PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

December 10, 2015
Report No.: 101895

Operation Name	Peru Boosting Human Capital and Productivity DPF-DDO
Region	LATIN AMERICA AND CARIBBEAN
Country	Latin America
Sector	General industry and trade sector (50%); Public administration- Industry and trade (30%); General public administration sector (20%)
Operation ID	P156858
Lending Instrument	Development Policy Financing with a Deferred Drawdown Option
Borrower(s)	GOVERNMENT OF PERU
Implementing Agency	Ministry of Economy and Finance, Peru
Date PID Prepared	December 10, 2015
Estimated Date of Appraisal	December 10, 2015
Estimated Date of Board Approval	February 2, 2015
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

Sound macroeconomic and structural policies over the last 20 years rendered significant growth and poverty reduction dividends for the country. Peru grew at an average of 4.5 percent per year during 1990–2013 (compared to regional and global growth of around 3 percent). Under a more favorable external environment for its commodities, Peru grew at an even faster average rate—above 6 percent per year—during the last decade. Growth helped Peru to reduce poverty from 55 to 24 percent of the population between 2001 and 2013, faster than other countries with similar income levels. Growth was also widely shared: between 2004 and 2013, real income per capita of the bottom 40 percent grew at an average rate of 6.8 percent, faster than the national average of 4.4 percent.

Peru continues to have a sound macroeconomic policy framework. Throughout the period of high growth and unlike many countries, Peru saved the commodities' windfall, leaving itself with significant savings to continue to afford needed investments and strong macroeconomic buffers to face more challenging times. Growth slowed to 2.4 percent in 2014. The recovery is expected to be gradual since Peru's growth potential in the following years is likely to be lower compared to that of the last decade under the assumption of a non-temporary price adjustment on the country's main exports. The current account is hovering around 4 percent of GDP, and remains mostly covered by FDI and portfolio investments. Foreign exchange reserves stood at 31 percent of GDP or 20 months of imports by the end of October 2015. Monetary policy has been prudent, and the Central Bank adheres to a well-established inflation targeting regime. The strong macroeconomic buffers have allowed the country to undertake a moderate and temporary fiscal impulse with the aim to smooth the economic transition to the less favorable external environment, without compromising macroeconomic stability. A gradual fiscal policy tightening is expected to begin in 2017—the fiscal deficit is projected to peak at 3 percent of GDP in 2016 and come down to 2.5 percent in 2017. Public debt remained relatively low at 20 percent of GDP and net public debt was 3 percent of GDP in June 2015 (one of the lowest in the world).

But the headwinds of the new global context, the need to continue advancing the social gains of the last years, and the ambition of Peru to continue its path of income convergence towards OECD levels, requires a new reform momentum. Sustaining the pace of economic development and poverty reduction in times of lower external demand for commodities requires that Peru's engine of growth relies even more on higher productivity. Against this background, the authorities have started a new wave of reforms supported by two parallel DPF-DDOs. This operation supports the objectives of the authorities' reform agenda to boost firms' human capital and productivity focusing on: (i) enhancing the education policy framework to enable better quality of skills, (ii) facilitating the entry, operation, and exit of firms; and (iii) reducing transaction costs in trade. The objectives of the DPF-DDO are fully aligned with key parts of the Country Partnership Strategy (CPS).

II. Operation Objectives

The DPF-DDO supports the Peruvian government's National Competitiveness Agenda 2014-2018 and the National Education Project to 2021. Although a portion of Peru's growth is already driven by improvements in productivity, in the next stage of convergence, and under the new external conditions, a larger contribution to economic growth will have to come from increasing productivity. There is evidence that low educational quality compared to countries at the same level of income reduces the adoption of more efficient technologies and workers' productivity and contributes to the high prevalence of less productive informal jobs; that markets distortions tend to misallocate labor and capital to less productive workplaces; that small and medium size firms in Peru grow very slowly compared to firms in countries at the same level of income; and that Peruvian firms trade relatively little despite a liberalized trade regime. The National Competitiveness Agenda and the National Education Project to 2021 start a new wave of reforms to deal with these issues. The DPF-DDO is structured around three pillars: (i) enhancing the education policy framework to enable better quality of skills, (ii) facilitating the entry, operation, and exit of firms; and (iii) reducing transaction costs in trade.

A contingent financing alternative such as the one provided by this DPF-DDO is very important for the authorities' financial planning and as a buffer for shocks. The contingent financing embedded in this operation is envisioned as a buffer to help support the authorities financing plans, debt maturity, and costs strategies over the coming years. The authorities see the DPF-DDO as a very useful contingent alternative, particularly as borrowing costs for emerging economies may increase in the context of the tapering of monetary policy in the United States. This type of contingent financing may also help as a buffer for other shocks if they materialize beyond expectations. For example, the climatic phenomenon El Niño may have a strong adverse effect on the country's infrastructure and on economic sectors such as agriculture and fisheries. The authorities also value the support of the World Bank's policy financing since the DPF-DDO embeds technical advice and it signals the government's commitment to critical reforms supporting economic development.

III. Rationale for Bank Involvement

The proposed Boosting Human Capital and Productivity Development Policy Financing with a Deferred Drawdown Option (DPF-DDO) aims to support Peru's efforts to foster productivity growth under a more challenging external environment. Lower export demand, including from China, worsening terms of trade, and the prospects of higher borrowing costs is affecting a large number of emerging economies. In this context, a larger portion of economic growth in Peru will have to come from further boosting productivity. While growth requires a number of important ingredients, increasing productivity will be a critical one in Peru. Productivity contributed to about a third of the country's growth over the last years, but there is still a large productivity gap with high-income countries. Peru's growth dividend from closing that gap is significant and this can be supported through deeper and sustained reforms targeting key determinants of productivity growth in Peru: human capital, competition, and trade. The proposed DPF-DDO supports measures targeting key productivity constraints by enabling the improvement of the quality of human capital, fostering competition pressures, and facilitating trade.

The reforms supported are the first installment of widely backed medium term reform programs—the National Competitiveness Plan 2014-18 and the National Education Project to 2021. First, the reforms enhance the quality of education and thus the human capital of the future workforce raise Peru's productivity. They aim to improve the quality of education helping workers to obtain the skills necessary to find a job in the more productive formal sector, address firms' shortage of skilled workers, and raise their ability to adapt new technologies or management practices. Second, the reforms will facilitate business regulations and harmonize them among different municipalities across the country. They will make the implementation of laws and regulations more consistent and predictable for all firms in Peru. It will further encourage the entry of new firms and formal sector job creation. Third, the reforms will reduce the administrative burden for firms to trade and support firms in producing higher quality goods to meet international quality standards. This will further promote firm entry, export competitiveness, and job creation in the formal sector.

The proposed operation is consistent with the WBG's CPS for Peru for 2012-2016 (Report No. 66187-PE). The CPS is built around four strategic objectives: (i) increasing access and quality of social services for the poor, (ii) connecting the poor to services and markets, (iii) promoting sustainable growth and productivity, and (iv) improving public sector performance for greater inclusion. This operation is well-aligned with the three pillars: (i) enhancing the education policy framework to enable better quality of skills, (ii) facilitating the entry, operation, and exit of firms; and (iii) reducing transaction costs in trade.

By focusing on facilitating the entry, operation, and exit of firms, reducing transactions costs in trade, and enhancing the quality of skills, the DPF-DDO complements other Bank operations in Peru. The BGP-DPF has been closely coordinated with and complements the following operations, for example, the forthcoming Innovation and Productivity Investment Loan (FY17). Furthermore, the proposed operation complements two current investment operations of the

World Bank in education, the Higher Education Quality Improvement (PROCALIDAD) project and the Basic Education project.

IV. Tentative financing

Source:		($m.)
Borrower		0
International Bank for Reconstruction and Development		1,250
Borrower/Recipient		
IBRD		
Others (specify)		
	Total	1,250

V. Institutional and Implementation Arrangements

The Bank will work with MEF and MINEDU to monitor progress of the proposed operation during the course of the program. For most indicators, monitoring and evaluation will be folded into the National Competitiveness Council regular activities, chaired by the minister of Economy and Finance. They will be supported by MINEDU for the progress on the indicators of the education reforms. Other ministries and agencies linked to the prior actions and results will monitor and provide budgetary, legislative, and economic data and verify official disclosures, directives, and regulations.

MEF and MINEDU have strong arrangements to monitor the progress of the proposed operation during the entire drawdown period. The DGPMACDF and the DGPPIP will provide progress reports, including indicators, to the World Bank for the two policy areas supported by the DPF-DDO. This will be facilitated given that the monitoring framework is built on the basis of existing statistics and reports that are regularly published by MEF. The Debt Management Unit of the MEF will coordinate the operation's financial aspects. MEF has requested that the World Bank supervise both the macroeconomic management and the implementation of the program supported by the DPF-DDO during the drawdown period on a quarterly basis. In doing so, MEF intends to also benefit from receiving World Bank's expertise on specific issues that might arise.

VI. Risks and Risk Mitigation

This operation entails an overall moderate level of risk. Reforms are all well entrenched in the institutional framework of the implementing agencies, some of which are accountable to the reforms these reforms in order to comply with the performance budgeting framework. Together with continuous World Bank support, this would mitigate risks arising from the forthcoming presidential elections.

Political and governance risks are considered moderate and are associated with election dynamics. The main internal risk relates to domestic politics (presidential elections April and June (2nd round) of 2016 and their potential impact on future reforms in these areas. These risks are mitigated as policy continuity is very likely and unrelated to election results, partly because it is entrenched in a technically sound management of the government.

Macroeconomic risks to the results of this operation are considered moderate. Peru's solid macroeconomic policies and fundamentals allow the government to respond to shocks. The less favorable external environment affects all countries in the LAC region, including Peru. China is also a significant export destination for Peru, and further deterioration of export demand in this country would continue to affect trade balances. While commodities represent 65 percent of total exports, they account for about 13 percent of GDP, and only around 2.3 percent of fiscal revenues in Peru. The climatic phenomenon El Niño is expected to have a strong adverse impact over the next 12 months and is expected to worsen, for example, the exports of the fishery sector in 2016. Nonetheless, throughout the past period of growth and favorable external conditions, and unlike many countries, Peru saved the commodities windfall, leaving itself with significant savings to continue to afford needed investments and strong macroeconomic buffers. Foreign exchange reserves stood at 31 percent of GDP or 20 months of imports by the end of October 2015. Public debt remained relatively low at 20 percent of GDP and net public debt was 3 percent of GDP in June 2015 (one of the lowest in the world). The Fiscal Stabilization Fund (*Fondo de Estabilización Fiscal*) provides an additional buffer in case of continued negative external shocks (standing at US$8.6 billion by end 2014 or 4 percent of GPD).

Risks related to institutional capacity for implementation are considered moderate. While most reforms are well entrenched into Peru's institutional framework, introducing a risk-based auditing system in municipalities, for example, is a new area. It will demand technical capacity and careful follow-up. The World Bank, as well as other key players, will continue to offer technical assistant to help Peru to successfully implement the reform.

Social and environmental risks are considered low. The specific policies supported by the DPF-DDO are not likely to have significant effects on Peru's environmental resources and natural habitats. The poverty and social impacts of the supported policy measures are expected to be either positive or poverty-neutral in the short term, and to be positive over the medium term.

Risks related to stakeholders are considered moderate. The reforms supported are the first installment of a widely backed medium term reform program—the National Competitiveness Plan 2014-18, which has been broadly consulted with all key stakeholders.

VII. Poverty and Social Impacts and Environment Aspects

The poverty and social impacts of policy measures supported under this DPF-DDO are expected to be either positive or poverty-neutral in the short term, and to be positive over the medium term. The policy areas covered by the operation are: (i) enhancing the education policy framework to enable better quality of skills, (ii) facilitating the entry, operation, and exit of firms; and (iii) reducing transaction costs in trade. All policies aim to promote private sector-driven growth by facilitating the entry, operations, and exit of firms, enhancing their export competitiveness, and increasing their human capital. The reforms are expected to result in more private sector competition raising firm productivity and inducing stronger economic growth in the medium and long term. The higher growth is expected to be inclusive, with poorer segments of society experiencing a sustainable increase in well-being through better access to services and economic opportunities. The reduction in the administrative burden for formal firms and the higher quality of secondary and higher education are expected to reduce informality which disproportionally benefits the bottom 40 percent of the income distribution. The impact of each individual reform is expected to have only marginal effects on formalization but taken together, the synergies in the proposed operation can have a noticeable impact.

The specific policies supported by the DPF-DDO are not likely to have significant effects on Peru's environmental resources (e.g. forests, water resources, etc.) and natural habitats. The policy areas covered by the operation are: (i) enhancing the education policy framework to enable better quality of skills, (ii) facilitating the entry, operation, and exit of firms; and (iii) reducing transaction costs in trade. The risk of unanticipated adverse effects to the environment and natural resources is very small. Credible scenarios for any significant, direct or indirect negative impacts appear very unlikely. For the measure related school infrastructure, the operation supports the strengthening of planning and regulation functions that enable better engagement with the private sector and enhanced coordination between the central and local governments in this area. This is an institutional reform measure without a physical footprint directly attached to it. MINEDU and subnational governments have in national policy the controls needed to comply with all country-wide regulations. Peru has adequate environmental controls in place and environmental legislation and regulations are aligned with good international practices.

VIII. Contact point

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