Peru's Road to Economic Success

By Alejandro Santos

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The transformation of the Peruvian economy over the past quarter of a century has been remarkable. Peru is a great example of how a stabilization program with a comprehensive structural reform plan should be implemented to significantly improve the standards of living of the population.

In a new IMF book, "Staying the Course of Economic Success"—published ahead of the Annual Meetings of the IMF and the World Bank in Lima next week—we showcase Peru's impressive accomplishments over the past two and a half decades. While much has been achieved, much remains to be done in Peru.

Amazing results

This impressive transformation cut across the entire section of Peru's economy.

- **Growth**. While the Peruvian economy contracted by about 25 percent in the 3 years prior to the implementation of the stabilization program in the early 1990s, soon after the economy grew at a healthy rate and recorded the second highest economic growth rate in Latin America in the last decade.

- **Inflation**. The central bank was able to tame the hyperinflation of the early 1990s through a skillful control of monetary aggregates, and then managed to generate the lowest inflation rate in Latin America in the last decade using a modern inflation targeting framework.

- **Public debt**. A well-designed fiscal policy reduced the public debt from about 70 percent of GDP in the early 1990s (when it was in default to all creditors, including the IMF) to around 20 percent of GDP now (while enjoying investment grade and unrestricted access to capital markets). On top of that, the public sector accumulated assets of about 15 percent of GDP. All this was facilitated by the adoption of a strong fiscal framework and fiscal rules that limited current spending growth.

- **International reserves**. Reserves moved from a negative level on a net basis in the early 1990s to about 30 percent of GDP now. Positive terms of trade shocks and capital inflows were managed with a view to strengthen the reserve position of the central bank.

- **Poverty**. While data are imprecise, it is estimated that the poverty rate in the early 1990s was above 60 percent and it now stands at somewhat above 20 percent thanks to a healthy economic growth and social policies that alleviated poverty (including the creation of the Ministry of Social Development and Inclusion).

- **IMF partnership.** All these amazing results were accompanied by continuous IMF involvement, including programs in the (almost) 2 decades after the stabilization of the early 1990s, and a massive program of technical assistance. Peru's relationship with the IMF switched dramatically—from having arrears to the IMF (and ineligible for credit), to having access to IMF loans, to repaying all of its outstanding credit to the IMF, and then to contributing to the IMF's reserves as a creditor.

The story so far

The history of Peru's successful performance began with an ambitious stabilization program in 1990–92, which addressed a multitude of macroeconomic problems, and began a long process of structural reforms that set the basis for high economic growth in the future. The program was responsible for a number of achievements, including: (i) sharply reducing the budget deficit; (ii) abolishing price controls and liberalizing financial markets; (iii) opening up economic activity; (iv) strengthening the framework for the implementation of monetary policy; and (v) bolstering financial supervision and prudential regulation.

The period from 1993–98 marked the resumption of sustained growth, something not seen since the early 1970s. However, the period also included 1998, the only year of economic contraction in the post stabilization period, and a reminder of Peru's vulnerabilities to external shocks. A number of additional structural reforms were implemented during this period— including tax reform, pension system restructuring, public enterprise divesture, and financial system strengthening. In addition, Peru finally normalized relations with all external creditors.

The following nine years (1999–2007) are associated with a temporary slowdown in growth, a positive swing in the fiscal accounts, improvements in external conditions, and a deepening of reforms. In particular, the reform process continued with two macroeconomic milestones: (i) the introduction of a fiscal rule in 1999; and (ii) the introduction of inflation targeting in 2002. The economy grew on average at an annual rate of 4½ percent, while inflation was finally brought down to levels similar to those in advanced economies, averaging 2½ percent.

In early 2008, Peru was booming, but there were clear signs of overheating, with inflation running at almost 6 percent, although the fiscal surplus was one of the highest in history. Public debt was on a continuing downward path and Peru was granted investment grade in the first half of 2008 (the third country in the region). However, the world changed in September 2008 with the onset of the global financial crisis. Fortunately, there was limited financial contagion from the global crisis thanks to a quick policy response, including vigorous monetary and fiscal stimulus.

The effectiveness of the countercyclical response and the rapid economic recovery soon turned the policy debate to the optimal speed of stimulus withdrawal in the post global financial crisis period. Real GDP grew on average by 6¾ percent in the period 2010–13, while core inflation remained under control. To prevent overheating risks, the authorities began the tightening cycle in 2010–11. However, the capital inflow problem came to an abrupt end following the announcement by the U.S. Federal Reserve in May 2013 of a potential "tapering" of its unconventional monetary policy. The news created uncertainty in the markets and the magnitude of capital inflows declined significantly. In the first half of 2014, Peru's economy experienced its sharpest deceleration since the global financial crisis. Real GDP grew 2½ percent in 2014 due to uncertainties about external conditions in a world economy with mediocre growth. Real GDP growth in 2015 is expected to remain moderate.

Building on success

To achieve a more advanced stage of development, Peru needs to preserve macroeconomic stability and deepen its structural reforms to improve competitiveness and enhance productivity. In this regard, it would be important to eliminate pervasive red tape to continue fostering an environment to attract investment. Labor markets need to be more flexible to allocate resources efficiently and to reduce informality, while capital markets need to develop further to support investment. If past policy implementation is an indication of the future, there is no doubt that Peru will continue on its road to success.

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