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**Implications of the recent macroeconomic policies
on employment and labour market outcomes in Peru**

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Employment
Policy
Department

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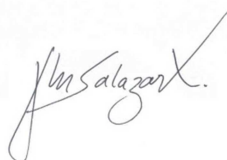
Preface

The primary goal of the ILO is to contribute, with member States, to achieve full and productive employment and decent work for all, including women and young people, a goal embedded in the ILO Declaration 2008 on *Social Justice for a Fair Globalization*,¹ and which has now been widely adopted by the international community. The integrated approach to do this was further reaffirmed by the 2010 Resolution concerning the recurrent discussion on employment².

In order to support member States and the social partners to reach this goal, the ILO pursues a Decent Work Agenda which comprises four interrelated areas: Respect for fundamental worker's rights and international labour standards, employment promotion, social protection and social dialogue. Explanations and elaborations of this integrated approach and related challenges are contained in a number of key documents: in those explaining the concept of decent work,³ in the Employment Policy Convention, 1964 (No. 122), in the Global Employment Agenda and, as applied to crisis response, in the Global Jobs Pact adopted by the 2009 ILC in the aftermath of the 2008 global economic crisis.

The Employment Sector is fully engaged in supporting countries placing employment at the centre of their economic and social policies, using these complementary frameworks, and is doing so through a large range of technical support and capacity building activities, policy advisory services and policy research. As part of its research and publications programme, the Employment Sector promotes knowledge-generation around key policy issues and topics conforming to the core elements of the Global Employment Agenda and the Decent Work Agenda. The Sector's publications consist of books, monographs, working papers, employment reports and policy briefs.⁴

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¹ See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf

² See http://www.ilo.org/public/libdoc/ilo/2010/110B09_108_engl.pdf

³ See the successive Reports of the Director-General to the International Labour Conference: *Decent work* (1999); *Reducing the decent work deficit: A global challenge* (2001); *Working out of poverty* (2003).

⁴ See <http://www.ilo.org/employment>.

Foreword

At the 99th session of the International Labour Conference, constituents endorsed the need to promote a ‘pro-employment’ macroeconomic framework. It was felt that the current framework, while making an important contribution to the goal of macroeconomic stability, paid insufficient attention to the way in which macroeconomic policy instruments either helped or hindered employment creation and poverty reduction. In the standard framework that has evolved since the days of the structural adjustment programmes of the 1980s and 1990s, and that has remained intact during the 2000s, the emphasis is on attaining key nominal targets pertaining to debts, deficits and inflation. The rationale is that attaining such targets in the medium to long run will engender a predictable macroeconomic environment that is crucial for supporting growth and hence employment creation. It now appears that macroeconomic stability is necessary, but by no means sufficient to engender inclusive, job-rich growth.

The Employment Policy Department has been endeavouring to identify existing constraints in the macroeconomic policy instruments that may hinder generation of full and productive employment, and to suggest a way forward for job-rich growth. A series of country case studies has been conducted, and the current case study of Peru represents one result. It analyzes recent macroeconomic performance, shows their relationship with employment outcomes or lack thereof, reviews the existing programmes on employment and social safety nets, and reflects the views of the ILO constituency and other key national stakeholders that were collected through preliminary interviews and consultations.

The study demonstrates that the Peruvian economy performed exceptionally well in recent years, averaging an annual growth rate of 6 percent between 2002 and 2009 and showed a strong resilience to the global economic crisis. Sustained high rates of growth gave way to notable employment generation that in turn contributed to poverty reduction. Although it is true that Peru was greatly favoured by a positive external environment, its economic performance owes much to the years of persistent implementation of favourable fiscal, monetary and external policies that were conducive to stability that laid the grounds for a healthy growth process to occur. However, growth in employment has failed to lead to a significant reduction in open unemployment rates. Between 2004 and 2009, unemployment declined by a meager 1.2 points and the overall unemployment level remains relatively high. The study analyzes the impact of macroeconomic policies on growth and employment creation in Peru. Fiscal consolidation and the adoption of a clear and transparent fiscal policy rule contributed to a virtuous cycle where growth fed into healthy fiscal policy, allowing for continuous reductions in fiscal deficit, a significant reduction in public debt, and the generation of fiscal space. This fiscal space allowed the government to increase spending in investment and targeted poverty reduction programmes. Monetary policy also played a key role in generating a stable economic environment propitious for investment and economic growth and trade openness triggered the development of a productive export sector that allowed Peru to take advantage of the favourable external environment. However, the economy remains poorly diversified and relies heavily on capital intensive export sector, which limits the capacity for greater employment generation. The real exchange rate is a potential explanation for this.

Azita Berar Awad
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Introduction

The Peruvian economy has performed exceptionally well in recent years, averaging an annual growth rate of 6 percent between 2002 and 2009, with a peak of 9.8 percent in 2008. Sustained high rates of growth have placed Peru well above the regional average of 3.4 percent for the same period. Furthermore, the Peruvian economy has shown a strong resilience to the global economic crisis, and despite a deceleration in 2009, it still managed to post a positive growth rate and bounced back the following year. Employment has followed economic growth although at a slower pace, averaging 4.2 percent per year during the same period. Growth in employment allowed for the absorption of the expanding labour force, which increased by approximately 4 million between 2000 and 2009. In addition, rising employment rates were accompanied by a decline in underemployment.

Peru's economic and social performance in recent years reveals some extraordinary accomplishments. Prudent macroeconomic management was combined with a decline in poverty rates and a persistent growth in employment. The incidence of poverty fell from 54.8 percent in 2001 to 34.8 percent in 2009. Extreme poverty also followed the downward trend. However, the impact on poverty reduction in urban areas has been much stronger than in rural areas, exacerbating the urban/rural divide.

The reduction in poverty suggests that the benefits of growth were broad based, which was, at least in part, fostered by persistent employment growth during the economic boom combined with targeted social programs. Total urban employment enjoyed positive and increasing growth rates from mid 2002 until the onset of the global financial crisis, where it began to decelerate, but remained positive. Moreover, Peru weathered the downturn quite well and after an 8-month slump in job creation, employment returned to an expansionary path.

However, growth in employment has failed to lead to a significant reduction in open unemployment rates. Between 2004 and end 2009, unemployment declined by a meager 1.2 points, reaching 8.2 percent in the latter year. In part, this has been due to a growing labour force and increasing participation rates, particularly among women. In addition, the overall unemployment level remains relatively high, suggesting that perhaps Peru's strong economic growth has not yielded maximum benefits.

Furthermore, aggregate economic indicators mask very different sectoral and regional patterns. In terms of employment, not all sectors have performed equally well and while some may have benefited from years of economic dynamism, others have remained sluggish, reflecting substantial adjustment processes in the economy that can impose a heavy burden on workers. In addition, the global recession had an uneven impact on the different sectors and questions remain regarding the quality of their recovery.

Informality is another important issue affecting the Peruvian economy. Estimated at close to 69 percent at the end of the decade, it is unclear whether Peru managed to translate the recent and sustained growth in employment into a higher degree of formalization of the economy, thus questioning the quality of the jobs generated during the economic boom. Furthermore, the Peruvian market exhibits low productivity in general and productivity varies significantly across sectors, with the less productive sectors being the most employment-intensive ones. This has not been overcome during periods of high economic growth.

The recent economic developments suggest that Peru has benefited from macroeconomic stability and high rates of economic growth, but it has not managed to fully translate these positive developments into sustainable and productive employment creation from both quantitative and qualitative perspectives. The lack of diversification of the Peruvian economy may be one of the factors at the root of the problem, given that growth

collapses have been tied to deteriorations in the terms of trade in an economy where the dominant exports are highly capital-intensive. These results show a twin challenge for Peru to overcome in the coming years: How to make growth more sustainable and less tied to terms of trade for a limited number of products, and how to strengthen the translation of growth into the creation of decent employment.

This study analyzes the impact of macroeconomic policies on growth and employment creation in Peru, seeking to answer two basic questions. On one hand: How did macroeconomic policies contribute to the relatively good economic and social performance over the last years and what can be learned from this experience? On the other: How could macroeconomic policies contribute to addressing the twin challenge of making growth more sustainable and more employment intensive while improving both the quantity and quality of the jobs created? For this purpose, the study will analyze developments in the different macroeconomic policy areas, the policies that have been implemented and their impact on employment and decent work outcomes. It is organized in four main sections.

The first section links economic growth to employment in Peru. First, it lays out the underpinnings of economic growth in Peru, it illustrates the most important contributors to GDP growth and analyzes the country's trade performance, and in particular the export performance, given the relevance of the export sector for economic growth in Peru. Such analysis provides the background for better understanding the context in which fiscal, monetary and exchange rate policies have been implemented. Second, it addresses the employment intensity of growth, providing a detailed view of the main employment trends. Third, it presents an overview of the impact of the recent global crisis on employment in Peru. Fourth, it analyzes the relationship between employment growth and poverty reduction. Finally, it analyzes recent wage trends and productivity.

Section two presents the cornerstones of macroeconomic policy in Peru over the past decade. The section addresses fiscal consolidation, monetary policy and inflation control, and external sector and exchange rate policies. It looks at the evolution of policy variables such as fiscal outcomes, public indebtedness, interest rate, inflation and exchange rate developments. The section also assesses macroeconomic policies from 2002 until today with respect to their impact on growth and employment, giving special attention to the events leading up to the global crisis and how the Peruvian economy weathered the shock. The analysis relies strongly on key policy recommendations provided by the IMF and how these helped shape Peruvian policymaking.

Section three describes the outcome of consultations with the Peruvian government, employers' and workers' organizations and other major stakeholders that took place in the week of November 22-26, 2010 in Lima, Peru. The section provides an overview of the feedback obtained during the visits to the interviewed experts and institutions.

The fourth and final section analyzes the role for macroeconomic policy to contribute to more sustainable growth and higher employment creation in the future.

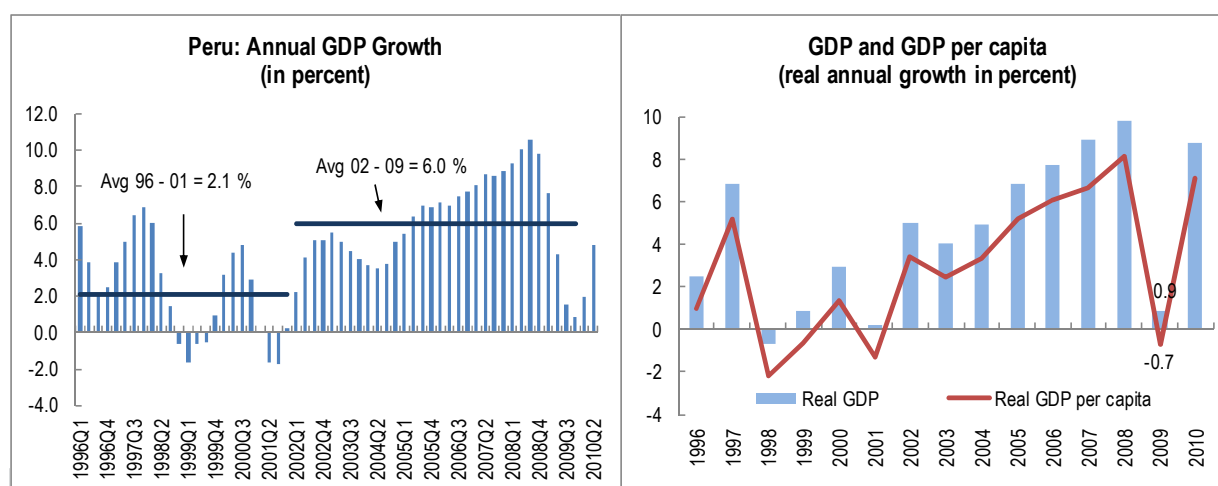
The methodology used for the analysis involved a desktop review of the literature, an analysis of the available data on macroeconomic variables and employment for Peru, and consultations with constituents, major stakeholders as well as a number of experts on Peruvian macroeconomic policy and labour markets.

1. Growth, Employment and Decent Work Deficits

Strong domestic demand and a favorable external environment that allowed for persistent export growth, particularly of minerals and metals, have underpinned Peru's economic expansion. The economy has benefited from growing investment, as well as strong private consumption. Furthermore, the positive terms of trade shock registered from 2006 onwards provided an important boost to the export sector.

Since 2002, Peru has maintained an average annual real GDP growth of 6 percent, including the deceleration observed in 2009 that resulted from the global financial crisis. Prior to the crisis there had been a notable acceleration in growth, particularly between 2005 and 2008, when Peru registered an average annual growth rate of 8.3 percent. Furthermore, economic growth translated into real GDP per capita gains. On average, between 2002 and 2008, GDP per capita grew at an average annual rate of 4.3 percent. Nevertheless, the global recession had a negative impact on real GDP per capita in 2009, causing a drop of -0.7 percent, the first decline observed since 2001 (Figure 1)

Figure 1: Real GDP Growth

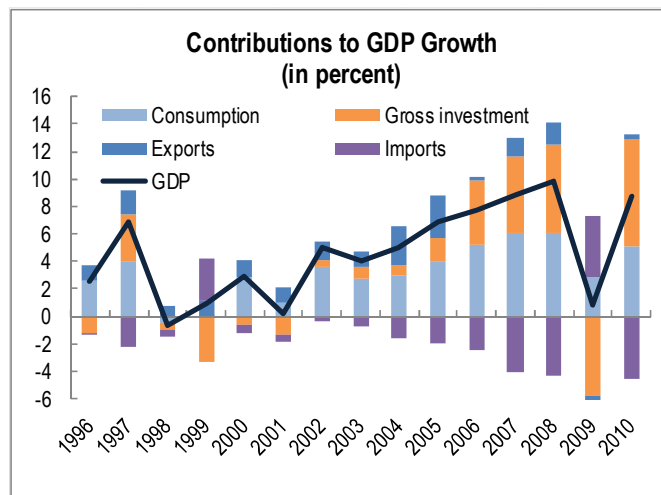


Source: BCRP, IMF WEO April 2010, and Author's calculations

The Underpinnings of Economic Growth in Peru

Economic growth in Peru has been driven primarily by a strong aggregate demand where both consumption and investment have played a critical role (Figure 2). Total consumption grew at an annual average rate of 5.3 percent between 2002 and 2009, driven by increases in private and public consumption. It consistently contributed the largest share to GDP growth until 2007, where it was surpassed by investment. Real investment posted an average growth rate of 8.7 percent during the period of analysis. Notably, it registered particularly high growth rates between 2006 and 2008, when it consistently grew by over 20 percent per year. Net exports were a source of growth in the early stages of the economic boom. However, since 2006, increasing imports driven by strong domestic demand have outweighed the growth of exports.

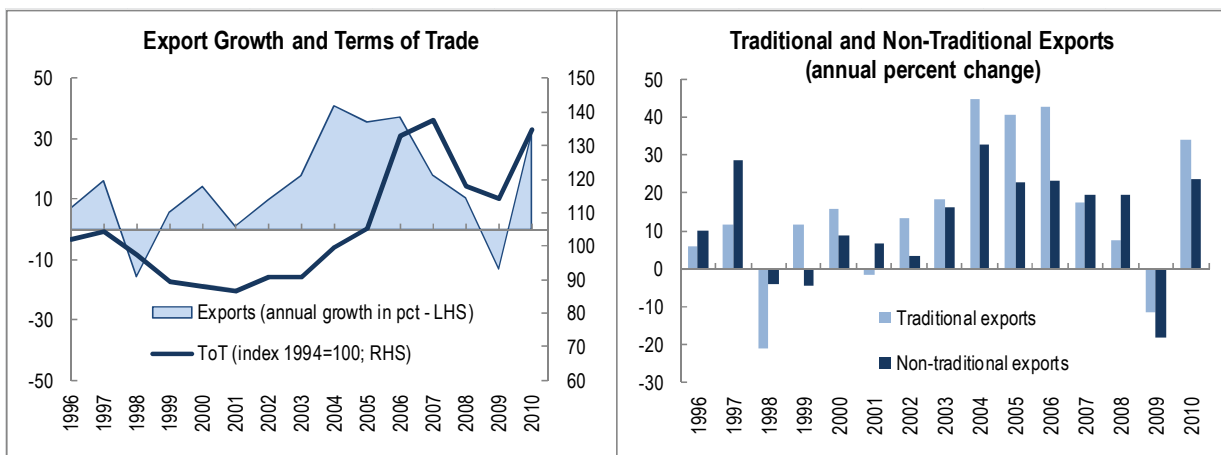
Figure 2: Contributions to real GDP growth



Source: BCRP and author's calculations.

As of 2002, Peru benefited from a favorable external environment, characterized by a growing external demand for Peruvian products, coupled with a prolonged period of persistent improvements in its terms of trade that provided the grounds for considerable export growth. Between 2002 and 2009, Peruvian exports grew at an average rate of 18.3 percent per year. This was supported by an increase in both traditional and non-traditional exports, as illustrated by Figure 3.

Figure 3: Export growth, traditional and non-traditional exports, and terms of trade



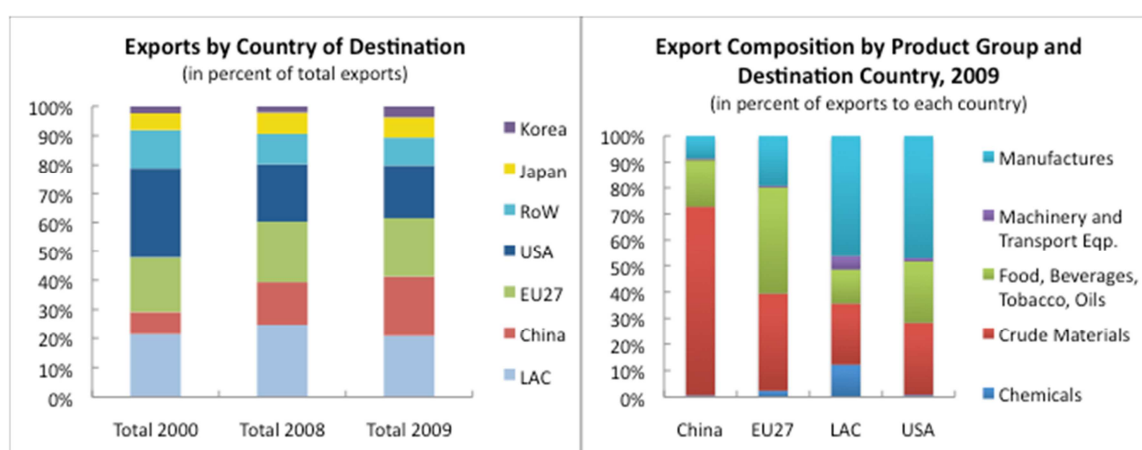
Source: BCRP and author's calculations.

The evident decline in exports experienced during the 2009 global crisis was due to both a fall in external demand for Peruvian products along with a crash in international prices of Peruvian exports, illustrated by the steep drop in terms of trade. The recession experienced in the United States led to a 29 percent annual fall in Peru's exports to that

market. Exports to the EU and Latin America were similarly impacted, while exports to China and Korea continued to grow, albeit at a slower pace.

In terms of major trading partners, Peru has a relatively diversified export portfolio, illustrated in Figure 4. Among the most important destinations for Peruvian exports are China, the United States, the European Union and Latin America and the Caribbean, with other Asian countries such as Japan and Korea also playing a relatively important role. According to the World Bank's export market destination concentration index, concentration has declined over the period 2000-2009.⁵ This has been due in part to a decrease in the share of exports destined to the USA, in favor for exports to China and the EU. Although this, in theory, can contribute to reduce the vulnerability of Peruvian exports to external shock (such as a fall in demand from one of its major partners), it must be taken with a grain of salt. The increase in exports to China seem to be led mainly by an increase in exports of crude materials, which, as will be shown in the following section, has contributed to the concentration of exports according to product sphere and may lead to other vulnerabilities.

Figure 4: Export diversification by country of destination



Source: UNCOMTRADE and author's calculations.

Source. UN COMTRADE and author's calculations.

As a commodity exporter, Peru greatly profited from the surge in commodity prices that occurred prior to the global downturn. Its traditional exports, dominated by precious metals and other mining products, grew at rates of over 40 percent per year between 2004 and 2006, increasing their share in traditional exports from about 70 percent in 2002 to a peak of over 80 percent in 2008 Figure 5.⁶ Exports of oil and oil products grew continuously and very rapidly as well, more than doubling their value in just one year⁷ and continuing to

⁵ The export market destination concentration index reflects the Herfindahl-Hirschmann index measure of the degree of export market concentration of a country. This index is a common measure of market concentration. It is defined as the sum of the squares of the market share of each firm in the total market.

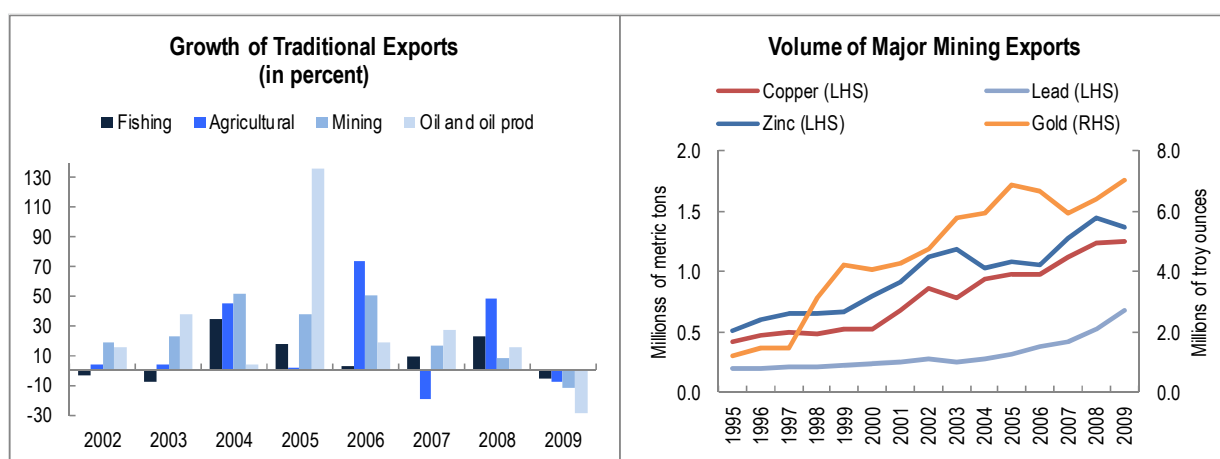
⁶ Among the most important mining products are copper, gold and zinc, which altogether account for over 60 percent of traditional exports.

⁷ Exports of oil and oil products increased from US\$ 646 million in 2004 to US\$ 1,525.6 million in 2005.

grow thereafter. Increasing world demand for metals and oil, combined with the surge in prices leading up to 2008, contributed to the dominance of these two export categories over other exports. In fact, much of the perceived growth is explained by the dramatic surge in prices of these products. When analyzed in terms of volume, the growth in mining exports is much more moderate. For example, exports of copper, gold, and zinc, which are among Peru's most important mining export products, grew in volume terms at an average annual rate of 7.8, 6.3, and 5.1 percent respectively. This, along with the overall low employment intensity of mining, would partly explain why growth didn't translate into many new jobs.

Traditional fishing and agricultural exports also grew during the period of analysis, albeit at a notably lower rate. Fishing exports averaged 8 percent annual growth, while traditional agricultural exports, grew at 15 percent per year in the same period, but presented a more volatile behavior where typically a year of high export growth was followed by a sharp deceleration. By the end of 2009, traditional fishing and agricultural exports accounted for just over 11 percent of traditional Peruvian exports, down from over 20 percent at the beginning of the decade.⁸

Figure 5: Traditional and major mining exports



Source: BCRP and author's calculations.

Non-traditional exports also fared relatively well during the period of analysis, growing at an average rate of 14 percent per annum. Particularly notable performers among this group were non-traditional agricultural products and chemicals, which posted average annual growth rates of 20 percent and 17 percent, respectively. Textiles, which are another important non-traditional export, increased at an average rate of 11 percent per year, explained mostly by the growth of clothing and apparel exports.

When compared to the pattern of world trade, the performance of Peruvian exports surpassed the expansion of the world market. On average its exports grew faster than world markets for the same products, which implies that Peru managed to increase its world

⁸ In 2002, traditional fishing products accounted for 16.6 percent of traditional exports, whereas agricultural exports represented 4 percent. By 2009, fishing exports had fallen to 8.2 percent and agricultural exports to 3.1 percent of traditional exports.

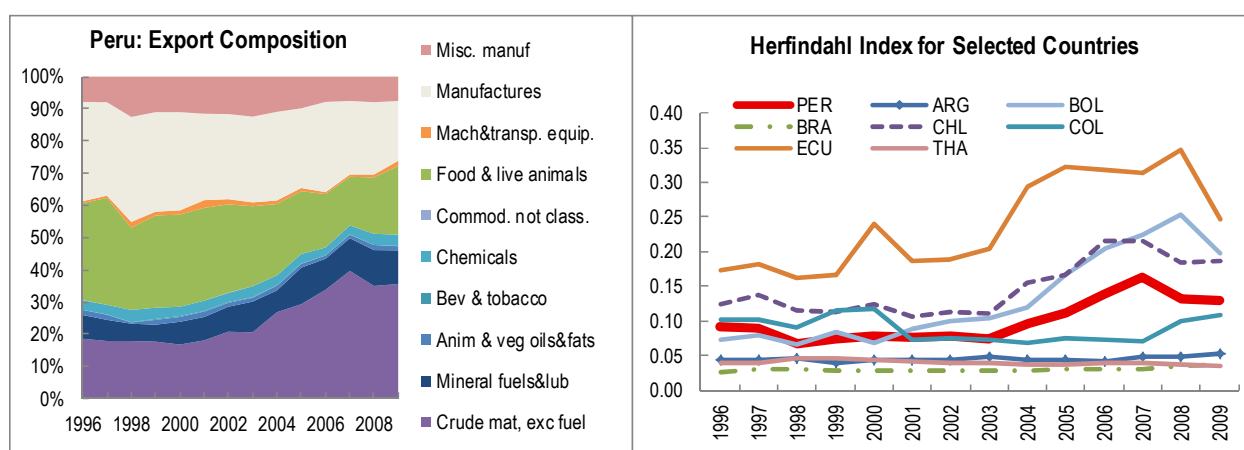
market share of key exports. This suggests that export growth was driven not only by favorable market conditions but also by increases in competitiveness.

Nonetheless, there have been significant differences between sectors. For example, Peru's traditional exports, and more specifically, exports of minerals and crude materials have grown mostly due to a dramatic price boom, but in terms of volume, increases have not been as marked. On the contrary, exports of a few non-traditional agro-industrial products more than tripled between 2002 and 2008, reaching a peak of US\$ 1.9 billion the latter year. Among these are asparagus, which are exported fresh, frozen or in preserves, and have contributed to the development of non-primary manufacturing. These non-traditional exports, however, do not account for the big chunk of Peruvian exports. In the long run, export growth that is based on productivity gains are a key factor for sustainable economic growth combined with the sustainable generation of decent employment.

Furthermore, Peru made little use of the favorable external environment to further diversify its export base. In terms of composition of exports, crude materials have increased their share considerably since 2002, whereas other more labor-intensive products such as manufactures have lost relative ground. In fact, the Herfindahl-Hirschman index, a common measure of export concentration, suggests that between 2002 and 2009, export concentration increased.⁹

As illustrated in Figure 6, export concentration showed a marked increase between 2004 and 2007, corresponding to the large part of the economic boom in Peru. This is explained entirely by the overwhelming growth in exports of crude materials and mineral fuels, which noticeably increased their participation in total Peruvian exports.

Figure 6: Export composition by product groups and export concentration



⁹ Herfindahl-Hirschman Index (H Index) is a common measure of market concentration. It is defined as the sum of the squares of the market share of each firm in the total market. For the purpose of this study, the H Index takes the shares of each export sector in total exports. The H Index ranges between 0 and 1, where 1 denotes higher concentration.

Source: UNCOMTRADE, calculated at the 3 digit level of the SITC classification system.

The growth of exports of mineral products is not a problem per se; however, the clear dominance of exports of capital-intensive goods such as these can limit the capacity for greater employment generation in the context of an economic boom, such as the one recently experienced by Peru. According to Hausmann and Klinger (2008), spells of economic growth in Peru have been closely tied to positive terms of trade shocks and, similarly, growth collapses have occurred along with a deterioration of the terms of trade. Dominated by mining and hydrocarbons, Peruvian exports are highly capital intensive and generate relatively few jobs. In addition, the predominant export sectors tend to generate employment in rural areas when in fact the Peruvian labor force has become increasingly urban. For the authors it is very clear that: “Peru’s current export package, is very capital intensive and generates few jobs, especially in urban areas where the bulk of the labor force is now located. This limits the welfare benefits of the current growth path.”¹⁰ They add that: “the social impact of the current growth spurt has been muted because the leading sectors have been capital intensive.”¹¹

GDP Growth by Sector

At a sectoral level, GDP growth has been bolstered by the services sector, which accounts for more than half of total GDP and has grown steadily at an average annual rate of 6.1 percent between 2002 and 2009 (Figure 7).¹² Within the services sector, the key contributors to growth have been commerce and other services, which groups together financial and insurance services, housing rent, and services provided to firms and households. Commerce has accounted for close to 15 percent of total GDP and averaged an annual growth rate of 6.4 percent during the period of analysis. Commerce consistently grew at rates higher than total GDP until 2008; however, it was impacted noticeably by the crisis.¹³ Other services have constituted more than one fifth of total GDP and have grown at a solid 5.5 percent per year on average. Growth in this sector has been driven mainly by financial and insurance services, in particular increased banking activity due to an overall expansion of credit.

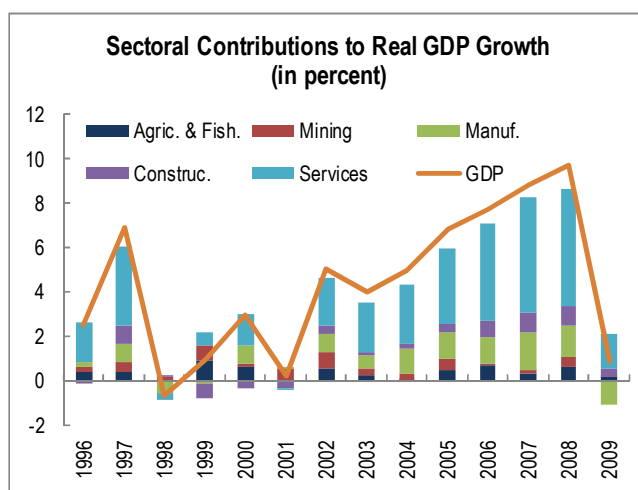
¹⁰ Hausmann and Klinger (2008).

¹¹ Hausmann and Klinger (2008).

¹² Includes commerce, transport and communication, electricity and water services, restaurants and hotels, government services and other services. The aggregation was conducted in this manner to ensure comparability with employment data by sector.

¹³ In 2009, commerce declined by 0.3 percent, contributing to the overall slowdown in GDP.

Figure 7: Contribution of sectors to real GDP growth



Source: BCRP and author's calculations.

Other important contributors to GDP growth have been manufacturing and construction. Manufacturing has played an increasingly important role, in part because it has a relatively large weight in total GDP (accounting for 15 percent on average) and because it grew steadily until 2008.¹⁴ Construction has also increasingly contributed to GDP growth, in particular due to its accelerated growth throughout 2005 to 2008. Growth of the construction sector reflected the economy's greater internal dynamism, which in turn led to a strong demand for housing, greater public investment in infrastructure projects as well as higher private investment in construction.

On the contrary, both agriculture and fishing and the mining sectors, have shown more volatile behavior and, on average, have grown at a slower pace than total GDP. Agriculture and fishing, which have accounted for almost 9 percent of total GDP, grew at very variable rates and often underperformed. Mining has had a slightly lower share of GDP, averaging around 6 percent throughout the period of analysis, and has also often grown at a noticeably slower pace than total GDP. This is particularly interesting considering that, as we can see in the table below, more than a third of private investment between 2007 and 2009 has been destined to projects in mining and hydrocarbons.

¹⁴ Prior to 2009, manufacturing averaged 7.4 percent annual real growth between 2002 and 2008. However, it was strongly affected by the global downturn, contracting by 7.2 percent in 2009.

Table 1: Main private investment projects (in millions of USD and in percent), 2007-2009

	Main Private Investment Projects					
	2007		2008		2009	
	mns of USD	% of Total	mns of USD	% of Total	mns of USD	% of Total
Agriculture	164	3.5	293	4.0	145	2.0
Fishing	225	4.7	84	1.2	84	1.1
Mining & hydrocarbons	1,617	34.0	2,775	38.1	2,918	39.7
Manufacture	1,168	24.6	1,301	17.9	1,002	13.6
Electricity, gas, & water	310	6.5	829	11.4	918	12.5
Construction	96	2.0	615	8.5	793	10.8
Commerce	487	10.3	517	7.1	447	6.1
Transport & Other Services	636	13.4	800	11.0	996	13.6
Other Services	48	1.0	60	0.8	38	0.5
Total	4,750	100.0	7,274	100.0	7,341	100.0

Source: BCRP, Annual Reports 2007, 2008 and 2009.

Employment Intensity of Growth

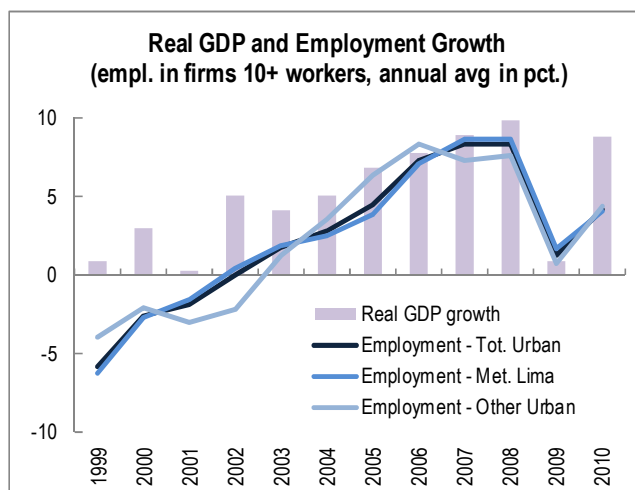
The 2002-2008 period of persistent economic growth in Peru was accompanied by a sustained increase in employment. In fact, it is remarkable how employment growth mimicked the pattern of GDP growth starting in 2002. Total urban employment enjoyed positive and increasing growth rates from mid 2002 until the onset of the global financial crisis, where it began to decelerate, but remained positive. During this period, employment increased at an average annual rate of 4.2 percent. The same trend was observed in Metropolitan Lima and other urban areas, as illustrated in Figure 8.¹⁵

It is worthy to note that this has not always been the case and that previous economic growth spurts had not necessarily led to increases in employment. Between 1999 and 2001, employment had fallen at an average annual rate of 3.5 percent despite positive real GDP growth rates.¹⁶ The protracted contraction of employment observed between 1998 and 2001 is striking and although it is true that during this period Peru had struggled with a series of external shocks combined with political uncertainty in the lead up to the 2000 elections, the contrast in the response to the most recent crisis may offer clues as to how policies can support employment in times of a weakened economy.

¹⁵ Corresponds to total urban employment in Peru, based on data of firms with 10 or more workers. Employment in Metropolitan Lima grew by 4.3 percent per year on average. Other urban employment increased at an average annual rate of 4.0 percent. Indicators provided by the Ministry of Labor (Ministerio de Trabajo y Promoción de Empleo, Dirección Nacional de Promoción del Empleo y Formación Profesional).

¹⁶ Corresponds to total urban employment in Peru, based on data of firms with 10 or more workers. Indicators provided by the Ministry of Labor (Ministerio de Trabajo y Promoción de Empleo, Dirección Nacional de Promoción del Empleo y Formación Profesional).

Figure 8: Real GDP and employment growth



Source: BCRP, Ministry of Labour, and author's calculations.

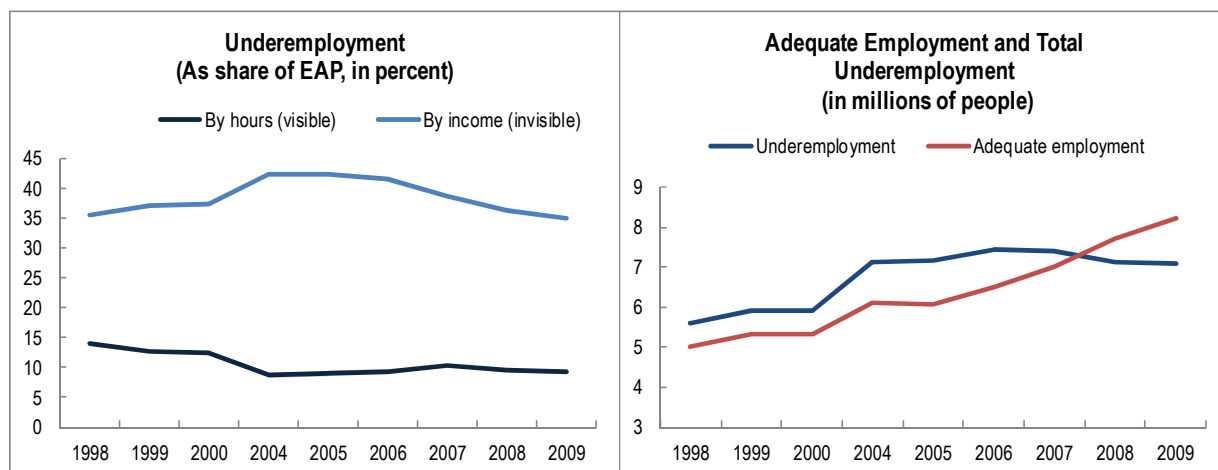
Between 2002 and 2009, employment in Peru increased notably. Total urban employment posted an annual average growth rate of 4.2 percent, allowing it to absorb the growing labour force, which increased by approximately 4 million between 2000 and 2009.

Rising employment rates were accompanied by a decline in underemployment, which fell about 7 percentage points between 2004 and 2009, reaching 44.4 percent of the economically active population in the latter year.¹⁷ Nonetheless, it is worth noting that the decline in underemployment only became notable towards the latter part of the economic boom. Until 2006 no significant reduction in underemployment had been achieved despite several consecutive years of high growth. Furthermore, underemployment by income remained significantly higher than underemployment by hours throughout the period, with the difference between them only narrowing starting in 2006. In 2009, underemployment by income remained 26 percentage points higher than underemployment by hours. Mirroring underemployment, the Peruvian measure for “adequate employment”¹⁸ increased persistently since 1998, surpassing underemployment in 10 years later (Figure 9).

¹⁷ Underemployment in Peru is defined as the workers whose occupation is not adequate quantitatively and qualitatively with respect to certain norms. Two subgroups are considered: Visible underemployment (by hours) refers to those who work less than 35 hours per week, wish to work more and are able to do so; and invisible underemployment (by income), which refers to workers who work for more than 35 hours per week but whose monthly income is below the minimum reference income.

¹⁸ Adequate employment is defined as the workers who are not underemployed by income or by hours.

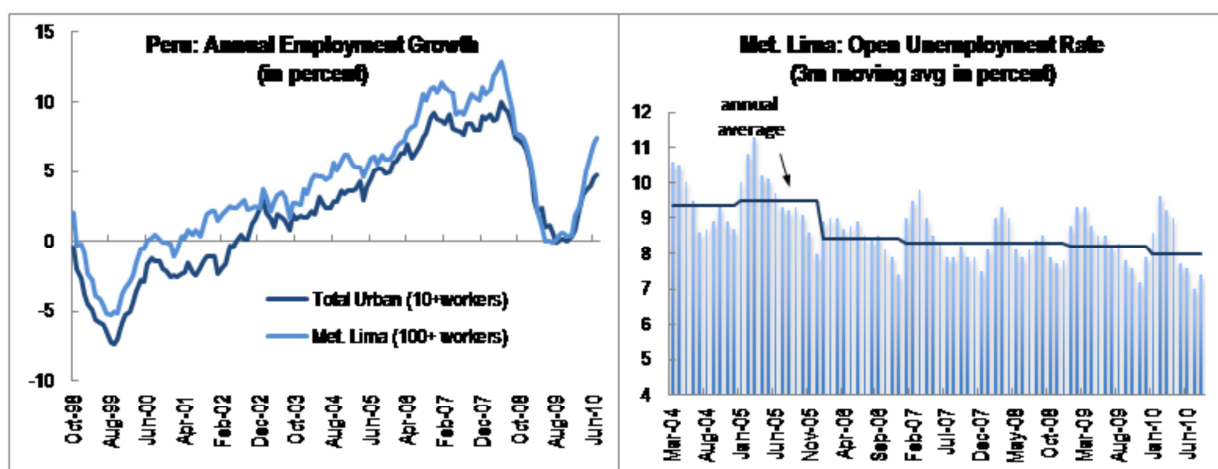
Figure 9: Visible and invisible underemployment



Source: Ministry of Labour and Employment, and author's calculations.

Growth in employment, however, has failed to lead to a significant reduction in open unemployment rates, as seen in Figure 10. Between 2004 and end 2009, unemployment in Metropolitan Lima declined by a meager 1.2 points, reaching 8.2 percent in the latter year. Data for total Peru revealed a similar trend where unemployment fell from 5 to 4 percent in the same period. The fact that there remains a large share of unemployed may be a first sign that Peru's strong economic growth has not yielded maximum benefits.

Figure 10: Employment growth and open unemployment rates



Source: BCRP, INEI and author's calculations.

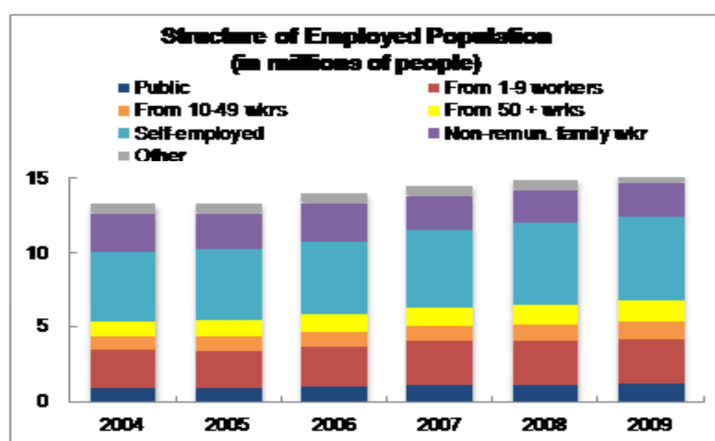
The favorable economic developments encouraged previously inactive people to seek employment, resulting in a rapidly rising labour force participation rate.¹⁹ Between 2005 and 2009, the economically active population increased faster than the working age population every single year. In consequence, the labour force participation rate increased from 71 to 74 percent.²⁰ The increase was particularly notable among women, where over 1 million joined the labour force in these years. All productive sectors enjoyed sustained growth rates throughout the period.

Employment Patterns by Sector

Employment patterns by sector reveal that while some may have benefited from years of economic dynamism, others have remained sluggish, reflecting substantial adjustment processes in the economy that can impose a heavy burden on workers.

First, it is important to understand the market structure of employment in Peru. The majority of jobs is concentrated among small firms or “microenterprises” with fewer than 9 workers per firm and among self-employed workers. In 2009, self-employed or independent workers accounted for 36 percent of the total employed, with microenterprises following with 20 percent. Large firms of 50 or more workers employed about 10 percent of the total. The public sector and medium sized firms are the ones who employ the smallest share, about 7-8 percent each. As Figure 11 illustrates, this structure remained basically unchanged during the economic boom.

Figure 11: Composition of employed population by type of employment



¹⁹ Labour force participation rate is the share of Economically Active Population (EAP) in the Working Age Population (WAP).

²⁰ Furthermore, there is an issue with the employment statistics being produced. In general, data is more easily accessible for Metropolitan Lima, which estimates the economically active population at 4.6 million people and mainly captures the evolution of a part of urban employment. Data for total Peru (both rural and urban), which estimates an EAP of 15 million, is not produced with the frequency, regularity and consistency of Metropolitan Lima. Furthermore, there is a discrepancy in the estimation of the EAP between the national household survey (ENAH0) and the labour survey of approximately 1 million people.

Source: Ministry of Labour and Employment, and author's calculations.

Employment in most sectors had maintained notably high growth rates in the few years leading up to the crisis. Although data from the two main surveys used to provide information on sector employment varies, results from both point towards particularly high growth between 2006 and 2008. According to the household survey, during this period, employment in all sectors increased, with the exception of agriculture, farming and fishing. Among the fastest growing ones were mining (15.5 percent), construction (11.7 percent), industry (7.7 percent), and services (6.5 percent).²¹

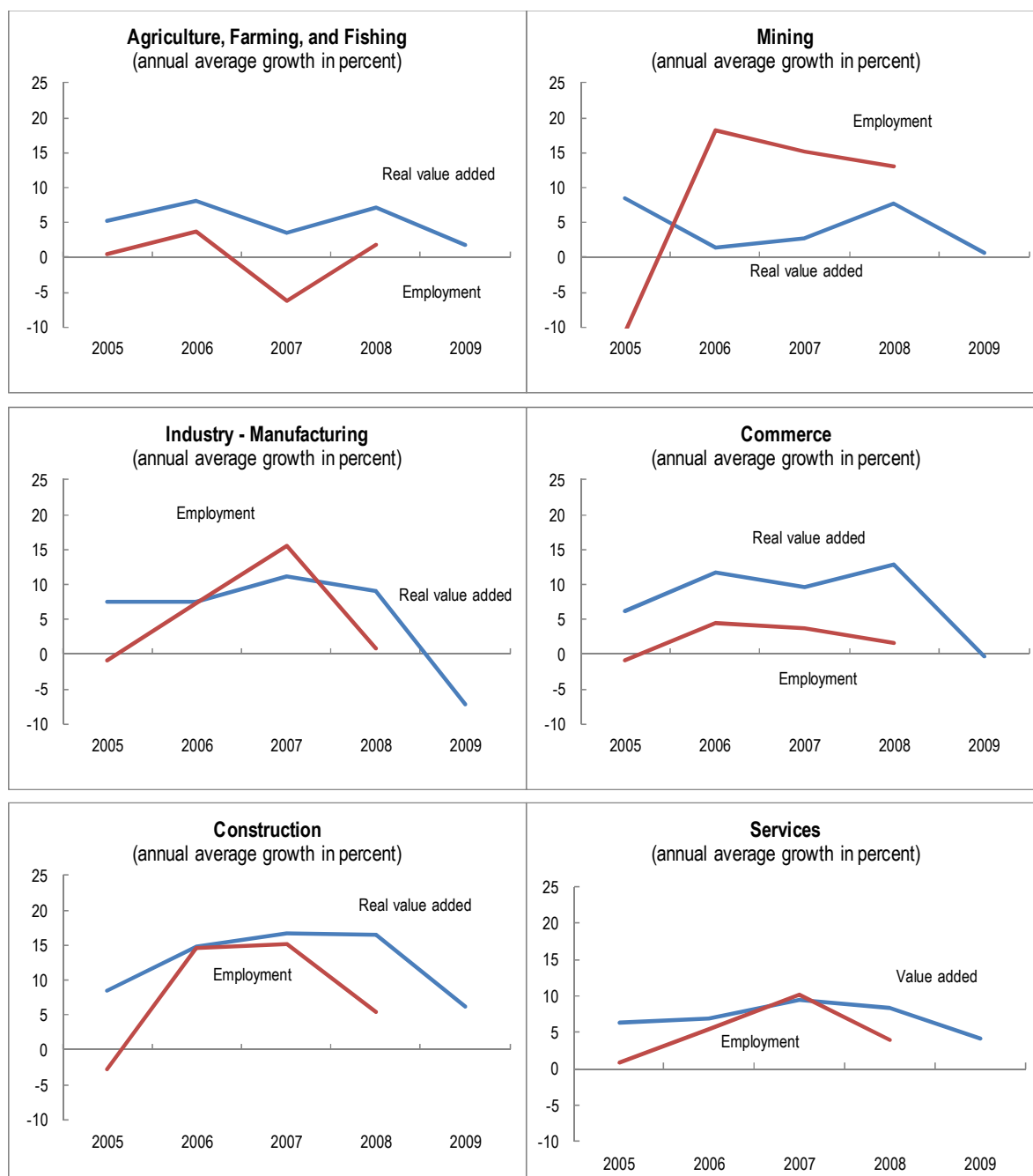
A comparison between GDP growth by sector and employment growth reveals interesting patterns. Most sectors show a coupled behavior where GDP growth is accompanied by a comparable increase in employment. In fact, the only sector where there seems to be a weaker relationship is in mining.²² Nonetheless, the rate of employment growth remained below that of GDP growth in the large part of the period and it was only until 2007 that employment seemed to finally catch up with GDP growth, only to stall in the year of the crisis. Figure 12 below illustrates the relationship between employment growth and value added growth in the major productive sectors.

Perhaps the single most important contributor to overall employment growth has been the services sector. This is due to the fact that the sector itself employs over a third of the labour force and that it has managed to consistently generate jobs throughout the economic boom. Between 2004 and 2008, the number of workers in the services sector increased by close to 1 million people.

²¹ The results from the monthly employment variation survey (*Encuesta Nacional de Variación Mensual del Empleo*), which focuses on firms with 10 or more employees, show higher growth rates than the results based on the household survey (*Encuesta Nacional de Hogares sobre Condiciones de Vida y Pobreza*) that covers households throughout the territory. According to the ENVM, the fastest growing sector was commerce (8.1 percent average annual growth rate) and the slowest was transport, storage and communication (5.7 percent). Data for the household survey is used because the aggregation of sectors allows for a closer comparison with the evolution of GDP.

²² A possible explanation for this is that mining is not very labour intensive. Furthermore, less than 1 percent of the EAP is employed in mining activities.

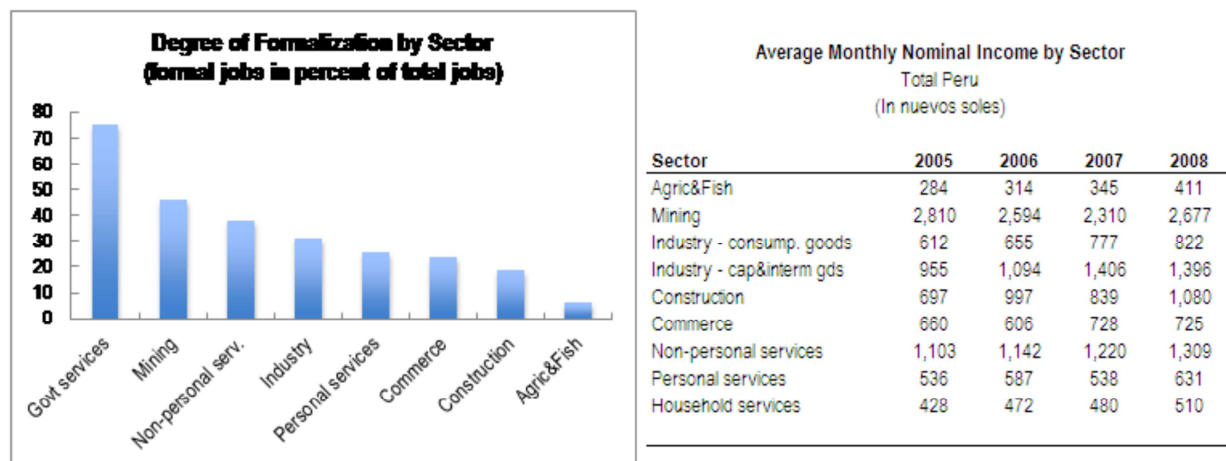
Figure 12: Real value added and employment growth by sector, 2005-2009



Sources: Ministry of Labour and Employment based on ENAHO, BCRP based on National Accounts, and author's calculations.

Within services, employment has increased most in non-personal services, which offer higher average monthly wages and, overall, show a higher degree of formalization (Figure 13). Non-personal services refer mainly to services provided to firms and cover those in electricity, gas and water, transport, storage and communication, financial services and other community and social services, and account for over 60 percent of jobs in services. The average monthly nominal income in this subsector more than doubles income in remaining services (personal and household services), which range from tourism related services to repair services and other domestic activities. According to Chacaltana and Yamada (2009), this subsector has among the highest degrees of formalization of firms. The fact that this sector offers higher incomes for its workers and shows a higher degree of formalization suggests that greater absorption of jobs in non-personal services represents an improvement in the quality of employment.

Figure 13: Degree of formalization and monthly income by sector



Sources: Chacaltana and Yamada (2009) based on ENAHO 05 - 06 iv quarter; income data provided by the Ministry of Labour and Employment based on ENAHO.

Agriculture, farming and fishing also employs approximately one third of the labour force. However, its impact on the generation of employment during the economic boom has been limited. With a much more volatile performance it has not generated many jobs and in 2008 it actually employed fewer workers than it did four years earlier. In fact, data suggests that in the past few years there has been a slight reallocation of workers moving away from agriculture to more urban activities such as industry, construction and the services mentioned above. On one hand this represents a positive development for employment given that workers are moving from a low productivity and volatile sector to more competitive sectors. On the other hand, it is important to bear in mind that this movement can imply high reallocation costs for workers. Additionally, it is unclear whether those who move out of agriculture can quickly be inserted into other sectors. Furthermore, the fact remains that the sector continues to provide employment to a large share of the population. Job shed in this sector has an enormous impact on overall employment numbers and high volatility increases the vulnerability of a large portion of workers. A competitive and productive agricultural sector would have the capacity to generate many jobs and benefit a large share of the labour force.

In this move towards urbanization, industry and construction have also contributed to job creation and to the quality of employment, albeit to a lesser extent than services. Employment growth in both sectors has been impressive (7.7 and 11.7 annual average percent growth, respectively). In absolute terms, this means that in 2008, the industrial sector employed 305 thousand more workers than in 2004, while construction employed 260 thousand more. However, it is important to bear in mind that these sectors are still relatively "small", employing about 10 and 4 percent of the economically active population, respectively.

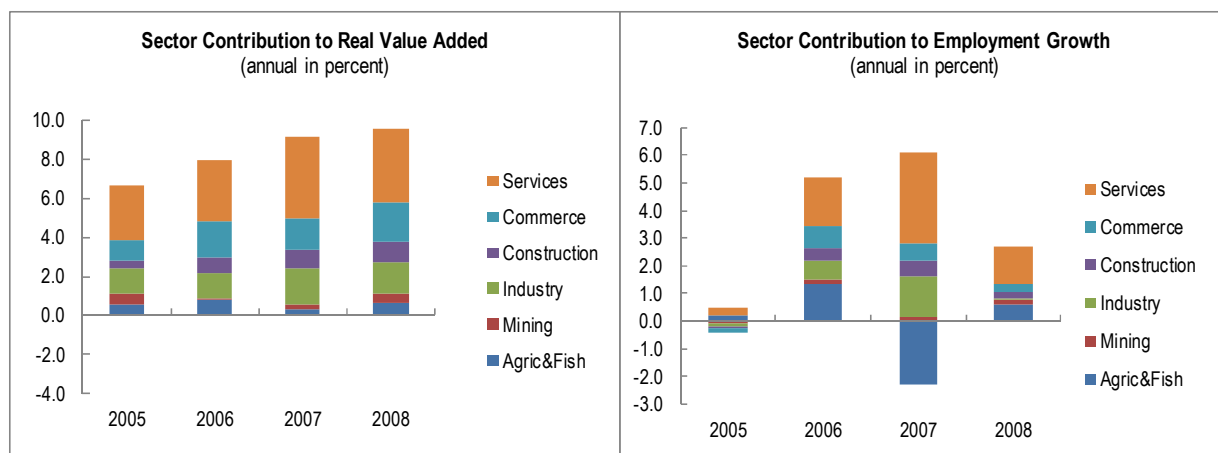
Commerce, which employs a relatively large portion of the population, has played a rather weak role in terms of job generation throughout these years.²³ In absolute terms, the people who are employed in this sector have risen by approximately 200 thousand between 2004 and 2008, but similar to agriculture, the sector has lost share to others. However, this may be seen under a positive light for overall employment patterns. It is possible that workers are choosing to move into other sectors, such as non-personal services, that are growing more rapidly, have a higher degree of formalization, and pay higher nominal monthly wages.

In the case of mining, it is well known that this sector is highly capital intensive and employs a very small share of the economically active population. The pronounced growth in employment of over 15 percent annual average over the past 4 years masks the fact that in absolute terms this has represented at most 60 thousand new jobs. In 2008, mining employed a slightly over 1 percent of the EAP, up from 0.8 percent in 2004. Although it is true that the mining sector has a relatively high degree of formalization and that monthly income in this sector is by far the highest, its capacity to generate employment is rather limited due to its capital-intensive nature (Figure 14). The creation of additional jobs in this sector relies on the large-scale expansion of production, which basically implies the activation of new mines. Nonetheless, there may be some scope for increasing the employment impact of mining if Peru could better exploit linkages with mining-related manufacturing and other activities.

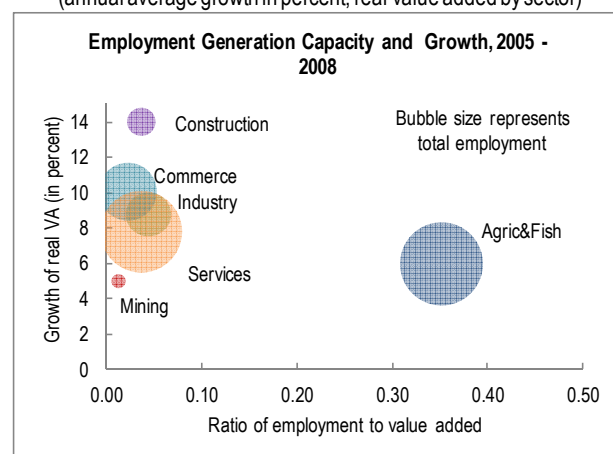
²³ Commerce includes wholesale and retail trade. For this specific sector, the data between the ENAHO and the EMVE results differs considerably. In the EMVE, this sector grows much more rapidly, at an average annual rate of 8 percent. The survey data used for the analysis presented in this study shows a much more moderate average annual increase of 3.2 percent.

Figure 14: Contributions to value added and employment growth by sector, and employment generation capacity

Sectoral contributions to Real GDP Growth and Employment Growth
(annual average growth in percent; real value added by sector)



Employment Generation Capacity, 2005-2008
(annual average growth in percent; real value added by sector)



Sources: Ministry of Labour and Employment based on ENAHO, BCRP based on National Accounts, and author's calculations.

The evolution of employment in Peru shows important positive developments but also points towards marked vulnerabilities. On one hand there has been a reallocation towards more urban activities in more competitive sectors that pay higher wages, that have room for higher productivity increases, and that offer, on average, a larger share of formal jobs. On the other hand, there remains a large portion of the labour force, which relies on activities such as agriculture and fishing, and commerce that tend to have a lower degree of formalization, offer lower average wages, and provide little chances of growth through productivity increases. Furthermore, in the case of those workers employed in agriculture and fishing, moving to other productive sectors can be very costly, both physically - requiring the worker to move- and in terms of employability, meaning that the skill set required is not necessarily transferable.

Quality of Employment

An additional issue affecting the Peruvian economy is the high level of informality, which was estimated to be close to 68.8 percent in 2007. Informal employment can manifest itself in two ways: as employment in the informal sector, which refers to production units that do not fulfill formal obligations, such as being formally registered as a firm or keeping accounting records; and as informal employment in formal firms, which refers to workers who are employed in a formally registered enterprise but are not covered by labour and/or social protection legislation (i.e. they have no social security).²⁴

Data suggests that the percentage of workers with access to health and/or pension coverage rose during the economic expansion from 33 percent in 2005 to 42.7 percent in 2008, suggesting that there has been a movement towards greater formalization of labour. The increase occurred across the board within the categories of employment, but it was more pronounced among domestic service, as shown in Table 2.

Table 2: Urban employed population with health and/or pension coverage

Urban employed population with health and/or pension coverage (in percent of number of employed in a given category)				
Year	Total	Wage and Salaried Workers	Non-Wage Workers	Domestic Service
2005	33.0	48.3	16.8	10.6
2006	40.7	58.5	21.1	17.3
2007	37.0	52.4	20.0	18.2
2008	42.7	57.2	25.2	21.5

Source: Labour Overview 2009: Latin America and the Caribbean, ILO.

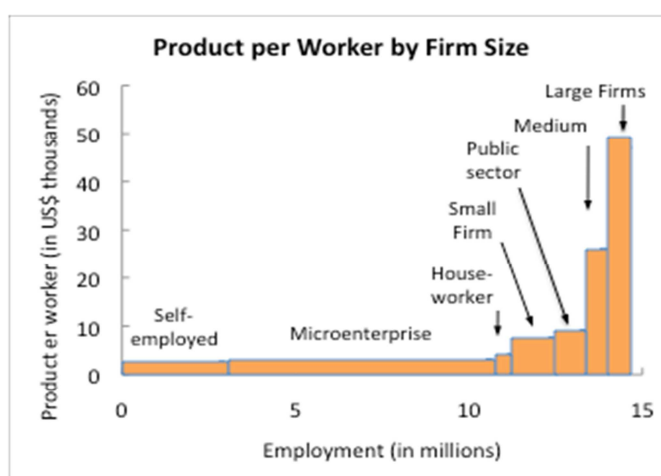
However, several concerns remain regarding the trend towards formalization of labour. First, the level of employed population with one form or other of social security is quite low, regardless of the increase in recent years. This is particularly noticeable among non-wage workers and domestic service. Second, the sample covering only urban employed population does not allow us to disentangle what this signifies for informality as a whole and it remains unclear whether Peru managed to effectively translate the recent and sustained growth in employment into a higher degree of formalization of the economy.

Chacaltana and Yamada (2009) find that the larger share of informality is concentrated in non-professional self-employed workers and in microenterprises. According to the authors, microenterprises (those with 2 to 9 workers) have the lowest degree of formalization, and this remained as such between 2001 and 2006. In 2006, they found that only 9.9 percent of microenterprises provided formal jobs, followed by 16 percent of “unipersonal” or self-employed. They also find that the level of formalization tends to increase with the size of the firm.

²⁴ ILO (2009), Labour Overview 2009, p. 50.

The fact that informality is significantly higher among the self-employed and in microenterprises is particularly worrisome considering that an important share of the employed population in Peru works in these sectors. According to a study by the Ministry of Labor and Employment, in 2008 non-professional self-employed workers accounted for approximately 26 percent of the total employed in Metropolitan Lima. Those employed in microenterprises accounted for 21 percent of the total employed. The study points out that in the informal sector wages are typically lower than in the formal sector and that the working conditions are inferior in quality. The workers usually labor in small production units in which the assets that they work with are not clearly separated from where they live. They may provide low-skill independent services under far from ideal conditions and often, receive no income at all, as is the case with non-remunerated family workers.²⁵ Moreover, productivity is typically lower among the self-employed and microenterprises, as illustrated in Figure 15.

Figure 15: Labour productivity by firm size



Source: Chacaltana and Yamada (2009).

Chacaltana and Yamada (2009) also point out that the pronounced growth in employment registered between 2001 and 2006 has meant an increase in employment in the formal and informal economy. Estimates suggest that for each formal job created by large firms, one informal job is created on par. Furthermore, given that jobs in small firms have a high component of informality, the authors conclude that the spectacular recent growth in employment has been accompanied by a rise in informal employment.²⁶ Moreover, they find that the degree of formalization has remained the same in general, except for the case of private firms with 10 or more employees, where formalization has increased slightly. The authors point to the inability to generate high quality jobs as one of the major challenges for the Peruvian economy.

In addition, the deceleration of employment growth during the global crisis in 2009 had a negative impact on formal employment mainly due to an increase in employment in the

²⁵ Ministerio de Trabajo y Empleo, (2008), Informe Anual del Empleo, 2008.

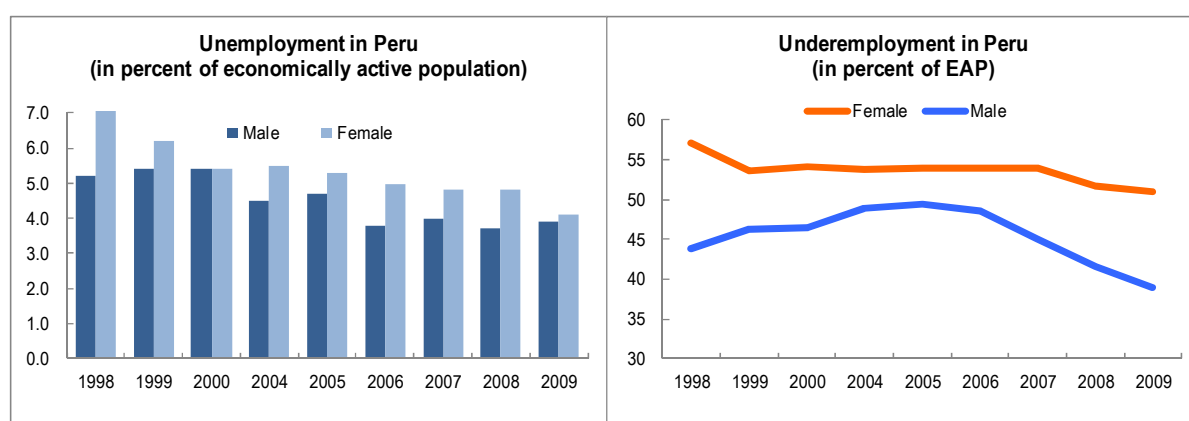
²⁶ Chacaltana and Yamada (2009).

informal sector. The Labour Overview 2009 points out that the crisis was accompanied by a decline in demand for wage and salaried employment. This in turn contributed to an expansion in employment in informal firms rather than an increase in informal jobs in the formal sector.

Women have benefitted noticeably from the prolonged period of economic growth, Not only did they increase their labour participation rate, but their rate of employment increased faster than that of the male population. In other words, not only were more women joining the labour force, more women were also being employed.

Despite improvements observed during the upward economic cycle, women continue to face higher unemployment levels than men. In Metropolitan Lima, female unemployment is on average approximately 3 percent higher than male unemployment. In total Peru, the difference is somewhat smaller, but the same trend is observed. In addition, women also face higher underemployment and are more likely to not be covered by health care or pensions. Figure 16 illustrates the differences in open unemployment rates between men and women as well as the evolution of underemployment during the economic boom. It is interesting to note that although underemployment declined for both men and women, the fall in male underemployment rates was considerably more pronounced. Table 3 below presents a summary of main employment indicators according to gender.

Figure 16: Unemployment and underemployment by gender



Source: Ministry of Labour and Employment, and author's calculations.

Table 3: Total Peru summary of employment statistics by gender (in percent), 2004 - 2009

	2004	2005	2006	2007	2008	2009
Labour force participation rate (EAP / WAP)	71.7	70.5	71.8	73.6	73.7	74.1
Male	81.3	80.5	81.2	82.9	82.9	82.9
Female	62.4	61.0	62.8	64.9	65.0	65.8
Employment rate (Employed / EAP)	68.1	67.0	68.7	70.4	70.6	71.2
Male	77.6	76.7	78.1	79.6	79.9	79.7
Female	59.0	57.7	59.7	61.8	61.9	63.1
Unemployment rate (Unemployed / EAP)	5.0	5.0	4.3	4.4	4.2	4.0
Male	4.5	4.7	4.8	4.0	3.7	3.9
Female	5.5	5.3	5.0	4.8	4.8	4.1
Underemployment (Underemployed / EAP)	51.0	51.4	51.0	49.1	46.1	44.4
Male	48.9	49.4	48.6	45.0	41.6	38.9
Female	53.7	53.9	53.9	54.0	51.6	50.9
Visible underemployment (by hours)	8.7	9.0	9.4	10.4	9.7	9.4
Male	6.7	6.9	7.0	7.5	7.1	6.9
Female	11.0	11.7	12.3	13.8	12.9	12.5
Invisible underemployment (by income)	42.4	42.4	41.6	38.7	36.4	35.0
Male	42.2	42.6	41.5	37.5	34.5	32.0
Female	42.7	42.2	41.7	40.2	38.7	38.4
Adequate employment	44.0	43.6	44.7	46.5	49.7	51.6
Male	46.5	45.8	47.6	51.0	54.7	57.2
Female	40.8	40.8	41.1	41.2	43.6	45.0

Source: Ministry of Labour and Employment

The Impact of the Global Crisis on Employment in Peru

The global economic crisis of 2008/09 did not affect the Peruvian economy as much as it did other countries. Nevertheless, the deceleration in 2009 was notable – Peru grew by a meager 0.9 percent. The country got back on track relatively quickly and authorities expect GDP to bounce back to between 6.8 – 8.0 percent in 2010.²⁷

The sharp deceleration of economic activity in Peru was mainly due to the collapse in global trade and high uncertainty regarding global growth prospects, in particular, that of developed countries that are among Peru's major trading partners such as the US and the European Union. In addition, investment declined substantially throughout 2009, bringing growth down even further. However, contrary to past crisis, consumption did not collapse. Instead, it remained fairly resilient to the downturn, contributing positively to growth. This was possible in part due to a strong fiscal stimulus and sustained employment throughout the crisis.

²⁷ The range corresponds to the forecasts of the Ministry of Economy and Finance (MEF) and the Central Bank (BCRP). The MEF forecasts growth to reach 6.8 percent this year while the BCRP provides a range of 7.5 – 8.0 percent, as established in the August 2010 revision of the Multiannual Macroeconomic Framework (*Marco Macroeconómico Multianual*) prepared by the MEF.

On an aggregate level, employment growth merely decelerated during the crisis. High frequency urban employment data shows an inflection point in November 2009, where employment contracted by 0.1 percent with respect to the same month of the previous year, after which employment continued to grow reaching 4.7 percent in July 2010.²⁸

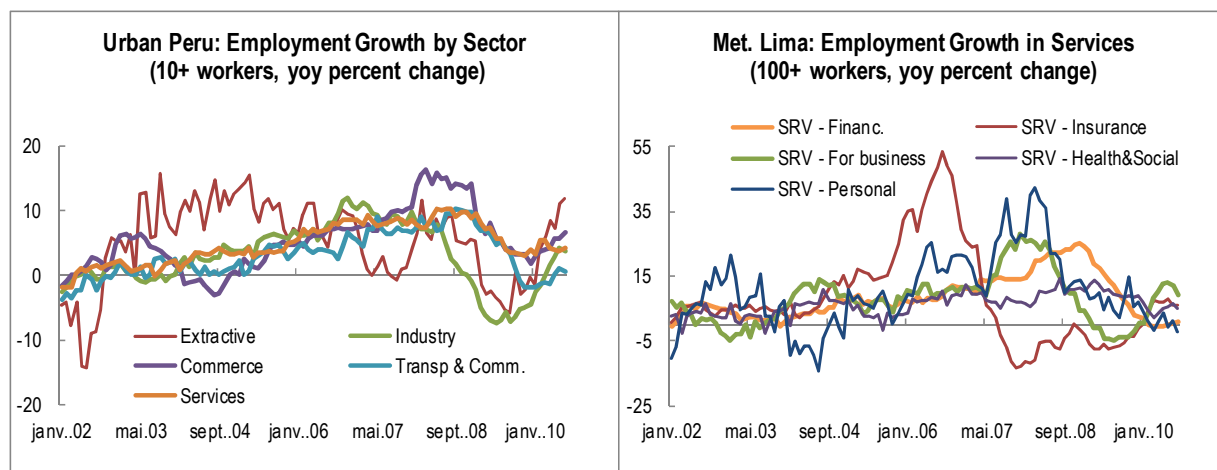
However, the impact on the different sectors has been uneven, with some sectors exhibiting a more volatile behavior and sharper declines in employment. In addition, questions remain regarding the quality of their recovery. It is unclear whether the sectors that absorbed the labour shed during the crisis have provided at least the same quality of jobs in terms of remuneration and formality. The Labour Overview 2009 states that during the crisis employment in informal firms increased due to the fall in demand for salaried employment, but that informal or unprotected jobs in formal firms did not increase. Overall there was a slight increase in informality, which is linked to lower job quality.

During the crisis, employment in the extractive and industrial sectors declined much more markedly than the rest, contracting for periods of 11 and 16 months, respectively. During 2009, employment in urban Peru fell by 1.6 percent in the extractive sector and by 5.7 percent in manufacturing (Figure 17). Data suggests that the labour shed was mainly absorbed by the services and commerce sectors, which continued to grow during the crisis albeit more slowly.

Unfortunately, available data does not allow to fully disentangle which sectors within services were absorbing the labour shed. Information for firms in Metropolitan Lima with 100 or more workers, which cover a fraction of total employment, suggests that the strongest declines within services were among insurance and business services. Financial services continued to grow throughout 2009 but have recently slowed down considerably. Instead, health and social services, personal services, and hotels and restaurants maintained the highest growth during this period. This suggests that employment shifted from formal employment to informal employment. Although this “flexibility” may temporarily shield workers from facing unemployment, it is usually associated with substantial reductions in wages and the quality of employment and may even undermine long run growth as it enlarges the informal share of the economy.

²⁸ July 2010 is the latest available data.

Figure 17: Employment growth by sector and within the services sector



Source: Ministry of Labour and Employment, and author's calculations.

In response to the job shed in the extractive and manufacturing sectors, the government launched a program for “reconversion” of workers called *Programa Especial de Reversión Laboral – Revalora Perú*. The main objective of Revalora Perú was to improve the employability of workers in the context of the crisis. This would contribute to mitigate the effect of the economic downturn on employment by helping relocate workers who were losing their jobs in the affected sectors to sectors that were not being affected. The program was designed to provide three main services: a) training for workers who had lost their jobs in order to help them shift sectors; b) provide information on job opportunities and help link the beneficiaries to firms that required personnel; and c) provide technical assistance for small and medium enterprises in their process of productive reconversion.²⁹ According to the Ministry of Labour and Employment, 45,000 people were trained through the program.

ECLAC’S Social Panorama 2010 points out that “[In Latin America] the data show that despite the economic crisis and the widespread fall in GDP in 2009, there was virtually no increase in poverty rates in the region and indigence rates rose only slightly. Among the contributing factors were the maintenance of real wages thanks to low inflation and policies geared towards preventing massive job losses, along with a slight improvement in the distributive structure of income. The positive trend in access to basic services and education has held.”³⁰

Regardless of the effectiveness of the government program to mitigate the effect of the crisis, or the fact that the crisis had a somewhat limited effect on employment in Peru, the trends described above reveal important issues for the sustainability of long-term growth along with the generation of productive employment and decent work. One of these issues is the high dependence of the Peruvian economy on the export performance of the mining sector. Although this sector does not provide a large number of direct jobs, the fact that its

²⁹ Website of the program: www.revaloraperu.gob.pe

³⁰ ECLAC (2010), Social Panorama of Latin America 2010, p.7.

performance is so closely linked to the terms of trade makes the economy very vulnerable to external shocks. Hausmann and Klinger (2008) point to Peru's lack of structural transformation in face of at least two terms of trade collapses as a long-term binding constraint to growth. Basically, the economy continues to rely on the same export sectors to fuel the economy as the ones in the 70s and 80s. The fact that these are unsophisticated mining and hydrocarbons sectors in which few people are employed limits the capacity of economic growth to translate into a significant number of productive and decent jobs. As Hausmann and Klinger clearly state: "A lack of new export sectors appearing in Peru's aggregate production function is a key drag to growth."³¹

The second issue for sustainability of long-term growth is the high concentration of jobs in sectors that generate little value added such as agriculture and fishing. An increase in labour productivity in agriculture and fishing could have a potentially important and positive effect on the quality of employment in this sector. In fact, the only "new" sector that has contributed to recent economic growth has been non-traditional agricultural exports. More sophisticated agroindustrial products with greater value-added is a welcome step towards upgrading the export package. Data on private investment, however, shows that a rather small portion of resources is destined to this sector. Between 2007 and 2009, agriculture and fishing received 5.5 percent of private investment.

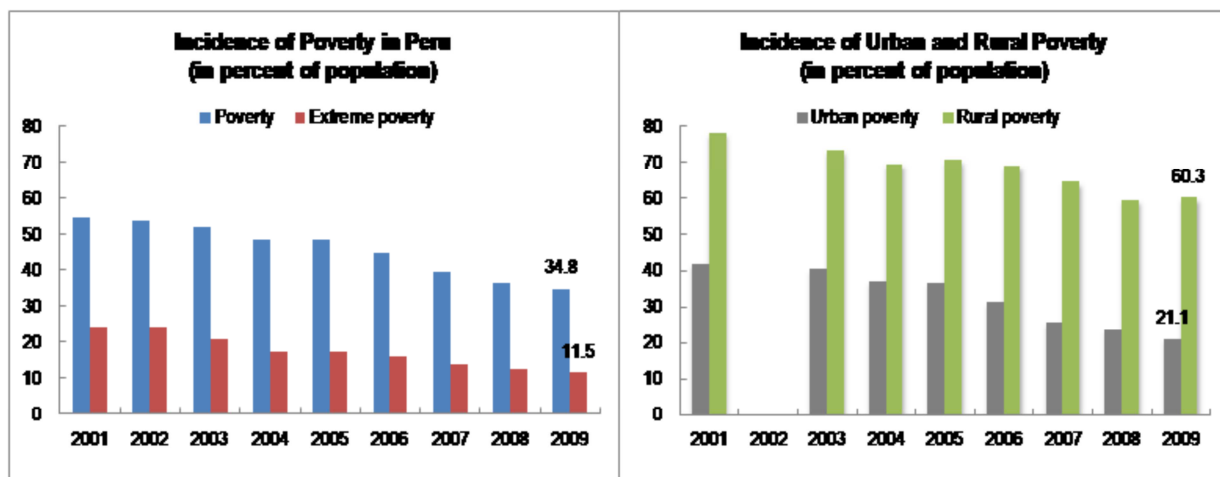
Linking Poverty to Employment

The access to decent work can play a key role in making economic growth conducive to effective poverty reduction. In other words, growth alone may not lead to poverty reduction unless it also serves as an engine of employment that generates greater and more equal opportunities for the population. In this sense, the expansion of the Peruvian labour force coupled with a sustained period of economic growth, a trend towards urbanization and higher formalization of the economy are consistent with the decline in poverty observed in the past decade. The incidence of poverty has fallen from 54.8 percent in 2001 to 34.8 percent in 2009, while extreme poverty fell from 24.4 percent to 11.5 percent in the same period. In addition, greater spending in education and targeted social programs aimed specifically at poverty reduction have contributed to the decline in poverty rates.

The reduction in poverty observed between 2001 and 2009 has occurred across the board, although it has done so at a noticeably faster pace in urban areas (Figure 18). Rural poverty remains very high, particularly in the highlands, where its incidence was at 65.6 percent in 2009 despite the fact that it had declined over the last 5 years. As the 2009 Poverty Report points out, the higher incidence of poverty is closely tied to lower education. In 2009, only 6.8 percent of the total poor had some form of tertiary education, whereas 55.9 percent had only attained primary education at most. This disparity makes evident the importance of continued efforts to invest in education and build human capital.

³¹ Hausmann and Klinger (2008), p. 10.

Figure 18: Incidence of poverty



Source: INEI, Informe Técnico: Evolución de la Pobreza al 2009.

An analysis carried out by the Ministry of Economy and Finance (MEF) finds that there is an important difference in the decomposition of poverty reduction between rural and urban households.³² In rural households, there has been an increase in income but hardly any redistribution. On the contrary, urban households have not only enjoyed an increase in income, but have also benefitted from redistributive effects. The growth elasticity of poverty has been higher in urban areas, thus accelerating poverty reduction in urban areas vis a vis rural areas.³³

Targeted social programs have contributed to the reduction in rural poverty. According to the MEF, targeted public transfers through programs such as JUNTOS have contributed to a 1.3 percentage point decline in rural poverty between 2005 and 2009. However, they conclude that the aggregate effect contributed through the increase in income but not through greater redistribution.³⁴

In addition to the urban/rural divide, there is a noticeable concentration of poverty of the economically active population that is employed in extractive activities. Table 4 below makes evident the relationship between poverty and extreme poverty with the agricultural sector. Although the category includes mining, we have already seen that a very small share of the labour force is employed in mining activities, and that it was agriculture that provided the lowest average income. The high proportion of labour employed in agriculture and fishing is not detached from the high rural poverty rates seen above. On the contrary, it bluntly reveals a challenge for the generation of decent employment and poverty reduction.

³² MEF (2010a), Multiannual Macroeconomic Framework 2011-2013, May 2010.

³³ The study finds that for the period 2003-2009, the impact of redistribution explains 25.5 percent of the reduction in poverty in urban areas, whereas for rural areas redistribution only explains 4.3 percent.

³⁴ MEF (2010a), Multiannual Macroeconomic Framework 2011-2013, May 2010.

Table 4: Employed EAP according to poverty level and activity in 2009 (in percent of total employed population)

Sector	Poverty	Extreme Poverty
Agriculture, Fishing & Mining	61.4	81.2
Manufacturing	7.6	4.5
Construction	3.6	1.7
Commerce	10.7	4.9
Transport & Communication	4.3	1.5
Other Services 1/	12.4	6.3

1/ Includes Restaurants and Hotels, Financial Services, Public Sector, Social and Community Services, etc.

Source: Informe de Pobreza 2009, INEI based on ENAHO.

In addition, there is a distributional effect that is also linked to poverty reduction and growth. Variations in poverty rates are explained by the interaction between the growth effect, which increases average income per person, and changes in how that income is distributed, known as the distributional effect.³⁵ According to the Social Panorama of Latin America 2010, the decline in poverty rates observed in Peru from 2008 to 2009 was due to the growth effect, whereas the distributional effect had a small, but negative impact on poverty reduction. Overall, income inequality has decreased in Peru over the past 10 years, but at the early stages of the economic boom, income inequality (measured with the Gini coefficient) actually increased.

It is important to bear in mind that link between employment and poverty can go both ways. On one hand, more and better employment contributed to the reduction of poverty. On the other hand, lesser poverty -in particular extreme poverty- can contribute to increasing productivity in the long run. As families come out of poverty, children will be better nourished and have greater opportunities to go to school, which in turn raises their human capital, providing for more productive workers. ECLAC states this compellingly as follows: “In a context of unequal access to educational opportunities, the link between education and employment reproduces —and can even worsen— social inequalities. [...] Investing in the capacities and capabilities of the new generations is vital to produce a more productive working-age population for the coming decades, something that will be essential to keep pace with the demographic transition and the steady rise in the proportion of older adults in Latin American and Caribbean societies. It is also important to have a more productive working-age population because of the impetus given to economic growth by the incorporation of know-how and innovation into the production system. Complemented by policies to promote social and employment rights, this is also a positive element for social protection systems.

This being said, it is important to stress that the quality of the generated jobs also plays a key role in poverty reduction. All in all, it is about more and better jobs that provide access to social security, and decent working conditions: “Decent Work involves opportunities for work that is productive and delivers a fair income; security in the workplace and social protection for workers and their families; better prospects for personal development and

³⁵ ECLAC (2010), Social Panorama of Latin America 2010.

social integration; freedom for people to express their concerns, organize and participate in decisions that affect their lives; and equality of opportunity and treatment for all.”³⁶

Wages, inflation and productivity

Wages play a key role for economic development and growth at a microeconomic level through their impact on the household and at a macroeconomic level through their effect on aggregate demand. At the household level, wages can reduce income inequalities, thus contributing to social justice. Workers with low wages are more vulnerable, and in times of economic crises, small reductions in their income can cause large declines in their living standards.³⁷ At the macroeconomic level, wages serve as a tool to stimulate aggregate demand, thus contributing to economic growth. Low wages limit household consumption and can therefore have a negative impact on overall economic growth. Although low-wages relative to productivity may contribute to boost the export sector, if the negative effect on consumption surpasses the positive effect on exports, the net effect can actually depress growth.³⁸

Real wages increased during the economic boom, albeit modestly. Between 2002 and 2008, the nominal minimum vital remuneration (RMV - *remuneración mínima vital*), which serves as a benchmark for workers' wages, increased an average annual rate of 4.3 percent. During this time inflation was maintained at around 2.5 percent on average, implying a real growth in the RMV of approximately 1.8 percent per year.

However, the reported average salaries and wages for non-production workers, and production workers in firms of 10 or more employees in Metropolitan Lima suggests that the increases in real wages did not follow the RMV and were, in fact, considerably lower.³⁹ The real wages of production workers declined between 1997 and 2001 and then increased a meager 0.9 percent annually during the economic boom. By end of 2008 they had barely caught up with levels registered in 1997. Real wage growth of non-production workers was actually negative during this time period. In the public sector, the average real wage of general government employees grew by 0.2 percent per year, on average (Figure 19).

The long-term reduction in inflation played a crucial role for the positive developments in real wages. Between 1985 and 1990, a period in which rampant hyperinflation destroyed the purchasing power of the currency and significantly undermined real wages, inflation averaged close to 2000 percent per year and real wages contracted at an average rate

³⁶ International Labour Organization homepage, accessed on January 27, 2010: <http://www.ilo.org/global/topics/decent-work/lang--en/index.htm>

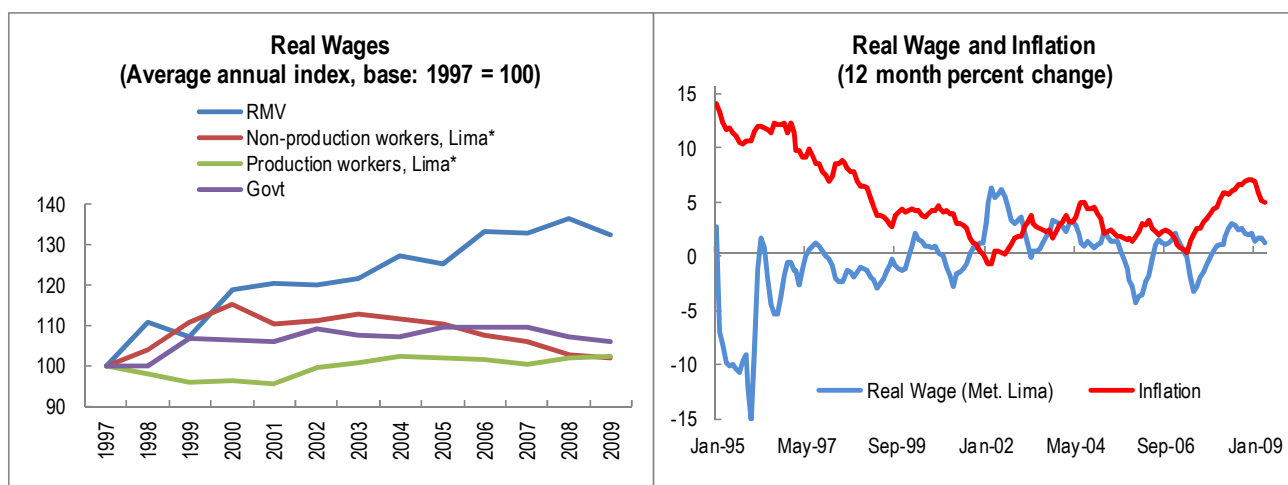
³⁷ Global Wage Report 2010, p. 47.

³⁸ Global Wage Report 2010, p. 48.

³⁹ Statistics on wages are broken down into 3 groups, “production workers” which comprises unskilled labor, “non-production workers” which, according to the Peruvian statistics office, corresponds to high level management positions and skilled employees, and “government employees” which comprises the public sector/general government employees.

between 12 and 20 percent per year!⁴⁰ **Error! Reference source not found.** illustrates how, as inflation rises, real wages tend to decline.

Figure 19: Real wages and inflation



*Data for Lima refers to firms with 10 or more workers in Metropolitan Lima.
Source: INEI and author's calculations

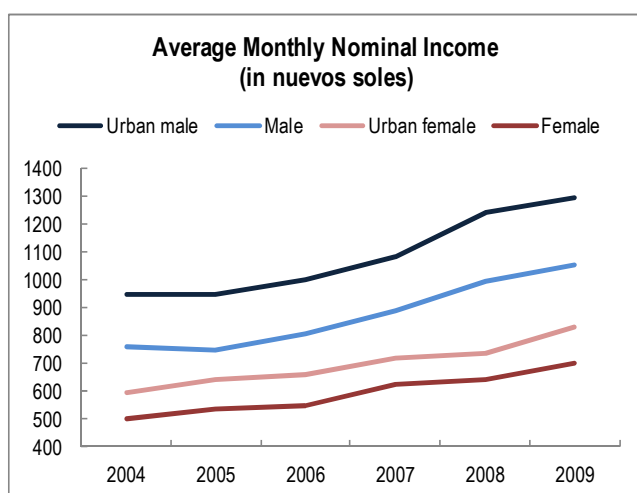
It seems surprising that during a period of sustained economic growth characterized by an increase in labor demand and a notable growth in employment a more significant increase in wages did not follow. A World Bank study suggests that this may have been due to strong demographic pressures that caused a parallel expansion in labor supply, thus allowing for higher employment, but no or little adjustment through wages.⁴¹ Nonetheless, as the Global Wage Report 2010-2011 points out, Peru has managed to decrease its share of low-wage employment over time from about 29 percent in 1995-2000, to 25.5 percent in 2007-2009.

On average, women continue to have lower wages than men. In total Peru (both urban and rural), men's salaries are approximately 33 percent higher than those of women. Little progress was made towards reducing these differences during the high growth years leading up to the crisis, and in fact, the margin actually widened at the peak of the economic boom, as illustrated by Figure 20.

⁴⁰ Real wages of production workers fell at an average annual rate of 12 percent, non-production workers' wages fell at 15 percent per year, and public sector real wages fell at an average of 20 percent per year.

⁴¹ The World Bank (2010), *Beyond Growth: Addressing Peru's Labor Market Bottleneck*.

Figure 20: Monthly nominal income by gender and area of residence



Source: Ministry of Labour and Employment, and INEI.

Minimum wage policy has not been implemented consistently in Peru.⁴² Although a single national minimum wage for the private sector has existed since 1985, its de facto application has been very variable. On one hand, it serves only as a benchmark for wage movements as there is a high level of non-compliance. On the other hand, the minimum wage is highly volatile. Until 2001, the Ministry of Labour and Employment had been in charge of adjusting the minimum wage level. Since then, the *Consejo Nacional de Trabajadores* (CNT– National Labour Council), a tripartite association comprising workers, private sector representatives and the government, has been in charge of determining the minimum wage. The CNT requires that all three parts be in agreement with the adjustment for it to take place. In practice there is no periodic readjustment of the minimum wage and these typically take place very sporadically, often responding to political circumstances. Since 2006, the minimum wage has only been increased twice.

An issue that is closely tied to low wages and represents one of the major challenges for the Peruvian labor market is the characteristically low productivity levels. As Chacaltana and Yamada (2009) point out, the limited capacity of the Peruvian economy to generate high quality jobs is closely related to low productivity levels. In 2008, at the height of the economic boom, nominal GDP per worker was US\$ 8,320, around US\$ 694 per month, out of which salaries and other factors of production must be compensated. As the authors suggest, it is not surprising, then, that average monthly incomes are so low. Furthermore, what is more worrisome is that the average product per worker has increased little in the past 30 years. According to the Chacaltana and Yamada study, two major factors were to blame. On one hand, the low and volatile economic growth vis a vis a rapidly growing labor force. The severe crisis of the 80s and early 90s had a dramatic impact on product per worker and, typically, product per worker takes a long time to recover. On the other hand, the enormous heterogeneity in productivity levels across sectors of production, where, on average, the one with highest productivity is 20 times more productive than the one with lowest productivity.

⁴² See Jaramillo, M. (2005).

This is due to a highly fragmented productive structure with few very productive sectors such as mining coexisting with multiple sectors with very low productivity levels such as subsistence agriculture, as seen in Figure 5.⁴³ ECLAC points to structural heterogeneity as a source of productivity gaps that in turn open up divides in access to labour rights, well-being, fair wages, a political voice, symbolic recognition and information.⁴⁴

Table 5: Product per worker by economic sector, 1961-2006

Sector	1961	1972	1981	1993	2006
Average product per worker	100	142	142	100	114
Mining	482	817	885	871	1197
Electricity	187	475	444	606	970
Industry	176	265	296	187	250
Construction	181	177	215	172	216
Services	221	179	112	112	96
Commerce	n.a.	195	167	76	82
Agriculture	32	45	41	46	57
Most productive / least productive	15	18	22	19	21

Source: Chacaltana and Yamada (2009)

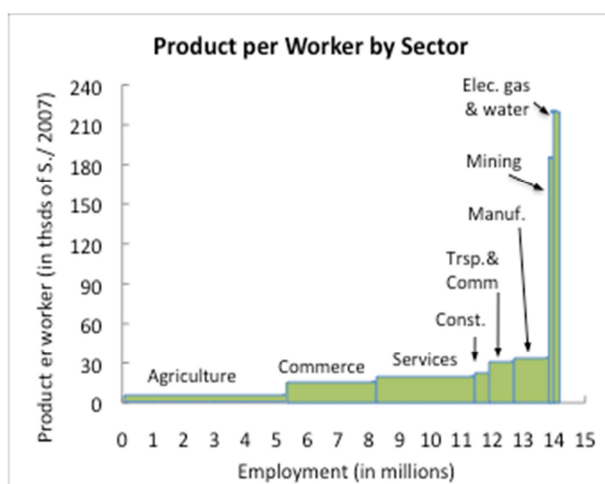
The detrimental effects of very heterogeneous productivity levels are exacerbated by the fact that the sectors that concentrate the most employment coincide with the least productive one, as illustrated by Figure 21. This structure has remained relatively unchanged over time regardless of economic upswings and downturns. In their study, Chacaltana and Yamada find that there is a positive correlation between product per worker and perceived income, and an even stronger one between product per worker and formal employment. In other words, firms in more productive sectors tend to generate more formal employment and offer higher wages, but the difference in wages among between sectors does not fully reflect the differences in productivity. Thus, when growth is led only by the most productive sectors, wages stagnate. In order to counter this, the authors suggest that policies should be geared towards increasing productivity in the sectors that are lagging, promoting mechanisms to articulate the productive activity among sectors linking the most dynamic sectors to the rest, and adopting schemes that link wages and productivity more directly.⁴⁵

⁴³ Chacaltana and Yamada (2009).

⁴⁴ ECLAC (2010).

⁴⁵ Chacaltana and Yamada (2009).

Figure 21: Labour productivity by sector



Source: Chacaltana and Yamada (2009).

2. The Cornerstones of Macroeconomic Policy in Peru

For the past decade, macroeconomic policy guidelines in Peru focused on securing and entrenching macroeconomic stability based on fiscal consolidation, the reduction in public indebtedness, and the maintenance of low inflation within an inflation-targeting framework. Emphasis was also placed on building an adequate stock of international reserves to shield the economy from external shocks, in particular given its high degree of dollarization. Furthermore, policy measures were geared toward strengthening supervision and prudential regulation in the banking system, promoting free trade agreements with strategic trading partners, deepening the capital market, and maintaining a favorable environment for foreign direct investment.

The Peruvian economy underwent substantial reform during the 1990s. During this decade, fiscal consolidation was attained, the debt crisis was ended, interest rates and the exchange rate were liberalized, and hyperinflation was overcome. The economy was liberalized dramatically through a comprehensive reduction in tariff barriers and the pursuit of numerous bilateral trade agreements. In addition, a comprehensive privatization program took place, granting concessions for electricity transmission, the international airport, and ports. Structural reform strengthened the financial system and paved the way for the private sector to take the lead in productive activities.

Since 2002, macroeconomic stability in Peru benefitted from structural reform and prudent management in the context of a favorable external environment. Inflation was kept within the bounds of the inflation-targeting framework, a prudent fiscal policy was adopted and an effective debt reducing strategy was set in place. An IMF staff report released in early 2007 stated that Peru was “reaping the benefits of the sound policies implemented over

the last decade- and-a-half, in the context of a favorable global environment.”⁴⁶ The document further stated that Peru’s performance owed “much to the policy efforts that have advanced fiscal consolidation and built on the structural reforms introduced during the 1990s.” In 2008, Peru was granted investment grade in recognition of the maintenance of low inflation, reduced fiscal risks, and high economic growth, which further enhanced its access to international financial markets. The three major pillars of macroeconomic policy have been fiscal consolidation, control of inflation, and external openness with exchange rate flexibility.

However, economic policies were not strictly limited to achieving macroeconomic targets. The need to generate employment and to work towards alleviating poverty was also openly addressed. In the 2007-2008 Stand-By Arrangement (SBA) with the IMF, the Article IV document stated that one of Peru’s critical medium term challenges is to achieve sustained and strong growth to boost employment and reduce high informality. It also explicitly stated that the country’s program aimed at “entrenching macroeconomic stability through fiscal consolidation, while providing scope for addressing pressing social and infrastructure needs.”⁴⁷

Fiscal consolidation

The resilience of the Peruvian economy to the global crisis owes much to the prudent policies and the adequate macroeconomic management that had been put in place prior to the crisis. In fact, Peru had created the fiscal space that allowed it to implement a stimulus plan amounting to approximately 3.2 percent of GDP in 2009 to better handle the economic downturn. Furthermore, the social protection plans that were already in place prior to the crisis allowed the government to better target vulnerable populations. Persistent fiscal discipline before the crisis gave the government room for targeted social programs that prevented the economy from taking a greater hit and protected, at least to some degree, Peruvian households.

In the fiscal front, reforms over the past years have been aimed at broadening the tax base, eliminating VAT exemptions, and strengthening tax administration while reducing tariff barriers. In addition, a government decentralization law was passed in 2002, creating three levels of government (national, regional and municipal). The reforms intended to decentralize resources and spending responsibilities in a fiscally neutral way, as well as enhance the accountability of government officials and set fiscal rules for regional and municipal governments that were compatible with the rules of the national government.⁴⁸

The Law on Fiscal Responsibility and Transparency (LFRT) has served as an important guideline for policymakers. Its purpose, as stated in its objectives, is to “ensure fiscal equilibrium or surplus in the medium term, accumulating fiscal surpluses in favorable times

⁴⁶ IMF, Peru: Staff Report for the 2006 Article IV Consultation and Request for Stand-By Arrangement, January 2007, p. 5.

⁴⁷ IMF, Peru: Staff Report for the 2006 Article IV Consultation and Request for Stand-By Arrangement, January 2007, p. 11.

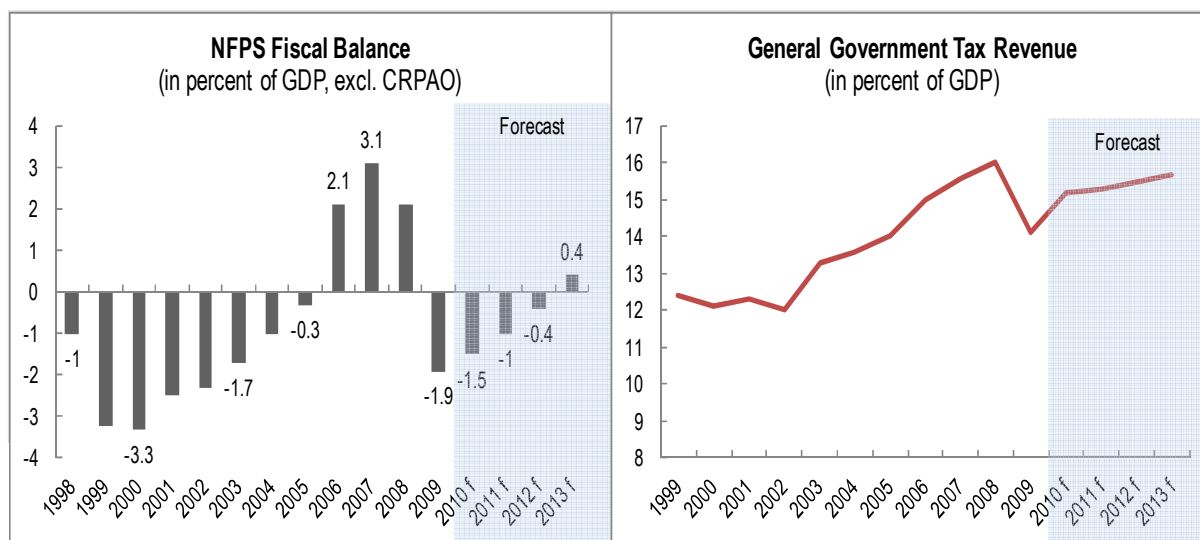
⁴⁸ The process of continued fiscal consolidation has been carried out with the support of 3 IMF Stand-By Arrangement programs since 2002. The last one ended in February of 2009.

and allowing moderate and non-recurrent deficits in periods of lower growth”.⁴⁹ It was first implemented in 1999 yielding positive results. However, the way the law was formulated gave too little flexibility to policy-making. It soon became apparent that the norm served well as a stabilizer for public finances in times of crisis but was not an adequate instrument to manage public finances efficiently in times of economic growth. The LFRT was amended in 2003 to provide for greater flexibility.

The LFRT established a maximum fiscal deficit of 1 percent of GDP for the Non-Financial Public Sector (NFPS) in any given year, placed a 3 percent cap on the annual growth rate of non-financial real expenditure of the general government, and limited the increase in indebtedness of the NFPS to the amount of the fiscal deficit of that year. In addition, it provided an exception for when a national or international crisis threatens economic growth, allowing the fiscal deficit to reach 2.5 percent of GDP, but requiring the government to get back on track as soon as there are indications of economic reactivation and limiting the exception period to a maximum of 3 years.

In practice, the LFRT paved the way for the implementation of countercyclical fiscal policy. In terms of fiscal performance, the Peruvian authorities managed to turn a persistent deficit around, posting fiscal surpluses for 3 consecutive years between 2006 and 2008, as shown in Figure 22. The effects of the law were monitored regularly and by 2006 it became evident that the cap on expenditures had put a brake on public investment. At that point in time, fiscal policy is reoriented towards greater investment. The successful implementation of the LFRT allowed Peru to put into action a comprehensive economic stimulus plan during the 2009 downturn, and thus effectively mitigate the impact of the global financial crisis.

Figure 22: Fiscal balance and tax revenue



Source: MEF, forecasts from Revised Multiannual Macroeconomic Framework, 2011-2013.

⁴⁹ Article 2 of Law 27245 of 1999.

The attainment of the fiscal goals relied heavily on an increase in tax revenue. In the early stages of the economic boom, tax collection was noticeably low in Peru, hovering around 12 percent of GDP. The increase was achieved through several tax reforms that augmented the tax base as well as tax rates, strengthened tax administration and reduced evasion. Between 2002 and 2008, Peru not only benefitted from increased cyclical income related to GDP but more importantly managed to raise its structural income as well. By 2008, tax revenue had reached approximately 16 percent of GDP. Although the crisis negatively affected tax collection, the authorities estimate that they will return to the levels of the boom period by 2013.

However, the current tax regime in Peru is far from ideal and continues to present several problems. On one hand, it has been deemed to have a small but regressive effect on income distribution measured through the Gini coefficient, according to a paper by Cubero and Hollar (2010). The authors find that redistributive impact of the overall tax system tends to be negative, but that social spending (excluding pensions) has a slight progressive effect, making overall fiscal policy progressive. Goñi et al (2008) conduct a similar analysis but they separate the effect of direct and indirect taxes, and include pension payments in social transfers. The authors find that direct taxes (such as income tax) have a small but progressive effect on the Gini coefficient. Indirect taxes (such as VAT), on the other hand, have a noticeably stronger regressive effect on income redistribution. This is also the case when transfers are included (these transfers include pension payments). Overall, they find that fiscal policy has a regressive effect in Peru.⁵⁰ Put simply, the poor are being taxed more heavily than the rich.

On the other hand, tax collection in Peru remains comparatively low. As Goñi et al argue, this can be one of the causes for such a limited progressive (if not regressive) effect of fiscal policy. The comparison with European economies, suggest that higher tax collection would allow for a stronger redistributive impact through greater transfers to the poor. Low tax collection can be due to low rates or a narrow tax base (or high tax evasion). All in all, the tax rates in Peru seem more or less in line with other countries in Latin America. However, it may be worth noting that its corporate income tax (a direct tax which has a potentially progressive effect) is relatively low (27 percent) when compared to countries such as Colombia (38.5 percent), Argentina and Uruguay (35 percent) and Mexico and Brazil (34 percent).⁵¹ In addition, its VAT rate (an indirect tax with potentially high regressive effects) is mostly flat at 19 percent, relatively high compared to the regional average of 15 percent. Furthermore, a key issue for tax collection is tax compliance, which is hindered by a weak administration and high levels of informality. The high level of informality characteristic of the Peruvian economy also contributes to its low tax collection.

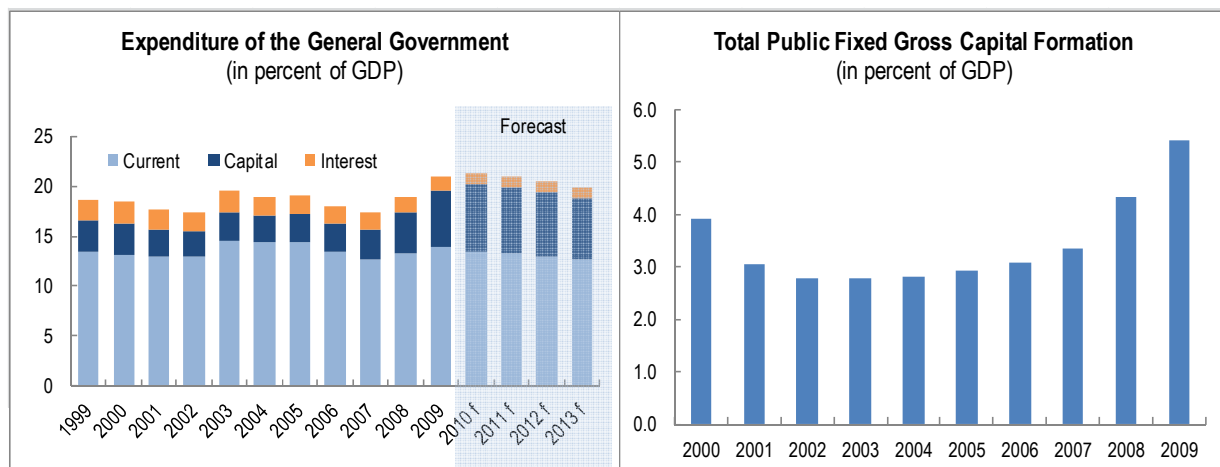
In addition to raising revenues, fiscal authorities were committed to improving the quality and efficiency of public expenditure. General government non-financial expenditures (i.e. excluding interest payments) increased persistently in real terms throughout 2002 to 2009, which served as an important stimulus for aggregate demand. The focus of expenditure during the economic boom, and in particular after 2006, was to increase capital expenditure in order to close infrastructure gaps and raise social investment with an

⁵⁰ Goñi et al, (2008).

⁵¹ Hausmann and Klinger (2008).

emphasis on human capital formation and accumulation. Current expenditure was brought down from 14.6 percent of GDP in 2003 to 13.2 percent in 2008, and in turn space was provided for an increase in investment and social expenditure, within a framework of fiscal prudence. Capital expenditures remained relatively contained up until 2006, after which public investment was prioritized and they began to increase healthily. With the implementation of the fiscal stimulus plan in 2009, capital expenditures rose to 5.7 percent of GDP, up from a low of 2.6 in 2001 (Figure 23).

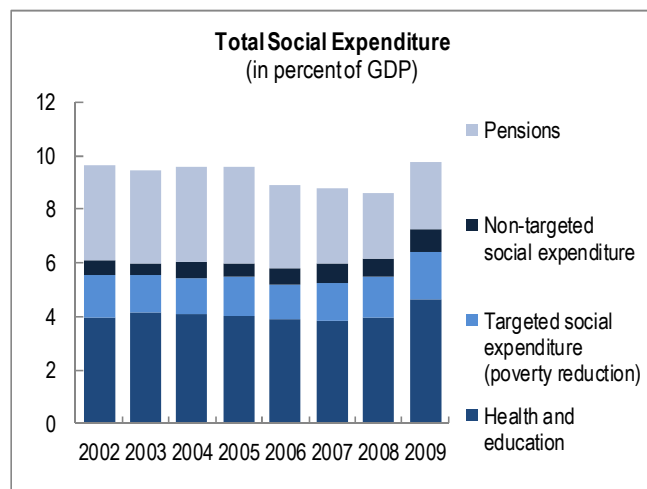
Figure 23: Government expenditure and investment



Sources: MEF, forecasts from Revised Multiannual Macroeconomic Framework, 2011-2013; Central Bank of Peru, and author's calculations.

The impulse in social expenditure was only observed after 2006, where it began to increase moderately as a share of GDP. Before that, the share of social expenditure and its components in GDP had remained roughly unchanged since the beginning of the economic boom, at around 6 percent of GDP (Figure 24). In 2007 and 2008 there was a notable push in spending on targeted poverty reduction programs, in particular through programs for improvement of water and sanitation (*Programa Agua Para Todos*), mother and child nutrition (*Programa Vaso de Leche*), and the expansion of the program of conditional cash transfers to the very poor (*Programa de Apoyo Directo a los Más Pobres – JUNTOS*). Spending on health and education was boosted in 2008 and 2009, reaching 4.6 percent of GDP in the latter year.

Figure 24: Total social expenditure



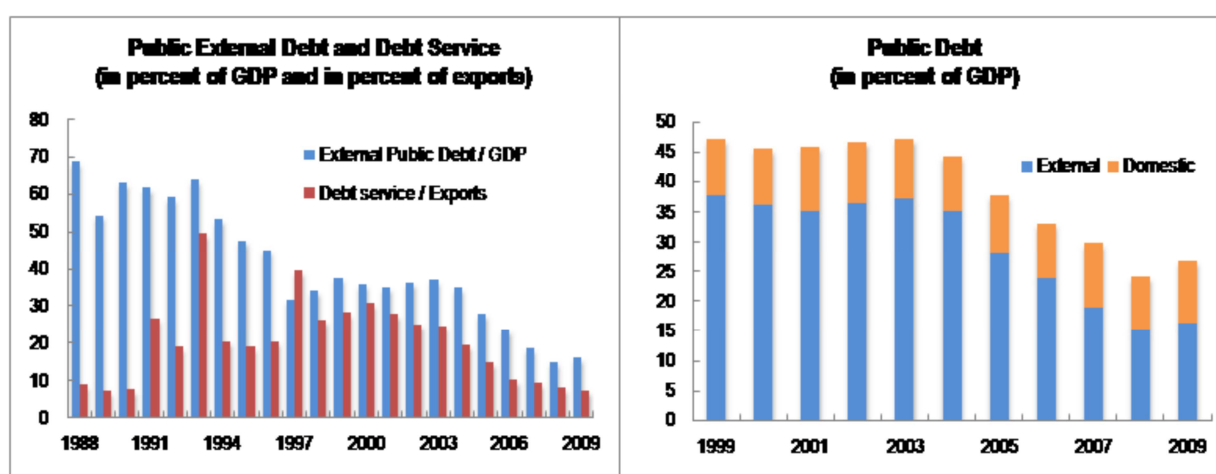
Source: INEI and Ministry of Economy and Finance, author's calculations.

In terms of social expenditure by sector, education, health and social protection account for slightly over 80 percent of total social expenditures (excluding pension payments). The

remaining spending is directed mostly to three sectors, a) transport and communication, which includes roads for rural areas; b) agriculture, which focuses on the productive development of rural agriculture; and c) energy and mineral resources, which is targeted towards providing electricity to rural areas. In 2009, transport and communication projects accounted for 5.4 percent of social spending, agricultural programs followed with 4.7 percent and energy and mineral resource programs accounted for 3 percent. It is worth noting that social spending on agriculture had declined considerably between 2002 and 2005, reaching a low of 2.8 percent of social spending in the latter year. Since then it has recovered, but it was only until 2008 that a unified rural agriculture development program was set up under the name of AGRORURAL.

Debt reduction has also been an important marker of policy in recent years. After experiencing a severe debt crisis in the 1980s and high levels of external debt throughout the early 1990s, Peru has successfully reduced its debt stock. At its peak in 1988, external public debt had reached 69 percent of GDP. By 2008, it was down to 15.1 percent. Along with a decline in stocks followed an important reduction in the cost of servicing external obligations. These accomplishments not only reduce Peru's vulnerability to external shocks, but also free up fiscal space and boost investor confidence. Figure 25 below illustrates the impressive reduction in external public debt levels since the 80s and 90s.

Figure 25: Public debt and debt service



Source: MEF, Central Bank of Peru, and author's calculations.

The authorities have also put efforts into enhancing debt management, improving the structure of public debt and developing the domestic capital market. They have aimed at reducing the share of foreign currency denominated debt in order to reduce their vulnerability to exchange rate changes, and lengthen the maturity profile of public debt. As a consequence, the share of foreign currency denominated debt has fallen by substantially to 60 percent of total public debt in 2009, down from over 90 percent at the beginning of the decade. In addition, the attainment of "investment grade" granted by Fitch and Standard and Poor's in 2008 further enhanced Peru's access to financial markets.

Monetary policy: keeping inflation under control

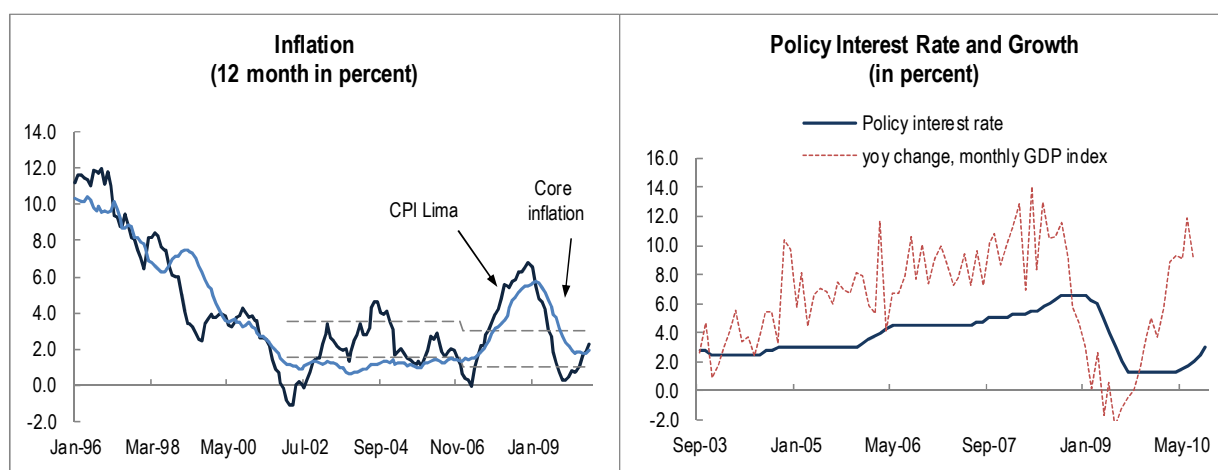
The cornerstone of monetary policy in the past decade has been to maintain low inflation rates, in line with the recommendations of the IMF and as part of a concerted effort to avoid the destructive effects of the rampant hyperinflation experienced in the 1980s and early 1990s. This period had left a strong mark on the population and since then there has been consensus regarding the importance to maintain inflation under control. After a decade of double and triple digit annual inflation rates, in 1991 inflation was finally anchored and gradually brought down from about 410 percent annual average to 11 percent in 1995. In 2002 the authorities implemented the inflation-targeting framework (IT) making control of

inflation the overarching goal of monetary policy. Since then, Peru has maintained single digit inflation rates.

When IT was first implemented, the target was set at 2.5 percent with a range of ± 1 percent. At the beginning of 2007 the target was readjusted to 2 percent, the range was left unchanged. Maintaining price growth within this range would keep Peruvian inflation in line with its major commercial partners and would set a clear signal of stability. Early on in the decade, the IMF raised the question regarding the appropriateness of the target and the rather narrow bands. At the time, the authorities considered that this framework struck the right balance between stability and credibility, that inflation was already low enough to withstand the band, and that the widening of the band could raise questions regarding their commitment to the target. Peru did not face strong inflationary pressures until the onset of the food and fuel price crisis.

In response to the food and fuel global price surge, the authorities tightened monetary conditions, but remained attentive to signs of a global deceleration. As the global environment deteriorated, the authorities began the easing of monetary policy by lowering the policy interest rate and reducing reserve requirements. As the IMF points out in the 2009 Staff Report, the Peruvian authorities were confident that the monetary easing would preserve stable liquidity conditions and protect the economy from a sharp slowdown in domestic demand.⁵² As the crisis deepened, they were able to recur to fiscal easing through the economic stimulus plan.

Figure 26: Inflation, the interest rate and growth



Sources: Central Bank of Peru, IMF Staff Reports and author's calculations.

In addition, Peru has greatly developed its financial system in the past decade focusing on strengthening and deepening it, that is, on increasing the financial services and resources available to the public. Prudential regulation and supervision have been strengthened as well, and are aligned with internationally accepted practices. Peru implemented Basel II

⁵² IMF (2009).

guidelines to ensure financial soundness and minimize risks.⁵³ This permitted a sound increase in credit throughout 2005 – 2009 that has greatly benefitted productive sectors and households.

Direct credit of the financial system to the private sector increased from a trough of 16.8 percent of GDP in 2004 to 27.5 percent of GDP in 2009. As of 2005, the increase in credit to the private sector was seen across the board, with both businesses and consumers benefiting from access to finance. As seen in Figure 27, commercial credit including microenterprises grew at double digit annual rates between late 2005 all the way through to end 2009. Commercial credit including microenterprises represents approximately 70 percent of total credit, followed by consumer credit (18 percent) and mortgages (12 percent). Despite a slowdown in credit observed during the 2009 crisis, loans continued to grow both in nominal and real terms throughout the year and picked up their pace in 2010.

Along with this increase in loans to the private sector, firms have reported that access to finance is not a major constraint to growth. This is particularly interesting and revealing, given that it is a common case among developing countries that access to finance is reported as one of the main obstacles for firms. Both the World Bank Enterprise Survey and the Global Competitiveness Report find that in Peru entrepreneurs consider that access to finance is not among their major concerns. The World Bank Enterprise Survey reveals that 14 percent of Peruvian firms identify access to credit as a major constraint, as opposed to 28 percent that state that this is so in the region, and 30 percent worldwide. In fact, the Global Competitiveness Report considers that Peru ranks well regarding financial market development (42 among 139 economies) and points to availability and affordability of finance and ease of access to loans among the notable competitive advantages of Peru vis a vis other countries.⁵⁴

⁵³ Basel II consists of three major pillars: a) minimum capital requirements, b) a supervisory review process and c) market discipline. The objective of Basel II stated in the Basel II Capital Accord document is to: “develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.”

⁵⁴ Rank for availability of finance is 31, for affordability of finance is 32, and for ease of access to loans is 37 out of 139 economies evaluated. In the overall Global Competitiveness Index, Peru ranks 73 out of 139 economies. See Global Competitiveness Report 2010-2011, World Economic Forum.

Figure 27: Credit to the private sector



Peru has also shown an interest in making sure that access to finance does not concentrate only on the more developed and richer regions of the country. For this, they have supported the development of financial institutions such as the *Cajas Municipales* and *Cajas Rurales* in more remote areas, in an attempt to reach marginalized populations, as well as the Edypymes, which focus on the provision of microcredits. In addition, the *Corporación Financiera de Desarrollo* (COFIDE) is a primarily public bank that channels resources for development. It has been operating as a development bank since 1992. Furthermore, in association with the Interamerican Development Bank (IaDB), the Association of Microfinance Institutions (ASOMIF Peru) and the Peruvian Federation of Municipal Financial Institutions (FEPCMAC) recently launched a project to strengthen microfinance institutions in order to provide mortgage loans to low-income households.

The fruits of the process achieved in recent years with respect to financial development were highlighted during the 2009 global crisis. Banks were prepared to weather the crisis well and financial contagion was limited. During 2009, banks remained well capitalized, liquid and profitable. The Banking Superintendency (SBS - *Superintendencia de Banca, Seguros y AFP*) attributed the small and passing impact of the international crisis on the Peruvian financial sector to the prudential measures in place and the overall soundness of the system.⁵⁵ The institutional framework of the financial system prevented a major credit squeeze during the global crisis without posing a risk to financial soundness.

Monetary policy in recent years seems to have worked well for Peru. Inflation has remained contained amidst increasing credit resources and adequate liquidity. Arguably there could be room for a slightly less constraining inflation target; however, Peruvian authorities have defended a target that maintains inflation on par with that of its major trading partners. Furthermore, given Peru's history of hyperinflation, there remains a strong sensitivity among the authorities and the public towards mounting inflation that can spiral out of control.

⁵⁵ Superintendencia de Banca, Seguros y AfP (2009), Memoria Anual 2009.

External openness and exchange rate flexibility

Peru has been characterized by open policies in the external sector. It underwent deep liberalization in the 1990s and policy continued to move in this direction throughout the 2000s. It has an open trade regime and has persistently sought bilateral trade agreements with important commercial partners. In addition, it has an open capital account and a floating exchange rate regime with sporadic spot market intervention to smooth out volatility.

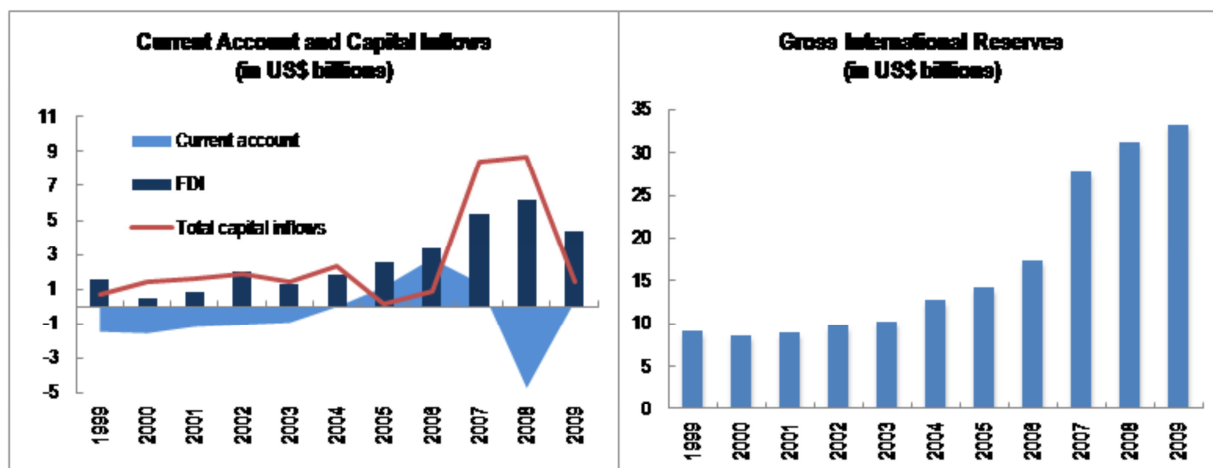
The favorable external environment characterized by increasing world demand for Peru's products along with a surge in commodity prices led to a reversal of the current account deficit that had persisted through the 1990s well into the current decade. In 2006, the current account balance reached a peak of 3 percent of GDP. Although the current account turned negative in 2008, it is important to bear in mind that this was in part due to a surge in imports that responded to strengthened domestic demand. In addition to export revenue flows, Peru also benefitted from growing remittance flows, which averaged close to 2 percent of GDP in the second half of 2000s.

The economic boom, along with the structural reforms the authorities had successfully carried out that provided for a heightened sense of stability and increased competitiveness, fostered significant capital inflows throughout the decade. In particular, since 2002 Peru has benefitted from increasing foreign direct investment (FDI). Between 2004 and 2008, FDI grew at impressive rates, reaching a peak of US\$ 6.2 billion in the latter year (See Figure 28).

The Central Bank used the opportunity to build up its stock of official reserves, which have served as an important buffer to mitigate external vulnerability. After the debt crisis of the 1980s, the central bank had been left with little international reserves. Throughout the 1990s it remained a priority to continue building up its reserves, particularly given the still high levels of foreign currency debt and bank dollarization. During the current decade, the central bank continued its policy of reserve accumulation, in part as a response to strengthened capital inflows, which raised questions by the IMF regarding the BCRP's commitment to a floating regime. Substantial purchases of foreign exchange combined with low exchange rate volatility could be seen as signs of government intervention of the exchange rate.⁵⁶ At the time, the Peruvian authorities considered market conditions provided a good opportunity to build up official reserves. As illustrated by Figure 28, reserve accumulation continued through 2009.

⁵⁶ This was brought up in the 2004 IMF Staff Report.

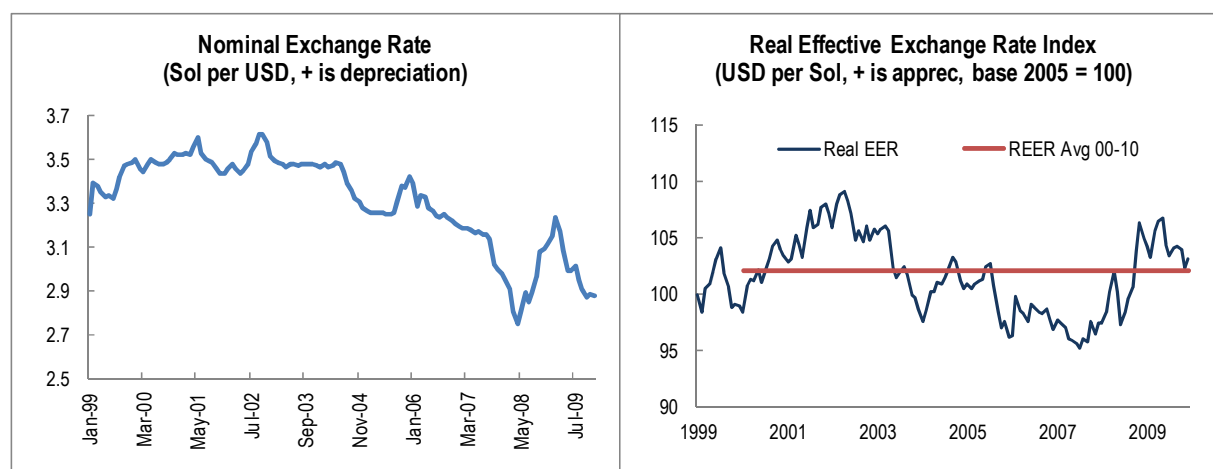
Figure 28: Capital inflows and reserve accumulation



Sources: Central Bank of Peru, IMF Staff Reports, WEO 2010, and author's calculations.

Increasing capital flows combined with greater competitiveness and productivity have pressured the nominal exchange rate to appreciate, a trend that has been most predominant since end 2005 albeit the post-Lehman respite. The real Effective exchange rate (REER), however, did not begin to appreciate until after mid-2008, mostly due to sustained strong fundamentals and a weaker US dollar (Figure 29). Throughout the period of strong economic growth, both the IMF and the Peruvian authorities found the real exchange rate to be broadly in line with fundamentals.

Figure 29: Nominal and real exchange rate movements



Sources: Central Bank of Peru, IMF INS, and author's calculations.

Nonetheless, the exchange rate may be one of the policy areas in which Peruvian authorities could work on to help promote the development of sectors that are lagging behind. Particularly in face of the appreciation pressures that are expected as a result of growing capital inflows (see IMF Art. IV 2010 and the Central Bank's annual memoir).

Hausmann and Klinger (2008) point out that a major constraint to growth has been the lack of diversification of the Peruvian economy, even in times of collapses in the terms of trade which would otherwise most likely serve as an incentive for the economy to move towards more productive activities. In their study, they suggest that the real exchange rate is a potential explanation for the lack of export diversification as it can act as a subsidy on tradable activities and cite authors, such as Hausmann, Hwang and Rodrik (2006) and Rodrik (2007), who have found that temporary exchange rate depreciations can trigger the search for more productive activities and thus lead to economic growth, and that an undervalued exchange rate can promote economic growth. Along similar lines, Chacaltana

and Yamada (2009) suggest that the exchange rate is among the three factors that can negatively affect productivity in the agroindustrial sector.⁵⁷ For Hausmann and Klinger (2009), the key policy message is that the public sector must act to encourage the development of new export activities that better utilize the human resources of the country, which involves achieving a more competitive real exchange rate, among others.⁵⁸

Ocampo (2008) and Epstein (2009) also make a case for targeting the real exchange rate, actively seeking a competitive and stable rate. Ocampo (2008) argues that “in addition to inflation targeting, they [monetary authorities] should not disregard the countercyclical role of monetary policy (output and employment targeting). Furthermore, to the extent that a stable, real exchange rate is a crucial determinant of growth and employment in open economies, an element of real exchange rate targeting is also an essential component of adequate macroeconomic management in developing countries.”⁵⁹

Targeting the real exchange rate, however, also poses challenges that should not be disregarded. Given that it is an endogenous variable, targeting it implies acting on its determinants. The fact that monetary authorities would not have a single policy objective would require coordination with the fiscal authorities (Ocampo 2008). As Hausmann and Klinger (2008) suggest, in the context of a floating exchange rate with an inflation-targeting regime, the balance between fiscal and monetary policy will impact the real exchange rate. Tighter fiscal policy means that the required interest rate to achieve the inflation target can be lower, implying a weaker exchange rate.

Furthermore, an inherent difficulty to targeting the exchange rate is that this policy measure can lend ground for speculative attacks on the currency. This in turn gives way to another policy option that may be used in conjunction with real exchange rate targeting in order to protect the economy from speculative flows, i.e. the implementation of capital controls.

In order to target the real exchange rate and protect the economy from speculative capital movements, Ocampo (2008) suggests the implementation of intermediate regimes that allow to manage the real exchange rate and that impose capital controls. This type of regimes allow for *graduated flexibility* of the exchange rate, with the appropriate level of flexibility being determined by the relative benefits of stability versus flexibility. The author points out, however, that under such a regime, there is limited monetary autonomy. This autonomy would depend on a) the effectiveness of capital account regulations, b) the generation of credibility in markets because, without such credibility, the regime remains subject to speculative attacks, and c) sterilized intervention in foreign exchange markets.

Ostry et al (2010) also make a case for the implementation of capital controls under certain circumstances. In particular, the authors suggest that in face of sizeable capital

⁵⁷ They study the particular case of the asparagus export sector, which has been one of the exceptional cases of export diversification in recent years. The other two factors that have the highest negative impact on asparagus productivity are transport costs and the costs of the inputs/raw materials used for asparagus production.

⁵⁸ Hausmann and Klinger (2008), p.2.

⁵⁹ Ocampo (2008) citing Frenkel (2004), p. 71.

inflows where a purely macroeconomic policy response does not suffice, capital controls are a useful part of the policy toolkit.⁶⁰ The key is to insure that the controls that are imposed do not introduce large distortions in the economy and that they do not crowd out less distortionary policy measures. Overall, they can be helpful for dealing with temporary inflows, but they should be implemented with caution if there is the expectation of a permanent rise in capital inflows that respond to developments in the macroeconomic fundamentals of a given economy.

3. Interviews of key informants

The mission to Lima intended to cover interviews with all the major tripartite stakeholders along with independent experts on the Peruvian labor market and macroeconomic performance. Meetings included government officials, private sector and worker representatives, and academics.

Overall, there was much optimism regarding Peru's performance over the past years, although workers representatives and organizations tied to social development were more reserved about the recent economic accomplishments. The prolonged period of economic growth combined with a well-weathered downturn and a quick pick-up in economic activity contributed to the positive sentiment. However, different agents flagged several issues. Among these were:

- Concern with the sustainability of economic growth: despite promising growth prospects in the short and medium term, stakeholders revealed their concern with the sustainability of growth. They pointed out that growth so far had relied heavily on a favorable external environment and terms of trade, but that future growth would need to rely more on productivity increases. Structural bottlenecks had not become evident yet, but they worried that these could prove to be an obstacle to future growth if they were not addressed in a timely manner.
- Importance of focusing on enhancing competitiveness: linked to the point above, several stakeholders stressed the importance of boosting competitiveness in Peru to make growth sustainable in the long run. Among the issues that came up were still insufficient and inadequate infrastructure and the importance of fostering innovation.

⁶⁰ The traditional macroeconomic policy options that the authors discuss are a) allowing the exchange rate to appreciate unless it is already overvalued or roughly in equilibrium; b) accumulating international reserves if their level is low or if additional accumulation is desirable from a prudential perspective; and c) sterilization of the inflows through open market operations if it is desirable and if domestic financial markets are deep enough to absorb the sterilization bonds bearing in mind that this may push up interests further and create added incentives for capital inflows. When these macro policy options are exhausted, economies can resort to lowering interest rates if there are no signs of overheating and no inflationary pressures. And if all of the above have been exhausted, implementing capital controls can prove to be an effective measure.

- Importance of diversifying the Peruvian economy: In particular authorities and the export sector saw the diversification of the economy as a key factor for ensuring sustainable growth in the long term. Exporters felt there were productive sectors with strong potential to generate many more linkages with other sectors (manufacturing and services), but that there are no programs to promote diversification.
- Lack of qualified labour: Sources mentioned across the board that lack of qualified labour was a problem that could potentially become a bottleneck for growth. Concerns cover the quality of education, an insufficient number of workers with a technical background and lack of training for employed workers.
- Insufficient improvement in the quality of employment that was being generated: workers' representatives and academics pointed out that there had been significant economic growth along with generation of employment, but that the quality of jobs had not improved. In particular, they expressed concern for jobs in the agricultural sector and more so for the substandard employment of women.
- Existence of a fractioned labour regime: Several sources mentioned the existence of multiple laws and special regimes regulating the labour market that made it cumbersome. The business sector also mentioned that there was lack of stability regarding special regimes, given that they could be subject to change with changes in the political environment. Instability in legislation generates uncertainty that is not conducive to a business friendly environment.

The organizations and experts that were consulted are detailed in Annex I.

4. Conclusions: fostering pro-employment macroeconomic policies

There is little doubt that Peru's economy has performed exceptionally well over the past decade. Sustained high rates of growth gave way to notable employment generation that has in turn contributed to poverty reduction. Although it is true that Peru was greatly favored by a positive external environment, its economic performance owes much to the years of persistent implementation of favorable fiscal, monetary and external policies that were conducive to the stability that laid the grounds for a healthy growth process to occur. Perhaps the greatest accomplishment has been following a consistent line of policy-making that granted stability in the rules, provided credibility, and nurtured an environment for the economy to prosper.

In terms of fiscal policy, substantial progress was made in the last decade. Fiscal consolidation and the adoption of a clear and transparent fiscal policy rule contributed to a virtuous cycle where growth fed into healthy fiscal policy, which in turn allowed for continuous reductions in the fiscal deficit, a significant reduction in public debt, and opened up fiscal space. The fiscal space that was generated allowed the government to increase spending in investment and targeted poverty reduction programs.

Employment benefited from the favorable economic environment fostered directly and indirectly from these policies. Greater spending in infrastructure had a direct employment generating effect, leading to a pronounced growth in employment in the construction sector. Furthermore, increased social spending will have multiplicative effects in the long run, contributing to developing more qualified labour necessary for long-term sustainable growth. Last but not least, greater spending in targeted poverty reduction programs contributed to lowering the levels of poverty in Peru. Although the latter may not have a direct effect on employment, it is important to bear in mind that poverty reduction, and in

particular extreme poverty, can contribute to increasing productivity in the long run, which in turn has a positive impact on growth and thus on employment.

Additionally, consistently prudent fiscal policies implemented throughout the decade proved to be indispensable for buffering the impact of the 2009 global crisis. The government was able to implement a fiscal stimulus plan that prevented a further slowdown of the economy, served to protect jobs, and contributed to quick economic reactivation.

Nonetheless, there is room for improvement in the implementation of sound fiscal policies. First, it is worth stressing that social spending was prioritized only towards the mid-end of the economic boom cycle. Had it been on the radar screen beforehand, Peru would have well reaped greater benefits from the upswing. Second, Peru could benefit further from periods of economic growth by improving the quality and efficiency of public spending and ensuring that the counter-cyclical nature of fiscal policies is not challenged as economic activity picks up. Third, the current tax regime in Peru has a slight regressive impact, which means that fiscal policy does not contribute to income redistribution. Indirect taxes have a highly negative effect on redistribution, overcompensating for the mild redistributive effect of direct taxes. Improving the tax structure, continuing to enlarge the tax base, and generating greater incentives to reduce informality could help make fiscal policy more progressive.

Monetary policy over the past decade has also played a key role in generating a stable economic environment propitious for investment and economic growth. After undergoing severe hyperinflation in the 1980s, both the public and the authorities remain, rightfully so, sensitive towards price increases. Thus, much effort has been put into keeping inflation in line with the target. The reduction in the levels of inflation provided the monetary authority with credibility and perpetuated a sense of confidence in the Peruvian economy that laid the basis for solid and healthy economic growth. In addition, low inflation levels had a direct impact on households as their incomes are no longer being eroded by rapid price increases. Furthermore, the control of inflation has allowed consumption to expand, further boosting domestic demand. In addition, authorities have ensured adequate liquidity and developed a sound banking system that has irrigated the economy with credit.

The effect on employment of monetary policy occurs mostly through indirect channels. The key factors that come into play are a stable economic environment conducive to growth (through inflation control) and the provision of adequate liquidity so that there are resources available to stimulate growth. In this sense, Peru has done a good job at ensuring that monetary policy is not detrimental to growth or employment generation.

With respect to the external sector and exchange rate policies, Peru underwent dramatic liberalization in the 1990s and continued to pursue open external policies throughout the last decade. Trade openness played a key role in developing a productive export sector and allowed Peru to take advantage of the favorable external environment that characterized the recent economic boom. In addition, an open capital account combined with economic stability has been conducive to capital inflows that have fueled investment and productive activities. In addition, the commitment to a flexible exchange rate regime with limited intervention to smooth out volatility has further contributed to a business-friendly environment.

Nevertheless, Peru faces strong capital inflows that pressure the currency to appreciate. Although the authorities have deemed the real exchange rate to be broadly in line with fundamentals, Peru may be a case that would benefit from real exchange rate targeting as a complement to the inflation targeting policy already in place. Peru has a poorly diversified economy that relies heavily on a capital intensive export sector. A slightly undervalued real exchange rate, as opposed to an overvaluing one, could be conducive to greater diversification of the production/export sectors and thus contribute to long-run sustainable growth.

After weathering quite well the global financial crisis, the main challenge that Peru faces ahead is re-entering the path of sustainable growth. This implies returning to its prudent macroeconomic policies and graduating in a timely manner from the stimulus measures implemented as a response to the crisis. Peru also faces important challenges in other areas that are not directly related to macroeconomic policies, but that are necessary to attain long-term sustainable growth that generates decent employment. In particular, Peru must focus on boosting productivity. For this it will have to pay special attention to investment in human capital, in particular through education, seeking to ensure that the skills acquired through academic programs match the needs of growing productive sectors. It will also have to make sure to continue enhancing the business environment to make sure it continues to attract investment and business sectors are not constrained by cumbersome regulation.

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Annex I

Fact-finding mission to Lima, Peru

List of organizations and individuals that were interviewed

Mr. Francisco Verdera - International Labour Organization
Mr. Juan Chacaltana – International Labour Organization

Government authorities:

- Ministerio de Trabajo y Promoción del Empleo (Ministry of Labour and Employment Promotion)
- Instituto Nacional de Estadísticas – INEI (National Statistics Institute)
- Banco Central de Reserva del Perú – BCRP (Central Bank of Peru)
- Ministerio de Economía y Finanzas – MEF (Ministry of Economy and Finance)

Private sector/Employers:

- Confederación Nacional de Instituciones Empresariales Privadas – CONFIEP (National Federation of Private Businesses)
- Asociación de Exportadores – ADEX (Association of Exporters)

Workers' representatives:

- Confederación General de Trabajadores del Perú – CGTP – (Workers' Union)

Non-governmental organizations:

- Mr. Federico Arnillas – Director – Mesa de Concertación para la Lucha Contra la Pobreza

Academics/Macro experts:

- Mr. Waldo Mendoza – Head of the Economics Department – Universidad Católica del Perú
- Mr. Humberto Campodónico – Professor – Universidad Nacional Mayor de San Marcos
- Mr. Elmer Cuba – Consultant – Macroconsult

International organizations:

- Mr. José González Vigil - United Nations Development Programme
- Mr. Javier Illescas – Country Economist – The World Bank

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