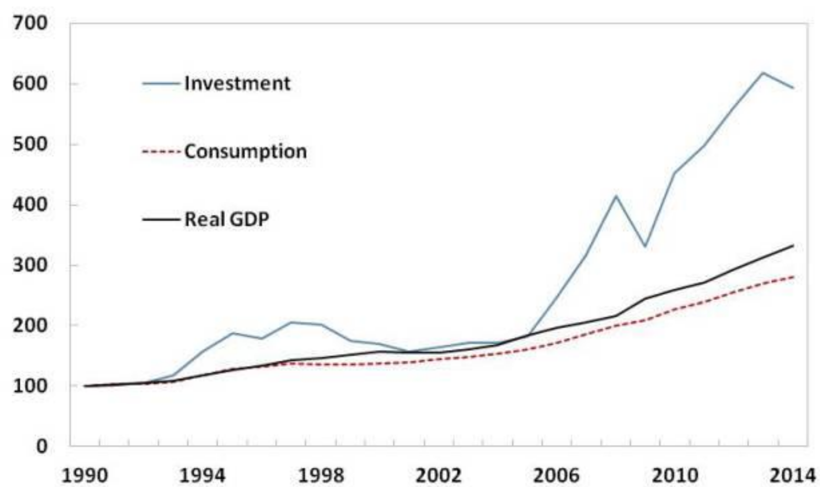
Peru: Stepping Up Investment and Growth

By Kevin Ross and Melesse Tashu

July 29, 2015

Thanks to a decade long investment boom, Peru was able to raise its productive capacity. However, falling commodity prices and an uncertain external environment have weakened investment in 2014, and dented growth prospects. So, how will Peru be able to sustain its higher growth potential? Past experience suggests that a renewed emphasis on implementing structural reforms is needed to boost productivity and growth.

Chart 1. Peru: Investment, Consumption and Real GDP (1990=100)

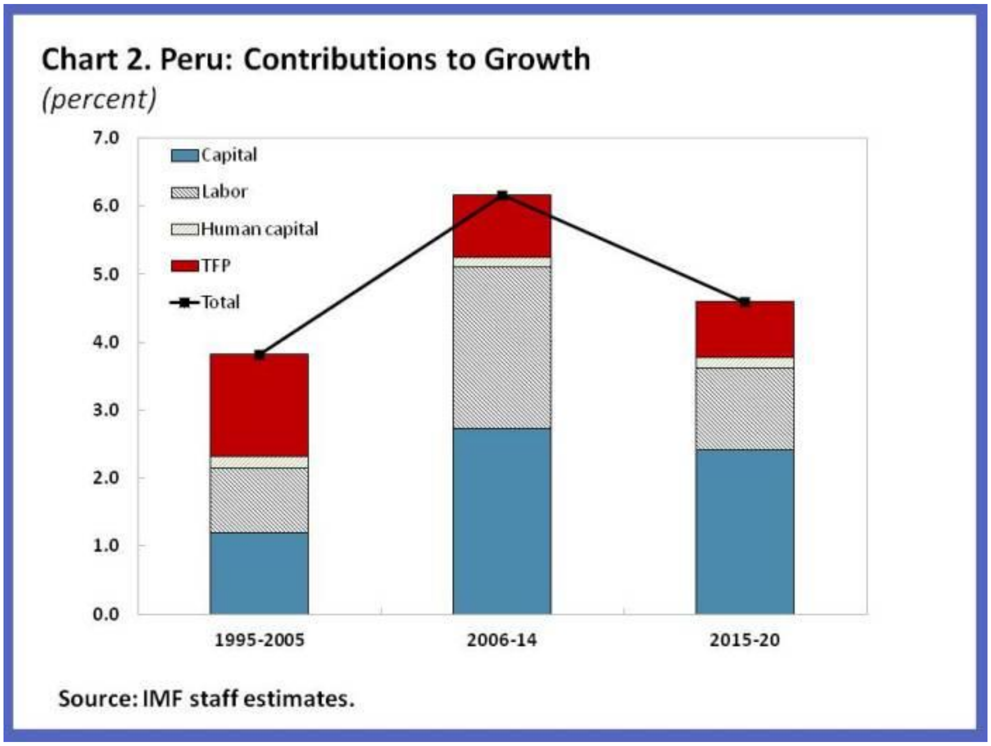


Source: National Authorities.

Higher potential growth Source

Over the past few decades, Peru consistently implemented a series of structural reforms and solid macroeconomic and investment frameworks. For example, the government introduced a fiscal rule in 1999 and a well-designed inflation targeting regime in 2002.

According to the Inter-American Development Bank's index of structural reforms, Peru is now a regional leader, rising from the bottom of a relative ranking among the six largest Latin American economies in the mid-1980s. These advancements allowed the country to take full advantage of a sizable and prolonged improvement in its terms of trade and historically low global interest rates. The result was a surge in investment and foreign direct investment flows, and a significant gain in productivity.



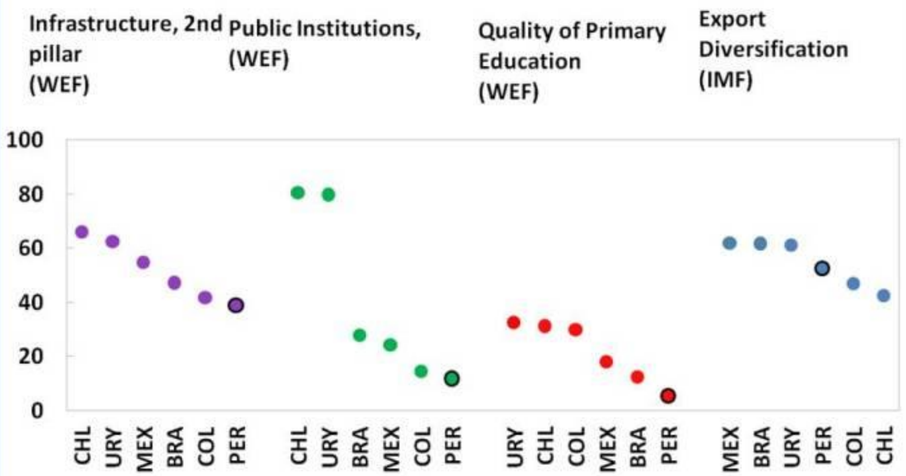
During 2003−13, growth averaged 6.2 percent—with investment contributing around half to *actual* GDP growth. Not surprisingly, these events also led to an increase in Peru's estimated *potential* growth rate, from around 4 percent in 2003 to about 6 percent in 2013. From a simple growth accounting exercise, approximately half of the expanded potential capacity stemmed from an increase in the contribution from total factor productivity (TFP), with the remaining evenly split between capital and labor additions.

The new reality

Changes in the external environment, however, call for a reassessment of potential growth. The two key factors that provided a strong tailwind to growth—positive terms of trade changes and easy global financial conditions—have started to reverse, and investment growth has been slowing. To assess how this weakness in the economic environment will impact potential growth, we used staff's baseline assumptions regarding the evolution of labor and capital, and estimated how changes in the terms of trade and an index of structural reforms will affect productivity (TFP) growth.

Our results show that, for example, if structural reforms were to improve at the same rate as during the commodity boom—a period with few incentives to make structural improvements—potential growth would only be 3.2 percent. Our baseline scenario estimates potential growth at 4½ percent, assuming structural reforms proceed at a slightly faster pace, in line with the authorities' ongoing agenda (see below).

Chart 3. Structural Indicators 1/
(percentile ranks)



Sources: World Economic Forum (WEF); and Export Diversification Database, IMF, 2010.
1/ The scale reflects the percentile distribution across all countries in the respective survey; higher scores reflect higher performance.

Giving investment a boost

Peru still suffers from relatively weak infrastructure and human capital development, labor market rigidities, and low institutional capacity. One overriding challenge is high informality, which limits firm size, human capital development, innovation, and financial deepening—all of which constrain productivity.

Labor market rigidities, as reflected in legally-mandated high non-salary compensation compared to the region, are one example of barriers to formality that negatively impact competitiveness. Another important impediment, evident through the growth slowdown of last year, is bureaucratic red tape, or *tramitologia*, which increases costs and hampers investment.

Selected Latin American Countries: Non-Salary Labor Costs
(In percent of salaries)

	Chile	Mexico	Colombia	Peru
Contributions and taxes	25.2	31.5	36.8	27.0
Vacations	4.2	1.7	4.2	8.3
Bonus/extra payments	0.0	0.0	4.2	16.7
Firing costs	2.3	3.2	8.3	7.0
Total non-salary labor costs	**31.7**	**36.4**	**53.5**	**59.0**
Memorandum item:				
Minimum salary/GDP per capi	0.30	0.15	0.41	0.46

Sources: World Bank Database. 2014; and International Labor Organization.

The authorities' broad-based structural reform agenda tackles these important challenges. Ongoing efforts to reform the civil service, streamline permit procedures, strengthen public enterprise governance, simplify public investment processes, enhance innovation, and diversify exports are steps in the right direction. Persevering with labor market reform, focusing on reducing non-wage costs and streamlining work rules are critical. Strong across-the-board political commitment remains essential for fostering reform efforts in the short and medium term.

****

Kevin Ross is a Senior Economist in the IMF's Western Hemisphere Department. During 2011–14, he was the IMF's Regional Representative for Peru and Paraguay. Since his return to headquarters, he has worked on various Road to Lima events and on a book on Peru's economic policies. He previously worked in the European Department on a number of advanced and transition economies. His research has mainly focused on monetary and exchange rate policies, banking sector competition, and investment.

Melesse Tashu is an Economist in Southern 1 Division of the IMF's Western Hemisphere Department, where he is the desk economist for Peru and Ecuador. He previously worked in the Caribbean 1 Division. Before joining the Fund, he also worked at World Vision International and the Central Bank of Ethiopia. His research interests include monetary policy, macro-financial linkages, capital flows, and the exchange rate.