

## Peru Macro View

### Changes to PF Investment Limits Unlikely to Dent USD/PEN

- **In the late stages of 2012 and early 2013, the appreciation of the PEN against the USD resumed in full.** The currency is currently trading at its highest point in well over a decade in both nominal and real multilateral terms. This situation has led authorities to step up intervention measures to try to put a brake on the USD/PEN's slide.
- **Among them, the BCRP recently announced that it was raising the foreign investment limits for pension funds (PFs).** On January 18, the BCRP announced that it was raising the foreign investment limit to 32% of assets under management from 30%. According to the BCRP, this would allow pension funds to invest an additional US\$750 million abroad. We believe the BCRP will continue to use this tool in the future.
- **Although we believe the measure will help the central bank smooth the pace of appreciation, it will not reverse it, considering that capital inflows (FDI and portfolio) are still plentiful.** We estimate that even in an aggressive scenario, where the BCRP raises the foreign investment limit rapidly and pension funds' assets under management grow strongly, the measure would still not be enough to offset capital inflows.
- **All in all, our call is that the increase in foreign investment limits will be very gradual, which reaffirms our view that by itself, the measure is unlikely to put a permanent dent in the USD/PEN trend.** The main benefit is that higher pension fund capital outflows will ease some of the pressure on the central bank to purchase foreign currency in the spot market, and with it, sterilization needs. This is particularly relevant at a time when international reserves are hovering around 30% of GDP and credit is growing strongly.
- **In the short term, a combination of measures has put strains on foreign currency availability, limiting PEN appreciation against the USD.** However, we expect currency strengthening to resume once capital flows regain some traction and USD liquidity is replenished.

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# Changes to PF Investment Limits Unlikely to Dent USD/PEN

## A little context before we start...

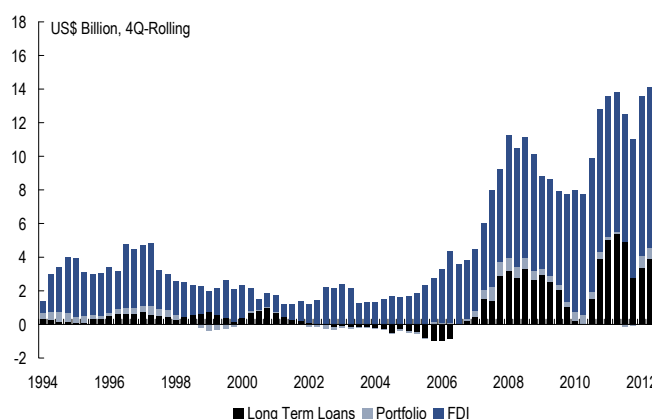
For quite some time, Peru has been facing a situation of continuous exchange rate strengthening driven by heavy capital inflows. Currently, the USD/PEN is trading at 2.553, which represents the strongest point for the Peruvian sol since 1996. When measured in real multilateral terms, the currency is at its most expensive point in two decades, comparable to when the economy was entering a stabilization phase after a long struggle with hyperinflation (see Figure 1). The appreciation trend of the PEN against the USD has intensified since 2004; not surprisingly this coincides with a period during which capital inflows have skyrocketed. Figure 2 shows capital inflows to the private sector jumping from under US\$2 billion a year in 2004 to around US\$16.8 billion (4Q rolling numbers) in 3Q12.

Figure 1. Peru: PEN at its strongest in well over a decade...



Source: BCRP and Citi Research

Figure 2. ...as capital inflows to the private sector have poured in

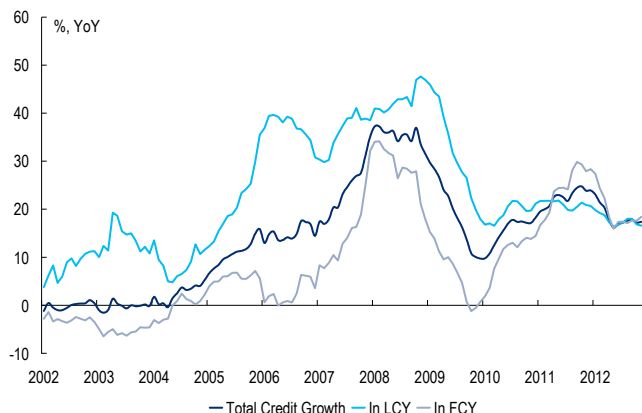


Source: BCRP and Citi Research

**Simultaneously, credit has been growing at a very strong pace and locals are getting increasingly indebted overseas.** According to data from the central bank on credit to the private sector shows that up to November, credit was growing at 17.4% YoY (Figure 3). Not only is credit growing, but it is also worth noting that it is growing strongly in both local and foreign currency. This trend has also been accompanied by rising indebtedness from abroad, especially in the banking and non-financial private sectors (see Figure 4).

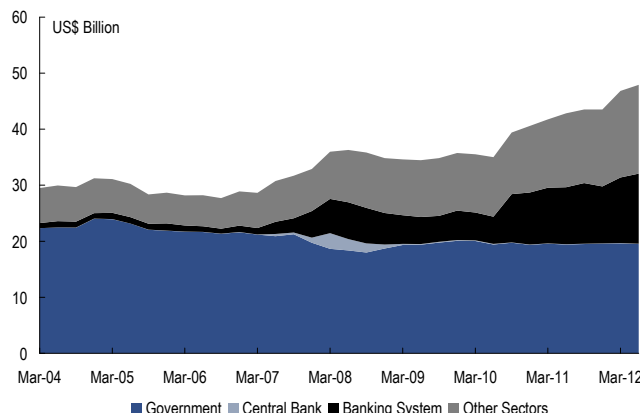
**There is one additional complication: Peru is a dollarized economy.** Fighting credit growth in a context of ample international liquidity and strong exchange rates is a challenge for most central banks, but it is a particularly difficult task in a dollarized economy such as Peru. In our [Peru Macro View - Reserve Requirements Are the Answer](#), we highlighted the challenges that the central bank is facing when it comes to controlling credit in the current context. To summarize, interest rate hikes might prove ineffective when trying to control credit growth because of the effect they might have on: 1) capital inflows and 2) the shift of local USD deposits to PEN denominated deposits. In the end, interest rate hikes might not bring credit growth down, while putting additional pressure on the exchange rate. It is in this context that the so called macro-prudential measures have risen in prominence as the central bank's weapon of choice to keep credit growth in check.

Figure 3. Peru: Credit growth remains strong...



Source: BCRP and Citi Research

Figure 4. ...and gross external debt is also rising



Source: Haver, BIS and Citi Research

As of late, the BCRP has used reserve requirements to prevent credit from growing excessively while avoiding additional downward pressure on the USD/PEN. Late in December 2012, the BCRP raised legal reserve requirements (RR) on local and foreign currency liabilities (by 25bp on the former and 75bp on the latter). However, Peru's reserve requirement system is more complex than that, considering that it also has an array of marginal RR: on liabilities with foreign financial institutions, on deposits associated with FX forwards and swap transactions and finally, on the system's foreign borrowing. As of November 2012, the effective reserve requirements for local currency liabilities stood at 18.8%, while those for foreign currency liabilities stood at 41.2%.

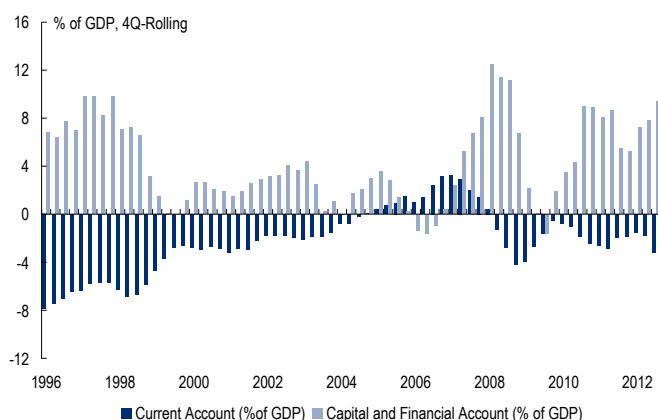
### About limits on PFs' foreign investments

In the past, the BCRP has used the limits on pension funds' (PFs) foreign investments as one of the tools to let some steam out of the FX market. However, once the operational limit reached the maximum regulatory limit of 30% in September 2010, the instrument was off the table. In July 2011, Congress approved a bill that raised the maximum regulatory limit to 50%, but the central bank refrained from taking any steps to raise the operational limit until now.

The BCRP raised the operational limit on PF foreign investments to 32% of assets under management (AUM) from 30% of AUM. The central bank announced the measure on January 18, although the possibility had been discussed several months before. According to BCRP estimates, the move would allow PFs to invest an additional US\$750 million abroad (0.34% of GDP), which should be clear by now, is not enough to offset the capital account surplus and the incoming investment flows.

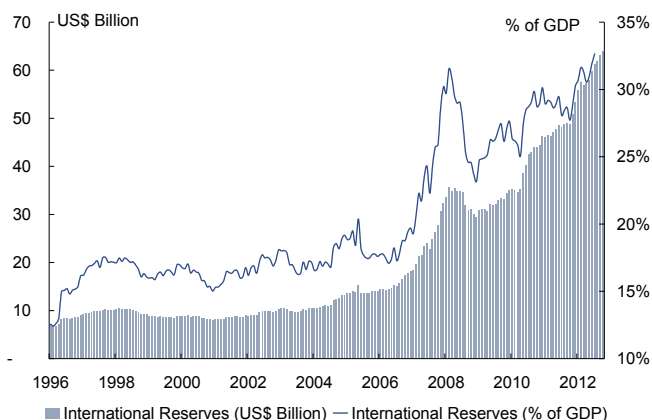
Nonetheless, the idea behind raising PFs foreign investment limits is to ease some of the pressure on the capital account surplus. As we mentioned above, since 2004, Peru has seen a substantial increase in capital inflows, as reflected by the fact that the capital and financial account have posted a surplus of around 6-7% of GDP per year. Although during the second half of the 1990's a strong capital account surplus was also the case, the current account deficit was deeper in negative territory, limiting pressure on the currency. Nowadays, the limited current account deficit (or even surplus in a couple of years) has implied a substantial increase in international reserves, as the central bank mops up the excess inflows.

**Figure 5. Peru: Massive capital account surplus and limited current account deficit...**



Source: BCRP and Citi Research

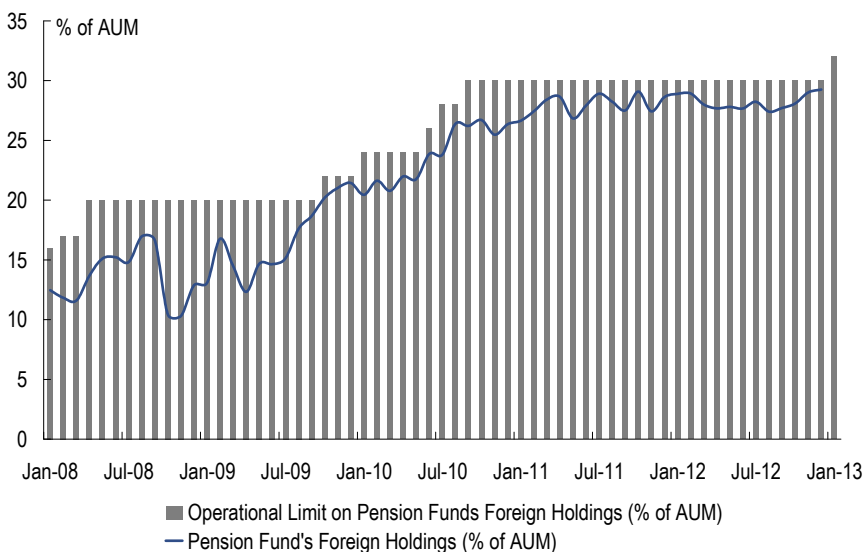
**Figure 6. ...translate into rising international reserves**



Source: BCRP and Citi Research

**So the relevant questions become: 1) How high will the central bank take foreign investment limits in the future and 2) can the measure generate enough capital outflows to weaken the strains on the currency?** To answer this question, we have to first take a closer look at PFs current portfolio, and determine whether the current limits on foreign investments are binding. Then, we can make some assumptions about how PFs assets are likely to evolve and how will they shift their portfolio allocation in the face of further increases in foreign investment limits.

**Figure 7. Peru: Limits on PFs foreign investments have been binding**

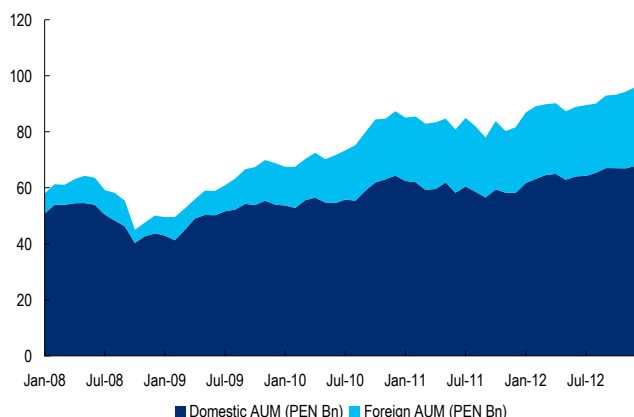


Source: SBS and Citi Research

**In the past, pension funds have taken the opportunity to invest abroad and their foreign investment allocation is currently close to the limits.** Figure 7, shows that since the second half of 2009, PFs actual foreign asset position has been fairly close to the operational limit set by the central bank. This remains the case nowadays, as the systems' foreign assets are equivalent to 29.3% of assets under management, slightly under the previous 30% limit. The only episode in

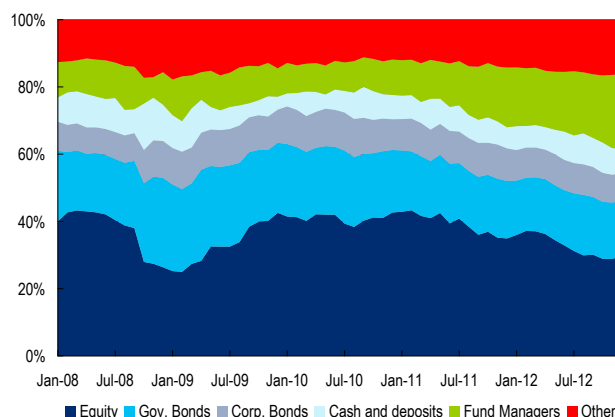
which pension funds steered clear of foreign assets was during the second half of 2008. Therefore, the assumption that PFs will take advantage to invest abroad if the BCRP raises foreign investment limits seems reasonable at the moment.

Figure 8. Peru: Domestic and foreign assets (PEN Bn)



Source: SBS and Citi Research

Figure 9. Peru: PF portfolio composition (as % of AUM)



Source: SBS and Citi Research

## PF capital outflow under several scenarios

**We estimated what pension fund capital outflows would look like under several scenarios.** The question we asked ourselves is: what would be the capital outflow (per year) from PFs that is consistent with reaching the 50% of AUM limit on foreign assets? The scenarios vary in two ways. First we consider the speed at which the central bank raises the foreign investment limit to 50%, because as Figure 7 shows, the approach is likely to be gradual. Second, we consider the speed at which PF assets grow, since this will determine the amount of foreign assets they will need to purchase in order to reach the BCRP's limit. Intuitively, the faster the BCRP raises the limit of PFs foreign holdings, the larger the capital outflow required. Similarly, faster AUM growth means larger capital outflows.

Figure 10. PF outflow scenarios (% of 2012 GDP)

		PF Asset growth per year (in PEN Billion)			
		5	10	15	20
Years for BCRP to raise foreign investment limit to 50%	3	1.7	2.2	2.7	3.2
	4	1.4	1.9	2.4	2.8
	5	1.2	1.7	2.2	2.6
	6	1.1	1.6	2.0	2.5

Source: Citi Research

Figure 11. PF outflow scenarios (in 2012 US\$ Bn)

		PF Asset growth per year (in PEN Billion)			
		5	10	15	20
Years for BCRP to raise foreign investment limit to 50%	3	3.5	4.4	5.4	6.3
	4	2.8	3.8	4.7	5.7
	5	2.5	3.4	4.3	5.3
	6	2.2	3.2	4.1	5.0

Source: Citi Research

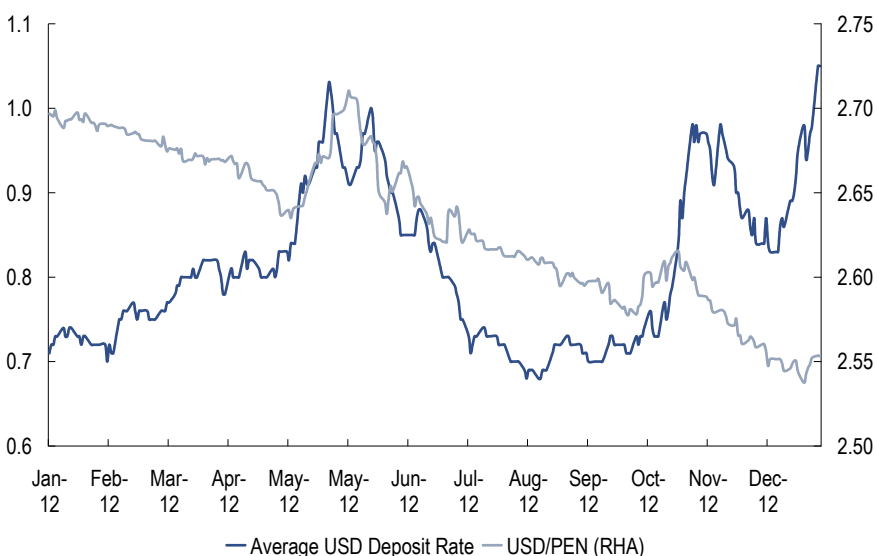
**The measure is unlikely to generate outflows large enough to counter the Peru's strong capital account surplus.** Even in an aggressive scenario where the BCRP raises the limit to 50% in as little as three years and PFs assets grow to the tune of PEN20 billion a year, PFs annual capital outflow would only amount to 3.2% of 2012 GDP per year (or US\$6.3 bn), which pales in comparison to the country's capital account surplus of 9.4% of GDP<sup>1</sup> up to 3Q12. In a very conservative scenario, where the BCRP takes 6 years to raise the limit to 50% and where PFs assets only grow by PEN5 billion a year, we estimate that capital outflow from the measure would only amount to 1.1% of 2012 GDP per year (or US\$2.2 bn). In our view, the BCRP will raise the limits on foreign investments very gradually, as it has done in the past, in order to avoid big swings in the currency. Therefore, the aggressive scenario could be viewed as an upper bound estimate of what pension fund capital outflows could be in the years to come.

## Implications for the USD/PEN

**The main conclusion from our analysis is that in the long term, the measure is unlikely to completely offset downward pressure on the USD/PEN, given that capital inflows are still abundant.** However, one benefit from the measure is that it will ease the pressure on the central bank to accumulate international reserves, and with it, pressure to sterilize foreign currency purchases. This, at a time when Peru's international reserves are already hovering around 30% of GDP and rising.

**In the short term, the combination of recent reserve requirement measures, aggressive currency purchases by the central bank and the increase in PFs' foreign investment limits have created a shortage of liquidity in foreign currency, putting a brake on the PEN's strengthening.** We therefore see the recent pause in PEN appreciation (against the USD) as temporary, and expect strengthening to resume once capital flows regain some traction and USD liquidity is replenished.

Figure 12. Peru: USD liquidity shortage should put a brake on PEN strengthening in the short-term



Source: Bloomberg and Citi Research

## Appendix A-1

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