BBVA Research

Peru

Economic Outlook

First Quarter 2011

Economic Analysis

- In 2011 we expect the Peruvian economy to maintain a strong growth rate of over 7%. This will be supported by private investment and consumption against a backdrop of high confidence, solid macroeconomic foundations and external conditions that will remain favorable. Over the coming years, domestic demand will pull output growth to be sustained at around 6%.

- The fiscal balance will continue to improve in the coming years due to greater revenues, turning moderately positive as of 2011. Hence, the public debt will maintain a downward trend and reach a level near 14% of GDP in 2015.

- The strength of domestic demand will also be reflected in a growing current account deficit, which could surpass 3% of GDP in the coming years. However, this level is structurally sustainable and will be more than financed by long-term capital inflows, inducing a domestic currency appreciation in the short and medium term.

- The inflation outlook for 2011 has turned complicated, with a positive output gap and high international prices for agricultural products and oil. In this context, the Central Bank will increase its policy interest rate, which could intensify capital inflows and the appreciation of the local currency. Therefore, the monetary tightening will be gradual and accompanied by high reserves requirements and, eventually, additional macro-prudential measures.

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Closing date: February 1st, 2011

1. Global outlook: decouplings at play

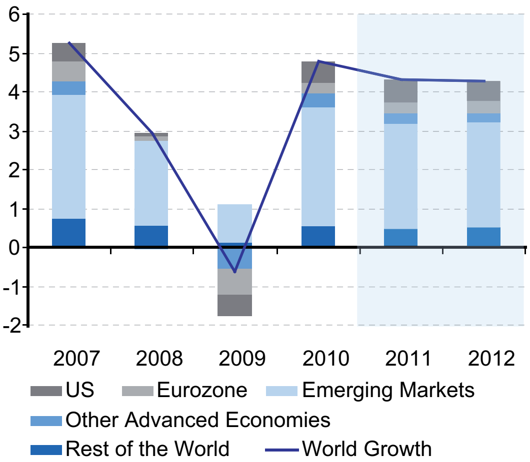
The world will continue on divergent paths, increasing growth and policy decouplings
Growth continues to be strong. After closing 2010 with a growth rate of 4,8%, the global economy is expected to decelerate slightly to 4,4% both in 2011 and 2012, a better performance than what could have been anticipated 12 months ago. This is explained by a better outlook for advanced economies, due to (i) the better growth expectation for the US after the fiscal stimulus, and (ii) a strong performance in core European countries, which have decoupled from those of the periphery, dragged by financial market tensions. In fact, even though financial market tensions in Europe worsened during the last quarter of 2010, economic activity the region as a whole has been able to accelerate, thus showing –at least temporarily– a degree of decoupling also between the financial and the real side. Overall, the pattern of global economic growth remains broadly unchanged as the real engine of dynamism continues to be the emerging world, led by Asia (China and India in particular, see Chart 1), and developed economies continue losing ground, more in Europe than in the US.

All these decouplings have three important implications for the outlook. First, the divergence between growth in advanced and emerging economies will continue to induce markedly different macroeconomic policies going forward. Monetary policies will remain highly accommodative in the US and Europe, fuelling a search for yield elsewhere (in emerging markets and increasingly in commodities as well). At the same time, signs of overheating are starting to emerge in some countries in Asia and Latin America, pushing authorities to consider tightening policy faster than previously envisioned given incipient inflationary pressures, especially in Asia (Chart 2). The resulting incentives for capital inflows into emerging economies will intensify policy dilemmas already present in both regions, between tightening policy to ensure a soft landing and preventing sudden and sharp exchange rate appreciations.

Second, the growth divergence between the US and EMU will –together with financial risk– put downward pressure on the euro and, perhaps more significantly, will keep drawing market attention to the relative difficulty of the EMU to grow out of their high public debt levels. This is one of the elements –together with the different size of central banks' bond-purchase programs and the turmoil around economic governance in Europe– that explains why markets have not reacted significantly to a further postponement of fiscal consolidation in the US. The difference with market punishment to some countries in Europe could not be starker.

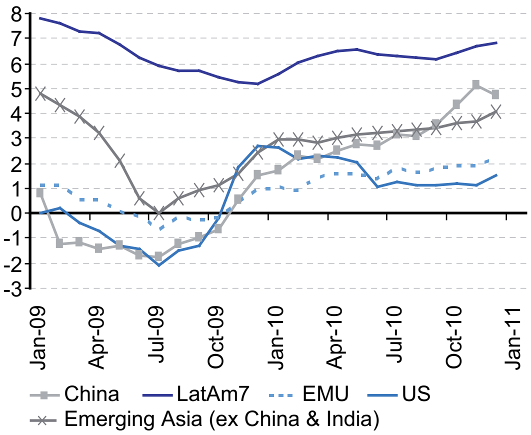
Finally, the increasing decoupling within the EMU will start straining the conduct of a common monetary policy for the region, already torn between an incipient risk of inflation, especially in core countries, and the need to continue supporting financial stability, especially –but not exclusively– in peripheral economies.

Chart 1
Global GDP growth and contributions



Source: BBVA Research

Chart 2
Inflation



Source: BBVA Research and Datastream

Growth in the major advanced economies has picked up, but fragilities remain. Chances of a double dip scenario in the US, which we thought were very low, have faded. But interest rate risks in the long-run now become more relevant

As we expected, the US did not fall into a double dip, and the chances of that happening in the future have faded since the summer. Four main factors have contributed to the change in sentiment regarding the outlook for growth in the US. First, better macro outturns at the end of 2010 signaled that household consumption was more resilient than was feared. Second, decisive action by the Feder al Reserve, implementing and additional round of asset purchases (QE2) provided support for bond prices in particular, and asset prices in general. Third, reduced uncertainty and increased business confidence is expected to benefit investment. Finally, and perhaps more important, a new fiscal stimulus package, approved at the end of 2010, will provide a significant boost to economic growth.

We have thus adjusted our growth forecast for 2011 by 0,7 percentage points, to 3%. However, weaknesses have not disappeared. Real estate markets remain feeble and still prone to negative surprises. Household income is still sluggish given that the speed of the recovery will not be sufficient to significantly reduce unemployment rates. On top of it, credit growth and securitization processes remain subdued. While none of this should derail the recovery, it continues to configure a scenario in which an additional negative shock would harm the economy. For now, this outlook of gradual economic recovery with low inflationary pressures on the demand side, will permit monetary policy to remain accommodative for an extended period.

Moreover, the lessons from the sovereign crisis in Europe should not be forgotten. Granted, the new fiscal package at the end of 2010 had the benefit of boosting growth in the short-run, at the time when doubts about a double dip were still in the air. But one should not overestimate the strength and persistence of the factors that have prevented a negative reaction from bond markets to a further delay of fiscal consolidation in the US. Central bank bond purchases and the turmoil in Europe (and thus flight to quality to US bonds) are by nature short-run factors that will disappear in the medium run, and before that happens the US will need to show a clear commitment to fiscal consolidation or risk a sudden spike in long-term interest rates. Rating agencies have already started to signal this risk. There is time, but discussions and plans should start as soon as possible to reduce long term fiscal concerns.

Institutional and economic reforms in Europe will be crucial for solving the financial crisis

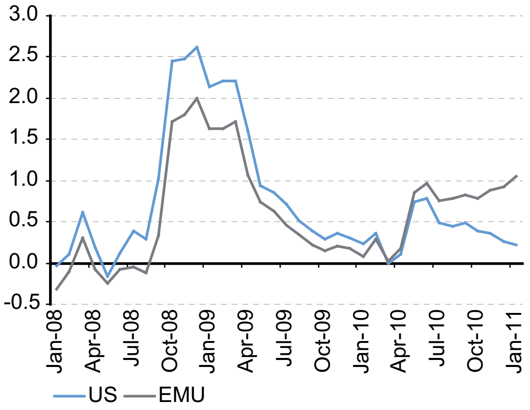
Since October 2010, financial tensions in Europe have surged again (Chart 3), especially in peripheral countries. Concerns about fiscal sustainability and financial sector losses resurfaced again, leading to widening sovereign spreads and funding pressures. However, contrary to the episode in May, financial spillovers to other countries in Europe and outside the EU were more limited.

The increase in financial market tensions was triggered by two events. First, markets were uncertain about the ability of European institutions to deal with sovereign debt crises. Private investors were spooked by the proposal that they would bear losses on possible restructurings after 2013, and the likelihood that haircuts on existing debt would be needed to restore fiscal sustainability. The second trigger was increasing doubts about the credibility of stress tests, given the need to support Irish banks shortly after they were deemed adequately capitalized. These two triggers developed amid the background of concerns about the capacity of some peripheral countries like Portugal and Ireland to fulfill their fiscal deficit targets and doubts about the ability of some European economies to generate enough growth momentum to make their debt burden sustainable.

The fragility of the recovery in financial markets right after the summer highlights that markets are increasingly focusing on sovereign solvency problems in some countries, rather than just liquidity concerns. This stresses the need for a comprehensive solution, both for solving this crisis, as well as establishing a sound crisis prevention and resolution mechanism for the future. For future crisis prevention, fiscal coordination needs to be reinforced, providing for shock absorbers for idiosyncratic shocks in individual countries, but also reinforcing surveillance both in the fiscal front and in the macroeconomic dimension (including preventing the build-up of private sector imbalances). For crisis resolution, a clear and transparent mechanism that defines those who will bear losses needs to be put in place, to avoid excessive market volatility due to uncertainty, but probably at this stage is extremely important to guarantee an adequate transition mechanism.

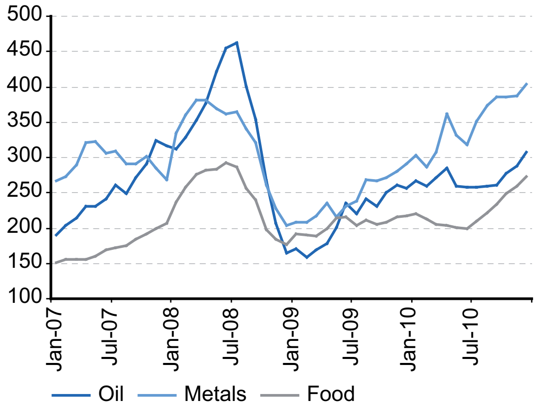
As pointed out above, financial spillovers from this recent episode have been rather limited, including to core countries in Europe. Thus, growth in the EMU as a whole was stronger than anticipated, especially due to very positive outturns in Germany and other core European countries. However, this decoupling between financial tensions in peripheral countries and real economic activity in Europe will not last if a comprehensive governance reform is not agreed soon and countries do not continue pushing economic reforms to reduce fiscal vulnerabilities, restructure the financial system and increase potential growth. What is agreed at the next European Council in March will be key in this respect.

Chart 3
BBVA Financial Stress Index



Source: BBVA Research

Chart 4
Commodity prices



Source: BBVA Research

Commodities prices will level off, but nonetheless inflation risks are becoming more relevant in emerging economies, which will continue to grow strongly

Commodity prices have surged across the board in recent months, reaching all-time highs in the case of some metal prices (Chart 4). This is consistent with what seems to be the beginning of a long-term upward trend in commodity prices driven by surging demand from emerging economies, but there are other short-run factors that have contributed to the recent surge, at least in some commodity classes.

For instance, the very fast increase in food prices in the past two months is to a great extent the effect of one-time supply-side factors (weather disturbances), which should wind down during the rest of 2011. Moreover, given ample global liquidity conditions, investors have piled into commodities as an asset class, increasing financial premia across the board.

Going forward, we expect commodity prices in general to level off around current readings. In the case of food prices this will be the result of normalizing crops in 2011. For metals, elevated inventories will start to weigh on prices. Only in the case of oil we expect a tight market to continue pushing prices slightly higher in 2011 but gradually easing afterwards. This easing will be helped by a likely reduction in financial tensions in Europe, which should shift investment flows away from commodities into other assets with more contained risk premia. Nevertheless, risks are tilted to the upside, as strong demand in Asia will continue to support an upward trend in prices in the medium run.

The increase in commodity prices has been responsible, in part, for the increase in inflation observed in emerging economies at the end of 2010 (Chart 2). In particular, the increase in food prices has had a direct and important first-round effect on higher inflation in a number of countries –especially in Asia– with the risk of feeding into overall inflation. However, going forward, the expected leveling of food prices will mean that this factor should become less important in determining headline inflation.

Although the risk has also increased in developed countries, it is smaller than in emerging economies, given that food prices have a smaller weight on CPI and ample unused capacity and anchored inflation expectations will help keep inflation pressures in check.

More worrying for emerging economies is the realization that rapid growth and strong capital inflows in Asia and Latin America are starting to generate overheating pressures, through inflation but also evident through rapid credit growth and increasing asset prices. Indeed, we expect Asian economies to continue growing strongly, although in our opinion authorities will be able to steer them to a soft landing and avoid overheating, although that is surely a more pronounced risk than three months ago. Driven by domestic demand and high commodity prices, Latin America is also poised to grow strongly in 2011, converging to potential growth of around 4% in the region. As mentioned before, the biggest challenge for both regions will be to manage the policy dilemmas generated by strong capital inflows. We expect policy to continue tightening in most countries, while at the same time imposing ever more stringent administrative controls to limit those inflows and prudential measures to limit credit growth, especially in Asia.

2. Peru: Favorable conditions for growth over 7% in 2011

The supports that have been boosting private spending will be maintained…

After closing 2010 with a strong cyclical rebound that resulted in GDP growth near 9%, the forecasts favor growth of over 7% in 2011. Therefore, our forecast for the year has been revised upwards from 6.3%, considering the improved forecasts for our primary trading partners, greater terms of trade, and domestically, robust growth of activity with elements that will continue to provide support over the coming quarters.

The domestic factors that back a more positive outlook for 2011 include the high level of dynamism with which the Peruvian economy has started the year. Electricity output, an indicator that closely follows the course of domestic demand, maintained a year-on-year growth rate of 10% in January, which is similar to that of the three previous months (a period in which the GDP had grown nearly 9% year-on-year). The momentum of 2010 remains strong.

Furthermore, the elements sustaining growth from the second half of 2010, especially those supporting private spending, are predicted to continue their course over the coming quarters. In terms of private investment, the business climate will continue to be favorable in a context of gradual improvement in the external conditions and an electoral process that has had very little impact on spending decisions. In that regard, the surveys indicated that the electoral preferences are leaning towards candidates who, in general, would provide continuity in terms of the current economic model, by reducing political noise so that business confidence could remain at high levels. This contrasts with the events of the past 2006 elections, when said indicator fell 10 points in the months preceding the election. Likewise, the strong growth of demand has reduced the slack in the manufacturing sector, with a rate of utilization of installed capacity at historic highs. The above will favor investment in the coming months, even more so considering that the level of corporate leveraging has been decreasing. In this context, the investment announcements for large projects that will start being implemented in 2011 (in sectors including mining, hydrocarbons, energy, infrastructure, etcetera) currently total nearly US$14,000m (Table 1), nearly 10% more than four months prior and 30% year-on-year.

Table 1

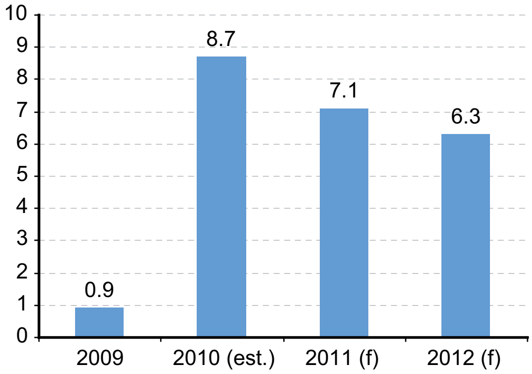
Investment Announcements 2011-12 (millions of USD)

	2011	2012	Total	% of GDP
Mining	6,102	7,519	13,621	7.8
Hydrocarbons	2,078	2,186	4,264	2.4
Electricity	1,487	1,801	3,288	1.9
Industry	1,289	1,003	2,292	1.3
Infrastructure	1,208	796	2,004	1.1
Other sectors	1,491	793	2,284	1.3
Total	**13,655**	**14,098**	**27,753**	**15.9**

Source: BCRP

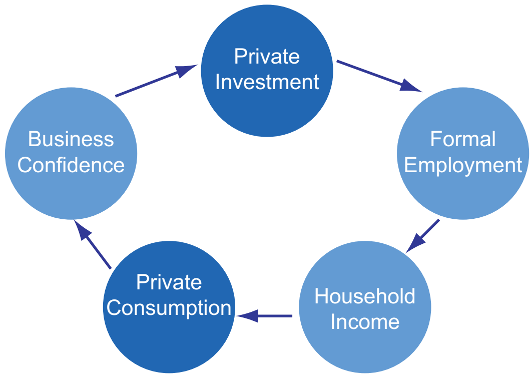
This increased investment will be accompanied by a greater employment demand. Thus, the generation of formal employment will continue to rise (it currently stands at 5.4% year-on-year, with an upward trend), which will encourage the increase of household income and, thus, private spending.

Chart 5
Gross Domestic Product (% change)



Source: BCRP and BBVA Research Peru

Chart 6
Factors determining growth



Source: BBVA Research Peru

The dynamics that will be generated as of 2011 will be quite similar to those of 2007/2008 (Chart 6). This could even been strengthened as households perceive that this robust economic activity will be more permanent, which would lead them to increase their spending at a similar rate. With the gradual recovery of developed economies and investment projects (in the tradable sector, especially) that will continue to mature, the increased foreign demand will contribute in the same way. Therefore, we forecast that the creation of an unending cycle of growth will make it possible for the growth rates in future years to be sustained at nearly 6% year-on-year.

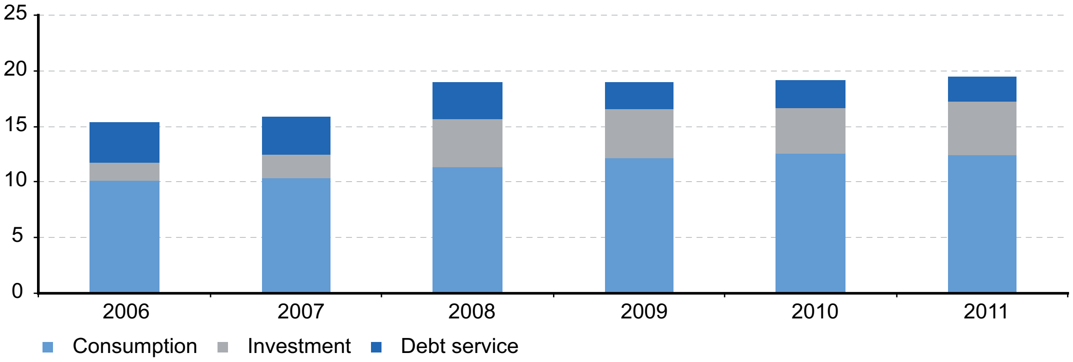
… while the fiscal stimulus will continue to be gradually removed to reduce the risk of too-high growth

Against this backdrop of strong economic activity forecast for 2011, fiscal revenue will continue to increase. Meanwhile, the public sector will continue to moderate its spending throughout the year, and more noticeably in the second half, after some of the large infrastructure projects are completed (electric train, transcontinental highways). Therefore, after two years the fiscal balance will again be positive.

In terms of revenues, domestic demand will favor greater collections on sales tax (IGV in Peru) and income taxes. Income tax collections will also feel the positive effect of the high international prices for exported metals, which will increase the profits of mining sector companies. The recent discount in tariffs to 3401 units (44% of the total), which reduced the average tariff from 5% to 3.4%, will negatively affect the collection of import and sales taxes as well as the selective taxes on consumption (ISC). However, we forecast that this effect will be offset by the greater volumes imported, incentivized by the decrease in tariffs, such that the final impact of the measure on the fiscal balance will be mild (near -0.1 pp of GDP).

It is also important to point out that the 2011 budget approved in November took into consideration an increase of spending of 8% with respect to the Initial Budget of 2010; this increase is lower than that observed in 2010 (13%) and in some other previous years (2007 and 2008). The adjustment is greater in the current expenditure (goods and services, pensions), while spending on infrastructure, healthcare, sanitation and social programs remain a priority (Chart 7). Likewise, the increase in funds that will be within the framework of the Revenues Budget is also noteworthy. Finally, though there is a risk that spending be higher because we are in a general election year and due to the inertia of the fiscal impulse in the previous two years, it is limited when considering the effect that, on the other side, a change in the administration has on municipal and regional governments, like that which occurred in January (after the elections of last October) and the particular fiscal regulations in place in years such as these. To summarize, we forecast moderately growing expenditure, which will be countercyclical (the fiscal impulse will be negative in 2011), and increasingly geared towards investment and be subject to the achievement of results.

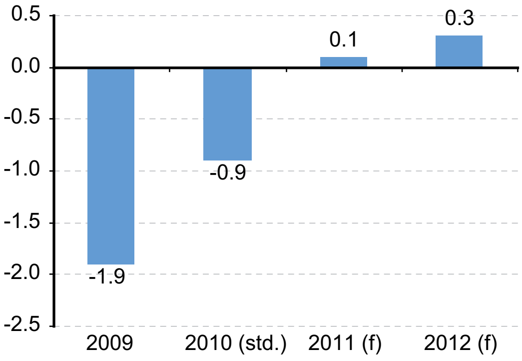
Chart 7
Public budget by type of expenditure (Percentage points of GDP)



Source: MEF

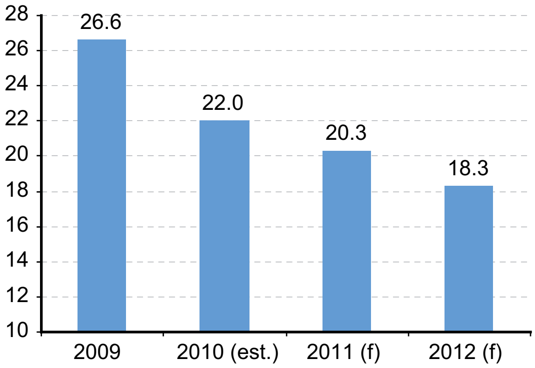
The improvement in public balances forecast for 2011 will allow for an accumulation of funds in the Fiscal Stabilization Fund, so that the protection against potential negative shocks can begin to be reconstructed. In coming years, the fiscal balance will remain positive with a tendency towards increase (Chart 8). This will lead the public debt to continue falling as a percentage of GDP, from 22% today to 20% in 2011 (Chart 9), and to nearly 14% in 2015. This strength in public balances will favor future improvements in the country's credit rating.

Chart 8
Fiscal balance (% of GDP)



Source: BCRP and BBVA Research Peru

Chart 9
Gross public debt (% of GDP)

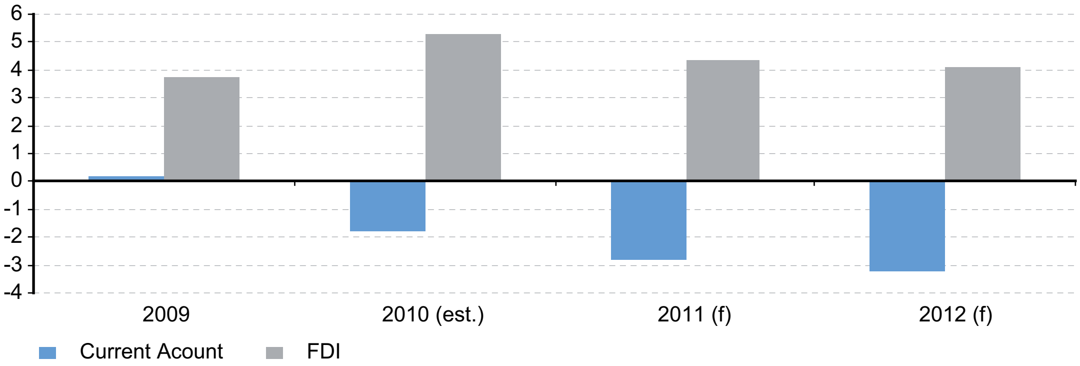


Source: BCRP and BBVA Research Peru

Strong growth that will be maintained in 2011, and the foreign deficit will increase in the following years. Is this deficit sustainable?

In terms of foreign accounts, we forecast the current account deficit to increase in 2011 to 2.8% of GDP (1.8% in 2010). This primarily takes into account the strength of domestic demand, which will be reflected in greater imports, while the gradual improvement in our main trading partners will cause the rise in exports to be more moderate. The greater foreign deficit, however, will more than financed by the inflow of long-term private capital, which would rise to nearly US$12,000m (nearly 7% of GDP), in particular with a FDI of US$7,600m (4.3% of GDP). In this context, net international reserves of the Central Bank will continue to rise in 2011 and reach US$50,000m (more than 28% of GDP). The outlook for the coming years is similar, with a negative foreign gap that will be somewhere over 3% of GDP, which will primarily reflect the downward correction anticipated for export prices (basically metals), but that will remain more than funded by the inflow of long-term capital (Chart 10).

Chart 10
Foreign accounts (% of GDP)

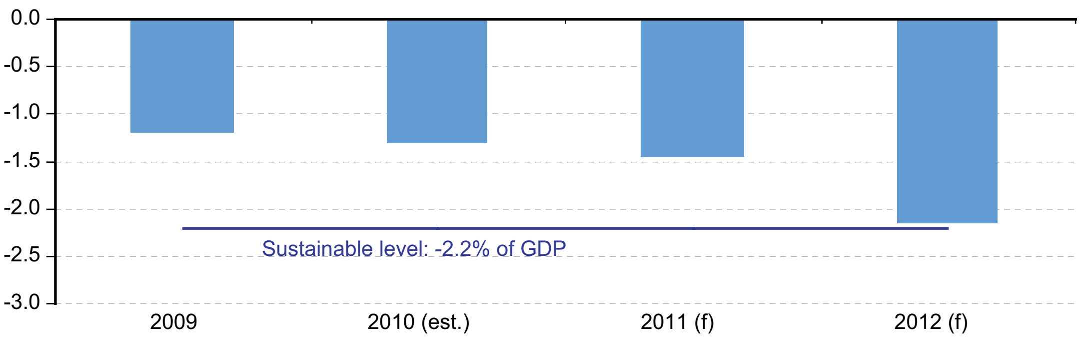


Source: BCRP and BBVA Research Peru

Despite the availability of long-term financing, there is a risk that the growth of the current account deficit of over 3% of GDP in the forecast horizon will not be sustainable. In this case, the economy could suffer an adjustment in coming years. Therefore, a sustainability analysis has been carried out. The analysis first took into consideration a current account balance excluding cyclical effects, e.g. (i) the impact that deviations with respect to a long-term level in the terms of exchange on the value exported and on the profits of foreign companies (factor income), and (ii) the impact of the output gap on imports. This is called the underlying current account (Chart 11). And secondly, a structurally sustainable level in the current account that is compatible with a steady net foreign liabilities position (as % of GDP) was also considered. A positive difference between both results would indicate that the foreign deficit is structurally sustainable.

The year (Chart 11) suggests that the current account predicted for the short and medium term is sustainable if the objective is to stabilize the net foreign liabilities position at a level similar to the current level of 30% of GDP. It is important to point out that the deficit of the underlying current account is lower than that observed due to the negative effects the following have had on it: (i) the positive output gap in the forecast horizon (generates greater imports) and (ii) the greater profits of foreign companies (negative factor income) in a context of high international metal prices, which as a whole is stronger than the positive effect on the value of exports. An interesting result that also arises out of the year is that the real effective exchange rate would have an underlying tendency to decrease in the next two years, which has been taken into account in the forecast for the nominal exchange rate.

Chart 11
Underlying and structurally sustainable current account (% of GDP)

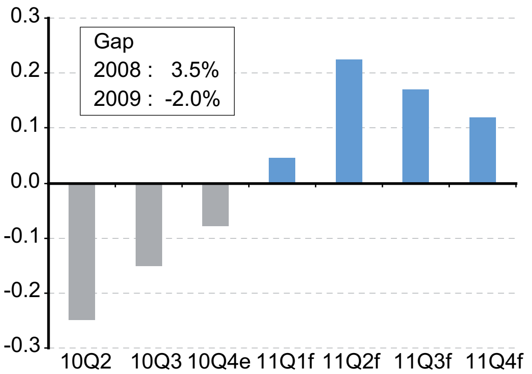


Source: BBVA Research Peru

3. Policy dilemma: inflationary pressure and appreciation of the PEN

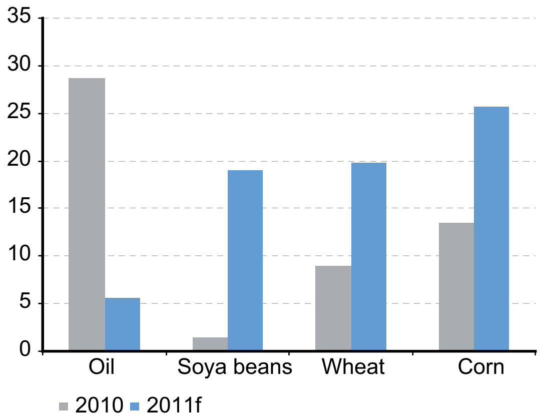
Greater domestic demand will be reflected in both the increase of the foreign deficit and the high agricultural and oil commodities prices and will also put pressure on prices…
The inflation scenario for this year is also complicated. On the one hand, the intense cyclical recovery in 2010 would have fully closed the negative output gap towards the end of said year. Considering our forecast for growth in 2011 of over 7%, which is higher than the prediction for potential (estimated at 6%), it would become positive in coming months (Chart 12). This would eventually be reflected in inflationary pressures. On the other hand, the increases in international agricultural and oil commodity prices over recent months (Chart 13) could later have a more sensitive impact on business costs[1]. This is more likely when output is expanding, as is predicted for this year, and could generate secondary effects. In this regard, we should mention that last January, the economic agents began to revise their expectations for inflation upwards.

Chart 12
Output gap (% of potential output)



Source: BCRP and BBVA Research Peru

Chart 13
Imported commodity prices (% change of average levels)



Source: Bloomberg and BBVA Research Peru

…which feeds the expectations for sharper adjustments in the Central Bank's reference rate... and also a more intense appreciation of the PEN, thus intensifying the monetary policy dilemma
In this context, we forecast that the normalization of the monetary position will be sharper than expected. This coincides with the upward cycle in the policy rate observed in January (up 25 bps to 3.25%). These increases would continue into coming months until the rate reaches a near-neutral level at the end of 2011 (near 4.50%).

The monetary adjustment will incentivize short-term capital inflows (the liquidity conditions in the United States and Europe will remain lax in 2011) and, in general, in the taking of long positions in PEN assets, which would increase the pressures towards a faster appreciation of the local currency. The above involves risks. A strong inflow of capital could result in disorderly growth in liquidity and credit, causing asset price bubbles. A rapid strengthening of the PEN could be difficult to absorb for the tradable economic sector. In addition, the convergence of both factors (capital inflow and local currency appreciation) foster foreign currency credit growth, undermining economic agents' balance sheets. Therefore, a possible reversal of capital flows and local currency depreciation would harm their ability to pay and lengthen the cycle.

This situation poses a dilemma for the monetary policy: on the one hand, increasing the policy rate to ensure ordered growth and restricted inflationary expectations, and, on the other, preventing the capital inflows and the appreciation of the PEN from worsening. We expect the Central Bank and financial authorities in general to continue addressing the issue in a coordinated manner to reduce this tension. In this regard, it is important that the policy rate adjustment cycle had restarted in January. First, because it helped the monetary restriction to be gradual, in search of a period of relative stability for the exchange rate, which reduces the probability of significant movements being incentivized on the foreign exchange market. And second, because the balance of risks is leaning towards excessive growth of domestic demand instead of towards a deterioration of the international outlook. Thus, acting early reduces the probability of having to make sharper adjustments later (with the potential

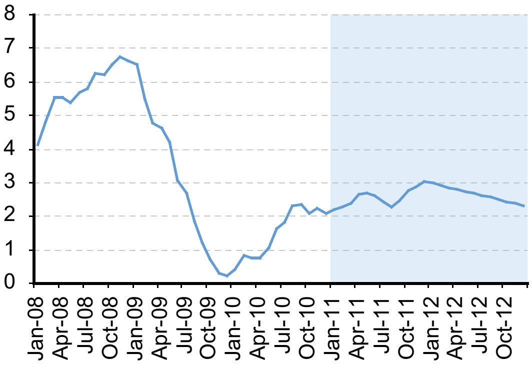
1: See Peru Economic Watch: "Inflation on an upward trend in 2011: a repeat of 2008?, February 2011, BBVA Research Peru consequences they could have for the foreign exchange market) in the event of greater deterioration of inflation or in the foreign accounts. Finally, because it favors the appropriate restriction of inflationary expectations, making it less necessary for the increases in the policy rate to be pronounced. Our forecast for the policy rate at 4.50% for the end of the year is consistent with inflationary expectations that will remain in the Central Bank's target range.

The normalization of the monetary conditions will be complemented by reserves that will remain high and that could even increase more. An indication of that was the recent increase in the average reserve rate in local and foreign currency, a measure that, due to its magnitude, had an impact above all in terms of indications, and was ahead of a way through which action could be taken to moderate inflationary pressures and prevent undesired effects in the foreign exchange market.

In addition, we do not rule out the implementation of other macro-prudential actions. Some of the spaces through which short-term capital inflows could have been generated and pressures on the PEN have been limited. The Central Bank, for instance, set reserve requirements for branches in Peruvian banks abroad. Before that, those branches could obtain short-term funds abroad without reserves and then broker them locally as parent company holding purchases or direct credit to non-financial corporations. These operations supported the growth of lending and, as they increased the supply of foreign currency, they reduced the interest rates in this market by reducing the cost of taking short dollar positions (greater appreciation pressure on the PEN). The Banking and Insurance Superintendency, in turn, established maximum limits for the net foreign currency derivatives positions for banks, thus making the taking of short positions in foreign currency forwards more expensive for those agents who anticipated the strengthening of the PEN (worsening it). We cannot rule out the possibility that, in extreme circumstances, the Government might introduce a tax on purchasing domestic assets for non-resident investors.

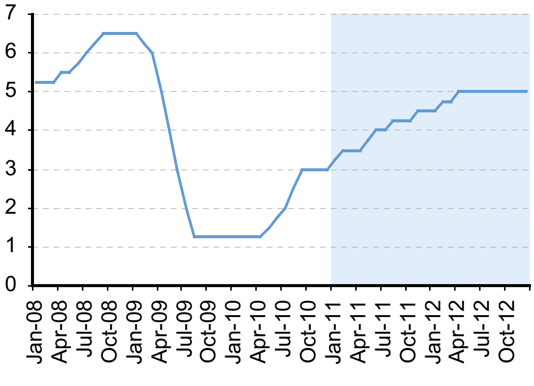
In all, our forecast takes into account a more complicated context for inflation in 2011 (accelerating to 3.0%), with a greater upward adjustment of rates (4.50% at year-end) which would keep the inflationary expectations contained. The monetary restriction would induce an increase of inflow of capital and a greater strengthening of the PEN (appreciation near 4% in 2011), which would be moderate so that the increase of rates is timely and gradual, and complemented by greater reserves and eventually with additional macro-prudential measures. As usual, the Central Bank would intervene in the foreign exchange market in episodes of rapid appreciation.

Chart 14
Inflation (% yoy change)



Source: BCRP and BBVA Research Peru

Chart 15
Monetary policy rate (%)



Source: BCRP and BBVA Research Peru

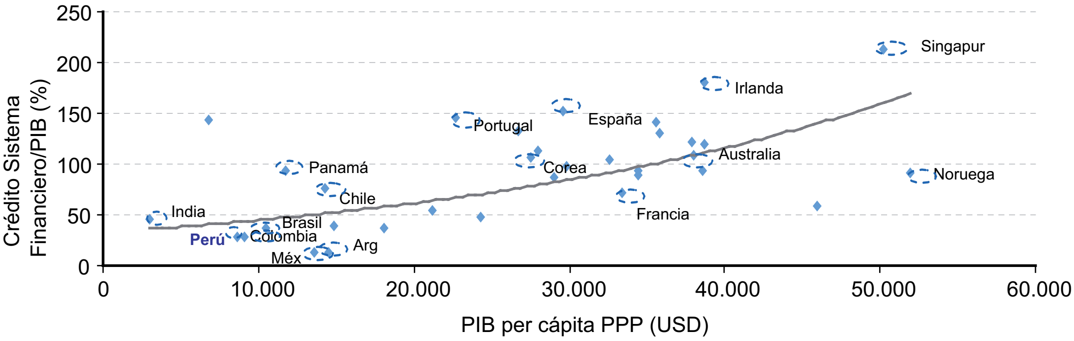
4. Lending increases sustainably

The dynamic economic activity in 2010 was accompanied by a recovery in the rate of lending growth, which closed the year at nearly 19% year-on-year. For this year, we expect a slight slowdown, in line with a more moderate growth of activity and a more neutral monetary position. We forecast wholesale lending and mortgages to record the largest increases, in a context of robust private sector investment. NPA, in turn, will remain limited with the improvements in household income and the low corporate leveraging.

The conditions for solid growth in lending in coming years are positive. On the one hand, the sustained growth expected to be reflected in greater income for the population (in current dollars, the GDP per capita will increase by nearly 60% in the next five years) and in a decrease in informal employment.

And on the other, the starting point shows that there is room for improving the depth of the financial system: the credit/GDP ratio is at 30%, which is relatively low as compared to both other countries with similar revenues and countries in the region with a lower GDP per capita. Against this backdrop, we believe annual lending growth rates between 15% and 20% to be sustainable over the coming years.

Chart 16
GDP per capita and credit/GDP



Source: CGAP and World Bank

5. Risk balance: projection of 2011 growth with an upward bias

Domestically, overheating cannot be ruled out...
There is a possibility that the growth of domestic demand be greater than expected, in a context of heightened optimism of the corporate sector and households. In addition, the demand pressures could be accentuated by greater inflow of capital in an international context of high liquidity and more attractive performance of domestic assets.

In this case, we would observe: (i) a faster expansion of credit and liquidity, (ii) a more pronounced appreciation of the PEN, (iii) a consumption boom led by the two factors mentioned above, (iv) additional demand pressures on prices, (v) reduced external competitiveness in the short term and (vi) an increase in the foreign gap and greater foreign debt.

In this scenario, the monetary policy would eventually have to be restrictive. To prevent greater upward pressures on the PEN (appreciation), the Central Bank would primarily opt to increase the reserve requirements to adjust the monetary conditions. Likewise, more aggressive foreign exchange interventions would be expected, which would have to be sterilized at a higher cost. On the fiscal side, a more intense slowdown in public spending would be expected.

…such that on the foreign side, a disordered exit from the financial crisis in Europe would have a negative impact
In this scenario, we would observe: (i) an increase in global risk aversion that would induce the reversion of capital flows of emerging economies and greater spreads, (ii) a fall in commodity prices and (iii) decreased foreign demand. As a result, investment and exports would slow. In this case, the Central Bank would pause the monetary restriction cycle and, given the solid foundations of the Peruvian economy, we would expect limited, short-lived impacts on output, with growth that would return in 2012 to a rate similar to that of the long-term.

6. Tables

Table 3

Peru: quarterly macroeconomic forecasts

	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12
GDP (yoy % change)	6.2	10.2	9.7	8.5	7.5	7.2	7.0	6.7	6.3	6.3	6.3	6.2
Inflation (yoy % change, average)	0.7	1.2	2.2	2.1	2.3	2.7	2.4	2.9	2.9	2.7	2.6	2.4
Exchange rate (vs. USD, average)	2.85	2.84	2.81	2.80	2.79	2.77	2.73	2.71	2.68	2.65	2.62	2.60
Interest rate (%, average)	1.25	1.50	2.50	3.00	3.42	3.75	4.17	4.42	4.67	5.00	5.00	5.00

Source: BCRP and BBVA Research Peru

Table 4

Peru: annual macroeconomic forecasts

	2010	2011	2012
GDP (yoy % change)	8.7	7.1	6.3
Inflation (yoy % change, average)	1.5	2.6	2.7
Exchange rate (vs. USD, average)	2.83	2.75	2.64
Interest rate (%, average)	2.06	3.94	4.92
Private consumption (yoy % change)	6.0	6.0	5.2
Public consumption (yoy % change)	9.5	4.0	4.0
Investment (yoy % change)	23.1	13.5	11.0
Fiscal balance (% GDP)	-0.9	0.1	0.3
Current account (% GDP)	-1.8	-2.8	-3.2

Source: BCRP and BBVA Research Peru

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