BBVA | RESEARCH

Peru Economic Outlook

FIRST QUARTER 2016 | PERU UNIT

01
The economy will grow by 3.6% in 2016 and by more than 4% in 2017, boosted by increased mining production and expenditure on infrastructure

02
The Peruvian currency will continue to depreciate, especially in the first half of the year, but will then tend to moderate and will end the year between

03
Inflation will soon start to ease, but high inflationary expectations will produce downward resistance, so that it will end the year still above target

04
Balance of risks of growth projection has downward bias due to China's performance and possible delays in infrastructure construction

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Closing date: 15 February 2016

1 Editorial

Global economic activity will grow in 2016 at a similar rate to last year (3.2%) before going on to improve gradually. As for the advanced economies, the US too will grow at a similar rate to that of 2015 (2.5%), underpinned in particular by private consumption, since job creation continues strong and this will offset the reduction in capital expenditure in the energy sector due to the low price of oil and the negative impact of the dollar's appreciation on exports. The weakness of capital expenditure, the contained inflationary pressures and the higher level of noise in the international markets suggest that the US Federal Reserve will continue to gradually ratchet up its key interest rate. We do not believe that it will do so more than twice this year (25 bps on each occasion). Turning to the emerging economies, China continues to moderate its dynamism, but the adjustment is not abrupt and has not led to any unpleasant surprises. Moreover, China's economic authorities have room to implement measures on the demand side to order the process and ensure a continued soft landing. The scenario is challenging, but it is also the most likely one and the one we are taking into consideration. In this context, the markets' current concerns about China's economy will tend to diminish. We foresee China growing by 6.2% in 2016 and slightly under 6% in 2017. Lastly, in Latin America, most of the major economies will see slower growth in 2016 than last year, reflecting weak commodity prices, idiosyncratic factors in some cases and, against that backdrop, lower business and consumer confidence. Thus the Pacific Alliance countries (Peru, Chile, Colombia and Mexico) will grow this year by between 2% and 2.5%, somewhat less than in 2015 but improving from then on, whereas the Mercosur countries (Argentina, Brazil, Paraguay, Uruguay and Venezuela) will see further contraction in 2016, by around 3.5%.

In this context, we estimate that the Peruvian economy will show greater dynamism from now on, accelerating from growth of 3.3% in 2015 to 3.6% in 2016 and to just over 4% in the following year. The main drivers of this growth will be increased mining production, particularly of copper due to major mines coming on-stream, and increased public and private sector capital expenditure on infrastructure projects such as Line 2 of the Lima Metro, the gas pipeline in the south of Peru, the Mantaro-Marcona-Socabaya-Montalvo electricity transmission line, the modernisation of the Talara refinery and Chinchero airport in Cusco, which will provide support for the construction and manufacturing sectors. Together, increased output of copper and these five infrastructure projects will contribute just over two percentage points to GDP growth in 2016 and a similar amount in the following year. From the expenditure point of view, this will tend to sustain the strong dynamism of exports (traditional exports of goods) and improved performance of public and private sector capital expenditure. The forecasts are consistent with an El Niño phenomenon of moderate intensity, the effects of which will start to dissipate in the second quarter of this year, and with a gradual improvement in business and consumer confidence as GDP growth figures increase, inflation and depreciation of the national currency ease, the shadow of the El Niño phenomenon clears, the domestic electoral process draws to a close and in general external noise moderates.

As for the public accounts, the fiscal deficit will be between 2.5% and 3% of GDP in 2016 and 2017. Thus it will deteriorate in comparison with previous years, above all due to expenditure on infrastructure and the improved performance of regional governments' capital expenditure. As a result, gross public debt will increase, although remaining at manageable levels. To finance it, the Peruvian State will have to turn increasingly to national and international debt markets. As regards the external sector accounts, the mining boom will contribute to a significant reduction in the current account deficit of the balance of payments, despite the low prices of the commodities exported, to somewhere nearer 3% of GDP this year and next, as opposed to 4% in the past two years.

In the currency markets, the trend of the national currency will be one of continuing depreciation, because the current account deficit of the balance of payments is still substantial, even after excluding transitory negative effects such as lower-than-"normal" commodity prices and global cyclical weakness. However, we estimate that the slide in the value of the Nuevo Sol will be more moderate than last year. Firstly, because a large part of the adjustment towards its equilibrium level, which we place at between 3.65 and 3.70 to the dollar, has already taken place (and the central bank's interventions limit the possibility of overreaction). Secondly, because the current account deficit will decrease significantly in 2016. Thirdly, because there is less and less scope remaining for taking new positions in favour of foreign currency. For example, the balance of currency forwards is at the maximum established by the central bank, and there has already been significant dollarisation of families' and businesses' surplus funds and funds administered by pension schemes. And lastly, because expectations of depreciation will ease as the current uncertainty about global economic growth moderates (China will continue its gentle descent, US growth figures will return to around 2.5% in the next few quarters), commodity prices will stop falling and even recover somewhat in the second half of the year, and the national electoral process will come to an end (because naturally there is some increased uncertainty, and in such a context defensive positions are taken in investment portfolios). Lower expectations of depreciation of the national currency will make it more attractive to save in local currency, the more so with the upward adjustments that the central bank has been making to its key rate. In this scenario, we foresee depreciation of the currency being accentuated in the first half of 2016, as we have already been seeing, but more contained in the second half, with the Nuevo Sol ending the year at between 3.60 and 3.65 to the dollar.

As for the outlook on prices, the year-on-year inflation rate has maintained an upward trend since the beginning of 2015, due mainly to the depreciation of the national currency and to higher food prices due to weather shocks. It has been above the target range for several months, and similar trends are seen in other price measurements such as core inflation and even inflation excluding food and energy. In this context, inflationary expectations have been unleashed. However, we believe that **year-on-year inflation will soon start to ease**. The two main sources of its acceleration (depreciating currency and higher food prices) will moderate from now on, in the latter case because the effects of the El Niño phenomenon (droughts in particular) will start to dissipate from the second quarter on. To this will be added the fact that, according to our forecasts, the price of oil still has some way to fall in the short term, which will have a similar effect on fuel prices. As a result, inflation **will end the year somewhat above the target range, at 3.2%**, in part because of the downward resistance caused by high inflationary expectations, but we see it being back within the range from the beginning of 2017.

In this environment of inflation and rising inflationary expectations, the central bank has been increasing its benchmark interest rate, by a cumulative 100 bps since last September. The communiqué accompanying its February decision, when it raised its policy rate by 25 bps, **reveals a greater determination to contain growing inflationary expectations**, something not seen in previous communiqués. **The recent improvement in activity lends credibility to this objective**. We think therefore that **the decision on whether or not to continue raising the reference rate will depend largely on how inflationary expectations evolve**. It is by no means impossible that the more energetic tone of the latest communiqué and its greater credibility might moderate these expectations, thus ironically making it unnecessary for the central bank to raise its rate further.

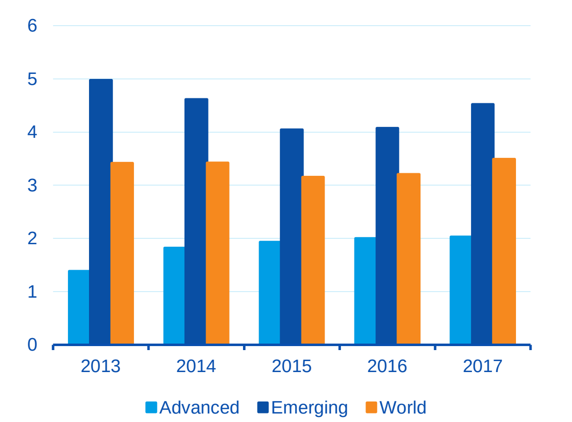
Lastly, **the balance of risks on the growth projection for 2016 has a negative bias**. China and delays to major infrastructure construction projects are main downside risks offsetting any positive surprise from mining production or anchoveta extraction.

2 A global outlook of anaemic and more fragile growth

During the last quarter of 2015 some of the risk clusters with a global impact intensified. The transition to a lower growth pattern in China, with economic reforms and changes to key objectives such as the exchange rate, is being accompanied by bouts of intense financial volatility and falling commodity prices. All this leads to a much less favourable global outlook for commodity-exporting economies, especially for those perceived as more vulnerable in financial terms. This has naturally had negative effects on the leading indicators of business confidence and has led to an increase in financial stresses, which will probably be reflected in the growth rate in early 2016, which will no doubt be more moderate than we forecast in our last report of three months ago.

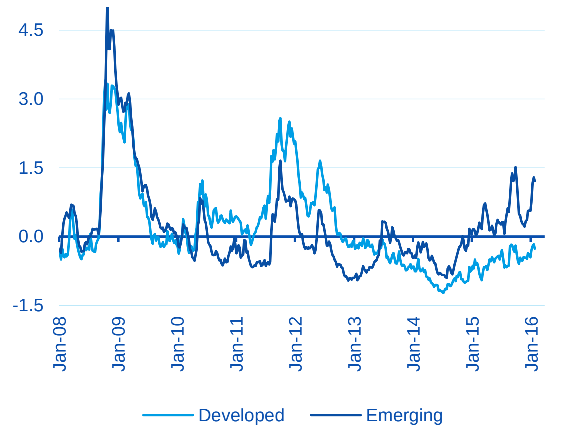
In this context, we estimate that world GDP will grow by 3.2% in 2016, a similar pace to that of last year, which would mean postponing the recovery to 2017 when global activity will grow at a rate of close to 3.5% (see Graph 2.1). These forecasts assume that demand in the emerging economies will remain weak and that recovery in the developed economies will continue to be fragile and highly dependent on the eventual impact of the slowdown in world trade and of financial instability on industrial output, corporate capital expenditure and consumer spending.

Figure 2.1
World GDP
(YoY % var.)



Source: BBVA Research

Figure 2.2
Financial stresses according to the BBVA index
(normalized values)



Source: BBVA Research

The recent behaviour of the financial markets is largely explained by doubts concerning the strength of the global economic cycle, especially in the case of the emerging economies. Activity indicators continue to show the greatest degrees of deterioration concentrated in manufacturing and trade. Services, which in the developed economies had benefited until now from the recovery of private consumption, are also starting to show signs of less dynamism. In this context, BBVA Research's Financial Stress Index for emerging countries has climbed back up to the levels seen in July and August 2015 (first wave of the Chinese stock exchange crisis), even matching the stress levels of 2011 (see Figure 2.2.) In contrast, financial stresses in the developed economies, which are seeing a flight-to-safety in low risk profile assets such as Japanese, US and German sovereign bonds, remain contained.

In this environment, world economic growth will not only be limited, but with risks showing a negative bias and concentrated in the emerging bloc. For example, the manner in which China's economy evolves, both as regards the degree of slowdown in activity and the way the authorities manage the financial imbalances that exist, will continue to have a significant influence on global capital flows and commodity prices in general, not just oil. An additional source of risk in emerging economies is the level of corporate indebtedness in those countries most vulnerable to the external environment, since revenues have declined and funding costs increased (high risk premiums). Added to all this are on the one hand geopolitical tensions in certain parts of the world and on the other the risk of a scenario of low growth and low inflation in the major developed economies.

US: moderate growth, relying on consumer spending

The US economy grew at 2.5% YoY in the second half of 2015. For the time being, our baseline scenario assumes that growth will continue at a similar pace this year and next. It also assumes that the price of oil will continue low and that there will be no upward pressures on inflation. In this context, we believe the path of adjustments to the monetary policy rate will be step by step, with not more than two hikes (each of 25 bps) in 2016, which is consistent with the US Federal Reserve's repeated statements that interest rate increases will be gradual and subject to continuous monitoring of the dynamic of domestic demand and inflation. Our forecast for US economic growth has a negative bias however, due to the slowdown in activity in the fourth quarter of last year and the advance signals provided by business confidence indicators.

China: the challenge of eliminating financial instability

The growth dynamic shown by China in the short and medium term will continue to be decisive for the world economic cycle. Our baseline scenario assumes that the path of gradual moderation and rebalancing of economic growth that started five years ago will continue in the next two years, such that after growing at somewhat less than 7% in 2015, this year activity will grow by 6.2%, and next year by 5.8%. Additional monetary stimulus measures during 2016 in the form of key interest rate cuts cannot be ruled out, although they will be constrained by the impact they might have on capital flows. The risk of the growth forecast has a negative bias however, due to the doubts about China's ability to successfully manage the transition to a more moderate and balanced economic growth model - doubts which grew once more in the last quarter of last year following a new bout of financial instability again deriving, as in August, from the stock and currency markets.

Euro zone: the pace of growth of activity will gradually improve

With the recent recovery dynamic, the euro zone should grow by 1.8% this year (1.5% in 2015) and 2.0% in 2017, the same figures as anticipated last quarter. The positive effect of low energy prices, the more expansionary fiscal policy and the continuation of loose monetary conditions will be partly offset by the negative impact of the slowdown in international trade on the export of goods and of increased financial and political instability on investment decisions.

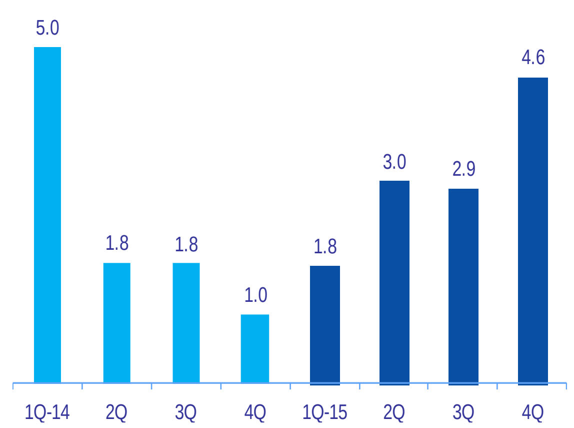
3 Peru: activity will grow by 3.6% in 2016 and by somewhat more than 4% in the following year

Growth improved over the course of 2015 and in Q4 2015 posted its best figure in almost two years, underpinned by the extractive industries.

The economy gradually recovered over the course of 2015. Thus, while GDP growth at the end of the previous year was around 1% YoY, in 2015 the figures tended to improve quarter by quarter, reaching 4.6% in the last quarter (see Figure 3.1). Thus GDP growth for the whole of 2015 was 3.3%, compared with 2.4% the year before.

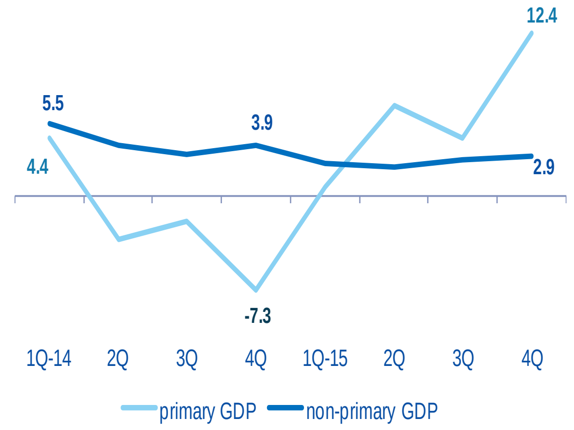
However, this improvement was uneven. From a sector point of view, the impetus came from primary activities, i.e. those associated with the extraction of natural resources such as metal mining and fisheries, and which are more dependent on supply factors and produce largely for export. In contrast, the non-primary sectors, which account for more than 70% of economic activity, generate the greater part of formal employment and provide a better reflection of trends in domestic demand, showed a low and unchanging level of dynamism over the course of the year (see Figure 3.2).

Figure 3.1
Quarterly GDP[1/]
(YoY % var.)



1/ Q4 own estimate.
Source: BCRP (Central Reserve Bank of Peru), INEI National Statistics and IT Institute) and BBVA Research

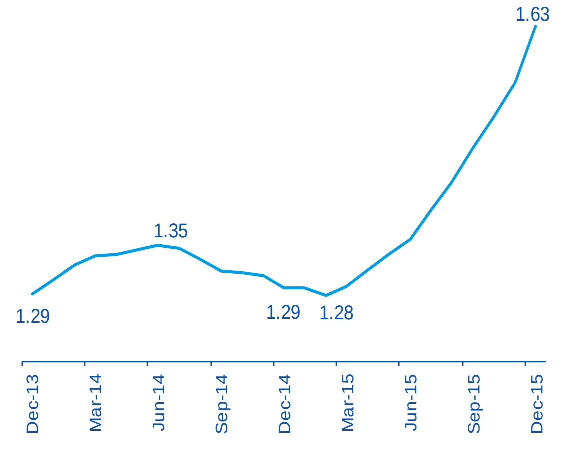
Figure 3.2
GDP: growth by productive sector[1/]
(YoY % var.)



1/ Non-primary GDP excludes import duties.
Source: BCRP (Central Reserve Bank of Peru), INEI (National Statistics and IT Institute) and BBVA Research

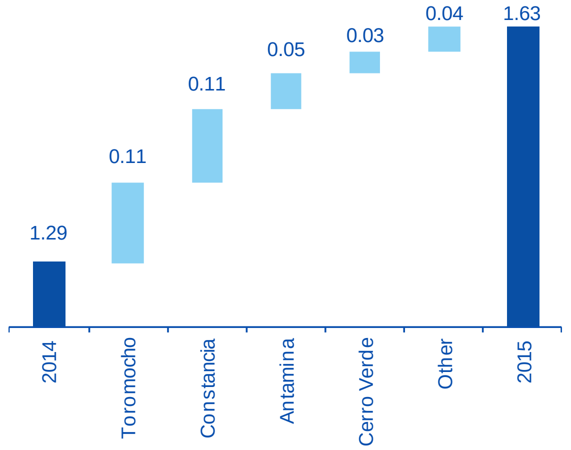
There were two main factors underpinning the performance of primary activity. The first was the substantial increase in copper extraction, which after increasing by 10% YoY in the first half of the year, increased by more than 40% in the second half (47% in Q4 2015), which was a positive surprise (see Figure 3.3). Toromocho and Constancia, two mines that came into production in 2014, gradually increased their extraction over the course of 2015; the former will attain its maximum operating capacity in 2016, while last year Constancia comfortably and consistently exceeded the maximum output initially announced. To this was added on the one hand the recovery during the second half of the year in volumes extracted by Antamina, currently Peru's biggest copper project, following the operational problems encountered in the previous year; and on the other hand the surprise start of production in the fourth quarter of two mines which may well turn out to be as big as Antamina: the expanded Cerro Verde and Las Bambas. As a result, copper extraction in Peru surpassed 1.6 million metric tonnes in 2015 (see Figure 3.4), 26% up on the previous year's production and directly contributing more than one percentage point to GDP growth for the year (according to our estimates, nearly two percentage points in Q4 2015).

Figure 3.3
Copper production (millions of metric tonnes, past twelve months cumulative)



Source: INEI, MINEM (Ministry of Energy & Mines) and BBVA Research

Figure 3.4
Copper: additional production in 2015 by project (millions of metric tonnes)

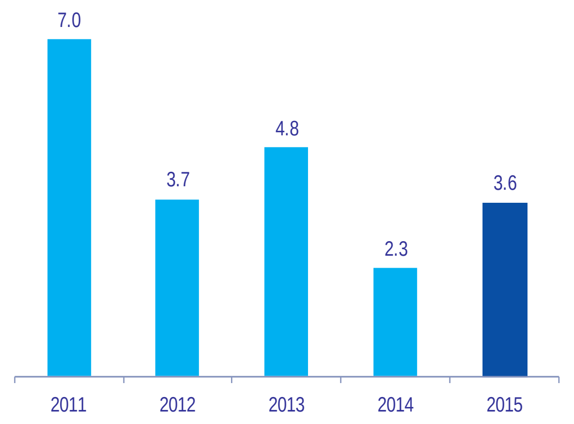


Source: INEI, MINEM (Ministry of Energy & Mines) and BBVA Research

The second factor underpinning primary activity was the increase in extraction of anchoveta. In 2014 the quota assigned for the first fishing season of the year was not fully achieved in the north-central region of the country, where 90% of the total is extracted, due to difficulties in extracting anchoveta attributable to warmer than normal sea temperatures, which cause the anchoveta to disperse and go deeper than usual, and which also affect their reproductive process, as a result of which the closed season was not lifted in the second half of the year. Thus 2014 was a bad year for the sector. 2015 was different. Although anomalies in sea temperature persisted, this time the start of the first season was brought forward, so that the quota catch assigned could be completed before the El Niño phenomenon exacerbated the warming; for the second season (November-January) there were initially doubts as to whether the closed season should be lifted, given the risk of depleting the resource if the biomass had been badly affected by the high temperatures, but in the end a smaller quota was established than the average one set for this period of the year, and surprisingly it was completed without compromising the sustainability of the species. As a result, anchoveta extraction increased by 45% YoY in the first half of the year and by nearly 130% in the second half, with a total catch for 2015 of more than 3.6 million metric tons (see Figure 3.5). Together with the indirect impact that it has on primary manufacturing (of fish meal and oil for export), the 60% increase in anchoveta extraction during 2015 will have contributed about half a percentage point to the GDP growth rate (and more than one percentage point in Q4 2015) according to our estimates.

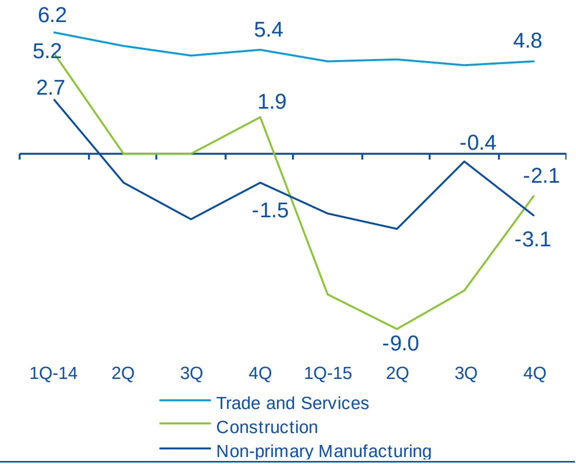
As for non-primary activities, which better reflect trends in domestic demand, they showed uneven performances. As a whole they posted low growth (the lowest since 2009), which was stable throughout 2015, but whereas Trade and Services maintained an attractive growth rate of between 4% and 5%, albeit with a slight downward trend, reflecting above all the behaviour of private sector consumer spending, non-primary Construction and Manufacturing contracted significantly in a context in which demand for capital expenditure and external demand for non-traditional products showed similar trends (see Figure 3.6).

Figure 3.5
Anchoveta catch
(millions of metric tonnes)



Source: INEI, IMARPE (Instituto del Mar del Perú) and BBVA Research

Figure 3.6
Non-primary GDP: selected activities
(YoY % var.)

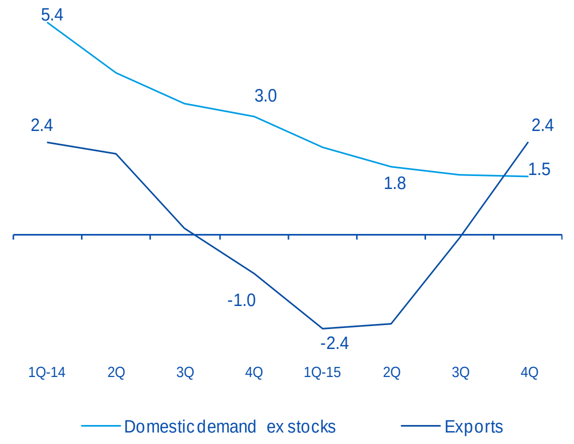


Source: INEI, BCRP and BBVA Research

On the expenditure side, the impetus provided by the extractive industries favoured export sales, particularly of traditional goods, but domestic demand (excluding inventories) continued to weaken.

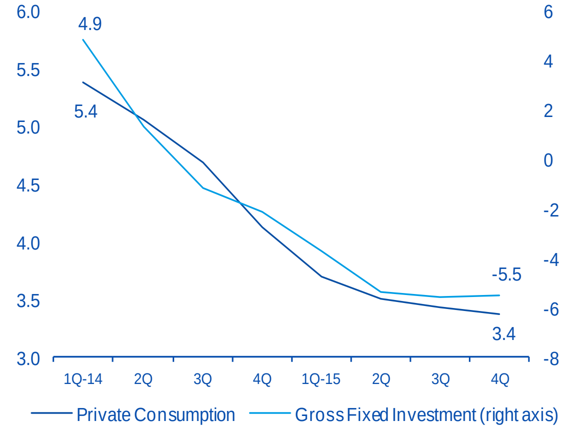
The strong dynamism of the extraction of natural resources was reflected on the demand side in increased exports. Volumes exported improved throughout the year (see Figure 3.7), in particular those of traditional products, and we estimate that this was clearer in the fourth quarter of 2015, when shipments of both copper and fish meal (made from anchoveta) increased by more than 45% YoY. Non-traditional exports, in contrast, continued to contract, especially textiles, chemicals and steel and metallurgical products, in an environment in which Latin America, the main market for these goods, continued to weaken.

Figure 3.7
Exports and Domestic Demand[1/]
(cum. in past 4 quarters, YoY % var.)



1/ Domestic demand excludes inventories so as to reflect final sales in the local market
Source: BCRP and BBVA Research

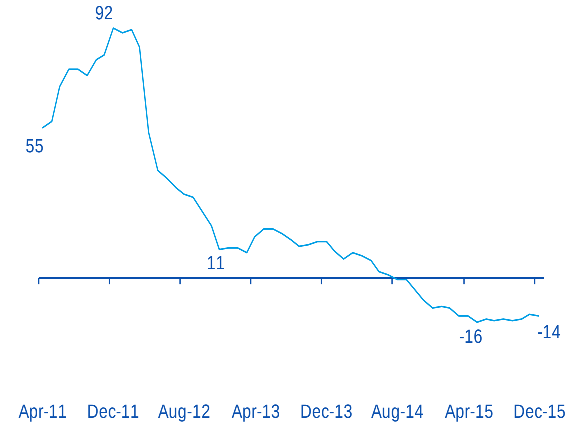
Figure 3.8
Gross capex & private consumption
(cum. in past 4 quarters, YoY % var.)



Source: BCRP and BBVA Research

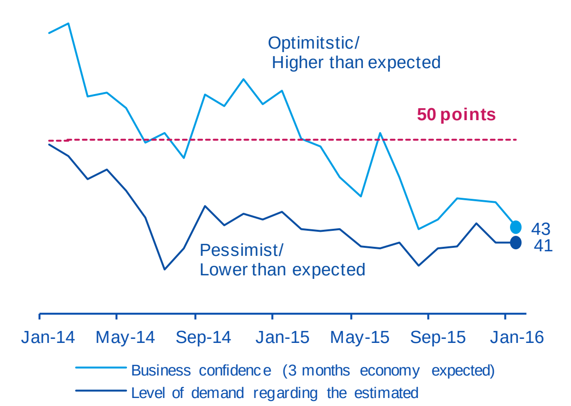
Domestic demand, for its part, which reflects sales in the local market, continued to lose momentum; at the end of 2014 it was advancing at a rate of 3% YoY, while at year-end 2015 we estimate that it was doing so at half that rate (see Figure 3.7). This behaviour is explained by the deterioration in both private and public sector capital expenditure (see Figure 3.8). In the case of the private sector, we estimate that it fell by between 4.5% and 5.0% in 2015, thus reflecting the gradual completion of the construction phase of the major mining projects such as Constancia, the extension of Cerro Verde and Las Bambas (see Figure 3.9). Other influences came from the weak dynamism of the property market (see Box 1) and more generally the decline in business confidence that has come about in a context in which on the one hand the figures for economic growth and demand faced by businesses were disappointing during much of the year (see Figure 3.10), and on the other, the increasing noise due to the intensification of sources of external risk, the greater financial stresses in the emerging economies, the dangers attaching to an El Niño phenomenon that was initially expected to be very intense in the summer, and the uncertainty that naturally precedes the election of a new government. Public sector capital expenditure, for its part, deteriorated over the course of the year and ended it with a decline of 9%, reflecting the low degree of execution of budgeted spending by regional governments, which we deduce from the slow learning process of the new authorities that came into power at the beginning of 2015.

Figure 3.9
Mining investment1/ (in US$, cum. in past year, YoY % var.)



1/ Represents approximately 20% of total private sector investment
Source: MINEM and BBVA Research

Figure 3.10
Business confidence and surprise in demand[1/] (in points)



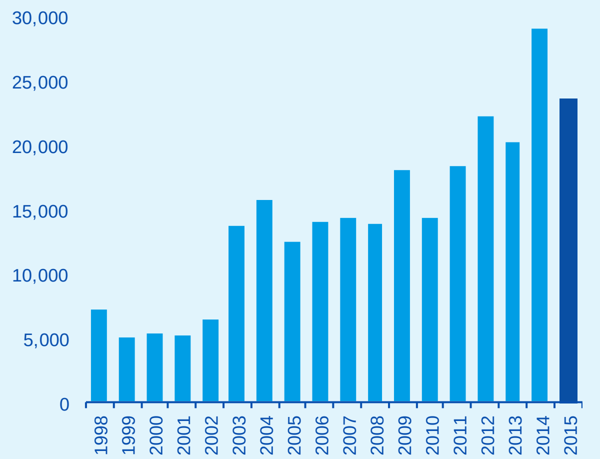
1/A figure below 50 points means that demand was weaker than business people expected; conversely if it is above 50 points.
Source: BCRP and BBVA Research

Box 1. The property sector showed some improvement in 2015, but has still not regained the dynamism of previous years, and stocks remain high[1]

Housing market

The supply of housing in Greater Lima[2], which reflects the number of units available for sale at year-end, was corrected downwards in 2015 (see Figure R.1.1)

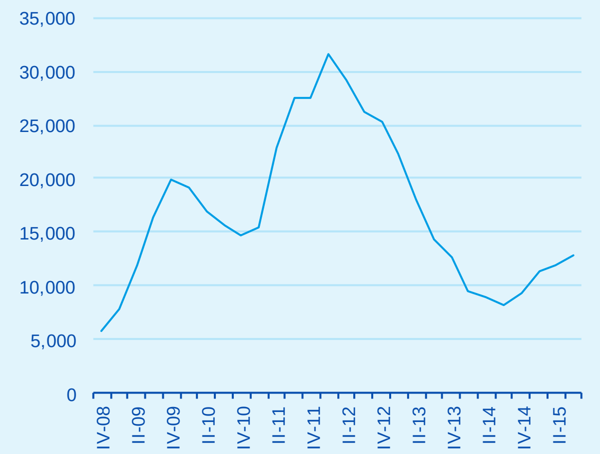
Figure R.1.1
Lima[1/]: supply of housing[2/] (in number of units)



1/ Comprises a total of 49 districts, 43 of them in Lima and 6 in Callao. 2/ 99% relate to supply of apartments; the remainder to houses and plots.
Source: CAPECO (Chamber of Construction) and BBVA Research

As for new units coming onto the market[3], there was an improvement compared with the year before (see Figure R.1.2). These new units were concentrated in districts such as Miraflores, Surco, Jesús María, Pueblo Libre and Lima Norte, most of which have above-average prices per square metre. Several of these districts are also those in which much of the available housing stock offered in the market was already concentrated.

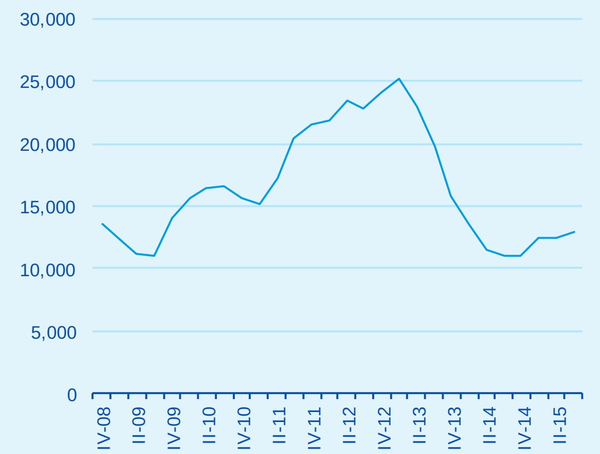
Figure R.1.2
Lima[1/]: number of housing units entering the market (cum. in past four quarters)



1/ Comprises 26 districts of Greater Lima.
Source: TINSA (real estate appraisals) and BBVA Research

As regards sales, these too posted improved performance in 2015 (see Figure R.1.3). On balance, this explains the downward correction in supply (stock) of housing.

Figure R.1.3
Lima[1/]: number of residential units sold (cum. in past four quarters)



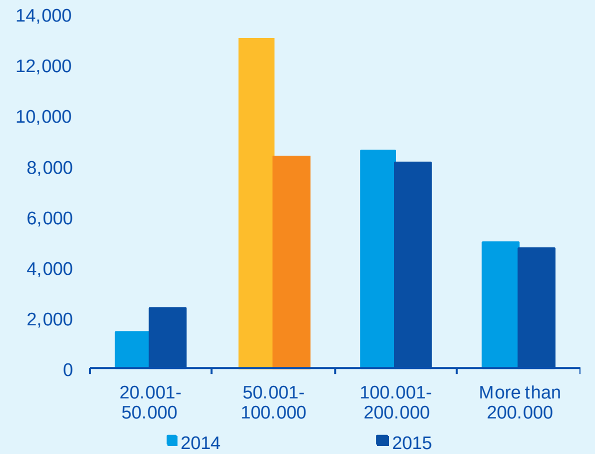
1/ Comprises 26 districts of Greater Lima.
Source: TINSA (real estate appraisals) and BBVA Research

However, in contrast with what happened with new units coming onto the market, the greatest dynamism in sales was seen in outlying districts of the city such as Comas, Barranco and Carabayllo, several of which have medium-to-low prices per

[1] Data available for Greater Lima only.
[2] The supply of housing includes the stock from the end of the previous year, to which is added the number of units coming onto the market during the current year less the number of units sold in that same period.
[3] We should mention that the construction date of these units does not necessarily coincide with the year in which they are placed on the market. For example, many or possibly even all of the new units offered in 2015 may have been built in prior years. However, in general terms, the trend in new housing coming onto the market is also an indicator of the trend in housing construction.

square metre. As a result, normalisation in the supply of housing was more marked in those districts (see Figure R.1.4).

Figure R.1.4
Lima[1/]: supply of housing by price[2/] (in number of units)



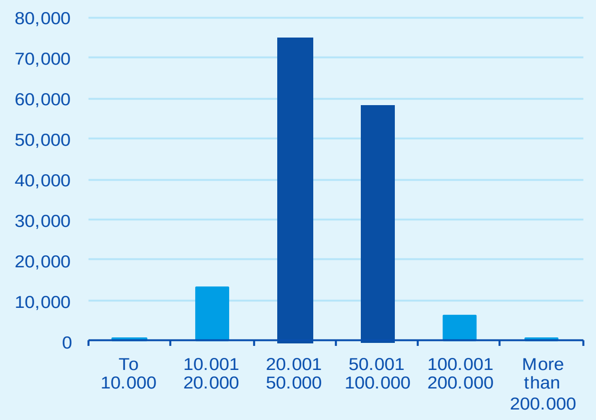
Share	10%	36%	35%	20%

1/ Comprises a total of 49 districts, 43 of them in Lima and 6 in Callao. 2/ 99% relate to supply of apartments; the remainder to houses and plots.
Source: CAPECO (Chamber of Construction) and BBVA Research

The greater dynamism of sales in the districts with medium-low price levels is consistent with the results of effective demand carried out by CAPECO, the Peruvian Chamber of Construction. This effective demand measures the intention to acquire a home[4], and in the case of apartments amounts to 153,000 homes, 96% of which would prefer to buy a medium-low priced property (less than US$100,000 see Figure R.1.5). In other words what we are seeing is that the supply and the new units coming onto the market are aimed at the higher-income public, but the greater part of effective demand is not there but in the lower income segment of the population. There are several reasons that may explain this imbalance. For example, the lack of land suitable for carrying out large-scale projects (scale makes it profitable to construct medium-low priced housing) or the difficulties encountered in verifying irregular income flows or income flows from informal sources such as a significant portion of households with lower purchasing power have (this prevents their accessing bank financing).

[4]According to CAPECO, a household's effective demand for a dwelling exists when it wishes to acquire it and is financially capable of doing so.

Figure R.1.5
Lima: effective demand for apartments, 2015 (in number of buildings)



Share	0.2%	9%	49%	38%	4%	0.1%

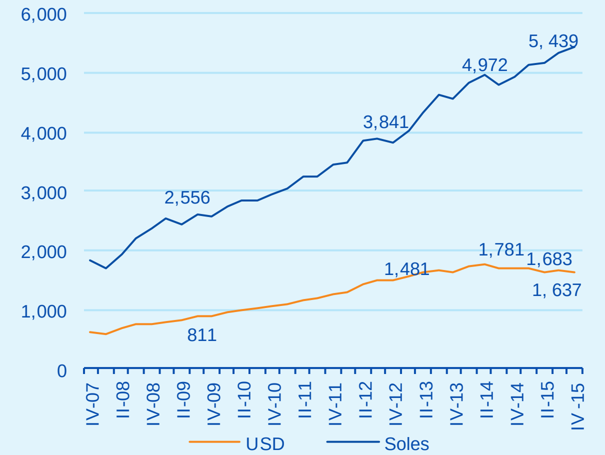
Source: CAPECO (Chamber of Construction) and BBVA Research

In summary, sales and new units coming onto the market both improved in 2015, and on balance the supply of housing corrected downwards. This adjustment was more marked in the medium-low price segments in which effective demand is concentrated but supply is scarce. From a wider time perspective however the dynamism of the housing market (sales and new units coming onto the market) is considerably less than it was just a few years ago, and supply (stock) remains high, not just in number of units but also as a proportion of sales made. In this situation, prices, measured in the currency in which apartments are mainly offered (dollars), have fallen[5] (see Figure R.1.6). Looking forward, this situation also points to a scenario in which, although the housing market might continue to show some improvement as the economy strengthens and uncertainty dissipates (external noise, greater caution leading up to the change of government, possible incentives for the market that the new administration may introduce), and in this context prices encounter a certain resistance to further declines (which stops people waiting longer before buying), this improvement would nevertheless be limited, because there is less and less room to grow significantly in the market segments at which

5 Measured in national currency, prices continued to increase in 2015 due to the significant depreciation of the currency, albeit at the slowest rate for several years.

supply has so far been aimed, unless of course the problems affecting the supply of and demand for medium-low priced housing are resolved.

Figure R.1.6
Lima[1/]: price of apartments (units of currency per square metre)



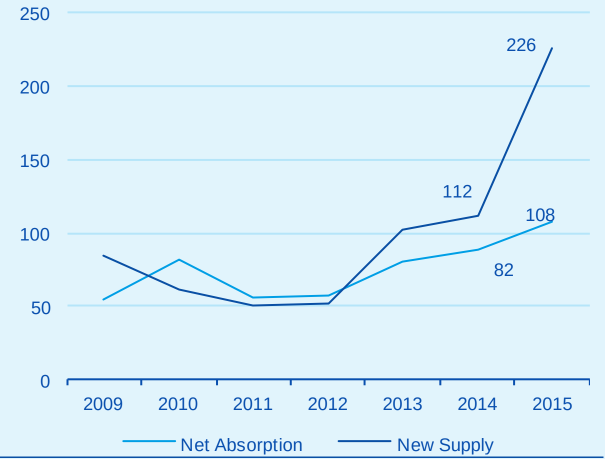
Chge. % p.a.	2010	2011	2012	2013	2014	2015
USD	19	17	21	14	6	-4
Soles	12	14	16	17	12	8

1/ Comprises 10 districts: Jesús María, La Molina, Lince, Magdalena, Miraflores, Pueblo Libre, San Borja, San Isidro, San Miguel and Surco. These are districts with medium and high prices, in which the supply of apartments is concentrated but effective demand is limited.
Source: BCRP and BBVA Research

Office market

The Greater Lima prime office market also showed some improvement in 2015. Net absorption, in particular, which reflects offices newly occupied in the period (net of offices vacated), increased to 108,000 square metres, the highest figure ever recorded (see Figure R.1.7).

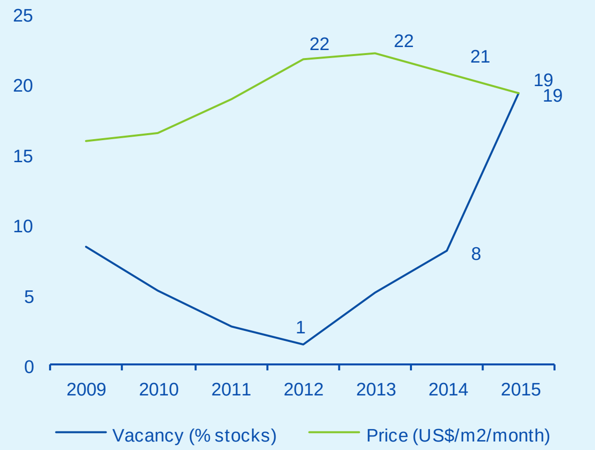
Figure R.1.7
Net absorption and new supply of prime office space[1/] (in thousands of m^2)



1/ These are offices in class A+ and A buildings in San Isidro, Miraflores, San Borja, Chacarilla, Magdalena, San Miguel, Surco and La Molina districts.
Source: Colliers and BBVA Research

This greater net absorption was not however able to keep up with the rate at which new offices came onto the market, which accelerated substantially in 2015 (see Graph R.1.7) due to the maturing of projects on which construction had started in previous years. Thus, whereas in 2014 just over 70% of new office space was placed, in 2015 less than 50% was. In other words demand increased, but supply inertia was even greater. As a result vacant space continued to increase, and this continued to push prices downwards (see Figure R.1.8).

Figure R.1.8
Vacancy rate and rentals for prime office listings[1/]



1/ These are offices in class A+ and A buildings in San Isidro, Miraflores, San Borja, Chacarilla, Magdalena, San Miguel, Surco and La Molina districts.
Source: Colliers and BBVA Research

Lastly, it is important to mention that according to Colliers International, in 2016 180,000 square metres of prime[6] new office space are expected to come onto the market, equivalent to 46% of offices currently under construction, with the remainder coming onto the market in 2017 or 2018. Bearing in mind the pace of net absorption, this makes it likely that this year the vacancy rate will continue to increase and that as a result prices will not yet start to recover.

[6] Of the 180,000 square metres of prime office space expected to come onto the market in 2016, 45% will be located in the Magdalena district, most notably the Prisma Business Center project, with more than 30,000 square metres.

In this context of reduced capital expenditure, affecting sectors such as Construction, non-primary Manufacturing and certain Services, most of the jobs created since the second half of 2015 have been relatively poorly paid, and as a result growth in the total payroll, one of the main supports of private consumption, has weakened. Household spending accordingly slowed throughout the year, although perhaps not so much as the slower growth of the total payroll might suggest, because households apparently expected the tighter situation to be only temporary, and financed the dip by means of increased consumer credit (see Box 2).

Lastly, it is important to mention that the build-up of stocks apparently explains approximately 40% of the GDP growth rate in 2015, according to our estimates. In other words not all the country's increased production in 2015 (which is what the GDP growth rate measures) was successfully placed in the markets (final sales of goods and services). These stocks, which probably built up derecognised (see "Surprise in demand" in Figure 3.10), are costly for producers (working capital, space to store them) and for this reason they will tend to be normalised in the next few quarters. This process could involve businesses meeting demand from their customers with accumulated stocks as opposed to newly produced goods, a risk that is all the greater if we consider the extent to which stocks have increased. However, it is also true that part of these increased stocks comes from the increased extraction of copper and anchoveta (subsequently transformed into fish meal) in the fourth quarter of 2015 (and most markedly in December) which had not been totally exported in the period but would be in early 2016. We estimate that this situation applies to approximately 20% of the increased amount of stocks. Another part of the stocks that have accumulated concerns imported products (import volumes accelerated in 2015 despite flagging private consumption and contracting capital expenditure), such as vehicles, domestic appliances and equipment, which have little local competition and the clearing of which will therefore have little effect on domestic production. In other words, although there was a significant increase in stocks in 2015, the drag on economic growth this year will not be of a similar magnitude.

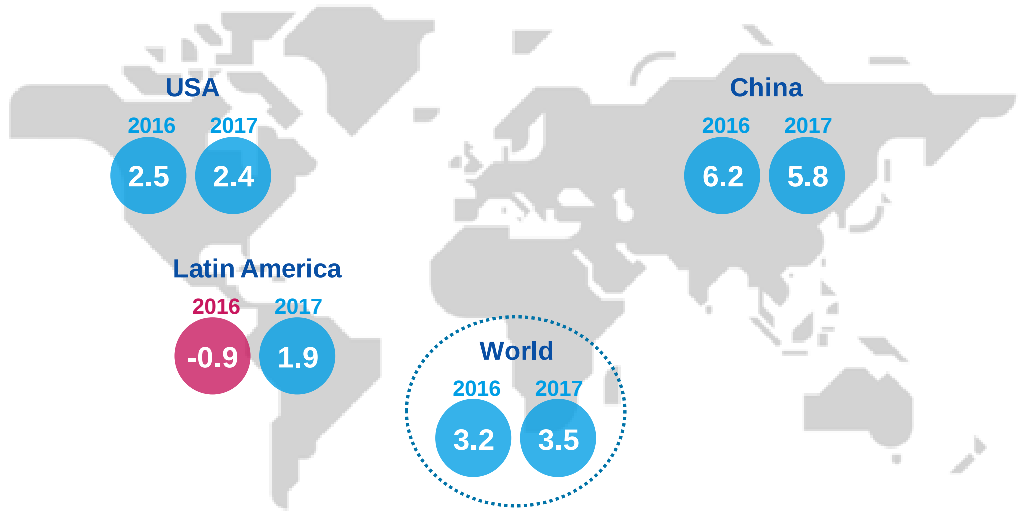
Projected baseline scenario for the Peruvian economy: main exogenous factors considered

Our projected baseline scenario for the Peruvian economy is consistent with both external and local exogenous factors. Some of the main ones are described hereunder.

Externally,

1. Global economic activity will grow in 2016 at a similar rate to last year (3.2%, see Figure 3.11) before going on to improve gradually. Internally, the advanced economies as a whole will grow by 2.0% in 2016, and in the particular case of the US, by 2.5%, not very different from our estimate of how it will have ended 2015. The main support for US growth will be private consumption, underpinned by the strength of the labour market and an environment of low prices which will favour increases in households' disposable income and more than offset the economic and political uncertainty at home and abroad and the decline in financial wealth following recent stock market corrections. The growth forecast for the US also takes into account that there will be very little increase in capital expenditure, thus incorporating the adjustment to capex in the energy sector (due to the fall in the price of oil) and a gradual improvement in the housing market, as well as weak exports in response to the appreciation of the dollar and, to a lesser extent, the slowdown in world trade.

Figure 3.11
World growth: weak, and more vulnerable (YoY % var.)



Source: BBVA Research

The emerging economies on the other hand will grow by about 4% in 2016, a similar rate to last year, but one which hides a more moderate advance of China and a greater contraction of Latin America. In the case of China, growth continued to weaken throughout 2015, but the adjustment was not an abrupt one. The most likely scenario is that the gentle descent towards a soft landing will continue in 2016. To this end, China's economic authorities will continue to implement expansive measures on the demand side, thus seeking to attain the GDP growth objective of between 6.5% and 7.0% for the year. This is no mean challenge, and there is little room for political error. In this environment, our baseline scenario considers that China will grow at a rate of 6.2% in 2016, below the target set by the government. And as regards Latin America, most of the major economies will see slower growth than last year, reflecting weak commodity prices, idiosyncratic factors in some cases and, against that backdrop, lower business and consumer confidence. Thus the Pacific Alliance countries as a whole will grow by between 2.0% and 2.5% in 2016, somewhat less than last year, while the contraction of Mercosur will increase to around 3.5%.

2. **The terms of trade will again diminish in 2016** (by between 4.5% and 5.0% on average), having lost a cumulative 20% during the previous four years. On average, export prices will be adjusted downwards once more, this time by between 11% and 12%, while import prices will also fall once again in 2016, in this case by between 7% and 8%. In general, we estimate that prices of commodities, and in particular of the two most important ones for Peru, copper and oil, will continue to fall in the first half of the year before starting to recover in the second half.

   In the specific case of the price of copper, which currently represents nearly 25% by value of Peru's exports of goods, the baseline scenario incorporates an average level of US$2.02/lb for 2016. From its current level of between US$2.05/lb and US$2.10/lb, our forecast is that in a context of doubts about global economic growth (in particular that of China), stocks to be digested, short positions of non-trading agents in the derivative markets, an appreciating dollar and low oil prices (lower costs), the price of copper will post some additional decline in the first half of the year, possibly even going below US$2.00/lb. After that, as certain globally less profitable copper projects cut production, it becomes more evident that world growth is on a path to gradual recovery and China in particular maintains its gentle glide path to a soft landing, uncertainty tends to dissipate, the sustained appreciation of the dollar starts to ease and oil prices pick up, the price of copper will gradually improve to end the year above USD2.15/lb, maintaining its rising trend thereafter to average around USD2.30/lb in 2017 and above USD2.50/lb at a medium-term horizon.

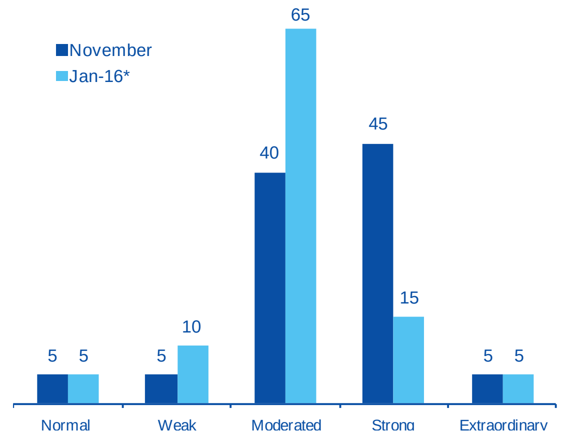
As for the WTI oil price, the baseline scenario incorporates an average level of US$29 per barrel for 2016. We anticipate that from its current level of between US$30 and US$33 per barrel, it will fall further in the short term to a low of US$20 per barrel in the second quarter due to the difficulties that OPEC and Russia are having in reaching agreement to cut production, the return of Iran to the oil market following the lifting of trade sanctions imposed b the international community, the resistance of US production in the short term to the climate of low oil prices, uncertainty about the extent and breakdown by sectors of the slowdown in China (and the authorities' skill in handling the situation with accommodative policies), and accumulated stocks that will still have to be cleared. From as early as the third quarter the price of oil will start to recover, reflecting above all the adjustment to US supply (see Box 4), which will eliminate much of the current over-supply of crude oil during the next twelve months. As a result, the price of oil will rise, ending the year at around US$37 per barrel and continuing from then on a rising path, averaging around US$44 per barrel in 2017 and closer to US$60 per barrel at a medium-term horizon.

3. The normalisation cycle of the US Federal Reserve's policy interest rate will be conducted in a gradual manner since inflationary pressures in the US will remain limited, well below the 2% target, in an environment with no substantial reactivation of private sector spending (beyond consumption and employment), with commodity prices remaining low and the dollar remaining strong. Furthermore the high degree of uncertainty in the short term about the strength of the global economic cycle and the decisions taken by developed economies' central banks (to maintain or boost current monetary stimulus measures) will probably weigh heavily in the Federal Reserve's decision. Accordingly we foresee there being no more than two policy rate hikes in 2016, each of 25 bps, to 1.0%. This brings us closer to the market consensus than to the FOMC's forecasts, a divergence that tends to be confirmed with the publication of low US GDP growth in Q4 2015, increased volatility in the financial markets and lower inflationary expectations.

Returning to Peru, our projected baseline scenario is consistent with:

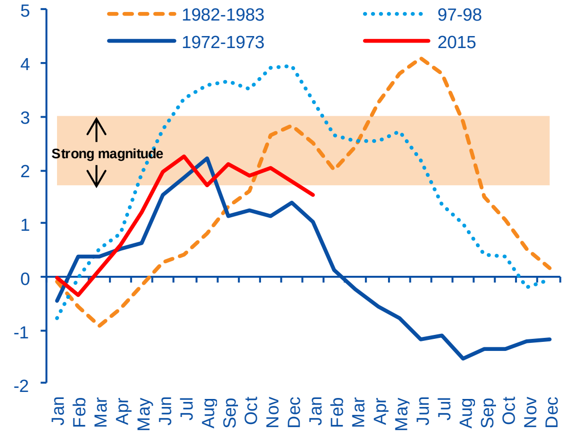
4. **An El Niño phenomenon of moderate intensity in the summer**. In this context, there will be negative effects on food production, the extraction of certain marine species, the processing of these natural resources and trade and transport in general (mudslides will probably cause damage to roads), although more limited and affecting fewer activities than in the case of a very strong El Niño such as had been expected until recently. In 2017, when weather conditions are more normal, the YoY comparison of growth of these productive activities will be favourably influenced.

Figure 3.12
Magnitude that El Niño could attain on the coast of Peru during the summer of 2016 (probability of occurrence)



Source: ENFEN (Institute for the Study of El Niño) and BBVA Research

Figure 3.13
Average Peruvian sea temperature (anomaly, in ºC)



Source: NOAA and BBVA Research

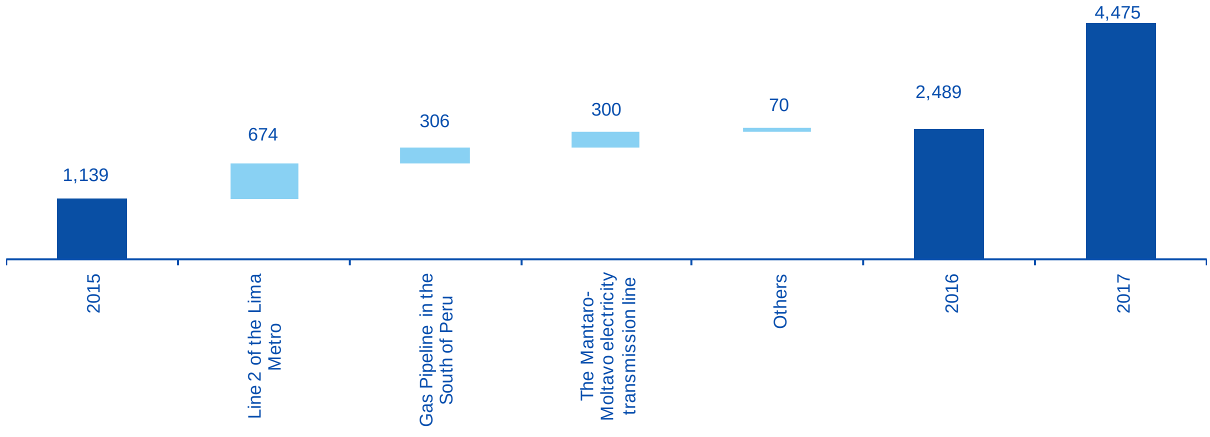
5. Gradual normalisation of the stocks accumulated in 2015. Part of the stocks that built up at the end of last year, particularly those of copper and anchoveta (from which fish meal and oil are subsequently made), will be placed on the international markets in early 2016. Another part was imported; it includes such goods as motor vehicles, household appliances and some machinery and equipment, for which there is very little local competition, so that clearing it will not involve much of a drag on economic growth. For the remainder, we are assuming that although there will be competition with, and displacement of, new domestic production, the process of clearing the stocks that accumulated last year will be gradual and orderly, such that little by little the process will be completed, with a negative but measured impact on the performance of national industry this year, becoming insignificant in 2017.

6. **An electoral environment which as usual will continue to give rise to uncertainty in the short term**. However, we consider that this uncertainty will be more limited than in previous electoral processes, because in general most of the proposals put forward by the candidates leading the polls at least for now are in line with the range of economic policies that the country has already been implementing for several years. Moreover there is almost universal acknowledgement of the need to improve certain aspects that will favour the productivity and competitiveness of the Peruvian economy, such as making it easier for the private sector to do business (by reducing the number of bureaucratic processes and the time and money spent on them, eliminating those that are unnecessary) and continuously pushing education and infrastructure, all of which sounds positive. Our projected baseline scenario assumes that electoral uncertainty, which naturally postpones certain spending decisions and leads to an element of flight-to-safety in less risk assets, will dissipate once the elections are over, allowing business and consumer confidence to increase from then on.

7. The acceleration of investment in major infrastructure projects such as Line 2 of the Lima Metro (we have assumed nearly US$700 million more capex than last year, public and private sectors combined), the gas pipeline in the south of Peru (US$300 million more capex than last year, by the private sector), the Mantaro-Marcona-Socabaya-Montalvo electric transmission line also in the south of Peru (US$300 million, private sector), the modernisation of the Talara refinery on Peru’s northern coast (for which we have assumed capex of just US$50 million more than last year), and the construction of the Chinchero airport in Cusco (US$20 million). Together, these projects involve increased public and private sector investment of approximately US$1.4 billion (see Figure 3.14),

equivalent to nearly four percentage points of gross fixed investment in real terms carried out in 2015 and to nearly one percentage point of real GDP for this year. The figures indicated already incorporate some delays that may occur, especially in the early part of the year, due to certain interference having to be dealt with, extra time needed to complete land expropriation, or difficulties in finalising arrangements for financing with which to continue the works. In 2017, the increase in private and public sector investment associated with these projects will be nearly US$2 billion, equivalent to just over five percentage points of gross fixed investment in real terms for 2016 and more than one percentage point of real GDP for 2016, so that the development of infrastructure will continue to provide support to economic activity next year.

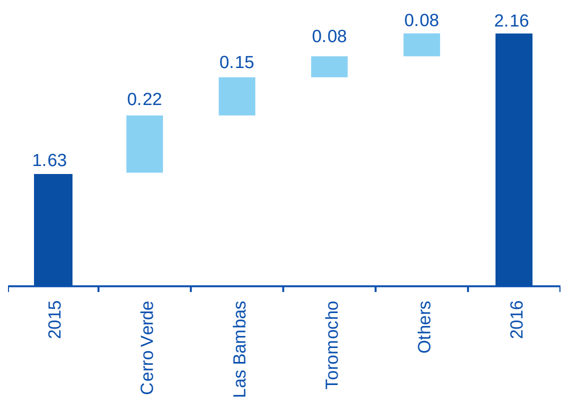
Figure 3.14
Selected infrastructure projects [1/] (US$ millions)



1/ Comprises five major infrastructure projects, the three indicated in the graph, the modernisation of the Talara refinery and the construction of the Chinchero airport in Cusco.
Source: BCRP and BBVA Research

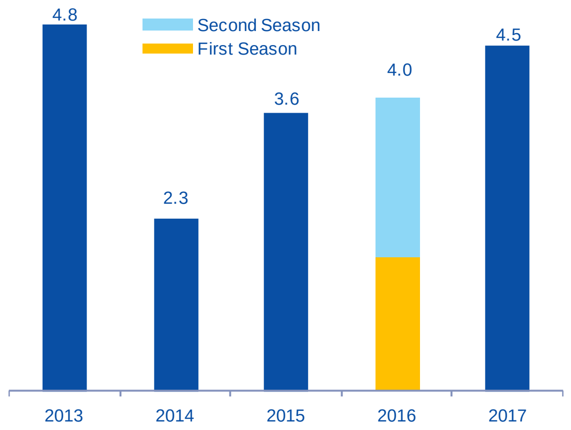
8. Significant expansion of primary activities. Copper extraction will continue to grow significantly in 2016 (see Figure 3.15). Toromocho will reach its maximum average monthly production capacity at the end of the first half of the year and the extension of Cerro Verde will do so at the end of the year. Las Bambas, for its part, will gradually increase its extraction and will consolidate at its maximum average monthly operating capacity at the beginning of 2017, in which year the Reputational extension will also come on stream. As a result, Peru's copper production, which was 1.6 million metric tons in 2015, will increase by 33% in 2016 and 15% in 2017. We should point out that the majority of these projects have relatively low cash costs of between US$0.90/lb and US$1.10/lb, which means that they are profitable even at such depressed prices as we expect to see in the first half of 2016. (Mines in the rest of the world would be more likely to cut production than would these projects, and this would produce resistance to further declines in the internationally quoted price of copper). Apart from this, the baseline scenario assumes that anchoveta extraction will improve in 2016 since the anchoveta's reproductive cycle will not be affected by anomalous sea temperatures (moderately intense El Niño). As a result, we have incorporated a catch of 1.75 million metric tonnes during the first season in the central-north zone, which in fact sounds conservative in light of the Minister of Production's statement to the effect that the catch quota will be "large" (it was 2.8 million metric tonnes last year), and 2 million metric tonnes for the same zone during the second season. In 2017 the catch will be even better, in an environment with no significant climatic anomalies, and anchoveta extraction could be closer to 4.5 million metric tonnes (see Figure 3.16).

Figure 3.15
Copper production (millions of metric tonnes)



Source: MINEM and BBVA Research

Figure 3.16
Extraction of anchoveta (millions of metric tonnes)



Source: INEI, PRODUCE and BBVA Research

Table 3.1.
Baseline scenario: main exogenous factors taken into account

	2014	2015	2016	2017
External Assumptions				
Growth (Var % YoY)				
Global	**3.4**	**3.2**	**3.2**	**3.5**
Developed	**1.8**	**1.9**	**2.0**	**2.0**
USA	2.4	2.5	2.5	2.4
Emerging	**4.6**	**4.0**	**4.1**	**4.5**
China	7.3	6.9	6.2	5.8
Latam-7[1]	0.8	-0.5	-0.9	1.9
Pacific Alliance	2.6	2.6	2.3	2.8
Mercosur	-0.4	-2.8	-3.4	1.1
Raw materials Price				
Terms of Trade (var% YoY)	-5.4	-6.3	-4.8	-4.3
Copper (LME, USD/lb., average)	3.11	2.50	2.02	2.29
Crude Oil (WTI, USD/bar., average)	93	49	29	44
Rates				
FED Rates (eop)	0.25	0.50	1.00	2.00
Internal Assumptions				
Stock	-	-	Gradual destocking	-
El Niño phenomenon (strenght)	-	-	Moderated	-
Investment in infrastructure projects (milions US$)[2]	563	1,139	2,489	4,475
Extraction of copper (milions MT)	1.3	1.6	2.2	2.5
Extraction of anchovy (millions MT)	2,3	3,6	4,0	4,5

1/ Takes account of the following countries: Mexico, Brazil, Argentina, Chile, Colombia, Peru and Venezuela.
2/ Takes account of the following projects: Line 2 of the Lima Metro, Gas pipeline in the south of Peru, Mantaro-Montalvo electricity transmission line, Modernisation of the Talara refinery and Chinchero Airport
Source: BCRP, INEI, IMARPE, MINEM and BBVA Research

In this context, we see activity growing by 3.6% in 2016 thanks to increased production of copper and capital expenditure on infrastructure, such that primary activities will continue to be the main support for GDP

In sector terms, the main support for GDP in 2016 will continue to be the primary activities, which will accelerate to around 8% (see Table 3.2). Their dynamism will be more accentuated in the first quarter of the year.

Table 3.2.
GDP by sector
(YoY % var.)

	2013	2014	2015	2016(p)	2017(p)
Agricultural	1.6	1.4	2.8	1.3	3.5
Fishing	24.1	-27.9	15.9	3.5	6.4
Mining and Hydrocarbons	4.9	-0.8	9.3	12.0	8.4
Metal Mining	4.3	-2.1	15.4	14.3	9.3
Hydrocarbons	7.2	4.0	-11.6	1.7	4.3
Manufacturing	5.0	-3.3	-1.7	-1.3	2.0
Primary	15.3	-9.7	1.3	3.2	3.4
Non-Primary	2.0	-1.0	-2.6	-2.8	1.5
Electricity and Water	5.5	4.9	6.2	6.5	6.2
Construction	8.9	1.7	-5.9	0.7	3.0
Trade	5.9	4.4	3.9	3.5	3.8
Other services	6.4	5.8	5.0	3.8	4.3
Global GDP	**5.8**	**2.4**	**3.3**	**3.6**	**4.2**
Primary GDP	5.9	-2.3	6.6	7.9	6.5
Non-Primary GDP*	5.8	4.1	2.6	2.6	3.8

* Non-primary GDP excludes taxes and import duties.
Source: BCRP (Central Reserve Bank of Peru), INEI (National Statistics and IT Institute) and BBVA Research

The star sector among primary activities will be metal mining, and within this, copper production. Its increase of 33% in the year will contribute more than one percentage point to the GDP growth rate in 2016. In contrast, our forecasts assume that extraction of zinc and more particularly gold will diminish during the year due to the depletion of some mines and the attempt to prolong the useful life of others (as well as waiting for higher prices). Fisheries, for their part, will grow by between 3% and 4% in 2016, underpinned by an increase of between 11% and 12% in anchoveta extraction during the year, which will also be reflected in the performance of primary manufacturing.

In contrast, agricultural and fisheries production will be depressed by El Niño-related weather anomalies (heavy rains in certain regions of the country and drought in others), as a result not only of failed harvests but also of plantings not taking place in the first half of the year, on top of those not carried out in the second half of 2015 because it was thought at the time that El Niño would be more intense than it eventually proved to be.

As for the non-primary sectors, they will not show any improvement in 2016, reflecting the demand-side situation. By component parts, Trade & Services will grow by between 3.5% and 4.0%, which although less than last year, consistent with a certain transitory fatigue of household spending, will still provide significant support to GDP.

The Construction sector will benefit from the boost provided by the major infrastructure works previously listed and the recovery in public sector investment at regional government level (after two consecutive years of contraction), but the property market will remain slow and investment in mines will continue to contract (est. US$1.3 billion), with the loss of the support from the last of the major mines in the construction phase, such as the Cerro Verde extension and Las Bambas, which will have passed into the production phase, plus the fact that reinvestment in existing mines will weaken as a result of lower profits of companies in this sector, due in turn to base metal prices remaining low. On balance, Construction will not show any appreciable recovery in 2016 (last year it fell sharply, by more than 6%) and its contribution to growth will be zero.

Lastly, the worst performing activity will be non-primary manufacturing. Exports of goods with relatively high manufactured content (non-traditional exports) will continue to decline in 2016, since the main buyer, Latin America, will contract even more than last year and the sector will have to gradually clear the stocks that built up in 2015. However, this contraction will be limited by the strength of household spending in the US, which to some extent will counteract the lower demand from Latin America for non-traditional Peruvian exports, and by the absence of the burden that the downturn in demand from the Construction sector meant for non-primary Manufacturing last year.

On the demand side, increased mining production will be reflected in exports, while investment in infrastructure will underpin public and private sector capital expenditure

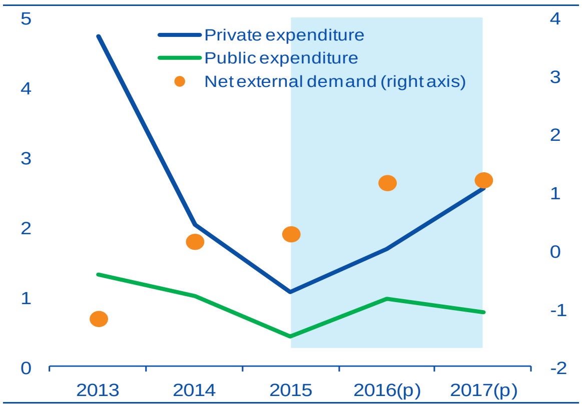
Exports will continue to be the best performers from the expenditure point of view (see Table 3.3). This will basically reflect the boom in copper production, while sales of non-traditional products and services will perform modestly.

Table 3.3
GDP from the expenditure point of view (YoY % var.)

	2013	2014	2015	2016(p)	2017(p)
1. Domestic Demand	**6.9**	**2.2**	**2.9**	**2.4**	**3.0**
a. Private Consumption	5.3	4.1	3.4	3.2	3.5
b. Public Consumption	6.7	10.1	7.5	4.5	4.0
c. Gross Domestic Investment	10.4	-4.9	-0.4	-0.5	1.3
Gross Fixed Investment	7.4	-2.1	-5.5	0.5	2.8
- Private	6.6	-2.2	-4.7	-1.4	2.2
- Public	10.7	-2.0	-8.9	8.2	5.2
2. Exports	**-1.3**	**-1.0**	**2.7**	**6.0**	**6.6**
3. GDP	**5.8**	**2.3**	**3.3**	**3.6**	**4.2**
4. Imports	**2.9**	**-1.5**	**1.2**	**1.3**	**1.8**
Note:					
Private expenditure (ex stocks)	*5.7*	*2.4*	*1.3*	*2.1*	*3.2*
Domestic demand (ex stocks)	*6.0*	*3.0*	*1.5*	*2.7*	*3.4*

Source: INEI and BBVA Research

Figure 3.17
GDP from the expenditure point of view: contributions[1/] (in percentage points of GDP)

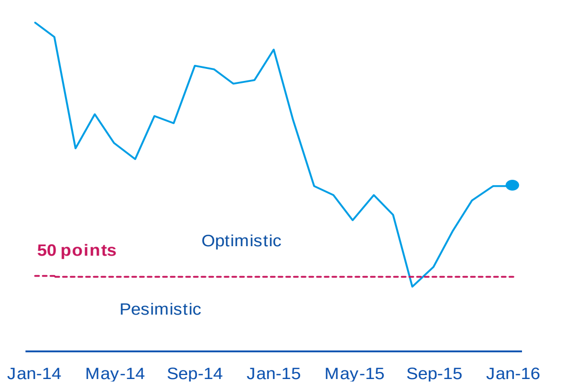


1/ Private sector expenditure excludes the accumulation of stocks.
Source: BCRP and BBVA Research

Gross fixed investment, for its part, which contracted in the past two years due to the weakness of both the public and private sector components, will start to grow again in 2016, albeit to a very limited extent. Domestically, public and private obtainment will perform very differently. Public sector investment will be underpinned by increased expenditure on infrastructure, most notably the increased outlay for Line 2 of the Lima Metro, and by the gradual recovery of the investment carried out by regional governments, whose authorities will now have had sufficient time (more than a year) to take firm command of the administration of this kind of expenditure. We would point out that in December 2015 the regional governments as a whole at last showed a surprising increase in their capital expenditure. This behaviour continued into January of this year. With these two supports, we foresee public investment growing by just over 8% in 2016.

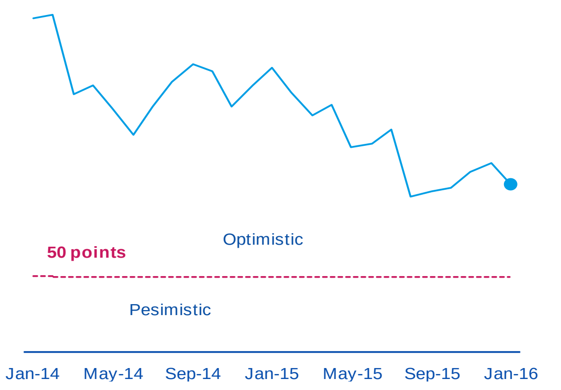
Private sector investment will remain in negative territory, falling for the third year in a row. This will however be the last time that it does so within the projected horizon. On the positive side, 2016 will see more private sector investment in infrastructure. The biggest projects on which expenditure will increase compared with 2015 will be the gas pipeline in the south of Peru, the Mantaro-Marcona-Socabaya-Montalvo electricity transmission line and Line 2 of the Lima Metro. Business confidence will also tend to improve. In the past few months it has been reflecting lacklustre activity, the natural uncertainty produced by the elections, the risk of an El Niño that until recently was expected to be unusually intense, the depreciation of the national currency (which squeezes capital expenditure of companies with currency exposure), the deterioration in commodity prices and the higher level of external noise in general. Growth figures have started to improve since those published for November; figures for December were better still (over 6% YoY) and during the first quarter of 2016 an average rate of growth of around 4% will be maintained. This will tend to boost business confidence. The elections and El Niño will have effects only until mid-year; after that uncertainty will dissipate as the causes will no longer be there. This will also boost business confidence from then on. Something similar will occur with commodity prices and external noise. In the former case, they will find better support in the second half and will start to recover, while the external noise in general will moderate little by little as the dust raised by doubts about lower growth in China, its authorities' ability to manage the soft landing, and more recently US growth, starts to settle. And lastly, as explained in section 5, forces depressing the value of the national currency will be less in 2016 than last year (and will also be less painful in that companies have been de-dollarising their liabilities). As a result, business confidence will probably improve, and this will favour private sector investment in plant and equipment for example as well as starting to strengthen the expansion of workforces. Something of this can be seen from the central bank's monthly surveys, which show pessimism on the part of business people as regards the economy's performance in the short term, but optimism, indeed growing optimism on more distant time horizons (see Figures 3.18 and 3.19). These surveys also suggest that businesses in the real economy and in the financial system are staring to adjust their growth expectations for 2016 upwards. On the negative side, the property market will continue to be slow, companies will gradually normalise the stocks that accumulated last year, which will discourage new production and therefore capital expenditure, interest rates in national currency for the biggest companies will be higher than those of last year, reflecting the central bank's monetary adjustment to attack inflationary expectations, and lastly investment on mining will continue to contract (est. US$1.3 billion), losing the support of the last major mines in the construction phase, which have recently moved on to the next stage in their life cycle (production). The balance of these factors is downwards for private sector investment, which we estimate will contract by around 1.5% in 2016.

Figure 3.18
Expectations for the economy at 12 months (in points)



Source: BCRP and BBVA Research

Figure 3.19
Expectations for the sector at 12 months (in points)



Source: BCRP and BBVA Research

Lastly, total payroll will continue to be lacklustre, at least in the first half of the year. The outlook for new hires in the next three months is still not good (see Box 2), so job creation will be limited in the short term. It is also true however that households' expectations regarding their economic situation are better for the second half of 2016. In a context of inflation starting to ease (see section 6), more positive economic growth figures, less local noise (El Niño fading and the elections past) and less external noise (which affects the exchange rate, a key indicator for some households), these expectations could be confirmed. As a result, households will be inclined to maintain the pace of improvement in their patterns of consumption, seeking finance with which to do so for some time longer. This is our baseline scenario. It is consistent with business people's optimism at the same time horizon as to how the economy as a whole and their particular sector will evolve (see Figures 3.18 and 3.19 respectively). Our balance between a weak labour market in the short term on the one hand and confidence that the situation will improve, lower inflation and access to financing on the other is that private consumption will grow by less this year than in 2015, but not much less, by just over 3%.

How does this growth projection for 2016 compare with that of three months ago? It improves, due to the fact that the El Niño phenomenon will be less intense than feared, and to the increase in mining production

In the past three months, two exogenous factors in our forecasts have behaved very differently from how we thought they would in October: El Niño and mining production. In the former case, the probability of El Niño being particularly intense in the summer has reduced substantially. In the latter, two major copper projects (the Cerro Verde extension and Las Bambas), which it was thought would start to produce between some time in Q2 2016, did so sooner.

Three months ago, the probability of El Niño being particularly intense in the summer was close to 50%. The heavy rains on Peru's northern coast would have a negative effect on agriculture, fisheries, the oil industry, trade and construction. On the expenditure side it would be reflected in lower exports, investment (public and private) and private consumption. However, the probability of its being so intense diminished in January to 15%, and the probability of the moderate scenario increased to 65% (see Figure 3.12). The latest readings of the anomalies in sea temperature point in the same direction (see Figure 3.13). This has been incorporated into the baseline macroeconomic scenario, with an upward effect on growth in 2016; on the other hand, the subsequent recovery in economic activities affected by El Niño will now be less pronounced in 2017, meaning that forecast growth for that year has to be adjusted downwards.

Apart from this, three months ago we expected the Cerro Verde extension to come into production at the end of the first quarter of 2016. However, this was brought forward: the mine started production in Q4 2015, as a result of which the volume it will produce in 2016 has been increased in our revised baseline scenario. The case of Las Bambas is similar: we estimated that it would start producing copper at the end of the second quarter of 2016, but in fact it started in December 2015. As a result, the volume of production of these two mines will be greater in 2016, with the corresponding upward effect on the rate of GDP growth for this year. But now that the volume produced in 2016 will be closer to its full operating capacity level, the increase in copper production in 2017 will be more limited, which has a downward effect on GDP growth for that year.

As well as these two supply factors, which both have a positive effect on the forecast, the new baseline scenario also takes account of other factors which on balance have had a negative effect on our growth estimate for 2016, albeit a more moderate one. One of them, perhaps the main one because it also affects business and consumer confidence, is the external environment. For example, we now estimate that Latin America will perform less well this year than we did in October, and this has a negative effect on non-traditional exports. Furthermore, we now have a more accentuated fall in the price of copper (and zinc) for 2016, which will have a negative effect on mining companies' earnings and therefore on their reinvestment.

As a result, this report revises upwards the GDP growth forecast for 2016, from the 2.8% we were using three months ago to 3.6%, while for 2017 the forecast is cut back from 5.0% to just over 4%.

The boost from mining and infrastructure will continue into next year, and to these will be added other factors, so growth for 2017 will accelerate to just over 4%

Next year the world economy, and in particular the economies of Peru's trading partners in Latin America, will perform better. On the home front, there will be a positive reversal of such effects as El Niño may have had in 2016, and the atmosphere for households and businesses will be more favourable in the absence of both El Niño and the noise from the elections, while inflation and the depreciation of the national currency will be more contained and much of the excess stocks will have been cleared. These factors, plus the continuing boost from increased mining production (copper) and greater spending on infrastructure, which will together contribute more than two percentage points to GDP growth, will lead to growth accelerating to just over 4%.

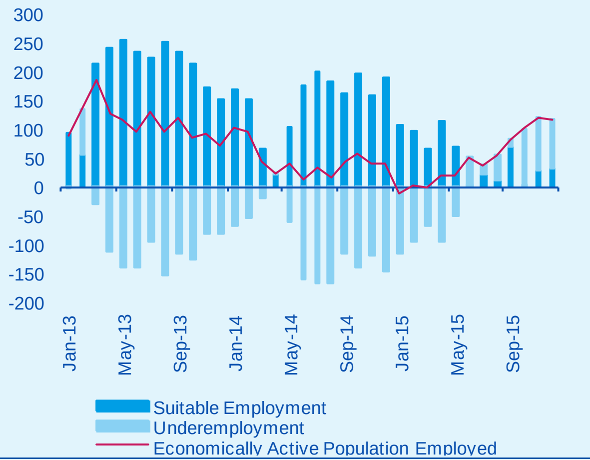
From the sector point of view, the fading of the effects of El Niño will benefit agricultural and fisheries, and with them primary industry. Construction will accelerate thanks to increased spending on infrastructure, and non-primary Manufacturing will again grow due to, among other things, improved demand from the construction sector and from non-traditional exports (Latin America). Lastly, Trade & Service will recover somewhat thanks to the improved performance of private sector spending.

On the expenditure side, exports will continue to lead growth, underpinned by mining production and increased export sales of non-traditional products. The increased expenditure on the construction of infrastructure will favour private sector investment, which will also benefit from improved business confidence. In this context, job creation will become more dynamic, and together with the easing of inflation will buttress household income and therefore private consumption, which we nevertheless see posting only moderate acceleration in 2017 because there will be some deleveraging by households that have borrowed in 2015 and 2016 to maintain their consumption. All in all, increased demand from the private sector will explain the acceleration of growth in GDP between 2016 and 2017. Lastly, public sector expenditure will increase at a more measured pace, consistent with maintaining a structural fiscal deficit at manageable levels.

Box 2. Labour market: deteriorating quality of new jobs and less dynamic total payroll[7]

In the second half of 2015 there was a significant increase in the economically active population (EAP). In a context in which the economy remained weak and prices, especially of food and public services, were rising fast, a larger proportion of the working-age population (WAP) actively sought work. And they found work: the increase in the employed EAP gathered pace over the course of the year and at year-end was growing at a rate not seen since 2013 (see Figure R.2.1), when GDP was growing at around 6% YoY.

Figure R.2.1
Greater Lima: increase in EAP employed (in thousands of persons, YoY % var.)

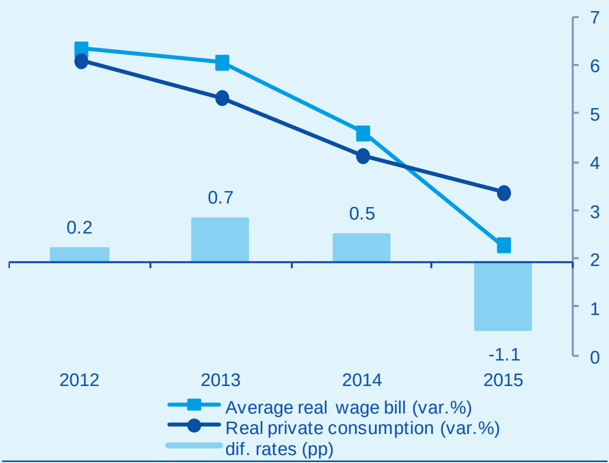


Source: INEI and BBVA Research

However, although the labour market has been able to absorb the increased number of persons wishing to work, it has not done so in appropriate conditions. Approximately 75% of the jobs created in the second half of 2015 can be classified as underemployment, and the majority of them require 35 hours a week or more but pay less than the minimum wage (underemployment in terms of income). It is thus consistent with the fact that many of these additional persons wishing to work and whom the labour market absorbed in the second half of the year have low qualifications (secondary education only), have found work in the service sector (one of the sectors with the lowest productivity), and mainly in small businesses (which are also usually the least productive). The quality of the new jobs created has deteriorated.

In this context, the total payroll has continued to increase because there is more employment, but it has lost impetus (see Figure R.2.2) because the majority of these new jobs are relatively poorly paid. The situation is not helped by the fact that inflation has tended to increase in the past year, eroding households' purchasing power.

Figure R.2.2
Total payroll[1/] and Private Consumption (YoY % var.)

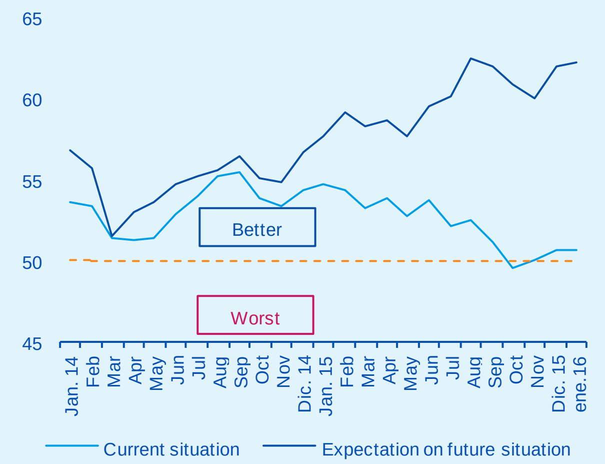


1/ Calculated as the EAP in employment multiplied by average income per worker.
Source: INEI and BBVA Research

The lower growth in the total payroll, which fell from just over 4.5% in 2014 to just under 2.5% in 2015, probably points to a slowdown in private consumption. This has come about, but perhaps in less pronounced form than might have been expected (see Figure R.2.2). One possible explanation is that households are expecting the situation to have tightened only temporarily (see Figure R.2.3).

[7] The information used corresponds to the EPE (Encuesta Permanente de Empleo or "Permament Employment Survey"). It contains data for Greater Lima only. Available information covering the whole country is published with greater time lags and less disaggregated. However, given Lima's importance in the economy, it is reasonable to suppose that its general trends will not be very different from those of the country as a whole.

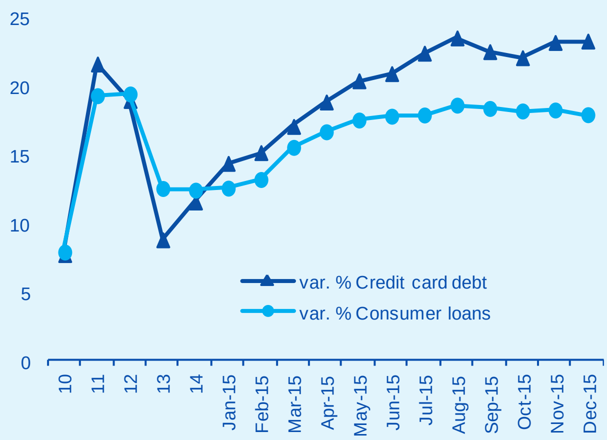
Figure R.2.3
Households: current situation and expectations of future situation[1/] (points, average past 3 months)



1/ "Current situation" assesses whether households perceive an improvement in their economic situation relative to that of a year ago, while "Expectations of future situation" assesses whether households consider that in one year's time their economic situation will have improved.
Source: Apoyo Consultoría and BBVA Research

In this context, some households might have opted to reduce their savings and others to take on debt (see Figure R.2.4); the subsequent improvement in their family situation would then give them time to repay these loans.

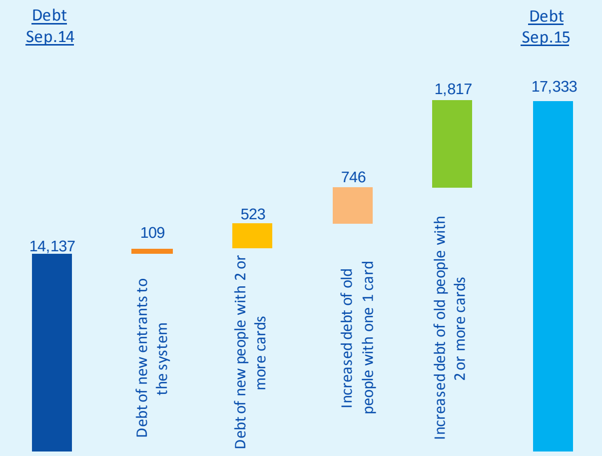
Figure R.2.4
Consumer loans and credit card borrowings (YoY % var.)



Source: SBS (Peru's banking and insurance supervisor) and BBVA Research

We should mention that in this climate of greater indebtedness, the consumer credit that has grown most is the use of credit cards. The data suggest that although there are people who have decided to obtain a first or additional credit card to finance their spending, the bulk of the additional indebtedness comes from the greater intensity of use of credit cards already held (see Figure R.2.5), mainly by people with more than two cards.

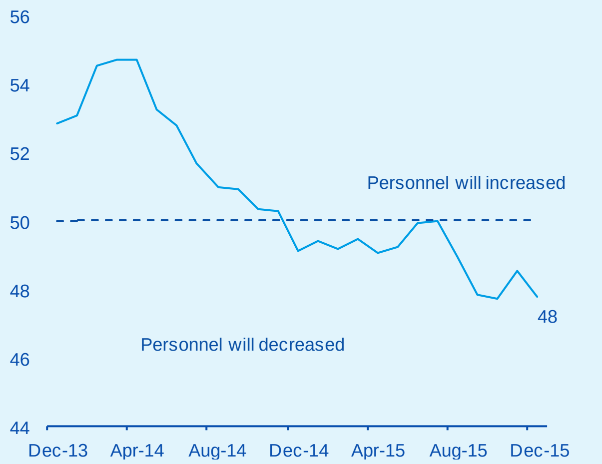
Figure R.2.5
Increase in credit card indebtedness (S/ millions)



Source: BCRP and BBVA Research

If these expectations of improved family situation do not materialise, naturally these families will tend to adjust their spending. This scenario cannot be ruled out, since we see that, on the whole, businesses are not inclined to increase their payrolls, at least not in the very short term (see Figure R.2.6).

Figure R.2.6
Expectations of hiring personnel in the next three months (points, avg. last 3 months)



Source: BCRP and BBVA Research

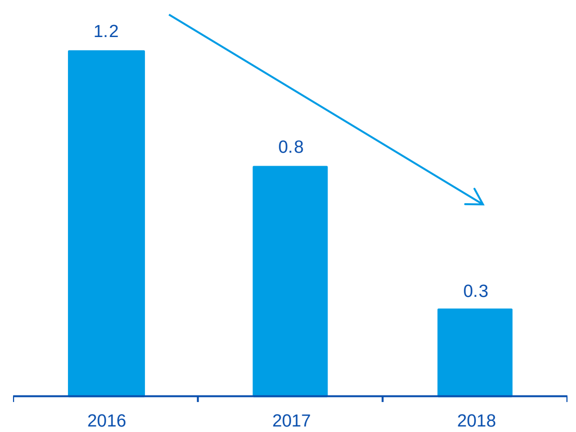
Our forecast is for no substantial improvement in the labour market or hiring conditions before mid-2016. After that, however, the outlook will be somewhat more favourable. Once the uncertainty about El Niño and the general elections has cleared and the dust raised by doubts over global growth has settled, businesses will gradually start to look once more at increasing their payrolls.

After 2017, the growth drivers lose momentum

The fall in economic growth in the past few years has highlighted the need to implement measures for regaining the path of rapid growth, i.e. measures favouring productivity and competitiveness. With a slower pace of growth it will be difficult to achieve sustainable reductions in poverty (which becomes more acute as the growth rate falls) and to create quality employment. This is a subject that we have been stressing in the last several editions.

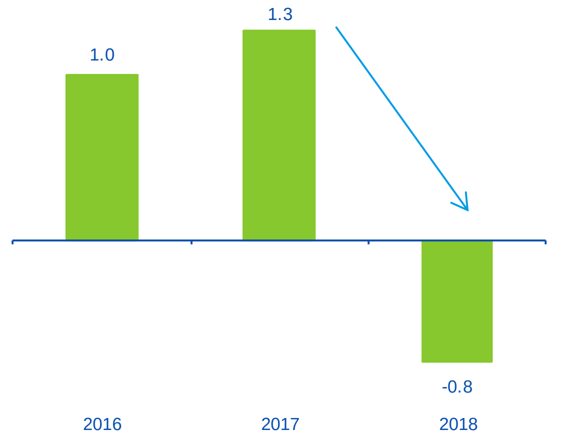
Peru is no longer a fast-growing economy: it no longer grows at average annual rates of 6.5%; recently it has been growing at around 3%, perhaps 4% after correcting for cyclical factors. Peru's growth potential has diminished. We estimate that in the medium term activity will grow at a moderate annual average pace, since it is difficult to identify significant growth drivers beyond 2017. In mining, for example, the coming on stream of the last major mining projects will sustain the advance of GDP in the short term (by around one percentage point per year until 2017), but with no prospect of other major projects (apart from the Toquepala mine extension) entering the construction phase in the foreseeable future, the boost provided by the sector will fade from 2018 on[8] (see Figure 3.20). A similar trend will be seen in expenditure on infrastructure (see Figure 3.21).

Figure 3.20
Metal mining: contribution to growth (percentage points of GDP)



Source: BCRP and BBVA Research

Figure 3.21
Capital expenditure on infrastructure: contribution to growth[1]/ (percentage points of GDP)

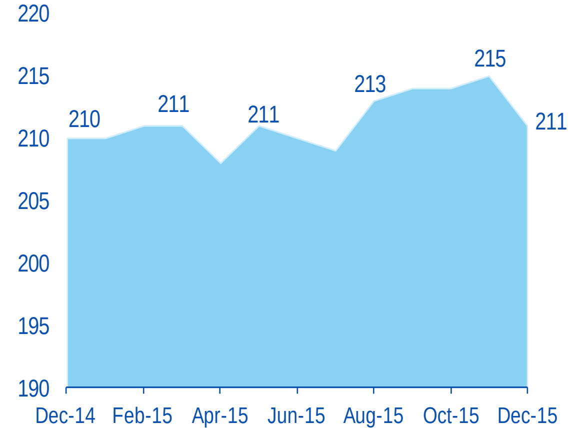


1/ Includes five major projects currently under construction: Line 2 of the Lima Metro, the gas pipeline in the south of Peru, the modernisation of the Talara refinery, the Mantaro-Montalvo transmission line and the Chinchero airport. Source: BCRP, MEF (Ministry of Economy and Finance) and BBVA Research

This document does not set out to list what must be done to sustain substantial growth rates in the future. But it is necessary to call attention once more to the need to do more. Where to start? What to prioritise? Social conflicts, facilities for doing business and continuous investment in human capital (education and health) and infrastructure. For example, the issue of social conflict associated with some major projects in portfolio (the mining projects brought to a halt by social conflicts represent investments of approximately US$10 billion, equivalent to 5.5 percentage points of GDP, see Figures 3.22 and 3.23) has prevented them from being developed. The unlocking of a few major projects (by means of agreements benefiting the parties directly involved) would provide a breathing space to give more structural measures such as those relating to education or health time to mature.

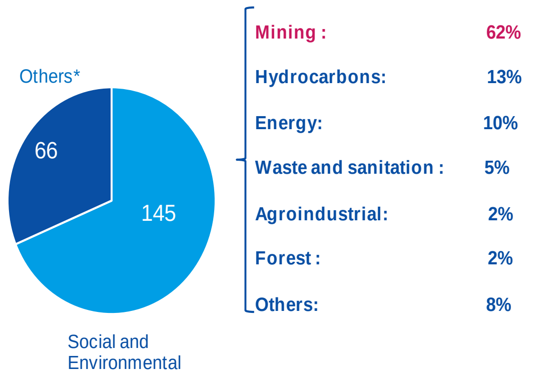
8: See presentation on the mining sector in Peru. https://www.bbvaresearch.com/publicaciones/sector-minero-en-el-peru/

Figure 3.22
Social conflicts*
(Number of cases)



*Includes both active and latent social conflicts. Of the social conflicts registered in December, 143 are active and 68 latent.
Source: Ombudsman and BBVA Research

Figure 3.23
Social conflicts
(Number of cases)

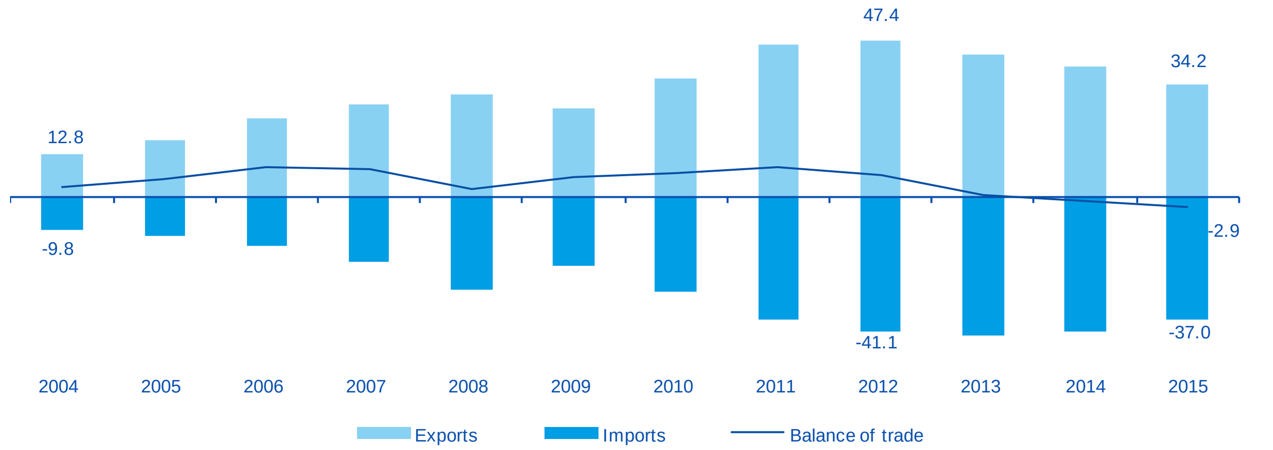


Source: Ombudsman and BBVA Research

In the next two years the mining boom will contribute to a significant decrease in the current account deficit of the balance of payments.

In 2015, the trade deficit stood at US$2.9 billion (1.5% of GDP, the highest level since 1998, see Figure 3.24). On the one hand there were favourable effects for the year: i) the greater volume exported, up by 1.5% (after two consecutive years of contraction) due to larger shipments of traditional goods (5.5%, in particular copper and fish meal in the second half of the year), which offset the decline in shipments of non-traditional goods (down 5.7%, due to lower demand from countries in the region); and ii) the contraction in total imports (by 9%), reflecting the fall in import prices, since volumes imported were unchanged relative to the year before due to weak domestic demand. On the other hand, this was offset by the greater deterioration in export prices (15%), especially traditional products such as metals (copper, gold, lead and zinc). In fact the index of export prices for traditional goods contracted by more than 21%, similar to the cumulative fall posted in the previous three years. Thus in aggregate the balance of trade deteriorated, and measured in dollars the gap more than doubled relative to the year before. In this environment of increased trade deficit, falling factor rent, mainly earnings of multinational companies operating in Peru, acted as an automatic stabiliser and so the current account deficit as a percentage of GDP was about 3.9% in 2015 (see Table 3.4), similar level to the year before.

Figure 3.24
Balance of trade (US$ billions)



Source: BCRP and BBVA Research

Table 3.4
Balance of payments (% of GDP)

	2013	2014	2015
I. CURRENT A/C BAL.	**-8,474**	**-8,031**	**-7,433**
Percentage of GDP	-4.2	-4.0	-3.9
1. Balance of trade	613	-1,276	-2,864
a. Exports	42,861	39,533	34,157
b. Imports	-42,248	-40,809	-37,021
2. Services	-1,801	-1,800	-1,760
3. Factor rent	-10,631	-9,328	-6,110
4. Current transfers	3,346	4,374	3,300
II. FINANCIAL ACCOUNT	**11,418**	**6,838**	**7,794**
Percentage of GDP	5.7	3.4	4.1
1. Private sector	14,881	6,490	5,637
2. Public sector [1/]	-1,338	-6	2,500
3. Short-term capital	-2,125	354	-343
III. ERRORS AND OMISSIONS	**-38**	**-985**	**-453**
IV. RESULT BAL. OF PMTS. (I+II+III)[2/]	**2,907**	**-2,178**	**-92**

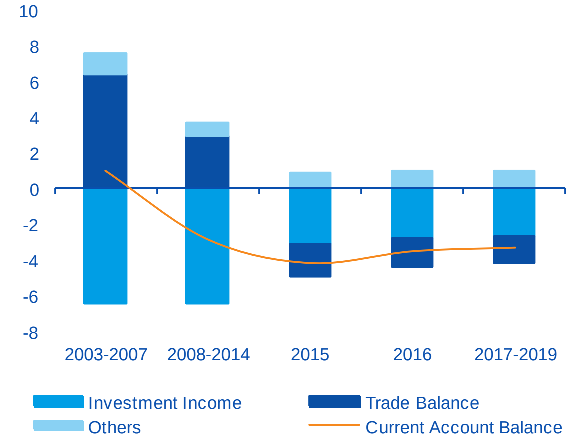
1/ Includes exceptional financing.
2/ Change in net foreign exchange reserves (NFER) and gold valuation and monetisation effect.
Source: BCRP and BBVA Research

For 2016 we estimate that the adverse international scenario, mainly for commodity prices, will continue to affect export performance. Similarly, non-traditional and service exports will continue weak against the backdrop of slowing economies in the region. However, this will be more than offset by the increase in volumes exported due to the boost provided by higher mining output related to the commissioning of new copper projects such as Las Bambas and the Cerro Verde extension, and by fisheries, which only had to contend with a moderate El Niño. An additional factor in the same direction will be the low price of oil this year (Peru being a net importer). As a result, we anticipate a more limited trade deficit and external (current account) deficit this year, of around 1.7% and 3.6% of GDP respectively (see Figure 3.25). For the period

2017-2019 we are projecting a decrease in the current account deficit to levels of around 3.0% of GDP, mainly reflecting increased tradable primary production (mainly mining).

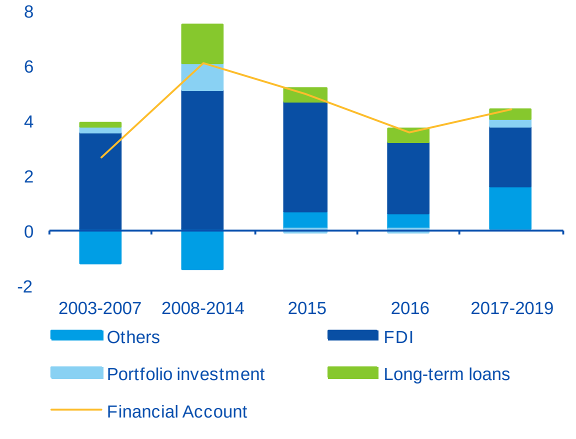
At the projected horizon we see sources of financing (private and public) being in line with or marginally exceeding the currency requirements of the current account (see Figure 3.26). Thus we expect long-term private capital flows (FDI and long-term loans) to cover an average of two thirds of the decreasing external deficit in the period 2016-2019. In particular, FDI flows will amount to around 2.6% of GDP this year, less than in 2015 (4.0%), in a context of low international prices which affect reinvestment of profits (mainly in mining companies) and slow recovery of domestic demand. Public sector external financing, for its part, unlike in previous years, will start to play a significant role in the aggregate of financial inflows to the economy at the projected horizon (accounting for around half of these flows), since the public sector will issue foreign debt to finance the increased deficit expected in the coming years.

Figure 3.25
Current account balance
(% of GDP)



Source: BCRP and BBVA Research

Figure 3.26
Financial account*
(% of GDP)



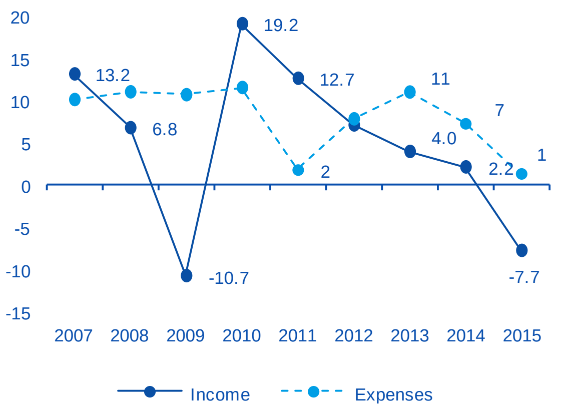
* The heading "others" mainly includes short-term funds and the public financial account.
Source: BCRP and BBVA Research

4 Fiscal deficit will continue to increase, as will public debt, which however will remain at manageable levels

The room for fiscal manoeuvre has narrowed, so the Government will use resources from the fiscal stabilisation fund.

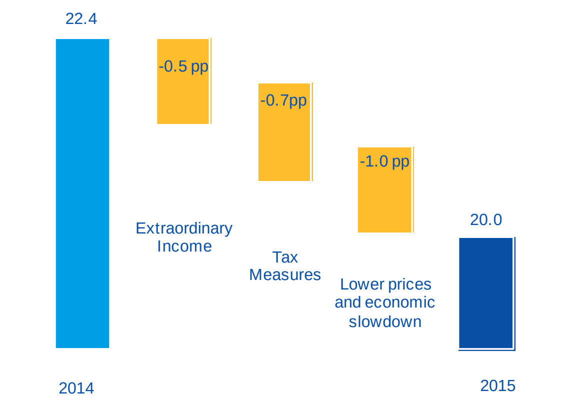
In 2015, the fiscal result was a deficit of 2.1% of GDP, more than in the previous year (0.3% of GDP). This deterioration reflected the decline in fiscal revenues (see Figure 4.1) in a context in which the economy and the price of exported commodities remain weak and in which a number of tax measures came into force including a permanent cut in income tax rates (see Figure 4.2).

Figure 4.1
Government Revenue and Expenditure[1/]
(in real terms, YoY % var.)



1/ Revenues and expenditure of state enterprises are not included
Source: MEF and BBVA Research

Figure 4.2
Government Revenues
(% of GDP)



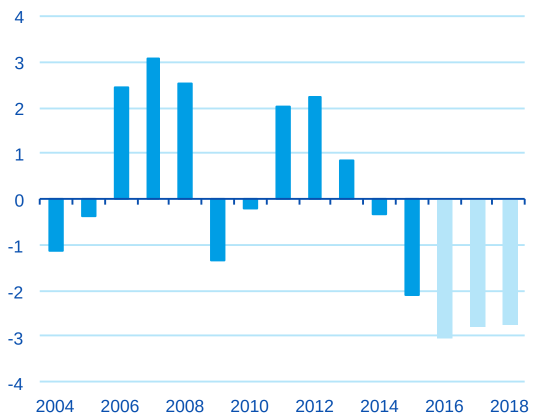
Source: BCRP and BBVA Research

In line with the gradual recovery in economic activity, we estimate that from 2016 on, fiscal revenues will start to grow gradually in real terms. The effect of the mining boom, while positive, will be limited because the price of the commodities exported, such as copper for example, will again decline on average. In this context, fiscal revenues will amount to around 20% of GDP in 2016. In the case of expenditure, it will increase consistently with the recovery in public investment at regional level and the execution of major public infrastructure projects such as Line 2 of the Lima Metro and the modernisation of the Talara refinery. On balance, we estimate that the fiscal deficit will be about 3.0% of GDP this year.

To finance this deficit, the Peruvian State will use part of the resources of the FEF (*Fondo de Estabilización Fiscal* or Fiscal Stabilisation Fund). This will amount to approximately US$1.3 billion in 2016. The law allows it to do so due to the sharp fall in tax receipts. For the remainder of the deficit to be financed we have assumed that, as happened in 2015, about 75% will be financed in the international markets and the rest will be financed locally (sovereign bonds, 30% of which will be acquired by non-resident investors, a smaller proportion than the current 36%).

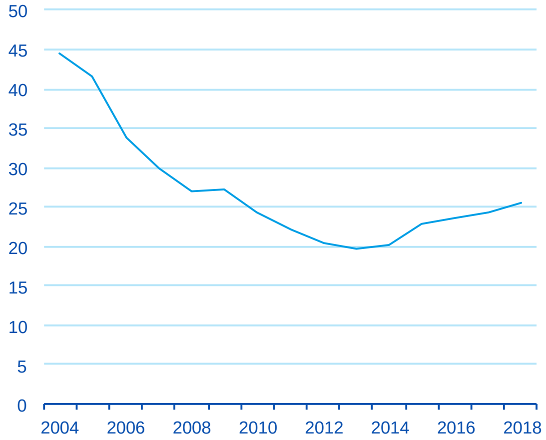
All along the planned path the fiscal deficit will be between 2.5% and 3.0%, from 2017 on (see Figure 4.3). This is consistent with real growth in revenues and non-financial expenditure of 3.0% per year on average over the whole projected horizon and with the completion of the modernisation of the Talara refinery, so that the structural fiscal deficit will not diverge from 2.5% of GDP. Therefore, the room for carrying out state reforms or implementing or expanding social programmes is limited, and it will be necessary to boost the efficiency of the resources disbursed. As a result, the balance of gross public debt will continue to increase (in 2017 it will still be legally possible to use resources of the FEF to finance the fiscal deficit, but not after that, we predict), but it will not exceed 27% of GDP within the forecast horizon (see Figure 4.4).

Figure 4.3
Fiscal result (% of GDP)



Source: MEF and BBVA Research

Figure 4.4
Gross public debt (% of GDP)



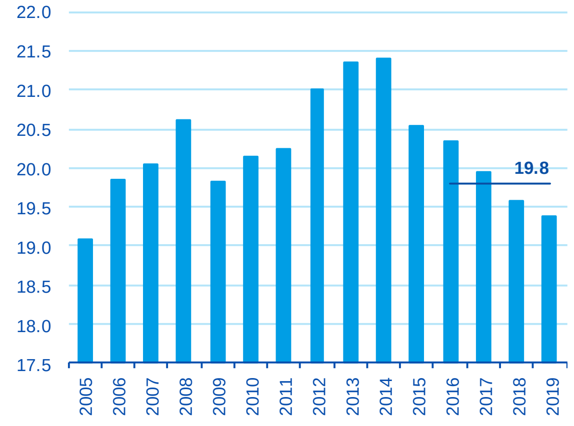
Source: MEF and BBVA Research

It is important to point out that due to the tax cuts introduced last year, structural revenues have been permanently affected. Correcting the revenue projection for the commodity price and economic activity cycle, we estimate that structural revenues at the projected horizon will amount to 19.8% of GDP (2016-2019), below the figure seen in previous years (see Figure 4.5). This result leads us to estimate an average structural deficit of 2.5% of GDP (see Figure 4.6) and a growing projection of gross public debt.

It should be mentioned that a structural deficit of 2.5% of GDP and the increase in the balance of gross public debt curtail the room for additional tax rate cuts, whether on income or on value added, and all the more so if they are not accompanied by tangible increases in the taxpayer base to offset them. For example, a reduction in the VAT rate, while it might have some effect in stimulating private consumption in the short term (by increasing households' purchasing power) and thereby stimulating economic activity, would be at the cost of a permanent reduction in tax takings unless complementary measures were implemented to widen the tax base. So far we have found no evidence to show that a cut in the VAT rate would provide an incentive for businesses to join the formal economy and thus increase the tax base[9].

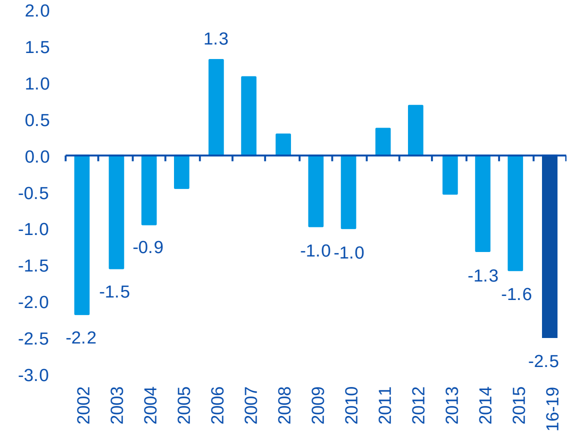
9: Informal businesses do not pay VAT. And those that do pay it do so on purchases of consumables or merchandise from other businesses in the formal economy (and pass on the VAT in the final selling price). In the second case, a reduction in VAT allows them to have greater liquidity, but provides no incentive to join the formal economy. If the aim is to draw these businesses into the formal economy, perhaps it would be better to simplify payment of tax, not just VAT but all taxes. A recent study by the ILO published in 2015 and entitled "Policies for the formalization of micro and small enterprises in Latin America" is much along these lines. As regards VAT what is recommended is not a cut in the rate but to make it easier to pay, for example by simplifying the bureaucratic process.

Figure 4.5
Structural fiscal revenues[1/]
(% of potential GDP)



1/ The estimate of fiscal revenues uses the new methodology recently approved by the MEF
Source: MEF and BBVA Research

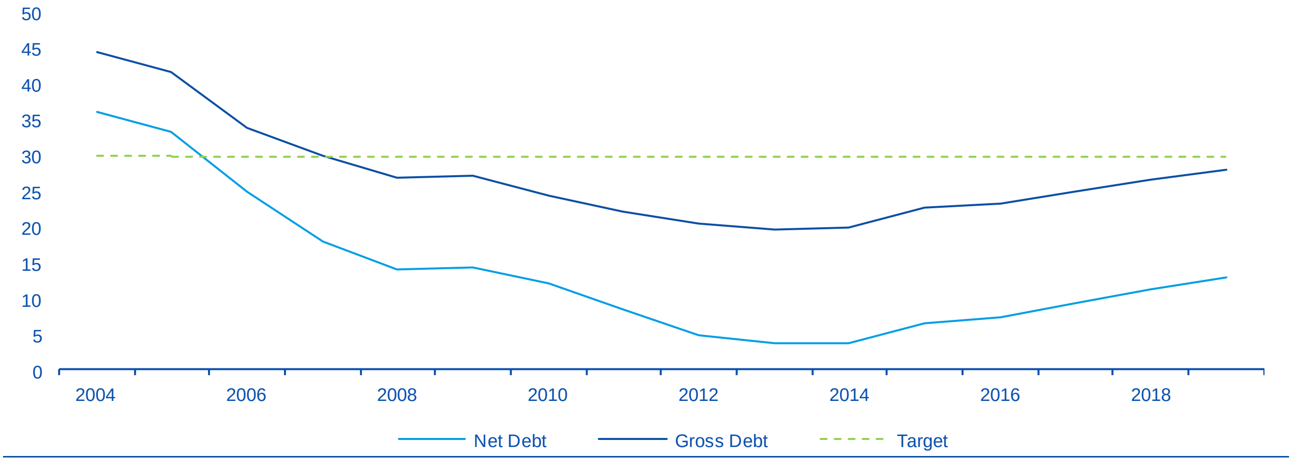
Figure 4.6
Structural fiscal result
(% of potential GDP)



Source: MEF and BBVA Research

In a hypothetical scenario in which VAT were cut by one percentage point during three years (and no measures were implemented to widen the tax base), structural revenues would decline annually by about four tenths of a percentage point of GDP, the structural deficit would be about 3.0% of GDP and by 2019 gross public debt would be close to the legal limit established in the Fiscal Responsibility and Transparency Act (30% of GDP, see Figure 4.7). We should mention that if gross public debt maintains an upward path and possibly surpasses 30% of GDP, one of the country's macroeconomic strengths could start to erode, which would not be good for the credit rating of government debt.

Figure 4.7
Gross public debt (% of GDP)



Source: MEF and BBVA Research

5 Local financial markets start the year with downturns

Local financial markets start the year with downturns

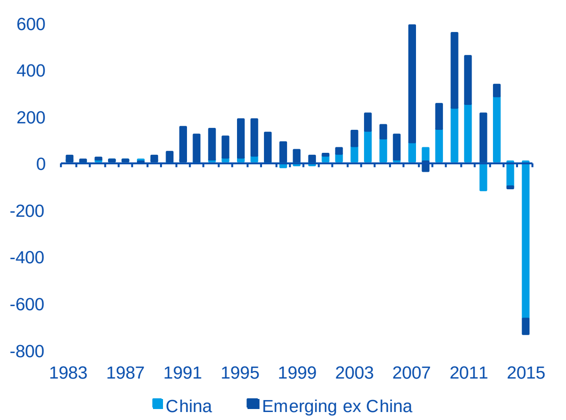
In 2015 the emerging economies saw massive outflows of capital due to the volatility of the financial markets. According to the Institute of International Finance (IIF), net outflows of capital from emerging markets reached US$735 billion, an all-time high, and much more than the year before (US$111 billion), with China the worst affected (see Figure 5.1).

According to the IIF, flows of capital of non-residents into emerging economies reached negative figures, especially towards the end of 2015: in the first half of the year they amounted to US$229 billion, while in the second half they were a negative US$59 billion. We would highlight that China had capital inflows from non-residents of US$48 billion in the first half of the year, whereas in the second the figure was a negative US$155 billion.

This outflow of capital from emerging markets led to devaluation of their currencies, impairment of their assets (which reduces the return on their shares reflected in the stock market indices) and increases in country risk and in loans being called in (see Figure 5.2).

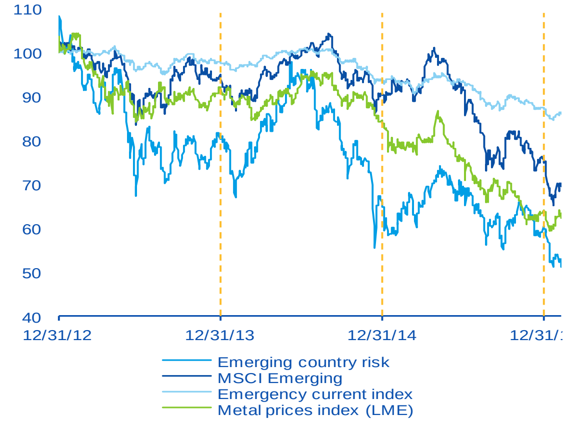
This phenomenon came about in a context of risk of a rate hike by the US Federal Reserve, the effects of lower growth of China's economy, its dwindling reserves and uncertainty as to its reactivation policies, further contributed to by the fall in commodity prices, which hit the economies that export them hard. There were also internal factors particular to the emerging economies, such as disappointing performance in cyclical and structural terms (decline in the increase in productivity, less trade, reduced competitiveness) which contributed to the outflow of capital.

Figure 5.1
Net flow of capital from emerging economies* (US$ billions)



*Including errors and omissions.
Source: IIF and BBVA Research

Figure 5.2
Financial indicators in emerging markets*



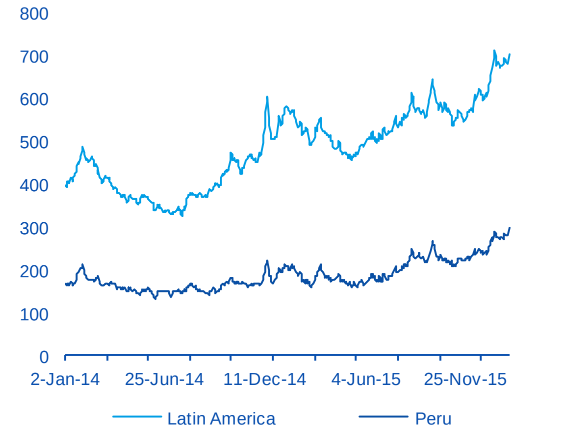
*As at 9 February 2016.
Source: Bloomberg and BBVA Research

Peru has also been affected by the external volatility of financial markets.

Peru also posted downturns in some financial indicators, for example a sharper fall in its stock market index than those of its peers and an increase in the yield on its sovereign bonds deriving from increased country risk. Thus we see non-residents holding fewer bonds, and a contraction in the issue of Peruvian corporate bonds in the past few months, mainly in the external market. This, together with pressures from certain local agents, has led to the currency depreciating in the past few months to levels not seen for ten years.

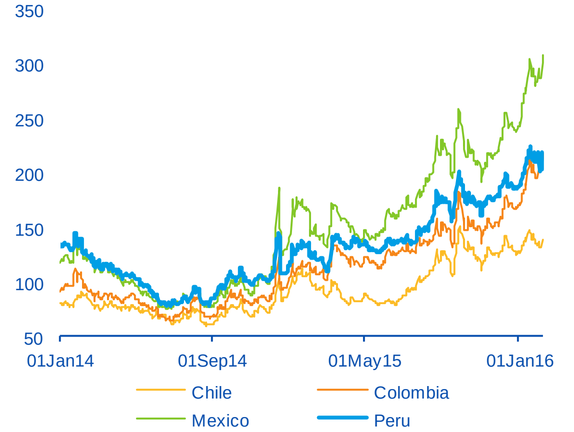
Risk perception in Peru has increased faster in the past few months, as it has in other Latin American countries. The risk perception for Peruvian bonds (EMBI) increased in annual terms at year-end 2015, by 32.0%. However, whereas in the first six months of the year it remained steady, in the second half the increase was 41.7%, and in 2016, up until 9 February, an increase of 24.7% (see Figure 5.3), a similar trend to that seen in the rest of Latin America. Apart from this, credit default swaps (CDS) on Peru at five years have been constantly going up in price for the past 18 months (see Figure 5.4), as have those of its peers.

Figure 5.3
Spread – EMBIG (basis points)



Source: Bloomberg and BBVA Research

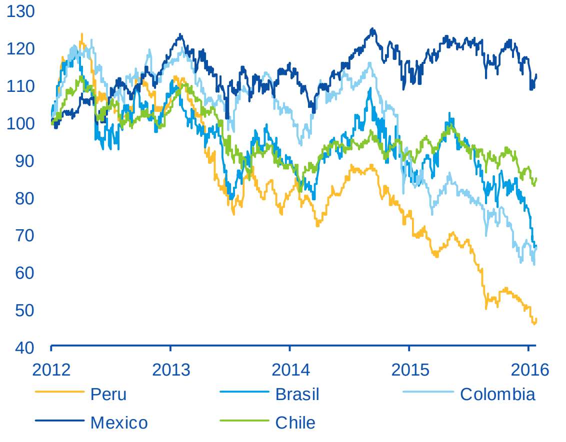
Figure 5.4
CDS Peru at 5 years (basis points)



Source: Bloomberg and BBVA Research

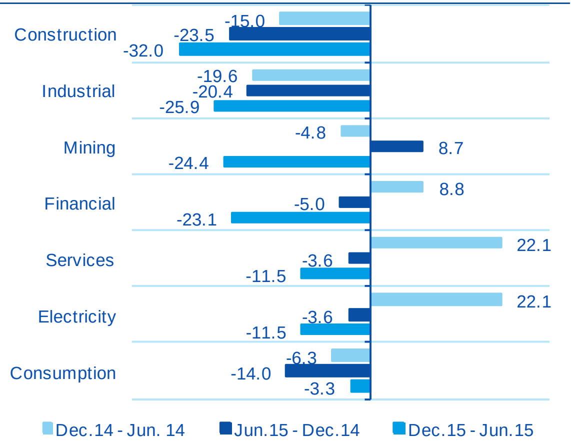
The IGVBL Lima stock exchange index fell by more than its peers in 2015 (see Figure 5.5). The fall in the second half of the year (24%) was more pronounced than in the first half (11%). This was influenced by MSCI's announcement of the Peru's possible reclassification from emerging market to frontier market (which would class it as a higher-risk country and possibly lead to capital flight). This review will be carried out again in June 2016. From a sector point of view we saw a fall in the IGBVL across the board in the second half of 2015, but especially in the construction and manufacturing sectors (see Figure 5.6).

Figure 5.5
IGBVL stock exchange index (100=Jan2012)



Source: Bloomberg and BBVA Research

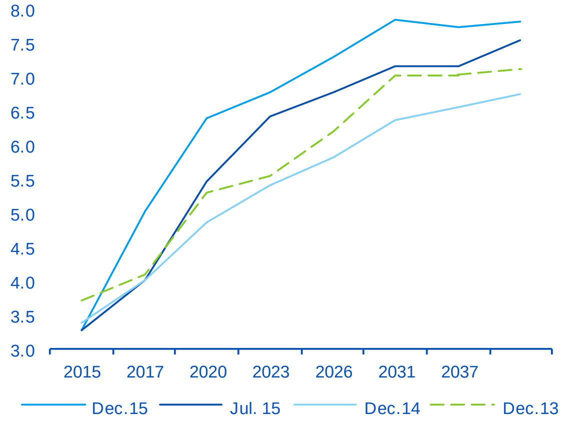
Figure 5.6
Yields on Peruvian sovereign bonds (%)



Source: Bloomberg and BBVA Research

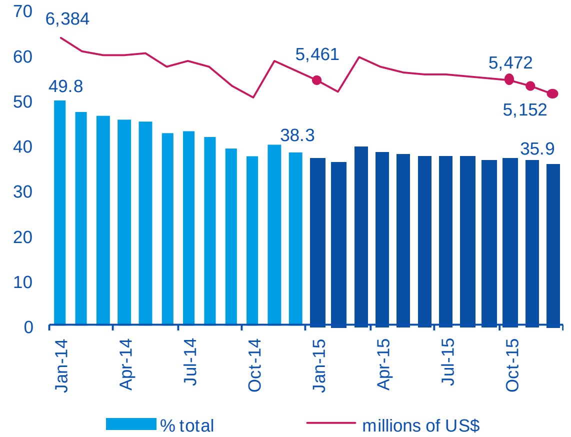
The deterioration was also seen in the yield curve for sovereign bonds. In December 2015 it was greater than in those reported in previous months, mainly in the medium term. Thus, between February and December the yield required on sovereign bonds maturing in 2026 and 2030 increased by more than 170 basis points, a very different picture from the previous year, when the rate fell on average (see Figure 5.7). This is a reflection of the readjustment of portfolios globally to the depreciation of the national currency, which reduces the yield expressed in foreign currency. In this context, the decline in the proportion of sovereign bonds held by non-residents has slowed (see Figure 5.6), from a fall of 11 percentage points in 2014 (from 49.8% to 38.3%) to a fall of around 1.4 percentage points in 2015 (from 37.4% to 35.9%). In amounts, at the beginning of 2015 holdings were US$5.4 billion, a similar amount to that seen in October of that year; however in the last three months the decline accelerated and by December the figure was just US$5.1 billion. (see Figure 5.8)

Figure 5.7
Yields on Peruvian sovereign bonds (%)



Source: Bloomberg and BBVA Research

Figure 5.8
Holdings of sovereign bonds by non-residents (% total)



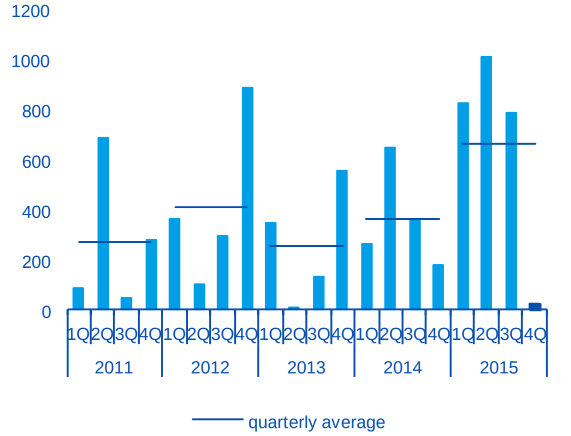
Source: Bloomberg and BBVA Research

Apart from this, financing of the corporate sector declined in the last few months of 2015. The issue of securities by non-financial companies in the local market local slowed in the second half of 2015, although it reached a cumulative total for the year of S/. 2.663 billion, more than in any of the previous five years (see

Figure 5.8). Three quarters of these issues are carried out in national currency, probably in view of the uncertainty still surrounding the future development of the exchange rate (see Figure 5.9).

Apart from this, the issue of bonds in the international market by non-financial companies saw a slight increase from 2014; however, uncertainty in the financial markets and the volatility of the exchange rate, which influence Peruvian companies' decisions, led to the external source of financing not being used in the last four months of the year. In total, external issues amounted to US$4.51 billion in 2015, less than in the previous year (see Figure 5.10).

Figure 5.9
Issue of bonds by non-financial companies in the domestic market (millions of Nuevos Soles)



As at November 2015.
Source: BCRP and BBVA Research

Year	Amount USD	Amount S/.
2013	458	584
2014	439	1,015
2015	718	2,945

In millions of soles
At November 2015.
Source: BCRP and BBVA Research

Figure 5.10
Issue of bonds in the international market

	Issue date	US$ millions	Term (years)	Rate
2014				
Non-finance sector		**3,306**		
Finance sector		**2,204**		
Private sector		1,025		
Public sector		1,179	10	4,75
Total 2014		**5,510**		
2015				
Non-finance sector		**3,361**		
GyM Ferrovías	03-Feb	206	25	4.75
Southern Copper Corporation	17-Apr	500	10	3.88
Southern Copper Corporation	17-Apr	1,500	30	5.88
Consorcio Nuevo Metro de Lima	10-Jun	1,155	19	5.88
Finance sector		**1,149**		
Private sector		**349**		
Intercorp	03-Feb	250	10	5.88
Interbank**	03-Feb	99	15	7.66
Public sector		**800**		
COFIDE	07-Jul	200	4	3.25
COFIDE	07-Jul	600	10	4.75
Total 2015		**4,510**		

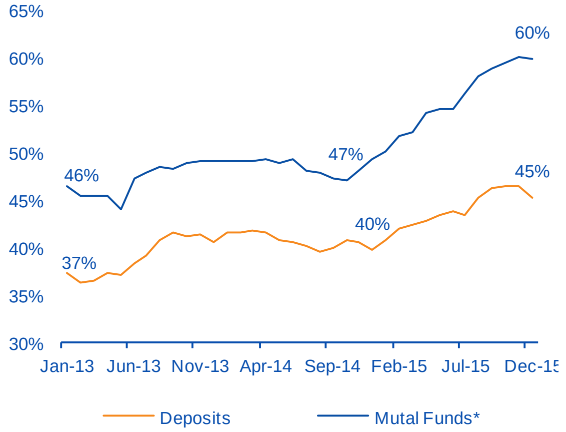
Source: BCRP and BBVA Research

Going forward, the trend of the national currency will be one of continuing depreciation, because the current account deficit of the balance of payments is still substantial, even after excluding transitory negative effects such as lower-than-“normal” commodity prices and global cyclical weakness.

However, we estimate that the slide in the value of the Nuevo Sol will be more moderate than last year. Firstly, because a large part of the adjustment towards its equilibrium level, which we place at between 3.65 and 3.70 to the dollar (see Box 3), has already taken place (and the central bank’s interventions limit the possibility of overreaction). Secondly, because the current account deficit will decrease significantly in 2016 (see Figure 3.25.) Thirdly, because there is less and less scope remaining for taking new positions in favour of foreign currency. For example, the balance of currency forwards is at the maximum established by the central bank, and there has already been significant dollarisation of families’ and businesses’ surplus funds and funds administered by pension schemes (see Figure 5.13). And lastly, because expectations of depreciation will ease as the current uncertainty about global economic growth moderates (China will continue its gentle descent, U.S. growth figures will return to around 2.5% in the next few quarters), commodity prices will stop falling and even recover somewhat in the second half of the year, and the national electoral process will come to an end (because naturally there is some increased uncertainty, and in such a context defensive positions are taken in investment portfolios). Lower expectations of depreciation of the national currency will make it more attractive to save in local currency, the more so with the upward adjustments that the central bank has been making to its key rate.

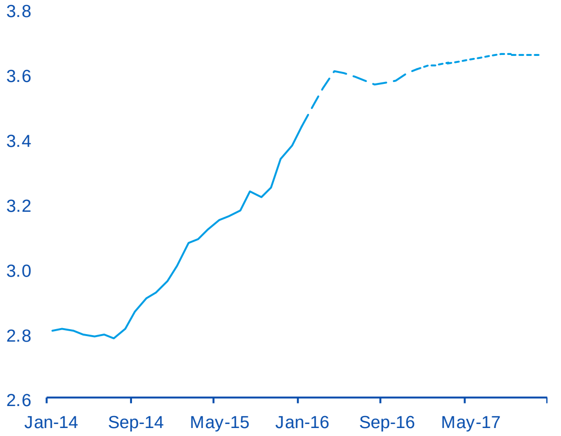
In this scenario, we foresee depreciation of the currency being accentuated in the first half of 2016, as we have already been seeing, but more contained in the second half, with the Nuevo Sol ending the year at between 3.60 and 3.65 to the dollar (see Figure 5.14).

Figure 5.13
Dollarisation of savings*
(US$ millions)



* Private individuals and private sector businesses. Not including holdings of financial institutions or the public sector.
Source: BCRP and BBVA Research

Figure 5.14
Peru: Exchange rate projection
(S/. per US$)



Source: BCRP and BBVA Research

Box 3. Methods for estimating the equilibrium exchange rate

In 2015 the Peruvian economy posted a trade deficit of 1.5% of GDP, the biggest since 1998, mainly due to the sharp contraction in exports. This deficit led to the current account balance (which reflects local activity's need of excess of US$) being around 4.0% of GDP for the third year in a row[10]. This financing need was covered by private sector flows, especially FDI, and to a lesser extent by public sector flows as the Government took on more external debt.

However, the current environment, in which greater financial costs are expected, and in general volatility in the international capital markets, point to sources of financing becoming not only more expensive but also more scarce in the medium term. In this context, it becomes necessary to reduce the external gap to sustainable levels.

Our baseline scenario assumes that the increased mining production (copper), as well as being one of the growth drivers, will also make it possible to expand the exportable supply (volume) and thus reduce the current account deficit. However, even with this extra exportable primary production, the external deficit will still tend to adjust gradually. Thus in addition to mining export this suggests the need to close the external gap by means of a "price variable". One of them is, typically, the exchange rate (especially in a world in which commodity prices continue to fall). So, what can the fundamentals and this entire macro environment tell us about future trends of the exchange rate? Is it feasible to estimate a trend-based or equilibrium exchange rate?

There are two definitions of exchange rate:

- The **nominal** concept denotes the rate at which one currency can be exchanged for another. In Peru specifically this means how many soles can be exchanged for one dollar.
- The **real** definition quantifies the price of a given basket of goods and services produced abroad relative to its counterpart in the local market. Thus the real exchange rate (RER) is expressed as the quotient of the external price index (P*) and the local price index (P) adjusted by the nominal exchange rate (PEN - Peruvian Nuevo Sol): in symbols, RER = (P*/P)(PEN). Increases in the RER are interpreted as indications that the local market is becoming more competitive vis-à-vis the exterior: it is less costly to produce this basket of goods and services in the domestic economy than abroad.

Although predicting the PEN is subject to many sources of volatility, empirical evidence points to the dynamic of the RER being driven by fundamentals, and suggests that deviations from this long-term trajectory cannot last long. For example, Caputo and Núñez (2008) show that marked deviations from the equilibrium lead to serious problems for the economy and that the corrections tend to be very costly[11], and according to Cello, Heresi and Pineda (2010), deviations significantly affect the allocation of resources[12].

Various different methods enable us to estimate the equilibrium RER, and one of them brings together precisely the evolution of the current account and the exchange rate. This approach is known as the "external sustainability" approach. The method consists of three stages[13]: (i) determining the current account balance to GDP ratio that would stabilise the long-term external liabilities (LTEL) at a desired or benchmark level (this ratio is known as the norm), (ii) estimate of the structural or underlying current account, which takes the short-term factors out of the current account being observed, and (iii) assessing the adjustment to the RER that is needed to close the gap between the norm of the current account and its structural level. The REER is the final level of the RER once this adjustment has been made.

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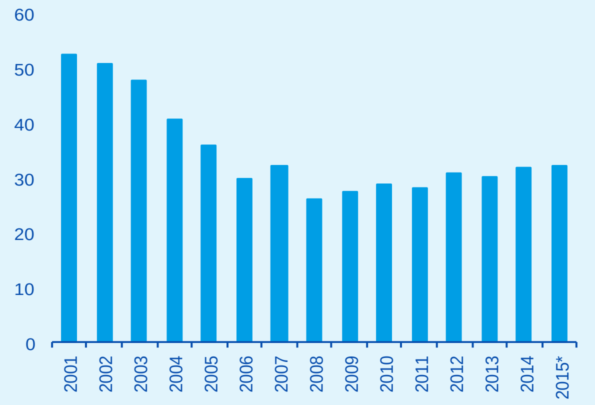
[10] Accounting requirement (or excess). Balance of Payment items are recognised on an accrual basis.

[11] Real equilibrium exchange rate in Chile: Alternative approaches.
[12] The real equilibrium exchange rate: A study of 17 Latin American countries.
[13] For further details on this methodology, please refer to Peru Outlook, first quarter 2015.

The main results of applying this method showed that:

- The current account balance that would stabilise LTEL at their current level (34.5% of GDP, see Figure R.3.1) is equal to minus 2.1% of GDP (norm)[14].

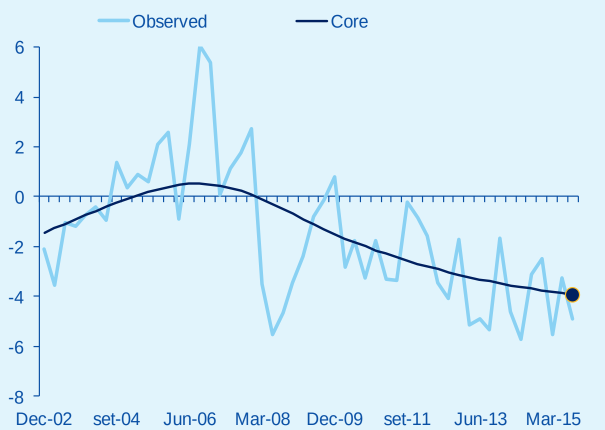
Figure R.3.1
Long-term external liabilities (% of GDP)



* In the third quarter of 2015.
Source: BCRP and BBVA Research

- The structural (underlying) current account balance in Q3 was around 3.9% of GDP, lower than the result observed (Figure R.3.2), but above the long-term level that would stabilise the external liabilities.

Figure R.3.2
Balance of payments: current account (% of GDP)



Source: BCRP and BBVA Research

- If the adjustment to bring the underlying current account balance to its equilibrium level had been made only through the nominal exchange rate, a depreciation in real terms of around 13% would have been needed in Q3[15]. In addition this would have brought the nominal exchange rate to between S/. 3.58 and 3.66 per dollar (whereby the underlying current account would have been at its sustainable level).

It is important to point out that estimation by means of the external sustainability approach is an exercise that serves as a reference for establishing whether the RER is out of alignment with its equilibrium. The results obtained are consistent with the pressures on the exchange rate currently observed, and indicate that, as has been remarked, the current account deficit is large and a weakening of the currency is required which in the short term will tend to make non-traditional exports more competitive (they represent only 30% of total exports).

To bolster these results, we estimated the equilibrium RER using an alternative method: the BEER approach[16], which seeks to relate the economic fundamentals directly with the trend in the exchange rate. We used Johansen's methodology for the bilateral Peru-US RER, constructing different models with the possible subsets of fundamentals from the empirical literature: terms of trade, relative productivity, government consumption and the net foreign debt position[17] (see Table R.3.1). In line with Rodríguez and Vega (2008) we did not work with the trends of these fundamentals since the equilibrium is highly sensitive to the statistical filter used[18].

[14] Average growth for the period 2015-2019 is used: GDP (3.7%), inflation (3.0%) and currency depreciation (3.5%).

[15] We estimate that as elasticity, a real depreciation of 10% improves the current account result by 1.4 percentage points of GDP.
[16] BEER: Behavioural Equilibrium Exchange Rate.
[17] In line with Arena and Tuesta (1998), Ferreyra and Herrada (2003), Salas and Ferreyra (2006), Rodríguez (2010) and Rodríguez and Winkelried (2011).
[18] In fact, this problem becomes more acute when the equilibrium exchange rate is analysed at the end of the sample.

Table R.3.1
Peru: Evidence in BEER approach

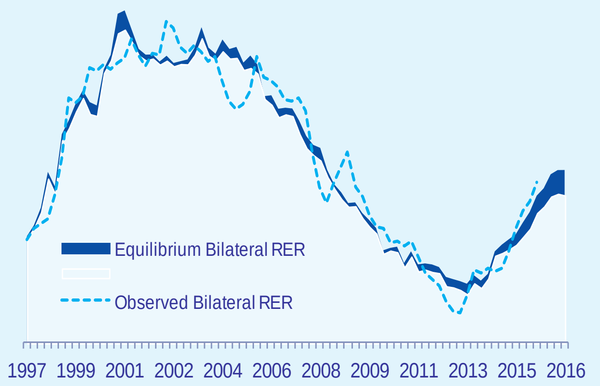
	2003 [1]	2006 [2]	2010 [3]	Evidence
Interest Rate Diferential	0.59			(+)
Trade Gap	5.10	1.90	0.14	(+)
Net External Liabilities	2.99	0.23	0.20	(+)
Dollarisation of SDD Credit			0.08	(+)
Productivity	-0.61	-0.25	-0.30	(-)
Government Expenditure	-0.03		-0.01	(-)
Terms of Trade	0.53	-0.72	-0.24	(+)/(-)

Note:
1/ Ferreyra and Herrada.
2/ Ferreyra and Salas.
3/ Rodríguez.
Source: BCRP and BBVA Research

With this approach we obtained results in line with the external sustainability method, suggesting a potential upward (i.e. more soles per dollar) correction of the exchange rate in the medium term. Specifically we found:

- that no significant misalignments with the equilibrium have been observed (Figure R.3.3). This is consistent with central bank currency interventions aimed solely at reducing extreme volatility of the PEN in the short term but subordinated to the trends imposed by the fundamentals.
- Providing the fundamentals projected by BBVA Research are correct, the RER will continue to depreciate.
- Lastly, taking account of expected inflation for Peru and the US, this would imply a nominal adjustment that would take the PEN to levels of around S/. 3.60 to the dollar towards the end of this year.

Figure R.3.3
Observed and equilibrium bilateral real exchange rate (Index 2009 =100)



The equilibrium real exchange rate band corresponds to the estimated average of the models +/- 2 standard deviations.
Source: BCRP and BBVA Research

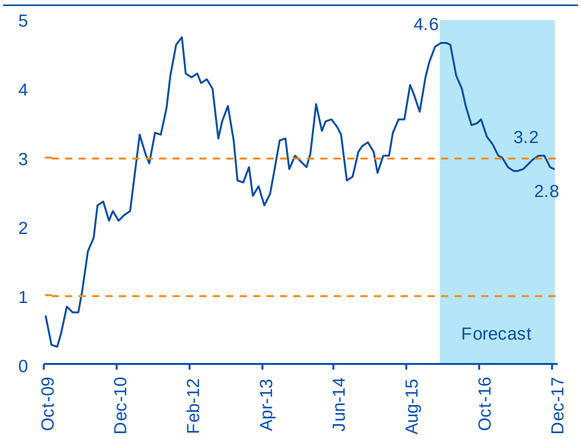
6 Inflation will soon start to ease and will end the year just above the target range

Inflation has been increasing in the past few months

Inflation has remained high and with a rising trend in the past few months, outside the target range. At the end of January, for example, inflation in year-on-year terms was 4.6% (see Figure 6.1). Factors driving inflation up include (see Figure 6.2): (i) depreciation of the national currency, which directly affects prices in sectors such as public services (where contracts and supplies are denominated in foreign currency), rentals, healthcare services, imported foodstuffs (such as maize, which directly influences the price of chicken), among others; (ii) higher food prices, e.g. potatoes, legumes, carrots, etc. due to low rainfall in the Central Sierra limiting planting and affecting yields; (iii) excess demand in certain markets, for example education and culture, healthcare and restaurants, in a context in which supply is growing more slowly. The fall in the price of oil (see Box 4) however counteracts part of these upward pressures through lower fuel prices, albeit to an extent reduced by the exchange rate effect.

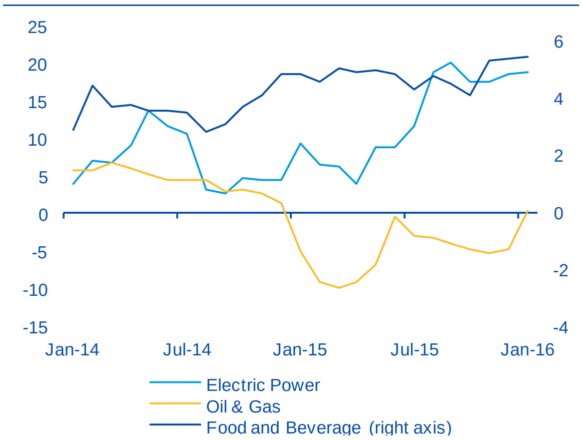
In this context, inflationary expectations have also remained above 3% in the past few months, more in line with the average YoY inflation rate for the past five years, and the trend is upward. This is due not only to the effects of El Niño and the persistent pressure on the currency, but also to the fact that inflation has been outside the target range for quite some time. Price formers also look at the past in forming their expectations. There has been some erosion of the central bank's credibility. In this context, inertia enters the price forming process, an inertia that is not in consonance with the target range and that will constitute downward resistance for inflation in the future.

Figure 6.1
Inflation (YoY % var.)



Source: BBVA Research

Figure 6.2
Inflation: selected items (YoY % var.)



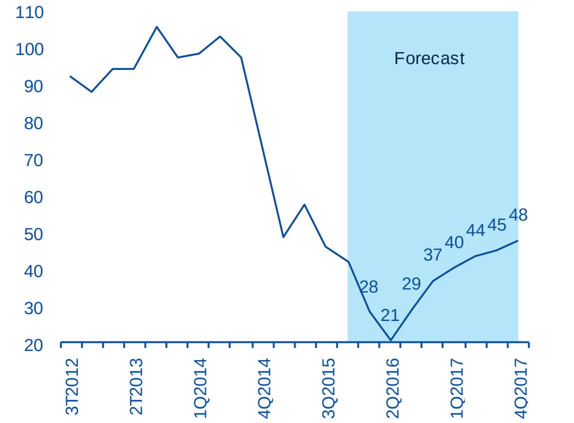
Source: BBVA Research

We foresee inflation soon starting to ease.

The sources of pressure on prices will start to weaken in the short term: (i) El Niño will gradually dissipate, along with its effects; and (ii) the currency situation will gradually moderate (a large part of the adjustment has already been factored in by the market) since our forecast assumes that the direction of the Federal Reserve's monetary policy will become clearer and that the Chinese authorities will be able to manage the economic situation better, while on the domestic front we expect the noise from the elections to subside. In addition to this, we still see the price of oil falling further in what remains of the first half of the year.

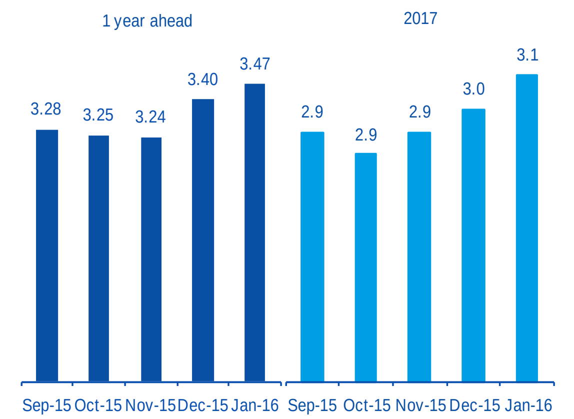
However, the subsequent fall in inflation will be gradual. The price of oil will start to recover in Q4 2016 (see Box 4) and the high inflationary expectations will lead to inertia in the price forming process and in the fall in inflation (see Figure 6.4). Thus it will end the year at 3.2% and will continue to fall after that, converging with the target range at the beginning of 2017 (see Figure 6.1). We should mention that, to the extent, if any, that expectations can be corrected, convergence with the target range will be all the quicker.

Figure 6.3
International oil price (USD/barrel)



Source: BBVA Research

Figure 6.4
Inflationary expectations (%)



Source: BBVA Research

Box 4. What is going to happen to the price of oil?

The end of an era

Between the beginning of 2000 and the second half of 2014, the price of oil showed a sustained increase interrupted temporarily by the Great Recession. This “supercycle” was characterised by robust growth both in demand for oil, especially from emerging markets (China), and in the supply of non-OPEC, especially US, crude oil.

An analysis of the increase in oil prices during this period indicates that the demand factor dominated market expectations. However, at the beginning of 2011, when US supply started to pick up, oil prices stabilised, since expectations took for granted a more balanced market. Nevertheless, in 2014 demand could not keep pace with supply, which gave rise to a fall in prices which has continued until now.

In previous episodes of price contraction, as in 2001 and 2008, OPEC’s reaction was to cut production; however in November 2014 the cartel surprised the markets with its decision to maintain production levels, which was seen as an attempt to protect its market share. The reluctance to cut production, and indeed an increase in production in 2015 while prices were still falling, were interpreted by some experts as an attempt to force high-cost producers out of the market.

At the same time, in mid-2014, China’s economic slowdown had become even more evident. For example, the manufacturing PMI has fallen continuously since July 2014. The effects on other emerging markets have been considerable. In this context, our econometric analysis confirms that the fall in the price of oil has been due to the supply and demand fundamentals, including expectations regarding both factors.

Thus our central scenario foresees a downward adjustment during the first half of the year, followed by a gentle recovery from then on. At the end of 2018 we see prices stabilising at around US$60 per barrel, which we estimate to be the long-term equilibrium level.

It is possible that there will be a further price correction in the next few months

Ever since the price began to fall, future contracts have persistently revised expectations downwards, which indicates remaining uncertainty about when the price will bottom out. From the point of view of supply, concerns still remain as to the surplus. OPEC has shown no sign of possible cutting production, which could be explained by two factors. On the one hand, the marginal cost per barrel for Saudi Arabia and other OPEC members is still well below US$20 a barrel. On the other hand, Saudi Arabia, the biggest producer and owner of the second biggest proven reserves, has been able to absorb the impact of low prices on its economy by means of a combination of austerity measures and sales of foreign exchange reserves. Bearing in mind the level of foreign exchange reserves (US$616 billion, equivalent to 100% of GDP) and the low level of public debt (6.7% of GDP), Saudi Arabia has a margin with which to withstand a prolonged period of low oil prices.

Some non-OPEC countries such as Russia, the world’s second biggest producer, and Brazil, might find it difficult to cut production voluntarily, since their economies are contracting and oil revenues are critical for supporting fiscal policy.

Another source of downward pressure on prices concerns Iran’s ability to export crude oil following the lifting of sanctions as a result of the agreement with the P5+1 group. The Iranian government aims to increase production by 1 million barrels a day in 2016, which would mean a return to full production capacity, estimated at around 4 million barrels a day. However, a more reasonable estimate points to the additional volume of oil that Iran can put on the world market in the short term as being between 300,000 and 500,000 barrels a day.

On the demand side, the outlook for global growth has deteriorated due to the weakness of the emerging markets and the modest growth of the developed economies. Specifically, China’s economic growth is expected to decline from 6.9% in 2015 to 6.2% in 2016 and 5.8% in 2017. Our central scenario assumes a soft landing; however, the uncertainty about the extent of the slowdown and the government's ability to manage the cycle by means of fiscal and monetary policy will probably exert downward pressures on oil prices in the short term. China's slower growth will have secondary effects on other emerging markets, with negative repercussions for demand for oil.

Another factor that will prevent prices from rising in the short term is the persistently high level of inventories, especially in the US, where oil stocks excluding strategic reserves are at their highest for eighty years, and where, despite the increase, pressures on operational storage capacity have so far been contained.

Modest improvement in the second half of this year and during 2017

Although the price could fall even further during the first half of the year, a sharper adjustment to US production could lead to its rising in the second half and during 2017, especially if the fall in US production is greater than the potential increase in supply from other producers (such as Iran). The rapid reduction in the number of active wells indicates that US oil production could fall by about a million barrels a day in the next twelve months. This would involve removing from the market a substantial part of the surplus supply, which is currently calculated to be between 1.5 and 1.8 million barrels a day. US production will also be affected by the growing number of failures and an environment of greater risk aversion which is reflected in stricter credit rules for financing the oil and gas sector.

Although a more far-reaching adjustment to US production of an agreement between OPEC and Russia could lead to a new increase in price, this will be limited by the following factors: firstly, if Saudi Arabia and its partners wish to retain or gain market share, they need the price to be just below the high-cost producers' breakeven price. This means that they cannot cut production to the point where high-cost producers become competitive once more.

Secondly, the flexibility and efficiency of the US shale oil sector suggest that firms can reactivate their production relatively quickly once they see that prices are rising again. Thirdly, the outlook for lower economic growth could counteract the increases deriving from an adjustment to supply.

Are oil prices heading towards a lower long-term equilibrium? Yes, this is probably the case, but there is a high degree of uncertainty.

The structural changes in the energy market will have a significant impact in the long term. On the supply side, increasing competition from non-member producers will continue to weaken OPEC's function as a stabiliser of prices. Increased competition will encourage innovation, which could bring down equilibrium prices, such that producers who currently have high costs would be more competitive in the future. The shale revolution in the US has shown that a more competitive environment encourages innovations which increase productivity and offer access to resources not previously available.

On the demand side, the emerging markets will continue to drive growth, while demand from the developed countries will continue to decline in relative importance; however, the rebalancing of China's economy could have more wide-ranging repercussions for oil. Even if China's GDP growth rate remains above 6%, reconstituting the sources of growth could involve a much more pronounced adjustment in demand for oil than if growth were to rely mainly on the manufacturing sector.

Lastly, we foresee the commitments to reduce CO_2 emissions made at the 2015 UN Climate Change Conference leading to investment in increasing the share of energy from renewable sources in the world's energy mix.

These trends will entail a new equilibrium price for oil, which can reasonably be expected to be lower than previously thought, although there is great uncertainty as to the intensity or even the actual materialisation of these long-term factors within the forecast horizon.

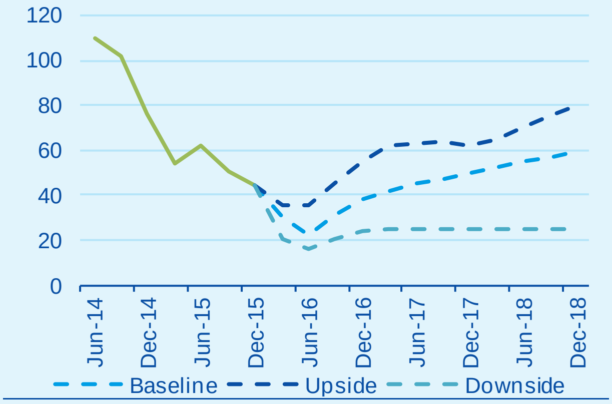
High degree of uncertainty surrounding our central scenario, even in the short and medium term

The uncertainty does not clear when we focus on the short and medium term. Prices could stop falling and see a rapid upturn if: 1) OPEC decides to cut production, 2) US production adjusts faster than expected, with a lasting impact on the sector, and 3) the slowdown in the world economy proves less serious than feared.

Conversely, the opposite of these events could lead to an opposite price scenario, i.e. if: 1) China's economy has a hard landing, 2) OPEC maintains its current production quotas and embarks on a price war with other producers, and 3) US production stays firm while equilibrium prices are brought down by innovation.

In conclusion, oil prices will ultimately be determined by the financial solidity of both OPEC and non-OPEC oil producers in a scenario of low oil prices, uncertainty about soft landings of emerging markets, and the real impact of technological innovations on the oil sector.

Figure R.4.1
Oil price forecasts
Brent, $/barrel



Source: BBVA Research

Table R.4.1
Oil price forecasts

	Central scenario	Up	Down
2015	52.6	52.6	52.6
2016	**30.3**	**45.0**	**20.3**
2017	**45.7**	**63.7**	**26.4**
2018	**55.7**	**75.7**	**26.8**
2019	**59.6**	**83.5**	**23.7**
2020	**59.6**	**87.7**	**21.4**

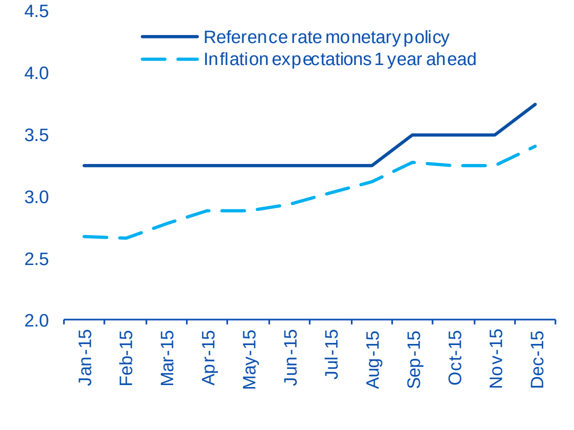
Source: BBVA Research

7 Central bank monetary policy focused on inflationary expectations

The central bank has been adjusting the rate, but…

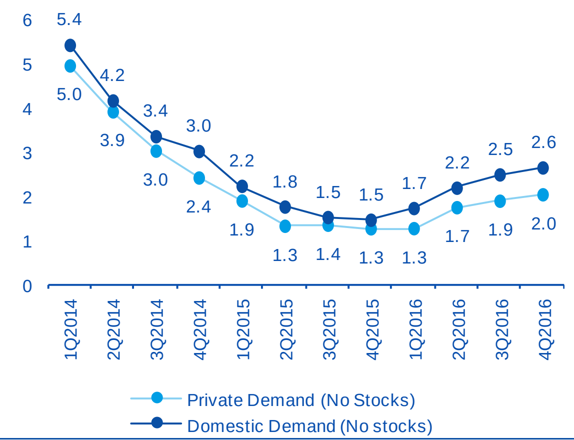
In this environment of inflation and rising inflationary expectations, the central bank has been increasing its benchmark interest rate, rising by a cumulative 100 bps since last September. It has done so in an environment in which activity has posted higher growth rates. However, expectations have not been contained (see Figure 7.1). For this reason, the communiqué accompanying its February decision, when it raised its policy rate by 25 bps, reveals a greater determination to contain growing inflationary expectations, something not seen in previous communiqués. The recent improvement in aggregate activity lends credibility to this objective.

Figure 7.1
Reference interest rate and Inflationary expectations one year out (%)



Source: BBVA Research

Figure 7.2
Private domestic demand excl. inventories (YoY % var., 4 qter. moving ave.)



Source: BBVA Research

In this context, the decision on whether or not to continue raising the reference rate will depend largely on how inflationary expectations evolve. One possible scenario is that the more energetic tone of the latest communiqué and its greater credibility might moderate expectations, thus ironically making it unnecessary for the central bank to raise its rate again, perhaps no more than another 25 bps. This is our baseline scenario. But another scenario, which is also possible, is that expectations do not ease quickly and that the central bank, having made the commitment, has to raise the rate further. In this second scenario it is likely that when inflationary expectations start to fall and approach the target range, the ex-ante real interest rate will increase and will become a drag on private sector demand, which is weak, advancing at a rate of between 1% and 1.5% YoY (see Figure 7.2), which we do not see accelerating much in the remainder of the year. Will the rate then come down? Does this lessen the credibility of the commitment to continue raising rates if expectations continue to rise?

8 On balance, risk factors give a negative bias to the growth projection for 2016

Deviations from the trends assumed in our baseline scenario for different key variables on the external and domestic sides could lead to a more challenging environment for the Peruvian economy in the coming months. Nonetheless it is important to point out that Peru has strengths that limit the potential effects of more adverse scenarios.

Externally, a more pronounced slowdown than foreseen in China or the US, or persistent episodes of financial stress with spill-over effects on emerging markets

Our baseline scenario assumes that the process of moderation of China's growth towards sustainable levels, and the rebalancing of its demand-side growth drivers (less investment and more consumption), will be gradual and orderly. However, the financial fragilities that are surfacing in China have generated doubts about the strength of its growth and its ability to sustain rates of around 6%. Lower growth in China would have a negative impact on the Peruvian economy, because it would involve lower prices for the metals that Peru exports (affecting mining companies' earnings and reinvestments as well as tax revenues), an increase in global risk aversion that would reduce appetite for investing in emerging economies such as that of Peru and lower external demand through China's impact on Peru's other main trading partners. Something similar could occur in the event that the US labour market were to lose impetus or the weakness of investment and exports were to prove more serious than we have estimated.

UN the domestic sphere, a large number of factors may have a negative effect on estimated growth in the baseline scenario

Three months ago, the probability of El Niño being very intense in the summer was close to 50% and it was therefore thought that the heavy rains on the north coast of Peru would have a negative effect on agriculture, fisheries, oil and gas, trade and construction. However, the probability of its being so intense has decreased to 15%. The most likely scenario now is that it will be moderate (65%). This has been incorporated into the baseline scenario, with a positive effect on growth in 2016. However, despite its reduced intensity, impacts of El Niño more sensitive than those anticipated would give our central scenario a negative bias.

Other factors of a domestic nature that would give our growth projection a negative bias are under-execution of public sector expenditure, particularly at Regional level, or delays in major infrastructure projects. At BBVA Research we expect growth of around 8% in public sector capital expenditure this year, driven by the start of construction of the major infrastructure projects and in an environment in which under-execution of capital expenditure in local and regional governments is gradually turning around. If this does not take place or is delayed, economic activity will grow more slowly than forecast.

Moreover, high levels of inventory would lead to drastic adjustments to production. Last year approximately 40% of GDP growth is said to have been due to accumulation of inventories. Although some 20% of this accumulation of inventories was due to the increased local production of copper (new projects) that were not placed in the international market but will be in early 2016, and another portion relates to imports which do not compete with local production, there will still be stocks to clear in 2016. Our baseline scenario provides for gradual normalisation of inventories in the next few quarters without jeopardising local production. If it is faster, there will be a drag on growth for the year.

On the positive side, greater growth in primary production

In preparing our GDP growth forecast for 2016 we have been conservative as regards the expansion of the primary sector. For the mining sector, in our baseline scenario we have assumed that the Las Bambas project will attain a level of copper production of close to 160,000 fine metric tonnes (FMT) this year, appreciably below its estimated full capacity, which is around 450,000 FMT a year, and below this year's production target of between 200,000 and 300,000 FMT. It is worth pointing out that in December this project reported nearly 7,000 FMT of copper, and our projection implies that this level of monthly production will grow gradually, to double towards the end of this year. Thus, monthly production that starts to exceed 13,000 FMT would give an upward bias to our growth projection for the year (at full operating capacity, the Las Bambas project will extract 38,000 FMT of copper a month). For the fisheries sector, we assumed a total anchoveta catch of around 4.0 million metric tonnes, 12% more than 2015. However, according to recent declarations of the Minister of Production, the quota for the first anchoveta fishing season this year will be “large”. What does “large” mean? The baseline scenario incorporates a catch of 1.8 million metric tonnes. If it is more, there will be greater growth in fisheries and in primary manufacturing.

The assessment of the probability of occurrence and of the magnitude that we assign to the upside and downside risk factors previously described leads us to consider, on balance, a negative bias in our growth forecasts for Peru.

9 Tables

Table 9.1
Previsiones macroeconómicas

	2012	2013	2014	2015	2016	2017
GDP (% YoY)	6.0	5.8	2.4	3.3	3.6	4.2
Inflation (% YoY, eop)	2.6	2.9	3.2	4.4	3.2	2.8
Exchange Rate (vs. USD, eop)	2.57	2.79	2.96	3.38	3.62	3.66
Interest Rate (%, eop)	4.25	4.00	3.50	3.75	4.50	4.50
Private Consumption (% YoY)	6.1	5.3	4.1	3.4	3.2	3.5
Government Consumption (% YoY)	8.1	6.7	10.1	7.5	4.5	4.0
Investment (% YoY)	16.4	7.4	-2.1	-5.5	0.5	2.8
Fiscal Balance (% GDP)	2.3	0.9	-0.3	-2.1	-3.0	-2.7
Current Account (% GDP)	-2.7	-4.2	-4.0	-3.9	-3.2	-3.1

Source: BCRP and BBVA Research Peru

Table 9.2
Previsiones macroeconómicas

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange Rate (USDCLP, eop)	Interest Rate (%, eop)
Q1 14	5.2	3.4	2.81	4.00
Q2 14	1.9	3.4	2.80	4.00
Q3 14	1.7	2.7	2.87	3.50
Q4 14	0.9	3.2	2.96	3.50
Q1 15	1.8	3.0	3.09	3.25
Q2 15	3.0	3.5	3.16	3.25
Q3 15	2.9	3.9	3.22	3.50
Q4 15	4.6	4.4	3.38	3.75
Q1 16	4.0	4.7	3.56	4.25
Q2 16	3.6	4.0	3.59	4.25
Q3 16	3.3	3.5	3.58	4.25
Q4 16	3.3	3.2	3.62	4.50
Q1 17	4.7	2.9	3.64	4.50
Q2 17	4.3	2.8	3.65	4.50
Q3 17	3.9	3.0	3.66	4.50
Q4 17	4.0	2.8	3.66	4.50

Source: BCRP and BBVA Research Peru

DISCLAIMER

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