

BUFF/ED/23/42

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**Statement by Mr. Herrera and Mr. Hendrick on Peru
Executive Board Meeting
March 22, 2023**

Key Points

- The Peruvian economy grew 2.7 percent in 2022 and is expected to grow at a similar rate in 2023, one of the highest in the LAC region, thanks to strong fundamentals, and despite the impact of multiple external and domestic shocks.
- Following a global trend, inflation in Peru increased in 2022, but less than in its LAC peers. Inflation peaked in June 2022 and is forecast to follow a downward trend since March 2023. The authorities are confident that Peru will continue to have one of lowest inflation rates in the region, as it has been so far this century.
- The fiscal position remains strong. By end-2022, the fiscal deficit declined further to 1.6 percent of GDP; and public debt fell to 34 percent of GDP, one of the lowest in emerging markets. Despite consolidation efforts, and supported by a strong recovery in revenues, spending in critical social sectors like health, education, and social protection has been prioritized.
- Peru's external position continues to be one of the strongest among emerging market economies. International reserves amount to 30 percent of GDP. This buffer, together with access to a precautionary FCL arrangement, provides additional insurance against tail risks.
- The financial sector remains solid, well capitalized, and with excellent financial soundness indicators, despite the full unwinding of COVID-related emergency measures. Recent stress testing continues to suggest that the financial system is resilient even under severely adverse scenarios.
- The Peruvian authorities continue to work on their structural reform agenda under the OECD accession process, to boost economic growth and address social needs. At the same time, recent political tensions underscore the need to muster social consensus across a range of issues to consolidate the hard-won gains of macroeconomic stability, inclusive growth, and poverty reduction.

INTRODUCTION

1. **The Peruvian authorities would like to express their gratitude to Mr. Santos and his team for constructive policy dialogue during the Article IV Consultation.** The staff report (SM/23/61) provides a well-balanced analysis of recent economic developments and policy discussions. The authorities are in broad agreement with the staff's assessment and policy recommendations. We appreciate the consultation's focus on the authorities' strategy to deal with the materialization of downside risks, such as the economic slowdown in trading partners (China, the U.S., and the euro area), tighter-than-anticipated global financial conditions, high inflation, and increased uncertainty, associated with the Russia-Ukraine war. Additionally, Peru has been hit by flooding and heavy rainfall caused by cyclone Yaku, which affected agricultural activities and damaged infrastructure in the coastal region. Moreover, road blockades during the first 45 days of 2023 hampered Peru's mining, tourism, and agribusiness industries, while also stoking inflation. However, Peru can build on its strong fundamentals to recover high potential growth once social and political stability is restored.

2. **Peru continues to maintain a strong economic performance and substantial policy buffers despite successive external and domestic shocks.** As stated in the first paragraph of the staff report, Peru's macroeconomic performance in the last quarter of a century has been one of the strongest in Latin America. This has been possible by maintaining very strong economic policies and institutional policy frameworks, despite political uncertainty episodes in recent years. The economy grew at an annual rate of almost 5 percent over the last two decades prior to the pandemic; and, under the inflation-targeting framework conducted by the Central Reserve Bank of Peru (BCRP), inflation averaged 2½ percent over the same period (the lowest in South America). After a strong rebound from the pandemic-induced contraction in 2021 (13.6 percent, the highest among peer countries), economic activity is normalizing but growth remains below potential (3 percent). Fiscal buffers are being replenished, international reserves are near 30 percent of GDP, and the FCL arrangement continues to provide insurance against tail risks.

RECENT DEVELOPMENTS

3. **The Peruvian economy grew 2.7 percent in 2022 on the back of strong domestic demand, reflecting a recovery in employment and the lifting of pandemic-related restrictions.** The national unemployment rate fell to 4.3 percent in 2022, while formal employment surpassed pre-pandemic levels in early 2022. While growth could have been higher, the slowdown reflected global trends, deteriorating terms of trade, lower external demand, tightening financial conditions, and road blockades affecting mining activities (especially copper production and exports). Real GDP growth was -1.1 percent (yoy) in January 2023, reflecting the impact of road blockades. However, the authorities believe the conditions are in place to expect a similar rate of growth as in 2022. Even considering the staff's more conservative forecast, a recent IMF Blog suggests that Peru's economic growth in 2023 may be one of the highest in the LAC region, as it has been so far this century.

Western Hemisphere: Real GDP growth

(year-over-year percent change)

	EST.		PROJECTIONS	
	2021	2022	2023	2024
North America	5.7	2.2	1.4	1.1
Canada	5.0	3.5	1.5	1.5
Mexico	4.7	3.1	1.7	1.6
United States	5.9	2.0	1.4	1.0
Puerto Rico	2.7	4.8	0.4	-1.6
South America	7.4	3.9	1.5	1.9
Argentina	10.4	4.6	2.0	2.0
Bolivia	6.1	3.4	2.9	2.8
Brazil	5.0	3.1	1.2	1.5
Chile	11.7	2.7	-1.5	1.9
Colombia	10.7	8.1	1.1	2.1
Ecuador	4.2	2.7	3.0	2.8
Paraguay	4.2	0.2	4.3	3.5
Peru	13.6	2.6	2.5	3.2
Uruguay	4.4	5.3	3.6	2.7
Venezuela	0.5	6.0	6.5	n.a.
Latin America and the Caribbean	7.0	3.9	1.8	2.1
LAC excluding Venezuela	7.1	3.9	1.7	2.1
LAC excluding Argentina and Venezuela	6.7	3.8	1.7	2.1
LAS	6.4	3.6	1.3	1.7

Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Projections are based on information available up to mid-Jan 2023. Regional aggregates are purchasing-power-parity GDP-weighted averages. CAPDR = Central America, Panama, and the Dominican Republic; LAC = Latin America and the Caribbean. **IMF**

Western Hemisphere: Inflation, end of period

(year-over-year percent change)

	EST.		PROJECTIONS	
	2021	2022	2023	2024
North America	7.2	6.9	2.5	2.2
Canada	4.7	6.7	3.3	2.1
Mexico	7.4	8.5	4.8	3.5
United States	7.4	6.7	2.5	2.1
Puerto Rico	4.2	4.8	2.3	2.5
South America	14.1	18.3	12.7	8.9
Argentina	50.9	95.9	60.0	44.0
Bolivia	0.9	3.8	3.5	3.5
Brazil	10.1	5.8	5.7	3.5
Chile	7.1	12.5	5.0	3.0
Colombia	5.6	12.7	7.3	3.2
Ecuador	1.9	3.7	2.3	1.3
Paraguay	6.8	8.2	4.2	4.0
Peru	6.4	8.0	3.0	2.3
Uruguay	8.0	8.9	7.2	5.8
Venezuela	686.4	220.0	150.0	n.a.
Latin America and the Caribbean	11.6	14.8	9.9	7.0
LAC excluding Venezuela	11.6	14.8	9.9	7.0
LAC excluding Argentina and Venezuela	7.8	7.9	5.2	3.4
LAS	8.3	8.0	5.4	3.4

Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Projections are based on information available up to mid-Jan 2023. Regional aggregates are purchasing-power-parity GDP-weighted geometric averages. Venezuela is excluded from all inflation aggregates. CAPDR = Central America, Panama, and the Dominican Republic; LAC = Latin America and the Caribbean. **IMF**

4. **Headline and core inflation have risen in line with global trends, but inflation is expected to return within the target band in 2023.** In the context of global inflationary pressures, headline inflation was 8½ percent at end-2022, driven by imported inflation and global supply shocks (including high energy and food prices). In February 2023, headline inflation declined slightly to 8.65 percent respect to January 2023 (8.75 percent). Factors such as moderating global food and energy costs, a reversal of agricultural supply shocks, and lower inflation expectations, are expected to drive inflation back to the BCRP's 1-3 percent target band by end-2023. Inflation in Peru will likely continue to be one of the lowest and less volatile among LAC and emerging countries, supported by solid BCRP credibility and strong fundamentals.

5. **The BCRP responded in a decisive and timely manner to curb inflation expectations and bring headline inflation back within the target band.** Following the first 25-bp policy rate hike in July 2021, the BCRP has raised it by 725 bps in 17 consecutive steps, to 7¾ percent in January 2023. The monetary authority then decided to pause its hitherto longest tightening cycle to assess the effects of the policy stance and the impact of the recent social unrest on the output gap. At the same time, the BCRP has signaled the markets that its policy stance is data-dependent and may be adjusted if warranted by market conditions. BCRP estimations show that currently the level of economic activity is close to potential.

6. **The fiscal position remains strong, and the public debt-to-GDP ratio is one of the lowest among LAC and emerging economies.** The non-financial public sector (NFPS) deficit continues on a rapidly declining trend (1.6 percent of GDP in 2022), well below the limit of 3.7 percent of GDP set by the fiscal rule, down from 8.9 percent of GDP in 2020 (due to the exceptionally large stimulus implemented to counter the impact of the COVID-19 pandemic).

The lower fiscal deficit in 2022 was driven by a strong 12.7 percent (nominal) increase in tax revenues (real terms 4.5 percent), offsetting a moderate (nominal) 6 percent expenditure increase (real term -1.7 percent, mainly in capital spending). Public debt fell to 34 percent of GDP in 2022, one of the lowest among emerging markets, while public assets stood at 12¾ percent of GDP. The sovereign credit rating remains at investment grade, and sovereign spreads remain among the lowest in the region. Going forward, fiscal consolidation will continue, and the deficit is expected to converge to the medium-term target of 1.0 percent of GDP by 2026.

7. **Peru’s external position continues to be strong and FX coverage remains adequate under all Fund metrics.** International reserves remained at a comfortable level of US\$72.2 billion as of end-December 2022, one of the highest FX coverages under different criteria (30 percent of GDP, 524 percent of short-term debt at remaining maturity, 207 percent of FX bank deposits, and 250 percent of the Fund ARA metric). Capital inflows are dominated by FDI and other private sources. Regarding the temporary increase in the current account deficit to 4.3 percent of GDP in 2022, it is worth mentioning that, in line with staff’s BOP forecasts, the deficit is expected to decline to 2.1 percent in 2023, close to the current account norm estimated from the multilateral EBA model. As highlighted by staff, this year’s estimations are subject to considerable model uncertainty, given the multiple shocks on the Peruvian economy in 2022. Moreover, with the update of commodities prices, the current account is expected to be even lower.

8. **The financial sector remains strong and resilient despite tightening financial conditions and the withdrawal of support measures.** It is worth underscoring that the financial system entered the pandemic from a position of strength and remained stable during 2020-2021, as shown by the previous financial soundness indicators heatmap. Profitability was positive but small; and performance has returned to near pre-pandemic levels, with ROE at 16½ percent and ROA at 2.0 percent as of December 2022. NPLs have stabilized around 4 percent, with a remarkably high provision coverage ratio. As expected, credit growth has decelerated rapidly, following the withdrawal of support measures, which included extensive government-guaranteed loans and flexible loan adjustment terms. An updated top-down stress test recently conducted by the authorities continues to confirm the 2018 FSAP findings that the financial system is resilient even under severely adverse scenarios. Yet, the supervisory and regulatory authority will continue to monitor market conditions and take measures as needed.

OUTLOOK AND RISKS

9. **The authorities are more optimistic than staff on the 2023 growth outlook and are confident that the envisaged structural reforms will enhance medium-term potential output.** The new Quellaveco mine, owned by UK’s Anglo America and Japan’s Mitsubishi, may provide additional growth over ½ percent. This factor will partially offset the output loss due to recent protests. In addition, in line with staff’s policy advice, the authorities are implementing a short-term fiscal impulse (“Con Punche Peru” program), which may provide an additional ½ percent growth.

10. **Despite the persistence of global uncertainty and the balance of risks tilted to the downside, we agree with staff that Peru has ample policy buffers to face adverse shocks.** As discussed above, economic fundamentals are very strong, international reserves are high by all standard metrics, the fiscal deficit continues to decline, fiscal consolidation is firmly in place, public debt is low, the sovereign rating remains at investment grade, there is ample access to international markets and low spreads, and the domestic financial sector is strong. These buffers are complemented by the FCL arrangement, thereby shielding the economy from the materialization of tail risks. There is a consensus among market participants that the BCRP's solid reputation and credibility will contribute to driving inflation back within the target band by end-2023 or early 2024. Nevertheless, the authorities stand ready to take additional actions as warranted from evolving and unpredictable global market conditions.

LOOKING FORWARD – RESUMING INCLUSIVE ECONOMIC GROWTH AND POVERTY REDUCTION

11. **The authorities agreed with staff that a small short-term fiscal impulse is appropriate, while maintaining the planned fiscal consolidation beyond 2024.** This is particularly important, not only to provide some stimulus in response to the recent sequence of supply shocks, but also to mitigate the implications of political unrest and higher inflation on vulnerable population segments. As explained in Box 1 of the staff report, the “Con Punche Peru” program aims to inject 0.6 percent of GDP into the economy by providing support to vulnerable households and firms in agriculture and tourism, among the most affected sectors. The program also includes support to subnational governments to help them execute their capital expenditure programs. There are encouraging initial results of these initiatives at the local and regional level.

12. **The authorities remain committed to the fiscal rule and fiscal consolidation in the medium term.** The original NFPS deficit target of 1 percent by 2025 was delayed by only one year, while the limit of the public debt-to-GDP ratio was temporarily set at 38 percent, with a view to returning to the original debt ceiling of 30 percent of GDP by 2032. The fiscal strategy is based on the authorities' Medium-Term Budgeting Framework, which attempts to strike a balance between fiscal consolidation and economic growth. In addition, the Fiscal Council plays a key role in providing an independent view to the Ministry of Finance on fiscal policies. Recent legislation has further enhanced the strength and credibility of the Fiscal Council. The authorities are aware of the importance of redesigning the pension system. Along these lines, they are assessing options and promoting a consensus among stakeholders and civil society.

13. **Maintaining stable and low inflation is also key to support growth and secure poverty reduction.** After the transitory COVID-related shocks in 2020-21 and the recent global supply shocks, the monetary authority is focused on reducing headline inflation back within the 1–3 percent target band. Inflation in Peru has been one of the lowest and less volatile in LAC (2.7 percent on average in 2001-2021). Maintaining single-digit inflation during more than two decades has been instrumental in creating a good business climate, favoring higher real

household incomes, and promoting substantial poverty reduction. The BCRP's successful inflation-targeting performance ensures a decisive data-driven policy response.

14. **Financial resilience and the absence of systemic risks are also instrumental in supporting economic growth and financial stability.** Despite the strength of Peru's financial system, tested in several recent crises, the authorities continue to further enhance the financial regulatory and supervisory framework. In January 2023, a new capital framework was introduced, fully aligned with Basel III requirements; and most FSAP recommendations have been implemented, including expanding financial cooperative oversight by the banking supervisor, monitoring banks' balance sheet exposures, introducing a deposit insurance scheme for credit unions, and enhancing the emergency liquidity assistance framework.

15. **The authorities remain committed to their structural reform agenda under the OECD accession process, although approval by Congress may take longer than expected.** Raising productivity and reducing informality continue to be top priorities. The authorities are cognizant that first the pandemic, and more recently political unrest, highlight the need to enhance the public provision of health, education, and social protection. To this end, the authorities are taking steps to enhance budget implementation capacities and the quality of public spending at the local and regional level. Progress has also been made on public accountability, as detailed in Annex X of the staff report.

16. **Peru was the first Latin American country to enact a Framework Law on Climate Change in 2018, in line with the Paris Agreement.** In 2020, the government established a High-Level Commission on Climate Change. Peru published its National Adaptation Plan in 2021 and declared a national climate emergency in 2022. It is important to underscore that Peru is not a large carbon emitter, as its energy matrix is intensive in natural gas and hydroelectric power. As explained in Annex XI, the main sources of emissions are land use change and forestry (LULUCF). As 57 and 95 percent of Peru's territory are forestland and Amazon rainforest, respectively, deforestation represents a considerable challenge.

FINAL REMARKS

17. **The strength of the Peruvian economy has been built over the last three decades.** After a deep recession and hyperinflation in the late 1980s, Peru transformed its economy and institutional framework through solid macroeconomic policies leading to sustained growth, low inflation, and substantial poverty reduction, thereby paving the way for a resilient economy. Fiscal discipline, openness, and a friendly investment framework were critical for building strong fiscal and international reserve buffers against a series of shocks in recent decades, and for strengthening the economy in the face of future challenges. The very strong fundamentals of the economy have helped to protect it from both external and domestic shocks, including political instability.; and Peru has emerged as one of the region's fastest growing and most stable and resilient economies. Nevertheless, the authorities are not complacent and stand vigilant to make

any necessary corrections along the road to ensure sustained and inclusive growth; and remain committed to complying with Peru's burden-sharing for a better and sustainable world.