Consejo Fiscal

Fiscal Rules: What do we really want from them?

An overview of the Peruvian experience

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Santiago, Chile

Opinions expressed in this presentation do not necessarily reflect the views of the Fiscal Council of Peru.

Consejo Fiscal

Contents:

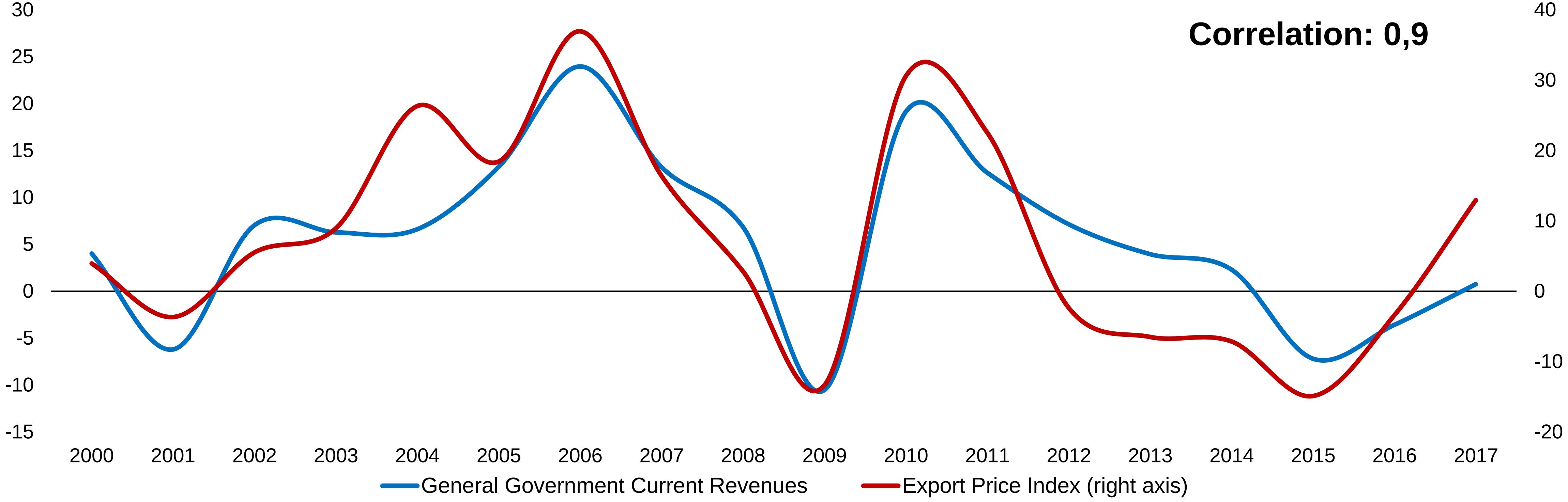
I. Peru in a snapshot

Peru in a snapshot

✓ Business cycle and tax revenues depend heavily on commodity prices

General Government current revenues[1/] and export prices

(Annual percentage change in real terms)



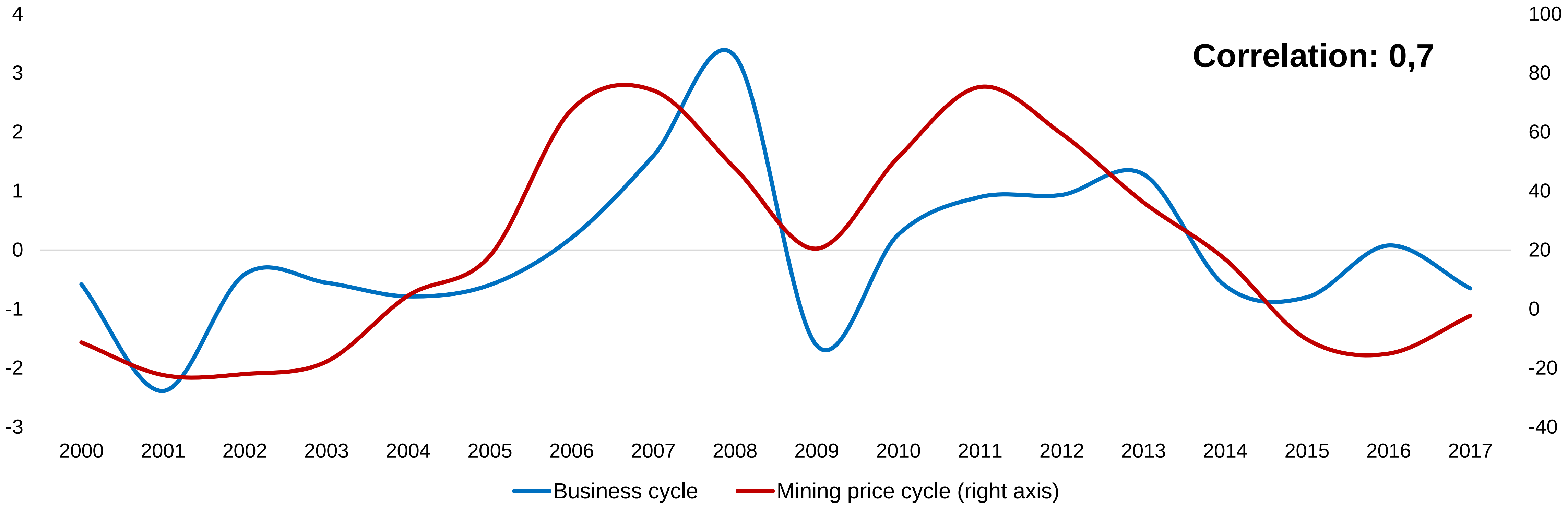
1/ Tax and Non Tax Revenues.

Source: Central Bank of Peru.

Peru in a snapshot

- ✓ Business cycle and tax revenues depend heavily on commodity prices

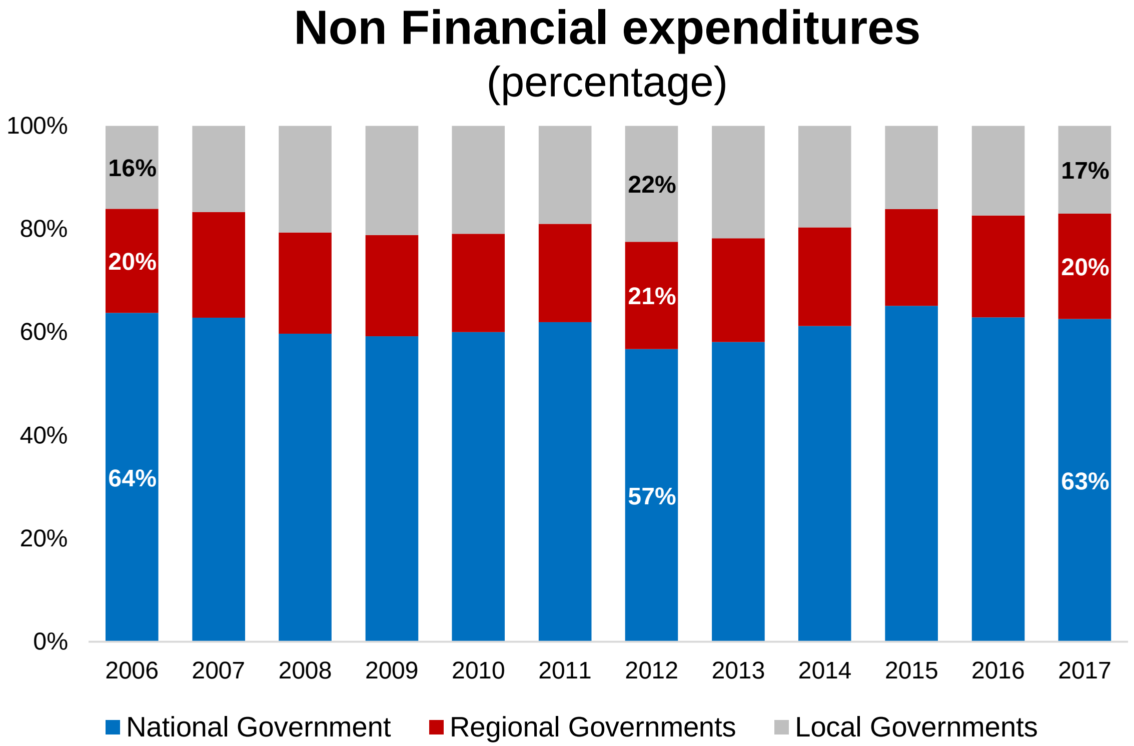
Business cycle[1/] and mining price cycle[2/]
(Percentage of their potential levels)

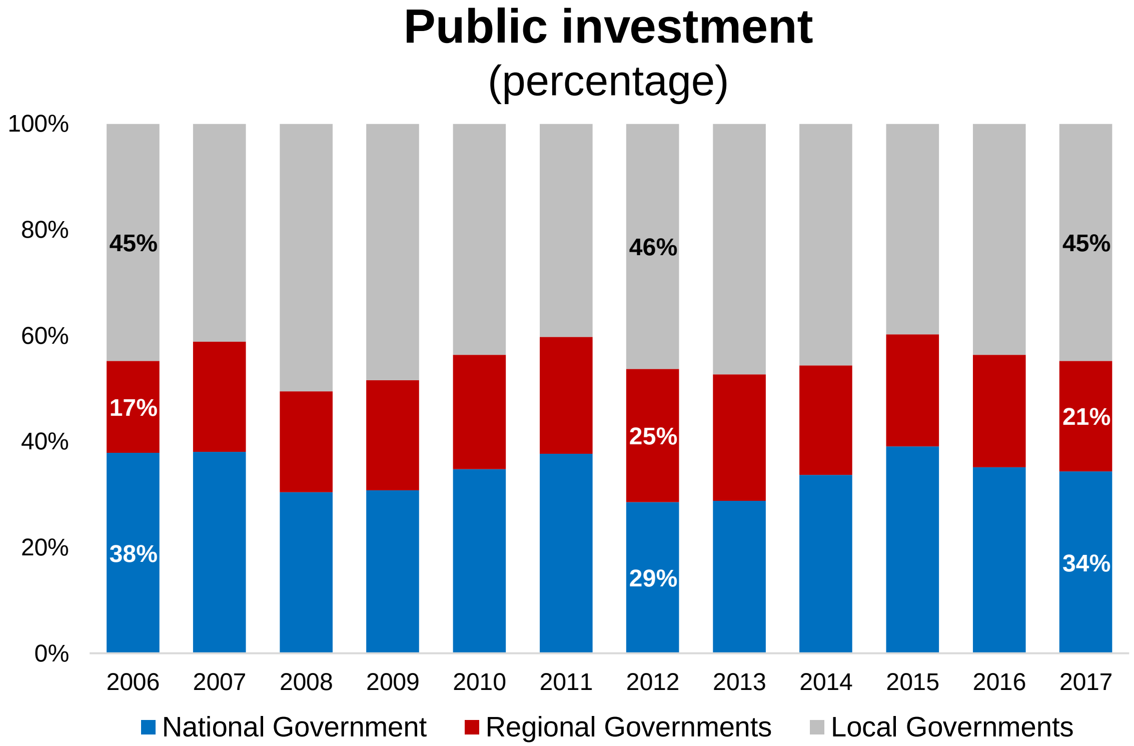


1/ Calculated as the difference between the GDP and the potential GDP. The potential GDP is calculated by the production function methodology, using the Baxter and King filter.
2/ Calculated as the difference between the mining price index and its potential level. The potential mining price index is calculated by a 15 years moving average filter (11 past years, the current year and the future 3 years).
Source: Ministry of Economy and Finance.

Peru in a snapshot

- ✓ Decentralized government system in which National Government manages 60% of total budget, and only 1/3 of public investment.





Source: Central Bank of Peru.

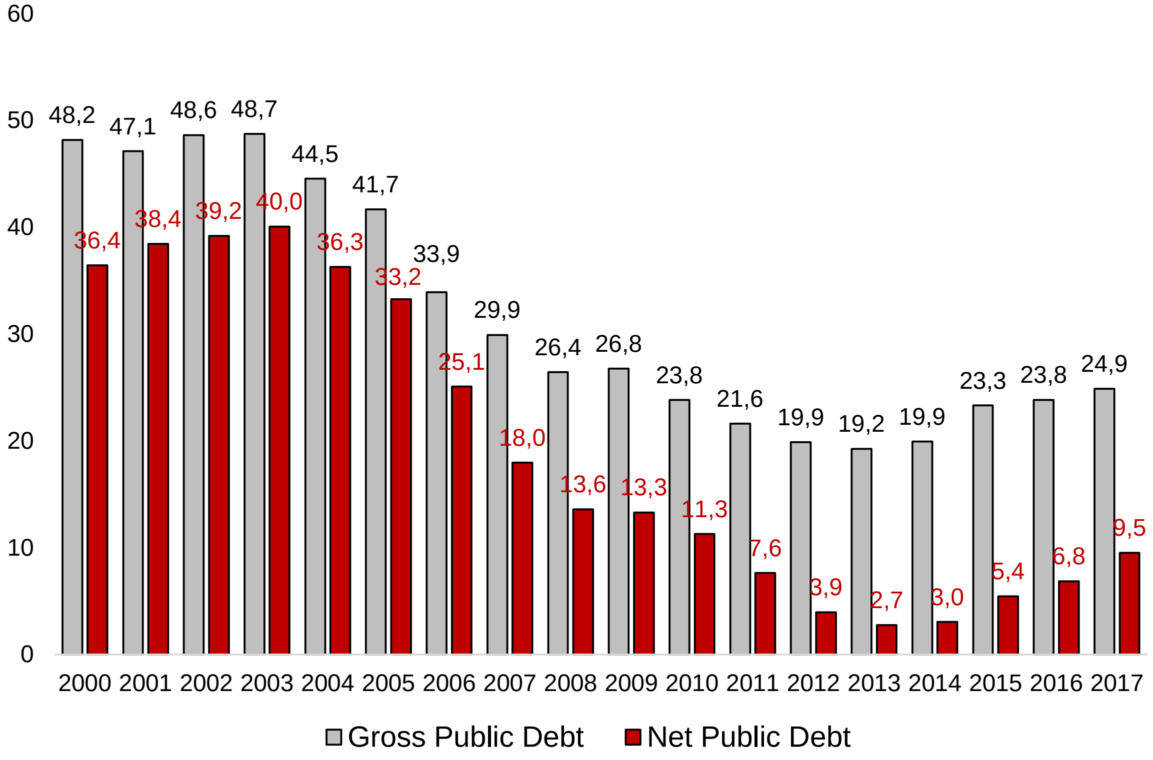
II. What have we achieved

A Maslow approach of fiscal (needs) goals

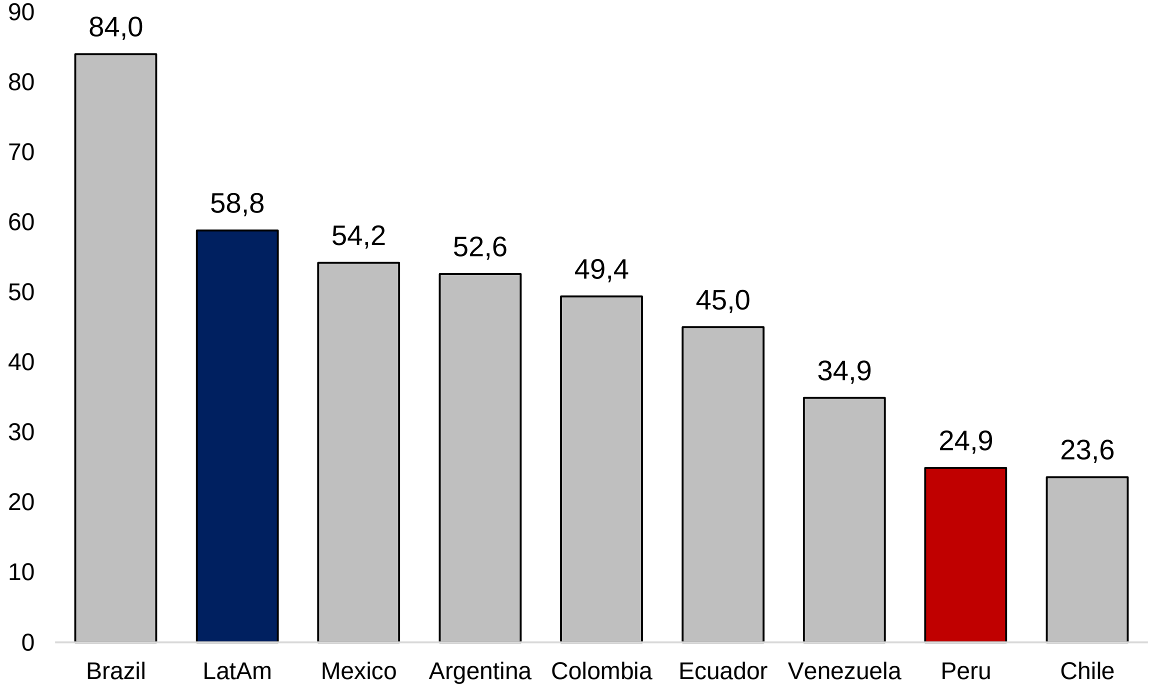
Mitigate major risks	❿Be fiscally prepared to tail risks with catastrophic impact (earthquake, severe El Niño Phenomenon, others)
Reduce volatility of the business cycle	❿Coordinate within government levels (national / subnational)
Impose prudent behavior	❿Save (in *automatic pilot*) during good times
Achieve fiscal solvency	• Reasonable values of fiscal indicators ❿Debt/GDP ❿Fiscal deficit ❿Sovereign risk

Low debt-to-GDP ratio

Peru: Gross and net public debt
(percentage of GDP)



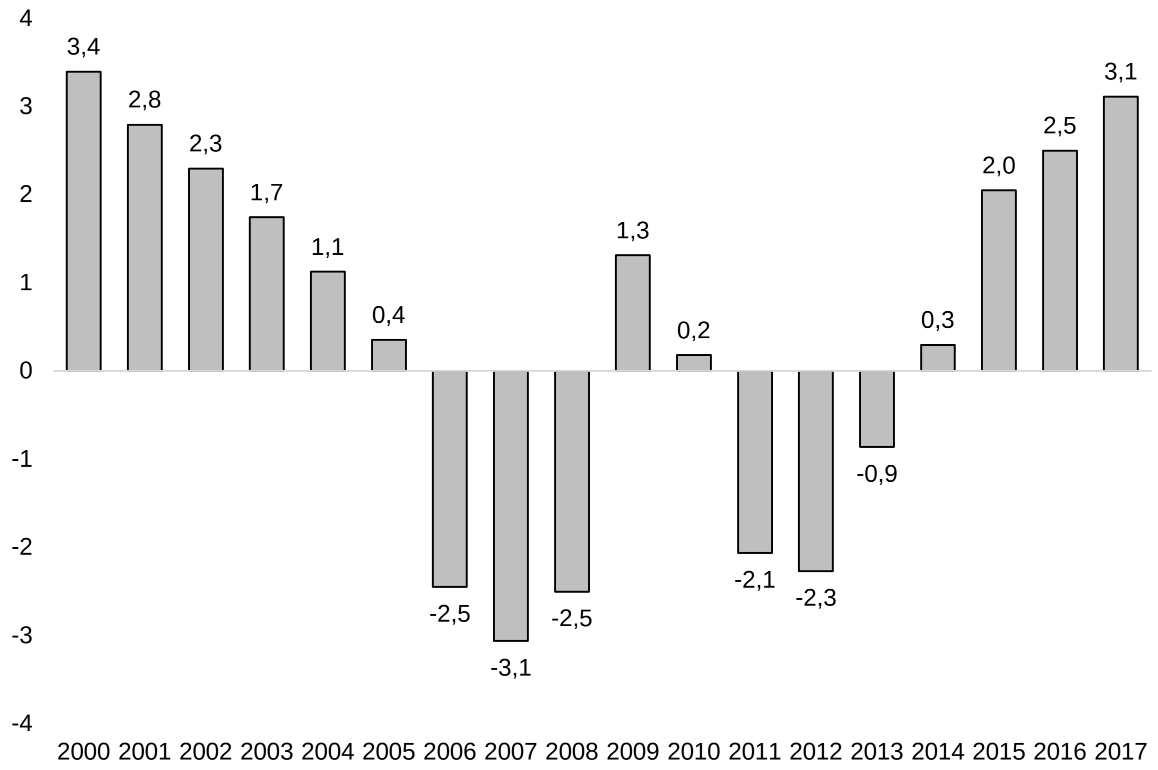
LatAm: Gross public debt in 2017
(percentage of GDP)



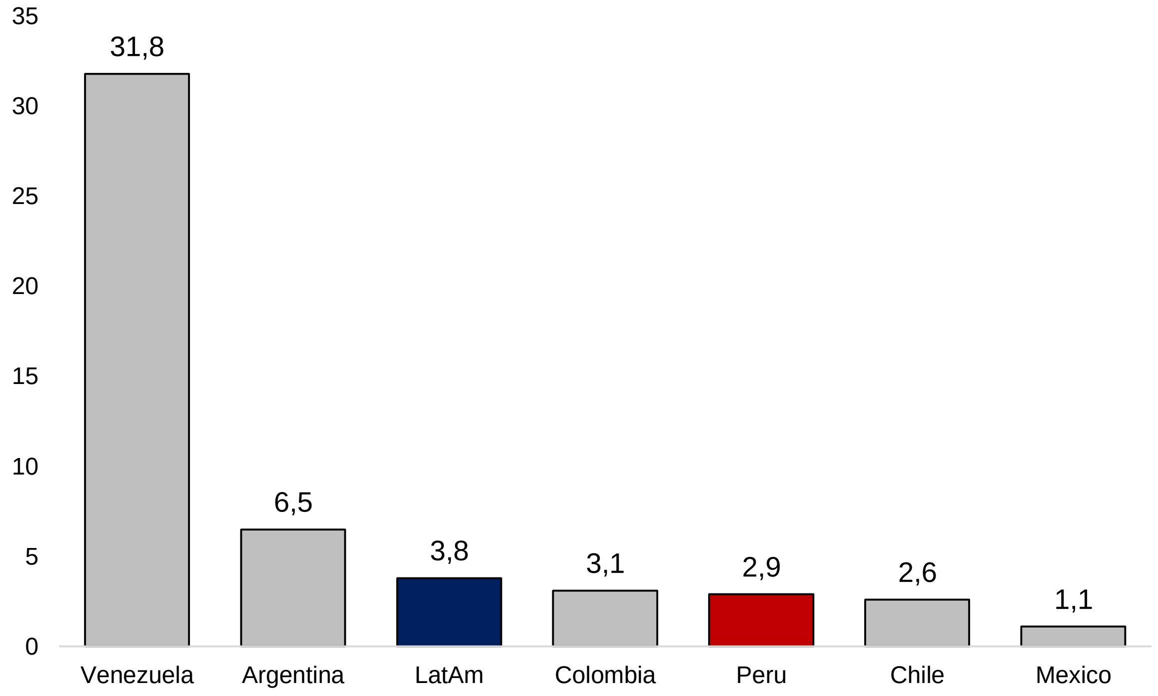
Sources: Central Bank of Peru and World Economic Outlook Database, October 2018, IMF.

Moderate fiscal deficits

Peru: Non Financial Public Sector fiscal deficit
(percentage of GDP)



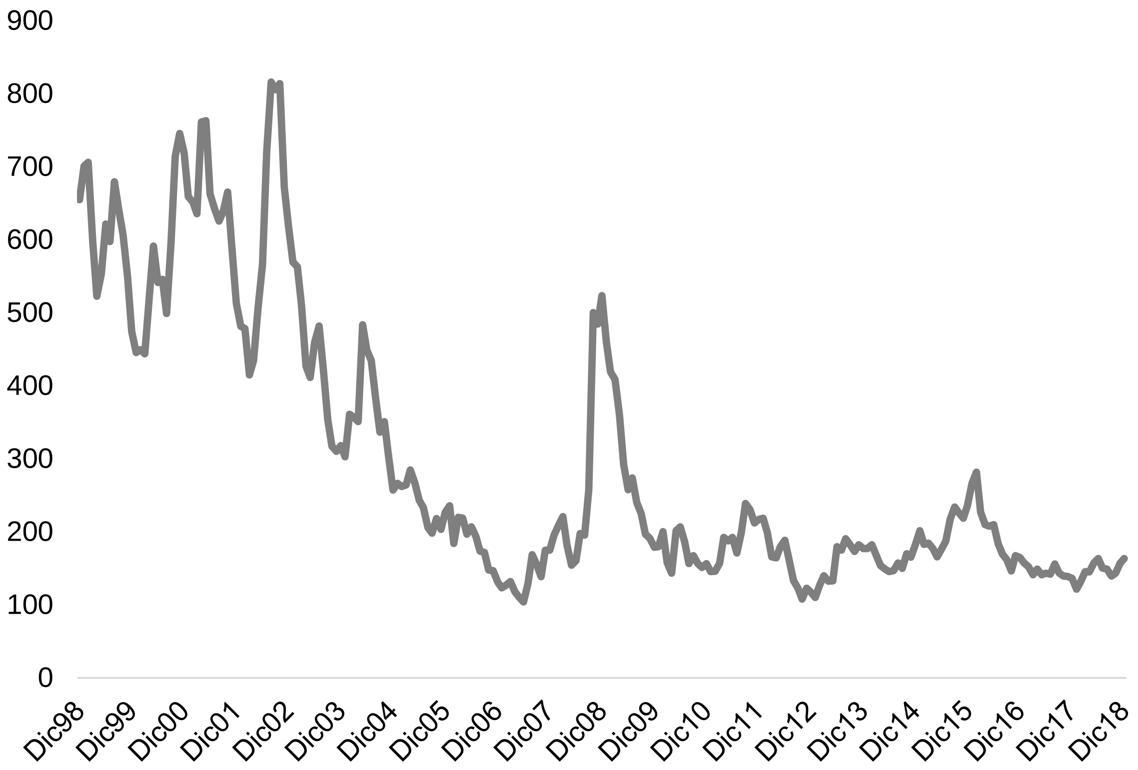
LatAm: General Government fiscal deficit in 2017
(percentage of GDP)



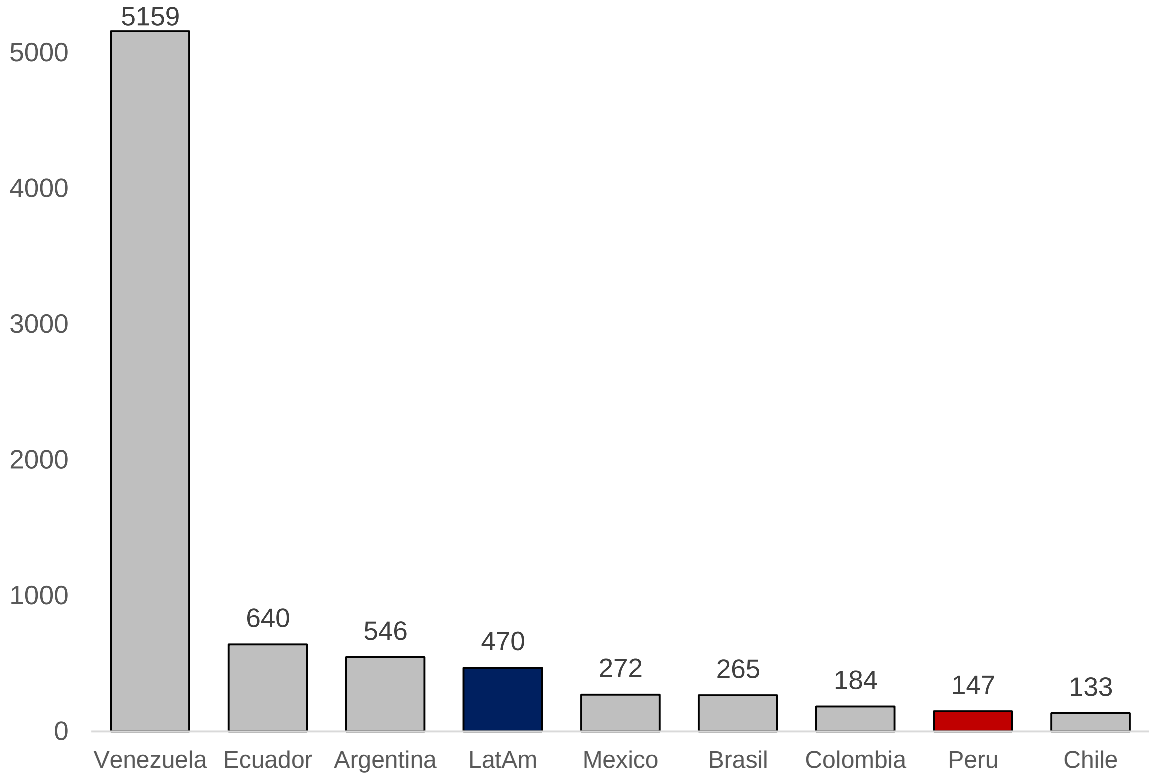
Sources: Central Bank of Peru and World Economic Outlook Database, October 2018, IMF.

Sovereign risks at investment grade levels

Peru: Sovereign risk
(EMBIG spread in basis points)



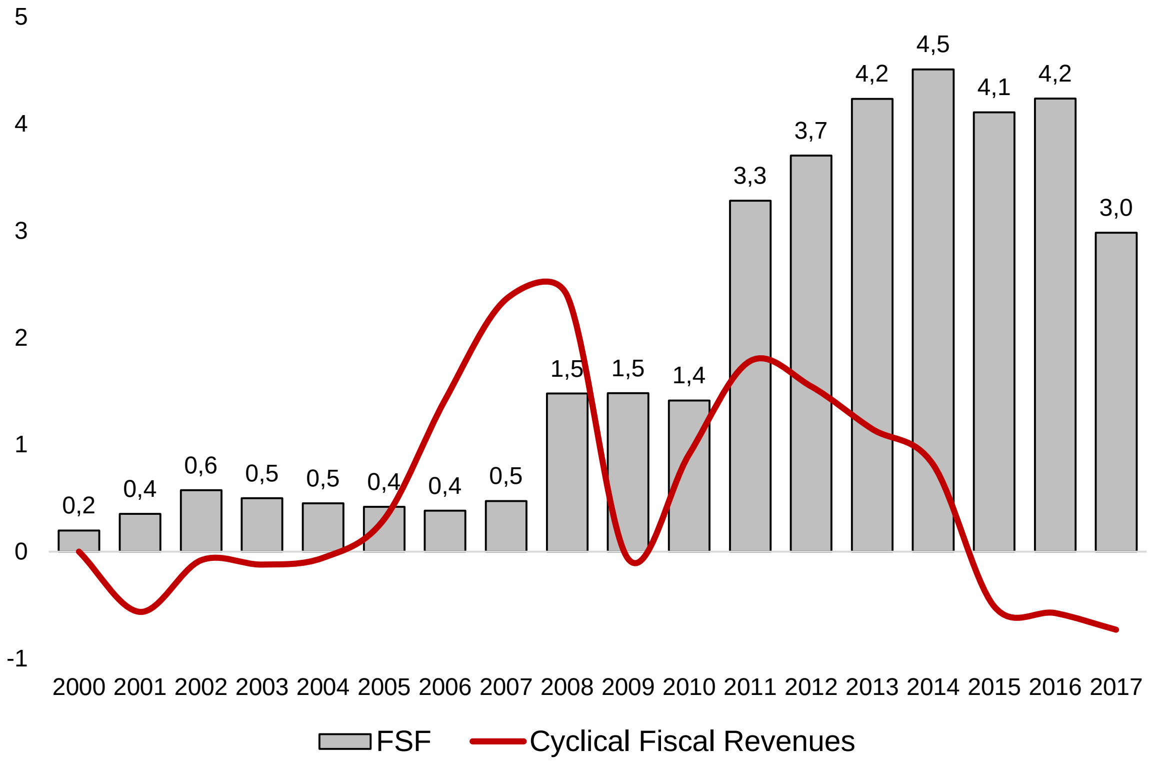
LatAm: Sovereign risk in 2018
(EMBIG spread in basis points, average of the year)



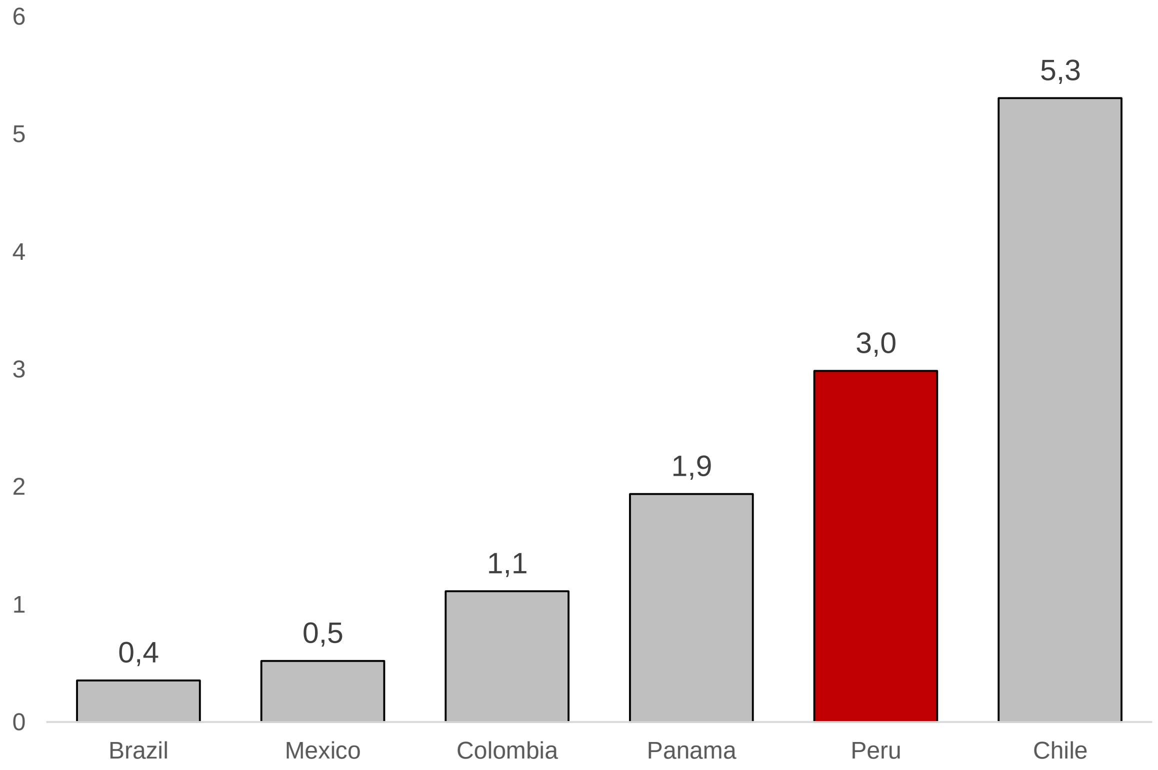
Source: Central Bank of Peru.

Save (in *automatic pilot*) during good times

Peru: Fiscal Stabilization Fund[1/]
(Percentage of GDP)



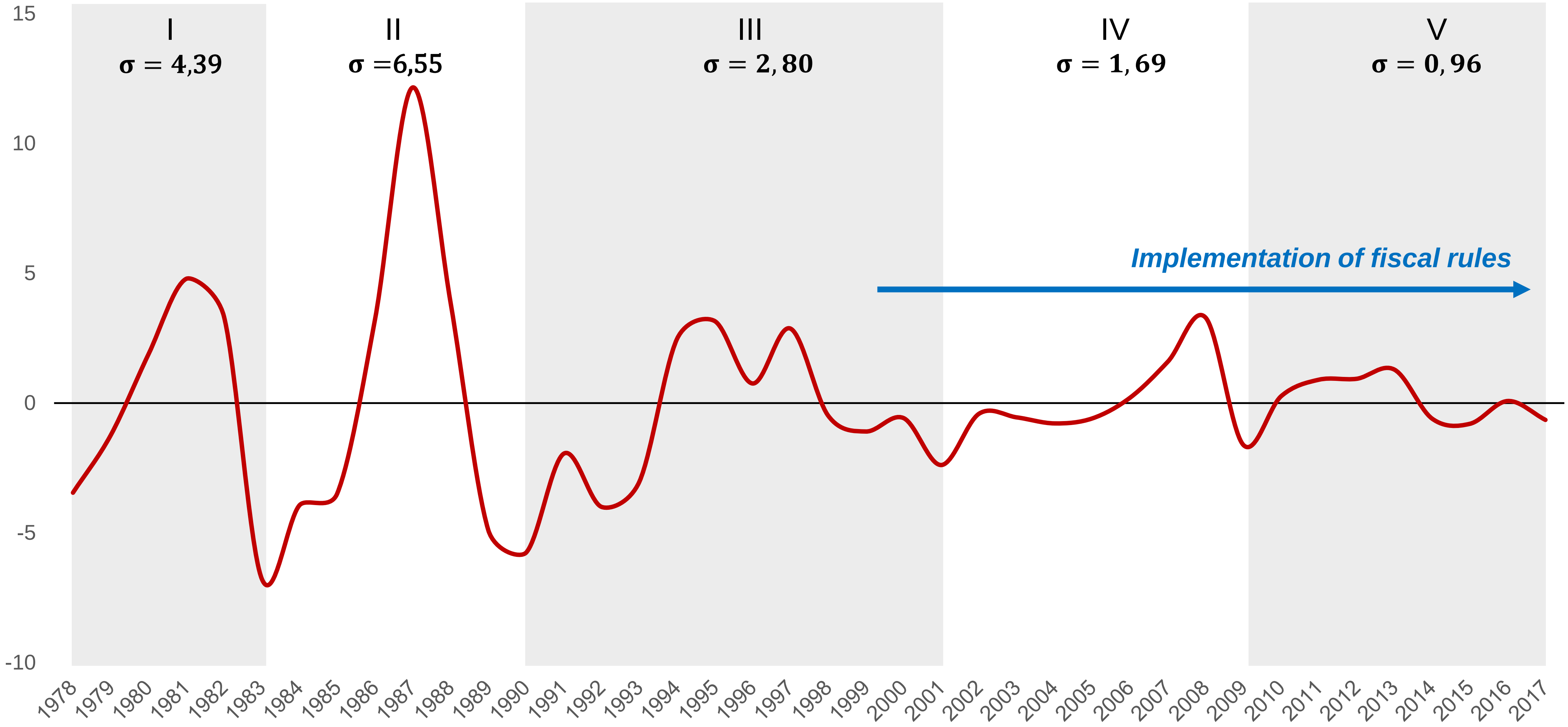
LatAm: Sovereign wealth funds in 2017[2/]
(Percentage of GDP)



Notes:
1/ In 2017, it has been applied an exception clause that reduces the amount of resources in FSF in order to use in the reconstruction process.
2/ These indicators were calculated using the nominal GDP (in US dollars) reported in the World Economic Outlook Database, October 2018.
Source: Central Bank of Peru, Ministry of Economy and Finance of Peru, International Monetary Fund and Sovereign Wealth Fund Institute.

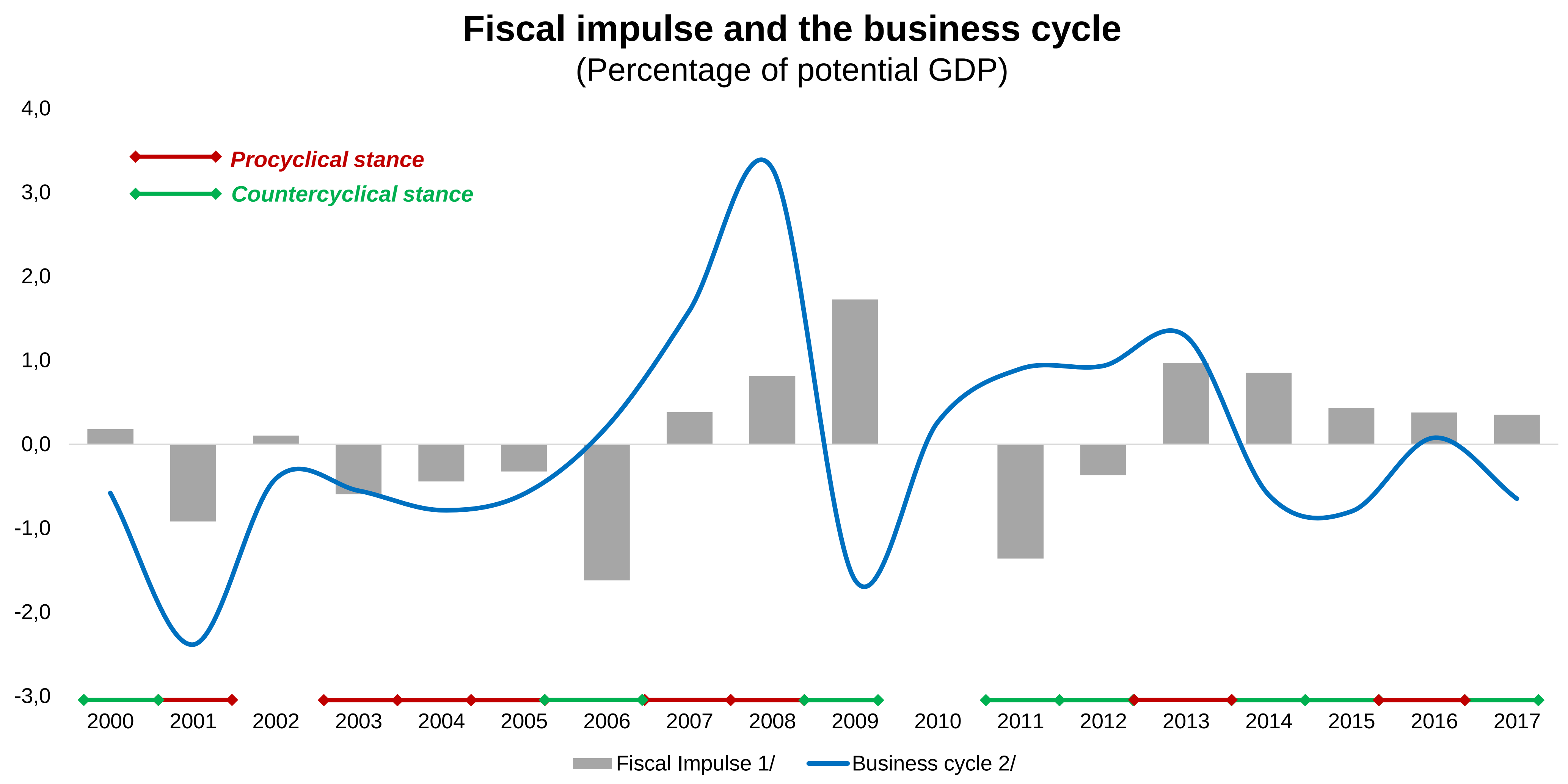
Reduce volatility of the business cycle

Peruvian business cycle
(Percentage of potential GDP)



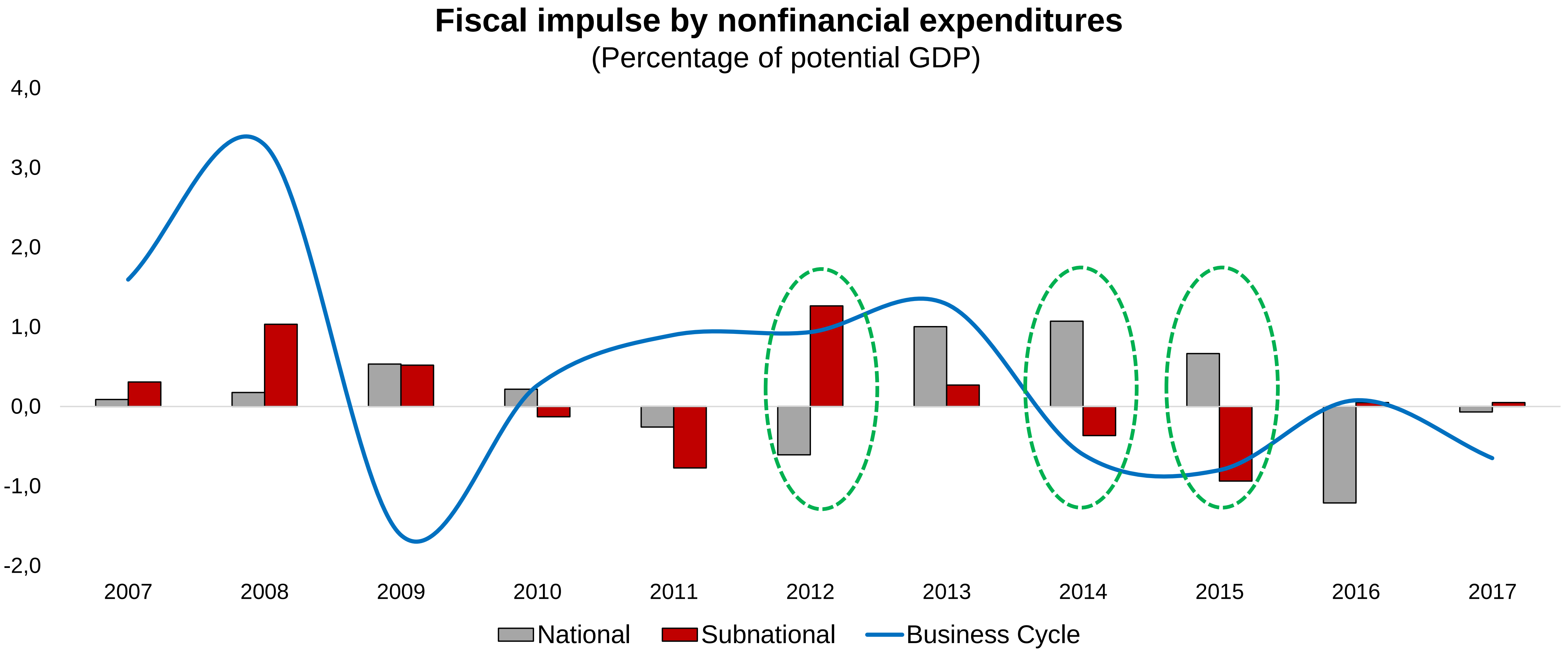
Note: σ is the standard deviation of the Peruvian business cycle in each period.

Remaining challenge: avoid a procyclical bias



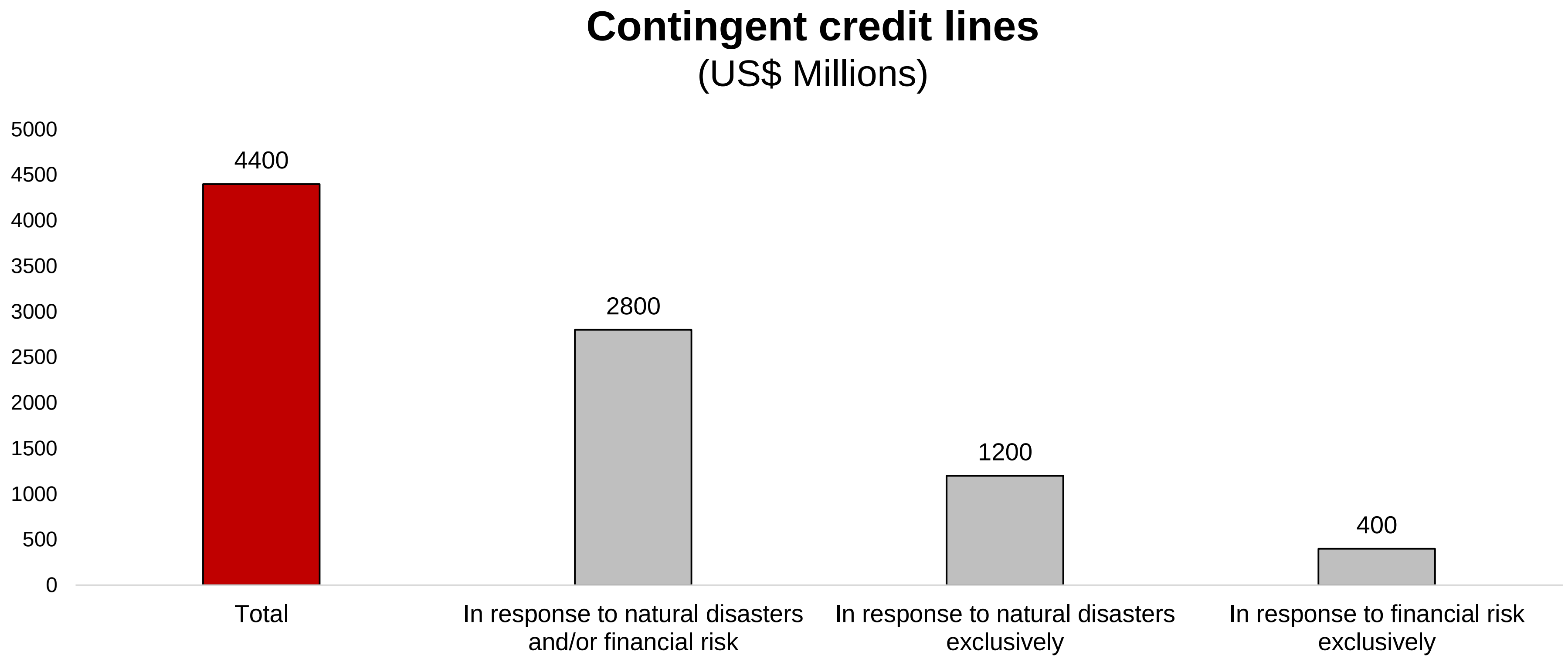
1/ It is defined as the change in the structural primary balance caused by changes in the public spending and fiscal revenues policy.
2/ Calculated as the difference between the GDP and the potential GDP.

Low coordination within government levels



Note: Fiscal impulse is the change of nonfinancial expenditures among two consecutive years measured as the percentage of potential GDP.
Source: Ministry of Economy and Finance.

Be fiscally prepared to tail risks with catastrophic impact



In addition, Peru has an earthquake insurance, with a coverage of up to US$ 200 million. This insurance was contracted in association with the other countries of the Pacific Alliance and through the issuance of a **CAT-bond** by the World Bank in February 2018.

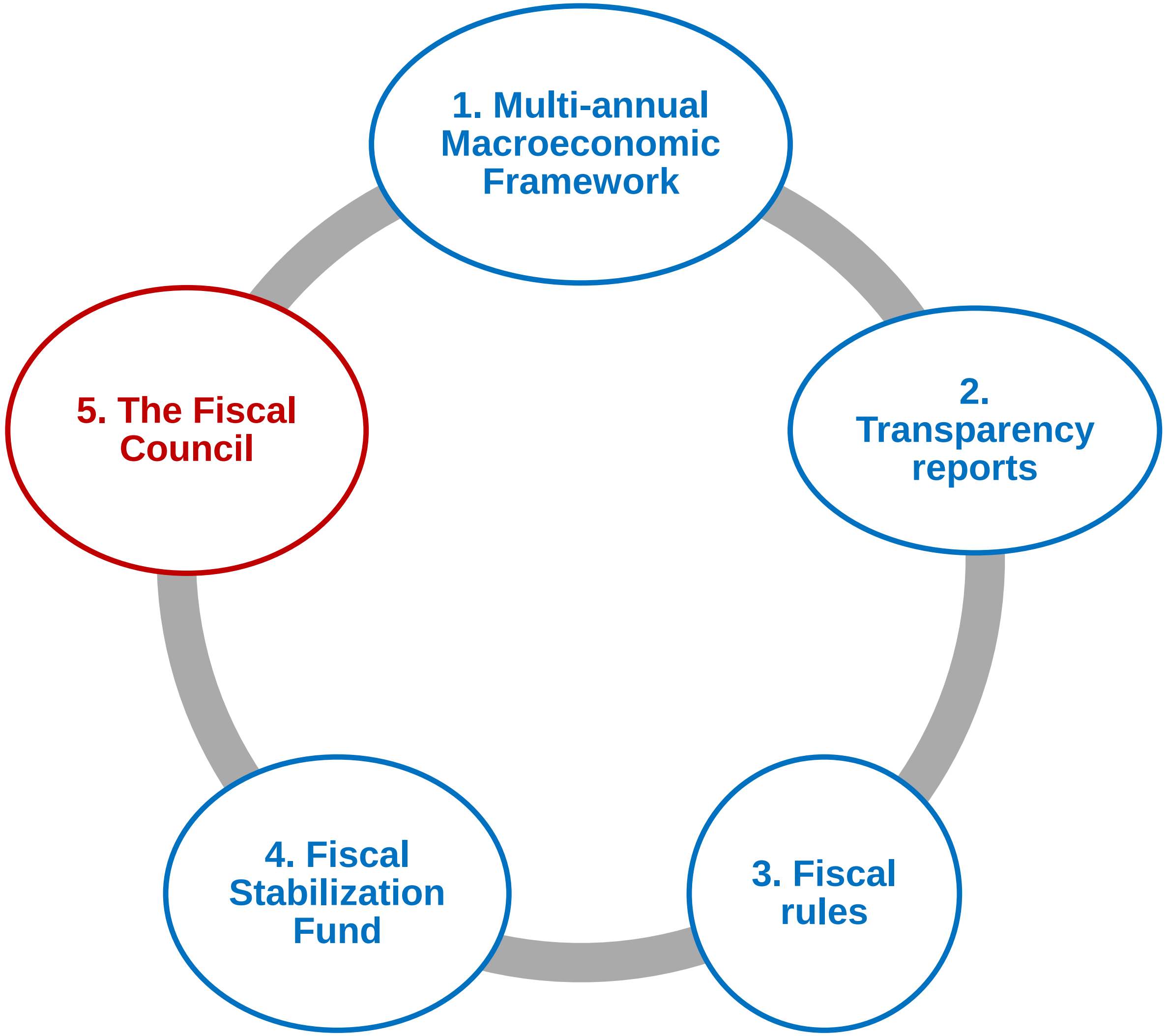
However, in the recent Multi-annual Macroeconomic Framework, it was registered a 10% of GDP in contingent liabilities.

Source: Ministry of Economy and Finance. June 2018,

III. Peruvian Fiscal Framework

Peruvian Fiscal Framework

Fiscal Responsibility and Transparency Framework



Objectives

This framework seeks to guarantee:

- ✓ Fiscal sustainability
- ✓ Predictability of public expenditures
- ✓ Transparent public financial management

Therefore, fiscal surpluses in booms and moderate and transitory fiscal deficits in times of low growth should be permitted.

1. Multiannual Macroeconomic Framework

It is the most relevant report on economic policy from the Government of Peru. It ***anticipates possible contingencies*** *with the elaboration of simulations and the assessment of their impact in the forecasts of the main macroeconomic variables. It must contain:*

- ✓ *Statement of Fiscal Policy Principles*
- ✓ *Projections of structural and cyclical fiscal revenues, nonfinancial and financial expenditures and the primary balance of state-owned enterprises*
- ✓ *Macroeconomic projections for the next 5 years, including the current year*
- ✓ *An assessment of explicit contingencies of NFPS*
- ✓ *The current level of public debt and a long-term projection*
- ✓ *Fiscal sustainability indicators*
- ✓ *An analysis of Fiscal Risks*
- ✓ *A list of Tax Expenditures*
- ✓ *A multi-annual projection of the main mandatory expenditures.*

2. Transparency reports

- ✓ *Statement of Fiscal Policy Principles*
- ✓ *Monitoring Report on Macro-fiscal Rules*
- ✓ *Statement of Fiscal Responsibility Compliance*
- ✓ *Report on Tax System Assessment*
- ✓ *Annual Report on Fiscal Stabilization Fund*
- ✓ *Report on the Strategy for Global Assets and Liabilities Management of Public Treasury*

3. Fiscal rules: Too many changes

Timeline

1993 → **Political Constitution of Peru (Article 84)**

The Central Bank is banned to finance public sector.

1999 → **Fiscal Prudence and Transparency Law**

Rules based on observable variables

2003 → **Fiscal Responsibility and Transparency Law**

Some changes on the previous Law (e.g. name of the law, parameters of the rules) and the addition of subnational fiscal rules (fiscal decentralization).

2013 → **Law to Strengthening Fiscal Responsibility and Transparency**

Structural rules (based on non observable variables)

2016 → **Fiscal Responsibility and Transparency Framework**

Rules based on observable variables

3. The first set of fiscal rules

The exceptions of the fiscal deficit rule were applied at the first years of the decade, when the business cycle was not favorable. Although, the exceptions of the expenditure rule were applied in booms (that were correlated with the increase of commodity prices)

Fiscal Prudence and Transparency Law (Law N° 27245) - 1999

Rules based on observable variables:

- ✓ *Fiscal deficit of Non Financial Public Sector (NFPS): non greater than 1% of GDP.*
- ✓ *Limits on growth of nonfinancial expenditures of General Government (GG).*
- ✓ *Public debt growth: the public debt of NFPS will not grow more than the fiscal deficit of NFPS[1/].*

Fiscal Responsibility and Transparency Law (Law N° 27958) - 2003

NFPS rules:

- ✓ *Fiscal deficit of NFPS : non greater than 1% of GDP.*
- ✓ *Limits on growth of nonfinancial expenditures of General Government. (There were many changes in the coverage of this rule. In 2006, the coverage of the rule changed from nonfinancial expenditure of GG to consumption expenditure of CG. This significant change limited the countercyclical characteristic of the public investment, especially in booms).*
- ✓ *Public debt growth: the public debt will not grow more than the fiscal deficit of NFPS[1/].*

Subnational rules:

- ✓ *The ratio of the stock of public debt to current revenues must not be greater than 100%.*
- ✓ *The ratio of annual debt service to current revenues must be lower than 25%.*
- ✓ *The average primary balance of the recent three years must not be negative.*

It has been prohibited to have external debt without the national government guarantee.

1/ It includes adjustments because of changes in currencies, in the assets of the NFPS, etc.

3. Subnational fiscal rules

There have been fiscal rules for subnational governments since 2003, but with many changes in the parameters.

Fiscal decentralization rules (2004)

It has been established four additional numeric rules:

- ✓ *The ratio of short-term debt to current revenues must not be greater than 12%.*
- ✓ *Two additional rules in case of not having national guarantees*
  - ✓ *The ratio of the stock of public debt to current revenues must not be greater than 40%.*
  - ✓ *The ratio of annual debt service to current revenues must be lower than 10%.*
- ✓ *Nonfinancial expenditure growth must not be greater than 3% in real terms.*

Emergency Decree (2009-2013)

Five numeric rules:

- ✓ *The ratio of total debt to current revenues must not be greater than 120%.*
- ✓ *The ratio of annual debt services to current revenues must not be greater than 25% (30% for local governments).*
- ✓ *The average primary balance of the recent three years must not be negative. .*
- ✓ *The ratio of short-term debt to current revenues must not be greater than 30% (35% for local governments).*
- ✓ *Consumption expenditure growth must not be greater than 4% in real terms.*

3. Fiscal rules: Focus on structural fiscal deficit

Law to Strengthening Fiscal Responsibility and Transparency (Law N° 30099) - 2013

Structural rules:

- ✓ *Limit on nonfinancial expenditures of National Government (NG) based on an structural fiscal deficit of NFPS of 1% of GDP. The nominal limit is established every year by Supreme Decree.*
- ✓ *Limit on pensions and personal expenditures of NG based on potential GDP growth (in nominal terms).*

Also, if the macroeconomic and fiscal conditions for the next three years cause the public debt to be greater than 30% of GDP, then the Statement of Macro Fiscal Policy and the structural fiscal deficit target must be modified.

Subnational rules:

- ✓ *The ratio of the stock of public debt to the average current revenues of the last 4 years must not be greater than 100%.*
- ✓ *The annual growth of non-financial expenditures must not be greater than the annual growth of the average current revenues of the last 4 years.*

3. Fiscal rules: the current ones

Fiscal Responsibility and Transparency Framework (Legislative Decree N° 1276) - 2016

Rules based on observable variables:

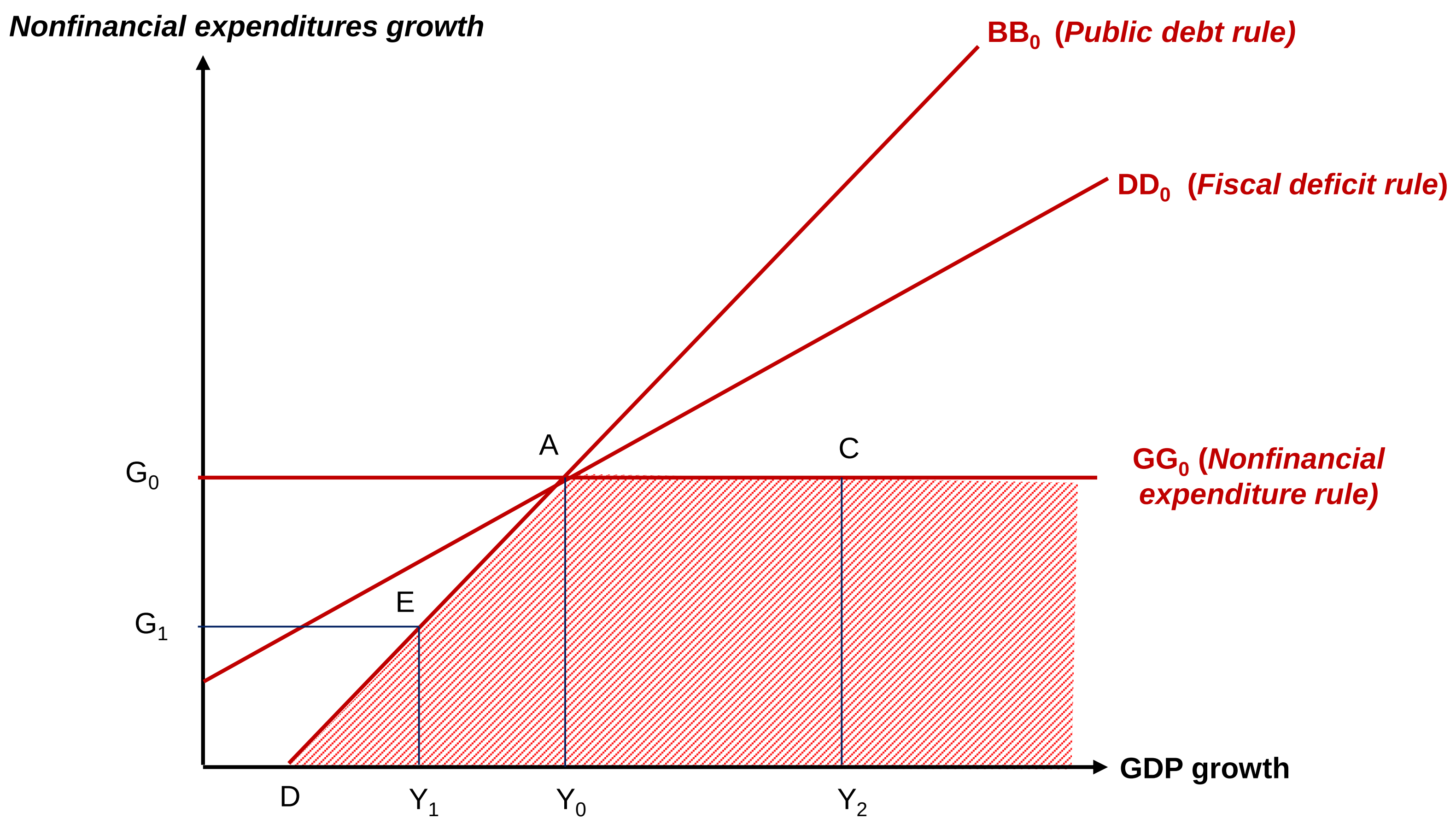
- ✓ *Public debt of NFPS: non greater than 30% of GDP (+4% in case of financial volatility).*
- ✓ *Fiscal deficit of NFPS: non greater than 1% of GDP.*
- ✓ *Nonfinancial expenditures of the General Government: limit on growth of non financial expenditures (average of GDP growth in the last 20 years plus 1 percentage point).*
- ✓ *Current expenditures of the General Government: limit on growth of current expenditures, excluding maintenance expenditures (average of GDP growth in the last 20 years minus 1 percentage point).*

The structural fiscal balance is still calculated but only as a reference for fiscal policy in the medium term. It is reported in the Multiannual Macroeconomic Framework.

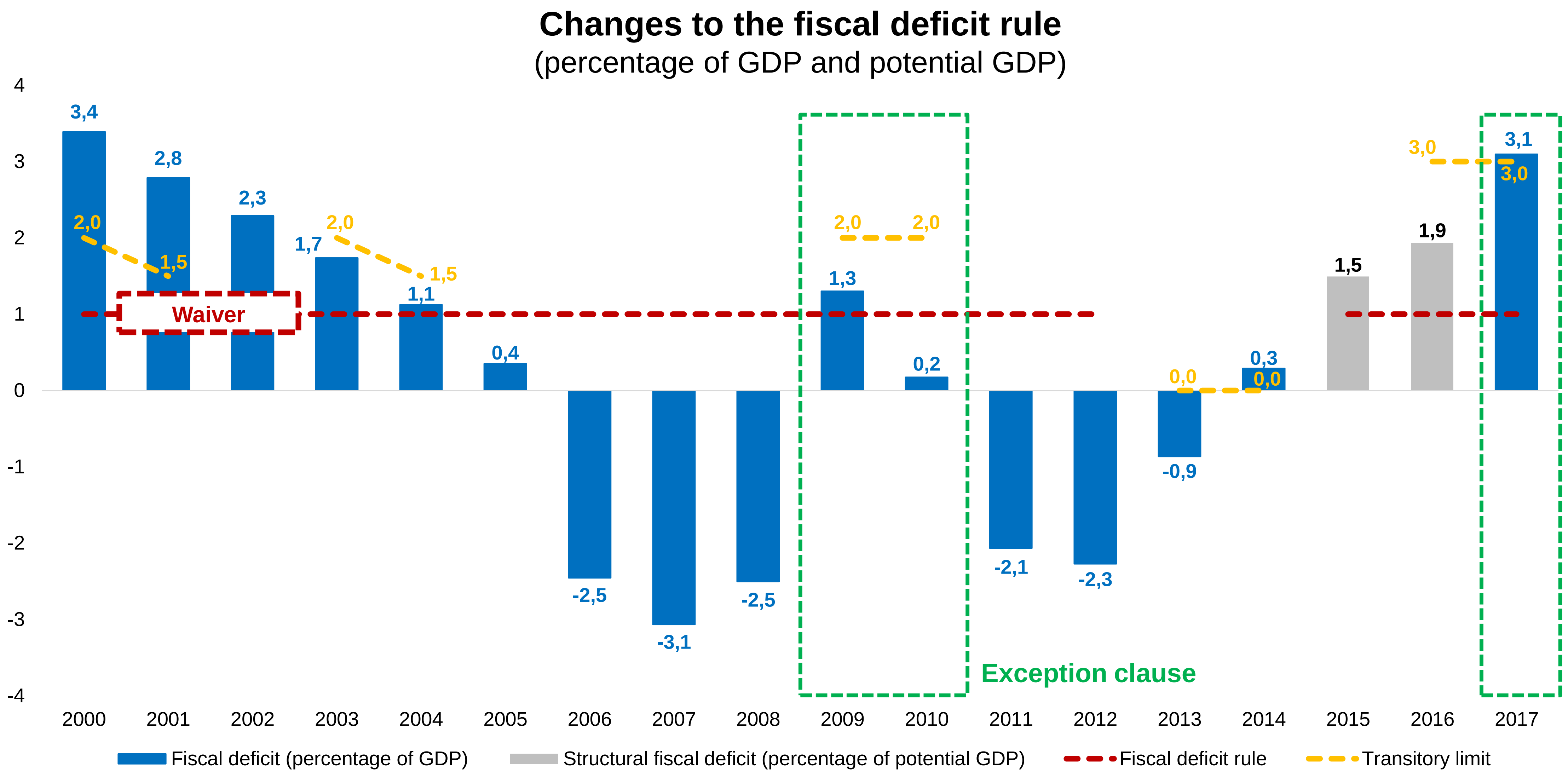
Fiscal Responsibility and Transparency Framework for Subnational Governments (Legislative Decree N° 1275) – 2016

- ✓ *The ratio of the stock of public debt to the average current revenues of the last 4 years must not be greater than 100%.*
- ✓ *The difference between the total current revenues and the non financial current expenditures must be positive.*

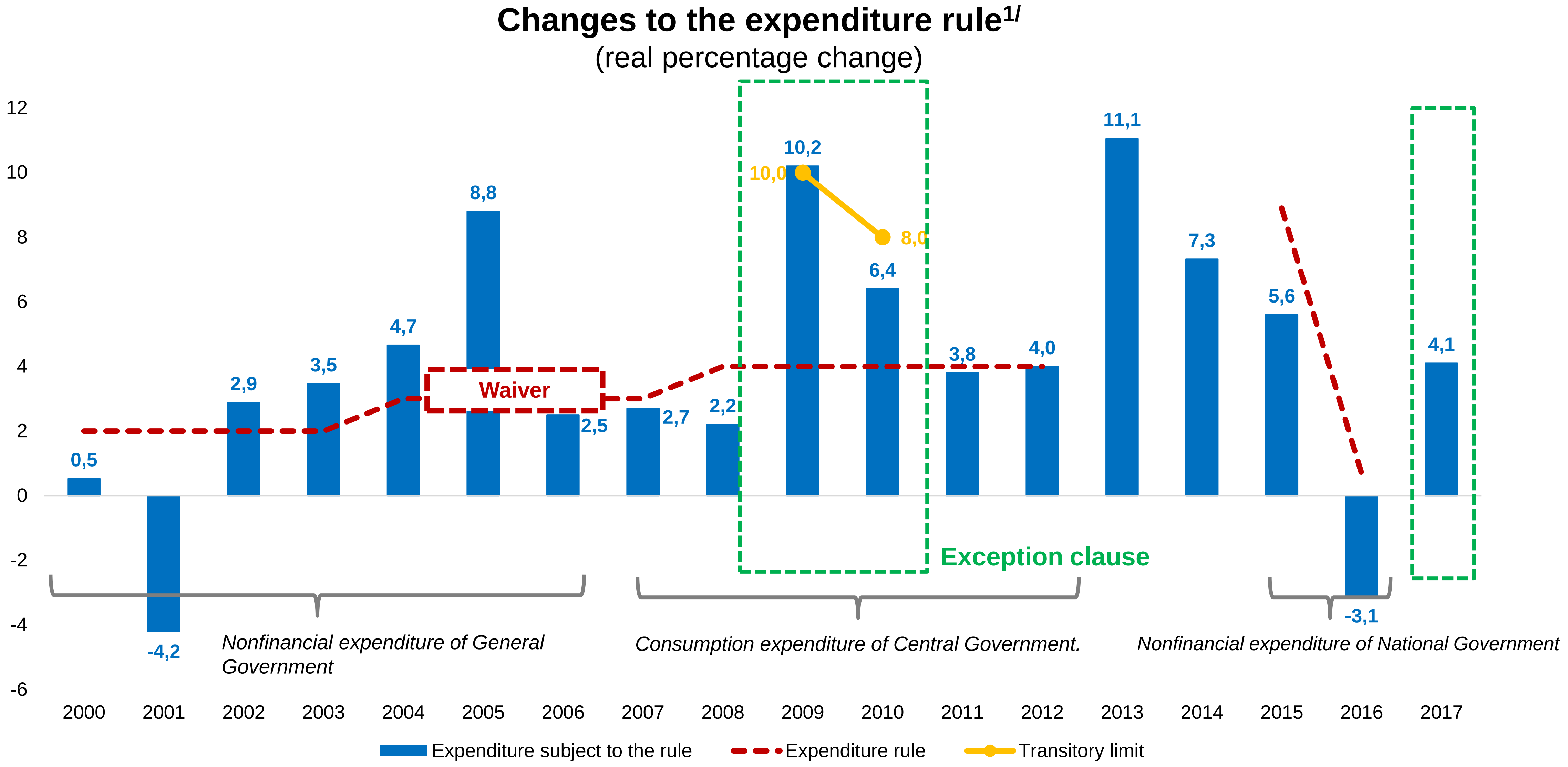
Fiscal Responsibility and Transparency Framework (2016)



3. Fiscal rules



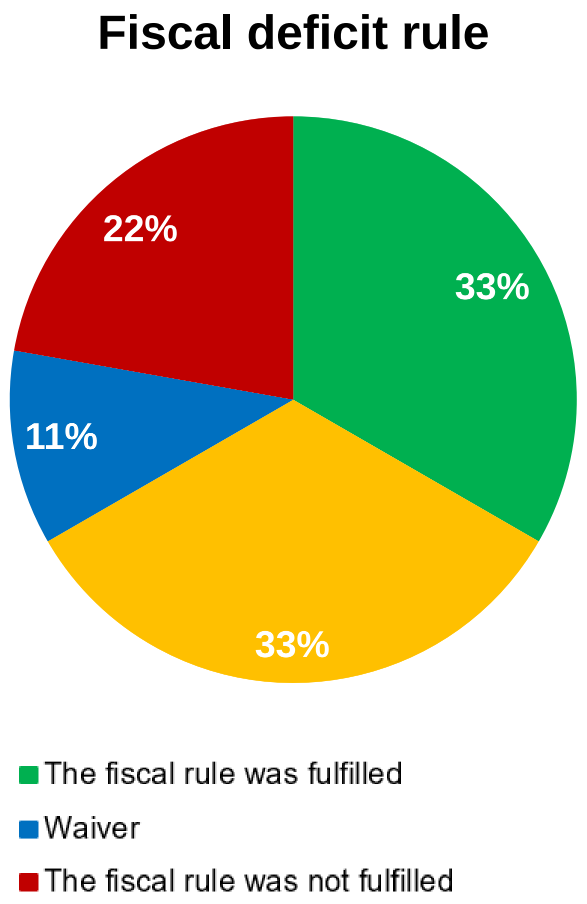
3. Fiscal rules

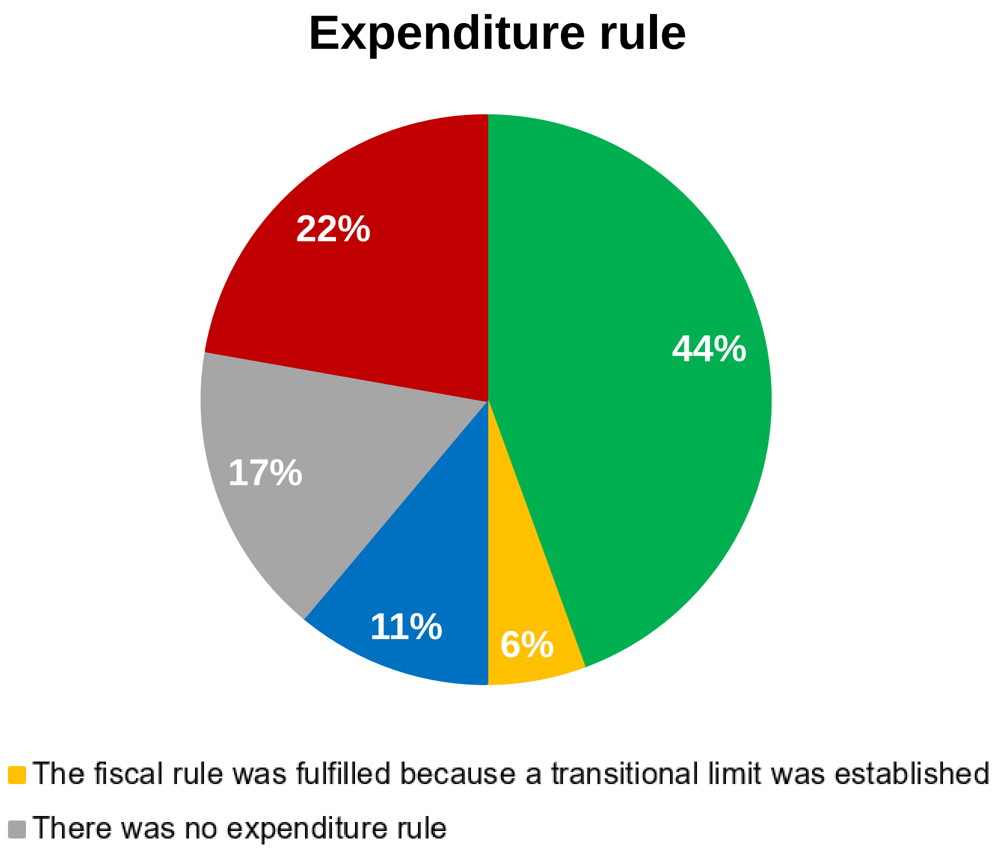


1/ The coverage of this rule has been changed frequently. The expenditure components presented in this chart are only referential.

3. Fiscal rules: The pledge is easy, compliance is harder

Compliance of fiscal rules (2000-2017)
(Percentage of years since their implementation)

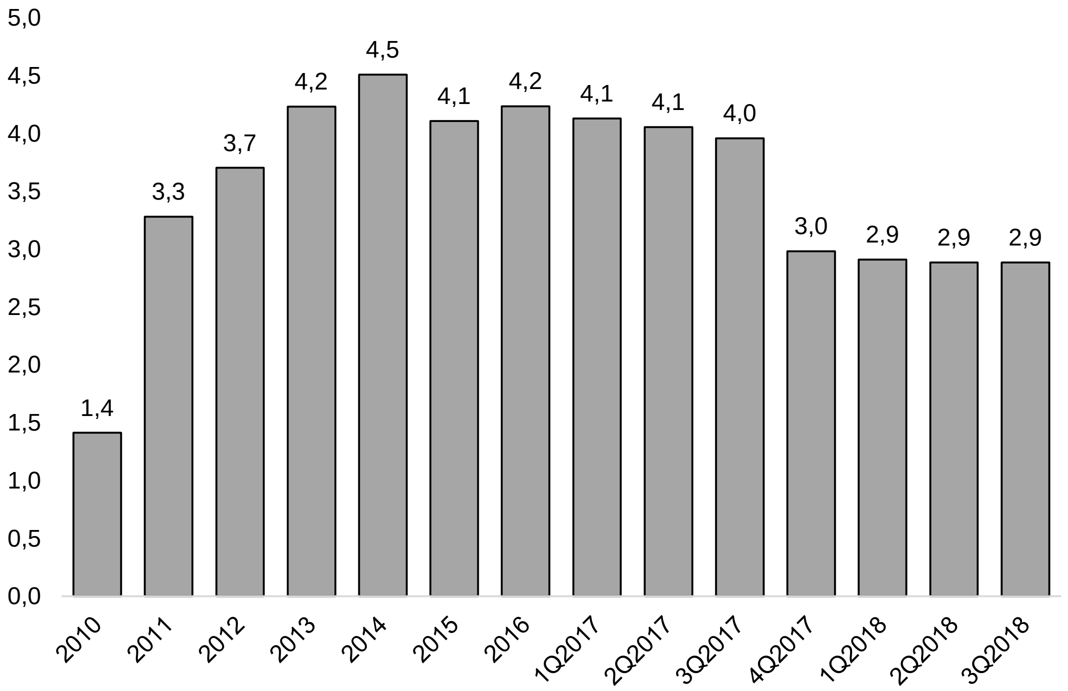




4. Fiscal Stabilization Fund

It is the main financial asset of the Peruvian state. The FSF acts as a mechanism of savings and a countercyclical tool for fiscal policy in case of adverse events.

Fiscal Stabilization Fund
(Percentage of GDP)



International comparison (2017)

Sovereign Wealth Fund	Country	US$ Billions
Social and Economic Stabilization Fund	Chile	14,7
Sovereign Fund	Brazil	7,3
Fiscal Stabilization Fund	**Peru**	**6,4**
Oil Revenues Stabilization Fund	Mexico	6,0
Savings and Stabilization Fund	Colombia	3,5
Savings Fund	Panama	1,2

Note: In the fourth quarter of 2017, the Government used resources from the Fiscal Stabilization Fund for the reconstruction phase after El Niño phenomenon.
Source: Ministry of Economy and Finance of Peru and Sovereign Wealth Fund Institute.

5. The Peruvian Fiscal Council

More countries have established independent fiscal institutions after the last financial crisis (2008).

- ✓ Many governments implemented fiscal councils to strengthen the fiscal institutional framework and boost credibility.
- ✓ In the EU, the law mandated member states to task independent entities to produce or assess the forecasts underlying budget preparation and to monitor the compliance with fiscal rules.

There was no economic crisis in Peru when our Fiscal Council was set up (in **October 2013**):

- ✓ The fiscal balance achieved a surplus (+0,9% of GDP).
- ✓ The debt ratio dropped to a historic low in that year (19,2% of GDP).

5. The Peruvian Fiscal Council

- ✓ The Fiscal Council of Peru was created as an autonomous, public institution that contributes to the independent technical analysis of the macro-fiscal policy and guarantees fiscal transparency.
- ✓ The Fiscal Council has begun its activities in **January 2016**.
- ✓ Currently, the Fiscal Council advises and alerts on possible fiscal risks.

5. The Peruvian Fiscal Council

Institutional features

The Peruvian Fiscal Council is an autonomous entity established by law.

Members of the Fiscal Council: *5 well-known and independent economists with more than 10 years of proven experience in fiscal and macroeconomic matters.*

Dismissal procedures: *members are removed only by resignation or misbehavior.*

Term: *4 years as the maximum. Terms are staggered (explicitly by law). President stays the 4 years in order to guarantee continuity.*

Staff: *own staff with full-time positions.*

Access to information: *access to relevant information from the government (guaranteed by law).*

5. The Peruvian Fiscal Council

Main duties

The Fiscal Council issues non-binding assessments on the following matters:

- *Modification and compliance with fiscal rules.*
- *Assessments of official macroeconomic projections.*
- *Evolution of public finances.*
- *Methodology of structural fiscal balance calculation.*

5. The Peruvian Fiscal Council

Comparison with other fiscal councils

		Chile	Colombia	Perú
Start of activity (Year)		2014	2012	2016
Ex-Ante Analysis	Forecast Preparation		✓	
	Forecast Assessment			✓
	Recommendations	✓	✓	✓
	Consistency with objectives (beyond fiscal rules)	✓		
	Monitoring of Fiscal Rules	✓	✓	✓
Ex-Post Analysis			✓	✓
Number of members		5	9	5
Technical Secretariat		DIPRES[1/]-Ministry of Finance	DGPM[2/]-Ministry of Finance and Public Credit	Own staff

1/ Budget Office.
2/ Macroeconomic Policy Office.
Source: IMF-Fiscal Council Dataset 2017, Ministry of Finance of Chile and Ministry of Finance and Public Credit of Colombia.

Concluding remarks

- ✓ Fiscal policy has become one of the pillars of the Peruvian macroeconomic stability. Fiscal rules have been important as a point of reference, as a visible obstacle in the public debate. But fiscal prudence was already in our DNA. A clearly fiscal prudent stance has been observed in the last 30 years, despite changes in the government political color.

- ✓ The Fiscal Council has served as an additional mechanism to support this stance. We have kept our promise of being an independent voice, we have been able to answer quick enough and with enough technical research to engage in an-evidence based discussion with the Finance Ministry.

- ✓ In this context, the role of Fiscal Council has been crucial for the transparency of public finances and strengthen fiscal institutions.

- ✓ However, our economy still faces high dependence of commodity prices and a low coordination between national/subnational governments for implementation of fiscal policy. It is clear that a structural fiscal rule and a subnational stabilization fund must be needed in order to reduce the likelihood of procyclical stance of the fiscal policy, especially in recessions.

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Fiscal Rules: What do we really want from them?

An overview of the Peruvian experience

Eduardo Morón Pastor

Member of the Fiscal Council of Peru

January 18th, 2019

Santiago, Chile

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Appendix: Fiscal rules

Changes to the fiscal deficit rule (2000-2013)

- **2000** → The fiscal deficit must not be greater than **2% of GDP**.
- **2001** → **Waiver** on the fiscal deficit rule.
- **2002** → **Waiver** on the fiscal deficit rule.
- **2003** → The fiscal deficit must not be greater than **2% of GDP**.
- **2004** → The fiscal deficit must not be greater than **1,5% of GDP**.
- **2009** → The fiscal deficit must not be greater than **2% of GDP**.
- **2010** → The fiscal deficit must not be greater than **2% of GDP**.

Exception clause

Changes to the expenditure rule (2000-2013)

- **2000** → The growth of nonfinancial expenditures of GG must no be greater than **the annual inflation rate plus 2% in real terms**.
- **2003** → The growth of nonfinancial expenditures of GG must no be greater than **3% in real terms** (calculated using the implicit deflator of GDP).
- **2005** → **Waiver** on the nonfinancial expenditure fiscal rule of GG.
- **2006** → **Waiver** on the nonfinancial expenditure fiscal rule of GG.
- **2007** → **The coverage was modified**. Now, the consumption expenditure (wages plus goods and services) of the Central Government was considered. The parameter of the real growth limit was maintained (3% in real terms). The Central Bank's inflation target was the deflator.
- **2008** → Pension spending was added to the consumption expenditure rule. Furthermore, the parameter of the growth limit **increased from 3% to 4%** in real terms.
- **2009** → Real growth of consumption expenditure must not be greater than **10%.**
- **2010** → Real growth of consumption expenditure must not be greater than **8%.**
- **2011** → The annual average CPI inflation of Metropolitan Lima was used instead of the Central Bank's inflation target tor the calculation of the growth limit in real terms. Limit was 4% in real terms.
- **2012** → Expenditures on maintenance, goods and services of social programs and equipment destined to public order and security were excluded from the rule. Limit was 4% in real terms.

Appendix: Fiscal rules

Changes to the fiscal deficit rule (2013-2016)

2013 → The fiscal balance of NFPS **must not be negative**.

2014 → The fiscal balance of NFPS **must not be negative**.

2015 → The structural fiscal deficit must not be greater than **1% of potential (long-term) GDP**.

2016 → The structural fiscal deficit must not be greater than **3% of potential (long-term) GDP**.

Appendix: Fiscal rules

Changes to the fiscal deficit rule (2017-…)
Exception rule

- **2017** → The fiscal deficit must not be greater than **3% of GDP**.
- **2018** → The fiscal deficit must not be greater than **3,5% of GDP**.

Changes to the expenditure rule (2017-…)
Exception rule

- **2017** → **Waiver** on the expenditure rule.
- **2018** → Limit in the current expenditure rule of GG was **4% in real terms.**

  Waiver on the nonfinancial expenditure rule of GG.

Appendix: Subnational fiscal rules

2003 — Fiscal Responsibility and Transparency Law

Total debt rule

$$\frac{Total\ debt\ stock}{Current\ revenues} \leq 100\%$$

Debt service rule

$$\frac{Debt\ service}{Current\ revenues} \leq 25\%$$

Primary balance (PB) rule

$$\frac{PB_{t-1} + PB_t + PB_{t+1}}{3} \geq 0$$

External debt must be guaranteed by the Government.

2004 — Legislative Decree of fiscal decentralization

2003 rules were applied
- Total debt rule.
- Debt service rule.
- Primary balance (PB) rule.
- External indebtedness with Government guarantee.

Additional rules:

Short-term debt

$$\frac{Current\ revenues}{12} \geq Short - term\ debt$$

Nonfinancial expenditure (NFE) rule

$$Real\ \%\ change\ in\ NFE \leq 3\%$$

Debt rule without guarantee of the National Government

$$\frac{Total\ debt\ stock}{Current\ revenues} \leq 40\%$$

Debt service without guarantee of the National Government

$$\frac{Debt\ service}{Current\ revenues} \leq 10\%$$

End of mandate rule
The last year of management is prohibited from making any current expenditure involving commitments after the end of the administration.

2009 — Emergency Decree N° 108-2009

Total debt rule

$$\frac{Total\ debt\ stock}{Current\ revenues} \leq 120\%$$

Debt service rule
Regional Government

$$\frac{Debt\ service}{Current\ revenues} \leq 25\%$$

Local Government

$$\frac{Debt\ service}{Current\ revenues} \leq 30\%$$

Primary balance (PB) rule

$$\frac{PB_{t-1} + PB_t + PB_{t+1}}{3} \geq 0$$

Short-term debt
Regional Government

$$\frac{Short\ - term\ debt}{Current\ revenues} \leq 30\%$$

Local Government

$$\frac{Short - term\ debt}{Current\ revenues} \leq 35\%$$

Consumption expenditure rule

$$Real\ \%\ change\ \ consumption\ expenditure \leq 4\%$$

End of mandate rule

2014 — Law to Strengthening Fiscal Responsibility and Transparency

Total debt rule

$$\frac{Total\ debt}{Avg.current\ revenues\ (4\ years)} \leq 100\%$$

Nonfinancial expenditure rule

Non Financial expenditure ≤ percentage variation of the four-year moving average of annual revenues.

External debt must be guaranteed by the Government.

2017 — Fiscal Responsibility and Transparency Framework of the Regional and Local Governments

Total debt rule

$$\frac{Total\ debt}{Avg.current\ revenues\ (4\ years)} \leq 100\%$$

Current account savings rule

$$Current\ revenues - Current\ expenditures \geq 0$$

Appendix: Exception clauses

Exception clauses

The Government must establish an explicit and gradual path to the regular rules.

Only in case of any of these events:

✓ Natural disasters

El Niño Phenomenon In past events, El Niño caused damage to the capital stock around 2,5% of GDP

Earthquakes Direct and indirect damages caused by Pisco's earthquake in 2007 were around 1,2% of GDP

✓ Significant external shocks which affects fiscal revenues or when the economic activity requires a modification of the fiscal deficit because of external factors

Dependence on international markets

- In Peru, terms of trade shocks have generated significant gains in TFP, mainly in the short-run[1/].
- A reduction in commodity prices and an increase in volatility increase the probability to delay investment in the mining sector[2/].

Exception clauses were activated in 2009 (because of the **international financial crisis**) and in 2017 (because of **El Niño phenomenon**)

1/ Castillo, P. and Y. Rojas (2014),"Términos de Intercambio y Productividad Total de Factores: Evidencia empírica de los mercados emergentes de América Latina". Estudios Económicos Journal, N° 28.
2/ Gondo, R. and M. Vega (2017),"The Dynamics of Investment Projects: Evidence from Peru". BIS Working Papers N° 621.