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# Economic Outlook

## Peru

Third Quarter 2012
Economic Analysis

- **Global growth will gradually recover in 2013** as European and U.S. authorities manage to reduce existing uncertainty.
- **We have revised our 2012 growth forecast downwards to 5.6%** as a result of weaker foreign demand and an expected moderation in private expenditure in the second half of the year.
- **Inflation will converge to the target range at the end of 2012.** Reduced demand-driven inflationary pressures and a downward revision of oil prices will offset higher food commodity prices.
- **The policy rate will remain at 4.25% until 2013.** Near-potential economic growth and moderating inflation will allow the Central Bank to remain on standby, closely monitoring how the external situation unveils.
- **The Peruvian currency has room for further strengthening since its fundamentals have remained solid.** However, transient episodes of volatility associated with the uncertainty from abroad cannot be ruled out in the short term.

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Closing date: August 6, 2012

# 1. Summary

**The global growth forecast has been revised slightly downward to 3.4% in 2012 and 3.7% in 2013.** This revision is based on the financial tensions in Europe and the slowdown that has been somewhat more intense than expected three months ago, especially in the largest emerging markets like China, India and Brazil. This global scenario presupposes that the necessary political agreements will be reached for making progress in the institutional development of the European monetary union and also for avoiding the automatic fiscal adjustment in the U.S.

**For Peru: downward revision of our growth forecast for this year to 5.6%.** The adjustment is explained mainly by the reduced strength of exports that, this year, have slowed significantly against a backdrop of weak foreign demand which will continue in the coming months. On the private expenditure side (investment and consumption), our forecast for this year remains unchanged. This is a result of the improved performance in the first six-month period of the year offset by the moderation in investment, in line with the decline of business confidence and the slowdown of capital goods imports. In this forecast revision, we continue to expect public expenditure to keep supporting growth, with a public investment we foresee will rise 30% this year, and greater expansion of public consumption.

**On the price side, we expect inflation to converge to the target at the end of this year.** Inflation at the end of July stood at 3.3% (4.7% at year-end 2011) in line with expectations. For the future, we foresee inflation will continue presenting a downward trend in a context of an economic activity slowdown and fewer pressures on the side of oil prices. However, the increases in the international agricultural product commodity prices will make the fall in inflation more gradual, which we expect will close the year at 2.8%.

**On the monetary policy front, the risks in the international context will lead the Central Bank to maintain the pause until late 2013.** Despite this, the current strength of domestic demand suggests that, for the time being, a greater monetary stimulus does not need to be implemented. In this situation, the monetary policy standardization process will be delayed until 2014, in a context in which the product will be situated around its potential level, inflation will be within the target range and global growth will begin to consolidate its recovery.

**The Peruvian currency has room to continue strengthening due to the solidity of its fundamentals.** We expect the Central Bank to maintain its foreign exchange interventions to gauge the strength of the currency. However, transient episodes of volatility associated with the uncertainty from abroad cannot be ruled out in the short term.

**The direction taken by the crisis in the eurozone remains the primary risk factor in our forecasts.** The most important source of uncertainty is associated with the timeliness with which agreements are made regarding the banking and fiscal union, since an "accident" could occur along the way. Although the impact on local activity will be significant, the Peruvian economy has the fiscal and monetary strength to mitigate it. In this scenario, the rate of growth would be slightly affected in 2012 and would have a moderate impact on 2013, with the recovery beginning in 2014. Likewise, a transient weakening would arise in the public sector and foreign sector accounts, but would be manageable.

# 2. Summary: a slowdown that may deepen without decisive policy action

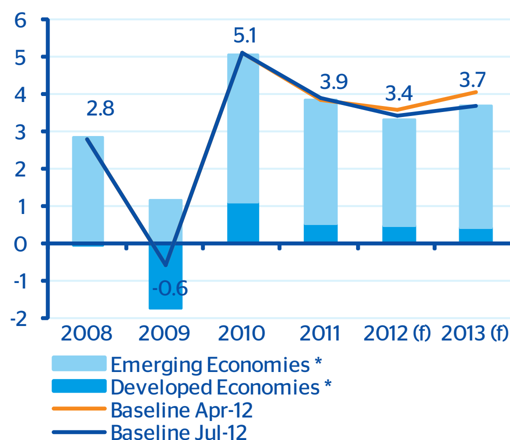
## Global growth will improve only if key economic policy measures re fully implemented in time. Some of them have already been approved but others are still under consideration

After the deterioration in global economic conditions in the first part of 2012, our current scenario that still envisages a slight economic rebound in 2013 is very dependent on economic-policy issues. Our global GDP growth forecast stands at around 3.5% in 2012-13, but relies on the assumption that several policy measures are implemented around the world. Some of them have already been brought into force but need appropriate implementation; others have been announced but not introduced yet; and, finally, some key measures still have yet to be passed. Policy measures must avoid a financial mess in Europe, an automatic fiscal adjustment in the US in 2013, and help reach higher growth rates in emerging economies. However, if economic policies fail to achieve their goals, the slowdown now in place since 2011 is likely to intensify in 2012 and 2013. That could leave 2013 global GDP growth at its slowest pace in 30 years (except for the 2009 recession).

At a summit in June, the eurozone leaders reached agreements in the right direction to reinforce the currency union: single bank supervision in the euro area, far-reaching plans covering banking and fiscal issues, and growth-supporting measures. However, financial-aid mechanisms that have been approved to ensure financial stability in the eurozone (i.e., EFSF&ESM) must be used in their full capabilities as soon as possible to avoid a financial "accident"[1]. This is the only way to make sure that those economies currently struggling to access financial markets have the chance to implement fiscal-consolidation plans and structural reforms. This should include the involvement of the ECB.

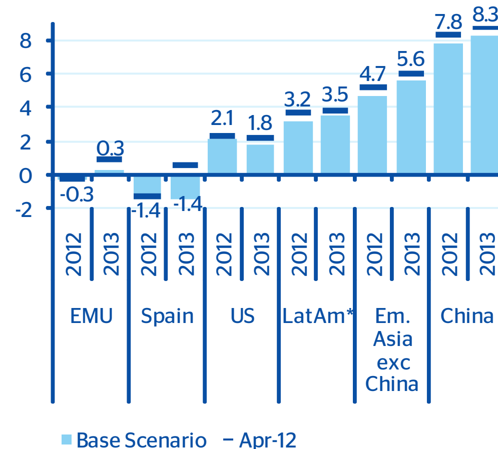
In the US, there must be an agreement to prevent that automatic spending-cut measures and the expiration of tax cuts come into force at the beginning of 2013. This "fiscal cliff" would not solve long-term sustainability of the country's public finances and, if all measures materialized, they would push the US economy back into recession in 2013. As the presidential campaign makes any kind of agreement difficult until the election, the surrounding uncertainty over the outcome of this process is likely to play a key role in shaping the economic and financial outlook as we move towards the end of the year.

Chart 1
**Global GDP growth (%) to pick up in 2013**




Source: BBVA Research

Chart 2
**GDP growth (%) is being led by emerging markets**




(*) Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Source: BBVA Research

1: The financial "accident" could take various forms, including for example the lack of demand for sovereign-bond issuances of peripheral economies.

Meanwhile, in emerging economies with room for policy stimulus, measures are needed to prop up domestic demand so that the effects of the external slowdown are mitigated. Additionally, volatility of capital inflows could increase due to the ebbs and flows of the eurozone crisis and, on the other hand, flows related to a new round of quantitative easing the US Fed is likely to embark on.

## Failure to dovetail sovereignty transfer with debt mutualisation at the rhythm that markets demand drags the euro crisis out

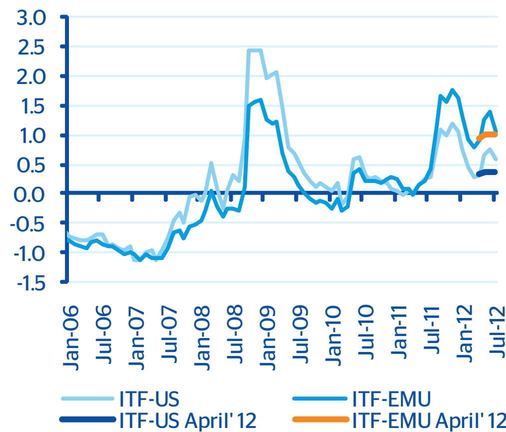
The main uncertainty over the current economic scenario is whether the efforts that the eurozone countries will have to make to reinforce its governance will be preceded by a further deterioration in its financial situation. If this were the case, we think that it will produce massive interventions from EU mechanisms to eventually assure the financial stability of the eurozone. The decisions already taken, if implemented forcefully could suffice but that requires that the measures approved at the end of June are implemented quickly. Those measures aimed to eliminate the risk emerging from the sovereign-banking feedback loop in Spain and to stabilise financial markets across the eurozone with the active use of the EFSF and later on of the ESM actively purchasing bonds in the primary and secondary market. Recent policy measures in Spain to reign in the deficit together with the strongly supportive stance by the President of the ECB are helping to ease tensions.

All in all we have revised downwards our previous forecast (released three months ago) due to continued financial stress stemming from the euro area crisis and ongoing deterioration in global economic confidence. This scenario implies a period of stagnation in the eurozone in 2012- 13. Despite this revision, in our view, the balance of risks continues to be tilted to the downside, given the likelihood that approved measures are introduced too slowly due to domestic-policy considerations in some countries. If that were to happen, then the risk of a recession in Europe in 2013 would be relevant, especially in countries such as Spain and Italy.

Eurozone countries have to solve the liquidity squeeze on some markets. Those constraints are a consequence of market participants assigning some chance that a euro break-up may occur. Euro countries are unable to dovetail the transfer of fiscal and banking sovereignty with effective mechanisms of reduction of imbalances at the rhythm that markets demand. As long as this situation continues, the risk of a euro break-up is fuelling the fragmentation of financial flows across the eurozone and impeding funding access for those economies with a net debt position with the rest of the zone. A fast implementation of financial-aid mechanisms and their reinforcement in terms of size and access to ECB's funding are key factors to eliminate the risk of a eurozone break up. However, in our opinion this extreme outcome is a tail risk; sooner or later, the measures needed to set up common institutions for banking supervision, deposit guarantee and banking resolution will be approved. Although there is political will to reinforce European currency-union institutions and governance, the implementation of appropriate measures are lagging behind. In the end, those measures will imply a transfer of national sovereignty to the European institutions and, at the end of the process, some form of liability sharing (debt mutualisation). That will also happen as for the fiscal policy, for example in the form of national consolidation plans having to be submitted to European institutions. If the challenges ahead are met satisfactorily, global growth could gradually gain traction during 2H12.

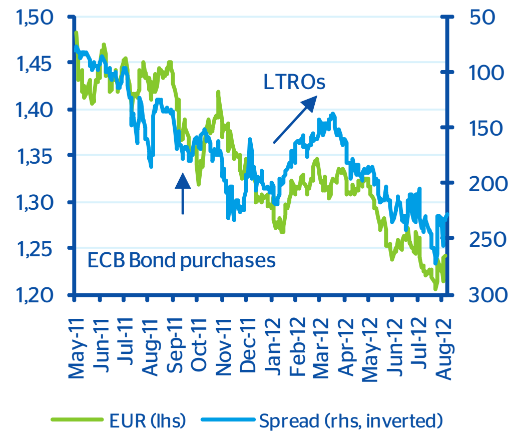
In the case of the US, the downward revision to our outlook for 2012 and beyond has been driven by a combination of disappointing growth figures in 1H12 and the impact of a high financial stress coming from the euro area. As a result, emerging economies are likely to be the main drivers behind the slight acceleration in global GDP we expect for 2013. In Latin America, despite a generalised downward revision in growth forecasts compared with three months ago, estimates for Mexico (3.7% and 3.0% for 2012 and 2013, respectively) remain unchanged thanks to upbeat activity data in 1H12, the continuation of favourable financing conditions in the domestic market, and gains in competitiveness. In Brazil, growth forecasts have been significantly revised downwards (to 2.2% from 3.3% in 2012) due to the impact of the external environment and to some domestic issues such as the slowdown in credit markets and increasing competitiveness problems. Even though activity is still expected to recover in the quarters ahead following the unprecedented softening of monetary conditions, the recent moderation warns against the current growth model and its excessive focus on private consumption and credit expansion.

Chart 3
Financial stress indicator, BBVA Research (*)




(*) Tracks the trend of a series of financial variables, including stock market volatility, interest rates and exchange rates, sovereign and corporate credit risk; and liquidity tensions.
Source: BBVA Research and EPFR

Chart 4
USD-EUR and Spanish and Italian risk premiums
Average spread vs. 10Y Bund, bp; index 1 Jan 11=100




Source: BBVA Research

As for Asia, growth in the first half of the year slowed in China by more than expected. In line with the weaker global outlook, we have accordingly revised down our projections for 2012-13. Nevertheless, monetary and fiscal measures to support growth should lead to a pickup in China, with growth in 2013 rising to 8.3%, a half percentage point higher than in 2012. Elsewhere in the Asia region there is also room for policy stimulus to support growth. However, there are downside risks, including a more severe worsening of external demand and a continued slowdown in China, exacerbated by ongoing domestic financial fragilities.

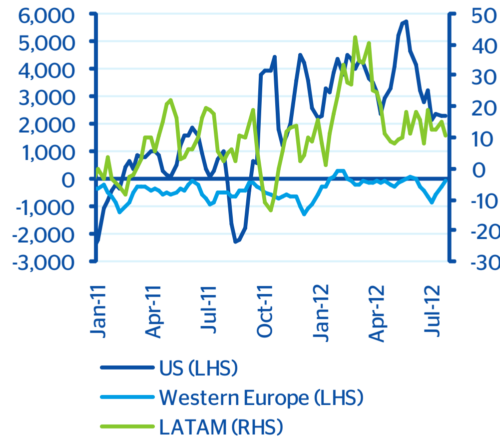
## Abundant liquidity, accumulated imbalances and doubts about the ability of policy makers to resolve the euro crisis are changing the risk perception across assets in developed and emerging markets

The outcome of the current economic problems is highly uncertain because there are political-economy considerations at stake that may not be consistent with the incentives to fix a supranational crisis. The risk scenario that dominates in the forecast horizon (2012-2013) appears to be more focused on the developed economies and in particular, on the eurozone. These emerging economies have more room to manoeuvre than developed economies when it comes to demand policies (fiscal and monetary), and also have, overall, lower accumulated imbalances. As a result, there have been increasing capital flows from Europe into the US and the emerging markets, including those in Latin America.

These shifts in financial flows are a reflection of the level of uncertainty and the fact that risk is focused on developed economies. Both factors have led to a change in the risk character across assets in emerging and developed markets. Since the end of May (when markets started pricing in that the US economy was running out of steam) yields on bonds that are traditionally regarded as risk-free sovereign assets (US and Germany) have fallen to historically low levels. Since the end of June, doubts surrounding the ability to reach a rapid solution to the euro crisis have been pressing in the same direction. Peripheral sovereign bonds have been perceived as riskier, whereas yields on emerging-market bonds such as Mexico's[2] and Colombia's have fallen to all-time lows. Record foreign inflows are searching for returns in economies as isolated from the source of the crisis as possible, with good macroeconomic policies and growth prospects; in countries where any direct channel of contagion is relatively narrow, and where the room for manoeuvre in economic policies is ample.

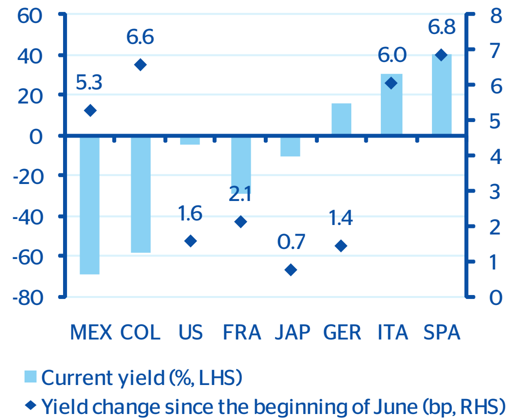
2: In the case of Mexican bonds, the inflows may even have been intensified by investors betting on a change of composition of the bench-mark indices used by global fixed income portfolios.

Chart 5
Sovereign debt flows (USD bin)




Source: BBVA Research and EPFR

Chart 6
Long term (10Y) bond yields, changes since the beginning of June (bp)




Source: BBVA Research

But there are risks to the sustainability of this scenario. Apart from changes to local inflation or growth outlook that may cause rising yields, global factors, such as systemic shock in the eurozone could wipe out all the safe-haven value recently gained by certain emerging-market assets, e.g. those in Latin America. In the case of a systemic event, it remains to be seen whether domestic strengths (e.g., lack of fiscal imbalances) would be preserved in the event of a "Lehman-type" shock. In the event of a systemic risk, it is likely that only the assets of economies that have their own currency and a central bank that acts as the lender of last resort, and do not have any significant external imbalances, will be regarded as risk free[3]. On the other hand, additional expansion of the Fed's balance sheets could encourage investors to move out of fixed income and into equity markets, particularly if there are no clear signs of further easing in domestic monetary-policy expectations.

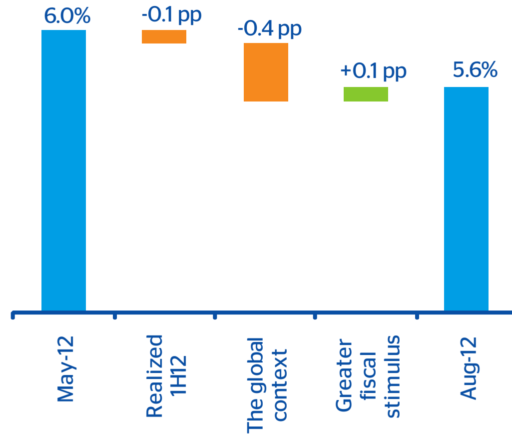
# 3. Peru: downward revision of the growth forecast for 2012 to 5.6%

## The revision is explained by a reduced dynamism of exports, which have already been negatively affected by the turbulence abroad

This year, the volume of exports has presented a marked slowdown. Exports recorded a year-on-year contraction of 10.2% (with May data) in the second quarter, the first quarterly drop since the end of 2009. In terms of commodities exports, a 13% reduction in the volume exported was observed. This was explained, in part, by temporary supply problems that we expect will be reversed in the second half of the year. Moreover, the commissioning of several mining expansion projects (Antamina) will enable copper sales abroad to recover in the coming months. However, for the future, manufacturing exports, such as textiles and agro-industrial products are concerning, as they are more sensitive to foreign demand and, since they are manpower intensive, they have a significant impact on job creation. In a context in which global growth estimates have been adjusted downwards, we expect exports to demonstrate less dynamism with respect to previous forecasts, explaining the majority of our downward adjustment in the GDP growth forecasts for this year (see Chart 7).

3: Chapter 3 of the IMF Global Financial Stability Report (April 2012) is dedicated to the implications of low supply of risk-free assets for financial markets stability.

Chart 7
**Change in the 2012 economic growth forecast (yoy % change and pp)**




Source: BBVA Research Peru

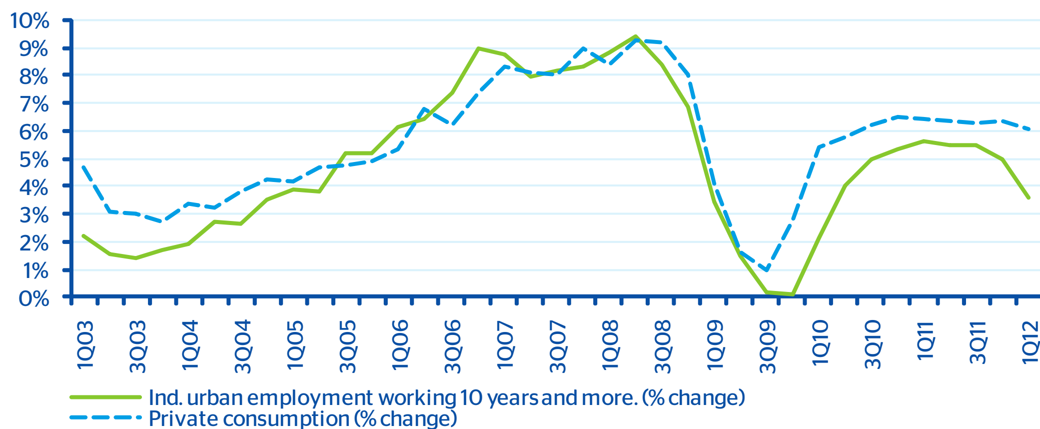
Table 1
**Indicators of economic activity (yoy % change, indices)**

| Indicator | 1Q12 | 2Q12 |
|---|---|---|
| Total exports (vol.)* | 16% | -10% |
| - Non-traditional exports (vol.)* | 10% | 0% |
| - Traditional exports (vol.)* | 19% | -13% |
| Employment (Lima) | 2% | 1% |
| Manufacturing (GAV)* | -1% | -1% |
| Imports of capital goods (USD) | 17% | 11% |
| Business confidence (index, EoP) | 64 | 57 |
| Corporate Lending (PEN) | 14% | 9% |
| Consumer Confidence (index, EoP) | 53 | 53 |
| Imports of consumer goods (USD) | 29% | 4% |
| Consumer credit (PEN) | 21% | 20% |
| Family car sales | 47% | 47% |

* Data up to May
Source: BCRP, INEI, APOYO and ARAPER

On the private spending side (investment and consumption), our forecast for this year remains the same. On the one hand, in the first half of the year, we observed a stronger performance of private sector demand with respect to what we expected three months ago due to greater dynamism of investment. And on the other, for the second half of the year, we expect a slowdown of this variable in line with the fall of business confidence (due to the stir regarding environmental conflicts that may affect mining projects and the uncertainty related to the foreign backdrop) and the slowdown of capital goods imports we have seen in recent months (see Table 1). In addition, the slower growth of investment and manufacturing exports will translate into reduced job creation, which will induce a moderation of household spending in the last part of the year. Therefore, the improved course of private spending in the first half of the year will be offset by a slightly greater expected moderation for the second half.

Chart 8
**Employment at companies with 10 or more workers and private consumption (yoy % change)**




Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

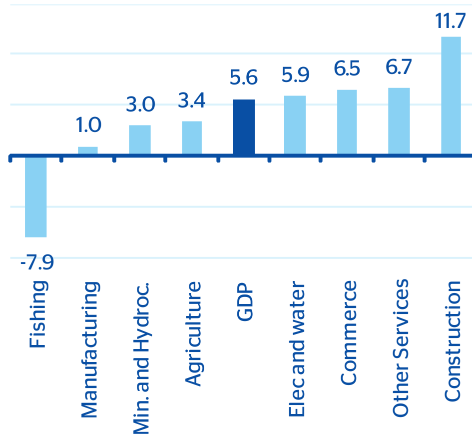
In this forecast revision, we continue to expect public expenditure will attenuate the moderation of private spending, with a public investment we foresee increasing 30% this year and a greater expansion of public consumption due to the application of the second economic stimulus package agreed upon in June. The total allocated to this package is equivalent to 0.4% of GDP and includes primarily expenses for infrastructure project maintenance and social programs. We estimate that nearly 50% of this additional spending will occur this year.

The balance of these factors leads us to adjust our previous forecast for GDP growth from 6.0% to 5.6%. Despite the downward correction, the Peruvian economy maintains an interesting dynamism, due to the support of domestic demand, with a growth rate near one that is sustainable in the medium term.

## The most dynamic activities this year will be geared towards the domestic market

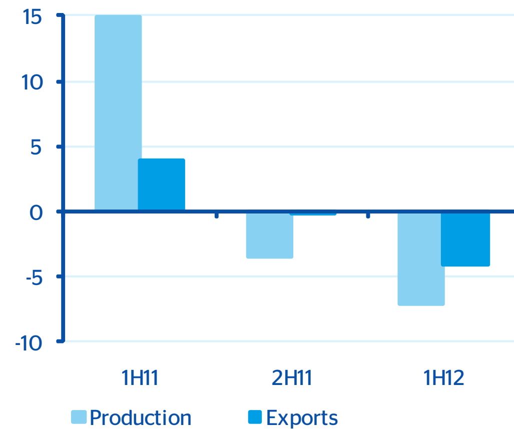
The dual nature of domestic and foreign demand will also be reflected in the sectoral sphere, where activities of greater growth will be those focused on satisfying the domestic market (see Chart 9). First, we calculate that Construction will end the year with a two-digit growth rate, upheld by mining-related projects, retail business and real estate activity, as well as by the development of infrastructure for roads, sanitation and building of school and hospitals. Likewise, the Services and Commerce sectors (retail sales), linked to household spending, will continue demonstrating their strength and we expect them to close the year with growth rates over 6.5%. Second, Manufacturing will maintain a weak rate of growth, due to the decreased demand faced by the industrial sectors with exposure to foreign markets. Specifically, output and exports of textiles will continue to be affected (the volume of shipments abroad shrank 4.0% in the first half of the year) due to spending on consumption in the United States and Europe.

Chart 9
**Peru: GDP growth by economic sector in 2012 (yoy % change)**




Source: BBVA Research Peru

Chart 10
**Textile output and export (yoy % change in real terms)**

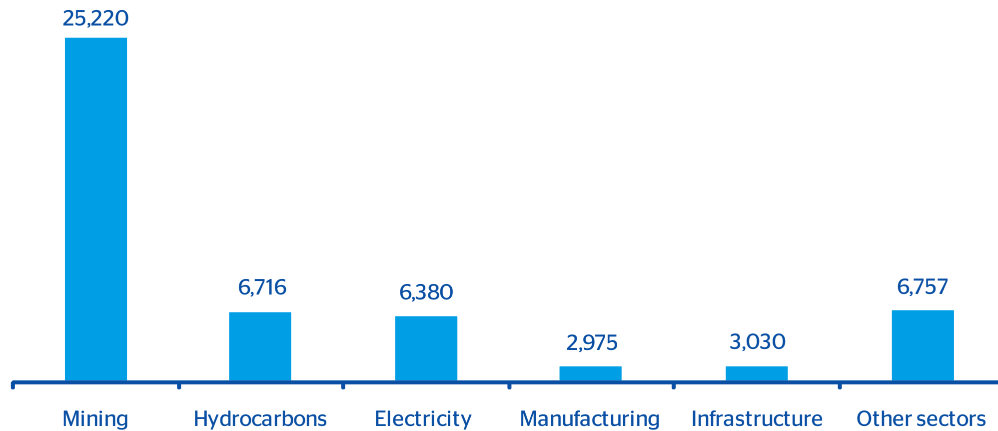



Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

## For the future, maturation of new investment projects will sustain growth consistent with their potential

The dynamism of investment in coming years will be fundamental to sustaining GDP growth rates close to 5.5% as the foreign situation remains relatively weak. In terms of the private sector, according to the Central Bank, the announcement of investment projects for the 2012-2014 period total USD 51,078 million, equivalent to 28.9% of GDP (see Chart 11). Fifty percent of these reports correspond to the mining sector, which include the extension of Cerro Verde, Las Bambas and Quellaveco, which are all predominantly copper rich. With the commissioning of these projects, copper production, which is estimated at 1.2 million fine metric tons for 2012, will triple by 2016. In addition, significant private investment announcements were released in the Hydrocarbon sector (South Andean Pipeline and the expansion of the Malvinas and Pisco Plant) and the Electricity sector (Cerro de Chaglla and Cerro del Águila hydroelectric plants).

Chart 11
Private investment projects announced for 2012-2014 (million USD)




Source: BCRP

The execution of significant infrastructure projects is also expected on the public investment side. These projects include Line 2 of the Electric Train (mass transport system in Lima), the Selva longitudinal roadway and the installation of a broadband network that will link the country's 195 provincial capitals. In the aggregate, ProInversión (a state-owned investment promotion entity) currently holds an investment portfolio of more than USD 10 billion, which we expect will be awarded over 2012-2013.

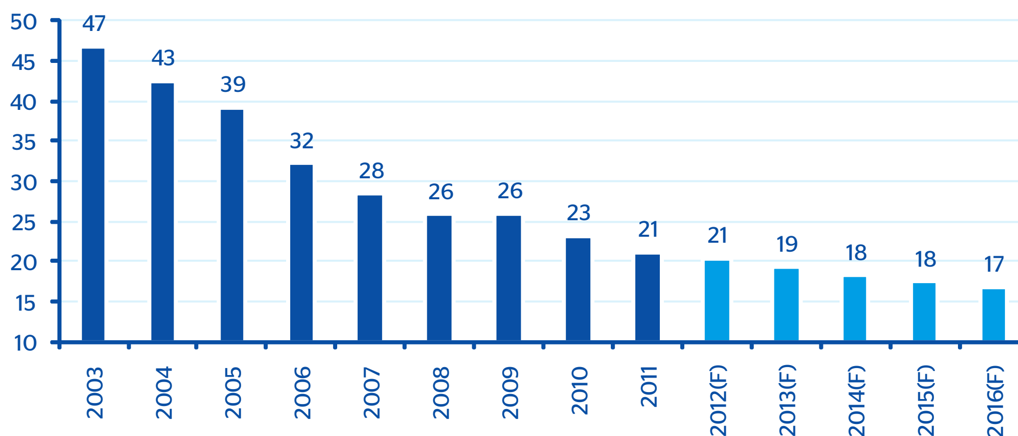
We also expect a gradual improvement of exports as of next year driven primarily by the expansion of existing mining projects (Antamina and Cuajone) and the commissioning of new projects (Toromocho, Antapaccay and Mina Justa, for copper, and Pucamarca and La Arena, for gold).

## Public debt will maintain a downward trend

For the coming years, we expect a fiscal surplus of around 1.0% GDP, slightly below our previous forecast due to decreased tax revenues linked to more moderate growth. In addition, we now forecast greater public expenditure due to the stimulus measures that will impact 2012 and 2013[4]. In general, public balances will remain solid and, given the expected progress of the fiscal outcome and debt repayments for coming years, we estimate that the government's financing requirements will be negative between 0.2% and 0.5% of GDP and that the ratio of government debt to GDP will fall to 17% (21.2% at year-end 2011) towards 2016 (see Chart 12).

4: The Fiscal Contingency Plan is made up of two stimulus packages dictated to date for a total amount of USD 1.9 billion, of which 60% (0.6% of GDP) will be spent this year.

Chart 12
Public debt (% GDP)




Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

In our forecasts for public balances, we continue to assume that the inter-temporal fiscal balance will be maintained; therefore, any eventual increases in public expenditure will be moderate and sustainable over time. Therefore, we understand that the President's recent announcement of salary increases in the public administration and the expansion of social programs is associated with constant improvements of fiscal revenues, that is, they are free from the transient cyclical effects and commodity prices over their long-term levels. Thus, the structural fiscal deficit (which includes constant revenues) could be closed as of 2013 in accordance with that announced in the bill the Government will send to Congress in April.

It is also important to maintain the quality of public expenditure to ensure that it is a source of endogenous growth. In that regard, another positive aspect has been the President's message to the Nation in which he announced that towards 2016, all of the State's non-financial and non-pension expenses will be included in the framework of the Budgeting for Results. This scheme of continuous assessment of the objectives attained provides greater transparency and ensures a minimum level of public expenditure quality. In the same sense, the restructuring of the SNIP (National Public Investment System, Spanish anachronism) announced to reduce the time needed for the approval of public infrastructure projects should be carried out by supporting procedures that ensure that the funds are allocated to projects with a positive social return.

## Moderate current account deficits are expected

In the medium term, we expect a current account deficit of nearly 2.5% of GDP; this implies a slight impairment for 2012 and 2013 with respect to the previous forecast. In part, the more deficitary earnings are explained primarily by reduced dynamism of exports that, due to the weakness of foreign demand, will tend to revert as of 2014 with the commissioning of various mining projects, particularly for copper. Likewise, we estimate that the current account deficits will be largely financed by long-term capital inflows, mainly foreign direct investment. Given our prediction that in this situation, the Central Bank will maintain its foreign exchange interventions to measure the capital inflows' monetary and appreciation impact on the Peruvian currency, we will observe a greater international reserve accumulation whose balance will lie around 25% of GDP towards 2016.

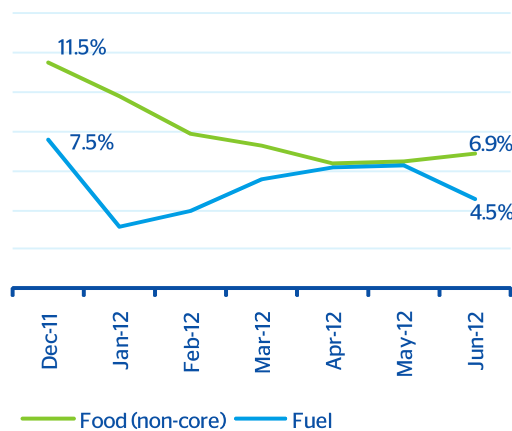
It should also be noted that these current-account deficits reflect inflows of funds from external sources that will complement local savings. This, in turn, will allow the investment to GDP ratio to stand at nearly 30% towards 2016, which is consistent with a potential growth rate of 5.5%.

# 4. Inflation will converge to the target in the fourth quarter

## Inflation in line with expectations

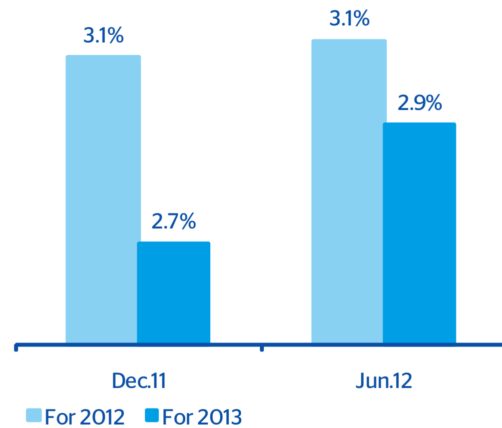
In late July, inflation stood at 3.3%, marking a fall from the 4.7% at which it closed 2011. This course is similar to what we had forecasted in our previous report and primarily reflected the downward correction in food and fuel prices, after the supply shocks that affected them in 2011 and early 2012 began to dissipate. It should also be noted that the recurrence of supply side shocks has already prolonged the inflationary deviation from its target for a year, and as a result of this, the inflationary expectations for 2012 and 2013 have reached the upper limit of their range. This will add some resistance to the downward trend of the rate at which prices advance.

Chart 13
**Food and Fuel Prices (yoy % change)**




Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

Chart 14
**Expectations for inflation**

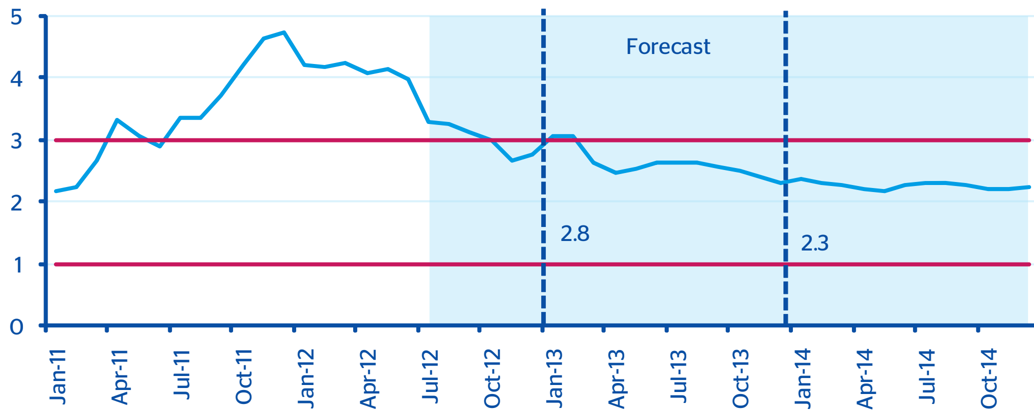



Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

## For the future, lower oil prices will offset the higher imported food commodity prices

We maintain our inflationary forecasts for 2012 and 2013. At the moment, the actual data is very similar to our forecast, and in the future, there will be adjustments in the balance sheet that will offset one another. On the one hand, the reduced economic growth we anticipated for 2012 and 2013 (down 0.4pp in each case) will, to an extent, moderate pressures on the demand side. In addition, international oil prices have been revised downwards. This reduction reflects two elements. Firstly, that some OPEC countries have not reduced their oil production after Libya began to increase its oil dispatches, and, secondly, in a context of higher global aversion to risk that will further support the dollar. On the other, the prices of imported food commodities will be higher than expected due to climatological problems in the productive regions and to the relatively tight inventories in world markets.

Chart 15
Inflation (year-on-year, %)



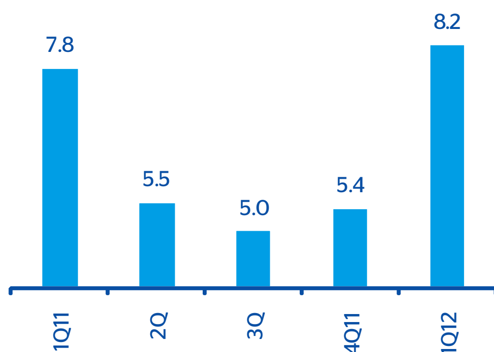

Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

# 5. Monetary pause until late 2012 due to foreign risk

## The strength of domestic demand is maintained and the inflationary expectations remain high; this reduces the need and space to cut rates

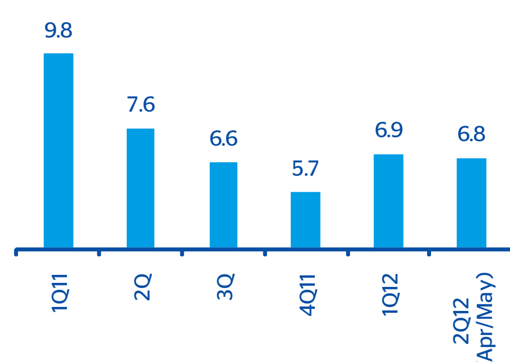
The indicators available for the second quarter continue to show significant dynamism of activity. The GDP for non-primary sectors of the economy, for example, which better reflect the pressures of aggregate demand and are growing over 6% yoy, are following that trend. In our base scenario, the average rate of quarter-on-quarter growth through 2013 will be near the potential rate, despite the fact that the export sector will be faced with less favorable conditions. In that period, the output gap will remain positive, and will only fully close at the end of said year. That is, despite the fact that exports have been feeling the impact of the renewed weakness in global growth, the still-strong domestic demand suggests that, for the time being, no additional stimulus on the monetary side is needed, especially when considering that, in real ex-ante terms the current level of the policy rate is more accommodating than at the beginning of the Lehman Brothers episode and even than that held until entering the second half of 2009.

Chart 16
Domestic demand
(excludes inventory variation, yoy % change)




Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

Chart 17
GDP of non-primary sectors (yoy % change



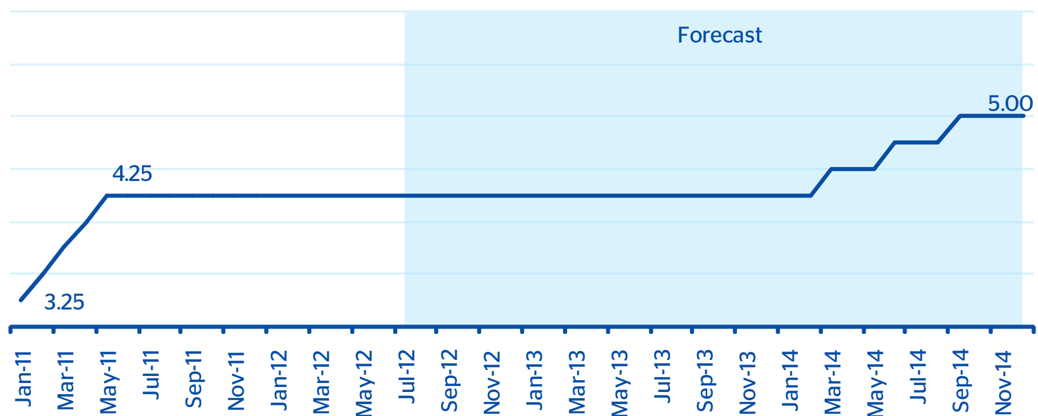

Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

The outlook for prices, on the other hand, has begun to turn around. Inflation is decreasing and the rate of its convergence on the target will become more accentuated in the second half of the year. However, the increased inflationary expectations, close to the upper limit of the target range for both 2012 and 2013, set the limits on the space for easing the monetary policy.

## The more complex foreign situation will postpone the normalization of the monetary policy

In our previous base scenario, we estimate that the Central Bank would resume the normalization process for the monetary policy position in the first quarter of 2013. Our review of the external conditions, weaker than three months ago, and the increase of the risks they present for local activity, suggest that the Central Bank will be vary cautious regarding the opportune time to resume the process. Moreover, the positive output gap will close somewhat sooner than we foresaw in our previous report due to the downward correction for economic growth, which enables the Central Bank to take more time to relaunch this process. In this context, we foresee that the policy rate will not begin to be taken to its neutral level until early 2014, when the product will be growing at its potential rate, inflation is near target and the foreign situation is gradually recovering.

Chart 18
Monetary Policy Rate (%)




Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

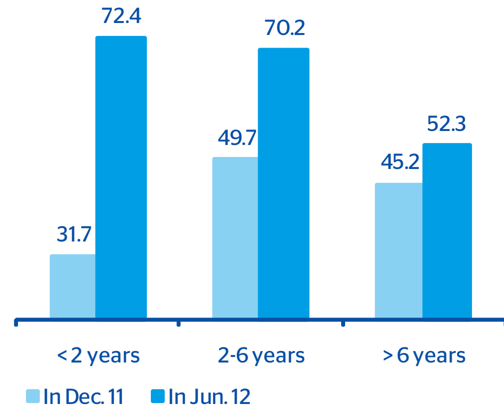
## Long-term rates are at minimum levels, but will tend to be corrected in the future as the situation in Europe gradually begins to be resolved

The longer-term rates, specifically those for public debt in local currency, have been falling notably over recent months and have reached all-time lows. The 2020 sovereign bond yield, for example, stands at 4.60%, only 35 bps above the policy rate. As mentioned in the first section, the positions in assets of peripheral European countries have been decreasing and these funds are being placed, in part, in emerging markets. In this context, Peru is especially attractive due to its strengths, the performance of its contribution and the low volatility of the exchange rate (even with the local currency's tendency to strengthen). As a result, the holding of sovereign bonds by the non-domestic sector has risen, particularly in the short and medium-term sections, which account for more than 70% of the total.

Chart 19
2020 Sovereign bond yield (%)

Source: Bloomberg and BBVA Research Peru

Chart 20
Sovereign bonds held by non-residents (% of total)



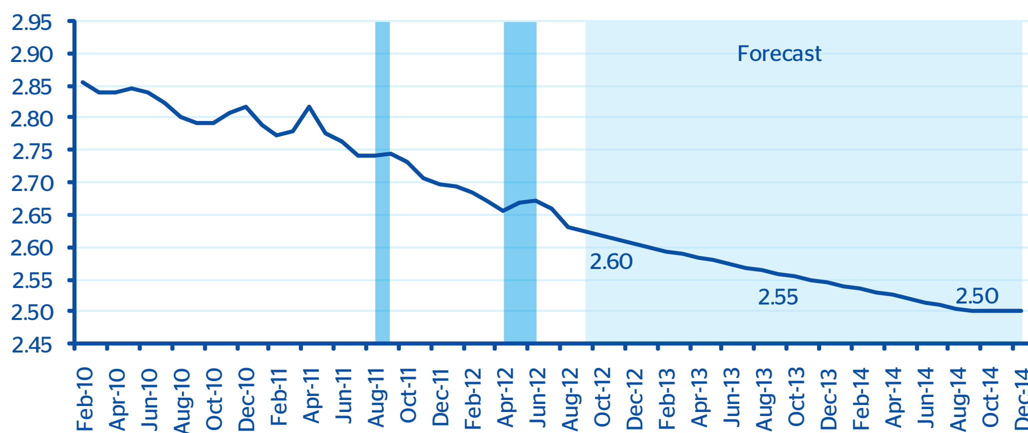

Source: MEF and BBVA Research Peru

Nevertheless, in our base scenario, global financial tension will be reduced progressively, especially from 2013 onward. This will generate a certain degree of reversion in these inflows, with the corresponding rise in yields. Due to the scarce depth of the Peruvian sovereign debt bond market, we cannot rule out that the adjustments could eventually become significant.

# 6. The PEN will continue to gain strength over the coming months

Despite the complicated foreign situation, the Peruvian nuevo sol (PEN) has gained more strength than expected. Appreciation to date stands at 2.7%, which would have been greater if not for the USD 8.2 billion purchased by the Central Bank in the foreign exchange market. This was in response to the greater attractiveness of Peruvian assets.

Chart 21
PEN/USD exchange rate



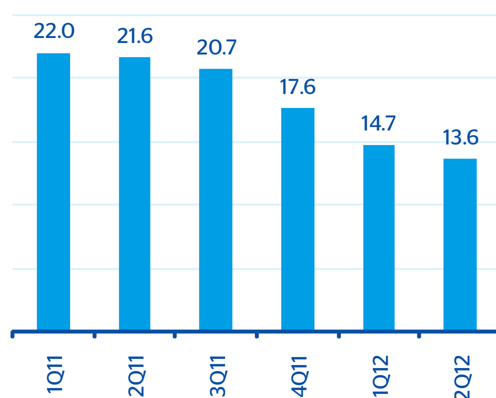

Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

In a medium term assessment, the fundamentals that support the trend for a stronger PEN have not varied. Our estimates of the productivity differential with the U.S. continue to be favorable to the Peruvian economy, and the net long-term foreign liabilities as a percentage of GDP show a falling trend in our forecasts, which makes it less necessary to generate a surplus in the balance of payments current account in the future. In addition to these two factors, we continue to estimate that the sustainable level of the current account (which in the long term stabilizes net foreign liabilities at around their average level for the recent years) is lower than its structural level (which corrects the price deviations of base metals exported by Peru and of GDP growth with respect to long-term trends). This suggests that the economy could absorb a greater appreciation of the PEN. Therefore, the local currency still has room to strengthen, but will not be entirely smooth depending on the course of the foreign situation. This falling trend in the exchange rate will be gradual, however, because the trade balance result will be less favorable, the space for an additional position of foreign investors in sovereign bonds has decreased, and because the Central Bank will remain active in the foreign-exchange markets to moderate the rate of appreciation, as it has usually done.

# 7. Credit growth will be more moderate in the future

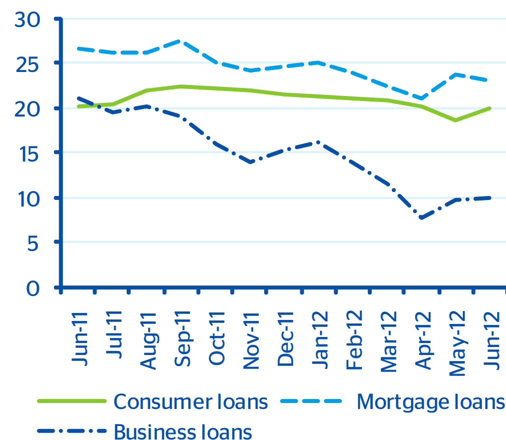
Bank lending to the private sector continues to slow (see Charts 22 and 23). This effect is more obvious in the case of lending to businesses; in particular, that designed to finance foreign trade transactions. The latter takes into account both the slowdown of foreign demand and also the replacement of this modality of financing with that of foreign entities, since the high level of reserves discourages the taking of local credit. In this context, for the financing conditions of the foreign trade operations of local banking to be more similar to those of foreign banking, the Central Bank cut the reserves for this type of transaction back from 60% to 25%. It should also be noted that the monetary authority has used the increase of reserves as an instrument to moderate the expansion of spending but avoids the exacerbation of pressures towards the strengthening of the local currency. The lines obtained by local banks outside of the country to finance these foreign trade transactions do not generate this type of pressure on the exchange rate; therefore, reducing the reserve requirement is also reasonable from this point of view.

Chart 22
**Bank lending to the private sector (yoy % change)**




Source: SBS

Chart 23
**Bank lending by borrower (yoy % change)**




Source: SBS

Furthermore, household-linked lending, though it has become more moderate, continues to present high rates of growth, specifically mortgage credit, which is expanding at a rate of over 20% yoy. This dynamism is especially interesting to analysts and authorities in terms of its sustainability and if it could be inducing an asset bubble similar to those observed in other countries (see Box 1).

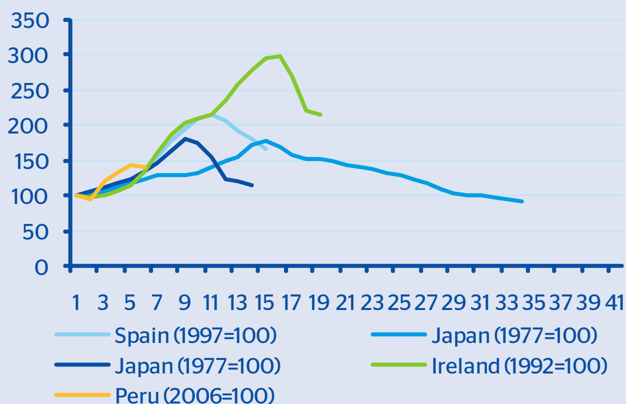
For the rest of the year, we expect the gradual credit downturn to continue and record growth of nearly 13% in 2012. For the future, the rate of growth of the financial system's lending will stabilize at levels of around 12%, which will cause the banking intermediation rate to rise at a rate of 2 pp of GDP per year. This growth is reasonable if taking into consideration that a large sector of the population, mostly informal independent workers, do not enjoy the benefits of bank lending. Likewise, lending will increase at a greater rate than deposits. Thus, the participation of other sources of bank funding (foreign debt and wholesale financing) will increase in coming years.

## Box 1: Real estate bubble?

The rapid increase reported for housing prices in Metropolitan Lima in recent years is interesting due to the possibility that prices are above their equilibrium levels. If this is the case, real estate prices would reflect speculative and volatile behaviors, which, eventually would lead to a downward adjustment. Our concern intensifies upon extrapolating the negative impact on economic activity, employment and wealth generated from the real estate bubbles bursting in the United States and Europe in the last five years (see Chart 24).

Chart 24

**Real Housing prices by country (index)**




Source: BIS, CAPECO

Is Peru close to facing a similar bubble? On the balance, there is no solid evidence to allow this statement to be confirmed, at least at the aggregate or average level. On the one hand, Peru does not exhibit the same factors as were present in the recent experiences of excessive spikes in real estate prices in the northern hemisphere: (i) an extremely lax monetary policy that maintained very low interest rates over a long period of time, (ii) poor banking supervision and regulation, (iii) a financial innovation process that induced greater levels of leveraging on the system entities ("inflate" balance sheets) and greater exposure to risk, and (iv) notable growth of lending.

In terms of the last point, we should emphasize that the low banking intermediation rate in Peru, in particular that of lending for the real estate sector, as well as the reduced default rates, suggest that the growth of lending has been healthy and that its strength is explained, in part, by the economy's formalization process.

We should also add that demand factors (like, for example, the rise of household income that has led to the growth of the middle class, the unsatisfied demand for homes and demographic changes that are reflected in a greater percentage of individuals between the ages of 30 and 40 with a housing demand) and supply (increase of the cost of land, construction materials and workforce) provide significant support to housing prices in Lima. In addition, our preliminary estimates of the equilibrium prices suggest that the level observed is not far from its fundamental value (see Chart 25). A recent study by the International Monetary Fund for a sample of Latin American countries, including Peru, supports these results. The study concluded that there are few signs of imbalances in the mortgage and real estate market and that the housing prices in the majority of the markets are at levels near their base[5].

In any case, if Peru undergoes a correction of real estate prices, its impact would be relatively limited. First of all, it is rare for Peruvian families to use a home as collateral for other transactions. In this way, though a downward correction of the property's price would harm their patrimony, it would not cause them to default on payments or restrict their consumption; therefore, on the aggregate level, the negative impact on demand would be bounded. Secondly, in some other countries, the borrower is incentivized to allow the bank to foreclose on their property if its price drops below the value of the loan. This is the case because their obligation to the bank culminates at that time. The financial entity thus suffers an equity loss that then reduces its capacity to lend, which, at the aggregate level, negatively affects spending. The same does not occur in Peru because, regardless of if the home was foreclosed on or not, the obligation to the financial system remains (for the difference between the value of the loan and that of the property). Finally, the banking entities maintain a moderate percentage of construction-linked holdings in their portfolios.

Nevertheless, the situation should be closely monitored. The Central Bank has been doing so since a sudden, abrupt correction of these prices would affect the dynamics of a key sector like construction and, as a result, of employment.

Chart 25

**Price per m2 in Lima Metropolitan and Callao (USD)**

Source: CAPECO and BBVA Research Peru

5: Cubeddu, Tovar and Tsounta (2012) "Latin America: Vulnerabilities Under Construction?" IMF Working Paper 2012/193, International Monetary Fund.

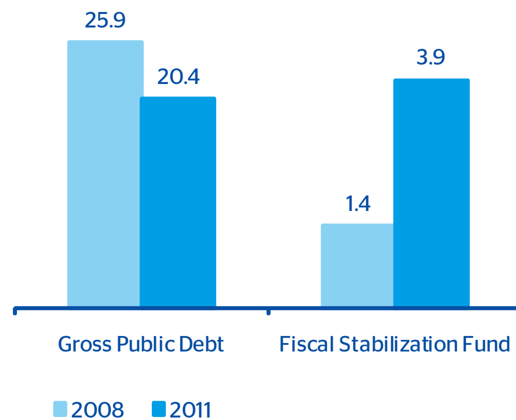
# 8. Europe continues to be the main risk factor

As we pointed out in our most recent reports, the main risk factor for the Peruvian economy is Europe. There is great uncertainty about the timeliness with which agreements will be reached regarding the banking and fiscal union, and on the way, "accidents" could happen, like a country's decision to leave the euro or a failed intervention of the ESM or ECB in the bond market. In that situation, global financial tensions would rise substantially and have major repercussions for the rest of the world and in Peru.

The impact at the local level would be felt through three channels. First, the substantial increase in global risk aversion would be reflected in an increase of the local risk premium, leading to greater funding costs, reduction of capital inflows and pressure on the exchange rate (depreciation of the local currency). Second, commodity prices and foreign demand would drop. Finally, business and consumer confidence would fall back. Private investment would be the component of expenditure most affected in this situation, as we already saw in the crisis of 2008-2009.

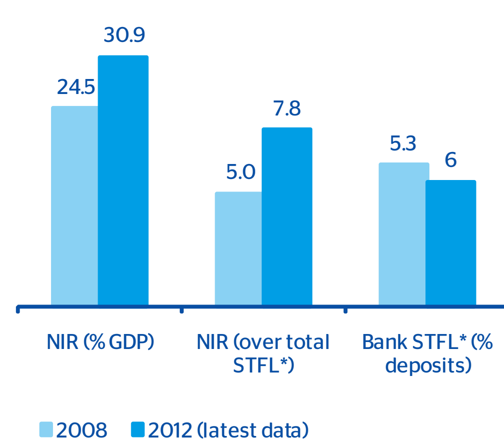
Although the impact on local activity will be significant, the Peruvian economy has the fiscal and monetary strength to mitigate it. On the fiscal side, in addition to the estimated excess (1.1% surplus in 2012), the State's stabilization fund has funds equivalent to 3.9% of GDP (see Chart 26). This allows it to carry out a counter-cyclical policy and limits the need to resort to the financial markets to obtain funds, which is fairly important in a context of elevated risk aversion and demand for liquidity.

Chart 26
**Indicators of fiscal vulnerability (% GDP)**




Source: BCRP and BBVA Research Peru

Chart 27
**Indicators of external vulnerability**




Source: BCRP and BBVA Research Peru

On the monetary policy side, there is room to limit the risk of a break in the credit chain, moderate a sudden depreciation in the local currency and stimulate private sector demand. First, the banking system holds more than PEN 55 billion (USD 21 billion, or around 42% of outstanding lending) in assets issued by the Central Bank, which could be used in repo or foreign-currency swap transactions. There could even be a reduction in the banks' PEN reserve requirement. In addition, if the banks had problems in renewing their short-term foreign debt (USD 3 billion), the currently high rates of foreign-currency reserve requirements could be cut (the average foreign-currency reserve requirement rate is around 40% of foreign-currency deposits and debt).

In a risk scenario, the Central Bank would also have to avoid an abrupt devaluation of the local currency to moderate its negative impacts. To deal with this, it can make use of its net international reserves of more than USD 58 billion, equivalent to 31% of GDP (see Chart 27) and issue foreign-exchange linked bonds, as has been the case in previous periods of volatility.

Finally, there is room to cut the interest rate (currently at 4.25%) and support private expenditure. Although inflation is currently above the target, in a difficult scenario its future trend would correct downwards, so the Central Bank would have room to prioritize the stabilization of economic activity during an external shock.

In this scenario, the rate of growth will only be slightly affected in 2012 and would have a moderate impact on 2013, with the recovery beginning in 2014. Naturally, a transient weakening would arise in the public sector and foreign sector accounts, but would be manageable. The fiscal stimulus measures and lower tax revenues linked to the slowdown of activity and reduced export prices would induce fiscal deficits. With that, the downward trend of the government debt to GDP ratio would be temporarily interrupted, and would resume as soon as the global conditions begin to improve. External accounts would tend to moderate since the combined effect of the slowdown of imports and lower profits of mining companies on the current account of the balance of payments would have a greater impact than the reduced growth of exports.

# 9. Tables

Table 2

Macroeconomic forecasts annual

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| GDP (y/y %) | 8.8 | 6.9 | 5.6 | 5.3 |
| Inflation (y/y %, eop) | 2.1 | 4.7 | 2.8 | 2.3 |
| Exchange rate (vs. USD, eop) | 2.82 | 2.70 | 2.60 | 2.55 |
| Monetary policy interest rate (%, eop) | 3.00 | 4.25 | 4.25 | 4.25 |
| Private consumption (y/y %) | 6.0 | 6.4 | 5.5 | 5.0 |
| Public consumption (y/y %) | 10.0 | 4.8 | 7.0 | 4.5 |
| Investment (y/y %) | 23.2 | 5.1 | 13.1 | 6.4 |
| Fiscal balance (% GDP) | -0.3 | 1.9 | 1.1 | 1.0 |
| Current account (% GDP) | -2.5 | -1.9 | -2.5 | -2.8 |

Source: BBVA Research Perú

Table 3

Macroeconomic forecasts quarterly

| | GDP (y/y %) | Inflation (y/y %, eop) | Exchange rate (vs. USD, eop) | Monetary policy interest rate (%, eop) |
|---|---|---|---|---|
| 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 | 5.0 | 4.0 | 2.67 | 4.25 |
| 3Q12 | 5.5 | 3.1 | 2.63 | 4.25 |
| 4Q12 | 6.0 | 2.8 | 2.60 | 4.25 |
| 1Q13 | 5.6 | 2.6 | 2.59 | 4.25 |
| 2Q13 | 5.5 | 2.6 | 2.57 | 4.25 |
| 3Q13 | 5.1 | 2.6 | 2.56 | 4.25 |
| 4Q13 | 4.9 | 2.3 | 2.55 | 4.25 |

Source: BBVA Research Perú

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