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Abstracts

Core Views

While we expect real GDP growth to slow over the medium term, significant mineral wealth, attractive investment opportunities at the sector level, and a growing consumer story underpin our view that Peru will remain one of the most dynamic economies in Latin America in the coming years.

Given our Asia Country Risk team's expectation that Chinese real GDP growth will trend lower in the coming years, as the economy rebalances away from an investment-led growth model to one in which private consumption plays a larger role, we anticipate that Peru will continue to be hit hard through the trade and investment channels due to weaker Chinese demand, lower average metals prices, and more moderate capital expenditure plans by major mining firms. Given these factors, we remain well below consensus on real GDP growth in Peru in the next few years, and we anticipate that these dynamics will precipitate a widening of the country's current account deficit, place downward pressures on the budget balance, and result in a weaker currency.

Major Forecast Changes

Following weak real GDP growth in H113, as well as further signs that the external sector weakness is weighing on the broader economy, we downgraded our 2013 real GDP growth forecast from 5.4% to 5.1%. In addition, following a substantial currency sell-off in recent months, we believe that a weaker sol is likely to weigh on consumers' purchasing power and dampen sentiment, leading to more moderate real private consumption growth.

With the Peruvian sol taking a substantial leg lower in recent weeks, in line with a broader sell-off in emerging market foreign exchange, and poor balance of payments dynamics likely to continue weighing on the currency in the coming months, we have revised our average exchange rate forecasts for the next few years to account for greater weakness, forecasting the unit to average PEN2.7100/US$ in 2013 and PEN2.7200/US$ in 2014.

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sector or the sol this year, we are downgrading our 2013 real GDP growth forecast to 5.1%, from 5.4% previously. This revision is underpinned by a downgrade to our real private consumption growth forecast for 2013, as we believe that a weak currency and an uptick in inflation will continue to dampen consumers' purchasing power in the coming months.

TABLE: ECONOMIC ACTIVITY

Exchange Rate Policy

PEN: Little Upside Following Substantial Sell-Off

Since our last update, the Peruvian nuevo sol has continued to weaken, finding support around the PEN2.8000/US$ level in recent weeks (see 'PEN: No Escaping Rebalancing Pressures', June 12). With sentiment towards the economy deteriorating on the back of slowing growth, we see little upside for the unit this year given our expectation for continued weakness in the current account and moderating investment in the mining sector. As such, we anticipate that the sol will continue to range trade between PEN2.7500/US$ and PEN2.8000/US$ in the coming months. However, a sustained break below PEN2.8100/US$ could indicate that further downside is ahead in the coming months, prompting us to revisit our exchange rate outlook.

Balance Of Payments

No Relief For Current Account As Exports Struggle

We are revising our current account forecasts for Peru to account for wider deficits of 5.5% of GDP in 2013 and 5.4% in 2014, due in part to further downgrades to our goods exports forecasts. While the financial account surplus remained robust in H113, and we expect that it will cover the current account deficit this year, significant volatility in emerging market assets in recent months has made us cautious about the potential for a sharp decline in financial inflows.

Monetary Policy

Rising Risks To Rate Cut View

We maintain our forecast for the Banco Central de Reserva del Peru to cut the policy rate by 25 basis points to 4.00% by end-2013, as slowing private consumption growth keeps economic activity weak. However, we acknowledge growing upside risks to this view, as inflation ticks up, following the Peruvian sol's significant sell-off in recent months, and the central bank continues to favour unwinding recent hikes in commercial banks' reserve requirements over adjusting the benchmark interest rate.

TABLE: MONETARY POLICY

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New Budget To Intensify Fiscal Pressure

The 2014 budget, recently presented before Peru's congress, is an ambitious attempt to expedite the country's economic development and maintain strong growth. However, the higher spending, coupled with global macroeconomic headwinds that are likely to weigh on revenues, will put downward pressure on the government's fiscal accounts. As such, we maintain our below-consensus view on the 2014 budget surplus, which we forecast will come in at 0.3% of GDP.

Regional: Sovereign Risk Ratings

Re-Pricing Of Regional Credit Risk Has Further To Run

A fundamental re-pricing of sovereign risk is under way in Latin America and the Caribbean, and we believe that further credit deterioration is likely. Nevertheless, selectivity will be key, as economies with more robust and sustainable growth models are likely to benefit from stronger investment flows and superior 'ability to pay' dynamics in the coming years.

CHAPTER 3: 10-YEAR FORECAST

The Peruvian Economy To 2022

Solid Growth Ahead

Economic growth in Peru will cool to an average growth rate of 5.0% between 2013 and 2022, as a slowdown in Chinese economic growth dampens metals demand and prices in the short term, while fixed investment and private consumption growth moderate from their recent highs. That said, we believe solid macroeconomic policies, substantial commodity wealth and a growing consumer base will continue to drive investor interest in Peru over the forecast period.

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