

## Peru Economic Viewpoint

## 2021 elections – Pivotal for the economy

**High chances of ballottage, market-friendly vs. populist**

The first round of the presidential election will take place on April 11<sup>th</sup>, and the run-off vote (ballottage) will be on June 6<sup>th</sup>. Polls suggest that one market-friendly candidate and one populist will likely make it to the run-off/ballottage. To win in the first round, a candidate needs 50% of valid votes, which is highly unlikely. The last time it happened was in 1995, when Alberto Fujimori was reelected for the first time.

**The presidential election has never been this open**

Only one month away from Election Day, the top three candidates in the polls barely account for 27%-37% of gross vote intentions, compared to 55%-65% in 2016 and 58%-65% in 2011, according to the four most reliable polls (Ipsos, Datum, CPI, IEP). In Peru, the elections are usually three or four-horse races at most. 2021 is atypical because polls are showing a small difference between the 2nd and the 10th candidate.

**This election is critical for the economic outlook**

This presidential election seems particularly important to restore political stability – after suffering the ousting/impeachment of three presidents and shutdown of Congress – and also because there are a number of major economic issues lined up for debate. Constitutional reform, the new public debt cap of the fiscal rule, an inescapable pension reform, laws approved by Congress with high fiscal cost challenged at the Constitutional Court, and a possible modification in the mandate of the central bank.

**Congress is likely to be highly fragmented in 2021-26**

The Congress election will also take place on April 11<sup>th</sup>. All 130 seats in the unicameral parliament are up for grabs. Polls indicate that no party has more than 13% support. We believe the next Congress will be highly fragmented, making governability challenging. However, we believe it is unlikely that the political instability observed in the past five years will continue. In fact, part of the discourse of some presidential candidates is that such instability was very damaging for the country. Public opinion strongly agrees on that. That is why Manuel Merino only lasted five days in power. In our view, candidates more inclined to the center, such as Forsyth and Lescano, could potentially forge more stable coalitions than politicians at the extremes, like Mendoza and Lopez Aliaga.

**FX strategy: start adding PEN exposure**

We expect politics to be a key driver of Peruvian local markets until the election, as has been the case in previous electoral cycles. This time around, PEN has considerable election risk premium as the REER is close to its weakest levels in decades. We find current prices attractive to start adding PEN exposure, but we prefer to do this against other EM currencies (beta-weighted) to avoid directional exposure to the dollar. In past elections, PEN ultimately tended to strengthen after the runoff even with leftist candidates winning the presidency. Moreover, we think Congress will continue being a strong check on the executive, thereby helping mitigate tail risk scenarios.

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# Presidential and Congress elections

## It's never been this open

### First round on April 11<sup>th</sup>, balloting on June 6<sup>th</sup>

In our view, the 2021 presidential election is the most open one in at least the past thirty years. By “open” we mean that a large number of candidates seem to have non-negligible chances at becoming the next president.

A fact to support this proposition is that, less than two months from Election Day, the top three candidates in the polls barely account for 27%-37% of gross vote intentions (Exhibit 1), compared to 55%-65% in 2016 and 58%-65% in 2011.<sup>1</sup> Roughly, less than half compared to the previous two elections, 2016 and 2011, according to data from the four most reliable polling firms (Ipsos, Datum, IEP and CPI).

Going further back in history, we note that the 2006 election was a three-horse race, between Alan García, Ollanta Humala and Lourdes Flores Nano. 2001 was broadly similar in this sense, considering that it was disputed by Alejandro Toledo, Alan García and Lourdes Flores Nano, right after the downfall of the Fujimori regime. The 1995 and 2000 elections were dominated by an autocrat, Alberto Fujimori, viewed with suspicion by civil society especially in 2000. That is why the 2000 election was repeated in 2001. And in 1990 there were pretty much only three candidates with chances, Mario Vargas Llosa, Luis Alva Castro, and Alberto Fujimori.

Thus, in contrast with all the elections since 1990, which were contested by a small number of candidates, in 2021 the 2<sup>nd</sup> and the 10<sup>th</sup> candidate in the polls only feature a difference between 5% and 8%, as of March (Exhibit 1). To the best of our knowledge, there has never been such a small difference in the Peruvian presidential elections of the past three decades.

### Why is the 2021 presidential election so important for the economy?

The cliché answer to this question in most Latin American elections is often that “the economic model of the country is at risk”. The risk that a sharp veer in the orientation of economic policies – towards populism – takes place, so to speak. For Peru we can narrow the risks further, to specific economic policy matters that are lined up either for debate or a decision from the government.

### Constitutional reform poses risk for plumbing of the economy

First and foremost, there is an upcoming constitutional debate, à la Chile, that we believe is flying below the radar of investors. The focus of this debate would vary depending on which candidate gets elected president. In the worst-case scenario it would be about dismantling the strong provisions written in the Constitution to protect private property rights and foreign investment, eliminating the constraints on Congress to pass laws that affect government expenditures, have a stronger grip over natural resources (emulating Bolivia), increase the number of SOEs in the economy, and earmark revenues to fund a new social contract between the state and the Peruvian people.

### Pension reform, new debt cap, mandate of Central Bank

But there are several other events that are becoming a core part of the discourse of several candidates. Comprehensive pension reform, to increase coverage for the population and subsidies (right now very low, 1% of GDP in 2021 budget). Changes to the mandate of the central bank, to complement the inflation target with a new – equally important – activity objective. The new debt cap of the fiscal rule, after the 30% limit was sadly breached during the pandemic.

<sup>1</sup> The comparisons are done with data from Ipsos, Datum and CPI. We do not have access to IEP polls for the 2011 and 2016 elections.



**Exhibit 1: Presidential election polls since the official beginning of the campaigns in December 2020**

(% of gross vote intentions)

Poll	Date	Lescano	Forsyth	Fujimori	Mendoza	Lopez Aliaga	Urresti	De Soto	Acuna	Guzman	Salaverry	Humala	Castillo	Others	Vitiated or Undecided
Ipsos	10–11 Mar 2020	16.8	11.2	8.6	8.4	9.3	5.1	4.8	2.6	3.1	1.9	2.2	3.0	3.4	19.6
IEP	8–11 Mar 2021	13.9	6.8	7.2	7.0	9.5	4.5	5.7	3.4	2.3	1.2	2.5	3.5	1.9	30.6
Datum	5–7 Mar 2021	13.0	7.0	7.0	6.0	7.0	4.0	5.0	3.0	3.0	2.0	1.0	2.0	3.0	37.0
IEP	19–23 Feb 2021	11.3	8.1	8.1	8.9	7.6	4.8	4.2	3.8	3.1	2.2	2.4	2.4	2.5	30.6
CPI	17–19 Feb 2021	8.0	8.9	6.4	4.7	3.0	4.7	2.9	3.1	2.4	2.6	-	1.7	2.7	48.9
Datum	9–12 Feb 2021	9.0	11.0	8.0	7.0	3.0	6.0	4.0	4.0	3.0	2.0	3.0	-	7.0	33.0
Ipsos	10–11 Feb 2021	10.0	11.0	8.0	8.0	3.0	7.0	4.0	3.0	4.0	3.0	2.0	2.0	6.0	29.0
IEP	21–27 Jan 2021	7.1	13.3	6.7	8.2	2.4	5.6	5.6	2.0	4.6	2.5	2.8	0.5	6.0	32.7
CPI	21–25 Jan 2021	5.0	10.1	5.6	4.7	1.1	4.3	2.8	3.7	4.1	3.2	1.6	2.4	1.6	49.8
Ipsos	13–15 Jan 2021	6.0	17.0	8.0	7.0	-	6.0	5.0	4.0	7.0	4.0	4.0	-	7.0	25.0
Datum	8–12 Jan 2021	4.0	13.0	6.0	5.0	-	3.0	3.0	3.0	5.0	2.0	2.0	-	5.0	49.0
Ipsos	10–11 Dec 2020	4.0	18.0	7.0	7.0	-	6.0	3.0	2.0	8.0	3.0	2.0	-	12.0	28.0
IEP	1–8 Dec 2020	4.5	14.7	7.7	9.1	0.2	6.3	4.1	2.0	9.1	3.1	2.9	0.2	6.7	29.4
Datum	3–6 Dec 2020	4.0	10.0	4.0	4.0	-	3.0	5.0	2.0	4.0	2.0	1.0	-	5.0	56.0

Source: Ipsos, Datum, CPI, IEP

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**Defusing of fiscal time bombs**

The effects of laws passed by Congress in 2020 whose fiscal cost add up to around 2% of GDP, and can only be defused if the new administration challenges them at the Constitutional Court. Just like the Sagasti administration did with the law that authorized withdrawals from the public pension system, ONP, and the law that created automatic promotions for public sector health workers, granting them permanent jobs.

The list is longer, of course, and it adds up to around 2% of GDP in permanent government expenditures that could pop up, if the government is not proactive in challenging them. For example, the law that eliminates outsourcing/temporary job contracts in the public sector (CAS regime) to move them to full-time/permanent/full-benefit jobs (cost >1% of GDP), the law that re-hires the teachers laid-off as part of the education reform of the Humala & PPK administrations, collective bargaining of public sector wages, re-hiring of public sector workers after judicial rulings irrespective of budget ceilings, mandatory clearing of arrears related to judicial sentences, pensions of military & police (challenged at Constitutional Court by PPK administration), among others.

The point is that the vast majority of these laws were strongly supported by the left. So, if Mendoza, Lescano or Pedro Castillo become president, it could well be that the government just decides to withdraw the challenge and clear the way for the laws to be implemented. Humala and Urresti are also politically left, but probably more mindful of fiscal stability, particularly Humala whose administration created the fiscal rule (1% of GDP NFPS deficit, 30% of GDP NFPS gross debt limit).

Some analysts will say the Purple Party is also left, but we disagree. While their progressive/liberal views on social issues may get on the nerves of ultra-conservatives, we view the Purple Party as centrist, and market-friendly.



### **Likely that next Congress will be highly fragmented**

The elections of Peru's unicameral Congress will take place on the same day as the first round of the presidential elections, April 11<sup>th</sup>. All 130 seats are up for grab. In Peru there's no mid-term elections for Congress, unlike in other LatAm countries. In 2018, former President Vizcarra pushed for a referendum that led to a Constitutional reform – finally approved in 2019 – that forbid the consecutive re-election of Congress members.

Despite the high uncertainty on the outcome of the presidential election, something on which there is a very wide consensus among political analysts in Peru is that the Congress composition in 2021-2026 will likely stay as fragmented as it is now. The last polls for the parliamentary elections show that no party right now has more than 13% of gross vote intentions. This will probably affect governability conditions to the extent that it will be difficult for the next government to pass reforms.

### **But without the instability of the past five years**

However, we don't believe that what happened in 2016-2021 – namely, the ousting/impeachment of three presidents and a shutdown of Congress – will happen again during the next period. It is indeed unlikely.

### **2016-21 had a distinctive set of circumstances, absent now**

Those traumatic events were the result of the confrontation between two specific political forces that are now far from dominant. One of them, in fact, has disappeared (Peruanos por el Cambio) after PPK's downfall. And the Fujimoristas (Fuerza Popular) are severely weakened. Back in 2016 they had more than half of the seat in Congress, and in 2021 the party is polling at less than 10% in the parliamentary elections. Public opinion has severely punished Fuerza Popular for its role in attempts of impeaching presidents, obstructing governability, and creating instability in the country. We cannot stress this point enough.

### **Public opinion might penalize political forces that create instability**

In our view, at this juncture, there is a fairly robust consensus among the political establishment, the media, and the people that that the political instability observed in the past five years was detrimental for the country.

At least some of the top presidential candidates seem to agree. Lescano said that Vizcarra's ousting did tremendous harm, regardless of the evidence. Forsyth and Guzman have pointed out that political instability – the outcome of irresponsible decisions, in their views – stifled policymaking in the middle of the pandemic. Keiko Fujimori has acknowledge that her party committed mistakes in the past years; not exactly an apology, but something close. And is now proposing reforms to change the rules on presidential impeachments and the use of the matter of confidence provision, with an eye on reducing political instability.

### **With the current set of rules (1993 Constitution), this hadn't happened before**

In the past, there's been several governments with minority representations in Congress (less than 40% of the seats) – such as Toledo (2001-06), Garcia (2006-11), Humala (2011-16) – and there weren't any presidential impeachments or shutdowns of Congress. In other words, we believe there will be more political stability compared to what we have witnessed in the past five years.

### **Of course, there are risk scenarios, and further instability cannot be ruled out**

We do not want to put forward a simplistic argument. Obviously, one can think about scenarios where the instability continues. For instance, if Peru elects a president from one of the extremes – either Veronika Mendoza (left) or Rafael Lopez Aliaga (right) – that could be conducive to less stable coalitions in Congress, for the simple reason that their agendas are more radical, and would probably stir up more confrontation. Another scenario is the occurrence of a corruption scandal which makes the president extremely

unpopular, similar to what happened to PPK in 2017. The lower the presidential approval, the higher the temptation for the Congress to impeach.

### **Likely that there will be a second round presidential run-off vote**

It is highly likely that there will be a second round, ballottage vote. To win the presidency in the first round, a candidate needs to get 50% of the valid votes. Not only the race is tight between the first and second positions, but there are nine additional candidates with decent chances. Like we argued previously, the polls published in March show that the difference in gross voter preferences (without netting out blank and undecided votes) between the second and tenth presidential candidate ranges between 5pp and 8pp. In this part of the report, we describe all of the main candidates. If there is a second round vote, it would take place on June 6<sup>th</sup>.

## **The presidential candidates**

### **Yonhy Lescano: The AMLO & Warren strategies combined**

Yonhy Lescano is polling in the first position in the last four polls (Exhibit 1). It is fair to say, at this point, that he is the front-runner. We see similarities in Lescano's political strategy and those of AMLO in Mexico and Elizabeth Warren in the US.

Just like AMLO (former member of traditional PRD party) Lescano is a traditional politician – Congress member for 19 years – whose discourse is centered on fighting corruption. However, we must say that Lescano doesn't have the magic of AMLO. He barely has 17% of the votes in a very open race.

Given that Lescano was a Congress member for almost two decades – between 2001 and the shutdown in September 2019 – there are multiple examples to illustrate how he thinks about economic policies. In our view, the more the markets learn about Lescano's policy preferences, the greater uncertainty he can create.

Lescano belongs to a center-left party called Accion Popular, which is currently divided in two factions. A faction more inclined to the left, to which Lescano belongs, and a moderate faction, with individuals such as the mayor of Lima Jorge Munoz and former President Toledo's VP Raul Diez Canseco.

The strength of Lescano's candidacy builds on the fact that he is viewed as a politician who has been fighting the corruption mafias for a long time, in political opposition to several of the presidents who ended up in jail or prosecuted. Also, Lescano comes from one of the poorest regions in Peru, Puno (highlands, border with Bolivia), which helps him to connect with people from the provinces.

Based on his track record as a Congress member, there is a risk that Lescano could derail the market-friendly orientation Peru's economic policies, if he wins the presidency. From an economic policy perspective, if we could compare him to another politician around the world perhaps it would be Elizabeth Warren in the US. Lescano is well-known for defending the little against the big, with an acid discourse towards corporations, something that has allowed him to gain many loyal followers who share these views.

For instance, he has championed the proposal of interest rate caps in the banking sector for a long time, private pension fund withdrawals in 2016 (the 95% law), the renegotiation of the Camisea natural gas contract (to keep more of the nat gas in Peru, limit the amount that the foreign companies were allowed to export), price controls for medicines, the elimination of outsourcing/service job contracts in the public sector, among other examples.

In recent interviews, there are signs that he is attempting to move to the center. For example, by saying that he would not establish a statist economy – differentiating himself from Mendoza – and that he recognizes the importance of promoting private investment, which – in his own words – “should always be watched by the government”.

If Lescano makes it to the second round, we would not rule out that he does something similar to what Humala did in 2011; that is, shifting the discourse a bit to the center, moderating the government plan (like Humala's *Hoja de Ruta*), and looking for support from respected academics and business leaders.

### **George Forsyth: The young outsider**

As shown in Exhibit 1, George Forsyth used to be the front-runner throughout most of the campaign but his lead was eroded. In our view, he's the outsider in the elections, and that could be a meaningful asset in the last weeks, when tactical voting – that is, “anti votes” towards certain candidates – becomes more evident. For instance, people from the center and progressive on social views could vote for Forsyth – but probably not for Lopez Aliaga, Fujmori and even de Soto – if they fear the risk of Lescano or Mendoza getting elected president.

Before becoming a politician in 2018 – when he was elected mayor of La Victoria – George Forsyth was a professional athlete. He is the former goalkeeper of the soccer team in Peru with the largest number of fans, Alianza Lima. La Victoria is one the most the most dangerous districts within Lima, the capital, troubled by drugs, extortion to small businesses, gangs, and organized crime. Forsyth confronted the mafias in a courageous way – even receiving death threats, as reported by the Peruvian press – which made him become increasingly popular.

As an outsider, with little knowledge of politics and economics, his policy views have only started to be revealed recently. An interesting fact is that George Forsyth's father, Harold Forsyth, is currently Peru's ambassador to Japan, and previously served as ambassador to the US and China. Harold Forsyth is an officer from the Foreign Service with an impressive career, viewed positively by the Peruvian private sector. Moreover, Forsyth's Chief Economic Adviser, Jorge Chavez, was the Governor of the Central Bank in the early 90s, and owns a business consulting firm in Peru called Maximixe. Overall, it seems like Forsyth's circle of advisers is market-friendly.

About his specific policy proposals, we highlight that in the last annual conference of executives (CADE) – arguably one of the most high-profile events that is carried out in Peru every year – Forsyth proposed to establish a public debt cap of 39% of GDP. Sadly, the 30% debt cap of the fiscal rule was breached because of the pandemic. Also, Forsyth has been talking about the need of reforming the constitution, to introduce anti-corruption provisions.

One idea in his economic plan that is creating concern is the proposal of amending the mandate of the Central Bank, to make it dual – rather than only focused on price stability – by introducing a second target related to economic activity. In our view, this could weaken the anchorage of inflation expectations, and risk higher interest rates for the government. Using the US as an example doesn't make any sense in Peru. The US owns the global reserve currency, and Peru suffered one of the worst hyperinflations witnessed by mankind in the late 80s, not so long ago.

### **Rafael Lopez Aliaga: Strong upward trend, like Lescano**

Rafael Lopez Aliaga and Yonhy Lescano are the two candidates that have shown that strongest upward trend in the polls in the past two months (Exhibit 1). Lopez Aliaga is a successful businessman, with activities in the Peruvian railway, hotels, and financial industries. Anyone who has visited the ancient ruins of Machu Picchu probably came across Lopez Aliaga's enterprise, considering that he owns the firm – PeruRail – that operates one of the two trains connecting Cuzco to the town of Aguas Calientes, the gateway to Machu Picchu. The other train belongs to Inca Rail.

Lopez Aliaga is at the far-right of the political spectrum, mainly on social issues, and may be cannibalizing some of the votes of Keiko Fujimori and Hernando de Soto. He actually describes himself as the “Peruvian Bolsonaro”.

To his disadvantage, the Peruvian people associate him to the former Mayor of Lima Luis Castañeda, who was convicted to prison for corruption charges (now doing house arrest). They belong to the same party, Solidaridad Nacional, which has changed its name to Renovacion Popular.

On economic policies, Lopez Aliaga has focused his speech to stress that he will implement stronger anti-trust & competition regulation, particularly in the written media (newspapers), milk, and mining sectors. He also often bashes Odebrecht and the Peruvian construction companies that operated in consortium with it, pledging to expel Odebrecht from Peru if he is elected president.

Other policy proposals include: reversing fiscal decentralization, particularly the investment budget of regional governments which increased massively during Vizcarra administration (increasing the rigidity of the national budget); judicial reform, to introduce a new framework for the career development of judges; emphasis on road infrastructure across the country, relying more on public investment (G2G contracts) rather than PPPs, something that could be quite expensive in our view; and the creation of a sovereign wealth fund, using part of the international reserves, to finance investment projects in Peru. We believe that last of these ideas is soon going to receive a lot of backlash, and might be withdrawn from the plan.

### **Keiko Fujimori: swimming against the current**

Keiko Fujimori wants to vindicate the legacy of her father's regime, which lasted over ten years and ended abruptly after former President Alberto Fujimori was reelected for a third consecutive term – something prohibited by the Constitution – triggering social protests, and eventually fleeing to Japan. Some years after, while staying in Chile, Alberto Fujimori was extradited to Peru and convicted to prison.

Keiko Fujimori is a right-wing conservative politician, only slightly to the left of Rafael Lopez Aliaga. In our view, she will battle against arguably the most powerful force in Peruvian politics: anti-Fujimori sentiment. It is a sentiment that polarizes the country like no other thing, even more than the common right-left divide.

The power of anti-Fujimori sentiment was very evident in the second round of the two previous elections. In 2011, when facing Ollanta Humala – back then an ally of the Venezuelan dictator Hugo Chavez – Keiko Fujimori lost the election, as anti-Fujimori sentiment was stronger than the fear for a possible leftist-populist government. Likewise, in 2016, Pedro Pablo Kuczynski narrowly defeated Fujimori, despite Kuczynski's several characteristics that made him an easy opponent to defeat. Indeed, not only Kuczynski was perceived as a foreigner by many Peruvians, but also carried the stigma of being the candidate of the rich and the oligarchy.

### **Veronika Mendoza: the far-left**

Veronika Mendoza is a young and charismatic leader from the progressive left, who almost made it to the second round the 2016 presidential elections. We are not exaggerating by saying she's the candidate that causes the most apprehension in the Peruvian private sector, given her strong advocacy of redistributive policies. There is the perception that unlike Ollanta Humala in 2011, Mendoza would not moderate her policy proposals if she were to become president.

Her main economic policy proposals are: Constitutional reform to increase the presence of the state in the economy and have greater control over natural resources (à la Bolivia); tax reform, with progressive emphasis, focused on increasing the tax burden on corporations; a national territorial plan, to restrict the areas where extractive activities (ie, metallic mining, oil & gas, among others) can take place; and universal access to social services such as health and pensions.

To cope with the pandemic, in the very short-term, she pledges to transfer PEN 15bn (over US\$ 4bn) in cash payments to households, PEN 30bn in subsidized loans (at 2% interest or less) to SMEs, and a PEN 2bn public investment plan.

### Daniel Urresti: handicapped by human rights accusations

We are surprised that some political analysts consider Urresti as a right-wing candidate. Perhaps it is his conservative views on security policy, migration, and minority rights what causes the confusion. But when it comes to economic policies his policy views are certainly inclined to the left. His track record as a Congress member, in the provisional parliament elected in early 2020, speaks by itself.

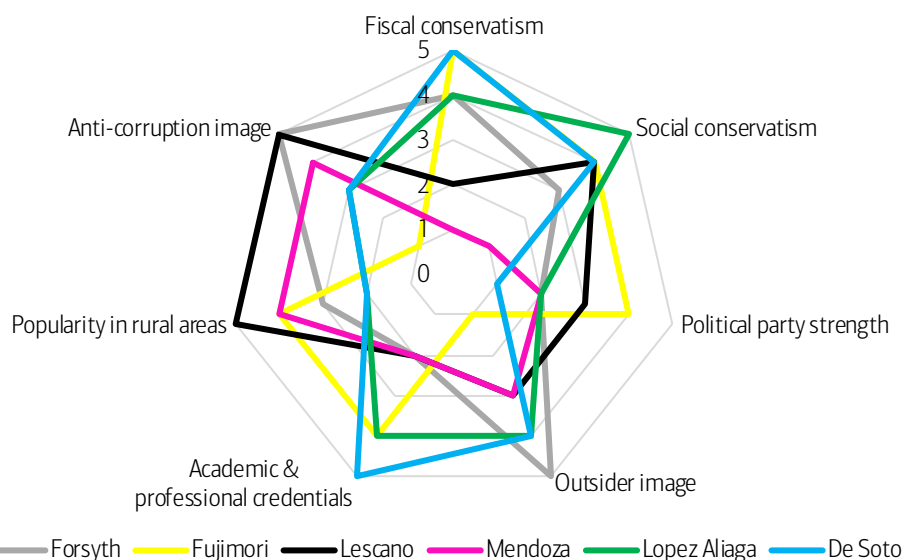
Urresti was the champion of the AFP withdrawal laws, and supported pretty much the entire list of populist laws approved by Congress in 2020: suspension of highway toll payments at the expense of private companies; interest rate caps and freezing of debt service in the banking sector; automatic promotion for public sector health workers, elimination of outsourcing/temporary job contracts in public sector (CAS regime), changes in the collective bargaining of public sector wages, among others.

Granted, his chief economic adviser, Carlos Anderson, former president of the Peruvian government's economic planning agency (CEPLAN), attached to the Prime Minister's office, is market-friendly. However, we believe this will make little difference, as Urresti is well-known for having a strong personality and doing things in his own way.

Perhaps his most important handicap are the accusations falling over him for the violation of human rights, during his career as a military officer. These accusations have been widely documented by the Peruvian press.<sup>2</sup> Our point is that the Peruvian people, especially the younger generations, are increasingly sensitive about human rights.

### Exhibit 2: The presidential candidates leading the polls

The top candidates rank high on anti-corruption. Corruption is the main concern of the population (Scores range from 0 to 5, values correspond to our opinions)



**Note:** Generally speaking, the larger the area of the heptagon the better the scores. With the exception of "social conservatism", where high or low social conservatism doesn't have major implications for the economic outlook. Although the scores on social conservatism are important to understand the profile of each candidate and their relations with other candidates.

**Source:** BofA Global Research

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<sup>2</sup> See <https://elcomercio.pe/politica/justicia/daniel-urresti-el-asesinato-de-hugo-bustios-y-un-caso-que-no-cierra-hace-32-anos-poder-judicial-podemos-peru-testigos-pruebas-noticia/>.



## Hernando de Soto: the world citizen and academic

Hernando De Soto is arguably the most famous Peruvian-born economist. Anyone who has pursued a career in development economics probably knows him. His book “The Mystery of Capital” (2003) was reviewed by former UK PM Margaret Thatcher in the following way: *“The Mystery of Capital has the potential to create a new, enormously beneficial revolution, for it addresses the single greatest source of failure in the Third World and ex-communist countries - the lack of a rule of law that upholds private property and provides a framework for enterprise. It should be compulsory reading for all in charge of the ‘Wealth of Nations’.”*

Therefore, this man may be the most intellectually fit for the job, even though by the day of the run-off vote, he will have turned 80 years old. Besides his advanced age, political analysts point out that one of De Soto’s vulnerabilities as a candidate are his links to the Fujimori regime.

To be more specific, the anti-Fujimori sentiment that burdens Keiko also spills over to De Soto, although to a smaller extent. The freshest memory of this link dates back to 2011, when in the run-off election between Ollanta Humala and Keiko Fujimori, Mario Vargas Llosa (Peru’s only Nobel Prize Awardee, in literature) godfathered Humala while De Soto did the same for Keiko. De Soto publicly challenged Vargas Llosa to debate over economic policies, each one representing their candidate. Vargas Llosa refused.

Also, local newspaper El Comercio has reported that Francisco Tudela, Vice President of Peru and Minister of Foreign Affairs during the Fujimori regime, is in the circle of Hernando de Soto’s closest advisers. In fact, Tudela’s daughter, Adriana Tudela, is a candidate for Congress in de Soto’s party, Avanza Pais.

## Julio Guzman: the candidate of the ruling party

Julio Guzman, the president of the Purple Party, the same party to which interim president Francisco Sagasti belongs, is also part of the group that we call the second platoon of candidates (Exhibit 3). He is at the very center of the political spectrum, with very liberal views on social issues, trying to catch the votes of the progressive youngsters, and somewhat conservative views on economic policies, which can be appealing for people more mindful about the economy.

In a recent op-ed, published local newspaper El Comercio, Guzman wrote that consolidating macroeconomic prudence is a priority in his plan, and criticized Congress for adopting a populist stance that is putting fiscal stability at risk. Guzman has been falling in the polls. Political analysts say this is associated to the decrease of President Sagasti’s approval, who put the country back to lockdown in January.

## Cesar Acuña: the self-made tycoon

Acuña is the founder and leader of the Alianza por el Progreso Party (APP), the party with the second highest number of seats in the present Congress (20 out of 130). APP has been gaining space in Peruvian politics, particularly since the 2018 regional & local elections where they had a relatively strong performance.

Acuña is a self-made wealthy individual, with a very humble background; the owner of the largest party university in the country, Universidad Cesar Valleja. This story of success resonates in the hearts and minds of many Peruvians.

APP is arguably a center-right party, but it has a populist pinch. For instance, Acuña is in favor of reforming the 1993 constitution. And his VP running mate, Carmen Omonte, is actually the chair of the Congress commission which approved the Comprehensive Pension reform bill, proposing the transfer of all AFP funds to a new (to be created) government-owned institution. Just like Accion Popular, APP voted in a very populist fashion throughout 2020, careless of the economic consequences. Acuña was silent.

## Daniel Salaverry: teaming up with Vizcarra

Salaverry was the President of Congress between mid-2018 and mid-2019, when he was a member of Fuerza Popular (Keiko Fujimori's party). He used to be a fervent supporter of Keiko, which is why we also believe that anti-Fujimori sentiment could also be hindering Salaverry's chances somewhat. Even though he resigned from Fuerza Popular in 2019, over the party's decision to fully-back the Attorney General Pedro Chavarry, who was accused of corruption.

It is the second time that Salaverry changes party, as in his early political career he used to be a member of the APRA (Alan Garcia's party), passing to Fuerza Popular, and now in Somos Peru. Somos Peru is a centrist party, founded by the former Mayor of Lima, Alberto Andrade, who was one of the main opposition leaders during Alberto Fujimori's government. In late 2020, former president Martin Vizcarra – who had a high approval rate during his administration – also joined Somos Peru, to head the list for Congress.

## Ollanta Humala: the only former president in the race

Ollanta Humala is the only former President (2011-16) in the race. In Peru, non-consecutive presidential reelection doesn't have a limit. For example, Alan Garcia was president twice (1985-90, 2006-11) and run for president in 2016. But consecutive reelection is indeed forbidden. Humala carries a somewhat similar – although much less heavier – burden than Keiko Fujimori, because his incarceration over the Odebrecht corruption scandal (overturned afterwards) tainted his anti-corruption image.

It is difficult to classify Humala on the economic policy stance dimension because his discourse is progressive, but his administration implemented quite conservative policies. Indeed, it was the Humala administration that created the fiscal rule (1% deficit, 30% public debt cap) that currently exists in Peru, and passed a tax reform that cut corporate taxes.

In addition, they passed an education reform that enshrined meritocracy as the core principle (similar to Peña Nieto's reform in Mexico) and fired teachers who didn't pass the knowledge evaluations. Moreover, they were the only government – since the 90s – that attempted a labor reform, dubbed by the critics as “Ley Pulpin”, which basically reduced labor benefits to young individuals to make their hiring cheaper for firms. This reform law was actually approved by Congress, but later eliminated amid social backlash.

## Pedro Castillo: also cannibalizing votes from Mendoza

Pedro Castillo is also one of the few candidates that is gaining traction in the polls, although in a less conspicuous way than Lescano and Lopez Aliaga because he only has 3% of the gross vote intentions according to the last Ipsos poll (March).

Castillo is a Teacher's Union leader from the region/department of Cajamarca. His leadership gained visibility in 2017 when he led the protests against the education reform. The same reform described in the previous section, approved by the Humala administration, deepened by the PPK government, and later sabotaged by Congress during the years of Vizcarra.

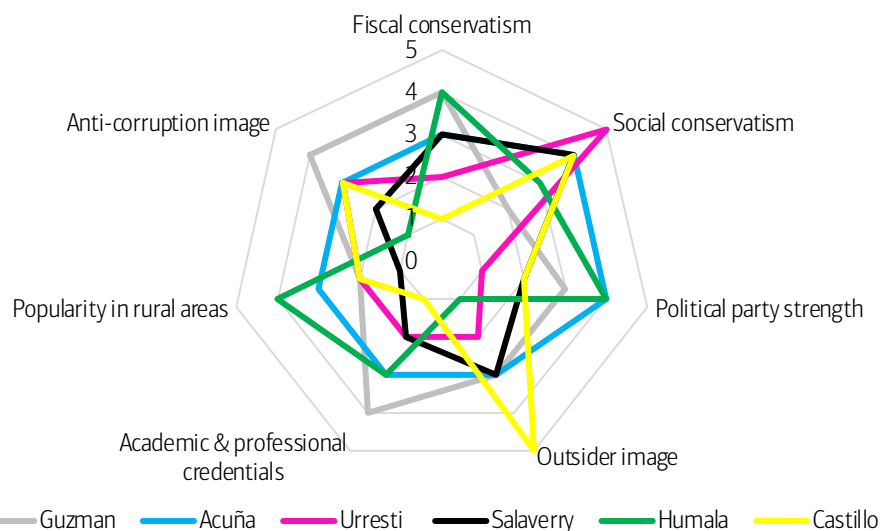
When it comes to economic policy proposals, Pedro Castillo is at the same extreme as Veronika Mendoza – the far-left – championing more presence of the state in the economy, anti-mining discourse, and so forth. But he differs significantly on social views. In fact, Castillo runs for president as part of the party Peru Libre, founded by Vladimir Cerron. Cerron, former regional governor of Junin, is one of the main faces of the Conservative Left movement in Peru. This movement is accused of being xenophobic (anti-Chilean, anti-Venezuelan), antagonistic to women rights movement, in favor of death penalty, among other issues.

Pedro Castillo's candidacy and momentum seem relevant at this point because he can erode the votes of Veronika Mendoza, to some extent. While Lescano is cannibalizing votes from Mendoza in her stronghold – the southern highlands (most leftist region in

Peru) – Castillo is taking a dent in Cajamarca (traditionally a leftist bastion in the northern highlands). Just like Gregorio Santos did in the 2016 election. In fact, many people from the left blamed Santos in 2016 for splitting the left vote, and preventing Mendoza from advancing to the run-off. Santos got 4% of valid votes (600k) at the national level and 40% in Cajamarca in 2016. Cajamarca is also Pedro Castillo's hometown.

### Exhibit 3: The second platoon of presidential candidates

There's high diversity in the characteristics of the different presidential candidates  
(Scores range from 0 to 5, values correspond to our opinions)



**Note:** Generally speaking, the larger the area of the heptagon the better the scores. With the exception of "social conservatism", where high or low social conservatism doesn't have major implications for the economic outlook. Although the scores on social conservatism are important to understand the profile of each candidate and their relations with other candidates.

**Source:** BofA Global Research

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## FX: start adding PEN exposure

**Gabriel Tenorio**  
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BofAS

We expect politics to be a key driver of Peruvian local markets until the election, as has been the case in previous electoral cycles. This time around, the Peruvian sol (PEN) has considerable election risk premium as the real effective exchange rate (REER) is close to its weakest levels in decades. We find current prices attractive to start adding PEN exposure, but we prefer to do this against other EM currencies (beta-weighted) to avoid directional exposure to the dollar. In past elections, PEN ultimately tended to strengthen after the runoff even with leftist candidates winning the presidency. Moreover, we think Congress will continue being a strong check on the executive and will remain fragmented, thereby helping mitigate tail risk scenarios.

### Trading the election: same story over and over

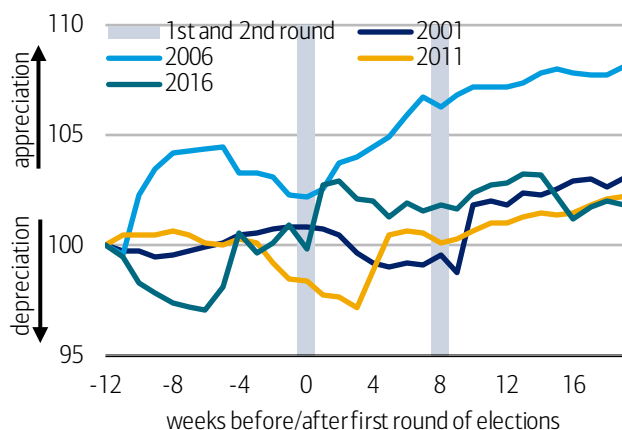
#### Elections are important drivers of PEN

Historically, PEN has been highly sensitive to presidential elections, as is typically the case for other EM currencies. In the four presidential elections that have taken place over the past 20 years, PEN tends to be highly volatile in the months preceding the first-round vote as the market responds to the evolution of polls (Exhibit 4). Our hypothesis is that this is driven by hedging demand as the risk event approaches and political uncertainty rises. For this analysis, we isolate PEN idiosyncratic volatility from that

driven by our [global macro drivers](#), in order to capture purely idiosyncratic PEN fluctuations that we attribute to the elections.

#### Exhibit 4: PEN Idiosyncratic factor (Index, 100=12w before first round)

PEN highly volatile before elections

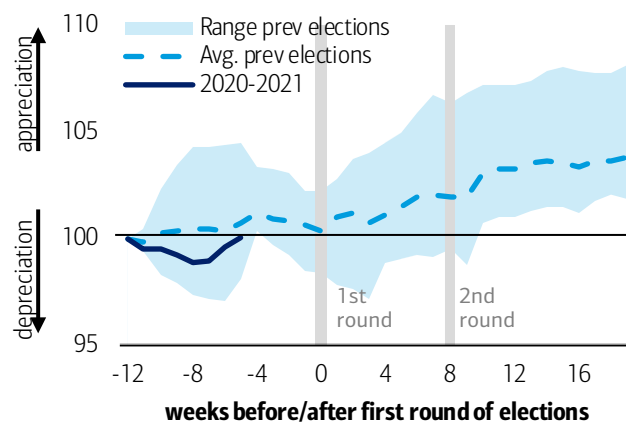


Source: BofA Global Research

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#### Exhibit 5: PEN Idiosyncratic factor (Index, 100=35w before first round)

PEN already displays substantial risk premium



Source: BofA Global Research

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Then, PEN usually strengthens ~2-5% in the period between the first and second rounds of the race. We have two potential explanations for this. First, this could be a direct result of the decrease in uncertainty, as having just two potential outcomes is better than having close to a dozen. Second, the runoff usually pushes candidates to moderate their rhetoric and move to the center, in an attempt to lure the median voter.

Finally, PEN typically continues its positive momentum after the election as political uncertainty is further removed. PEN usually strengthens by an additional ~2-5% in the 30 weeks following the election. Interestingly, this pattern seems to be somewhat independent of who wins the election. For instance, the 2011 election witnessed a leftist victory (Humala) while PEN continued appreciating after the runoff. On the other extreme, the 2016 election witnessed a rightist victory (Kuczynski) and PEN strengthened much less after the runoff.

#### This year, PEN slightly on the weaker side

According to our calculations, this year, the idiosyncratic component of PEN is slightly weaker than the historical election average at the same point of the campaigns (Exhibit 5). We think part of this is due to the populist measures undertaken by Congress at the end of last year, as well as the highly open electoral landscape we described in the previous section. Therefore, the exchange rate is already reflecting some risk premium entering into the first-round vote.

#### Our scenarios: PEN at 3.60 if moderate wins; 3.80 if populist wins

How do we expect PEN to move in coming weeks? The answer depends on the evolution of polls and the outcomes of the first and second round elections. Given the large number and heterogeneity across candidates described in the previous section, we need to simplify a bit and assume that there are only two types of candidates running for office, the “populists” and the “moderates”.

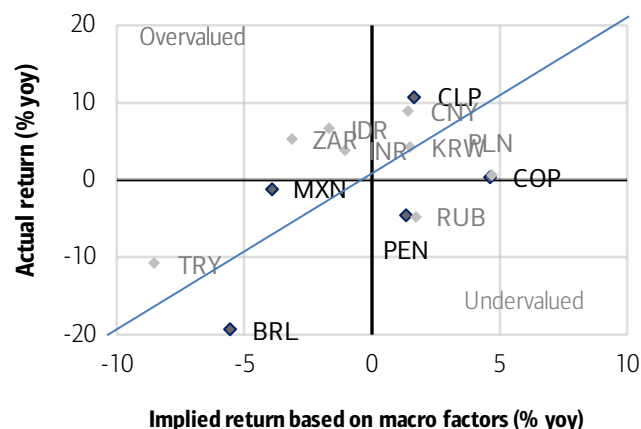
We proceed our analysis by backward induction. We first define the value of PEN for a “populist” and a “moderate” victory in the runoff, and then we define the scenarios for the first round elections based on this.

For the runoff, we claim that the “clean” exchange rate, i.e., the level of PEN that reflects no political risk premium assuming a “moderate” victory, is at around 3.60

(absent sharp moves on the dollar side). We get to this number by looking at a longer time window. On the one hand, PEN has underperformed its high-frequency global macro drivers by ~6% over the past 12 months (Exhibit 6, see [Where do EM returns come from?](#) and [Around the world in five factors](#) for a description of our factor analysis). On the other hand, the PEN real effective exchange rate (REER) is ~7% weaker than its long-term average (Exhibit 7).

#### Exhibit 6: Actual vs. Macro factors based changes

PEN is one of the currencies that underperformed its factor-implied valuation the most



Source: BofA Global Research estimates. Data as of Mar 5, 2021

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#### Exhibit 7: Peru's REER index

From a LT perspective, the REER looks weak



Source: BofA Global Research, BIS.

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We think a good fraction of the PEN weakness is due to populist measures approved by Congress and political uncertainty around the destitution of former president Vizcarra. However, good part of this underperformance is also likely due to election uncertainty. Therefore, being conservative, we attribute ~3pp of risk premium already embedded in the exchange rate as arising from elections risk, which sets the “clean” exchange rate at 3.60.

From here, we estimate that a “populist” victory would carry an additional ~5% risk premium over a “moderate” victory, which would put PEN level at 3.80 (again, absent sharp moves on the dollar side). The size of the “populist” risk premium is hard to pin down with precision as it depends on specific candidate that wins, his or her policy platform, and the relationship of the winner with Congress. However, in our experience, 5% is a reasonable risk premium given our findings from recent LatAm elections (e.g., [Mexico's 2018 election](#)). Moreover, the  $\pm 5\%$  PEN variation in prior elections also suggests this risk premium is sensible. Exhibit 8 summarizes our runoff scenarios.

#### Exhibit 8: Runoff: PEN at 3.60 if moderate wins; 3.80 if populist wins

Runoff scenarios for PEN

Runoff outcome	PEN
Moderate victory	3.60
Populist victory	3.80

Source: BofA Global Research

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#### Exhibit 9: First round: three potential scenarios for PEN

First round scenarios for PEN

First-round outcome	PEN
Moderate vs Moderate	3.60
Moderate vs Populist	3.70
Populist vs Populist	3.80

Source: BofA Global Research

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#### First round volatility also relevant

Naturally, PEN should fluctuate from now until the first round election depending on which candidates seem to be coming ahead in polls. In the first round, the race will narrow down to just two candidates for the runoff. Therefore, under our simple framework, there are three potential outcomes from the first round vote: that the

election becomes a “populist vs populist” race, a “moderate vs populist” race or a “moderate vs moderate” race.

Calculating the value of the two extreme scenarios is straightforward, as we are assuming that the market would assign any candidates of the same type (moderate or populist) with the same risk premium. In the middle case of a “moderate vs populist” race, we assign a 50-50% chance to the final outcome as we do not know ex ante how different combinations of candidates would perform in a runoff. This would leave the expected value of PEN for that scenario at around 3.70, very close to current levels. Exhibit 9 summarizes our PEN scenarios for the first round.

In the spirit of simplicity, we do not calculate the value for a first-round victory as the polls seem to suggest no candidate has enough support yet to win in the first round.

### **How to position: start adding PEN exposure**

Under our framework, the current exchange rate at 3.71 is virtually pricing the split runoff scenario (i.e., “moderate vs populist”). Under this pricing, we like the risk-reward of being long PEN for two main reasons.

First, historically, PEN tends to fade the election risk premium even when leftist candidates win (Exhibit 4). We think this is a result of “populist” candidates usually moving to the center after being elected, given Peru’s traditionally conservative policy-making. So we would not be surprised if that were to happen again this time around if a “populist” were to win. Of course, there is always a risk that “this time is different”, particularly considering the social and economic impact of the pandemic, but we think that risk is already somewhat reflected in the exchange rate.

And second, even though there is a non-trivial probability of a “populist” victory, Congress will likely remain a significant check to the executive since polls suggest that the new configuration will be highly fragmented. This would make it difficult for the president to pass any extreme legislation, thereby helping mitigate tail-risk scenarios.

In the short term, we would prefer to add PEN exposure against other EM crosses (beta-weighted) given that the dollar could continue strengthening if the US growth outlook keeps improving. The main risk to our view is that PEN continues underperforming other EM currencies if two populist candidates make it to the runoff or if the pandemic intensifies in Peru.



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