RESEARCH

Economic Watch

Peru

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Economic Analysis

Peru
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Positive GDP surprise in the second quarter

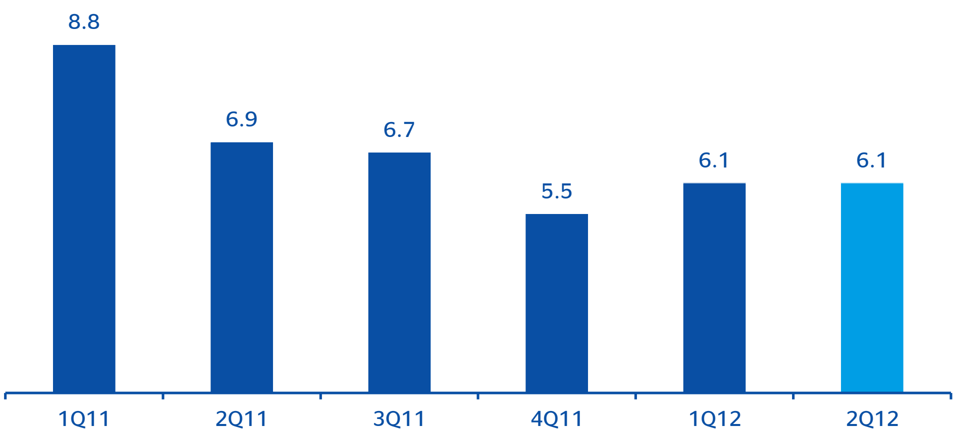
Strong domestic demand offset the drop in exports

- **Private spending and greater fiscal stimulus supported output growth**
  Economic activity proceeded at a fast pace in 2Q12 growing by 6.1% year-on-year in real terms, despite the deterioration in the international context. Going forward, we anticipate a gradual downturn in private spending, in line with the deterioration of business confidence and the slowdown in the creation of quality employment.

- **Lower foreign demand increased the balance of payments current-account deficit to 4.3% of GDP**
  Because long-term capitals are still financing this gap excessively, the Central Bank continued to accumulate international reserves.

- **The fiscal balance remains at a comfortable level, increasing the annualized surplus to 2.7%, the highest in the last four years**
  The increase in household income and contributions, the new tax system for the mining sector and the better results posted by state-owned companies all had an effect on this result.

Chart 1
Peru, quarterly GDP growth. Year-on-year percentage change



Source: BCRP

The strength of domestic demand supported the expansion of economic activity

GDP recorded a 6.1% growth in the second quarter, despite the deterioration in the international context. Although exports declined, this effect was offset by strong domestic demand. Going forward, we anticipate a downturn in private spending, in line with the deterioration of business confidence and the slowdown in the creation of quality employment.

Investment continued to grow at double-digit rates, complemented by the growth in public consumption

Strong GDP growth in the second quarter was associated with the strength of all the components of domestic demand, particularly investment, which continued to record double-digit growth rates. Private investment grew by 13.5%, linked to the continuity of a number of projects in various sectors, including mining, with an overall investment in excess of one billion dollars between April and May. On the public side, investment continued to grow above 30%, notably investment by regional governments, in line with the greater experience acquired in the implementation of spending. The investment ratio (on output) was 27.5% and, according to our forecasts, could reach 30% of GDP in 2016, which is consistent with a potential growth level of nearly 5.5%.

Public consumption growth was 10.6% (-0.7% in 1Q12), due in part to the implementation of the stimulus plan introduced last year, which involved greater spending in road maintenance and security and defense equipment. Private consumption slowed down slightly (5.8% vs. 6.0% in 1Q12), but still enjoys a healthy growth rate.

This rather strong performance of domestic demand was offset by a 2.5% decline in exports, against a background of high external turbulence, which mainly affected shipments of traditional products. However, part of this decline could also be explained by domestic supply problems, which could disappear over the coming months.

Table 1
GDP: growth of expenditure components. Year-on-year percentage change

	1Q12	2Q12	1H12
Domestic demand [1/]	8.5	9.1	8.8
Consumption loans	5.2	6.4	5.8
Private consumption	6.0	5.8	5.9
Public consumption	-0.7	10.6	5.0
Investment [1/]	17.8	16.5	17.1
Private investment [1/]	13.7	13.5	13.6
Public investment	37.2	30.3	33.5
Exports	17.9	-2.5	7.2
Imports	11.3	5.7	8.4
GDP	**6.1**	**6.1**	**6.1**

1/ Without inventories
Source: BCRP and BBVA Research

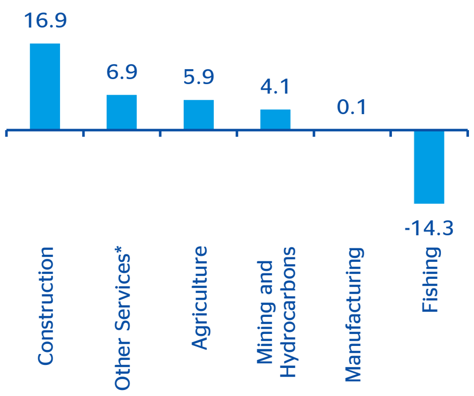
The boost in investment is being reflected at sector level in strong construction performance

The Construction sector led the country's economic activity with a 16.9% growth rate, due to a great extent to construction work related to investment in mining, manufacturing and trade, as well as home building. Commerce and Services, two activities strongly linked to domestic demand, also posted strong growth. In services, worth mentioning are business services, vehicle rental and mining sector machinery, as well as restaurant and hotel activity and transportation and communications. Among the primary sectors, strong growth in the agricultural sector (5.9%) was offset to a great extent by the decline in fishing -14.3%). The performance of the first one was favored by the increased production of rice, palm oil and corn, whereas the latter was affected by the occurrence of a slight El Niño phenomenon that resulted in warmer waters and reduced the availability of some marine species. Manufacturing performance remained weak, although it did manage to post a positive growth rate (0.1%) due to the better performance of the metal and non-metal mineral product industries. However, the textile and leather industry continued to show negative performance due to lower production for the foreign and domestic markets.

Leading indicators anticipate an output slowdown in the second half of the year

In July, the statistical effect of three additional working days means that the output growth rate will remain high. The activity indicators available for this month show an acceleration: electricity production increased 6.3% y/y, imports 23.8%, sales of new cars 39.7% and cement orders 25.5%.

Chart 2
GDP: Growth by sector. Year-on-year percentage change



* Includes: Taxes, Electricity and Water, Commerce and Other Services.
Source: BCRP

Table 2
Activity indicators. Year-on-year change and indexes

	2Q12	Jul-12
Average worker income	9	10
Sales of new cars	32	40
Local cement dispatches	17	26
Electricity consumption	6	6
Loans to individuals 1/	21	22
Imports	4	24
Consumer confidence (index)	54	55
Business confidence (index)	61	56

1/ Refers to the nominal change in consumer and mortgage loans. .
Source: BCRP

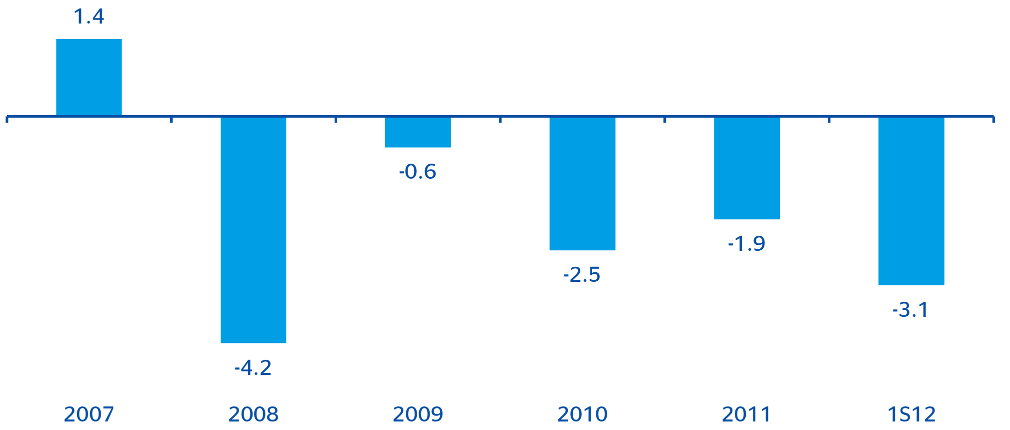
Going forward, however, the expansion of economic activity will be slower due to external and local factors. On the one hand, weak foreign demand will continue to affect exports, mainly non-traditional ones. On the other hand, we anticipate some moderation in private spending, in line with the fall in business confidence (9 points in the last three months) and the slowdown in the creation of quality employment. However, these effects should be mitigated by the support that public spending will continue to offer, driven by the implementation of the stimulus package issued in June and the acceleration in public investment in the second half of the year. As a result, we forecast a gradual slowdown of economic activity in the last months of the year, with output starting to converge gradually towards its potential level.

The weakness of international conditions is starting to be reflected in the external accounts

The balance of payments current-account deficit amounted to 4.3% of GDP in 2Q12, which represented a decline of 2.4 pp compared to the previous quarter and 1.3 pp over the same quarter last year. This result can be explained by a less favorable performance of the commercial balance, due mainly to the decline in both the volumes and the average prices of traditional exports, while non-traditional exports continued to expand, although at a slower pace. Meanwhile, (nominal) imports continued to grow driven by strong private spending, despite the decline in some import prices (mainly food and oil). This was mitigated by the improvement in factor income, due to falling profits of foreign companies in line with lower mineral prices. The increase in the external account in this quarter contrasts with the figure posted in 2009, when the external turbulence affected both exports and imports, which prevented further deterioration of the current account.

As for financing, net capital inflow from long-term capitals continues to exceed the current-account deficit, which is linked to a great extent to the large amounts of direct foreign investment, as well as loans to subsidiary matrix, in line with the growth in private investment. In addition, the public sector's financial account continues to show a positive result, as loan repayment is being exceeded by the acquisition of sovereign bonds by non-residents (USD 436 million in 2Q12). Thus, the Central Bank continued to accumulate international reserves for an amount of just over USD 2 billion.

Chart 3
Balance of payments current-account deficit - As a percentage of GDP

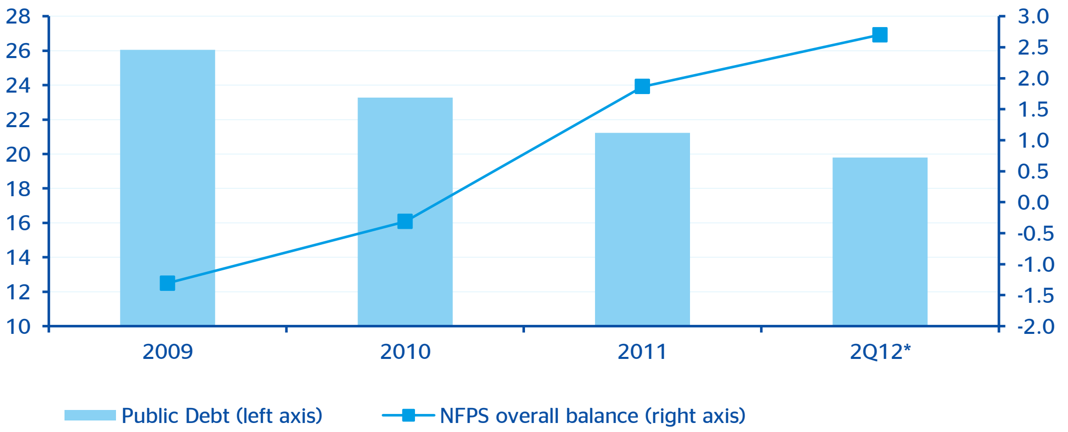


Source: BCRP

The fiscal surplus mitigates financing needs and introduces a downward trend on public debt

The non-financial public sector's overall balance amounted to 6.9% of GDP, 1.4 pp higher than in the same period last year. This result is explained, on one hand, by increasing current revenues due to the high dynamism of the sectors linked to domestic demand and, on the other hand, the moderate growth of non financial expense due to lower transfers and lower investment spending, particularly National Government. Thus, the accumulated public sector surplus for the last four quarters rose to 2.7% of GDP (2.2% of GDP in the last quarter), the highest recorded in the last four years. Going forward, we anticipate a reduction in this surplus due to the fact that public expenditure tends to accelerate in the second half of the year, prior to the close of the fiscal year. However, we expect an upward bias in relation to our fiscal surplus forecast (1.1%), due to the positive performance of tax receipts. Against this background, the downward trend of the government debt ratio continued, reaching 19.8% of GDP in the second quarter.

Chart 4
Fiscal Balance and Public Debt - As a percentage of GDP

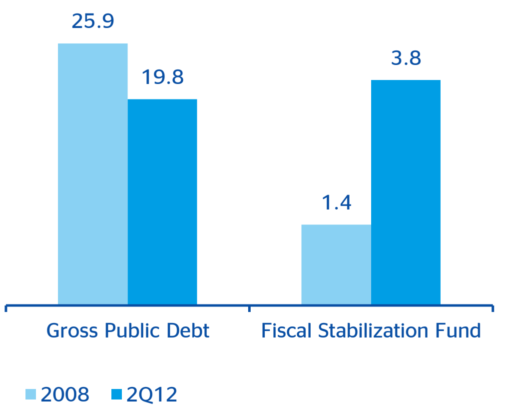


* The 2Q12 data for the overall balance refers to the rolling quarter of last 4 quarters.
Source: BCRP

The macroeconomic accounts show that the Peruvian economy remains well positioned to face the eventuality of greater deterioration of the external environment

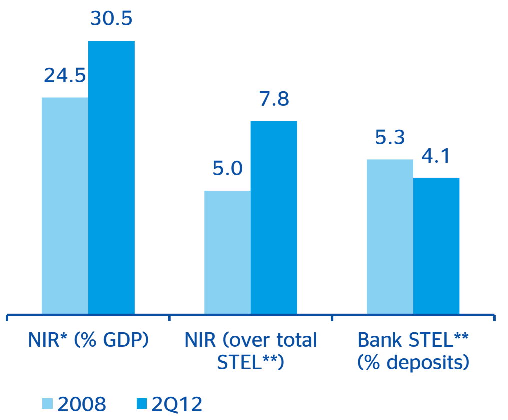
The indicators of fiscal and external vulnerability continue to show positive performance and also show that in the eventuality of greater deterioration of global economic activity, the Peruvian authorities have ample room for fiscal and monetary response, even more than that seen during the months prior to the international financial crisis in September 2008. On the fiscal side, the low level of public borrowing is worth mentioning, with a gross debt of 19.8% of GDP and a net debt of 4.3%. The positive performance of the public balances has been emphasized by the risk rating agencies. Moody's recently upgraded Peru's sovereign debt rating to Baa2 (with a positive outlook), a level equivalent to that granted previously by Fitch and Standard & Poor's (BBB+). In addition, Standard & Poor's upgraded the outlook of Peruvian debt from stable to positive, arguing that the continuity of the macroeconomic policies and the investments expected in mining, hydrocarbons, infrastructure and electricity will continue to support GDP growth in the coming years. On the monetary side, the international reserve balance covers nearly 8 times the total short-term obligations (with maturity under 1 year) of the public and private sectors, while the short-term foreign liabilities of banks as a percentage of total loans continued to fall to 4.1%.

Chart 5
Indicators of fiscal vulnerability (% of GDP)



Source: BCRP

Chart 6
Indicators of external vulnerability



* CPET: Short-term external liabilities of the banking
Source: BCRP

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