Development Challenges in Peru

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Abstract

This policy brief presents a summary of the development challenges facing the country.

Key Words: Regional Integration, Economic Growth, Productivity and Growth, Economic Integration, Investment, and Global Trade

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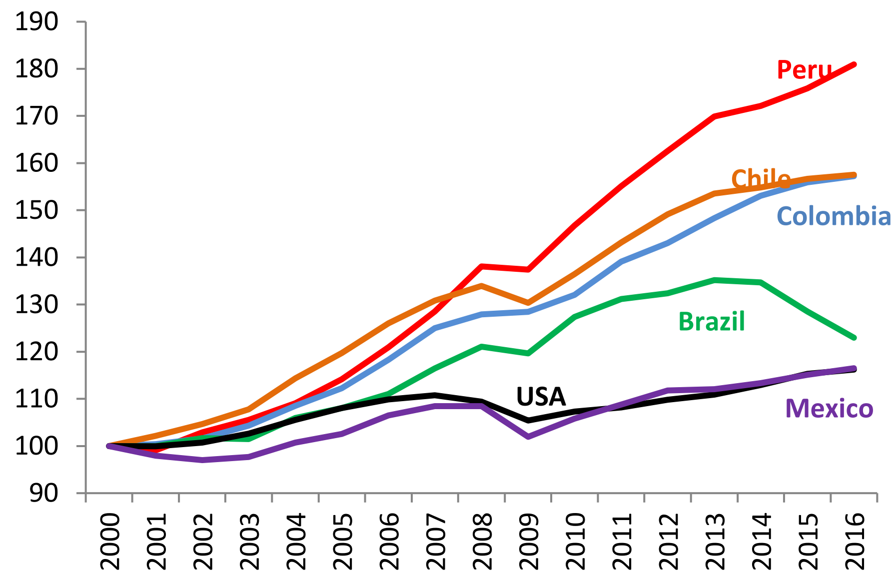
Medium-Term Economic and Social Trends

Peru is one of the most successful countries in the region in terms of economic growth and social progress. The Peruvian economy has undergone a radical transformation in the last quarter century. The country went from the instability and economic deterioration of the 1980s to one of the most prosperous economies in Latin America, and to the top of regional economic growth. Since the 2000s, Peru has undergone an unprecedented economic expansion, with an average real growth rate of more than 5% per annum. Significant progress has also been made in the social sphere, where Peru is among the region's countries with the greatest reductions in poverty and income inequality in the last fifteen years. Overall, this socioeconomic progress is the result of the combination of sound macroeconomic policies, structural reforms and favorable external conditions. Between 2000 and 2015, Gross Domestic Product (GDP) per capita grew at a real average rate of 3.5%, a rate above similar economies and even the United States, exceeding US$6,021 in 2015. Peru became a high middle-income country (based on the World Bank classification) in 2008 and is currently implementing the OECD program for possible admission as a member.

Figure 1. Real Per Capita GDP

(Index: Year 2000=100)



Source: IMF (2016).

Structural reforms and prudent management of public policies have been the basis of Peru's successful transformation. The oil shock of the 1970s, the debt crisis of the 1980s, and adoption of distortionary policies, including a system of multiple exchange rates, led to internal and external imbalances. In the mid-1990s, Peru adopted a stabilization program and began a continuous process of structural reforms which consolidated macroeconomic stability and laid the foundations for sustained growth in the last fifteen years. Milestones included i) adoption of a fiscal rule, under the Fiscal Responsibility and Transparency Law in 1999, to reduce the procyclical bias and volatility of public spending and contribute to the sustainability of public debt; ii) adoption of an inflation targeting regime in 2002 to promote price stability, along with the greater autonomy and credibility achieved by the Central Bank; iii) unification and flexibility of the exchange rate to allow the exchange rate to act as a shock absorber for external shocks; iv) trade and financial opening; v) the establishment of a legal framework to promote investment and higher private sector's involvement in the economy; and vi) a decentralization framework that granted autonomy to regional entities.

Favorable external conditions also made a significant contribution to the positive economic performance. One of the main factors behind the commodity boom was the rapid growth of emerging economies, particularly China, which greatly increased demand for raw materials. In turn, following the global financial crisis of 2008-2009, the central banks of industrialized economies cut their interest rates to historic levels to reactivate their economies. These measures created highly favorable external financing conditions in international markets where Peru and other economies in the region were important recipients of capital flows. In this context, the mining sector was the main driver of growth during the boom period. Between 2000 and 2013, this sector's production expanded 87% at a 4.7% average annual rate, and the value of mining exports (mainly copper and gold) grew more than six times, representing more than half the country's total exports. The trade balance improved from a deficit of 0.8% of GDP in 2000 to a peak surplus of 5.4% of GDP in 2011. Foreign Direct Investment (FDI) flows, largely associated with the mining sector, reached an average of 4.5% of GDP in that period. These external conditions combined with the internal policies detailed above allowed the economy to flourish without creating large imbalances and sustainability challenges observed in some other countries.

Peru has also made great strides in social indicators, particularly halving poverty. Peru is one of the countries in the region which has made the most progress in reducing poverty. Monetary poverty plunged from 55% in 2001 to 20.7% in 2016. Economic growth accounts for 70% of the decrease in poverty between 2004 and 2013, while the remaining 30% is explained by distributive factors. Higher labor income has been the factor that has contributed most to poverty reduction. The annual increase in lower deciles was five times more than in higher deciles. Through social mobility, the middle class increased by 19 percentage points since 2000, comprising at present more than a third of the population. Inequality in income distribution also decreased, as the Gini coefficient fell from 0.51 in 2005 to 0.44 in 2016. However, inequality remains relatively high, and its dynamic shows geographical differences that perpetuate the rural-urban and interregional gaps.

Medium-term Economic and Social Outlook

With the end of the commodity boom, Peru suffered an economic slowdown. The sharp drop in hydrocarbon and mineral prices, falling external demand and reduction in private investment associated

with mining projects contributed to Peru's economic slowdown. This context was aggravated by a series of transitory supply shocks associated with climatic factors such as the Coastal El Niño in early 2017. In that year, GDP grew only 2.5% (vs. 4.0% in 2016), the lowest level in three years. In recent years, fiscal policy has been expansive to stimulate the economy. The fiscal position has reversed from a surplus of 2.3% of GDP in 2012 to a deficit of 3.2% of GDP in 2017, above the 3.0% of GDP target set in the fiscal rule for that year. In 2018, the economy is expected to perform better than the year before, with growth projections between 3.5% and 4.0%.

Despite socioeconomic progress, important development challenges remain. Poverty in rural population is three times higher than in urban population, 43.8% and 13.9%, respectively (INEI, 2016). Likewise, extreme poverty is predominantly rural, with 13.9% of the rural population vs. 1% of urban population (INEI, 2016). In turn, rural multidimensional poverty is 86% vs. 24% in urban areas (ECLAC, 2014). Other challenges are related to structural issues such as high levels of informality where Peru is among the countries with the highest rates in the region, estimated between 70% and 80% depending on the measure used. In fact, 94.5% of the working poor are in informal jobs, which means they do not have health insurance or a pension system. Adding to this, Peru's middle-class population is one of the lowest for a country of its per capita income level; and 40% of the total population belongs to the so-called *vulnerable* group, the stratum with a high probability of falling into poverty.

Risk Factors

While external factors are evolving favorably, downside risks are mainly domestic. In line with the world economy showing signs of recovery, external demand is higher, and terms of trade are improving. Prices of Peru's main raw material exports, such as copper, are experiencing an upward correction, although they will remain below the levels of the boom period. Adding to this there are other favorable factors, including the economic rebound effect after the Coastal El Niño (FEN) and the countercyclical fiscal and monetary policy. By contrast, there are some downside risk factors, mainly domestic in nature, such as a lower-than-expected recovery in investment, longer delays in megaprojects (e.g., Line 2 of the Metro), and the negative impact of corruption cases on both the construction sector and the reconstruction of the northern areas affected by the FEN. Finally, other domestic downside risks are the political noise and uncertainty created by the antagonism between the Executive and Legislative branches, and structural sources of vulnerability related to climatic factors. Overall, in a scenario of lower growth than in the boom period, social gains could be eroded, jeopardizing the gains achieved in terms of poverty reduction and inequality.

Development Challenges

Among the main identified development challenges Peru faces in relation to achieving sustainable growth in the medium term, becoming a high-income country, and continuing to advance along the path of social development, the following three stand out.

Productivity needs to be increased by more efficient allocation of resources. Economic activity need to diversify given that historically it has been highly concentrated in primary sectors, in micro and small

enterprises with low productivity, and in the informal sector. The productivity lag is associated with several distortions that limit the efficient allocation of resources among economic agents and their productive performance. These distortions are created by rigidities in the Peruvian labor market and tax system, a low level of institutional capacity for providing public goods and services (e.g., infrastructure), along with limited access to credit. These deficiencies create perverse incentives in both companies' and workers' behavior and, at the aggregate level, they compromise efficient allocation of resources in the economy (Restuccia and Rogerson, 2008; Hsieh and Klenow, 2009; Syverson, 2011; Bartelsman, Haltiwanger, and Scarpetta, 2013). Peruvian productivity in relation to the United States is estimated at less than 24%, much lower than peer countries such as Chile (43%), Uruguay (38%) and Mexico (32%).[1]

Productive, inclusive and sustainable agriculture needs to be developed through effective management of natural capital and environmental protection. Rural areas in Peru concentrate most of the country's natural resources. Paradoxically, those areas present the widest welfare gaps. Overall, Peru's agricultural productivity gap with respect to the region and the OECD is still wide. The disparities are both geographical and at product level. The producers of the Costa (coast) are up to 5% more productive than those of the Sierra (highlands) and Selva (rainforest). These disparities mean that this sector's growth has made a more significant contribution to reducing poverty on the Costa than in the Sierra and Selva (Zegarra and Tuesta, 2009). Apart from access to land and water, other obstacles include the limited provision of supplementary public infrastructure. In turn, the poor quality of rural public goods and services, as well as their weak targeting, limit the efficient use of those assets that are accessible to producers. In the long term, there are challenges to guaranteeing the availability of water resources given growing demand for irrigated land, hydroelectric projects, and the increase in urban population. Moreover, given Peru's context of weak governance in natural resource management, natural capital could be compromised in the long term.

Public management and institutions need to be strengthened to improve public spending efficiency, its impact on closing social gaps, and the business climate. The institutional performance indexes for Peru are below what is expected given its income level. According to the World Economic Forum (2017), the pillar of institutions in the Global Competitiveness Index 2017-2018, together with the innovation index, shows the deepest lags, with Peru in 116th place among 137 countries. Peru is also below the regional average in the World Bank's government effectiveness and corruption control indexes.[2] The most problematic factors for doing business in Peru are state inefficiency (18.7% of respondents) and rigid labor legislation (16.6%) (World Economic Forum, 2015). Moreover, there are still a wide range of challenges in terms of government execution capacity, coordination and responsiveness; transparency; tax collection; quality of spending; and regulatory optimization and simplification, among other areas. Particularly, the effectiveness of public institutions is constrained by lack of planning, coordination and limited human capital, while high levels of bureaucracy and red tape encourage corruption. All these limitations in public institutions impact negatively on citizens' trust in institutions, business entrepreneurship and private investment.

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[1] See Conference Board, https://www.conference-board.org/data/economydatabase/index.cfm?id=27762.
[2] See the World Bank's Worldwide Governance Indicators, http://info.worldbank.org/governance/wgi/#home.

Conclusion

Peru's economic fundamentals allowed the country to navigate external shocks. The country maintains a sound fiscal position and public debt will remain among the lowest among peer economies with investment grade. Fiscal stimulus has continued in recent years, helping to smooth lower growth, while debt levels remain relatively low and below the legal limit of 30% of GDP. Sovereign debt has been at investment grade since 2008. The current account adjustment is progressing through the recovery of exports and better terms of trade, and the financial system appears to be relatively strong despite the recent economic slowdown. In addition, the country has several shock absorbers including international reserves close to 30% of GDP, a managed float exchange rate policy, and public assets such as the Fiscal Stabilization Fund (FEF) with resources of approximately 4.0% of GDP. Moreover, Peru has access to contingent loans of more than US$4 billion for natural disasters.

To overcome development challenges, a multi-pronged policy approach is required. In productivity, to achieve a more flexible labor market and promote formality and social insurance, the establishment of a continuous training model for workers is recommended, as well as an in-depth analysis of alternatives for reducing non-wage costs. Improvements in management and sectorial planning capacities for provision of quality road and energy infrastructure are also advised. Furthermore, if these proposals are combined with a better business climate in the context of a strengthened Public-Private-Partnership framework, they would stimulate private participation in the implementation phase. Similarly, developing instruments to promote innovation and access to credit would provide the business sector with the tools to reach its productive potential. For agricultural development and environmental sustainability, it is essential to provide quality public goods and services by reducing subsidies and increasing support for road and irrigation infrastructure, land ownership rights, agricultural health, innovation and access to credit. All this would have to be combined with a strengthened integrated environmental management system, which permits decision-making based on reliable information, with mechanisms for participation by civil society to monitor the timely implementation of environmental regulations. In institutional strengthening, measures such as obtaining additional fiscal resources to close investment gaps in public services and expanding the tax base with rationalization of exemptions and deductions would go hand in hand with the urgent need for more efficient public spending. This requires a reinforced capacity to plan, execute, evaluate and monitor public policies at all levels of government and sectorial institutions. Moving forward in this area requires selective identification of the main government priorities, a professional civil service, regulatory simplification and a legal and institutional framework with high integrity that leads to lower corruption and better transparency in public management.

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