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Minutes of Executive Board Meeting 20/1-3

12:00 p.m., January 8, 2020

3. Peru—2019 Article IV Consultation

Documents: SM/19/280, and Cor. 1, and Cor. 2, and Sup. 1, and Sup. 1, Cor. 1, SM/19/286

Staff: Bonato, WHD; Zakharova, SPR

Length: 1 hour and 2 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	**Alternate Executive Directors**
	A. Nainda (AE), Temporary
M. Raghani (AF)	
	R. Morales (AG), Temporary
	C. White (AP)
	B. Saraiva (BR)
	P. Sun (CC)
L. Villar (CE)	
L. Levonian (CO)	
R. Kaya (EC)	
	P. Rozan (FF)
	K. Merk (GR)
	B. Singh (IN), Temporary
D. Fanizza (IT)	
	K. Chikada (JA)
	M. El Qorchi (MD)
H. Beblawi (MI)	
	V. Rashkovan (NE)
	J. Damgaard (NO), Temporary
A. Mozhin (RU)	
	R. Alkhareif (SA)
A. Mahasandana (ST)	
	V. Djokovic (SZ), Temporary
	D. Ronicle (UK)
	P. Pollard (US), Temporary

C. McDonald, Acting Secretary
E. Tsounta, Summing Up Officer
E. Mannefred, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Communications Department: M. Candia Romano, M. Henriquez. Office of Executive Directors: A. Alzamel, J. Bukovina. Strategy, Policy, and Review Department: D. Zakharova. World Bank Group: E. Korczyc. Western Hemisphere Department: L. Bonato, M. Ghazanchyan, A. Husain, S. Khalid, P. Rodriguez Martinez, J. Torres Trespalacios.

Executive Director: P. Moreno (CE). Alternate Executive Director: A. Guerra (CE). Senior Advisors to Executive Directors: Z. Mahyuddin (ST), J. Weil (CO). Advisors to Executive Directors: M. Albert (FF), A. Arevalo Arroyo (CE), S. Belhaj (MD), L. Cerami (IT), T. Chrimes (UK), J. Corvalan (AG), J. Essuvi (AE), H. Koh (GR), K. Kuretani (JA), M. Merhi (MI), D. Shestakov (RU), J. Yoo (AP), Y. Zhao (CC).

3. PERU—2019 ARTICLE IV CONSULTATION

The staff representatives from the Western Hemisphere Department submitted the following statement:

> *This statement provides information that has become available since the staff report was issued on December 19, 2019. This information does not alter the thrust of the staff appraisal.*
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> 1. **The latest data and information releases suggest that economic activity remains sluggish.** The monthly GDP data for October shows a 2.1 percent y-o-y growth, with the growth for the period January-October staying at 2.2 percent (y-o-y). While the October data recorded some recovery in the primary sectors, this positive development was offset by a weakening in the nonprimary sectors, particularly in manufacturing and construction. In its last quarterly inflation report for the year, issued on December 20th, the BCRP revised down its 2019 growth projection from 2.7 percent to 2.3 percent. This revision is in line with Staff's projections. The BCRP left its 2020 growth forecast unchanged at 3.8 percent.
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> 2. **The government invoked the escape clause of the fiscal rule framework to relax the fiscal deficit ceilings for the period 2021-23.** As indicated in the staff report, in 2017 the government invoked the fiscal rule's escape clause after the economy was impacted by a severe El Niño weather pattern. This allowed the fiscal deficit to exceed the 1 percent ceiling for the period 2017-20, but the deficit was required to meet the ceiling again in 2021. Given the current economic slowdown, the government has invoked the escape clause one more time in order to implement a more gradual consolidation. Under the new path, the fiscal deficit ceiling will be 1.8, 1.6, and 1.3 percent of GDP in 2021, 2022, and 2023, respectively. The increase in the ceiling is primarily aimed at creating room for higher capital expenditure. The deficit ceiling for 2020 remains unchanged at 2 percent of GDP. The temporary modification of the fiscal rule has been legislated via a government decree. The latter has been submitted to Congress' Permanent Commission, which will in turn bring it to the new Congress once it is in session.
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> 3. **On balance, staff assess this measure as appropriate, although some actions are needed to enhance its benefits and mitigate its shortcomings.** The relaxation of the deficit ceiling is in line with staff's view about the desirability of short-term fiscal easing. In addition, using the additional fiscal room for capital spending is in line with the objective of closing infrastructure gaps. Finally, Peru's sound fiscal position, with low public debt and significant fiscal assets, limits risks to the debt dynamics. Nonetheless, the actual impact of this measure will crucially depend on the government's capacity to reverse the budget under- execution, which has been a difficult task in recent years. It will also be important to the government to

implement measures to maintain the credibility of the fiscal framework. As indicated in the staff report, frequent revisions may weaken the integrity of the rules-based fiscal framework. As a result, it may be important for Peru to add additional flexibility to the fiscal framework in the medium term rather than relying on frequent uses of the escape clause.

4. **The government has also extended the agriculture promotion law until 2031, although with some modifications.** As indicated in the staff report, the law was set to expire in 2021 and the uncertainty about its future was affecting investment decisions. The government has issued a decree extending the law for an additional ten years, while also applying some of its provisions to the forestry and aquaculture sectors. The decree includes some modifications to the existing law, including an increase in the number of vacation days (from 15 to 30), an 8 percent increase in the minimum daily remuneration, as well as an increase in employers' health care contributions (which will gradually converge to the 9 percent rate applicable economy wide). The extension of the agriculture promotion law is in line with staff's policy advice and, as in the case of the modification of the fiscal rules, the decree has been submitted to Congress' Permanent Commission, which will in turn bring it to the new Congress once it is in session.

Mr. Lopetegui and Mr. Morales submitted the following statement:

On behalf of the Peruvian authorities, we would like to thank staff for the comprehensive Article IV report and selected issues paper. The authorities consent to the publication of the reports and appreciate the open discussions in Lima and the staff's thorough analysis of recent economic developments and relevant policy issues.

Macroeconomic Background

Peru's macroeconomic performance remains strong. Economic growth reached 5.4 percent on average for the last 15 years in an environment of macroeconomic stability, free trade, and capital mobility. Moreover, Peru has made substantial inroads in mitigating key vulnerabilities by reversing dollarization, strengthening financial soundness, and reducing poverty. Peru's GDP growth is expected to decelerate to 2.2 percent in 2019, a decline largely associated with temporary and/or idiosyncratic factors, mainly in mining and fishing. Non-primary industries are expected to grow by 3.2 percent (down from 4.2 percent in 2018), mainly due to lower terms of trade and lower growth in trade partner economies (associated with international trade tensions and China's economic deceleration).

Despite deteriorating external conditions, Peru maintains strong buffers which have proved instrumental in helping to limit the risks from currency mismatches and dollarization. Gross international reserves reached USD 68 billion and net public debt remains low at 12.6 percent of GDP (26.7

percent in gross terms), with a declining share of foreign currency liabilities. These buffers and Peru's long-standing track record of consistent economic policies ensure the continuation of macroeconomic stability and facilitate an effective policy response to external shocks.

The Central Reserve Bank of Peru (BCRP) implements its monetary policy within an inflation-targeting scheme, with the short-term interest rate as the main instrument. Changes in the BCRP policy rate have evolved in line with inflation and output gap forecasts. This has allowed the implementation of counter-cyclical monetary policy to mitigate the impact of demand shocks on inflation and economic activity.

Unconventional monetary instruments in Peru complement policy rate decisions and aim at limiting the risks from financial dollarization and the impact of the credit cycle on financial stability. In a context of financial dollarization and high volatility in capital flows, the use of reserve requirements and foreign exchange intervention (FXI) has contributed to increasing the effectiveness of the interest rate as a counter-cyclical policy tool. During the global financial crisis, the use of non-conventional instruments allowed the BCRP to maintain low policy rates and implement and effective counter-cyclical policy response. As a result, between 2001 and 2019 Peru's inflation and growth performance was considerably stable. Over the same period, credit dollarization declined by 54 percentage points (from 80 to 26 percent) and financial intermediation (measured as the credit-to-GDP ratio) increased from 23 to 42 percentage points of GDP.

Recent Developments

Lower GDP growth in 2019 reflects mainly a contraction in primary sectors during the first half of the year, especially mining and fishing, because of external and idiosyncratic factors. In addition, domestic demand slowed down to 2.5 percent annual growth in 2019 (from 4.2 percent the year before) in response to lower terms of trade and a slowdown in global activity. However, consumer and business confidence started to recover in the second half of the year. Non-commodity exports, mainly agricultural products, continued to rise, placing Peru among the world top exporters of blueberries, citrus, grapes, avocados and others, thereby contributing to job creation and poverty reduction. In the absence of shocks, we expect an important recovery both in exports and in domestic demand in 2020-2021, triggered by a normalization of production in major mines, the phasing-out of "base effects" affecting fishing growth, and the start of operations of new mining projects. We project a faster narrowing of the output gap relative to staff forecasts as confidence recovers and public investment rebounds.

Some political economy developments had an impact on overall confidence. Corruption allegations and difficulties in the interaction between the government and congress affected investor sentiment. Additionally, the assumption of duties by new local authorities caused a delay in the implementation of regional projects. Going forward, the weight of these factors on expectations and domestic demand should diminish as the underlying frictions are resolved and new congressional authorities are elected at end-January.

External Sector

The external current account deficit in 2019 remained unchanged relative to 2018. In addition, a soft global growth environment contributed to a decline in traditional exports. However, commodity prices recovered somewhat towards the end of the year because of diminished trade tensions and the depreciation of the US dollar. As economic activity picks up, the current account deficit is expected to remain stable in 2020 and 2021, below the average for the last 8 years. Foreign direct investment continues being the main source of external financing, coupled with a significant increase in capital inflows explained by a decline in the probability of a rise in interest rates in advanced economies and a positive assessment of Peru's economic performance and prospects by foreign investors. Foreign portfolio investors allocated US$2.1 billion to the private sector assets and US$4.2 billion to sovereign securities in 2019, a significant increase relative to previous years.

Monetary Policy

The BCRP reduced its policy interest rate in August and again in November to 2.25 percent, thereby expanding policy stimulus in the face of a negative output gap and well-anchored inflation expectations. In 2019, inflation was 1.9 percent and the estimated output gap around -1 percent on average. The current monetary policy stimulus aims at maintaining inflation and inflation expectations around the midpoint of the inflation target range of 1-3 percent and gradually closing the negative output gap.

BCRP intervention in the foreign exchange market has continued to aim at containing excessive exchange rate volatility, although FXI frequency had decreased significantly. During 2018 and 2019, the number of days of central bank intervention declined to less than a week in both the spot and the derivative markets. At the same time, the participation of non-residents in the foreign exchange market has increased over time, consistent with their higher share in sovereign bonds holdings, which reached 47 percent towards the end of the year. In 2019, foreign investors mostly sold foreign exchange in the spot market to acquire domestic currency to purchase government securities and hedged their currency exposure in the derivatives market (which has become much more active in recent years).

Fiscal Policy

The overall fiscal deficit is expected to decline to 1.7 percent in 2019, mostly because of higher revenue. Efforts to monitor tax compliance and to strengthen oversight by the revenue authority translated into higher extraordinary revenue collection for the year. Regarding government expenditure, the share of capital spending declined because of investment underperformance by regional and local governments. As a result, the structural fiscal balance improved by 0.8 percent of potential GDP, reflecting fiscal policy stance more contractionary than originally envisaged.

The authorities aim at reversing fiscal policy pro-cyclicality by raising budget execution. At the same time, higher tax revenue should contribute to enlarge fiscal space for capital and social spending. With that purpose, the tax authority has put in place a results-based strategy to expand the tax revenue base through different initiatives such as introducing a Digital Transformation Plan, encouraging voluntary compliance, introducing anti-elusion measures, and expanding electronic invoicing. These measures should help to reduce widespread compliance gaps, particularly VAT compliance.

The decline of public investment in 2019 resulted from a combination of idiosyncratic factors. Consistent with historical patterns, the implementation of regional projects slowed down as new local authorities took office. At the national level, recurrent implementation problems explain project execution well below original targets. To address these challenges, a monitoring system has been implemented to receive timely feedback regarding project execution, and “urgency decrees”, subject to validation by the new congress, have been enacted to introduce a simplified process to implement priority projects included in the National Infrastructure Plan for Competitiveness and to adopt measures to encourage a higher execution of public projects. These measures comprise the reallocation of fiscal resources to projects with better implementation track record, the removal of red tape hampering the continuation of public works showing substantial implementation progress, and a fast-track allocation of contingent fiscal resources to regional governments showing improved project execution.

Regarding debt management, the government has been active in issuing new obligations to improve the country’s debt service profile. In this regard, tangible results have been achieved over time in lengthening the average maturity of obligations, raising the share of local currency liabilities, and increasing the share of fixed-rate borrowing instruments. To make further progress on these fronts, the government issued local currency bonds in June and November 2019. The November issuance amounted to 10 billion soles (about USD 3 billion), with maturities of 15 and 21 years, attaining interest rates of 4.95 (record low for domestic currency securities) and 5.35 percent respectively.

For the medium term, the government has revised the trajectory of the overall fiscal deficit to smooth out the transition towards the one percent fiscal deficit rule, as economic activity is still below potential. On current trends, the prior trajectory would have brought about a significant fiscal adjustment between 2020 and 2021, implying a pro-cyclical fiscal stance. The new trajectory aims at reaching a 1 percent overall fiscal deficit by 2024.

Financial Sector

Consumer loans continue to increase, while business loans are decelerating. Overall, this has resulted in a continuous increase in financial intermediation, with a ratio of credit to GDP of 44 percent, up by 3 percent from 2014. Consumer loans have picked up in response to an environment of lower interest rates in domestic currency, contributing to de-dollarization. The deceleration in business loans reflects higher risk aversion by banks and firms, and weaker economic activity. Although nonperforming loans remain low at 3.5 percent of total, the Superintendency of Banks, Insurance and Pension Funds (SBS) remains vigilant to anticipate any deterioration in credit risk arising from the slowdown and/or the acceleration in borrowing by households.

The banking sector remains well capitalized. The SBS is enhancing the monitoring of banks' off-balance sheet exposures and is considering additional surcharges for systemic banks. It also introduced an additional capital charge equivalent to an 8 percent increase in the risk weight for foreign exchange credit risk exposures. Regarding non-bank institutions, risk-based supervision of insurers is fully implemented. Moreover, in line with the new SBS mandate to incorporate more than one thousand financial cooperatives under its supervision, the SBS is taking stock of basic information on the financial soundness of existing institutions. Regarding pension funds, the SBS is coordinating with the Ministry of Finance and the Ministry of Labor on reform proposals to be discussed with relevant stakeholders.

Structural Reform

The authorities agree with the urgent need to raise productivity to raise growth potential over the medium term. The National Plan of Competitiveness and Productivity approved last July provides the framework and a roadmap to support appropriate government intervention in key areas around nine priority objectives, namely improving infrastructure, human capital, innovation, financial deepening, labor markets, the business environment, international trade, government institutions, and environmental sustainability. Complementarily, the National Infrastructure Plan for Competitiveness identifies 52 priority projects to narrow the infrastructure gap estimated at about USD 100 billion, with institutional arrangements for a better planning and monitoring of projects at different government levels. In addition, given slow progress to rebuild infrastructure in regions affected by the 2017 "El Niño" disaster, the entity in charge has been empowered to sign government-to-government agreements to accelerate this process.

Reducing the large share of informal employment in the labor market is a challenging task. On the one hand, the informal sector has provided employment alternatives especially to the economically disadvantaged, with national unemployment at 3.7 percent of the labor force in the third quarter of 2019. However, widespread informality makes it difficult to raise productivity in a scale sufficient to raise standards of living significantly, in a sustainable and inclusive manner. In this regard, the government gives high priority to policies to strengthen human capital, including by improving access to high quality education, job training, and matching capacity building with skill gaps. Because of the success of the agrarian promotion law in driving labor formalization in the sector, it has been extended for ten more years. The new law retains the flexibility in labor contracts, at the same time increasing the benefits to workers. In the medium term, it would be necessary to formulate policies conducive to a more efficient absorption of Venezuelan immigrants to the formal job market.

The government gives high priority to improve public sector transparency and governance. The implementation of the 2018-21 Anti-corruption Plan is helping to strengthen anti-corruption institutions. To support these efforts, the government created the Council for Judicial Reform in May 2019, to coordinate and monitor all judiciary reform initiatives. Regarding AML/CFT prevention, the number of suspicious activities reported to the Financial Intelligence Unit has more than tripled between 2013 and 2018, and is expected to have increased further in 2019, reflecting increased awareness among the population about the need to contribute to enhance integrity at all levels of society.

Mr. Saraiva and Mr. Fuentes submitted the following statement:

We thank staff for the paper and Mr. Lopetegui and Mr. Morales for their helpful statement. The Peruvian economy has sustained an outstanding performance in the last 15 years among regional peers, supported by sound macroeconomic policies, achieving significant progress in social outcomes and maintaining ample buffers. Moreover, Peru achieved some convergence with advanced economies during the commodity boom and has been making strides in fighting corruption and strengthening institutions. Authorities have responded to the recent slowdown – mainly due to transitory domestic factors – with appropriate policies and acceleration of economic activity is expected in the short term. That notwithstanding, potential growth has lowered and to continue building on historical gains will require additional reforms to help Peru advance towards sustained development.

Fiscal discipline has ensured a comfortable position with ample buffers, but fiscal space should be employed to help reduce the output gap and remove obstacles to potential growth. The fiscal responsibility law has enforced prudent fiscal behavior, strengthening solvency and reducing business cycle volatility during years of weak commodity prices while mitigating tail risks. As a result, public debt is low and sustainable, and ample fiscal buffers in the form of bank deposits have been accumulated. However, avoiding the rule's procyclical bias, which is magnified by shortfalls in investment execution, remains a challenge. Therefore, while resorting to the escape clause has helped smooth the pace of convergence and mitigate procyclicality, we see merit in staff's recommendation to add further flexibility to the fiscal framework to allow for more appropriate use of existing fiscal space under specific circumstances. Overall, we encourage authorities to enhance the use of fiscal policy to support growth, including by improving budget execution, while keeping a sustainable fiscal position over time. We are encouraged by Mr. Lopetegui and Mr. Morales statement on this respect.

The multi-year infrastructure investment plan could indeed provide a boost to economic activity in the near term, while the focus should remain on expanding potential output. Addressing structural constraints obstructing the execution of large infrastructure projects and removing financing restrictions to local and regional governments will provide a much-needed lift to short-term growth prospects. However, Peruvian authorities have rightfully identified a considerable infrastructure gap, which the public sector is unable to bridge on its own, and that could hinder the sustainability of future growth. According to the National Plan of Infrastructure for Competitiveness, 52 projects have been prioritized to be executed in the next decade, including both PPPs and government-financed. As a first step to attract private investors, authorities have pledged to focus on strengthening institutions to send a signal to the market. In this regard, we would like to hear staff's assessment of how authorities can improve project implementation?

Continuing efforts to reduce dollarization would presumably reduce financial vulnerability and increase the effectiveness of monetary policy. The de-dollarization program implemented by the Central Bank of Peru (BCRP) since 2013 have steadily diminished the credit in USD-to-total credit ratio. Nonetheless, financial dollarization remains relatively high and seemingly exacerbates credit risk associated with exchange rate volatility. Furthering the de-dollarization process should allow the BCRP to accept greater exchange rate flexibility to absorb external shocks and promote financial market development. In the absence of more active central bank intervention, agents would be incentivized to internalize risks discouraging dollarization and fostering the development of hedging instruments. Having said that, we take note of the authorities' view that the current level of dollarization reflects the invoicing of intermediate and service transactions. We are also comforted by the measures taken by the Superintendence of Banks, Insurance and Pension Funds (SBS) to monitor and rein in forex credit risk exposure, as underlined by Mr. Lopetegui and Mr. Morales. Given the fact that many corporates have their income in US dollars and that dollar-denominated deposits have kept a significant wedge over dollar-denominated loans to the private sector, we wonder whether staff has an assessment of how large the remaining unhedged dollar-liability in the Peruvian economy is.

The resolute implementation of the National Policy for Competitiveness and Productivity (NPCP) should remain a priority to successfully tackle structural bottlenecks. Notwithstanding the sustained increase in Peru's GDP per capita in the last two decades and the social progress experienced in this period, productivity growth has been disappointing, slowing down convergence to high income status. While the empirical evidence suggest that middle-income countries do not systematically fall into a trap, the prospect of a middle-income trap alluded in the staff report in the case of Peru is useful for guiding policy discussion to reassess strategies to overcome deep-seated obstacles to productivity growth. Against this background, we welcome the adoption of the NPCP and the collaboration with the World Bank to support these efforts. Yet, we believe these actions should be properly focused and sequenced to achieve maximum effectiveness.

The prevalence of high levels of informality continues to limit policy effectiveness and potential growth. Informality in Peru remains well above the already high Latin American average, reducing productivity, narrowing the tax base and limiting social protection. Therefore, reform efforts should be directed towards reducing the rigidity of labor regulation in Peru to help reduce barriers to formalization and incentivize workers to participate formally. However, we acknowledge that reducing informality is a complex task that requires a comprehensive package of reforms to achieve tangible results. Consequently, these actions must be part of a multi-pronged approach including greater government transparency and higher investment in education, job training and social programs, to reduce the costs of formalization and disincentivize workers and firms from shifting to informality. That said, while understanding that there is no exact optimal timing for reform, staff's caution note to properly account for adequate cyclical conditions to change labor regulation seems sensible.

Mr. Chikada and Mr. Kuretani submitted the following statement:

We thank staff for the informative reports and Mr. Lopetegui and Mr. Morales for their helpful statement. It is encouraging that Peru continues to be one of the best-performing Latin American economies notwithstanding external and domestic environments, including trade tensions, volatile international financial markets, lower commodity prices, El Niño weather event, and corruptions. However, to reinvigorate its economic momentum, the authorities need to expedite implementing public investment projects and structural reforms. As we broadly agree with the thrust of the staff's appraisal, we will limit our comments to the following points:

Macroeconomic Outlook

We take a note with caution that Peru's expected growth recovery is contingent on moderate strengthening of growth in its trading partners and the dissipation of political uncertainty. In this context, given that more than half of Peru's exports are directed to China and the US, and China's growth rate is on a decelerating trend in particular, we would appreciate if staff could elaborate on which trading partners are likely to support Peru's growth recovery.

Fiscal Policy

Fiscal policy should be conducted in a countercyclical manner. It is also important to strengthen revenue mobilization capacity in the medium term. We commend that the long-term fiscal position is strong, and the government is on track to comply with fiscal rules. However, we concur with staff that in the short term additional fiscal support would be desirable, and in the medium term the authorities should develop an integrated control strategy for income taxes and VAT and continue to develop information systems that can fully exploit e-invoicing data. Regarding expenditure side, we welcome the government's strategy to improve competitiveness focuses on enhancing the quality of infrastructure, such as transportation, sanitation, telecommunications and water.

Monetary Policy and Financial Sector

We welcome Peru's progress in de-dollarization, and the central bank should allow greater exchange rate flexibility to absorb external shocks and promote financial market development. In this regard, additional efforts are needed to complete the legislative and regulatory reform agenda building on the considerable progress already made. We also take a positive note that the authorities are making progress in strengthening financial sector oversight based on FSAP recommendations. It is encouraged to complete the legislative and regulatory reform agenda.

Structural Reform

Facilitating progress on the broad structural reform agenda and additional reforms are needed to mitigate governance vulnerabilities and limit the scope for corruption. We welcome that the National Competitiveness Plan released in last June covers a large spectrum of reforms. As analyzed in the report, boosting productivity and enhancing competitiveness are essential to realize significant growth. In this context, we encourage the authorities to address infrastructural gap by improving public investment management and to promote economic diversification to other sectors. We also commend the authorities for strengthening anti-corruption enforcement. However, more efforts are needed to enhance public sector transparency and governance. We concur with staff that internal and external audits should be introduced and strengthened to improve this area.

Mr. Sigurgeirsson and Mr. Evjen submitted the following statement:

We thank staff for the good set of reports and Mr. Lopetegui and Mr. Morales for their informative Buff statement. Peru's macroeconomic performance remains solid, but external and domestic headwinds have reduced growth momentum. The latest data releases suggest that economic activity remains sluggish. Peru is exposed to several downside risks, both external and domestic, but Peru's sound fiscal position, with low debt, significant fiscal assets, and a solid financial sector could mitigate the impact of adverse shocks. We broadly concur with staff's assessments and offer the following points for emphasis.

Given the current macroeconomic headwinds, we agree that the relaxation of the deficit ceiling in the short term is appropriate. The latest data show that the economy is growing slower than the authorities had previously expected. As highlighted in the report, the fiscal stance has been procyclical. Given the slowdown confirmed by the data released after the draft report was issued, we note positively that the authorities have relaxed the fiscal deficit ceilings for the 2021-2023 period, as a more gradual fiscal consolidation would be advantageous. Using the additional fiscal room for capital spending is in line with the objective of closing infrastructure gaps. In the medium term, however, a modest fiscal consolidation, including through domestic revenue mobilization, and focus on maintaining the credibility of the fiscal framework is required. We agree with staff that it may be important for Peru to add more flexibility to the fiscal framework in the medium term, rather than relying on the use of the "escape clause" of the fiscal rule.

Risks to financial stability have declined slightly. The financial sector remains well capitalized, but some vulnerabilities have persisted in the banking sector, such as financial dollarization, concentration, and off-balance sheet exposures. To this end, we welcome the important steps that the authorities have taken to strengthen financial sector oversight to address these weaknesses, such as the SBS' progress in implementing a broad set of FSAP recommendations. We note that further steps are needed to enhance the effectiveness of the AML/CFT framework and encourage the authorities to continue their efforts to improve risk-based supervision to ensure AML/CFT compliance by financial institutions.

We concur with staff that a stronger focus on key priorities would facilitate progress on the authorities' broad structural reform agenda, which is needed to boost potential growth. We encourage the authorities to remain focused on key areas to improve productivity, including education, infrastructure, institutions, and labor market reform. We welcome that the government has put fighting corruption at the top of its agenda. Improvements in the anti-corruption framework play an important role in boosting investor confidence and improving the business climate. Lastly, the huge inflow of Venezuelan migrants will pose challenges to the labor market and probably reduce productivity in the short term. Hence, we commend the authorities for their efforts to increase the ability of the migrant population to effectively contribute to the labor market.

Mr. Villar and Ms. Arevalo Arroyo submitted the following statement:

We thank staff for the set of comprehensive reports and Mr. Lopetegui and Mr. Morales for their informative Buff statement. Despite the growth slowdown, Peru continues to be one of the best performers of the region amidst a complex background both externally and internally. Notwithstanding that economic activity has weakened, the strong policy framework underpinned by low public debt, ample international reserves and a sound financial sector will help the country navigate the uncertainty. Going forward, implementing a comprehensive structural reform agenda to increase productivity and improve governance will contribute to boost potential growth.

We thank staff for the useful box on the economic impacts of migration. We welcome the efforts of the authorities to allow the labor market to effectively absorb the migrant population and encourage them to design policies to support vulnerable groups that might be temporarily displaced by this influx.

We welcome the authorities' plans to expand public investment to enhance infrastructure quality. The identification of priority projects in the National Plan of Infrastructure for Competitiveness is encouraging. However, we note that capacity constraints have hampered these efforts in the past. Staff comments are welcome on the ongoing measures to remove capacity constraints both at the national and regional level.

Strengthening revenue mobilization capacity in hand with improving spending efficiency could provide additional resources for priority spending in the medium-term. We note that Peru has lagged its regional peers in the past 20 years in increasing revenue mobilization. In this regard, we welcome the efforts to reduce the VAT's compliance gap, tax administration improvement measures and electronic invoices. Additionally, expenditure control should also be focused on priority areas to improve social protection and close the infrastructure gap.

We agree with staff that additional flexibility to the rules-based fiscal framework in the medium term could be warranted. While we note that the escape clause was invoked to implement a more gradual consolidation, we agree with staff that the authorities could implement measures to maintain the credibility and integrity of the rules-based fiscal framework. Could staff comment on the reasons to switch from the 2014-2016 framework to the one currently in place? Was the previous framework more flexible? Has the current rule enough flexibility to provide room for counter-cycle policy adjustments if needed?

The monetary policy stance is appropriate and as dollarization continues to decrease, the BRCP should allow greater exchange rate flexibility. Monetary policy should remain data-dependent. While FXI has declined over time as stated in the Buff, we encourage authorities to limit the FX interventions solely to episodes of disorderly market conditions.

The use of a multi-instrument inflation targeting framework to achieve its policy objectives has served Peru well as it has provided strong macroeconomic performance during the past years. In this regard, we thank staff for the very illustrative SIPs on the evolution of this framework and its performance in comparison to peers. We note staff considers the multi-instrument framework could be enhanced by evaluating its trade-offs. Could staff comment on the benefits for Peru of maintaining a multi-instrument framework vis-à-vis a more orthodox one going forward? Could the multi-instrument inflation targeting framework be considered as transitory?

A structural reform agenda that boosts productivity and competitiveness, improves governance while reducing informality and improving social protection will provide for inclusive and sustainable growth. We are encouraged by the comprehensive agenda and the priorities set in the National Competitiveness Plan. We welcome the reforms to improve the business climate, enhance public sector transparency and governance, and address the infrastructure gap and critical needs regarding poverty reduction.

Mr. Bhalla and Mr. Singh submitted the following statement:

We thank the staff for the report and Mr. Lopetegui and Mr. Morales for their informative Buff statement.

One of the best economic performers among Latin American countries, Peru has experienced sound growth and significant reduction in the poverty levels over the years. Despite expected slowdown in 2019, Peru's economic performance may bounce back in the future on the back of fiscal support for investment, easy monetary conditions, improved private investment and gains in terms-of trade with turnaround in commodity prices. Recent developments indicate the need for strengthening of investment on infrastructure to improve productivity and competitiveness and enhancing the degree of formality in private sector employment. External vulnerabilities from rising protectionism and tightening of global financial conditions and domestic impediments such as delays to public investments and PPP projects, and domestic political uncertainties could particularly stifle private investment and pose downside risks to growth.

We support the staff advice that the current slowdown in economic activity and heightened uncertainty justify policy stimulus. We agree with the advice that given the negative output gap and the absence of inflationary pressures, accommodative monetary policy is appropriate, and the policy stance should continue to be data-driven. The fiscal position improved more than anticipated, partly reflecting low implementation of capital spending by the newly-elected regional and local governments, which may not be construed as growth conducive, given the prevalence of significantly negative output gap. At the same time, given low tax yields, the authorities need to enhance revenues through tax administration reforms to support infrastructure investments and higher outlays in the social sector. VAT compliance gap appears to be a common problem across many emerging market countries. The staff would like to comment whether the issues in VAT non-compliance are similar to other EMEs. As highlighted in the Buff, the authorities have put in place a strategy to expand the tax revenue base through different initiatives viz., Digital Transformation Plan, anti-evasion measures, and expanding electronic invoicing. How far these measures will reduce compliance gaps, particularly VAT compliance? Given the findings of the special note that the VAT gap appears to co-move with the commodity cycle, how far the tax revenues could be vulnerable to international commodity price cycles?

We concur with the staff that as dollarization declines, the Central Reserve Bank of Peru (BCRP) should allow greater exchange rate flexibility to absorb external shocks and promote financial market development viz., hedging instruments. Although the dollarization of loans has moderated, given the still significantly high dollarization of bank deposits, what risks it may pose in the event of sudden tightening of external financing conditions?

Structural reforms are vital for bringing a turnaround in the lackluster productivity growth, which has also raised concerns about Peru getting stuck in a middle-income trap. It's encouraging to note that the National Plan of Infrastructure for Competitiveness Investment, particularly needed to boost investment in transportation, sanitation, health, telecommunications and water, would help augment the productivity growth. At the same time, reducing misallocation of resources, removing impediments to productive enterprise, eliminating tax distortions, rationalizing regulations for small enterprises and improving access to credit should comprise key pillars of the structural reform strategy. Better governance through reduction in corruption and enhancement of AML/CFT supervision would serve to boost investor faith. It's encouraging to note that Anti-Corruption Plan is currently being implemented to strengthen anti-corruption institutions and improve transparency. Given the high potential impact of product market and legal system reforms on productivity growth, we encourage that authorities prioritize such reforms.

In the context of informality, the staff report highlights that informal employment in Peru is much above the average for the Latin American average. The staff analysis highlights the role of accelerated depreciation and simplified tax regimes and other regulations to incentivize greater formality. Does the staff think that informality in EMEs like Peru may also be an outcome of elastic supply curve of unskilled/low skilled labour, which keeps production cost low for small and micro enterprises?

We wish the authorities very best and success in their future endeavors.

Ms. Mahasandana and Mr. Mahyuddin submitted the following statement:

We thank staff for the comprehensive set of reports on Peru and Mr. Lopetegui and Mr. Morales for the informative Buff statement.

A sound macroeconomic policy framework has supported the Peruvian economy and helped build adequate policy buffers. While the economy is expected to gradually recover from the underperformed growth in 2019, Peru is exposed to significant downside risks from possible weak global growth and volatile financial conditions as well as adverse domestic factors. We also note that weak productivity growth and competitiveness have been a long-standing concern. To this end, we welcome the authorities' appropriate policy mix to respond to these challenges and the broad range of reforms to remove structural obstacles to sustainable growth. We also broadly agree with the thrust of the staff appraisal and would like to offer the following comments for emphasis.

The success of multi-instrument policy framework could be enhanced further through a better understanding on how the policy mix can be improved given different risk scenarios and assessing the trade-offs of the different tools. The policy mix has worked well in achieving macroeconomic stability and lowering dollarization. This allows for greater exchange rate flexibility and limiting the foreign exchange intervention (FXI) to episodes of disorderly market conditions. Given the significant spillover risks from financial instability, the move towards greater exchange rate flexibility should be progressive and gradual as FXI remains an important policy tool for containing disorderly market movements. We also note the authorities view that the remaining dollarization largely reflects widespread dollar invoicing of intermediate goods and services, which would be irresponsive to additional exchange rate volatility. We would welcome staff comments on this view, including on whether dollar invoicing plays a significant role in influencing Peruvian policy stance. Notwithstanding the importance of FXI, we agree with staff that an assessment of the potential adverse effects of FXI on the development of hedging markets and on dollarization is equally important to further improve the overall policy stance and enhance financial market development. Could staff elaborate on any potential TA or future collaboration with the authorities on the IPF study to better understand the trade-off and right policy mix that would be helpful for the Peruvian authorities?

The additional fiscal easing, with emphasis on improving public investment is warranted given the uncertain economic prospects. Ample fiscal buffers and low public debt provide some fiscal space for policy easing and opportunity to accelerate the much-needed investment to close the infrastructure gaps. To this end, we take positive note that measures to improve budget execution on delayed public investment are expected to yield positive results and we support the authorities' latest decision to invoke the escape clause again in order to implement a more gradual consolidation given the current economic slowdown. To sustain medium-term consolidation, raising revenue mobilization and strengthening the Medium-Term Budget framework would be necessary to improve public infrastructure. However, we view that revenue mobilization measures will take time. We appreciate staff comments on whether the high-than-expected revenue achieved in 2019 is sustainable in the near term and whether the speed of the consolidation effort recently announced by the authorities is appropriate, taking into consideration the need to boost infrastructure spending and the available fiscal space? We also see merit in reviewing the appropriateness of the current fiscal framework of 1-percent headline deficit target to make sure that the current fiscal framework is not too restrictive and limits the space for infrastructure spending to address the gaps.

Phasing the implementation of the broad structural reform agenda is key to enhance country's competitiveness and support sustainable reform agenda. We welcome the authorities' strong commitment towards The National Competitiveness and Productivity Policy. We also note that the plan covers a large spectrum of reforms. While the broad reforms agenda is necessary, strategizing the implementation effort through multiple phases with a clear timeline over the long-term will accommodate effective use of resources and manage potential capacity constraints. We view that structural reforms for enhancing productivity and infrastructure investment are key to raising the potential growth and sustaining inclusive growth over the long term.

Further strengthening of the financial supervision and enhancing the effectiveness of the AML/CFT framework are essential to enhance the financial system resilience. We note that some changes will take time and may not be a priority in the current political context. Nonetheless, a sensible commitment on the timeline to carry out the necessary reforms would be desirable given the high concentration of the banking sector in the financial system.

We wish the authorities all the success in their future endeavors.

Mr. de Villeroché, Mr. Rozan and Ms. Albert submitted the following statement:

We thank staff for their insightful set of papers, as well as Mr. Morales and Mr. Lopetegui for their clear Buff statement. We welcome Peru's strong macroeconomic performances, which have been accompanied by a significant poverty reduction, even though external and domestic factors have recently had an adverse effect on growth. This performance is linked to authorities' sound management and adequate policy-mix. Nevertheless, there is margin for progress, especially to improve budget execution in light of the significant infrastructure gap, and to boost productivity. The reduction of corruption and informality are also key to improve the business climate and stimulate potential growth. These should prevent the country from being stuck in a middle-income trap. We share the thrust of staff's appraisal and would like to offer the following comments for emphasis:

We welcome the strong economic performance. Growth has been dynamic over the last few years but has slowed recently, due to the external environment, weather events and underperforming public investment spending. Among the downside risks, we note that Peru has been the second largest recipient of Venezuelan migrants. We encourage the authorities to adopt policies to facilitate the labor market integration of entrants and mitigate the frictions on the labor market due to the competition from migrant workers, to ensure the accumulation of human capital and boost potential growth in the long run. Has staff assessed the fiscal cost of the Venezuelan migration, and could staff provide some details about its collaboration with the World Bank on this issue and how to mitigate the frictions? Beyond the temporary factors which have negatively affected growth recently, we see the fact that potential growth has been revised downward to 3½ percent as a critical issue.

We commend the authorities' cautious fiscal approach but see the full budget execution as a priority, to cope with the current slowdown and to respond to the infrastructures needs. We regret the budget under-execution for this year, which is causing the fiscal stance to be pro-cyclical in a time of slowdown. This budget under-execution remains a structural issue to overcome. Building capacity at the subnational level is a priority. We also note that tax to GDP ratio remain low and did not improve in 20 years and consequently encourage the authorities to make strong progress in this area by increasing excises and property taxes. The selected issues paper was very helpful in this regard. Can staff elaborate on possible further technical assistance efforts in this regard? The reform of the pension system recommended by staff has not been implemented and deserves more attention to improve the social protection. We also strongly encourage more progressivity of the personal income system as highlighted in the 2018 article IV, to improve redistribution. We agree with staff's recommendation that more flexibility in the fiscal framework in the medium term is warranted, given the significant fiscal needs of the country and the possible cost of structural reforms. Against this background, we welcome the recent use of the escape clause to implement a more gradual consolidation in the medium term.

The monetary policy has been well managed and should continue to be data-driven. We agree that if downside risks were to materialize, and considering financial vulnerabilities, further monetary easing could be appropriate. FXI has been used more actively but should remain used to face disorderly market conditions. As dollarization decreased, a flexibilization of the exchange rate seems appropriate as the strong macroeconomic performance have demonstrated confidence and credibility. Does staff see an optimal level for dollarization? We thank staff for their interesting focus on the multi-instrument policy framework in the selected issues paper and we are looking forward to seeing the result of staff's assessment about explicit and implicit costs and benefits of the different tools used in this framework, which will help to define the optimal policy stance. Finally, we note that financial stability risks have declined, and that the financial sector remains well capitalized and profitable, though we note that additional reforms are needed with regard to supervisors' legal framework, the Basel III capital framework, and the effectiveness of the AML/CFT framework.

We welcome the government efforts to tackle corruption and underline the need to boost productivity growth to help the country converge to higher income status. The anti-corruption plan and the president's proposals could significantly improve governance. Boosting TFP is paramount, especially through the reduction of informality, as more than 70 percent of total employment is informal and represent a major obstacle to the business environment. The redesign of labor regulation when cyclical conditions have improved could also play a key role in this sense. Could staff elaborate on its policy advice to reduce informality, and to which extent they collaborate with the World Bank on this matter? Other reforms are necessary to boost potential growth and help the country in the convergence process. We thank staff for the interesting Box 2 which identifies the legal and product markets as priorities. Finally, we welcome the progress in terms of economic diversification through the agro-exporting boom and the recent extension of the agriculture promotion law until 2031. We also note that new investment in infrastructures is needed to extend farmland and reduce transportation and logistics costs, which shows the importance of providing the adequate spending and capacity development for infrastructures.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

Following 15 years of impressive growth, the Peruvian economy has recently slowed. While a recovery is expected, the authorities can support growth now with countercyclical fiscal and monetary policies. Further steps to liberalize the exchange rate and the capital account can also improve the policy mix. Going forward, boosting investment, tackling governance issues, and increasing productivity will be critical for achieving convergence with advanced economies. We generally agree with the thrust of the staff report and offer the following comments.

We agree with staff's assessment that the economic slowdown and heightened uncertainty justify policy stimulus. Given low debt and favorable dynamics – combined with the current procyclical nature of fiscal policy – the authorities can easily make fiscal policy more countercyclical by improving budget execution this year. This is particularly true for infrastructure projects, which not only can help provide some fiscal impulse but are also significantly needed to remove bottlenecks and improve potential growth. We also welcome staff's options for improving the flexibility of the fiscal framework.

Likewise, the absence of inflationary pressures allows for some monetary easing, and we welcome the central bank's openness to future easing if downside risks to the inflation outlook materialize. The multi-instrument policy framework has contributed to stability, but monetary policy could be further strengthened if the central bank allowed for greater exchange rate flexibility, particularly in light of the decline in dollarization. Additionally, the authorities should consider phasing out their CFM and their CFM/MPMs as conditions permit. We welcome that the reserve requirement on FX derivative transactions was eased in early 2019 and look forward to steps on the remaining measures. Could staff comment on the timeline, the conditions that would be needed, and alternative measures (for the CFM/MPMs) that could be put in place?

Finally, we welcome the focus of the report on governance and corruption, and the authorities' efforts to improve transparency and governance. Priorities should include asset declarations, independent audits, procurement system simplification, and judicial reform. The analysis in the report helps demonstrate the extent to which corruption and governance issues are truly macro-critical, including for improving productivity.

Mr. White and Mr. Yoo submitted the following statement:

We thank staff for their informative reports and Mr. Lopetegui and Mr. Morales for their insightful Buff statement. We broadly concur with the staff assessment and have the following comments for emphasis.

We commend the authorities for implementing a sound macroeconomic policy framework over the past two decades that has helped raise incomes, reduce poverty, keep inflation low, reduce financial dollarization and build large international reserves. Having said that, improving productivity and enhancing competitiveness are of critical importance to overcome a middle-income trap. In this regard, we welcome the government's master plan for a National Policy for Competitiveness and Productivity, which identifies nine priority objectives. We encourage the authorities to further prioritize them in order to quickly obtain tangible results. That, in turn, will help build public support for accelerating crucial but difficult reforms such as legal system reforms. One of the key priorities is to expand public investment in economic and social infrastructure given that lack of infrastructure investment has hampered Peru's growth potential. We recommend the authorities build technical and institutional capacity to execute budgeted expenditure in a timely and efficient way. What were the main reasons for the low execution of public investment in 2019 and how can this be addressed by the authorities?

We support the government's recent announcement to relax the fiscal deficit ceilings for the period 2021-23. In light of an expected negative output gap, a more gradual fiscal consolidation over three years will boost domestic demand and also secure more resources for public investment. What changes in the baseline growth projection do staff expect under the new path for the fiscal deficit?

We agree with the authorities that monetary policy should remain data-dependent and that further policy easing may be needed if fiscal policy continues to be procyclical or if downside risks materialize. We see merit in staff's proposal that the central bank could allow greater exchange rate flexibility to absorb external shocks and promote financial market development as dollarization declines. At the same time, we support the authorities' intention to continue to use foreign exchange intervention at a minimum in cases of significant volatility.

The domestic political situation has continued to be one of the risk factors to the economic forecast. Political uncertainty may remain elevated depending on the result of the forthcoming legislative elections or the ruling of the Constitutional Court on the president's dissolution of Congress, or both. How do staff assess the impact of political uncertainty on the Peruvian economy?

We commend the authorities for accepting a large number of Venezuelan migrants and for their efforts to assimilate them effectively into the labor market. Considering that the educational attainment of these migrants as a group exceeds the Peruvian average, their absorption into the workforce could exert a positive impact on productivity and economic growth in the medium and longer term. Increasing labor market formality and effective skills matching would contribute to obtaining the greatest benefits from these skilled migrants and help avoid ongoing displacement of lower skilled Peruvian workers.

Mr. Mozhin, Mr. Palei and Mr. Shestakov submitted the following statement:

We thank staff for the informative report and Mr. Lopetegui and Mr. Morales for their well-written Buff statement. Against the background of strong economic growth for an extended period, over the past five years, Peru has been experiencing growth slowdown. The economy was struck by a series of adverse shocks, including the decline in commodity prices, 2016/17 El Niño damages, the fallout from Lava Jato/Odebrecht corruption scandal, and conflicts between the executive and legislative powers. Taking advantage of accumulated fiscal buffers, adequate international reserves, and low net public debt, the Peruvian authorities are in a good position to accelerate the implementation of structural reform agenda aimed at increasing productivity growth, advancing revenue mobilization, closing infrastructure gaps, and improving education and human capital.

The multi-instrument inflation targeting framework has served Peru well, delivering the low inflation rate and well-anchored inflation expectations. Interventions in the FX markets within the policy mix serve as a shock absorber and remain limited to address temporary shocks, while also shielding the financial system against disruptive balance sheet effects. With the gradual decline in dollarization, FX operations might be further reduced, and more emphasis might be given to macroprudential policy for preserving financial stability. Further easing of the monetary policy could be considered if downside risks to the inflation outlook materialized.

Given the current economic slowdown, we support the authorities' decision to invoke, as a short-term response, the fiscal rule's escape clause and implement a more gradual consolidation during 2020-23. At the same time, we agree with staff that a frequent use of the escape clause may harm credibility of the authorities' fiscal framework. In this respect, we agree with staff that an additional fine-tuning of the rule itself would be preferable. Despite strong macroeconomic performance over a long period, Peru's gains in revenue mobilization were limited. Due to high tax evasion and avoidance, as well as weaknesses in administration, the VAT gap remains high. Multiple tax regimes for small firms enable tax evasion, which resulted in deteriorating corporate tax revenues. A high percentage of working population declaring themselves subject to zero marginal tax suggests income underreporting and points to a scope for improved control over personal income declarations. We commend the steps taken by the Peruvian authorities to improve the current tax and tax collection systems, including increased excise and corporate tax rates, decreases in distortionary tariffs, adoption of electronic invoicing, and functional autonomy and capabilities of the tax administration authority.

Despite multiple structural constraints, the Peruvian economy maintained high growth rates over an extended period. It would be useful if staff could provide comparisons in per capita GDP growth between Peru and its peers. The negative output gap is worrying in an environment of weak productivity growth. Considering weaker growth performance in recent years, the estimates of growth potential have become less reliable and may need to be revised downwards. There is a scope for easing structural constraints in the economy. According to staff, the structural reform gaps are the highest in the legal system and product markets, but labor market reforms could also yield high growth payoff. We agree with staff that the current design of labor market regulations creates incentives for firms to remain small and hire informally, with ensuing misallocation of resources having adverse implications for aggregate economic growth. Informality has declined in the agricultural sector but still remains high. Moreover, the transition toward a more formal economy could have become more difficult due to the arrival of Venezuelan migrants, who are highly qualified, but face high accreditation fees, and a lack of information and proper documentation. We would like staff to comment on the risks of the growth slowdown becoming of a more permanent nature. In addition, staff may want to give an update on the progress in reducing economic informality. We are also interested to hear about additional measures for reducing informality in the competitiveness plan and their projected impact.

According to staff, Peru's infrastructure compares unfavorably with both its rivals in export markets and LAC6 countries. Limited capacity in investment execution resulted in procyclical fiscal stance. We welcome recent improvements in the framework for public investments and PPPs, but more should be done to unblock the pipeline of major infrastructure projects and close the infrastructure gap, currently estimated at about 15 percent of GDP. We support the National Plan of Infrastructure for Competitiveness with its large priority projects and consider addressing structural constraints hampering these projects to be crucial. We note that the extension of the agriculture promotion law was a rather controversial decision in Peru. What was the nature of disagreements between the government and Congress (Annex I)? Given that this sectorial law was successful in export diversification, is there a case for replicating this experience in other sectors? In Annex II, staff addressed an important issue of insufficient export complexity in Peru. What are the authorities' plans to achieve progress in this area? We would also appreciate additional details on the Special Economic Zones in Peru. How do staff evaluate the progress in subnational investment capacity building during the last two years, and what are main remaining bottlenecks in this area?

With these remarks, we wish the authorities success in facing challenges ahead.

Mr. Alkhareif and Ms. Alzamel submitted the following statement:

We thank staff for the well-written set of reports and Mr. Lopetegui and Mr. Morales for their informative Buff statement. We broadly share the thrust of staff's analysis and policy recommendations and would therefore limit our comments to the following issues for emphasis.

It is encouraging that Peru continues to be one of the best-performing economies in the region. Here, we take positive note that real GDP was well-above the regional average in 2018 and inflation rate among the lowest. However, the growth momentum slowed in 2019 and risks are titled to the downside stemming from both domestic and external headwinds. In this context, we are comforted that policy buffers are adequate to mitigate the impact of potential shocks.

The fiscal position is strong, but further efforts are needed to address low execution of public investment. In this context, we commend the authorities for the strong fiscal position demonstrated by low and sustainable public debt, and ample fiscal buffers. We also take positive note that the government is on track to comply with fiscal rules, and share staff's view that this will require a modest consolidation effort as cyclical conditions improve. Going forward, due focus should be given to enhancing revenue mobilization, including through strengthening tax administration and reducing VAT exemptions, while reducing current spending and achieving better expenditure control more generally. This would be necessary to create additional fiscal space to support public investment and address considerable infrastructure gaps. In this connection, further efforts to improve public investment management, including through strengthening project design and better integration with budget preparation, will be crucial.

Efforts to further strengthen financial sector resilience should continue. In this regard, we are reassured by the overall soundness of the financial system that remains well capitalized, liquid, and profitable, with low NPLs. We also commend the authorities for the important efforts made in strengthening financial sector oversight and further progress in this regard would be welcome. In addition, we echo staff's views on the need to focus on advancing financial development and inclusion and strengthening the effectiveness of the AML/CFT framework.

Finally, steadfast implementation of the structural reform agenda is necessary to boost potential growth. In this context, we look forward to continued efforts towards boosting productivity, fostering economic diversification, and strengthening governance and tackling corruption. Peru has made considerable progress in reducing poverty. At the same time, reforming the pension system remains important to improve social protection, as underlined by staff. Efforts to reduce labor market rigidities are essential to help reduce informality and promote more inclusive growth.

With these remarks, we wish the authorities further success.

Mr. Kaya and Mr. Bukovina submitted the following statement:

We thank staff for well-focused set of reports and Messrs. Lopetegui and Morales for their informative Buff statement. We broadly concur with the thrust of staff's appraisal and would like to emphasize the following aspects.

The long-term fiscal position is strong, though expansion of public investment and strong revenue mobilization are needed. The fiscal position continues to improve more than anticipated, driven by robust revenues and low implementation of capital spending by the newly-elected local and regional governments. Risks to the Peruvian economy are skewed to the downside, especially due to lackluster productivity performance, global trade tensions and lower commodity prices, although Peru has sufficient fiscal buffers to address potential shocks. Additionally, Peru faces substantial infrastructure gaps. The government should therefore use the available fiscal space under the fiscal rule and increase the efforts to fully execute the 2020 budget through addressing structural constraints hampering large infrastructure projects and removing financing and capacity constraints to activate local and regional inactive projects. Could staff elaborate on whether the execution of the 2020 budget is jeopardized by the recent political stalemate and the parliamentary elections? Despite the resilient revenues, we concur with staff that additional revenue mobilization is needed to increase the fiscal space over the medium term to address the infrastructure gaps and for social spending. In this vein, we welcome the excise taxes reforms and successful introduction of electronic invoicing to improve the VAT's compliance gap. The authorities should furthermore focus their efforts on building the business intelligence unit consisting of a data warehouse and skilled data analysts who utilize the large quantities of e-invoicing data allowing the prompt reaction to misreporting of tax liabilities. A further boost in revenues could be achieved by eliminating the multiple tax regimes for micro and small businesses.

While the current monetary policy stance appears appropriate, responding to weaker growth and in the absence of inflationary pressures, the

Central Reserve Bank of Peru should allow greater exchange rate flexibility which may increase the effectiveness of the monetary policy. The recent monetary easing does not necessarily imply further cuts as monetary policy remains data driven. As dollarization declines, with loan dollarization below 30 percent, greater exchange rate flexibility would contribute to absorb external shocks and promote financial market development without substantial risks We also see scope for further enhancements to Peru's inflation targeting multi-instrument framework, guided by staff's preliminary analysis.

While the banking sector remains well capitalized and profitable, the legislative and regulatory agenda should be pursued to strengthen financial sector oversight. We commend the authorities for the progress in implementing a broad set of the FSAP recommendations, including in the areas of systemic risks, macroprudential policies, crisis management and the introduction of a new law on credit cooperatives. Evaluating additional surcharges for systemic banks as mentioned in the Buff statement seems warranted. Further efforts are needed to advance the legal protection of all supervisors, grant the Superintendence of Banks, Insurance, and Pension Managers (SBS) the powers to effectively perform their supervisory mandate and improve the AML/CFT framework. Moreover, we share staff's recommendations to bring several regulations in line with Basel III. We also concur that the SBS needs to remain vigilant about potential credit risk as consumer loans continue to increase in the low interest environment.

For Peru to unlock its medium-term potential growth and reach high-income status, addressing the legacy issues of weak productivity growth, better quality education, infrastructure gaps, the large share of informal employment and broader export diversification will need to be addressed. We are encouraged by the authorities' Anti-Corruption Plan which is currently implemented and the substantial progress in enhancing public sector transparency and governance. We broadly share staff's recommendation to prioritize a range of necessary reforms focusing on the legal system and product market accompanied by a reduction in labor markets rigidities which motivate firms to employ workers informally. Growth-enhancing policies should be accompanied by further efforts to improve social protection, including by reforming the pension system and providing a more equitable distribution of natural resource revenues across regions.

Ms. Levonian, Ms. McKiernan, Mr. Ronicle, Mr. Weil and Mr. Chrimes submitted the following joint statement:

We thank staff for the useful report, annexes and selected issues papers, as well as Mr. Lopetegui and Mr. Morales for their helpful buff statement. Peru has an enviable record on growth and poverty reduction over the last 15 years and continues to be a top performer in the region, supported by large buffers, progress towards a strong macroeconomic policy framework, and some economic diversification (particularly into agricultural exports). However, continued progress is not assured, and it is clear that the economic and political conjuncture became more challenging in 2019. Some of these headwinds may prove temporary, and we note that staff expect growth to recover towards potential, hitting 3.7% by 2021. Nevertheless, we believe that some of the difficulties which have been prominent in 2019 have deeper roots and are linked to wider trends. Collectively, these developments sharpen the need to tackle growth, productivity and inequality challenges in a manner that is strategic and sustainable. As elsewhere in the region, strong public communication will be crucial if the reform agenda is to continue with popular buy-in.

The report projects a negative output gap enduring throughout the forecast period; we therefore agree with staff that short-term policy stimulus would be appropriate. We note that staff see the current stance of monetary policy as appropriate, but that fiscal policy could be loosened – could staff elaborate on their preference for easing of fiscal policy in this context, rather than further monetary accommodation?

We agree that addressing the current procyclicality in fiscal policy will be important in the medium term, and that ensuring the budget is fully executed going forward should help mitigate fiscal procyclicality in the near term. We would welcome staff views on the capacity to deliver more capital spending effectively in 2020 and beyond.

We note that since the draft staff report was issued, the authorities have invoked the escape clause in the fiscal rule framework to relax fiscal deficit ceilings between 2021 and 2023, with a view to supporting growth by allowing for a more gradual withdrawal of the fiscal impulse. We share staff’s view that in the medium term, the framework might be more credible if it had more in-built flexibility to adjust to shocks, rather than requiring the authorities to invoke the escape clause.

In the medium term, we strongly agree with the importance of raising revenue mobilization capacity, including by developing the institutions and culture to support a higher tax-to-GDP ratio: this will be politically difficult, but is crucial to support further sustainable development of public services, in particular for the most vulnerable. One example area, noted in the insightful selected issues paper, relates to the revenue mobilization potential of new information which should be provided by updated urban cadasters (on which the World Bank has been working with central and municipal authorities). Harnessing this potential will require careful sequencing, coordination between domestic parties and with international organizations, and effective communication. The same is true for many other revenue-mobilization priority areas.

The report's focus on the right balance between monetary, exchange rate and macroprudential policies is valuable, as is the analysis on the multi-instrument inflation targeting regime. It is positive that foreign exchange interventions, while frequent, have been largely balanced and contained. With loan dollarization having reduced over time, there is merit in considering allowing greater exchange rate volatility and in limiting foreign exchange intervention to cases of disorderly market conditions.

We are pleased to read that financial stability risks have declined and that there has been progress implementing a broad set of FSAP recommendations, but we agree with staff's assessment that there is further to go on the regulatory reform, legislative and legal reform agendas, and to enhance the governance framework. Efforts to improve the AML/CFT framework will be important.

Addressing weak productivity growth is crucial if Peru is to achieve sustainable convergence. The report prioritizes legal system and product market reforms. The authorities' recognition of judicial reform as a priority is positive, though muted public support again highlights the necessity of effectively communicating policy intentions and actions. We agree that social protection should be bolstered: despite remarkable progress over the last few decades, the poverty rate is still around 20%, and we note that previous Fund advice on the distribution of natural resource revenues between regions and on reforming the pension system to enhance social protection has not been implemented.

We welcome measures being undertaken to strengthen public sector governance and transparency. The authorities are encouraged to continue implementing their anti-corruption plan and enhancements to public investment and procurement mechanisms. The authorities should consider additional governance reforms to address vulnerabilities, including in the area of public asset declaration and associated enforcement.

Mr. Inderbinen and Mr. Djokovic submitted the following statement:

For nearly two decades, Peru has been growing at a robust pace and has decisively lowered poverty, also thanks to sound macroeconomic policies and increased resilience to shocks. More recently, the uncertain external environment, spillovers from the fight against corruption, and a series of climate events have dented the country's strong performance. Peru nonetheless continues to enjoy a sound macroeconomic framework, and the planned economic reforms should support recovery, address productivity and infrastructure gaps, and improve governance. We thank staff for the valuable set of reports. We also thank Mr. Lopetegui and Mr. Morales for their informative Buff statement.

Macroeconomic policies should support the recovery. Economic growth is below potential, and activity is expected to gradually rebound in 2020 and onwards. The subdued inflation pressures have allowed for monetary easing to support the recovery. Nonetheless, the under-execution of the 2019 budget—in particular the underperformance in public investment—has led to a procyclical fiscal stance. This underlines the need for reforms to improve public investment management (PIM), including addressing capacity constraints at the local and regional levels. A modernized PIM would support the authorities' efforts to improve key infrastructure. We welcome the authorities' intention to reverse pro-cyclicality by improving budget execution, as emphasized in the Buff.

Enhancing revenue mobilization over the medium term is warranted. The critical need for infrastructure and other priority spending will require raising domestic revenue. Efforts should focus on reforming the tax regime for small businesses and strengthening revenue administration, with the objective to improve compliance and narrow the sizable VAT gap.

We appreciate the authorities' efforts to keep monetary policy data-dependent and credible. We also welcome the effective communication. The expansionary monetary stance is appropriate at the current juncture. We note that Peru's multi-instrument policy framework has been effective and has enabled positive macroeconomic outcomes. We see merit in finetuning the framework going forward, in line with staff's advice.

Structural reforms will play a key role in fostering higher and more inclusive growth.

We welcome the reforms to improve governance and fight corruption. The ongoing implementation of the Anti-Corruption Plan attests to the authorities' willingness to tackle this long-standing macro-critical issue. We strongly encourage the authorities to heed staff's recommendations on how to improve the governance framework further and how to mitigate vulnerabilities. Additional structural reforms are warranted to improve productivity and competitiveness and to mitigate the risks of a middle-income trap. In that regard, the adoption of the National Plan for Competitiveness and Productivity is a step in the right direction.

Mr. El Qorchi and Mr. Belhaj submitted the following statement:

We thank staff for the well-written set of reports and Mr. Lopetegui and Mr. Morales for their insightful Buff Statement. We broadly agree with staff's assessment and would like to make the following comments.

Solid policies have enabled Peru to be one of the best performing countries in Latin America, with good resilience to shocks. We commend the authorities for maintaining a sound macroeconomic policy framework that has helped the country preserve price stability, achieve sustainable fiscal and external balances, and keep fiscal buffers despite domestic and external headwinds. We hope that the forthcoming legislative elections would reduce political tensions and help the adoption of further reforms, supported by the strong popular backing to business-friendly policies.

The current negative output gap is temporary under the baseline scenario, which projects a return to potential growth in 2020-23 subject to certain actions to close the country's growth and structural investment gaps. These include, maintaining an accommodative monetary policy stance, using the available fiscal space, and activating delayed projects. We have noted the escape clause of the fiscal rule framework invoked recently by the Government to allow a gradual consolidation. We support the measure given the sluggish growth outlook, as it will provide additional room for capital expenditure over the period 2021-23 and contribute to achieving the growth target. However, we encourage the authorities to tap into the large stock of non-mobilized resources to build an appropriate fiscal space that could help reduce the deficit in the coming years. If it proves difficult to comply with the current limit, then we agree with staff that it would be preferable to relax the deficit ceiling rather than make frequent revisions to the fiscal rule that would ultimately undermine its credibility. In this regard, could staff elaborate on why the authorities are now using a headline deficit ceiling instead of a structural deficit ceiling along the lines of the framework in place during 2014-16?

More structural reforms are needed to push potential output to a higher level. We share staff's concerns that the country might be caught in a middle-income trap. The post-GFC quasi-stagnation of total factor productivity in Peru—the most performing LA6 country—is disconcerting considering the progress made in structural reforms and the dramatic change in technology in recent years. More elaboration from staff on the factors behind this situation would be welcome.

That said, we command the authorities for their willingness to address the sluggish productivity growth by adopting the National Policy for Competitiveness and Productivity. The agenda includes a wide range of multi-sector reforms, some of which are politically challenging, including those related to labor flexibility and reducing informality. We concur with staff on the need for prioritization for the sake of efficiency, while recognizing the complexity of the task for the authorities.

The financial sector remains sound overall with areas of moderate vulnerability that should be addressed. The financial sector is well capitalized and profitable, NPLs ratio is low, and dollarization is decreasing. Weaknesses in the banking sector should, however, be closely monitored and addressed.

We note with satisfaction the progress made by the authorities in implementing a broad set of FSAP recommendations and encourage them to move forward in other areas of reform, in particular to improve the effectiveness of the AML/CFT framework through new reporting measures, stronger sanctions, and improved information sharing.

We commend the authorities for making good governance and the fight against corruption a key element of their reform program. The political and social will to support this policy is essential. We believe that the authorities are fully aware that corruption undermines democracy and has a high economic and social cost, and that they are determined to fight it. Nevertheless, the effective implementation of anti-corruption policies requires coordination among institutions, which has long been eroded in Peru by tense relations between the executive and legislative branches. Despite the likelihood of electing a new fragmented parliament after the January 2020, broad public support for anti-corruption policies could be the driving force behind a political consensus on these issues and the authorities are encouraged to build on this basis to rapidly advance anti-corruption reforms.

The Peruvian authorities had taken ambitious legislative measures to make climate change one of the government's flagship policies, and the staff's assessment would have been welcome. Peru is one of the most seriously affected countries by climate change, with severe droughts and risks to food security in rural areas. We welcome the authorities' sense of urgency and their proactive policies to encourage mitigation and adaptation efforts in dealing with extreme climate phenomena. These efforts led, inter alia, to the adoption of a Climate Change Framework Law in 2018. We note, however, the absence of any reference to this matter in the last two Article IV consultation reports. Staff assessment of political support, legislative advances, and effective implementation of climate policies in Peru would have been a useful complement to this insightful report. Staff elaborations would be welcome.

With these comments, we wish the authorities every success.

Mr. Sun and Ms. Zhao submitted the following statement:

We thank staff for the well-written set of papers and Mr. Lopetegui and Mr. Morales for the informative Buff statement. We welcome the continuous strong performance of the Peruvian economy. With low public debt and a large stock of foreign reserves, Peru has ample buffers to deal with domestic and external headwinds. Going forward, more reform efforts are needed to escape the middle-income trap and boost productivity growth, including improving budget execution, increasing exchange rate flexibility, reforming the labor market, and fostering economic diversification. We broadly agree with staff's assessment and would like to offer the following comments for emphasis.

It is essential for the authorities to accelerate budget execution and make fiscal policy more agile. While the long-term fiscal position is strong, the current fiscal stance is procyclical due to budget under-execution mainly for capital spending. We read from the report that capacity and structural constraints regarding public investment and infrastructure projects remain major obstacles for budget execution. Could staff provide more information about these constraints, and what measures could be taken to mitigate them? We welcome the authorities' plan to enhance the quality of infrastructure and encourage them to improve revenue administration and reduce current spending.

Greater exchange rate flexibility should play a more important role in absorbing external shocks and promoting financial market development. We commend the authorities for the significant progress in de-dollarization. Nevertheless, dollarization is still high (35 percent for deposits and 27 percent for credit) and could expose the financial sector to higher exchange rate risks. We encourage the authorities to enhance exchange rate flexibility and limit foreign exchange intervention only to excessive disorderly market conditions. This would help foster the development of hedging instruments and strengthen transmission of monetary policy. It is good to note that the banking sector is well capitalized and resilient to macroeconomic shocks. Given the vulnerabilities stemming from high credit concentration and low financial inclusion, efforts are needed to encourage competition and strengthen financial sector oversight.

Structural reforms are needed to escape the middle-income trap and enhance competitiveness in the medium term. We welcome the authorities' focus on improving governance and addressing the infrastructure gap and encourage them to push forward with other important reforms. The labor market reform is important to raise productivity by reducing the level of informal sector activities and enhance integration of migrant workers. To achieve more inclusive and sustainable growth, we encourage the authorities to improve social protection by reforming the pension system and deepening financial inclusion.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Fanizza and Ms. Cerami submitted the following statement:

We thank Mr. Lopetegui and Mr. Morales for their informative statement and staff for an outstanding set of papers. We welcome Peru's continued strong economic performance despite headwinds, including corruption investigations, and heightened political uncertainty, which has weakened the reform momentum. We broadly agree with the thrust of the staff's appraisal and offer the following comments for emphasis.

Given the negative output gap and ample fiscal buffers, additional fiscal support is warranted in the short term. As economic growth has remained sluggish in recent months, we welcome the authorities' decision to invoke the escape clause and allow the fiscal deficit to exceed 1 percent of GDP beyond 2021. We also welcome the intention to use the additional fiscal space for capital spending. However, like staff, we are concerned about the current under-execution of capital spending. We therefore encourage the authorities to improve the implementation of public investments, not only to counter the economic slowdown but also to address the large infrastructure needs and boost potential growth. In this regard, what specific measures would staff recommend based on the recent Public Investment Management Assessment? Given the damages caused by the El Niño event in 2017, does the National Plan of Infrastructure for Competitiveness foresee any measures to strengthen the resilience against extreme weather events? How would staff assess the country's preparedness to climate-related risks?

Improving the quality of infrastructure and social protection will require additional revenue mobilization efforts. As shown in the insightful Selected Issue Paper, Peru's VAT design compares favorably with peer countries (c-efficiency), suggesting that efforts to improve collections should focus on increasing tax compliance. We therefore encourage the authorities to further exploit the data collected through the electronic invoicing system to enhance control procedures. We support staff's recommendation to reduce and simplify the special tax regimes for small businesses to limit the scope for tax avoidance. We also see merit in increasing the contribution of excises and property taxes to overall tax revenues.

The multi-instrument inflation targeting framework has worked well. We appreciate staff's analysis of the evolution of the framework adopted by the central bank as well as the comparative assessment with Chile's orthodox inflation targeting regime. The use of sterilized foreign-exchange interventions and macro-prudential policies along with the policy interest rate has allowed the central bank to simultaneously achieve macroeconomic and financial stability and reduce dollarization substantially. We also share staff's assessment that declining dollarization and greater control of capital flows have created the conditions for greater foreign exchange flexibility to absorb external shocks and promote financial development.

Strengthening anti-corruption institutions, reducing informality, and enhancing competitiveness remain key priorities. Recent policy measures such as those to facilitate the integration of migrants and the extension of the agriculture promotion law until 2031 go in the right direction. As the promotion law has contributed to the rapid development of the agro-exporting sector and to the reduction of poverty in the affected coastal areas, we welcome the extension of the law. However, some modifications of the law, which increase labor costs, may reduce export competitiveness. Staff comments are welcome.

Mr. Beblawi and Ms. Merhi submitted the following statement:

We welcome the strong macroeconomic performance of Peru in the past decade and the build-up of large buffers and international reserves, which would mitigate the impact of adverse shocks. Economic activity has weakened in 2019, due to temporary domestic factors and the external environment, which justifies policy stimulus. We commend the authorities for the substantial progress made in mitigating key vulnerabilities by reducing dollarization, strengthening the financial soundness of the financial system, and combating poverty, as highlighted by Mr. Lopetegui and Mr. Morales in their insightful Buff statement. We concur with the thrust of the staff's appraisal and will therefore limit our comments to the few following points:

Pressing needs for infrastructure and social spending highlight the importance of raising revenue mobilization capacity in the medium term. We welcome in this regard the focus in the SIP on how to increase revenue mobilization, including by improving VAT compliance and eliminating multiple tax regimes for small businesses to boost revenues from corporate taxes.

We positively note the authorities' intention to reverse fiscal procyclicality by improving budget execution. We note that given the current economic slowdown, the government has invoked the escape clause of the fiscal rule framework one more time to implement a more gradual consolidation for the period 2021-23. While this is in line with staff's advice regarding fiscal easing, as well as with closing infrastructure gaps by using the additional fiscal room for infrastructure and social spending, we see merit in staff's views that frequent revisions to the framework may weaken the integrity of the rules-based fiscal framework, and it might be better to add additional flexibility to the fiscal framework in the medium term rather than relying on frequent uses of the escape clause.

We welcome the authorities' plan to enhance the quality of infrastructure in order to improve competitiveness. We note in this regard that the National Plan of Infrastructure for Competitiveness has identified 52 priority projects to be executed in the next decade amounting to 13 percent of GDP, including both PPPs and government-financed projects. To that end, we commend the authorities on the creation of invierte.pe and Proinversion aimed at strengthening institutional mechanisms for public investment and PPPs and ensuring the proper functioning of the payment chain for contractors that had provided goods and/or services to companies subsequently involved in corruption investigations. We would be interested to learn whether the authorities have taken into account the recommendations provided by the 2017 PIMA report to enhance the efficiency and impact of public investment?

With these remarks, we wish the Peruvian authorities the best in their reform efforts.

The Acting Chair (Mr. Zhang) made the following statement:

As we discussed on previous occasions, Peru has evolved into one of the best-performing Latin American economies in the past one and a half decades. This has been achieved with its sound macroeconomic framework, robust fiscal and external buffers, and a model of successful macroeconomic management. That also reflects the authorities' efforts and commitment. I think the Fund also played a significant role in it and in terms of the continued constructive dialogue, engagement, including providing technical assistance (TA) to Peru.

As you noted in your gray statements, the economy is now facing important challenges, some of which are associated with the recent economic slowdown and also with the political instability. Some others, of course, are more structural in nature. In staff's view, and as also pointed out in your gray statements, some of these challenges--including, for example, the reduced growth momentum in terms of the fiscal stance and fiscal reforms, monetary policy, dollarization, low productivity, and others are all among these challenges. I look forward to a good discussion.

The staff representative from the Western Hemisphere Department (Mr. Bonato), in response to questions and comments from Executive Directors, made the following statement:[1]

We wish to thank Executive Directors for their support and their insightful comments, suggestions, and questions. We have addressed most of the questions in our written answers. We will take this opportunity to address a few broader policy questions and provide some additional information. More specifically, I will touch on four topics. The fiscal/monetary policy mix, monetary policy and dollarization, the multi-instrument policy framework, and something on informality.

On the appropriate fiscal/monetary policy mix, I think there is broad agreement that an additional policy stimulus would be desirable; but a few

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

Directors questioned whether it should come from fiscal easing, rather than monetary accommodation. Let me clarify that we do not mean to express an a priori preference for fiscal policy; rather, the need for rebalancing, in a context where monetary policy is providing substantial stimulus and fiscal policy is withdrawing it. The ample fiscal space available makes this rebalancing possible; and, as you know, the authorities are already moving in this direction.

On monetary policy and dollarization, the authorities have been very successful in reducing dollarization from 80 percent to about 30 percent in less than 20 years. A large part of this remarkable achievement reflects the attainment of macroeconomic stability and the subsequent change of expectations and behaviors. Further reductions are certainly possible but will have to be more gradual. Borrowing in dollars remains necessary, given the widespread dollar invoicing of intermediate goods and sometimes of homes and large consumer goods.

Have we reached an optimal level? We do not think so. As we have consistently advised, more exchange rate flexibility is likely to reduce dollarization further by internalizing exchange rate risk for agents and fostering the development of tools.

What are the risks associated with the current level of dollarization? Adverse balance sheet effects are mostly connected with dollar liabilities, which have declined the most. For companies exporting and/or producing intermediate goods, dollar exposures are largely hedged by dollar revenues. Stress tests conducted by the Superintendency of Banks, Insurance and Pension Funds (SBS), the banking supervisor, showed that large firms would be quite resilient to sizable exchange rate depreciations. Why then is the central bank reluctant to allow further exchange rate flexibility? As we have noted in the report, the central bank has gradually reduced foreign exchange intervention in tandem with the decline of dollarization over the years but remains wary that additional exchange rate volatility may trigger a loss of confidence in the sol, the local currency. We think that a gradual move to a more flexible exchange rate, accompanied by a well-crafted communication strategy could minimize this risk. The discussion is ongoing.

On the multi-instrument policy framework, we thank Directors for their encouraging comments but recognize that some of the questions they asked--for example, the benefits of the current framework vis-à-vis a more orthodox one--are very hard to address. Peru is a very interesting case of a multi-instrument framework. It adopted inflation targeting in 2002 when dollarization was high, challenging the common wisdom at the time that inflation targeting could not work in highly dollarized economies, where concerns for exchange rate movements are prevalent.

As we described in the selected issues paper, good macroeconomic management has been a key ingredient in Peru's success story since then. However, it is impossible to draw general conclusions on this framework in the absence of a counterfactual. In this regard, I would like to clarify that the scope of our work in this consultation was limited to providing some initial analytical basis for a conversation with the authorities. The conversation has just started, but further progress will have to rely on new analytical tools that are currently being developed in the institution, with efforts led by the Strategy, Policy, and Review Department (SPR), the Research Department (RES), and the Monetary and Capital Markets Department (MCM) as part of the Integrated Policy Framework work stream.

Finally, let me conclude on informality. I would like to add to and partially correct the written response that we have given to one Director's question on the evolution of informality and measures to address it in the national competitiveness plan. The statistical institute releases a measure of informality which shows that informal employment is about 73 percent of total employment, down from about 80 percent in 2008. In our written response, we said that the competitiveness plan does not directly address the reforms that would affect informality. This is not fully correct. The competitiveness plan does include some specific measures, such as specifying the conditions under which a person can be fired in the labor law. It is extending part-time contracts and teleworking, providing help to small and medium-sized enterprises (SMEs) in the formalization process, improving the competencies of young workers, restructuring labor training programs, modernizing the employment agency, and strengthening labor inspection.

Mr. Merk made the following statement:

We thank staff for the insightful set of papers, as well as Mr. Lopetegui and Mr. Morales for the buff statement. We have the not issued a gray statement, but I would like to offer a few remarks.

We commend the authorities for their fiscal rule framework that kept public debt to GDP in check and helped to build up fiscal buffers. The fiscal rule framework has so far proven its effectiveness without compromising on the built-in flexibility for unforeseen emergency events, such as the El Niño weather pattern.

Going forward, we encourage the authorities to work toward improving revenue collection and budget execution, the latter via enhancing absorptive capacity at the subnational level.

We recognize Peru's extraordinary challenge in integrating migration flows from Venezuela. To reap the potential benefits associated with the inflow, we welcome the authorities' commitment to progress with labor market reforms that improve skill matching and reduce informality.

Mr. Rashkovan made the following statement:

We thank Mr. Bonato and his team for the insightful report and introductory intervention and Mr. Lopetegui and Mr. Morales for their buff statement. We have not issued a gray statement but want to speak on a few topics.

We commend the authorities for the overall strong macroeconomic performance and poverty reduction, although slowing down due to the external environment, weather events, and the underperforming public investment spending. GDP growth is still significant, which makes Peru one of the best performing countries in the region in the last decade. However, with GDP per capita about $7,000 and a skewed distribution of it, the discussion should focus on how to make this growth more inclusive, rather than on how to exit the middle-income trap.

There are recognizable positive evolutions in the Peruvian economy, which led to the increasing investor appetite for Peru's sovereign debt, reducing country risk spreads, and shifting the sovereign yield curve downward. Nevertheless, there are also some visible challenges that are also elevated by the prolonged political uncertainty, which raised some questions that we want to emphasize. I will focus on five specific topics.

First, public debt is low, gross reserves are adequate, and the net international investment position is at a sustainable level, but the current account deficit is deteriorating. As Mr. Bonato said in his introductory intervention, we also think that dollarization brings significant risks and think that it is very important to allow for greater exchange rate flexibility and to continue a gradual decrease of economic dollarization, both in terms of loans and deposits to further reduce the sensitivity from an external shock.

Second, another persistent vulnerability is the low execution of capital projects. The Peruvian authorities should address the structural constraints hampering large infrastructure projects to attain the expansion of public investments in transportation, sanitation, health, telecommunication, and water. These are required to close the large infrastructure gap. At the same time, spending efficiency should improve through better resource allocation and more transparent control mechanisms.

Third, in view of the low inflation, the recent easing of the monetary policy is timely to provide necessary economic stimulus. This will also contribute to the further improvement of financial stability indicators in the short run; but in the medium run, financial sector oversight should be strengthened to fully comply with Basel III practices and indicators.

Four, as in many other emerging economies, sound economic progress is not fully and equally distributed among the population. Microlevel tensions coexist with macroeconomic performance. Social protection needs to be improved in order to reduce inequality and to protect the lowest income households from the effects of the labor market reforms that are envisaged.

Last but not least, we welcome the focus of the report on governance and the authorities' efforts to strengthen transparency. Integrity and anticorruption reforms are urgent. Corruption distorts resource allocation, privatized profits to personal interest, and prevents the benefits of growth from reaching most of the population.

While progress has been made in recent years, domestic checks and balances mechanisms should function better, and fighting systemic corruption should be a priority in Peru. This should include consolidating judicial independence, creating a proper mechanism for income and asset declaration, improving the transparency of public companies, establishing a simplified but more transparent and efficient public procurement system, and strengthening the accountability of public officials. We would appreciate it if the issue of governance reforms would be more extensively discussed in the next Article IV report.

With these remarks, we wish the Peruvian authorities success with their reforms.

Mr. Raghani made the following statement:

I would like to join other Directors in thanking staff for the insightful reports and for the responses to the questions raised by Directors. I also thank Mr. Lopetegui and Mr. Morales for the helpful buff statement. We did not issue a gray statement but broadly concur with the staff's policy recommendations and would like to make the following points for emphasis.

We commend the Peruvian authorities for the implementation of sound macroeconomic policies and key structural reforms over the past 15 years, which have helped to build ample buffers, keep inflation low, raise incomes, and reduce poverty. Peru remains a very strong economic performer, notwithstanding the headwinds that hampered the growth momentum in 2019. We note that, despite an expected recovery in 2020 and over the medium term, risks to the outlook are tilted to the downside, and call to commence efforts to address the remaining challenges and increase the country's potential growth.

We agree that increasing infrastructure investment, improving governance, and increasing productivity will be key to tackling the challenges facing the country toward more sustainable and inclusive growth. Like many Directors, we wish to highlight the need for continuous reforms to address the longstanding structural bottlenecks of informality and low productivity.

We appreciate the analysis of Boxes 2 and 3 of the report and concur with Mr. White, Mr. Sigurgeirsson, and others, that a heightened focus on the key priorities is of paramount importance to obtain prompt results and facilitate progress on the authorities' far-reaching reform agenda. The recent adoption of the National Policy on Competitiveness and Productivity is commendable. We encourage the authorities to make further inroads, in that it will help to lessen the risk of a middle-income trap.

Finally, like Mr. El Qorchi and Mr. Belhaj, we would have welcomed staff's view on the proactive measures taken by the authorities to mitigate climate change-related risks, especially for a country like Peru. We encourage staff to take these comments into consideration and look forward to a further elaboration on this issue in the next Article IV consultation report.

With these remarks, we wish the Peruvian authorities success in their endeavors.

Mr. Saraiva made the following statement:

I thank staff for the introductory remarks this afternoon--they were very clarifying--and also for the high-quality set of papers. I particularly liked the two chapters in the selected issues paper on the policy framework for monetary policy, foreign exchange interventions, and macroprudential policies. The triangle was a very ingenious way of schematically presenting the trade-offs that the policymakers face and how policy choices have evolved over time in the case of Peru, given the changing circumstances. It was a very insightful paper. In fact, I believe that Peru is certainly an insightful case for the development of the Integrated Policy Framework. So I believe that you must be heavily involved with this discussion, given the experience in Peru.

Before entering into other matters, I would also like to thank Mr. Lopetegui and Mr. Morales for the very useful buff statement. Peru is clearly a remarkable case in the region for the very good performance in the past decades, not only regarding growth, but I think what is more remarkable is the progress in establishing a sound macroeconomic framework that delivered this high growth but also delivered strengthened fundamentals and allowed the country to build up buffers.

That said, I would concur with staff, that more flexibility in the fiscal framework will be good at this point. I think Ms. Mahasandana raised the issue about the target, if it is still the best one, given the current circumstances. I understand that there is ample fiscal space that could be used. I think your words earlier reinforced this understanding. I believe that this is the view of the authorities, that the fiscal space should be used.

One thing is to use this space now; the other thing is to maybe envisage some changes in the framework that would provide more flexibility to couple with the changing circumstances when it is warranted. Of course, all of that should be done considering the need to ensure fiscal sustainability and debt sustainability. That is not under question.

On the issue of reducing informality, I acknowledge the stance taken by staff on waiting for the improved cyclical conditions. I think this is also warranted. But I also believe that balancing increasing flexibility, mainly reducing the costs of dismissals, with a higher and better provision of social services will be key. Even with the progress made in reducing informality, it is still very high. So I think there is much space to make advances in this area by using active labor market policies to boost investment in education and training, to increase productivity, and to create better incentives for formal jobs.

Finally, a brief comment on the structural reform prioritization and sequencing. I took note of the use of the same kind of analytical framework that was used in the case of Brazil in the past. In the case of Peru, basically, there was not much variation in terms of public support. This is actually an indicator that is very difficult to assess. And I remember--even though I did not have the chance to go back to the report, but in the Article IV for China last year, they worked with a somewhat different framework that I think was very useful in terms of setting the returns of those reforms but also how those reforms could be sequenced in a way that one would reinforce the other; one would remove obstacles for the others so that you could have a more logical and stronger path and heighten the probability of success in proceeding with those reforms.

Mr. Mozhin made the following statement:

Like others, let me thank staff for the well-written report and also Mr. Lopetegui and Mr. Morales for their informative buff statement. I would also like to thank Mr. Morales for the very tasty cookies supplied. I am thinking that perhaps we could have more frequent discussions on Peru in this Board.

We have issued a gray statement, wherein we raised quite a few questions, perhaps more than we usually do. The written responses by staff to our questions are very well appreciated. They are very detailed and specific responses in writing but also the oral comments at the beginning of this meeting, especially on the informality and the measures to address it.

We have issued our written statement, and I will only make a few additional comments.

Over the past five years, Peru has been experiencing a growth slowdown. The economy has been affected by a series of adverse shocks, including the decline in commodity prices, the 2016-2017 El Niño damages, and the fallout from corruption scandals and political conflicts. Some of these shocks are not specific to Peru but perhaps are reflecting some regional and even global developments.

On the policy side, we agree with staff that the delays in structural reforms and infrastructural investments could significantly hamper productivity growth in Peru. With such significant fiscal buffers, adequate international reserves, and low public debt, the Peruvian authorities stand in a very good position to accelerate the implementation of the structural reform agenda, advance revenue mobilization, and close the significant infrastructure gaps. Both staff and the Peruvian authorities recognized that a significant improvement in infrastructure is needed to foster economic growth. The National Plan of Infrastructure for Competitiveness is, therefore, key in this regard. But complementary governance issues are tricky to address. It seems somewhat surprising that, in evaluating the structural reform priorities in Box 2 on page 16, staff opted for a methodology that used the Fraser Institute's property rights protection index. The Fraser Institute is a Canadian think tank, frequently described in the media as conservative or sometimes even libertarian. In this respect, we would caution against an excessive reliance on the opinion of the Fraser Institute. In the area of assessing pro-growth institutional quality, the Fund could rely more on its own structural reforms database and the doing business database of the World Bank as reference points.

The econometric methodology to analyze the structural reform priorities also appears to be somewhat dated, since it does not account for dynamic responses to structural reforms. Efforts are made to check how the responses change with the state of the economy. This kind of analysis was done by the IMF staff in numerous publications, including Chapter 3 of the October 2019 World Economic Outlook; but for some reason, this is not applied in the report, while the situation of the growth slowdown would suggest that it would make it useful.

In an economy plagued by informality--and this is the language used by the well-known Peruvian economist Hernando de Soto--better property rights protections come at a cost of evicting the actual stakeholders and heavy misallocations. Having said that, we consider labor and product market reforms, as well as the further development of trade and the diversification of the economy to be of high priority and would encourage the authorities to leverage the Fund's experience and advice in this area.

With these remarks, we wish the Peruvian authorities every success.

The Acting Chair (Mr. Zhang) made the following statement

Thank you, Mr. Mozhin. I also would join our dean in appreciating the kindness of Mr. Morales offering the cookies to all of us.

Ms. Mahasandana made the following statement:

We thank staff for the insightful report and the answers to our questions. We also thank Mr. Lopetegui and Mr. Morales for the useful buff statement. We have issued a gray statement, but we would like to provide two comments for emphasis and make one additional comment.

Our first comment would be associated with Mr. Saraiva's comments on Peru's multi-instrument framework. We also commend staff for the comprehensive assessments on Peru's multi-instrument policy framework and thank staff for the additional comments today.

We encourage a closer collaboration between staff and the authorities in conducting further studies on the framework, for example, maybe through technical assistance. We view that cooperation between staff and the authorities is critical and can go a long way in helping the authorities enhance their policy framework, as well as enhancing the Fund's work on the IPF. In particular, Peru's experience highlights several critical aspects in developing the IPF, including recognizing that the country's characteristics affected their policy choice. Policy configurations and reactions are characterized by different global risks that are being managed and may evolve over time. A better understanding of the interactions of different instruments, such as how the FX interventions and MPP may help monetary policy achieve its objectives and also the need for a further analysis to understand the limitations and potential impacts of the multiple tools being used.

Second, in response to Ms. Pollard's questions on the CFM/MPM measures, staff highlight several broad examples of alternative measures that could address the associated risks without limiting capital inflows. We just wonder if staff could further elaborate on whether there are any specific alternative measures that were proposed to the authorities and the authorities' views on these alternative measures. Like my first point, such dialogue and collaboration will also be beneficial to the authorities and the IPF work.

Third, I would like to echo the other Directors' remarks on the importance of improving productivity and competitiveness in order to overcome the middle-income trap. Among other priorities, improving education quality, reducing the infrastructure gap, and removing distortionary barriers that limit the growth of productive firms, such as the legal system and product market reform, should be prioritized for a tangible outcome in the medium and long term.

Ms. Pollard made the following statement:

Let me begin by thanking staff for the report and the answers to questions. I particularly welcome your phrasing this morning about how there is a need for a rebalancing of the policy mix. That is really important to think about. I also want to echo thanks to Mr. Morales for the cookies this morning and Mr. Lopetegui and Mr. Morales for their buff statement.

We issued a gray statement, and I just want to follow up on one question that we had asked about the CFM and CFM/MPMs.

Staff noted that the measures were introduced to alleviate capital flow pressures and guard against financial system risks and that the first part, the capital flow pressures, have subsided. They note that they have encouraged the authorities to prepare for phasing out these measures and consider alternative ones, as Ms. Mahasandana just mentioned. We welcome that push but think that, since there are no longer any capital flow pressures, staff should be a little bit firmer in pushing for the removal of the CFMs more quickly. We think this should be possible, particularly given that the stand-alone CFM seems to be quite narrow in scope and, as you mention in the report, has already been reduced. We think this is in line with the IV, which calls for CFMs to be temporary and also to be phased out once capital flow pressures abate, which, as you noted, has occurred.

We encourage the authorities to move quickly to phase out the CFM and to implement alternative measures for the joint CFM/MPMs as soon as possible. I also want to echo Ms. Mahasandana’s question about whether there has been a discussion about these alternative measures.

Mr. Villar made the following statement:

I join others in thanking the staff for the set of reports and for their answers to our questions, as well as Mr. Lopetegui and Mr. Morales for their informative buff statement.

We issued a gray statement, in which we broadly agree with the staff assessment which, in turn, mostly coincides with the authorities’ views. So I will just highlight a few points for emphasis.

Despite the growth slowdown, Peru continues to be one of the best performers in the region amidst a complex background, both externally and internally. We congratulate the Peruvian authorities for their achievements, which are largely based on a very orthodox and cautious fiscal policy. However, in the current context in which the economic activity has weakened, we agree with the staff that additional flexibility to the rules-based fiscal framework could be warranted to provide room for countercyclical policy adjustments.

We also highlight in our gray statement that Peru has lagged behind its regional peers in the past 20 years in increasing revenue mobilization. In this regard, we welcome the efforts to reduce the VAT compliance gap and to improve tax administration and electronic invoicing.

On exchange rate policy, we find that the authorities have achieved a very important success in reducing dollarization in both assets and liabilities in the financial sector. At this point, we agree with the staff and with several other Directors, that the greater exchange rate flexibility will help to further reduce dollarization by inducing agents to internalize exchange rate risks and foster the development of hedging instruments.

Finally, we thank staff for the very useful box on the economic impacts of migration from Venezuela. We welcome the efforts of the authorities to allow the labor market to effectively absorb the migrant population, even in a context of economic growth deceleration.

With these comments, we wish the Peruvian authorities all success.

Mr. Fanizza made the following statement:

Let me say at the outset that I fully share Mr. Saraiva’s assessment of the quality of the work done by the mission. These papers are very interesting. I think they should be used as a basis for the development of the Integrated Policy Framework.

In fact, while I was reading, I was wondering, how the ongoing work on the new framework would add value in the discussion that we have here.

Having said that, let me thank Mr. Lopetegui and Mr. Morales for their buff statement. I agree with Mr. Mozhin on the cookies, less on the idea that we should look at the political inclinations of providers of third-party data.

I will stress one point. Of course, the most interesting part of the discussion is the inflation targeting experience in Peru. I think the bottom line is that you do not argue with success. It is going so well, particularly in the regional environment, and the point that the paper makes is valid.

Nevertheless, looking at the particular juncture at the moment, I was wondering, what do the authorities think about the choice between intervening on the foreign exchange market to limit the appreciation pressures and the choice of relying only on interest rates at this juncture? Why do they choose to still intervene on the market, where the pressures toward appreciation will go in the direction to discourage dollarization in that sense, and a lower interest rate will be in the direction of sustained economic activity?

Here, the important thing is not abandoning the framework they are following, which should still be multi-pronged, a three-pronged approach. But this understanding that, actually, the novelty of the framework is that it is not symmetric. You do not minimize the volatility, but actually, you should act in a different way when the exchange rate depreciates and when it appreciates.

I would like to understand better why you are still reluctant at this juncture to even further limit the intervention in the foreign exchange market.

Mr. Alkhareif made the following statement:

I join colleagues in thanking Mr. Bonato for his informative statement, as well as the well-written set of reports. I also join my colleagues in thanking Mr. Lopetegui and Mr. Morales for their informative buff statement.

We have issued a gray statement, but we would like to take this opportunity to commend the authorities for their strong economic performance. Indeed, as you mentioned, Mr. Chair, Peru continues to be one of the best performing economies in the region.

Peru also enjoys ample fiscal space, with low debt, a strong fiscal position, and robust financial sectors. As highlighted by Ms. Mahasandana, we encourage the authorities to focus on improving educational outcomes, increasing spending on infrastructure projects, and focusing on advancing productivity growth going forward, with more of a focus on inclusiveness.

I join Mr. Saraiva in thanking staff for the excellent selected issues papers, especially on the revenue. We note from the finding that there is a strong co-movement between tax revenues and commodity prices. This is an issue not only for Peru but for a lot of commodity-producing countries. And we welcome staff's analysis in this area.

We also take positive note of Box 1's analysis on the use of technology in advancing the tax collection. We encourage staff to elaborate more in future reports on the use of technology in improving tax collections.

A particular emphasis should be even more on the SME sectors. We are now in a global economy with weaker growth but, at the same time, countries are grappling with increasing domestic revenue mobilization. Staff's analysis in this context is very useful to a lot of countries. We invite the staff to elaborate on these issues going forward.

Finally, I see merit in the points raised by Mr. Mozhin on being cautious in using third-party indicators when we discuss different indicators, especially on corruption, given the sensitivity of this subject.

With these remarks, we wish the authorities continued success.

The staff representative from the Western Hemisphere Department (Mr. Bonato), in response to further questions and comments from Executive Directors, made the following additional statement:

Thank you very much for the further remarks. There are probably two points I need to touch upon.

One, on the capital flow measures, we did not have a discussion on alternative measures. I would like to note that the measure is very narrow, as Ms. Pollard herself said. We went there to establish the facts because we were not sure that the measure was still in place. It was not very high on our priorities for discussion, and the authorities, themselves, did not feel the need to have a discussion on that. But we will certainly follow up, as you recommended.

On the question raised by Mr. Fanizza on foreign exchange intervention, I think it is an important issue. It is an interesting issue. Some of the work that has been done, some of the empirical work that has been done by colleagues at the Fund and also outside the Fund shows that, in fact, there is an asymmetry in foreign exchange intervention and the concern is much more about depreciation than about appreciation. That is natural, given that dollarization, according to the authorities themselves, is the main reason for intervening in the foreign exchange market to limit the adverse balance sheet effects that would follow large depreciation.

Our understanding--and I mentioned that in my opening remarks today--is that the authorities still think that additional volatility may trigger some sudden change in views and in expectations about the exchange rate that could be disruptive. In our discussion, our point was that, if you do not try, you will never know. So there has to be a balance. The authorities have had this balance because it shows that foreign exchange intervention has diminished over time. But that has happened mainly as a result of the fact that Peru has managed shocks very well --it has gone through several important shocks in the last decade. And it did not need to intervene as much because capital flows were not as volatile as they used to be in the past, when Peru did not have this reputation and had a much higher risk in the perception of the investors.

Going forward, this is a discussion that will have to continue. What you find is that--as other countries that have gone under periods of hyperinflation and financial crisis, there is a lot of prudence and a lot of hesitation in making changes to a framework that has worked well in the past. So I think this is fully understandable, but change will certainly occur.

Mr. Morales made the following concluding statement:

I would like to reiterate our thanks to the team, under the leadership of Mr. Bonato, for their excellent work, open attitude in their discussions with the authorities, and the overall good spirits displayed by the team during the mission. I also thank the Board for their support and advice, which my authorities will take very seriously.

Our solid performance so far in the 21st century is a testament to our strong commitment to preserve macroeconomic stability and pursue sustainable and inclusive growth.

External developments affecting the primary sector and idiosyncratic factors constraining domestic demand has led to a slowdown in economic activity in 2019, which we expect to reverse this year. However, we are aware that more work is needed to raise productivity so that our economy operates at full potential in the medium term.

Our National Plan of Competitiveness and Productivity lays out a road map for government action and coordination with stakeholders in many areas that we plan to periodically review against actual implementation to reprioritize the specific policies down the road.

The rollout of our National Plan of Infrastructure for Competitiveness and the acceleration of reconstruction efforts in the regions affected by natural disasters should create momentum to revamp government capital spending dynamics which, in turn, could help to take care of the longstanding problems with budget under-execution, contributing this way to remove the structural bottlenecks constraining private initiatives.

Peru’s sound fiscal position, low debt and robust financial sector contrasts sharply with our economic situation just three decades ago. We have come a long way from the days of hyperinflation and stagnation, to the point that we can now have a serious discussion about how to better use fiscal resources to stimulate growth.

In that regard, we appreciate the support to our approach to add flexibility to our fiscal framework. This strategy would help us to use fiscal space to spur investment, complemented by efforts to strengthen revenue mobilization so that our commitment to our fiscal rules remain credible while, at the same time, sufficient resources are allocated to priority spending.

Our monetary policy has been successful alone in keeping inflation on target but also in maintaining inflation volatility at levels comparable with advanced economies. This has helped to restore confidence in our domestic currency, which we believe is the main factor explaining the sharp reversal of dollarization experienced in recent years.

Today dollarization, to a large extent, reflects currency hedging by large firms subject to invoicing in U.S. dollars.

We agree that the exchange rate flexibility is an appropriate shock-absorber for a small open economy like Peru, which is still relying on commodity exports. In fact, the exchange rate of the Peruvian sol against the U.S. dollar in 2019 fluctuated within a 4 percent range, not too different from 5 percent within the U.S. dollar and the euro. The limited central bank intervention in the foreign exchange market last year addressed the volatility spikes triggered by swings in external market conditions, which often lead to large capital flows, relative to the size of our financial sector within short periods of time.

We will continue upgrading our financial policies in line with FSAP recommendations. We will continue monitoring emerging risks in banks and non-banks. In this regard, incorporating supervision of the corporate sector is a major undertaking that we are embarking on steadily and decisively.

Regarding AML/CFT activities, we will continue improving risk-based supervision to enhance compliance with our legal framework, and we will assess our sanctions framework to ensure effectiveness and proportionality.

We know from the cases discussed in this room week after week that achieving sustainable growth rates is a challenge for countries at all levels of income. In the case of a middle-income country like Peru, the challenge is compounded by the need to reach a consensus among different stakeholders to undertake difficult reforms on labor market legislation, pension schemes, and the provision of health and education, so that these reforms contribute to make the economy more dynamic at the same time that social protection reaches the population at large.

Finally, I want to say that it is always difficult for an Article IV consultation to cover all key sectors in the economy; and, in fact, the well-recognized culinary sector of Peru was not included in the staff assessment. For that reason, those who have not had the chance now are invited to try these Peruvian sweets that are available to you as you leave the room that I am sure meet the standards of the Board's Cookies Committee.

With this, I again thank the staff and the Board for their support.

The Acting Chair (Mr. Zhang) noted that Peru is an Article VIII member and no decision is proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended Peru for continuing to be one of the best-performing economies in Latin America, despite the recent growth deceleration. Noting the country's strong policy buffers and long track record of prudent economic policies, Directors indicated that the authorities would be in a strong position to mitigate the potential impact of any external and domestic risks to the Peruvian economy. In that context, Directors encouraged the authorities to provide short-term policy stimulus to support the recovery as well as undertake growth-enhancing structural reforms to address productivity and infrastructure gaps. They also called for measures to improve governance, and implementation of social protection policies to achieve strong and inclusive growth that would help the country converge to higher income status.

Directors commended the authorities' strong fiscal position demonstrated by low and sustainable public debt and ample fiscal buffers. However, given pro-cyclical fiscal policy and significant infrastructure gaps, Directors called for further efforts to address low capital budget execution that hamper Peru's productivity and competitiveness. In this context, Directors welcomed the recently announced relaxation of the deficit ceiling for the 2021-23 period and the intent to use the extra room for public investment. Noting that frequent modifications of the fiscal rule could undermine its credibility, Directors encouraged the authorities to consider introducing additional flexibility to the fiscal framework rather than relying on periodic modifications of the deficit ceiling. Over the medium term, Directors also encouraged enhanced domestic revenue mobilization, especially in terms of VAT compliance and tax administration, and lower current spending to create space for much needed infrastructure and social spending.

Directors welcomed the renewed monetary easing implemented in the second half of 2019 and suggested that the policy stance should continue to be data-driven while remaining vigilant against the emergence of financial sector vulnerabilities. As dollarization declines, Directors also saw room for additional exchange rate flexibility to absorb shocks and promote financial market development while stressing that foreign exchange interventions should be limited to addressing disorderly market conditions. Also, the remaining non-binding capital flow measure should be phased out.

While commending the authorities' actions to strengthen financial sector supervision, including through progress in implementing the 2018 FSAP recommendations, Directors encouraged further efforts to deepen the legislative and regulatory agenda and improve the effectiveness of the AML/CFT framework.

Directors welcomed the authorities' efforts to improve governance and transparency under the *Anti-Corruption 2018-21 Plan* and called for continued efforts in this area, including limiting the scope for corruption, through independent audits, procurement system simplification and judicial reforms.

Directors welcomed the authorities' structural reform agenda under the *National Plan for Competitiveness and Productivity,* to boost potential growth and achieve sustainable income convergence. Priorities include reforming the legal system and product markets, addressing labor market rigidities and enhancing integration of migrant workers, which would also help address informality and promote more inclusive growth. Directors also encouraged further efforts to improve social welfare, including through pension system reforms, to ensure adequate social protection, a more equitable distribution of natural resource revenues across regions, and deepening financial development and inclusion.

It is expected that the next Article IV consultation with Peru will be held on the standard 12-month cycle.

APPROVAL: September 20, 2022

CEDA OGADA
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***Given that more than half of Peru's exports are directed to China and the U.S., and China's growth rate is on a decelerating trend, we would appreciate if staff could elaborate on which trading partners are likely to support Peru's growth recovery.***

- Import demand in China and the U.S. is expected to rebound following a disappointing performance in 2019. Import of goods is projected to grow by 2 percent in China and 3.3 percent in the U.S. in 2020. In addition, Peru's mining exports should benefit from the opening of new mines and the de-escalation of social conflicts, and fishing exports from the cessation of adverse factors that affected production in 2019.

2. ***What changes in the baseline growth projection does staff expect under the new path for the fiscal deficit?***

We haven't had the opportunity to revise our growth projections based on the new path for the fiscal deficit, which was announced only in late December 2019. The assessment will depend on how the additional fiscal space will be used and how effective will be the government's efforts to improve the execution of capital spending. The fiscal framework will ensure that most spending will be used for key capital projects, but the ability of the government to execute its investment plans will grow only gradually.

3. ***How does staff assess the impact of political uncertainty on the Peruvian economy?***

The impact is likely to be limited. The recent political turmoil did not have significant repercussions on financial markets, highlighting the importance of Peru's sound track record of economic management and strong buffers. Private investment may be postponed and continued uncertainty in 2020 would certainly have an impact, but not for mining investment projects, which have longer planning and execution phases and are a sizable component of private investment.

4. ***It would be good if staff could provide comparisons in per-capita GDP growth between Peru and its peers.***

Please see the table below (levels are in PPP):

	Per Capita Real GDP 2000 (PPP)	Per Capita Real GDP 2019 (PPP)	Growth Per Capita Real GDP 2000-2019
Argentina	15010.7	17508.9	16.6
Bolivia	4412.3	7134.6	61.7
Brazil	11470.2	14371.6	25.3
Chile	14233.7	22975.6	61.4
Colombia	8274.2	13567.9	64.0
Ecuador	7445.0	10251.7	37.7
Mexico	15810.9	18218.1	15.2
Paraguay	8042.5	11859.3	47.5
Uruguay	12555.6	20586.5	64.0
Peru	6503.8	12850.2	97.6

Source: WEO

5. ***We would like staff to comment on the risks of the growth slowdown becoming of a more permanent nature.***

- The slowdown experienced over the last few years has been partly caused by temporary adverse shocks, as in 2017 and 2019. In our view, however, delays in structural reforms and infrastructure investment are also part of the explanation and we have consequently downgraded our assessment of potential growth.

Fiscal Policy

6. ***As a first step to attract private investors, authorities have pledged to focus on strengthening institutions to send a signal to the market. In this regard, we would like to hear staff's assessment of how authorities can improve project implementation.***

- Low implementation reflects several problems. Regional governments and municipalities receive ever increasing revenues that far exceed their capacities, which they use for small projects that are not attractive for large (and more efficient) infrastructure companies. To address these issues, the government could either create a few strong regional entities or expand its capabilities at the central level to help local authorities prepare valuable projects and implement them. At the central government level, slow execution is due to structural problems with large projects, which must be addressed with stronger project design and better integration with budget preparation. The execution of the resources for the reconstruction from the damages of the 2017 El Niño is expected to accelerate as the reconstruction agency has taken over the execution (on behalf of the regions) and is expected to sign in the coming months government-to-government agreements for standardized infrastructure projects, including works to prevent future weather-related damages. This model, although not applicable to all projects, has worked very well for the infrastructure investment in preparation for the 2019 Pan-American Games hosted by Peru.

7. ***Staff comments are welcome on the ongoing measures to remove capacity constraints both at the national and regional level.***

See response to previous question.

8. ***What were the main reasons for the low execution of public investment in 2019 and how can this be addressed by the authorities?***

See response to previous question.

9. ***We read from the report that capacity and structural constraints regarding public investment and infrastructure projects remain major obstacles for budget execution. Could staff provide more information about these constraints, and what measures could be taken to mitigate them?***

See response to previous question.

10. ***How do staff evaluate the progress in subnational investment capacity building during the last two years, and what are main remaining bottlenecks in this area?***

See response to previous question.

11. ***We would welcome staff views on the capacity to deliver more capital spending effectively in 2020 and beyond.***

See response to previous question.

12. ***We would be interested to learn whether the authorities have taken into account the recommendations provided by the 2017 PIMA report to enhance the efficiency and impact of public investment?***

- The authorities have prepared the national infrastructure plan and have continued to work with FAD TA in the strengthening of the multi-annual budget framework, both of which were key recommendations of the report. Other ongoing measures to improve the efficiency and impact of public investment are also in line with the PIMA recommendations. An important issue going forward will be strengthening the project evaluation framework, particularly at the stage of pre-investment. This would be particularly crucial in cases where climate-related risks need to be considered.

13. ***What specific measures would staff recommend based on the recent Public Investment Management Assessment?***

See response to previous question.

14. ***Could staff elaborate on whether the execution of the 2020 budget is jeopardized by the recent political stalemate and the parliamentary elections?***

- The 2020 budget was issued by emergency decree and the new Congress elected at end-January will have to approve it. After that, budget execution, particularly of capital spending, will depend largely on the structural problems mentioned above and the effectiveness of the government's measures to address them.

15. ***Could staff elaborate on their preference for easing of fiscal policy in this context, rather than further monetary accommodation?***

Staff will respond to this question orally.

16. ***Could staff comment on the reasons to switch from the 2014-2016 framework to the one currently in place? Was the previous framework more flexible? Has the current rule enough flexibility to provide room for counter-cycle policy adjustments if needed?***

- The 2014-16 framework was anchored on a structural deficit rule and was more flexible in terms of the time allowed for returning to the 1 percent structural deficit ceiling. However, the factors that made the framework more flexible also made it less transparent. The administration of President Kuczynski preferred to change to a more transparent rule, while also strengthening other fiscal anchors (such as the debt rule). A comparison of the two frameworks can be found in the staff report for the 2017 Article IV consultation. The current framework is not completely devoid of flexibility because the escape clauses provide room for dealing with adverse shocks. However, as Directors have noted, the excessive recourse to escape clauses can undermine the credibility of the framework and additional flexibility would be preferable.

17. ***In this regard, could staff elaborate on why the authorities are now using a headline deficit ceiling instead of a structural deficit ceiling along the lines of the framework in place during 2014-16?***

See response to previous question.

18. ***How far these measures will reduce compliance gaps, particularly VAT compliance? Given the findings of the special note that the VAT gap appears to co-move with the commodity cycle, how far the tax revenues could be vulnerable to international commodity price cycles?***

- According to the revenue administration (RA) Gap report (FAD, 2015), the VAT gap in Peru was higher than the Latin American and EU average in 2007-2014, largely because of compliance gaps. The tax authority (SUNAT) has a very close working relationship with FAD technical assistance teams and recent FAD mission have found a high degree of compliance with TA recommendations. Measures such as electronic invoicing and digital transformation, which have been adopted recently, should improve SUNAT's ability to monitor and control economic transactions and lower tax noncompliance. Strengthening of laws on tax avoidance will also have a positive impact on SUNAT's ability to address noncompliance. The authorities envision a 3.5 percent increase in tax revenues as a result of these and other measures in 2020. This increase looks ambitious, but the impact of these reforms is very difficult to assess.

19. ***VAT compliance gap appears to be a common problem across many emerging market countries. The staff would like to comment whether the issues in VAT non-compliance are similar to other EMEs.***

See answer to previous question.

20. ***We also note that tax to GDP ratio remain low and did not improve in 20 years and consequently encourage the authorities to make strong progress in this area by increasing excises and property taxes. The selected issues paper was very helpful in this regard. Can staff elaborate on possible further technical assistance efforts in this regard?***

- Important areas of ongoing TA include improvements in the IT systems and data management, improving the quality of the taxpayer registry, improving risk analysis of taxpayers, conducting an in-depth review of the systems for sanctions and penalties, and reform of the small businesses tax regimes.

21. ***We view that revenue mobilization measures will take time. We appreciate staff comments on whether the high-than-expected revenue achieved in 2019 is sustainable in the near term and whether the speed of the consolidation effort recently announced by the authorities is appropriate, taking into consideration the need to boost infrastructure spending and the available fiscal space?***

- Revenues are expected to remain robust in 2020, primarily driven by some recovery in commodity related revenues and by stronger GDP growth. The new consolidation path recently announced by the authorities is appropriate because it provides room to avoid a negative fiscal impulse in 2020-21. However, as indicated in the Staff Statement, the actual impact of this measure will crucially depend on the government's capacity to improve budget execution.

22. ***Has staff assessed the fiscal cost of the Venezuelan migration, and could staff provide some details about its collaboration with the World Bank on this issue and how to mitigate the frictions?***

- Staff and the authorities have estimated the fiscal cost of Venezuelan immigration. The World Bank recently released a report estimating a net potential fiscal benefit of 0.23 percent of GDP on average in 2019-2023. An element of uncertainty is related to the estimates of additional revenues, which might be affected the high level of informality of jobs taken up by immigrants. The authorities have already taken steps to mitigate labor market frictions by reducing the cost and improving the process to facilitate accreditation of skilled migrants.

Monetary, Exchange Rate, and Financial Policies

23. ***Given the fact that many corporates have their income in U.S. dollars and that dollar-denominated deposits have kept a significant wedge over dollar-denominated loans to the private sector, we wonder whether staff has an assessment of how large the remaining unhedged dollar-liability in the Peruvian economy is?***

Staff will respond to this question orally.

24. ***Could staff comment on the benefits for Peru of maintaining a multi-instrument framework vis-à-vis a more orthodox one going forward? Could the multi-instrument inflation targeting framework be considered as transitory?***

Staff will respond to this question orally.

25. ***Although the dollarization of loans has moderated, given the still significantly high dollarization of bank deposits, what risks it may pose in the event of sudden tightening of external financing conditions?***

Staff will respond to this question orally.

26. ***We also note the authorities view that the remaining dollarization largely reflects widespread dollar invoicing of intermediate goods and services, which would be irresponsive to additional exchange rate volatility. We would welcome staff comments on this view, including on whether dollar invoicing plays a significant role in influencing Peruvian policy stance.***

Staff will respond to this question orally.

Could staff elaborate on any potential TA or future collaboration with the authorities on the IPF study to better understand the trade-off and right policy mix that would be helpful for the Peruvian authorities?

Staff will respond to this question orally.

27. ***Does staff see an optimal level for dollarization?***

Staff will respond to this question orally.

28. ***Could staff comment on the timeline, the conditions that would be needed, and alternative measures (for the CFM/MPMs) that could be put in place?***

- The CFM/MPMs were initially introduced to alleviate capital flow pressure and guard against financial system risks. A specific timeline cannot be provided for the removal of the measures, which depends on whether there is still a need to mitigate the financial risks that the measures are meant to address and whether alternatives are available. Although there are no capital flow pressures, financial risks may still be present. We recommended the authorities prepare for phasing out these measures and consider alternative ones that directly address systemic risk without limiting capital inflows. For example, the authorities could consider non-discriminatory, currency-based measures that should help mitigate risks associated with external short-term borrowing in FX. Further improving MPMs and prudential measures' monitoring and enforcement would help to foresee risks build up.

Structural Issues

29. Does the staff think that informality in EMEs like Peru may also be an outcome of elastic supply curve of unskilled/low skilled labor, which keeps production cost low for small and micro enterprises?

- As in other EMs, the high rate of informality in Peru has many different causes: i) the quality of labor is relatively low due to the lack of access to adequate education; ii) firing workers is extremely difficult (a ruling by the Constitutional Tribunal in 2001 has established that severance is not enough compensation for "unjust dismissal" and instead the restitution of the job is required); iii) elevated minimum wages that are not aligned with the low productivity of a large fraction of workers; iv) size-dependent regulations (for tax and labor requirements) that create incentives for firms to atomize and "stay small"; v) the fact that non-contributory health care is considered to be of higher quality than the contributory system (which has less coverage, particularly in rural areas); vi) weak enforcement of existing labor regulations (for example, formal firms have both formal and informal staff, and sometimes even rotate them, to reduce costs but without them losing their benefits).The solution to this problem is not simple and as mentioned in the report it would require a multi-pronged approach that increases the incentives for formality and raises the costs of informality.

30. *Could staff elaborate on its policy advice to reduce informality, and to which extent they collaborate with the World Bank on this matter?*

- See response to previous question. On the collaboration with the World Bank, informality is one of the key issues we discuss normally in our periodic meetings, but we don't have any joint projects ongoing.

31. *In addition, staff may want to give an update on the progress in reducing economic informality. We are also interested to hear about additional measures for reducing informality in the competitiveness plan and their projected impact.*

- See response to previous question. The competitiveness plan does not address reforms that would directly affect informality (like labor market reform, taxation, provision of public services, etc.), but it addresses low productivity, which is one of the causes of large informality.

32. ***We note that the extension of the agriculture promotion law was a rather controversial decision in Peru. What was the nature of disagreements between the government and Congress (Annex I)? Given that this sectorial law was successful in export diversification, is there a case for replicating this experience in other sectors?***

- According to the experts we have seen during the mission, the agriculture promotion law was key in ensuring the success of the agro-exporting sector, particularly the provisions enhancing labor flexibility given the seasonality of labor demand in agriculture. The recent extension of the law to aquaculture and forestry could help the development of these sectors, which also present important competitive advantages. However, other reforms are needed, including to facilitate the release of land permits and access to cheap long-term financing. The disagreement between the government and Congress was mainly as to whether the benefits provided by the law should be kept only for new firms and phased out over time, whether the benefits were too generous and should be brought closer to the regulation for other sectors (such as the changes to vacation days and health contributions), and whether sectoral wages should be higher to share some of the profits from the sector.

33. ***Some modifications of the law, which increase labor costs, may reduce export competitiveness. Staff comments are welcome.***
The increase in labor costs from the modifications of the law are limited. More important are the provisions on labor flexibility, which are the critical element in the law and remain unchanged.

34. ***The post-GFC quasi-stagnation of total factor productivity in Peru—the most performing LA6 country—is disconcerting considering the progress made in structural reforms and the dramatic change in technology in recent years. More elaboration from staff on the factors behind this situation would be welcome.***

- Following the GFC, the less conducive external environment has affected both investment and productivity in Peru and has translated into lower growth levels. As the impact of past reforms on growth begins to dissipate, the country needs to implement new reforms to maintain the growth momentum. Among the key features of the Peruvian economy that may have hampered productivity growth are the high degree of business and labor informality, which leads to misallocation of the factors of production. Business informality can be the result of high tax or administrative costs of formalization, including costs of hiring and firing formal labor. In addition, size dependent tax or labor market policies can prevent small formal firms from growing or result in firm splitting. Additionally, firms may be growth-constrained owing to lack of complementary public resources in the economy such as the poor quantity and quality of physical infrastructure in Peru. Low labor productivity can additionally derive from poor educational inputs. Surveys of quality of education in Peru indicate poorer performance than coverage indicators would suggest.

35. In Annex II, staff addressed an important issue of insufficient export complexity in Peru. What are the authorities' plans to achieve progress in this area? We would also appreciate additional details on the Special Economic Zones in Peru.

- The authorities recognize that significant improvement in infrastructure is needed to foster higher value-added exports and their National Plan of Infrastructure for Competitiveness is therefore key in this regard. Other important pillars of their export diversification strategy are laid out in a Strategic National Export Plan (from the Ministry of External Commerce and Tourism) and a National Plan for Productive Diversification (from the Ministry of Production), and include export marketing, technical assistance to exporters, and simplification of business regulations. As described in a 2019 FAD technical assistance report on the tax regime for small taxpayers and special economic zones, the latter were set up decades ago with a decentralization objective in mind, but have been largely unsuccessful, accounting for less than 0.1 percent of total goods exports in 2018. Poor infrastructure, among other factors, have been cited as main causes for their failure.

36. ***Staff assessment of political support, legislative advances, and effective implementation of climate policies in Peru would have been a useful complement to this insightful report. Staff elaborations would be welcome.***

- This is certainly an area that we are aiming to cover in the future. The authorities are mindful as well of the importance of this issue. This is not only reflected in the adoption of the 2018 Climate Change Framework Law, but also on their approach to infrastructure work. In response to the 2017 El Niño weather event, the authorities vowed to enhance the resilience of infrastructure to weather events, which has informed the elaboration of many projects included in the National Plan of Infrastructure for Competitiveness, and the definition of the concept of environmental sustainability for the assessment of projects. The Minister of Environment is currently working on a framework for the assessment of climate-change risk management, which is expected to be incorporated into the next version of the National Plan of Infrastructure for Competitiveness. We haven't assessed the country's preparedness to climate-related risks, but it is important to note that the ample fiscal space constitutes an important asset in that regard. For instance, after the 2017 El Niño weather event the government was able to provide significant assistance to the regions hit by the disaster.

37. ***Given the damages caused by the El Niño event in 2017, does the National Plan of Infrastructure for Competitiveness foresee any measures to strengthen the resilience against extreme weather events? How would staff assess the country's preparedness to climate-related risks?***

See response to previous question.