

## MEMORANDUM

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**TO:** President Martín Vizcarra  
**FROM:** Patrick Campbell, Minister of Foreign Affairs  
**SUBJECT:** Peru's Economic Relations with the US and China  
**DATE:** May 6, 2019

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### ABSTRACT

Since 2001, Peru's economic growth has come to depend increasingly on trade and economic investment from China and other Asian countries with high demand for Peruvian commodities rather than on more traditional western trading partners like the US. With growth in China beginning to slow, however, Peru must diversify its trade and investment opportunities to keep economic growth strong. By adopting win-win policies centered on areas of overlapping national and US interests, Peru can help to revive investment and economic assistance from the US to its historically strong position while increasing the resilience of the Peruvian economy to slowing growth in Asia. Peru's FTAs with China can also be made more robust to these challenges by installing mechanisms to support regulatory compliance of foreign investors and by funding programs for students and professionals aimed at building capacity in Chinese and Peruvian tax and legal frameworks, financial systems, language, and culture. By removing these obstacles, Peru will have more leverage to pursue an FTA with China that more effectively achieves its goals of increased diversification and productivity.

### I. INTRODUCTION

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#### Socioeconomic Conditions in Peru

Since 2001, Peru has experienced greater economic growth than virtually any other Latin American country. The country's gross domestic product (GDP) growth rate averaged 8.8% from 2001 to 2008 and remained positive at 0.9% even during the 2008-2009 global financial crisis. As of 2011, GDP growth had rebounded to 6.9% and remained above 6% for the next several years<sup>1</sup>—almost twice the regional average.<sup>2</sup> Peru's remarkable economic growth has primarily been driven by a combination of high global demand for the minerals and other primary commodities that Peru exports, sound macroeconomic policymaking, and a strong commitment

to international trade.<sup>3</sup> Minerals like copper, iron, and gold currently account for around 60% of total Peruvian exports, as well as 25% of total FDI and 15% of total tax revenues.<sup>4</sup>

Taxation of mined resources has also served as a critical policy tool for helping to distribute the country's wealth more equitably among its population, although economic disparity continues to be a major challenge for the country.<sup>5</sup> Despite poverty rates dropping from 54.3% in 2001 to 25.8% in 2012, the disparity between Peru's rural and urban populations remains marked, with over half (53%) of the rural population living in poverty compared to just 16.1% of the urban population. Likewise, the income gap remains significant with the top 20% of the population garnering 52.6% of the country's income while the lowest 20% garners only 3.9%.<sup>6</sup>

The US and China also have played important roles in Peru's recent economic growth and continue to represent major priorities for future economic policies. Economic relations between these three countries is grounded in their shared commitment to expanding economic growth, job creation, and inclusion through integration into global markets.<sup>7</sup> As Peru has integrated into the world economy, it has increasingly sought to pursue these goals through free trade agreements and multilateral trade agreements and alliances. Peru's participation in the Trans-Pacific Partnership (TPP) negotiations and the United States–Peru Trade Promotion Agreement (PTPA) are two prominent examples from recent history.<sup>8</sup> In 1998, Peru also joined the Asia-Pacific Economic Cooperation (APEC), which promotes economic relations between Peru and Asian countries.<sup>9</sup>

### Economic Relations with the US

The US established diplomatic relations with Peru in 1827, shortly after it gained its independence from Spain. Today, the two countries continue to enjoy a strong relationship based on the shared values of democracy, security, mutually beneficial trade, and human rights.<sup>10</sup> Peru's economic relations with the US center on several areas of overlapping interest. The most notable of these include consolidating democratic rule, combating terrorism and drug trafficking (especially of cocaine into the US<sup>11</sup>), and strengthening public infrastructure and service delivery through institutional reform.<sup>12</sup>

The most important piece of economic policy between Peru and the US is the U.S.-Peru Trade Promotion Agreement (PTPA), approved by Congress in 2009. The PTPA is a comprehensive trade agreement that serves to eliminate tariffs and other trade barriers, provide a secure, predictable legal framework for investors, and strengthen protections for intellectual

property, workers' rights, and the environment. In general, the PTPA has been much more significant for Peru's economy than for that of the US. While trade with Peru accounts for only a small percent of total US trade, the US is Peru's second leading trade partner. Since 2009, total trade between the United States and Peru has risen from approximately \$9 billion to \$15.9 billion in 2017.<sup>13</sup> At the same time, however, US funding to Peru has been declining. In 2010, the US provided almost \$120 million in assistance to Peru. By 2011, this number had dropped to just \$97 million, and then down again to \$79 million in 2012<sup>14</sup> This trend has accelerated under the Trump administration, with funding dropping from \$74 million in 2016 to just \$49.7 million in 2018 (-34%).<sup>15</sup>

The US has often leveraged economic assistance to further its broader political objectives in Peru. One particularly striking example is in the area of environmental protection. After an Environmental Investigation Agency (EIA) report revealed that millions of dollars' worth of illegal wood from the Peruvian Amazon had been exported to the United States between 2008 and 2010, Congress amended the PTPA to require both countries to enforce their domestic environmental laws. Subsequent amendments required the two countries to take steps to improve forest sector governance and promote legal trade in timber products.<sup>16</sup> Similarly, in 2008, Peru and the US implemented a "debt-for-nature swap" by which Peru could reduce its more than \$25 million debt to the US by committing those funds to support grants to protect its tropical forests.<sup>17</sup> In the area of social justice, Peru and the US signed a \$35.6 million Millennium Challenge Threshold program for 2010 to support Peru's efforts to reduce corruption in public administration and improve child immunization coverage.<sup>18</sup>

#### **Quick Facts<sup>19</sup>**

- In 2006, 23% of Peru's exports went to the United States, and 16% of Peru's imports were supplied by the United States.
- In the same year, Peru accounted for 0.5% of total US trade.
- Peru ranks 43<sup>rd</sup> among US export markets and 42<sup>nd</sup> as a source of US imports.
- The #1 US import from Peru is gold (24% in 2006)
- The #1 US exports to Peru are petroleum oils and related products (9% in 2006).

#### Economic Relations with China

Although Peru only formally established diplomatic ties with the People's Republic of China in 1971, China has been present in Peru for more than 160 years.<sup>20</sup> Today, Peru is home to the largest ethnic Chinese population in all of Latin America. China's relationship with Peru has taken on even greater significance in the past decade as China became interested in the region as a provider of raw materials and potential market for Chinese products.<sup>21</sup> This relationship has been helped along by the Peruvian government's pro-export economic policies and has been a major factor in Peru's remarkable economic growth over the past two decades.

In 2011, only 40 years after establishing diplomatic relations, China replaced the United States as Peru's top trading partner.<sup>22</sup> Peru was among the group of Latin American countries that first granted market economy status to China in 2004, and by 2008, the two countries entered bilateral relations that resulted in the signing of their first FTA, which went into effect in 2010.<sup>23</sup> As of 2013, Peru and China had signed eleven new bilateral accords as part of a comprehensive strategic partnership aimed at optimizing trade infrastructure; strengthening cooperation in agriculture, infrastructure, and minerals; and increasing cooperation for social development.<sup>24</sup>

#### **Quick Facts<sup>25</sup>**

- China represents Peru's single largest export market and second largest source of imports after the US.
- Today, more than 100 Chinese firms are legally registered to operate in Peru.
- In 2012, China bought US \$7.7 billion worth of Peruvian goods (17% of total exports).
- Peru is the #1 location for Chinese mineral investment in Latin America, with at least 14 Chinese firms holding important concessions.
- Peruvian exports to China remain largely primary goods with just four products (copper, iron, lead, and fishmeal) comprising 83% of the total.

The dominant pattern of economic exchange between China and South America is one in which Latin American countries serve as commodity exporters in service of China's massive manufacturing economy. This pattern largely typifies China's economic relations with Peru as well. While this pattern has yielded generally positive macroeconomic outcomes for Peru to date, it is not sustainable in the longer term.<sup>26</sup> By their nature, commodities markets tend to have decreasing economies of scale, volatile prices, and low interconnection with other industries of

economic sectors.<sup>27</sup> They are therefore more likely to lead to increasing unemployment and loss of competitiveness in the long-run.

These concerns over the risks of excessive dependency on commodity exports and the structural challenges to achieving a more productive and diversified economy have long been major motivations in Peru's economic relationships with other countries. In fact, the primary motivation behind Peru's FTA with China was to diversify the country's trade and investment opportunities. Nonetheless, numerous obstacles have prevented Peru from achieving this goal.

*First* is Peru's cumbersome regulatory requirements for foreign investors, in particular, those related to obtaining work visas, translating and certifying documents, and obtaining the necessary permits for their operations. The obstacles can be especially high for Chinese investors less familiar with the region.<sup>28</sup>

*Second* are the many incompatibilities between the Chinese and Peruvian tax and legal frameworks and financial systems. This problem is further exacerbated by the lack of professionals on both sides with appropriate language and cultural skills.<sup>29</sup>

*Third* is the deteriorating perception of Chinese projects among the Peruvian population. Many of Peru's mines, including those operated by Chinese companies, are located in poor, rural areas containing large indigenous populations. Such populations often shoulder a much higher proportion of the negative consequences of these operations while receiving many fewer of their benefits. These conflicts have been on the rise in recent years leading to anti-mining projects led by rural residents and indigenous groups. As economic growth in Peru is slowing, some have noted that this situation may deteriorate even further as the government is forced to cut back on social programs, putting greater pressure on Peruvian officials to respond to protesters' demands.<sup>30</sup>

## II. RECOMMENDATIONS

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**R1: Adopt “win-win” policies centered on areas of overlapping national and US interests to attract greater investment and economic assistance from the US, strengthen social services and institutions, and increase resilience of the Peruvian economy to slowing growth in Asia.**

Economic relations between Peru and the US are supported by a strong foundation of shared values and political goals. Nonetheless, current policies have failed to realize much of the potential benefits that these common interests afford. While trade remains relatively strong (with the US falling just behind China as Peru's leading trading partner), US funding to Peru has been

declining significantly since 2010. This trend can be reversed by reviving and/or strengthening many of the former policies that garnered US support in the first place. The biggest opportunity for strengthening economic ties with the US are in pursuing win-win policies centered on strengthening social services and institutions and environmental protections. These two areas represent major priorities of US assistance to Peru and are increasingly hot button issues domestically as well, due to the inequitable distribution of benefits from between Peru's current trade and investment opportunities.

As the risks related to climate change continue to grow in urgency, economic partnerships premised on the protection of Peruvian forests through increased investment in sustainable industries (e.g., ecotourism and carbon markets like REDD+) present themselves as especially appealing options for US-Peruvian cooperation. Likewise, greater investment in strengthening the regulations and enforcement mechanisms related to mining and other extractive activities in Peru's poorer, rural regions will help to reduce tensions between local residents and foreign investors and increase the likelihood that sustainable development initiatives succeed. The absence of these mechanisms, however, will ensure that such initiatives fail by failing to remove the deeper, structural factors—including high poverty rates and lack of opportunities for upward mobility—that created these dependency relations in the first place.

As Peru's economic growth continues to slow from decreasing demand for exports to China, the potential benefits of reviving economic relations with the US are significant. While trade patterns with China have remained largely asymmetrical and restricted to commodities, the more diverse US market represents a more promising avenue for growing the capacity of Peru's other market sectors, including service, manufacturing, and logistics. Once these markets have been developed to a sufficient extent, they are likely to attract more interest from other large investors as well, including China, which has already begun to demonstrate interest in entering the logistics sector and other areas related to overall development of the Peruvian economy.<sup>31</sup>

**R2: Stimulate Chinese investment in underdeveloped sectors by providing support for foreign investors in regulatory compliance and building capacity in Chinese and Peruvian tax and legal frameworks, financial systems, language, and culture.**

Growth in China has been slowing in recent years, leading to a decrease in demand for the commodities that Peru exports and weakening the overall economic impact of the country's FTAs with China. Even if that demand could be sustained, it would ultimately lead to an

overdependence on a commodity-based market, weakening Peru's competitiveness in the long-term and making the country vulnerable to disruptions in the current economic system.

In order to make the country's FTAs with China more robust to these challenges, Peru should provide free or low-cost training programs and legal consulting services to foreign investors, to lighten the burden imposed by current regulatory requirements, especially in the areas of immigration (including work visas), permitting, and the completing and filing of official documents. Furthermore, government funding should be directed to building capacity in the areas most critical to facilitating foreign investment. Subsidies should be provided to public institutions to develop curriculum related to Chinese languages and culture, as well as cultural exchange opportunities. Additional funding should be directed to the development of capacitation programs aimed at increasing the literacy of professionals in the relevant sectors to both Chinese as well as Peruvian tax and legal frameworks and skills related to mediating the transition between the two.

Removing these obstacles will lower the barrier of entry to prospective Chinese investors and allow for a wider diversity of trade and investment opportunities, including smaller ventures in underdeveloped sectors like logistics, transportation, and service industries.

### **III. CONCLUSION**

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To maintain strong economic growth into the coming years and decades, Peru must achieve greater diversity in its trade and investment opportunities. By adopting win-win policies centered on areas of overlapping national and US interests, Peru can help to revive investment and economic assistance from the US to its historically strong position while also strengthening domestic social services and institutions, improving protections for workers and the environment, and alleviating economic disparity and social unrest. Likewise, Peru's FTAs with China can be made more robust to changing global markets by adopting policies aimed at lowering the barrier of entry currently faced by foreign (especially Chinese) investors. By directing funding toward programs designed to support foreign investors in regulatory compliance and build capacity among students and professionals in Chinese and Peruvian tax and legal frameworks, financial systems, language, and culture, Peru will be able to stimulate Chinese investment in underdeveloped sectors and lay a foundation for a more resilient and diversified economy.

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- <sup>2</sup> Franklin Briceno, Joshua Goodman, "Peru's president tells Trump he prefers 'bridges to walls.'" (*The Associated Press*, February 24, 2017).
- <sup>3</sup> Cynthia A. Sanborn, Alexis Yong, "Peru's Economic Boom and the Asian Connection," Prepared for the Conference "Reaching Across the Pacific: Latin America and Asia in the New Century," (Woodrow Wilson International Center for Scholars, Washington, DC, June 20, 2013).
- <sup>4</sup> Taft-Morales, "Peru in Brief."
- <sup>5</sup> M. Angeles Villarreal, "US-Peru Economic Relations and the US-Peru Trade Promotion Agreement," (*CRS Report for Congress*, July 27, 2007).
- <sup>6</sup> Taft-Morales, "Peru in Brief."
- <sup>7</sup> "Fact Sheet: U.S. - Peru Economic Relations," (The White House Obama Administration, June 11, 2013).
- <sup>8</sup> Ibid.
- <sup>9</sup> Taft-Morales, "Peru in Brief."
- <sup>10</sup> "US Relations with Peru," (US Department of State, Bureau of Western Hemisphere Affairs, March 18, 2019).
- <sup>11</sup> Taft-Morales, "Peru in Brief."
- <sup>12</sup> Ibid
- <sup>13</sup> "Peru Trade Promotion Agreement." (Office of the United States Trade Representative. Executive Office of the President).
- <sup>14</sup> Taft-Morales, "Peru in Brief."
- <sup>15</sup> Adam Isacson, "Trump's 2018 Foreign Aid Budget Would Deal a Devastating Blow to Latin America," (Washington Office on Latin America. May 24, 2017).
- <sup>16</sup> Taft-Morales, "Peru in Brief."
- <sup>17</sup> Ibid.
- <sup>18</sup> Ibid.
- <sup>19</sup> Ibid.
- <sup>20</sup> Sanborn and Yong, "Peru's Economic Boom."
- <sup>21</sup> Ruben Gonzalez-Vicente, "The Political Economy of Sino-Peruvian Relations: A New Dependency?" (*Journal of Current Chinese Affairs*, 41, January 2012), 97-131.
- <sup>22</sup> Sanborn and Yong, "Peru's Economic Boom."
- <sup>23</sup> Ibid.
- <sup>24</sup> Ibid.
- <sup>25</sup> Ibid.
- <sup>26</sup> Gonzalez-Vicente, "Political Economy of Sino-Peruvian Relations."
- <sup>27</sup> Sanborn and Yong, "Peru's Economic Boom."
- <sup>28</sup> Ibid.
- <sup>29</sup> Ibid.
- <sup>30</sup> Nathaniel Parish Flannery. "How China's Relations with Peru Explain its Approach to Diplomacy," (*The Atlantic*, September 12, 2013).
- <sup>31</sup> Sanborn and Yong, "Peru's Economic Boom."