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Statement by Mr. Chodos and Mr. Hendrick on Peru
Executive Board Meeting
April 29, 2022

Key Points

- The Peruvian economy grew 13.3 percent in 2021, one of the highest rates in the LAC region, thanks to timely and effective policy actions taken by the authorities at the beginning of the COVID-19 pandemic.
- Inflation in Peru has been one of the lowest and less volatile in LAC so far this century (2.7 percentage on average 2001-2021). The temporary increase in inflation in 2021-22 is expected to return to the central bank inflation target range in 2023.
- As of March 2022, the fiscal deficit stood at 1.7 percent of GDP, one of the lowest in LAC, marking 12 consecutive months of decline.
- Despite a substantial fiscal stimulus to sustain economic activity and provide social protection during the pandemic, and the associated borrowing to finance part of the additional expenditure, public debt to GDP was 36.1 percent as of end-2021.
- Peru's external position is one of the strongest among emerging market economies. International reserves amount to 35 percent of GDP. This buffer, together with access to a precautionary FCL provides additional insurance against exogeneous financial shocks.
- The financial sector remains solid despite the gradual unwinding of emergency measures, and recent stress tests suggest that the financial system is resilient even under severely adverse scenarios.
- Looking ahead, and with the OECD accession process underway, the authorities are working on a broad range of structural reforms to boost economic growth, address social needs highlighted during the COVID-19 pandemic, and resume the successful poverty reduction process that was taking place prior to 2020.

INTRODUCTION

1. **Our Peruvian authorities would like to convey their appreciation to Mr. Bonato and his team for a frank and constructive policy dialogue during the Article IV Consultation.** In its Staff Report (SM/22/83), staff provides an in-depth analysis of the strong performance by the Peruvian economy and the challenges ahead. Our authorities are in broad agreement with the staff's assessment and policy recommendations. We appreciate the focus on the consultation on the appropriate near-term policy mix, during the transition to a post-COVID-19 world, and the staff's recommendations to face the new challenges associated with the war in Ukraine and bleak global outlook. Dealing with potential additional global spillovers, risk of a new wave of the pandemic, and domestic inflationary pressures, will also require structural reforms and policies to rebuild buffers and reinforce high growth prospects over the medium term.

2. **Peru has maintained its strong economic performance and substantial policy buffers during the last two decades.** As stated in the first paragraph of the staff report, Peru has successfully navigated significant economic shocks in recent years, thanks to strong economic policies and institutional policy frameworks. Despite recent political uncertainty, real GDP growth remained strong during the first quarter of 2022, after a substantial two-digit rebound in economic growth in 2021. Yet the shock caused by the pandemic is still affecting employment and caused a backtrack of the successful poverty reduction trend in the last decade. Nonetheless, large macroeconomic buffers, complemented by the FCL arrangement expiring on May 27, will continue to shield the economy from downside and tail risks.

POST-COVID 19: RECOVERY AND OUTCOME OF THE POLICY RESPONSE

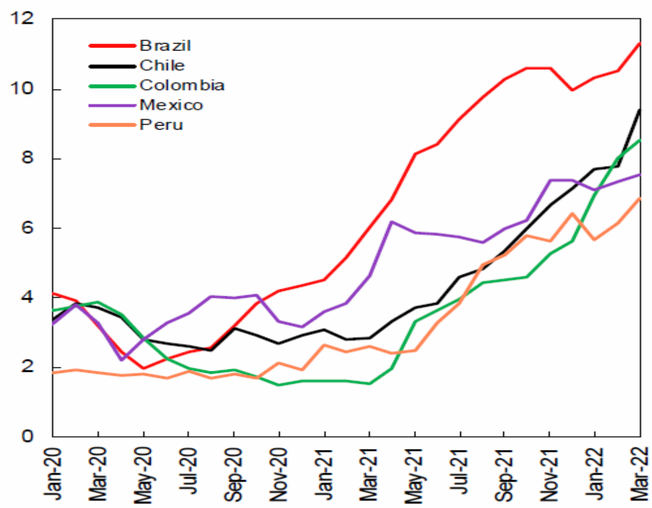
3. **The Peruvian economy grew 13.3 percent in 2021, one of the highest rates in the LAC region.** The relaxation of the COVID-19 related mobility restriction and a widespread vaccination rollout[1], supported by a substantial fiscal stimulus and expansionary monetary policy, allowed a strong rebound of economic activity in 2021, after the deepest economic recession in decades. Economic activity continued its recovery path in early 2022, despite the Omicron surge, which was relatively short-lived and had a very limited impact on mortality. Real GDP growth was 3.9 percent in the first two months of 2022 (yoy), and higher than the 3.2 percent of 2021 Q4.

4. **Inflation in Peru has been one the lowest and less volatile in LAC so far this century, 2.7 percent on average in 2001-2021.** However, in a context of global inflationary pressures,

[1] As of April 9, 2022, 26.3 million people were fully vaccinated, equivalent to 80 percent of the population, and 43 percent of the population received a booster shot.

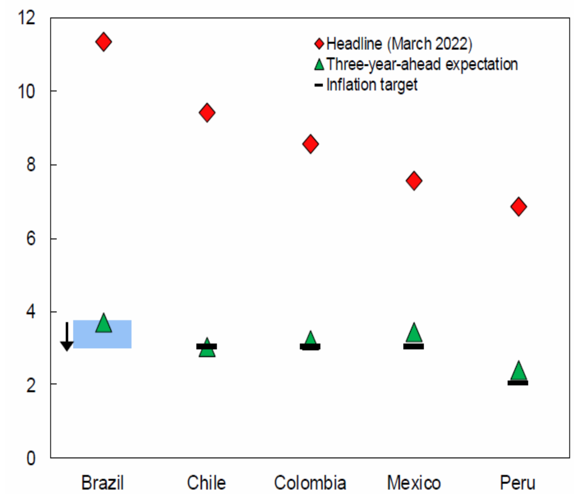
12-month headline inflation increased to 6.8 percent in March 2022, due to higher food and oil prices. Core inflation only rose to 3.5 percent. Twelve-month inflation expectations reached 4.4 percent, above the 1-3 percentage target range of the Central Bank. However, inflation is expected to return to the target range in 2023, as transitory supply-side effects revert, and economic activity remains below potential. See charts below[2].

Headline Consumer Price Inflation
(Year-over-year percent change)



Sources: Haver Analytics; national authorities; and IMF staff calculations.
Note: Peru refers to Lima.

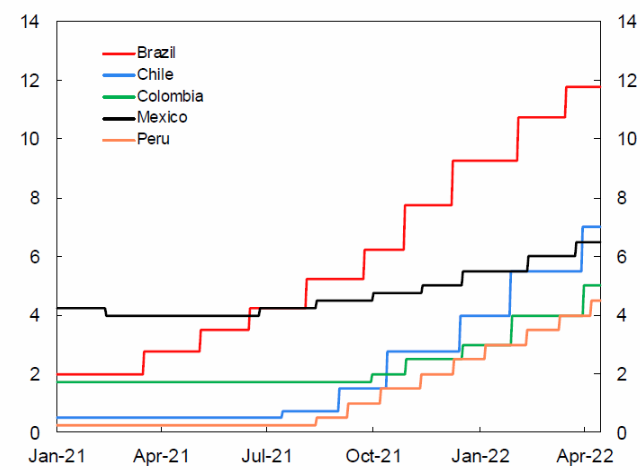
Headline Inflation and Expectations
(Percent)



Sources: Consensus Economics; Haver Analytics; and national authorities.
Note: Brazil inflation target is set to decline over time from 3.75 percent in 2022 to 3 percent in 2024.

5. **The Central Bank of Peru (BCRP) had a decisive and rapid response to curb inflation expectation and bring headline inflation back within the target range.** The monetary authority raised its policy rate by 425 bps to 4.5 percent in nine consecutive steps, but the policy stance remains accommodative. Nonetheless, the BCRP stands ready to continue adjusting the policy rate, to guide inflation and its expectations back to the target range. Policy decisions will continue to be data driven and are based on a careful monitoring of inflation expectations.

Policy Rates
(Percent)



Sources: Haver Analytics; national authorities; and IMF staff calculations.

6. **The fiscal stance in 2021 and during the first months of 2022 has been stronger than originally expected.** The non-financial public sector (NFPS) deficit fell from 8.9 percent of

[2] Presentation by WHD during the Meeting with the Authorities of South America and Mexico, April 23, 2022.

GDP in 2020 to 2.6 percent of GDP in 2021. This outcome is mainly explained by a substantial increase in tax revenues associated with higher metal prices, and the reactivation of economic activity, after the lifting of mobility and sanitary restrictions. This will support economic activity in high-contact industries and services sectors, particularly tourism, which has a lot of room for further growth. As of March 2022, the fiscal deficit stood at 1.7 percent of GDP (yoy), one of the lowest in LAC, marking 12 consecutive months of decline. The favorable fiscal results of 2021 allowed to rebuild liquid financial assets for around US$4.6 billion, of which about US$ 1.4 billion will go to replenish the Fiscal Stabilization Fund, while the rest will go to the Secondary Liquidity Reserve. Despite public borrowing to finance part of the fiscal stimulus, public debt as of end-2021 reached only 36.1 percent of GDP, one of the lowest among emerging markets. The sovereign credit rating remains at investment grade. Going forward, fiscal consolidation will continue, and the deficit is expected to decrease as the economy gradually recovers from the COVID-19 shock.

7. **Peru's external position remains strong and international reserve coverage remains adequate under all Fund metrics.** For a small open and commodity exporting economy, with substantial domestic foreign currency liabilities, maintaining large external buffers is a key tool to enhance the resilience of the Peruvian economy. Despite historical short-term capital outflows in 2021, due to the political uncertainty, this was more than compensated by inflows of FDI, public borrowing and the 2021 SDR allocation. By end-2021, international reserves increased to US$ 78.5 billion (US$ 3.6 billion larger than end-2020), and equivalent to 35 percent of GDP. We concur with the staff's assessment that the external position in 2021 is broadly in line with the level implied by fundamentals and desirable policies.

8. **The financial sector remains strong and resilient as emergency measures are gradually unwound.** As shown in the Financial Soundness Indicators Heatmap, the financial system remains stable after some volatility in 2021. Sovereign and corporate spreads remain low and stable compared with other countries in the region. Equity prices fully recovered previous losses. Following a gradual withdrawal of policy support, including the reduction of countercyclical capital buffers, and the government-guaranteed loans, credit growth has naturally declined, while profitability has continued to recover. Top-down stress tests conducted recently by the authorities confirm the 2018 FSAP findings that the financial system is resilient even under severely adverse scenarios. Although the anticipated rise in non-performing loans is limited (4 percent by end 2021), the supervisory and regulatory authority will continue to monitor market conditions and take measures as needed.

OUTLOOK AND RISKS

9. **After a strong rebound in 2021, real GDP is expected to reach 3.4 percent in 2022, supported by a rebound of the primary sector and a recovery of private consumption.** The lower growth is consistent with withdrawal of the policy stimulus, expected slower

global growth, tighter global financial conditions, among other factors. On the other hand, the successful vaccination of the population, the elimination of remaining sanitary restrictions due to COVID-19, the reopening of schools and universities, and more demand of other activities including in the services and tourism sectors will provide a boost to economic activity and further increase in employment.

10. **Despite the global uncertainty and risks tilted to the downside, we agree with staff that policy buffers remain ample to protect the economy from external and domestic risks.** As discussed above, economic fundamentals are very strong, international reserves are high by standard metrics, the fiscal deficit fell substantially after the pandemic, public debt is low, the sovereign credit rating remains investment grade. The Central Bank's strong reputation and credibility will help to guide inflation back to the target range in 2023. The financial system continues to be strong and resilient. Nevertheless, the authorities remain ready to take additional actions as warranted by evolving and unpredictable global market conditions.

BUILDING BLOCKS FOR A POST COVID-19 WORLD WITH STRONGER AND INCLUSIVE ECONOMIC GROWTH

11. **The authorities agreed with staff that a neutral fiscal stance is appropriate in the short term, and that an enhancement of the medium-term strategy would be helpful to preserve fiscal sustainability.** As noted above, the fiscal stance in 2021 and so far in 2022 is already much better than anticipated. The 2022 budget is balanced and in line with past IMF advice, with increased spending in health, education, and social protection. The authorities stand ready to take additional actions if some of the contingent fiscal risks materialize. As discussed with staff, last week, the Executive branch submitted to Congress a proposal for a new law for a recalibration of the fiscal rule. The proposal establishes a ceiling of 2.4 percent of GDP in 2024, and a convergence to 1.0 percent of GDP in 2026 and beyond. Also, it is proposed that the ratio of public debt to GDP should not be greater than 38 percent, and that this ratio should gradually converge back to 30 percent of GDP in no more than 10 years. This approach is slightly more gradual than original envisaged, but this is needed considering the additional spending pressures causes for the higher inflation, and the need to reduce taxes for staple foods and additional cash transfers to assist the poorest segments of the population.

12. **Enhancing the effectiveness of the Fiscal Council is also a priority.** The Fiscal Council has been supporting Peru's fiscal framework with transparency and independence. Their opinion and views (even when they have been different from the Ministry of Finance's) have always been welcomed and openly disseminated to the markets and public in general. Yet, there could be room for further improvement. In that sense, the Minister of Finance formally requested technical assistance from the IMF Fiscal Department to further improve the framework of the Fiscal Council, following best international practices.

13. **The Central Bank's long track record of implementing a successful inflation targeting framework is the best warranty of a decisive data driven policy response.** Since August 2021, the monetary authority began to increase its policy rate, in line with the normalization of the monetary stance, and has since introduced nine rate hikes, to 4.5 percent currently. The Central Bank will continue to take the necessary steps to bring inflation back within the target range over the forecast horizon. The real exchange rate plays an important role as a shock absorber, which is why the sol depreciated significantly in 2021, despite the large FX interventions, which were justified, as explained by staff, by the historically large capital outflows, and the still relatively high rate of dollarization, and significant volatility in market conditions.

14. **The resilience and strength of the financial system and the absence of systemic risks, allows a gradual unwinding of policies taken during the pandemic.** Yet, the authorities are mindful of providing continued support to weaker entities in the cooperative and microfinance sectors, which are important for micro and small size businesses. They are also closely monitoring bank portfolios and lending standards for any unexpected increase in non-performing loans, although the likelihood is very low. With the help of the IMF and other international agencies, the authorities are exploring ways to improve the digital payment infrastructure, potentially through the introduction of a central bank digital currency. This initiative is still in the early stages of the process.

15. **With the OECD accession process underway, the authorities are focusing on a broad range of structural reforms.** Enhancing the public provision of health, education, and social protection (needs exposed by the pandemic) is a number one priority. Many reforms, including a substantial improvement of the civil service, is key to enhance the quality of public spending, quality control, and to optimize the needed increase in the budget for these critical sectors. Significant progress has been made in the implementation of the Anti-Corruption Plan 2018-2021 and the effectiveness of monitoring COVID-related spending, nonetheless, recognizing that there is still room for further improvement.

16. **Peru was the first Latin American country to ratify the Paris Agreement in July 2016 and its fully committed to a 2030 target of 20 percent for the energy produced from unconventional renewable sources.** It is important to underscore that Peru is not a large carbon emitter. Its energy matrix is intensive in natural gas, 42 percent as primary source and 11 percent for natural gas liquids. It is land use and deforestation which account for most of the country's emissions. At the same time, Peru is one of the most vulnerable countries due to the impact of extreme weather events. As it is well explained in Box 1, earthquakes, landslides, droughts, and floods together cause large welfare losses every year. The 2017 El Niño event left around US$ 6-9 billion in monetary losses, affecting 1.7 million people. The assistance to be provided by the World Bank and other partners will be instrumental to reach the commitment to carbon neutrality by 2050.

FINAL REMARKS

17. Peru's strong economic fundamentals and more than three decades of implementing good economic policies, with sustained growth, low inflation, and a substantial reduction in poverty has paved the way for a resilient economy, with the buffers and drive to navigate through these difficult times and potential challenges ahead. The authorities do not take anything for granted and remain vigilant to make any necessary corrections along the road for a continuation of sustained inclusive growth and fulfillment of its commitment to comply with its burden sharing for a better and sustainable world.