Economic Outlook

Peru

Second Quarter 2012
Economic Analysis

- **The global economy continues its gradual recovery, but risks have risen again.** The emerging world will remain as the main global growth driver.
- **Our output growth forecast for 2012 has increased to 6,0%.** Economic activity surprise on the upside in the first quarter and the expected strength of domestic demand onwards explain this change.
- **Inflation's convergence to the target will be delayed until end-2012,** closing the year at around 2,8%. The persistency of this deviation could worsen inflation expectations, giving our forecast an upward bias.
- **The policy rate will continue at 4,25% for the rest of the year.** However, we expect the monetary stance to be tightened if inflation expectations worsen. In this case, the use reserve requirements will be an option to avoid further appreciation pressures on the local currency.
- **The Peruvian currency will keep strengthening,** supported by capital inflows, a somewhat more restrictive monetary policy tone, and the de-dollarization of domestic portfolios.

Index

Closing date: May 7, 2012

1. Summary: global recovery, but risks reignite

Global economic activity will gradually recover, with wider growth differentials across the main areas. But the risks to growth are tilted to the downside

After a gradual deceleration during 2011, especially in the last quarter, the global economy is starting to show signs of increased dynamism. Global growth in 2012Q1 is expected to have been higher than in Q4, given stronger growth in Asia ex China (including Japan) and Latin America and sustained –but modest– dynamism in the US. We estimate that global growth will continue increasing and surpass 1% quarter-on-quarter at the end of 2012 (0.6% in 2011Q4). This recovery will also be quite heterogeneous, increasing the divergence in growth rates between the main economic areas. The increase in growth in 2012 will be more evident in Asia, given the rebound from natural disasters in Thailand and Japan (affecting regional supply chains) and the partial turnaround of policy tightening measures implemented until mid-2011. Also, growth in Latin America is likely to pick up, as Brazilian growth rates increase on the back of easier monetary policy and Mexico maintains growth over 3.5% helped by US demand, improved competitiveness and supportive funding conditions. On the other hand, the US will continue sustaining quarterly growth rates of around 0.6% in 2012 and 2013, significantly lower than in previous recoveries. Still, this will be better than a basically stagnant activity in the euro-area in 2012, dragged in peripheral countries by aggressive fiscal consolidation and persistently high financial stress, after tensions eased temporarily in the first quarter.

Therefore, emerging economies will recover their growth differential vis-à-vis developed economies, of around 4 percentage points, for the whole of 2012 and 2013. In turn, Europe and the US also will continue to increase their growth gaps in the next two years, even as we expect European authorities to continue taking decisive actions which will slowly lower financial tensions.

All in all, our growth projections are not very different from those of our previous Global Economic Outlook (published in February). We expect global growth of 3.6% in 2012 and 4% in 2013, with emerging economies contributing around 80% of that increase in global activity (Chart 1). But, as mentioned before, this scenario is conditioned on the evolution of the crisis in Europe, and thus risks to these projections are still strongly tilted to the downside.

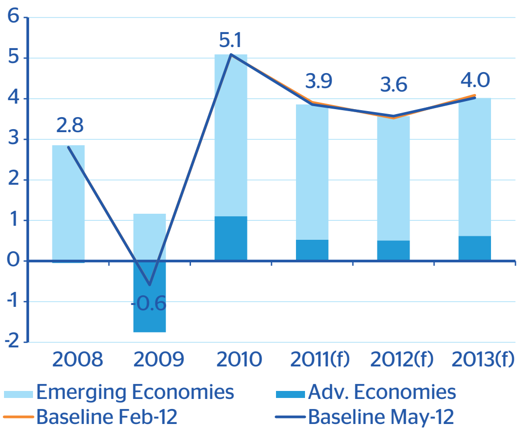
In this context, monetary policies in advanced economies will continue to be very accommodative for an extended period, fulfilling the role of bridging the slump in activity towards the medium and long-run. However, the effectiveness of further intervention (conventional or not) is decreasing, while at the same time the costs increase –including the risk of reduced central bank independence and the collateral damage from unconventional measures–. Thus, it is time for other policymakers and institutions in the US and Europe to decisively take up part of the burden of reviving growth from central banks, implementing economic and institutional reforms and managing fiscal risks. While these measures take effect, central banks should continue supporting an adequate functioning of the monetary transmission mechanism.

Easy monetary policies in advanced economies will mean favourable financing conditions in emerging countries. Here central banks will have to weigh the pressure from capital inflows and an uncertain external demand against inflationary risks (in part from oil prices) and strong domestic demand. The difference in inflation projections in Asia and Latin America –declining in the former but stable in the latter- will condition a different outlook for monetary policies. We expect the easing cycle to have ended in much of emerging Asia (except, notably, in China and India), and a cautious tightening bias in most of Latin America, except in Brazil.

There have been some advances towards the solution to the European crisis, but crucial steps are still to be taken. Europe needs a clear roadmap to end the crisis.

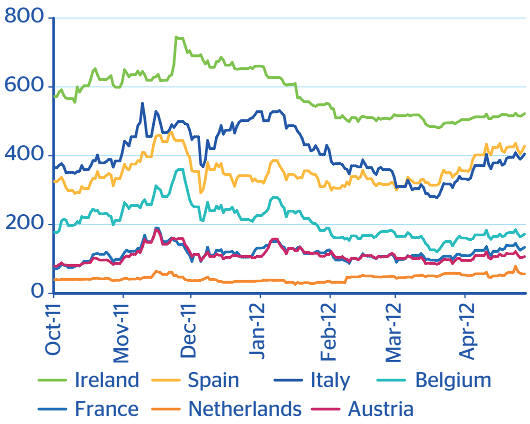
In the last months, there have been some advances towards the solution to the European crisis, but there are still many important pending issues. First, Greek sovereign debt held by the private sector was restructured, although substantial doubts about its long-run sustainability persist, including reform fatigue and a possible deeper recession than projected. Second, the European Stabilization mechanism (ESM) was provided with a fresh lending capacity of 500bn EUR (on top of 200bn already committed by the EFSF). However, that has not been enough to quell market anxiety, given its falling short of Spain and Italy's financing needs for the next 3 years and the presumption that ESM loans would be senior to existing private bondholders, thus seriously impairing its catalytic effect on further financing from the private sector. Further, it was not clear to what extent the increase in IMF resources by 430bn USD (approximately 330 bn EUR) could be targeted to European countries. Also, the fiscal compact was sanctioned (pending national approval), committing governments to structural deficits not bigger than 0.5% of GDP. This is a significant change towards controlling member's budgets, but the allowance for deviations to the rule under "exceptional circumstances" may depict it as not strong enough to justify a more forceful action by hardliners at the ECB of core countries in Europe. In addition, there have been no advances towards a fiscal union or Eurobonds. All in all, a clear roadmap to where Europe is heading continues to be missing.

Chart 1
Global GDP growth (% qoq)



Source: BBVA Research

Chart 2
European sovereing risk premia (10yr bond spreads to Germany, bps)



Source: Datastream and BBVA Research

A new flare-up of the European crisis is still the main global risk

Undoubtedly, one of the most important actions in the last four months was the provision of long-term liquidity by the ECB. This allowed, at least until March, a significant reduction in liquidity risk in European banks, a timid opening of wholesale funding markets and a compression of sovereign spreads in peripheral countries (Chart 2). But these positive effects proved temporary, as markets (i) detected some complacency on the part of policymakers as risk premia decreased in the first quarter of 2012, and (ii) they both doubted the ability of many peripheral countries to reach their fiscal targets and feared the fallout on growth of actually achieving them. Thus, since March, risk premia increased rapidly in Italy and Spain, in the latter to levels similar to the high tensions reached back in November (Chart 2).

The short-lived effect of the long-term liquidity injections and the conundrum between fiscal consolidation and restoring growth highlight two conclusions. First, ECB actions can only bridge the short-run while the underlying economic and institutional problems are tackled. This means that talk of exit strategies for the ECB should not come too soon, but it also implies that economic reforms should be pushed forward, at the same time as demand is rebalanced within the Euro zone, with core countries stimulating it. Second, it is imperative to reconsider fiscal consolidation paths in a coordinated way (or risk being singled out by markets), targeting structural deficits –consistent with the spirit of the fiscal compact– in a more gradual trajectory. In exchange for more gradualism, member states must produce explicit, comprehensive, detailed and multi-annual consolidation plans. This way, sound public finances could be achieved without big damage to short-term growth. At the same time, this will allow to reap the benefits of long-term structural reforms that are being implemented in peripheral countries.

In this context, we still see a new flare-up of the European crisis as the main risk, with potentially very negative consequences for global growth. Increased tensions can come about from reform fatigue in peripheral countries coupled with bailout fatigue in core countries, in the context of electoral processes –and a referendum– in many European countries: France, Greece, Germany –two states–, Ireland and the Netherlands are holding them in the first half of this year.

Current oil prices will have only a moderate impact on global growth. However, a big oil price spike constitutes a significant risk to growth

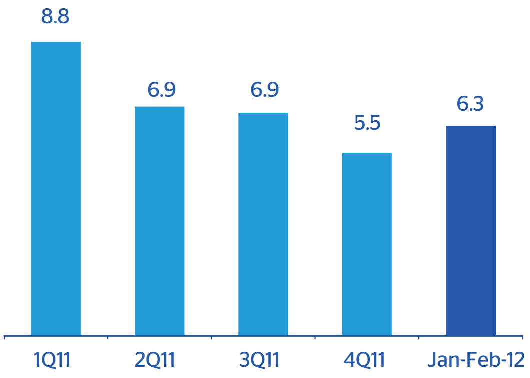
A second threat to the global economy is a further increase in oil prices. The recent spike at the beginning of 2012 can be traced back in part to tightening fundamentals (demand and supply) but also to an increase in the geopolitical risk premium to around 10-15 USD per barrel, given tensions around Iran and very reduced market buffers (oil inventories and producer's spare capacity). In our baseline scenario, we consider prices around 120 USD per barrel of Brent oil for much of 2012, around 15% higher than in our February forecasts. In our view, this will only have a moderate negative impact on global growth, as central banks in advanced countries will view this as a temporary shock and their weak cyclical positions will prevent them from tightening monetary policy, one of the traditional channels of transmission to lower growth. Nevertheless, should the conflict in the Gulf escalates, there could be a very large spike in oil prices, and even if central banks still do not react, growth could be damaged through the associated increase in global risk aversion. We consider that the probability of an escalation in the Gulf is relatively reduced, but it is a scenario that would have a significant impact on global growth should it materialize.

2. Peru: we raise our growth forecast for 2012 to 6%

GDP has performed more positively in the early months of the year

In general, the available indicators of economic activity suggest that GDP growth in 1Q12 will have accelerated (see Chart 3) and exceeded expectations at the start of the year. This is mainly due to the greater strength of domestic demand (private and public expenditure). In the indicators linked to private consumption there were notable increases in sales of new family cars (a record of units sold in March) and of import volumes of consumer goods (see Table 1). Private-sector investment has also started the year auspiciously, as there is a sustained recovery of business confidence. Investment in the mining sector is particularly positive: in the first quarter it was up nearly 50% in real terms.

Chart 3
Quarterly GDP* (y/y % change)



* First two months in 2012
Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

Table 1
Indicators of economic activity
(y/y % change in real terms)

Indicator	4Q11	1Q12
Adequate employment 1/	3%	9%
Average wages	8%	9%
Consumer Confidence Index	56	55
New family car sales	15%	47%
Imports of consumer goods	16%	29%
Business confidence (index)	57	60
Mining investment *	82%	49%
Imports of capital goods	15%	17%
Public expenditure on capital	11%	42%
Domestic cement consumption	4%	13%
Exports	5%	7%

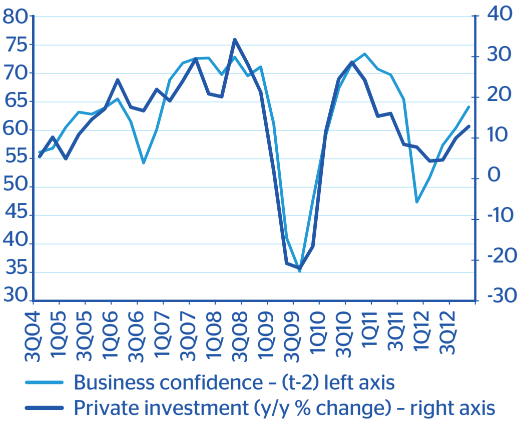
1/ Refers to the working population non in sub-employment.
* Data to February.
Source: BCRP, INEI, MINEM, APOYO and BBVA Research Peru

Public expenditure, the other component of domestic demand, also provided support for economic activity in the first three months of the year. Capital expenditure by the general government (a proxy for public sector investment) was up 42% in this period, favored by the incentives granted by central government to help investment by regional and local governments, which has boosted spending on highways and sanitation works.

The strength of domestic expenditure will continue to support activity over the coming quarters

Investment by the private sector will be key to sustaining growth rates of close to 6.0% for the rest of the year. In this revision of the forecasts for 2012 we have assumed that three elements will provide support for this variable. First, the index of business confidence will remain at current levels, which are compatible with year-on-year growth rates of investment of around 10% (see Chart 4). This scenario considers that the environmental conflicts affecting investment in extractive projects will be resolved in an orderly fashion, and that the government will maintain the positive economic management that has characterized its first months in power. Second, even though we continue to anticipate some correction in metal prices, they will remain attractive over the year and have a positive effect on mining investment. Finally, the faster economic growth than initially expected will lead to increased investment in inventories and in projects linked to the economic cycle such as construction, sales, retail and services. It is worth pointing out in this respect that currently 17 new shopping malls are being constructed (this figure is higher than the total new malls constructed in the last four years); twelve new power stations are being commissioned; the network of bank branch offices is being extended; and construction of new housing in Lima is expected to grow by over 15%.

Chart 4
Private investment and business confidence (year-on-year % change, index)



Source: BCRP and BBVA Research Peru

Table 2
Projects to be awarded in 2012-13 (USD million)

Project	Investment
Highways (includes Long. Sierra and Jungle)	3,800
Electric Train - Line 2 - Section 1	3,000.
Extension of natural gas use	600
Chavimochic irrigation project	499
Chinchero International Airport	420
National fiber optic backbone network	420
LNG supply system	400
Moyobamba - Iquitos transmission line	330
Mobile telephony bands	298
Cajamarca-Moyobamba transmission line	130
National Theatre	95
General San Martín Port Terminal	93
LPG supply system	90
Other	197
Total	10,372

Source: Proinversión

We also forecast that public expenditure will continue to grow at a significant pace and boost economic activity. A low base of comparison means we can expect that public investment could expand at rates of over 30% in the coming quarters (in the second and third quarter of 2011 public investment shrank by 36% and 23% respectively as projects were not executed by local governments due to the entry of the new administration and the fiscal adjustment measures implemented by central government). Second, public expenditure for the maintenance of infrastructure, acquisition of goods and services for social programs and equipment for policing will be boosted by the temporary exceptions authorized by Congress on the real 4% limit (Responsibility and Fiscal Transparency Act) to increases of public consumption. In addition, the Minister of Economy has announced an increase in capital expenditure by central government, which will initiative a new cycle of projects. Among them are the second stage of the Electric Train and the Majes-Siguas irrigation project, as well as commitments already made through public-private associations, such as the IIRSA Sur highway. Finally, ProInversión (a state-owned investment promotion entity) has announced a portfolio of 26 new projects for USD 10 billion will be awarded and executed over the two-year period 2012-2013 (see Table 2).

To sum up, as a result of the better execution of activity in 1Q12 and the positive outlook on domestic spending for the coming months, the growth forecast for the year has been revised upwards from 5.0% to 6.0%. In particular, the strength of private and public demand will allow the economy to maintain robust growth at close to potential, despite the weakness of the global environment.

High mineral prices and greater economic growth will have a positive impact on the fiscal balance...

The prices of exported products, particularly metals, have performed better than anticipated in our earlier report. In addition, expectations are for a sustained if slow recovery in the U.S., a mild recession in Europe, and a soft landing in China. Both elements suggest that the downward correction expected in metal prices will be somewhat more gradual than we anticipated at the start of the year. In the case of copper, the main product of the mining industry in Peru, the average price over the year will be around 3.6 USD/lb, higher than the average for the last five years (3.2 USD/lb). This increases the prospects for tax revenues from this activity.

At the same time, the greater strength of GDP will be accompanied by increased revenues from taxes on sales and income. In this situation, we have increased our forecast of the fiscal surplus from 1.2% to 1.5% of GDP for 2012. This combination of greater fiscal savings and a higher growth rate will result in a fall of the public debt as a proportion of GDP to a level of below 20% at the end of the year. The low level of public debt, prospects that the downward trend in this variable will be maintained in the future, and sound macroeconomic management are good arguments for the rating agencies to upgrade Peru's sovereign debt to BBB+ over the coming months.

... but only temporarily, so the fiscal position will have to be assessed in structural terms to ensure the solvency of the public finances

It is important to keep in mind that although high commodity prices and the expansive phase of the economic cycle lead to an improvement in tax revenues, this is only temporary (in the case of commodities, the current high prices are in part supported by abundant global liquidity, which over the coming years will gradually drain away). Eventually, metal prices will converge towards their long-term levels, which could be lower than those now observed, and GDP will slow towards its potential level. The sustainability of the public finances could then deteriorate significantly if expectations and pressures for permanent increases in public spending (e.g. through wage demands) are generated in a situation of temporary fiscal easing. That is why it is desirable that government spending decisions should take into account revenues that are permanent in nature in order to ensure that the spending is sustainable over time. A structural measurement of the fiscal result, i.e. one that removes cyclical effects and considers long-term mineral prices, could help in this respect.

The government's recent proposal to include considerations of a structural nature in the analysis of the public finances is therefore positive. In particular, a new bill is proposing that starting in 2013 the fiscal result measured in structural terms should improve by at least 0.2% GDP per year (starting from a situation of structural deficit, the aim is to gradually achieve a balance). The bill also includes the constitution of a technical committee that will prepare a proposal to perfect the current macro-fiscal framework (the Fiscal Responsibility and Transparency Act), and probably study migration towards a structural fiscal rule.

Although its implementation faces technical difficulties (How are long-term mineral prices to be defined? In what phase of the economic cycle are we in now?) and policy difficulties (clear independence of those in charge of determining the long-term level of mineral prices, the phase of the cycle and the structural balances), we consider that the execution of fiscal policy within a structural concept will be a great step forward and will speed up the upgrade of the government's debt ratings. Finally, within this field it would be a good idea to consider the creation of a Sovereign Fund that would administer revenue from extraordinary situations and help distribute wealth across generations.

Growth for 2013-2016 will be supported by greater investment

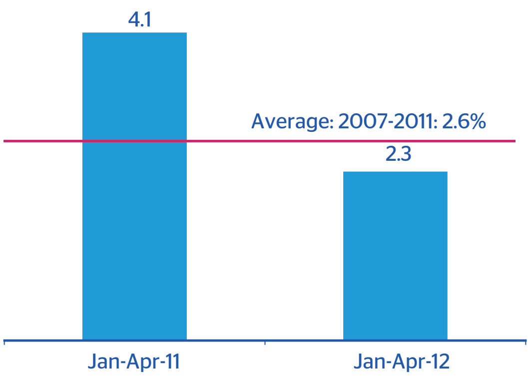
Starting in 2013, the rate of GDP growth will converge towards its long-term trend, which will be at around an annual 5.5%. The main support for this rate of potential growth will be the accumulation of physical capital in line with the forecast of a favorable performance of public and private investment. Thus we estimate that gross capital formation will increase from a level equivalent to 26% of GDP in 2012 to 28% in 2016. We forecast that over 85% of private investment will be financed with domestic savings, so external financing needs will be limited and the current balance of payments account will run an average deficit equivalent to 2.8% of GDP. We also expect a fall in the ratio of public debt to GDP to around 16% by 2016.

3. Convergence of inflation to the target will be delayed until the end of 2012

The rate at which prices are rising shows stubborn resistance to easing...

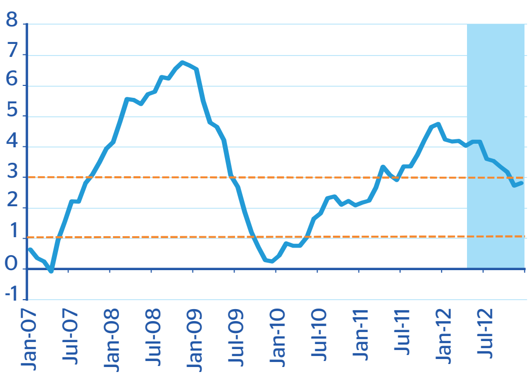
This year, inflation began to fall, from 4.7% year-on-year at the end of 2011 to 4.1% in April. The rate at which it has been falling has been slower than we expected, partly because the reversal of the supply shocks affecting the food component in 2011 was not as pronounced due to the intense rains affecting some of the production areas and the movement of these goods during the summer (see Chart 5). In this context, inflationary expectations for 2012 remain around the upper target limit.

Chart 5
Food prices (y/y % change)



Source: BCRP and BBVA Research Peru

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



Source: BCRP and BBVA Research Peru

... and the outlook for the coming months is somewhat less favorable, which has led us to adjust upwards our forecast for 2012

The outlook for prices over the coming months has deteriorated somewhat. As a result, we continue to forecast that inflation will fall to the target range this year, but only near the end of the year, and will close at around 2.8% (see Chart 6). In other words, the process of convergence will be more gradual, above all until the second half of the year.

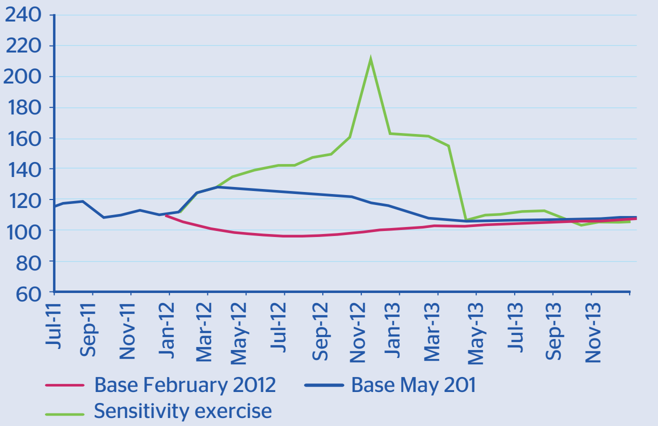
Three factors support this view. First, the international oil price has remained above forecast levels, and although we expect that there will be a slight fall in the coming months, the downward adjustment will be less steep than what we expected in our previous report. Locally, the stabilization fund for fuel prices has passed on part of these increased prices to the end consumer and will continue to do so (the adjustment is still lagging behind in some areas). Some types of gasoline are no longer covered by the fund, so that the amount passed on in these cases is higher. Second, the greater expansion of output that we expect in 2012 (it has been revised up from 5.0% to 6.0%, more in line with its potential rate) will reduce slack in the goods and services markets. It is important to mention here that the trend for core inflation, and even the inflation rate that excludes food and fuels, is rising. This reflects that some of the pressures on prices are linked to the renewed strength of economic activity. Finally, the high level of inflationary expectations will create some resistance against the process of inflation converging with its target.

The bias in this forecast (2.8% at the close of the year) is upward, as the persistent deviation of inflation above the target range, which has continued for a year and will be extended for a few more months, could eventually exacerbate public expectations.

Box 1. What are the impacts of a significant increase in the international oil price?

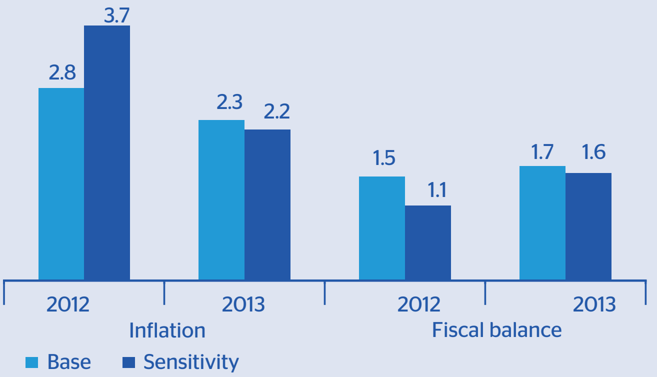
As well as the base inflation forecast for this and upcoming years, a simulation has been carried out in which the international oil price rises sharply and substantially for a period of close to a year (see Chart 7). This could be linked, for example, to an escalation of geopolitical tension in the Persian Gulf. In this exercise, the average price of Brent crude in 2012 is 20% higher than in the base scenario, and could even at times reach over USD 200.

Chart 7
International oil price (Brent, USD per barrel)



Source: Bloomberg and BBVA Research

Chart 8
Sensitivity scenario: inflation and the fiscal balance (year-on-year, % GDP)



Source: BCRP and BBVA Research Peru

We expect that in this scenario the stabilization fund for fuel prices will only pass on the higher oil prices to final consumers gradually, to try to allow them to adapt to the impact. The fiscal cost of this measure would be around PEN 2.5 billion. The support of the stabilization fund for fuel prices and the relatively short duration of the shock would make the impact on output limited. However, inflation would increase in 2012 to around 4% (see Chart 8) and the fiscal surplus would be reduced by 0.4 percentage points to around 1.0% of GDP). In this situation, there would be some adjustment of the monetary position in an attempt above all to contain a possible rise in inflationary expectations.

4. Some tightening bias in the forecast of the policy rate

Expansion of output at its potential rate and falling inflation suggest that there will not be any changes in the policy rate, but...

The factors that affect monetary policy decisions are currently more balanced, unlike the case at the end of last year when external risks gave it a certain downward tone. This change is basically the result of the positive surprise in economic activity in the first quarter. The economy has adapted better than expected to the weak global environment and in this situation business expectations have continued to recover. As a result, the rate of growth of output has speeded up to around its potential. In our base scenario, the economy will continue to grow at similar rates over the coming quarters.

On the side of prices, pressures have begun to ease and will continue to do so over the coming months, above all starting midway through the year, as supply shocks that spiked inflation above the target are gradually dissipated. The nature of this deviation suggests that the Central Bank will not have to alter its monetary policy position. The gradual convergence of inflation with its target will from now on lead to an increase in the real interest rate to its natural level. This position is coherent with the forecast growth in output and prices.

This outlook and the renewed uncertainty regarding fiscal problems and growth in Europe support our view that the policy rate will be maintained at its current level of 4.25% for the upcoming months, as we forecast in our previous report.

...the persistent deviation of inflation from the target could exacerbate public expectations and make the process of convergence more difficult; as a result, the monetary position now has a tightening bias

Inflation has fallen slowly, so convergence to the target range will not be completed until the end of the year. It will have been outside the target for a year and a half. The risk is that the persistent deviation could in the end exacerbate inflationary expectations (currently at 2.9% for 2012), above all in a situation in which economic activity is recovering its strength. This would delay the process of convergence still more.

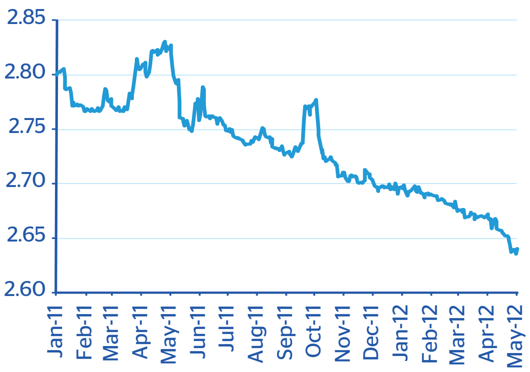
In this situation, the Central Bank recently adjusted the bank reserve requirements. We believe that this aims to moderate the sustained rate of credit growth, one of the elements that supported the positive surprise in output in the first quarter. In addition, the adjustment of the monetary position would signal that the appropriate steps will be taken to contain any increase in public inflationary expectations, and that convergence of inflation with the target will not be delayed further. The choice of reserve requirements and not the policy rate to carry out the adjustment has aimed to avoid any increased upward pressure on the PEN.

Taking this risk into account, we do not rule out that the Central Bank could again adjust its monetary position over the coming months. This gives an upward bias to our forecast for the policy rate. However, in this scenario we believe it most probable that priority will once more be given to action through reserve requirements, to avoid feeding continued upward pressure on the PEN.

5. The PEN will continue to gain over the coming months

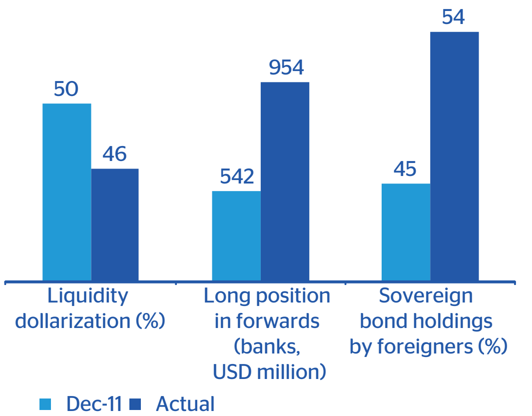
So far this year the PEN has continued to gain (see Chart 9). This has occurred in an environment in which global risk aversion has fallen slightly, return on Peruvian assets is attractive and the markets expect the local currency to continue to gain in strength. Currency supply has flowed from a variety of sources. First, the rate of de-dollarization of domestic portfolios has speeded up. This has been combined with the increase in short USD positions held by the public (against the banks) in the forward market and the greater appetite of foreign investors for sovereign bonds (see Chart 10). Finally, the large corporations in the real economy are beginning to finance themselves directly from abroad to take advantage of low international interest rates, among other factors, and to avoid the cost of reserve requirements. In this situation, the Central Bank has intervened on the foreign-exchange market by buying USD 8 billion so far this year to moderate gains by the local currency (16% of the net balance of international reserves as of the end of 2011).

Chart 9
PEN/USD exchange rate



Source: BCRP

Chart 10
Pressure in the foreign-exchange markets



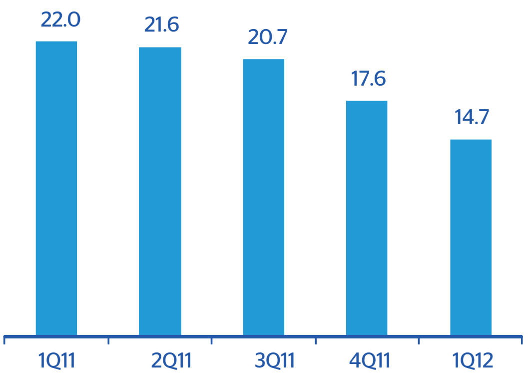
Source: BCRP and MEF

We expect that in the coming months the trend of a stronger PEN will continue, in particular if the situation at the global level does not suffer a major deterioration, and it will close the year at around 2.60 PEN/USD. One reason is that the external accounts (trade balance and financial account) will continue to be favorable. This implies a greater supply of foreign currency in the local market. In addition, the more restrictive tone of monetary policy will make the return on PEN assets more attractive. The stronger exchange rate could itself create incentives for continued de-dollarizing of portfolios, creating a feedback mechanism for the process (the position of the Central Bank with respect to a stronger local currency due to this factor would seem to be more accommodative than if it originated in capital inflows). In this situation, the Central Bank will continue to be active in the foreign-exchange market, moderating the rate at which the PEN gains. It cannot be ruled out that given the size of the interventions already carried out, it may eventually become difficult to sterilize the liquidity (in local currency) injected by this means. With this in mind, the Central Bank will continue to use the support of other instruments to curb the gains of the national currency. These include: reserve requirements; a raise in the percentage of funds administered by the PFAs that can be invested abroad; and coordination with other public institutions to implement measures that in general increase the cost of external financing and of positions that make the PEN rise.

6. Credit will maintain a sustained growth in the future

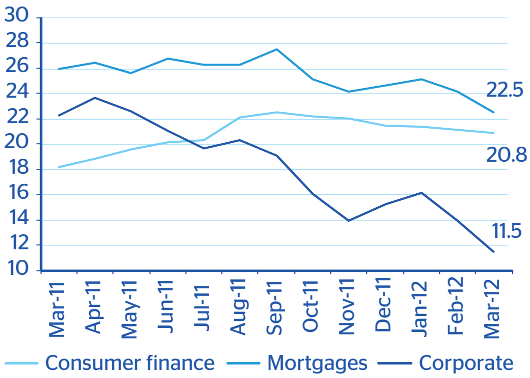
In recent months bank lending to the private sector has been moderating. Despite this, its strength continues to be significant (see Chart 11), above all in lending to households. Both consumer finance and residential mortgage lending are growing at a rate of more than 20% year-on-year (see Chart 12). This reflects the good performance of formal employment, which is growing at around 10% and increasing household income. As a result, the demand for durable goods and housing has continued to grow.

Chart 11
Bank lending to the private sector (y/y % change)



Source: SBS

Chart 12
Bank lending by borrower(y/y % change)



Source: SBS

We expect that over the rest of the year the gradual slowdown in household credit growth will continue, while corporate lending will recover somewhat. This will reflect improved business confidence, which will boost private investment. In all, total credit will grow by around 16% year-on-year at the close of 2012.

It is important to note that the Central Bank is not very comfortable with the speed at which credit is expanding. At the start of the year it suggested a set of measures to increase the cost of bank finance for housing. Recently it increased the reserve requirements as a way of reducing the growth in lending to households (corporate lending has already slowed significantly). The measures are prudential in nature. This is because consumer finance and residential mortgage loans are growing far above the rate of nominal GDP, which involves a risk of over-indebtedness. In addition, the funding for credit is increasingly less dependent on deposits and more on external sources (in general more volatile). Lending is expected to increase in the coming years at a higher rate than deposits, so that the use of external funds will grow. To moderate this vulnerability, the Central Bank has made long-term debt taken by banks abroad more expensive, specifically by introducing a new reserve requirement for these transactions when they are over 2.5 times the effective financial institution's effective patrimony. So far this new reserve requirement is not restrictive, but it will become so in future years.

To sum up, the Central Bank's increased concern regarding the growth of credit is leading it to adopt measures that guarantee macroeconomic stability. However, these measures also involve costs. First, financial intermediation in Peru is still at relatively low levels, not above 30% of GDP. This implies that there is a broad sector of the population that does not enjoy the benefits of bank credit. The measures adopted delay the entry of these households into the credit market. Second, the interest of the corporate business segment for financing itself directly abroad is growing: given the increasing cost of the money that banks borrow abroad (due to the higher reserve requirement) to lend to local companies in Peru, the companies themselves are using the international markets to find finance at low rates and avoid the reserve requirements. This in part explains the slowdown in lending in Peru (see Chart 12). In other words, the measures adopted are not achieving their objective of reducing the vulnerability of the economy to external finance. This requires a careful assessment to be made when adopting macroprudential measures, and this is undoubtedly being done by the authorities.

7. Europe continues to be the main risk factor

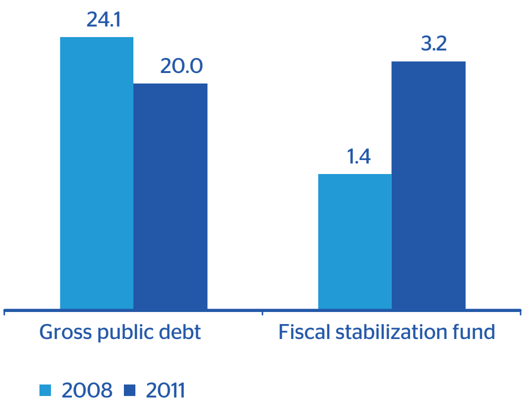
As we pointed out in our most recent reports, the main risk factor for the Peruvian economy is Europe. The moratorium on sovereign debt payment in some of the countries with the biggest fiscal problems in Europe, or the collapse of a major financial institution, would have significant repercussions in the rest of the world and in Peru.

In this scenario, financial and liquidity tensions would rise significantly. This would lead to a severe credit squeeze and affect the real economy of the euro zone significantly. The Peruvian economy would be affected through three channels. First, the substantial increase in global risk aversion would be reflected in an increase of the local risk premium, leading to greater funding costs, reduction of capital inflows and pressure on the exchange rate (depreciation of the local currency). Second, commodity prices and foreign demand would drop. Finally, business and consumer confidence would fall back. Private investment would be the component of expenditure most affected in this situation, as we already saw in the crisis of 2008-2009.

Is Peru prepared to accommodate a shock of this nature?

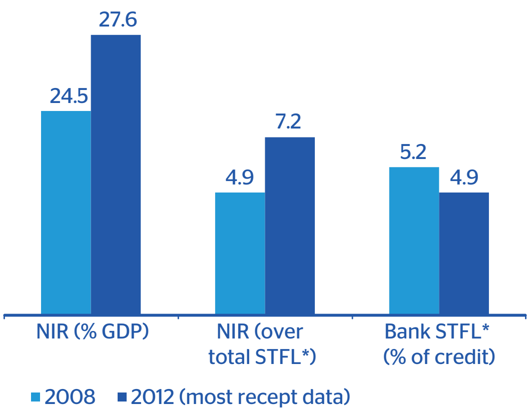
Although an external shock of this magnitude will have negative impacts locally, there are elements to suggest that the resistance of the Peruvian economy could be relatively good; better even than it showed after the collapse of Lehman Brothers. On the fiscal side, for example, the government has resources in its stabilization fund that are equivalent to just over 3 percentage points of GDP, enabling it to implement a countercyclical policy in a difficult situation. The amount is more than double what was available in 2008 (see Chart 13). In addition to this there are the funds from the fiscal surplus of 2011, which was close to 2% of GDP. As a result, there is less need to go to the financial markets to obtain funds, which is important in an environment of high risk aversion and demand for liquidity.

Chart 13
Fiscal vulnerability indicators (% GDP)



Source: BCRP and BBVA Research Peru

Chart 14
External vulnerability indicators



* STFL: short-term foreign liabilities
Source: BCRP and BBVA Research Peru

On the monetary policy side, there is room to limit the risk of a break in the credit chain, moderate a sudden depreciation in the local currency and stimulate private sector demand. In the case of credit, the Central Bank has a set of instruments that help inject liquid funds into the banking system when required. Currently the banking system holds around PEN 30 billion in assets with the Central Bank. This amount is equivalent to more than USD 11 billion, or around 23% of outstanding lending. These securities could be used for repo transactions with the Central Bank. An alternative would be foreign-currency swap transactions. 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 2.4 billion), the currently high rates of foreign-currency reserve requirements could be cut (the average foreign-currency reserve requirement rate is around 39% of foreign-currency deposits and debt).

An additional element that would reduce the impact of an external shock is that in Peru the banks with foreign capital usually have a decentralized management model. In other words, these subsidiaries look for funds in the local market and do not depend on the international headquarters. They are subject to Peruvian supervision and regulation and are covered by the guarantee fund for local deposits. Although this funding autonomy reduces the gains that can result from handling liquidity on a great scale (economies of scale), it has the advantage that it reduces the probability of contagion (the need for deleveraging, a process that could be disorderly) at times of turbulence such as in the risk scenario we present here.

In a risk scenario, the Central Bank would also try to avoid a sudden fall in the value of the local currency to moderate the negative impacts this would involve for an economy in which 44% of lending to the private sector is in foreign currency. To deal with this, it can make use of its net international reserves of more than USD 57 billion, equivalent to 28% of GDP (see Chart 14) and issue foreign-exchange linked bonds, as has been the case in previous periods of volatility.

Finally, there is room to cut the interest rate (currently at 4.25%) and support private expenditure. Although inflation is currently above the target, in a difficult scenario its future trend would correct downwards, so the Central Bank would have room to prioritize economic activity during an external shock.

To sum up, although a more severe deterioration of the global situation would have impacts on the local economy, the Peruvian economy has strengths capable of mitigating them. In this scenario, Peru could grow at above 4.0% in 2012 and around 3.5% in 2013, then begin a steady recovery. Of course, the fiscal and external balances would be weakened, but this would be manageable. Lower tax revenues and stimulus measures would lead to fiscal deficits not exceeding 2.0% of GDP in the forecast horizon. The ratio of public debt to GDP would return to 20%. In the external accounts, the balance of payments current account deficit could reach a level of around 3.5% of GDP at the most critical time.

8. Tables

Table 3

Macroeconomic forecasts annual

	2010	2011	2012	2013
GDP (y/y %)	8.8	6.9	6.0	5.7
Inflation (y/y %, eop)	2.10	4.70	2.80	2.30
Exchange rate (vs. USD, eop)	2.82	2.70	2.60	2.55
Monetary policy interest rate (%, eop)	3.00	4.25	4.25	5.00
Private consumption (y/y %)	6.0	6.4	5.8	5.2
Public consumption (y/y %)	8.5	4.9	5.5	4.5
Investment (y/y %)	23.2	5.2	11.9	6.8
Fiscal balance (% GDP)	-0.3	1.8	1.5	1.7
Current account (% GDP)	-2.5	-1.9	-2.3	-2.1

Source: BBVA Research Perú

Table 4

Macroeconomic forecasts quarterly

	GDP (y/y %)	Inflation (y/y %, eop)	Exchange rate (vs. USD, eop)	Monetary policy interest rate (%, eop)
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	8.8	2.7	2.78	3.75
2Q11	6.9	2.9	2.76	4.25
3Q11	6.7	3.7	2.75	4.25
4Q11	5.5	4.7	2.70	4.25
1Q12	5.5	4.2	2.66	4.25
2Q12	5.8	4.2	2.65	4.25
3Q12	6.1	3.3	2.63	4.25
4Q12	6.5	2.8	2.60	4.25
1Q13	5.7	2.6	2.59	4.50
2Q13	5.7	2.5	2.57	4.75
3Q13	5.7	2.5	2.56	5.00
4Q13	5.7	2.3	2.55	5.00

Source: BBVA Research Perú

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