BBVA | RESEARCH

Peru Economic Outlook

Third Quarter 2014
Peru Unit

- World economic growth will accelerate in the second half of 2014, after the slowdown earlier this year. This will be increasingly driven by the advanced economies, which will thus gradually withdraw their monetary stimulus
- In Peru, activity will rise by around 4% in 2014. In the second half of the year, the economy will begin to overcome the current slump in output, with a greater boost from the mining sector and the recently-announced government measures. Momentum will increase further over the next two years, with growth close to 6%.
- The foreign deficit will come in at roughly 5% of GDP in 2014 and 2015, to then start gradually shrinking, driven by the mining sector
- Inflation remains outside the target and inflationary expectations have risen. Within this context, we expect prices to climb by 3.3% in 2014, and that the process of convergence toward the target will be somewhat slower.
- The central bank is in a quandary: economic slowdown, but also macroeconomic imbalances. There is little room to apply further monetary stimulus. We expect the benchmark rate to close the year at 3.50%.
- Main risk is domestic: a further decline in business confidence causing lower private investment will make the cyclical adjustment of the economy more difficult.

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Closing date: 1 August 2014

1 Summary

After the slowdown in the first half, world economic growth will accelerate in the second half of 2014. In general, global activity indicators and contained financial stresses are consistent with a gradual improvement in world growth. For example, the US economy recovered from the sharp slump early this year, which was due to temporary factors such as bad weather and a sharp adjustment in inventories. China saw improved exports and has applied monetary and fiscal stimulus, all of which reduces the risk of a hard landing. In this environment, we expect global growth to rise from 3.0% in 2013 to 3.3% in 2014, and to 3.8% in 2015. This will be increasingly driven by the advanced economies, which will thus gradually reduce their extraordinary stimulus measures. The Fed will cease to expand its balance sheet in October, and we expect the first monetary policy interest rate hike to take place in the third quarter of 2015.

Activity in Peru will rise by around 4% in 2014, with a pick-up in the second half gaining further traction over the next two years. The slowdown over the last months was steep, with output growth currently below 2%. However, the explanatory factors are partly of a temporary nature. We expect the performance of the Peruvian economy to improve from the third quarter. Firstly, mining activity will pick up, supported by the fact that the Toromocho mining megaproject will at last achieve full-capacity production and that some mines will resume operations, after the partial shutdown for maintenance work over the first half of the year. On the demand side, this will be reflected by higher exports. Secondly, the government's recently-announced measures will promote household spending and open the way to spurring public expenditures. Lastly, there will be a degree of recovery in private-sector demand, supported by a labour market that has started to improve. With the second-half bounce-back in output of somewhat more than 4.5%, growth in 2014 will come in at around 4%. The pace of activity will approach 6% over the next two years, as some major mining projects start their operational phases, combined with the recently-awarded infrastructure construction works, including Lima Metro Line 2.

On the external accounts side, we expect the current account deficit to come in at around 5% of GDP in 2014 and 2015, to then start gradually narrowing. The current account deficit reached 6.0% of GDP in the first quarter of 2014. We nevertheless expect that it will tend to decline over the rest of the year, spurred by a higher push from the mining sector (higher exports) and a continuing limited demand for imports. This will make up for the downward trend in the copper price. The deficit will gradually shrink over the coming years, especially from 2016 onwards, as some other major mining projects come into operation. It should be noted that long-term capital inflows will continue to finance these deficits, though to a lesser extent than in past years. **On the public accounts side, the fiscal result will start to turn mildly negative next year**. We expect the result to continue showing a slight surplus in 2014, less than in previous years due to forthcoming government stimulus, especially in the second half. Over the next few years, the result will shift towards a moderate deficit, which implies that the trend towards reducing gross public debt will continue, but at a slower pace, reaching a level of around 18% of GDP in 2018. This includes the public debt taken on to finance major infrastructure works, such as the modernisation of the Talara refinery.

Local financial markets continued to recover over the last few months. The bullish trend in the markets seen in the second half of the first quarter continued, thus making up a fair share of the cumulative corrections recorded since May 2013. The performance of local asset prices was supported by the positive fundamentals of the Peruvian economy (which actually led Moody's to upgrade Peru's sovereign credit rating by two notches to A3), the moderation of international financial stresses, ongoing risk appetite, and the still abundant international liquidity, which on the whole favoured renewed capital inflows in spite of the slowdown in economic activity. In the currency market, in particular, the peso has strengthened since February. However, we expect that this trend will soon start to reverse, and that the exchange rate will close the year at USDPEN 2.85, stabilising in the medium term at around 2.90. The high foreign deficit and the normalisation of US monetary policy, which will strengthen the USD globally, underlie this forecast. Lastly, we should mention that Argentina's default on its public debt at the end of July failed to impact the financial markets in the rest of the region, due to the country's limited international financial relations and the idiosyncratic nature of the event.

On the side of prices, the scenario remains complicated. Inflation remained above the target range over the last few months. Although this deviation is partially due to supply factors, such as rises in the prices of food and fuels, there are also demand-side pressures, particularly in the prices of services such as healthcare and education. Within a context of a protracted above-target deviation of inflation, which has been the case of core inflation for three years now, inflation expectations one year out (and even those for 2015 and 2016) have risen to close to the ceiling of the target range. This will provide momentum to the price formation process over the coming months, thus making up for the lower pressures induced by the moderation in economic activity growth and the reversal of supply shocks. We expect inflation, currently at 3.3%, to fluctuate between 2.9% and 3.5% over the rest of the year, closing 2014 at around its current level. Convergence back within the target range and its consolidation therein will likely only take place in the second half of 2015.

This macroeconomic environment puts the central bank in a quandary. On the one hand, activity has slowed markedly, more than expected, and business expectations have deteriorated, which may extend the slump. This suggests cutting the benchmark rate. On the other, inflation, inflation expectations and the deficit in the current account of the balance of payments are high, which in contrast suggests acting with restraint. Within this context, the central bank opted for prioritising its output-stabilising role, and cut the benchmark interest rate in July, although by a modest 25bp. It thus supplemented the measures that are also being applied on the fiscal side. A similar cut will likely take place in August. The more active role of monetary policy, while understandable in the current environment, entails a risk: a potential loss of credibility. We therefore believe that from now on no further stimulus will be seen on the monetary side, which means the benchmark rate will close the year at 3.50%. In 2015, the recovery in activity will encourage the central bank to target its actions toward consolidating the return of inflation to the target. We expect the policy rate to be adjusted in unison with the start of the upward rate cycle in the US, thus mitigating potential bouts of volatility in the local currency markets, to reach a level of 4.0% at the end of this year.

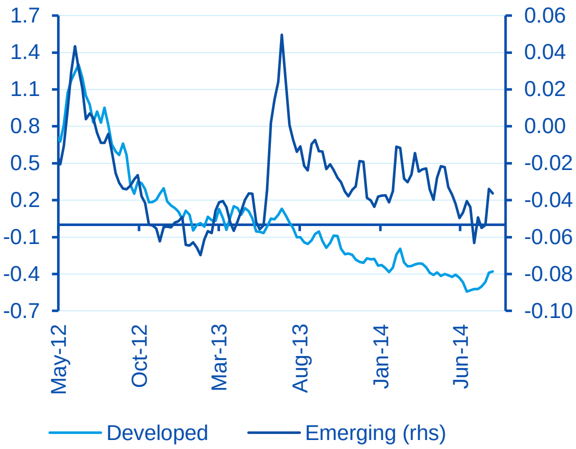
Lastly, we perceive that the main risk is currently domestic: a greater decline in business confidence causing lower investment to exacerbate the cyclical adjustment of the economy. Our growth forecast includes an improvement in activity from the third quarter of the year. Mining will recover and the recently-announced government measures will encourage public and private spending. However, if the rebound takes too long or is too weak, business confidence might display a certain sensitivity and ultimately affect investment decisions. The cyclical adjustment of activity would thus intensify. In this scenario, we would expect further fiscal and monetary stimulus.

2 Global scenario: a slower global recovery in a complex environment

Low financial tensions, dominated by the Fed, support a scenario favourable to growth

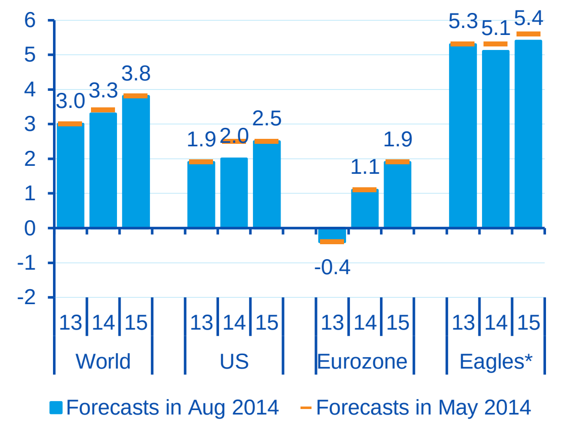
The global leading indicators are consistent with a favourable scenario for growth. First, tensions in financial markets remain low, according to our indicators, in both emerging and developed markets (Figure 2.1) – the recent uptick is due specifically to Russia. Second, industrial activity and global trade are keeping up a good momentum. All of this is taking place in a global environment in which geopolitical risk events, while not causing outright disruption to economic activity, are cropping up everywhere, and as such increasing uncertainty. For the moment, financial volatility is at historically low levels, since the factor dominating the behaviour of global financial markets is the Fed, and this institution is carefully managing a very gradual exit from the exceptional monetary measures implemented in the last few years.

Figure 2.1
BBVA Research's Financial Stress Index



Source: BBVA Research

Figure 2.2
GDP growth forecasts (%)



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

In China, the risk of a hard landing is receding and growth will remain above 7%

The risk of a hard landing in China, predicted by some a few months ago, is receding, thanks to the improvement in exports and in fiscal and monetary support measures. Increased external demand and the brake put on the appreciation of the yuan have helped exports to recover, while monetary policy has been relaxed by cutting the bank reserve ratios, thus favouring credit. Shadow banking controls and plans to liberalise the more regulated part of the banking sector are enabling most of this new financing to be provided by the latter segment. This combination of supervisory measures and simultaneous liberalisation to help traditional banking entities compete (freedom to set interest rates, easing the entry of private investment, promoting lending to private companies over those in the public sector) should enable the deleveraging process to take place in an orderly manner, without any sharp corrections. Finally, more focused fiscal policy measures than on other occasions have also been introduced, above all in relation to the increase in infrastructure spending.

All in all, our outlook is for a very controlled deceleration, with growth easing to 7% in 2015, from 7.7% in 2013. Furthermore, this movement is linked to a long-term trend of an increase in household consumption over business investment, while at the same time the Chinese currency returns to its previous appreciation trend against the dollar. In short, an economic rebalancing, with a moderate increase in debt, for which the authorities have the room for manoeuvre provided by their high level of reserves and control of their current account, together with high levels of private savings and relatively low public-sector debt.

Transitory hiccup in US growth. The Fed's communication policy will be key in lowering market volatility

The fall in US GDP during the first quarter of 2014 was mainly due to transitory factors, but the intensity of the correction made us revise our growth forecast downward for 2014 from 2.5% to 2% (Figure 2.2). The 2.1% quarterly drop, in annual terms, of US GDP is the sharpest of the historical series in a cyclical growth phase. The most recent information on the situation (Figure 2.3) shows that the US economy has recovered from the intense, but transitory, effect of the bad weather and from the steep fall in the accumulation of stocks.

There is greater uncertainty about the perspective of monetary tightening by the Fed and, in particular, about the global impact this will have on financial markets. The Fed will stop expanding its balance sheet in October, starting a phase in which rates and monetary measures will be determined based on the incoming information about the strength of the economic cycle and the anchoring of inflationary outlooks. In our most likely scenario, the first rise in the Fed funds rate will be in 3Q15, with a bias towards this happening closer to the middle of that year. In this scenario, the US central bank's communication policy on its view of the economic situation will become more important; as such, an increase in global financial market uncertainty is also a possibility.

The outlook in the eurozone is improving thanks to supportive domestic demand policies and progress in banking union

Leading indicators in the eurozone are consistent with a slight recovery in GDP, in line with our forecast of 1.1% for the year as a whole, the first annual growth since 2011. Sustained improvement in access to financial markets, particularly for more stressed economies on the periphery of the eurozone, is the main factor supporting the area's growth, together with the relaxation in public deficit targets in the short term and a more positive external environment. Ultimately, there are essentially two reasons for this virtuous circle. First, the confidence gained as a result of the decisions taken by the euro area authorities to strengthen the single market in the financial sector, and the ECB's reinforcement of monetary policy, which goes beyond what might have been foreseen just a few quarters ago. Second is the anchoring of global financial tensions at minimum levels. In addition, the reforms undertaken in the markets of productive factors in some economies, designed to improve competitiveness, are another positive factor.

All in all, although we are sticking to our growth forecasts of 1.1% in 2014 and 1.9% for 2015 (Figure 2.2), the bias for these is to the upside if the potential impact of the measures announced by the ECB is taken into account. All this does not, however, rule out the existence of risk to the downside which could be triggered by the worsening crisis in Ukraine and the knock-on effects of economic sanctions imposed on Russia, to which the eurozone would be far from immune.

In summary, global growth which will strengthen from the second half of 2014 onwards

In our central scenario, the slowdown in global growth in the first part of 2014 has already ended. The most recent indicators of cyclical confidence and financial volatility are consistent with a gradual improvement, which should enable worldwide growth to reach 3.3% in 2014, 30bp higher than in 2013 (Figure 2.2).

Maintaining favourable global financing conditions and supporting economic demand policies will help growth to accelerate faster in 2015 at rates close to 3.8%, with an increase in the contribution made by the more developed economies, which could gradually start positioning themselves for the withdrawal of the exceptional stimulus of the last few years.

The uncertainty within this baseline scenario continues to the downside because of the re-emergence of geopolitical risks and the doubts about the global impact on capital flows and asset prices caused by the proximity of interest-rate hikes in the US.

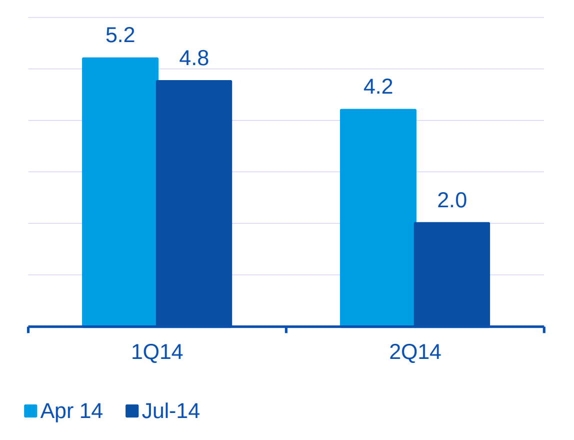
3. Peru: moderate growth in 2014, but outlook more favourable going forward

Supply factors exacerbated the first-half slowdown in spending

Economic activity has slowed so far this year, from 4.8% YoY growth in the first quarter to 2% YoY (estimated) in the second. This is somewhat less than half what we expected three months ago (see Figure 3.1) and would be the lowest quarterly growth rate since 2009, when the Peruvian economy was affected by the global financial crisis.

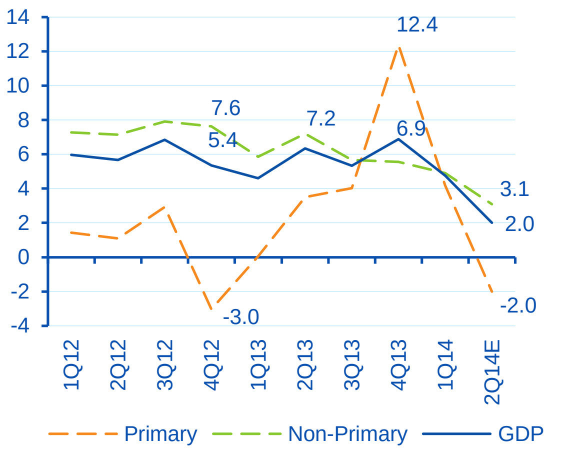
The negative surprise is explained by a series of factors. Firstly, the contraction in the mining sector, which had lower supply due to the execution of maintenance work at the main copper mining unit (Antamina), as well as to the closure of some gold mining units (Pierina) and lower grade ores at some deposits. Negative results were also returned by the construction and non-primary manufacturing sectors, which were already affected by the low momentum of private investment and which, in this quarter, saw the slowdown exacerbated due to lower investment by local/regional governments, which control around 60% of total public-sector investment spending. Furthermore, a moderation in growth was recorded in the sectors most associated with household spending, such as trade and services. Consequently, growth continued slowing in non-primary sectors, those that are more associated with household spending, a trend that at the level of total GDP was heightened by the temporary contraction of the primary sectors (see Figure 3.2).

Figure 3.1
Quarterly GDP: expected and executed (% var. YoY)



Source: CRBP and BBVA Research

Figure 3.2
Quarterly GDP: Primary and non-primary (% var. YoY)

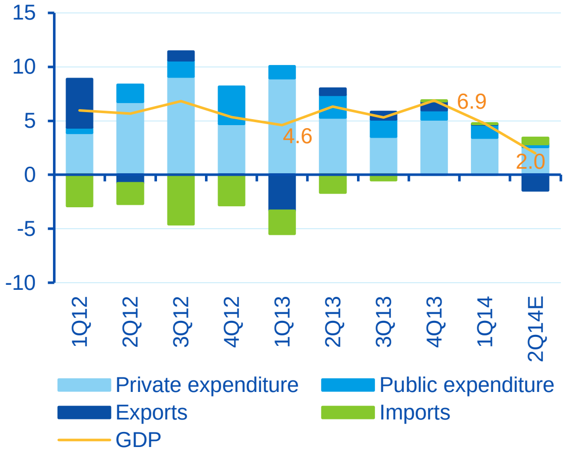


Source: CRBP and BBVA Research

In retrospect, the contribution of domestic demand to GDP growth is the lowest in recent years (see Figure 3.3). To a large extent this is related to the moderation in private spending, but the limited momentum of public spending also played a role. On the private side, investment has been slowing since last year, mainly due to the lower return on mining projects. The latter is the result of the downward trend in the international prices of metals (copper in particular), and rises in the costs of production. These are global trends that have forced mining companies to reconsider their worldwide investment strategies. This in turn has major effects on the local economy, given that about 20% of total investment is directly related to mining, a share which becomes larger when taking into account mining-related sectors, such as construction and services. On the one hand, this reveals that the relationship between global and Peruvian economic performance remains tight; on the other, that if the goal is to maintain the relatively high rates of growth that were recorded over the last decade (above 6% on average), then the reforms to enhance domestic market efficiency with supply-side measures that support potential growth must continue.

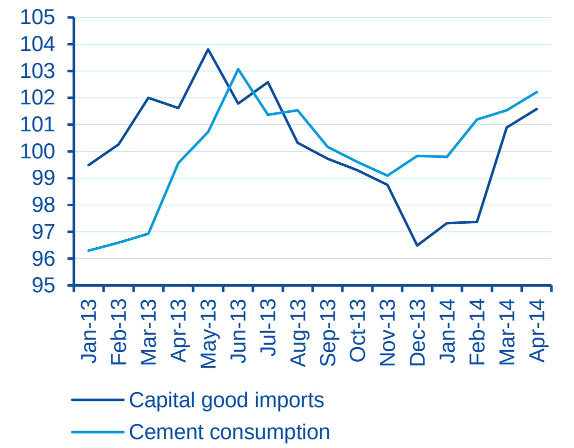
Regarding public spending, the reduced drive displayed so far this year is explained by the freezing injunction of the accounts of some sub-national governments, after their main authorities were placed under investigation for alleged acts of corruption, and by the central government's greater supervision of budget increases. All of this was exacerbated by the decline in exports, in the context of lower mining production.

Figure 3.3
Contribution to GDP growth (% var. YoY and pp)



Source: CRBP and BBVA Research

Figure 3.4
Private investment indicators (3-month moving average, seasonally adjusted index 2013 = 100)



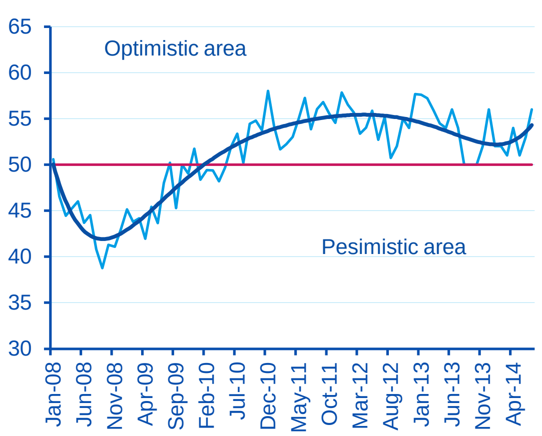
Source: INEI (National Institute of Statistics and Informatics) and BBVA Research

Slowdown has probably bottomed-out, and we expect activity to pick up in the second half

Some factors suggest that private spending components will start showing a more promising performance over the coming months. On the investment side, the seasonally adjusted figures for capital goods imports and cement shipments are progressing favourably (see Figure 3.4) and, in MoM terms, their growth has been positive, as opposed to their activity early this year. This is not yet reflected in YoY growth rates because the basis of comparison (volume for the same month last year) remains high. However, should this trend continue, the results will be better over the coming months. Furthermore, the central bank's recent benchmark rate cut will have an impact on reducing short-term borrowing costs in the corporate sector.

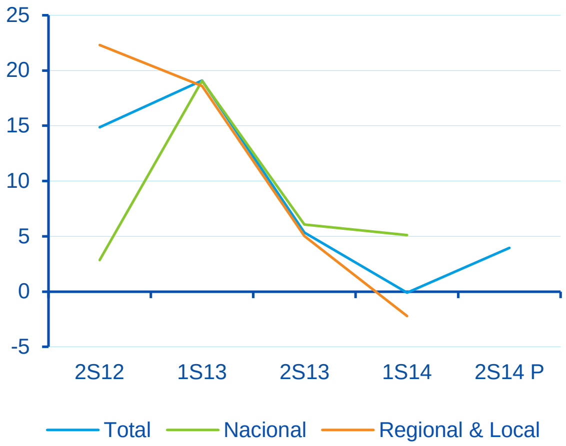
On the consumption side, there has also been an improvement in labour market prints over the last few months, with a pick-up in salaried employment growth (4.6% YoY in 2Q14 vs. -0.2% YoY in 1Q14), as well as in wages (7.1% YoY in 2Q14 vs. 4.9% YoY in 1Q14). This has had a positive impact on consumer confidence, which has podyrf rises over the last two months and has come in at 56 points, nearing four-year highs (see Figure 3.5). Household spending might find additional support in future in the government's recently-announced stimulus package, which includes greater flexibility in the use of CTS accounts (individual accounts that serve as an unemployment fund) and one-off payments for civil servants (bonuses for Independence Holidays). Within this context, we believe that private consumption is perform better over the next few months.

Figure 3.5
Consumer confidence (APOYO index)



Source: APOYO and BBVA Research

Figure 3.6
Public investment: Total and by government level (% var.. YoY)



Source: CRBP, MEF and BBVA Research

We also expect a recovery in public spending, based on two factors. First, the El Niño Effect prevention works are already underway, and will continue over the course of the second half. This project equates to an investment of 0.4% of GDP, 40% of which will be executed this year. Public investment growth would thus once again record positive rates in the second half of the year (see Figure 3.6). Second, the spending package provided by the Emergency Decree N°001-2014 will also be applied over this period, which includes outlays for infrastructure maintenance and purchases of healthcare and education equipment, in addition to higher bonuses for civil servants.

Box 1. Fiscal measures to reactivate the economy

In recent months, the government has adopted diverse measures that support economic activity. The measures target both the short term, acting counter-cyclically in a context in which the Peruvian economy has slowed, and the medium term, encouraging productivity and competitiveness to buttress potential output growth. The fiscal cost of the measures will result in the public accounts posting only a mild surplus in 2014 and a moderate deficit thereafter, notwithstanding which gross public debt will continue to decline mildly over the coming years.

1. Counter-cyclical measures that stimulate demand in the short term:
The short-term measures are temporary in nature, and centre on stimulating demand by raising household consumption and public investment spending:

- Increasing household purchasing power. On the side of public-sector employees, the measures provide for: (i) one-off bonus in July; (ii) payment of labour lawsuit debts; (iii) early application of the already-scheduled pay increases in the compensation of Armed Forces and National Police staff; (iv) pay increases for tenured teachers (education sector); (v) increases in the pensions of widows and retired persons. Furthermore, the unrestricted availability of the deposits made by employers into the Compensation by Length of Service plan (CTS, an unemployment protection scheme) will be increased, starting from four salaries, and including both public-and private-sector employees.
- Raising public spending in investment with the El Niño Effect prevention works.
- Raising public spending on goods and services. Spending is earmarked for education sector infrastructure maintenance and replacement of healthcare facility equipment. Also includes purchases of educational kits, footwear and stoves from MSMEs.
- Facilitate the acquisition of social housing. The public fund used to finance the Family Housing Benefit and Good Payer Benefit will be expanded.

The fiscal cost of these measures is estimated at somewhat more than 1pp of GDP.

2. Measures that foster productivity and competitiveness in the medium term:
The medium-term measures focus on the supply side, and provide for changes in the tax system that reduce transaction costs, cut surcharges faced by companies, simplify paperwork to secure permits and licences and, lastly, drive investment in major sectors by contributing to growth and employment. The main measures include:

- Procedural simplification of environmental studies and permits, inter-sector co-ordination of environmental standards and reduction of environmental and labour fines. Furthermore, the perverse incentives state tax agencies have to apply penalties will be eliminated.
- Changes in the regularisation of the Workplace Safety and Health Law, such that companies face more reasonable costs and the incentives to opt for informality are thus reduced, without this entailing any neglect for worker safety and health.
- Greater competition will be sought in government hiring processes, which will also be speedier.
- Changes will be made to the tax system, seeking to reduce transaction costs. The "retention" rate (amount deducted from purchases toward tax payment) is cut from 12% to 10% for service activities, thus reducing this regime's financial cost to taxpayers. Furthermore, the GST collections regime is amended to include market criteria.
- Also, the term of the GST Tax Refund Regime is extended for large investment projects.
- Higher spending in the education sector. This will give priority to infrastructure, a reappraisal of the teaching profession and an improvement in the quality of student learning. To this end, the 2015 education budget will be increased by PEN4bn, which equates to 0.5pp of output, which means that

total resources earmarked for this sector will rise to 3.5% of GDP.

- Higher spending in the healthcare sector. An infrastructure and equipment investment programme will be executed in the amount of PEN8.4bn through 2016.
- Broadening of social programmes. To be expanded according to target criteria. Moreover, SIS (state healthcare system) coverage will be expanded to include all kindergarten and primary school pupils within the scope of the QaliWarma programme.
- Greater infrastructure concessions. Concession awards for Lima Metro Line 3 are expected to run up to 2016. The third group of airports (Jauja, Huánuco and Jaén) and the Amazon Waterways project will also be awarded.
- Expansion of the Works for Taxes (OxI) investment scheme to include the education, healthcare, agriculture and law enforcement sectors.
- Strengthening of public safety. Over the rest of the year, 30,000 people will join the police force. Co-ordination among state entities will also be boosted to identify and prevent threats to public safety.
- The process of decentralisation will be improved, including a proposal to modify the distribution and use of mining royalties.
- Modernisation of state electrical power companies with an allowance for private capital of up to 20%.
- Implementation of the National Production Diversification Plan. Will favour the expansion of the export basket, simplify procedures with the state and drive productivity.

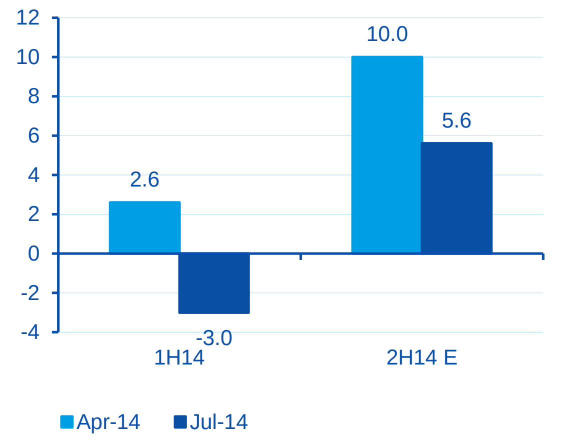
In general, the measures announced over the last months are appropriately oriented. They not only seek to support activity in the short term, moderating the cyclical adjustment of output over the rest of the year, but also underpin the Peruvian economy's potential growth. The biggest challenges Peru has to sustain a considerable pace of expansion in the medium and long term, such as increasing physical and human capital, are precisely some of those on which the measures are centred.

Plus, the rise that will take place in current public spending is to a large extent a pre-application of a previously scheduled increase, which means that the impact on fiscal accounts in this regard will only be temporary. We thus expect the fiscal result to show a mild surplus in 2014 and a mild deficit over the coming years, such that the gross public debt balance will continue to decline slightly going forward.

In summary, our assessment of the announced measures is generally positive. It will be important for the government to ensure that the measures that seek to raise productivity and competitiveness, that is, the potential growth of the Peruvian economy, are driven forward. In this regard, the business environment must be further improved, avoiding duplicate paperwork and reducing its delays and costs. This will require continuing work in conjunction with the private sector, to identify and remove (or prevent the creation of) barriers that hinder investment. The flexibility of the labour market also needs to be improved, as well as facilitating access to markets (both domestic and foreign, in the latter case by making better use of free trade agreements), fostering product and process innovation at companies and expediting work on infrastructure and human capital. Lastly, formal labour must be made appealing, because otherwise companies cannot achieve their full potential and the tax burden is borne by only a few, which damages competitiveness.

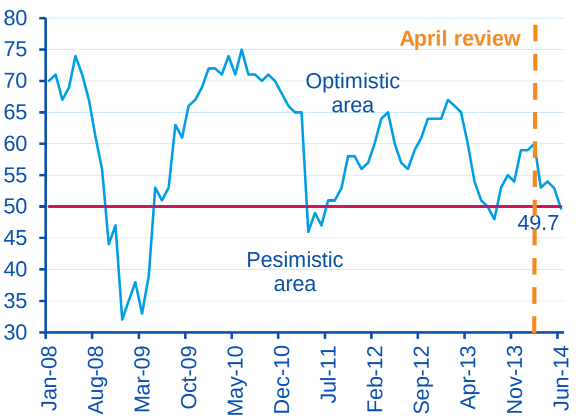
Exports will also receive a greater boost from the support provided by increased momentum in mining. The latter is associated with the Toromocho project starting to operate at full capacity, and the resumption of operations at mines that were partially shut down for maintenance.

Figure 3.7
Exports (% var. YoY, real)



Source: CRBP and BBVA Research

Figure 3.8
Business Confidence (index)



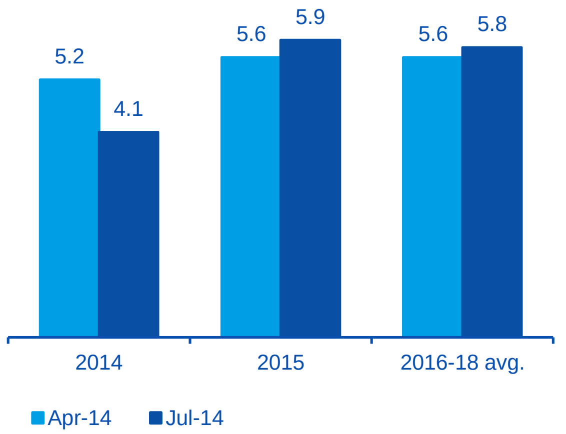
Source: CRBP and BBVA Research

We should note, however, that the second-half bounce-back in output will be moderate. On the side of exports, although they will pick up due to the improvement in mining production, the rise will not be as steep as we expected three months ago (see Figure 3.7). The fact is that the Toromocho delay in starting full production could extend up to the middle of the third quarter (in our previous forecast we believed it would be fully operational at the start of the second half of the year). Plus, some factors that explained the low production in the first half of the year still exist, such as the low grades at some mining units. On the side of investment, business confidence entered into pessimistic territory and may deteriorate further, due to the second quarter's negative surprises in growth (see Figure 3.8). This is consistent with a moderate recovery in private investment. Lastly, some of the factors that have stood as a restriction on the expansion of public investment, such as the freezing of some regional government accounts, will remain.

A downward revision to 2014 growth

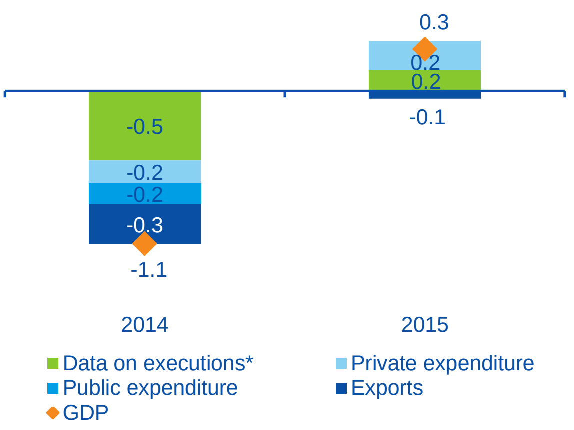
Our growth forecast for this year is 4.1%, lower than we expected three months ago (5.2%) by somewhat over 1pp. Close to half of this revision is explained by the lower momentum we now expect in domestic and foreign spending over the second half (vs. our expectations in April), and the other half, by the negative surprises in growth in the first half of the year, especially in the second quarter (see Figure 3.10).

Figure 3.9
GDP projections (% var. YoY)



Source: BBVA Research

Figure 3.10
Components that explain the changes to projections (pp)

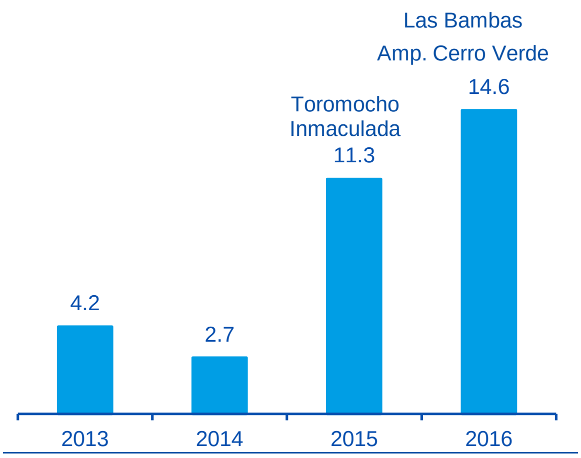


Source: BBVA Research

Output will nevertheless bounce back to rates of close to 6% from 2015

We expect a major bounce-back in economic expansion over the coming years. This is based on two factors. First, the entry of major mining projects into their operational phases. Toromocho's start-up will soon be followed by that of Inmaculada (gold and silver) and Constancia (copper), then Las Bambas, and in 2016, by the expansions of Cerro Verde and Toromocho (both copper). Figure 3.11 shows these projects according to their greater impact on the mining growth rate. Thus, although Toromocho will start its full operating capacity phase in August 2014, only in 2015 will it have completed a year of mining at regular levels. Therefore, its impact on the mining growth rate will be higher next year, accounting for close to three quarters of the estimated growth rate for the sector in 2015. On the same basis, the production of Las Bambas and the expansion of Cerro Verde and Constancia account for more than 90% of the sector's growth in 2016. With these projects, we expect copper production to virtually double toward 2017 with respect to last year's production. The second factor that underlies our more promising projections for GDP growth from 2015 forward is the construction of major infrastructure projects (see Table 3.1). So far this year, ProInversión has displayed a positive momentum in the concession of investment projects, and has completed tenders in an amount of almost USD16.6bn, featuring the South Peruvian Gas Pipeline for USD7.3bn and Lima Metro Line 2 for USD5.7bn. This is in addition to the announcement by PetroPerú (state oil company) of the modernisation of the Talara Refinery, a project entailing an investment of USD3.5bn.

Figure 3.11
Mining (% var. YoY)



Source: BBVA Research

Table 3.1
Main infrastructure projects

Project*	**Investment (USDmn)****
Peru South pipeline	7,300
Lima metro, line 2	5,658
Modernisation of Talara refinery	3,500
Southern Energy Hub	826
Chinchero airport	776
LT Moyobamba-Iquitos	686
Sierra extension - tranche 2	651
LT Mantaro-Montalvo	388
LT Machupicchu-Tintaya	159
Total	**19,944**

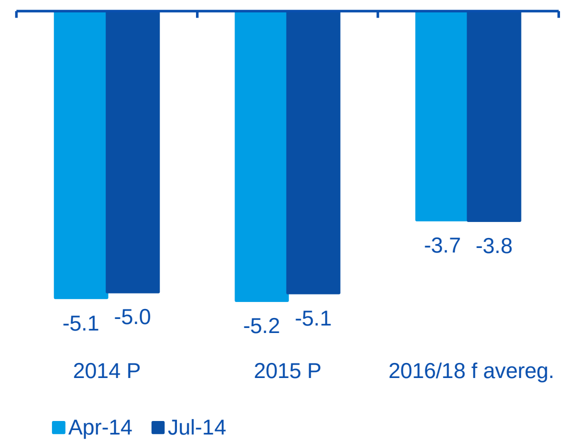
* Projects tendered by Proinversión, apart from the Talara refinery, which will be managed by Petro Perú.
* Sums are for each project's execution period. IGV included.
Source: BBVA Research

In this context, we expect infrastructure investment to experience a boom over the next five years, which is relevant to the local economy for two reasons. First and in the medium term, it will make up for the expected decline in mining investment and, therefore, private capital spending will be able to sustain positive rates of expansion and keeping total investment at a level above 27% of GDP. This will continue providing support to a trend in excess of 5% growth a year. Second, this investment will contribute to the goal of closing the country's infrastructure gap, estimated at USD88bn (in accordance with the 2012-2021 National Infrastructure Plan proposed by AFIN). This will consequently tackle one of the structural weaknesses that has plagued the Peruvian economy, as evidenced by its rank at 91 (of 148 countries) in terms of infrastructure in the World Economic Forum's Global Competitiveness Index 2013–2014. These works will enable Peru to rectify this weakness, at least partially, by offering improved interconnectivity (between Peru and the world and between the country's different regions), facilitating the creation of value chains and complementarity among the diverse economic activities. All of the above leads us to believe that this infrastructure investment boom will drive productivity and potential growth in the medium and long term.

The external gap will remain the main macroeconomic vulnerability factor

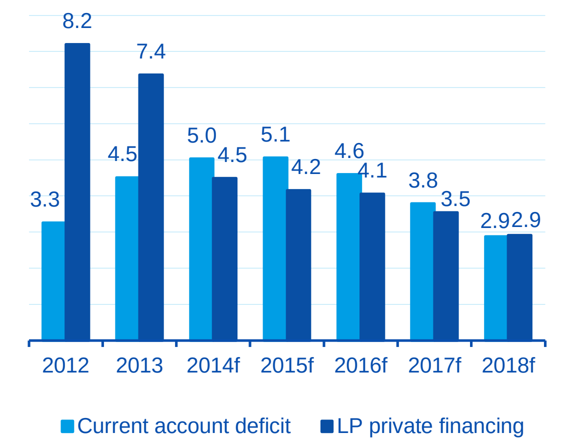
We stand by our estimates of a deficit in the current account of the balance of payments of around 5% of GDP this year and next (see Figure 3.12). We revised our April forecast for the price of copper to the upside, which implies a slower decline toward its long-term level. In 2014, this will be offset by lower exported volumes, given Toromocho's delay in starting to work at full capacity. We also believe oil will trade at higher levels, closer to USD110 (for Brent) than USD105 (our previous forecast), as a result of geopolitical tensions in the Middle East. This adds pressure to the foreign deficit and, in 2015, offsets the higher copper prices.

Figure 3.12
Current account (% GDP)



Source: BBVA Research

Figure 3.13
Current account deficit and long-term private financing (% GDP)



Source: CRBP, BBVA Research

Although the estimated level of the external gap is relatively high and implies a vulnerability factor in the event of a potential global credit crunch, there are two items that mitigate these concerns. First, the gap will gradually narrow mainly due to the rise in exports entailed by the commissioning of the new mining projects. Second, the deficit will remain financed by long-term capital, although to a lesser degree than in the past (see Figure 3.13). This is related to lower FDI inflows into mining, in a context in which large mining corporations are cutting back on spending in new projects to focus more on expansions, due to the lower risk entailed.

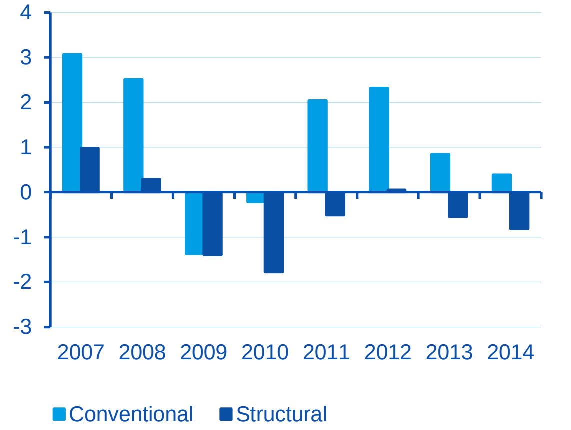
The fiscal result will show a slight deficit over the coming years, and the declining trend in public debt will continue

We expect the fiscal accounts to record a slight surplus of 0.4% of GDP in 2014. This forecast includes non-recurrent payments revenues from the share sales of two non-resident companies, which generated capital gains. The impact of this non-recurrent revenue is estimated at around 0.4% of GDP.

On the expenditures side, we expect a recovery in the second half of the year, led by the national government's public investment spending (factors in the execution of spending on prevention works for the El Niño Effect) and higher current spending due to the compensation increase for Armed Forces staff and tenured teachers, increases in pensions, a one-off bonus for civil servants, and expenditure earmarked for education sector infrastructure maintenance and replacement of equipment at healthcare facilities (see Box 1).

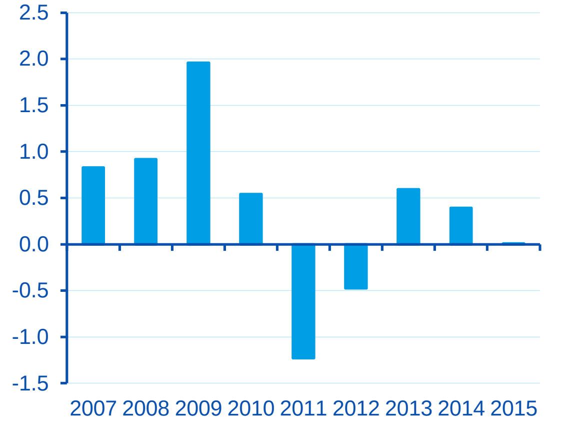
In structural terms, this result will lead to a moderate deficit in 2014, while the fiscal position will be expansionary, which is reasonable in a scenario that seeks to mitigate a slowdown in activity.

Figure 3.14
Conventional and structural economic result (% of GDP)



Source: BBVA Research

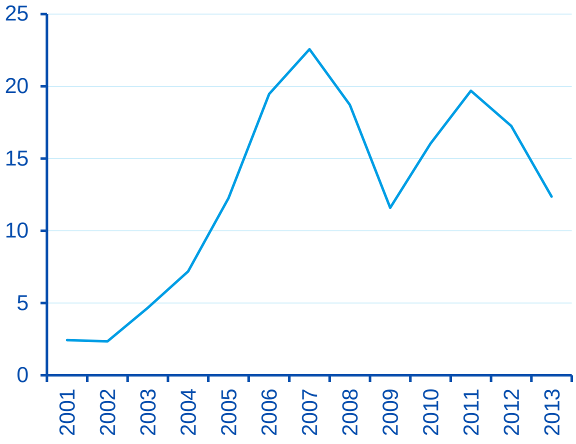
Figure 3.15
Fiscal boost (% of GDP)



Source: BBVA Research

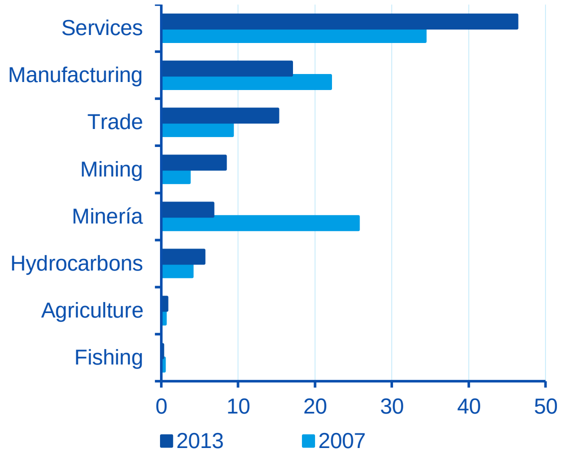
We continue to expect moderate fiscal deficits in future, but not exceeding 0.3% of GDP within the forecasting horizon. It is important to note that over the last few years the reliance on revenues from natural resources (mining and fossil fuels) has dropped. In 2013, revenues from this sector accounted for 12.0% of total fiscal revenues, lower than the figure for 2007 (22.6%), which limits the impact of the lower metal prices expected in the future on revenues, and raises the importance of non-primary activity sectors in revenue collection.

Figure 3.16
Mining and fossil fuel sectors as % fiscal revenues



Source: SUNAT (National Superintendence of Customs and Tax Administration) and BBVA Research

Figure 3.17
Share of tax revenues by economic sector (%)

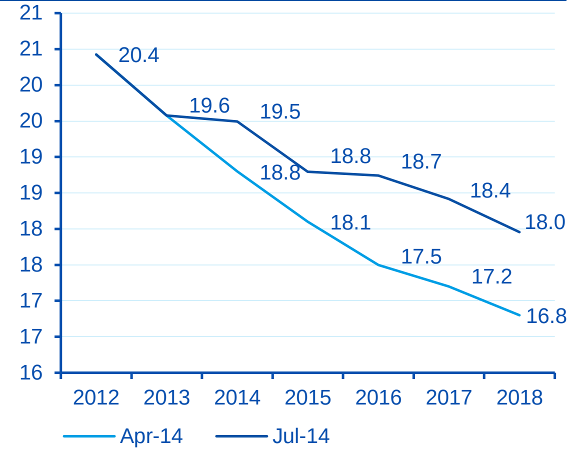


Source: SUNAT and BBVA Research

We expect the public debt ratio to decline over the coming years

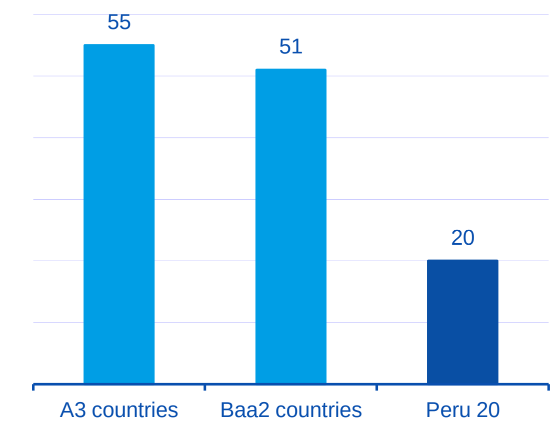
Toward 2018, gross public debt will account for around 18% of GDP, somewhat over 1.5pp less than where it currently stands. The decline in this ratio would be less steep than expected three months ago (Peru Economic Outlook for May), given that we are including the public borrowing operations to finance the large infrastructure projects. It is important to note that in July, Moody's upgraded Peru's credit rating by two notches to A3, making it one of the region's three best-rated economies (together with Chile and Mexico). The following are the main factors behind the upgrade: (i) greater strengthening of government balances and fiscal framework (which entails a high ability to pay); (ii) a sustained drive of structural reforms to increase the country's growth potential and deal with structural limitations; and (iii) the expectation that economic activity will pick up toward 2016. It is important to note that Peru's debt ratio is lower than that of countries with a similar credit rating.

Figure 3.18
Gross public debt ratio
(% of GDP)



Source: CRBP and BBVA Research

Figure 3.19
Public debt ratio by Moody's rating category
(% of GDP)



Source: Bloomberg

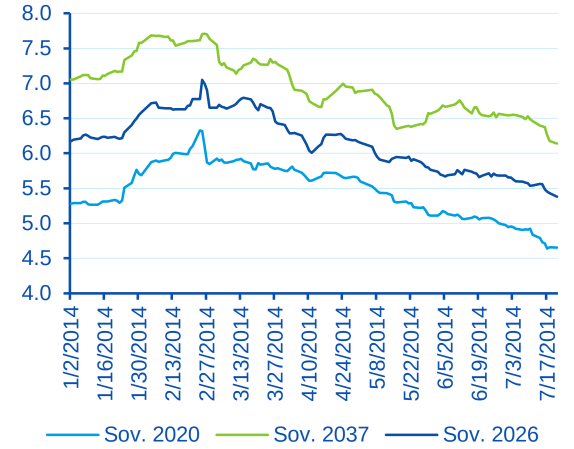
4. Local financial markets reveal a recovery

Sovereign bond yields drop

Since March, the yields demanded on Peruvian sovereign bonds have trended downward. The decline was around 50bp at the shorter end of the curve (2015 and 2017 bonds) and more than 100bp over the rest (see Figure 4.1). This behaviour was not only seen in Peruvian sovereign yields. Other bond markets, including Colombia's and Chile's, also displayed falling yields (see Figure 4.2), though to a lesser extent than in Peru. One factor that may have affected this differentiation is Moody's upgrade of Peru's credit rating at the close of June, from Baa2 to A3. The market's reaction was as expected: the country risk dropped by 8bp in the days after the announcement, thus ending up below Colombia's, while on 2 July the default risk premium (CDS) reached its lowest historical level since July 2007.

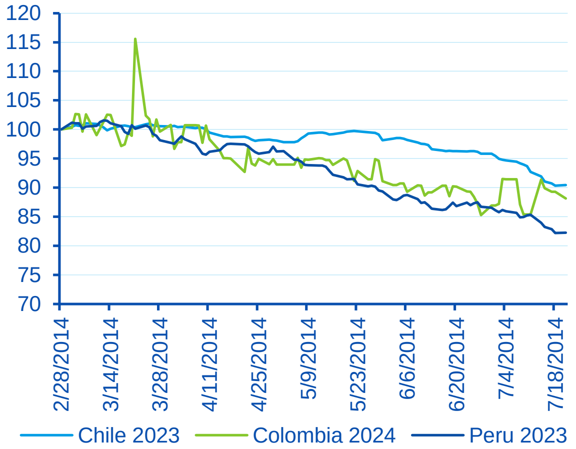
Other factors behind this downward trend in sovereign bond yields are the lower risks faced by emerging economies, as fears fade over a hard landing of the Chinese economy, which is reacting positively to the measures announced by the government over the course of the year, as well as expectations that the Federal Reserve will keep interest rates at historically low levels for an extended period. We should add that the yields on Peruvian bonds dropped even though non-resident sovereign bond holdings fell to PEN15,489 in June (vs. PEN16,327 in March), now accounting for 44% of the total balance. Local financial institutions made up for the drop in non-resident holdings.

Figure 4.1
Peru sovereign bond yields (%)



Source: Bloomberg

Figure 4.2
Sovereign bond yields (%)



Source: Bloomberg

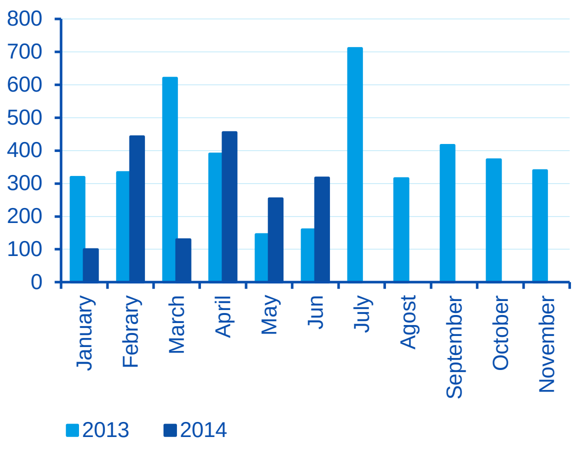
Within this favourable environment, the Ministry of Economy and Finance (MEF) issued a new 40-year sovereign bond (maturing in 2055). Demand for the new 2055 bond was PEN208mn, almost seven times the initial offering amount (PEN30mn), of which PEN137mn were placed at a weighted average yield of 6.71%. The rate obtained came in below the estimated levels for this new benchmark. With this issue, the maximum length of the yield curve in PEN is extended from 27.5 to 40 years, making Peru the Latin American country with the longest-maturity bond issue in domestic currency.

Corporate bond issues recover in the second quarter

Over the second quarter of the year, corporate debt issues in the domestic market began to reactivate, exceeding the placements for the same period last year by 47%. This makes up for the poor momentum recorded over the first three months of the year, in which the pace of placements slowed as a result of lower funding needs in a context of slower GDP growth (see Figure 4.3). Although the financial sector conducted most of the debt issues, non-financial companies also increased the pace of their placements. In this regard, Cineplex, Edelnor and Luz del Sur placed amounts of around PEN100mn with maturities of 7 to 10 years and rates of 6% to 8%, while Los Portales and Jaime Rojas Representaciones Generales conducted dollar-denominated issues for USD5mn and USD1mn, respectively.

Furthermore, the scenario of low interest rates in the international markets and the improved perception of Peru and Peruvian companies from abroad, have encouraged some entities to seek financing in foreign markets. Bond issues in the international market YtD equate to 64% of total placements in 2013, totalling USD4.081bn through 8 July, with the placement of USD600mn made by COFIDE. In addition to financial sector companies, to be noted is the case of InRetail Shopping Mall, which on 1 July placed USD350mn at 7 years with a rate of 6.5%, and a demand that reached USD4bn. The proceeds will be used to continue shopping centre expansion plans, and to redeem bonds it issued in 2011. Other companies that also obtained resources from abroad include Banco de Crédito, Compañía Minera Ares, Minsur, Camposol, Rutas de Lima and Fondo MiVivienda (see Table 4.1).

Figure 4.3
Domestic market debt issues (USD mn)



Source: SMV (securities market regulator)

Table 4.1
International market debt issues (USD mn)

Company	Amount (USDmn)	Time (yrs)	Rate
Compañía minera Ares	350	7	7.75%
Banco de Crédito	200	13	6.13%
Minsur	450	10	6.25%
Interbank	300	15	6.63%
Fondo MiVivienda	300	5	3.38%
Abengoa Transmisión Sur	432	29	6.88%
Camposol	75	3	9.88%
Fondo MiVivienda 1/	279	4	1.25%
Rutas de Lima 2/	370	22	8.38%
Rutas de Lima 3/	150	25	5.25%
Banco de Crédito	225	4	2.75%
InRetail Shopping Mall	350	7	6.50%
COFIDE	300	5	3.25%
COFIDE	300	15	5.25%

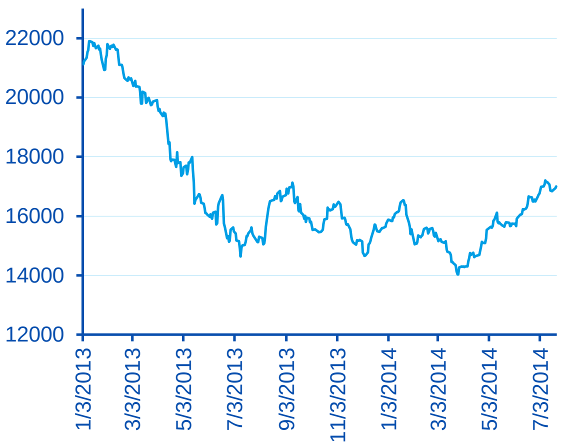
1/ Issue in Swiss francs; 2/ Issue in PEN; 3/ Issue in VAC sol
Source: CRBP

Peruvian equity market favoured by improved stock prices of mining sector companies

From the close of the first quarter of 2014 to the last week of July, the General Index of the Lima Stock Exchange (IGBVL) recorded a growth of 18.9%, with a cumulative rise of 7.9% so far this year (see Figure 4.4). The mining sector registered the highest growth, accumulating a variation of 30.5%, followed by the banking sector with 16.4% (see Figure 4.5). Featured companies include Atacocha, Rio Alto, Milpo, Minsur, Credicorp and Banco Continental. On the negative side, the shares of industrial sector companies recorded a cumulative loss of 15.9% from January to July, affected by the lower momentum seen in economic activity.

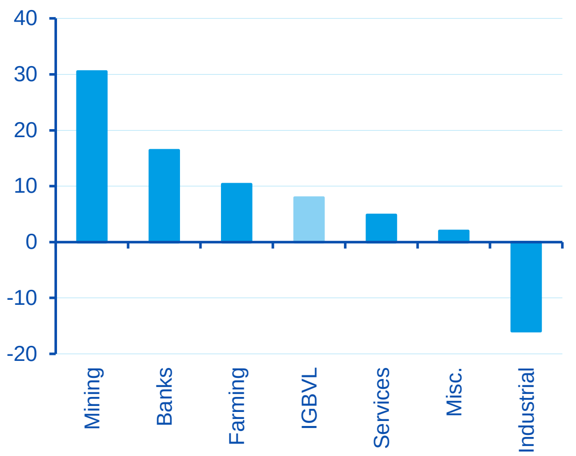
The main factors underlying the recovery in the IGBVL were the measures to reactivate the Peruvian economy announced by the MEF on 12 June, the recovery in economic activity in China, which favoured copper prices, as well as the Fed's commitment to keep rates low for an extended period and the optimistic tone over the recovery of the US economy.

Figure 4.4
Lima Stock Exchange General Index



Source: Bloomberg

Figure 4.5
Cumulative returns of sector indices YtD, at 22 July (%)



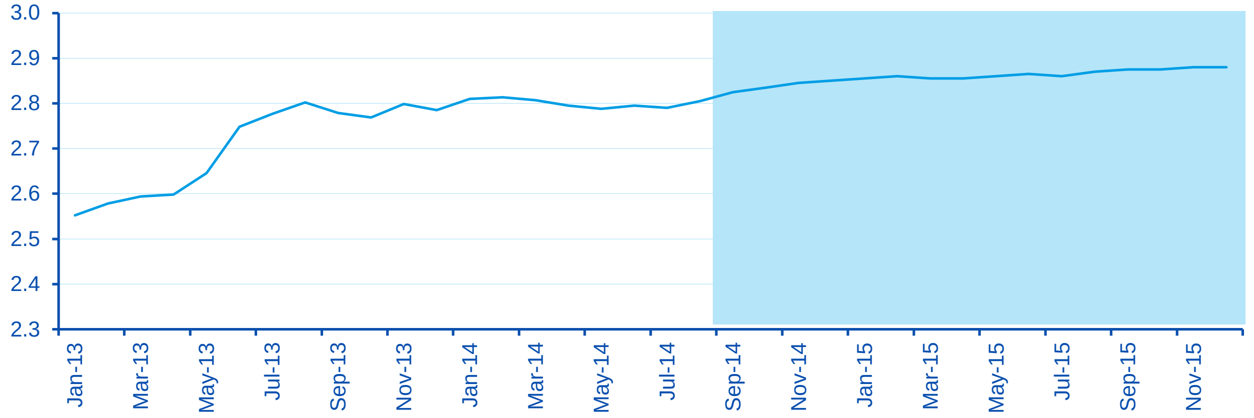
Source: BVL (Lima Stock Exchange)

Stable exchange rate in the short term, but we still see upward pressures going forward

The PEN mildly strengthened over the last few months. USDPEN fell 0.8% between the close of March and July, accumulating a variation of -1.4% since reaching its high for the year in February (see Figure 4.6). The relative stability of the currency, favoured by NDFs that matured with no rollovers and higher seasonal demand in July, led the central bank to have virtually no need to intervene directly in the currency market by buying or selling USD, in contrast to what we saw over the first two months of the year.

We stand by our exchange rate forecast of USDPEN 2.85 toward the close of the year. We also expect that this variable will tend to stabilised toward 2016 at around USDPEN 2.90, a level consistent with a narrowing of the negative external gap over the next years. The weakening of the PEN will take place in a context of: (i) a certain deterioration of the fundamentals: lower terms of trade, high current account deficit (which we estimate at 5% of GDP for 2014 and 2015), decline in the fiscal result and a somewhat more expansionary monetary policy; (ii) lower long-term capital inflows, in particular, on the side of foreign direct investment (especially in mining); and (iii) a normalisation of Fed monetary policy, which will strengthen the USD globally. The central bank has ample resources that will enable it to remain active in the currency market, to smooth the transition toward a more depreciated currency. In this regard, international reserves stand at 32% of GDP (similar to the calculated optimum level) and cover short-term foreign liabilities by a factor of at least seven. Here we must note the desirability of higher currency flexibility as a mechanism to buffer external shocks and to correct the current account deficit. Lastly, we do not rule out that at times there could be bouts of high currency volatility associated with factors such as the process of monetary normalisation in the United States.

Figure 4.6
USDPEN

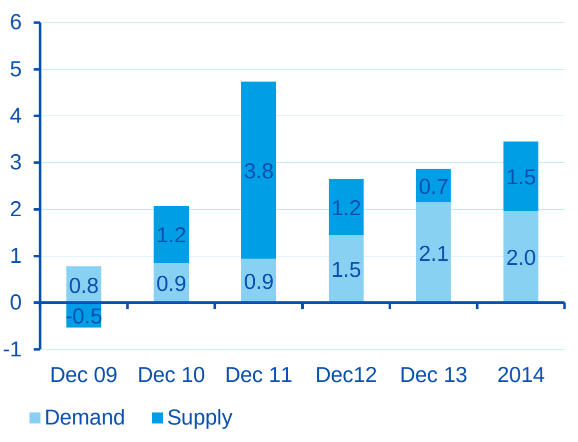


Source: CRBP, BBVA Research

5 Peru: Inflation remains a thorny problem for the central bank

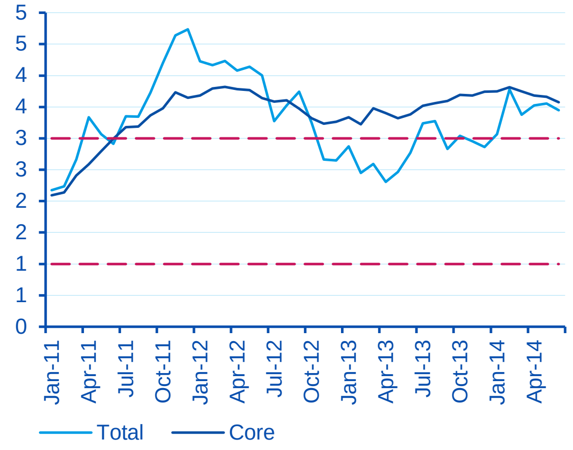
Inflation came in at 3.4% YoY as at the first half of the year, above the high end of the central bank's target range. This was partially associated with supply factors that raised the prices of food, fuel and transportation, which together contributed 1.5pp to inflation. However, categories whose prices are usually related to demand factors (such as services, textiles and other industrial products) on the whole provided a contribution of close to 2.0pp, which explains most of the rise (close to 60%) in the CPI over the last 12 months (as at June).

Figure 5.1
Contribution of supply and demand factors to inflation (%)



Source: CRBP, BBVA Research.

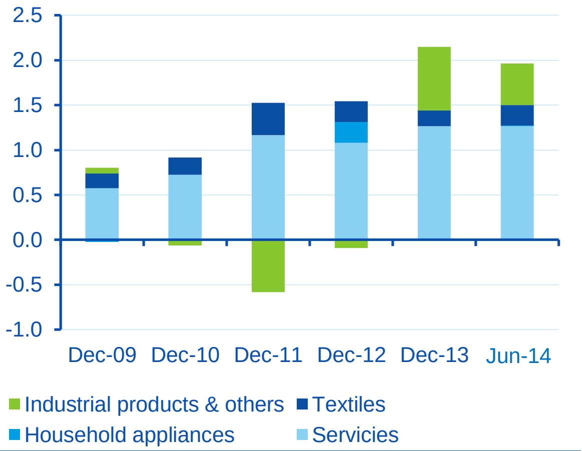
Figure 5.2
YoY inflation (%)



Source: CRBP, BBVA Research.

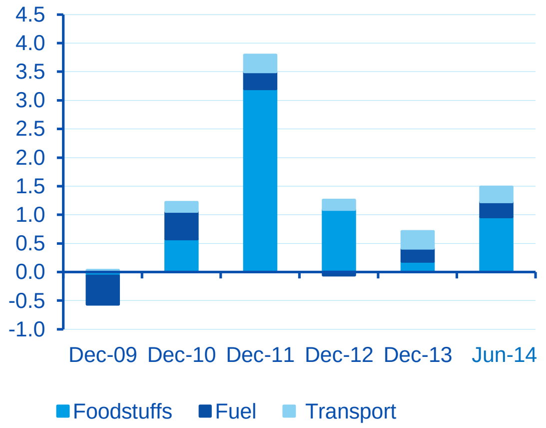
Note also the performance of inflation in the services category. Some of its components, such as food eaten outside the home and healthcare recorded rises of over 5.0% as of the first half of the year, while the increase in education was more than 4.0%. The higher demand for services, in a context of rises in household income and a swelling middle class, as well as delays in expanding supply, are behind the upward pressures on prices in this category. In other words, there are changes to relative prices (a key variable in resource allocation), which raises the question of whether the central bank should react, or temporarily accept higher inflation to facilitate the adjustment.

Figure 5.3
Contribution of demand factors to inflation (%)



Source: BBVA Research

Figure 5.4
Contribution of supply factors to inflation (%)



Source: BBVA Research

For their part, other inflation trend indicators also came in around, or above, the high end of the target range. This is the case of core inflation, which has remained above 3.0% for 37 consecutive months. This performance reflects the existence of demand pressures on the prices of some services, which is consistent with our forecast of a top-down convergence of GDP toward its potential level.

It is important to note that the contribution of demand factors to inflation has remained unchanged for one year, with a contribution of 2pp. Meanwhile, the participation of supply factors has risen considerably so far this year. This has contributed to a pick-up in inflation in 2014 (see Figure 5.4).

It is also interesting to mention that we have not found major evidence of any significant pass-through (effect of exchange rate pass-through to prices). The direct impact seems to be limited. When analysing the annual exchange rate variation as at May 2014 (this month was taken due to the considerable spike in the exchange rate seen in May 2013) and the shopping basket categories that tend to be more susceptible to currency movements, we find that the depreciation recorded over that period does not appear to have had a significant impact on the inflation of household appliances and home rentals. In the case of imported inflation, the rise would be affected by the increase in fuel prices, and to a scarce degree by an exchange rate effect (see Figure 5.5). The impact of the exchange rate on prices might have been mitigated by the situation of economic slowdown, which inhibited the pass-through (asymmetric pass-through from the business cycle).

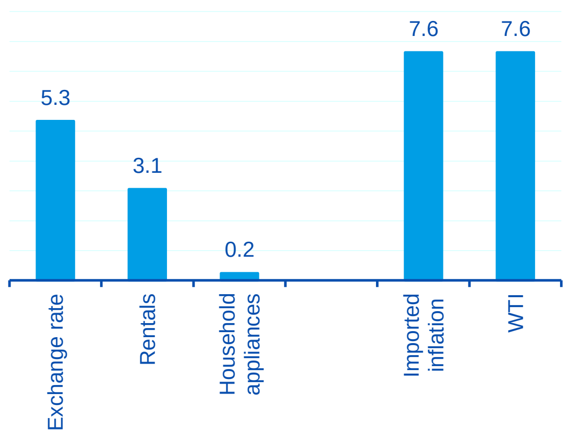
Lastly, inflation expectations have remained near the high end of the target range for over a year. This suggests that inflation has become more inertial. Thus, in an environment with greater inflation expectations, inflation could be higher in the absence of demand pressures and supply shocks.

Table 5.1
Diverse inflation measures (% YoY)

Inflación	Dec-12	Dec-13	Jun-14
Total	2.6	2.9	3.4
Core	3.3	3.7	3.6
Excl. food & energy	1.9	3.0	2.8
of non-tradables	3.2	3.1	3.7
of non-tradables excl. Foodstuffs	2.0	3.4	3.4
expectations for 2014	2.6	2.8	3.0
expectations for 2015	2.6 *	2.7	2.8

* Figure from Feb 13
Source: CRBP, BBVA Research

Figure 5.5
Inflation between May 2013 and May 2014 (%)

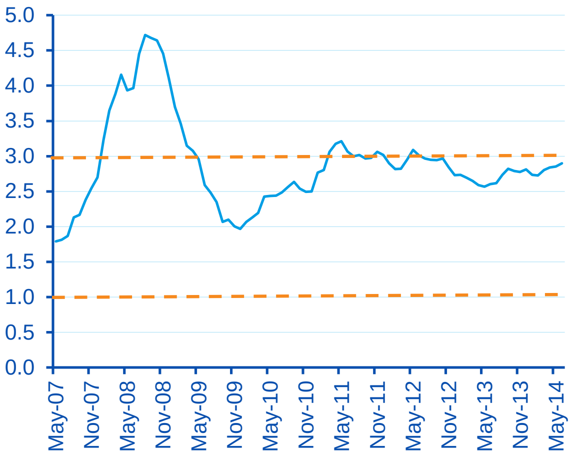


Source: CRBP, BBVA Research

We expect inflation to fall back within the target range in 2015

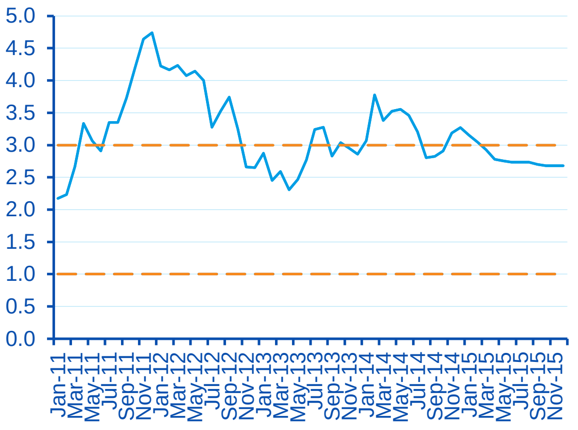
Over the next months, the slowdown in the economy and the reversal of the supply shocks that affected the prices of food and fuels will lead prices to trend to the downside. Nevertheless, the convergence of inflation back within the target range will be slow, due to the deterioration of inflation expectations. We see the following risk factors: (i) geopolitical tensions in the Middle East, especially in Iraq, which could lead to a rise in the international oil price, with a potential upward impact on domestic inflation; and (ii) an El Niño Effect that would affect domestic supply of some agricultural products.

Figure 5.6
Inflation expectations at one year (%)



Source: CRBP, BBVA Research

Figure 5.7
YoY inflation (%)



Source: CRBP, BBVA Research

6 Central bank prioritises the stabilising role of monetary policy

The benchmark interest rate was cut by 25bp in July, in a context of slowing growth but also of macroeconomic imbalances

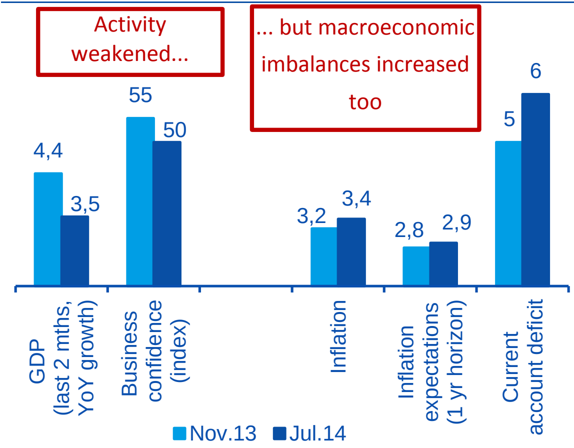
At its last meeting, prior to the close of this issue, the Board of Governors of the Central Reserve Bank of Peru (CRBP) cut the monetary policy rate from 4.0% to 3.75%. This easing goes together with the effort being made on the fiscal side, through measures intended to encourage private spending, facilitate or bring forward public sector spending, and provide support to business confidence.

The benchmark rate cut took place in a complicated context. While on the one hand economic growth slowed more than expected, which would support the cut, on the other, inflation remains above the target and the deficit in the current account of the balance of payments remains high. Faced with this dilemma, the CRBP chose to prioritise the stabilising role of monetary policy, as it has on previous occasions.

The last time the central bank cut the benchmark rate prior to July was in November 2013 (by 25bp, to 4.0%). At that time, economic activity growth had been surprising to the downside with growth below 4.5%, while inflation was above the high end of the target range (3.2%) and the deficit in the current account of the balance of payments was somewhat greater than 5.0% of GDP. In other words, there was low momentum in activity but also certain macroeconomic imbalances. The decision that was made on that occasion prioritised the former.

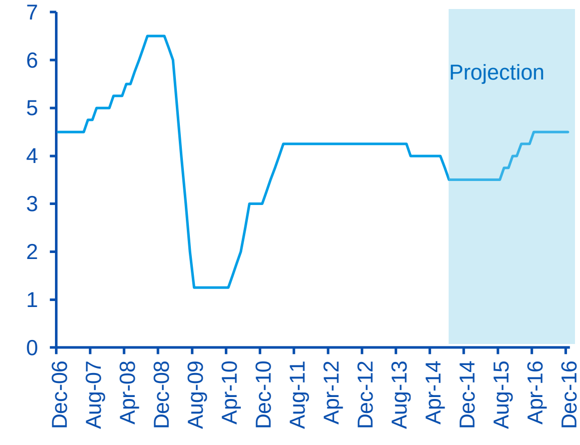
The decision in July was even more complicated: the slowdown had intensified, but so had the macroeconomic imbalances (see Figure 6.1). On the one hand, the weakness in GDP at the end of the first quarter and start of the second was surprising, suggesting a rise in activity of around 3.5%. Furthermore, the available indicators for the rest of the second quarter pointed to a continuation of the slowdown. This context suggested a cut in the policy rate, especially if the negative surprise had a downside impact on business expectations, a factor that was already starting to manifest (entering into pessimistic territory in June) and which could exacerbate the economic slowdown. On the other hand, however, since the start of the year inflation had remained above the target range and inflationary expectations had risen toward the high end (at 2.9% one year out), and the last reading of the current account of the balance of payments revealed that the deficit had risen to 6.0% of GDP at the start of the year. The central bank once again chose to cut the benchmark rate, prioritising the provision of some type of support to activity.

Figure 6.1
Economic scenario during the last two MPR cuts (%)



Source: CRBP, BBVA Research

Figure 6.2
MPR (%)



Source: CRBP, BBVA Research

This reveals that the stabilising role of monetary policy now seems to have greater weight in CRBP decisions than in the past. We assessed this assumption empirically and the data would appear to confirm it. Although the inflation deviation (expected by the market consensus) with respect to the target is still the main determinant in benchmark interest rate decisions, the analysis suggests that the focus on this variable has fallen to a certain extent over the last year, and that the output gap has become more important (see Box 2).

Box 2. Estimating the central bank's reaction functions

Over the last months, the CRBP has been in a quandary regarding monetary policy management. On one hand, above-target inflation and a relatively high foreign deficit suggest that the time is not right to cut the benchmark rate. On the other, a greater than expected economic slowdown opens the door to monetary easing. In this context, the CRBP cut its benchmark rate in July, choosing to provide greater support to economic activity. There are good reasons for this decision. First and looking forward, if activity is slowing the potential demand pressures on prices will recede and inflation will fall back within the target range. Plus, monetary stimulus was limited and could be construed as a sign that seeks to provide support to business confidence and investment, and thus prevent higher output volatility. This context gives rise to the following questions. What underlies the CRBP's recent policy rate cuts? Are the cuts associated with a sharper-than-expected adjustment in the business cycle, or are they a structural change in the central bank's reaction function?

Estimation

To find an answer to these questions we estimated reaction functions for the CRBP. Following Clarida et al. (1998)[1], we considered the following model:

$$\begin{aligned} I_t = (1-\rho)(\alpha) + (1-\rho)\beta(E[\pi_{t+n} - \pi^*{}_{t+n}]) \\ + (1-\rho)\gamma(E[y_{t+k} - y^*{}_{t+k}] \\ + \rho(I_{t-1}) + v_t \end{aligned}$$

Where: I_t is the monetary policy rate, α represents the long-term nominal equilibrium interest rate, π_t indicates inflation, $\pi^*{}_t$ the inflation target, y_t the GDP growth rate and $y^*{}_t$ potential GDP and $E[.]$ denotes the expected value operator, ρ the gradualness with which interest rates are adjusted and v_t captures the stochastic.

[1]Clarida R. J. Gali. M. Gertler. 1998. "Monetary Policy Rules in Practice. Some International Evidence." European Economic Review, 42.
Salas, J. 2010 "Bayesian Estimation of a Simple Macroeconomic Model for a Small Open and Partially Dollarized Economy." Central Reserve of Peru Working Paper, N° 2010-2007.
Selected Issues Paper Peru. January 2014. International Monetary Fund.

The estimation was conducted with the Generalized Method of Moments (GMM), which enables dealing with the problem of endogeneity, and allows obtaining consistent estimators by using instrumental variables.

We estimated different specifications of the above-mentioned base model and took the best result. This is the one that considers, within the reaction function, the lag in the monetary policy rate, the non-primary GDP gap, the expected inflation gap one year out[2], the gap in the Real Bilateral Exchange Rate[3] and, as instrumental variables, the lags in explanatory variables, credit growth and variables related to FED monetary policy. We also considered the period of the global financial crisis as a dummy variable. The estimated reaction function acceptably replicates the movements of the CRBP's benchmark rate (see Figure R.2.1).

The estimation also reveals that the ratio associated with expected inflation is slightly higher than the output gap. However, if we conduct a recursive estimation, we see that the weighting assigned to deviations of inflation vs. the target declines, while that of output becomes more important (see Figure R.2.2). It is important to note that the regressor ratios are significant at each cutoff of the sampling. We also find that the instruments used are valid.

In accordance with the results, we note that the CRBP would take currency considerations into account in its policy decisions explicitly, and take Fed actions and credit growth (which might reflect macroprudential concerns) into account indirectly.

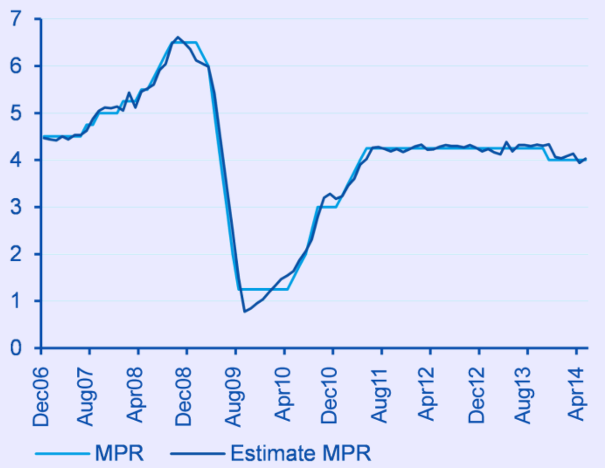
[2]We must note that the model considered the core inflation gap and inflation excluding food and energy, but the regressors are not significant.
[3]The difference in the exchange rate with respect to its long-term level is considered.

Table B.2.1
Estimating of the CRBP's monetary policy reaction function

	Constant (α)	MP rate (-1)	GDP gap	π (+ 12 mths)	RER Gap	J - test *
2004.09 - 2014.05						
Constant	0.14	0.96	**0.04**	**0.06**	0.02	0.96
Statistical T	2.1	64.0	8.4	4.1	5.0	
2004.09 - 2013.05						
Constant	0.22	0.95	**0.04**	**0.08**	0.03	0.92
Statistical T	3.23	64.93	7.15	5.12	6.64	
2004.09 - 2012.05						
Constant	0.21	0.95	**0.04**	**0.08**	0.02	0.97
Statistical T	3.3	71.2	6.5	5.0	4.5	

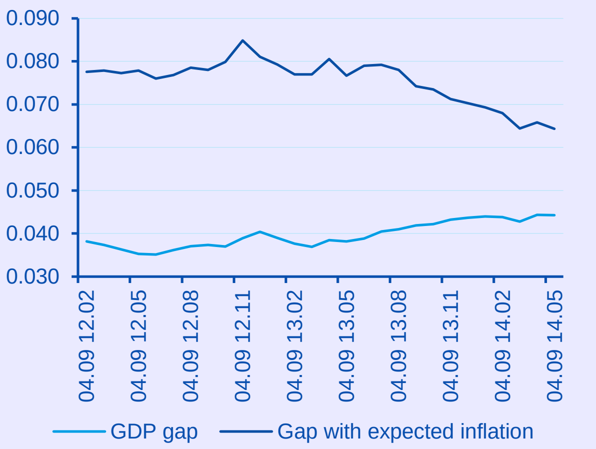
* The null hypothesis which considers the validity of instruments used in the regression is not rejected
Source: BBVA Research

Figure B.2.1
Effective and MPR (%)



Source: BBVA Research

Figure B.2.2
CRBP reaction function ratios: recursive estimation



Source: BBVA Research

In accordance with the results, we note that the CRBP would take currency considerations into account in its policy decisions explicitly, and take Fed actions and credit growth (which might reflect macroprudential concerns) into account indirectly.

Lastly, the results reveal that over the last years the CRBP has given priority to its role in stabilising economic activity. Expected inflation has thus lost weight in monetary policy decisions, with a greater role played by the position of the GDP cycle.

There are arguments to support a somewhat more active behaviour in the current scenario. The slowdown in activity will reduce demand pressures on prices, and inflation will thus ultimately recede. Plus, monetary stimulus was limited and can be basically construed as a sign that seeks to provide support to business confidence. Increased monetary activism, however, also entails risks, and thus must be applied with great caution. A central bank's main asset is its credibility in keeping prices stable, that is, around the inflation target. Until some time ago, the central bank emphasised that the inflation target was 2%, but as temporary deviations can of course take place, in practical terms it was a thickpoint, a thickpoint that emphasised that 2%. For some time now, however, the emphasis is on a "target range" from 1% to 3%. This may give the impression that the monetary authority has relaxed its objective, and that it feels comfortable with inflation rates that stray from the 2% for relatively lengthy periods (even outside of the range that is now emphasised), if this can somehow provide some support to activity. The last two decisions to cut the policy rate are understood in this context. The risk here is that credibility weakens, thus making it harder for inflation to return to 2% in the medium term, even with a nil output gap and in the absence of supply shocks, something that inflation expectations already seem to be suggesting (coming in at 2.9% one year out, close to the target range ceiling, with those for 2015 and 2016 not that far from it).

We do not rule out a further cut in the benchmark rate in the short term, especially if output remains weak

After the monetary policy meeting in July, economic growth continued surprising to the downside. For example, May GDP growth was 1.8% YoY (consensus: 3.1%). This figure is not only distant from the potential pace of growth, which we estimate between 5.0% and 5.5%, but rather also suggests that the slowdown accelerated. April had two fewer business days (in YoY terms), which partially explains the low growth for that month (2.0%), but May did not have this negative effect and the pace of output expansion nevertheless continued to drop. The available indicators for June point to even lower growth. Business expectations are likely to have suffered in this scenario. The main concern that seems to have led the central bank to cut the policy rate in July has thus intensified. The higher monetary activism, the heightened economic slowdown and the CRBP's forecast that inflation will continue receding over the next months (expects the year to close at 2.8%) suggest that another benchmark rate cut in the short term is likely, and as early as August.

This additional cut would nevertheless be limited, at 25bp (see Figure 6.2). There is little room for major stimulus considering, as mentioned above, that inflationary expectations are on the rise and very close to the target range ceiling, and that the deficit in the current account of the balance of payments is high. Aggressive monetary stimulus would raise the stakes in terms of credibility, thus instilling greater inertia into the inflationary process. Furthermore, the positive sign will have already been given, and the bounce-back in output, expected in the second half by both the central bank and most economists, will be closer.

The recovery in activity in 2015 will lead the central bank to target its actions toward consolidating the return of inflation within the target

Our forecast is for a 6% rise in output in 2015. In this context of higher momentum, concerns over activity will fade. There will thus be room for the central bank to focus on consolidating the return of inflation back within the target range. To do this, we expect it to raise the benchmark interest rate to 4.0% before the end of 2015, which in real terms and according to our estimates suggests that the rate in 2015 will rise by somewhat more than one percentage point. The two 25bp hikes would take place from the third quarter of the year forward. As they would practically coincide with the start of the rate hike cycle in the US Federal Funds Rate, potential bouts of currency volatility associated with the normalisation of US monetary policy will be mitigated.

Lastly, we must mention that our base-case scenario assumes that the Peruvian economy can weather the start of a gradual upward cycle in US rates, as we expect will occur, with no major upsets. The CRBP's role will be important in this context. The process of US monetary normalisation will involve, for example, higher depreciatory pressures on the domestic currency. We do not expect these pressures to be excessive, as the exchange rate will be close to its fundamental levels. At any rate, the expected rise in the policy rate will tame them. This is in addition to the fact that the central bank has a high level of international reserves, which allows it to comfortably intervene in the currency market for an orderly transition toward a weaker currency. This consequently limits the impact that a sudden and significant depreciation could have on any economic agents with currency mismatches.

The start of the US monetary normalisation process will also entail, for example, a rise in foreign borrowing costs. On the side of banking, the amount of short-term foreign liabilities is small (around USD1.5bn, equating to 2.5% of extended credit). Plus, foreign currency reserves are high and the central bank could release them to accommodate the higher cost of external financing. The macroprudential measures, however, do not extend to the non-financial corporate sector or to the state. In the first case, an interesting appetite to directly secure financing from abroad was seen over the last years. In principle, this constitutes a risk in the new scenario, as to both [interest] rate and exchange rate. However, a considerable share of debt issues are zero-coupon long-term bonds, and involve companies in the tradables sector, which makes the currency risk nil (for the rest, the impact will be moderate because, as mentioned above, the depreciation would be orderly). On the side of the state, fiscal deficits over the next years will be lower and, consequently, so will financing needs. New private investment will perhaps be the most affected item, and our base-case scenario includes this possibility, by assuming it will rise quite more moderately over the coming years than in the past.

7 Risk factors lend a downward bias to our growth forecasts for 2014 and 2015

We assign a low likelihood to unfavourable scenarios caused by external factors

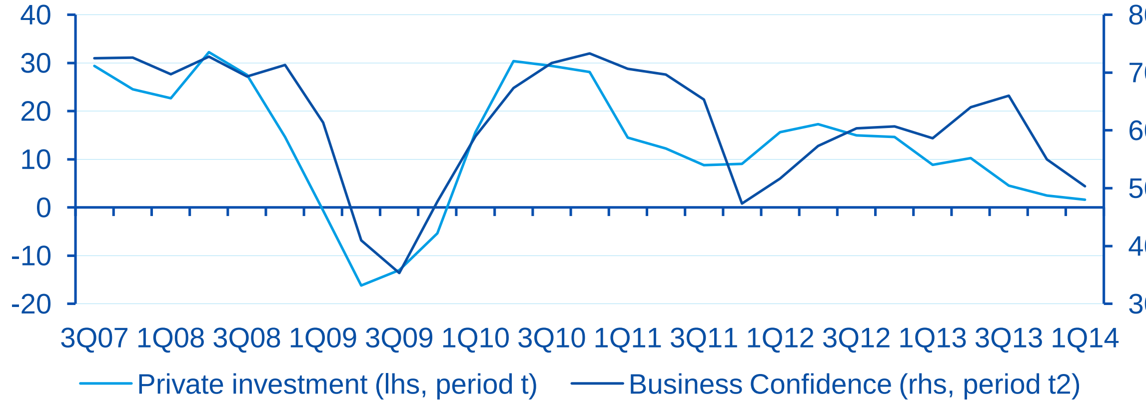
In our two previous reports, we cited a hard landing for China as the main risk factor we saw for the Peruvian economy. This scenario may unfold, given the financial frailties that have been emerging in that country (liquidity problems, rising local government debt, growth of shadow banking), which has forced the authorities to accept more moderate growth rates and be more cautious with the implementation of potential stimulus policies. The transmission of the effects to the Peruvian economy would occur through lower foreign demand, a drop in the prices of the metals that Peru exports (which would negatively affect mining company profits and reinvestment thereof, as well as fiscal revenues), and greater global risk aversion, which would affect capital inflows into, and foreign investment in, emerging countries. In a scenario of a protracted slowdown in China, the fundamentals of the Peruvian economy would weaken. In this case, economic policy response would have to accommodate a gradual transition toward a new balance, with a weaker currency and lower growth. Although this risk scenario remains latent, we believe that the risk of a hard landing in China's economy is diminishing, thanks to the improvement in exports and fiscal and monetary support measures (see global economy analysis section at the beginning of this report).

A second risk factor on the foreign side is an earlier than expected start of the upward monetary policy rate cycle by the Fed. Our base-case scenario assumes the first rate adjustment will take place in the third quarter of 2015. However, in a scenario where positive surprises on the side of activity and labour market data continued to emerge, with rising inflation and incipient concerns over potential deviations of financial asset prices or real prices vs. their fundamental values, the Fed could bring forward the start of its upward monetary policy rate cycle. We should add that uncertainty over potential Fed actions over the coming months has risen, due to the perceived debate within the Federal Open Market Committee (FOMC). Some of its members, such as Federal Reserve Bank of Dallas President Richard Fischer, have hinted at the possibility that the Federal Reserve might bring forward the monetary policy rate adjustment, which has triggered bouts of volatility in the region's financial markets. An early exit by the Fed would generate an increase in global risk aversion, rising EMBIs and higher borrowing costs. Furthermore, capital flows toward the emerging economies would reverse, particularly in economies with high current account deficits such as Peru's, and pressures on the exchange rate would rise (weakening the PEN). In this scenario, we would expect the central bank to intervene in the currency market, selling foreign currency to buffer the weakening of the domestic currency, while fiscal policy could turn expansionary, potentially raising spending on domestically-produced goods (non-tradables sector).

Our impression is that the most significant risk scenario is a fall in business confidence, which would exacerbate the cyclical adjustment of the economy due to lower investment

The persistently disappointing activity and spending data released over the last few months seem to have negatively affected business confidence. The last reading of this central bank index came in slightly below 50 points, now in pessimistic territory, after the negative surprise in April's GDP growth data (2.0%). Note also that May's GDP figure once again surprised the consensus to the downside (1.8%) and, with the available information to date, we expect an even lower GDP expansion in June than that recorded in the previous two months. Although we expect improved activity data prints to start in July, they will still reflect only a mild rebound. In this context, business confidence could display a certain sensitivity to the information that will be released, which could negatively affect investment decisions and intensify the cyclical adjustment of the economy. As seen in Figure 7.1, business confidence anticipates the activity in private investment spending by roughly two quarters. Under a scenario of a steeper slowdown, due to weakness in aggregate demand (lower investment), we would expect monetary and fiscal stimulus. Over the coming months, it will also be important for the authorities to continue implementing measures that improve the business environment, to boost business sector expectations.

Figure 7.1
Private Investment and Business Confidence (% var. YoY, pp)



Source: CRBP, BBVA Research

Lastly and on the domestic side, we maintain the risk scenario, albeit with a low probability, of the occurrence of a severe El Niño Effect (FEN). According to the Development Bank of Latin America (CAF) the losses caused by the El Niño Effect in 1997-98 equated to somewhat more than 6% of GDP. Fishing would be one of the affected sectors, due to the lower availability of the anchovy (the sector's main species) resulting from the migration of shoals to cooler waters, which would also reduce fishmeal processing and 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 harvest of artichoke, mango and grape. Finally, excess rainfall can cause natural disasters associated with landslides and floods, with impacts on infrastructure.

8 Tables

Table 8.1
Annual Macroeconomic Forecasts

	2013	2014	2015f	2016f
GDP (%,YoY)	5.8	4.1	5.9	6.1
Inflation (%,YoY, eop)	2.9	3.3	2.7	2.2
Exchange rate (vs. USD, eop)	2.79	2.85	2.88	2.90
Monetary policy rate (%,eop)	4.00	3.50	4.00	4.50
Private consumption (%, YoY)	5.4	4.7	5.0	5.1
Public consumption (%, YoY)	6.7	5.7	5.5	5.5
Investment (%, YoY)	7.6	2.9	7.0	5.8
Fiscal balance (% of GDP)	0.9	0.4	0.0	-0.2
Current account (% of GDP)	-4.5	-5.0	-5.1	-4.6

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	4.6	2.6	2.59	4.25
2Q13	6.3	2.8	2.75	4.25
3Q13	5.3	2.8	2.78	4.25
4Q13	6.9	2.9	2.79	4.00
1Q14	4.8	3.4	2.81	4.00
2Q14	2.0	3.4	2.80	4.00
3Q14	4.4	2.8	2.83	3.50
4Q14	5.0	3.3	2.85	3.50
1Q15	5.0	2.9	2.86	3.50
2Q15	5.5	2.7	2.87	3.50
3Q15	5.6	2.7	2.88	3.75
4Q15	7.5	2.7	2.88	4.00

Source: BCRP and BBVA Research

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