BBVA Research

Peru

Economic Outlook

Second Quarter of 2010

Economic Analysis

- The growth forecast for 2010 has been revised upwards, from 4,3% to 5,7% due to a stronger global cyclical recovery and a greater boost to private investment related to a significant improvement in business expectations.

- The recovery in tax revenues will favor the reduction of the fiscal deficit to 1,4% of GDP in 2010 and public debt to 20,2% of GDP in 2012. Regarding external accounts, we forecast moderate current account deficits between 0,5% and 2,0% of GDP for 2010-2012, which will be mainly financed by foreign direct investment.

- Inflation in 2010 will be 2,4%, within the central bank's target range. This scenario considers that the central bank will continue removing the monetary stimulus, taking the policy rate to 2,5% towards the end of this year.

- The balance of risks shows that our GDP growth forecast has an upside bias due to an inventory restocking that could become stronger and to a slower withdrawal of the fiscal stimulus package. However, there are also factors that could push the growth forecast downwards, such as a protracted increase in global risk aversion due to the fiscal problems in Europe and corrections in commodity prices caused by a more aggressive withdrawal of the stimulus policies in Asia.

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Closing date: May 17th, 2010

1. Challenges ahead for a sustained global recovery

The cyclical situation has improved significantly over the last few quarters, driven by the recovery in emerging market economies and the US. Global trade is growing at 7%, and we forecast a 4,2% global growth for 2010. At the same time, there are doubts about the ability of the European Monetary Union within its current decision-making framework to deal with the high level of indebtedness of some of its countries. These doubts have given rise to widening spreads and renewed financial stress. Such developments may impinge first on the European economy with possible spillovers to the rest of the world. The timing and the extent of these adverse impacts will crucially hinge on the effectiveness and lasting effects of the announcement of the rescue package agreed by the European Council on May 9th and the exceptional measures adopted by the ECB. While the package has stabilized market conditions in the short run, uncertainties remain in three main areas: (i) the implementation of the rescue package in the months to come, (ii) the credibility of further fiscal consolidation to be adopted by some EU countries, and (iii) EMU core countries' medium-term commitment to the package.

While economic recovery in early 2010 has been widespread, its intensity has varied a great deal across countries. This is the result of different degrees of easiness in their fiscal and monetary policies. These policies have been particularly instrumental in providing impulse to the cyclical upturn in China and the US. At the same time, emerging economies are benefiting from the strength of their domestic demand. As a result, the recovery in these economies looks more likely to be self-sustained. Conversely, in developed countries, as expansionary policies fade away, doubts about the sustainability of the recovery beyond 2010 are growing.

A very gradual path of interest rate hikes by the Fed is forecast. Rate hikes by the Fed are not expected until the beginning of 2011, with rates rising slightly above 1% at the end of 2011. There are major differences in economic backgrounds in the US and Europe that will lead to different monetary developments in both areas. Although economic growth may prove sluggish in 2010 and beyond, the risk of a major reversion of current dynamics is rather limited in the US, with incipient inflationary pressures looming. Conversely, in Europe, in addition to a far more fragile financial situation, the upturn looks more uncertain and inflationary pressures are absent. In the case of emerging economies' monetary policies, there is no doubt about the need for a tightening stance. Given their cyclical divergences, exit strategies will vary across countries. In some countries, if the tightening of monetary policy and other measures are not implemented soon, macroeconomic imbalances will build up.

During periods of heightened risk aversion, financial markets are particularly good at tracking inconsistent macroeconomic policies, which might otherwise be overlooked at normal times. Despite the huge rescue package in Europe, substantial risk premia should prevail in the market amid uncertainty on the fiscal consolidation path. Increasing contagion has been clear evidence of the fragility of the current scenario. Economic history is fraught with examples of undue contagion from some countries to others in the aftermath of a crisis. In these cases, geographical linkages or cyclical similarities often matter more than differences in fundamentals. In fact, the current episode of contagion appears not to be fully justified either by the direct financial channel triggered by the Greek crisis or by any similarities in fundamentals. Though its justification may be open to debate, to cope with pressures from international investors, there is a compelling need for some countries to enhance credibility.

There are growing concerns about the long-term consequences of the build-up in public debt. This will unavoidably give rise to upward pressures on real interest rates and high risk premia for a protracted period. Even if recent contagion gradually fades, increasing discrimination across countries depending on the credibility of their fiscal stance will prevail.

Uncertainty stemming from the financial sector is primarily twofold. The sluggish restructuring of the financial industry, particularly in Europe, will lead to a creditless recovery. This is a growing concern since both historical episodes and empirical evidence show the importance of the credit channel in the early stages of the economic upswing. There is also uncertainty regarding the ongoing regulatory reform. The most likely outcome is one of a significant increase in capital and liquidity requirements. This could hinder the ability of the banking sector to grant credit in coming years.

2 .Growth speeds up, driven by private demand

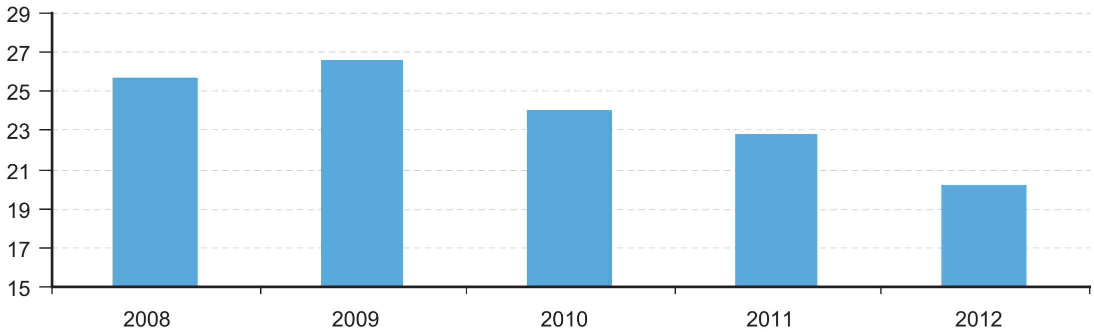
In the first three months of the year, Peru's economy recorded an increasing growth pace, with an upturn in private expenditure, as shown by leading activity indicators. Furthermore, business expectations reached highs, suggesting a significant recovery in private investment. We expect private demand to have accounted for more than half of GDP growth in the first quarter, in contrast to the negative contribution it recorded in 2009. Thus, economic activity growth is becoming less dependent on stimulus policies and in this way more self-sustained.

For the rest of the year, we expect domestic private expenditure to continue driving growth. Private investment, in particular, will be driven by favorable financing conditions and appealing export prices, which will stimulate the revival of projects postponed during the crisis and the development of new ones, mainly linked to the mining and construction sectors. Private consumption will also record an improvement, but this will be limited due to a still slow increase in employment.

It is worth mentioning that the contribution of fiscal expenditure to output growth will still be significant this year and we foresee that it will account for a fourth of Peru's growth rate, mainly due to public infrastructure investment. Given the cyclical recovery of tax revenues, we expect the fiscal deficit in 2010 to drop from 2,1% to 1,4% of GDP and public debt over GDP to resume its downward trend, falling to 24,0% by the end of this year and to 20,2% by 2012.

Chart 1

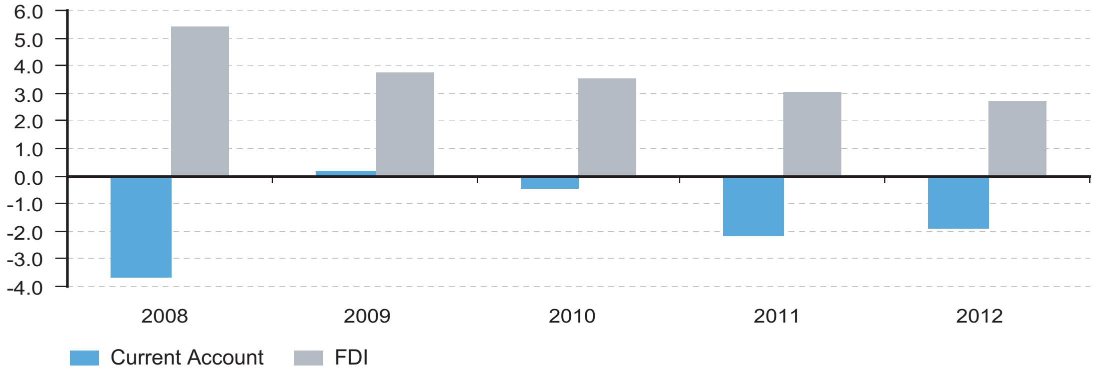
Public Debt (% of GDP)



Source: BCRP, BBVA Research Peru

Regarding external accounts, we forecast moderate current account deficits between 0,5% and 2,0% of GDP for 2010-2012, which will be largely financed by long-term capital inflows, mainly foreign direct investment.

Chart 2
Current Account and Foreign Direct Investment (% of GDP)



Source: BCRP, BBVA Research Peru

Inflation in 2010 will be around 2,4% due to a stronger demand growth, together with supply factors such as adjustments in domestic fuel prices. However, to prevent the transitory increase in inflation from contaminating expectations and to moderate economic growth, the Central Bank will continue to remove the monetary stimulus and will take the policy rate to 2,5% by the end of this year.

Considering the improvement in external conditions and the changing trend in domestic demand, our growth forecast for 2010 has been raised from 4,3% to 5,7%. In the medium-term, we are holding on to our prediction that Peru's economy can maintain growth rates between 5.0% and 6.0%, mainly based on capital accumulation. In addition, the increase recorded in recent years in the country's infrastructure will result in the medium-term in productivity growth.

3. Risks of higher growth and stronger policy adjustments

The balance of risks shows that our growth forecast is subject to an upside bias due to:

1. An eventual stronger inventory restocking. Due to the volatility and the difficulty to predict this variable, our baseline scenario cautiously considered a slight business inventory restocking. However, due to the business optimism recorded and the significant increase in raw material imports, we cannot rule out more intense inventory restocking, in which case the GDP growth forecast for 2010 could exceed 6.0%.
2. A slower withdrawal of the fiscal stimulus package. Our baseline scenario assumes that in 2010 the fiscal stimulus will be lower than in 2009 and that it will be withdrawn gradually. The recent measures announced by the Ministry of Finance to slow down public spending support our forecast. However, regional and local governments, which account for a large part of public investment, have not been affected by these measures. In this sense, there is a latent possibility of a greater fiscal expansion with respect to the baseline.

If these risk factors materialize, the withdrawal of the monetary stimulus will need to be more aggressive, which would result in a greater appreciation pressure on the PEN due to higher short-term capital inflows.

It is worth noting that the balance of risks considers three factors that could push economic growth below our forecast: (i) an increase in global risk aversion related to the fiscal sustainability problems in some European economies, (ii) a larger drop in commodity prices explained by a more aggressive withdrawal of stimulus policies in Asia, and (iii) a higher than expected political noise considering the elections that will take place in the next twelve months (to elect regional and local authorities in October, and the presidential and parliamentary elections in April 2011).

4. Main challenge: withdrawal of policy stimuli and PEN appreciation pressures

To avoid downward pressures on the exchange rate that would force the Central Bank into more significant foreign exchange purchases, the fiscal stimulus needs to be withdrawn early and gradually. This is the underlying assumption in our forecasts. However, this will be particularly challenging in an electoral environment such as the current one, in which there is major pressure on spending above the budget. If this does not materialize, the job of the Central Bank will be harder because it would have to hasten the monetary stimulus withdrawal in the coming months, after having increased its policy rate (by 25pb) at the last meeting. This would increase the pressures for a PEN appreciation. Although the Central Bank has so far been successful in moderating the appreciation of the local currency through USD purchases exceeding USD 2,5 billion, further foreign currency purchases could make monetary management more difficult. In this sense, the recent measures that the Government has adopted to slow down public spending will limit the scope of monetary sterilization operations. In addition, they reduce the likelihood of the Central Bank having to resort to quantitative measures, such as increasing mandatory reserve requirements for banks.

This situation could change if uncertainty regarding the fiscal problems in Europe persist, raising risk aversion levels and affecting raw material prices and access to external funding. As happened at the end of 2008, this could even cause a depreciation of the domestic currency, being necessary to reconsider monetary and fiscal policy movements. However, we think that the effects of the European situation will be limited and transitory due to the favorable market outlook regarding Peru's economy and the large stock of international reserves in the Central Bank that could be used if an eventual foreign currency liquidity restriction occurs.

5 .Tables

Table 1

Peru: quarterly macroeconomic forecasts

	1Q 09	2Q 09	3Q 09	4Q 09	1Q 10	2Q 10	3Q 10	4Q 10	1Q 11	2Q 11	3Q 11	4Q 11
GDP (y/y % change)	1.9	-1.2	-0.6	3.4	4.6	6.1	6.3	5.7	5.6	5.1	4.7	4.5
Inflation (% y/y, average)	5.6	4.0	1.9	0.4	0.7	1.2	1.9	2.3	2.4	2.4	2.4	2.4
Exchange Rate (vs. USD, average)	3.19	3.02	2.96	2.88	2.85	2.82	2.76	2.76	2.84	2.87	2.79	2.72
Interest Rate (%, average)	6.25	4.00	1.50	1.25	1.25	1.25	1.75	2.33	2.92	3.42	3.92	4.25

Source: BCRP and BBVA Research Peru

Table 2

Peru: annual macroeconomic forecasts

	2009	2010	2011
GDP (y/y % change)	0.9	5.7	5.0
Inflation (% y/y, average)	2.9	1.5	2.4
Exchange Rate (vs. USD, average)	3.01	2.79	2.80
Interest Rate (%, average)	3.25	1.65	3.63
Private Consumption (y/y % change)	2.4	3.2	3.9
Government Consumption (y/y % change)	16.5	6.2	3.7
Investment (y/y % change)	-8.6	9.8	6.2
Fiscal Balance (% GDP)	-2.1	-1.4	-1.0
Current Account (% GDP)	0.2	-0.5	-2.1

Source: BCRP and BBVA Research Peru

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