BBVA

Peru Watch

Economic Research Department

First Semester 2009

Tensions in global markets ease

Impacts of the crisis become more evident

Inventories downward adjustment amplifies the economic slowdown

Inflation should converge to the target in the third quarter

The Central Bank accelerates policy rate cuts

Closing date: June, 1

Publication coordinated by:

Joaquín Vial jvial@bbvaprovida.cl

Publication prepared by:

Hugo Perea Flores hperea@grupobbva.com.pe
Francisco Grippa Zárate fgrippa@grupobbva.com.pe
Jasmina Bjeletic Saavedra jbjeletic@grupobbva.com.pe
María Cecilia Deza Delgado mdeza@grupobbva.com.pe
Javier Dorich Doig jdorich@grupobbva.com.pe
Rosario Sánchez Hidalgo rdpsanchez@grupobbva.com.pe

Editorial

The effects of the global financial crisis on the Peruvian economy become more notorious

Although somewhat delayed compared to the other countries of the region, the Peruvian economy has finally begun to feel with greater intensity the negative effects of the global financial crisis. In this respect, the slowdown of economic activity has been notable: the year-on-year GDP growth rate has gone from averaging 11.0 per cent in the first three quarters of 2008 to 6.5 per cent in 4Q08, and to 1.8 per cent in the first quarter of this year.

As expected, the most affected sectors have been those most highly exposed to foreign demand. Hence, in the current context of global economic weakness various substantial investment projects have been postponed, principally related to the mining industry. Even more worrying for its implications on employment is the contraction of exported manufactures, particularly textiles and the agriculture industry, activities which are labor-intensive.

It is worth adding that the process of inventories adjustment that followed the severe fall in sales in the final quarter of 2008 has amplified the slowdown in economic activity. It is estimated that this process will have subtracted nearly 4.9 percentage points from the year-on-year growth rate in 1Q09.

What factors must be taken into consideration in order to anticipate the dynamics of production in the second half of the year? Firstly, the progress of global economic activity, particularly that of the main trading partners of Peru. Even though there are signs of stabilization in the biggest world economies, there is still a high uncertainty context and it is expected that recovery will be slow. Secondly, we anticipate that the majority of the cuts in inventories will end during 2Q09, so that activity will cease to be weighted down by this process.

Finally, the effectiveness with which fiscal and monetary stimuli operate will be fundamental because they will be necessary to attenuate lower private expenditure. Regarding fiscal stimulus, it is worth mentioning that the implementation of public investment in 1Q09 was lower than expected; therefore, the Government should increase expenditure during the rest of the year. Taking into account that adequate steps have been taken to eliminate frictions in public expenditure, it is expected that in the second half of the year the fiscal stimulus will be more important. On the monetary side, the Central Bank has already reduced the policy rate by 350 basis points, and we estimate that in the third quarter it will reduce it by 100 additional basis points, taking it to 2 per cent. The transmission of these cuts towards credit rates should encourage a gradual recovery of consumption and private investment.

The overall assessment of these factors suggests that in the second half of 2009 GDP should perform better than what has been observed in 1H09, so that there should still be a positive growth rate for the whole of 2009. This is undoubtedly better than what we are seeing in almost all of the rest of the region, but it should not be ignored that this will imply a significant cost in terms of the production that will cease to be generated. In any case, it is important to stress that the vigorous easing of fiscal and monetary policies has limited these losses, thus demonstrating the benefits of fiscal and monetary prudence applied in the recent past.

Executive summary

Since March a change in market sentiment has been registered. On the one hand, it is related to the increase in measures to confront the global financial crisis, particularly by the United States. Hence, in this country stress tests on the balances of the main banking institutions have been carried out to determine their capital needs, and a Public-Private Investment Program has been announced which will seek to attract private investors to buy banks' toxic assets. On the other hand, monetary and fiscal stimulus policies have been accentuated. In this context, recent data suggests that global economic activity contraction is easing. All these have encouraged relatively greater market optimism, which has been translated into a reduction in risk aversion and a relaxation of financial markets tensions.

These positive effects have also reached emerging economies. Hence, in the same period, sovereign risks have strongly corrected downwards, upward pressures on interest rates have reversed, and capital inflows have begun to be registered, driving up assets prices. This would not only be related to the reduction of global risk aversion, but also to the perception of these economies as less risky. The latter would have been influenced by the International Monetary Fund greater resources availability to support these economies (in accordance with the G-20 summit agreement), added to which is the creation of a new credit facility from this institution to which economies that are fundamentally solid, but with temporary liquidity problems, can have access (an instrument that seeks mainly to prevent an eventual crisis, more than to reduce its impact). Very important in this perception of less riskiness have been the countercyclical fiscal and monetary policies that various emergent economies have implemented and whose effects should begin to be felt with greater intensity in the second half of 2009.

However, despite measures adopted in the developed world representing a favorable impact on global economic activity, the data that have appeared in the last months indicate that the downwards adjustment has been reduced, but has not stopped. That is to say, it is foreseeable that over the next few quarters falls in developed economies GDP will continue happening, although less sharply. Furthermore, supports for a rapid, significant and sustainable recovery are not clear. Therefore, we estimate that the end of the global recession will begin in 2010, that it will be slow and moderate, and that it will take longer in Europe than in the United States.

In this context, indicators of real economic activity also show a downwards adjustment in the emerging world. The slowdown of GDP in these countries (contraction in some cases, such as Eastern Europe or in some Latin American economies) in 4Q08 was sudden, initially as a consequence of the significant deterioration of foreign trade, and the effects have continued taking place in 1Q09. In the particular case of the Peruvian economy, it has been slowing down at a greater speed than expected, reflecting the most notorious effects of the global crisis and deterioration in households and firms future expectations. Hence, for example, after registering an average growth of around 11% yoy during the first three quarters of 2008, the rate of economic expansion fell to 6.5% yoy in 4Q08 and to 1.8% yoy in 1Q09. The greater speed with which the Peruvian economy has slowed down reflects a more pronounced deterioration in global activity and has been amplified by a downwards adjustment in inventories, which has been sudden and of great magnitude (reducing production levels). With this, employment growth has decreased (given the adjustment of inventories and lower business confidence) and private expenditure has slowed down (the expansion of private consumption fell from 9% yoy in the first three quarters of 2008 to 3.7% yoy in 1Q09, while gross fixed private investment went from 27% yoy to 1.8% yoy in the same period).

For how long will economic activity continue slowing down? According to surveys carried out last April, the majority of business people are inclined to think that this will continue to happen until mid-2009. Leading indicators of economic activity suggest something similar. Hence, for example, Central Bank surveys show that inventories continued declining and that purchasing orders and hiring of personnel will decrease in the short term; what is to highlight, however, is that the fall of inventories is increasingly smaller and that the disposition of businesses to increase purchasing orders and hire personnel is improving. On the other hand, consumers confidence, although still on the pessimistic side, has begun recovering in May. These data is consistent with the monthly development of GDP in seasonally adjusted terms, which indicates that it continued contracting until March, although increasingly at a lower rate. On the basis of this information, it is reasonable to think that the slowdown of the economy is close to being reversed.

In addition, since the third quarter of 2009 the impact of fiscal and monetary stimuli, the two supports for economic growth in 2009 and 2010, should be more notorious. In the first case, the fiscal stimulus should moderate in the short term the negative impact that the slowdown of private expenditure will have on aggregated demand and, hence, on the rate of expansion of economic activity. Moreover, given the emphasis on greater public expenditure on infrastructure, the positive impact on the economy will not only be in the short term, but also in the long term. This means that after the effects of the global risis are diluted, the country will emerge in a more solid position.

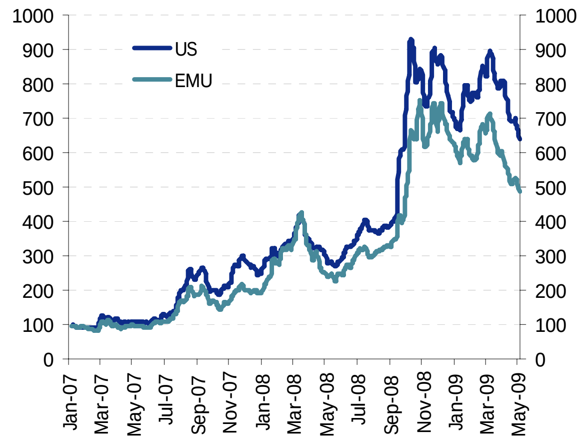
On the monetary side, the aggressive stimulus that has been provided by the Central Bank is transmitting more clearly to market interest rates, which will attenuate the slowdown of private demand. Interest rate reductions are already observed in the case of financial operations of shorter terms or with low-risk clients, and may also be seen in the next months in the case of mortgage loans (also induced by the fall in country-risk and lower funding costs of public resources intended for the financing of social housing); in terms of small businesses, credit conditions should be eased by the facilities (partial guarantees, for example) that the Government is granting for loans to this sector.

Therefore, we estimate that the slowdown of the Peruvian economy will continue until the second quarter of the year, and then begin a gradual recovery which will enable the year 2009 to close with an expansion of GDP of 2.4% and of 3.6% in 2010.

In terms of inflation, the upward pressures that took it to 6.7% year-on-year at the end of 2008 have disappeared. On the cost side, average international prices of food and fuel have decreased; on the demand side, its slowdown reduces the risk of inflationary pressures. In this context, the average monthly inflation rate in 2009 to date is 0.07%, which in annualized terms represents less than 1%, below the lower limit of the Central Bank's inflation target (2%, +/- 1pp). Added to that is the decreasing trend that inflationary expectations have shown (currently between 3.1% and 3.2% for 2009 and 2010). Therefore, it is estimated that inflation will converge in 2009 to the Central Bank target and that it will stay around this same level in 2010. This has provided room for monetary policy to act in a countercyclical way and complement the fiscal stimulus.

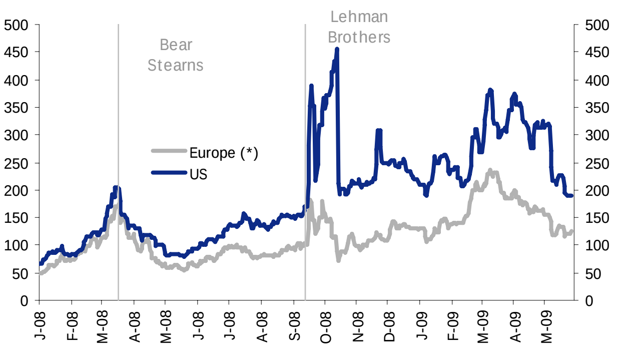
Finally, fiscal and foreign accounts balances, although negative in 2009 and 2010, appear to be sustainable. Hence the Peruvian economy will be hit by the global crisis but without generating imbalances. This should encourage the resumption of a significant and sustainable economic expansion rate in the coming years.

Indicator of financial tensions



Source: Research Department
The first standardized principal component of the OIS spread series, implicit stock market volatility, bank, corporate and sovereign (in the case of Europe) CDSs

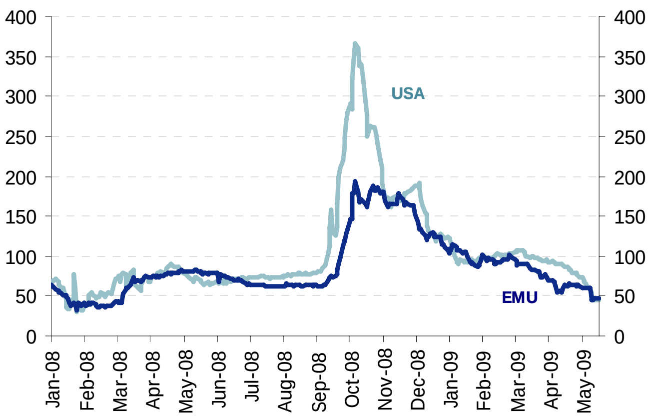
Banks: CDS senior debt 5 years (bp)



Source: Bloomberg

* Banks included:: Barclays, Barclays, RBS, Lloyds, HSBC, Alliance & Bingley, Standard Chartered, Allied Irish Bank, BNP, Deutsche Bank, ING, Unicredito, UBS, Credit Suisse, Credit Agricole, Societe Generale, Intesa, BBVA, Santander

Interbank markets: OIS three month spread (3M LIBOR – 3M OIS) (bp)



Source: Bloomberg

I. The Global Context

After a complicated beginning of the year, featuring high financial pressures and a severe decline in activity, tensions are decreasing in the second quarter.

Since the beginning of the year the global situation has continued to be characterized by high levels of tensions in financial markets, even though several indicators have shown considerable improvements over the last month. Hence, in May, US banks CDS reached the lowest level since the collapse of Lehman Brothers, and the Europeans –which are still under the Americans- their lowest level since November 2008. In addition, significant corrections have also been registered in the interbank markets, with the 3-month OIS spread in the US and the EMU reaching its lowest point since the beginning of 2008.

In the first months of the year, the contraction of the global economy was a fundamental element in maintaining increased rates of risk aversion. The data for 1Q09 continued showing a severe decline in activity in the US (-1.6% quarterly rate), with a rate of decline very similar to that of 4Q08. In Europe, indicators maintained an extraordinarily negative tone, with a quarterly GDP fall of 2.5% in 1Q09, higher than the 1.6% fall in 4Q08. However, the general tone of indicators on the situation using the data from April and May is generally less negative. This means that the rate of contraction on activity may be reducing, although negative growth will still be observed in the short term. The markets reacted very positively to this likely inflection, although because of uncertainty around the duration of the crisis, this movement may have vulnerable foundations.

Governments implement new measures to stabilize the situation

In this context, governments have bolstered measures to tackle the global financial crisis. The US remains the economy that has made most progress in the adoption of these policies, with a new programme of measures aimed at stabilizing the financial system. One key element of this program was the conducting of stress tests on the balance sheets of the major banking institutions, which revealed the capital needs of the system. As a result, 10 of the 19 largest American financial institutions must raise $75 billion of additional capital within 6 months. These results were well received by the market, generating a large part of the recent reduction in financial pressure. A second pillar is the Public-Private Investment Program, which seeks to attract private investors to buy toxic assets from banks through funds where the capital will be supplied jointly by the private and public sectors, with a highly significant level of leveraging. Finally, the Obama administration has implemented a plan to improve access to housing, which allows greater facilities to refinance mortgages and subsidies for those financial institutions that change the terms of the mortgages of families facing default risk. Our assessment of the banking stabilization strategy is positive, even though the implementation of the approved plans presents great complexities, and their impact could be limited unless all the elements are combined correctly.

In its turn the Federal Reserve has also played a crucial role in the financial stabilization process and is tackling deflationary risk mainly through asset acquisition. Hence, the Federal Reserve has embarked on a program to purchase $1,250 billion in mortgage bonds, and up to $300 billion in public debt. Additionally, the Federal Reserve plans to participate actively in funding the Public-Private Investment Program through the Term Asset-Backed Securities Loan Facility (TALF) program, which could reach around $1,000 billion.

In Europe, financial stabilization efforts have occurred mainly at the national level, with very different initiatives according to the country. Thus, Germany and Ireland are finalizing the details of a "bad bank" to buy the most toxic assets of the banks. In turn, the ECB continued with its process of lowering the interest rate, which was at 1% at the time of writing. The European monetary authority has decided to continue conducting weekly liquidity auctions through the fixed-rate system covering full allotment during whatever

Time is necessary and in any case until after the end of 2009, and has extended the term of loans made by the ECB up to 12 months. Additionally, in May the acquisition was announced of €60 billion of bank bonds, although the details are not yet known.

The adoption of these measures is justified as in the short term the key risk is that the persistence of a very weak economic situation results in negative inflation rates being maintained for too long. In addition, although the balance sheets of the central banks continue experiencing strong expansion, especially the Federal Reserve, the central banks should not have any difficulties in draining liquidity rapidly when the time comes, the way the Bank of Japan did at the end of their non-conventional monetary policy program.

Despite stabilization and the measures taken, recovery continues to be uncertain

The effectiveness of policies aimed at stabilizing the financial systems on the one hand, and of fiscal policies to boost demand on the other, will be the focus of attention in coming months. Their success will depend to a great extent on the answers to the questions of when the recovery will begin, how fast it will be, and which economies will prove most dynamic.

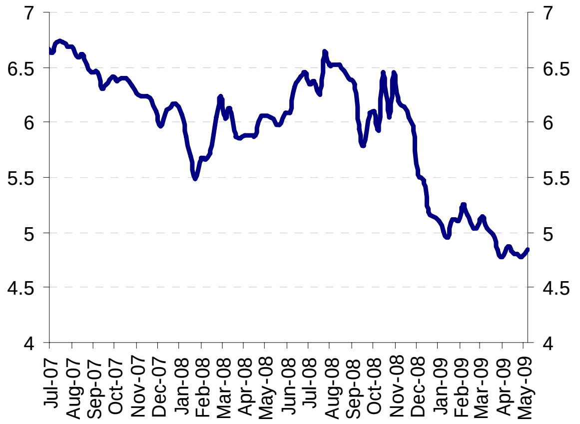
Despite the fact that these measures are having a favorable impact on the economy, the elements of a possible recovery in 2010 are still uncertain. Recent datas seem to suggest that the recession has bottomed out, so it is foreseeable that in the next few quarters falls in GDP will be lower. However, our perception is that the end of the recession, to occur in 2010, will in any case be with very moderate growth rates and below its potential growth. Besides, it is probable that it will occur later in Europe, given the slowness of the adoption of both financial stabilization and monetary policy measures. These uncertainties will oblige central banks to keep the official rates low for an extended period of time.

Emerging countries reflect the global situation, but are receiving important support

The financial indicators are showing very favorable progress in the last month, following a sharp deterioration in the last quarter of the past year which continued into the first quarter of this one. Sovereign risk spreads have corrected strongly, depreciatory pressures on currencies have reversed, and even inflows in emerging countries are again on the positive side, leading to significant rises in the stock exchange indexes.

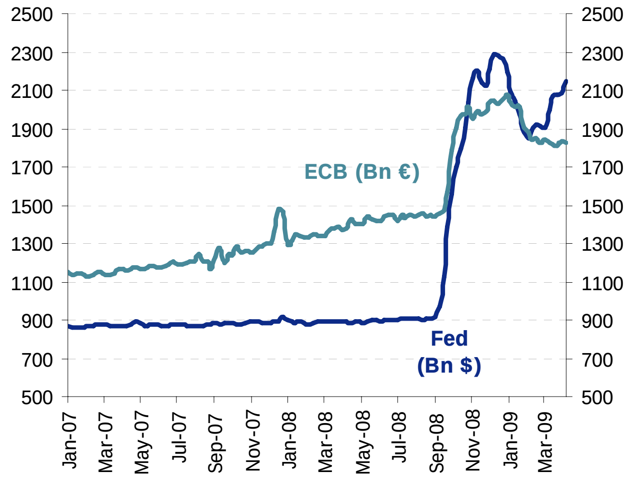
There is no doubt that one of the factors that have contributed to this movement has been the reduction of global risk aversion. But at least two additional factors should also be mentioned. On the one hand, the G20 summit has supported emerging markets through an increase in the provision of resources made available by the IMF. Additionally a new line of credit from the IMF has been created which may be used by economies which are fundamentally solid, but which may be experiencing temporary financing problems, this instrument to be more focused on preventing, rather than containing, an eventual crisis in the emerging economies. The success of this new formula has already been confirmed after applications from some countries such as Mexico, Poland and Colombia, and the positive reaction from the markets. Finally, but no less important, are the measures adopted on the domestic front to cushion the impact of the crisis. In this respect, we find that to varying degrees a large number of emerging economies have adopted demand, fiscal and monetary policies whose impact on activity will begin to be felt during the second half of the year, and in some economies already in 2Q09. China is clearly the most noteworthy example within the emerging countries, after the approval of a substantial fiscal stimulus package (16% of GDP over two years) and the exceptional relaxation of monetary conditions which have encouraged a reactivation of credit to the private sector. Also noteworthy is Latin America, which for the first time in this crisis has leeway to carry out the countercyclical policies which are being used.

Average 30 year mortgage interest rate in United States



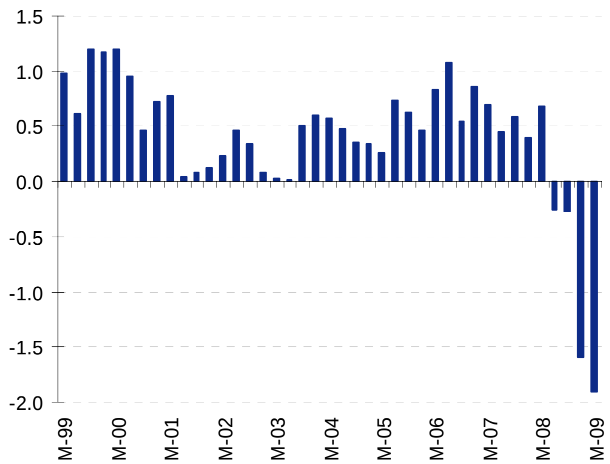
Source: Bloomberg

Central Banks: Total Assets

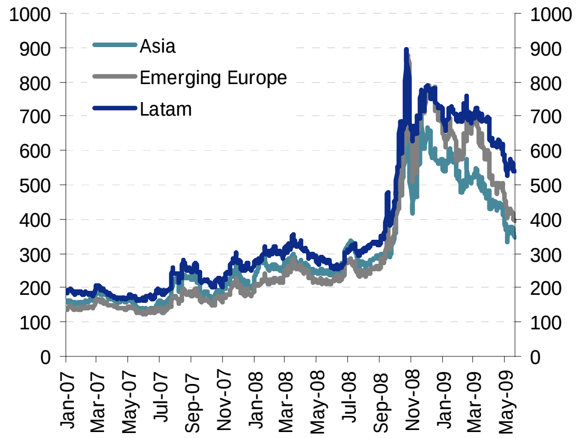


Source: Datastream

EMU: Growth of GDP (%, quarter-on-quarter)

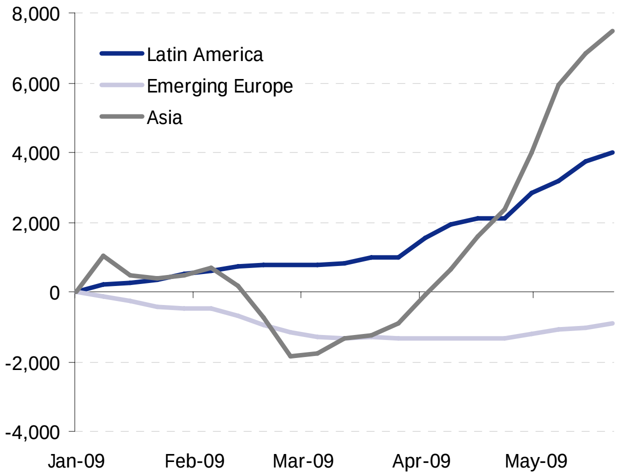


EMBI spread (bps)



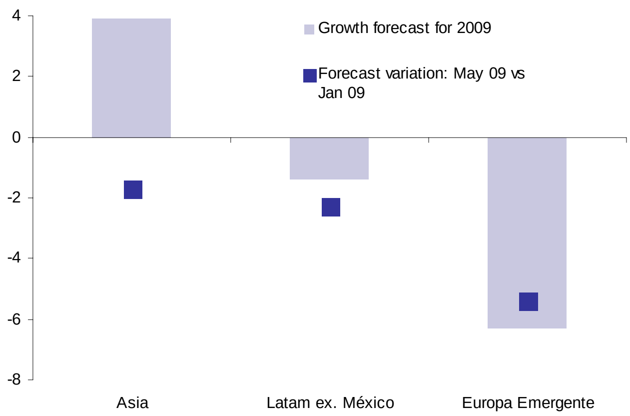
Source: Datastream y JP Morgan

Net income from equities: 2009 (accumulated, $bn)



Sources: BBVA and EPFR

Emerging economies: forecast of growth for 2009 and variation in the forecast since January



Source: BERD y BBVA

Nevertheless, the impact of the crisis on activity in emerging countries is significant. The GDP adjustment in 4Q08 was extremely sudden, fundamentally as a consequence of the collapse of international trade, which led to a downward adjustment of forecasts in the first months of the year. In this respect, it is important to emphasize the high degree of heterogeneity within the emerging world. The well-known vulnerabilities of emerging Europe – bulky fiscal and external imbalances, strong credit growth accompanied by high currency discrepancies, and high dependence on external financing - will bring about very intense adjustments. Hence, it is estimated that the region's GDP will fall around 6%, with some economies falling up to twice this figure, which entails an element of risk for western European economies. Overall, it is anticipated that emerging markets, led by Asia and with very moderate falls in GDP in Latin America, will grow at higher rates than the developed economies in coming years.

Despite weak global demand, commodity prices rose above the historical averages in the first quarter of 2009. More recently, commodity prices once again rose considerably due to significant production cuts and the perception in the financial markets that the worst of the crisis may have passed. Prospects for the valuation of the dollar should limit the current upward trend in commodities, but prices should keep supporting countries exporting commodities, including Latin American countries.

II. The Macroeconomic Context

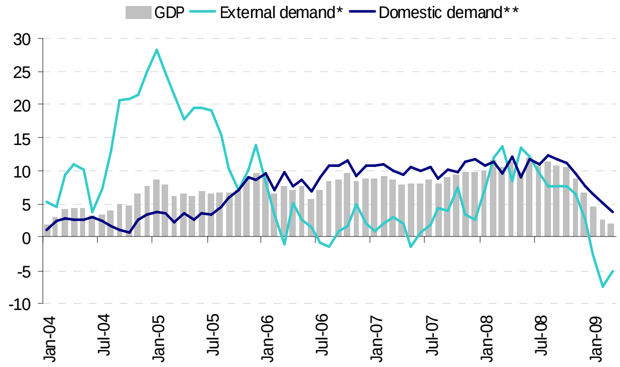
Impact of the global crisis becomes more evident

Since 4Q08, the Peruvian economy has shown a rapid slowdown in economic activity and employment. Hence, after reaching an average growth of 11% on January-September 2008, production began a new trend, registering an increase of 6.5% in 4Q08 and of 1.8% in 2009Q1. This decline is mainly explained by:

a. ***The increase of financial tensions and the contraction of global activity.*** The rapid deterioration of external conditions that followed the collapse of Lehman Brothers was reflected in the fall in commodity prices, a rise in spreads and a reduction of global trade. In this context, since the last quarter of 2008, Peruvian exports have fallen (both in prices and in volume), some private investment projects have been postponed, and initial pressures on local financial markets were perceived. By sectors, mining and manufacture were the most affected activities. Additionally, business expectations have deteriorated, and, consequently, various spending decisions have been revised.

b. ***A rapid and severe adjustment of inventories, principally in manufacturing.*** The sudden deterioration of external conditions and the fall of commodity prices left local producers with a significant amount of unwanted inventories. In order to eliminate such surpluses, firms have had to cut back, and, in some cases, stop production, even in a greater proportion to that of the fall in demand (see Article *The Economic Stimulus Plan to tackle the global crisis*).

GDP and domestic and foreign demand
(y/y % chg. – moving average 3 months)



(*) Exports
(**) Excluding inventories
Source: BCRP
Prepared by: BBVA Banco Continental ERD

Economic activity will tend to improve towards the second half of the year

Various indicators suggest that the economic slowdown could be moderated in 2H09. Therefore we expect the economy to show a better performance in the last part of the year. This outlook assumes:

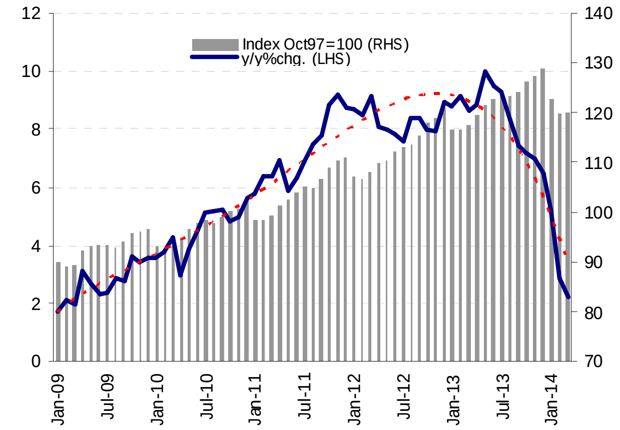
a. Stabilization of global activity, in coherence with recent financial and activity indicators.

b. The more noticeable impact of the Economic Stimulus Plan (ESP) expected for the second half of the year. It is assumed that the implementation of public infrastructure projects, basically in transport (under the category of both public and Public-Private Associations), will accelerate and support economic growth.

c. Further monetary policy easing in order to stimulate private spending.

d. The inventories adjustment process would have already finished. In such a situation, we expect that in 2H09 inventories adjustment should not exacerbate the economic slowdown anymore. Moreover, we expect firms to adapt their production levels to the new demand level.

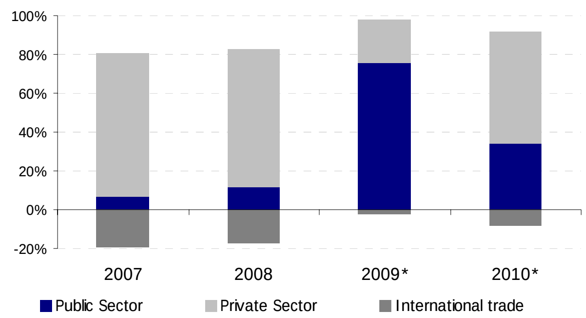
Urban employment in firms with 10 or more workers
(y/y % chg.)



Source: MINTRA
Prepared by: BBVA Banco Continental ERD

Aggregate real demand: recent quarterly data				
(yoy % change)	**II-08**	**III-08**	**IV-08**	**I-09**
Total consumption	9,0	9,0	6,9	4,3
Private	9,4	9,5	8,0	3,7
Public	5,5	5,0	-1,0	8,2
Gross Fixed Capital Formation	35,8	31,5	21,2	4,0
Private	32,5	27,7	21,0	1,8
Public	60,2	56,8	21,7	22,2
Domestic Demand	**14,6**	**13,5**	**9,1**	**-0,8**
Exports of Goods and Services	11,4	6,5	2,1	-3,0
Imports of Goods and Services	26,3	19,0	14,1	-13,7
GDP	**11,7**	**10,7**	**6,5**	**1,8**

Economic activity: contribution to growth



(*) Forecast
Source: BCRP
Prepared by: BBVA Banco Continental ERD

Investment projects for 2009 (USD bn)

Company	Investment	Total (US$ bn)
Peru LNG	Camisea II	600
Telefónica del Peru	Investment to extend network coverage	250
Dubai Ports	Muelle Sur (Callao)	250
Vale	Bayovar Phosphates	200
Votorantim	Extension of the Cajamarquilla Refinery	200
Chinalco	Toromocho (copper)	190
Odebrecht and others	Transcontinental highways (IIRSA south and north)	170
Various	Investment in exploration and exploitation	150
Soc. Hoteles del Peru	Hotel infrastructure projects	100
Shougang	Marcona	100
Inmobiliari	Real estate projects	100
Kallpa	Thermal power station Kallpa 2	85
TGP	Extension of the Camisea pipeline	75
Maple	Ethanol plant	10
	Total (US$ bn)	**2,480**

Source: BCRP and investment announcements
Prepared by: BBVA Banco Continental ERD

Public expenditure will attenuate the slowdown in private expenditure

On the demand side, we expect a re-composition for this year and the following one, in which the private component will slow down and greater public spending will reduce the impact on growth. Hence, the downward pace of consumption and private investment will be partly compensated by public investment (and consumption), mainly in 2H09.

The slowdown of private consumption is related to: (i) lower employment growth, (ii) lower households income, and (iii) adjustment of growth expectations.

In the same way, the expansion of private investment will be lower than that observed throughout 2008. This adjustment would respond to the following factors: (i) the difficult external scenario which, together with high risk aversion, will deter flows of foreign investment towards emerging countries, making sources of funding more expensive, (ii) the process of inventories adjustment, which will imply the postponement of some private investment projects, and (iii) the correction in commodity prices, which will reduce the profitability of projects and make some of them non-viable.

As a result, of the total portfolio of projects (up to a total of USD 27 billion) expected to be implemented in the next 4 years-, around 65% will continue. Investment plans that are expected to continue are those of the Shougang (the Marcona project), Chinalco (the copper project Toromocho), Votorantim (the extension of the Cajamarquilla refinery), Odebrecht (the construction of the IIRSA Sur highway) and Dubai Ports (Muelle Sur del Callao). On the other hand, within the group of projects whose implementation has been postponed or which are being evaluated, the majority belongs also to the mining and hydrocarbon sectors, in which could be mentioned the copper projects Los Chancas, Minas Conga and La Granja, the modernization of the Talara refinery, and the extension of plants by PetroPeru and Aceros Arequipa.

The public sector will act in a countercyclical way, seeking to compensate for the slowdown of private spending. Therefore, more than 50 public infrastructure projects have been prioritized, focused mainly on highways, education, health and sanitation. At the same time, within the ESP, the concession of 12 Public-Private Association (PPA) projects on roads, ports and airports will also be prioritized, like the Taboada water treatment plant; the ports of Paita, San Martin (Pisco), Salaverry, Pucallpa and Iquitos, the “Autopista del Sol” (Trujillo-Sullana), the “IIRSA Centro” highway and the second group of regional airports. The first two projects were granted in February and March, respectively.

Among productive sectors, the most affected will be mining, the agricultural industry and certain manufacturing sectors, all of them exposed to the contraction in foreign demand. Regarding sectors most exposed to domestic dynamics, one of the most affected will be commerce, given the context of the slowdown of private spending and the inventories adjustment.

Aggregate real demand: annual data

(yoy % change)	2007	2008	2009(p)	2010(p)
Total consumption	7,8	7,9	2,5	2,8
Private	8,3	8,7	2,3	2,7
Public	4,5	1,8	4,1	3,6
Gross Fixed Capital Formation	22,6	28,1	7,4	8,0
Private	23,4	25,6	2,1	5,0
Public	18,2	42,8	35,0	20,0
Domestic Demand	11,8	12,3	2,3	3,8
Exports of Goods and Services	6,2	8,2	-4,8	3,7
Imports of Goods and Services	21,3	19,9	-3,8	4,7
GDP	8,9	9,8	2,4	3,6

Savings accumulated on previous years will allow the implementation of countercyclical fiscal policy measures

In 2008 there was a fiscal surplus for the third year in a row (2.1% of GDP), as a result of high flows of current revenues during the first three quarters of the year, in a context in which investment expenditure grew in an important way at all levels of government. 4Q08 made the difference, as the reduction of fiscal revenues was followed by a severe public expenditure adjustment which was implemented in order to mitigate the expansion of domestic demand, in a context in which inflation showed an upward pattern related to higher international commodity prices and inflationary expectations were deviated from the Central Bank inflation target.

For this year we expect the fiscal outcome to be negative, driven by the reduction of public revenues (both tax and non-tax, in coherence with the correction of commodity prices) and, mainly, by the implementation of the Economic Stimulus Plan, that will imply additional spending to the approved Budget (see box *The Economic Stimulus Plan to tackle the global crisis effects*). For 2010, a lower fiscal deficit is expected due to i) a gradual recovery in fiscal revenues (in line with the greater dynamism of economic activity), although it will remain at levels below those seen in the years before the crisis, and (ii) a smaller fiscal stimulus, given the recovery of private spending expected for that year.

It is worth mentioning that, recently, fiscal limits on deficit and public consumption growth have been modified, seeking to establish an adequate legal framework for the implementation of the Economic Stimulus Plan. At the same time, it is important to indicate that the implementation of this fiscal stimulus will not compromise the sustainability of public finances since the deficit estimated for 2009 and 2010 will be lower than its sustainable level, estimated at 1.6%.

External accounts at sustainable levels

The current account will record a deficit of 3.3% of GDP, similar to the result of 2008. On the one side, the global economic contraction will impact negatively on exports (slowdown in external demand and lower international prices for exported commodities), the balance of services (tourism revenues) and transfers (remittances). Nevertheless, these downward effects will be compensated by lower imports (related to the deceleration of private domestic spending and the adjustment of inventories) and by the improvement in investment income (lower profits from mining firms).

Regarding the financial account, Foreign Direct Investment (FDI) flows will reach USD 2.5 billion, lower than its levels of end 2008 (USD 4.1 billion). However, lower private capital inflows in the short and long term will be partially offset by the issuance of Government bonds abroad (USD 1.0 billion at the end of 1Q09).

For 2010, we expect a lower deficit in the current account as a percentage of GDP, related to an improvement in the trade balance, driven by the recovery of global activity. Given the structure of financing above mentioned, external results for 2009-2010 are sustainable.

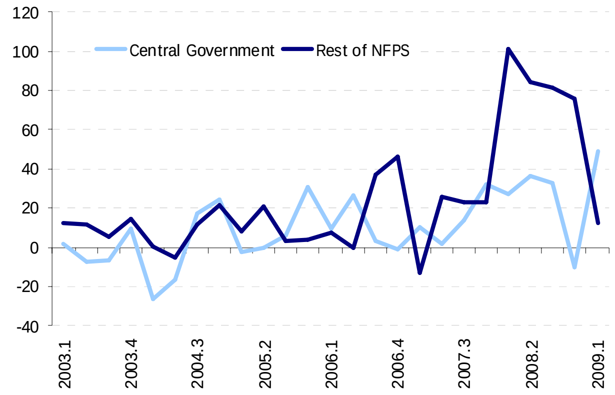
Risks for our central scenario

The main risks that may alter our central forecasts are the following:

a. An external scenario that is more complicated than originally expected
b. A process of inventories adjustment more extended by time and economic sectors,
c. The Economic Stimulus Plan is not implemented as expected way, or its impact on economic activity, employment and consumer and business confidence is lower than estimated.

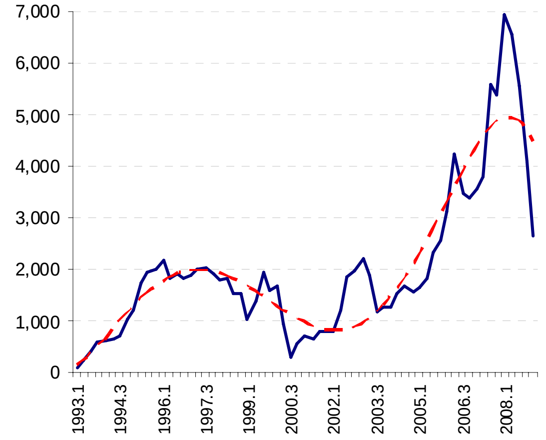
In this scenario, the downward impact on local activity will have a negative effect on job creation, which could imply the possibility of greater political and social conflicts, mainly given the proximity of the regional/municipal elections of 2010 (which could be considered as the first round of the general elections of 2011).

Public Investment (y/y % chg.)



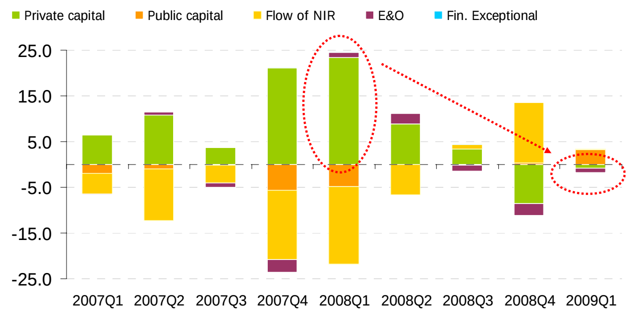
Source: BCRP
Prepared by: BBVA Banco Continental ERD

Foreign Direct Investment (Moving sum 12 months – millions of USD)



Source: BCRP
Prepared by: BBVA Banco Continental ERD

Current account deficit by source of financing (% of GDP)



Source: BCRP
Prepared by: BBVA Banco Continental ERD

The deterioration of economic and financial conditions in the developed world that followed the collapse of Lehman Brothers has affected the dynamism of private spending in an important way. In this context, economic authorities around the world have implemented various fiscal policy measures in order to compensate the deceleration of both consumption and private investment.

Following this trend, in Peru, the Economic Stimulus Plan (ESP) was announced at the beginning of the current year. Due to the positive fiscal results achieved in previous years, this is the first time our country can implement a countercyclical policy. Additionally, it is worth stressing that the Peruvian fiscal package is almost totally focused on infrastructure spending.

The ESP totalizes S/. 12.6 billion[1] (3.2% of GDP) for 2009-2010. In this total, measures intended to stimulate the infrastructure of the country have the highest weight (69% of the total) and are mainly focused on highways, health, sanitation and education. The emphasis on infrastructure projects seems to be appropriate because its impacts in the short term and, simultaneously, its capacity to generate sustainable growth when the crisis has passed. The remaining total of the ESP will seek, among other things, to act more directly, reducing possible negative effects on employment as well as compensating SME's for the higher risk perception. Complementing these actions, administrative processes facilitate the spending execution.

Peru: Economic Stimulus Plan

Item	Main measures	Structure (%)
Stimulus to economic activity	Purchases to SME's Guarantees to loans of exporting companies Labor productivity	15.8
Infrastructure	Priorized of public projects Infrastructure fund Highway maintenance	68.5
Social protection	Maintenance of schools Fund for social programs	9.9
Others	Incentive to local governments	5.8
Total		**100.0**

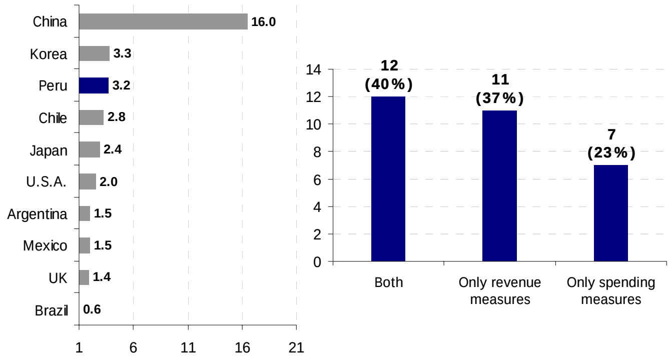
Source: EMU
Prepared by: BBVA Banco Continental ERD

The ESP is, as a percentage of GDP, one of the largest in Latin America and in the world, and it does not include tax reduction measures, which seems suitable considering that the relevant literature find that fiscal multipliers of taxes are less than public expenditure ones[2]. Hence, in the current scenario, the increase of income available to families through tax reduction could be directed towards savings or the payment of debt, which would not stimulate private spending in the short term. In this document, the authors review a long list of studies produced on the subject of fiscal multipliers and their impact on production at different moments in time.

Regarding the Budget approved for 2009, the ESP implies additional spending of around S/. 4.2 billion (1.1% of GDP). If this amount is entirely executed in this year, public investment could grow almost 50% in real terms.

Although certain delays have been perceived during the first half of the year, this performance seems to have been reversed in the last few months[3]. In this respect, the growth of public investment in the 2009Q1 has been 24%, driven basically by the dynamism of regional governments and, to a lesser extent, national government.

Size (% of 2008 GDP) and distribution* of the fiscal packages by type (%)



Source: BBVA, IMF, CEPAL.
Prepared by: BBVA Banco Continental ERD
(*) Considering a sample of 30 countries (Latin American and the US)

It is expected that the ESP execution will be greater over the coming months, given that i) prioritized public expenditure projects accounts for small amounts, and that ii) in the first quarter, the execution rate to these projects was still mall (10% on average).

As a consequence of this stimulus, a fiscal deficit is expected in 2009, the first negative result after three years of fiscal surplus. However, this deficit will not compromise the sustainability of the fiscal balance because the ESP in 2009 will be financed mainly by the funds accumulated in 2008 (around 1% of GDP), inasmuch as the resources the Government maintains in the local financial system (13.1% of GDP), which includes funds accumulated by the surplus of previous years that can support additional stimulus if legal requirements for their use are fulfilled.

Final considerations

In terms of size, opportunity, temporality and sustainability, the ESP will be the main supports for economic activity, contributing with around 1 pp to the expected growth of 2009, with the greatest incidence within 2009H2. Moreover, it reflects the relevance of resource accumulation during the years of high economic dynamism.

It is worth noting that the fiscal stimulus will not only have positive effects in the short term on the economy, compensating for the slowdown of private spending, but it will also have important effects in the long term, through the improvement of physical infrastructure. This will mean that once the negative effects of the international crisis have passed, the country will emerge in a more solid position.

Finally, it is worth mentioning that the success of the Economic Stimulus Plan in achieving the aforementioned objectives will depend basically on the following elements: i) the speed and efficiency with which the resources of the Economic Stimulus Plan are implemented over the year, ii) the capacity to adapt the Economic Stimulus Plan to an scenario in which the magnitude and duration of the crisis in the developed world and its local effects might be greater, which implies rationing the available resources appropriately, and iii) the facilities granted for the execution of the investment projects in financial and administrative terms should be consistent with a constant improvement in their quality.

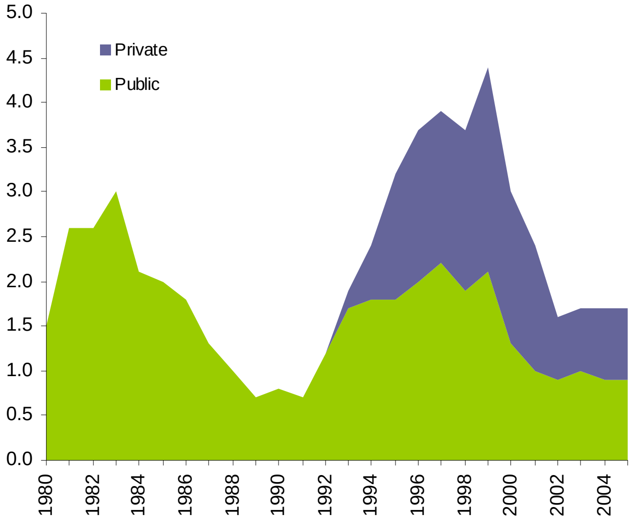
Maria Cecilia Deza
mdeza@grupobbva.com.pe

[1] Billions. As of May 14, 2009.
[2] Spilimbergo, Symansky y Schindler (2009). Fiscal Multipliers, IMF SPN 09/11. May 20, 2009.
[3] Particularly, in March, additional funds included for IIRSA Sur project pressed the growth of public investment upwards.

Box Infrastructure investment: Participation of the private sector through the private pension fund managers

In Latin America, investment in infrastructure has been historically low, with an amount equivalent to 1.3% of GDP, while in Asia is more than 5% and in the world is around 2%. As a result of this low level of investment an infrastructure deficit has been generated that does not encourage sustainable development in the countries of the region. In the case of Peru, according to recent figures the deficit in infrastructure amounts to about USD 43 billion (35% of GDP)[4] and is reflected in deficiencies in sanitation, energy, communications and transport, among other sectors.

Public and private investment in the public service infrastructure, Peru 1980-2005 (% of GDP)



Source: MEF, MTC, VMCS, MINEM, OSIPTEL, OSITRAN, Calderón and Servén (2004).

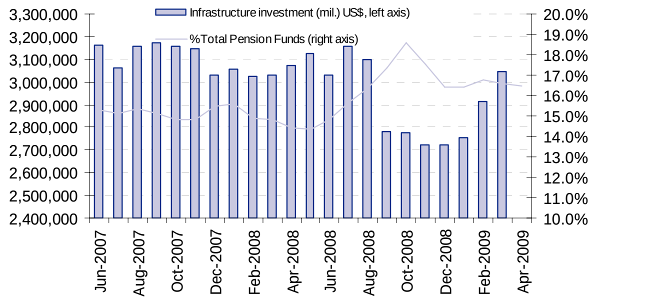
With the slowdown of the emerging economies after the collapse of Lehman Brothers, fiscal stimulus plans have begun to be implemented in some of these countries, which include an important component of investment in infrastructure. In this context, the President of Mexico recently announced that the Federal Government will boost public and private investment in the infrastructure by a total sum of more than USD40 billion in the current year. In Brazil, in turn, expenditure on infrastructure will be increased up to USD 61.3 billion. Chile and Peru have also made announcements of increases of spending on infrastructure as part of the tax incentives that they are implementing.

This type of countercyclical response to the economic slowdown is appropriate. On one side, it compensates in part for the reduced expansion of private expenditure in the current atmosphere of international crisis. In this sense, Norman Anderson, the president and founder of CG/LA, the American consultancy that specializes in infrastructure, states that “investing substantially in infrastructure can cushion the impact of the financial crisis on real economies”. However, the favorable impact is not only in the short term: the accumulation of capital allows the productivity of the workers and the competitiveness of the country to be increased. This way, fiscal stimulus by this route also favors the sustainable growth of the economy and the generation of permanent employment, with the consequent increase in the income of families and the improvement in their welfare.

How to make the private sector participate in this process? In the particular case of Peru, the countercyclical response of the Department Treasury has not only happened through the boost to public investment in the infrastructure, but also the implementation of facilities is being speeded up in order that the private sector can participate in the improvement of the infrastructure of the country. Among the economic actors that may be interested are the Administradoras de Fondos de Pensiones- AFP (Private Pension Fund Managers). This interest is based on the fact that AFP are long term investors (their liabilities are long term), but in the local market assets that can be acquired for these periods are not abundant; investment in infrastructure, over an extended term of maturity, allows them to match maturities better on their balance sheets. Additionally, the regulatory framework has been made more flexible: in 2001, the Superintendency of Banking and Insurance passed a law that allows the purchase of instruments linked to infrastructure projects.

Under this framework, the AFP have accumulated a total investment in infrastructure[5] that rose in December 2008 to approximately USD 2.7 billion. It is estimated that these agents will have additional funds that could rise to USD 1.5 billion in order to continue making this investment.

Private Pension Fund Managers infrastructure investment:



Source: Superintendency of Banking and Insurance, March 2009

These totals, however, could be better. To increase them, the Peruvian Government has authorized the creation of an infrastructure investment fund of USD 500 million, whose main objective is to attract private capital to stimulate investment in infrastructure projects. The first step has already occurred with the contribution of US$ 100 million of capital from the Ministry of Economics to the Corporación Financiera de Desarrollo (Financial Development Corporation) to start the fund. Multilateral agencies, such as the Corporación Andina de Fomento (Andean Development Corporation) and the International Development Bank will participate with US$100 million, while the remaining US$300 million will be contributed by the AFP. It is worth mentioning that the policy of investment to be employed is still not clear, neither is the identity of the manager of the investment fund who will be in charge of its administration. In addition to the decision to create the infrastructure investment fund, other measures have been studied to promote private investment of this type and to help close the gaps in the existing infrastructure. One of these is the creation of a trust for infrastructure works, in which the AFP will make a contribution of capital to its resources and will evaluate each project in order to give its approval. This measure has a series of advantages, among the most important its rapid and cost-effective implementation, thus stimulating investment in this type of project.

In summary, the international financial crisis will serve as a catalyst to stimulate investment in infrastructure, which will not only have short term but also long term benefits.

Jasmina Bjeletic
jbjeletic@grupobbva.com.pe

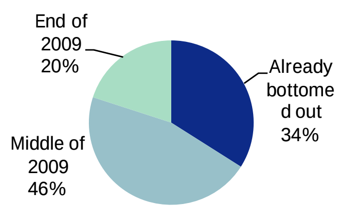
[4] According to the Institute of the Economy and Business Development (2008). Includes social infrastructure (hospitals, schools, prisons, etc) and economic infrastructure or infrastructure with productive objectives (roads, bridges, electrification, water, etc.).

[5] Includes both direct and indirect investment. The first refers to the purchase of debt instruments or equity issued by the companies awarded the infrastructure projects, while the second refers to the purchase of participation quotas in investment funds that are specialized in infrastructure.

Box Leading indicators and the turning point for the Peruvian economy

Since the third quarter of 2008, the Peruvian economy has registered a slowdown, the product of the deterioration of global activity. How long will this process continue? According to a survey carried out by Apoyo Consultoría last April, the majority of business people believe that economic activity has still not bottomed out, but rather this will occur towards the middle of 2009, presumably within the second and third quarters (see **Chart 1**).

Chart 1: When do you think the Peruvian economy will bottom out?

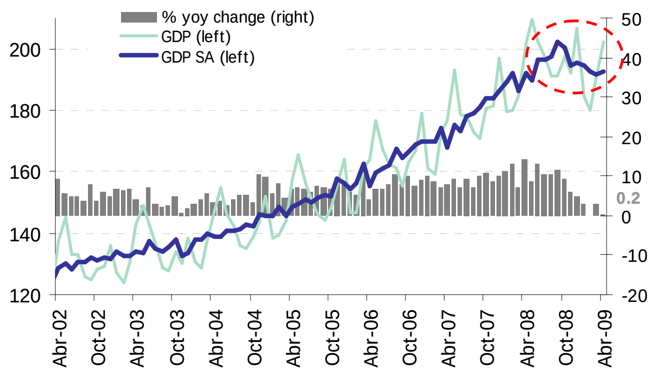


Source: Survey SAE Apr09 (Apoyo Consultoría)

What indicators must we see?

- **Seasonally adjusted GDP:** at times when a breakdown in economic activity trends occurs, the year-on-year growth rate of GDP loses relevance, as it does not reflect the lower dynamism of production. In these cases, a better measure of the development of activity is seasonally-adjusted GDP, which allows for making comparisons between two months or quarters. In fact, this indicator shows a contraction since October 2008 (see **Chart 2**), after the collapse of Lehman Brothers which resulted in greater aversion to risk, pressures in the financial markets, falls in commodity prices and a deterioration in the confidence of families and companies. However, the rate of contraction has been reducing in the last few months, which could be in anticipation of a certain stabilization.

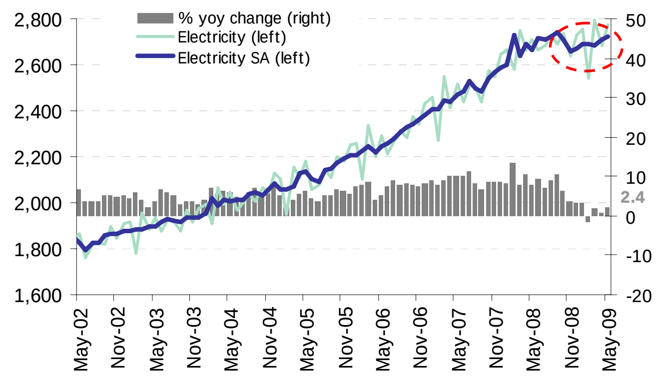
Chart 2: Gross Domestic Product (GDP)*



*Seasonally adjusted through the method Census X12
Source: INEI

- **Electricity production:** according to information available at the end of May, energy generation bottomed out in December 2008 (see **Chart 3**), after which it has been recovering to levels before the collapse of Lehman Brothers. This could be reflecting the performance of industry and mining, the two main energy customers (they account for more than 50% of electricity demand). In the latter case, seasonally adjusted mining production has been recovering since March, in the context of higher international prices for base metals.

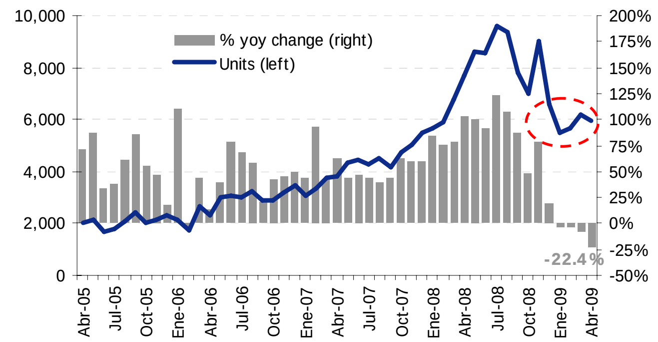
Chart 3: Electricity production (Gw/h)



Source: COES-SINAC

- **New car sales:** this indicator reached the lowest level in January (see **Chart 4**). Since then, sales have been stabilizing at levels close to 6 thousand units monthly, 40% below the maximum reached in 2008.

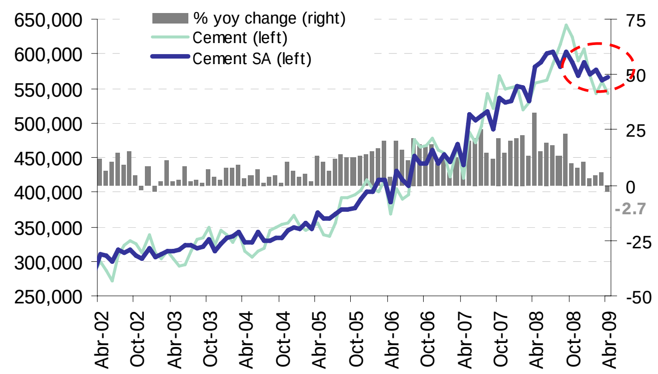
Chart 4: Sales of new cars (units)



Source: APAPER

- **Sales of cement:** sales of cement (the principal indicator of dynamism in the Construction sector) will have bottomed out in the month of March (see **Chart 5**). Looking ahead, their recovery is expected in line with the advance of the implementation of the Economic Stimulus Plan (see Box *Economic Stimulus Plan to confront the external crisis*).

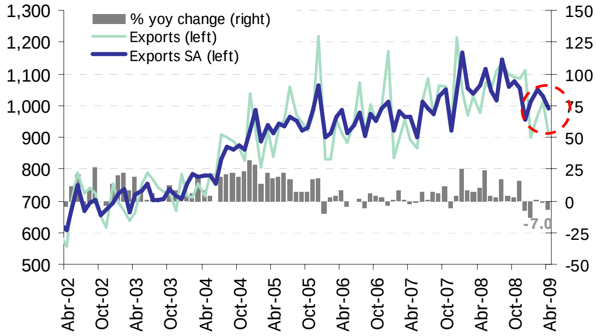
Chart 5: Sales of cement: (tons)



Source: ASOCEM

- **Exports:** it can be seen from information from the month of April that the exports of goods in real terms would already have breached its lowest levels towards the end of 2008 (see **Chart 6**). This is consistent, for example, with the recovery of consumption in the United States, where in 4Q08 it contracted 4.3% (compared to the previous quarter), to later grow (according to advance data) 1.5% (compared to the previous quarter) in 1Q09. It is worth mentioning, however, that the progress of consumption in the United States may not be sustainable because, in part, it is supported by the reduction of taxation (a one-off upwards effect) and by the high indebtedness of American families.

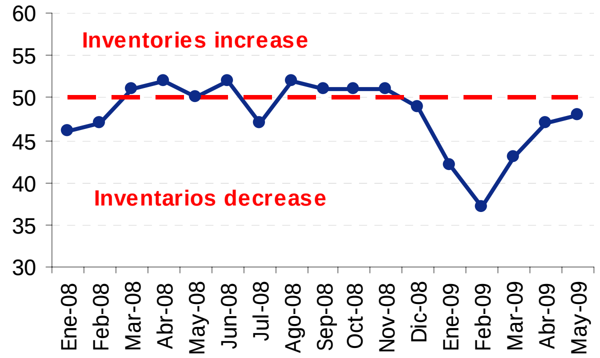
Chart 6: Real Exports (US$ millions of 1994)



Source: BCRP

- **Inventories:** According to a monthly survey of the main industrial and commercial companies of the country, the proportion of companies that registered falls in inventories increased between November 2008 and February 2009 (see **Chart 7**).

Chart 7: Index of Inventories

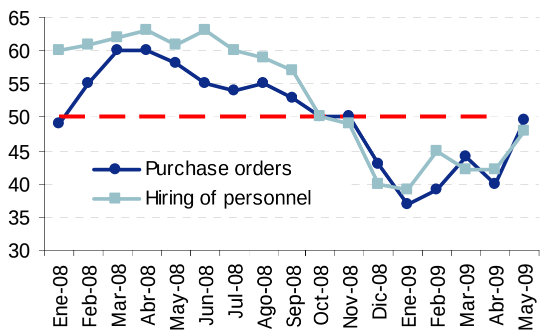


Source: Survey of expectations of the BCRP

Since February, although the index of inventories continues to lie in the negative zone (reduction of stocks), the rate of fall is increasingly lower. In fact, up until the month of May, the index is very close to neutral (50), which suggests that the balance of inventories may be achieving desired levels in the next few months. Hence companies could resume production levels in accordance with the new demand.

- **Purchase orders and hiring of personnel:** these two indicators, extracted from surveys, fell to their lowest point between January and February 2009 (see **Chart 8**). By May, they were still on the negative side (fall in purchase orders and lesser intention to hire personnel in the next 3 months), although both indicators will be closer to their turning point.

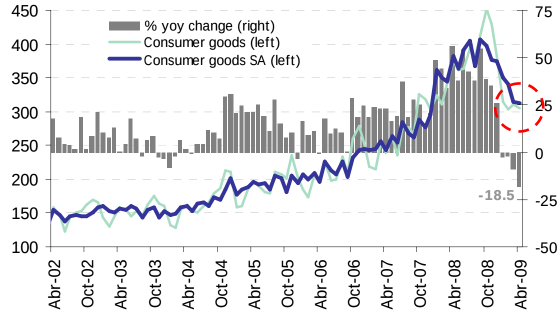
Chart 8: Purchase Orders and Hiring of Personnel:



Source: BCRP Survey of Expectations

- **Imports of consumer goods:** As of the month of April, imports of consumer goods have still not stopped falling (see **Chart 9**). This would be consistent with an adjustment in the inventories of trading companies, given the greater dynamism of sales in the last few months. The fall will be greater in the case of those companies that trade in durable consumer goods, such as motor vehicles (dealers) and domestic electrical goods (department stores).

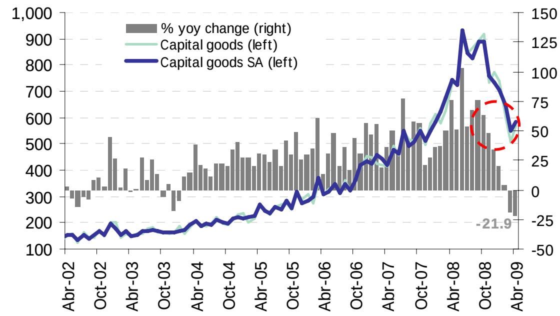
Chart 9: Imports of consumer goods (US$ million)



Source: BCRP

- **Imports of Capital Goods:** As of the month of April, imports of capital goods show certain signs of stabilization (see **Chart 10**). Even so, imports of machinery and equipment are at 2007 levels.

Chart 10: Imports of Capital Goods (US$ million)



Source: BCRP

Assessment

The majority of economic indicators suggest that economic activity will still not have bottomed out (see **Table 1**), although it will be close to doing so in line with what business people expect.

Table 1: Economic activity indicators

Indicator	Final data	Bottomed out?	When?
Seasonally adjusted GDP (index)	Mar-09	No	-
Exports of goods (real index)	Apr-09	Yes	Dec-08
Imports of Capital Goods (US$ millions)	Apr-09	Yes	Mar-09
Imports of Consumer Goods (US$ millions)	Apr-09	No	-
Sales of cement: (tons)	Apr-09	Yes	Mar-09
Intention to hire personnel (index)	May-09	No	-
Inventories (index)	May-09	No	-
Purchase Orders (index)	May-09	No	-
New car sales (units)	Apr-09	Yes	Jan-09
Electricity generation (Gw/h)	May-09	Yes	Dec-08

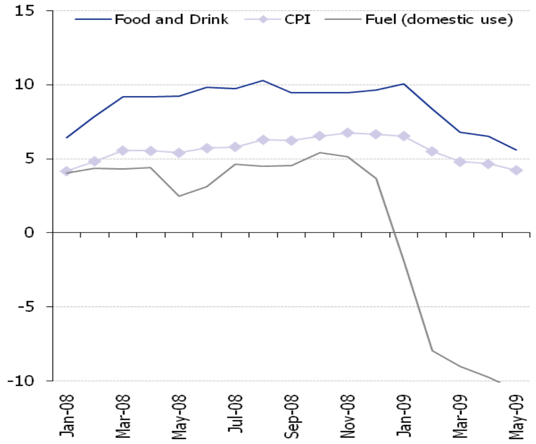
Prepared by: BBVA Banco Continental ERD

We estimate that the economy may bottom out in the second quarter of 2009. The recovery will be based on: (i) a financial stimulus that will have a major impact in the next few months, (ii) lower rates of interest, due to monetary flexibility, and (iii) the culmination of the process of adjustment of inventories.

However, two other conditions must be in place for the recovery to be sustainable: (i) the stabilization of the world economy; and (ii) that the growth in private spending (consumption and investment) recovers, so that economic activity depends increasingly less on fiscal and monetary stimulus.

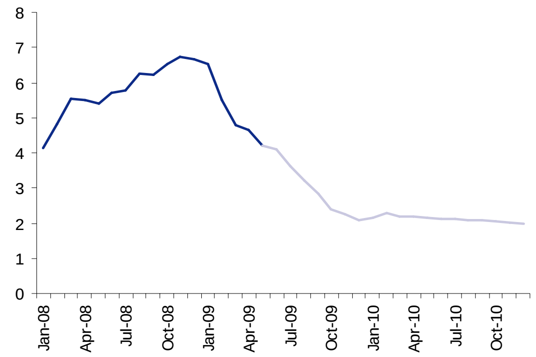
Javier Dorich
jdorich@grupobbva.com.pe

Inflation
(yoy % change)



Source: INEI
Prepared by: BBVA Banco Continental ERD

Inflation forecast for 2009 and 2010
(yoy % change)



Source: INEI, BBVA
Produced by: BBVA Banco Continental Economic Research Department.

Inflation shows a downwards trend in the first months of 2009

Different from that seen during 2008, the year-on-year inflation rate has shown a downwards tendency in the first half of the present year, positioned at 4.2% at the end of May (6.7% at the end of 2008). Lower inflationary pressures are also being certified, observing that inflation accumulated in the first five months is 0.4%, 1.2% in annualized terms.

This rapid decline in inflation is explained mainly by cost factors: Firstly, the reduction in food prices stands out (a principal component of the shopping basket, to a percentage of 47.5%), in a context of lower international grains and cereals prices, supplies that are employed in the local production of processed foods (oils, flour, poultry products, among others). A second factor is the reduction of local fuel prices, reflecting the fall in the international markets of the price of petrol. Hence, prices of fuel for domestic use registered in May a reduction of 10.6% in year-on-year terms, while prices of fuel for vehicular use registered a fall of 23.9%.

In terms of underlying inflation, this also has declined, although at a lower rate (5.8% in February and 5.1% in May). This gradual change is sustained in an increase of private consumption by 3.8% in 1Q09.

Year-on-year inflation will end the year around 2%

The downward trend of the year-on-year inflation rate will continue in the next few months and it is expected to return to a level between 1% and 3% during the second quarter of 2009. This projection takes into account the following scenario for the next few months:

- A greater knock-on effect of the fall of prices of grains and cereals on processed foods. For example, comparing the average for 2009 with the average of the previous year, the international price of soy has been reduced 19%, while soy oil in the local market has only been reduced 11% in the same period. This suggests that there could be space for a major consequent effect on the prices of final products.

- A greater knock-on effect of the slowdown of wholesale prices (from -0.22% year-on-year up to May) on prices for the consumer.

- The downward trend in inflationary expectations will continue over the coming months in line with the reduction of the year-on-year inflation rate.

- Fewer pressures on the demand side in the context of the slowdown in private consumption. Nevertheless, underlying inflation will have fewer supporting factors and its reduction will speed up.

Prices: recent monthly data

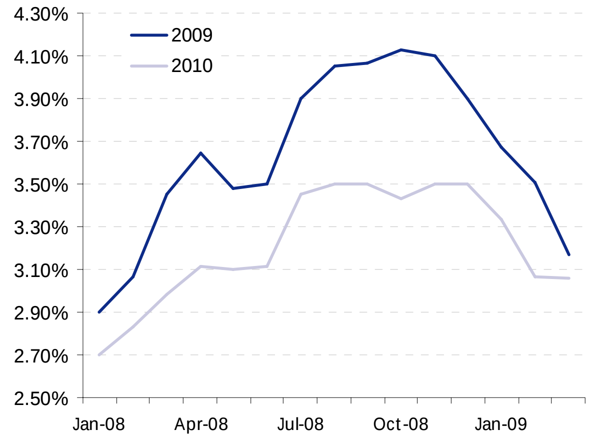
(var. % interanual)	Feb-09	Mar-09	Apr-09	May-09
Consumer Price Index (CPI)	5,49	4,78	4,64	4,21
Food and Drink	8,3	6,8	6,5	5,6
Fuel (vehicular use))	-23,2	-23,8	-23,8	-23,9
Underlying Index	5,77	5,69	5,42	5,11
Consumer Price Index – Imported*	-4,52	-5,62	-6,45	-6,88
Wholesale Price Index - IPM	4,03	2,67	1,66	-0,22
Price Index-Machinery and Equipment	11,97	13,10	13,68	9,14
Price Index-Construction Materials	6,47	3,46	-1,96	-7,43

* Imported inflation takes into account those prices which are related to imported supplies (flour, maize, soy, petrol), understood mainly as food and fuel,

III. Monetary policy and exchange rate

The Central Bank speeds up policy interest rate cuts

Inflation expectations
(yoy % change)



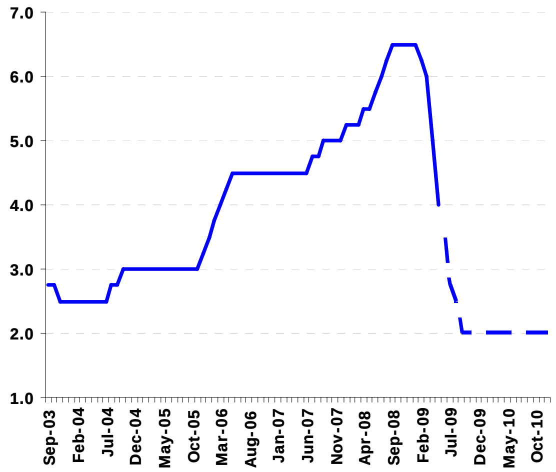
Source: BCRP
Prepared by: BBVA Banco Continental ERD

Since February 2009, the Central Bank has cut its policy interest rates by 250 basis points (bps), taking it in May to a level of 4.0%. The first two reductions were of 25 bps each (in February and in March); however, in the context in which the impact of the international financial crisis on local economic activity became more noticeable and the year-on-year inflation rate declined rapidly, the Central Bank speeded up the process through cuts of 100 bps in April and May.

Hence, the greater aggressiveness towards monetary flexibility is related to the sudden change in economic conditions: (i) a rapid slowdown of GDP, which went from averaging growth of around 11% yoy in the first three quarters of 2008 to 1.8% yoy in the first quarter of this year; (ii) the decline in the year-on-year inflation rate, which went from 6.7% at the end of 2008 to 4.2% in May, reflecting the pronounced decline in the average monthly inflation rate, which went from 0.54% in 2008 to 0.07% in 2009 (up until May); and (iii) the reduction of inflation expectations for 2009 and 2010, which have currently settled around the upper limit of the target range (3.0%). The appreciation registered by the Peruvian currency in the current year (around 8%) has also facilitated the monetary stance easing.

It is worth adding that the recent policy interest rate reductions are the most aggressive the Central Bank has ever made since this variable is used as the operational target of monetary policy (September 2003), as before it had only made movements of 25bp.

Policy interest rate
(%)



Source: BCRP, BBVA
Prepared by: BBVA Banco Continental ERD

The Central Bank will continue to ease monetary policy over the coming months

The rapid slowdown of economic activity and the absence of inflationary pressures indicate the need to continue relaxing monetary policy. This is also deduced from testing monetary policy rules (Taylor Rule) in which the concerns of the Central Bank over inflation and economic activity are considered, which indicates that the level of the policy interest rate could decrease to levels of around 2% (in nominal terms) towards 3Q09. Taking this into consideration, we estimate that during the rest of the year the Central Bank will continue reducing the policy interest rate until maintaining it at a level (in real terms) close to 0%.

It is also important to mention that the President of the Central Bank raised the possibility of making direct purchases of Public Treasury bonds in order to induce a decrease of interest rates in the long term (these take as a benchmark in their formation the yield from sovereign debt). Additionally, a new monetary instrument has been created, repo transactions with a loan portfolio, which seeks to insure that financial institutions, particularly the smallest, can access liquid funds, which will encourage the effectiveness of the process of reducing the policy interest rate.

Currency and bank credit: recent monthly data

(var. % year-on-year)	Jan.09	Feb.09	Mar.09	Apr.09
Interbank exchange rate sale (average, S/. by USD)	3,152	3,238	3,176	3,086
Monetary base (end of period)	20,7	10,1	7,1	-1.9
Total liquidity	24,9	26,2	23,7	15,8
Liquidity ME / Total liquidity (%)	47,4	47,7	47,4	47,0
Net international reserves (US$) bl.)	30,1	29,4	30,9	31,1
Interbank interest rate in MN. (%)	6,6	6,4	6,1	5,3
Interbank interest rate in ME (%)	0,5	0,3	0,2	0,2
Private sector credit in MN	46,1	44,6	45,6	39,7
Private sector credit in ME	17,7	14,4	11,6	8,9
Delinquency rate (%)	1,34	1,43	1,41	1,52

Exchange rate movements during the rest of the year will respond mainly to what happens in the global context

Since March, the exchange rate has been registering downward pressures (it reduced from S/. 3.26 per US$ at the beginning of that month to S/. 2.99 per US$ currently). Therefore the upward tendency which there had been until then has been reversed (and began last October).
The appreciation of the local currency is related to lower global aversion to risk, which has encouraged greater demand for assets in the local currency, despite the aggressive drops in the policy interest rate by the Central Bank. At the same time, its growth has influenced the increase of the prices of international commodities that Peru exports, in particular those of metals (the price of copper, for example, rose more than 50% during 2009 up to May), which increased the terms of exchange around 10% in the first quarter of the present year. Additionally, the announcement by the International Monetary Fund that it will grant liquid funds through the *Flexible Credit Line* on the application of those countries who have a good record of macroeconomic policies (Peru is one of them), which reasserts the availability of foreign liquidity the country will have in case the global crisis is accentuated. Finally, the ratification by the two important international risk ratings agencies (Fitch, S&P) of the investment grade of the sovereign debt has also been relevant, as well as the raising of the possibility that a third agency will award it that category (Moody's).

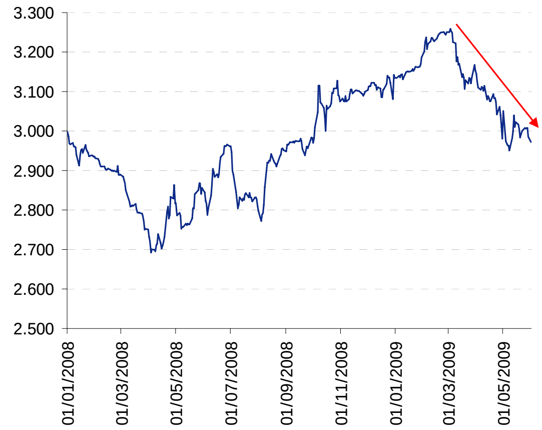
All this has been reflected in a reduction in the exchange position of the banks. Hence, this reached its maximum in February; since when it has been reduced by more than US$ 400 million. In the same sense, the CDRBCRPs (Central Reserve Bank of Peru Deposit Certificates) have matured, deposit certificates issued by the Central Bank in local currency but index-linked to the exchange rate which have not been renewed.

We foresee, however, that downward pressures on the exchange rate will be dispelled in the coming months. Therefore, at the end of the year the local currency will depreciate compared to its current level and to that of the end of the year 2008 (S/. 3.12 per US$. The weakness of the Peruvian Sol in the coming months is related to:

- The conditions of supply and demand for commodities by the real sector of the global economy, in particular base metals. These suggest that there is room for the prices of these metals (as for example that of copper) to partly reverse the increase seen during 2008;
- A certain recovery in the level of imports, in particular supplies and capital goods, diluting the process of downwards adjustment in inventories;
- The aggressive decrease of the policy interest rate of the Central Bank, which will be transferred to other market interest rates reducing the attractiveness of assets in the local currency; and
- That the end of the crisis, reflected in global private expenditure increasing again, will not be that close and, in any case, will be slow. Therefore, the reaction the markets have had in the last few months (to the data that has appeared) appears excessive and there could be a certain reverse in sentiment, which would put upwards pressure on the exchange rate.

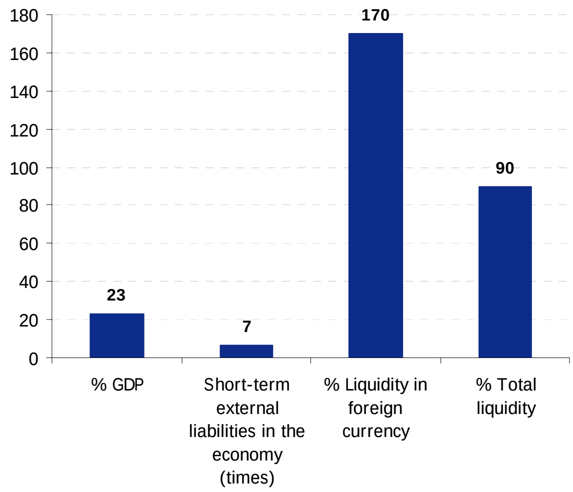
Finally, it is worth mentioning that net international reserves currently lie at US$ 31.0 billion, a similar level to the end of 2008. Hence, net sales of foreign currency in the exchange market (US$1.1 billion), intended to soften the upwards trajectory of the exchange rate during the first two months, have been partly compensated for by greater public sector deposits, related to the issue of bonds in the international market by US$1 billion at the end of March. This level of international net reserves is equivalent to more than 23% of GDP, more than 6 times the foreign short term liabilities in the economy, 170% of liquidity in local currency of the deposit companies and 90% of the total liquidity of the deposit companies.

Exchange rate (S/. to US$)



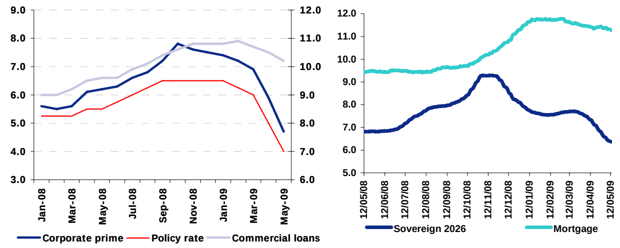
Source: BCRP
Prepared by: BBVA Banco Continental ERD

International reserves



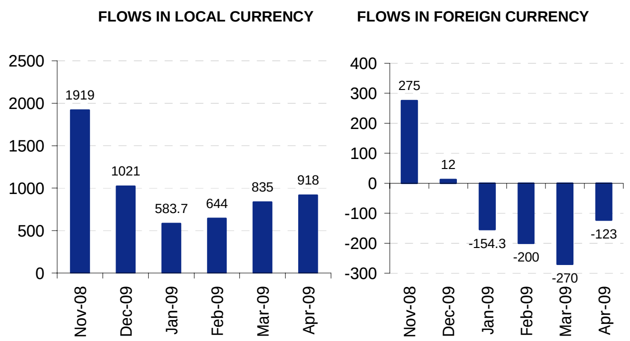
Source: BCRP, BBVA
Prepared by: BBVA Banco Continental ERD

Interest rates: 2008-May 2009
(%)



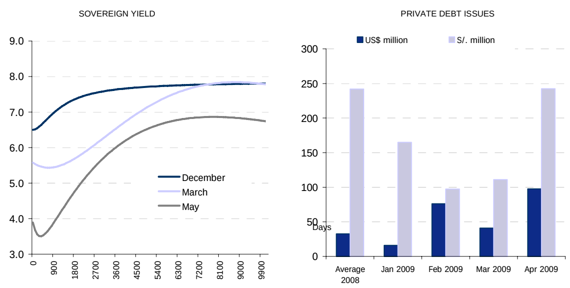
Source: BCRP, Bloomberg, SBS
Prepared by: BBVA Banco Continental ERD

Credit flows
(Millions of S/. and US$ respectively)



Source: INEI, BBVA
Prepared by: BBVA Banco Continental ERD

Sovereign yield and private debt issues
(Millions of S/. and US$ respectively)



Source: SBS, Conasev
Prepared by: BBVA Banco Continental ERD

IV. Financial context

Corporate and mortgages interest rates should tend to reduce over the coming months

In the year to date, the banking system's interest rates have performed differently. Hence rates on short term transactions and with low credit risk (corporate, commercial) have registered a downward trend that has not happened in the same way with other market interest rates (small business, consumer and mortgage). In the first case, it is principally related to the aggressive reduction of the policy interest rate of the Central Bank, while in the second case it may have influenced a greater perception of risk of those agents in the current situation (the rate of delinquency of loans to small business is the one which most increased in the current year, from 3,2% to 4,1% between December 2008 and April 2009).

For what remains of the year we expect that corporate, commercial and mortgage interest rates will show a downward trend. This will be influenced by:

- The increase in monetary stimulus that the Central Bank will continue making over the coming months. This, in particular, will encourage the reduction of corporate and commercial interest rates. The decreases may be similar to the reductions that have been recorded in the policy interest rate (-150/-200 bps over what remains of the year).
- The credit facilities that the state is giving to encourage the construction of social housing. In this respect, the costs of funds that the state channels through private banks, intended to finance loans for the acquisition of low cost housing, has been reduced. This should tend to reduce mortgage interest rates to the extent that lower costs are transmitted to borrowers.
- The lower spread that should be registered between the yield of the sovereign bonds and the mortgage loan interest rate. The yield of the sovereign bonds constitutes the benchmark in the formation of mortgage interest rates, and has been decreasing over the last few months (115 bps for the 2025 bond in the current year). This does not appear to have yet been transmitted to mortgage rates, which in part should happen over the coming months (despite the perceived risk of mortgages having increased in the current situation).

Credit growth would be low in the rest of the year

In line with the slowdown of private spending, bank credit demand has shown a downwards trend, according to monthly credit flow data by currency. In the case of foreign currency in particular, and in a way consistent with the contraction of global trade and with the slowdown in private investment, what is noticeable is that the balance of commercial credit has been reduced by US$ 746 million in 2009 to date, especially in foreign trade and financial leasing.

We expect that over the coming months credit flows will continue being reduced, with the year-on-year rate of growth tending to move downwards. This will reflect the slowdown of demand. However, lower interest rates and positive external factors generated by the Fiscal Stimulus Plan will act as supports.

Debt issues on the capital market are reviving

During the final quarter of 2008, debt issues in the local capital markets were scarce in the context of greater risk aversion. In 2009 to date, and in line with market easing and lower risk levels, debt issues have been revived, being greater than those registered in a similar period of the previous year. With the improvement in the conditions of demand, a downwards trend is seen in the yield required of these issues. In this respect, in 92% of the issues made during the year, the amount demanded was greater than that offered, reflecting the high availability of resources in the hands of institutional investors (such as AFP, insurance companies, mutual funds, among others). Additionally, the yield of the issues made have declined (by an average fall of 100 bps compared to the beginning of the year). However, corporate spreads have not yet followed this latest trend, which may be related to the adjustment observed in company revenue during 1Q2009. We expect that these will begin to be reduced during 2H2009 to the extent that the economy begins to recover and business confidence improves.

V. Article

The process of inventories adjustment in the Peruvian economy

Hugo Perea
hperea@grupobbva.com.pe

Javier Dorich
jdorich@grupobbva.com.pe

Over the last few months, the slowdown in economic activity has been amplified by a process of inventory adjustment that has been particularly intense in manufacturing and trade[1]. But, how much longer can this situation last? This is a relevant question in making decisions of economic policy which are effective and opportune. On the other hand, what may be expected of economic activity once companies eliminate the excess stocks they currently have?

The inventory cycle

Inventories vary according to market conditions: they accumulate when supply is greater than demand, and fall if the reverse is true. This variation is known as "inventory change" in the national accounts, and is a component of gross domestic investment. As **Chart 1** show, between 1950 and 2008 inventory variation was on average positive, of the order of 0.6% of GDP[2].

In the short term, inventory changes tend to be more volatile and exaggerate economic cycles. These changes could be of two types, depending on the expectations of agents:

- **Anticipated:** when the producer or trader anticipates a potential increase or fall in demand. If expectations are correct, this type of change would tend to be smoothed out over time.
- **Non-anticipated:** When demand registers movements that have not been calculated by the producer or trader. In this case, unwanted increases or reductions can be registered in inventory levels, which will have to be corrected in future periods through an adjustment in production (so that the inventories fall or increase, as the case may be).

In recent adjustment of inventories, economic actors appear to have reacted more than proportionately compared to the slowdown in sales, reducing production in order to take stocks towards the optimum level[3]. On the other hand, in this last crisis, this tendency has been exaggerated by fear of the lack of liquidity in a context of credit restriction, which has led companies to react more quickly, adjusting production to tackle the fall in sales.

Equally, price expectations for supplies or finished goods may lead industrial or trading companies to adopt a particular inventory policy. For example, if the price of supply is expected to increase, the company may decide on a policy of increasing inventories (the contrary policy would be adopted if prices are expected to fall).

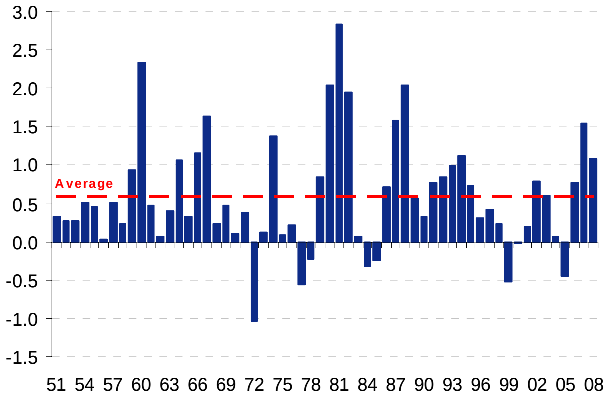
The recent case of the inventory cycle in Peru

Until the third quarter, economic activity in Peru was growing at over 10%, in a context of high levels of consumer and business confidence, which was reflected in buoyant consumption and private investment. At the same time, boosted by global inflation, commodity prices were also at all-time highs. Against this background, many companies speeded up production and the purchase of supplies to increase inventories because they anticipated that high growth and price levels would be maintained in the future.

However, this situation reversed completely with the collapse of Lehman Brothers in September 2008, which had a major impact on global economic activity and commodity prices.

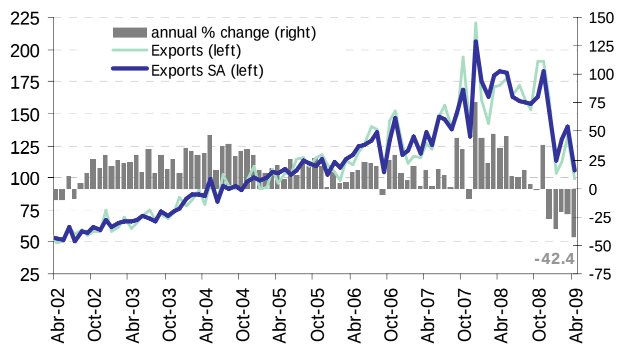
The new scenario led to a sudden, excessive and unwanted accumulation of inventories, against a slowdown of sales that was more than expected, and an unforeseen drop in the prices of imported supplies. To correct this problem, the companies affected opted to reduce or even halt production, using their inventories to cover some of their sales in order to get rid of excess stock.

Chart1: Inventory change (% of GDP)



Source: BCRP
Prepared by: ERD BBVA Banco Continental

Chart 2: Textile and Clothing Exports (US$ million)



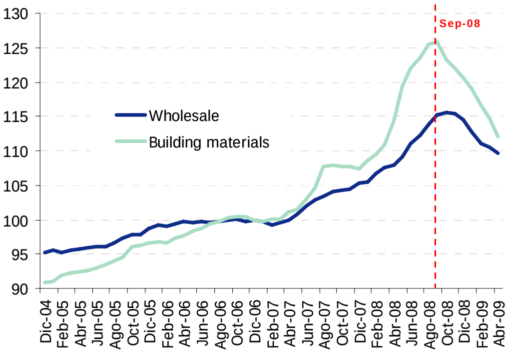
Source: BCRP
Prepared by: ERD BBVA Banco Continental

1/ In the first quarter of the year, GDP grew 1.8%, after having grown 6.5% in the fourth quarter of 2008 and 11% in the first three quarters of 2008.

2/ In order for the stock of inventories to be maintained as a constant proportion of GDP, it would have to grow at the same rate as economic activity (3.9% on average between 1950 and 2008). A lower inventory growth rate would reflect: i) a more efficient use of inventories, associated with a greater asset rotation; and ii) the steady bias of the economy towards the service sector.

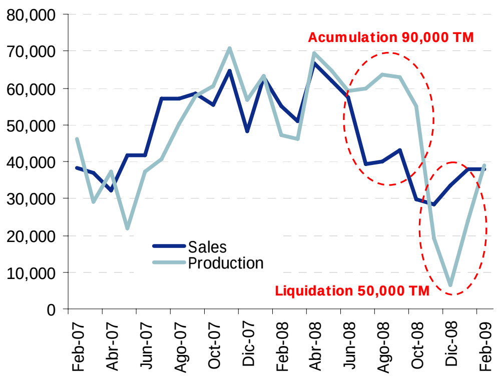
3/ The optimum level of inventories is that which maximizes the net benefits of maintaining them. Hence, if inventories are very large, storage costs will grow increasingly, beside the opportunity cost of the money invested (if you have static money, it does not generate value). By contrast, if inventories are very small, production and transport costs are increased (no advantage from economies of scale).

Chart 3: Index of prices (index – Dec 06 = 100)



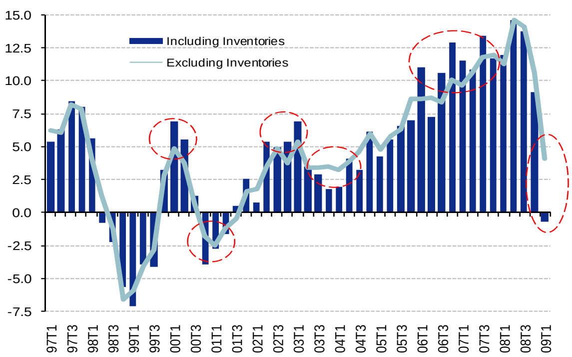
Source: INEI
Prepared by: BBVA Banco Continental ERD

Chart 4: Production and Sales of iron bars (units)



Source: INEI
Prepared by: BBVA Banco Continental ERD

Chart 5: Internal Demand (var . % anual)



Source: BCRP
Prepared by: BBVA Banco Continental ERD

The first companies affected by this problem were those that sell most of their goods abroad (i.e. exporting companies), due to lower product demand in the United States and the European Union, which accounts for close to 50% of Peruvian foreign exports. Among the most significant cases are the textile and clothing industries (see **Chart 2**), as well as the agricultural industry. After the fall in foreign sales, these sectors reduced their rate of production as well as their demand for supplies, to an extent even greater than the fall in sales.

At the same time, prices of imported supplies (including oil, cereals, steel, plastics, fertilizers) registered falls of more than 50% in some cases (see **Chart 3**). Against this background, the manufacturing sector and distribution channels reversed the process of accumulating inventories. A representative example is that of the iron and steel industry, where even the major corporations in the sector had to stop production temporarily (see **Chart 4**) while they liquidated stock that had been accumulated over previous months.

Finally, it is worth pointing out that, owing to the effects of the international crisis, a deterioration in consumer and business confidence occurred, which was reflected in the re-evaluation or postponement of consumer decisions affecting both spending on durable goods (automobiles, electrical appliances) and investment (the real estate sector, acquisition of capital goods). In this context, inventories in these sectors increased above the desired levels.

The adjustment of inventories increases the volatility of domestic demand

A practical way of quantifying the impact of inventories on economic activity is by measuring the contribution that inventory changes have on domestic demand, measured in percentage points. In this respect, as can be seen in **Chart 5**, variations in inventory tend to exaggerate both expansions and slowdowns[4]. Over the last 10 years, up to 6 episodes have occurred in which inventory changes have had a relevant impact (see **Table 1**). The average duration of an inventory adjustment process (the time it takes for the effect of inventories on growth to disappear) has been 4 quarters, and the average impact 1.5 percentage points per quarter. In accordance with these figures, the current adjustment process (which started in the third quarter of 2008) could end at the close of the second quarter.

Table 1: Internal Demand (var. %anual)

Period	Considering Inventories	Excluding Inventories	Difference (pp)	Duration (Quarters)
4Q99-3Q00	4.2	3.0	1.2	4
4Q00-2Q01	-2.8	-1.9	-1.0	3
2Q02-1Q03	5.6	4.3	1.2	4
3Q03-1Q04	2.2	3.3	-1.2	3
3Q06-3Q07	11.8	10.1	1.7	5
3Q08-1Q09	7.3	9.6	-2.2	3
Average			**1.5***	**3.7**

* Absolute average value
Prepared by: ERD BBVA Banco Continental

An analysis at company level: the ratio of inventories as days of sale

At the level of companies or even industries, one way of analyzing the development of inventories is through the ratio of inventories measured as days of sale (DSI):

$$DSI = \frac{Inventories}{Sales}$$

where both inventories and sales are measured at production cost. This quotient may be interpreted as the number of days that it would take to sell all inventory given current sales levels. When this ratio rises above historical averages, it may suggest that there is an over-accumulation of inventories, either as a result of excessive production or a slowdown in sales. Whatever the case may be, sooner or later the company will have to reduce its rate of production in order to liquidate its excess inventories and return to optimum levels of inventory rotation.

4/ It is worth pointing out that domestic demand contracted by 0.8% in the first quarter of 2009 in year-on-year terms. However, ignoring the effect of the de-accumulation of inventories, the growth rate would have been 5%.

A very clear example of this situation is the iron and steel industry (see **Chart 6**), which experienced a process of inventory accumulation due to favorable expectations of growth in construction as well as a rally in the price of steel. The ratio of inventory as days of sale went from 140 days in the first quarter of 2008 to 340 days in the third quarter.

With the fall in the price of steel and the slowdown in demand (registered from the third quarter of 2008), the industry opted to sell its excess inventories, generating a temporary fall in production. In fact, the iron and steel companies even stopped production completely between the end of 2008 and the beginning of 2009.

At the close of the first quarter, the ratio of inventory in terms of days of sales had been reduced to 220, a level that is still above the historical average of 150 days. A similar situation can be seen in other industries, such as those linked to mass consumption, such as food and drink, and textiles and clothing. In the case of clothing, although inventories have fallen, the reduction in sales has been so significant (-25%) that the rate of production must be reduced still further (or sales will have to recover) to reach optimum inventory levels.

Given the trend in these ratios, we estimate that most of the adjustment of inventories will take place in the second quarter, in the case of some industries even falling below historical averages. In the second half of the year, production will resume on a more dynamic course, consistent with the new conditions of demand.

How large is the adjustment expected?

Although manufacture is clearly the sector that comprises the greater surplus of inventory, not all the subsectors of the industry show a similar trend (see **Chart 7**). In fact, according to a poll produced by the Central Bank in the month of April, stocks in some sectors such as non-metallic minerals (cement), were at desired levels. At the same time, in industries such as Wood and Furniture, Chemicals and Plastics or Food and Drink, the differences between the current levels and those desired are not greater than 20%, which suggests that there will not be an important adjustment in production to liquidate unwanted stocks.

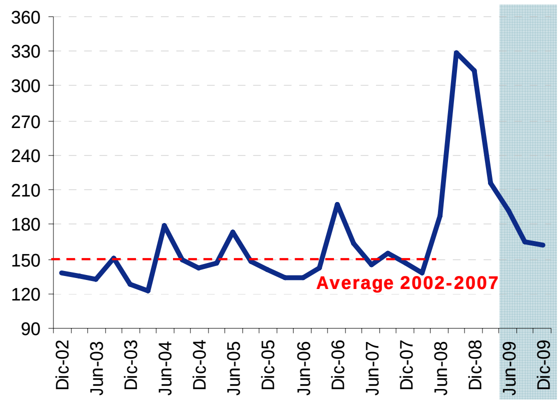
On the negative side, the branches of industry that registered greatest differences between the current level and that desired are the following:

- The Iron and Steel Industry as of April, inventories were above desired levels by 47%. Consistent with this, iron and steel production fell by 34% in year-on-year terms during the first quarter. It is worth pointing out that the excess of stock was as much of raw materials as it was of finished product. The industry worked 63% of its installed capacity (83% in 2008).
- Textiles and Clothing at the end of April, inventories were above the desired level by 42%. In the first quarter, production of the sector fell by 25% in year-on-year terms, supplying part of the demand with the excess of stock. It only used 55% of the installed capacity (76% in 2008).

Assessment

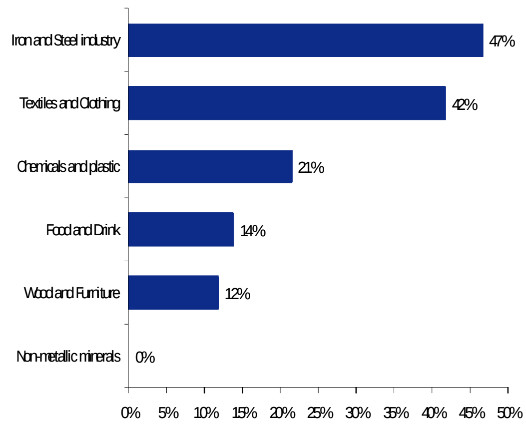
The current process of inventory adjustment has been rapid and extensive compared to previous adjustments. According to macroeconomic information, at a corporate level, most of the process of inventory adjustment process could end during the second quarter, when it will no longer have a negative influence on economic activity. In fact, in the second half of the year an upturn in GDP may happen, even above what the consensus currently suggests. This new dynamism in production could be explained by a period of inventory reduction (correcting what is very probably an overreaction currently being shown by the industry) that will complement the larger fiscal and monetary stimulus in economic activity.

Chart 6: Steelmakers' inventories (days of sales)



Source: Estados Financieros de empresas
Prepared by: BBVA Banco Continental ERD

Chart 7: Excess of inventories (% over expected level - April 2009)



Source: BCRP
Prepared by: BBVA Banco Continental ERD

Forecasts of the Economic Research Department

	2006	2007	2008	2009(p)	2010(p)
Economic activity					
GDP nominal (S/. billions)	305.1	335.7	372.8	386.8	418.0
GDP nominal (USD billions)	93.3	107.5	127.7	125.2	130.1
Real GDP (yoy %)	7.6	8.9	9.8	2.4	3.6
Prices, end of period					
CPI (yoy %)	1.1	3.9	6.7	2.1	2.0
Public finances					
General Government balance (% of GDP)	2.1	3.1	2.1	-1.2	-1.1
Total public debt (% of GDP)	32.7	29.6	24.0		
External public debt (% of GDP)	23.6	18.7	15.1		
External sector					
Exports (USD billions)	23.8	28.0	31.5	23.8	26.5
Imports (USD billions)	14.9	19.6	28.4	23.3	25.5
Trade Balance (USD billions)	8.9	8.4	3.1	0.5	1.0
Current Account Balance (% of GDP)	3.0	1.4	-3.3	-3.3	-3.2
Nominal exchange rate (S/. by USD, end of period)	3.20	3.00	3.11	3.15	3.20
Multilateral real exchange rate (yoy %)	-2.3	-1.7	-		
External debt (% of GDP)	31.0	30.8	27.1	-	-
International reserves (USD billions)	17.3	27.7	31.1	31.2	31.7
Financial sector					
Policy interest rate	4.50	5.00	6.50	2.00	2.00

International Context

Commodities (end of period)	2007	2008	2009		2007	2008	2009
Oil Brent (USD/barril)	72.7	97.5	57.0	**Soybean (USD/TM)**	320	457	385
Copper (USD/pound)	3.2	3.1	1.8	**Corn (USD/TM)**	139	195	168
Gold (USD/troyoz.)	697.1	872.3	897.5	**Wheat (USD/TM)**	236	295	210

	Real GDP (%)				Inflation (%, end of period)*			
	2007	**2008**	**2009**	**2010**	**2007**	**2008**	**2009**	**2010**
USA	2.0	1.1	-2.0	1.1	2.9	3.8	-0.3	1.5
EU	2.6	0.6	-3.3	-0.1	2.1	3.3	0.3	1.0
Japan	2.4	-0.7	-6.0	-0.4	0.7	0.0	-0.8	0.4
China	13.0	9.0	8.1	8.4	6.5	2.0	0.0	2.0
Latin America								
Argentina	8.7	7.0	-1.8	0.7	8.5	7.2	7.5	10.0
Brazil	5.9	5.1	-2.1	3.0	4.5	5.9	4.2	4.4
Chile	4.7	3.2	-1.2	2.1	7.8	7.1	0.2	1.8
Colombia	7.5	2.5	-0.5	1.1	5.7	7.7	4.3	3.8
Mexico	3.3	1.4	-6.3	1.7	3.8	6.5	3.8	3.9
Peru	8.9	9.8	2.4	3.6	3.9	6.7	2.1	2.0
Venezuela	8.4	4.8	-0.5	-2.9	22.5	31.9	42.3	49.2
LATAM [1]	5.7	4.1	-2.9	1.9	6.0	8.1	6.6	7.5
LATAM Ex-México	6.8	5.1	-1.4	1.8	7.1	8.7	7.5	8.7

1 Average of 7 mentioned countries
* USA and EU inflation: average of period

	Public Sector Balance (% GDP)				Current Account Balance (% GDP)			
	2007	**2008**	**2009**	**2010**	**2007**	**2008**	**2009**	**2010**
USA	-1.2	-4.6	-12.7	-8.4	-5.3	-4.8	-3.0	-2.9
EU	-0.6	-1.9	-5.4	-6.0	0.5	-0.1	-0.3	-0.4
Japan	-5.4	-4.9	-8.0	-9.0	4.8	3.2	3.0	3.0
China	0.7	-0.4	-2.9	-1.4	11.0	6.8	9.5	10.0
Latin America								
Argentina [2]	3.2	1.4	0.1	0.8	2.7	2.3	1.9	2.0
Brazil	-2.3	-1.7	-2.3	-1.4	0.1	-1.8	-1.3	-1.4
Chile [2]	9.9	4.9	-4.2	-3.8	4.4	-2.0	-3.1	-4.6
Colombia	-2.7	-2.3	-4.2	-3.5	-2.8	-2.8	-4.0	-2.7
Mexico	0.0	-0.1	-1.8	-1.8	-0.8	-1.4	-1.9	-2.1
Peru	3.1	2.1	-1.2	-1.1	1.1	-3.3	-3.3	-3.2
Venezuela [2]	3.0	-0.2	-6.0	-6.6	8.7	13.1	0.7	2.4
LATAM [1]	0.1	-0.4	-2.3	-1.8	0.7	-0.4	-1.3	-1.3
LATAM Ex-México	0.4	-0.4	-2.6	-1.9	1.3	-0.1	-1.2	-1.0

[1] Average of 7 mentioned countries; [2] Central Government

	Exchange Rate (vs $, end of period)				Official Rate (%, end of period)			
	2007	**2008**	**2009**	**2010**	**2007**	**2008**	**2009**	**2010**
USA					4.25	0.25	0	0
EU ($/€)	1.5	1.3	1.2	1.1	4.00	2.50	0.75	0.50
Japan (yenes/$)	112	93	93	93	0.77	0.10	0.20	0.70
China (cny/$)	7.3	6.8	6.8	6.6	7.47	5.31	4.50	3.96
Latin America								
Argentina	3.1	3.4	4.1	4.5	13.50	19.08	17.00	15.03
Brazil	1.8	2.3	2.1	2.1	11.25	13.75	8.50	8.50
Chile	499	649	560	566	5.90	8.25	0.75	2.00
Colombia	2015	2244	2343	2586	9.50	9.50	5.00	5.00
Mexico	10.9	13.7	13.0	12.4	7.50	8.25	4.50	4.50
Peru	3.0	3.1	3.15	3.20	5.00	6.50	2.00	2.00
Venezuela	2.2	2.2	2.7	3.5	11.70	17.60	16.00	14.50

For more information please contact:

Servicios Generales Difusión BBVA Gran Vía 1 planta 2 48001 Bilbao P 34 944 876 231 F 34 944 876 417 www.bbva.es

Register in Madrid: M-31252-2000

Economic Research Department BBVA Group

Chief Economist

José Luis Escrivá

Unit Heads

North America: Jorge Sicilia
Mexico: Adolfo Albo
Macroeconomic Analysis Mexico: Julián Cubero
United States: Nathaniel Karp

Spain and Europe: Rafael Doménech
Europe: Miguel Jiménez
Spain: Miguel Cardoso

Emerging Markets: Alicia García-Herrero
Emerging Markets Analysis: Sonsoles Castillo
South America: Joaquín Vial
Argentina and Uruguay: Gloria Sorensen
Chile:
Colombia: Juana Téllez
Peru: Hugo Perea
Venezuela: Oswaldo López
China: Li-Gang Liu
Asia exc. China: Ya-Lan Liu

Economic and Financial Scenarios: Mayte Ledo
Sector Analysis: Ana Rubio
Financial Scenarios: Daniel Navia
Quantitative Analysis: Giovanni di Placido
Global Trends: David Tuesta

Other publications