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Peru: in need of fresh stimulus

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Summary: Driven by the boom in its mining sector and its rigorous macroeconomic policies, since the early 2000s Peru has experienced a period of spectacular development, described as the "Peruvian Miracle". Nominal GDP in US dollar terms has increased almost fivefold over the last 20 years and the various human development and poverty indicators have made significant progress. This cycle is especially remarkable as it follows two decades, from 1980 to 2000, marked by civil war and economic crisis.

Since at least 2016, Peru's economic dynamism and sound macroeconomic framework have contrasted with the chronic instability of its polarized political system, rife with corruption and rejected by the population. This instability reached a peak during the presidency of Pedro Castillo. Elected in 2021 after an extremely tense campaign, Mr. Castillo was finally ousted by Congress in December 2022 following a "self-coup attempt", and then saw his Vice President, Dina Boluarte, sworn in as the new president. This episode made her the sixth president in office between 2018 and 2022 and prompted violent protests between December 2022 and March 2023, which left at least 49 people dead. Despite an economic slowdown (contraction of GDP of 0.5% year-on-year in the first half of 2023), the effects of this crisis on activity are expected to remain limited, as has been the case over the last 20 years. Indeed, there has always been a dichotomy between a chronically unstable political sphere and a remarkably resilient economic sphere in Peru.

However, the economic outlook for the longer term is less favorable. Indeed, the persistence of a number of structural barriers to growth, including high levels of inequality, a high degree of informality, a low level of financial inclusion, an infrastructure gap, over-centralization and rampant corruption, raises the fear of a gradual slowdown in activity. The inability of the authorities to implement strong and ambitious policies to remove all these barriers suggests that a slowdown in the pace of economic growth is almost inevitable. The International Monetary Fund (IMF) thereby now only estimates Peru's growth potential at 3%, far from the level of the 2000s, which was close to 7%. Consequently, economic growth would appear to be "falling in line", converging towards the Latin American average, meaning that the "Peruvian Miracle" seems to be gradually fading away.

Thematic area: **Macroeconomics**
Geographical area: **Peru**

1. Boom in the mining sector and rigorous macroeconomic policies: the recipe for the "Peruvian Miracle" (2000-2019)

Over the last 20 years, Peru has experienced a period of rapid development which has substantially increased the standard of living of its population. Driven by **an average annual economic growth of 5.1% between 2001 and 2019, almost double the Latin American average,** Peru's human development indicators have shown a spectacular improvement. GDP per capita in purchasing power parity terms has thereby doubled, allowing Peru to become an upper-middle-income country (UMIC) back in 2008. At the same time, extreme poverty has been virtually eliminated and the rates for literacy, child mortality and access to electricity have made significant progress (see Table 1). This "Peruvian Miracle" is all the more spectacular as it followed two decades, from 1980 to 2000, marked by civil war (70,000 deaths[1]), a succession of economic crises, and IMF support via six funding programs.

Table 1 – Peru's Human Development Indicators

	2000	2010	2021	*2000-2021*	
GDP per capita (current USD, PPP)	6,376	9,997	12,515	*+6,139*	*+96%*
Extreme poverty rate ($2.15 2017 PPP)	19	7	3	*-16*	*-84%*
HDI	0.676	0.725	0.762	*+0.086*	*+13%*
Literacy rate (%)	87	90	94	*+7*	*+8%*
Life expectancy (years)	70	74	72	*+2*	*+3%*
Child mortality rate (‰)	29	15	11	*-18*	*-62%*
Access to electricity (%)	72	88	96	*+24*	*+33%*
Access to drinking water (%)	45	49	51	*+6*	*+13%*

Sources: World Bank, UN.

Traumatized by this period of instability, **Peru has gradually managed to put its fiscal house in order and stabilize its macroeconomic framework.** Between 2000 and 2019, in addition to an almost fivefold increase in its nominal GDP in USD, Peru maintained its annual inflation rate at a historically low level of 2.7% on average, dispelling the specter of the hyperinflation of the years of crisis (up to 12,000% in August 1990). In terms of public finances, a series of restructuring measures and recognized budgetary discipline led to a reduction in the government debt ratio to a low level of less than 20% of GDP in 2013, against over 100% in 1980 (34% at the end of 2022). At the same time, a substantial effort to rebalance the external accounts, by increasing exports of goods, attracting investment and limiting recourse to external debt, enabled the country to accumulate sizeable foreign exchange reserves, estimated at a total of $73 billion in mid-2023, equivalent to about one year of imports of goods and services. As shown by the investment grade[2] sovereign rating attributed to Peru by the three main rating agencies (S&P, Moody's, Fitch) since 2008-2009, the country has today largely regained the confidence of international markets.

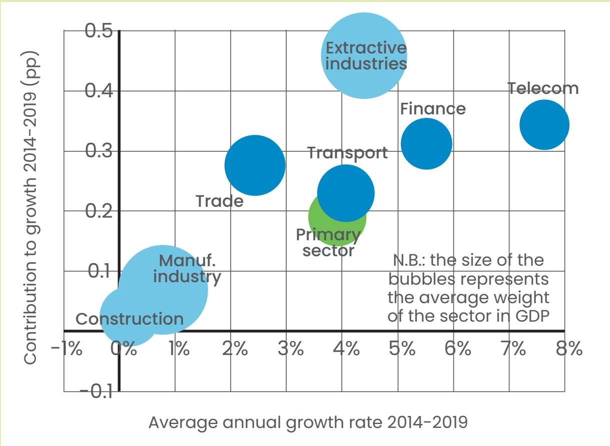
The boom in the mining sector has been the main driver of this "Peruvian Miracle". In addition to sizeable hydrocarbon reserves, Peru is the world's 2nd largest producer of copper and zinc, 3rd for silver, 4th for tin, 5th for lead and 8th for gold (American Geological Institute, 2023). With its abundance of metals and minerals, there was a rapid development of Peru's subsurface starting in the 1990s, driven by the introduction of an investor-friendly legal framework, relatively low energy costs, growing global demand, and high prices during the

1 Comisión de la Verdad y Reconciliación (CVR)

2 Rating of BBB- or higher for S&P and Fitch, Baa3 or higher for Moody's.

"commodity supercycle" (2004-2014). While mining concessions cover almost 15% of the territory,[3] the mining sector today accounts for about 15% of GDP, at least 10% of government revenues, and two-thirds of the country's exports. In addition, it is estimated to generate 300,000 direct jobs and more than 2 million indirect jobs (World Bank).

Graph 1: The mining sector is the main driver of Peru's economy

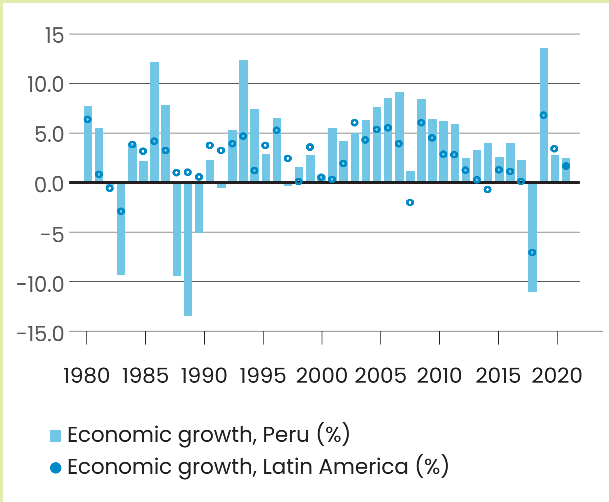


Source: Instituto Nacional de Estadística e Informática *(INEI)*, author's calculations.

The economy outside the mining sector may appear less dynamic, but is relatively developed. Agricultural production benefits from a wide variety of climates and is very diverse (including coffee, cocoa, fruit, wheat, rice, sugar cane and cotton). In addition, the coastline covering more than 2,000 km is conducive to an intensive fishing activity, alongside small-scale fishing and fish farming. Peru was thereby the world's 5th largest fish producer in 2020 and 3rd for capture fisheries (FAO). However, it should be noted that agricultural and fisheries production are highly exposed to climate hazards, in particular disruptions originating from the El Niño phenomenon. At the same time, the manufacturing industry has low added value (agribusiness, steel, refining, chemistry, textiles) and its share in GDP has been declining for around 15 years, while there has been a slowdown in the construction industry following a period of rapid development between 2004 and 2014. Finally, the services sector is dominated by trade, transport, finance and telecommunications.

Besides the dynamism of the mining sector, Peru's excellent macroeconomic results over the last 20 years are linked with **the rigorous and orthodox economic policies** implemented by the authorities. Elected president in 1990, Alberto Fujimori laid the foundations of Peru's current economic model. In association with the IMF, brutal austerity measures and a forced liberalization of the economy were implemented ("Fujishock"). This included privatizations of public enterprises amounting to almost $10 billion, 300,000 job cuts in the civil service, a drastic reduction of subsidies, the introduction of the nuevo sol, the rescheduling of the external debt, and the conclusion of fiscal "stability contracts" with certain companies.

Graph 2: As of 2001, Peru's growth overtook the Latin American average



Source: IMF (WEO), author's calculations.

3 Mining concessions covered 14.78% of Peru's territory in 2022 (Observatory of Mining Conflicts in Peru).

The authorities have gradually managed to restore Peru's macroeconomic stability and turn it into one of the most liberal economies in the region. Several principles to limit the role of the State in the economy were set out in the 1993 Constitution, including the right to property, the possibility of holding foreign currency on a bank account, the principle of subsidiarity limiting the prerogatives of state-owned companies, and equal treatment for domestic and foreign investors. This orientation continued with the introduction of a fiscal rule in 1999[4], the implementation of an inflation targeting mechanism by the Central Bank as of 2002, the conclusion of free trade agreements with the USA and China in 2009-2010, and the series of tax cuts decided as of 2014. The powerful *Ministerio de Economía y Finanzas* (MEF) and *Banco Central de Reserva del Perú* (BCRP), guarantors of the country's budgetary and monetary orthodoxy, are today largely recognized for the seriousness and credibility of their macroeconomic policies in Latin America.

2. Peru's economy shows impressive resilience, despite an unstable political framework

Since at least 2016, Peru's sound macroeconomic framework has contrasted with the **chronic instability of its polarized political system, rife with corruption and rejected by the population.** The four presidents who led the country between 2001 and 2018 are all involved in the Odebrecht corruption scandal[5], and there were subsequently six presidents between 2018 and 2022. This political instability reached a peak during the presidency of Pedro Castillo (2021-2022). A newcomer to politics, from the radical left and an Andean farming family, Mr. Castillo was elected president in 2021, after an extremely tense campaign, with a lead of only 44,000 votes against the daughter of former President Alberto Fujimori, Keiko Fujimori. Castillo's presidency was in particular constrained by the almost systematic obstruction of a Congress dominated by conservative parties. It was marked by major institutional instability, with a total of about 80 ministers appointed (including 5 prime ministers), 3 impeachment attempts, and 6 judicial proceedings initiated against the President in just 16 months. In December 2022, Mr. Castillo was finally ousted by Congress following a failed "self-coup attempt"[6]. This episode prompted violent protests between December and March especially in the most deprived regions of the country, which voted massively for Mr Castillo in 2021 (at least 49 deaths).

Though serious, **these many episodes of political turmoil have only had a limited impact on economic growth.** There was a slowdown in the economy as of 2014, but it was primarily due to the end of the "commodity supercycle" (2004-2014) which led to a decline in the prices of metals and minerals exported by Peru, and ultimately to a sharp decline in investment and less vigorous export activity and household consumption. The political instability may have exacerbated this slowdown as of 2016, but it is only a secondary cause. There was subsequently a record recession in 2020 due to the Covid-19 pandemic, with Peru recording the world's highest death rate (6,658 deaths per million population) and having imposed strict health measure restrictions (suspension of mining activities and stoppage of the vast majority of informal sector activities).

This economic slowdown over the last decade must also be put in perspective. Economic growth was indeed halved between the periods 2001-2013 and 2013-2019 (down by an annual average of 6.1% to 3.1%), but it remained much more dynamic than the average of its neighboring countries, in a context of a slowdown almost everywhere in the region due to a shared dependence on exports of raw materials. Similarly, despite a record recession in 2020 (-11.0%), there

4 The *Ley de Prudencia y Transparencia Fiscal* of 1999 (amended several times) introduces a deficit and debt limit for the public sector, an annual growth limit for public expenditure, and the obligation of establishing a multi-year macroeconomic framework. The *Ley de Bases de la Descentralización* of 2002 prohibits recourse to external debt for regional governments without a guarantee from the central government and establishes a tax rule at sub-national level.

5 Named after the Brazilian construction company which paid about $800 million in bribes in 12 Latin American and African countries between 2001 and 2016. "The four presidents in question are Alejandro Toledo, Alan García, Ollanta Humala and Pedro Pablo Kuczynski.

6 On December 7, 2022, Pedro Castillo announced the dissolution of Congress, the formation of an caretaker government, the drafting of a new Constitution by a Constituent Assembly and his willingness to rule by decree. This attempt was a failure and led to the vote of a motion of impeachment by Congress (101 votes out of 130).

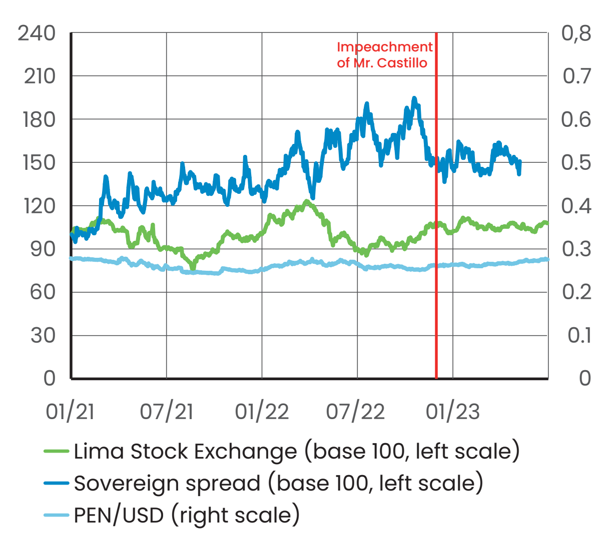
7 Except for 2020.

was a rebound of 13.6% in 2021. In terms of public finances, the fiscal balance – historically in surplus – did show a deficit as of 2013, but it remained well under control[7] and Peru's government debt ratio is still today the lowest in South America (after Guyana). The investment grade sovereign rating attributed by the rating agencies is, for the time being, not at risk[8] and the return to fiscal rules in 2022 (suspended during the pandemic) constitutes a strong safeguard against any undermining of Peru's traditional budgetary orthodoxy. Finally, with about $73 billion of foreign exchange reserves and an IMF Flexible Credit Line[9] of $5.5 billion, the external liquidity and solvency situation remains comfortable, reducing the risk of potential tensions.

This **paradox of a chronically unstable political and institutional sphere and an economic sphere that has remained competitive and dynamic despite the shocks** is linked to the nature of Peru's development model. While state interventionism was widely considered responsible for the slump between 1980 and 1990, the weight and levers of the State on the economy were significantly reduced by the liberal reforms implemented from 1990 onwards (see above). Combined with the budgetary and monetary orthodoxy of the MEF and the BCRP, the country has managed to largely decouple politics from the economy, substantially minimizing any turbulence the former may cause for the latter.

This relative resilience of the economy to political turbulence seems to have prevailed in recent months. While activity should logically suffer from the direct consequences of the political crisis and the blocking, destruction and closure of tourist sites, along with the resulting postponement of projects between December 2022 and March 2023 (GDP contracted by 0.5% in the first half of 2023 (INEI)), these effects should remain cyclical and temporary. Indeed, the impressive stability shown by financial markets during the crisis suggests that the foundations of Peru's economic model have not been affected: while Peru faced one of the most serious political crises in its history, the sovereign spread[10], the Lima Stock Exchange and exchange rate have remained stable to a very large extent. Despite fears of a possible "turning point" brought about by these protests, and in particular speculation over the rewriting of the "economic chapters" of the Constitution (at the basis of the dichotomy between politics and the economy), financial agents banked on a status quo, which has since appeared to be the case.

Graph 3: Financial indicators have remained stable despite the political crisis



Sources: J.P. Morgan, Macrobond, author's calculations.

8 However, the political tensions prompted the three rating agencies to recently add a negative outlook to their ratings (after having each downgraded the rating by a notch since 2021).

9 Since May 2022, Peru has benefited from an IMF Flexible Credit Line (FCL) of USD 5.4 billion for the period 2022-2024. Introduced in 2009, this instrument is dedicated to emerging countries with solid macroeconomic fundamentals (only Peru, Colombia, Morocco, Mexico and Poland benefit from an LCM).

10 The sovereign spread corresponds to the difference, in basis points, between the weighted average yield on a given country's external debt securities and the yield on benchmark securities (US Treasury securities in this case) over the same maturity.

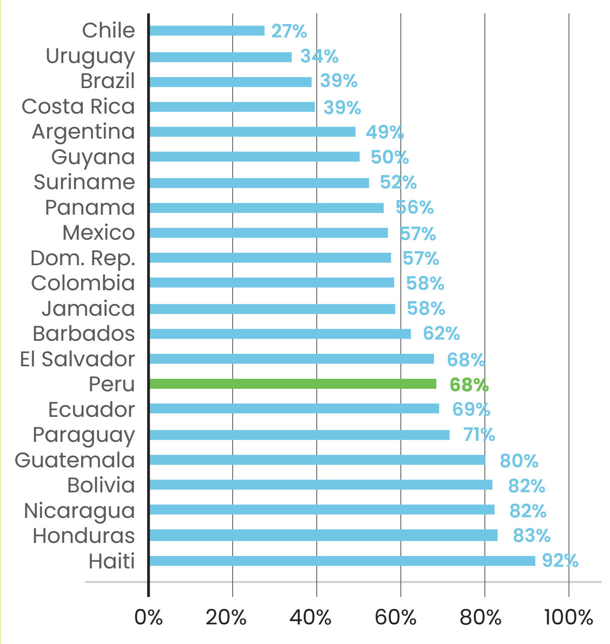
3. An economic slowdown inevitable in the longer term?

On the face of it, Peru's economic prospects are overall favorable. **Indeed, the opening of new mines should drive economic growth** in the medium term, especially as the prospects for the metals and minerals mined in Peru are extremely favorable in the context of the global low-carbon transition (copper and lithium in particular). In 2023 alone, the Government aims to develop 74 new mining projects.[11]

However, outside the mining sector, the prospects look less favorable, and not only due to the negative effects expected from the *El Niño* phenomenon. Structurally, **the persistence of a number of barriers to economic growth indeed raises fears of a more protracted slowdown in activity in Peru,** with it showing several worrying signs.

While Peru's development model has performed well over the last 20 years, it is primarily highly unequal. The Gini index[12] may have fallen from 55 to 40 between 1999 and 2022, a level lower than the Latin American average (albeit high for a middle-income country), but other indicators, in particular those on the holding of capital, position Peru among the most unequal countries in the region. This attests to the existence of an elite holding a substantial proportion of wealth[13] and huge informal neighborhoods home to about a third of the country's urban population (World Bank). In terms of employment, these inequalities result in one of the highest levels of informality on the continent, with almost 70% of the active population in informal employment according to the International Labour Organization. Similarly, Peru's financial inclusion indicators are among the poorest in the region: in 2021, only 58% of adults had access to formal financial services, 36% had a credit card, and 38% had made digital payments in the year (World Bank). In addition, the bulk of wealth and power is concentrated along the Pacific coast, in particular in the capital Lima, which alone accounts for 50% of national GDP. While a decentralization process was initiated in 2002, it has many shortcomings in terms of control, and the management and implementation capacity at local level remains weak. In connection with these inequalities, the critical lack of infrastructure is also regularly criticized (including transport, sanitation, logistics, education and health). Indeed, 30 years of liberal reforms and public underinvestment, exacerbated by the administrative paralysis after the Odebrecht scandal broke out in 2016 (see above), led to this situation. The continuing inaction of officials paralyzed by the criminal and judicial risks incurred should be noted. This can be seen with the shortcomings in budget execution and the increased delegation of project management to foreign expertise, de facto absolving the administration of its responsibility. Finally, corruption obviously hampers growth. Peru indeed ranked in 101st place out of 180 on the 2022 Corruption Perceptions Index of Transparency International. In South America, it is only preceded by Bolivia, Paraguay and Venezuela.

Graph 4: Peru has one of the highest levels of informality in Latin America



Source: International Labour Organization (ILO), author's calculations. Latest available data (Peru: 2022).

11 https://www.gob.pe/institucion/minem/noticias/727026-cartera-de-proyectos-de-exploracion-minera-2023-concentra-inversiones-por-mas-de-us-596-millones

12 Synthetic indicator on the level of income inequality.

13 It is estimated that 1% of the population held 28% of wealth in Peru in 2021, the second highest level in Latin America after the Dominican Republic (World Inequality Report 2022).

While these barriers are largely recognized and, at first sight, surmountable, removing them requires the implementation of strong and ambitious policies. But the Peruvian State does not have the levers to affect the economy, as the liberal reforms conducted from the 1990s onwards aimed to minimize state interventionism. While the resulting dichotomy between the political and economic spheres has contributed to the "Peruvian Miracle" of the past 20 years, it is today a handicap, as it holds back the emergence of new growth drivers. This situation is exacerbated by the considerable political instability which makes it virtually impossible to implement long-term reforms. Through its lack of control over the economy, the Peruvian State appears to be too weak, unable to get the country out of a rentier model, dependent on the mining sector. This means that a slowdown in the pace of economic growth is almost inevitable in the medium term.

As a result of these many barriers, the IMF currently estimates Peru's potential growth at only 3% a year, far from the level of the 2000s, which was close to 7%. While this level remains relatively good, it positions Peru among the Latin American average. This explains why its **economic growth would appear to be "falling in line" and the Peruvian Miracle gradually disappearing.** Peru's membership of the OECD could hypothetically make it possible to overcome certain obstacles, but it still has a long way to go (submission of its application in 2012, discussions opened in 2022). Indeed, the accession process is theoretically combined with an alignment of local legislation on taxation, public procurement management and governance with international standards.

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List of acronyms and abbreviations:

BCRP: Banco Central de Reserva del Perú (Central Reserve Bank of Peru)

FDI: Foreign direct investment

ILO: International Labor Organization

INEI: Instituto Nacional de Estadística e Informática (National Institute of Statistics and Informatics of Peru)

MEF: Ministerio de Economía y Finanzas (Peruvian Ministry of Economy and Finance)

PPP: Purchasing power parity

PRITS: Upper-middle-income countries

UNDP: United Nations Development Program

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