RESEARCH

Peru Economic Outlook

First Quarter 2014
Economic Analysis

- **Global economic activity will continue to recover this year in a context of reduced uncertainty.** Even so, a number of risk factors remain, such as the impact of tapering on the emerging economies.
- **Peru did not escape the volatility in financial assets and exchange rates caused by the start of tapering.** Looking forward, we expect the elements that distinguish Peru as an economy based on strong fundamentals to predominate.
- **Growth in the Peruvian economy will accelerate to 5.6% in 2014 and 5.9% in 2015.** The evolution in domestic demand will remain favourable, and rising exports, mainly minerals, will provide an additional boost.
- **The increase in the current account deficit is temporary and will gradually lessen with growth in exports.** The external deficit will continue to be financed principally with long-term capitals.
- **The policy rate would remain unchanged in 2014,** in a context of GDP growth similar to potential and inflation converging to the target range.

Index

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1. Summary

The global economic cycle grew stronger in the latter months of 2013, in line with expectations. In view of this, we continue to predict world GDP growth of 3.6% in 2014 and 3.9% in 2015 following the expansion of 2.9% last year. The progress made by the developed economies, in particular the United States, was a key factor in the improvement in the global economy. The growth path on which the US embarked in 2013, the reduction in the fiscal adjustment to be made in 2014/15, and the decline in uncertainty about the funding of Government spending in that period have created space for the Federal Reserve to start scaling back monetary stimulus. As usual, the shift in the direction of monetary policy has had a global impact. The emerging economies have been the most affected by reductions in capital inflows and depreciation in their currencies, and among them the hardest hit have been those with high trade deficits funded by short-term borrowing in foreign currencies. These tensions have not altered our forecasts for growth in the emerging economies as a whole, but they do point to a not insignificant downward risk.

Peru has not escaped this tension in the financial markets. As in the rest of the region, risk indicators have risen, the prices of domestic assets have fallen and the currency has depreciated. The Peruvian sol was in fact overvalued, however, a situation that was only corrected by the weakening of the currency. Because of this, we assume in our base scenario that the exchange rate will tend to move close to its current level in the coming months. However, we would not rule out episodes of high volatility at any given moment caused, for example, by the continuation of tapering in the US or by turbulence in any other emerging market, but these problems will be resolved by the intervention of the Central Bank. In such cases, the exchange rate would eventually return to a level closer to the fundamentals as the markets differentiate between economies, an analysis in which Peru displays a number of strengths.

We expect GDP growth to accelerate to 5.6% this year and 5.9% in the next. Available data show that the economy picked up in the fourth quarter of 2013, and that this boost will continue in the early part of the current year. Furthermore, the latest data on business and consumer expectations suggest that private spending will continue to provide support for domestic demand. The additional growth achieved in comparison with last year (which ended on a figure of around 5.0%) is expected to come from more dynamic exports as various major mining projects come on stream.

We estimate that annual growth will converge on 5.5% in the period 2015-2018, in line with potential GDP growth. This will be supported by capital accumulation and the expansion of employment, although the contribution of productivity will decline in relation to the past decade. In this regard, an accelerating growth rate will require the implementation of policies to boost productivity, such as improvements in the quality of education, as well as labour market reform and simplification of the administration to encourage investment and roll back the informal economy.

In this year and the next, the current account deficit is expected to remain at a level of around 5.0% of GDP. However, we would stress that Peru's current account deficit, unlike that of other emerging economies, is explained by an increase in the investment ratio and not by an excess of public spending or private consumption. Moreover, the funding for the deficit consists mainly of long-term FDI loans aimed largely at the tradable sector of the economy. These investments will encourage export growth, gradually closing the trade deficit over the next few years. Nevertheless, this will require an increase in domestic saving, a task which will fall mainly to the private sector, given the forecasts for the public sector.

We foresee that public sector accounts will suffer a slight deterioration in the future and that moderate deficits will be reported from next year. From the standpoint of income, we estimate that the tax burden will remain at around 15% of GDP in the coming years, and that there is little chance that the government will achieve its goal of 18%. In terms of spending, we believe that pro-cyclical management of fiscal accounts will not be avoided. One of the factors contributing to the adoption of an expansive bias will be rising wages for public employees as part of the central government's reforms. These results will not, however, compromise fiscal solvency insofar as the ratio of public debt (as a % of GDP) will continue on a downward path.

From the standpoint of prices, we expect the outlook to become more benign as time goes on, enabling inflation to begin a process of convergence towards the middle of the target range in the second quarter, ending the year on 2.4%. This forecast is based on three factors. In the first place, the weak growth of recent months has resulted in moderation of the output gap, which combined with GDP growth close to potential in 2014 will reduce inflationary pressures on the demand side. Second, the exchange rate will remain relatively stable this year, having reached a level which is more in line with the fundamentals, limiting the transfer into prices. Finally, international prices for foodstuffs will continue to fall given favourable supply-side conditions at the world level.

In this context of limited inflationary pressures and economic growth in line with potential, monetary policy will hold interest rates at their current level of 4.0% for the rest of the year. Should it eventually become necessary to provide additional support for growth, we believe the Central Bank will back a reduction in the reserve requirements held in domestic currency, which still remain relatively high despite the fall in recent years. It is unlikely that the Central Bank will apply the policy rate to hold up activity, because this would exacerbate the pressure of depreciation on the local currency in a volatile context due to the tapering. Neither, however, do we foresee any upward adjustment of the reference rate during any episodes of high exchange rate volatility, such as those applied recently in some emerging economies seeking to support their currencies, because in such a context the Central Bank would use its large international reserves to intervene in the market, in line with its usual policy.

Finally, there are two main external downside risks in our base scenario for growth, namely an intensification of financial tensions in the most vulnerable emerging economies and a sharp slowdown in the Chinese economy. In the first case, the difficulties encountered by some emerging economies in handling tapering could raise perceptions of risk in these markets, leading to contagion in Peru. In this scenario, we would see a trend towards depreciation of the Peruvian sol, a downward correction in the prices of local assets and tougher conditions for external borrowing, which could affect the real economy. In a second phase, the financial weaknesses which have begun to emerge in China could complicate the implementation of counter-cyclical policies in that country. The impact on the Peruvian economy would be more structural, affecting exports of metals and their international prices for a longer period. Significantly, however, Peru continues to display fiscal and monetary strengths which would allow it to implement economic policy measures to accommodate any such impacts.

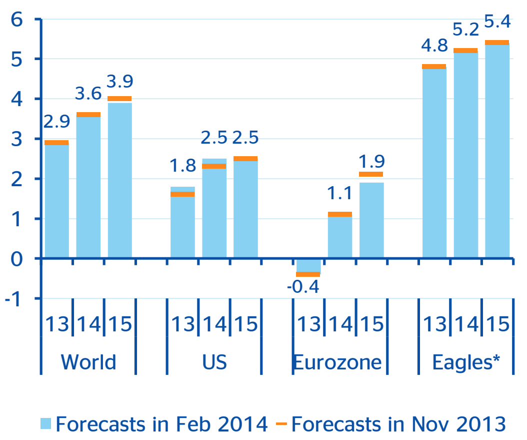
2. External environment: more growth and more balanced risks

The global economic cycle is improving and we now have clarity on some economic policy uncertainties

The global economic cycle strengthened during the latter months of 2013. According to our estimates, during the second half of 2013, global GDP accelerated to a rate close to 1% QoQ, leaving behind the moderation with its roots in 2012 and its low at the beginning of 2013, when growth was barely 0.5%. This improvement was driven by the acceleration of the developed economies – particularly the US, but also the eurozone, which started to see moderate growth. In the emerging markets, the situation is more diverse, but some of them (e.g. China) are posting relatively stable rates of growth.

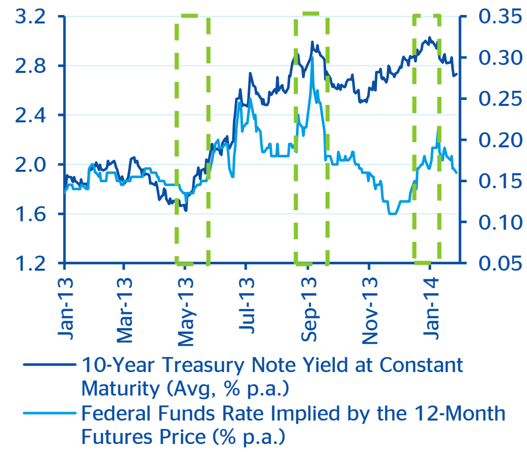
Our improved assessment of the global scenario is also the result of the developments in economic policy, inasmuch as this helps to reduce uncertainty. First, the US reached a more far-reaching agreement on fiscal policy than we expected. Meanwhile, the improvement in activity allowed the Fed to start tapering its expansive monetary policy at the beginning of 2014. In Europe, further steps have been taken towards the construction of banking union, which together with the ECB's determination to keep risks under control, should eliminate the hobble represented by financial fragmentation. The global outlook would be clearer if it were not for the effect that the tapering is having on financial markets in the EMs, and which could eventually affect economic growth in some of the countries included in this category.

Chart 2.1
GDP growth forecasts (%)



EAGLES is the group of emerging economies that will make the biggest contribution to global GDP in the next 10 years. The group comprises China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: BBVA Research and IMF

Chart 2.2
EU: Federal funds futures and long-term interest-rates (%)



Source: BBVA Research and Bloomberg

Thus, global GDP growth, which in 2013 had decelerated to 2.9%, will increase to 3.6% and 3.9% in 2014 and 2015, respectively (Chart 2.1), almost the same as our forecasts three months ago. The expected increase in global growth does not detract from the existence of downside risks to our forecasts. Although these risks are a long way from having the systemic nature that they had in the past, some recent events such as the fall in asset prices and currency depreciation in EMs have made themselves felt.

The US starts to unwind its monetary stimulus

US GDP growth has been accelerating through 2013, which by year-end allowed the Fed to take the first steps towards withdrawing monetary stimulus. Furthermore, in December, an agreement was reached that represents an important step forward in eliminating the uncertainty regarding the funding of the government's activity in 2014-15, as well as reducing the fiscal adjustment initially forecast for that period.

The outlook for monetary policy has also clarified recently, in line with our expectations. As a consequence of an acceleration in activity with well-anchored inflation expectations, the Fed decided to start to taper its monthly purchases of financial securities. All in all, in the fourth quarter of 2014, the central bank will have stopped expanding its balance sheet. Our base scenario also assumes that the first increase in interest rates will take place in the second half of 2015, although the FED will continue to use its forward guidance to anchor interest-rate expectations. In fact, the Fed's efforts to explain its exit strategy have been relatively successful in avoiding episodes of volatility like we saw last summer. Both long-term interest rates and expectations regarding Fed funds remain at levels no higher than the beginning of the summer (Chart 2.2). This is significant because part of the US recovery was due to interest-rate sensitive sectors such as real estate.

In this context, we have revised upwards our forecast for US growth in 2014 to 2.5%, the same as our estimate for 2015 (Chart 2.1). This adjustment reflects both the strength of the US economy in the second half of 2013 and the additional momentum contributed by the reduced fiscal drain thanks to the agreement reached at the end of last year. Note that there are also upside risks to our forecast if the improvement in confidence results in additional corporate investment and hiring.

The withdrawal of monetary stimulus in the US could cloud the outlook for some emerging economies

The change of direction in US monetary policy has, as usual, had a global impact. The emerging economies are being subjected to reduced capital inflows and currency depreciation, intensified in some cases by domestic events that have increased uncertainty regarding the management of their respective economic policies. In addition, there continues to be a differentiation between economies depending on their fundamentals: higher external deficits and more dependence on short-term and foreign-currency funding are associated with greater vulnerability to capital outflows and currency depreciation (Chart 2.3).

The recent tensions have not changed our growth forecasts for the EMs as a whole, but they do represent a significant downside risk. This risk is higher in the economies that have a higher weighting in global investment portfolios and that have the above-mentioned vulnerabilities: Turkey, Brazil, Indonesia and India in particular. The monetary tightening being introduced by some of these countries to control currency depreciation and inflation expectations will inevitably have a negative impact on growth. All in all, the diversity within the EM group means that our outlook remains favourable for some parts of South America, such as the Andean economies, emerging Asia and Mexico, some of which are benefiting from the cyclical momentum of the US economy (Chart 2.4).

Growth in China remains at around 7.5%, but the vulnerabilities are more evident

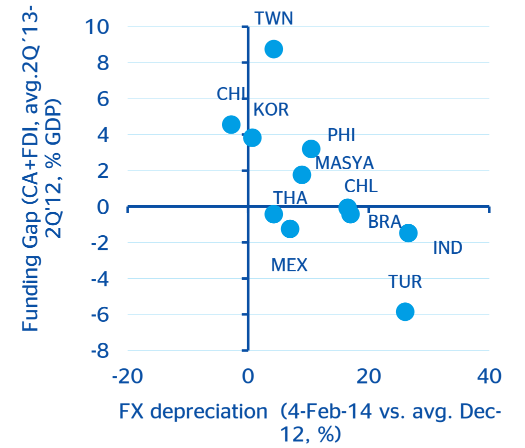
The fourth quarter was a clear example of the duality of China's economy as both a support for the global economy and a potential risk factor. The uncertainty at the beginning of the last year regarding the sustainability of its growth and the possibility of a hard landing dissipated in the short term. The economy recovered in the second half of 2013 (Chart 2.4) and maintains a good tone, although some of the more recent data on confidence and expectations of manufacturing activity are once again below market expectations.

Fundamental changes in economic policy have also been announced. At the Third Plenum of the Chinese Communist Party, the authorities reiterated their commitment to maintaining high rates of growth, while proposing measures that will strengthen the role of the market in allocating resources and a rebalancing from a model of investment and exports towards increasing household consumption. These announcements are steps in the right direction, but their effectiveness will depend on their execution, and they are not without risk.

For example, as regards the financial sector, the authorities are continuing to demonstrate their commitment to tackle the current vulnerabilities, fundamentally linked to the rapid growth of credit. This is being reflected in liquidity tensions in the interbank market which are above all affecting the so-called shadow banking sector[1], although the authorities have not managed to moderate the rate of growth in credit.

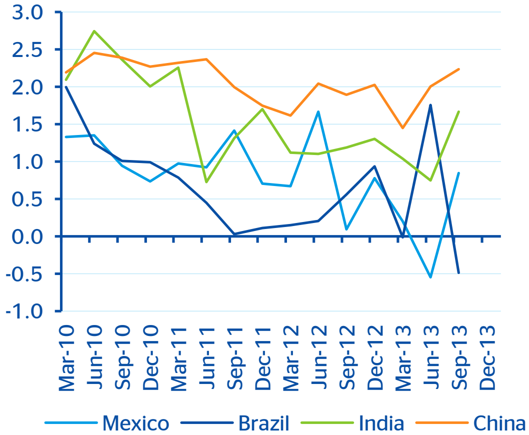
In any case, our 2014 and 2015 growth forecasts for China's economy remain unchanged (at 7.6% and 7.5% respectively), based on our confidence in the authorities' scope and ability to take action.

Chart 2.3
Exchange-rate depreciation (%) vs. external funding gap (CA + FDI, % GDP)



Source: BBVA Research and Haver Analytics

Chart 2.4
GDP growth in EMs (% QoQ sa)



Source: BBVA Research

The gradual recovery in the eurozone continues, with the support of the ECB and with banking union in its sights

After starting the year in recession, the eurozone managed to sustain moderate expansion throughout the second half of the year, in line with our forecast. Thus the fourth quarter data indicate YoY growth of 0.4%, which although only slight, is its best since the end of 2011. The driver of this slight improvement was the prospect of an increasing role played by domestic demand and the sustained improvement in credit financial conditions, favoured by the determination and commitment of the ECB to an expansive monetary policy. Nonetheless, the engine of European growth in 2013 and 2014 was, and will continue to be, the export sector.

In any case, we cannot rule out periods of instability as we approach events that could alter the panorama of progress in banking union and of strengthening the monetary union in Europe in general. The events to watch in this context include the European Parliamentary elections, and developments on the conditions and results of the stress test and asset quality review of the banking sector.

All in all, we reiterate our forecast for eurozone GDP growth at 1.1% for 2014. For 2015 we estimate 1.9%. However, given our projection of continued cyclical weakness, we are also maintaining as a risk event to our forecast horizon a scenario of significant deflation, although we assign a low probability to this risk.

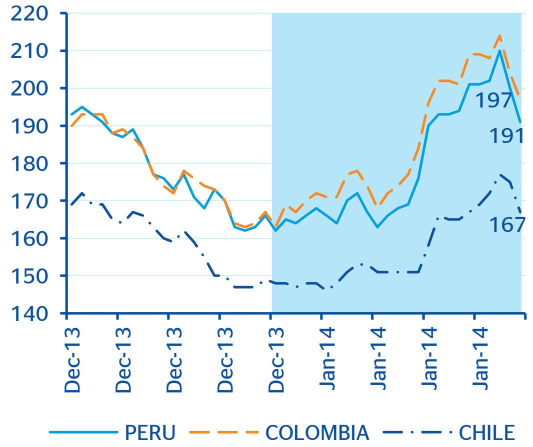
1: The group of financial institutions and vehicles that fall outside the regulation of the banking system, but that carry out the same intermediary functions between the economic agents with surplus liquidity and those with insufficient savings to take consumption or investment decisions.

3. Local financial markets will take their cue from tapering and events in other emerging markets

As was only to be expected, the start of tapering has had a global impact, which has been more intense in the emerging economies, causing major macroeconomic imbalances

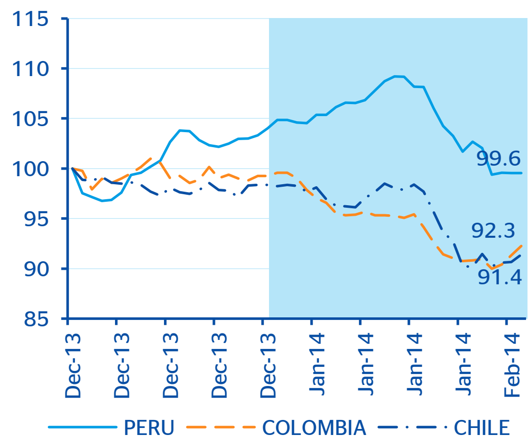
Though initial reactions to the gradual withdrawal of the monetary stimulus program in the United States were muted, concern grew in recent weeks with the publication of data on the US and Chinese economies, suggesting that the recovery in the case of the former and stabilisation in the case of the latter are rather more embryonic than had at first been thought. In addition to these two issues, the emerging economies have been affected by a further idiosyncratic factor: some of these markets, including a group of the largest, have been showing signs of structural weakness, such as considerable trade deficits financed mainly by major inflows of short-term capital, and the absence of economic policy measures to correct such situations. As a consequence, the reduction in quantitative easing has caught some emerging economies in the midst of major macroeconomic imbalances. As a result, investors' appetite for the emerging nations has declined, risk indicators have risen, the prices of domestic assets have suffered a downward correction and local currencies have depreciated.

Chart 3.1
Country risk: EMBI (basis points)



Source: Bloomberg

Chart 3.2
Stock Market Index (02/12/13 = 100)



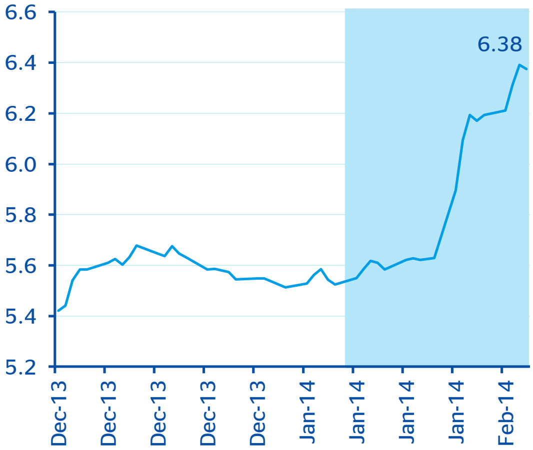
Source: Bloomberg

Peru has not escaped this panorama. In January, the EMBI Peru index increased by over 40bp to more than 200bp, a similar level to that reached when tapering was initially announced in the second quarter of last year (see Chart 3.1). In this context of increased perception of risk, the stock market fell by close to 2% (losing another point in the month of February to date: see Chart 3.2), while the liquidation of positions in the sovereign bonds market by non-resident investors[2] caused yields on bonds maturing in 2023 to rise by almost 65bp (and a further 18bp in February, see Chart 3.3). In the currency markets, pressure on local

2: As a yardstick for the liquidation of positions, the balance of sovereign bonds held by non-residents fell by more than USD 400 million in December, when tapering had not yet been affected by any discouraging news about the US or Chinese economies, and concerns were not yet growing with regard to the macroeconomic imbalances in some of the leading emerging economies. Liquidation probably gathered pace in January.

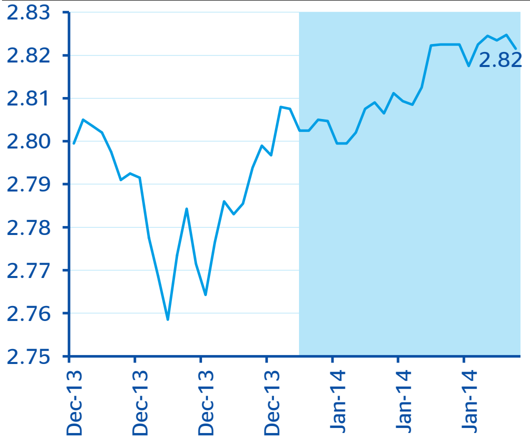
currencies raised the exchange rate above 2.82 (see Chart 3.4), a level not seen since the first half of 2011, despite the intervention of the central bank which has sold foreign currency (USD1.04 bn in January and a further USD430mn in the month of February to date, for a total equal to some 2.2% of the balance of international reserves held at the end of 2013) and issued securities bearing yields indexed to the exchange rate (for the net equivalent of USD750mn).

Chart 3.3
Yield on sovereign bonds (SOB2023, %)



Source: Bloomberg

Chart 3.4
Exchange rate (PEN/USD)



Source: Bloomberg

The local currency has reached a level in line with its fundamentals, but further episodes of high volatility cannot be ruled out

The upward trend in the exchange rate has brought the currency down to a level which is more consistent with the economic fundamentals according to our calculations. Because of this, we assume in our base scenario that this variable will tend to move close to its current level in the coming months. However, we would not rule out episodes of high volatility at any given moment caused, for example, by the continuation of tapering in the United States or by turbulence in other emerging markets. The central bank would certainly intervene in the event of very sharp fluctuations, and the exchange rate would eventually return to a level closer to the fundamentals as the markets differentiate between economies, an analysis in which Peru displays a number of strengths. The risk is that such episodes of volatility might become frequent, which could result in contagion of the stronger emerging economies such as Peru.

Box 1. Which way is Peru's sovereign spread headed?

As the withdrawal of quantitative easing gets under way in the United States, liquidity conditions will become tighter globally. In this context, we have already seen an increase in the yields on US Treasury bonds and wider sovereign spreads in the emerging economies. In particular, the Peruvian sovereign spread (EMBI Peru) increased by approximately 50bp from 130bp in May 2013 to an average of 180bp in June-Dec.2013 (see Chart B.1.1) after the first signs of an announcement of tapering by the Fed in the second quarter of 2013.

The expected increase in US interest rates will affect sovereign spreads via the liquidity channel. In recent years, quantitative easing has increased liquidity worldwide, with the result that capital has sought higher returns in emerging markets, narrowing sovereign spreads. The start of tapering will produce the opposite effect, as capital will obtain higher returns in the United States while reducing exposure to assets in emerging markets.

Empirical studies suggest that there is a positive and significant relationship between the yield on a 10-year US Treasury bond and sovereign spreads in emerging markets. For example, González-Rozada, M and Levy Yeyati, E (2008)[3] have found that the appetite for risk (proxied by the spreads on high yield corporate debt) and international liquidity (proxied by the yield on 10-year US Treasury bonds) are a significant determining factor for emerging market spreads and explain around 30% of variations in the long run. Hartelius, K., Kashiwase, K and Kodres, L (2008)[4] found similar results, at the same time noting that uncertainty over changes in Treasury rates has a greater influence than the exchange rate itself.

In order to analyse the potential effects of tougher global liquidity conditions in the Peruvian case, we have estimated an equation reflecting the determining factors for the sovereign spread, which is explained by the economic fundamentals and the yield on 10-year US Treasury bonds/notes.

$$EMBI_t = \boldsymbol{\alpha} + \boldsymbol{\beta}_1 Treasury10A_t + \boldsymbol{\beta}_2 X_t + \boldsymbol{\beta}_3 dummy1 + \boldsymbol{\beta}_4 dummy2 \boldsymbol{\varepsilon}$$

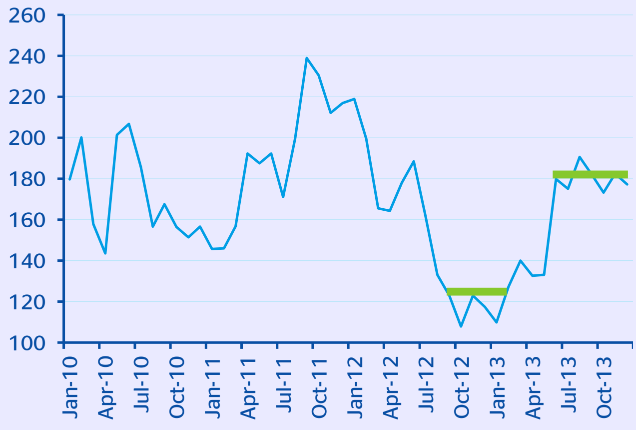
Where EMBI is the country risk indicator; Treasury10A is the yield on the 10-year US Treasury bond; X is a series of fundamental variables (current account as a % of GDP, terms of trade, GDP, external debt as a % of GDP, reserves as a % of GDP); dummy1 captures the contagion effect of elections in Brazil in 2002; and dummy2 captures the contagion effect of the Lehman Brothers bankruptcy in the last quarter of 2008. Quarterly data for the period 1Q99-1Q13 were applied.

The results of the regression show that an increase of 100bp in the yield on the 10-year US Treasury bond (T10Y) causes an increase of approximately 20bp in the EMBI Peru index. On this basis, if the consensus market forecast that the T10Y yield will rise to around 3.50% by the end of 2015 (an increase of 70-80bp compared to the current yield) turns out to be correct, the EMBI Peru index will increase by between 10bp and 15bp in the coming months, which would place it slightly above 200bp. The result would be to increase the financial cost of sovereign issues by almost 1pp over a period of one year. This result would suggest that the impact of tapering in the USA on the Peruvian economy would be gradual and fairly limited (assuming no change in other determining factors for the Peruvian sovereign spread).

Naturally, the total effect on the spread would depend on the expected evolution of the economic fundamentals, and whether this information has already been included in assessments of country risk. For example, yields on the 10-year Treasury bond rose by around 200bp in the period 2003-2007 when the Fed realigned its monetary policy, while Peru's sovereign spread fell by 300bp. This fall was explained by the improvement in the fundamentals of the Peruvian economy, helped by a positive shock in the terms of trade, which was reflected in a reduction in the public deficit and in the ratio of public and foreign debt, an improvement in the current account balance and faster GDP growth. We forecast a slight decline in the balance of these fundamental variables over the next two years (see Table B.1.1), which will not exert greater pressure on the spread on Peruvian public debt.

3: González-Rozada, M. and Levy Yeyati, E. (2008) Global Factors and Emerging Market Spreads, Economic Journal 118, 1917-1936
4: Hartelius, K., Kashiwase, K., and Kodres L. (2008) "Emerging Market Spread Compression: Is it Real or is it Liquidity?" IMF Working Paper

Chart B.1.1
EMBI+ Peru (basis points)



Source: Bloomberg

Table B.1.1
Macroeconomic fundamentals of sovereign risk

	2010-2012	2013-2015	Effect
Current account (% of GDP)	-2.6	-5.0	↓
Fiscal result (% of GDP)	1.3	0.0	↑
Public debt (% of GDP)	21.5	17.8	↑
Foreign debt (% of GDP)	27.7	30.7	↓
International reserves (% of GDP)	29.5	31.9	↓
Terms of trade (Avg. % change)	6.2	-5.8	↑
GP (Avg.% change)	7.3	5.5	↓

Source: Bloomberg

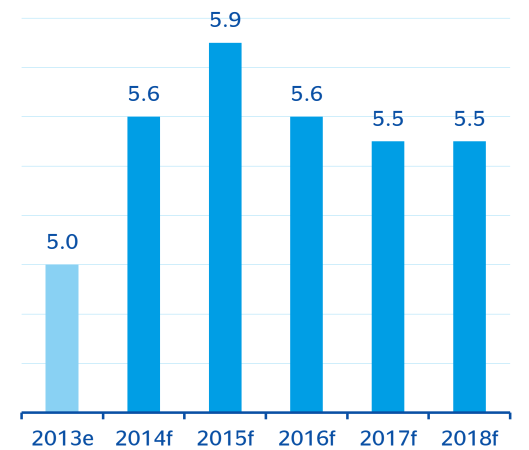
4. We maintain our growth forecasts of 5.6% in 2014 and 5.9% in 2015

The Peruvian economy started the year with a favourable outlook. On one hand, in the short-term available economic indicators suggest that the GDP growth observed in the last quarter will hold up. On the other, the sustained improvement in confidence indices points to continuing private sector support for expansion in the coming months.

In addition to this good start to the year, economic activity is expected to speed up temporarily both this year and next, due to the strong recovery in minerals export volumes, as various major mining projects currently in the pipeline come on stream. We also anticipate that the improvement in the world economic cycle will favour stronger performance in our manufacturing exports. Finally, we continue to believe that the prices of the raw materials exported by Peru will remain at levels that will support growth in the coming years, gradually converging towards their long-run levels. In this context, we maintain the growth forecasts of 5.6% in 2014 and 5.9% for 2015 published for Peru three months ago (see Chart 4.1).

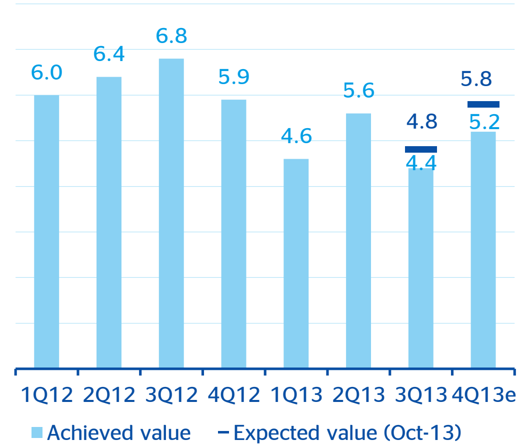
The current account deficit will remain at fairly high levels (around 5.0% of GDP) this year and next. While this deficit is a reflection of strong investment dynamics, and has mainly been funded against long-term borrowing, it still represents a weakness in the current context of volatility in international financial markets, where global investors have been taking defensive positions which do not distinguish between economies, despite their significant structural differences. We may recall at this point that the emerging markets which have faced the greatest pressure in recent months due to the shifting position of the Fed's monetary policy have been those with the largest trade deficits. However, we may also note that the deficit in these cases was accompanied by other factors, like high levels of dependence on short-term foreign borrowing, low levels of international reserves, a weak fiscal position and poor macroeconomic management, raising international investors' concerns about these economies. The fundamentals of the Peruvian economy remain very sound, however, and none of these factors are present. In general, we perceive that the markets will begin once again to differentiate between the emerging markets in the coming months based on the soundness of their fundamentals, and Peru could well be one of the economies to benefit in terms of capital inflows and more favourable borrowing conditions.

Chart 4.1
Peru: GDP growth, 2013-2018 (%)



Source: BBVA Research

Chart 4.2
Peru: Quarterly GDP growth (% YoY change)



Source: BCRP and BBVA Research

Growth picked up in the fourth quarter, although more slowly than had been expected

In line with expectations, growth picked up in the last quarter of 2013 (see Chart 4.2). This was mainly linked to the better performance of the primary sector, in particular Mining (around 7% YoY in 4Q13) and Fisheries (42.9% YoY in 4Q13). In the former, various new mines have started production since the end of 2012 (Antapaccay, Santander and Apumayo, for example) and this factor began to have a noticeable impact on output of copper, silver, zinc and lead in the latter months of 2013. Meanwhile, the fishing industry benefitted from an anchovy quota of 2.3 million metric tonnes (for the Central-North zone in the second fishing season), almost three times the catch allowed in the previous year. The performance of the primary sector. combined with the excellent momentum in other sectors linked with domestic demand, such as Commerce and Services, where growth rates accelerated to more than 6% year-on-year. Supermarkets in particular enjoyed dynamic growth, in line with the continued strength of consumer spending. Financial services also performed well, as a result of the expansion of lending towards the end of the year.

The upturn was not as strong as anticipated, however (see Chart 4.2). In terms of spending, this was because of a relatively slow recovery in private investment and the weakness of exports. On a sectorial basis, this was reflected in a slowdown in Construction and the weak performance of Manufacturing. The former was affected by the slow progress of investment in a series of retail, telecommunications and manufacturing projects. In turn, the sluggish pace of growth in Construction had some impact on demand for related manufactured products (e.g. window glass), and, together with falling demand for textiles in the USA and Venezuela, this would explain the weakness of Manufacturing in the latter months of 2013.

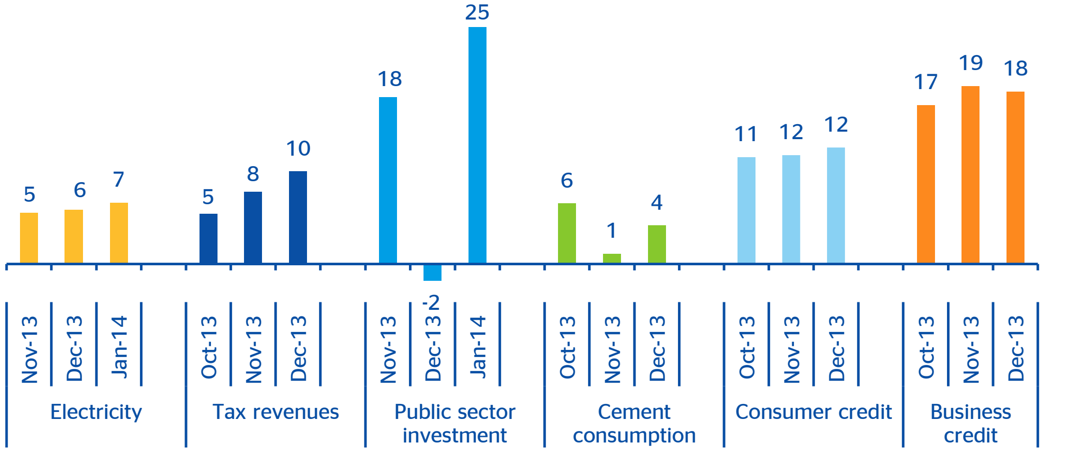
In contrast to the picture revealed by the figures, we expected a stronger recovery in the sectors most closely linked to domestic demand (Construction, Commerce and Services), which usually display a sustained dynamic, lending stability to GDP growth. However, it was actually the primary sectors, which are usually more volatile, that accounted for much of the additional growth achieved in the last quarter. On a positive note, we expect that Mining will continue to perform strongly in the future, which suggests that recovery based to some extent on extraction industries would be sustainable.

Taking into account the result for the last quarter, GDP growth for 2013 would be 5.0%, the most moderate rate of expansion in the economy since 2004 (except for the crisis year of 2009). This is in line with our view that the economy is in the process of convergence with its long-run trend after a period of faster growth driven by exceptionally benign external conditions which stimulated investment. We believe this process of convergence will be completed shortly, and GDP will therefore grow at rates that are closer to potential.

Activity and confidence indicators were positive at the beginning of the year

The available activity indicators for December and January were mainly positive (see Chart 4.3), showing that the economy remained in good health at the beginning of the year. Domestic consumption of cement grew by 4.1% in December (1.1% YoY in November), while public investment expanded by 25% in the first month of the year, largely due to the progress of local government projects. Both indicators anticipate favourable results for the construction sector. Furthermore, the fastest growth in tax receipst and electricity generation adds, that in January would have been 6.5%.

Chart 4.3
Peru: Business indicators (actual % change, YoY)

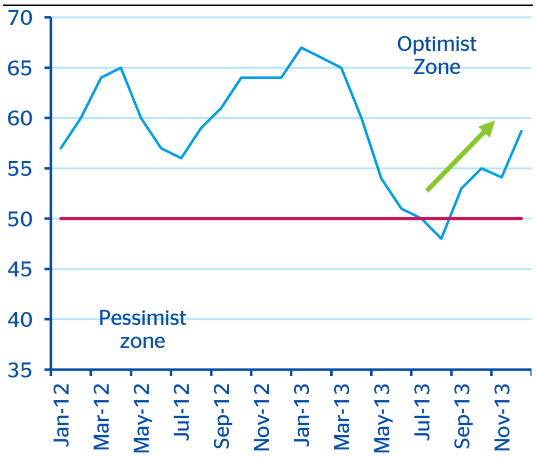


Source: BCRP, MEF, COES, INEI, SBS

Total bank lending expanded by 17.6% YoY in December. Loans made to business increased by 18.2%, continuing the growth trend observed in recent months. By sector, lending was most dynamic in Mining (17.6% YoY) and Manufacturing (15.9% YoY), mainly in food and beverages, wood and paper, and metals manufacturing. The favourable development in commercial lending would be in line with the growth that we expect to see in investment in the coming months.

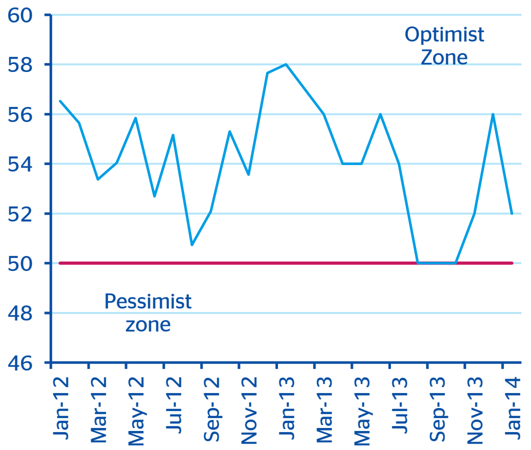
The positive outlook for the economy is also reflected in the business confidence index, which in December climbed to 59 points, its highest level in the last 8 months (see Chart 4.4). Other indicators like the current business situation index and the sales index more precisely reflect business perceptions of conditions, rising to 61 and 57 points respectively in December. The percentage of firms which consider their situation to be bad fell from 9% to 5%, and the outlook in Commerce and Services is particularly bright. Maintaining entrepreneurs' high levels of optimism in their business expectations will be a key factor in ensuring future growth in private investment. In this regard, it will be necessary to continue with the implementation of policies designed to ensure/underpin macroeconomic stability and a favourable business climate.

Chart 4.4
Business confidence (Index)



Source: BCRP

Chart 4.5
Consumer confidence (Index)



Source: APOYO Consultoría

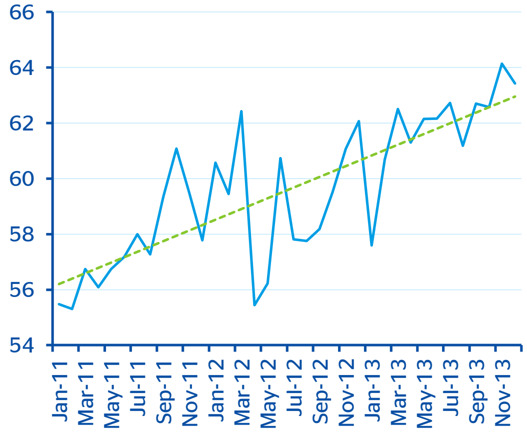
In January, consumer confidence (measured by the INDICCA index published by Apoyo Consultoría) stood at 52 points (see Chart 4.5). While this result is four points lower than the level reported in the previous month, households are inclined to particular optimism in December given the Christmas festivities. Furthermore, rising prices of certain foodstuffs had a negative impact on the index's price component. The January result should, then, be interpreted as positive, given that it remains in the optimistic zone, which means that the number of people perceiving improved conditions for consumption is slight majority. A further positive sign for family spending is offered by the performance of consumer lending by banks, which began timidly to reverse the downward trend observed in recent months, displaying growth of 12.3% in December. These indicators point to stronger private sector spending in the coming months.

Dynamic mining exports will provide a further boost for growth in 2014 and 2015

We maintain our growth forecasts of 5.6% this year and 5.9% next. This represents an acceleration of economic activity compared to 2013. In this regard, we foresee that the expansion of GDP will continue to enjoy the support of domestic demand, which will contribute 5.3 percentage points to growth this year and next. The growth of private consumption and public spending will stand out particularly.

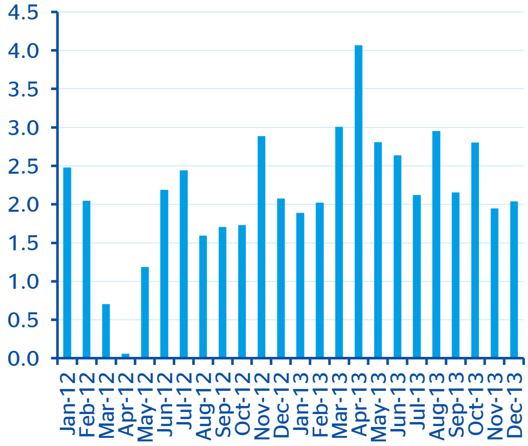
Thus, we predict growth of around 4.9% in spending by families in the coming years. This figure assumes that consumer confidence will remain at optimistic levels above 50 points, and that the evolution of consumer lending will remain positive. Our estimates also assume that the labour market will continue to expand, driven by investment. In this regard, the Index of hiring expectations was in the optimistic range (53 points) in December, and 18% of firms expected to increase their workforce over the next three months, with sectors like Construction, Manufacturing, Commerce and Services to the fore in job creation. We also expect the trend seen in prior years to continue, resulting in an ongoing increase in the proportion of quality jobs (see Chart 4.6). In the last quarter of the previous year, employment grew by around 2% year-on-year in Metropolitan Lima (see Chart 4.7), while higher-paid jobs increased by 6.2% and low-paid jobs decreased by -6.9%. These differences indicate that economic growth has not only been accompanied by higher overall levels of employment, but also that employees can find jobs under terms and conditions which are better attuned to their aspirations. A key factor in maintaining these levels of employment and job quality will be to improve the education standards of the workforce. More skilled people are more productive, and they are also likely to obtain better working conditions than the unskilled. This is reflected in the employment figures. In the last quarter of 2013, adequate employment increased faster in the segment of the population with non-university higher education (12.6%), followed by those educated to secondary level (6.1%).

Chart 4.6
**Workforce in adequate employment
(% working population in Metropolitan Lima)**



Source: INEI

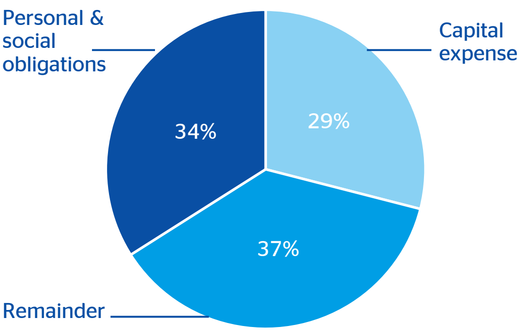
Chart 4.7
**Growth in employment in Metropolitan Lima
(3-month moving average YoY % change)**



Source: INEI

Public spending will also maintain a fast rate of expansion, in line with Budget forecasts for the year, which are almost 7% higher in real terms than in 2013. Some 63% of this increment is explained by additional resources for personnel and capital expenditure (see Chart 4.8). In this regard, public consumption will continue to reflect the wage increases agreed within the framework of reform packages in different areas of the administration. Accordingly, funds earmarked for personnel costs will increase by PEN3.5bn (USD 1.3bn) this year, mainly benefitting health workers and teachers, the armed forces and the national police force (see Table 4.1). As a result, public sector pay will continue to grow from 3.6% of GDP in 2011 to 4.3% in 2014. Meanwhile, public investment will grow in double digits in 2014 and 2015, on the strength of numerous infrastructure projects. Transport projects account for half of the increase budgeted for this year. The most important projects are those related to major road repairs and improvements in different parts of the country, and the construction of schools and hospitals.

Chart 4.8
Distribution of Budget increases by spending type (percentage structure)



Source: MEF

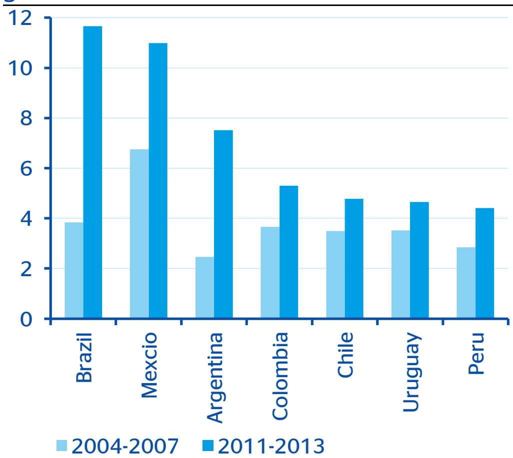
Table 4.1
Public sector: Reform-based wage increases in 2014 (PEN mn)

Measure	Sum
Teaching Reform- II Phase	761
Healthcare salary reform- II Phase	776
Armed Forces & Police Salary Reform- II Phase	762
Civil Service Law-I Phase	500
Total	2,799

Source: MEF

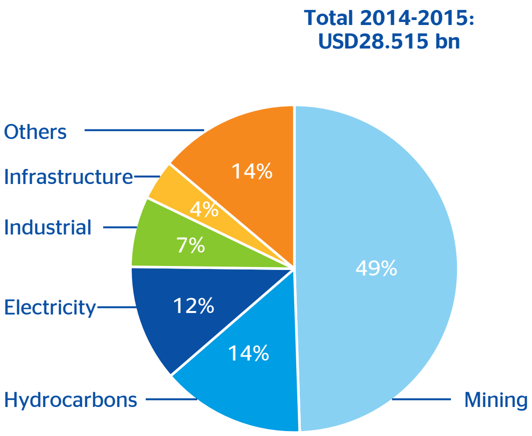
We also expect private investment to maintain an attractive rate of expansion close to 5% in the coming years, which is based on the anticipation that business confidence will continue to reflect on average optimism levels similar to current. This would mean that private investment would stabilise at a level of more than 20% of GDP. Though the increase in this ratio in recent years has resulted in some loss of investment effectiveness, Peru remains one of the countries in which capital expenditure will continue to have a significant impact on GDP growth (see Chart 4.9). The levels of investment forecast are compatible with a rate of capital accumulation which would validate our potential growth estimate of 5.5% on one hand, and with a gradual narrowing of the foreign borrowing gap on the other.

Chart 4.9
Investment effectiveness in Latin America (Ratio of investment as a % of GDP to GDP growth)



* A lower figure implies greater effectiveness, because each additional percentage point of investment would generate higher GDP growth.
Source: BCRP and BBVA Research

Chart 4.10
Forecast investment by sector, 2014-2015 (percentage structure)



Source: BCRP

The private investment projects which will be undertaken over the next three years continue to be concentrated in Mining and Hydrocarbons (see Chart 4.10), chief among them being the copper mining developments at Las Bambas (USD5.2bn), the Cerro Verde Expansion (USD4.4bn) and Quellaveco (USD3.3bn). All of them are scheduled for completion between 2015 and 2017, however, and there are currently no further projects in the pipeline for which Environmental Impact Studies have yet been approved, which would assure the continuity of mining investment beyond this time horizon. The exception is Minas Congas, for which environmental approval has been obtained, but which faces opposition from local leaders, preventing the start of construction work. In addition to these local factors, a number of external factors could also affect new mining investment. The most important of these is the expected correction in the price of industrial minerals, due both to the slowdown in the Chinese economy and to the improved outlook for global supplies (a result of high investment flows in recent years). As in the case with other non-renewable extractive activities, meanwhile, new mining projects generally face higher extraction costs in the absence of significant technological developments. All of these factors affect the outlook for the profits of mining concerns worldwide, in a context in which international financial conditions have become less benign. In these circumstances, a significant slowdown in global mining investment is foreseeable, which would certainly have local repercussions in Peru.

Other major projects planned for the coming years are related to infrastructure developments promoted by ProInversión. This Peruvian government agency was very active in the last two months of 2013, awarding six investment projects under public private partnership arrangements (PPPs) for a total of almost USD3.4bn, representing two-thirds of the total investment awarded in 2013. These projects, which will begin this year, include: i) the

Southern Energy Node project, which consists of the construction of two 500MW thermo-electric power plants for an estimated investment of USD826mn; ii) the Chavimochic – Stage III project to irrigate more than 100,000 hectares of land for an estimated investment of USD590mn; iii) the Longitudinal Sierra Highway – 2nd Stretch project for road building and maintenance in Peru's Northern Andes at an estimated investment of USD401mn; and iv) the Backbone Fibre Optic Network project, to provide broadband data transmission connecting Lima with regional and provincial capitals, for an estimated investment of USD324mn. We believe that the excellent work done by this agency is a spur to private investment, and we expect it to maintain the same level of commitment in the future and, in particular, to award the majority of the concessions scheduled for this year (see Table 4.2). For the moment, three consortia have been shortlisted to participate in the concession for Line 2 of the Lima Metro, which is expected to be awarded by 28 February. The estimated amount of the investment in this project alone would exceed the sums committed in all of the awards granted in 2013 (USD5bn). Meanwhile, the transport infrastructure regulator Ositran has completed all of its studies with regard to the Chinchero Airport concession, and has begun to relocate families in the area. In this context, the award of the project may be expected shortly. In general terms, the total investment committed would be double that of 2013, if all of the planned projects were awarded this year.

Table 4.2
Principal projects pending award by ProInversión in 2014

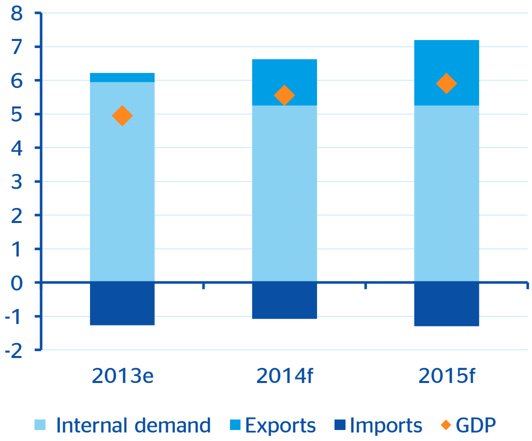
PROJECT	LOCATION	ESTIMATED INVESTMENT (USD mn)	PROBABLE TENDER DATE
Linea 2 & branch line Av. Faucett - Av. Gambetta for the Basic Metro network for Lima and Callao	Lima & Callao	5,701	1Q14
Improvements to the country's energy security infrastructure & development of the southern gas pipeline	Arequipa, Cusco & Moquegua	3,722	1Q14
International Chinchero Airport - Cusco	Cusco	658	1Q14
220 kV electricity transmission line between Moyobamba & Iquitos with corresponding substations	San Martín & Loreto	434	2Q14
LNG supply system for the national market	Lima & Callao	250	4Q14
San Martín (Pisco) General Port Terminal	Ica	103	1Q14

Source: ProInversión

While the evolution of domestic demand is vitally important to support and stabilise GDP growth, it will be renewed export growth which makes the difference from now on, driving the acceleration of the economy in 2014 and 2015. We expect the five major mining projects scheduled to come on stream between 2013 and 2017 to drive exports, mainly of copper. The first of these projects is Toromocho (operated by Chinalco), which came on stream in December last year, although it will not begin producing at maximum capacity (275mtn of fine copper per annum) until the middle of the year, when copper output will increase by some 20%. Operations will begin at Constancia (operated by Hudbay Minerals) towards the end of the year, and it is expected that around 80,000mtn will be extracted from the mine annually from 2015 (6% of current output). The Las Bambas project (currently operated by Glencore Xstrata, although it will shortly be transferred to a Chinese consortium) is currently operating at 50% capacity, and it will add more than 30% (400,000mtn per annum) to copper output when it comes fully on stream at the end of 2015. Finally, the Cerro Verde Expansion (Freeport – McMoRan) and Quellaveco (Anglo American) will start their operations in 2016 and 2017, each producing annual output of more than 200,000mtn per year.

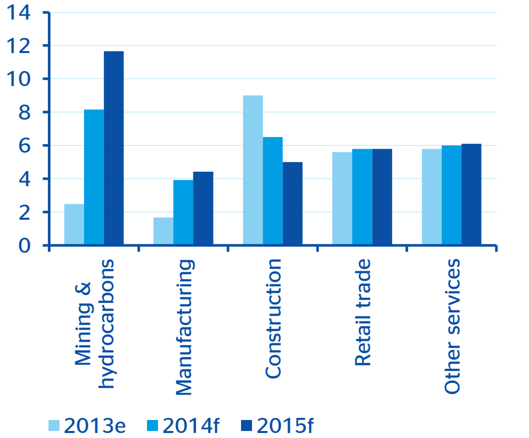
In addition to this expansion of the mining industry, growth is expected in non-conventional (higher value-added) exports, both as a result of supply-side domestic factors (good harvests of agro-industrial products towards the end of last year) and also due to recovery in the world economy. In this context, the contribution of exports to the economy will increase over the next two years (see Chart 4.11).

Chart 4.11
Peru: contribution to GDP growth, 2013-2015 (% and pp)



Source: BBVA Research

Chart 4.12
Peru: sector growth 2013-2015 (% YoY change)



Source: BCRP and BBVA Research

In sectorial terms, Mining will expand rapidly over the next two years, to become Peru's fastest growing industry (see Chart 4.12). We also expect Commerce and Services to continue growing at rates of between 5.5% and 6.0% per year, based on more stable private spending. Meanwhile, Manufacturing will continue to benefit from the support of domestic demand, the recovery in the world economy and the strong performance of primary sectors. On this basis, a recovery in the rate of growth in Manufacturing industry is to be expected. Finally, Construction has performed exceptionally well in the last two years, driven by investment in mining and infrastructure, and it is expected to continue to display strong, if somewhat lower, growth rates in line with a more moderate evolution of private capital expenditure.

In the medium term, the Peruvian economy will continue to grow at rates of around 5.5%

We forecast that the annual growth in the Peruvian economy will converge towards 5.5% in 2016-2018, a similar rate to the potential expansion of GDP based on our calculations. This growth will be supported by capital accumulation and job creation. However, we also predict that productivity will decline in comparison to its contribution to growth in the period 2000-2010. This trend has already appeared in Manufacturing (see Box 2) and it should sound a warning, because productivity is the factor which generates sustained gains in per capita income. From a long-run standpoint, then, faster growth rates will require the immediate implementation of supply-side policies to boost Peru's competitiveness and productivity. These measures should be oriented to closing the country's infrastructure gap, improving the quality of the public education system, fostering research, reforming the labour market and simplifying government procedures in order to achieve a substantial reduction in the informal economy.

Box 2. Peru needs to consolidate gains in manufacturing competitiveness through further reforms

The principal productivity indicators do not clearly show whether manufacturing has gained or lost competitiveness over the last decade. This is probably due to the very mixed performance of different manufacturing industries, and to the relatively low share of manufactured goods in total exports, consisting mainly of products which are less intensive users of raw materials. However, an overall reading of export performance indicators and analysis of Peru's idiosyncrasies point to gains in manufacturing competitiveness over the last decade, despite the recent deterioration.

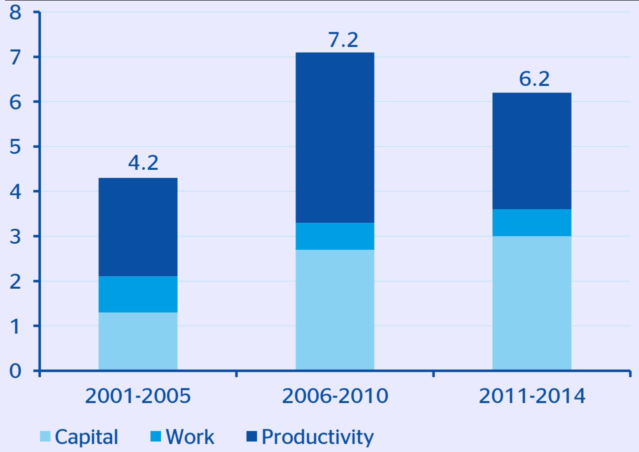
Manufactures gained share in exports in a context of productivity gains

Peru is the country in the region which experienced the fastest growth in the ratio of exports to GDP in the decade from 2002 to 2012, although its performance has slipped over the last five years. It is also one of the few nations, together with Mexico and Chile, where exports of manufactured goods have increased as a share of GDP (+2.4pp).

The growth in Peru's exports of manufactured products has been very significant over the last decade. The country gained share in the world market for its main non-basic manufactures (knitted and crocheted textiles, plastics, inorganic chemicals and woollens), especially in the first half of the decade. Despite gains in world markets, the overall share of manufactures in Peru's total exports has declined due to strong growth in exports of raw materials.

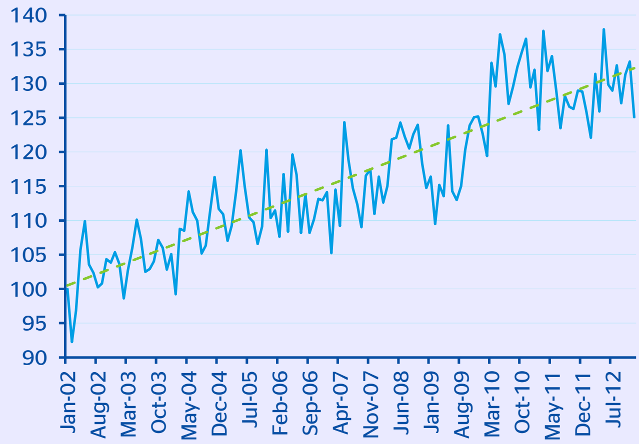
The positive performance of manufacturing has taken place against a backdrop of rising productivity in the economy in general. Between 2002 and 2012, GDP grew by an average 6.4%. According to Ministry of Economy data, around 40% of economic growth in recent years has been due to productivity gains. In that period, Peru's productivity increased at an annual rate of around 2.6pp of GDP (see Chart B.2.1), one of the fastest rates of growth in LatAm. In spite of their promising evolution in recent years, however, productivity rates in Peru remain low at just 16% of the US level, which indicates that there is still ample potential for further gains through education reform, the creation of favourable conditions for the formalisation of the economy, deepening of the financial system and openness to trade, among other measures. Measured as real manufacturing GDP divided by urban employment in industry, productivity gains in manufacturing industry in the period 2002-2012 were around 25% (see Chart B.2.2).

Chart B.2.1
GDP and growth accounting (% change and pp)



Source: BCRP

Chart B.2.2
Manufacturing productivity (Index)



Source: INEI, BCRP, BBVA Research

We still have considerable room for competitive gains

Peru ranked 61st out of a total of 148 countries examined in the Global Competitiveness Index for 2012-2013. This position represents a considerable improvement compared to the ranking for 2007, when the country was placed 86th out of a total of 131 countries. However, it continues to lag behind other countries in the region, like Chile, Brazil and Mexico. The most problematic factor for business is corruption, followed by the inefficiency of the state bureaucracy and tax regulation. The inefficiency caused by excessive bureaucracy in some areas is also reflected in the World Bank's *Doing Business* report, which relates that six documents must be completed to export a standard container at a cost of USD860, in a process that takes 12 days. At the world level, Peru is in 56th place in the ranking of 183 for ease of cross-border trade.

In both the 2007 and 2012 rankings, Peru lags behinds its peers in terms of innovation, displaying low levels of R&D expenditure and poor quality in its scientific institutions. As a result, Peruvian exports of technology products represent only a nugatory percentage of the total over the period analysed.

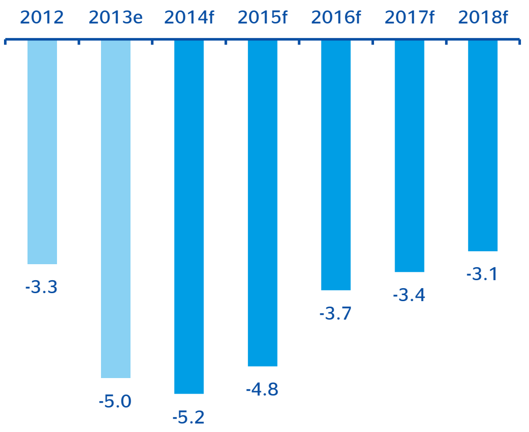
Despite improvements in the quality of its infrastructure in recent years, Peru is still far from the levels of development and infrastructure considered to be international standards. Among the countries of the Pacific Alliance (Chile, Mexico, Colombia and Peru), it is in fact the third least developed in terms of infrastructure quality. For example, only 14% of the roads are paved, which combines with traffic problems caused by other deficiencies to cause serious delays and raise costs.

To conclude, then, the increase in Peru's industrial competitiveness over the last decade is the result of factors such as productivity gains, open trade policies (via both tariff cuts and free trade agreements), and measures to facilitate the business environment. Despite these gains, however, much remains to be done in the future. Key issues on the competitiveness agenda include improvements in infrastructure, measures to strengthen the institutions, improvements in the quality of education and a drive to foster innovation and the use of technology.

The current account deficit will stay high in 2014 and 2015

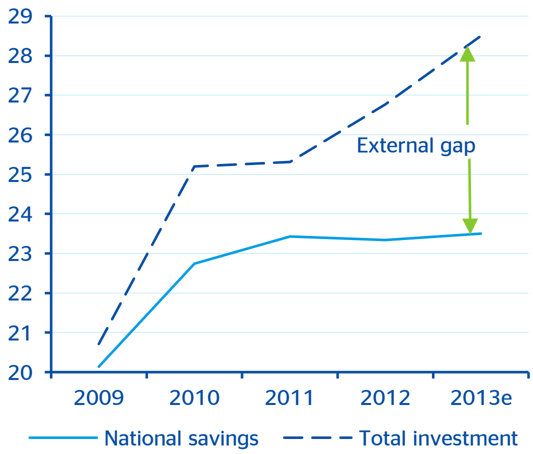
We anticipate that the current account deficit will stay around 5% of GDP this year and next, and that it will fall gradually over the course of the forecast period (see Chart 4.13), due to rising volumes of mining exports as the mega-mining projects currently being undertaken come on stream.

Chart 4.13
Balance of payments current account 2012-2018 (% of GDP)



Source: BCRP and BBVA Research

Chart 4.14
Saving and investment 2013-2015 (% of GDP)



Source: BCRP and BBVA Research

A trade deficit of close to 5% is relatively high, sounding a warning note in the current climate of re-appraisals of emerging markets, given the possibility that the country could be perceived as vulnerable to external factors, which could cause pressures in local financial markets. However, we would stress that, unlike other emerging economies, the increase in Peru's current account deficit is due mainly to the increase in total investment and not to any drop in domestic saving, which might reflect excess public spending and private consumption (see Chart 4.14 and Table 4.15). Hence, domestic saving has remained relatively stable in the Peruvian case, while total investment as a percentage of GDP has risen by approximately seven percentage points since 2009.

Chart 4.15
Saving, investment and current in various countries (% of GDP)

	Saving			Investment			Current Account		
	2007		2013e	2007		2013e	2007		2013e
Argentina	26.7	↘	20.9	24.1	=	24.2	2.6	↘	-0.8
Brazil	18.4	↘	15.8	18.3	↗	19.2	0.1	↘	-3.4
Chile	24.7	↘	20.8	20.6	↗	25.7	4.1	↘	-4.6
India	36.8	↘	30.6	38.1	↘	35.0	-1.3	↘	-4.4
Turkey	15.2	↘	12.6	21.1	↘	20.0	-5.8	↘	-7.4

Source: IMF

Furthermore, external financing of the current account has mainly been obtained by way of Foreign Direct Investment (FDI), which consists of long-term funds. This compares positively with other emerging economies, which tend to display significant dependence on short-term borrowing, leaving them very exposed to sudden changes in the direction of capital flows. It might also be added that most FDI has flowed into the export sector of the economy (major mining projects), which will in future generate foreign exchange to reduce the present temporary rise in external liabilities.

We may recall here that one of the most significant analyses contained in our previous report estimated the size of the structural current account deficit (i.e. the deficit without short-term cyclical effects) based on the long-term values of the metals exported by Peru. The conclusion was that, despite the temporary factors behind the current rise in the deficit, it is in fact low from a long-term standpoint and is sustainable in the medium term (i.e. it is consistent with a non-explosive evolution of external debt as a percentage of GDP).

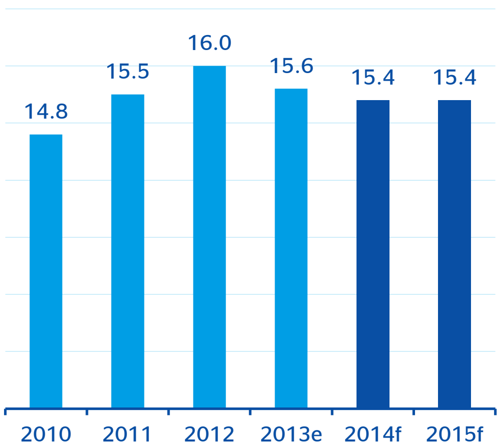
Finally, closing the trade gap in the coming years will require relatively significant domestic savings in order to maintain the ratio of investment to GDP at levels of around 28-29%. Assuming that public saving will remain stable (a conservative stance taking into account wage rises for government employees, which would rather suggest that public saving could even fall), the increase in domestic saving needed to close the trade deficit will have to come from the private sector. This analysis of saving-investments gaps in the coming years reveals the limits on faster growth in the Peruvian economy. It will be difficult to achieve growth above 5.5% if the current account deficit and dependency on funding from abroad are to be reduced. Hence, it is highly unlikely that Peru will see sustained double-digit growth in investment like that which it enjoyed in the past, or any acceleration in consumption in the coming years.

Public sector: moderate deficits as of next year

We expect tax revenues to grow at a (nominal) rate of around 8% in 2014, which we believe will be maintained in the coming years in line with a less-dynamic economy and a downward adjustment of metals prices. As a consequence, the tax burden will remain at its current level of around 15% (see Chart 4.16). The government is therefore unlikely to achieve its objective of raising the tax burden to around 18%.

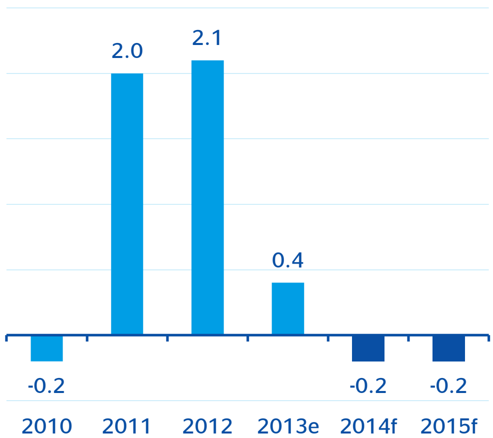
From the standpoint of public spending, our forecasts assume that pro-cyclical management of public spending will not be avoided. Personnel costs and social benefits are bound to increase as a result of changes in remuneration policy, which include health sector reform, and wage reforms in the national police force and armed forces (additional spending of around PEN2.8bn in 2014).

Chart 4.16
Tax burden (% of GDP)



Source: BCRP and BBVA Research

Chart 4.17
Fiscal Balance 2010-2015 (% of GDP)



Source: BCRP and BBVA Research

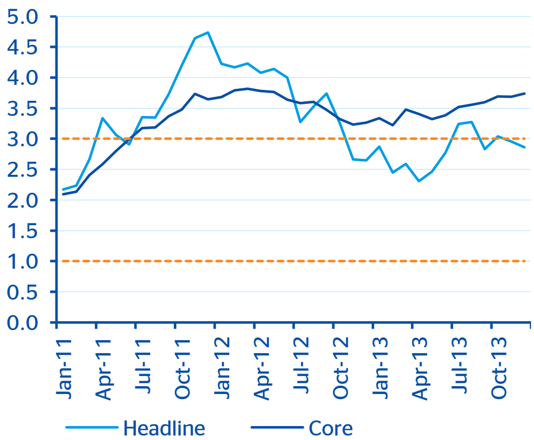
As a result of these estimates of revenue and expenditure of the public sector, we expect Fiscal Balance deficit equivalent to -0.2% in both 2014 and 2015 (see Chart 4.17). These results would not compromise fiscal solvency, given that the ratio of debt to GDP will continue to shrink in the coming years (dropping from 18% to 15% by 2017). As a result, Peru will continue to be one of the countries with the lowest level of debt for its credit rating (BBB+ according to S&P). Furthermore, net public debt is only 2% of GDP, one of the lowest in the region, leaving plenty of fiscal-policy room to implement counter-cyclical policies should they become necessary.

5. Inflation will move towards the middle of the target range beginning in the second quarter

In line with the predictions contained in earlier reports, year-on-year inflation has fluctuated around the upper limit of the central bank's target range (2%, +/-1pp). This situation in part reflects the depreciation of the local currency (around 9% in the last 12 months), which has had an impact on local prices for imported products and certain services. We estimate that the cumulative transfer of variations in the exchange rate into prices amounts to approximately 10% after 18 months, and on this basis we calculate the inflationary impact of this factor over the last year at 0.6 percentage points.

However, we consider that certain demand-side pressures on prices and medium-term inflation expectations which are out of line with centre of the target range are the main factors which have prevented inflation from making a sustained move towards mid-range values. With regard to the first of these factors, we may note that core inflation has stayed above the target range since July 2011 (see Chart 5.1) and that other indicators used to measure the inflationary trend explained by demand-side pressure also reveal an upward trend (see Table 5.1). In general, this evolution of prices is consistent with our perception that GDP has been converging downwards (a sign of demand-side pressures), towards its potential level (sustainable in the medium term). Inflationary expectations have, meanwhile, remained between 2.7% and 2.8% with a horizon of one or two years, above the 2% target level set by the central bank in the medium term according to its method for defining the inflation target, which stresses the centre of the range. We may note here that when inflationary expectations are above 2%, a certain friction occurs which prevents inflation from moving easily towards the middle of the range, even in the absence of demand-side pressures and supply-side shocks, as the parties responsible for price formation anticipate higher inflation.

Chart 5.1
Year-on-year inflation (%)



Source: BCRP

Table 5.1
Other inflation measures (%, year-on-year)

Inflation:	Dec-2012	Dec-2013
...headline	2.6	2.9
...core	3.3	3.7
...exc. food & fuels	1.9	3.0
...of non-tradables	3.2	3.1
... of non-tradables ex. Food	2.0	3.4
...expectation for 2014	2.6	2.8
...expectation for 2015	2.6*	2.7

* figure at Feb. 14.
Source: BCRP

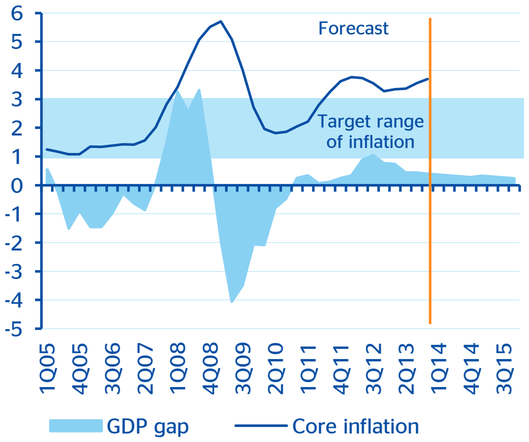
Looking forward, we see a more favourable inflationary outlook

Our forecasts of GDP growth for this year and next (5.6% and 5.9% respectively) are compatible with an output gap (the difference between observed and potential GDP, considered a sign of demand-side pressures when positive), which will gradually close in the coming months (see Chart 5.2). In a context in which GDP will grow at around its potential level, then, any possible demand-side pressures will gradually dissipate, resulting in a fall in underlying inflation, which represents around 65% of total inflation.

As we have explained in past reports, the outlook for world supplies of foodstuffs is favourable, and we may therefore expect a fall in the prices of these commodities. According to the Food and Agriculture Organization of the United Nations (FAO), cereals production will grow to a peak some 9% above the level of the last harvest, which will bring down the prices of wheat (10.8%), maize (29.0%) and soya (13.5%) compared to the average prices for last year. Finally, no significant increases in exchange rates are expected (depreciation of the currency), because the overvaluation of the local currency was largely corrected in 2013 (depreciation of 9%), and the influence of this factor on prices will therefore be significantly less than in the preceding months.

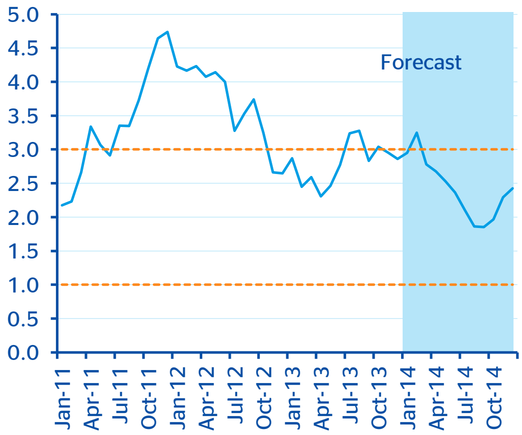
In this context, we expect year-on-year inflation to move gradually towards the middle of the target range, beginning between the second quarter and to close 2014 at 2.4% (see Chart 5.3), the level to lowest year since 2010.

Chart 5.2
Output gap (% of potential GDP) and core inflation



Source: BCRP and BBVA Research

Chart 5.3
Year-on-year inflation (%)



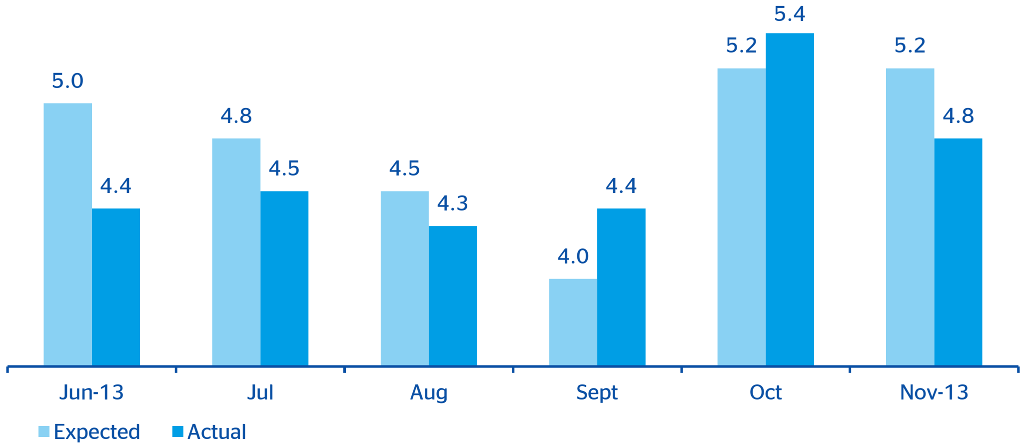
Source: BCRP and BBVA Research

6. Monetary policy: no change in the reference rate in 2014

The surprise in the rate of output growth, which was below potential, encouraged the central bank to take a more flexible monetary stance

In general, the rate of output growth has been lower than expected. The market consensus anticipated that GDP would expand at an average monthly rate of 4.8% between June and November (last figure available), but the final rate was lower (see Chart 6.1). Meanwhile, these expectations were already below the rate at which it is estimated that the Peruvian economy could potentially grow without generating macroeconomic imbalances. The negative surprise of relatively weak growth and the return of inflation towards the middle of the target range have provided room for the central bank to adopt a more flexible stance on monetary policy. It has done so mainly by reducing local currency reserve requirements, resulting in the release of more than PEN7bn since June (equal to almost 4 percentage points of private sector bank lending), and it also cut its policy rate by 25bp in December. This more flexible monetary stance has provided support for growth in lending to the private sector, which has accelerated by 4pp since the end of the first half of 2013. Furthermore, as the measures implemented mainly affect the local currency, they have favoured de-dollarisation of lending (lending in soles grew by more than 8pp in the second half of 2013, while dollar-denominated loans fell by close to 6pp), thereby reducing the economy's exposure to currency shortages.

Chart 6.1
GDP: expected and official figures (% year-on-year change)

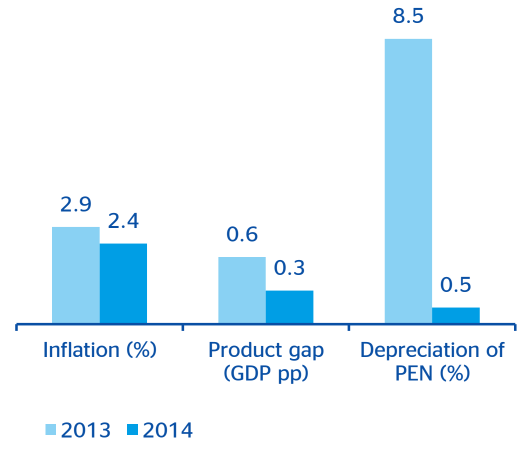


Source: Bloomberg and BCRP

More moderate inflationary pressures in 2014 mean the central bank will hold its policy rate at the current 4.0% level for the rest of the year

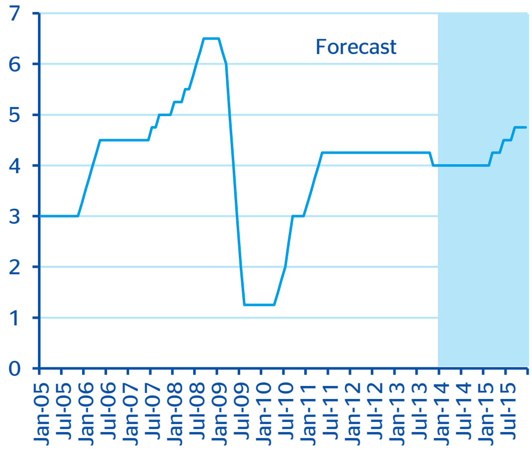
The relatively weak growth seen in recent measures has narrowed the output gap according to our estimates. As a consequence, and given that forecast GDP growth for 2014 will be more closely aligned with the potential rate, demand-side pressure on prices will be contained this year. This means that inflation will converge towards the centre of the range, in particular in the second half of the year, and this process will be supported by a more moderate depreciation of the currency and falling international prices for foodstuffs (see Chart 6.2). In this context, the reference rate will stay at its current level of 4.0% in the coming months (see Chart 6.3). Should it eventually become necessary to provide additional support for growth, we believe the central bank will back a reduction in the requirements for reserves held in domestic currency, which still remain relatively high despite the fall observed in recent years. It is unlikely that the central bank will apply the policy rate to hold up activity, because this would exacerbate the pressure of depreciation on the local currency in a volatile context, due to the withdrawal of quantitative easing and monetary stimuli in the United States.

Chart 6.2
Determining factors for the monetary policy stance



Source: BCRP and BBVA Research

Chart 6.3
Reference rate of interest (%)



Source: BCRP and BBVA Research

Nevertheless, we do not believe that the conventional instruments of monetary policy will be employed at any time to support the Peruvian sol, as certain other emerging economies did in the recent episode of exchange rate volatility. The Peruvian central bank holds significant international reserves to act in such events, and this is the instrument it has usually employed to halt sharp fluctuations in the exchange rate.

Finally, our base scenario for 2015 includes a cumulative adjustment of 75bp in the monetary policy rate. This will occur in a scenario in which GDP growth will pick up temporarily (to 5.9%, somewhat above our estimated potential growth rate) and the normalisation of monetary conditions in the United States will begin through increases in the Federal funds rate.

7. Latent external risks remain, but Peru has strengths to mitigate the consequences of possible impacts

The main external risk factors which could reduce growth in our base scenario for Peru are as follows:

Intensification of financial tensions in more vulnerable emerging economies. Concerns have grown in recent weeks about the capacity of some emerging economies (EMs) to manage the impacts of tapering in the United States or a possible outbreak of difficulties in the Chinese financial sector. In this context, EMs running high trade and fiscal deficits, and those with structural problems or poor economic management have faced downside pressures (depreciation) on their currencies and significant volatility in their financial markets. These pressures have also been transferred to some extent to sound EMs such as Peru, and in this light we cannot rule out an increase in risk aversion towards these countries and contagion affecting the Peruvian economy. In this scenario, we would see depreciation of the Peruvian currency, volatility in local financial markets and tougher conditions for foreign borrowings, all of which could have negative impacts on the real economy (due to balance sheet effects, currency shortages and increased interest rates), the size of which would depend on the intensity and duration of the contagion. In an extreme case, the inflow of long-term capital into Peru could be reduced.

Under this risk scenario, meanwhile, the occurrence of complex events in the more vulnerable EMs could be relatively recurrent in the coming months. Taking into account the outcomes of similar stress events in the past, we would expect international investors initially to take defensive positions in all emerging economies without discriminating between the weak and the problem-free, and this would result in contagion. However, Peru has a number of strengths which would enable it to act in the case of such events, including significant international liquidity and considerable capacity to articulate its fiscal and monetary policy responses (see Table 7.1), and these advantages would eventually represent factors differentiating it from other emerging economies.

Table 7.1
Trade and fiscal vulnerability indicators

	2008	2013*
Gross public debt	25.9	18.1
Fiscal stabilization fund (% of GDP)	1.4	4.1
NIR (% of GDP)	24.5	31.7
NIR (STFL** times the economy)	5.0	10.2
Banking sector's STFL** (% of issues)	5.1	2.7

* Most recent figure.
** STFL: Short-term foreign liabilities.
ource: BCRP and BBVA Research

Sharp slowdown in the Chinese economy. This possibility is linked to the financial weaknesses which have emerged in China (liquidity problems, rising local government debt, growth of informal parallel banking activities), a phenomenon which has obliged the authorities to accept more moderate growth rates and take a more cautious stance towards the possible implementation of stimulus measures. The outbreak of these financial problems could result in significantly lower Chinese growth than estimated in the base scenario. This is basically a structural risk factor for Peru, which could cause lasting, significant impacts on exports of metals and on international metals prices, thereby weakening the fundamentals of the country's economy. In this case, the economic policy response should seek gradually to accommodate a transition towards a new equilibrium based on further depreciation of the currency and slower growth. Once again, Peru's advantage is that it has strengths which would allow it to smooth any transition in this risk scenario and avoid severe adjustments.

Such external events could be exacerbated by a deterioration in confidence at the local level. In this case, we would observe a sharper slowdown in private sector investment, increased caution in the pattern of family consumer spending and a more intense moderation of business activity. This would require more aggressive fiscal and monetary stimulus measures.

8. Tables

Table 8.1
Annual macroeconomic forecasts

	2012	2013e	2014f	2015f
GDP (%,YoY	6.3	5.0	5.6	5.9
Inflation (%,YoY, eop)	2.6	2.9	2.4	2.3
Exchange rate (vs. USD, eop)	2.57	2.79	2.80	2.72
Monetary policy rate (%,eop)	4.25	4.00	4.00	4.75
Private consumption (%, YoY)	5.8	5.0	4.8	4.9
Public consumption (%, YoY)	9.4	5.5	6.5	4.0
Investment (%, YoY)	14.8	6.9	6.9	5.9
Fiscal result (% of GDP)	2.1	0.4	-0.2	-0.2
Current account (% of GDP)	-3.3	-5.0	-5.2	-4.8

Source: BCRP and BBVA Research

Table 8.2
Quarterly macroeconomic forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD,eop)	MPR (%,eop)
1Q12	6.0	4.2	2.67	4.25
2Q12	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	4.4	2.8	2.78	4.25
4Q13	5.2	2.9	2.79	4.00
1Q14	5.5	2.8	2.79	4.00
2Q14	5.1	2.4	2.78	4.00
3Q14	5.9	1.9	2.79	4.00
4Q14	5.7	2.4	2.80	4.00

Source: BCRP and BBVA Research

DISCLAIMER

RESEARCH

This report has been produced by the Peru Unit:

Chief Economist for Peru
Hugo Perea
+51 1 2112042
hperea@bbva.com

Daniel Barco
+51 1 2111548
daniel.barco@bbva.com

Isaac Foinquinos
+51 1 2111649
ifoinquinos@bbva.com

Francisco Grippa
+51 1 2111035
fgrippa@bbva.com

Rosario Sánchez
+51 1 2112015
rdpsanchez@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Latam Coordination
Juan Ruiz
juan ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@ bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo_lopez@ bbva.com

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Global Areas:
Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Clara Barrabés
clara.barrabes@bbva.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@grupobbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Recovery and Resolution Strategy
José Carlos Pardo
josecarlos.pardo@bbva.com

Global Coordination
Matías Viola
matias.viola@bbva.com

Contact details

BBVA Research Peru
Av. República de Panamá 3055
San Isidro
Lima 27 - Peru
Teléfono: + 51 1 2112042
E-mail: bbvaresearch_peru@bbva.com
www.bbvaresearch.com