CE-20

STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

Supplementary Analysis:
Republic of Peru

Primary Credit Analyst:
Lisa M Schineller, PhD, New York (1) 212-438-7352; lisa.schineller@standardandpoors.com

Secondary Contacts:
Sebastian Briozzo, Mexico City (52) 55-5081-4524; sebastian.briozzo@standardandpoors.com
Livia Honsel, Mexico City 5550812876; livia.honsel@standardandpoors.com

Table Of Contents

Table Of Contents (cont.)

Supplementary Analysis:

Republic of Peru

This report supplements our research update "Peru Foreign Currency Ratings Affirmed At 'BBB+/A-2'; Outlook Remains Stable," published on Aug. 28, 2015. To provide the most current information, we may cite more recent data than that stated in the previous publication. These differences have been determined not to be sufficiently significant to affect the rating and our main conclusions.

Rationale

Sovereign Credit Rating
Foreign Currency
BBB+/Stable/A-2
Local Currency
A-/Stable/A-2

The sovereign ratings on the Republic of Peru consider our revised assessment of its trend growth prospects and monetary policy flexibility. Standard & Poor's Ratings Services expects growth to average 3.6% per year from 2015-2018, or 2.8% in per capita terms. We no longer expect Peru's growth trajectory to be consistently well above that of its peers with a similar level of per capita GDP. Peruvian per capita GDP will likely be about US$6,200 in 2015. We previously had expected growth to remain consistently above 5% (over 4% in per capita terms) over the forecast period, supported by ongoing investment in mining projects and other policy efforts, despite some declines in commodity prices. The downturn in global commodity prices has exacerbated delays in key mining investments associated with local opposition to some projects, and some projects are not likely to advance.

The Peruvian government continues to face implementation challenges, particularly at the local government level, in expanding public investment to mitigate the slowdown in private investment. Despite efforts to offset some of the slowdown, also owing to weather effects such as El Niño, growth in 2014 and 2015 has been lower than initially expected. We now expect trend growth to be lower absent more successful concerted efforts to advance structural reforms (such as those related to labor market flexibility, infrastructure, bureaucracy, and regulations). We don't expect meaningful progress on any reform in the remaining months of President Ollanta Humala's Administration given the political climate in Congress and the president's low popularity. After a new Administration takes office in July 2016, the pace and prospects for reform are also likely to be limited by fragmentation in Congress even after next year's elections--an exception is education reform, the success of which is very important for growth over the longer term.

Peru's monetary institutions have gained credibility over the years. The central bank has contained inflation, with one of the lowest inflation rates in the region. A managed floating exchange rate regime also supports monetary flexibility. This has supported lower levels of dollarization and development of domestic capital markets. Recent efforts by the central bank have facilitated a further decline in dollarization, particularly borrowing in dollars, which was 34% of total credit to the private sector in July, down from 42% as of year-end 2014 and 44% as of year-end 2013.

Peru's key credit strength is its fiscal position, which includes its policy performance and flexibility and its low level of debt. The government took advantage of recent years of favorable commodity prices by making structural changes to fiscal policy, improving its Fiscal Responsibility and Transparency Law to measure structural balances, boosting its

Fiscal Stabilization Fund, and smoothing its debt profile. It generated an average general government surplus of almost 1% from 2010-2014. We expect general government deficits to average a still-low 1.5% of GDP in 2015-2016 and decline somewhat thereafter. While the government aims to pursue some countercyclical policy, lack of expertise, at the local government levels in particular, has hampered execution--weak revenue performance underpins an important part of the higher deficit. Net general government debt was 6.1% of GDP in 2014, and we expect it to rise toward 10% by 2018. With general government interest to revenues projected to be an average 4.4% for 2015-2018, Peru has one of the lowest debt burdens among the sovereigns we rate. We assess contingent liabilities from the financial sector and all NFPEs (nonfinancial public enterprises) as "limited," as our criteria define the term.

Peru's political institutions are still maturing, with some uncertainty regarding policy continuity from one election to the next. In the end, policies have supported economic prosperity, but in each election, political outsiders have often entered the race and gained traction, which could lead to inconsistency. This reflects Peru's weaker party system and institutions. A sustained--though slow--process of reform in areas such as education, health, and social development, which started with previous governments, continues under the current Administration with ministers that are well-respected within their areas of expertise. Quantitative improvements in education or health will take time to materialize, yet these issues remain a priority within the government's agenda, and the next government's as well--key presidential candidates already have signaled their desire to maintain the current education minister and advance further on this agenda. However, still-significant political dislocations, including the frequent reshuffles in the position of prime minister and allegations of corruption and mismanagement in the local and regional government, hurt the effort to improve public policies and contribute to political risk in Peru.

Amid lower commodity prices and despite ongoing increases in mineral export capacity--that should jump further next year with production from the Las Bambas and Cerro Verde mines--the trade and current account deficits have widened, and we expect them to remain higher than during the commodity price boom. Peru's narrow net external debt was 5% of current account receipts (CAR) in 2014, a shift from a net asset position of an average 13% in the prior five years. Higher current account deficits, no longer fully funded by foreign direct investment (FDI) (which is also likely to moderate amid the drop in global commodity prices and fewer mega-mining projects in the pipeline), underpin an expected rise in external debt during 2015-2018. We no longer expect steady increases in gross international reserves; this implies a decline in usable international reserves, which account for reserve requirements on foreign currency deposits in the banking system. This contrasts with the doubling of reserves (according to both measures) between 2008 and 2013.

The local currency rating on Peru is one notch higher than the foreign currency rating, reflecting our view of the credibility of its monetary policy, its floating exchange-rate regime, and the size of its capital markets.

Outlook

The stable outlook reflects our view that Peru remains well-placed to conduct moderate countercyclical policy given net general government debt levels of less than 10% of GDP. We also believe Peru can manage a widening of its current account deficit and some increase in external debt despite potential local and global market volatility ahead of the 2016 presidential elections and a more challenging global backdrop. We expect continuity in key economic policies after the change in Administration next year.

Further improvements in Peru's political landscape, such as stronger institutions and public-sector capacities to deliver social and infrastructure needs, could lead to stronger creditworthiness. Improved government effectiveness, along with more investment in the country's physical infrastructure and continued cautious macroeconomic policy, could boost investor confidence. We could raise the ratings under such a scenario.

Conversely, an unexpected reversal of the government's commitment to stable economic policies could weaken investor confidence. That, along with potentially even weaker external indicators, could erode Peru's financial profile and lead to a downgrade.

Summary Statistics:

Republic of Peru--Selected Indicators

	2009	2010	2011	2012	2013	2014	2015f	2016f	2017f	2018f
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	365.06	419.69	469.85	508.33	545.55	575.12	609.54	649.17	694.04	744.85
Nominal GDP (bil. $)	121.22	148.56	170.60	192.72	201.91	194.20	192.28	185.48	182.64	190.99
GDP per capita (000s $)	4.2	5.1	5.8	6.4	6.6	6.3	6.2	5.9	5.7	6.0
Real GDP growth	1.0	8.5	6.5	6.0	5.8	2.4	2.5	3.5	4.0	4.5
Real GDP per capita growth	0.0	7.2	5.2	4.6	4.4	0.9	1.4	2.4	2.9	4.5
Real investment growth	(23.3)	38.8	12.9	10.2	10.4	(3.5)	4.5	5.0	4.0	3.0
Investment/GDP	20.9	25.2	25.7	26.2	27.8	26.6	27.1	27.5	27.6	27.3
Savings/GDP	20.4	22.8	23.9	23.5	23.6	22.4	22.4	23.1	23.5	23.7
Exports/GDP	25.2	26.6	29.7	27.1	24.1	22.4	21.9	24.4	27.0	27.9
Real exports growth	(0.7)	1.3	6.9	5.8	(1.3)	(1.0)	0.4	15.1	14.9	8.1
Unemployment rate	8.3	8.0	7.7	6.9	5.9	5.7	6.5	6.7	6.0	6.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(0.5)	(2.4)	(1.9)	(2.7)	(4.2)	(4.1)	(4.7)	(4.4)	(4.1)	(3.5)
Current account balance/CARs	(1.8)	(8.1)	(5.8)	(9.2)	(15.9)	(15.7)	(19.2)	(16.4)	(13.9)	(11.5)
Trade balance/GDP	5.0	4.7	5.4	3.3	0.3	(0.7)	(1.4)	(1.0)	(0.7)	0.1
Net FDI/GDP	5.0	5.5	4.4	6.1	4.5	4.0	3.9	3.7	3.8	3.1
Net portfolio equity inflow/GDP	(2.6)	(0.6)	(0.8)	(1.3)	(0.3)	(2.3)	(2.1)	(1.6)	(1.1)	(1.0)
Gross external financing needs/CARs plus usable reserves	75.2	82.4	73.0	74.7	71.2	69.1	75.1	78.3	82.7	83.3
Narrow net external debt/CARs	(9.9)	(12.4)	(10.3)	(18.9)	(15.7)	5.3	16.5	26.4	31.0	33.5
Net external liabilities/CARs	87.9	92.8	70.6	76.1	99.1	120.0	140.7	144.5	142.8	138.4
Short-term external debt by remaining maturity/CARs	26.5	25.9	16.3	18.4	27.6	23.0	30.7	26.5	24.1	23.6
Reserves/CAPs (months)	8.3	7.0	7.6	7.8	10.5	10.4	10.0	8.5	7.0	6.7

Republic of Peru--Selected Indicators (cont.)										
FISCAL INDICATORS (%, General government)										
Balance/GDP	(1.5)	(0.1)	2.0	2.1	0.7	(0.3)	(1.6)	(1.4)	(1.1)	(0.7)
Change in debt/GDP	0.2	0.8	(0.1)	(0.2)	0.4	1.8	2.4	2.4	1.5	0.7
Primary balance/GDP	(0.2)	1.1	3.2	3.1	1.8	0.8	(0.6)	(0.5)	(0.2)	0.2
Revenue/GDP	19.9	21.0	21.8	22.4	22.3	22.3	21.3	21.2	21.0	20.7
Expenditures/GDP	21.4	21.0	19.8	20.3	21.6	22.6	22.9	22.6	22.1	21.4
Interest /revenues	6.7	5.7	5.3	4.8	4.9	4.7	4.7	4.5	4.3	4.1
Debt/GDP	25.3	22.9	20.3	18.5	17.6	18.5	19.9	21.1	21.2	20.5
Net debt/GDP	16.6	14.3	10.1	6.9	5.6	6.1	6.9	8.9	9.9	9.9
Liquid assets/GDP	8.7	8.6	10.2	11.6	12.1	12.4	13.0	12.2	11.4	10.6
MONETARY INDICATORS (%)										
CPI growth	2.9	1.5	3.4	3.7	2.8	3.2	3.4	2.9	2.8	2.7
GDP deflator growth	1.6	6.0	5.2	2.1	1.5	3.0	3.4	2.9	2.8	2.7
Banks' claims on resident private sector growth	1.3	14.2	21.4	12.4	21.1	14.0	12.9	10.1	10.1	12.8
Banks' claims on resident private sector/GDP	25.7	25.6	27.7	28.8	32.5	35.1	37.4	38.7	39.8	41.9

Note: Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. f--Forecast.

Institutional And Governance Effectiveness: Broad Consensus On Macroeconomic Policy Amid A Still-Fragile Political Environment

- President Ollanta Humala continues to struggle with poor approval ratings, a divided Congress, and disappointing GDP growth.
- Corruption scandals continue to weigh on the credibility of Peru's institutions.
- The next presidential and legislative elections will be held in April 2016, and we expect continued fragmentation in Congress.

Peru's political system has benefited from smooth political transitions particularly since 2000. In recent years, the Congress has played a more important role in counterbalancing the executive branch, although its fragmentation requires coalition building for the passage of legislation. The absence of a strong party system--undermined by former President Alberto Fujimori (1990-2000)--facilitates the ability of political outsiders to repeatedly play a key role in presidential elections. Surprise candidates have gained traction as viable presidential candidates and assumed the presidency. Therefore, a weak party system and fragile institutions sustain policy uncertainty from one election to the next. However, in the past 10 years, most politicians and, once in office, Peru's presidents have accepted the restrictions imposed by a sound macroeconomic framework and have generally adopted market-friendly pro-growth policies.

Following the last presidential elections in 2011, social issues, such as health and justice, gained priority in the new government's political agenda. The appointment of a cabinet with strong technical credentials in key areas such as education, coupled with high GDP growth in the beginning of President Humala's term, enabled the government to pass two important reforms on education and health. It also contributed to a further fall in Peru's poverty rate to 22.7% in 2014 from 27.8% in 2011, which had been declining over the past decade amid economic prosperity and low inflation.

Nevertheless, recent polls show the president's approval stands at just 10%, making him one of the least popular heads of state in Latin America. Such low levels of popularity are not uncommon in Peru amid a tradition of weak party allegiance. Corruption scandals related to campaign financing, favoritism in the awarding of contracts, and misappropriation of information have undermined Mr. Humala's popularity. In particular, former Prime Minister Ana Jara was censured by the Congress because she failed to control the nation's intelligence-gathering agency. Furthermore, the first lady is being investigated on charges of money laundering.

These cases of corruption, coupled with a sluggish economy, led 16 out of 47 members of the president's party--Gana Peru (Peru Wins) coalition--to defect to the opposition. That, and poor relations between the president and the opposition, has weakened his party's ability to pass legislation. We believe that the president is unlikely to regain much of his lost political support, harming Gana Peru's prospects in the next general election. In the meantime, a divided opposition limits prospects for policy slippage.

Overall, the administration has benefited from the absence of broad destabilizing social conflicts. However, anti-mining movements have taken advantage of Mr. Humala's unpopularity. There has been a series of strikes and roadblocks against the construction of the Tia Maria copper-mining project. Although not significant in size, Tia Maria is emblematic of challenges the mining sector faces. In May 2015, the government brought relative calm to the affected regions by imposing a state of emergency. Nonetheless, leftist movements continue working to extend the conflicts to denounce possible violations of environmental regulations. Security issues are also a growing concern, particularly in the cities. As a result, business confidence in the country has been declining, and we expect it to remain low ahead of the elections--as it traditionally does. However, in our view, these threats should not put at risk broader political stability in the coming years.

The next presidential and legislative elections will take place in April 2016. The next presidential and legislative elections will be held in April 2016 (with a second round between the top two candidates in June). The main candidates running in the presidential elections--Keiko Fujimori, Alan Garcia (who was president from 2006-2011 and 1985-1990), and Pedro Pablo Kuczynski--have presented a business-friendly stance, supportive of foreign investment. Keiko Fujimori, daughter of former President Alberto Fujimori and a former congresswoman who lost the election to Mr. Humala in 2011, is currently leading the polls. There is no sign of a populist outsider candidate for the moment, but the risk could materialize in the coming months, as happened in the 2006 elections with Mr. Humala (during his first campaign for president).

The next government will have to manage a fragmented Congress, forming alliances to pass legislation. The need to negotiate across a group of parties could delay or dilute new laws. Furthermore, the weakness of institutions creates a fertile ground for corruption, especially at local and regional levels, where there is less transparency and control over the political leaders.

Economic Analysis: Large Mining Projects Support Some Recovery In Growth

- We project per capita GDP to be $6,200 in 2015, down from prior years because of a weaker local currency and a slower pace of growth.

- We no longer expect Peru's growth to be meaningfully above that of its peer group.
- We expect GDP to average 3.3% in 2015-2017 on increased copper output and higher public spending, up from 2.4% in 2014.

Peru has achieved rapid economic expansion, based in large part on mining. During the past 15 years, South America's sixth-largest economy achieved consistent, robust growth, buoyed by high commodities prices and higher mining production. Peru has significant reserves of copper, gold, silver, zinc, natural gas, and oil. Mining accounted for 55% of total exports and 12% of GDP in 2014. The commodities boom, coupled with prudent macroeconomic policies and a strategy of trade liberalization, contributed to economic growth of 5.5% on average between 2000 and 2013, compared with 3.5% for the rest of the region. The favorable economic conditions enabled a marked improvement in the poverty rate, which dropped by more than half between 2005 and 2013. In recent years, the country also managed to consolidate its economic fundamentals, such as a reduction in the public debt level public, a stabilization of inflation and exchange rates, and large international reserves.

Peru has important challenges ahead to sustain, and raise, its growth potential, which has trended lower toward 4% per year, and continue to improve social inclusion. Key reforms should focus on deficiencies that limit its competitiveness--such as the large informal sector resulting from a rigid labor market and a low-skilled workforce, shortcomings in infrastructure, regional disparities partly caused by regional governments' underspending, and a continued dependence on commodities exports. The government has achieved important progress recently in the education sector as it managed to increase budget resources going toward education and to implement a teacher evaluation program.

Although growth has been disappointing in 2014-2015, we expect a pick up in the next three years. The Peruvian economy grew less than expected in 2014--at a rate of 2.4% compared with more than 5% in the previous years--because of weak public-sector investment and private consumption. We expect growth of 2.5% in 2015. During the first quarter of 2015, real GDP increased only 1.8% versus the first quarter of 2014, leading the authorities to loosen monetary and fiscal policies. Although growth picked up in the second quarter, it still averaged only 2.4% in the first half of 2015 compared with 2014. Growth has been hurt by external factors, including a pronounced drop in commodity prices and lower demand from China (nearly 25% of Peruvian total exports), which led to lower investment and exports. Moreover, the prospect of higher interest rates in the U.S. has amplified volatility in the local market, including downward pressure on the Peruvian nuevo sol (PEN).

According to the Ministry of Finance, 55% of the GDP volatility in Peru is due to external factors. Among the internal factors, regional governments' spending has slowed sharply since the past local elections in October 2014 and because of corruption issues. As of July 2015, the annual decrease was more than 30%. Private-sector investment growth has remained subdued despite the fiscal stimulus measures.

We expect a pickup in real GDP growth to an average 4.0% over 2016-2018 on a surge in copper output and a higher public infrastructure spending. However, we expect GDP growth will remain lower than in Peru's recent past and will no longer be meaningfully higher than its peers'.

Mining and infrastructure projects will be the key to a more favorable economic outlook. In particular, the start of operations in Las Bambas ($10 billion investment), expected by the end of 2016, increased production by Constancia (scheduled to start the end of this year), as well as Cerro Verde, Toromocho, and Antamina mine, and/or production expansions, should double copper production over the next three to four years. Investment in the mining sector is estimated at $63 billion during the next five years, according to the Ministry of Energy, despite lower prices. Intermittent protests in key mining locations are a latent risk for foreign investment, as are less favorable commodity prices.

Stronger growth should also result from the development of large infrastructure projects, such as the Lima Metro Line 2, the South Gas Pipeline, and the modernization of the Talara refinery. In addition, we expect planned spending by local governments to recover.

We believe that the implementation of structural reforms will be the key to maintain high growth and social cohesion given that no major infrastructure projects are planned after 2018. The country's potential growth rate has trended lower toward 4% per year. A rigid labor market, a low-skilled workforce, shortcomings in infrastructure, and weak regional governments constrained trend growth absent reform. Important progress recently in education, as the government has increased its budget and implemented a teacher evaluation program, should slowly yield important benefits over time. In our opinion, downside risk to growth stems from delays in the public- and private-investment spending projects. The El Niño weather phenomenon could hurt Peru's agricultural and fishing output. In the short term, uncertainty ahead of presidential elections could lead to deterioration in business sentiment.

External Analysis: The Current Account Deficit Will Remain High In 2015 And Then Begin To Decline

- We foresee a current account deficit of 4.7% of GDP this year that will narrow gradually in 2016-2018 thanks to higher mining exports.
- Amid weaker global commodity prices and the end of large projects, we expect FDI to decline over the forecast period.
- Given these trends, we expect narrow net external debt to rise further and average 27% of CAR from 2015-2018 while usable international reserves decline.

In 2014, the current account deficit remained relatively stable despite worsening terms of trade and a difficult external environment. The current account showed a deficit of 4.1% of GDP in 2014, unchanged versus 2013, but higher than previous years as a result of deterioration in the trade balance. Peru's trade balance swung into deficit of about 0.7% of GDP in 2014--its first deficit since 2002. Moderating growth in China (Peru's main trading partner), lower metal prices, and temporary supply disruptions in mining, fishing, and agriculture contributed to a decline in exports.

Total exports of goods decreased to $39.5 billion in 2014 from $42.8 billion in 2013. In particular, the exports of mining products and petroleum and derivatives declined because of lower commodity prices and weaker demand. By contrast, nontraditional exports increased about 5% from 2013 to 2014, and we project further improvements for 2015. Although nontraditional exports represent a relatively small portion of total exports (30%), this figure is still encouraging, particularly because of their positive impact on employment. Likewise, total imports of goods decreased to $40.8 billion in 2014 from $42.2 billion in 2013. For 2015, we project a further decline in total imports.

For 2016, we project total exports to return to their 2014 levels due to higher global demand and added output from a number of large mining projects come on stream. In particular, the start of production at the Las Bambas mine, the expansion of the Cerro Verde mine, and higher production levels in Toromocho and Constancia mines could lead to significant growth in copper production by 27% and 15% in 2016 and 2017, respectively. While the trade balance is projected to register a deficit of 1.4% of GDP this year, we expect it to decline and return to a surplus by 2018.

The services deficit and net transfers will remain broadly stable in historical terms. Net transfers represent the largest positive contributor to the current account because of high levels of remittances from workers living abroad (about $2.6 billion in 2014 and $2.8 billion expected in 2015). We project the net income deficit to remain below the average of the past five years as profit repatriation continues to decline. As a result, we expect the current account deficit to remain high in 2015 (4.7%) and move lower from 2016-2018 as profits/dividends decline and the volume of mining exports gains ground.

FDI is likely to fund a declining share of the current account deficit in the next couple of years, increasing the reliance on debt inflows. We estimate the level of net FDI to be about $7.4 billion in 2015 (down from $7.8 billion in 2014 and $9.2 billion in 2013). Inflows of FDI are likely to trend lower in 2016-2018 amid weaker commodity prices. Moreover, we expect net portfolio equity outflows to remain negative.

We project external debt will rise. Peru's narrow net external debt shifted from an average 14% asset position in 2010-2013 to a debtor position of 5% of CAR in 2014. We expect debt of the public and private sectors, net of liquid assets (which incorporate usable international reserves), to rise further during 2015-2018 and average 28% of CAR. The increase reflects larger current account deficits not fully covered by FDI, an increase in external debt issuance by the government (with the shift from fiscal surpluses to deficits), and a more moderate increase in nonresident holdings of locally issued sol-denominated securities by the government and some GREs. In particular, domestic debt securities held by nonresidents were about $4,848 million in 2011 and $7,999 million in 2014. We expect a moderate increase in the coming years given global financial market volatility and a weaker Peruvian currency.

We project the increase in external debt to occur along with a decline in usable international reserves. Gross international reserves are expected to hold fairly steady on balance, around $60 billion over the next several years--down from a peak of $66 billion in 2013. However, adjusting for reserve requirements on foreign currency deposits in the banking system, usable reserves are projected to be $36 billion, down from $51 billion in 2013. On a broader measure, we expect Peru's net external liability position to increase further from 120% of CAR in 2014.

We expect that gross external financial needs as a share of CAR and usable reserves will average 80% from 2015-2018, compared with an average of 72% from 2011-2014.

Fiscal Analysis: A Shift To Countercyclical Deficits And A Moderate Increase In Debt

- A severe drop in global metal prices, as well as tax cuts adopted late last year and weaker economic growth, has hurt government revenues.
- Expenditures have increased as a result of stimulus measures to mitigate the economic slowdown.
- Consequently, Peru's general government deficit will deteriorate modestly in the short term, with an overall general government deficit of about 1.2% of GDP in 2015-2018.
- We expect net general government debt to GDP to rise, but remain below 10% of GDP, and interest to revenues to average 4%.
- Contingent liabilities are limited.

The Fiscal Responsibility and Transparency Law is an important signal of Peru's commitment to fiscal sustainability. Despite numerous modifications, including some relaxation of rules or parameters, the Fiscal Responsibility and Transparency Law established in 2001 has strengthened Peru's fiscal performance over the past decade--both in terms of lower deficits and a decline in debt. The current economic slowdown led the government to modify its structural deficit target of 1% of GDP for the next three years, raising it to 2% of GDP in 2016 and 1.5% in 2017. Fiscal consolidation is expected to commence in 2016, returning to the 1% structural fiscal deficit by 2018 as growth recovers. Adherence to the revised targets would send an important signal of commitment to fiscal credibility.

Peru's fiscal stabilization fund (FEF) (established by its Fiscal Responsibility and Transparency Law) is funded by fiscal surpluses, privatization proceeds, and revenues from concessions. It had assets equal to 4.7% of GDP at the end of 2014. The FEF resources--which are deposited at the central bank--may be used in specified instances of revenue shortfall or in case of emergency.

The general government deficit is trending higher. The general government balance showed a deficit of 0.3% of GDP in 2014 from a surplus of 0.7% in 2013 and an average surplus of 1.6% of GDP during 2011-2013. In 2015-2018, we expect the general government deficit and the central government deficit to average 1.2% of GDP. This year, weaker revenues are associated with lower growth as well as various fuel and import tax cuts. Central government spending will rise this year, unlike local government spending (because of administrative inexperience of the newly elected governments in the October 2014 local elections). We expect revenues to improve gradually in 2016-2018 with faster GDP growth and new output from the mining sector. We expect a modest deceleration in current expenditures in the medium term while capital expenditure should stabilize as countercyclical policies and election-related expenses will be reduced after 2016. Overall, we foresee a narrower general government deficit to GDP by the end of the forecast period.

Public debt will remain low, although it will increase in 2015-2018. In 2014, the net general government debt was 6.1% of GDP, up from 5.6% in 2013. We expect net general government debt to reach 6.9% of GDP at the end of 2015 and 9.9% in 2018.

Recent years of good fiscal performance, coupled with active debt management, have reduced costs and improved the profile of the country's debt, making it less vulnerable to a sharp spike in interest rates or fluctuations in the exchange rate. Interest expense to general government revenue has remained constant at about 5% since 2011, down from 10% in 2005. We estimate the interest burden to remain at this low level.

The government has also deepened the domestic capital market for Peruvian nuevo soles debt, allowing it to replace foreign currency-denominated debt with local currency debt at fixed interest rates. In December 2014, 44% of public-sector debt was denominated in foreign currency, compared with 59% in 2009. The central government's locally issued nuevo sol-denominated bonds, or soberanos, are overwhelmingly at fixed rates: 84% as of year-end 2014, up from 43% at year-end 2002. Nonresidents hold a significant portion of this debt and have helped build out the 30-year domestic yield curve. In July 2015, they held 38% of the central government's soberanos, which is down from 45% in December 2014 and a peak of 57% in 2013. Despite the decline in as a share of total soberanos, we expect nonresident holdings in nuevo soles and U.S. dollars to continue to rise, albeit at a more moderate pace as U.S. interest rates increase. We expect the country to retain solid access to financing from domestic and international markets as well as from multilateral institutions. The government may also resort to the FEF in case of revenue shortfall.

Contingent liabilities are limited, under our criteria. We consider Peru's overall contingent liabilities a limited. The starting point is contingent liabilities from banks, which are limited based on our Banking Industry Country Risk Assessment and banking sector assets to GDP of 60%. No adjustment to this base score is made for contingent liabilities from public and private non-deposit-taking institutions. Assets of both non-deposit-taking public-sector institutions and other shadow-banking activities, such as funds and insurance companies, are not material in size, at about 2.5% of GDP.

Contingent liabilities of NFPEs are also deemed minimal, as are other contingent liabilities stemming from infrastructure projects and agriculture bonds, relative to the government's debt-to-GDP ratio. A number of infrastructure projects financed with debt instruments backed by payment obligations--Certificados de Reconocimiento de Derechos del Pago Anual por Obras (CRPAOs) and Retribuciones por Inversiones según Certificado de Avance de Obras (RPICAOs)--from the government pose a contingent liability. By law, the accumulated balance of explicit and contingent commitments in public infrastructure projects may not exceed 12% of GDP (at present value). According to the Ministry of Finance, as of December 2014, the accumulated commitments amounted to 4.2% of GDP (30 years' time horizon).

The eventual payment by the government of agriculture bonds-–issued in the 1970s during a land expropriation program--is another contingent liability. The nominal value of these bonds collapsed with the currency change to the nuevo sol. In 2013, the Constitutional Court ruled in favor of bondholders and ordered the government to pay these bonds at their present value. The amount and timing of payment is not known. The maximum amount estimated by the creditors is US$4 billon (about 2% of GDP). Neither the CRPAOs/RPICAOs nor the agricultural bonds are significant enough in size compared with the current government debt level to modify the starting limited contingent liability assessment under our criteria.

Monetary Policy Analysis: A Slow Reduction In Dollarization Amid Foreign Exchange Depreciation

- We expect inflation to remain above the target in the coming months because of exchange rate depreciation, before declining next year.
- The Banco Central de Reserve del Perú (BCRP) will continue intervening in the foreign exchange market, and we expect it to raise rates as needed.
- The central bank introduced a package of measures to further decrease dollarization at the end of 2014.

With inflation above the top of the target range, the central bank does not have the room to further stimulate the economy. Peru's monetary institutions have gained credibility over the years. The central bank has contained inflation, with one of the lowest inflation rates in the region. A managed floating exchange rate regime also supports monetary flexibility. This has supported lower levels of dollarization and development of domestic capital markets. The central bank adopted an inflation-targeting regime in 2012. Inflation was 4% (year over ear) in August 2015, while inflation expectations are now above the ceiling of the target range for 2015 and 2016. We expect the inflation rate to remain slightly above the target range of 1%-3% in the coming months and to decelerate to 2.9% in 2016 and lower in 2017-2018.

In September 2015, the bank raised the policy rate by 25 basis points to 3.5%--ahead of any move by the U.S. Federal Reserve. Given the central bank's track record, we expect it to act--adjust interest rates--to guide inflation and inflation expectations back within the targeted range.

Monetary policy has been accommodative, with four rate cuts since 2013, in an attempt to boost GDP growth. The central bank had kept its reference rate unchanged at 3.25% since January 2015, despite rising inflation, but it then shifted its tone given the risks of further depreciation and consequently higher inflation expectations.

The Peruvian central bank is likely to continue intervening in the foreign exchange market. Inflation has exceeded the central bank's target range of 1%-3% for much of 2015 because of the impact of currency depreciation. The Peruvian currency has fallen about 8% against the dollar so far this year and stands at its lowest level in over six years, reflecting weaker commodity prices and expectations of higher U.S. interest rates. We expect the sol to close the year around

3.30 against the dollar, compared with 2.98 at the end of 2014.

Exchange rate depreciation is a concern given the level of dollarization in the economy (reflecting the proportion of deposits and credit denominated in dollars). As a result, the BCRP actively intervenes in the foreign exchange market to smooth exchange rate fluctuations. It already sold US$11 billion since last year.

We expect the authorities will continue to intervene to smooth further depreciation of the sol. We think economic recovery and the gradual rise of U.S. interest rates, as well as the expected increase in the BCRP reference rate, will lead to a stabilization of the exchange rate.

The BCRP introduced a package of measures to further decrease dollarization. Financial dollarization exposes the economy to external shocks and diminishes the effectiveness of monetary policy. Weakness of the sol against the dollar over the past several years prompted the central bank to accelerate efforts to reduce the dollarization. Over the past two years, the BCRP has implemented a series of measures as a prudential tool to face foreign-currency risk. The packages include (1) an increase in reserve requirements for dollar-denominated deposits, (2) a decrease in reserve requirements for sol-denominated deposits to 6.5%, (3) higher capital requirements for certain loans, (4) and de-dollarization targets by types of loans (by 5% by June 2015 and by 10% by December 2015 relative to September 2013).

Thanks to this process, the banking sector has been reducing its lending in foreign currency (to 34% of total credit in July 2015 from 42% at year-end 2014 and 80% at the end of the 1990s). However, commercial banks are now faced with the rise of dollar-denominated deposits given the depreciation of the sol against the dollar. In this context, the central bank began offering funding in nuevo soles through the nuevo sol-based repurchase agreements (repos) in addition to traditional repo operations. These facilities are aimed at increasing domestic currency lending. In addition to the repos, the central bank has launched the auction of public deposits. This strategy has helped to strengthen the financial sector in a context of high volatility. Nevertheless, the currency mismatch on corporate balance sheets could persist if local currency liquidity does not normalize and the dollar continues to strengthen.

Local Currency Rating And Transfer And Convertibility Assessment

Our 'A-' local currency rating is one notch higher than the foreign currency rating. The gap reflects Peru's monetary flexibility, plus the size of the local currency debt market, which provides capacity to issue sol-denominated debt. Capitalization of the corporate bond is about 20% of GDP.

Our transfer and convertibility (T&C) assessment is 'A', two notches higher than the sovereign foreign currency rating. We believe the likelihood of the sovereign restricting access to foreign exchange that Peruvian-based non-sovereign issuers need for debt service is moderately lower than the likelihood of the sovereign defaulting on its foreign currency obligations. Although the government has some foreign-exchange restrictions, they are mostly on the capital account, and economic policies are externally oriented. This suggests a lower likelihood of resorting to such restrictions in a severe downside scenario than in more interventionist sovereigns. That said, with CAR at 25% of GDP, the Peruvian economy is not as open as Mexico, for example, with a T&C assessment that's three notches higher than its foreign currency rating.

Related Criteria And Research

Related Criteria

- Sovereign Rating Methodology, Dec. 23, 2014
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Latin American And Caribbean Sovereign Rating Trends Mid-Year 2015, July 13, 2015 (accessible for free at www.spratings.com/sovereignoutlook)
- Sovereign Risk Indicators, June 30, 2015 (a free interactive version can be found at www.spratings.com/sri)
- 2014 Annual Sovereign Default Study And Rating Transitions, May 18, 2015
- Latin American And Caribbean Sovereign Debt Report: Commercial Borrowing Is Likely To Increase To $328 Billion In 2015, March 5, 2015 (accessible for free at www.spratings.com/sovereignborrowing)

Research Assistance: Gabriela de la Oliva

Ratings Detail (As Of September 30, 2015)		
Peru (Republic of)		
Sovereign Credit Rating		
Foreign Currency		BBB+/Stable/A-2
Local Currency		A-/Stable/A-2
Certificate Of Deposit		
Local Currency		A-2
Senior Unsecured		A-
Senior Unsecured		BBB+
Sovereign Credit Ratings History		
19-Aug-2013	*Foreign Currency*	BBB+/Stable/A-2
28-Aug-2012		BBB/Positive/A-2
09-Jul-2012		BBB/Stable/A-2
30-Aug-2011		BBB/Stable/A-3
19-Aug-2013	*Local Currency*	A-/Stable/A-2
28-Aug-2012		BBB+/Positive/A-2
14-Jul-2008		BBB+/Stable/A-2

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.