BBVA | RESEARCH

Peru Economic Outlook

First quarter 2015
Peru Unit

- World growth will rise to 3.6% in 2015 and to 3.8% by 2016, although with geographic differences. On balance, the lower price of oil will be positive for global activity. The recovery in the US is taking hold and the Fed is preparing to raise its interest rates.
- We are holding to our growth forecasts for Peru of 4.8% for 2015, with a bias to the downside. The estimate is conditional on better exports performance (mining) and a slight recovery in private-sector investment.
- Upside pressures on the exchange rate in the next few months. Depreciation is expected, due to uncertainty about when the Fed will start raising its policy rate and also because the external deficit will remain relatively high.
- We forecast that inflation will converge towards the centre of the target range in the next few months. Favourable performance, thanks to the drop in the price of oil, normalisation of food prices and no demand pressures.
- The central bank will hold to its expansive stance on monetary policy because of low growth at the beginning of the year and an environment without inflation problems. However, exchange rate pressures could cramp greater flexibility.
- Risks to our growth scenario are biased to the downside. In particular, business confidence could be affected by continued disappointing growth figures and political grandstanding.

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Report closed: 6 February 2015

1 Synopsis

World growth will rise to 3.6% in 2015 and to 3.8% in 2016, although with differentiation between the main economic areas. An important event affecting the global economic panorama in the last few months has been the sharp drop in the oil price and its uneven impact on countries depending on whether they are net importers or exporters. We forecast that, globally, cheaper oil will be good for growth, but it also heightens the risk of a scenario of too-low inflation in some developed regions, at least until the end of 2015. In the US, growth is settling in and the Fed is getting ready to start raising its policy rate, which will put emerging economies to the test. The controlled deceleration of activity in China continues, while in Europe downward pressures on inflation remain and the ECB is expanding its balance sheet. Despite the support provided by economic policy and the drop in the oil price, the risks to world growth in 2015 are still to the downside.

We are sticking to our growth forecast for Peru of 4.8% for 2015, with a downside bias. The growth drivers this year will be: i) an uptick in primary sectors; ii) the fall in the oil price; iii) the start of work on major infrastructure projects, and iv) the tax measures announced at the end of last year. It is worth noting, on the spending side, that our GDP growth forecast for this year is closely conditioned to an improvement in exports (particularly mining) and to a slight recovery in private-sector investment. The first quarter will be crucial in order to calibrate whether the economy is starting to gain traction and to demonstrate whether the low rate of growth seen in the latter part of last year is behind us, which to a large degree can be accounted for by poor performance in the primary sectors.

For 2016 and 2017, we forecast a temporary acceleration in growth. Two major copper mining projects, Las Bambas and the enlargement of Cerro Verde, currently in their final construction phase, will go into operation, providing a boost. Thanks to these two projects, together with the return to normal operations at Antamina and full operations at Toromocho, we estimate that Peru will double its copper production in 2017 over its 2014 level. However, it needs to be pointed out that this acceleration will be temporary, so it will only be possible to sustain GDP expansion at above 5.0% if productivity and competitiveness reforms are introduced.

The current account deficit will remain relatively high this year, although it is somewhat over-estimated because of illegal gold exports. The current account deficit in the balance of payments will come in at around 5.0% of GDP by the end of this year. On the one hand, the reduction in the international oil price, which we forecast at nearly 35% on average, will improve external accounts by about 0.4pp (percentage points). On the other, the forecast fall in the average copper and gold prices (by around 10% in each case), metals which Peru exports, will weaken the current account. According to our estimates, unlike previous years, net long-term capital inflows from the private sector will not fully finance the entire external deficit forecast for 2015. However, this situation will reverse from 2016 onwards, since we forecast greater expansiveness, for two reasons. First, because the current account deficit will shrink, tending to stabilise at around 3.5% of GDP due to the boost provided by the entry into operation of major mining projects for exports; second, because of the greater influx of long-term capital linked to financing infrastructure projects which have been awarded in the last two years.

The exchange rate will suffer upside pressure over the next few months. We expect a depreciation because of the uncertainty about the beginning of the policy rate hikes by the Fed (as well as the speed with which the corrections will be introduced) and because of an external deficit which will remain relatively high this year. We forecast that towards the close of this year, the exchange rate will be around USDPEN3.20, a value which is compatible with this variable's current equilibrium, in our opinion. The transition towards a higher exchange rate will be relatively gradual, since the central bank will smooth the fluctuations with its exchange rate interventions. Nevertheless, we think that greater exchange rate flexibility would be desirable as a mechanism for absorbing external shocks and for correcting the current account deficit.

We expect inflation to converge towards the middle of the target range in the next few months. With year-on-year (YoY) inflation ending 2014 at 3.2%, for this year we forecast a falling trend, pushed down by lower fuel prices, more moderate increases in food prices, and a backdrop characterised by the absence of demand pressures (we estimate that the input gap will remain negative this year). These factors will be partly offset by the rise in the exchange rate and its transfer through to tradable goods and services prices.

The central bank will keep to a moderately expansive stance on monetary policy in the short term. On the one hand, the year will kick off with a growth rate that will still denote weakness, not only in aggregate but also of the private-sector spending indicators. On the other, inflation will return to the central bank's target range in February and will continue falling in the months following, which will give more scope for an additional rate cut at some point. For this reason, we cannot rule out some monetary flexibility in the short term, but the decision, in our opinion, is highly dependent on the information that is forthcoming and in particular on the exchange rate volatility in the days leading up to the central bank's monetary policy meetings.

The balance of risk factors over our growth projection is biased to the downside. Scenarios which could have a negative impact on this year's growth include a more intense deceleration of the Chinese economy, greater financial stress because of the beginning of the Fed's interest rate hikes, and a deterioration in business confidence, which might be affected by the continuity of disappointing growth figures and a high level of political skirmishing.)

2 Global backdrop: increasing divergence between the key economic areas

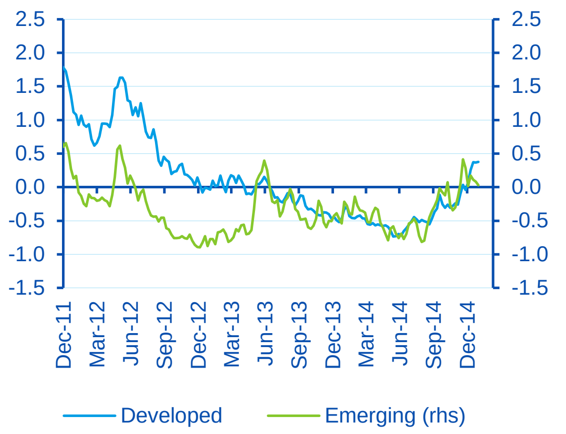
Global growth should increase to 3.6% in 2015 and 3.8% in 2016

The world economy grew in the fourth quarter of 2014 at a similar pace to the third. A dynamic economic performance in the US has been offset by the weakness of the recovery in Japan and the eurozone, and the progressive deceleration of China and other emerging economies. Hence, we estimate that global GDP will have grown 3.3% in 2014, 10bp more than in 2013, with a slight increase in the DMs' contribution over the three previous years, and the EMs continuing to decelerate.

One of the biggest pieces of news in the global economic scenario in recent months is the very sharp fall in the oil price and its uneven impact on different countries, depending on whether they are net importers or exporters. Overall, we think the global impact of cheaper oil should be positive in terms of growth, inasmuch as the reduced burden on household and corporate income in oil-importing countries (such as the US, the eurozone and China) offsets the reduced activity in the principal producer countries.

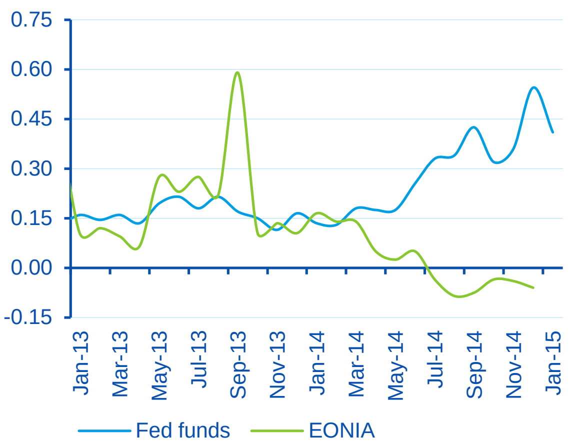
The increased volatility in financial markets, which has now reached the same level as in mid-2013, according to the BBVA Financial Tensions Index (Figure 2.1), is another of the highlights of the quarter, and one the EMs and the DMs have in common as a consequence of two factors: i) doubts about the economic development of many EMs, and ii) the uncertainty around the Fed's rate-hiking cycle.

Figure 2.1
BBVA Research Financial Tensions Index



Source: BBVA Research and Bloomberg

Figure 2.2
Monetary policy expectations: 12M fwd interest rates (%)



Source: BBVA Research and Bloomberg

In this context of low inflation and moderate economic growth, monetary policies remain accommodative in tone, although the biases differ, with the Fed and the Bank of England on the one side, and the ECB and the PBoC on the other (see Figure 2.2).

Thus, the improvement in global growth will continue in 2015 and 2016, by more than 3.5% on average, but there will be a significant differentiation between areas, given the asymmetric effect of falling commodity prices and monetary policy divergence in the development bloc, with these being the two effects that mark *a priori* the prospects for the global economic scenario.

All in all, and in spite of the support offered by economic policies and lower oil prices, the risks to world growth in 2015 remain to the downside. The risks presented by geopolitical tensions have been exacerbated by those associated with the effectiveness of the monetary policies introduced to increase inflation expectations and – in the case of the Fed in particular - to establish a strategy for withdrawing stimulus that does not erode the EMs' financing conditions to such an extent that this restricts their growth.

The US consolidates its recovery and the Fed is ready to raise interest rates

Momentum in the US recovered over the course of 2014, based on the strength of domestic demand and also lower oil prices. Looking forward, US growth could reach 2.9% in 2015 which, together with low inflation, will accentuate the Fed's dilemma when it comes to start its monetary normalisation process. In this context, our forecast date for the first increase in the Fed funds rate remains 3Q15.

The controlled slowdown in China continues

In China, the slow deceleration in activity continued, with an estimated growth of 7.2% in the fourth quarter, the slowest since 2009 due to the loss of momentum in fixed capital investment, the deterioration in external competitiveness which was driving the yuan's appreciation and the correction in the real estate sector.

Although we have left our forecast for growth in 2015 unchanged at 7%, the risks are clearly biased to the downside as a reflection of the magnitude of accumulated financial imbalances, the uncertainty over the evolution of the real estate market and the doubts about the capacity of policies to achieve a correction in the present imbalances with economic liberalisation underway. It is important to remember that the authorities have started to show more tolerance towards economic deceleration, provided that job-creation moves in line with the active population.

Finally, the downward pressures on inflation in Europe continue

Of the large economic areas, the eurozone is the most likely to have to deal with a scenario of inflation that is too low for too long. In addition to the negative surprises on consumer prices, the area has only a moderate economic growth profile, in line with expectations. In particular, an increase of 0.8% in 2014 is anticipated, which could increase up to 1.3% in 2015, supported by the fall in the price of oil, the accumulated depreciation of the euro in recent months and the relaxation of monetary conditions thanks to the ECB's actions.

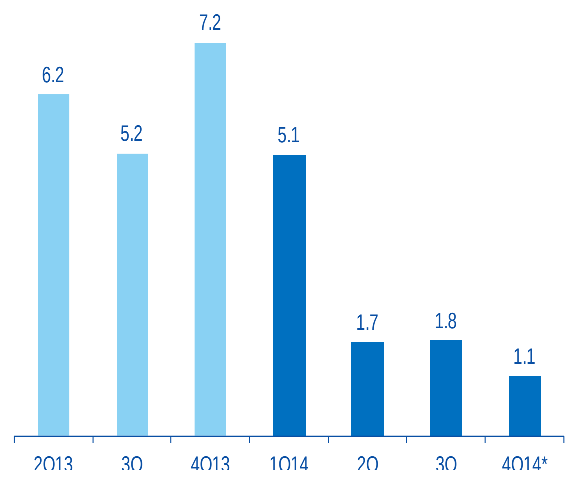
Among the main focus-points of downside risks is the increased tension in Russia's sphere of influence. A second risk factor is the uncertainty generated by the divergences between some national authorities and the EU institutions as to the most appropriate supply-side reform, the pace of fiscal consolidation and the ECB's support in fostering growth. Finally, another risk is that medium-term inflation expectations will continue to fall, discouraging consumption in the short term, and leading to a negative feedback loop.

3 Peru: we maintain our growth forecast of 4.8% for 2015, with a bias to the downside

Progress in the final quarter of last year remained weak, with GDP likely to have grown by 2.4% in 2014

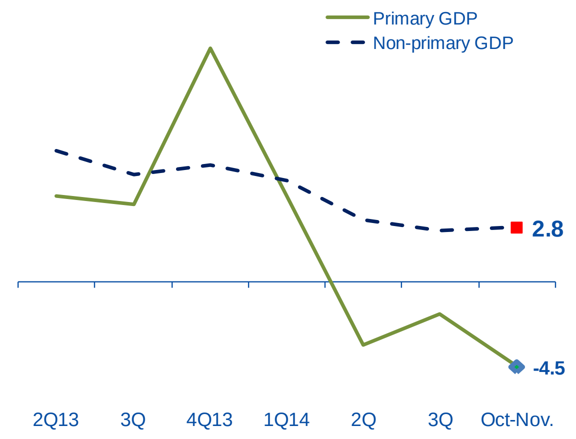
The economy did not recover in the fourth quarter of 2014 (see Figure 3.1). On the contrary, once again we saw the negative impact of supply shocks. Primary activities were the most affected (see Figure 3.2), contracting as a whole by 4.5% YoY in October and November[1], adding to the reverse recorded in the two previous quarters. There are two explanations for this poor performance. First, the second anchovy fishing season was not opened. The scarcity of biomass and the large proportion therein of underage fish led the Production Ministry, entirely reasonably, to extend the closed season. This also had a negative effect on the anchovy processing industries, producing fishmeal and oil. We estimate that, in all, the negative incidence on GDP growth in 4Q14 was between 0.7pp and 0.8pp. The second factor accounting for the poor performance of GDP's primary component was that the production at Antamina, Peru's biggest copper project, is still temporarily below maximum capacity. Between October and November, copper production at this mine fell by over 29% YoY, which also had a negative impact on the metal refining industry.

Figure 3.1
GDP
(%, YoY)



*Projection assuming 0.5% growth for December 2014.
Source: Central Bank and BBVA Research

Figure 3.2
GDP: primary and non-primary components
(%, YoY)



Source: Central Bank and BBVA Research

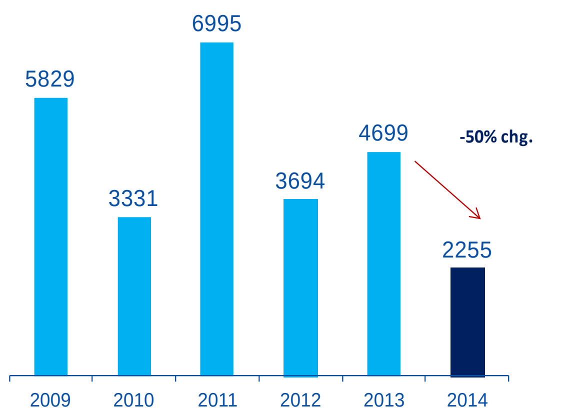
Non-primary sectors as a whole, on the other hand, continue to be the major prop for activity. Services stood out, with significant growth between October and November of around 5.5%, as did electricity, which stabilised at around 4.5%. Retail, meanwhile, continued to grow at 4%, but inside this sector there is a slowdown in retail and wholesale sales, highlighting that household consumer spending has slowed down, which would be consistent with a labour market that has lost energy. The weakest non-primary sectors are still construction and non-primary manufacturing. Although the former stopped contracting in the final months of last year, it is still not showing solid recovery, despite the positive statistical effect of a low base for comparison YoY. Non-primary manufacturing, especially industries linked to mass consumption such as

1: At the close of this edition, the December figures had not been published.

bakeries and furniture, those focusing on the foreign market (among them, textiles, which is reflecting the weakness of other Latin American economies) and those producing inputs which satisfy demand in the productive sectors in the economy which have slowed down.

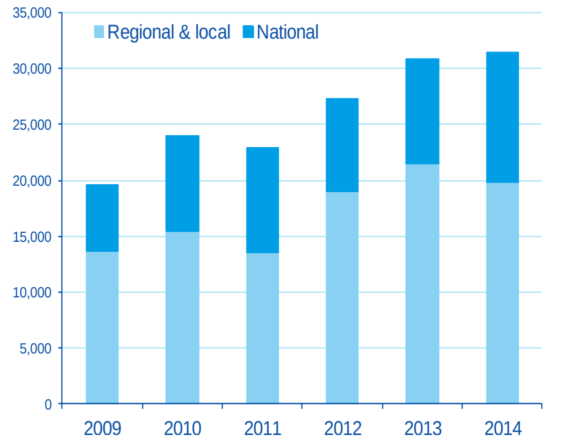
Once the fourth quarter figure is known, GDP is likely to have expanded by around 2.4% in 2014, its most feeble progress since 2009 and well below the average rate of the ten preceding years (6.4% YoY). This reflects structural factors, but also temporary elements which intensified the slowdown. The latter group includes essentially two categories. The first is the supply problems which affected the primary activities of metal mining and fishing, to which we have referred in our previous reports. If we look only at the direct impact on growth, had Toromocho reached full operating capacity in the third quarter, as initially planned, we estimate that GDP would have grown by a further 0.3pp in 2014; if production at Antamina had returned to normal in that same quarter and reached an extraction rate similar to that of the year before, the positive incidence on GDP would have been a further 0.3pp; and if anchovy landings had been similar to 2013 (see Figure 3.3), GDP would have risen by a little over an additional 0.1pp. We should also add to all this the indirect impact, also an important one, which the industries processing these natural resources would have generated.

Figure 3.3
Anchovy landings
(mn TN)



Source: Central Bank and BBVA Research

Figure 3.4
Gross capital formation spending
(S/. mn)



Source: Central Bank and BBVA Research

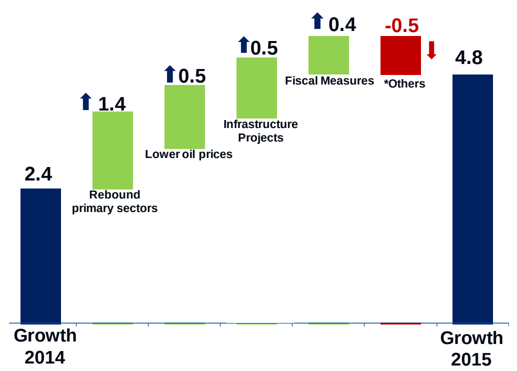
The second non-structural factor exacerbating the slowdown in economic activity was the disappointing execution of investment spending (see Figure 3.4), in particular on the part of sub-national governments against a backdrop of concerns about how the authorities were handling public resources, and of elections at the beginning of the fourth quarter. Expenditure at this level of government, which in 2013 made up 70% of total public investment, contracted by 10% in 2014. However, had it kept to its 2013 rates of growth (around 12% in real terms), which would be reasonable in a context requiring a counter-cyclical boost (which we did indeed see in the investment spending at national governmental level), GDP would have grown by a further 0.8pp.

In summary, supply and one-off factors account for around 2pp of the deceleration in 2014, whereas the rest is linked to: i) a complex international environment, in which, for example, metal prices (copper and gold) fell, which reduces incentives for mining investment, and in which growth in the region fell, which has a negative impact on the higher added value products which Peru exports; ii) the negative feedback which slower growth creates for expectations of project profitability and therefore on private-sector investment, and iii) more structural elements (less progress in productivity and competitiveness). By their nature, however, part of these supply and one-off factors will correct upwards in 2015 and this will help activity to bounce back.

We forecast growth of 4.8% in 2015, conditional on an improvement in exports and a small recovery of private-sector investment

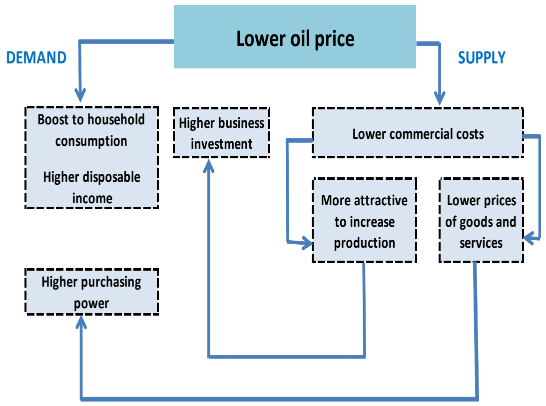
Economic activity will perform more strongly this year than last. The biggest boost to growth will come from four sources, according to our estimates (see Figure 3.5). The first of these is the recovery in the primary sectors. The supply problems faced last year by metal mining, fishing and the industries linked to natural resource processing will reverse in 2015. Our forecast factors in that the correction will be only partial, but even so it will give an important push to the growth rate. The second source is the lower international market prices for oil in 2015, of which Peru is a net importer. On the demand side, this will have a positive effect on households' disposable income, which they will be able to spend on other goods and services, while on the supply side, costs will fall (in the services, mining and manufacturing sectors, for example), and thus make it more attractive to increase production. The first stone-laying/start of construction of major infrastructure, among them Lima Metro's line 2 and the gas pipeline in the south of the country, will be their third driver of growth in 2015. Finally, the tax stimulus measures announced in the closing months of last year will also have a positive effect on GDP's rate of expansion.

Figure 3.5
Main drivers of growth acceleration in 2015 (pp of GDP)



*Covers, for example, lower investment in the mining sector (with the completion of major project construction and lower metal prices), more tense political environment, new authorities in sub-national governments, tighter external borrowing conditions and higher growth forecasts in the US (with more support from private sector spending), LatAm and Europe. Source: BBVA Research

Figure 3.6
Pass-through of lower oil price to economic activity, channels



Source: BBVA Research

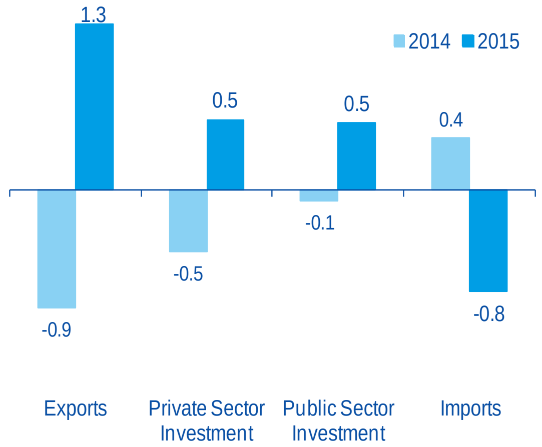
This 4.8% forecast for 2015 is unchanged from our report at the beginning of November, although the composition of this growth has certainly changed. In terms of the main sources accounting for the rate at which the Peruvian economy will advance this year, we have now introduced a more marked drop in gold and copper prices (and, as such, investment in the mining sector), a slightly more limited expansion in emerging countries, a less pronounced increase in mining production than we thought three months ago, and a political environment that is rather more on edge. All this has been offset, though, by the positive impact of a much steeper fall in the international oil price, by the tax measures announced at the end of last year, and by the greater progress that we now forecast for the advanced economies, especially the US.

Table 3.7
GDP on the expenditure side (%, YoY)

	2013	2014	2015
Domestic demand	7.0	2.5	4.2
Private consumption	5.3	4.3	4.6
Public consumption	6.7	8.4	5.0
Gross domestic investment	10.5	-2.2	2.9
Gross fixed investment	7.6	-2.0	3.9
Private	6.5	-2.1	2.5
Public	12.1	-1.6	9.5
Exports	-0.9	-2.5	5.5
Imports	3.6	-1.4	3.0
GDP	**5.8**	**2.4**	**4.8**

Source: Central Bank and BBVA Research

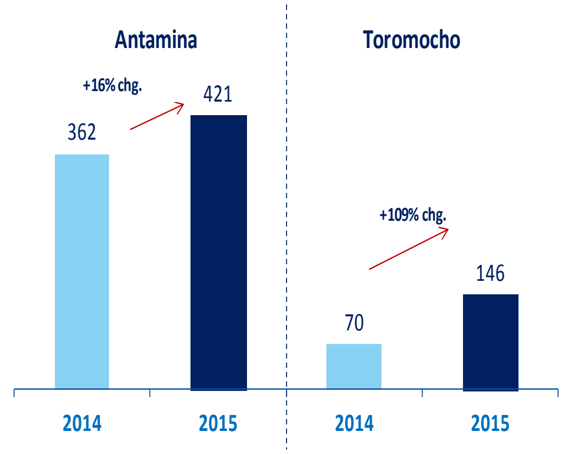
Figure 3.8
Contributions to GDP of components on the expenditure side* (pp of GDP)



*The components excluded in the Figure are consumption (both private and public) and stock accumulation. Taken as a whole, these excluded components will have accounted for 3.4pp of GDP in 2014 and we estimate that they will bring in 3.2pp in 2015; thus the change in their contribution to product is not substantial.
Source: BBVA Research

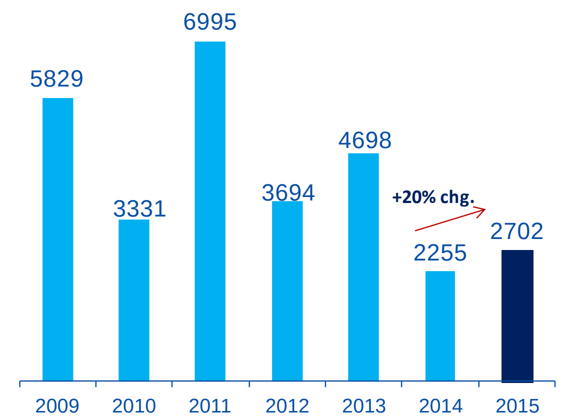
On the demand side, sources of growth in 2015 will lead to better performance on the part of exports and investment (private and public), which are key in supporting our forecast (see Table 3.7). In the first case, we estimate that sales abroad will make up 1.3pp of GDP (see Figure 3.8), a remarkable improvement from their negative contribution (-0.9pp) the year before. The growth spurt is mainly a result of the uptick in primary activities. On the side of metal mining, we consider that Toromocho will gradually increase its production, this year mining just over half the amount of copper it will be able to extract when it is up to full operating capacity (see Figure 3.9). As far as Antamina is concerned, we believe it will return to full capacity production by the fourth quarter of 2015, meaning that over the year the amount of copper extracted from this field will rise by 16%. Finally, we have included the start of operations in Constancia, with an extractive volume of 30,000 fine metric tons (FMT) of copper a year, just under 40% of its potential annual production. These assumptions for mining activity are conservative and, taken together, imply that copper production will grow by 15% in 2015, after having practically stagnated last year, despite the revenue from Toromocho (where the maximum extraction level is equivalent to nearly a quarter of the total extracted in 2014). Rather optimistic estimates, such as that calculating that both Toromocho and Antamina will reach full operating capacity at the beginning of the second half, would suggest that copper production will advance a further 0.6pp over the year (equivalent to adding just over 0.2pp to GDP), thus boosting exports more than we had forecast.

Figure 3.9
Production from major copper mines (FMT, mn)



Source: MINEM and BBVA Research

Figure 3.10
Anchovy landings (TN mn)



Source: Central Bank and BBVA Research

Turning to fisheries, this is the other primary sector where we expect an improvement this year, which would also underpin exports. Reports are coming in that on balance are encouraging: the sea temperature is returning to normal after several months (May to October) in which it was higher than usual, and the most recent measurement of anchovy biomass was positive. Even so, we have been somewhat conservative and estimate that, in the first season of anchovy fishing in 2015, the catch will be similar to last year (when only 70% of the quota assigned was extracted, because of the anomalous sea temperature, even though the fishing period was extended by a few days), while in the second season the catch will be half that of 2013. Thus, we are assuming that anchovy extraction will only recover gradually, reaching 2.7 million tonnes this year; while this is 20% higher than in 2014 (see Figure 3.10), it will still be well below the 2012 and 2013 landings. The larger anchovy catch will also be reflected in increased export volumes of fishmeal and oil.

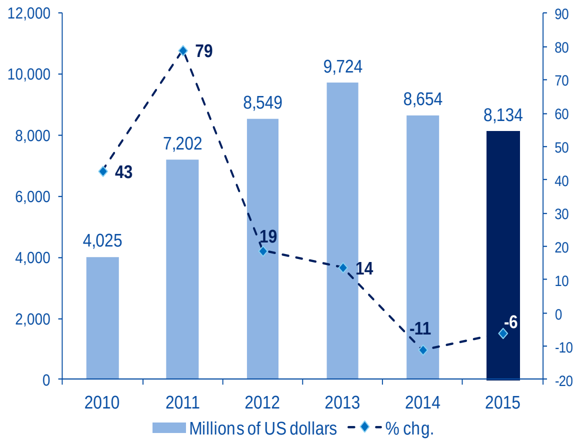
Finally, we forecast that non-traditional exports will expand by 3.6% in real terms, a similar rate to our estimate for last year. The result could end up being somewhat higher, however, bearing in mind that world GDP will accelerate by 0.3pp in 2015 (from 3.3% to 3.6%). The greater economic dynamism expected this year in the US is extremely relevant to these exports, particularly the support provided by private-sector consumer spending, for the Latam countries as a whole and for Europe.

Table 3.11
Main projects that will start construction in 2015

Projects	Amount of Investment USD	Construction period*
Infrastructure		
Metro line 2	5,658	5 years
Talara	3,500	5 years
Chancay Port Terminal **	2,800	3 years
Jorge Chávez Airport Expansion **	850	4 years
Nodo Energético del Sur**	800	3 years
Chinchero Airport	658	3 years
Longitudinal de la Sierra - Tramo 2	552	4 years
Remodeling of Camino Real Mall**	300	2 years
San Martín Port Terminal **	182	3 years
Fuel		
Gaseoducto**	4,000	5 years
Electricity*		
Central Hidroeléctrica - Molloco	1,397	7 years
Central Termoeléctrica de Ilo	500	3 years
Central Hidroeléctrica - Belo Horizonte	389	3 years
Central Hidroeléctrica - Pucará	360	3 years
Central Termoeléctrica Nueva Esperanza	128	2 years
Transmission Lines *		
Red Dorsal Nacional de Fibra Optica	400	3 years
Moyobamba Iquitos, Friaspata - Mollepata, entre otros	727	4 -5 years
Total	**22,801**	

* Reference deadlines. ** Projects financed almost completely by the private sector. Source: Maximixe, press media, BBVA Research

Figure 3.12
Investment in mining (year to date balance in USD, % YoY)



Source: MINEM and BBVA Research

We estimate that private investment will recover slightly, by 2.5%, after contracting by a similar rate in 2014. This figure includes two components. The first, is private-sector participation in financing several major projects that start building this year. Table 3.11 is a summary of the main project that we have identified in different sectors of the economy. Our forecast for private-sector investment for 2015 considers that only part of the almost USD23bn that will be spent on building these projects will be funded by the private sector (around 60%). We have included the total funding of the electricity power stations, electricity transmission lines and some of the infrastructure and oil projects on the list, along with the partial funding of the rest. Furthermore, we have taken into consideration the construction deadline and when in 2015 construction could start. Second, our private-sector investment forecast assumes that business confidence will remain similar to the end of 2014 on average (between 53 and 54 points); slightly above the optimism threshold, which will provide certain support for investment to recover. We consider that investment in mining will decline in 2015 (see Figure 3.12), continuing the trend since the end of the year, and there will be a slow-down in real-estate investment, particularly in the housing market, where sales fell in 2014 and the available housing stock has grown. These two factors will partially offset the private-sector investment recovery.

Public-sector investment will also finally contribute to accelerated economic growth this year. We forecast a 9.5% increase in public-sector spending in real terms, the equivalent of PEN3.8bn in nominal terms. Firstly, we are assuming that only 60% of the PEN3bn that the authorities announced at the end of last year to drive public investment in projects prioritised according to their social impact will be implemented; over 15pp below the average spending implemented on projects in the last two years, involving a disbursement of PEN1.8bn. Second, we considered that public-sector investment in the sub-set of projects identified in Table 3.11., including Line 2 of the Lima Metro, the modernisation of the Talara refinery, Chincheros airport and the second stretch of the North-South Andean highway will increase this year by around PEN1bn. Finally, the forecast factors in the increase in the public-sector budget for infrastructure works in the Health and Education sectors. Our conservative estimate for the implementation of this spending is 30% (PEN1bn).

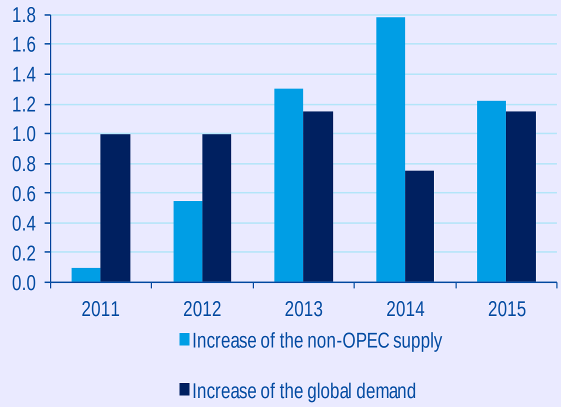
It should also be pointed out that new regional and municipal authorities will take office in early 2015, after the elections of last October. In the past, this has driven a dip in public spending at this level of government while the new authorities took on-board the spending implementation procedures. But we believe the impact will be relatively constrained on this occasion because: i) some of the authorities have been re-elected, so they are aware of the spending procedures; ii) we understand that the central government has been skill-building among the new authorities (and their teams) before they take office, and iii) there was no significant rise in regional public-sector spending in 2014 (election year, which there had been on the previous occasion), and in fact it shrunk 10% in real terms, so the baseline for comparison is now relatively low.

Box 1. Impact of falling oil, copper and gold prices on macro-economic forecasts

Oil

The price of oil has declined significantly since last August, falling 54% between July 2014 and January 2015. The lower price can be explained by a reduced demand for crude and by surprising increases in supply from the US and from countries in which more moderate supply was initially expected due to geo-political tensions (see Figure B.1.1).

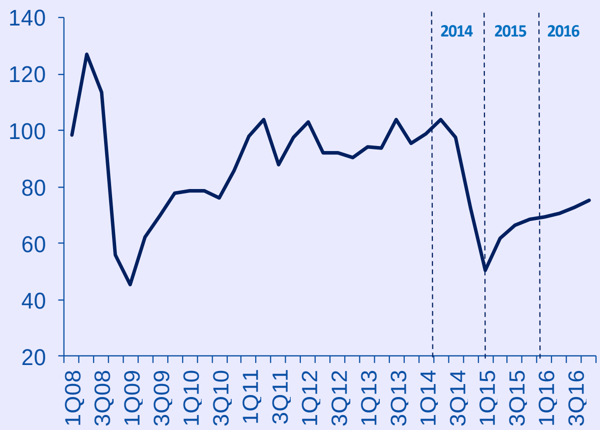
Figure B.1.1
Annual increase in non-OPEC oil supply and global oil demand (mb/d)



Source: BBVA Research and AIE

Our base line scenario estimates that oil prices will fall to their minimum in 1Q15 and then start to rally in 2Q15 (see Figure B.1.2), as low prices discourage investment in the sector and drive expectations of falling supply in the future. It also assumes that OPEC will maintain its production quota for at least the first six months of 2015, with the possibility of cuts later on. With respect to the other key supply-side stake-holders, these prices enable the shale-oil operations that are already online to continue (with estimated production costs of USD35-40/bbl), but offer little return for new investments (with costs in the range of USD70-80/bbl when sunk costs are factored in). Given the rapid rate of decline of shale oil well reserves (80% after two years, versus 20% for conventional wells), shale oil production should slow down sharply in the US, with the impact felt especially in 2016, after the present over-supply is consumed. For the medium term, we expect the price to climb to around USD86/bbl for WTI, driven by the industry's cost structure and by a better balance between the increase in demand and non-OPEC supply.

Figure B.1.2
Price of WTI oil
(USD/bbl)



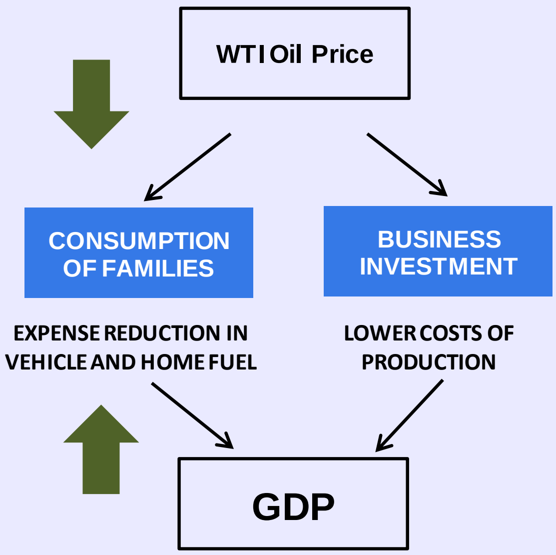
Source: Bloomberg and BBVA Research.

In average terms, we estimate that international oil prices will fall off by just under 35% in 2015 from 2014 prices. According to our calculations, this will have a 0.4-0.5pp positive impact on local GDP for this year. On the one hand, there will be an improvement in available household income as part of the income for other goods and services will be freed up, and costs will also fall for businesses, making it more attractive for them to increase production and invest (see Figure B.1.3).

It is important to point out that Peru is a net importer of oil. The trade deficit of the oil industry is 1.3% of GDP (USD3.8bn a year are exported and USD6.4bn imported)[2]. The trade deficit will improve by 0.4pp of GDP with the fall in average oil prices for the year.

[2] 2013 figure. It includes exports and imports of oil and derivatives.

Figure B.1.3



Source: BBVA Research

Copper

We believe that copper prices will continue to fall in 2015, to around an average of USD2.82 per pound, thus falling 10% against the level they reached last year. This scenario factors in the slow-down in growth in China and the global strengthening of the dollar.

Locally, the fall in international copper prices will have a negative impact on the profits generated by mining companies and hence on the amount they re-invest in the industry. Against this backdrop, we estimate that the negative impact on GDP in 2015 will be around 0.4pp, and USD850mn on exports.

Gold

Our forecasts suggest a fall in international gold prices of around 9% on average this year, in a context of falling global inflation and the Fed starting to raise interest rates. In our calculations, this will reduce GDP by around 0.3pp and cut exports by approximately USD400mn. The way this comes about will be similar to the copper scenario.

Figure B.1.4
Impact of falling oil, copper and gold prices on macro-economic forecasts

	Oil	Copper	Gold	Balance
GDP	+	−	−	−
Current Account Balance	+	−	−	−

On the supply side, there will be a more dynamic performance from the Fisheries and Construction sectors

The fishing industry will perform the best, with forecast growth of 10% for 2015. The scenario factors in the more promising news about sea temperature and bio-mass, suggesting a better outlook for the sector than last year (see Figure 3.10 about anchovy catches).

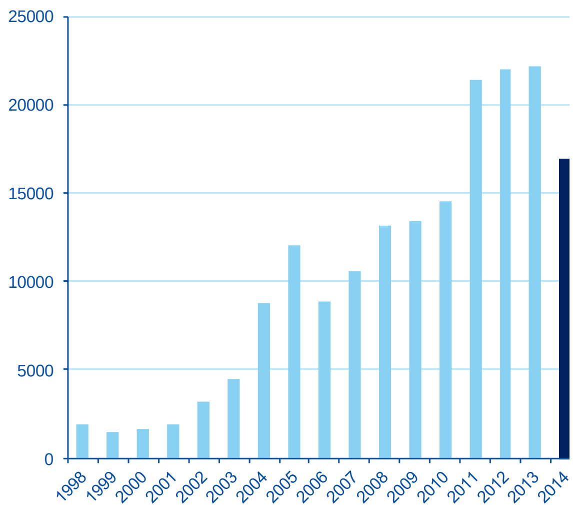
We foresee a 7% expansion in Construction in 2015 (see Table 3.13) after quite a poor year, hit by the slow-downs in regional government spending and investment in mining. The growth forecast for 2015 will be sustained mainly by the start of major infrastructure projects (see Table 3.11). Our forecast takes into account that the performance of the construction industry will probably be constrained by more moderate growth in house building, after sales fell off last year and market supply rose (see Figure 3.14).

Table 3.13
Sectorial GDP
(%, YoY)

	2013	2014	2015
Agriculture	1.6	1.6	1.5
Fishing	18.1	-24.3	10.0
Mining and fuel	4.9	-0.8	4.7
in which mineral	*4.2*	*-2.6*	*4.4*
Manufacturing	5.1	-3.3	4.0
based on raw materials	8.7	-10.0	4.0
non-primary	4.4	-1.0	4.0
Electricity and water	5.5	4.9	5.4
Building	8.9	1.4	7.0
Commerce	5.9	4.4	4.7
Other services	6.5	5.7	5.8
GDP	**5.8**	**2.4**	**4.8**

Source: Central Bank and BBVA Research

Figure 3.14
House sales
(units)



Source: CAPECO, BBVA Research

Moreover, we anticipate a recovery in metal mining during the year, due mainly to greater production from the Toromocho Project and the trend towards normal production at Antamina. Taken together with the strong Fisheries performance, this will also promote a spike in natural resource-linked Manufacturing.

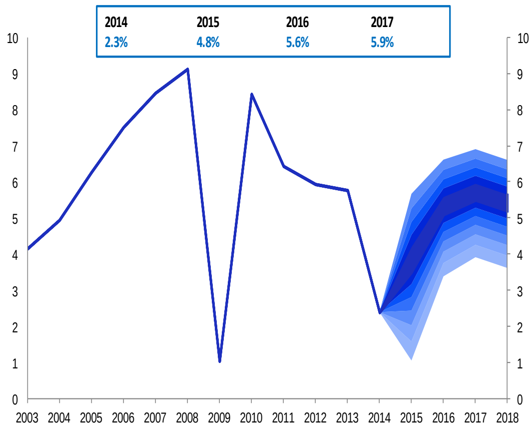
We forecast a temporary acceleration in growth for 2016-17

We consider that output will grow at a faster rate in the next two years (see Figure 3.15), due to two major copper mining projects coming on line that are currently in the final construction phase: Las Bambas and the extension of Cerro Verde. USD10bn has been invested in the construction – currently 75% complete – and commissioning of the former[3]. According to our forecasts, the project will start producing copper in the first quarter of 2016 and it will reach 30% of its maximum annual production capacity that year (450,000 FMT, equivalent to more than one-third of Peru's current output), increasing gradually until the end of 2017. The

[3] According to the latest calculations from MMG Limited, a China Minmetals subsidiary, the required investment increased by 65% against the first estimate (USD6bn).

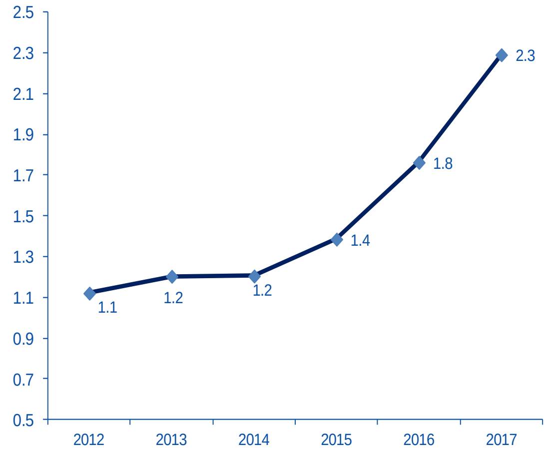
extension of Cerro Verde has required an investment of USD4.6bn. We calculate that the extension will come into production next year, and will reach 40% of its maximum operating capacity in 2016 (272,000 FMT, equivalent to over one-fifth of Peru's current output), which will be attained in late 2017. These two projects, along with the normalisation of Antamina and Toromocho operating at full capacity, will enable Peru to double its copper output in 2017 against 2014 (see Figure 3.16). In spending terms, this will translate into greater exports.

Figure 3.15
GDP: forecast
(%, YoY)



Source: Central Bank and BBVA Research

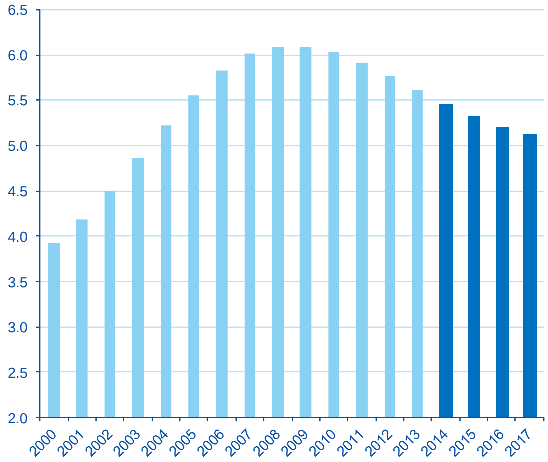
Figure 3.16
Copper production
(millions FMT)



Source: MEM and BBVA Research

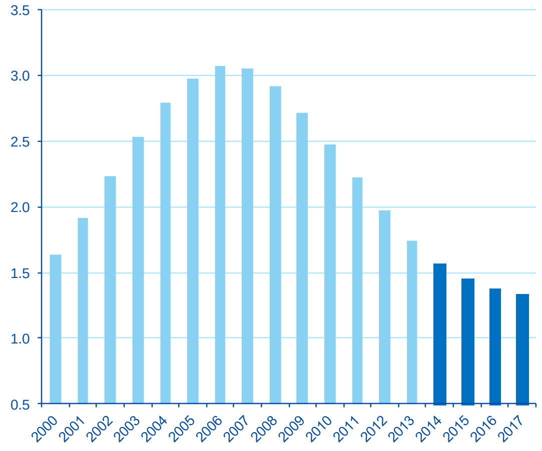
Accelerated growth will only be transitory, however. In our opinion, the sustainable growth rate of the Peruvian economy over the next few years will be around 5.0% (see Figure 3.15), below the average for 2002-13, which was over 6.0%. This is due mainly to the fall in productivity gains that we have witnessed in recent years (see Figure 3.17), a trend that we believe will continue in the future. Attaining accelerated economic growth again will require measures to drive productivity and competitiveness, including raising educational and health standards, closing the infrastructure divide, promoting innovation, making the labour market more flexible and improving the public administration.

Figure 3.17
Potential GDP (%, YoY)



Source: Central Bank and BBVA Research

Figure 3.18
Productivity: contribution to potential growth (percentage points)



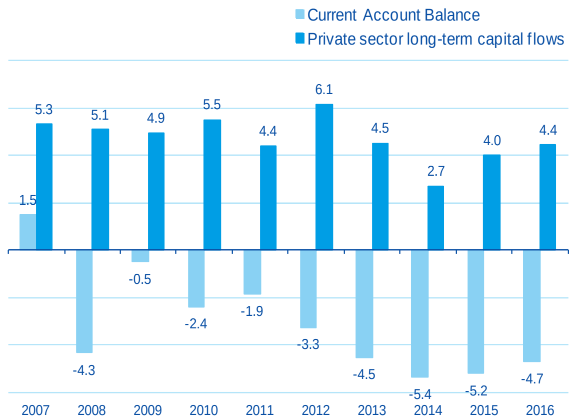
Source: Central Bank and BBVA Research

The external deficit will remain high in 2015-16, but it is over-estimated because a portion of the gold exports is not reported

The balance of payments deficit on the current account will be around 5.0% of GDP at the end of this year. The fall in international oil prices, estimated at almost 35% on average, will improve the overseas accounts by approximately 0.4pp of GDP, a moderate impact that takes into consideration that Peru is a net importer of oil. But the projected fall in average copper and gold prices (by nearly 10% for each of them), metals that Peru exports, will weaken the current account (see Box 1).

With respect to financing this result, unlike in previous years we do not think that long-term, net capital entries from the private sector will be enough to finance the total forecast external deficit (see Figure 3.19). This is a weakness that must be monitored closely, as it could exacerbate pressures on the exchange and debt markets against a backdrop of rising interest rates from the Fed. On the up-side, we believe the situation will only be temporary, as we foresee an easing of the situation in 2016. The improvement is due to both a reduction in the deficit on the current account, which will tend to stabilise at around 3.5% of GDP in the future because of the drive to exports provided by major mining projects coming into operation, and because of a greater influx of long-term capital associated with financing infrastructure concessions granted in the last two years.

Figure 3.19
Private-sector current account and financial account (% of GDP)*



*If illegal gold exports are considered, current account earnings would improve by 0.7pp of GDP since 2014.
Source: Central Bank and BBVA Research.

It is also important to point out that the Peruvian authorities have increased their actions to restrict illegal gold production since 2013. Some of these measures were aimed at monitoring gold traders more closely. Illegal gold producers have sought ways to outwit the greater control and it appears that they are smuggling gold into other countries and then exporting it from there to its final destination. This is consistent with a recent World Bank study[4] that indicates that gold exports from Bolivia have increased five-fold against 2013. The magnitude of the increase is surprising, especially as the price of gold has fallen considerably in the last two years and no major gold mines have been developed in Bolivia that would explain it. Moreover, there was a sharp decline in gold production and exports reported in the national accounts in 2014, along with a significant spike in the “Errors and omissions” line of the balance of payments (around USD2bn). All in all, it would appear to be reasonable to assume that illegal gold production – and later export – has ceased to appear in the balance of payments current account in the face of tighter state controls, but that, in practice, exports to neighbouring countries continue. We calculate that these illegal gold sales account for around USD1.5bn, the equivalent to 0.7pp of GDP. Thus, the real deficit on the current account, i.e. adjusted for illegal gold exports, would be less than the figures published by the Peruvian government by 0.7pp of GDP. This is a significant adjustment, but even so, the overseas deficit remains high.

A sustainability analysis of the balance of payments current account is also striking. It is somewhat contradictory that an economy like Peru’s, that has slowed down significantly, has increased its overseas deficit at the same time (and that the deficit is so high). This combination could suggest that the real exchange rate is out of balance and that a real depreciation of the local currency is necessary to ensure that the overseas accounts remain sustainable. Our analysis (see Box 2) defines the sustainable deficit on the current account as one that stabilises overseas liabilities at their current level (31% of GDP), that is, 2.1% of GDP. It also corrects the deficit on the current account due to three factors: cyclical factors (e.g. raw material prices and output gap); one-offs, such as transfers (between non-residents) for the sale of two major Peruvian companies, which generated capital gains in 2014; and illegal gold exports not booked to the current account. Thus we get a result that is more of a trend, which we call underlying deficit, which we currently estimate to be around 4.0% of GDP. In conclusion, the overseas deficit that the Peruvian economy can sustain is less than the underlying deficit, which suggest that there is room for a real depreciation of the

[4] Estimates of Latin American Trade Trends 2014 (IDB, 2014)

national currency, something that has been observed and, as we discuss later on, that we have factored into our exchange rate forecast.

Budget deficits will grow in the next few years, but they will not compromise the sustainability of public-sector accounts

We forecast budget deficits of around 1.3% of GDP for both this year and the following years. Thus, the result of the Peruvian public-sector accounts will deteriorate against previous years. On average, this is approximately one percentage point higher than the forecasts published in our last report.

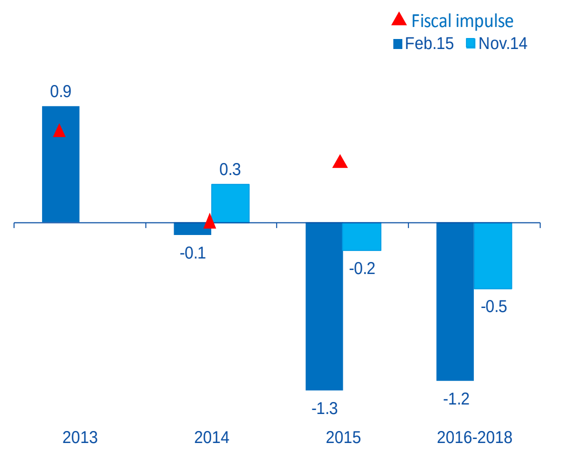
One of the main reasons for the increase in the budget deficit in 2015 is a permanent fall in tax revenues. This reflects the raft of measures announced at the end of last year to drive economic activity in the short and medium term, including cuts in personal income and business income tax rates, accelerated depreciation and the modifications made to general sales tax legislation applicable to remunerations, deductions and withholdings. We estimate that tax revenues will decline permanently by about 0.7pp of GDP as a consequence of these measures. The greater projected budget deficit also factors in an acceleration in public investment to finance the list of projects that the government has prioritised in accordance with their social impact, the infrastructure concessions that have been granted over the last two years and more budget resources allocated to the education and health sectors.

Consequently, the fiscal drive will be greater this year (see Figure 3.20), providing support for the cyclical recovery of the economy. According to our calculations, however, this implies that the structural budget deficit will be more than 1% of GDP for at least this year and the next few. This means that consideration will have to be given to how this deficit can be cut in 2016 as the law prevents the government from programming spending that would lead the structural budget result to exceed 1% of GDP. A first option is to reduce the rate of public spending growth. In other words, future government budgets will have to expand at a slower rate than in previous years (an average of 10% in the last five years). The question is whether this option is the best one given the deficits in infrastructure, law and order, public education and the quality of the public administration, for example, which constrain greater advances in the productivity and competitiveness of the Peruvian economy. A second option is to relax the rules and raise the structural deficit ceiling. According to our calculations, if the structural deficit were 1.5% of GDP, gross public-sector debt could stabilise at around 20% of output, which is only slightly higher than the current figure. This way, the government could maintain a slightly higher growth rate for spending, but care would have to be taken not to affect the country's credit rating. A third option would be to raise the tax burden with higher indirect taxes, but we do not believe this to be the best option as these are already high (the general sales tax rate, for instance) and an additional hike would work against the objective of formalising the economy.

It should be pointed out that despite the deterioration in the budget results forecast for this year and the next few years, the gross public-sector debt/GDP ratio is expected to be between 19% and 20% (see Figure 3.21), which does not affect the sustainability of public finances and compares well with the average of countries with a similar sovereign credit rating (44% of GDP for BBB+ countries, which is the S&P rating for Peru, and 60% of GDP BBB+ countries, which is the Fitch rating for Peru[5]), but these are somewhat higher than our forecasts from three months ago (before the tax cuts and other measures that drive revenues down, which were announced at the end of 2014).

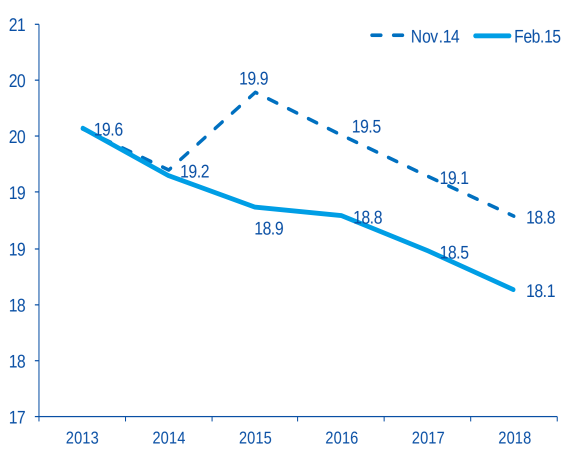
[5] The long-term sovereign debt rating in foreign currency is considered.

Figure 3.20
Fiscal result and fiscal drive (% of GDP)



Source: Central Bank, SUNAT and BBVA Research.

Figure 3.21
Gross public-sector debt (% of GDP)



Source: Central Bank, SUNAT and BBVA Research.

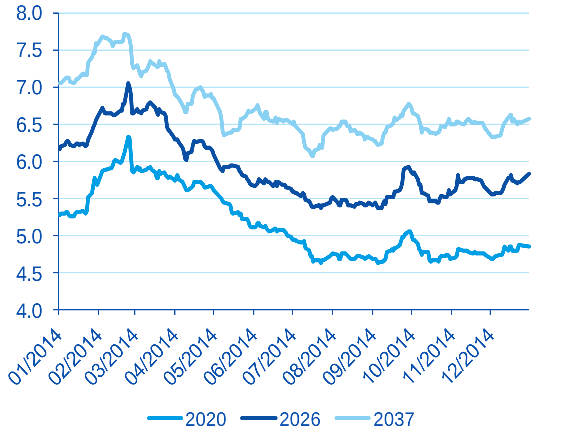
4 Local financial markets: turbulence continues, associated with the uncertainty around when the Fed will start to make adjustments

Sovereign bond yield falls

The yield on Peruvian sovereign bonds continued to fall in the last quarter of the year, by over 100 basis points in the case of the 2020 and 2037 bonds (187bp and 191bp respectively) and to a lesser extent in the case of the 2026 bond, which fell by 61bp. These results helped to prolong the fall in sovereign bond yields observed throughout the year, bringing it down to around 400bp below the close of last year (see Figure 4.1). This decline has halted in the last two months of the year, and there has even been an increase in the yield of some paper.

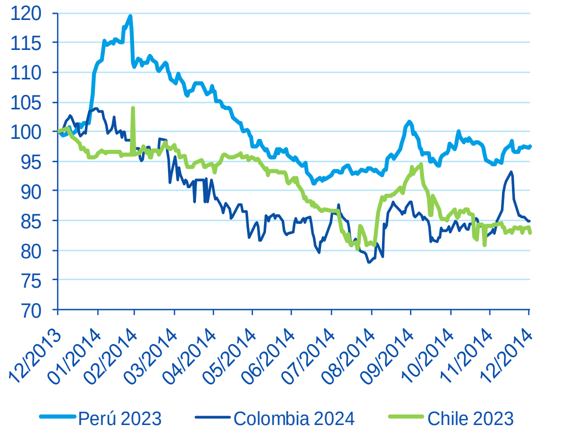
Sovereign bonds have performed in a similar fashion to the local market in the other countries of the region, such as Colombia and Chile (see Figure 4.2). The turbulence seen since September reflects the uncertainty about the recovery of the US economy and about when the Fed will start to discontinue quantitative easing.

Figure 4.1
Peruvian sovereign bond yields



Source: Bloomberg

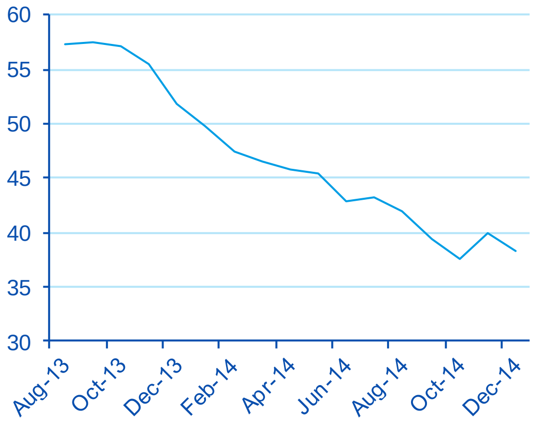
Figure 4.2
Sovereign bond yields



Source: Bloomberg

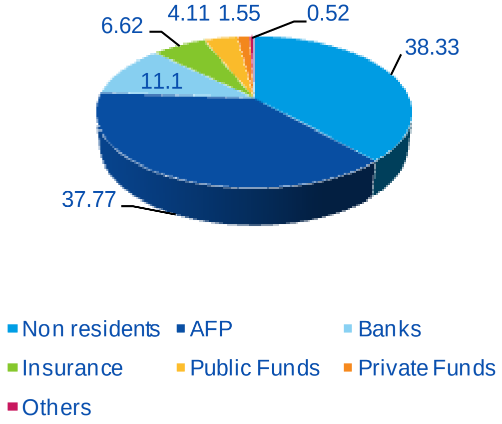
It is worth mentioning that the trend among sovereign bonds in the hands of non-residents continued to fall throughout the year (see Figure 4.3), falling from over half in 2013 (57% in August 2013) to 38.3% at year-end 2014. Local institutional investors such as pension funds and banks have increased their share in the sovereign bond market to 37.8% and 11.1% respectively (see Figure 4.4).

Figure 4.3
Trend of sovereign bonds in non-resident hands (%)



Source: Bloomberg

Figure 4.4
Sovereign bond trend



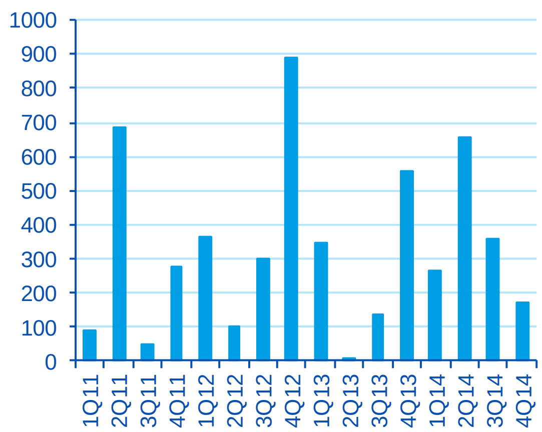
Source: Bloomberg

Corporate bond issues fell in the last quarter of the year

The last quarter of the year saw issues in dollars to the amount of USD38.5mn and issues in soles amounting to PEN643.7mn. Non-financial companies accounted for 23% of these operations (see Figure 4.5). The largest issue was the Alicorp three-year bond issued in December, amounting to PEN116m at 4.97%. Financing through the debt market came to a total of USD148mn and PEN2.893bn with these transactions, about 32% down against last year (issues in dollars fell 79.3% while issues in local currency rose 5.0%). The slow-down in corporate debt issues took place against a backdrop of slowing GDP with lower investment funding needs.

Issues in the international market totalled USD1.129bn in October-December 2014, down 23.5% against the previous quarter. The largest operation was made by Unión Andina de Cemento, which raised USD625mn over seven years at an interest rate of 5.9%. Maturity terms reached 20 years with a coupon rate of 6.0% (see Table 4.1). These issues were made in a context of low interest rates on the international markets and the favourable view that the market has of the country.

Figure 4.5
Non-financial company bond issues (S/. mn)



Source: Central Bank

Table 4.1
Debt issues in the international market in 2014

Company	Amount (USD Million)	Term (years)	Rate
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%
InRetail Consumer	300	7	5.25%
Unión Andina de Cementos	625	7	5.88%
Energía eólica	204	20	6.00%

1/ Issue in Swiss Francs
2/ Issue in Nuevos Soles
3/ Issue in Nuevos Soles adjusted by inflation

Source: BCRP

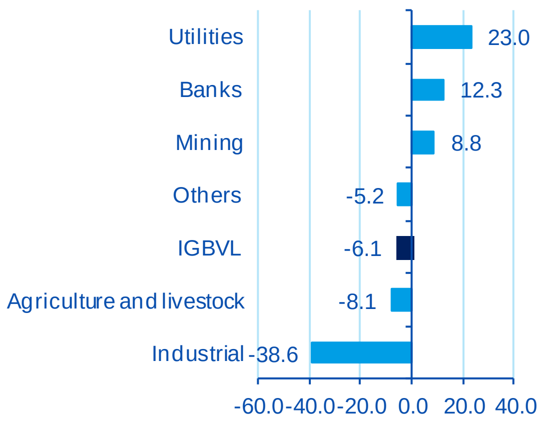
The Peruvian stock market closed 2014 down 6.0%

The General Lima Stock Exchange Index (IGBVL from the Spanish) fell 8.8% in the first quarter of 2014, affected mainly by industrial shares, which were down 18%, and the mining sector (down 13%). In the case of mining, the good job figures published in December in the United States and the doubts about the Chinese economy boosted the price of the dollar and triggered falls in the price of gold (1.27% between the end of September and December 2014) and copper (5.74%). This year to date, the IGBVL has continued to slip, down 7.0% in January (see Figure 4.6).

Figure 4.6
General Index of the Lima Stock Exchange

Source: Bloomberg

Figure 4.7
Year-to-end yields in sectorial indexes in 2014 (%)



Source: BVL

The sectors that fell the most in 2014 were industry (-38.57%), with sharp falls in energy-sector shares such as Maple Energy and BPZ Energy, followed by Construction (Siderperu was down 39% in the year) and Food (Alicorp -21%). The agriculture sector also fell (by 8.1%) as did the miscellaneous sector (by 5.2%). The lines that reported the strongest gains were Services (+23%), Banks (+12.3%) and Mining (+8.8%), with

Edegel (+57%), Luz del Sur (+22%), Banco de Credito (+22%), Banco Continental (+9%), Rio Alto (+49%) and Minsur Inve (+95%) among the most liquid shares and the ones offering the best returns (see Figure 4.7).

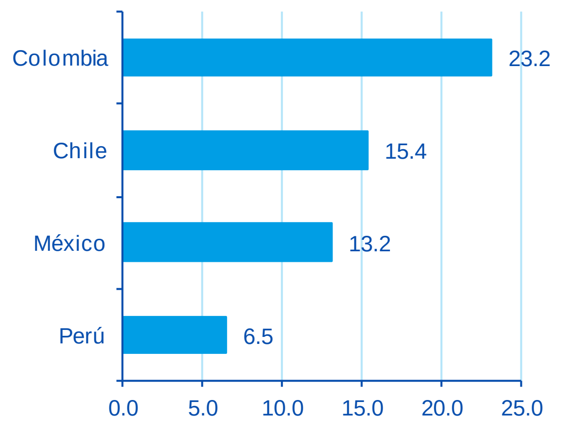
The Lima Stock Exchange and S&P Dow Jones Indexes announced a strategic alliance in December 2014 to calculate a new index for the Peruvian market: S&P/BVL Peru Select. This new instrument will measure the yield on the shares of the largest and most liquid companies, to make it easy to replicate and allows for new investment products to be developed, such as ETFs, indexed mutual funds, etc.

Exchange rate: a bullish trend in the coming months

The exchange rate rose 3.1% in the fourth quarter of the year, closing 2014 at PEN 2.98 to the dollar, 6.5% up on the close of the previous year. This can be explained by the stronger performance of the United States economy and the expectations of the withdrawal of quantitative easing there. The depreciation of the local currency was in line with other regional markets, although the variations were considerably smaller than those seen in countries such as Colombia, Chile and Mexico (see Figure 4.8), which exceeded 10%. The demand for dollars grew in the last quarter of the year, especially among non-residents (see Figure 4.9), driving the Peruvian central bank (BCRP) to sell dollars both spot and forward in the exchange market (the central bank sold more than USD2bn in the months September-December) (see Figure 4.10).

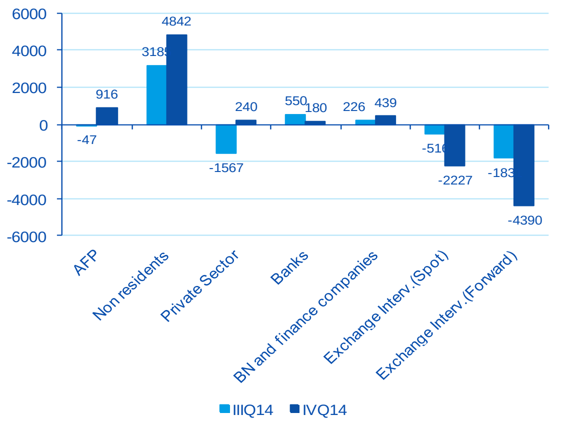
Against a backdrop of exchange rate pressures, which reduce the margin for easing monetary policy, the central bank announced new measures that will ring-fence daily and weekly operations in the forward market. First, the BCRP brought in additional provisions in local currency that will only be applied in the event that the daily and weekly operations with exchange derivatives exceed either 10% of the entity's equity or USD100mn (whichever is the greater) for daily operations, and 30% of equity or USD400mn for weekly operations. The BCRP also set out a limit on the balance of operations with exchange-traded derivatives for the banking sector. Local financial companies that exceed the ceilings set by the BCRP must also increase their provisions in local currency. Hence, the central bank seeks to limit the excessive volatility in the exchange rate that can be triggered by a large volume of transactions with exchange-traded derivatives, particularly by non-residents. If these measures are successful, they will allow greater independence of monetary policy with respect to exchange rate considerations, thus gaining greater exchange rate flotation which will help to absorb external shocks.

Figure 4.8
Variation in exchange rate during 2014



Source: Bloomberg

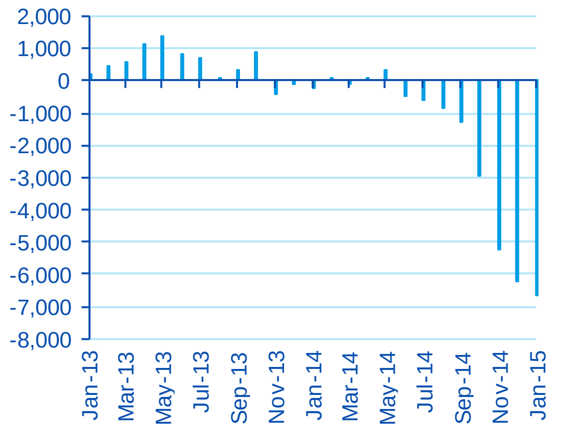
Figure 4.9
Spot and forward exchange rate market flows (USD mn)



Source: Central Bank

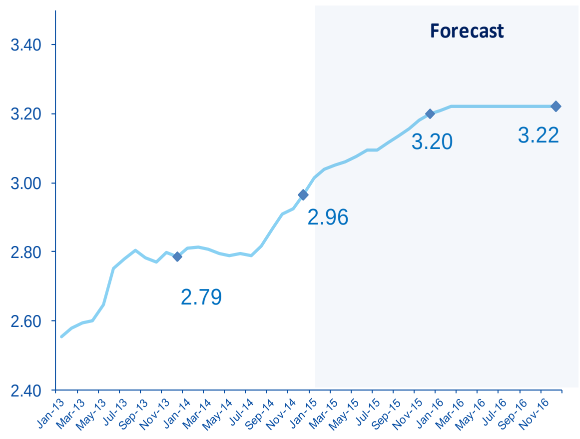
Pressure continued on the local currency in January 2015, particularly in the second half of the month. The PEN lost around 3% of its value during this period. Several factors will continue to push the exchange rate up in the coming months: i) deteriorating fundamentals (fall in trade terms, high deficit on the current account, less sound budget and less economic growth); ii) smaller influxes of long-term capital, particularly due to lower FDI (mainly the mining sector), and iii) the divergence between Peruvian and US monetary policies, the former introducing greater flexibility and the latter an adjustment that will strengthen the dollar world-wide. Against this backdrop, our exchange-rate forecasts are PEN 3.20 and 3.22 to the dollar by the end of 2015 and 2016 (see Figure 4.10), respectively, helping to reduce the overseas deficit in the next few years. The transition to a higher exchange rate will be a gradual one, because the central bank will dampen the path with its interventions. However, we consider greater exchange rate flexibility to be desirable as a mechanism to absorb external shocks and correct the deficit on the current account.

Figure 4.10
Forward balance of banks in foreign currency



Source: Central Bank

Figure 4.11
Exchange rate (S/. / USD)



Source: Central Bank, BBVA

Box 2. An equilibrium exchange rate estimate pursuant to the external sustainability approach

There are several approaches to estimating the real equilibrium exchange rate (REER). The external sustainability approach is comprised of three steps: i) determine the current account/GDP ratio that stabilises Long Term External Liabilities (LTEL) at the desired, or benchmark, level (this ratio is known as the norm); ii) estimation of the structural (or underlying) current account, which takes the short-term factors out of the observed current account, and iii) appraisal of the necessary adjustment to the RER to close the gap between the current account norm and its structural level. The REER is the final RER, once this adjustment has been made.

Pursuant to the IMF (2006)[6], the current account ratio (norm) that stabilises the LTELs is calculated as follows:

$$cc^{n} = \frac{g_{t} + \pi_{t}}{(1+g_{t})(1+\pi_{t})} b \qquad (1)$$

Where g_t is the real GDP rate, π_t is the inflation rate and b is the level of LTEL that the government wants to stabilise.

To estimate the structural current account, we follow Artiaga et al (2011)[7]. The underlying current account is built from the long-term relation (equation 2). To this end, you take the estimated parameters and replace the observed values of the explanatory variables with the trends of these same variables (the Hodrick-Prescott or HP filter was used to get the trend).

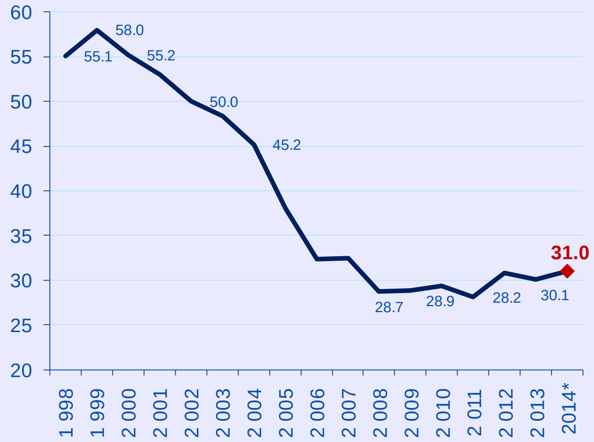
$$ccs = c + a_{1} ltcr_{t} + a_{2} ltot - a_{3} lpbi_{t} + a_{4} pbis_{t} \qquad (2)$$

Where: $ltcr_t$ is the log of the real exchange rate, $ltot_t$ is the log of the terms of trade, $lpbi_t$ the log of domestic GDP and $lpbis_t$ the log of world GDP.

Estimation of the standard current account and the structural current account

This exercise considers that the current account that allows for LTEL stability at its current level (around 30% of GDP) is -2.1% of GDP (standard)[8].

Figure B.2.1 Long-Term External Liabilities (% of GDP)



*To 3Q.
Source: BBVA Research.

The underlying current account, in turn, is calculated with equation (2), where we find the following[9]:

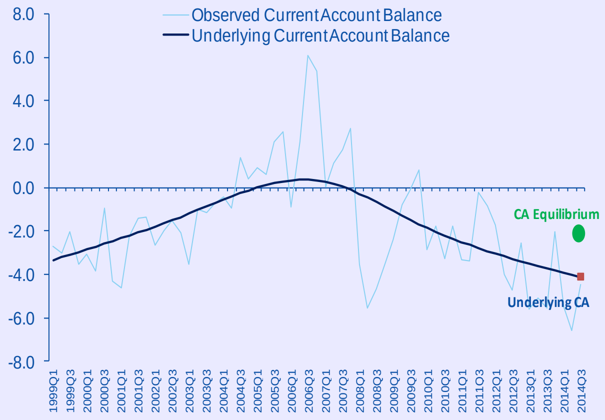
$$ccs = -1.59 + 0.13 ltcr_{t} + 0.05 ltot - 0.18 lpbi_{t} + 0.34 pbis_{t} \qquad (3)$$

It is important to point out that the estimate has been made by adjusting the deficit on the current account for the one-off revenues from asset transfers that generated capital gains and by the 0.7% of GDP increase in exports from gold smuggling (see section 3, current account).

6 Methodology for CGER Exchange Rate Assessments IMF (2006).
7 Normas de la Cuenta Corriente y Tasa de Cambio Real de Equilibrio en Colombia. Artiaga Carolina, Luna Roderick and Ojeda Jair. Central Bank of Colombia (2011).

8 Consideration is given to the potential growth of the economy, around 5%, and forecast inflation for the next four years).
9 All the variables have a single root. Moreover, there is evidence of a co-integration vector and the co-efficient of the co-integration vector, which are significant.

Figure B.2.2 Balance of Payments Current Account (% of GDP)



Source: BBVA Research.

Figure B.2.1 shows that the structural current account is around 4% of GDP in Q3, below the observed result, but above the long term level (2.1% of GDP that stabilises external liabilities.

Estimating REER

REER is defined as the RER that ensures that the structural current account corrects to its normal level. It is assumed that the adjustment will be made through movements in the real exchange rate.

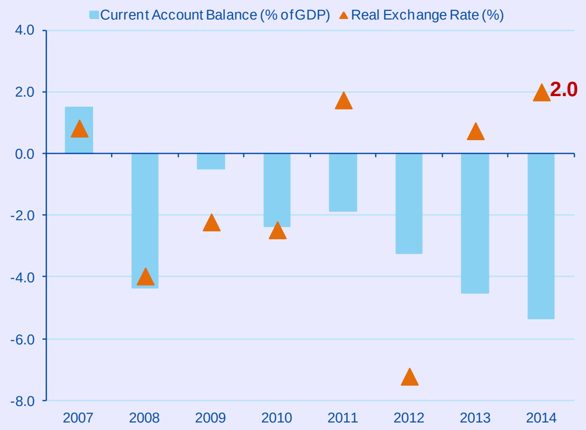
This requires an elasticity that relates the current account with the RER. This elasticity can be found in equation (3), by taking the value 0.14. Hence, a real depreciation of 10% improves the result of the current account by 1.3pp of GDP. In the same way, a 7.6% increase in the real exchange rate is required to improve the current account by 1pp of GDP. Thus, the adjustment of the RER that allows an adjustment of the current account and underlying norm is calculated as follows:

$$\Delta tcre_t = 7.6(cc^n - ccs_t)$$

A 14.3%[10] depreciation would have been required in 3Q14 for the real exchange rate to have reached its equilibrium. If this had been done solely through movements in the nominal exchange rate, the Peruvian sol would have had an exchange rate of around 3.22 to the USD in 3Q14 and this would have brought the underlying current account to its sustainable level.

It is important to point out that this is an exercise that acts as a reference as to whether the RER is out of balance. The results obtained in this exercise are consistent with the current pressures on the exchange rate, and they indicate that the deficit on the current account of around 5% of GDP is high. Thus the currency needs to be weakened, which, in the short term, will make non-traditional exports more competitive (a group that only accounts for 30% of total exports).

Figure B.2.3 Peru: Current Account of the Balance of Payments and the Real Exchange Rate

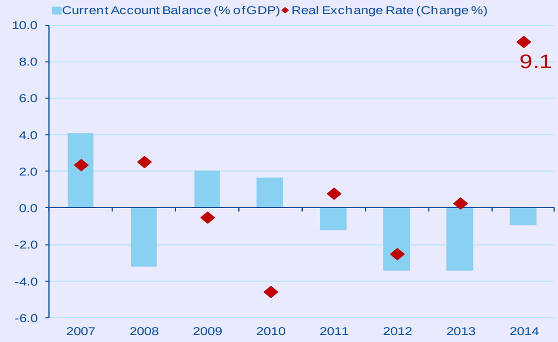


Source: BBVA Research.

Finally, it is striking that the deficit on the Peruvian current account was so high in 2014, given the weak growth that year (see Figure B23). One explanation is the fact that the currency is over-valued (currently by around 4% against the current value). The story is different in Chile, where the greater depreciation of the currency has been accompanied by a narrowing of the overseas deficit (see Figure B.2.4).

[10] The underlying current account is estimated to have been 4.0% of GDP in 3Q14.

Figure B.2.4 Chile: Current Account of the Balance of Payments and the Real Exchange Rate



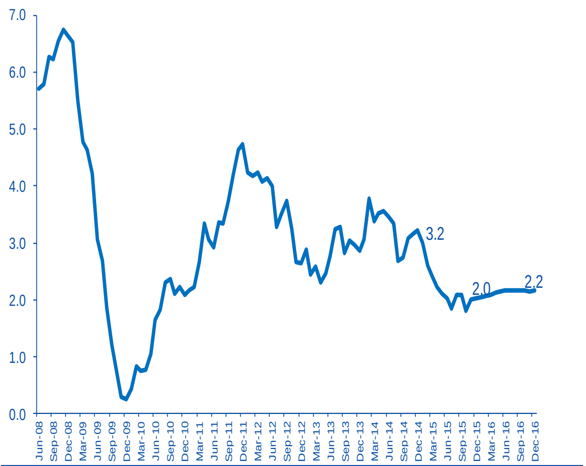
Source: BBVA Research.

5 Inflation: converging towards the centre of the target range in the coming months

YoY inflation closed 2014 3.2% above the ceiling of the target range (2%, +/- 1 percentage point). We forecast a falling trend for 2015 (see Figure 5.1) to around 2.0% towards the end of the year, due to:

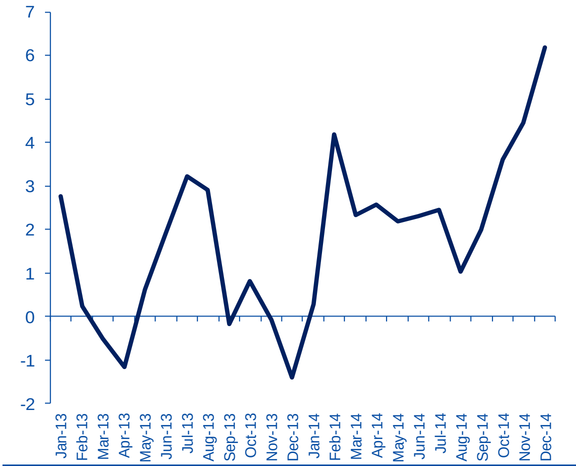
- **Normalisation of food price rises**. There has been a sustained increase in the prices of this category, which includes fruit, vegetables and meat, for example, since the middle of last year (see Figure 5.2), with a significant impact on inflation due to the weight it has (15%) on the consumer price index. This took place in a context in which weather factors affected the supply of some of these foodstuffs. We forecast that the rate of increase of these prices will slow, coming more in line with the average price rises over the last three years. More normal weather conditions and the low chance of fruit and vegetable prices, for example, increasing significantly for two or three years in a row, support this forecast according to empirical evidence.

Figure 5.1
Inflation
(%, YoY)



Source: Central Bank and BBVA Research

Figure 5.2
Non-underlying food inflation
(%, YoY)

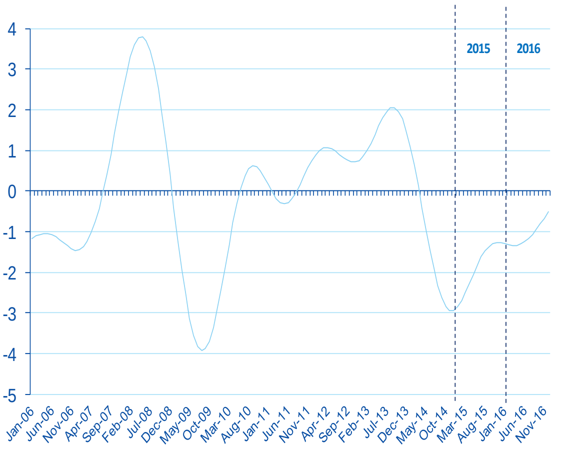


Source: Central Bank and BBVA Research

- **Sharp fall in international oil prices**, which should translate into lower local fuel prices. The impact of lower oil prices on inflation is 0.3-0.4pp.

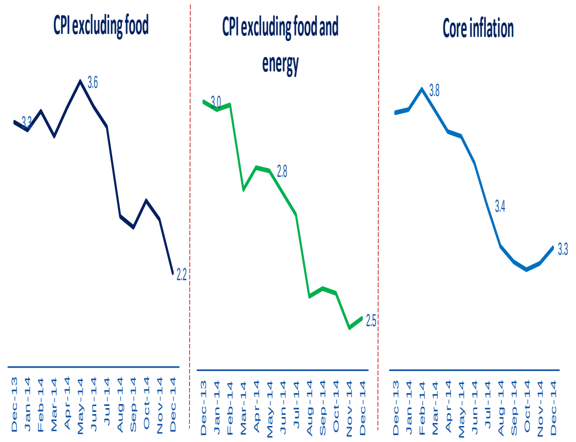
- **Absence of demand pressure**. We believe that the product divide will remain negative during the year, closing only gradually (observed GDP at year-end 2014 was just over 2% below our estimate of potential GDP, a difference that is comparable with the 2009 slow-down) (see Figure 5.3). In this context, we anticipate limited demand pressures. It is worth adding that several inflation indicators (inflation without food, inflation without food or fuel and underlying inflation) have been falling since June, with monthly increases that are more in line with the BCRP inflation target (see Figure 5.4).

Figure 5.3
**Product Gap
(% of potential GDP)**



Source: Central Bank and BBVA Research

Figure 5.4
**Measures of inflationary trend
(%, Y0Y)**



Source: Central Bank and BBVA Research

The aforementioned factors will be partially off-set by: i) the increase in the exchange rate and the effect this has on the price of tradable goods and those priced in dollars, and ii) the inertia of inflation expectations that are at the upper end of the target range (2.5-3.0%).

6 The central bank eases monetary policy

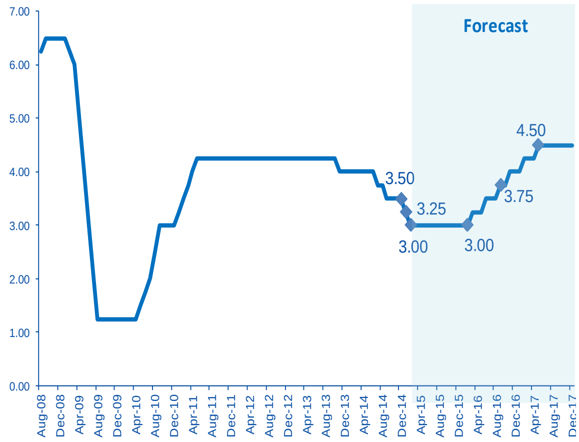
But the additional flexibility has been limited, considering the intensity of the slow-down in production, which is greater than expected

Despite the sharp cyclical weakening of output that we saw last year, particularly in private-sector spending, the central bank responded with an accumulated cut in the benchmark interest rate of just 50 basis points in 2014. The limited easing of monetary policy was due to a macro-economic context that left little room for a more aggressive move. Firstly, inflation remained persistently above the target range, above all underlying inflation. Second, the turbulent international situation, reflecting uncertainty about when the Fed would start to raise interest rates and by how much, put downside pressure on the local currency, which may eventually have real negative impacts on companies and families with currency mismatches on their books. And third, a more aggressive cut in the benchmark interest rate would have amplified the deficit on the current account of the balance of payments, large enough as it is, which could then have run into problems finding financing on turbulent international markets (and feeding exchange rate pressure even further). Apart from the macro-economic factors, there is also the fact that the inter-bank interest rate in local currency was above the reference level in three of the last four months of last year (e.g. 20bp in September and up to 30bp in December), so an additional easing of monetary policy would have been somewhat complicated to implement in practice.

It became clear at the beginning of the year, however, that the expected recovery in output in 4Q14 had not occurred. On the contrary, the published November growth figures were disappointing in the opinion of the market (the lowest of the year, at almost zero) and the first economic activity indicators for December did not show any significant improvement. Furthermore, the sharp fall in international oil prices and the expectation that this would later trickle down to local fuel prices led to forecasts of a more benign inflationary panorama in the coming months. Finally, exchange rate pressures receded for a few days and the inter-bank interest rate came in line with the benchmark. Against this backdrop, the central bank cut interest rates by another 25bp in mid-January.

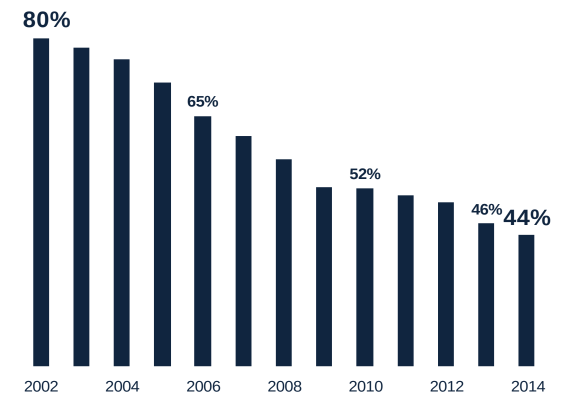
Looking forward, we believe that monetary policy will remain expansive in the short term. The year will start with a growth rate that still shows signs of weakness, not only aggregate growth, but also private-sector spending indicators. Hence we forecast that output will not expand at more than 3% on average in the first three months of 2015. Although this is higher than in 4Q14 (1.1% in our estimate), it will remain well below its potential. On the other hand, inflation will return to the central bank's target range in February and will continue to fall in the following months, which will provide more room for an eventual additional cut in interest rates. For this reason, we cannot rule out some easing in monetary policy in the short term, but in our opinion the decision will depend very much on the information that emerges, and particularly on any turbulences there may be in the exchange rate in the days leading up to the central bank's monetary policy meetings.

Figure 6.1
Benchmark interest rate
(%)



Source: BCRP, BBVA Research

Figure 6.2
Dollarization of issues (issues denominated in USD as % of the total)



Source: Asbanc, BBVA Research

In 2016, interest rates will start to become more neutral according to our forecasts, enabling the government to keep inflation in the target range against a backdrop of more robust economic growth and recovering oil prices. Thus, the economy will be more in tune with our expectations for the Fed rate, which will ring-fence the downward pressure on the value of the local currency.

De-dollarisation measures: in line with the objective of reducing financial vulnerability, but its impacts must be followed closely to prevent frictions

The central bank established additional reserve requirements in dollars at the end of last year, seeking to drive a faster reduction in loans denominated in dollars (dollarisation) (see Figure 6.2), which remain high in some segments of the market and consequently make the Peruvian economy vulnerable in the event of a significant depreciation of the local currency. One of the additional provision measures that have been announced establishes targets for reducing the total balance of loans in foreign currency, excluding overseas trade transactions and those agreed on in 2015 for a term of more than four years and for more than USD10mn. These reductions will be assessed in June and December. There will be additional provisions applied to banks that fail to comply.

Specifically, the measure is aimed at banks that have a balance on their dollar loan book that exceeds their effective equity at the end of 2014. Considering that, in aggregate terms, the effective equity of the banking sector is around 20% of total placements, we in BBVA Research understand that this is the degree of dollarisation that the central bank would consider prudent for loans granted by a bank. This figure coincides with the share that productive sectors most oriented to meeting external demand have of GDP, and also with the declarations made in the press by the governor of the BCRP.

For example, if a bank does not manage to cut back its loans in foreign currency by at least 5% of their September 2013 balance by June, then it will be made to set aside the additional provisions. And if it does not reduce it by 10% by December, it will also be ordered to set aside these provisions. The measures also include specific requirements for the dollar loan book aimed at financing vehicles and houses, which are more restrictive than for the total balance.

Banks that have a dollar loan book balance of less than their effective equity (this is usually the case of new banks coming into the market) are not obliged to cut back their loans in this currency. They only have to ensure that the balance of these loans does not exceed their effective equity at any time because, otherwise, they too would be subject to the additional provisions. In other words, these banks are assigned a ceiling to their dollar placements, rather than a target to cut them back to.

We believe that these measures are well-thought out as they seek to ring-fence one of the main weaknesses of the Peruvian economy. However, we do have doubts about how they are trying to do this. First, frictions could be generated in the process. We calculate that loan placements in dollars will have to fall by around USD1.7bn by June. This is an appreciable sum. We estimate that the banking sector will have to meet the demand for loans in the future solely with loans in soles and they will have to avoid renewing the maturities of dollar loans in dollars, if they are to meet the target. But it will also be necessary to de-dollarise some loans that have already been granted, which implies negotiating with the customers. Some of these are probably willing to change currency because of the depreciation pressure on the sol (which will affect them adversely if they generate revenues in local currency), but others may not. Second, the highest rate of dollarisation is found among loans to companies. Some loans in dollars granted to the larger companies may have to be de-dollarised (those that mature, for example). But, unlike people or smaller companies, the larger companies find it easier to access direct credit from overseas banks and thus they could evade this measure if they wish to continue financing their businesses in foreign currency and not in soles. In this case, the measure will not meet the objective of reducing that Company's exchange rate vulnerability exposure. Moreover, the BCRP will lose visibility of capital influxes, which is important for managing economic policy as these operations are not reported to them because they do not pass through the local financial system. Finally, there is no information about what the central bank plans to demand after December 2015 (the measure will not have cut back dollarisation to 20% by that time), making planning more difficult for the banking sector. On balance, our appraisal is positive, but it will have to closely monitored to prevent possible frictions or evasion, and it will be advisable for the central bank to publish the actions that it will take from next year, based on what happens at the June milestone.

Box 3. Dollarization in Peru: causes and attempts to reduce it

Dollarization is one of the weaknesses of the Peruvian economy that is often highlighted. The preference for deposits or loans denominated in dollars could cause the country problems.

One of the complications is the "currency mismatch", something that occurs when families or companies contract debts in dollars, but earn their income in soles. In this case, when the exchange rate rises significantly, the effort required to meet the payments on the loan also increases. Eventually, the number of defaults can increase substantially, inhibiting the banks' capacity to lend as it is difficult to identify good loans. This situation leads to a credit squeeze, which has an adverse effect on private-sector consumption and investment, leading eventually to an economic slow-down, or even a recession. One example of how the currency mismatch can have a severe effect on an economy occurred in Peru in the late-90s. "Contagion" from Asian and Russian crises spread to several emerging economies between August 1998 and December 1999 in the form of a depreciation of the Peruvian currency by nearly 20%. The dollarization of loans in Peru exceeded 70% at the time. Against this backdrop, the combination of a large currency mismatch and a sudden depreciation stressed the banks' balances (another factor was the El Niño phenomenon that affected the extractive sectors of the economy). In some cases, this process led several banks to bankruptcy. As a result, the Peruvian economy went into severe recession, possibly the worst since the late 1980s.

Another problem triggered by dollarization is that it constrains monetary policy. For example, it reduces its ability to stabilise aggregate demand, as part of private-sector spending is made in a currency that is beyond the control of the central bank. Furthermore, the central banks of partially dollarized economies have a "greater fear of letting the exchange rate float", due to the pernicious effects that currency mismatch can trigger, so monetary policy decisions can be conditional on pressures on this variable.

Dollarization occurs in countries that have experienced episodes of high inflation. In this situation, the purchasing power of the local currency is quickly eroded, so people look for alternatives to defend the real value of their income or equity. One way of doing this is by taking refuge in a "hard" currency. This is what happened in Peru in the 1980s. That is why inflation control was fundamental to regain the confidence of families and companies in the Peruvian currency and also to start reducing dollarization. After several years of very low inflation rates (generally, below 3.0% since 1999) dollarization has fallen slightly, to approximately 40% of total loans. However, although it has been a significant reduction, dollarization remains high for an economy that has managed to consolidate price stability and in which the tradable sector may account for only approximately 20% of the economy.

In order to accelerate the de-dollarization process, the central bank of Peru has recently implemented an additional provision requirement applicable to banks that do not meet a reduction target for their dollar loan book balance (see details in section 6 of this report). The measure hits dollarization on "the asset side" of bank balances (it inhibits placements in dollars) and, as it is aggressive (regulatory requirements for loans in foreign currency) and innovative, the monetary authorities will have to monitor its impacts closely to prevent it from generating frictions on financial intermediation. Measures are also needed on "the liability side", such that the general public (customers) realise the risk that using a foreign currency entails for the economy. Actions on this side are necessary to consolidate de-dollarization as, in the end, banks are intermediaries of the preferences of the public. Hence, discussions may be needed as to the possibility of the Deposit Insurance Fund providing different cover for deposits, depending on whether they are in dollars or soles, or raising the Financial Transaction Tax for operations made with accounts in foreign currency, apart from the measures that have already been rolled out in recent years, such as high provisioning requirements for deposits in dollars (which penalises their remuneration).

7 The balance of risks on our growth forecasts for Peru are biased to the downside

Internationally, the possibility of a more-pronounced slow-down in China and a hike in interest rates by the Fed, causing high stress in the local financial markets, would reduce growth prospects

A slower growth scenario in China could emerge if its financial fragility (high local government debt, bad loans granted by the informal parallel banking sector) is exacerbated. As for the Fed starting to raise interest rates, this could come sooner than expected and take people by surprise, and the adjustment could be more aggressive than initially anticipated if economic activity and labour market data in the US show a more robust performance or if there is a perceived risk of an asset bubble.

In the first scenario, the Peruvian economy would be affected by lower external demand, a fall in the price of the metals that Peru exports (which would have a negative impact on mining company profits and their re-investment, and on tax revenues), and a greater global aversion to risk which would weaken the influx of capital to the emerging countries. Furthermore, the fundamentals of the Peruvian economy would deteriorate. In the latter case, global aversion to risk would increase, and EMBIs would rise, as would financing costs. Moreover, there would be a fall in capital influxes to the emerging economies, particularly to those with a high deficit on the current account, which is the case of the Peruvian economy, and upside pressure on the exchange rate (depreciation of the local currency).

Other international risk factors that drive a downside bias to our growth forecasts for Peru concern the international geo-political situation (tensions between Ukraine and Russia and in the Middle East) and the outcome of the situation in Greece, where the newly-elected government is seeking new negotiations with its creditors. In general, if these factors deteriorate, there would be an increase in global aversion to risk, which would have an adverse effect on emerging economies such as Peru's.

Locally, the main risk factor is still the possibility of weakening business confidence, which would extend the period of slow growth

Business confidence recovered slightly in the last quarter of last year (on average, it grew from 51.3 in Q3 to 53.7). But the improvement could be fragile for two reasons. First, continuing disappointing data on economic activity could create doubts about the potential for sales growth, which would lead to greater caution in companies' capital spending. Moreover, the rising tone of politics that has been observed could increase business uncertainty, particularly if some of the government proposals that could help to improve the business climate are blocked in the end. Against this backdrop, private-sector investment spending would fall, which would affect job creation and family consumption, and consequently the cyclical recovery of the economy would be slower.

A growing risk factor: greater recovery of the mining sector

We have been conservative about the recovery of the mining sector in our 2015 GDP growth forecasts. For example, we have assumed that the Toromocho Project will produce 146,000 metric tons (MT) of copper this year in our base-line scenario, slightly below its estimated full capacity (around 276,000 MT). It is worth pointing out that monthly production of this mine was nearly 9,000 MT in the last quarter of last year, so average monthly output has to reach slightly over 12,000 MT to meet our forecasts for 2015 and to reach its maximum capacity of 23,000 MT. Hence, a monthly output that is starting to exceed 12,000 MT would put an upside bias to our projected growth for the year. If it reached its maximum output capacity, we estimate that the direct impact (without considering the positive effect on other sectors such as Primary Manufacturing) would raise growth by around 0.4pp.

To close, assessing the probability and magnitude that we assign to the up and downside risk factors described above has led us to consider a downside bias in our growth forecasts for Peru on balance.

8 Tables

Table 8.1
Annual Macroeconomic Forecasts

	2013	2014	2015f	2016f
GDP (%,YoY)	5.8	2.4	4.8	5.6
Inflation (%,YoY, eop)	2.9	3.2	2.0	2.2
Exchange rate (vs. USD, eop)	2.79	2.96	3.20	3.22
Monetary policy rate (%,eop)	4.00	3.50	3.00	4.00
Private consumption (%, YoY)	5.3	4.3	4.6	4.8
Public consumption (%, YoY)	6.7	8.4	5.0	5.5
Investment (%, YoY)	7.6	-2.0	3.9	4.5
Fiscal balance (% of GDP)	0.9	-0.1	-1.3	-1.3
Current account (% of GDP)	-4.5	-5.4	-5.2	-4.7

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	4.4	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	3.5	2.80	4.00
3Q14	1.8	2.7	2.87	3.50
4Q14	1.1	3.2	2.96	3.50
1Q15	3.1	2.4	3.05	3.00
2Q15	4.1	2.0	3.10	3.00
3Q15	5.6	2.1	3.14	3.00
4Q15	6.1	2.0	3.20	3.00

Source: Central Bank and BBVA Research

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