Economics

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Peru Macro View

Better than Expected… But Humala is Not Perfect

- Ollanta Humala is off to a better start than what was once feared. He has announced a strong commitment to macroeconomic stability, namely independent monetary policy and fiscal discipline. Markets seem to be giving him the benefit of the doubt.
- However, risks prevail, especially on the fiscal front. The administration's plan to raise social spending seems at odds with the government's pledge to keep fiscal discipline. In the face of a very ambitious social spending agenda, the government's assumption that current spending will decline (as a percentage of GDP) over the 2011-2014 period is overtly optimistic.
- We believe the government will likely disappoint on both the magnitude of social spending and the fiscal discipline pledge. In our baseline scenario, the worsening of general government primary balances should not become evident until 2014 and even then, our view is that the primary balance deficit will be relatively low at 1%. This situation should not threaten debt sustainability, considering that Peru's strong economic growth should still imply declining debt-to-GDP ratios.
- However, a worst case scenario analysis shows, unsurprisingly, that fiscal sustainability is very sensitive to assumptions on GDP growth and international commodity prices.

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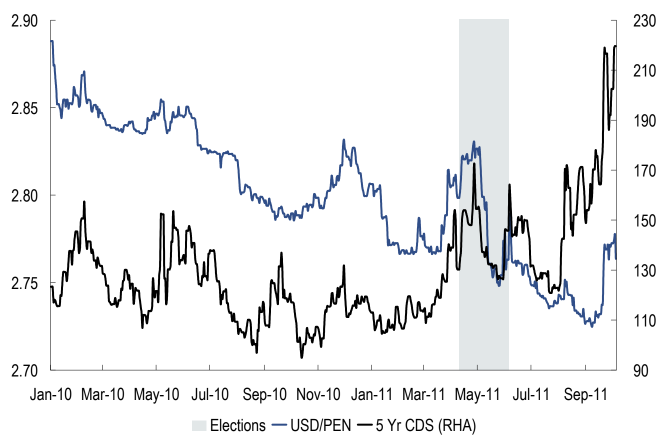
Better than Expected… But Humala is Not Perfect

Ollanta Humala is off to a better start than what was once feared. He has announced a strong commitment to macroeconomic stability, namely independent monetary policy and fiscal discipline. However, we believe his pledge for fiscal discipline is at odds with his promises to raise social spending. We therefore expect him to disappoint somewhat on both accounts. We estimate a simple fiscal account model (for the general government) that takes into account our GDP and commodity price forecasts, as well as our views on spending decisions. In our baseline scenario, the deterioration in fiscal accounts should not be evident until 2014 and even then, it should not be much of a threat for Peru's fiscal sustainability outlook. However, a worst case scenario analysis shows, unsurprisingly, that fiscal sustainability is very sensitive to assumptions on GDP growth and international commodity prices.

Policy risks under the Humala administration

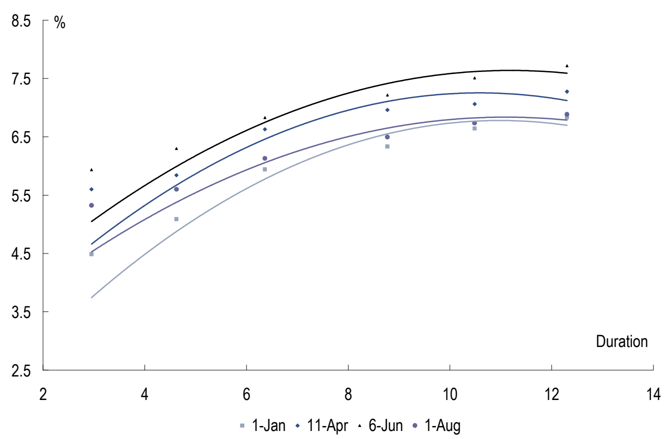
Ollanta Humala's haunting past. When Ollanta Humala started rising in the presidential election polls, markets feared a hard turn toward market-unfriendly and radical policies, as evidenced by the sharp sell-off in Peruvian assets (see Figure 1 and Figure 2). Although in the 2011 campaign Humala tried to show himself as a moderate – especially after the first round, when both candidates turned to the center to appeal to undecided voters – markets were still weary of the 2006 version, with his strong ties to Venezuela's Hugo Chávez and memories of his very radical proposals. Investors feared that the moderation was just a campaign trick and that once elected, he would go ahead with changing the Constitution, increasing State intervention in the economy through nationalization, deteriorating fiscal accounts and weakening central bank independence (just to name a few).

Figure 1. Peru: The Humala effect at work on the USD/PEN, CDS…



Source: Bloomberg and Citi Investment Research and Analysis

Figure 2. … and the Soberano yield curve



Source: Bloomberg and Citi Investment Research and Analysis

Nowadays, markets seem less weary of Humala. So far, Humala has assuaged these fears by announcing a strong commitment to economic growth and macroeconomic stability; even though he would like the government having a more active role in poverty reduction through social spending. In his speeches, he has vowed to keep fiscal discipline and independent monetary policy. These words have been backed up by appointments in top economic policy jobs. Shortly before taking over from the García administration, Mr. Humala appointed moderate Luis Castilla as Minister of Finance and kept Julio Velarde at the helm of the central bank for the 2011-2016 term. Regarding the three additional BCRP members that the government is entitled to, Mr. Humala chose José Gallardo, Jaime Serida and Luis Arias. Although these appointees do not seem to have a very strong background in monetary policy, they are moderates with academic and economic policy track records. As such, we see no major risk regarding the conduct of monetary policy for

the time being. Therefore, Humala seems to have pleased markets and investors, as reflected by the overall strengthening of Peruvian assets shortly after the elections.

However, risks prevail, especially on the fiscal front. Regarding economic activity, we expect Peru's growth to remain robust in the coming years. There are nonetheless some pieces of legislation that could cause some trouble. The Previous Consultation law – which envisages indigenous settlements agreeing to large investment projects in their land – could pose some hurdles for investment, depending on its implementation. Similarly, the proposals for labor reform seem to point toward an even more inflexible labor market, which should have the unintended consequence of keeping workers out of the formal sector. Another source of risk is political, as seems to be the permanent case in Peru. Core Humala supporters have made their discomfort felt with moderate cabinet appointments. Therefore, at the first sign of problems with the cabinet, we believe Humala will face substantial pressure to turn back to the left. We nevertheless believe that the most tangible source of risk comes from fiscal policy. The Humala administration has a very ambitious social agenda and it is now clear that higher taxes on mining companies will not finance it entirely. This fact seems at odds with the government's pledge to keep fiscal discipline.

The social spending bill should be hefty. Humala's social programs are extensive and include spending on education, social benefits, health, agriculture policy and security. Among the highlights, the *Pensión 65* plan would provide a free PEN250/month pension to the elderly (+65) who lack coverage. The *Juntos* program, which provides conditional cash transfers to poor households, is to be extended throughout the country. The *Cuna Más* program will provide child care to poor households and the *Beca 18* program is intended to give underprivileged students higher education scholarships. Humala also wishes to address security, currently one of the population's main concerns, through higher wages, training and better equipment for the police and the armed forces. Humala's initial campaign programs mention an increase in social spending worth 3% of GDP. Although we welcome the fact that the implementation of these programs will be gradual, spending is likely to rise through his term.

Can the MEF pay for all of this?

The recently released Multiannual Macroeconomic Framework (MMF) lays out a detailed plan of the government's fiscal strategy for the 2011-2014 period. The government's fiscal policy strategy for the next three years has five pillars: 1) reaching a structural balance for fiscal accounts by 2014; 2) rebuilding fiscal buffers; 3) keeping a countercyclical fiscal policy management; 4) continue reducing the public debt-to-GDP ratios and finally 5) a conservative 2012 budget, that will deliver campaign promises, reach fiscal targets and will allow the government to act if external conditions continue deteriorating.

Figure 3. Peru: Finance Ministry's Fiscal Outlook Forecasts*

	2011		2012		2013		2014	
	% of GDP	PEN Bn	% of GDP	PEN Bn	% of GDP	PEN Bn	% of GDP	PEN Bn
Current Revenue	**20.5**	**98.1**	**20.7**	**107.6**	**21**	**117.9**	**21.2**	**129.0**
Non-Financial Expenses	**18.7**	**89.3**	**18.6**	**96.3**	**18.4**	**103.5**	**18.3**	**111.6**
Current Expenses	12.9	61.8	12.4	64.1	12.1	67.8	11.7	71.4
Capital Expenses	5.7	27.5	6.2	32.2	6.3	35.7	6.6	40.2
Capital Income	**0.1**	**0.3**	**0.0**	**0.2**	**0.0**	**0.2**	**0.0**	**0.2**
Primary Balance	**1.9**	**9.1**	**2.2**	**11.5**	**2.6**	**14.7**	**2.9**	**17.6**
Interests	**1.2**	**5.5**	**1.1**	**5.9**	**1.1**	**6.1**	**1**	**6.3**
Final Balance	**0.7**	**3.5**	**1.1**	**5.6**	**1.5**	**8.5**	**1.9**	**11.4**

Source: MEF

* General Government

On the revenue front, the Finance Ministry (MEF) is not counting on a substantial increase in revenues. According to the government's estimations, consolidated government current revenues, as a percentage of GDP should rise from 20.5% in 2011 to 21.2% by 2014. Regarding tax revenues the administration said it will focus on improving collection efficiency and an all-out attack against tax evasion. As the economy shifts from the informal sector to the formal sector, tax collection should also feel some support. When it comes to other revenue sources, the recently approved tax on mining firms should provide higher royalty payments.

However, and despite social spending plans, the government expects spending as a share of GDP to decline over time. The government expects to cut non-financial expenditures to 18.3% of GDP in 2014 from 19.3% of GDP in 2010. The brunt of the decline in spending will fall on current spending, expected to decline to 11.7% of GDP by 2014 (from 13.2% in 2010). In the meantime, the MEF wishes to increase capital expenditures (public investment) over the period, for it to reach 6.6% of GDP by 2014. At first glance, this scenario seems at odds with the government's plan of boosting social spending. The MEF justifies these forecasts by saying that the improvements in public sector efficiency will allow it to open room for the ambitious social agenda. As a result, the consolidated government would post an average primary surplus of 2.6% of GDP during 2012-2014.

In our view, the government's initial plan is overtly optimistic. We welcome the fact that the government is fairly conservative regarding its assumptions on revenues. We also welcome that the government expects to raise capital spending to 6.6% of GDP by 2014, as the country is in sore need of infrastructure if it wishes growth to remain in the vicinity of 6%. However, in the face of a very ambitious social spending agenda, the assumption that current spending will decline (as a percentage of GDP) over the forecast period – relying on higher public sector efficiency to finance social programs – is overtly optimistic. We welcome any improvements in public efficiency, but it is safe to say that these will not likely come in the quantities the government currently expects. Therefore, some campaign promises will have to be broken. Either the social spending will have to be less generous than what is contemplated or the Humala administration will have to tolerate somewhat looser fiscal policy.

What can we expect from fiscal accounts?

The government will likely disappoint on both the magnitude of social spending and the fiscal discipline pledge. Our baseline scenario is that the government will not be able to use higher government efficiency as a means for financing its social spending agenda. Nonetheless, it will be able to raise spending to some extent, which will imply that final fiscal balances are going to be weaker than what it is currently expecting.

We estimate a very simple model of fiscal accounts. Our simple model for the general government's (consolidated public sector) balances takes into account our forecasts on economic growth and commodity prices as well as our views on spending decisions. Below are some of the main assumptions (a summary of the macroeconomic assumptions used in the model can be found in Figure 11):

- General government current revenues are a function of nominal GDP growth and Peru's export prices, which we consider as exogenous variables. Current revenues are also affected by lagged values of nominal GDP and export prices. We assume that capital income will be in line with the government's assumption embedded in the MMF.
- Peru's export prices are a function of international prices for its main mining export products. We take into account the prices of gold, copper, silver and zinc.
- Current spending, as a percentage of GDP, will gradually reach 14.5% by 2014, up from 12.9% in 2011. Our assumption here is that there will be little gains in public sector efficiency. As such, the Humala administration will only be able to raise social spending by 1.5% of GDP, as opposed to Humala's plan for a 3% of GDP social spending plan.
- Capital spending should rise in line with government plans. The country needs to boost infrastructure spending and therefore the assumption to take capital spending slightly above 6% seems reasonable to us.
- The implicit interest rate paid on government debt will rise to 5.2% by 2014, which is in line with the historical average. The implicit interest rate is calculated as the amount of interests paid in one year, divided by the overall debt stock of the previous year.

Figure 4. Peru: Citi Fiscal Account Forecasts*

	2011		2012		2013		2014	
	% of GDP	PEN Bn	% of GDP	PEN Bn	% of GDP	PEN Bn	% of GDP	PEN Bn
Current Revenue	**21.2**	**101.5**	**21.7**	**112.6**	**20.9**	**117.0**	**20.08**	**121.5**
Non-Financial Expenses	**18.7**	**89.3**	**19.7**	**101.8**	**20.3**	**113.8**	**21.1**	**127.9**
Current Expenses	12.9	61.8	13.4	69.6	14.0	78.2	14.5	87.7
Capital Expenses	5.7	27.5	6.2	32.2	6.4	35.7	6.6	40.2
Capital Income	**0.1**	**0.3**	**0.0**	**0.2**	**0.0**	**0.2**	**0.0**	**0.2**
Primary Balance	**2.6**	**12.5**	**2.1**	**11.0**	**0.6**	**3.4**	**-1.0**	**-6.2**
Interests	**1.0**	**4.8**	**0.9**	**4.8**	**0.8**	**4.6**	**0.8**	**4.6**
Final Balance	**1.6**	**7.7**	**1.2**	**6.2**	**-0.2**	**-1.2**	**-1.8**	**-10.8**

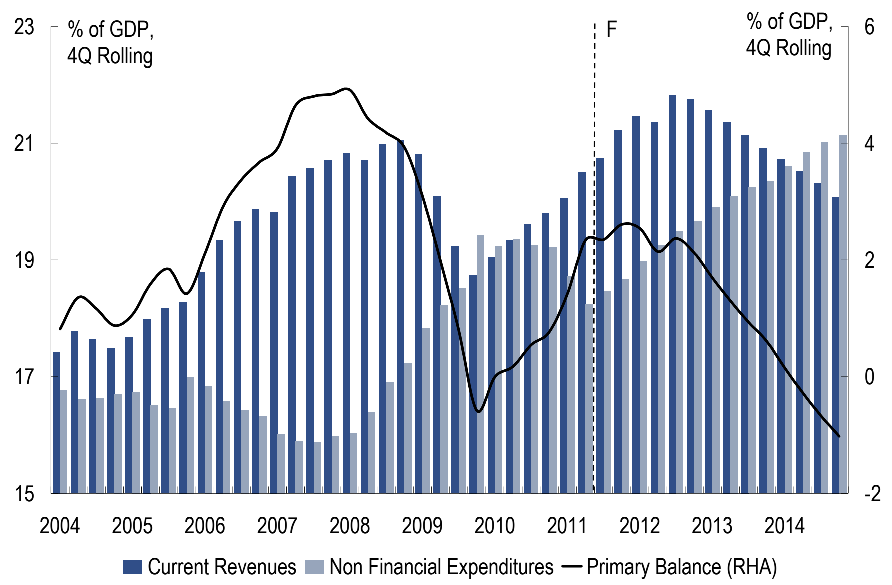
Source: Citi Investment Research and Analysis

* General Government

In the medium term, we expect a less rosy fiscal outlook relative to the government's estimation. The results from our simple fiscal model are summarized in Figure 4. We find that in 2011 and 2012, fiscal accounts are likely to perform better than what the government is currently expecting, but this would be

mainly due to revenue inertia, as strong commodity prices and growth in 2011 support revenues in 2012, despite a slowing down of economic activity[1]. From there on, our less optimistic view on commodity prices (for assumptions see Figure 11) should drive overall revenues lower at a time when overall spending is rising. As a result, we expect the primary balance to enter negative terrain and reach -1.0% of GDP in 2014. Figure 5 gives a clearer picture of the overall fiscal dynamics in our baseline scenario. Considering that social spending programs are very hard to cut, we would expect this additional rigidity on spending to keep the primary balance in negative terrain after 2014. Revenues in 2014 are consistent with long-term GDP growth and commodity prices and therefore, we would not expect them to surpass those levels in future years.

Figure 5. Peru: We expect the primary balance to deteriorate over time.



Source: MEF and Citi Investment Research and Analysis

What would a worst case scenario look like?

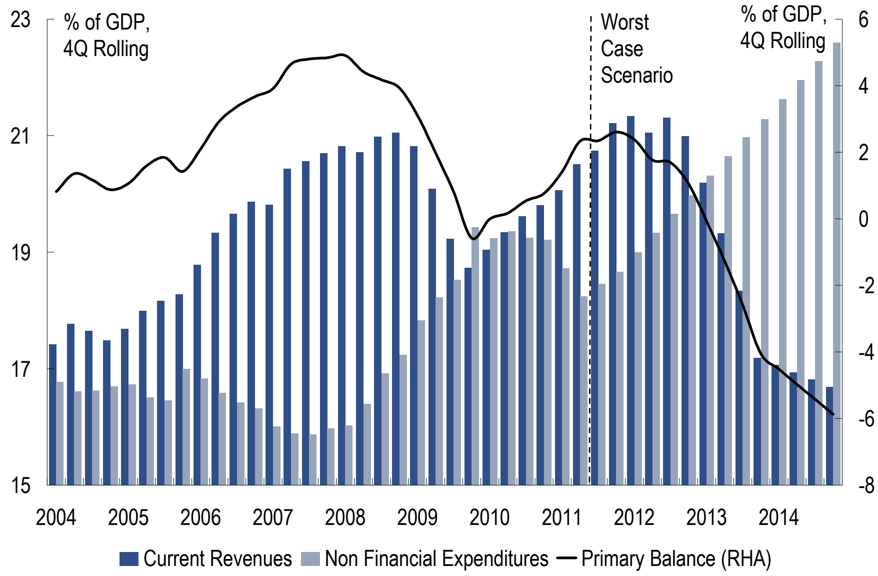
A worst case scenario for fiscal accounts would imply lower growth and commodity prices and higher spending. Given the current risks to the global economic outlook and uncertainty regarding Humala's spending plans, we would take advantage of this exercise to illustrate, what in our view, would be a worst case scenario for fiscal accounts. This scenario would materialize in the case where the world economy enters a protracted slump (implying lower commodity prices and GDP growth in Peru) and Humala goes full steam ahead with a social spending plan that would raise current expenses by 3% of GDP. The main assumptions under this negative scenario are (for more detail on macroeconomic assumptions see Figure 11):

- Nominal GDP growth would stand at only 4% from 2012 through 2014.
- Commodity prices would be 50% below the levels envisaged in our baseline scenario in the 2012-2014 time frame.

[1] Our assumption here is that real GDP growth slows down to 4.5% in 2012 from 6.5% in 2011. In a scenario where growth plummets due to international shocks, we would expect revenues to follow as they did in the 2008-2009 period.

- Current expenditures rise to 16% of GDP by 2014 and capital expenses rise to 6.6% of GDP by 2014.
- The implicit interest rate on government debt still rises to 5.2%, as risk aversion offsets the low global interest rate and deflationary environment.

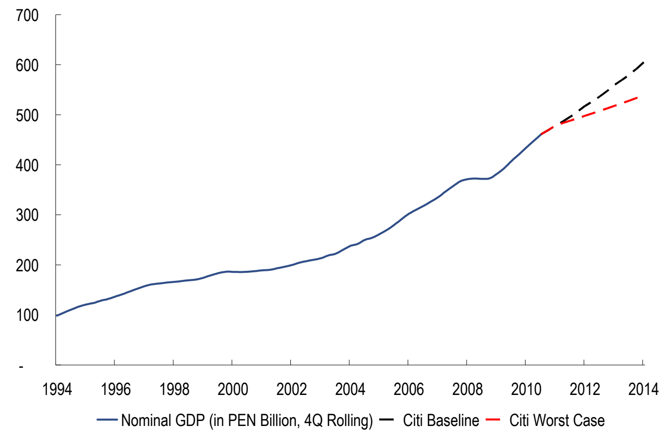
Figure 6. Peru: In a worst case scenario, fiscal accounts would deteriorate very quickly



Source: Citi Investment Research and Analysis

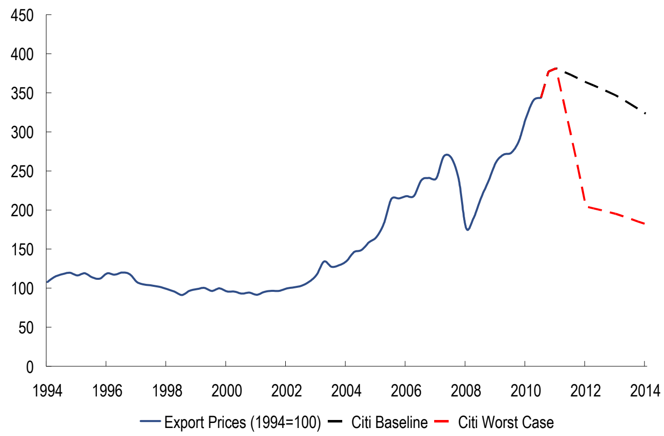
Unsurprisingly, fiscal accounts would deteriorate very quickly under said scenario. Under the scenario described above (See Figure 6), current revenues would deteriorate markedly, reaching 16.7% of GDP by end 2014. In the meantime, expenses would rise to 22.6% of GDP, resulting in a primary deficit of 5.9% of GDP. This would have a sizeable effect on public debt sustainability and would lead to much faster debt accumulation. Overall, even though the worst case scenario is very unlikely, this situation highlights that commodity prices and economic growth play a key role in Peru's fiscal outlook. The comparison between some key variables in our baseline scenario and our worst case scenario should provide valuable insight into the country's sensitivity to changes in fundamentals, as shown in Figure 8 through Figure 10.

Figure 7. Peru: Nominal GDP outlook



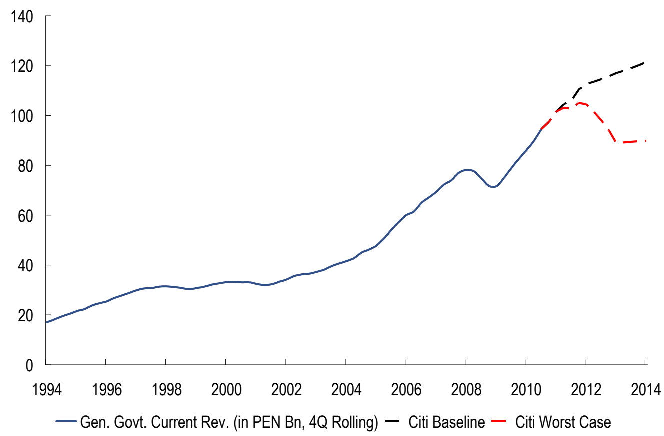
Source: BCRP and Citi Investment Research and Analysis

Figure 8. Peru: Export Price Outlook



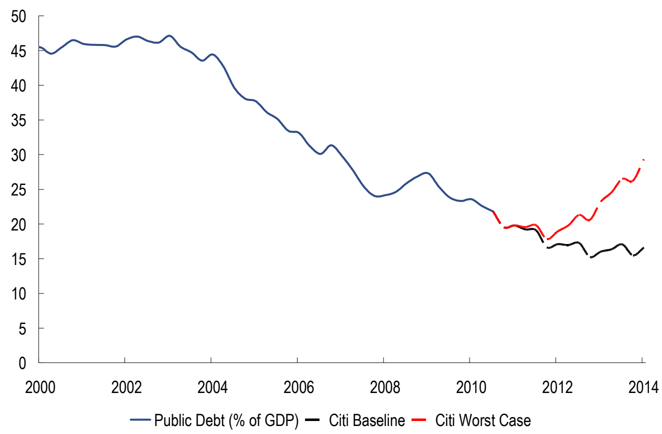
Source: BCRP and Citi Investment Research and Analysis

Figure 9. Peru: Current revenues outlook



Source: MEF and Citi Investment Research and Analysis

Figure 10. Peru: Debt-to-GDP ratio outlook



Source: MEF, BCRP and Citi Investment Research and Analysis

Closing comments

There should be some deterioration of fiscal accounts during the Humala administration, but it should be manageable. In our view, the explicit aim of raising social spending should entail some deterioration of fiscal accounts. The assumption that public sector efficiency will provide room to spend on social programs, although desirable, is unlikely to become a reality, at least at the level the current administration expects. However, we believe the deterioration in fiscal accounts should not be felt immediately. In our baseline scenario, the worsening of primary balances should not become evident until 2014 and even then, our view is that the primary balance deficit will be relatively low at 1%. This situation should not threaten debt sustainability, considering that Peru's strong economic growth should still imply declining debt-to-GDP ratios. We expect the debt-to-GDP ratio to continue trending south in the years to come, reaching 17% by the end of 2014. With a very favorable maturity profile (the average duration of public debt is 7.75 years), the outlook for Peruvian debt is still positive. However, as our worst case scenario suggests, fiscal sustainability is quite sensitive to GDP growth and in the case of Peru, to the international price of its main exports. We will be updating our simple fiscal model frequently, as in these uncertain times for the world economy, severe shocks to the aforementioned variables, and therefore to the fiscal outlook, are certainly a possibility.

Appendix

Figure 11. Peru: Macro Assumptions for fiscal model

	Baseline Scenario				Worst Case Scenario			
	2011F	**2012F**	**2013F**	**2014F**	**2011F**	**2012F**	**2013F**	**2014F**
Nominal GDP Growth (y/y)	10.1	8.1	8.1	8.1	10.1	4.0	4.0	4.0
Interest Rate (on govt. debt)	4.7%	5.0%	5.2%	5.2%	4.7%	5.0%	5.2%	5.2%
Export Prices (y/y)	20.0	-4.6	-4.6	-6.7	20.0	-46.4	-4.6	-6.7
Copper US$/lb.	4.1	3.7	3.8	3.6	4.1	1.9	1.9	1.8
Gold US$/oz.	1,591	1,650	1,500	1,350	1,591	825	750	675
Silver US$/oz.	33	26	22	19	33	13	11	10
Zinc US$/t	2,260	2,075	2,256	2,400	2,260	1,038	1,128	1,200

Source: Citi Investment Research and Analysis

Appendix A-1

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