Office Memorandum

To: Members of the Executive Board June 20, 2014

From: The Acting Secretary

Subject: **Peru—Assessment Letter for the Inter-American Development Bank**

Attached for the **information** of Executive Directors is the Fund's assessment letter on the macroeconomic conditions in Peru, which was requested by the Inter-American Development Bank.

The authorities of Peru have not consented to the publication of this assessment.

Questions may be referred to Mr. Santos (ext. 36629), Ms. Vtyurina (ext. 38940), and Mr. Tashu (ext. 38758) in WHD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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PERU—ASSESSMENT LETTER FOR THE INTER-AMERICAN DEVELOPMENT BANK

(Board discussion of three Programmatic Loans)
June 20, 2014

1. **Solid economic performance of Peru has been recognized by the Executive Board of the IMF.** At the 2013 Article IV consultation meeting on January 30, 2014, Directors commended Peru's impressive macroeconomic performance, underpinned by strong fundamentals and sound policy management. The country achieved strong growth, low inflation and public debt, and made progress in reducing poverty and improving living standards. Directors emphasized the importance of continued implementation of flexible and coordinated policies as well as structural reforms to maintain macroeconomic stability and foster more inclusive long term growth.

2. **The growth momentum slowed slightly in 2013 mostly due to adverse external conditions and a decline in domestic confidence.** Following an expansion of about 6 percent in 2012, economic growth slowed slightly to about 5¾ percent in 2013 (yoy) due to a moderation in private investment and a decline in exports.[1] After a fall in metal prices, uncertainty increased; and domestic confidence levels dropped, reflecting also some concerns about the direction of domestic policies. On the supply side, the moderation of growth in 2013 reflected a slowdown in the mining, fishing and construction sectors. Despite the deceleration, the economy continued to operate somewhat near potential. Inflation was 2¾ percent and unemployment was at historic lows. Growth is expected to decelerate further in 2014 on slower private investment, lower mining output and weak external demand.[2] In June 2014, the government submitted to congress a package of measures to invigorate growth through simplification and promotion of investment and tax debt forgiveness.

3. **Fiscal policy became more supportive of the economy in 2013 given the challenging external environment.** The non-financial public sector (NFPS) overall fiscal surplus increased to 2¼ percent of GDP in 2012, mainly due to stronger-than-expected revenues and slower implementation of public investment plans despite efforts to accelerate it. In 2013, the fiscal surplus fell to about ½ percent of GDP due to: (i) budgeted allowances to increase primary spending to achieve social inclusion goals and higher wages following the civil service reform; (ii) efforts to increase capital spending; and (iii) falling mining-related revenues as metal prices weakened. Debt to GDP was at about 20 percent and government savings accounted for about 15 percent of GDP. The 2014 budget envisages a

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[1] At the time of the 2013 Article IV Consultation, the GDP series available had the base year 1994. The attached table is based on the data available at that time. In 2014 the authorities released a new GDP series with the base year 2007, with mining and services taking a larger share of the economy. Growth figures mentioned in the text correspond to the new GDP series. As a result of the change in base year, real GDP growth was revised upward in 2013 (from 5.0 to 5.8 percent) and downward in 2012 (from 6.3 to 6.0 percent).

[2] At the time of the 2013 Article IV Consultation, staff expected the economy to grow at 5½ percent in 2014. Staff is in the process of revising growth projections downward, given the lower-than-expected growth in the first quarter of 2014 (4¾ percent, yoy).

deficit of 1percent of GDP; however, based on historical execution rates, staff projects a small surplus.

4. **Monetary policy was relaxed and macro-prudential measures were unwound recently on evidence of a continued slowdown in economic activity.** The BCRP cut the reference rate by ¼ of a point to 4 percent in November 2013, citing slower domestic and global growth, and declining inflationary expectations. The BCRP unwound macro-prudential measures to ease liquidity flows to address the end of unconventional monetary policy in the U.S. The exchange rate policy has been more flexible over the past year, although the BCRP has intervened to limit excessive volatility in the foreign exchange (FX) market. The *nuevo sol* depreciated about 8½ percent in real terms in 2013, and the exchange rate remains in line with fundamentals. The BCRP continued accumulating international reserves in 2013 and its reserve position remained comfortably above 30 percent of GDP. The BCRP recently announced the reduction in reserve requirements in local currency effective July 1, 2014.

5. **The external position has deteriorated mostly due to weak export performance and lower private capital inflows.** In 2013, the current account deficit reached close to 5 percent of GDP, as terms of trade deteriorated, export volumes fell and import growth remained strong. However, despite lower inflows, the current account deficit was easily financed by private capital flows amounting to some 8 percent of GDP (mainly FDI).

6. **The financial sector remains solid and healthy.** With capital to risk-weighted asset ratios (CAR) of 14 percent, non-performing loan ratios (NPL) of 2 percent, and return-on-equity (ROE) of 21½ in 2013, the banking system remains well-capitalized, sound, and profitable. Credit growth was about 16 percent, yoy, in 2013. But with high dollarization of over 45 percent, the banking system remains vulnerable to exchange rate fluctuations. To moderate risks, the BCRP and the superintendency of banks (SBS) actively employed macro-prudential policies. To limit the expansion of loans in U.S. dollars and encourage their substitution by credits in *nuevos soles*, BCRP increased the reserve requirement on dollar liabilities in 2013. The non-banking sector was in in a weaker position, but remained well-capitalized with CARs ranging from 13½ for *Cajas Rurales* to about 18 for *Empresas Financieras*. Recently, one Caja Rural has been taken under receivership by the SBS.

7. **The near-term outlook remains favorable, but global conditions pose important risks.** While growth continued to slow down, the economy is projected to grow at around trend in the coming years (about 5¾ percent) supported by domestic demand, but will remain vulnerable to terms-of-trade shocks and a weakening of the global economy. The current policy mix remains broadly appropriate but sustained advancement with Peru’s structural reform agenda remains key to maintaining progress with respect to growth and poverty reduction. This will require removing infrastructure bottlenecks, raising productivity and competitiveness by boosting human capital and further improving the business climate.

Table 1. Peru: Selected Economic Indicators

(Peru: Report for the 2014 Article IV Consultations)

					Est.	Proj.	
	2009	2010	2011	2012	2013	2014	2015
Social Indicators							
Life expectancy at birth (years)	73.5	73.8	74.0	74.2	...	...	...
Infant mortality (per thousand live births)	20.0	17.0	16.0	17.0	...	...	...
Adult literacy rate	92.4	92.6	92.9	...	...	...	...
Poverty rate (total) 1/	33.5	30.8	27.8	25.8	...	...	...
Unemployment rate	8.4	7.9	7.7	6.8	6.0	6.0	6.0
	(Annual percentage change; unless otherwise indicated)						
Production and prices							
Real GDP	0.9	8.8	6.9	6.3	5.0	5.5	5.8
Real domestic demand	-2.8	13.1	7.1	7.2	5.7	5.9	5.7
Consumer Prices (end of period)	0.2	2.1	4.7	2.6	2.9	2.3	2.0
Consumer Prices (period average)	2.9	1.5	3.4	3.7	2.8	2.5	2.1
External sector							
Exports	-13.1	31.9	30.1	-0.7	-8.9	6.6	6.8
Imports	-26.1	37.1	28.3	11.2	2.6	5.7	4.9
Terms of trade (deterioration -)	-2.8	17.9	5.4	-4.9	-4.7	-0.8	0.1
Real effective exchange rate (depreciation -)	3.4	2.4	-1.0	8.5	...	...	...
Money and credit 1/ 2/							
Broad money	6.8	21.7	15.1	12.1	14.1	13.8	13.5
Net credit to the private sector	5.0	16.7	21.6	13.3	18.4	14.5	14.5
	(In percent of GDP; unless otherwise indicated)						
Public sector							
NFPS Revenue	24.0	25.2	26.3	26.7	26.5	26.4	26.7
NFPS Primary Expenditure	24.0	24.2	23.3	23.4	25.0	25.0	25.4
NFPS Primary Balance	0.0	1.0	3.0	3.2	1.6	1.4	1.4
NFPS Overall Balance	-1.3	-0.2	1.9	2.2	0.5	0.3	0.4
External Sector							
External current account balance	-0.6	-2.5	-1.9	-3.4	-4.9	-4.8	-4.4
Gross reserves							
In millions of U.S. dollars	33,175	44,150	48,859	64,049	65,710	66,710	68,210
Percent of short-term external debt 3/	424	342	589	539	569	681	780
Percent of foreign currency deposits at banks	204	241	228	301	276	249	232
Debt							
Total external debt	28.1	26.4	24.7	26.1	23.9	22.7	21.9
NFPS Gross debt (including CRPAOs)	27.1	24.4	22.4	20.5	19.6	18.1	16.6
External	15.4	12.7	11.1	9.5	8.9	7.4	7.1
Domestic	11.7	11.7	11.3	11.0	10.7	10.6	9.5
Savings and investment							
Gross domestic investment	20.7	25.2	25.3	26.7	27.6	28.4	28.7
Public sector 4/	5.2	5.9	4.5	5.2	5.8	6.2	6.6
Private sector	17.7	19.2	19.6	21.4	21.5	22.2	22.2
National savings	20.1	22.7	23.4	23.2	22.7	23.6	24.3
Public sector 5/	4.5	6.1	7.2	7.8	6.8	6.9	7.3
Private sector	15.7	16.7	16.3	15.4	15.9	16.7	17.0
Memorandum items							
Nominal GDP (S/. billions)	382.3	434.5	486.2	526.4	558.1	600.7	648.2
GDP per capita (in US$)	4,362	5,205	5,883	6,550	6,674	6,895	7,386

Sources: Central Reserve Bank of Peru (BCRP); Ministry of Economy and Finance (MEF); National Statistical Institute (INEI); UNDP Human Development Indicators; and Fund staff estimates/projections.

1/ Corresponds to depository corporations.

2/ Foreign currency stocks are valued at end-of-period exchange rates.

3/ Short-term debt is defined on a residual maturity basis, and includes amortization of medium- and long-term debt.

4/ Includes CRPAOs.

5/ Excludes privatization receipts.