Chapter 1

Structural reforms and the recent macroeconomic context in Peru

Peru suffered from hyperinflation and a deep economic crisis during the 1980s. A first wave of structural reforms took place in the early 1990s. Private investment, including foreign investment, was promoted. New measures to open the country to foreign trade were introduced. And measures to ensure fair market competition were enacted. However, by the second half of the nineties, reform actions decelerated sharply. Notwithstanding, Peru's macroeconomic performance over the last decade has been the best in over a century. This performance is in part the result of a very favourable external environment, but is also a consequence of a successful combination of sound fiscal policy based on a fiscal responsibility law and monetary credibility. Significant improvements in economic growth, well-being and poverty reduction have been observed since the introduction of reforms in the 1990s, but more reforms are needed to achieve a more inclusive and sustainable path.

Overview of recent structural reforms in Peru

This section provides an overview of the main structural reforms that took place in Peru during the 1990s, which laid the foundation for the high recent economic performance of the country. It is based on expert papers, on the OECD Report *Multidimensional Review of Peru* (OECD 2015), and on information collected by OECD through interviews to public officials to prepare the current report, along with supporting documentation.

The description of events and reforms in this section does not necessarily follow a strict chronological order. Rather, the intention is to present a coherent and logical description of actions and progress, keeping a broad consistency with the timeline.

Peru suffered from hyperinflation and a deep economic crisis during the 1980s

After a decade of state control by the military during the 1970s, democracy in Peru was reinstated in 1980. Despite the appearance of democracy and some incipient reforms efforts of market liberalisation, foreign trade and promotion of investment, the state model of a heavy regulated economy, in which the state had the control of the economic activity, was not fundamentally changed. The government's influence was exerted through state monopolies, restriction for private investment, price controls, and heavy and numerous bureaucratic barriers (Martinez-Ortiz, 2015).

In order to re activate the economy, the government in the second half of the eighties in agreement with a group of private sector leaders (called "the 12 apostles") tried to expand the public expenditure by allowing for some inflation. Also, more market restrictive measures on internal and external commerce and on investment were introduced. These rigidities led to a fall on production and the emergence of black markets. The monetary supply grew at a higher rate than production and aggregate demand in order to finance the growth on public expenditure. This model was not sustainable due to large public budget deficit, public debt crisis, and inefficiency by the government. Additionally, Peru suffered the effects of social unrest.[1] These problems materialised in hyperinflation, poverty and lack of security. At the end of the presidential term of 1985-1990, the aggregated inflation was of 2.2 million per cent, the GDP per capita fell to USD 720 (amount comparable to 1960), there were billionaire widespread losses in state-owned companies, an poverty increased sharply (Martinez-Ortiz, 2015).

A first wave of structural reforms took place in the early 1990s

In order to face economic crisis, the government elected at the start of the 1990s implemented a stabilisation program with strong measures to reduce inflation. This program included drastic reduction of subsidies, budgetary discipline, and restrictive monetary policy. This was followed by actions to reform the State and change the functions, roles and activities inherited from the seventies and eighties. The idea was to give more room to market and private forces in the economy. The government had the objective to reverse predominant public policies in Peru, during two decades.

In this perspective, the economy was liberalised and deregulated, and a model more oriented to market forces was pursued. Reforms were undertaken to establish new regulatory entities, open the country to foreign investment, and international trade. Reforms to the Central Bank were introduced to ensure its autonomy, exchange rate controls were terminated, capital markets restrictions were eliminated, many state companies were privatised, state monopolies terminated, tax and customs systems were simplified, and the State moved out from banking and financial sector. As a result, a more market friendly economy was established, private investment started to grow and the country rapidly recovered macroeconomic stability.

The main vehicle for these reforms was legislative decrees (*Decretos Legislativos*).[2] In 1991, Congress enacted Act No. 25327. This Act gave power (delegate) to the President to approve and enact legislation through Legislative Decrees in three areas: national pacification, employment promotion and private investment growth.

Through these Acts, the government initiated a clear change in state functions, activities and roles and in the economy. The economy was opened and liberalised and market forces freed. The message was clear: the State withdrew from performing economic activities and participating in the market. The government eliminated monopolies, controls and restrictions on markets. The government would focus in regulation (when necessary) and in the provision of public services (directly or through private sector).

Private investment, including foreign investment, was promoted

Reforms included the recognition of private investment, liberty of enterprise and private property, in order to create a more oriented market economy, in which competition was set as a principle. Rights, warrants and obligations applicable to all natural persons and legal entities, national or foreign making investments in Peru were established, along with provisions for the equal treatment of national and foreign investors, subject to the same rights and obligations.[3]

Any advantage or preferred treatment to State companies was banned. In this setting, prices were not regulated by the State and were the result of interaction between supply and demand forces. Only prices of public services (defined by law) would be subject to price regulation.[4]

Private property was guaranteed. Expropriation when considered necessary for strict reasons of national security or public utility required a specific Act enacted by Congress. In this case, proper compensation by the State was necessary.[5]

Reforms were also introduced to eliminate the authorisation of foreign investment and open the economy to this investment without any restriction to sector. Therefore, there were no protected monopolies or reserved areas for the State or for Peruvian nationals.[6]

Foreign investor could transfer foreign currency, coming from investment, income, profit or royalties obtained in Peru without any previous limitation or authorisation. The only obligation – common in all the world – was paying national taxes. Foreign investors also had the right to buy or acquire shares or participations in companies in Peru. They had the right to buy or acquire any kind of property as well. Finally, the liberties of commerce were recognised as well as the liberty to export and import by foreign investors.[7]

In order to attract foreign investment, legal stability agreements (*convenios de estabilidad jurídica*), could be signed between foreign investors and the government. Through these agreements, the government could freeze the tax regime, the regime of foreign currency transfer, labour regulation regime and other special regime applicable. The conflicts related to his agreements could be solved through arbitration.[8]

Reforms also included specific provisions to allow for and promote investment in sector specific areas of the economy, such as the mining sector, maritime and air transport, electricity, and telecommunications, amongst others.

In the mining sector, tax benefits and deductions were introduced, rights of equal treatment were strengthened, and simplification of authorisations and permits was applied.[9] Maritime and air transport markets were opened and liberalised, finishing the period of heavy regulation. Shipping, maritime and air transport activities were opened to national and foreign investment. Permits and authorisations in these sectors were drastically simplified.[10]

The legal framework for activities in the electricity sector (generation, transmission and distribution) derived from thermic, hydric or geothermic sources was established. Similarly to other sectors, this market was opened and liberalised to national and foreign investment. A new public entity, the Electricity Price Commission (CT, *Comisión de Tarifas Eléctricas,* later on merged with the Supervisory Agency for Investment in Energy and Mining, OSINERGMIN) was created.[11] This entity exemplified the new role of the State. Electricity was a public service provided by private companies, subject to economic regulation to prevent abuse of market power.

Similarly, in the Telecommunication area, the legal framework to carry out activities in this sector was introduced. This market was opened and liberalised. All the operations in this market were opened to national and foreign investment. The Supervisory Agency for Private Investment in Telecommunications (OSIPTEL)[12] was created to regulate tariffs and behaviour of private companies in telecommunication.[13]

Financial markets in Peru were also opened and liberalised, thus ending a period of heavy regulation. Equal legal treatment to national and foreign investment in financial activities was set, as well as openness to any of the financial market activities, freedom of contract, and freedom to establish of interest rates. The government confined its role to regulation, oversight and supervision of this market: the Superintendence of Banking, Insurance and Private Pension Fund Administrators (SBS) was reformed and modernised. This public institution was granted a high level of autonomy and powers to accomplish its mission. The Superintendence had to regulate, authorise, oversee, supervise the companies in the financial market and had power to enforce the regulations; including the capability to intervene and dissolve financial institutions and impose sanctions on them.[14]

New measures to open the country to foreign trade were introduced

Freedom of international and foreign trade as well as internal commerce was introduced. Liberty to possess foreign currency and liberty to exchange that currency were recognised. The following rules were also set:[15]

- Further reduction of tariffs to importation.
- Elimination of non-tariffs and barriers to importation (registries, permits, authorisations, restrictions and prohibitions).
- Elimination of any kind of exonerations or special treatments in tariffs and taxes applicable to importation.
- Elimination to all kinds of subsidies to exportation.

The economic intervention of the state in markets and in the economy was reduced and restricted, and measures to support the government's activities with private investment were set

Reforms included the transfer of State property and companies to the private sector. Different forms to make effective the transfer to private sector were defined: i) transfer of assets ii) transfer of shares, iii) increase of equity, iv) management, lease or joint venture contracts, and v) liquidation of assets.[16] The purpose was to increase asset profitability utility, generate income for the State, reduce the public budget deficit, provide more and/or better goods and services to the population, diversify the economy, increase competition in the market and promote productive potential through investment and know-how.

To implement the privatisation process, the Private Investment Promotion Commission (COPRI, *Comisión de Promoción de la Inversión Privada*) was created. This was a board integrated by ministers (the highest level public officials in the executive branch in Peru). COPRI had powers to: i) determine the State companies to be privatised, ii) the form of privatisation, iii) the policies to follow during the process, and iv) the members to conform the Special Privatisation Committee.[17]

The COPRIs had to analyse the situation of the company, describe the steps in the privatisation process, and estimate the projected earnings. The COPPRI had to propose a base price for the privatisation process. The sale of the assets had to be under open competition. For that purpose the sale was made through the stock exchange or open public bids.[18]

Under this scheme, 180 State companies were privatised from 1991 to 1998. All this privatisation process generates income of USD 7.7 billion coming from the sale of assets, and USD 7.9 billion coming from investment made by private sector in privatised companies (Martinez-Ortiz, 2015).

A system of concessions was also introduced.[19] A concession was a contract whereby private companies received authorisation from the State[20] to build, maintain, managed and/or exploit[21] for a certain period of time (usually long periods) infrastructure and/or public services.[22] In the concession, the state kept ownership of assets and services but transferred control over them.

Concessions were granted through open public bidding. These contracts established the time of the concession, the rights and obligations of parties and particularly, causes of termination, characteristics of the infrastructure to be built, conditions and standards of service, fees the private companies could charge to users and dispute resolution methods.

The government also took efforts to increase the predictability of government actions, hence reducing uncertainty to investors and businesses. For instance, the principle of "tax legality" was introduced. According to this principle, no tax could be established, modified, increased or enforced without proper approval by Congress through an Act.[23]

First efforts on administrative simplification were also introduced through the Single Text of Administrative Procedures (TUPA). The TUPA was mandatory for all the public entities, in which all the necessary information to initiate and successfully complete an administrative procedures and formalities was codified and consolidates for the benefit of all citizens. A policy establishing that administrative procedures should be rationalised, simplified, reduced or eliminated was also initiated. Related to this, it was established that new administrative procedures could only be created or established by certain type of legislation.[24]

And measures to ensure fair market competition were enacted

All these reforms contributed to a withdrawal of the government's activities and influence from performing economic activities and participating in the market. Nevertheless, the elimination of state monopolies, control and restrictions on markets, and the liberalisation of market forces, called also for additional arrangements to promote fair and open competition. Problems could arise derived from market failures, such as private monopolies, anticompetitive actions, and asymmetric information, amongst others.

Hence, new powers were given to the government to challenge any practice limiting or restricting free competition, monopolistic behaviour, and abusive practices of dominant position in the markets.[25] Protection for consumers was also instituted,[26] as well as provisions to regulate commercial publicity related to proper and adequate information.[27] A new public agency was entrusted with the enforcement of these activities: the National Institute for the Defence of Free Competition and Protection of Intellectual Property (INDECOPI, see below)

The reforms were consolidated with a new political constitution

After political turmoil resulting from the impact of the reforms in the early 90's, a new constitution was issued in Peru in 1993 which consolidated and secured to the highest normative levels de reforms started in 1991 (Martinez-Ortiz, 2015).

The 1993 Political Constitution established the country's economy was a "social market economy". In addition, the Political Constitution mentions that the State should guide the country's development and it is "principally active" in promoting employment, health, education, security, public services, and infrastructure. These two expressions ("social market economy" and "principally active") can be interpreted to understand the roles of State in the economy: as a regulator in case of market failures and as a public services provider.

Regarding the market, this Political Constitution recognised the right of private property, liberty of commerce, liberty of industry, freedom of contract and entrepreneurship freedom. According to the Political Constitution, the application of these freedoms must not be harmful to the public moral, health, or safety.

In regulating private property, the Political Constitution established this right should be exercised in harmony with "common good" and within the limits established by the law. Expropriation (taking of property) is possible in case of public security or public utility. In that case, cash payment must be made prior to the expropriation. In addition to that, the Constitution stated that property can be temporarily restricted only on grounds of public security.

National and foreign investments were subject to the same conditions. Freedom in the production of goods and services was installed. The Political Constitution also established freedom in international and foreign trade. But, all foreigners having residency in Peru are subject to the law and jurisdiction of the country.

The Political Constitution also established that private and state owned companies would receive the same legal treatment. The state could only engage in business activities – directly or indirectly – if authorised expressly by Law of the Congress, for reasons of high public interest or evident national convenience.

A wave of new, stronger and more independent government institutions were established, that helped to boost the market orientation of the economy, whilst providing oversight to protect the public´s interest

The institutional and legal reforms undertaken in the nineties changed the economy and the government in Peru. The reforms moved the economy from a closed, protected, and heavily regulated economy to an open market economy. By the same token, the government shifted roles and functions. From the main, if not the only, economic player in many markets, coupled with heavy regulation and controls, the governments shifted to a position of oversight and supervision.

These changes demanded new public entities to make effective the new functions and roles of the government, in order to ensure fair competition and adequate protection to consumers and the public at large. Therefore, in the 1990s, new entities with special powers, proper personnel and adequate budget, within a particular legal framework, were therefore created. These new agencies included the Central Bank (BCR), the SBS, and INDECOPI, along with many others.[28] This new entities were established to enforce the regulatory framework in specific areas of the economy, and were granted varying degree of independence, and technical capacity, with the aim of discharging their functions effectively, and ensure isolation from the political process.

In this sub section, only a brief description of the Central Bank, the SBS and INDECOPI are included, as examples of the new institutional arrangement introduced in Peru in the 1990s.

The Central Bank

The Central Bank’s prime objective is to preserve monetary stability. It has the following functions: i) regulate the money supply, ii) manage international reserves iii) issue money, and iv) report on the public finances. Considering the hyperinflation process Peru suffered in the eighties, the Central Bank was granted the highest possible level of autonomy.

This agency is an “Autonomous Constitutional Organism” under the Political Constitution, regulated complementarily by an Organic Act (a special Act passed by Congress). This institutional arrangement shields the Central Bank from undue influence from the legislative or executive branch.

The highest authority in the Central Bank is the Board of Directors. The Board is integrated by seven members. The executive and the legislative branches each appoint three members to the Board. The Chairman is designated by the executive and ratified by the Permanent Commission of Congress.

Superintendence of Banking, Insurance and Private Pension Fund Administrators (SBS)

The SBS has to regulate, authorise, oversee and supervise the companies in the financial market and has the power to enforce the regulations; including the capability to intervene and dissolve financial institutions and impose sanctions on them.

With the same objective of granting the highest level of autonomy, the SBS was also established as an Autonomous Constitutional Organism. The head of the SBS is appointed by the executive branch who must be ratified by the Congress to take office.

The National Institute for the Defence of Free Competition and Protection of Intellectual Property (INDECOPI)

INDECOPI was created by Law Decree No. 25868 on November 1992, and started his functions in March 1993. This institution,[29] part of the executive branch, was established as an independent arbitrator who must focus in promoting market competition, protect intellectual property, enforcing the new rules enacted at that time.[30]

The highest authority in this public entity is the Board of Directors, whose members are appointed by the executive branch (by different ministries). Despite this situation, INDECOPI has enjoyed a high degree of political autonomy and managerial freedom.

However, by the second half of the nineties, reforms decelerated sharply

Similar to other Latin American economies, reforms lost dynamism in Peru by the second half of the nineties (Lora, 2012) Lack of political will and political instability were some of the factors that did not contribute to a deepening of reform and privatisation actions in the second half of the nineties (Martinez-Ortiz, 2015). At the time, privatisation process was frozen in sectors such as oil, electricity, sanitation, amongst others.[31] In the same line, concessions were paralysed and no major or additional private investment was made in roads, ports, airports, and sanitation. Additionally, administrative reform in public entities was cancelled, which left public administration and civil service reforms as some of the pending issue.

Decentralisation measures took place in early 2000's

In 2001, the administration elected led a process of decentralisation with the hopes of strengthening democracy and improving the delivery of public services (Martinez-Ortiz, 2015). The Constitution was amended and new legislation passed. The decentralisation implied the transfer of functions and resources from national governments to local ones. Elections for new local authorities took place as one of the results of the process, and the elected officials started function in 2003.

Transfer of functions started in 2004, and it was reinforced in 2006 and 2008, which kept a very fast pace. However, the assessment and accreditation of local capacities, which was part of the planned decentralisation, fell short. As a result, functions were transferred without expert personnel. In parallel, the budgetary resources transferred to subnational governments increased, but in many cases no allocations were made for some of the functions transferred. Additionally, many areas of legal attribution and powers by subnational governments were not defined in detail, increasing the likelihood of conflict across different levels of government (Martinez-Ortiz, 2015).[32]

Significant improvements in economic growth, well-being and poverty reduction have been observed since the introduction of reforms in the 1990s and 2000s, but more reforms are needed to achieve a more inclusive and sustainable path

Structural reforms take usually a few years to show their full impact on an economy. Peru has experienced considerable socioeconomic progress and improved well-being in the last two decades due to a combination of sound domestic policies resulting to a large extent from the reforms in previous years and favourable external conditions (see next section). The country has recorded strong economic growth since the beginning of the 21st century, which has been accompanied by a significant reduction in poverty, from around 60% in 2004 to less than 24% in 2013. While inequalities remain large and relate not only to income but also to different dimensions of well-being, they have decreased. Sound macroeconomic policies, economic openness and effective social protection programmes are largely behind this success, many of them started since the 1990s, which has also been fuelled by favourable external economic conditions.

However, in order to achieve a more inclusive and sustainable path, Peru must overcome low productivity growth, large inequalities and high and widespread informality. The current drivers of growth, which are strongly reliant on labour, capital accumulation and on the commodity exporting sector, seem insufficient to sustain further socioeconomic progress. To unlock new drivers of lasting growth and improvements in social outcomes, Peru must find ways to boost productivity growth, and to reduce inequalities and informality. They should include significant improvements in healthcare and education, the reduction of informality to increase labour quality and productivity, improvements in the tax structure to complement a sound macroeconomic framework, and a stronger public governance and greater state capacity to prioritise and implement.[33]

Peru's macroeconomic performance has been strong over the last decade

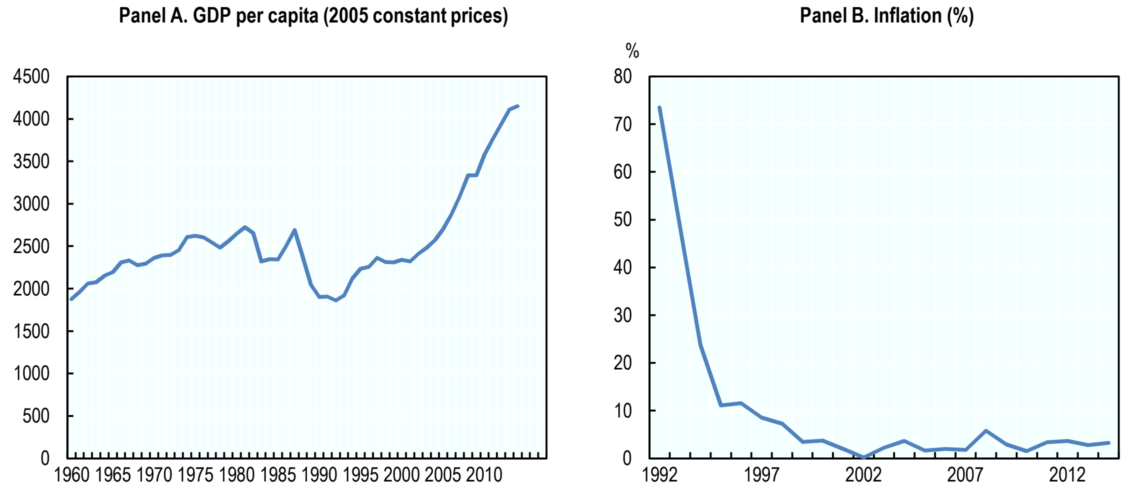
This section includes extracts of the chapter *Macroeconomic policies for inclusive development* of the OECD report *Multidimensional Review of Peru* (OECD, 2015), and it is also enriched by expert papers.

Peru's macroeconomic performance over the last decade has been the best in over a century

Underpinned by better macroeconomic management and an exceptionally favourable external environment, Peru's macroeconomic performance has been strong over the last decade. Between 2004 and 2014, per capita GDP grew by an average of 5% per year – the second highest rate of growth in Latin America – and the average inflation rate was 2.6% per annum (Figure 1.1). The unemployment rate fell to historical lows; down from 9.5% in 2004 to 6% in 2014, while labour participation rose from 71% to 79% in the same period (see Chapter 2). In sum, the last decade has been, in macroeconomic terms, the best Peru has had in over a century (Seminario and Alva, 2012; Mendoza, 2013).

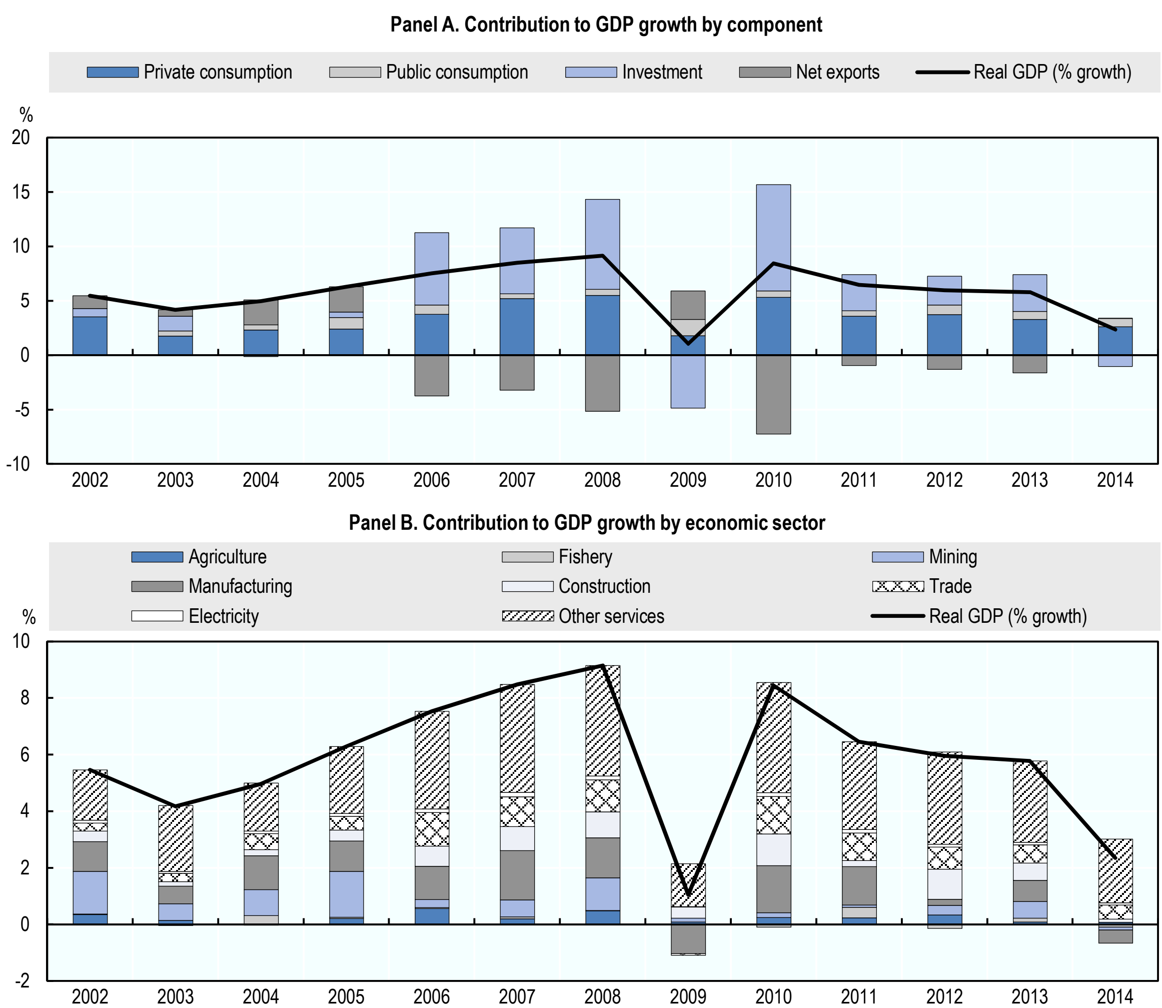
Like other Latin American countries, Peru had suffered for many decades from serious political instability, which had a negative impact on economic growth (OECD, 2015, Chapter 1; Alesina et al., 1996). But the return to democracy and the stabilising political situation have allowed the country to put in place a sound macroeconomic framework as a solid base from which to build stronger economic growth. Key plans in this framework include major changes in the design of Peru's fiscal and monetary policy, which have helped to reduce macroeconomic instability and improve the capacity of policy makers to respond to external shocks, boosting investment and growth.

Figure 1.1. **Peru's macroeconomic performance**



Source: World Bank (2015), World Development Indicators (database), Washington, DC, http://data.worldbank.org.

Figure 1.2. **Trends in GDP and GDP growth in Peru**



Source: Central Bank of Peru (*Banco de la Reserva del Perú*), www.bcrp.gob.pe/estadisticas.html.

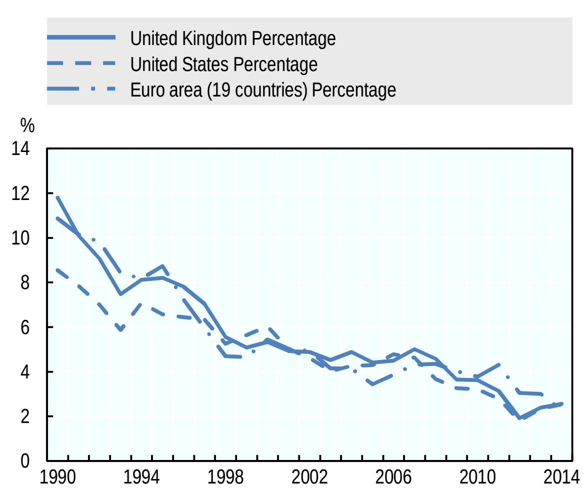
Private consumption and investments have been the leading drivers of economic growth, although their performance has weakened gradually in the last years—with more of a negative impact on investments (Figure 1.2, Panel A). For the period 2002-08, private investment accounted for 43% of GDP growth prior to the 2009 international crises. Meanwhile, private consumption accounted for an average of 68% of GDP growth over 2012-14.

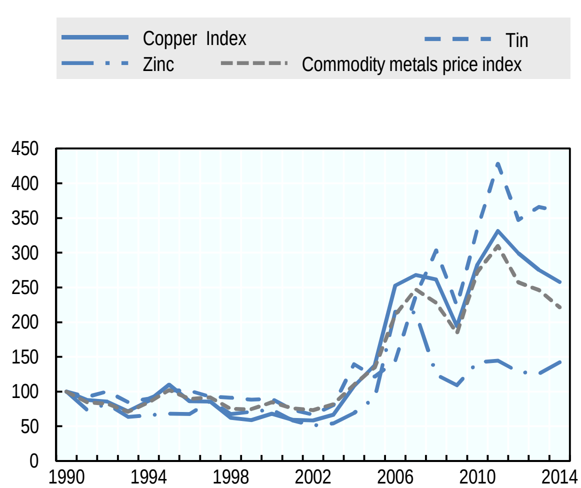
From a sector's perspective, services have been the main contributor to economic performance accounting for 56% of the GDP growth over the 2012-14 (Figure 1.2. Panel B). In terms of labour productivity, however, this sector along with agriculture and commerce are the lowest performers. In contrast, the best performers in labour productivity are manufacturing, mining and transport and communications.

This performance is in part the result of a very favourable external environment, although diversification of the production is required to smooth external shocks…

Peru has also benefitted from the exceptional external environment prevalent during the last decade. As one of the largest producers of metals in the world (OECD, 2015, Chapter 3), Peru benefited immensely from the upswing in commodity prices that started a decade ago, and which, together with record low international interest rates (Figure 1.3), had important macroeconomic implications. First, they provided a strong impulse for GDP growth, which, during the last decade, was one of the highest in Latin America. Second, high investment, especially in mining, attracted large capital inflows. More than two-thirds of these capital flows were in the form of foreign direct investment, lending relative stability to the financing of the current account. Nevertheless, over-reliance on externals conditions represents a drawback, as external shocks might jeopardise economic stability. Public policy should seek diversification of production (see below).

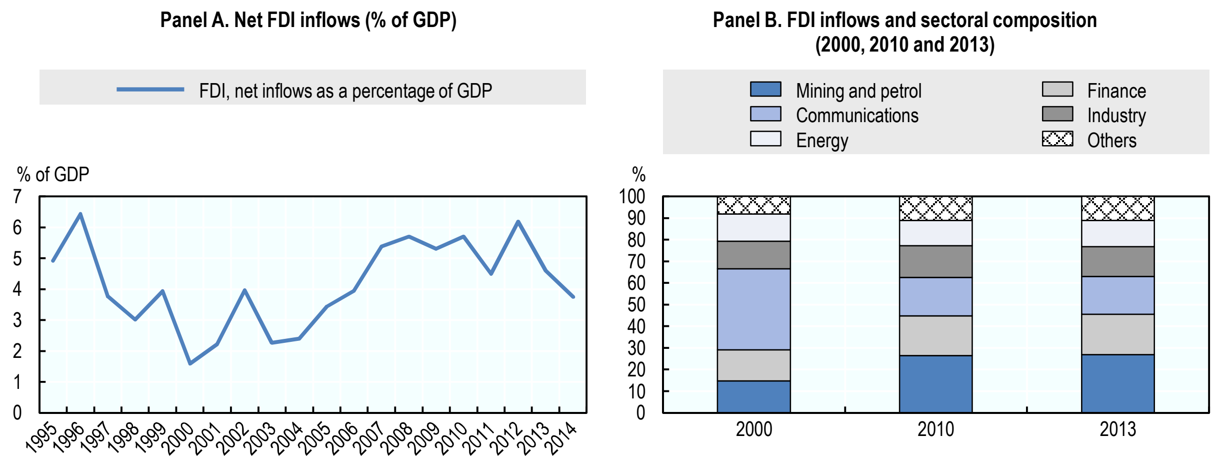
Figure 1.3. **The external conditions influencing Peru**





Source: IMF (2014), World Economic Outlook Database, International Monetary Fund, Washington D.C., www.imf.org/external/pubs/ft/weo.

Figure 1.4. **Foreign direct investment in Peru**



Note: "Others" in Panel B includes the following sectors: commerce, services, tourism, construction, agriculture, transport and housing.

Source: ProInversión (2015), Estadísticas Generales, www.proinversion.gob.pe/modulos/LAN/landing.aspx?are=0&pfl=1&lan=10&tit=proinversi%C3%B3n-institucional.

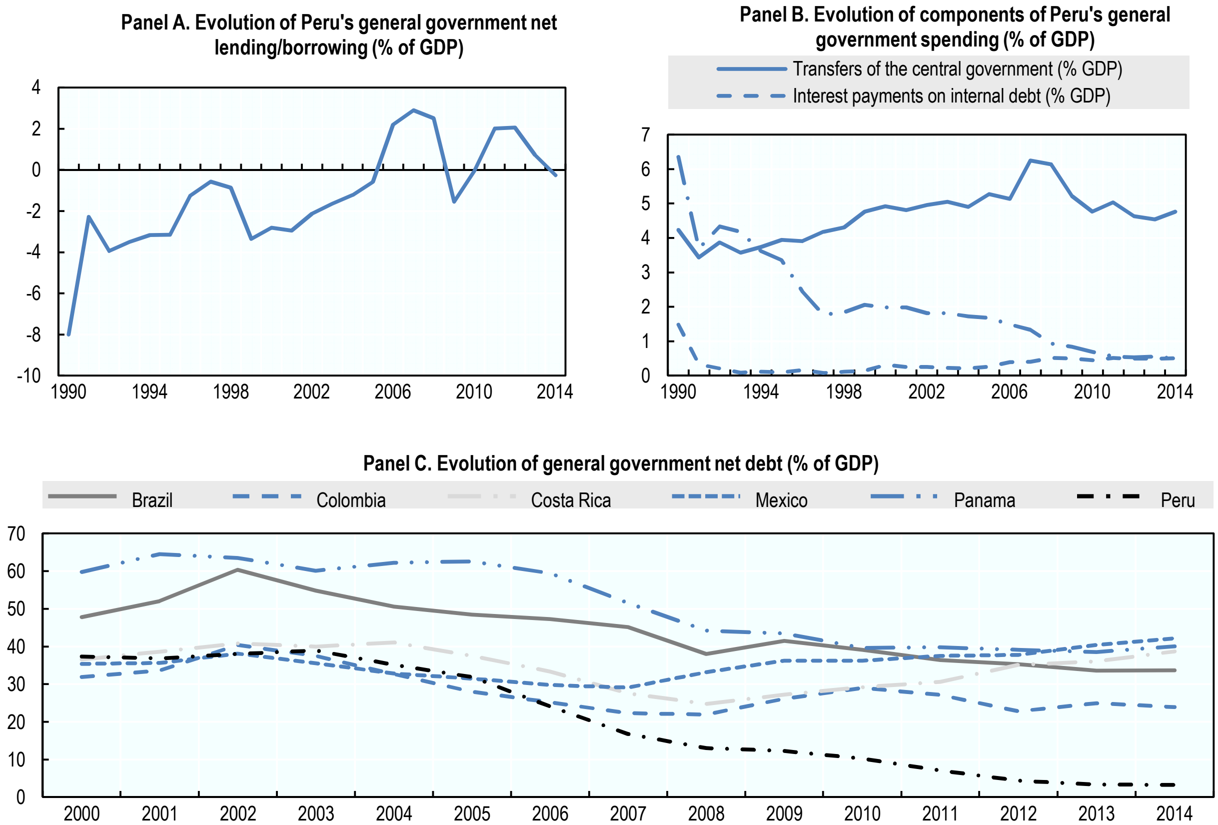
Foreign Direct Investment (FDI) inflows averaged more than 5% of GDP over the period 2010-13, and averaged close to 3.5% of GDP over the last decade (Figure 1.4, Panel A). From 2000 to 2013, the share of total FDI to the mining and petroleum industry combined increased by more than 12 percentage points, reaching 27% in 2013, the largest share of FDI for any sector (Figure 1.4, Panel B). Peru's efforts to boost production and its continual announcements of large-scale mining projects have fuelled expectations and lead to greater levels of investment in recent years. Many of Peru's largest investors, such as the United Kingdom and the United States, invest primarily in mining and petroleum. However, Spain, Peru's primary investor, concentrates its investment in communications, while the Netherlands and Chile invest more in Peru's financial industry.

… but is also a consequence of a successful combination of sound fiscal policy based on a fiscal responsibility law …

Fiscal policy responsibility in Peru has gained credibility over the last decade. In the past Peru's public finances were extremely weak and often the cause of financial and economic crises. For instance, the economy operated with fiscal deficits exceeding 10% of GDP during the 1970s and 1980s. High fiscal deficits generated a sharp and unsustainable rise in the government debt-to-GDP ratio: from 29% of GDP in 1980 to 89% in 1990.

In the early 1990s, the government launched a set of constitutional changes that freed up monetary policy to be independent of fiscal policy. For instance, in 1993 Congress passed a law prohibiting the Central Bank from lending to the government. This measure, and the pensions reform of 1992 which helped reduce the large fiscal gap, saw the fiscal deficit rapidly reduce: from 9% of GDP in 1990 to a fiscal surplus of 2% of GDP in 1995 (Figure 1.5). However, by the end of that decade an expansionary fiscal policy combined with the creation of a set of tax exemptions saw the fiscal deficit re-emerge – at almost 3% of GDP.

Figure 1.5. **Fiscal debt and public borrowing in Peru, 1990-2014**



Source: Central Bank of Peru (*Banco de la Reserva del Perú*), www.bcrp.gob.pe/estadisticas.html and IMF (2014), World Economic Outlook Database, International Monetary Fund, Washington D.C.

The Fiscal Responsibility Law, introduced in 1999, has been very effective in strengthening public finances and reducing public debt. Since then, the management of fiscal policy has significantly improved. Between 2002 and 2007 the fiscal deficit was reduced from 2% of GDP to a surplus of 3% (Figure 1.5). Although the international crisis of 2008-09 prompted the public deficit to rise to 1.3% in 2009, since then the government resumed the downward path of fiscal deficit. Between 2010 and 2013 the government has had fiscal surplus. Consistent with the behaviour of the fiscal deficit, the public debt to GDP ratio also declined sharply over the same period (Figure 1.5).

Another strong point is that the decision-making process in the fiscal and budgetary frameworks is relatively well designed. The Ministry of Economy and Finance has made significant improvements through the Public National Investment System (OECD, 2015, Chapter 5). In addition, fiscal transparency has been enhanced by frequent and efficient fiscal reporting, such as the latest Multiannual Macroeconomic Framework (MEF, 2016). Fiscal reporting and statistics classify information according to international standards. Budgeting practices also operate according to advanced standards. The budget covers the general government, although with few exceptions, such as the Peruvian National Oil Company (PeruPetro). The strategic plan (covering 3 to 10 years) includes detailed and comprehensive medium-term macroeconomic and fiscal projections thanks to the Multiannual Macroeconomic Framework and the fact that the Multiannual Budget Plan baseline projections allow for a two-year outlook.

…and monetary credibility, supported by an inflation targeting regime under a highly dollarised financial system.

Peru's sound monetary policy framework has helped to reduce inflation, supporting strong economic growth. Average inflation in Peru fell from over 100% at the beginning of the 1990s to an average of 2.6% between 2002 and 2014. The conduct of monetary policy during the last two decades can be split into two different periods. The first span, from 1990 to 2002, was one of gradual disinflation. During this period, monetary policy in Peru was implemented through a monetary target framework that used the annual growth rate of the monetary base as an intermediate target and also included instruments such as foreign exchange intervention and high reserve requirements for deposits in foreign currency. The success in disinflation during this period can be attributed to the efficient co-ordination of macroeconomic policies, with a build-up of credibility and a reduction in the consolidated public debt. Low levels of public debt have kept sovereign spreads low, helping to sustain a sharp reduction in monetary policy rates since 2000. The co-ordination between fiscal and monetary policies became the basis of the sound institutional framework that Peru has today

Since 2002, the monetary framework has been characterised by targeting under a monetary system within a highly dollarised financial system. Indeed, Peru's inflation targeting framework has a particular design, as it is the only central bank in the world to implement the framework within a highly dollarised financial system. The inflation target is 2%, with a tolerance band ranging from 1% to 3%. But the framework requires the central bank to actively intervene in the foreign exchange market to smooth out exchange rate fluctuations, which can lead to the building of international reserves as a self-insurance mechanism against negative external shocks. Since 2008, reserve requirements have been used as an active monetary control tool to moderate the impact of capital flows on domestic credit conditions in both domestic and foreign currency.

The economic environment calls for a stronger and more effective prudential macroeconomic framework accompanied by reforms at the micro level

As a small and open economy, Peru is highly exposed to external shocks and will, therefore, be significantly affected by the shifting external environment. One important threat to Peru's growth prospects is the deteriorating economic situation in People's Republic of China (China), which has become an increasingly important destination for Peruvian exports (OECD 2015, Chapter 3). Lower economic growth in China will hurt Peru through its impact on world metal prices, and hence Peru's terms of trade and economic activity. Estimates suggest that a decrease in China's investment growth by one standard deviation is likely to reduce Peru's terms of trade and GDP growth by about 2 and 0.2 percentage points, respectively (Han, 2014).[34]

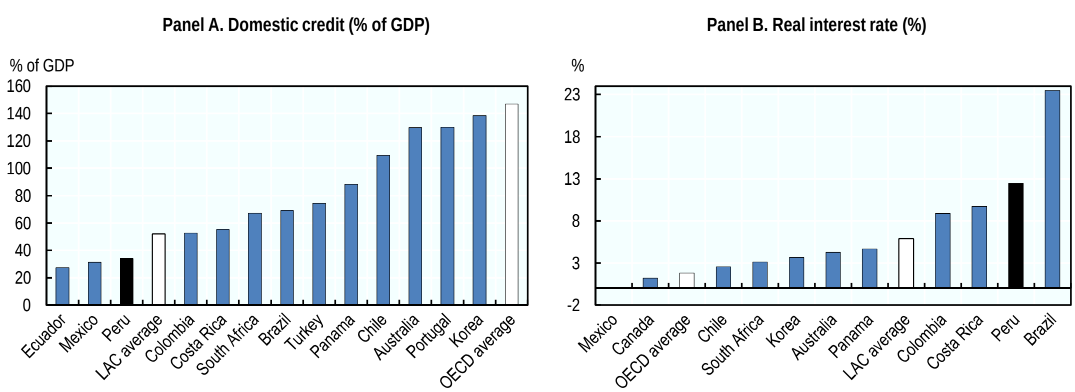
Shifting external conditions are lowering commodity prices, increasing long term dollar interest rates, weakening regional currencies and lowering flows of capital to emerging economies. All of these will put pressures on Peru's financial markets and potential growth. To better prepare the economy to adjust to the new environment, Peru should reinforce its macroeconomic framework and make sure that banks, governments, businesses and households have solid balance sheets.

Peru still has a relatively underdeveloped and inefficient financial market

Overall, the financial system is in a solid position. Thanks to a strong regulatory framework, the solvency of the financial system remains good. Banks in Peru account for almost 90% of the assets of the financial system and their solvency and liquidity indicators remain strong. Non-performing loans and credit risk indicators are relatively low. For instance, as of 2014, Peru's bank regulatory capital to risk-weighted assets ratio was 14.4%, above that of Australia, Portugal and Argentina (OECD 2015, Chapter 4).

Despite increases in domestic credit to the private sector over the last decade, access to finance remains low, responding in part to the structural challenges of the Peruvian economy. In the wake of the 1998-2000 emerging markets crisis, credit to the private sector contracted from its peak of 30% of GDP in 1999 to 18% of GDP in 2004. It has since increased – to more than 31% of GDP in 2013. However, this is still very low compared to the OECD average (above 150% of GDP), and some Latin American economies, such as Chile (100% of GDP), Brazil, Colombia and Costa Rica (Figure 1.6, Panel A). To increase investment going forward, access to finance needs to increase and real interest rates need to go down. Borrowers in Peru pay an average annual real interest rate of 18% in 2013, which is significantly higher than in most countries (Figure 1.6, Panel B).

Figure 1.6. **Access to credit and the cost of finance in Peru (2013)**



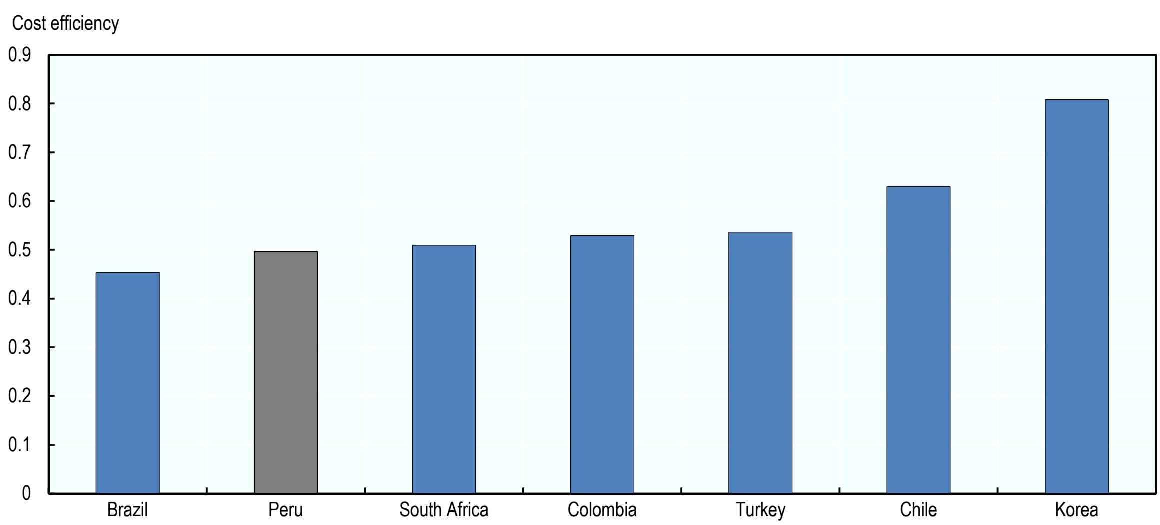
Source: World Bank (2015), World Development Indicators (database), Washington, D.C., http://data.worldbank.org.

In addition, Peru's banking sector has a large degree of concentration and has lower efficiency compared to other countries. The degree of concentration of credit and deposits from financial entities remains high, responding in part to previous financial crises. In particular, close to 80% of the market share is retained by only four banks in Peru. The Herfindahl-Hirschman Index (HHI) in lending (corporate, large enterprises, medium enterprises) and on mortgages shows a relatively high level of concentration: at between 1 500 and 2 500 (Financial Stability Report, 2014).[35] Estimates of cost efficiency and market contestability show that efficiency in Peru's banking system is relatively low (Figure 1.7). Recent evidence from Latin American countries shows that efficiency and competition are the main determinants of interest rates (Chortareasa et al., 2012). Thus, improving efficiency could be a key driver of lower interest rates (Brock and Rojas-Suárez, 2000). Furthermore, concentration of business activities within a public institution creates distortions in the market. In particular, *Banco de la Nación* concentrates some public payments, such as subsidies to low-income households, affecting efficiency in the access to finance.

Also, the high level of dollarisation of the financial system increases the economy's vulnerability to external shocks

Dollarisation distorts the transmission mechanism of monetary policy and increases liquidity and solvency risks within the financial system. Because of the high degree of dollarisation in the financial system, the Central Bank of Peru since 2013 has taken several steps to induce a faster reduction in credit dollarisation (Castillo et. al., 2016). Additionally it has to intervene frequently in the foreign exchange market to reduce exchange rate volatility and accumulate international reserves to prevent balance sheet effects. In a financially dollarised economy, the interest rate setting also has to take into account how financial dollarisation affects the transmission mechanism of monetary policy. The central bank addresses this issue by explicitly taking into account the impact of dollarisation on credit market conditions and on the dynamics of the exchange rate and inflation (Winkelried, 2013). Dollarisation reduces the impact of monetary policy on inflation and real activity, since a large depreciation not only typically generates a positive impact on exports, but also triggers a negative impact on the financial position of firms with currency mismatches. In sum, the role of credit in the transmission of monetary policy is relatively weak, but would improve if Peru reduced its levels of dollarisation.

Figure 1.7. **Peru's efficiency in the banking system**



Notes: Cost efficiency is a measure of the relative distance from the efficient frontier. It ranges between 1 for a fully efficient and 0 for a fully inefficient firm. The selection of benchmark countries is based on data availability.

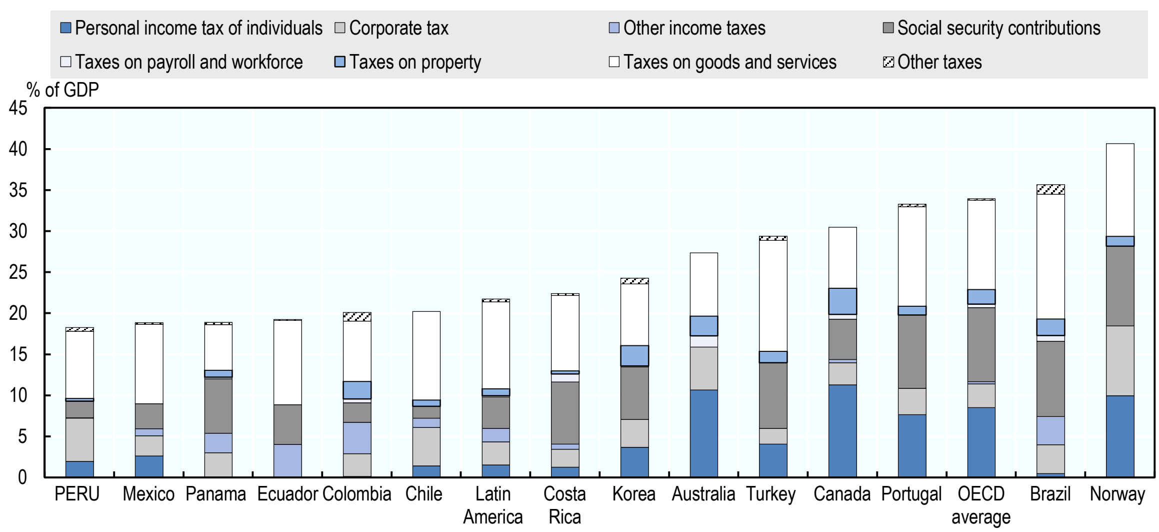
Source: Daude, C. and J. Pascal (2015), "Efficiency and contestability in the Colombian banking system", *OECD Economics Department Working Papers*, No. 1203, OECD Publishing, Paris, http://dx.doi.org/10.1787/5js30twjgm6l-en.

Finally, a comprehensive fiscal reform is needed to improve the efficiency and equity of the tax system, and in particular to increase fiscal revenues

A key challenge for Peru is to improve its tax policy so as to turn revenues into a more effective tool for economic and social development. The current tax system does not raise sufficient revenues to finance the provision of the services needed to stimulate inclusive and sustainable economic growth. More revenues need to be raised to finance investment in education and skills, infrastructure, and innovation. In the context of the emergence of the middle class, there is a need to provide more and better quality of public services. Social expenditure and infrastructure needs will also require more revenue in the near future. To achieve this objective, it is essential that Peru consolidates the fiscal legitimacy achieved through the public governance improvements.

Tax revenues in Peru are still low compared to benchmark, OECD and Latin American countries (see Annex 1.A1 of OECD 2015, Chapter 1 for a description of benchmark countries). While tax revenues represented 18.3% of Peru's GDP in 2013, the average share in Latin American and OECD countries was 21.3% and 34.1%, respectively (OECD/ECLAC/CIAT/IADB, 2015). Fiscal resources are also lower than in all benchmark countries (Figure 1.8).

Figure 1.8. **Tax revenues as % of GDP, 2013**



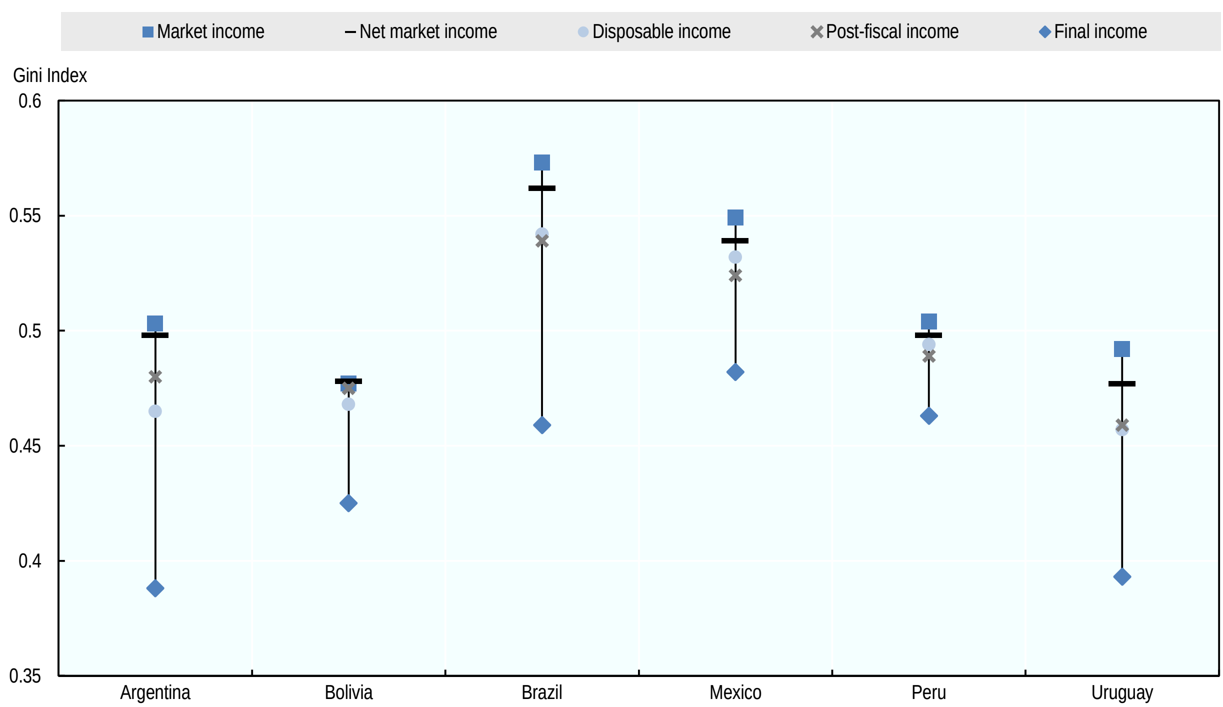
Note: 2012 data for Australia.

Source: OECD/ECLAC/CIAT/IADB (2015), Revenue Statistics in Latin America and the Caribbean, OECD Publishing, Paris http://dx.doi.org/10.1787/rev_lat-2015-en-fr.

Redistributive mechanisms, such as taxes and social transfers, do little to reduce income inequalities in Peru. The impact of taxes and transfers on reducing inequalities remains well below that of some other countries in the region (Figure 1.9). This is directly linked to the ineffectiveness of direct transfers, which largely involve in-kind transfers for free or subsidised government services in education and health (Lustig and Higgins, 2013). The effectiveness indicator of social expenditure (i.e. the ratio between the variation of the Gini index and the size of direct transfers as a percentage of GDP) is very low, with only Bolivia performing below Peru within the group of countries portrayed in Figure 1.9 (Lustig and Higgins, 2013). Moreover, while in Peru inequalities only decline by 2 percentage points after taxes and transfers, in OECD economies they decline by more than 15 percentage points (OECD/ECLAC, 2012). Improvements in fiscal legitimacy at national and subnational levels are fundamental to increase progressivity and tax revenues in Peru.

Tax evasion should be tackled in order to increase fiscal space in Peru. Evasion hinders development and inclusive growth and undermines the overall sense of fairness on which the taxation system should be based (Carrasco, 2010). Although it is difficult to estimate tax evasion, studies show that Peru is one of the Latin American economies with the highest levels of tax evasion. In particular, estimated evasion rates for VAT and income taxes are close to 38% and 48%, respectively (Gómez-Sabaini and Jiménez, 2012). Beyond the tax structure, better information systems, and increased transparency and integrity in tax administration operations are fundamental for tackling tax evasion. Moreover, in an international context it is important to ensure that profits are taxed in the country where economic activities generating the profits are performed and where value is created. Like in other developing and emerging markets, base erosion and profit shifting (BEPS) is of major significance for Peru due to its heavy reliance on corporate income tax, particularly from multinational enterprises. Further involvement of Peru in this OECD work in the framework of the Country Programme would help to minimise base erosion and profit shifting.

Figure 1.9. **Impact of taxes and transfers on income distribution**



Source: Lustig et al. (2013), "The impact of taxes and social spending on inequality and poverty in Argentina, Bolivia, Brazil, Mexico, Peru and Uruguay: An overview", *CEQ Working Paper*, No. 13, CEQ.

Conclusions

Peru implemented bold and ambitious reforms in the 1990s, which laid the foundations of a strong macroeconomic performance in the last decade, as well as for the improvement of social conditions. A combination of promotion of private investment, market oriented policies, elimination of state monopolies and controls, and a new regulatory framework to pursue competition and protections of the public, along with the corresponding regulatory agencies for supervision and oversight, led Peru in a path of economic growth and poverty reduction during the last decade. However, in order to achieve a more inclusive and sustainable path, Peru must find ways to boost productivity growth, and to reduce inequalities and informality.

In terms of macroeconomic performance, credible macroeconomic framework has been crucial for increasing economic stability and boosting economic growth in Peru. Initiated in the 1990s, it has improved the country's monetary and fiscal stances remarkably. The adoption of an inflation targeting regime to increase stability in the monetary front and the implementation of a fiscal rule to avoid volatility in the public finances contributed to boosting investment and improving consumers' confidence.

However, some risks remain on the macroeconomic front as external conditions become less favourable Shifting external conditions are lowering commodity prices, increasing long term dollar interest rates, weakening regional currencies and lowering flows of capital to emerging economies. All of these will put pressures on Peru's financial markets and potential growth. To better prepare the economy to adjust to the new environment, Peru should reinforce its macroeconomic framework and make sure that banks, governments, businesses and households have solid balance sheets.

Notes

1. During this time, Peru suffered from terrorist attacks which targeted the civil population, police forces and public and economic infrastructure.
2. According to the 1979 Constitution, the Legislative Branch (the Congress) may give power (delegate) trough and Act, to the President of the Republic (the Executive Branch). With this powers the President could approve and enact legislative instrument called Legislative Decrees. This legislative decrees have the same value, force and level of legislation (Acts) approved by the Congress. Therefore, a legislative decree from the Executive Branch could change, modify or nullify Acts from the Congress.
3. Legislative Decree No. 757, Act for the Growth of the Private Investment.
4. Idem.
5. Idem.
6. Legislative Decree No. 662, Act for the Promotion of Foreign Investment.
7. Idem.
8. Idem.
9. Legislative Decree No. 708, the Act for the Investment Promotion in the Mining Sector.
10. Legislative Decree No. 644, Act for the Elimination of Administrative and Legal Obstacles and Restrictions that Block the Free Access to the International Routes and Traffic for the National Shipping Companies; Legislative Decree No. 645, Act that Grants Faculties to the Cooperatives and Business to Conduct Tasks of Loading, Unloading, Transhipment and Cargo Handling in Merchant Ships at Sea, River and Lake Ports; and Legislative Decree No. 670 Reform to the Civil Aviation Law No. 24882.
11. Legislative Decree No. 649, Act for the Investment Promotion in the Electricity Sector.
12. Legislative Decree No. 702, Act for the Investment Promotion in the Telecommunications Sector.
13. The organization, responsibilities, and functions of the regulatory agencies OSINERGMIN, OSIPTEL, along with SUNASS (National Superintendence of Sanitation Services) and OSITRAN (Supervisory Agency for Investment in Public Transport Infrastructure), were later consolidated in the Law 27332: Framework Law of the Regulatory Organisms of the Private Investment in Public Services. The governance of these independent regulators is described and analysed in Chapter 7.
14. Legislative Decree No. 637, General Act of Banking, Financial and Insurance Institutions.
15. Legislative Decree No. 668, Act to guarantee freedom of international and foreign trade and internal commerce.

16. Legislative Decree No. 674, Act for the Promotion of Private Investment in State Owned Enterprises.
17. Idem.
18. Idem.
19. Legislative Decree No. 758, Act for the Private Investment in Public Services Infrastructure.
20. Usually one Ministry at the time.
21. In this contract, the private party usually assumed the financing of the infrastructure. In return, it had the right to charge fees to users.
22. This included the built, maintenance, management, operation and exploit of roads, highways, railroads, electric infrastructure, airports, and hospitals, among others.
23. Legislative Decree No. 757, Act for the Growth of the Private Investment.
24. Legislative Decree No. 757, Act for the Growth of the Private Investment. For a description and assessment of recent efforts on administrative simplification, please see Chapter 4.
25. Legislative Decree No. 701, Act for the elimination of Anticompetitive Practices.
26. Legislative Decree 716, Consumer Protection Act.
27. Legislative Decree 691, Publicity Act.
28. These are some examples of the new public agencies created in the context of the reforms. However more agencies were created, for example, the National Superintendence of Customs and Tax Administration (SUNAT), and the utilities regulatory agencies: OSIPTEL, OSINERGMIN, OSITRAN, and SUNASS. See Chapter 7 for a description and assessment of the governance arrangements of the latter.
29. INDECOPI had to enforce market rules related to free competition, dumping and subsidies control, consumer protection, unfair competition, technical and commercial standards, market access, market exit, trademark, patents and copyrights.
30. See Chapters 2, 4 and 5 for a description and assessment of the current functions of INDECOPI related to regulatory policy.
31. Reforms in these sectors were undertaken later on. Amongst others, it included measures to implement a free trade agreement with the USA which led to the update of the regulatory framework, including new powers for INDECOPI, regulation on copyright linked to innovation, and a new law on customs, amongst the most relevant. See OECD (2015) for a general description and assessment of the recent competitiveness and economic diversification of Peru.
32. In the forthcoming publication of the OECD Review of Public Governance of Peru, the decentralisation process is described and assessed in detail.
33. For a detailed discussion and assessment of these elements, see OECD (2015).
34. In Nolasco et al. (2016), using a similar model to Han (2014), more external sources of economic growth are quantified, including the USA. According to their calculation, these external sources at times accounted for as much as 40% of growth during the 2000s.

35. The Herfindahl-Hirschman Index (HHI) can range from close to 0 to 10 000. It approaches zero when a market is occupied by a large number of firms of relatively equal size and reaches its maximum of 10 000 points when a market is controlled by a single firm. According to the US Department of Justice, the agencies generally consider markets in which the HHI is between 1 500 and 2 500 points to be moderately concentrated, and consider markets in which the HHI is in excess of 2 500 points to be highly concentrated.

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From:

Regulatory Policy in Peru

Assembling the Framework for Regulatory Quality

Access the complete publication at:

https://doi.org/10.1787/9789264260054-en

Please cite this chapter as:

OECD (2016), “Structural reforms and the recent macroeconomic context in Peru”, in *Regulatory Policy in Peru: Assembling the Framework for Regulatory Quality*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264260054-5-en