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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED LOAN

IN THE AMOUNT OF US$1.25 BILLION

TO

THE REPUBLIC OF PERU

FOR THE

PUBLIC EXPENDITURE AND FISCAL RISK MANAGEMENT

DEVELOPMENT POLICY FINANCING WITH A DEFERRED DRAWDOWN OPTION

January 16, 2016

Governance Global Practice
Bolivia, Chile, Ecuador, Peru and Venezuela Country Management Unit
Latin America and the Caribbean Region

REPUBLIC OF PERU–GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange rate effective as of January 11, 2016)
Currency Unit = Peruvian Soles (PEN)
US$1 = 3.43 PEN

ABBREVIATIONS AND ACRONYMS

BCRP	Peruvian Central Bank (*Banco Central de Reserva del Perú)*
BOP	Balance of Payments
CAPEX	Capital Expenses
COFIDE	Financial Corporation for Development *(Corporación Financiera de Desarrollo)*
CPI	Consumer Price Index
CPS	Country Partnership Strategy
DDO	Deferred Drawdown Option
DGPMACDF	General Directorate of Macroeconomic Policy and Fiscal Decentralization (*Dirección General de Política Macroeconómica y Decentralización Fiscal*)
DGPPIP	General Directorate for Private Investment Promotion Policy (*Dirección General de Política de Promoción de la Inversión Privada*)
DPF	Development Policy Financing
DPF-DDO	Development Policy Financing with a Deferred Drawdown Option
DS	Supreme Decree *(Decreto Supremo)*
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GoP	Government of Peru
GRS	Grievance Redress Service
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
LAC	Latin America and Caribbean
LGs	Local Governments
MEF	Ministry of Economy and Finance
MMM	Multiannual Macroeconomic Framework (*Marco Macroeconómico Multianual)*
MYFMR	Multi-annual Fiscal Management Reports
NPV	Net Present Value
OECD	Organization for Economic Cooperation and Development
OSCE	Peruvian Public Procurement Agency *(Organismo Supervisor de las Contrataciones del Estado*)
PCM	Presidency of the Council of Ministers *(Presidencia del Consejo de Ministros)*
PDO	Program Development Objective
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PPIAF	Public-Private Infrastructure Advisory Facility
PPO	Payment for Construction Progress *(Pago por obra)*
PPP	Public-Private Partnership
PSIA	Poverty and Social Impact Assessment
RGs	Regional Governments
RPI	Compensation for Investment Certificates (*Retribuciones por Inversiones)*
SEDLAC	Socio-Economic Database for Latin America and the Caribbean
SERVIR	National Civil Service Authority (*Autoridad Nacional del Servicio Civil)*
SIAF	Integrated Financial Management System *(Sistema Integrado de Administración Financiera)*
SNG	Subnational Governments
SNIP	National Public Investment System (*Sistema Nacional de Inversión Pública*)
SIISU	Specialized Investment Implementation Support Unit (*Equipo Especializado de Seguimiento de la Inversión*)
TSA	Treasury Single Account
WBG	World Bank Group
WDI	World Development Indicator
WPS	Working Paper Series

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LOAN AND PROGRAM SUMMARY

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Borrower:	Republic of Peru
Implementing Agency:	Ministry of Economy and Finance (MEF)
Financing Data:	IBRD Loan Amount: US$1.25 billion. Terms: Flexible Loan at 6 month Libor plus variable spread, with a maturity of 14 years and 13.5 year grace, with bullet repayment of principal. Front end fee: 0.25 percent of loan amount to be financed from own resources. Stand-by fee: 0.50 percent on the Unwithdrawn Loan balance.
Operation Type:	Development Policy Financing with a Deferred Drawdown Option (DPF-DDO)
Main Policy Pillars and Program Development Objective(s):	The proposed operation aims at supporting the Government of Peru's efforts to improve: (i) the management and reporting of public expenditures in subnational governments (SNGs), and (ii) the Government's legal and institutional framework for public-private partnerships (PPPs). The proposed DPF is central to the World Bank's engagement in the area of improving public sector performance for greater inclusion, as described in the 2012-2016 Country Partnership Strategy.
Result Indicators:	Percentage of regional governments (RGs) and local governments (LGs) in compliance with fiscal rules for SNGs: 2014 Baseline: 50% of RGs (representing 66.3% of RGs total revenue) met fiscal rules' targets and 59% of LGs (representing 66.4% of total LGs revenue) met fiscal rules' targets. 2017 Target: 65% of RGs and 70% of LGs met fiscal rules or their convergence targets.
	Percentage of RGs and LGs that submitted the Multiannual Report of Fiscal Management in compliance with reporting obligations (gradual reporting obligations through a six year period (2015-2020): 2015-2017: 100% of RGs submit the Multiannual Report of Fiscal Management. 2015 Baseline: 80% of LGs that represent 50% of total LGs' income. 2017 Target: 80% of LGs that represent 70% of total LGs' income.
	Number of managerial positions covered by professional public managers (Directivos Públicos) as a percentage of total professional managerial positions in RGs: 2014 Baseline: 0% 2017 Target: 77% (800 professional managerial positions covered by *Directivos Públicos*)
	Percentage of PPP promoters (spending units) at all levels of government that issue the Multiannual Report on PPP Investment on a yearly basis: 2015 Baseline: 0% 2017 Target: 100%
	Number of unsolicited proposals presented for evaluation: 2015 Baseline: 147 2017 Target: 88
	Number of PPP contracts without MEF's favorable opinion prior to the tender process at all levels of government 2014 Baseline: 17 2017 Target: 0
Overall risk rating:	Moderate
Operation ID:	P154981

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1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Development Policy Financing with a Deferred Drawdown Option (DPF-DDO) in the amount of US$1.25 billion aims to support the Government of Peru (GoP) in their efforts to improve public expenditure and fiscal risk management.** Against the backdrop of a less favorable external environment the GoP embarked upon the implementation of structural reforms to boost human capital and productivity, and to promote fiscal effectiveness and responsibility. Within this context, the proposed operation supports the GoP's efforts to improve: (i) the management and reporting of public expenditures in subnational governments (SNGs), and (ii) the Government's legal and institutional framework for public-private partnerships (PPPs).

2. **Sound macroeconomic and structural policies over the last 20 years, also supported by favorable external conditions over the last decade, rendered significant growth and poverty reduction.** 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 (Figure 1). Growth was also widely shared: between 2004 and 2013, real income per capita of the bottom 40 percent grew at an average 6.8 percent, faster than the national average (Figure 2). Growth was the main driver of poverty reduction and inequality primarily through improved labor incomes rather than redistribution policies, and in the context of a smaller size of the state relative to other higher middle income countries.

3. **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. Indeed, domestic savings increased from just above 10 percent of gross domestic product (GDP) in the early 1990s to 24 percent in 2014, with public sector savings playing a key role over the last 10 years. 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 in the country's main exports. The current account is hovering around 4 percent of GDP, and remains mostly covered by foreign direct investment (FDI) and portfolio investments. Foreign exchange reserves stood at 32 percent of GDP or 20 months of imports by the end of December 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).

4. **As part of its overall reform program, the GoP has focused on improving the public management and reporting framework for subnational levels, and the basis to evaluate fiscal risks coming from PPP projects**. These have been two key areas in need of improvement for an otherwise very robust economic management framework. Fiscal responsibility of SNGs is important as they account for about 38 percent of total non-financial public sector spending and 60 percent of total public investment spending. Although SNGs' finances are not particularly out of line in the aggregate, it is important that they stay that way with the forthcoming expected reduction in their revenue while also improving their management capacity to implement public investment programs. Similarly, appropriate management of PPPs is essential, both to manage fiscal obligations and risks coming from PPP initiatives and to accelerate the implementation of existing projects. Rightly, the GoP has focused on putting in place the full legal and institutional framework to implement the recently-enacted '*Fiscal Responsibility and Transparency Law*' and the '*PPP Law.*' This DPF-DDO will help maintain the dialogue with the next government, facilitating the implementation of the reform agenda in these important areas.

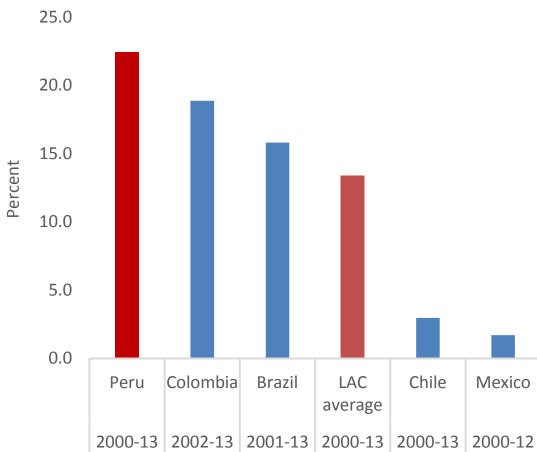
5. **Against this background, the authorities have started a new wave of reforms supported by two parallel DPF-DDOs**. This operation supports the objectives of the authorities' reform efforts to improve: (i) the management and reporting of public expenditures in subnational governments' (SNGs), and (ii) the Government's legal and institutional framework for public-private partnerships (PPPs). A parallel, and complementary DPF-DDO, would support a boost to 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. Other important factors, limiting growth are the country's infrastructure gaps and managing the available resources for public investments adequately. The objectives of these DPF-DDOs are fully aligned with key parts of the 2012-16 Country Partnership Strategy (CPS) (Report No. 66187).

6. **From a financing perspective, the proposed DPF-DDO is an important element of the authorities' medium term financial plan and a buffer to negative shocks**. The proposed operation supports the authorities' medium term financing plan, debt maturity, and costs strategy. The authorities see the DPF-DDO as a very useful alternative, particularly as borrowing costs for emerging economies may increase in the context of the tapering of monetary policy in the United States. They also value the hedging feature of the DDO, particularly in times of volatility in international capital markets. This type of contingent financing may also help as a buffer for other shocks if they were to 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. In the context of strong institutions for macroeconomic management, authorities in one government use disbursements under the DPO but also leave some contingent financing for the upcoming government, as demonstrated by the use of DPF – DDO's of 2008-2009.

7. **A DPF-DDO is also important for policy and institutional reform continuity.** The authorities value the technical support of the World Bank's policy-based financing. This support is embedded in the proposed DPF-DDO design and preparation, and supervision. With a Presidential

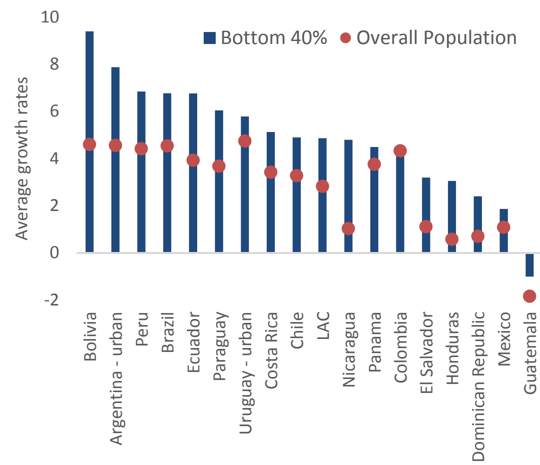
election in mid-2016[1], this instrument also signals an ongoing commitment to policy reforms. That is, by focusing on policy changes with long-term impact, which are also anchored in the widely backed medium-term reform programs of the country that go well beyond 2016, this operation supports policy and implementation continuity beyond the financing option for the incoming administration.

Figure 1. Growth has been pro poor
(poverty reduction in percent)



Source: World Bank staff calculations based on data from the National Institute of Statistics and Information, Economic Commission for Latin America & the Caribbean.

Figure 2. Growth has been broadly shared
(average annual per capita income growth)



Source: World Bank staff calculations based on SEDLAC and WDI. *Note*: From 2004-13 for Peru.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

8. **Peru's growth over the past decade was one of the fastest in the Latin America and Caribbean region (LAC), but its pace has recently slowed.** Between 2004 and 2013, GDP grew at an average annual rate of 6.2 percent on the back of prudent macroeconomic policies, structural reforms, large foreign direct investments, and a favorable external environment. Growth slowed in 2014 to 2.4 percent—still faster than the average for the LAC region (which advanced only 0.8 percent). Public investment in real terms contracted by 2.0 percent in 2014; the main driver was slow execution rates of subnational governments despite an increase in central government's public investment due to construction and improvement of roads across the country. A weak external environment with declining commodity prices and the economic slowdown of key trading partners (especially China) led to a contraction of private investments and exports. At the same time, and like in other mineral exporting countries, the economy suffered from the postponement of large mining projects. Performance of the fishing sector was affected by weather related events.

9. **The current account deficit narrowed slightly in 2014, and remained chiefly financed by foreign direct investment (FDI)**. The current account deficit improved marginally from 4.2 percent of GDP to 4.0 percent in 2014 (Table 1), owing to a decline in the outflow of foreign firms'

[1] The first round of the Presidential election is planned for April 2016 and the second round, if needed, would take place in June 2016.

profits which outweighed the impact of the fall in commodity prices. Copper and gold are the two most important commodities in Peru and accounted for about 35 percent of total exports in 2014. Copper prices have been declining since 2011. But overall commodity exports represent only about 13 percent of GDP. Net FDI reached 3.8 percent of GDP, down from 4.5 percent of GDP in 2013, mainly due to a slowdown in the extractive industry investments. The terms of trade deterioration of 2013-14 is expected to continue in 2015. International reserves fell slightly from US$65.7 to US$62.3 billion between 2013 and 2014. But they remain at comfortable levels, accounting for 32 percent of GDP or 20 months of imports by the end of December 2015.

10. **Inflation expectations remain well-anchored.** Average inflation, measured by the consumer price index, amounted to 3.2 percent in 2014, only marginally above the upper level of the target band. In an effort to mitigate the slowdown, the Peruvian Central Bank (*Banco Central de Reserva del Perú*, BCRP) reduced its policy rate from 4 to 3.5 percent in 2014 and further to 3.25 percent in January 2015. It also eased reserve requirements to free up 4.9 billion of *Soles*. The reduction in the policy rate has recently been reversed—the BCRP increased the policy rate to 3.5 percent in September 2015 and to 4 percent in January 2016 to temper inflationary expectations. The BCRP also allowed the currency to depreciate, especially during the last months of 2014. The *Soles* depreciated by 6.3 percent in 2014 and by 14.5 percent in 2015, after lifting temporary interventions to smooth out the rate of depreciation. Additional de-dollarization measures were initiated in the last quarter of 2014, particularly higher reserve requirements for foreign currency deposits and Repo operations in local currency to support credit growth in *Soles*. The dollarization ratio of private sector credit fell from 38 to 31 percent between November 2014 and November 2015. Growth of private sector credit slowed to an annualized rate of 10.4 percent in November 2015, compared to 10.6 percent in November 2014. Furthermore, between November 2014 and 2015, credit in local currency surged by 29.2 percent while credit in foreign currency shrank by 19.4 percent, the lowest rate recorded so far.

11. **The banking sector remains profitable, well-capitalized, and resilient to external shocks.** The ratio of regulatory capital to risk-weighted assets remained stable at 14.3 percent as of November 2015. The banking system's return on equity remained among the highest in the region and reached 22 percent in November 2015. The non-performing loans (NPLs) ratio for the banking sector is low, but increased slightly from 2.5 to 2.6 percent between November 2014 and 2015. The ratio of provisions to overdue loans remains high at 160 percent in November 2015. For the financial system as a whole—including banks, municipal credit unions, and other lending institutions (excluding cooperatives)—the NPLs ratio slightly increased from 2.9 percent in November 2014 to 3.0 percent in November 2015.

12. **The overall fiscal balance turned from a surplus in 2013 into a small deficit in 2014.** The overall balance of the general government fell from 0.7 percent of GDP in 2013 to -0.3 percent of GDP in 2014 as a result of the economic slowdown and a moderate fiscal impulse that started in late 2014. The fiscal impulse for 2014/15 consists of a gradual reduction in income tax rates and higher current expenditures (mainly salaries). The fiscal cost of these measures is estimated at 0.25 percent of GDP in 2014 and 1.6 percent of GDP in 2015. In 2015, the general government deficit is expected to increase primarily because of the continued gradual reduction in income tax rates while overall spending is expected to stay at a comparable level, as percent of GDP, to 2014. The expected fiscal deficit for the general government in 2015 is projected to be around 2.4 percent of GDP.

13. **Public debt levels remain low owing to sound macroeconomic policy management in recent years.** In 2014, Peru's total public debt stood at US$39 billion, or 20.1 percent of GDP, down from 42 percent in December 2005 (Figure 3), one of the lowest in Latin America (Figure 4). The reduction in public debt followed a decade of high real GDP growth accompanied by overall fiscal surpluses. There has also been a significant change in the debt structure: domestic currency denominated debt now represents more than half of the total public debt while it was close to eight percent a decade earlier. The average maturity of debt also increased from 8 to 12 years between 2001 and 2014. Markets have recognized Peru's prudent macroeconomic policies by continuously upgrading its sovereign debt ratings. Moody's upgraded Peru's sovereign rating in July 2014 from Baa2 to A3, with a stable outlook, reflecting, in addition to a sound macroeconomic management, a good record in implementing structural reforms in pension systems, health care, education, and public private partnerships for infrastructure investments.

Figure 3. Public debt
(US$ billion, percent of GDP)

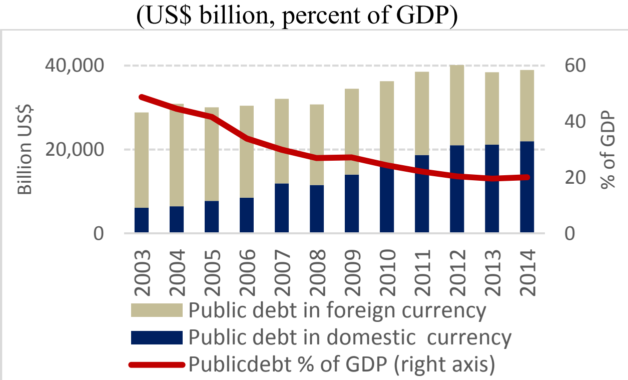
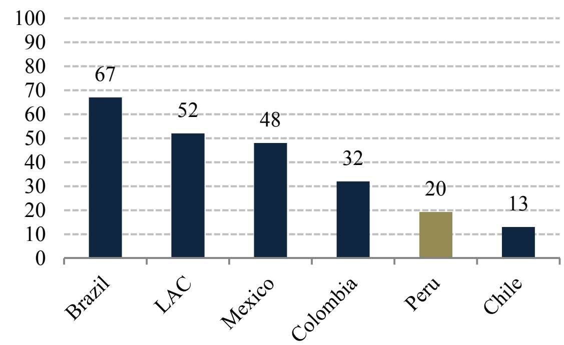


Figure 4. Public debt in LAC in 2014
(Percent of GDP)



Source: MEF, BCRP and World Bank staff estimates.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

14. **Economic growth is projected to be slightly above its 2014 level and to recover gradually in 2016-17**. The recovery path is based on the assumption of a non-temporary price adjustment on the country's main exports and as a consequence a reduced growth potential over the projection period compared to that of the last decade.[2] Investment continues to be low in 2015 due to sluggish private investments. Total investment is projected to rebound somewhat in 2016 on the back of an increase in public investments and a stabilization of private investment, including the start of several large public-private partnership infrastructure projects. Over the past few years, the government has signed on 10 new projects, equivalent to US$14.3 billion. The large public investments will support growth in 2016 despite stagnating exports and a slowdown of public consumption. Exports are projected to remain low in 2016 but would start to rebound in 2017 when the fishery sector is expected to recover and several mining projects are expected to have entered into production (e.g., Antamina, Toromocho, Inmaculada, Invicta, Constancia, Shahuindo, Las Bambas, and Cerro Verde). But the positive outlook is subject to downside risks due to global export demand, financial conditions, and uncertainty regarding the execution rates of the large infrastructure investment projects.

[2] Early 2015 World Bank and IMF estimates suggest that potential output growth amounts to 4.5 percent of GDP.

Table 1. Peru: Key Macroeconomic Indicators, 2011-2017

	2011	2012	2013	2014	2015	2016	2017
Real sector	Annual percentage change, unless otherwise indicated						
GDP (nominal--local currency)	469,854	508,326	545,554	575,250	593,901	628,066	666,637
Real GDP	6.5	6.0	5.8	2.4	2.7	3.3	4.5
Per Capita GDP (In US$ Atlas Method)	5,378	5,634	5,891	5,962	6,052	6,182	6,390
Contributions:							
Consumption	4.2	4.6	4.0	3.6	2.9	2.3	2.5
Investment	3.3	2.8	3.0	-1.4	-0.5	1.4	1.8
Net exports	-1.1	-1.4	-1.2	0.2	0.2	-0.4	0.1
Imports	11.6	11.3	2.9	-1.5	-1.8	2.7	3.1
Exports	6.9	5.8	-1.3	-1.0	-0.9	1.0	3.9
Unemployment rate (ILO definition)	3.9	3.6	3.9				
GDP deflator	5.2	2.1	1.5	3.0	0.6	2.4	1.6
CPI (average)	3.4	3.7	2.8	3.2	3.8	3.5	2.8
Fiscal Accounts	Percent of GDP, unless otherwise indicated						
Expenditures	19.8	20.3	21.6	22.6	22.6	23.3	22.5
Revenues	21.8	22.4	22.3	22.3	20.2	20.3	20.0
General Government Balance 1/	2.0	2.1	0.7	-0.3	-2.4	-3.0	-2.5
Selected Monetary Accounts	Annual percentage change, unless otherwise indicated						
Base Money	15.1	12.2	14.8	8.8			
Credit to non-government	21.6	13.3	18.4	13.5			
Interest (key policy interest rate)	4.25	4.25	4	3.5	3.5		
Balance of Payments	Percent of GDP, unless otherwise indicated						
Current Account Balance	-1.9	-2.7	-4.2	-4.0	-4.3	-4.2	-3.3
Imports	25.6	25.2	24.7	23.9	20.5	20.6	20.3
Exports	29.7	27.2	24.1	22.4	18.2	17.4	17.0
Foreign Direct Investment	4.4	6.1	4.5	3.8	4.1	3.9	3.7
Gross Reserves (in US$, eop)	48,859	64,043	65,711	62,353			
In months of next years' imports	15.8	18.7	18.7	18.3			
As % of short-term external debt	7.7	7.2	10.2	8.9			
External Debt	28.2	30.8	30.1	31.8			
Terms of Trade (percentage change)	6.9	-2.0	-5.7	-4.6	-5.8	-3.9	-1.8
Exchange Rate (average)	2.8	2.6	2.7	2.8			
Other memo items	Percent of GDP, unless otherwise indicated						
GDP nominal (in million US$)	170,564	192,680	201,849	202,597	185,594	184,725	196,070
Non-Financial Public Sector (NFPS) balance	2.0	2.3	0.9	-0.3	-2.7	-3.0	-2.6
Gross Public Debt	22.1	20.4	19.6	20.1	22.9	24.8	25.5
Net Public Debt	8.6	5.0	3.7	4.0	3.0		
Gross NFPS financing needs (in million US$)	-1,993	-2,788	1,288	3,895	7,750	7,396	7,624
External	1,024	967	967	382	2,718	5,743	2,339
Internal	-3,017	-3,755	321	3,513	5,032	1,653	5,285

Source: Government of Peru data and World Bank staff calculations and projections.

Table 2. Peru: Key Fiscal Indicators, 2011-2015

(Percent of GDP)

	2011	2012	2013	2014	2015	2016	2017
Overall Balance	2.0	2.1	0.7	-0.3	-2.4	-3.0	-2.5
Primary balance	3.2	3.1	1.8	0.8	-1.4	-1.8	-1.3
Total Revenues (and grants)	21.8	22.4	22.3	22.3	20.2	20.3	20.0
Tax revenues	16.4	16.9	16.8	17.0	15.2	15.3	14.9
Taxes on goods and services	7.5	7.5	7.7	7.8	7.3	7.6	7.5
Direct Taxes	7.2	7.3	6.7	7.0	5.8	5.6	5.4
Taxes on international trade	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other taxes	1.5	1.8	2.1	1.9	1.8	1.8	1.8
Non-tax revenues	3.4	3.4	3.2	3.1	2.8	3.0	3.0
Social insurance contributions	1.9	2.0	2.1	2.2	1.9	1.9	2.0
Capital revenues	0.1	0.1	0.2	0.1	0.2	0.1	0.1
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditures	19.8	20.3	21.6	22.6	22.6	23.3	22.5
Current expenditures	14.6	14.7	15.5	16.7	16.8	17.1	16.4
Wages and compensation	4.9	5.0	5.4	5.9	6.2	6.4	6.3
Goods and services	5.1	5.6	5.8	6.1	6.2	6.3	5.9
Interest payments	1.2	1.1	1.1	1.1	1.0	1.2	1.2
Current transfers	3.5	3.0	3.2	3.6	3.4	3.2	2.9
Capital expenditures	5.2	5.7	6.1	6.0	5.8	6.2	6.1
Capital investments	4.9	5.4	5.6	5.5	5.3	5.8	5.7
Capital transfers	0.3	0.3	0.5	0.5	0.5	0.5	0.4
Non-financial Public Sector financing requirements	-1.3	-1.4	0.7	1.8	4.0	3.8	3.7
Amortization	0.7	0.9	1.6	1.5	1.4	0.8	1.1
Non-Financial Public Sector balance 1/	2.0	2.3	0.9	-0.3	-2.7	-3.0	-2.6

Source: Multiannual Macroeconomic Framework for 2016-18 from MEF and Government of Peru data.
1/ The general government balance includes the central and local governments' balances but excludes public enterprises. The Non-Financial Public Sector balance includes the general government balance and the balance of non-financial public enterprises.

Table 3. Peru: Balance of Payments Financing Requirements and Sources, 2011-2017

	2013	2014	2015	2016	2017
BOP financing requirements and Sources					
Financing requirements (US$ million)	-16,369	-15,296	-13,842	-14,119	-14,437
Current account deficit	-8,474	-8,031	-8,025	-7,834	-6,440
Long term debt amortization (excl. IMF)	-5,731	-5,287	-6,020	-6,285	-7,997
Other short term capital outflows	-2,164	-1,978	203	0	0
Financing Sources (US$ million)	16,369	15,290	13,842	14,119	14,437
FDI and portfolio investments (net)	13,883	6,005	3,805	4,522	5,141
Capital grants	0	0	0	0	0
Long term debt disbursements (excl. IMF)	5,388	7,103	8,517	9,202	9,273
Change in reserves	-2,907	2,171	1,508	384	11
IMF credit (net)	0	0	0	0	0

Source: Government of Peru and Central Bank data, and Bank staff calculations and projections.

15. **The current account deficit is projected to hover at around 4-4.5 percent of GDP in 2015 and 2016 and to narrow thereafter.** This deficit is projected to be financed by FDI inflows and government's long term borrowing. The decline in exports due to falling commodity prices in 2015 is partly counterbalanced by the depreciation of the currency. Moreover, prices of imports also fell netting out the decline in exports—import prices fell by 9 percent relative to a 13 percent price decline of exports. The current account deficit is projected to be around 4.3 percent of GDP in 2015. It is projected to remain at that level (4.2 percent of GDP) in 2016 as global demand for commodities is expected to remain weak and the climatic phenomenon "El Niño" is expected to continue to reduce the exports of the fishery sector in 2016. But it would recover starting in 2017 on the back of a gradual export recovery.

16. **Inflation is expected to remain well-anchored.** Despite edging slightly above the upper target band in 2014 (3.2 percent), inflation projections between 2015 and 2018 are between 3 and 4 percent. The *Sol's* depreciation may affect inflation for tradable goods in 2015, but the effect will be compensated for by decreasing commodity prices. The inflation rate is expected to increase somewhat to 3.8 percent in 2015, slightly above the higher level of the band fixed by the Central Bank, and then start to decline again. Monetary policies are expected to continue to support price stability.

17. **The general government deficit is expected to peak at 3.0 percent of GDP in 2016 and decline thereafter.** The large fiscal buffers accumulated over the past decade have allowed for a moderate and temporary fiscal impulse smoothing the economic transition to the less favorable external environment. The fiscal impulse started in late 2014 and is projected to continue into 2016. The projected increase in the fiscal deficit by 0.6 percentage points of GDP in 2016 (compared to 2015) is expected to be driven primarily by public investments (and a marginal carry over effect of the wage increase of late 2014). But a gradual fiscal policy tightening is expected to start in 2017. The fiscal deficit is projected to decline to 2.5 percent of GDP in 2017, primarily driven by expenditure retrenchment. While the government is projected to maintain the level of capital expenditures in 2017, it will reduce the share of current expenditures in GDP (Table 2). The deficit is expected to gradually decline to 1 percent of GDP by 2020 in structural terms. Fiscal policies are expected to uphold the Fiscal Responsibility and Transparency Law[3] which limits government debt to 30 percent of GDP. The government is expected to continue to implement a prudent medium term fiscal framework, including strengthening the control over subnational expenditures. Peru's Medium-Term Fiscal Framework projects gross financing needs to be US$22 billion from 2016-18, three-fourths of which are planned to be funded externally.

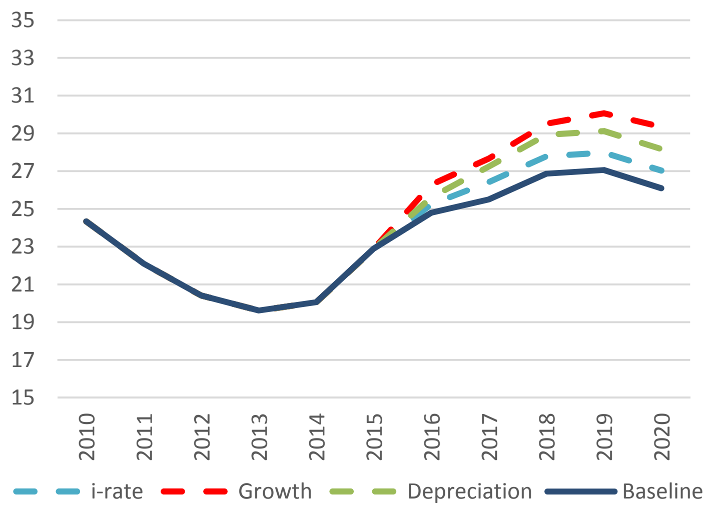
18. **Peru's low public debt levels are resilient to adverse economic shocks.** In the baseline scenario (Table 1),[4] total public debt is expected to increase until 2019 as a result of the fiscal deficits, and to start declining thereafter (Figure 5). The debt analysis indicates resilience to different economic shock scenarios. A real interest rates increase of 2 percentage points for two consecutive years would raise the debt to-GDP ratio—it would peak at 28 percent in 2019 and start declining thereafter (Figure 5). The debt-to-GDP ratio is projected to rise to 28.2 percent in 2020

[3] The guidance also includes the following elements: (1) the non-financial level of spending must be consistent with the structural balance target; and (2) the growth rate of wage and pensions spending cannot exceed the nominal growth rate of potential GDP.

[4] The real interest rate in the baseline scenario is the average nominal interest rate on public debt minus the projected inflation rate (see Table 1).

in a scenario of a real depreciation of 30 percent for two consecutive years and to 29.4 percent in a scenario of a one-time growth shock (reducing economic growth to 0 percent in 2016).

Figure 5. Debt Sustainability Analysis
(Debt as percentage of GDP under different scenarios)



Source: MEF, BCRP, and World Bank staff calculations.

19. **The risks to the economic outlook stem from external conditions and domestic factors and other exogenous shocks.** Growth rates are vulnerable to further shocks in mineral prices, a further slowdown in external demand for Peruvian exports, and unexpected global volatility and higher borrowing costs transmitted through financial channels. Volatility in mining prices represent an important risk for the overall economic outlook. Copper and gold are the two most important commodities in Peru and accounted for about 35 percent of total exports in 2014. But these external risks have a limited potential fiscal impact. Revenues from commodities account for a relatively small portion of central government budget—11.7 percent of total revenues or 2.3 percent of GDP in 2014. A further 10 percent decline in copper prices is estimated to worsen the fiscal balance, ceteris paribus, by 0.3 percentage points of GDP. On the other hand, any further decline in oil prices is beneficial for growth and the fiscal accounts since Peru is a net oil importer. Domestic sources of risk include the pace of implementation of the public investment program and a possible deterioration of investors' confidence associated with the elections in mid-2016. Additionally, the climatic phenomenon El Niño may have a strong adverse impact over the next 12 months hampering the exports of the agriculture and fisheries sectors in 2016.

20. **Ample macroeconomic buffers, access to international financial markets, and a strong track record in macroeconomic management place Peru in a strong position to mitigate the potential impact of adverse economic shocks.** Peru has full access to international capital markets. The net public debt is about 3 percent of GDP in June 2015—one of the lowest in the world. Furthermore, the Fiscal Stabilization Fund provides an additional buffer in case of continued negative external shocks, although the resources in this Fund can only be used for gross financing needs if specific criteria are met. The Fiscal Stabilization Fund's resources increased from US$100 million in December 2000 to US$9.1 billion in December 2014 (4.5 percent of GDP). The government's sound macroeconomic management also provides a buffer against negative external shocks in the short term. The government's strategic debt management approach has

resulted in low levels of public debt, high average maturity rates (12 years), and a low exposure to foreign currency risks. An effective asset management policy has resulted in high international reserves and ample fiscal buffers. Prudential regulations in the financial sector have further reinforced macroeconomic policies. Peru's macroeconomic policy framework is sustainable over the medium term and hence adequate for the proposed operation.

2.3 IMF RELATIONS

21. **The Government maintains an ongoing dialogue with the International Monetary Fund (IMF) on macroeconomic policy in Peru**. On May 20, 2015, the IMF's Executive Board concluded the Article IV consultation and highlighted that, in spite of downside risks on the horizon, the existence of ample buffers places Peru in a comfortable position to respond to future shocks. The IMF Assessment Letter from December 7, 2015, is presented in Annex 3.

3 THE GOVERNMENT'S PROGRAM

22. **The Government's long term development plan is captured in the Bicentennial Plan: Peru to 2021.**[5] The Plan was published in March 2011 and presents long term objectives along six strategic axes: (i) citizen's rights and dignity; (ii) opportunities and access to basic services; (iii) state and governance; (iv) economic growth, competitiveness, and employment; (v) regional development and infrastructure; and (vi) natural resources and environment. Both this operation and the parallel and complementary DPF-DDO support key elements of the Bicentennial Plan. This operation supports the third and fifth axes:

- **State and Governability**: Under this axis, the Government aims at supporting a democratic and decentralized state that is efficient, effective, and accountable. Improving the policy and institutional articulation between the three existing levels of government and the key functions of the state is high in this agenda. Broad reforms to the public administration, at the central and subnational levels, are highlighted, such as: (i) improving the management capacity of subnational governments, (ii) strengthening the public career path of the national and subnational civil service, and (iii) supporting citizen participation through transparency of public information and accountability.

- **Regional Development and Infrastructure**: Under this axis, which is the mirror area of the axis of State and Governability but looking at private sector development at regional levels, the Government aims at generating decentralized development of productive economic activities including social services. The aim is to achieve a balanced territorial development via enhancing the competitiveness of regions. A key instrument to achieve the objectives under this axis is the promotion of PPPs in support of decentralized investment in productive and basic services infrastructure (also highlighted under the axis of Opportunities and Access to Services).

23. **The recently approved Government's rolling three-year Multiannual Macroeconomic Framework (Marco Macroeconómico Multianual, MMM) for 2016-18 also highlights the need to enhancing fiscal management**. In addition to presenting the basic parameters of the 2016

[5] http://www.mef.gob.pe/contenidos/acerc_mins/doc_gestion/PlanBicentenarioversionfinal.pdf

budget, the 2016-18 MMM highlights the tools that the Government is deploying to improve the management of SNGs and PPP projects. The 2016-18 MMM also briefly summarizes measures to help build the public financial management capacity of the recently elected subnational authorities, and the continued support to civil service management and compensation reforms initiated in 2012. The MMM also includes measures being deployed to improve the management of the risks arising from PPPs. The actions proposed in the DPF-DDO are well-aligned and cover both long-term strategic and medium-term objectives in the Bicentennial Plan and the MMM.

4 THE PROPOSED OPERATION

4.1 LINKS TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

24. **The proposed operation is consistent with the Bicentennial Plan and the 2016-18 MMM.** As highlighted in both the Plan and MMM, Peru has come a long way in improving its public expenditure management institutions and in particular its public investment management framework at the national level. However, the rapid decentralization process in Peru and the rapid expansion of PPPs programs in the past decade have together posed new challenges to the existing framework. SNGs are now empowered to develop, evaluate, approve and implement their own investment projects, but face technical and incentive difficulties to follow the rules and, often, also face issues absorbing available resources. The framework to manage PPP projects was appropriate but an additional step was needed to fully integrate them into the public investment system and to deploy a proper decision making process for the assumed fiscal risks. This operation supports efforts in these directions. In the future, the GoP plans to broaden and deepen these reforms throughout the three year envisaged span of this operation, which allows the World Bank to support and reinforce this process. Joint multi-year technical and analytical work with the World Bank will continue in these two areas. In particular, both the policy notes and the Systematic Country Diagnostic will feature topics relevant to the operation and the Authorities have recently requested a Public Expenditure Review that could also be used as vehicle for further dialogue and follow up.

Pillar 1: Improving management and reporting of public expenditures in SNGs

25. **A decentralization process has been under implementation over the last 10-15 years**. Aimed at improving public service delivery and promoting regional development, Peru started a fiscal decentralization process after a constitutional reform in 2001. A series of rapid measures to accelerate the process were taken in 2006, including the rapid devolution of responsibility over key investments and also key health and education functions. In particular, about 93 percent of the sectoral functions and the associated financial resources were transferred to the 26 Regional Governments (RGs) and more than 1,800 Local Governments (LGs), irrespective of their readiness to assume the functions.

26. **The bulk of resources received by the SNGs comes from their share in revenues from extractive industries**. The decentralization process also introduced a sharing scheme for the extractive industry's fiscal revenue, including licensing, royalties and, most importantly, a 50 percent share of the corporate income tax paid by extractive industries. As a result of this scheme and the boom in commodity prices, the income of SNGs increased by 20-fold between 2001 and 2012 in nominal local currency terms. The recent fall in the price of commodities has reduced the relative size of SNGs' revenues in 2014 to about 12 times those in 2001, which is still significant.

As a result of the increase in revenues and responsibilities, SNGs accounted for about 60 percent of total public investment spending and 38 percent of total spending in the non-financial public sector in 2014.

27. **The intergovernmental fiscal relations embedded in the ongoing decentralization process pose short- and medium-term challenges.** In the short-term, the challenge is to continue enhancing the absorption capacity and service delivery of SNGs. This requires first and foremost an incentive and reporting framework that fosters both fiscal responsibility and the efficient management of available resources. But this also requires addressing a number of institutional constraints for SNGs to improve service delivery (in areas such as human and financial management, oversight, and accountability). Over the medium-term, however, the fiscal decentralization process would need to be completed and fine-tuned; something that the authorities believe is best to leave for the new administration.[6] In particular, there is still a need for stronger coordination between the three existing levels of government (municipal, regional and national), including greater clarity of spending responsibilities. On the revenue side, the medium-term challenges include improving the own revenue base (e.g., property tax) and addressing the acute horizontal disparities in fiscal capacity across subnational entities that have been exacerbated by the sharing of canons and royalties derived from the exploitation of natural resources.

28. **While work is ongoing to design ways to improve fiscal decentralization and SNGs' capacity in Peru, the authorities have taken a number of measures to ensure that SNGs' fiscal management is responsible and to strengthen subnational management capacity**. While SNGs' finances are not particularly out of line in the aggregate, it is important that they stay that way with the forthcoming expected reduction in their revenue. In this context, the authorities introduced in early 2000 a framework for subnational fiscal rules and transparency through the Fiscal Responsibility and Transparency Law (Law 27245), which has been enhanced and improved as recently as in 2014. The authorities have also been working on enhancing the conditions for subnational governments to professionalize their staff and, jointly with the comptroller's office, the framework to enhance the mechanisms to deal with mismanagement and corruption cases[7].

29. **This pillar supports reforms aimed at improving the management and reporting of public expenditures in SNGs.** The strategy of the Government is two-fold: (1) promoting fiscal responsibility among all SNGs; and (2) providing tools for improving the administration of subnational governments and, over time, their efficiency and transparency. The first three Prior Actions describe improvements made in the reporting and fiscal responsibility framework for the public sector as a whole and for subnational governments in particular (rules, accountability, monitoring and transparency), and the technical support put in place to facilitate SNGs' compliance. The fourth Prior Action aims at enhancing SNGs implementation capacity by increasing professional management capacity. The Government has been continuously working on the adoption and implementation of these reforms over the past eighteen months. Because

[6] The Bank is preparing a background note on fiscal decentralization challenges and options in the context of the forthcoming Policy Notes for the new administration.

[7] For example, under Article 53 of Law 28696, in cases where there is public knowledge of situations that pose a risk to adequate use of public funds, the Controller's Office, the Ministry of Interior, or the Ministry of Justice can request that MEF temporarily freeze the SNGs' accounts to safeguard affected public funds and track financial evidence. In addition, Law 30201 recently issued, provides precautionary measures to ensure public service continuity and adequate use of public resources for SNGs whose accounts have been frozen by authorizing MEF to execute selected types of expenses.

continued attention to implementation is critical to the achievement of the reforms objectives, the deferred nature of the operation allows the Government and the Bank to jointly sustain their momentum.

Prior Action 1: *The Government has issued regulations to strengthen the management and reporting framework for fiscal responsibility in SNGs including the procedures for determining the fiscal targets-setting methodology, reporting and disclosure requirements and sanctions for non-compliance with the fiscal rules established by Law 30099 and its amendments.*

30. ***Context*** **– SNGs' success in setting and monitoring spending and debt targets has been limited.** The framework for subnational fiscal rules and transparency was established as early as 2000 through the Fiscal Responsibility and Transparency Law (Law 27245) and associated bylaws. However, since then, most SNGs experienced difficulties in complying with the fiscal rules, primarily due to the complexity of the prior fiscal responsibility framework and the extensive number of fiscal rules (In 2012, only one third of the RGs and a negligible share of the LGs were in compliance). This, however, did not result in fiscal problems nationally due to the significant increase in public revenues during that period. In 2009, partly in response to the impact of the global financial crisis, there were renewed efforts to ensure compliance by simplifying and improving coherence between fiscal rules on spending and debt limits. However, SNG compliance continued to remain low.

31. **The 2013 Fiscal Responsibility and Transparency Law (Law 30099) further modernized the principles and institutions to promote fiscal responsibility among SNGs and streamlined the number of subnational fiscal rules from seven to two**. The first rule aims at smoothing the volatility of SNGs' revenue by limiting the annual growth in total (non-financial) public expenditure to the average of revenue growth of the last four years. The second restrains the overall fiscal framework by capping the overall stock of debt that a given SNG can take (now defined broadly to include accounts payable) to less than their own revenue (measured as an average over the last four years). Law 30099 also empowers the executive to regulate the full management and reporting framework associated with these two rules.

32. ***Reforms*** **– The Government has issued bylaws which spell out the key implementation details for Law 30099.** DS 104-2014-EF of May 11, 2014 defines, among others, the types of revenues and debt to be included in calculation of the fiscal rules, and the procedural details for the application of corrective measures in cases of repeated non-compliance with fiscal rules. The definition of debt, for instance, includes debt towards other public institutions (e.g., social insurance contributions to both the state and private pension funds, the health fund and other accounts payables). It also mandated that the Ministry of Economy and Finance (MEF) develop a web application through which SNGs' multi-year fiscal management reports (MYFMR) would be prepared. The tool that has been prepared guides SNGs through the preparation process, including a module for projecting fiscal rules and convergence targets.

33. **Ministerial Resolution 338-2014-EF/15 of October 16, 2014 provides the details required to effectively roll-out SNGs' reporting obligations**. Law 30099 requires SNGs to submit MYFMRs with a description of their financial situation and establish targets for converging with fiscal rules (in cases of non-compliance). But these are more than simple reports, as they provide the information basis for MEF to plan future transfers, which represent the bulk of SNGs'

revenue (i.e., including the revenue-sharing arrangement for mineral revenues), and guide SNGs through the analysis of potential ways to bring their finances into alignment with the rules. The reports are designed to be a very powerful tool both for building subnational fiscal management capacity and for making subnational governments accountable in the context of a "repeated-game" under which the MEF builds an information base on a regular basis, and uses it to check consistency. Details on the required content and MEF's procedures and timeline for verifying the information prior to the reports' public release are spelled out in DS 104-2014-EF, and Ministerial Resolution 338-2014-EF/15 sets forward the complementary selection criteria for the gradual rolling out of the reporting requirement to local governments between 2015 and 2020, proceeding from the largest (and presumably higher capacity) governments to the smallest[8] – which will likely require more intensive capacity building and support to meet reporting and fiscal rule compliance requirements.

34. **For those SNGs that are not in compliance with the fiscal rules, MYFMR reporting requirements entail the establishment of convergence plans with annual targets in order to bring them into alignment.** Ministerial Resolution 432-2014-EF/15 (December 29, 2014) approves the methodology for the calculation of these convergence targets over the following years (with the timeline based upon the degree to which the SNG is out of line with the rule). Those with only small deviations from the rule, which are currently the bulk of the non-compliant SNGs and are defined as those with debt/revenue ratios no greater than 105 percent, or those with expenditure limits greater than or equal to 92.5 percent of their actual expenditures the prior fiscal year, are expected to comply within the current year, while those with larger deviations have additional time.

35. **If SNGs remain non-compliant with the fiscal rules, convergence targets and reporting requirements, specific sanctions can be imposed** - the implementation procedures of which are described in DS 104-2014-EF/15. As previously established, such SNGs are not allowed to contract or issue debt of any kind, thus controlling potential deterioration of their financial stances. Additionally, non-compliant SNGs do not have access to central government co-financing programs or additional transfers from special allocations (including those for stimulus purposes).

36. **The new procedures for compliance have allowed MEF to monitor consistently and systematically the fiscal performance of SNGs**. As illustrated in Table 4 below, which summarizes the first compliance report prepared by MEF in May 2015, the fiscal outcome of the RGs and LGs are either in balance or slightly negative, and the stocks of debt are around 2 percent of GDP (half the level of their revenues which means that, at least on average, the rule on debt being less than SNGs average revenue is met with significant margins). Thus, the SNGs fiscal situation is not likely to threaten the aggregate fiscal management and stability.

[8] From 2015 onwards, all regional governments are required to submit MYFMRs. In 2015, local governments covering fifty percent of local governments' average annual income over the last four years – specifically those in the provinces where department capitals are located, as well as the local governments with the largest average annual incomes over the last four years – are required to report. Each following year, local governments representing an additional ten percent of such income (ordered in terms of size), are required to submit reports, until the entire universe of local governments is covered in 2020.

Table 4. Peru –Summary of SNGs Fiscal Operations and Debt, 2013-14
(Percent of GDP)

	Regional Governments		Local Governments	
	2013	**2014**	**2013**	**2014**
Total revenues	**4.0**	**4.2**	**4.1**	**4.0**
Expenditures, *of which*	**4.2**	**4.2**	**4.5**	**4.3**
- *Current*	2.8	3.0	1.8	1.8
- *Capital*	1.4	1.1	2.6	2.5
- *Interest*	0.0	0.0	0.0	0.0
Overal balance	-0.2	0.0	-0.3	-0.3
Debt	**1.9**	**2.2**	**1.9**	**1.7**

Source: MEF - Annual Report on SNGs Fiscal Rules Compliance (May, 2015)
Note: Debt stocks includes that with public entities (social security, tax administration), debt with private pension funds. Debt also includes short and medium and long-term

37. ***Results*** - Through the implementation of the fiscal responsibility framework at the subnational level, these measures are expected to strengthen the management of fiscal risks by improving SNG compliance with either the expenditure and debt limit rules or their convergence targets, which is expected to increase from 50 percent and 59 percent, in RGs and in LGs, respectively in 2014, to 65 and 70 percent in RGs and LGs in 2017, respectively. As shown in Table 5, below, the 13 RGs that complied with both the debt and spending rules in 2014 represent half of the number of regions, but 66.3 percent of their total revenue. At the LGs level, the 1,088 municipalities that fulfilled the two rules in 2014 represent 59 percent of the total number, but 66.4 percent of their total revenue. Moreover, during 2015 19 RGs and 225 LGs have already presented their convergence targets towards compliance with the debt and expenditure rules. Looking ahead, and given SNGs' past low levels of compliance, it will be important to continue to support governments in their progress towards their convergence targets while also expanding the universe of SNGs covered by the MYFMR reporting requirements.

Table 5. Peru – Compliance of SNGs with Fiscal Rules, 2014

	Regional Governments				Local Governments			
	No.	% of total No.	% of total revenues [1/]	% of total population	No.	% total No.	% of total revenues [1/]	% of total population
Debt fiscal rule	21	80.8	85.8	88.4	1,727	93.6	87.8	75.8
Spending fiscal rule	15	57.7	70.0	78.3	1,162	63.0	74.2	69
Both rules	13	50.0	66.3	76.2	1,088	59.0	66.4	53.5

Source: MEF - Annual Report on SNGs Fiscal Rules Compliance (May, 2015)
[1/] revenues are measured as the average of current revenues of the last 4 years.
Total revenues for local governments cover 1851 municipalities, of which 1 did not report fiscal compliance and 12 were exempted because they have been recently established..

Prior Action 2: *The Government has granted authority to the General Directorate of Macroeconomic Policy and Fiscal Decentralization (Dirección General de Política Macroeconómica y Decentralización Fiscal, DGPMACDF) within MEF, to monitor SNGs' fiscal and financial management performance according to Law 30099 and its amendments, and provide technical assistance to SNGs.*

38. ***Context*** **- There have been many reasons to explain SNGs' inability to comply with fiscal rules and reporting requirements in the past.** While misaligned or perverse incentives might have played an important role, lack of technical capacity to understand or implement the rules and reporting requirements was also important given the complexity of the previous fiscal

responsibility framework for SNGs. Efforts to provide support from the central government were not formally organized or commissioned to a specialized unit. Furthermore, broader accountability of SNGs to their constituencies and stakeholders (including think-tanks) was unfeasible since the annual reports on compliance with the rules prepared by MEF were not published.

39. ***Reforms*** **– As such, another key aspect of implementation of the subnational fiscal rules has been to create an institutional "home" within MEF for the associated subnational capacity building, implementation support, monitoring, and compliance mechanisms.** DS 117-2014-EF (May 23, 2014) approves MEF's Organizational and Functional Regulations. Article 112 of the regulations notes that DGPMACDF is the line entity of the MEF in charge of ensuring Peru's macroeconomic stability, taking into account the macroeconomic environment and fiscal rules. Among its responsibilities are the permanent monitoring of public finances – including the design and evaluation of subnational fiscal rules, and approving and supervising technical assistance to SNGs related to the elaboration and presentation of MYFMRs. Within the General Directorate, the Directorate of Fiscal Decentralization Policy and Subnational Finances has specific responsibilities related to the formulation and management of technical assistance, preparation of tools and other materials needed by SNGs to project their expenditure and debt limits, and analysis and validation of the submitted MYFMRs. Reflecting the exercise of these responsibilities, prior to the May 2015 deadline for the submission of MYFMRs by the 26 regional governments and 356 local governments, training workshops on the concepts and reports were programmed for these SNGs and additional workshops are planned for the coming years as the reporting requirement is rolled out to additional local governments as per the schedule in Ministerial Resolution 338-2014-EF/15. This dissemination and capacity building effort represents a critical evolution in the Government's strategy related to subnational fiscal rules, intended to address the underlying challenges that have complicated previous efforts and their future continuation is viewed as key to the successful implementation of the recent round of reforms.

40. ***Results*** - Implementation of the new institutional framework supporting the fiscal responsibility framework is expected to improve transparency and result in more effective monitoring of SNGs' compliance. Given that RGs are already in compliance with this obligation, this will be measured through the maintenance of RGs' full compliance and the percentage of LGs that submit the MYFMR in compliance with their gradual reporting obligation over the first three years of the operation, which implies that the current 80 percent of LGs representing 50 percent of total LGs' revenue will increase to 80 percent of LGs representing 70 percent of total revenue in 2017.

41. ***Prior Action 3:*** *The Government has issued regulations to implement the new Strengthening Fiscal Responsibility and Transparency Law (Law 30099), which created an independent Fiscal Council (Consejo Fiscal) whose functions are to: (i) evaluate ex-post compliance and changes of fiscal rules; (ii) evaluate the macro fiscal forecasts considered in the Multiyear Macroeconomic Framework; and (iii) evaluate short and medium term fiscal policy in terms of stance and sustainability.*

42. ***Context*** **– A key pillar of the 2013 Fiscal Responsibility and Transparency Law (Law 30099) was the creation of an independent technical body to issue public opinions on fiscal policy.** An independent fiscal institution, such as the fiscal council, is expected to increase fiscal performance and by now most middle- and high-income countries have one (including all members

of the European Union and most OECD members). According to a 2011 review commissioned by the OECD[9], the effectiveness of fiscal councils hinges on factors such as having full autonomy within the scope of their mandates, active and unfettered dissemination of their analysis, and their credibility. The review also suggests that delegating macroeconomic forecasting to an independent fiscal council (as done, for instance, in Chile) can reduce forecasting bias, and presents evidence that independent fiscal institutions can buttress a government's capacity to comply with a numerical rule.

43. **In the case of Peru, a fiscal council was needed to review fiscal policy formulation (macro/fiscal projections and budgeting) and implementation (compliance)**. In the context of the preparation of the annual budget, MEF establishes the assumptions and prepares the macroeconomic projections to be included in the MMM, which in turn determine the spending paths for both national and each subnational government level. The quality, credibility, and transparency of the revenue and overall fiscal projections is thus essential to enhance the quality of planning and budgeting practices at all levels of government. At the budget execution stage, currently, only MEF follows up upon compliance with the fiscal rules by itself and the SNGs—a function that carries a clear conflict of interest. While local think tanks, academics and often even the Central Bank of Peru issue independent views on the country's fiscal policies, none has established a rigorous methodology nor a periodicity for their reviews[10].

44. ***Reform* – On October 8, 2015, the GoP issued Supreme Decree 287-2015-EF, which establishes the independent Fiscal Council, the first time such arrangement has been introduced in Peru**. The key objective of the Fiscal Council is to provide technical, independent and non-binding opinions on: (i) the fulfillment of fiscal rules by the national government and SNGs; (ii) the macroeconomic and fiscal projections used for the formulation of the MMM; (iii) the short- and medium term evolution of public finances; and (iv) the methodology used to calculate fiscal accounts in structural terms as required by Law 30099. The Decree establishes the ability of the Council to access information from MEF and other entities in order to perform its functions. The reports prepared by the Council are to be published on the entity's page. The Council is to be composed of no fewer than three well-recognized independent experts, with no fewer than 10 years of proven experience in fiscal matters, including research, that are to be appointed by a separate Presidential Decree by end of the year (the list needed to be submitted within 30 days of enactment of the Supreme Decree 287-2015-MEF). The Council will also have a Technical Secretariat and a budget allocation to support its operations. Important future milestones identified by MEF in the implementation of the Fiscal Council include:

- In 2016: the full implementation of Fiscal Council and Technical Secretariat with its own budget and the issuance of an opinion on the 2017-2019 MMM in 2016; and

- In 2017: the Fiscal Council is expected to have issued an opinion on the new administration's Statement of Macro Fiscal Policy (Article 3, Law 30099).

45. ***Results*** - The Fiscal Council's oversight role, and its inputs and opinions on the calculation of fiscal projections and public finances are expected to provide a powerful incentive to MEF and

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[9] See Hagemann, Robert (2011); *How Can Fiscal Councils Strengthen Fiscal Performance?*; OECD Journal: Economic Studies; Vol 2011/1.

[10] The Peru Central Bank formally includes an opinion of the MMM macroeconomic framework.

SNGs to improve quality of the fiscal projections and thus strengthen their planning practices, better project revenues, and improve budget execution. This Prior Action is expected to reinforce the results of Prior Actions 1 and 2, and thus, is expected to be measured through the same indicators.

Prior Action 4: *The Government has issued regulations to implement the professionalization of managers in the civil service, creating a new category of public managers for both national and SNGs, the Public Directors (Directivos Públicos), subject to merit-based recruitment and regular performance evaluations.*

46. ***Context*** **- The low level of professionalization of staff and managers has had a particularly detrimental effect on both SNGs' public management, execution of spending, and compliance with fiscal rules.** The National Civil Service Authority (*Autoridad Nacional del Servicio Civil*, SERVIR) estimates that the recruitment or promotion in over 70 percent of key management positions in SNGs depend on political affiliation rather than professional ability or merit. Staff also move when administrations change and a new set of officials take over. As these positions include key functions such as planning, budget and investment management, administration and logistics, introducing merit-based recruitment and promotion criteria for them was an urgent reform.

47. **In 2008, the GoP created a group of professional middle managers (the Public Managers cadre) but it was a voluntary scheme, and was not institutionalized.** If SNGs requested such managers, SERVIR would deploy them for a period of three years. In SNGs where these managers were deployed, there was an average improvement of 90 percent in the execution of public investments. Unfortunately, these managers were not kept beyond the three years, largely because of the voluntary nature of the program and the SNGs' elections in 2013, which interrupted what seemed to be a successful initiative.

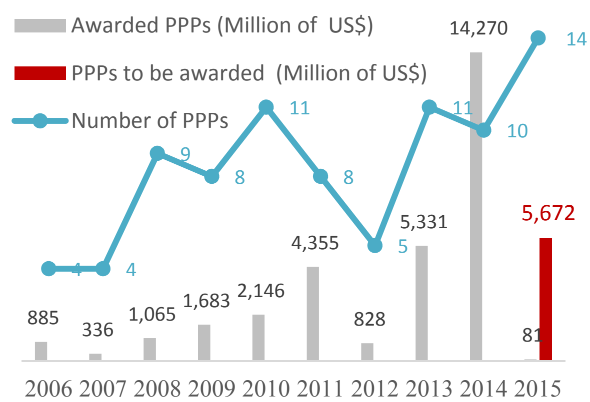
48. ***Reform*** **- The GoP approved a broad civil service reform program in 2013, and the relevant implementation decrees in 2014, which place restrictions on political appointments for managerial positions.** This reform, among several human resource management improvements, consolidated the previously fragmented public service system into a single regime and created a new group of civil servants in management positions whose terms in office are insulated from election cycles i.e. Public Directors. DS 040-2014-PCM of June 13, 2014 establishes the gradual but mandatory designation of Public Directors at the subnational level through the implementation of merit-based recruitment and performance-based evaluation procedures that are aimed at professionalizing the managerial segment in SNGs. In a first phase, the process will start with the recruitment in RGs and subsequently follow in LGs.

49. ***Results*** **-** The creation of the new Public Director posts is expected to strengthen management capacity at the subnational level, translating into improved public expenditure execution, and by complementing the capacity-building aspects of Prior Actions 1 and 2, improve compliance with fiscal rules. Effective implementation of this action will be measured by the increase in the number of managerial positions covered by professional public managers (*Directivos Públicos*) as a percentage of total managerial positions in RGs from 0 in 2014 to 800 *Directivos Públicos,* representing 77 percent of all managerial positions at the regional level in 2017.

Pillar 2: Improving the Government's legal and institutional framework for public-private partnerships (PPPs)

50. **PPPs in Peru have expanded rapidly.** Between 2006 and 2014, contracts for 70 PPP projects were signed amounting to more than US$30 billion (including indirect taxes) – of which 10 projects amounting to US$14 billion were signed in 2014 alone (Figure 6). These projects have focused predominantly on infrastructure, such as highways, bridges, rails (metro lines) and electricity. These PPPs were either self-sustaining (requiring minimum or no guarantees from the Government or the nonfinancial guarantees have a very small probability of less than 10 percent[11]) or co-financed proposals. The latter demand budget resources that can represent either tangible spending commitments (i.e., above the line, and commonly called "availability" payments in the literature) or explicit contingent liabilities that are formalized in a legal instrument (i.e., below the line, which in Peru are called certificates of recognition of the right to annual payments for works). While all PPPs contribute to closing the country's significant infrastructure gaps, their expansion has heightened fiscal risks. [12]

Figure 6: Peru – Trends in PPPs, 2006-15



Source: MEF and PROINVERSION.
Note: Data as of April15, 2015 and all amounts include VAT.

51. **The PPP pipeline represents a manageable but increasing demand on the budget that needs to be continuously monitored.** In 2014, approximately 0.7 percent of GDP was spent on PPPs out of the budget, the bulk of it to finance capital expenses (CAPEX) generally in the form of a (quarterly) payment for construction progress (PPO). While still small, CAPEX represented 9 percent of the public investment budget, a share that is expected to increase to about 17 percent by 2017– and a much larger proportion of the central budget investments. These expenditures are in addition to the usual preparation expenses (land acquisition, geological surveys, prospecting and others). (Table 6)

52. **In addition to project co-finance, the GoP provides explicit contingent guarantees that are formalized in legal instruments**. There are two categories of guarantees. First, certificates of recognition of the right to annual payments for works issued to enhance the probability of financial

[11] The methodology of valuation of contingent liabilities was recently updated through Ministeral Resolution No. 048-2015-EF (*Aprobación de los "Lineamientos para la Valuación de compromisos contingentes cuantificables y del flujo de ingresos derivados de la explotación de los proyectos materia de los Contratos de Asociación Público Privada"*). In brief, the proponent of a PPP should include, as part of the financial proposal, a rigorous valuation for each potential risk based on a stochastic model with Monte-Carlo type simulations. It is recommended that the valuation of risk be made by a professional econometrician.

[12] For a good account of the evolution of PPPs in Peru see: Marchesi, G and Valencia A (2015) "The role of public-private partnerships in closing infrastructure and public service gaps" in Santos, A. and Werner, A."(2015) Peru: Staying the course economic success" IMF.

closure for a given PPP project. These *financial* guarantees amounted to 0.2 percent of GDP at the end of 2014, with an additional 0.4 percent of GDP expected to be issued in 2015. Second, the GoP also issues *non-financial* guarantees mainly in the form of a minimum annual revenue guarantee (IMAG). By the end of 2014 the Government had issued 2.1 percent of GDP, mainly for roads (1.5 percent of GDP) and water and sanitation projects (0.6 percent of GDP).[13]

Table 6: Peru - Government commitment associated with PPPs, percent of GDP
(Actual for 2014; forecast for 2015-17 based on existing PPP)

	2014	2015	2016	2017
		(percent of GDP)		
Direct spending, of which	0.7	1.3	1.7	1.4
- recurrent (O&M)	0.1	0.2	0.2	0.3
- investments (CAPEX)	0.6	1.0	1.4	1.1
- triggered warranties (IMAG)	0.0	0.0	0.0	0.0
Explicit contingent liabilities, of which	2.3	2.7	..	..
- financial	0.2	0.6	..	..
- non-financial	2.1	2.1	..	..
Value of PPP projects (stock)	15.3	19.0	22.7	25.8

Source: WB staff calculations based on the MMM 2016-2018 (August 2015) and Contingent Liability Report (June 2015)
Note: Excludes expenses related to land adquicision and project preparation.

53. **There are also a number of firm commitments and contingent guarantees embedded in signed PPP contracts**. MEF estimated that by the end of 2014 the net present value (NPV) of all firm and contingent commitments embedded in contracts, net of income that might be collected from the projects, amounted to 4.2 percent of GDP. The PPP Law required the Government to maintain this NPV at below 12 percent of GDP (raised from 7 percent of GDP in December 2014).

54. **The operation supports the GoP's efforts to make PPP project evaluation more rigorous, to minimize fiscal risks, and to facilitate PPP project implementation.** Specifically, it supports actions to harmonize the evaluation of all PPP projects (especially those related to unsolicited proposals) and subject them to the budgetary allocation process, and to enhance MEF's role in appraising and approving the risk associated with PPP projects. MEF has also gained legal powers to improve the PPP program through Ministerial Resolution if it is considered necessary. It also supports the creation of structures to accelerate the PPP process while making project preparation, implementation, and completion transparent, and better handling of unsolicited proposals and dispute settlements. Finally, it supports a revision of the existing PPP legal framework to ensure full consistency with all regulations and guidelines recently issued (e.g., effective and equitable expropriation, platforms for renegotiation, guidance and filters for content of unsolicited proposals, better balanced risk allocation) and, most importantly, to align PPP payment mechanisms with international best practice.

Prior Action 5: *The Government has enacted a new PPP framework to: (i) incorporate PPPs into the budget process, and ensure spending units (PPP promoters) prioritize their budget allocations for PPPs in a way that is consistent with their existing fiscal framework; (ii) ensure that only projects with a strong business case as reflected in the evaluation report (Informe de Evaluación) that adhere to the principles of value-for-money and adequate risk sharing are selected; and (iii) require MEF's favorable binding opinion to the business case reflected in the evaluation report*

[13] See: http://www.mef.gob.pe/contenidos/pol_econ/informes/Informe_Contingencias_Explicitas.pdf.

(Informe de Evaluación) and to the final draft of the corresponding PPP agreement prior to the entering into any PPP contract.

55. ***Reforms*** **– The Government made a major effort to modernize the PPP framework, which has earned recognition as one of the most modern pieces of legislation in LAC.** The 2014 amendments to the PPP framework Law No. 30167 and a number of subsequent decrees were all consolidated and upgraded in Legislative Decree 1224 of September 2015. Already in the 2014 Infrascope index (produced by the Economist Intelligence Unit), which measures a country's ability to mobilize private investment in infrastructure through PPPs, Peru had scored high in the LAC region; Peru scores below Chile and Brazil but above Mexico and Colombia. The revamped PPP framework that has come out of the Legislative Decree 1224 will likely further improve Peru's standing -- the index evaluates the regulatory and institutional frameworks, operational maturity, investment climate, financial facilities and subnational adjustment.

56. **The legislation and corresponding bylaw regulation issued through Supreme Decree No. 410-2015 establish a process to identify a coherent and complementary portfolio of projects, including procedures to handle unsolicited proposals**. Projects are also matched with feasible financial resources, as opposed to proceeding in an ad-hoc manner selecting individual projects. Amendments also introduce actions to bring PPPs under budget scrutiny, to enhance MEF's role in appraising and approving such projects to facilitate their speedy implementation and completion, and to clarify the handling of unsolicited proposals and dispute settlements. The amendments set up the rules and criteria for Government support to PPP projects, such as direct funding. Several instruments for project selection (Value for Money and relationship between cost and quality of service methodology), project preparation, and complementary procedures were also issued in order to ensure that only proposals with strong business cases are admitted. The "business case" arguments should all be included in the Evaluation Report (*Informe de Evaluación*), which must receive a favorable opinion from MEF. MEF's opinion also applies to the draft PPP contract. Unlike opinions received from regulators or other agencies, MEF's opinions are binding: no contract is considered valid unless it has received a favorable opinion from MEF. (However, an "administrative silence" principle however applies wherein if an institution has not issued an opinion within the number of days established in the regulation it is considered favorable.)

57. **The amendments introduced best practices in public resource management for PPP funded projects.** The revised procedures and rules cover the entire project-cycle (proposal, appraisal, selection, approval, allocation, and contracting) and are now consistent with those for a typical public investment project. While these actions were important for all PPP projects, the introduction of a clear-cut processing calendar (aligned with the overall budget calendar) was especially important for the co-financed unsolicited proposals – the Law creates a 45 days window for Proinversion, the PPP agency, to accept submissions. The new system ensures that the budget allocation for investment projects under PPPs, as well as their recurrent expenditure requirement, is consistent with the country's growth objective and its approved budget framework. These harmonized processes for both PPP and public investments ensure that the overall budget constraint – and line ministries' expenditure ceilings – apply irrespective of whether a project is a co-financed PPP or a public project. Multiannual reports on PPP investment (created under Legislative Decree 1224) are to be prepared annually each February by Investment Committees in ministries, regional, and local governments engaged in PPP projects. These reports include planning and programming of projects and commitments, ensuring that entities take a long-term view of their commitments and providing the market with signals about future priorities. Perhaps

most importantly, these changes encourage entities to have a global view of the PPP project portfolio, allow the Government to explicitly and systematically compare the relative benefits of one type of project versus the other, and require the relevant sector ministries to prioritize among projects when deciding upon the allocation of their capital and recurrent budgets.

58. ***Results*** **-** These measures are expected to improve budget formulation practices for all projects that are implemented under a PPP arrangement. In particular, the incorporation of PPPs in the budget processes should improve the binding nature of the budget ceilings given to spending units and enhance decisions on expenditure allocation across sectors. The authorities will measure this as the percentage of PPP promoters (spending units) at all levels of government that issue the Multiannual Report on PPP Investment on a yearly basis, increasing from 0 percent of the total to 100 percent between 2015 and 2017.

Prior Action 6: *The Government has appointed the MEF as the guiding entity (ente Rector) of the National Private Investment Promotion System for the development of PPPs, acting through the recently created General Directorate for Private Investment Promotion Policy, which enables MEF to play its role as the highest normative authority for the interpretation of PPP legislation, as well as to enact and improve guidelines and methodologies for the development of PPPs.*

59. ***Context*** **– This Prior Action follows international best practice for fiscal authorities to temper the growth goal of PPP promoters on the basis of sound overall medium-term budget planning, which Peru already has**. It allows MEF to play the role of the leading authority provided under Law 30167 (now updated through Legislative Decree 1224) in reducing the current significant bias in Peru for the Government to bear most of the construction risks through PPO, compensation for investment certificates (RPI) and the like. Additionally, if the pace of approval of projects is likely to place excessive demands on the budget, MEF can contribute to managing the approval process and thus the fiscal risk emanating from the projects.

60. ***Reforms*** **- In 2014, MEF created the General Directorate for Private Investment Promotion Policy (DGPPIP) (DS N° 117-2014-EF) and staffed the Directorate with around 30 qualified staff**. This enhanced MEF's role in PPP contract design, risk-allocation, and approval, as well as in continuous monitoring of risks and maintenance of records. The DGPPIP has decision-making authority on when and what types of fiscal support may be provided to PPP projects. While a similar authority previously existed at the final stage of a PPP project's approval, it could be circumvented and MEF's institutional capacity to engage in the analysis even at this late stage was very weak. Now, MEF has a role in all PPP projects irrespective of their initial classification as well as a team to exercise this responsibility. The responsibilities of MEF, through DGPPIP, were further sharpened and enhanced in the recently enacted Legislative Decree N° 1224 of September 25, 2015 and its regulation (DS 410-2015-EF published December 27, 2015).

61. **The DGPPIP is already playing a key role, including among others**: (i) liaising with Proinversion, MEF's risk management unit, and line ministries on the fiscal implications of PPP project design: (ii) issuing an opinion at different stages of a PPP project or contract (design, negotiation, and renegotiation) and if necessary, vetoing the signature of a PPP contract (in consultation with other units within MEF); (iii) monitoring closely the evolution of risks associated with PPP projects that are under construction or in operation; and (iv) operating and managing the registry of all PPP contracts.

62. **The DGPPIP has used its mandate and authority to define instruments, guidelines, good practices, and a standard contract guidance document for the structuring and tendering of PPPs**. By the end of March 2016, the DGPPIP will implement, with World Bank support, the following instruments: (1) a "Standard PPP project risk allocation matrix" and evaluation tools that assist analysts in the evaluation of the PPP business model, financial structure and risk allocation; (2) a "Green Book" on PPP policies and practices for project preparation; (3) a standard Model Contract (and key model contract clauses) for mandatory use in PPP projects so as to speed up the process and improve contracts; (4) a matrix risk baseline, based in PPP contracts and key contractual clauses and the identification of the most important risks associated with PPP processes and contracts; (5) a framework for the provision of sovereign non-financial guarantees for PPP projects and a manual to guide and regulate renegotiations and its process; and (6) a review of current PPP contracts termination, force majeure and relief contractual clauses and recommendations for modifications based on international best practice. The above instruments will be issued as a MEF Regulation given its new powers to improve or modify the procedures or regulations of the PPP program.

63. **The DGPPIP is also expected to work closely with Proinversion at the proposal and design stage, thereby involving MEF early in the process**. This avoids common complaints of late interventions or the possibility of circumvention. Additionally, MEF's obligation to provide opinions on proposals and selection will require explicit justification of its decisions so that all involved parties can review the reasoning. In addition to its policy design responsibilities, the DGPPIP provides technical assistance to public entities on the PPP mechanism.

64. **The DGPPIP will operationalize the requirement of the updated legal framework for the Government to establish and maintain a comprehensive registry of PPP projects and contracts.** Data on PPP projects is currently dispersed across the country, including at subnational levels, making it difficult to have a comprehensive view of PPPs in the country. All central and SNGs ministries and public agencies will now be required to inform MEF and submit their PPP projects for its clearance and approval, allowing the systematic consolidation of PPP data. Establishment of the registry will contribute to better accounting and managing of medium and long term fiscal commitments and fiscal risks, and allow MEF to improve its report on fiscal contingencies required by the new macro-fiscal framework (Law 30099).[14] Finally, the DGPPIP has now the jurisdiction to improve processes and procedures aimed at increasing the effectiveness of the overall PPP program.

65. **A commendable complementary effort of the Government was the creation a Specialized Investment Implementation Support Unit (SIISU) (*Equipo Especializado de Seguimiento de la Inversión*), within MEF, to facilitate the implementation of PPPs.** Equally important to the strategy of managing risks emanating from PPPs is ensuring that PPPs contribute to closing the key infrastructure gaps that they have been designed to address. Peru's PPP experience had been plagued by delays in implementation partly because of the number of permits (e.g., for construction) required at all levels of government. The cumbersome steps are not easy for private operators to navigate without organized government support. Since simplifying processes across the board might neither be desirable nor feasible, there was a need to have a designated government agency with the authority to cut through the bureaucracy.

[14] http://www.mef.gob.pe/contenidos/pol_econ/informes/Informe_Contingencias_Explicitas.pdf (June 2015).

66. ***Results* -** The expected result of this reform will be measured through the same indicator defined for Prior Action 5, above, given that these two prior actions complement and reinforce each other.

Prior Action 7: *The Government has revised: (i) the procedures for receiving and processing co-financed unsolicited PPP proposals, including the roles and responsibilities of key government agencies (soliciting agency, PROINVERSION and MEF) and the requirement at the national level of a Supreme Decree listing the specific interventions and the amount of budgetary support that the soliciting agency (e.g., ministries) will need to allocate to said co-financed unsolicited PPP proposals; and (ii) the dispute resolution mechanisms in PPP contracts, which include arbitration, a dispute settlement body (Junta de Resolución de Disputas) and the use of an alternative mechanism through the intervention of a neutral third party (Amigable Componedor).*

67. ***Context* – Part of this Prior Action established international best practice "rules of the game" for unsolicited proposals.** Unsolicited proposals for PPPs can drain public sector resources even at the stage of reviewing proposals if they are not aligned with policy priorities. They also pose risks to the concept of "value for money" in projects, depending on the process that a country follows to develop and procure the specific project. Unsolicited proposals, however, can fill important gaps in the infrastructure planning system of a country like Peru if they are transparently processed, follow a set of rules and introduce economies of scale by concentrating staff efforts to collect, process, evaluate and compare proposals in one part of the year. Comparing proposals can facilitate their ranking by including potential competition and highlighting valued-added coming from priorities and synergies among projects.

68. **The calendar for processing unsolicited proposals requires they be accepted once a year through the enactment of a Supreme Decree**. Unsolicited proposal can be submitted to Proinversion during a 45 day window, after which the authorities will review them. Those accepted will have to be included in a Supreme Decree listing them and the multiannual budgetary commitment that the soliciting agency (e.g., line ministry) will need to make.

69. **Another important issue to be addressed was to improve the PPP contract framework by introducing commonly-used mechanisms for voluntary settlements.** The incidence of renegotiations in Peru has been quite significant and can be associated with fiscal risks: more than sixty percent of the contracts are renegotiated and often the same contract is renegotiated several times, and fairly quickly after awarding the project. While the incidence of renegotiations is expected to decline given the ability of MEF to review PPPs at different stages of the project cycle, expeditious conflict resolution instruments, such as voluntary settlements based on the advice of an independent third party, were needed to further reduce renegotiation occurrences and the costs associated with disputes. Voluntary, out of court settlements, are already a common and well-established practice in the banking sector (particularly during economic crises) and for civil cases. Internationally, countries with the strongest PPP legal and institutional frameworks (e.g., the UK and Australia) have also adopted them.

70. ***Reforms* - Unsolicited proposals will follow the Government's Public Investment System (*Sistema Nacional de Inversión Pública,* SNIP) that processes all public investment projects.** The new legislation and bylaw regulation *(Legislative Decree N° 1224 published September 25, 2015 and the Supreme Decree No. 410-2015-EF published on December 27, 2015, respectively)* set up an open window to receive unsolicited proposals annually. The regulations

also establish criteria for project selection, Government support (guarantees and subsidies), as well as roles and responsibilities for clearances. According to the updated regulation, unsolicited proposals once vetted at the various levels will need to be explicitly approved with the issuance of a Supreme Decree. Additionally, they have clarified and set up terms and time limits for the responses of public entities involved in the decisions, devolution of costs of studies requested by the Government, improving competition and transparency rules. Together, these regulations have set up a new mandate for the PPP agency (Proinversion) and regulate all the stages of the PPP cycle for unsolicited proposals (minimum requirements, timing, terms, fiscal clearances, etc.). This experience has introduced better incentives for proponents to reduce the number of proposals and improve quality in the coming years.

71. **Legislative Decree 1224 also regulates the concept of alternative settlements based on independent third party advice.** This figure introduces the possibility of an alternative settlement of PPP project-related disputes including independent (non-binding) opinions by unrelated honest parties. This improves the process of dealing with disputes, especially in early stages, during the period established for direct discussion among the parties.

72. ***Results* –** Since the uptake of the mechanism for voluntary settlement of disputes is too new, the result will focus only on the new guidelines and procedures for screening unsolicited proposals. These are expected to result in fewer (but higher quality) proposals being accepted. Since the quality of an unsolicited PPP proposal is difficult to quantify ex-ante, results will be measured through the number of unsolicited proposals submitted to Proinversion for evaluation, which is expected to decrease from 147 received in 2015 to 88 in 2017. An indicator for the number of proposals already prioritized out of the 147 submitted was not available at the time of project preparation so it could not be included as part of the indicator.

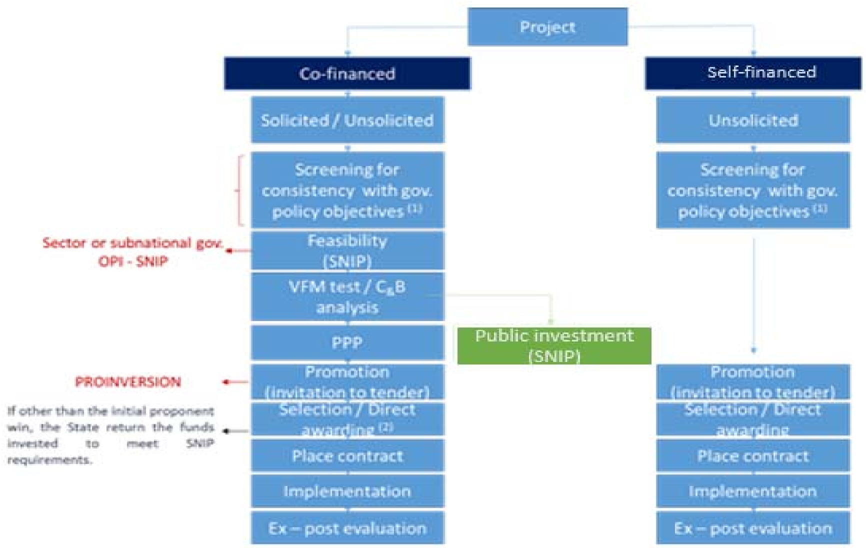
Prior Action 8: *The Government has set up the National Private Investment Promotion System to guide PPPs under a clear, streamlined and traceable process with roles and responsibilities to provide greater predictability to private investors while further enhancing the channels to evaluate the overall fiscal impact.*

73. ***Context* – The Government created the National Private Investment Promotion System as a single entry point to manage private investments.** The path to track processes related to private participation in PPP at the national and subnational levels was not clear given the different pieces of legislation and unwritten processes that existed to handle PPPs within the SNIP. There was a need to provide more transparency to the investment process, in particular at the subnational level, and to provide more predictability to private investors in the decision making process, while also preserving the treatment of the fiscal effects and investment decisions within a unified and transparent process.

74. **Reforms** - The new system creates a clear, streamlined, and traceable process with roles and responsibilities for each stakeholder. Key functions of the new system include, among others a clear allocation of roles and accountability, actions to streamline and accelerate the investment process, fiscal controls and some criteria to recommend projects for preparation and execution by national and subnational governments. The National Private Investment Promotion System was included into the PPP law amended via Legislative Decree 1224 of September 25, 2015. Regulations were approved at the end of November, including details on the roles and

responsibilities of the stakeholders involved in the "*Sistema Nacional de Promoción de la Inversion Privada*". The sketch of the new process is presented in Figure 7, below.

Figure 7: The unified framework to declare investments viable, including budget funded projects as well as PPPs (with or without government co-financing, and solicited or unsolicited)



Notes: (1) Includes admission / verification with government requirements and infrastructure strategy. Moreover, includes the fiscal impact and evaluation of multiannual budget affordability. (2) If the initial proponent loses the selection process, the government owns the project and return to investor their spending on SNIP requirements.

75. ***Results*** **-** The procedures of the new National Private Investment Promotion System have strengthened, among others, MEF's role at different stages of a PPP project preparation process. The authorities will measure the effectiveness of the system through adherence to its procedures, captured in the number of PPP contracts without MEF's favorable opinion prior to the tender process at all levels of Government, which is expected to fall from 17 in 2014 to 0 in 2017.

4.2 ANALYTICAL UNDERPINNINGS

76. **The Pubic Expenditure and Fiscal Risk DPF-DDO is underpinned by extensive analytical work in topics covering both SNGs, public management and PPPs.** The following table presents the analytical work corresponding to each policy area.

Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Pillar 1: Improving management and reporting of public expenditures in SNGs	
Prior Actions 1, 2, and 3 - Implementation of the Revised Fiscal Responsibility Framework, Institutionalization of Related Entity (DGPMACDF), and Fiscal Council	• World Bank, Policy Notes (2012). "Perú en el umbral de una nueva era: Lecciones y desafíos para consolidar el crecimiento económico y un desarrollo más incluyente." Volume 2. *This report includes a discussion of subnational compliance with fiscal rules; it recommends their simplification, and adjustments to incentives so as to better enforce compliance and ensure fiscal sustainability in the medium term.* • World Bank (2014). "Implementing the Subnational Aspects of Peru's 2013 Law on Fiscal Responsibility and Transparency." Technical Note and Discussion with International Experts on International Experiences Implementing Fiscal Responsibility Laws (2014). *This note reviews SNG-related aspects of the law and discusses how it could be regulated, implemented and perhaps augmented, including some recommendations related to MYFMRs. Included among the*

Prior Actions	Analytical Underpinnings
	recommendations is that MEF provide SNGs with the most accurate possible projects of revenue to inform budget estimates, which is being operationalized through the Fiscal Council. Additionally, a technical discussion shared Brazil's experience implementing its fiscal responsibility law at the subnational level, covering aspects such as dissemination and capacity-building, among others. • Fiscal Decentralization Achievements and Challenges (mimeo); Background Note for the 2016 Peru Engagement Notes: Development Cities for Sustainable and Equitable Growth.
Prior Action 4 – Introduction of Public Directors Service Regime	• Loayza, Calvo, Rigolini (2011) "More than you can Handle: Decentralization and Spending Ability of Peruvian Municipalities." WB WPS 5763. *In its examination of the factors influencing local governments expenditure execution capacity, this analysis finds qualitative evidence of a lack of qualified personnel (as reported by municipal managers) as well as quantitative evidence of higher levels of execution in municipalities with greater percentages of white collar municipal staff.* • SERVIR (2014): "Ejecución de las inversiones por parte de los Gerentes Públicos." Government of Peru, Lima, Peru. Unpublished. *This technical note measures the impact of the roll-out of the Public Directors Cadre on Budget execution in selected regional governments.* • SERVIR (2015). "Marco Conceptual del Grupo de Directores Públicos del Servicio Civil Peruano." Working Paper No. 1-2015. *This report analyzes the potential impact of the creation and deployment of the Public Directors, comparing the proposed regime with international best practices.*
Pillar 2: Improving the Government's legal and institutional framework for public-private partnerships (PPPs).	
Prior Action 5 – Bringing PPPs into the Budget Process and Presentation of Strong Business Cases	• World Bank PPIAF Report (2011). Best Practices for the Financing of PPP in LAC. *This report shows and evaluates the tendencies and best practices for the financing of PPPs. It notes the importance of properly distributing PPP costs over the budget process so as to ensure good project selection and the careful design of contracts.* • OECD (2012). Recommendation of the Council on Principles for Public Governance of Public-Private Partnerships. *Among other things, this publication recommends that the central budget authority ensure PPP project affordability and the overall sustainability of the investment envelope, and notes that it is ideal if PPPs are part of an integrated public sector infrastructure investment and procurement framework.* • World Bank Policy Research Working Paper (2014). How do countries measure, manage, and monitor fiscal risks generated by public-private partnerships? Chile, Peru, South Africa, Turkey. *This publication focuses on how governments can manage balance sheet exposure to PPPs by quantifying and capturing direct obligations and provisions for potential calls on government guarantees associated with PPP projects in the preparation of the medium term fiscal framework and annual budget. It examines how four countries (Chile, Peru, South Africa, and Turkey) with active PPP projects manage the costs and risks of financial obligations generated by these investments throughout the lifetime of the contracts.* • Posner et al (2009). "Public-Private Partnerships: The Relevance of Budgeting." OECD Journal on Budgeting. *Noting that PPP project shift costs from shorter-term capital expenditures to longer term recurrent expenditures, this article points to the importance of stronger budget controls and processes in order to ensure that the PPP modality is the correct one and that proposed projects are able to be effectively compared with other activities requiring funding.*
Prior Action 6 – Appointing MEF as highest regulatory authority for PPPs and creating the DGPPIP within MEF to implement new responsibilities	• Irwin and Mokdad (2010). "Managing Contingent Liabilities in Public-Private Partnerships: Practice in Australia, Chile, and South Africa." World Bank, PPIAF. *This report describes good PPP risk management practices in Australia, Chile, and South Africa, and examines their applicability to other countries. In all three, someone other than the line minister promoting the PPP approves the PPP before it is undertaken, and that decision maker is advised by a group in the Ministry of Finance with expertise in PPPs.* • World Bank PPIAF Report (2011). Best Practices for the Financing of PPP in LAC. *Within this report's evaluation of tendencies and best practices in PPP financing, it notes the importance of the PPP Unit within the Treasury Department for evaluating fiscal risks, checking proposals, and guaranteeing the efficiency of contract management, among other things.*
Prior Action 7 – Unsolicited Approvals and Dispute Settlement	• Public Private Infrastructure Advisory Facility (2014). Unsolicited Proposals – An Exception to Public Initiation of Infrastructure PPPs: An Analysis of Global Trends and Lessons Learned. World Bank. *This report examines global trends in unsolicited proposal processes, lessons learned, and factors for further consideration. It notes the importance of developing an unsolicited proposal process policy framework, building institutional capacity to manage them, and following competitive procurement processes and procedures.*

Prior Actions	Analytical Underpinnings
	• Evaluation and Lessons for Unsolicited Proposals (2014), The Rebel Group, LAC PPP Days, Uruguay. *This report evaluates the results of unsolicited proposals around the world and present lessons and best practices.* • World Bank (2010). Public Private Partnership (PPP) dispute resolution framework report. *The document analyzes the dispute resolution framework for the post-award management of technical assistance projects. The concession agreements relating to Maharashtra provide for either a 2 or 3 tier structure of dispute resolution comprising of mutual negotiation and mediation in some cases, and arbitration in the event mutual negotiation fails.*
Prior Action 8 – National Private Investment Promotion System	• Under a Swiss Trust Fund, the WBG provided direct inputs to the drafting of this new piece of legislation, including convoking a brainstorming with experts from Mexico, Chile, and Colombia. The WBG is also providing substantial technical inputs to the drafting and consultation process for the regulation of this law that is expected to be enacted before end 2015 or early in 2016.

4.3 LINK TO CPS, OTHER WORLD BANK OPERATIONS AND THE WBG STRATEGY

77. **The proposed operation is consistent with the World Bank Group's (WBG's) CPS for Peru for 2012-2016** (Report No. 66187-PE). The CPS is built around four strategic objectives: (i) increased access and quality of social services for the poor, (ii) connecting the poor to services and markets, (iii) sustainable growth and productivity, and (iv) improved public sector performance for greater inclusion. This operation is well-aligned with this last pillar, which anticipated support to strengthening management frameworks at the national and subnational levels, balancing the need to maintain quality control of investments with accelerated expenditure execution through a DPF.

78. **The DPF-DDO has been closely coordinated with and complements key WBG operations, both directly and indirectly.** These include: (1) the parallel Boosting Human Capital and Productivity DPF-DDO, which supports measures to enhance the education policy framework to enable better quality of skills, facilitate the entry, operation, and exit of firms; and reduce transaction costs in trade; and (2) the Lima Metro Project (FY15), which supports the country's biggest PPP and one that is implemented in Lima, a key SNG. The DPF-DDO also enhances the ability of the International Finance Corporation (IFC) to actively participate in new PPPs, something that has been precluded in part by the excessive issuance of public guarantees.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

79. **Consultations for this operation have been led directly by officials of the MEF, who have discussed in detail with World Bank staff the concerns expressed by key stakeholders**. In particular, the DGPMACDF has been in touch continuously with SNGs, which are the most interested parties with respect to the reforms under Policy Area 1 and the subject of various support initiatives led by the same DGPMACDF as a result of the consultations. Similarly, the DGPPIP has managed the dialogue with PPP stakeholders, including financial institutions, construction companies, SNGs, private investors and the broader non-governmental organization (NGO) community. These stakeholders expressed concerns about the new risk management system, which could raise the overall financial costs of new PPPs. In response, MEF is working closely with the WBG and the Government's second tier development bank (COFIDE) to develop insurance products for key PPP risks. The WBG and COFIDE are also studying, with support from the Swiss Trust Fund, how the private sector insurance industry can be induced to also develop cost-

accessible risks management instruments for PPPs. This initiatives are being closely coordinated with IFC.

80. **Several operations supported by other international financial institutions complement this operation's objectives**. These include operations by the Inter-American Development Bank (IADB), Development of Latin America (*Corporación Andina de Fomento,* CAF), and KfW Development Bank. The GoP is currently receiving technical assistance to: (i) evaluate fiscal contingencies according to their new macro-fiscal framework, and (ii) enhance the SNIP's capacity to prioritize and monitor public investment projects.

5 OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT (PSIA)

81. **The set of measures that are supported by this operation are likely to have positive poverty and social impacts in at least three ways.** First, economic growth, adversely affected by external shocks, will be supported by better management of public spending by SNGs as well as spending on PPP projects. Second, social services are likely to be strengthened because SNGs are responsible for much of the country's public spending on social programs and because the diversification of PPP projects is expected to contribute to the expansion of social services. Third, poorer parts of the country are likely to benefit more from SNG spending, because the program focuses on improving capacity for public expenditure management, which is likely to have a greater impact in SNGs with weaker capacity, as well as on greater compliance with fiscal rules by all SNGs.

82. **Specifically, measures to strengthen public spending by SNGs and on PPPs, and to contain fiscal risk will have a favorable impact on poverty by protecting growth.** Peru's decade-long growth has been highly successful in reducing poverty and raising the income of the bottom two-fifths of households. In fact, economic growth accounted for three-quarters of the reduction in national poverty and more than nine-tenths of that of rural poverty.[15] Between 2003 and 2013, poverty fell by more than 35 percentage points as the economy grew by more than 6 percent a year and per capita income of the bottom 40 percent grew by 6.5 percent, which exceeded the growth in the country's per capita income of 5.3 percent. In particular, labor income was the main source of income behind poverty reduction. Since external shocks reduced economic growth sharply to 2.4 percent in 2014, various Government policies to protect growth and support internal demand, including several supported by this operation, have been implemented to ensure that growth recovers.

83. **Since public spending by SNGs and capital spending on PPPs are both significant in size, actions that improve their effectiveness will benefit growth at a difficult time.** Approximately two-fifths of total public spending is done by SNGs, including the bulk of social sector expenditure. PPP projects are projected to comprise nearly a quarter of total public capital spending, as well as private investment, with most of this spending on infrastructure. Delayed implementation and re-negotiation of PPP contracts not only increases their cost but also delays

[15] The Datt-Ravallion decomposition show that GDP growth accounted for 72 percent of the decline in poverty on a national level. More than 90 percent of the decline in rural poverty can be attributed to growth. (see Background Paper 3, prepared for the 2015 flagship report on 'Growth and Productivity')

their operation and thus their growth impact on the economy; this operation explicitly addresses this problem, among others.

84. **Strengthening SNGs staff and managerial capacity for public spending will affect social spending and services favorably, given their dominant role in this area.** In Peru, shared prosperity can be limited by large gaps in infrastructure, both in terms of access and quality of services (World Bank, 2015).[16] In addition, inequalities in coverage across regions limit the return of other development initiatives such as investments in education, health, and social programs. Importantly, there is evidence that contextual factors such as access to infrastructure and basic services explain a large share of income disparities across districts in Peru (Bazan, et al, 2015). SNGs spend a significant share of total public expenditure on education, health as well as water and rural roads. Thus, enhanced capacity to manage and implement expenditure programs, as is supported by this operation, can contribute to better educational and other outcomes at the subnational level, thereby expanding endowments of the poor and contributing to future poverty-reduction.

5.2 ENVIRONMENTAL ASPECTS

85. **The risk of unanticipated adverse effects to the environment, forest, and natural resources from specific policies supported by the DPF-DDO is very low.** The actions supported by this DPF-DDO, particularly those aimed at improving the management and reporting of public expenditures in SNGs, indirectly entail positive environmental effects by improving the conditions under which SNGs can hire technical staff in general and to deal with environmental issues – understaffed subnational socio-environmental units has been highlighted as an issue for the implementation of the environmental framework.

86. **The Bank has supported environmental reforms under the Programmatic Environmental Development Policy Finance between 2009 and 2015, including the strengthening of the National System for Environmental Impact Assessment (SENACE and SEIA) and institutions such as the Ministry of Environment (MINAM) and the National Service for Protected Areas (SERNAP).** Improving country environmental management systems is also of concern to the GoP, which is currently preparing, with the WBG support, an "Investments in Environmentally Sustainable Development" project to enhance environmental quality control at the national level. This investment program will include strengthening the main controlling and enforcement agency of Peru, the Environmental Evaluation and Auditing Agency (OEFA), and local Environmental Evaluation and Auditing entities (EFAs); and, improving environmental transparency and accountability of national and regional development decisions. All public investment projects, including those implemented through PPPs are subject to the National System for Environment Impact Assessment. The public investment management system (SNIP) duly enforces these requirements. Prior actions 5 and 8 of this operation ensures that PPPs are fully subject to the SNIP, which guarantees that environmental impact controls are fully activated.

[16] Cord, Louise; Genoni, Maria Eugenia; Rodriguez Castelan, Carlos. 2015. *Shared Prosperity and Poverty Eradication in Latin America and the Caribbean*. Washington, DC: World Bank. © World Bank. https://openknowledge.worldbank.org/handle/10986/21751 License: CC By 3.0 IGO."

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

87. **Peru's public financial management (PFM) and public procurement systems are sound.** A joint European Union, IADB and World Bank Public Expenditure and Financial Accountability (PEFA) assessment was published in June 2009 and updated in 2015. The report concluded that PFM in Peru has improved since 2009 in several aspects and remains in line with international best practices. The following aspects are important to highlight in regards to Peru's PFM system:

- The central government's budget has improved its reliability and credibility as a financial tool. Fiscal and transparency tools enhance budget planning and predictability. There is a reduced variance between budget execution and the final budget. Budget formulation continues to follow international best practice.

- Budget classifications are compatible with international practices (IMF 2001). In addition, more than 50 percent of budget resources are allocated under programmatic classifications, and predictability of budget resources is working well. There are no significant delays in availability of funds or in payments for legal obligations.

- Budget execution is well documented and the Consolidated Financial Statements are prepared annually within 6 months from the end of the year and made publicly available in printed and electronic versions. The budget execution reports are comprehensive, providing information on revenues, expenditures, and financial assets and liabilities.

- Budget execution reports are audited within the legally established periods by the General Comptroller's Office (*Contraloría General de la República*) and conducted pursuant to the respective regulations and within the time frames established by law. In addition, legislative scrutiny of the annual budget bill is conducted in accordance with well-established procedures, which are also used in examining the general accounts.

88. **Since 2009, the Government has undertaken critical reforms necessary to improve the management of public finances.** A new budget classification system using a programmatic approach and a new chart of accounts in line with international standards were adopted and are operating in all government ministries and agencies. The implementation of the Treasury Single Account (TSA) at the central government level and subnational level has been implemented and is working in line with international best practice. The Treasury Directorate is working now on the implementation of the TSA for external sources of funds. There has been steady progress in establishing the foundations for performance-based budgeting, with the development of well-defined measures of performance that link priority policies and programs. On-going efforts to continue modernizing the budget and improving PFM include: (i) the design and gradual implementation of a multi-annual budget framework (which include all government levels, current and capital expenditure planning, and debt service payments); (ii) continued strengthening of the Budget Directorate including through the implementation of instruments to improve the quality of spending; and (iii) the design of a new Integrated Financial Management System (SIAF II).

89. **The World Bank has conducted analytical work and provided technical assistance on the public procurement system.** The updated 2015 PEFA report concludes that the public procurement system follows international best practices and has improved since 2009. In 2012,

the World Bank suggested areas of improvement in the public procurement system in delivering value for money, including: (a) onerous requirements for bidders to participate in procurement processes, (b) the use of reference price (bracketing) "*valor referencial*" for evaluation purposes, (c) financial costs linked to government contracts, and (d) skill gaps linked to low level of professionalization in procurement professionals. These, among other factors, led to low participation amongst potential bidders as well as a high rate of failure of bidding processes. Also in 2012, the World Bank supported the Peruvian Public Procurement Agency (OSCE) in the design and implementation of a sustainable training program on international best procurement practices and innovative procurement methods, in order to increase the efficiency and economy of the procurement system, particularly for the implementation of infrastructure projects. In 2014, support was provided by the World Bank and other donors such as the State Secretariat for Economic Affairs (*Secretaría de Estado para Asuntos Económicos,* SECO) and Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) to OSCE in the reform of the procurement law (Law 30225, approved in July 2014). The Law will enter into force once a number of specific regulations ("*Reglamento*") are issued.

90. **The control environment for budget support proceeds flow has improved.** A summary of the IMF Safeguards Assessment carried out in 2007 (the latest report) found no significant weaknesses in the Central Bank's safeguards framework and the updated PEFA highlights the improvements in the internal control environment of the budget process since the last evaluation in 2009. The latest external audit report on the 2013 financial statements of Central Bank did not reveal any significant issue related to the internal control environment; and the IMF latest Article IV Consultation (concluded on May 20, 2015) noted the Central Bank's sound management.

91. **The Bank will disburse the loan proceeds into the US dollar Single Treasury Account (*Cuenta Unica del Tesoro*) of the MEF at the Central Bank**. The funds will be available to finance budgeted expenditures and fully incorporated into the Borrower's accounting records and financial statements. The full amount of the loan would be available as a line of credit that can be drawn down subject to satisfactory semiannual review on the maintenance of the program supported and an adequate macroeconomic policy framework in line with OP/BP 8.60.

92. **Given that the control environment into which the DPF-DDO proceeds would flow is adequate, the World Bank will not require a dedicated account at the Central Bank for loan proceeds.** As such, no audit will be required for the deposit account.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

93. **MEF has 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.

94. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, and/or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaints to the World Bank's independent Inspection Panel, which determines whether harm occurred, or could occur, as a result of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and World Bank Management has been given the opportunity to respond. Information on how to submit complaints to the World Bank's corporate GRS can be found at http://www.worldbank.org/GRS. Information on how to submit complaints to the World Bank Inspection Panel can be found at visit www.inspectionpanel.org.

6 SUMMARY OF RISKS AND MITIGATION

95. **This operation entails an overall moderate level of risk.** The most relevant risks that could affect achievement of the program development objective (PDO) defined for this operation and which have been rated moderate are: (i) political and governance, (ii) macroeconomic, (iii) institutional capacity for implementation and sustainability, and (iv) stakeholders.

96. **Political and governance risks are considered moderate and are associated with election dynamics.** The main internal risk relates to domestic politics (presidential elections in the first half of 2016) and their potential impact on reforms. These risks are mitigated as policy continuity is very likely, partly because it is entrenched in a technically sound middle-level management in the public sector.

97. **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 may have a strong adverse impact over the next 12 months, particularly affecting the fishery sector and its exports 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 32 percent of GDP or 20 months of imports by the end of December 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 GDP).

98. **Risks related to institutional capacity for implementation are considered moderate**. Public sector capacity constraints at the subnational level are considerable and have constituted a major challenge to executing public expenditures efficiently. In addition, sub-optimal inter-institutional cooperation among different levels of government could limit the impact of the GoP's

reform program. However, as described in this Program Document, the GoP has implemented several measures to mitigate institutional weaknesses. Moreover, the proposed operation seeks to mitigate these risks in several ways. First, it focuses on a few key policy areas with implementation responsibilities relying on a small number of government directorates, all of them reporting to the MEF. Second, MEF has been progressively investing in building capacities at the subnational level of government. Third, the operation builds on ongoing initiatives as opposed to introducing new ones.

99. **Stakeholder risks are considered moderate as relevant affected parties, SNGs in the case of policy area 1 and potential private investors in the case of PPPs may require time to absorb proposed reforms.** SNGs, in particular small LGs, will require time and support to fully adopt fiscal regulation and increase their management capacity. However, actions supported by this operation are specifically geared to address these issues through extensive communication and training. Potential PPP private sector partners may see new regulations as a limitation to participation but enhanced quality requirements will attract more experienced and stronger players, particularly for bigger investments, which will at the end result in more convenient arrangements for the public sector and more effective implementation of PPP projects.

Table, Systematic Operations Risk-Rating Tool (SORT)

Risk Categories	**Rating (H, S, M or L)**
1. Political and governance	M
2. Macroeconomic	M
3. Sector strategies and policies	L
4. Technical design of project or program	L
5. Institutional capacity for implementation and Sustainability	M
6. Fiduciary	L
7. Environment and social	L
8. Stakeholders	M
9. Other	L
Overall	M

ANNEX 1: POLICY AND RESULTS MATRIX

<table>
<tr><th>Prior Actions</th><th>Results</th></tr>
<tr><td colspan="2">Pillar 1: Improving management and reporting of public expenditures in SNGs</td></tr>
<tr><td>Prior Action #1. The Government has issued regulations to strengthen the management and reporting framework for fiscal responsibility in SNGs including the procedures for determining the fiscal targets-setting methodology, reporting and disclosure requirements and sanctions for non-compliance with the fiscal rules established by Law 30099 and its amendments (Supreme Decree (DS) N° 104-2014-EF, published May 11, 2014; Ministerial Resolution N° 432-2014-EF/15, published December 30, 2014; and Ministerial Resolution N° 338-2014-EF/15, published October 18, 2014).</td><td rowspan="3">Result: Improved fiscal management through SNG compliance with fiscal rules and convergence plans.
Indicator: Percentage of regional governments (RGs) and local governments (LGs) in compliance with fiscal rules for SNGs.
2014 Baseline: 50% of RGs (representing 66.3% of RGs total revenue) met fiscal rules' targets and 59% of LGs (representing 66.4% of total LGs revenue) met fiscal rules' targets.
2017 Target: 65% of RGs and 70% of LGs met fiscal rules or their convergence targets.
Source: Annual Report of Compliance Fiscal Rules, DGPMACDF, MEF website.

Result: Improved transparency and more effective monitoring by MEF of SNGs compliance manifested in their regular reports.
Indicator: Percentage of RGs and LGs that submitted the Multiannual Report of Fiscal Management in compliance with reporting obligations (gradual reporting obligation through a six year period; 2015-2020).
Regional Governments:
2015-2017: 100% of RGs submit the Multiannual Report of Fiscal Management.
Local Governments:
2015 Baseline: 80% of LGs that represent 50% of total LGs' income.
2017 Target: 80% of LGs that represent 70% of total LGs' income
Source: DGPMACDF, MEF website.</td></tr>
<tr><td>Prior Action #2: The Government has granted authority to the General Directorate of Macroeconomic Policy and Fiscal Decentralization (Dirección General de Política Macroeconómica y Decentralización Fiscal, DGPMACDF) within MEF, to monitor SNGs' fiscal and financial management performance according to Law 30099 and its amendments, and provide technical assistance to SNGs (DS N° 117-2014-EF published May 23, 2014).</td></tr>
<tr><td>Prior Action #3: The Government has issued regulations to implement the new Strengthening Fiscal Responsibility and Transparency Law (Law 30099), which created an independent Fiscal Council (Consejo Fiscal) whose functions are to: (i) evaluate ex-post compliance and changes of fiscal rules; (ii) evaluate the macro fiscal forecasts considered in the Multiyear Macroeconomic Framework; and (iii) evaluate short and medium term fiscal policy in terms of stance and sustainability (DS N° 104-2014-EF published May 11, 2014; DS N° 287-2015-EF published October 9, 2015).</td></tr>
<tr><td>Prior Action #4: The Government has issued regulations to implement the professionalization of managers in the civil service, creating a new category of public managers for both national and SNGs, the Public Directors (Directivos Públicos), subject to merit-based recruitment and regular performance evaluations (DS 040-2014-PCM published June 13, 2014).</td><td>Result: Enhanced management capacity in several SNGs.
Indicator: Number of managerial positions covered by professional public managers (Directivos Públicos) as a percentage of total managerial positions in RGs
2014 Baseline: 0%
2017 Target: 77% (800 professional managerial positions covered by Directivos Públicos)
Source: SERVIR</td></tr>
</table>

Prior Actions	Results
Pillar 2: Improving the Government's legal and institutional framework for public-private partnerships (PPPs).	
Prior Action #5: The Government has enacted a new PPP framework to: (i) incorporate PPPs into the budget process, and ensure spending units (PPP promoters) prioritize their budget allocations for PPPs in a way that is consistent with their existing fiscal framework; (ii) ensure that only projects with a strong business case as reflected in the evaluation report (*Informe de Evaluación*) that adhere to the principles of value-for-money and adequate risk sharing are selected; and (iii) require MEF's favorable binding opinion to the business case reflected in the evaluation report (*Informe de Evaluación*) and to the final draft of the corresponding PPP agreement prior to the entering into any PPP contract (Legislative Decree 1224 published September 25, 2015 and DS 410-2015-EF published December 27, 2015). **Prior Action #6:** The Government has appointed MEF as the guiding entity (*ente Rector*) of the National Private Investment Promotion System for the development of PPPs, acting through the recently created General Directorate for Private Investment Promotion Policy, which enables MEF to play its role as the highest normative authority for the interpretation of PPP legislation, as well as to enact and improve guidelines and methodologies for the development of PPPs (Legislative Decree N° 1224 published on September 25, 2015, DS 410-2015-EF published December 27, 2015, and DS 117-2014-EF published May 23, 2014).	***Result:*** *Improved budget formulation practices for projects implemented through PPPs:* **Indicator**: Percentage of PPP promoters (spending units) at all levels of government that issue the Multiannual Report on PPP Investment on a yearly basis: **2015 Baseline:** 0% **2017 Target:** 100% Source: DGPPIP-MEF
Prior Action #7: The Government has revised: (i) the procedures for receiving and processing co-financed unsolicited PPP proposals, including the roles and responsibilities of key government agencies (soliciting agency, PROINVERSION and MEF) and the requirement at the national level of a Supreme Decree listing the specific interventions and the amount of budgetary support that the soliciting agency (e.g., ministries) will need to allocate to said co-financed unsolicited PPP proposals; and (ii) the dispute resolution mechanisms in PPP contracts, which include arbitration, a dispute settlement body (*Junta de Resolución de Disputas*) and the use of an alternative mechanism through the intervention of a neutral third party (*Amigable Componedor*) (Legislative Decree N° 1224 published September 25, 2015 and DS No. 410-2015-EF published December 27, 2015).	***Result:*** *Fewer but higher quality unsolicited proposals accepted.* **Indicator:** Number of unsolicited proposals presented for evaluation: **2015 Baseline:**147 **2017 Target:** 88 Source: DGPPIP-MEF
Prior Action #8: The Government has set up the National Private Investment Promotion System to guide PPPs under a clear, streamlined and traceable process with roles and responsibilities to provide greater predictability to private investors while further enhancing the channels to evaluate the overall fiscal impact (Legislative Decree N° 1224 published September 25, 2015).	***Result:*** *Procedures of the new National Private Investment System followed.* **Indicator**: Number of PPP contracts without MEF's favorable opinion prior to the tender process at all levels of government: **2014 Baseline**: 17 **2017 Target**: 0 Source: DGPPIP-MEF

ANNEX 2: LETTER OF DEVELOPMENT POLICY

PERÚ | Ministerio de Economía y Finanzas | Despacho Ministerial

"DECENIO DE LAS PERSONAS CON DISCAPACIDAD EN EL PERÚ"
"AÑO DE LA CONSOLIDACIÓN DEL MAR DE GRAU"

ALONSO SEGURA VASI
MINISTRO

Lima, 12 ENE. 2016

OFICIO N° 041 -2016-EF/10.01

BANCO MUNDIAL LIMA - PERU
12 ENE. 2016
RECIBIDO HORA: 6:35 FIRMA

CARTA DE POLITICAS

Señor
Jim Yong Kim
Presidente
Banco Mundial
Av. Álvarez Calderón 185, San Isidro
Lima

Referencia: Programa de Gestión del Gasto Público y del Riesgo Fiscal

Estimado Señor Kim,

Mediante el presente le manifiesto a usted el compromiso del Gobierno del Presidente Ollanta Humala Tasso, de impulsar los avances en el fortalecimiento del desempeño fiscal a nivel regional y local, así como apoyar el desarrollo de la inversión mediante iniciativas privadas cofinanciadas, con el fin de disminuir las brechas de infraestructura de los servicios públicos sustentado en el cumplimiento de reglas fiscales.

En este marco, se ha venido desarrollando con el Banco Mundial (BM) el "Programa de Gestión del Gasto Público y del Riesgo Fiscal", el cual comprende acciones de reforma y compromisos para el año 2015 y comprende una operación bajo la modalidad de desembolso diferido.

A continuación se describe el contexto internacional y el contexto económico del Perú y posteriormente los objetivos del Programa, así como las acciones realizadas en el marco del Programa.

A. Contexto Internacional[1]

*Los indicadores de la **economía mundial** muestran señales mixtas de recuperación, acompañados de alta volatilidad en los mercados financieros internacionales. Las economías avanzadas como EE.UU. y Zona Euro continúan expandiéndose moderadamente, mientras que las economías emergentes como China y América Latina presentan resultados desalentadores. El PMI[2] manufacturero global registró 50,9 puntos en diciembre, ligeramente por debajo de noviembre (51,2 puntos) y del promedio julio-noviembre 2015 (51,0 puntos). Las expectativas de crecimiento global están a la baja. En octubre pasado, el Fondo Monetario Internacional (FMI) recortó su proyección de crecimiento mundial para el 2015 a 3,1% (vs. 3,5% esperado en enero 2015), la tasa más baja en seis años, y para el 2016 estima una recuperación de 3,6%.*

[1] *Información al 04 de enero 2016.*
[2] *Índice de Gestores de Compras, se elabora mensualmente, a través de encuestas realizadas a los encargados de realizar las adquisiciones de materias primas en empresas privadas. Mayor a 50 puntos significa expansión.*

Jirón Junín N° 319, Lima 1 – Teléfonos: 311-9900, 311-5930

OFICIO N° 041 -2016-EF/10.01

En **EE.UU.**, el crecimiento del PBI se moderó de 3,9% en el 2T2015 a 2,0%[3] en el 3T2015. Este menor dinamismo, se debe a la contribución negativa de los inventarios privados (-0,59 puntos porcentuales-p.p.), las exportaciones netas (-0,22 p.p.) y la inversión privada (-0,05 p.p.). Sin embargo, el gasto de consumo personal se mantuvo sólido (+2,05 p.p.), en un contexto en el que la tasa de desempleo oficial (U3) y aquella que considera una definición de desempleo más amplia (U6) han alcanzado tasas mínimas desde febrero y mayo 2008 de 5,0% y 9,9% en noviembre 2015, respectivamente. Dado lo anterior, en su reunión del 15-16 de diciembre 2015, la FED elevó la tasa de interés por primera vez en casi una década desde un nivel cercano a cero a un rango entre 0,25% y 0,50%.

La economía de la **Zona Euro** creció 1,5% en los tres primeros trimestres del 2015, la mayor tasa desde el 2011, mostrándose una recuperación en el empleo y la manufactura, pero que aún se encuentra débil respecto al nivel pre-crisis. La tasa de desempleo se ubicó en 10,7% en octubre, la menor tasa desde noviembre 2011. El PMI manufacturero se elevó a 53,2 puntos en diciembre, el mayor registro en 21 meses. Sin embargo, el índice de precios al consumidor registró una tasa anual de 0,1% en noviembre, muy por debajo de la meta de inflación del Banco Central Europeo-BCE (2,0%). Tomando esto en cuenta, el BCE, en su última reunión de diciembre, redujo su tasa de depósitos en 10 puntos básicos de -0,20% a -0,30% y extendió el plazo de su programa de compra de bonos de € 60 mil millones mensuales hasta marzo 2017 (fecha límite anterior era setiembre de 2016). En octubre, el FMI proyectó un crecimiento de la Zona Euro para el 2015 de 1,5%, superior al registrado en el 2014 (0,9%) y para el 2016 de 1,6%.

En **China**, la información más reciente confirma un menor dinamismo económico: si bien la economía China creció 7,0% en los tres primeros trimestres del 2015, el sector industrial y construcción -motor de la actividad económica e intensiva en el uso de materias primas- registró un crecimiento solo de 6,2%. Por su parte, los indicadores adelantados muestran que la desaceleración continuaría en los próximos meses: (i) el PMI manufacturero oficial se ubicó por quinto mes consecutivo en zona de contracción, registrando 49,7 puntos en diciembre y (ii) las exportaciones chinas cayeron por quinto mes consecutivo, registrando una caída de -6,8% en noviembre.

Con información al 31 de diciembre, la bolsa de Shanghai ha disminuido -31,5%, desde su nivel "pico" (12 de junio del 2015), luego de subir 135% desde agosto del año anterior. Esto ha generado fuertes dudas sobre la estabilidad del mercado bursátil y preocupaciones sobre el sistema financiero en general. En octubre, el FMI proyectó un crecimiento de China para el 2015 de 6,8%, inferior al registrado en el 2014 (7,3%) y para el 2016 de 6,3%. En este contexto, el gobierno chino, en su décimo tercer plan quinquenal, estableció metas agresivas para el desarrollo y sostener su crecimiento en torno al 6,5%[4] para los próximos 5 años.

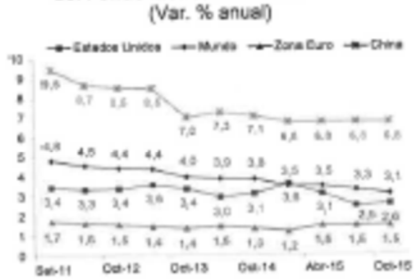
Los países de **América Latina y el Caribe** continúan mostrando signos de desaceleración económica, en un contexto de menores precios de materias primas, aumento de percepción de riesgo, incremento de costos de financiamiento y salidas de capitales. En el 3T2015: Brasil profundizó su recesión de -4,5%, acumulando seis

[3] Tercer estimado oficial para el 3T2015.
[4] Entre las metas: duplicar el PBI y los ingresos residenciales para el 2020, la eliminación de la pobreza y el abandono de la política de un solo hijo.

trimestres de caídas consecutivas; Chile creció 2,2%, igual al registro del 1S2015; México avanzó 2,6%, acelerando ligeramente respecto al 1S -0,1%; Uruguay avanzó apenas 0,6%, luego de registrar su primera contracción en doce años en el trimestre previo (-0,3%), y el PBI de Colombia registró un crecimiento de 3,2%, inferior al 3T2014 (4,2%). En el caso particular de Brasil, dada la contracción económica, la inestabilidad política, la baja perspectiva de crecimiento y el elevado déficit fiscal, las agencias calificadoras de riesgo redujeron el rating crediticio soberano, quitándole Standard & Poor's y Fitch la calificación de grado de inversión el 09 de setiembre y el 16 de diciembre de 2015, respectivamente[5]. En octubre, el FMI proyectó para el 2015 una contracción económica para América Latina y el Caribe en -0,3%, la primera caída desde el 2009, y para el 2016 un crecimiento de 0,8%.

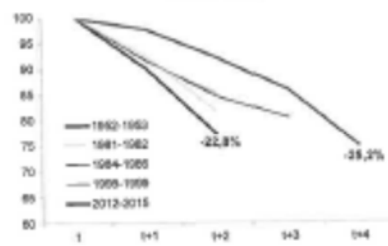
En línea con la menor demanda externa china y la preferencia de los inversionistas por otros activos financieros, las cotizaciones de ***materias primas*** *cayeron fuertemente, siguiendo su tendencia a la baja desde el año 2011. Cabe destacar, la caída de precios de metales, que enfrenta la economía peruana, es la más larga y profunda de los últimos 65 años. Así, en el 2015[6], el precio del cobre cayó -19,8%, oro -8,3% y petróleo WTI -47,6%.*

Mundo: Proyecciones de crecimiento 2015 del Fondo Monetario Internacional
(Var. % anual)



LA6: Brasil, Chile, Colombia, México, Uruguay y Perú.
Fuente: FMI, BCRP.

Episodios de caídas Consecutivas del IPX
(Índice: Año previo a los episodios de caída=100)



B. Contexto Económico Nacional

La economía peruana creció 2,6% en el periodo enero-octubre 2015; cifra ligeramente superior a lo registrado en el 2014 (2,4%), que estuvo afectado por un escenario internacional complejo y choques de oferta transitorios. Este resultado se sustenta en el mayor avance de los sectores primarios (4,2%) respecto a los sectores no primarios (2,5%).

[5] El 11 de agosto 2015, Moody's recortó la calificación de deuda en moneda extranjera en una escala de "Baa2" a "Baa3" con perspectiva estable, a un paso de perder la calificación crediticia; y el 09 de diciembre puso esta calificación en revisión. El 9 de setiembre 2015, Standard & Poor's redujo en una escala, de BBB- a BB+, a "grado especulativo" y con perspectiva negativa. El 16 de diciembre 2015, Fitch redujo en una escala a "BB+" pasando a "grado especulativo" y con perspectiva negativa.

[6] Respecto al 2014.

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- *A nivel sectorial, el PBI creció 3,0% en octubre, impulsado por los sectores primarios que en conjunto crecieron 7,0%, la mayor tasa en 6 meses, se destaca el resultado favorable de la minería metálica que volvió a crecer a dos dígitos (15,9%), registrando 8 meses de crecimiento continuo y ratifica el inicio del ciclo de producción minera (cuprífera). Por su parte, los sectores no primarios se expandieron 2,4%, favorecidos por el crecimiento estable de los sectores vinculados al consumo privado (comercio y servicios).*

- *Cabe indicar que los últimos indicadores dan señales que la recuperación continuará en los próximos meses:*

  - *De acuerdo al COES[7], la producción de electricidad creció alrededor de 11,8% en diciembre, el mayor crecimiento en 65 meses. Por el lado de la demanda, la demanda por electricidad de clientes libres creció 36,6% (empresas mineras 49,5% y empresas manufactureras 13,3%); mientras que el resto de clientes creció 2,4%.*
  - *Se reduce la probabilidad de un FEN fuerte en el verano 2016. De acuerdo al último comunicado del ENFEN[8], la probabilidad de que el FEN sea extraordinario (tal cual el FEN 97-98) se mantiene en sólo 5%, la probabilidad de un fenómeno fuerte se redujo a 35% y la probabilidad de un FEN moderado se incrementó a 50%.*
  - *Según IMARPE, para diciembre, se espera un desembarque de anchoveta de 550 mil TM; que impulsaría el crecimiento del sector fuertemente, dado que el año pasado el nivel de desembarque fue nulo. Al tener en cuenta el desembarque de noviembre, el monto acumulado alcanzaría el 76% de la cuota autorizada (1,11 millones de TM).*
  - *Según datos de Perupetro, en diciembre, hidrocarburos caería -5,6%, la menor contracción en 6 meses. El resultado se explica por la menor producción de petróleo que cayó alrededor de -11,8%, por el menor precio internacional del crudo, y LGN -4,8%, la mejor tasa en 6 meses. Por su parte, la producción de Gas Natural creció 1,8%, acumulando tres meses consecutivos de crecimiento continuo.*
  - *En diciembre 2015, el índice de avance físico de obras registró una caída de -3,7%[9], la menor caída del año, y por debajo de lo registrado durante enero-noviembre 2015: - 19,6%.*
  - *Según el BCRP, en noviembre, el crédito en soles creció 29,2%. Por otro lado, el crédito en dólares cayó -19,4%, con lo que registra tasas negativas por onceavo mes consecutivo; ante, la caída de créditos a empresas (-19,6%) y familias (-19,5%). El menor avance de los créditos en dólares ha permitido reducir la dolarización de los créditos a 30,8%, -9,7 puntos porcentuales desde inicios del 2014.*
  - *De acuerdo al INEI, en el trimestre móvil setiembre-noviembre 2015, el empleo en Lima Metropolitana creció 2,2% (vs. 1,8% previo), el mayor registro en 21 periodos. Sin embargo, el empleo asalariado se desaceleró a 0,7% anual (vs. 2,5% previo), la más baja en los últimos cuatro registros. Por su parte, la tasa de*

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[7] *Comité de Operación Económica del Sistema Interconectado Nacional.*
[8] *17 de diciembre.*
[9] *Cifras preliminares. Considera estimación de anulaciones de S/. 400 millones.*

desempleo (5,8%) se mantuvo sin cambios respecto al trimestre móvil previo. Respecto al ingreso laboral, este aumentó 4,2%, superior al previo (2,3%) y al promedio de los tres registros anteriores (1,9%).

- Según el Ministerio de Trabajo y Promoción del Empleo, en octubre 2015, el empleo en empresas de 10 a más trabajadores del ámbito urbano creció 1,4%, su mayor avance en 10 meses. Esta mayor tasa se debe al desenvolvimiento positivo de cuatro de las cinco ramas de actividad económica: transportes, almacenamiento y comunicaciones (4,3%), servicios (2,1%), seguida por, comercio (1,6%) y extractiva (1,2%). Sin embargo, el empleo en la industria manufacturera continúa en terreno negativo (-1,1%) desde hace casi dos años.
- Sin embargo, aún persiste el deterioro del sector externo debido a la mayor desaceleración de China, LATAM, la Zona Euro, y la caída en los precios internacionales de los metales. Según SUNAT, en noviembre, las exportaciones totales cayeron -14,2%. Este resultado se explicó por la contracción de los precios de exportación (-14,7%), mientras que el volumen creció ligeramente (0,6%). Las exportaciones tradicionales disminuyeron -16,3%, principalmente por menores envíos de productos mineros (-9,7%) como oro (-18,3%), cobre (-7,8%) y zinc (-6,8%). Las exportaciones no tradicionales disminuyeron -10,0% (décima caída consecutiva), ante menores envíos de productos pesqueros (-29,9%), textiles (-25,7%), metal-mecánico (-24.3%), sidero-metalúrgicos (--21,6%) y químicos (-10,2%).
- Asimismo, según SUNAT, en noviembre, las importaciones de bienes de consumo cayeron -1,4% (segunda caída consecutiva). Este registro negativo se explica principalmente por menores importaciones de bienes duraderos (-8,0%, registra 3 meses de caída consecutiva).

Así, esperamos que la economía crezca alrededor de 3,0% en el 2015 de acuerdo al MMMR 2016-2018. Según el consenso de mercado, en el 2015, la economía peruana será una de las economías que acelere su ritmo de expansión respecto del 2014. Según el último sondeo de Consensus Forecasts (CF) de diciembre, Perú se aceleraría en 0,4 p.p., de 2,4% en el 2014 a 2,8% en el 2015, seguido por Chile (0,2 p.p., de 1,9% en el 2014 a 2,1%) y México (0,1 p.p., de 2,3% en el 2014 a 2,4%). Caso contrario, Colombia se desaceleraría en -1,7 p.p., de 4,6% en el 2014 a 2,9% en el 2015.

Para el 2016, la proyección de crecimiento del PBI se acelerará a 4,3% sustentado en:

- Una política fiscal moderadamente expansiva, adoptada de forma preventiva a través del Decreto de Urgencia 003-2015, que contempla fortalecer la respuesta del Estado frente al Fenómeno de El Niño, así como maximizar su efecto multiplicador sobre la actividad económica, a través de una mayor inversión pública.
- Incremento significativo en la inversión en infraestructura de envergadura mediante la modalidad de Asociaciones Público Privadas (APP).
- Mayor crecimiento de la minería metálica dado el inicio de la producción de Las Bambas y la Ampliación de Cerro Verde, la mayor producción de proyectos como Toromocho y Constancia, así como por la recuperación de la producción de Antamina.
- Mayor crecimiento esperado de los principales socios comerciales, en especial, de América Latina y el Caribe y EE.UU., que impulsarán la demanda por las exportaciones no tradicionales, las cuales se expandirían 6,7% (2015: -2,3%)[10].

[10] Cifras reportadas en el Marco Macroeconómico Multianual 2016-2018 Revisado.

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C. Reformas asociadas al Programa de Gestión del Gasto Público y del Riesgo Fiscal

En línea con lo anterior, el Gobierno Peruano es consciente de la necesidad de fortalecer los mecanismos institucionales para promover la gestión pública responsable en los diversos niveles de gobierno y, a la vez, continuar disminuyendo las brechas existentes en infraestructura y servicios públicos mediante mecanismos de participación privada.

En el marco de lo anterior, el Gobierno Peruano, con el apoyo del Banco Mundial, ha desarrollado el Programa de Gestión del Gasto Público y del Riesgo Fiscal (el "Programa"), con el cual se busca promover la eficiencia en el gasto público a nivel Subnacional, así como mejorar el mecanismo de Asociaciones Público-Privadas.

El Programa apoya la adopción de reformas de política, las cuales están estructuradas en dos pilares: i) Mejora de la gestión y rendición de cuentas del gasto público en los Gobiernos Subnacionales, y ii) Mejora del marco legal e institucional del Gobierno para evaluar los riesgos fiscales en Asociaciones Público-Privadas y acelerar su implementación.

C.1 Mejora de la gestión y reporte del gasto público en los Gobiernos Subnacionales

Actualmente el Gobierno está desarrollando los mecanismos necesarios para asegurar una administración prudente, responsable, transparente y predecible, por lo cual, una de sus prioridades es asegurar la sostenibilidad fiscal y el adecuado uso de los fondos públicos.

En ese contexto, se ha considerado conveniente fortalecer el marco de gestión y reporte de los Gobiernos Subnacionales, realizar el monitoreo de la gestión de dichos Gobiernos, establecer un mecanismo de análisis técnico independiente de la política macro fiscal y mejorar la calidad de los recursos humanos en las entidades públicas en los distintos niveles de gobierno.

En relación a mejorar el marco de gestión y reporte de los Gobiernos Subnacionales, el Programa incorpora los procedimientos para definir la metodología con la cual se determinan las reglas fiscales, el establecimiento de las obligaciones de reporte y transparencia por parte de los Gobiernos Subnacionales, y el establecimiento de las sanciones de incumplimiento.

Asimismo, se considera necesario realizar un acompañamiento a los Gobiernos Regionales y Locales a fin de facilitar el proceso de implementación de las reglas fiscales, así como realizar su seguimiento, para lo cual se ha dispuesto que la Dirección General de Política Macroeconómica y Descentralización Fiscal del Ministerio de Economía y Finanzas (MEF) sea la instancia encargada de realizar el monitoreo de la gestión fiscal y financiera, así como prestar la asistencia técnica requerida.

Adicionalmente, el Programa contempla la implementación del Consejo Fiscal como una comisión autónoma, adscrita al MEF, el cual tiene la responsabilidad de emitir una opinión no vinculante sobre la política macro fiscal en relación a modificaciones de las reglas fiscales y su cumplimiento, proyecciones fiscales contempladas en el Marco Macroeconómico Multianual, y evolución de corto y mediano plazo de las finanzas públicas, entre otros.

En línea con mejorar la gestión de los recursos humanos en el Sector Público, especialmente en los Gobiernos Regionales y Locales, se está impulsando la reforma del servicio civil dentro de la cual se ha creado una nueva clase de servidor público denominado Directivo Público, el cual está sujeto a procesos de selección competitiva y a evaluaciones de desempeño.

C.2 Mejora del marco legal e institucional para Asociaciones Público-Privadas

Desde el punto de vista de la inversión pública, el Gobierno viene impulsando una serie de medidas que contribuyen a cerrar las brechas de infraestructura y servicios públicos a lo largo del país, enfatizando el desarrollo de esquemas de Asociación Público-Privados (APPs). Si bien la promoción de la inversión privada se inició desde hace más de dos décadas, se requiere afinar los instrumentos normativos para lograr consistencia con la responsabilidad fiscal adecuada.

En ese sentido, se requiere avanzar en asegurar los recursos requeridos para los esquemas de futuras APPs dentro del marco presupuestal y que las iniciativas privadas cofinanciadas priorizadas sean aquellas que cuenten con casos de negocios robustos, la designación de la máxima autoridad del Sistema Nacional de Promoción de la Inversión Privada, fortalecer el marco regulatorio para la estructuración y transacción de APPs, incorporar un procedimiento de resolución de controversias, y contar con un marco normativo unificado para la promoción de la inversión privada mediante APPs.

De esta manera, el Programa contempla modificaciones normativas en las cuales se dispone la incorporación de APPs en el proceso presupuestal, asegurar que las iniciativas privadas cofinanciadas cumplan con criterios de elegibilidad, y contar con la opinión previa del MEF al Informe de Evaluación y a la versión final del Contrato de una APP.

En línea con lo anterior, mediante el Decreto Legislativo 1224, se ha designado al MEF como el ente rector y máxima autoridad técnico normativa del Sistema Nacional de Promoción de la Inversión Privada, cuya función es asegurar el cumplimiento de la política de promoción y desarrollo de las Asociaciones Público Privadas y Proyectos en Activos, con la participación de todas las entidades del Estado, en los distintos niveles de gobierno, en el marco de sus competencias. Asimismo, con la creación de la Dirección General de Política de Promoción de la Inversión Privada (DGPPIP) dentro de la estructura del MEF se facilitará la implementación de la nueva legislación de APPs.

Adicionalmente, se ha definido un nuevo marco legal, con el cual se detalla el procedimiento para nuevas iniciativas privadas cofinanciadas, incluyendo los

PERÚ | Ministerio de Economía y Finanzas | Despacho Ministerial

"DECENIO DE LAS PERSONAS CON DISCAPACIDAD EN EL PERÚ"
"AÑO DE LA CONSOLIDACIÓN DEL MAR DE GRAU"

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roles y responsabilidades de las entidades participantes en el proceso, y el establecimiento del requerimiento de emisión de un Decreto Supremo que incorpora las intervenciones específicas y el presupuesto que se estaría asignando a dichas intervenciones. Asimismo, se reglamenta el mecanismo voluntario de resolución de controversias para contratos de APPs mediante la figura del "Amigable componedor".

Finalmente, mediante el Decreto Legislativo 1224 se establece el Sistema Nacional de Promoción de la Inversión Privada como un sistema funcional para el desarrollo de APPs y Proyectos en Activos, con el fin de promover, fomentar y agilizar la inversión privada, cuya rectoría la ejerce el Ministerio de Economía y Finanzas. De esta manera, el sistema está conformado por el MEF, organismos públicos del Gobierno Nacional, la Agencia de Promoción de la Inversión Privada, los Gobiernos Regionales y los Gobiernos Locales.

D. Conclusión

Como se desprende de lo descrito, el Gobierno Peruano está comprometido con diversas acciones para mejorar la eficiencia y sostenibilidad de la gestión fiscal, así como optimizar y fortalecer los mecanismos de provisión de servicios públicos ligados a las iniciativas privadas cofinanciadas.

El Gobierno se compromete a continuar avanzando en estos ámbitos, para lo cual requiere contar con el apoyo del Banco Mundial en las áreas señaladas.

En virtud de lo manifestado, por medio de la presente el Gobierno Peruano solicita la aprobación del "Programa de Gestión del Gasto Público y del Riesgo Fiscal" por un monto de US$ 1 250 millones por parte del Banco Mundial, bajo la modalidad de desembolso diferido.

Sin otro particular, hago propicia la ocasión para reiterarle a usted mi especial consideración.

Atentamente,

Jirón Junín N° 319, Lima 1 - Teléfonos 311-5900 311-5930

UNOFFICIAL TRANSLATION

Lima, January 12, 2016

LETTER No. 041 -2016-EF/10.01

LETTER OF POLICY

Mr.
Jim Yong Kim
President
World Bank
Av. Álvarez Calderón 185, San Isidro
Lima

Reference: *Public Expenditure and Fiscal Risk Management Program*

Dear Mr. Kim,

By means of this letter I wish to convey to you the commitment of the Government of President Ollanta Humala Tasso to promote progress in strengthening fiscal performance at the regional and local levels, and to support the development of investment through co-financed private initiatives, for the purpose of reducing gaps in infrastructure and public services based on compliance with fiscal rules.

In this context, Peru has been developing with the World Bank the "Public Expenditure and Fiscal Risk Management Program," which includes reform actions and commitments for 2015 and involves an operation with a deferred drawdown option.

Below we will describe the international context and Peru's economic context, then the Program's objectives, as well as the actions accomplished in the framework of the Program.

A. International context[1]

Indicators of the ***global economy*** *show mixed signs of recovery, accompanied by high volatility in the international financial markets. The advanced economies such as the United States and the Euro Zone continue to expand moderately, while emerging economies such as China and Latin America show discouraging results. The PMI[2] of global manufacturing was 50.9 points in December, slightly below November(51.2 points) and the average for July-November 2015 (51.0 points). Expectations are for global growth to decline. In October the International Monetary Fund (IMF) lowered its world growth projection for 2015 to 3.1%*

[1] *Information as of January 4, 2016.*
[2] *Purchasing Managers Index, prepared monthly based on surveys of the persons in charge of procurement of raw materials for private companies. Greater than 50 points shows expansion.*

(vs. 3.5% expected in January 2015), the lowest rate in six years, and for 2016 recovery is expected to be to 3.6%.

In the ***United States,*** *GDP growth declined from 3.9% in the second quarter of 2015 to 2.0%[3] in the third quarter of 2015. This sluggishness is due to the negative impact of private inventories (-0.59 percentage point), net exports (-0.22 percentage point), investment (-0.05 percentage point). Nevertheless, personal consumer spending remained strong (+2.05 percentage points), in a context in which the official unemployment rate (U3) and the rate that uses a broader definition of unemployment (U6) have been the lowest since February and May 2008, at 5.0% and 9.9% in November 2015, respectively. In view of the foregoing, the FED at its meeting of December 15-16 raised the interest rate for the first time in almost a decade, from a near-zero level to a range of between 0.25% and 0.50%.*

The ***Euro Zone*** *economy grew by 1.5% in the first three quarters of 2015, the most robust growth since 2011, showing recovery in employment and manufacturing, but was still weak in comparison with the pre-crisis level. The unemployment rate was 10.7% in October, the lowest rate since November 2011. The manufacturing PMI rose to 53.2 points in December, the highest recorded performance in twenty-one months. However, the consumer price index registered an annual rate of 0.1% in November, well below the inflation target of the European Central Bank (ECB) (2.0%). Against this backdrop, at its most recent meeting in December, the ECB lowered its deposit rate by ten basis points—from -0.20% to -0.30%—and extended the deadline for its monthly 60 billion Eurobond purchase program until March 2017 (the previous deadline had been set at September 2016). In October, the IMF forecast economic growth of the Euro Zone for 2015 at 1.5%, higher than that recorded in 2014 (0.9%), and for 2016 it forecast 1.6%.*

In ***China****, the latest information confirms slower economic growth: although China's economy grew by 7.0% in the first three quarters of 2015, the industrial and construction sector—the engine of economic activity and an intensive user of raw materials—grew by only 6.2%. The forward indicators show that the slowdown will continue in the upcoming months: (i) the official manufacturing PMI was contracting for the fifth consecutive month, at 49.7 points in December and (ii) Chinese exports fell for the fifth straight month, with a drop of -6.8 % in November.*

Based on information as of December 31, the Shanghai stock market declined by -31.5% from its "peak" (June 12, 2015), after surging ahead by 135% since August of the previous year. This has triggered serious doubts about the stability of the stock market and worries about the financial system in general. In October the IMF predicted that in 2015 China would have economic growth of 6.8%, lower than that recorded in 2014 (7.3%), and for 2016 it forecast 6.3%. In this context, the Chinese Government's thirteenth five-year plan set aggressive development targets with growth of 6.5%[4] for the next five years.

The countries of ***Latin America and the Caribbean*** *continue to show signs of economic deceleration, in a context of lower prices for raw materials, increased perception of risk,*

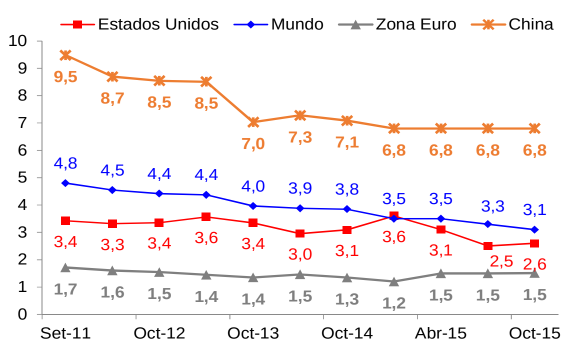
[3] *Third official estimate for third quarter of 2015*

[4] *The goals include: doubling GDP and personal income by 2020, eradication of poverty, and abandoning the single-child policy.*

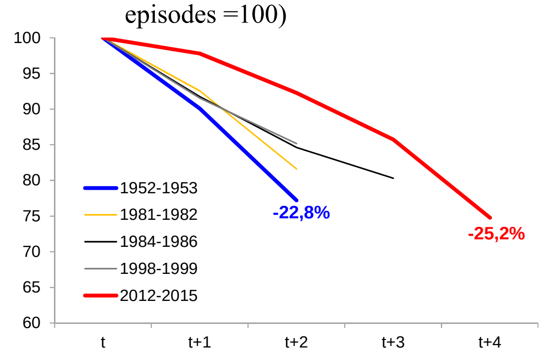
higher financing costs, and capital flight. In the third quarter of 2015: Brazil sank deeper into recession by -4.5%, accumulating six consecutive quarters of decline; Chile grew by 2.2%, similar to that registered in the first semester of 2015; Mexico grew by 2.6%, slightly better than the first half of 2015 (0.1%). Uruguay saw growth of just 0.6%, after the economy registered its first contraction in twelve years in the previous quarter (-0.3%) and Colombia's GDP recorded growth of 3.2%, lower than that of the third quarter of 2014 (4.2%). In the particular case of Brazil, given the economic contraction, political instability, the low prospects for economic growth, and the high fiscal deficit, rating agencies downgraded the country's sovereign credit rating; Standard & Poor's and Fitch removed their investment grade rating on September 9 and December 16, 2015, respectively.[5] *In October, the IMF predicted that for 2015 Latin America and the Caribbean will have an economic contraction of -0.3%, the first decline since 2009, and it forecast growth of 0.8% for 2016.*

Owing to reduced Chinese external demand and investors' preference for other financial assets, the prices of ***raw materials*** *fell significantly, continuing their downward trend since 2011. It should be noted that the slump in metal prices, which affects Peru's economy, is the longest and deepest in the past 65 years. In 2015*[6]*, the copper price fell -19.8%, gold fell -8.3%, and WTI petroleum fell -47.6%.*

World: Growth Projections for 2015 by the International Monetary Fund
(% of annual variation)



Episodes of Consecutive Declines in the IPX
(Index: Year before the decline episodes =100)



LA6: Brazil, Chile, Colombia, Mexico, Uruguay and Peru.
Source: IMF, BCRP.

B. National economic context

Peru's economy grew by 2.6% in the period January-October 2015, a figure slightly above that recorded in 2014 (2.4%), which was affected by a complex international scenario and temporary supply shocks. This result can be attributed to greater growth in the primary sectors (4.2%), over and above the non-primary sectors (2.5%).

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[5] *On August 11, 2015, Moody's dropped the foreign currency debt rating from "Baa2" to "Baa3" with a stable outlook, one step from losing the credit rating and revised the rating on December 9. On September 9, 2015, Standard & Poor's reduced its rating from BBB- a BB+, a "speculative grade," with a negative outlook. On December 16, 2015, Fitch lowered its rating to "BB+", a speculative grade with a negative outlook with a negative outlook.*

[6] *With respect to 2014*

- *At the sector level, GDP grew 3.0% in October, driven by the primary sectors that together grew by 7.0%, the highest rate in six months, with the metal mining sector experiencing double-digit growth (15.9%), recording eight months of uninterrupted growth and reflecting the start of the (copper) mining production cycle. Non-primary sectors grew by 2.4%, boosted by the stable growth of the sectors related to private consumption (business and services).*

- *The latest indicators show signs that the recovery will continue in the coming months:*

    - *According to the COES,[7] electric power production increased by about 11.8% in December, the highest gain in 65 months. On the demand side, demand by clients not bound by a supply contract for electric power grew 36.6% (mining companies 49.5% and manufacturing companies 13.3%); while other clients grew by 2.4%.*
    - *A strong El Niño Phenomenon (FEN) in the summer of 2016 is less likely. According to the latest forecast by the ENFEN[8] (National Committee for the Study of the El Niño Phenomenon), there is only a 5% probability of an FEN of extraordinary strength (comparable to 97-98) and the likelihood of a strong phenomenon was reduced to 35%, while the probability of a moderate El Niño phenomenon increased to 50%.*
    - *According to the IMARPE, anchovy unloading is projected to amount to 550,000 MT in December; this should significantly boost the growth of the sector, especially since there were zero unloading last year. Taking into account unloading figures for November, the accumulated amount should be 76% of the authorized quota (1.11 million MT).*
    - *According to data from Perupetro, hydrocarbons production fell -5.6% in December, the least significant reduction in six months, owing to a decline in oil production of roughly -11.8% and the drop in the international price of crude and LNG (-4.8%), the most favorable rate in six months. Production of Natural Gas grew 1.8%, making for three consecutive months of continuous growth.*
    - *In December 2015, the index of the progress of implementation of public works fell -3.7%[9], the smallest decline for the year and lower than the rate recorded for January-November 2015: -19.6%.*
    - *According to the BCRP, in November credit in soles grew by 29.2%. However, credit in dollars declined -19.4%, recording negative rates for the eleventh straight month, due to the reduction in credits to businesses (-19.6%) and families (-19.5%). The lower advance in dollar credits has made it possible to reduce the dollar portion of the loans to 30.8%, -9.7 percentage points since the start of 2014.*
    - *According to the INEI, in the September-November 2015 moving quarter, employment in Greater Lima grew by 2.2% (vs. 1.8 % in the previous period), the most significant increase in 21 periods. However, salaried employment fell to 0.7% on an annualized basis (against 2.5% for the previous period), the lowest rate for the last four recorded periods. The unemployment rate (5.8%) remained unchanged with respect to the previous moving quarter. Wage income increased by 4.2%, higher than the previous period (2.3%) and the average rate of the three previous periods (1.9%).*

[7] *Committee on Economic Operation of the Interconnected National System*
[8] *December 17*
[9] *Preliminary figures. Includes estimated cancellations of 400 million soles.*

- *According to the Ministry of Labor and Promotion of Employment, in October 2015 employment in companies with 10 or more workers in the urban area grew by 1.4%, the biggest advance in ten months. This result is due to the positive performance of four of the five areas of activity: transport, storage and communications (4.3%), services (2.1%), followed by trade (1.6%) and the extractive industries (1.2%). However, employment in the manufacturing industry has been in negative territory (-1.1%) for nearly the past two years.*
- *However, deterioration in the external sector persisted owing to the greater deceleration in China, Latin America, the Euro Zone, and the slump in international metal prices. According to the SUNAT, total exports in November declined by -14.2%. This result is explained by the contraction of export prices (-14.7%), while the volume of exports increased slightly (0.6%). Traditional exports decreased by -16.3%, mainly because of smaller shipments of mining products (-9.7%) such as gold (-18.3%), copper (-7.8%), and zinc (-6.8%). Non-traditional exports declined by -10.0% (the tenth consecutive decline), because of smaller shipments of fishing products (-29.9%), textiles (-25.7%), metalworking (-24.3%), iron and steel metallurgy (-21.6%) and chemicals (-10.2%.).*
- *According to the SUNAT, imports of consumer goods in November decreased by -1.4%, (second consecutive decline). This negative performance is explained mainly by a decline in imports of durable goods (-8.0%, with three consecutive months of decline).*

We therefore expect the economy to grow by about 3.0% in 2015, in agreement with the MMMR 2016-2018. The market consensus is that in 2015 Peru's economy will do better than in 2014. According to the latest survey of Consensus Forecasts (CF) in December, Peru's economy is projected to grow by 0.4 percentage point, from 2.4% in 2014 to 2.8% in 2015, followed by Chile (0.2 percentage point, from 1.9% in 2014 to 2.1%) and Mexico (0.1 percentage point, from 2.3% in 2014 to 2.4%). In the other direction, growth in Colombia is projected to decelerate by -1.7 percentage point, from 4.6% in 2014 to 2.9% in 2015.

For 2016, GDP growth is projected to accelerate to 4.3% based on:

- *A moderately expansive fiscal policy, adopted as a precautionary measure through Emergency Decree 003-2015, which provides for strengthening the Government's response to the El Niño phenomenon and maximizing its multiplier effect on economic activity through increased public investment.*
- *Substantially increased investment in large-scale infrastructure through public-private partnerships (PPPs).*
- *Greater growth in metallic mining given the start of production at Las Bambas and the expansion of Cerro Verde, the greater production of projects such as Toromocho and Constancia, as well as resumption of production at Antamina.*
- *Greater growth expected among the principal trading partners, particularly in Latin America and the Caribbean, and the United States, which will stimulate demand for non-traditional exports, which are expected to expand by 6.7% (2015: -2.3%).[10]*

C. Reforms associated with the Public Expenditure and Fiscal Risk Management Program

[10] *Figures reported in the Multiannual Macroeconomic Framework 2016-2018 Revised.*

In keeping with the foregoing, the Peruvian Government is aware of the need to strengthen institutional mechanisms to promote responsible public management at the different levels of government, and to continue to close the existing gaps in infrastructure and public services through private participation mechanisms.

In this context, the Peruvian Government, with the World Bank's support, has developed the Public Expenditure and Fiscal Risk Management Program (the "Program"), which seeks to promote more efficient public spending at the subnational level, and to improve the public-private partnerships mechanism.

The Program supports the adoption of policy reforms that are structured into two main pillars: (i) Improved management and accountability of public spending by subnational governments, and (ii) Improvement of the government's legal and institutional framework to evaluate fiscal risks in public-private partnerships and accelerate their implementation.

C.1 Improving management and reporting of public expenditure in subnational governments

The Government is currently developing the necessary mechanisms to ensure a prudent, responsible, transparent, and predictable administration, for which one of the priorities is to ensure fiscal sustainability and the proper use of public funds.

In this context, it has been considered desirable to strengthen the management and reporting framework of subnational governments, monitor their management, establish a mechanism for independent technical analysis of macro fiscal policy, and improve the quality of human resources in the public entities at the different levels of government.

With respect to strengthening the management and reporting framework of subnational governments, the Program incorporates procedures to define the methodology to determine the fiscal rules, the requirements for reporting and transparency by the subnational governments, and the establishment of penalties for noncompliance.

The Program considers it necessary to provide support to the regional and local governments to facilitate the process of implementation of fiscal rules, and to monitor them, for which it has established that the General Directorate of Macroeconomic Policy and Fiscal Decentralization of the Ministry of the Economy and Finance (MEF) will be the entity responsible for monitoring fiscal and financial management and providing the necessary technical assistance.

In addition, the Program provides for the implementation of the Fiscal Council as an autonomous commission attached to the MEF that is responsible for issuing a non-binding opinion on macro fiscal policy with respect to amendments to the fiscal rules and their compliance, fiscal projections covered in the Multiannual

Macroeconomic Framework, and short and medium term evolution of public finance, among others.

To improve human resources management in the public sector, especially in the regional and local governments, the Program is promoting the civil service reform, within which a new category of public managers called Public Directors has been created, subject to merit-based recruitment and performance evaluations.

C.2 Improving the Government's legal and institutional framework for public-private partnerships

From the public investment standpoint, the Government is promoting a series of measures that contribute to closing the gaps in infrastructure and public services throughout the country, emphasizing the development of public-private partnership systems (PPPs) schemes. Although promotion of private investment began more than two decades ago, it is necessary to adjust the regulatory instruments to ensure consistency with proper fiscal responsibility.

In this regard, it is necessary to move ahead to ensure adequate resources required for future PPP schemes in the budget, and to ensure that prioritized private initiatives that receive co-financing are those with robust business cases. It is also necessary to designate the National System for the Promotion of Private Investment as the maximum authority, strengthen the regulatory framework for the structure and operation of the PPPs, to incorporate a procedure for dispute resolution, and to have a unified regulatory framework to promote private investment through PPPs.

In this way, the Program includes regulatory amendments that provide for the inclusion of PPPs in the budget process, and ensure that co-financed private initiatives comply with eligibility requirements and that the Evaluation Report and the final version of the PPP contract are subject to the prior opinion of the MEF.

In line with the above, through Legislative Decree 1224, the MEF has been designated as the governing body and highest technical and regulatory authority of the National System for the Promotion of Private Investment. It is responsible for ensuring compliance with the policy for the promotion and development of Public Private Partnerships and Asset Projects ("Proyectos en Activos"), with the participation of all State entities at the various levels of Government and within their respective areas of competence. Furthermore, with the creation of the General Directorate for Private Investment Promotion Policy (DGPPIP) within the MEF structure, implementation of the new PPP regulatory structure will be facilitated.

Furthermore, a new legal framework stipulating the procedure for new co-financed private initiatives has been defined. It includes the roles and responsibilities of entities participating in the process, and establishes the requirement for issuing a

Supreme Decree including specific interventions and the budget allocations for such interventions. Furthermore, the framework regulates the voluntary mechanism for dispute resolution of PPP contracts through the intervention of a neutral third party ("Amigable componedor"*).*

Finally, Legislative Decree 1224 has established the National Private Investment Promotion System as a functional system for the development of PPPs and Asset Projects in order to promote, encourage, and simplify private investment, which is overseen by the Ministry of Economy and Finance. The system is made up of the MEF, public organs of the national government, the Agency for the Promotion of Private Investment, the regional governments, and the local governments.

D. Conclusion

As can be seen from the above information, the Peruvian Government is committed through various actions to improve the efficiency and sustainability of fiscal management, and to optimize and strengthen the mechanisms for providing public services linked to co-financed private initiatives.

The Government pledges to make further progress in these areas, which will require the support of the World Bank in the indicated areas.

Therefore, by means of this letter the Peruvian Government requests approval of the "Public Expenditure and Fiscal Risk Management Program" in the amount of US$1.25 billion by the World Bank, under the deferred drawdown option.

Please accept, Sir, the renewed assurances of my respectful consideration.

Yours truly,

Alonso Segura Vasi

ANNEX 3: FUND RELATIONS ANNEX

Peru—Assessment Letter for the World Bank

(Documentation to support the proposal on Boosting Human Capital and Productivity Development Policy Financing with a Deferred Drawdown Option and the Public Finance Management Development Policy Financing with a Deferred Drawdown Option)

December 7, 2015

1. **Peru's good growth performance over the past decade was recognized by the IMF Executive Board at the conclusion of the 2015 Article IV Consultation.** Directors commended Peru's impressive macroeconomic performance, underpinned by strong fundamentals and sound policy management. The country achieved high growth, low inflation and low public debt, and made progress in reducing poverty and improving living standards. Given the current downturn, Directors emphasized the importance of continued implementation of flexible and coordinated policies as well as structural reforms to maintain macroeconomic stability and foster more inclusive long-term growth.

2. **As in the rest of the region, the pace of economic activity slowed markedly in 2014.** Real GDP grew by 2.4 percent in 2014 (down from 5.5 percent on average over the last 5 years) due to a combination of adverse external and domestic factors. External shocks were compounded by an unexpected drop in sub-national investment and temporary supply disruptions in mining, agriculture and fishing. These developments lingered into this year and staff revised down the growth forecast for 2015 from 3.8 to 2.4 percent in the *October WEO*. Growth is expected to rise above 3 percent in 2016 as new mines come on stream and large infrastructure projects unfold.

3. **Inflation has been above the 3 percent upper band of the central bank target since end-2014 due to supply shocks and currency depreciation.** The central bank increased the policy rate from 3.25 to 3.5 percent in September, but left it unchanged in two subsequent meetings, to ensure that medium-term inflation expectations remain anchored despite further currency depreciation. While expectations are well anchored, financial market participants expect a return to the target range (1 to 3 percent) only in 2017.

4. **The authorities have drawn on their large fiscal buffers to provide stimulus to the economy.** After being in balance in 2014, the fiscal position is expected to switch into a deficit of about 2 percent on the back of a significant decline in commodity and tax revenue—due to the reduction in income tax rates as part of the stimulus measures and slow economic growth. The final deficit figure for the year could be lower, however, if sub-national spending continues to underperform. While Peru has ample policy space to undertake countercyclical fiscal policy, allowing such a deficit required an application of an exceptional clause under the new fiscal rule. Gross public debt is expected to grow to 22 percent of GDP in 2015, which is still low by regional standards. While the authorities envisage a fiscal deficit of 3 percent in 2016 due to the effect of lower growth on revenue and provisions for El Niño, which augmented the capital expenditure envelope, staff projects the

deficit to be below 2.5 percent of GDP given persistent difficulties in the execution of public investment.

5. **The external current account deficit has been narrowing, despite further deterioration in the terms of trade.** The current account deficit was around 4 percent of GDP in 2014, and international reserves declined by around US$3 billion as capital flows were insufficient to cover the deficit. The current account deficit is expected to shrink further in 2015, to below 4 percent, not least due to a sharp reduction in imports and investment income payments; it remains fully financed, mostly by long-term flows. Exchange rate policy has been more flexible over the past two years, although the central bank intervened both in the spot and forward markets to limit excessive volatility. The sol depreciated 13.7 percent (yoy) as of mid-November 2015 and has been trading recently at 9-year lows. The real exchange rate is assessed to be broadly in line with fundamentals and NIR stood at around US$62 billion (about 30 percent of GDP) in October 2015.

6. **The financial sector remains healthy.** Despite some weaknesses identified in a few small non-bank depository institutions, the overall health of the financial system remains solid. Private credit growth has remained robust (at about 10 percent yoy in September 2015) and credit dollarization has continued to decline in response to measures introduced by the central bank (31.5 percent of total credit in September was in U.S. dollar compared to 39 percent a year earlier). At the beginning of November, the central bank set a new target for financial institutions' de-dollarization process, specifying that by December 2016 they must reduce the stock of U.S. dollar-denominated credit by 20 percent from the levels of September 2013.

7. **The current policy mix is broadly adequate.** Monetary conditions remain appropriately accommodative, but policymakers should remain attentive to inflation expectations. Exchange rate flexibility remains key for cushioning external pressures. Given the continuing difficulties with execution of capital expenditure at the local level, greater spending is encouraged at the central government level, mainly through improving the rates of execution. However, scaling up of public investment should be in line with enhancements in public financial management capacity, also at the sub-national level, in order to ensure high rates of return for investment projects. There is also a need to increase revenue collection to offset the recent erosion of tax revenues due to income tax rate cuts. As the recovery takes hold, a gradual fiscal consolidation will be appropriate. Over the medium term, it would be advisable to target a small structural fiscal surplus of ½ percent of GDP to preserve buffers in light of commodity shocks, natural disaster risks, and contingent liabilities.

8. **Downside risks are manageable given large international reserves and fiscal buffers.** Peru is already facing a significant terms-of-trade shock, with further risks to the downside. The outlook is subject to other important risks, such as a more rapid economic slowdown in China, normalization of monetary policy in the United States, uncertainties

linked to the 2016 presidential elections in Peru, and a possibly more severe El Niño weather phenomenon. The effects of potential shocks should be cushioned by ample fiscal policy space, including the low levels of debt and high savings, together with still high NIR, which are adequate according to the Fund's reserve metrics, and Peru should be using its buffers wisely. Boosting Peru's productive potential and ensuring all-inclusive growth requires steadfast implementation of structural reforms to enhance productivity, investment, human capital, and formal employment.

Peru: Selected Economic Indicators

(Post-October WEO Projections)

		Prel.	Proj.					
	2013	2014	2015	2016	2017	2018	2019	2020
Social Indicators								
Life expectancy at birth (years) 1/	74.8	...	...	...	...	...	...	...
Infant mortality (per thousand live births)	12.9	...	...	...	...	...	...	...
Adult literacy rate 1/	93.8	...	...	...	...	...	...	...
Poverty rate (total)	23.9	...	...	...	...	...	...	...
Unemployment rate	5.9	5.9	...	...	...	...	...	...
	(Annual percentage change; unless otherwise indicated)							
Production and prices								
Real GDP	5.8	2.4	2.4	3.3	5.5	5.2	4.3	4.0
Real domestic demand	6.9	2.2	2.1	2.0	5.3	4.7	4.1	4.0
Consumer prices (end of period)	2.9	3.2	3.9	3.4	2.5	2.0	2.0	2.0
Consumer prices (period average)	2.8	3.2	3.5	3.0	2.5	2.0	2.0	2.0
External sector								
Exports	-9.6	-7.8	-14.2	2.0	9.9	8.9	6.5	5.4
Imports	2.7	-3.4	-10.5	0.1	8.2	6.4	5.2	4.6
Terms of trade (deterioration -)	-5.7	-5.4	-5.1	-3.1	0.6	0.6	0.4	0.6
Real effective exchange rate (depreciation -)	-0.2	-1.5	...	...	...	...	...	...
Money and credit 2/ 3/								
Broad money	14.8	8.4	13.8	15.1	13.4	13.5	13.5	13.5
Net credit to the private sector	18.4	13.5	13.8	15.1	13.4	13.5	13.5	13.5
	(In percent of GDP; unless otherwise indicated)							
Public sector								
NFPS revenue	27.9	27.4	25.4	25.4	25.2	25.3	25.4	25.4
NFPS primary expenditure	25.9	26.6	26.6	26.5	26.0	25.6	25.3	25.2
NFPS primary balance	2.0	0.7	-1.2	-1.2	-0.8	-0.2	0.2	0.2
NFPS overall balance	0.9	-0.3	-2.3	-2.4	-2.0	-1.5	-1.0	-0.9
External Sector								
External current account balance	-4.2	-4.0	-3.7	-3.5	-3.6	-3.5	-3.4	-3.3
Gross reserves								
In millions of U.S. dollars	65,710	62,353	58,853	58,353	58,153	58,053	57,953	58,703
Percent of short-term external debt 4/	539	508	425	484	506	493	450	509
Percent of foreign currency deposits at banks	275	262	260	250	237	225	216	212
Debt								
Total external debt	27.3	29.7	32.0	32.3	30.3	28.3	26.2	24.9
Gross non-financial public sector debt (incl. repayment certificates)	20.3	20.7	22.3	24.4	24.5	24.1	23.5	23.5
External	8.8	8.8	9.3	9.8	9.6	8.9	7.9	7.6
Domestic	11.5	12.0	13.1	14.6	14.9	15.2	15.6	15.9
Savings and investment								
Gross domestic investment	27.8	26.2	25.3	23.9	25.0	25.0	25.0	24.9
Public sector (incl. repayment certificates)	5.8	5.6	5.1	5.0	5.0	5.0	5.1	5.1
Private sector (incl. inventories)	22.0	20.6	20.2	18.9	20.0	20.0	19.9	19.8
National savings	23.6	22.2	21.7	20.4	21.4	21.5	21.7	21.7
Public sector	7.1	5.8	3.3	3.3	3.7	4.3	4.8	5.0
Private sector	16.5	16.4	18.4	17.2	17.7	17.2	16.9	16.7
Memorandum items								
Nominal GDP (S/. billions)	545.6	575.2	604.2	634.7	683.8	734.3	781.3	830.2
GDP per capita (in US$)	6,524	6,449	5,652	5,596	5,937	6,278	6,579	6,883

Sources: National Authorities; UNDP Human Development Indicators; and Fund staff estimates/projections.
1/ Data for 2012.
2/ Corresponds to depository corporations.
3/ Foreign currency stocks are valued at end-of-period exchange rates.
4/ Short-term debt is defined on a residual maturity basis and includes amortization of medium and long-term debt.