FitchRatings

25 Sep 2019 | Affirmation

Fitch Affirms Peru's Ratings at 'BBB+'; Outlook Stable

Fitch Ratings-New York-25 September 2019:

Fitch Ratings has affirmed Peru's Long-Term Foreign Currency Issuer Default Rating (IDR) at 'BBB+' with a Stable Outlook.

Key Rating Drivers

Peru's ratings reflect its strong public and external balance sheets and its longstanding credible and consistent macro policies, which have entrenched macroeconomic and financial stability. These strengths balance vulnerabilities from high commodity dependence, financial dollarization, and a low government revenue base, as well as lower income per capita and governance indicators (including government effectiveness) than the current 'BBB' median.

Fitch has revised down its economic growth forecast for Peru to 2.5% for 2019 (from 3.5% in June) and around 3.0% (from 3.7%) for 2020-2021. Global growth and trade uncertainty will weigh on Peru's exports, especially copper, and renewed political confrontation between the president and congress will weigh on business confidence and investment. However, several large copper investments continue to anchor growth, and supply-side shocks in the first half of 2019 (1H19) have dissipated. During the 1H19, the temporary blockade of a large copper mine's exports and low fishing yields caused the primary sector GDP to contract and local and regional government capital spending (40%-60% of government investment) slowed after local elections in October 2018.

Peru's five-year average real GDP growth at 3.3% is now slightly below the current 'BBB' median at 3.6%. Peru's potential growth is likely to remain at 3.5%-3.6%, absent substantial measures that would boost investment and productivity such as improvement in infrastructure or labor market reform. The government passed new competitiveness and infrastructure plans in 2019. However, securing congressional approvals of the micro reforms may be difficult in the current political climate, and the slow resolution of Odebrecht-related concessions and assets as well as bureaucratic effectiveness constraints pose challenges for ramping up infrastructure investment, in Fitch's view. New copper investments will lead to increased production and exports but are heightening Peru's sensitivity to the metal's price, investment and production cycles.

Governability challenges have re-emerged with the potential for early general elections (potentially

2020 versus 2021) urged by President Vizcarra. Slow congressional progress on a package of political and institutional reforms advanced by President Vizcarra in response to the wide Odebrecht and local judicial corruption revelations has put the two government branches at loggerheads. Political tensions are expected to endure until the next election hampering investment and impeding major economic reforms. In Fitch's view, Peru's strong fiscal framework and macro policymaking institutions will provide stability during this period.

Credible fiscal policy anchors Peru's public finances. In its August budget plan, the government adjusted its budget in response to a downward revision to revenue expectations for 2019-2021. Fitch expects Peru to reduce the general government (GG) deficit to 1.8% of GDP in 2019 (from 2% in 2018) reaching 1% of GDP in 2021, in line with Peru's fiscal rule, supported by firmer mining revenues (up from 2015 lows), anti-tax-evasion measures, and current expenditure restraint. Frequent underperformance of the capital budget adds a secondary buffer for the government to meet its fiscal targets. This would be sufficient to stabilize gross GG debt/GDP (non-financial public sector basis) at 27%-28% in 2020-2021 in our baseline scenario, below Peru's 30% debt limit. GG debt/GDP reached 25.8% in June, below the current 'BBB' median of 35.8%. Interest/revenue is projected at 6.6% in 2019.

The government's revenue-led deficit reduction strategy, which requires lifting GG revenues about 1.4pp to 21.1% of GDP in 2021 by Fitch's estimates, is sensitive to economic performance and copper prices despite expected pick-up from mining revenues. Growth below budget assumptions could challenge compliance with the 1% of GDP deficit target in 2021. While Peru has a track record of fiscal policy credibility, Fitch expects lower economic growth performance could increase the policy trade-offs of expenditure adjustment.

A strong external balance sheet offsets vulnerabilities including high commodity dependence (71.9% of current external receipts, 2019 Fitch forecast) financial dollarization, and non-resident participation in the local capital market (54% of PEN treasury notes, June 2019). Peru is a net external creditor; the sovereign has a net foreign asset position 15.3% of GDP stronger than the current 'BBB' median of 2.8% of GDP (2019 Fitch forecast), and the central bank's USD68.9 billion international reserves drive the country's international liquidity ratio above 200%. The current account deficit is expected to be less than 2% of GDP and financed by FDI.

Inflation, which averaged 2.04% yoy in August, is low and stable with public expectations anchored around the central bank's target of 2%+/-1%. The central bank cut the policy rate 25bps to 2.5% in August in response to downside economic growth risks and against a backdrop of lower U.S. rates. However, the low real interest rate limits space for further significant easing. The Peruvian sol-U.S.

dollar exchange rate depreciated 3.6% yoy during 2018, with the central bank intervening periodically to smooth volatility, and it has been relatively stable, ranging 3.3-3.4 Peruvian sol to the U.S. dollar, during 2019.

Peru's commercial banks are well capitalized (14.8% capital adequacy ratio, July) with low non-performing loans (3.1%, July) more than covered by provisions and adequate liquidity. Credit dollarization, although still high relative to rating category peers, continued its steady decline to 27% in July 2019 from 40% in December 2013. The central bank and financial supervisor have made progress reducing foreign currency credit to households and small businesses, whereas roughly half of corporate credit remains foreign currency denominated.

Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns Peru a score equivalent to a rating of 'BBB' on the Long-Term Foreign Currency (LT FC) IDR scale. Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

--Macroeconomic outlook, policies and prospects: +1 notch: Peru's consistent and credible macro policy framework has entrenched macroeconomic and financial stability.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centered averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main risk factors that, individually or collectively, could trigger a positive rating action are:

--Higher growth that reduces Peru's income gap relative to higher-rated sovereigns;

--Structural improvement of governance standards and strengthened institutional capacity;

--Significant improvements in Peru's fiscal and external balance sheets and material reduction of financial dollarization.

Conversely, the main factors that could lead to a negative rating action are:

--Weakening of the consistency and credibility of the macro or fiscal policy framework;

--Weakening of the economic growth outlook and/or failure to reduce the government deficit resulting in the further rise of general government debt/GDP;

--A negative external shock, such as a sharp decline in the price of Peru's main commodity exports, resulting in weaker macroeconomic performance and deterioration in fiscal and external balance sheets.

Key Assumptions

Fitch assumes that global growth, commodity prices and interest rates evolve in line with Fitch's quarterly Global Economic Outlook.

ESG Considerations

Peru has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as social stability and voice and accountability are reflected in the World Bank Governance Indicators that have the highest weight in the SRM. They are relevant to the rating and a rating driver.

Peru has an ESG Relevance Score of 5 for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are relevant to the rating and a key rating driver with a high weight.

Peru has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight.

Peru has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Peru, as for all sovereigns.

Peru; Long Term Issuer Default Rating; Affirmed; BBB+; RO:Sta
----; Short Term Issuer Default Rating; Affirmed; F1
----; Local Currency Long Term Issuer Default Rating; Affirmed; A-; RO:Sta
----; Local Currency Short Term Issuer Default Rating; Affirmed; F1
----; Country Ceiling; Affirmed; A-
----senior unsecured; Long Term Rating; Affirmed; A-
----senior unsecured; Long Term Rating; Affirmed; BBB+

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Additional information is available on www.fitchratings.com

Applicable Criteria
Country Ceilings Criteria (pub. 05 Jul 2019)
Sovereign Rating Criteria (pub. 26 May 2019)

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