BBVA | RESEARCH

Economic Outlook

Peru

Fourth Quarter 2011
Economic Analysis

- **A better-than-expected economic performance in 3Q11 gives our 2011 growth forecast an upward bias.** The additional boost came from the primary sectors, but will be transitory.
- **For 2012 we expect GDP to moderate due to a less favorable external environment**
- **Inflation will remain above the Central Bank's target for a few more months** and will then converge to it as previous transitory shocks reverse.
- **In the short-term, the Central Bank will maintain its policy rate at its current level.** As inflation subsides, it will have room to ease the monetary policy stance if the global context further deteriorates.
- **The main short-term risk is a disorderly resolution of the European debt crisis.** The Peruvian economy has strengths that will lessen the impact.

Index

Closing date: November 10th 2011

1. Summary: Global slowdown and risks tilted to the downside

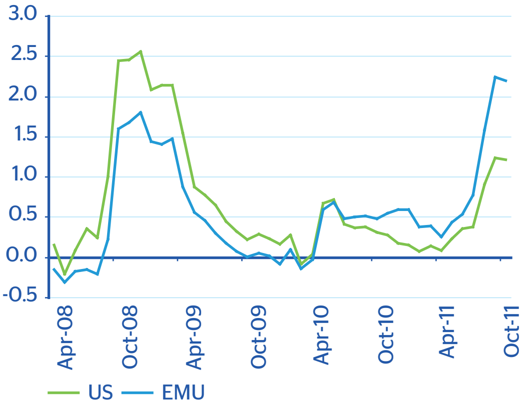
The global economy slows down and the outlook is heavily dependent on the resolution of the European debt crisis. Risks are strongly tilted to the downside

The outlook for the global economy has worsened over the past few months, driven mainly by four factors that are still exerting their influence. First, lower than expected economic growth mainly, but not only, in developed economies (data had been already disappointing in the US in the first half of the year, which led to some analysts to expect a double dip). Although growth increased in the US in the third quarter, economic activity in Europe, which held very well in the first quarter, is now on a clear decelerating path. Second, the sovereign debt crisis in Europe has intensified and turned more systemic. While decisions announced in the October summit go in the right direction, there are still key elements unresolved, especially regarding the real firepower of the mechanisms for providing sovereign liquidity (a leveraged European Financial Stability Fund or EFSF), the restructure of Greek debt held by private investors, and a clear roadmap for advancing European governance towards a fiscal union. Third, the feedback between sovereign concerns and the health of the European financial system has intensified, and financial tensions in Europe have reached levels in many respects higher that after the fall of Lehman Brothers in October 2008 (Chart 1). This increases the risks of a negative impact on economic activity (see Box 1), further feeding a real-financial vicious circle. Finally, higher global risk aversion has increased financial market volatility significantly, spilling over to most risky assets, including emerging economies for the first time since 2009.

In this context, we revise downward our global growth forecasts by 0,3pp in 2011 and 2012, relative to our previous Global Economic Outlook, mostly due to lower expected growth in advanced economies (US and Europe, compensated in part by Japan), although emerging markets will also grow slightly less than previously anticipated. Thus, the global economy would grow by 3.9% in 2011 and 4.1% in 2012, supported by solid growth in emerging economies against lackluster performance in advanced countries (Chart 2).

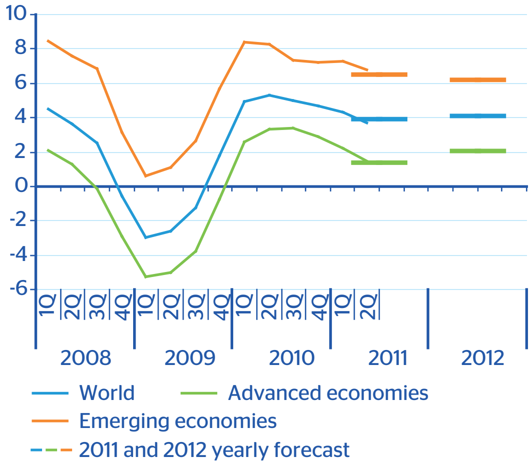
These are still robust growth rates, but risks to these projections are now strongly tilted to the downside, hinging in the short term on the evolution of the sovereign-financial crisis in Europe. In particular, a quick reduction of financial stress in Europe is needed to avoid a sharp effect on growth there and in other regions through financial exposures and global risk aversion.

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: BBVA Research and IMF

The October European summits have taken some steps in the right direction, but still leave key elements unresolved. This does not bode well for the reduction of financial stress in Europe

In our view, there were five main points that needed to be successfully addressed in the October EU summits: (i) tackling definitively the sustainability of Greek debt; (ii) erecting sovereign firewalls in the EMU; (iii) pushing for further reforms in peripheral countries; (iv) strengthening the banking sector; and (v) advancing euro area governance. Although some of the more technical details still need to be determined, the recent summits have taken important steps in the right direction, but have not addressed definitely most of these points. First, private bondholders of Greek debt are asked to take a voluntary haircut of 50% –much higher than agreed in July– but doubts still linger about participation in the exchange and, even with full participation, about the solvency of Greece, which is still strongly conditional on measures that need to be taken in this country. Second, the EFSF will be leveraged as an insurance mechanism and complemented with outside investors (including possibly the IMF, although the G20 meeting was inconclusive in this respect), but it is unlikely that any of the specificities of the functioning of the EFSF are ready before December. Thus, many weeks will be needed to ascertain its effectiveness vis-à-vis private investors, and hence the ECB will still be needed as a buyer-of-last-resort for sovereign debt, against the reticence of core European countries. Third, it is welcomed that more economic reforms are now on the agenda of some countries (notably Italy, where these will be monitored by the IMF), and that as the help of the EFSF will be triggered by a request from countries and against conditionality, the likelihood of those being implemented increases. At the same time, the recapitalization of the banking sector is being done inefficiently, compensating a moderate stress testing of banks' balance sheets –just using market prices for sovereign portfolios but not for so-called "legacy assets"– with a significant increase in capital requirements (9% core tier1 capital). This risks a sudden and sharp deleveraging of European banks, with negative effects on the supply of credit without cleaning the balance sheets of banks in the euro area. Moreover, a long term liquidity provision mechanism is not in place yet, even though this is extremely important for banks to obtain financing. Finally, there have been some advances in European governance, but there is no clear roadmap to a fiscal union or Eurobonds, in our view a key element to make the monetary union more credible in the long run.

As we have mentioned in the past, partial solutions will probably just help prevent a further escalation of financial tensions, but they will remain elevated, increasing downside risks for economic activity in the eurozone. The agreements still leave doubts whether the necessary structure to prevent contagion and a systemic event from a Greek debt restructuring is in place: a large enough EFSF with the ECB as debt-buyer-of-last-resort and cleaned and recapitalized banks' balance sheets with access to financing. Without all of them, markets will continue to factor increased fatigue for reforms in Greece and fatigue for further bailouts in core countries, which increases the probability of a risk scenario of a credit crunch and a recession in Europe, with global spillovers.

Some improvements in US growth in Q3, but structural weaknesses remain, including political deadlock

More on the positive side, growth in the US seems to have reaccelerated in the third quarter, at least according to preliminary estimates. This is not saying much –growth in the first two quarters was very low and the output gap is still very high– but seems to have reduced market nervousness about a double dip. Nevertheless, the structural weakness of the US economy remains, as consumer and business confidence continue to be weak and the housing market could adjust further. This means lower resilience in the face of a possible shock coming from Europe. In addition, political deadlock could impede a "grand bargain" to (i) prevent an unintended fiscal contraction in the short run and (ii) push reforms towards a credible fiscal consolidation in the long run.

Emerging economies are on track for a soft landing, but with increasing external headwinds

Emerging economies continue growing strongly, supported by the resilience of domestic demand. Still high commodity prices for Latin America and export growth in Asia –despite strong corrections in both cases– also contribute to a strong growth outlook, which is on track for a much awaited soft landing, which would be welcome in some countries. Renewed turmoil in Europe and the US already represent strong headwinds from financial markets in both regions –reflected in increased market volatility, depreciated exchange rates and reduced capital inflows–. However, many countries also enjoy sizable buffers –stronger public finances and better macroeconomic management than in the past– and are well positioned to introduce policy stimulus to counter weaker external demand. Overall, a more negative external environment has switched the focus in emerging countries from overheating to downside risks and, increasingly, the possible need for policy support.

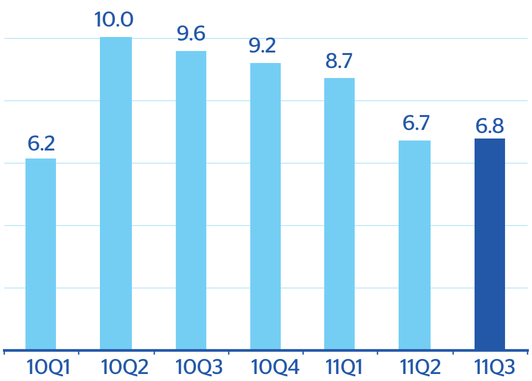
2. Peru will grow 6.3% in 2011, with an upward bias

Positive signs from the incoming administration help dissipate the uncertainty that built up during the presidential election

Initial uncertainty arising from the change of government gradually dissipated over the third quarter. The first move clearing the way was the appointment of senior officials to the Central Bank and the Ministry of Economy and Finance. This was an important sign of continuity in macroeconomic policy. It was followed by a draft budget that made a moderate and targeted increase in funds for social spending compatible with a fiscal surplus of 1% of GDP in the forecast horizon. In other words, the new administration' actions suggest that its goal will be to speed up better distribution of opportunities among the population while maintaining basic macroeconomic balances. This has been positively received by the markets and has given better than expected support to private spending in the third quarter.

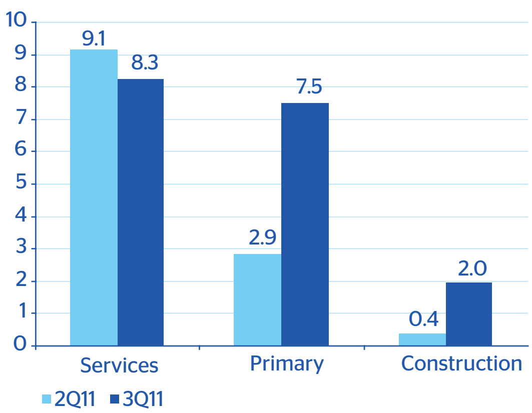
In this context, household consumption has continued to grow at a rate of 6% in 3Q11, supported by increased employment, higher wages and improved consumer expectations. Private investment has slowed, but somewhat less than expected. In all, the economy will have grown by around 6.8% year-over-year in the third quarter (see Chart 3).

Chart 3
GDP (year-on-year % growth)



Source: BCRP and BBVA Research Peru

Chart 4
GDP by sector*/ (year-on-year % growth)



* Only includes some sectors, which account for around 80% of GDP.
Source: Ipsos Apoyo and BBVA Research Peru

On the supply side, productive activities that are most linked to private consumption, such as the service sector, continued to provide significant support to output (see Chart 4). In addition to this, we estimate that the additional contribution to growth from primary activities (agriculture, fisheries, mining and the processing of resources from these three sectors) was between one half and a full percentage point of GDP in the third quarter. However, this support will be short-lived, as it is a result of a low basis of comparison arising from anomalous weather conditions in 2010.

The sectors that attract investment, such as construction or the production of capital goods, performed positively, despite the lower level of execution of public expenditure on infrastructure works (due to spending adjustments implemented in the second quarter and management problems at lower levels of government).

Our growth forecast of 6.3% for 2011 has an upward bias

The deterioration in the external conditions has not had any notable impact at local level, at least for the present time. Economic activity has responded favorably, and there have even been some positive surprises. This has introduced an upward bias to our growth forecast of 6.3% for 2011, which could materialize if support from the primary sectors extended into the final months of the year, or if there was a recovery in public expenditure. In this respect it is worth mentioning that the government has introduced special measures to boost the execution of the budget. The authorities estimate that with these measures fiscal expenditure will begin to accelerate towards the end of 4Q11.

3. Growth will moderate in 2012

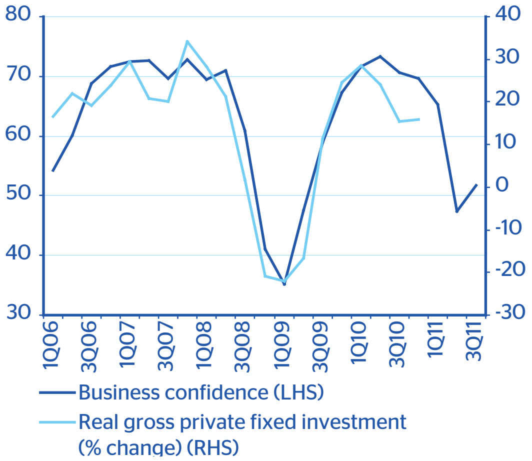
Business confidence has not recovered the levels at which it began the year, and this will have an impact on the economy in the coming months

Business confidence has recovered after it was weakened by electoral uncertainty in the second quarter, but it has not reached its earlier exuberant levels. The signals being sent out by the new government have in general been positively received and the country's credit rating has been upgraded (by Standard & Poor's and Fitch, from BBB- to BBB). However, some concerns still persist. First, the official line insists on the goal of increasing the government's direct involvement in the economy, such as through the exploitation of hydrocarbons, the operation of ports and in domestic air transport. This is considered negative due to its adverse consequences on long-term growth and the public finances. Second, disputes continue between the companies extracting natural resources and local communities. Although the recently passed Ley de Consulta Previa aims to provide a solution to these disputes (the projects executed must be approved by the communities), its regulations have not been implemented and the result could be an in increase in expenses and delays in investment beyond a reasonable time. Meanwhile, some projects have been halted. Third, the new General Labor Law, which is due to be debated in Congress soon, opens up the possibility of additional frictions in the labor market. This would not help to reduce informality and could end up affecting long-term growth.

In short, there are factors that continue to generate concerns. Together with the deterioration in the external outlook, they explain why we expect aggregate demand to slow.

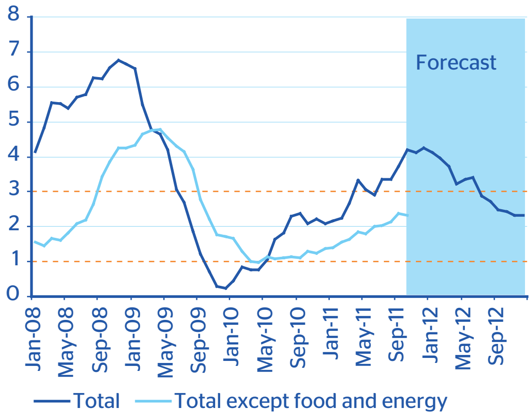
Evidence suggests that business confidence and private investment are closely related, and that this link is strongest at a half-year distance (see Chart 5). This leads us to expect that private investment will grow over the coming quarters at around 7% year-over-year (growth in the first half of 2011 was 15%). Reduced business expenditure will result in a slower progress in employment and wages, as well as household income. Thus the support given by private consumption to economic growth will be reduced in 2012. In addition, exports will feel the negative effects of an environment of reduced growth in global GDP. We expect that the moderation in corporate and household spending and the weakness of foreign demand will be offset in part by the measures recently announced by the government to prop up public expenditure. As a result, the rate of economic growth should be around 5% next year.

Chart 5
Business confidence1/ and private investment (index; year-on-year % change)



* Non-financial business expectations for the economy over the following three months.
Source: BCR, BBVA Research Peru

Chart 6
Inflation (year-on-year, %)



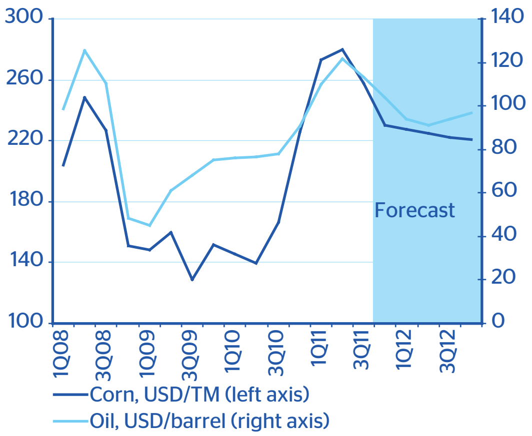
Source: INEI and BCR

... and also on inflation, which will moderate gradually

The rate of growth in prices has provided an upside surprise. Since the second quarter year-over-year growth has been above the Central Bank's target range of 2%, +/- 1 pp). This trend has been mainly sustained by supply factors, in particular food and fuel prices. If we extract the food and fuel items from the consumer basket, inflation is only 2.3% (see Chart 6).

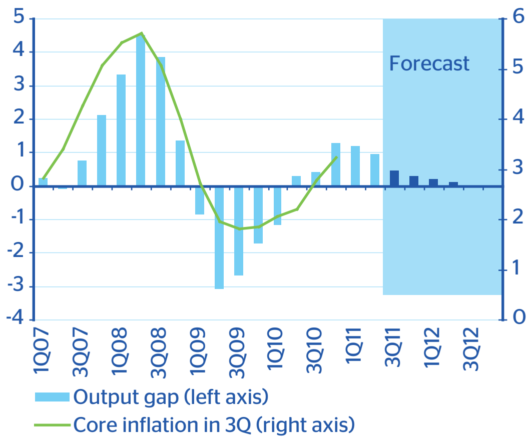
We expect that the deviation of inflation above the target range will tend to be corrected in the first half of next year. This is because the trend in the international prices of foodstuffs and oil will fall in an environment that is less favorable to global economic growth (see Chart 7). As a result, supply pressures on prices will be reduced. In addition, weakened activity will gradually close the current positive output gap (see Chart 8). As a result, we expect an annual inflation rate of 2.3% at the end of 2012.

Chart 7
International commodity prices



Source: Bloomberg and BBVA Research

Chart 8
Output gap and core inflation (% of potential GDP, year-on-year %)



Source: BCR and BBVA Research Peru

The Central Bank will maintain its monetary policy stance in 2012

In our base scenario we continue to expect the monetary policy rate to remain at 4.25% until the end of 2012. Although it is true that the external environment will continue to be a source of risk and that in line with this the Central Bank has announced that it is ready to make monetary conditions more flexible, lowering the reference rate in a scenario in which there is no serious deterioration in the global economic environment could exacerbate inflationary expectations, which currently stand at 2.7% for 2012. We do not therefore expect a reduction of rates in the short term. In the future we expect that output will converge gradually towards its long-term trend and that inflation will return towards the middle of its target range, so more additional adjustments in the policy rate will not be required.

Worsening external conditions pose a risk for economic growth...

The rate of economic growth we expect for Peru in 2012 assumes that growth in developed economies will continue to be slow and that the solution to Europe's fiscal problems will unfold gradually, although with some surprises. This means contagion to the rest of global activity will be limited.

Of course, it has to be recognized that in recent months surprises about the growth of the global economy have been mainly negative and the tone of the sovereign debt crisis in Europe is becoming increasingly systemic. In this context, the probability that the external panorama will become more problematic has risen with respect to what we forecast in our previous publication. In this scenario, the Peruvian economy will be impacted through a number of channels. First, the risk premium will rise and capital inflows fall, thus making finance more expensive. Second, commodity prices and foreign demand will drop. Finally, business and consumer confidence will be reduced. In this environment, private investment will be the component of expenditure that is most affected, as we already saw in 2009.

However, economic authorities have room to mitigate the impact of a negative external shock

Fiscal policy has more resources than in 2008-09 to finance possible support measures. In the particular case of the Fiscal Stabilization Fund, for example, it has resources amounting to just over 3 percentage points of GDP, while in 2008 the figure was half that. This reduces the need to go to the financial markets to obtain finance, which is important in an environment of greater risk aversion and demand for liquidity. Then there is the experience of the 2008-09 period regarding the best way of channeling increased public expenditure. This becomes more important in the current situation given the difficulties faced at all levels of government (national, regional and local) in executing infrastructure works.

Table 1
Indicators of fiscal and external vulnerability

	2008	Current
Gross public debt (% of GDP)	24.1	21.8
Funds available in the Treasury1/ (% of GDP)	4.1	6.3
Net international reserves		
% of GDP	25	28
Ratio of net international reserves / short-term foreign liabilities	4.9	6.9

*: Includes the Fiscal Stabilization Fund
Source: BCR and BBVA Research Peru

With respect to monetary policy, the Central Bank has instruments to address the risk of a break in the chain of finance. Repos could help to provide bank liquidity (banks hold PEN 15 billion in securities issued by the Central Bank, equivalent to USD 5.5 billion) and FX swaps could also be used for the same purpose. There could even be a reduction in the banks' PEN reserve requirement. In addition, if the banks had problems in renewing their short-term foreign debt (USD 2.5 billion), the currently high rates of foreign-currency reserve requirements could be cut (the average foreign-currency reserve requirement rate is around 40% of deposits and debt).

The Central Bank would also have to avoid a sudden fall in the value of the local currency to limit the risks this involves for an economy in which 45% of lending to the private sector is in foreign currency. To deal with this, it can make use of its net international reserves of USD 48.5 billion (28% of GDP) and issue foreign-exchange linked bonds, as has been seen in previous periods of volatility.

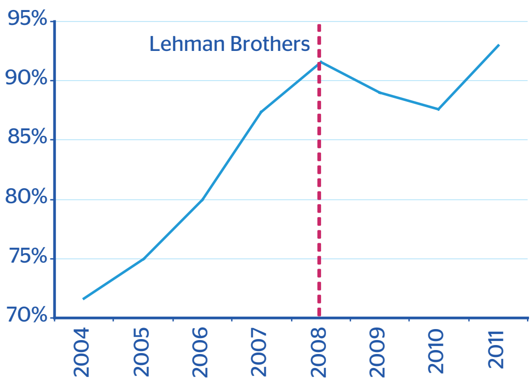
Finally, there is room for a reduction in the monetary policy rate to boost private spending, given that it is currently at 4.25%. This stimulus could be provided earlier than in 2008-09, because this time the inflationary outlook is more benign, in particular for 2012.

Is the current rate of credit expansion a source of concern?

The swift growth in bank lending to the private sector (20% year-on-year) may appear high. It is important to note in this respect that much of this rate is a result of increased banking penetration, the population's higher income and the growth of the middle classes. The strength of credit has not led to increases in non-performing loans, which stands at around 1.5% of the portfolio.

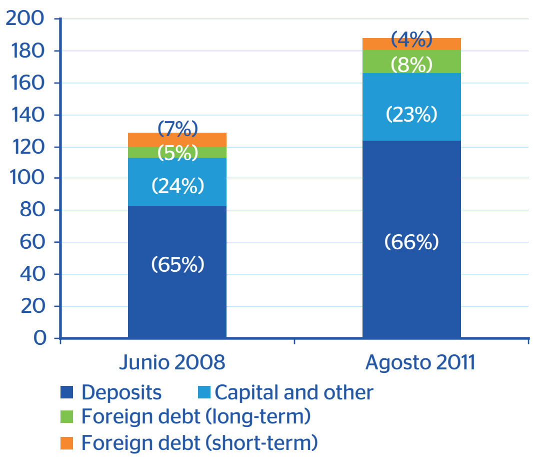
However, it could be a source of vulnerability in the event of an external shock if foreign funding account for a significant share of total funding. In the case of Peru, deposits exceed loans (Chart 9), so the sources of finance are mainly domestic. In addition, despite the strong growth in credit, external funds represent a relatively limited portion (12%) of all bank funding (Chart 10). To this should be added that fact that short-term credit is now less important in foreign funding, so banks are less vulnerable to a sudden interruption of capital inflows.

Chart 9
Bank lending to the private sector (as % of deposits)



Source: SBS and BBVA Research Peru

Chart 10
Funding of bank assets (billions)

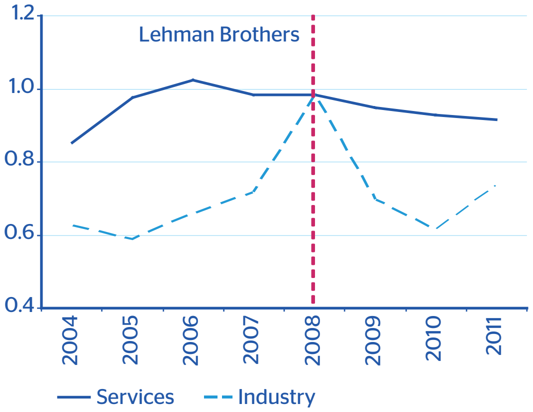


Source: SBS and BBVA Research Peru

Companies in the real sector of the economy have a sounder financial position than in 2008

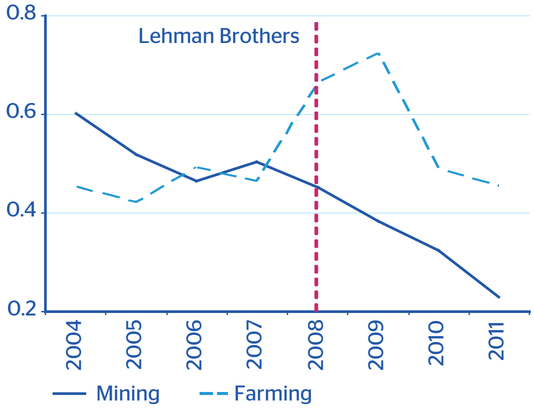
With respect to the companies that use bank finance, an analysis of the companies listed on the Lima Stock Exchange (BVL) suggests that not only are their levels of leverage low, but they have been falling since 2008 (see Charts 11 and 12). As a result, the debt burden of companies is not currently a very significant percentage of gross earnings (before tax and financial expenses).

Chart 11
Business leverage (liabilities/equity)



Source: BVL and BBVA Research Peru

Chart 12
Business leverage (liabilities/equity)



Source: BVL and BBVA Research Peru

To sum up: Peru could resist an external shock relatively well, and handle any deterioration in the public and external balances

Although a more severe deterioration of the foreign situation would have impacts on local activity, the Peruvian economy has strengths capable of mitigating them. Of course, the public and foreign balances would be weakened. The public balances would be affected by the lower revenues linked to cuts in metal prices and slowing activity; while expenditure would be up due to the increased debt service payments and attempts to support growth. We estimate that in a difficult scenario such as this the fiscal result would be a deficit of around -2% of GDP. This deterioration could be handled, given the resources available to the public sector and a relatively low starting-point for the public debt as a proportion of GDP (22%). The deficit would be steadily eliminated in the medium term. In the external balances the deterioration over the coming years would be the result of a less favorable environment for export prices, a reduction of foreign demand and lower revenues from remittances. However, this would be mitigated by the lower rate of expansion of domestic demand, as already seen in 2009. The balance of payments current-account deficit could at the most critical level reach a figure of around 4% of GDP.

But a watchful eye should be kept on other factors as well

In a more difficult foreign scenario there is only a limited chance of the sources of finance, and thus of lending to the private sector. This is because of the low level of foreign exposure of the Peruvian banking system. However, there is a risk that its strength could be significantly reduced. Around half of new foreign-currency loans have been financed so far this year from abroad, so in a difficult scenario this inflow would be reduced and affect growth in private spending. Another element to take into account is that the support provided by economic policies should be dispensed carefully. Care should be taken in assessing the size of support provided in the short term because the most developed economies will for a number of years grow slowly and could present surprises on the way. Finally, there is a risk that a slowdown in China could be more pronounced than expected as a result of contagion from the situation in Europe. China has become the main source of foreign demand for products from Peru and is its biggest buyer of commodities. Slower growth in the Asian giant would therefore have major consequences on international metal prices and foreign demand, and have a negative effect on growth in Peru.

4. Tables

Table 2
Annual macroeconomic forecasts

	2009	2010	2011	2012
GDP (yoy % change)	0.9	8.8	6.3	5.0
Inflation (%, yoy, eop)	0.2	2.1	4.2	2.3
Exchange rate (vs. USD, eop)	2.88	2.82	2.70	2.65
Policy rate (%, eop)	1.25	3.00	4.25	4.25
Private consumption (yoy % change)	2.4	6.0	6.2	5.4
Public consumption (yoy % change)	16.5	10.6	5.3	4.5
Investment (yoy % change)	-9.2	23.2	7.2	6.8
Fiscal balance (% of GDP)	-1.9	-0.5	0.6	0.5
Current account (% of GDP)	0.2	-1.5	-2.1	-3.0

Source: BBVA Research Peru

Table 3
Quarterly macroeconomic forecasts

	GDP (yoy % change)	Inflation (%, yoy, eop)	Exchange rate (vs. USD, eop)	Policy rate (%, eop)
1Q09	1.9	4.8	3.18	6.00
2Q09	-1.2	3.1	2.99	3.00
3Q09	-0.6	1.2	2.92	1.25
4Q09	3.4	0.2	2.88	1.25
1Q10	6.2	0.8	2.84	1.25
2Q10	10.0	1.6	2.84	1.75
3Q10	9.6	2.4	2.79	3.00
4Q10	9.2	2.1	2.82	3.00
1Q11	8.7	2.7	2.78	3.75
2Q11	6.7	2.9	2.75	4.25
3Q11	6.0	3.7	2.73	4.25
4Q11	4.0	4.2	2.70	4.25
1Q12	4.2	3.7	2.70	4.25
2Q12	4.5	3.4	2.67	4.25
3Q12	5.4	2.5	2.66	4.25
4Q12	6.0	2.3	2.65	4.25

Source: BBVA Research Peru

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