the period 1994–2002. While the MEF and the BCRP uses a potential growth rate of 6.4 percent, staff uses 6.0 percent. According to staff estimates, output gap would be close by end 2011 (Figure 5). Yet, the MEF and the BCRP estimates suggest that the output gap would be closed later, around 2013.

Figure 5. Output Gap
(In percent of potential GDP)



33. **The business cycle adjustment has been considerable in the last years.** According to staff estimates, the adjustment for the business cycle reaches its peak in 2008 and 2009 (0.9 and -0.5, respectively), both purging revenues from the impact of the economic boom and the subsequent global financial crisis, respectively (Table 2).

Adjustment for commodity prices

34. **Adjustments beyond the output gap are warranted when changes in commodity prices are significant, they have a temporary component, and they have a relevant impact in the overall balance.** Commodity prices could rise temporarily because of surges in global demand. If the fiscal revenue derived from these sources is significant, an adjustment is needed to determine the underlying fiscal position.

⁷ BCRP, 2008, Appendix 1.

35. **The revenue base for this adjustment comprises commodity-related revenues of the general government, which are significant and have been increasing.** Total revenues from the mining and oil sector are presented in Table 4. This includes both taxes and other revenues such as special contributions (i.e., canon) and royalties.

36. **There are differences in the revenue base used by each methodology.** The MEF and the IMF adjustment is based on total revenues from the mining and oil sectors (both taxes and other revenues)⁸; whereas the BCRP only adjusts income taxes and other revenues. Moreover, the BCRP's adjustment includes a correction to account for the fact that income taxes collected this year not only depend on current commodity prices, but also on prices of the previous year. This lag in revenue collection is not considered by the other two methodologies. In turn, these discrepancies have implications for the estimation of the adjustment for the business cycle, since non-commodity related revenues—the base for such adjustment—are calculated as residual.

37. **Elasticities of commodity-related revenues to the price gap are other sources of discrepancies between methodologies.** Following the same conservative approach as in the case of elasticities to output gap, staff assumes a unitary elasticity of revenues to changes in commodity prices. The MEF and the BCRP calculate such elasticity using econometric regressions that result in values significantly higher than one (e.g., close to 2 in the case of the BCRP).

38. **Identifying deviations of commodity prices from their “norm” is a critical but slippery input when estimating structural balances.** Standard filtering techniques used for arriving at the output gap may not be suitable for commodity prices. Given their high volatility, estimated trends may be influenced heavily by the sample chosen. Moreover, the fact that Peru exports multiple commodities (i.e., copper, gold, silver, zinc, lead, oil, among others) complicates the adjustment. In this regard, all three methodologies calculate a weighted commodity price index, based on the participation of each commodity in total commodity-related exports.

⁸ Source data corresponds to estimates of tax collections by sectors of the economy published by the SUNAT. These estimates comprise all taxes: income tax, VAT, excise taxes, etc.

Table 4. Commodity-related Revenues

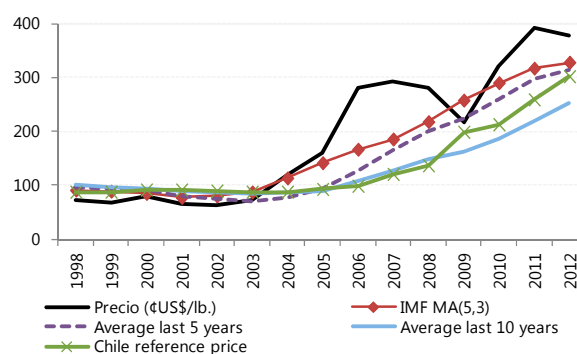
	2003	2004	2005	2006	2007	2008	2009	2010	2011
<i>(in % of GDP)</i>									
Commodity-related revenues	1.0	1.3	2.0	4.2	4.7	4.1	2.6	3.5	4.1
Taxes on mining and oil	0.8	1.2	1.7	3.2	3.8	3.0	1.8	2.5	2.8
Other revenues	0.2	0.2	0.3	1.0	0.9	1.1	0.8	1.0	1.3
<i>(in % of total revenues)</i>									
Commodity-related revenues	5.9	7.5	10.9	20.8	22.4	19.5	13.7	17.4	19.5
Taxes on mining and oil	4.6	6.5	9.2	15.8	18.2	14.4	9.4	12.4	13.2
Other revenues	1.2	0.9	1.6	5.0	4.2	5.0	4.3	4.9	6.3

Sources: MoF, Sunat, and Funds estimates.

39. **Alternatives approaches are used to estimate “benchmark” prices for relevant commodities.** Benchmarks can be estimated using past and future information on prices. For example, the IMF methodology estimates long-term prices of commodities using a moving average of 8 periods (5 backwards and 3 forwards). The projection for the 3 periods ahead corresponds to the WEO estimations for each commodity. If projections are adequate, this method incorporates valuable information to assess the structural position. However, because WEO uses future contracts as base for forecast, current prices may be overrepresented and significant updates can occur. An alternative is to use prices that prevailed in the recent past. In this vein, the MEF and the BCRP estimate long-term commodity prices using the average of the last 10 years.⁹ Finally, guidance on specific benchmarks may also exist from independent experts (e.g., Chile’s independent copper price board sets a benchmark level for the long-run price of copper).

40. **Results obtained for alternatives methods of estimating “benchmark” prices vary significantly.** Figure 6 illustrates different benchmarks for copper prices.¹⁰ For example, in 2011 the moving average of 8 years seems to be the most optimistic guess (based on WEO projections for 2012 to 2014)¹¹, followed by the moving average of the last 5 years, and the Chilean reference price. The moving average of the last ten years—the alternative used by the MEF and BCRP—seems to be the most conservative approach, when prices are abnormally high, thus

Figure 6. Alternative Benchmarks for Copper Prices



⁹ The BCRP used to estimate long-term commodity prices as the average of the last 20 years; while, the MEF used an average of the last 5 years. Recently, the two converged to an average of the last 10 years.

¹⁰ The same smoothing techniques are applied to the rest of export commodity prices.

¹¹ As of WEO estimates of September 2011.

resulting in a higher adjustment in revenues, and therefore a lower structural balance. This partially explains the different structural results between methodologies for 2011.

Other Adjustments

41. **In the case of Peru, the impact of changes in oil prices on the expenditures may also need to be taken into account.** The stabilization fund for the price of oil (i.e. *Fondo de Estabilización del Precio de Combustible*, FEPC) was introduced as a mechanism to smooth the impact of oil price volatility. When oil prices increase beyond a threshold, the authorities transfer resources from the budget to retail companies to compensate them for not being able to increase retail prices. On the contrary, when oil price goes below a threshold, retail companies should made transfers to the fund. Cash transfers to private companies—netted out of cash payments to public corporations—are recorded as government spending. The BCRP includes an adjustment for the impact of the FEPC on government spending (comprising accrued expenditures and not yet paid). Such concept accounted for adjustments to up 0.2 percentage points of GDP between 2007 and 2009, but has lost significance recently mainly due to the authorities efforts in aligning retail prices to international prices. Neither the MEF methodology, nor the IMF one incorporates such adjustment.

42. **Finally, large, non-recurrent fiscal operations may distort the analysis of the underlying fiscal position and should be excluded from structural balance estimates.** This adjustment should be carried out before proceeding to any form of adjustment to avoid biased elasticity estimates and ensure correct identification of the cyclical component. In the case of Peru, such an adjustment is related to accrued expenditures recorded in 2009 but that corresponds to 2010, which accounts for 0.4 percentage points of GDP (see Table 2). Both staff's and MEF's methodologies include this adjustment, while the BCRP's estimate of these transactions is smaller.

D. Main Challenges and Recommendations

43. **There is space to formalize a more robust fiscal framework.** While maintaining public finances on a sustainable path, fiscal policy could allow for further output smoothing and promote savings to cushion against adverse shocks and long-term risks.

44. **To achieve such objective the current fiscal framework could be strengthened** by: (i) incorporating discretionary changes in taxes within the framework; (ii) applying spending caps on a more consistent way, covering total primary spending of general government; and (iii) refining exceptional clauses to make them more clear and timely.

45. **While the authorities are already working on some of these areas, and improvements have been significant, further refinements could be considered.** Extending the coverage of the spending cap to total primary expenditures would add teeth to the rule, and seems a step in the right direction given the level achieved in capital spending. Similarly, extending the institutional coverage of the cap to general government would

improve spending control, even though its implementation may be politically challenging. Exceptional clauses could be enhanced by better specifying the extraordinary circumstances activating them to allow for a timely response. This could be achieved, for example, by better defining the conditions of an economic crisis looking forward, instead of the current backward looking version of the clause. Similarly, the type of shocks that would call for policy action could be clearly stated (e.g., a severe earthquake) together with their minimum related fiscal cost.

46. **In turn, there is a need to gradually introduce structural measures in the policy discussion as an additional instrument to help anchor medium-term fiscal policy.** This would help to avoid procyclicality by building up political support to target fiscal balances aligned with medium-term fiscal policy objectives. Yet, benefits of this approach should be carefully evaluated against implementation challenges.

47. **Structural measures should be calibrated with caution.** As discussed in previous sections, structural measures are sensitive to changes in main parameters and revisions of estimated trends of main macro variables. While differences in MEF, BCRP and IMF methodologies can be broadly justified and reconciled, there is scope for better understanding what these various methodologies do and how they can be refined and extended.

48. **To maximize their potential gains, structural measures should be introduced and used in a transparent way.** To prevent unnecessary debate regarding some factors entailed in the computation of these measures, it is particularly important to have transparency in estimation procedures. In this regard, there is a need to refining and harmonizing official estimates of the structural position of the public sector disseminated by the MEF and the BCRP. The authorities have taken steps in such direction.

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II. INSTITUTIONAL FRAMEWORK FOR MACROPRUDENTIAL POLICY¹

A. Introduction

1. **Embedding a macroprudential perspective into the policy framework is one of the lessons of the past global financial crisis.** The 2008–09 global financial crisis highlighted the potential force of financial and real sector interactions. Macroeconomic policies and micro prudential frameworks have limitations in identifying and managing systemic risk, as they may fail to identify or appropriately handle financial excesses or adverse shocks that pose a risk to the financial system and the economy as a whole. The challenge is how to set in place a broader framework of macroprudential policy to preserve financial stability through assessing and managing systemic risk early on and its potential amplifying effects in the financial sector. Macroprudential policy can be useful as a complement for macroeconomic policies, especially to lean against the wind and to deal with volatile capital inflows.²

2. **This chapter suggests ways to enhance coordination for the conduct of macroprudential policy in Peru, taking into account recent cross-country experiences.** In order to improve systemic risk oversight and monitoring, advanced and emerging market economies have been adopting financial stability responsibilities, usually through more structured frameworks that outline mandates and roles. A formalized institutional framework would facilitate the conduct of macroprudential policy to manage more effectively systemic risks, and enhance the role of macroprudential policy in the policy toolkit.

B. Conduct of Macroprudential Policy: Current Institutional Framework

3. **The Peruvian authorities have been very proactive in implementing macroprudential instruments to support financial and macroeconomic stability.** The central bank (BCRP) has used of reserve requirements to manage liquidity in the financial system, both during the up-and downturn, and as a complement to the conduct of monetary policy. The Superintendency of Banks (SBS) has implemented, among others, measures to help smooth pro-cyclicality of financial services (through dynamic provisioning since end-2008) and internalize FX credit risks (additional provisions and capital, limits to the FX derivative position); and analyzed interconnectedness of financial institutions. In July 2010, the SBS issued regulations to impose additional capital requirements taking into account the economic cycle and concentration risks.

¹ Prepared by M. Vera Martin (WHD).

² See IMF WP/11/159.

4. **In the current legal framework, financial stability objectives are not explicitly allocated, but implicitly established in the objectives of the different economic authorities.** Responsibility for financial stability is not explicitly assigned to any particular institution in the legal or regulatory frameworks, but it is clearly a collective goal for the financial authorities, including the BCRP, the SBS, and the Ministry of Economic and Finance (MEF). The BCRP has a clear involvement on financial stability issues through its mandate on ensuring monetary stability (see below), and more specifically the stability of the payment systems and as a lender of last resort. The SBS, the microprudential regulator, is responsible of the health of the financial institutions, and the stability of the financial sector as a whole. The role of the MEF in the conduct of macroprudential policy could be seen as more passive during normal times, while being clearly involved during crisis times, as decisions potentially have a fiscal cost.

5. **BCRP and SBS have clear roles in preserving financial stability.** Peru is clearly a case of “twin-peaks” in financial stability policy design. Both are constitutionally independent institutions with explicit mandates for preserving monetary stability and monitoring and supervising financial institutions, respectively.

- **BCRP.** The central bank’s objective is to preserve monetary stability (Constitution, Article 84). Its functions are to regulate currency and credit in the financial system, manage international reserves, issue currency and coins, and inform the country about financial conditions. In addition, the Central Bank Board is in charge of establishing, regulating and modifying reserve requirements of financial institutions and of the payment system (Organic Law, Article 24.c and d respectively).
- **SBS.** The Superintendence of Banks, Insurance and Private Pension Funds is in charge of the monitoring and supervising banking enterprises, insurance companies, and private pension funds, and other deposit-taking institutions as well as other companies that, because of interconnectedness or similar, are determined by law (Article 87 of the Constitution). In its supervisory responsibilities, the SBS has the objective of protecting the interests of the public in the sphere of the financial and insurance systems (Article 345 of the General Law of the Financial System and Private Pension Funds, and Organic Law for the Superintendence of Banking Sector and Insurance). Article 347 of the same law notes that the SBS is responsible of defending the interests of the public, safeguarding the economic and financial strength of the entities under its control.

6. **On prudential grounds, both institutions oversight the financial sector, providing relevant information to the public.** BCRP prepares a financial stability report on a bi-annual basis. The report discusses recent economic and financial developments, including a discussion of the challenges and risks ahead. The information is processed by the

central bank's financial sector unit, with limited participation of SBS' staff. The SBS publishes monthly bulletins on balance sheets, income statements and risk assessments (credit, liquidity, operational) of banking institutions, pension funds, microfinance institutions, and insurance companies. Recent efforts by the stock market regulator (Superintendencia de Mercado de Valores, SMV) to gather corporate sector financial information are valuable.

7. **An important shortcoming is that institutional coordination happens on a voluntary basis, with no specific institution with a clear mandate of analyzing systemic risk in the economy.** At the technical level, coordination is currently done through a voluntary consultative committee established in 2008 in light of the global financial crisis, with the participation of the MEF, SBS, and BCRP staff. Created as a “crisis” committee, the committee has evolved to discuss other issues that require inter-institutional coordination, and is not necessarily circumscribed to financial stability. The meetings—on a bi-weekly basis—from this committee are then followed up by a meeting at the highest level to discuss policy coordination. This setup—dependent on willingness—hinders establishing an overall macro-prudential perspective in the policy framework; and decisions seem to be made based on a piecemeal approach that could be prone to delays in policy action. The committee has no mandate for financial stability and therefore lacks accountability.

8. **The institutional setup could be enhanced to facilitate information sharing, analysis of systemic risks in the economy, and facilitate actions and accountability.** Challenges lie ahead in designing macroprudential policy with a broad and systematic perspective to ensure an integrated evaluation of financial and economic vulnerabilities and sufficient oversight of systemic risks, and prevent delays in implementing new measures. It would also facilitate the integration of macroprudential policies in the policy toolkit, and enhance its complementary role with macroeconomic and microprudential policies. At a more operational level, information sharing could be enhanced to facilitate a better understanding of risks, and feedback loops between the financial and real sectors of the economy—with the aim of better managing plausible sources of systemic risk (that could rise outside the regulated financial system). In this context, efforts to enhance understanding of a detailed balance sheet of the economy with expanded sectoral analysis will be very helpful to assess interconnectedness, maturity mismatches and FX risks in the context of a still dollarized economy.³

C. Recent International Experience in Enhancing Institutional Frameworks

9. **Since the 2008–09 global financial crisis, a number of countries have reviewed their institutional frameworks for financial stability to develop the macroprudential policy function.** Keeping in mind that no universal recipe for the institutional setup exists, as

³ For example, see IMF Working Paper (WP) 06/5 for a detailed balance sheet analysis for [Colombia](#).

country specific features need to be accounted for, the effort to enhance preventive action is strongly recommended. Given the incipient experience, the discussion about the institutional framework for macroprudential policy is mostly kept at the conceptual level and hinders any empirical assessment about effectiveness.

10. **Efforts have been diverse in scope, from setting up dedicated committees to the elimination of the institutional boundaries between the central bank and the financial regulatory agencies.** Nier et al. (IMF, 2011) summarizes recent trends, noting that institutional arrangements are shaped by country-specific circumstances, including the initial legal framework, the culture of coordination, and the need for accountability.⁴ The authors identify seven models according to the degree of institutional integration of central bank and supervisory agencies, the ownership of the macroprudential mandate; the role of the treasury; the separation of policy decisions and control over instruments; and the existence of a separate body coordinating across policies (see Table). Peru, together with Iceland and Switzerland, is reported as having the least institutional integration between the central bank and the financial regulatory functions; with multiple agencies sharing the macroprudential mandate and no active role for the treasury in macroprudential policy.

11. **Central banks are always represented and often play a leading role.** This reflects its experience and expertise in the assessment of macroeconomic and financial developments, available resources, as well as their role in ensuring the stability of the payment systems and being lenders of last resort. The spectrum of responsibilities varies depending on the institutional arrangements, going from the central bank having clear responsibilities for both macroprudential and microprudential policy (in Malaysia and the U.K.) to account for a large share of the votes in the committee (as in the European Systemic Risk Board (ESRB) in the European Union and the financial stability council in Mexico) (Box 1). In the US, the Fed is one of the 10 voting members of the FSOC but is in charge of the regulation of the systemically important banks and non-banks, as designated by the Financial Stability Oversight Council (FSOC).

12. **Powers to communicate risk warnings and to recommend the adjustment of regulatory instruments are common in existing and emerging frameworks.** Examples include the ability to issue non-binding recommendations to other authorities—as established for the ESRB, the financial policy committee (FPC) in the United Kingdom, and the FSOC in the United States. Recommendations are often subject to a “comply or explain” mechanism; sometimes strengthen with the ability to publish recommendations.

13. **Powers to set and adjust instruments directly are most common where the macroprudential mandate and control over the instruments fall under the same authority.** This is also the case when a central bank serves also as financial supervisor.

⁴ See IMF (2011a, 2011b).

Mechanisms to assign specific instruments to a new macroprudential body are also being developed in some cases but remain less common. For example, the new U.K. arrangement envisages the FPC being able to issue binding directions on specific macroprudential instruments.⁵ Where responsibility for the operation of the new macroprudential tools remains ill-defined, clear assignments are needed.

14. **One principal design challenge is to establish accountability in the absence of an easily-measurable metric of success.** The challenge is often compounded by the presence of multiple agencies in macroprudential policy-making that may differ in their primary objective and/or other views. Transparency and clear communication of policy decisions to the public are central elements of accountability. This is a strategy that could be expanded by including ex-ante statements of strategy, publication of records of meetings, and annual performance statements with an ex post assessment of policy effectiveness. In some cases, accountability is also done to Parliament. The EU establishes accountability for the ESRB to the European Parliament. In the U.K., the FPC's Financial Stability Report will be laid before Parliament. The U.S. structure combines both strong reporting requirements to Congress and FSOC's members' obligation to individually attest that they believe that the proper actions are being taken to support financial stability.

⁵ The draft legislation calls for the Financial Services Authority to be dismantled and a new subsidiary of the Bank, called the Prudential Regulatory Authority, to be created to supervise banks and insurers. The Bank would also get a new body, the Financial Policy Committee that would be charged with identifying and reducing looming threats to financial stability. The governor would be expected to chair the FPC and the board of the new PRA, in addition to his traditional duties as head of the Bank and the monetary policy committee.

Box 1. From Coordination to a Fully Integrated Macroprudential Framework

Mexico: Enhancing Coordination

Mexico's newly created financial stability council is a consultative committee responsible for the assessment, analysis, and institutional coordination in financial stability issues.

Objective. Promote financial stability, avoiding disruptions in the functioning of the financial system, and when those occur, minimize its impact. The committee is in charge of identifying conditions that could risk the adequate functioning of the financial system and the country's economic development, as well as proposing policies and solutions to face such situations. The committee is required to respect independence of each of its institutional members.

Functions. (i) identify potential risks to financial stability and recommend and coordinate policies, measures or actions that must be undertaken by the institutions that are represented in the committee; (ii) consultative organ for the Executive in topics related to financial stability; (iii) prepare an annual report of financial stability, incorporating the diagnosis, and activities undertaken by the committee; and (iv) other actions required to reach objectives.

Structure. The Council is led by finance minister, and its other members are deputy finance minister, Bank of Mexico governor, three central bank deputy governors, as well as the heads of securities and banking regulator CNBV, insurance regulator CNSF, pension regulator CONSAR, and deposit insurance agency IPAB. With quarterly regular meetings, the committee could invite individuals from public and private institutions (under confidentiality agreements).

The committee is supported by a **technical committee**, responsible for proposals and recommendations in issues of financial stability or crisis resolution. For that purpose, the technical committee would gather all economic and financial information required for the analysis and assessment of financial stability.

The council created **four working groups** (i) to standardize and gather information on relevant issues related to monitoring financial stability; (ii) to establish a framework to identify financial vulnerability; (iii) to design the metrics and methodologies for systemic risk measurement; and (iv) to ensure that financial market participants access sufficient and relevant information for decision making, as well as to elaborate the annual report on financial sector stability.

United Kingdom: Toward An Integrated System

The 2009 Banking Act gives the Bank of England (BoE) a statutory financial stability objective, and creates a new **Financial Stability Committee** to advise on and monitor the nature and implementation of the Bank's financial stability strategy. The BoE becomes responsible for microprudential and macroprudential regulation, to avoid gaps in responsibilities and regulatory powers. This architecture ensures that macro-prudential regulation is coordinated effectively with the prudential regulation of individual firms.

A new **Financial Policy Committee** (FPC) in the Bank of England will control macro-prudential tools to ensure that systemic risks to financial stability are dealt with.

Structure. The majority of the FPC's members will be BoE executives, to bring the expertise and understanding of the financial system that only a central bank can provide. The governor and current Deputy Governors for financial stability and monetary policy will be joined by a new Deputy Governor for prudential regulation, as well as two other BoE executives. The FPC will also include external members to ensure a wider perspective—including from other regulatory bodies and from the markets themselves.

Accountability. The FPC will be a transparent and accountable institution, with appropriate lines of accountability into the Court of Directors of the Bank of England and the Treasury, as well as broader accountability to Parliament.

A new subsidiary of the Bank of England—the **Prudential Regulation Authority** (PRA)—will be responsible for prudential regulation of all deposit-taking institutions, insurers and investment banks.

Structure. The PRA will have a board chaired by the Governor of the Bank, and a chief executive who will also be the newly created Deputy Governor for prudential regulation.

Coordination with FPC. The FPC will be able, within the remit of macro-prudential policy, to require the PRA to take regulatory action with respect to all firms. The FPC may also suggest amendments to rules to make the system more resilient, and the FPC could have similar macro-prudential controls over the new consumer protection and markets authority (CPMA) in the context of macroprudential tools.

D. Moving Forward: Adapting the Institutional Framework in Peru

Some General Considerations

15. **Governance structures for macroprudential policy should ensure an alignment of goals, instruments and know-how as well as operational autonomy from the government.** Mandates should be realistic and avoid of false sense of precision, given difficulties to underpin systemic risk. Control over instruments should be commensurate with those of mandates, in order the enhance accountability. And given the especially long lag between the build-up of systemic risk and its materialization and the political economy of economic booms, the operational autonomy from the government is important. In this regard, clearly distinguishing the set up for macroprudential policy and that of crisis management can reduce the need for strong treasury involvement.

16. **A formalized institutional setup would facilitate monitoring systemic risks more effectively, design better macroprudential policies in response to evolving financial vulnerabilities, and enhance analysis and coordination across institutions.** As a starting point, enhancing information sharing would facilitate a better and common understanding of systemic macro-financial linkages. But also it will be important to adopt a more robust institutional mechanism (see below) to ensure a methodical approach to the analysis of systemic risks in the Peruvian economy; which should go beyond financial sector surveillance, and include potential financial activities our for the purview of regulations and other plausible sources of systemic risks.

17. **Different configurations for the assignment of the macroprudential policy function among agencies would call for different governance arrangements.** These will differ on the decision-making, autonomy and accountability arrangements. The range of the institutional framework for macroprudential policy could be then be seen as a shared responsibility across agencies; reside on a separate macroprudential agency with decentralized implementation; or as a sole responsibility of the central bank (with a separate microprudential regulator or not).

18. **An institutional arrangement for macroprudential policymaking should strive to be conducive to effective mitigation of systemic risk.** This involves having a clear objective; providing incentives and tools for authorities to act timely with that objective; supporting accountability and transparency of decisions; and ensuring effective coordination across policy areas that have a bearing on financial stability. The authorities will need to take into consideration that the analysis that underlies macroprudential policy shares characteristic with analysis used for microprudential policy (to understand the risks of systemically important institutions, for example), and for monetary and fiscal policy (to understand the implications of different financial structures). Some aspects of the analytical underpinning for macroprudential policy however are also specific to the task, such as issues of financial interconnectedness.

Enhancing Coordination

19. **Given the current legal framework, a possible step would be to form a macroprudential or financial stability council.** The council will institutionalize the current informal setting, going beyond individuals' willingness to coordinate; and fits with the structure of having multiple bodies with a financial stability mandate (Box 2). A financial stability committee should go beyond its "key person" and voluntary nature, as well as extend its mandate across the political cycle, without jeopardizing the operational autonomy and independence of each agency. A key step will be to recognize financial stability coordination as its sole mandate. Given that decision making powers would be distributed among several agencies and have no control over instruments, the council will help coordinating several agencies—the central bank, the microprudential regulator, the securities market regulator, and the ministry of finance—in the design of macroprudential policy. Instruments control would remain.

20. **The council would help the authorities raise awareness about potential risks, facilitate consensus building on the appropriate policy mix, and identify overlaps and gaps in monitoring vulnerabilities.** The committee will be the venue for joint analysis and peer pressure. In addition, the committee would have the advantage to overview the potential for regulatory arbitrage, helping to identify the most appropriate tools. Europe and the United States have adopted a peer review and recommendation approach, so that the members of the council retain autonomy over their sphere of responsibility. In those instances, in order to make the council operational and form the basis for effective coordination while respecting the agencies' autonomy, recommendations are hardened through a "comply-or-explain" obligation on the recipient of the recommendation; which could ultimately be made public.

21. **While helpful at enhancing coordination, this proposed financial stability council presents some shortcomings.** The council will not have an explicit mandate on financial stability issues nor control over instruments, which could result in a lack of accountability and delays in action as the council would not have powers to direct members' actions. Despite difficulties defining specific objectives for financial stability, clarifying mandates and the articulation of a financial stability policy could help enhance financial surveillance. In search for an operational definition of financial stability, countries have considered defining it in terms of preconditions (New Zealand), in terms of outcomes—either the absence of the negative or smooth functioning (India), in terms of robustness to shocks (Norway); or in terms of a multidimensional objective (Deutsche Bundesbank, United Kingdom).⁶

⁶ For details, see Box 1 of the Ingves report (BIS, 2011).

Box 2. Peru: Proposed Terms of Reference for a Financial Stability Council

Objective/Mandate. Surveillance of systemic risk, oversight for the stability of the financial system as a whole. The committee could clarify the responsibility of financial stability in the current regulatory framework and be in charge of the coordinated design of macro-prudential policies over the medium term. Earlier crises have shown that there is a need not to only “do more of the same,” but new questions and challenges are constantly emerging.

Responsibilities. (i) monitoring systemic risk in the economy, by analyzing the pro-cyclicality of financial services and interconnectedness in the economy as a whole; (ii) identify vulnerabilities that could pose systemic risks; (iii) monitor changes in the condition of sectoral balance sheets (including corporates and households), and developments in credit and asset markets, all of which have the potential to affect the level and distribution of systemic risk within the economy; (iv) design early warning systems for systemic risk, and incorporate economy-wide stress testing analysis; (v) effectively coordinate macroprudential policy with macroeconomic and micro-prudential policies; and (vii) determine new data requirements for the analysis of systemic risks, while serving as a forum for information and data sharing among institutions.

Nature and Structure: Consultative (non-executive) committee—with representatives at the highest level (akin to the Monday Committee, members being the Finance Minister, BCRP President, SBS’s Superintendent, and the President of stock market regulator (SMV)). The committee is to be supported by a technical committee (akin to the “Friday Committee,” done on a bi-weekly basis). Recommendations are to be considered and eventually implemented by the competent institutions.

22. **Information and analytic expertise relevant to macroprudential policy should be readily available to the macroprudential structure.** When information is already collected through reporting channels (regulatory returns, on-site examinations, or information from payment systems), the framework could govern the access rights for the macroprudential authority. Ideally, the arrangements for sharing information are often complex, since they involve confidential and market sensitive information, but clear memoranda of understandings should facilitate cooperation among the different agencies. The council should also have the power to request information directly from private firms when relevant information is not readily available to the macroprudential authority through other means (e.g. FX exposures of corporate).

23. **While this chapter does not explore the legalities to follow; the stronger the legal framework that establishes the coordinating committee, the stronger its institutional setup.** In the case of Mexico, an executive order established the Financial Stability Committee. The FSOC in the U.S.—established by Title I of the Dodd–Frank Wall Street Reform and Consumer Protection Act—was signed into law by President Barack Obama on July 21, 2010. In Australia, the Council of Financial Regulators is the coordinating body for the main financial regulatory agencies. Its setup is as an informal body and provides a flexible, low-cost approach to co-ordination among the main financial regulatory agencies.

The Council is non-statutory and has no regulatory functions separate from those of its members.⁷

24. **The central bank should play a prominent role in the financial stability council because of its role on price stability and as a lender of last resort.** Financial stability can affect the macroeconomic environment, with consequences for economic activity, price stability and the monetary policy transmission mechanism. Central banks are the ultimate source of liquidity for the economy, and an appropriate liquidity provision is also crucial for financial stability. The performance of the monetary policy functions provide the central bank with a macroeconomic focus and an understanding of financial market functioning and infrastructures that are required for macroprudential policy. Placing the monitoring and management of systemic risks at the central bank will benefit the analysis from important synergies, given the central banks' comparative advantage in understanding feedback loops between the financial sector and the real economy. Safeguards however need to be in place to ensure the autonomy of the central bank in the conduct of monetary policy.

25. **The participation of the MEF in the financial stability council needs to be safeguarded to avoid pressures from the political cycle.** MEF's involvement in the council reflects the role of the ministry in crisis resolution, given its responsibility on the use of public funds—so they need to have a role in the preamble of designing prudential policy. Finance ministries are often involved in setting objectives and priorities for macroprudential policy, and have an important role if changes in legislation are expected to be needed to mitigate systemic risk, for instance with respect to expanding the perimeter of regulation. However, mechanisms to isolate the macroprudential policy framework from pressures linked to the political cycle are important; especially because of the asymmetry between the visibility and time profile of costs and benefits of macroprudential policy. The costs of macroprudential measures (restrictions on certain activities) are felt immediately while benefits (lower incidence of financial stress) accrue over the longer-term and are hard to measure.

26. **The SBS brings the expertise of the microprudential regulator, with a clear advantage about instruments' design and interconnectedness—the cross-sectional dimension of systemic risks.** While analysis and decision-making can be centralized in a council, implementation may not. Separate macroprudential policy instruments do not exist in significant scale or reach; and implementation must use instruments primarily assigned to

⁷ In September 2008, the Council members released a joint Memorandum of Understanding (MOU) dealing specifically with financial crisis management arrangements. The MOU builds on the co-operative arrangements that have been in place for a number of years and which have been set out in bilateral Memoranda of Understanding signed between various members of the Council. They also establish regular bilateral co-ordination arrangements that aim, among other things, to ensure close consultation and to avoid overlaps and gaps in regulatory coverage. See <http://www.rba.gov.au/fin-stability/reg-framework/cfr.html> for details.

other policy objectives. In this regard, the settings for the relevant microprudential instruments can be supplemented by an additional macroprudential overlay; and the SBS has control over numerous instruments. For example, the SBS has worked on interconnectedness and recent measures requesting additional capital requirements take into account this element (via concentration risks and size).

27. **SMV's involvement is more related to structural aspects of macroprudential policy.** Many of the tools deployed by securities market regulators (product disclosure, settlement arrangements, and market access rights, for example) are likely to be relevant to macro financial stability policy objectives. Further, securities market often span the regulatory perimeter, while the corporate sector can also become a source of systemic risk, as Brazil and Mexico experienced in the wake of the 2008–09 financial crisis.

E. Conclusions

28. **Formalizing an institutional setup for the macroprudential policy in Peru could enhance the systematic analysis of systemic risks in the economy, and facilitate information sharing, actions and accountability.** While Peru has been at the forefront on the implementation of macroprudential instruments, the institutional framework is relatively informal and involves independent institutions with a general mandate for financial stability. The setup lacks clear mandates on macroprudential policy, and could be prone to inaction. A financial stability council could facilitate the integration of macroprudential policies in the policy toolkit, and enhance its complementary role with macroeconomic and microprudential policies.

29. **A council could help the authorities form a consolidated appreciation of risks, foster consensus on the appropriate policy mix, and identify and monitor vulnerabilities.** The council could also help the authorities identify overlaps and gaps in monitoring vulnerabilities. Information and analytic expertise relevant to macroprudential policy should be readily available to the macroprudential structure. The central bank needs to play a prominent role in the financial stability council because of its central role on price stability and as a lender of last resort. The participation of the Ministry of Economy and Finance in the financial stability council would need to be protected to avoid pressures from the political cycle.

Table 1. Stylized Institutional Models for Macroprudential Policy

Features of the Model/Model	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model R 1
1. Institutional integration of central bank and supervisory agencies	Full (at a central bank)	Partial	Partial	Partial	No	No (Partial*)	No	No
2. Ownership of macroprudential policy mandate	Central bank	Committee "related" to central bank	Independent committee	Central bank	Multiple agencies	Multiple agencies	Multiple agencies	Committee (multinational; regional)
3. Role of MoF/ treasury/government.	No (Active*)	Passive	Active	No	Passive	Active	No	Passive (European Commission; Economic and Financial Committee)
4. Separation of policy decisions and control over instruments	No	In some areas	Yes	In some areas	No	No	No	Yes
5. Existence of separate body coordinating across policies	No	No	No (Yes*)	No	Yes	Yes (de facto**)	No	No
<i>Examples of specific model countries/ regions</i>	<i>Czech Republic Ireland (new) Singapore*</i>	<i>Malaysia Romania Thailand United Kingdom (new)</i>	<i>Brazil* France United States</i>	<i>Belgium (new) The Netherlands Serbia</i>	<i>Australia</i>	<i>Canada Chile Hong Kong SAR* Korea** Lebanon Mexico</i>	<i>Iceland Peru Switzerland</i>	<i>EU (ESRB)</i>

Source: Neir et al. (2011)

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III. ADVANCES AND CHALLENGES IN SOCIAL POLICIES¹

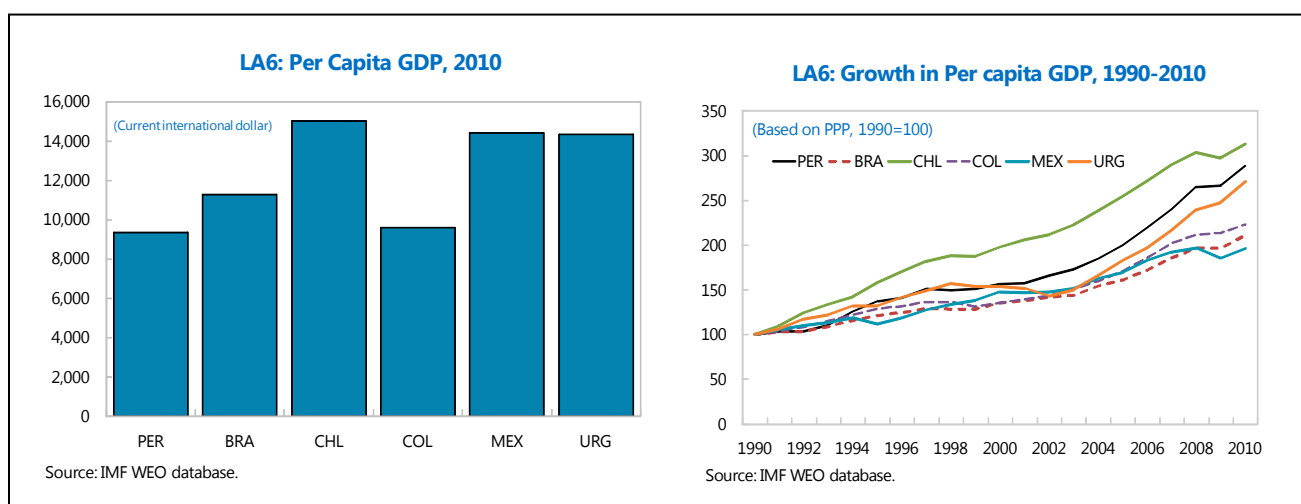
A. Introduction

1. **Peru's solid economic performance in the past ten years lead to significant poverty alleviation and improvements in income equality, but some challenges remain.** Rapid income growth and employment creation facilitated strong social outcomes in the last decade. However, despite the substantial progress, there are still important gaps to be closed, particularly in further reducing intra-country social disparities, enhancing the efficiency of social spending through better targeted social programs, and raising more resources to increase social expenditure.

2. **This chapter reviews progress as measured by different social indicators in Peru, compare them with its regional's peer and examines the policy challenges in achieving more social inclusive growth.** Section B reviews the performance of Peru's key social indicators, in comparisons with other emerging market economies in Latin America and other peer countries. Section C reviews Peru's key challenges in further reducing intra-country or regional disparities in poverty level and meeting basic needs. A snapshot of public social expenditure in Peru is presented in Section D. Section E summarizes the authorities' recently announced priorities and action plans to achieve key social target by 2016 and highlights the efforts needed to increase the size and efficiency of social expenditure inputs. Section F provides some conclusions.

B. Peru's Performance in Social Indicators—Some Comparisons²

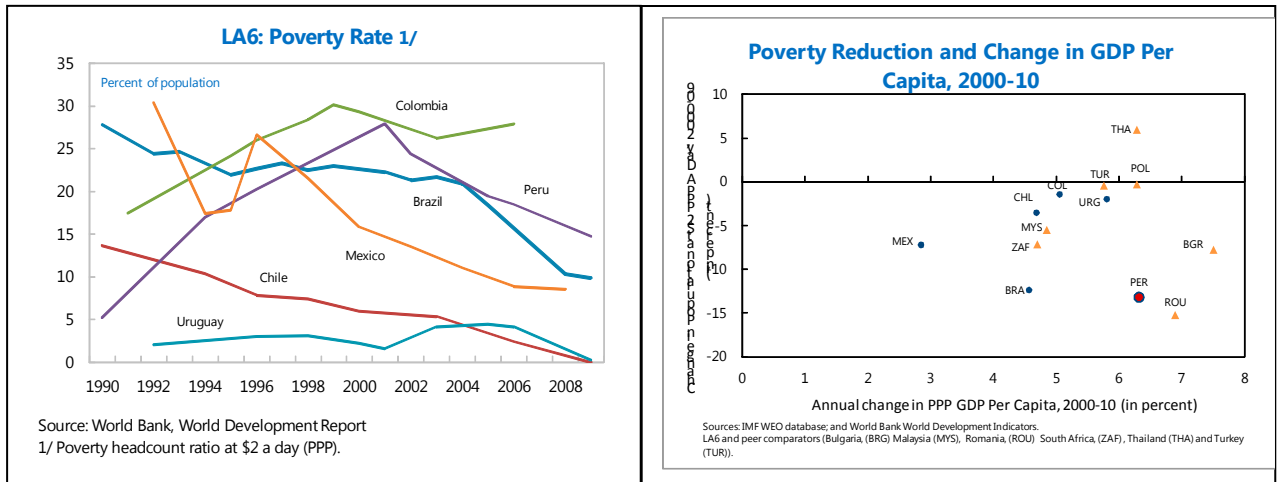
3. **Growth and macro-stability in the past ten years have contributed to a significant reduction in poverty.** Peru's economic growth has been one of the strongest among the LA6 countries in the region, with PPP GDP per capita expanding on average 6½



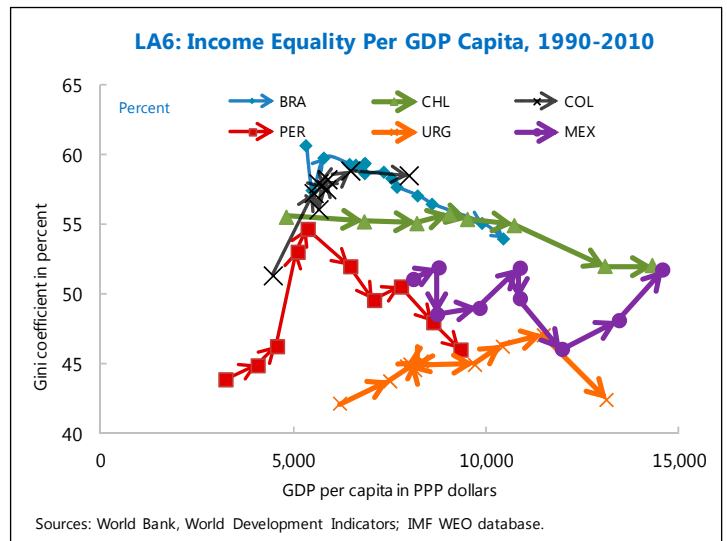
¹ Prepared by Yu Ching Wong (WHD).

² For cross-country comparison of Peru with other LA6, social indicators data from the World Bank and UNDP are used.

percent 2001–10. Against this background, poverty in Peru, as measured by the international benchmark of the share of population at \$2 (PPP) per day, was reduced by half during 2001–09. This largely reversed a large increase in poverty during 1990–2000—as poverty reduction was slow in response to economic expansion in the 1990s and poverty increased in the wake of the Asian crisis which affected Peru. Among the LA6 economies, Peru’s poverty levels are below that Colombia, but above those of other LA6 based on a \$2 (PPP) per day poverty line.

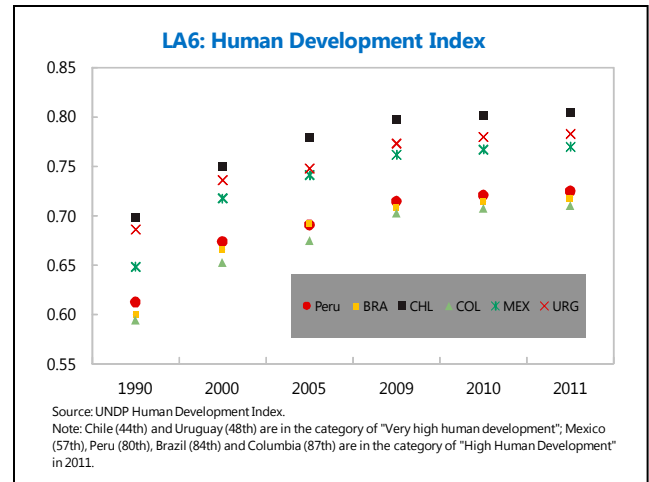


4. **Peru has also achieved important progress in reducing income inequalities.** Income inequality declined steadily as per capita income rose with the Gini coefficient declining to 46 percent in 2010, representing an improvement of 12 percentage points for the period 2001–10. Peru ranks the second lowest among LA6 in the measure of income inequality by the Gini coefficient, although Latin American countries are among the more unequal in the world.³



³ Peru ranks 27th in income inequality out of 129 countries with data on the Gini coefficient. In fact, for the top 55 countries with the highest income inequality, 22 are countries from the Latin America and Caribbean region (UNDP (2011)).

5. **Strong improvements are also observed in the performance of a large number of key social indicators.** Peru has made steady progress in human development. It ranked 80th out of a total 187 countries (43th percentile) in the Human Development Index (HDI) in 2011, classifying it within the second highest category. In terms of relative ranking, the latest score represents a slight improvement compared to its relative performance in 2005 (46th percentile) but on par with that in 2000 (43th percentile). Peru's performance of other social indicators, especially health and education, are also comparable to LA6 countries and other countries in the upper income category (Figure 1). For instance, Peru achieved impressive progress in reducing infant mortality, by about half to 15 per thousand live births in 2010 from 2000. However, Peru has still rooms for improvements compared to other LA6 countries in terms of access to improved rural water sources (only available to 61 percent of rural population), and adult literacy rates (Figure 1). Secondary and tertiary education enrollments are not particularly low when compared with other countries but progress in the last decade has been slow.



C. Intra-Country Disparities

6. **Peru has much room for improving gender inequalities.** Peru ranked 72 out of a total of 146 countries (49th percentile) in 2011 in the human development gender inequality index—a composite measure reflecting inequality in achievements between women and men in reproductive health, empowerment and the labor market. In particular, Peru's maternal mortality rate at 98 per 100,000 live births is the highest among LA6. Also, only 83 percent of child-birth is attended by skilled health personnel in Peru, the lowest among LA6 (Figure 2).⁴

⁴ In fact, Peru ranked the sixth lowest (Haiti 26 percent, Honduras 67 percent, Bolivia 71 percent, Nicaragua 74 percent, and Paraguay 82 percent) among countries in Latin America and the Caribbean.

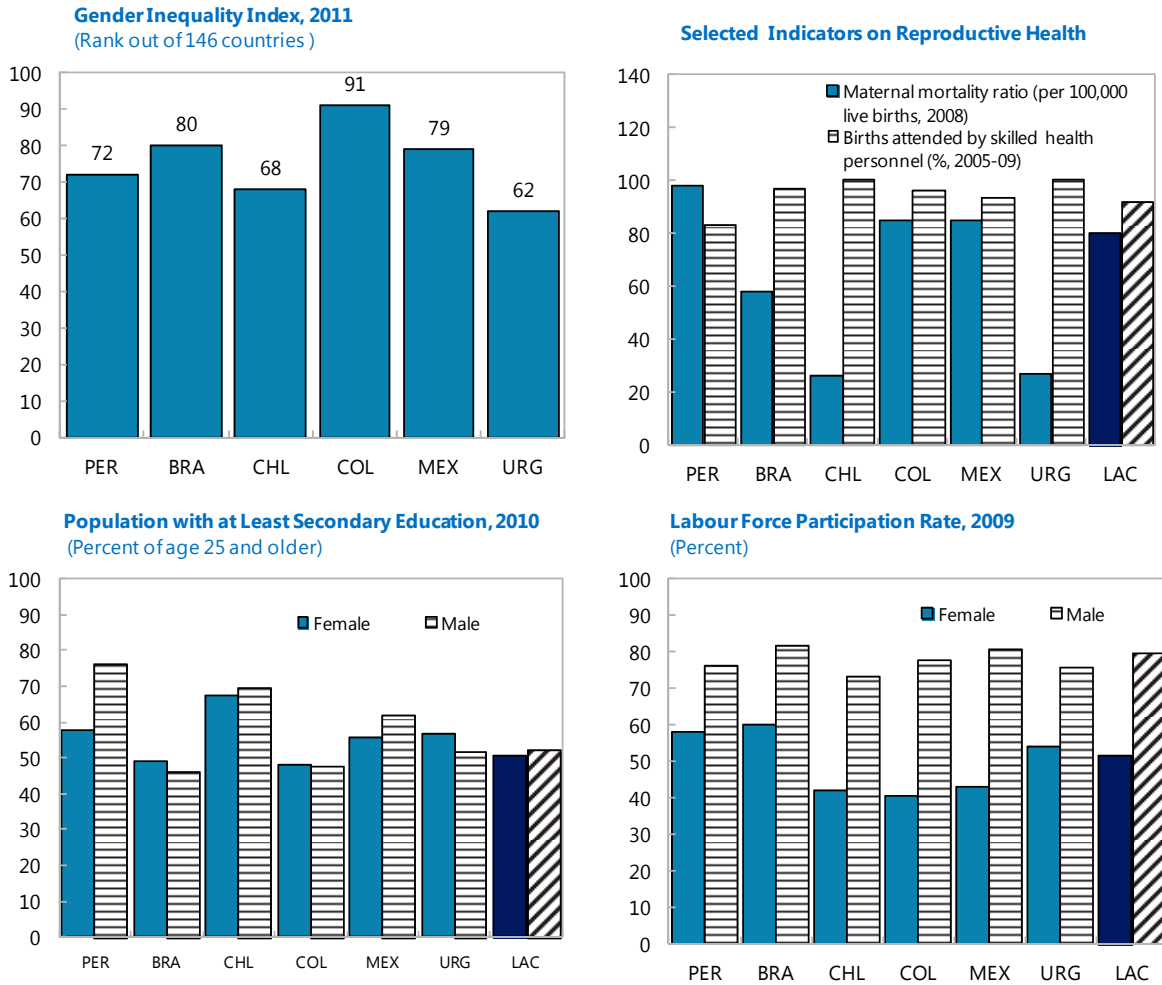
Figure 1. Selected Social Indicators



Source: World Bank World Development Index database.

Notes: PER: Peru, BRA: Brazil; CHL: Chile; COL: Columbia; URG: Uruguay; and UMC: Upper-middle income countries. Economies are divided among income groups according to 2010 GNI per capita, calculated using the World Bank Atlas method: low income (LIC), \$1,005 or less; lower middle income (LMC), \$1,006–\$3,975; upper middle income (UMC), \$3,976–\$12,275; and high income, \$12,276 or more.

Figure 2. Selected Gender Inequality Indicators



Source: UNDP *Human Development Report 2011*.

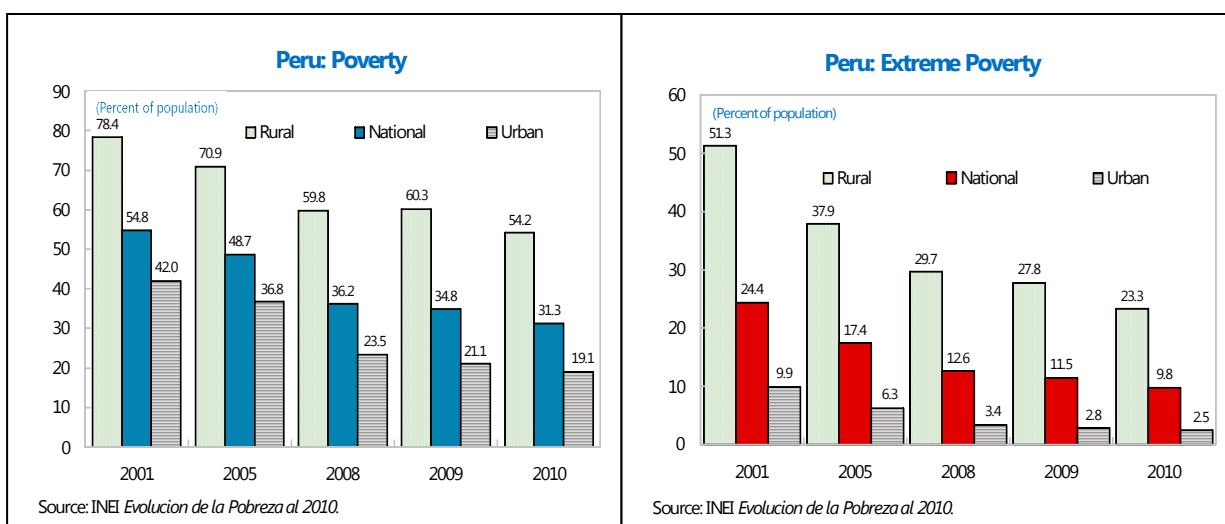
Notes: Gender Inequality Index: A composite measure reflecting inequality in achievements between women and men in three dimensions: reproductive health, empowerment and the labour market.

LAC: Latin America and the Caribbean.

7. **Reducing wide spread rural poverty remains a major policy challenge.** Rural population accounts for a third of Peru's total population but 60.2 percent of the poor are concentrated in the rural areas in 2010.⁵ There are 5.6 million poor in the rural areas, of which 2.5 million are extremely poor.⁶ While one in ten of the national population fell below the extreme poverty line in 2010, close to a quarter of Peruvians in rural areas were still living in extreme poverty compared to less than 3 percent of the population in urban areas. By geographical distribution, 55.1 percent of the poor are concentrated in the highlands (*Sierra*), followed by coastal areas 29.2 percent and forest (*Selva*) 15.7 percent in 2010. In 2010, 14 out of the 24 regions/departments recorded poverty rates above the national average of 31.3 percent, of which 6 regions/departments have poverty rates well above 50 percent.

Peru: Distribution of Poor and Extreme Poor Population (In percent)				
	Poverty		Extreme poverty	
	2005	2010	2005	2010
Area of residence	100.0	100.0	100.0	100.0
Urban	49.1	39.8	23.6	16.9
Rural	50.9	60.2	76.4	83.1
Geographical region	100.0	100.0	100.0	100.0
Costa	36.1	29.2	11.3	10.4
Sierra	47.5	55.1	69.2	72.4
Selva	16.4	15.7	19.5	17.2

Source: INEI *Evolucion de la Pobreza al 2010*.



8. **While still high, there has been a significant decline in extreme poverty in rural areas over the past ten years.** The national population living below extreme poverty

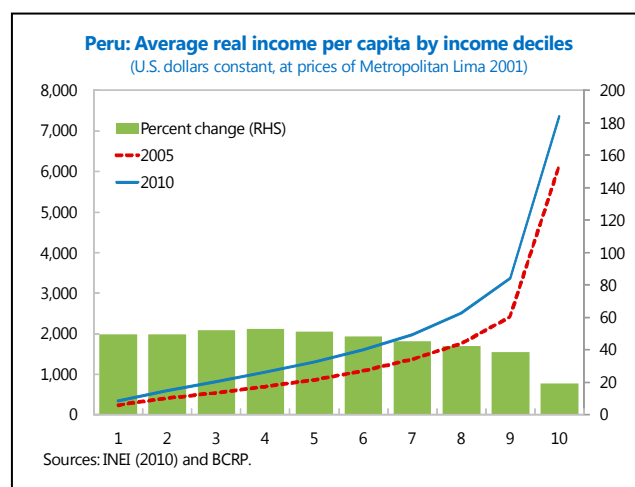
⁵ With increasing urbanization, 65.2 percent of the population resides in the urban areas and only 34.8 percent in the rural areas (INEI (2010)).

⁶ By national definition in Peru, households are classified as *poor* if their total expenditures are lower than the cost of a basic food basket plus an estimate of nonfood expenditures and as *extremely poor* if their total expenditures are lower than the cost of a basic food basket. In 2010, the threshold is defined at 263.8 nuevos soles per capita per month for poverty and 148.6 nuevos soles per capita per month for extreme poverty (INEI 2010).

dropped by 15 percentage points during 2001–10 to about 10 percent. Extreme poverty in rural areas has declined more rapidly, by 28 percentage points from 51 percent in 2001 to 23 percents in 2010. On the other hand, the national population living below poverty line declined by close to 24 percentage points over the past 10 years from about one-half to about one-third in 2010. Similar pace of reduction is seen in the share of rural population living below the poverty line, declining from 78 percent in 2001 to 54 percent of the rural population in 2010.

9. **Poverty is particularly high among the indigenous population, the self-employed and primary sector workers and population with lower education attainment.** The incidence of poverty is found to be higher at 35.9 percent in households which their heads are native (including Quechua, Aymara and Amazonian origin) in 2010 even though this ratio has declined from 55.4 percent in 2005 (INEI (2010)). For 2010, 43.4 percent of the poor (45.9 percent of the extreme poor) are self-employed compared to a lower 34.4 percent for the non-poor. In addition, 60.4 percent of the economically active poor (80.1 percent of the extreme poor) are working in the agriculture, fishery and mining sector whereas only 21.9 percent of the non-poor are employed in this sector. Low education attainment contributes directly to poverty incidence. An adult of 25 years and above, if poor has 6.7 years of formal education, 5.4 years if he or she is extreme poor and 10.1 years if non-poor (INEI (2010)).

10. **Employment growth has had a strong positive impact in reducing poverty.** Household income has increases through higher employment and higher wages. For the period 2001–09, employed economically active population grew by 24.4 percentage points, with a higher growth of 30.3 percentage points in Metropolitan Lima (INEI (2010)). Real per capita income of population in third, fourth and fifth deciles increased by more than 50 percent between 2005 and 2010. Other studies, such as ECLAC (2010) have found that poverty reduction in Peru during 2002–09 was mainly due the growth effect (78 percent) whereas the distribution effect (22 percent) has a smaller impact.



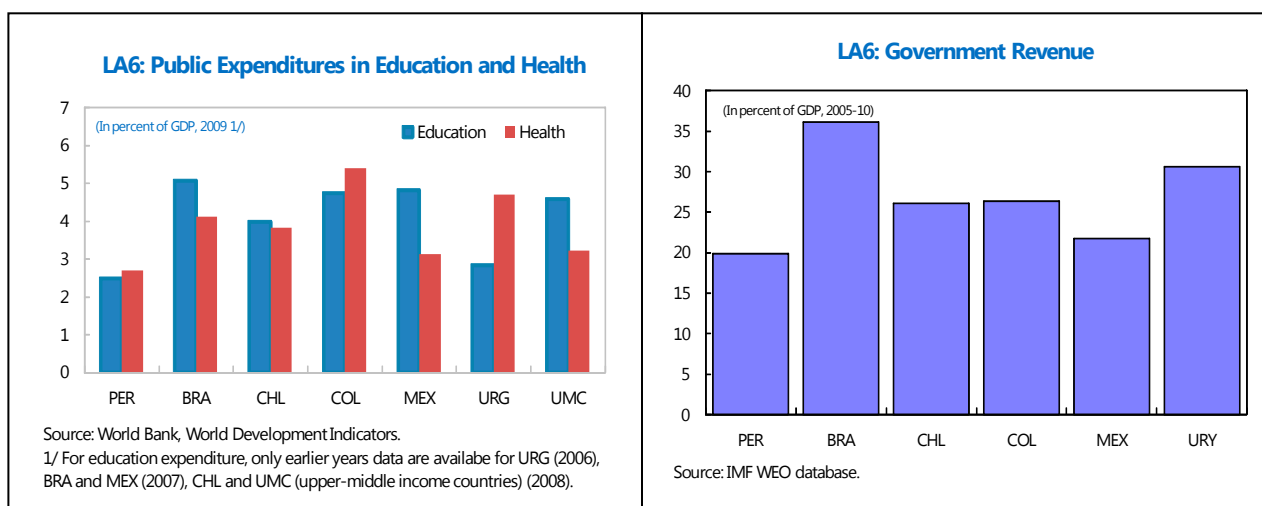
11. **The macroeconomic management success of recent years has helped poverty reduction and job creation, and this will likely continue with sound macroeconomic policies.** A large number of studies have examined the reasons why economic growth has not translated into more rapid poverty reduction.⁷ Beside geographical and endowment

⁷ For example, World Bank (2005) and (2011).

differences, growth has been focused on natural resource extraction industries—which are highly capital-intensive and small in job creation, and in the rural agricultural and urban informal employment sectors, which are characterized by relatively lower productivity and low wage growth. Therefore, strengthening the linkage between growth and employment creation would require microeconomic reforms to achieve higher productivity levels and a more diversified economy including more labor-intensive sectors. In addition, increasing the efficiency of public investments would reduce the regional gaps in physical and human capitals and bring about greater redistribution over the medium term.

D. Public Spending Comparison

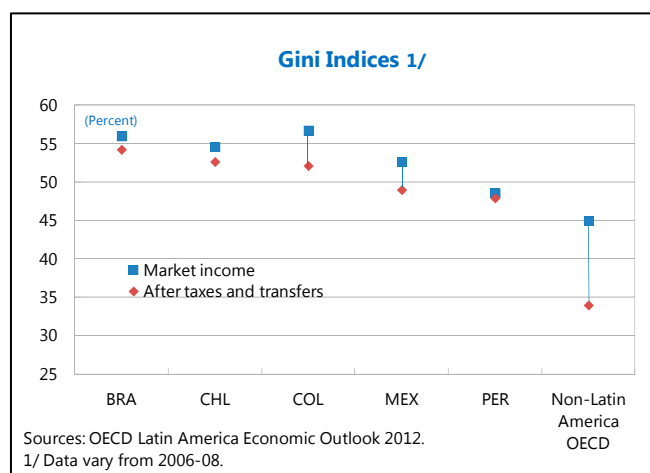
12. Peru has lower public expenditures on education and health than other LA6 countries. Comparable data from the World Bank Development Indicators show that Peru's total public expenditures on education and health are at slightly above 5 percent of GDP, the lowest among the LA6, in part due to the smaller size of its government revenue only at 20 percent of GDP. This suggests that greater effort at government revenue mobilization would help to provide the additional resources to increase social spending beyond current level.



13. Fiscal policy has a limited effect in lowering inequality in Peru. OECD (2012) shows that cash transfer has been effective in reducing income inequalities in non-LA OECD economies. However, in the case of Peru and other LA6 countries, transfer appears to have only a limited impact on lowering income inequality.

14. Targeted social programs have attempted to alleviate poverty and promote development of low-income population. In Peru, universal coverage of health and education accounts for about 40 percent of social spending, followed by non-target social programs representing 35 percent of the total. Targeted social programs for the purpose of mitigating extreme poverty showed the largest increase among universal education and health and non-targeted social programs by an average of 14.5 percent during 2005–10,

accounting for 1.7 percent of GDP or about 16 percent of total social expenditure in 2010. There are a total of 22 social programs conducted by state agencies, including major programs such as *Juntos*, *PIN* (Comprehensive Nutrition Program), *SIS* (*Seguro Intergral de Salud*), the Glass of Milk and *PRONIE* (National Education Infrastructure). Results focused budgeting has been implemented since the 2007 Budget Act.



Peru: Public Sector Social Expenditure									
			Share of GDP		Average increase	Share of general government expenditure		Share in total	
	2005	2010	2005	2010	2005-10	2005	2010	2005	2010
	(In mil. of Nuevos Sole)				(In percent)				
Total social expenditure and pensions	28,607	46,367	10.9	10.7	10.1	57.8	52.3	100.0	100.0
Universal coverage (Education and Health) 1/	10,587	18,979	4.0	4.4	12.4	21.4	21.4	37.0	40.9
Education	7,527	11,292	2.9	2.6	8.4	15.2	12.7	26.3	24.4
Health	3,060	7,687	1.2	1.8	20.2	6.2	8.7	10.7	16.6
Targeted programs (Extreme Poverty)	3,711	7,300	1.4	1.7	14.5	7.5	8.2	13.0	15.7
Non-Targeted Social Programs	12,951	16,215	4.9	3.7	4.6	26.2	18.3	45.3	35.0
ESSALUD	3,626	5,609	1.4	1.3	9.1	7.3	6.3	12.7	12.1
Pensions	9,324	10,605	3.6	2.4	2.6	18.8	12.0	32.6	22.9
Housing Development Program (FONAVI)	1	0	0.0	0.0	...	0.0	0.0	0.0	0.0
Other Social Expenditure 2/	1,358	3,873	0.5	0.9	23.3	2.7	4.4	4.7	8.4

Source: Ministry of Economy and Finance.
1/ Net of spending on education and health already included in the extreme poverty programs. Includes social expenditure of the 3 levels of government: national, regional and local.
2/ Includes basically other social expenditure of the local and regional government.

15. **The authorities have highlighted the need to further improve the quality and targeting of social expenditure.** Social expenditure effectiveness is hindered by the presence of imperfect targeting—leakage (benefiting non-target population) surpasses 40 percent in four out of five major social programs and undercoverage (not benefiting target population) ranges from 46 percent in the program with the smallest rates of exclusion to 97 percent in the worst case. The cost of leakage in these five programs is estimated by the government to represent more than one-third of their total budget.⁸ In this context, better utilization of the household targeting system—SISFOH (Sistema de Focalización de Hogares) could help to achieve greater delivery efficiency. For instance, the ongoing application of the National Identity Document (DNI) to the age group made up of minors has

⁸ Llanos and Rosas (2010), p. 4.

enabled a total of 11 million children—the recipients of the bulk of social programs—to be identified.⁹

E. The Government's Key Priorities and Action Plan

16. The authorities are committed to deliver more social inclusive growth.

The draft 2012 Budget allocates additional resources for strengthening human capital and social inclusion (see Box below). The government has also released a set of key quantitative social targets which include reducing the overall poverty ratio (national definition) to 20 percent, and reducing by a half extreme poverty to 5 percent and rural poverty to 27 percent, respectively, by 2016. In addition, a new Ministry of Social Development and Inclusion has been created with the objective to better coordinate social programs currently managed by the Ministry of Women's Affairs, the Ministry of Economy and Finance, and the cabinet.

Peru: Social Indicators-Outcome and Goals		
(In percent)		
	2010	Goal 2016
Poverty		
Poverty rate	31	20
Extreme poverty	10	5
Rural poverty	54	27
Health		
Chronic infant malnutrition	18	5
Neonatal mortality (per thousand)	9	5
Education		
Coverage of intital education	70	95
Rural elementary education 1/	8	40
Social services 2/		
Rural electrification	60	85
Rural water supply	39	57
Rural sanitation	11	45

Sources: Macroconsult; and Fund staff estimates.
1/ Completion.
2/ Coverge of homes.

17. Priorities include greater focus on the poorest districts and expanding the coverage of successful social programs. The authorities are prioritizing their programs on the 800 poorest districts through the household targeting system. Other key measures include expanding successful social programs, such as the *Juntos* cash transfer program to additional districts, and increasing the coverage of targeted programs for elderly over the age of 65 in extreme poverty and who have not received state benefits through expanding the coverage of *Pension 65*. The program is targeted to expand from the current coverage of S/. 47 million to 70 thousands persons, to S/. 241 million to 170 thousands persons in 2012, and S/. 400 million to 267 thousands persons in 2013.

⁹ MEF (2011).

Key Policy Priorities on Growth with Social Inclusion

1. Early childhood
 - Launch of *CUNA MAS* (Cradle More - a comprehensive care to children from 0 to 3 years focusing on nutrition and early education) and *SAMU* (a government-run Mobile Emergency Care Service)
 - Expansion of the Articulated Nutritional Program
 - Expansion of the Maternal and Newborn Health
2. Education for children and adolescents
 - More schools and teachers in rural areas
 - Teaching taking into consideration the diversity, multilingualism and multiculturalism of the country
 - Evaluating the learning achievements of students and teacher performance.
 - Educational support.
3. Providing young people with opportunities for advancement through scholarships in universities and technical colleges: *Beca 18*
4. Assisting poor families with minimum income: the expansion of the *Juntos* program
5. Assisting elderly in extreme poverty without a retirement pension through: *Pension 65*
6. Rural development
 - Coordinated infrastructure investment (e.g., rural roads, electrification, sanitation) tendered under the lowest subsidy.

 Source: Presentation by the Minister of Economy and Finance to the Congress in August 2011

18. **Further enhancing social spending programs and raising more resources to increase social expenditure are necessary.** While the current expenditure envelope allows for initial increases in social spending, additional fiscal space need to be created for higher spending in outer years through increasing revenue mobilization efforts. In this context, the new mineral taxation regime, consisting of profit margin-based royalties, a new special mining tax as revenue for the central government; and a special voluntary levy on profits targeting companies holding stability contracts, are expected to generate an addition \$1 billion (about 0.5 percent of GDP) each year at current metals prices. This will help fund infrastructure and social expenditure. In addition, increasing the efficiency of public investments would reduce the regional gaps in physical and human capitals and bring about greater redistribution over the medium term.

F. Conclusions

19. **Peru has achieved steady progress in reducing poverty and income inequality in the past 10 years but several challenges remain.** However, while Peru compares well with its regional peers in key social indicators despite low levels of social spending, it has much room for improvement in specific areas such as gender inequality. Importantly, large regional and rural-urban disparities persist and further reduction of rural poverty remains a key policy challenge. While economic growth and macro stability remain the prerequisites for poverty reduction, further enhancing social spending efficiency and raising more resources to increase social expenditure are needed. In addition, increasing the efficiency of public

investments would reduce the regional gaps in physical and human capitals and bring about greater redistribution over the medium term.

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