Peru Economic Outlook

Fourth Quarter 2014
Peru Unit

- Global activity will grow by 3.2% in 2014, at a similar pace as last year. We expect it to pick up to 3.7% in 2015, driven by both the advanced and emerging economies
- Over recent years, structural factors and the reversal of favourable foreign conditions led to a moderation of Peru's economic growth that intensified in 2014, due to short-term factors and a cyclical adjustment of private spending
- Within this context, while we expect activity to rise by 2.6% in 2014, we also foresee a rebound next year to 4.8%, supported by higher mining production and the start-up of major infrastructure works
- The domestic currency weakened within a scenario of rising global financial market volatility. We expect this trend to continue next year and that the exchange rate will close 2015 at USD/PEN 3.05
- Inflation will close the year at 3.3%, but the scenario will be more benign going forward, as a result of more limited demand pressures on prices and a fall in the international prices of imported inputs
- The weakness of output and the fiscal boost, together with the more benign scenario expected for prices, provide room for a further limited cut in the monetary policy rate. We believe a 25bp cut is likely before the end of the year, which would take the rate to 3.25%

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Closing date: 3 November 2014

1 Summary

Global activity will grow by 3.2% in 2014, at a similar pace as last year. We expect it to pick up to 3.7% in 2015. This recovery will take place in both the advanced and emerging economies. The United States, in particular, will grow 2.0% this year and 2.5% in 2015. This outlook is supported by an overall balance in activity, spending and employment indicators, which point to consolidating dynamism, and by the cautious posture the Fed has taken toward this improvement. On the side of the emerging economies, we expect improved performance next year in those countries in both Latin America and Asia. One of the exceptions will be China, where growth will continue to approach more sustainable rates, declining from 7.2% in 2014 to 7.0% in 2015. This will unfold in an environment in which the country will continue to realign its sources of growth toward the domestic economy and reduce the risks to its financial system.

In Peru, activity continued to surprise to the downside. The strong slowdown in GDP in 2014 is a reflection of a set of factors. **No major structural reforms were made over recent years**, which weakened the rise in productivity and competitiveness and, consequently, potential output growth. The **reversal of favourable foreign conditions** also contributed to lower GDP growth. The downward correction in metal prices and costlier foreign financing had an impact, for example, on the strong slowdown in mining investment, which accounts for somewhat less than 25% of total private investment. **Furthermore, short-term factors** such as supply issues at two of the country's largest copper deposits and the contraction in public investment by sub-national governments exacerbated the slowdown. **Lastly**, there was a **cyclical moderation of private spending** on investment and consumption.

Within this context, while we expect activity to rise by 2.6% in 2014, we also foresee a rebound to 4.8% in 2015. After a third quarter in which the drivers that were to kick-start the recovery failed to provide the expected support, specifically higher mining production and greater public spending, some initial fourth quarter indicators suggest a somewhat better performance. Our base case scenario thus includes a pick-up over the last months of the year, contingent upon the ultimate execution of the fiscal boost, a certain improvement in copper production, the adjustment of inventories having taken place mainly in the third quarter with a moderately negative impact on the fourth, and no further deterioration of business confidence. We still expect a rebound in 2015, associated with higher mining production and the start-up of construction at tendered infrastructure works, such as Lima Metro Line 2, and at works that the government will execute directly (modernisation of the Talara refinery).

With respect to the financial markets and after a relatively calm period, volatility climbed over the last months. The improvement in US activity, spending and employment indicators has enlivened the debate within the Fed on the appropriate time to start the upward policy rate cycle and on the pace at which it would be conducted, generating uncertainty in the markets. **Domestically, this has raised the upward pressures on the exchange rate** (depreciation of PEN), as has also the more accommodative monetary stance and the outlooks that it will so remain within a context of severe output weakness. We thus expect the exchange rate against the US dollar to close the year somewhat above 2.920. The domestic currency will continue weakening in 2015. First, because interest rates in USD will rise globally as the Fed starts to adjust its monetary policy, which we expect will occur in mid-2015, thus reducing the appeal of PEN-denominated assets. Second, because the capital inflows for mining investment financing will weaken due to the reduced profitability of this activity (lower metal prices) and to the higher costs of financing worldwide. Third, because in an environment of a strengthening foreign currency, domestic financial system deposits will probably tend to become dollarized. We expect these factors to take the exchange rate to **around USD/PEN 3.05 at the end of 2015**, a domestic currency depreciation that is consistent with a gradual reduction of the deficit in the current account of the balance of payments, and which will unfold in an orderly manner due to the likely intervention of the central bank.

On the side of prices, we continue to expect a more benign scenario starting in 2015. **Inflation will remain somewhat above the target range for the rest of the year, closing at 3.3%**. The trend will moderate from that point forward. This is due to lower demand pressures in a negative output gap environment, and to the decline that the international prices of imported food inputs will experience. Furthermore, if oil companies adjust their distribution prices to place them at a level similar to the benchmark published by the domestic regulatory entity, which factors in the downward trend that the international oil price has recorded, not only will inflation recede more quickly but inflationary expectations also (currently at 2.8%, close to the target range ceiling), thus leading to reduced inertia in the price formation process. Within this context, partially offset by the upward impact of the higher exchange rate on the prices of imported goods and, generally, on the prices of foreign currency-denominated goods and services, we **expect inflation to close 2015 at around 2.5%**.

The **weakness of output and the fiscal boost, together with the more benign scenario on the side of inflation, suggest that there is room for a cut in the benchmark interest rate in the short term and that it is necessary**, in addition to the total 50bp reduction made since July. The central bank expects fourth quarter economic growth to come in at around 4% YoY (seasonally adjusted, an annualised pace of more than 10% QoQ). The current level of the policy rate is consistent with this projection. At BBVA Research, we expect GDP to rise at an appreciably lower pace. We believe that upon the release of the new activity data, which will reveal a lower-than-expected output dynamism, the central bank will be inclined to once again cut the benchmark interest rate, thus seeking to maintain consistency in its actions and buttress activity. **This cut might occur before the end of the year and would be limited (25bp)**, given that a more aggressive monetary stimulus might fuel the upward pressures on the exchange rate (especially when the current account deficit is high and financial conditions in the international markets are beginning to tighten), and thus impair the balance sheets of companies and households that have a currency mismatch. In the second half of 2015, when we expect GDP to rise at a somewhat higher pace than potential, the policy rate will probably start to be geared toward a more neutral level, closing the year at 3.75%. This will also curb potential bouts of currency volatility associated with the normalisation of Fed monetary policy.

Lastly, we have identified risks that lend a downward bias to our base case economic growth scenario for 2014 and 2015. On the foreign side, in addition to a sudden and protracted slowdown in China and the potential for an early (unexpected, and not too orderly) start of the upward policy rate cycle by the Fed, this report includes another one: geopolitical risk. This encompasses, for example, the political tensions in Eastern Europe and the Middle East, and the social unrest in Asia (Hong Kong). Domestically, we maintain that the main risk is for business confidence to remain weak and thus extend the period of slow output growth. There is yet another factor: the risk of a continued delay in the start-up of construction at the major awarded infrastructure works, one of the main growth drivers for the coming years.

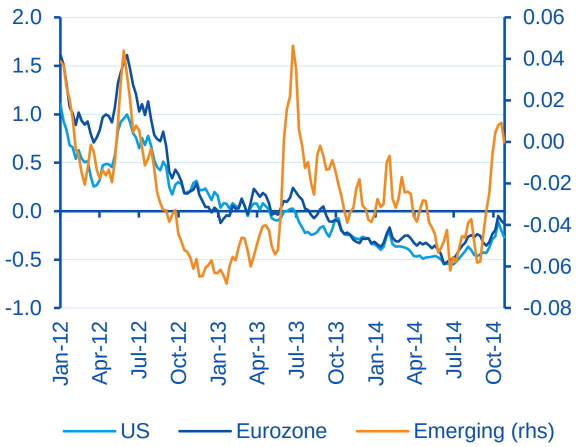
2 Slow global recovery with greater financial volatility

World growth is still rising, closing 2014 at 3.2% in 2014 and 2015 at 3.7%. But financial tensions and geopolitical risks are on the increase as well

Global economic growth continued in the third quarter. However, quarterly growth is very moderate in the more developed economies, and of these, more in Japan and the eurozone than in the US.

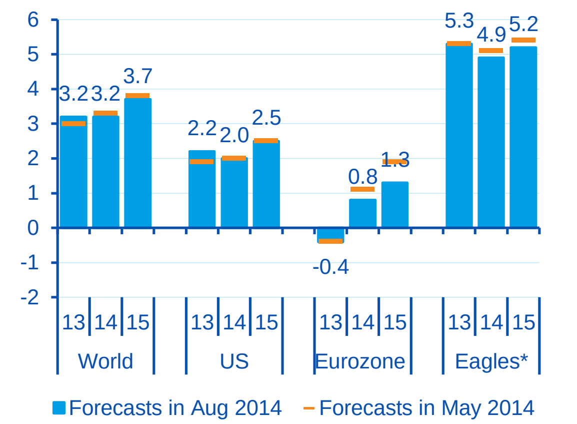
The confidence indicators for September remain consistent with the expansion of manufacturing activity, although it has been some months since they stopped improving in the key economic areas. An additional sign of the fragility of the present cyclical recovery is the uptick of the tension indicators in the financial markets since mid-September. In the case of the emerging economies (EMs), these have reached levels not seen since May 2013 (Figure 2.1). Then the market discounted a rapid withdrawal of Fed stimuli that actually never happened and is still pending. At the same time, geopolitical risks have been multiplying and negative surprises are building up on the consensus in the activity indicators, particularly in the eurozone and South America.

Figure 2.1
BBVA Research Financial Tensions Index



Source: BBVA Research

Figure 2.2
GDP growth forecasts (%)



* EAGLES is the group of emerging economies which will contribute most to world GDP in the next 10 years. Group made up of China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: BBVA Research

Altogether, the most likely scenario is that global growth improved from the second to the third quarter, rising from 0.6% QoQ to an estimated 0.8% respectively. However, there is downside risk to these figures given that the industrial activity indicators and world trade in September could still moderate, and the effects of the financial volatility on confidence could be more persistent than we expect. Also, there are the geopolitical risks associated with the situation in Syria and Iraq and the fragile agreement between Ukraine and Russia. It is worth noting that sanctions are already having an impact on activity in important sectors such as Russian energy.

In this context, monetary policy will remain focused on supporting activity, while fiscal policy will be less restrictive in tone in 2014-15 in both the US and the eurozone than in the recent past. Even in China, together with the budget consolidation at the local and regional government level it is felt that additional measures to support growth could be implemented.

Finally, we must point to the fall in oil prices as a favourable factor for global growth expectations although not for exporter countries to the extent that this is a result of a positive supply shock.

Growth in the US remains in line with expectations, and is likely to reach 2.5% in 2015

After the unexpected and transitory drop in activity in 1Q14, the activity, spending and employment indicators have recovered, implying that the pace of GDP growth could be around 2.5% in the second half of the year, and thus average 2% for 2014 as a whole (Figure 2.2). The role of the Fed, which emphasises caution and patience before acting on the signs of improvement in the economy, continues to support our scenario of a cyclical recovery in the US underpinned by the solid creation of employment and the increase in household wealth.

Our outlook for China is unchanged, but with a downward bias due to the external environment and the supervision of shadow banking

In the third quarter GDP growth continued to decelerate, to 7.3%, reflecting the moderation in domestic activity, particularly in the construction and real estate sectors, but partially offset by an unexpected and intense upturn in exports. We maintain our outlook for GDP growth at 7.2% in 2014. Altogether, the risks to growth in China continue to be to the downside from 2015 onwards (7.0%), precisely because of the brake on external demand that the situation in Europe might imply and the adjustment underway in the real estate sector in a context of high leverage and the introduction of measures to control its less regulated banking system.

China is facing the task of managing the present deceleration of economic growth while reducing its financial risks and rebalancing growth in favour of domestic demand. In this scenario, the authorities will intervene so that the deceleration does not intensify, and growth does not fall below the targets set. Thus we would not be surprised to see additional monetary policy easing (with cuts in the reserve ratio or liquidity injections), expansive central government fiscal policy (albeit with consolidation at the local government level) and on-going execution of structural reforms.

In the eurozone the recovery will be even slower than we were expecting

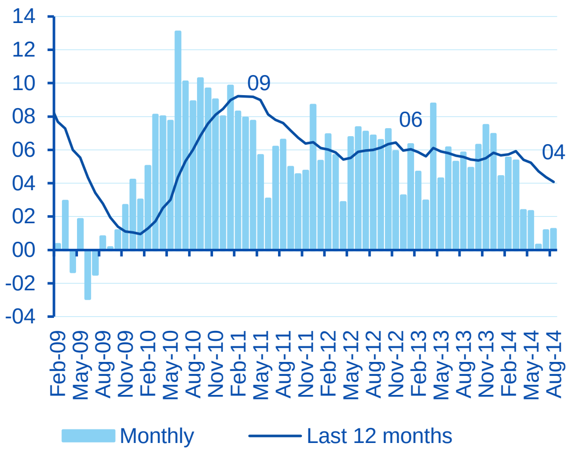
The stagnation of GDP growth in the second quarter, with weaker performances in general in the larger economies, has led us to revise our outlook for growth in the region downwards for 2014 and 2015 (Figure 2.2). The Ukraine/Russia crisis is having an impact on trade and the confidence indicators of the economies in the centre of Europe, including Germany. The ECB has continued to take action, with measures designed to bring inflation expectations more closely into line with the objective of price stability, which have been de-anchoring since 2012. In our most likely scenario, euro depreciation has to make a contribution, given the different expectations of Fed and ECB actions, with a withdrawal of stimuli by the former and balance-sheet expansion by the latter.

3. Peru: we project growth rates of 2.6% and 4.8% for 2014 and 2015

The slowdown of the economy is motivated by both structural and foreign factors…

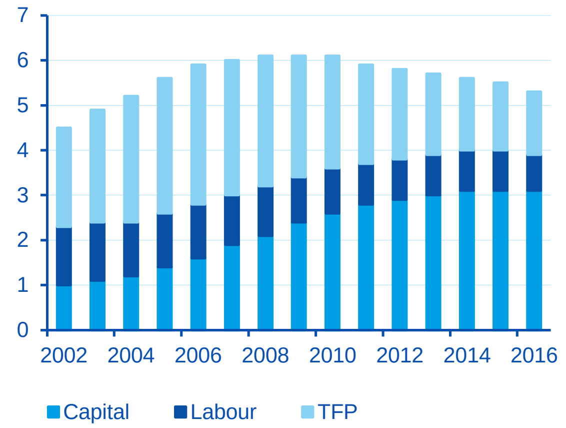
The pace of GDP growth has been showing signs of fatigue since 2011 (see Figure 3.1), when it began to gradually converge toward a slower trend growth, which could come in at 4.5-5.0% over the next few years. The change in favourable foreign conditions was proof that pre-2011 growth rates were no longer sustainable.

Figure 3.1
GDP: Cumulative growth last 12 months (% annual var.)



Source: Central Bank and BBVA Research

Figure 3.2
Contribution of potential GDP to growth (%)



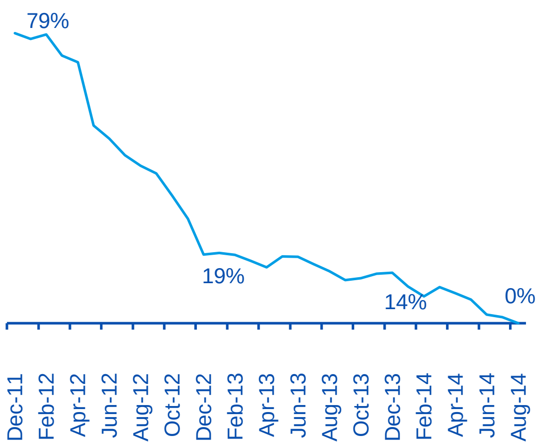
Source: Central Bank and BBVA Research

From a structural perspective, the lower trend growth is mainly explained by a decline in productivity and competitiveness, within a context of several years during which no reforms were made nor measures taken for a renewed push to reform. According to our estimates, the average contribution of productivity to potential growth has fallen considerably since 2011 (see Figure 3.2). In this regard, it should be noted that the average contribution of productivity to growth went from 2.8pp in 2003-10 to 1.9pp in 2011-14. This means that the Peruvian economy is growing roughly one point less due to lower productivity. On the side of competitiveness, the World Economic Forum's (WEF) Global Competitiveness Report 2014-15 reveals that Peru dropped four positions versus the previous year's measurement, with the country now ranking 65th (out of 144 countries), after Chile (33rd), Brazil (57th) and Mexico (61st). Although the Report continues to highlight the positive Macroeconomic Environment ranking, pillars such as Institutions, Innovation, Infrastructure and Education, all of which are associated with long-term growth, remain far behind and have not displayed any improvement over the last years. State bureaucracy, corruption and restrictive labour regulation top the list of the main problems in doing business in the country, according to the WEF Report (see Box 1).

With respect to the contributions of the factors of production (labour and capital) to potential growth, we project they will remain relatively stable over 2015-18. The contribution of labour will remain supported by the demographic bonus for some additional years, which means that the rate of labour participation will rise slightly, although its positive effect on growth will gradually decline.

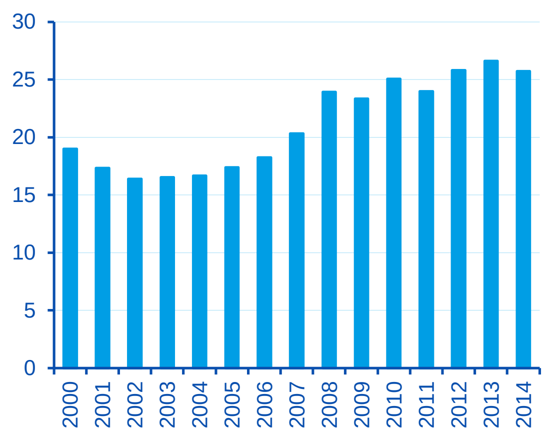
The pace of capital accumulation is expected to moderate. Going forward, investment is projected to grow at single-digit rates, which contrasts with the growth rates it displayed some years ago. These forecasts are consistent with the expectation that mining investment (which accounts for somewhat less than 25% of total private sector investment) will slow in coming years, due to outlooks for falling metal prices and higher operational and financing costs. In fact, this trend has been visible domestically over the last two years (see Figure 3.3). Of course, this is a global phenomenon that not only affects the sector's investment in Peru, but throughout the world.

Figure 3.3
Mining investment (Index)



Source: central bank and BBVA Research

Figure 3.4
Gross fixed investment (% of GDP)

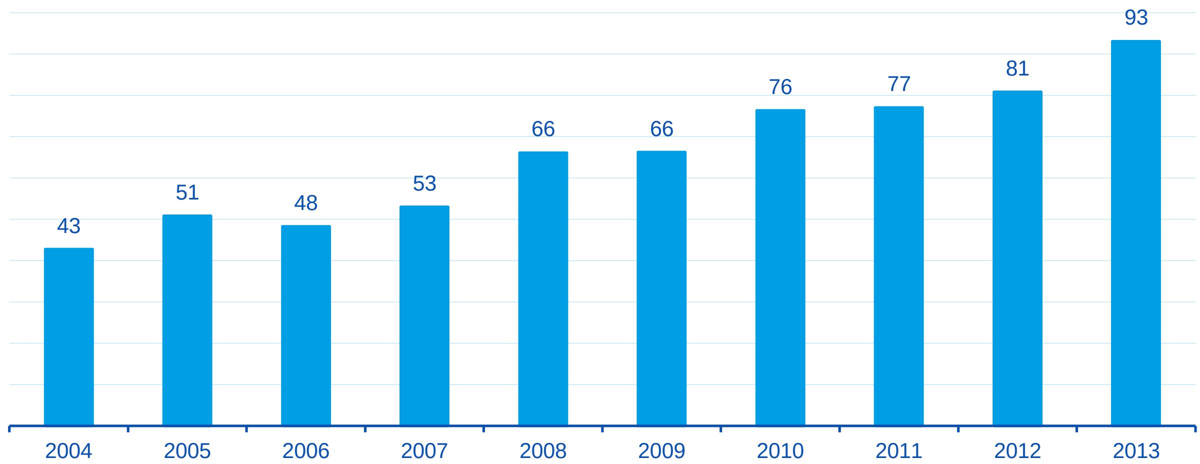


Source: central bank and BBVA Research

We should add that the ratio of gross fixed investment (private plus public) as a percentage of GDP is currently around 27%, a level similar to that of fast-growing economies such as South-east Asia's. Raising this ratio further will be complicated because it will require higher domestic savings, which will not only have to finance higher investment but also assist in reducing the high level of reliance on foreign savings (around 5% of GDP) that the Peruvian economy currently displays. Our forecasts suggest that capital accumulation (private and public) will grow by around 6% from 2015 to 2018, which will suffice to keep the ratio of gross fixed investment at around 27% of GDP. Lastly, it is important to note that public investment faces a structural cap entailed by the State's ability to manage an increasingly bigger budget with limited resources (number of personnel, appropriately qualified staff) (see Figure 3.5). To illustrate this situation, we note that, from 2004 to 2013, the Initial Opening Budget (PIA) rose at an average annual rate of 9.8%, while the number of public employees rose by 2.5%.

Given the stabilisation (or slight decline) expected for labour and capital contributions, a resumption of higher growth rates requires productivity-stimulating reforms in key sectors (such as Education, Healthcare and Infrastructure).

Figure 3.5
Public budget among number of public employees (PEN '000)

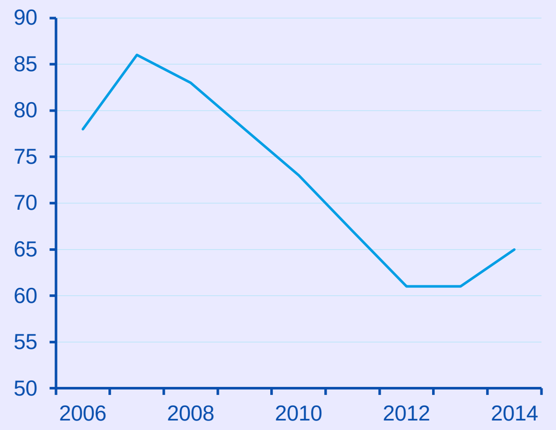


*Includes PIA by number of public employees (PEA).
Source: MEF, MTPE and BBVA Research

Box 1. Evolution of competitiveness in the country

According to the Global Competitiveness Report published by the World Economic Forum (WEF), Peru significantly improved its competitive position from 2007 to date (see Figure B.1.1).

Figure B.1.1
Evolution of Global Competitiveness Ranking



Source: WEF, BBVA Research

The ranking pillars that explain most of the improved performance are macro stability (Peru climbed 46 positions, from 67th to 21st) and greater labour market efficiency (from 75th to 45th, see Figure B.1.2). Aside from this positive evolution, some key components associated with sustained long-term growth did not improve or even worsened. And while others reveal a slight improvement, they still lag far behind. Innovation and Institutions fall within the group that worsened its score and, together with Infrastructure, Education and Technology, are the biggest laggards within the ranking.

Figure B.1.2
Peru. Global Competitiveness Ranking 2008-12

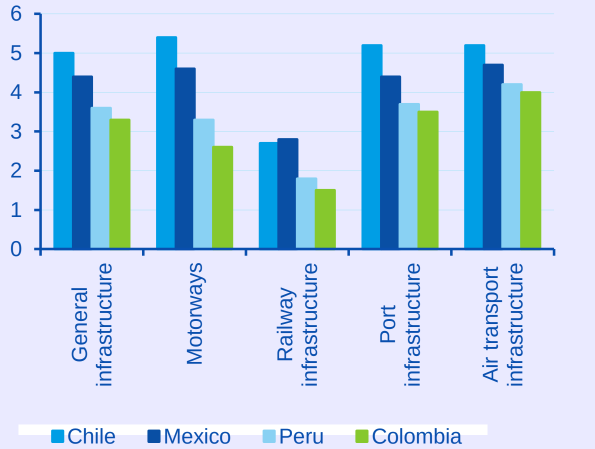
		2012-13	2008-09
Global competitiveness ranking	**65**	**61**	**83**
Basic requirements	**74**	**69**	**94**
Institutions	118	105	101
Infrastructure	88	89	110
Macroeconomic stability	21	21	67
Health and primary education	94	91	95
Efficiency	**62**	**57**	**69**
Secondary education and training	83	80	89
Efficiency of the goods market	53	53	61
Efficiency of the labour market	51	45	75
Sophistication of the financial market	40	45	45
Technology	92	83	87
Size of market	43	45	50
Innovation and sophistication	**99**	**94**	**83**
Sophistication of businesses	72	68	67
Innovation	117	117	110

Source: WEF, BBVA Research

Peru ceased to improve its position on the Global Competitiveness Ranking in 2012, and eventually declined to a rank of 65 in the last measurement of 2014-15, coming in behind countries such as Mexico (61st) and Brazil (57th) and nearly on a par with Colombia (66th).

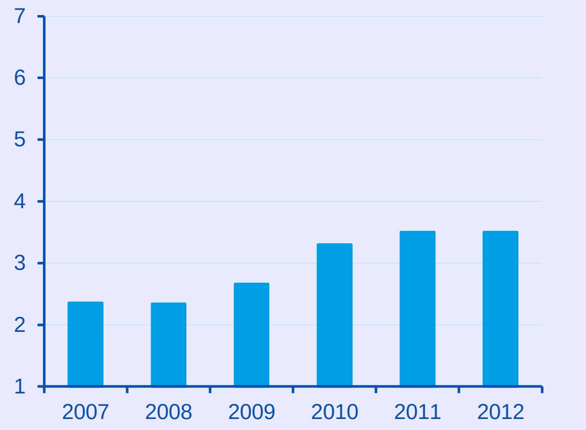
The most problematic factors in doing business in Peru remain the same as reported in past measurements, although in a different order: inefficient state bureaucracy, corruption, restrictive labour regulation and inadequate infrastructure supply. On this last point, although infrastructure quality would seem to have improved over the last years, it is still far from being considered compliant with international standards in terms of levels of development and efficiency. Among the Pacific Alliance countries (Chile, Mexico, Colombia and Peru), Peru is the third least developed with respect to infrastructure quality (see Figures R.1.3 and R.1.4). In the case of roads, for example, only 14% are paved which, together with the traffic generated by other roadway deficiencies, generates significant wastage of time and greater costs.

Figure B.1.3
Infrastructure Competitiveness (7=best)



Source: WEF, BBVA Research

Figure B.1.4
Quality of port infrastructure and efficiency, according to international standards (1=highly precarious; 7=good development)



Source: WEF, BBVA Research

With respect to the ease of doing business, according to Doing Business 2015, Peru ranks 35th out of 189 countries (58th in 2008), ahead of Mexico (39th) and Chile (41st) and right behind Colombia (34th, see Figure B.1.5). Peru cut the time required to start a business from 72 days in 2008 to 26 days currently.

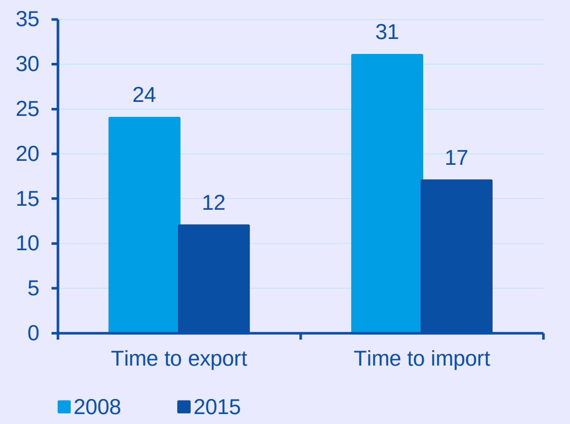
According to this report, exporting a standard container of goods requires five documents, costs USD860 and takes 12 days, 12 less than in 2008 (see Figure B.1.6). On a worldwide level, Peru ranks 56th out of 183 countries in ease of trading across borders.

Figure B.1.6
Peru. Doing Business 2015

Ranking Doing Business	**35**
Starting a business	89
Handling construction permits	87
Obtaining electricity	86
Property Registry	26
Access to loans	12
Protection of minority shareholders	40
Payment of taxes	57
Cross-border trade	55
Resolution of insolvency problems	76

Source: Doing Business, BBVA Research

Figure B.1.7
Time required to export and import

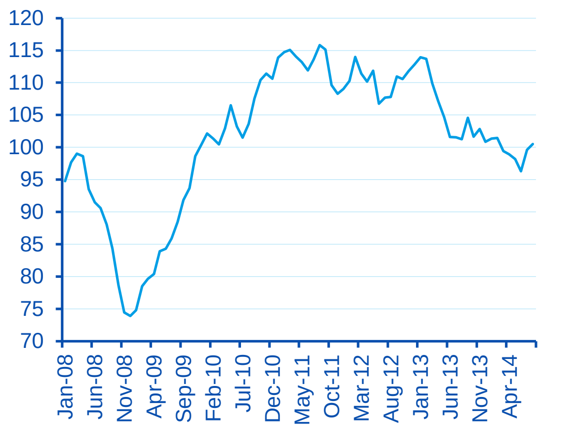


Source: Doing Business, BBVA Research

Although the country has improved its competitive position and is now more attractive for doing business than it was in the previous decade, many aspects still remain to be developed. Raising potential output to levels of over 6% is a task that involves tackling pending competitiveness issues, notably improvements in infrastructures and human capital, institutional strengthening, greater innovation in processes and products, cutting red tape on investment and continuing to reduce informality.

With respect to the change in foreign conditions, the Peruvian economy was affected by the downward correction in metal prices and costlier foreign financing. The terms of trade recorded a cumulative fall of 10.9% from the end of 2012 to August 2014, a contraction similar to the one registered from September 2008 to December 2009 (12.5%) during the global financial crisis. With respect to financing conditions in the international markets, we should note that the yield demanded on the Peruvian government's 2025 global bond rose some 70 basis points, from 3.18% (average Q1 2013) to 3.88% (average so far this year). The swift deterioration of foreign conditions is proof that the Peruvian economy's average annual pace of growth in 2010-13 (around 6.7%) was not sustainable in the medium term. We should add that in its April 2014 Report entitled *Economic Outlooks: The Americas*, the International Monetary Fund (IMF) submitted proof that the effect of rising commodity prices on growth is generally transitory. As the IMF shows, once investment adjusts to the rise in primary sector profitability and the wealth effect materialises, the output growth rate returns to its pre-boom trend, even if prices remain high.

Figure 3.6
Terms of Trade Index



Source: central bank and BBVA Research

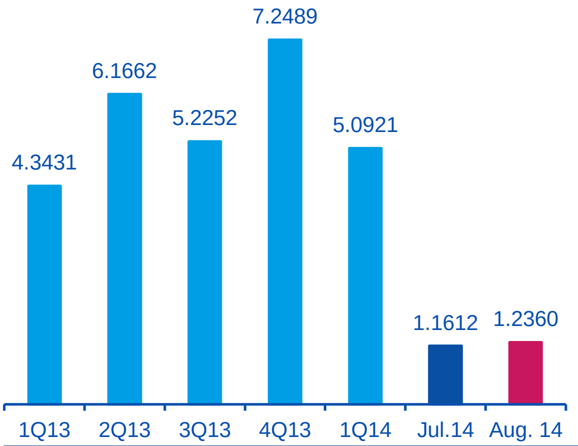
Figure 3.7
2025 Global bond yield (%)

Source: Bloomberg and BBVA Research

…as well as by short-term and cyclical factors that have caused a more widespread and severe weakening in activity than previously expected

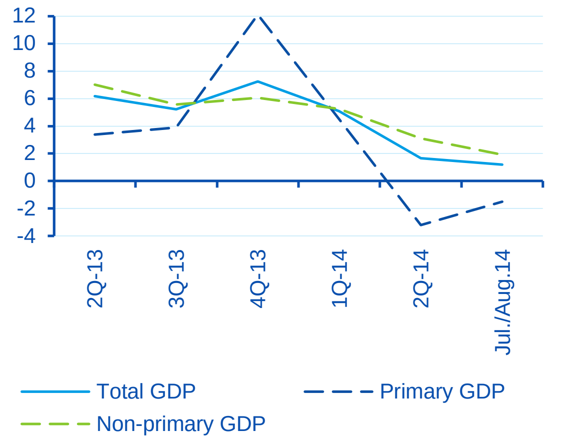
Regarding the moderation of potential growth and the reversal of favourable foreign conditions, economic activity in 2014 was affected by unexpected short-term and cyclical factors that temporarily heightened the slowdown in growth. Thus, after 1Q2014 growth of 5.1%, the rate dropped to 1.7% in 2Q14 (the lowest since the 2009 crisis) and to 1.2% in July and August (see Figure 3.8). The weakness in economic activity was striking (the growth rates lie well below the potential pace) and is explained not only by supply-side factors (as it was initially), but also by factors that are more associated with demand. In this regard, the growth rates of both the primary and non-primary sectors (more associated with domestic spending) revealed a marked decline (see Figure 3.9).

Figure 3.8
GDP (% var. YoY)



Source: central bank and BBVA Research

Figure 3.9
Total and non-primary GDP (% var. YoY)



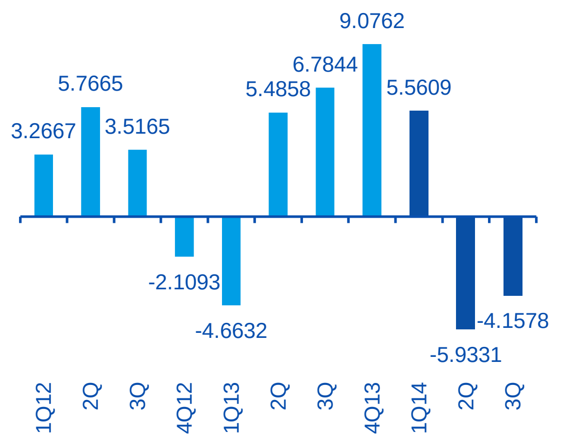
Source: central bank and BBVA Research

On the side of the short-term factors that caused lower growth we note: i) the supply issues that affected the mining sector, but which will tend to subside over the coming months, and ii) the difficulties and delays in executing public investment, due to the problems that have surfaced among sub-national governments.

Metals mining generates around 8% of Peru's GDP, with copper accounting for a third of that figure. The supply issues in this sector led the activity to shrink considerably so far this year (see Figure 3.10). Two major copper projects are to be noted in this evolution. Antamina, Peru's largest copper mine, has an average monthly production of roughly 38,000 fine metric tons (450,000 FMT per year), and accounts for over 30% of total copper mined in the country. So far this year, however, Antamina has been unable to produce more than 31,000 FMT per month on average. This was initially due to plant maintenance work. However, when it concluded, the quarry that was being mined was expanded and, as is common in these cases, the ore content temporarily dropped. Within this context, its maximum production capacity is unlikely to recover until well into 2015. According to our estimates (direct impact), the drop in Antamina's copper production this year, of 15% YoY up to August (but which we expect will be greater in coming months), would account for nearly two tenths of lower GDP growth in 2014.

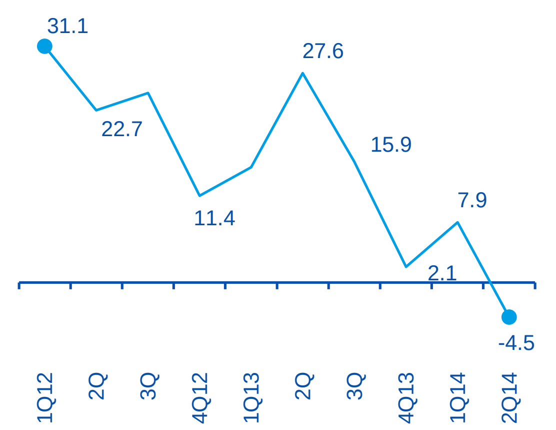
The other major copper project is Toromocho, which started its production phase at the end of 2013 with plans to reach full operating capacity at the start of 3Q2014, with an average monthly production of 23,000 FMT (275,000 FMT annually). This did not happen, however (it is currently mining somewhat more than 8,000 FMT/month). We are assuming that it will only reach average levels in excess of 20,000 FMT/month by the start of 2015. Toromocho seems to have had two technical issues: one in connection with the arsenic contained in its concentrates, and the other with the testing of its concentrators. Maintaining current production levels through the rest of the year would entail 70,000 FMT of lost production (versus maximum capacity), that is, around 6% of Peru's annual copper production, which equates to a direct impact of close to two tenths of a percentage point of GDP.

Figure 3.10
Metals mining GDP (% var. YoY)



Source: central bank and BBVA Research

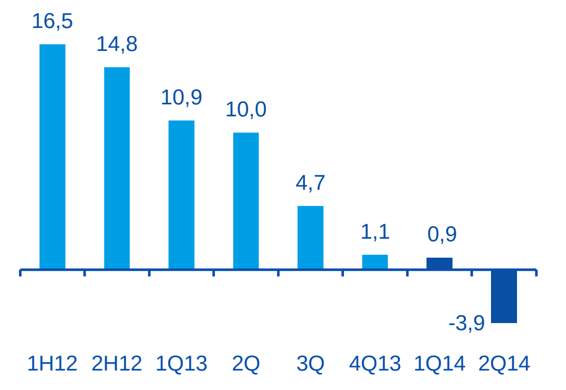
Figure 3.11
Public investment (% var. YoY)



Source: central bank and BBVA Research

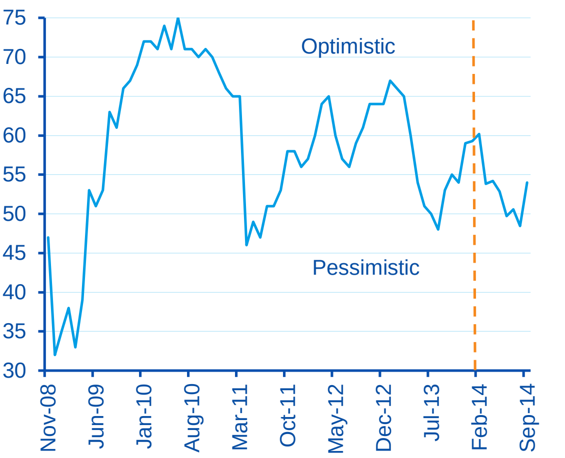
On another note, questions over the handling of public resources by some sub-national governments (which in total control roughly two thirds of public sector capital expenditures) explain the contraction displayed by public investment so far this year (see Figure 3.11). We expect that the lower execution of public investment over this year, versus what was expected at the start of the second quarter, will shave 0.8-0.9 percentage points from 2014 growth.

Figure 3.12
Private investment (% var. YoY)



Source: central bank and BBVA Research

Figure 3.13
Business confidence (Index)

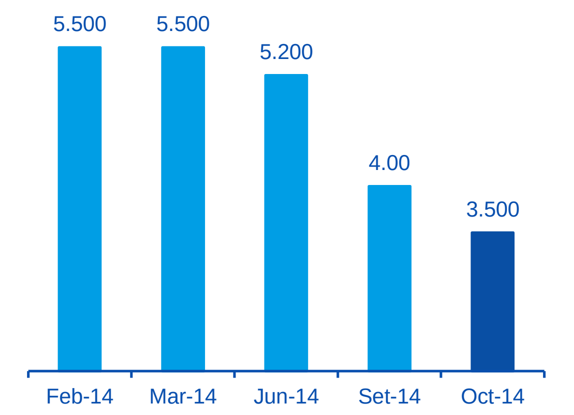


Source: central bank and BBVA Research

Finally, the cyclical moderation in private spending on investment and consumption has also had a negative impact on 2014 growth. While investment had already been moderating for two years, in the second quarter of 2014 it went so far as to record a contraction (see Figure 3.12), within a context of falling business confidence (see Figure 3.13), affected by the ongoing negative surprises in the pace of economic activity.

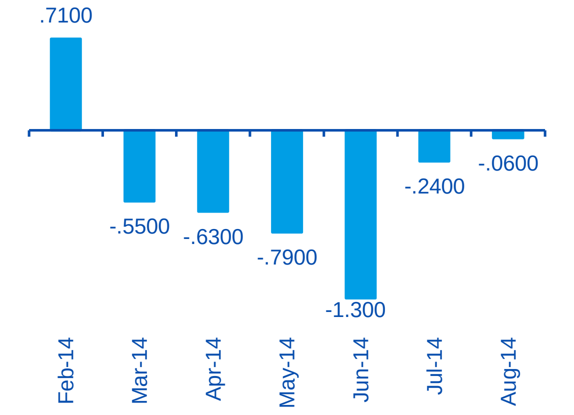
This is gleaned from economic analysts' surveys. At the start of the year, the consensus expected that the Peruvian economy would grow 5.5% in 2014. This forecast currently stands at closer to 3.5% (see Figure 3.14), while BBVA Research estimates that it will ultimately come in at one percentage point below said rate. This negative surprise is also seen in the shorter forecasting horizons. Figure 3.15 shows the monthly surprises in the pace of output growth, that is, the different between the analysts' consensus growth estimate for a particular month and what ultimately happened. It reveals that the surprises were consistently negative and considerable for most of the year. Activity grew well below what was expected. This leads us to infer that corporate sales probably did too, affecting business optimism.

Figure 3.14
GDP: 2014 Growth forecasts (%, consensus of analysts surveyed)



Source: Latin Focus Consensus Forecast, BBVA Research

Figure 3.15
GDP: Monthly growth forecasts (% var. YoY, analysts' consensus)

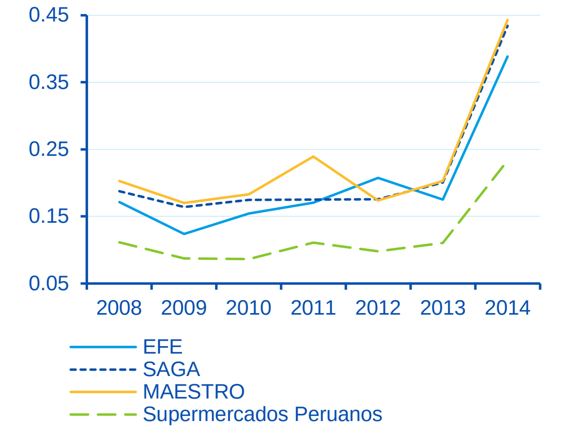


Source: Bloomberg and BBVA Research

Lower sales with respect to initial budgets led to an unintended rise in inventories over the first half of the year (see Figure 3.16). Companies are likely to have produced below their demand to reduce excess inventories, which would explain the third-quarter drag on GDP growth.

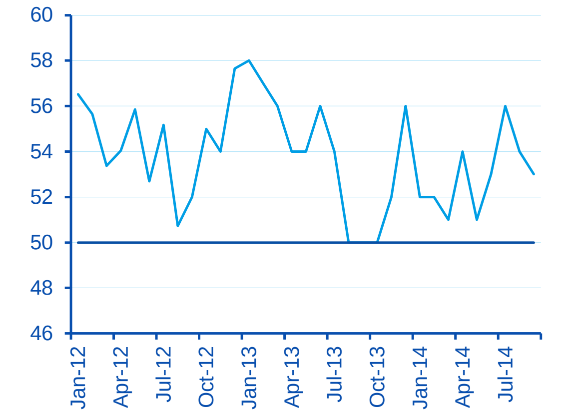
The perception of a lack of effectiveness in the government's measures to improve the business atmosphere and stimulate demand would be another factor that has negatively impacted business confidence. In this regard, in addition to announcing the measures (which the private sector welcomed), it is important to ensure adequate levels of execution to sustain leadership over expectations.

Figure 3.16
Balance of inventories* (as % of sales)



*As at 1H2014. Considered for some companies that release financial statements. Source: SMV and BBVA Research

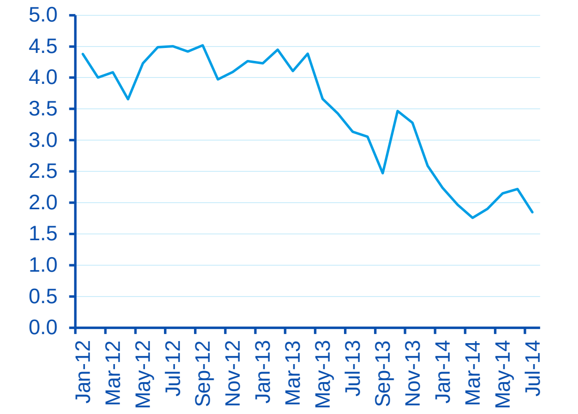
Figure 3.17
Consumer Confidence Index



Source: Apoyo Consultoría and BBVA Research

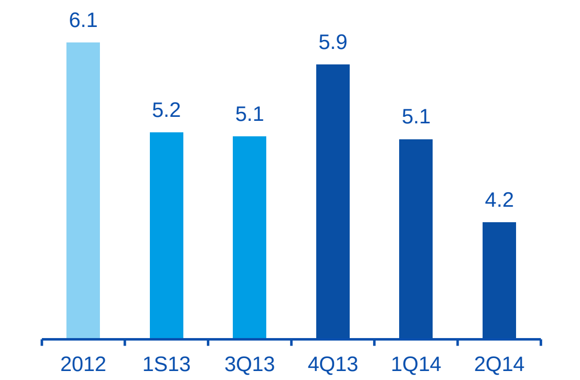
Households have displayed a bit more caution (see Figure 3.17), within a context of lower output growth and lower labour market dynamism (see Figure 3.18).

Figure 3.18
Urban employment growth in Lima (% var. YoY)



Source: central bank, BBVA Research

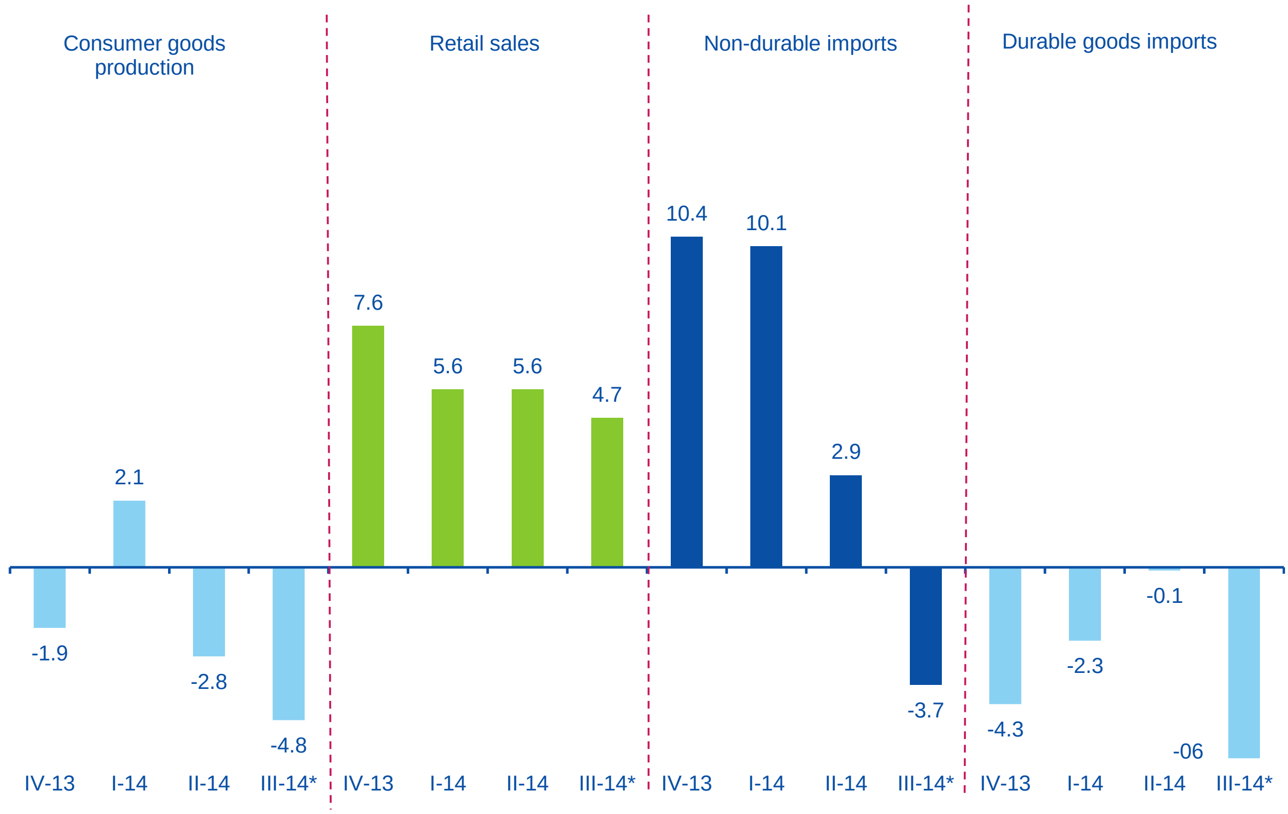
Figure 3.19
Private consumption (% var. YoY)



Source: central bank, BBVA Research

Furthermore, and according to a study by Apoyo Consultoría, over one-third of low/medium income households mention having "many difficulties" in paying their debts at this time, while 40% of them allocate over one-third of their monthly income to said payments. Private consumption has consequently moderated over the course of the year (see Figure 3.19), while other household spending indicators reveal a weak performance (see Figure 3.20).

Figure 3.20
Household spending indicators (% annual var., points)

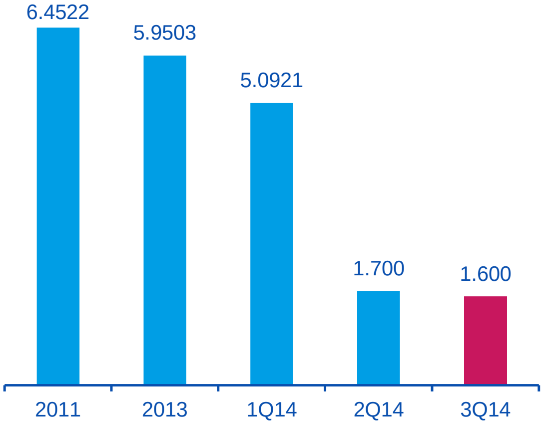


*July-August. Source: central bank, INEI and BBVA Research

Within this context, GDP growth will be relatively weak in 2014

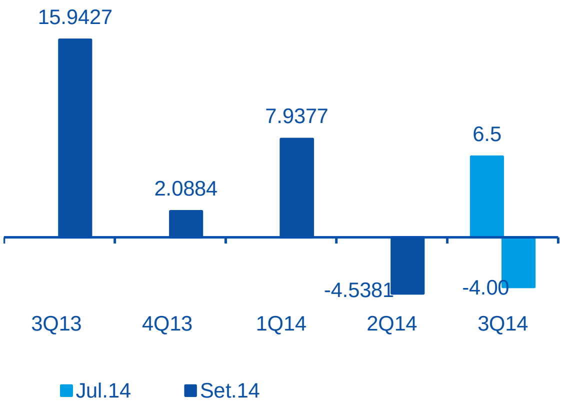
We estimate third quarter GDP growth of 1.6% YoY. This rate is similar to the previous quarter's (see Figure 3.21), which means that the expected rebound did not materialise. The primary sectors disappointed. In the case of mining, major copper projects such as Antamina and Toromocho still face problems in reaching full production capacity (what is more, a strike was announced at Antamina, which will begin to affect production in mid-November of this year). In fishing activity, above-normal temperatures led to anchovy catches falling short of the quota established for the year's first season (only 68% of the quota was met). And, in the agricultural sector, the yellow rust plague had a longer-than-expected negative impact. All in all, this also led to a negative impact on the primary resources processing industry. Additionally, the fiscal boost was weaker than anticipated, particularly the boost for investment (see Figure 3.22). To be noted is the low level of execution of the funds budgeted for the El Niño Effect Prevention Plan. This affected the construction sector and manufacturing activities geared toward meeting its needs. In summary, the drivers that were to start spurring the recovery in the third quarter, specifically higher mining production (which would be seen on the spending side through increased exports) and greater public spending, did not provide the expected support, while fishing continued to face difficulties.

Figure 3.21
GDP (% var. YoY)



Source: central bank and BBVA Research

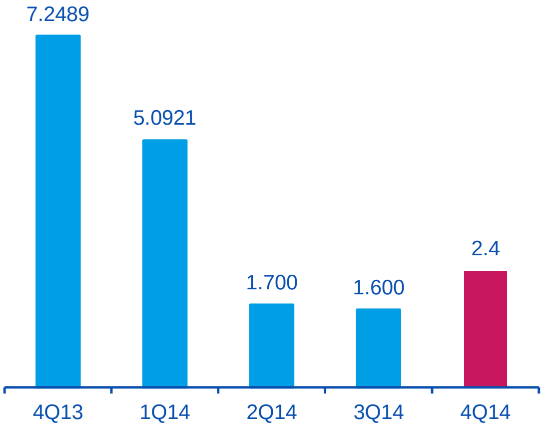
Figure 3.22
Public investment (% var. YoY)



Source: central bank and BBVA Research

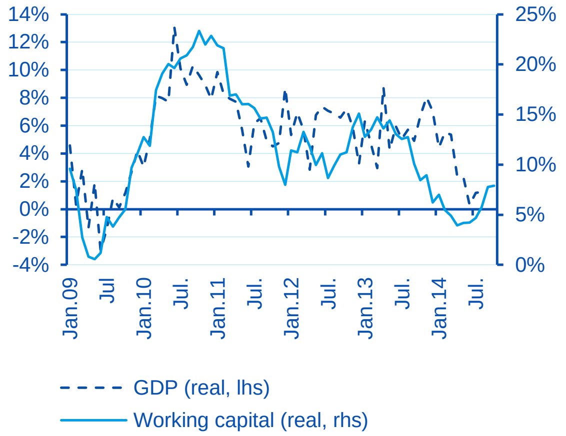
Our fourth quarter GDP growth projection is 2.4% YoY (see Figure 3.23). Some initial indicators thus suggest a certain pick-up in output versus the previous quarter. For example, October's electricity production grew at a higher pace than in 3Q14. Furthermore, the evolution of currency in circulation (cash) has picked up since the end of September, which suggests that transactions in the economy are picking up and, consequently, so is activity. Figure 3.24 shows that the trend of currency in circulation is similar to that of output. In particular, it provides a relatively good picture of the turning points in activity: in mid-2009, the second half of 2010 and the slowdown of 2014. The recent moderate rebound in activity (in YoY terms) might be suggesting something similar for GDP at the start of the fourth quarter.

Figure 3.23
GDP (% var. YoY)



Source: central bank and BBVA Research

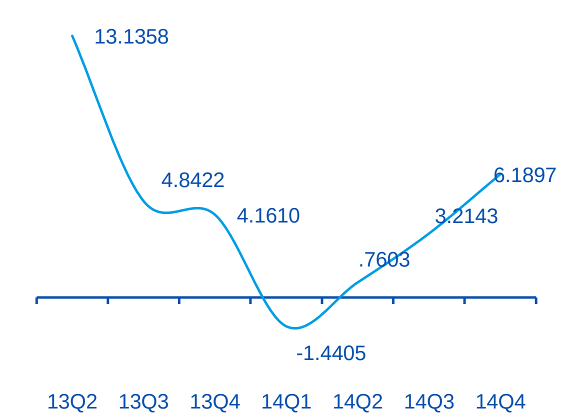
Figure 3.24
Currency in circulation and GDP (% var. YoY)



Source: central bank and BBVA Research

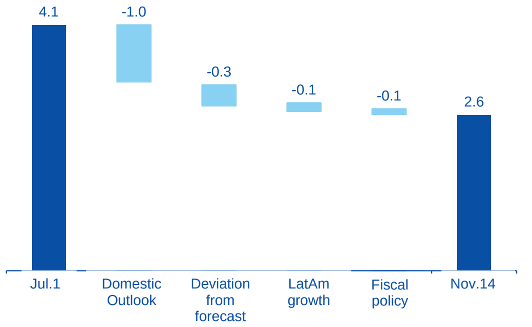
In deseasonalised terms, the YoY expansion we expect for the fourth quarter (2.4%) entails an annualised QoQ growth of over 6%, twice the figure expected for 3Q14 (see Figure 3.25). When considered from this perspective, it is a considerable pick-up. The rebound we expect is contingent upon four factors. First, that the fiscal boost is ultimately executed. Second, that Antamina and Toromocho copper production volumes experience a certain improvement. Third, that most of the inventories adjustment took place in the third quarter, and that its negative impact on the fourth is moderate. Lastly, that business confidence will not deteriorate further. Under this scenario, 2014 growth will close at around 2.6%.

Figure 3.25
Seasonally adjusted GDP (% var. QoQ annualised)



Source: central bank and BBVA Research

Figure 3.26
2014 GDP: Changes in forecasts (pp)



Source: central bank and BBVA Research

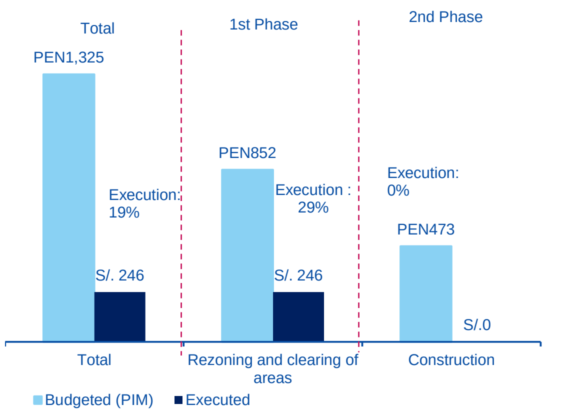
Mining and infrastructure investment remain the growth drivers for 2015, but with a more moderate impact

We still expect the pace of output expansion to rebound in 2015. This will occur within a context in which mining production will rise. Our base case scenario assumes, for example, that the Toromocho deposit will reach full operating capacity in the first quarter of 2015, and that production at the new Constancia deposit will gradually rise over the course of the year. Furthermore, construction will begin at concessioned infrastructure works, such as Lima Metro Line 2, and at works that the government will execute directly (modernisation of the Talara refinery). These will be the two major engines of output growth not only for 2015, but also in following years. These factors will be boosted on the foreign side by a one-half percentage point pick-up in global growth, which will favour export demand.

With respect to our report of three months ago, however, we are somewhat more wary as to the intensity with which we expect activity to rebound in 2015. On this occasion, we expect next year's growth to come in at around 4.8%, below the 5.9% that we forecast in our previous report.

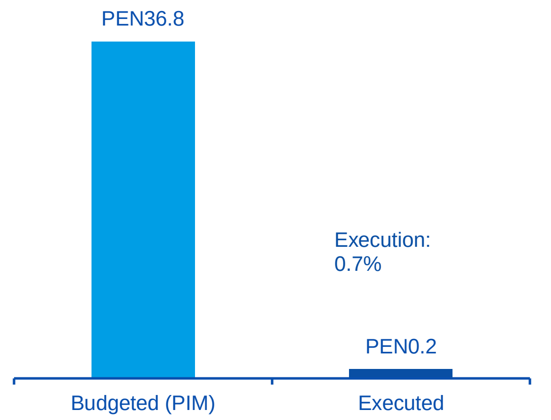
The downward correction takes two factors into account. The first is that we now have a more conservative view of the push that the two 2015 growth engines will provide. In the case of mining production, for example, the problems that Antamina encountered in 2014, as previously mentioned, will not be solved in the short term. In our base case scenario, we are assuming that that will only happen at the end of the third quarter, which translates into an annual production shortfall (versus the figures we estimated three months ago) of around 95,000 FMT, that is, the equivalent of 8% of Peru's annual copper production. The direct impact on GDP is between two- and three-tenths of a percentage point, to which one must add indirect impacts, such as lower industrial processing of metals. In the case of concessioned infrastructure construction, we have observed certain delays in reaching the established milestones. They seem to have been ambitious, as the Ministry of Transportation and Communications also noted. Our previous forecast assumed that the project would progress according to the established time frames, especially when taking into account the environment of a strong economic slowdown, and that this expenditure would thus act countercyclically. What was observed, however, were delays. This can be inferred from the differences between the amounts budgeted for, and spent on, the works. For example, in the case of Lima Metro Line 2 (see Figure 3.27), less than 20% of the amount budgeted for 2014 had been executed as at October. As expressed by the authorities, we should add that the level of execution in this case will not exceed 50% for this year. Of the total budgeted for 2014, close to two-thirds pertain to the project's first phase, which entails rezoning and clearing the land. To date, 30% of the amount earmarked for this phase has been executed. This implies two things. First, given the official estimate, land rezoning and clearing will not be completed this year. Second, that if the land is not rezoned nor cleared, construction cannot begin (it was scheduled to begin in 2014). There are other cases, such as the motorways (Longitudinal de la Sierra, for example), on which there have been virtually no disbursements made to date on the expenditure the State must schedule in 2014. Within this context, we have assumed that the boost of major infrastructure construction to 2015 growth will be somewhat less than what we expected in our previous report.

Figure 3.27
2014: Budgetary execution of Metro Line 2* (PEN mn)



*To be co-financed by the State of Peru (USD5.701bn, GST excluded). Contract signed in April 2014. The start of works on the project's first section was scheduled for 2014, with completion in 2016. The completion of the entire project was expected for 2019. Figures as at 3 November 2014. Source: MEF (SIAF), Pro Inversión and BBVA Research

Figure 3.28
2014: Budgetary execution of Longitudinal de la Sierra, Section 2* (PEN mn)

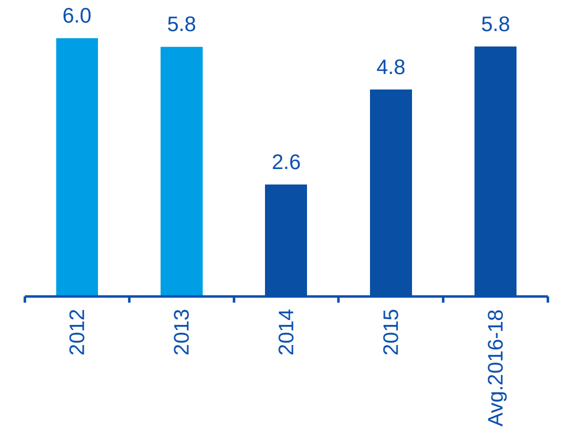


*Co-financed system (USD552mn, GST excluded). Contract signed in May 2014. Figures as at 3 November 2014. Source: MEF (SIAF), Pro Inversión and BBVA Research.

The second factor that leads us to our downward revision of the output growth pace we expect for next year is the lower dynamism with which 2015 will start. Activity will end this year by growing at a weaker pace (2.4% growth in the fourth quarter) than we projected three months ago. This will impact the dynamism of output to the downside at the start of 2015. While the economy will continue to recover at the start of next year, as we also forecast in our previous report, that improvement will be more moderate than we anticipated.

Going forward, we expect the economy to grow at an average annual pace of 5.8% from 2016 to 2018 (see Figure 3.29). These growth rates are above the potential rate, due to the temporary boost from increased mining production (recovery of Antamina's production levels and the maturity of diverse projects which, among other things, will enable doubling the copper supply). During this period, we also expect that growth will be supported by the construction of major infrastructure projects (see Table 3.2).

Figure 3.29
GDP projection (% var. YoY)



Source: central bank and BBVA Research

Table 3.2
Infrastructure Projects (USD mn)

Project*	Investment ** (USDmn
South Peruvian Gas pipeline	5,794
Line 2 of Lima Metro	6,727
Modernisation of Talara refinery	4,130
Southern Energy hub	944
Chinchero airport	634
Longitudinal de la Sierra - Tranche 2	651
Kuélap skilifts	21
San Martín port terminal	152
LT 220 KV La Planicie industrial parks	70
LT 220 KV Mollobamba - Iquitos	589
Total	**19,713**

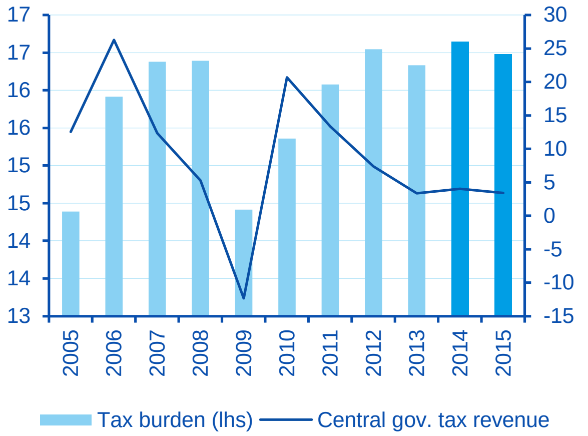
Projects tendered by Pro Inversión, except for the Talara refinery, which will be carried out by Petroperú. **Includes GST. Source: MEF (SIAF), Pro Inversión and BBVA Research.

Fiscal position is relatively neutral, which reveals public spending execution problems. Going forward, we expect moderate deficits that will not jeopardise fiscal sustainability

We expect the fiscal accounts to close 2014 with a surplus of 0.3% of GDP. The projection assumes a rise in central government revenues of around 4.0%, in line with a tax burden of 16.6% of GDP (see Figure 3.30). It also includes revenues from the extraordinary payment of capital gains taxes on two non-resident asset transfer operations, estimated to equate to roughly 0.4% of GDP[1]. If this extraordinary payment were excluded, the tax burden would come in at 16.2% of GDP, below the level recorded in 2013 (16.4% of GDP). This result would be due to lower tax revenues caused by the economic slowdown (see Figure 3.31).

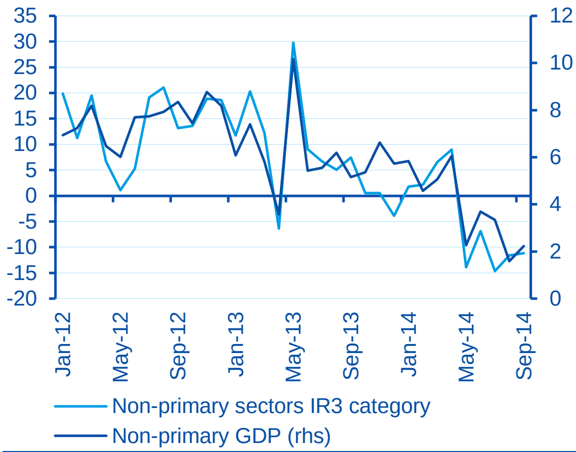
1: Recognised under the Revenues from Income Tax on Non-Domiciled Taxpayers line item.

Figure 3.30
Tax burden and central government tax revenues (% GDP and % var. YoY)



Source: central bank, SUNAT and BBVA Research

Figure 3.31
3rd category income tax and non-primary GDP (% var. YoY)

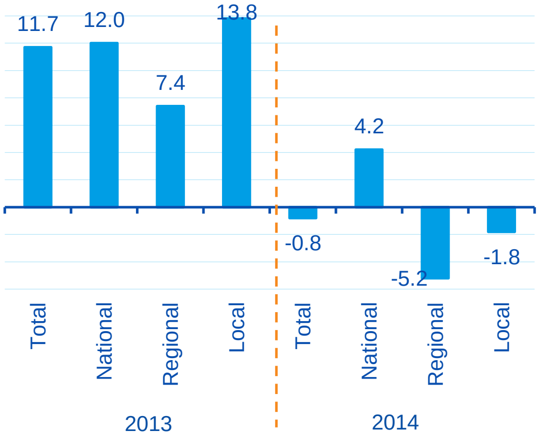


Source: central bank, SUNAT and BBVA Research

On the expenditures side, we expect a growth of 6.0% in central government spending for 2014, which is explained mainly by its current component (8.0%), due to the raise in Armed Forces' compensation, one-off bonuses for civil servants and the payment of lawsuit labour debts, among other items. In contrast, we expect poor performance in investment spending (zero growth for the year), due to the lower execution not only by the sub-national governments (70% participation), but also by the national government (see Figure 3.32). As at October, the national government's budgetary disbursements only reached 55% (see Figures 3.33 and 3.34); by year-end they would fail to reach the 2013 execution level (82%). This is reflected, for example, by the slow execution of the El Niño Effect Prevention Plan (0.5% of GDP), particularly in investment (accounts for close to 80% of the Plan) in the housing, sanitation and transportation sectors. Furthermore, PEN1.325bn in 2014 spending had been earmarked[2] for the construction of the first phase of Lima Metro Line 2, of which 60% would be allocated to the first stage of the works, which covers land deregulating and clearing, and 40% to construction (second stage). As at October, only 20% of the budgeted figure had been executed.

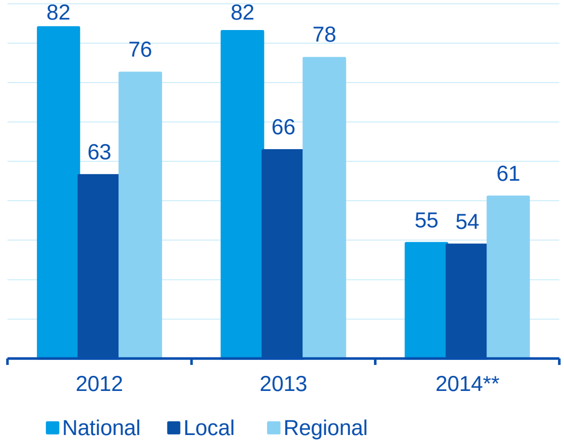
[2]Corresponds to Modified Institutional Budget (PIM).

Figure 3.32
Cumulative growth of investment spending from January to September (% var.)



Source: central bank and BBVA Research

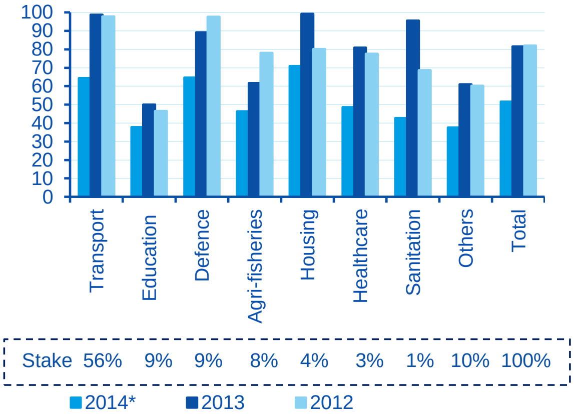
Figure 3.33
Execution of investment projects* (%)



*Accrued between Modified Institutional Budgets (PIM). ** As at 3 November. Source: central bank and BBVA Research

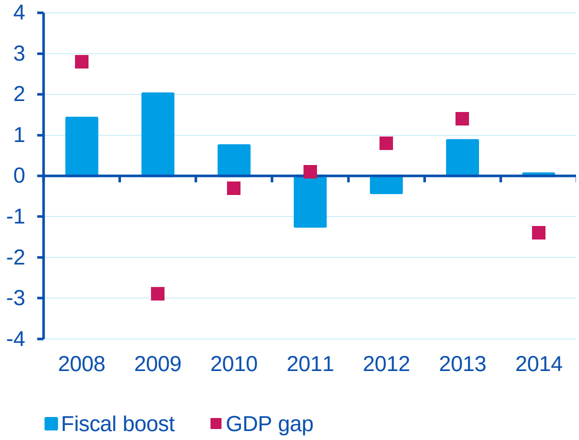
The structural economic result for this year will be slightly negative, with a near-zero fiscal boost (see Figure 3.35). This result is striking, because given the current phase of the cycle (negative GDP gap), a clearly more expansionary fiscal policy is required. This neutrality, which we believe is an unintended result, is not a problem of fiscal policy design, as the measures proposed to tackle the cyclical part of the slowdown are geared in the right direction. The problem has been the lack of ability to instrument and execute public spending, particularly in investment.

Figure 3.34
Execution of national government investment projects by budgetary function (%)



*As at 3 November.
Source: central bank and BBVA Research

Figure 3.35
Fiscal boost and GDP gap (% GDP and % potential GDP)

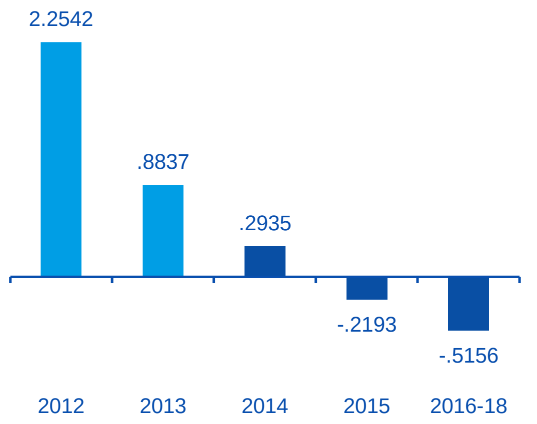


Source: central bank and BBVA Research

Given the lack of alacrity in public spending on investment, we must warn against giving in to the temptation to increase current spending, which is easy to execute but hard to reverse when the economic cycle changes. Another alternative would lie on the side of revenues. However, we found proof indicating that the multiplier effect of the measures on the tax side is much lower than that of public spending, in particular than that of public investment (see Box 2 on fiscal multipliers). Therefore, reforms are urgently needed to overcome the major domestic lags that exist in executing investment spending.

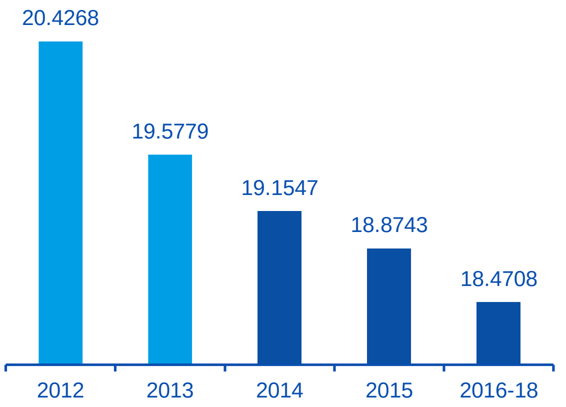
Going forward, we still expect moderate fiscal deficits that will not exceed 0.5% of GDP within the forecasting horizon. Within this context, we expect the public debt as a percentage of GDP to continue falling to levels of around 18% toward 2018.

Figure 3.36
Fiscal result
(% of GDP)



Source: central bank and BBVA Research

Figure 3.37
Public debt
(% of GDP)



Source: central bank and BBVA Research

Box 2. Fiscal multipliers, the importance of boosting public investment

Implementation of the countercyclical fiscal response worldwide has not been without controversy, both as regards its scale and how it is structured. The multiplier effect of fiscal policy will hinge on certain features of the economy. In this sense it is more substantial if: i) the marginal propensity to consume is high; ii) automatic stabilisers are small; iii) the interest rate does not rise in reply to a fiscal expansion; iv) the exchange rate system is fixed, and v) the fiscal accounts are sustainable. (Spilimbergo et al. (2009))[3].

The multiplier effect of fiscal policy will also depend on the instrument employed; whether it is conducted via an increase in investment spending or current expenditure, or else through cutting taxes.

Here, a recent study by the International Monetary Fund[4] shows that investment spending on infrastructure is a major factor in short- and long-term growth. On top of this, it impacts positively on private investment, owing to its tendency to complement infrastructure services.

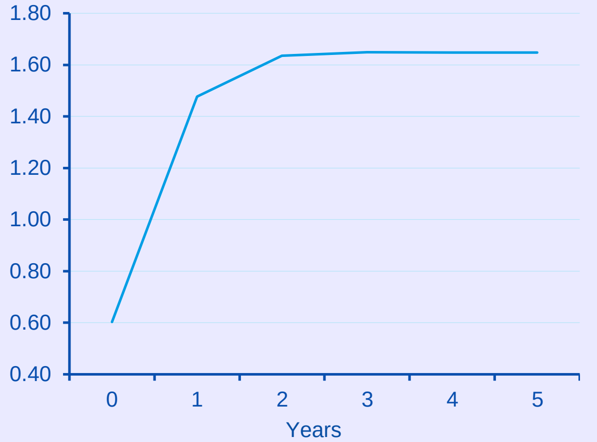
Estimates

For the purpose of evaluating the effectiveness of fiscal policy on the Peruvian economy, an estimate is made of multipliers by type of expenditure and tax. The methodology used is a Structural Vector Autoregression model. Within the identification in the SVAR model's structural system, account is taken of the methodology advanced by Blanchard & Perotti (1999, 2002)[5].

The results found indicate that the investment expenditure multiplier effect is far greater than for current expenditure. Moreover, the current expenditure's multiplier effect is immediate and too short-lived to extend into the long-term, whereas the investment effect is kept up for longer(PEN1.6 over 5 years, see Figure B.2.1).

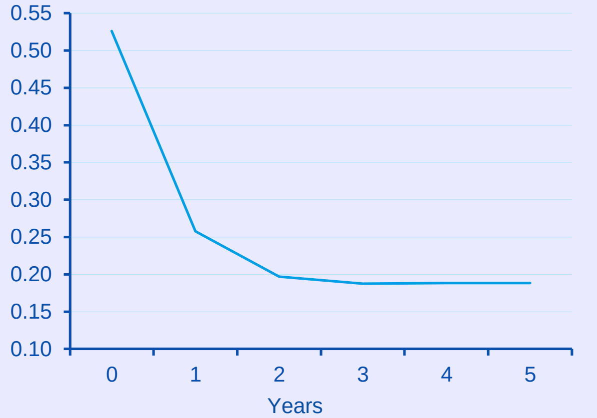
This is likely to be due to the fact that investment expenditure allows an increase in potential GDP. On the other hand, the tax multiplier is much lower than that for investment expenditure (see Figures B.2.2 and B.2.3).

Figure B.2.1
Investment expenditure multiplier (cumulative effects in sector)



Source: WEF, BBVA Research

Figure B.2.2
Current expenditure multiplier (cumulative effects in sector)



Source: WEF, BBVA Research

[3] Spilimbergo Antonio, Steven Symansky & Martín Schindler. 2009. Fiscal Multipliers. IMF
[4] Is it time for an infrastructure push? The macroeconomic effects of public investment. WEO (2014).IMF.
[5] Blanchard Olivier, Perotti Roberto, 1999. An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output.NBER Working Paper 7269.National Bureau of Economic Research.

Figure B.2.3
Tax multiplier (cumulative effects in sector)

Source: WEF, BBVA Research

It should be pointed out that the results obtained are much the same as in other studies. An especially interesting result may be observed in recent work by the Central Reserve Bank of Peru, where the position along the economic cycle is taken into account in estimates and it notes that expenditure multipliers are bigger in periods of lower growth[6]. Furthermore, the investment expenditure multiplier is larger than for current expenditure. In the long term (five years) the multiplier reaches PEN1.42.

To close, it would be advisable to stick to a countercyclical fiscal policy (in low-growth periods) with a leaning towards investment expenditure, due to its spur-and-kick-start effect on the economy, in both the short and the long term. There is thus a pressing need to drive home reforms to head off the customary lengthy internal delays in carrying out investment spending.

[6] Report on Inflation, December 2012.

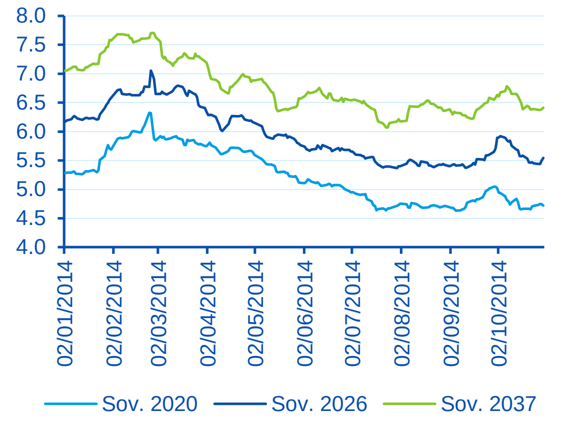
4. Domestic financial markets: higher volatility associated with the uncertainty over the start of Fed tightening

Sovereign bond yields down

From late February (when they hit a high) up to now, Peruvian sovereign bond yields have displayed a downward trend of over 100 basis points all along the curve (see figure 4.1). On the other hand, the volatility witnessed since last September reflects uncertainty surrounding the recovery of the US economy (following the release of indicators with mixed readings in the opening weeks of September) and the timing when the Fed may start easing up on monetary accommodation.

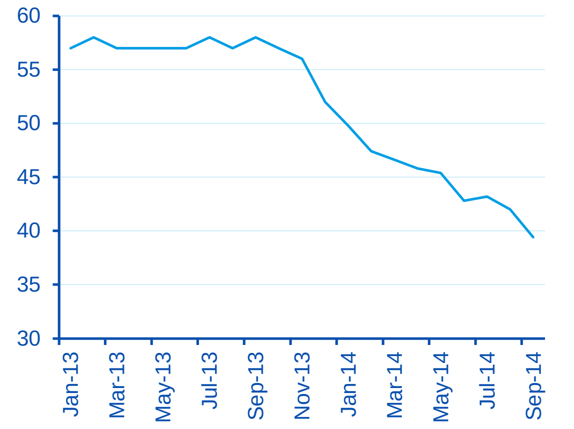
Although the number of bonds held by non-residents has fallen off over the year (from accounting for 49.8% in January 2014 to 39.4% by the close of September, see figure 4.2), they still speak for the largest share in these instruments. Local institutional investors such as pension funds and banks have stepped up their share in the sovereign bond market, to 35.6% and 11.9% respectively.

Figure 4.1
Peruvian sovereign bond yields (%)



Source: Bloomberg and BBVA Research

Figure 4.2
Sovereign bonds held by non-residents (%)



Source: MEF and BBVA Research

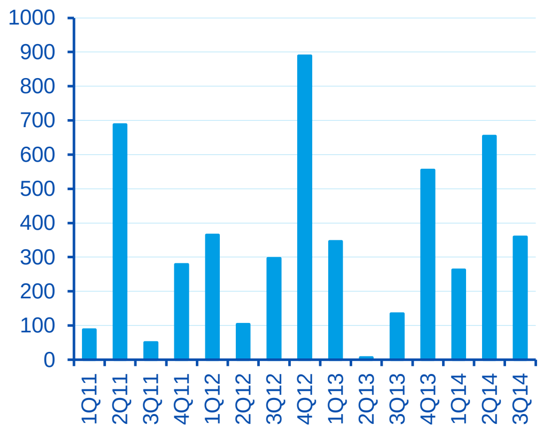
In late October 2014, the Ministry of Economy and Finance (MEF) carried out the largest comprehensive debt operation in soles and dollars for a total amount of PEN8.86bn, which it has completed via: i) an international offer of new bonds in local currency and maturing in 2024 (totalling approximately PEN7.41bn and offering a coupon rate of 5.70%). The issue was performed within the context of a debt management operation involving repos and/or swaps of 2015, 2016 and 2019 Global Bonds as well as 2015 and 2020 Sovereign Bonds for a value of PEN5.688bn and PEN1.44bn to raise funds to cover the borrowing requirement for 2015, and ii) the reopening of its 2050 Global Bond 2050 in the amount of USD500mn (PEN1.457bn) at a coupon rate of 4.90%, which implied a new issue premium of around 8bp, which shows the confidence of investors in the Peruvian economy's fundamentals through the demand for a long term bond with over 30 years to run. The funds from this issue shall be used exclusively to cover the year's pre-financing for 2015.

MEF has used this operation to enhance the profile of government debt, by lifting the share of the local currency within the liabilities portfolio and increasing their average life. Lastly, mention should be made of the 2024 bond, which has become the new 10-year benchmark for the yield curve. This operation joins the 2055 Sovereign Bond issue carried out in July this year, which stretched the long-end of the yield curve in new soles to 40 years and made Peru the LatAm country with the longest-term bond issue in local currency.

Corporate bond issues dwindled in the third quarter of 2014

Corporate bond issues in the third quarter of the year totalled PEN858mn, a figure some 16.4% down on that registered the previous quarter and 40.5% lower than the like quarter the year before. Non-financial companies carried out 41.8% of the issues (see figure 4.3), notable among these being those by Gloria (S/.150mn), Luz del Sur (PEN143mn), Edelnor (PEN129mn) and Los Portales (PEN13mn), as well as the dollar-denominated issue by Red de Energía del Perú worth USD20mn. The terms for these ranged from 180 days to 15 years in the case of Luz del Sur. The lull in corporate bond issues comes within a context of a slowdown in GDP where investment borrowing requirements are more modest. On the other hand, some companies have continued to look to raise funds abroad, in a scenario of persistently low interest rates in international markets and a bullish feeling about Peru and Peruvian companies outside the country (see Table 4.1). Issues on the international market between July and September totalled USD1.125bn, above the figure of USD1.306bn recorded in the previous quarter, the terms ranging from four to 15 years and with coupon rates of between 2.75% and 5.25%. Even so, placements by Peruvian companies represent a very small portion of those in the region as a whole in 2014 (at around 4%), while Brazil accounts for 38%, Mexico 27%, Chile 8%, and Colombia 6%.

Figure 4.3
Non-financial corporate bond issues (PEN mn)



Source: BCRP and BBVA Research

Table 4.1
Debt issues in the international market, January to September 2014

Company	Amount (USD mn)	Maturity (years)	Tasa
Compañía minera Ares	350	7	7.75%
Banco de Crédito	200	13	6.13%
Minsur	450	10	6.25%
Interbank	300	15	6.63%
Fondo MiVivienda	300	5	3.38%
Abengoa Transmisión Sur	432	29	6.88%
Camposol	75	3	9.88%
Fondo MiVivienda 1/	279	4	1.25%
Rutas de Lima 2/	370	22	8.38%
Rutas de Lima 3/	150	25	5.25%
Banco de Crédito	225	4	2.75%
InRetail Shopping Mall	350	7	6.50%
COFIDE	300	5	3.25%
COFIDE	300	15	5.25%
BBVA Continental	300	15	5.25%

Source: BCRP and BBVA Research

The Peruvian stock market fell back in September

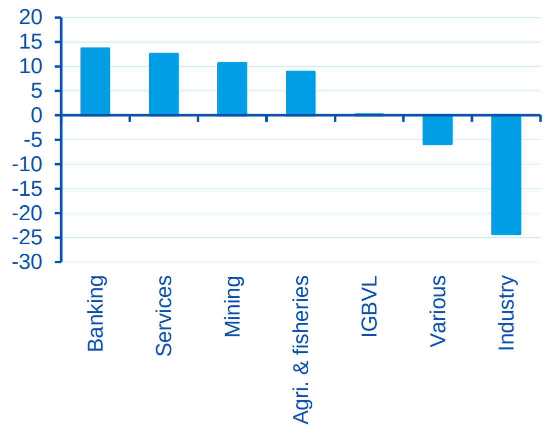
At the October close, the Lima General Stock Market Index (IGBVL) was virtually unchanged (+0.14%, see figure 4.4). Although the IGBVL had been on the rise (driven by mining and banking sector stocks) between late in the first quarter and August this year, in September the gains made over the previous three months were trimmed back. Mining companies put in a positive performance of 10.62% between January and October, followed by banks with 13.64% (see figure 4.5). Industrials offered the worst showing, sliding back by an overall 24.24% YtD.

The IGBVL's performance was hit by the release in the first few weeks of September of mixed figures on the US economy, which engendered uncertainty over the timing of an easing up of monetary accommodation by the Fed, this being accompanied by weakness in base metal prices on the back of growing concerns about the Chinese economy.

Figure 4.4
Lima General Stock Market Index (IGBVL)

Source: Bloomberg and BBVA Research

Figure 4.5
YtD cumulative performances by sector. Indexes at 30 October (%)



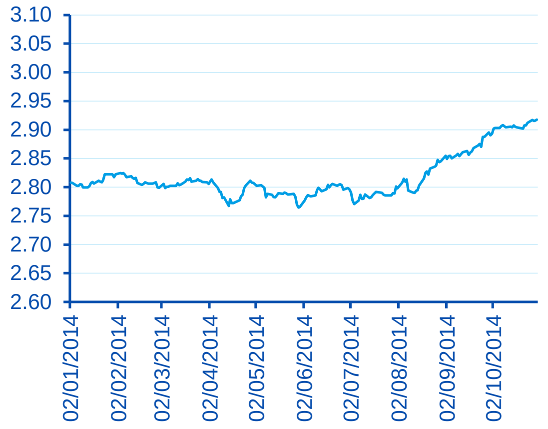
Source: BVL and BBVA Research

Exchange rate: upward pattern in the coming months

The new sol has weakened in the last few months, slipping from PEN2.79 to the dollar as July closed to PEN2.92 in late October (which equates to a 4.6% change), the currency's exchange rate experiencing greater volatility (see figure 4.6) and hitting the level of our year-end prediction before time. The Peruvian currency has felt downward pressure given a high balance of payments deficit on current account (7.3% of GDP in the second quarter of this year), the chance of more flexible monetary policy in Peru to underpin domestic demand, and a growing feeling that the onset of Fed policy rate hikes could come earlier. Increased dollar-demand has mainly come from non-resident agents, who switched from offering currency in Q2 to calling for it in Q3 (see figure 4.7).

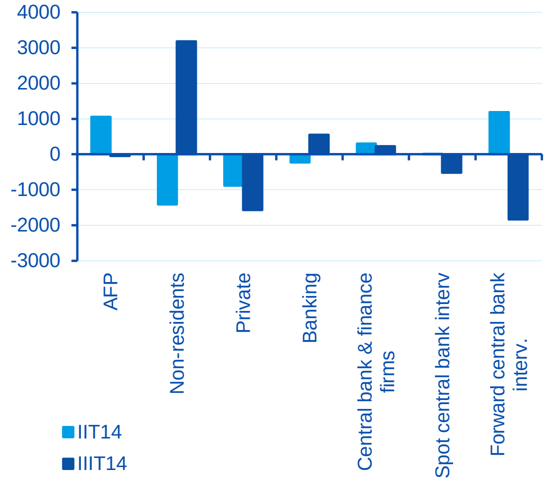
Against this backdrop, we forecast that the exchange rate will close 2014 at levels a little over PEN2.920 to the dollar and that it will continue rising in 2015, up to PEN3.050 against the dollar. Among the factors behind this projection are: looser money policy in a situation of economic slowdown, the beginning of a series of Fed rate hikes (which makes local assets less attractive), thinner inflows of mining investment capital (as a result of higher financing costs and lower metal prices), and greater dollarisation by economic agents generally. The transition towards a higher exchange rate will be gradual, since the Central Reserve Bank of Peru will make the road less rough by intervening in the market. We do, however, take the view that greater exchange rate flexibility would be desirable as a mechanism to absorb shocks from outside and steer the current account deficit in the right direction. In the medium term the rate will find a level closer to PEN3.10 against the dollar. This is consistent with the worsening Net Foreign Assets situation caused by a heftier current account deficit across the entire forecast horizon.

Figure 4.6
USDPEN exchange rate



Source: Bloomberg and BBVA Research

Figure 4.7
Spot and forward FX market flows (USD mn)



Source: central bank and BBVA Research

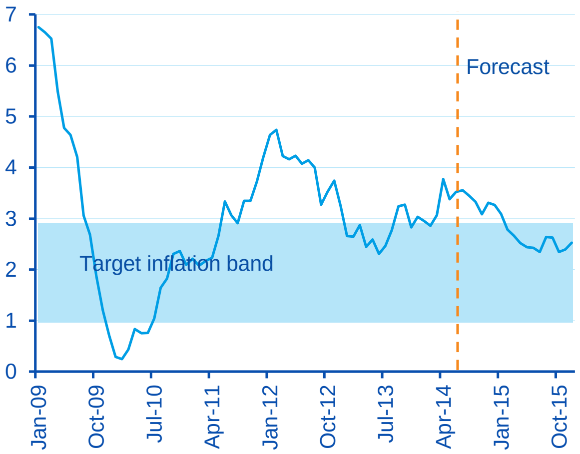
In September the central bank created a new currency instrument, the FX swap. Since October the FX swap sell has come into use. Through this instrument the central bank commits to paying a fixed interest rate on a nominal amount in dollars, which is converted into soles at the prevailing exchange rate when it matures, while the market participant undertakes to pay a variable rate of interest on the nominal in soles. Ultimately the exchange rate is the net of these two positions. The advantage of this FX intervention instrument is that it eases pressure on the interbank rate in soles and allows it to remain in alignment with the benchmark rate set by the central bank.

5. Peru: Inflation: a more positive scenario for the coming months

Over this year, YoY inflation has tended to hold above the upper limit of the target range (2.0% +/- 1 pp), hitting a high of 3.8% in February of this year, though displaying a downward trend since the third quarter. The pattern for inflation 2014 YtD has been coupled with supply shocks which have affected food prices, demand pressure on the prices of certain services (for example within the captions of Eating Out, Education and Health, where YoY price rises have been clocking rates of over 4% in recent months) and the shift in the exchange rate increase (lower local currency) towards tradable goods prices. In this context we foresee inflation seeing out this year at 3.3%, but for 2015 we forecast that this variable will consolidate inside the target range (see figure 5.1) due to:

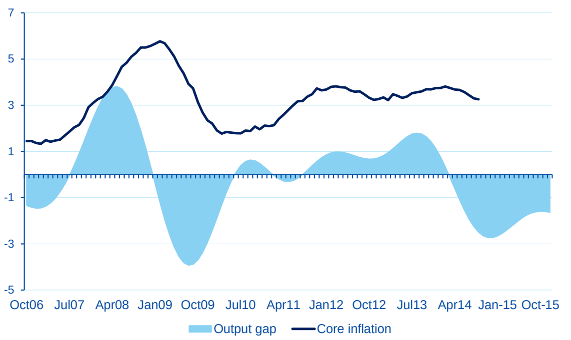
- **The drop in business activity**, which will dampen the demand pressures that have surfaced in the prices of certain services where supply growth has been sluggish. In fact, given the circumstances of lower domestic demand growth and the negative GDP gap (see figure 5.2), since June, several inflation trend indicators (inflation ex foods, inflation ex foods or fuels, and underlying inflation) have revealed a flagging pattern on account of a slowdown in their monthly changes.

Figure 5.1
YoY inflation (%)



Source: Central bank and BBVA Research

Figure 5.2
GDP gap (% of potential GDP and underlying inflation (%)



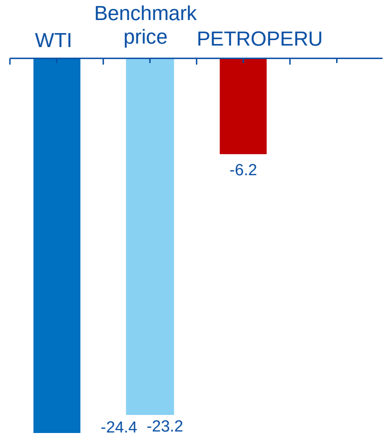
Source: central bank and BBVA Research

- The f**all in world oil prices, which will be reflected in lower local fuel prices.** Notwithstanding this, it should be said here that the recent and sharp dip in the oil price has not fed through locally to any significant extent. The reason is that the distribution prices set by Petroperú are more than 60% over the benchmark price fixed by the energy market regulator (Osinergmin)[7]. It is interesting to note the differences in what has been happening this year and a similar context at the end of 2012 as regards the filter-through of world oil price falls to local fuels (see figures 5.3 and 5.4). In fact, the weaker current transmission process stands out even more if we consider that the world oil price fall in 2014 has actually been substantially heavier. In our estimates we are assuming that there will be greater alignment with movements in the international price, i.e.

[7] http://www2.osinerg.gob.pe/PubPreciosReferencia/DocPublicaciones/2014/octubre/PrecioReferencia20102014.pdf and http://www.petroperu.com.pe/PortalWeb/UpLoad/UpLoaded/PDF/COMB-44-2014.pdf

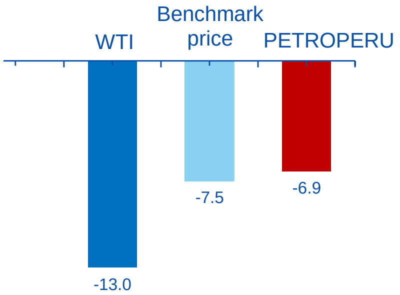
in a scenario more akin to what was seen in 2012, which would mean that the shifting of the burden onto the private sector will be avoided.

Figure 5.3
2014: Benchmark 84 oct. gasohol price vs. Petroperú price (% var.)



* Comprises the variation: 24/10/2014 vs 23/07/2014.
Source: OSINERGMIN, central bank, Petroperú and BBVA Research

Figure 5.4
2012: Benchmark 84 oct. gasohol price vs. Petroperú price (YoY % var.)

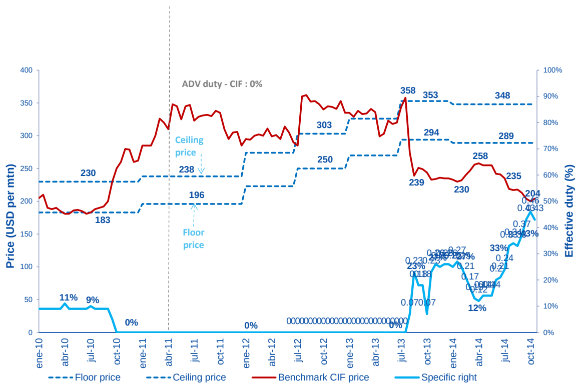


** Comprises the variation: 12/11/2012 vs 13/09/ 2012.
Source: OSINERGMIN, central bank, Petroperú and BBVA Research

Something similar can be observed as regards the surcharge on agricultural produce, which has restricted the fall in world grain and cereal prices. Currently the import price (CIF) of yellow maize is under the price band (see figure 5.5). As a result, importers are shouldering bigger costs due to the fact they are paying an additional fee (surcharge) on top of the customs duty (fixed value), which imposes a certain resistance to a fall in retail prices of goods used as raw materials, as is the case for poultry products. The import price (CIF) has come down by 25% YtD, whereas the CIF price plus the surcharge has risen by 0.3% (see figure 5.6). It should be pointed out that imports of yellow maize have been paying a standing surcharge since August 2013[8].

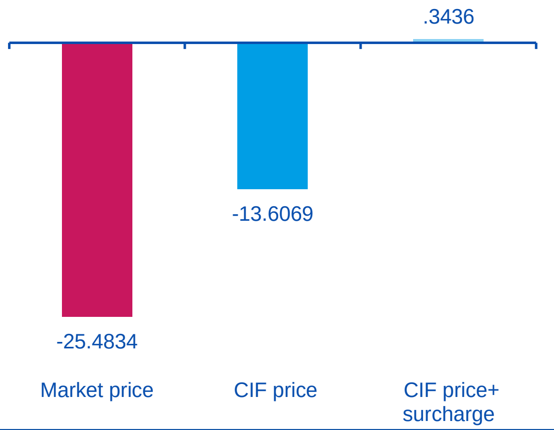
[8] http://www.minag.gob.pe/portal/herramientas/boletines/franja-de-precios/analisis-quincenal#

Figure 5.5
Duty on imports of hard yellow maize under the price band system (% var., YoY)



Source: MINAG and BBVA Research

Figure 5.6
2014: Hard yellow maize: Market price, CIF price and price with surcharge* (% var. YoY)

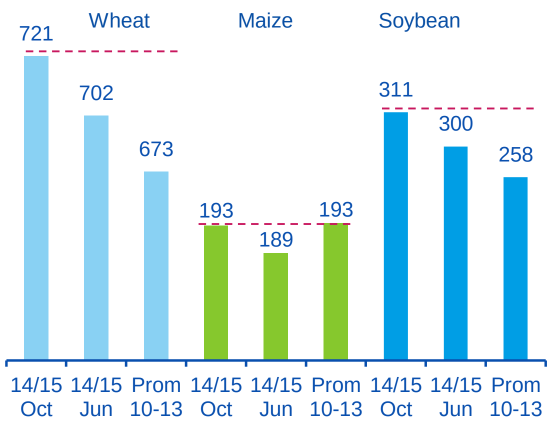


*This is the change for Oct 14 vs Jan 14.
Source: MINAG and BBVA Research

It is important for these prices (fuels and agricultural) to come into line to allow a faster fall in inflation, which would give the central bank more latitude to ease the monetary policy position.

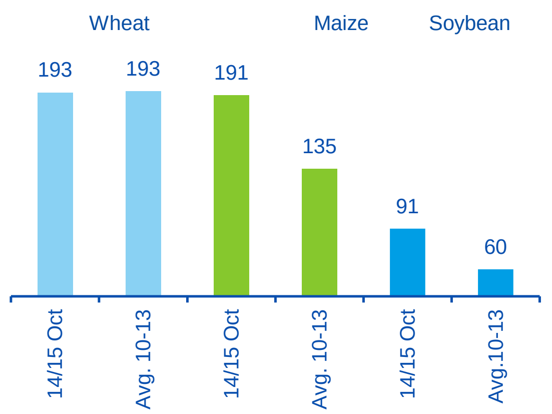
- An expected plunge in agricultural commodity market prices, owing to the upward revision of the worldwide crop of agricultural commodities. Between June and October, the US Department of Agriculture revised its forecast upwards for the 2014-15 crops of wheat, maize and soya, which is attributable to good weather conditions and better agricultural yields in the United States (see figures 5.7 and 5.8). The magnitude of the feed-through of lower world agricultural prices to local prices will of course depend on how the surcharge is established (see previous paragraph).

Figure 5.7
World agricultural commodity output (mtn)



Source: USDA and BBVA Research

Figure 5.8
Stocks of agricultural commodities (mtn)



Source: USDA and BBVA Research

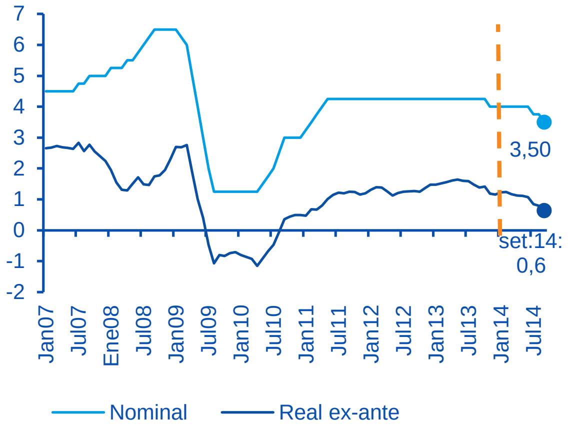
The factors mentioned above will be partly offset by: i) the higher exchange rate and how this is passed on to tradable goods prices or those such market prices quoted in dollars, and ii) the inertia which inflation expectations in the upper bracket of the target range (between 2.5% and 3.0%) will provide. Consequently, we forecast that the drop in inflation will be gradual and close 2015 at 2.5%.

6. Monetary policy: more monetary stimulus is required

Easing in the YtD has been limited, considering the sharpness of the slowdown in output, which was greater than expected

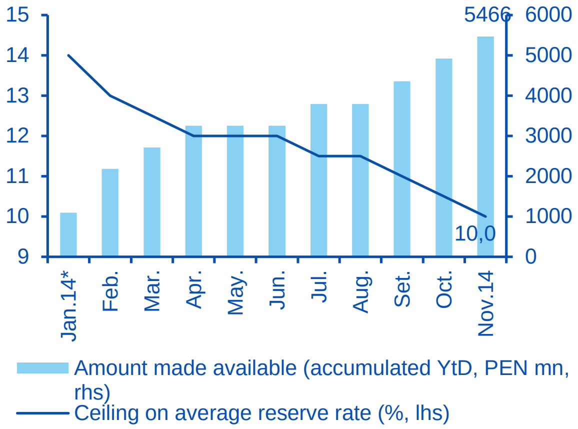
The Central Reserve Bank of Peru in the year to date has responded to weakening aggregate demand by cutting its policy rate on two occasions (by 25 basis points each time). Consequently this has moved to 3.50%. In real terms, a more accommodating position has also been noticeable: since December last year the ex-ante real benchmark rate has come down by 0.5pp (see figure 6.1).

Figure 6.1
Benchmark rate
(%)



Source: BCR, BBVA Research

Figure 6.2
Reserves in local currency
(%, PEN mn)



*: in January, the ceiling on the average reserve rate was reduced by 1pp, from 15% to 14%. Source: BCR, BBVA Research

The Central Reserve Bank of Peru has also been employing other instruments over the year. One of these is the reserve requirement. The lowering of the ceiling on the average reserve rate in local currency, for example, has released more than PEN5bn in 2014 YtD (see figure 6.2). This has been significant in a context in which two phenomena have been observed. First, lending has been notably more vigorous in local currency than foreign, which is just the opposite of what has happened with deposits, the latter above all in the opening months of the year. Secondly, since August the central bank has intervened very considerably in the currency market via the placement of CDRBCRPs (readjustable certificates of deposit denominated in local currency but pegged to the exchange rate) and selling off foreign currency. In this context, the liquidity has been tight in soles required to meet the expansion of the demand for credit in the same currency. The lowering of the reserve requirement in soles, therefore, has not so much eased credit conditions, as helped them not to tighten further. It has thus served to complement the cutting of the policy rate and helped this to pass through into the market.

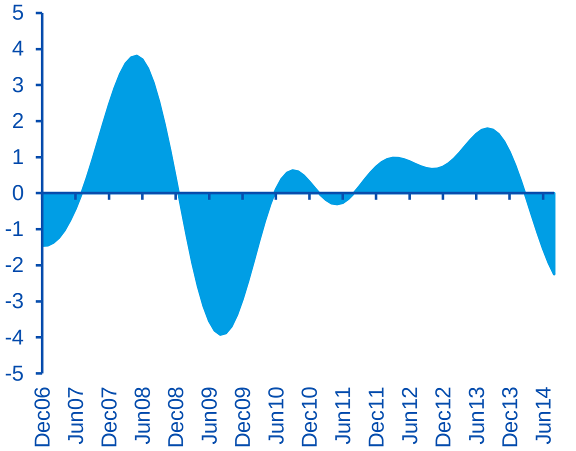
The easing that has been imposed on monetary policy in recent months, of 50bp altogether, has been modest considering how sharp the slowdown in GDP has been, more than was bargained for. This has been due to the restrictions facing the central bank over the year. First, inflation has persistently held at above the target range, and even though it has fallen back in recent months, it is still hovering around the ceiling on the range. Added to this there is a sizeable balance of payments deficit on the current account. A boost to private investment could trigger higher imports and make matters even worse, which is something to be avoided when financial conditions worldwide begin apply pressure. Finally, volatility on world financial markets has become more acute, owing to uncertainty surrounding the process of Fed policy rate hikes, which has led to spells of downward pressure on the local currency (depreciation). An aggressive monetary push would heighten such pressures, and could conceivably have a real impact on companies (half of the credit they receive is dollar-denominated) and families with a currency mismatch in their finances.

Despite restrictions which have held back a more aggressive stimulus, we see room and a need for further cutting of the rate in the short term

As we said in the previous section, the inflationary landscape is kinder looking ahead, especially after 2015. This could turn out to be even more so if the oil companies bring their distribution prices more into line with the benchmark level published by the local regulatory body, which takes into account the downward trend traced by the oil price on world markets. It should be said here that according to Central Reserve Bank of Peru figures an alignment of this kind would whittle down private sector fuel costs by over PEN550mn (the equivalent of a little under 0.1% of GDP), which would work through as a countercyclical measure because it would free up funds that could be used for spending on other goods. An adjustment of local fuel prices to provide a more faithful reflection of world oil price movements would not only help inflation to come down more quickly, but would also be conducive to expected inflation doing so too, which currently stands at 2.8% (close to the target range ceiling). Either way, looking ahead the inflationary pressures will soon tend to recede and this paves the way for an additional monetary push in the short term.

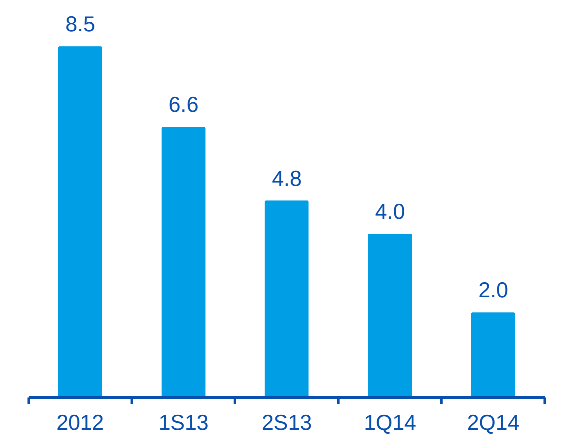
On the other hand, the GDP gap is markedly negative according to our estimates, as can be appreciated in figure 6.3, and we predict that it will remain at these levels throughout the first half of 2015. An impact on this has come not only from temporary supply problems, as in the case of exports, and the fact that the State has been found wanting in its ability to handle public investment satisfactorily, but also from the slowdown in private spending (see figure 6.4). This context suggests that aggregate demand is in need of a bigger stimulus. Fiscal policy is hard-pressed to deal with this. The stabilising role of output thus falls squarely on monetary policy. On top of the elbow-room for bringing down the policy rate, this also needs to be done.

Figure 6.3
GDP gap
(GDP deviation with respect to its natural level, %)



Source: BBVA Research

Figure 6.4
Private spending
(excl. accumulated stocks, % var., YoY)



Source: BCR, BBVA Research

Moreover, according to the Inflation Report just out from the Central Reserve Bank of Peru, the authorities anticipate a major rebound in business activity over the rest of the year. In YoY terms the central bank expects growth of around 4% in the fourth quarter of 2014, which implies an annualised QoQ expansion of output (seasonally adjusted) of over 10%. The current policy rate level is compatible with this scenario. At BBVA Research, we forecast that GDP will move ahead at a noticeably more sedate pace in the final quarter of the year. As fresh economic activity figures come out, reflecting that GDP is not as robust as was initially thought, we foresee the bank being inclined to cut the reference rate again in a bid to endow its actions with a bit of consistency. Such a lowering could come before the year is out and would be limited to 25bp, given that a more assertive monetary shove could pump up pressure on the exchange rate to climb (weakening the local currency), above all at a time when the current account deficit is running high and financing conditions on world markets are beginning to tighten up, with all the damage this would do to corporate balance sheets and family finances with a currency mismatch.

The monetary policy position will start to return to normal in the second half of 2015, when business activity growth is more robust

We predict that in the second half of 2015 economic activity will advance at a rate of 5.5%, slightly above potential growth. The negative GDP gap will thus begin to narrow and concern about activity will steadily subside. In this context, such a flexible monetary policy will not be called for to such an extent and so we see the benchmark rate starting to trend towards a more neutral level from the third quarter next year. We estimate that there will be two hikes before 2015 is out, of 25bp apiece, which would take the policy rate to 3.75%. This implies that in real terms it would move to around 1.3%. This level is comparable to the average for the last three years and will still work in favour of the GDP gap continuing to close up, but it will also make it possible to head off the greater demand pressure fall-out in a more acceptable way. Furthermore, by practically coinciding with the start of hikes in the US federal funds rate, any episodes of currency volatility associated with the normalisation of US monetary policy will be alleviated.

Finally, it is important to mention that our baseline scenario assumes that the Peruvian economy can assimilate the beginning of an orderly series of interest rate increases in the United States, such as we are predicting, without any great upsets. The role of the central bank will be important in this context. The process of a monetary return to normal in the United States will, for example, mean greater pressures on the local currency to weaken. We do not see these pressures as excessive, as the exchange rate at the time will be close to the level which fundamentals suggest. The rise expected in the policy rate will, in any case, allay these. In addition to this, the central bank holds a high level of international reserves, which allows it plenty of scope to step into the currency market to set the scene for an orderly transition towards a weaker currency. This would also enable it to contain the impact which a sudden, sharp drop in the value of currency might otherwise have on the finances of economic agents with a currency mismatch.

7. Risks lend a downward bias to our growth forecasts

From abroad, besides China and the Fed there is another risk too: the geopolitical aspect

We are standing by our inclusion of the two key risks on the list of the most serious which we mentioned in our previous report: a sharp, sustained slowdown in China, and the commencement of a cycle of monetary policy rate hikes by the Fed which could either be brought forward by surprise or carried out in a disorderly manner.

In the first case, the Peruvian economy would be affected through lower demand from abroad, a drop in the prices of metals which Peru exports (which would impact negatively on the profits of mining companies and the extent to which these are ploughed back into their activities, as well as the tax revenue flows), and greater risk-aversion worldwide, which would dampen the inflow of capital to emerging countries. The fundamentals of the Peruvian economy would also be hit. In the second case, it is important to point out that our baseline scenario assumes that the policy rate hikes by the Fed will get underway in mid-2015 and that they will be done in an orderly fashion. If this process should suddenly be brought forward, which might, for example, arise if economic activity and the labour market figures show better-than-expected readings in the United States, or if it should be carried out haphazardly, this would mean that risk-aversion would accentuate the world over and EMBIs and borrowing costs would rise. There would also be a reversal of capital flows into emerging economies, particularly those running high current account deficits, as is the case with the Peruvian economy, and upward pressure on the exchange rate (local currency weakness). These two risk factors give a downward slant to the economic growth forecasts we offer in our baseline scenario.

In this report, we are adding a third element to the mix of risk from abroad: geopolitical risk. This includes, for example, the tensions between Ukraine and Russia, and in the Middle East, and the social unrest in Asia (Hong Kong). In general, any exacerbation of these problems would undermine the confidence of economic agents in the areas most affected (Europe, Asia), which would have an adverse effect on their growth rates. Furthermore, risk aversion generally would increase. Thus greater geopolitical tensions also provide the economic growth forecast in our baseline scenario with a downside bias.

Locally, the chief risk is of business confidence remaining at a low ebb and drawing out the period of slow growth

On the home front, we still see weak business confidence as posing a risk. This showed no improvement in the third quarter, and from the doldrums it could lead to the rough patch the Peruvian economy has found itself in going on for longer. The lower level of business optimism comes in a climate in which several factors have transpired. First, nasty surprises have continued to rear their head in the activity growth figures (June, July, and August). There is no sensation of a recovery of the kind expected. Second, although the activities most affected were initially in the primary sector, this has now become more widespread. Non-primary Manufacturing and Construction have been shrinking for some months now, while Commerce and Services are moving ahead more slowly. Added to this, the authorities have frequently downgraded their growth forecasts (on some occasions within the space of only a few days), which produces unease among the business community. Finally, the countercyclical fiscal stimulus has had no major impact on output, in part due to the state's apparent inability to organise an increased volume of investment expenditure. Some of the fiscal measures are thus, in effect, no more than mere announcements, which is counterproductive to any attempt by the authorities to spearhead a move towards boosting business optimism.

The official growth forecasts for 2014, of a little over 3%, imply a strong recovery in the fourth quarter of around 4% YoY. In seasonally adjusted figures (annualised), this means that activity should advance relative to 3Q14 at a double-digit pace for the rest of the year. We view this as unlikely. We cannot see any drivers that could push growth along at such a speed, so what is most likely to happen is that output (and sales) will grow at a lower rate than the authorities are predicting. In such circumstances the risk exists that business optimism is again hit, resulting in a continuation of private investment weakness. If this risk materialises, economic growth in 2014 and early 2015 should come in below what we are forecasting in our baseline scenario, thus dragging out the temporary bad patch that output has been going through.

Two additional elements could lead economic growth to stray from our baseline scenario, especially from 2015. One of these is the outcome of the regional and municipal elections. These were carried out early last October, and in some cases there will be a second round in the next few weeks featuring the two candidates gaining the most votes. The risk is that certain key regions, such as, for example, those where there are major mining projects, could come to be governed from January by people who have declared themselves against private investment, thereby creating problems in seeing this through. The other additional risk is that the start of construction work on major infrastructure projects where contracts have been awarded, one of the key drivers for growth in the next few years, could continue to be delayed. If this happens, investment growth would be below our estimate, which in turn would imply slower output growth.

To summarise, in this report we have identified certain risks that are additional to those we noted three months ago. All in all, this brings a downside skew to the forecasts for economic growth in our baseline scenario.

8. Tables

Table 8.1
Annual Macroeconomic Forecasts

	2013	2014	2015f	2016f
GDP (%,YoY)	5.8	2.6	4.8	5.8
Inflation (%,YoY, eop)	2.9	3.0	2.5	2.2
Exchange rate (vs. USD, eop)	2.79	2.92	3.05	3.10
Monetary policy rate (%,eop)	4.00	3.25	3.75	4.50
Private consumption (%, YoY)	5.3	4.3	4.7	4.9
Public consumption (%, YoY)	6.7	7.9	5.0	5.5
Investment (%, YoY)	7.5	-1.3	4.1	6.6
Fiscal balance (% of GDP)	0.9	0.3	-0.2	-0.5
Current account (% of GDP)	-4.5	-5.5	-5.2	-4.8

Source: central bank and BBVA Research

Table 8.2
Quarterly Macroeconomic Forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD,eop)	MPR (%,eop)
1Q12	6.0	4.2	2.67	4.25
2Q12	5.7	4.0	2.67	4.25
3Q12	6.8	3.7	2.60	4.25
4Q12	5.4	2.6	2.57	4.25
1Q13	4.3	2.6	2.59	4.25
2Q13	6.2	2.8	2.75	4.25
3Q13	5.2	2.8	2.78	4.25
4Q13	7.2	2.9	2.79	4.00
1Q14	5.1	3.4	2.81	4.00
2Q14	1.7	3.4	2.80	4.00
3Q14	1.6	2.7	2.86	3.50
4Q14	2.4	3.3	2.92	3.25
1Q15	3.8	2.7	2.94	3.25
2Q15	4.0	2.4	2.97	3.25
3Q15	5.5	2.6	3.00	3.75
4Q15	5.6	2.5	3.05	3.75

Source: central bank and BBVA Research

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