
OPPORTUNITIES AND RESTRICTIONS FOR PERU'S ECONOMIC GROWTH IN THE COMING YEARS

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 Main Content

□ [STATE OFISSUE]

Between 1995 and 2011, Peruvian GDP grew by 4.9% each year, driven by exports and private investment's increase. However, it only grew by 3.3% in 2015 and by 4% in 2016 due to a reduction in the international price of metals that the country exports.

□ [CAUSE ANDANALYSIS]

In this scenario, the government elected in 2011 faced the challenge of replacing private investment with public investment as a growth engine. However, this decision revealed two structural problems of the Peruvian economy: 1) the limited spending capacity of central and regional governments; and 2) the difficulty of increasing tax collection due to a very significant informal sector in the country.

□ [EXPECTATIONS AND IMPLICATIONS]

However, trade liberalization, stability in domestic prices and reforms in public management are strengths of the Peruvian economy, which would enable it to return in the next few years to growth rates of around 4% or more.

1 Status of Issue

Between 1995 and 2011, Peruvian GDP grew by 4.9% each year, driven by exports and private investment's increase. However, it only grew by 3.3% in 2015 and by 4% in 2016 due to a reduction in the international price of metals that the country exports.

Since the 1990s, Peru's economy is open to international trade and investment. The international price boom of commodities experienced during the first decade of this century, plus the low interest rates of the main world financial markets had very positive effects on the country's main macroeconomic indicators. Copper, gold, silver, zinc and fuel exports produced enough tax revenues to finance government services without resorting to debt or generating public deficits.

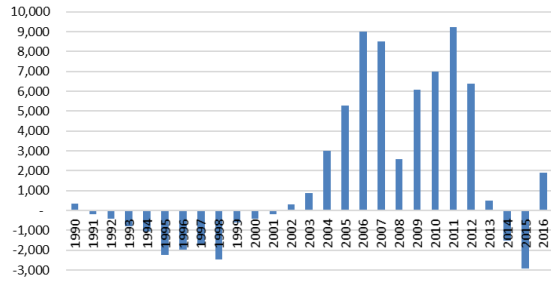
As represented in Figure 1, between 2002 and 2013 the Trade Balance experienced 12 consecutive years of positive results. Likewise, Figure 2 shows that between 2006 and 2013, the public finance experienced 6 years of surplus. In addition, foreign capital inflow made it possible to maintain a surplus Balance of Payments, despite a significant increase in machinery and equipment imports which complemented the country's economic growth.

Thanks to fiscal and external balance and prudent monetary policy applied by the Central Reserve Bank, the national currency was not depreciated, contributing to domestic price stability. Private investment, and especially construction sector, benefited from this stability because it had enough liquidity to start long-term projects, which shaped the so-called construction boom in Peru. It is widely known that construction activity involves many supplies and large amounts of labor, thus its growth has greater effects on extensive sectors of our society. All these factors allowed wages, profits of family businesses and corporations to grow, including the corresponding favorable effects on poverty reduction.

However, during the second decade of this century, global economic trends changed. Commodity prices started falling in 2012 and effects were felt on several indicators. Trade Balance showed some deficit in 2014 and 2015; likewise, the national currency underwent a devaluation against the dollar, and fiscal accounts showed deficits since 2015.

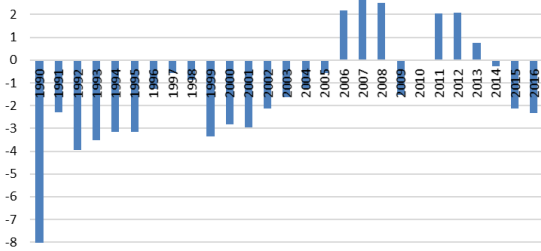
Thus, in order to evaluate the role of each of the components of GDP during its growth, Figure 3 shows that, between 1995 and 2011, private investment grew on average by 8.4% every year, and exports by 7.0%; therefore, they have stimulated the GDP, which grew by 4.9% annually. However, between 2012 and 2015, investment only grew by 4.0% and exports by 0.1%. Clearly, these components ceased to be a driver of growth for the Peruvian economy.

Figure 1 Balance of Trade (million US\$)



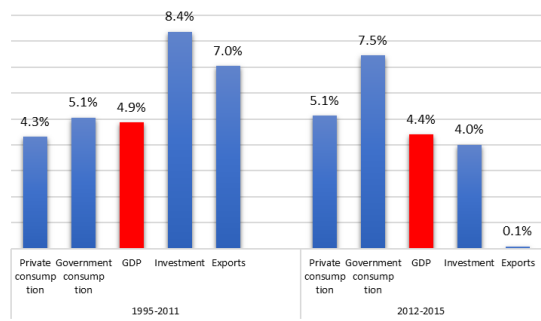
Source: Central Reserve Bank of Peru 2017.

Figure 2 Central Government Superavit / Deficit (% of GDP)



Source: Central Reserve Bank of Peru 2017.

Figure 3 Peruvian GDP growth by expenditure component 1995-2011 and 2012-2015 (averages)



Source: National Institute of Statistics and Informatics 2017. Own calculations.

2 Causes and Analysis

□ In this new scenario, the government elected in 2011 faced the challenge of replacing private investment with public investment as a growth engine. However, this decision revealed two structural problems of the Peruvian economy: 1) the limited spending capacity of central and regional governments; and 2) the difficulty of increasing tax collection due to a very significant informal sector in the country.

Regarding this first issue, Peru started a decentralization process of the public budget management since 2002. This involved the transfer of functions previously carried out by the Central Government to the local governments, with the respective financing. However, the expenditure execution at the regional level was very uneven. Figure 4 shows that, between 2002 and 2015, no region spent its entire budget and the unexecuted percentage ranged from almost 30% to 10%.

This inefficiency is concentrated in capital spending and is explained by various causes. On the one hand, the excessive control imposed by the Central Government through the National System of Public Investment, the entity responsible for approving the region's investment projects, which became a bottleneck in expenditure execution (Calvo-Gonzalez et al., 2010). Moreover, there was a great number of existing municipal governments, each of them with available budget (Vega, 2008), but many of them with little technical capacity for planning projects. On the other hand, there was a high concentration of income in regions rich in extractive resources (Canavire-Bacarreza et al., 2012) but with few companies supplying materials and equipment to be purchased with the budget. As a result, even though there was money available to increase public spending, it did not occur, as shown by the surpluses of several years (Figure 5); thus, public spending did not fulfill its role as a stimulus to production.

With regard to the second issue, business structure in Peru is composed mainly of small and medium-sized enterprises, both in the agricultural and industrial sectors, with low production levels and high production costs; thus, their economic performance is poor. For most of these companies, it is not profitable to formally register their production or their workers, thereby evading the payment of taxes. Figure 6 shows that in 2015 76.5% of the total number of companies are informal businesses, while Figure 7 shows that around 75% of the employed population work under informal conditions. Then, the number of companies that are taxed and the amounts collected are not enough to allow an increase in public spending, at the level of a Central Government.

Some authors explain informality as a result of the excessive number of procedures and their associated costs of formalization; however, in Peru such requirements have been reduced.

According to the Doing Business Ranking published by the World Bank, 6 steps are required to open a business in Peru, which takes 26 days and costs 10% of the income per capita (The World Bank Group, 2017). Other authors (La Porta and Shleifer, 2014) find that informality is more a result of companies' low productivity, due to the low education level of their owners and limited access to credit, which prevents them from improving their technological capacity and its scale of production.

Although the recent GDP growth is among the highest in Latin America, the aforementioned issues put its sustainability at risk since it concentrates a large part of production, tax collection and exports in a small number of economic activities, which reveals production system's lack of diversification.

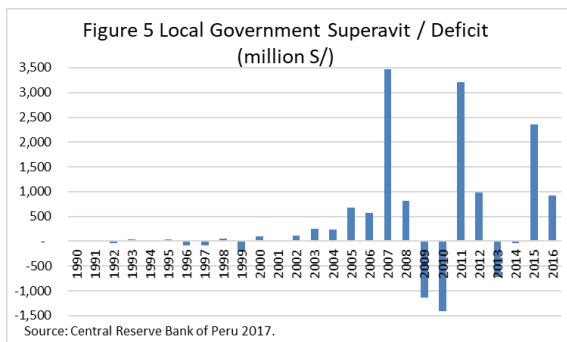
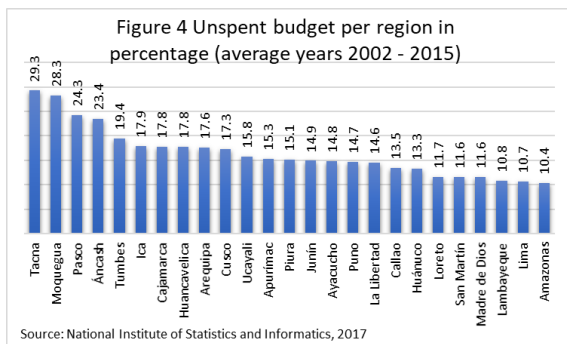


Figure 6 Productive units year 2015

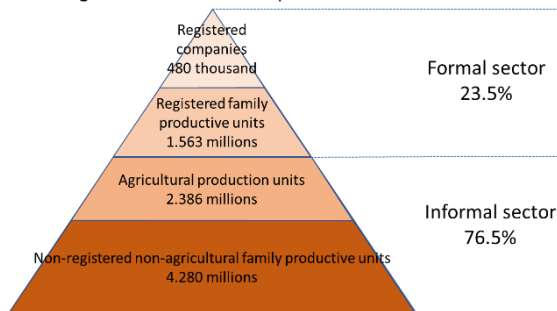
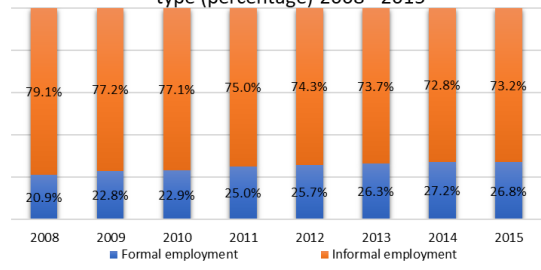


Figure 7 Occupied population by employment type (percentage) 2008 - 2015



Source: National Institute of Statistics and Informatics, 2017

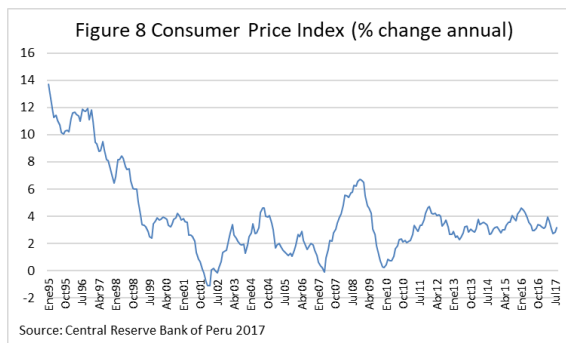
3 Expectations and Implications towards nearest future

However, trade liberalization, stability in domestic prices and reforms in public management are strengths of the Peruvian economy, which would enable it to return in the next few years to growth rates of around 4% or more.

At the same time, the Peruvian economy maintains some strengths that could allow a sustained growth for next years. All governments elected since 2001 have maintained a policy of opening up to international trade in the search for new growth opportunities. So far trade agreements have been signed with 14 countries and four further agreements are currently under negotiations. This opening has boosted the growth of agricultural exports mainly, from US\$ 621 million in 1995 to US\$ 5580 million in 2016 (Central Reserve Bank of Peru, 2017).

Likewise, it has also been possible to maintain a monetary stability during all these years. Figure 8 shows that since the beginning of this century inflation has fluctuated around 3% per year, a condition which allows planning in the long term in sectors with large growth opportunities, such as fishing for human consumption, agro-industry and tourism.

On the other hand, a set of reforms that would unlock large investment projects managed by the Central Government, such as: the construction of Line 2 of the Lima Metro; the modernization of the Talara Oil Refinery; and, the construction of infrastructure and venues for the 2018 Pan American Games (MEF, 2017) continued. Therefore, forecasts for GDP show it will grow by 2.8% in 2017 and by 4.0% in 2018.



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