PERU

FROM ONE POLITICAL CRISIS TO ANOTHER

Peruvian GDP returned to its pre-crisis level thanks to the strong upturn in activity recorded in 2021. However, the country's capacity to rebound further is limited and short-to-medium-term growth prospects are moderate. Firstly, inflation pressures are weighing on private consumption and disruptions in the value chains are hampering the export sector. Secondly, the continuing political crisis is dampening the investment outlook. In addition, public finances have deteriorated over the past two years. It is not so much the level of debt, which is still moderate, but its composition which is worrying and is making the country more vulnerable to changes in investor sentiment.

SIGNIFICANT GROWTH SLOWDOWN

After a rebound of more than 13% in 2021, one of the highest growth rates in the region, activity is expected to slow very sharply in 2022 and 2023, to around 3% on average. The gradual withdrawal of pandemic-related support measures (monetary and fiscal), inflation pressures and social movements will weigh on domestic demand. At the same time, slowing global demand, deteriorating terms of trade (mainly due to geopolitical shocks), supply disruptions and value-chain disruptions are slowing exports.

Furthermore, inflation pressures have intensified since mid-2021 and have accelerated significantly since the beginning of 2022 (to 8.8% year-on-year in May). Although trade links with Ukraine and Russia are very limited, the impact of the war in Ukraine on commodity prices is significant for price increases in Peru. The Central Bank reacted quickly and increased its key rate by 525 basis points since July 2021 (to 5.5% at the end of June 2022). Inflation pressures are expected to persist at least in the coming months: disruptions in value chains will, at least in the short term, continue to put pressure on prices, and, above all, energy and commodity prices should remain stubbornly high. On average, inflation is expected to reach 7.0% in 2022 and we expect further rate hikes in the short term.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	2.2	-12.0	13.3	3.2	2.9
Inflation, CPI, year average, %	2.1	1.8	4.0	7.0	3.5
Central Gov. balance / GDP (%)	-3.0	-8.3	-2.8	-2.6	-2.6
Public debt / GDP (%)	26.8	35.4	36.1	35.8	35.4
Current account balance / GDP, %	-1.5	0.7	-2.8	-1.3	-1.3
External debt / GDP, %	34.7	44.7	41.2	42.4	41.7
Forex reserves, USD bn	68.4	71.5	76.6	81.8	82.9
Forex reserves, in months of imports	19.4	25.1	16.2	15.6	15.8

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

STRUCTURAL WEAKNESSES

Activity returned to the level seen in December 2019 (i.e. before the start of the COVID-19 pandemic) but is struggling to surpass it (Chart 1).

The economy's capacity to rebound is constrained. The country's structural weaknesses in terms of governance gradually worsened during the previous administration (2016–2021), as illustrated by parliament's distrust of the government and the increase in the number of corruption scandals. During that period, four presidents (three in November 2020), two parliaments and a large number of governments succeeded each other. The number of economic and social reforms put in place by the government has fallen sharply (compared to the previous decade) and growth (GDP grew by barely 3% per year on average between 2015 and 2019 compared to 5% between 2011 and 2015) and investment (whose share of GDP represented 21% of GDP between 2016 and 2019 compared to 24.3% of GDP between 2011 and 2015) has slowed significantly.

In addition, the massive support from the authorities from the start of the pandemic was not enough to prevent the deterioration of several social indicators (e.g. the poverty rate) and the labour market. According to the IMF, the very strict lockdowns imposed by the authorities (and prolonged school closures) will have negative effects on the accumulation of human capital and, therefore, on potential growth. The IMF now estimates that Peruvian potential growth is around 3%, while it was slightly above 3.5% before the crisis.

PERU: MONTHLY ACTIVITY INDEX

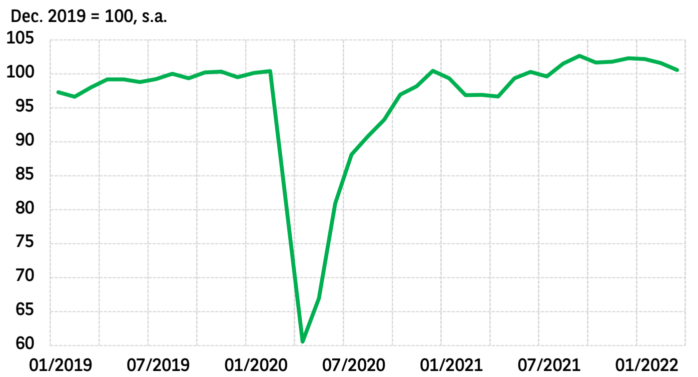

CHART 1

SOURCE: CENTRAL RESERVE BANK OF PERU, BNP PARIBAS

POLITICAL CRISIS: NO SHORT-TERM SOLUTION

In the short term, the political climate could deteriorate even further. Only 37 (out of 130) members of the assembly belong to the same party as President Castillo (who was elected in April 2021) and coalitions are fragile. In less than a year (the term began at the end of July), there have been numerous government reshuffles and the President has already avoided two impeachment proceedings.

If Pédro Castillo completes his mandate (in 2026), the relationship between parliament and the government will remain tense and the risk of impeachment proceedings multiplying is high. Conversely, if the President is removed, or if he resigns, new elections could lead to an even more pronounced polarisation of political life. Parliament is likely to remain fragmented, with no overwhelming majority, which will not improve governance and the ability to lead reforms.

Since last January, tensions have crystallised around the presidential plan to rewrite the constitution (influenced by the ongoing process in Chile). After a first proposal, rejected by parliament, Congress enacted a law which required members to approve any potential public referendum. The aim of this new law is to minimise the possibility of a new proposal being presented. At the end of April, however, the President submitted to parliament a new proposal for a referendum (which would be held on 2 October) concerning a new constitution. Although it is unlikely to be adopted, the bill is currently under discussion in parliament.

DETERIORATING PUBLIC FINANCES

For the moment, the economy is showing no sign of major imbalance and it has not proved possible to implement the most radical (and most costly) reforms envisaged by the government. However, the prolonged political crisis is likely to continue to weigh on the investment outlook (domestic and foreign). Above all, the President is unlikely to succeed in implementing the extensive tax reform he had committed to.

New populist measures are to be feared, further delaying the consolidation of public finances. Inflation pressures (the rate of inflation, which has continued to rise since mid-2021, reached 8.8% year-on-year in May) and numerous social movements in April have already led Congress and the government to provide further support measures. Congress allowed employees to draw on their pension savings. In April, the President announced a 10% increase in the minimum wage, as well as several support measures aimed at offsetting the effects of inflation: increases in fuel price subsidies and exemptions from certain taxes on essential goods, representing 0.3% of GDP. After a sharp reduction in 2021, the deficit is expected to shrink very slightly in 2022 (the increase in copper prices, and therefore government income, will offset the increase in expenditure associated with the support measures).

The risk associated with slipping public finances has increased over the last year. Although it is still at a moderate level, debt has increased sharply over the past two years, from 25% of GDP at the end of 2019 to 35% of GDP at the end of 2021).

However, it is not so much the level of debt but its deteriorating profile that is worrying: the increase in the deficit and the authorisation given to employees to draw on their retirement savings has resulted in an increased use of external financing. The debt is now 50% denominated in foreign currencies, and 50% owned by non-residents (each of the two indicators represented less than 30% of the total in 2019), which increases the country's vulnerability in the event of turmoil on the financial markets. Moody's and Fitch downgraded the country's sovereign rating in September-October 2021, and Fitch downgraded its rating in March 2022.

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PERU: PUBLIC DEBT

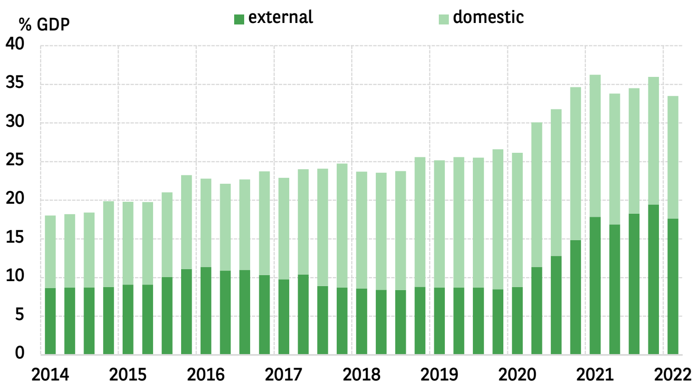

CHART 2 SOURCE: CENTRAL RESERVE BANK OF PERU, BNP PARIBAS