Economic Outlook

Peru

Fourth Quarter 2013
Economic Analysis

- **Global activity continues to recover, albeit slowly.** Reduced financial tensions have contributed to growth, although there are still diverse global risk factors at play.
- **GDP growth in Peru will come in at 5.3% this year and will rise to 5.6% in 2014.** In addition to the impulse by exports and public spending, stronger confidence will be key to stabilize growth around its potential rate.
- **Trade deficit has widened, but only temporarily.** In addition, its source (linked to investment), funding (long-term) and sustainability in structural terms minimize the risks of a sudden adjustment.
- **On the fiscal front, moderate deficits are expected from 2014 on.** This result will not affect solvency in public balances: public debt as a percentage of GDP will continue to decline and come in at around 15% in 2007.
- **The monetary policy rate will remain unchanged in 2014.** No changes are expected in reserve requirements for the rest of the year, although this instrument will continue to be the first option for easing monetary policy if necessary.

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Closing date: October 31, 2013

1. Summary

The global economy continued to show signs of recovery, albeit at a somewhat slower-than-expected rate. Although there are noteworthy improvements in output indicators for Europe and China, figures for the U.S. have been coming in below expectations. In this scenario, we have revised down expected growth by 0.2 pp in 2013 and 2014, to 2.9% and 3.6%, respectively. Thus, we continue to forecast an upswing in growth for the coming year, something that has become more likely given the lower financial tensions after the Fed's surprise move postponing its tapering schedule.

With regard to the Peruvian economy, we expect growth this year to come in at 5.3%, a positive result that underscores a trend of activity highly resistant to bouts of external turbulence such as those seen throughout 2013. It should be stated that recent business and output forecasts suggest that the slowdown in the Peruvian economy this year seems to have bottomed out at the end of the third quarter.

We expect the 2014-2017 period to see annual average growth of around 5.6%, which will be supported by the temporary up-tick in exports, thanks to large mining projects currently being executed coming online (as a result we expect to see peak growth of 5.9% in 2015) and sustained contributions from domestic demand.

Thus, growth forecasts for Peru this year and for the next four years continue to be positive. Nonetheless, in order to make progress as a middle income nation and close the income gap with other countries in the region in a reasonable timeframe, Peru should maintain growth rates like those currently being seen for an extended period. In order to do this, the Peruvian economy needs to cut its reliance on temporary boosts such as those from mineral exports, and shore up factors that have a permanent impact on productivity and competitiveness.

This year and next, the current account deficit is expected to come in at a level equivalent to 5.3% of GDP, the highest since 1998. The higher deficit is explained by the decline in the terms of trade and lower export volumes, but also by strong investment (especially in the import component). It is important to highlight that, unlike developments seen recently in other emerging markets, the wider trade deficit in Peru is not due to a decline in domestic saving but to higher investment. In addition, we believe that the wider trade deficit will be temporary and will start to narrow from 2015 onwards, thanks to higher mining exports and that the deficit will continue to be financed by foreign direct investment directed at the tradable sector of the economy. Lastly, our estimate of the structural level of the current account (taking into account long-term metal prices and excluding economic cycle effects) shows that the deficit is sustainable.

We forecast a slight fall in the fiscal balance compared to our forecasts from three months ago. This forecast takes into account limited improvements in tax revenue due to a slightly lower rate for economic growth. Thus, we predict that the treasury will have a 0.2% surplus (in terms of GDP) this year and moderate deficits for the 2014-2017 period. It must be underlined that the slight deficit in the fiscal balances expected in the years to come is in line with a downward trend in the ratio of public debt to GDP, which we forecast at around 15% of GDP toward the end of 2017. In this way, the sustainability of public finances will remain strong and we think it is likely that, over the forecast period, the public debt rating will continue to improve (currently at BBB+) and enter the A-rating group. One aspect to highlight is the change in current fiscal rules (currently under the Fiscal Responsibility and Transparency Act), which include limits on increments on non-financial current spending and on the size of the deficit, incorporating structural elements and greater institutional grounding. Although the new rules might face some technical difficulties in measuring the structural fiscal balance, the greater institutional development in formulating fiscal policy is a huge step forward.

Inflation will gradually converge towards the middle of the target range in 2014. The cyclical slowdown in the economy will maintain demand pressures on prices limited and no supply shocks (from fuel and fuel) are expected. Nevertheless, convergence toward the middle of the

target range will face some inertia since inflation expectations remain near the ceiling of inflation target range (2% +/- 1 percentage point).

Central Bank: pause in easing of reserve requirements until the end of the year and a stable policy rate in 2014. Reduced tensions in local financial markets have enabled the Central Bank to take a pause in the process of easing of reserve requirements. In general, thanks to the improvements in credit growth and in the most recent output indicators, we do not expect additional changes to this instrument in the remainder of the year. Furthermore, as inflation continues to move toward the middle of the target range and the economy continues to grow around its potential level, no changes to the policy rate will be needed. In any event, we continue to believe that any change in the monetary policy position will firstly come via additional cuts to reserve requirements.

The exchange rate will remain relatively stable, between S/. 2.74 and S/. 2.80, but episodes of volatility due to financial upheavals overseas cannot be ruled out. After the correction seen between May and August this year, we believe the exchange rate is currently in line with its fundamental level. The latter is higher than what we expected at the start of the year, which can be explained by some decline in a few variables which determine its medium-term performance (a wider current account deficit, lower terms of trade, a slight drop in fiscal revenues). It should be added that we do not ruled out periods of volatility, mainly in relation to the Fed decision to start tapering on its quantitative easing, and also to the uncertainty surrounding the fiscal issues to be resolve in the U.S. parliament.

Risks on the external side could have a medium/high impact on the Peruvian economy. We continue to see that the main risk sources come from abroad. In the short term, in the U.S. there is the risk of a disorderly withdrawal of the Fed's quantitative easing program and uncertainty linked to political debate surrounding fiscal matters. These events could lead to reversal in capital flows, a bigger fall in metal prices and a major rise in long-term interest rates in the U.S. In the medium-term, there is a risk of a sharp slowdown in China which would lead to a sustained drop in mineral prices and volumes exported by Peru. These events could get exacerbated, due to lower confidence at domestic level. Nonetheless, Peru has fiscal and monetary strengths that will enable it to implement economic policy responses to cushion these impacts.

2. A slow global recovery with downward risks

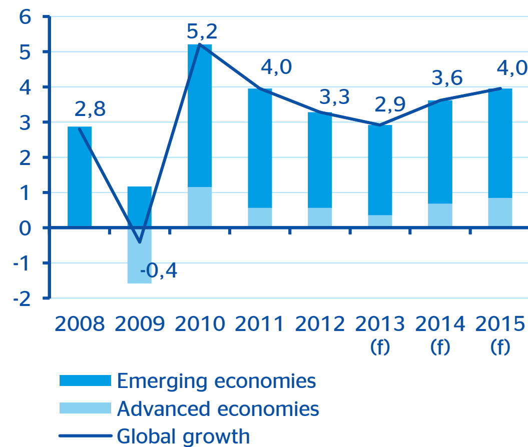
The economic cycle is improving, mainly in advanced economies, although it is still far from a strong recovery

From the macroeconomic perspective, two features have characterized the last quarter. First, the confidence indicators of economic agents and the volatility of the financial markets have continued to reflect a low probability of tail risk events that could be disruptive for the global situation. Thus, economic recovery is consolidating and there is less risk of derailing. However, there have also been events, over the third quarter, that contributed to a scenario of weak global recovery. These events include the partial closure of the U.S. government and the anticipation of the exit from the exceptional liquidity support measures.

Overall, we have revised down by 0.2 pp the expected growth for the global economy in 2013, to 2.9%, and in 2014, to 3.6%. The revision of 2013 rate of growth is due to the worse than expected figures recorded in the U.S., and the slowdown in some of the countries in developing Asia, which are also affected by financial turbulence in the wake of the Fed's announcement of tapering. Growth in 2014 has also been revised down to 3.6%. The emerging markets are behind this downward revision (except for China, where we stick to our forecasts), although they

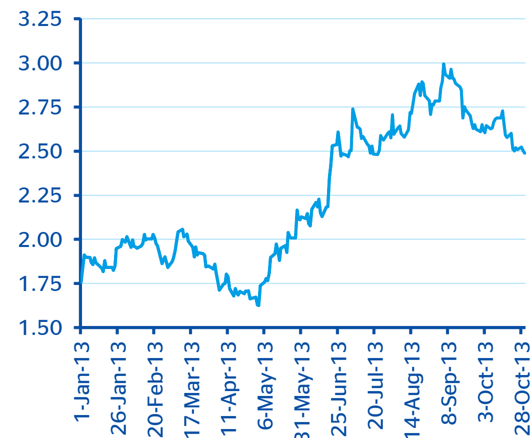
will continue to be the biggest contributors to global growth (see Chart 1). The higher rate of global growth in 2014 is backed by an acceleration of the economy in all geographical areas, except for Asia, where growth is expected to remain relatively stable.

Chart 1
Global growth and contribution by regions (% %)



Source: BBVA Research and IMF

Chart 2
U.S.: yield on 10-year public debt (%)



Source: Bloomberg

The tensions in the financial markets caused by the announcement of Fed tapering ease off, providing a boost, not only in the U.S.

The Fed caused surprise when in September t decided not to start the process of reducing the rate of asset purchases in its quantitative easing (QE) program. By delaying the start, it underpinned the nature of the program as "data-dependent" (an assessment of the economic data that are released). In addition, the postponement takes into account the effect from the uncertainty surrounding the negotiation of the fiscal deficit and the public debt ceiling.

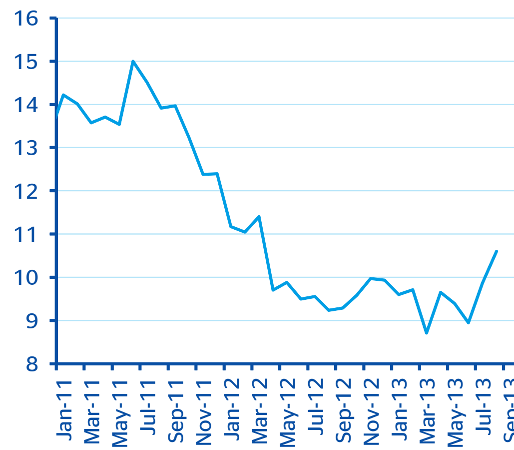
The clarifications on the process of tapering, prepared by Fed members in the light of the unexpected reaction of the market after they let slip in May that it could start before the end of the year and the later delay until (possibly) the start of 2014, have reduced the risks of a derailment in the recovery. First, much of the rise in interest rates recorded since May has been reversed (see Chart 2), and by now markets do not anticipate rises in the rates until 2015. Second, volatility and financial tensions have eased at a global level, particularly with respect to emerging markets in Asia and Latin America, which are also affected by lower capital inflows. Thus, fears of a "sharp landing" in emerging markets have gradually eased, while confidence show signs of recovery, after the stoppage in the middle of the year.

In any event, tapering will end up arriving, and it will change the global scenario where liquidity injections favored indiscriminate flows to emerging markets. The impact of tapering, once it is effectively underway, will probably be a greater discrimination in flows toward emerging markets according to their fundamentals.

China, once more, stimulates growth, but in a more limited fashion

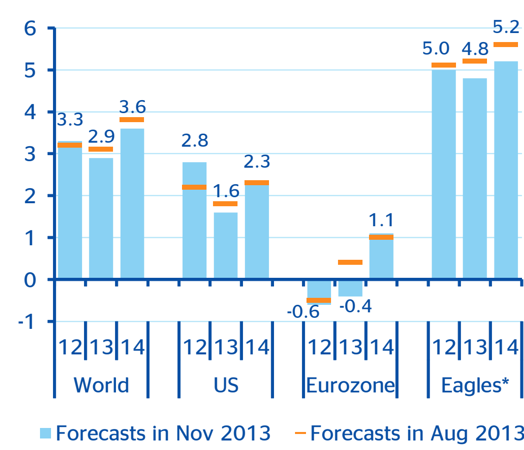
In China, the doubts at the start of the year on the possibility of a sharp adjustment to its economy have also dissipated, at least in the short-term. It has maintained a high rate of growth, and the most recent data (third quarter) suggest that GDP is picking up (see Chart 3). Better than expected figures this year means that the outlook for growth has been revised upwards slightly, from 7.6% to 7.7%. Even so, doubts remain on the sustainability of growth in the medium and long term, as the recent upturn in growth has been the result of the improvement in foreign demand, but also of one-off measures of tax policy and public spending with a renewed use of credit.

Chart 3
China: industrial output (y/y %)



Source: BBVA Research and Haver

Chart 4
Global growth estimates (%)



* EAGLEs are the emerging markets that will contribute most to global GDP over the next 10 years. The group is made up of China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: IMF and BBVA Research

The fiscal agreement in the U.S. has been another patch that does not address long-term fiscal sustainability and does not avoid a contractive impact in the short term

The fiscal agreement reached on October 16 in the U.S. is a simple extension of the current situation, as it only includes that the Government will have funding until January, while the new debt ceiling will be reached in February. Intense negotiations are drawing near on cuts in discretionary expenditure and increases in taxation. The U.S. thus once more has to address an uncertain process that it has already passed through in these months on previous occasions, and this can only have negative consequences. Most likely is that the partial closure of government for 16 days has had a relatively marginal direct effect on the GDP for the quarter, perhaps a few tenths of a pp. However, the threat of this process continuing may have an additional impact. In any event, the situation in which economic policies push in opposing directions will continue, with a lax monetary policy that will continue to be so for a long period, and an unnecessarily contractive fiscal policy in the short term. Thus the U.S. public deficit will have fallen without market pressure (unlike in Europe) from 6.8% in 2012 to 4% in 2013, which can be considered a drain of 1.3 percentage points of GDP growth in 2013. And the long-term challenges for the fiscal sustainability of the U.S. economy have not been tackled. In any event, in our baseline scenario, a lower fiscal burden in 2014 and continued recovery should enable growth in the U.S. from our estimate of 1.6% for 2013, to 2.3% in 2014 (see Chart 4).

The perception on Europe improves and the most extreme risks are dissipated. The reforms geared toward better governance continue and growth returns

In Europe the forecasts have been confirmed and the economic situation has continued to improve, to the point that the Eurozone emerged from the recession with growth of 0.3% in the second quarter of 2013, after 6 quarters of recession. The reading of the data is positive in two respects, given that the recent upturn is largely underpinned by improved domestic demand and the improvement in activity has also reached the periphery, contributing to eliminate the

systemic risks characterizing previous quarters. The recovery of activity has been helped by a reduction in financial tensions in the area and by a relaxation of the more short-term targets of fiscal consolidation.

GDP growth in this part of the year formed part of our scenario, and there has been no additional element to make us change our expectations of a weak recovery. In 2013 Europe's GDP will fall by 0.4% and grow by 1.1% in 2014. The weak recovery is consistent with the deleveraging process underway in the private sector in some economies in the area and the financial fragmentation that is still in place, which affects the capacity of bank credit supply. The next few months will be decisive in progress toward banking union, with the entry into operation of a single supervisor, the ECB, and the definition of the mechanisms for bank resolution, the model for implementing which is still under discussion.

Risks in the forecast: downward bias but a priori with less probability and lower impact

Fewer risks to the aforementioned baseline scenario. This does not take away the fact that the balance of risks continues to be downward, given that a variety of factors are still in place. First of all, it is worth mentioning the possibility that the Fed's exit process from QE may be disorderly, giving rise to an excessive increase in interest rates (in the U.S. and in other countries). Financial conditions that are too tight for the rest of the world could abort a global recovery if it is not especially dynamic, particularly in the Eurozone.

Second, it is worth identifying as a risk factor the possible adjustment in growth in China and in other emerging markets. This could be the result of idiosyncratic factors, but also of dilemmas which domestic policies have to address in a less favorable global financial environment.

Lastly, the resurgence of the euro crisis remains a globally relevant risk. The authorities have to support the good perception of the markets with decisive progress to strengthen monetary union, in particular banking union. In all, there are a number of elements that could lead the better perception to change, ranging from a check in the necessary reforms to unexpected results in the review of bank balance sheets and the stress tests to risk scenarios, needed for the implementation of a single banking supervisor, the ECB. Finally, as has been shown by past experience, disagreements on the definition of policies that strengthen the euro area, in this case bank resolution mechanisms, may produce tensions and volatility in the financial markets.

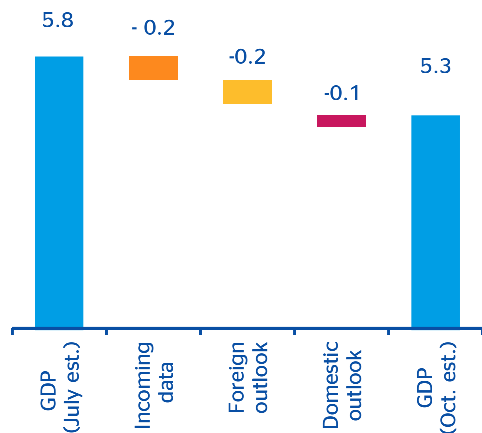
3. Peru: growth at around 5.5% in the coming years

The slowdown in the Peruvian economy this year has been more pronounced than initially expected, but seems to have bottomed out at the end of the third quarter. Indeed, the latest figures from the set of indicators of business confidence released by the Central Bank have shown a general recovery, although they remain at low levels compared to the start of the year. In any event, they suggest an improvement in private sector investment. In addition, different output indicators from August and September showed better performance than two or three months ago (mining output, exports, electricity generation, credit expansion). On a less positive note, it should be stated that consumer confidence remained at 50, pointing to families still being somewhat cautious regarding spending decisions in a scenario where they believe getting a job has become more difficult. Nonetheless, this outlook should gradually change as investment starts to speed up and, with this, employment rises.

On balance, we believe the recent confidence and output figures point to higher GDP in the fourth quarter. This output performance is in line with what we stated in our previous publication: the Peruvian economy is undergoing a cyclical slowdown after several quarters of strong growth supported by exceptionally favorable external circumstances. This means the slowdown is temporary and reflects a transition toward growth rates that are more in line with our potential GDP estimates.

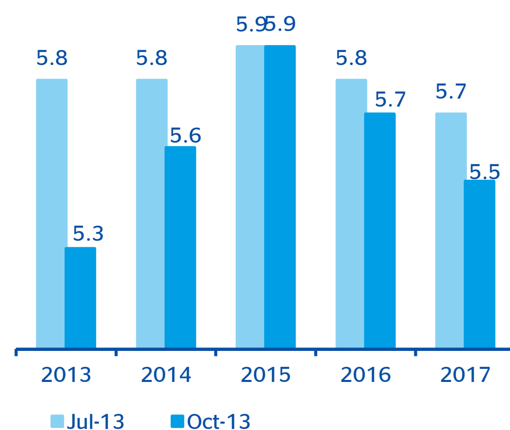
In this scenario, we expect the economy to expand by 5.3% this year which, although being a downward revision compared to our forecast from three months ago (due to a sharper decline in exports and lower private spending, see Chart 5), is a positive result and continues to show economic expansion as being highly resistant to periods of external turbulence such as those seen throughout 2013.

Chart 5
Peru: change in 2013 GDP forecast (% change and pp)



Source: BBVA Research

Chart 6
Peru: GDP growth 2013-2017 (y/y % change and pp)



Source: BBVA Research

For the 2014-2017 period, we expect to see annual average growth at around 5.6% (see Chart 6), which will be supported by a temporary up-tick in exports thanks to large mining projects currently being executed entering the productive phase, and sustained contributions from domestic demand.

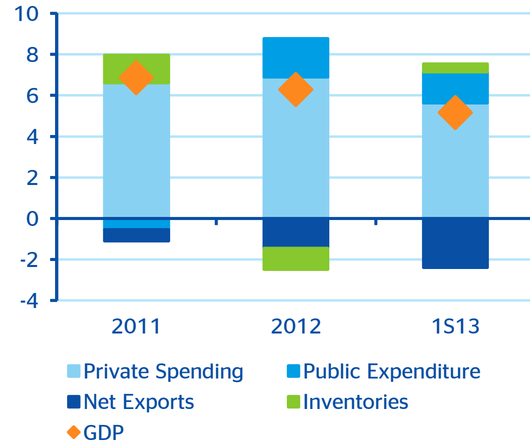
Slower growth should have bottomed out

The Peruvian economy growth rate has been slowing since the start of 2011 (see Chart 7), a trend that became more pronounced in the first part of this year due to a more negative contribution from exports given the lower volumes sent abroad (see Chart 8). The contribution of private sector spending also showed a drop compared to last year, which reflected in a more discreet performance in investment.

Chart 7
Peru: monthly GDP (% change y/y)

Source: BCRP and BBVA Research

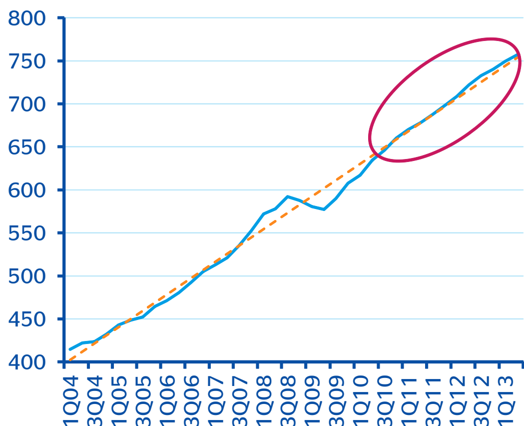
Chart 8
Peru: Contribution to GDP growth (y/y % change and pp)



Source: BCRP and BBVA Research

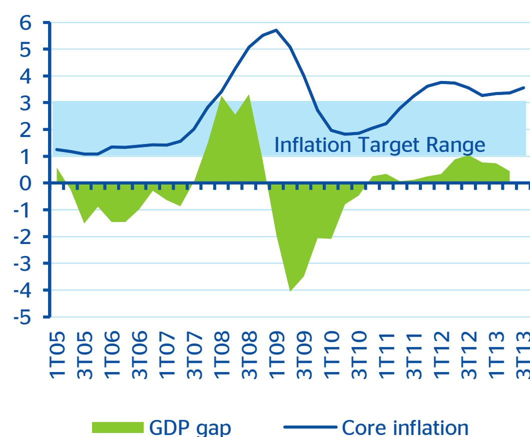
According to our estimates, the slowdown seen for the last couple of years is consistent with a cyclical convergence of output towards its potential level. In this sense, GDP has moved from a peak to a more sustainable path in the medium-term, after several quarters of high growth rates driven by exceptionally favorable external conditions (see Chart 9). The perception that the Peruvian economy has been expanding above its potential can be corroborated by evidence that suggests there are slight demand pressures on prices. Thus, core inflation has remained above the target range since July 2011 in a scenario where the output gap (the difference between actual and potential GDP) has remained positive (see Chart 10).

Chart 9
Peru: seasonally-adjusted GDP and trend (Index of real GDP)



Source: BCRP and BBVA Research

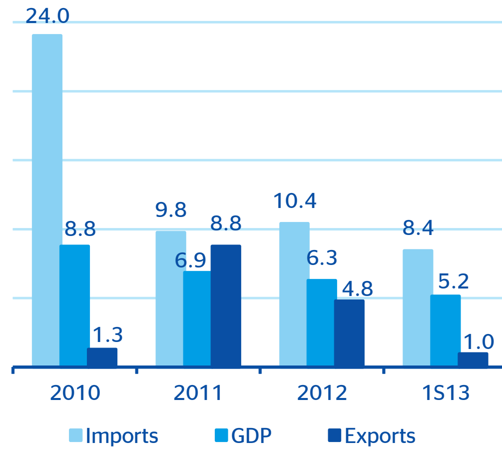
Chart 10
Peru: Output gap and core inflation (%)



Source: BCRP and BBVA Research

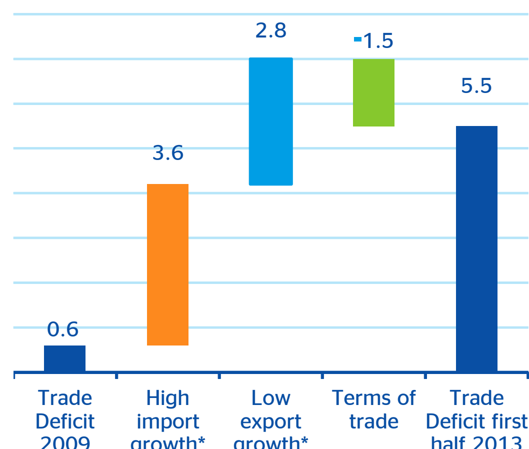
The strong expansion of GDP and, specifically, of domestic demand has also reflected in pressures on the current account due to higher imports (see Chart 11). In fact, purchases of goods and services from overseas are the main reason behind the worsening current account in recent years (see Chart 12).

Chart 11
Foreign Trade and GDP
(Real % change)



Source: BCRP and BBVA Research

Chart 12
Breakdown of the higher current account deficit
(% of GDP and pp)

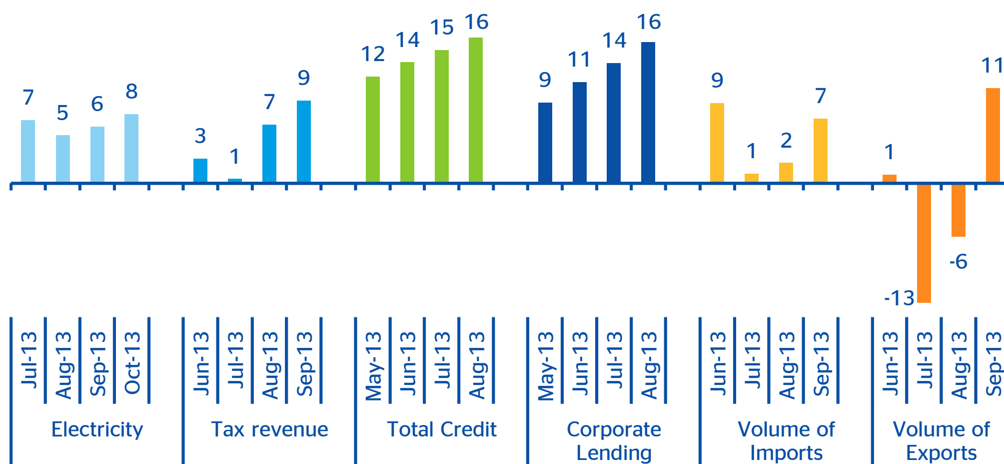


Source: BCRP and BBVA Research

We expect a gradual recovery of GDP growth since the last quarter of the year

Available indicators to date point to slower growth having bottomed out and suggest a better performance in the last quarter of the year (see Chart 13). Firstly, electricity production has been gaining force since September and expanded almost 8% in October, the highest rate so far in the year. Secondly, tax revenue increased in September (9.3%) thanks to an improvement in domestic sales tax and utilities tax payments. In addition, more flexible reserve requirements are stimulating credit growth, mainly favoring corporate lending.

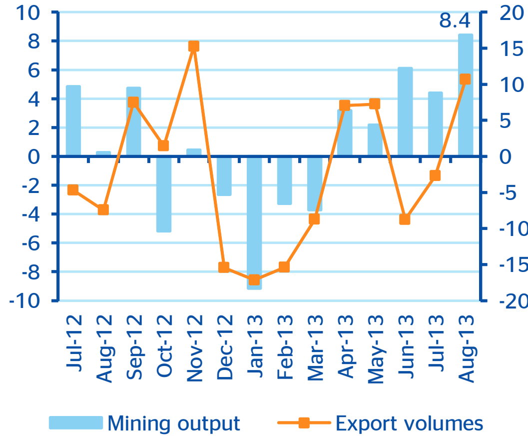
Chart 13
Indicadores de actividad (Var % real a/a)



Source: BCRP, MEF, COES, SBS, SUNAT and BBVA Research

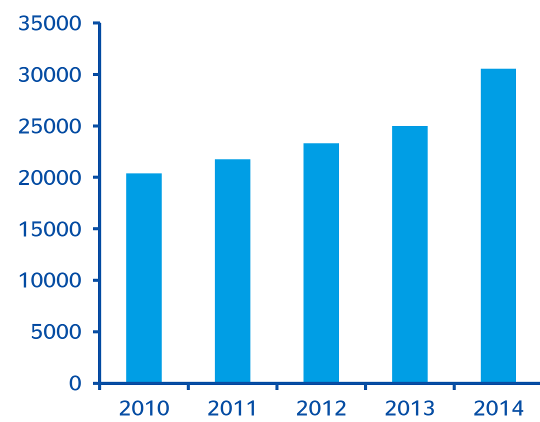
In terms of expenditure, exports will provide greater support for GDP, in line with the recovery in mining production which has improved since June (see Chart 14) and we see an additional boost with the start of the operations at the Toromocho copper project, announced for December this year. Moreover, the decline in exports and mining in the first few months of 2013 should generate a statistical effect that will positively impact results during the first quarter next year.

Chart 14
Mining output and exports (real y/y % change)



Source: BCRP and BBVA Research

Chart 15
Fiscal budget for staff and social benefits (million soles)



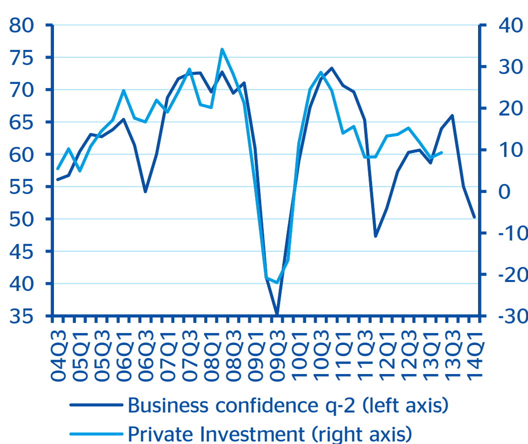
Source: BCRP and BBVA Research

Lastly, we expect public spending to continue to provide support for domestic demand in the remainder of 2013 and in 2014. This forecast takes into account the higher resources aimed at current expenditure thanks to the changes in remuneration policies within the framework of reforms in some public sector areas (see Chart 15), as well as the higher public investment levels included in the 2014 budget (see fiscal policy section below).

Recovery of confidence will be key to ensure a soft landing

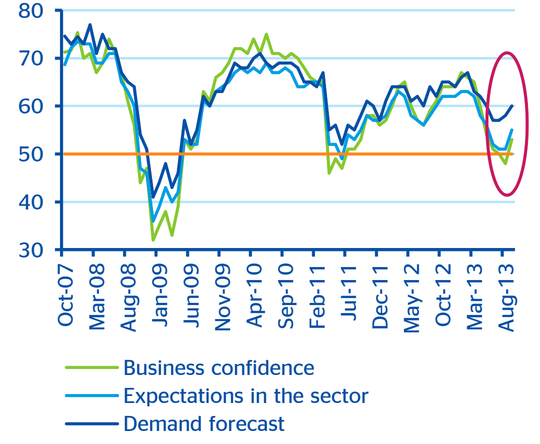
As stated above, the Peruvian economy is in a convergence phase moving toward growth rates around 5.5%. For this process to be gradual and neat, it is important to boost private sector confidence, so as to avoid sudden (and unnecessary) moves in investment spending due to self-fulfilling prophecies where business apathy and low growth feed back into each other (see Chart 16). In this sense, the 5-point jump in the business confidence indicator in October was a positive sign, as it now sits at 53 points and returned to the optimistic zone (see Chart 17).

Chart 16
Business confidence and investment (Index and real y/y % change)



Source: BCRP and BBVA Research

Chart 17
Business expectations indicators (Indices)

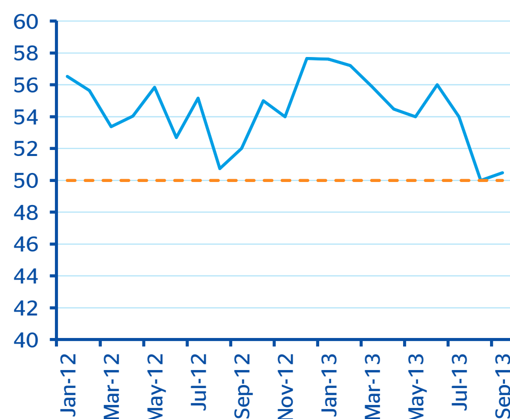


Source: BCRP and BBVA Research

Indicators for "sector expectations" and "demand expectations" also point to a better performance for business spending over the coming months, as they correlate well with investment and reflect greater certainty among entrepreneurs' opinions. The levels of these two indicators are above the one for business confidence (see Chart 17). In our forecasts, we have taken into account that the latter will converge at levels currently seen in the former (between 55 and 60 points). In order for this improvement in business confidence to materialize, macroeconomic and business conditions need to have a positive slant. Regarding foreign issues, this would be supported by fewer problems in the world's leading economies. On the domestic front, it would be favorable that expectations of a devaluation that came up in previous months dissipate and a boost in the dynamism of the business environment. To achieve this, it would be better to start obtaining specific results rather than announcing projects or measures. These results may include, for example, reducing procedures and timeframes for permits and licenses for businesses, as well as a quick roll-out of large infrastructure projects and access to capital markets by SMEs.

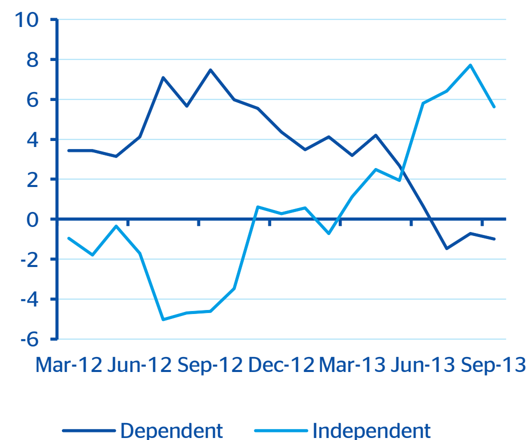
On the consumer front, confidence (as measured by the INDICCA of Apoyo Consultoría) remained neutral (50 points) in the last three months, after coming in at historically high levels of optimism at the start of the year (see Chart 18). While inflation has affected the perception of well-being in lower income sectors (SES E and D), the lower chances of finding a job have started to be a concern for nearly all socioeconomic levels. In relation to the latter, although statistics show a lower unemployment rate (from 6.1% at the start of 2013 to 5.6% in the third quarter), the slowdown in private investment should have started to impact dependent employment, which is a more stable source of income. Thus, dependent employment to August declined 0.7% compared to the same period last year, while independent employment increased 7.6% (see Chart 19).

Chart 18
Consumer confidence (Index)



Source: Apoyo Consultoría

Chart 19
Employment in Lima (% change y/y)

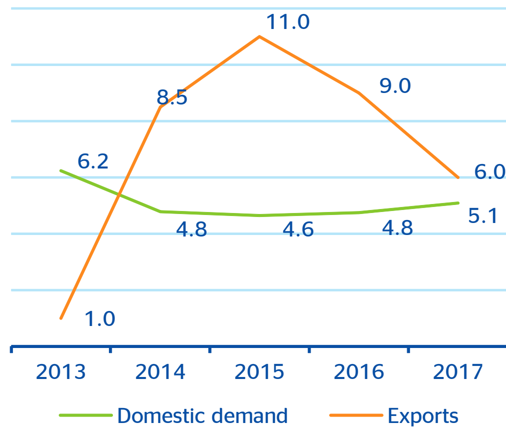


Source: BCRP and BBVA Research

Looking forward, growth forecasts for the Peruvian economy continue to be positive

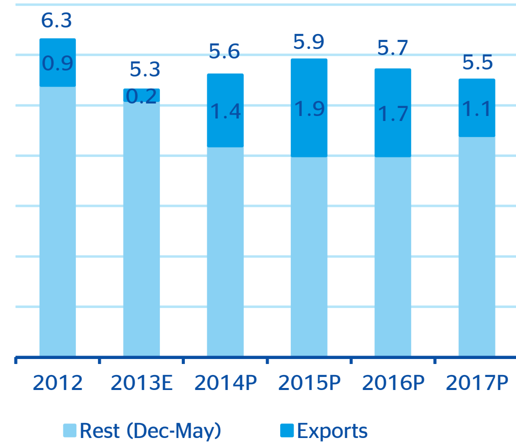
We forecast the 2014-2017 period seeing annual average growth of around 5.6%, which will be supported by a temporary up-tick in exports thanks to large mining projects currently being executed coming online and, thanks to this, we expect a growth peak of 5.9% in 2015 (see Charts 20 and 21). Also, a sustained contribution in domestic demand is forecast.

Chart 20
Domestic demand and exports
(% change y/y)



Source: BCRP and BBVA Research

Chart 21
Contributions to annual GDP growth
(% change and pp)



Source: BCRP and BBVA Research

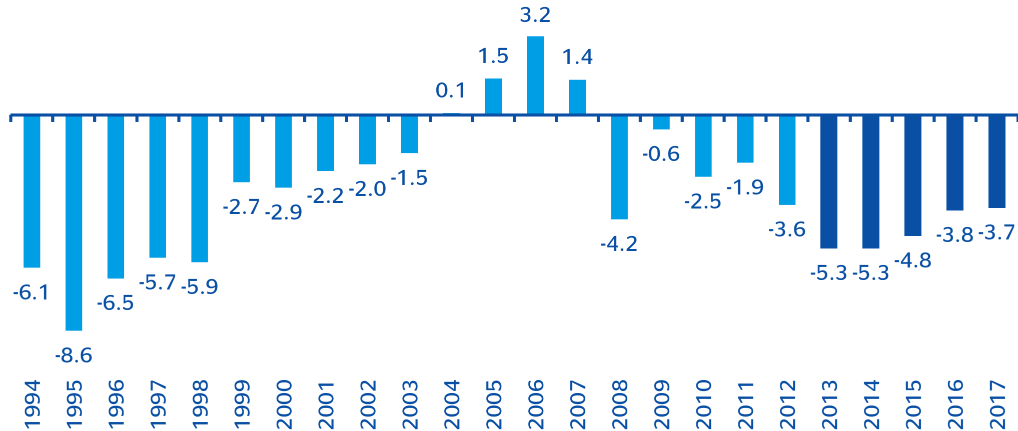
In this way, growth prospects for Peru continue to be favorable and if they come about will lead to an increase in purchasing power per inhabitant of around 20% toward 2017. Nevertheless, in order to make progress as a middle income country and close the income gap with other countries in the region in a reasonable timeframe, Peru will need to sustain growth rates like those it currently enjoys for a longer period. For example, it would take Peru around twelve years to reach Chile's current income per inhabitant level, with the current GDP and population growth rate (see the Medium-Term Outlook section below). In general, beyond 2017, in order to sustain growth in the economy, it needs to cut its reliance on temporary boosts such as those from mineral exports and shore up the factors that have a permanent impact, such as productivity and competitiveness. To do this, the country will need to see large-scale development of infrastructure, improvements in the quality of human capital and reforms that allow workers to move toward higher-performance activities (lower informality).

Current account deficit will expand temporarily in 2013 and 2014

This year and next, the current account deficit will temporarily rise above 5% of GDP, the highest levels since the end of the 1990s, when the knock-on effects from the Asian and Russian crises led to sudden major adjustments in external deficits (see Chart 22). In this sense, and looking at the pressures that some emerging markets with relatively large trade deficits dealt with, we should ask how likely it is today to see a similar external adjustment in Peru: is this temporary widening in the trade gap sustainable? Is it part of a natural process to permanently increase productivity and revenue? Are imbalances being created that could possibly lead to a major external adjustment? In order to analyze these issues, we look at the source, composition and financing of the current account deficit[1] and whether the structural level (which removes exceptionally high/low metal prices as well as the effects of the economic cycle status) is sustainable (in line with the fundamentals).

1: The analysis follows the line of Roubini, Nouriel and Paul Wachtel (1998) "Current Account Sustainability in Transition Economies", National Bureau of Economic Research, Working Paper 6468

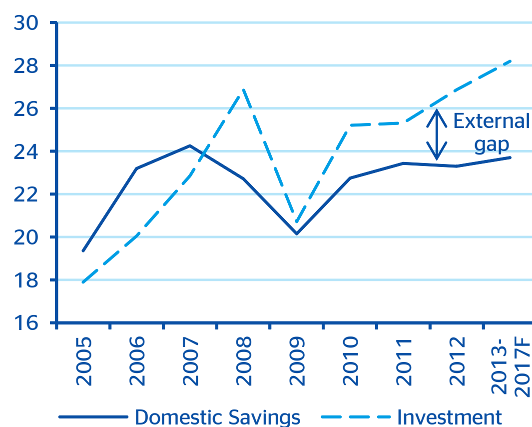
Chart 22
Current account of the balance of payments (% of GDP)



Source: BCRP and BBVA Research

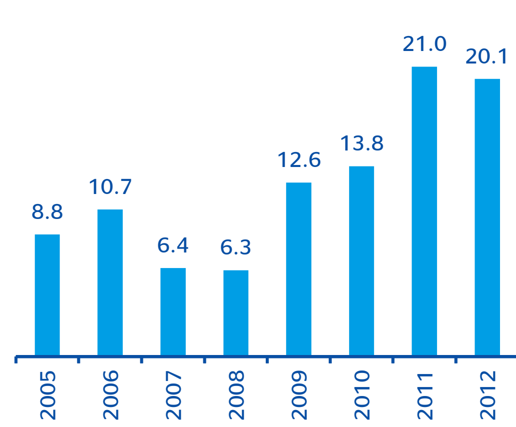
In relation to the source, any current account deficit may be due to lower domestic savings or higher investment. Current account deficits associated with a decline in the domestic saving rate are generally caused by fiscal imbalances, are unsustainable over time and require a domestic adjustment that reduces excessive spending and reliance on external funding. Regarding trade deficits linked to high investment levels, they will be sustainable if the capital is directed to the tradable sector, since they lead to higher future export levels allowing the country to service its foreign debt. In Peru, the wider deficit can be explained by higher investment (see Chart 23). It is worth point out that a significant part of the increase in investment by the private sector has been for tradable sectors such as mining. In this vein, we saw mining investment triple its share as a percentage of private investment (see Chart 24) while domestic saving levels remained steady.

Chart 23
Investment and domestic savings
(% of nominal GDP)



Source: BCRP and BBVA Research

Chart 24
Mining investment
(% of nominal private investment)

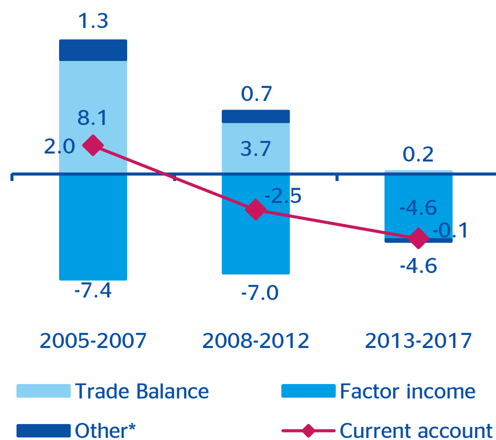


Source: BCRP and BBVA Research

In relation to the composition, we see that a significant part of the imbalance is linked to profits from foreign companies (mainly mining) that operate in Peru. Nonetheless, a major share of profits, instead of being sent back overseas, is reinvested in the country in tradable activities (see Chart 25). In addition, given that a major part of the economy's exports are commodities that depend on international prices, net factor income shows revenues linked to these exports

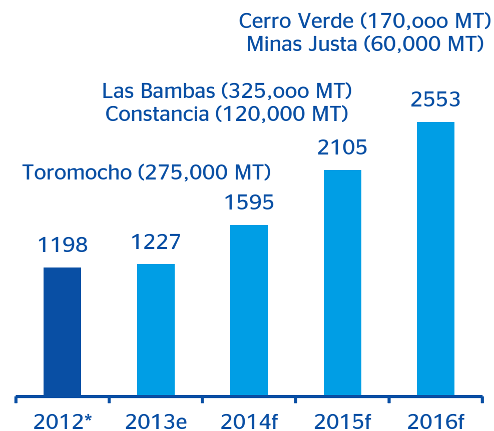
and would act as an automatic stabilizer that would diminish in the face of a decline in the prices of export products, easing pressures on the current account. Both reasons suggest that an imbalance created by profits from foreign companies is more sustainable than one linked to persistent deficit trade balances or high interest payments. If the main factor were a trade deficit, the gap would be evidence of a loss of competitiveness in the export sector. In Peru, although this year and next we expect to see slight trade deficits (the first in 11 years) due to lower terms of trade, the boost to exports from new mining projects coming online, for example in copper production (see Chart 26), will lead to positive levels in the trade balance. In turn, if the external gap is associated with interest payments, this would be evidence of an accumulation of foreign debt which could become unsustainable. The latter is not Peru's case.

Chart 25
Current account, by components (% of nominal GDP)



Source: BBVA Research Peru

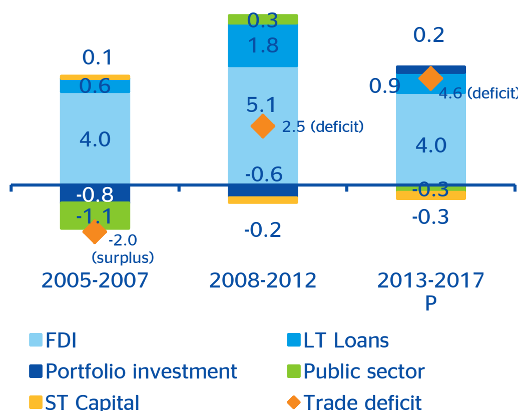
Chart 26
Copper production (Thousands of MT)



Source: BCRP

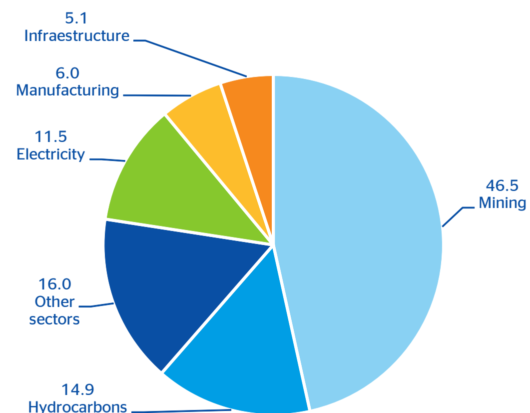
The breakdown of the current account deficit financing is another important factor to take into account when assessing the possible risks it may pose. Long-term foreign direct investment (FDI) is more stable than short-term capital and investment in portfolio or in shares is more dangerous than the loans from issuing bonds overseas. The current account deficit in Peru has been financed mainly through FDI, which we forecast will continue to be the most important component in the future for the financial account (see Chart 27), with a major share of investment going to the tradable sector (see Chart 28).

Chart 27
Financial account of the balance of payments (% of GDP)



Source: BBVA Research Peru

Chart 28
Private investment projects announced for 2013-2015 (percentage structure)



Source: BCRP and BBVA Research Peru

Lastly, it is useful to have a current account measure that does not include cyclical or short-term factors, which we call structural current account. This will give us a view of the fundamental or lon-term imbalance level in the trade gap (see Box 1). According to our estimates, the structural current account shows a deficit of 2.5% of GDP, meaning the imbalance would be moderate (currently 2.8 percentage points of GDP). Moreover, it is important to highlight that the structural level is sustainable in the medium term (in the sense that foreign liabilities as a percentage of GDP do not grow exponentially).

However, there are risk factors such as a possible delay in mining projects coming online that could lead to deficits above 5% for longer than two years or a sudden reversal of capital with noticeable consequences for economic growth. In this regard, Freund (2005)[2] finds that for around 25 episodes of the trade gap widening, on average a typical reversal starts when the deficit worsens for four years and hits 5.0% of GDP. In turn, 80% of the trade gap disappears in three years, the real devaluation of the currency stands at between 10% and 20% and real income growth slows for three years.

In conclusion, we have evidence that the widening trade gap will not create major imbalances that could lead to possible sharp adjustments in the near future. According to our forecasts, this process would be temporary and sustainable in the medium term. Nevertheless, we cannot completely rule out the risks of a longer downturn or a sudden reversal of capital flows.

2: Freund, C. (2005). "Current Account Adjustment in Industrial Countries", Journal of International Money and Finance, Vol. 24, pp. 1278-1298.

Box 1. Methodology for calculating the structural current account

The calculation for the structural current account is done in two stages. In the first, a panel data model for 72 countries that covers the period 1980-2012 is estimated via the Feasible Generalized Least Squares technique (FGLS), which allows corrections for auto-correlation and heteroscedasticity. The analysis is done in three dimensions according to the following equation:

$$CA_{it}=\eta_i+\beta_{long}\overline{X}_i + \beta_{med}\,(\overline{X}_{it}^{5yMA}\;\; X_i) +\beta_{short}(X_{it}-\overline{X}_{it}^{5yMA}) + \Phi_{cyc} Z_{cyc,it_i} + u_{it}$$

where CA is the current account and X is the set of theoretical variables that determine the current account (see Table 1). This equation enables the current account to be broken down into two parts: (i) one long- and medium-term (or structural) that is seen in the average of each variable throughout the period and the deviation from the average of the last 5 years with regard to the average for the entire period and (ii) one short-term (or cyclical) that takes into account the deviation of each variable in relation to the average for the last 5 years. In addition, Z is a set of global idiosyncratic variables that only have short-term cyclical effects. The variables are expressed in deviations from the global average, except for the dependent variable net foreign assets (% of GDP), the oil trade balance and the variation of the terms of trade, since in these instances the global average would be zero.

Table 1
Variables to determine the structural current account

	Variable	Expected sign	Theoretical explanation
Population	Old-age dependency ratio (% of total population)	(-)	An increase in the non-active population reduces the savings rate
	Young person dependency ratio (% of total population)	(-)	
	Population growth (%)	(-)	An indicator of workforce availability that will allow for higher deficits
	Healthcare spending (% of GDP)	(-)	Higher healthcare spending reduces saving
Growth and development	Investment (% of GDP)	(-)	Increased investment given constant savings will worsen the current account balance
	Gap of GDP (% of potential GDP)	(-)	A higher gap increases investment and reduces savings.
	GDP per capita (log adjusted for PPP USD)	(-)	Low income countries normally have current account deficits ("Catch Up")
Savings factors	Fiscal balance (% of GDP)	(+)	Higher fiscal deficits increase available income and reduce saving. Twin deficit hypothesis
	Private sector credit (% of GDP)	?	A more developed financial system may lead to higher saving (+). A higher level could indicate fewer credit restrictions and therefore lower saving (-)
	Net foreign assets (% of GDP)	(-)?	Higher net foreign assets should generate higher net foreign income flows (+). In turn, it could allow countries to have higher trade deficits (-). Negative in empirical works
Commercial and external factors	Trade openness (% of GDP)	?	This is an indicator to trade barriers (or trade costs in a wider sense). It could also be linked to other aspects that make a country attractive to foreign capital (+)
	Trade balance in oil (% of GDP)	(+)	High oil prices increase the current account balance for oil exporter nations and reduce the balance for oil importers (+)
	Terms of trade (index)	(+)	High terms of trade improve the trade balance and current account
External cyclical	Terms of trade (% change)	(+)	An increase in the terms of trade should increase real available income and therefore savings (+)
	Real effective exchange rate	(+)	A real depreciation improves the trade balance and current account
	VIX (change in %)	(+)	Increased global risk aversion leads to preventive savings (+)

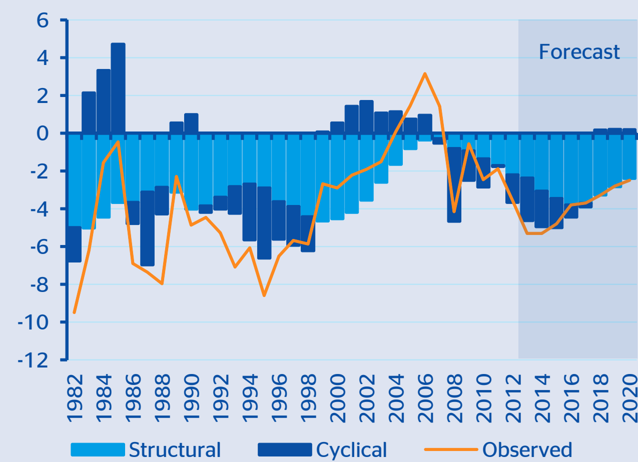
Source: Diversas, BBVA Research

The second stage adapts the estimate of the short and medium-term coefficients that come from the panel estimate for Peru. Specifically, these coefficients are re-estimated in a specific Bayesian model of time series for Peru, where the short and medium-term coefficients from the panel model and their distribution are used as preliminary information in the Bayesian estimate. The estimate for the long-term panel model coefficients remains intact.

The results from the estimates show that in recent years the structural current account is above the observed, however both converge at the end of the forecast horizon (see Chart 29). The most important cyclical factors that would explain this gap in the short term include the terms of trade, which are expected to be lower than those seen in recent years while, on the contrary, investment levels will remain high in comparison to those seen previously (see Chart 30).

Chart 29

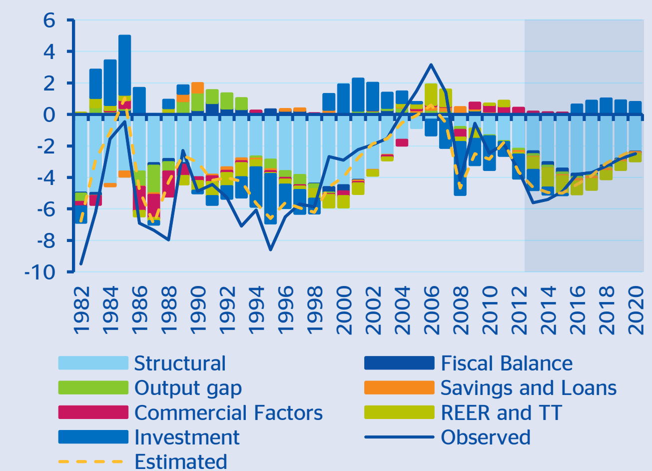
Observed and structural current account (% of GDP)



Source: BBVA Research Peru

Chart 30

Current account, cyclical breakdown (% of GDP)



Source: BBVA Research

In turn, the sustainable current account calculation is based on an inter-temporal approach regarding the budget restriction in the economy, as follows:

$$B_t - B_{t-1} = CC_t$$

Where CC_t denotes the structural current account and B_t are the net foreign assets. Dividing this equation by GDP, we can show that the sustainable current account is:

$$CC^s \approx \frac{g+\pi}{1+g+\pi} B^s$$

Where g is the real GDP growth rate and π is the inflation rate. Using our GDP, inflation and net foreign assets forecasts for 2013-2017, the sustainable current account that is consistent with these levels is -2.3%, a figure close to the structural result. This sustainability measure would show both the availability of foreign capital to finance the current deficit and the debtor nation's predisposition to repay its foreign debt.

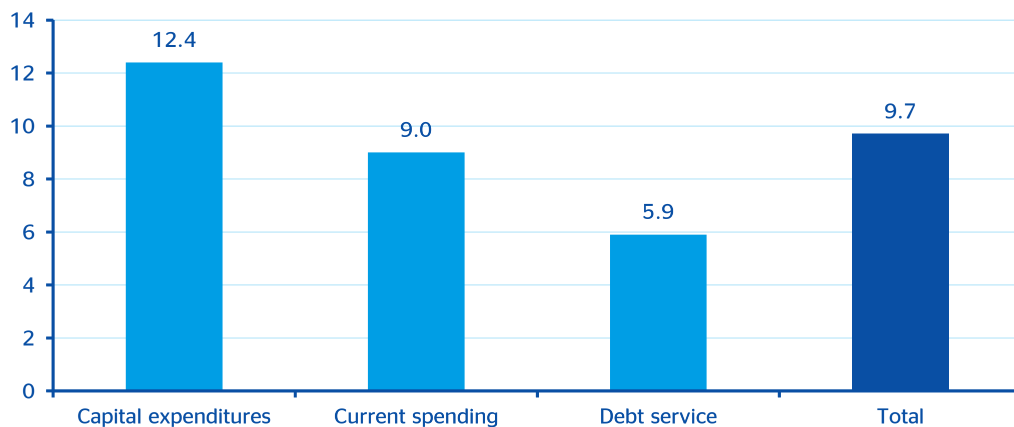
Public sector: moderate deficits since next year

Our forecasts take into account that the growth in fiscal revenues will be affected by the lower dynamism of the economy and the adjustment in metal prices (we expect a reduction in the average price of copper of 8.6% in 2013 and 9.0% in 2014). In this scenario, tax revenue would end 2013 at levels similar to those seen the previous year, and then increase at an average annual (nominal) rate of 8% toward 2017. With these increases, the tax burden would remain at the current level of 16% of GDP for the entire forecast horizon. In this sense, we believe it highly unlikely that the government will hit its target of increasing the tax burden to 18% toward 2016.

In terms of public spending, we expect increases from both current spending, as a result of salary reforms implemented in some areas of the public administration, and from higher public investment (see Chart 31).

Regarding remuneration policies, the reform in the healthcare sector, the teaching reform act and the National Police and Armed Forces salary reform are worth pointing out. As a whole, their implementation involves S/. 2.3 billion extra in the 2014 Budget to deal with the salary rises of doctors, teachers and military professionals. With this, the government's salary effort has raised the weight of employee and social contribution items as a percentage of GDP, going from 4.5% in 2012 to 5.1% in 2014. If the reforms bring about better quality services provided by the State, they could generate better results in the competitiveness measures. Furthermore, it should be stated that around 9% of the active population employed works in the public sector and most belong to middle income levels, meaning some positive impact could be expected on private consumption by households in these segments.

Chart 31
2014 budget compared to the previous year (% change)



Source: BBVA Research Peru

Table 2
Main investment projects at fiscal budget level in 2014 (S/. millions)

Project	Tender	2014 budget
Construction of line 2 and branch Av. Faucett-Gambeta on the basic Lima and Callao metro network	M. Transport	1550
Improving Av. Nestor Gambetta-Callao	M. Transport	330
Construction and equipping of educational institutions for basic middle school education	M. Education	268
Special mass transit electric system project for Lima and Callao	M. Transport	267
Renovating north Pan-American road	M. Transport	217
Construction and improvement of the road Camana-DV. Quilca-Matarani-Ilo-Tacna	M. Transport	151
Improving the San Marcos-Cajabamba-Sausacocha road	M. Transport	143
Majes Siguas 2nd Stage	GR. Arequipa	126
Renovating and improvement of Chamaya-Jaén-San Ignacio-Rio Canchis road	M. Transport	120
Renovating and improvement of Chamaya-Jaén-San Ignacio-Rio Canchis road	M. Transport	111
Improving irrigation and hydro-energy generation in Alto Piura	GR. Piura	76

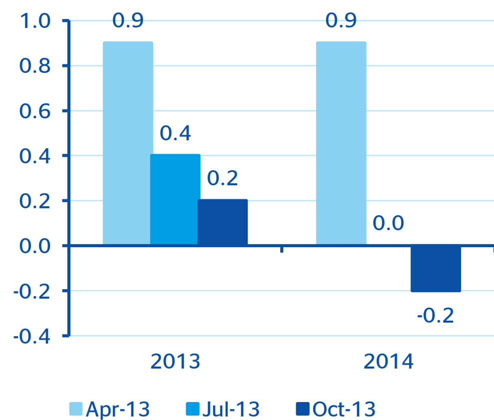
Source: BCRP and BBVA Research Peru

On the public investment front, performance to the third quarter this year saw real year-on-year growth of 18% and, given that the performance level is lower than 50% of the annual budget, we expect this growth rate to be sustained for the rest of the year. The 2014 fiscal budget allocated S/. 32 billion for capital expenditure, representing an increase of over 12% from 2013 (see Chart 31). Around 83% of these funds are mainly aimed at financing investment projects as well as producing profile and feasibility studies. The largest projects are in the transport sector (see Table 2), including construction of subway line 2 in Lima (S/. 1.55 billion), improving Av. Nestor Gambetta at Callao (S/. 330 million) and the special mass transit electric system project for Lima (S/. 267 million). Most investment projects, however, are relatively small and, in some instances, have performance problems. In this sense, in order to encourage project growth, the 2014 budget allocated S/. 500 million to the Promotion Fund for Regional and Local Public Investment (FONIPREL), which will cover not only projects but also pre-investment studies. In addition, the Support Fund for Co-financed Public Private Partnerships (PPA Fund) has been set up with up to S/. 1.5 billion. The aim of this would be to ensure the co-financing and awarding of guarantees for projects declared viable.

It should be stated that the Private Investment Promotion Agency (Proinversión) has 25 projects in its books with a planned awarding date for 4Q13 to 4Q14 for an amount of around USD 12.8 billion. The main projects already announced include Section 2 of the Carretera Longitudinal de la Sierra highway with an estimated investment of USD 552 million under the co-financing method, the Lima and Callao Subway (5.508 billion, co-financed), improvements to energy security and developing the southern gas pipeline (USD 2.431 billion, concession) and the third stage of the Chavimochic project (USD 606 million, co-financed).

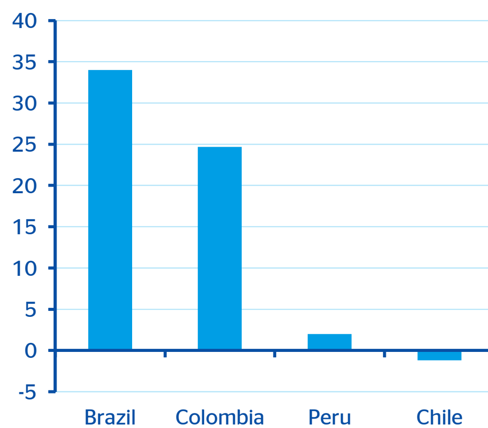
As a result of these forecasts for public sector revenue and expenditure, we expect a lower fiscal surplus in 2013 (0.2% of GDP) and moderate deficits from 2014 on (see Chart 32). These results do not compromise fiscal account solvency, as the debt-to-GDP ratio will continue to show a decreasing trend for the coming years (going from a current level of 18% to 15% in 2017), although more gradual than our previous forecast. This has been one of the factors behind Fitch Ratings raising the sovereign debt rating in foreign currency to BBB+ last October, in a similar vein to what S&P carried out previously. It should be stated that among the countries rated BBB+ by the latter agency, Peru is the second with the lowest level of debt, and the Peruvian debt level is far below that of other countries with a higher rating (A). Moreover, the country's net debt is among the lowest in the region, which leaves room for fiscal policy to implement counter-cyclical policies if required (see Chart 33).

Chart 32
Fiscal balance (% of GDP)



Source: IMF and BBVA Research

Chart 33
Net debt (% of GDP)



Source: Bloomberg

Box 2. Change in fiscal rules strengthens the stabilizing role of public balances

The Fiscal Responsibility and Transparency Act (LRTF) came into effect in the country in 2000. This act aimed to establish the guidelines for better public finance management, creating the Fiscal Stabilization Fund and, thus, contributing to economic stability and sustainable growth in the country. The main quantitative limits that were established with this act are: (i) the annual fiscal deficit of the Consolidated Public Sector will not be higher than 1% of GDP, (ii) the non-financial annual spending increase of the Central Government will not exceed the average annual inflation rate by more than two percentage points and (iii) the medium-term public debt will be in line with the principle of balance or fiscal surplus. In addition, other spending and debt limits were established for Regional and Local Governments.

The implementation of this act was beneficial, allowing transparent and responsible management of macro fiscal accounts. The most noteworthy result of these policies was the lower public sector debt levels, going from almost 50% of GDP in 2000 to current levels, below 20%. Furthermore, public debt payments went from 26% of the public budget in 2005 to just 8% of the budget in 2013. In turn, the implementation of these rules, alongside sustainable economic growth and higher commodity prices, have enabled several years of fiscal surplus and accumulated funds that amount USD 8.6 billion in the Fiscal Stabilization Fund (FEF).

Despite the success in reducing the debt ratio, the problem is that the established rules are pro-cyclical and do not provide a stabilizing role in fiscal policy during periods of crisis or economic slowdown. This represents a major restriction if the strong reliance of public sector revenue with regard to commodities is taken into account. Therefore, when the government has aimed to ease the unfavorable cycle phases, it has needed to temporarily loosen some of the rules.

In order to avoid these modifications and the uncertainty they could generate, the government has presented a bill to modify the LTRF, incorporating structural elements into the limits imposed. The main measures proposed include:

- The non-financial public sector structural fiscal deficit will not be higher than 1% of GDP. The government must adopt an estimate of the structural economic result as an ex ante guide.
- The non-financial spending limit of the central government will be established based on the ex ante guide from the planned structural result for a period of 3 years.

At regional level:

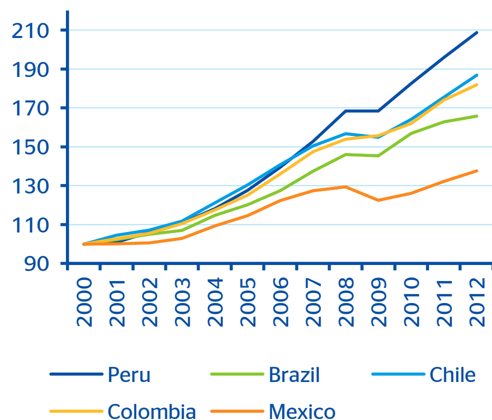
- The ratio between the total debt balance and average total current revenue in the last 4 years will not be above 100%.
- The annual percentage change in non-financial spending will not be higher than the 4-year rolling average change in annual revenue.
- External borrowing may only be obtained with the guarantee of the State and only to fund public infrastructure.

Conceptually, we believe that it is necessary to make changes to the LRTF and that incorporating structural elements into the rules is positive. However, we see some problems that the application of the presented proposal could have. Firstly, since the spending level fiscal rule is supported by a structural exercise (which involves calculating long-term commodity prices and potential GDP, among others) and this being not easily measured, major estimate errors may be made. One example of these measuring errors are the estimates made by the IMF for Spain, Greece and Ireland that show major changes between those in 2007, before the crisis, and the revisions in 2011. Secondly, the rule and the calculations it involves are not simple and, therefore, will be difficult to explain and understand, which could reduce their success and social acceptance. Lastly, it will be necessary for these calculations to be made by a technical committee that is truly independent from the government and which would not be subject to accountability. Regarding this point, we should ask ourselves if elected authorities will want external technicians calculating the structural elements that will define their spending levels. Generally speaking, we believe that adapting the fiscal rules to the new economic environment is favorable and the bill presented in that sense is a good effort from the government. However, a simpler rule could be considered (perhaps seeking to stabilize the ratio of public debt to GDP throughout the cycle at a socially acceptable level). What should not be overlooked is that the final aim is to maintain public finance sustainability.

Medium-term outlook: what is needed to move toward higher value-added activities?

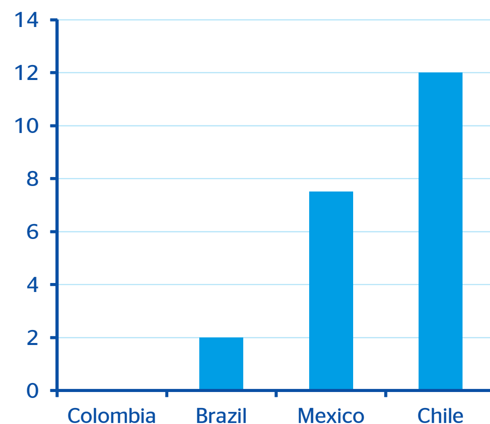
The Peruvian economy has seen average growth rates of 6.4% over the last ten years thanks to economic reforms, responsible monetary and fiscal management and a favorable external setting with high metal prices. This strong performance has enabled an 81% rise in revenue levels between 2001-2012 and a decline in poverty from 42.4% in 2007 to 25.8% in 2012. Although Peru has expanded more quickly than other countries in the region (see Chart 34) and has reduced the income gap, it is still below several of them. In this sense, Peru's GDP per capita in terms of purchasing power parity (PPP) is 58% of Chile's and 67% of Mexico's. At the current growth rate, reaching income similar to Chile's today would take around 12 years (see Chart 35).

Chart 34
Income per capita by PPP (Index, 2000=100)



Source: IMF and BBVA Research

Chart 35
Term to reach the current income level of diverse countries (years)



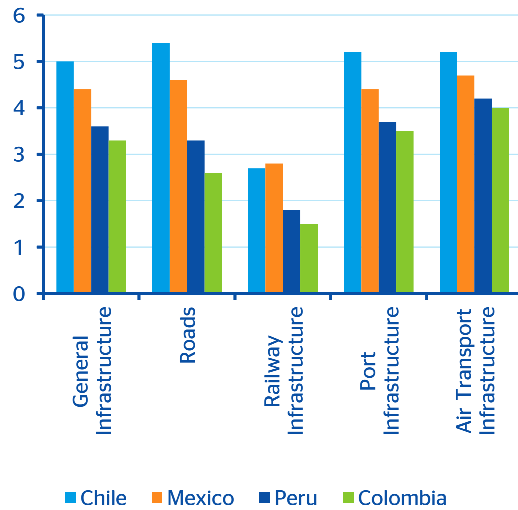
Source: IMF and BBVA Research

Peru's economic growth has been generally based on activities with low added value and has been largely supported by high prices for the metals it exports. Along this line, 75% of exports come from primary activities and 14% from fiscal revenues come from natural resources (mining and hydrocarbons). Achieving sustainable growth would require diversifying productive activities, moving toward those with higher added value. In this respect, we should perhaps begin to look at creating a trend toward greater industrialization. Some international experiences show that increasing competitiveness and attracting higher foreign investment to develop manufacturing is highly beneficial for sustained growth in the country. Ireland is an example of this, where the economy expanded by almost 80% between 1993 and 2000, and consumption per capita went from 65% of the EU average in 1987 to parity in 2000. Ireland implemented economic policies that included tax incentives and concessions which, combined with the availability of a highly qualified workforce, managed to attract large investment, especially in the high technology manufacturing sector.

Compared to Ireland, one of the major problems Peru faces to make the leap toward high value added activities is workforce training and qualifications. The Human Capital Index from the World Economic Forum, which measures the capacity of countries in terms of healthy, educated workers and a favorable employment setting, shows Peru coming 75th out of 122 countries, 39 places behind Chile and also behind other countries in the region such as Uruguay, Brazil, Mexico, Ecuador, Argentina and Colombia. Within the index components (education, health and well-being, workforce and employment, and favorable environment), we come in worse off in education, in 84th place. In addition to the fact that a large part of the population does not have higher education qualifications, in many instances the higher education provided is low-quality. Another factor with a major lag is infrastructure. As in the previous point, the role of the state

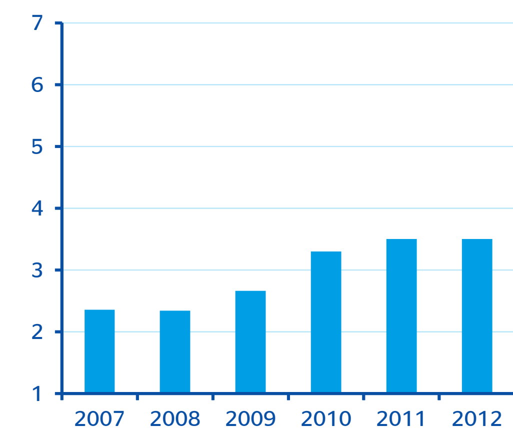
here, easing bottlenecks, would be key. According to the latest measurement on the 2012-2013 Global Competitiveness Report produced by the World Economic Forum (WEF), Peru came in 61st place out of 148 countries. Although the quality of infrastructure seems to have improved in recent years, it is still far from being considered at developed and efficient levels in line with international standards (see Charts 36 and 37). Within the Pacific Alliance group of nations (Chile, Mexico, Colombia and Peru), Peru is the third least developed in terms of infrastructure quality. With regard to roads, for example, only 14% are paved, which, in addition to the traffic due to other deficiencies on the roads, results in significant waste of time and higher costs. In this sense, although economic growth in recent years has been important in improving revenue and reducing poverty, looking forward it will be necessary for productive activities to turn toward high value added areas, increasing productivity and competitiveness in industry.

Chart 36
Infrastructure competitiveness (Index; 1=very poor, 7= good development)



Source:WEF

Chart 37
Quality of port infrastructure (Index; 1=very poor, 7= good development)



Source: WEF

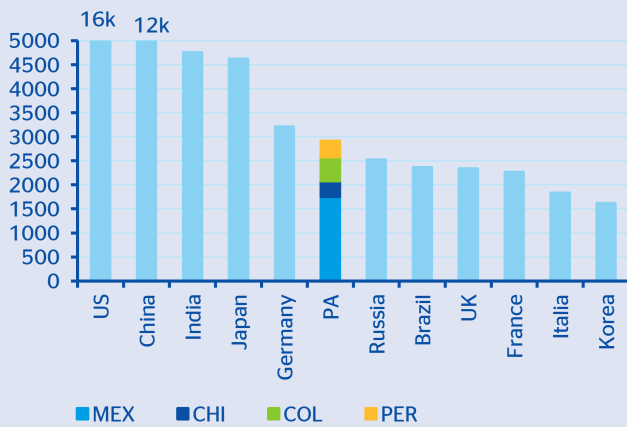
Box 3. The Pacific Alliance, the Latin American giant committed to trade and financial integration

The Pacific Alliance (PA) is an ambitious process for economic and trade integration. One of its pillars is the building of an area of close integration through participation and agreement, progressing gradually towards the free movement of goods, services, capital and persons. At present it is made up of Chile, Colombia, Mexico and Peru (Costa Rica and Panama are in the process of joining). It not only aims to extend integration among its members but also with the rest of the world, with particular emphasis on the Asia-Pacific region.

The commitment to integration among these four economies means that it makes more and more sense to see this bloc as a whole, and not as isolated countries. From this perspective, the four countries making up the Alliance represent the sixth biggest world economy, behind Germany but ahead of Russia and Brazil (see Chart 38). More important still, it will be the fourth biggest economy in terms of contribution to world growth in the next ten years, behind China, India and the United States (see Chart 39). It appears clear that the Pacific Alliance (PA) is becoming Latin America's real giant.

Chart 38

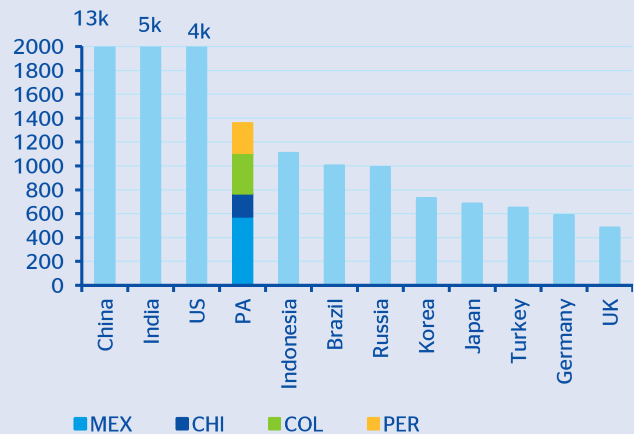
The biggest economies in 2012 (USD million adjusted for PPP)



Source: BBVA Research and IMF

Chart 39

Biggest contributions to global growth in the next 10 years (USD million adjusted by PPP)



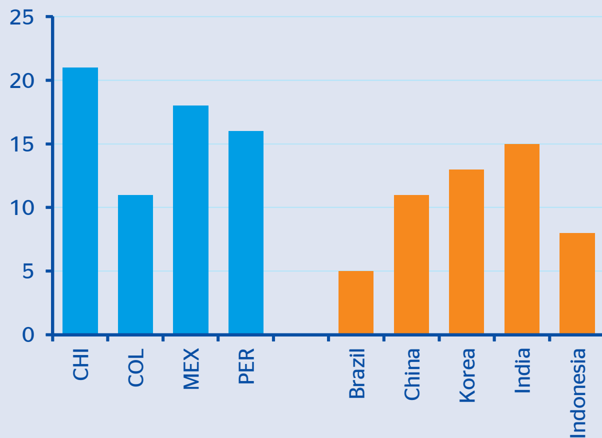
Source: BBVA Research and IMF

But size is not everything. Also important is the type of policies that can be expected from the countries making up the Alliance. Here the PA is also notable for its commitment to integration, not only among its members but also with the global economy. The countries in the Alliance are the emerging markets with the greatest number of free trade agreements signed (see Chart 40); in the case of Peru and Chile this includes agreements with the four main economic areas: the U.S., the European Union, Japan and China. This contrasts with Brazil, for example, which does not have free trade agreements with any of them.

The commitment to trade integration also involves boosting trade flows among the members of the PA. There has been significant progress in this respect, with 92% of the customs tariffs being eliminated completely, and an additional 6.5% due to be eliminated within a very short period. Overall, given the current structure of exports (mainly manufacturing in Mexico, compared with the significant level of commodities in the Andean countries), there is some asymmetry in the potential for increasing the trade of goods within the Alliance. In principle, this should favor Mexico more than the three Andean countries (see Chart 41). Even so, there is a great deal of potential for cooperation, transmission of know-how and investment in the infrastructure and capital market sectors[3].

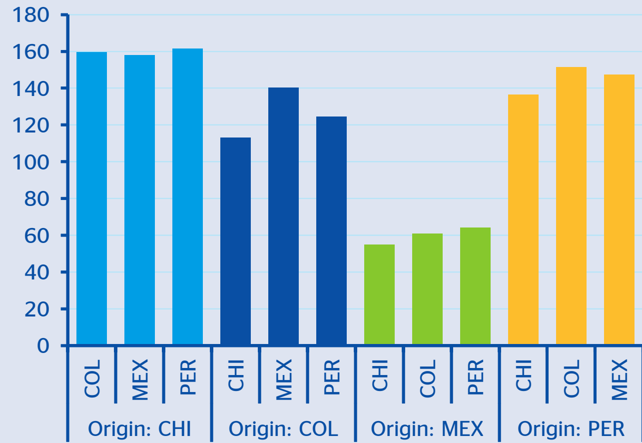
3: For a more detailed analysis of trading links in the Pacific Alliance, see our Economic Watch, August 2012: "New Pacific Alliance Bloc: Mexico and Andeans look towards Asia", available at http://www.bbvaresearch.com/KETD/fbin/mult/120822_EW_EAGLEs_New_Pacific_Alliance_Bloc_tcm348-355823.pdf?ts=25102013

Chart 40
Number of trade agreements signed



Source: BBVA Research and WTO

Chart 41
Export potential index (0 = very high; 200 = very low)



Source: BBVA Research and COMTRADE

The PA is also firmly committed to financial openness and integration, both with the rest of the world and among the countries in the alliance. The countries in the PA have been major recipients of direct investment (in absolute terms and in relation to the size of their economies), above all from the U.S. and Europe, but increasingly from Asia as well. Even more importantly, according to UNCTAD, the countries in the PA are in the top 25% of the global ranking of countries with potential to attract FDI. Table 3 shows that by comparing the two dimensions (observed FDI flows and potential for attracting FDI), the Pacific Alliance countries not only have a high potential for attracting FDI flows, but they actually achieve the rates to be expected by this high potential[4], unlike many other countries in the region[5].

4: Mexico only appears in the second quartile of the world ranking for attracting FDI, but it should be noted that in its case the non-equity modes of production (NEMs), such as manufacturing under contract or service outsourcing, are very significant. They do not count as FDI but include many of its advantages, including transfer of know-how and technologies.
5: A more detailed analysis of the potential to attract FDI and FDI flows within the PA can be found in our Economic Watch, November 2013 "Integración financiera en la Alianza del Pacífico: alta potencialidad y grandes desafíos para una integración exitosa", available at http://www.bbvaresearch.com/KETD/fbin/mult/120822_EW_EAGLEs_New_Pacific_Alliance_Bloc_tcm348-355823.pdf?ts=25102013

Table 3
Ranking of FDI inflows (2009-2012) and potential to attract FDI (2012)

Legend: Above expectations (blue) | In line with expectations (green) | Below expectations (orange)

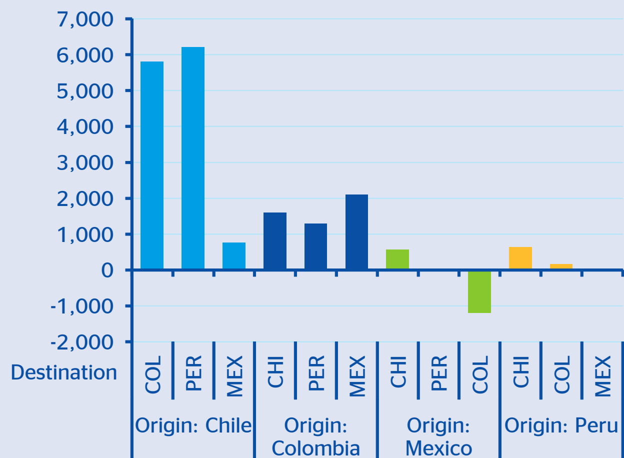
FDI attraction index (2009-2012)	4th quartile (Low)	3rd quartile	2nd quartile	1st quartile (High)
1st quartile (High)		Bahamas	Uruguay, Panama	Brazil, Chile, Colombia, Peru, China, United Kingdom
2nd quartile	Nicaragua	Costa Rica, Honduras	Portugal	Mexico, France, Germany, Spain, U.S.
3rd quartile			Bolivia, Guatemala	Argentina, Japan, Korea
4th quartile (Low)		Paraguay, El Salvador	Ecuador, Greece	

Potential for attracting FDI Index

Note: The ranking and distribution by quartiles are based on a total of 177 countries. The table only shows the Latin American countries and some selected countries outside the region.
Source: BBVA Research and UNCTAD

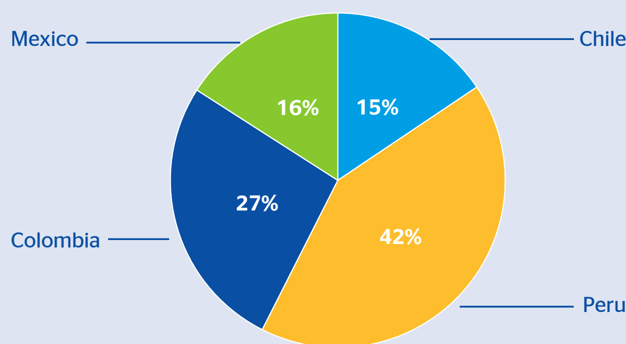
As in the case of trade flows, if we observe the FDI flows within the PA, the first thing to note is its limited percentage in terms of the total FDI received by the four countries (3% of the total in 2009-2013). Further, they are also strongly concentrated in FDI flows from Chile to Peru and Colombia (see Chart 42), probably due to the smaller size of the Chilean economy (leading some of its companies to diversify and expand their operations within the region). There is no doubt that the maturity of the pension system in Chile has also enabled capital to be injected into companies with regional expansion policies, particularly in the retail sales and financial sectors. The concentration of FDI flows to Peru and Colombia would be conditioned by their geographical and cultural proximity, which is associated with the lower costs of monitoring and controlling these investments. The foregoing is also reflected in the aggregate figures from 2009 to 2012, when Peru absorbed 42% of intra-PA foreign investment, followed by Colombia with 27% (see Chart 43).

Chart 42
Cumulative intra-PA FDI flows, 2009-2012. By origin and destination (USD million)



Source: BBVA Research and Central Bank of Chile

Chart 43
Destination of intra-PA FDI. Cumulative 2009-2012 (% of total)



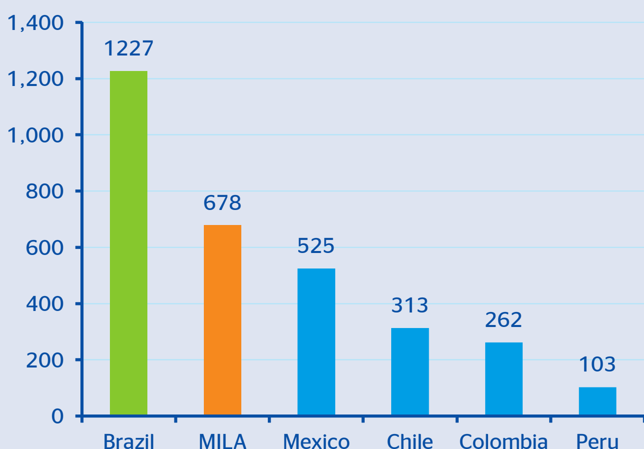
Source: BBVA Research and Central Bank of Chile

It is true that the integration of portfolio flows is still at its early stages, but initiatives such as the integrated Latin American market (MILA), with the full incorporation of Mexico at the start of 2014, have the potential to create a stock market with a capitalization similar to that of Brazil (see Chart 44), although with lower depth and market liquidity. In this context, we expect the cross-flows to begin to increase, using and generating synergies toward deeper and more integrated markets, particularly if the process of harmonization, clarification and coordination of the tax treatment by the authorities of each country continues.

What is the economic outlook for the PA in the long term? This is a region with a high growth potential, around 6% in Peru and 5% in Colombia and Chile. In the case of Mexico, the current reform agenda could increase potential growth to around 4%. This means an average potential growth for the PA of close to 4.5% per year, higher than in Brazil and nearly three times the figure expected in developed economies (see Chart 45).

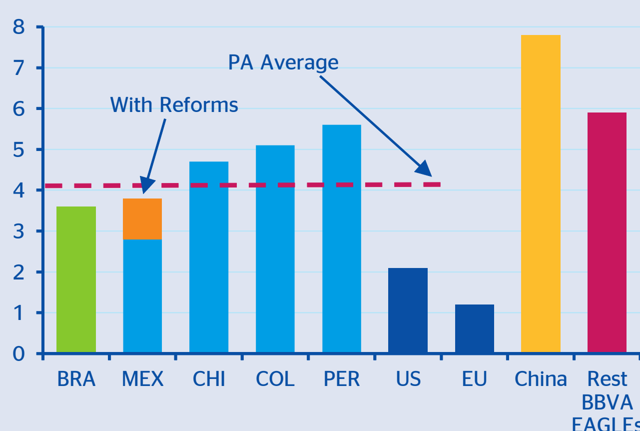
Although the region still has major challenges ahead (high informality, inadequate infrastructures, low quality of education and health), progress has been made in recent years in the right direction. A firm commitment to reform in these areas could increase their high potential growth still further.

Chart 44
Stock-market capitalization, December 2012 (USD million)



Source: BBVA Research and Bloombreg

Chart 45
Potential growth (%)

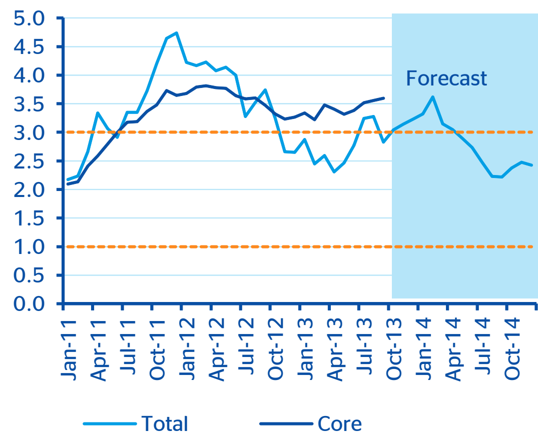


Source: BBVA Research and COMTRADE

4. Inflation will start to move towards the middle of the target range in 2014

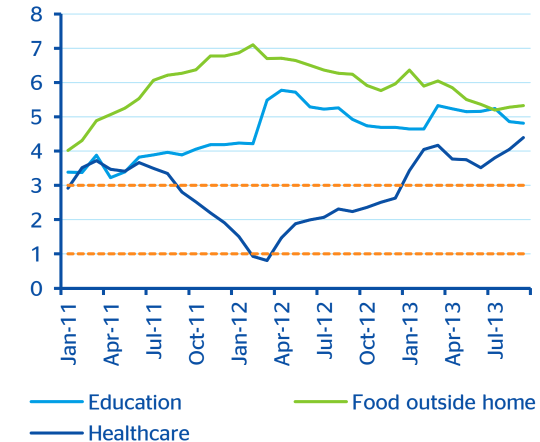
In recent months, inflation has fluctuated close to the upper limit of the Central Bank's target range (2%, +/- 1 pp) coming in at 3.0% at the end of October (see Chart 46). The resistance shown by inflation to converge at its target level mainly reflects that the core component (most closely linked to demand factors and representing almost two thirds of the total) has remained persistently above the upper target range limit for the last two and a half years, with some sub-components standing out with growth rates near 5%, such as Food Outside Home and Education (see Chart 47). This performance comes in a context where the economy has been expanding at a rate slightly above its potential (see section 2).

Chart 46
Year-on-year inflation (%)



Source: BCRP and BBVA Research

Chart 47
Year-on-year core inflation, sub-components (%)

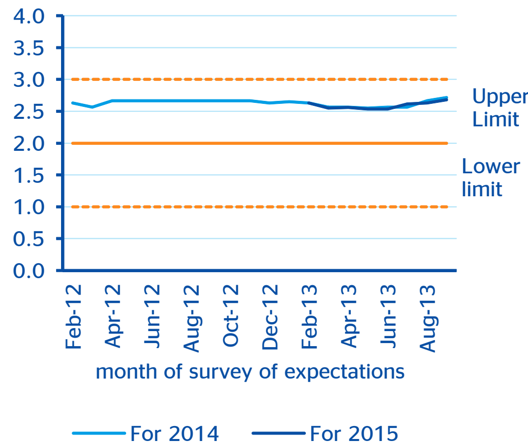


Source: BCRP and BBVA Research

Core inflation's resistance to ease could be explained by the high inflation expectations reflecting the perception that changes in costs are permanent as a consequence of continual supply shocks. In turn, this increases the transmission from changes in costs to end prices (second round effects), which gets worse in an expansive stage of the economic cycle. Indeed, our forecasts show that the persistence of inflation has risen in recent years[6]. Thus, expectations are consistently near the upper target range limit, even in a medium-term horizon (see Chart 48) where they should converge at their target level as would be expected under an explicit inflation target scheme

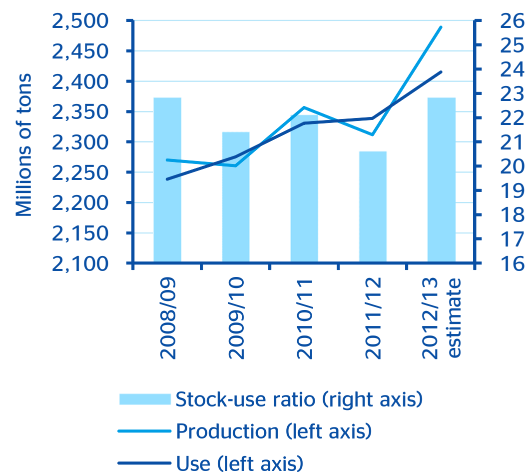
6: We assess the increase in the persistence level according to the methodology put forward by Taylor, John (2000) "Low inflation, pass-through, and the pricing power of firms", European Economic Review, for two sub-periods: 2000-2005 and 2006-2013. The results show that inflation persistence is higher and significant in the second period: the sum of the coefficients associated with the lags in inflation is greater.

Chart 48
Inflation expectations for 2014 and 2015 (% end of period)



Source: BCRP and BBVA Research

Chart 49
Cereals: production, use and global stock levels (millions of tons)



Source: BCRP and BBVA Research

In absence of supply shocks, inflation will gradually return within the target range

In the short term, the reversal of supply shocks for domestically produced food, as well as a normalization in the international oil price (as long as tensions in the Middle East remain contained), should lead to a downward inflationary trend.

We see no external supply shocks for 2014. On the one hand, as we stated in our previous reports, the global supply outlook for cereals is favorable (see Chart 49), which will contain agricultural prices, although the knock-on effect at local level may be somewhat slower (see Box 4). On the other hand, the international oil price will remain relatively stable as the political tension in the Middle East calms down. At local level, the lower private spending we expect will limit demand pressure on prices, and we will see a gradual decline in the core component.

In this scenario, we expect inflation to return to the target range toward the second quarter of next year. It should be stated that despite our estimate of the output gap being almost zero in 2014, inflation will end above the target range due to expectations being resistant to give way.

Box 4. Removal of price band for food imports should ease inflation

In the year to date, international prices for the main agricultural produce have seen a major decline (maize, wheat and soya have declined by 37%, 13% and 10%, respectively). However, domestic consumer prices for goods that use those products have not seen similar drops. One of the reasons for this is that imports of some of this produce, such as maize, sugar and rice, are subject to a price band.

This band is calculated on the standard deviations from the average in the last 60 months of international prices deflated by US inflation . When the import price is above this band, the importer has access to a discount with a maximum limit of the established tariff, while when it is below it, a duty is paid in addition to the tariff (fixed value). In theory, this mechanism should enable the domestic price to remain in or near the band. Nonetheless, since the tariffs on these products are zero, the impact of international prices on local ones is full and immediate when the import price is above the band, as there is no discount for buying the product, but when prices are below the band, passing this on is slow as importers pay an additional duty.

Import prices are currently below the band (see Table 4). As a result, importers are seeing higher costs (equivalent to the additional duty paid) that leads to some resistance on consumer prices to fall. One example of this is poultry products, where the cost of maize (the main source of feed representing around 70%) is 20% higher than the import price, with a contribution to inflation that we estimate to be around 0.3 percentage points. Something similar occurs with drinks using sugar as an ingredient.

One option to avoid the impact of low international prices on domestic prices being low is for the band to be recalculated based on a longer average period for international prices since the current 60 months used for calculation are taking into account the high prices seen in the second half of 2008. The logical idea would be for the band to take into account longer cycles of international prices. If the band dropped, it would have a positive downward effect on inflation.

Table 4
Tariff and reference prices for the import price band

	Corn	Sugar	Milled Rice
CIF Benchmark Price (USD per MT)*	243	513	470
Lower range limit (USD per MT)	289	677	624
Percentage difference	18.9	32.0	32.8

* Corresponding to Sep 16-Sep 30
Source: El Peruano, Sunat

5. Central Bank: pause in easing of reserve requirements until the end of the year and a stable policy rate in 2014

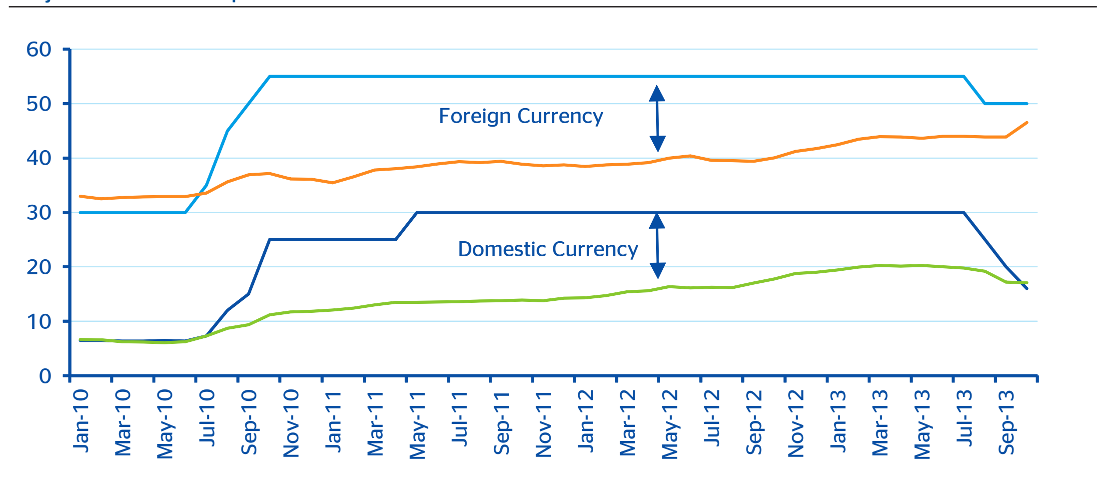
After the Fed announced, in the third week of May, the possibility that the start to tapering of its quantitative easing program (QE3) could come forward to the end of this year, major financial tensions were seen in emerging markets. The Peruvian economy was no exception and between the end of May and August saw drops on stock markets and higher sovereign and global bond yields (as well as the spreads of the latter).

In addition, the exchange rate in this period saw a slight increase (depreciation for the domestic currency) and demand for loans in foreign currency dropped due to higher FX risk. In order to limit upward pressure on the exchange rate, as is common in this kind of situation the Central Bank (BCRP) sold dollars on the FX market and issued Readjustable Certificates of Deposit (CDR, certificates indexed to the exchange rate) to deal with the demand for currency hedges from domestic institutional investors (see section 6).

With regard to loans, in order to ensure a neat evolution and avoid the rise of frictions in the economy, the BCRP cut reserve requirements (see Chart 50 and Table 5). This easing was much more aggressive for reserves in domestic currency, given the higher public preference for loans in this currency, a demand that required lending sources in a scenario of higher dollar deposits. Thus, between June and October the BCRP implemented measures every month to make reserves in domestic currency more flexible: it reduced the marginal reserve from 30% to 16% and established average reserve limits (first in June at 20% and then more recently in October at 16%). These measures have freed up funds for S/. 4.137 billion (equivalent to 3.8% of total bank deposits in domestic currency) and seemingly led to more loans in domestic currency which went from a y/y expansion rate of 12.8% in June to 19.3% in August (latest figures available). In this way, the increased flow of credit as a result of the easing of reserves also helped to provide support to output.

Chart 50

Average and marginal domestic and foreign currency reserves (% of TOSE - transactions and obligations subject to reserve requirements)



Source: BCRP and BBVA Research

Table 5
Recent reserve measures (% of TOSE)

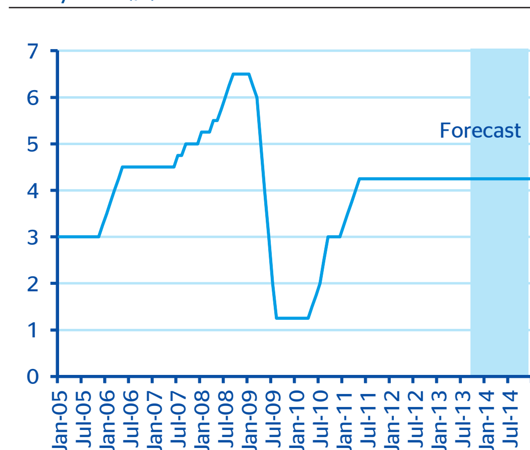
	Recent currency measures				
			Foreign currency		
	Domestic currency		General scheme		External debts
	Marginal currency for deposits	Average currency limit	Marginal currency for deposits	Average currency limit	Short term
May.13					
Jun.13					
Jul.13	30%	-	55%		60%
Aug.13	25%	19%	50%	45%	50%
Set.13	20%	17%	50%	-	50%
Oct.13	16%	16%	50%	-	50%

Source: BCRP

Lower tensions in local financial markets have let the BCRP to take a pause in the process of easing reserve requirements and assessing their impact. In general, thanks to the improvements in expanding credit and the most recent output indicators, we do not expect additional changes to this instrument in the remainder of the year.

Lastly, as inflation continues to move toward the middle of the target range and the economy continues to grow around its potential level, no changes to the policy rate will be needed (see Chart 51 and Table 6). In any event, we continue to believe that any change in the monetary policy position will firstly come via additional cuts to reserve requirements.

Chart 51
Policy rate (%)



Source: BCRP and BBVA Research

Table 6
Determining factors for the monetary policy rate

Factor	Status	Expected effect on benchmark rate
Inflation	Converging with the range	=
Expectations for inflation	Anchored	=
Economic cycle	GDP near potential level	=

Source: BBVA Research

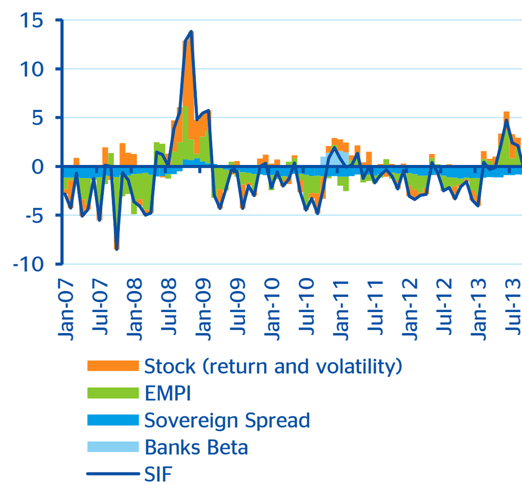
6. Tensions in local financial markets decline, although periods of volatility cannot be ruled out

The exchange rate will continue to fluctuate between S/. 2.74 and S/. 2,80

After the financial tensions seen between May and July, linked to the expected start of tapering by the Federal Reserve, financial markets stabilized in recent weeks (see Chart 52). This easing became stronger when the Fed surprised markets by deciding to postpone the start of tapering in September. In this scenario, the exchange rate moved to between S/. 2.75 and S/. 2.80 per USD. These values are near the fundamental level that we currently estimate for the Peruvian currency, at S/. 2.75, which is higher than the one we calculated at the start of the year. This is linked to the correction in the price of metals in the first part of the year. This increased our expected current account deficit (especially for 2013 and 2014) and would lead to lower dollar supply on the commercial front.

Chart 52

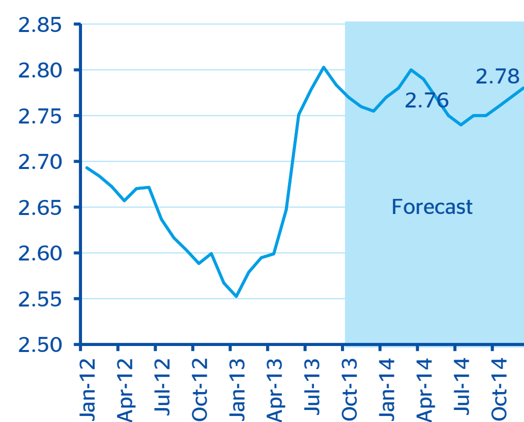
Peru: Financial stress index FSI (Index)



Source: BBVA Research

Chart 53

Exchange rate (S/. per USD)



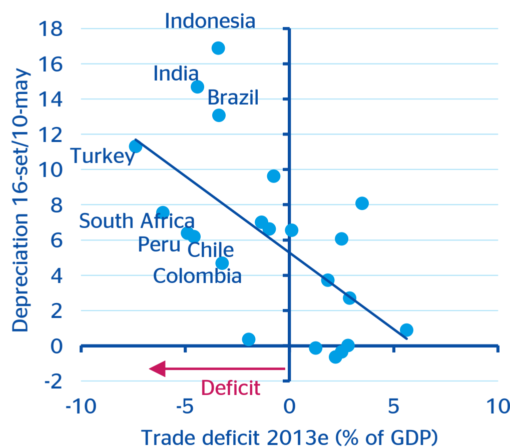
Source: BCRP and BBVA Research

Looking forward, we expect the exchange rate to remain near this fundamental value, leading us to estimate for the end of the year an approximate value of S/. 2.76, and in 2014, S/. 2.78 (see Chart 53). Nevertheless, we cannot rule out episodes of volatility. Firstly, the outlook for the start and execution of tapering will continue to impact the local value of dollar. In addition, as the fiscal agreements the U.S. needs to reach between December this year and next February (related to the budget and the debt ceiling) influence the outlook for the economic recovery or Federal Reserve decisions, there could be some volatility.

Secondly, the wider current account deficit could also be a source of exchange pressures, especially if there are major fluctuations in metal prices. However, we expect the volatility caused by this source not to be as strong as in other countries with a similar size trade gap. Thus, for example, during the recent exchange volatility period, the devaluation of the sol was lower than for most countries with a relatively high current account deficit (see Chart 54). This would be linked to the fact that while in Peru this gap reflects a relatively high investment level (nearly 30% of GDP), in other countries such as Indonesia, India and Turkey it is linked to fiscal

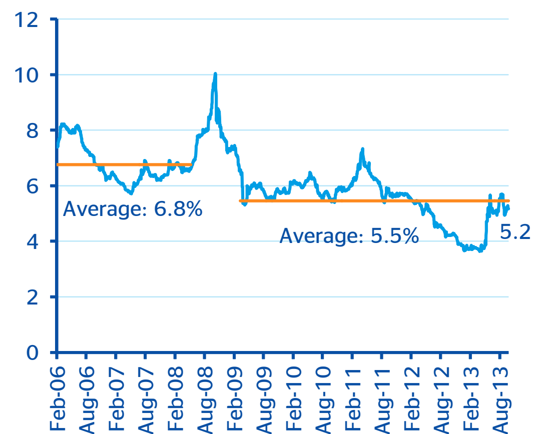
deficits that have cut domestic savings. Along these lines, while Peru's trade deficit will narrow as investments in tradable sectors (mainly mining) start to mature, in these other countries a contractive adjustment may be required for public balances.

Chart 54
Devaluation and trade gap in emerging economies (domestic currency per USD and % of GDP)



Source: IMF and BBVA Research

Chart 55
2020 Sovereign Bond Yield (%)



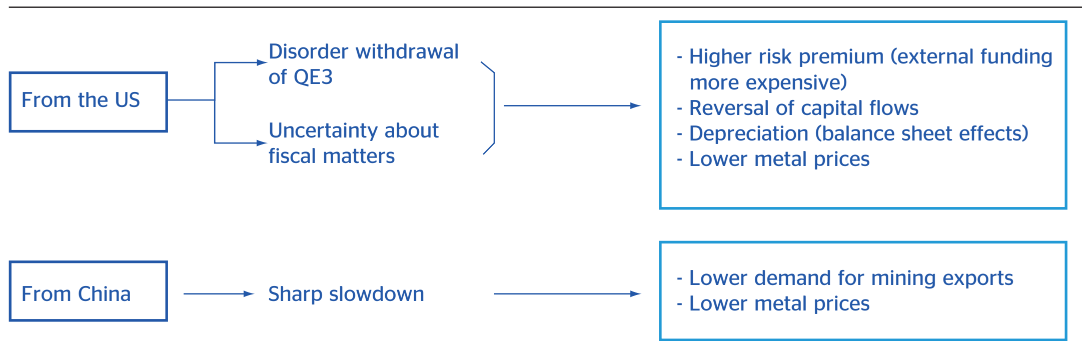
Source: Bloomberg and BBVA Research

It should be stated that the greater stability seen in recent months was also reflected on the fixed income securities market. In this instance, after yields increased since May, they have been near their average level for the last four years (see Chart 55).

7. Risks on the external side could have a medium/high impact on the Peruvian economy

We continue to see that the main risk sources come from abroad (see Table 7). In the short term, two factors highlight in the U.S.: (i) a disorderly withdrawal of the Fed's quantitative easing program (faults in communication on the form, pace and term in which the withdrawal will be made could lead to an overreaction by financial markets) and (ii) the uncertainty linked to political discussions on fiscal matters. In the medium term, there is a risk of a sharp slowdown in China due to the financial weaknesses it currently faces, which are forcing the authorities to be more cautious in implementing possible stimulus policies.

Table 7
External Risk Scenarios



Source: BBVA Research

Domestic impacts of the adverse scenarios described above would be different. If the risk scenario comes from the United States, the financial channel appears more important, while if it comes from China, it will be the trade channel. In the case of the financial channel, the risk premium would increase, thus making finance more expensive; capital inflows would be reduced; and there would be stronger pressure on the exchange rate (depreciation of the local currency). In the case of trade, there would be a fall in foreign demand, mainly for traditional products for which China is our main trading partner. In both cases, we would see international metal prices (copper and gold) plummet, which would extend the current-account deficit still further, and reduce the levels of confidence and private spending.

These events could exacerbate due to lower domestic confidence levels, meaning we would see a slowdown in private investment and economic activity in general. However, Peru still shows fiscal and monetary strengths that will allow it to implement economic policy responses to cushion these impacts (see Table 8).

Table 8
Fiscal and external vulnerability indicators

	2008	2013*
Gross public debt	25.9	18.3
Fiscal Stabilization Fund (% of GDP)	1.4	4.1
NIR (% of GDP)	24.5	32.4
NIR (times STFL** of the economy)	5.0	8.3
Bank STFL (% of deposits)	5.1	5.4

* Latest figures.
** STFL: Short-Term Foreign Liabilities.
Source: BCRP and BBVA Research

8. Tables

Table 9

Annual macroeconomic forecasts

	2011	2012	2013p	2014p
GDP (y/y %)	6.9	6.3	5.3	5.6
Inflation (y/y %, EoP)	4.7	2.6	3.2	2.4
Exchange rate (against USD, EoP)	2.7	2.57	2.76	2.78
Monetary policy interest rate (%, EoP)	4.25	4.25	4.25	4.25
Private consumption (y/y %)	6.2	5.8	5.3	4.5
Public consumption (y/y %)	6.2	9.4	8.0	7.5
Investment (y/y %)	4.8	14.8	9.0	6.0
Fiscal balance (% GDP)	2.0	2.2	0.2	-0.2
Current account (% GDP)	-1.9	-3.6	-5.3	-5.3

Source: BCRP and BBVA Research Peru

Table 10

Quarterly macroeconomic forecasts

	GDP (y/y %)	Inflation (y/y %, EoP)	Exchange rate (against USD, EoP)	Monetary policy interest rate (%, EoP)
1Q12	6.0	4.2	2.67	4.25
2Q12	6.4	4.0	2.67	4.25
3Q12	6.8	3.7	2.60	4.25
4Q12	5.9	2.6	2.57	4.25
1Q13	4.6	2.6	2.59	4.25
2Q13	5.6	2.8	2.75	4.25
3Q13	4.8	2.8	2.78	4.25
4Q13	5.8	3.2	2.76	4.25
1Q14	6.2	3.2	2.74	4.25
2Q14	5.5	2.7	2.73	4.25
3Q14	5.4	2.2	2.75	4.25
4Q14	5.3	2.4	2.78	4.25

Source: BCRP and BBVA Research Peru

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