

Peru

Economic Outlook

Third Quarter 2010

Economic Analysis

- So far this year, GDP growth has accelerated more than expected, driven mainly by the dynamism of private spending. In this context, the growth forecast for the year has been raised from 5.7% to 6.8%.
- The medium-term outlook appears favorable, with growth rates for the 2011-2012 period close to 6% per year and a moderate deficit in the current account (about 1.5% of GDP) to be financed by long-term foreign capital. We also estimate that public debt as a percentage of GDP will be 20.4% in 2012, which will favor future improvements in Peru's credit rating.
- The acceleration of the cyclical recovery has advanced the convergence of output to its potential level of medium term. Therefore, the Central Bank has begun to drive monetary policy towards a more neutral position, a process which will continue in the coming months.
- The appreciation of the PEN has accelerated due to increased capital inflows in view of positive prospects for the Peruvian economy. In order to modulate these inflows as well as the strengthening of the PEN, the increase of the policy rate will be accompanied by higher reserve requirements.
- We consider that the Peruvian economy is currently facing the risk of overheating, given the strong expansion of private and public spending. Under this scenario, the Central Bank would face a dilemma between the need to adjust monetary policy and the objective of moderating the appreciation of the PEN.

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Closing date: July 19th, 2010

1. Reevaluation of the prospects for the global economy

The effects of the fiscal adjustment on the economic growth of Europe will be less than what is being anticipated. Positive implications on credibility will almost compensate the negative effects of decreased public spending. However, medium-term risks derived from unsustainable fiscal policies in other developed regions will possibly be overestimated

One of the clearest ways in which the financial crisis has affected the European economy has been loss in confidence, and a necessary condition for the latter's reestablishment is fiscal prudence. European consolidation plans are being introduced according to a calendar presented to the EU at the start of 2010. European fiscal consolidation has to focus on the structural aspect, but a positive factor is that the adjustment is swift and oriented to reducing expense. This will improve confidence and practically balance the negative effects on growth that are derived from the reduction in public spending. Thus while the effort at fiscal consolidation persists, the implications on economic activity in Europe will be limited and temporary. Other advanced economies in which fiscal stimuli have been substantial and whose levels of debt grew at the same rate as the European, were relatively slow in responding to the obligation to reduce their deficits and, at least, stabilize their debt levels. There is a medium-term risk that is underestimated, as experience demonstrates that the effects of a lax fiscal policy on interest rates are extremely non-linear: there is a risk of a sudden increase in long-term interest rates and of movement in private spending. This is precisely the opposite effect that is aimed for by the fiscal stimuli packages.

The main risk for the global outlook continues to be the financial markets. The stress tests have had positive, though asymmetrical, results in Europe. Although risks have been reduced, there are still significant chances of a reverse

Financial risks, derived from the problems of sovereign debt, form a vicious circle that ended up increasing market risk and absorbing liquidity, particularly in Europe. However, the strong increase in financial tensions in the second quarter is beginning to ease (see Chart 1). The publication of the results of the stress tests on European banks has had the positive effect of lowering tension, although there has been a clear difference between countries. In particular, they may act as a powerful boost for dissipating uncertainty regarding the Spanish financial system, as the implementation of the tests has been rigorous, and their results, with a great deal of disclosure, appear credible. Nevertheless, the risks for Europe and for the world economy from the financial markets undoubtedly continue to be the main cause for concern.

Growing divergence in monetary policy strategies. Increased uncertainty will lead the Fed and the ECB to delay withdrawing monetary stimuli. In contrast, most of Asia and Latin America have begun to raise interest rates

Financial tensions in Europe and uncertainty with respect to the rate of recovery in the U.S. will oblige central banks in both regions to delay their first increases in interest rates; therefore maintaining reference rates at very low levels for a prolonged period of time. Inflationary pressures in both areas will continue to be under control. This will allow flexible monetary policies to be maintained. However, a swifter recovery in the U.S. will lead to the withdrawal of monetary stimulus starting earlier than in Europe, and both factors will have an effect on the euro. Although the two central banks will delay monetary adjustments, the way of communicating and evaluating risks continues to be different in each institution. This limits the relative capacity of reaction of the ECB, in particular to deflationary risks. In addition, reference rates have already begun to rise in emerging economies, after the pause (in particular in Asia) that provoked the European debt crisis. This will help reduce inflationary pressures in Asia, where they had begun to soar, and prevent possible pressures in South America later in the year. A notable exception is the Bank of Mexico, which is likely to maintain interest rates until the second quarter of 2011. This is because, even though inflation in this economy will increase over the second half of 2010, this will be 5% in 4Q10 (middle of the band provided by Banxico), longer-term inflationary expectations are anchored at around 3.5% and the output gap is still negative, but has been gradually closing.

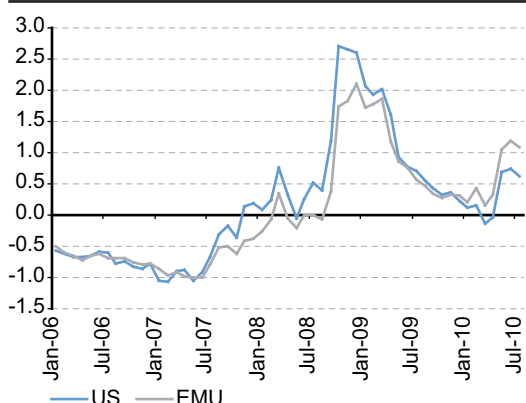
The world economy is moving towards a progressive and varied slowdown. This situation will be convenient for China and the rest of the emerging countries in Asia, as it will lead to convergence in growth at more sustainable rates. In the United States, private spending will continue to be fragile without official support, while in Europe confidence will be negatively affected by the consequences of the financial crisis

The impacts of the European financial crisis in other geographical regions have been relatively limited. However, global economic growth is expected to slow down soon (see Chart 2). The seriousness of European financial tensions will affect confidence and reduce growth in the second quarter of 2010 and the start of 2011. In addition, external demand will not be as sound as in the first half year, although it will continue to give some support for economic activity. In the U.S. the recovery will probably lose

momentum as a result of the situation in the labor and real estate markets. This shows the limits of private spending in that economy as an independent motor for growth. In China, the slowdown in GDP growth in the second quarter and some other indicators of a slowdown of activity suggest that the adjustment measures implemented by the authorities are being effective in directing the economy towards more sustainable rates of growth. Latin America will also slow down in 2011, although it will still maintain a strong expansion. As a result, the divergences between advanced and emerging economies will continue to grow, as will those within each of these groups.

Chart 1

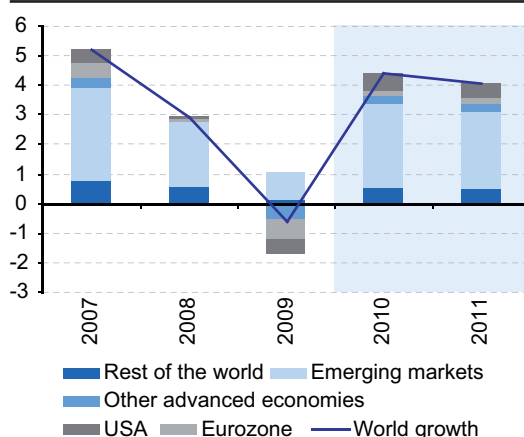
Financial Stress Index*



* Composite indicator of financial tensions in 3 credit markets (sovereign, corporate and financial), liquidity strains and volatility in interest rate, foreign exchange and equity markets
Source: BBVA Research

Chart 2

Contributions to Global GDP growth



Source: BBVA Research based on national accounts

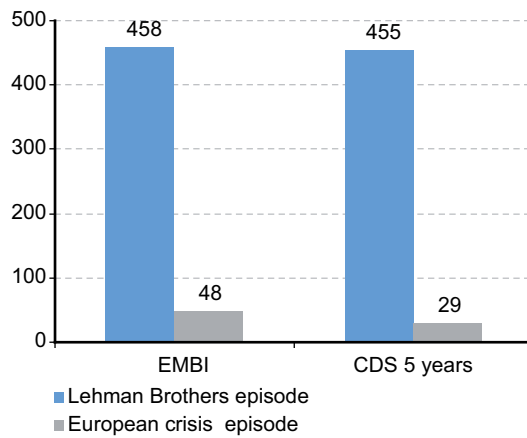
Although some measures have been taken in the right direction, a reduction in global imbalances is required in the future, which will require adjustments in spending by economic area

The return to equilibrium of the Chinese economy towards increased domestic demand (particularly consumption) continues, and the recent extension of monetary flexibility measures could help in this respect. However, more reforms are required to improve the adjustment of the weight of consumption to international parameters. Other advanced economies with a current account surplus should also implement reforms in order to expand internal demand, particularly in the service sector. In addition, the U.S. and other countries with significant external financing requirements should move from a consumption-based model to one that is based on investment, in particular the tradable goods sectors. The recent financial crisis has shown the limits of foreign financing on growth. Thus, economies with elevated needs for this foreign financing are very vulnerable to the renewal of international financial tensions and the recent and sudden fluctuations in exchange rates could undermine world financial stability.

2. Limited impact of the financial crisis in Europe

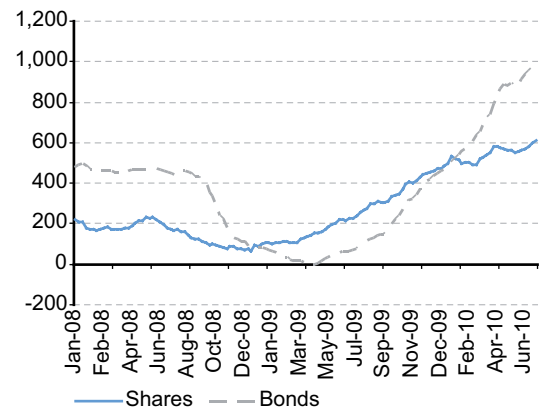
At a local level, the increased uncertainty associated with financial solvency problems in Europe during the second quarter had limited impacts. On the financial side, risk indicators (EMBI+ and CDS) recorded substantially lower increases than those observed after the bankruptcy of Lehman Brothers, while the currency of Peru (PEN) remained relatively steady, in a context in which the appetite of foreign investors for domestic financial assets did not decline. Also, since mid-June, the PEN has resumed its tendency to appreciate with greater intensity due to an increase in capital inflows and a restructuring of the portfolio of institutional investors who are choosing to increase their positions in local currency.

Chart 3
Peru: country risk increase according to various indicators (basis points)



Source: Bloomberg

Chart 4
Net purchases of funds investing in Peru (million USD)



Source: EPFR

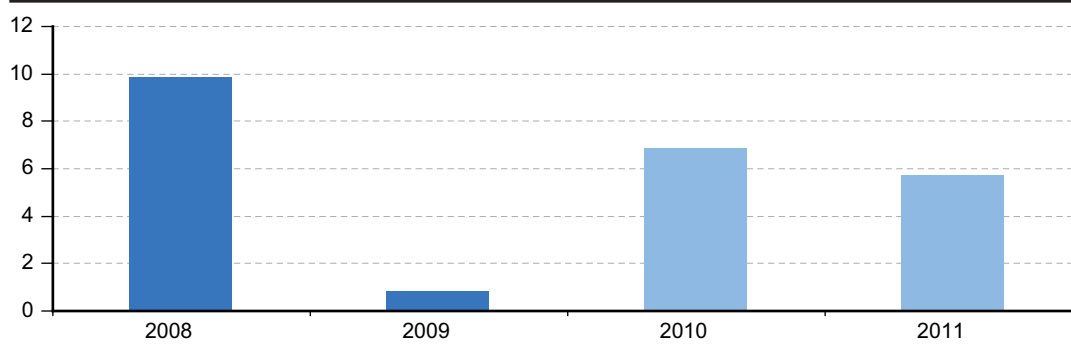
On the real side of the economy, significant impacts have not been observed. In fact, GDP growth has accelerated more than expected and we believe that in the second quarter (2Q10) it will have expanded by more than 9.0% year-on-year, over 6.1% considered in the previous forecast.

3. Growth forecast increases due to more dynamic private spending

In the second quarter, the evolution of activity has been underpinned by a strong recovery in private investment, which grew by around 20% (9% in the previous forecast) in an environment where business confidence are at maximum levels and the resumption of important projects that were paralyzed during the financial crisis. It is also expected that companies will have accumulated inventory during this period, as indicated by the readings from the last three months of the index of inventories released by the Central Bank and the dynamism of imports of intermediate goods. In this context of an improvement in the performance of private spending, we have increased our forecast for economic growth for 2010 from 5.7% to 6.8%.

For the medium term (2011-2012), the outlook for the Peruvian economy looks favorable, with growth rates of around 6.0%, slightly higher than the previous and potential forecast, which is supported by: (i) strong growth in private consumption due to a permanent increase in disposable household income and greater job creation, (ii) the development of investment projects in mining, oil, energy, telecommunications and transport infrastructure, so that total investment (public and private) will be around 26% of GDP in 2012, and (iii) an improvement in the forecast in terms of trade due to better demand prospects for base metals for the following years.

Chart 5

GDP: 2008/11 (% change year-on-year)

Source: BCR and BBVA Research Perú

In the external side, a moderate current account deficit of around 1.5% of GDP is expected for the 2011-2012 period, which will be financed by long-term foreign capital, especially FDI. In particular, it is expected that exports will register a significant increase in 2012 due to the start of mining project operations, which will substantially raise the production capacity of copper and iron.

Table 1

New investment projects in copper that will begin operating in 2012

Project	Investment (million USD)	Potential output growth in copper (annual, in thousands of MT)
Toromocho	2,200	275
Antapaccay	1,500	150
Río Blanco	1,440	190
Tía María	950	120
Total	6,090	735

Memo: Copper production in 2009 (thousands of MT)

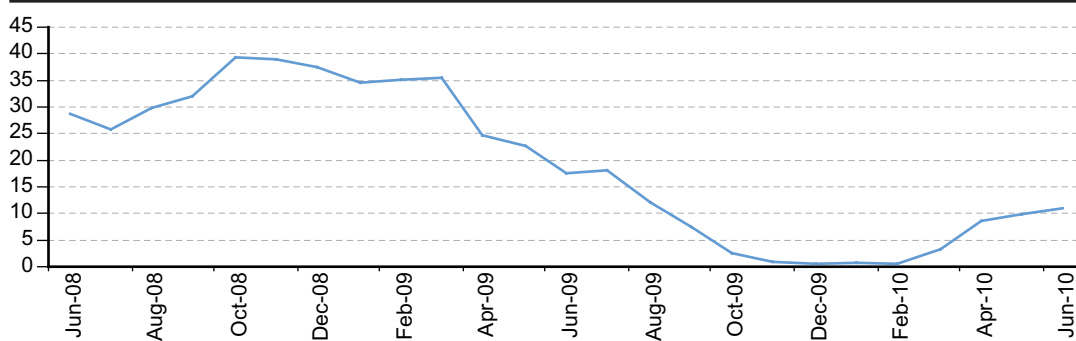
Source: MINEM. Prepared by: BBVA Research Perú

For the public sector accounts, we expect a gradual improvement in the medium term due to the recovery of tax revenues and the end of fiscal stimulus, which will be reflected in reducing fiscal deficit to less than 1.0% of GDP and a declining trend of the ratio of public debt to GDP, which we expect to decrease from 26.6% in 2009 to 20.4% in 2012, favoring possible improvements in Peru's credit rating. In this regard, it is worth mentioning the recent improvement in the outlook of Peruvian public debt (from stable to positive) made by Fitch Ratings.

4. Credit is steadily recovering

Total credit provided to the private sector by banks has shown a relatively positive performance in the last two years, despite a volatile external environment in this period. Even though they slowed down significantly in 2009, they did not contract and they have recorded a growing trend since early this year that we expect will continue in the second half. On the one hand, the strong cyclical recovery in activity and interest rates that still remain at attractive levels will continue to support the demand for credit, while on the supply side, banks will have high levels of liquidity enabling them to meet the increased requirements. Thus, we forecast that growth in credit to the private sector will increase from 0.6% year-on-year at the end of 2009 to around 16% at the end of 2010. By segments, we expect mortgage loans to record the strongest growth supported by rising employment levels and family incomes. Also we expect that loans to firms will be benefited from the recovery in private investment. It is worth adding that, given the strong pace of growth in GDP, it is expected that pro-cyclical provisions will be reactivated next August.

Chart 6

Bank loans to the private sector (% year-on-year change)

Source: SBS and Asbanc

Regarding to the delinquency rate, it is worth pointing out that during the slowdown experienced by the Peruvian economy associated with the international financial crisis, the deterioration of the quality of the bank's portfolio was limited. Thus, the delinquency rate never exceeded 1.8% (in September 2008, shortly before the bankruptcy of Lehman Brothers, delinquency rate was 1.2%), and we forecast that it will be between 1.5% and 1.6% at the end of 2010.

A steady growth around 6.0% for the next two years will encourage an expansion in employment and, therefore, a reduction in informality. In this context, we expect credit to grow at an average annual rate of 13%, so that financial intermediation (credit as a percentage of GDP) will be above 31% of GDP in 2012 (27.5% in 2009).

5. BCR in the short term: withdrawal of monetary stimulus in view of appreciation of the PEN

The strength of the cyclical recovery has advanced the convergence of output to its potential level in the medium term; therefore, the authorities have started to remove economic incentives. On the fiscal side, in May the Government announced measures to slow public spending up to an amount equivalent to 0.7% of GDP, with which we forecast that the fiscal deficit will close around 1.6% of GDP in 2010, below the 2.0% limit set by the Law of Fiscal Responsibility and Transparency for this year. Nevertheless, both consumption and public investment continue to show high growth rates, so a more pronounced adjustment is expected to be seen in the second half of the year.

On the monetary side, since May the central bank (BCR) has consecutively raised the benchmark interest rate by 25 basis points each time, which currently stands at 2.0%. It should be noted that the monetary policy position is still far from neutral. Given our inflation expectations to twelve months (2.6%), the benchmark rate in real terms (adjusted for inflation) is still negative and our estimation of the neutral rate lies between 5.5% and 6.0% (nominal). In this regard, to ensure that output growth converges to a sustainable level in the medium term (without inflationary pressures or significant deterioration of foreign accounts), we believe the central bank will keep raising the benchmark interest rate until it reaches around 3.25% at the end of this year and to a level close to the neutral level in late 2011.

It is noteworthy that the inflow of short-term capital has increased in recent weeks, attracted by expectations of more pronounced upward adjustments in the Central Bank policy rate and a prospective improvement in the credit rating of Peruvian public debt. Thus, non-resident investors have been purchasing bonds from the Peruvian Government and Central Reserve Bank of Peru Deposit Certificates (CDBCRP), instruments used as vehicles to position themselves in assets in local currency. Additionally, they are taking short positions in USD in the forward exchange market. As a result, upward pressure on the PEN (greater appreciation) has been accentuated.

In this context, the BCR is facing a dilemma between the required monetary tightening and a quick appreciation that it considers to be due to speculative factors and not the fundamentals of the exchange rate. Thus, it has been taking a series of measures, some in coordination with the regulator, to modulate capital inflows and mitigate short-term movements in the price of the PEN (see Table). In particular, it has raised the reserve requirements twice so far this year and we do not rule out further increases arising during the second half year. Also, the central bank has resumed the purchasing of

foreign currency (a daily record high was recorded on the 14th when it acquired 494 million USD), which we expect to continue for the remainder of the year. Thus, the accumulation of international reserves during 2010 will amount to around USD 6,000 million.

Table 2

Main measures to moderate appreciation of the PEN

Measure	Level on December 2009	Actual level
Reserve requirements		
Legal minimum (both currencies)	6%	8%
Marginal in foreign currency	30%	45%
Marginal in local currency	0%	12%
Marginal short-term foreign credits (less than two years)	0%	50%
Tax on capital gains arising from exchange rate (transactions within sixty days)	0%	30%
Commission for sale of BCR securities by non-residents	0,01%	4%
Operational limit of pension fund investments abroad	22%	28%
Purchases of foreign currency in the BCR foreign exchange market¹	USD 1,256 millions	USD 4,553 millions

1: Until 19 July

Source: BCRP, SBP and Congress of the Republic

BCR exchange interventions are being sterilized through the sale of CDBCRP and mainly with public sector deposits. The latter facilitates monetary management and reveals the importance that the BCR and the Ministry of Economy and Finance (MEF) maintain an adequate level of coordination in policies to moderate the expansion of output. Additionally, we believe the Central Bank has sufficient space to meet the costs of sterilization operations as it has capital of almost 1% of GDP.

It should be noted that in addition to the widening of interest rates, several factors lead us to expect that the PEN will show a tendency to appreciate in the next two years: (i) relative improvement in the fiscal position (reduction in public debt ratio), (ii) inflows of long-term capital that will adequately finance the moderate current account deficit, and (iii) a productivity differential in favor of the Peruvian economy.

6. Balanced risks

We identify two factors that could alter our growth forecast:

- a. Strong growth in domestic demand and overheating (upward bias). GDP growth has accelerated (in seasonally-adjusted terms, it was 14% qoq annualized in the second quarter) and it is predicted that if this trend continues the output gap will soon be positive. The strong dynamism of activity has been driven by private spending, mainly investment in an environment of high business optimism and inventory replenishment. Furthermore, public spending continues to provide important support to output and raise questions about whether it can be slowed down more gradually during the rest of the year. In fact, General Government spending (government consumption over gross capital formation) grew by over 25% in the second quarter, a greater dynamism than that consistent with the forecasts that the government has provided for this year.

Additionally, in an environment of positive expectations about the evolution of the Peruvian economy for the following years, one cannot rule out a long-term capital inflow significantly higher than expected, which would further accelerate GDP growth. Furthermore, if the capital inflow is massive and mainly directed to the non-tradable sector of the economy, this could lead to asset price bubbles.

The combined impact of these internal and external factors would cause: (i) rapid expansion of credit and liquidity, (ii) a sharp appreciation of the PEN, (iii) a consumption boom led by the two factors mentioned above, (iv) overheating of the economy that would be reflected in inflationary pressures, (v) reduced external competitiveness in the short term and (vi) a current account deterioration and increased foreign debt.

In this case, the central bank would have to accelerate the upward trend in the benchmark rate and complement this process with quantitative monetary measures (raising reserve requirements) to discourage the inflow of short-term capital.

- b. Increased global risk aversion (downward bias) In a scenario in which financial stress arising from fiscal problems in the developed economies is spreading and has a more noticeable impact on major economic areas of the world we expect: (i) a rise in spreads, (ii) reduced growth in global activity and thus external demand, (iii) a more pronounced downward correction in the prices of base metals due to the liquidation of speculative positions and lower global demand would place them at structurally lower levels (that may negatively impact on the large-scale mining investment, which has positive spillovers onto the economy, so that medium-term growth would be slower), and (iv) a slowdown in investment due to a lower inflow of long-term capital and a fall in business optimism.

In the short term, it is expected that fiscal policy is adaptable, although its space would be somewhat more limited with regard to the response implemented during the recent worsening of the international financial crisis. In relation to Central Bank, we expect a pause in the monetary tightening cycle, reduced reserve requirements and selling dollars in foreign exchange (loss of reserves) to mitigate the depreciation pressure on local currency (a particularly sensitive issue in an economy with even higher levels of financial dollarization and currency mismatches in the private sector). The high level of the central bank's international reserves would grant a relatively comfortable space to meet this contingency.

To estimate the strength of the Peruvian economy against an unfavorable foreign environment, a stress exercise has been carried out for 2011 that assumes the following for the base scenario: (i) slower global growth (U.S., Eurozone and China reduce their growth between 1 and 3 percentage points in 2011), (ii) a steeper decline in exchange terms (an additional 4-percentage point drop, bringing the decline in terms of trade to -10%) (iii) an increase of 200 basis points (bps) in the income limit for the global sovereign bonds compared to the assumptions in the baseline scenario, (iv) lower capital inflows, and (v) a fiscal policy response is implemented equivalent to 3pp of GDP (similar to 2009). Under this stress scenario, we find that 2011 growth would be 2.5% (lower by around 4pp compared to the base) mainly due to a severe contraction in private investment. Furthermore, we find that fiscal deficit would rise to up to 4% of GDP (0.7% in the baseline scenario) and public debt 26.6% of GDP (23.0% in the baseline scenario). Although the effects of this scenario are noticeable, our estimates suggest that the fiscal policy could still mitigate the impacts of a negative situation abroad, without causing a significant deterioration in public finances.

7 .Tables

Table 3

Peru: quarterly macroeconomic forecasts

	1Q 09	2Q 09	3Q 09	4Q 09	1Q 10	2Q 10	3Q 10	4Q 10	1Q 11	2Q 11	3Q 11	4Q 11
GDP (y/y % change)	1.9	-1.2	-0.6	3.4	6.0	9.0	7.6	4.7	5.7	3.8	5.7	7.7
Inflation (% y/y, average)	4.8	3.1	1.2	0.2	0.7	1.1	2.0	2.5	2.4	2.6	2.5	2.4
Exchange Rate (vs. USD, average)	3.18	2.99	2.92	2.88	2.85	2.84	2.83	2.85	2.85	2.86	2.85	2.80
Interest Rate (% , average)	6.00	3.00	1.25	1.25	1.25	1.50	2.25	3.00	3.42	3.92	4.42	4.75

Source: BCRP and BBVA Research Peru

Table 4

Peru: annual macroeconomic forecasts

	2009	2010	2011
GDP (y/y % change)	0.9	6.8	5.7
Inflation (% y/y, average)	2.9	1.6	2.5
Exchange Rate (vs. USD, average)	3.01	2.84	2.84
Interest Rate (% , average)	3.25	2.00	4.13
Private Consumption (y/y % change)	2.4	4.1	4.6
Government Consumption (y/y % change)	16.5	8.0	3.9
Investment (y/y % change)	-8.6	15.2	10.1
Fiscal Balance (% GDP)	-2.1	-1.6	-0.7
Current Account (% GDP)	0.2	-0.7	-1.4

Source: BCRP and BBVA Research Peru

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