



PERU

July 2018

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR PERU

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Peru, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 9, 2018 consideration of the staff report that concluded the Article IV consultation with Peru.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 9, 2018 following discussions that ended on May 22, 2018 with the officials of Peru on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 18, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Peru.

The documents listed below have been or will be separately released.

Financial Stability System Assessment

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IMF Executive Board Concludes 2018 Article IV Consultation with Peru

On July 9, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Peru.

Peru has been one of the top performers in Latin America since the turn of the century. Robust growth has helped close the income gap with the largest regional economies and reduce poverty significantly, while inflation has remained low. Sound macroeconomic and structural reforms have played an indispensable role in this.

After a difficult 2017, the economy is recovering. Extreme weather caused by El Niño and spillovers from the Odebrecht investigation led to subpar growth in 2017, and the poverty ratio increased. While high commodity prices are currently supporting investment and broader economic activity, domestic headwinds have continued. The Odebrecht case led to the resignation of President Kuczynski. The authorities have also been facing the challenge of rebuilding infrastructure damaged by El Niño. In the face of this, the new Cabinet has moved quickly to implement various measures and receive special legislative powers from Congress to speed up the reconstruction and implement needed reforms. Recent indicators suggest a pickup in economic activity.

Against this backdrop, growth in 2018 is expected to increase to 3.7 percent, supported by countercyclical fiscal and monetary stimulus. In 2019–20, the recovery of private domestic demand is expected to push growth above 4 percent, even as gradual fiscal consolidation takes place. In the medium term, growth is projected to converge to its potential of 4 percent. Headline inflation is expected to gradually increase to the center of the central bank target range of 1–3 percent by end-2018.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment²

Executive Directors commended the authorities for implementing sound macroeconomic policies and key structural reforms over the past two decades, which have helped keep inflation low, raise incomes and reduce poverty. While medium-term risks are tilted to the downside, high copper prices and reduced political uncertainty create a window of opportunity for addressing remaining challenges and increasing potential growth.

Directors agreed that the fiscal policy stance should remain countercyclical in 2018. Given the negative output gap, Directors supported the authorities' objective to expand public investment to meet the significant reconstruction needs after the flooding and landslides, while also stressing the importance of increasing implementation capacity of subnational governments.

Directors welcomed the commitment to medium-term fiscal consolidation, under the fiscal responsibility framework. They supported the focus on revenue mobilization through strengthening tax policy and administration, and streamlining current expenditures to help free up space for much needed public investment.

Directors considered that the accommodative monetary policy stance remains appropriate and that monetary policy should remain data dependent. While the central bank has improved the communication of its policy guidance, it could consider further enhancements in this area. Directors underscored that exchange rate flexibility is an important shock absorber, and foreign exchange interventions should continue to be two-sided and limited to addressing disorderly market conditions.

Directors observed that the financial sector remains sound and resilient to severe macroeconomic shocks, as shown by the stress tests, thanks to a robust supervisory framework, although high concentration, off-balance sheet positions, and common exposures call for continued monitoring of risks and for increasing capital surcharges for systemically-important banks. Directors welcomed the reduction in financial dollarization, but stressed the importance of taking steps to reduce it further. Directors recommended further improvement of the macroprudential framework, including by giving enhanced mandates for macroprudential policy to the central bank and the financial supervisor.

Directors underscored the need for continued structural reforms to tackle the long-standing challenge of high informality and low productivity. Directors called for further efforts to strengthen governance, improve education, increase labor market flexibility, and enhance financial deepening and inclusion. They highlighted the importance of reforming the pension system to enhance social protection and reduce inequities.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Peru: Selected Indicators Table

	2013	2014	2015	2016	Prel. 2017	Proj. 2018	2019
Social Indicators							
Life expectancy at birth (years)	74.2	74.4	74.7	74.9	...	...	...
Infant mortality (per thousand live births)	13.5	12.9	12.4	11.9	...	...	...
Adult literacy rate	93.8	93.7	94.2	94.2	...	...	...
Poverty rate (total) 1/	23.9	22.7	21.8	20.7	21.7	...	...
Unemployment rate	5.9	6.0	6.5	6.7	6.9	...	...
Production and prices							
Real GDP	5.8	2.4	3.3	4.1	2.5	3.7	4.1
Real domestic demand	7.3	2.2	2.9	1.1	1.6	4.5	4.7
Real domestic demand (contribution to GDP)	7.4	2.2	2.9	1.1	1.6	4.4	4.7
Consumption (contribution to GDP)	4.3	3.1	3.7	2.0	1.7	3.0	2.9
Investment (contribution to GDP)	3.0	-0.9	-0.7	-1.0	-0.1	1.4	1.8
Net Exports (contribution to GDP)	-1.5	0.2	0.4	3.0	0.9	-0.7	-0.6
Output gap (percent of potential GDP)	1.7	-0.2	-0.9	-0.6	-1.1	-1.1	-0.8
Consumer prices (end of period)	2.9	3.2	4.4	3.2	1.4	2.2	2.0
Consumer prices (period average)	2.8	3.2	3.5	3.6	2.8	1.3	2.0
External sector							
Exports	-9.6	-7.8	-12.9	7.6	21.3	13.2	4.0
Imports	3.3	-3.1	-9.0	-5.9	10.0	9.8	6.0
Terms of trade (deterioration -)	-5.2	-5.4	-6.4	-0.7	7.3	6.0	0.4
Real effective exchange rate (depreciation -)	-0.2	-1.6	0.8	-2.4	1.4	n.a.	n.a.
Money and credit 2/ 3/							
Broad money	15.3	9.5	11.6	4.3	8.8	8.8	8.5
Net credit to the private sector	18.3	13.2	14.0	5.0	5.1	7.5	7.3
Public sector							
NFPS revenue	27.7	27.7	24.9	23.2	23.0	23.4	23.9
NFPS primary expenditure	25.7	26.9	25.9	24.6	24.9	25.4	25.2
NFPS primary balance	2.0	0.8	-1.0	-1.4	-1.9	-2.0	-1.3
NFPS overall balance	0.9	-0.3	-2.0	-2.5	-3.1	-3.3	-2.7
NFPS structural primary balance 4/	0.7	-0.3	-0.5	-1.1	-1.5	-1.7	-1.1
External sector							
External current account balance	-4.6	-4.4	-4.8	-2.7	-1.3	-1.7	-1.8
Gross reserves							
In billions of U.S. dollars	65.7	62.4	61.5	61.7	63.7	63.7	64.2
Percent of short-term external debt 5/	536	534	523	450	312	478	454
Percent of foreign currency deposits at banks	274	258	224	230	225	220	222
Debt							
Total external debt 6/	29.9	34.1	38.1	38.2	35.7	33.1	31.2
Gross non-financial public sector debt 7/	19.9	20.6	23.9	24.4	25.3	26.6	27.6
External	8.8	8.7	11.1	10.3	8.7	8.5	8.3
Domestic	11.1	11.8	12.8	14.0	16.6	18.2	19.4
Savings and investment							
Gross domestic investment	25.8	24.9	24.1	22.6	21.4	21.9	22.6
Public sector (incl. repayment certificates)	5.8	5.6	5.0	4.8	4.5	4.8	5.0
Private sector (incl. inventories)	20.1	19.3	19.1	17.8	16.9	17.1	17.6
National savings	21.2	20.5	19.3	19.9	20.2	20.2	20.8
Public sector	7.0	6.0	3.8	2.7	2.0	2.2	3.0
Private sector	14.2	14.5	15.6	17.2	18.2	18.0	17.7
Memorandum items							
Nominal GDP (\$/ billions)	548.2	576.5	612.7	659.7	701.8	749.0	796.9
GDP per capita (in US\$)	6,655	6,586	6,168	6,208	6,762	7,198	7,533

Sources: National authorities; UNDP Human Development Indicators; and Fund staff estimates/projections.

1/ Defined as the percentage of households with total spending below the cost of a basic consumption basket.

2/ Corresponds to depository corporations.

3/ Foreign currency stocks are valued at end-of-period exchange rates.

4/ Adjusted by the economic cycle and commodity prices, and for non-structural commodity revenue. The latter uses as equilibrium commodity prices a moving average estimate that takes 5 years of historical prices and 3 years of forward prices according to IMF World Economic Outlook.

5/ Short-term debt is defined on a residual maturity basis and includes amortization of medium and long-term debt.

6/ Includes local currency debt held by non-residents and excludes global bonds held by residents.

7/ Includes repayment certificates.



PERU

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

June 18, 2018

KEY ISSUES

Context. Peru has been one of the top performers in Latin America since the turn of the century: robust growth has helped close the income gap with the largest regional economies and reduce poverty significantly. Last year, however, growth was subpar and the poverty ratio increased. While high commodity prices are an important tailwind, the economy is facing domestic headwinds. The Odebrecht case led to the resignation of President Kuczynski, and the new cabinet has moved quickly to implement various measures and request special legislative powers from Congress. The authorities have also been facing the challenge of rebuilding infrastructure following the extreme weather caused by El Niño in 2017.

Outlook and Risks. Growth is expected to increase to 3.7 percent in 2018, supported by countercyclical fiscal stimulus. It should rise to above 4 percent in 2019–20, driven by private sector domestic demand, even as gradual fiscal consolidation takes place. In the medium term, growth is projected to converge to potential of 4 percent. Risks are balanced in 2018, with potential for further delays in implementing investment projects and PPPs, given capacity constraints, offset by higher spillovers from the pickup in commodity prices. Risks are, however, tilted to the downside beyond 2018, mainly reflecting potential external shocks. Peru has ample buffers, such as low public debt and high international reserves, to withstand possible negative shocks.

Policy Advice. In the short term, countercyclical fiscal and monetary policies remain appropriate given a negative output gap and anchored inflation expectations. Structural reforms are an indispensable complement to raise potential growth, further reduce poverty, and maintain financial stability. Important issues are strengthening the tax system, improving public investment and PPP management, buttressing macroprudential policies and financial sector oversight, improving governance, and enhancing the pension system's social protection role.

Approved By
Krishna Srinivasan
(WHD) and Zeine
Zeidane (SPR)

Discussions took place in Lima and Trujillo during May 8–22, 2018. The staff team comprised Ravi Balakrishnan (Head), Dmitriy Kovtun, Frederik Toscani (all WHD), and Yen Mooi (MCM). Adrian Robles and Irina Sirbu (WHD) provided assistance. Krishna Srinivasan (WHD, Deputy Director) attended some meetings and Prasad Ananthakrishnan (MCM, FSAP Mission Chief) participated in the closing meetings. Pedro Rodriguez (WHD), Roberto Schatan (FAD), and Romain Lafarguette (MCM) contributed to specific sections of the report. Staff met with the Prime Minister, César Villanueva; the Minister of Economy and Finance, David Tuesta; the Central Bank Governor, Julio Velarde; other senior central government officials; the Regional Governor of La Libertad, Luis Valdes Farías; and representatives of the private sector and civil society. Mr. Armas (OED) also participated in the discussions.

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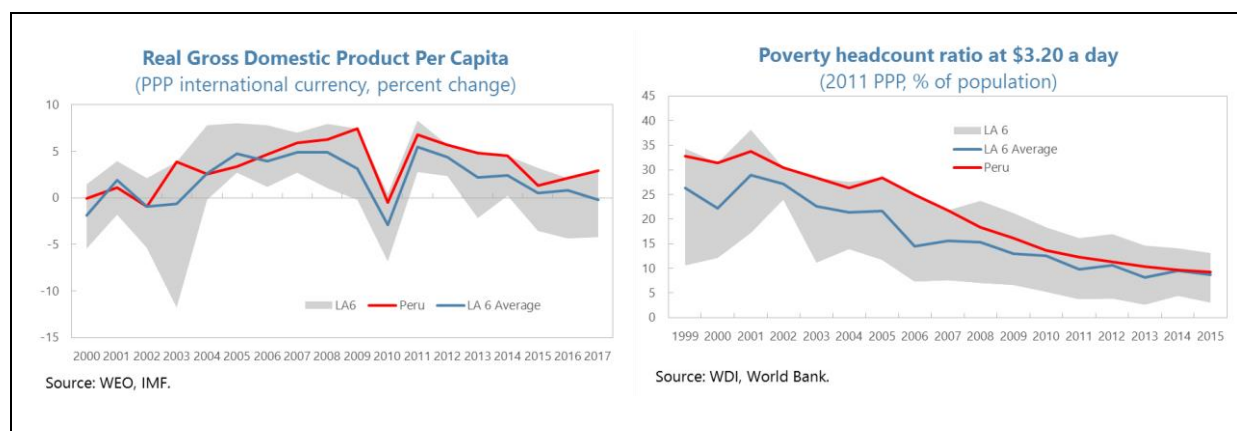
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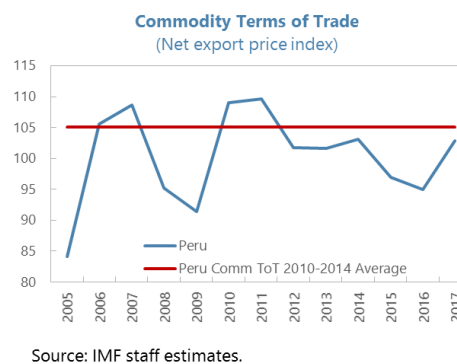
CONTEXT

1. In the context of a commodity boom, Peru has been one of the top performers in Latin America since the turn of the century. Robust growth has helped Peru to close the income gap with the largest Latin American economies and reduce poverty significantly (chart). Inflation has remained low, the fiscal position has strengthened, dollarization has declined markedly, and financial deepening has continued. Sound macroeconomic and structural reforms have played an indispensable role in this, and Peru's macroeconomic policies have been broadly in line with staff's advice (Annex I).



2. High commodity prices are a significant tailwind, but domestic headwinds persist. Commodity prices have picked up significantly since mid-2016, although Peru's commodity terms of trade are still below the average during 2010–2014 (chart). On the domestic side, rebuilding infrastructure and housing following the worst floods and landslides in recent memory last year is proving to be a slow process given logistical challenges and capacity constraints.

Moreover, the spillovers from the *Lava Jato* corruption investigation have been widespread and led to major political dislocations. President Kuczynski resigned in March 2018, following two impeachment attempts related to his financial links with the Brazilian construction company Odebrecht. The probe is still ongoing, with other key political figures under investigation for receiving illegal campaign financing. A minimum wage hike of around 9½ percent was also approved in March. Regional elections take place in October 2018.

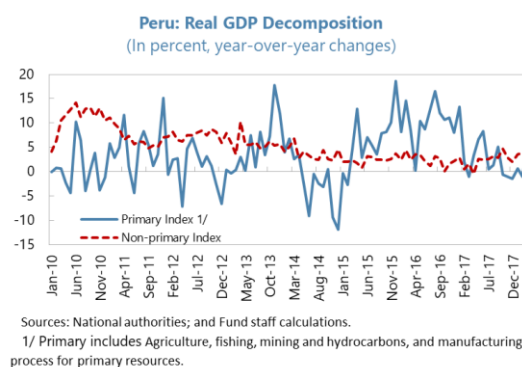


3. Against this backdrop, new President Vizcarra and his Cabinet have moved quickly to implement measures and request special legislative powers from Congress. Fiscal measures include excise tax hikes, improving tax administration, and streamlining current expenditures. A law (30737) was passed to provide more clarity on civil damages in corruption cases and set out rules for asset transfers by construction companies under investigation or those convicted. Special powers

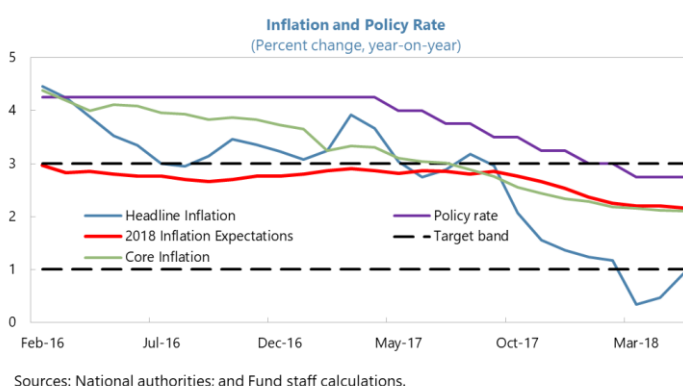
were also requested in six areas: (i) tax policy and administration; (ii) competitiveness; (iii) post-El Niño reconstruction and closing infrastructure gaps (already granted); (iv) anti-corruption measures; (v) protection of vulnerable groups (and preventative measures), and (vi) modernization of the state.

RECENT DEVELOPMENTS

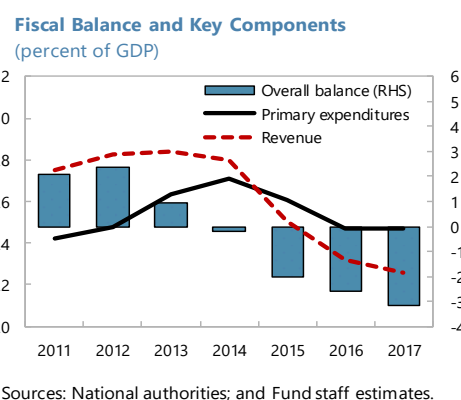
4. Growth and employment creation were subpar in 2017, but activity has picked up in 2018. While non-primary demand picked up in 2017 (chart, Figure 1), the impulse was not strong enough to offset flattening mining volumes. 2017 GDP growth was only 2½ percent and the output gap remains negative. Employment continued to grow in 2017. In 2018Q1, GDP growth increased to 3.2 percent (yoy) and high frequency indicators for April point to a further rebound in activity.



5. Inflation has declined, and the BCRP has eased monetary policy (Chart, Figure 1). Inflation declined from early 2017 to March 2018, reflecting dissipating weather effects, an appreciating sol, and soft growth conditions. By May 2018, headline inflation had rebounded to 0.9 percent, still below the 1–3 percent target range. Core inflation and inflation expectations have also been declining, and in May 2018 stood at 2.1 and 2.2 percent, respectively. The BCRP gradually reduced the policy rate starting in May 2017 from 4¼ to 2¾ percent and has been on hold since April 2018. The BCRP has also reduced reserve requirements, particularly for foreign currency deposits.¹



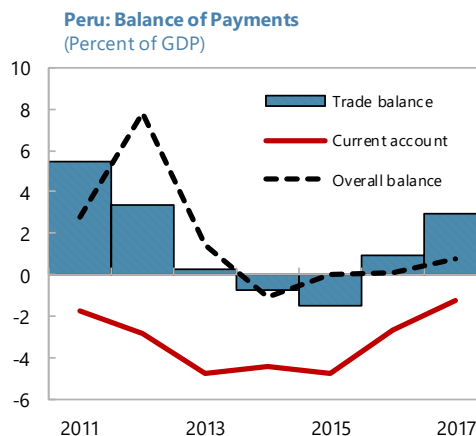
6. The fiscal deficit increased in 2017, reflecting temporary shortfalls in revenue in H1 2017 and a planned fiscal stimulus, but narrowed in early 2018. Tax revenues, which in 2017 were affected by the adverse weather event (El Niño Costero) and weak growth conditions, have started to recover in 2018 (21 percent



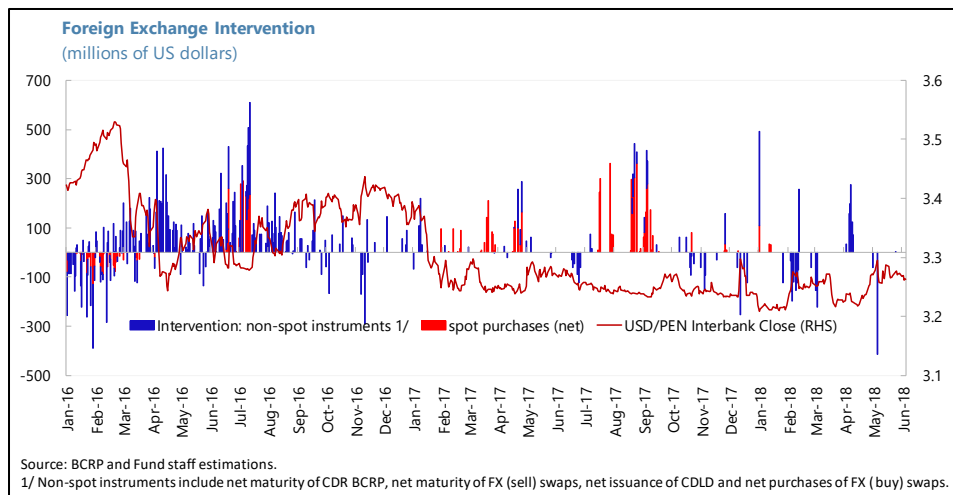
¹ The marginal reserve requirement rates on FX and local currency liabilities have been gradually reduced from 70 and 6.5 percent in December 2016 to stand at 36 and 5 percent, respectively, in June 2018.

growth yoy in January-April). Public investment grew about 14 percent (y/y). As a result, the 12-month cumulated deficit of the NFPS through April narrowed to 2.7 percent of GDP. Public debt closed 2017 at 25¼ percent of GDP, a large cushion with respect to the fiscal rule ceiling of 30 percent of GDP (Figure 2).

7. The current account has improved (Figure 3, Annex II). Peru’s goods’ exports grew 21 percent in 2017 given increasing commodity prices (particularly of metal products), new copper mines coming on stream, and a growing nontraditional export sector (mainly agricultural products). Reflecting this, the 2017 current account deficit declined to 1.3 percent of GDP deficit (chart), and the external position in 2017 was assessed as moderately stronger than implied by fundamentals, although the gap is expected to narrow in 2018 and beyond (Appendix II). The exports trend continued in early 2018, although volumes have moderated as the new mines reach production capacity. The sol has remained broadly stable against the U.S. dollar in 2018, although there have been episodes of volatility, such as before the first impeachment vote in mid-December and the global stock market jitters in February. In response, the central bank has intervened, mainly with non-spot instruments (chart). There have been no changes in capital flow management measures (CFMs) since the last Article IV consultation.²



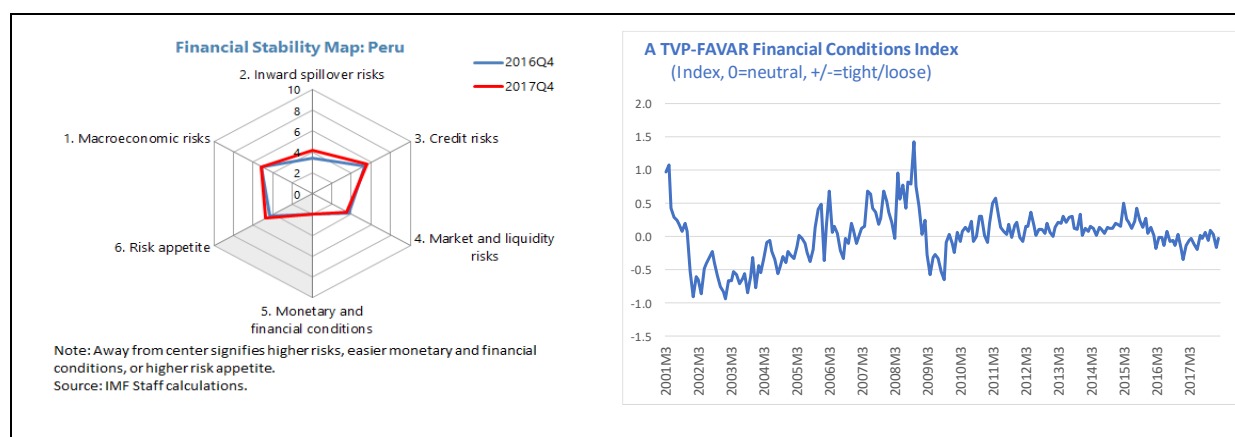
Sources: National authorities; Haver Analytics, and Fund staff estimates.



8. The financial sector remains sound and financial conditions continue to be growth neutral. Weak activity translated into increasing nonperforming loans, but at 3.4 percent of total

² There are five CFMs comprising a reserve requirement on short-term (ST) external liabilities, a tax on non-resident income gains from ST derivatives and limits and reserve requirements related to FX derivatives. The relaxation of FX derivative transaction limits in 2017 is in line with Fund’s institutional view on capital flows, while other CFMs should be periodically reviewed.

loans in March 2018 they remain low and are adequately provisioned for (151 percent). Macro-financial risks are stable (chart) and financial soundness indicators remain broadly solid (table). Buffered by strong profitability (ROA and ROE of 2.1 and 18 percent in March 2018, respectively), the financial system capital adequacy ratio increased to 15.2 percent in February 2018. Deposit dollarization declined below 40 percent by March 2018, while loan dollarization was stable at around 30 percent (Annex III). Credit grew modestly in 2017 (about 5.5 percent) and the credit gap remained negative, although growth has started picking up in 2018. With financial conditions (measured by a Financial Conditions Index) relatively neutral for the past two years (chart), the credit slowdown and nascent recovery appear to be driven primarily by macroeconomic developments and monetary policy actions, rather than financial shocks.³



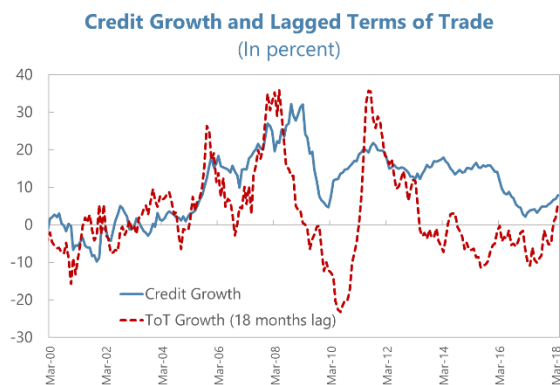
Peru: Financial Soundness Indicators Heatmap											
Peru	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1
Overall Financial Sector Rating	M	M	M	M	M	M	M	M	M	M	M
Credit cycle	M	M	L	L	L	L	L	L	L	L	L
Change in credit / GDP ratio (pp, annual)	3.5	3.0	1.5	0.4	-0.5	-1.2	-1.8	-1.6	-1.6	-0.9	0.1
Growth of credit / GDP (% annual)	10.7	8.9	4.4	1.1	-1.3	-3.3	-4.9	-4.5	-4.5	-4.4	-2.5
Credit-to-GDP gap (st. dev)	0.4	-0.8	-3.1	-3.2	-2.7	-2.5	-2.7	-2.2	-1.6	-0.9	-0.7
Balance Sheet Soundness	M	M	M	M	M	M	M	M	M	M	M
Balance Sheet Structural Risk	M	M	M	M	M	M	M	M	M	M	M
Deposit-to-loan ratio	90.2	92.0	91.7	88.8	89.3	88.4	90.6	90.9	91.4	92.1	91.0
FX liabilities % (of total liabilities)	50.6	49.5	49.5	46.7	44.7	44.1	42.7	41.6	39.3	39.3	38.5
FX loans % (of total loans)	31.4	30.1	28.9	28.4	29.5	28.8	28.4	29.1	29.4	29.4	29.2
Balance Sheet Buffers	L	L	L	L	L	L	L	L	L	L	L
Leverage	L	L	L	L	L	L	L	L	L	L	L
Leverage ratio (%)	7.9	7.9	8.4	8.7	8.7	8.7	9.3	9.3	9.4	9.4	10.1
Profitability	L	L	L	L	L	L	L	L	L	L	L
ROA	2.1	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.1	2.1	2.1
ROE	20.7	21.1	20.3	19.6	19.1	19.2	18.6	18.2	18.1	17.7	18.0
Asset quality	L	L	L	L	M	M	M	M	M	M	L
NPL ratio	3.0	2.9	3.1	3.2	3.2	3.1	3.3	3.4	3.4	3.3	3.4
NPL ratio change (% annual)	0.3	-1.4	2.7	4.6	8.5	7.3	7.8	6.3	5.6	7.5	2.7

Note: M= medium vulnerability; L= low vulnerability
Source: IMF Staff calculations.

³ The FCI is purged of cyclical influences and the direct effect of monetary policy decisions, and represents a common element of a set of over thirty financial indicators.

OUTLOOK AND RISKS

9. Domestic demand is expected to help growth rebound to 3.7 percent in 2018, with inflation converging to the center of the BCRP's target band. A key driver is public investment rising about 0.4 percent of GDP in 2018 and an overall fiscal impulse of 0.2 percent of GDP. Private investment is also projected to grow after four weak years, supported by easier monetary conditions, a more favorable credit and investment climate that typically follows improvements in the terms of trade (chart), and a recovery of mining investment. With the statistical effect of the early-2017 inflation spike dissipating through the year, headline inflation is expected to gradually return to the center of the central bank target range.

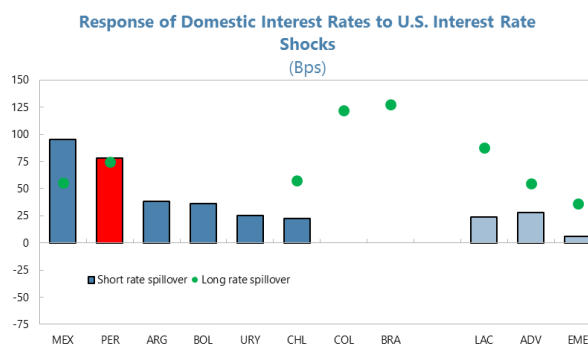


Sources: BCRP; and Fund staff estimates.

10. Growth is projected to accelerate above four percent in 2019, gradually declining back to potential thereafter.⁴ Strong domestic demand, especially higher private investment, should be the key driver, in the context of a gradual fiscal consolidation in 2019–20. Exports also make a significant contribution, aided by a continuing global recovery, although the current account will deteriorate somewhat given the impact of stronger import demand. In the medium term, growth is projected to fall moderately back to potential—estimated at 4 percent—unless additional structural reforms are implemented. The fiscal deficit is also expected to converge to 1 percent of GDP by 2021 in line with the fiscal rule.

11. Risks are balanced in 2018, and while they are tilted to the downside in the medium-term, Peru maintains significant buffers to withstand adverse shocks (Annex V):

- On the domestic front, key downside risks include further delays to public investment projects and PPPs given capacity constraints and the ongoing corruption investigations. On the external front, more protectionist trade policies, a slowdown in China, or a more rapid increase in international interest rates could adversely affect Peru via weaker growth of exports and tighter financing conditions (chart). Growth-at-risk (GaR) analysis for Peru indicates that external conditions are the largest drivers of Peru's growth at short horizons, and these are indeed the main source of near-term upside risk



Source: REO, and IMF staff calculations.

Note: Short rate spillovers denote the response of domestic short-term interest rates to a change in the Fed Fund rate; long rate spillovers denote the response of domestic long-term interest rates to a change in the 10-year T-bill rate. Dark bars denote statistically significant. LAC = Brazil, Chile,

⁴ Annex IV evaluates staff forecast errors for GDP growth in Peru over recent years.

as higher commodity prices could cause large positive spillovers to the broader economy. The authorities' efforts to reduce impediments to investment projects could also bear fruit earlier than expected. Overall, GaR analysis suggests that growth would still be about 2.1 and 1.7 percent 1-year and 3-year ahead, respectively, even if Peru found itself at the 5th percentile of its growth distribution implied by current financial conditions.⁵

- Peru has ample buffers—low public debt and a high level of international reserves—to manage potential shocks, as underscored by stress tests conducted for the 2018 FSAP. Specifically, the banking sector stress tests found that profits and previously accumulated countercyclical buffers would help the sector withstand a severe GDP shock (deviation of around 9½ percent over a period of three years from the baseline) and sol depreciation of nearly 20 percent (Annex III). Similarly, the corporate stress tests found the sector capable of withstanding adverse macroeconomic shocks, although some vulnerabilities in domestic-oriented sectors were identified.

POLICY DISCUSSIONS

In the short term, countercyclical fiscal and monetary policies remain appropriate, while structural reforms are an indispensable complement. Important issues are strengthening the tax system, improving public investment and PPP management, buttressing macroprudential policies and financial sector oversight, tackling governance vulnerabilities, and enhancing the pension system's social protection role.

A. Delivering a Short-Term Fiscal Impulse and Initiating a Medium-Term Consolidation

12. Staff supports the planned increase in public investment and the focus on boosting execution capacity as an immediate priority. With the economy facing a negative output gap, and significant reconstruction needs associated with last year's flooding and landslides, expanding public investment—which has a high multiplier—remains appropriate. Given Peru's sound fiscal situation (see Annex VI), the fiscal expansion can be delivered without generating sustainability concerns. Important steps to improving the framework for capital expenditure include strengthening long-term planning and credibility of investment budgeting, better prioritization, simplifying project monitoring and evaluation, and increasing execution transparency. Given the key role local governments play for investment, continuing efforts to build subnational capacity remains essential. It will also be important that PPP projects—both ongoing and in the pipeline—continue to move forward. These measures will be instrumental in advancing the large pipeline of Peru's investment projects (table).

⁵ GaR analysis provides a mapping between current financial conditions and the probability distribution of future GDP growth. For Peru, relevant financial conditions include indicators of price of risk (e.g., interest rate spreads), financial aggregates (e.g., leverage and credit growth), and external factors (e.g., commodity prices). See the 2018 FSAP for more details.

Major Investment Projects in Peru

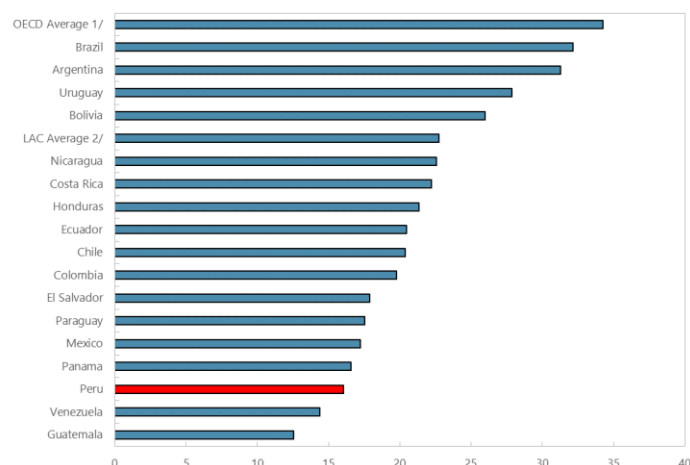
Projects	Companies/investors implementing projects	Total investment		Implemented by end-2017 (accumulated)		Timeline
		Billions of US dollars	Percent of GDP	Billions of US dollars	Percent of GDP	
Public sector projects		15.9	6.9	4.1	1.8	
Reconstruction after 2016/2017 El Niño	Varios companies	7.9	3.4	0.02	0.0	2017-21
Modernization of Talara refinery	Tecnicas Reunidas, Cobra-SCL	5.0	2.2	2.4	1.0	2008-20
Projects for the Panamerican Games	Consorcio Besco - Besalco, Cosapi, Consorcio Sacyr - SACEEM, others	0.9	0.4	0.1	0.0	2017-19
Highways	Varios companies	2.2	0.9	1.6	0.7	2008-20
Private sector projects/PPPs		27.2	11.7	5.3	2.3	
Mining		17.2	7.4	3.1	1.3	
<i>of which</i>						
Quellaveco mine	AngloAmerican	4.9	2.1	0.9	0.4	2018-22
Pampa del Pongo mine	Jinzhao Mining	2.5	1.1	0.1	0.0	2018-22
Michiquillay mine	Southern Copper Peru	2.5	1.1	0.0	0.0	2022-25
Mina Justa	Marcobre	1.3	0.6	0.1	0.0	2018-21
Expansion of Toromocho mine	Chinalco	1.3	0.6	0.0	0.0	2018-21
Expansion of Marcona mine	Shougang Hierro Peru	1.3	0.6	1.1	0.5	2015-19
Expansion of Toquepala mine	Southern Copper Peru	1.3	0.5	0.9	0.4	2015-18
Infrastructure		8.5	3.7	2.2	0.9	
<i>of which</i>						
Line 2 of Lima Metro	Consorcio Nuevo Metro de Lima	5.1	2.2	1.2	0.5	2014-21
Expansion of Jorge Chavez Airport in Lima	Lima Airport Partners S.A.	1.1	0.5	0.3	0.2	2018-22
Stage III of Chavimochic irrigation project	Consorcio Río Santa	0.7	0.3	0.2	0.1	2015-21
Hydrocarbons		1.1	0.5	0.0	0.0	
<i>of which</i>						
Exploration of Lot 58	China National Petroleum Corporation	0.6	0.3	0.0	0.0	2018-21
Energy and Insutry		0.3	0.1	0.0	0.0	
Total		43.1	18.6	9.4	4.0	

Source: National Authorities and Fund staff calculations.

13. The authorities' strategy to focus the medium-term consolidation effort on the revenue side and streamlining current expenditure is appropriate. In line with the fiscal rule, the authorities are planning to reduce the deficit to 1 percent of GDP by 2021. The focus on raising revenue is welcome given Peru's tax revenues appear low compared to other countries (chart), existing infrastructure gaps, and the need to maintain government expenditure in key social areas.⁶ In this regard, the recent increase in excise taxes (full-year gain of 0.4 percent of GDP) and adoption of a decree reducing current spending by 0.3 percent of GDP relative to the 2018 budget are welcome. Higher commodity prices should also contribute to fiscal consolidation by significantly boosting revenues (0.6 percent

Tax to GDP Ratio for 2016

(Total tax revenue as % of GDP)



Note: The figures exclude local government revenues for Argentina (but include provincial revenues), the Bahamas, Barbados, Cuba, Dominican Republic, Honduras and Venezuela as the data are not available.
 1/ Represents OECD member countries. Chile and Mexico are also part of the OECD (35) group
 2/ Represents the unweighted average of the 25 Latin American and Caribbean countries.

⁶ Spending to reduce poverty and foster social inclusion equaled 1.7 percent of GDP in 2016, which includes the non-contributory pension (Pension 65) and targeted transfers to the poor.

of GDP in the baseline scenario). If revenue overperforms, staff would support increasing public investment further.

14. Staff supports the authorities focus on a tax reform that simplifies the system, levels the playing field, and improves tax administration. The tax system is complex, with numerous special regime exemptions (including tax stability contracts), and widespread and overlapping withholding schemes. Priority should be given to reducing the compliance gaps (especially the VAT gap, which is estimated to be around 3 percent of GDP), moving towards a less fragmented income tax regime, making personal income taxes more progressive, rationalizing tax exemptions, and increasing revenues from property taxes.

15. Staff stressed the importance of maintaining progress towards implementation of the medium-term budget framework. Staff noted that this framework may be particularly useful as the fiscal consolidation begins in 2019–20, and encouraged the authorities to implement IMF recommendations as soon as possible ahead of the 2019 budget exercise. In this context, it will be important to build on the new directives for multi-annual budgeting and ensure that the multi-annual allocations are taken as credible ceilings, rather than as implicit floors for negotiation.

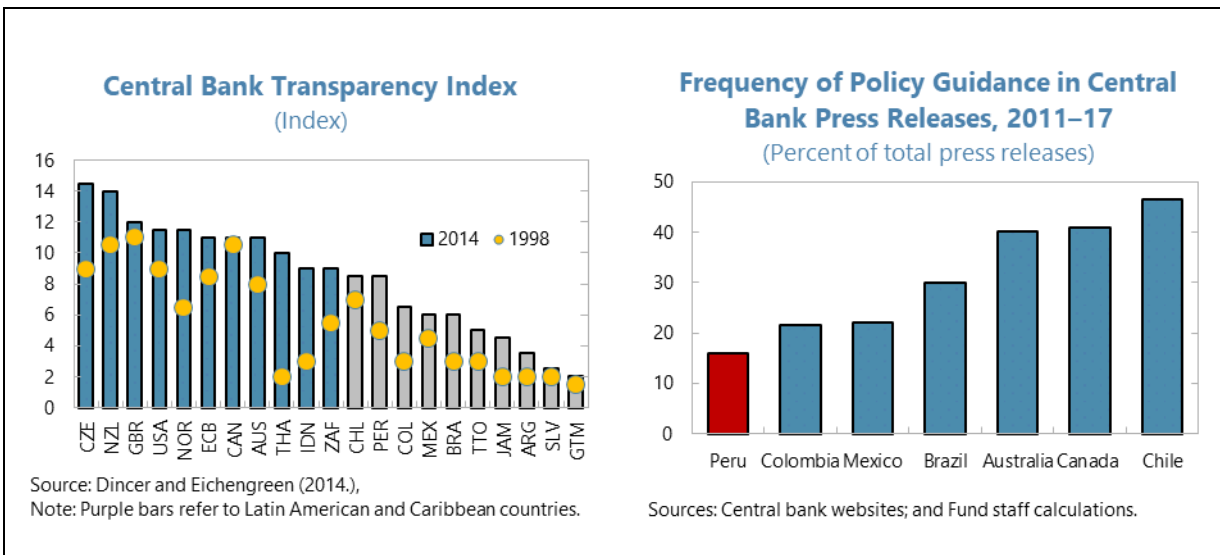
B. Keeping Monetary Policy Data Dependent and Credible

16. The current monetary stance is appropriate and should remain data dependent. The BCRP appropriately loosened monetary conditions in response to weaker than expected growth developments and declining inflation outturns and expectations. The real policy rate now stands at just 0.6 percent, significantly below the BCRP's estimate of the neutral rate (around 1¾ percent), implying substantial monetary stimulus. Under staff's baseline scenario, this suggests limited scope for additional interest rate cuts given core inflation and inflation expectations near the mid-point of the target range (two percent), and a projected narrowing of the output gap.

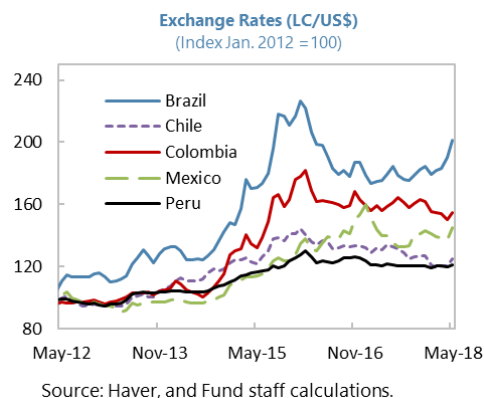
17. Credible and agile monetary policy management has been central to macroeconomic stability in Peru, and the BCRP could consider further enhancements in the following areas:

- *Communications.* While the inflation targeting regime has brought significant transparency gains to the BCRP, there is potential for further improvements, especially when looking at practices in advanced economies (chart). The BCRP could consider enhancing the communication of its guidance of the conditions for future policy rate moves.⁷

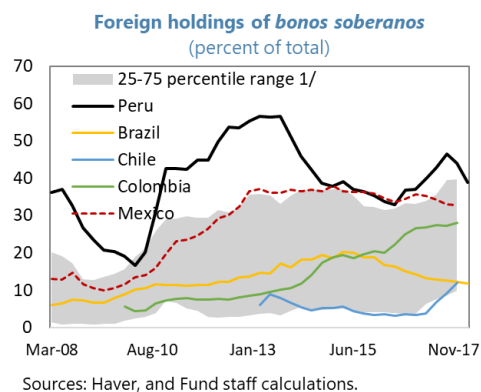
⁷ See Chapter 3 of the IMF Spring 2018 *Regional Economic Outlook* for the Western Hemisphere for further details.



- *Exchange rate flexibility.* Sol flexibility played an important role in adjusting to the decline in commodity prices during 2014–16. Nonetheless, the sol is considerably more stable than other currencies in LA6 (chart), partly reflecting the BCRP’s policy of leaning against the wind (e.g. intervention through the spot market and other instruments amounted to 2½ percent of GDP in 2017, although it has been limited so far in 2018). Future interventions should be limited to disorderly market conditions. And allowing two-way exchange rate flexibility is likely to stimulate market development and support dedollarization efforts. Peru has all the supporting elements (e.g. a credible inflation targeting regime, ample buffers, financial stability) that should minimize risks associated with greater exchange rate flexibility.

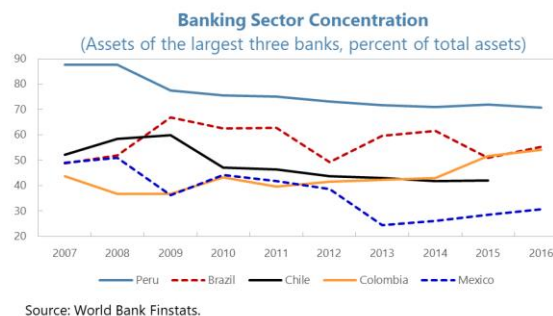


18. Peru has a high share of nonresidents holding local currency bonds, but there is no evidence of a resulting increase in interest rate volatility. At 39 percent in Q1 2018, the share is one of the highest amongst emerging markets (chart). Given low public debt, however, nonresident holdings are still modest as terms of GDP (5.1 percent in Q1 2018). Moreover, while staff analysis finds that an increase in foreign participation significantly reduces long-term bond yields in Peru, there is no evidence of an associated increase in volatility (Annex VII). This likely reflects the strength of Peru’s macroeconomic and financial management, and ample buffers.



C. Maintaining Financial Stability and Fostering Financial Development

19. Even though the stress test exercises found the banking sector to be resilient to macroeconomic shocks, it is important to monitor a broader set of financial vulnerabilities. More specifically, the 2018 FSAP found that:



- High concentration.* Peru's financial sector is highly concentrated (chart), and dominated by financial conglomerates.⁸ While concentration does not appear to be a significant risk currently—the 2018 FSAP contagion and systemic risk analysis found limited vulnerabilities (Annex III)—it is important to monitor emerging risks in this area. For example, large banks have similar loan portfolios and credit risk is strongly correlated among banks. As a result, shocks that trigger common exposures have the potential to become systemic events. To mitigate these risks, capital surcharges for systemic banks should be increased to levels in line with the Basel III framework. Furthermore, increasing the countercyclical provisioning of smaller banks would strengthen their capacity to withstand potential shocks.
- Off-balance sheet exposures.* Banks have significant amounts of off-balance sheet exposures in the form of untriggered guarantees. These have the potential to affect the solvency position of banks.⁹ The notional value of untriggered guarantees is significantly higher than the total capital of banks (approximately 121 percent of the total capital for the large banks in the sample). Importantly, these positions are not direct loans and hence the associated financial risk is low, as evidenced by the FSAP stress test of guarantees written for construction companies.¹⁰ Nonetheless, the idiosyncratic and potentially concentrated nature of these exposures warrants close monitoring.

20. Peru's broad toolkit has helped facilitate significant dedollarization in recent decades, and further measures could help cement this. Dollarization has declined significantly from a peak level of around 80 percent in the early 2000s given the wide range of measures deployed by the authorities, together with sustained macroeconomic stability. But with around 40 percent of deposits and 30 percent of loans still dollarized, potential risks remain. To make additional progress, the authorities should increase risk weights on FX loans along the lines suggested by recent Basel III guidelines.

⁸ The two largest conglomerates control around US\$67 billion (33 percent of GDP), and more than half of banking system assets are owned by conglomerates registered abroad.

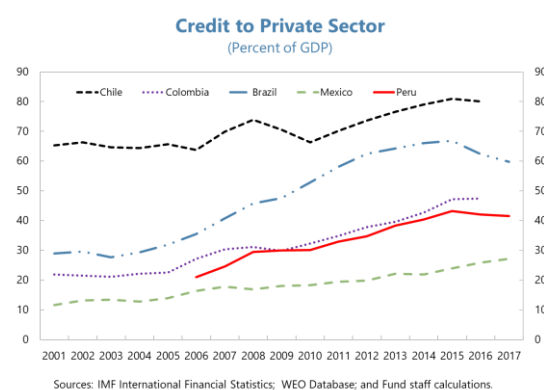
⁹ 90 percent of the guarantees are "cartas fianzas". These provide financial protection to third parties if the purchaser of the guarantee fails to honor the obligation (e.g. fails to complete a project according to a contract).

¹⁰ Based on SBS analysis, about 40 percent of construction-related guarantees is at very low risk of being triggered. The stress test used the remaining 60 percent as the basis of the loss estimation, and found an additional decline of 0.3 p.p. in system-wide total capital, roughly equal among large and small banks.

21. The use of foreign currency reserve requirements for moderating the credit cycle needs to consider its impact on dedollarization efforts. Peru's high ratio of FX reserve requirements (36 percent) simultaneously constitutes a powerful prudential buffer and a dedollarization tool. The BCRP has also used FX reserve requirements as a tool to offset the impact of external developments—e.g., changes in international interest rates—on domestic credit conditions. While this remains a valid concern for the BCRP, there is a potential side-effect of modifying FX reserve requirements on incentives to dedollarize. Given this, staff recommended that changes in FX reserve requirements be tied to the dedollarization process or addressing adverse macrofinancial shocks.

22. Staff welcomed the authorities' plans to strengthen financial sector oversight, but noted that further efforts in some specific areas remain important (Annex VIII). The passing of the legislation migrating the supervision of the saving and credit cooperatives to the SBS is an important step. There is still a need, however, to remove legal limitations and enhance the supervisory framework that would strengthen the SBS's capacity for consolidated supervision of financial conglomerates. Continuing the process of transitioning to risk-based supervision of the insurance sector is also warranted. In addition, the authorities could improve their macroprudential framework even further, including by giving enhanced mandates for macroprudential policy to the BCRP and the SBS, and by implementing a memorandum of understanding to strengthen coordination. This could eventually pave the way for establishing a formal coordination mechanism.

23. Financial development efforts should focus on expanding financial access and inclusion, and addressing high concentration. While branch penetration has quadrupled over the last decade, overall financial depth remains low relative to fundamentals and the region (chart). High concentration could also indicate a lack of banking sector competition in some segments. In this regard, the authorities should strengthen the legal and institutional framework to more effectively oversee all aspects of competition, market conduct, and consumer protection.



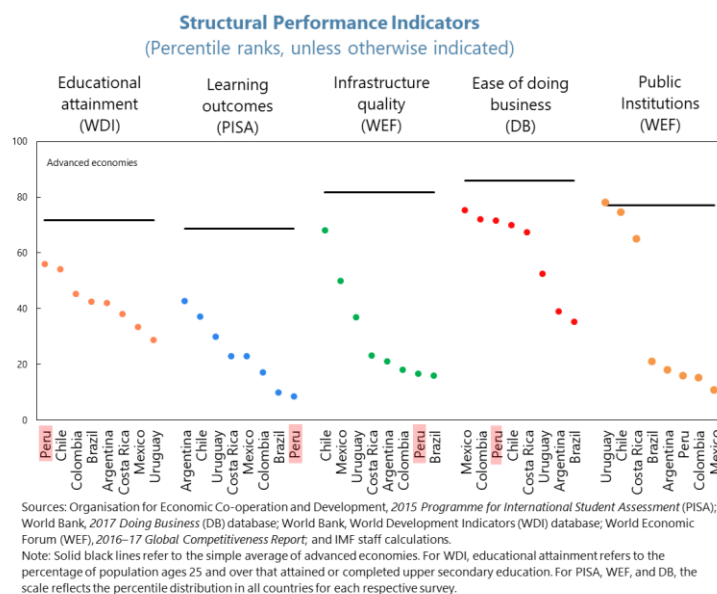
24. Regarding financial inclusion, reforming the e-wallet *Billetera Móvil* (BiM) and studying approaches to fintech used elsewhere could be considered (Annex IX). The uptake of BiM is below expectations. It could benefit from interoperability with bank accounts, digitization of government payments, and expanded access criteria for the mobile money platform. Fintech institutions, while currently limited in scale, could provide new solutions for financial inclusion. Drawing lessons from regulatory approaches emerging elsewhere, such as the adoption of regulatory sandboxes (e.g., see Singapore and the U.K.), could be helpful to develop the fintech sector by appropriately supporting innovation while managing risks.

D. Driving Growth and Expanding Social Protection Through a Broad Structural Reform Agenda

25. A multi-pronged approach is needed to boost potential growth. Total factor productivity (TFP) growth in Peru outperformed LAC peers and a broader group of EMDEs during the commodity boom, but has been disappointing in recent years (chart). Despite some convergence, labor productivity remains at one-fifth of the U.S. level. Reassuringly, staff and the authorities agree on many priority areas to boost productivity, including: education, infrastructure, institutions, and labor market reform. This is supported by third party indicators (chart). Staff analysis also suggests that misallocation of resources has likely been a key driver of low productivity (Box 1). To reduce the misallocation, removing barriers which limit growth of productive firms is important, including distortions created by tax incentives, burdensome regulation, and limited access to credit.¹¹

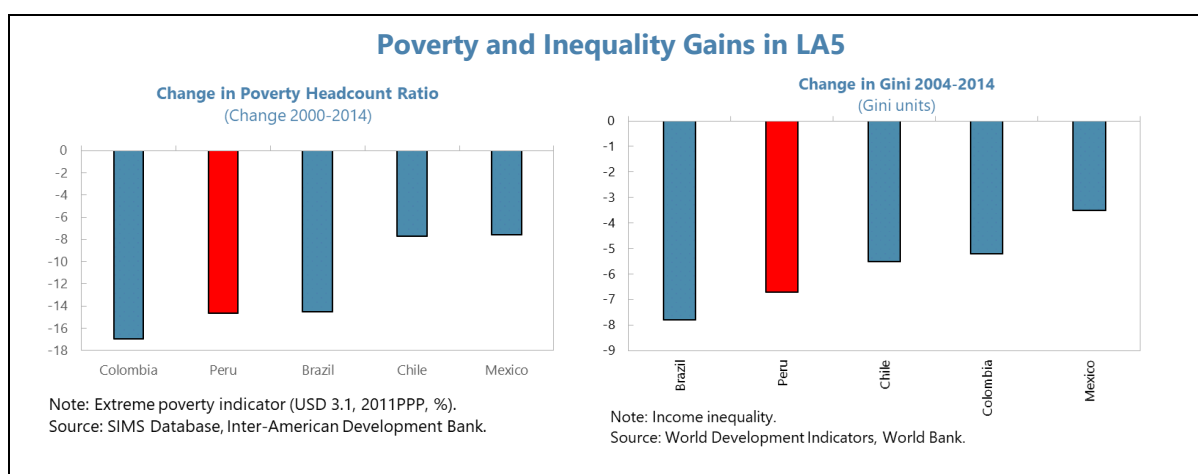
26. The *Lava Jato* scandal has had a major impact on the economy and the authorities rightly view governance as a priority (Box 2). Law 30737 should reduce uncertainty in the construction sector, while requiring conflict of interest statements from public officials (as envisioned in the special legislative powers) would be a welcome step to help reduce corruption. In addition, apart from broadly improving fiscal governance, staff recommended: improving timely exchange of information and financial intelligence among anti-corruption agencies; strengthening the asset declaration system (i.e., verification, beneficial ownership information, and public access); enhancing risk-based anti-money laundering and combating the financing of terrorism (AML/CFT) supervision and the reporting system for suspicious transactions; creating a beneficial ownership registry; and ensuring customer due diligence for politically exposed persons. Staff stands ready to further support the authorities in their efforts.

¹¹ Size-based distortions in Peru include labor regulations and tax schedules depending on firms' sales. Additionally, firms with more than 20 salaried workers are subject to mandatory profit sharing with employees. More broadly, business licensing and permits are identified as a major constraint (World Bank, 2015).



27. While poverty and inequality declined markedly during the commodity boom, poverty increased in 2017 and a recalibration of policies may be warranted.

Peru has made impressive social progress compared to other LA5 countries since the turn of the century (chart), with less than a quarter of the population below the national poverty line in 2017. Much of this was driven by real labor income gains of lower-skilled workers in the nontradable sector.¹² At the subnational level, larger mining-related fiscal transfers were also associated with larger declines in poverty (Box 3).¹³ After a period of lower commodity prices, some of these drivers are already going into reverse, as evidenced by an increase in poverty in 2017—the first increase in over a decade. Increasing tax revenues as outlined earlier will help protect needed infrastructure and social spending. Increasing the *progressivity* of the personal income tax system—by closing loopholes, avoiding preferential treatments and combating tax evasion and avoidance, especially for higher-income households—will also enhance redistribution.¹⁴ Given highly concentrated transfers and problems with absorptive capacity at the subnational level, it would be worthwhile re-thinking the distribution of natural resource revenues to reduce horizontal inequities while still compensating producer regions for the environmental impact.¹⁵ Specifically, in addition to natural resource production, revenue-sharing formulas could better reflect spending needs, for example population size and poverty levels.



28. The pension system could be reformed to enhance social protection and reduce inequities, but there are significant tradeoffs, necessitating public consultation and careful communication. As discussed in the 2017 report of the Social Protection Committee, pension coverage in Peru is low relative to the region (chart). And partly due to frequent spells of informality, replacement ratios in the public defined benefit plan (SNP) and private defined contribution plan (SPP) are projected to be below 30 percent in the medium term (Box 4). Given low pension

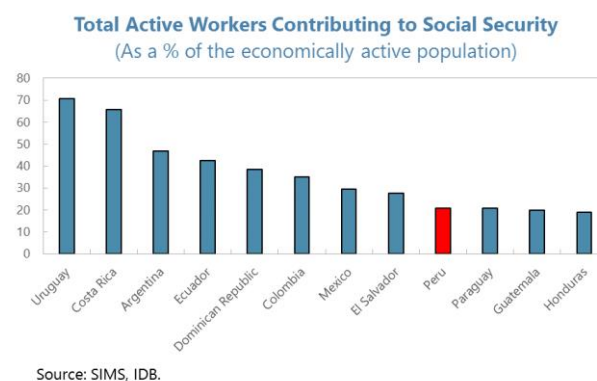
¹² See Chapter 5 of the IMF April 2018 *Regional Economic Outlook* for the Western Hemisphere for further details.

¹³ Peru redistributes a larger share of extractive sector revenues back to producer regions through the *canons*.

¹⁴ The redistributive impact of personal income taxes in Peru is weak (similar to the Latin America average), reducing income inequality by just 2 percent, much less than the EU average of 12 percent (OECD, 2018).

¹⁵ Some local governments with the biggest windfalls per capita began to accumulate large deposits during the boom according to Santos and Werner (2015).

coverage, the non-contributory pillar (Pension 65) will remain important, and should be broadened. In the public system, shortening the minimum 20-year contribution period would allow more low-income workers to receive a pension. In both these areas, fiscal costs should be carefully assessed. Several reforms could help increase replacement ratios in the private system. Specifically, high pension management fees should be lowered and excessive flexibility to withdraw lump-sum amounts removed. Increasing contributions could also be considered, but might adversely impact labor formality. Given these reforms will still lead to replacement rates well below OECD levels, it will be crucial to communicate realistic expectations to the public. Over the longer term, a larger institutional reform should also be pursued to better integrate the private and public pillars, considering tradeoffs between pension adequacy, coverage and fiscal sustainability.



E. Authorities' Views

29. The authorities shared staff's view regarding the short-term outlook, but considered that growth could reach 5 percent in the medium term given planned reforms. They expressed commitment to improve the execution and quality of public investment, strengthen tax policies and administration, streamline current public expenditure, enhance governance, and boost competitiveness. The planned reforms and a new investment cycle linked to high commodity prices would lead to a significant pickup in potential growth.

30. The authorities stressed their commitment to the fiscal rule and lifting public investment execution. On the revenue side, they considered tax reform a high priority and believed that the proposed measures (focused on tax administration) could increase revenues by nearly two percent of GDP by 2021, creating space for public investment and at the same time assuring compliance with the fiscal rule. The authorities agreed with the need for improving the public investment framework to help narrow the infrastructure gap. They expect that streamlined processes for reconstruction and the acceleration of several large infrastructure projects will significantly boost public investment in 2018–19, but acknowledged that a lack of capacity at subnational level poses a significant challenge.

31. The authorities agreed that monetary policy should remain data dependent. The BCRP noted that the policy rate cuts had supported the cyclical recovery and the risks of accelerating inflation were limited given the negative output gap and anchored inflation expectations. The BCRP has no plans to modify the way it communicates monetary policy decisions, since the current communication strategy has been successful in signaling future policy decisions. Regarding the exchange rate policy, the BCRP stressed that intervention seeks to prevent excess volatility in a context of partially dollarized banking credit. The authorities consider that the real exchange rate is

aligned with its fundamentals and is consistent with a projected current account deficit of 1.7 percent of GDP in 2018.

32. In the financial sector area, the authorities saw merit in some of the staff's recommendations, and offered clarity on a few issues:

- Regarding banking sector concentration, they underscored that there are no regulatory barriers for entry into the market and that market outcomes are affected by informality, which raises costs of due diligence.
- The authorities stressed that the risks in the financial sector are contained and agreed that the off-balance sheet items warrant continued close monitoring.

33. The authorities and staff agree on the structural reform agenda. The authorities noted that improving the governance framework and boosting productivity are immediate priorities, which they are addressing in their request for special legislative powers. Other key challenges such as pension, education and labor reform will be tackled in the coming years.

STAFF APPRAISAL

34. High commodity prices and reduced political uncertainty create a window of opportunity for addressing domestic challenges and lifting potential growth. Commodity prices have picked up significantly since mid-2016, supporting a rebound in the economy. The appointment of the new administration has reduced political uncertainty, improving confidence and creating better conditions for implementing necessary reforms. At the same time, the economy faces domestic headwinds, as the reconstruction following last year's El Niño damages is slow and the fallout from the *Lava Jato* corruption scandal creates a drag on investment.

35. The economy is recovering and risks are broadly balanced in 2018. Growth is expected to reach 3¾ percent in 2018 given the fiscal stimulus and rebounding private investment. In 2019–20, growth is likely to increase further, before converging to potential of 4 percent in the medium term. Headline inflation is expected to gradually return to the center of the BCRP's target range as food price inflation normalizes. While broadly balanced in 2018, risks are tilted to the downside thereafter. The financial sector is sound, and the economy maintains significant buffers to withstand adverse shocks.

36. In the short term, countercyclical fiscal and monetary policies remain appropriate. Expanding public investment is welcome given the negative output gap and significant reconstruction needs. Given the key role of subnational governments in public investment, continuing efforts to build their capacity remains essential. The fiscal stimulus has been appropriately complemented with easing monetary policy. Looking ahead, monetary policy should remain data dependent, and the BCRP could consider enhancing communications of its policy guidance. Exchange rate flexibility remains an important shock-absorber and FX interventions should be limited to disorderly market conditions. The 2017 external position is assessed to be

moderately stronger than implied by fundamentals, although the gap is expected to narrow in 2018 and beyond. Additional macroprudential measures such as increasing capital surcharges for systemic banks and countercyclical provisioning for smaller banks would help to strengthen financial sector resilience.

37. The authorities' strategy of combining medium-term fiscal consolidation with structural reforms aimed at boosting productivity is sound. The authorities' commitment to the fiscal responsibility framework is commendable. Revenue mobilization through strengthening tax policy and administration, supplemented with the streamlining of current expenditure will allow gradual consolidation in line with the fiscal rule. At the same time, it will create space for much needed investment, helping close the infrastructure gap. Increasing the progressivity of the personal income tax system and expenditures will enhance redistribution. Complementing the adjustment with structural reforms would tackle the long-standing challenge of high informality and low productivity, helping unlock Peru's growth potential. In this regard, the authorities could consider reforms to strengthen Peru's institutions and governance, improve education, increase labor market flexibility, and enhance financial deepening and inclusion. The pension system could also be reformed to enhance social protection, while re-thinking the distribution of natural resource revenues is warranted, and could help reduce horizontal inequities between regions.

38. Staff would like to express their appreciation to the authorities for a constructive engagement. It is recommended that the next Article IV consultation take place on the 12-month cycle.

Box 1. Productivity Trends at the Macro and Micro Level

The commodity boom helped increase labor productivity relative to advanced economies.

Peru's labor productivity levels converged somewhat closer to U.S. levels during recent years, with sectoral output per worker data showing labor productivity increases in most sectors linked to domestic demand such as construction, utilities, transportation and manufacturing. While TFP growth played an important role, standard growth decompositions and preliminary analysis using detailed firm-level manufacturing data show that capital accumulation was also a key driver of higher labor productivity.¹

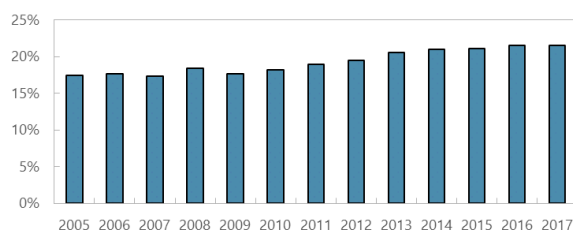
Misallocation of resources is likely to be a key driver of weak aggregate TFP levels.

Recent evidence shows that Latin American countries could substantially increase aggregate TFP if distortions are removed and resources are allocated to more productive firms (April 2018 WHD REO). Peru is no exception. One can proxy misallocation by calculating the relationship between firms' shares of resources and their relative productivity (Bartelsman and others, 2013). When the term is zero, resources (for example labor) are randomly assigned to firms, irrespective of their productivity. A larger, positive term indicates that productive firms have more resources. Staff estimates show that in Peru the term is positive but close to zero for the manufacturing sector, suggesting substantial misallocation which is more severe than in most LA peer countries (IDB, 2014). Moreover, it has not improved in recent years.²

¹ The October 2015 WEO finds that in a broad sample of commodity exporters, capital deepening played a larger role than TFP growth in pushing GDP growth higher during commodity booms.

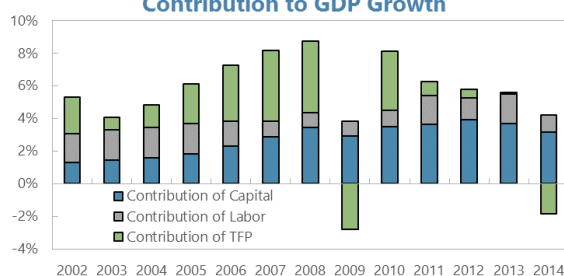
² Misallocation is even more severe in the services sector than in the manufacturing sector (see IDB 2014 for evidence on LAC and World Bank 2015 for Peru).

Output per Worker in Peru relative to the United States



Source: WDI, World Bank.

Contribution to GDP Growth



Source: Penn World Table.

Box 2. Governance and Corruption

Corruption is now identified as the greatest problem to doing business in Peru.¹ The fallout from the Odebrecht case illustrates its macro-criticality: large investment projects were frozen (e.g. Southern Peru Gas Pipeline), reducing GDP growth by an estimated 0.8 percent of GDP in 2017.

Among state functions relevant to economic activity,² **fiscal governance** appears particularly vulnerable:

- **Public investment.** A recent IMF assessment found key weaknesses in the effectiveness of public investment management, such as evaluation and selection of projects (including PPPs) and coordination/monitoring of subnational governments.
- **Governance at the subnational level.** A significant number of mayors are under investigation on corruption charges, underscoring severe governance weaknesses at the state and district levels. Moreover, regional assessments point to serious weaknesses in PFM.
- Cross-country indicators suggest **tax efficiency** is below average. Regarding **tax administration quality**, while Peru scores relatively well overall, past IMF assessments have signaled weaknesses in auditing processes; the high stock of arrears; and inadequate attention to managing institutional risks. Foreign companies have complained about tax officials extorting payments disguised as disproportionate fines and interest charges on unpaid taxes. The **complexity of the tax system** may also promote tax evasion through informality and potentially corruption.
- **Transparency and financial integrity.** Peru's practices meet most of the principles of the IMF's Fiscal Transparency Code at good or advanced level. However, recent IMF assessments have signaled some weaknesses, including limited effectiveness of auditing and control institutions, and concerns with PPPs.

Regarding other functions, while corruption is criminalized in Peru's legal code, **implementation and enforcement of relevant corruption laws** tends to be weak due to inefficiencies in controls, investigation, and sanction mechanisms. On the **AML/CFT side**, the authorities' national risk assessment identified significant corruption risks, and noted the use of companies and real estate as vehicles of laundering corruption proceeds.

¹ World Economic Forum Global Competitiveness index, 2017.

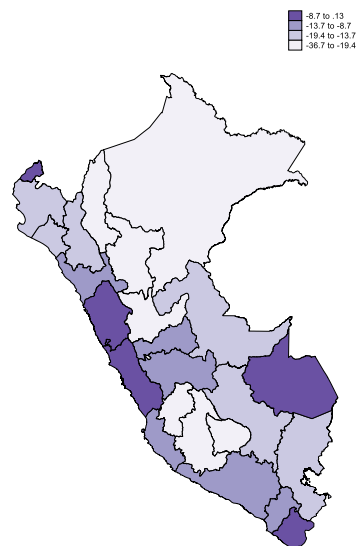
² State functions most relevant to economic activity include: (i) fiscal governance, (ii) financial sector oversight, (iii) central bank governance and operations, (iv) market regulations, (v) rule of law, and (vi) AML/CFT.

Box 3. Poverty and Inequality Reduction During the Commodity Boom

Poverty reduction was broad based and especially large in some of the poorest regions in the interior. Regression analysis also shows that regions which benefited from larger natural resource (canon) transfers during the commodity boom reduced poverty by more than others.

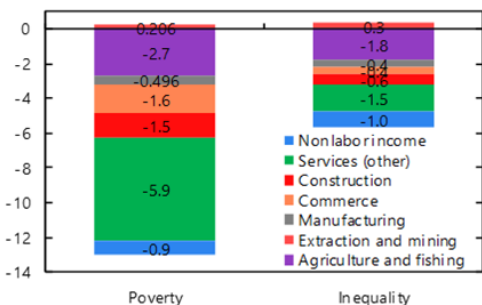
Much of the boom-time progress reflected real labor income gains for lower-skilled workers, especially in nontradable sectors. This is illustrated by formal Shapley decompositions of household survey data—a rigorous way to calculate factor contributions to changes in the income distribution. Higher real incomes of low income households allowed them to exit poverty while at the same time compressing the skills premium, thereby reducing inequality. Government transfers also played a positive role, but to a lesser extent.

Change in Poverty (2009-2017)



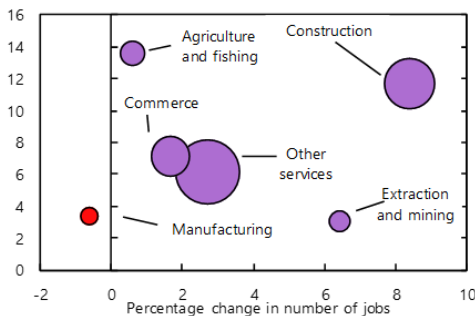
Note: Poverty line constructed by basic basket of goods and services. National poverty line defined by National Statistics Authority. Source: ENAHO Survey, INEI.

Decomposition of Poverty and Inequality Changes (2007-11)



Source: Household Survey data, and Fund staff calculations.

Annualized Percentage Change in Real Labor Income (2007-11)

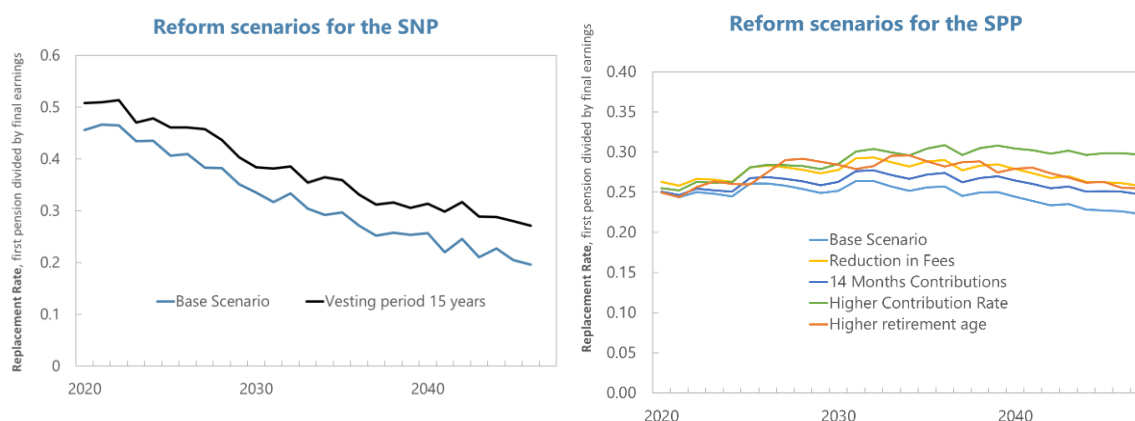


Source: Household Survey data, and Fund staff calculations.

A closer look at the labor market shows that both employment and wages in the nontradable sector increased. The broad services sector contributed the most to employment growth, in part reflecting its size, while high investment led to double digit real income growth in the construction sector and the largest expansion in employment of all sectors. Manufacturing did poorly during the boom, especially in terms of employment growth, in line with a standard crowding-out story (“Dutch Disease”).

Box 4. Pension Projections and Reform Scenarios

Low contribution densities partly explain low projected replacement rates. Detailed administrative microdata for SPP and SNP affiliates show that contribution densities are only 40 percent in the SPP and 34 percent in the SNP. In other words, affiliates contribute for 4 to 5 months out of 12 months per year on average over their working life. High income households have substantially higher contribution densities, with the top income quintile four times as likely to reach the minimum 20-year contribution period in the SNP as the bottom quintile. Using these contribution densities, staff projected replacement rates for pension cohorts from 2018–2047. In the baseline scenario, average replacement rates in the SNP are projected to decline from over 40 percent in 2020 to around 20 percent in 2047, largely reflecting past reforms which made the system more sustainable but less generous. In the SPP, they decline marginally over time from around 25 to 22 percent. The real rate of return is a key assumption for the SPP projections. In an upside scenario, where it is 5.2 instead of 4.2 percent (baseline assumption), replacement rates in 2047 would be 30 instead of 22 percent.¹

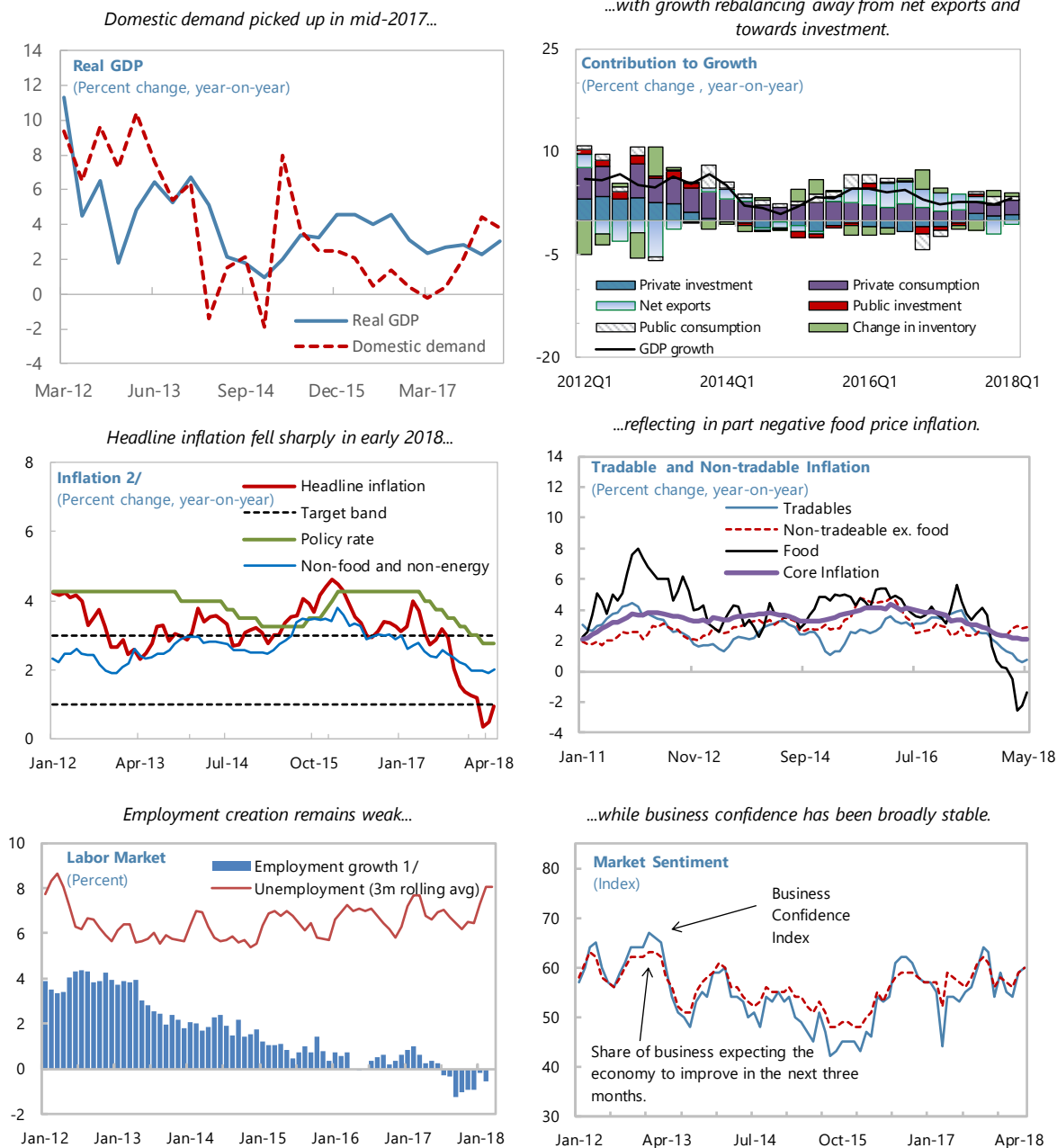


Sources: National Authorities and IMF staff estimates.

Several changes to the contributory pillars could help raise replacement rates. Improved industrial organization structures in the private system which lower fees by 0.5 percentage points would raise replacement rates by over 3 percentage points. A broadening of the contribution base which makes pension contributions obligatory for the 13th and 14th monthly salaries would increase replacement rates by close to 3 percentage points. An increase in contribution rates by 5 percentage points has the largest impact but could adversely affect labor formalization. In the SNP, reductions in the 20-year minimum contribution (vesting) period by 5 years would raise average replacement rates by over 5 percentage points and reduce inequities—lower income affiliates are much less likely to reach the 20-year mark than affiliates in higher income segments—but have fiscal implications.

¹ While real rates of return in Peru have been historically higher than 5 percent, the baseline scenario assumes they converge over time towards levels achieved by a “best practice” fund, such as the Norwegian Government Pension Fund Global.

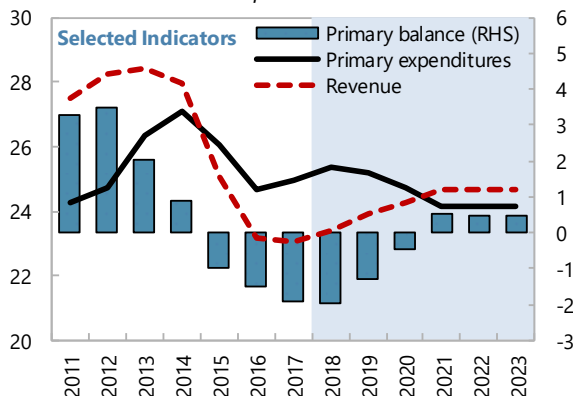
Figure 1. Real Sector Developments



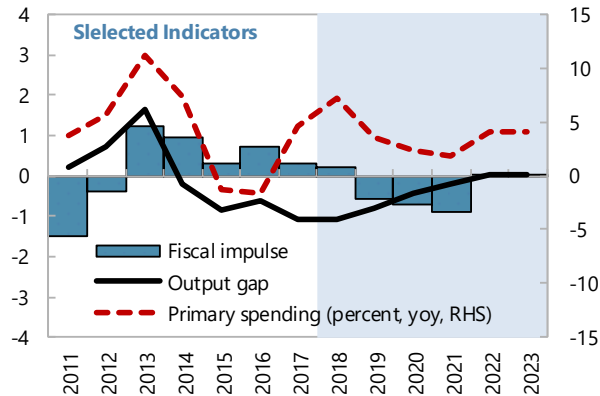
Sources: National authorities; and Fund staff calculations.
 1/ Formal employment in firms with 10 or more employees, all urban areas.
 2/ Inflation values correspond to Metropolitan Lima.

Figure 2. Fiscal Sector Developments
(Percent of GDP)

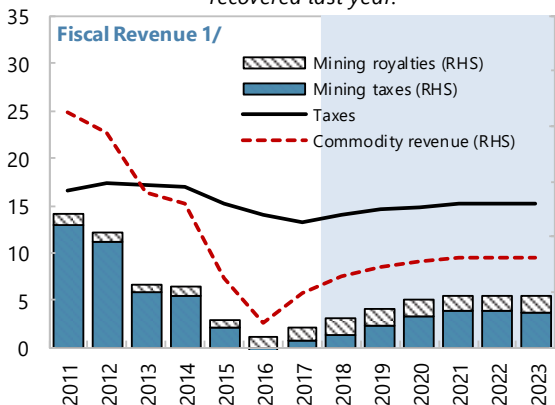
Primary fiscal balances have been declining on account of weaker revenues...



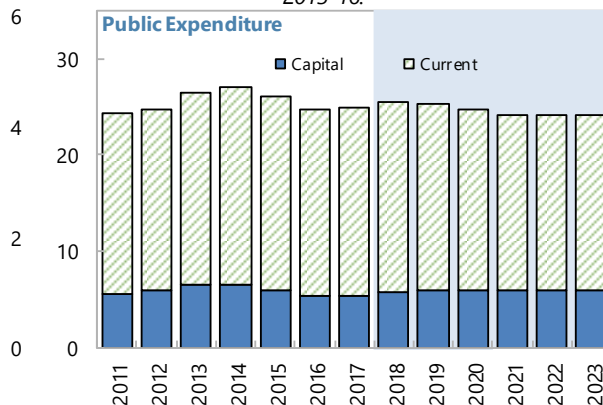
...resulting in positive fiscal impulses in the past 5 years.



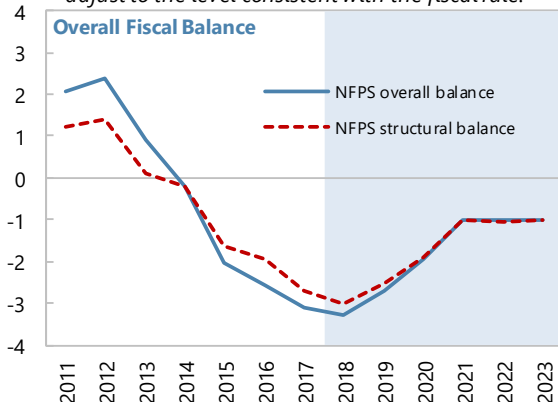
After a long period of decline, commodity revenues recovered last year.



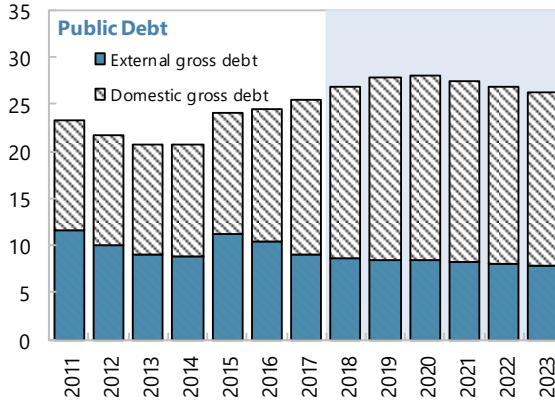
Public expenditure has stabilized after reductions in 2015-16.



After peaking this year, the fiscal deficit is expected to adjust to the level consistent with the fiscal rule.



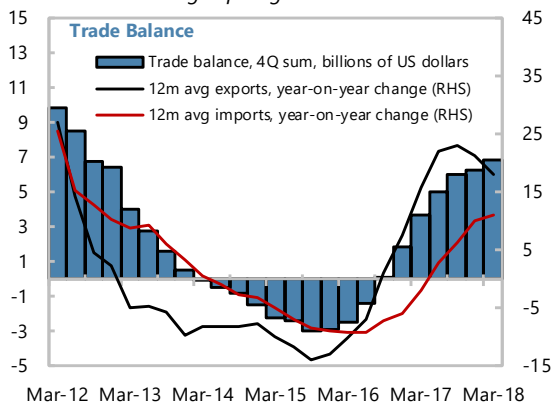
...stabilizing the public debt stock below the ceiling of 30 percent of GDP.



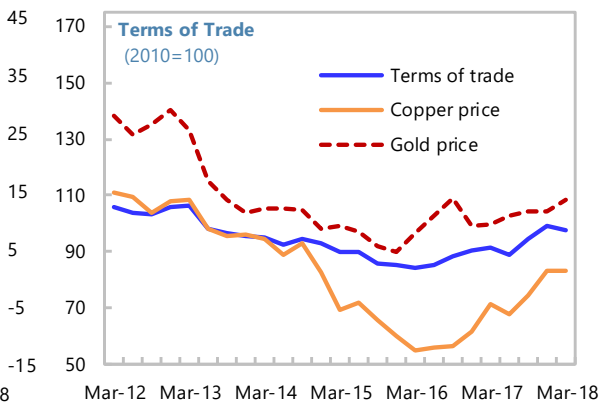
Sources: National authorities; and Fund staff estimates.
1/ Net of restitutions.

Figure 3. External Sector Developments

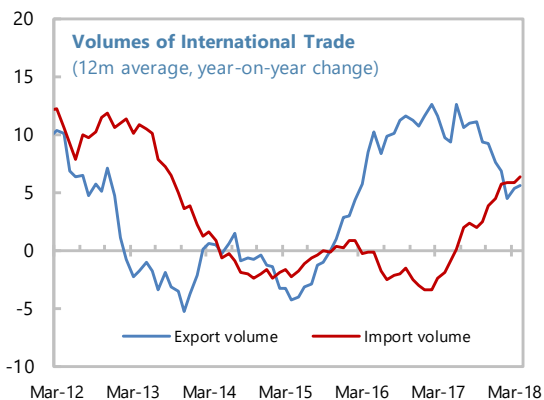
The trade balance has improved on account of strong export growth...



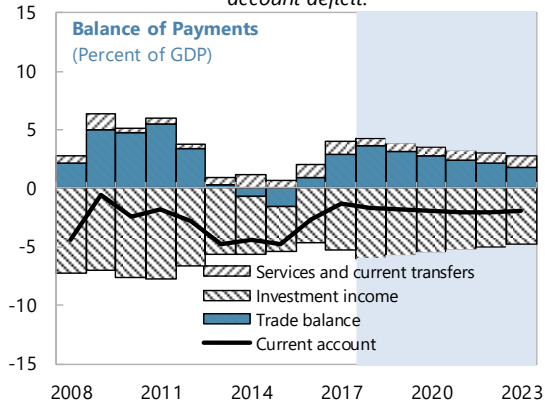
...supported by a rebound in commodity prices...



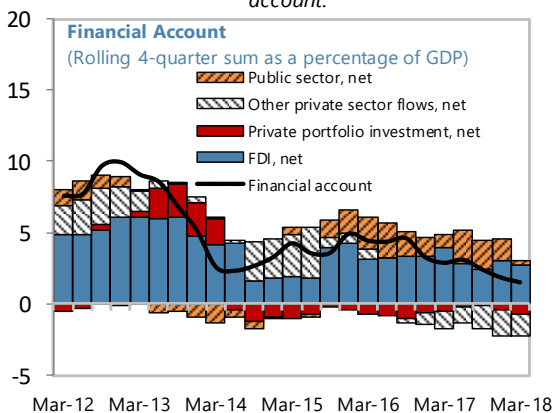
...as well as strong growth in export volumes.



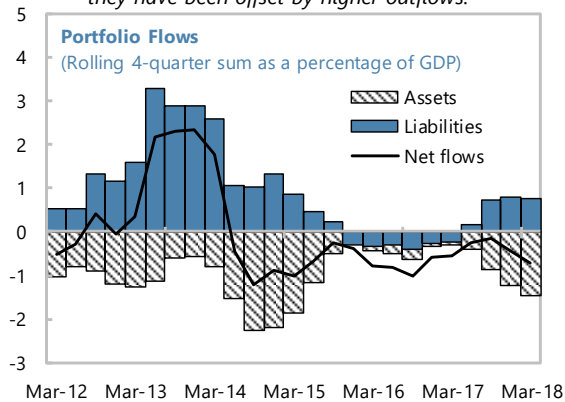
A higher trade surplus has reduced the current account deficit.



FDI continues to be the main component of the financial account.



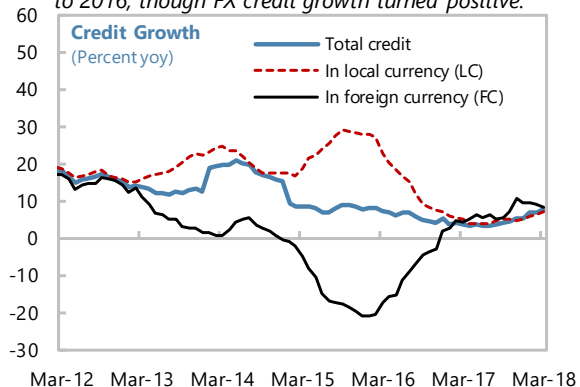
Private portfolio inflows have picked up, although they have been offset by higher outflows.



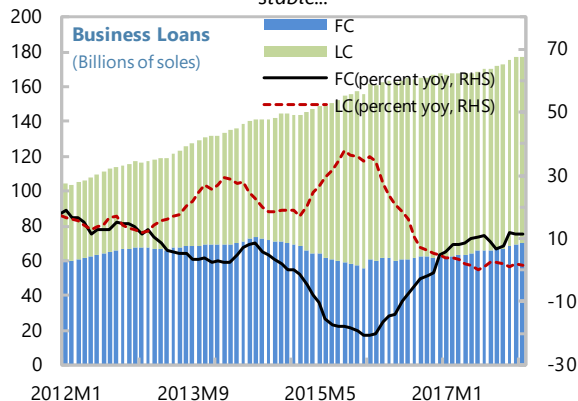
Sources: National authorities; and Fund staff estimates.

Figure 4. Financial Sector Developments

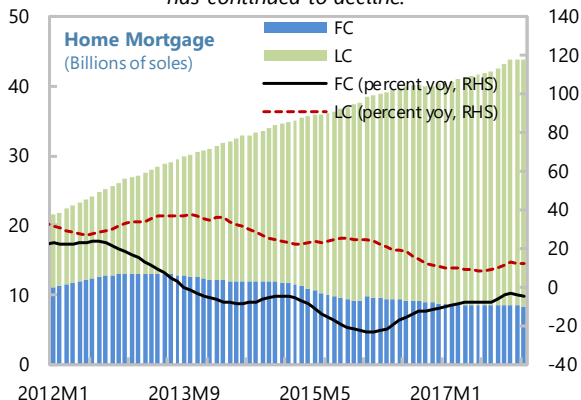
Private sector credit growth was moderate, similar to 2016, though FX credit growth turned positive.



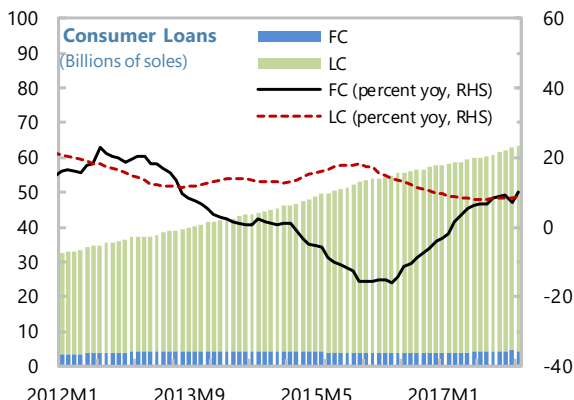
The share of corporate loans in dollars has remained stable...



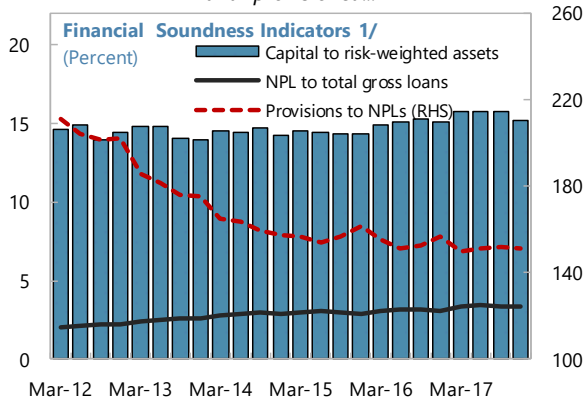
... but the share of dollar-denominated mortgage loans has continued to decline.



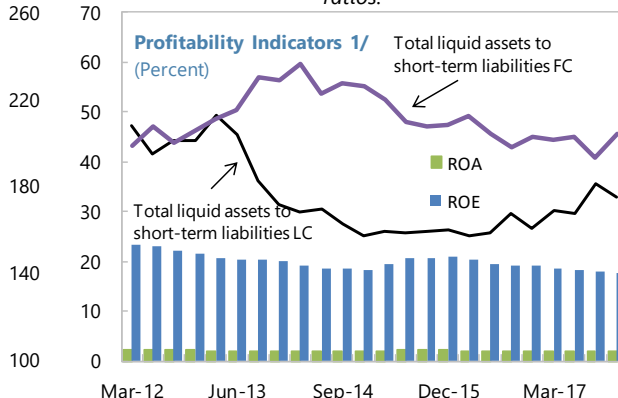
Dollarization of consumer loans remains low.



Deposit-taking institutions are well-capitalized and provisioned...



...with adequate liquidity and comfortable profitability ratios.

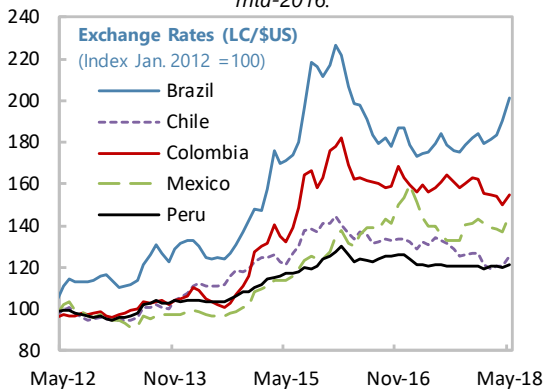


Sources: National authorities; and Fund staff estimates.

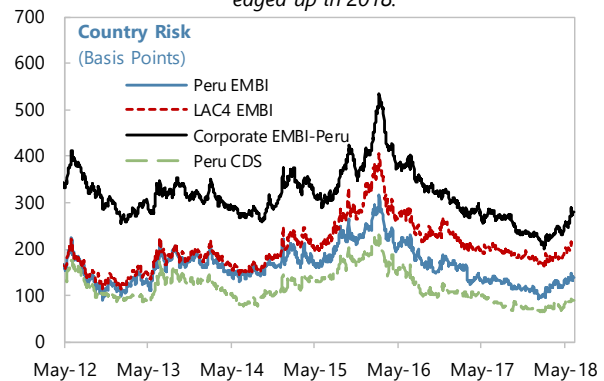
1/ Data corresponds to depository corporations. Last data available is for Dec-2017.

Figure 5. FX and Capital Market Developments

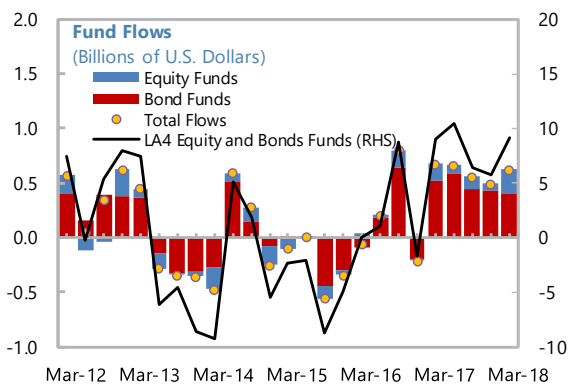
The sol has remained relatively stable since mid-2016.



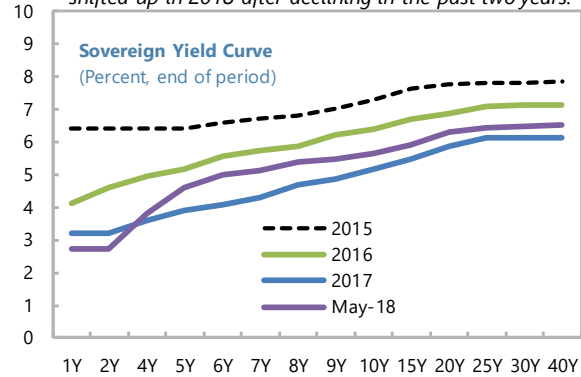
In line with other economies in the region, spreads have edged up in 2018.



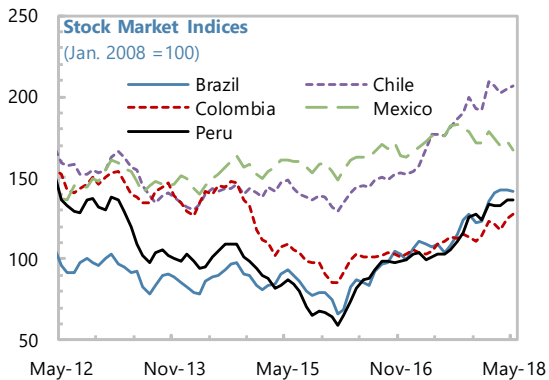
Bond and equity flows have recovered.



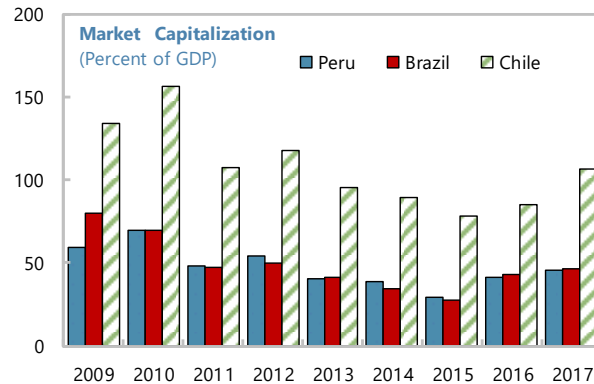
The longer end of the sovereign bond yield curve has shifted up in 2018 after declining in the past two years.



Equity prices have rebounded...



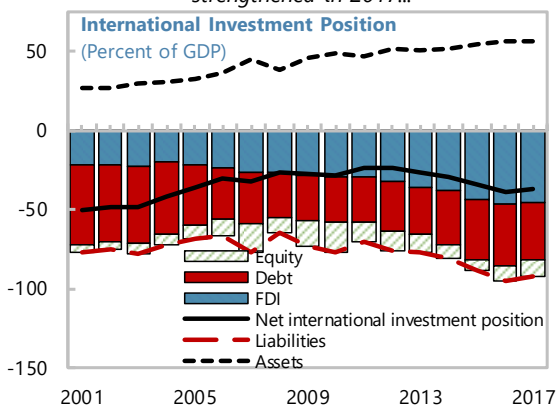
...while market capitalization continues to recover.



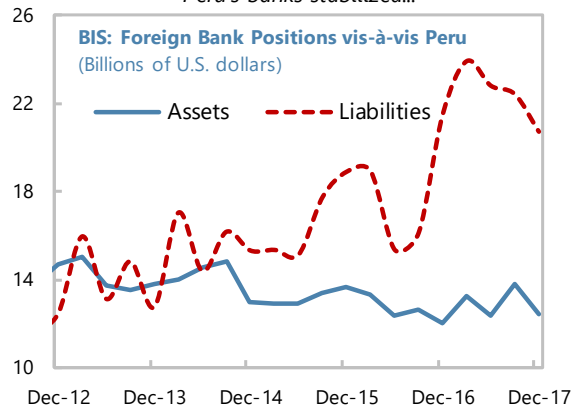
Sources: Bloomberg, Haver Analytics, National authorities, and Fund staff estimates.

Figure 6. Balance Sheet Indicators

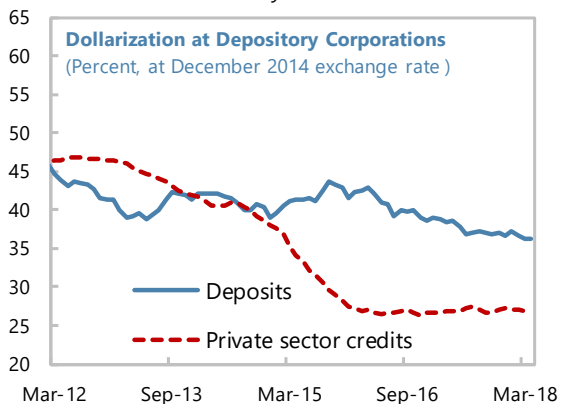
Peru's net international investment position strengthened in 2017...



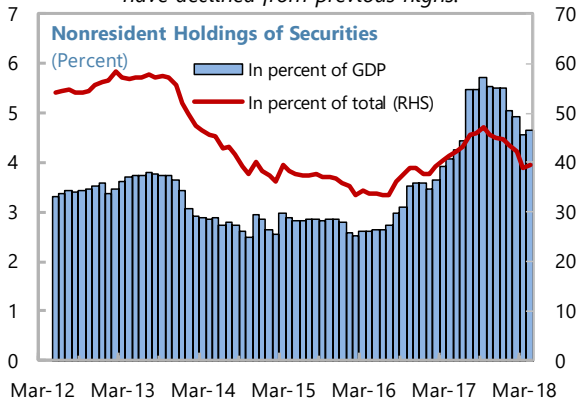
...as foreign banks' liabilities and claims on Peru's banks stabilized...



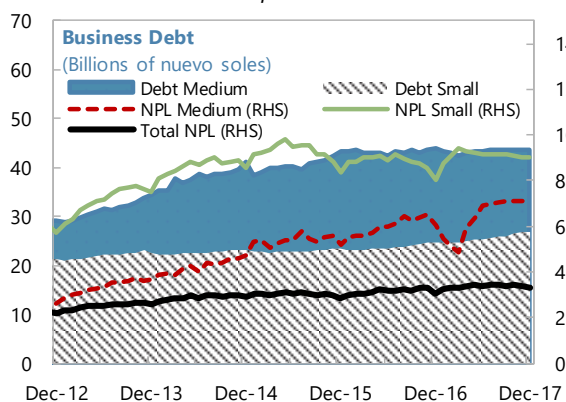
...and deposit dollarization declined during the year.



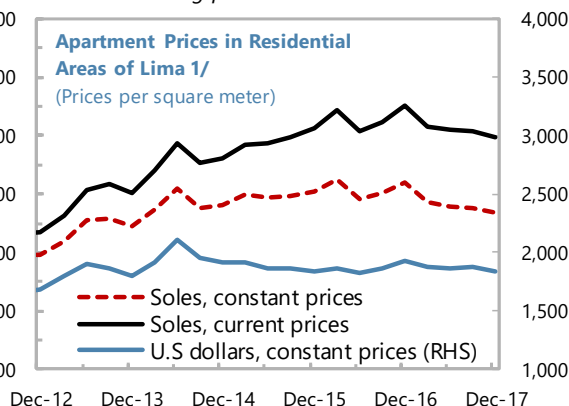
Non-residents' holding of government securities have declined from previous highs.



NPL ratios for SMEs have risen.

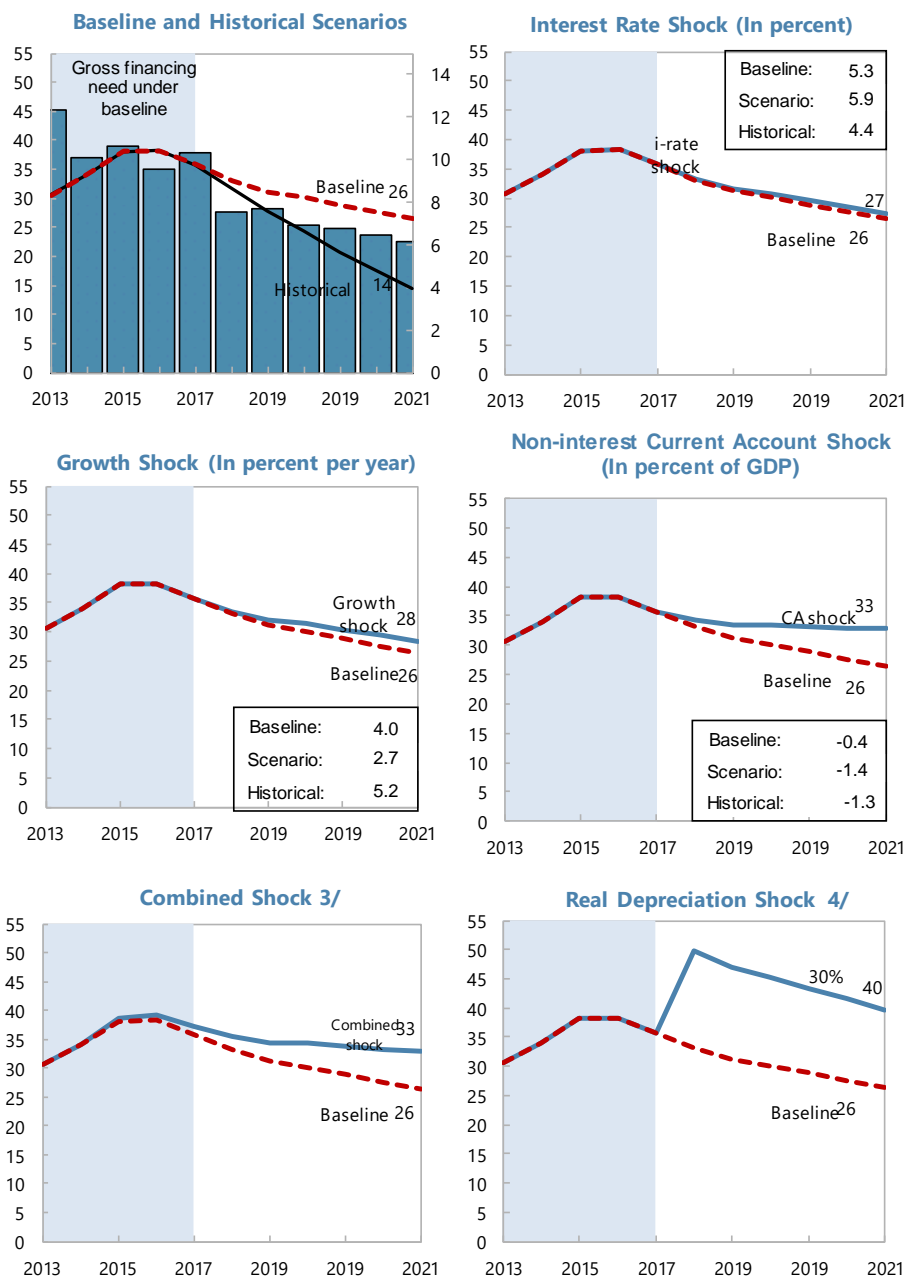


Housing prices have stabilized.



Sources: National authorities; Association of Banks; Bank for International Settlements; and Fund staff estimates.
1/ La Molina, Miraflores, San Borja, San Isidro, and Surco.

Figure 7. External Debt Sustainability: Bound Tests 1/ 2/
(In percent of GDP)



Source: Fund staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2018.

Table 1. Peru: Selected Economic Indicators

	2013	2014	2015	2016	Prel.		Proj.				
					2017	2018	2019	2020	2021	2022	2023
Social Indicators											
Life expectancy at birth (years)	74.2	74.4	74.7	...	...	...	...	...	...	...	...
Infant mortality (per thousand live births)	13.5	12.9	12.4	11.9	...	...	...	...	...	...	...
Adult literacy rate	93.8	93.7	94.2	94.2	...	...	...	...	...	...	...
Poverty rate (total) 1/	23.9	22.7	21.8	20.7	21.7	...	...	...	...	...	...
Unemployment rate	5.9	6.0	6.5	6.7	6.8	...	...	...	...	...	...
(Annual percentage change; unless otherwise indicated)											
Production and prices											
Real GDP	5.8	2.4	3.3	4.1	2.5	3.7	4.1	4.2	4.2	4.1	4.0
Real domestic demand	7.3	2.2	2.9	1.1	1.6	4.5	4.7	4.7	4.5	4.5	4.5
Real domestic demand (contribution to GDP)	7.4	2.2	2.9	1.1	1.6	4.4	4.7	4.6	4.5	4.5	4.5
Consumption (contribution to GDP)	4.3	3.1	3.7	2.0	1.7	3.0	2.9	2.9	3.0	3.1	3.1
Investment (contribution to GDP)	3.0	-0.9	-0.7	-1.0	-0.1	1.4	1.8	1.8	1.5	1.3	1.4
Net Exports (contribution to GDP)	-1.5	0.2	0.4	3.0	0.9	-0.7	-0.6	-0.4	-0.3	-0.4	-0.5
Output gap (percent of potential GDP)	1.7	-0.2	-0.9	-0.6	-1.1	-1.1	-0.8	-0.4	-0.2	0.0	0.0
Consumer prices (end of period)	2.9	3.2	4.4	3.2	1.4	2.2	2.0	2.0	2.0	2.0	2.0
Consumer prices (period average)	2.8	3.2	3.5	3.6	2.8	1.3	2.0	2.0	2.0	2.0	2.0
External sector											
Exports	-9.6	-7.8	-12.9	7.6	21.3	13.2	4.0	3.6	3.6	3.9	4.1
Imports	3.3	-3.1	-9.0	-5.9	10.0	9.8	6.0	5.7	5.6	5.1	5.7
Terms of trade (deterioration -)	-5.2	-5.4	-6.4	-0.7	7.3	6.0	0.4	-0.2	-0.5	0.2	0.4
Real effective exchange rate (depreciation -)	-0.2	-1.6	0.8	-2.4	1.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Money and credit 2/ 3/											
Broad money	15.3	9.5	11.6	4.3	8.8	8.8	8.5	7.9	7.6	7.5	7.6
Net credit to the private sector	18.3	13.2	14.0	5.0	5.1	7.5	7.3	6.8	6.6	6.5	6.6
(In percent of GDP; unless otherwise indicated)											
Public sector											
NFPS revenue	27.7	27.7	24.9	23.2	23.0	23.4	23.9	24.3	24.7	24.7	24.6
NFPS primary expenditure	25.7	26.9	25.9	24.6	24.9	25.4	25.2	24.7	24.2	24.2	24.2
NFPS primary balance	2.0	0.8	-1.0	-1.4	-1.9	-2.0	-1.3	-0.4	0.5	0.5	0.5
NFPS overall balance	0.9	-0.3	-2.0	-2.5	-3.1	-3.3	-2.7	-1.9	-1.0	-1.0	-1.0
NFPS structural primary balance 5/	0.7	-0.3	-0.5	-1.1	-1.5	-1.7	-1.1	-0.4	0.5	0.5	0.5
External sector											
External current account balance	-4.6	-4.4	-4.8	-2.7	-1.3	-1.7	-1.8	-1.9	-2.0	-2.0	-2.0
Gross reserves											
In billions of U.S. dollars	65.7	62.4	61.5	61.7	63.7	63.7	64.2	64.2	64.2	64.2	64.2
Percent of short-term external debt 4/	536	534	523	450	312	478	454	506	508	509	515
Percent of foreign currency deposits at banks	274	258	224	230	225	220	222	224	228	232	238
Debt											
Total external debt 6/	29.9	34.1	38.1	38.2	35.7	33.1	31.2	30.2	28.9	27.6	26.4
Gross non-financial public sector debt 7/	19.9	20.6	23.9	24.4	25.3	26.6	27.6	27.7	27.2	26.6	26.2
External	8.8	8.7	11.1	10.3	8.7	8.5	8.3	8.5	8.3	8.1	7.8
Domestic	11.1	11.8	12.8	14.0	16.6	18.2	19.4	19.3	18.9	18.6	18.3
Savings and investment											
Gross domestic investment	25.8	24.9	24.1	22.6	21.4	21.9	22.6	23.3	23.8	24.1	24.5
Public sector (incl. repayment certificates)	5.8	5.6	5.0	4.8	4.5	4.8	5.0	5.1	5.1	5.1	5.1
Private sector (incl. inventories)	20.1	19.3	19.1	17.8	16.9	17.1	17.6	18.2	18.7	19.0	19.4
National savings	21.2	20.5	19.3	19.9	20.2	20.2	20.8	21.4	21.8	22.1	22.5
Public sector	7.0	6.0	3.8	2.7	2.0	2.2	3.0	3.8	4.7	4.8	4.8
Private sector	14.2	14.5	15.6	17.2	18.2	18.0	17.7	17.5	17.1	17.3	17.6
Memorandum items											
Nominal GDP (S/. billions)	548.2	576.5	612.7	659.7	701.8	749.0	796.9	848.1	901.6	958.0	1016.6
GDP per capita (in US\$)	6,655	6,586	6,168	6,208	6,762	7,198	7,533	7,823	8,133	8,486	8,864

Sources: National authorities; UNDP Human Development Indicators; and Fund staff estimates/projections.

1/ Defined as the percentage of households with total spending below the cost of a basic consumption basket.

2/ Corresponds to depository corporations.

3/ Foreign currency stocks are valued at end-of-period exchange rates.

5/ Adjusted by the economic cycle and commodity prices, and for non-structural commodity revenue. The latter uses as equilibrium commodity prices a moving average estimate that takes 5 years of historical prices and 3 years of forward prices according to IMF World Economic Outlook.

4/ Short-term debt is defined on a residual maturity basis and includes amortization of medium and long-term debt.

6/ Includes local currency debt held by non-residents and excludes global bonds held by residents.

7/ Includes repayment certificates.

Table 2. Peru: Nonfinancial Public Sector Main Fiscal Aggregates

	2013	2014	2015	2016	Prel.	Projections					
					2017	2018	2019	2020	2021	2022	2023
(In millions of soles; unless otherwise indicated)											
Revenues	151,806	159,446	152,631	153,226	161,144	175,355	190,747	205,992	222,606	236,280	250,528
Taxes	91,617	97,649	92,788	92,221	93,475	104,714	115,692	126,189	136,890	145,446	154,222
Other	60,189	61,797	59,842	61,005	67,669	70,641	75,055	79,803	85,716	90,834	96,306
Primary expenditures 1/	140,988	154,915	158,636	162,496	174,541	190,133	200,921	209,775	217,988	231,509	245,677
Current	106,446	118,107	122,503	127,122	137,103	147,329	153,959	159,778	164,880	174,409	184,907
Capital	34,542	36,808	36,133	35,373	37,438	42,803	46,963	49,997	53,108	57,100	60,770
Primary balance	10,818	4,531	-6,005	-9,270	-13,398	-14,777	-10,174	-3,783	4,618	4,771	4,851
Interest	6,090	6,206	6,475	7,137	8,336	9,967	11,224	12,613	13,868	14,382	15,080
Overall balance	4,729	-1,675	-12,480	-16,407	-21,734	-24,745	-21,398	-16,396	-9,250	-9,611	-10,228
External financing	-4,386	-843	9,733	1,033	-14,628	2,545	1,335	5,208	2,393	1,827	1,761
Domestic financing	-343	2,518	2,747	15,374	36,362	22,200	20,063	11,188	6,857	7,784	8,468
Public Gross Debt 2/	109,221	118,558	146,652	160,653	177,656	199,538	219,957	235,290	245,270	255,261	265,879
External	48,149	50,388	67,956	68,057	61,163	63,454	65,750	71,847	74,970	77,177	79,328
Domestic	56,908	64,004	74,236	88,552	112,749	132,640	151,062	160,599	167,756	175,839	184,607
Repayment Certificates	4,164	4,166	4,460	4,044	3,744	3,444	3,144	2,844	2,544	2,244	1,944
Public Assets	85,404	90,618	99,497	100,795	92,709	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
(In percent of GDP; unless otherwise indicated)											
Revenues	27.7	27.7	24.9	23.2	23.0	23.4	23.9	24.3	24.7	24.7	24.6
Taxes	16.7	16.9	15.1	14.0	13.3	14.0	14.5	14.9	15.2	15.2	15.2
Other	11.0	10.7	9.8	9.2	9.6	9.4	9.4	9.4	9.5	9.5	9.5
Primary expenditures 1/	25.7	26.9	25.9	24.6	24.9	25.4	25.2	24.7	24.2	24.2	24.2
Current	19.4	20.5	20.0	19.3	19.5	19.7	19.3	18.8	18.3	18.2	18.2
Capital	6.3	6.4	5.9	5.4	5.3	5.7	5.9	5.9	5.9	6.0	6.0
Primary balance	2.0	0.8	-1.0	-1.4	-1.9	-2.0	-1.3	-0.4	0.5	0.5	0.5
Interest	1.1	1.1	1.1	1.1	1.2	1.3	1.4	1.5	1.5	1.5	1.5
Overall balance	0.9	-0.3	-2.0	-2.5	-3.1	-3.3	-2.7	-1.9	-1.0	-1.0	-1.0
External financing	-0.8	-0.1	1.6	0.2	-2.1	0.3	0.2	0.6	0.3	0.2	0.2
Domestic financing	-0.1	0.4	0.4	2.3	5.2	3.0	2.5	1.3	0.8	0.8	0.8
Public Gross Debt 2/	19.9	20.6	23.9	24.4	25.3	26.6	27.6	27.7	27.2	26.6	26.2
External	8.8	8.7	11.1	10.3	8.7	8.5	8.3	8.5	8.3	8.1	7.8
Domestic	10.4	11.1	12.1	13.4	16.1	17.7	19.0	18.9	18.6	18.4	18.2
Repayment Certificates	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.3	0.3	0.2	0.2
Public Assets	15.6	15.7	16.2	15.3	13.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<i>Of which: Treasury Deposits and Fiscal Stabilization Fund</i>	8.1	8.2	9.4	9.0	7.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public Net Debt	4.3	4.8	7.7	9.1	12.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Memorandum items											
Commodity related revenues 3/	2.7	2.6	1.3	0.5	1.0	1.3	1.5	1.6	1.6	1.6	1.6
Output gap (percent of potential GDP)	1.7	-0.2	-0.9	-0.6	-1.1	-1.1	-0.8	-0.4	-0.2	0.0	0.0
NFPS non-commodity structural balance	-2.4	-3.3	-2.8	-2.8	-3.8	-4.3	-3.9	-3.4	-2.6	-2.6	-2.6
NFPS non-commodity primary structural balance	-1.3	-2.2	-1.7	-1.7	-2.6	-2.9	-2.5	-1.9	-1.1	-1.1	-1.1
NFPS structural balance 4/	-0.4	-1.3	-1.5	-2.2	-2.7	-3.0	-2.5	-1.9	-1.0	-1.0	-1.0
NFPS structural primary balance 4/	0.7	-0.3	-0.5	-1.1	-1.5	-1.7	-1.1	-0.4	0.5	0.5	0.5
Fiscal impulse (+ = expansionary)	1.2	1.0	0.2	0.6	0.4	0.2	-0.6	-0.7	-0.9	0.0	0.0

Sources: National Authorities; and Fund staff estimates.

1/ Official data excludes expense accrued during the period by Repayment Certificates (CRPAOs) and Petroleum Price Stabilization Fund (FEPC), but includes corresponding cash payments.

2/ Official data excludes stock of debt accumulated and not paid during the period by Repayment Certificates (CRPAOs) and Petroleum Price Stabilization Fund (FEPC).

3/ Net of tax restitutions. In 2014, excludes one-off revenue from the sale of a mine Las Bambas.

4/ Adjusted by the economic cycle and commodity prices, and for non-structural commodity revenue. The latter uses as equilibrium commodity prices a moving average estimate that takes 5 years of historical prices and 3 years of forward prices according to IMF World Economic Outlook.

Table 3. Peru: Statement of Operations of the General Government 1/
(In percent of GDP; unless otherwise indicated)

	2013	2014	2015	2016	Prel.		Projections				
					2017	2018	2019	2020	2021	2022	2023
Revenue	22.2	22.3	20.2	18.7	18.2	18.6	19.2	19.6	19.9	19.9	19.9
Taxes	16.7	16.9	15.1	14.0	13.3	14.0	14.5	14.9	15.2	15.2	15.2
Social Contributions	2.1	2.2	2.0	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other revenue	3.3	3.1	2.9	2.4	2.7	2.5	2.5	2.5	2.5	2.5	2.5
Expense 2/	15.4	16.6	16.9	16.3	16.4	16.6	16.4	16.0	15.6	15.5	15.5
Compensation of employees	5.2	6.0	6.2	5.9	6.1	6.1	6.0	5.8	5.7	5.6	5.6
Use of goods and services	6.2	6.0	6.5	6.2	6.1	6.2	6.1	5.9	5.8	5.7	5.7
Interest	1.1	1.0	1.0	1.0	1.1	1.2	1.3	1.4	1.4	1.4	1.4
Social benefits	2.0	1.9	2.0	2.1	2.1	2.1	2.0	2.0	1.9	1.8	1.8
Other expenses 3/	0.8	1.6	1.2	1.0	1.0	1.0	0.9	0.9	0.8	0.9	0.9
Net acquisition of nonfinancial assets	6.1	6.0	5.4	4.7	4.7	5.1	5.3	5.3	5.3	5.4	5.4
Acquisitions of nonfinancial assets	6.1	6.0	5.4	4.7	4.7	5.1	5.3	5.3	5.3	5.4	5.4
Gross Operating Balance	6.8	5.7	3.3	2.4	1.8	2.0	2.8	3.5	4.3	4.4	4.4
Net lending (+) borrowing (-) 4/	0.7	-0.2	-2.1	-2.2	-2.9	-3.1	-2.5	-1.8	-1.0	-1.0	-1.0
Net acquisition of financial assets 5/	0.3	0.8	-1.4	0.4	-0.9	-0.3	-0.2	-0.9	-0.7	-0.8	-0.8
<i>By instrument</i>											
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits 6/	0.3	0.8	-1.4	0.4	-0.9	-0.3	-0.2	-0.9	-0.7	-0.8	-0.8
<i>By residency</i>											
Domestic	0.3	0.8	-1.4	0.4	-0.9	-0.3	-0.2	-0.9	-0.7	-0.8	-0.8
External	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities 7/	-0.5	1.0	0.8	2.6	2.0	2.7	2.2	0.8	0.3	0.2	0.2
<i>By instrument</i>											
Debt securities	0.3	1.1	0.8	2.5	3.5	2.4	2.1	0.2	0.0	0.0	0.0
Loans	-0.8	-0.1	-0.1	0.2	-1.6	0.3	0.2	0.6	0.3	0.2	0.2
<i>By residency</i>											
Domestic	0.3	1.1	0.8	2.5	3.5	2.4	2.1	0.2	0.0	0.0	0.0
External	-0.8	-0.1	-0.1	0.2	-1.6	0.3	0.2	0.6	0.3	0.2	0.2
Memorandum items											
Central Government Net lending (+) borrowing (-)	-0.1	-1.1	-2.8	-2.7	-4.4	-3.6	-3.2	-2.7	-2.1	-2.0	-2.0
Regional Governments Net lending (+) borrowing (-)	0.4	0.6	0.7	0.1	0.1	0.3	0.4	0.5	0.7	0.7	0.8
Local Governments Net lending (+) borrowing (-)	-0.2	0.2	0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.1	-0.1
General Government Primary Balance	1.8	0.8	-1.1	-1.2	-1.8	-1.9	-1.2	-0.4	0.5	0.4	0.4
General Government Overall Balance	0.7	-0.2	-2.1	-2.2	-2.9	-3.1	-2.5	-1.8	-1.0	-1.0	-1.0
Gen. Gov. primary spending (real percentage change)	11.1	7.3	1.5	-2.7	4.1	7.7	3.7	2.1	1.6	4.3	4.2
<i>Of which:</i> Current spending	10.5	10.6	4.6	0.1	3.9	5.7	2.2	1.4	0.7	3.8	4.1
Capital spending	12.4	-0.4	-6.6	-10.8	4.8	14.1	8.1	4.4	4.2	5.5	4.3
General Government non-financial expenditures	20.4	21.5	21.3	19.9	20.0	20.5	20.3	19.9	19.4	19.4	19.5

Sources: National authorities and Fund staff estimates.

1/ Fiscal data is not fully compiled on an accrual basis.

2/ Official data excludes expense accrued during the period by Repayment Certificates (CRPAOs) and Petroleum Price Stabilization Fund (FEPC), but includes corresponding cash payments.

3/ Includes transfers to the Petroleum Price Stabilization Fund (FEPC).

4/ Net lending (+)/ borrowing (-) is equal to gross operating balance minus net acquisitions of nonfinancial assets.

5/ (+) corresponds to increase in financial assets; (-) to a decrease in financial assets.

6/ Includes Fiscal Stabilization Fund (FEF).

7/ (+) corresponds to increase in liabilities (disbursement and/or issuance); (-) to decrease in liabilities (amortizations).

Table 4. Peru: General Government Stock Positions
(In percent of GDP; unless otherwise indicated)

	2013	2014	2015	2016	Prel. 2017	2018	2019	Projections 1/			2023
								2020	2021	2022	
Stock positions:											
Net worth	....	....	....	....	....	....	....	....	....	....	....
Nonfinancial assets	....	....	....	....	....	....	....	....	....	....	....
Net financial worth	-1.5	-2.7	-5.3	-6.9	-8.7	-11.2	-13.0	-14.0	-14.1	-14.3	-14.4
Financial assets	14.9	14.9	15.4	14.5	12.4	11.3	10.4	8.8	7.6	6.4	5.2
<i>By instrument</i>											
Currency and deposits 2/	14.6	14.7	15.1	14.2	12.2	11.1	10.2	8.6	7.4	6.2	5.0
Debt securities	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
<i>By residency</i>											
Domestic	14.6	14.7	15.1	14.2	12.2	11.1	10.2	8.6	7.4	6.2	5.0
External	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
<i>By currency 3/</i>											
Domestic	14.0	13.8	13.9	14.1	12.1	11.0	10.0	8.5	7.3	6.2	6.2
Foreign	0.4	0.4	0.4	0.5	0.4	0.4	0.3	0.3	0.2	0.2	0.2
Liabilities 4/	16.4	17.6	20.7	21.4	21.1	22.5	23.4	22.8	21.7	20.7	19.6
<i>By instrument</i>											
Debt securities	11.4	11.9	12.1	13.7	16.4	17.7	18.8	17.9	16.8	15.8	14.9
Loans	5.0	5.7	8.6	7.7	4.7	4.8	4.6	5.0	5.0	4.9	4.7
<i>By residency</i>											
Domestic	7.4	8.5	9.2	10.8	13.2	14.8	16.0	15.2	14.3	13.5	12.7
External	9.1	9.1	11.5	10.6	7.9	7.8	7.5	7.6	7.4	7.2	6.9
<i>By currency 3/</i>											
Domestic	19.9	24.1	29.2	36.4	43.0	47.8	51.9	50.2	47.7	45.3	42.9
Foreign	24.5	25.9	36.7	35.8	25.8	25.1	24.3	25.1	24.8	24.2	23.5
Memorandum items											
Fiscal Stabilization Fund and other public savings	4.2	4.5	4.1	4.2	3.0	2.4	2.0	1.7	1.6	1.5	1.5
Debt of SOEs guaranteed by government 5/	0.7	0.7	0.7	0.7	0.6	0.6	0.5	0.5	0.5	0.5	0.5

Sources: National authorities and Fund staff estimates.

1/ Assuming zero other economic flows.

2/ Includes stocks of Fiscal Stabilization Fund (FEF).

3/ Preliminary data.

4/ Excludes debt of public enterprises guaranteed by the central government, debt of Petroleum Price Stabilization Fund (FEPC), and Repayment Certificates (CRPAOs).

5/ This debt is excluded from general government liabilities since it is a liability of SOEs.

Table 5. Peru: Balance of Payments
(In billions of U.S. dollars; unless otherwise noted)

	2013	2014	2015	2016	Prel. 2017	Projections					
						2018	2019	2020	2021	2022	2023
Current account	-9.4	-8.9	-9.2	-5.3	-2.7	-4.0	-4.5	-5.0	-5.4	-5.6	-5.9
Merchandise trade	0.5	-1.5	-2.9	1.9	6.3	8.4	7.9	7.2	6.5	6.1	5.5
Exports	42.9	39.5	34.4	37.0	44.9	50.8	52.9	54.8	56.8	59.0	61.4
Traditional	31.6	27.7	23.4	26.1	33.1	37.7	38.9	39.9	40.9	42.2	43.6
Mining	23.8	20.5	19.0	21.8	27.2	30.9	31.9	32.8	33.7	34.7	35.8
Nontraditional and others	11.3	11.8	11.0	10.9	11.8	13.1	13.9	14.8	15.8	16.8	17.8
Imports	-42.4	-41.0	-37.3	-35.1	-38.7	-42.5	-45.0	-47.6	-50.3	-52.8	-55.8
Services, income, and current transfers (net)	-9.9	-7.4	-6.3	-7.2	-9.0	-12.3	-12.4	-12.2	-11.9	-11.8	-11.5
Services	-2.0	-1.9	-2.0	-2.0	-1.4	-2.2	-2.3	-2.4	-2.4	-2.4	-2.4
Investment income	-11.2	-9.9	-7.5	-9.2	-11.3	-13.9	-14.0	-14.1	-14.2	-14.4	-14.5
Current transfers	3.3	4.4	3.3	4.0	3.7	3.8	4.0	4.3	4.7	5.1	5.4
Capital and financial account balance	10.4	6.6	9.5	6.4	3.9	4.0	5.0	5.0	5.4	5.6	5.9
Public sector	-1.8	-0.1	3.1	2.7	3.2	1.0	0.6	1.8	0.9	0.7	0.7
Medium-term loans 1/	-1.3	1.3	4.0	0.2	-1.5	0.8	0.4	1.6	0.7	0.5	0.5
Other public sector flows 2/	-0.1	-0.7	-0.4	2.7	4.1	0.2	0.2	0.2	0.2	0.2	0.2
Short-term flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	12.2	6.7	6.3	3.8	0.7	2.9	4.4	3.2	4.5	4.9	5.2
Foreign direct investment (net) 3/	9.7	3.6	8.1	6.6	6.5	7.0	7.2	7.4	8.1	8.8	9.0
Medium- and long-term loans	0.9	5.7	1.4	-1.7	-3.9	-1.4	-1.1	-0.8	-0.6	-0.4	-0.1
Portfolio investment	4.7	-1.8	-0.7	-1.2	-0.9	-2.2	-2.2	-2.2	-2.2	-2.2	-2.2
Short-term flows 4/	-3.1	-0.9	-2.4	0.1	-1.0	-0.5	0.5	-1.2	-0.9	-1.4	-1.5
Errors and omissions	1.8	0.1	-0.2	-0.9	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	2.9	-2.2	0.1	0.2	1.6	0.0	0.5	0.0	0.0	0.0	0.0
Financing	-2.9	2.2	-0.1	-0.2	-1.6	0.0	-0.5	0.0	0.0	0.0	0.0
NIR flow (increase -)	-2.9	2.2	-0.1	-0.2	-1.6	0.0	-0.5	0.0	0.0	0.0	0.0
Change in NIR (increase -)	-1.7	3.4	0.8	-0.2	-1.9	0.0	-0.5	0.0	0.0	0.0	0.0
Valuation change	-1.2	-1.2	-0.9	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
						(In percent of GDP)					
Current account balance	-4.6	-4.4	-4.8	-2.7	-1.3	-1.7	-1.8	-1.9	-2.0	-2.0	-2.0
Trade balance	0.2	-0.7	-1.5	1.0	2.9	3.6	3.2	2.8	2.4	2.2	1.8
Exports	21.1	19.5	17.9	18.9	20.9	22.0	21.6	21.3	21.0	20.7	20.4
Traditional	15.6	13.6	12.2	13.4	15.4	16.3	15.9	15.5	15.1	14.8	14.5
Mining	11.7	10.1	9.9	11.1	12.6	13.4	13.0	12.8	12.5	12.2	11.9
Nontraditional and others	5.6	5.8	5.7	5.6	5.5	5.7	5.7	5.8	5.9	5.9	5.9
Imports	-20.9	-20.2	-19.4	-18.0	-18.0	-18.3	-18.4	-18.5	-18.6	-18.5	-18.6
Services, income, and current transfers (net)	-4.9	-3.7	-3.3	-3.7	-4.2	-5.3	-5.1	-4.7	-4.4	-4.1	-3.8
Investment income	-5.5	-4.9	-3.9	-4.7	-5.2	-6.0	-5.7	-5.5	-5.2	-5.1	-4.8
Capital and financial account balance	5.1	3.3	4.9	3.3	1.8	1.7	2.0	1.9	2.0	2.0	2.0
Foreign direct investment (net)	4.8	1.8	4.2	3.4	3.0	3.0	2.9	2.9	3.0	3.1	3.0
Overall balance	1.4	-1.1	0.0	0.1	0.8	0.0	0.2	0.0	0.0	0.0	0.0
Memorandum items						(Annual percentage change)					
Export value	-9.6	-7.8	-12.9	7.6	21.3	13.2	4.0	3.6	3.6	3.9	4.1
Volume growth	-4.2	-1.0	2.4	11.6	7.3	2.6	3.4	3.3	3.4	3.3	3.3
Price growth	-5.7	-6.9	-15.0	-3.6	13.1	10.3	0.6	0.3	0.3	0.5	0.7
Import value	3.3	-3.1	-9.0	-5.9	10.0	9.8	6.0	5.7	5.6	5.1	5.7
Volume growth	3.8	-1.6	0.2	-3.0	4.4	5.6	5.8	5.2	4.8	4.7	5.4
Price growth	-0.5	-1.5	-9.2	-3.0	5.4	4.0	0.2	0.5	0.8	0.3	0.3
Terms of trade	-5.2	-5.4	-6.4	-0.7	7.3	6.0	0.4	-0.2	-0.5	0.2	0.4
Gross international reserves (in billions of US\$)	65.7	62.4	61.5	61.7	63.7	63.7	64.2	64.2	64.2	64.2	64.2
Average exchange rate (\$/ per US\$)	2.70	2.84	3.19	3.38	3.26	...	...	...	...	...	...

Sources: National authorities and Fund staff estimates and projections.

1/ Includes financial public sector.

2/ Includes public sector's net external assets and other transactions involving Treasury bonds.

3/ Excluding privatization.

4/ Includes Financial Corporation for Development (COFIDE) and the National Bank.

Table 6. Peru: Monetary Survey 1/
(In billions of soles; unless otherwise noted)

	2013	2014	2015	2016	2017	Projections					
						2018	2019	2020	2021	2022	2023
I. Central Reserve Bank											
Net foreign assets	144	140	133	142	151	147	151	153	155	156	158
Net international reserves 2/	184	186	210	207	206	205	210	213	215	216	217
(In billions of U.S. dollars)	66	62	61	62	64	64	64	64	64	64	64
Foreign currency liabilities	-40	-46	-77	-66	-56	-58	-59	-60	-60	-60	-59
Net domestic assets	-92	-86	-82	-88	-93	-85	-81	-75	-68	-60	-52
Net credit to nonfinancial public sector	-61	-67	-71	-76	-65	-58	-52	-47	-42	-37	-32
Credit to the financial sector 3/	-8	2	23	22	15	15	15	15	15	15	15
Securities issued	-22	-14	-20	-21	-32	-35	-39	-42	-47	-51	-56
Other assets (net)	-2	-6	-13	-13	-11	-7	-6	-1	5	13	21
Monetary base	52	54	51	53	57	63	70	78	86	96	107
Currency	35	39	41	43	46	51	56	62	68	75	82
Reserve	17	15	11	10	11	12	14	16	19	22	25
II. Depository Corporations 4/											
Net foreign assets	152	152	171	176	178	178	183	185	187	188	189
Net domestic assets	52	72	78	85	106	130	152	176	201	229	260
Net credit to the public sector	-73	-73	-78	-78	-63	-41	-21	-9	-3	5	14
Credit to the private sector	198	224	256	269	282	304	326	348	371	395	421
Other assets (net)	-74	-79	-100	-106	-114	-133	-154	-163	-167	-171	-175
Broad money	204	224	250	260	283	308	334	361	388	417	449
Domestic currency	137	152	156	170	191	215	239	266	293	324	358
Foreign currency	67	72	94	90	92	94	95	95	95	93	92
III. Financial System 5/											
Net foreign assets	203	211	237	246	261	259	264	268	270	272	273
Net domestic assets	119	143	157	178	206	249	287	327	369	416	467
Net credit to the public sector	-58	-50	-52	-45	-24	-16	-8	-4	-1	2	5
Credit to the private sector	240	271	303	323	336	354	385	419	456	496	537
Other assets (net)	-63	-77	-94	-100	-106	-89	-90	-89	-86	-82	-75
Liabilities to the private sector	322	355	394	424	467	508	551	595	640	688	740
Domestic currency	246	273	288	317	359	398	440	484	530	580	636
Foreign currency	76	82	106	107	108	110	111	111	109	107	104
(12-month percentage change)											
Monetary base	-1.5	3.7	-4.8	4.1	7.2	10.0	11.1	11.2	11.2	11.1	11.0
Broad money	15.3	9.5	11.6	4.3	8.8	8.8	8.5	7.9	7.6	7.5	7.6
Domestic currency	11.6	10.6	3.0	9.1	12.5	12.0	11.6	10.9	10.5	10.4	10.4
Foreign currency	23.6	7.3	29.8	-3.6	1.7	2.1	1.3	0.3	-0.6	-1.3	-2.0
Liabilities to the private sector	10.1	10.2	10.9	7.7	10.1	8.8	8.5	7.9	7.6	7.5	7.6
Domestic currency	7.6	11.1	5.5	9.9	13.3	11.0	10.6	9.9	9.5	9.5	9.6
Foreign currency	19.0	7.4	29.2	1.6	0.6	1.8	1.0	-0.2	-1.1	-1.9	-2.7
Depository corporations credit to the private sector	18.3	13.2	14.0	5.0	5.1	7.5	7.3	6.8	6.6	6.5	6.6
Domestic currency	22.6	17.7	28.4	6.8	5.3	7.7	8.8	8.5	8.5	8.5	8.5
Foreign currency	12.6	6.5	-9.4	0.8	4.5	7.1	3.5	2.3	1.2	0.7	0.7

Sources: National Authorities; and Fund staff estimates.

1/ Stocks in foreign currency are valued at the end-of-period exchange rate.

2/ Excludes subscriptions to the IMF and the Latin American Reserve Fund, Pesos Andinos, credit lines to other central banks, Andean Development Corporation bonds, and foreign assets temporarily held by the Central Bank as part of swap operations.

3/ Including the National Bank.

4/ Depository corporations comprise the Central Bank, the National Bank, commercial banks, the Agricultural Bank, financial firms, municipal banks, rural banks and credit unions.

5/ Financial system comprises depository corporations and other financial corporations. Other financial companies include mutual funds, COFIDE, insurance companies, leasing companies, pension funds, the Financing Agency for Small and Medium-sized Enterprises and the Fund for Financing Housing.

Table 7. Peru: Financial Soundness Indicators 1/
(In percent; unless otherwise indicated)

	2012	2013	2014	2015	2016	2017
	(as of December)					
Capital Adequacy						
Capital to risk-weighted assets 2/	14.4	13.9	14.2	14.3	15.1	15.2
Regulatory Tier I capital to risk-weighted assets 3/	10.9	10.4	10.4	10.3	11.0	11.4
Nonperforming loans net of provisions to capital 4/	-2.0	-0.7	-0.2	-0.3	-0.4	-0.5
Leverage 5/	7.9	7.9	8.3	7.9	8.7	9.4
Asset Quality						
Nonperforming loans to total gross loans 4/	2.2	2.6	2.9	2.9	3.1	3.3
In domestic currency	3.0	3.3	3.4	2.9	3.2	3.6
In foreign currency	1.1	1.5	2.1	2.9	2.8	2.6
Nonperforming, refinanced and restructured loans to total gross loans 4/ 6/	3.2	3.6	4.0	4.0	4.4	4.8
In domestic currency	4.2	3.3	3.4	2.9	3.2	3.6
In foreign currency	1.8	1.5	2.1	2.9	2.8	2.6
Refinanced and restructured loans to total gross loans	1.1	1.0	1.1	1.1	1.3	1.5
Provisions to nonperforming loans 4/	202.0	175.2	157.7	161.8	157.1	151.0
Provisions to nonperforming, restructured, and refinanced loans 4/ 6/	134.9	126.3	114.4	116.5	111.1	104.9
Sectoral distribution of loans to total loans						
Consumer loans	19.1	18.4	18.1	18.3	18.9	19.2
Mortgage loans	14.7	15.3	15.5	15.2	15.1	15.4
Large corporations	15.8	17.6	17.2	21.4	22.2	22.6
Small corporations	15.3	15.5	17.0	15.8	14.8	14.3
Medium size firms	17.5	17.6	18.3	16.9	16.4	15.4
Small firms	12.5	11.4	10.1	9.0	9.1	9.4
Microenterprises	5.2	4.3	3.8	3.4	3.6	3.7
Earnings and Profitability						
Return on equity (ROE)	21.5	20.0	18.2	21.1	19.2	17.7
Return on assets (ROA)	2.2	2.0	1.9	2.1	2.0	2.1
Financial revenues to total revenues	82.7	85.6	85.0	85.1	85.3	84.2
Annualized financial revenues to revenue-generating assets	11.2	10.9	10.6	10.5	10.1	10.2
Liquidity						
Total liquid assets to total short-term liabilities (monthly average basis)	45.0	43.0	39.4	37.7	35.4	38.5
In domestic currency	44.2	31.4	25.3	26.2	26.7	33.0
In foreign currency	46.2	56.4	55.2	47.5	44.9	45.7
Deposit-to-loan	95.2	98.1	90.5	92.0	88.4	92.1
Foreign Currency Position and Dollarization						
Share of foreign currency deposits in total deposits	38.2	43.6	43.4	49.5	44.1	39.3
Share of foreign currency loans in total credit	44.4	41.1	38.4	30.1	28.8	29.4
Operational efficiency						
Financing to related parties to capital 7/	11.5	9.3	9.4	12.3	9.1	9.6
Nonfinancial expenditure to total revenues 8/	33.6	33.7	33.0	30.9	30.8	30.7
Annualized Nonfinancial expenditure to total revenue-generating assets 8/	4.6	4.3	4.1	3.8	3.7	3.7
Memorandum items						
General Stock market index, IGBVL	20,629	15,754	14,794	9,849	15,567	19,974
EMBI+ PERU spread, basis points	117	174	181	243	170	112

Source: National authorities.

1/ These indicators correspond to depository corporations.

2/ Since July 2009, the regulatory capital requirement applied to all risks: credit, market and operational risk.

3/ Since July 2009, Banking Law component establishes that the Tier I capital have to be defined, and Risk-weighted assets include overall risks (credit, market and operational).

4/ Nonperforming loans are overdue loans after 15 days since the due date for commercial loans, and after 30 days for small businesses loans. In the case of mortgage, consumer and leasing loans, they are considered overdue after 30 days since the due date only for the non paid portion and after 90 days for all the credit. The overdue loans include credits under judicial resolution. Figures are net of specific provisions.

5/Tier I regulatory capital / Total Exposure (on-balance sheet exposures, derivative exposures and off-balance exposures converted into credit exposure equivalents using credit conversion factors).

6/ Includes restructured loans, refinanced loans, and arrears. Refinanced loans refer to those loans subjected to either term and/or principal modifications with respect to the initial debt contract. Restructured loans refer to those loans whose payments have been restructured according to the "Ley General del Sistema Concursal."

7/ Financing to related parties corresponds to those loans to individuals and firms owning more than 4 percent of the bank.

8/ Nonfinancial expenditures do not consider provisions nor depreciation.

Table 8. Peru: Financial and External Vulnerability Indicators
(In percent; unless otherwise indicated)

	2013	2014	2015	2016	Prel.		Projections				
					2017	2018	2019	2020	2021	2022	2023
Financial indicators											
Public sector debt/GDP	19.9	20.6	23.9	24.4	25.3	26.6	27.6	27.7	27.2	26.6	26.2
<i>Of which:</i> in domestic currency (percent of GDP)	11.1	11.8	12.8	14.0	16.6	18.2	19.4	19.3	18.9	18.6	18.3
90-day prime lending rate, domestic currency (end of period)	4.5	4.7	4.9	5.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
90-day prime lending rate, foreign currency (end of period)	1.0	0.7	1.1	1.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Velocity of money 1/	2.6	2.6	2.5	2.5	2.5	2.4	2.4	2.4	2.3	2.3	2.3
Net credit to the private sector/GDP 2/	36.2	38.9	41.8	40.7	40.2	40.5	40.9	41.0	41.1	41.2	41.4
External indicators											
Exports, U.S. dollars (percent change)	-9.6	-7.8	-12.9	7.6	21.3	13.2	4.0	3.6	3.6	3.9	4.1
Imports, U.S. dollars (percent change)	3.3	-3.1	-9.0	-5.9	10.0	9.8	6.0	5.7	5.6	5.1	5.7
Terms of trade (percent change) (deterioration -) 3/	-5.2	-5.4	-6.4	-0.7	7.3	6.0	0.4	-0.2	-0.5	0.2	0.4
Current account balance (percent of GDP)	-4.6	-4.4	-4.8	-2.7	-1.3	-1.7	-1.8	-1.9	-2.0	-2.0	-2.0
Capital and financial account balance (percent of GDP)	5.1	3.3	4.9	3.3	1.8	1.7	2.0	1.9	2.0	2.0	2.0
Total external debt (percent of GDP)	29.9	34.1	38.1	38.2	35.7	33.1	31.2	30.2	28.9	27.6	26.4
Medium- and long-term public debt (in percent of GDP) 4/	11.8	11.8	13.9	15.2	15.3	14.6	13.9	13.9	13.5	13.0	12.5
Medium- and long-term private debt (in percent of GDP)	15.0	19.1	20.7	19.4	16.7	15.1	14.1	13.4	12.7	12.1	11.7
Short-term public and private debt (in percent of GDP)	3.1	3.1	3.6	3.7	3.7	3.4	3.1	2.9	2.7	2.5	2.3
Total external debt (in percent of exports of goods and services) 4/	124.5	152.2	180.3	172.3	147.0	131.1	124.7	121.2	116.7	112.3	108.0
Total debt service (in percent of exports of goods and services) 5/	35.0	30.3	34.0	37.1	43.1	28.9	29.5	26.6	25.6	24.5	23.3
Gross official reserves											
In millions of U.S. dollars	65,710	62,353	61,537	61,746	63,731	63,731	64,231	64,231	64,231	64,231	64,231
In percent of short-term external debt 6/	536.5	534.3	523.0	449.8	312.4	478.2	454.4	505.7	508.4	509.3	515.2
In percent of short-term external debt, foreign currency deposits, and adjusted CA balance 6/ 7/	124.3	131.2	112.9	121.6	113.2	123.7	121.2	123.7	122.9	122.1	123.0
In percent of broad money 8/	90.0	83.2	84.1	79.6	72.9	66.8	62.9	59.1	55.5	51.9	48.4
In percent of foreign currency deposits at banks	273.9	257.8	224.3	230.1	225.2	219.7	221.8	224.1	227.6	231.8	237.6
In months of next year's imports of goods and services	16.1	16.4	17.0	15.6	14.6	13.7	13.0	12.3	11.6	10.9	n.a.
Net international reserves (in millions of U.S. dollars)	65,663	62,308	61,485	61,686	63,621	63,621	64,121	64,121	64,121	64,121	64,121
Central Bank's Foreign Exchange Position	41,097	35,368	25,858	27,116	37,493	37,493	37,993	37,993	37,993	37,993	37,993

Sources: National authorities; IMF's Information Notice System (INS); and Fund staff estimates/projections.

1/ Defined as of the ratio of annual GDP to end-period broad money.

2/ Corresponds to depository corporations.

3/ End of period; data from INS.

4/ Includes Central Bank's debt.

5/ Includes debt service to the Fund.

6/ Short-term debt includes amortization of medium- and long-term loans falling due over the following year, including debt swaps.

7/ Current Account deficit adjusted for 0.75*net FDI inflows; if adjusted CA balance > 0, set to 0.

8/ At end-period exchange rate.

Table 9. Peru: Medium-Term Macroeconomic Framework

	2013	2014	2015	2016	Prel.	Projections					
					2017	2018	2019	2020	2021	2022	2023
(Annual percentage change)											
Production											
GDP at constant prices	5.8	2.4	3.3	4.1	2.5	3.7	4.1	4.2	4.2	4.1	4.0
Domestic demand at constant prices	7.3	2.2	2.9	1.1	1.6	4.5	4.7	4.7	4.5	4.5	4.5
Consumption	5.9	4.2	4.9	2.6	2.3	4.0	3.8	3.8	4.0	4.2	4.1
Investment	7.9	-2.0	-5.2	-4.7	-0.3	6.3	6.9	7.5	6.3	5.4	5.8
Of which: Private	7.1	-2.2	-4.2	-5.7	0.3	4.9	6.4	8.1	6.9	5.7	6.1
Of which: Public	11.1	-1.1	-9.5	-0.2	-2.3	11.8	8.7	5.1	4.0	4.4	4.5
Net exports (contribution to GDP growth)	-1.5	0.2	0.4	3.0	0.9	-0.7	-0.6	-0.4	-0.3	-0.4	-0.5
Exports	-1.3	-0.9	4.1	9.5	7.2	2.6	3.4	3.3	3.4	3.3	3.3
Imports	4.2	-1.4	2.4	-2.2	4.0	5.6	5.8	5.2	4.8	4.7	5.4
Consumer prices (end of period)	2.9	3.2	4.4	3.2	1.4	2.2	2.0	2.0	2.0	2.0	2.0
GDP deflator	1.6	2.7	2.9	3.5	3.8	2.9	2.2	2.2	2.1	2.1	2.0
Trade											
Merchandise trade											
Exports, f.o.b.	-9.6	-7.8	-12.9	7.6	21.3	13.2	4.0	3.6	3.6	3.9	4.1
Imports, f.o.b.	3.3	-3.1	-9.0	-5.9	10.0	9.8	6.0	5.7	5.6	5.1	5.7
Terms of trade (deterioration -)	-5.2	-5.4	-6.4	-0.7	7.3	6.0	0.4	-0.2	-0.5	0.2	0.4
(In percent of GDP; unless otherwise indicated)											
External current account balance	-4.6	-4.4	-4.8	-2.7	-1.3	-1.7	-1.8	-1.9	-2.0	-2.0	-2.0
Total external debt service 1/	8.4	6.8	7.2	8.2	10.5	7.3	7.4	6.6	6.3	6.0	5.7
Medium- and long-term	4.0	3.7	3.8	4.6	7.1	3.7	4.0	3.5	3.5	3.4	3.3
Nonfinancial public sector	1.9	1.3	1.1	1.5	2.6	0.9	1.3	0.9	0.9	0.9	0.9
Private sector	2.1	2.4	2.7	3.1	4.4	2.8	2.7	2.6	2.5	2.5	2.4
Short-term 2/	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Nonfinancial public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Interest	1.0	1.1	1.3	1.4	1.4	1.5	1.5	1.6	1.6	1.5	1.5
Amortization (medium-and long-term)	3.0	2.6	2.6	3.3	5.7	2.4	2.6	2.0	2.0	1.9	1.9
Public sector											
NFPS primary balance 3/	2.0	0.8	-1.0	-1.4	-1.9	-2.0	-1.3	-0.4	0.5	0.5	0.5
NFPS interest due	1.1	1.1	1.1	1.1	1.2	1.3	1.4	1.5	1.5	1.5	1.5
NFPS overall balance 3/	0.9	-0.3	-2.0	-2.5	-3.1	-3.3	-2.7	-1.9	-1.0	-1.0	-1.0
Public sector debt 3/	19.9	20.6	23.9	24.4	25.3	26.6	27.6	27.7	27.2	26.6	26.2
Savings and investment											
Gross domestic investment	25.8	24.9	24.1	22.6	21.4	21.9	22.6	23.3	23.8	24.1	24.5
Public sector 3/	5.8	5.6	5.0	4.8	4.5	4.8	5.0	5.1	5.1	5.1	5.1
Private sector	20.1	19.3	19.1	17.8	16.9	17.1	17.6	18.2	18.7	19.0	19.4
Private sector (excluding inventories)	20.9	20.3	19.5	18.0	17.1	17.3	17.6	18.2	18.7	19.0	19.4
Inventory changes	-0.8	-1.0	-0.4	-0.2	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0
National savings	21.2	20.5	19.3	19.9	20.2	20.2	20.8	21.4	21.8	22.1	22.5
Public sector 4/	7.0	6.0	3.8	2.7	2.0	2.2	3.0	3.8	4.7	4.8	4.8
Private sector	14.2	14.5	15.6	17.2	18.2	18.0	17.7	17.5	17.1	17.3	17.6
External savings	4.6	4.4	4.8	2.7	1.3	1.7	1.8	1.9	2.0	2.0	2.0
Memorandum items											
Nominal GDP (billions of nuevos soles)	548.2	576.5	612.7	659.7	701.8	749.0	796.9	848.1	901.6	958.0	1016.6
Gross international reserves (billions of U.S. dollars)	65.7	62.4	61.5	61.7	63.7	63.7	64.2	64.2	64.2	64.2	64.2
External debt service (percent of exports of GNFS)	35.0	30.3	34.0	37.1	43.1	28.9	29.5	26.6	25.6	24.5	23.3
Short-term external debt service (percent of exports of GNFS)	0.2	0.2	0.3	0.4	0.3	0.5	0.6	0.6	0.5	0.4	0.4
Public external debt service (percent of exports of GNFS)	7.8	5.9	5.4	6.9	10.8	3.5	5.4	3.5	3.7	3.8	3.7

Sources: National authorities and Fund staff estimates.

1/ Includes interest payments only.

2/ Includes the financial public sector.

3/ Includes Repayment Certificates (CRPAOs).

4/ Excludes privatization receipts.

Table 10. Peru: External Debt Sustainability Framework, 2015–23
(In percent of GDP, unless otherwise indicated)

	2015	2016	2017	Projections						Debt-stabilizing non-interest current account 6/
				2018	2019	2020	2021	2022	2023	
Baseline: External debt	38.1	38.2	35.7	33.1	31.2	30.2	28.9	27.6	26.4	-2.2
Change in external debt	4.0	0.1	-2.5	-2.6	-1.9	-1.0	-1.3	-1.3	-1.2	
Identified external debt-creating flows (4+8+9)	-0.3	-1.6	-2.2	-1.6	-1.5	-1.3	-1.4	-1.5	-1.4	
Current account deficit, excluding interest payments	3.5	1.3	-0.1	0.2	0.3	0.3	0.4	0.4	0.5	
Deficit in balance of goods and services	2.6	0.0	-2.2	-2.7	-2.3	-1.9	-1.5	-1.3	-1.0	
Exports	21.1	22.2	24.3	25.3	25.0	24.9	24.7	24.6	24.4	
Imports	23.7	22.2	22.1	22.6	22.7	23.0	23.2	23.3	23.4	
Net non-debt creating capital inflows (negative)	-3.9	-2.8	-2.6	-2.1	-2.0	-2.0	-2.2	-2.3	-2.3	
Net foreign direct investment, equity	4.2	3.4	3.0	3.0	2.9	2.9	3.0	3.1	3.0	
Net portfolio investment, equity	-0.4	-0.6	-0.4	-0.9	-0.9	-0.8	-0.8	-0.8	-0.7	
Automatic debt dynamics 1/	0.1	-0.1	0.5	0.2	0.3	0.4	0.4	0.4	0.5	
Denominator: 1+g+r+gr	0.9	1.0	1.1	1.1	1.1	1.0	1.1	1.1	1.1	
Contribution from nominal interest rate	1.3	1.4	1.4	1.5	1.5	1.6	1.6	1.5	1.5	
Contribution from real GDP growth	-1.2	-1.5	-0.9	-1.2	-1.3	-1.2	-1.2	-1.1	-1.0	
Contribution from price and exchange rate changes 2/	...	...	...	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	4.3	1.7	-0.3	-1.0	-0.4	0.3	0.1	0.2	0.1	
External debt-to-exports ratio (in percent)	180.3	172.3	147.0	131.1	124.7	121.2	116.7	112.3	108.0	
Gross external financing need (in billions of U.S. dollars) 4/	20.5	18.7	22.2	17.5	18.9	17.9	18.2	18.5	18.6	
In percent of GDP	10.7	9.6	10.3	7.6	7.7	7.0	6.7	6.5	6.2	
Scenario with key variables at their historical averages 5/		38.2	35.7	31.7	27.7	24.2	20.8	17.6	14.5	-4.7
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (in percent)	3.3	4.1	2.5	3.7	4.1	4.2	4.2	4.1	4.0	
GDP deflator in U.S. dollars (change in percent)	-8.3	-2.4	7.4	3.7	1.6	0.8	0.9	1.3	1.5	
Nominal external interest rate (in percent)	3.6	3.7	4.1	4.4	4.9	5.4	5.5	5.6	5.7	
Growth of exports and services (U.S. dollar terms, in percent)	-10.6	6.6	20.7	11.8	4.8	4.4	4.6	4.8	5.0	
Growth of imports and services (U.S. dollar terms, in percent)	-6.7	-4.8	9.4	10.1	6.5	6.2	6.1	5.7	6.2	
Current account balance, excluding interest payments	-3.5	-1.3	0.1	-0.2	-0.3	-0.3	-0.4	-0.4	-0.5	
Net non-debt creating capital inflows	3.9	2.8	2.6	2.1	2.0	2.0	2.2	2.3	2.3	

Source: National authorities and Fund staff calculations.

1/ Derived as $[r - g - r(1+g) + ea(1+r)]/(1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)]/(1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex I. Implementation of Past Fund Advice

Recommendations	Authorities' Response
Fiscal policies	
<p>Implement short-term fiscal stimulus plan to address flood-related reconstruction needs, underpinned by strong public investment management. Keep a focus on enhancing capacity to implement projects at the subnational level.</p>	<p>In progress. The authorities are ramping up public investment spending, with significant increase expected in 2018. They have received special legislative powers to amend the framework for reconstruction, aimed at improving the rate of project execution.</p>
<p>Raise the tax to GDP ratio. Streamline tax administration and reduce VAT exemptions and informality.</p>	<p>In progress. The authorities have increased excise rates on selected products. In addition, they are advancing in the implementation of tax administration measures to reduce tax evasion, including via electronic invoices. The latter became mandatory for a set of agents on January 1st in 2018.</p>
<p>Improve the PPP framework and introduce a comprehensive approach to monitoring fiscal risks. Publish an annual comprehensive fiscal risk statement, covering contingent liabilities and risks associated with investment plans.</p>	<p>In progress. The authorities have advanced in issuing regulations regarding the functioning of Proinversion, the agency in charge of PPPs. In addition, the August 2017 Multiannual Macroeconomic Framework included a section assessing the explicit contingencies faced by the NFPS, although a formal fiscal risk statement is still to be issued.</p>
Monetary and exchange rate policies	
<p>Complement fiscal policy with easier monetary policy as needed.</p>	<p>Completed. The monetary policy stance has been appropriately loosened.</p>
<p>Tie future changes in the FX reserve requirements to the de-dollarization objectives.</p>	<p>Partially implemented. The authorities have traditionally used FX reserve requirements as a tool with multiple objectives, which include: building buffers given the dollarization of the banking system, and regulating credit conditions. During the past year, given other dedollarization tools are now available, the BCRP has been focusing on reducing FX reserve requirements to what they consider a more neutral level with respect to local currency reserve requirements.</p>

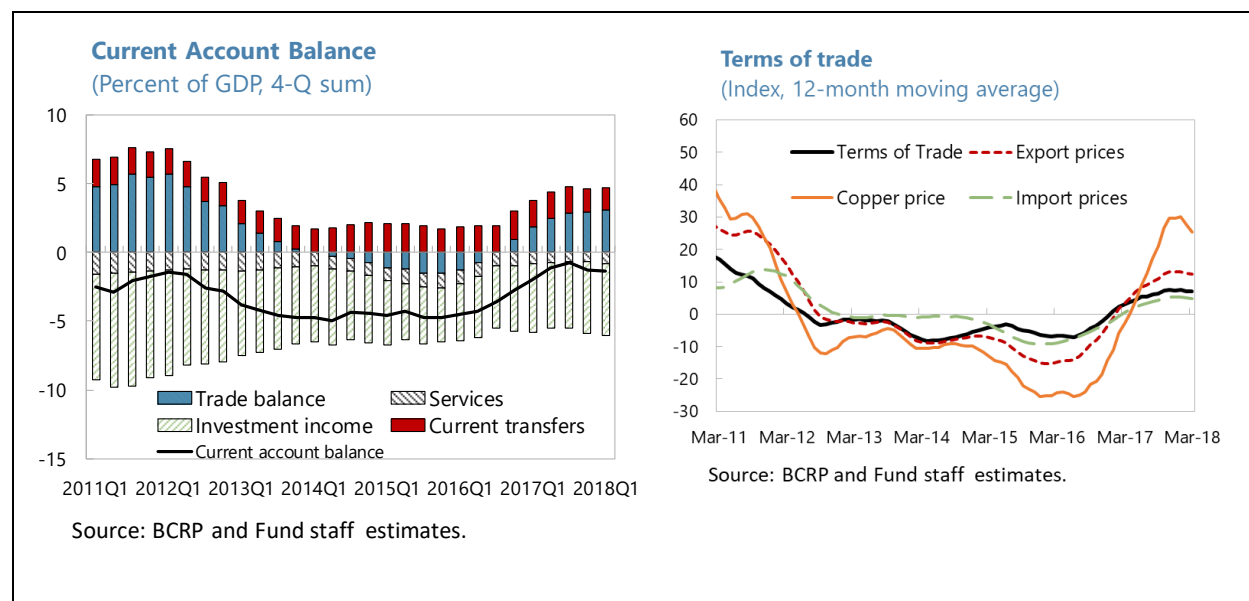
Limit FX interventions to cases of disorderly market conditions.	Partially implemented. The authorities continue to implement flexible exchange rate regime without targeting any particular level of exchange rate. Spot market interventions have been close to zero so far in 2018, and intervention using other instruments has been two-way.
Financial policies	
Formalize the Financial Stability Council.	Not implemented. The authorities' view is that current arrangements are working well and there is no need to designate a formal committee for macroprudential policy.
Broaden the financial supervisory perimeter.	In progress. A bill to reform the supervision of cooperatives and bring the large institutions under the purview of the SBS has been approved by Congress.
Enhance financial deepening and inclusion.	In progress. The state-owned Banco de la Nación modified its statute to be able to issue e-money, and implemented new online and mobile payment channels. Improvements to the Securities Market Law were made, and there are plans to reform the Alternative Stock Market.
Structural policies	
Increase labor market flexibility.	Not implemented.
Reduce economic informality.	In progress. The authorities agree that this is priority which will require a multi-faceted approach.
Close infrastructure gap.	In progress. The authorities are implementing an ambitious public investment agenda which will contribute to improving infrastructure.
Improve business climate.	In progress. The authorities requested special legislative powers to formulate policy in the area of competitiveness.
Strengthen implementation of anti-corruption and AML/CFT measures.	In progress. The authorities have implemented regulation to limit the use of FX cash transactions when they exceed specific thresholds. The authorities are also requesting special legislative powers from Congress to legislate in the area of integrity and anti-corruption.

Annex II. External Sector Assessment

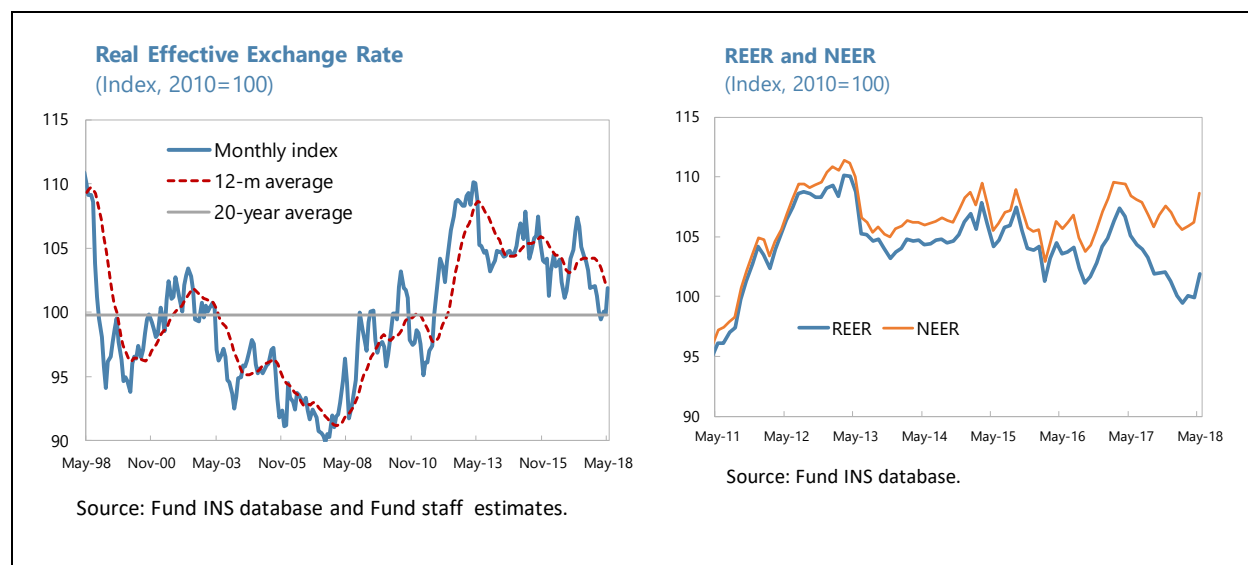
Peru's external position in 2017 strengthened and is now assessed to be moderately stronger than the level consistent with medium-term fundamentals and desirable policies. The current account (CA)-based approach suggests a positive current account gap of 1.6 percent of GDP, although the gap is likely to narrow this year and over the medium term. The lack of consistency with other methods is an important caveat. Reserve adequacy remains satisfactory, notwithstanding the impact of volatile commodity prices from Peru's large mining exports and the presence of significant domestic FX liabilities in foreign reserves. Both the level of international investment position and its trajectory are sustainable.

Background

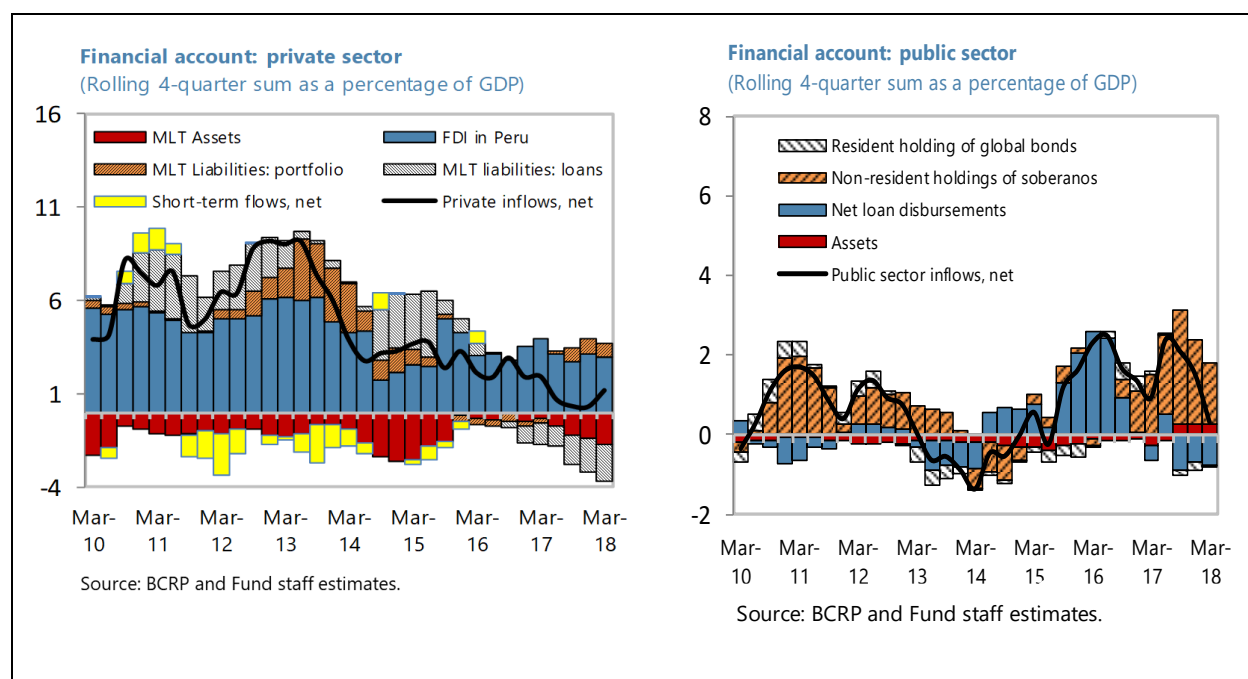
1. The CA balance continued to improve in 2017 given better terms of trade and further expansion of export volumes. The CA deficit shrank from 2¾ percent of GDP in 2016 to 1¼ percent of GDP in 2017, driven by a significant (nearly 2.3 percent of GDP) improvement in the balance of goods and services. The expansion of the goods trade balance mainly reflected an improvement in terms of trade driven by higher copper and other commodity prices, although fast growth in export volumes at the beginning of 2017 also contributed. The increase in the trade surplus was partially offset by higher income and dividends accrued on foreign investments in Peru. Over the medium term, the CA deficit is expected to widen to about 2 percent of GDP as investment and domestic demand recover.



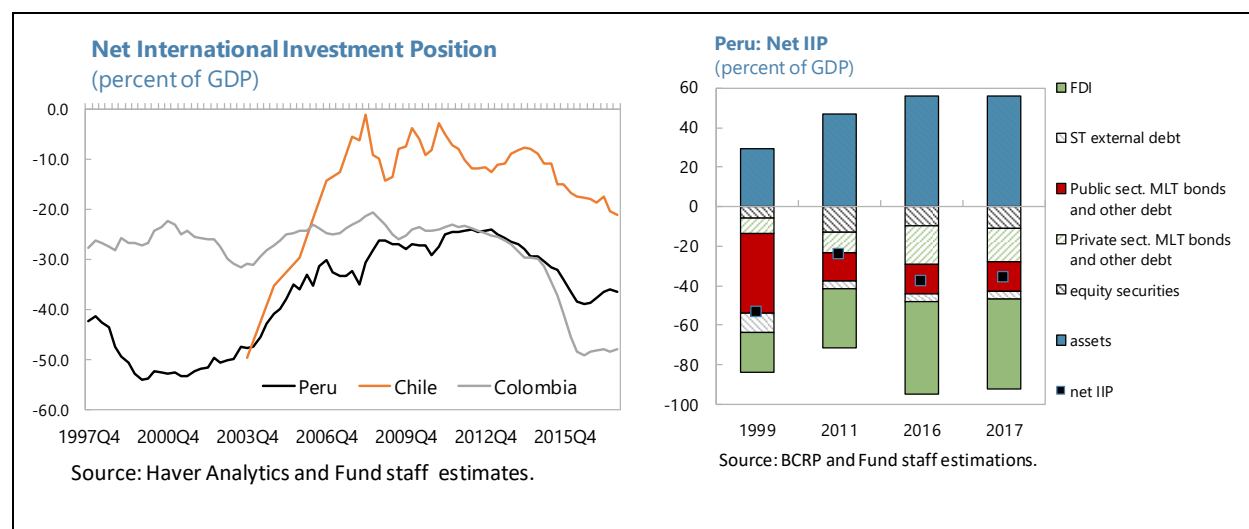
2. In the past five years, the REER gravitated closer to its 20-year historical average. The REER has been trending downwards since the peak observed in 2013, although with some volatility. The real depreciation since Q1 2017 was driven due to lower relative prices. At present, the REER index is very close to the 20-year historical average.



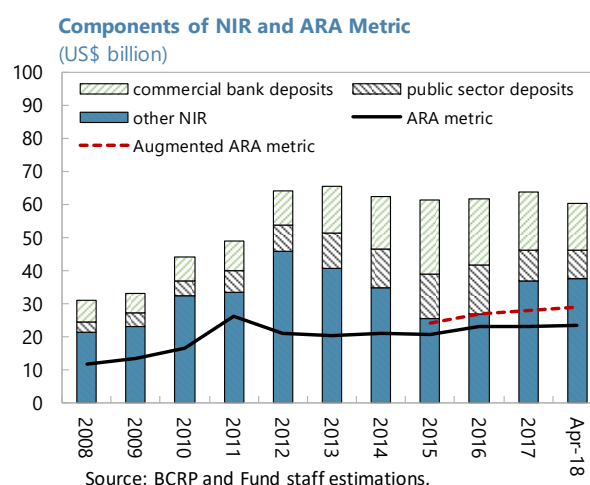
3. The financial account balance remained positive and sufficient to cover the current account deficit, although there has been some rebalancing between the private and public sectors. Net private sector inflows declined to below 0.5 percent of GDP in 2017 as FDI—which has historically been the dominant component of these inflows—was nearly offset by higher outflows comprising the accumulation of foreign assets (as pension funds increased foreign investments) and higher loan repayments (as some private entities took advantage of favorable financing conditions and issued portfolio securities to pre-pay some of their external debt). Inflows into the public sector have been propelled by non-resident holdings of local currency bonds, which have picked up since late 2016. However, the vulnerability to a sudden reversal in these flows is limited as the entire stock of non-resident holdings is around 5 percent of GDP.



4. Peru's IIP is characterized by large BCRP reserves on the assets side and moderate external debt and large FDI liabilities on the liability side. Peru's IIP improved from a low of -54 percent of GDP in the late 90s to -23½ percent of GDP in 2011. Since then, the IIP position has been on a declining trend, driven by the accumulation of FDI liabilities, although it strengthened to -36½ percent of GDP last year in line with a moderate decline in external debt. Peru's significant external assets (56 percent of GDP) include sizeable holdings of foreign assets by the central bank (almost 30 percent of GDP), and foreign assets of the financial system (16 percent of GDP). The assets are offset by large FDI liabilities (45½ percent of GDP), moderate external indebtedness (public and private external debt amounts close to 36 percent of GDP), and other liabilities (11 percent of GDP). The IIP is projected to improve slightly to about -33–34 percent of GDP in the medium term.

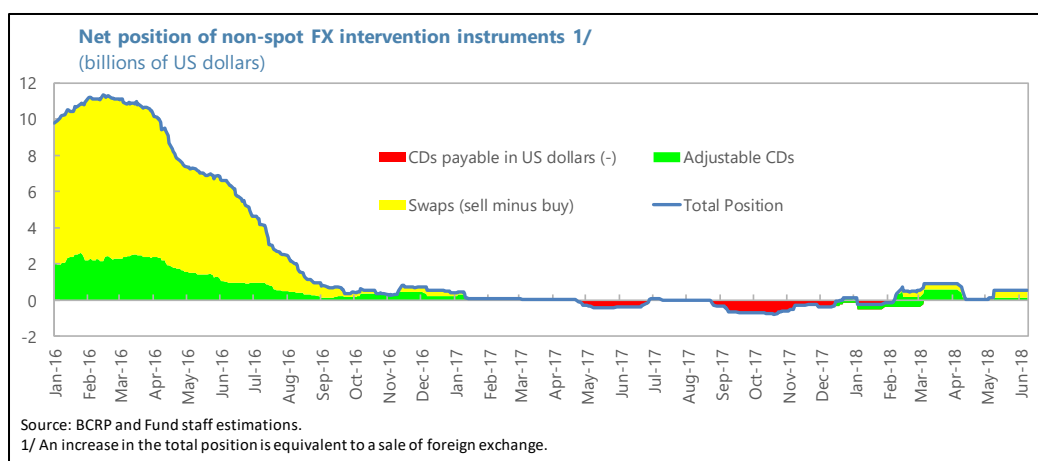
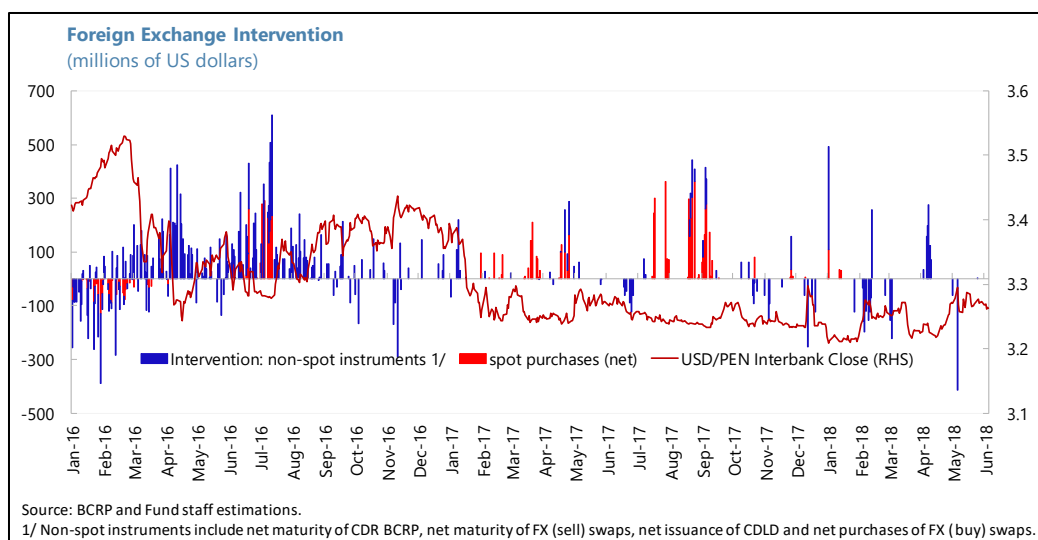


5. Peru's gross international reserve coverage exceeds adequacy metrics. Gross international reserves increased by \$2 billion in 2017, reaching US\$63.7 billion (nearly 30 percent of GDP), or close to 280 percent of the ARA metric, which is well above the 100–150 percent adequacy range. Reserves are also adequate when considering Peru's heavy reliance on commodity exports—at about 230 percent of the ARA metric augmented with a buffer considering uncertainty of the copper and gold prices. Subtracting large FX liabilities to the banking sector (required reserves and deposits stemming from de-dollarization swaps) does not change the overall conclusion—the reserves would be at 162 percent of the augmented ARA metric.



6. The BCRP continues to participate in the foreign exchange market with the objective of reducing excessive volatility without targeting any specific exchange rate. In 2017, BCRP purchased \$5.2 billion (2.4 percent of GDP) in the spot market, while the use of non-spot instruments

(FX swaps and adjustable CDs) was generally two-way, with a cumulative sum limited to 0.12 percent of GDP. In the first five months of 2018, spot market transactions were close to zero, whereas intervention through other instruments continued to be two-way, with a limited cumulative amount.



Assessment

7. The CA-based approach suggests that the external position in 2017 was moderately stronger than the level consistent with medium-term fundamentals, although other approaches point to different results. The EBA current account regression yields an estimate of a current account norm of -2.6 percent of GDP, although it is subject to sizeable uncertainty as its standard error is one percent of GDP. The cyclically adjusted current account deficit is estimated at one percent of GDP, considering the output and the terms of trade gaps. Thus, the overall CA gap in 2017 was about 1.6 percent of GDP. The positive CA gap implies that the average 2017 REER was moderately stronger than the level consistent with fundamentals, although the gap is likely to narrow in 2018 and over the medium term as the CA deficit increases. On the contrary, the REER regressions point to different results: the index-based regressions suggest that the REER is broadly in line with fundamentals, whereas the level-based regression indicates that the REER is overvalued. Given the

CA regression-based approach is more reliable than REER regressions, the assessment places more weight on this approach.

Current Account and REER Gaps, 2017 (in percent of GDP, unless stated otherwise)			
	EBA methodology		
	CA regression	REER regression (index)	REER regression (level)
Actual CA	-1.3	..	..
Cyclically adjusted CA	-1.0	..	..
CA norm	-2.6	..	..
CA gap 1/ o/w Policy gaps	1.6 -0.3	..	..
Elasticity	-0.2		
REER gap (in percent) 2/	-7	0.0	8.7
Source: Fund staff estimates.			
1/ CA gap is cyclically adjusted CA minus CA norm.			
2/ Positive value indicates overvaluation.			

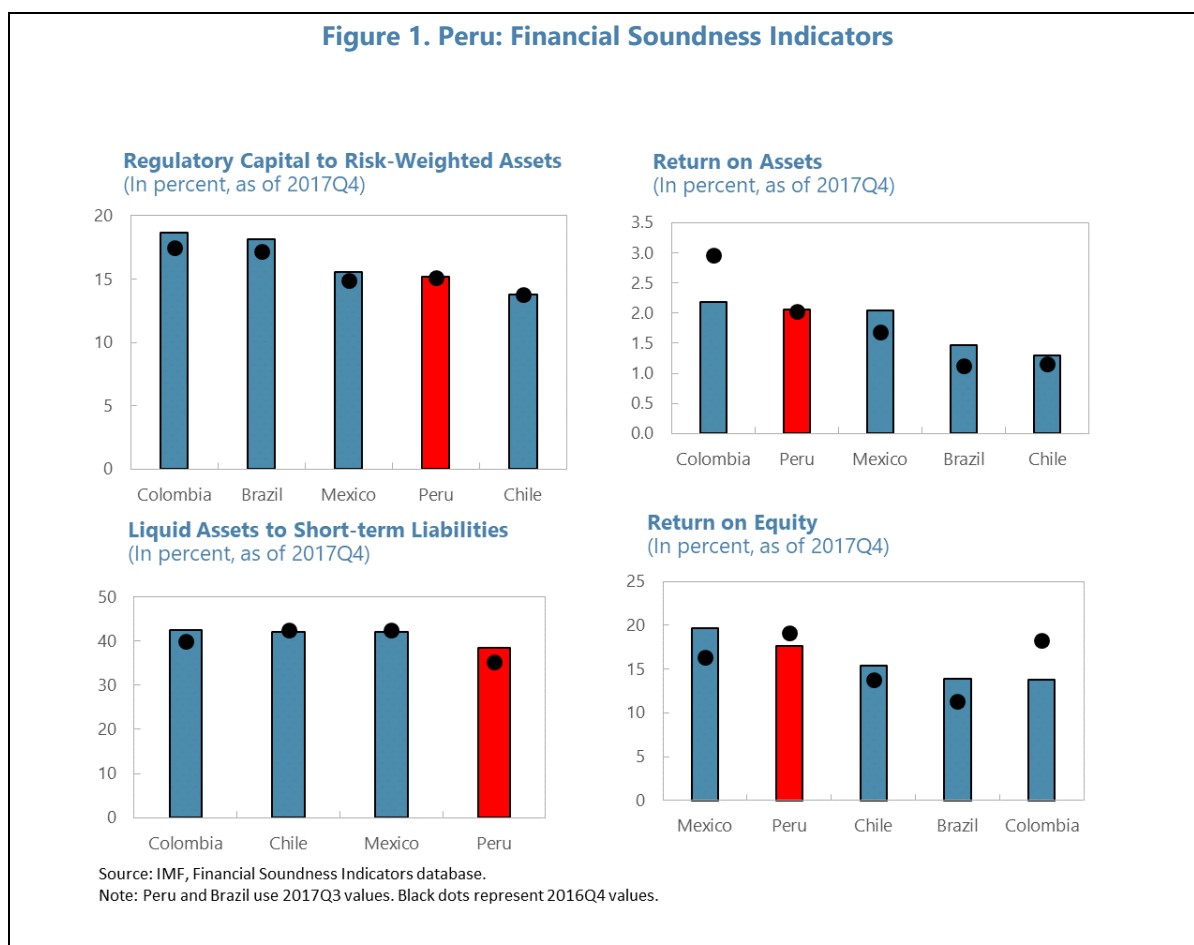
8. Both the IIP and its trajectory are sustainable. The external sustainability approach suggests that the IIP would be stabilized with a current account deficit of 2.2 percent of GDP, which is marginally wider than the medium-term projected CA deficit, suggesting that the IIP is sustainable. This method implies that the REER gap is close to zero.

External Sustainability Approach, 2017 (in percent of GDP, unless stated otherwise)	
	2017
Actual IIP (2016)	-40
Benchmark IIP	-40
Medium term CA balance	-2.0
Adjusted medium term CA balance	-2.0
CA norm 1/	-2.2
CA gap 2/	0.20
Elasticity	0.22
REER gap (in percent) 3/	-0.7
Source: Fund staff estimates.	
1/ CA balance that stabilizes the IIP at a benchmark level.	
2/ CA gap is adjusted MT CA balance minus CA norm.	
3/ Positive value indicates overvaluation.	

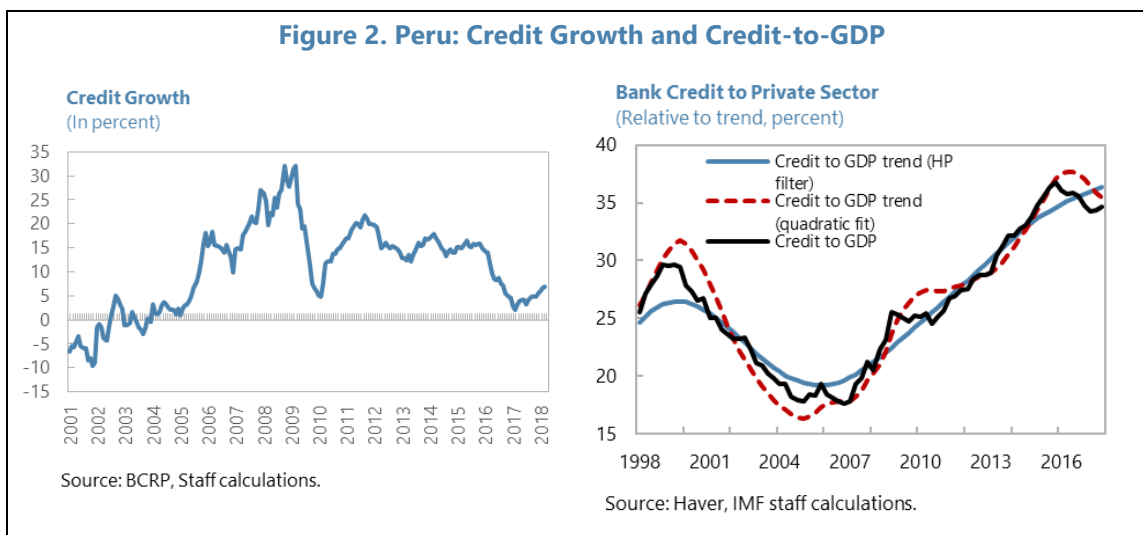
Annex III. Macro-Financial Stability Update

A. Financial Sector Risk Assessment

1. Financial soundness indicators (FSIs) are broadly solid. Banks are well-capitalized, liquid and profitable (Table 7). Non-performing loans (NPLs) have continued to edge up as economic activity slowed, mainly driven by the deterioration in small and medium enterprise (SME) portfolios, but are adequately provisioned for (151 percent). Compared with regional countries, Peru has average capital adequacy and liquidity ratios, and slightly higher than average profitability.



2. Credit developments do not suggest broad based-risks. In line with slower activity, financial sector credit growth was moderate at around 5.5 percent in 2017, with a negative credit gap since 2016. Credit growth was stronger in FX compared to local currency in 2017, in tandem with sol appreciation, and the credit gap has started to narrow. In line with an improving economy and more political stability, credit growth has picked up to around 7 percent as of end-March 2018.



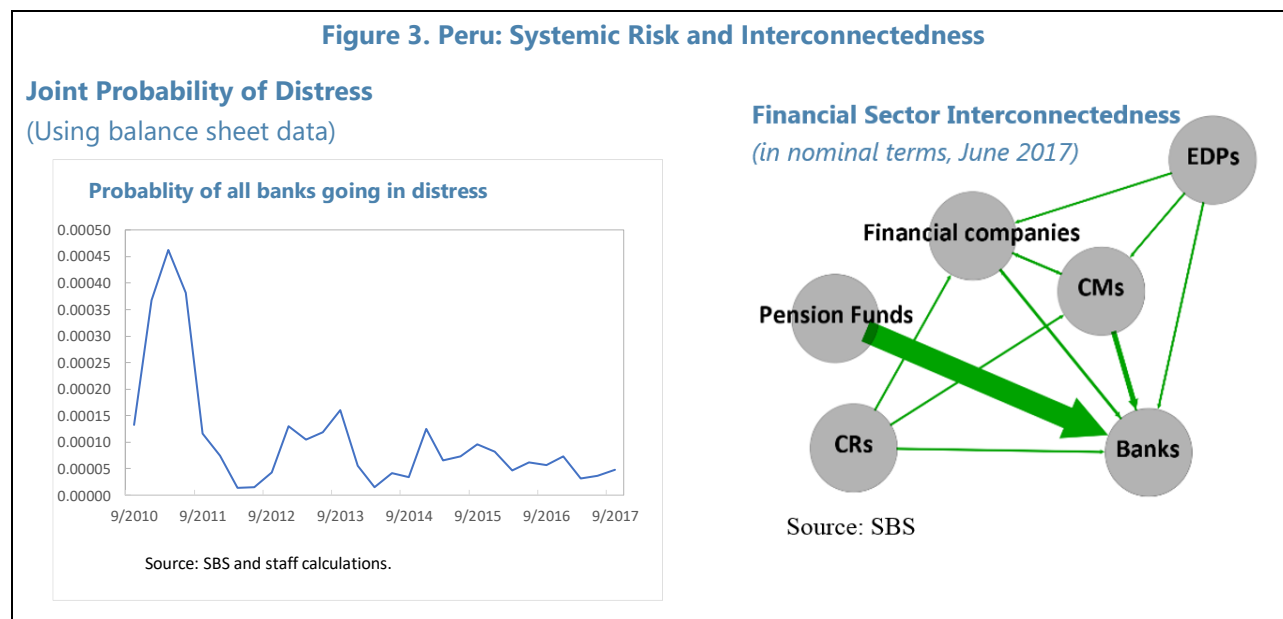
3. Dollarization has stabilized, although remains significant. Credit dollarization has stabilized at around 30 percent since end-2015. This masks a divergence between rising credit dollarization in the large firm segments (driven by growing FX credit, mainly in trade, which is exempt from BCRP dedollarization measures), and declining or low levels of credit dollarization in SMEs and households. Deposits continue to dedollarize, with 39 percent of deposits not in soles as of April 2018 (42 percent at end-2016). In March 2018, the BCRP introduced new measures, allowing foreign currency loans to increase if local currency credit to enterprises rises more than proportionally, subject to certain thresholds. The BCRP wanted to provide additional incentives to lend in domestic currency, and to reduce the risk of credit constraints.

4. The recent FSAP financial stability and stress testing analysis found that the overall banking system appears resilient to severe macrofinancial shocks.¹ The banking system is overall resilient to adverse shocks, largely due to initial strong capital buffers and profitability. In the adverse scenario, all large banks experience credit losses, but initial high capital and profitability help them remain above the minimum regulatory capital adequacy ratio (CAR) threshold of 10 percent. For a few small banks, the capital adequacy ratios fall below the regulatory threshold. Overall banking system profits decline substantially in the adverse scenario, with some banks facing losses, but the aggregate capital shortfall for these banks is modest. Banks were also resilient to cash-flow based liquidity stress tests, with limited FX liquidity risk as there are significant buffers from the high level of FX reserve requirements. In terms of financial system interconnectedness, the cross-sectoral exposures of the banking sector are small in Peru.² The interbank contagion analysis did not find large risks of either direct exposure between the important banks or indirect risks coming from fire sale effects.

¹ See FSAP Financial System Stability Assessment for more details.

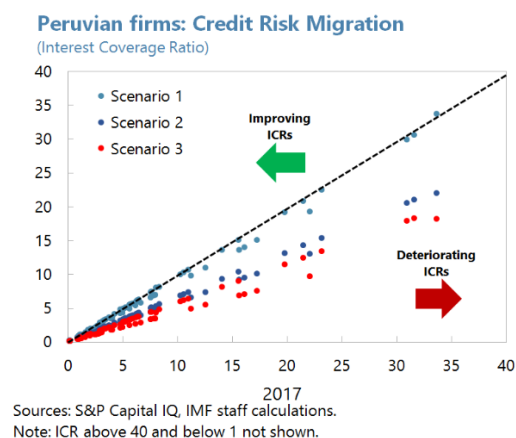
² The banking sector does not rely on non-bank financial sector deposits in a significant way, and loans to non-bank financial entities remain a small portion of overall banking sector assets.

5. While the risk that a large bank falls in distress is low, high concentration in the banking sector is the main systemic risk factor. Systemic risk indicators show that the probability of a systemic crisis (the joint probability of distress across all banks) has fallen since its post Global Financial Crisis peak in 2010. However, the conditional probabilities of distress show that were one bank to be in distress, it is very likely that one other bank would also be in distress as credit portfolios are highly correlated among the large banks.³ Due to high banking sector concentration, where the four largest banks hold around 80 percent of private banking sector assets, such a situation would be a systemic event.



B. Non-Financial Sector Risk Assessment

6. Corporate leverage has increased for large Peruvian firms, and repayment capacity has declined, but debt-at-risk (DAR) represents only a small portion of total corporate debt.⁴ This is broadly in line with regional trends, where leverage has also risen for large firms in LA4 countries (Chile, Colombia, Mexico, and Peru). Meanwhile, repayment capacity has declined for Peruvian firms more broadly, although the median ICR is well above the “at-risk” threshold of one. The share of DAR in 2017 is only three percent of total corporate debt of the sample.⁵

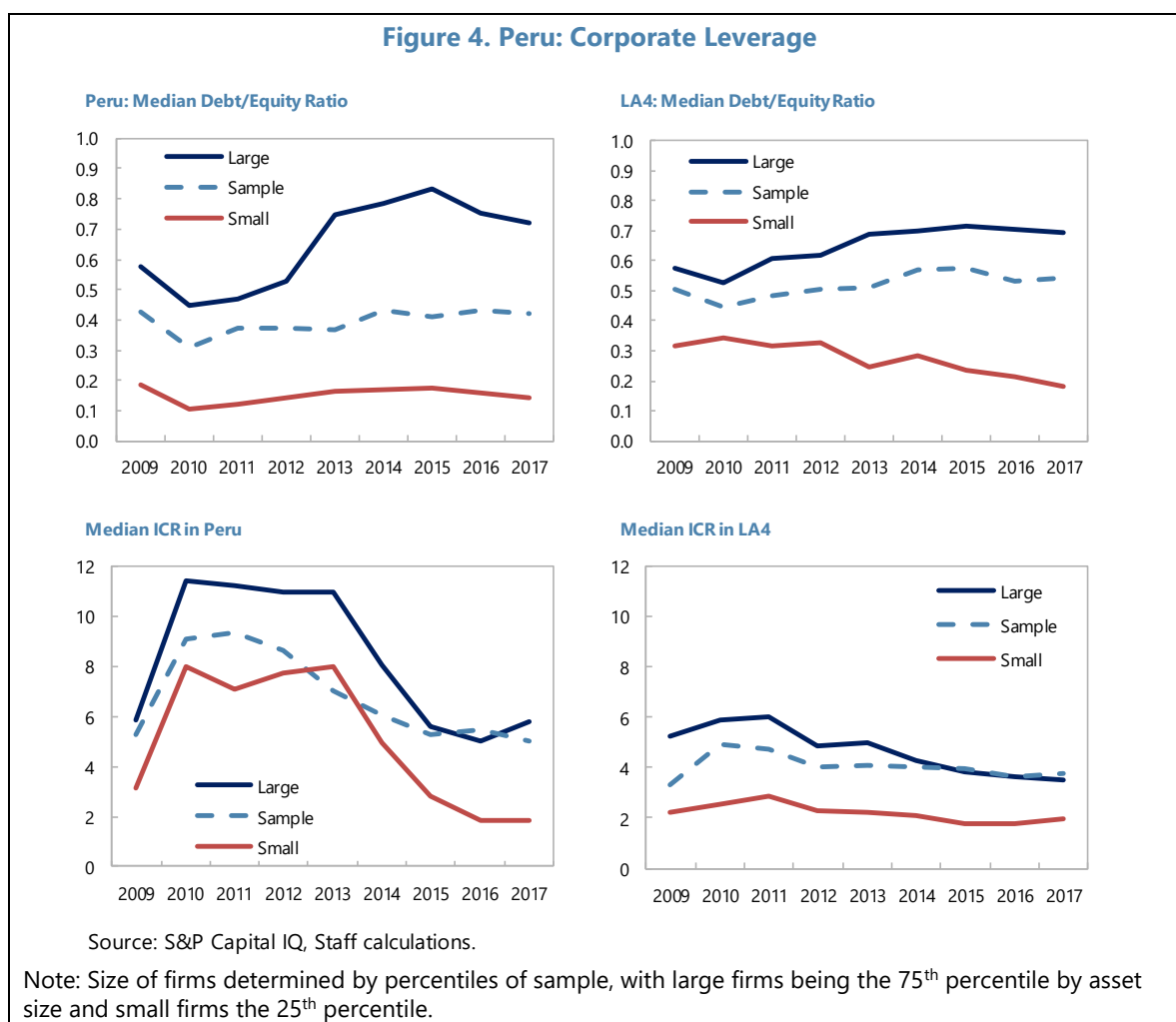


³ Average pairwise correlation is 84 percent across products.

⁴ Firms in the sample had a total debt of USD 18.8 billion in 2017, or an estimated 20 percent of total debt of Peruvian firms (based on total credit to firms of USD 55.9 billion and outstanding bonds of USD 38.6 billion in 2017).

⁵ See FSAP 2018 Technical Note on Financial Stability Analysis and Stress Testing for more details.

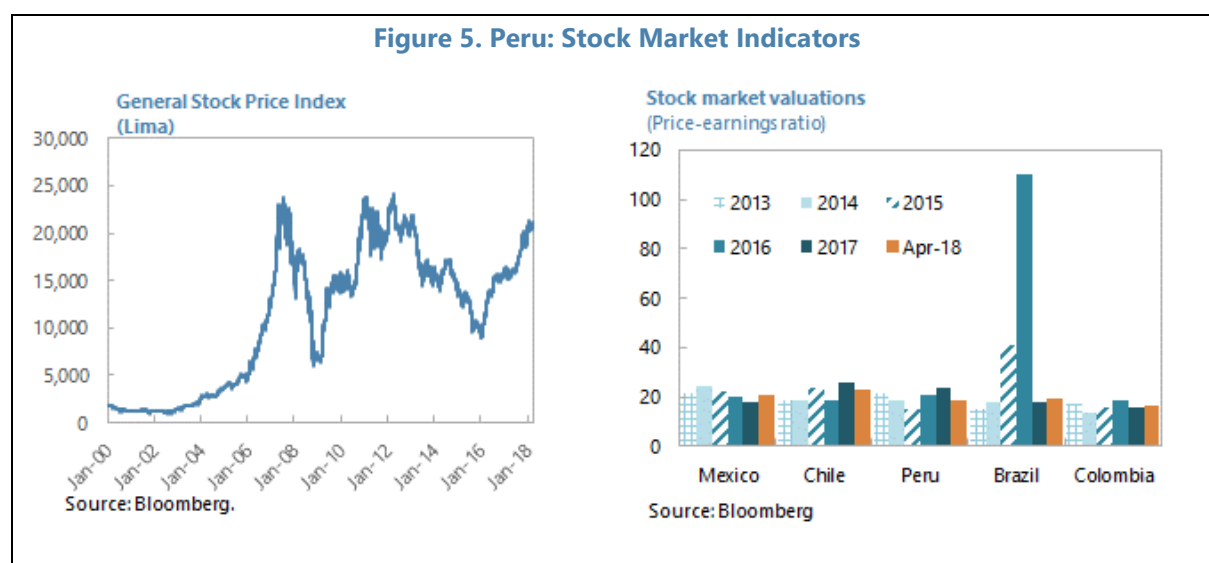
7. Staff sensitivity analysis indicates that the corporate sector is in general resilient, although pockets of vulnerability exist. Based on a sample of 93 firms, a sensitivity analysis applying a range of FX, earnings, and interest expense shocks shows that the corporate sector is in general resilient, with the median interest coverage above one.⁶ An exchange rate shock alone (Scenario 1) has minor impact on firms' debt repayment capacity, but credit risk measures worsen with the impact of the additional earnings and interest expense shocks (Scenarios 2 and 3), as seen in the deteriorating ICRs (chart). The overall share of DAR increases from 3 to 6 percent (Scenario 1), 11 percent (Scenario 2), and 12 percent (Scenario 3). However, there are significant differences between the export- and domestic-oriented sectors. In the export-oriented sector, the impact of the shocks on DAR is marginal, while the share of distressed debt in the domestic-oriented sector at least doubles, and contributes to the bulk of the rise in the overall DAR.



⁶ Scenario 1 is an exchange rate shock of 15 percent, Scenario 2 combines a 15 percent exchange rate shock and decline in earnings of 15 percent and decline in interest expense of 30 percent. Scenario 3 doubles the exchange rate and earnings shocks (to 30 percent) with the shock to interest expense at 30 percent.

C. Asset Prices

8. Equity prices have been rising, though valuations remain in line with the region. The general index rose by 28 percent in 2017 compared to 2016, buoyed by robust commodity prices. The price-to-equity (PE) ratio for Peru is in line with other regional countries, although slightly higher than the PE ratio for the MSCI Emerging Markets. As the interest rate cycle turns, however, equity prices could correct. In May 2017, two additional firms (Volcan and Graña y Montero) were included in the MSCI indices, which increases the number of constituents to five and reduces the risk of reclassification from Emerging Market status.⁷ The authorities are also introducing risk-based capital requirements for mutual funds and broker dealers, among other reforms, with the passing of improvements to the Securities Market Law in July 2017.



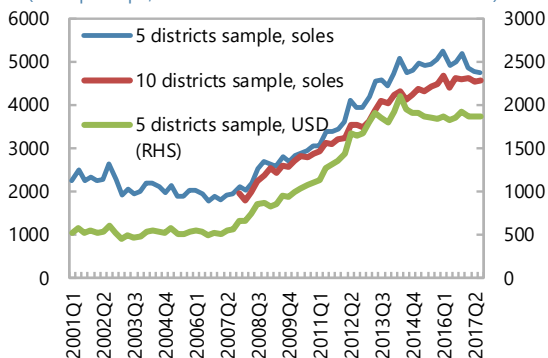
9. Housing prices have stabilized and cross-country indicators on balance do not suggest a misalignment, although careful monitoring is warranted. Regional comparators show that Peru's property market is still in line with the rest of the region. Although indicators of the price-to-rent ratio show Peru relatively high in the distribution of Latin American countries, the absolute value of this indicator does not appear excessive. In addition, cross-country indicators of housing prices place Peru in the bottom-half of the price distribution of a broader sample of countries. Nevertheless, property price indices in Peru only reflect the capital, Lima.

⁷ In June 2016, the stock exchange successfully retained its status in the MSCI Emerging Market Index after a potential reclassification to Frontier Market.

Figure 6. Peru: Housing Market Indicators

Peru. Real Apartment Prices, Lima

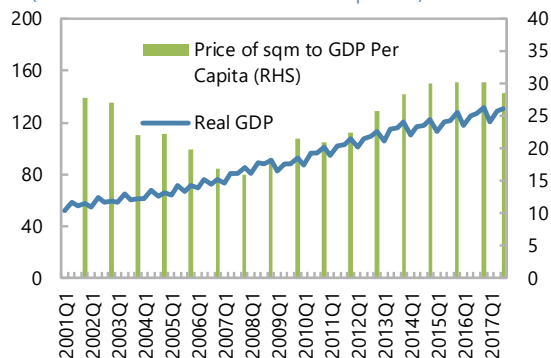
(Price per sqm, constant soles of 2009 and current USD)



Source: BCRP.

Peru. Real GDP and Apt. Prices to GDP Per-Capita

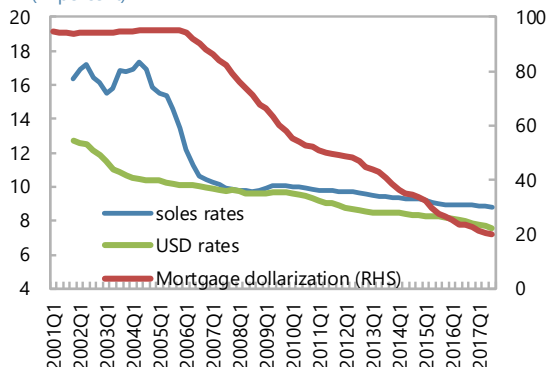
(billions of constant soles of 2007 and percent)



Source: BCRP.

Peru. Mortgage Interest Rates and Mortgage Dollarization

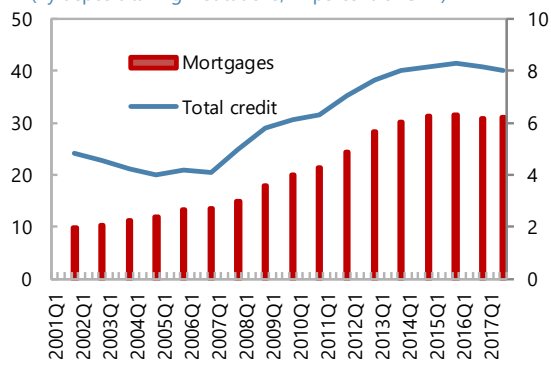
(in percent)



Source: BCRP.

Peru. Credit to Private Sector

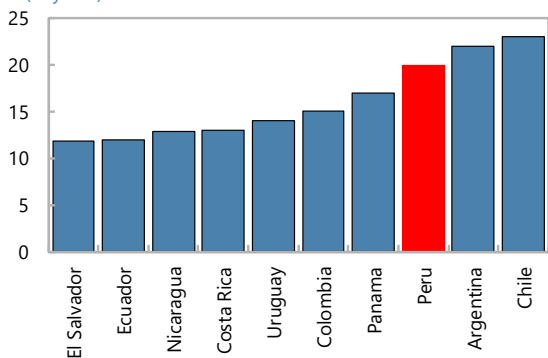
(By deposit taking institutions, in percent of GDP)



Sources: BCRP and IMF staff estimates.

Price to Rent Ratio

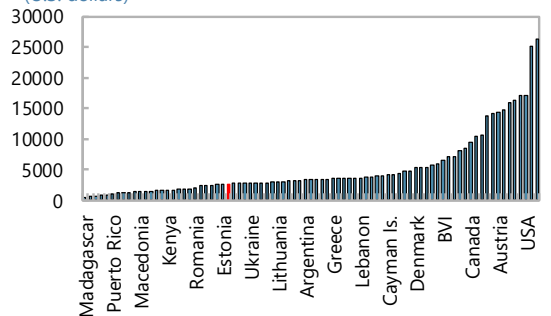
(In years)



Sources: Global Property Guide and IMF staff estimates.

Price per Square Meter in City Center

(U.S. dollars)



Sources: Global Property Guide and IMF staff estimates.

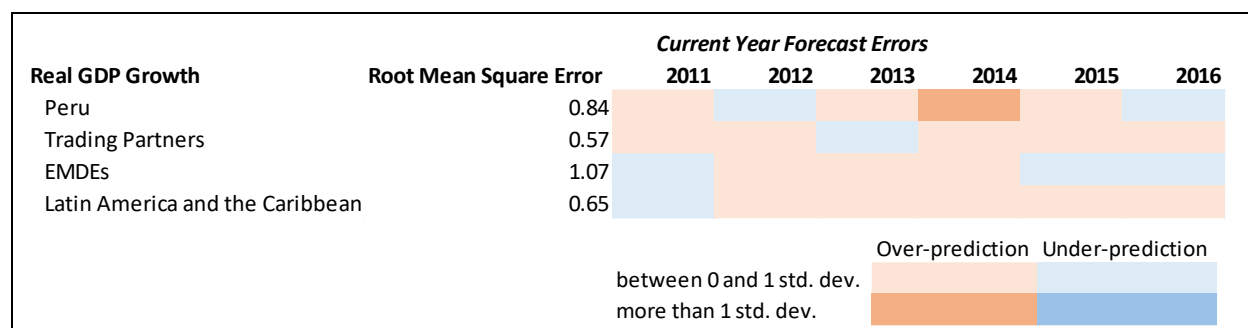
Note: Peru in red.

Annex IV. Staff GDP Forecast Errors

In recent years, forecast errors of GDP growth for Peru have been smaller than the EMDE average but larger than for LAC peers. The higher forecast error relative to other LAC countries is mainly due to a large overestimation of growth in 2014. External shocks such as lower Chinese growth and commodity prices in 2014 were compounded by temporary supply disruptions in fishing, mining, and agriculture as well as an unexpected drop in subnational investment implementation. In 2015–16 deviations from forecasts were smaller and largely explained by unexpected movements in commodity prices. In 2017, domestic shocks related to the Odebrecht corruption scandal and the el Nino weather phenomenon reduced growth by one percent relative to the April WEO forecast.

Peru: Real GDP Forecast Error				
Vintages	2014	2015	2016	2017
Peru Real GDP Growth (in percent)				
Outturn	2.4	3.3	4.1	2.5
Forecast April of each year	5.5	3.8	3.7	3.5
Current year error (pp)	-3.1	-0.5	0.3	-1.0
Metals (2005 = 100)				
Outturn	164.4	126.6	119.7	146.3
Forecast April of each year	173.0	136.8	108.3	147.5
Current year error (percent)	-4.96	-7.49	10.51	-0.78
Trading partner GDP Growth (in percent)				
Outturn	3.5	3.2	2.7	3.3
Forecast April of each year	3.2	2.7	2.3	2.8
Current year error (percent)	0.3	0.4	0.4	0.5

Source: WEO and Fund staff calculations



Annex V. Risk Assessment Matrix 1/

	<i>Likelihood</i>	<i>Impact</i>	<i>Policy Advice²</i>
Country-specific risks			
Extended period of uncertainty and spillovers from ongoing Odebrecht corruption investigation, resulting in delays in investment	M	M (↓) Uncertainty stemming from the ongoing Odebrecht corruption investigation could stifle investment and economic recovery. This could be accompanied by a tightening of domestic financial conditions and the price of risk.	Persevere with structural reforms, especially those aimed at increasing investment execution rates and improving the framework for PPPs. Strengthen anticorruption institutions and seek synergies between anticorruption and AML tools.
Extreme weather events such as El Niño phenomenon	L	L (↓) Heavy rainfall and landslides damage infrastructure and reduce investment and growth. Reconstruction could generate significant claims on public resources.	Maintain high level of preparedness for these events. Respond with countercyclical macro policies as needed.
Systemic banking sector event stemming from high banking system concentration and portfolio homogeneity	L	H (↓) If any of the largest banks were making significant losses on its portfolio, it is likely that another large bank would also be subject to significant losses given the homogeneity of banks' exposures. Due to banking sector concentration, this could trigger a systemic event.	Increase capital surcharges for systemic banks, continue enhanced supervision. Address concentration in the banking sector.
Positive spillovers related to high commodity prices	M	M (↑) The high price of copper and other metals can spillover to the broader economy more than expected, raising government revenues and boosting private investment more than projected in the baseline.	Materialization of this upside scenario will help address long-standing challenges such as the infrastructure gap and advance other structural reforms.
<p>¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.</p> <p>² Recommended by staff.</p>			

External risks			
Tightening of global financial conditions, accompanied by sharp increases in interest rates, significant further strengthening of the U.S. dollar and higher volatility	H	H (↓) Balance sheets will be strained for U.S. dollar debtors. Tighter financial conditions will lead to funding pressures for banks and higher borrowing costs for non-financial corporates. Default rates among corporate and household debtors with unhedged FX debt would increase, resulting in credit losses for banks. Higher FX debt service cost would reduce consumption and investment demand.	Continue de-dollarization and macroprudential policies to stem FX risks. Allow exchange rate flexibility, while intervening to smooth excessive volatility, to help develop a market in hedging instruments so agents can internalize risks in the absence of the central bank intervention. Monitor systemic risks stemming from the tightening of financial conditions.
Structurally weak growth in key advanced economies/Significant China slowdown and its spillovers	H/M	M/M (↓) Weaker global demand would reduce commodity prices, worsen the current account deficit and weaken growth, especially through lower exports. Higher funding needs of the government would lead to higher domestic yields. This would be accompanied by lower corporate profits and lower household income, which, together with higher unemployment, would lead to higher NPLs and credit losses for banks.	Exchange rate flexibility as the first line of defense and use liquidity buffers as needed. Use policy space (e.g., fiscal and/or monetary if inflation remains anchored) as a countercyclical measure if necessary. Accelerate structural reforms.
External policy uncertainty and divergence. Two-sided risks to U.S. growth with uncertainties about the positive short-term impact of the tax bill on growth and the extent of potential MT adjustment to offset fiscal costs; uncertainties associated with NAFTA and associated market fragmentation risk. A shift to more protectionist policies	M	M (↓) A spike in global volatility (e.g. VIX) can spill over to Peru. Fragmentation of the global markets and a shift towards more protectionist policies can affect Peru's exports. The uncertainty could adversely affect the financial conditions and stifle consumer confidence. This could occur also in an environment of higher public sector financing needs.	Exchange rate flexibility and use of fiscal buffers. Countercyclical monetary policy instruments could be used.

Annex VI. Public Sector Debt Sustainability Analysis

Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario (In percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators 1/

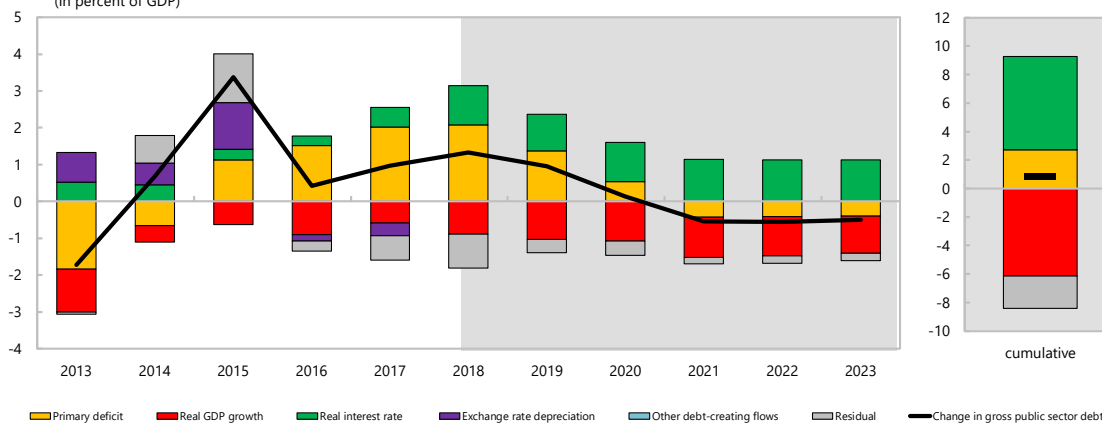
	Actual		Prel.		Projections					As of May 30, 2018		
	2012-2015 2/	2016	2017	2018	2019	2020	2021	2022	2023	Sovereign Spreads		
Nominal gross public debt	21.5	24.4	25.3	26.6	27.6	27.7	27.2	26.6	26.2	Spread (bp) 3/	142	
Public gross financing needs	1.0	3.7	5.5	4.9	3.6	2.9	1.5	1.5	2.4	CDS (bp)	91	
Real GDP growth (in percent)	4.4	4.1	2.5	3.7	4.1	4.2	4.2	4.1	4.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	3.3	3.6	2.8	1.3	2.0	2.0	2.0	2.0	2.0	Moody's	A3 stable	A3 stable
Nominal GDP growth (in percent)	7.2	7.7	6.4	6.7	6.4	6.4	6.3	6.2	6.1	S&Ps	BBB+ stable	A- stable
Effective interest rate (in percent) 4/	5.4	4.9	5.2	5.8	6.0	6.3	6.5	6.5	6.5	Fitch	BBB+ stable	A- Stable

Contribution to Changes in Public Debt

	Actual			Projections							cumulative	debt-stabilizing primary balance 9/
	2012-2015	2016	2017	2018	2019	2020	2021	2022	2023			
Change in gross public sector debt	0.2	0.4	1.0	1.3	1.0	0.1	-0.5	-0.6	-0.5	0.8		
Identified debt-creating flows	-1.1	0.7	1.6	2.2	1.5	0.6	-0.3	-0.3	-0.2	3.5		
Primary deficit	-1.2	1.5	2.0	2.1	1.4	0.5	-0.4	-0.4	-0.4	2.7	0.2	
Primary (noninterest) revenue and grants	27.0	23.1	22.9	23.3	23.8	24.2	24.6	24.6	24.6	145.1		
Primary (noninterest) expenditure	25.8	24.6	24.9	25.4	25.2	24.7	24.2	24.2	24.2	147.8		
Automatic debt dynamics 5/	0.1	-0.8	-0.4	0.1	0.1	0.1	0.1	0.1	0.2	0.7		
Interest rate/growth differential 6/	-0.5	-0.7	0.0	0.2	0.0	0.0	0.1	0.1	0.1	0.4		
Of which: real interest rate	0.4	0.3	0.5	1.1	1.0	1.1	1.1	1.1	1.1	6.5		
Of which: real GDP growth	-0.9	-0.9	-0.6	-0.9	-1.0	-1.1	-1.1	-1.1	-1.0	-6.2		
Exchange rate depreciation 7/	0.5	-0.2	-0.4	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt-creating flows (specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual, including asset changes 8/	1.3	-0.3	-0.7	-0.9	-0.4	-0.4	-0.2	-0.2	-0.2	-2.3		

Debt-Creating Flows

(In percent of GDP)



Sources: National authorities and Fund staff estimates.

1/ Public sector is defined as non-financial public sector.

2/ Based on available data.

3/ Bond Spread over U.S. Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ Derived as $[(r - p(1+g) - g + ae(1+r))/(1+g+p+gp)]$ times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate;

a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 2/ as $ae(1+r)$.

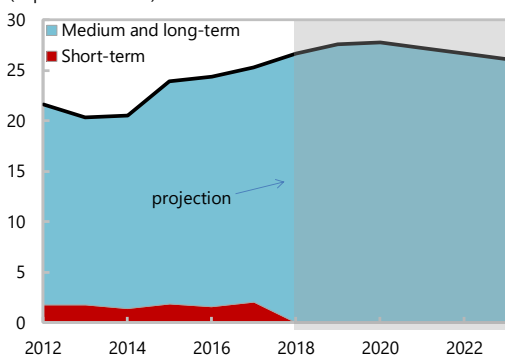
8/ For projections, this line includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Public DSA—Composition of Public Debt and Alternative Scenarios

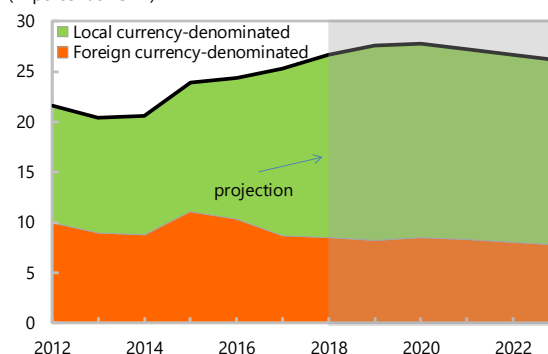
By Maturity

(In percent of GDP)



By Currency

(In percent of GDP)



Alternative Scenarios

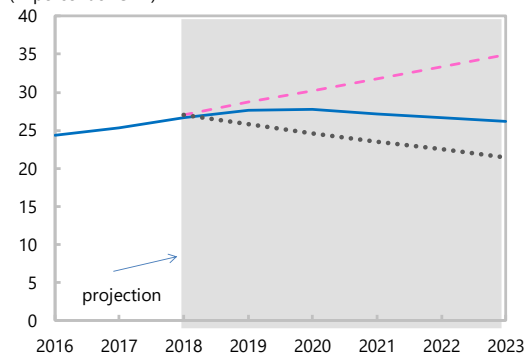
— Baseline

..... Historical

- - - Constant Primary Balance

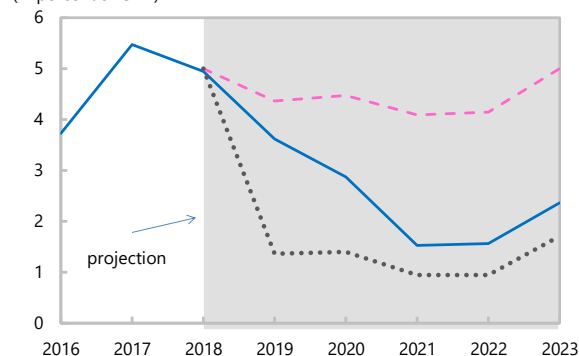
Gross Nominal Public Debt

(In percent of GDP)



Public Gross Financing Needs

(In percent of GDP)



Underlying Assumptions

(In percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	3.7	4.1	4.2	4.2	4.1	4.0
Inflation	1.3	2.0	2.0	2.0	2.0	2.0
Primary Balance 1/	-2.1	-1.4	-0.5	0.4	0.4	0.4
Effective interest rate	5.8	6.0	6.3	6.5	6.5	6.5
Constant Primary Balance Scenario						
Real GDP growth	3.7	4.1	4.2	4.2	4.1	4.0
Inflation	1.3	2.0	2.0	2.0	2.0	2.0
Primary Balance	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1
Effective interest rate	5.8	6.0	6.2	6.2	5.9	5.6

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	3.7	4.9	4.9	4.9	4.9	4.9
Inflation	1.3	2.0	2.0	2.0	2.0	2.0
Primary Balance	-2.1	0.9	0.9	0.9	0.9	0.9
Effective interest rate	5.8	6.0	6.5	6.9	7.0	7.1

Source: Fund staff estimates.

1/ Excludes interest income.

Annex VII. Impact of Non-Resident Holdings of Local Currency Bonds on Local Currency Yields

1. Non-residents hold a large share of Peruvian local currency sovereign bonds, although the ownership is modest given the small stock of debt. At around 39 percent in March 2018, it is also one of the highest in a sample of 23 emerging market economies (Figure 1). This share fluctuated from a low of 17 percent in 2009 to a peak of 58 percent in early 2013, with increases driven by the interest rate differential, expectations of sol appreciation, and facilitation of non-resident access by placing bonds through the Global Depository Note (GDN) mechanism. More recently, the share rose with placement of bonds (about 1.4 percent of GDP) through international securities depository Euroclear. Expressed as a share of GDP, however, foreign participation is comparable with many emerging economies (5.1 percent of GDP in Q1 2018).

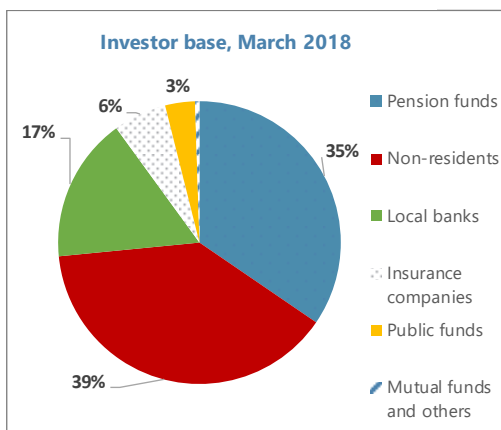
2. Foreign participation can potentially bring significant benefits, although it can be associated with the risk of sudden stops and reversals. Foreign inflows into local debt markets can reduce local currency yields, increase market liquidity, and contribute to overall market development. However, the benefits may come at the cost of potentially higher volatility, as high non-resident participation strengthens the channel for transmission of external shocks. This annex looks at the impact of foreign participation on the level and the volatility of yields on local currency government bonds in Peru.

Does foreign participation help reduce local currency yields?

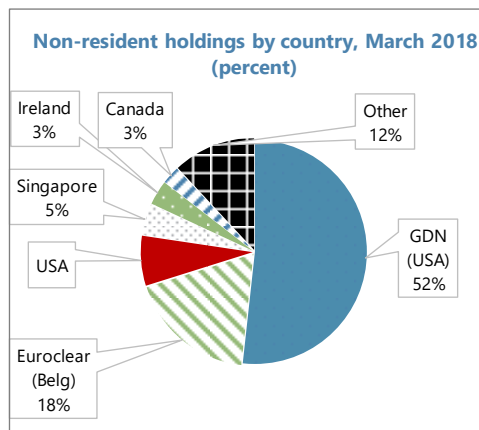
3. Consistent with previous studies, the results indicate that foreign ownership reduces the long-term local currency yields (Table 1). A fixed-effects panel model is estimated to look at the relationship between foreign participation and yields in a quarterly sample of 5 LATAM economies and a broader sample of 21 emerging market economies. In the LATAM sample, an increase in the foreign participation by a percentage point reduces yields by 4.1–4.4 basis points, depending on model specification, and the coefficient is statistically significant at 1 percent level. The result holds in the broader sample, although the range of estimates is wider, from 3.3 to 5.3 basis points. Most of the control variables have the expected signs and reasonable magnitudes.

Figure 1. Peru: Investor Base of *Bonos Soberanos*, 2004–2018

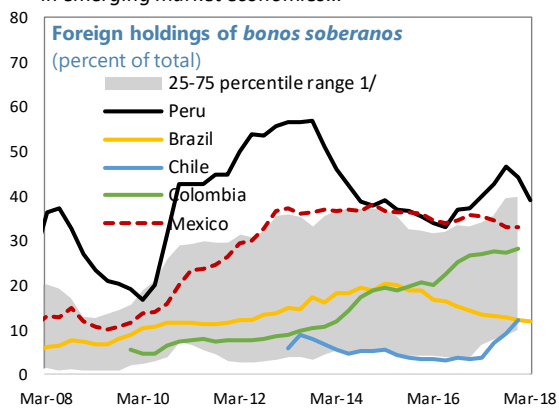
Non-residents hold a large share of sol-denominated government securities.



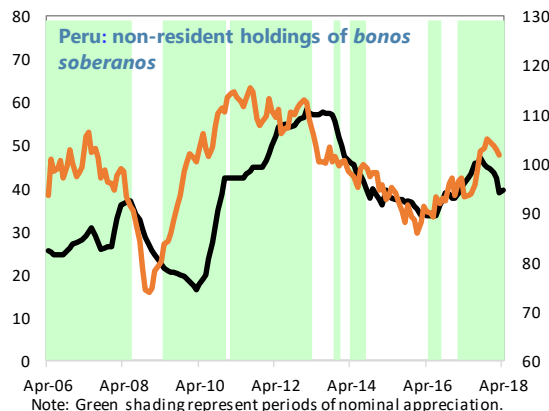
...with large shares of non-resident participation via Global Depository Notes and the Euroclear system.



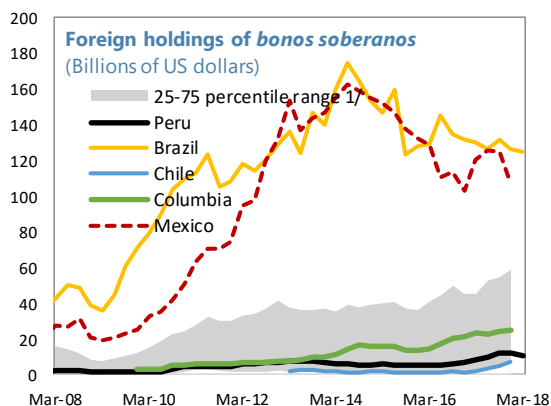
Foreign participation has been among the highest in emerging market economies...



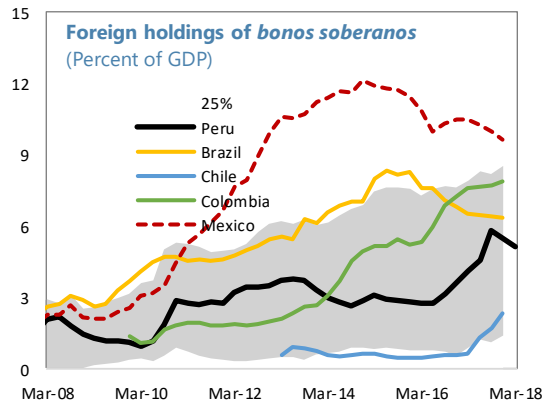
...increasing broadly during the periods of nominal exchange rate appreciation.



In the US dollar terms, foreign ownership of soberanos has been relatively low.



In terms of GDP, foreign participation has been moderate.



Source: Arslanalp and Tsuda (2014), Haver Analytics, Peru authorities, and Fund staff estimations.
 1/ 25-75 percentile range refers to a sample of 23 economies, including 6 countries in Latin America, 6 countries in Asia, 9 countries in Europe, Egypt and South Africa.

Table 1. Impact on Long-Term Local Currency Bond Yields.

	Latin American sample 1/			Full sample 2/		
	(1)	(2)	(3)	(4)	(5)	(6)
Share of foreign participation	-0.044*** (-13.7)	-0.044*** (-14.68)	-0.041*** (-5.1)	-0.033*** (-3.76)	-0.033*** (-3.71)	-0.053*** (-3.80)
Policy interest rate	0.34*** (6.63)	0.33*** (6.59)	0.33*** 6.74	0.342*** (5.14)	0.34*** (5.52)	0.33*** (5.01)
US 10-year yield	0.58** (3.09)	0.57** (3.45)	0.58** (3.51)	0.29 (1.6)	0.27 (1.61)	0.22 (1.49)
12-m inflation expectations	0.67** (4.45)	0.65*** (4.85)	0.64*** (5.17)	0.145 (0.93)	0.148 (0.98)	0.19 (1.23)
12-m expected ER appreciation	0.019 (0.72)	... ...	... ...	-0.0049 (-0.16)	... ...	... ...
Fiscal balance	-0.11** (-3.18)	-0.094* (-2.5)	-0.11** (-3.60)	-0.23*** (-3.37)	-0.22*** (-3.38)	-0.22*** (-3.11)
Stock of public debt	0.0086 (0.58)	0.0098 (0.64)	... ...	-0.0065 (-0.2)	-0.0059 (-0.18)	... ...
Current account balance	-0.13** (-2.93)	-0.14* (-2.63)	-0.13* (-2.62)	-0.05** (-2.17)	-0.051** (-2.24)	-0.046 (-1.49)
Constant	1.82	1.189	2.22	3.35	3.38	3.94
No. of observations	175	175	175	729	741	741
No of countries	5	5	5	21	21	21
Adj. R-squared (overall)	0.85	0.85	0.84	0.59	0.59	0.57

Note: T-statistics based in robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1

1/ LATAM sample includes Argentina, Brazil, Chile, Mexico, and Peru.

2/ The sample includes LATAM and Bulgaria, China, Hungary, India, Indonesia, Latvia, Lithuania, Malaysia, Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, and Ukraine.

Does foreign participation increase yield volatility?

4. A conditional heteroscedasticity (GARCH) model with foreign participation included in the variance equation is used to model the relationship between foreign participation and yield variance.

$$r_t^{LT} = \theta_0 + \theta_1 r_{t-1}^{LT} + \theta_2 r_t^{ST} + \theta_3 r_t^{US} + \theta_4 \pi_t^e + \theta_5 FP_t + \varepsilon_t$$

$$\varepsilon_t \sim N(0, \sigma_t^2)$$

$$\sigma_t^2 = \varphi + \alpha \varepsilon_{t-1}^2 + \beta \sigma_{t-1}^2 + \gamma FP_t$$

The mean equation includes the lagged yield, along with the short-term interest rate, U.S. long-term bonds yields, 12-month inflation expectations and the share of foreign participation. The variance equation is a typical GARCH(1,1) model with the share of foreign participation included as an exogenous variable. The model was estimated in a monthly sample from March 2006 to February 2018.

5. The variance equation does not show evidence that foreign participation raises volatility. The GARCH coefficients α and β are statistically significant, indicating presence of heteroscedasticity (Table 2 below). At the same time, foreign participation is statistically insignificant, indicating no evidence that it increases yield volatility. While future research is needed, this result can perhaps be attributed to the strength of the macroeconomic policies and to ample buffers (high reserves, low fiscal debt, a well-capitalized banking system) that reduce the risk of abrupt market corrections and therefore increase incentives of investing in sol-denominated securities. The mean equation is consistent with findings of the panel regression, also pointing to high degree of yield persistence. Non-resident participation reduces the mean contemporaneously by 1.4 basis points per percentage point of foreign participation (implying a long-term impact of about 6 basis points).

Table 2. GARCH Model of 10-year Yields on in Peru

Variable	Coefficient/Z-stat
Mean equation	
Lagged yield on 10-year bonds in Peru	0.73 (29.84)***
Key policy rate	0.092 (4.87)***
Yield on 10-year US bond	0.12 (5.46)***
Expected inflation	0.54 (8.99)***
Share of foreign participation	-0.014 (-7.37)***
Variance Equation	
Constant	0.04 (3.26)***
Lagged squared residual	1.05 (4.39)***
GARCH (-1)	-0.04 (-5.09)***
Foreign participation	-0.00029 (-1.21)
R-squared	0.89
Number of observations	144

Annex VIII. Key FSAP Recommendations

Recommendations	Time
Systemic Risk and Macroprudential Policy	
Increase capital surcharges for systemic banks to levels in line with Basel III framework; increase countercyclical provisioning for smaller banks. (SBS)	ST
Enhance the monitoring of off-balance-sheet exposures of banks. (SBS)	IT
Increase foreign currency lending risk weights in line with Basel III guidelines. (SBS)	ST
Introduce new risk-monitoring tools, such as growth-at-risk, systemic risk analysis, and corporate sector stress testing; give enhanced mandate for macroprudential policy to BCRP and SBS; implement Memorandum of Understanding between BCRP and SBS to strengthen coordination. (BCRP/SBS)	ST/MT
Financial Sector Oversight	
Banks	
Amend legal framework to grant SBS powers to exercise full consolidated supervision. (SBS)	MT
Enhance financial group supervisory and regulatory approach with regard to (i) group governance and risk-management requirements; (ii) consolidated capital adequacy and liquidity risk-management assessment; (iii) establishing a lead supervisor; and (iv) establishing a supervisory group rating. (SBS)	ST
Implement requirements for recovery and resolution planning for D-SIBs, as well as for financial groups. (SBS)	MT
Strengthen legal protection of all SBS staff in line with international best practice. (MEF)	MT
Strengthen the internal governance and control framework by enhancing the Internal Audit Function, including the establishment of an Internal Audit Committee. (SBS)	ST/MT
Finalize the review of the current methodology for the calculation of the additional capital requirements as planned; enhance the activation trigger of the countercyclical buffer, and enhance the systemic and single name risk buffers. (SBS)	ST
Insurance	
Implement risk-based supervision for all insurers and brokers. (SBS)	ST
Cooperatives	
After passage of law to bring financial cooperatives under supervisory umbrella of SBS, design a deposit-insurance system. (BCRP, MEF and SBS)	MT
Crisis Management	
Strengthen crisis preparedness and management arrangements. (MEF, BCRP, SBS, FSD)	MT
Enhance information-sharing between SBS and FSD. (SBS, FSD)	MT
Require payout of most insured deposits within seven working days and provide legal protection to FSD staff/agents. (SBS, MEF)	MT
Enhance the ELA framework by specifying eligibility and collateral requirements, and by providing for enhanced supervision, to ensure its effectiveness. (BCRP)	ST
Financial Integrity	
Strengthen risk-based AML/CFT supervision (including sanctioning powers to enhance effectiveness) for banks and other high-risk reporting entities, focusing on preventive measures for mitigating risks of laundering of proceeds of corruption and drug trafficking. (MEF/SBS)	ST/MT
Financial Deepening and Pension Reforms	
Deepen repo markets, improve clearing and settlement infrastructure, prioritize medium- and long-term issuances around benchmark tenors. (BCRP/MEF)	ST/MT
Design reforms to improve the private pension system. (MEF)	ST/MT
Time Frame: IT (immediate) = less than 1 year; ST (short term) = 1-3 years; MT (medium term) = 3-5 years.	

Annex IX. The Potential for Fintech to Improve Financial Inclusion in Peru

1. Peru has made substantial progress in financial inclusion, although levels remain low relative to the region and given its income level. Account ownership has risen from 29 percent of adults in 2014 to 43 percent in 2017, driven by increases in rural accounts. While overall account ownership has improved, some gaps remain: the gender disparity in account ownership has widened, and Peru's level remains below regional and income averages (Figure 1). In the 2017 Global Findex survey, respondents who did not own accounts cited high costs as the main reason.

2. Still remaining gaps afford an opportunity for fintech to provide new solutions for financial inclusion. The innovative use of technology can help to overcome barriers in supply (e.g. high operational costs of serving rural areas, lack of credit history for the unbanked) and demand (e.g. financial products that are not tailored to the needs of users). In fact, the bulk of Latin American fintech firms cited financial inclusion as the main incentive for their operations.²³ Innovative lending platforms and alternative credit scoring using predictive analytics are some examples of technological applications aimed at addressing constraints to financial inclusion.

3. Fintech in Peru is nascent, and is mainly in the segments of online lending and payments and remittances. There are 45 fintech firms in Peru, and it is a small market compared to regional neighbors.²⁴ Peruvian fintech companies are more equally distributed across the different segments, unlike the rest of the region. In the area of payments, Pagos Digitales Peruanos (PDP) introduced a standardized, interoperable e-wallet (*Billetera Móvil*, or BiM) in 2016 with the aim of increasing financial inclusion.²⁵

4. The e-wallet BiM's uptake has fallen short of expectations due to implementation challenges. The lack of integration between the e-money platform and the core banking system generated a duplication of operating systems and the need for separate working capital at the agent level. Furthermore, BiM lacks interoperability with bank/deposit accounts. Low coverage of agents particularly in rural and remote areas limits BiM's reach. These factors cause users difficulties to cash-in/cash-out, which hinders BiM's usefulness.

5. While design shortfalls are being remedied, the operating model could be redefined. PDP has been working to expand both its footprint and value proposition to final users. An important step was state-owned Banco de la Nación's participation in the mobile money platform. Other efforts include piloting suppliers' payments, and two banks enabling cash-in through POS terminals. Issues also being discussed include how to address the inability of non-shareholders to use the PDP

²³ 41 percent of respondents to the 2017 IDB-Finnovista survey, which covered almost 400 fintech startups in Latin America.

²⁴ Source: Finnovista, Fintech Radar Peru 2017.

²⁵ PDP brings together 34 financial institutions and e-money issuers, and three mobile network operators. PDP participants are also its shareholders, with banks holding the majority shares (53 percent) through the banking association.

platform, lack of interoperability between BiM and bank accounts, and the operation of BiM on an exclusive basis. The digitization of government payments, both in government-to-person (e.g. social program disbursements, salary payments) and person-to-government payments (e.g. tax collection, license fee payments) could also boost usage and help build a critical mass of transactions.

6. Fintech sector regulation should aim to support innovation while managing risks.

Technology and regulation affect each other—the authorities should consider not only how regulation should respond to technology, but how regulation can impact the development and adoption of technological innovations. In that regard, regulation should seek to safeguard financial integrity, support competition, protect consumers, and guard against systemic risk. Regulations should also consider flexible perimeters to monitor and eliminate arbitrage between regulated and unregulated entities/activities, and be proportional to the contribution of activities/entities to systemic risk. The specific form of regulation would depend on a country's specific risks and existing regulatory framework.

7. The Peruvian authorities could draw lessons from regulatory approaches emerging elsewhere, such as the use of regulatory sandboxes (e.g. in Singapore and the U.K.).

A regulatory sandbox allows fintech firms to test out their innovations in a controlled environment. It brings benefits to both the regulator and the innovator—the former could learn more about fintech innovation and understand its risks better, while the latter can learn how the financial industry is governed. This would enable smarter regulations for when a more permanent regulatory framework is eventually established.

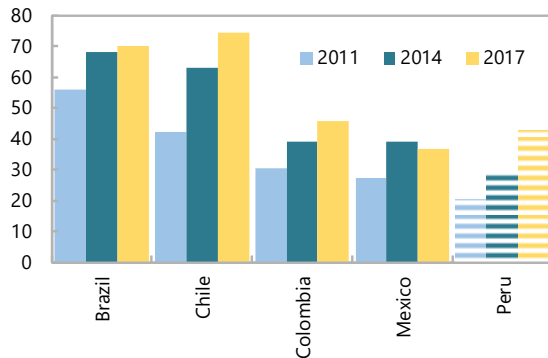
8. Sandboxes typically include safeguards to mitigate risks and to contain potential consequences of fintech testing. Some jurisdictions adapt selected regulatory and licensing requirements in a sandbox to provide relief to innovator firms who might be unable to meet these requirements at the onset. Even so, key AML/CFT measures and fit and proper requirements are typically not waived. To mitigate risks, sandboxes often include safeguards to contain restrictions on the scope of the test, such as the duration, and number and type of customers.

Figure 1. Financial Inclusion in Peru

Account ownership has risen markedly...

Account ownership

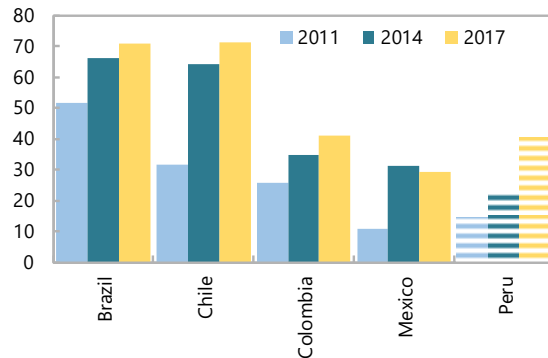
(Percent of adults with account at a financial institution)



...driven by rural accounts.

Account ownership - rural

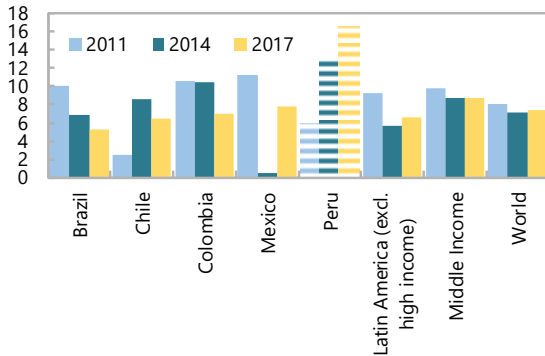
(Percent of adults with account at a financial institution)



But gender disparities are widening...

Account ownership - disparities by gender

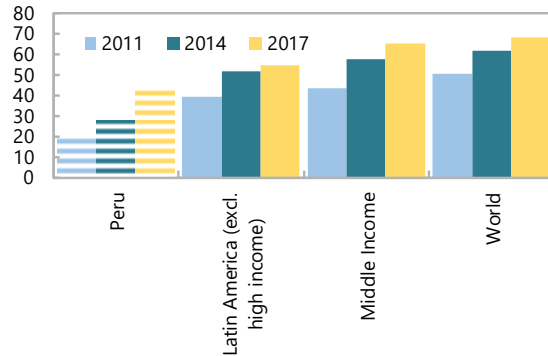
(Difference between men and women, percentage points)



... and levels are still below regional and income peers.

Account ownership

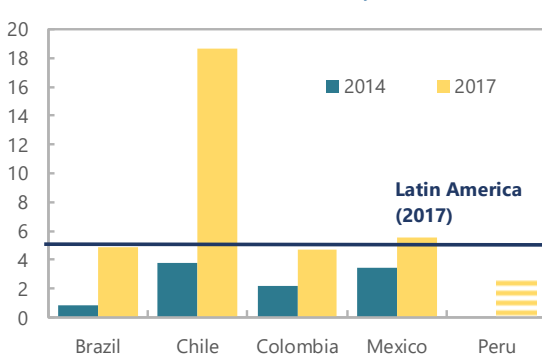
(Percent of adults with account at a financial institution)



There is potential to increase mobile money accounts...

Mobile Money Account

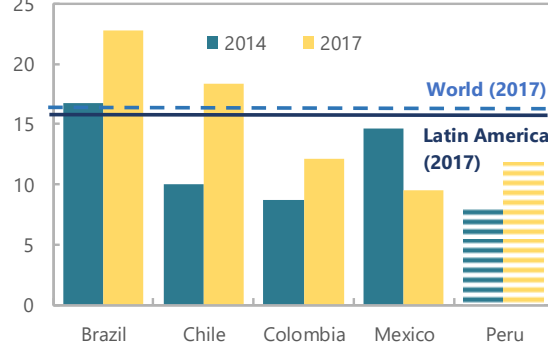
(Percent of adults with mobile money account)



...e.g. by channeling government payments.

Received Government Payments

(Percent of adults who received government payments into financial accounts)



Source: Global Findex.



PERU

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 18, 2018

Prepared By

The Western Hemisphere Department
(In consultation with other departments)

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FUND RELATIONS

(As of May 31, 2018)

Membership Status: Joined 12/31/1945; accepted the obligations of Article VIII, Sections 2(a), 3, and 4 on 2/15/1961.

General Resources Account:	SDR Million	Percent of Quota
Quota	1334.50	100.00
Fund holdings of currency	1199.32	89.87
Reserve Tranche Position	135.23	10.13

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	609.89	100.00
Holdings	530.85	87.04

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Jan. 26, 2007	Feb. 28, 2009	172.37	0.00
Stand-By	Jun. 09, 2004	Aug. 16, 2006	287.28	0.00
Stand-By	Feb. 01, 2002	Feb. 29, 2004	255.00	0.00

Projected Payments to Fund¹

(SDR Million; based on existing use of resources and present holdings of SDRs):

		Forthcoming				
	2018	2019	2020	2021	2022	
Principal	0.00	0.00	0.00	0.00	0.00	
Charges/Interest	0.37	0.75	0.75	0.75	0.75	
Total	0.37	0.75	0.75	0.75	0.75	

Exchange Arrangements

Peru maintains a unified, floating exchange rate. On December 29, 2017, the average of interbank buying and selling rates was 3.24 soles per U.S. dollar. The exchange system is free of restrictions,

¹ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

except for those maintained solely for the preservation of national or international security, and which have been notified to the Fund pursuant to Executive Board Decision No. 144–(52/51).

Last Article IV Consultation

The 2017 Article IV consultation was concluded on June 16, 2017 (IMF Country Report No. 17/166).

FSAP and ROSCs

Several joint Fund-Bank missions visited Lima in the period September 2000–January 2001 to conduct an FSAP for Peru. The corresponding Financial System Stability Assessment (FSSA) report was discussed by the Executive Board on March 12, 2001. A follow-up FSAP mission was concluded in February 2005. In April 2011, the Executive Board took note of the staff’s analysis and recommendations in the report on Peru’s FSAP Update. More recently, Fund-Bank missions visited Lima in the period July 2017–February 2018 to conduct another FSAP Update. Regarding ROSCs, in October 2002, an FAD mission conducted a Fiscal ROSC for Peru (IMF Country Report No. 04/109, 4/16/04), while an STA mission conducted a Data ROSC for Peru in February 2003 (IMF Country Report No. 03/332, 10/24/03).

Technical Assistance

Department	Purpose
FAD	Medium-Term Budgeting
	Public Investment Management
	Public Financial Management
	Treasury management
	Macro-fiscal framework and fiscal rules
	Tax policy and administration
	Fiscal Transparency Evaluation
	General Tax Policy
MCM	Developing fixed income swap markets
LEG	Risk based supervision of securities markets
STA	Housing Price Indexes
	National accounts (sectoral balance sheets, GDP statistics)
	Monetary and Financial Sector Statistics

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

World Bank Group:

- Country page: <http://www.worldbank.org/en/country/peru>
- Overview of World Bank Group lending to Peru: <http://financesapp.worldbank.org/en/countries/Peru/>
- IBRD-IDA project operations: http://projects.worldbank.org/search?lang=en&searchTerm=&countrycode_exact=PE

Inter-American Development Bank:

- Country page: <https://www.iadb.org/en/countries/peru/overview>
- IADB's lending portfolio: <https://www.iadb.org/en/countries/peru/projects-glance>

STATISTICAL ISSUES

(As of June 13, 2018)

General. Macroeconomic statistics are broadly adequate for policy formulation, surveillance, and monitoring. Peru subscribes to the Special Data Dissemination Standard (SDDS). A data ROSC was prepared and published in 2003.

Despite progress in recent years, there is scope for improvement in the following areas:

(i) coordination among the agencies that compile official statistics to avoid duplication of efforts; (ii) expanding the coverage of the wholesale price index to include mining, oil and gas extraction, electricity and water, public transportation, and communication; (iii) finalizing the migration to the standardized report forms for monetary data with the introduction of report forms for the central bank, other depository corporations, and other financial corporations; and (iv) expanding the scope of data sources for compiling financial flows of individual residents.

National accounts. In 2014, the National Statistics Office (INEI) released a new national account series implementing the 1993 SNA and using 2007 as the base year.

Price statistics. The official measure of inflation for Peru currently is the CPI for Metropolitan Lima, compiled and published by INEI. Starting in January 2010, the Metropolitan Lima CPI has been compiled using updated weights based on the 2008/09 Encuesta Nacional de Presupuestos Familiares (ENAPREF). Since January 2011, city level indices have been compiled and disseminated for the 24 departmental capitals and another large urban area using weights from the 2008/09 ENAPREF and a methodology matching that employed for the Metropolitan Lima CPI. A new law issued in 2009 required the INEI to compile a new national level CPI. An STA mission on the CPI was conducted in May 2–13, 2011 to evaluate the methodology of the new national CPI index. A national level CPI, starting with the January 2012 index, was disseminated since February 2012 (the WPI). Statistical techniques used to compile the index generally follow international standards and the base year for the calculation of the weights is 2013.

Labor market statistics. The authorities monitor labor market developments using four indicators: open unemployment, underemployment, employment, and remunerations. While monthly unemployment, employment and income data for metropolitan area of Lima from INEI are timely, only urban employment indexes are available from the Ministry of Labor for other areas and with some delays; monthly remuneration data for the government are timely but the monthly remuneration data for the private sector are no longer available. The nationwide unemployment and underemployment situation is surveyed quarterly, and INEI is now publishing a broader regional coverage of the labor market statistics based on the Encuesta Nacional de Hogares (ENAHOG). It would be useful to develop competitiveness indicators such as productivity and unit labor cost indexes.

Government financial statistics. The Central Bank (BCRP) compiles government finance statistics (GFS) following the GFSM2001, for the general government and its subsectors. Data for all subsectors are reported on a cash basis for revenues and on accrual basis for expenditures, and financial assets and liabilities are reported at face value. The authorities have not yet sent to the Fund information on the components of expenditures by function. The coverage of published national budget data is narrower than the fiscal statistics prepared for the combined public sector. The authorities report data for publication in the Government Finance Statistics Yearbook (GFSY) using the GFSM 2001. No high frequency data is published in the International Financial Statistics (IFS), but is available from the weekly report of the BCRP.

Monetary statistics. The BCRP compiles and publishes the analytical accounts of the central bank, depository corporations, and financial corporations broadly in line with the methodology recommended by the Monetary and Financial Statistics Manual. The main divergences are the exclusion of the deposits of other financial corporations, state and local governments, and public nonfinancial corporations from the definition of broad money; and valuation of some financial assets held to maturity at cost rather than at market prices or at the lower of cost or market price for investment securities. At the request of the authorities, a mission visited the country in January 2007 to assist with the migration to the new standardized report forms (SRFs) for reporting monetary data to the IMF. The mission finalized the SRF for the central bank, recommending improvements in the classification and sectorization of some accounts. A follow-up mission took place in September 2008. The mission completed the work on the SRF for the central bank and developed a bridge table linking the source data reported by banks to the BCRP to the report form 2SR (other depository corporations). The mission identified shortcomings in the management of the database that generate the accounts of the other depository corporations sector at the BCRP. After the completion of the two technical assistant missions the BCRP sent a first version of the SRFs in October 2016. A follow up technical assistance took place in June-July 2017. Significant progress has been achieved in terms of SRFs for the central bank and other depository corporations, but further work is needed for the SRFs of the other depository corporations.

Financial soundness indicators. Peru started reporting data and metadata for financial soundness indicators (FSIs) with a quarterly frequency in June 2011.

External sector statistics. The BCRP prepares quarterly data on the balance of payments and international investment position largely in line with the recommendations of the fifth edition of the Balance of Payments Manual (BPM5). Data are reported to the Fund for publication in the IFS and the Balance of Payments Statistics Yearbook. Departures from BPM5 include the lack of coverage of assets held abroad and land acquisition abroad by residents; and not recording on an accrual basis some external debt transactions.

The BCRP has been reporting since August 2001 weekly data on international reserves in accordance with the Operational Guidelines for Data Template on International Reserves and Foreign Currency Liquidity. Since August 2006, the BCRP is including the full amount of the liquidity requirements in the reserve template both under official reserve assets and as a contingent net drain (as specified in Section III of the Data Template). Peru disseminates quarterly data on external debt with an eight week lag on the National Summary Data Page with a hyperlink to the Fund's website.

Peru: Table of Common Indicators Required for Surveillance
(As of June 13, 2018)

	Date of Latest Observation	Date Received	Frequency of data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷	Memo Items:	
						Data Quality – Methodological Soundness ⁸	Data Quality Accuracy and Reliability ⁹
Exchange Rates	06/13/18	06/13/18	D	M	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	05/31/18	06/07/18	D	M	W		
Reserve/Base Money	05/31/18	06/07/18	W	M	W		
Broad Money	05/31/18	06/07/18	W	M	W		
Central Bank Balance Sheet	05/31/18	06/07/18	W	M	W		
Consolidated Balance Sheet of the Banking System	05/15/18	06/07/18	W	M	W	O, LO, LO, LO	O, O, O, O, O
Interest Rates ²	05/31/18	06/07/18	D	M	D		
Consumer Price Index	May 2018	06/07/18	M	M	M	O, LO, LO, LO	LO, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – CG and GG ⁴	Q1 2018	05/31/18	Q	Q	Q	O, LO, O, O	O, O, O, LO, O
Stocks of CG Debt ⁵	Q1 2018	05/31/18	Q	Q	Q		
International Investment Position ⁶	Q1 2018	05/24/18	Q	Q	Q		
External Current Account Balance	Q1 2018	05/24/18	Q	Q	Q	O, LO, LO, LO	LO, LO, O, O, O
Exports and Imports of Goods and Services	April 2018	05/24/18	M	M	M		
GDP/GNP	Q1 2018	05/24/18	Q	Q	Q	LO, LO, LO, LO	LNO, LNO, LNO, LO, LO
Gross External Debt	Q1 2018	05/24/18	Q	Q	Q		

¹ Every Friday the central bank disseminates daily net international reserves, and weekly International Reserve Assets and Reserve Liabilities.

² Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³ Central government (CG) and general government (GG) revenue and expenditure data are available monthly; and the composition of financing are available quarterly. Financing comprises of foreign, domestic bank, and domestic nonbank financing.

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵ Including type of instrument, maturity and type of creditor.

⁶ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁷ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

⁸ Reflects the assessment provided in the data ROSC published in October 2003 and based on the findings of the mission that took place during February 12–26, 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), not observed (NO), or not available (NA).

⁹ Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative on Peru
July 9, 2018

This statement provides information that has become available since the staff report was issued on June 18, 2018. This information does not alter the thrust of the staff appraisal.

1. Congress granted the special legislative powers requested by the government.

The approval was granted on June 19 with 81 favorable votes (23 against), and is in line with expectations at the time the staff report was written (see paragraph 3). Once the associated regulation is published, the government will have sixty days to legislate in the following areas: economic management, taxation and competitiveness, integrity and the fight against corruption, social protection, and modernization of the public sector.

2. The new Finance Minister, Carlos Oliva, announced continuity with respect to fiscal policy.

Mr. Oliva took office on June 7. In recent public statements, he has made it clear that he will continue to implement the macro-fiscal framework Peru has had in place over the last 25 years. Regarding the excise tax increases that were recently implemented, he confirmed that they will not be reversed.

3. Recent economic data releases point to a further strengthening of the economy.

Monthly GDP increased by 7.8 percent in April (y-o-y), higher than expected and the fastest rate in the last five years, driven by both primary industries (fishing and agriculture) and sectors tied to domestic demand (manufacturing and construction). The trade balance (January to April) and income tax revenues (January to May) also continue to improve markedly (up over 60 and 20 percent y-o-y, respectively). As expected, headline inflation re-entered the Central Bank's target range (1-3 percent) in June and stood at 1.4 percent (y-o-y).

4. Peru has been largely unaffected by recent market volatility.

The Central Bank did not intervene in spot or non-spot FX markets in June (data available until June 28) and the exchange rate was broadly unchanged. On June 28, the Central Bank reduced the marginal reserve requirement rate on FX liabilities from 36 to 35 percent, releasing \$0.17 billion in liquidity to the financial system. EMBI spreads widened by only 0.73 percent in June, less than for other EMDEs.

Statement by Adrian Armas, Executive Director for Peru
July 9, 2018

On behalf of my authorities, I would like to thank staff for their intensive work and open discussions in Lima and for their comprehensive assessment of the Peruvian economy and its financial system in the Article IV and FSSA reports. The authorities consent to their publication. Staff has provided a well-balanced description and analysis of recent economic developments and policy discussions.

Macroeconomic background

Peru is one of the best performing economies in Latin America this century, due to a solid macroeconomic framework and an open trade policy (19 free trade agreements and an average tariff rate of 0.9 percent). GDP growth has been the second highest (5.1 percent on average after Panama) and inflation has been the second lowest (2.7 percent on average after El Salvador) in the region during 2001-2017. Moreover, general government gross debt is the lowest in the region (23.3 percent of GDP) and, consequently, sovereign rates in domestic currency (5.5 percent for a 10-year bond) are in the low range among EMEs. This solid macroeconomic framework was built together with deep structural reforms since the beginning of the 90s.

As a small open and commodity exporting economy, Peru's economic cycle is correlated with the evolution of mineral prices. During the commodity boom period (2006-2013, except 2008), Peru created important buffers by running fiscal surpluses, building international reserves, raising reserve requirements, and establishing provisions to avoid credit booms and bubbles. These buffers allowed Peru to face periods of falling commodity prices during the onset of the Global Financial Crisis (GFC). As of 2017, Peru had experienced 19 years of uninterrupted economic expansion, with only three years of growth below 2 percent (1999, 2001, and 2009).

Recent macroeconomic developments

After a year of low growth, driven by the impact of the El Niño phenomenon and the Lava Jato corruption scandal, recent economic data point to a further strengthening of the economy. The Peruvian economy is already growing at 4.6 percent between January and May 2018. Formal employment in the private sector is growing at 3.8 percent in the first four months and the construction sector (a labor-intensive activity) has recovered after 2 years of contraction (2015 and 2016) or low growth (2.3 percent in 2017), reaching an expansion of 7 percent in January-May 2018. During a similar period, mortgage loans increased 8 percent and VAT collections grew 12 percent.

The current account deficit is sustainable, declining from -2.7 to -1.3 percent of GDP in 2016 and 2017, respectively, due to higher commodity prices and the weak economic cycle. Peru's external debt is relatively low (35.7 percent of GDP) as most of the external financing has come as FDI. During the last years, international reserves have remained relatively stable at around 30 percent of GDP. Our authorities are comfortable with this level of reserves (built during the commodity boom periods), which proved to be very effective in facing macroeconomic and financial risks from financial dollarization (FD) when dealing with capital outflows at the peak of the GFC and in the latest taper tantrum episode, which coincided with a strong fall of commodity prices (2013-2015).

Monetary Policy

The Central Reserve Bank of Peru (BCRP) follows an inflation targeting (IT) regime that takes into account the financial risks created by partial dollarization (30 percent of loans are dollar-denominated). The real exchange rate plays an important role as a shock absorber, and Peru was the first country in the region to abandon its exchange rate peg in 1990. The BCRP was also the first economy with high FD to formally adopt IT in 2002. Forex intervention aims exclusively at preventing negative balance sheet effects with recessionary and financial stability risks on the economy. The frequency of forex intervention has been lower this year. In addition, higher reserve requirements for dollar deposits are used to discourage financial intermediation in foreign currency and promote faster de-dollarization. Higher reserve requirements also allow banks to build international liquidity buffers in periods of increased capital inflows and reduce liquidity pressures during capital outflow episodes. The latest reductions in reserve requirements are consistent with a path of normalization to a steady-state.

As of June 2018, headline inflation (1.4 percent) is within the BCRP inflation target range (1-3 percent) and below the mid-range (2 percent) due to the reversals of negative supply shocks. Core inflation (2.2 percent) is close to the mid-range and different indicators of the inflation trend show similar results.

Communication and consistency of monetary policy decisions have been crucial to guide financial markets on future monetary policy measures and to keep inflation expectations anchored. The monetary policy stance has been accommodative during the last years. The BCRP reduced the interest rate 6 times, from 4.25 percent in April 2017 to 2.75 percent in March 2018, as the output gap became negative (-1 percent) and forecasted inflation and inflation expectations (2.2 percent) remained within the inflation target. The recent monetary policy statements have highlighted that future changes in policy rate will depend on new information, in particular on the evolution of inflation expectations and on how fast the output gap approaches its neutral position. The experience over the last years has shown that market rates have responded in line with BCRP communication statements.

Fiscal Policy

The Government has enough space to implement a counter cyclical fiscal policy to support the cyclical economic recovery by increasing public investment this year and start a fiscal consolidation process in 2019 to achieve a fiscal deficit of 1 percent by 2021. The limit for the fiscal deficit has been raised to 3.5 percent of GDP in 2018 to face the infrastructure and reconstruction needs after El Niño; however, the forecasted deficit is likely to be close to 3 percent, given the recent increase in tax collections. The aim is to stabilize gross public debt at about 27 percent of GDP in the medium term, as the fiscal framework is consistent with a cap on public debt of 30 percent of GDP and a steady-state fiscal deficit of 1 percent of GDP. In addition, the Treasury has deposits in the financial system, mainly at the BCRP, equivalent to 15 percent of GDP, resulting in a net public debt of less than 10 percent of GDP.

The fiscal consolidation process will be achieved mainly by increasing revenues and streamlining expenditures. After 4 years of declining fiscal revenues, the figures as of June show a clear reversal of this trend, as economic activity starts to rebound and commodity prices have partially recovered. In the first half of 2018, fiscal revenues have increased 18 percent compared to the same period in 2017, reaching a 12-month ratio of 19 percent of GDP, higher in 1 percentage point.

In addition, the new administration has taken steps to enhance revenues. The Government raised excise taxes (0.4 percent of GDP) on goods with negative externalities (diesel fuel, cigarettes, alcoholic beverages, sugary drinks, etc.). In the short term, the focus will be on reforming the tax administration, including by improving fiscal databases. The information from the recent repatriation tax at the end of last year has extended the tax base for income taxes. The Superintendence of Tax Administration (SUNAT) is working on the full digitalization of the VAT payment process by 2019.

Furthermore, Peru signed an agreement with 122 countries in the context of the BEPS (Base Erosion and Profit Shifting) plan led by the OECD. The agreement aims to fight fiscal evasion by accessing international information, including on tax havens, and promoting investment by reducing double taxation.

Regarding public expenditure, the Government approved measures aimed at reducing non-critical expenses equal to 0.3 percent of GDP. The adjustment will be governed by guidelines for optimizing rental expenditures and the purchase and use of vehicles, among others. In addition, the special legislative powers granted by Congress include the ability to introduce measures for strengthening the efficiency and sustainability of the Fuel Price Stabilization Fund (FEPC). Changes in the FEPC are expected to create annual savings up to 0.2 percent of GDP.

The Peruvian Congress passed a law in March 2018 to provide more clarity on civil damages in corruption cases, to allow the normal continuity of public investment projects equivalent to 4.5 percent of GDP. The law establishes rules for asset transfers by construction companies that are under investigation or those already indicted. Hence, the law reduces uncertainty for the construction sector and for banks in their risk assessment process.

The implementation of public investment has taken longer than planned but finally there is a clear recovery. The new administration, in coordination with local governments, has taken several actions to revert a 4-year declining trend in public investment. The Government signed a cooperation agreement with the UK to build the infrastructure needed for the 2019 Lima Pan-American Games, based on the experience of the 2012 London Olympics (New Engineering Contract, NEC 3).

Reforms and high potential GDP growth

Congress granted special legislative powers to the new administration with the aim of reaching higher potential GDP growth and fiscal consolidation, thus sending a strong signal of political consensus on key reforms. The areas covered are tax policy and administration (including BEPS); competitiveness (include SME regulation and customs procedures); post-El Niño reconstruction; anti-corruption measures (including requiring conflict of interest statements from public officials); protection of vulnerable groups; and modernization of the state.

The new administration is committed to implementing reforms to improve governance and to fight corruption. The recent legislative powers provide an opportunity to review legislation and procedures to reduce corruption risks. The authorities welcome the next Fund mission on Governance and Corruption in collaboration with the World Bank. The mission is part of the anti-corruption pilot initiatives under the recent update and more operational framework approved by the Board.

Another group of reforms is geared to enhance high productivity sectors. The Government has committed to empowering the “Consejo Nacional de Competitividad y Formalización” (National Council for Competitiveness and Formalization) and continuing the implementation of “Mesas Ejecutivas” (Executive Bureaus). The former measure seeks to completely reform the Council by providing it with powers for articulating policies among various economic sectors (e.g., elimination of unnecessary rules and design of efficient incentive schemes). The latter measure looks to establish a space of agreement between private and public actors to overcome development barriers in strategic sectors (e.g., aquaculture and forestry).

Peru continues to have a substantial infrastructure gap, but solid long-term fiscal sustainability enables the Government to implement an ambitious investment program. This year, several important infrastructure projects will take place, such as the expansion of the international airport and the restart of the second line of the Lima metro.

The current economic recovery presents an opportunity to address a reform of the state to provide more and better quality of basic public services such as education, security, and health. Despite impressive economic growth during this century, Peru's social needs are persistent. The authorities are cognizant that it is a medium-term task, as human and material capacity constraints are significant challenges in improving the efficiency of the public sector.

Financial Sector

The development of the financial system is a key driver of higher potential GDP growth. The expansion of credit to the private sector has been impressive in this century, escalating from 28 percent of GDP in 2000 to 40 percent in 2017. The number of borrowers has increased from 1 million to 7 million during the same period (Peru's population is 31 million). Nevertheless, the financial system is still underdeveloped in comparison with other economies in the region. The main goals of Financial Inclusion 2021 are focused on achieving greater depth in financial markets, broadening the coverage of financial services to promote higher use of digital payments, and creating adequate financial ecosystems for the population.

The financial system has become increasingly resilient and the Superintendence of Banks and Insurance Companies (SBS) has made progress in strengthening financial supervision and regulation. Congress passed a new law extending the SBS supervision perimeter to include cooperatives. The banking system is very well capitalized and profitable and credit developments do not suggest broad-based risks. Banks remain highly resilient to negative shocks, including a deep recession, as suggested by the FSAP stress tests. The banking sector is also highly resilient to liquidity shocks due to reserve requirements. The SBS is working on additional measures to increase the capital buffers of domestic systemic banks and to implement the Net Stable Funding Ratio (NSFR).

The FSAP assessment is that Peru's financial sector remains solid since the previous evaluation (2011) and has adequate buffers to manage severe shocks. The banking sector stress test found that profits and previously accumulated countercyclical buffers would be instrumental to withstand a negative cumulative GDP growth shock of 9.5 over a three-year period. Similar satisfactory results were found for the corporate sensitivity

analysis. We welcome the use in Peru's FSAP of the new Growth-at-Risk (GaR) methodology, which was published in the last Global Financial Stability Report (GFSR).

Conclusion

Peru has enjoyed almost two decades of economic expansion with prudent macroeconomic policies. Looking ahead, the base scenario shows a clear economic recovery in a low inflation environment, with a sustainable fiscal position and very healthy balance of payment. The Peruvian economy has ample buffers to face negative shocks in case of a deterioration of the international conditions.