BBVA | RESEARCH

Economic Outlook

Peru

First Quarter 2013

Economic Analysis

- **Measures adopted in the world's biggest economies have helped to reduce uncertainty,** benefitting the global activity outlook.
- **In Peru, growth forecasts have been revised upwards. GDP is expected to grow by 6.5% in 2013 and 6.3% in 2014,** driven by the relatively lower uncertainly on global markets and increased support from domestic demand.
- **The convergence of inflation towards the center of the target range will be completed next year.** In 2013 inflation will remain close to the upper end of the target range due to the robustness of domestic expenditure and reducing slackness in the labor market.
- **Long-term private capital inflows will continue strengthening the local currency.** Central Bank foreign exchange interventions will slow down this appreciation process, incurring in an important financial effort.
- **The policy rate will remain at its current level.** Any required change in the monetary policy stance is expected to come through higher reserves requirements in order to avoid mounting additional pressure on the exchange rate.

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Closing date: Februrary 4, 2013

1. Summary

Early in the year, Peru's economic growth prospects look strong. On the external side, uncertainty has decreased due to measures adopted in the world's leading economies. Both the likelihood of challenging events happening and the impact they could have shall they occur are now lower. Besides, recent indicators suggest that the global growth slowdown would have ended last quarter. On the local front, the economy maintains its good momentum. Activity indicators are evolving favorably, outperforming expectations in some cases. Furthermore, business and consumer confidence, which signpost how private sector expenditure is likely to perform in future quarters, remain at high levels. If we add to these the larger fiscal impulse that will take place in 2013 and the good financing conditions, economic growth this year will be higher than the one we anticipated three months ago and will reach 6.5%. Increased exports in 2014 due to several mining projects beginning their production phase would offset the moderation in private expenditure and a less accommodative fiscal policy, leading GDP to grow 6.3% that year.

Inflation, on the other hand, has moved back within the target range, now standing at 2.9%. This decline is largely due to the reversal of supply shocks. Over the rest of 2013 we do not expect any further important reductions because of the influence of factors such as the continued expansion of domestic demand and tight labor market conditions. Thus, the gradual convergence of inflation to the center of the target range should be completed next year in a context of a more moderated pace of growth in private and public expenditure and the absence of supply shocks.

We also expect a further strengthening of the local currency. Fundamentals support a declining trend in the exchange rate, particularly the improvement in productivity. This would be reinforced by long-term private capital inflows, which should remain strong in 2013 via foreign direct investment and financing that Peruvian firms get abroad. The appreciation pace will remain subdued by the Central Bank´s foreign exchange interventions. The financial effort that these operations imply have already been significant and we therefore expect complementary measures such as extending the limit private pension funds have to invest abroad, increased reserves requirements, further purchases of foreign currency by the government, and an eventual increase in the withholding tax on interests that local businesses must pay for their foreign loans, which would tend to raise funding costs. As a result, the exchange rate would stand at around 2.45 at the end of the year. In 2014, as markets anticipate that monetary conditions in advanced economies would start to normalize, global portfolios would begin to be reallocated, giving the exchange rate a more stable path.

In terms of monetary policy, there are factors that suggest that the Central Bank will make policy adjustments. Private spending will continue to grow at a significant pace in a context where the slackness in both the labor market and in the production capacity of some industries has reduced. Therefore, unlike the past two years, it will not be supply- or cost-side elements the ones to push prices up but demand-side ones. Considering the fiscal impulse in 2013, the task of moderating demand-side pressures on prices will be the Central Bank's. Our forecast of a slow convergence of inflation towards the center of the target range is consistent with a less accommodative monetary policy. The monetary policy stance tightening is set to come in 2013 via higher reserves requirements, leaving the policy rate unchanged to prevent intensifying the strengthening trend of the local currency. Next year, with reduced pressures on the exchange rate, there will be more room to start moving the policy rate to a more neutral level.

Finally, there are two key risk factors in our forecasts. Europe remains the main risk one. A lack of commitment to fiscal targets among some periphery Euro countries, adverse political events in Italy or Germany, or a financial "accident" in Greece or Cyprus could all trigger problems. However, we believe the probability of these occurring, as well as the impact they would have, has diminished because of the support promised by the European Central Bank. This, as well as the growing strength of the Peruvian economy, leads us to expect that the impacts of this shock would be relatively contained at a local level. The second key risk is that the abundant global liquidity might trigger massive capital inflows, leading on the one hand to a more intense appreciation of the local currency and thereby to a loss of competitiveness in the export sector, and on the other to an excessive expansion of credit and hence to asset prices bubbles in some markets. In such a scenario there would be a transitory strong acceleration in economic activity (with a subsequent decline once capital inflows reverse), overborrowing in the private sector, an increase in inflationary pressures, and a larger current account deficit that would not be sustainable. The challenge for economic authorities is to reduce these potential effects, for which macroprudential measures are being implemented.

2. Global outlook: improved sentiment and lower tail risks

The global economic outlook improved in the last quarter with the continued decline of global financial tensions, especially in Europe, and with the agreement to avoid the so-called "fiscal cliff" in the US

expenditures remain consistent with a moderate global expansion. Europe has seen financial tensions ease for six months, with a gradual opening, still incomplete, of corporate finance, financial and nonfinancial markets of some peripheral economies in the euro area.

The mood of the financial markets of developed countries has improved steadily in recent months due to three factors: (i) data show that China will not suffer a hard landing, as some analysts had expected; (ii) in the US was avoided the "fiscal cliff" and, in fact, its economy maintain reasonable growth despite uncertainty; and (iii) even in Europe continued to make progress in union bank, reinforcing the authorities' commitment to monetary union, shown with the ECB's actions in the second half of 2012.

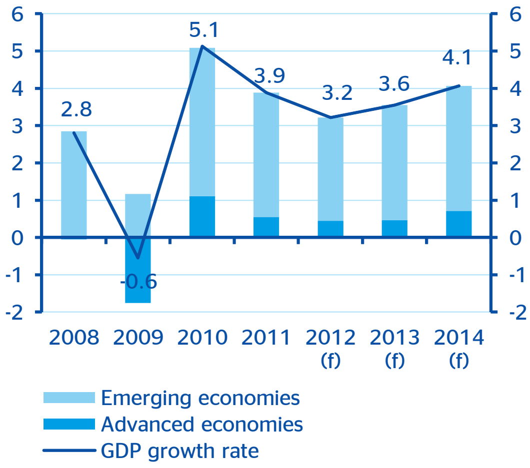
Nonetheless, the improved in market perception does not change too much the fundamentals and global growth will remain weak in developed countries. Therefore, global growth is set to rise from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014 (Chart 1)- almost the same forecast as three months ago. In 2013, the downward revision of Brazilian growth and the unchanged scenario in the Eurozone and the US offset the better forecasts for China, Mexico and some Latin American economies (Chart 2).

The recovery will only continue if the appropriate policies are implemented in the US and the eurozone. US should go beyond temporarily dampen the impending tax rises and should avoid uncertainties the payment of the debt and the distribution of the burden of fiscal consolidation. In the euro zone, progress in governance should continue, especially with respect to the banking union, both through additional agreements as well as the effective implementation of the agreements reached on banking supervision and resolution procedures.

Although positive surprises are not out of the question, the uncertainty of the global economic outlook is biased downward. Lower global growth would be the consequence of increased financial tensions and a drop in confidence if resurface doubts about the commitment of the European authorities with the strengthening of the euro, which have been contained for now because of the ECB's statement last July and the agreements between the countries in the eurozone in support of the single currency. If these tensions occur, new agreements on financial safeguards would be necessary and the recession in the eurozone would continue throughout 2013. The risk in the US would arise if the contagion arising from the European risk was added to the disagreements regarding fiscal consolidation or the debt ceiling. In that case, and with the support of emerging markets, the global GDP would range from 2.5% to 3% in 2013 and 2014.

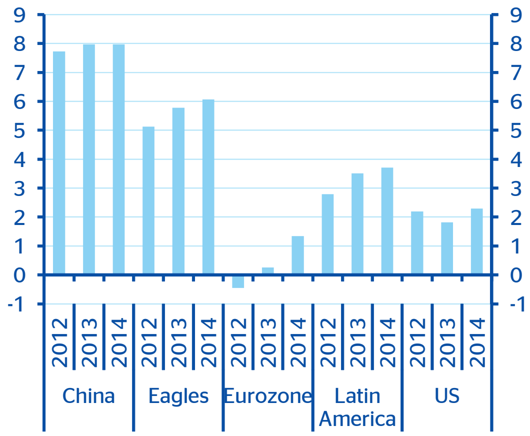
This risk scenario is less likely and the impact is lower than estimated three months ago because of the progress obtained with the definition and policy implementation in the most developed regions, and the resilience demonstrated by the growth in emerging economies.

Chart 1
World GDP growth rate



Source: BBVA Research

Chart 2
GDP growth rate

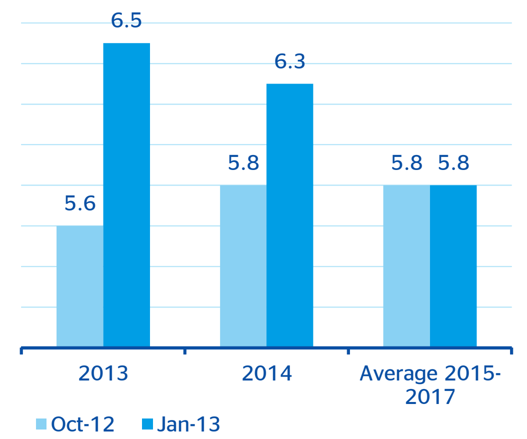


(*) Eagles: Emerging and Growth-Leading Economies, emerging economies leading global growth. Included China, India, Brazil, Indonesia, Korea, Russia, Turkey, Mexico and Taiwan.
Source: BBVA Research

3. Peru: upward revision on growth forecasts for 2013 to 2014

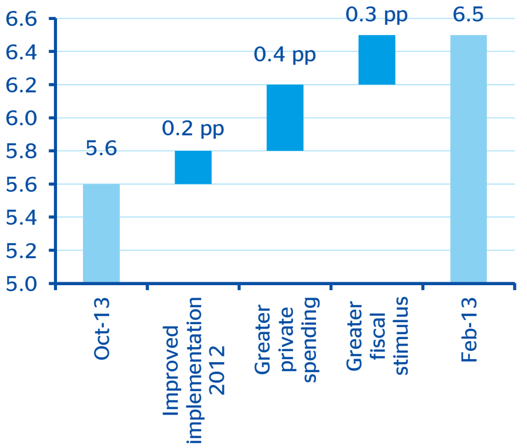
Earlier this year, the growth outlook for the Peruvian economy is favorable. On the external side, there is a context of lower uncertainty and the probability of occurring difficult events and their potential impacts have diminished. Furthermore, recent indicators suggest that the slowdown in global growth would have concluded last quarter. On the local front, the economy keeps a good momentum with indicators that maintain a solid pace of expansion and, in some cases, have performed better than expected. Furthermore, business and consumer confidence indicators remain at high levels, and this year is expected more fiscal impulse and the maintenance of good funding conditions. In 2014, a further boost of exports is anticipated due to the startup of several mining projects. As a result, we have upward revised our growth forecasts for this and next year (see charts 3 and 4).

Chart 3
Peru: Economic growth forecast 2013-2017 (%)



Source: BBVA Research Peru

Chart 4
Peru: adjusted growth forecast for 2013 (% and pp)



Source: BBVA Research Peru

Economic activity keeps showing a strong dynamism

Activity and expenditure indicators suggest that economic growth begins with a good boost earlier this year. Both business and consumer confidence show an upward trend, with the former at its highest level in 25 months (see Table 1). Furthermore, stand out the capital goods imports (linked to investment) that continue to grow at double-digit rates, and the acceleration of the electricity production in January.

Table 1
Peru: Economic activity and expenditure indicators

	3Q12	4Q12	January
Business confidence (index)	59	64	67
Capital goods imports (yoy % ch.)	16	14	
Consumer confidence (index)	53	56	58
Sales of family vehicles (yoy % ch.)	28	35	14
Consumer lending (yoy % ch.)	18	16	
Public spending, consumption (yoy % ch.)	5	17	
Public spending, capital (yoy % ch.)	28	16	
Electricity production (yoy % ch.)	6	6	7

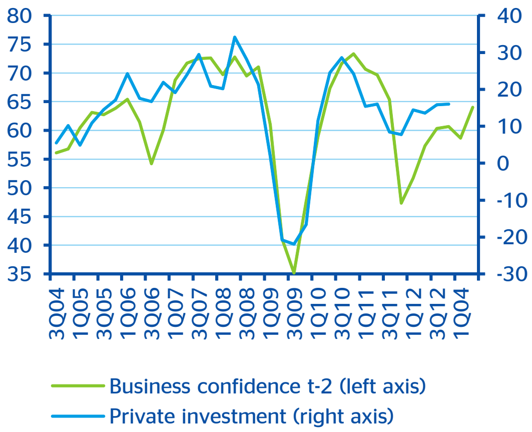
Source: BCRP, Apoyo Consultoría, ARAPER, SBS, COES, BBVA Research Peru

As well as business optimism, access to external financing under good conditions should provide a solid support for private investment

We believe that current business confidence indicator levels are consistent with investment growth of between 10% and 15% (see Chart 5). This positive outlook complements with good financial conditions that Peruvian companies have found in foreign markets. Thus, in the first six weeks of the year local corporations (financial and non-financial) have already issued US$1.3bn in bonds, a sum equivalent to 38% of the total issued last year (see Chart 6). It is projected that in an context of abundant liquidity in foreign financial markets and lower global risk aversion, Peruvian companies will continue accessing to external funding markets under good conditions.

Chart 5

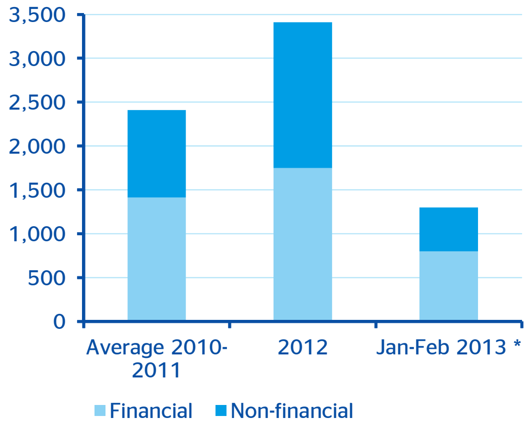
Business confidence and private investment (index and % change year-on-year)



Source: BCRP. Elaboration: BBVA Research Peru

Chart 6

Securities issues by Peruvian companies on international markets (millions of US$)

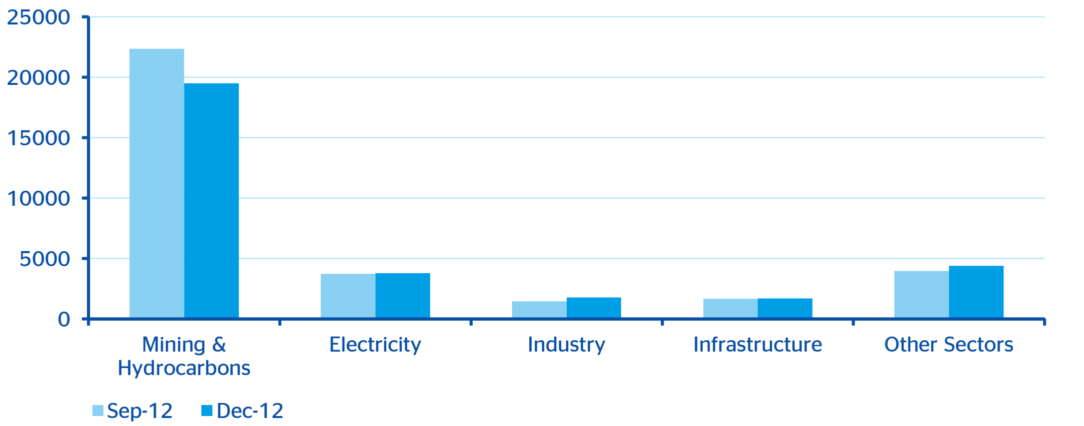


Source: Bloomberg. Elaboration: BBVA Research Peru

The positive impact that these factors should have on private investment will be mitigated by the delays that some projects to exploit natural resources (minerals and hydrocarbons, mainly) have suffered. In this regard, three obstacles have been reported are delays and regulatory changes to obtain environmental licenses; social disputes regarding some mining projects and delays in enforcing the Prior Consultation Law (which establishes consultation mechanisms to the surrounding population to extractive projects, but it is not binding). As a result, there has been a drop in investment announcements of the mining sector for the period 2013 -2014 (see Chart 7).

Chart 7

Large private investment projects announced for 2013-2014 (Millions of USD)



Source: BCRP. Elaboration: BBVA Research Peru

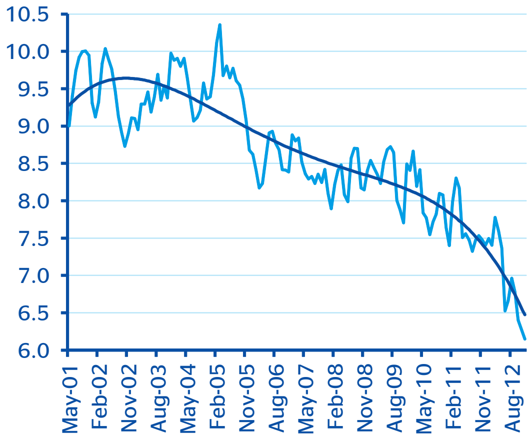
Strong employment and higher public sector wages will support consumption

The labor market has shown positive trends. The unemployment rate now stands at record lows (see Chart 8), informal employment has declined[1] and real worker income grew 5.0% in 2012 in the Lima Metropolitan area. The performance of these variables has induced a consumer greater optimism, particularly in the high-medium income segments that register the highest confidence levels (see Chart 9), which should buttress household spending (see Box 1).

1: Adequate employment, i.e. the population not in a position of underemployment, has been growing faster than total employment: 4.5% compared with 2.0% in 2012. These figures are for the Lima Metropolitan area.

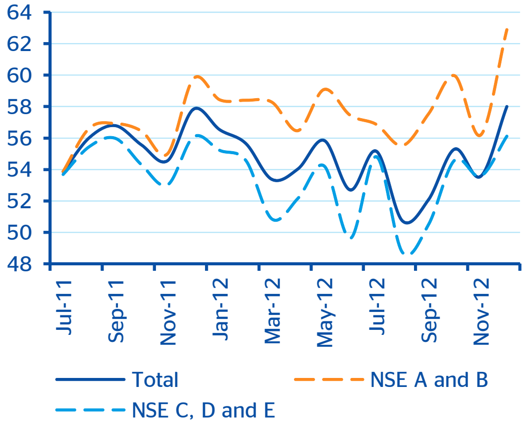
Furthermore, this year the government has promised wage increases for public sector workers, which will mainly benefit health workers, the police, the armed forces and teachers. As a whole these increases could represent around 0.4% of GDP in 2013.

Chart 8
Unemployment rate: Lima Metropolitan area (as a % of the labor force)



Source: BCRP, INEI. Elaboration: BBVA Research Peru

Chart 9
Consumer Confidence - INDICCA (Index)

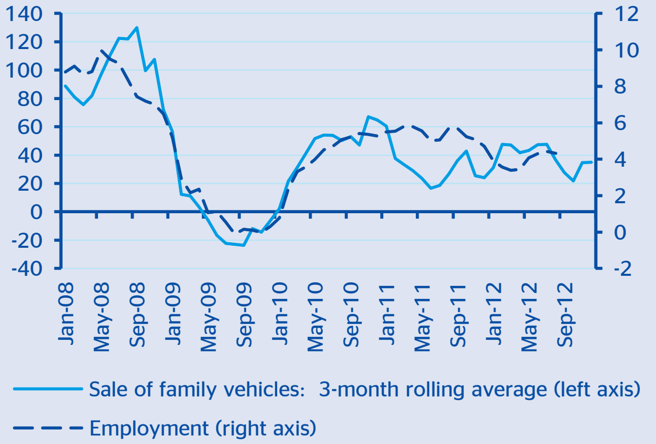


Source: Apoyo. Elaboration: BBVA Research Peru

Box 1: The thrust of demand and durable goods expenditure

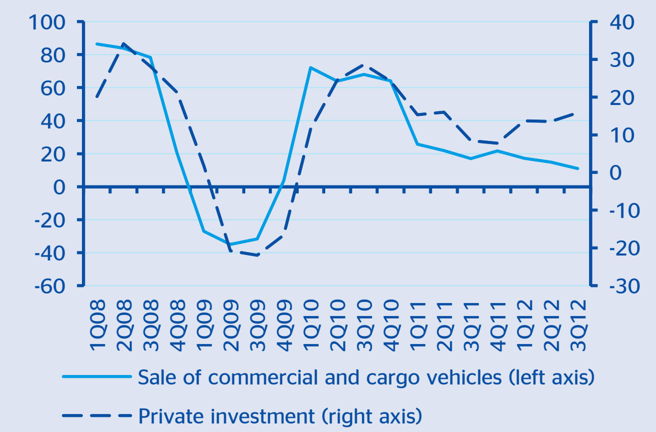
A part of the sustained expansion of private spending has been reflected in a growing demand for durable goods. An example of stronger consumption of such goods can be found in vehicles, whose sales (new units) rose27% in 2012. By vehicle type, light vehicle sales demanded by households, were up 38%, in line with buoyant employment and increased household income (see Chart 10). Commercial and cargo vehicle sales grew 11.5% due to the strong dynamism of investment (see Chart 11).

Chart 10
Employment and new light vehicle sales (% change year-on-year)



Source: Araper and BCRP. Elaboration: BBVA Research Peru

Chart 11
Private investment and sale of commercial and cargo vehicles (% change year-on-year)



Source: Araper and BCRP. Elaboration: BBVA Research Peru

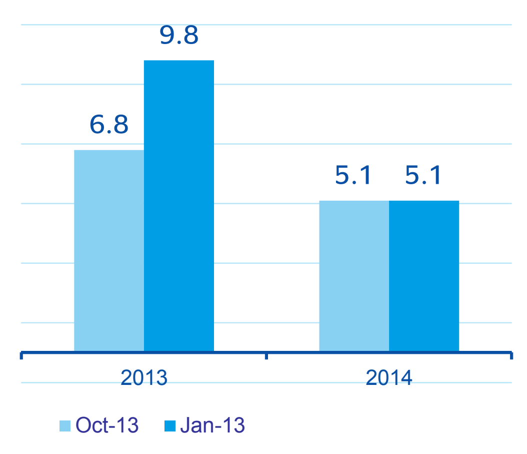
In addition to the increased penetration of Asian brands, which offer cheaper cars maintaining comfort features, accessible conditions for consumer financing have also benefitted vehicle sales. Last year, vehicle loans grew by around 18% and it is a credit category that has great potential and will promote cars demand. It is worth pointing out that just 20% of light vehicle sales are made using bank financing, and relatively novel financing options have begun to take hold in the local market, such as American Leasing (offering lower payment installments). As a result of the factors that will support the vehicle market in Peru (income growth, consolidation of the middle class, urbanization, greater access to financing), BBVA Research estimates that the automotive fleet will increase from approximately 2 million units in 2012 to 4.5 million in 2020.[2]

2: For further information, see Peru Automobile Market Outlook 2012: (http://www.bbvaresearch.com/KETD/fbin/mult/situacion_automotriz_peru_2012_tcm346-363506.pdf?ts=3012013).

A higher fiscal impulse is expected this year

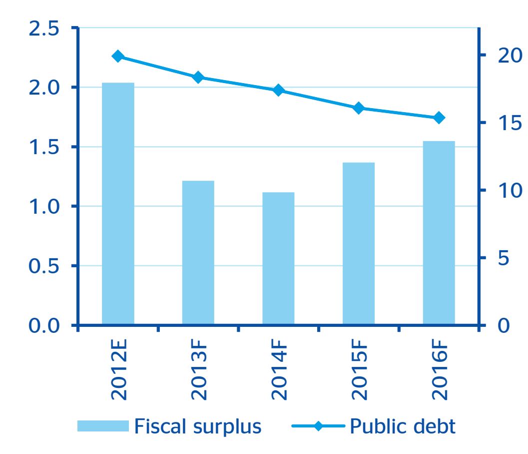
The 2013 state budget includes a larger increase in public expenditure than in 2012 (real increase of 10% this year, compared to 4% in 2012). As well as the wage improvements mentioned above, there has been a sharp increase in spending on social programs and investment. In line with this, we move upwards in our forecast for public expenditure (see Chart 12) on goods to 8% (from 5%) and on investment to 13% (from 10%). This should have an additional impact on GDP this year of 0.3pp.

Chart 12
Public expenditure growth (in real terms, ch. %)



Source: BBVA Research Peru

Chart 13
Fiscal surplus and Gross public debt (% GDP)



Source: BBVA Research Peru

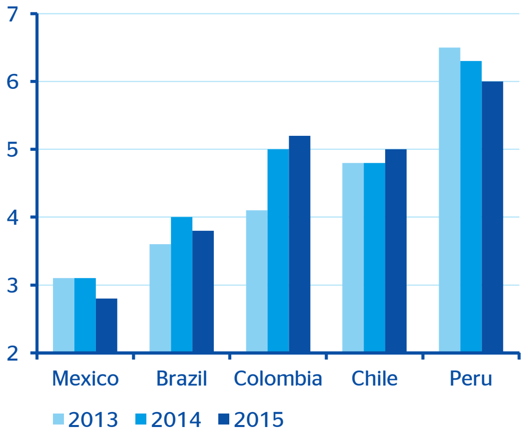
Despite this increase, government revenue should still outstrip expenditure. We forecast a surplus of 1.2% in 2013 (2.0% in 2012). Since this solvency could be determined, to some extent, by the favorable position of the business cycle and the metals prices, it should be evaluated taking a long-term level of both factors. The Central Bank regularly measures the structural fiscal deficit, putting it at 0.5% of GDP in 2013, a level that is considered sustainable. Looking ahead, we expect the public spending growth to be scaled back to more conservative levels, consistent with the expected evolution of GDP and tax revenues. This is consistent with the rules stipulated in the Transparency and Responsibility Fiscal Act, which prevent the formulation of a budget involving a deficit of greater than 1.0% of GDP. It would be useful if in this more moderate public expenditure growth, investment hold a major stake, which would benefit the competitiveness of the Peruvian economy and its growth potential.

One positive effect of strong fiscal solvency is a reduction of the country's debt position. To the downward trend that currently records the public debt ratio (see Chart 13), has joined an announced by the Executive of an international bond buyback operation worth up to US$2.0bn. This high capacity of compliance (even anticipated) by the government, as well as the resilience that the economy has shown against the global economic slowdown, are arguments that rating agencies take into account in assessing Peru's sovereign risk. Therefore, we considered the Peru's credit rating could be upgraded again this year.

Since 2014 domestic demand will moderate, but exports will begin to improve

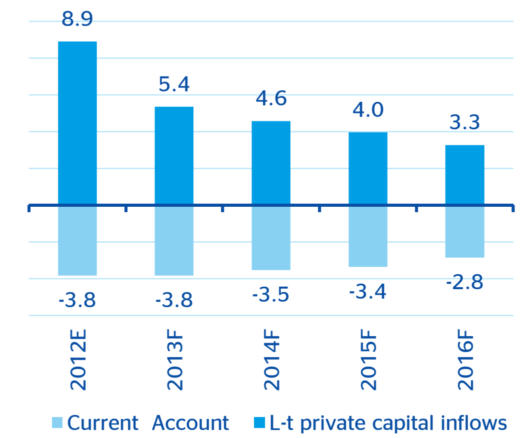
On the private side, mining and hydrocarbons investment will remain dynamic, but there will no longer be capacity for the same strong growth as seen in recent years. This is because of three reasons: reduced availability of locally large projects, the prospects of a gradual correction in copper prices towards long term trends and the persistent setbacks that have dogged some projects. This, along with lower public expenditure growth, will tend to slow domestic demand to growth rates below 6% since 2014. By contrast, a global economic recovery and the beginning of the extraction stage of a number of mining projects (Toromocho and Las Bambas in 2014, La Granja and Constancia in 2015, and Quellaveco and the Cerro Verde extension in 2016) should provide an additional boost to exports, which we expect to grow at an average annual rate of 10% between 2014 and 2016. As a result, the GDP growth rate will gradually slow to 6.3% in 2014 and to 6.0% between 2015 and 2016. We believe these rates will continue to place Peru among the best performing major Latin American economies (see Chart 14).

Chart 14
Latin America GDP growth forecast (%)



Source: BBVA Research

Chart 15
Current account and inflow of long-term private capital (% of GDP)



Source: BBVA Research Peru

Expansion of the external deficit is temporary and remains financed by long-term private capital

The current account deficit closed 2012 at around 4% of GDP, with a similar level expected this year. This is due, on the one hand, to domestic demand dynamism and, on the other, to weak global activity. However, as of 2014 external accounts will begin to gradually improve, as extraction stage begins at several mining projects, thus increasing mineral exports, particularly of copper, which production is set to triple by 2016. We expect the positive trade effect dominates over the impact on factor income. This, because the increase in profits of the major extractive capacity will be mitigated by the downward trend we anticipate for the price of copper.

As for financing, the inflow of long-term private capital hit record highs last year, at close to US$20bn. Over the next few years, investment opportunities in a fast growing economy like Peru will continue to attract capital in the form of foreign direct investment and long-term loans. Thus, even while expecting a significantly lower rate of long-term private capital inflows over the next few years (see Chart 15); these should continue to comfortably finance the external deficit.

4. Convergence of inflation towards the center of the target range will be completed in 2014

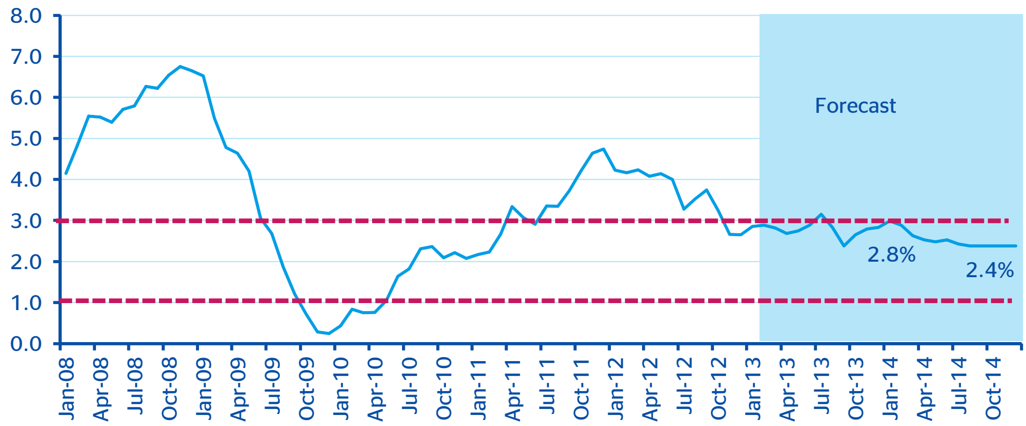
In January yoy inflation stood at 2.9% (see Table 2), while no further significant declines are expected over the rest of the year due to factors such as the sustained expansion of domestic demand and a more tight labor market. As of 2014, in a context of private and public expenditure moderation, and in the absence of supply shocks, inflation will gradually converges towards the center of the target range (see Chart 16).

Table 2
Sector year-on-year inflation (%)

	Weighting	Dec-11	Jan-13
1. Inflation	**100.0**	**4.7**	**2.9**
2. Core inflation	**65.2**	**3.6**	**3.3**
2.1 Goods	**32.9**	**3.2**	**2.5**
Food and drink	11.3	4.7	4.1
Textiles and footwear	5.5	4.7	2.9
Electrical appliances	1.3	-1.1	-2.7
Rest of industrial products	14.9	1.8	1.3
2.2 Services	**32.2**	**4.1**	**4.2**
Eating out	11.7	6.8	6.4
Education	9.1	4.2	4.6
Health	1.1	1.9	3.4
Rents	2.4	-0.7	-0.4
Rest of services	7.9	1.7	1.7
3. Non-core inflation	**34.8**	**6.8**	**2.0**
Food	14.8	11.5	2.8
Fuel	2.8	7.5	-0.1
Transport	8.9	3.6	2.4
Public services	8.4	1.5	0.9

Source: BCRP. Elaboration: BBVA Research Peru

Chart 16
Year-on-year inflation (%)



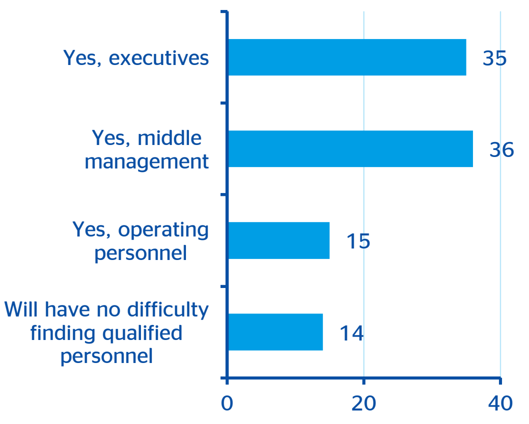
Source: BCRP. Elaboration: BBVA Research Peru

Over the next few months, inflation will remain close to the upper end of the target range

This year the main aspect sustaining inflation around the upper limit of the target range will be the thrust of the domestic demand. It is worth pointing out that core inflation, the trend component of inflation that reveals any pressure on prices caused by demand-side factors and represents 65% of total inflation, still stands at over 3.0%. Within core inflation, the headings Textiles and Footwear, Education and Eating out, which have a high combined weighting, recorded yoy growth in January between 2.9% and 6.4% (see Table 2), in line with the strength of household spending, which is expected to continue over the year.

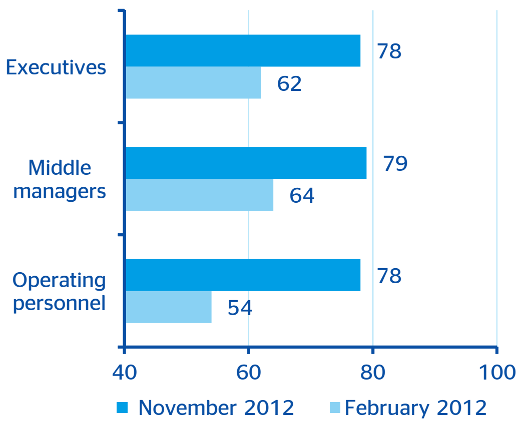
The labor market conditions will also add some inertia to lower inflation. According to Apoyo Consultoría, a consultancy firm, the increase in real wages over recent years has reflected the effects of the increased productivity and the growth of local businesses, but also suggests that around a third of the increase is due to a shortage of qualified personnel. This factor has put pressure on companies' labor costs and is a situation expected to persist over the forthcoming months. A recent survey from the same consultancy firm indicated that over the next 6 months most companies will struggle to find qualified labor (see Chart 17) and nearly 80% of companies expect to increase wages for executives and middle management (see Chart 18). Eventually, higher labor costs may lead to higher prices for end consumers. Such a transfer could be accelerated by current state of the economic cycle.

Chart 17
Companies with difficulties to find qualified labor over the next six months (%)



Source: Apoyo Consultoría

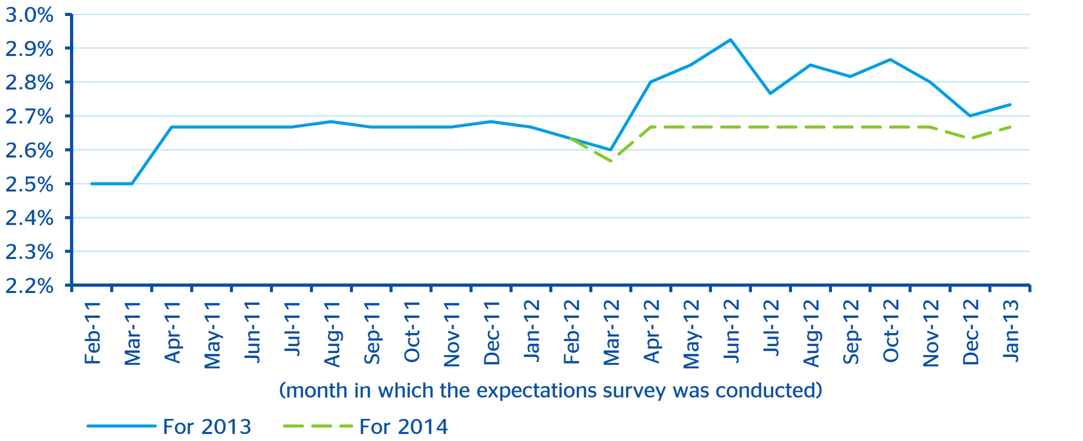
Chart 18
Companies that will increase wages over the next six months (%)



Source: Apoyo Consultoría

Lastly, it is worth adding that inflationary expectations may also delay the convergence of inflation towards the center of the target range. In 2014, following a downward trend in November and December, in line with declining inflation, it is have seen a stabilization at around 2.7% (see Chart 19).

Chart 19
Inflationary expectations for 2013 and 2014 (% end of period)

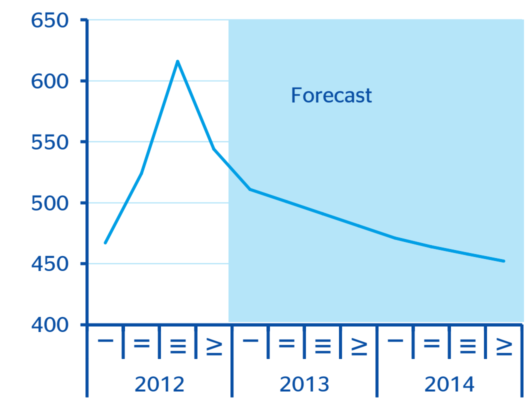


*Average expectations of economic analysts, financial system and non-financial companies.
Source: BCRP. Elaboration: BBVA Research Peru

Lower pressure expected from imported food commodity prices and oil prices

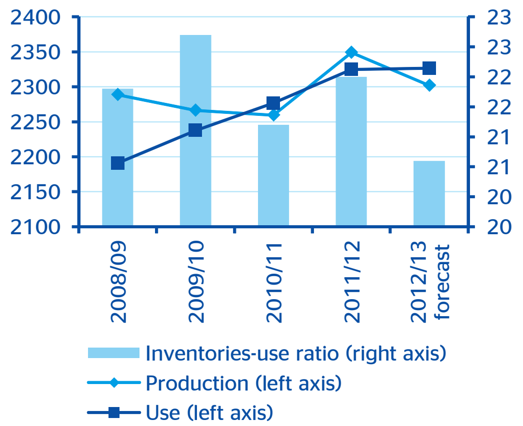
Global production of grains and cereals is expected to increase in 2013 due to better weather conditions. The soya harvest forecast (see Chart 20) has been revised upwards in the United States, while the prospects are very good for the main producer countries in the Southern Hemisphere (Argentina and Brazil). Wheat production should also benefit from an increase in the area planted in Europe so far this winter. These forecasts have already been reflected into prices, which have been declining after shooting up in the third quarter of 2012. It is worth pointing out, however, that any adverse weather conditions could cause prices to spike due to current low inventory level (see Chart 21).

Chart 20
Soy prices (US$/MT)



Source: Bloomberg and BBVA Research

Chart 21
Production, use and existence of cereals



Source: FAO. Elaboration: BBVA Research

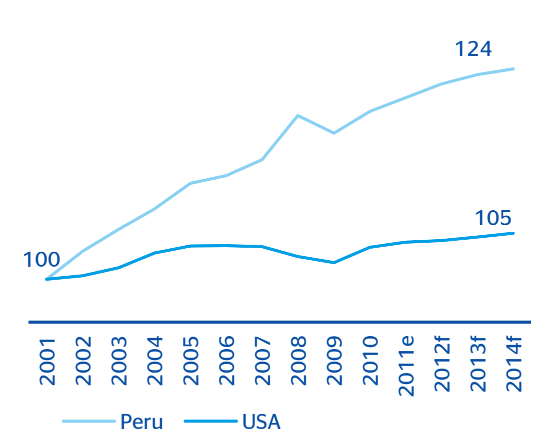
As for oil prices, we believe these should remain relatively stable in 2013 in a context where global growth will still be weak. Furthermore, inventories are currently at comfortable levels of more than 50 days of consumption. Lastly, the OPEC is expected to continue its policy of increase its oil production capacity to prevent any excessive spikes in oil prices and to discourage the emergence of alternative energy sources.

5. The local currency will maintain its appreciation trend

Fundamentals support greater strength of the Peruvian currency

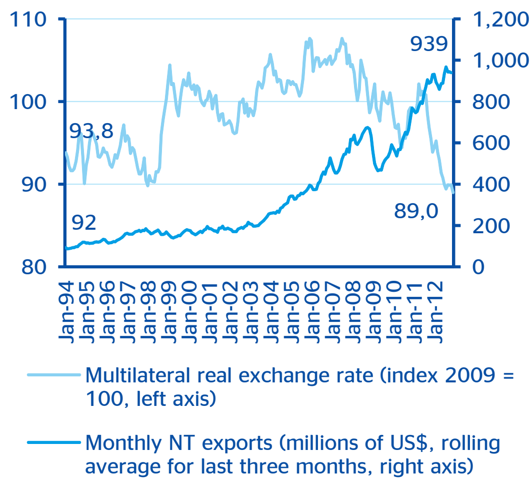
Our estimates indicate that the exchange rate stands between 3% and 4% over the equilibrium level (the level consistent with the country's external sustainability)so there would be room for further appreciation of the Peruvian currency. According to our results, the downside trend seen from the exchange rate (appreciation) over recent years was largely a reflection of Peru's relative productivity improvements (see Chart 22), particularly in the tradable sector, which allowed to export more manufactured goods at lower costs. It is worth adding that between 2007 and 2012 the value of non-traditional Peruvian exports (manufacturing) doubled in a context where the real multilateral exchange rate fell by more than 13% (see Chart 23).

Chart 22
Total factor productivity (index, 2001 = 100



Source: Conference Board and BBVA Research Peru

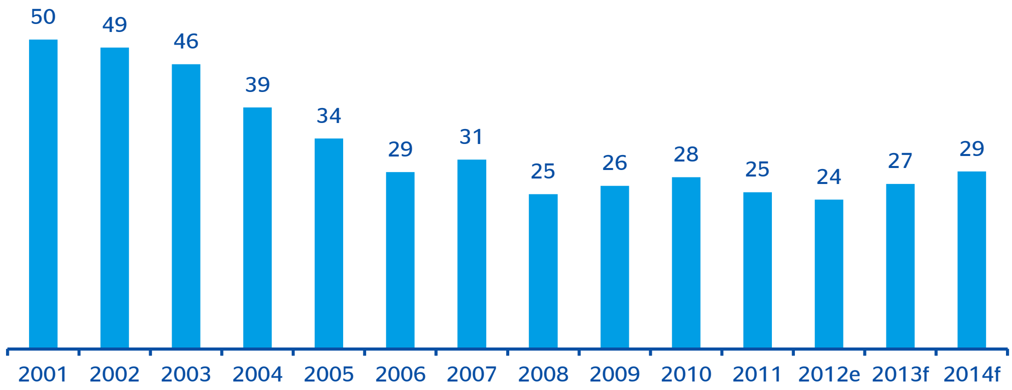
Chart 23
Real exchange rate and Non-traditional exports



Source: BCRP. Elaboration: BBVA Research Peru

Furthermore, we find that the decline in the country's foreign liabilities (see Chart 24) has also been a factor that has led to a further strengthening of the local currency. As these liabilities decline, the surplus in the current account of the balance of payments that should be generated in the future to meet external obligations may be less and therefore, they are consistent with a lower exchange rate.

Chart 24
Net foreign liabilities (% of GDP)



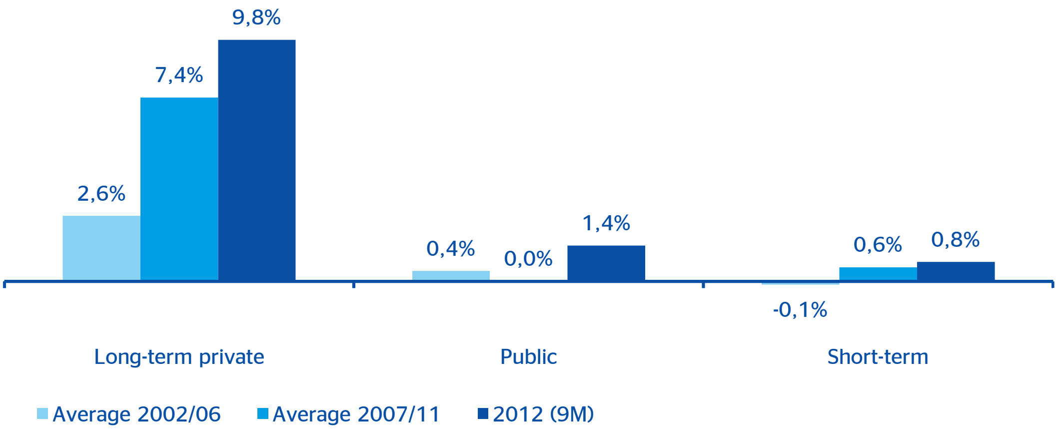
Source: BCRP and BBVA Research Peru

We anticipate that the path that will show the productivity differentials will continue to put downside pressure on the exchange rate (appreciation), attenuated by a slight increase in the net foreign liabilities over GDP ratio.

Larger capital inflows could accentuate appreciation…

Besides the factors that determine its trend, in the short term the exchange rate has been affected by significant capital inflows (see Chart 25), which has generated abundant liquidity in foreign currency, driving up the value of the Peruvian currency (greater appreciation). It is worth pointing out that in 2012, a year in which such inflows hit record highs, the real multilateral exchange rate fell (appreciated) 7.6%, a rate that cannot be attributable only to increased productivity in the export sector.

Chart 25
Annual capital inflows (as % of GDP)



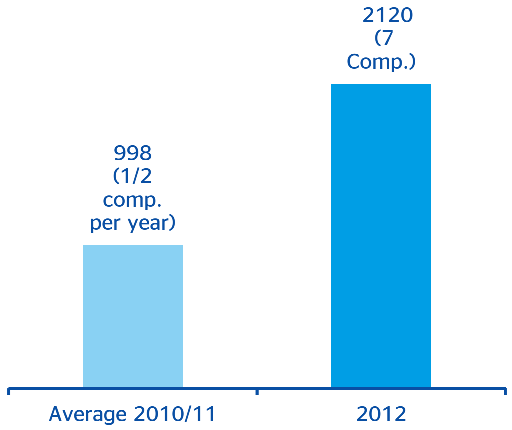
Source: BCRP. Elaboration: BBVA Research Peru

It is important to emphasize that most of the capital inflows in recent years has been long-term capital, which means less probability of a sudden reversal in the flows direction and destabilizing effects it generates. Furthermore, this foreign financing was largely aimed at the tradable sector, which ensures future currency generation in order to meet obligations to the foreign sector.

Going forward, in a context of expanding liquidity in advanced economies, less global risk aversion, favorable financing conditions and good prospects for the Peruvian economy, the inflows of long-term private capital will remain significant, particularly from direct foreign investment linked to large mining projects that are currently under construction, and other sectors such as energy, industry and trade (see Chart 7, section 3).

Likewise, we anticipate that the number of Peruvian companies that directly access to international market for medium and long term financing will continue to increase, particularly among non-financial companies (mainly medium-sized companies), in line with the trend seen last year (see Chart 26). This reflects the size that local companies' operations have reached, the ones that now need more financing, as well as low external interest rates and greater foreign appetite for Peruvian corporate bonds. It is worth pointing out that in the first five weeks of 2013, issues made abroad by locally operating companies (financial and non-financial) now stand at US$1.3bn (a sum equivalent to 38% of the total issued in 2012) (see Chart 3).

Chart 26
Peru: securities issues by non-financial Peruvian companies on international markets (millions of US$)



Source: BCRP. Elaboration: BBVA Research Peru

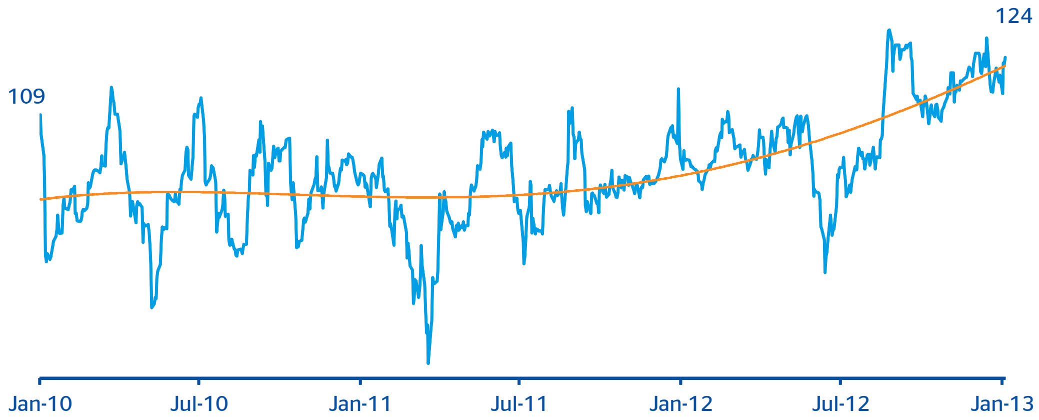
Table 3
Peru: corporate securities issued on international markets in January 2013 (millions of US$)

Issuer Company	Issued amount (millions)	Term	Yield
Cementos Pacasmayo	300	10 years	4.6
Pesquera Exalmar	200	7 years	7.9
Fondo Mivivienda	500	10 years	3.6
BBVA Banco Continental	300	3 years	2.8
Total	1,300		

Source: Bloomberg. Elaboration: BBVA Research Peru

Finally, we would not rule out further nonresident investors positioning in sovereign bonds, particularly in long tranches where their relatively participation is lower than in shorter tranches, while yields remain attractive (the yield curve is close to maximums, see Chart 27), particularly taking into account that Peru has one of the least volatile exchange rates in the region.

Chart 27
Slope of yield curve for sovereign bonds (sov42 - sov20, bp)



Source: Bloomberg. Elaboration: BBVA Research Peru

… therefore the Central Bank will continue to intervene on the foreign exchange market, which means a further important financial effort

Over the coming months, capital inflows will continue putting downward pressure on the exchange rate (appreciation), meaning we cannot rule out overvaluation of the Peruvian currency which would negatively affect the competitiveness of the tradable sector. In this context, the Central Bank (BCR) is likely to continue acquiring significant amounts of foreign currency to provide support to the dollar, as it has done in similar situations. Thus, the Peruvian Central Bank's intervention should ensure a gradual decline of the exchange rate, which we anticipate will stand around S /. 2.45 per dollar at the end of the year, which would mean appreciation of 4.7%, similar to that recorded in 2012. In 2014, as markets anticipate that monetary conditions in advanced economies, in particular the United States, begin to normalize (BBVA Research estimates that the Fed will lift its policy rate in 2015), the exchange rate should stabilize due to an adjustment of global portfolios (less exposure to emerging economies as returns in advanced economies gradually improve).

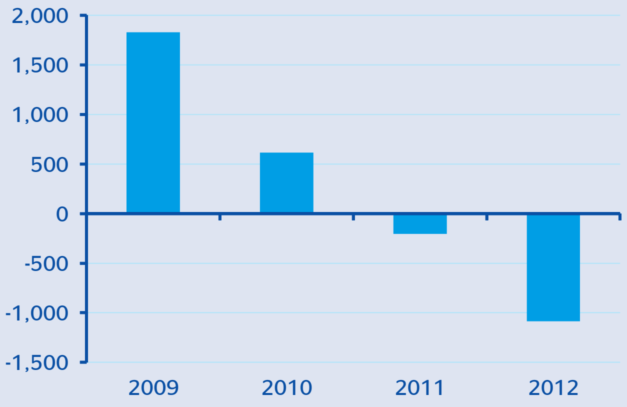
It is noteworthy that the financial effort being made by the Central Bank to modulate the fall in the exchange rate has been significant and it is affecting in a sensitive manner the institution's results (see box 2).

Box 2. Foreign exchange interventions and sterilization costs

In order to absorb the excess liquidity expansion triggered by significant purchases of foreign currency, the BCR issues monetary sterilization instruments. For these, it has to pay an interest rate which exceeds the yield that get with the dollars invested in outside assets of high credit rating and highly liquid (international reserve assets). The spread between the rates that the BCR pays and those at which reserve assets are remunerated has widened in the current scenario, with international interest rates at lows. Thus, the greater amount purchased in dollars, the greater the amount that needs to be sterilized and the greater the financial costs.

In this context, in 2011 the Central Bank recorded losses of S/. 203 million (see Chart 28), its first deficit since 1994 when the institution was in a process of reorganization and asset streamlining. In 2012, year that had a record amount of dollar purchases in the exchange market by nearly US$14bn (almost three times more than in 2011), the losses are set to exceed S/.1.1bn. This negative result will consume about 60% of the Central Bank's patrimonial reserves, defined as the sum of the legal reserve and special statutory reserve (see Chart 29). According to the Central Bank Act, if its legal reserve is not enough to take losses, the Treasury must recapitalize the institution by issuing bonds, which must be done within 30 days after the approval of the Bank's balance sheet. Note that, eventually, the legal reserve may be increased with the accumulated in the special statutory reserve which increases the ability of BCRP to absorb losses.

Chart 28
Central Bank net profit
(millions of PEN, 2012 based on November data)



Source: BCRP. Elaboration: BBVA Research Peru

Chart 29
Central Bank's equity and overall balance in 2012
(PEN million, 2012 with data as of November)

Source: BCRP. Elaboration: BBVA Research Peru

In 2013, if Central Bank keeps the pace of dollar purchases presented the first six weeks of the year, the financial cost of sterilizing the monetary surplus that these exchange interventions generate will have again a negative impact on the outcome of the entity. On the Ministry of Economy and Finance's side, the announcement of dollar purchases to prepay external public debt points in the same line as part of the operation would be financed with sovereign bonds (Treasury performs the "sterilization" work instead of BCRP) and the other with the deposits held in the Central Bank (the Central Bank will have less liability to compensate). Thus, the Treasury assumes part of the financial effort involving exchange interventions, which actually could be considered quasi-fiscal transactions.

It is important to note that the Central Bank's actions do not follow the logic of financial profitability, but macroeconomic stability. These losses clearly plotted the efforts being made by the Central Bank to avoid the harmful effects that can generate massive capital inflows; a negative externality that is a consequence of the lack of capacity of the industrialized economies to perform internal structural adjustments, what have been ultra expansionary monetary policies with global impacts.

In this context, we would not rule out that economic authorities can continue implementing complementary actions to mitigate the pace of currency appreciation, which would also ease the financial burden supported by the Central Bank. Therefore, as far as the Central Bank is concerned, is likely to continue increasing the limit to invest abroad for private pension funds, which would benefit the outflow of dollars from the economy. The monetary authority could continue raising reserve requirements on foreign currency, which would drive up demand for dollars among banks to meet the increased demands of deposits at the Central Bank.

The Ministry of Economy and Finance (MEF) announced that over the year they would buy US$4bn for various purposes, half of which will be used to pay off in advance some external debt. This measure will not provide direct support to the exchange rate as the Government does not buy dollars on the market, but rather buys from the Central Bank. Therefore, the country's net creditor position against the rest of the world would remain unchanged. However, as the Treasury will use its bearing deposits maintained at the Central Bank to buy these dollars, alleviates the Central Bank's financial effort and gives additional space to continue making sterilized purchases in foreign currency on the exchange market. Furthermore, the MEF could increase withholdings demanded from local companies on interests payable for loans directly taken out abroad (as income generated in the country).

Finally, the government may consider imposing some sort of controls over capital. It is worth pointing out that this would be a last resort and would not substitute other macroeconomic policy measures, such as adjusting fiscal policy or allowing greater exchange rate flexibility. Thus, it should be taken into account that an eventual implementation of such measures could generate welfare losses to persons or entities with limited access to credit (which affects consumer and savings decisions), meaning the distortion that such action seeks to rectify must be clearly identified. Furthermore, it is important to take into account that, in general, using such controls has only transitory effects because the ways of side-stepping new requirements are eventually found. A further aspect that needs to be taken into account is that such measures might trigger an unwanted downturn in growth.

6. Over the next few months, adjustment of monetary conditions via reserve requirements

Certain factors point to further adjustments to the monetary policy stance…

The performance shown by indicators of activity, internal expenditure and prices suggest that the Central Bank will continue to take the precautionary step of adjusting monetary conditions over the next few months. Domestic demand continues to show high dynamism, which has reflected in a declining slack in the labor market, industries operating at high capacity rates and a external deficit of close to 4% of GDP. These trends are expected to continue this year due to the support of private expenditure on investment and consumption, in a context of business and household optimism at record highs, as well as favorable financial conditions. Furthermore, the expansionary bias from public expenditure in 2013 will drive a higher boost to domestic demand growth.

Looking at prices, while inflation has moved back within the target range, we expect it to hold close to the upper limit of the range over the next few months, due to tightening of the economy amid robust domestic demand growth. It is worth pointing out that core inflation in January stood at 3.3%, meaning it has now been outside the target range since mid-2011.

...which would come via increased reserves requirements, keeping the policy rate at its current 4,25% level in order to avoid exerting greater upside pressure on the local currency

In this context, with demand expected to remain strong, inflation set to hold close to the upper limit of the target range and capital inflows putting upside pressure on the local currency (appreciation), the Central Bank is likely to further increase reserve requirements in 2013 in order to control output growth and credit expansion. It is worth pointing out that in the third quarter 2012 the Central Bank began a cycle of raises of reserve requirements on a monthly basis, by an increasing degree (see Table 4).

Table 4
Recent reserve requirements measures adopted by the Central Bank

			Foreign currency		
	Domestic currency		General system		Foreign debt
	Marginal reserve rate for deposits	Increase in the average reserve rate	Marginal reserve rate for deposits	Increase in the average reserve rate	Short-term
May-12	30%	0.50%	55%	0.50%	60%
sep-12	30%	0.50%	55%	0.50%	60%
Oct-12	30%	0.50%	55%	0.50%	60%
Nov-12	30%	0.75%	55%	0.75%	60%
Jan-13	30%	0.25%	55%	0.75%	60%
Feb-13	30%		55%	1.00%	60%

Source: BCRP. Elaboration: BBVA Research Peru

Use of this instrument not only makes consumer and investment financing more expensive, but also lifts the cost of taking USD short positions (betting on a stronger local currency) and credit in foreign currency. Therefore, in the current scenario of strong economic growth and downside pressure on the exchange rate (appreciation), the use of reserves requirements to adjust monetary conditions appears more convenient than the conventional policy rate tool, which we expect to hold at 4.25% this year. Next year, with less pressure on the exchange rate due to the absence of additional monetary stimulus in developed economies and a more moderate increase in direct foreign investment (large mining projects will move into production), here will be more room to start orienting the policy rate to a more neutral level.

Our forecasts take into account that less accommodative monetary policy would allow a gradual convergence of output towards more sustainable levels and inflation will move towards the center of the target range as of early 2014. Given that this year higher fiscal impulse is expected, the onus is on the Central Bank to provide economic stabilization policies.

Would it be possible to cut the reference rate?

In a context of strong capital inflows, some local media have reported opinions suggesting that cutting the policy rate would help to attenuate appreciation pressures on the local currency, as it would induce a yield reduction of financial assets denominated in the local currency. However, we believe a cut in the policy rate is not currently viable and is not an option being considered by the Central Bank in the short term. As has been described, the state of the economic cycle points to adjustments of monetary conditions that would allow the convergence of domestic demand towards compatible levels with sustaining internal and external macroeconomic equilibriums. In this context, a rate cut when the right conditions are not in place might suggest that the Central Bank is subordinating its price stability goal for exchange rate goal, which would have negative impacts on the credibility and anti-inflationary reputation that the Central Bank has been consolidating since the early 90s.

7. Europe and the abundance of global liquidity are the main risks

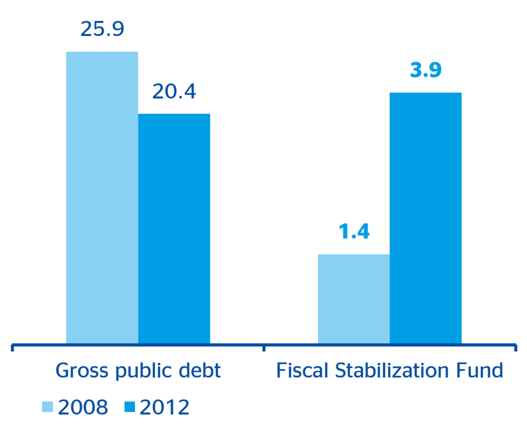
Although financial tensions in Europe have declined, it remains the key risk factor

The liquidity support provided by the European Central Bank (ECB) has substantially reduced financial stresses in Europe and therefore the probability of occurrence of a crisis. Likewise, a possible transmission is limited, so it would be more bounded impact. However, there are still many elements that must be overcome to reach a definitive solution to the crisis and on the road does not rule out that some elements could trigger a change in market sentiment. For example, a lack of commitment to fiscal targets from some countries, as well as adverse political events in Italy or Germany or a financial "accident" in Greece or Cyprus.

The Peruvian economy would be affected through three channels. First, a substantial increase in global risk aversion would drive up the local risk premium, leading to higher financing costs, a reduction of capital inflows and pressure on the exchange rate (depreciation of the local currency). Second, commodity prices and foreign demand would drop. Finally, there would be a decline in business and consumer confidence. In this context, private investment would be the hardest hit component of expenditure, as we saw in the crisis of 2008-2009.

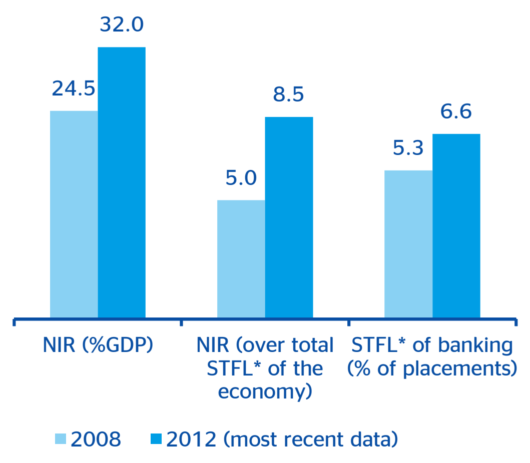
The smaller size of the shock and growing strength of the Peruvian economy make us believe that local impacts would be relatively contained. The country's fiscal position has improved over recent years and there is room to implement countercyclical measures (see Chart 30), while on the monetary side there are instruments that would make it easier to provide liquidity and support output growth (see Chart 31).

Chart 30
Gross public debt and the Fiscal stabilization fund (% of GDP)



Source: BCRP. Elaboration: BBVA Research Peru

Chart 31
Indicators of external vulnerability



*STFL: Short-term foreign liabilities.
Source: BCRP. Elaboration: BBVA Research Peru

Risks inherent to massive capital inflows: loss of competitiveness in the export sector, excessive credit expansion, and asset price bubbles

Since the international financial crisis erupted, central banks in developed countries have deployed a series of unconventional monetary measures to support their financial systems and economic activity. As a result, we have seen unprecedented increases in liquidity in these countries. The effects of these policies were not limited to developed countries that applied them; they had global impact, in emerging economies it has been reflected in significant capital inflows. The positive effects of these inflows include access to foreign loans under favorable conditions. However, if these are excessive and short-term, the economy could suffer some unwanted effects.

There are three ways that these capital inflows might have negative impacts on the economy. Firstly, they can exert strong appreciation pressure on the local currency, even driving it to below its equilibrium level, which would make the tradable sector less competitive (particularly the non-traditional sector), with negative impacts on employment and exports, and therefore increasing the current account deficit to unsustainable levels. Secondly, such capital inflows could finance excessive expansion of credit and domestic demand, leading to over borrowing by households and generating inflationary pressure. Likewise, appreciation of the local currency and the lower cost of foreign currency loans would make the latter more attractive, increasing the credit exchange rate risk. Finally, they could lead to an overvaluation of assets, for example in the non-tradable sector (real estate), which eventually could lead to a burst bubble with negative impacts on household wealth, consumption and activity.

The challenge facing economic authorities is to find ways of reducing the economy's vulnerability to these factors, which could be exacerbated in the event of sudden changes to the direction of capital flows. One option is to impose capital controls. However, some believe such restrictions are only effective in the short term because investors will eventually find avoidance mechanisms. Thus, the most widely accepted means of discouraging an excess inflow of capital looks to be macro-prudential measures as long as these do not restrict consumption or saving decisions made by households and companies.

8. Tables

Table 5
Macroeconomic forecasts annual

	2011	2012	2013f	2014f
GDP (%, yoy)	6.9	6.4	6.5	6.3
Inflation (%, yoy, EoP)	4.7	2.6	2.8	2.4
Exchange rate (vs. USD, EoP)	2.70	2.57	2.45	2.45
Policy interest rate (%, EoP)	4.25	4.25	4.25	5.00
Private consumption (%, yoy)	6.4	5.8	5.7	5.3
Public consumption (%, yoy)	4.8	9.0	8.0	4.5
Investment (%, yoy)	5.1	16.4	12.2	6.8
Fiscal balance (% of GDP)	1.9	2.0	1.2	1.1
Current account (% of GDP)	-1.9	-3.8	-3.8	-3.5

Source: BCRP and BBVA Research Peru

Table 6
Macroeconomic forecasts quarterly

	GDP (%, yoy)	Inflation (%, yoy, EoP)	Exchange rate (vs. USD, EoP)	Monetary policy interest rate (%, EoP)
1Q09	1.9	4.8	3.18	6.00
2Q09	-1.2	3.1	2.99	3.00
3Q09	-0.6	1.2	2.92	1.25
4Q09	3.4	0.2	2.88	1.25
1Q10	6.2	0.8	2.84	1.25
2Q10	10.0	1.6	2.84	1.75
3Q10	9.6	2.4	2.79	3.00
4Q10	9.2	2.1	2.82	3.00
1Q11	8.8	2.7	2.78	3.75
2Q11	6.9	2.9	2.76	4.25
3Q11	6.7	3.7	2.75	4.25
4Q11	5.5	4.7	2.70	4.25
1Q12	6.0	4.2	2.67	4.25
2Q12	6.3	4.0	2.67	4.25
3Q12	6.5	3.7	2.60	4.25
4Q12	6.5	2.6	2.57	4.25
1Q13	6.4	2.8	2.53	4.25
2Q13	6.4	2.9	2.52	4.25
3Q13	6.4	2.3	2.48	4.25
4Q13	6.7	2.8	2.45	4.25
1Q14	6.4	2.6	2.43	4.50
2Q14	6.4	2.5	2.41	4.75
3Q14	6.3	2.4	2.42	5.00
4Q14	6.1	2.4	2.45	5.00

Source: BCRP and BBVA Research Peru

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