Peru Economic Outlook

Second Quarter 2014
Economic Analysis

- **The global recovery will continue although with less growth in China,** which will have limited and diverse impacts around the world.
- **Peru will grow by 5.2% and 5.6% in 2014 and 2015.** This forecast assumes a less favourable external environment and a lower support from mining.
- **The external deficit will stand at around 5% of GDP both this year and next.** A sustainable level of this gap will require a more depreciated currency and higher private savings.
- **The central bank will keep the policy rate unchanged for the rest of the year.** In 2015, we expect a pre-emptive adjustment to monetary policy, in a context in which the Fed will begin rising the Federal Funds Rate and to keep inflation within the target range.
- **The main risk factor is a stronger slowdown in China**. A shock from this economy could shave up to one point off Peru's growth.

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1. Summary

Global economic growth will accelerate over the coming two years, but somewhat less than we expected three months ago. Global activity continued to recover at the beginning of the year, in an environment of cyclical improvement in the developed economies. The United States, for example, has overcome the impact of an unusually cold winter, and the second quarter began somewhat more robustly than the first, which leads us to stand by our US growth forecast of 2.5% for both 2014 and 2015. The scenario in the emerging economies is different. Some of them are slowing down. In particular, growth in China moderated at the beginning of the year, and the indicators suggest a loss of cyclical momentum, especially on the side of investment expenditure. Considering the latter, together with the tightening of regulations on the non-banking financial sector, shadow banking and environmental protection, we expect China's growth to be closer to 7.2% in 2014 and 7.0% in 2015, somewhat lower than we anticipated three months ago, which will have a negative impact on international commodity prices. In summary, we continue to expect global economic growth to speed up over the coming two years, but at a slower pace than we expected last January, reaching levels of 3.4% in 2014 and 3.8% in 2015.

Within this context, we have revised our growth forecasts for the Peruvian economy to the downside, to 5.2% for 2014 and 5.6% for 2015, 0.3pp – 0.4pp less than we expected in January. Three factors explain this adjustment. The first is that output seems to have grown at a slower-than-expected pace in the first quarter, which we associate with weakness in exports and private spending. Second, we have cut our estimate for metal ore production, especially copper, given that the impact of the lower grades of some deposits will be more pronounced and, in the meantime, the Toromocho copper megaproject will take somewhat longer than expected to reach the fully productive operational phase. Lastly, the steeper slowdown in China, will have a negative impact on the terms of trade of Peru.

These growth rates are lower than the average pace of expansion recorded by the Peruvian economy over the past 10 years, and are a sign of a more structural dimension to the loss of dynamism in the progress of productivity and competitiveness. Regaining growth similar to that of recent years requires a more zealous stimulus of supply side measures. First of all, there is an urgent need to improve the business environment even further, avoiding the duplication of and reducing delays and costs in paperwork. Subsequently, work on infrastructure, human capital and product and process innovation must be sped up. Within the Pacific Alliance, Peru lags behind in the first of these areas, which raises business costs. The second area is a longer task but must start now, together with workforce training oriented toward meeting market needs. On the side of product and process innovation, there is still plenty of scope for support, for example, by co-financing with contestable public funding, which will boost new ventures. Lastly, there must be incentives to join the formal economy, because otherwise companies cannot reach their maximum potential and the tax burden falls on only a few, which hurts their competitiveness.

The downward revision to Chinese growth is consequently accompanied by a negative adjustment to export prices and, in turn, to the terms of trade, which will impact the external and fiscal accounts over the coming years. While the result we expect in 2014 for the current account of the balance of payments has not materially changed from our January 2014 estimate (due to extraordinary transfers), from 2015 forward we do expect deterioration by an average of 0.3pp of GDP. The external deficit will thus come in at around 5% of GDP over the next two years, a level not seen since 1998. It is therefore a factor of vulnerability for the Peruvian economy, although mitigated when bearing in mind that its financing will be mainly long-term. From 2016 onwards, as the large mining projects currently under construction enter into their operational phase, the external deficit will gradually shrink. On the public accounts side, the impact of lower commodity prices on fiscal revenues will be limited, because the latter's reliance on the income generated by the mining sector has lessened. Within this context, we continue to expect that the fiscal deficit will not exceed 0.5% of GDP over the coming years, and that gross public debt will continue to drop, reaching a level of around 17% of GDP in 2018.

With respect to the financial markets, they have tended to normalise after the turbulence earlier this year. The general appetite for emerging economy assets, among which Peru stands out due to its high growth, good macro fundamentals and an attractive carry trade, has been whetted over the last two months. Peruvian currency has benefited from this. However, **the exchange rate outlook has experienced certain deterioration with a view to the future.** The downward trajectory of the copper price, which has steepened at the time of this revision due to lower Chinese growth, has caused the following changes within the forecasting horizon: (i) an increase in the current account deficit, and (ii) a reduction in the appeal of mining investment, which will moderate capital inflows. The exchange rate will consequently see somewhat more upside pressure (the local currency will weaken), which leads us to expect that it will close the year at USDPEN 2.85 and trend toward the USDPEN 2.90 level in the medium term.

In the matter of prices, we continue to expect inflation to drop over the coming months, although less sharply due to the momentum it will receive from certain supply factors. The activity growth we expect for 2014 is below its potential pace, which means that the positive output gap will continue to close. Inflation will thus tend to drop over the coming months. However, we expect its downward trajectory to be less intense than we anticipated in January. On the external side, we have made an upward revision to imported food prices, to thus account for the impact of weather anomalies in Brazil. Locally, the absence of rainfall over the northern coast early this year will lead to an impaired planting of water-intensive crops such as sugar and rice, which will put pressure on their prices to the upside. Within this context, inflation will close the year closer to the target range ceiling, at around 2.7%.

Monetary policy thus faces a dilemma which restricts its actions in the short term, with inflation that is still high and a current account deficit of 5% of GDP on the one hand, and a below-potential pace of output growth on the other. **Within this environment, we do not expect the policy interest rate to change over the rest of the year.** With respect to reserves, we see little leeway for further cuts, given that the central bank's exchange rate interventions are no longer affecting liquidity in the currency market (soles), and that the growth pace of credit has risen substantially over recent months, a context in which delinquency has increased, which will probably lead banks to be more cautious, thus limiting the impact of a potential further cut in reserves on credit.

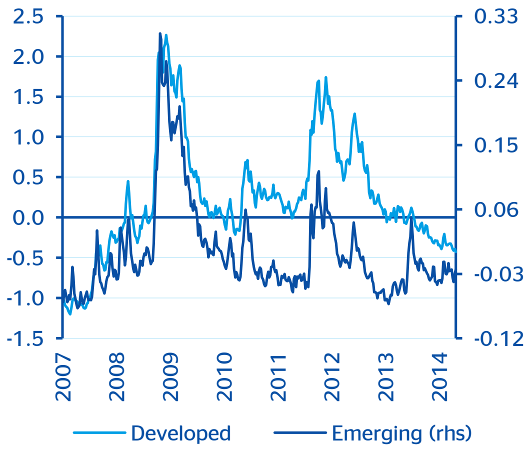
Lastly, the main external risk is an abrupt slowdown of the Chinese economy. The financial frailties that have surfaced in China will hinder the implementation of countercyclical policies in that country. The impact on the Peruvian economy will be more structural, with a more prolonged effect on the export and international prices of metals, which would mean less growth and an even further depreciation of the local currency. However, it is important to mention that, on the fiscal and monetary side, Peru continues to display strengths that would enable it to implement economic policy responses to accommodate these impacts.

2. Deceleration in China and Fed's tighter monetary policy mark the global scenario

The global recovery continues, but the improvement is being hampered by the deceleration in the EMs

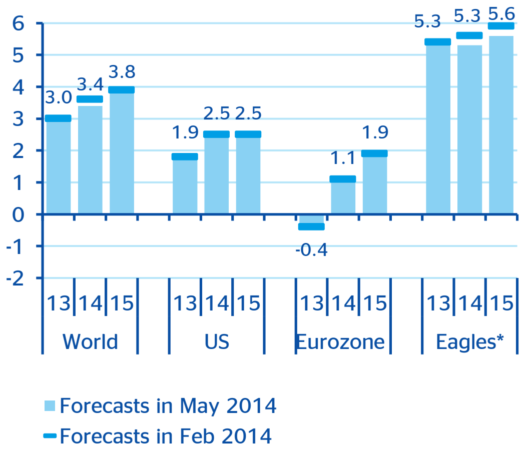
The global economic cycle remains robust at the start of 2014. According to our estimates, in the first quarter of 2014 global GDP has accelerated very slightly to around 0.8% QoQ. We expect this pace to be maintained for the first part of the year. In the wake of this sustained global recovery is the cyclical improvement in the DMs, which has offset the deceleration in some EMs in Asia and Latin America. Meanwhile, in the last few months the financial markets have performed very differently in the two regions, and with more differentiation between the EMs. Capital flows, asset prices, interest rates and financial tension indicators have fundamentally performed in line with the outlook for rate hikes in the US, and, in the case of EMs, depending on the outlook for deceleration in China and idiosyncratic factors. Asset prices in EMs have recovered in the last few months, particularly in March and April, while financial tensions have waned after the spike at the beginning of the year (Figure 2.2).

Figure 2.1
BBVA Research financial tensions index in DMs and Ems



Source: BBVA Research

Figure 2.2
GDP growth forecasts (%)



* EAGLEs is the group of emerging economies which will contribute most to world GDP in the next 10 years. The group contains China, India, Indonesia, Brazil, Russia, Turkey and Mexico.
Source: IMF and BBVA Research

Our assessment of the global scenario has a downward bias compared with our valuation three months ago, which is reflected in the adjustments to our forecasts (Figure 2.2). After growing at 3.0% in 2013, global GDP will start to accelerate again in 2014 and 2015 at around 3.4% and 3.8% respectively. By areas, we have not made significant changes to our forecast for expansion in US activity and the eurozone. The downward pressures in our forecasts are the result, therefore, of what we believe will happen in the EMs, in 2014 and 2015, in both Asia and Latin America, as a result of concerns over economic slowdown in China.

Finally, the main risks continue to be to the downside in the short- and medium-term. Some factors with a global impact could make themselves felt more intensely than expected in the base scenario on a short-term time horizon, such as a tighter monetary policy on the part of the Fed, reduced growth of the global demand stemming from economic slowdown in China or on an (even lower) scale of macro-economic repercussion, the geopolitical risks derived from Eastern Europe.

In the developed economies, the US overcomes the impact of an unusually cold winter and the perspectives for an improvement in the eurozone have increased

US GDP has maintained steady growth at the beginning of 2014 in spite of the impact of unusually adverse weather conditions. In the labour market, employment has increased by an average of 178,000 jobs in 1Q14, in line with the print in 4Q13, and the unemployment rate has fallen to 6.7% of the labour force, a smaller than expected fall because the increase of the population available to work. As a result, the Fed has pressed ahead with the announced moderation in its balance-sheet expansion. In this context, we are expecting the Fed to complete its exit from the asset-purchase programme towards the end of the year, and the market to focus on a possible change in inflation trends as it anticipates the start of interest-rate hikes in a scenario of a gradual acceleration in GDP growth. Growth in 1Q14 reached 0.1% annualised. The leading indicators point to a more robust start to the second quarter than to the first. Altogether, we are maintaining our forecast for US growth at 2.5% in 2014, and the same in 2015 (Figure 2.2). The forecast has upside risks if the improvement in confidence provides additional incentives to corporate investment and job-creation.

For Europe, our short-term models point to an acceleration of around 0.5% QoQ, although the boost from the external sector could moderate in the coming months due to: i) euro appreciation, with a slight impact on growth but clearly differentiated by country; ii) the reduced demand from China, also with diverging direct effects; and iii) geopolitical risks in the East if the crisis in Ukraine continues. Altogether, we maintain our forecasts for the eurozone in 2014 at 1.1%, and 1.9% in 2015 (Figure 2.2), in a scenario of contained financial tensions and fiscal and monetary policies that do not put a brake on growth.

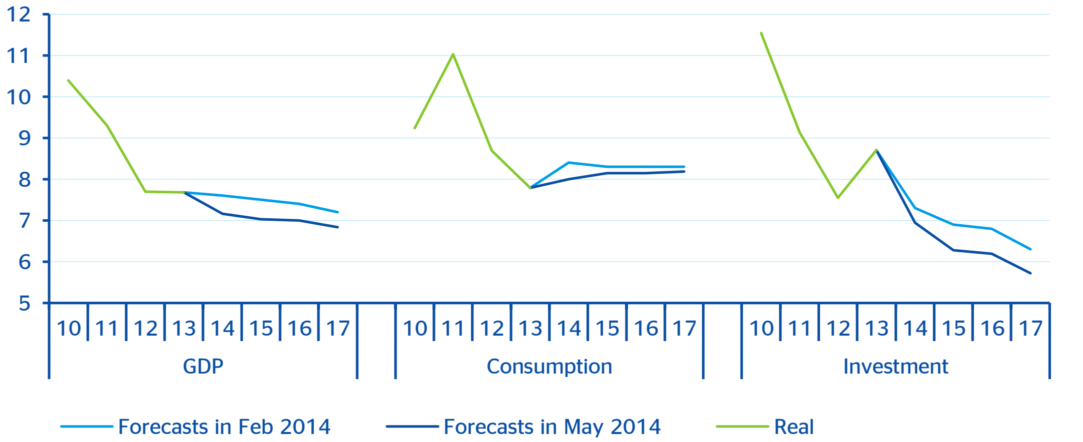
Finally, among developed economies, there is slightly more uncertainty about the growth outlook for Japan, which has had a QE programme underway since January 2013, together with fiscal stimuli to return to having inflation and favouring consumption and investment. We have revised downwards our outlook for growth in 2014 for Japan by four basis points to 1.1%, and we are maintaining our estimate for 2015 at 1.3%.

In China, the deceleration that began at the Chinese New Year is here to stay, in an environment of lower-than-expected inflation

In line with our forecasts in our last quarterly report, uncertainties about the cyclical strength of the Chinese economy have materialised, with a deceleration in activity during the first quarter of 2014. The latest data from indicators on both domestic and foreign demand show the loss of momentum in the cycle, more so in investment than in consumption, in an environment of lower-than-expected inflation. At the same time, the authorities are starting to introduce measures to deal with the weaknesses arising from economic policy decisions taken in the last few years to support growth in the short term. This has involved postponing the deleveraging of local governments and companies, and continuing to approve infrastructure projects and excess installed capacity which are unlikely to be profitable while families, who are financing the process, are receiving negative real interest rates on their savings. This is an inefficient allocation of resources, which also encourages the development of financial systems in parallel with the more regulated one and which may be a source of problems in the future. To this end, regulations on the non-banking financial sector, shadow banking and environmental protection are all being toughened.

In view of this, we have revised Chinese growth downwards to 7.2% and 7.0%, in 2014 and 2015 respectively, around half a point less than we forecast three months ago (Figure 2.3). The increasing importance of China as a source of world demand in the last few years is undeniable. But the differentiation between areas is unchanged, with higher exposures in Southeast Asia, some South American and African countries and, among developed economies, Germany. According to our estimates, the impact on world growth of each point of Chinese growth lost is around 4pp, principally as a result of lower demand from China itself. Note also that the expected adjustment in the local scenario is limited, and clearly not enough to unleash episodes of global financial uncertainty.

Figure 2.3
China: Growth forecasts (%)



Source: BBVA Research

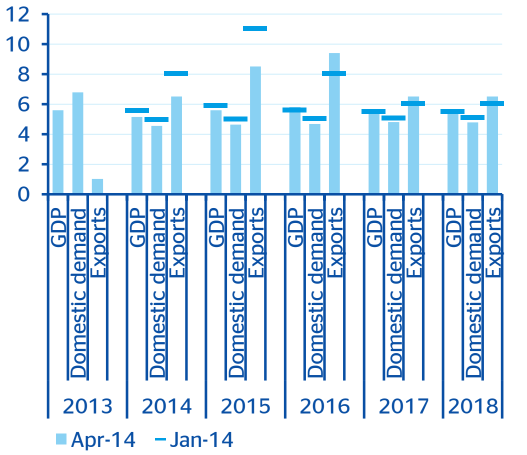
In summary, there are two factors with a global impact on the forecast horizon: the tightening of the Fed's monetary policy, and lower growth of Chinese demand, with macro-economic repercussions that are clearly differentiated between economies. As outlined above, the sudden perception by the market that the tightening by the Federal Reserve of the monetary cycle was imminent with the withdrawal of quantitative easing, raised financial volatility in emerging economies. There was a clear differentiation between different areas, however, with greater volatility in those exchange rates whose exposure to foreign funding is greater. On the other hand, also among emerging economies, it is the Asian economies which are most exposed to a reduction in Chinese demand, with the further addition to the list of a few raw materials exporters, such as Chile. All these factors can be shown in a map of vulnerabilities where differentiation is a vital factor.

3. Peru: a downward revision to our growth forecasts for 2014 and 2015

Our growth forecasts for 2014 and 2015 now come in at 5.2% (previous: 5.6%) and 5.6% (previous: 5.9%). On the expenditures side, we now anticipate a more moderate expansion of exports and domestic demand for 2014 and 2015, while on the sectorial side, the main downward adjustment is in mining, due to supply factors (see Figures 3.1 and 3.2). We project that GDP growth will peak in 2016, as the large mining projects currently underway enter into their operational phases, which will translate into a rally in exports.

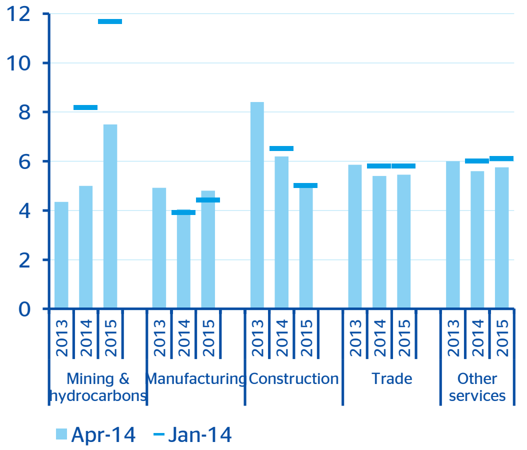
Three factors explain our downward revision to our forecasts for 2014-15. First, we foresee lower first quarter growth than that expected three months ago, due to the somewhat weaker behaviour of exports and private expenditure. A second factor is the cut in our forecast for metal mining production, of copper in particular, in line with the lower grades that are now expected from certain copper mining deposits, and with a lengthier timeframe for Toromocho to begin its full production operational phase. Lastly, we expect the slowdown in China to be somewhat more intense, and to have effects over the course of our forecasting horizon (2014-18), mainly due to its negative impacts on the terms of trade.

Figure 3.1
Peru: GDP growth 2013-18 (% var. YoY)



Source: BCRP and BBVA Research

Figure 3.2
Peru: sectorial growth (% var. YoY)



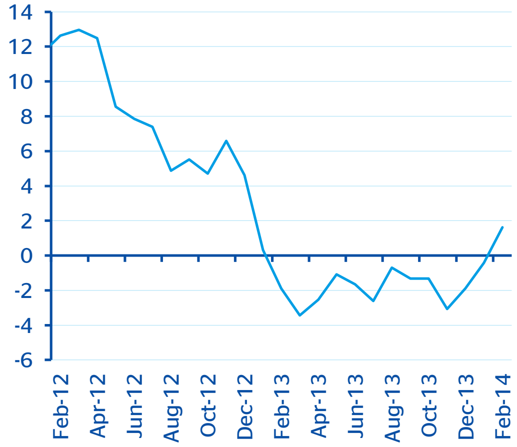
Source: BCRP and BBVA Research

China's lower pace of economic growth also places further pressure on Peru's current account, which we project will display deficits approaching 5.0% of GDP in 2014 and 2015. These deficit levels are relatively high (the highest since 1998), and will consequently stand as a vulnerability factor for the Peruvian economy, in a context where lower global liquidity will hinder its financing. However, worth noting is that the upturn in mining exports expected for 2015 will enable a gradual closure of the external gap over the coming years.

First quarter GDP seems to have maintained a good pace of growth, although lower than expected

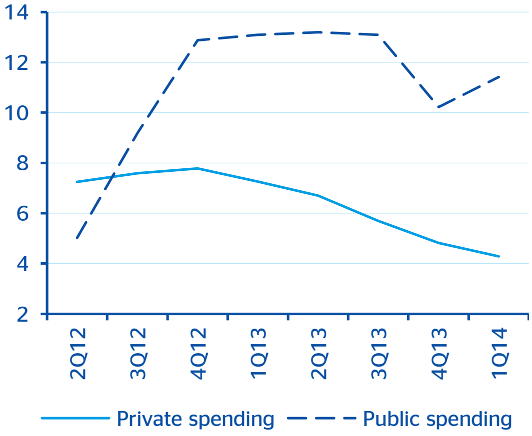
We expect first quarter growth to come in from 5.3% to 5.7%, below our January forecast (over 6.0%), due to the lower dynamism in exports and private expenditure (see Figures 3.3 and 3.4). As opposed to our expectations, exports appear to have recorded sluggish progress over the year's first quarter (volume rose 5.1% YoY over the first two months, but preliminary figures suggest a setback in March). This behaviour has reflected the lower foreign sales of gold (as a result of the eradication of informal mining operations), as well as lower shipments of certain manufactured products (textiles and iron and steel) to some of the region's economies.

Figure 3.3
Peru: export volume
(% var. YoY, 12-month moving average)



Source: BCRP and BBVA Research

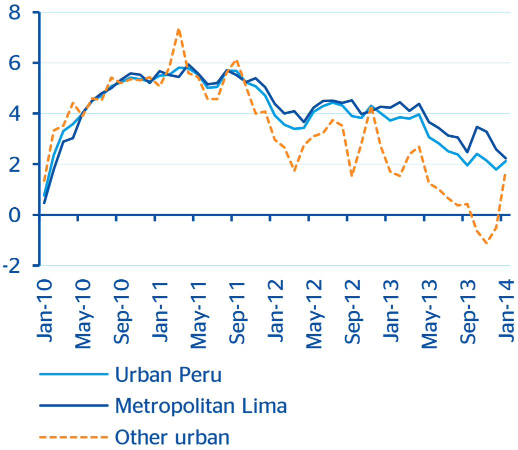
Figure 3.4
Peru: private and public expenditures
(% var. YoY, 12-month moving average)



Source: BCRP and BBVA Research

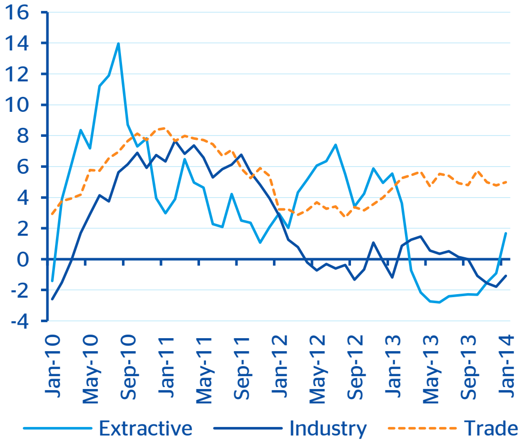
Regarding private expenditure, we anticipate that investment will have stagnated in the first quarter, in line with the decline recorded in capital goods and inputs and lower domestic sales of commercial and cargo vehicles over the first months of the year. Furthermore, private consumption appears to have recorded slower progress, due to the lower dynamism in the labour market that has been observed within the context of subdued private investment. Thus, urban job creation from private, formally-constituted companies with 10 or more workers slowed down over recent months, particularly in the extractive industries (which comprise agriculture, fishing and mining) and in the country's inland (see Figures 3.5 and 3.6).

Figure 3.5
Peru: urban employment (% Var.)



Source: Ministry of Labour

Figure 3.6
Peru: urban employment by economic activity
(% Var.)

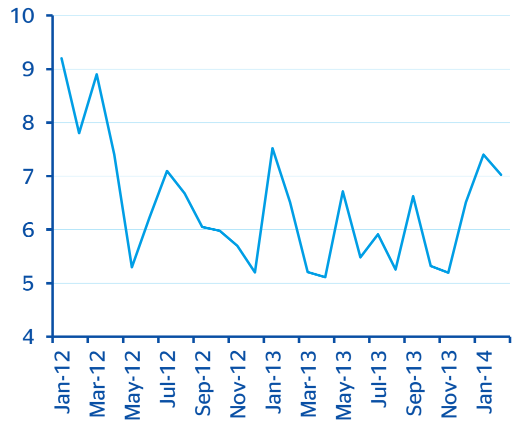


Source: Ministry of Labour

In the Lima Metropolitan Area (LMA), the unemployment rate has started to rise, after the lows reached in early 2013. According to INEI (National Institute of Statistics and Information Technology) data, LMA income recorded a year-over-year variation of 4.9% in the first quarter, lower than the 8.0% at the end of 2013. A March 2014 survey conducted by Apoyo Consultoría revealed a moderation in job growth and household income that led to an adjustment in household spending: 18% of households surveyed stated they had spent less on entertainment (cinema, parties, trips, outings, etc.) and on food away from home.

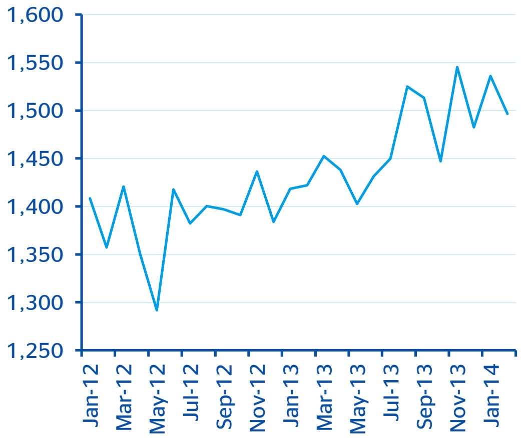
Furthermore, the medium- to high-income sectors stated that they had reduced their spending on household goods (furniture, domestic appliances, etc.).

Figure 3.7
Lima Metropolitan Area: unemployment rate (%)



Source: Ministry of Labour

Figure 3.8
Lima Metropolitan Area: monthly income (PEN)



Source: Ministry of Labour

Supply factors explain the cut to our forecast for mining production growth in 2014

On the one hand, according to central bank information, lower grades are currently expected from copper mining. The most recent central bank´s Inflation Report mentions that this effect alone would bring copper production down five percentage points below the projection of three months ago. On the other hand, while in our January projection we anticipated the rise in Chinalco's (owner of Toromocho) copper production to be gradual, we expected higher production levels in the second quarter. But anew data indicates this rise will be more gradual, which entails a delay that we have included in these new forecasts. Finally, the maintenance work at Antamina, the closure of some mines (Barrick's Pierina and Hochschild's Ares) and the depletion of reserves at others have had a greater-than-anticipated impact on the production of some ores. Within this context, we expect mining to grow around 5.0% this year, below our previous 8.0% estimate.

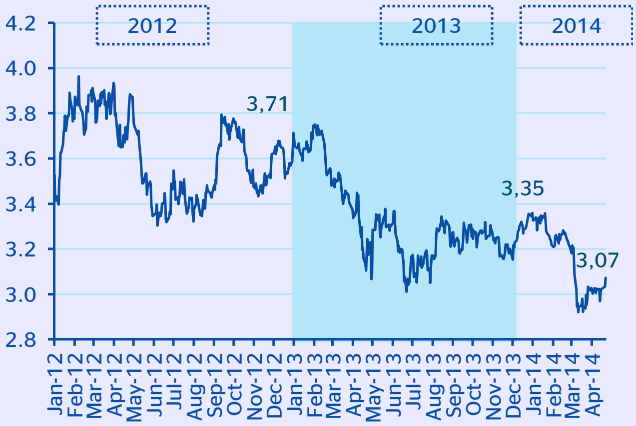
Lower growth in China affects the outlook for the Peruvian economy in the medium term

The cut to our growth forecasts for China is mainly associated with a swifter moderation in investment, which will slow down the expansion of its industry and, therefore, its demand for base metals. These dynamics will negatively affect commodity prices. In particular, we have applied a downward revision to our medium-term forecasts for the price of copper, Peru's main export product (see Box 1).

Box 1. What has happened to the price of copper and what do we expect for the future?

The international price of copper markedly retreated over the first months of the year. It currently trades around USD3.07/lb, that is, over 8% below the level of its 2013 close (Figure B.1.1). The decline was as low as 13% at some points over the year. What caused such a steep decline in the price?

Figure B.1.1
Copper price (USD per pound)



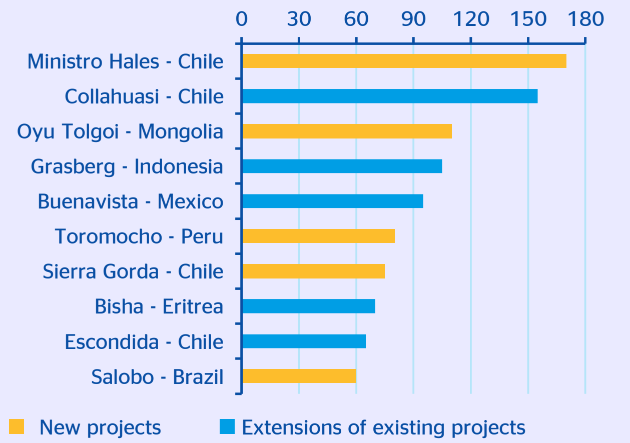
Source: Bloomberg

The main factors are associated with the Chinese economy, which accounts for the largest share of global copper demand (over 40% of the total worldwide). Early this year, concerns rose over a greater-than-expected slowdown in China's economic activity. The balance of the indicators, such as fixed asset investment, industrial production and exports, would so suggest.

A second factor that supported the downward correction to the copper price was the fear that the restrictions the Chinese government has been applying in its financial regulation (on non-banking and shadow banking) would lead to an unwinding of the operations that use copper as collateral within China's financial system. Chinese companies that have met with difficulties in accessing a conventional loan have been importing large amounts of copper to use it subsequently as collateral, and thus access soft-terms financing. This is the case, for example, of Shanghai Chaori Solar Energy. Over the first half of March, Chaori Solar was unable to meet the interest payment on its debt (bonds). The company's position was already weak, having posted losses over the last two years, which made its inability to service its debt foreseeable. However, local governments had previously supported companies in similar situations, either with bailout funds or by extending the payment periods. Not this time. Letting Chaori Solar default was perceived by the markets as a change in the government's attitude, a clear message that from now on selective defaults would be allowed, an action by which it probably sought to prevent insolvent companies from continuing to access credit in the financial system, consequently placing it at risk. In this context, operations that use copper as collateral become riskier and could unwind. The metal freed up would enter the market, increasing copper supply and placing a bearish bias on price. Pre-empting this possibility, and also motivated by the uncertainty over the amount of copper that might be freed up, the markets reacted and the price gave way.

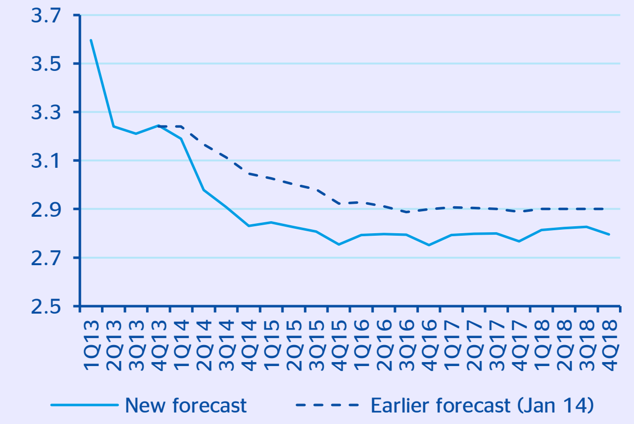
Our copper price forecast was already displaying a downward trend over the course of the year, with an average price of USD3.14/lb in 2014, and a medium-term (toward 2016) price of USD2.90/lb. On the demand side, this trend accounted for an economic expansion in China that will be more moderate going forward, and a shift in that country's growth model from one that was intensive in investment spending (consequently having a high demand for copper) and export-oriented, to a more balanced one with a relatively greater weight of support from consumption spending. On the supply side, it reflected the operations start-up of important copper projects and the expansion of others. In 2014, for example, operations will start at projects which, taken together, will increase global copper production by over 7% versus 2013, progress that is far superior to that of recent years. Lastly, the trend took into account the tapering of monetary stimulus in the United States.

Figure B.1.2
Copper: ten major projects that will start operating in 2014



Source: Macquarie Research

Figure B.1.3
Copper: price projection



Source: Bloomberg and BBVA Research

Figure B.1.4
Production cost of main copper mines and projects in Peru* (USD/lb)

		Production cost
Main copper mines	Toromocho	0.68
	Antapaccay	0.9
	Antamina	0.90 - 1.10
	Cerro Verde	0.93
	Toquepala & Cuajone	1.84
Coppper projects	Las Bambas	1
	Constancia	1.13

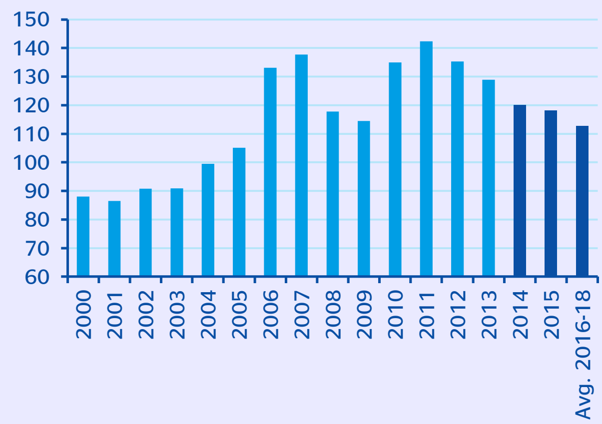
* Overall, these mines will produce close to 90% of Peru's copper in 2014
Source: Apoyo Consultoría

This revision to macro-economic forecasts includes an additional factor with an impact on the price of copper: the downside revision we are making to China's growth projection for the next two years, of around 0.5pp. The resulting lower demand for the metal, together with a lower-than-expected first quarter copper price (and its explicatory factors), lead us to expect an average price of around USD2.99/lb in 2014 and USD2.80/lb from that point forward. That is, we now anticipate that the downward trajectory will be steeper in the short term.

Our downward adjustment of close to 5% in 2014 and somewhat more than 3% in the medium term is relatively moderate, considering the new environment for the copper market and the behaviour of the price early this year. This is due to the fact that the price will find some support in the increasing costs of production (a lower price would lead to the closure of some copper projects, reducing the amount supplied on the market and thus containing downward pressures on the price of the metal), and in the restocking of inventories, which are currently at 15-month lows. In summary, there is limited risk of the copper price recording a sharper drop than that which we now expect.

It is also important to note that the lower copper prices we will see from now on do not jeopardise the production of Peruvian mines nor the copper projects currently under construction, because their production costs are among the world's lowest, ranging from USD0.70/lb to USD1.10/lb. Toquepala and Cuajone have higher production costs, at around USD1.80/lb, but still, we expect there to be a certain leeway with respect to prices, as the cost is 35% less than the medium-term level that the copper price will reach.

Figure B.1.5
Peru: terms of trade (index 1994 = 100)

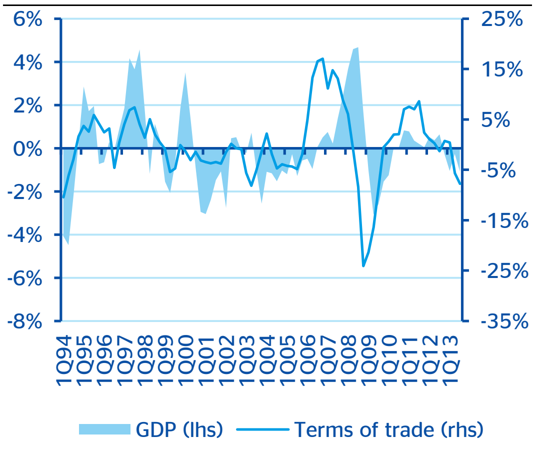


Source: BCRP and BBVA Research

With the new expected trend for the copper price, the terms of trade will recede within the forecast horizon (Figure B.1.5). In 2014, the level of the terms of trade will be close to 4% less than the 10-year average, and 10% less in the medium term. It is worth noting that this average includes the positive levels that metal prices reached in the first decade of the 2000s. The downward correction to the terms of trade will naturally be reflected in the expected trends for the current account of the balance of payments, fiscal result and exchange rate, as described in the rest of the Report.

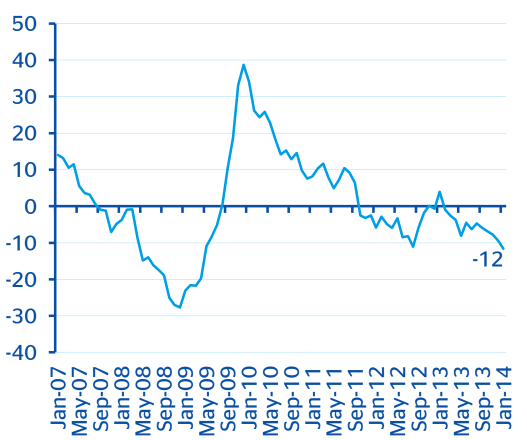
The evidence suggests that Peru's economic cycle is highly related to the behaviour of the terms of trade (see Figure 3.9)[1]. In this regard, it is interesting to note that the current GDP slowdown coincides with the fall in the terms of trade over the past three years, and that they are currently recording year-over-year contractions not seen since the global financial crisis (see Figure 3.10 and 3.11). Thus, given our outlooks for Peru's export prices, lower support on the side of the terms of trade is to be expected.

Figure 3.9
Cyclical GDP component and terms of trade (%of trend level)



Source: BCRP and BBVA Research

Figure 3.10
Terms of trade (% var. YoY)

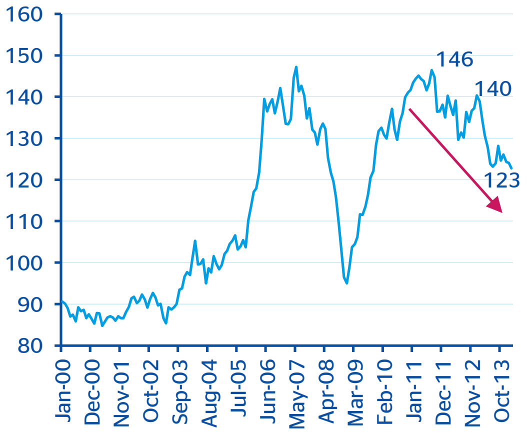


Source: BCRP and BBVA Research

It is worth noting that the lower terms of trade will also negatively affect domestic demand. Lower metal prices will thus reduce the appeal of mining investment, which is the country's most important sector (accounting for roughly a quarter of total investments). On a global level, greater caution in the investments of large mining corporations is already being detected, due to the lower expected prices, growing production costs and the tightening of financing terms. As a result, they are reducing their greenfield projects (new mines), which entail greater risk, and are opting to consolidate their capital outlays in brownfield projects (expansion). Slower investment growth will induce less dynamism in job creation and, therefore, in private consumption expenditure. An interesting association that has emerged in recent years is that of net capital inflows with domestic demand (see Figure 3.12). Therefore, given the perspectives of a slowdown in income on the side of the financial account of the balance of payments, we have moderated our domestic demand growth forecasts for the coming years.

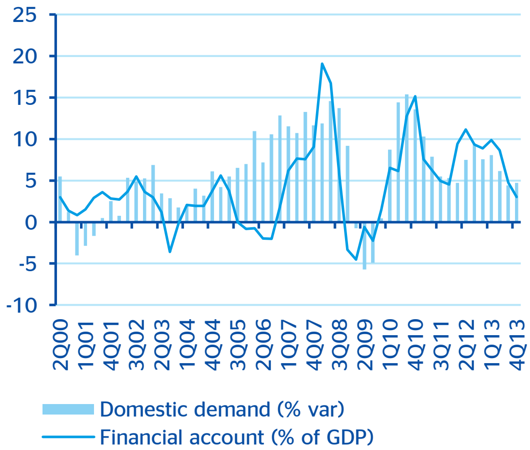
1: See Castillo, Paul; Carlos Montoro and Vicente Tuesta (2007): "Stylised Facts of the Peruvian Economy." Journal of Economic Studies No. 14. Central Reserve Bank of Peru.

Figure 3.11
Terms of trade (Index)



Source: BCRP and BBVA Research

Figure 3.12
Domestic demand and capital inflows (% var. YoY and % GDP)

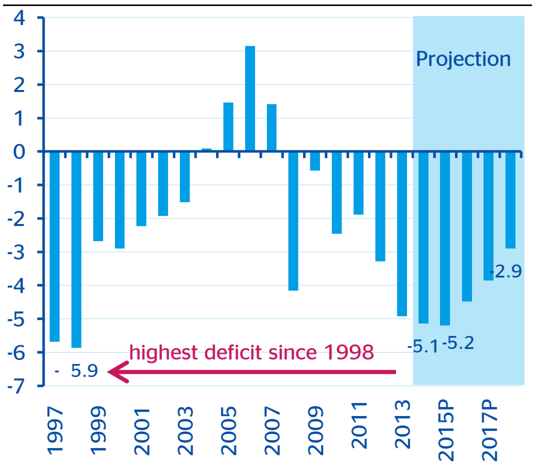


Source: BCRP and BBVA Research

The current account deficit remains as a factor of vulnerability

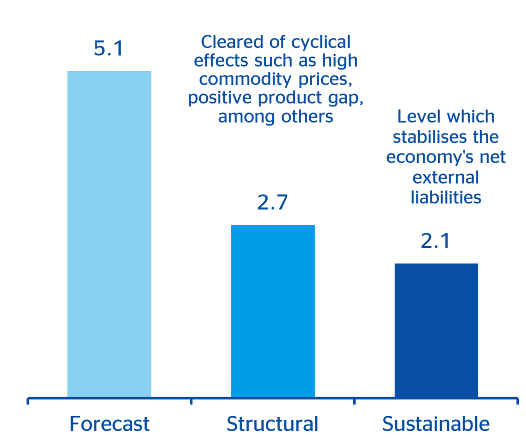
On the side of the external accounts, the lower terms of trade will exert greater pressure on the deficit of the current account of the balance of payments. Over this year, the latter will be mitigated by an extraordinary tax payment from the Petrobras and Las Bambas copper project asset sales. These operations are recognised as a positive transfer of non-resident resources, and will reduce the pressure on the external gap by roughly 0.3 pp. The balance of these factors leads us to stand by our current account deficit forecasts of around 5.0% of GDP for 2014 and 2015, the highest since 1998, with a subsequent gradual decline in 2016-18, due to the operational start-up of large mining projects currently underway (see Figure 3.13).

Figure 3.13
Current account of the balance of payments (% of GDP)



Source: BCRP and BBVA Research

Figure 3.14
Diverse definitions of current account (% of GDP, average 2014-15)



Source: BCRP and BBVA Research

The deficits projected for this year and the next are relatively high, which may affect the perception of the country's external vulnerability, within a context of less funding supply for the emerging markets. It should be noted that for the country to maintain its current level of external liabilities (roughly 30% of GDP)[2], the current account deficit should be cut to levels

2: Only considers short- and long-term public and private external debt. Excludes foreign direct investment liabilities and non-resident equity interests. It is worth noting that the level of external liabilities of 30% of GDP could be a demanding benchmark, when considering that countries with a similar credit rating to Peru (BBB+) have a ratio of 59% (excluding Ireland, whose ratio is much higher).

near 2% of GDP. A similar conclusion is reached when considering the structural current account deficit (which excludes short-term cyclical factors from the deficit calculation), which we estimate at 2.7% of GDP (see Figure 3.14).

According to our estimates, the deficit adjustment will require a more depreciated currency in the medium term (a higher exchange rate), which will favour the allocation of resources toward the economy's tradable sector. It is important to note that the central bank's high availability of international reserves will assuage the transition toward a higher exchange rate, which will provide the private sector with leeway to adjust to this new environment (see next section on financial markets and the exchange rate).

Lastly, we reiterate what we mentioned in our previous report: the adjustment of the external gap toward levels of around 2% of GDP (a level that ensures "sustainability" in the sense that external liabilities are kept at their current level as a percentage of GDP) over the next years will require a domestic savings increase of approximately 3pp, if the goal is to maintain an investment ratio close to 28% of GDP. Assuming that public savings remain relatively stable (a conservative assumption when considering the government wage increases), the effort on the domestic savings side will have to fall on the private sector. This analysis reveals the limitations that exist to accelerate growth over the next years. The conclusion is that it will be difficult to grow by more than 5.5% if the intention is to reduce the current account deficit and the reliance on external financing. Within this context, we see low probability of recording double-digit investment growth rates on a sustainable basis, as in past years, or of a pickup in private consumption.

Public sector: the public debt will continue to display a decreasing trend

In our base scenario, fiscal policy will display some deterioration going forward. On the side of revenues, the lower prices of metals will affect tax receipts from mining corporations. Nevertheless, the importance of fiscal revenues from mining and fossil fuels has been on the decline, and currently represents 15% of total revenues collected (24% in 2011). Notwithstanding, overall tax pressure has remained relatively stable; as long as other revenue sources have substituted those from mining and the public sector now displays less reliance on the latter. Thus, the impact of lower metal prices on the national treasury will be relatively limited.

Furthermore, this year's revenues will be favoured by the positive impact of tax payments associated with the Petrobras asset transfer, on the one hand, and the sale of Las Bambas, on the other. The impact of these transactions is expected to amount to roughly 0.3pp of GDP.

On the expenditures side, the reforms that have been improving the wages of public sector workers in different specialisations (doctors, teachers, police officers, members of the military and civil servants, in general) will be reflected in a current expenditure increase. Furthermore, the government's intention to accelerate infrastructure spending is becoming more obvious. On the one hand, public investment grew 18% YoY over the first two months of the year. On the other, infrastructure works concessions are being processed more speedily. Thus, in recent weeks, ProInversión (the agency in charge of promoting private investment in infrastructure) awarded three major projects (Lima Metro Line 2, Chinchero Airport in Cuzco and the San Martín Port Terminal) for a total amount of USD6.5bn. Additional works concessions for more than USD4bn (see Table 3.1) are expected over the rest of the year. This will continue to stimulate not only public investment (due to the co-financing agreements made), but also private, through both a direct (infrastructure spending) and indirect conduit, by fostering a more optimistic business atmosphere and generating a positive impact on business confidence.

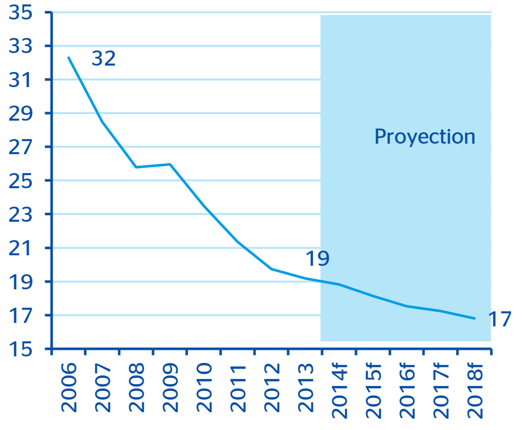
Table 3.1
Main projects to be awarded under concession in 2014

Projects	Sector	Location	Amount (USD mn w/o IGV [General Sales Tax])	Probable Award Date
Improvements to the country's energy safety and development of Southern Peruvian Gas Pipeline	Fossil fuels	Arequipa, Cusco, and Moquegua	2,800	2Q 2014
Moyobamba - Iquitos 220 kV Transmission Line and related substations	Electricity	San Martín and Loreto	434	2Q 2014
Headwater and Conveyance Works for the Supply of Potable Water to Lima	Sanitation	Junín and Lima	400	4Q 2014
LNG Supply System for the Domestic Market	Fossil fuels	Lima	250	4Q 2014
Azángaro - Juliaca - Puno 220 kV Transmission Line	Electricity	Puno	81	4Q 2014

Source: ProInverisón

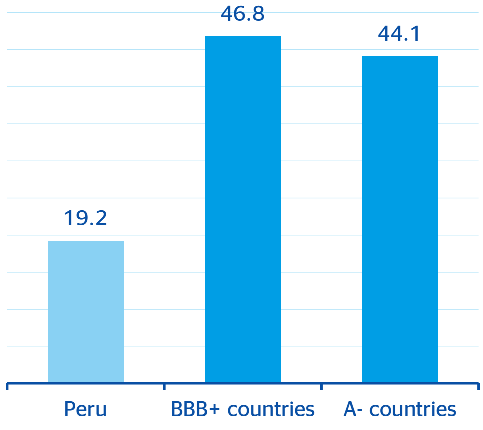
Within this context and looking forward, we project moderate deficits that will not affect the solvency of public finances, to the degree that government debt as a percentage of GDP stays on a downward trend, which will converge toward 17% of GDP in 2018 (see Figure 3.15). This level compares favourably with countries that have the same credit rating as the Peruvian government, and even with those that have a higher rating (see Figure 3.16).

Figure 3.15
Peru: public debt (% of GDP)



Source: Standard & Poor's and BBVA Research

Figure 3.16
Public debt 2013: Peru, BBB+ and A- countries (% of GDP, average according to S&P classification)

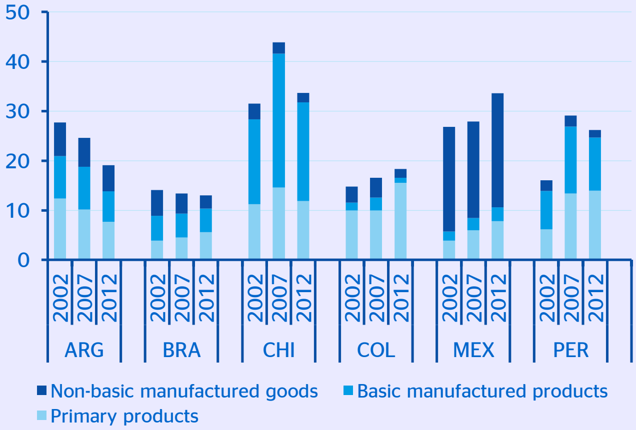


Source: BCRP and BBVA Research

Box 2. What happened to manufacturing competitiveness in 2002-12?

From 2002 to 2007, exports gained a greater share of GDP. Although this progress in exports was mainly explained by foreign sales of primary products (mining and fishing), the dynamism of manufacturing products was also important (see Figure B.2.1). In fact, the latter products gained share at a global level, given that they grew at a faster pace than that displayed by similar products from the rest of the world (see Figure B.2.2).

Chart B.2.1
Total exports (as % of GDP)



Source: WITS and BBVA Research

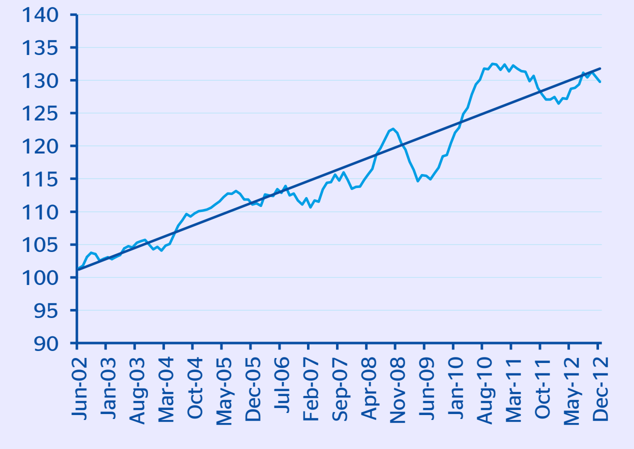
Chart B.2.2
Growth of export products (% var. annual avg)

Source: WITS and BBVA Research

The factors that enabled competitiveness to increase over the first half of the previous decade were:

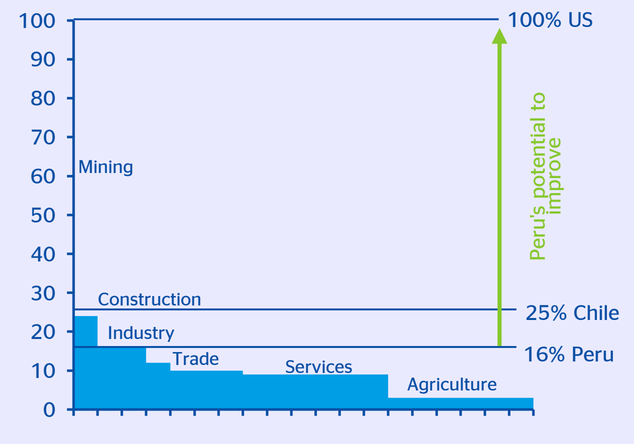
- The growth in productivity: From 2002 to 2007, economic activity grew at an average annual rate of 6.2%. A little over 40% of this growth was due to improvements in productivity, which during that period increased at an annual pace of around 2.6%, one of the fastest rates of expansion in Latin America. Among all of Peru's main trading partners, only in China did labour productivity grow faster. In the manufacturing sector in particular, the improvement in productivity (measured as the real manufacturing GDP among urban employment in the industry) observed for 2002-07 was around 17% (see Figure B.2.3). However, in comparison with the United States it is still low (see Figure B.2.3 and B.2.4). The rises in productivity levels allowed unit labour costs to remain relatively stable (see Figure B.2.5) and manufacturing exports to keep growing in spite of the drop in the real exchange rate (see Figure B.2.6).

Chart B.2.3
Manufacturing productivity index (six-month moving average)



Source: BCRP, MTPE [Ministry of Labour and Employment Promotion] and BBVA Research

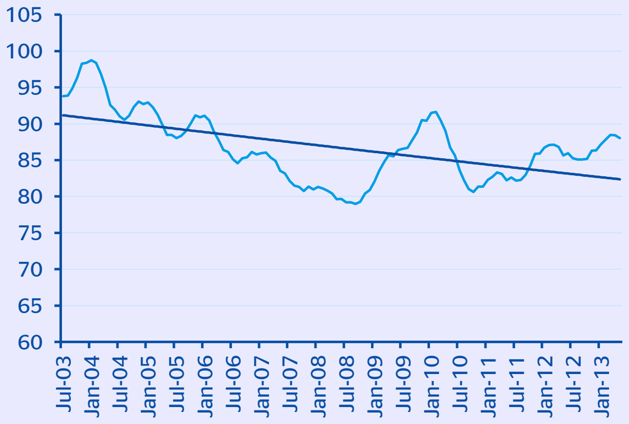
Chart B.2.4
Peru: relative productivity



Source: McKinsey (2010). Beyond the Global Crises: What's next for Peru?

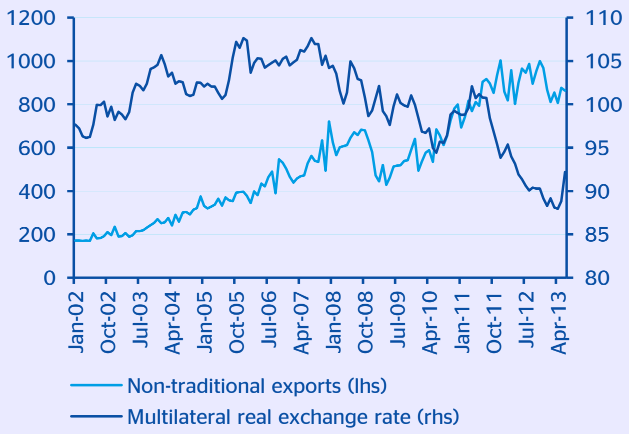
- Greater trade openness: cheapened the costs of imported capital goods and inputs (reduction of tariffs) and the entry into new markets with more advantageous terms (trade agreements).
- Improved atmosphere for doing business, in particular to export and import. According to Doing Business, exporting a standard container of merchandise requires six documents, costs 860 dollars and takes 12 days, ten fewer than in 2005. On a worldwide level, Peru ranks 56th out of 183 countries in ease of trading across borders. With respect to the ease of starting a business in Peru, the Doing Business report reveals that the required time dropped to almost one-third in 2002-12, and that the number of procedures is five, below the figures for countries such as Mexico, Brazil, Argentina, Venezuela and Bolivia.

Chart B.2.5
Unit labour cost (six-month moving average index)



Source: BCRP, MTC (Ministry of Transport and Communication) and BBVA Research

Chart B.2.6
Non-traditional exports and Real exchange Rate

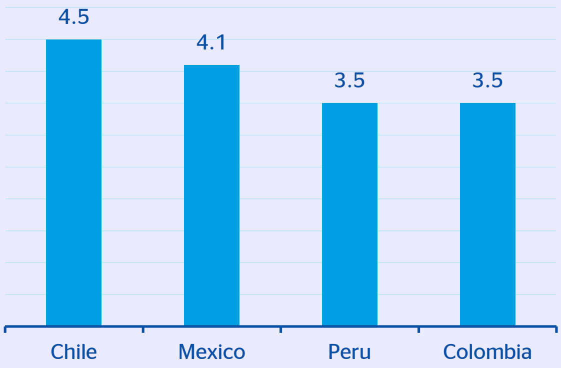


Source: BCRP

However, after a period of consistent progress (2002-07), the competitiveness of Peruvian manufacturing products showed a decline over the next five years. The following steps are required to drive it once again:

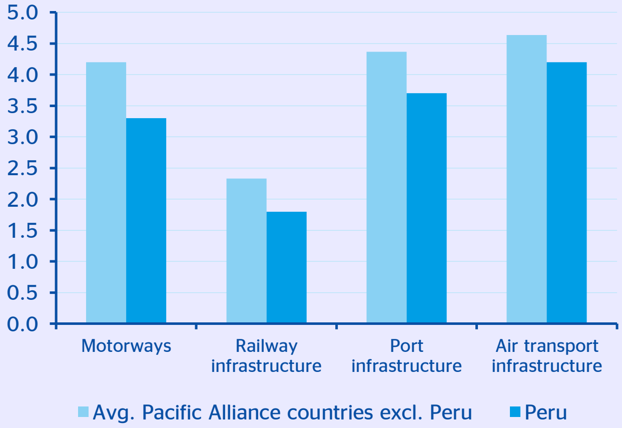
- Speed up infrastructure improvements: although infrastructure quality seems to have improved over recent years, it is deemed still far from meeting international standards in levels of development and efficiency. Among the Pacific Alliance countries (Chile, Mexico, Colombia and Peru), Peru is the third least-developed in terms of the quality of infrastructure (see Figures B.2.7 and B.2.8). In the case of roads, for example, only 14% are paved which, together with the traffic generated by other roadway deficiencies, generates significant waste of time and greater costs.
- Enhance the quality of human capital: only around 25% of the population over age 25 has a university or technical higher education degree and, although this percentage is higher than that recorded in previous years, it is still insufficient.
- Greater innovation in processes and products: in both the 2007 and 2012 assessments of the Global Competitiveness Index, Peru lags way behind in innovation, displaying poor levels of R&D spending and low quality scientific institutions. Peruvian exports of high, medium and low technology products represent a residual percentage of total exports over the course of the analysed period.
- Reduce obstacles to investment and strengthen institutions: according to the Global Competitiveness Index, the biggest obstacle to doing business is corruption, followed by the inefficiency of state bureaucracy and tax regulations.
- Reducing informality levels: the Peruvian economy is currently one of the region's and the world's most informal, with levels at around 70%.

Chart B.2.7
Infrastructure competitiveness index 2013-2014 (score)



Source: WEF

Chart B.2.8
Competitiveness by infrastructure type (7=best)



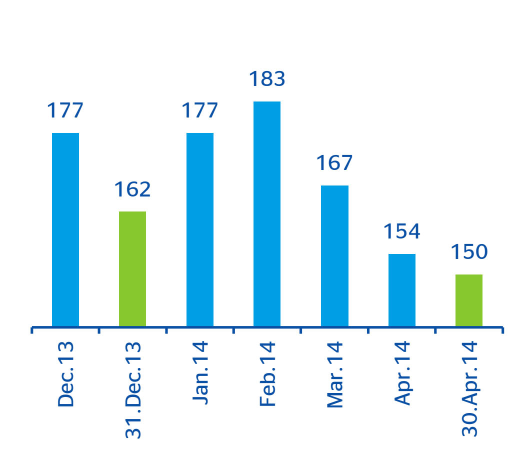
Source: WEF

4. Tensions in domestic financial markets ease after a volatile beginning of the year

Risk indicators and public debt yields have gone down after February's peak

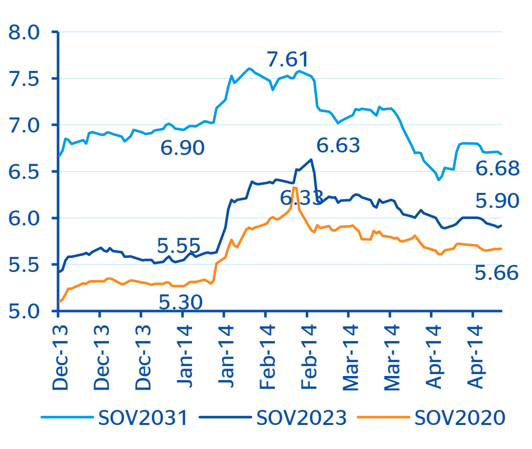
After the turbulence over the first six weeks of the year, the general appetite has been whetted for emerging markets assets, within which Peru is one of those with the highest output growth rates, the best macroeconomic fundamentals, and an attractive carry trade (even when adjusted for traded volume). Local financial markets have consequently tended to normalise. Risk indicators, for example, are currently below their 2013 closing levels (Figure 4.1). On the side of sovereign bonds yields, there has also been a correction, although milder (Figure 4.2). This has taken place in a context where foreign investors' positioning in these securities has stabilised at high levels of around 47% of total holdings (56% in November 2013), while pension funds and local banks have found room to increase their stakes, taking them close to their two-year highs. Consequently, the market is now somewhat more balanced in terms of bondholders participation.

Figure 4.1
Country risk: EMBI (basis points, average for period)



Source: Bloomberg

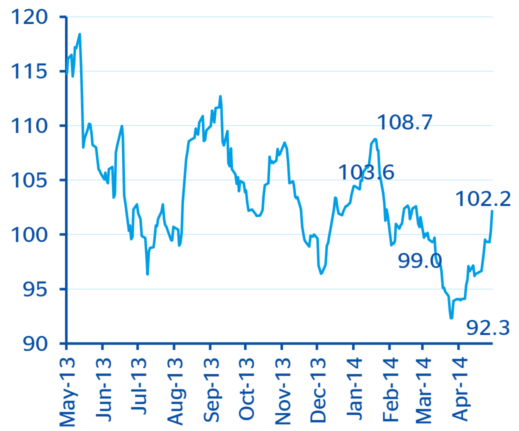
Figure 4.2
Sovereign bonds: demanded yields (%)



Source: Bloomberg

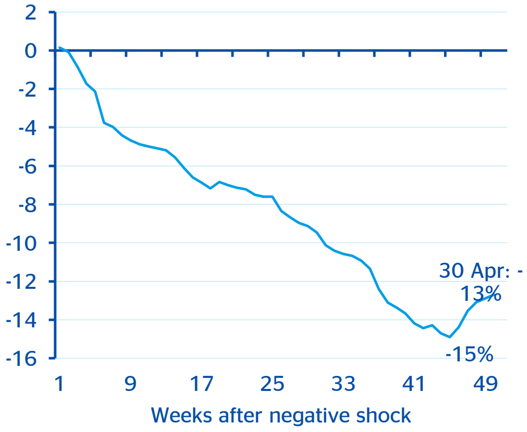
A similar picture is seen on the equity market, although in this case the correction after the turbulence period took longer to get started (Figure 4.3). This is due to the fact that a considerable portion of the equity index is related to the mining sector (around 40% of Lima's stock exchange market cap) and that the copper price did not display any recovery until after mid-March. Additionally, local activity indicators were weak and below expectations until the mid-April publication of February's output growth print, which positively surprised the market consensus. Within a longer timeframe, local financial markets have started to benefit from the stabilisation of foreign investment portfolio flows, after the steady trimming of positions that followed the May 2013 announcement of monetary tapering in the US (Figure 4.4).

Figure 4.3
Stock market: BVL general index
(29 Nov 2013 = 100)



Source: Bloomberg

Figure 4.4
Portfolio flows
(accumulative; % of managed funds)

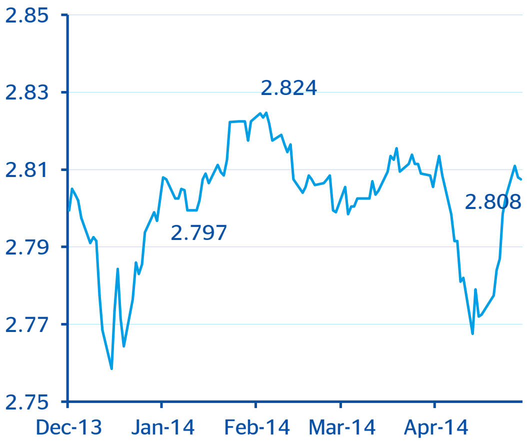


Source: EPFR and BBVA Research

The local currency also strengthened after the turbulence, but the foreign exchange outlook has fainted

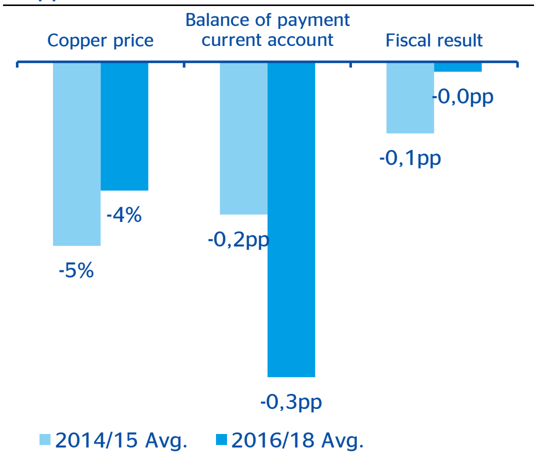
As in the case of all other local assets, the PEN started appreciating in mid-February (Figure 4.5). However, this strengthening has been relatively limited, topping at 0.6% from the most critical moment in 2014. This becomes clearer when two aspects are considered. First, that the central bank's foreign exchange interventions during the period of turbulence were significant and sustained, with foreign currency sales and placements of exchange-rate-indexed securities which totalled more than USD3bn over the first two months of 2014. The latter prevented a greater depreciation at that time. However, aside from around USD500mn in exchange-rate-indexed securities, the bulk of these operations have not been unwound (USD are still there in the market) while the PEN appreciation has nevertheless been modest. Second, that the following occurred during the normalisation of the local markets beginning in mid-February: (i) the income tax payment compliance adjustment period, which usually generates additional demand for local currency and strengthens it against the dollar (export firms, for example, sell foreign currency and buy the domestic one to satisfy compliance); and (ii) one-off currency operations that involved a sizeable rise in dollar supply on the foreign exchange market. Notwithstanding, the appreciation of the Peruvian sol was only modest, once again. In summary, the tenuous correction of the exchange rate after the turbulence of early this year suggests that the local currency has weakened structurally. This behaviour is consistent with the revision to our forecasts. We believe that exchange rate dynamics are more related to current fundamental factors, as opposed to what was observed last year (May and September) with the shift in perception over the course of monetary policy in the US.

Figure 4.5
Exchange Rate (USD/PEN)



Source: Bloomberg

Figure 4.6
Adjustments to our January baseline (in pp of GDP)



Source: BBVA Research

Our revised baseline scenario assumes that copper's price will follow a somewhat steeper downward trend than the one we anticipated back in January of this year. As a result, the price of copper will stabilise at a lower level in the medium term (Box 1). Terms of trade have moved in the same direction and, consequently, the deficit of the current account of the balance of payments will be slightly higher (Figure 4.6). Furthermore, the lower copper price will to some degree lessen the appeal of mining investment (and thus output growth) and therefore capital inflows. On the public accounts side, there will be a lower income tax revenue dynamism, which means that the fiscal deficit will be somewhat higher than what we anticipated three months ago. In other words, our forecasts for Peru's external and fiscal accounts have deteriorated.

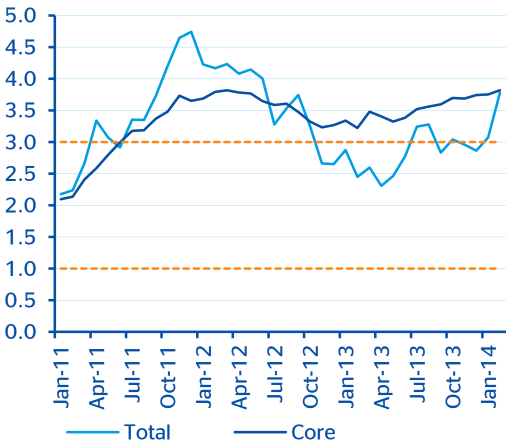
Within this environment, we have revised our foreign exchange forecast to the upside (depreciation of the PEN) towards a medium-term level consistent with somewhat weaker macroeconomic fundamentals. Therefore, we now expect this variable to tend to stabilise around USDPEN 2.90 in 2016. The transition from its current level of USDPEN 2.81 will be gradual because the central bank will probably cushion the decline, as it has usually sought to do. Taking into account the expected size of the deficit of the current account of the balance payments, rather greater exchange rate flexibility than that in the past would be convenient for adjustment purposes. Our forecast is that towards the end of 2014 this variable will be at around USDPEN 2.85, and at USDPEN 2.88 at the close of 2015. The gradual decline in the deficit of the current account of the balance of payments within the forecasting horizon is consistent with this course. Naturally, we do not rule out that bouts of high currency volatility may appear at certain times, associated with, for example, the reduction of the monetary stimulus in the US or with turbulence in an emerging market.

5. The inflation scenario for the coming months is more favourable

Over the first months of the year, YoY inflation remained above the upper limit of the central bank's target range (2%, +/- 1 pp) (see Figure 5.1). Furthermore, diverse measures of inflation trends that attempt to exclude transitory price shocks remain high (see Table 5.1). For example, core inflation has been above 3.0% for 36 consecutive months. This behaviour is associated with demand pressures on the prices of some services, such as meals in restaurants, education, and health, as a result of the rise in households' income and much less slack in those sectors, something which is consistent with our perception that output has been displaying a top-down convergence toward its potential level (a sign of demand pressures).

The greater demand for certain services is a consequence of the improvements in purchasing power. It is being reflected by a change in relative prices. Within this context, the question arises as to whether the central bank should react or merely facilitate this adjustment of prices, allowing higher short-term inflation. Of course, the temporary acceptance of higher inflation can have negative effects on the central bank's credibility and, therefore, on its ability to anchor inflation expectations in the medium term. In this regard, it is worth pointing out that inflation expectations two-years-out remain relatively close to the upper limit of the target range. In an environment of higher inflation expectations, inflation will be greater even in the absence of demand pressures and supply shocks.

Figure 5.1
YoY Inflation (%)



Source: BCRP

Table 5.1
Diverse measures of inflation (% YoY)

Inflation	Dec-12	Dec-13	Mar-14
...total	2.6	2.9	3.4
...core	3.3	3.7	3.8
...excluding food and energy	1.9	3.0	2.8
...non-tradable	3.2	3.1	3.6
...non-tradable excluding food	2.0	3.4	3.0
...2014 expectations	2.6	2.8	2.8
...2015 expectations	2.6*	2.7	2.7

* Feb-13 data.
Source: BCRP

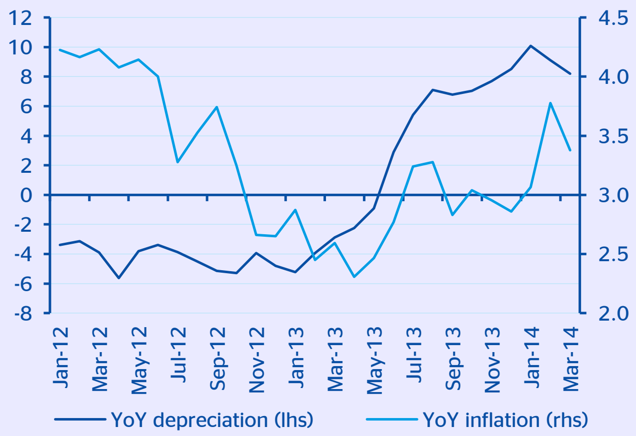
One factor that has also affected prices dynamics has been the currency's depreciation, which manifested as a strong rise in the exchange rate over 2013. According to our estimates, the exchange rate pass-through to prices is approximately 12% after one year. Therefore, assuming that all other determinants of prices dynamics remained constant, last year's depreciation would have added up to 1pp to YoY inflation (see Box 3).

Box 3. Exchange rate pass-through to domestic prices

The weakening of the local currency since the second quarter of 2013 has drawn attention to the effects that depreciation can exert on domestic inflation. In this sense, the USD/PEN exchange rate went from 2.60 in April 2013 to 2.81 in April 2014, recording an increase of close to 10%, while during the same period year-on-year inflation went from 2.3% to 3.4% (see Figure B.3.1). The question is then what share of this higher inflation is due to the Peruvian currency depreciation?

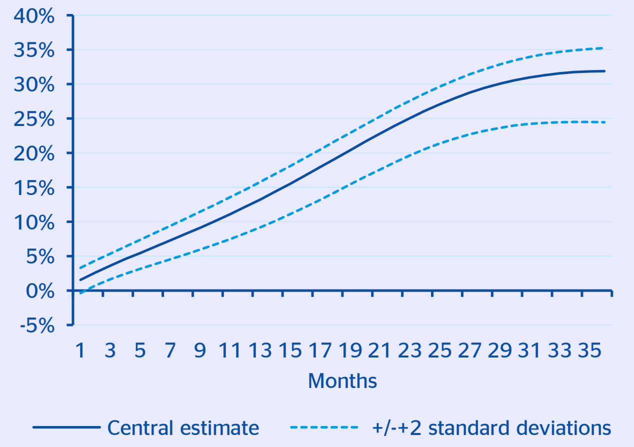
The effect of exchange rate pass-through to domestic prices occurs through two conduits: the direct and indirect. In the first case, a rise in the exchange rate raises the value of consumer goods which are expressed in dollars, such as home rentals and airline tickets, in local currency, and imported items such as domestic appliances and motor vehicles. In the second case, consumer goods rise in step with the rise in the cost of imported inputs (expressed in dollars) used in the manufacture thereof.

Figure B.3.1
Inflation and depreciation (% YoY



Source: BCRP

Chart B.3.2
Estimate of exchange rate depreciation pass-through to domestic inflation (% depreciation)



Source: BBVA Research

With respect to the empirical evidence, Winkelried (2003, 2012)[3] estimates that the pass-through effect will come in at around 10% and is asymmetrical, that is, it intensifies in periods of strong economic growth and high inflation. We updated our pass-through effect calculations with the vector auto regression (VAR) method proposed by McCarthy (1999)[4], via the following model error structure:

$$\pi_t^{fao} = E_{t-1}(\pi_t^{fao}) + \varepsilon_t^{fao}$$

$$y_t^{gap} = E_{t-1}(y_t^{gap}) + \alpha_1\varepsilon_t^{fao} + \varepsilon_t^{y}$$

$$\Delta e_t = E_{t-1}(\Delta e_t) + \beta_1\varepsilon_t^{fao} + \beta_2\varepsilon_t^{y} + \varepsilon_t^{\Delta e}$$

$$\pi_t^{m} = E_{t-1}(\pi_t^{m}) + \delta_1\varepsilon_t^{fao} + \delta_2\varepsilon_t^{y} + \delta_3\varepsilon_t^{\Delta e} + \varepsilon_t^{m}$$

$$\pi_t^{p} = E_{t-1}(\pi_t^{p}) + \gamma_1\varepsilon_t^{fao} + \gamma_2\varepsilon_t^{y} + \gamma_3\varepsilon_t^{\Delta e} + \gamma_4\varepsilon_t^{m} + \varepsilon_t^{p}$$

$$\pi_t^{c} = E_{t-1}(\pi_t^{c}) + \phi_1\varepsilon_t^{fao} + \phi_2\varepsilon_t^{y} + \phi_3\varepsilon_t^{\Delta e} + \phi_4\varepsilon_t^{m} + \phi_5\varepsilon_t^{p} + \varepsilon_t^{c}$$

where π_t^e is consumer price inflation, π_t^p is producer price inflation (estimated by wholesale prices), π_t^m is import price inflation, Δ_t^e is the variation in the nominal exchange rate, y_t^{gap} is the output gap (using the HP filter) and π_t^{fao} is food inflation based on the FAO index.

3: Winkelried, D (2003), "Is Pass-Through in Peru Asymmetrical? An Aggregate Analysis," Central Reserve Bank of Peru, Journal of Economic Studies, 10. Winkelried, D (2012), "Exchange Rate Pass-Through and Inflation Targets in Peru," Central Reserve Bank of Peru, Journal of Economic Studies, 23.
4: McCarthy, Jonathan (1999) "Pass-Through of Exchange Rate and Import Prices to Domestic Inflation in Some Industrialized Economies," BIS Working Paper No. 79, Bank for International Settlements.

The estimate period runs from January 2000 to December 2013, and a lag was taken into account in accordance with the Schwarz Information Criterion. The main identification assumptions are the following: i) supply shocks are identified with the dynamics of global food inflation; ii) demand shocks are identified from the dynamics of the output gap after taking into account the contemporary effect of the supply shock; and iii) external shocks are identified from the dynamics of the local currency's depreciation, after taking into account the contemporary effects of demand and supply shocks. Furthermore, it is assumed that import and wholesale inflation may have contemporary impacts on consumer inflation, but not vice versa, and that the exchange rate affects all of the aforementioned measures of inflation. Lastly, it is assumed that system-conditioned expectations may be replaced with linear projections of the lags of system variables. The VAR estimate thus uses the Cholesky decomposition. Finally, the pass-through ratio is calculated based on the accumulated impulse response functions.

The calculations show an exchange rate depreciation pass-through to domestic inflation of 12% in one year (see Figure B.3.2), which suggests that the 10% depreciation observed in January would have an impact of around 1pp on year-end inflation. However, it is worth pointing out that the effect could be lower due to the fact that we are currently in a decelerating phase of the economic cycle, which leads producers who use imported inputs to sacrifice their margin to deal with lower demand. Going forward, we expect the pass-through to weaken, which would help inflation to converge toward the middle of the target range (2%, +/- 1pp) in 2015.

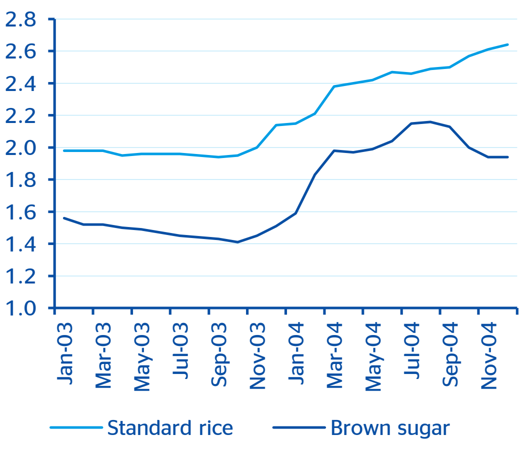
Going forward, inflation will go down, but supply factors will restrain a faster drop

Within a context in which output will grow somewhat below its potential rate, the temporary demand pressures will weaken, driving down core inflation. Furthermore, considerable rises in the exchange rate (currency depreciation) are no longer expected, given that the overvaluation of the local currency seems to have corrected to a large extent over 2013 (9% depreciation), which would mean that its influence on prices would be much less than that of previous months.

Nevertheless, some supply factors will affect inflationary dynamics over the coming months. On the external side, a greater volatility in the international prices of the main agriculture inputs (corn, wheat, soy bean) could pass through into the prices of domestic food, which would be partially offset by a downward revision to our oil price forecast (see Box 4). On the local side, the absence of rainfall over the country's northern coast in the first quarter of the year could affect the growing and supply of some water-intensive food crops, such as sugar and rice. According to Apoyo Consultoría estimates, the production of those products in the northern coast may fall by 25% this year, which would lead to a rise in their prices of over 20%, as occurred during a similar episode in 2004 (see Figure 5.2), and an inflationary impact of around 0.5pp. These agriculture supply conditions could worsen even further were an intense El Niño effect to occur that continues until the rainfall seasons and thus leads to excess rain.

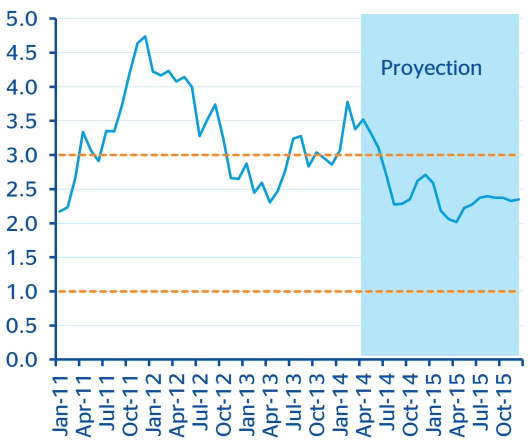
All in all, we estimate that the convergence of inflation towards the middle of the target range will be delayed with respect to what we were expecting back in January, and that over the coming months inflation will fluctuate around the range's upper limit, ending the year at 2.7% (see Figure 5.3). For 2015, with a zero output gap and an absence of supply shocks, inflation will converge to 2.3% at the end of that year.

Figure 5.2
Price of common rice and brown sugar (PEN per kg.)



Source: INEI

Figure 5.3
YoY Inflation (%)



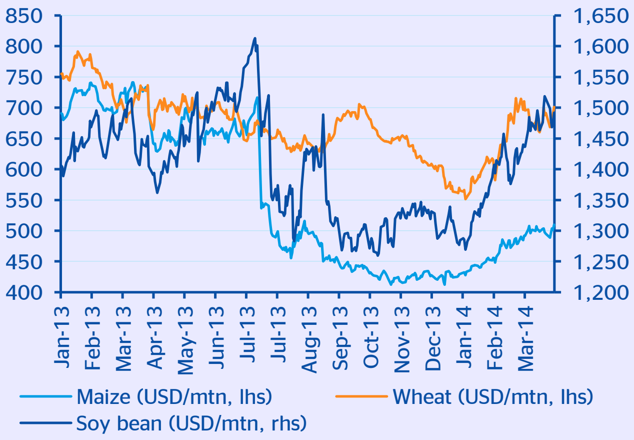
Source: BCRP and BBVA Research

Box 4. Food and oil prices forecast

The international prices of the main agricultural Peruvian imports (corn, wheat and soy bean) have risen over recent months (see Figure B.4.1). Some of the factors that explain these increases are as follows: (i) weather anomalies in Brazil (droughts and excess rainfall), which have reduced soy bean harvest expectations, and the effect on winter wheat crops of the prolonged drought in central and southern US; and (ii) political tensions in the Black Sea region, which accounts for 20% of world corn and wheat exports, in particular, the uncertainty with respect to grain shipments from the Ukraine.

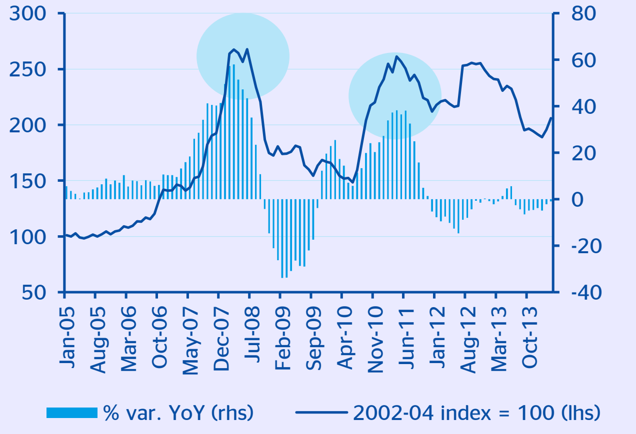
Notwithstanding these increases, the rises in international prices are taking place from historically low levels. Thus, in year-over-year terms, the increases do not compare with those observed in 2008 and 2011 (see Figure B.4.2). Going forward, although these price increases raise our estimated averages for the year, we expect prices to converge toward their long-term levels (see Figure B.4.3), given the excellent harvest that is expected in the US, which would make its way to the market toward the end of the year, and the strengthening of the USD due to the tapering of the Fed's monetary stimulus.

Chart B.4.1
International food prices



Source: Bloomberg

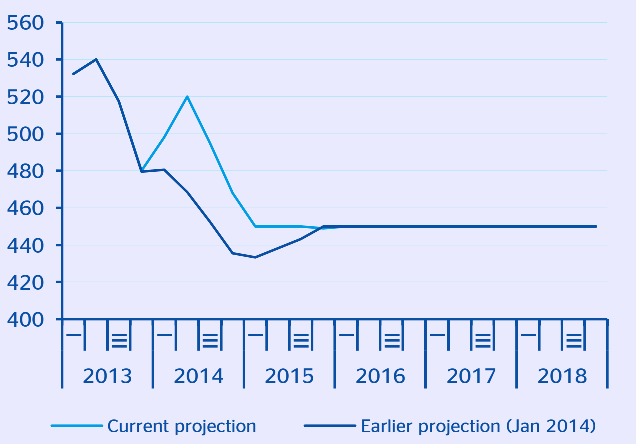
Chart B.4.2
Cereals price index



Source: FAO

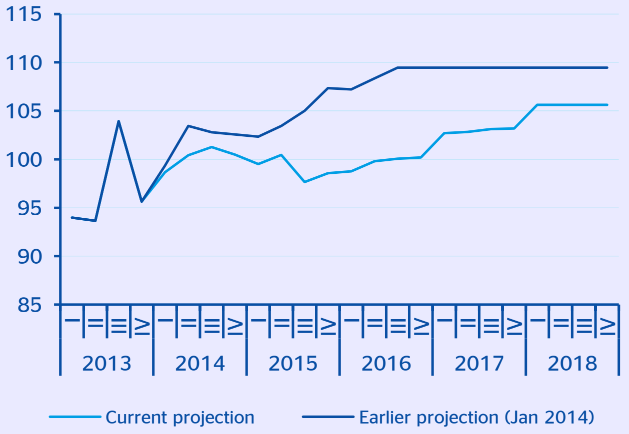
With respect to the price of oil, we have revised our forecasts to the downside (see Figure B.4.4), due to the expectations of lower growth in China and the resulting drop in crude consumption. The adjustment was not major, given that the high marginal costs of new oil projects will place a floor under the price of around USD105 per barrel. However, we do not rule out higher short-term price volatility, in connection with the persistence of the crisis in Ukraine. In this regard, it must be remembered that Russia stands as a major supplier of oil to Europe.

Chart B.4.3
International soya bean price (USD/MT)



Source: BBVA Research

Chart B.4.2
International oil price (USD/barrel)



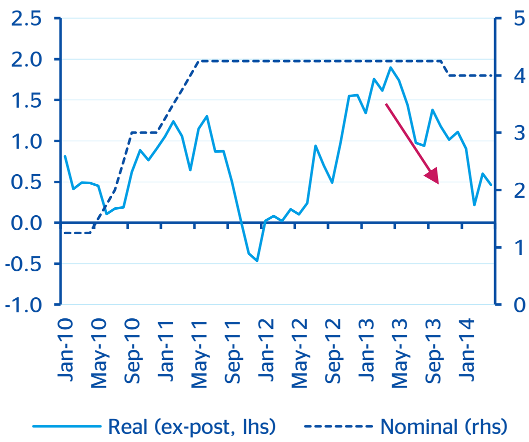
Source: BBVA Research

6. Monetary policy: a more challenging macro scenario for the Central Bank

The monetary policy stance has continued to ease over recent months…

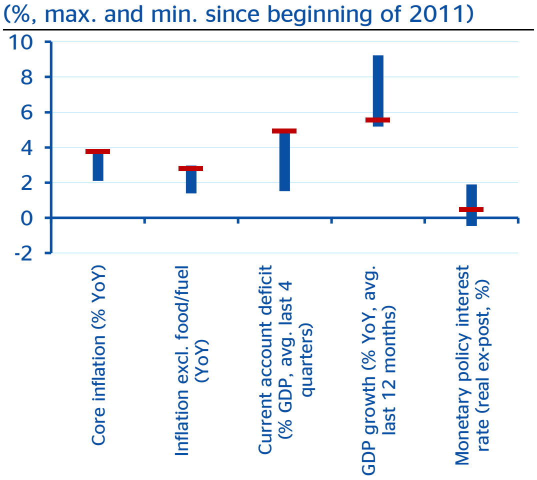
The policy rate in nominal terms has remained at 4.0%, but in real terms (ex-post) has fallen somewhat more than 50bp since the end of last year (100bp since mid-2013) to its current level of 0.5% (Figure 6.1). In addition, reserve requirements have been reduced. This monetary easing has supported credit growth. Since the end of the first half of 2013, financial system lending has accelerated by 8pp, and although a share of this greater dynamism is only accounting-based, that is, associated with the depreciation of the local currency (which means the PEN equivalent of loans extended in foreign currency rises), the trend is nevertheless similar when discounting this effect, although less steep (6pp). Furthermore, given that reserve requirements cuts have been largely on the side of the local currency, this has helped the de-dollarisation of credit (lending in soles accelerated by 14pp since mid-2013, while that in dollars retreated by more than 3pp), thus continuing to reduce the vulnerability of the economy arising from currency mismatches.

Figure 6.1
Monetary policy interest rate (%)



Source: BCRP and BBVA Research

Figure 6.2
Macroeconomic indicators
(%, max. and min. since beginning of 2011)



Source: BCRP and BBVA Research

… but we do not see much further room for that to endure

As observed in Figure 6.2, the different measures of inflation are at three-year highs. Some of these measures are even above the inflation target (core and total), and have been for some time (core). In the case of the current account of the balance of payments, the deficit is relatively high, close to 5% of GDP, a level which is also at three-year highs. This suggests that the Peruvian economy presents certain internal (above-target inflation) and external (high current account deficit) imbalances, which could be associated with a still-positive output gap.

The central bank thus faces a challenging macro-economic environment. On the one hand, high inflation and an elevated external deficit suggest a hike in the policy rate. On the other, the lower dynamism in economic activity (since the end of 2013, the central bank has been stating that output is growing at a below-potential pace) favours a cut. The quandary that monetary policy currently faces limits its actions, given that, for example, additional demand stimuli would exacerbate the internal and external imbalances (see Box 5).

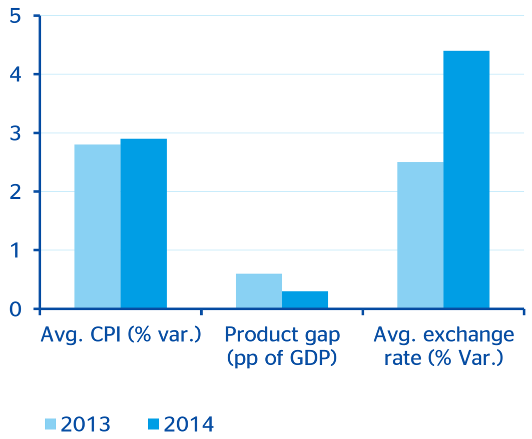
Within this context, we expect the policy rate to remain at its current 4.0% level for the rest of the year

Our estimates suggest that the output gap remains somewhat positive (see Figure 6.3), which is validated by both the above-target inflation and the external deficit. However, its trend is to close due to the relative weakness GDP has been displaying. As a result, demand pressures on prices will give way, and inflation's deviation from its target will thus be only transitory (returning to the range in the third quarter). We perceive that the central bank is willing to tolerate that temporary deviation. Within this environment, we continue to expect that the policy rate will remain unchanged over the coming months.

As for reserves requirements, these have been used to support credit growth. The ongoing central bank foreign exchange interventions, in particular over the first two months of the year, reduced the supply of local currency on the market. The easing of reserves requirements in soles sought to offset these operations so that credit would not be affected. The central bank is currently not intervening in the foreign exchange market, which means that a reduction of reserves requirements becomes less necessary. Furthermore, financial system lending to the private sector already shows a strong acceleration, a context in which delinquencies have increased (from 1.75% of total lending at the end of 2012 to 2.33% currently). Hence, in the coming future banks might adopt a more cautious stance toward credit expansion, making it unnecessary to provide them with greater resources. In summary, the situation has changed, and we see that there is less room to continue cutting reserve requirements.

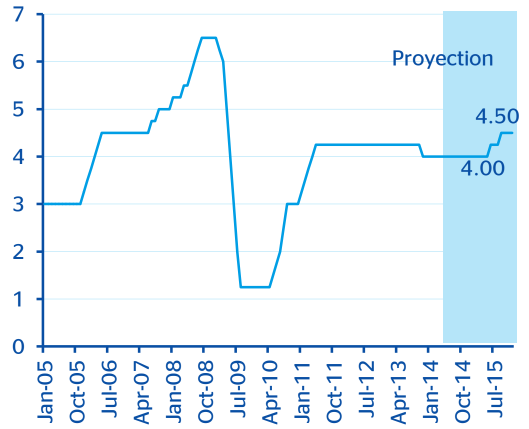
Finally, our baseline scenario for 2015 includes an accumulated 50bp rise in the monetary policy rate (see Figure 6.4). This will help to consolidate the return of inflation to its target range, in a context in which output will begin to accelerate (up to 5.6% in 2015 and somewhat more in 2016). Moreover, the policy rate hike will help to limit abrupt movements in the exchange rate when US monetary conditions begin to normalise via increases in the Federal Funds rate.

Figure 6.3
Monetary policy stance determinants



Source: BCRP and BBVA Research

Figure 6.4
Policy interest rate (%)



Source: BCRP and BBVA Research

Box 5. Economic growth slows down: are demand-side stimuli necessary?

The slowdown that the Peruvian economy has displayed over recent months has coincided with worsening external conditions that are relevant for the country. First, lower economic growth in China, as well as the rebalancing of its demand components, in which investment will lose weighting versus consumption, will be reflected by a moderation in global demand for industrial metals Peru exports and in prices (the latter is already being seen). A second factor is that capital inflows from direct investment will slow down due to the less favourable outlook that mining corporations face globally: falling metal prices, rising marginal costs, and higher financing costs (in Peru, mining investment is by far the most important). Finally, the beginning of QE3 tapering and the upcoming normalisation of interest rates in the US will entail less favourable external financial conditions: the era of global abundance of liquidity, low international interest rates and widespread willingness of investors to acquire emerging markets assets is coming to an end.

Given the nature of the (external and persistent) shock that the Peruvian economy faces, to define the importance and room for manoeuvre stimulus policies currently have on the demand side, two crucial aspects must be taken into account:

1. **The position of GDP in the economic cycle.** If the economy is above potential GDP (the level that is sustainable in the medium term because it does not cause internal or external macro-economic imbalances, such as higher inflation than desirable or a sizeable current account deficit), demand stimuli would not in theory be required. In this case, the slowdown in growth would be explained by the cessation of the favourable conditions that drove it over its potential level, which means it could be seen as a process of GDP converging (from “above” its potential) toward its sustainable level. In this case, demand policies, which should not be highly aggressive, could have a certain room to smooth the economy's transition to a more moderate, but healthy, growth rate. In our view, the dynamics described are present in Peru. The favourable international economic and financial environment the country enjoyed until the first quarter of 2013 allowed a very quick expansion of the economy, which was reflected by demand pressures on prices (core inflation has been above 3.0% for roughly three years) and by a rise in the current account deficit (which at year-end could approach levels of 5.0% of GDP, the highest since 1998). Of course, it is difficult to provide a conclusive answer to the question of the state of the economic cycle, because that requires estimating a non-observable variable: potential GDP. However, the symptoms of a somewhat overheated economy have been present over the last two or three years.

2. **The imbalances currently faced by the Peruvian economy.** Even if the Peruvian economy were below its potential level, the presence of an inflation that is higher than the central bank target and a high current account deficit place restrictions on the intensity of demand policies. Highly aggressive stimuli would exacerbate these imbalances, the correction of which would require a more intensive adjustment of the economy. Faced with this possibility, the perception of strength in the Peruvian economy in the international markets could weaken, which would translate into a reversal of capital inflows and, in turn, the generation of additional pressures. In this regard, it is worth noting that we recently witnessed bouts of stress in diverse emerging markets, due to concerns over their sizeable external deficits. In general, markets reacted to the fact that these economies will have to apply adjustment measures, which are politically difficult to implement, to correct concurrently the overvaluation of their currencies and the laxity of their monetary policies, as well as accelerate structural reforms in some cases.

The factors mentioned imply that any demand stimuli that may be implemented must be moderate. The evidence suggests that, over the previous two or three years, the Peruvian economy grew above its sustainable level for the medium term, driven by highly favourable external and short-term conditions, but not by structural factors. Today, the relevant international scenario for Peru is changing quickly, and in large part explains the slowdown its growth has been displaying. From this point of view, the moderation in the pace of GDP expansion is a process of convergence toward its sustainable level. In this case, demand policies may help to smooth the transition to a more moderate pace of growth, but it must be borne in mind that the imbalances currently displayed by the Peruvian economy place limitations on the intensity of demand stimuli. Given Peru's slowdown in productivity gains and its loss of competitiveness over recent years (see Box 2), one cannot rule out that what have been (and are still) missing are supply-side policies to speed up economic activity, and that the potential GDP growth rate may not lie in the 6.5-7.0% range, but rather somewhat closer to that of 5.0-5.5%. Therefore, one must be careful of falling into the temptation of implementing highly aggressive demand policies to sustain the "miracle" of Peruvian growth, when the agenda of structural reforms that will provide the economy with sustained drive has not been addressed.

7. Downside risks on both the external and domestic fronts

China is the main concern

The main risk factor for our forecasts is a more intense slowdown of the Chinese economy, given the financial fragilities that have been emerging in that country (liquidity problems, high local government debt, growth of shadow banking), which have forced the authorities to accept more moderate growth rates and be more cautious with the implementation of potential stimulus policies.

Within this context, we performed a sensitivity exercise on our (baseline scenario) forecasts of a negative shock arising from lower growth in China beginning in the second half of 2014. In this risk scenario, the Asian country's slowdown would be associated with a significant drop in investment, which would also impact consumption. As a result, Chinese output growth would converge toward 6% within the forecasting horizon, around 1pp below our baseline scenario.

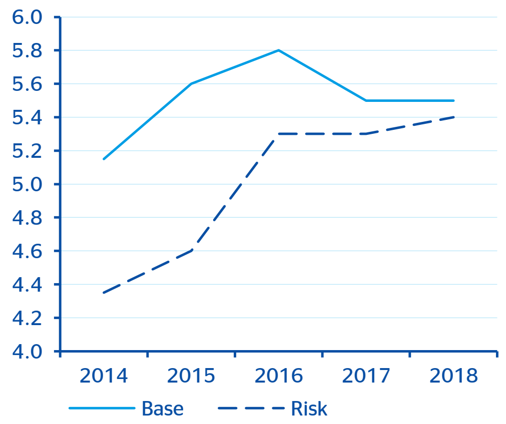
This is a structural risk for Peru because of the high degree in which exports, GDP, and tax revenues rely on mining (55%, 15%, and 15%, respectively). Within this context, the transmission of the effects to the Peruvian economy would occur through three channels. First, lower external demand, which would have an impact on export volumes. Second, lower export prices, which would negatively affect terms of trade, mining firms profits, and reinvestment, as well as tax revenues. Third, a business confidence channel, to the degree that this scenario would affect the business climate and reduce firms' optimism, shrinking investment, which would also have an impact on jobs and private consumption. It is worth noting that the exercise assumes that confidence goes down by half (and thus its effect on private investment is a half) of what it fell during the financial crisis of 2008-09. This exercise did not consider the impact on global risk aversion caused by a more intense slowdown of the Chinese economy, which would generate situations of stress in the local financial markets due to abrupt capital outflows (or halted inflows).

In this risk scenario, Peru's fundamentals would weaken and the impacts would thus be permanent. Economic policy response will have to gradually accommodate the transition towards a new equilibrium, with a more depreciated currency and lower output growth. The exercise assumes that there will be a policy response via, for example, higher public consumption, and that its size would be equivalent to half of the stimulus recorded during the previous financial crisis.

The results of the exercise reveal that the greatest impacts would occur between 2014 and 2015, with a reduction of output growth of close to 1pp. Thereafter, the effects would diminish, converging toward a somewhat lower growth rate than the baseline scenario, which implies a permanent loss of GDP (see Figure 7.1). In the forecasting horizon, GDP annual growth would be on average 0.5pp lower.

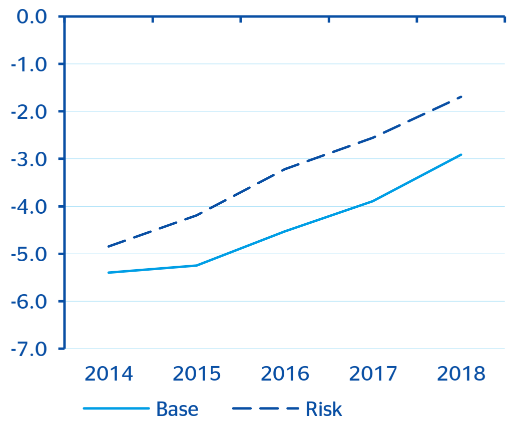
On the external gap, the net effect would be the reduction of the deficit (see Figure 7.2). In this case, the negative effect on the trade balance of the lower terms of trade would be more than offset by the lower volume of imports, in light of the slowdown in investments and private consumption.

Figure 7.1
GDP growth (%)



Source: BBVA Research

Figure 7.2
Current account (% of GDP)



Source: BBVA Research

At the local level, an El Niño phenomenon with a greater-than-expected intensity is a risk factor

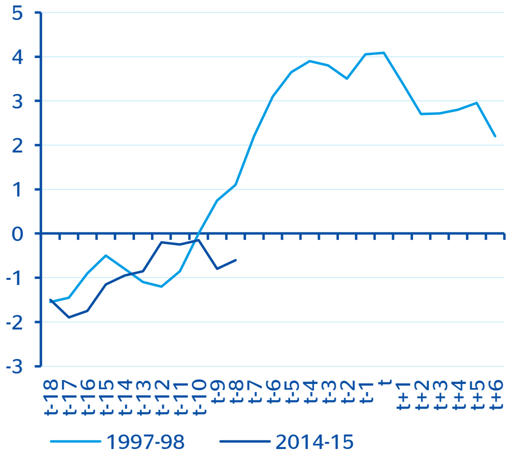
Another risk factor for our forecast is associated with the occurrence of a high-magnitude El Niño phenomenon, similar to that observed in 1997-98 (see Figure 7.3). According to the Andean Development Corporation (CAF), the losses caused by El Niño in 1997-98 were somewhat more than 6% of GDP (Table 7.1).

Fishing would be one of the affected sector, due to the reduced availability of anchovies resulting from the migration of shoals to cooler waters, which would also reduce fishmeal manufacturing. Thus, for example, export volumes of fishmeal and fish oil in 1998 dropped 62% and 86%, respectively. Another sector that would be affected is agricultural exports due to the lower artichoke, mango and grape harvests, while retail would be affected by the temperature change that would lead to scarce sales of winter season clothing. Finally, the excess rainfall may cause natural disasters associated with landslides and floods, with impacts on infrastructure and construction. These negative effects could only be partially offset by higher temperatures raising sales in the beverage sector.

In this regard, a 2010 Universidad del Pacífico study estimated the economic impact of a highly severe El Niño phenomenon at around 2pp of GDP, with the main affected sectors being agriculture, housing, transportation and sanitation. The impact could be greater if the aforementioned effects on fishing are considered.

Finally, it should be noted that in the last report of the multi-sectorial committee in charge of the National Study of El Niño phenomenon (ENFEN) of 15 April, the forecast for an El Niño phenomenon of a weak to moderate magnitude was maintained for mid-year, which means that the probability of an extreme scenario is low.

Figure 7.3
Anomalies in sea surface temperature (° Celsius)



Source: NOAA

Table 7.1
El Niño sectorial damage
(1998 USD dollars, in million)

	1982-1983	1997-1998
Social Sectors	218	485
Housing	115	222
Education	9	228
Health	94	34
Production Sectors	2533	1625
Agricultural/Livestock	1064	612
Fishing	174	26
Mining	509	44
Industry	786	675
Trade		268
Infrastructure	532	1389
Transportation	497	686
Electricity	32	165
Other	3	538
Total	3283	3500
% of GDP	12%	6%

* Includes emergency prevention and care expenses.
Source: The Lessons of El Niño - Peru. CAF

8. Tables

Table 8.1
Annual Macroeconomic Forecasts

	2013	2014e	2015f	2016f
GDP (%,YoY)	5.6	5.2	5.6	5.8
Inflation (%,YoY, eop)	2.9	2.7	2.3	2.2
Exchange rate (vs. USD, eop)	2.79	2.85	2.88	2.90
Monetary policy rate (%,eop)	4.00	4.00	4.50	5.00
Private consumption (%, YoY)	5.2	4.6	4.7	4.8
Public consumption (%, YoY)	6.3	6.5	4.0	4.2
Investment (%, YoY)	6.2	6.4	5.9	5.1
Fiscal balance (% of GDP)	0.9	-0.1	-0.4	-0.5
Current account (% of GDP)	-4.6	-5.1	-5.2	-4.5

Source: BCRP and BBVA Research

Table 8.2
Quarterly Macroeconomic Forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD,eop)	MPR (%,eop)
1Q12	6.0	4.2	2.67	4.25
2Q12	5.7	4.0	2.67	4.25
3Q12	6.8	3.7	2.60	4.25
4Q12	5.4	2.6	2.57	4.25
1Q13	4.3	2.6	2.59	4.25
2Q13	6.1	2.8	2.75	4.25
3Q13	5.1	2.8	2.78	4.25
4Q13	6.7	2.9	2.79	4.00
1Q14	5.2	3.4	2.81	4.00
2Q14	4.2	2.8	2.83	4.00
3Q14	5.8	2.1	2.84	4.00
4Q14	5.4	2.7	2.85	4.00

Source: BCRP and BBVA Research

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RESEARCH

This report has been produced by the Peru Unit:

Chief Economist
Hugo Perea
+51 1 2112042
hperea@bbva.com

Daniel Barco
+51 1 2111548
daniel.barco@bbva.com

Francisco Grippa
+51 2111035
fgrippa@bbva.com

Rosario Sánchez
+51 1 2112015
rdpsanchez@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Xia Le
xia.le@bbva.com.hk

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Latam Coordination
Juan Ruiz
Juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@ bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo_lopez@ bbva.com

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Global Areas:
Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Clara Barrabés
clara.barrabes@bbva.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Recovery and Resolution Strategy
José Carlos Pardo
josecarlos.pardo@bbva.com

Global Coordination
Matías Viola
matias.viola@bbva.com

Contact details

BBVA Research Peru
Av. República de Panamá 3055
San Isidro
Lima 27 - Peru
Teléfono: + 51 1 2112042
E-mail: bbvaresearch_peru@bbva.com
www.bbvaresearch.com