BBVA | RESEARCH

Peru Economic Outlook

2ND QUARTER 2016 | PERU UNIT

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

02
Further devaluation of local currency is expected, albeit to a lesser degree, and it should end the year at a level of around 3.50.

03
Over the next few months, inflation will continue to slow and will close the year slightly below the Central Bank's target.

04
Neutral balance of risks concerning growth outlook

Contents

Closing date: 1 May 2016

1 Editorial

Economic activity began the year on a buoyant note, with a growth rate of over 4% YoY. GDP is underpinned by the group of primary (extractive) activities, above all metal (especially copper) mining, with the start-up of two large copper mines. In year-on-year terms, copper production rose over 50% in the first quarter, and, according to our estimates, added two percentage points to GDP growth during this period. On the demand side, the strong mining activity is leading to higher exports. Other sectors of the economy, however, are less buoyant, and this is relatively clear if we look at the situation in domestic demand. Although official data on domestic demand have not yet been published, the available indicators suggest that growth remains feeble. The fact that the two major mines have now been completed, the natural reluctance to spend against a background of general elections and unusual weather phenomena (*El Niño*), the slow generation of formal employment, and the relatively high inflation which erodes purchasing power- are some of the reasons why we have yet to see stronger recovery in business and household spending. One positive aspect of domestic demand, however, is that a more positive trend in public spending by regional governments has begun to be evident, after two years of cutbacks.

If we take this as the starting point, then we estimate that after having expanded 3.3% in 2015**, the Peruvian economy will grow 3.6% in 2016 and 4.3% in 2017**. **Growth drivers will be higher mining production**, particularly of copper, which will continue to benefit from large mines coming on stream (gradually reaching their peak operating capacity), **and the higher public and private spending on infrastructure works** such as Line 2 of the Lima Metro and the Mantaro-Marcona-Socabaya-Montalvo electrical transmission line in 2016, as well as others to be added in 2017. Overall, increased copper output and these five infrastructure projects will contribute approximately two percentage points to GDP growth in 2016 and a slightly larger proportion the following year. From the expenditure point of view, this will tend to sustain the strong dynamism of exports and improved performance of public and private sector capital expenditure. The estimates are consistent with fiscal spending which implies maintaining a structural deficit equivalent to 2% of potential GDP: with a gradual improvement in business and consumer confidence insofar as the effects of the *El Niño* phenomenon fade, the general elections are completed, the expansion in domestic demand gains traction, inflation and the devaluation of the local currency ease off, and, in general, the “background noise” falls away; as well as the reversal, in 2017, of the impacts of *El Niño* in 2015.

On the fiscal side, the structural deficit of 2% of potential GDP which we have taken into account throughout the projected horizon implies that growth in public expenditure in real terms will not be higher than 4% per year on average during the 2017/19 period. Here, two conclusions may be drawn. One, that from now on **gross public debt will trend upward** and will reach a level of 27.5% of GDP by 2020. According to our estimates, there is even a 26% possibility of gross public debt rising above 30% of GDP. Such a trend and the level which would soon be reached by gross public debt might possibly jeopardise the country's credit rating (the current rating is firmly based on the health of the Peruvian current account balances). Two, clearly **there is not much leeway for funding expansionary fiscal policies in the short term, either through increasing expenditure or cutting taxes, or the structural reforms needed in Peru**. It is a challenging scenario given that the only way that Peru will be able to sustain a rate of growth to allow people to continue joining the job market under appropriate conditions, to reduce extreme poverty and expand the middle classes, is through structural reforms. Hence, the incoming government will have to find a way to increase tax receipts in a structural way, and it will be crucial to bring down informal labour. It will have to efficiently use the resources at its disposal, and give clear priority to sectors where social rewards will be greater.

The local currency recently strengthened, as did the currencies of other emerging markets and, in general, assets perceived to be higher risk. We believe **that this will be temporary and that soon the**

upturn in the USD/PEN exchange rate will be resumed. Why? First, because our view of what will happen with some of the key factors which affect the short-term exchange rate trend differs somewhat from market consensus. For example, we expect the FED to increase rates during the rest of the year because the labour market remains robust, downward inflationary pressures are beginning to ease off, and global financial tensions have retreated, although market consensus does not expect this to happen. We believe that the market's sense of surprise will trigger upward pressure on interest rates. And second, a trend of devaluation in the local currency is borne out by structural factors. The current account deficit in the balance of payments is still significant, even after taking into account the boom in mining production and exports. Furthermore, capital inflows towards the more tradable sectors of the economy, such as the mining sector, are on the wane and this situation looks set to continue against a background in which we do not expect a substantial recovery in commodity prices, above all metals, and in which lending conditions worldwide will grow gradually tighter. The **exchange rate will close the year at between 3.45 and 3.50 and will be closer to 3.65 at the end of 2017**.

Turning to prices, **year-on-year inflation** remains high and has been above the target range for several months. However, it **has begun to retreat** against a background of appreciation in the local currency and in which the rise in food prices has been checked (the *El Niño* effect has retreated). According to our estimates, **inflation will continue to slow over the rest of the year**. We have based this estimate on two factors: that unusual weather patterns will continue to fade, leading to further slowing of growth in food prices; and that the year-on-year rate of devaluation in the local currency will be more constrained. Taking these factors into account, we expect inflation will **converge at the target range towards the end of the year** and not drift too far from this ceiling in 2017.

With the respite in inflation in recent months, inflationary expectations have begun to adopt a similar pattern. In this setting, the **Central Bank, having increased its key interest rate by 100bp since September, has decided to put it at 4.25% since February. We expect the Central Bank to keep it at this level over the next few months**. There are few reasons to continue increasing it. On the one hand, there are no demand pressures: private sector spending is weak and over the rest of the year will grow below 2% YoY. On the other, while inflation and its different measurements, such as inflationary expectations, are still some way off the target range and will probably remain so during most of the year, they have actually begun to fall and will continue to do so over the next few months. In this setting, it does not seem appropriate to force through an improvement in prices (with additional adjustments in the key interest rate).

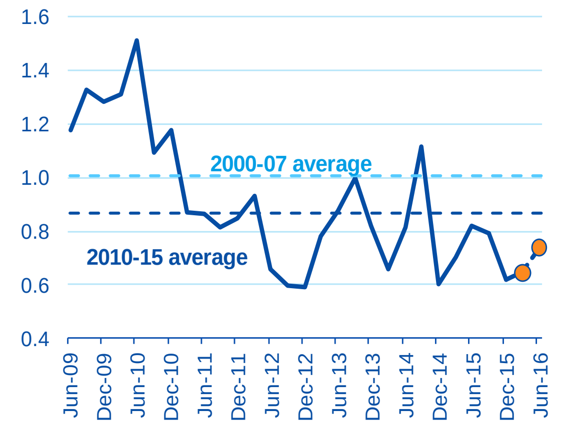
Lastly, **the risks to our growth estimates for 2016/17 are balanced**. China and possible delays in executing major infrastructure works are downside risks. However, these are offset by the upside risk stemming from the positive shock which the incoming government can create for business and household confidence, encouraging economic activity to a stronger degree than is considered in our baseline scenario.

2 Fragile global growth, dependent on China

The data available for the first quarter of 2016 confirm our forecasts of stabilising growth in the global economy, with low rates albeit slightly higher than in late 2015. The BBVA-GAIN[1] indicator puts the qoq increase in global GDP at 0.6% (2.6% annualised rate), although below the average registered between 2010 and 2015 (Chart 2.1). This rate of growth may pick up slightly in the second quarter if the signs of less deterioration apparent in production, trade and business confidence indicators are consolidated, but it is still not enough to bring annual growth in the world economy to around 3.2% (which is our forecast for 2016 as a whole).

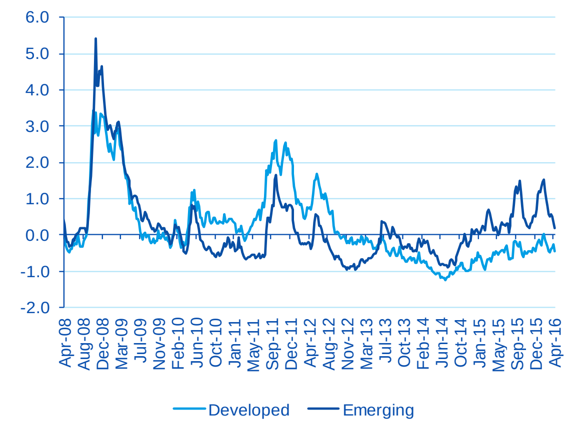
The sharp spike in financial volatility seen between December 2015 and February 2016 was not only a reaction to slowing global activity, but it also threatened to compound the situation if it continued on such a scale and led to a reduction in expenditure decisions. The better than expected pattern of economic indicators in China, and lower downward pressures on the yuan, the recovery in commodity prices and cooling of expectations for interest rate hikes by the Fed, have proved crucial in playing down financial turbulence from then on and in turn, in reducing the likelihood of a short term global stress scenario occurring.

Figure 2.1
Global GDP, % qoq 1Q and 2Q forecasts for 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA financial stress index (normalized values)



Source: BBVA Research and Haver

China: fewer short-term risks, but more long-term doubts

The fact that Chinese authorities have bolstered both monetary and fiscal stimulation policies has helped to cool the effects of the reshaping the of the manufacturing sector on aggregated production, and, thus on the country's trade flows with respect to the rest of the world. In the short term, deploying countercyclical measures may help to allow a more gradual economic slowdown (softer landing) than is expected; however, if it entails putting off the correction of fundamental imbalances such as the high leverage in the corporate sector or excess supply in certain branches of industry and construction, then China's economy would become more vulnerable to shocks such as that observed in summer 2015, and this would also heighten its destabilising effects for the rest of the world. Taking these factors into account, we have revised our growth estimates for China in 2016 upwards to 6.4% and maintained growth of 5.8% in 2017.

1: See https://www.bbvaresearch.com/en/publicaciones/global-gdp-growth-remains-stuck-at-2-6-yoy-in-q1-less-cloudy-outlook-but-the-same-risks/

The Fed's decisions are shaped by the international backdrop, which helps to allay pressures on emerging markets

The delay in expectations regarding the forthcoming interest rate hike is due to the importance given to the deterioration in the international setting with regard to the Fed's reaction function. While FOMC predicted two hikes in 2016, the market has now put off the following increase to early 2017. The dollar's reaction, of further devaluation despite the good relative performance still apparent in domestic demand in the US, and the easing of the long tranches of the dollar curve, has helped to relieve funding restrictions in the emerging block, as shown by: (i) the BBVA financial stress index for this region, which has corrected the entire rebound observed in the first months of 2016 (Figure 2.2), and (ii) reactivation of foreign capital inflows, with net capital inflows in emerging countries since mid February partly due to the relocation of investment flows towards higher-return instruments.

Furthermore, insofar as central banks maintain the same direction of monetary policy in recent months (reinforcing or maintaining stimuli in the case of the ECB or the Bank of Japan; prudent approach in normalisation of interest rates by the Fed), emerging countries' authorities will have greater leeway to give priority to economic recovery, amongst their other targets. Aggressive interest rate hikes are less necessary because of the gradual approach which the Fed is expected to adopt (which supports capital flows towards the region) and the recent recovery in currencies (containing the possible increase in inflation from higher prices of imported goods).

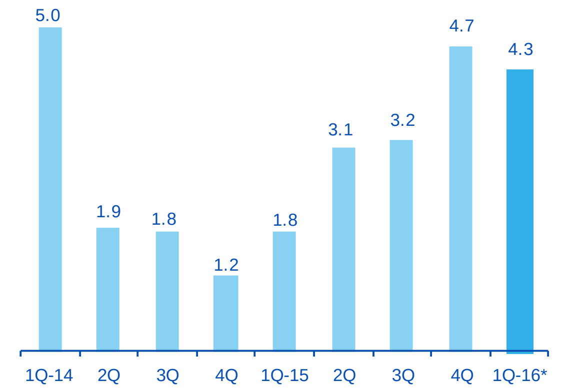
However, the relative improvement in the global economic backdrop in the first quarter remains precarious and, in the short term, hinges very much on the performance of the Chinese economy and also on how sources of geopolitical instability in Europe will play out. In any event, bouts of financial turbulence such as those seen in early 2016 may occur again (with higher or lesser intensity), against a background of great uncertainty about emerging countries' ability to cope with the slowdown and for developed central banks to revive growth.

3 Peru: we maintain our growth forecasts for 2016 and 2017 of 3.6% and 4.3%

How did activity fare in the first months of the year?

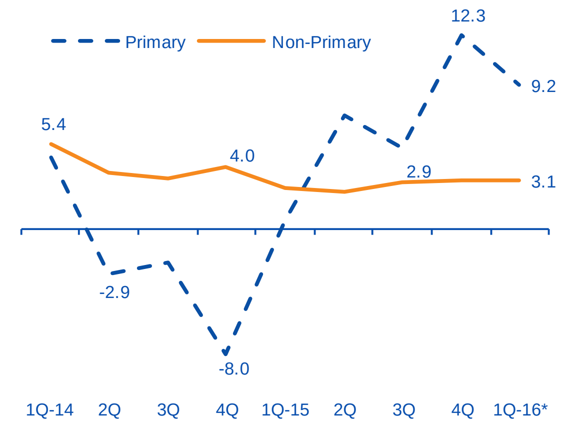
In general, GDP has continued to grow above 4% YoY (see Figure 3.1). The core driver remains the group of extractive sectors (see Figure 3.2), particularly the metal mining sector.

Figure 3.1
GDP
(chge. % YoY)



*Estimated.
Source: INEI and BBVA Research

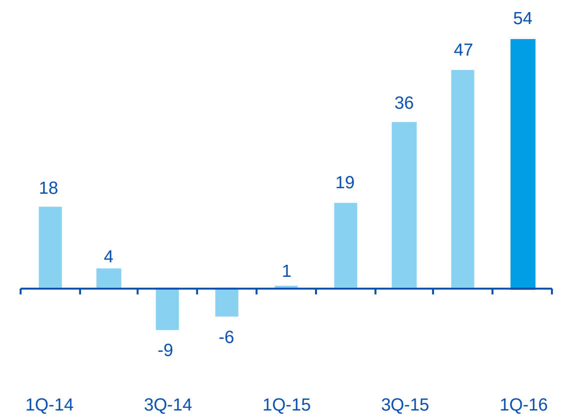
Figure 3.2
GDP: primary component (extractive) and non-primary (chge. % YoY)



*Estimated. Non-primary GDP excludes import duties.
Source: INEI and BBVA Research

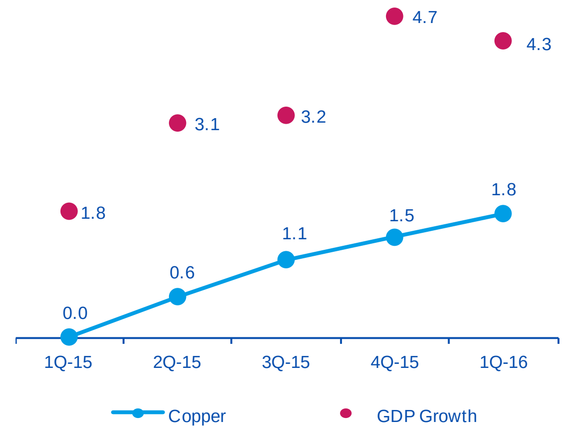
Copper mining is still the most important support within metal extraction. The increase of over 50% YoY in copper mining in the first quarter (see Figure 3.3) was underpinned by higher production from Cerro Verde (extension), consolidation of levels at Antamina, and production coming on stream at Las Bambas. Copper production thus accounted for approximately half of the economic growth in the quarter (see Figure 3.4). In our opinion, this will continue to be a crucial driver in the future, though its importance will gradually wane.

Figure 3.3
Copper production
(chge. % YoY)



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

Figure 3.4
Copper production: contribution to growth (percentage points)

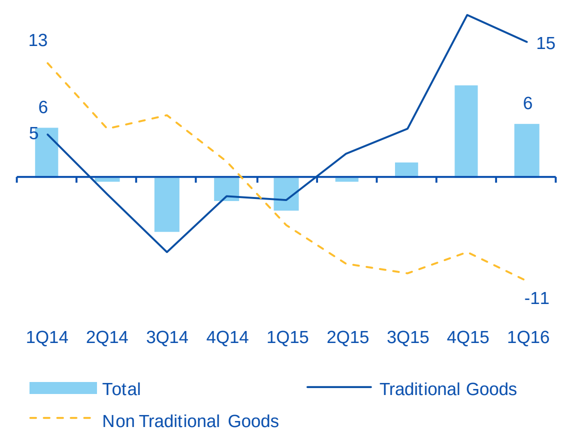


Source: INEI, MINEM (Ministry of Energy & Mines) and BBVA Research

Growth in non-primary sectors remains modest, though there has been some improvement. Construction, for example, which had shown a negative trend since January 2015, is beginning to show positive signs mainly due to increased investment by regional governments. Services has also held firm, bolstered by furthered activities linked to the financial, telecommunications and public administration sector. More negatively, Trade is beginning to run out of steam against a background of slowing household spending due to persistent weak job creation, further high inflation, slowing growth in consumer credit, further weakness in non-primary Manufacturing, which reflects, in particular, highly constrained external demand (contraction in Latam) and perhaps some normalisation of inventories which had built up last year.

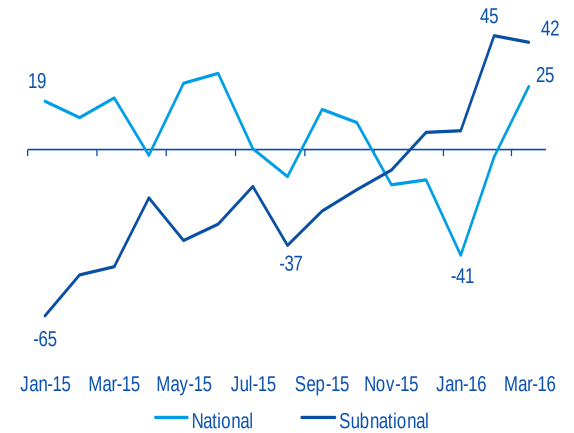
In terms of spending, the official first quarter figures have yet to be published. However, available indicators suggest that the most dynamic components are exports, owing to the heavy growth in metal mining, and public investment due to resumed capital expenditure by regional governments. Indeed, the performance in real terms of exports has been positive, with growth of 6% in the first quarter, basically driven by the boom in copper production. Shipments of non-traditional products contracted (see Figure 3.5). The improved performance in public investment over the first three months of the year was mainly underpinned by the better result by regional governments against a background where authorities have had sufficient time to acquire know-how about how to manage this type of expenditure (see Figure 3.6).

Figure 3.5
Real exports of goods (chge. % YoY)



Source: BCRP, SUNAT and BBVA Research

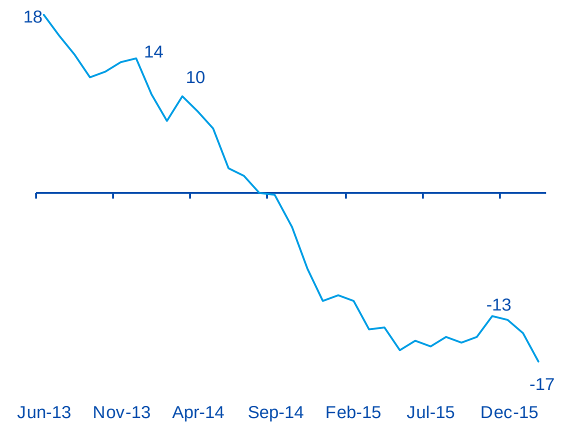
Figure 3.6
Public investment (chge. % YoY)



Source: BCRP, MEF (Ministry of Economy and Finance) and BBVA Research

Private investment indicators, however, suggested that it remained feeble in the first quarter. According to our own estimates, private investment continued to retreat in a context of lower mining investment (by February it had an accumulated annual nominal contraction of 17%, see Figure 3.7), surpluses which are due to relatively high inventory levels and negative surprises in corporate demand (see Figure 3.8), as well as a measure of caution with the general elections.

Figure 3.7
Mining investment[1/]
(in US$, accum. in past year, chge. % YoY)



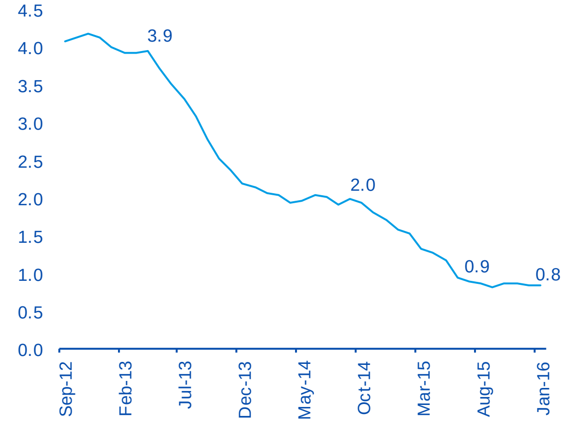
1/ Represents approximately 20% of total private sector investment.
Source: MINEM and BBVA Research

Figure 3.8
Level of demand vs. expectations
(in points)

Source: BCRP and BBVA Research

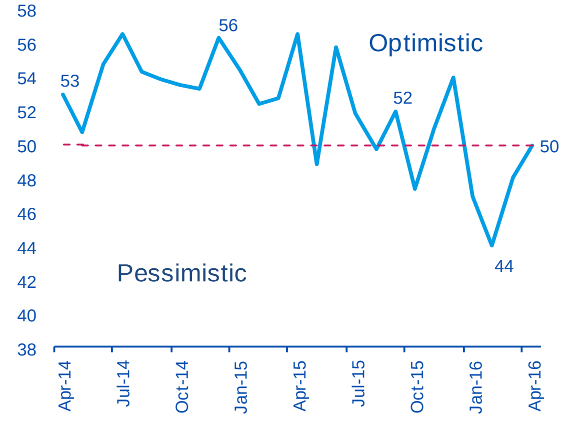
On the consumption side, weak formal job creation (see Figure 3.9) and relatively high inflation, which erodes purchasing power, have harmed household economies (see Figure 3.10), which, in this setting, would have increased their spending to a lesser degree than in preceding quarters (increase closer to 3%).

Figure 3.9
Formal urban employment
(chge. % YoY, six month moving average)



Source: INEI and BBVA Research

Figure 3.10
Current household situation (in points)



Source: Apoyo Consultoría and BBVA Research

Projected baseline scenario for the Peruvian economy in 2016/17: 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.

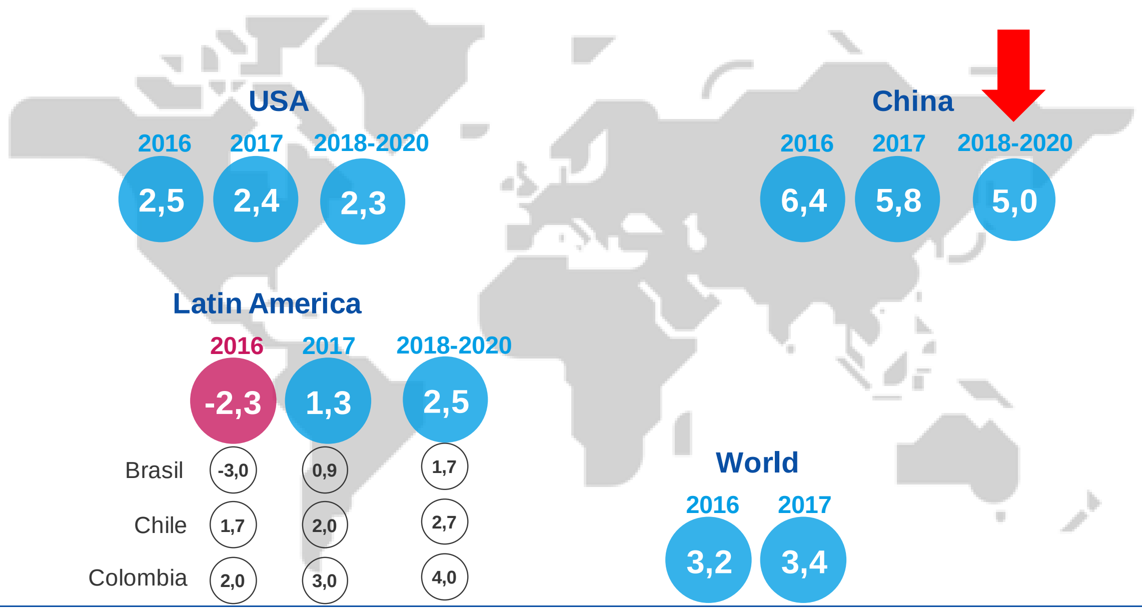
Externally,

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, developed 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 how it ended 2015. The main support for US growth will be private consumption, underpinned by the strength of the labour market and a favourable prices environment, supporting the increase in households' disposable income and more than offsetting the economic and political uncertainty (at home and abroad). 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 lower oil price) but also 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.

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 China's case, growth will continue to slow, but the adjustment will not be pronounced (nor has it been so far). 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 6.4% in 2016, not far off 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 over 3.5%.

Figure 3.11
Global growth (chge. % YoY)



Source: BBVA Research

Global growth will be slightly higher in 2017, 3.4%. This improvement will stem from two core economic areas, Latam and the Eurozone (see Figure 3.11), while the rate of growth in the US will not differ greatly from the rate in 2015, and the trend of slowing growth in China will be sustained.

2. **The terms of trade will again diminish in 2016** (on average, by slightly over 3%), having lost a cumulative 20% during the previous four years. On average, export prices will be adjusted downwards once more, this time by about 8%, while import prices will also fall again, in this case by slightly over 5%. According to our estimate, commodity prices would have hit bottom, generally speaking, in the first quarter of the year. Afterwards, they have improved against a background of production cuts (due to low prices), central banks of developed countries which are extending or even heightening the expansionary tone of their monetary policies (the FED is more dovish, weakening the dollar), and activity data in

different parts of the world which suggest that recovery is proving slow (or which point to slowing growth, such as in China's case), but which are basically in line with expectations, thus allaying fears of a risk scenario actually coming to pass. We believe, however, that part of this rebound in commodity prices will not be sustained over the rest of the year because it does not fit with the fundamentals of the global economy.

Against this backdrop, and 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$2.20/lb for 2016**. From its current level of around USD$2.25/lb, our estimate is that the copper price will stand at approximately USD$2.22/lb at the close of the year. Thereafter, as a number of less profitable copper projects worldwide decrease their production and it becomes more apparent that world growth is on the path of gradual recovery - China, in particular, through its “soft landing” - the copper price will gradually increase (on average to USD$2.28/lb in 2017 and close to USD$2.45/lb in a mid-term horizon).

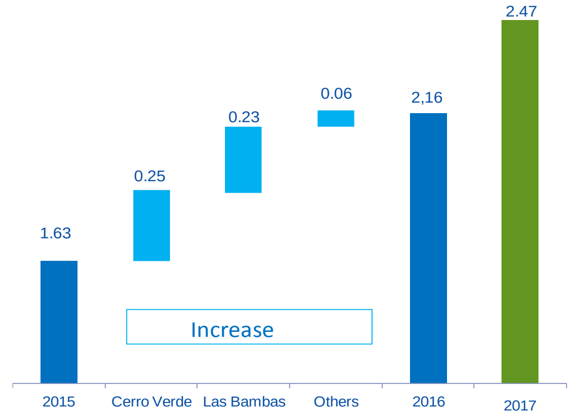
As for the WTI oil price, the baseline scenario incorporates an average level of US$35 per barrel for 2016. We expect that from its current level above USD$40/barrel, the WTI oil price will have some lag in the short term (the factors mentioned above imply both oversupply and high inventories in this market), closing the year in the region of USD$37/barrel. Thereafter, the lagging impact of the current capital expenditure in the oil sector (due to sustained low crude oil prices) and even the collapse of some North American companies will constrain growth in global supply and reduce inventories, thus supporting the price (putting it at an average of around USD$44/barrel in 2017 and closer to USD$58/barrel within a mid-term horizon).

3. **The normalisation cycle in the FED's policy interest rate will continue in 2016** due to the robust labour market, the fact that the downward pressures on inflation are easing off, and the respite from financial turbulence (which was very pronounced in the first quarter of 2016). However, **the adjustment will be gradual** given that inflation is still below the target of 2% against a background in which private spending will not be significantly revived (beyond consumption and employment). We foresee there being **no more than two policy rate hikes in 2016, each of 25 bps**, to 1.0%. Here we differ from market consensus, which believes that the FED will not adjust its policy rate during the rest of the year. We consider that this surprise move will have a downward impact on the prices of highest-risk assets, for example those of emerging countries, such as Peru. The US will continue to gradually adjust its monetary position in 2017, and at the close of the year we estimate a FED interest rate of 2.0%.

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

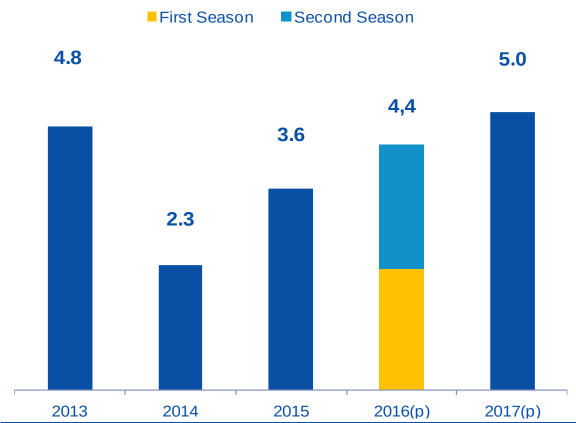
4. **Significant expansion of primary activities**. Copper extraction will continue to grow significantly in 2016 (see Figure 3.12). The extension of Cerro Verde will increase its output over the course of the year, leading it to reach its peak operating capacity in late 2016. Mining output in the Las Bambas mine will gradually be increased, and to an even greater extent in 2017. As a result, Peru's copper production, which was 1.6 million metric tons in 2015, will increase by 33% in 2016 and 14% in 2017. Most 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 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).

Figure 3.12
Copper production (millions of metric tonnes)



Source: MINEM and BBVA Research

Figure 3.13
Anchoveta extraction (millions of metric tonnes)

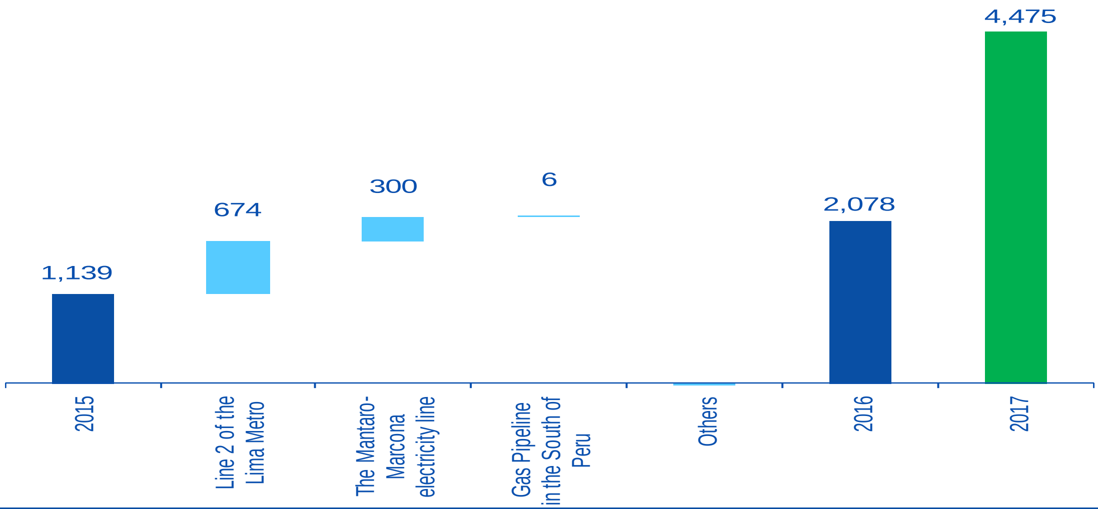


Source: INEI, PRODUCE and BBVA Research

Apart from this, the baseline scenario assumes that anchoveta extraction will improve in 2016 since the anchoveta's reproductive cycle would not be affected by anomalous sea temperatures (moderately intense *El Niño*). As a result, we have incorporated a catch of 1.9 million metric tonnes during the first season, 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 2.4 million metric tonnes for the same zone during the second season. In 2017 the catch will be even better, in an environment with no expected significant climatic anomalies, and anchoveta extraction could be closer to 5 million metric tonnes (see Figure 3.13).

5. **The faster pace of investment associated with major infrastructure projects**, particularly Line 2 of the Lima Metro and the Mantaro-Marcona-Socabaya-Montalvo electrical transmission line in southern Peru in 2016. Together, these two projects account for a higher expenditure than last year in terms of private and public investment, approximately USD$ 1.0 billion (see Figure 3.14), equivalent to seven tenths of a percentage point of GDP in real terms. In general, the faster pace we are expecting in construction of major infrastructure projects has already factored in certain potential lags (in some cases, they are already occurring) due to dealing with interference, longer time needed to complete land expropriation, or difficulties in raising funds to be able to continue works. Consequently, our estimates for higher growth in investment for 2016 do not include works such as the gas pipeline in southern Peru or the modernisation of the Talara refinery.

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

In 2017, expenditure will increase once again with building Line 2 of the Lima Metro, and also including the modernisation of the Talara refinery, the south Peru gas pipeline and the Chinchero airport, because by then the funding to continue the works will have been secured, and for a number of other reasons The increase in private and public investment involved in this set of projects will amount to over USD$ 2.0 billion in 2017, equivalent to over one and a half percentage points' contribution to economic growth in that year. Hence, infrastructure development will continue to act as driver for economic activity in 2017.

6. **Gradual normalisation of the inventories 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 international markets in the first half of 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.

7. **Structural budget deficit of 2% of potential GDP in the projection horizon.** Although the outgoing administration stated that hereafter it intended to bring down this deficit by half a percentage point per year, this would significantly restrict the incoming administration's spending. This adjustment is thus unlikely to be implemented, particularly taking into account that the two presidential candidates who have made it into the second round of the electoral process have stated that they intend to step up public spending in the short term, indeed one of them proposes a permanent tax cut. Against this background, our baseline projection scenario for the Peruvian economy adopts a working hypothesis of public spending which is consistent with a structural budget deficit at a level of 2% of potential GDP throughout the projection horizon. Weaker public balances could be a temporary additional driver for economic activity on the fiscal side, but would also increase risk premiums, which would in turn have a negative impact on private sector spending, thereby offsetting at least part of the stimulus.

Our forecasts do not include substantial economic reforms, i.e. reforms which not only would drive growth in GDP in the mid term but would also lead to pronounced improvement in business confidence, which we expect in the short term. These are matters which go beyond public expenditure, but have some connection with how the incoming administration will proceed in the third quarter of the year. Our baseline scenario is conservative in this respect, as we await specific plans announced by the winning presidential candidate of the elections held on 5 June.

8. **In 2017, reversal of impacts of the *El Niño* phenomenon (in 2015)** *El Niño* has had a negative impact this year, for example, on food production, both those consumed domestically and those exported abroad. In 2017, when weather conditions will be more normal, a positive impact will be apparent in the year-on-year comparison of growth in these productive activities such as agriculture.

The most important exogenous factors included in our baseline scenario for the Peruvian economy in the 2016/2017 period are summarised in Table 3.1.

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

	2014	2015	2016	2017
External Assumptions				
Growth (Var % YoY)				
Global	**3.4**	**3.1**	**3.2**	**3.4**
Developed	**1.8**	**1.9**	**2.0**	**2.0**
USA	2.4	2.4	2.5	2.4
Emerging	**4.6**	**4.0**	**4.1**	**4.5**
China	7.3	6.9	6.4	5.8
Latam-7[1]	0.8	-0.5	-1.2	1.7
Pacific Alliance	2.6	2.7	2.3	2.8
Mercosur	-0.5	-2.9	-3.7	0.8
Raw materials Price				
Terms of Trade (var% YoY)	-5.4	-6.3	-3.6	-3.6
Coppers (LME, USD/lb., average)	3.11	2.50	2.20	2.28
Crude Oil (WTI, USD/bar.,average)	93	49	35	44
Rates				
FED Rates (eop)	0.25	0.50	1.00	2.00
Internal Assumptions				
Stocks	-	-	Gradual destocking	-
El Niño phenomenon (strenght)	-	-	Moderated	Positivie Reversion
Investment in infraestructure projects (millions US$	563	1,139	2,078	4,475
Copper Extraction (millions MT)	1.3	1.6	2.2	2.5
Anchoveta Catch (millions MT)	2.3	3.6	4.4	5.0

1/ Includes Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.
2/ Includes the following infrastructure projects: Line 2 of the Lima Metro, southern Peru gas pipeline, Mantaro-Montalvo electrical transmission line, modernisation of Talara refinery, and Chinchero airport.
Source: BCRP, INEI, IMARPE, MINEM and BBVA Research

Against this background, we maintain our forecast of 3.6% growth in GDP in 2016 underpinned by copper production and infrastructure spending

In sector terms, the main support for GDP in 2016 will continue to be 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 (chge. % YoY)

	2013	2014	2015	2016(p)	2017(p)
Agricultural	1.6	1.4	2.8	0.2	3.2
Fishing	24.1	-27.9	15.8	5.0	4.2
Mining and hydrocarbons	4.9	-0.8	9.3	12.5	8.3
Metal Mining	4.3	-2.1	15.5	15.5	8.5
Hydrocarbons	7.2	4.0	-11.6	-0.9	7.3
Manufacturing	5.0	-3.3	-1.7	-1.5	2.7
Primary	15.3	-9.7	1.3	3.0	4.1
Non-Primary	2.0	-1.0	-2.6	-3.0	2.2
Electricity and Water	5.5	4.9	6.2	7.6	6.3
Construction	8.9	1.7	-5.9	-0.3	3.4
Trade	5.9	4.4	3.9	3.1	3.5
Other Services	6.4	5.8	5.1	4.2	4.3
Global GDP	**5.8**	**2.4**	**3.3**	**3.6**	**4.3**
Primary GDP	5.9	-2.3	6.6	7.9	6.5
Non-Primary GDP*	5.8	4.1	2.7	2.7	3.9

* 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 in the region of two percentage points to the GDP growth rate in 2016. In contrast, our forecasts assume that zinc and gold mining 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 in the future). Fisheries will grow by 5% in 2016, underpinned by an increase of over 20% 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 (drought in certain regions of the country, for example), 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 4.5%, which although less than last year, consistent with a certain transitory fatigue of household spending, will still provide significant support to GDP.

Construction will include the positive impact of major infrastructure works, outlined above, and the recovery in public investment at regional government level (following two years of contraction). There are three factors, however, which will not help to drive growth in Construction in 2016. First, a property sector which will be lethargic once again in 2016. Second, mining investment, which will continue to contract (est. US$2.1 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. Third, investment in the hydrocarbons sector (exploration and production) which will remain lack-lustre against an environment in which our estimated oil price level does not make it very compelling. On balance, Construction will not show recovery in 2016 (last year it fell sharply, by around 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 spelled 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.

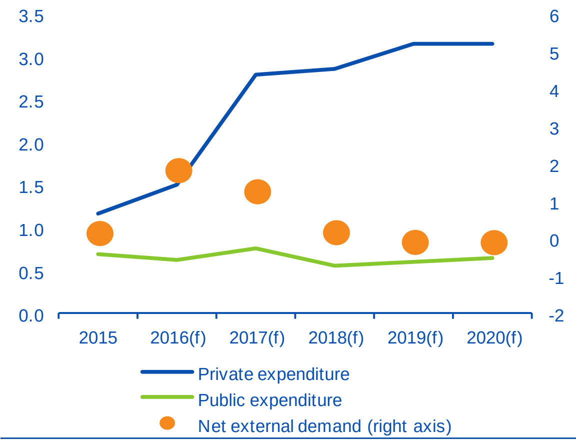
Exports will continue to be the best performers from the expenditure point of view (see Table 3.3). This will basically reflect the boom in copper production, while sales of non-traditional products and services will perform modestly.

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

	2015	2016(p)	2017(p)	2018(p)	2019(p)	2020(p)
1. Domestic Demand	**3.0**	**1.7**	**3.0**	**3.6**	**3.8**	**3.7**
a. Private Consumption	3.4	3.1	3.4	3.5	3.7	3.7
b. Public Consumption	9.3	2.4	3.0	2.5	2.9	3.3
c. Gross Domestic Investment	-0.5	-1.9	1.9	4.3	4.3	3.8
Gross Fixed Investment	-4.9	-0.5	4.6	4.1	4.7	4.7
- Private	-4.3	-2.2	3.7	3.8	4.6	4.6
- Public	-7.5	6.5	7.7	5.0	5.0	5.0
2. Exports	3.3	5.7	6.3	3.0	2.1	2.1
3. GDP	**3.3**	**3.6**	**4.3**	**3.8**	**3.7**	**3.6**
4. Imports	2.4	-1.7	1.1	2.4	2.5	2.5
Note:						
Private expenditure (ex stocks)	*1.4*	*1.8*	*3.5*	*3.6*	*4.0*	*4.0*
Domestic demand (ex stocks)	*1.9*	*2.1*	*3.6*	*3.5*	*3.9*	*3.9*

Source: BCRP and BBVA Research

Figure 3.15
GDP, expenditure (contribution to growth)

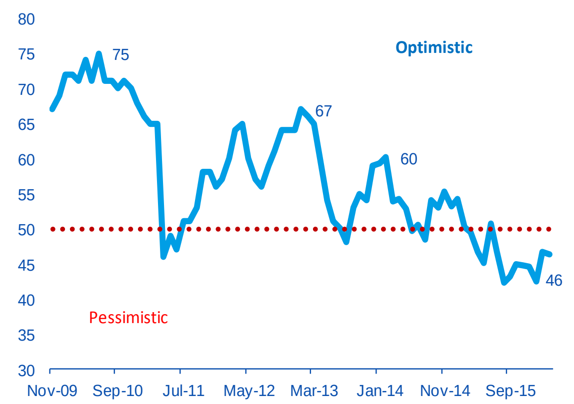


Source: BCRP and BBVA Research

Gross fixed investment, which contracted in the past two years due to the weakness of both the public and private sector components, will do so again in 2016, albeit to a very limited extent. Domestically, public and private investment will perform very differently. Public expenditure will grow by between 6% and 7%. It will be driven by higher infrastructure spending, especially the higher expenditure for Line 2 of the Lima Metro, and recovery in investment made by regional governments, a trend which began to be evident in early 2016 following several months of highly constrained spending (their authorities, which had been changed in early 2015, needed some time to organise the administration of investment expenditure).

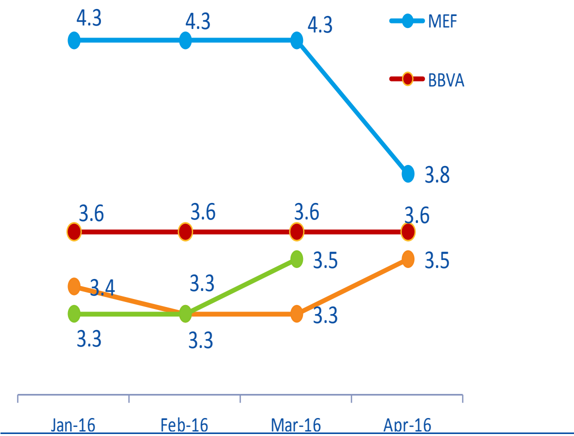
Private investment, on the other hand, will contract by over 2%, thus remaining in negative territory for the third successive year, although, according to our estimates, this will be the first time it will do so in the projection horizon. There are two positive developments: higher infrastructure construction, and the improvement in business confidence from the second quarter. On the one hand, 2016 will bring greater private sector investment in infrastructure. The largest-scale projects, with increased expenditure, compared to last year, will be the Mantaro-Marcona-Socabaya-Montalvo electrical transmission line and Line 2 of the Lima Metro. On the other hand, business confidence will tend to brighten following years in which the trend reflected lack-lustre activity, the natural uncertainty produced by the elections, the risk of an *El Niño* phenomenon that until recently was expected to be unusually intense (and which would therefore have important impacts on the economy), 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 see Figure 3.16). Growth figures have recently improved, causing positive surprises for market consensus. This will tend to boost business confidence. An increase in business outlook regarding growth in GDP in 2016 can already be observed (see Figure 3.17). The lower financial tensions worldwide, observed in the recovery in commodity prices and in the local currency appreciation, the election result (which so far has been positively received), and the easing off of the *El Niño* phenomenon also enhance business confidence. Against this backdrop, there will be greater support for private investment in machinery and goods, while staff recruitment will be bolstered.

Figure 3.16
Business confidence
(in points)



Source: BCRP and BBVA Research

Figure 3.17
Estimates for GDP growth for 2016
(chge. % YoY)

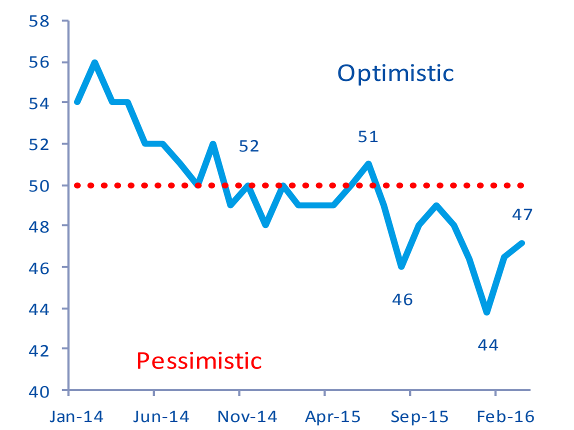


Source: MEF, Latin Focus, BCRP and BBVA Research

On the negative side for private investment, 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 companies will be higher than those of last year, reflecting the central bank's monetary adjustment, and lastly mining investment will continue to contract (est. fall of US$2.1 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).

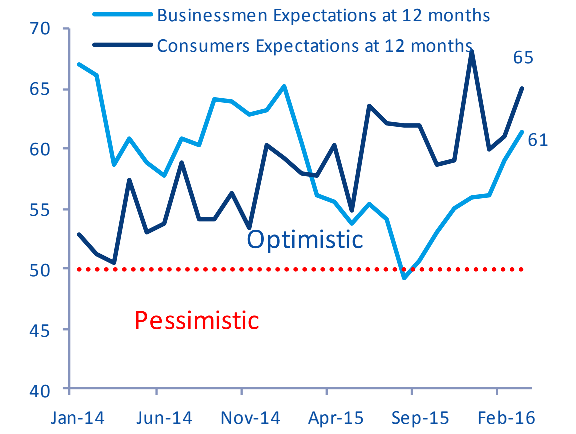
Lastly, total payroll will continue to be weak, at least in the first half of the year. The outlook for new hires in the next three months is still not good (see Figure 3.18), so job creation will be limited in the short term. Nonetheless, looking further down the line both new business and consumer expectations are more positive (see Figure 3.19). As inflation continues to ease off (see section 5), local noise dies down (fading away of El Niño, end of the elections and the measures of the elected candidate are defined), there are no major shocks on the international panorama (which has an impact, for example, on commodity prices and exchange rates, which for some households are yardstick for the country's performance; see section 4) and economic growth figures consolidate around 3.5% (closer to potential growth), these expectations will grow firmer still. In this setting, staff recruitment will tend to gradually increase. Meanwhile, households are likely to want to maintain the trend of improvement in their consumer patterns through bank lending. Our balance between what is still a weak labour market in the short term, on the one hand, and confidence that the situation will improve, lower inflation and access to lending, on the other, is that private consumption will grow by less this year than in 2015, but not much less, by just over 3%.

Figure 3.18
3-month recruitment outlook (in points)



Source: BCRP and BBVA Research

Figure 3.19
Business and consumer outlook for twelve months (in points)



Source: BCRP, Apoyo Consultoría and BBVA Research

The boost from mining and infrastructure will continue into next year, and to these will be added other factors, so growth for 2017 will amount to between 4.0% and 4.5%

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* has had in 2016, and the climate 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 around two and a half percentage points to GDP growth, will lead to growth accelerating temporarily to around 4.5%.

From the sector point of view, the agricultural and fisheries sectors, and with them primary industry, stand to benefit from the fading away of the effects of *El Niño*. Construction will accelerate thanks to increased spending on infrastructure (and because the contraction in mining investment will not be so significant, and, will on the other hand, tend to stabilise), and non-primary Manufacturing will again grow, for example due to improved demand from the construction sector and from non-traditional exports (Latin America). Lastly, Trade & Services 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. Lastly, the public sector will increase its spending, for example, ramping up works to modernise the Talara refinery and the construction of Line 2 of the Lima Metro, but, as we are assuming in our baseline scenario, it will maintain consistency with a structural budget deficit at sustainable levels (2% of potential GP).

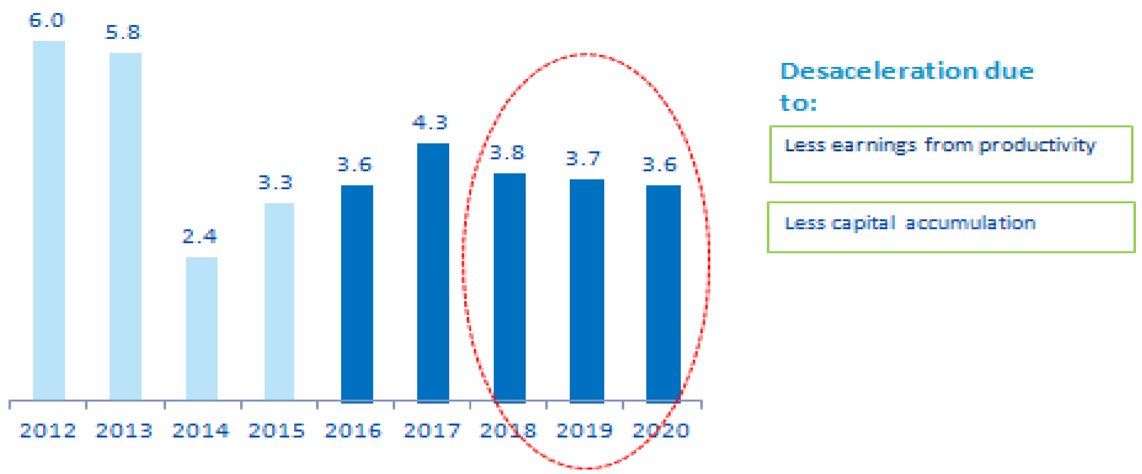
...without reforms, growth will amount to approx. 3.5% in the mid term

Our mid-term growth forecasts paint a picture which is based around two key factors (2018-2020). First, the mining driver running out of steam due to the higher copper production: Las Bambas and Cerro Verde will have reached their peak operational levels by the end of next year, and no projects are under way to replace them. Between 2014 and 2017, copper production will have increased almost twofold, going from 1.3 metric tonnes to 2.5 million metric tonnes. From 2018, however, judging by the available data, there are not expected to be important variations in copper extraction.

The second key factor is the downward revision of our growth forecasts for China in the mid-term, from an average of 6.0% estimates three months ago for the 2018-2020 period down to 5.0%. As we stated in our section 2, in which we analysed global growth, monetary, fiscal and credit stimuli measures appear to have successfully held off the prospect of a “hard landing” in the short term. However, these expansionary measures will have to be gradually withdrawn to prevent aggravating fragile financial issues, and they also imply postponing the task of correcting imbalances and implementing reforms, jeopardising China’s mid-term growth outlook. Slower growth in China will have a negative impact on metal prices, which does not help Peru's growth prospects for the 2018-2020 period.

Taking into account the two above factors, and assuming a scenario without important economic reforms, our forecast would be for growth in the Peruvian economy to slow towards levels of 3.5% to 4.0% (see Chart 3.20).

Figure 3.20
GDP (chge. % YoY)



Source: BCRP and BBVA Research

This projection consists of analysing the growth in potential Peruvian GDP estimated for future years, which is consistent with our investment and job creation estimates (see Box 1). Specifically, the analysis points to a number of structural factors behind this trend of slowdown in the Peruvian economy. Under a passive scenario, assuming that substantial economic reforms are not implemented, the contribution made by output to growth in potential GDP will stagnate at the current low levels, while the capital contribution will decline.

It is important for Peru to get back on track and report higher growth rates. According to our estimates concerning the degree of elasticity between growth in GDP and growth in employment, the Peruvian economy needs to grow at a rate of between 4.0% and 4.5% to be able to absorb the newcomers on the job market arriving every year (approx. 250,000 new workers). At lower rates, job creation will not suffice, prompting an increase in the structural unemployment rate or an increase in the level of informal employment or “sub-employment”. Although considerable headway has been made in reducing poverty (the poverty rate is currently estimated to be 22%), further down the line this will be more difficult with lower growth bearing in mind that it is now that the strongest pocket of poverty has to be tackled.

As the international background will no longer be a driver in future years, the incoming government (in late July 2016) will face a more challenging environment to seek higher growth. However, beyond seeking a cyclical recovery in the economy, which is necessarily temporary, the structural measures or reforms which are eventually adopted will have to be focused on areas which reinforce sustainable mid-term growth. We can get a good idea by analysing potential growth. If the slowdown in the Peruvian economy is due to declines in the contributions made by capital and output to growth, then reforms must be designed to reverse these trends.

As far as capital accumulation is concerned, the reforms would have to include:

- Ramping up infrastructure development.
- Driving the execution capacity of public sector capital spending.
- Improving the business climate. This would have to include unblocking bureaucratic processes which have hampered investment decisions in recent years (getting rid of “red tape”)
- Stronger development of the capitals market and financial intermediation so as to channel resources efficiently towards capital accumulation.
- Greater competition in the commodities and goods markets (make them work better and more efficiently).

These would be some of the measures to be considered in terms of output:

- A more flexible job market, which will help to bring down what remain high levels of informal unemployment, where a huge collective engages in low-productivity tasks. The idea is to shift workers towards formal employment, where they can enjoy more adequate working conditions with better equipment; this should raise the average productivity of the Peruvian economy and bring other associated benefits such as a broader tax base.
- Raise the quality of the service offered by the public administration.
- Provide higher quality education.
- Incentives to promote research and innovation
- Greater institutional development, in order to ensure that the legal framework which sustains the economy supports private initiatives (reinforcing the legal system to assure compliance of contracts, effectively fighting corruption, limits to bureaucracy, ensuring transparency of information, etc.).

Fortunately, some of these suggestions have already been brought to the table and others are being discussed at present. Needless to say, it is important to bear in mind that implementing these measures will require a lot of fine detail at micro level and broad political support, and also that it will take some time for them to have an impact on the economy. The next administration will have to continue with these measures, improve them, adjust them and consider them in more depth, if necessary, as well as proposing other measures.

Box 1. Change in potential growth in the Peruvian economy

Potential GDP is defined as the level of production which an economy is able to create when it is using its resources at full capacity and without creating macroeconomic imbalances.

A characteristic of this variable is that it cannot be directly observed. In order to estimate potential GDP, in fact, we need to apply a number of different methods, which can generally be divided into statistical and economic methods.

Statistical methods mainly use filters to isolate the trend or long-term component (Hodrick and Prescott[2], Baxter and King[3], inter alia). Methods based on economic models adopt a more intuitive approach by using an analytical framework in which potential GDP is an endogenous variable which is related to other variables. The "production function "is one of the methods used in this latter category. This method estimates potential GDP based on its determining factors (in essence, output, employment and capital).

Production function

In this case, a Cobb-Douglas production function is used with constant returns to scale and adjusted by human capital (García-Fuentes and Lynn, 2009[4], and Hofman and Tapia, 2003[5]):

$$Y_t = A_t K_t^{\alpha} \, (h_t L_t)^{1-\alpha}$$

where, Y_t is gross domestic product, A_t is output, K_t is physical capital stock, h_t is the factor of human capital and L_t is the number of workers. All the variables have an annual frequency. Also, α is the participation of physical capital in GDP, while $1-\alpha$ represents the participation of employment and human capital.

The relevant variables used in the estimate are calculated as follows:

a. Capital stock: As there is no direct measurement of physical capital stock (K_t), it was decided to generate a historical series since 1950, using the perpetual inventory method:

- Conventional capital accumulation: $K_{t+1} = (1-\delta)K_t + I_t$; where I_t is the level of investment and δ is the depreciation rate. A straight-line depreciation function, with a 30-year useful life span for the capital, is assumed.
- In order to define the initial capital stock (K_0) a steady state scenario is assumed in 1950: $K_0 = \frac{I^*}{g+d}$
  - where, I^* is the average of the Investment/GDP ratio between 1950-1980 and GDP for 1950.
  - On the other hand, g is the average of the rate of growth in GDP between 1950-1980.

b. Capital-GDP elasticity: A value of $\alpha = 0{,}50$ is taken, in concordance with the average determined in various estimates for Peru (for example, Vega-Centeno (1989)[6], Seminario and Beltrán (1998)[7], Carranza, Fernandez-Baca and Morón (2002)[8] and the Instituto Peruano de Economía (2003)[9]).

Human capital: As with capital stock, there is no direct measurement of

a. human capital (h_t). The following equation is used to generate this variable:

$$h_t = exp\left[\left(\frac{\theta}{1-\psi}\right) s_t^{1-\psi}\right]$$

where s_t represents the average years of schooling of the population aged over 15, while θ and ψ are sensitivity and curve parameters of the function which adopt values of 0.32 and 0.58, respectively in accordance with the proposals of Bils and Klenow (2000)[10].

2 Hodrick, R. and Prescott, E. (1997), "Postwar U. S. Business Cycles: An Empirical Investigation", Journal of Money, Credit And Banking, Vol. 29, No. 1.
3 Baxter, M. and King, R. (1995), "Measuring Business Cycles Approximate Band-Pass Filters For The Economic Time Series", National Bureau Of Economic Research, Working Paper No. 5022.
4 Garcia-Fuentes, P. and Lynn, P. (2009), "Remittances and Economic Growth in Latin America and the Caribbean: The Impact of Human Capital Development".
5 Hofman, A. and Tapia, H (2003) "Potential output in Latin America: a standard approach for the 1950-2002 period", Serie Estudios estadísticos y prospectivos No25, CEPAL.

6 Vega-Centeno, M. (1989), "Inversiones y cambio técnico en el crecimiento de la economía peruana".
7 Seminario, B. and Beltrán, A. (1998), "Crecimiento económico en el Perú 1896-1995: Nuevas evidencias estadísticas".
8 Carranza, E., Fernández-Baca, J. and Morón, E. (2003), "Peru: markets, governments and the sources of growth".
9 Instituto Peruano de Economía (2003), "La Brecha en Infraestructura, Servicios Públicos, Productividad y Crecimiento en Perú".
10 Bils, M. and Klenow, P. (2000), "Does Schooling Cause Growth? ".

b. **Work force**: Work force is considered to be (L_t) the Occupied Economically Active Population.

c. **Total Productivity of Factors (PTF)**: The PTF is obtained as the result of the following:

$$A_t = exp[logY_t - \alpha logK_t - (1-\alpha)logh_t - (1-\alpha)logL_t]$$

Lastly, to construct the series of potential GDP Y_t^* the procedure is as follows, as shown by Sosa et al. (2013):

$$Y_t^* = A_t^* K_t^{*\alpha}(h_t^* L_t^*)^{1-\alpha}$$

A_t^*, A_t^*, h_t^*, A_t^*, h_t^*, k_t^* and A_t^*, h_t^*, k_t^* y L_t^* are the trends of output, human capital and employment obtained using the Hodrick-Prescott filter.

Main results

If we analyse potential GDP, it is apparent that the growth in the economy during the boom phase was not a temporary or cyclical phenomenon. Table 1, which contains the breakdown of growth in potential GDP between production and output factors, shows the role played by the latter variable (controlling by human capital) and capital accumulation within the process of rapid growth in the Peruvian economy between 2002 and 2013. In fact, these two variables accounted for 43% and 42% of average annual growth in the period, respectively.

This same approach also shows it is not only short-term factors which are behind the slowdown observed in recent years. For example, a significant decline in the contribution made by output is apparent, which suggests that there are structural factors behind this growth trend which are shifting the economy towards permanently slower growth rates (see Table R.1.1).

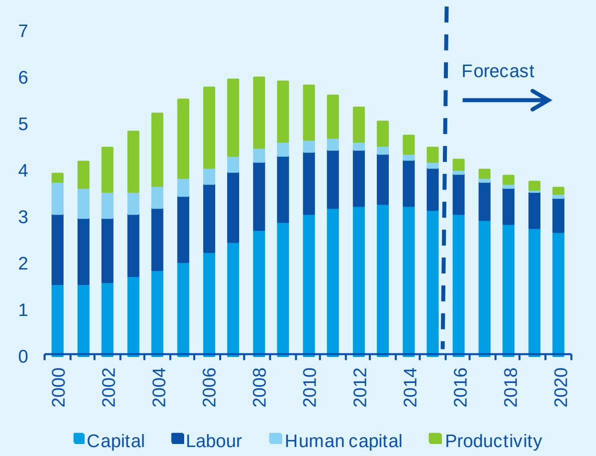
Table R.1.1
Potential GDP (chge. % YoY, percentage points)

	Potential growth	Contribution to growth			
		A	K	h	L
1980-1990	0.5	-3.7	1.6	0.7	1.9
1991-2001	2.9	-1.1	1.4	0.7	1.9
2002-2013	5.5	1.2	2.5	0.3	1.3
2014-2015	4.6	0.3	3.2	0.1	1.0
2016-2020	3.9	0.2	2.8	0.1	0.8

Where, A: Output, K: Physical capital, h: Human capital, L: Employment.
Source: BCRP, World Bank and BBVA Research

In future years, consistent with our macroeconomic projections, output's contribution to growth in potential GDP is estimated to stagnate at the current low levels, while the contributions of capital (tied to investment) and employment (due to restrictions imposed by a rigid labour market, and possibly, by population trends) would begin to decline. As a result of these projected trends, sustainable growth in the Peruvian economy is expected to decline in future years and to amount to less than 4.0% (see Figure R.1.1).

Figure R.1.1
Potential GDP: contribution to growth (percentage points)

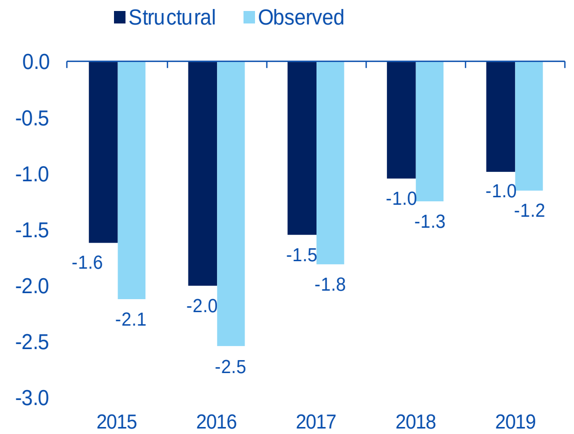


Source: BCRP, World Bank and BBVA Research

Fiscal policy: The objectives of further improvement in the credit rating and implementing reforms suggest that there is limited margin for greater flexibility in the fiscal position

The Multi-annual Macroeconomic Framework ("Marco Macroeconómico Multianual", MMM) released by the government in late April considers a fiscal consolidation process for the next three years[11]. According to this document, the structural deficit in the non-financial public sector will show a downturn, going from 2.0% of potential GDP in 2016 to 1.0% in 2018 (see Figure 3.2.1). In line with this consolidation scenario, the government has projected a sharp downturn, in real terms (inflation-adjusted-), in public spending over the 2017-2019 period (see Table 3.4). Official forecasts are for public consumption to contract next year and of zero growth for 2018. As a result of this trend, the public spending to GDP ratio will decline in coming years. However, despite these consolidation efforts, the authorities expect public debt to increase by 2.1 percentage points between 2015 and 2019.

Figure 3.21
Tax Revenue of MMM [1/ 2/]
(% of GDP)



*Ratio of structural result over potential GDP.
1/ NFPS: Non-Finance Public Sector.
2/ Macroeconomic Framework Projections (April 2016).
Source: MEF

Table 3.4
Government spending and public debt of MMM [1/]
(chge.% real and % of GDP)

	Avg. 2012-2015	2016	2017	2018	2019	Avg. 2017-2019
Var.% real						
Total Expenditure	**7.5**	**5.2**	**1.0**	**1.4**	**3.3**	**1.9**
Consumption	8.6	4.3	-1.2	0.0	3.0	0.6
Investment	5.3	7.4	6.7	4.6	4.1	5.1
% of GDP						
Total Expenditure	**17.1**	**18.4**	**17.9**	**17.5**	**17.4**	**17.6**
Consumption	11.7	13.1	12.5	12.1	11.9	12.2
Investment	5.3	5.2	5.4	5.4	5.4	5.4
Public Debt	20.8	25.2	25.9	25.9	25.4	25.7

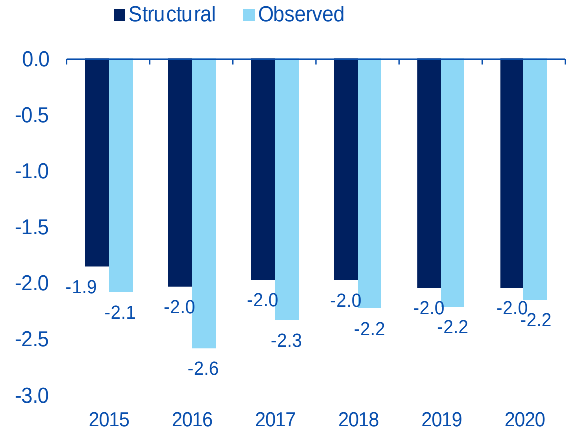
1/ MMM: Multi-annual Macroeconomic Framework April 2016.
Source: BCRP and MEF.

The fiscal scenario set out in the MMM, which is perceived as restrictive, should only be considered as a reference, given that the next government, which will take over in late July, may define a sequence for a different structural deficit. In fact, according to statements made by the representatives of the two parties who will define the presidency of the republic in the second round of voting, on 5 June, it seems likely that an expansionary fiscal policy will be applied through higher spending and/or tax cuts, possibly over the next three years. Under such a scenario, it is our understanding that fiscal consolidation is unlikely.

Hence, until the new administration provides a clear picture of the fiscal policy to be followed in coming years, as a working hypothesis to prepare our estimates on the baseline scenario, we have assumed that the structural deficit will remain at 2% of GDP throughout the 2017-2020 forecast horizon. Under this scenario, we estimate that the observed deficits will be, on average, 2.2% of GDP per year, with 3.7% average annual growth in public spending (see Figure 3.22 and Table 3.5).

11: Pursuant to the Fiscal Responsibility and Transparency Act, every year it is mandatory to prepare a Multi-annual Macroeconomic Framework ("Marco Macroeconómico Multianual", MMM), which will include the macroeconomic projections for the year which is being budgeted and the two following years. The MMM also sets out the ceiling for non-financial spending, considering ex ante guidance of the structural economic revenue of 1% of potential GDP.

Figure 3.22
Tax Revenue BBVA Research* (% of GDP)



*Ratio of structural result over potential GDP.
Source: BBVA Research

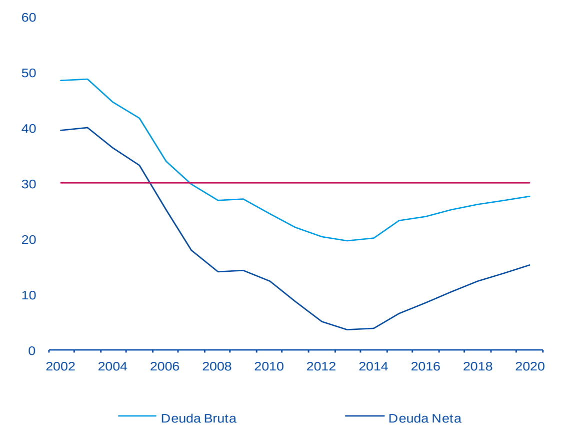
Table 3.5
Government spending and public debt BBVA Research (chge.% real and % of GDP)

	Avg. 2012-2015	2016	2017	2018	2019	2020	Avg. 2017-2019
Var.% real							
Total Expenditure	**7.5**	**3.6**	**4.4**	**3.2**	**3.5**	**3.8**	**3.7**
Consumption	8.6	2.4	3.0	2.5	2.9	3.3	2.9
Investment	5.3	6.5	7.7	5.0	5.0	5.0	5.7
% of GDP							
Total Expenditure	**17.1**	**18.1**	**18.3**	**18.3**	**18.3**	**18.3**	**18.3**
Consumption	11.7	12.9	12.9	12.8	12.7	12.6	12.8
Investment	5.3	5.2	5.4	5.5	5.6	5.6	5.5
Public Debt	20.8	24.1	25.2	26.2	26.9	27.5	26.4

Source: BCRP and BBVA Research

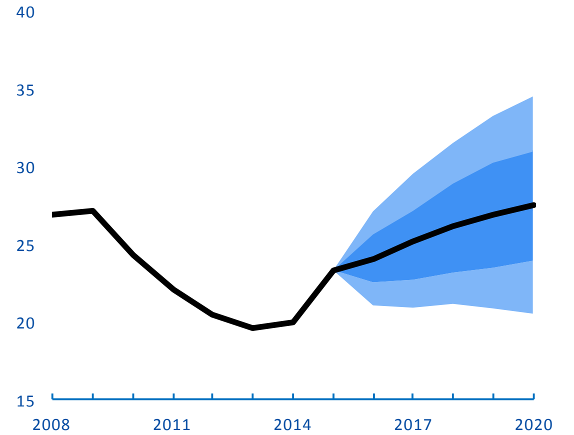
According to our estimates, the public debt/GDP ratio will trend upwards and will amount to 27.5% of GDP towards the end of 2020 (see Chart 3.23). The sensitivity analysis that we have performed for this variable assigns a probability of 26% that it will surpass the level of 30% of GDP towards 2020[12] (see Figure 3.24). We also estimate that net debt (the government's liabilities less its assets) will trend upwards and will stand at 15% of GDP towards the end of 2020.

Figure 3.23
Gross and Net Public Debt (% of GDP)



Source: BCRP and BBVA Research

Figure 3.24
Public Debt: sensitivity analysis (% of GDP)



Source: BCRP and BBVA Research

Although our estimates show that the public debt/GDP ratio will keep at relatively low levels over the next few years, there are certain aspects which should be noted. First, the public debt has been analysed not taking into account the government's explicit contingent liabilities, which amount to 8.2% of GDP, according to MMM[13]. If part of these contingent liabilities were to materialise over the next few years, then the public debt scenario would naturally become more complicated. A second factor to be taken into account is the uptick we expect to observe in public debt during the projection horizon. This suggests that in order to

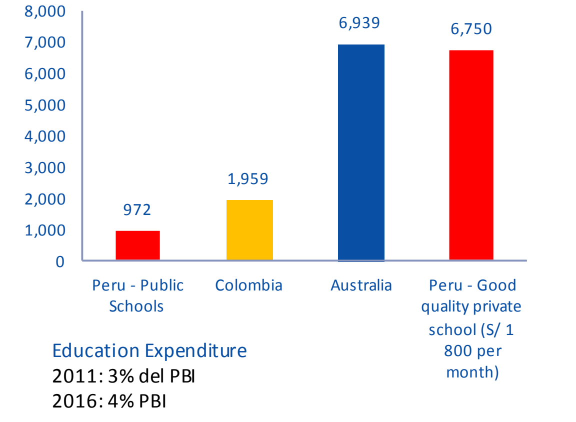
12: Pursuant to the Fiscal Responsibility and Transparency Act (LRTF), if, according to the government's estimates, there is a possibility of debt surpassing 30% of GDP, then it will have to take pre-emptive measures to avoid that level being breached. Alternatively, the government might amend the LRTF, but this might have a negative impact in terms of its credibility vis-à-vis the fiscal rule.
13: According to Multi-annual Macroeconomic Framework estimates, contingent liabilities consist of legal claims (4.2% of GDP), international conflicts about investment (0.8%), collateral put forward in PA contracts (2.7%), and other guarantees, deposits and similar sureties granted to public sector entities (0.5%).

stabilise this variable some kind of adjustment will have to be made, which will be more intense if the government applies a more flexible fiscal policy than that considered in our baseline scenario[14].
Another question to be taken into account is that a persistent trend, over a number of years, of rising public debt to GDP would weaken one of Peru's macroeconomic strengths. In fact, within the investment grade group of countries, the Peruvian government's credit rating has been bolstered by macroeconomic and public finance variables (given that its performance is relatively unremarkable within the group of variables which concern external finances, and, in particular, structural characteristics). Against a scenario of relative deterioration in the fiscal accounts, which has hitherto been one of Peru's strengths, further improvement in the Peruvian government's credit rating will be a challenge.

Lastly, as we have said, Peru needs to implement structural reforms to be able to drive productivity and sustained growth. In certain cases, however, the government will need to make greater efforts in these reforms. For example, the reform of the public administration, which includes salary increases based on performance and skills, will necessitate a rise in government employees. Public spending will also have to be increased to further push forward with the progress made in public education (Peru is still ranked low in terms of spending per student; see Figure 3.25) and in narrowing the infrastructure gap.

In short, taking into account the targets of continuing to improve the government's credit rating and implementing structural reforms, there is, according to our estimates, not much margin for greater fiscal flexibility. The government does indeed have a high level of saving (see Table 3.6), but, importantly, not all these resources are freely available, and perhaps substantial changes to the legal framework in force might have to be made for the government to be able to avail itself of them. Hence, under this scenario, the next government will have to prioritise the use of resources, improve its spending capacity, and ensure that the level of tax revenue is sufficient to fund additional expenses associated with reforms.

Figure 3.25
Annual spending per pupil (% of GDP)



Source: MINEDU

Table 3.6
Public sector assets (% of GDP)

Fiscal Stabilization Fund (FSF)	4.4
Budget Expenditures 1/	4.0
Others 2/	2.5
Consolidated Pension Reserve Fund 3/	2.3
Determined Resources 4/	1.4
Revenues collected directly	1.2
FONAFE	0.7
ESSALUD	0.6
Grants and Transfers	0.5
ONP	0.2
Total	**17.8**

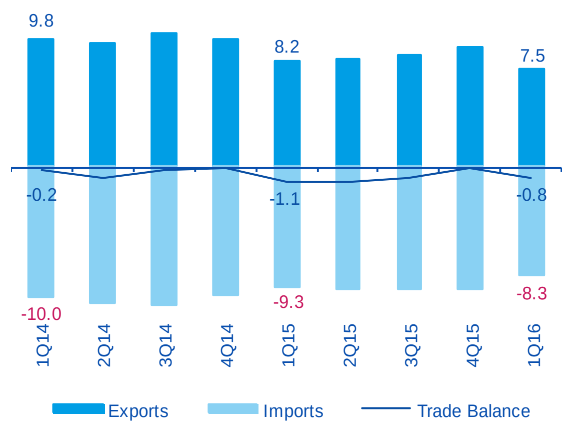
1/ Earmarked for budget expenses, resources stem largely from tax receipts. 2/ Earmarked for public investment funds, contingents, and other specific purposes. 3/Used to back pension obligations of the National Pension System (ONP). 4/ Derive from the fee, royalties used to fund investment expenses in regional governments. 5/ Derive from revenue of public entities and entities managed directly by the former.
Source: MEF.

14: As stated above, the Multi-annual Macroeconomic Framework considers a sharp slowdown in public spending, which would ultimately allow the public debt ratio to be stabilised in the projections presented by the government.

The current account deficit of the balance of payments will begin to close

During the first quarter, the trade deficit amounted to approx. USD 780 million (-1.8% of GDP see Figure 3.26). This result is due to the reduction in exported value (-8%), which was offset by the fall in imports (-10%). The fall in total exports was mainly due to prices which remained in negative territory (see Table 3.7), particularly in traditional products such as metals (copper, zinc, etc.). This was partly offset by the rise in export volume against a background of higher shipments of traditional goods (such as copper and fishmeal), despite the lower shipments of non-traditional goods due to slacker demand from countries in the region. The slump in total imports, on the other hand, reflected the drop in both import prices and volumes. In terms of product groups, there were fewer purchase of commodities and capital goods, evincing the weakness in domestic demand, particularly in investment. There was a slight drop in purchases of consumer goods (see Table 3.7).

Figure 3.26
Trade Balance
(US$ billions)



Source: BCRP and BBVA Research

Table 3.7
Trade balance
(US$ million)

	Part. % 2015	1st Quarter 2015	1st Quarter 2016	Var. %
Exports (X)	**100**	**8,164**	**7,544**	**-7.6**
Traditionals	68	5,392	5,096	-5.5
Non Traditionals	32	2,752	2,428	-11.8
Imports (M)	**100**	**9,256**	**8,325**	**-10.1**
Consumption Goods	24	2,119	2,044	-3.5
Raw Materials	43	4,001	3,446	-13.9
Capital Goods	32	2,945	2,745	-6.8
Trade Balance	**-**	**-1,093**	**-781**	**-**
Note				
X prices		-13.4	-12.6	
X volumes		-3.6	5.7	
M prices		-8.5	-6.8	
M volumes		1.5	-3.5	

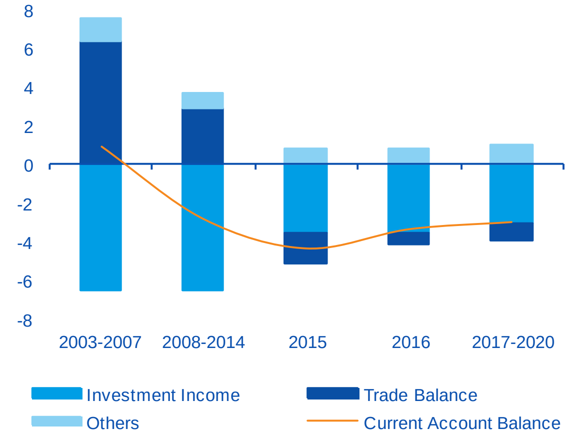
Source: BCRP and BBVA Research

Over the next few quarters, we anticipate a more limited trade deficit and external (current account) deficit, and at the end of this year, around -0.6% and -3.4% of GDP, respectively (see Figure 3.27). This is mainly due to the increase in volumes exported, underpinned by expected higher mining production; while low oil prices this year will also help in this regard (Peru is a net importer). However, the international backdrop of persistent low commodity prices will further impact the performance of exports. Non-traditional and services exports are expected to remain feeble due to lower sales to the region, which is currently undergoing a cyclical downturn.

For the period 2017-2020 we are projecting a decrease in the current account deficit to levels of around 2.7% of GDP, mainly reflecting increased tradable primary production (largely mining) and higher growth in our trading partners, mainly Latam.

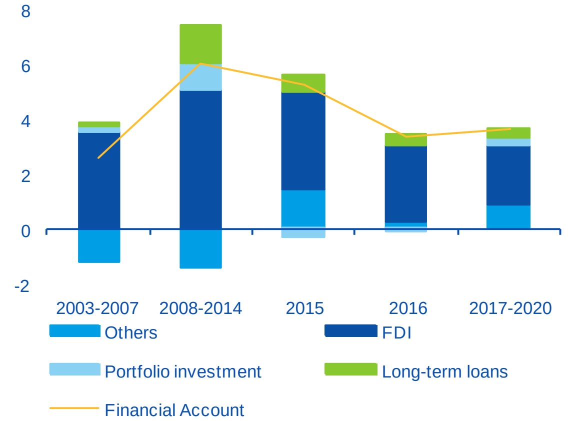
Lastly, on the projected horizon we see sources of financing, private and public, being in line with or exceeding - in certain years - the currency requirements of the current account. Thus, long-term private capital flows (FDI and long-term loans) would cover on average ninety per cent of the decreasing external deficit in the 2016-2020 period. FDI flows would amount to around 2.8% of GDP this year, less than in 2015 (3.6%); and in coming years, in a setting of low international prices (which affect reinvestment of profits, mainly in mining companies) and slow recovery of domestic demand, we expect lower FDI flows. Thus, 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 (see Figure 3.28).

Figure 3.27
Current account balance (% of GDP)



Source: BCRP and BBVA Research

Figure 3.28
Financial account (% of GDP)



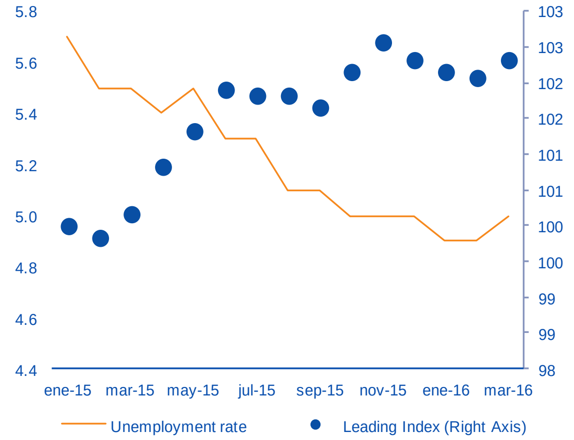
Source: BCRP and BBVA Research

4 Local financial markets: only temporary rise in value of assets and currency

Following an early 2016 with strong downward pressures on financial markets, currencies and generally on assets of emerging markets, the trend since February has definitely been of revaluation. In Peru's case, it has experienced global trends common to a set of emerging countries and others which are more idiosyncratic.

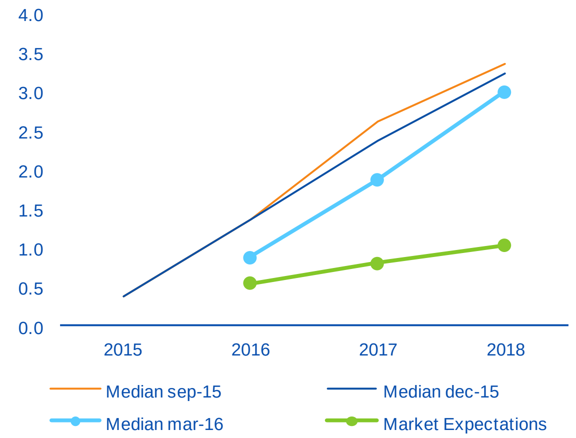
One of the common global trends which drives asset revaluation is firstly confirmation of the fact that some of the world's most important economic areas face challenges in achieving recovery (the US), or in maintaining a buoyant tone (China), but this does not mean that they are going to fall behind. In the US's case, labour market and household spending indicators remain upbeat, and even include some positive surprises (see Figure 4.1). In China, the slowdown is smooth and authorities have shown their willingness to apply measures to ensure that this will continue to be the case, even if this comes at the cost of less growth in the mid term.

Figure 4.1
US: Unemployment rate and future outlook



Source: Bloomberg and BBVA Research

Figure 4.2
FED interest rate*



*Medians are calculated using individual estimates of members taking part in the FED meeting. Market consensus is as of 2 May 2016.
Source: Bloomberg and BBVA Research

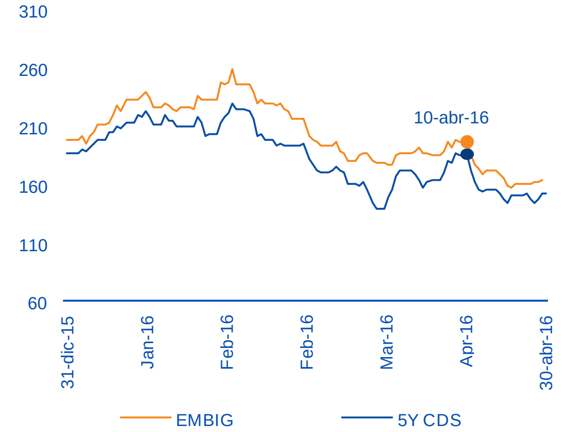
Second, despite the little apparent leeway available, central banks in developed economies further stepped up quantitative easing, taking key interest rates into negative territory (for the first time) or expanding their balances sheets further still; the FED became even more dovish after it began its cycle to adjust its policy rate in December 2015 (see Figure 4.2). In other words, the central banks of developed economies showed that they still had the means of supporting economic activity. Against this background, markets have realised that monetary conditions will be more loose for a longer period of time.

These two factors, in conjunction with the greater support from the oil price (due to a possible agreement between major producers to halt production and the closure of oil platforms in the US), helped stoke the global demand for assets perceived to be higher risk but with higher return, including commodities and emerging markets. In Peru's case, on top of the common global trends there was also the result of the first electoral round on 10 April, which provided additional support to Peruvian financial markets. This result provided continuity for the main lines of the economic policies which have given the Peruvian economy significant and sustained growth over the last twenty-five years (the likelihood of this scenario had grown slimmer in the weeks preceding the first electoral round).

Against this background, the perception of the country's risk (EMBI and CDS), the returns on sovereign bonds and stock market indices, all improved. The fall in the EMBI was heavier than that observed in Latin America: 19% vs. 10% over the year so far. External factors remained similar at the start of the year, while idiosyncratic domestic factors allowed it to set itself apart. Furthermore, the 5-year credit default swaps also showed the same pattern as country risk, with a moderate fall from mid-February and an extraordinary reduction following 10 April (see Figure 4.3).

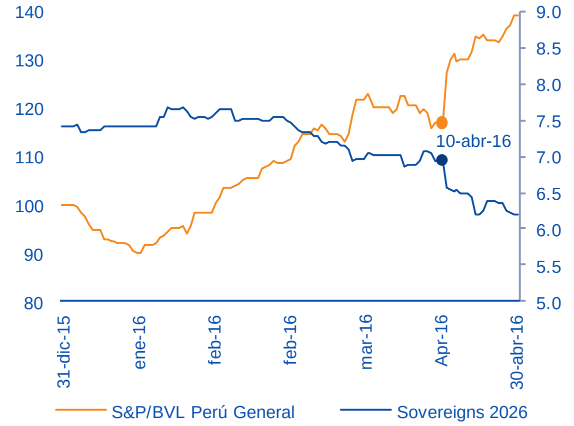
The sovereign bonds yield curve has also fallen in recent months as a result of the lower country risk. In February 2016, after four months, Peru issued a €1.0 billion bond on the European market, maturing in 2030; due to the positive long-term perception of Peru, it was able to achieve a yield of 3.77%. Furthermore, the Lima Stock Exchange Index (S&P/BVL Perú General) rallied by 15% in less than one month (from 10 April to 24 April), a change not observed in other Latam countries (see Figure 4.4). All sectors benefited during the first 4 months of the year, especially the financial, construction and industrial sectors. In June 2016, Morgan Stanley Capital International (MSCI) will evaluate changing Peru's status from emerging country to frontier market, a latent risk which, if it materialised, would see Peru rated as a riskier country and possibly trigger capital outflows.

Figure 4.3
5-year EMBIG and CDS (index 31Dec15=200, and basis points)



Source: Bloomberg and BBVA Research

Figure 4.4
Stock exchange index and Sovereign Bonds yield



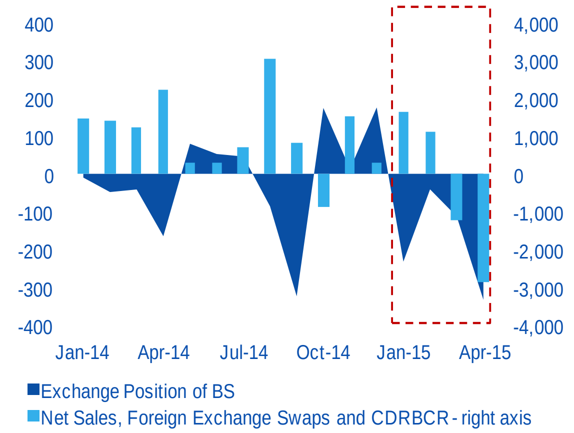
Source: Bloomberg and BBVA Research

The extraordinary improvement in the Peruvian financial market is not sustainable over time as no significant changes have been observed in fundamentals. It can, however, follow a similar pace as that of other countries in the region, which have also improved over the course of the year.
Until mid-February 2016, the Peruvian currency had been gradually devalued mainly due to higher external volatility. However, the USDPEN, like other currencies in the region, has appreciated strongly over the last two months in keeping with the increased value of all emerging market assets. Consequently, the Central Bank of Peru had fewer incentives to reduce liquidity on the market, and private entities had less need to hedge against exchange rate rises. This was shown in higher maturity of exchange swaps and Central Bank certificates of deposit against those issued, prompting a negative flow and lower net sale of USD. The banks' global currency position has been reduced as they have preferred to narrow the gap between assets and liabilities in foreign currency (see Figure 4.5).

The currency is expected to resume its downward course, however. First, because structurally the Peruvian economy needs a higher exchange rate to narrow the current account deficit. Second, we expect to see a short-term overreaction in the global and Peruvian markets prompted by the adjustment which will take place in emerging country asset prices following the FED's key interest rate hike (we are assuming two hikes each of 25bp), considering that market consensus does not consider this as a possibility.

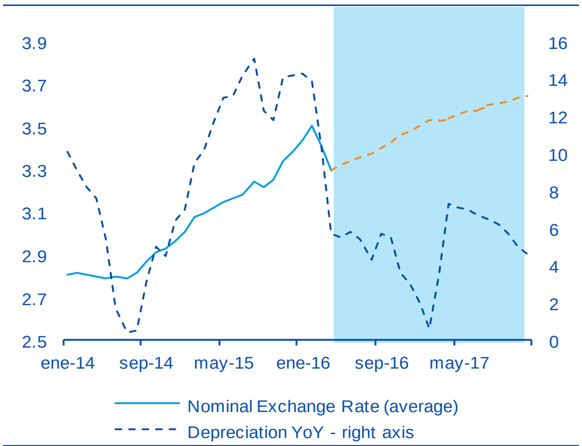
Overall, the structural trend of the PEN will be to depreciate. We put the exchange rate at around S/. 3.45 and S/. 3.50 per USD towards year end and closer to S/. 3.65 per USD at the end of 2017 (see Figure 4.6).

Figure 4.5
Exchange position of Banking System



Source: Bloomberg and BBVA Research

Figure 4.6
Exchange rate
(new soles per dollar)



Source: BCRP and BBVA Research

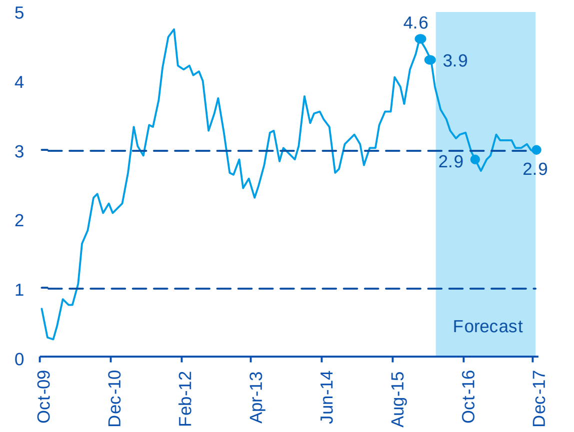
5 Inflation began to ease off and will move within the target range towards the end of the year

In April, inflation stood at 3.9% year-on-year, above the target range (see Figure 5.1). Generally speaking, in recent months the inflationary trend has been tied to higher prices of different Services such as Eating out, Education and Health, which have registered year-on-year increases of over 5% (see Table 5.1). Certain food prices were also affected by unusual weather conditions (the *El Niño* phenomenon), pushing total inflation upward.

However, since early 2016 inflation has followed a downward trend (in January it registered a high of 4.6%). This more positive performance has been driven by lower upward pressures on the exchange rate (lower rate of devaluation), and the fall in domestic vehicle fuel prices (above all, petrol), in keeping with lower international oil prices.

Importantly, inflationary expectations, both short-term and two-yearly, have also begun to ease off (see Figure 5.2). The better performance in inflationary expectations is significant because it shows agents' confidence that the inflation target will be met within the time horizon in which monetary policy has full impact.

Figure 5.1
Inflation (chge. % YoY)



Source: BCRP and BBVA Research

Table 5.1
Inflation (chge. % YoY)

	2009 = 100	Jan-16	Feb-16	Mar-16	Apr-16
Core Inflation	65.2	4.1	4.4	4.2	4.0
Goods	32.9	3.4	3.5	3.4	3.2
Foods and Beverages	11.3	3.2	3.3	3.3	3.3
Textiles and Footware	5.5	2.9	2.6	2.5	2.5
Services	32.2	4.7	5.3	4.9	4.8
Restaurants	11.7	5.6	5.8	5.7	5.6
Education	9.1	5.2	6.5	5.6	5.5
Health	1.1	5.1	5.7	5.5	5.2
Non Core Inflation	34.8	5.6	4.6	4.5	3.8
Food	14.8	7.0	4.9	5.4	4.9
Fuel	2.8	0.5	1.1	-3.2	-3.4
Transportation	8.9	2.2	2.8	2.8	1.8
Utilities	8.4	8.5	7.4	7.4	6.2
Inflation	100.0	4.6	4.5	4.3	3.9

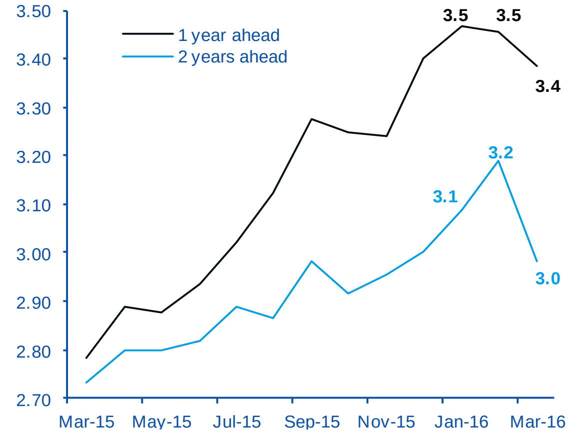
Source: BCRP and BBVA Research

We expect inflation to ease off further in coming months

Further down the line, we expect further slowing of inflation and a figure of around 2.9% at year end, bringing it back within the target range (Central Bank target range: 2%, +/- one percentage point) after 22 months. This forecast reckons on further normalisation in food prices over coming months, and a more restrained pace of currency devaluation. Furthermore, inasmuch as the fall in inflationary expectations is consolidated, inflation may converge more swiftly to the target range.

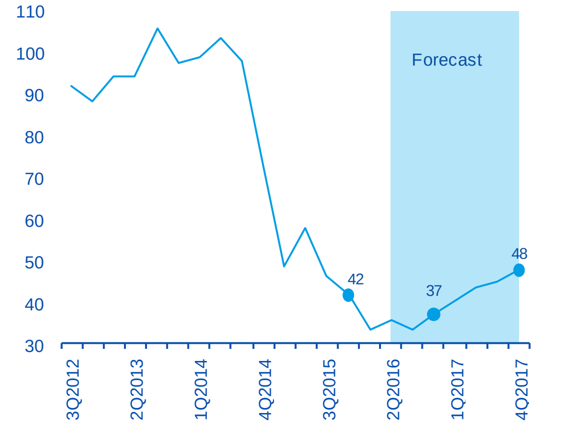
It is important to note that during the rest of the year we expect the oil price to remain relatively stable, and thus this factor should have a moderate effect on inflation. In 2017, we expect the oil price to have recovered by around 30% by year end, having a significant impact on inflation, which will remain close to the upper limit of the target range (see Figure 5.3).

Figure 5.2
Inflationary expectations (%)



1/ Based on Central Bank of Peru expectations data.
Source: BCRP and BBVA Research

Figure 5.3
International oil price (USD/bar)



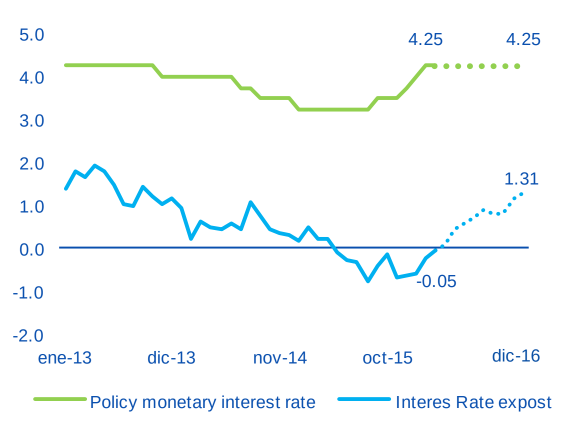
Source: Bloomberg and BBVA Research

6 Monetary policy: we estimate that the Central Bank will not make further adjustments to interest rates during the rest of the year

The prices scenario begins to improve and it seems a better idea not to force this process to happen more quickly

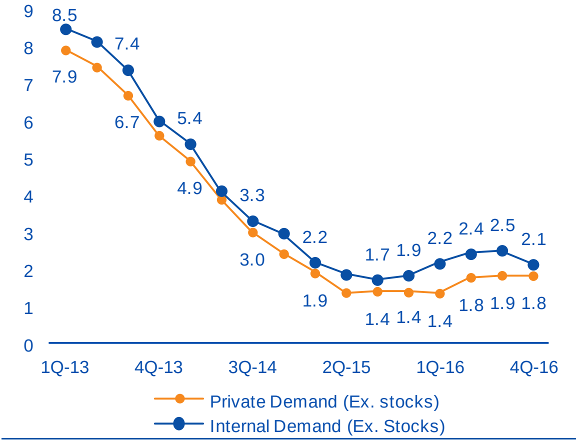
With the respite in inflation in recent months, inflationary expectations have begun to adopt a similar pattern. In this setting, the Central Bank, having increased its key interest rate by 100bp since September, has decided to keep it at 4.25% since February (see Figure 6.1).

Figure 6.1
Benchmark interest rate (%)



Source: BCRP and BBVA Research

Figure 6.2
Private spending and Domestic demand* (accum. 4 quarters, chge. % YoY)



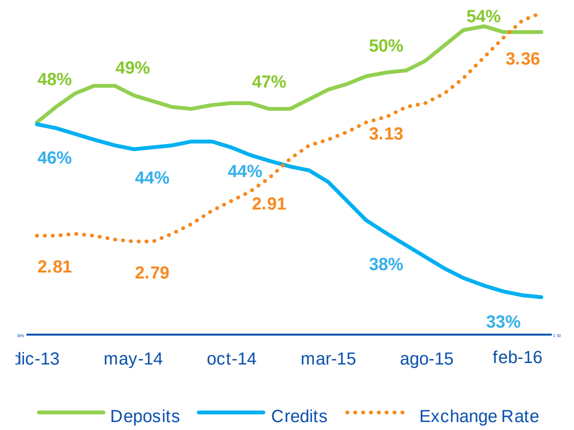
* Do not include inventories. Source: BCRP and BBVA Research

In coming months, we expect the monetary policy rate to be kept at 4.25%. There are few reasons to continue increasing it. On the one hand, there are no demand pressures: private sector spending is weak and over the rest of the year will grow below 2% YoY (see Figure 6.2). On the other, while inflation and its different measurements, such as inflationary expectations, are still some way off the target range and will probably remain so during most of the year, they have actually begun to fall and will continue to do so over the next few months. The negative effects of the *El Niño* phenomenon on food prices will fade while the currency devaluation year-on-year will be more restrained. Consequently, we expect inflation to move within the target range towards the end of the year. The downturn in inflation will probably shift inflationary expectations in the same direction, which would imply that the ex-ante real interest rate, which is a better reflection of investment cost and gains, will increase (even if the nominal benchmark rate does not do so). This will hamper recovery in private spending, which remains feeble. In this setting, it does not seem appropriate to force through an improvement in prices (with additional adjustments in the key interest rate).

Further drop in dollarisation of lending, though greater preference for saving in foreign currency prompts foreign exchange exposures on banks' balance sheets

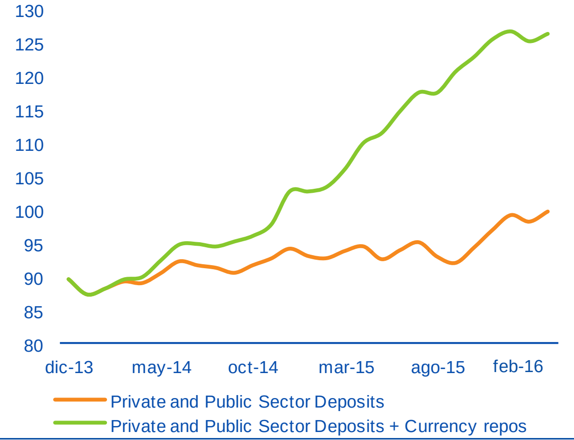
Dollarisation of issues continued to decline in recent months and currently stands below 30% (see Figure 6.3). Both supply and demand factors are behind this pattern. On the supply side are the ceilings which have been established - and which are still applied - by the Central Bank regarding the level of credits in dollars, not including foreign trade and larger loans (USD 10 million or more) or long-term loans. On the supply side, borrowers have preferred to take out loans in local currency against a context in which this currency's depreciation expectations have remained high.

Figure 6.3
Dollarization of issues and deposits (%)



Source: ASBANC, BCRP and BBVA Research

Figure 6.4
Funding sources in soles (S/ billions)



Source: ASBANC, BCRP and BBVA Research

Deposit dollarisation, however, has behaved in quite the opposite way (see Figure 6.3). Expectations of an increase in the exchange rate have outweighed the return on deposits in local currency. Banks have thus captured deposits in dollars because this has been their customers' preference; however, according to regulations, the balance of issues in this same currency cannot be increased, while the public is not interested in asking for loans in dollars, but in soles. This has caused a mismatch, or exposure, in banks. The Central Bank has dealt with this situation by transforming funding in dollars to soles through currency repos (see Figure 6.4). Through repos, the bank receives the deposit in dollars from the public, and after allocating 70% of it to reserves, makes a restricted deposit in the Central Bank; using this deposit as a collateral, the Central bank grants the banks funds in soles which it can subsequently issue on the market. The financial entities bid using an auction mechanism for a term of up to four years. It is important to note that through this instrument, a credit is not leveraged against another credit; rather it is done by the same public funding, but in another currency.

This has led to Peruvian banks increasing their dependence upon the Central Bank to fund growth in issues in soles. However, this dependency may come into conflict with internal limits imposed by some financial entities. As a result, it is increasingly common for there to be campaigns aimed at capturing deposits in soles from the public, offering high returns on this currency. This has put upward pressure on interest rates in soles.

7 Balanced risks on our growth forecasts 2016-2017

Different patterns to those assumed in our baseline scenario for different key variables can cause deviations in our growth estimates. On this occasion, we believe the main downside risks are lower global growth and delays in executing infrastructure works. Meanwhile, a positive confidence shock would give our growth forecast an upward bias.

The main downside risk is lower growth in China

Our baseline scenario assumes that the process of slowing in China's growth towards sustainable levels, and the reshaping of its demand-side growth drivers (less investment and more consumption), will be gradual and orderly. However, if the monetary, fiscal and credit stimuli being applied turn out to be excessive, then financial weaknesses which are apparent in China could be accentuated, and hamper its growth.

Slower growth in China would have a negative impact on the Peruvian economy for the following reasons: (i) it would involve lower prices for the metals that Peru exports, hitting mining companies' earnings and reinvestments as well as tax revenues, (ii) it would increase global risk aversion that would reduce appetite for investing in emerging economies such as that of Peru, (iii) it would lower external demand through China's impact on Peru's other main trading partners.

Delays in infrastructure works would also have a downward impact on our growth forecasts

Already this year, some of the large-scale infrastructure projects already under way have suffered certain delays in execution. In some cases, the delays have caused by the process of obtaining and preparing the land (Line 2 of the Lima Metro), and in others due to hold-ups in funding (Southern Gas Pipeline). In other cases, the works have simply not got off the ground despite more than six months' delay (Chincheros airport). These delays are the reason why we now expect infrastructure works to account for 0.3% less growth in GDP this year than we did in our report three months ago (from a contribution of 1.0% contribution estimated in February to 0.7% now). Another cause of concern is the fact that concessions for certain important projects have not been awarded within with the expected term (e.g. Line 3 of the Lima Metro). Delays in executing infrastructure works will imply lower public and private investment, which if they materialise would put downward pressure on our forecast.

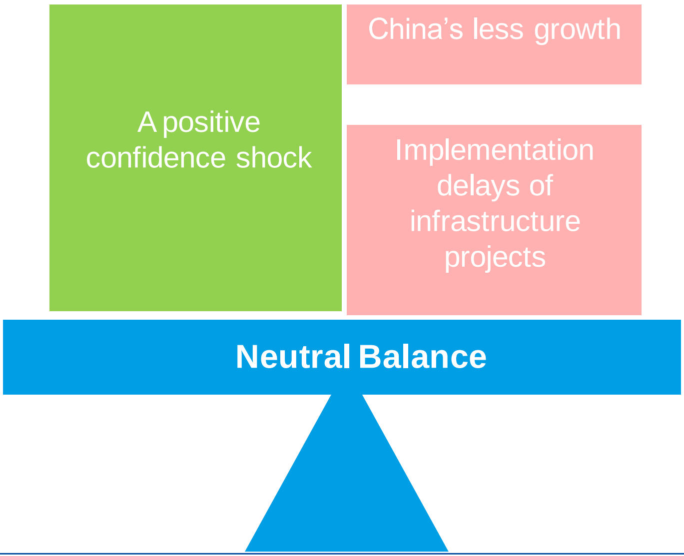
A positive confidence shock introduces an upward bias in our growth in GDP estimates

If the government which enters office in late July manages to create a climate of general agreement and consensus then it might be able to make good use of the political support which a new government often has at its disposal. Under this scenario, if the government announced measures and reforms to encourage growth, which are consistent and well communicated, then it will receive society's backing and create an appropriate setting to enhance household and corporate confidence. In this case, consumption and private sector investment would be expected to be more upbeat, prompting a positive mood in economic activity as a whole.

In short...

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 neutral bias in our growth forecasts for Peru.

Figure 7.1
Balanced risks on our growth forecasts 2016-2017



Source: BBVA Research.

8 Tables

Table 9.1
Macroeconomics forecasts

	2012	2013	2014	2015	2016	2017
GDP (% YoY)	6.0	5.8	2.4	3.3	3.6	4.3
Inflation (% YoY, eop)	2.6	2.9	3.2	4.4	2.9	2.9
Exchange Rate (vs. USD, eop)	2.57	2.79	2.96	3.38	3.49	3.65
Interest Rate (%, eop)	4.25	4.00	3.50	3.75	4.25	4.5
Private Consumption (% YoY)	6.1	5.3	4.1	3.4	3.1	3.4
Government Consumption (% YoY)	8.1	6.7	9.7	7.5	2.4	3.0
Investment (% YoY)	16.3	7.3	-2.1	-4.9	-0.5	4.6
Fiscal Balance (% GDP)	2.3	0.9	-0.3	-2.1	-2.6	-2.3
Current Account (% GDP)	-2.7	-4.2	-4.0	-4.4	-3.4	-3.1

Source: BCRP and BBVA Research Peru

Table 8.2
Macroeconomics forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange Rate (USDCLP, eop)	Interest Rate (%, eop)
Q1 14	5	3.4	2.81	4.00
Q2 14	1.9	3.4	2.8	4.00
Q3 14	1.8	2.7	2.87	3.50
Q4 14	1.2	3.2	2.96	3.50
Q1 15	1.8	3	3.09	3.25
Q2 15	3.1	3.5	3.16	3.25
Q3 15	3.2	3.9	3.22	3.50
Q4 15	4.7	4.4	3.38	3.75
Q1 16	4.1	4.3	3.41	4.25
Q2 16	3.8	3.7	3.35	4.25
Q3 16	3.3	3.4	3.41	4.25
Q4 16	3.3	2.9	3.49	4.25
Q1 17	5.2	3.0	3.53	4.50
Q2 17	4.3	3.0	3.58	4.50
Q3 17	4.0	2.9	3.62	4.50
Q4 17	3.9	2.9	3.65	4.50

Source: BCRP and BBVA Research Peru

DISCLAIMER

This report has been produced by the Peru Unit:

Chief Economist for Peru
Hugo Perea
hperea@bbva.com
+51 1 2112042

Francisco Grippa
fgrippa@bbva.com

Yalina Crispin
Yalina.crispin@bbva.com

Ismael Mendoza
Ismael.mendoza@bbva.com

Vanessa Belapatiño
Vanessa.belapatino@bbva.com

Marlon Broncano
Marlon.broncano@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

US
Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area

Cross-Country Emerging Markets Analysis
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey
Alvaro Ortiz
alvaro.ortiz@bbva.com

LATAM Coordination
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

Financial Systems and Regulation Area
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Global Areas

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Contact details:

BBVA Research
Azul Street, 4
La Vela Building - 4 and 5 floor
28050 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com