




»» Peru – a promising economy

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Economic situation

-  Real growth
-  Private consumption (yoy)
-  Inflation rate

Higher copper output is driving economic upswing

Peru has recovered from its growth slump in 2014 on the back of expanding copper production. Real GDP is forecast to grow 4 % next year. However, the fast pace of growth means that inflation, which exceeds the target set by the central bank, will recede only slowly. Most of the strong growth performance is sustained by private consumption expenditure, while investment has been weak for the last two years.




Growth financing

-  Budget balance / GDP
-  Current account balance / GDP
-  External debt / GDP

Fiscal boost countered cyclical downturn

Fiscal policy responded to the cyclical downturn of 2014 with expansionary measures. The tax reform and investment incentives have also put pressure on public finances, resulting in a substantial budget deficit. The new president has pledged to continue the loose fiscal policy. Public and foreign debt, however, is low. The country is running a significant current account deficit because of the weak external environment, which includes low commodity prices.




Growth resources

-  Investment ratio
-  Share of manufacturing
-  Real effective exchange rate

Investment is dependent on the mining sector

Peru is heavily dependent on mining and its share of manufacturing matches the low Latin American average. Its mining dependence is also reflected in the investment weakness of the last few years, which was mainly due to reduced mining investment. Accordingly, the investment ratio has fallen, prompting measures to increase investment incentives. The recent real effective currency depreciation has been relatively low compared with other emerging economies.

Economic relations with Germany

-  Germany's share in exports
-  Germany's share in imports
-  FDI inflows from Germany

Trade focuses on commodities and machinery

Peru's main exports to Germany include primarily copper, zinc and lead, as well as coffee and spices, while Peru imports mainly vehicles, machinery of all types and electrotechnical equipment from Germany. The volume of German direct investment in Peru also reflects the relatively small size of the Peruvian economy.

Legend (see p. 5 for detailed explanation of methodology)

 very good  good  neutral  poor  very poor

Investment climate – assessment by our local experts

Peru has a strong economy and made good progress in reducing poverty. It achieved this on the back of structural reforms, relative political stability and a stability-oriented monetary and fiscal policy. The new government has also pledged to continue its business-friendly policies, which will mainly involve supporting investment. Further progress will require, among others, better education, improved infrastructure and less bureaucracy. That should also help reduce the large informal sector. Social conflicts with a potential for violence fuelled by environmental problems associated with extractive activities are a particular issue.

Continued on p. 2

Focus: An evolving financial system

Peru has a well-functioning banking system, while capital markets play only a minor role and is particular relevant for large enterprises in the tradable goods sector. Non-banks serve an increased number of micro, small and medium-sized enterprises. The cyclical downturn of 2014 has left its traces here, with strong increases in NPL ratios. But at least the regulated part of the financial system should have adequate buffers to handle more bankruptcies. At the same time, the intensely competitive micro-finance sector is due for consolidation. The continuing substantial dollarisation of the financial system is seen as a major weakness although significant progress has been made using the national currency (the sol) for deposits and lending.

Continued on p. 2

Investment climate – assessment by our local experts

Newly-elected president Pedro Pablo Kuczynski will take office on 28 July 2016. His government is also expected to continue the investment-friendly, stability-oriented and liberal economic policy of its predecessors. In order to create an investment-friendly environment, Peru is also building on its membership of regional economic groupings such as Mercosur and the Pacific Alliance with Chile, Mexico and Colombia. The latter was founded in 2011 for close coordination of standards and regulations so as to promote the exchange of goods and services and the free movement of persons. The planned accession to the OECD is also intended to bring the country closer to international standards. Even before a formal invitation to join, an OECD country programme was launched in December 2014 to support Peru in designing structural reforms. It aims to improve the standard of education, reduce the informal sector, strengthen the tax system and create capacity to offer government services such as access to water and sanitation, even in remote areas. The programme also covers environmental policy and compliance with international environmental standards.

As a second-generation emerging economy, Peru still has major infrastructure weaknesses and needs investment in

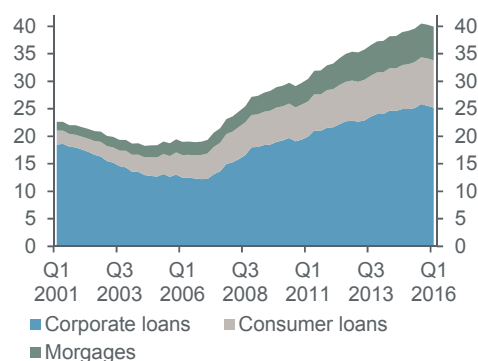
areas such as public urban development, renewable energies, water supply and sanitation, as well as transport infrastructure. The country's commodity wealth has turned the extractive and associated industries into major economic drivers. Plans to more strongly diversify the economy and reduce its dependence on commodity prices require investment in other sectors. But since this process will take time, mining will remain a significant driver of economic development for some time to come. Moreover, mineral deposits have not yet been developed to the same degree as in other Latin American countries such as Chile and Mexico, so this sector can still be expanded further.

What is problematic for private enterprises is extensive bureaucracy, which hampers businesses' day-to-day operations. It is even a problem for the public sector itself as it impairs anti-cyclical fiscal policy by slowing down the implementation of measures that bolster economic activity. Weak institutions, especially at decentralised level, and the associated relative legal uncertainty are further obstacles for private enterprises. Legislative changes aimed at improving the overall framework will also take time. Nevertheless, Peru will have to implement further reforms if it is to continue its economic success story.

Based on an interview conducted with Silke Hermes, Director of the KfW Office in Lima, on 27 June 2016. ■

Figure 1: Loans to the private sector

In per cent of GDP



Notes: Lenders are deposit-taking institutions. Loans in US dollars were converted by the Central Reserve Bank at the average exchange rate of December 2014.

Source: Central Reserve Bank of Peru, own calculations

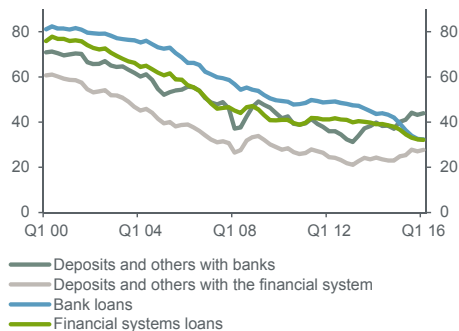
Focus: An evolving financial system

Banks are the main providers of capital for non-financial enterprises in Peru, even if the market for corporate bonds is gradually gaining importance. In the first quarter of 2015, total debt (loans and securities) of the private non-financial sector (businesses and households) was 58 % of GDP. Bank loans account for the highest share, with just under 60 %. The ratio of loans made to the private non-financial sector to GDP has also been rising since the mid-2000s. That trend also survived the global economic and financial crisis. The growing depth of the financial system is supporting economic growth. However, a rule of thumb also says that a more than 30-percentage points increase of private sector debt to GDP within ten years makes a banking crisis more likely. But Peru has not yet reached that level.

The banking system is generally regarded as stable, particularly as banks are operating at a profit, have liquidity and are well capitalised. Banks traditionally fund their lending through deposits. Four of the 17 banks dominate the system, together holding 83 % of the deposit and credit volume. Despite this concentration, they have been rated as having high operational efficiency. In addition, a certain degree of monopolistic competition has been identified and the interest spread has fallen since the mid-2000s – at least on deposits and loans in domestic currency. The interest spread between lending and deposits remains higher in domestic currency than in foreign currency, particularly because of the higher lending rates. One likely reason is that foreign interest rate levels act as an anchor for loans in US dollars. Another reason is that banks make local currency loans primarily to private households and small enterprises and therefore charge higher premiums.

Figure 2: Extent of dollarisation

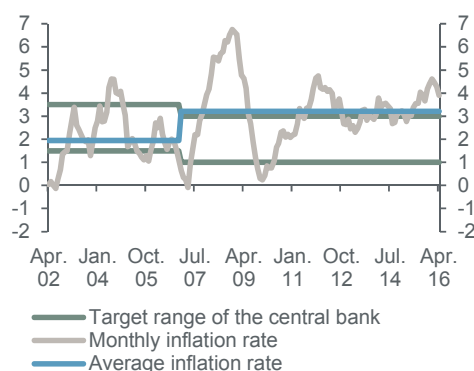
Share in foreign currency (in per cent)



Source: Central Reserve Bank of Peru, own calculations

Figure 3: Inflation and target inflation

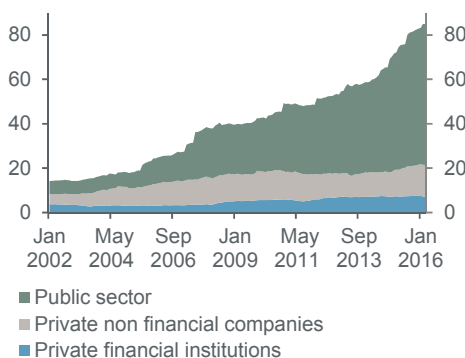
In per cent



Source: Central Reserve Bank of Peru, own calculations.

Figure 4: Local bond market

In PEN billions



Source: Central Reserve Bank of Peru, own calculations

The market penetration of banking services is relatively low, with just under 30% of adults holding an account in the formal financial system. That is less than the 51% average of Latin American developing and emerging economies. In order to expand access to financial services Peru is focusing on, among other things, mobile banking, since around 71% of adults own a mobile telephone. Rural areas are not well serviced while the cities are already oversupplied. Non-banks also lend to small and microenterprises, so their share in business loans from banks is on the decline. The microfinance environment has received good marks overall for regulation and innovation. A National Strategy of Financial Inclusion was launched in July 2015 with the aim of enabling three fourths of adults to hold a bank account by the year 2021, an ambitious goal. A much-needed consolidation of the sector has set in at the same time.

Dollarisation is regarded as the biggest weakness of the financial system and one reason for Peru's exchange rate management. The share of loans in US dollars has already been scaled back, from around 80% in the early 2000s to below 40% today. The share of US dollar deposits has also dropped significantly since the early 2000s. That trend has reversed again lately, however, and is associated with a depreciation of the sol against the US dollar. An anticipated depreciation creates an incentive to borrow in domestic currency but make deposits in US dollars. As the Central Reserve Bank's minimum reserve policy gives commercial banks strong incentives to lend in soles, while deposits in domestic currency are currently not following this trend, banks need to have alternative funding sources. The Central Reserve Bank therefore offers securities repurchase agreements to substitute and expand credit. The strong focus on reducing lending in US dollars, however, is raising some doubts about the sustainability of recent success. After all, reducing dollarisation is not an end in itself, but intended to reduce vulnerabilities of the financial system without disturbing financial intermediation. A major element is therefore to bolster the credibility of the sol in order to encourage domestic currency deposits. Since 2002 Peru has therefore applied a strategy of direct inflation targeting with a corridor of 1 to 3%. Inflation is higher at present, however. On the one hand, inflationary pressure stems from the depreciation of the sol, on the other hand the El Niño weather event has driven up the prices of food and other items via its impact on crop and fishing industries.

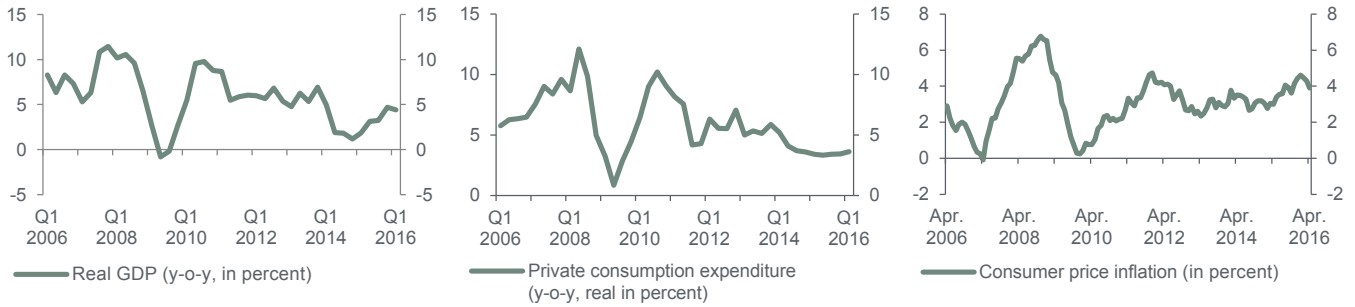
Enterprises rarely tap the capital markets for funding. The domestic bond market is therefore relatively illiquid although there is a functioning segment for government bonds. Just over half the bonds outstanding issued by non-financial enterprises on the domestic market are denominated in US dollars, whereas about 90% of bonds newly issued in 2014 and 2015 were in soles. But on the international capital market, where enterprises have been more active in recent years, bonds are almost exclusively issued in US dollars. Rising levels of private sector external debt are a common feature of Peru and other developing and emerging market economies. Even though this trend has to be monitored, a further development of the financial system with a focus on stability is indicated. ■

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Emerging Markets Spotlight

Overview of figures

Economic situation



Source: Thomson Reuters Datastream; Central Reserve Bank of Peru, IMF; own calculations

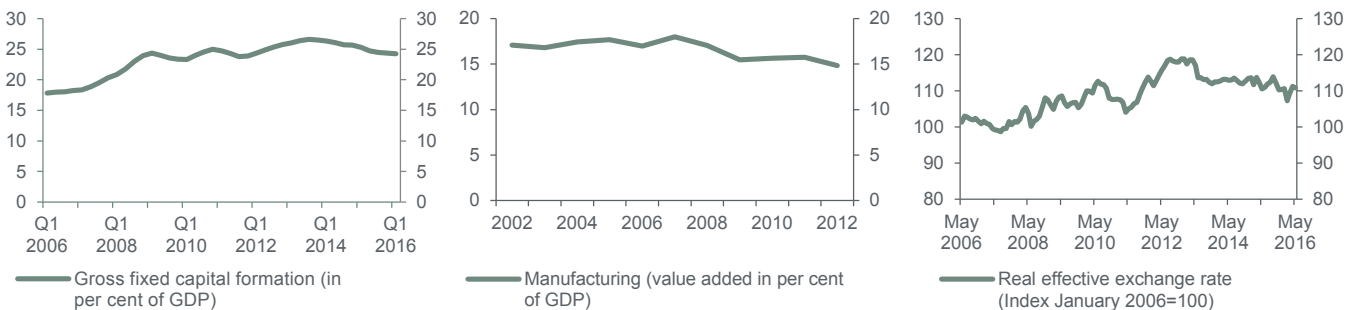
Growth financing



Budget balance to GDP as four quarter moving average, for calculation of external debt to GDP with sum of GDP over four quarters.

Source: Thomson Reuters Datastream; IMF, Central Reserve Bank of Peru, Worldbank; own calculations

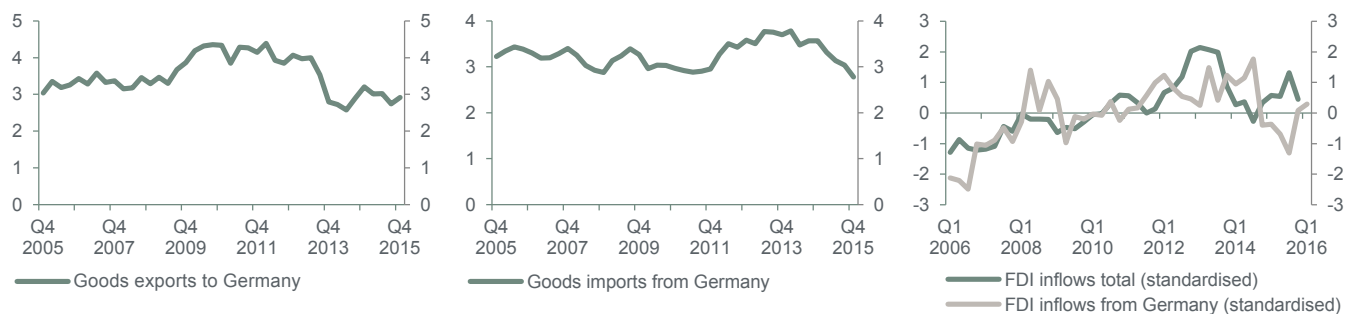
Growth resources



Gross fixed capital formation to GDP as four quarter moving average.

Source: Thomson Reuters Datastream; Central Reserve Bank of Peru, Worldbank, Bank for International Settlements; own calculations

Economic relations to Germany



Each as four quarter moving average.






Source: Deutsche Bundesbank; Thomson Reuters Datastream; IMF; European Central Bank; own calculations

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Emerging Markets Spotlight

Methodology

In the Emerging Markets Spotlight, a selected country is analysed based on various macroeconomic indicators. These indicators are grouped into four categories: economic situation, growth financing, growth resources and economic relations with Germany.

 Quintile 1	The indicators are used to compare the country's situation with its peers. The group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The comparison is based on a quintile ranking in five categories, which are labelled in different colours (see chart):
 Quintile 2	
 Quintile 3	The country is assigned to a quintile of the country group for each indicator analysed. The best quintile may be different for each indicator. For example, higher growth rates are better, so here the upper quintile is coloured dark green, but higher debt rates are a negative factor, so here the upper quintile is coloured dark red.
 Quintile 4	
 Quintile 5	

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