

August 27, 2016

Executive Summary

After winning a vote of confidence from Congress ratifying his Cabinet, President Pedro Pablo Kuczynski will seek decree powers to fast-track legislation. Whether or not the opposition-controlled Congress approves decree powers will directly affect the president's effectiveness during his first 100 days in office.

An unguarded comment from the new finance minister, who implied the previous government may have placed people in her trust inside the finance ministry, and subsequent backlash illustrate the political inexperience of the new Cabinet.

Congress has passed a bill to change Peru's bankruptcy regulation, extending the terms of liquidation, in an effort to save the La Oroya smelter in Junin. The move bought one more year, and up to two, for the government to create the economic conditions to attract an operator willing to purchase the historic smelter and La Cobreza copper mine.

Former President Ollanta Humala's sister was the target of a home invasion in which Spanish-speaking assailants ransacked her home in search of documents, presumably incriminating evidence against the former president and first lady for money laundering.

The interior minister presented to Congress the findings from an investigation into the national police force which confirms the existence of a "death squad" which committed extrajudicial killings.

The state oil firm has alleged that two recent spills were caused by vandalism to the Northern Peruvian Pipeline in the jungle states of Loreto and Amazonas.

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Kuczynski government gears up to request decree powers

Next week Cabinet chief Fernando Zavala will ask Congress to grant the government decree powers to pass legislation in matters related to the economy, crime, corruption and expanding coverage of running water.

President Pedro Pablo Kuczynski's popularity has spiked since winning the election on June 5. While granting the president decree powers after assuming office is standard, nothing is guaranteed given this Congress is controlled by the Popular Force party of his runoff opponent, Keiko Fujimori. Whether or not Kuczynski can implement fast change will depend on the opposition party's political calculus.

Kuczynski's approval has risen to 61 percent according to a recent Ipsos survey. This level of support is usually normal but considered a feat in this case given Kuczynski was never the first choice among Peruvians. Kuczynski won just 21 percent of the vote in the first round of voting and never polled higher than that throughout the election season. He ultimately defeated Fujimori by just half a percentage point.

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[Opposition makes government kneel in confidence vote](#)

But Kuczynski's unorthodox behavior, which includes dancing at parades and exercising in front of the Government Palace, along with his policies seem to have won over Peruvians who did not vote for him. A majority of the public supports granting the government the decree powers across the board (85 percent for corruption, 86 percent for economy, 92 percent for running water and 93 percent for crime).

Popular Force could suffer a backlash if it were to deny the government the power to legislate in its first 100 days. The same Ipsos survey showed that 72 percent of Fujimori voters want Congress to grant the government decree powers while only 23 percent want them to prioritize their own platform.

The most contentious issue will be Kuczynski's plan to reduce the national sales tax, which the president has called to bring progressively from 18 percent to 15 percent over three years. Fujimori attacked the policy during the campaign, and Popular Force has portrayed the idea as benefitting big business at the expense of everyday Peruvians.

Popular Force congressman Miguel Angel Torres has penned op-eds for various newspapers arguing against the tax cut, arguing instead for his own plan to allow small and medium-sized companies to defer tax payments for receipts already billed but not collected for three months.

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Finance minister Alfredo Thorne has said that reducing the sales tax would be part of the economic legislative package, but Zavala has not confirmed whether or not the government will decree the tax cut or send it to Congress. Popular Force controls 73 of Congress's 130 seats.

Of the remaining parties, Kuczynski's Peruvians for Change party holds 18 seats which will vote in favor, APRA congressman Jorge del Castillo has said his party will vote in favor and Popular Action spokesman Yonhy Lescano said his party will vote for decree powers for at least crime and corruption.

Neither the left-wing Broad Front party nor the centrist Alliance for Progress party has stated their positions at the time of publish. Broad Front is almost certain to vote against decree powers in matters of economy.

Finance minister's spat illustrates Cabinet weakness

Finance minister Alfredo Thorne said in an interview that former first lady Nadine Heredia had placed "agents" inside the Ministry of Economy and Finance. Popular Force politicians immediately created a congressional committee to investigate Heredia for usurpation of power.

Former finance minister Alonso Segura, a winner of The Banker magazine's 2016 award for Finance Minister of the Year, emerged to challenge Thorne to oust the alleged moles. "Retract or give names," Segura told El Comercio. Segura has since met with Kuczynski privately in what the media framed as the president's throwing Thorne under the bus.

The incident may highlight the lack of political experience in Kuczynski's Cabinet. The president touted his technocrat-heavy Cabinet as a "luxury" government, while some observers cautioned that it lacked the political savvy needed to implement reforms.

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[Kuczynski's Cabinet ministers](#)

Alfredo Thorne is a respected economist with experience on Wall Street and at the World Bank. But navigating the cutthroat environment of national politics is new terrain for him. The verdict is still out on this Cabinet's ability to deal with a hostile Congress.

Congress gives another year to save La Oroya smelter

Congress has approved a bill which would allow the bankrupt Doe Run Peru to continue operating while legally in liquidation proceedings. No mining companies have shown any interest in the company's assets in Junin which include the operational La Cobriza copper mine, the shuttered La Oroya smelter and over \$500 in liabilities.

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An attempt to auction off the smelter received no bids last year, which the company handling the auction said was due to emissions standards which make operations economically unviable. Mineworkers in La Oroya held violent protests last year to demand the government relax the law in order to save 1,400 jobs, which account for 4 percent of the town's population.

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[Peru changes bankruptcy law in bid to save historic smelter](#)

Humala's government helped end the violent protests last year by brokering a deal which effectively prolonged the issue until now so the new government could decide how to proceed. This week's change to the bankruptcy law effectively achieves the same end in buying more time for the company to find a way to keep the smelter open.

Finding a company willing to take on La Oroya would likely mean not only relaxing environmental standards but also forgiving at least \$163 million in debts the company owes the state. A mix of tax breaks and other government incentives could also be employed to effectively offset the fines.

The center-left Popular Action was the only party which did not back the bill. But even their legislators abstained instead of voting against it. The unanimous vote illustrates the lack of political will to allow the smelter to be sold off piecemeal as in a normal liquidation process.

The situation suggests Congress and Kuczynski's government will at least ease emissions standards to save the smelter. It is unclear if that will be enough to find a new operator.

Former President Humala's sister targeted in Switzerland

Two armed burglars invaded the home of President Ollanta Humala's sister, Ivoska Seiffert, in Switzerland. The men tied Seiffert and her daughter up as they ransacked the house in search of documents. The women managed to escape, prompting the men to flee. They stole nothing. According to Seiffert, they spoke Spanish with Peruvian accents.

Seiffert came under scrutiny last year when an investigative news program revealed emails between her and her sister-in-law, former first lady Nadine Heredia, which allude to the latter using Seiffert's Swiss bank accounts.

The aim of the burglars in Switzerland was likely an attempt to obtain incriminating evidence against Humala and Heredia for money laundering. It is not clear whether the motive was extortion or political.

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[Ex-President's Sister Target of Home Invasion in Switzerland](#)

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Given last week's marathon sessions over Congress's confidence vote hinged on Cabinet chief Fernando Zavala and other officials publicly denouncing Humala's government and vowing to prosecute corruption, there are clearly power brokers who are committed to seeing Humala and Heredia charged with money laundering and maybe even sent to prison.

Interior minister presents 'death squad' findings to Congress

Interior minister Carlos Basombrio testified before Congress on his department's investigation into the alleged death squad within the Peruvian National Police on Friday.

Basombrio confirmed that there was a conspiracy among police to entrap and then murder criminals to earn promotions and win recognition, and the conspiracy was made up of nine officers including one general and one commander. The group's first case involved charging a Trujillo businessman \$5,000 in exchange for thwarting his kidnapping.

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[Peru police planned extrajudicial killings to earn promotions: report](#)

The revelation of its first test for the government after Kuczynski campaigned on rooting out corruption, especially in the police, as a way to reduce crime in Peru.

State oil firm alleges vandalism in latest spills

Petroperu closed the Northern Peruvian Pipeline in February following two highly publicized spills in Amazonas and Loreto states. Three more have followed, resulting in the spilling of stagnant oil left inside the pipeline.

Petroperu issued statements this month saying that at least two of these last three spills were caused by vandals who broke holes in the pipeline with tools. The state oil firm reported each breach as crimes with local police.

Both alleged cases of vandalism occurred during the month of August. The first spill occurred in the Condorcanqui province of Amazonas with the second coming in the Loreto province of Loreto state.

While the state firm has not declared who might be responsible, the most likely assumption is that environmental activists may be sabotaging the pipeline to discourage oil drilling in the Amazon jungle.

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Kuczynski's formalization strategy: will it work?

President Pedro Pablo Kuczynski has vowed to double Peru's formally-employed workforce from 30 percent to 60 percent by the end of his term in 2021.

Economists say that reducing the massive informal sector is the most important challenge in boosting productivity and sustaining Peru's economic growth. Informal or "extralegal" economic activity is much less productive than formalized business. In Peru, 70 percent of workers are informal while the informal sector's GDP makes up less than a fifth of the national total.

Informal production is lower than its potential because labor is employed with less efficiency. Informal businesses have less access to credit and government services. They also tend not to purchase more productive means of capital because long-term investments are risky. Finally, these companies actually aim to remain small in order to avoid detection by the authorities.

Whether trying to increase productivity among Peru's workers or broaden the tax base to boost government revenues, tackling informality is the government's top priority in driving the economy.

Kuczynski's goal is wildly ambitious given a recent study by the University of Denver which forecast that Peru's formal labor market will not reach 60 percent until 2050. That study was based on the International Futures (IFs) forecasting model used by the United Nations, the National Intelligence Council and Atlantic Council.

The model bases its assumptions on current policy on drivers that discourage informal businesses from registering with the government, such as high regulatory and tax burdens. Informal actors also see little incentive to formalize if they perceive weak protection of property rights, difficult registration systems or high costs due to corruption among government officials.

The model used to predict informal labor as a share of the total uses a weighted index of criteria in the following categories:

- education
- taxes
- government transfers
- business regulation

Researchers also ran 35-year forecasts based on various "interventions," or policy reforms Peru could undertake in order to accelerate the formalization of the economy. These "aggressive but reasonable" reforms modified Peru's index enough to yield significant effects on informal labor and GDP.

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<u>Forecasts for 2050</u>	<u>Informal labor</u>	<u>Informal GDP</u>	<u>GDP (billions \$)</u>
No intervention	27.4%	3.4%	1496
Adult education	24.2%	3.0%	1576
Firm tax rate	24.7%	3.1%	1500
Government transfers	23.2%	2.9%	1490
Business regulation	15.4%	1.9%	1539
All interventions	11.5%	1.4%	1888

Source: CEPLAN Informal Economy Report V20

In the highly unlikely case of Peru's employing all of the report's interventions, then by 2050 the informal labor share would be reduced to 11.7 percent, the informal sector's GDP would comprise just 1.4 percent and Peru would average 5.9 percent GDP growth.

Education

Adults in Peru currently have on average 8.9 years of formal education. The IFs model under current circumstances sees that figure going to 11.3 in 2050, while an aggressive intervention could push it to 12.5.

Education is one of the most expansive sections in Kuczynski's government plan with 21 pages. Proposals include curriculum overhauls, pay raises for teachers, improved infrastructure including renovated buildings and equipping 80 percent of schools with computers and driving research and development projects at universities, with a focus on those which receive mining and energy royalties.

Taxes

Peru's effective tax rate for firms is 8.5 percent, similar to 8.4 percent in South Korea or 8.1 percent in the United Kingdom. The model's base case is that taxes increase to 8.8 percent, but suggested intervention could reduce it to 6.6 percent.

Ollanta Humala cut the corporate income tax rate from 30 percent to 27 percent in 2015, and it will reach 26 percent in 2019. Kuczynski's plan does not call for a reduction in corporate tax, but he does want to offer informal companies a tax incentive to register with the government. If implemented, companies can opt to pay either 10 percent of income or 2.5 percent of gross sales for 10 years.

Kuczynski campaigned on a sales-tax cut from 18 percent to 15 percent during the 2016 election. That pledge is uncertain now that Congress is controlled by his Keiko Fujimori's Popular Force party, which has depicted the tax cut as favoring large corporations over small businesses.

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Government transfers to households

Strong safety nets can act as a pulling force to compel informal actors into formality. But the IFs report on government transfers acknowledges that the nature of these transfers, instead of promoting formality, can also discourage employment altogether.

“Higher government transfers to households and greater R&D spending, to some degree reflect a broader improved quality of governance overall and focus on the kind of economic and social transformations that do pull people into formality with both opportunities and capabilities,” reads the report.

Kuczynski’s government plan looks to overhaul unemployment insurance and the pension system as well as expand healthcare coverage to all Peruvians. In addition to social security and healthcare, his pet issue has been to bring running water to rural areas.

Business regulation

The report states that, of each indicator, improving Peru’s business-regulation score had the greatest impact on informal labor in the model simulation. The business-regulation index is based on five ratings:

1. The cost of starting a business from the World Bank’s Doing Business database
2. The number of procedures needed to start a business from the World Bank’s Doing Business database
3. An index capturing the ease of firing an employee from the World Bank’s Doing Business database
4. A measure of business freedom from the Heritage Foundation
5. An index reflecting property rights from the Heritage Foundation

The two ratings with the most room for improvement are the ease of firing an employee and property rights.

Red tape

The World Bank ranks Peru 97th in the world for the ease of starting a business. The process requires six procedures which take 26 days. The cost of starting a business, however, is fairly low and closer to the OCDE average than the norm in Latin America. The Heritage Foundation ranks Peru’s Business Freedom ranking of 67.8 makes it “Moderately Free” and just two points short of “Mostly Free.”

Kuczynski wants to make it simpler by creating a red-tape committee which will be tasked only with reducing and even eliminating unnecessary procedures and fees. His government will also

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create a “One Window” program so businesses can file all paperwork and complete processes to register a business in one place.

Firing an employee

According to Peruvian law, a worker must be fired only for specific reasons outlined in the labor code. If a worker proves his employer fired him arbitrarily, he is entitled to severance pay of up to one-and-a-half year’s salary, or the right to be moved to a different position inside the company.

The World Economic Forum’s Global Competitiveness Report ranked Peru 133rd of 140 countries in the ability of companies to hire and fire workers.

Kuczynski’s formalization plan does not change Peru’s rigid labor regulation.

Property rights

“Property rights are not well protected, and the judicial system is not efficient,” reads the Heritage Foundation’s profile of Peru. The organization gives Peru ratings of 40 and 38 for Property Rights and Corruption, earning a designation of “Repressed” in both categories. “The dysfunctional judiciary is widely distrusted and prone to corruption scandals.”

Reducing corruption in government was another of Kuczynski’s top campaign issues. He has vowed to overhaul the judiciary to more efficient. His government plan, however, does not go into great detail.

Better education, tax incentives and improved services

Kuczynski’s education reforms, if implemented, could have a positive effect on informality and GDP. However this is a long-term solution given the nature of requiring Peru’s adults to attain years of education. Even if the reforms were implemented today and Peru’s adults immediately began attaining three more years of education on average, the aggregate level of education would rise very slowly as most adults have already completed their education. The formal education of most of the workforce will not change. This reform is too slow to have a noticeable impact by 2021.

Peru’s effective tax rate on businesses is not prohibitively high, and the IFs model’s aggressive interventions in taxes had the smallest impact of any on informal labor and informal GDP. While Kuczynski does not want to reduce the corporate income tax, the incentive for informal companies could pull some actors into the formal sphere. But it is not clear how many of these companies would formalize while keeping their employees off the books.

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Kuczynski's plan to bring running water to all Peruvians, while immensely expensive, will be the easiest transfer to implement politically. Offering unemployment insurance from the state would be a modest transfer, but probably not enough to drive formality. Overhauling the pension system and public healthcare system will be drawn-out political battles, as seen in the recent moves by Congress to allow retirees to dissolve their private pension accounts. Those funds finance the EsSalud public healthcare system, which will already see budget cuts due to the new change. Implementing significant changes to both systems, as Kuczynski proposes, is unlikely.

Business regulation: the elephant in the room

Peru's rigid labor regulation is the economy's top villain according to Peruvian business leaders. In addition to making it so difficult to fire employees, Peru also requires employers to give workers 30 days of vacation per year including 13 of which are paid, two annual bonuses equal to one month's salary, health insurance, life insurance and a small stipend for workers who have children.

The fact that Kuczynski has promised not to modify Peru's labor laws would lead some to believe that his formalization plan is limited at best and completely ineffective at worst.

But a senior researcher on the University of Denver staff points out that the ease of firing an employee is only one part of the Business Freedom index. He said that reductions in informality could be made without changing the labor code by implementing reforms to improve education, reduce taxes and increase household transfers.

However, the researcher declined to comment on whether Kuczynski's plan could achieve its lofty goal of reducing Peru's share of informal labor to 30 percent. He also emphasized that the IFs informal labor model was designed to work for 183 countries around the world. It was not developed with Peru in mind.

The possibility that one glaring weakness such as rigid labor regulation could limit formalization is supported by the fact that many of Peru's informal workers are employed by formal companies. These are companies who have registered with the government and pay taxes, but prefer to employ their workers off the books to avoid the labor regulation.

While Peru's total number of informal workers has declined slightly in the last 10 years, the number of informal workers in formal companies has increased both as a share of informal workers and the entire workforce.

The World Bank recently recommended a more flexible labor regulation as the most important economic reform Peru could take on. The Heritage Foundation's Labor Freedom rating for Peru

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is 62.9, which makes it “Moderately Free” and just three points away from being “Mostly Unfree.”

Kuczynski likely nixed any labor-flexibility reforms from his platform given it is politically unviable. While the vast majority of Peru’s workers enjoy no benefits, efforts to loosen the labor regulation have met violent protests from a vocal minority.

In December 2014 and January 2015 thousands protested against the “Pulpin Law” in five demonstrations in downtown Lima. The labor reform would have allowed workers under 25 years old to waive their labor benefits in an effort to promote formal employment. The protests resulted in violent clashes with police, and Congress quickly repealed the initiative.

Kuczynski also promised the General Workers Confederation of Peru (CGTP) he would not attempt to repeal any current protections for workers in exchange for the country’s largest labor union’s endorsement.

Kuczynski’s formalization plan looks to tackle every item in the IFs model except the elephant in the room, which is labor regulation.

But labor regulation, and specifically the ability to fire workers, would have the greatest impact on formalization, and the impact would be immediate. Labor regulation aside, easing the tax burden and simplifying incorporation procedures are the only measures which would have an immediate effect.

Easing taxes and making it easier to incorporate are only modest barriers to formalization and there is not much room for improvement. Meanwhile, improving education and household transfers will take at least five years from implementation to affect Peru’s overall scores.

It is our view that, even if the government can implement each policy with a hostile Congress, the formalization rate will fall far below its lofty goal. Kuczynski’s promise of a nosedive in the informal labor market which has persisted for generations is unlikely.

Effect on GDP

On the other hand, Kuczynski’s proposed reforms would positively affect GDP more than loosening labor regulation. According to the IFs report, reducing corruption, improving education and increased spending on research and development have a greater impact on GDP than business regulation does.

These reforms have a disproportionate effect on GDP because the formal actors in Peru’s economy have already surmounted the obstacles to formalization. So initiatives aimed to help the

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formal sector, which is responsible for more than 80 percent of Peru's GDP, will naturally have a greater effect on Peru's GDP as a whole.

Read more

[Procurement of Consulting Services for Implementation of a Prospective Module about the Informal Economy in the IFs Model, in order to Adapt it to the Case of Peru](#) (Frederick S. Pardee Center for International Futures, Josef Korbel School of International Studies, University of Denver)

[Economía informal en Perú: Situación actual y perspectivas \(Spanish\)](#) (CEPLAN)

[PLAN DE GOBIERNO 2016 – 2021 \(Spanish\)](#) (Pedro Pablo Kuczynski's official website)

[Ease of Doing Business in Peru](#) (World Bank)

[Economic Freedom Snapshot: Peru](#) (Heritage Foundation)

Economy

Gross Domestic Product

Month	June 2016	May 2016	April 2016	March 2016	Feb. 2016	Jan. 2016	Dec. 2015	Nov. 2015	Oct. 2015	Sept. 2015	Aug. 2015	July 2015
YOY percent	3.6	4.8	2.7	3.7	6.2	3.5	6.5	4.0	3.4	3.4	2.8	3.6

Peru's statistical agency INEI published its second-quarter GDP data which reflected 3.7 percent growth, down from 4.5 percent in the first quarter. Annualized GDP growth as of June fell to 3.6 percent, according to a previous report.

Inflation

Inflation	July 2016	June 2016	May 2016	April 2016	March 2016	Feb. 2016	Jan. 2016	Dec. 2015	Nov. 2015	Oct. 2015	Sept. 2015	Aug. 2015
Monthly	0.08	0.14	0.21	0.01	0.6	0.17	0.37	0.45	0.34	0.14	0.03	0.38
Annualized	2.96	3.34	3.54	3.91	4.3	4.47	4.61	4.4	4.17	3.66	3.9	4.04

July saw annualized inflation in Peru fall to within the central bank's target range of 1 percent to 3 percent for the first time in 17 months. The bank has left its benchmark rate unchanged at 4.25 percent for the sixth consecutive month as inflation falls into line but growth remains below potential.

Currency

Peruvian Sol (PEN)	Aug. 27	Aug. 20	% change
USD	3.35100	3.32025	-0.93
EUR	3.75151	3.76034	0.23
GBP	4.40206	4.34189	-1.39
JPY	0.03290	0.03313	0.69

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Peru's currency has continued a slow slide against the solar on positive economic news from the United States and increased expectations that the Federal Reserve will hike its benchmark rate.

Mining

Metal	June 2015	June 2016	% change	Jan. - June 2015	Jan. - June 2016	% change
Copper (tons)	145,727	207,197	42.18	740,883	1,122,113	51.46
Gold (grams)	12,179,036	12,660,459	3.95	71,815,010	77,114,321	7.38
Zinc (tons)	116,860	111,213	-4.83	684,997	630,333	-7.98
Silver (kg)	347,564	364,239	4.80	1,874,774	2,169,993	15.75
Lead (tons)	24,938	25,258	1.28	151,450	155,971	2.98
Iron (tons)	731,410	721,889	-1.30	4,206,706	4,183,678	-0.55
Tin (tons)	1,679	1,554	-7.41	9,530	8,847	-7.17
Molybdenum (tons)	1,686	1,948	15.52	10,104	12,288	21.62

Stocks

Index	Aug. 27	Aug. 19	1W%	1M%	6M%	1Y%
S&P/BVL PERU GENERAL	15,220.15	15,590.30	2.37	2.12	42.03	45.20
S&P/BVL PERU SELECT	399.39	411.92	12.53	9.63	132.58	151.49
S&P/BVL LIMA 25 INDEX	23,106.87	23,656.91	2.33	3.46	57.08	71.40
iShares MSCI All Peru Capped	33.51	35.55	2.04	0.57	3.71	12.57