BTMU Focus Latin America

Peru: macroeconomic performance

(2Q GDP and Current Monthly Indicators)

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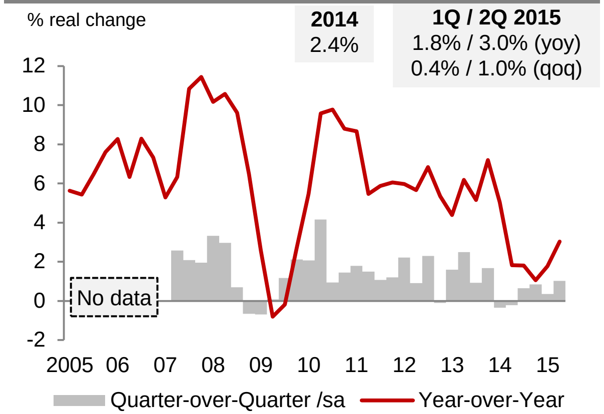
I) Peru: Growth Momentum (1)

▪ Second-quarter growth rebound, albeit positive, underscores lingering weakness in investment and exports.

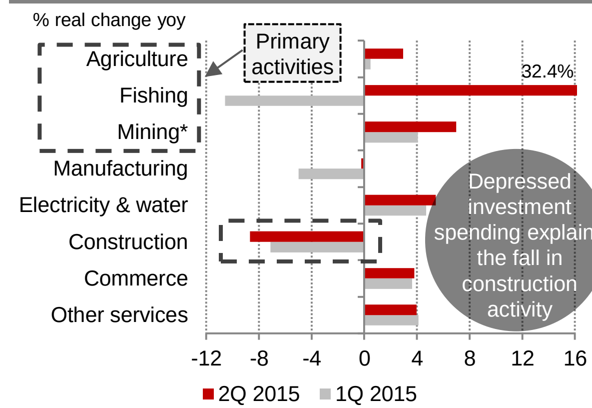
- The Peruvian economy climbed by 3.0% yoy in 2Q 2015 after a 1.8% yoy rise in 1Q. This expected rebound, largely shored up by the pickup in mining production (led to increased inventory), and a still-healthy private consumption (reflected in the service sector), was certainly a welcome relief after 4 quarters of anemic growth. But beside that, there is not much to cheer about. For starters, export volume dipped for the fourth consecutive quarter in 2Q, suggesting an ever more hostile external backdrop for relatively undiversified economies such a Peru (e.g., copper and gold accounted for 39.5% of the country's total exports in 2014). To be precise, the drop in export volume so far this year has been driven by manufacturing exports rather than by mining exports, which possibly explains why manufacturing output fell by 2.6% yoy in 1H 2015. Also, gross fixed capital formation (GFCF), a key engine of growth over the last decade and a proxy for public and private investment, shrank by 9% in 2Q, the fifth yoy contraction in a row. No wonder optimism is still in short supply these days.

Figure 1: GDP Growth



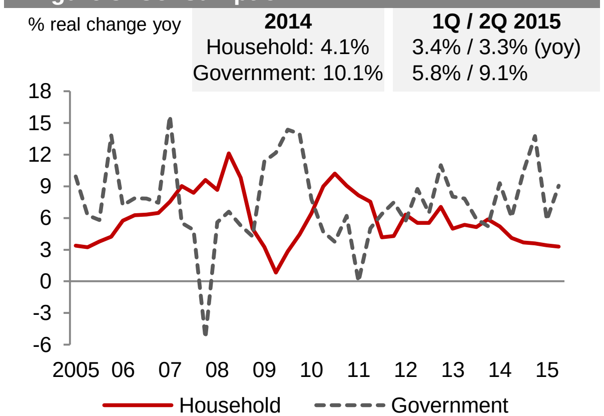
Source: Instituto Nacional de Estadistica e Informatica (INEI); Central Reserve Bank of Peru; BTMU

Figure 2: GDP by Sector



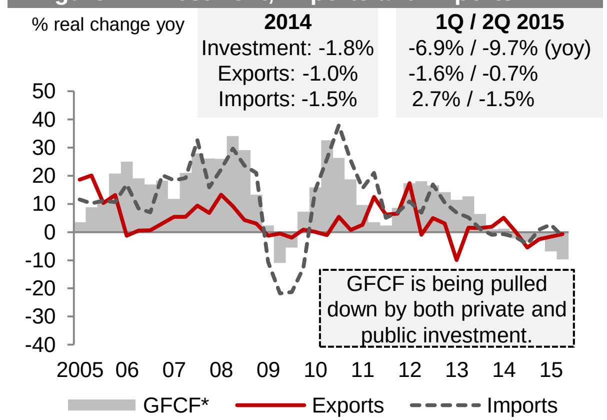
Source: Central Reserve Bank of Peru; BTMU

Figure 3: Consumption



Source: Central Reserve Bank of Peru; BTMU

Figure 4: Investment, Exports and Imports



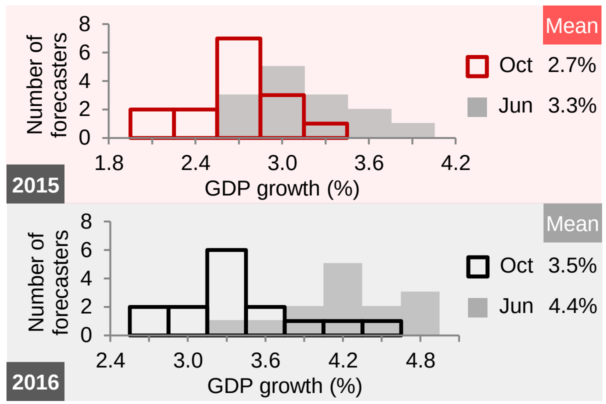
*Gross Fixed Capital Formation
Source: Central Reserve Bank of Peru; BTMU

I) Peru: Growth Momentum (2)

- **GDP growth will disappoint again in 2015, and next year's forecasted recovery should not be taken for granted.**

- Over the last decade, Peru has become one of the brightest spots in Latin America, underpinned by market-friendly policies, solid macro fundamentals, and in particular a commodity bonanza that helped boost export revenues, lure foreign investors and raise household income. But with commodity prices and external demand languishing, the once fastest-growing economy of South America is now losing shine rapidly. This year's growth is now expected to be around 2.5%, well below the initial forecasts (e.g., 4.4% in January). What went wrong then? Critics of Mr. Humala, President of Peru, blame the government's failure to bolster business confidence and run countercyclical fiscal policies despite having the means. The government puts the fault on the harsher external conditions instead. But the reality probably lies in the middle. Now, most forecasts signal a mild recovery in 2016, chiefly on the prospects of higher mining output and large investment projects. Still, that may be too sanguine given the possibility of an intense El Niño weather event and harder domestic and external conditions.

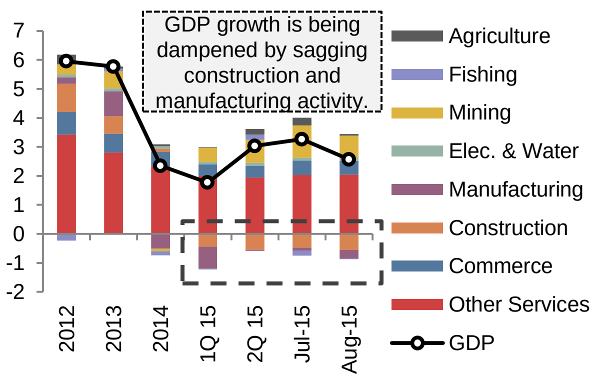
Figure 5: GDP Growth (Private forecasts)



Source: Consensus Economics; BTMU

Figure 6: GDP Growth by Sector

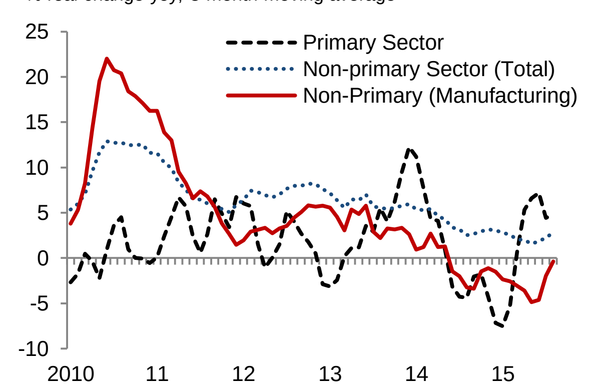
Percentage point, contribution to yoy GDP growth



Source: INEI; BTMU

Figure 7: Primary and Non-Primary GDP

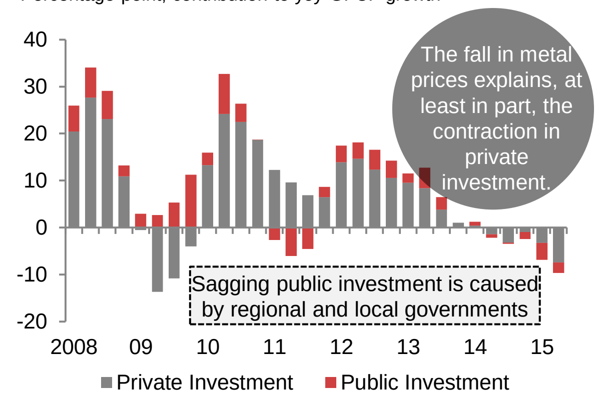
% real change yoy, 3-month moving average



Source: Central Reserve Bank of Peru; BTMU

Figure 8: Private and Public Investment

Percentage point, contribution to yoy GFCF growth



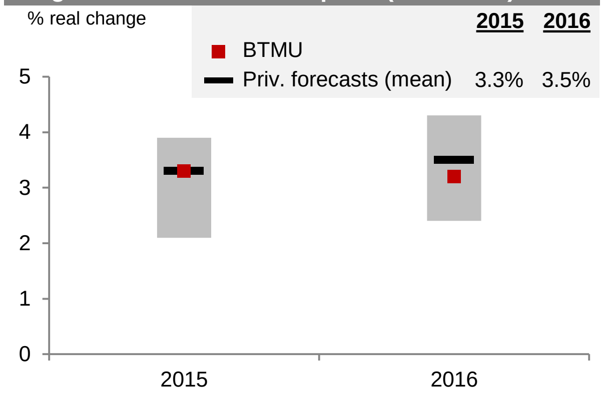
Source: INEI; Central Reserve Bank of Peru; BTMU

I) Peru: Growth Momentum (3)

▪ Household consumption is slowing down, but will probably remain growth-supportive throughout 2016.

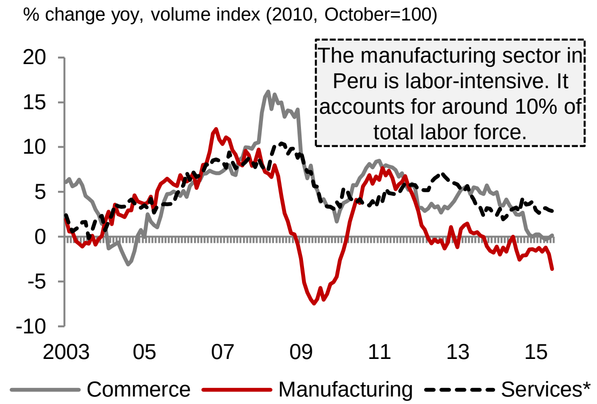
- Household consumption has been steadily slowing down since 2013, and should the average forecast for this year's growth prove to be accurate (around 3.3%), then consumer spending would be growing at its slowest pace since the midst of the financial meltdown in 2009. Several factors are behind this slowdown. An obvious one is the weakening trend in employment growth, especially in labor-intensive sectors such as commerce and manufacturing (~29% of the total labor force). Another reason is the adjustment of consumers to the prospects of softer economic growth (reflected in the fall of imports of durable goods). No less important are the stimulus measures (e.g., income-tax cuts) that were put in place last year: it is likely they are tapering off. Of course, from a regional perspective, the situation in Peru looks less daunting: a 3.3% pace would be still one of the fastest in the region. In fact, we expect private consumption to remain reasonably growth-supportive next year. The relatively small depreciation of the nuevo sol is one reason; the other one is the rise in consumer loans.

Figure 9: Private Consumption (Forecasts)



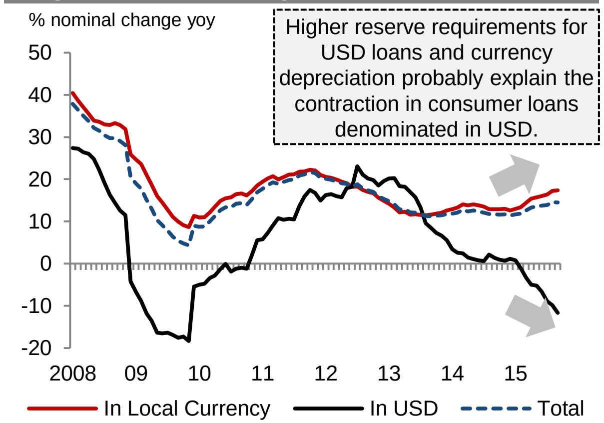
Source: Consensus Economics; BTMU

Figure 10: Employment by Sector



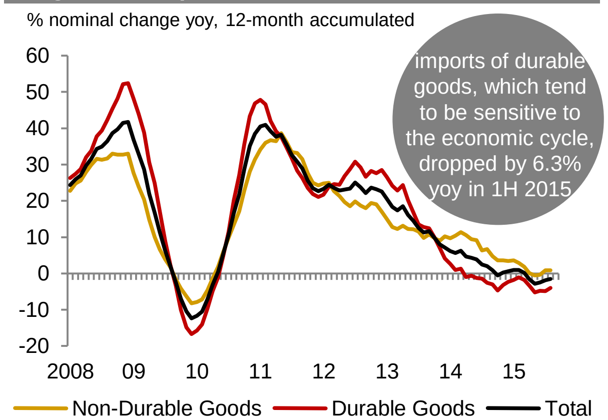
*Does not include the commerce sector
Source: INEI; Central Reserve Bank of Peru; BTMU

Figure 11: Outstanding Consumer Credit



Source: Central Reserve Bank of Peru; BTMU

Figure 12: Imports of Consumer Goods



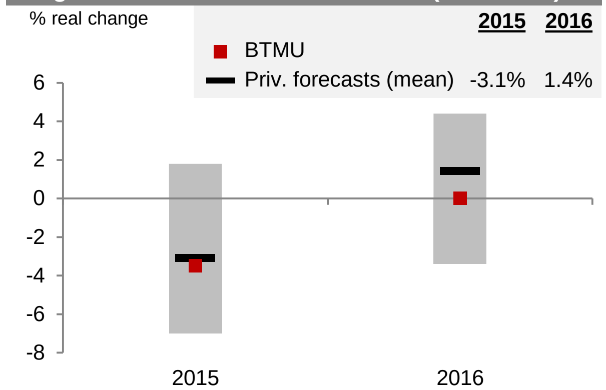
Source: Central Reserve Bank of Peru; BTMU

I) Peru: Growth Momentum (4)

▪ Private investment will probably stay as a drag to economic growth well into 2016.

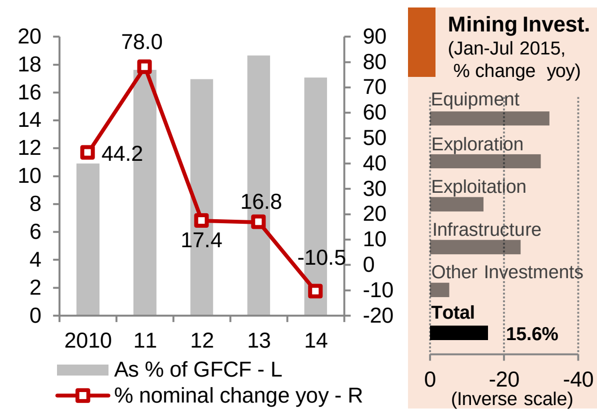
- Investment was no doubt one of the engines behind Peru's impressive economic growth over the last decade. To put things into perspective, the Andean economy grew at an average rate of 6.1% during 2005-14, and investment alone contributed 2.6 pp. Now the situation is quite the opposite: investment has been the main drag to GDP growth since 2013, and is expected to dive by more than 3% in 2015. One explanation for this gloomy outlook is the fall in mining investments, caused by lower metal prices, and to a lesser extent, by mining conflicts (e.g., the unrest over the Tia Maria copper project). What is more daunting, perhaps, is the possible contraction in construction activity in 2016 (-6.2%). True, part of the fault can be placed on low public investment and it should pick up next year. Yet weak private investment is also to blame. The central bank sees private investment picking up next year, but we have our doubts. 2016 is a presidential election year and will probably increase political uncertainty. Add to that a tougher external backdrop, and the most likely outcome is another year of contraction.

Figure 13: Gross Fixed Investment (Forecasts)



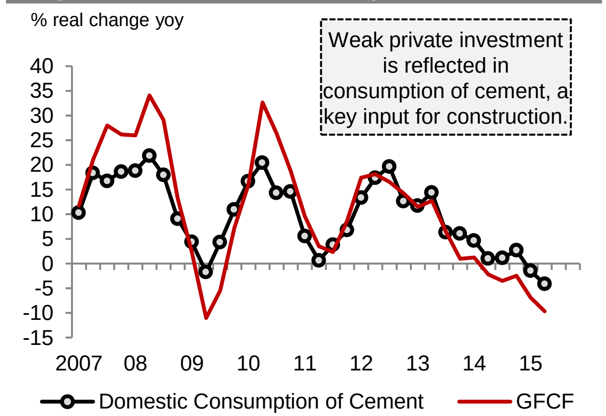
Source: Consensus Economics; BTMU

Figure 14: Mining Investment



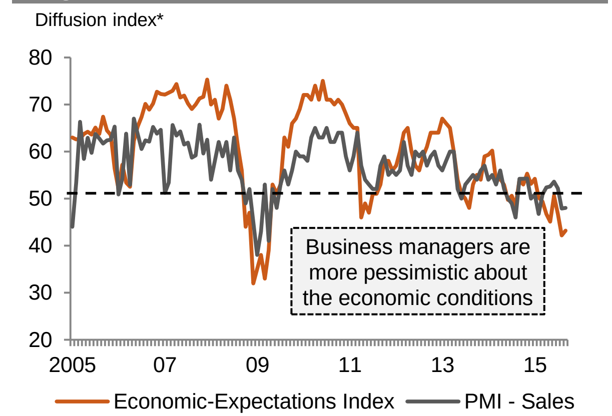
Source: Ministry of Energy and Mines of Peru; BTMU

Figure 15: GFCF and Consumption of Cement



Source: INEI; Central Reserve Bank of Peru; BTMU

Figure 16: Business Confidence



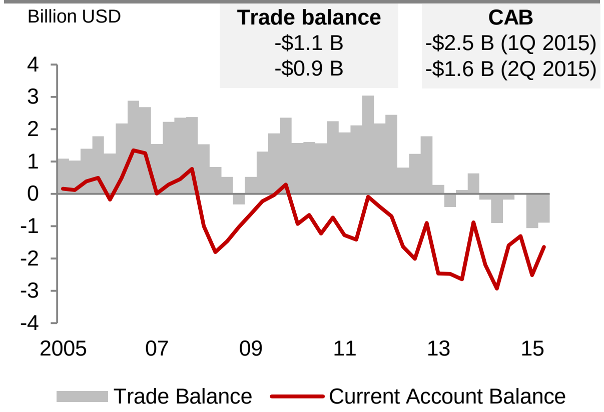
*Below 50 means there are more pessimists than optimists
Source: Central Reserve Bank of Peru; BTMU

II) Peru: External Sector

▪ Trade deficit will probably linger in the short-to-medium term despite higher export volume of metal ores.

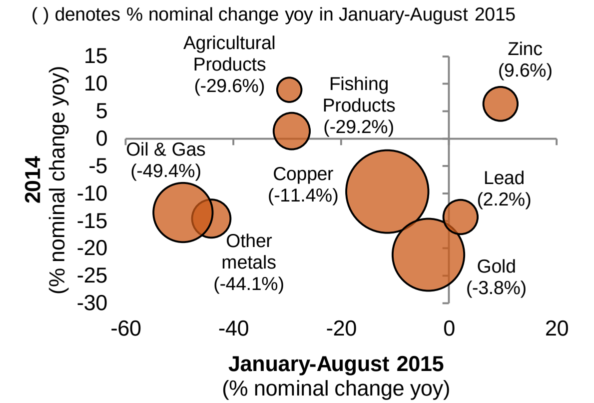
- Current account deficit shrank to $1.6bn in 2Q 2015 from $2.5bn in the first quarter, largely explained by the stark drop in income account deficit as mining companies continue to reduce their overseas profit remittances in the face of weakening metal prices. The country's trade balance also improved slightly in 2Q, posting a deficit of $0.9bn, down from $1.1bn in 1Q. Yet it will likely stay in the negative territory in the short-to-medium term for two reasons. First, household consumption will continue to cushion the fall in imports, as consumer spending is expected to remain relatively growth-supportive in 2016. A breakdown by types of products shows that imports of consumer goods only dropped by 2.6% yoy in the first 8 months of 2015, which is pretty small compared to fall in intermediate and capital goods (-13.7%). Second, this year's exports will possibly dipped by about 10% in nominal terms, despite higher export volume of metal ores. True, exports could well pick up in 2016 on the grounds of higher mining production, but the recovery is expected to be limited, in line with softer metal prices.

Figure 17: Current Account Balance



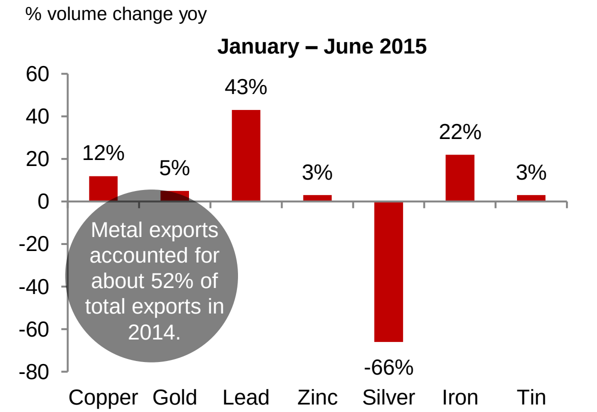
Source: Central Reserve Bank of Peru; BTMU

Figure 18: Traditional (≈ Commodity) Exports*



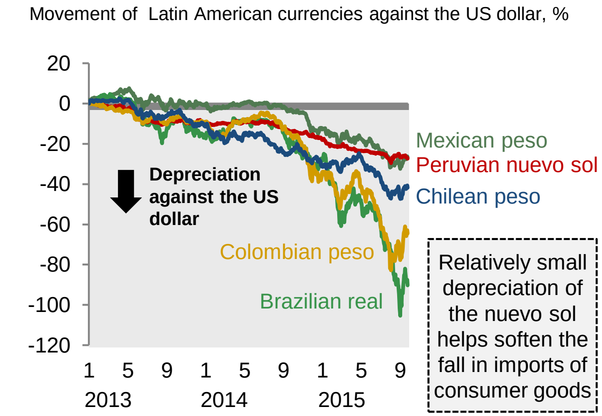
*Size of bubbles indicates share in total Peru's exports
Source: Central Reserve Bank of Peru; BTMU

Figure 19: Metal Exports



Source: Ministry of Energy and Mines of Peru; BTMU

Figure 20: Exchange rates



Source: Thomson Reuters; BTMU

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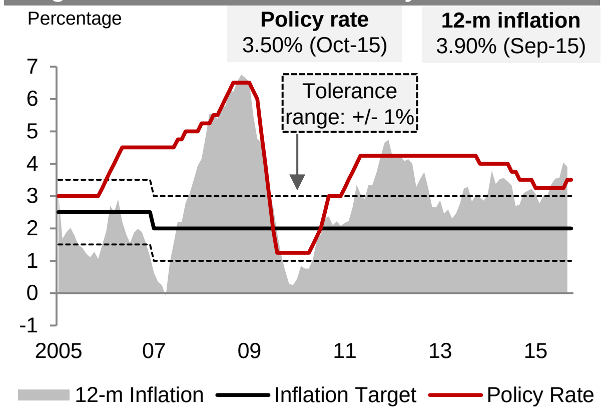
III) Peru: Prices and Monetary Policy

▪ The depreciation of the nuevo sol will probably keep inflation above the target range of 1%-3% well into 2016.

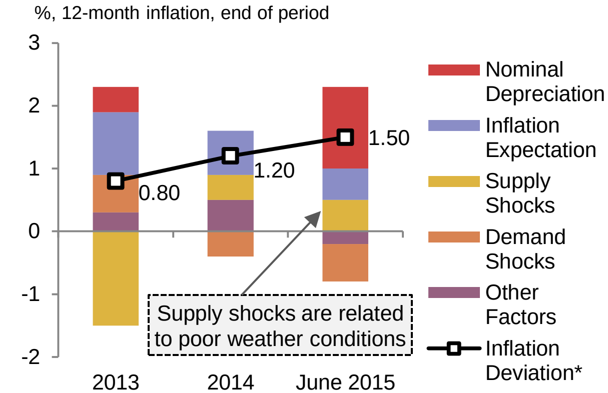
- Like in other major Latin American economies, the Peruvian monetary authorities are having a tough time taming inflationary pressures, while at the same time jockeying with weaker-than-expected economic recovery despite highly accommodative monetary policy. The country's annual inflation hit 3.9% in September on the back of higher electricity rates and food prices. What is worse, it has been entrenched above the official target range of 1%-3% since early 2015, which seems to suggest the pass-through from a weaker nuevo sol into inflation has not been trivial. In fact, a report published by the central bank appears to corroborate that thesis: nominal depreciation has been the most important driver of inflation this year (added 1.3 pp to June's 12-month inflation). More unnerving, perhaps, is that currency depreciation has directly translated into higher short-term inflation expectations, forcing the central bank to raise its policy rate by 25 bps in September. That might help, but it will not be enough to push inflation back toward the target of 2% in the short-term.

Figure 21: CPI Inflation and Policy Rate



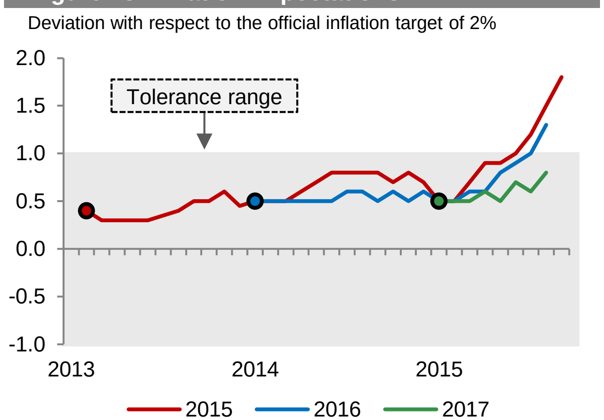
Source: INEI; Central Reserve Bank of Peru; BTMU

Figure 22: Decomposition of Inflation Deviation*



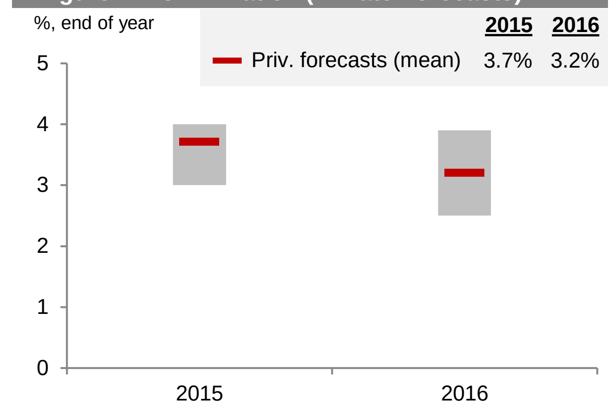
*Respect to the central bank's target of 2%
Source: Central Reserve Bank of Peru, Inflation Report (09/2015); BTMU

Figure 23: Inflation Expectations



Source: Central Reserve Bank of Peru; BTMU

Figure 24: CPI Inflation (Private Forecasts)



Source: Consensus Economics; BTMU

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