RESEARCH

Peru Economic Outlook

FOURTH QUARTER 2016 | PERU UNIT

01
We estimate that the Peruvian economy will grow by about 3.9% in 2016 and by 4.1% in 2017 when infrastructure projects will provide support

02
Peru's currency will tend to depreciate henceforth, albeit to only a limited extent, ending 2016 at between 3.40 and 3.45 and 2017 at between 3.50 and 3.55 soles to the dollar

03
Inflation will end the year close to the upper limit of the target range and will fall in 2017 due to the cut in the general sales tax rate

04
The Central Bank will hold its reference rate at the current level of 4.25% for the next few months, as a result of which the monetary position will tend to be neutral

Index

Closing date: 31 October 2016

1. Summary

During the last few months we have seen no significant changes in the drivers of growth in economic activity in Peru, which continues to be driven by the extractive sectors. Metal mining production, and in particular copper production, continues to show high rates of growth. However, as the new mines that came into operation last year draw ever closer to their full operating capacity, this thrust has started to ease off, and will continue to do so in the next few quarters. The contribution of mining to GDP growth will therefore diminish from now on. We estimate that in this context, and with the adjustment to public spending announced by the government for the rest of the year, economic activity will increase by close to 3.9% in 2016.

For 2017 on the external side we foresee the US and Latin America performing better, which will benefit Peru's non-traditional exports for example, while China will continue to slow, albeit gradually. There will also be a very gradual upward adjustment of dollar interest rates globally, which will encourage investors to keep looking for attractive returns outside the advanced economies, although this effect will tend to ease gradually. Finally, the terms of trade will once again deteriorate next year, above all because average oil prices will increase significantly.

On the domestic front, our baseline scenario for 2017 incorporates five main factors. Firstly, an acceleration in the construction of infrastructure, especially for the major projects such as the modernisation of the Talara refinery, the Southern Peru gas pipeline, Line 2 of the Lima metro and Chinchero airport. Thanks to the increased progress on work on these projects, they will contribute just under one percentage point to next year's GDP growth. Secondly, a continuing high level of business confidence, which will favour investment other than in mining and formal job creation. Thirdly, dissipation of the drag effect of the sharp contraction in investment in the mining sector. Fourthly, a reduction in the thrust from mining production next year, continuing the trend which we already started to see in the second half of 2016. And fifthly, a negative fiscal impulse, since the government has committed to gradually reducing the fiscal deficit.

As a result, we estimate that in 2017 the economy will grow rather more than this year, by around 4.1%, with a greater impulse from non-primary activities and a declining one from primary activities as mining production loses strength. This forecast is consistent with a recovery in private sector spending, especially investment, which will be partly reflected in increased imports, whereas the increase in exports will be more contained, as will that in public spending in view of the proposed consolidation of fiscal accounts.

As for the financial markets, investors have been showing increased appetite for domestic assets. On the one hand the low interest rate environment in the advanced economies, with negative rates in some cases, sends investors on a "search for yield" in other markets and regions of the world, among them Latin America. On the other hand, Peru's macroeconomic indicators remain solid, and this attracts demand for its financial assets. This has been reflected for example in increased holdings of Peruvian sovereign bonds by non-resident investors, the dip in yields on these bonds and in country risk, the stock market rally and the success of the recent sovereign debt issue. Looking ahead, we see the appreciation of domestic assets moderating, since there have been no changes in the fundamentals of the Peruvian economy. In the case of the exchange rate in particular, we continue to project depreciation of the national currency in the coming months, ending this year at between 3.40 and 3.45 and 2017 at between 3.50 and 3.55 soles to the dollar. This is firstly because we believe the US Federal Reserve will soon restart the upward cycle of its key rate, and this will lead investors to adjust their portfolios in favour of financial assets in dollars at the expense of riskier ones. And secondly because the current account deficit, which is still significant at more than 3% of GDP and thus above the level which we estimate would stabilize the external liabilities of the economy, will prove impossible to finance in 2017 with the inflow of capital largely earmarked for acquiring assets in the private sector. The depreciation of the sol in the remainder of the year (by about 1%) and in 2017 (between 3% and 4%) will however be limited, since financial conditions in dollars globally will tighten only gradually, so that dollar interest rates will remain relatively low.

As for prices, beyond the passing uptick which has once again pushed inflation above the target range in the short term, we estimate that in November it will resume its downward trend, to end the year close to the ceiling of the target range. Next year, with a one percentage point cut in the general sales tax (similar to VAT in other countries), pressures on demand continuing to be contained, with domestic demand and private sector spending each increasing by about 3.5%, limited currency depreciation and inflationary expectations remaining anchored within the target range, we foresee inflation falling to around 2.5%. It will be prevented from falling further by the downward resistance deriving from the higher oil prices we are projecting for 2017.

In view of the forecast behaviour of inflation, domestic demand and the exchange rate, the Central Bank is unlikely to alter its Monetary Policy Rate in the next few months from its current level of 4.25% which we see as being close to neutral at present. For now there is not much room for cutting the rate to speed up the recovery in private spending, since inflation is overshooting the target. Nor would it be prudent to do so, since the resumption of the US Federal Reserve's upward cycle could produce turbulence in the currency markets, which would be better to confront with a key rate like the current one rather than with a lower rate. On the other hand an increase in the reference rate in the remaining part of 2016 or in 2017 is also unlikely, since it could stifle the recovery in private sector spending, the more so when we consider that the fiscal impulse will turn negative.

Lastly, there are certain risks attached to our forecast of economic growth for 2017 (4.1%, with a recovery in private sector spending). On the external front, a correction in China's property market and the policies implemented in the US following the presidential election. At home, continued delays to major infrastructure projects, deflation of the people's high hopes of Peru's new government if improvements are not delivered quickly, and the need for greater-than-expected tightening of public spending if tax receipts do not respond as anticipated.

2. World growth is slow and fragile

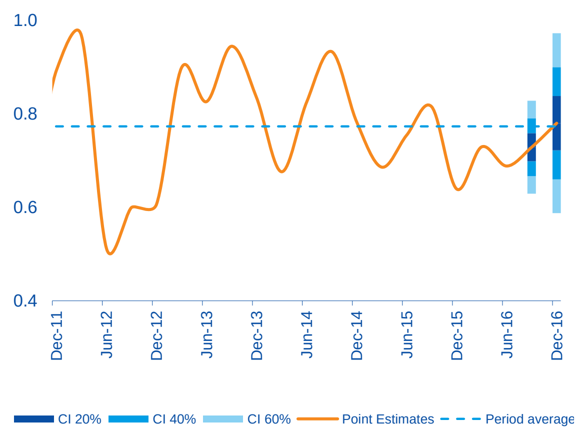
Global scenario: slow recovery with the support of central banks

There has been very little news in the past few months on the performance of the world economy. Financial stresses have remained moderate, while global activity seems to be showing signs of slight improvement (Figure 2.1) following a weak first half-year and some stabilization of international trade. All this with the continued support of the economic authorities, especially the developed countries' central banks. In particular, the US Federal Reserve's more cautious tone confirms a very gradual normalisation of interest rates once the second hike materialises, probably in December.

Meanwhile the emerging economies continue to see inflows of capital driven by the search for yield and low volatility, plus the recovery in oil and other commodity prices. As regards currencies, the US Federal Reserve interest rate hike expected before year-end is favouring the dollar's generalised appreciation.

Figure 2.1

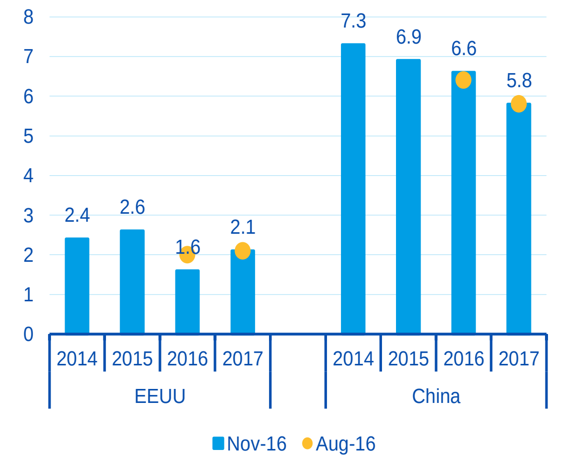
Global GDP, % QoQ. 3Q and 4Q forecasts for 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2

GDP growth in the US and China (%)



Source: BBVA Research

Changes in forecasts for the US and China, the two economies with the most influence on Latin America, have gone in opposite directions. The latest US data point to less robust growth in the second half of the year than was foreseen three months ago, following a first half that was already weak, and this leads us to revise our growth forecast for this year downwards by 0.4 pp to 1.6% (Figure 2.2). This is a clear slowdown in activity compared to the average increase of close to 2.5% in the 2014-15 biennium.

The growth composition continues to stoke concerns about medium-term potential, as it continues to show a two-speed economy, with solid private consumption but investment that might fall slightly for 2016 as a whole, after advancing by less than 1% on average in the past five years. Expectations of lower long-term growth potential might be holding back investment decisions, and might in turn feed back into reduced increases in productivity in the future, with a labour market at practically full employment. Even so, we still expect a moderate advance of 2.1% in 2017.

World growth will increase slowly in 2017 relative to 2016

Turning to China, the fiscal and monetary stimulus measures put in place at the beginning of the year to stabilize growth have borne fruit and will allow the short-term growth target set by the authorities to be met, at the expense of building up growing imbalances. We are therefore revising our growth forecast for 2016 upwards to 6.6% (Figure 2.2). Nonetheless, the outlook is still for gradual slowdown to 5.8% in 2017. Moreover, medium-term risks are increasing, especially those of overheating in the real estate sector, financial instability, depreciation of the yuan and capital flight, as well as companies' indebtedness. In the long term, doubts about growth prospects persist given the slow progress of structural reforms in certain key areas, particularly state-owned companies.

In this context, we have revised our global growth forecast slightly downwards, partly in view of the worse-than-expected results of the first half of the year in certain areas, and also in the light of the lower growth foreseen in the USA. In any case, growth will hold at around 3% in 2016, with a slight increase to 3.2% in 2017.

3. Peru: we estimate that GDP will grow by around 4% in 2016 and in 2017

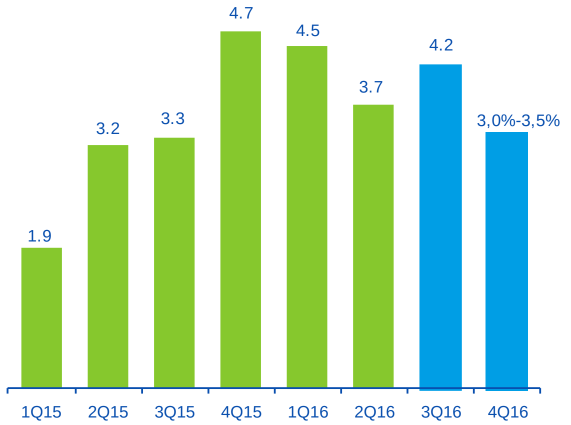
So far in this second half, economic activity has continued to be supported by the extractive sectors…

We have not seen any significant changes in growth drivers in the last few months. Domestic economic activity continues to be driven by the extractive sectors. In this context, we estimate that in the third quarter GDP will have grown by around 4.2% YoY (see Figure 3.1), driven by the primary activities as a whole, which will have grown by around 13%. Meanwhile the non-primary sectors have in general continued to perform poorly, and are likely to show combined growth of around 2% YoY, their lowest growth rate since mid-2009.

The main support among the extractive sectors continues to come from metal mining production and in particular the production of copper, which is still growing strongly. However it is also true that this rate of growth is starting to slacken (see Figure 3.2). Thus, while in the first half-year extraction of copper increased by approximately 55% year-on-year, we estimate that in the third quarter it did so by less than 40%. Despite this, the economy as a whole will have grown by more than it did in the second quarter (3.7%). This is basically explained by two reasons. The first is the postponement of the start of the first anchoveta fishing season in the north-central region of the country, which pushed up third-quarter growth figures for fisheries and primary manufacturing (and therefore GDP) to the detriment of 2Q. The second is the positive surprises in production of molybdenum and in catches of fish for direct human consumption (especially mackerel). Although molybdenum has a relatively small weight in GDP, extraction has been accelerating throughout the year, reaching significant growth rates, as a result of which its contribution to GDP growth has now become significant. We estimate that production of molybdenum will have increased by more than 50% YoY in the third quarter, contributing approximately 0.3 pp to GDP growth for the period. Part of these positive surprises could carry over into the last quarter of the year.

Figure 3.1

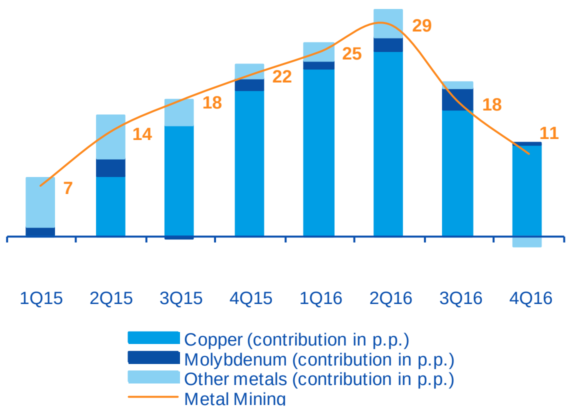
GDP (chge. % YoY)



(e): estimated; (p): projected.
Source: INEI (National Statistics & IT Institute) and BBVA Research

Figure 3.2

Metal mining production (chge. % YoY)



(e): estimated; (p): projected.
Source: INEI, MINEM (Ministry of Energy & Mines), Central Bank of Peru and BBVA Research

… but we anticipate a slowdown in the last quarter of the year due to the moderation in mining and the fiscal adjustment that has been announced. Against this backdrop, GDP will grow by about 3.9% i 2016

With the slowdown in copper production which we continue to anticipate since the new mines that came into operation last year are ever closer to their full operating capacity, mining production will moderate too (see Figure 3.2). As a result, its contribution to GDP will diminish in the last quarter of the year (see Table 3.1). On the expenditure side, this will be reflected in reduced dynamism of exports (see Table 3.2). A second factor leading to lower growth in the last quarter of the year will be the more limited increase in public spending. In order to contain the increase in the fiscal deficit and ensure that it ends the year below 3% of GDP, to which the government has committed, limits have been imposed on spending for the last few months of 2016. We estimate that these limits will reduce spending by 0.3 pp of annual GDP, leading to a slower rate of growth in economic activity in the rest of the year. Added to these two factors will be the continuing contraction in investment in mining (at a rate of around 43% YoY in real terms) and the weakness of factors affecting household spending, such as formal job creation and the slowing growth of consumer credit.

Table 3.1

GDP by productive sector (chge. % YoY)

	2015	1T16	2T16(e)
Agriculture	3,3	1,0	1,9
Fishing	15,8	-41,9	59,2
Mining and Hydrocarbons	9,3	19,8	11,7
Metal Mining	15,5	26,9	14,6
Hydrocarbons	-11,6	-9,0	-1,5
Manufacturing	-1,7	-5,3	0,9
Primary	1,3	-15,8	16,0
Non - Primary	-2,7	-1,5	-3,7
Electricity and Water	6,1	8,9	6,4
Construction	-5,8	1,5	-3,1
Trade	3,9	2,5	1,8
Other Services	5,1	4,9	4,3
Global GDP	**3,3**	**4,1**	**3,8**
Primary GDP	6,7	7,0	10,8
Non - Primary GDP	2,6	3,4	2,1

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

Table 3.2

GDP on the expenditure side (chge. % YoY)

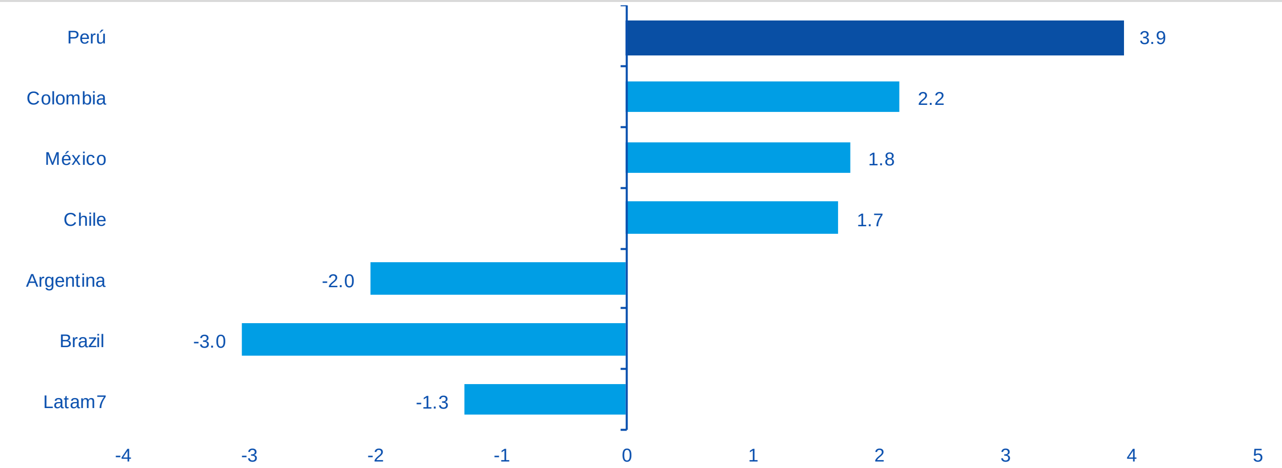
	2015	1T16	2T16(e)
1. Domestic Demand	**2,9**	**1,1**	**1,1**
a. Private Consumption	3,4	3,5	3,2
b. Public Consumption	9,5	6,8	2,7
c. Gross Domestic Investment	-0,9	-7,2	-4,4
Gross Fixed Investing	-5,1	-1,5	-2,0
- Private	-4,5	-4,6	-4,9
- Public	-7,5	16,5	7,1
2. Exports	3,5	8,3	7,2
3. GDP	**3,3**	**4,1**	**3,8**
4. Imports	2,1	-3,7	-3,1
Note:			
Private expenditure (ex stocks)	*1,4*	*1,6*	*1,2*
Domestic demand (ex stocks)	*1,8*	*2,7*	*1,7*

(e): estimated.
Source: INEI, Central Bank of Peru and BBVA Research

On the positive side, we expect the second anchoveta fishing season to be opened in the fourth quarter (from November) in the north-central region, which will boost fisheries and primary manufacturing. We also estimate that the negative drag of normalisation of inventories on economic activity, which knocked 1.6 pp off GDP growth in 1H, will be considerably more contained. In this context, we estimate that the Peruvian economy will grow by between 3.0% and 3.5% in the fourth quarter, ending the year with growth of close to 3.9%, which will once again be the highest among Latin American economies (see Figure 3.3).

Figure 3.3

Latin America: estimated GDP growth in 2016 (%)



"LatAm 7" comprises the countries shown in the figure plus Venezuela.
Source: BBVA Research

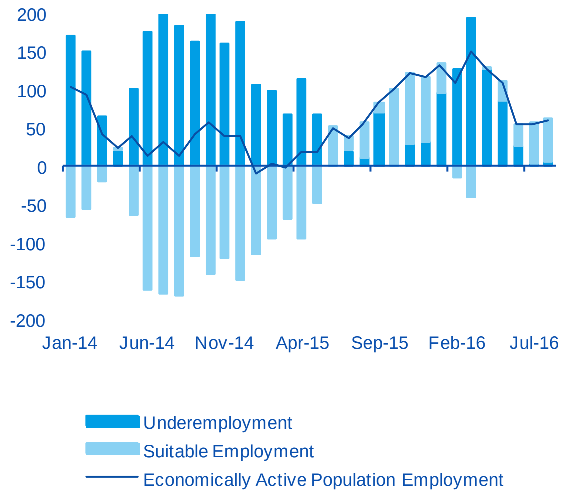
Employment still not recovering

The latest employment figures published show a persistently weak labour market. In Greater Lima, job creation mainly reflects the growth of underemployment, while creation of proper, decent full-time jobs has stagnated (see Figure 3.4). The labour market is basically absorbing young workers without university degrees in the trade and services sectors. The number of self-employed workers has also increased since last year.

Looking ahead, hiring intentions have improved (see Figure 3.5), which suggests that there could be some improvement in informal job creation in the short term. However, growth in formal demand for manpower could be constrained by the regulatory framework of the labour market, and this has been incorporated into our forecasts.

Figure 3.4

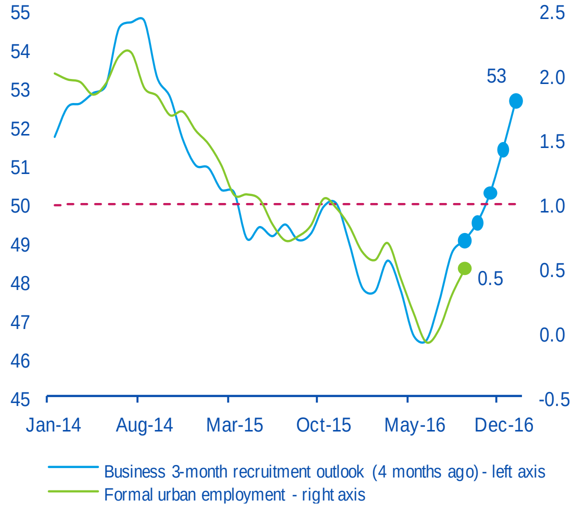
Greater Lima: increase in EAP in employment (thousands of persons, chge. YoY)



Source: INEI

Figure 3.5

Businesses' hiring expectations for the next three months and formal employment in urban Peru (index and chg. % YoY)



Source: INEI and Central Bank of Peru

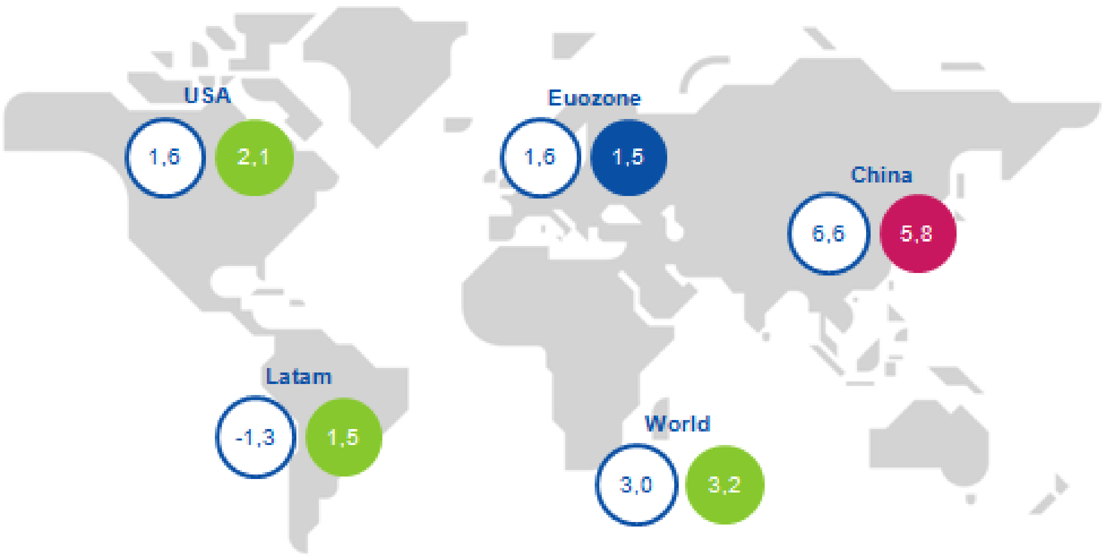
GDP in 2017? Execution of infrastructure projects will be the main growth driver next year

The baseline scenario incorporates the following assumptions.

- **On the external front:**
  - The world economy will show moderate expansion (see Figure 3.6). The US and Latin America will perform better in 2017, the US tending towards its potential growth rate and Latin America improving for the first time since 2014. This will favour demand for Peru's non-traditional exports. China, on the other hand, will continue to slow, and this will limit recovery in industrial metals prices.

Figure 3.6

Estimated world growth for 2016 and 2017 by geographical region (%)

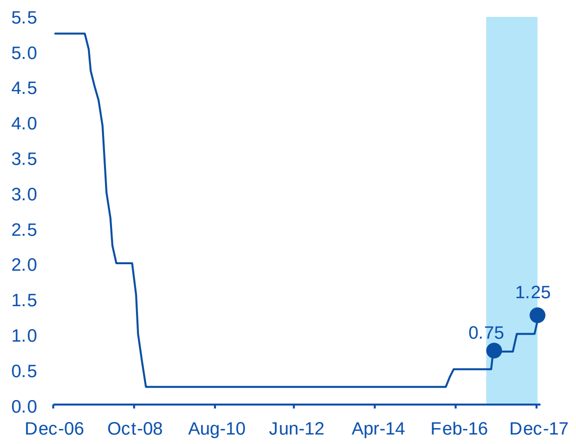


Source: BBVA Research

– The US Federal Reserve will return to the upward path for its key rates in the final part of the year. Economic conditions in the US are consistent with key rates higher than the current ones, which suggests that there will soon be an adjustment in this direction. For example, the unemployment rate is close to its long-term equilibrium level, the rate of job creation is nearly twice that needed to absorb new entrants to the labour market, and the various inflation metrics are increasing towards the Federal Reserve's objective. Added to this is the fact that conditions in general are improving in both advanced and emerging economies and global financial tensions have eased since the results of the Brexit referendum. On balance, the risks involved in postponing the resumption of the Federal Reserve's upward rate cycle even further would now seem to be rather greater than those incurred by increasing the rate too soon. We estimate that the Federal Reserve will continue to make upward adjustments in 2017, albeit very gradually (see Figure 3.7), and that long-term international interest rates will remain relatively low (see Figure 3.8).

Figure 3.7

US: interest rate (%)



Source: Bloomberg and BBVA Research

Figure 3.8

US: yield on 10-year Treasury bonds (%)

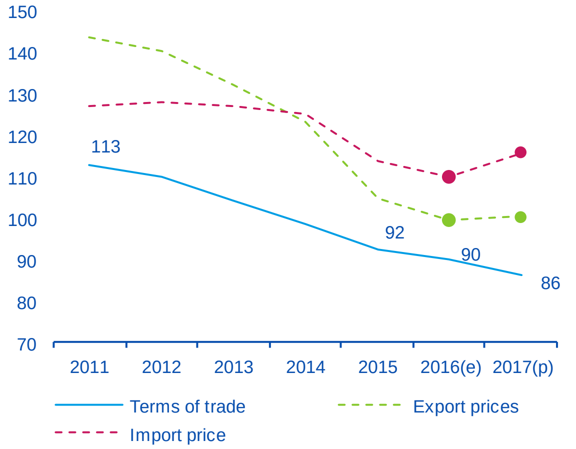
Source: Bloomberg and BBVA Research

– In an environment of low interest rates in the advanced economies, we anticipate that the “search for yield” on the part of investors will continue to be reflected, at least in the short term, in inflows of capital to the emerging economies. This will provide support to Peru’s currency, but this support will gradually diminish as global dollar interest rates are adjusted upwards.

– The terms of trade will continue to deteriorate next year (see Figure 3.9) due to increased oil prices. (We estimate that the average price of WTI will increase by 23%, see Figure 3.10).

Figure 3.9

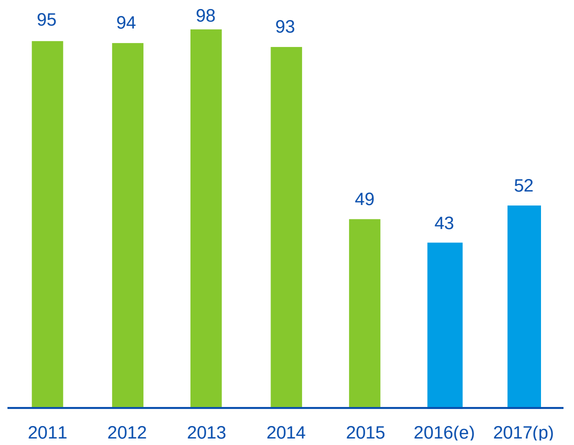
Terms of trade (index, 2007 = 100)



(e): estimated; (p): projected.
Source: BBVA Research

Figure 3.10

Price of WTI (US$ per barrel, average for the period)

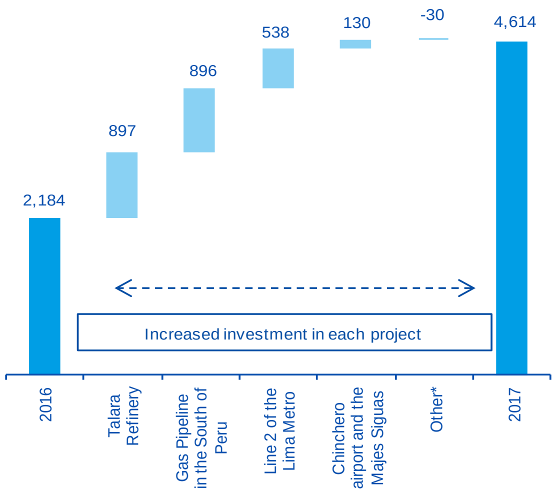


(e): estimated; (p): projected.
Source: BBVA Research

- **On the domestic front:**
  - Greater progress on construction of major infrastructure projects (see Figure 3.11). The acceleration of construction work on these infrastructure projects will involve investment in the major projects increasing by US$2.4 billion in 2017, with a contribution to GDP growth more than twice as much as that of 2016 (see Figure 3.12).

Figure 3.11

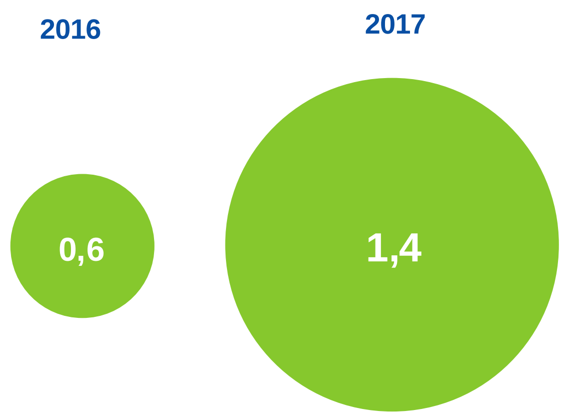
Capital expenditure on selected infrastructure projects 1/ (US$ millions)



1/: includes the Talara refinery, the southern Peru gas pipeline, Line 2 of the Lima metro, Chinchero airport and the Majes Siguas II and Chavimochic III * irrigation projects. Majes Siguas II and Chavimochic III.
Source: BBVA Research

Figure 3.12

Capital expenditure on selected infrastructure projects 1/: contribution to GDP growth (in percentage points)

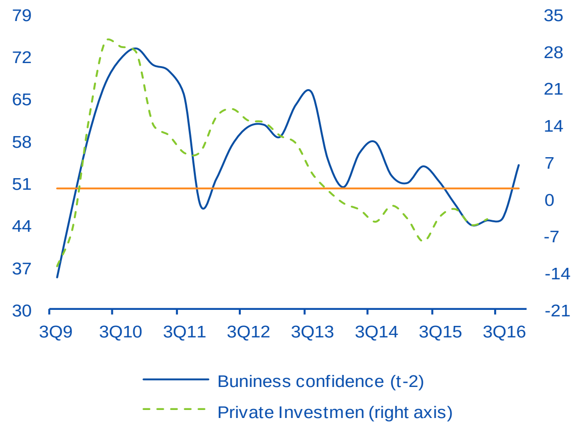


1/: includes the Talara refinery, the southern Peru gas pipeline, Line 2 of the Lima metro, Chinchero airport and the Majes Siguas II and Chavimochic III irrigation projects.
Source: BBVA Research

  - Business confidence remains high, around levels reached recently (see Figure 3.13). This will favour non-mining investment and thus also formal job creation.

Figure 3.13

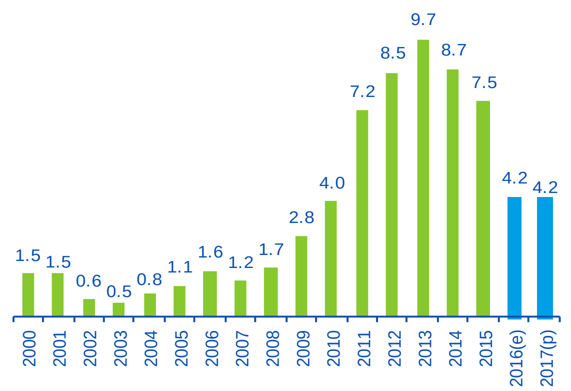
Business confidence and Private investment (in points and chge. % YoY)



Source: Central Bank of Peru

Figure 3.14

Mining investment (US$ billions)



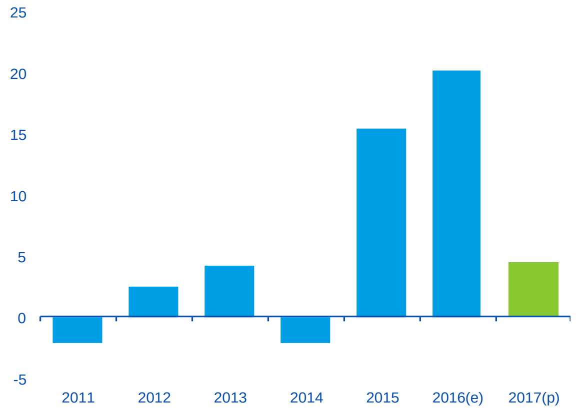
(e): estimated; (p): projected.
Source: MEM (Ministry of Energy & Mines) and BBVA Research

– Investment in mining, which in the twelve months to the end of August 2016 was down by more than US$2 billion on the figure for the twelve months to the end of 2015, will complete its process of adjustment this year, and in 2017 it will hold practically constant (zero growth, see Figure 3.14). The drag which it has been exerting on private investment will thus fade away.

– Mining production, and in particular that of copper, will continue to increase until the end of 2017 (see Figure 3.15), but its boost to GDP growth will be more and more limited (see Figure 3.16).

Figure 3.15

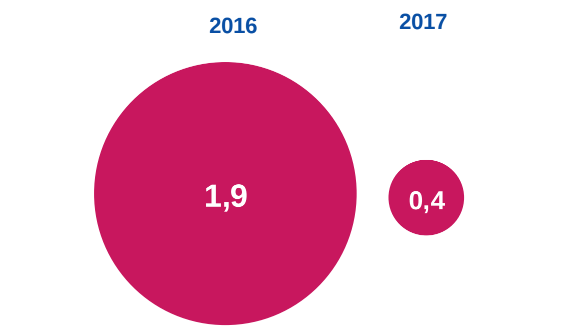
Metal mining production (chge. % YoY)



(e): estimated; (p): projected.
Source: INEI (National Statistics & IT Institute) and BBVA Research

Figure 3.16

Metal mining production: contribution to GDP growth (in percentage points)

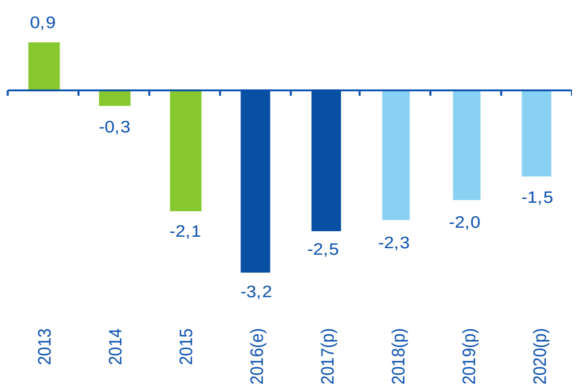


Source: Central Bank of Peru and BBVA Research

– The public sector deficit will be 2.5% of GDP, so the fiscal impulse will be negative in 2017. In this way a gradual consolidation of the fiscal accounts will begin (see Figure 3.17), leading the balance of gross public debt to increase at the projected horizon (see Figure 3.18), although even so it will still compare favourably with the level of public debt of other Latin American countries and of economies with similar sovereign debt ratings to Peru's.

Figure 3.17

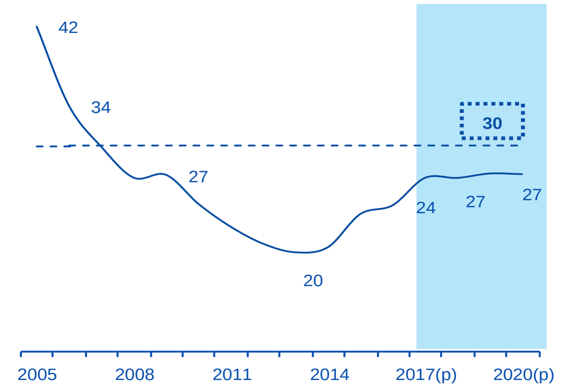
Fiscal result observed (in % of nominal GDP)



(e): estimated; (p): projected.
Source: Central Bank of Peru and BBVA Research

Figure 3.18

Gross public debt (in % of nominal GDP)



(e): estimated; (p): projected.
Source: Central Bank of Peru and BBVA Research

With these assumptions characterising our baseline scenario, we foresee GDP growing by 4.1% in 2017. In terms of sectors (see Table 3.3), we anticipate that the drive from primary (extractive) activities will continue to be significant, but that it will slacken in comparison with 2016 due to the fact that the lower rate of growth in metal mining production will more than offset the positive effect of the normalisation of weather conditions on the agriculture and fisheries sectors (and through them, on primary manufacturing).

Table 3.3

GDP by productive sector (chge. % YoY)

	2015	2016(e)	2017(p)
Agriculture	3,3	1,4	4,5
Fisheries	15,8	-3,7	18,5
Mining and oil & gas	9,3	15,5	4,8
Metal mining	15,5	20,3	4,4
Oil & gas	-11,6	-5,4	7,0
Manufacturing	-1,7	-2,2	3,0
Primary	1,3	-0,5	6,6
Non-primary	-2,7	-2,6	1,7
Electricity and water	6,1	7,6	6,3
Construction	-5,8	-1,1	4,3
Trade	3,9	2,2	2,8
Other services	5,1	4,6	4,6
Total GDP	**3,3**	**3,9**	**4,1**
Primary GDP	6,7	9,4	5,2
Non-primary GDP*	2,6	2,7	3,9

(e): estimated; (p): projected.
* Non-primary GDP excludes taxes and import duties.
Source: INEI, Central Bank of Peru and BBVA Research

Non-primary activities, in contrast, will perform better in 2017, especially construction and to a lesser extent non-primary manufacturing. Construction will be favoured by the greater progress on infrastructure works, the possible boost to the real estate market from the freeing up of 25% of the fund administered by pension fund administrators for contributors wishing to buy a first home, and by the recovery that can be seen in “autoconstruction” (people building their own houses) in a context in which job creation will gain some traction and inflation will be more contained. This increased dynamism in the construction sector will lead to greater demand for non-primary manufactured goods, which will also be favoured by the higher growth of Peru’s trading partners (especially those with demand for non-traditional exports), the recovery of investment other than in mining in an environment of renewed business confidence, and inventories that will have reached more reasonable levels by 2017.

On the demand side, we see private sector spending playing a bigger role in 2017, while export growth will slacken and the fiscal impulse will be negative as the gradual consolidation of public accounts gets under way (see Table 3.4).

Table 3.4

GDP on expenditure side (chge. % YoY)

	2015	2016 (e)	2017 (p)
1. Domestic demand	**2,9**	**1,1**	**3,5**
a. Private consumption	3,4	3,3	3,4
b. Public consumption	9,5	4,6	3,1
c. Gross domestic investment	-0,9	-5,7	4,0
Gross fixed investment	-5,1	-1,8	4,2
- Private	-4,5	-4,7	4,0
- Public	-7,5	10,3	5,0
2. Exports	3,5	7,7	3,4
3. GDP	**3,3**	**3,9**	**4,1**
4. Imports	2,1	-3,4	0,9
Note:			
Domestic demand (excl. inventories)	*1,8*	*2,2*	*3,5*
Private spending (excl. inventories)	*1,4*	*1,4*	*3,5*
Public spending (consumption and investment)	*4,2*	*6,2*	*3,6*
Accum. of inventories (contribution to GDP growth)	*1,1*	*-1,1*	*0,0*

(e): estimated; (p): projected.
* Non-primary GDP excludes taxes and import duties.
Source: INEI, Central Bank of Peru and BBVA Research

In the particular case of private investment, there will be a positive result in 2017 following three consecutive years of contraction. Non-mining investment has started to increase again in the last few quarters, and will improve somewhat more in 2017 in a context of improved business confidence and greater progress on infrastructure works. Moreover, private investment will no longer be dragged down by investment in mining, which we expect to remain practically constant next year (zero growth) following the sharp adjustment of 2016.

As for private consumption, we expect it to grow at a very similar rate to that of 2016. While inflation will admittedly be more contained, and while more buoyant investment suggests increased demand for formal employment, it is equally true that the regulatory framework as it applies to the labour market might dampen new formal job creation. Turning to exports, growth will slacken in 2017 due to the smaller increase in mining production, which will be partly offset by increased agricultural and fisheries exports (as meteorological conditions return to normal) and non-traditional products (recovery of growth in Latin America and greater dynamism of the US economy).

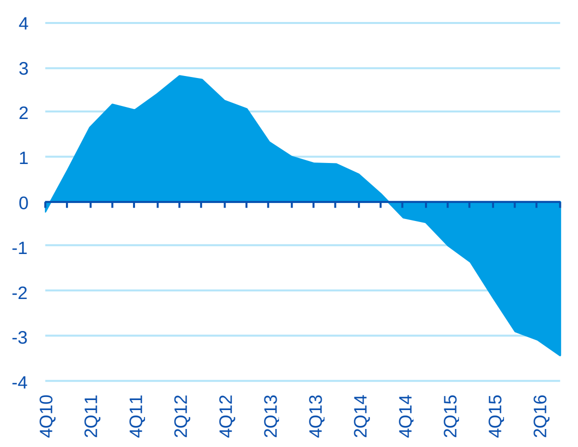
In summary, we estimate that in 2017 economic growth will be somewhat greater than this year, with increased input from non-primary activities due to greater progress on infrastructure works, business confidence, normalisation of inventories and the reduced drag from mining investment, while the contribution of primary activities will decline, in spite of the return to normal meteorological conditions, due to mining production's losing strength. This forecast is consistent on the demand side with a recovery in private sector spending, especially investment, which will be partly reflected in increased imports, whereas the increase in exports will be more contained, as will that in public spending in view of the proposed consolidation of fiscal accounts.

Fiscal policy: consolidation in sight

On a cumulative basis for the twelve months to the end of September, the fiscal deficit was 3.4% of GDP (see Figure 3.19). This is a level that had not been seen since the beginning of the century, and is due to both reduced revenues and increased spending, the former resulting from weak domestic demand and tax refunds[1], the latter from progress on the construction of such projects as the Talara refinery.

Figure 3.19

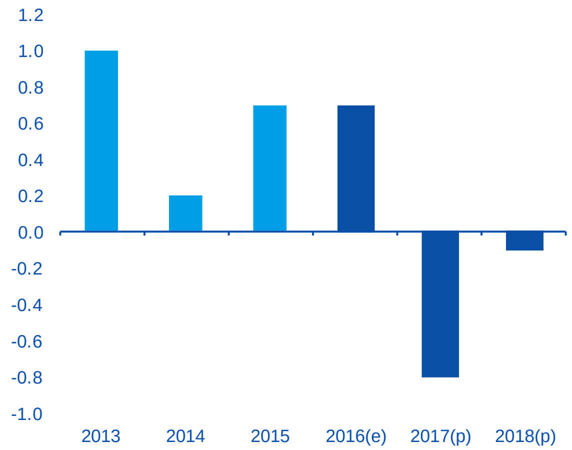
Fiscal result (% of GDP)



Source: Central Bank of Peru

Figure 3.20

Fiscal impulse* (% of GDP)



* A positive fiscal impulse in a given period results from an increase in the structural primary result relative to that of the preceding period. (e): estimated; (p): projected.
Source: BBVA Research

In order to contain the widening of the fiscal deficit and comply with its commitment to a deficit for 2016 of not more than 3% of GDP, the government taking office at the end of July has set caps on ministries' spending for the rest of the year. As mentioned previously, we estimate that these caps will reduce spending by approximately 0.3% of GDP. The government has also announced that from next year it will seek gradual reductions in the deficit, from 2.5% of GDP in 2017 to 1.0% in 2021. This would bring it back to the limit established in the Fiscal Responsibility and Transparency Act (LRTF in the Spanish initials). We have incorporated the trend in the fiscal deficit set out by the government for the coming years into our baseline scenario. This implies that the fiscal impulse, which was positive in 2016, will turn negative next year (see Figure 3.20). The rate of growth in public spending will slow. With this trajectory for the fiscal result and our GDP growth forecasts, we estimate that gross public debt will stabilize at a level equivalent to 27% of GDP in the medium term (see Figure 3.18).

Finally, it is important that the process of gradual fiscal consolidation proposed by the government for the coming years should materialise. This will limit the risk of an increase in public indebtedness possibly leading to reduced economic growth in the medium term (see Box 1: Public debt and growth).

1 : Increased refunds of IGV (general sales tax, similar to VAT) to mining exporters (Cerro Verde and Las Bambas) and accelerated recovery of the IGV paid by companies involved in the construction of infrastructure projects such as the southern Peru gas pipeline.

Box 1

Public debt and Growth

How worried should we be about increased government debt? Globally, the debate about the implications of public indebtedness has revived in the last few years, in a context of substantial increases in the sovereign debt of the advanced economies. Two subjects in particular have commanded attention: (i) the causal link between public debt and medium-term growth, and (ii) the possible existence of public debt thresholds which, if surpassed, have appreciable negative effects on growth.

The economic literature suggests that high government indebtedness could have a negative effect on medium-term growth because: (i) it leads to higher interest rates, which affect investment and capital accumulation, (ii) it forces the government to impose more distorting taxes in order to meet its future debt payments, (iii) it introduces greater uncertainty about the economy, and (iv) it limits the use of countercyclical fiscal policy, leading to greater volatility and therefore lower growth.

In 2010, professors Rogoff and Reinhart published a document stating that they had found that for some reason when governments of advanced economies exceeded levels of indebtedness of 90% of GDP, growth seemed to slow appreciably[2]. The existence of the 90% threshold established by these researchers was subsequently questioned on the basis of errors of estimation and omissions from the sample of countries. However, the debate remains open.

It is now fairly generally agreed that there is a negative correlation between the size of public debt and growth, although the causal link is by no means always clear. Moreover, it is generally considered that the relation between these variables depends on idiosyncratic factors such as the quality of each country's institutions, and that there is no clear evidence of the existence of thresholds beyond which the effect of one variable on the other is intensified. Finally, the evidence seems to indicate that the trend in government debt is just as important as its level for assessing the fiscal implications for growth prospects.

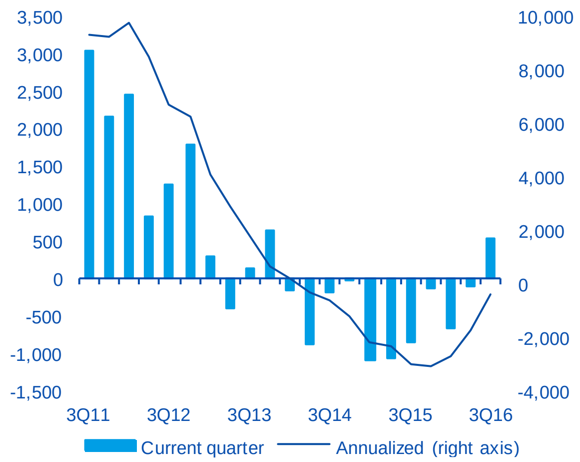
[2] : Reinhart, C. and Rogoff, K. (2010): "Growth in a Time of Debt", NBER Working Paper No. 15639.

External accounts? The balance of trade has been improving, but we estimate that the current account deficit will still exceed 3% of GDP in 2016 and 2017

The balance of trade turned positive in the third quarter for the first time since the latter part of 2013. The trend so far this year has been one of improvement (see Figure 3.21). This is due firstly to the weakness of imports, which in turn reflects the sluggishness of domestic demand and the fall in prices of inputs such as oil and certain foodstuffs. A second factor favourably affecting the balance of trade is increased mining production, particularly of copper. These factors will generally speaking remain in place for the rest of the year, so that the fourth quarter will also show a trade surplus. As a result we estimate that the current account deficit will be 3.3% of GDP in 2016 (see Figure 3.22).

Figure 3.21

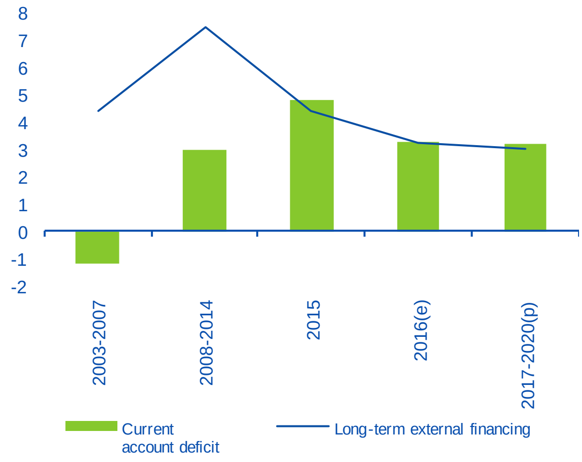
Balance of trade (US$ millions)



Source: Central Bank of Peru

Figure 3.22

Current account deficit and Long-term external financing* (% of GDP)



*Comprises inflows of capital for the acquisition of domestic private sector assets, foreign direct investment, portfolio investment and long-term loans.
(e): estimated; (p): projected.
Source: Central Bank of Peru and BBVA Research

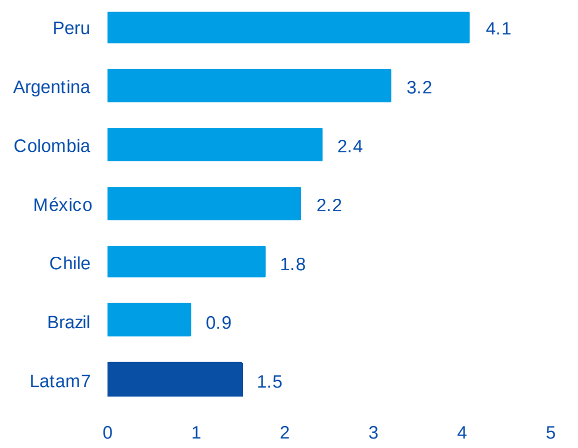
We foresee imports increasing in 2017 because domestic demand will gradually recover and prices of imported inputs, notably oil, will rise. Export growth however will slacken due to the more limited thrust from mining production, which will more than offset the increased agricultural and fisheries exports associated with the return to normal meteorological conditions and the rise in demand for non-traditional exports in a context in which the economies of Latin America and the US will perform better than in 2016. As a result, the trade surplus is unlikely to increase further next year, and we are accordingly projecting a current account deficit still above 3% of GDP in 2017. According to our estimates, inflows of capital for buying domestic private sector assets will not be enough to cover this deficit, and this will be a source of upward pressure on the exchange rate (i.e. weaker sol) in 2017.

4. Financial markets: growing interest in domestic assets

During the third quarter investors evinced greater appetite for domestic assets. On the one hand the low interest rate environment in the advanced economies, with negative rates in some cases, sent investors on a "search for yield" in other markets and regions of the world, among them Latin America. On the other hand, Peru's macroeconomic indicators remain solid, and this attracts demand for its financial assets: of the major Latin American economies, Peru has the highest growth rate and some of the best prospects for the next few years (see Figure 4.1), and together with Chile and Mexico it has the lowest rate of inflation and the smallest fiscal deficit, with a limited level of gross public debt which compares favourably with the level of public debt of other Latin American countries (see Figure 4.2) and of economies with similar sovereign debt ratings to Peru's. In addition to all this, Peru recently elected a president and a congress who generally favour pro-market policies. The major credit rating agencies recently upheld the rating and outlook for Peruvian government debt, unlike for other countries in the region.

Figure 4.1

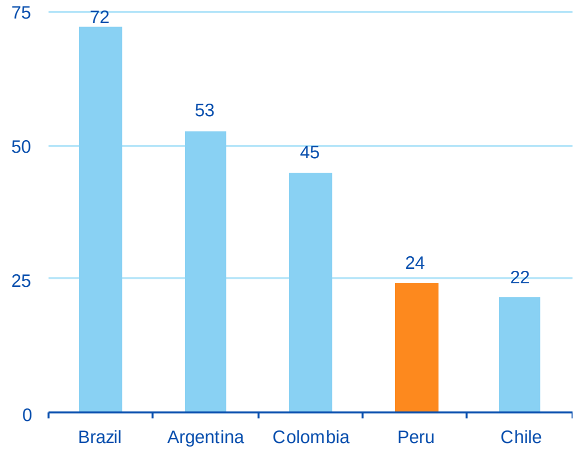
Latin America: estimated GDP growth in 2017 (chge. % YoY)



"LatAm 7" comprises the countries shown in the figure plus Venezuela. Source: BBVA Research

Figure 4.2

Latin America: estimated balance of gross public debt for 2016 (% of nominal GDP)

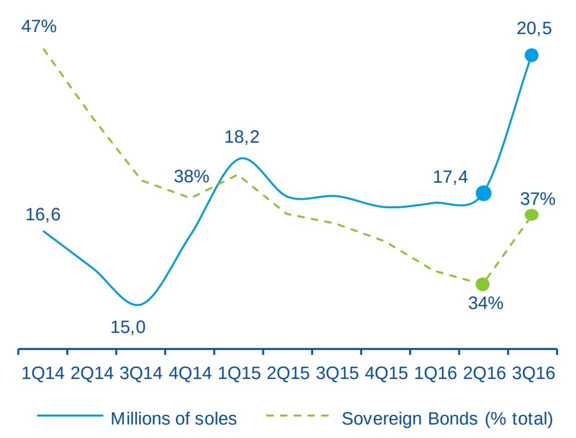


Source: BBVA Research

This growing appetite for domestic financial assets was seen for example in holdings of sovereign bonds by non-resident investors, which increased by more than S/ 3 billion in the third quarter (see Figure 4.3). Yields demanded of these sovereign bonds eased in that same period (by about 50 bps in the case of the 2020 bond, see Figure 4.4) and the country risk premium as measured by the EMBIG diminished by about 50 bps. Another positive point was the increase in corporate bond issues in the third quarter and the rise in the stock exchange indices (10% for the general index and 14% for the selective index). The growing appetite for domestic financial assets was also reflected in the extensive take-up of the Peruvian government's S/ 10.25 billion (US$3 billion) sovereign bond issue maturing 2028 carried out in the latter part of September. It was the biggest issue of sovereign debt in domestic currency ever carried out by an emerging economy in the international markets, and demand surpassed supply by more than two to one. This placement of bonds did not involve an increase in public debt, because the proceeds were used to redeem more expensive bonds and bonds close to maturity in both soles and dollars.

Figure 4.3

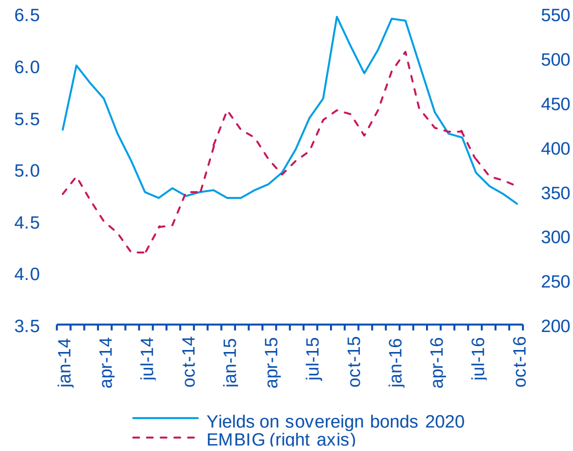
Sovereign bonds: holdings by non-resident investors (in millions of soles and % of total sovereign bonds)



Source: MEF

Figure 4.4

Yield on sovereign bond 2020 and Country risk premium as measured by the EMBIG (average level for the period in % and bps)



Source: Bloomberg

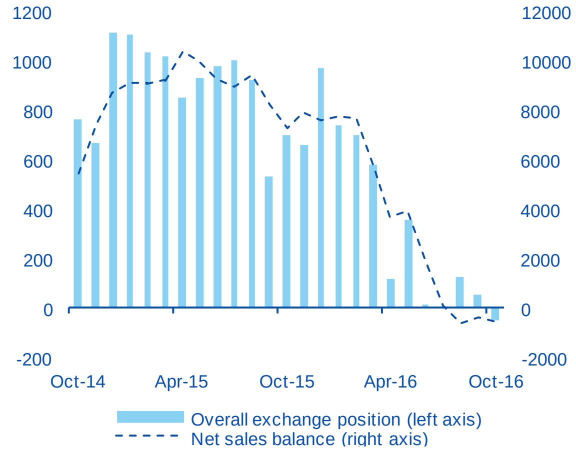
As for the exchange rate, it has shown itself to be volatile, tending to depreciate in the past three months, responding above all to market expectations of upcoming moves by the US Federal Reserve on its key rates.

Even so, we are holding to our forecast of a weaker sol going forward

We foresee the appreciation of domestic assets moderating, since there have been no changes in the fundamentals of the Peruvian economy. In the case of the exchange rate in particular, we continue to project depreciation of the national currency in the coming months, ending this year at between 3.40 and 3.45 and 2017 at between 3.50 and 3.55 soles to the dollar. This is firstly because we believe the US Federal Reserve will soon restart the upward cycle of its key rate, and this will lead investors to adjust their portfolios in favour of financial assets in dollars at the expense of riskier ones, especially those that have not yet factored in this event. At home, with positions currently favourable to the national currency (see Figure 4.5), we estimate that this adjustment will have an impact on the currency markets. And secondly, as mentioned previously, because the current account deficit, which is still significant at more than 3% of GDP and thus above the level which we estimate would stabilize the external liabilities of the economy, will prove impossible to finance in 2017 with the inflow of capital largely earmarked for acquiring assets in the private sector. The depreciation of the sol in the remainder of the year (by about 1%) and in 2017 (between 3% and 4%) will however be limited (see Figure 4.6), since financial conditions in dollars globally will tighten only gradually, so that dollar interest rates will remain relatively low.

Figure 4.5

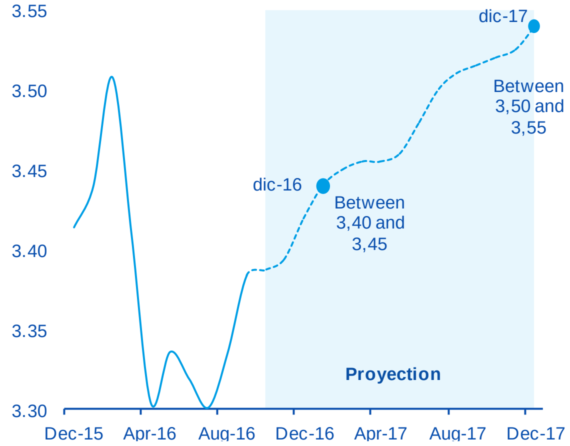
Banks: overall exchange position and net sales of non-delivery forwards (US$ millions)



Source: Central Bank of Peru

Figure 4.6

Exchange rate USDPEN (Soles per Dollar)



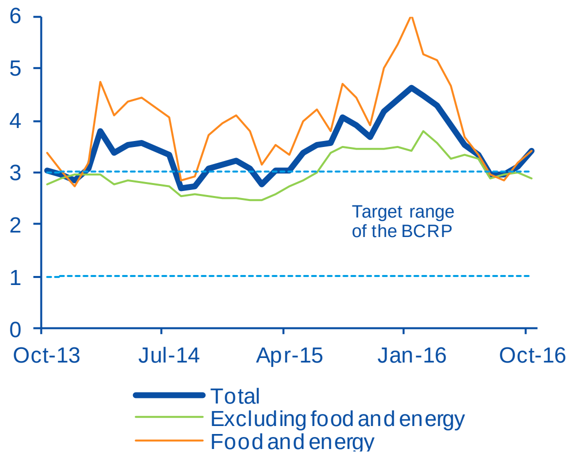
Source: Central Bank of Peru and BBVA Research

5. Monetary policy: rate unchanged in the next few months

From the foregoing sections we can derive two important facts on which to base our forecast of the Central Bank's future handling of its policy rate. First, that domestic demand will gradually recover in the next few quarters, especially private sector spending. Second, that in a global context of gradually rising dollar interest rates and falling capital inflows to emerging markets and a current account deficit still above 3% of GDP, the sol will come under moderate downward pressure (i.e. the sol/dollar exchange rate will come under upward pressure). What will happen with inflation?

Figure 5.1

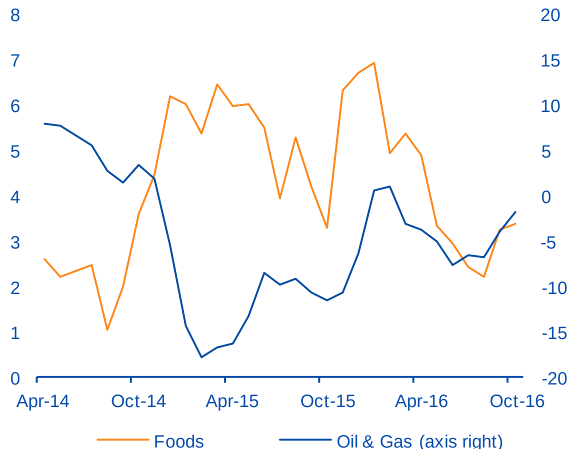
Inflation: headline, excluding food and energy (chge. % YoY)



Source: Central Bank of Peru

Figure 5.2

Inflation: selected headings (chge. % YoY)



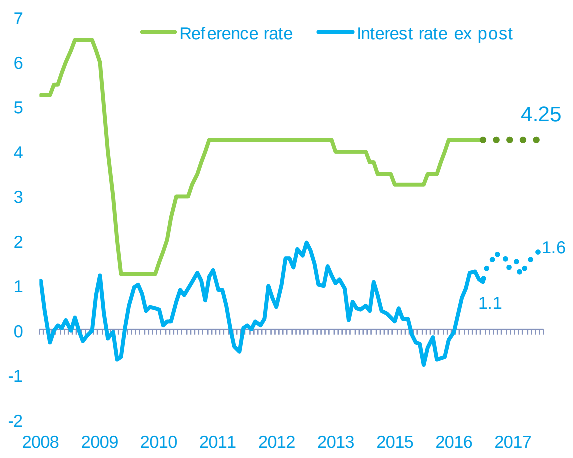
Source: Central Bank of Peru

In the past two months, after touching bottom at 2.9% YoY in August, inflation has edged up again and is now at 3.4%, above the Banco Central target range (see Figure 5.1). This uptick is associated with a surge in inflation of food and energy prices, especially non-core foodstuffs such as rice, some varieties of potato, and chicken, and in fuels (see Figure 5.2), to which is added the gradual loss of the favourable effect of the communications heading (including telephone tariffs for example). This upturn poses a slight problem for the return of inflation to the target range in the very short term. Nevertheless, we expect inflation to be close to the ceiling of the Banco Central target range by year-end. November is usually a month of low monthly inflation. And since this was not the case in November 2015 (because of the significant increase in the exchange rate, and in some food prices due to abnormal weather conditions), the year-on-year comparison in November 2016 will be favourable. This in mind, we estimate that inflation will ease next month and start to move closer to the target range. Next year, with a one percentage point cut in the general sales tax (similar to VAT in other countries), pressures on demand continuing to be contained, with domestic demand and private sector spending each increasing by about 3.5%, limited currency depreciation and inflationary expectations remaining anchored within the target range, we foresee inflation falling to around 2.5%. It will be prevented from falling further by the downward resistance deriving from the higher oil prices we are projecting for 2017.

In view of the forecast behaviour of inflation, domestic demand and the exchange rate, the Central Bank is unlikely to alter its Monetary Policy Rate in the next few months (see Figure 5.3) from its current level which we see as being close to neutral (see Figure 5.4). The room for rate cuts aimed at further boosting private sector spending in a context in which the fiscal impulse will turn negative, is limited. At the moment, inflation is overshooting the target range. Moreover, the US Federal Reserve will soon start to raise its key rates, and it is more prudent to transit this process with a policy rate at its current level than with a lower one. A rate cut could even prove unnecessary in view of two factors. First, the fact that the current weakness in private sector spending comes from investment, particularly in mining, which does not respond to movements in key interest rates. Second, the fact that non-mining investment has already started to recover and increased business confidence, the acceleration of work on infrastructure projects and the normalisation of inventories will lead to continued improvement in performance in the next few quarters. On the other hand an increase in the reference rate in the remaining part of 2016 or in 2017 is also unlikely, since it could stifle the recovery in private sector spending, the more so when we consider that the fiscal impulse will turn negative.

Figure 5.3

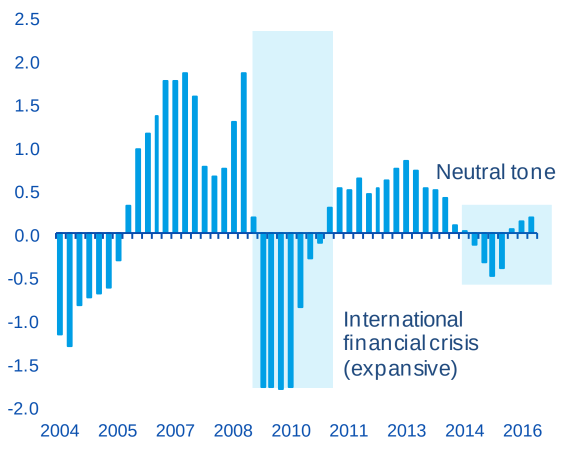
Benchmark interest rate (%)



Source: Central Bank of Peru and BBVA Research

Figure 5.4

Position of monetary policy (Interest rate in real terms, %)



Source: BBVA Research

6. Risks to our growth forecast for 2017

There are five main risks, two of them external and three domestic. The first one relates to China, and in particular the vulnerability shown by its real estate market. In an environment of low interest rates and easy access to credit (aimed at moderating the economic slowdown), the pace of placings for the acquisition of residential property has increased. This is reflected for example in the growth of mortgage lending as a proportion of total credit. Property market prices in various Chinese cities have increased significantly since the middle of last year. There is a risk of a real estate bubble, that is of prices in the property market exceeding levels that are consistent with the fundamentals of China's economy and if its property market in particular. A possible correction in prices and therefore to activity in the property sector would have negative effects on several sectors of the economy, such as construction, chemicals, cement, iron and steel and glass. The wealth of the Chinese population would also be affected, since it is estimated that around 60% of the typical family's assets are in the form of property, which in the event of a price correction would decline in value and act as a brake on household spending. In other words, correction of a real estate bubble in China would weaken China's economy, leading to reduced demand for goods and services, which would hit metal prices, global growth and therefore the Peruvian economy.

The second external risk is in the United States, more specifically in the result of the November presidential election. The polls are showing both candidates with similar numbers of people saying they will vote for them. In other words either one may win. What will most likely be different however is the set of economic measures that either will implement. This introduces a risk to our baseline scenario: at the moment it is by no means clear what economic policies will be adopted following the election.

On the domestic front, one of the risks is that of continuing delays in the major infrastructure projects. Our baseline scenario for economic growth in 2017, as previously described, relies on the construction work being speeded up. For this to happen it is necessary for land expropriation to be completed, interference to be eliminated and the financing of the works to be provided. The government is working towards these ends. However, if it does not manage in the end to speed up construction of infrastructure in 2017, or at least to the extent forecast, GDP growth will be less.

A second risk on the domestic front is that the high expectations initially greeting the new government will become deflated. In other words the risk that the population might for example perceive that economic activity other than the extraction of natural resources is not recovering, or is recovering only very slowly, that the infrastructure projects remain stuck, or that social conflicts are intensifying. In such an environment, business and consumer confidence, which has strengthened in the past few months, could weaken and thus jeopardise the recovery of private sector spending which is factored in to our baseline scenario.

The third most significant risk on the home front is that tax revenues might not pick up as forecast. This could be related for example to the materialisation of some of the other risks already referred to, but it has a particular implication: adjustment to public spending. The government has committed to consolidating the public accounts in the next few years, which for 2017 means cutting the fiscal deficit to 2.5% of GDP. If tax revenues are weaker than expected, complying with this limit to the fiscal deficit will involve having to squeeze spending, which will have consequences for GDP growth.

7. Tables

Previsiones macroeconómicas

Macroeconomic forecasts

	2012	2013	2014	2015	2016	2017
GDP (% YoY)	6.0	5.9	2.4	3.3	3.9	4.1
Inflation (% YoY, eop)	2.6	2.9	3.2	4.4	3.0	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	3.3	3.4
Public Consumption (% YoY)	8.1	6.7	10.1	9.5	4.6	3.1
Investment (% YoY)	16.3	7.3	-1.9	-5.1	-1.8	4.2
Tax Revenue (% GDP)	2.3	0.9	-0.3	-2.1	-3.2	-2.5
Current Account (%GDP)	-2.7	-4.2	-4.0	-4.8	-3.3	-3.4

Source: BCRP y BBVA Research Perú

Tabla 7.2

Macroeconomic forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange Rate (vs. USD, eop)	Interest Rates (%, eop)
Q1 14	4.9	3.4	2.81	4.00
Q2 14	1.8	3.4	2.80	4.00
Q3 14	1.8	2.7	2.87	3.50
Q4 14	1.1	3.2	2.96	3.50
Q1 15	1.8	3.0	3.09	3.25
Q2 15	3.2	3.5	3.16	3.25
Q3 15	3.3	3.9	3.22	3.50
Q4 15	4.7	4.4	3.38	3.75
Q1 16	4.5	4.3	3.41	4.25
Q2 16	3.7	3.3	3.32	4.25
Q3 16	4.2	3.1	3.38	4.25
Q4 16	3.4	3.0	3.42	4.25
Q1 17	5.3	2.7	3.46	4.25
Q2 17	4.6	2.7	3.48	4.25
Q3 17	2.9	2.7	3.52	4.25
Q4 17	3.7	2.5	3.54	4.25

Fuente: BCRP y BBVA Research Perú

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