BBVA | RESEARCH

Peru Economic Outlook

THIRD QUARTER 2016 | UNIT: PERU

01
We maintain our GDP growth forecasts at 3.6% for 2016 and 4.3% for 2017. The drivers will be mining production and infrastructure

02
The local currency will depreciate over the rest of the year and close 2016 at between 3.40 and 3.45 soles per USD

03
Inflation will remain within the target range against a backdrop of contained demand pressures and lower domestic currency YoY depreciation

04
During the rest of the year, the Central Bank will maintain the official policy rate at its current level

Contents

Closing date: 15 August 2016

1 Summary

The global economy has reported moderate growth over the last three quarters, with annualised growth rates of around 3%. Little progress is being made in the developed economies; however, there are some signs of improvement in emerging markets. So far the expected recovery in the USA has not been apparent, and this, coupled with global risks, has led us to lower our growth forecasts for the world's largest economy to levels of 2% for this year and the coming year. Against this setting, we expect the Fed to tighten the stance of its monetary policy very gradually. We maintain our growth forecasts for China at 6.4% for 2016 and 5.8% for 2017.

Since late 2015, higher rates of growth in GDP have been underpinned by a strong momentum in the mining sector. Large-scale mining projects have come on stream, causing a sharp increase in copper production, which accounted for 60% of GDP growth during the first half of 2016. In the remaining sectors, however, which have a stronger correlation with domestic demand, growth has been more modest, and in some it is actually slowing down. Recovery of confidence indicators will be a key factor looking forward. If optimism, which has increased over the last few months, consolidates, then we would expect to see higher private sector expenditure in the closing months of the year and a more marked improvement starting in early 2017.

We stand by our GDP growth forecasts for the Peruvian economy of 3.6% in 2016 and 4.3% in 2017. Higher mining production and the implementation of large-scale infrastructure works will shore up output growth over the next few quarters. Together, these two factors will account for slightly over 2 percentage points of GDP growth in 2016 and in 2017. According to our estimates, the adjustment in mining investment will end this year, business confidence will remain around its recent levels, and the budget deficit will continue at about 3.0% of GDP (so that government spending, as a percentage of GDP, will remain relatively stable).

As a proportion of GDP, gross public debt will tend to grow in future years to levels of around 30%. The deficits that are consistent with the increase of public debt are estimated assuming that the government does not cut Value Added Tax (or IGV as it is known in Peru, “Impuesto General a las Ventas”), even though this is one of its proposed measures. Naturally, if there is a cut in the IGV rate, it will have an impact on tax revenue in the short term, increasing the budget deficit, and this would put pressure on gross public debt as a proportion of GDP. However, if debt needs to be increased in order to push up short- and medium-term output growth, it would be preferable to do so not through lower taxes (IGV rate, in this case) but through higher spending on infrastructure as the latter would have a greater multiplier effect on economic activity.

Local financial markets have risen in value over the last three months, despite the volatile external setting. Mid-term fundamentals have not changed, however, so we consider this rise in asset prices (particularly in the currency) to be a temporary phenomenon. *Brexit* had a limited and very brief impact at the local level. Furthermore, although investor demand for German, Swiss and USA treasury bonds rose during a few weeks because of risk aversion, this did not affect all asset classes (investors appear to have been more selective, so that certain emerging markets were hardly affected). Also, fewer concerns about short-term growth in China and the perception of a more dovish Fed bolstered metal prices, creating a more positive mood in emerging markets like Peru. Demand for assets in local currency rose because of global investors’ search for yield (against a backdrop of lower interest rates in the developed economies) and domestic factors (election results, changes in pension fund regulations, lower depreciation expectations). Against this backdrop, the Peruvian currency has strengthened over the last three months. Looking forward, however, we expect it to steadily depreciate because of the still significant current account deficit and because the Fed will resume its monetary policy tightening before the end of the year, a factor which has not been taken on board by the market consensus. This means that the exchange rate will close the year at between 3.40 and 3.45 soles per USD, and will continue to rise in 2017, ending that year between 3.50 and 3.55 soles per USD.

Inflation has been brought back within the target range (2.0%, +/-1 percentage point) earlier than expected and we do not foresee further complications in the near future. Over the next few months, without demand pressures on prices, downward adjustment in inflation expectations, and a lower YoY rate of domestic currency depreciation, inflation will steadily consolidate within the target range, closing this year at 2.7% and next year at 2.5%.

We do not expect the Central Bank to change its official policy rate during the rest of 2016 (it currently stands at 4.25%). In our forecast, the inflation outlook has improved and there will be a steady recovery in economic activity. However, if private spending remains weak, the Central Bank may decide to adopt a more flexible monetary policy position.

Lastly, **the risks to our growth estimates taken at the base scenario for 2016/17 are balanced**. Lower growth than expected in the Chinese economy and delayed execution of large-scale infrastructure works are events which could prompt a downward bias to these forecasts. However, our GDP growth forecasts could be shifted up due to a higher appetite for global risk (which would draw capital inflows), a positive shock regarding business and household confidence (from the expectations about the new government), and a more buoyant construction sector due to recent legislative changes for pension funds (which could raise investment in real estate construction if housing demand grows faster).

2 Global environment: the central banks tackle *Brexit*

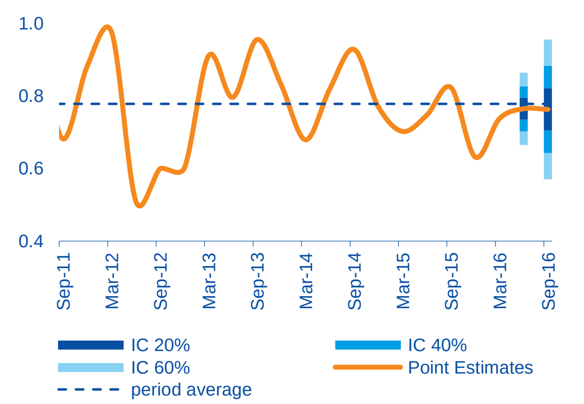
In the past three months, the global economy continued its trend of moderate growth, with annualised growth rates of around 3% (Figure 2.1), well below the pre-crisis rates. Within this average, the developed economies have shown no signs of recovery, whereas we are starting to notice some improvement in the emerging economies, especially in Asia. As a result, the globally aggregated data have either improved somewhat or slowed down their decline.

Brexit brought with it a substantial increase in financial volatility, common to most asset classes. Its effect, however, was transient and non-systemic (Figure 2.2), partly thanks to the response of the central banks, which delayed the process of normalising interest rates (the US Federal Reserve) or remained ready to strengthen stimulus measures (ECB, BoE and BoJ). In particular, the Fed's response was crucial to how the emerging markets weathered the storm. The search for yield in an environment of very low interest rates and the relief produced by the Federal Reserve's delaying its action on financing conditions encouraged the redirection of capital flows to the emerging bloc, which in July received the largest inflow since 2013.

In the US, the poor data for the first and second quarters still do not show the expected degree of recovery. This, coupled with the uncertainty surrounding the elections in the second half of the year and global risks (Brexit and other risks in Europe, and in China in the longer term), leads us to reduce our growth forecast for 2016-17 from around 2.5% to around 2%. In addition, in its latest meetings the US Federal Reserve voiced further doubts about the US economy's potential for long-term growth in productivity and GDP, and this, coupled with the risks from the global economy, led it to put its rate monetary policy normalisation process on hold. In this context, we now expect the Federal Reserve to announce one additional rate hike this year (probably in December) and two in 2017.

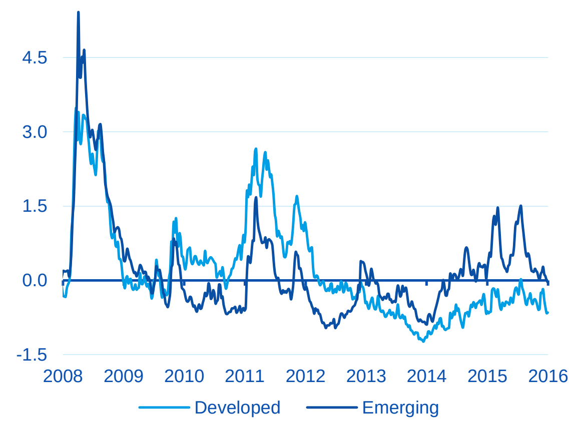
In China, fears of a sharp slowdown in the economy have partly dissipated following the stabilisation of GDP growth at 6.7% in the second quarter, although there are less encouraging signals coming from weak investment, especially by the private sector. However, we are maintaining our forecast of a slowdown in growth to 6.4% in 2016 (from 6.9% in 2015) and to 5.8% in 2017. Short-term risks persist regarding financial stability, the depreciation of the renminbi and capital outflows, as well as the property market and corporate indebtedness, while long-term questions remain about growth prospects due to the slow progress of structural reforms in some key areas, particularly in public companies.

Figure 2.1
Global GDP, % QoQ. 2Q and 3Q forecasts for 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA financial stress index (normalised values)



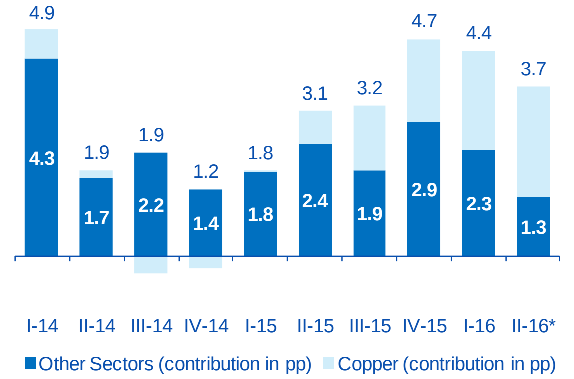
Source: BBVA Research

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

Improved mining growth figures in the first half of the year The rest of the economy has not yet taken off

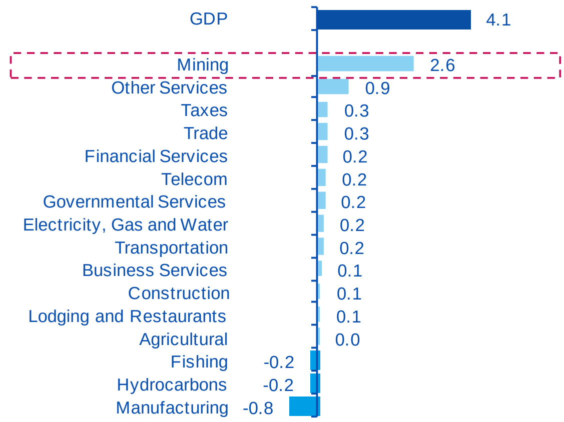
Since late 2015, GDP has improved due to sharp growth in copper production, which has accounted for a greater proportion of growth (see Figure 3.1). The significant slowdown in growth in 2Q16 came because the first anchovy fishing season was not opened off the north-central coast of Peru, as a result of which the fishing and anchovy processing sectors knocked 1.5 percentage points off GDP growth for the quarter[1]. Apart from mining, other sectors, which have a stronger correlation with domestic demand, continue to show more modest growth (see Figure 3.2).

Figure 3.1
GDP
(chge. % YoY and percentage points)



Source: Research based on INEI data

Figure 3.2
Input to growth, January-June 2016
(percentage points)



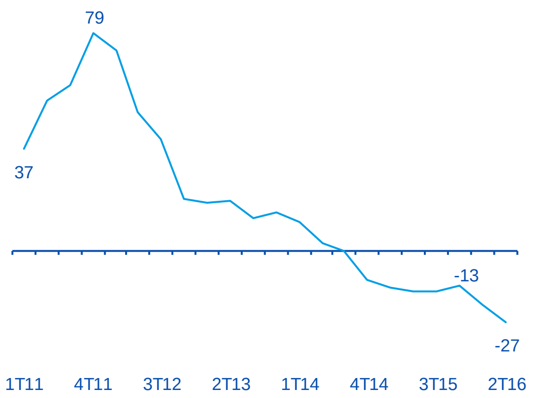
Source: Research based on INEI data

In terms of expenditure, domestic demand remains weak, but the strong momentum in exports continues

Private investment edged lower in the second quarter, impacted in particular by the adjustment in mining investment, which fell 43% in real terms - 27% in current dollars (see Figure 3.3). Although mining investment has gradually taken on a less critical role in total investment in the private sector, it still bears a significant weight (approx. 17%), so that any changes have an effect on total capital accumulation in Peru.

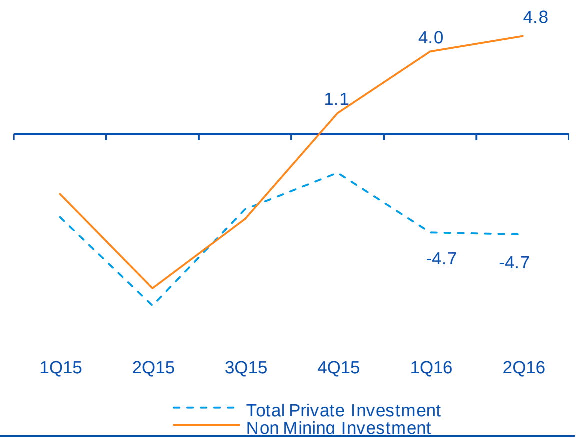
1: The first anchovy fishing season in the north-central coastal area usually opens in the second quarter. In 2015, for example, it started in early April (with a quota of 2.6 million MT). 2016 has been an unusual year, however, in that restrictions (i.e., a ban on fishing, to preserve the species) were not lifted until mid June. The season then ended in July (it was not extended any further due to the start of the anchovy egg-laying period) and only 50% of the quota set was caught (1.8 million MT).

Figure 3.3
Mining investment
(in USD, chg. % YoY)



Source: BBVA Research based on Ministry of Energy & Mines data

igure 3.4
Non-mining private investment[1]
(chg. % YoY))



1/ Second quarter is estimated.
Source: BBVA Research based on Central Bank data

According to our estimates, non-mining investment continued on positive ground for the third successive quarter, rising 1.1% in 4Q15, and by over 4.0% in the first two quarters of 2016 (see Figure 3.4), to some extent buoyed up by the launch of infrastructure works. Initially, a large proportion of imports - capital goods or inputs - were used for these works, which means that they have not yet driven up domestic manufacturing or the labour market. These projects have also suffered from some delays due to problems preparing the terrain, expropriations, incomplete technical studies and funding problems (see Table 1).

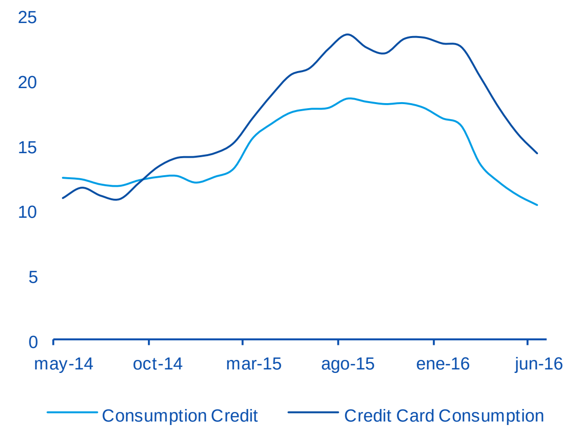
Table 1
Investment projects

Investment	Projects (USD million)	Current situation
Lima Metro line 2		There have been delays in handing over buildings to the consortium carrying out the work and approval of engineering studies has also been held up. By July, only 20% of the amount earmarked for this year had been used (S/ 2,257 million).
South Gas Pipeline		Much of the work has been held up due to a lack of funding In September, the concession company should present the agreements concluded with international banks, provided the government approves the bankability addendum.
Modernisation of the Talara refinery		The work is currently being funded using short-term loans from local banks. The external lending deal is currently being evaluated. By May, 37% of the project had been physically completed.
Jorge Chávez international airport		The Government has not yet handed over all the land (without interference).
Majes Siguas Stage II		The preliminary groundwork is being performed. The works supervisor recently approved the optimisation proposal submitted by the concession company. The concession company still has to submit the modified technical dossier including the optimisations.
Total	**14 380**	

Source: BBVA Research based on Central Bank of Peru, MEF and press

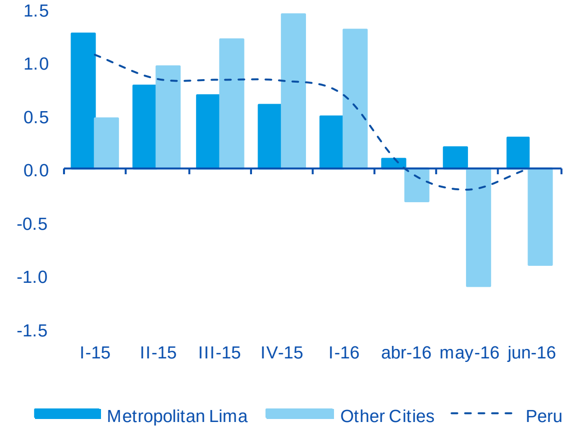
Private consumption slowed against a backdrop of household deleveraging (slower growth in consumer loans; see Figure 3.5) and weak formal urban employment figures (see Figure 3.6). The market has cooled more significantly in inland Peruvian cities.

Figure 3.5
Household consumer loans (chg. % YoY)



Source: BBVA Research based on ASBANC data

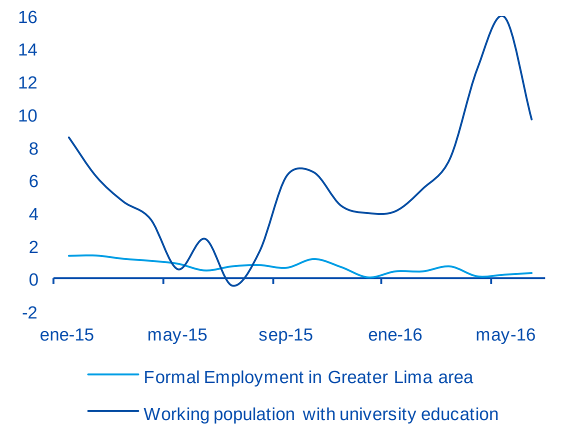
Figure 3.6
Formal urban employment* (chge. % YoY)



* Employment in formal private companies with 10 or more employees.
Source: BBVA Research based on MINTRA data

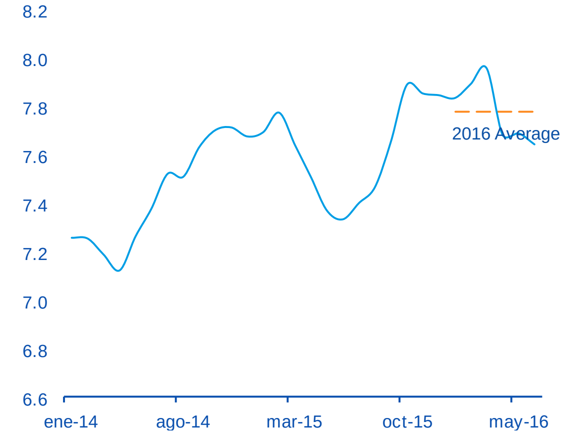
In the Greater Lima area, the growth of the working population slowed in the second quarter, although there was increased demand for workers with higher education. However, as formal employment in Lima is practically stagnant, many workers with higher education levels appear to have been absorbed by the informal sector (see Figure 3.7). As a result, average real wages and salaries (inflation-adjusted) have not grown since 4Q15 (see Figure 3.8), impacting consumer trends.

Figure 3.7
Greater Lima area: Formal employment and working population with university education (chge. % YoY)



Source: BBVA Research based on INEI data

Figure 3.8
Greater Lima area: payroll in real terms* (billion soles at June 2016)



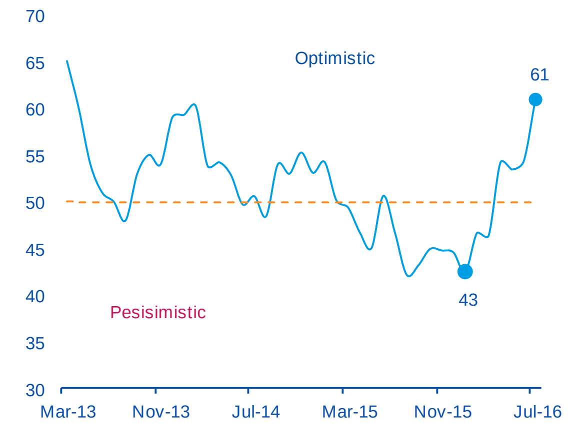
* Total payroll is calculated by multiplying the active working population by the average monthly salary in real terms.
Source: BBVA Research based on INEI data

Exports performed better in the second quarter, in line with higher mining production. The trend in the volumes of non-traditional exports (0.5% YoY) was also positive, marking the first increase since 2012. In our opinion, however, it is too early to tell whether from now on there will be positive figures for foreign sales of such products - which have a higher value-added - because of the general lack-lustre tone of the Latin American region, which is the core destination for exports.

Business and household confidence have improved, and if this trend is consolidated, then private spending will begin to improve in the last months of the year and more markedly in early 2017. The momentum in the mining sector is expected to wane, however

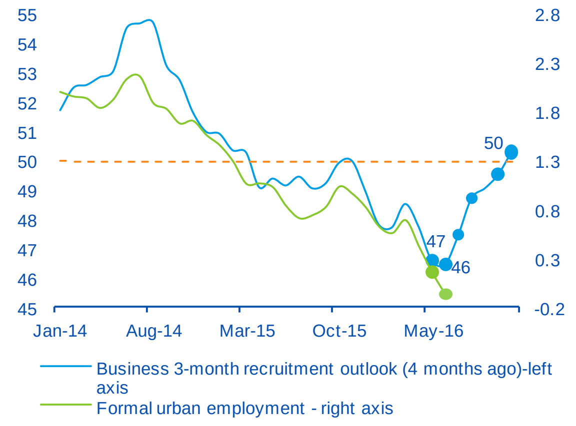
Copper aside, the mood of the Peruvian economy is low-key, particularly in activities more strongly correlated with domestic demand. However, the confidence indicators have recovered. Business confidence has remained on positive ground for four successive months (see Figure 3.9). This is possibly because Peruvians felt more confident about these elections compared to other presidential elections (the two candidates who went on to the second round claimed that they would continue the macroeconomic models used over the last 25 years) and expectations about the new government. In this setting, businesses are more confident about being able to increase their payrolls over the next three months (see Figure 3.10), a shift that could anticipate a rebound in formal job creation after the end of 2016.

Figure 3.9
Business confidence (points)



Source: Central Bank of Peru

Figure 3.10
Business 3-month recruitment outlook and formal employment in urban Peru (index and chg. % last three months)

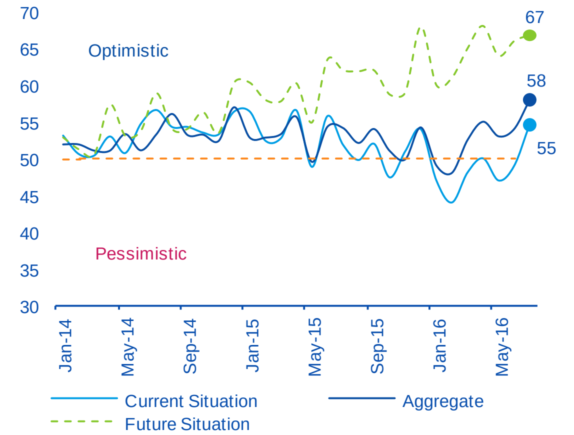


Source: BBVA Research based on Central Bank data

Lower inflation has helped instil a perception of moderate optimism in consumers (see Figure 3.11). It is also interesting to note that households express significantly more confidence about their future situation (compared with their current one), which suggests that they consider the current slowdown in the economy and employment to be temporary.

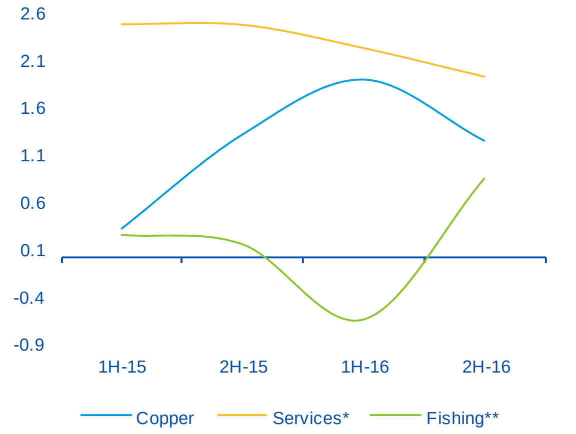
In the second half of 2016, copper production, public spending (which improved significantly in the first quarter), and the Services sector will lose some momentum, although fishing will improve (see Figure 3.12). Overall, growth in GDP will tend to slow in the second half of the year.

Figure 3.11
Consumer confidence (in points)



Source: Apoyo Consultoría

Figure 3.12
Copper, fishing and services: input to growth (percentage points)



*Includes the trade sector.
** Includes the positive effect of fishmeal processing.
**Estimated.
Source: BBVA Research based on INEI data

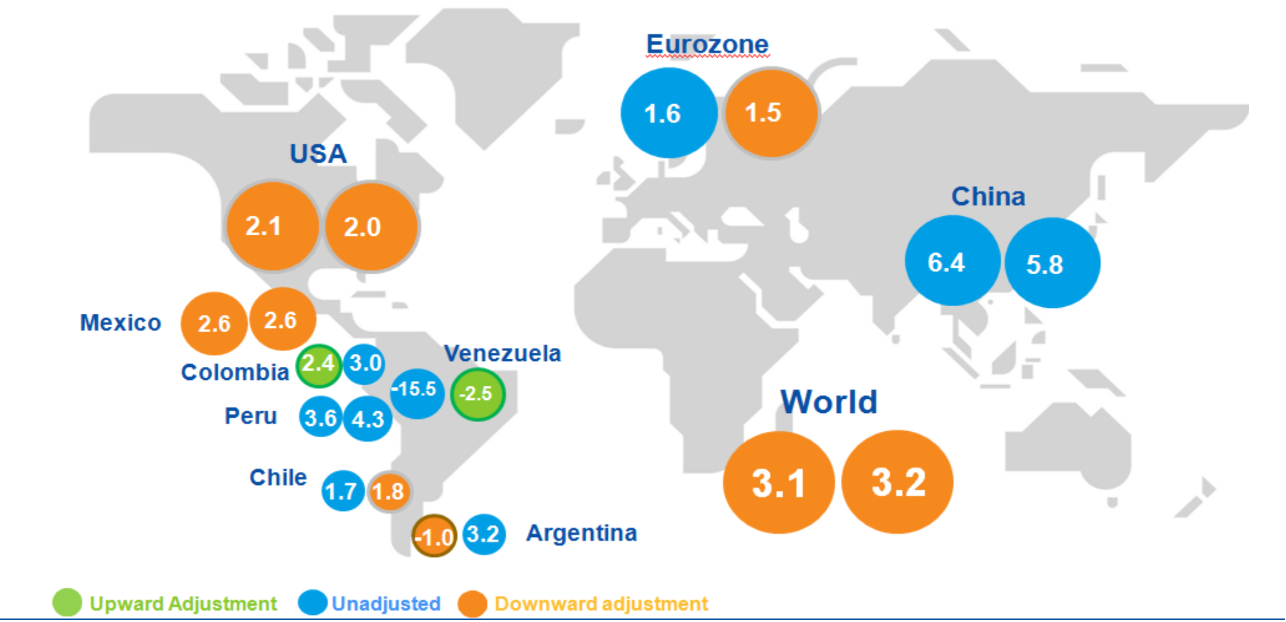
Development of infrastructure projects and strong mining activity will be the main drivers of growth over the next few months

Our base scenario for GDP growth forecasts includes a number of different assumptions:

Externally,

- the global economy will report moderate growth (for more details see Figure 3.13 and Section 2, Global environment) (i) Further steady slowdown in growth in China, (ii) in the USA, GDP growth will gradually converge towards lower long-term levels, and (iii) LatAm will improve little by little.

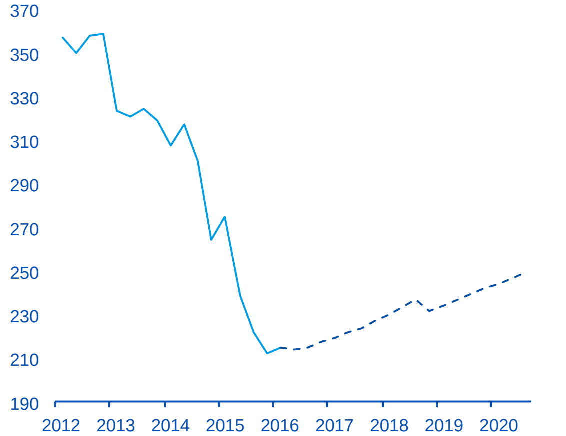
Figure 3.13
Global growth (chge. % YoY)



Source: BBVA Research

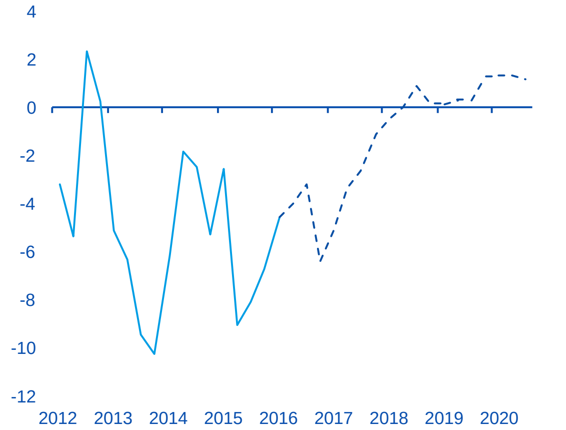
- The terms of trade will continue to deteriorate this year and even more in 2017. This contraction is correlated with a greater slump in export prices, copper especially, and recovery in import prices due to the brighter outlook for international oil prices (see Figure 3.14 and Figure 3.15).

Figure 3.14
Price of copper (¢USD/pound)



Source: BBVA Research based on Bloomberg

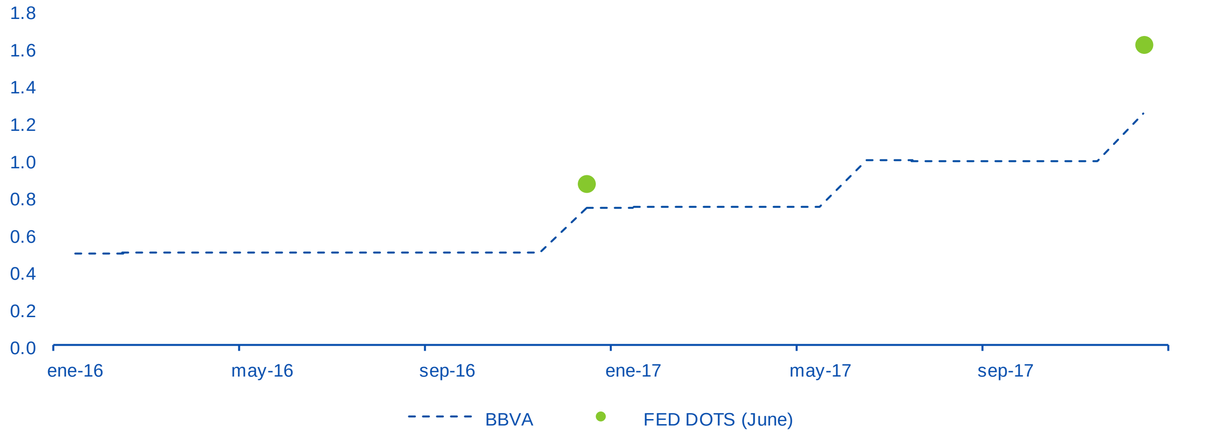
Figure 3.15
Terms of trade (chg. % YoY)



Source: BBVA Research based on Central Bank data

- Toward the end of the year, the Fed will resume its upward adjustment of interest rates as part of its monetary policy; the adjustment will continue very gradually in 2017 with two increases of 25bp each (see Figure 3.16 and Section 2, Global Setting). The markets are currently pricing in a more gradual approach by the Fed than that contained in our base scenario; we therefore expect to see bouts of volatility in local financial markets due to investors reshaping their portfolios. Looking beyond these temporary phenomena, the important thing as far as the economic decisions of a doveish Fed are concerned is that interest rates on international markets will remain low for a considerable period.

Figure 3.16
FED interest rate forecast (%)

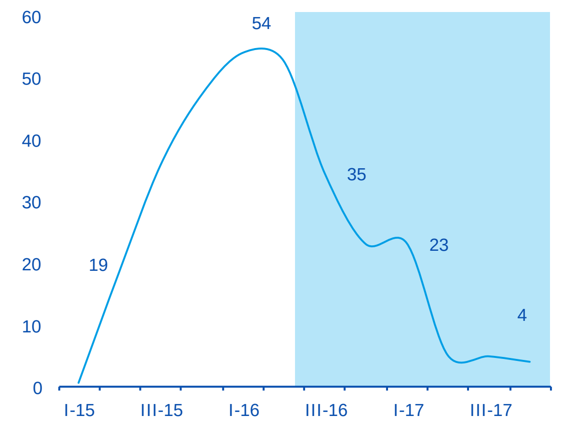


Source: BBVA Research based on Bloomberg

At the local level, the assumptions are as follows:

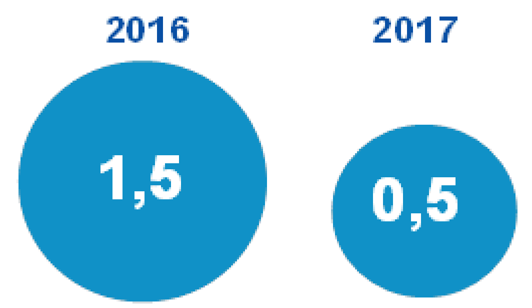
- Copper production will rise further toward the end of 2017, but growth rates will steadily slow, making lower contributions to growth (see Figure 3.17 and Figure 3.18).

Figure 3.17
Copper production (chge. % YoY)



Source: BBVA Research based on Ministry of Energy & Mines data

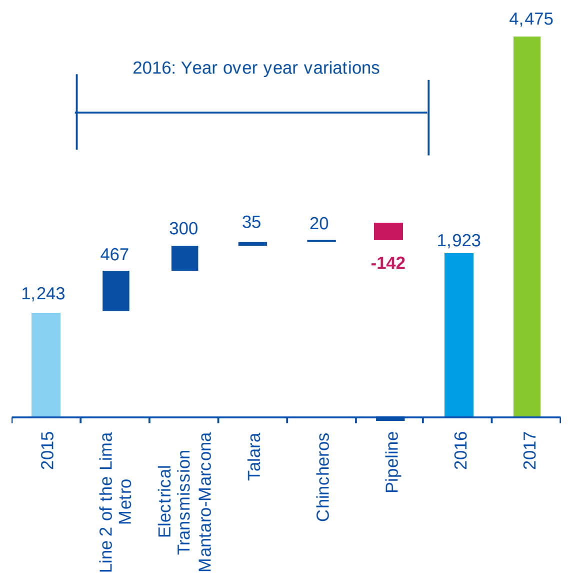
Figure 3.18
Copper production: input to growth (percentage points)



Source: BBVA Research

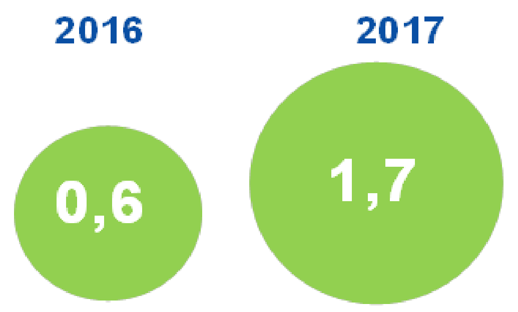
- Next year, large-scale infrastructure works (public and private) will pick up their pace considerably (see Figure 3.19). According to our estimates, investment in infrastructure in dollars will increase by over 130% in 2017. Infrastructure expenditure will therefore grow threefold next year, in contrast with the situation in the mining sector.

Figure 3.19
Selected infrastructure projects* (investment, USD mn)



*The following projects have been selected (investment included in 2016 in brackets): Line 2 of the Lima metro (USD 606 million), Southern Gas Pipeline (USD 358 million), Mantaro-Montalvo electricity transmission line (USD 300 mn), modernisation of the Talara refinery (USD 639 million), and Chinchero airport (USD 20 mn).
Source: BBVA Research based on MEF and Central Bank of Peru

Figure 3.20
Infrastructure projects*: contribution to growth in GDP (percentage points)

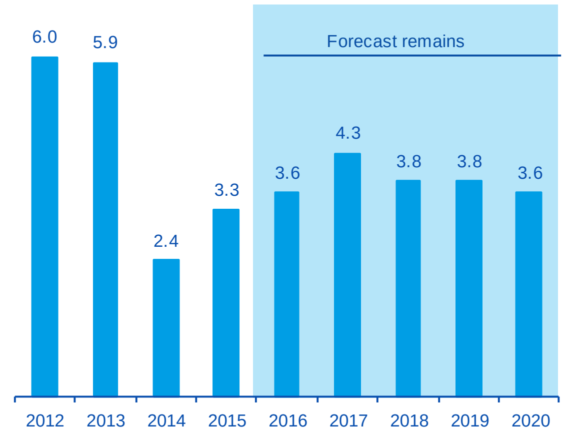


*Features five large-scale infrastructure projects: Line 2 of the Lima Metro, the Mantaro–Marcona-Socabaya- Montalvo electrical transmission line, modernisation of the Talara refinery, building of Chinchero airport, and the Southern Peru Gas Pipeline.
Source: BBVA Research based on MEF and Central Bank of Peru

- This year the adjustment in mining investment will be completed, and 2017 will bring slight positive growth. Under this scenario, only small and medium-scale projects (Tambomayo and the extension of Toquepala, with investments of USD 340 million and USD 1,200 million, respectively) remain; these projects will come on stream in 2017 or 2018. Looking ahead, mining investment will be driven by companies in this sector reinvesting their profits, which on the whole will be lower due to basic metal prices remaining at low levels.
- Business confidence stands around the levels reached recently (optimistic band).
- The structural deficit in the public sector, i.e., the deficit measured using the government's permanent revenues, will amount to 2.5% of GDP. It is assumed that there will be no cut in Value Added Tax (IGV).

Taking into account these assumptions, we maintain our GDP growth forecasts for the Peruvian economy at 3.6% in 2016 and 4.3% in 2017 (see Figure 3.21). In 2016 and 2017, the core drivers will be the momentum from higher mining production and the execution of large-scale infrastructure works. Together, these two factors will account for slightly over 2 percentage points of growth in GDP in 2016 and 2017 (see Figure 3.22).

Figure 3.21
GDP
(chg. % YoY)



*Estimated.
Source: BBVA Research based on INEI and Central Bank of Peru data

Figure 3.22
Contribution to growth in GDP (percentage points)

	2016	2017
Total	2.1 pp	2.2%
Copper production	**1.5 pp**	0.5 pp
Infrastructure projects*	0.6 pp	**1.7pp**

*Features five large-scale infrastructure projects: Line 2 of the Lima Metro, the Mantaro–Marcona-Socabaya- Montalvo electricity transmission line, modernisation of the Talara refinery, building of Chinchero airport, and the Southern Peru Gas Pipeline.
Source: BBVA Research

Focusing on individual sectors, we believe that primary (extractive) activities will report significant growth. Metal mining, for example, will continue to grow up to late 2017, although its growth rates will begin to wane (see Table 2). In the Fishing sector, anchovy extraction volumes will recover to levels more consistent with average historical volumes. Non-primary sectors will report steady recovery, which will be more significant in 2017, particularly Construction and non-primary Manufacturing, in line with the development of infrastructure projects, recovery in the real estate market (new regulations for pension funds will fuel housing demand), the lower burden from mining investment, and a brighter performance by LatAm economies.

Table 2
GDP by production sectors (chge. % YoY)

	2015	2016(p)	2017(p)
Farming and agriculture	3.0	1.3	4.0
Fishing	15.8	-6.9	19.4
Mining and hydrocarbons	9.3	14.2	5.5
Metal mining	15.5	18.6	4.5
Hydrocarbons	-11.6	-5.1	11.6
Manufacturing	-1.7	-2.6	3.3
Primary	1.3	-1.6	6.8
Non-primary	-2.7	-2.8	2.0
Electricity and water	6.2	7.2	6.3
Construction	-5.9	-1.3	4.9
Trade	3.9	2.4	3.3
Other services	5.1	4.5	4.7
Global GDP	**3.3**	**3.6**	**4.3**
Primary GDP	6.6	8.3	5.6
Non-primary GDP*	2.6	2.6	4.1

* Non-primary GDP excludes taxes and import duties.
Source: INEI, Central Bank of Peru and BBVA Research

Table 3
GDP on demand side (chge. % YoY)

	2015	2016 (p)	2017 (p)
1. Domestic demand	**2.9**	**1.0**	**3.9**
a. Private consumption	3.4	3.1	3.4
b. Public consumption	9.5	5.7	2.2
c. Gross domestic investment	-1.0	-6.1	6.0
Gross fixed investment	-5.0	-1.3	5.4
- Private	-4.4	-3.2	4.0
- Public	-7.5	6.5	10.8
2. Exports	3.5	7.8	3.5
3. GDP	**3.3**	**3.6**	**4.3**
4. Imports	2.2	-2.5	1.7
Note:			
Private spending (excl. inventories)	*1.4*	*1.6*	*3.5*
Domestic demand (excl. inventories)	*1.9*	*2.3*	*3.7*

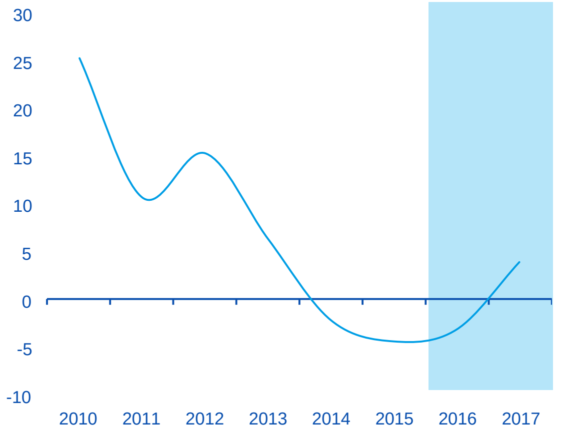
Source: INEI, Central Bank of Peru and BBVA Research

On the demand side, we expect modest performance from gross fixed capital formation in 2H16 but renewed growth from 2017 on, after three successive years of contraction (see Table 3). Generally speaking, the faster pace in large-scale infrastructure works, coupled with the resolution of problems such as land expropriation, non-interference and funding, will create a greater impetus for both public and private investment (see Figure 3.23). Private investment will also benefit from four factors. First, the improvement in business confidence, which will favour non-mining investment. Two, more positive performance by the real estate market, as the funds released by pension fund managers for purchasing first homes will drive demand against a background in which stocks are now close to normal levels. Third, self-building, which will be shored up more firmly by the steady recovery in job creation and the fall in inflation. Lastly, most of the burden of lower mining investment will have faded.

In the remaining months of 2016, growth in private consumption will slow to rates of close to 3%, according to our estimates, impacted by weak formal job creation and household deleveraging. The expected recovery in private investment in 2017 will help to create jobs; inflation will also see further falls, while consumption will gradually gain traction toward our growth estimate of 3.5% (see Figure 3.24).

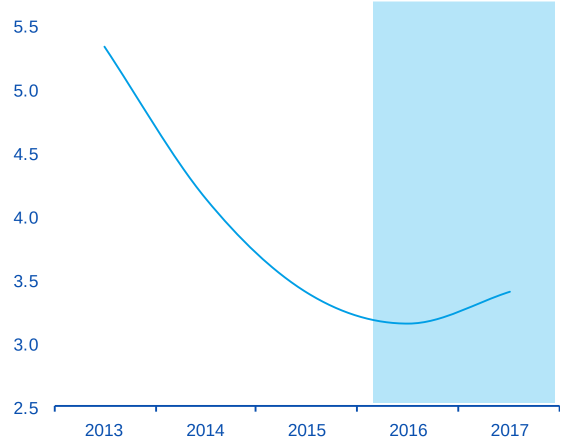
During what is left of 2016, exports will be the most dynamic part of the expenditure side, helped by mining production and by copper extraction, in particular. In 2017, growth in exports will be more constrained; the momentum of mining activity will cool, although offset by higher exports of fishing products (we expect anchovy catches to increase by over 45% under what should be more normal weather conditions) and by higher non-traditional exports bolstered by recovery in economic growth in LatAm countries.

Figure 3.23
Private investment
(chg. % YoY)



Source: BBVA Research based on Central Bank data

Figure 3.24
Private consumption
(chg. % YoY)

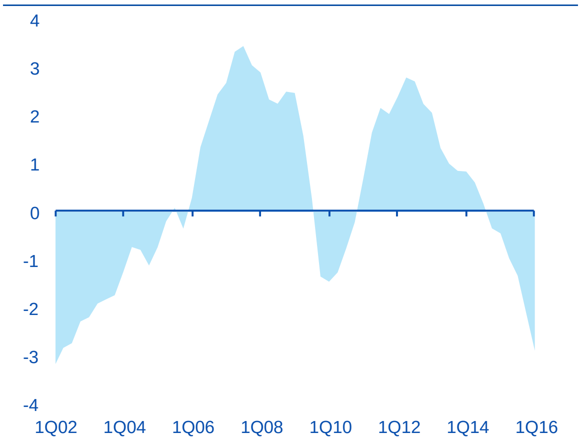


Source: BBVA Research based on Central Bank data

Fiscal policy: little margin for tax cuts

As of June, the cumulative budget deficit for the last four quarters amounted to 3.0% of GDP, mainly as a result of the slump in the government's current revenue, due to cyclical factors and the cut in personal income tax rates. The last time Peru saw such large budget deficits was in the previous decade (see Figure 3.25).

Figure 3.25
Tax revenue*
(cumulative for last year, as % of GDP)



* Non-finance public sector.
Source: BBVA Research based on MEF data

Figure 3.26
Tax revenue*
(% of GDP)

* Non-finance public sector.
Source: BBVA Research based on Central Bank data

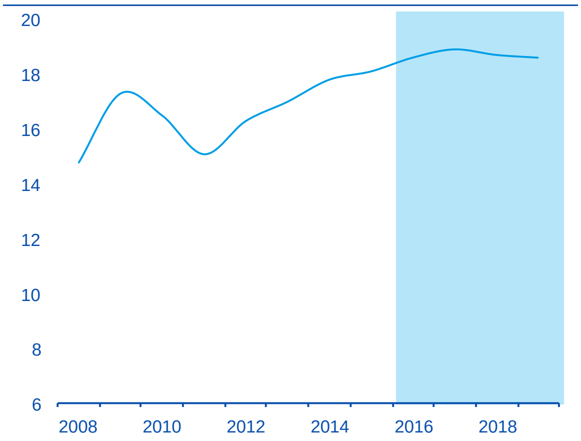
We have used the following assumptions to estimate the fiscal accounts:

- No tax cuts other than the measure announced by the government in late 2015 to lower the rate of corporate income tax in 2017 and 2019). In particular, we are assuming that there will be no reduction in Value Added Tax (IGV). The new government proposed this tax cut during the election campaign as part of a plan to help formalise the economy.
- The structural deficit in the public sector, i.e., the deficit measured using the government's permanent revenues, will amount to around 2.5% of GDP for the 2016-2018 period (see Figure 3.26). During the

2019-2020 period, the government plans to implement a gradual budget retrenchment by slowing growth in public spending and thereby bringing down the deficit.

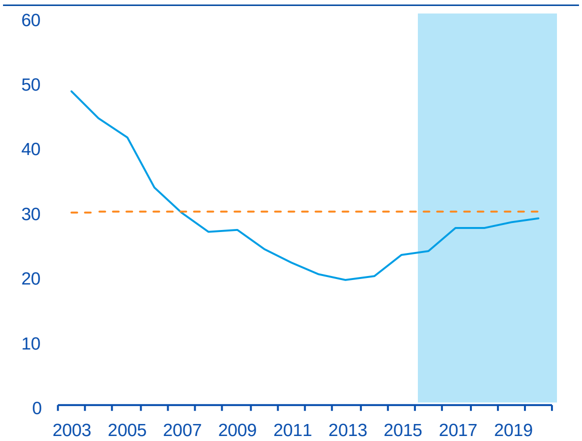
Under this scenario, i.e., with these assumptions, public spending as a percentage of GDP would keep relatively stable in the forecast horizon (see Figure 3.27), but we have assumed that it will be reshaped, with a gradual increase in public investment, in line with higher infrastructure spending, and a decrease in government consumption. Under this scenario, the observed deficit would stand at approximately 3.0% of GDP in 2016-2018 and an average of 2.4% in the 2019-2020 period. Lastly, public debt would trend upward and would stand at close to 30% of GDP by 2020 (see Figure 3.28).

Figure 3.27
Public spending (% of GDP)



Source: BBVA Research based on Central Bank data

Figure 3.28
Gross public debt (% GDP)



Source: BBVA Research based on Central Bank data

However, if Value Added Tax is cut by one point in 2017 (as announced by the authorities) and it does not have the expected effects of formalising the economy sought by the government, then tax revenue would fall by approximately 0.5% of GDP. Under such a scenario, the observed budget deficit would be closer to 3.5% of GDP in 2017 and 2018, while gross public debt would exceed the 30% limit established in the Fiscal Responsibility and Transparency Act (LRTF). Looking back at the historical patterns for budget deficit and gross public debt, it appears that there is not much margin for applying a reduction in VAT if the targets (which are naturally positive) of boosting infrastructure spending, improving the public administration, and providing greater resources for the education and health sectors are to be met.

The new government has stressed that the cut in VAT would help to formalise the economy, but they have not clearly explained what mechanism would be used to achieve this. and there is also little evidence to go on. Indeed, a cut in VAT would have an immediate negative impact on tax revenue and if it did in fact help to formalise the economy, then the tax base would be expanded very gradually. The result would be a short-term deterioration in the fiscal balances.

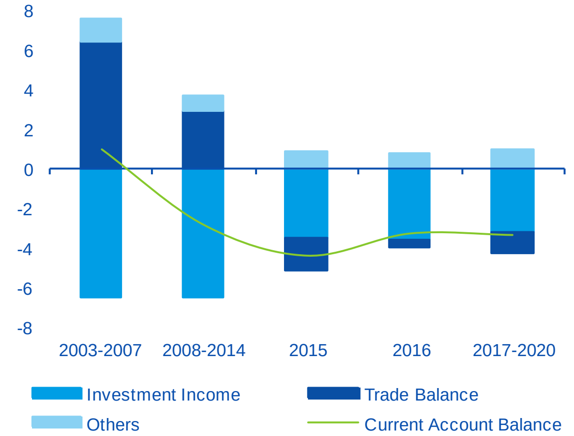
Lastly, two other factors have to be taken into account. On the one hand, looking forward, the Peruvian economy will have a lower growth trend, due to external and structural factors, leaving less margin for possible fiscal stimuli. On the other, an environment of lower interest rates in coming years will put less pressure on financing efforts, allowing the government a higher debt capacity. In any case, if the government is willing to accept a somewhat higher level of public debt in the mid term, the best way of doing this would be an increase in public spending, particularly on infrastructure that benefits society. According to IMF studies published recently, and according to our own estimates published in late 2014 , a cut in tax has a less significant multiplier effect than government expenditure. And within expenditure, the highest impact is that of public investment.

The trade deficit is narrowing, against a backdrop of a sharp drop in imports

The trade deficit improved in the second quarter, largely due to a (nominal) fall in imports, in line with weak domestic demand. Foreign sales contracted because the higher volumes exported were offset by the fall in prices. Taking this into account, in the second quarter, the current account deficit in the balance of payments —as a percentage of GDP, cumulative over the last four quarters— fell 0.3%.

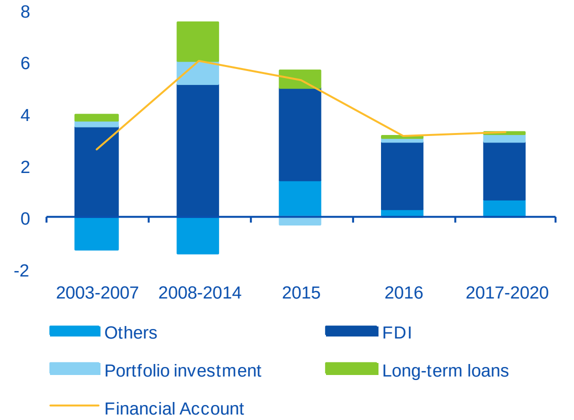
We expect improvement in the current account in the coming years, especially from 2018 on (see Figure 3.29). Mining and fishing production will increase, the currency will depreciate, and as of next year the economic performance of Latin America - the main market for non-traditional exports - will improve. However, we also expect a deterioration in the terms of trade in 2016 and 2017 and an increase in imported volumes due to a gradual recovery in domestic demand.

Figure 3.29
Current account
(% of GDP)



Source: BBVA Research based on Central Bank data

Figure 3.30
Current account
(% of GDP)



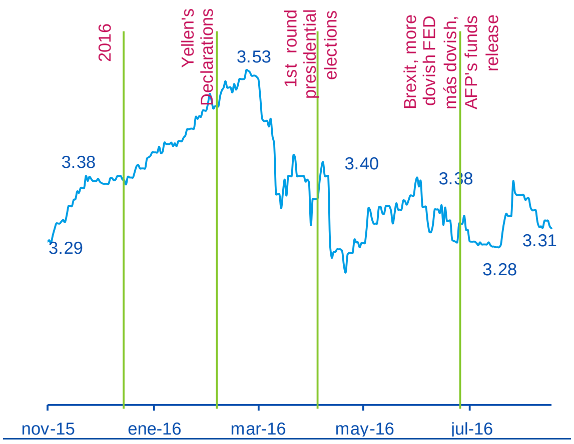
Source: BBVA Research based on Central Bank data

Overall, we expect funding sources to be similar to the trade deficit, and in some years they will be higher (see Figure 3.30). It will not just be a question of buying private sector assets, however. Capital inflows, such as FDI and long-term flows, will only cover part of the current account deficit. Capital inflows to buy public sector assets (e.g., sovereign or global bonds) will play an important role at the forecasts horizon, because the public sector will issue debt to fund the budget deficits expected in coming years. It is important to bear this in mind, because this latter type of capital inflow (increased supply of dollars) will have less impact than if the inflow is used to acquire private sector assets.

4 Local financial markets: risk aversion, the Fed and the search for returns

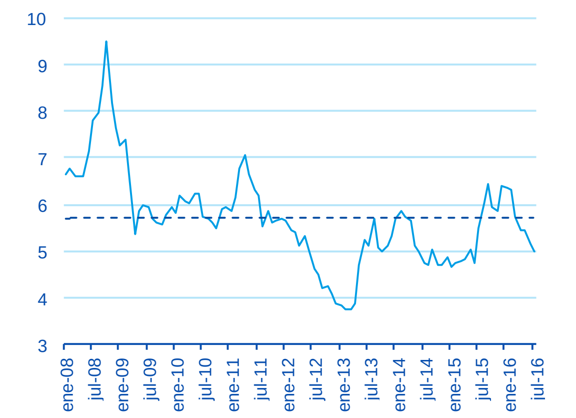
During the second quarter, local financial markets were affected by a number of different external and domestic events which sparked volatility and ultimately encouraged a trend among Peruvian assets to rise in value (see Figures 4.1 and 4.2).

Figure 4.1
Exchange rate*
(PEN /USD)



*At 16 August.
Source: BBVA Research based on Bloomberg

Figure 4.2
Yield: sovereign bond 2020
(%)



Source: Bloomberg

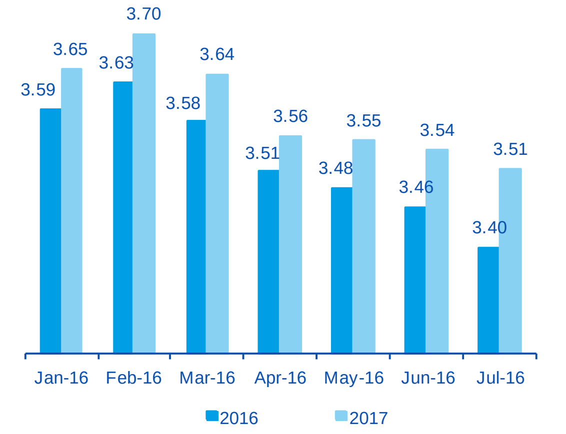
External factors *Brexit*, even though the central banks in developed economies are maintaining their doveish approach and China its short-term growth, prompting investors to chase compelling returns

External events such as Brexit exerted sporadic pressure and pushed down the value of local financial assets, although they had a limited impact and did not last long. Against a backdrop of higher global risk, the central banks and developed economies adopted a more doveish approach (including the Fed). With extremely low or even negative interest rates set to stay for some time, investors sought to find attractive returns in emerging markets, especially those with good fundamentals. China's growth figures published in the second quarter, at about the same level as in the first quarter (6.7%) gave investors further incentives to seek attractive returns and allayed concerns about a sharp adjustment in the Chinese economy in the short term. This sentiment helped drive up commodity prices and emerging market assets.

Idiosyncratic factors also played an important role in price changes in local assets in the second quarter

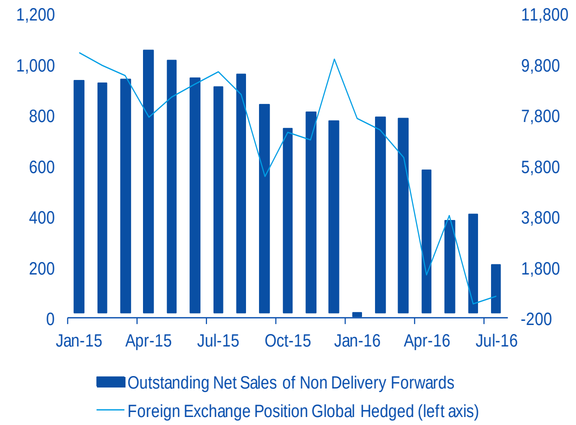
The result of the elections in April caused a positive sentiment because the two candidates who went into the second round claimed that they would continue the same macroeconomic guidelines as those used in the last twenty-five years, calming investors’ jitters. The financial markets were also affected by the change in regulations for private pension funds. From now on, retirees will be able to take out up to 95.5% of their fund, or anybody paying into a fund can use up to 25% of that amount to buy a first home (or also pay off the loan used to buy it in advance). Accordingly, pension funds have been liquidating some foreign currency positions, pushing up the demand for soles to meet these withdrawals.

Figure 4.6
Exchange rate expectations (PEN/USD, year end)



Source: BCRP

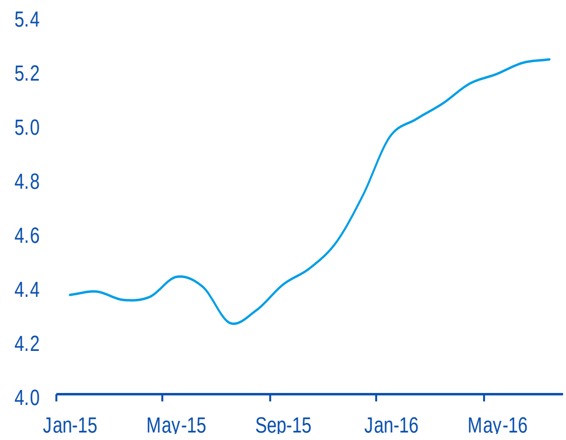
Figure 4.7
NFD net sales balance by banks and banks' global exchange position (US$ millions)



Source: BCRP

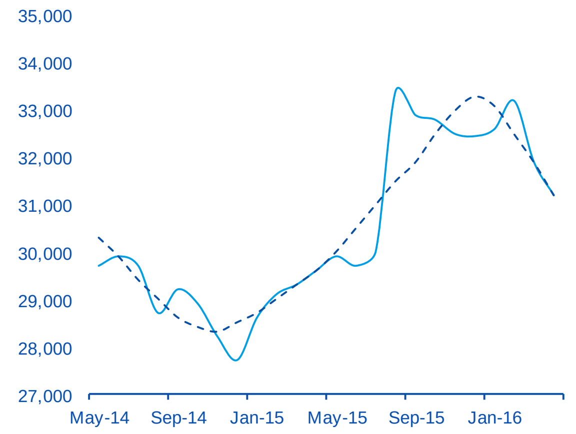
The more favourable short-term outlook for the PEN has been reflected in a lower expected exchange rate in coming months (see Figure 4.3). Against this backdrop, agents in the foreign exchange market, such as foreign investors and the banks themselves, have markedly reduced their positions in USD (see Figure 4.4). As people expect the exchange rate to be kept more in check, coupled with the increased interest rate for deposits in soles (see Figure 4.5), which is the result of the adjustment in benchmark interest rates and the de-dollarisation of credit, they have reduced their foreign currency assets (see Figure 4.6). In short, external and domestic factors have been rebalanced in such a way that the general picture is more favourable for the PEN. It strengthened from levels of 3.40 in March to closer to 3.30 in July, despite the Central Bank's efforts to moderate this process.

Figure 4.4
Interest rate on deposits in soles (time, between 180 and 360 days, %)



Source: BCRP

Figure 4.5
Foreign currency deposits (US$ millions)

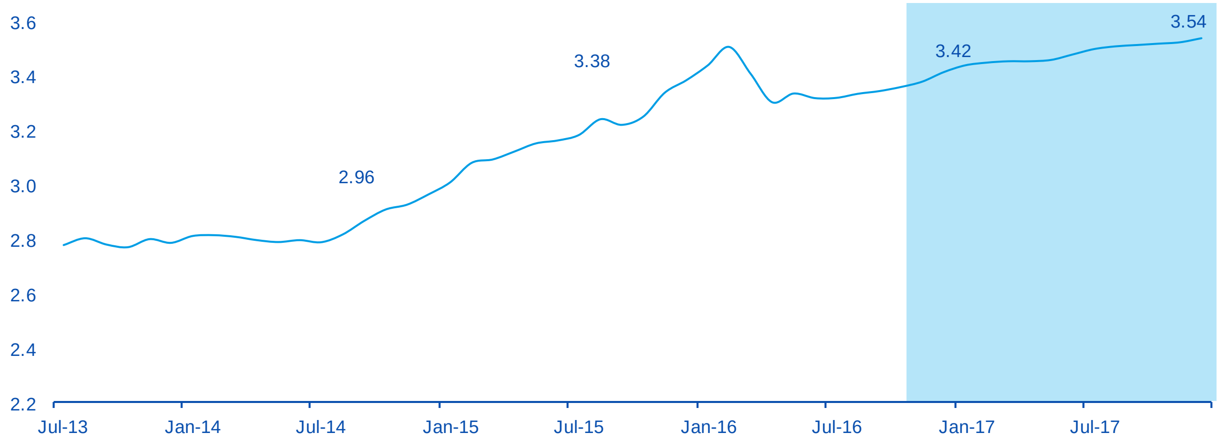


Source: ASBANC

Looking ahead, we maintain our forecast of a weaker PEN

As we expect the terms of trade to deteriorate, and for domestic demand to eventually improve (helping imports), the current account deficit in the balance of payments will continue to be significant, despite increased mining, fishing (if weather conditions return to normal) and non-traditional exports (as Latin AMerica gains traction). These factors will put pressure on the exchange rate to tend to rise. The important thing is to know when this trend will be resumed and how quickly. According to our estimates, the elements that have exerted a downward pressure on the exchange rate will soon be depleted (they will not create greater additional pressures to devalue), while on the other hand the Fed will be inclined to raise its official policy rate before the end of the year, and do so on two more occasions in 2017. Our forecasts for the Fed's actions do not match the market consensus. As the consensus steadily begins to come around to an adjustment in the Fed rate in 2016, the PEN will resume its trend of devaluation. In fact, we expect this process to begin soon and as a result, our estimate is for an exchange rate of between 3.40 and 3.45 by year end. In 2017, the current account deficit will still be significant and the Fed will be adjusting its interest rates (albeit gradually), In this context, we expect further devaluation of the PEN towards a level of between 3.50 and 3.55 (see Figure 4.7), edging closer to what we see as the equilibrium level.

Figure 4.7
Exchange rate (PEN /USD)

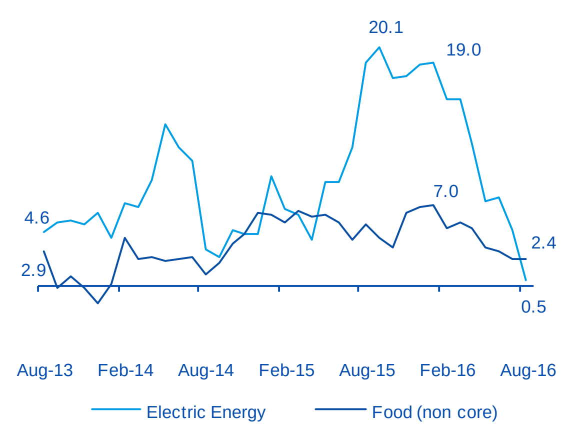


Source: BBVA Research based on Central Bank of Peru data

5 Inflation came back within the target range sooner than expected, and from now on there will be no major pressures

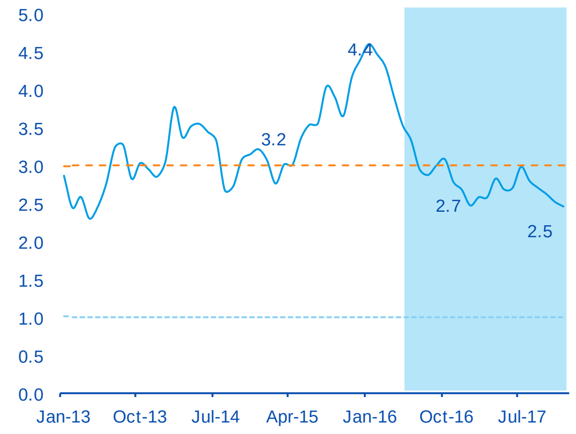
Inflation has subsided since early 2016. While it began the year above 4.5%, it was back within the target range by July. This pattern has been driven by three factors. Firstly, lower food prices (see Figure 5.1). Supply shocks (unusual weather conditions) that affected food supply have faded, coupled with the recent fall in the prices of imported food inputs, especially maize. Secondly, the relatively stable currency, which in year-on-year terms has depreciated much less in recent months (by less than 3% at present compared wtth 14% in December 2015). This has had the same impact on the prices of certain items in the consumer basket, one of which is imported goods (e.g., cars and electrical appliances), goods manufactured using imported commodities, and services in dollars (rents, for example) or which are tied to changes in the exchange rate (electricity, for example). Lastly, inflationary expectations have begun to fall against this milder inflationary setting.

Figure 5.1
Food prices* and electricity prices (chge. % YoY)



*Reflects the pattern of food prices within the non-core component of the consumer basket.
Source: Central Bank of Peru

Figure 5.2
Consumer prices index (chge. % YoY)



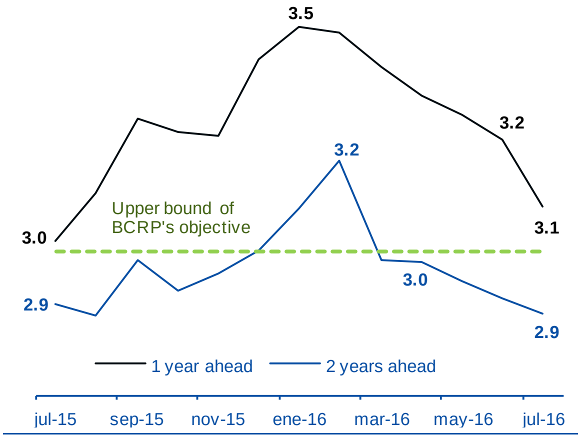
Source: BBVA Research based on Central Bank of Peru data

Looking forward, we expect inflation to fall further and for it to consolidate within the target range of the year, against a background of more moderate increases in the exchange rate (according to our estimates, the rate of depreciation YoY will fall a little further), lack of demand pressures, and steady downward adjustment in inflation expectations in this more benign price setting (see Figure 5.2). We should add that the fall in inflation will be checked by the increase we are expecting in the international oil price (WTI) in the rest of the year, with a level of close to USD52/barrel towards the end of 2016.

6 Monetary policy: The Central Bank will keep its official policy rate at 4.25% for the rest of 2016

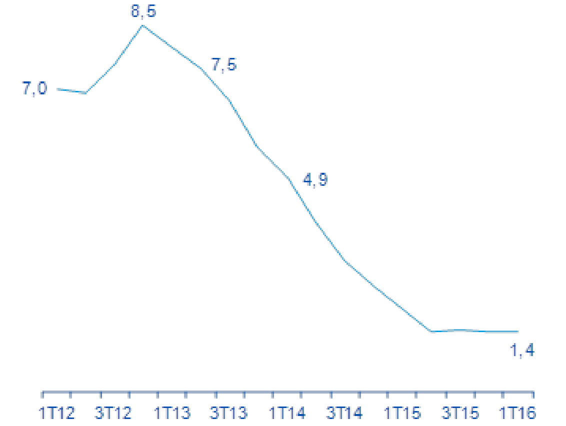
The monetary policy rate has remained constant at 4.25% in recent months, against a background of a downward trend in inflation, albeit still high and above the target range; in fact it only moved back within the target range in July. The pattern was similar with inflation expectations (see Figure 6.1). Turning to general economic activity, private sector spending remained weak, with growth in the region of 1.5% YoY (see Figure 6.2). The general trend on the foreign exchange market was for the currency to strengthen, although important external risks (e.g., China, the Fed rate) are still in the picture and have prompted bouts of volatility.

Figure 6.1
Inflation expectations*
(%)



*Prepared using private sector expectations data collected by the Central Bank of Peru in their monthly surveys.
Source: BBVA Research

Figure 6.2
Private spending not including inventories
(moving average last 4 quarters, chg. % YoY)

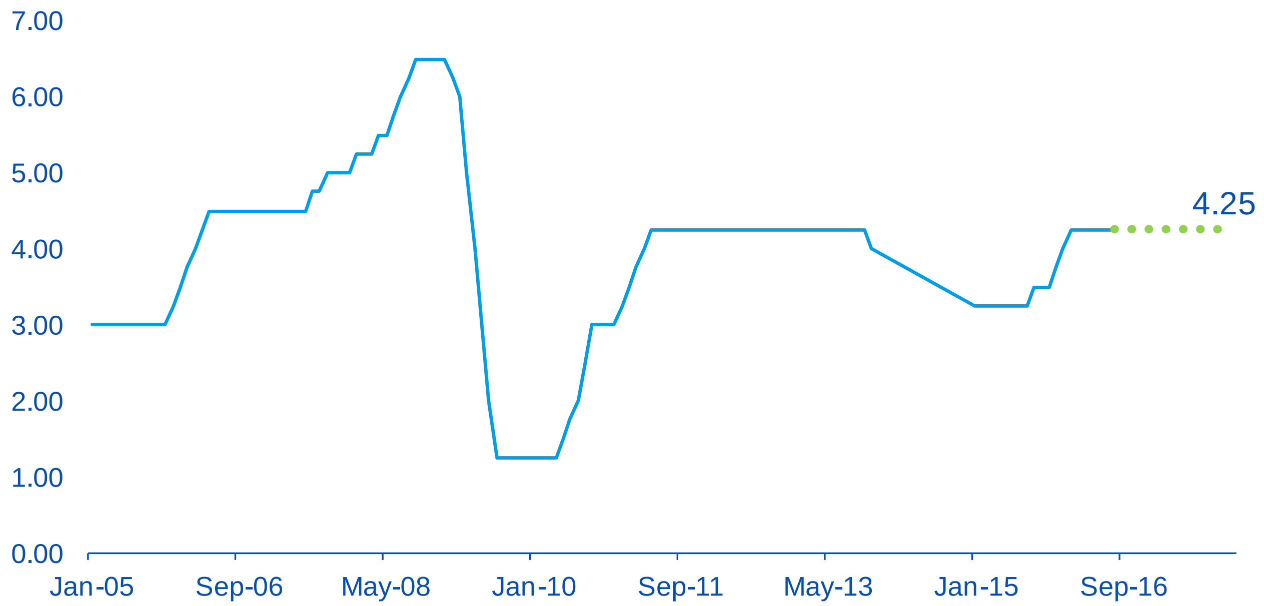


Source: BBVA Research based on Central Bank of Peru data

The fact that inflation is now back within the target range (and two-year inflation expectations) has created a milder price setting, and largely ended the upward pressure on the benchmark interest rate. Private sector spending remains weak, however, and according to our estimates, this situation will continue for the rest of the year, possibly encouraging the Central Bank to cut interest rates at some point over the next few months. We have not included this assumption in our base scenario - although evidently it cannot be ruled out - for the following two reasons. Firstly, because business and consumer confidence has significantly brightened, and if this outlook remains optimistic, private sector spending may recover - perhaps not in the immediate short-term but by the start of 2017. In its latest monetary policy announcement, the Central Bank itself pointed to this improvement in confidence. In such a situation, the Central Bank does not necessarily have to cut interest rates, especially since such a move would have a delayed impact on spending. The second reason has to do with the currency: The local currency is now under pressure to strengthen, but latent risks also persist, especially external ones (China, the Fed, US elections), and these could push up the exchange rate at any moment. Such an upward movement could be accentuated due to the fact that banks and foreign investors have very low foreign exchange positions in terms of the dollar. So, the sensible course of action appears to be to keep the policy rate at its present level and not to cut it. Furthermore, we expect the Fed to increase interest rates in December - here we differ from the market consensus, which currently assigns a probability of only 50% to this event. If the Fed does increase its interest rate, then the market will have to reshape its portfolios over the next few months, and, in particular,the market agents currently have low positions in the dollar, so this reshaping at the local level may be significant, and ultimately this process would push up the exchange rate. In this situation, it would also be prudent to maintain the current interest rate as it stands, because cutting it could further encourage pressures to depreciate.

In short, while we certainly cannot rule out a cut in interest rates during the rest of 2016, in our base scenario the most likely situation is that the Central Bank will keep the official policy rate at 4.25% in coming months (see Figure 6.3). We expect a similar picture in 2017, when private sector spending will gain traction, according to our estimates, and inflation is expected to go down further.

Figure 6.3
Official policy rate
(%)

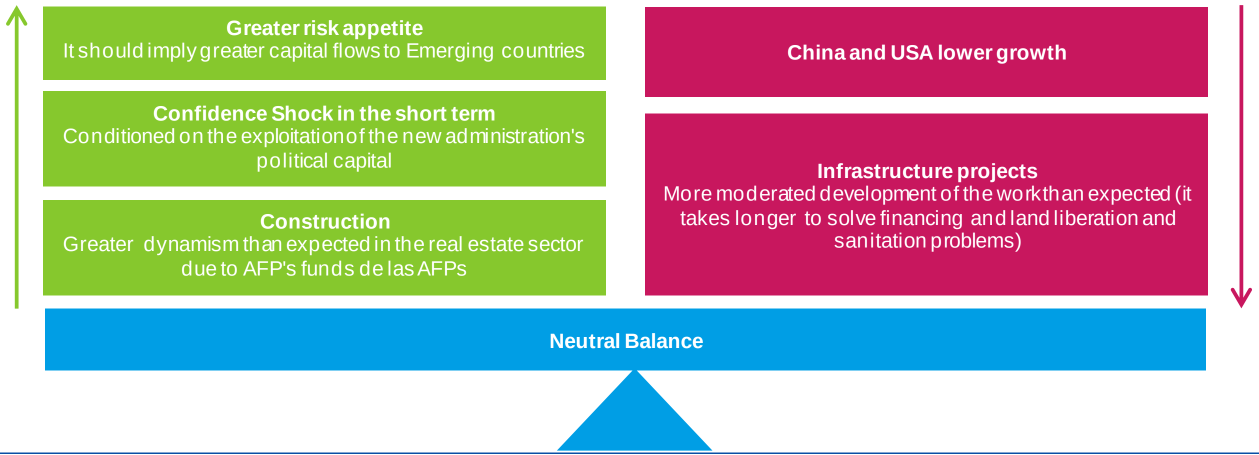


Source: BBVA Research from BCRP

7 Balanced risks on our growth forecasts 2016-2017

Less buoyant growth in the Chinese economy and the execution of large-scale infrastructure works are events that could prompt a downward bias to these forecasts. However, our GDP growth forecasts could be shifted upward due to a greater appetite for global risk (which would draw capital inflows), a positive shock from business and household confidence (due to expectations about the new government), and a more buoyant construction sector due to recent legislative changes to pension funds (which could raise investment in real estate construction if housing demand grows faster).

Figure 7.1
Balanced risks on our growth forecasts 2016-2017



Source: BBVA Research

8 Tables

Table 8.1
Macroeconomic 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	2.7	2.5
Exchange rate (per USD, eop)	2.57	2.79	2.96	3.38	3.42	3.54
Interest rates (%, eop)	4.25	4.00	3.50	3.75	4.25	4.25
Private Consumption (% YoY)	6.1	5.3	4.1	3.4	3.1	3.4
Public Consumption (% YoY)	8.1	6.7	10.1	9.5	5.7	2.2
Investment (% YoY)	16.3	7.3	-2.1	-5.0	-1.3	5.4
Tax Revenue (% GDP)	2.3	0.9	-0.3	-2.1	-2.9	-2.9
Current Account (% GDP)	-2.7	-4.2	-4.0	-4.4	-3.3	-3.4

Source: BBVA Research Peru based on BRP

Table 8.2
Macroeconomic forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD, eop)	Interest rate (%, eop)
Q1 14	5.0	3.4	2.81	4.00
Q2 14	1.9	3.4	2.80	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	4.4	4.3	3.41	4.25
Q2 16	3.6	3.3	3.32	4.25
Q3 16	3.5	3.0	3.35	4.25
Q4 16	3.1	2.7	3.42	4.25
Q1 17	5.3	2.6	3.46	4.25
Q2 17	4.7	2.7	3.48	4.25
Q3 17	3.3	2.7	3.52	4.25
Q4 17	4.0	2.5	3.54	4.25

Fuente: BCRP y BBVA Research Perú

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