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PERU: A balanced economy set for higher growth

- In this report we summarize our recent discussions with authorities and market participants regarding the Peruvian economy. In summary, the economy is shaking off the effects of years of heightened political uncertainty, bouts of social unrest, and climate shocks, with GDP growth projected to snap back this year close to 3%, driven by a recovery of private consumption and investment. Inflation has largely surprised to the downside since last year, fluctuating close to the BCRP's 2% inflation target, with one year ahead inflation expectations edging down towards ~2.5%. The central bank has gradually cut the policy rate and is projected to continue doing so towards slightly above neutral (4.5%) over the following quarters; spikes in exchange rate volatility driven by global swings in risk aversion and low interest rate differentials with the U.S., would be smoothed out via interventions of the central bank's ample reserves.

- Even though persistently weaker-than-expected cyclical revenues have led to a significant widening of the nominal fiscal deficit this year (4% of GDP in rolling 12-months through September), well above the MoF's annual 2.8% target, fiscal consolidation should proceed next year supported by the normalization of revenues and lower public investment. Changes in economic policy in the U.S. are projected to spillover through tighter global financial conditions, as concerns regarding a more pronounced slowdown in China pose a greater risk through terms-of-trade and demand for the country's exports.

Activity

In 2023, the Peruvian economy contracted due to the lagged effects of contractionary monetary policy and compounded by transitory shocks that weighed on activity – protests and social unrest during 1Q23 and climate shocks throughout the year.

Authorities and market participants forecast 2024 GDP growth at roughly 3%, with a recovery across all demand-side components. On the external front, positive terms-of-trade continue to support exports, especially mining, which have led to a comfortable trade surplus. On the supply side, in addition to the mining-led recovery, services and tourism are supporting improvement in economic activity.

At a higher frequency, market participants have downplayed the effects of recent crime-related trucker strikes on inflation and activity. Electricity production, estimated to have risen by 2.7% YoY in October, is closely monitored as a proxy for economic activity.

Business confidence at the 3 and 12-month horizons have improved for several months, breaching optimistic territory for the first time since early 2021. Demand for commercial credit is gradually improving. Imports of capital goods, leading indicator for investment dynamics in the economy rose by 8.9% in the rolling quarter ended in August. Market participants claim lower political uncertainty has contributed to greater clarity on investment plans for firms. However, concerns regarding crime and insecurity pose risks for sentiment and the investment recovery.

Potential GDP is seen close to 3%, well below previous years, mainly reflecting the effects of years of elevated political uncertainty and weak productivity growth. Market participants believe that improvements in governability that would lead to lower economic policy uncertainty could easily raise potential GDP back to 4%. Years of higher growth could eventually revert the Covid-related jump in poverty and reduce informality in Peru's labor market.

The projected economic impact of the new Chancay Port came up in our discussions. China Ocean Shipping Group (COSCO) owns 60% of the port, that would reduce transit times between Asia and Peru from a total of 25 to 15 days. The port's investment is estimated to have reached roughly USD1.5 billion and considers further developments that would lead to total investments of USD3 billion. In doing so, Chancay is described as a potential shipping hub for the region with authorities claiming that it will improve Peru's competitiveness, enhance productivity, facilitate the development of additional transportation infrastructure, and allow for the development of new industries close to the port. The port would operate roughly a third of the volumes of Callao, the country's main port. Congress is expected to discuss a bill that creates a Special Economic Zone (SEZ) where the port is located, with special tax treatment for firms to produce and export from Chancay; BYD and Huawei were mentioned as firms that had plans of producing in this SEZ.

Inflation & Monetary Policy

Inflation has largely surprised to the downside since last year. In October, inflation fell by 0.09% MoM, driven primarily by volatile food items, leading to annual inflation to 2%, at the BCRP's inflation target. Core printed at 2.5%. After several quarters of declines, inflation expectations at the one year horizon have stabilized at roughly 2.5%, above the BCRP's 2% inflation target. In discussions, we learned that the BCRP's 2% inflation target, below the 3% of other inflation-targeters in the region, was set to facilitate the de-dollarization of the economy, considering it is equivalent to the Fed's inflation target.

In this context, the BCRP has cut the policy rate from its cycle peak at 7.75% to the current 5.0%. Market participants expect the BCRP to take the policy rate to 4.75% - 5.0% by year-end and to 4.5% next year, slightly above neutral (4%). Some were of the view that bouts of greater exchange rate volatility would be mitigated by central bank interventions. The central bank has ample reserves (roughly 26% of GDP). The BCRP's long-standing Governor Julio Velarde ends his fourth five-year term in 2026.

Fiscal Policy

Market participants downplayed the large fiscal deficit accumulated in the year through September (4.0% of GDP), stating the deterioration is largely due to a delayed recovery in cyclical revenues that have already begun to turn the corner. Consistent with this view, rating agencies S&P and Fitch recently stabilized the sovereigns outlook from negative. The MoF is implementing several measures with the tax and customs offices to reduce tax evasion and elusion; Congress recently approved a law that charges VAT on digital services that should raise revenues by 0.1% of GDP per year. Importantly, public investment has increased materially and is projected to conclude this calendar year, facilitating the fiscal consolidation process in 2025 (MoF deficit target of 2.2% of GDP). Still, the MoF's 2024 nominal deficit target (2.8%) is likely to be missed for a second consecutive year. The fiscal consolidation next year is also to be facilitated by low real expenditure growth (2% YoY in the 2025 budget), and the revenue kick from the annual tax season (to be concluded in May 2025) that should reflect this year's recovery in economic activity.

Limited impact of pension fund withdrawals on the sovereigns funding. MoF authorities state that following the series of seven pension fund withdrawals, banks have become a more important player in absorbing the supply of government debt, without a material effect on the sovereign's market access.

Politics

Economic policy uncertainty has declined materially in recent years. In parallel, the Executive and Congress have very low approval ratings. Political fragmentation is extreme—with more than 30 parties – and on the rise – another +30 are in the process of being registered. With presidential and legislative elections looming in 2026, governability challenges remain a concern among market participants. Recent constitutional changes to the political system that approved the return to a bicameral system and eliminate measures that have contributed to the constant clashes between the Executive and Congress in recent years, could reduce tensions and eventually facilitate improvements in governability.

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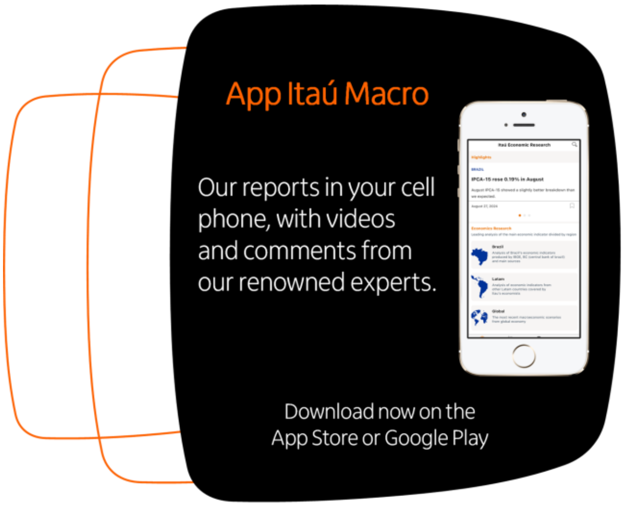

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