BBVA | RESEARCH

Peru Economic Outlook

Second quarter 2015
Peru Unit

- World growth will be 3.5% in 2015 and 3.9% in 2016. The pick-up next year is thanks to the support from developed economies, which will record their best reading since 2010.
- For Peru, we forecast growth of 3.1% in 2015 and a brief acceleration in the next two years. Primary sectors and fiscal measures will underpin growth this year, but we will still see weakness in private spending, so the rebound in activity will be discreet.
- The exchange rate will continue to experience upside pressure in the coming months. Spates of currency volatility are expected, owing to uncertainty over the normalisation process which the Fed's policy rate will undergo.
- Inflation will stay at close to the upper bound of the target range in 2015 due to currency depreciation and the inertia imposed by the current level of inflation expectations. Cyclical weakness minimises the risks from any demand pressure.
- The central bank faces a complex macro scenario, which is marked by demand weakness, inflation that is nudging the upper limit of the target range and upward pressure on the exchange rate.
- The growth forecast has downward bias. Risks from the outside environment (Fed adjustment and sharper slowdown in China), household and business confidence at a low ebb, and a harsher "El Niño" weather phenomenon.

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Closing date: 1 May 2015

1 Summary

World growth will be 3.5% in 2015, 0.1pp above last year's rate, an improvement which will originate from the advanced economies. In the case of the United States in particular, the year began with activity at a low ebb, partly attributable to the unusual severity of the weather conditions as well the impact of the lower oil price on the energy sector and the stronger USD on exports. In spite of this, we expect GDP to pick up by 0.5pp this year to 2.9%, buoyed by the strength which the labour market is still showing, which should in turn boost family spending in the coming quarters and therefore economic activity too. In this context, we expect the Fed to begin hiking its policy rate in September and that subsequent rises will be gradual. On the emerging economy front the outlook is different. In China and Latam the economic slowdown has taken a firmer hold. Growth in China, in particular, has lost momentum due to the correction in the real estate market, domestic currency appreciation, and the effects of the local government fiscal consolidation, although the stimulus measures which the authorities have been implementing (and which are expected to continue) will help GDP to grow at 7.0% in 2015. Further ahead, the support from the advanced economies will mean even higher world GDP in 2016, of around 3.9%.

For Peru, we forecast that growth for economic activity will be 3.1% in 2015, with downside bias. The better performance by the Peruvian economy (+2.4% last year) will rely mainly on the rebound in the extractive industries, particularly fisheries and metal mining, following the supply problems they faced last year, and this will be reflected in greater exports. We also predict that there will be a better execution rate in public expenditure, especially in the second half of the year. Our forecast assumes that all of this will partly be offset by the impact of a decline in business confidence, which factors in the prolonged torpor suffered by GDP, the difficulty in implementing counter-cyclical policies, and the greater political ructions. In this situation not only will private investment edge forward timidly in 2015 but so too will job creation and, with it, family spending. The rally in economic activity will be modest this year.

In the next two years, the pace of activity growth will continue to pick up, underpinned by the coming on-stream of mining mega-projects such as the Las Bambas site and the Cerro Verde expansion undertaking, which will lift copper production by 80% compared to the level attained in 2014. GDP will thus advance by 4.6% in 2016 and closer to 6.0% in 2017. The gathering of speed will nonetheless only be short-lived, as little action has been taken to head off falling productivity and competitiveness nationwide, which means that the growth rate that Peru will be able to sustain in the medium term is more like 4.5% than the average pace of 6.0% seen over the last 10 years.

On the external accounts front, the current account deficit in the balance of payments will remain relatively high in 2015 and 2016. The deficit reached 4.0% of GDP in 2014 and there will be no substantial improvement in the next two years, despite the steady recovery of export volumes of metals and fish products, as well as of still unconvincing domestic demand. This is because of the sharp decline expected in the average terms of trade, which, for 2015-16 taken together, will be more than 11%. The net capital inflow in the financial account in the balance of payments will not be enough to finance the external imbalance, which is something that was already observed last year. Nor will the capital inflow directed at acquiring long-term assets in the private sector. This will put pressure on the local currency to depreciate and entail a further outflow of international reserves (even though these are fairly ample, which means that the reduction is manageable). This situation will nonetheless be only brief, as from 2Q16 we are expecting there to be more room for manoeuvre because of both the narrowing of the external deficit, which will arrive at a more tolerable level of 3.0% of GDP thanks to the mining upsurge, and the greater inflow of long-term capital associated with the funding of infrastructure projects granted under concession in the last two years.

On the other hand, the fiscal deficit will stand at around 1.5% of GDP in the coming years, which is a level that does not compromise the sustainability of the public finances. This forecast factors in items such as, for example, the permanent cut in income tax rates for businesses and families, as well as the higher level of investment expenditure to fund the major infrastructure projects for which construction work is due to begin this year. Consequently, the gross public debt balance will have a gently falling trend in terms of GDP, subsiding to a little under 19% towards the end of the present decade.

In the FX market, downward pressure on the value of the local currency continues and is unlikely to remit over the rest of the year. The expected depreciation originates from uncertainty over the timing of the start of the cycle of Fed policy rate hikes and the speed at which the adjustment will be implemented. On top of this there is the external deficit, which will remain relatively high this year and the capital inflow will not be enough to cover it. We forecast that towards the close of this year the dollar exchange rate should stand at around PEN 3.25. It should be noted that the transition towards a higher exchange rate will be relatively gradual since the central bank will continue to smooth out movements in this variable using exchange rate intervention. We nonetheless think that greater exchange rate flexibility would be desirable as a means to soak up external shocks and correct the current account deficit.

Turning to prices, these will climb in 2015 at a pace approaching the ceiling of the target range. Inflation currently stands at 3.0% and our forecast assumes that over the rest of the year it will fluctuate at around the ceiling level for the target range and close at 2.9%. Higher prices of locally produced foods (due to poor weather conditions), the depreciation of the domestic currency, the upward shift in the oil price, and the inertia imposed on the price formation process by the relatively high inflation expectations (around 3.0%) are behind this pattern. On the other hand, the cyclical weakness of the economy serves to minimise demand pressure on prices. In 2016, the downward correction of food prices and the negative GDP gap will cause inflation to ease to 2.5%, despite the fact that the global oil price will continue to rise.

The central bank faces a complicated macroeconomic scenario, in which private sector spending has weakened and there is substantial pressure on the local currency to depreciate. This gives rise to a dilemma, as the continual exchange rate intervention to mitigate the weakening of the PEN has been putting upward pressure on interest rates in the market, which works against spending. The concern over the exchange rate, which is reasonable given the still high dollarisation of businesses and families, places limits on the effectiveness of monetary policy. This does not leave much margin to act counter-cyclically, and, as the impending start of the Fed's rate hike cycle draws nearer, the window of opportunity for a cut in the local benchmark rate is closing. It will therefore be unlikely that we might see an aggressive monetary stimulus in the next few months, despite the cyclical output weakness and the difficulties which the public sector is experiencing in executing planned expenditure.

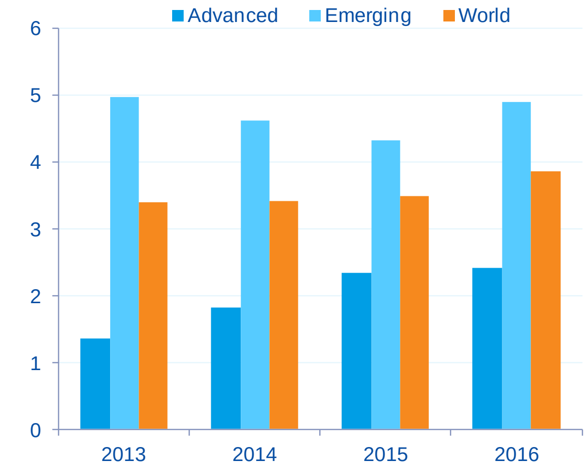
Finally, the balance of risk factors with regard to our growth forecast is biased on the downward side. The main scenarios which would lead to a negative impact on growth this year are those involving a hard landing for the Chinese economy, greater financial stress deriving from the beginning of the Fed's rate hike cycle, and a decline in business confidence which could be influenced by any continuation of disappointing growth figures or substantial political ructions.

2 World growth is suffering from the slowdown in the emerging economies

World growth came off the pace in 1Q15

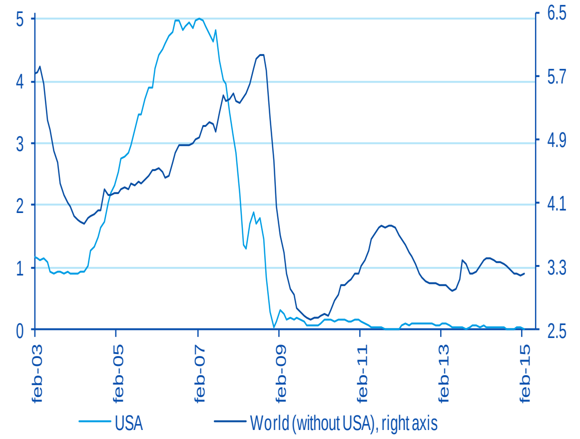
The slowdown in world growth in Q1 was produced by the slowdown in the US economy, less drive in the Chinese economy and the drop in activity in some of the most prominent emerging countries (such as Russia and Brazil). The consolidation of growth in the block of developed countries contrasts with the broad flagging trend among the emerging economies, which was more pronounced in Asia and Latin America than in Eastern Europe.

Figure 2.1
World GDP growth: 2015-16 forecasts (%)



Source: BBVA Research

Figure 2.2
Short term nominal interest rates (%)



Source: BBVA Research

We are therefore revising our world growth forecast for 2015 down to 3.5%, which is 0.1pp below the estimate from January and only 0.1pp above the figure for 2014 (see Figure 2.1). For 2016, world growth should show average growth of 3.9%, partly as a result of expansionary monetary policies in the developed countries, which ought to record their best rates since 2010. In a scenario of gradual trend deceleration in China, the emerging economies should reverse the current slowdown thanks to the pull effect from the developed economies, the gradual climb in commodity prices and a potentially more restrained rise of interest rates than in other historical episodes of Fed normalisation.

The progressive rise in commodity prices in line with our forecasts and the reinforcement of loose monetary policies worldwide have been two of the more prominent elements on the economic landscape in recent months. Central banks have in fact been more proactive, in both developed and emerging economies, and, even if the Fed decides on a strategy of gradual monetary tightening, the emerging economies have chosen to give priority to reactivating domestic demand by looking to cut interest rates (see Figure 2.2), in some cases at the cost of both taking on greater local currency volatility and discouraging inward and continued flows of foreign capital.

Despite this, and the fact that economic policies will continue to be accommodative, the downside risks for world growth persist. The biggest threats are the extent of the slowdown in China and the fallout from the start of Fed interest rate normalisation. The deflationary pressure associated with the drop in the oil price, geo-political tensions and the potential for failure by the ECB to relaunch inflation expectations in the eurozone are risks which, despite appearing less likely and to entail less of an impact than predicted some months ago, cannot be ruled out. Finally, a risk which remains latent is the lack of any agreement between the Greek government and the European institutions and the IMF over the refinancing of its debt.

Growth slowed down in the United States in Q1…

The United States has begun 2015 with a significant slowdown in its growth rate to an annualised quarterly rate of 0.2%, from an increase of 1% on average in the three preceding quarters. The unusual severity of the weather conditions accounts for some of this deceleration, to which one might add the oil price fall and its impact on the energy sector and the beginnings of the effect of the stronger USD on exports. Even so, the robustness which the labour market continues to exhibit should continue to sustain household incomes and private consumption. Annual US growth could therefore reach 2.9% in 2015 and stay at rates of around 3% in 2016 too.

The Fed's interpretation of whether the slower growth in Q1 was temporary or longer-lasting will define how it reacts from now on. The most likely outcome is that the first policy rate hike will take place in September 2015, followed by a gradual rise to no further than 1.5% by the end of 2016.

… as it did in China too

In China the economic slowdown has taken a firmer grip in the last few months, with growth for 1Q15 registering 7% YoY and featuring an adjustment in industrial production and investment, although there was a brighter relative showing from private consumption. The slowdown is attributable to the correction playing out in the real estate market, political uncertainty ahead of the National People's Congress in March, the decline in competitiveness caused by the worldwide appreciation of the CNY, and finally the effects of the fiscal consolidation of local authorities which began in 2014.

The structural character of the factors mentioned lends weight to the prediction that China will grow less in the medium term and experience greater volatility. The annual growth target of 7% for 2015 laid down by the Chinese authorities is based on the implementation of new stimulus measures, of both a monetary and a fiscal nature. Subsequently in 2016, growth will continue to adjust at 6.6%.

The eurozone showed the biggest recovery these past few months

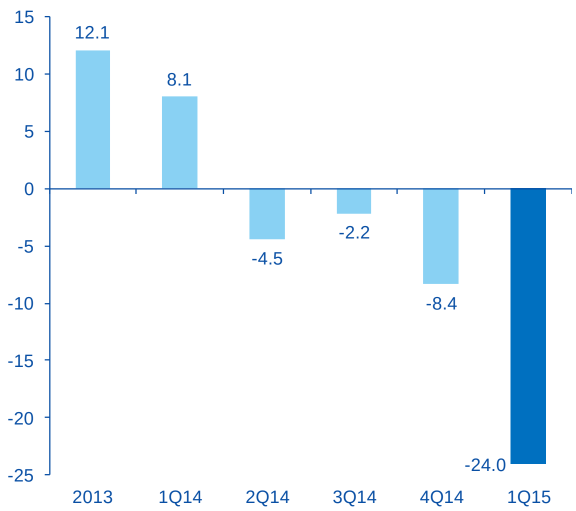
Of the developed economies, it was the eurozone which put in the best relative performance going into 2015. GDP could have grown at the highest pace since mid-2011, with Germany and Spain heading up growth in the area as a whole. The recovery has been driven by the better financing conditions and the euro's depreciation, both prompted by the ECB's quantitative easing programme, together with the drop in the oil price. The less restrictive fiscal policy and containment of the fall in nominal wages in the periphery countries are also helping to relaunch growth. This means that GDP should advance by 1.6% in 2015, which should rise to 2.2% in 2016.

3 Peru: we forecast growth of 3.1% for 2015 and a brief acceleration in the next two years

GDP began the year in lacklustre fashion. We estimate that Q1 growth was around 1.7%

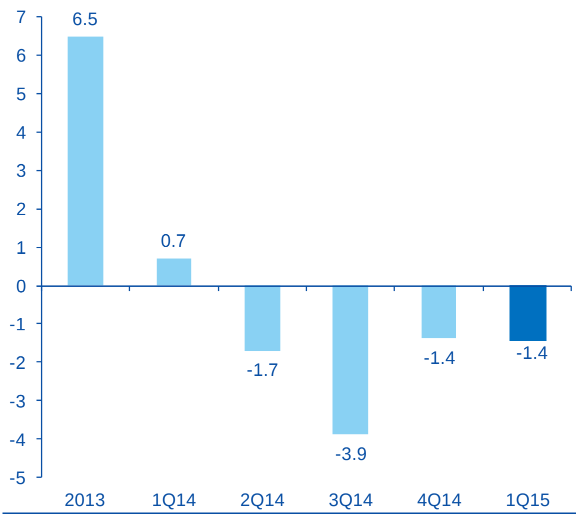
At the outset of the year, economic activity continued to perform weakly. On the expenditure side, this trend essentially reflected three factors. First, a sharp contraction of public investment, which we estimate is likely to have dropped back by around 25% (see Figure 3.1). In particular, there was a notable fall of approximately 50% in investment by local governments below the national level (regional and municipal authorities which are in charge of executing roughly 60% of total public sector investment), which was partly offset by the 19% rise in that made by the state administration (ministries and other arms of central government).

Figure 3.1
Public investment (% var. YoY)



Source: Central bank and BBVA Research

Figure 3.2
Private investment (% var. YoY)



Source: Central bank and BBVA Research

The spiritless showing by economic activity in Q1 was also associated with an additional fall in private sector investment (the fourth consecutive quarterly setback, see Figure 3.2). As of February or March, the indicators linked to investment (capital equipment imports, heavy goods vehicle (HGV) sales, construction work executed by the private sector etc.) were in negative territory (see Table 3.1). On the basis of this information, we forecast that private investment should have slipped back by 1.4% in Q1.

Table 3.1
Available activity and confidence indicators associated with private investment (% var. YoY)

Indicators	4Q14	1Q15	Lastest Available Data	
Capital goods import	-5.0	-7.2	5.6	Mar.
Freight car sales	-23.7	-13.5	-6.7	Mar.
Domestic consumption of cement	2.7	-1.5	1.1	Mar.
Business confidence	54	51	49	Mar.

Source: Central bank and BBVA Research

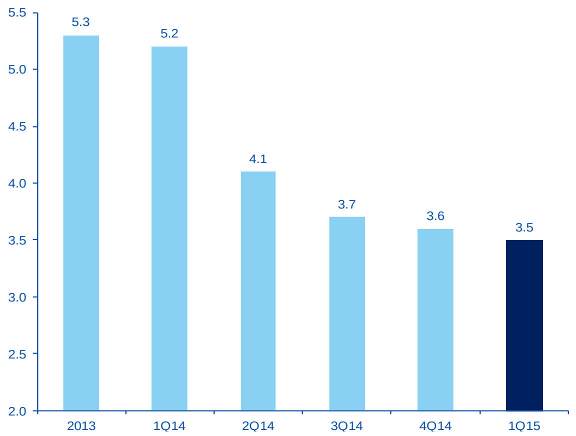
Table 3.2
Available activity and confidence indicators associated with private consumption (% var. YoY)

Indicators	4Q14	1Q15	Lastest Available Data	
Consumption goods import	1.5	1.6	0.1	Feb.
Family car sales	8.2	-0.9	0.6	Mar.
Dependent employment	3.6	3.1	2.7	Mar.
Consumer confidence	54	53	53	Mar.

Source: Central bank and BBVA Research

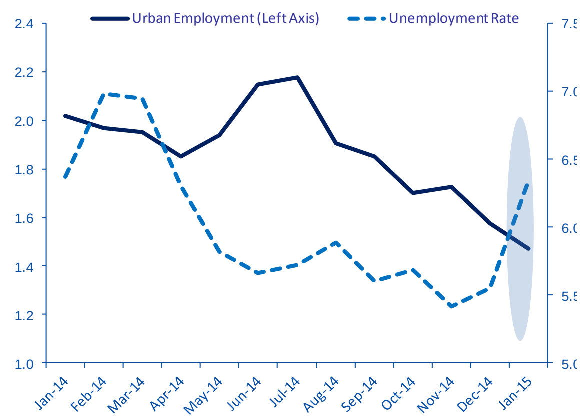
Finally, the slowdown in household consumption. According to our estimates, family spending is likely to have edged up by a discreet 3.5% in Q1, in a context of a more lethargic labour market in which there is noticeably slower creation of formal sector waged jobs and a rising unemployment rate (see Figures 3.3 and 3.4). In a way similar to the case of investment, the indicators which reveal patterns in family spending (family auto sales, consumer goods imports, wholesale and retail sales, etc.) show more modest performances (even falls) compared to a few months ago (see Table 3.2).

Figure 3.3
Private consumption (% var. YoY)



Source: Central bank and BBVA Research

Figure 3.4
National urban employment and unemployment rate in Metropolitan Lima (% var. YoY in the three-month moving average)

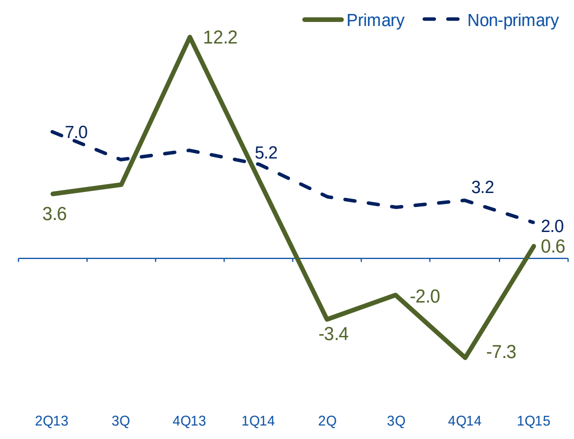


Source: Central bank and BBVA Research

In the sector analysis, we estimate that in Q1 primary GDP (which brings together the farming and livestock sector, mining and quarrying and fisheries, as well as the processing industry for the resources deriving from these activities) ought to have grown by 0.6 % (see Figure 3.5), after dropping back by 7.3% in the previous quarter, which suggests a relative improvement tied in with the positive result displayed by mining and quarrying (the first rise after four quarters).

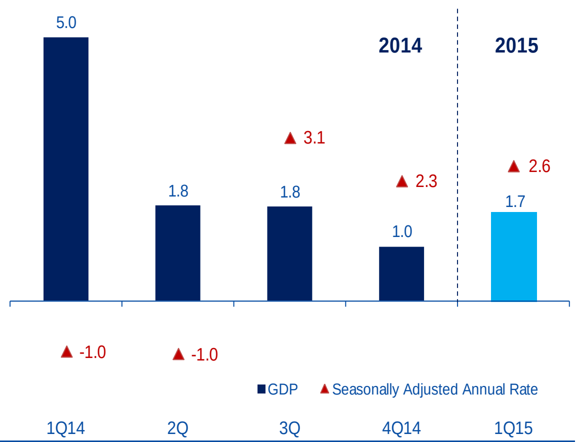
With regard to non-primary GDP (which includes those activities more associated with domestic demand, such as non-primary manufacturing, construction, electricity, wholesale and retail trade, and services), this lost steam in Q1, showing growth of close to 2.0% (3.2% in the previous quarter). Generally speaking, it can be seen that the non-primary GDP growth rate has revealed a mildly subsiding pattern in the past few months and is stagnating at a relatively low level (see Figure 3.6).

Figure 3.5
Primary and non-primary sector GDP (% var. YoY)



Source: Central bank and BBVA Research

Figure 3.6
GDP (% var. YoY)



Source: Central bank and BBVA Research

Two non-primary sectors which have probably been in retreat in Q1 are construction and non-primary manufacturing. The construction performance was hampered by the drop in public investment, although the slowdown in private projects also exerted a depressing effect on the sector (for example, the deceleration of real estate work due to a less buoyant market, the build-up of stocks of housing and more sluggish sales). On the non-primary manufacturing side, the contraction was linked to lower production of FMCG and intermediate goods. Finally, we should mention the slowdown in the services sectors (due to the deceleration in the transport, financial services and business services categories, which are activities that are related to private investment), as well as wholesale and retail trade (owing to an unrelenting fall in vehicle dealing and lower wholesale sales, although the growth rate in retail sales recovered slightly compared to the previous quarter).

As a result of all this, we estimate that first quarter GDP growth ought to have been around 1.7% (see Figure 3.6), which represents an improvement on the previous quarter (1.0%). We should, however, point out that according to our estimates seasonally-adjusted GDP growth (which enables comparison with the activity level in the previous quarter and thus determination of whether there has been any change in trend) held at around 2.5% in the opening three months of the year, which is a similar figure to that of the previous period. In this respect, the economy's expected rally is still to materialise.

In spite of an awkward scenario looking ahead, we forecast a brighter economic performance for the rest of the year, thanks to the recovery in primary activities and greater public expenditure execution

The scenario for the upcoming quarters will continue to be problematic. On the external side, our forecasts factor in the financial impact of uncertainty over precisely when the Fed's cycle of policy rate hikes is due to begin and how aggressive the adjustment will be. Likewise, we assume growth forecasts for this year and the next of 2.9% and 2.8% for the United States, while for China these are 7.0% and 6.6%. As for the prices of the commodities which Peru exports, some sort of downward correction is still expected this year and the next (beyond the odd brief improvement in the short term), as well as a rising trend for the world oil price (Peru is a net importer). Finally, we assume that the El Niño weather phenomenon will be moderate and have a limited impact on economic activities such as fisheries and agriculture.

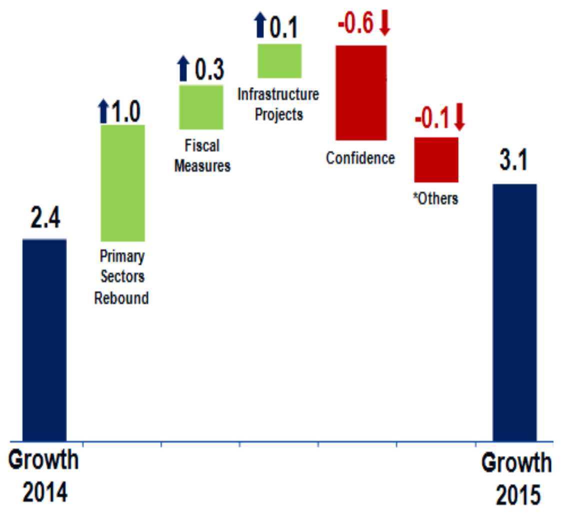
With respect to this general scenario, we foresee recovery in the primary sectors providing a platform for growth this year. In particular, we forecast strong progress in fisheries (around 17%, compared to a contraction of 27.9% in 2014; see Table 3.3) due to the bigger anchovy catches expected for this year, given their greater abundance despite the abnormal weather conditions. We also forecast a major upturn in metal mining (4.0% compared to a 2.1% fall in 2014), due to increased copper production associated with a better performance by the Toromocho project (the assumption is that it will produce some 176,000 tonnes this year, equal to approximately 70% of its maximum production capacity, which contrasts favourably with last year's level of 70,000 tonnes). We should also mention that a recovery is expected in production at Antamina, Peru's largest copper mine (we anticipate 4.0% growth for production against 2014). In relation to last year, we estimate that the recovery by the primary sectors will produce one percentage point more growth in 2015 (see Figure 3.7).

Table 3.3
Sector GDP (% var. YoY)

	2013	2014	2015
Agriculture	1.6	1.4	1.5
Fishing	24.1	-27.9	17.0
Mining and fuel	4.9	-0.8	2.6
Mining	4.2	-2.1	4.0
Fuel	7.2	4.0	-2.5
Manufacturing	5.0	-3.3	0.2
based on raw materials	*8.7*	-9.8	*1.1*
non-primary	*3.7*	-1.0	*-0.3*
Electricity and water	5.5	4.9	4.8
Building	8.9	1.7	2.4
Commerce	5.9	4.4	3.9
Other services	6.4	5.8	4.4
GDP	**5.8**	**2.4**	**3.1**
GDP Primary Sectors	**5.0**	**-2.3**	**2.4**
GDP Non- primary sectors	**6.0**	**3.6**	**3.2**

Source: Central bank and BBVA Research

Figure 3.7
Key drivers to growth acceleration in 2015 (pp of GDP)



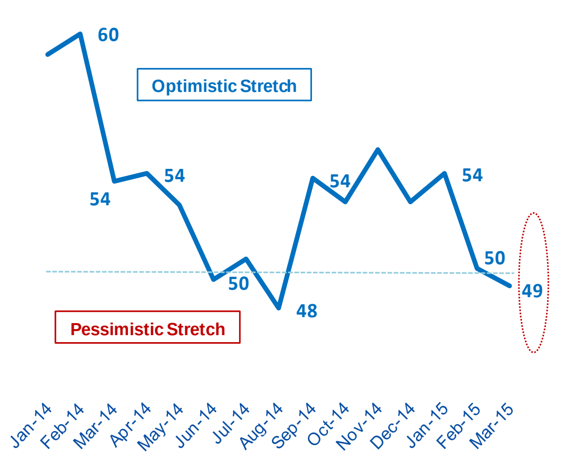
*Assumes, *inter alia*, a lower export price and financial volatility in external markets.
Source: Central bank and BBVA Research

Another element which will support growth this year will be the improvement in public expenditure thanks to a positive base effect (in 2014 public investment sank by 3.6%) and the implementation of the fiscal stimulus measures announced late last year (mainly fast-tracked investment projects worth PEN3bn this year). Finally, the greater progress made as regards infrastructure construction work (such as Line 2 on the Lima Metro, the southern gas pipeline and the modernisation of the Talara refinery) will also impact positively on economic activity in 2015. We estimate that these last aspects will contribute 0.3pp and 0.1pp more growth compared to last year.

Yet the decline in confidence levels suggests that private spending weakness will persist, within a context where implementation of counter-cyclical policies has run up against problems: a discreet bounce and growth this year will be 3.1%

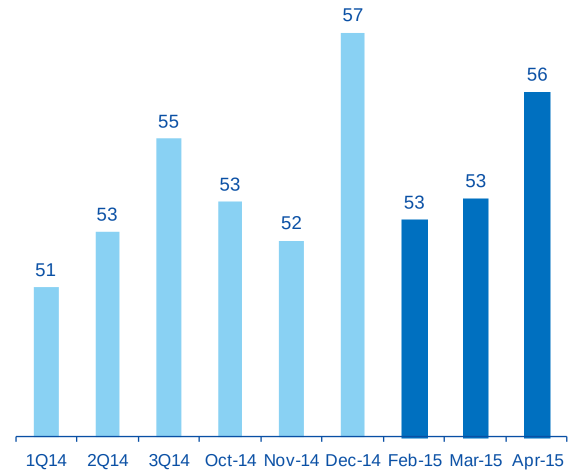
Business confidence in April was in pessimistic territory (see Figure 3.8), while mining investment is still showing a downward pattern. Both elements suggest uninspiring private sector investment this year. As for consumer confidence, it remains in the doldrums (see Figure 3.9) in a situation where employment is harder to come by (urban job creation is growing at around 1.0% and the unemployment rate in the Lima metropolitan area has climbed for the third month in succession). Moreover, food prices are dearer (although this is only expected to be transient) and some surveys reveal that families are having difficulties in repaying debts. Compared to last year, we estimate that the decline in confidence levels will pare down 2015 growth by 0.6 percentage points.

Figure 3.8
Business confidence (points)



Source: Central bank and BBVA Research

Figure 3.9
Consumer confidence (points)



Source: Apoyo Consultoría and BBVA Research

It should be added that the difficulties encountered in implementing stimuli on the fiscal side, as well as on the monetary front, also point to private sector demand remaining relatively muted (see Box 3 below regarding the limitations faced by fiscal and monetary policy in providing stimuli).

Box 1. Animal spirits and self-fulfilling prophecies

In his classic book, *The General Theory of Employment, Interest and Money*, the great economist, John Maynard Keynes, referred to private sector confidence (i.e. that of consumers and investors) in the following terms: "…a large proportion of our positive activities depend [more] on spontaneous optimism .... [Perhaps most] of our decisions to do something positive ...... can only be taken as a result of animal spirits — of a spontaneous urge to action…" Specifically, Keynes stressed the fundamental role of confidence in taking business decisions. He believed that long-term investment projects face great uncertainty and so seeing them through could only be a product of animal spirits (confidence).

Keynes' musings on confidence add to our appreciation of this variable and its importance in accounting for cyclical fluctuations in economic activity. From the orthodox point of view in economics, the degree of confidence about the future is the result of a rational process, given that people make use of all the available information to arrive at the best prognoses they can and, based on these, to take rational decisions. But what Keynes is suggesting is that business decisions are the outcome of "a spontaneous urge to action", and that they are not therefore purely rational. Economic agents can actually accept/reject or process/not process certain information and, in any case, act irrationally according to their expectations about the future. There is thus a psychological element in investment decisions by entrepreneurs that can amplify an economic expansion or slowdown.

In Peru there has been a noticeable apathy and lack of confidence on the part of business decision-makers about the expected performance of the Peruvian economy for the year ahead, which has made them wary in their business expansion decisions. Several factors explain the currently dampened the animal spirits: a continuation of disappointing activity figures, political ructions, and the temptation of populist measures which affect Peru's productivity and competitiveness, and the lack of impact of the counter-cyclical measures that have been implemented, as well as those to improve the business climate, the volatile international context, etc.

Evidently the government and the political class could do a lot more to stop some of the factors mentioned from becoming worse and business confidence declining further. But the private sector also has an important role to play. If it falls into a state of overblown pessimism, which overlooks the strengths and solid fundamentals of the Peruvian economy, investment decisions will be held back and growth will indeed languish (self-fulfilling prophecies). How these two protagonists behave will determine whether or not growth at the close of this year is nearer 3.0% than 2.0%.

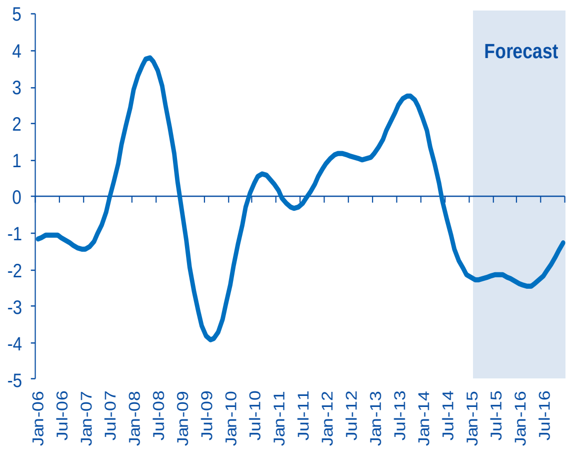
Consequently, our growth forecast for 2015 is 3.1% (see Table 3.4), implying a better performance than in 2014 (2.4% growth), although still a long way below the growth rate of the Peruvian economy's potential GDP, which we estimate is in the 4.5-5.0% range. Given this situation, we forecast that the GDP gap (the distance between observed and potential GDP) will still remain in negative territory (see Figure 3.10).

Table 3.4
GDP by Type of Expenditure (% var. YoY)

	2013	2014	2015
Domestic demand	6.8	2.0	2.5
Private consumption	5.3	4.1	3.5
Public consumption	6.7	6.4	4.4
Gross domestic investment	10.0	-3.9	-0.4
Gross fixed investment	7.6	-2.0	1.6
Private	6.5	-1.6	1.0
Public	12.1	-3.6	4.0
Exports	-0.3	-0.3	4.0
Imports	3.6	-1.4	1.7
GDP	**5.8**	**2.4**	**3.1**

Source: Central bank and BBVA Research

Figure 3.10
GDP gap (% of potential GDP)

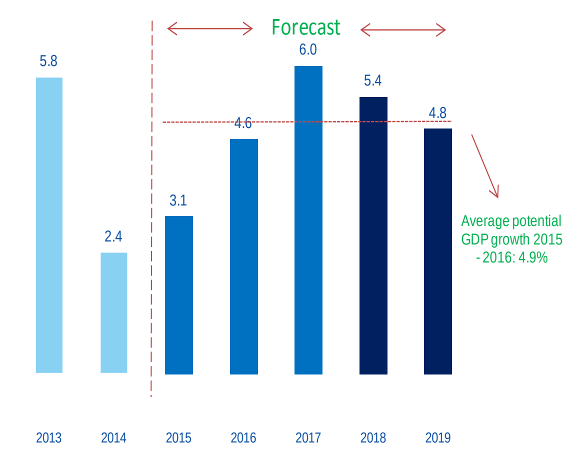


Source: Central bank and BBVA Research

In 2016-17 growth will accelerate, driven by higher mining production,…

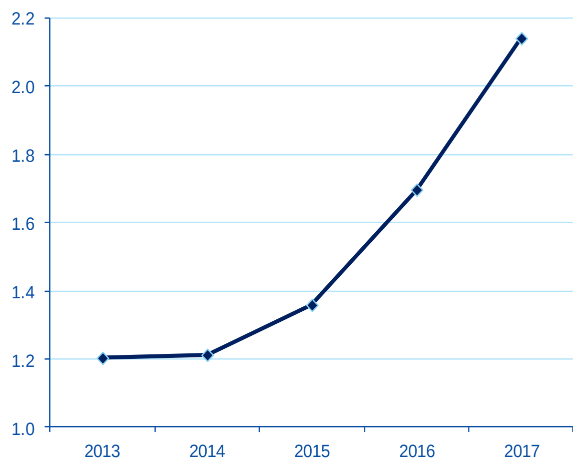
Our forecasts assert that growth will pick up in the next two years (see Figure 3.11) due to increased mining production, particularly of copper (see Figure 3.12). On the expenditure side, this will be reflected in more exports. Las Bambas and the Cerro Verde expansion will together yield 513,000 tonnes of copper (which is the equivalent of 42% of total 2014 production). We estimate that mining and quarrying will add around 1 percentage point more growth in each of these years.

Figure 3.11
GDP growth (% var. YoY)



Source: Central bank and BBVA Research

Figure 3.12
Copper production (FMT mn)



Source: Central bank and BBVA Research

…but only temporarily. Without reforms, the economy will drift back to more moderate growth rates, in line with potential GDP

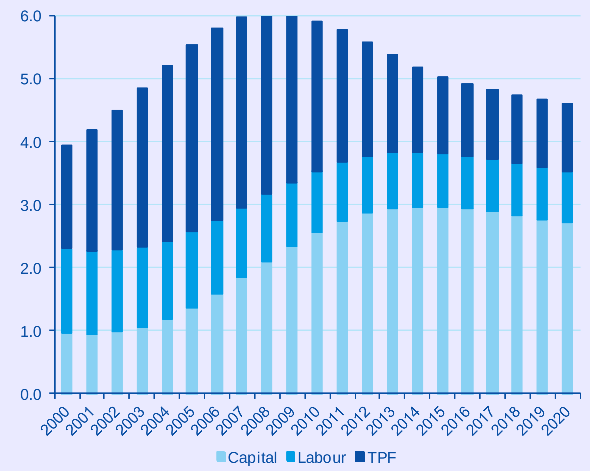
The slowdown which has been hitting the Peruvian economy has brought out the need to implement measures to enable the country to return to a path of rapid growth, and it goes without saying that a more sedate growth rate means that it will be harder to achieve long-lasting poverty reduction and the creation of quality jobs.

Specifically, Peru has ceased to be a fast-growing economy with rates approaching 6.5% a year. We estimate that the AAGR in the next few years will be in the 4.5-5.0% range, with a more modest rate arising from not having acted to head off Peru's declining productivity and competitiveness (see Box 2). Here we note that the present government is taking some interesting initiatives to kick-start long-term growth again. Sadly, it will be some time before the positive effects reach the desired level, which means that the Peruvian economy's "cruising speed" will be roughly 2 percentage points lower in the coming years.

Box 2. Estimation of potential GDP and growth accounting

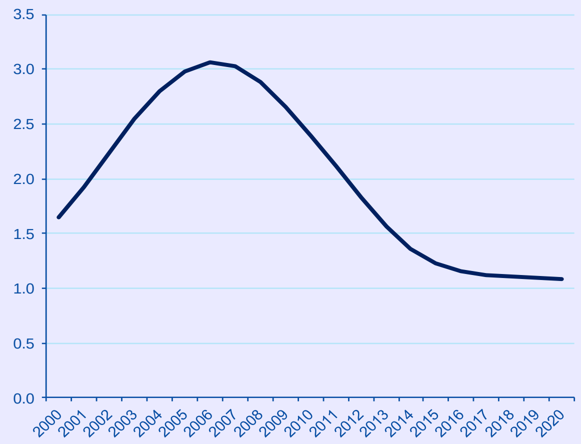
According to our estimates, Peru's potential GDP had an AAGR of 5.7% between 2003 and 2012 (see Figure B.2.1)[1]. This was a period of rapid and sustained growth for the Peruvian economy, which translated into a sharp drop in poverty, swelling of the middle classes, better family incomes and quality jobs, among other things. When we decompose potential GDP growth into the contributions from capital, labour and total factor productivity (TFP)[2], we find that the biggest input was from this last element, which accounts for a little over 40% of average GDP growth over these years (see Figure B.2.2). Also notable in this period was the rising contribution from capital, reflecting the high investment rates which were recorded during most of the past decade.

Figure R.2.1
Contribution to potential GDP growth (percentage points)



Source: Central bank and BBVA Research

Figure R.2.2
Total factor productivity: contribution to potential growth (percentage points)



Source: Central bank and BBVA Research

From 2013, however, we observe a let-up in the rate of potential growth, which we estimate will be in the 4.5-5.0% range in the next five years. The growth decomposition reveals that the loss of momentum is mainly attributable to a reduction in the contribution by TFP, which we estimate is likely to have fallen back by between 1 and 1.5pp. Our estimates also show that, going forward, the joint contribution from capital and labour remains relatively stable. The trend slowdown in the Peruvian economy that has been noticed since 2012 is thus a little over 1pp and is almost wholly accounted for by a smaller contribution from TFP.

But what implications does growing 1 to 1.5 points less have? Such differences, which appear minor, impact significantly on the quality of life which the population will come to have in a few years' time. For example, if Peru were to sustain annual growth of 6.0% once again, it would take approximately 14 years to double real income per

1: Potential GDP is the level of output which a country can sustainably achieve given its resources (capital and labour) and the efficiency with which it uses them.
2: TFP takes into account aspects such as technological improvement, innovation, institutional development, etc., which help to increase efficiency in utilising the factors of capital and labour.

inhabitant. On the other hand, growing at a rate of 4.5%, this would take 20 years. These years taken mark a major difference when it comes to reducing poverty quickly. The consequences are more impressive if we look over a longer time-frame. At the beginning of the 60s, income per inhabitant in Peru was slightly more than double what it was in South Korea. In that decade South Korea embarked on a process of rapid growth, with an AAGR of 6.0%. Growing at this pace it caught up with Peru in terms of income per inhabitant in the early 80s, and today its relative figure is a little over three times higher.

What did South Korea do to enjoy so much success? Even though opinions vary on the matter, most experts maintain that the strong growth of the “Asian Tigers” was attributable to a big investment drive in physical capital and education. Peru’s experience of rapid growth, which ran from 2003 to 2012 and lasted for a far shorter time, also reveals that investment (accumulating physical capital) was extremely significant, as were productivity gains (in contrast to what was noted of the Asian tigers, where it seems that this element showed no difference).

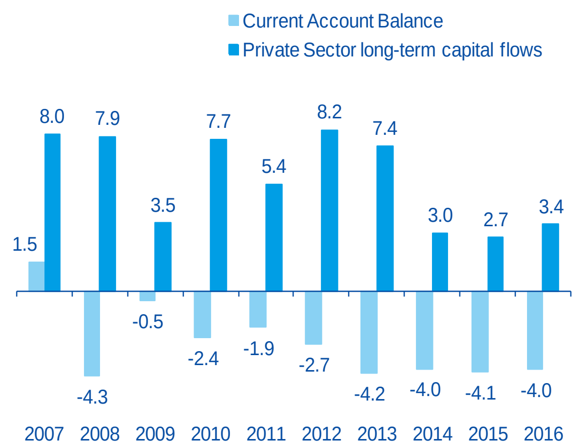
The South Korean experience underlines the importance of investment, at least for a few years, in successful processes of sustained growth. In this respect, Peru has room in the medium term to stimulate capital accumulation, which, given other experiences, could be achieved through tax incentives, encouraging greater competition, developing financial markets more enthusiastically and infrastructure investment. Nevertheless, in the long run the stock of capital is endogenous and what ultimately matters is the supply of labour and total factor production. With respect to the former, public policy affects the quality of the labour force through education and training and specialisation programmes. As for TFP, where dynamism has ebbed in Peru in the past few years, the state could fund research programmes and campaigns to boost innovation, as well as implement improvements in institutions which affect how people and businesses behave. Institutional strength ought to ensure that the legal framework within which the economy operates encourages private initiative (with a judicial system that guarantees that contracts are honoured, as well as property rights and transparency of information, while corruption is also addressed). It is also important for regulation of markets to be effective and that this does not hinder their normal functioning.

The external deficit will remain at around 4.0% of GDP in 2015-16 and long-term private capital inflows will not be enough to finance it

The current account deficit of the balance of payments reached USD8.2bn in 2014, the equivalent of 4.0% of GDP[3]. In the next two years, in spite of the gradual recovery of export volumes of metals and fish products, and domestic demand weakness, there will not be any substantial improvement in this result. The main element behind this is the sharp decline in the average level of the expected terms of trade, which, in cumulative terms for 2015-16, will amount to over 11%.

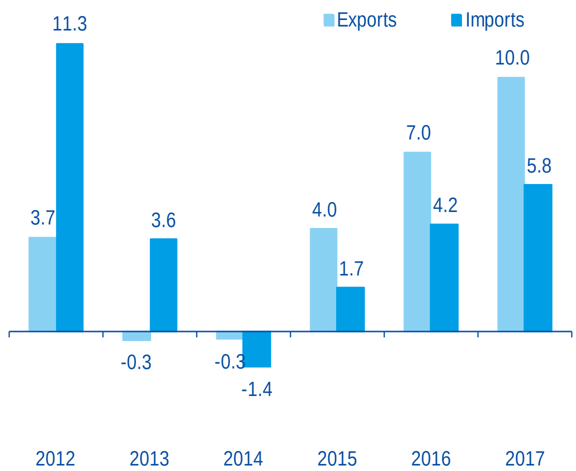
In 2015 in particular, the current account will be affected by the heavy fall in the average price level on international markets of the goods which Peru exports. For example, we predict that the average copper price will adjust downwards from USD3.11/lb in 2014 to USD2.75/lb this year. The factors affecting this will be the strengthening of the USD worldwide, more modest growth by the Chinese economy, and currently high inventory levels, which will only be smoothed out gradually over the course of the year. Something similar will take place with respect to the gold price, which will drop back from USD1,266/oz. (troy) in 2014 to USD1,190/oz. this year in an environment where the monetary stimulus in the United States is starting to be withdrawn, the USD will rise compared to its average level last year, and inflation pressure in the world's major economic zones will be weaker than in 2014. In addition to the lower world prices of exported Peruvian goods there will be no one-off income tax revenues in 2015 from sales of companies between non-resident economic agents, at least not to the extent which was observed last year (around USD1.5bn, equal to 0.7pp of GDP, most notably, for example, the extraordinary tax revenue of over USD520mn produced by the Glencore Xstrata/Las Bambas sale).

Figure 3.13
The current account and financing of it with long-term private capital (pp of GDP)



Source: Central bank and BBVA Research

Figure 3.14
Export and import volumes (% var. YoY)



Source: Central bank and BBVA Research

Certain factors will offset those above, so the current account deficit will continue at around 4% of GDP (see Figure 3.13). First, the export volume will improve in 2015 (see Figure 3.14). The rally in metal mining (primarily copper) and fishing activities will be reflected in greater exports on the expenditure side. Second, just as there will be a fall in the prices of Peru's export goods, the average level of world prices of imported

3: The result includes an estimate of exports of illegally mined gold of around USD1.2bn (0.6% of GDP). These exports used to be classified as part of the errors and omissions in the balance of payments, but the central bank, which is the official body that publishes the balance of payments statistics, introduced a change in methodology when it released the figures for 4Q14.

inputs will be lower too, among these the oil price. Our forecast is for the average price of WTI oil to come down by around 40% this year in a situation where, on the one hand, inventories have reached record levels and can only be used up gradually, while on the other hand the world supply of crude will be sustained, particularly in the United States, in spite of the lower price. Last but not least, recorded outflows of factor income, principally originating from profits generated by foreign mining companies, will decrease in 2015 as a result of the fall in metal prices (the larger volumes produced and exported will only reduce the effect of this).

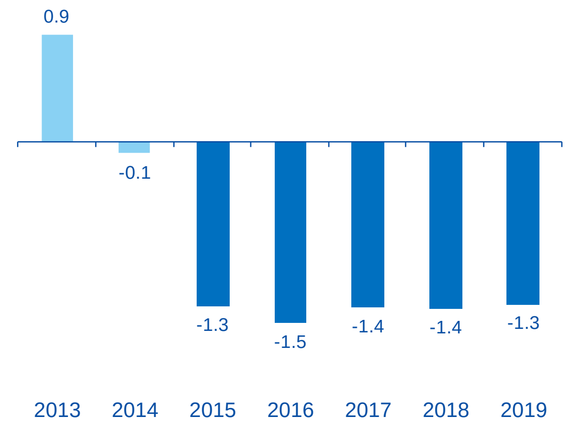
The net capital inflow included in the financial account in the balance of payments will not be enough in 2015 to cover the current account deficit, which is something that was already seen last year. Neither will the inflow directed at acquiring long-term assets from the private sector. This will put pressure on the PEN to depreciate, as our forecasts reflect, and will entail an additional loss of net international reserves (although these are fairly ample, so the decrease is manageable). Our estimates for the financial account in 2015 assume, for example, that foreign direct investment will fall off this year compared to the last in a context where foreign companies, will, on the one hand, have fewer funds available for reinvestment and, on the other hand, have less of a need or find it less attractive to do so. With regard to the first of these points, foreign companies will generate less profits due to the drop in the price of exported commodities and the weak level of local economic activity. As for the second point, the major mining projects currently at the construction phase are now drawing to a close (and there are no others of a similar magnitude that will replace them) and soon they will come into production, while the investing in new projects is losing its appeal in circumstances where no substantial recovery of the prices of key commodity exports is on the horizon in the medium term and the costs of funding from abroad are rising because of the Fed's monetary adjustment. Moreover, Peruvian companies will demand less external financing via security issues in international markets or loans because the local economy will still be weak, the cost of borrowing will be greater (the Fed adjustment), and the PEN will depreciate (which affects companies which acquire dollar-denominated liabilities but target their sales mainly towards the domestic market). In the case of financial companies, on top of these elements which make it less attractive to pick up debt in international markets there are the official measures which have been passed to reduce credit dollarisation. Finally, the forecast for the financial account assumes that there will be a more substantial fall in sovereign bond holdings by non-residents, bringing levels steadily closer to the share held by foreigners in the sovereign debt of other countries in the region. On the positive side as regards the net capital inflow in 2015, the pension fund administration companies are already approaching the legally permitted upper limit for investment abroad, and we do not see further increases in the level of this item this year.

The inadequacy of capital inflows to finance the current account deficit is a factor of vulnerability which should be carefully monitored, as it could exacerbate pressure on the FX and bond markets in a context where the Fed is set to begin its monetary policy hike. On the positive side, we estimate that this situation will only be brief, as from 2H16 we anticipate there will be greater room for manoeuvre both because of the reduction in the current account deficit, which from then on will tend to stabilise at around 3.0% of GDP, thanks to the boost that exports will receive from the coming on-stream of major mining projects, and the greater impact of long-term capital associated with the financing of infrastructure projects under concession in the past two years.

We forecast that the government deficit will remain at around 1.5% of GDP in 2015-19, which will not compromise fiscal stability

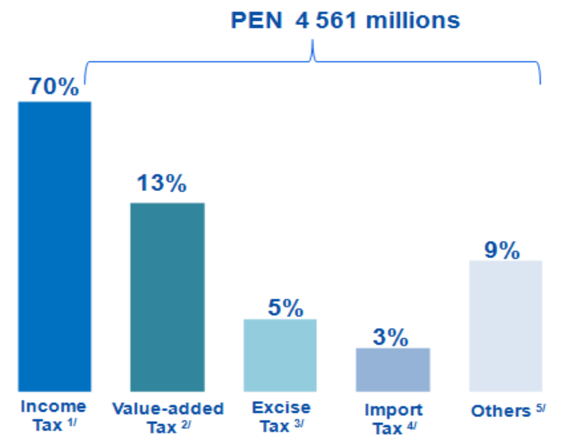
For this year and those thereafter, we forecast fiscal deficits of around 1.5% of GDP (see Figure 3.15), which is attributable, on the one hand, to the permanent drop in tax revenues of around 0.8pp of GDP. This reflects the various tax measures announced at the end of last year to stimulate activity in the short to medium term, among which are the cut in the personal and corporate income tax rate, accelerated depreciation[4], a reduction to zero percent of customs duty on 1,085 items, a cut in the Selective Fuel Tax rates and simplification of Value Added Tax (IGV) treatment (receipts, deductions, and withholding) (see Figure 3.16).

Figure 3.15
Fiscal balance (% of GDP)



Source: Central bank, SUNAT and BBVA Research.

Figure 3.16
SUNAT: Costs of tax measures in 2015



1/ Includes accelerated depreciation for buildings and structures of 5% to 20%. 2/ Rationalisation of the system of VAT (IGV) withholding and receipts. 3/. Reduction of the customs duty on fuels; 34.5% on average. 4/. Reduction of customs duty to 0% for 1,085 items associated with inputs. 5/. Flexibilisation of the grounds for appropriating tax-payers' deductions from accounts and rationalisation of the SPOT system.
Source: MEF, Multiannual Macroeconomic Framework 2016-18.

On the other hand, the forecast fiscal deficit includes the recovery of public investment expenditure to finance infrastructure projects under concession and investment projects given priority according to their social impact. It should be noted that, for the current year, the government expects to execute expenditure of PEN1.549bn on Line 2 of the Lima and Callao Metro and PEN2bn on modernising the Talara refinery.

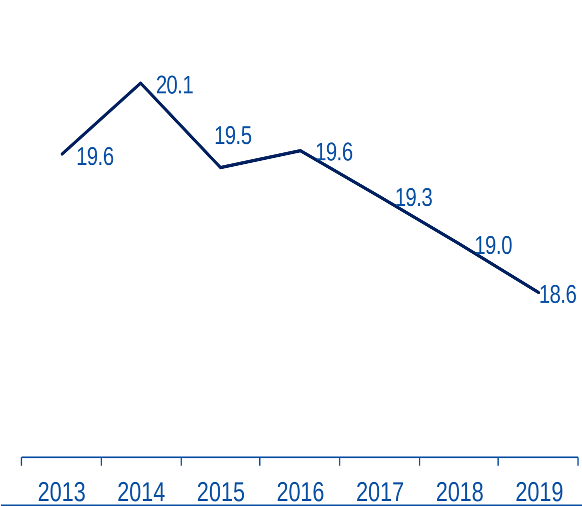
It is important to note that, from 2015, the ceiling estimate for public expenditure is being made according to an *ex ante* rule regarding the structural fiscal result for the Non-financial Public Sector. Public expenditure arises from the difference between structural fiscal revenues and the *ex ante* guidance on the fiscal result. To this result are added interest and the primary results for public companies. For 2015-17 it was established that the *ex ante* guidance should be a deficit of 1.0% of GDP. Likewise, on account of the tax measures implemented by the government, a permanent decrease is expected in tax revenues. This has weakened the structural fiscal result for this year (more than 1% of GDP), which has implications for formulating future budgets. If the *ex ante* guidance (structural deficit of 1% of GDP) in setting the ceiling for expenditure for 2016 were taken into account, this would have to decrease with respect to the previous year. This sounds rather illogical in a situation where economic activity will still need support from the fiscal side. To avoid these

4: For buildings and structures begun in 2014-2016.

circumstances, in late April the government authorised the use of *ex ante* guidance of a structural deficit of 2.0% of GDP for 2016 and 1.5% for 2017. This avoids the contractionary effect in the short term, but at the same time it seeks to correct the deviation in the medium term.

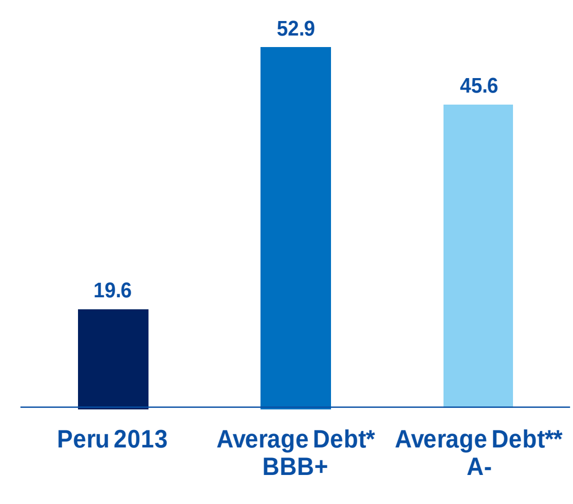
The projected fiscal deficit is consistent with a gently decreasing course for gross public sector debt as a percentage of GDP (see Figure 3.17), and levels which do not affect the sustainability of public finances, and compares favourably with the average for countries with a similar sovereign credit rating (52.9% of GDP for BBB+ countries, which is Peru's rating according to Fitch).

Figure 3.17
Public sector debt (% of GDP)



Source: Central bank and BBVA Research

Figure 3.18
Gross public sector debt (% of GDP)



*Spain, Thailand, Slovenia and Mexico.
**Latvia, Poland, Lithuania and Malaysia.
Source: Central bank, Bloomberg and BBVA Research

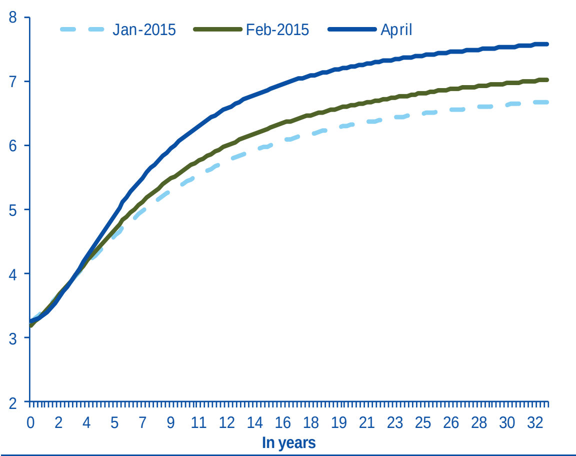
4 Local financial markets: asset prices have come down at the beginning of the year

International financial conditions have been mirroring the uncertainty over the timing of the start of the Fed's fine-tuning of the reference rate and world growth prospects. In this situation the USD is keeping to its pattern of strengthening, buttressed by consolidation of the relative soundness of the US economy in global terms. On the other hand, commodity prices are still languishing and there is evidence of greater risk aversion in financial markets.

Within this scenario, between January and April the sovereign bond yield curve showed a rising trend (see Figure 4.1) in the medium and long sections. Specifically, the yield asked of 2026 and 2031 sovereign bonds rose by over 50 basis points, although in the case of the 2020 bond the increase was more subtle (18bp), and it is worth noting that in the final weeks of April the sovereign bond yield curve stayed relatively stable.

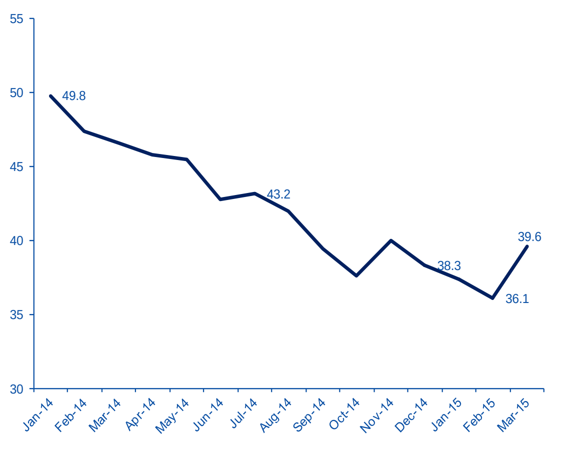
The non-resident sovereign bond holdings category moved marginally up, from a share of 38.3% at the close of 2014 to 39.6% at the end of March this year (see Figure 4.2). Meanwhile, the share of local institutional investors, such as the pension funds in the sovereign bond market, came down to 36.2% in March from a level of 38.3% at the close of 2014.

Figure 4.1
Peruvian sovereign bond yields (%)



Source: Bloomberg and BBVA Research

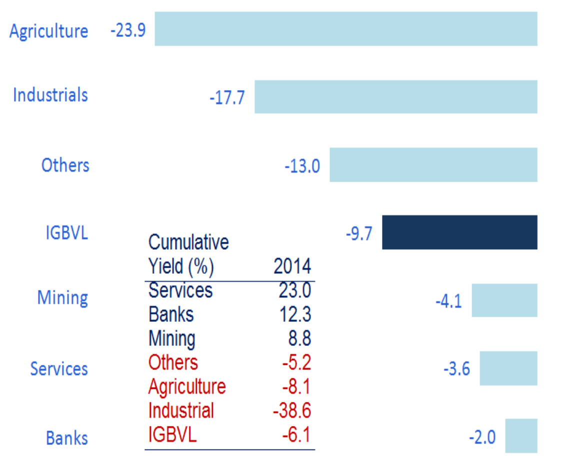
Figure 4.2
Non-resident sovereign bond holdings (% of the total)



Source: Bloomberg and BBVA Research

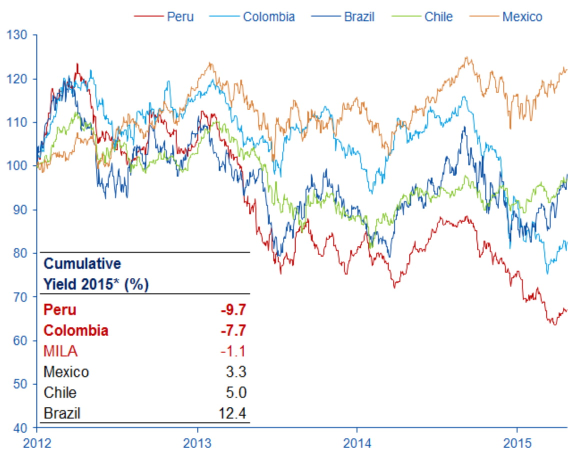
Turning to the equity market, the Lima Stock Exchange's General Index (the IGBVL) came down by 9.7% in April, due not only to the fall of mining sector share prices (which account for 30% of the shares that make up the IGBVL), but also to the other sectors, which was associated with the lacklustre performance of economic activity (see Figure 4.3). It is interesting to note that while the Lima Stock Exchange is in negative territory (as is its counterpart in Colombia), the stock markets in other countries in the region offer a brighter picture, and in April the exchanges in Mexico, Chile and Brazil moved 3.3%, 5.0% and 12.4% higher respectively.

Figure 4.3
Sector index cumulative performances to April*
(% in 2015)



* 30/04/2015 vs. 31/12/2014.
Source: BVL and BBVA Research

Figure 4.4
General Stock Exchange Index for Latin America
(January 2012=100)



Source: Bloomberg and BBVA Research

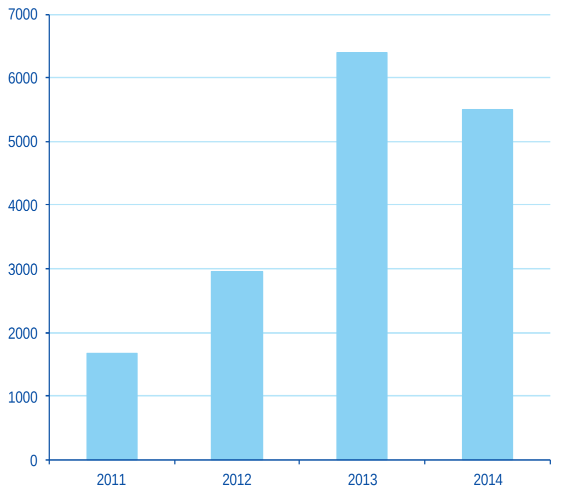
Unlike what is happening in the equity market, the fixed income market has put in a dynamic display. In 1Q15 funding via debt security placements was PEN 1.306bn, which marked a 73% jump compared to 4Q14 (in excess of PEN552mn). Of this figure, some 97% was in PEN, which is more than double the 4Q14 placement level, while dollar-denominated issuance was down by 55% (see table 4.1).

Table 4.1
Corporate bond issuance

	Issuer	Placement Amount Mill. S/.	US$	Total Mill. S/.	Interest Rate	Term Years
I. FINANCE COMPANIES						
15-Jan-15	BIF	50		50	4.4	1.0
15-Jan-15	COFIDE	40		40	4.5	1.0
15-Jan-15	Scotiabank	100		100	5.0	3.0
27-Jan-15	Andino Investment Holding		10	31	2.8	1.0
29-Jan-15	Banco Financiero del Perú	89		89	5.5	2.5
29-Jan-15	COFIDE	78		78	5.7	5.0
5-Feb-15	Financiera TFC	15		15	6.2	0.5
26-Feb-15	Financiera Uno	37		37	5.3	1.0
	Total	**410**	**10**	**440**		
II.NON- FINANCIAL COMPANIES						
16-Jan-15	ICCGSA	38		38	6.4	5.0
16-Jan-15	ICCGSA	23		23	8.0	5.0
21-Jan-15	Alicorp	500		500	7.0	15.0
2-Feb-15	Medrock Corp		1	3	3.0	0.5
4-Feb-15	Gloria	140		140	5.6	5.0
4-Feb-15	Gloria	150		150	7.1	20.0
26-Feb-15	Medrock Corp		1	3	2.8	0.5
	Total	**852**	**2**	**858**		
	(I+II) Total of Placement Instruments	**1,261**	**12**	**1,298**		

Source: Central bank and BBVA Research

Figure 4.5
Debt issuance in the international market
(USD mn)



Source: Central bank and BBVA Research

Meanwhile, non-financial companies accounted for 65% of total issuance, with the PEN500mn Alicorp placement of 15-year corporate bonds at 7.0% being the most notable.

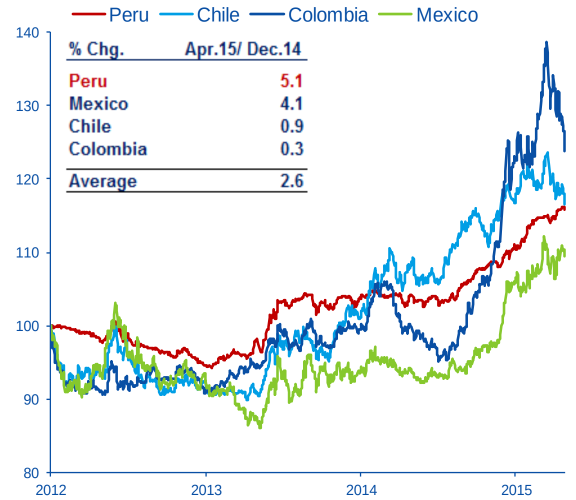
On the other hand, issuance in the international market totalled PEN629mn in Q1, which was 23.5% down on the previous quarter. The only activity here was by GYM Ferrovías, which raised PEN629mn, due in 24.8

years and paying 4.75%, and it is worth adding that issuance abroad has been coming down since 2014 (see Figure 4.5).

The exchange rate has continued to climb at the beginning of the year

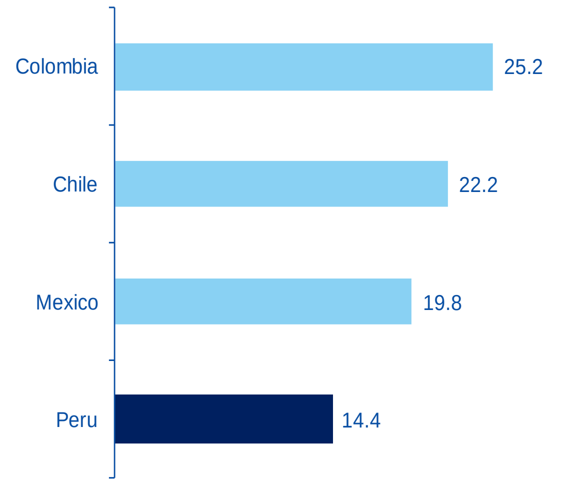
In the opening months of the year, there has been considerable exchange rate pressure from uncertainty over Fed rate moves. So far this year, the PEN has depreciated by 5%, which is more than has been seen elsewhere in the region (see Figure 4.6), although since the tapering process began in May 2013, the depreciation in Peru has lagged behind somewhat (see Figure 4.7).

Figure 4.6
Exchange rate in Latam countries (January 2012=100)



Source: Bloomberg and BBVA Research

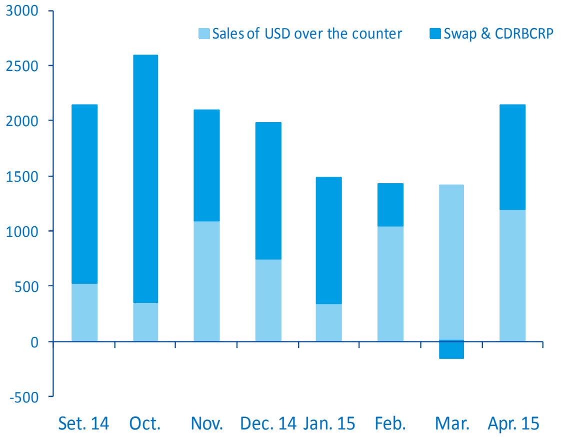
Figure 4.7
Cumulative depreciation since tapering began* (%)



*Takes into account the cumulative variation at 30/04/2015 from. 31/05/2013.
Source: Bloomberg and BBVA Research

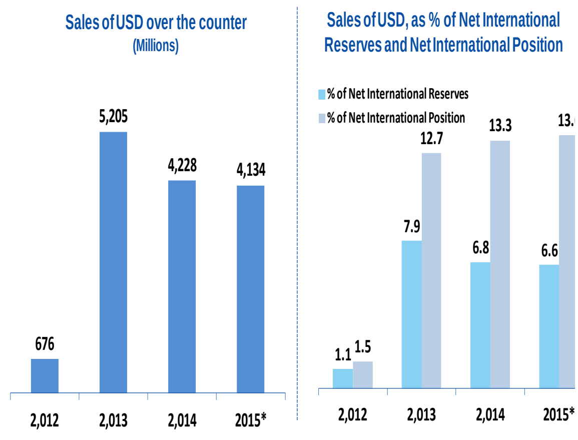
In this context, the central bank has been actively intervening to make the PEN's depreciating trend more orderly, and it has mainly done this through FX swap sell auctions and sales of USD in the currency spot market (see Figure 4.8). These last have amounted to over USD4.1bn for the YtD, which is equal to 98% of the dollar sales that the central bank carried out last year, 13% of the central bank's currency position, and 6.6% of net international reserves (see Figure 4.9).

Figure 4.8
Central bank exchange rate intervention (USD mn)



Source: Central bank and BBVA Research

Figure 4.9
Net USD sales by the central bank (USD mn, %)



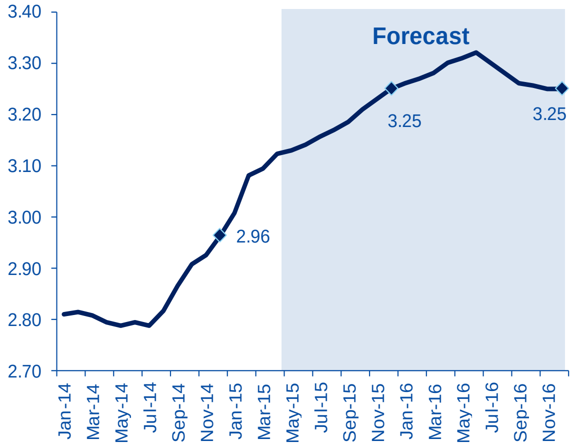
* As of 4 May.
Source: Central bank and BBVA Research

Looking forward, we see further PEN depreciation

The upward course of the exchange rate will continue over the next fifteen months, reaching dollar exchange levels of PEN3.25 at the end of 2015 (PEN2.97 in 2014) and PEN3.32 in mid-2016 (see Figure 4.10). In one sense, this reflects the expected adjustment in monetary conditions in the United States, which will increase the appeal of dollar-denominated assets and make funding from abroad more costly. In another sense, it points to the current account deficit in the balance of payments, which is still above its sustainable level and will stand to be reduced by a weaker PEN (see Figure 4.11). Added to this mix, there is the fact that the election campaigning will soon be getting underway in Peru, which is likely to have a bigger impact on the FX market in 1H16. We cannot rule out bouts of currency volatility tied in with developments on the international scene (the imminent start of the Fed's rate hike cycle and growth in China, with its impact on metal prices, as well as geo-political stress), but the exchange rate adjustment will in general be made more orderly via interventions by the central bank, using its array of tools.

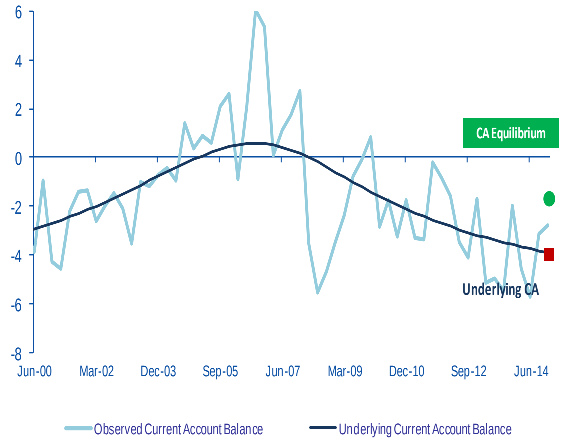
We forecast that the dollar exchange rate will close this year at PEN3.25 and will hit a high of PEN3.30 in 1H16, thereafter gradually drifting down to around PEN3.22 by the end of 2017 (in which year mining production and, by extension, exports will move ahead substantially), which is more in harmony with its equilibrium level.

Figure 4.10
**Exchange rate
(USD/PEN)**



Source: Central bank and BBVA Research

Figure 4.11
**Current account measures*
(% of GDP)**

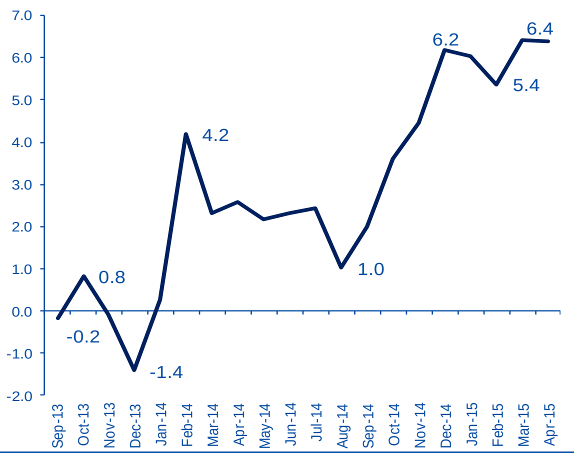


*The equilibrium CA level is where the economy's net external liabilities stabilise at their current level. The underlying CA is below this scenario, which suggests that the PEN needs to depreciate.
Source: Central bank and BBVA Research

5 Inflation: will hold at around the ceiling of the target range this year, although we forecast that there will be an absence of demand pressure

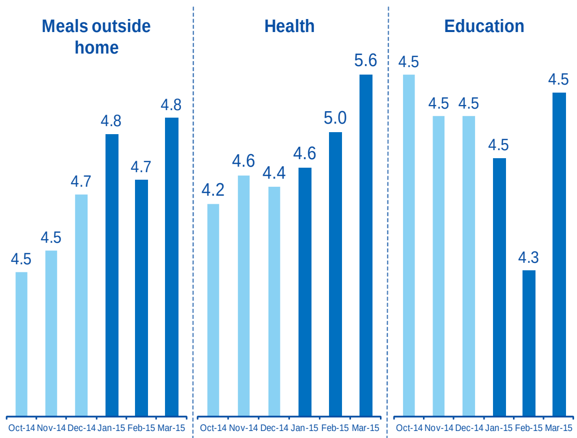
In the first few months of 2015, YoY inflation has been at the upper end of the target range. Inflation's behaviour is linked with supply shocks due to the weather conditions which have hit the prices of food items produced locally (see Figure 5.1). Moreover, the prices of certain services (such as, for example, eating out, education and health) are tracing an upward trend and have been rising at a rate of around 5.0% (see Figure 5.2).

Figure 5.1
Food inflation *
(% var. YoY)



*Includes those foods which have shown the greatest volatility.
Source: Central bank and BBVA Research

Figure 5.2
Core inflation components
(% var. YoY)

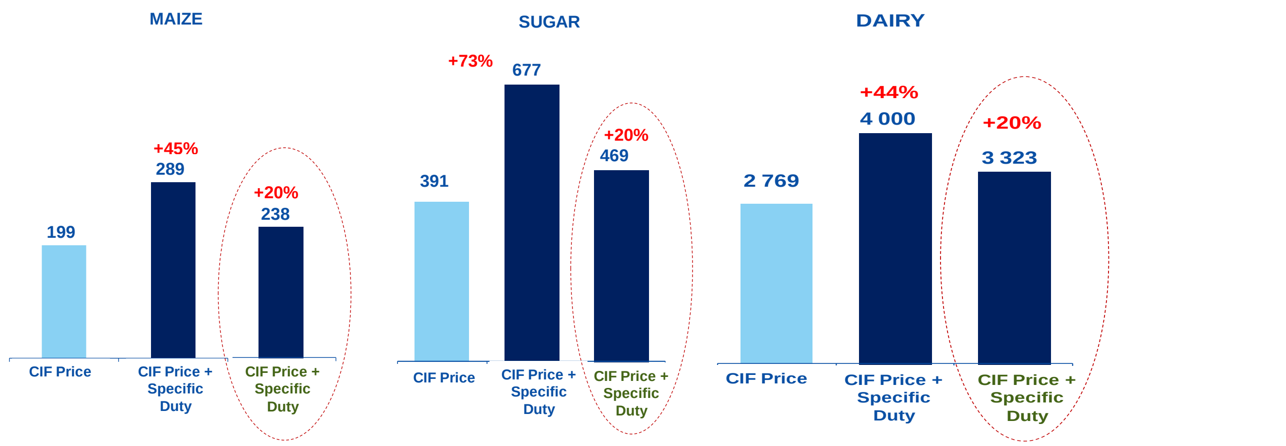


Source: Central bank and BBVA Research

For the next few months, we forecast that inflation will continue to fluctuate at around the 3.0% level. Exceptional temperatures (higher than those typically recorded) are affecting harvests of certain food produce, while upward pressure is also expected on tradable goods or those which are priced directly in dollars, such as rents.

On the other hand, with the intention of passing on lower international prices to end consumers, the government has set limits on the system of price bands for importing certain foods (maize, sugar and dairy products). The price band is a mechanism that consists of setting an upper and a lower limit on import prices, which are regularly adjusted according to the long-term trend (moving average for the last 60 months). When the international price of foods is below the band, additional duties are charged, and in cases where the international food price is above the upper limit, tariff discounts are applied. With respect to this, in the past few days the government has laid down that the surcharge may not be greater than 20%, which implies a significant reduction to that which had been applied before (45% for maize, 73% for sugar and 44% for dairy products: see Figure 5.3). It should be remembered that the effect of this measure on keeping inflation in check will depend on how much is passed on to end consumers, and this will in turn be influenced by, for example, the market structure (greater/lesser degree of competition). In the case of maize, in particular, it should be borne in mind that 70% of imports come from the United States, which are not subject to the price band system.

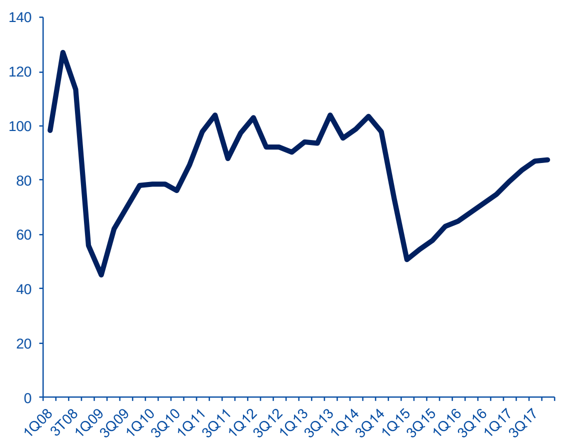
Figure 5.3
Benchmark CIF price and tariff duties * (USD/tonne)



*As of 30 March.
Source: Central bank, MEF and BBVA Research

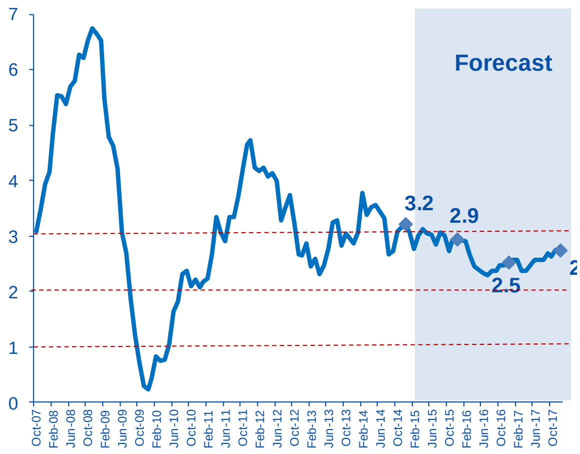
The absence of demand pressure (we forecast that the GDP gap will remain negative in 2015 and part of 2016) should help inflation to move towards the centre of the target range. There are, nonetheless, certain factors which exert an upward effect on inflation, such as the oil price recovery from 2Q15 (see Figure 5.4) and the fact that economic agents are expecting inflation to hold at close to the ceiling of the target range, which imposes a degree of inertia on the price formation process. All of this will mean, on balance, that when inflation subsides this will be a very gradual process, and that we will only see a more clear-cut downward trend from Q2 next year (see Figure 5.5).

Figure 5.4
WTI crude oil price (USD/bbl)



Source: Bloomberg and BBVA Research

Figure 5.5
Inflation (% var. YoY)



Source: Central bank and BBVA Research

6. Monetary policy: complicated macro environment for the central bank

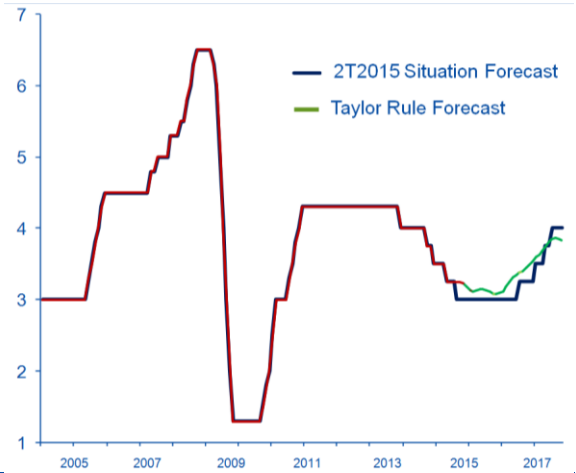
Cut the rate? Yes, but no… The dilemma between private sector spending and pressure on the PEN to weaken…

So far this year, the central bank has cut the reference rate on one occasion, from 3.50% to 3.25% in January. Since then, economic activity has remained sluggish, and even displayed cases of a setback in the rate at which the most trend-representative component of GDP is progressing (see Figure 6.1), i.e. the set of activities that together best encapsulate what has been happening to domestic demand, and, most particularly, private sector spending (services, wholesale and retail trade, electricity generation, construction and non-primary manufacturing). There has also been a decline in the optimism of the business community and consumers, and in job creation, which is something that suggests that this, the component which is the best indicator of trends for GDP, will continue to perform weakly. The outlook for economic activity thus points to further policy rate cuts. Estimation of the Taylor rule[5], for example, suggests the need for some kind of lowering , even bearing in mind the negative effect which any depreciation would have on GDP in Peru (see Figure 6.2). Yet this has not happened. So why not?

Figure 6.1
Non primary GDP, 12-month moving average (% var. YoY)

*As of February.
Source: Central bank and BBVA Research

Figure 6.2
Monetary policy interest rate (%)



Source: Central bank and BBVA Research

In our opinion, this is mainly due to strong upward pressure on the exchange rate (currency depreciation). In the YtD the PEN has depreciated by more than 5%, even though the central bank has sold around USD4bn in the FX market and it made net placements of approximately USD2.3bn more in instruments where the returns are tied in with the depreciation of the PEN, in transactions that were intended to soften the PEN weakness. What we have is a central bank that is concerned about exchange rate pressures. This is reasonable, bearing in mind that the dollarisation of lending to businesses and families is still high (around

5: Estimation of the Taylor Rule has been done using the Generalised Method of Moments (GMM). The reaction function includes the lag of the monetary policy rate, the output gap, the expected inflation gap one year out and, as instrumental variables, the lags of the explanatory variables, variables which are associated with monetary policy and exchange rate deviations with respect to an equilibrium level. It should be added that the null hypothesis is not rejected which assumes the instruments used are valid.

40% of the total): the currency mismatch in balances entails exchange rate risk, to the extent that a sudden, sharp depreciation could have a systemic impact and harm activity. The concern over exchange rate pressures, however, limits the room for manoeuvre for monetary policy to act counter-cyclically. If the central bank cuts the policy rate to boost private sector spending (via transmission to other interest rates in the financial system, above all those at the short end and which are low-risk), this will fuel exchange rate pressures. It could thus avail itself of the plentiful net international reserves which it has, to keep depreciation in check, as it has been doing, but exchange rate intervention like this will drain PEN from the system and push up interest rates. This is inconsistent with the original wish to implement a counter-cyclical stimulus. This, then, is the context in which the central bank has not made further cuts to the policy rate since January.

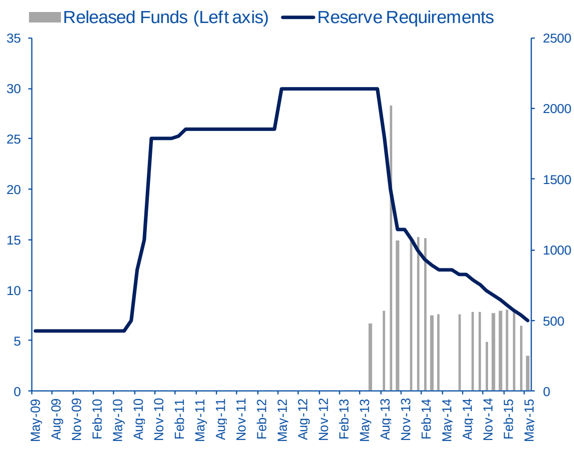
Exchange rate intervention puts upward pressure on interest rates in an environment of asymmetric interbank liquidity

In April, the overnight interbank rate was a little over 3.50% on average. This is a deviation of over 25bp with respect to the benchmark rate (at 3.25% since January). This is significant, and for practical purposes is as though the central bank had not even made its last policy rate cut. There were even days on which interbank business took place at rates of 4.0%. And this is nothing new, as it also happened in February (20bp deviation on average) and December (30bp average deviation). May began on a similar footing. Since this is a significant and sustained deviation, it has fed through to the other interest rates within the financial system. For example, the corporate prime rate for 90-day transactions in PEN climbed from 4.2% in March to 4.4% in April. This does not sound at all consistent with the need to stimulate private consumption. What is more, any cut in the reference rate in these circumstances would not have a major effect on the other rates in the system and thus would not lead to increased spending by businesses and families either.

This situation has not only been influenced by the central bank’s exchange rate intervention, which has drained PEN from the market and thus put upward pressure on interest rates denominated in PEN, but also by the current asymmetry of liquidity in the interbank market. On the one hand, there are financial institutions in this market which require funds yet find them hard to come by (and their demand pushes up the interbank rate, to levels above the reference rate). On certain occasions they have then accessed the window of last resort provided for them by the central bank. Specifically, they have requested direct repos: the central bank buys an asset from the financial institution on a temporary basis (for one day), which might be a CDBCRP (central bank certificate of deposit), foreign currency or something else, in exchange for which it provides liquid funds discounted at 4.05%. In April, there were days when the financial institutions requested over PEN700mn from the central bank via this instrument. These were substantial amounts, bearing in mind that towards the end of the month an average of PEN1.2bn daily were traded in the overnight interbank market, and at relatively high interest rates (above those in the interbank market), which suggests that these financial institutions cannot obtain interbank liquid funds at reasonable rates. On the other hand, there are financial institutions that are highly liquid yet have no wish to place their funds in the interbank market. They then go to the central bank to leave them as overnight deposits. On some days in April, the central bank took overnight deposits of over PEN2bn. The central bank pays interest of 2.05% on them, which means that the banks with liquidity have preferred to leave deposits with the central bank and receive 2.05% rather than to place the funds in the interbank market and earn a higher rate of interest. This is why there is understood to be asymmetry, with some banks that are very long, while others are very short. Normally, in situations like this the funds are traded among them, but for some reason this has not been happening. Perhaps the lines of interbank credit are being used to a maximum, and so those banks with funds to spare choose to deposit them with the central bank.

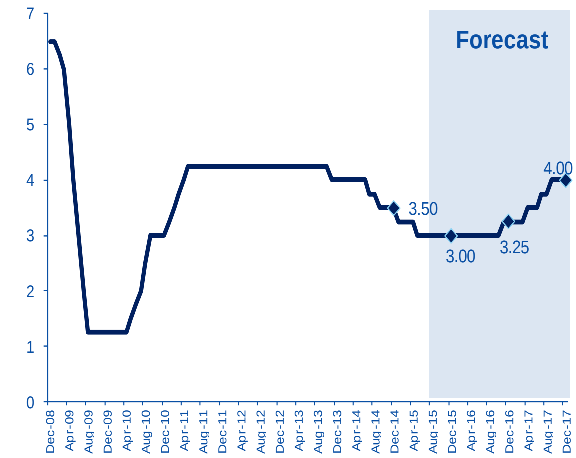
The central bank has been injecting liquidity through its market instruments (repos using its certificates of deposit/Treasury notes, foreign currency repos) and steadfastly lowering reserve ratios (see Figure 6.3), but this still does not seem to be enough. And not only the high interbank rate reflects this relative shortage of liquidity: the repos by the central bank have been done at average rates quite a long way over 4.0% in the last few days. This situation urgently needs to be corrected because, as was mentioned earlier, this ends up being passed on to interest rates for the customers of the financial institutions, which thus stifles private sector spending at a time when the precise opposite is needed. As regards the reserve ratio, there is not much more space available to continue to bring the level down (this already stands at 7%). Perhaps one option would be to look into the possibility of auctioning off a portion of the funds in PEN which the public sector has on deposit with the central bank (these amount to over PEN40bn).

Figure 6.3
Reserve requirements in PEN and released funds (% and PEN mn)



Source: Central bank and BBVA Research

Figure 6.4
Monetary policy interest rate (%)



Source: Central bank and BBVA Research

The central bank will continue to face this dilemma in the coming months, which means that it is unlikely to implement aggressive monetary policy

In brief, the dilemma which the central bank faces, between private spending weakness and pressure on the PEN to depreciate, limits its room to act. Monetary policy does not have any margin for counter-cyclical manoeuvre as the situation stands. And as the beginning of the Fed's cycle of rate hikes approaches, the window of opportunity will eventually close up. It will therefore be unlikely that we will see an aggressive monetary stimulus in the next few months, in spite of the cyclical weakness of output (the Peruvian economy has already been growing at under 2% for a year, and in the short term the recovery will be timid and mainly driven by supply-side factors) and despite the difficulties encountered by the public sector in executing its expenditure. Looking further ahead, from 2H16, when the take-off for mining production becomes more clearly apparent and the political ructions are likely to have died down, we forecast that the central bank will start to shift its policy rate upwards, guiding it towards a more neutral level (see Figure 6.4).

Box 3: The difficulties which stabilisation policies face

From a temporary perspective, economic policies can be divided into two groups. Into the first of these fall those measures which are intended to lift economic growth in the medium and long term, by ensuring the right conditions for the efficient functioning of markets for goods and services and the factors of production. These policies are very important because they harbour consequences for productivity, incomes and wealth creation, which, in the long run, will have a decisive bearing on the standard of living which the population will have in the future.

The second group encompasses actions which in the short term aim to smooth out cyclical fluctuations in the economy. Economies are subject to shocks (uncontrollable exogenous events) which sometimes boost them and at other times slow them down, briefly making them stray from the output level which their resources and state of technological development might allow them to achieve (known as their potential GDP). Such fluctuations can give rise to a significant loss of welfare. For example, if a slowdown takes a firm grip, finding a job becomes harder, sales fall off and no wealth is accumulated, among other negative aspects.

To smooth out such oscillations in the economy, governments use monetary and fiscal policy. Monetary policy affects the economy through the way central bank action can influence interest rates, and fiscal policy does so by managing public expenditure and taxation via the economy's Treasury. In Peru, we have unfortunately had to bear witness to how both policies can run up against major restrictions on implementing stimuli to counteract the slowdown currently in progress. Peru's central bank wanted to bring about interest rate cuts but exchange rate pressure and the adverse effects that this can have, on the assets of families and businesses with dollar-denominated debt but which earn in PEN, inhibits the monetary authorities from doing this since it could exacerbate the weakness of the local currency. On the fiscal front, the Ministry of the Economy (MEF) faces problems when it comes to speeding up the execution of public expenditure and has shown some degree of inertia as regards continuing to provide stimuli on the revenue side.

One of the lessons which this slowdown is teaching us is that we must modernise and adapt the current institutional framework to monetary and fiscal policies in a way that enables them to be used as tools to stabilise the economy.

The framework has made it possible to consolidate the central bank's anti-inflationary reputation and ensure that the fiscal account are sound, but at this juncture it has manifestly proved inadequate for the purpose of allowing policies of this kind to fulfil a proper stabilising role for the economy.

Enhancing the power of monetary policy calls for the economy to continue to reduce the risk of currency mismatches. Given that the freedom to hold foreign currency in Peru is guaranteed under the Constitution, economic agents will always exhibit a preference for dollar deposits to diversify their portfolios (a completely rational decision). This implies that the banks will always be able to have foreign currency funding, which naturally leads them to lend in USD to match up their lending and deposit business. In this situation, one option which could be brought to the table for discussion to reduce the risk of a private sector currency mismatch might be for lending arranged in USD to be accompanied by a requirement to carry out a mandatory currency hedge for individuals and businesses that earn in PEN. The possibility could also be discussed of implementing an explicit mandate for the central bank to aim for full employment, on top of its current brief to achieve price stability (to avoid an excess of discretion in monetary policy such an extension of the central bank's mandate should also entail greater autonomy: board members who remain in place for longer than the political cycle).

On the fiscal side, action is required to take on more highly qualified professionals as of necessity. This involves implementing competitive remuneration schemes in public office. Efforts by SERVIR have been made along these lines and they should be continued and more far-reaching. It is worth noting that in the past 10 years the state budget has grown at an approximate annual rate of 10%. Over the same period the number of public sector employees has only grown at a rate of about 2.5% a year. This means that we have more or less the same amount of people in the civil service but now there are a lot more resources and projects to manage. It is also important to carry on reinforcing the legal system so that civil servants feel that the state is right behind them in legal matters if the decisions they make are appropriate and fall within the set of approved parameters, which will stop them feeling constrained in authorising appropriate spending.

7 Risk assessment: Downward bias to the growth forecast

Risk factors on the downward side, on the external landscape, are China, the United States (the Fed), and Greece

There are six chief risk factors on the downward side with respect to our 2015 growth forecast (3.1%): three on the external front and another three locally. Abroad, the first of these is that of the Chinese economy experiencing a harder-than-expected landing. In our baseline scenario, China is expected to grow at 7% in 2015, yet the bias to this forecast is on the downward side. Economic activity has moved ahead relatively meekly at the start of the year in spite of monetary stimuli, there is a risk of deflation and China still has financial weak-points, such as, for example, high borrowing among local governments or the high prices of real estate assets, which, in a scenario where these are corrected could impinge on short-term growth. The second risk relates to how the emerging economies, especially Peru, digest the Fed rate adjustment when this starts taking place. If they baulk at it, this is likely to affect growth. Finally, the denouement of the narrative in Greece could be negative and give rise to increased risk aversion worldwide.

In a scenario where growth in China fails to live up to expectations, the Peruvian economy would be hit via weaker external demand, a fall in the prices of those metals which Peru exports (which would adversely affect the profits of mining companies and their reinvestment, as well as fiscal revenues), and greater global risk aversion, which would have a debilitating effect on capital inflows to emerging countries, among these Peru. Moreover, the fundamentals of Peru’s economy would be harmed. In a scenario where the emerging economies recoil at the Fed’s opening move in its rate hike cycle or the matter of Greece plays out negatively, risk aversion the world over would rise and both the EMBI indexes and borrowing costs would go up. There would additionally be a reversal of capital inflows to the emerging economies, especially among those running high current account deficits, as is the case in Peru, and upward pressure on the exchange rate (local currency depreciation).

These are joined by, on the local front, weaker business confidence, public expenditure execution and the “El Niño” weather phenomenon.

In March, business confidence continued to sink, reaching 49 points, which marks pessimistic territory. This has occurred in a context where the expected economic recovery has still not arrived and political ructions have intensified. Our baseline scenario assumes that GDP will go on gradually picking up speed, which will in turn serve as a tonic for business optimism. Should this fail to happen, and the political commotion takes a turn for the worse, business confidence would be likely to deteriorate further, which would affect business investment spending and job creation (and, with that, family consumption), and as a result the cyclical recovery of the economy would take even more time.

Another factor of a domestic nature which adds downward bias to our economic growth forecast is the poor rate of execution of public investment expenditure, particularly at sub-national government level. In Q1, public investment shrank by around 25% in YoY terms. At BBVA Research we expect stabilisation in Q2 and then a surge in the second half of the year, driven by the commencement of construction work on the major infrastructure projects granted under concession since 2013 and a climate of gradual improvement in the execution rate of capital expenditure among local and regional governments. If this should not transpire or only do so with delays, economic activity would progress at a slower-than-expected pace.

Finally, the third local downside factor is if the El Niño weather phenomenon is harsher than forecast. Our baseline scenario assumes that this will be weak to moderate. Anything more than this will have a negative impact on growth for activities such as livestock and farming, the fishing industry, the industrial sector and wholesale and retail trade. In this context, Peru's GDP would not move ahead by as much as our baseline scenario predicts.

Anything positive? Upside risk factor: a more vigorous recovery by the mining industry

To arrive at our GDP growth forecast for 2015, we have been somewhat conservative with regard to the recovery of the metal mining sector. For example, in our baseline scenario we have assumed that the Toromocho project will reach a level of copper production of 176,000 FMT this year, which is noticeably below its estimated full capacity level, which is about 276,000 FMT a year. In Q1, average monthly production for this mine was over 12,000 FMT and only in March did it achieve a figure in excess of 15,000 FMT. This means that attaining an extraction level for the year of 176,000 FMT in 2015 implies that average monthly production for the rest of the year will have to be on a par with the March level. On this basis, the projection is on the conservative side, as Toromocho is steadily upping its production to its full operating capacity, which, in monthly terms, suggests mining 21,000 FMT of copper. Thus, monthly production which starts to exceed a rate of 15,000 FMT a month would lead to upside bias regarding our growth forecast for the year. Something similar happens with the Antamina copper project, where production surprised positively in March, when it reached a level which we were not expecting it to regain (after the problems which this mine faced last year) until towards the end of 2015.

To conclude, consideration of the likelihood of occurrence, as well as the scale which we ascribe to the downside and upside risks described above, lead us, on balance, to settle on a downside bias to our growth forecasts for Peru.

8. Tables

	2013	2014	2015f	2016f	2017f
GDP (%, YoY)	5.8	2.4	3.1	4.6	6.0
Inflation (%, YoY, eop)	2.9	3.2	2.9	2.5	2.7
Exchange rate (vs. USD, eop)	2.79	2.96	3.25	3.25	3.22
Monetary policy rate (%, eop)	4.00	3.50	3.00	3.25	4.00
Private consumption (%, YoY)	5.3	4.1	3.5	3.7	4.4
Public consumption (%, YoY)	6.7	6.4	4.4	5.5	5.5
Invesment (%, YoY)	7.6	-2.0	1.6	3.8	6.0
Fiscal balance (% of GDP)	0.9	-0.1	-1.3	-1.5	-1.4
Current account (% of GDP)	-4.5	-4.0	-4.1	-4.0	-3.1

Source: Central Bank and BBVA Research

	GDP (% YoY)	Inflation (% YoY,eop)	Exchange Rate (vs. USD,eop)	MPR (%,eop)
1T13	4.4	2.6	2.59	4.25
2T13	6.2	2.8	2.75	4.25
3T13	5.2	2.8	2.78	4.25
4T13	7.2	2.9	2.79	4.00
1T14	5.0	3.4	2.81	4.00
2T14	1.8	3.5	2.80	4.00
3T14	1.8	2.7	2.87	3.50
4T14	1.0	3.2	2.96	3.50
1T15	1.7	3.0	3.09	3.25
2T15	2.5	3.0	3.14	3.00
3T15	3.5	3.0	3.19	3.00
4T15	4.6	2.9	3.25	3.00
1T16	4.0	2.7	3.28	3.00
2T16	3.9	2.3	3.32	3.00
3T16	5.6	2.4	3.26	3.00
4T16	4.7	2.5	3.25	3.25

Source: Central Bank and BBVA Research

DISCLAIMER

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