BBVA | RESEARCH

Economic Outlook

Peru

Second Quarter 2013
Economic Analysis

- **The global economy continues its slow recovery.** The higher resistance it is showing against negative shocks eases this positive trend.
- **We maintain output growth estimates for Peru of 6.5% in 2013 and 6.3% in 2014.** The strength of domestic demand will offset the temporary weakness in exports.
- **The fiscal policy will be somewhat more expansive this year.** The sustainability of the public sector balance could be enhanced by introducing structural considerations into the fiscal rule.
- **The local currency weakness is transitory.** Fundamentals, sound long-term capital inflows and stable commodity prices will lead it to strengthen in the coming months.
- **The monetary policy rate will be kept at its current level in 2013.** Alongside high reserve requirements, the stance will therefore remain somewhat restrictive.

Index

Closing date: May 2, 2013

1. Summary

Growth perspectives for the Peruvian economy continue to be positive. On the external front, recovery in the largest advanced economies continues, albeit heterogeneous, while emerging markets continue to provide major support for global GDP. Along general lines, this outlook is similar to what we predicted, so we have made no major changes to our forecasts. We estimate that from here on in the recovery will gain some more traction in a context where global output is showing resistance to situations that would have led to huge financial volatility before. This reduces the likelihood of external shocks having a major impact on global growth. On the domestic front, the economy continues to look buoyant. The general balance of output indicators continues to suggest a robust underlying trend. This is especially true for domestic demand, which is offsetting the temporary weakness in exports. Furthermore, business and household confidence indicators remain at high levels, pointing to a good performance for private-sector spending in future quarters. If this optimism gels and good financial credit terms continue, economic growth this year will come in around 6.5%, just as we forecast three months ago. Thanks to several mining projects getting under way, increased exports in 2014 should offset a reduction in private expenditure and a less accommodative fiscal policy, leading to GDP growth of 6.3% in the year.

It is important to note that fiscal policy this year will see a slightly more expansive bent. Although our forecast from three months ago included this, the increase in public spending on wages is coming in higher than predicted. This comes at a time when private expenditure is strong, meaning the process takes on a procyclical character. In this way, a relatively neutral fiscal stance would have been more appropriate to avoid overloading the stabilizing role on monetary policy. Looking forward, the sustainability of public balances should be supported by the incorporation of structural elements into the fiscal rule. This would ensure counter-cyclical management of the fiscal balances.

Looking at prices, inflation remains inside the target range, and now stands at 2.3%. Nonetheless, this masks different trends within its components. Non-core inflation saw a major decline as a result of supply shocks reversing. This meant price rises have remained within the target range, since inflation linked to demand pressures is nearer 3.5%. This situation in the non-core component will eventually return to normal as long as demand pressures remain high due to the sustained expansion in domestic spending and reduced slack in the labor market. We therefore forecast inflation will be closer to the upper limit of the target range in the coming months, followed by a gradual convergence early in 2014 toward the mid-range level in a context of slower private and public expenditure and assuming that there are no new supply shocks.

On the foreign exchange market, fundamentals, especially the rise in productivity, continue to support the strengthening trend for the domestic currency. This trend will be backed by the sustained strong inflow of long-term private capital, via foreign direct investment and external funding for Peruvian companies, as has been observed in the first few months of the year. Nevertheless, there are elements that will weaken this trend. The perception of some market agents has become less favorable to domestic currency. This comes after a major downward correction in international metal prices over recent weeks and the decline in export volumes in the first quarter, in addition to higher domestic political noise. As a result, some positions in assets priced in soles have been scaled back. How the Central Bank acts will, as usual, be another factor marking out the rate at which we forecast the Peruvian sol will strengthen over the rest of the year. In 2014, as markets anticipate that monetary conditions in advanced economies begin to normalize, thus triggering a reallocation of global portfolios, the exchange rate should be more stable.

In terms of monetary policy, the current position has a somewhat restrictive bent if we take into account a wider measurement including not only the effect of the policy rate but also the high reserve requirements. This is understandable in a context where domestic demand remains very strong, thanks not only to the major rise in private expenditure but also to the boost from the public sector. This means the effort for stabilization falls to monetary policy. We do not see major changes in this position for the rest of the year. When injections from global liquidity start to slow in 2014, the Central Bank will have room to reset monetary policy, cutting reserve requirements (their intensive use has led to distortions on the credit market) and compensating for this with a policy rate rise without this creating major pressures on a stronger sol.

Finally, there are still two major external risk factors. The most important is Europe and is linked to more restrictive credit conditions after the handling of the Cyprus bailout. This risk is more likely now than we identified in our previous report, but its impact should be limited thanks to the support from the European Central Bank. This, as well as the growing strength of the Peruvian economy, leads us to believe that the impacts of such a shock would be relatively limited at the local level. The second key risk is that abundant global liquidity might trigger a massive capital inflow, leading to sharp appreciation of the currency and a loss of competitiveness for the export sector, as well as excessive expansion of credit, leading to price bubbles forming in some assets. In such a scenario there would be rapid and short-lived acceleration in activity levels (with a subsequent decline once capital flows reverse), over-borrowing in the private sector, an increase in inflationary pressure, and a larger current account deficit in the balance of payments, which would not be sustainable. The challenge for the economic authorities is to rein in these effects, so it would be prudent to maintain a more neutral fiscal stance.

2. External outlook: global economy continues to recover gradually, with heterogeneity

At the global level output has grown by 0.7% q/q in the first quarter of the year, according to our estimates, slightly above the figure of 0.6% at the end of 2012. This means the economic recovery is continuing, although at a more moderate pace. By geographical areas, the available indicators suggest that Europe will again lag behind the U.S. and Japan, so that there is a growing dispersion in the rate of growth between the most developed economies. Meanwhile, emerging markets continue to drive global expansion. Overall, global GDP is estimated to improve by 3.3% in 2013, 0.1 points above the estimate for 2012 (Chart 1). In 2014 the rate will be close to 4%, although the risks continue to be downside.

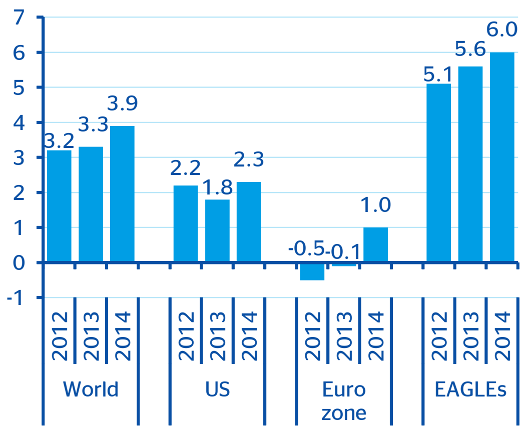
In the euro zone the recovery has been delayed until 2014, despite the role of the ECB as a firewall for financial tensions, aided by the boost provided to banking union. The ECB has been surprisingly effective as guarantor of the euro against shocks such as the disordered bailout of Cyprus, the political situation in Italy and the ruling by the Portuguese Constitutional Court. As a result, the markets and financial tensions have only reacted to these events to a limited extent (Chart 2). On the negative side, economic indicators show a general cyclical weakness beyond the European periphery, justifying the ECB's recent interest-rate cut. Although this is a positive measure, in itself it is unlikely to reduce the financial fragmentation that is now impacting less on sovereign issuers and even large corporations, but is continuing to affect households and companies due to the uneven operation of the banking channel. The conditions of credit supply in the area as a whole continue to tighten while demand for credit is falling in peripheral countries. More is needed than the extension in the liquidity line for banks, at least until 2014; measures currently being studied have to be implemented to boost finance for business, with the participation of institutions such as the European Investment Bank.

In this context, our scenario includes a downward revision of growth for the euro zone. We estimate GDP will fall by 0.1% in 2013 and rise 1% in 2014, 0.4 and 0.3 points, respectively, below the figure forecast in our January publication. In any event, the risks continue to have a downside bias. A key point is that Germany must not remain the only source of growth in the area thanks to its easy access to finance, high level of competitiveness and greater exposure to the best performing sources of global demand.

One additional consequence of the weakness of the European cycle is the growing debate on the appropriate level of fiscal consolidation to achieve a credible schedule for cutting the deficit without leading to such a short-term deterioration in growth that it makes the adjustment effort a waste of time. The European Commission's support for the postponement of the public deficit targets in some European countries is in line with the idea of stressing the quality and composition of the fiscal adjustment and emphasizing structural reforms above short-term objectives. What is Europe missing? More determined progress towards banking union, shifting the debate on deficit targets to structural measures, and a firmer commitment to the reforms in the peripheral countries.

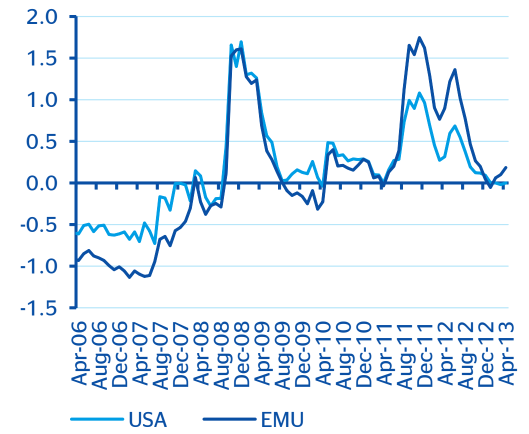
In the U.S., the strength of private demand is sustaining growth prospects, despite the brake of fiscal adjustment. Uncertainty regarding fiscal policy in the short term has receded in terms of scenarios that included the closure of government offices (although credible long-term fiscal consolidation measures have still not been taken). The elimination of some tax breaks and the entry into force of expenditure cuts have not triggered alarms in the financial markets (Chart 2), nor in the end do they appear to have put a substantial brake on private expenditure, thanks to monetary expansion that is maintaining very favorable financing conditions and is contributing to the improvement of income and wealth. Thus it is reasonable to maintain growth prospects for 2013 at 1.8%, despite the downward surprise of public demand in the GDP figures for the last two quarters.

Chart 1
GDP growth



The EAGLEs are the emerging countries that will contribute most to growth over the next 10 years. They are: China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: BBVA Research

Chart 2
BBVA Financial Stress Indicator



Source: BBVA Research

Meanwhile, in China the economy lost steam in the first quarter of 2013, with a negative surprise of weak investment, despite the greater strength of foreign demand and growth remaining in line with the government's target of 7.5% for 2013. The measures implemented to limit domestic financial fragility appear to have contributed to the slowdown. However, the change in the growth model towards a greater weight of consumption continues. With inflation also lower than expected, there is less pressure for making monetary conditions tougher, so authorities have room for maneuver, given their commitment to sustainable growth for achieving the announced growth target. That is why our growth forecast for China remains unaltered at 8% for 2013 and 2014.

Finally, it is important to mention that the policy of sustaining monetary expansion over time, which the Central Bank of Japan has now subscribed to, involves challenging problems. The idea that investors looking for returns should move to more risky assets may favor valuations in some markets that are a long way from their long-term fundamentals, which could lead to disordered adjustments when the stimuli are withdrawn. This risk is growing because of the lack of coordination between the central banks with quantitative expansion policies, each of them looking to its respective domestic anchored inflation targets and sustainable growth. In the case of emerging economies, although for now they are holding up well the strong capital inflows, it is essential to maintain vigilance over the domestic excesses this could generate.

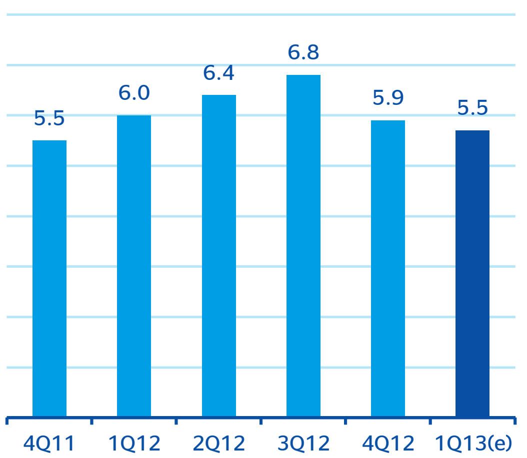
3. Peru: we maintain our GDP growth forecasts at 6.5% for 2013 and 6.3% for 2014

Economic activity at the start of the year remains positive, driven by the dynamism of domestic demand. In addition, expenditure and consumer and business confidence indicators point to the second quarter seeing a higher year-on-year growth rate. In the future, there will be major support from exports when the temporary factors that recently affected them start to dissipate. Beyond some volatility on the external side, the economy therefore remains healthy, and we estimate that if high business optimism continues, the economy's growth rates will be above 6% for this year and next.

GDP growth remained strong in the first months of the year

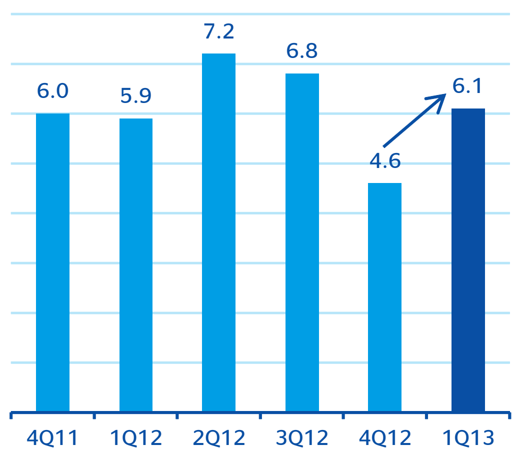
Output in the first quarter will have grown around 5.5% year-on-year (see Chart 3). If the statistical effect of fewer working days in the first three months of this year compared to the same period for 2012 is stripped out (a leap year, two holidays for the public sector and Easter Holidays), we estimate GDP growth was above 6.0%. This suggests a continuing underlying strength in economic activity. Something similar can be gleaned from an analysis that is seasonally adjusted and corrected for differences in the number of days. Specifically, on this calculation growth gathered pace in the first quarter of 2013 (see chart 4).

Chart 3
Peru: GDP growth (y/y % change)



Source: BCRP and BBVA Research Peru

Chart 4
Peru: seasonally adjusted growth rate (y/y % change, annualized)



Source: BCRP and BBVA Research Peru

On the spending front, support for growth continues to come from strong domestic demand and, in particular, investment, which has increased at double-digit pace in both its public and private components. This has offset the decline in exports, which was somewhat higher than expected in the first quarter.

Indicators of expenditure and high levels of optimism suggest domestic demand will continue positive in the coming months

On the household spending side, consumer confidence remains at relatively high levels in an environment of a positive labor market and credit expansion (see Table 1). This comes in a situation where job creation gathered pace in the first quarter (3.1% y/y compared with 2.0 % in 4Q12), keeping the jobless rate at all-time lows (6.4% in 1Q13). Moreover, personal loans continued their outstanding expansion at the start of the year (18% y/y).

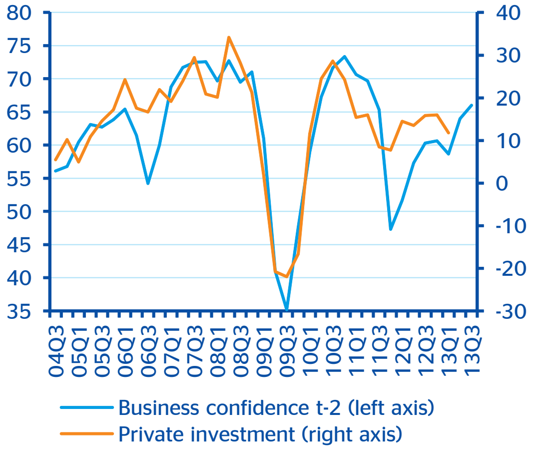
Table 1
Perú: indicadores de actividad y de gasto

	4Q12	1Q13	April
Private consumption			
Employment (y/y % change)	2	3	
Personal loans (y/y % change)	19	17	
Consumer confidence (APOYO Index)	56	57	54
Private investment			
Business confidence (index)	64	66	
Corporate securities issued on international markets (millions of USD)	400	2,.100	2,946
Public expenditure			
Salaries and wages (y/y % change in real terms)	10	16	
Investment (y/y % change in real terms)	10	11	
Domestic demand			
Electricity output (y/y % change)*	6	7	6
Foreign demand			
Exports (y/y % change in real terms)**	1	-19	

* Figures adjusted for leap year and days worked.
** As of February.
Source: BCRP, Apoyo Consultoría and BBVA Research Peru

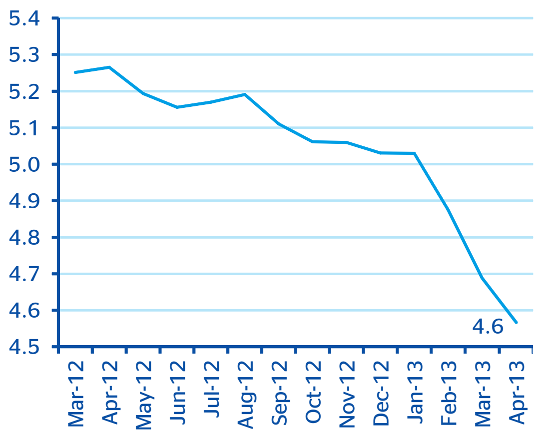
Indicators linked to investment also show a positive trend, taking business confidence to a high level of optimism (66 points) and suggesting that private capital expenditure will continue to expand at double-digit rates for the rest of the year (see Chart 5). A supporting factor for this forecast is high global liquidity, which is driving international securities issues by domestic companies. So far this year, international placements by Peruvian firms have are already above the amount issued in the whole of last year (more than USD 5 billion through April compared to just over USD 3 billion in 2012). Furthermore, the corporate rate in soles for preferential clients is showing a major decline. At a domestic level, this complements the favorable financial credit terms for businesses (see Chart 6).

Chart 5
Business confidence and private investment (index and y/y % change)



Source: BCRP and BBVA Research Peru

Chart 6
Preferential corporate interest rate in soles (%)



Source: BCRP and BBVA Research Peru

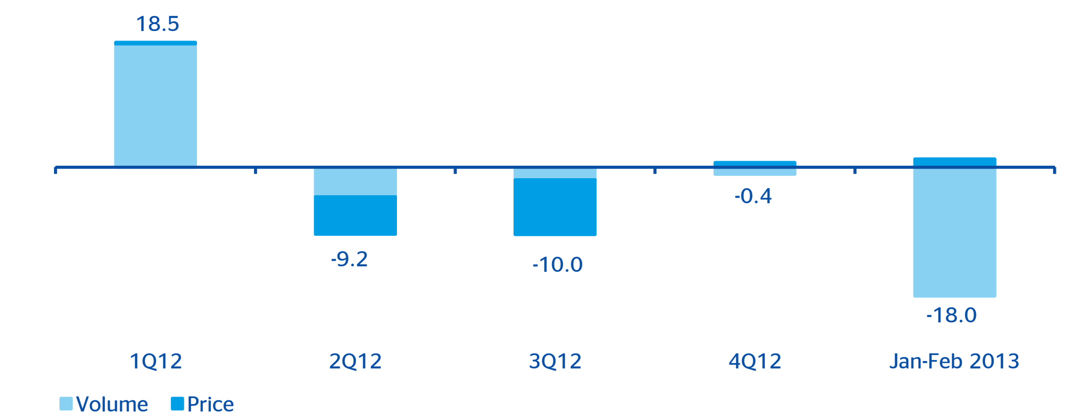
Public expenditure also continued to drive domestic demand via salary increases for the government administration and better execution of infrastructure works in comparison with the first quarter of 2012. We estimate investment expenditure for the rest of the year will continue to expand above 10%, largely boosted by building transport networks including the Electric Train (Line 1) and the IIRSA North and South highways. The second half of the year is also likely to see the concession for Line 2 of the Electric Train awarded, involving investment of USD 5.3 billion, and the development of the South Peru Gas Pipeline for around USD 2.5 billion.

In short, we forecast domestic demand this year will continue to expand above output. At the aggregate level this will continue to offset temporary export weakness.

The decline in exports in the first quarter was largely linked to supply factors

Exports saw a major fallback at the start of the year due to lower volumes (see Chart 7). In addition, there was a major drop in international metal prices in April.

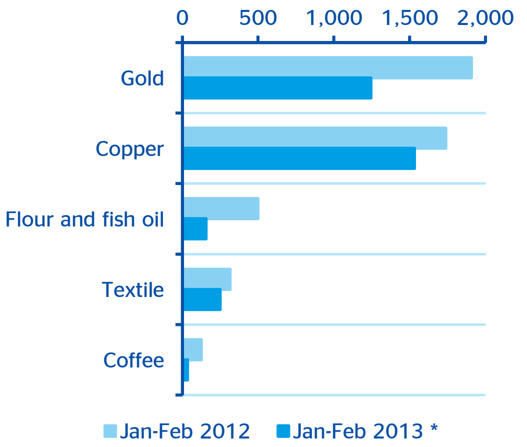
Chart 7
Exports of goods (y/y % change)



Source: BCRP and BBVA Research Peru

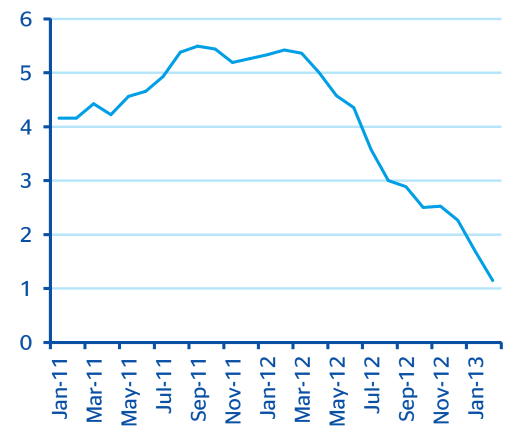
The decline in export volumes is linked to specific factors in some of the main products sold overseas (see Chart 8). These include lower gold production due to lower grades at the Yanacocha mine and higher technology costs involved in submitting mining in Madre de Dios to formal regulations. Copper exports also dropped in the first few months of the year due to maintenance work at Antamina (a mine that accounts for around one third of copper production) and the production realignment with the closure of the Tintaya mine and the gradual increase at Antapaccay, both operated by Xstrata. In turn, flour and fish oil production declined as a result of lower seasonal fish quotas in December and January. This is in addition to the negative effect on the textile sector of the devaluation of the Venezuelan bolivar, leading to a major decline in exports to Venezuela (one of the main destinations for textile products). Finally, the rust plague affected coffee harvests, where prices have dropped over 30% y/y.

Chart 8
Products with biggest falls in export value (USD million)



* Figures available to February.
Source: BCRP and BBVA Research Peru

Chart 9
Trade balance (% of GDP, 12-month cumulative)



Source: BCRP and BBVA Research Peru

As a result, the trade balance surplus (annualized) fell from 2.3% of GDP in December last year to 1.2% in February (see Chart 9). This will widen the balance of payments current-account deficit in the short-term.

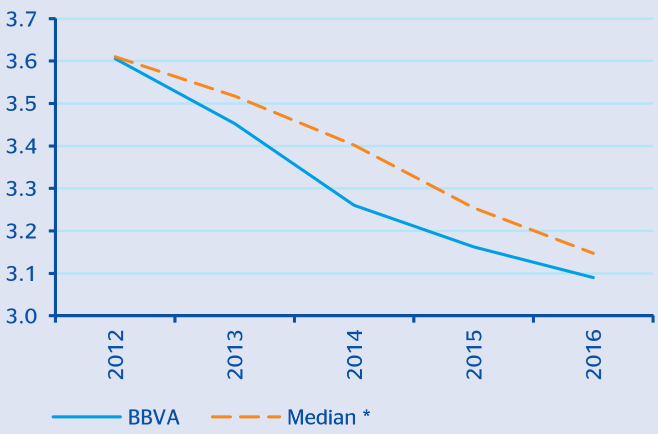
Nonetheless, we expect this trend to reverse in coming months when some of the factors having a negative effect on exports start to dissipate. For example, copper production will be favored by the return to normal of operations at Antamina in April and the gradual output increase at Antapaccay. In addition, increased zinc mining is expected thanks to the entry into operation of the Santander mine and higher production at Milpo and El Brocal. In addition, the fishing quota announced for the May-June season is higher than before and expected to increase again at the end of the year thanks to the likely recovery of the marine biomass. An additional aspect that will begin to affect the growth rate for exports from the second quarter on is the positive impact of a low year-on-year comparison basis. For the year as a whole, we forecast a rise in exports seeing, although this will be below 5% due to events early in 2013.

Box 1. Impact of lower metal prices on the balance of payments current account

International metal prices fell back between March and April. The recent outlook for a sharper slowdown in China and the likelihood of this reducing demand for base metals impacted the copper price. In addition, the rumored sale of gold reserves at the Central Bank of Cyprus led to a fear that other central banks on the European periphery would do the same, thus impacting the gold price. Since mining exports represent 57% of Peruvian exports, many analysts have made downward revisions to their balance of trade forecasts for Peru. This will have also impacted the local currency market.

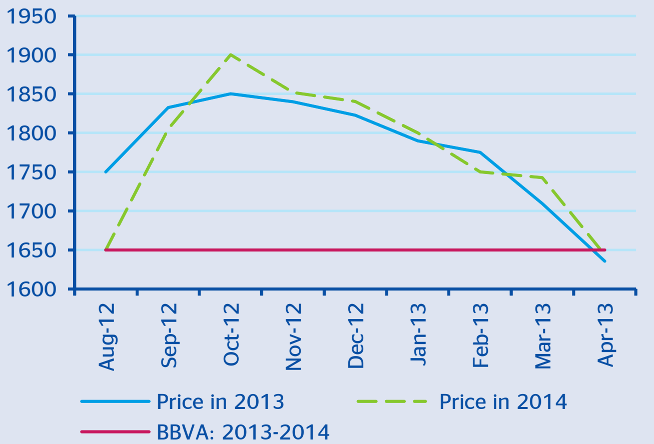
Our base forecasts for this year are for an average copper price somewhat below that in 2012: USD 3.45/lb. compared to USD 3.61/lb. This is explained by the uncertainty surrounding the speed of the US and European recovery and by the volatility shown by output figures from China. In addition, a larger-than-expected inventory stockpiling was recorded at the start of 2013. In coming years, we estimate the metal price will remain on this downward path, taking it to a long-term level of around USD 3.0/lb. It should be stated that these forecasts are more conservative than the market consensus (see Chart 10).

Chart 10
Copper price forecasts (USD/lb.)



* As of 30 April.
Source: BBVA Research and Bloomberg

Chart 11
Gold price forecast: market estimates (USD/oz.)



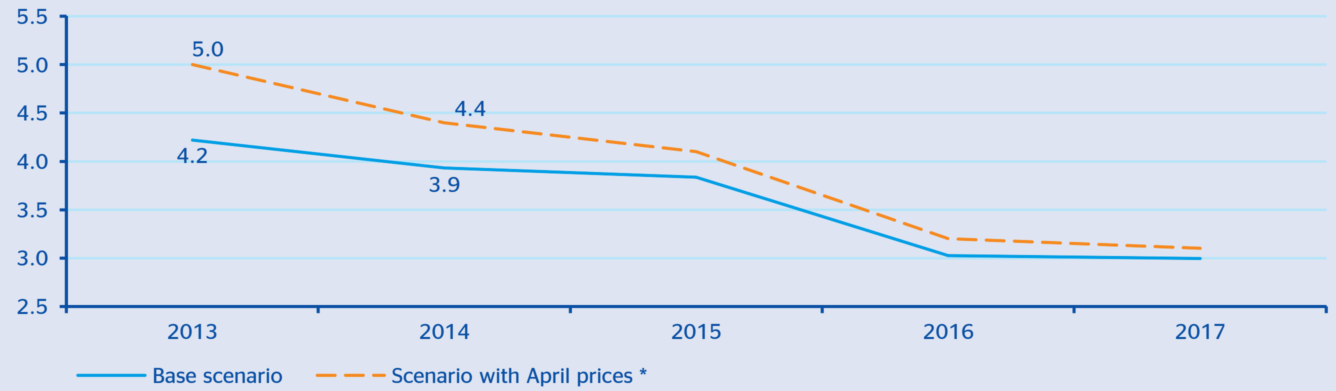
Source: BBVA Research and Bloomberg

Similarly, our base scenario takes into account a drop in the gold price in 2013, to USD 1,650/oz. from an average USD 1,670/oz. in 2012. Although the spot price is currently below USD 1,500/oz., most analysts expect a recovery to a level in line with our forecast (see Chart 11). The main supporting factor for the price is the slow global recovery leading to very low interest rates until at least 2015.

In this baseline scenario, the balance of payments current-account deficit would come in at 4.2% this year and 3.9% next year.

Nevertheless, we should consider up to what level the deficit could deteriorate if the copper and gold price remain at the average levels recorded in April, of USD 3.3/lb for copper and USD 1,500/oz. for gold. To do this, we have carried out an exercise where, keeping everything else constant and the same as in the baseline scenario, we correct these prices downward (this not only affects goods exports but also remittances of profits made by mining companies to their foreign parent companies). As a result, the external deficit would increase to 5.0% of GDP this year and 4.4% next year (see Chart 12). In a more difficult scenario where prices dropped to USD 3.2/lb for copper and USD 1,400/oz for gold, the balance of payments current-account deficit would increase to 5.5% of GDP in 2013.

Chart 12
Balance of payments current-account deficit (% GDP)



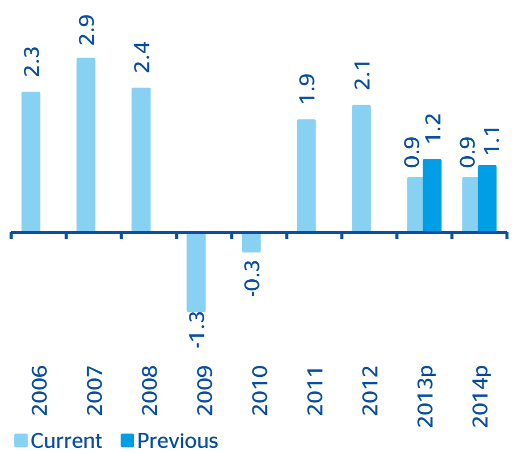
* Copper: 3,3 USD/lb; Oro: 1,500 USD/oz.
Source: BBVA Research

Fiscal policy: wage increases and changes to macro-fiscal rules

We have revised the fiscal surplus forecasts for 2013 and 2014 downward on our February publication, to 0.9% of GDP for both years (three months ago the forecasts were 1.2% and 1.1%, respectively: see Chart 13). This adjustment mainly reflects the higher public expenditure on wages during the first quarter of the year (18.9% y/y compared with a forecast 12%).

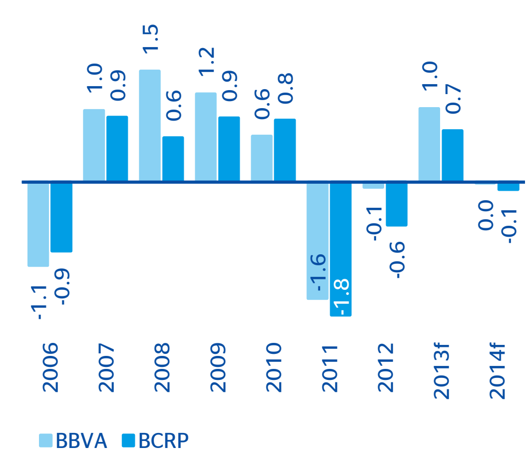
We expect the fiscal impulse (an indicator that removes the effects of the economic cycle on the fiscal position, and thus identifies the stimulus to aggregate demand) to be positive, meaning it will be expansive in 2013 as compared to last year and procyclical in nature (see Chart 14). We believe that since growth will come in above 6.0%, a relatively neutral fiscal policy would have been more appropriate to avoid burdening monetary policy with the role of stabilizing domestic demand and provide support for the Central Bank efforts to lower the currency's rate of appreciation (a less expansive fiscal policy helps neutralize monetary surpluses created by the Central Bank's dollar purchases).

Chart 13
Fiscal Balance (% of GDP)



Source: BCRP and BBVA Research Peru

Chart 14
Fiscal Impulse * (% GDP)



* The fiscalimpulse is the difference in the primary structural balance, and is an indicator as to how the fiscal position affects the economic cycle.
Source: BCRP and BBVA Research Peru

Box 2. Fiscal rules: higher expenditure limit or structural balance?

The Financial Equilibrium Law for this year has temporarily replaced the macro-fiscal rules set out in the Fiscal Responsibility and Transparency Law (LRTF). Specifically, it has been established that this year the non-financial public sector balance may not be negative, which will replace the limits in the LRTF for 2013 for central government public consumption (which may not exceed a 4% growth in real terms) and for the fiscal deficit (which may not be higher than 1% of GDP). The law establishing at least a 0.2% of GDP annual improvement target for the structural fiscal balance (which excludes cyclical and temporary factors) was also repealed.

One interpretation of the loosening of macro-fiscal rules this year is that the government wishes to carry out improvements in government administration and speed up infrastructure maintenance expenditure. This goal was possibly limited due to the public expenditure growth ceiling under the LRTF. The temporary removal of this limit means the fiscal budget for this year includes wage increases of between 15% and 20% for around 60% of public-sector employees. Without the legal change, increases of this size in wages would have exceeded the growth limit for public expenditure and, therefore, failed to comply with the LRTF.

Nevertheless, these unexpected exemptions for complying with fiscal rules, as well as the reversal in attempting to place more importance on the structural analysis of public balances, could have undesired effects. For example, it creates a perception of a more discretional nature in public expenditure, something the LRTF seeks to limit. This is particularly so when the planned wage increases were not announced as part of a comprehensive systematic reform of government administration, and funding for this measure is based on fairly ambitious tax revenue increases. The important point is to define what the government can spend without impacting the sustainability of public finances in the future.

Given the major benefits in terms of macroeconomic stability and credit rating that the fiscal rules have given Peru, they clearly need to be maintained. Those in the LRTF have worked very well to set up a perception of disciplined management of the public accounts. Nonetheless, they have been questioned as: (i) their limits are very demanding and do not allow for reforms to the public administration (which include career paths and salary increases), nor an appropriate expenditure level for infrastructure maintenance; and (ii) they tend to lead to a procyclical fiscal policy since, as they have been defined, the government tends to spend more when revenue is high.

One option to rectify the first issue is to permanently raise the limit for public consumption expenditure (goods, services and wages), avoiding temporary discretional changes to already announced rules. Indeed, a ceiling could even be defined for total non-financial expenditure growth (including expenditure on public investment), then choosing the balance between current expenditure and investment based on objectives to be achieved (e.g. a public investment level as a percentage of GDP), although in this case the discretional nature of expenditure would increase. The problem with this option is that it would not avoid fiscal policy possibly being procyclical and it is not necessarily in line with the sustainability of public finances over time.

A second way of improving the LRTF would be a rule on the structural fiscal balance. We believe this would be better than the previous solution, since it would deal with the two aforementioned issues as well as the discretional nature, as long as the authority assessing the structural deficit has enough independence. Under this concept, the public sector balance deducts the effects of the economic cycle and the most important commodity prices the country exports from the conventional result, giving a better indicator of the long-term fiscal position. In this way, when mineral prices are above their long-term levels, tax revenue will be high. But this effect on fiscal revenues is temporary, as mineral prices will tend to converge toward their equilibrium levels, which could possibly be lower. The same idea is applied when revenues are exceptionally high because the economy is in a expansion period. By eliminating these temporary effects (high mineral prices and an economy expanding above its potential level), we get a better idea on the performance of public finances. We would see when revenues are extraordinary and temporary, meaning it would be a good idea to save them for future use, when shocks affecting the economy need to be addressed. In this way, defining a structural balance rule ensures countercyclical management of fiscal policy.

In any event, a key issue is to define the size of the structural balance we want. Should it be a surplus? Can it be a deficit? How big? Some analysts have suggested a structural balance that stabilizes the current 18% level of the government debt-to-GDP ratio (one of the lowest in the world)[1]. The argument is that Peru has already saved enough in the last 12 years, reducing this ratio from around 50% of GDP to current levels. Furthermore, given the current infrastructure gaps, the good conditions for finance and the economy perspectives seeing sustained growth, implying richer future generations (savings are not needed to make inter-generational transfers) also point to the current debt-to-GDP ratio being sufficient.

1: See Ghezzi Piero (2012): "Elementos para una nueva regla fiscal en el Perú", mimeo, December

The sustainability of public debt over time emphasizes the analysis of variables such as percentage of GDP (debt, fiscal balance, etc.) and allows us to obtain a simple equation (approximate) to calculate the fiscal balance (as a percentage of GDP) in line with a stable debt-to-GDP ratio:

$d + i\bar{b} = (\pi + g)\bar{b}$

Where:

d: primary deficit as % of GDP (non financial expenditure less revenues)

i: nominal interest rate

$\bar{b}$: debt ratio as % of GDP for stabilization

$i\bar{b}$: government financial expenditure (debt interest payments)

π: inflation

g: GDP growth rate

AThe left side of the equation is the fiscal balance. Working on the right side of this equation, if we take inflation at 2% (the Central Bank target) and growth at 6% and we want to stabilize the current public debt ratio, a deficit of 1.4% of GDP is required (0.02+0.06)x18%.

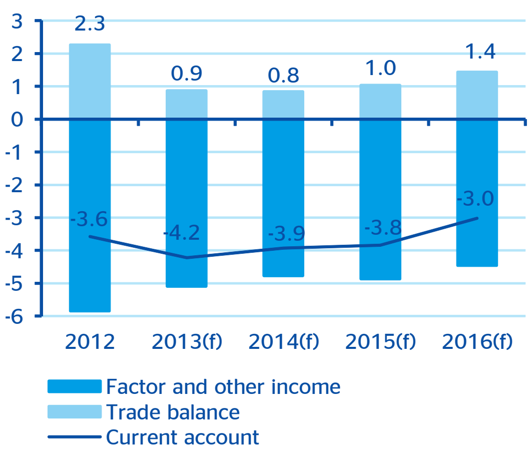
Having defined the deficit required to maintain the government debt ratio at 18% throughout the economic cycle, the other challenge is to estimate the structural balance. This is not an easy issue to resolve, given the difficulty in defining long-term commodity levels and identifying the position of the economic cycle. Usually, a commission is set up to do this, with its independence being critical to lend credibility to the rule and avoid manipulation. Of course, estimating such variables that are not directly observable creates controversy due to the different methodologies that can be used. For example, IMF calculations on structural positions to 2007 (the year before the global financial crisis) showed Spain had an ample structural surplus and Ireland structurally sound fiscal balances. In fact, they failed to show the underlying fiscal weaknesses, possibly as they did not take into account the effects of asset bubbles. Later calculations carried out by the IMF in October 2011 showed that in reality Ireland had a structural deficit of 8.4% of GDP and was not balanced, while Spain had a structural deficit of around 1% of GDP and not a surplus.

Beyond the technical difficulties caused by its implementation however, we believe a rule on the structural balance such as the one suggested is a better alternative for strengthening the LRTF: it reduces the likelihood of a procyclical fiscal policy and allows a sustainable deficit to be defined that would help deal with the needs of the size of public expenditure that is consistent with the sustainability of the fiscal balance; it also establishes a deficit insofar as it suggests the current debt ratio be maintained.

In the medium-term, increased mining production will drive exports, which will compensate for slowing domestic demand

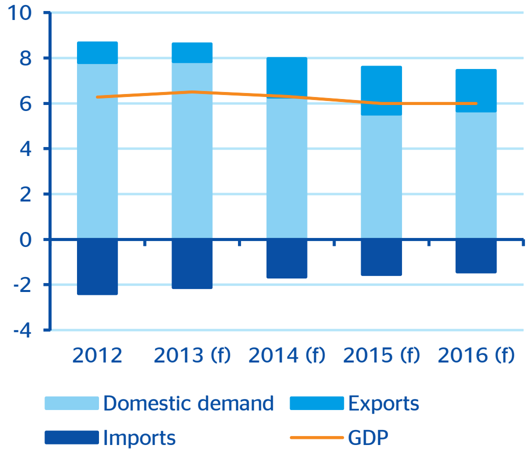
For 2016, the outlook for mining exports is favorable. Specifically, we estimate copper production will triple with the entry into operation of Toromocho toward the end of this year, and Las Bambas and Constancia in 2014; and with the extension of Cerro Verde and Quellaveco in 2016. This will have a positive impact on the trade balance and, therefore, on the balance of payments current account, which will see its deficit fall in the following years (see Chart 15).

Chart 15
Trade balance and current account (% GDP)



Source: BCRP and BBVA Research Perú

Chart 16
Contribution to GDP growth (percentage points)

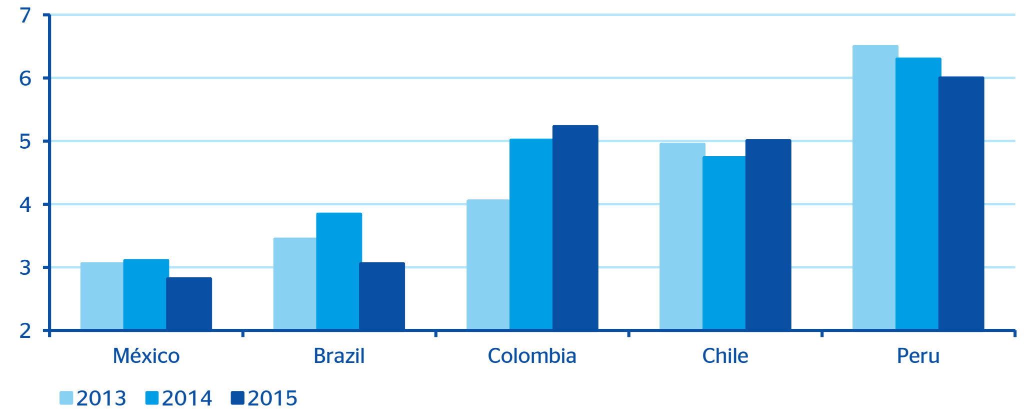


Source: BCRP and BBVA Research Peru

In contrast, starting in 2014 domestic demand will moderate its impulse toward more sustainable long-term rates (see Chart 16). This forecast is based on the anticipated slowdown in private and public expenditure. On the private front, growth in consumption will be somewhat lower, in line with job creation having less room for expansion (the unemployment rate is at an all-time low and there is a shortage of workers for some industrial sectors). Investment will also slow, as large-scale projects become less available and other domestic factors as a delay on some investments in mining and hydrocarbons (industrial disputes and institutional changes to the system for obtaining environmental permits). On the public side, maintaining the fiscal balance will be a factor determining a slower pace of increase in expenditure over the coming years (see Box 2).

Consequently, we expect to see a more balanced trend in external and domestic expenditure from next year on. Specifically, we estimate that growth in domestic demand will be similar to that for total output and the latter will continue to perform in line with its potential long-term trend. This positive result depends on current business confidence levels being maintained and, therefore, investment continuing strong. If these come together, GDP growth will remain above 6% for 2013 and 2014, meaning Peru will continue to be one of the top performing economies in Latin America (see Chart 17).

Chart 17
GDP growth in Latin America (y/y % change)

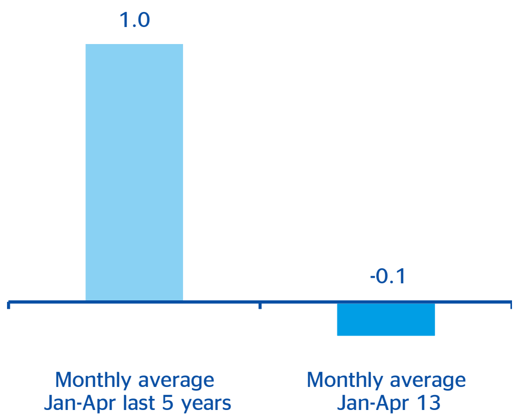


Source: BBVA Research Peru

4. Demand pressures will move inflation to around the upper limit of the target range in coming months

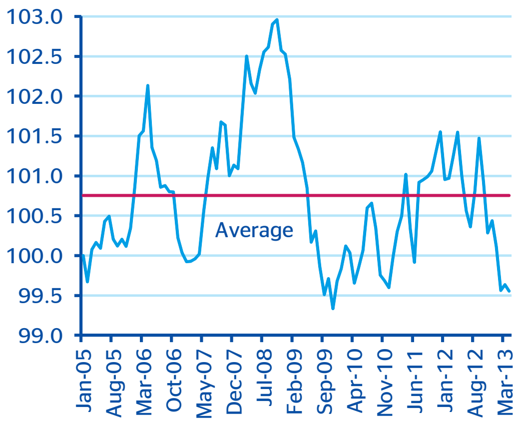
At the end of April, year-on-year inflation was 2.3%, somewhat below initial forecasts. This behavior was in line with food prices showing an atypical performance at the start of the year: declining when they usually rise for seasonal reasons (see Chart 18). The favorable weather conditions meant a bigger supply of some products with a high weighting in the consumer basket of goods. As a result, non-core inflation, the component including goods and services with more volatile prices, came in at 0.3% y/y. The level of non-core prices is thus fairly low. The overall price index (see Chart 19) is at a low for recent years. This makes it unlikely that non-core inflation will continue to lag behind. Looking ahead, we expect it to return to normal, coming in at least more in line with its historical average of around 2% for the year-on-year rate in a context where international agricultural products and oil prices have no additional room to drop.

Chart 18
Monthly food inflation within the non-core component (%)



Source: BCRP and BBVA Research Perú

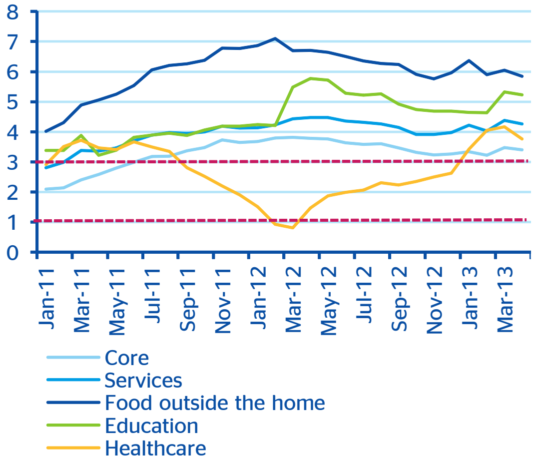
Chart 19
Non-core prices
(related to the total price level, Jan-2005=100)



Source: BCRP and BBVA Research Perú

Core inflation, in turn, which better reflects demand pressures on prices, continues above the target range (2%, +/- 1pp). Prices in items such as Food outside the Home, Education and Healthcare are rising at rates between 3% and 6% (see Chart 20 and Table 2). We predict this will continue over the year due to the strength of domestic demand, which in the first two months of the year expanded at an average monthly rate of 10% year-on-year, and a tight job market where the unemployment rate (Metropolitan Lima) is around 6.5%, the lowest since records began (see Chart 21). The tight labor conditions will put upward pressure on wages, which by not being directly linked to better productivity, raise relative costs for business. This could eventually have a knock-on effect on product prices. In this context, our estimates suggest core inflation will remain around 3% in 2013, in line with a slightly positive output gap that will only close toward the end of the year.

Chart 20
Year-on-year inflation, core component (%)



Source: BCRP and BBVA Research Perú

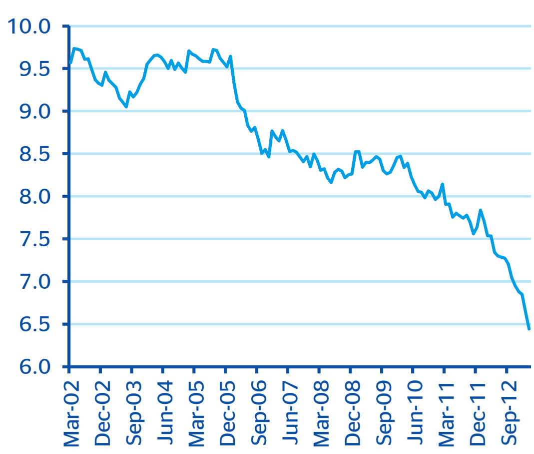
Table 2
Some items of core inflation (%)

	Weight (% total)	Dec-11	Dec-12	Apr-13
Core Inflation	65,2	3,6	3,3	3,4
Food at home	11,3	4,7	4,3	4,1
Food outside the home	11,7	6,8	6,0	5,8
Education	9,1	4,2	4,7	5,2
Healthcare	1,1	1,9	2,6	3,8

Source: BCRP and BBVA Research Perú

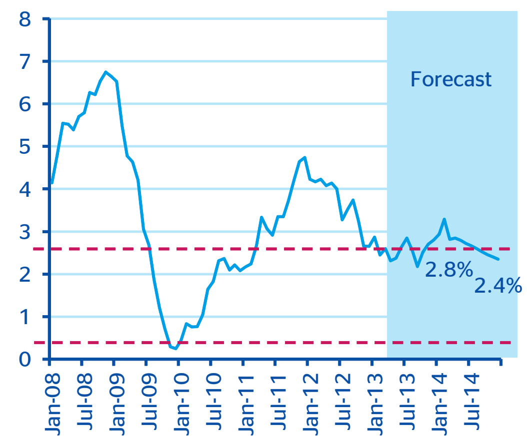
To sum up these different trends in prices, we forecast inflation closing the year around the upper limit of the target range. Starting in 2014, in a context of slowing GDP and in the absence of supply shocks, inflation should gradually converge toward the center of the target range (see Chart 22).

Chart 21
Unemployment rate in Metropolitan Lima (%, rolling average last 12 months)



Source: BCRP and BBVA Research

Chart 22
Year-on-year inflation (%)



Source: BCRP and BBVA Research Peru

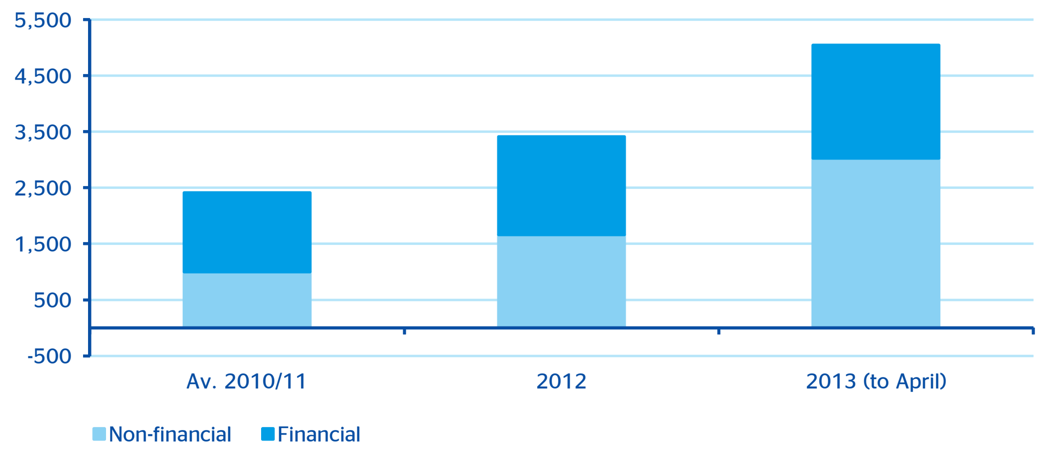
5. Somewhat exchange-rate volatility for the rest of the year…

Fundamentals and capital inflows will strengthen the Peruvian sol

As we stated in our previous report, the underlying trend for the Peruvian sol is to strengthen. First relative improvements in productivity in the country over recent years, especially in the tradable sector, favor exports of manufactured products at lower costs. Second, the decreasing trend in external liabilities (as a percentage of GDP) means the balance of payment current-account surplus required in the future to cover these obligations is lower, in line with a lower PEN/USD exchange rate. Over the last ten years, these elements have supported, and generally continue to support, the trend for a stronger Peruvian currency.

This progress in productivity makes the local economy attractive and invites long-term capital inflows. For example, ever more Peruvian companies are seeking funding directly from overseas and finding it on favorable terms. International securities issues gathered pace in April and to date, the total amount issued in 2013 has exceeded that for the whole of last year (see Chart 23), when they hit a record. In a context where the outlook for the Peruvian economy is positive (and therefore companies will continue to expand), reserve requirements are high and external financing terms continue to be attractive, everything points to these transactions continuing. Long-term capital inflows will also be geared toward the private sector through FDI linked to large mining projects that are being constructed and to other sectors such as energy, manufacturing, infrastructure and trade. We expect around USD 11.5 billion to come in through this channel in 2013, a figure similar to that for last year. In short, fundamentals and long-term capital inflows should lead to a stronger local currency over the rest of the year.

Chart 23
Securities issued by Peruvian companies on international markets (Millions of USD)

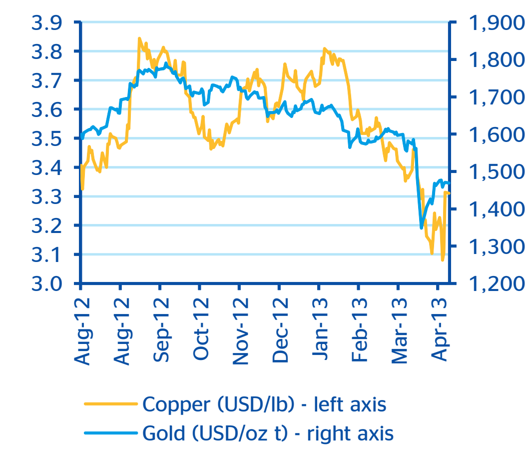


Source: BCRP and BBVA Research Peru

How quickly the Peruvian sol strengthens will depend on the external context and Central Bank intervention

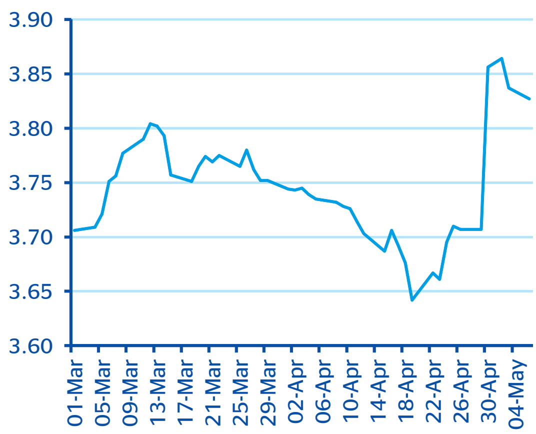
The exchange rate saw upward pressure in recent weeks, closely linked to external factors. The big debate at the US Federal Reserve surrounding a possible early reduction in the rate of cash injections, the way the Cyprus bailout was resolved and its possible knock-on effects for European banking and economic recovery on the continent, and macroeconomic data showing downward surprises in several large markets including China, are elements that taken together have raised uncertainty, leading to effects such as commodity prices falling back heavily (see Chart 24). This arose in a context where the trade balance was showing weakness, with a deficit of over USD 500 million in the first two months (average surplus of USD 1.3 billion in the first two months of the previous three years) as a result of both the strength of domestic demand, which continues to boost imports, and lower export volumes due to specific factors. Consequently, the market has adjusted its forecasts for this variable downward. Alongside the greater domestic political noise, this has led, for example, to investors cutting some of their positions in domestic currency-denominated assets at least for the time being (see Chart 25) and banks choosing to increase their currency spots, driving the Peruvian sol down.

Chart 24
International copper and gold prices



Source: Bloomberg

Chart 25
2020 Sovereign bond yield (%)

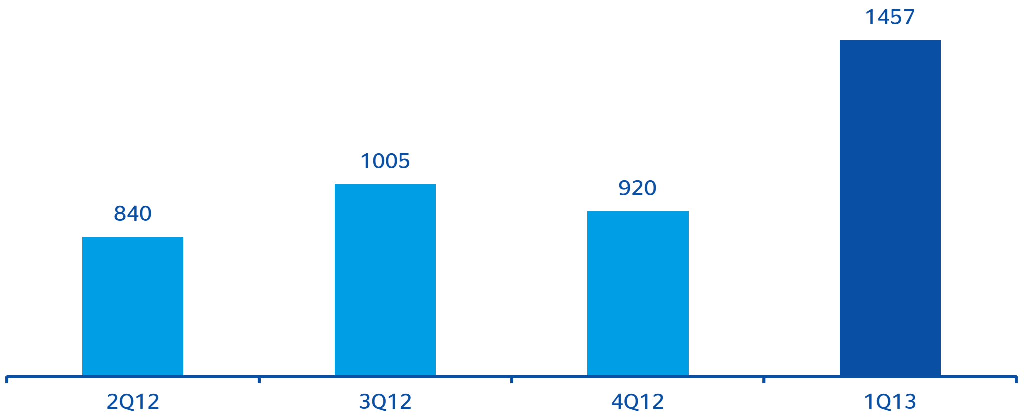


Source: Bloomberg

We do not, however, expect the external factors to provide additional support to the dollar on the domestic currency market in the future. On the export prices front, we estimate a more stable trend in the coming months after the major downward correction seen recently. Our baseline scenario shows that the monetary stimuli in advanced economies, especially the US, will only gradually decrease, since the recovery remains weak, as confirmed by recent macroeconomic figures; and that the slump in China (a major customer for metals on the international markets) is temporary, since with inflation under control there is room for the authorities there to support growth and expand output to around 8% for the year. Prices of the main Peruvian exports will find support in this context. On the export volume front mining projects that are coming into production, replacing others, will gradually reach full operating capacity.

As for the Central Bank, the support it has provided to the exchange rate will continue, although we believe it could be somewhat weaker. In the first quarter of 2013, foreign currency purchases increased at a monthly rate of almost USD 1.5 billion (see Chart 26), 25% above last year's rate. Furthermore, there is still room for maneuver to continue accumulating international reserves (see Box 3). Despite this, the level of these reserves is getting closer to the optimal amount. Moreover, international reserve accumulation carries major costs, which although not decisive as stated by Central Bank officials, will be a further element to take into account. An alternative way of maintaining the rate of dollar purchases without creating so many losses would be to reduce sterilization. In an economy with sustained high growth rates such as Peru, cash injections may be absorbed without creating imbalances such as inflation. However, it is difficult for any economy to absorb cash injections as high as those generated in Peru through foreign-currency interventions. Therefore, limiting monetary sterilization would translate into high demand pressures, pushing overall price levels higher (when core inflation is already above-target) and increasing ever further the deficit in the balance of payments current account. In short, although the Central Bank has room to continue purchasing dollars on the markets, it will find it difficult to do so at the same rate as at the beginning of the year, so support from foreign currency interventions will tend to weaken.

Chart 26
Central Bank: exchange interventions as buyer (USD million, monthly average)



Source: BCRP and BBVA Research Peru

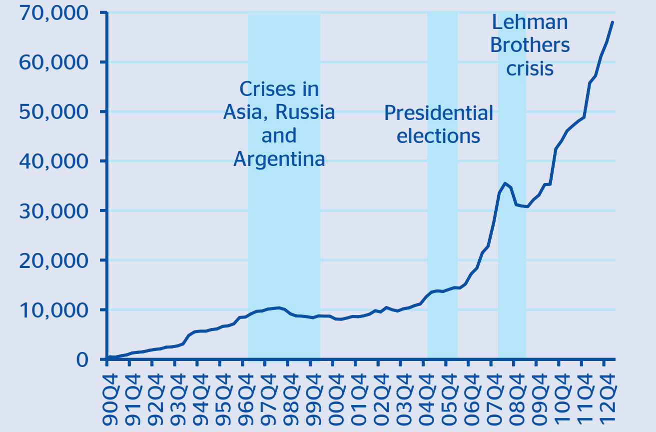
Reserve requirements have already hit high levels. In recent months, there has been a constant increase in the foreign-currency reserve requirements. In this way, the funds banks have to deposit as a proportion of the balance of dollar-denominated deposits accumulated a rise of 425 bps from September. The aim has been to moderate lending growth, especially dollar-denominated mortgages and consumer loans, but the measure has also had an impact on foreign exchange since banks need to rearrange their holdings in foreign currency to comply with the higher requirements. The major increase in reserve requirements generates distortions on the markets for lendable funds. As stated earlier, an increasing number of companies is currently accessing the international financing markets directly. In an environment of major liquidity expansion in the advanced economies and a good outlook for the Peruvian economy, these funds come with very attractive rates, below what local banks can offer (since the latter have to cover the reserve requirement costs). This means that the increase in dollar reserve requirements to restrict the issuing of loans in dollars and thus limit the exposure of the economy's non-tradable sector to foreign-currency credit risk loses its effectiveness, especially if the requirement is already high, since economic agents are able to avoid it. The support given to the exchange rate also loses effectiveness, since although banks will demand more dollars to meet the higher requirements, there will in turn be an inflow of foreign currency linked to issuances of securities by Peruvian companies on the international markets. It even contributes to some fragmentation between companies with the size or logistics to tap international markets and those that cannot. Finally, high reserve requirements generate incentives that favor the maturity mismatches at banks since, in relative terms, they reward long-term external funding (the reserve requirement for this is lower than for short-term funding) that banks may then channel to shorter-term lending. For all these reasons we do not see much more room for rises in reserve requirement rates, at least not in the way they have increased in recent months. This means another exchange-rate support will be weakened.

In summary, the fundamentals and the inflow of long-term capital will support a trend for the domestic currency to strengthen over the coming months, although the rate will be subject to both events overseas and action from the monetary authority. We predict that these two supports for the dollar on the domestic currency market will be somewhat weaker for the rest of the year. In 2014, as markets begin to factor-in a return to normal monetary conditions in advanced economies, thus triggering a reallocation of global portfolios, the exchange rate should be more stable.

Box 3. Current international reserves still below the optimal[2]

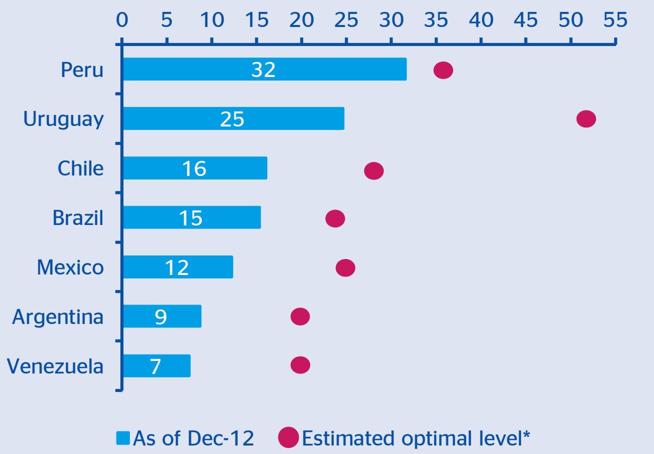
Over the last three years, net international reserves in Peru doubled (see Chart 27) and are currently around USD 70 billion. This is equivalent to 34% of GDP and as such it is the highest level among the main economies in the region (see Chart 28).

Chart 27
Peru: net international reserves (Millions of USD)



Source: BCRP and BBVA Research Peru

Chart 28
LatAm: International reserves in 2012 (% GDP)



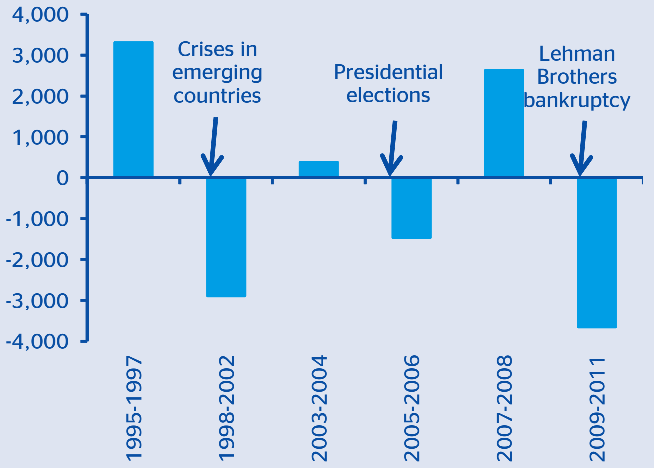
* Estimate by Calvo, Izquerdo and Loo-Kung (2012).
Source: IMF, CIA, BCRP and BBVA Research

The Central Bank of Peru has been taking advantage of the appreciation pressures on the domestic currency to intervene on the market as a buyer and thus accumulate international reserves. However, this accumulation carries a cost, especially when a large amount of domestic currency has to be issued in order to purchase these dollars, and therefore needs to be sterilized so that no imbalances such as inflation are created. In order to absorb the excess expansion in liquidity, the Central Bank issues monetary sterilization instruments for which it has to pay interest greater than the return that it makes on dollars invested abroad in very liquid assets with high credit ratings (international reserves assets). The spread between the rates that the Central Bank pays and those at which reserve assets are remunerated has widened in the current scenario, with international interest rates at record lows. Thus, the greater the dollar purchases, the higher the international reserves; but also the higher the amount that needs to be sterilized and thus the financial costs. In 2012 for example, the Central Bank recorded losses of PEN 1.2 billion, largely due to these operations, equating to 60% of its capital reserves. If there are costs, why then accumulate international reserves? And in any event, why is Peru accumulating such high international reserves, the highest in Latin America (as a proportion of GDP)?

This foreign-currency balance the Central Bank holds in highly liquid, safe foreign assets could be used to deal with turbulent episodes such as that of 2008. With events such as these (see Chart 29), international reserves have allowed the Central Bank to cover the higher demand for foreign currency at banks (in the face of non-renewal of short-term foreign credit lines, the dollarization of deposits, withdrawal of foreign-currency deposits) while limiting upward pressure on the exchange rate (see Chart 30). The latter factor is important for an economy such as Peru's, where 50% of bank loans are dollar-denominated and, therefore, there is major exposure to foreign-currency credit risk. This context suggests that it is a good idea for Peru to have a higher level of international reserves than in countries without these characteristics.

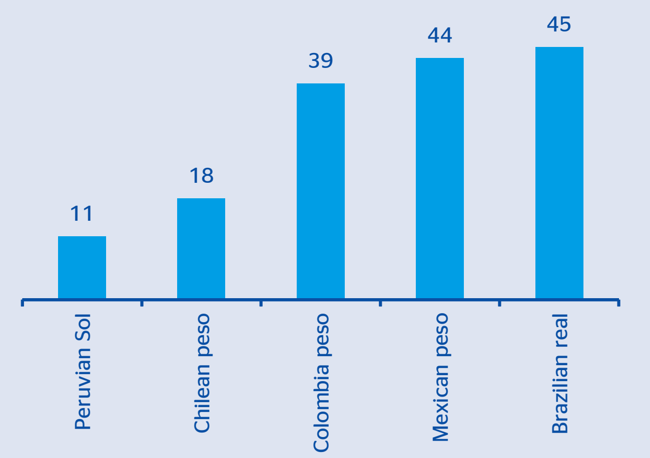
2: We will publishing an Economic Watch on this topic soon.

Chart 29
Peru: aggregate increase in short-term capital outflows (Millions of USD)



Source: BCRP and BBVA Research Peru

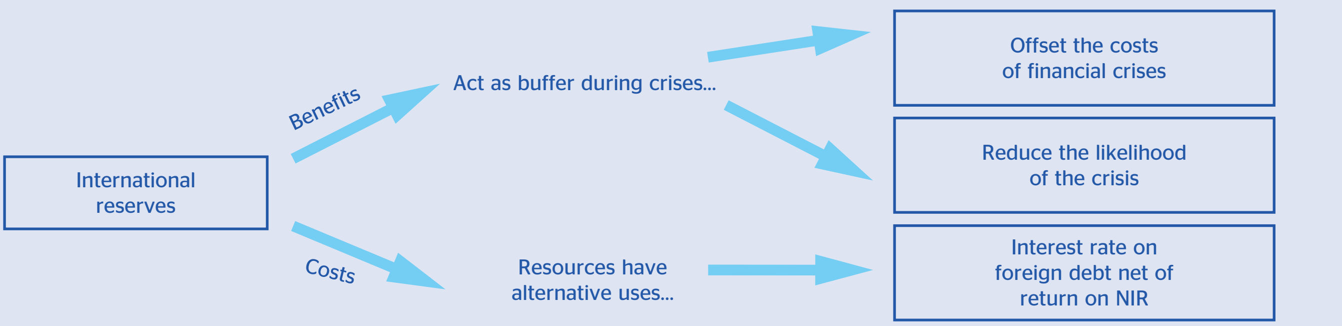
Chart 30
LatAm: nominal depreciation of currencies as a result of the collapse of Lehman Brothers (cumulative % change between 07/2008 and 03/2009)



Source: Bloomberg and BBVA Research Peru

There are therefore benefits to having a high level of liquid foreign assets, especially in an economy such as Peru's, but there are also costs; as with any type of insurance. What, then, is the optimum level balancing out costs and additional benefits of international reserves? There are two methodologies that try to answer this question. The first is the traditional one that compares the level of international reserves with an ad-hoc threshold for a macroeconomic variable that reflects a major source of potential demand for foreign currency in a period of stress. These include, for example, the country's short-term foreign liabilities, imports, some monetary aggregate or even a weighted variable that brings together all three (as is done by the IMF[3]). According to this methodology, Peru's international reserves exceed the appropriate level in all cases. Nonetheless, the methodology has been criticized since it is static and thus fails to allow for changes in financial links over time; and it does not include the specific characteristics of each economy. The second methodology compares the benefits and costs of maintaining international reserves (see Chart 31). It is thus closer to the type of economic analysis appropriate for answering the question. One example is Calvo, Izquierdo and Loo-Kung's study (2002), which concludes that the optimum level for Peru is around 36% of GDP. This would mean that there is still room to accumulate foreign assets for over USD 12 billion, taking into account that this year the country's GDP will be around USD 225 billion. This room could even be wider if the benefits of maintaining a high level of international reserves in normal periods are taken into account: by acting as an insurance in possible critical periods, it reduces the intensity of the cycle and thus favors private capital inflows to the private sector in good periods.

Chart 31
Benefits and costs of accumulating international reserves



Source: BBVA Research Peru

3: International Monetary Fund (2011), "Assessing reserve adequacy."

6. The policy rate will remain unchanged in the coming months

The current monetary policy stance is somewhat restrictive in a context that are perceived demand pressures

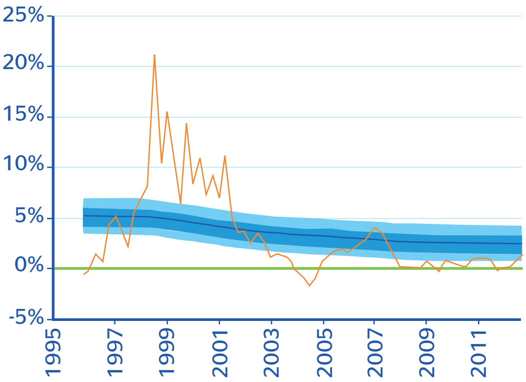
The policy rate is currently near neutral according to different estimates[4] (see Table 3), including our own (see Chart 32). Nevertheless, by also taking into account the effect of higher reserve requirements, we obtain a wider measurement of monetary conditions that place them near the restrictive zone. This is in line with the outlook for output and prices described earlier. Domestic demand continues to show high dynamism, which has led to declining slack in the job market and some industries, and is reflected in an external deficit of close to 4% of GDP. These trends will continue this year in a context of high business and household optimism, favorable financial credit terms and an expansionary fiscal policy. However, prices reveal demand pressures that exceed the Central Bank target. Although the major decline in the non-core inflation component means the price increase remains within the target range, in the end this will tend to readjust. Therefore, our forecast is for inflation to end 2013 around the upper limit of the target range and the current restrictive tone of monetary policy is in line with this. Some additional rises in reserve requirements cannot be ruled out in the coming months to ensure this, although they will not be as steep as the series that began to be implemented last September.

Table 3
Monetary policy interest rate: neutral level according to different estimates (% in real terms)

1. CAPM consumption model	5.0
2. Uncovered interest-rate parity	2.3
3. Dynamic Taylor Rule	1.8
4. Implicit common stochastic trend	1.5
5. Hodrick-Prescott Filter	1.3
6. General equilibrium model	1.3
7. Taylor Rule augmented for inflation expectations	1.0
Average	2.0

Source: IMF

Chart 32
Monetary policy interest rate: neutral level according to BBVA estimate and observed level (in real terms)



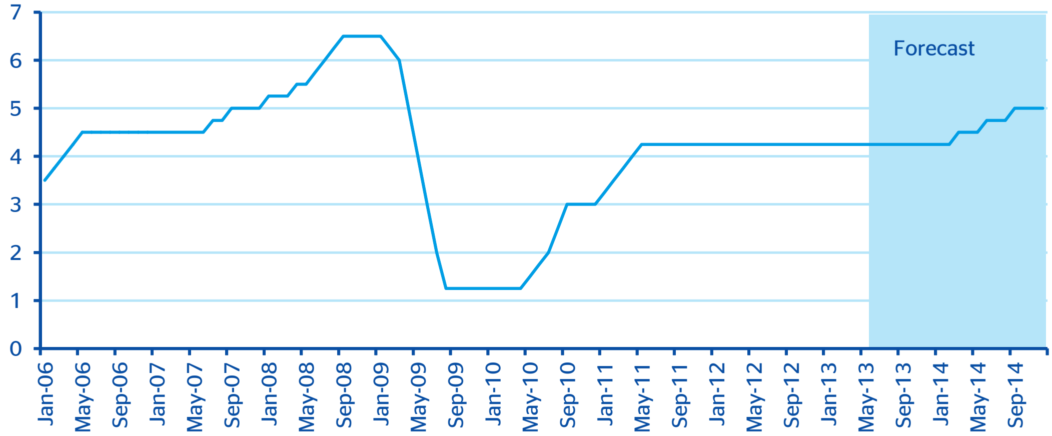
Source: BCRP and BBVA Research Peru

There will be more room to recomposing the monetary policy stance in 2014, raising the policy rate and reducing reserve requirements

The intensive use of reserve requirements to tighten monetary conditions creates distortions, as mentioned above. This has been done to prevent capital inflows to Peru from increasing in an environment of high global liquidity that will remain in the short term. Nevertheless, when these stimuli start to slow in 2014, especially in the U.S., upward pressure on the sol will decline and the Central Bank will have more room to balance the components of monetary policy better, relying more on the conventional instruments. We estimate that some downward correction will be seen in reserve requirements, which will be offset with a rise in the policy rate (see Chart 33).

4: Magud, N. and E. Tsounta (2012), "To cut or not to cut: that is the (Central Bank's) question. In search of neutral interest rates in Latin America," IMF WP/12/243, Washington, D.C.

Chart 33
Policy interest rate (% in nominal terms)



Source: BCRP (Central Reserve Bank of Peru) and BBVA Research Peru

7. Europe and the high global liquidity are the main external risks

The main risk factor is associated to more restrictive credit conditions in Europe

Europe continues to be the main external risk factor. The most likely shock there, however, is different to that included in our previous reports. How the bailout for Cypriot banks was handled could have major negative consequences on the confidence in other banking systems on the periphery and lead to worsening credit conditions that would delay economic recovery even further. The likelihood of this occurring is higher than that of the main risks we identified three months ago; but its impact would be more limited since the support provided by the European Central Bank would contain tensions regarding sovereign risk. As a result, the shock would be more limited to the European financial sector.

In this risk scenario, the Peruvian economy would be affected through a number of channels. First, the risk premium would increase, thus making finance more expensive; capital inflows would be reduced; and there would be stronger pressure on the exchange rate (depreciation of the local currency). Commodity prices and foreign demand would then both fall. Finally, business and consumer confidence would be reduced. Private investment would be the component of expenditure most affected in this situation, as we already saw in the crisis of 2008-2009.

The smaller size of the shock and growing strength of the Peruvian economy (see Table 4) make us believe that the local impacts would be relatively limited. The fiscal position has improved over recent years and there is room to implement countercyclical measures, while on the monetary side there are instruments available to make it easier to provide liquidity and support growth.

Table 4
Fiscal and external vulnerability indicators (% of GDP)

	2008	2013*
Gross public debt	25.9	19.8
Fiscal Stabilization Fund	1.4	3.6
NIR (% GDP)	24.5	34.6
NIR (over STFL** for the economy)	5.0	8.1

* Latest figures.
** STFL: short-term foreign liabilities
Source: BCRP

On the domestic front, the main risk is associated to massive capital inflows

In a context of high global liquidity, Peru has become an appealing destination for investment, and has been attracting foreign capital. The positive effects of these flows include access to foreign loans under favorable conditions. However, if these are excessive and short-term, the economy could suffer some unwanted effects.

T There are three ways that these capital inflows might have negative impacts on the economy. Firstly, they can exert strong appreciation pressure on the local currency, even driving it to below its equilibrium level, which would make the tradable sector less competitive (particularly the non-traditional sector), with negative impacts on employment and exports, and therefore increasing the current account deficit to unsustainable levels. Secondly, such capital inflows could finance excessive expansion of credit and domestic demand, leading to over borrowing by households and generating inflationary pressure. Likewise, appreciation of the local currency and the lower cost of foreign currency loans would make the latter more attractive, increasing the credit exchange rate risk. Finally, they could lead to an overvaluation of assets, for example in the non-tradable sector (real estate), which eventually could lead to a burst bubble with negative impacts on household wealth, consumption and activity.

The challenge facing economic authorities is to find ways of reducing the economy's vulnerability to these factors, which could be exacerbated in the event of sudden changes to the direction of capital flows. One option is to impose capital controls. However, some believe such restrictions are only effective in the short term because investors will eventually find avoidance mechanisms. Thus, the most widely accepted means of discouraging an excess inflow of capital looks to be macro-prudential measures as long as these do not restrict consumption or saving decisions made by households and companies.

8. Tables

Table 5
Annual macroeconomic forecasts

	2011	2012	2013p	2014p
GDP (y/y %)	6.9	6.3	6.5	6.3
Inflation (y/y %, EoP)	4.7	2.6	2.8	2.4
Exchange rate (vs USD, EoP)	2.70	2.57	2.49	2.48
Monetary policy interest rate (%, EoP)	4.25	4.25	4.25	5.00
Private consumption (y/y %)	6.4	5.8	5.7	5.3
Public consumption (y/y %)	4.8	10.0	9.0	4.5
Investment (y/y %)	5.1	14.9	12.2	6.8
Fiscal balance (% GDP)	1.9	2.1	0.9	0.9
Current account (% GDP)	-1.9	-3.6	-4.2	-3.9

Source: BCRP and BBVA Research Peru

Table 6
Quarterly macroeconomic forecasts

	GDP (y/y %)	Inflation (y/y %, EoP)	Exchange rate (vs USD, EoP)	Monetary policy interest rate (%, EoP)
1Q11	8.8	2.7	2.8	3.75
2Q11	6.9	2.9	2.8	4.25
3Q11	6.7	3.7	2.7	4.25
4Q11	5.5	4.7	2.7	4.25
1Q12	6.0	4.2	2.7	4.25
2Q12	6.4	4.0	2.7	4.25
3Q12	6.8	3.7	2.6	4.25
4Q12	5.9	2.6	2.6	4.25
1Q13	5.9	2.6	2.6	4.25
2Q13	6.7	2.7	2.6	4.25
3Q13	6.4	2.2	2.5	4.25
4Q13	7.0	2.8	2.5	4.25
1Q14	6.7	2.8	2.5	4.50
2Q14	6.1	2.7	2.4	4.75
3Q14	6.2	2.5	2.4	5.00
4Q14	6.3	2.4	2.5	5.00

Source: BCRP and BBVA Research Peru

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