# Peru Watch

Economic Research Department

Second Semester 2009

The global economic outlook improves

We expect Peru to grow by around 4,3% in 2010. Investment will be the main driver

Monetary policy tightening in 2010: the impossible trinity again?

Lending will recover in 2010

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## Executive Summary

Over recent months, the economic stimulus measures implemented in most countries have stopped the rapid fall in world GDP which lasted from the end of 2008 to the middle of this year. We have now moved to a situation of relative stability and, in some cases, moderate growth. However, the fundamentals of this recovery are still fragile.

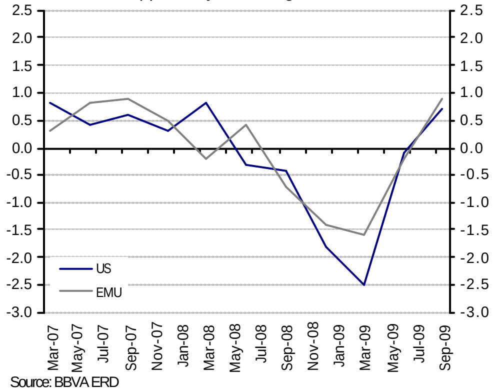
The global economic crisis has also impacted on Peru, causing a major slowdown in its growth rate. Despite this, the country's GDP will avoid a contraction in 2009. The resistance of the Peruvian economy is based on the recent strength of its fiscal accounts, firms and banks, which has increased its ability to absorb external shocks rather than to amplify them as previously usually happened.

The most recent economic activity indicators point to the start of an economic recovery. Business confidence is again in the optimistic zone, firms seem to have stopped to attend demand with inventories, and public spending is accelerating. There is renewed dynamism in the Construction sector as a result of the monetary and fiscal stimuli. In this context, growth in the final quarter of 2009 will be around 4%, with an overall expansion of 1,1% for the year.

For 2010 we expect increased dynamism in private spending, in an environment in which global economic activity will recover, although at a slow pace, and the monetary and fiscal stimuli will remain in place. The downturn in private investment seen in 2009, in particular, will be reversed next year, encouraged by lower global risk aversion and the attractiveness of economies that have shown resilience in the current crisis, such as Peru's; private consumption recovery, on the other hand, is expected to be moderate given the continuing weakness of job creation. As a result, the economy will expand by around 4,3% in 2010.

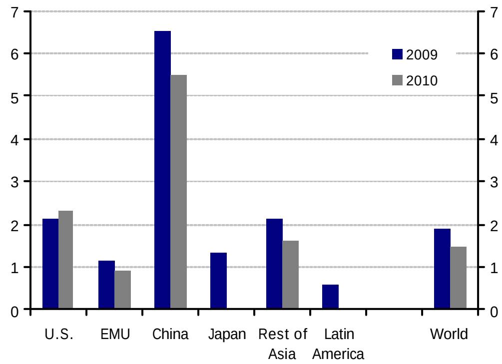
As the recovery becomes more firmly established, the monetary and fiscal stimuli will have to be removed to ensure a gradual and orderly convergence to the economy's potential growth trend (around 5%). We expect that the monetary stimulus will start to be withdrawn in the second half of 2010, when inflation has returned to its target range and the recovery in economic activity is more firmly established. Monetary tightening will be gradual (the policy rate will rise to around 2% by the end of next year). This could lead to a dilemma for the Central Bank, as an increase in the policy rate will increase interest rate differentials in favor of assets denominated in domestic currency, putting upward pressure on the Nuevo Sol (with its inherent risks, particularly for a country with a still significant financial dollarization such as Peru). For this reason the withdrawal of the stimuli will need to be coordinated by the monetary and fiscal authorities.

**U.S. and EMU: GDP growth**
(quarterly % change)




Source: BBVA ERD

**Fiscal and budget programs: relative size**
(% GDP)




Source: BBVA ERD

**Indicator of Financial Tension**
(100=January 07)


Source: BBVA Research Department
The first standardized principal component of the OIS spread series, implicit U.S. stock market volatility, bank and corporate CDS

**Interbank markets: 3-month OIS spread** (3M LIBOR-3M OIS)


Source: Bloomberg

## I. The global economic environment

### Global economic prospects improve

Since the middle of the year the world economy has been giving clearer signs of recovery. The sensation of free fall prevalent at the end of 2008 and the start of this year has given way to relative stability and, in come cases, moderate growth.

The change in the trend has been encouraged by the exceptional stimulus measures implemented in most economies. The measures have been implemented both on the monetary front (substantial reductions in the intervention rates, massive injections of liquidity and unconventional operations with assets), and the fiscal front (fiscal stimuli that have boosted sectors such as the automobile industry, and have helped temporarily sustain the income and spending of private agents).

### … although latent risks of a downturn in the short term continue, particularly in the most advanced economies

Nevertheless, the fundamentals of the world economy continue to be fragile and the risks of a downturn therefore remain in the short term. The main risk is a possible premature withdrawal of the stimulus packages, above all in the most advanced economies, and uncertainty over whether private-sector spending can replace public spending as the main driving force of recovery. In developed countries, growth during the expansionary phase was boosted by domestic demand, supported by increases in disposable income and also very high private debt. This will not recur in this new phase of the cycle. The labor market figures will also not contribute to a swift emergence from the crisis, since the rate of destruction of employment continues to be very high in many economies.

For all these reasons, the biggest challenge now facing economic policy is to organize a timely and well-planned withdrawal of the public, fiscal and monetary support programs.

In this situation, the most probable scenario would point to official interest rates being held low for an extended period, as it does not appear likely that there will be a significant upturn in inflation, given the large amount of productive capacity available. However, the maintenance of the stimuli over time could also have detrimental consequences, since they distort incentives for taking decisions on adjusting balance sheets; and they also question the sustainability of the public accounts in many economies.

It therefore appears probable that central banks will gradually try out possible alternatives for bringing their liquidity policies back to normal when the time comes. The evidence of recent weeks shows the importance of communication on the part of the monetary authorities during this phase. They have to separate what is said about the design of the exit strategies from the moment of their application, which should be delayed until the economy gives signs of self-sustaining recovery.

Whilst financial strains have gradually reduced from the highs experienced following the collapse of Lehman Brothers, the present situation is still far from satisfactory. In fact, the strains on the market are still far greater than before the crisis. The biggest progress so far has been in the interbank markets. The 3-month OIS spreads in the U.S. and the EMU are currently at 18-month lows, despite the fact that these markets are still dependent on injections of liquidity by central banks.

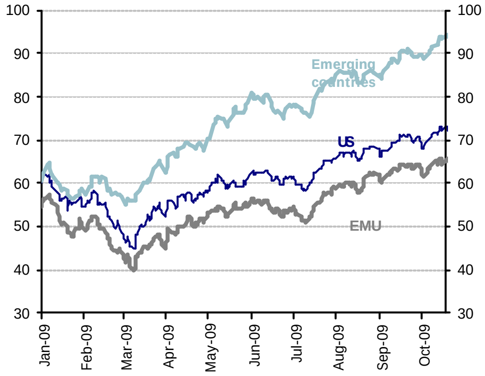
The reduction in risk premiums has been extraordinarily swift over recent months. U.S. bank CDS have reached their lowest levels since the start of the crisis, and European CDS reached their lowest level for nearly a year before stabilizing. Caution appears to have taken hold in most markets (including equity), in a scenario in which a historically high level of risk aversion still predominates.

### Emerging economies, the new motor of global growth...

Economic recovery is very uneven. In general terms, emerging economies are on a more solid path to recovery than developed ones. This can be explained by a number of factors that set these economies apart and have made it easier for most of them (with the exception of Emerging European countries) to cope with more expensive funding from the markets and the contraction in activity and employment. Specifically, these factors include: their lower exposure to the financial crisis, above all in its initial stage; the success of the fiscal and monetary stimulus packages implemented after the start of the crisis; the growth in commodity prices in recent months; the modest recovery in world trade after its collapse at the end of 2008; and, perhaps most importantly for stable long-term growth, the earlier efforts made in many of the countries to promote and practice a policy of macroeconomic stability.

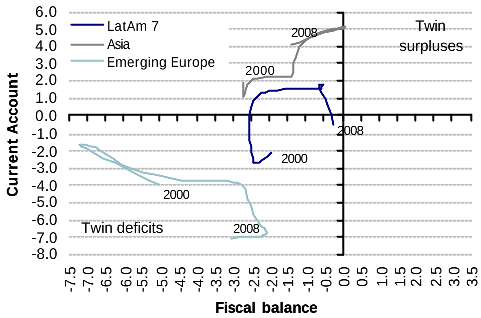
Among developed economies, the U.S. appears to be in a better position than Europe. In particular, the fiscal stimulus in the U.S. will have a relatively greater impact on growth over the coming years. In 2010 it is expected to have an impact of 3 percentage points (pp), compared with 1.5 pp in Europe. The most probable scenario for the U.S. economy is moderate growth, as there is no certainty that once the public stimulus ends, the private sector will return to high level of sustained growth. In addition, questions such as unemployment and the public accounts are still sources of obvious concern.

**Equity markets** (July 2007=100)



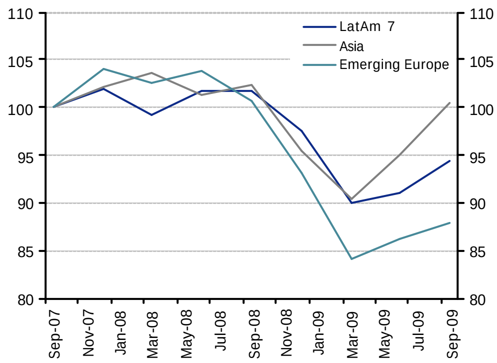

Source: Bloomberg and MSCI

**Current account and fiscal result 2000-2008** (% GDP)



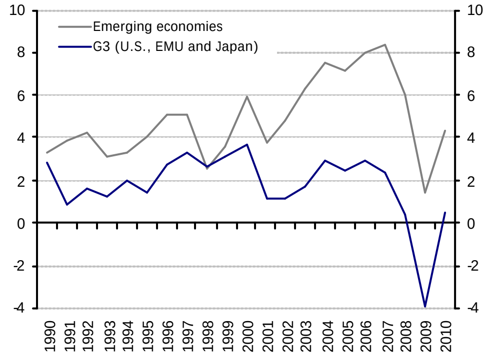

Source: WEO, IIF, BBVA LatAm 7: Argentina, Brazil, Chile, Colombia, Peru, Mexico and Venezuela. Emerging Europe: Poland, Hungary, Czech Republic, Slovakia, Estonia, Latvia, Lithuania, Bulgaria, Romania, Turkey and the Ukraine. Asia: China, Hong Kong, India, Indonesia, Korea, the Philippines,

**Industrial output**
(Index, 2007:3= 100)



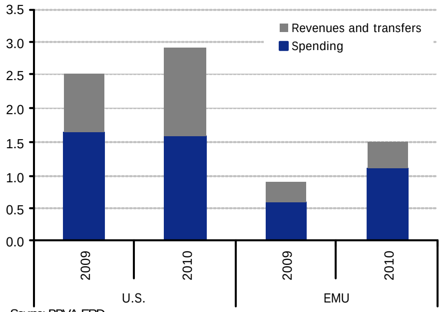

Source: Bloomberg

**Emerging economies and G3: GDP growth**
(year-on-year change)



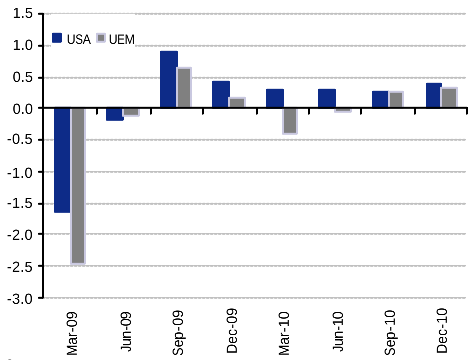

Source: BBVA ERD

**U.S. and EMU: contribution of the fiscal stimulus packages to GDP growth** (pp)



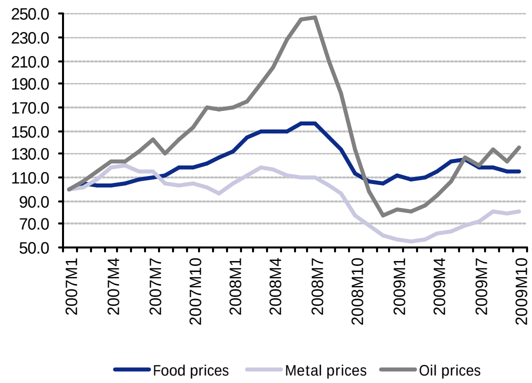

Source: BBVA ERD

**U.S. and EMU: GDP growth**
(quarterly % change)




Source: BBVA ERD

**Commodity prices**
(January 2007=100)




Source: IMF

In Europe, the fiscal stimulus will be comparatively lower in 2010, and will vary from country to country. The recovery in economic activity will also be delayed by the greater rigidity in European labor markets.

The signs of recovery in activity are already clear in emerging countries, although there are some notable variations. China, for example, has already returned to high growth rates, partly as a result of an extremely rapid increase in credit and other stimulus measures. In Latin America, most countries are already showing signs of positive growth in the third quarter. There is however greater risk in the situation of emerging European economies, which are weaker in macroeconomic and financial terms.

## Commodity prices are recovering in this more positive context

Strong demand, above all from China, and the prospects of a recovery in developed countries in 2010, have greatly supported commodity prices, which have begun to recover, as have the equity markets. In recent months, the reduction in risk aversion and the weakness of the dollar have attracted financial investment to these markets and supported a recovery in prices. This has eased the pressure on public funding felt in some emerging economies at the start of the year, and given additional support to the appreciation of the currencies of those countries that are rich in natural resources.

The outlook for prices in 2010 will depend on synchronizing the recovery of industrial production in developed countries with demand returning to normal in China. As we expect that Chinese demand will return to normal before the recovery in industrial production, we estimate that the fundamentals point to a moderate correction in commodity prices in the coming months, followed by further increases as the recovery in global demand begins to reveal the restrictions on extending supply capacity in the coming years.

## II. The macroeconomic environment

Despite the rapid deceleration in the Peruvian economy so far this year, we estimate that it will be one of the few in the region which will not contract over 2009 as a whole. This reflects, in part, the implementation of economic stimulus policies on the fiscal and monetary side, but also the endogenous response capacity of the real economy and the financial sector to an external shock on the scale of the current international financial crisis. In this respect, it is worth noting that the number of firms under a creditors' committee has not increased this year (in fact, it has been stable over the last three years) and is five times lower than that seen during the external crisis at the end of the 1990s. This would suggest that the implementation of appropriate economic policies and structural reforms (for example, increasing trade openness) has encouraged the development of more competitive companies with good corporate management, and this has made them more efficient and resistant to changing economic conditions. In addition, appropriate financial regulation has contributed to maintaining the soundness of banking institutions, resulting in the system not amplifying the cyclical adjustments resulting from the external shock, as has occurred on previous occasions.

The leading indicators published indicate that the economy has been performing better over the last quarter:

i) In seasonally-adjusted terms, GDP has been increasing since July; this is the result of a more sensitive response to the monetary and fiscal stimuli, which has, for example, been reflected in renewed dynamism in the construction sector.

ii) The inventory index shows companies increased their inventories in September. This indicates that the downward adjustment of inventories (which explains -4.2 pp of the change in domestic demand in 1H09) has now run its course.

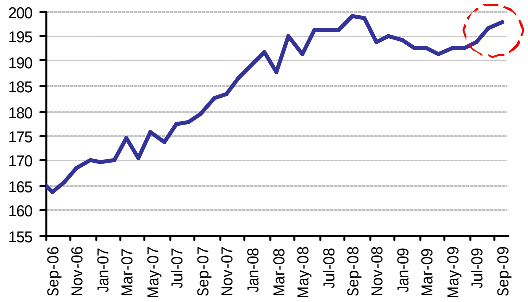
iii) Business confidence and orders have become more optimistic.

iv) The installed capacity of the non-primary manufacturing sector has reached its highest level since December 2008 (69.5%).

v) Public sector spending has been accelerating, growing by 27% year-on-year in 3Q09.

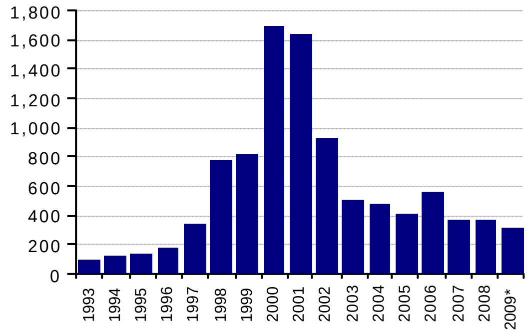
As a result, we estimate that GDP will grow by around 4% year-on-year in 4Q09, with the growth rate for the year being 1.1%.

Gross domestic product
(Index: 1994 = 100, seasonally adjusted*)



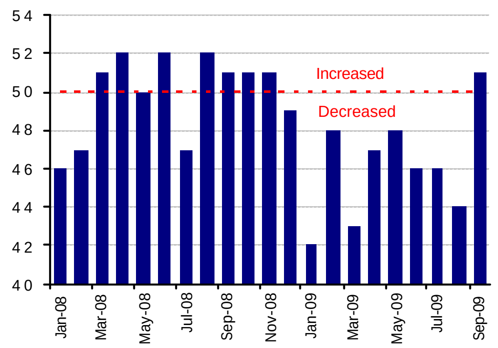
Source: BCRP
Produced by BBVA Banco Continental Economic Research Department
* Seasonally adjusted using the TRAMO-SEATS method adjusted for working days

Number of firms under a creditors' committee



Source: INDECOPI (approximated by the number of companies in insolvency proceedings)
Produced by BBVA Banco Continental Economic Research Department
* To September

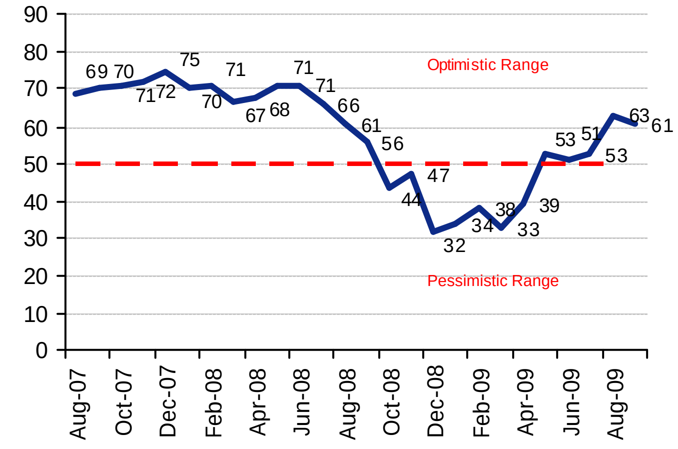
Inventories index
(changes compared to previous month)




Source: BCRP
Produced by BBVA Banco Continental Economic Research Department

| Real aggregate demand: latest quarterly data (% change year-on-year) | III-08 | IV-08 | I-09 | II-09 |
|---|---|---|---|---|
| Total Consumption | | | | |
| Private | 8,4 | 6,8 | 4,2 | 2,6 |
| Public | 2,4 | -1,0 | 8,2 | 8,9 |
| Gross fixed capital formation | 31,8 | 21,2 | 3,9 | -16,2 |
| Private | 27,9 | 21,0 | 1,7 | -20,8 |
| Public | 56,8 | 21,7 | 22,2 | 12,9 |
| **Domestic demand** | **13,7** | **9,1** | **-0,9** | **-5,5** |
| Exports of Goods and Services | 6,5 | 2,1 | -2,1 | -3,1 |
| Imports of Goods and Services | 19,0 | 14,1 | -13,3 | -24,0 |
| **GDP** | **10,9** | **6,5** | **1,8** | **-1,1** |

## Business confidence index




Source: BCRP
Produced by BBVA Banco Continental Economic Research Department

## Investment projects portfolio 2009-2010 (USD million)

| Sector | Empresa | Nombre del Proyecto | Monto (millones USD) |
|---|---|---|---|
| Electricidad | Electrobras | Proyectos hidroeléctricos | 4,800 |
| Industrial | SK Corea | Planta petroquímica (Pisco) | 4,000 |
| Minería | Anglo American Quellaveco | Quellaveco | 2,200 |
| Minería | Chinalco | Toromocho | 2,200 |
| Hidrocarburos | Perenco Peru Limited | Lote 67 | 2,000 |
| Minería | Zijin Mining Group | Río Blanco | 1,440 |
| Hidrocarburos | CF Industries | Planta petroquímica | 1,000 |
| Minería | Anglo American | Michiquillay | 700 |
| Construcción | Falabella Perú y Ripley | Centros comerciales | 600 |
| Construcción | El Libertador | Hoteles | 150 |
| Industrial | Siderperú | Horno | 122 |
| Construcción | Grupo Interbank | Centros comerciales | 115 |
| Construcción | Inmobiliari | Proyectos inmobiliarios | 100 |
| Construcción | Parque Arauco | Complejo comercial (Arequipa) | 45 |
| Construcción | EKIMED | Centros comerciales | 36 |
| Comercio | Makro | Apertura de nuevos locales | 35 |
| Industrial | Unicon | Ampliación de capacidad de planta | 15 |
| | Total | | 19,558 |

Source: BCRP, Maximixe, APOYO, Minem, investment announcements
Produced by BBVA Banco Continental Economic Research Department

## Investment will drive growth in 2010

We expect greater dynamism in private consumption in the coming year, particularly for investment, against a background of continuing expansionary monetary and fiscal policies, with a gradual recovery in global economic activity.

This increased investment by the private sector will reverse some of the adjustment in 2009. This reflects:

- Increased business optimism. In the base scenario, we assume that global economic activity will continue to recover over coming quarters, although only gradually. Against this background, the perception of risk will be more favorable to investment in emerging economies, among which Peru stands out[1].
- Lax credit conditions. The tone of monetary policy – both domestic and external- will continue to be expansionary in 2010, facilitating investment.
- Metal prices will be at attractive levels. These prices have risen significantly in 2009 as the signals of stabilization in the global economy have increased: increased demand in China, low international interest rates and the weakness of the dollar. Although we expect a degree of correction in 2010, prices will continue to encourage investment in mining activity.

As a result, we expect work with a total value of USD 10 billion to start next year, mainly in mining, hydrocarbons, industry and construction; added to the projects started in 2009, the total will be around USD 20 billion. In addition, projects commenced in previous years will continue (Camisea II, Bayóvar, Muelle Sur, Shougang and others), which represent a portfolio worth USD 2 billion, as will the award of concessions by Proinversión for 2009-2011 (USD 27 billion).

| Real aggregate demand: annual data (% change year-on-year) | 2007 | 2008 | 2009(f) | 2010(f) |
|---|---|---|---|---|
| Total Consumption | 7,8 | 7,9 | 2,3 | 2,5 |
| Private | 8,3 | 8,7 | 1,8 | 2,6 |
| Public | 4,5 | 3,9 | 9,4 | 3,7 |
| Gross fixed capital formation | 21,3 | 27,9 | -5,6 | 8,0 |
| Private | 23,4 | 25,6 | -11,3 | 6,4 |
| Public | 10,0 | 41,9 | 23,9 | 14,1 |
| ***Domestic demand*** | ***11,8*** | ***12,3*** | ***-1,3*** | ***4,5*** |
| *Exports of Goods and Services* | *6,2* | *8,2* | *-3,0* | *4,0* |
| Imports of Goods and Services | 21,3 | 19,9 | -13,2 | 4,8 |
| **GDP** | **8,9** | **9,8** | **1,1** | **4,3** |

[1] Moody's recently put its rating for Peru's public debt under revision with a view to a possible increase in its rating. It should be noted that Peru's public debt is currently rated as being investment grade by Fitch and S&P, whilst Moody's rates it at one level lower than this.

Public sector investment will continue to support economic activity (fiscal stimulus). The resources under the Economic Stimulus Plan not applied in 2009 will be used next year. We estimate that these resources could amount to up to 1.5 pp of GDP.

Growth in private consumption will be more modest, explained by:

- A gradual recovery in non-primary manufacturing. This sector is one of the most labor intensive, and is where the largest adjustment took place in 2009 (in particular in the part of the sector which focuses on the export market). This will recover gradually over the coming quarters, in line with the rate of recovery in global economic activity.
- There will be relative stability in the Terms of Trade. The positive impact (wealth effect) of this on disposable income for consumers will not be very significant.
- Some fiscal measures implemented in 2009 to support private consumption (contributions holidays for Pension Fund Administrators, tax exemption for redundancy payments in 2009, exceptional bonuses to public sector workers) are not planned for 2010.

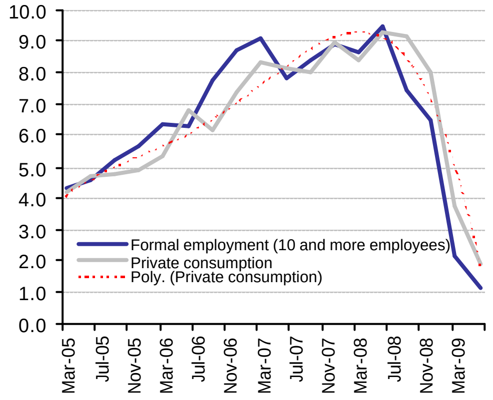
As a result, the economy will expand by around 4.3% in 2010.

## Fiscal and foreign trade accounts will continue to be in deficit, but at manageable levels

The implementation of the Economic Stimulus Plan and the fall in tax revenues resulting from the weakness of domestic demand and lower international metal prices will result in a fiscal deficit of 1.8% of GDP in 2009, the first since 2005. We expect the fiscal stimulus to be gradually withdrawn next year as private spending recovers and increased global and domestic activity has a positive effect on tax revenues. This will result in the fiscal deficit closing. It is worth noting here that it will be fairly easy to withdraw the fiscal stimulus given the way that it was implemented, with expenditure of a transitory nature, such as infrastructure and maintenance projects, among others. As a result, in 2009 and 2010 the public deficit will veer from the downward path it had been on it previous years, but it will return to this path in 2011.

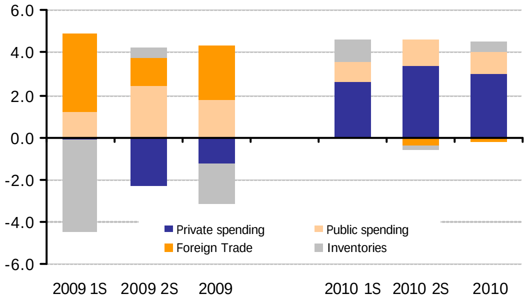
In terms of foreign trade, the balance of payments current account deficit will be lower in 2009 than in the previous year. This is due to the major contraction in imports (raw materials and capital goods in particular) associated with inventory adjustments, lower private investment and lower international commodity prices. These factors will reverse in 2010 (imports will recover), and as a result we expect the current account deficit to increase, although it will remain at manageable levels. This deficit will largely be financed by long-term capital (direct foreign investment).

### Formal employment and Private consumption (% change year-on-year)



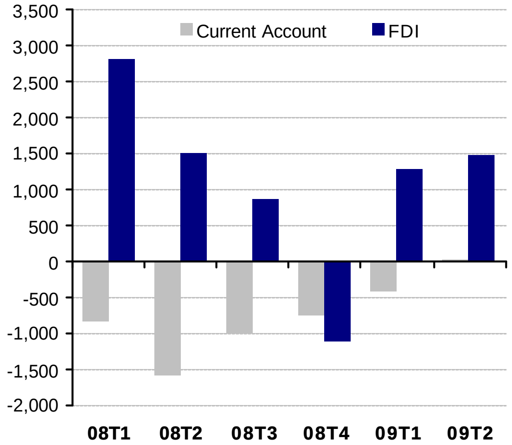

Source: BCRP
Produced by BBVA Banco Continental Economic Research Department

### Contribution to GDP growth 2009-2010 (percentage points)




Source: BCRP
Produced by BBVA Banco Continental Economic Research Department

### Current account and FDI flows (USD million)



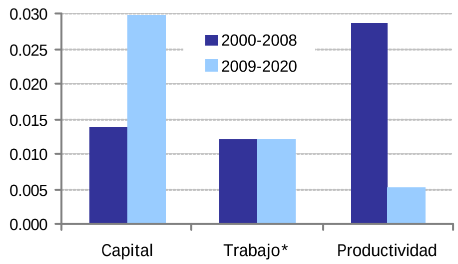

Source: BCRP
Produced by BBVA Banco Continental Economic Research Department

The Peruvian economy has withstood the impact of the global economic crisis relatively well. It will be one of the few economies to grow in 2009, and we expect it to have one of the highest growth rates in the region in 2010.

What can we expect beyond that? Our forecasts indicate potential growth for the country slightly in excess of 5%, and we expect the economy to converge on this rate in the medium term. The main factor which will drive the increase in economic activity is capital accumulation. Against a background of macroeconomic stability and expanding domestic (due to more families earning average income) and foreign (from opening up to trade) markets, Peru will be an attractive investment destination. In addition, the country is starting from relatively low levels of capital (for example, the infrastructure deficit has been calculated at 30% of GDP), which give it greater scope for growth.

However, this growth motor tends to exhaust itself as the return on investment decreases in the process. One factor which will support more sustainable economic growth over the longer-term, complementing the accumulation of capital, is improved productivity. The performance of productivity over the period 2000-2020 has been calculated in an accounting exercise (approximated using the Solow residual in a neoclassical growth model). The results indicate that whilst productivity contributed some 2.8 pp to annual economic growth from 2000 to 2008, this will decrease in the future (0.5 pp between 2009 and 2020).

**Chart 1. Contribution to Peru's GDP growth 2009-2010** (percentage points)



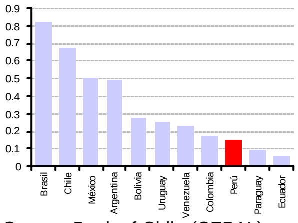

Source: INEI, BCRP, ENAHO household survey data for several year, BBVA Banco Continental ERD
(*) Figures adjusted for human capital quality, approximated by the number of years of education for the total population and estimated returns to education.

What can be done to continue increasing the productivity of the factors of production over the coming years? Firstly, there is room for improvements in education and health services. In these areas, public expenditure per head of the population is among the lowest in the region, and this does not help the productivity of Peruvian workers.

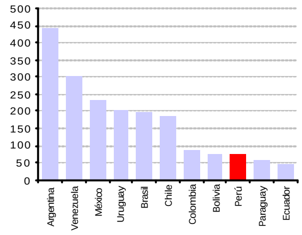
The situation with regard to research and development expenditure is similar. A third route for promoting productivity of the factors of production is to close the infrastructure gap by improving roads, ports and airports in order to exploit the opportunities arising from expanding markets.

**Chart 2. Social indicators, Latin America**

**Public spending on R&D** (% of GDP, 2005)



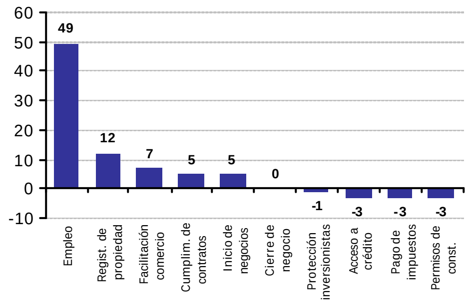

**Public spending per capita on education, 2005** (in USD 2000)




Source: Bank of Chile (CEPAL)

An additional factor to consider is the improvement in the business climate. In this context, whilst Peru has been making advances over recent years (up 9 places in the general *Doing Business* rankings between 2009 and 2010, for example), it is still in 56th place out of 183 countries. Progress has been shown in some labor market indicators (reduced labor costs and less rigidity in working hours); however, in other areas progress has been minimal (and there has even been some slippage).

**Chart 3. *Doing Business* Ranking, Peru**
(change in positions between 2009 and 2010)




Source: World Bank

It should be noted that the Government has set itself the target of improving conditions for business development. It aims to have moved Peru into 25th position in the *Doing Business* Rankings by September 2011 (the Rankings will be published in 2012). Achieving this target will move Peru above Puerto Rico, which is currently the highest placed Latin American country (35th position), and will be an additional stimulus for sustaining economic growth over coming years.

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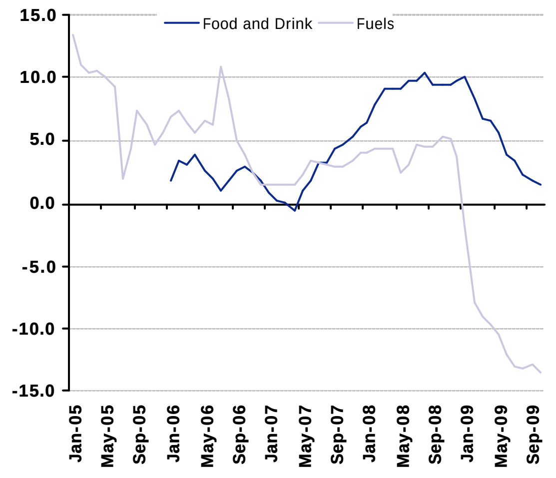
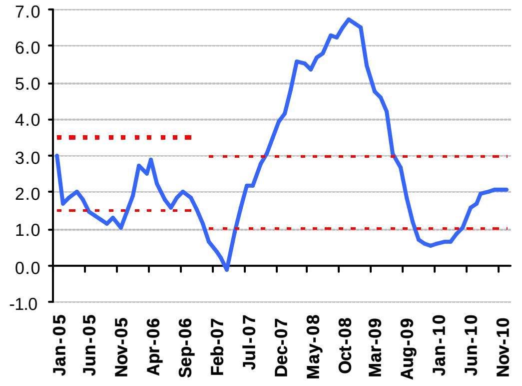
## Food and fuel price indices: 2005/09
(% change year-on-year)




Source: INEI
Produced by BBVA Banco Continental Economic Research Department

## Consumer price index: 2005-10
(% change year-on-year)




Source: INEI, BBVA
Produced by BBVA Banco Continental Economic Research Department

## Inflation will stay below its target range in the coming months

In 2009, the year-on-year inflation rate has been on a downward trend, mainly due to reversal of the supply shocks in 2008 on domestic fuel and food prices. This brought the year-on-year inflation rate to 0.7% year-on-year in October, which is below the Central Bank's target range (2%, +/-1 pp). This is the lowest level recorded since May 2007. Core inflation has also been decreasing (3.1% year-on-year in October) in line with the economic cycle, although by less than overall inflation.

We estimate that in the coming months the year-on-year inflation rate will begin to reverse its downward trend and that it will return to the target range during the second quarter of 2010, finishing the year at around 2%. This forecast is based on a number of factors, including:

- The transitory nature of the reversal of the supply shocks, which will have dissipated towards the end of the year or the beginning of 2010. In fact, international fuel and food commodity prices have been increasing over recent months, and this reduces the possibility for further reductions in the inflation rate.
- A gradual recovery in economic activity, which will act slowly to support increasing prices.
- Inflation expectations for 2010 (2.4% in October) in line with Central Bank targets.

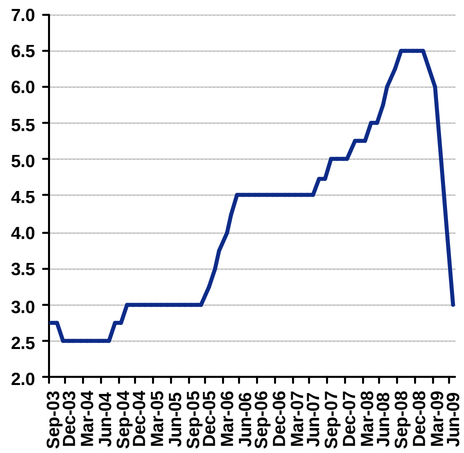
There are two risks to this forecast. In the short term, although the available data suggests that the El Niño effect will be moderate, any increase in this will affect prices (mainly through increased food costs). In addition, over a longer time horizon, increased international commodity prices (in the context of high liquidity, low interest rates and the weakness of the dollar) could generate increased upward pressure on local prices.

**Prices: most recent monthly data**

| (% change year-on-year) | Jul-09 | Aug-09 | Sep-09 | Oct-09 |
|---|---|---|---|---|
| Consumer Price Index (CPI) | 2,68 | 1,87 | 1,20 | 0,71 |
| Food and Beverages | 3,35 | 2,35 | 1,69 | 1,52 |
| Fuel (for vehicles) | -13,07 | -13,20 | -12,78 | -13,55 |
| Core index | 4,38 | 3,93 | 3,73 | 3,13 |
| Consumer Price Index – Imports | -8,16 | -8,49 | -8,53 | -8,92 |
| Wholesale Price Index | -3,26 | -4,99 | -6,21 | -6,35 |
| Machinery and Equipment Price Index | 6,12 | 4,37 | 1,38 | -2,00 |
| Construction Materials Price Index | -10,72 | -11,94 | -11,81 | -9,95 |

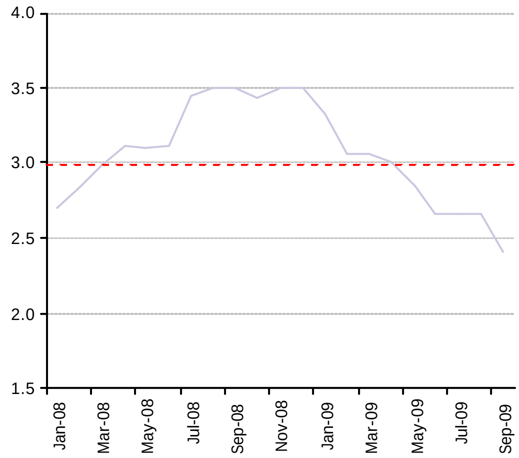
* Imported inflation considers assets for which prices are associated with commodities (wheat, corn, soya, oil); as a result, it considers food and fuel in particular.

Policy interest rate
(%)




Source: BCRP, BBVA
Produced by BBVA Banco Continental Economic Research Department

Inflation expectations for 2010
(%)




Source: BCRP
Produced by BBVA Banco Continental Economic Research Department

## III. Monetary policy and exchange rate

### The Central Bank completes the monetary easing cycle

In August this year, the Central Bank cut its policy interest rate by 75 basis points (bp), and announced that it would make no further cuts. As a result, it brought to an end a cycle of cuts in the policy rate, which has fallen from 6.5% in February to 1.25%, the lowest level since this variable started being used as the monetary policy operational target. The absence of inflationary pressures and decreasing inflation expectations have enabled the Central Bank to implement an expansionary monetary policy, against a background of a rapid slowdown in private spending and GDP.

### We expect the policy interest rate to stay at 1.25% over the coming months

Since August, the Central Bank has reiterated in its monetary policy communiqués that it does not plan to change the current level of its policy interest rate. This is consistent with our base case scenario, which assumes that the policy rate will stay at 1.25% until the end of the first half of next year, in the context of:

- A gradual recovery in economic activity. The leading indicators published suggest that there will be a recovery in GDP in the fourth quarter, although there is some uncertainty about this on the consumption side. GDP will perform better in 2010, but will grow by less than potential.
- The absence of inflationary pressures in the short-term. To October, inflation (0.7% year-on-year) was below the Central Bank's target range (2.0%; +/-1 pp), and it will return to the target range in the second half of next year.
- Inflation expectations are in line with the official target. Inflation expectations for 2010 are anchored at the Central Bank's target range.

As a result, in the base scenario we expect that the monetary stimulus will start to be withdrawn in the second half of 2010, when inflation has returned to its target range, and the recovery in economic activity is more established. Monetary tightening will be gradual, and will result in the policy interest rate increasing to 2% at the end of the coming year.

**Cash and bank credit: latest monthly figures**

| (% change year-on-year) | Jul.09 | Aug.09 | Sep.09 | Oct.09 |
|---|---|---|---|---|
| Interbank selling exchange rate (average, sole/USD) | 3,013 | 2,952 | 2,910 | 2,873 |
| Primary issuance (end of period) | 0,17 | 2,35 | 0,89 | -1,40 |
| Total liquidity | 10,0 | 5,5 | 3,4 | n.a |
| Foreign currency liquidity/Total liquidity (%) | 15,8 | 15,9 | 16,1 | n.a |
| Net international reserves (USD million) | 32,1 | 32,0 | 32,1 | 32,9 |
| Interbank interest rate in domestic currency (%) | 2,2 | 1,3 | 1,2 | 1,2 |
| Interbank interest rate in foreign currency (%) | 0,2 | 0,2 | 0,2 | 0,3 |
| Private Sector Credit in local currency | 28,4 | 26,3 | 24,5 | n.a |
| Credit to private sector in foreign currency | 4,4 | 2,4 | -1,3 | n.a |
| Delinquency rate (%) | 1,64 | 1,69 | 1,58 | n.a |

## Removing the monetary stimulus: the impossible trinity again?

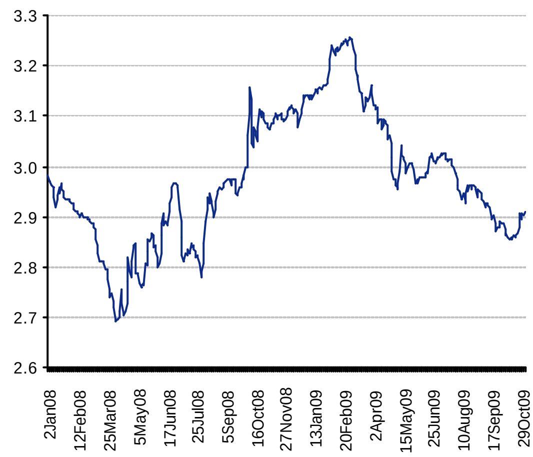
In line with the trends of other currencies in the region, the Nuevo Sol (PEN) continued to strengthen against the dollar in the second quarter. This took place against a background of (i) readjustments of investor portfolios (mainly local institutions) in favor of assets denominated in PEN (due to lower overall risk aversion); (ii) excellent results on the trade balance; and (iii) a greater than expected net increase in direct foreign investment. The upward trend of the PEN against the dollar has been offset to some extent by the BCR through exchange rate intervention, and by not renewing deposit certificates index-linked to the exchange rate on maturity.

Although the electoral process (municipal and regional elections in 4Q10 and general elections in 2Q11) may induce some upward pressure on the exchange rate next year, these will be transitory and limited[2]. However, in addition to these background factors, analysis of the fundamentals of the Peruvian economy suggests that in the medium term there is scope for the PEN to further appreciate against the dollar. Firstly, this is because we expect a positive productivity differential for Peru, in a context of opening up of the economy and major increases in the imports of capital goods which have encouraged technology transfer. A second factor is the solvency of the public finances in Peru which have not deteriorated greatly in the current international financial crisis. In this respect, it is worth noting that we expect that the ratio of Peruvian government debt to GDP will return to a downward trend from 2010 onwards, and that the fiscal deficit should close over coming years, which will increase rates of domestic savings.

In this context the removal of the monetary stimulus by the Central Bank could present it with a dilemma. On the one hand, the increased dynamism expected in the second half of the coming year will require less expansionary monetary policy to ensure gradual and ordered convergence towards growth levels compatible with potential (around 5%) in 2011. It should be remembered that the policy interest rate is at historically low levels and this will not be sustainable in a context of full economic recovery. On the other hand, given that we do not expect any changes from the Federal Reserve, an increase in the policy rate will result in an increase in the interest rate differential in favor of assets denominated in domestic currency, which could increase short-term capital inflows and, as a result, lead to the PEN becoming overvalued.

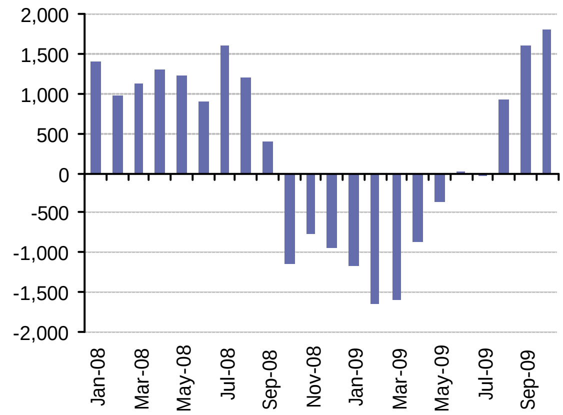
[2] In this context the proposal which the Central Bank has just launched to reduce the limit on banks' long positions in foreign currency from 100% of real assets to 50% could offset any upwards pressure from sudden and rapid increases of the type seen during past periods of political noise (See the section The Central Bank Proposes Reducing the Limit for the Banks' Long Foreign Currency Positions).

Exchange rate (PEN/USD)



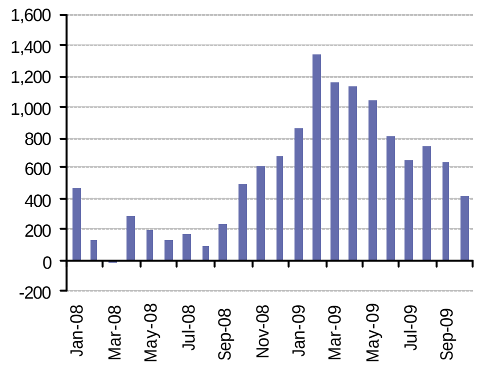

Source: BCRP
Produced by BBVA Banco Continental Economic Research Department

Balance of net *forward* sales of foreign currency by the private sector to banks (USD million)




Source: BCRP
Produced by BBVA Banco Continental Economic Research Department

Bank's global long position in foreign currency (USD million)




Source: BCRP, BBVA
Produced by: BBVA ERD - Banco Continental

A large deviation of the exchange rate from its equilibrium levels is a particularly sensitive topic in an economy which is highly exposed to the dollar, as is the case for Peru, as a result of currency mismatch and the effects that this might have on balance sheets in the private sector. In particular, in a context of imperfect information, excessive currency appreciation could lead to greater indebtedness in foreign currency for local agents who receive revenue in local currency, but who have not adequately priced in the exchange rate risk they are taking on. In addition, as observed on other occasions, overvaluation of the currency can result in loss of competitiveness in the short term, a deterioration in the balance of payments current account, and, eventually, against a background of major capital inflows, credit and consumer booms and a bubble in the non-tradable sector of the economy (as with the real estate bubble in Eastern Asia before the crisis of the 1990s).

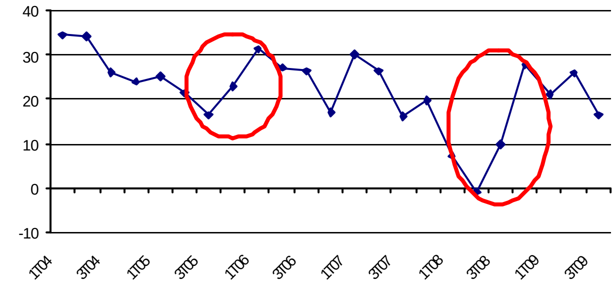
The aforementioned dilemma reveals the difficulties faced by the Central Bank in implementing a counter-cyclical monetary policy with a floating exchange rate in a small economy and free movement of capital (the impossible trinity). We should remember that in the first quarter of 2008, a major inflow of short-term capital led the Central Bank to implement unprecedented measures to contain the inflow. These considerations suggest that withdrawal of the monetary stimulus will have to be gradual, and this will limit the incentives associated with the increased yield on assets denominated in the local currency. Furthermore, this will have to be coordinated with fiscal policy, where the stimulus could be withdrawn first, leaving space for the policy interest rate to be gradually increased later. We should add that the fiscal stimulus measures implemented have been transitory in nature, which will make it easier to withdraw them when the time comes. Finally, we cannot rule out the Central Bank imposing some form of direct or indirect control on capital inflows, despite the balance of the costs and benefits of such measures not being clear.

## Box. The Central Bank proposes reducing the limit to banks' long positions in foreign currency

The Central Bank (BCR) has recently proposed a reduction in the limit to banks' long foreign currency positions from 100% of capital to 50%[1]. This measure aims to limit the volatility which fluctuations in such positions cause in the foreign exchange market and which make monetary management more difficult.

Regulation by the Banking, Insurance and Pension Funds Supervisor (SBS) establishes that banks have a limit on long positions of 100% of their capital, and a limit of 10% on short positions. These asymmetrical foreign exchange positions were established in the 1990s, when exchange rate shocks mainly involved the depreciation of the domestic currency. However, during the present decade, the frequency of such episodes has reduced (as the Peruvian Nuevo Sol has appreciated). In this context, since 2004 banks' global long position in foreign currency has not exceeded 40% of capital.

**Banks global long position in foreign currency: 1Q04/3Q09 (as a % of capital)**

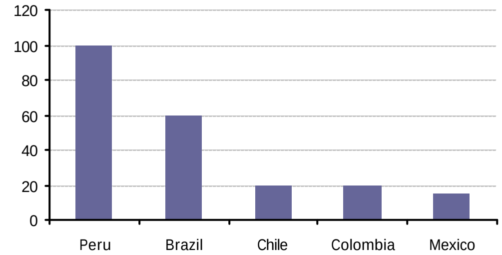



Source: SBS

In turn, however, evidence shows that at times of high uncertainty (election periods and external shocks) long positions in foreign currency have tended to increase sharply, increasing downward pressures on the domestic currency (depreciation). The most recent example of this was in 2008, when in the last four months of the year, at a time of volatility due to the deepening of the international financial crisis, banks increased their long positions in foreign currency by approximately 20 percentage points of capital[2], and there was a weakening of 7,5% in the value of the Peruvian Nuevo Sol (PEN). In this context, to offset the upward pressures on the exchange rate, the BCR sold USD 5 699 million (16% of net international reserves as of September 2008). Some months later, and as global risk aversion has decreased, this has been reversed: banks' foreign exchange positions have reduced by 10pp of capital, the domestic currency has strengthened, and the BCR has intervened in the foreign exchange market purchasing dollars.

With the Central Bank's proposal, fluctuations in banks' foreign exchange positions would tend to be less pronounced, as would the resulting volatility in the exchange market, particularly for a relatively small one such as the Peruvian. In addition, the limit suggested for long positions is similar to that in other countries in the region.

**Latin America: legal limits on long positions in foreign currency (as a % of banks capital)**




Source: Central Banks and Regulators

In the present context of expectations that the Peruvian currency will appreciate, no banking institution has a long dollar position over 50% of capital. As a result, if the measure were implemented today, it would have no major effect on the market since no bank would need to sell dollars (increasing the supply on the exchange market) to adjust to the new limit.

Therefore, the Central Bank proposal would seem to be aimed at limiting foreign exchange volatility episodes which might be seen in 2010 and 2011, which are election years in Peru.

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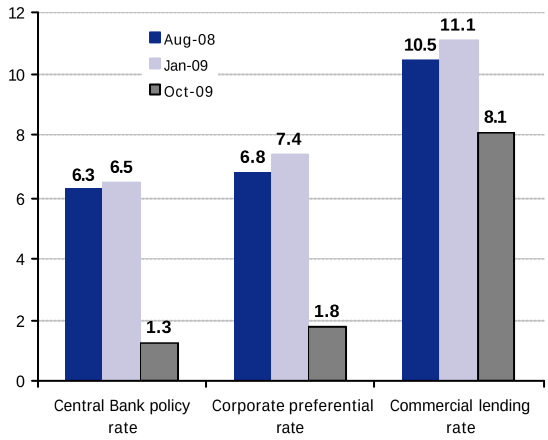
[1] A bank's foreign exchange position is defined as the difference between its foreign currency assets and liabilities, including its net position in financial derivatives. If this position is positive, the Bank is said to be "long" in the foreign currency. Usually, as expectations that the domestic currency is going to depreciate increase, the foreign exchange position tends to rise.

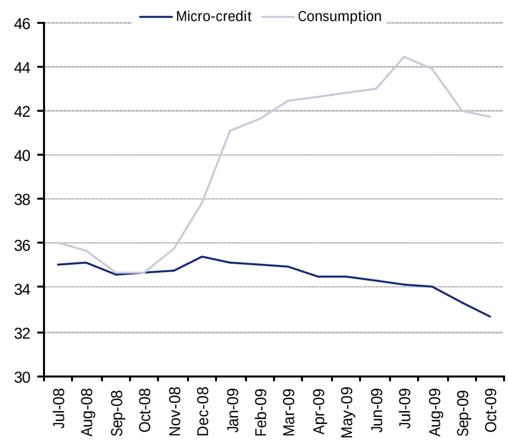
[2] The foreign currency position of some banks in particular reached levels of over 50% of capital.

Interest rates in domestic currency
(%)



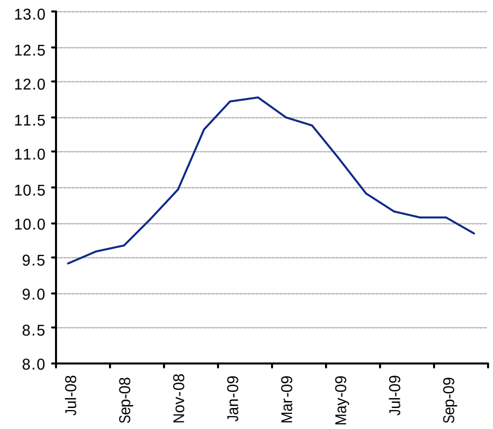

Source: BCRP, SBS
Produced by BBVA Banco Continental Economic Research Department

Interest rates in domestic currency for micro-credit and consumption
(%)




Source: SBS
Produced by BBVA Banco Continental Economic Research Department

Interest rate in domestic currency for mortgage loans
(%)



Source: SBS, Conasev
Produced by BBVA Banco Continental Economic Research Department

## IV. Financial Context

### Interest rates would be relatively stable over the coming months

In line with the reduction in the policy rate implemented by the Central Bank, there was a downward trend in bank interest rates in the first three quarters of the year. The preferential corporate rate fell by 560 basis points (bps) between January and October 2009, and by 500 bps compared to levels before the financial crisis intensified (August 2008). The commercial rate has fallen by 302 bps so far this year, and by 240 bps compared to August 2008. Finally the interest rates for mortgages in soles and dollars fell by 187 bps and 127 bps respectively between January and October 2009, in line with the lower returns demanded on sovereign debt, which is used as a reference point in the calculation of this rate in soles, and with the cuts in international rates. In other credit segments, where risk is greater and where increases in NPL have been more pronounced, such as micro-credit and consumer lending, the feed through of monetary policy has not been so clear.

For the coming year, we expect interest rates to remain stable, or for there to be a slight fall. This is against a backdrop of global stabilization, reductions in risk and recovery in local economic activity. The main factors which will affect this include:

- The Central Bank will hold its present policy rate (1.25%) during the first half of 2010. As economic activity –particularly private spending- shows clear signs of improvement the Central Bank will begin to withdraw the monetary stimulus; however, this will be very gradual, as a result of which interest rates will not be under great pressure in the second half of the year.
- Greater competition on the credit supply side and the weakness of demand for finance in a context of less dynamic economic activity.
- Greater competition between banks and capital markets.
- The incentives granted by the Government to encourage credit growth –particularly in segments such as housing (through lower funding costs and social programs) and micro-credits (reducing the reserve requirement for investment funds) will give a downward bias to interest rates.

Local dollar interest rates will depend on the performance of external markets. In particular, we assume that the FED will hold its policy rate in the range 0% to 0.25% in 2010, and that against a background of relaxation in international financial markets, yields on the long end of the dollar curve will remain around current levels.

## Lending will recover in 2010

In 2009 the growth of credit was affected by the slowdown in economic activity. The year-on-year increase in bank credit reduced from 35% in January 2009 to 7% in October 2009. The largest slowdown was in the commercial credit in dollars segment, affected mainly by the major decrease in finance for foreign trade transactions against a background of lower foreign demand and lower placement of dollars in sectors such as manufacturing and trade. The recovery in credit will depend on factors related, mainly, to demand. Low interest rates, particularly in the business sector, together with the recovery in economic activity, will drive increased demand for credit. On the supply side, credit conditions have improved and companies are not experiencing problems in accessing finance according to the BCR's monthly survey. Furthermore, increases in levels of employment and income, together with measures introduced in the Fiscal Stimulus Plan (lower funding costs for housing, exemption of taxes on bonuses), will continue to encourage growth in credit for consumption and mortgages in the coming months. In the latter segment, the upward trend has been observed since July 2009.

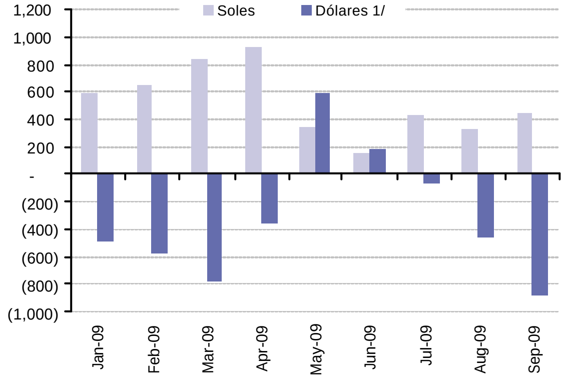
## Higher economic growth since 4Q09 will limit the increase in non-performing loans

In line with what is to be expected against a background of deteriorating economic activity, NPL levels in the banking system increased moderately during the first few quarters of 2009. This increase was accompanied by high levels of provisions, which on average cover 230% of total of the portfolio in arrears. Given the rapid deterioration in economic activity, the Banking Supervisor deactivated the pro-cyclical component of generic provisions from September, reassigning these to constitute other obligatory provisions. In the future, the recovery of the economy, and the associated increase in income levels, together with the risk policies adopted by banks, will reduce the scope for future increases in NPL, which will remain limited to near current levels.

## Corporate debt issuances start to increase

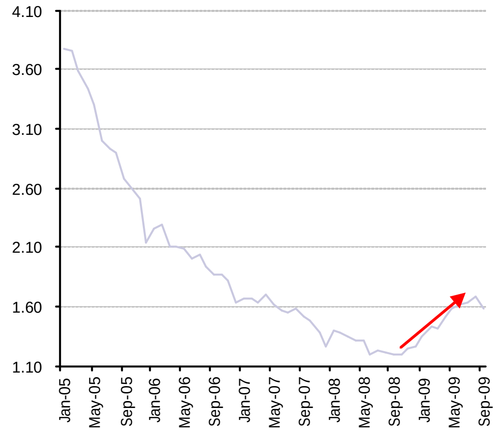
In the first 8 months of the year, the volume of activity recorded in capital markets was low, due to the uncertainty associated with the international financial crisis and the wider spreads required. However, since September this situation has been reversing, and there has been a recovery in corporate debt issues, which were at similar levels to those of the third quarter in the previous year, with demand on average being double supply. In the coming months, against an improving economic background and with financial conditions returning to normal, we expect the capital market to continue to recover.

### Credit flows by currency
### (PEN million)



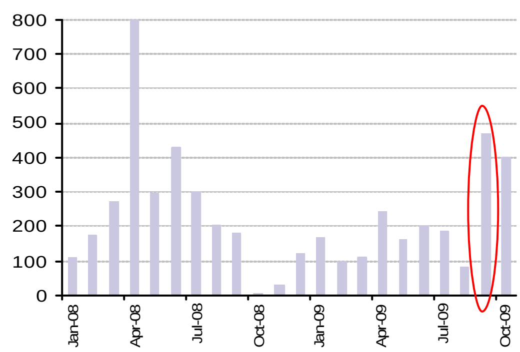

1/ Valued at the exchange rate current in September 2009 (2.89 soles/dollar)
Source: SBS
Produced by BBVA Banco Continental Economic Research Department

### Delinquencies in the banking system
### (%)




Source: SBS, Conasev
Produced by BBVA Banco Continental Economic Research Department

### Corporate debt issued in domestic currency
### (PEN million)




Source: BVL
Produced by BBVA Banco Continental Economic Research Department

## PeruWatch
## Economic Research Department forecasts

| | 2006 | 2007 | 2008 | 2009(f) | 2010(f) |
|---|---|---|---|---|---|
| **Economic activity** | | | | | |
| GDP nominal (S/. billions) | 305.1 | 335.7 | 372.8 | 384.8 | 409.8 |
| GDP nominal (USD billions) | 93.3 | 107.5 | 127.7 | 127.4 | 140.6 |
| Real GDP (yoy %) | 7.6 | 8.9 | 9.8 | 1.1 | 4.3 |
| **Prices, end of period** | | | | | |
| CPI (yoy %) | 1.1 | 3.9 | 6.7 | 0.6 | 2.1 |
| **Public finances** | | | | | |
| General Government balance (% del PIB) | 2.1 | 3.1 | 2.1 | -1.8 | -1.1 |
| Total public debt (% of GDP) | 32.7 | 29.6 | 23.8 | 25.6 | 26.6 |
| External public debt (% of GDP) | 23.6 | 18.7 | 15.1 | 16.9 | 17.3 |
| **External sector** | | | | | |
| Exports (USD billions) | 23.8 | 28.0 | 31.5 | 26.7 | 28.0 |
| Imports (USD billions) | 14.9 | 19.6 | 28.4 | 22.8 | 25.0 |
| Current Account Balance (USD billions) | 8.9 | 8.4 | 3.1 | 3.9 | 3.0 |
| Current Account Balance (% of GDP) | 3.0 | 1.4 | -3.3 | -1.3 | -2.0 |
| Nominal exchange rate (S/. By USD, end of period) | 3.20 | 3.00 | 3.11 | 2.90 | 2.95 |
| External Debt (% of GDP) | 31.0 | 30.8 | 27.1 | - | - |
| International reserves (USD billions) | 17.3 | 27.7 | 31.1 | 32.4 | 32.6 |
| **Financial sector** | | | | | |
| Policy interest rate | 4.50 | 5.00 | 6.50 | 1.25 | 2.00 |
| Banking system loans (yoy %, nominal) | 19.5 | 25.9 | 30.0 | 17.9 | 9.9 |
| Banking system deposits (yoy %, nominal) | 14.5 | 18.1 | 30.5 | 16.8 | 12.6 |

**International Context**

| Commodities (end of period) | 2008 | 2009 | 2010 | | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|
| **Brent (USD/barrel)** | 45.6 | 60.6 | 68.3 | **Soybean (USD/t.)** | 343 | 368 | 339 |
| **Copper (USD/t)** | 3070 | 5732 | 3969 | **Corn (USD/t.)** | 144 | 130 | 136 |
| | | | | **Wheat (USD/t.)** | 216 | 168 | 160 |

| | Real GDP (%) | | | | Inflation (%, end of period)* | | | |
|---|---|---|---|---|---|---|---|---|
| | **2007** | **2008** | **2009** | **2010** | **2007** | **2008** | **2009** | **2010** |
| **USA** | 2.1 | 0.4 | -2.5 | 1.5 | 2.9 | 3.8 | -0.7 | 1.1 |
| **EU** | 2.7 | 0.6 | -3.8 | 0.2 | 2.1 | 3.3 | 0.3 | 0.8 |
| **Japan** | 2.3 | -0.7 | -5.3 | 1.1 | 0.5 | 1.0 | -1.5 | -0.3 |
| **China** | 13.0 | 9.0 | 8.3 | 9.3 | 4.8 | 5.9 | -1.1 | 1.2 |
| **Latin America** | | | | | | | | |
| **Argentina** | 8.7 | 5.7 | -2.5 | 2.6 | 8.5 | 7.2 | 7.5 | 10.0 |
| **Brazil** | 5.7 | 5.1 | 0.0 | 4.7 | 4.5 | 5.9 | 4.2 | 4.6 |
| **Chile** | 4.7 | 3.2 | -1.2 | 4.1 | 7.8 | 7.1 | -0.7 | 2.5 |
| **Colombia** | 7.5 | 2.4 | 0.1 | 2.4 | 5.7 | 7.7 | 2.4 | 3.8 |
| **Mexico** | 3.3 | 1.4 | -7.2 | 3.1 | 3.8 | 6.5 | 4.0 | 5.2 |
| **Peru** | 8.9 | 9.8 | 1.1 | 4.3 | 3.9 | 6.7 | 0.6 | 2.1 |
| **Venezuela** | 8.4 | 4.9 | -2.1 | -0.5 | 18.7 | 31.3 | 29.3 | 35.1 |
| **LATAM** [1] | 5.7 | 4.0 | -2.6 | 3.5 | 5.8 | 8.1 | 5.6 | 7.1 |
| **LATAM Ex-Mexico** | 6.7 | 4.9 | -0.6 | 3.6 | 6.7 | 8.6 | 6.0 | 7.7 |

* USA and EU Inflation: Period average

| | Public Sector Balance (% GDP) | | | | Current Account Balance (% GDP) | | | |
|---|---|---|---|---|---|---|---|---|
| | **2007** | **2008** | **2009** | **2010** | **2007** | **2008** | **2009** | **2010** |
| **USA** | -1.2 | -3.2 | -9.9 | -9.5 | -5.2 | -4.9 | -2.6 | -2.0 |
| **EU** | -0.6 | -2.0 | -6.6 | -7.2 | 0.1 | -1.1 | -0.8 | -0.3 |
| **Japan** | -0.4 | -0.5 | -0.9 | -1.0 | -4.9 | 3.2 | 2.1 | 2.1 |
| **China** | 0.7 | -0.4 | -3.8 | -4.4 | 11.0 | 9.8 | 5.3 | 4.7 |
| **Latin America** | | | | | | | | |
| **Argentina** [2] | 1.1 | 1.4 | -2.0 | -0.4 | 2.9 | 2.2 | 2.8 | 2.5 |
| **Brazil** | -2.8 | -2.0 | -3.5 | -2.6 | 0.1 | -1.8 | -1.0 | -2.2 |
| **Chile** [2] | 9.9 | 4.9 | -3.9 | -1.9 | 4.4 | -2.0 | 2.7 | 1.9 |
| **Colombia** | -2.7 | -2.3 | -4.2 | -4.5 | -2.8 | -2.8 | -2.4 | -1.6 |
| **Mexico** | -1.1 | -2.1 | -3.0 | -3.7 | -0.8 | -1.4 | -1.0 | -1.5 |
| **Peru** | 3.1 | 2.1 | -1.8 | -1.1 | 1.1 | -3.3 | -1.3 | -2.0 |
| **Venezuela** [2] | 4.5 | -0.2 | -4.6 | -6.3 | 9.0 | 13.1 | 1.4 | 2.5 |
| **LATAM** [1] | -0.6 | -1.1 | -3.3 | -3.0 | 0.8 | -0.4 | -0.4 | -1.0 |
| **LATAM Ex-Mexico** | -0.1 | -0.5 | -3.4 | -2.7 | 1.4 | -0.1 | -0.1 | -0.6 |

[1] Average of 7 mentioned countries; [2] Central Government

| | Exchange Rate (vs $, end of period) | | | | Official Rate (%, end of period) | | | |
|---|---|---|---|---|---|---|---|---|
| | **2007** | **2008** | **2009** | **2010** | **2007** | **2008** | **2009** | **2010** |
| **USA** | | | | | 4.3 | 0.5 | 0.1 | 0.1 |
| **EU** ($/€) | 1.5 | 1.3 | 1.4 | 1.3 | 4.0 | 2.5 | 1.0 | 1.0 |
| **Japan** (yenes/$) | 113 | 96.1 | 98.0 | 100.9 | 0.0 | 0.0 | 0.0 | |
| **China** (cny/$) | 7.61 | 6.95 | 6.8 | 6.8 | 7.47 | 5.31 | 5.31 | 6.12 |
| **Latin America** | | | | | | | | |
| **Argentina** | 3.1 | 3.4 | 3.9 | 4.3 | 13.52 | 19.08 | 13.50 | 14.03 |
| **Brazil** | 1.8 | 2.3 | 1.7 | 1.6 | 11.25 | 13.75 | 8.75 | 10.25 |
| **Chile** | 499 | 649 | 560 | 564 | 6.00 | 8.25 | 0.50 | 3.00 |
| **Colombia** | 2015 | 2244 | 2020 | 2070 | 9.50 | 9.50 | 4.00 | 4.75 |
| **Mexico** | 10.9 | 13.0 | 13.2 | 12.7 | 7.50 | 8.25 | 4.50 | 4.50 |
| **Peru** | 3.0 | 3.1 | 2.9 | 2.9 | 5.00 | 6.50 | 1.25 | 2.00 |
| **Venezuela** | 2.2 | 2.2 | 2.2 | 2.2 | 11.40 | 16.20 | 15.20 | 13.80 |

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