Rabobank

Country update

PERU

Summary

Fuelled by higher commodity prices and improved business and consumer sentiment, Peru has recovered vigorously from the global economic crisis. As a result, the economy is now operating close to full capacity. The rapid recovery helped to narrow a budget deficit which was even in crisis year 2009 rather modest. Nonetheless, it remains to be seen whether the government is willing to tighten fiscal policy with important elections approaching in early 2011, when Peru will vote for a new president and congress. We consider the risk that a new government will implement populist policies that may endanger macroeconomic stability to be low, as center right presidential candidates are leading in the polls while the most important left wing candidate seems to have less radical economic views than four years ago. Nevertheless, poverty, inequality and social conflicts continue to result in sizeable political and social risks. With the economy growing rapidly and now operating close to full capacity, preventing overheating is an important challenge for the government. The central bank has already raised interest rates, but its overall monetary stance remains rather accommodative. The task of the central bank is complicated by large capital inflows. The central bank has heavily intervened, and the government wants to tighten its capital controls.

Things to watch:

- 2011 congressional and presidential elections
- Global economic sentiment and its effects on commodity prices
- Large capital inflows and possible overheating of the economy

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Peru

National facts		
Type of government	constitutional republic	
Capital	Lima	
Surface area (thousand sq km)	1,285	
Population (millions)	29.2	
Main religions	Roman Catholic (81.3%)	
	Evangelical (12.5%)	
Main ethnic groups	Amerindian (45%)	
	Mestizo (37%)	
	White (15%)	
Head of State (president)	Alan Garcia Perez	
Head of Government	Alan Garcia Perez	
Monetary unit	nuevo sol (PEN)	

Economy		2009
Economic size	*bn USD*	*% world total*
Nominal GDP	127	0.22
Nominal GDP at PPP	251	0.36
Export value of goods and services	31	0.20
IMF quotum (in mln SDR)	638	0.29
Economic structure	*2009*	*5-year av.*
Real GDP growth	0.9	7.7
Agriculture (% of GDP)	6	6
Industry (% of GDP)	33	33
Services (% of GDP)	53	52
Standards of living	*USD*	*% world av.*
Nominal GDP per head	4288	47
Nominal GDP per head at PPP	8506	76
Real GDP per head	3491	45

Social and governance indicators	rank / total
Human Development Index (rank)	78 / 182
Ease of doing business (rank)	56 / 183
Economic freedom index (rank)	45 / 179
Corruption perceptions index (rank)	75 / 180
Press freedom index (rank)	85 / 175
Gini index (income distribution)	49.6
Population below $1 per day (PPP)	7.9%

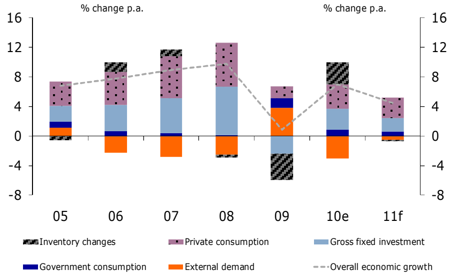
Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
US	15	US	26
China	13	China	12
Canada	9	Brazil	10
Japan	6	Ecuador	8
Main export products (%)			
Gold			25
Copper			22
Fishmeal			6
Zinc			5
Main import products (%)			
Intermediate goods			53
Capital goods			25
Consumer goods			21
Openness of the economy			
Export value of G&S (% of GDP)			24
Import value of G&S (% of GDP)			20
Inward FDI (% of GDP)			3.8

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

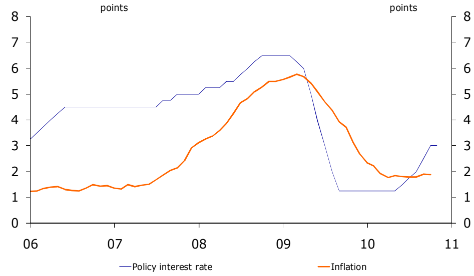
With economic growth of 9.2% year-on-year (yoy) in September 2010 and 8.4% yoy in the January-September 2010 period, Peru's recovery from the global financial crisis has been vigorous. The economy is now likely to grow around 8% in 2010 as a whole. Growth is driven by a renewed build-up of inventories and strong consumption and investment (see chart 1), fuelled by improved business and consumer sentiment and fiscal and monetary stimulus. Moreover, as Peru's exports are dominated by commodities, with gold, copper and zinc accounting for 50% of total exports, the country benefited from higher commodity prices. Peru's commodity dependence means that the economic performance of the country continues to be strongly influenced by global economic sentiment and its effects on commodity prices. Thanks to the strong recovery, the economy is now operating more or less at full capacity. A tightening of monetary policy started in May and continued until September. It resulted in a 175 basis point increase of the benchmark rate, which now stands at 3% (see chart 2). With the economy operating at full capacity, this is still a rather accommodative rate and the central bank may decide to increase rates further, even after it left rates unchanged in early October. Indeed, even as inflation has so far remained within the 1-3% target band (see chart 2), we consider preventing the economy from overheating currently the main economic challenge of the government. Lending has been rapidly growing, with loans to consumers and small business rising by about 30% this year. Meanwhile, public debt, already rather low at 25% of GDP, is likely to fall as a percentage of GDP in the coming years. Despite the fiscal stimulus, the country posted a manageable fiscal deficit of 2.1% of GDP in 2009. Moreover, the budget position is improving, on the back of the strong recovery. The government expects the deficit to narrow to 1.2-1.3% of GDP. Nonetheless, it remains to be seen whether the government will withdraw the fiscal stimulus, as Peru will go to the polls next year.

Chart 1: Economic growth



Source: EIU

Chart 2: Inflation and interest rates



Source: EIU

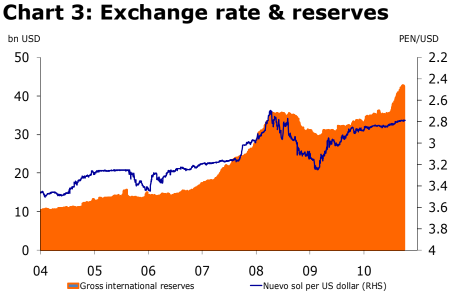
Preparing for an election year

2011 will be a year marked by important elections. In April, congressional elections will be held simultaneously with the first round of the presidential elections. In case none of the presidential contenders manages to secure a single majority in the first round, which we consider highly likely, a second round will be held in June. The last time Peru had to choose a new president was in 2006. The two contenders in the second round were Alan Garcia and Ollanta Humala. At the time, there were fears for the left-wing populist policies of Humala, but in the end Garcia won. As Garcia's reputation was still somewhat tainted by the hyperinflation that marked his first presidency in the late eighties, he was intent on following strong anti-inflation policies. Peru's economy has performed very well during his reign, but corruption allegations and conflicts between his administration and local communities have held back the popularity of the government. However, the strong recent upswing of the economy may nonetheless increase support for the government. Although Garcia is not allowed to run for a new term, it may boost support for presidential candidates of his ruling party. Whereas poverty has declined substantially in recent years, a significant part of the population remains poor, while inequality remains high. Moreover, the country remains characterized by severe ethnic and regional divisions, which has resulted in social conflicts, with some parts of the country falling under emergency rule. Nevertheless, we consider a continuation of Peru's basic macroeconomic policies likely. Firstly, the success of the existing economic framework has boosted the support for market friendly policies. Macroeconomic stability is now more widely seen as a basic tenet of economic policy. Furthermore, so far moderate right wing candidates are leading the polls, with Humala only coming fourth. Nevertheless, from a structural point of view, the inequalities and social strains result in political and social risks continuing to contribute disproportionally to total country risk.

The renewed strength of the nueva sol

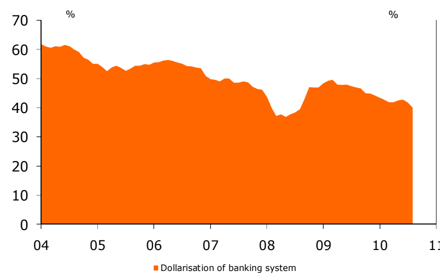
Fuelled by inflows of foreign direct investment, strong export income and the capital lured by the (compared to rates in the western world) high interest rates, Peru's currency, the nuevo sol, has been under strong upward pressure this year. In principle, the nuevo sol is a free floating currency, but the central bank has heavily stepped up its interventions. Especially after the currency had recovered most of the late-2008 depreciation, the authorities have chosen to limit further appreciation by buying large foreign currency reserves (see chart 3). Between October 2009 and October 2010, the central bank has bought USD 9bn in additional foreign reserves, which is equal to almost 6% of GDP. With purchases of USD 6.3bn since 18 June, most of this increase has taken place very recently. Thus, within Latin America, Peru has been one of the most zealous buyers of foreign currency. As a result of these purchases, foreign exchange reserves now exceed foreign debt. Some currency intervention is justified by the fact that the financial system of Peru is still substantially dollarized. However, the total size of domestic credit remains rather small, while dollarization has reverted to its downward trend after the global financial crisis temporally boosted dollarization (see chart 4). In mid-October, the Peruvian government announced administrative measures to give it further control over capital inflows. It is not yet clear what these measures might look like, although the government made clear that it will not introduce a tax. Instead, the government may limit the ability of local banks to participate in short-term derivates. More macro-prudential measures can also be expected. Earlier, the central bank already increased the reserve requirements on short-term external loans and eased the restrictions on capital outflows. Given Peru's recent economic track record, we expect the measures to be rather market friendly. However, with ultra low interest rates in the western world, and countries like China intent on limiting the appreciation of their currency through foreign reserve accumulation, it remains to be seen whether countries with a relatively open capital account regime like Peru can stave off capital inflows. Moreover, due to the recent increase of domestic interest rates, the costs of sterilization have increased. All this leads to further challenges for a central bank that has to deal with an economy that may be close to overheating.

Chart 3: Exchange rate & reserves



Source: ECOWIN

Chart 4: Dollarization



Source: EIU

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Peru

Selection of economic indicators	2005	2006	2007	2008	2009	2010e	2011f
Key country risk indicators							
GDP (% real change pa)	6.8	7.7	8.9	9.8	0.9	7.7	4.6
Consumer prices (average % change pa)	1.6	2.0	1.8	5.8	2.9	1.8	2.8
Current account balance (% of GDP)	1.4	3.1	1.1	-3.3	0.2	-0.2	0.2
Total foreign exchange reserves (mln USD)	13599	16733	26857	30272	32013	35870	36680
Economic growth							
GDP (% real change pa)	6.8	7.7	8.9	9.8	0.9	7.7	4.6
Gross fixed investment (% real change pa)	8.9	26.5	26.3	25.0	-20.9	22.0	7.0
Private consumption (real % change pa)	4.6	6.4	8.3	8.7	2.4	5.5	4.6
Government consumption (% real change pa)	9.1	7.6	4.5	2.1	16.5	10.5	6.0
Exports of G&S (% real change pa)	15.2	0.8	6.2	8.8	-2.5	2.7	5.1
Imports of G&S (% real change pa)	10.9	13.1	21.3	19.8	-18.4	16.1	7.4
Economic policy							
Budget balance (% of GDP)	-0.3	2.1	3.2	2.2	-2.1	-1.4	-0.8
Public debt (% of GDP)	38	33	30	24	25	24	23
Money market interest rate (%)	4.0	5.3	5.8	7.3	2.1	4.8	6.2
M2 growth (% change pa)	17	12	23	23	3	19	12
Consumer prices (average % change pa)	1.6	2.0	1.8	5.8	2.9	1.8	2.8
Exchange rate LCU to USD (average)	3.3	3.3	3.1	2.9	3.0	2.8	2.8
Recorded unemployment (%)	7.6	7.5	6.9	8.1	8.1	6.7	6.6
Balance of payments (mln USD)							
Current account balance	1122	2854	1220	-4212	246	-330	300
Trade balance	5260	8986	8287	3091	5874	7990	8810
Export value of goods	17336	23830	27882	31529	26885	33730	35660
Import value of goods	12076	14844	19595	28439	21011	25740	26860
Services balance	-834	-737	-1187	-1962	-1112	-1370	-1080
Income balance	-5076	-7580	-8374	-8144	-7371	-9860	-10770
Transfer balance	1772	2185	2494	2803	2856	2910	3340
Net direct investment flows	2580	3467	5424	6188	4364	6320	5110
Net portfolio investment flows	74	-1521	2637	1947	-2387	420	820
Net debt flows	1483	-593	3964	-1340	1903	3310	2770
Other capital flows (negative is flight)	-3749	-943	-2899	887	-2150	-5670	-8100
Change in international reserves	1510	3264	10345	3470	1976	4040	900
External position (mln USD)							
Total foreign debt	28953	28491	28884	28555	30512	33290	35740
Short-term debt	3211	3011	5806	6147	5249	5390	5820
Total debt service due, incl. short-term debt	6273	7025	10211	10753	10557	7970	8930
Total foreign exchange reserves	13599	16733	26857	30272	32013	35870	36680
International investment position	-26288	-25678	-31164	-30245	-36978	n.a.	n.a.
Total assets	24962	32747	47615	48253	56152	n.a.	n.a.
Total liabilities	51250	58425	78779	78498	93130	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	6.6	9.7	7.7	2.4	4.6	5.1	5.2
Current account balance (% of GDP)	1.4	3.1	1.1	-3.3	0.2	-0.2	0.2
Inward FDI (% of GDP)	3.2	3.8	5.1	5.4	3.8	4.2	3.1
Foreign debt (% of GDP)	36	31	27	22	24	21	21
Foreign debt (% of XGSIT)	131	96	82	72	88	80	80
International investment position (% of GDP)	-33.1	-27.8	-29.1	-23.7	-29.2	n.a.	n.a.
Debt service ratio (% of XGSIT)	28	24	29	27	30	19	20
Interest service ratio incl. arrears (% of XGSIT)	8	6	6	4	2	2	2
FX-reserves import cover (months)	10.7	11.0	13.5	10.7	14.9	13.9	13.8
FX-reserves debt service cover (%)	217	238	263	282	303	450	411
Liquidity ratio	145	150	152	137	158	164	161

Source: EIU