ANDEAN REGION: Failure of confidence

10/10/2013 | Lucien Chauvin

Their economies are expanding at above average rates, but social protest in Peru and Colombia is on the rise

Looking back on his presidency, Peru's Ollanta Humala will likely want to forget the winter of 2013 in the southern hemisphere. No doubt Colombian president Juan Manuel Santos will feel the same.

The economies of both countries are expanding at rates above the international average, and other macroeconomic fundamentals are strong, but the numbers are lower than in the past, causing confidence to fall and creating a sense of malaise in these "Andean pumas". There has been an uptick in social protests, and the two presidents have witnessed steep declines in their popularity.

While Peru's economy grew by 5.6% in the second quarter of 2013, President Humala's popularity fell from 60% in April to 35% in August, according to a monthly survey by the Datum polling company. Colombia's economy grew by an estimated 4% in the second quarter, but President Santos saw his numbers fall from 48% in June to 21% at the end of August, according to a Gallup poll.

The general consensus is that stronger growth rates should return shortly, but this will depend as much on policies adopted locally as on factors outside the region, primarily a slowdown in China and the US Federal Reserve's decision on its quantitative easing policy. Higher growth will also depend on political considerations, particularly in Colombia where President Santos needs to decide shortly if he will run for a second four-year term in May 2014.

Peru's government in August announced that it was modifying the forecasts for 2013 for the worse. It now projects GDP growth of 5.7%, down from a previous forecast of 6.3%, inflation slightly above the 2.5% target and, most importantly, what will likely be the largest trade deficit in a decade. The initial projection was for a trade surplus of $2 billion, but the newest estimates are a deficit around $750 million, with analysts saying it will likely top $1 billion. The Central Reserve Bank said in August that the main factor in the slowdown was a drop in export earnings.

"Peru, like most emerging markets that are highly dependent on China for exports, is slowing down some. The question is how much. The first half of the year was pretty good, but the second half will be much slower," says Pedro Pablo Kuczynski, a former finance minister and 2011 presidential candidate. He estimates that GDP growth could come in around 5% for this year and 2014.

Research by BBVA Continental, Peru's second-largest bank, agrees with Kuczynski's analysis but is a bit more optimistic. It forecasts 5.8% growth for the current year and for the next. Hugo Perea, the bank's chief economist, believes the fundamentals are still strong. He says second quarter growth at 5.6% "is impressive, taking into account the external problems."

Exports in the first half of the year were $19.7 billion, a 13% drop from the same period in 2012. The United States regained its place as Peru's top export destination after having ceded that spot to China three years ago. Exports to the United States were $3.4 billion, up 17% from the same six-month period in 2012, while exports to China were $3.1 billion, down 15%.

FIGHTING WEAKNESS

The Humala government has moved on a number of fronts in the past few months, including three packages of legal modifications to reduce bureaucracy and speed up investment. It also secured approval by Congress of capital market reform and passage of new civil servant legislation, both of which will be implemented in the final quarter of the year.

The central bank has also played a more aggressive role, buying dollars to keep the local currency from fluctuating too quickly, reducing reserve requirements and maintaining interest rates at 4.25%, where they have been for 27 consecutive months. Only Malaysia in the emerging economies has kept rates steady as long as Peru. Most analysts do not forecast an increase this year.

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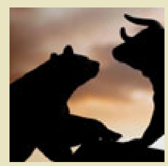

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Kuczynski, who is widely expected to run for president in 2016 and is currently second in all opinion polls, says the central bank's moves will help some, but that growth will pick up starting in 2015 as a result of new mining projects under development. A series of large-scale copper projects – copper is Peru's primary export – under construction will double the country's output starting in 2015. It will easily consolidate its position as the world's second-largest copper producer, even though production will still be around half that of world leader Chile. "If you look ahead, doubling copper output is going to boost GDP growth. We are going to see a strong growth in 2016 and if more projects are developed, the expansion should continue for years to come," says Kuczynski.

The administration received some good news in mid-August when Standard & Poor's raised Peru's credit rating one notch to BBB+, making it the highest-ranked major Latin American economy after Chile, which is four levels higher at AA-. Brazil and Mexico are a level lower at BBB. Economy and finance minister Luis Miguel Castilla told reporters the move "will give us greater capacity to attract investment, given that the cost of financing and risk will be lower".

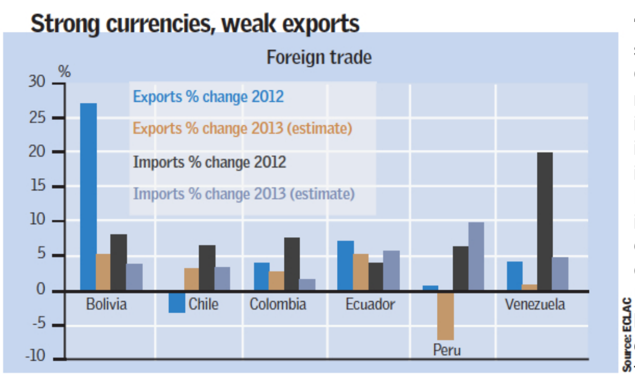
At the same time, the administration had to face a new round of strikes and social protests. Medical professionals, including doctors, were on strike for a month through late August, and there were loud and somewhat violent protests by small-scale miners and coffee farmers demanding government assistance. According to the August poll by Datum, 72% of Peruvians have little or no confidence that the country's economic situation will be better in 2016, when President Humala leaves office. This is a 20-point increase from the start of the year.

> "Because in the eurozone there is no political process to decide how the cost of adjustment should be shared out, there is now a breakdown of trust between different countries."
>
> Stephen King, chief economist, HSBC

COLOMBIA TROUBLES

Colombia was also hit by some of the worst protests in recent history in August and early September. A three-week strike by farmers, which ended on September 7, was unexpectedly violent. At least five people were killed. A strike by miners, which lasted six weeks, ended in early September. Colombians' confidence in the country's outlook has dropped. In the Gallup poll, 82% said the country was sliding backwards instead of improving.

The sparks behind many of the protests are rising prices for raw materials and cheaper imports, which farmers and their supporters blame on free trade agreements (FTAs) with the United States and the European Union. These two FTAs, staunchly backed by the Santos government, as well as others under discussion are meeting rising opposition. José Antonio Ocampo, a former finance minister and candidate for World Bank president, believes the government should have been more cautious implementing the trade pacts.



"The FTAs have created a sense of indignation in Colombia. The government needs to focus on investment in science and technology, in infrastructure, to create industries that can compete. Right now, Colombia's industries cannot compete," Ocampo, a professor at Columbia University, says. Under current conditions, he hopes the Colombian congress does not approve a trade agreement negotiated with South Korea.

Ocampo and most experts expect GDP growth this year to come in around or slightly below the forecast 4%. The former minister comes in at the low end of the range: his optimistic forecast is 3.7%.

David Rees, an emerging markets economist at Capital Economics, believes that growth would likely end the year at 4%, "which is not bad, but the devil is in the details. The driver of growth is consumer spending, which continues strong, while industry is in recession. This has to change, but it requires difficult political decisions."

The general consensus is that the Colombian peso remains too strong. Ocampo says the peso is artificially high, creating "a wave of imports that have affected local industry and slowed growth. Devaluation would have a long-term positive impact. It is the most important thing the government could do right now."

The central bank has helped weaken the peso somewhat with currency purchases and reducing interest rates, but more has to be done. "This is a problem that will not go away easily," Rees says.

The central bank announced at the end of September that the interest rate would remain at 3.25%, where it has been for six months. Analysts have argued that the rate should fall to help keep GDP growth from slipping below 4% this year. The economy, however, is going to take a back seat in the 2014 elections if Santos is a candidate. Front and centre will be the peace talks – successful or unsuccessful – his government has started with the Revolutionary Armed Forces of Colombia (FARC) to end 55 years of fighting, during which more than 200,000 people have been killed.

The peace talks began in Cuba in late 2012, and the first major agreement, on land and rural economy, was reached in May. It was considered a breakthrough, but the pace of talks has slowed. The government created a small crisis in August, when President Santos suggested that an agreement reached be put to a vote that would coincide with congressional elections next year. FARC negotiators left the dialogue table but came back quickly.

“The re-election of President Santos is going to be about politics, not the economy. It will be about the peace talks. Everything else will be secondary,” says Ocampo.

Jorge Restrepo, director of a research centre focused on conflict analysis (CERAC), is “moderately pessimistic” about the negotiations because the FARC have started talking about the need for constitutional reform, which is not part of the original agenda. Another problem would arise if the FARC pushed for political participation in the upcoming elections, he points out. A large majority of Colombians polled are opposed to the guerrillas joining the political system.

At the beginning of September, President Santos named five new ministers to what he said was a “cabinet of unity and peace”, calling on ministers to help him successfully end the conflict. However, he will need the aid of more than a few ministers if he is to regain his top spot in Colombians’ preferences.

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