BBVA | RESEARCH

Peru

Economic Outlook

1ST QUARTER 2017 | PERU UNIT

01
Our output growth forecast for 2017 has been reduced from 4,1% to 3,5% due to the delay in the execution of infrastructure works

02
Appreciation pressures on the Peruvian currency should revert in the coming months, with the exchange rate rising to between 3,40 and 3,45 by year end

03
Inflation is expected to remain around the ceiling of the target range for much of 2017, but should abate towards the end and close the year around 2,7%

04
There is currently little room for a rate cut that seeks to accelerate the recovery of private spending, but we do not rule it out in the second half of 2017

Contents

Closing date: 2 February 2017

1. Summary

The global environment improved in the last months of 2016 and is continuing to do so in early 2017. Global economic growth has accelerated, confidence has improved, industrial sector indicators are growing and there is an incipient improvement in global trade. Our forecasts are that world GDP will grow by 3.2% this year, slightly above the increase in 2016. In addition to the improvement in activity, inflationary pressures in developed economies have also increased. In this context, central banks in these economies will this year continue to adjust their rates gradually, as in the case of the FED, or they will begin to evaluate the quantitative stimulus they are implementing, as in the case of the ECB.

Locally, we have revised our growth projection downwards, from 4.1% to 3.5%. The delay in infrastructure construction, one of the main risk factors considered in the report that we published last quarter, materialised in early 2017. The gas pipeline works in Southern Peru, a project worth more than USD 7.3 billion, has been delayed because the consortium in charge of its construction was not able to finalise the financing to continue with the project. In line with what was established in the contract, the Government withdrew the concession. We estimate that, with respect to our previous scenario, the delay in the construction of the gas pipeline will take away about six tenths of a percentage point from economic growth in 2017.

The output growth forecast for 2017 of 3.5% takes into account infrastructure construction work on large projects such as the second Lima metro line, the new Talara oil refinery, the Lima and Chinchero-Cusco airports, and the Majes-Siguas irrigation project, which will all move forward at a faster rate this year. Our output growth forecast also considers that business confidence remains optimistic, at levels not so distant from the current one, which in turn is close to the highest for the last three or even four years, thus supporting non-mining investment and the creation of formal employment. The GDP projection incorporates too, on the extractive side, that copper production will continue to increase in 2017, albeit at a slower rate than in previous years, and that anchovy extraction will reach somewhat more than 5 million metric tonnes if current climate anomalies do not prolong. An additional element that has been considered is that the burden from the strong contraction that mining investment has undergone will dissipate, compensating for the smaller thrust of mining production and, in particular, of copper. Finally, the fiscal deficit target of 2.5% of GDP is taken into account, which means that the value added tax rate will not be reduced and that instead there will be exceptional tax revenues that will come from incentives to repatriate capital from abroad, thus giving the public sector room to accelerate its spending.

On the demand side, this forecasted GDP growth for 2017 reflects a larger contribution from domestic demand, particularly from private investment (which, even so, will still advance weakly) and from public spending, the first in an environment where the burden of mining investment is dissipating and confidence is holding in this upbeat stretch. This will mean higher imports, which together with the moderation in exports growth (reflecting the more limited expansion of mining production) will reduce the contribution of the external sector to GDP increase.

As for the financial markets, investors have been showing increased appetite for domestic assets. In that environment, the local currency has appreciated more than 2% so far this year. However, we expect that it will in the future tend to depreciate, probably more clearly in the second half of 2017, and that it will close the year at between 3.40 and 3.45 Sol per dollar. This projection is consistent with, on the one hand, that in the coming quarters capital inflows to emerging economies will tend to moderate in an environment where the Fed gradually raises its rate and central banks from other developed economies reassess their quantitative monetary stimuli and in which the incoming US administration makes investment in that country more attractive with the announced cut in taxes. On the other hand, the projection reflects that in the coming quarters the price of copper will decrease, China will moderate its economic growth, the thrust of mining production will slow and domestic demand will begin to gain traction (boosting imports), all of which will imply a certain deterioration in the balance of payments current account deficit (in the fourth quarter of 2016 it would have decreased substantially, almost closing according to our preliminary estimates).

In terms of prices, we expect that for a good part of the year inflation will keep around 3% or even somewhat above that. This projection considers that even if the world oil price does not have much additional room to move further upwards, in YoY terms it will continue to push inflation upwards (through local fuel prices), especially during the first half of the year. This forecast also incorporates some short-term pressures from food prices, related to recent weather anomalies that for the moment we believe are just transitory. In the second half of the year, when the effect of higher oil prices wears off and food prices increase at a more contained rate, inflation will tend to decline and we estimate that it will end the year at around 2.7%.

In this scenario, where spending by firms and families is still weak and where inflation is set to fall, we cannot rule out that the Central Bank will be encouraged to cut its policy interest rate in the second half of 2017. This would anticipate the smaller room the public sector would probably have to keep supporting economic activity growth next year, when no extraordinary tax revenue will be collected.

Finally, our forecasts for 2017 are subject to certain risks. On the external side, the financial vulnerabilities presented by China and the high uncertainty about the policies that the incoming administration will implement in the US. Locally, risks are related to further infrastructure works delays, lower business confidence if there is no improvement in the economy, and persistent weather anomalies. The risk balance on our economic growth forecast for this year is downwards.

2. Global environment – higher growth, but with high uncertainty

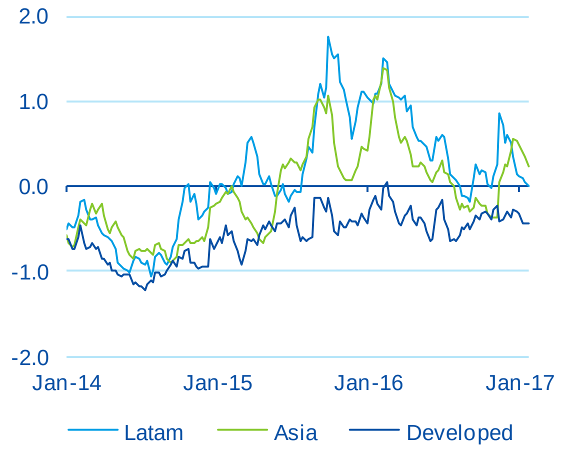
Increased global economic growth, but uncertainty is high and there are long-term risks

The global environment improved in the last months of 2016 and is continuing to do so in early 2017. Global growth accelerated in the last quarter of 2016, confidence has clearly improved in all areas and the indicators for the industrial sector are growing alongside a budding improvement in world trade.

Despite this acceleration, the outlook for 2017 and 2018 is plagued with uncertainty. This is principally related with the economic policy of the new US administration, the shape of which remains largely to be seen. Fiscal stimulus and deregulation measures have been announced in various sectors, which was positively received by the markets in developed economies, but not in the emerging ones, which registered capital outflows and depreciation in their currencies, reflected in an increase in financial tensions at the end of 2016 (Figure 2.1). However, announcements of protectionist measures can seriously damage international trade in the medium and long term and affect confidence in the near future, especially outside the US. Likewise, the uncertainties still pending on US economic policies appear to have been moderating market optimism since the beginning of the year.

Figure 2.1

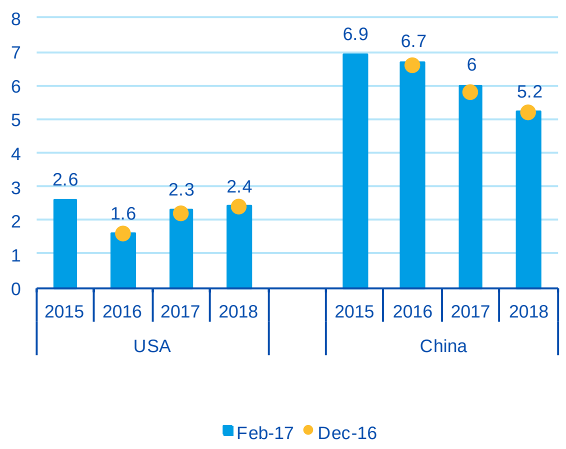
BBVA financial stress index



Source: BBVA Research

Figure 2.2

GDP growth in the US and China (%)



Source: BBVA Research

The magnitude of inflationary pressures is another unknown opening up at a global level. Raw material prices (in particular oil) have picked up somewhat more than expected in recent months, following the OPEC agreement and improved activity. If to this, we add the size of the balances accumulated by the developed countries' central banks in recent years due to quantitative easing programmes and the prospect of fiscal stimulus, the result is that the risks of deflation of just a few quarters ago have been replaced by inflationary pressures, generating a number of questions about the responsiveness of their monetary policy.

In principle, the Federal Reserve remains cautious and continues to aim for a relatively slow rate normalisation. Our forecast is for two interest rate increases to take place this year, with a further two in 2018. For its part, we expect the ECB to begin the process of withdrawal from QE in early 2018 and decide on the first interest rate increase at the end of that year.

Overall, our growth projections for 2017 in the major economies have not been substantially revised, although they are subject to a greater degree of uncertainty than usual. The base effect of increased growth at the end of 2016 and its inertial effect, together with the fiscal stimulus packages expected in the US, encourage us to slightly upwardly revise the forecasts for the US and Europe and slightly more for China, while the forecasts for Latin-American countries are being revised downward, principally due to idiosyncratic factors. In particular, in the US we anticipate growth of 2.3% and 2.4% in 2017 and 2018 (Figure 2.2). In China, we expect growth of 6% in 2017, which would be reduced to 5.2% in 2018, given the vulnerabilities facing the economy and an economic policy aimed more at ensuring financial stability than maintaining growth. Thus, overall growth should increase slightly from 3% in 2016 to 3.2% in 2017 and 3.3% in 2018.

Global growth will increase from 3% in 2016 to 3.2% in 2017 and 3.3% in 2018

The risks are largely downward and are governed by the mentioned uncertainty linked with protectionism in the US, a less friendly attitude towards immigration and the danger that the fiscal stimulus policies will not have any impact on growth and will increase inflation, or that the deregulation announced in various sectors will not be properly managed. To this is added the possible reaction of other countries or regions to these protectionist impulses. An unexpected rise in inflation could lead to the tightening of monetary policy by the main central banks, with global consequences. In the long term, the risks of the accumulation of imbalances in China, together with the lack of structural reforms in public companies, may have an impact on capital flows and currency and lead to sudden slow-down. In Europe, the political risk is high, in a year filled with election dates. Furthermore, geopolitical risks continue to run high, generally speaking.

3. Peru – output growth forecast for 2017 has been lowered to 3.5%

The downward adjustment is due to the delay in the construction of infrastructure

One of the risk factors in our growth forecasts for this year, described in our report on the previous quarter, materialised. The construction of infrastructure in 2017 has been weakened, mainly due to the postponement of the Southern Peru Gas Pipeline (GSP), a project worth more than USD 7,300 million. The consortium in charge of its construction was not able to finalise the financing to continue with the project, so that, in line with what was established in the contract, the Government withdrew the granting of the work.

We estimate that the smaller amount of infrastructure construction will take about six tenths of a percentage point away from the economic growth that we predicted three months ago for 2017. On the side of sectors, the impact will affect construction, non-primary manufacturing and services, while on the expenditure side the main impact will be on private investment (which will also drag back private consumption), mitigated by lower imports. Therefore, the expected recovery in domestic demand will be slower. Considering the time it will take to put the project back out to tender, our baseline projection scenario assumes that GSP construction work will resume in 2019.

However, the contribution of domestic demand to the growth of economic activity in 2017 will exceed the external sector

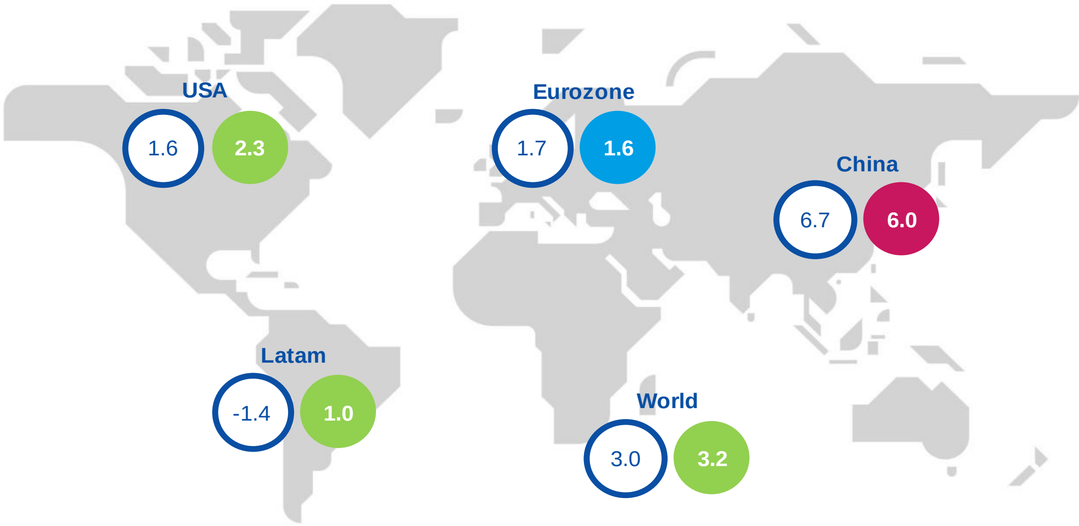
The base scenario for our forecasts considers the following:

- **External variables most relevant to the Peruvian economy**
  - Global GDP will perform better than last year (see Figure 3.1), especially in areas such as the US and Latin America, although China's dynamism will continue to moderate. The greater expansion of the US and LatAm will favour the demand for non-traditional Peruvian exports; on the contrary, the additional deceleration of China will affect the prices of the metals that Peru exports and probably the perception of risk for the Peruvian economy.
    - United States We estimate that growth will accelerate in the short term due to the expectation of fiscal stimulus from the incoming administration (tax cuts, increased infrastructure spending) and the deregulation of certain activities. This will be carried out in a context where the labour market is solid, the rate at which wages rise maintains a certain upward trend (currently standing at around 2.5% YoY) and where corporate profits are improving. In addition, the drag of investing in the mining sector is dissipating (due to the recovery in the oil price) and the correction of inventories. However, the increase in the FED rate, a strong dollar and more

structural trends (lower productivity growth, for example) are in line with our forecast for US GDP growth in 2017 to 2.3%.

Figure 3.1

Global growth by geographic area estimated for 2016 and 2017[1] (change % YoY)



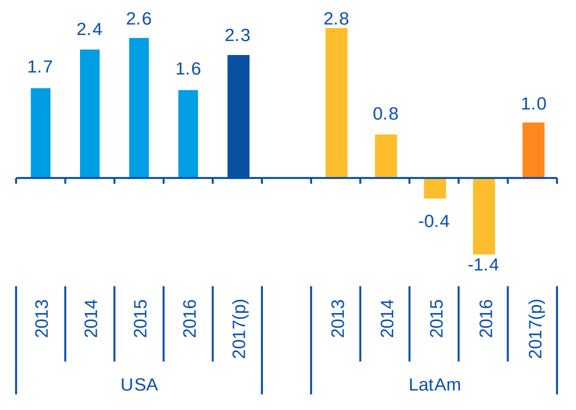
1. For 2017, green when growth accelerates, blue when it remains practically unchanged and red when it decreases.
Source: BBVA Research

- Latin America After two years, economic activity in the region will once again expand, mainly due to the recovery of Brazil and Argentina and the improvement in Colombia's performance. The common denominator will be higher private investment, which will occur in an environment where commodity prices will rise, monetary policies will tend to become more flexible in several countries, reforms will be put forward or implemented (Brazil in fiscal and social security areas and Colombia regarding the reduction of VAT on the acquisition of capital goods). Furthermore, weather conditions in Colombia will improve in a more timely manner or, in the case of Argentina, there will be a more favourable environment for business (distortions being eliminated) and for accessing finance in capital markets. In this context, we estimate that LatAm will increase 1% in 2017, after falling back by 1.4% last year (see Figure 3.2).

- China Our base scenario considers that economic growth will continue to moderate this year. Concern about growing financial vulnerabilities in some sectors of the country (real estate market, corporate sector indebtedness, public enterprises and parallel banking) will lead the authorities to lean a bit more towards the implementation of policies that prioritise financial stability instead of economic growth. That is to say, we are considering that there will be some more flexibility in the growth target for 2017, which could translate into a wider range around the medium-term target (6.5%). This will mean postponing additional monetary measures that seek to stimulate the economy and that macro-prudential measures are tightened somewhat more. In this context, we estimate that China will decelerate from 6.7% in 2016 to a rate closer to 6% this year (see Figure 3.3).

Figure 3.2

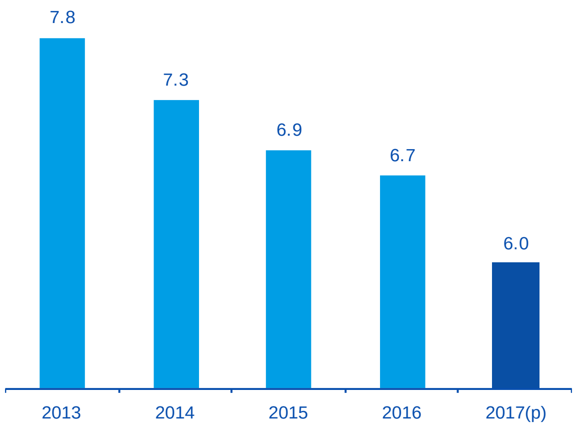
The US and LatAm[1]: GDP (change % YoY)



1. This corresponds to LatAm7, which consists of Brazil, Mexico, Argentina, Colombia, Venezuela, Chile and Peru.
(p): projection
Source: Bloomberg and BBVA Research

Figure 3.3

China: GDP (change % YoY)

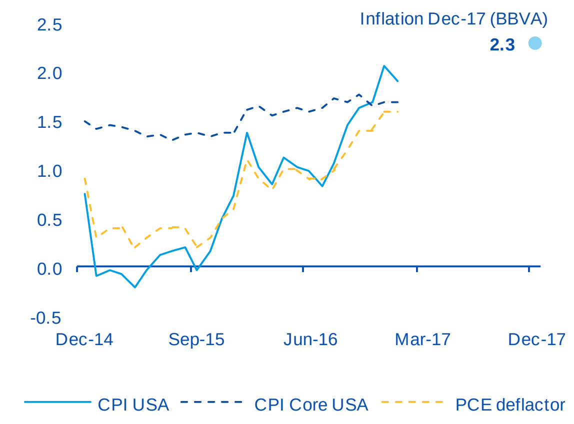


(p): projection
Source: Bloomberg and BBVA Research

– Following the adjustment of 25 basis points last December, we expect that in 2017 the Fed will continue with a gradual and moderate increase in the US monetary policy interest rate. Inflationary pressures are increasing gradually (see Figure 3.4) in an environment of higher energy prices, lower labour market slack (see Figure 3.5) and expectations of a fiscal boost from the incoming administration; the strength of the dollar has been posting a steep rise. We anticipate that the Fed will act cautiously as there is still a great deal of uncertainty as to the policies that President Trump's administration will implement (what will be done, how it will be done, how much, when). The rotation of voting members that this year will be on the committee that takes the monetary policy decisions within the FED, (the new members have a more dovish bias than the outgoing members), also suggests that it will behave in that way. In this context, we estimate that during the first half of the year there will be a 25bp increase in the FED rate, to 1%, highly probable in June; then, in the second half, there would be another increase of similar magnitude, closing the year at 1.25%. This projection for the trend of the FED rate, higher expectations for economic growth and inflation, a certain appetite for global risk and the slight upward correction in the term-premium have been consistent with a moderate increase in yields of two-year (from the current 1.2% to 1.5% at year end) and ten-year (from the current 2.5% to 2.7% at year end) treasury bonds.

Figure 3.4

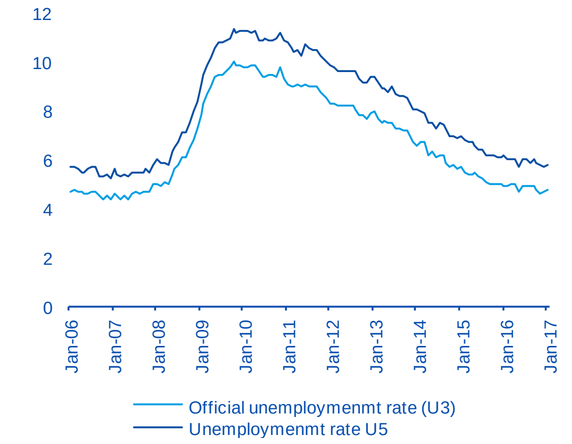
US: inflationary pressure measures (change % YoY)



Source: Bloomberg and BBVA Research

Figure 3.5

US: unemployment rate (% of the civilian work force)

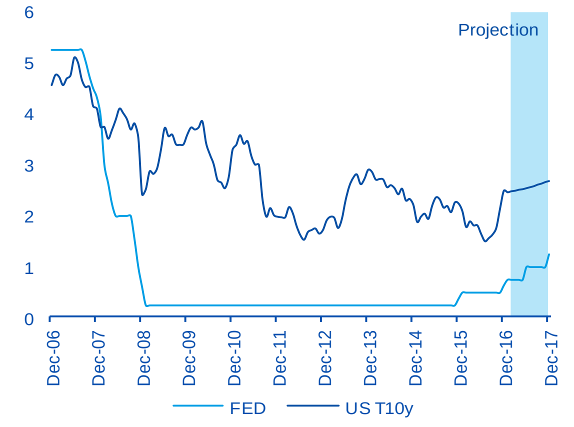


Source: Bloomberg and BBVA Research

– The "search for yield" by global investors will be maintained throughout the year in an environment of relative abundance of liquidity and still low interest rates in the more developed countries. This will continue to favour the appetite for assets of emerging economies, among them Peru. However, as US dollar-denominated global interest rates (FED, US Treasury bonds, see Figure 3.6) are adjusted upwards and pressures to curb monetary stimuli from other developed countries' central banks increases (in the case of the ECB, for example, we estimate that by the end of the year tapering could start being evaluated and that this, in early 2018) would initiate the moderation in the trend in that demand for the assets of emerging economies. Locally, the support that the Peruvian sol has at this moment will decrease, perhaps more clearly in the second half of the year.

Figure 3.6

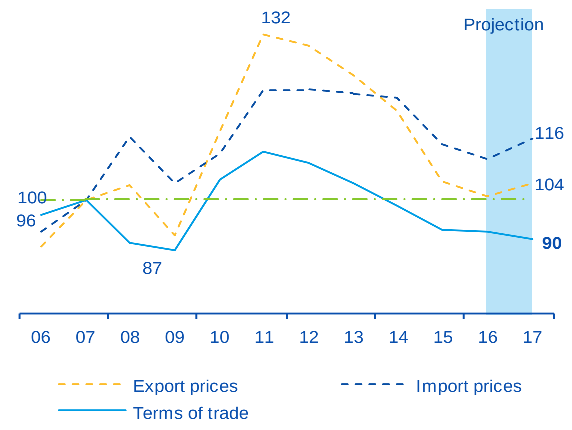
US: FED rate and yield on 10-year Treasury bonds (%)



Source: Bloomberg and BBVA Research

Figure 3.7

Terms of trade (index year 2007 = 100, average of the year)



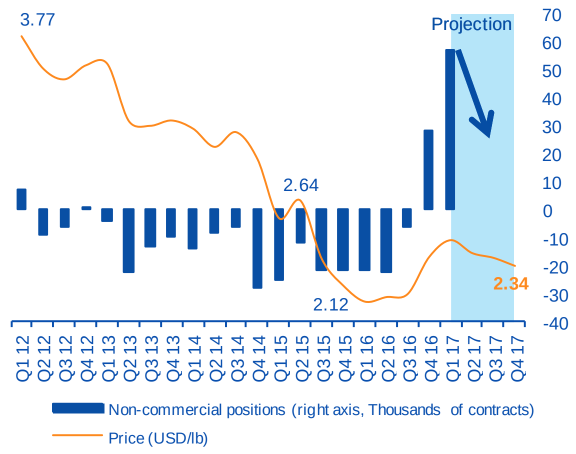
Source: Central Bank of Peru and BBVA Research

– The terms of trade as an average for the year will revert back in 2017 (see Figure 3.7), mainly due to the fact that although the price of copper is set to rise, the price of oil will also increase and in a more pronounced way.

- We estimate that the average price of copper will increase by 9% in 2017. At this time, the price of this metal, Peru's main export, is around 2.60 USD/lb. We believe that this level is far from what the most fundamental variables in the market suggest; on the contrary, it is mainly explained by a great deal of activity on the part of non-commercial agents (see Figure 3.8). These positions, which speculate that the price of copper will rise, have increased significantly over a short time. We expect that in the coming months these speculative positions will be corrected, so that the copper price will decline, being in the fourth quarter of the year at around 2.35 USD/lb. Despite the expected decline over the year, the average price of copper in 2017 (2.41 USD/lb.) will be higher than last year (2.21 USD/lb.)

Figure 3.8

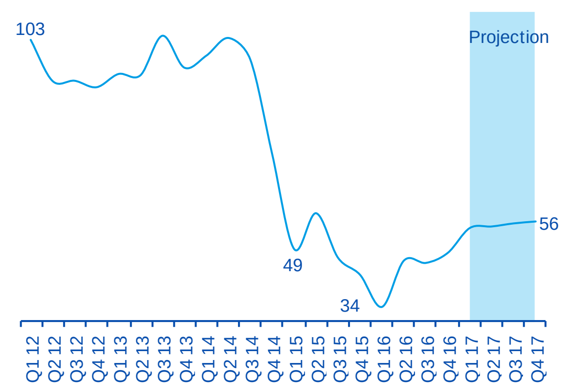
Copper: price and net non-commercial positions (average for the quarter)



Source: Bloomberg and BBVA Research

Figure 3.9

Price of WTI oil (USD/barrel, average for the quarter)



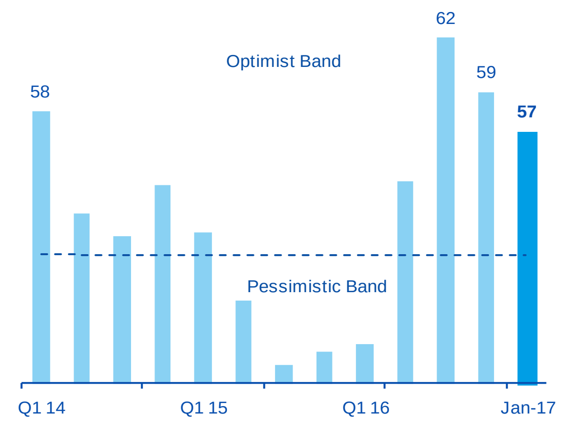
Source: Bloomberg and BBVA Research

- We forecast that the average price per barrel of WTI oil, a product imported by Peru, will increase by 28% this year. The price is currently around 53 USD/barrel. We estimate that throughout the year, it will increase gradually to around 56 USD/barrel in the fourth quarter. This will take place within a context in which, in general, the agreement on production quotas between the main oil exporting countries will continue to be implemented, leading to a downward correction of inventories, thus giving price support. The strength of the dollar, the recovery of shale oil production in the US (as a result of the price increase since the first quarter of last year) and some improvement in production in Libya and Nigeria will all limit the increase in the listed price. With this forecast, we anticipate that, for the price of a barrel of WTI oil throughout the year, the average price will increase in 2017 up to 55 USD/barrel from the 43 USD/barrel of last year.

- **Local Variables**
  - Progress will be made in the construction of major infrastructure projects. The list of the largest projects we are keeping track of, includes one transport project (the second line of the Lima metro), two hydrocarbon projects (GSP and the new Talara refinery), two airports (Lima and Chinchero-Cusco) and two irrigation projects (Chavimochic III and Majes-Siguas). Our base projection scenario considers that this year the construction of the second line of the Lima metro, the Talara refinery, the Lima airport expansion, the Chinchero airport in Cusco and the Majes-Siguas irrigation project will accelerate. However, it considers that there will be no major progress on the Chavimochic III irrigation project or, above all, on the GSP. As a result, spending on these works will, in 2017, contribute six tenths of a percentage point to GDP growth.
  - Business confidence is being maintained on the optimistic side, at levels not very different from current ones. Despite some decline over the last four months, business confidence remains relatively high, at levels close to the highest in the last three or even four years (see Figure 3.10). This favours non-mining investment and thus total private investment (see Figure 3.11), as well as some recovery in formal employment (limited by a lack of flexibility in the labour market). The measures that the State has announced to boost investment and in general to favour the business facilitating environment (administrative simplification of the State, reduction of bureaucratic barriers) will in future support business confidence, although additional delays in construction could erode it.

Figure 3.10

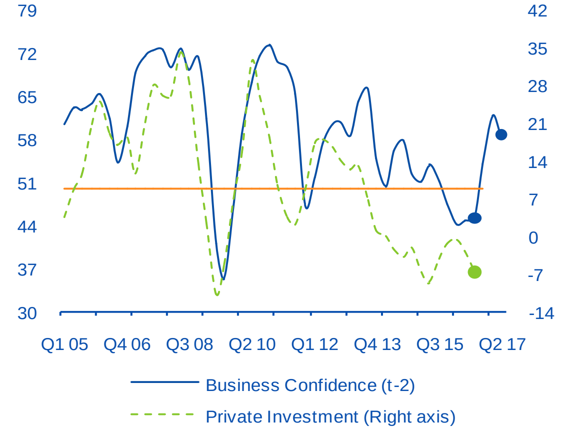
Business confidence[1]
(in points, quarterly average)



1. Measured through the expectation of entrepreneurs about how the economy will progress in the next three months.
Source: Central Bank of Peru and BBVA Research

Figure 3.11

Business confidence[1] and Private investment
(in points and change % YoY)



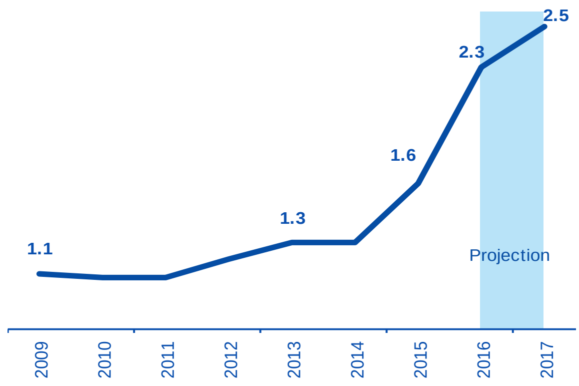
1. Measured through the expectation of entrepreneurs about how the economy will progress in the next three months.
Source: Central Bank of Peru and BBVA Research

  - Copper production will continue to increase in 2017, albeit at a slower pace than in previous years. We estimate that copper extraction will be 2.5 million metric tonnes (see Figure 3.12), 10% more than last year. This figure is based on Las Bambas achieving its maximum annual operating capacity in 2017 and that Toromocho will gradually continue to approach its peak level. As a result, increased copper production will contribute 0.5%-0.6% to GDP growth.

– Anchovy extraction will increase this year by about 100% (it decreased by 25% in 2016), reaching a little over 5.3 million metric tonnes. The forecast assumes that weather conditions will improve after the anomalies that occurred last year (a moderately intense El Niño phenomenon). That figure also includes the more than 600 thousand metric tonnes that were already captured last January and that correspond to part of the quota allocated for the second season of anchovy extraction belonging to 2016. Together with the positive impact it also has on economic activity, when used as an input in fish-meal and fish oil production, we estimate that the larger haul of anchovy will contribute about five tenths of a percentage point to GDP growth in 2017.

Figure 3.12

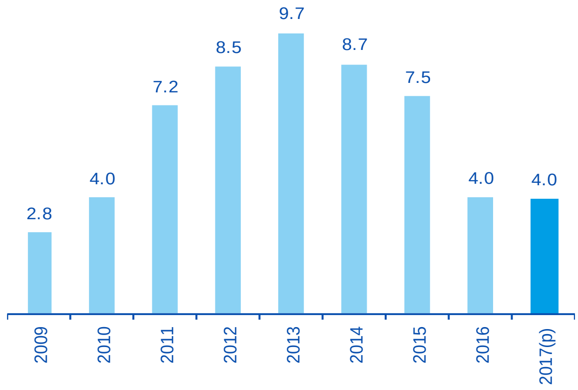
Copper production (Million metric tonnes)



Source: INEI (National Statistics & IT Institute) and BBVA Research

Figure 3.13

Mining investment (USD billions)



(p): projected.
Source: MINEM and BBVA Research

– Mining investment has completed its adjustment process and this year is practically constant (zero growth). After the last large copper mines (Las Bambas and the Cerro Verde expansion) were completed by the end of 2015, investment in the mining sector contracted sharply (see Figure 3.13), from USD 7.5 billion to about USD 4 billion in 2016. This as a result of the fact that the investment made in the production stage is less than that in the construction phase and that last year there were no other big construction projects starting up to take the batten (something that we did not anticipate in 2017). The decline in mining investment was equivalent to 1.5 percentage points of GDP. Our base scenario for this year forecasts that mining investment will remain at an amount that does not differ too greatly with that of last year and will therefore not generate a negative impact on GDP in 2017. On the other hand, when the drag dissipates, it will statistically favour the growth figure for economic activity by just over 1.5 percentage points. This positive effect will offset the lower momentum of this year's advance in copper production.

– The fiscal deficit will decline from 2.7 percent of GDP in 2016 to 2.5 percent this year, in line with the Government's target. This is, however, consistent with an acceleration of public spending as this will be financed, for example, by the exceptional tax collection that will result from the incentives to repatriate capital abroad that until now have not been declared to the tax authority. The acceleration of public spending also means that the general sales tax rate (see details below) will not be cut, a tax that is equivalent in other countries to VAT.

With these assumptions that characterise our base scenario, we expect GDP to grow 3.5% in 2017. On the sectoral side (see Table 3.1), we anticipate that the push for primary (extractive) activities will continue to be important, but will moderate compared to 2016 because the expansion in metallic mining production will be more limited in line with the lower advance of copper extraction, especially from the second quarter onward. This will more than compensate for the greater haul of anchovy, which will benefit fishing and primary manufacturing.

Table 3.1

GDP by productive sector (change % YoY)

	2015	2016(e)	2017(p)
Farming	3,4	1,1	2,8
Fisheries	15,8	-10,1	25,2
Mining and oil and gas	9,4	16,3	5,5
Metal mining	15,6	21,2	5,3
Oil and gas	-11,6	-5,4	6,4
Manufacturing	-1,5	-1,9	3,0
Primary	1,3	-0,8	10,2
Non-primary	-2,4	-2,2	0,5
Electricity and water	5,9	7,3	6,3
Construction	-5,8	-3,5	1,7
Trade	3,9	1,7	1,4
Other services	5,1	4,3	3,8
Total GDP	**3,3**	**3,8**	**3,5**
Primary GDP	6,8	9,6	5,8
Non-primary GDP*	2,7	2,3	2,9

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

The group of non-primary activities, on the other hand, will perform better in 2017. This includes the expansion that will be re-registered by both Construction and Non-Primary Manufacturing, which will however be limited in both cases. The first of them will advance after two years of decline, supported by infrastructure construction, increased public spending on investment and business confidence that has improved compared to the previous two years. The greater dynamism of the Construction sector will mean an increase in demand for Non-Primary Manufacturing, an activity that will expand again (although still in a limited way) after three years of contraction and which will also be favoured in 2017 by the higher growth of the commercial partners of Peru (particularly those that demand non-traditional exports) and the performance of non-mining investment in an environment in which the prospects of the business sector have improved.

On the expenditure side, we forecast that domestic demand will play a greater role in 2017 (see Table 3.2), while the contribution of the external sector to economic growth will decline in a context in which, the impulse from greater mining production will moderate (although non-traditional exports and fish-meal and fish oil exports will perform better) as imports start to recover due to the higher expenditure of the private and public sectors.

Table 3.2

GDP on the expenditure side (change % YoY)

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

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

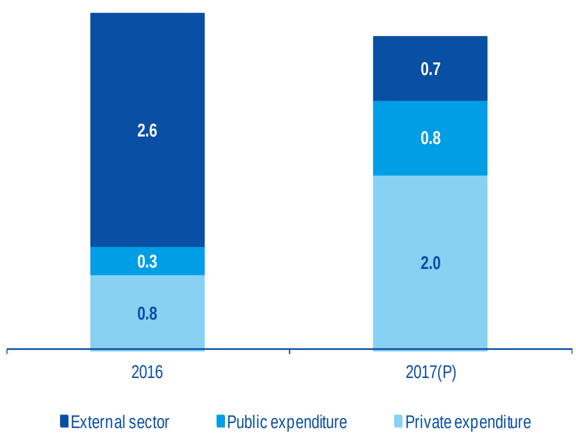
In the particular case of private sector spending, we expect investment to post a positive result in 2017 after three consecutive years of contraction. The reversal is largely related to the fact that mining investment has completed its adjustment process and will no longer be a drag. That will be reflected in this year's figure. In addition, the improvement in business confidence and the measures implemented by the State to encourage investment, and more generally to favour a ‘doing business’ environment, which could begin to have something of a positive impact given that from 2017 onward, this will support non-mining investment.

As for private consumption, we estimate that there will be some slowdown in 2017. Household spending continued to grow at around 3.4% over the last two years, despite the slowdown in employment, particularly in the formal sector, and the erosion of purchasing power, which leads to sustained price increases at a rate of more than 3.5% YoY in that period. This happened in a context in which part of the funds accumulated by the workers in their compensation for time served (CTS, which resembles unemployment insurance) was released, a measure that became permanent; certain deductions, which were made to the gratuities of the workers were eliminated; and salaries were increased in the public sector. In addition, families used banks to support their spending, which was reflected in the transitory acceleration of consumer loans. Our base scenario projection for this year does not incorporate any additional measures as described, as consumer credit has tended to lose momentum, probably due to the greater caution of families in an environment in which the generation of formal employment has weakened (and we do not anticipate a strong acceleration in 2017) and inflation continues (and will continue for much of the year) at a rate of more than 3% YoY.

In summary, we expect a GDP expansion of 3.5% in 2017, with a smaller contribution from exports because mining production will lose strength and with a greater contribution from domestic demand, which will reflect the increase that we anticipate in fiscal spending and the start of the recovery in spending by the private sector, particularly investment (see Figure 3.14). This growth rate will continue to place Peru as the fastest growing country in the region's largest group of economies (see Figure 3.15).

Figure 3.14

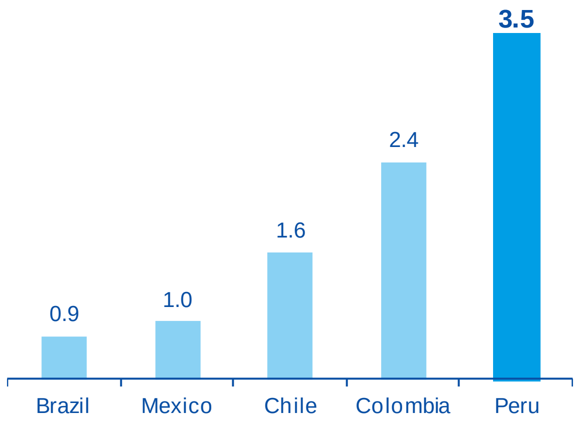
GDP from the expenditure side: contribution to growth (in percentage points of GDP)



(p): projection
Source: BBVA Research

Figure 3.15

LatAm: growth projection for GDP in 2017 (change % YoY)



Source: BBVA Research

In the first quarter of the year, in particular, economic activity will grow somewhat above 4%, supported by the renewed dynamism of primary activities

In the first quarter, the expansion of the Fisheries sector will stand out, since in January the remaining (slightly over 600 thousand metric tonnes) quota allocated for the second anchovy fishing season of last year was extracted. The extracted resource will then be used to make fish-meal and fish oil, which will favour the primary manufacturing sector. It will also highlight the greater production of copper, especially in Las Bambas; the extraction of this metal will increase 25% in inter-annual terms, perhaps the last quarter in which it does so at a double-digit rate. Finally, there will be a recovery of hydrocarbon production as the fluid transport of gas and gas liquids from the highlands to the coast through the pipeline is anticipated, something that did not happen at the beginning of last year. On the side of non-primary activities, the advance will be discrete, around 2% YoY. Even so, this figure will be higher than that registered in the previous quarter, reflecting two things – that the public expenditure adjustment implemented at the end of last year has ended and that the negative burden of lower mining investment will begin to dissipate. These two elements will have a positive impact on construction (its decline will moderate) and on non-primary manufacturing (possibly expanding again, something that it has not done since the second quarter of 2016).

Further ahead? The deepening of measures to boost investment, and, in general, to favour the environment for doing business, can improve future growth prospects

We project an average annual growth of 3.7% for the period 2018/2021. By 2018, in particular, we expect GDP growth that is not too different to the one we estimated for this year, because although the public sector will have less space within which to spend, since the extraordinary revenues of 2017 will no longer be present and the fiscal deficit target will somewhat tighten, private sector spending will continue to recover.

For this recovery to take place, four things will be important: the advancement of concessions, greater incentives to invest, simplification of administrative procedures in the State and a reduction of bureaucratic barriers.

As for the progress on the concessions, this year the Government is seeking to unlock projects that altogether will involve investments of USD 12 billion; their development would support 2018 GDP. It also plans to award concessions worth USD 4 billion this year, the construction of which could begin to have a positive effect on GDP from 2018. Finally, the pre- and post-awarding processes of concessions have been strengthened with the modification to legislation on PPPs – strengthening public officials who take decisions, accompanying, monitoring and facilitating the contractual execution of investment projects. A further part of these changes are higher private sector involvement in the decision-making process of ProInversión and, with regards to OxI, the elimination of the implementation limit of projects with sub-national governments, extension of the sectors in which this mechanism can be used. This may make it, possible for sub-national governments to sign joint-way agreements, in order that projects can have two sources of financing. All of this will take place in a more general framework that promotes competition and seeks to prevent companies related to acts of corruption, inside or outside Peru, being able to gain contracts with the State.

As for the greater incentives to invest, the State has introduced a tax incentive for the acquisition of capital goods by MSEs and the anticipated recovery of the general sales tax. There has also been progress regarding the administrative simplification of the State. For example, the intention is to facilitate labour recruitment procedures and commercial operating licenses, the search for standardisation of procedures at all levels of State and the analysis of the regulatory quality of administrative procedures at the level of the executive branch of State. In the latter case, all legal rules establishing administrative procedures will be reviewed, reducing or eliminating those that are unnecessary, unjustified, disproportionate, or redundant. In addition, any new rule that establishes administrative procedures in the Executive Branch will first have to be evaluated by a multi-sectoral commission before it comes into force, which will only be extended for three years (then it will have to be reassessed, something that will also apply with regard to the norms current at this time). Finally, on the reduction of bureaucratic barriers, the judgements issued will now be of general application, that is, the bureaucratic barrier cannot be demanded of anyone subject to an administrative process (and not only, as previously, the person who submitted the complaint), a mandate that fails to be complied with will be sanctioned. In addition, if the resolution is appealed against, the non-derogation mandate will remain enforceable on the administrative entity during the appeals process. In addition, anonymous complaints can be made about the imposition of a bureaucratic barrier, a situation in which INDECOPI (National Institute for the Defence of Competition and Protection of Intellectual Property) will evaluate an *ex-officio* action. All these measures also contribute to the formalisation of business activity.

The measures described above to boost investment and to favour the environment for doing business in, will have a positive impact not only in 2018 but also in future. Our base projection scenario considers that from 2019, this will be added to by the restart of the construction of the gas pipeline in the south of the country.

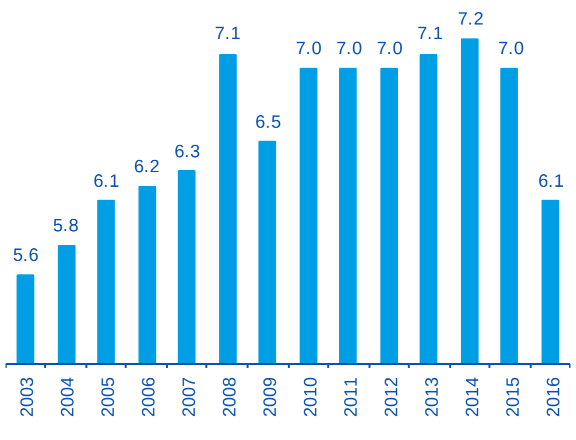
Fiscal policy: the public sector deficit will continue to fall this year, in line with the path announced by the Government

The non-financial public sector deficit would have closed last year at 2.7% of GDP, below the ceiling proposed by the Government (3%). This result is explained by the fiscal adjustment implemented during the fourth quarter of 2016, which was more intense than we anticipated. The contraction in public spending reduced GDP by about two percentage points in that quarter. An extraordinary income equivalent to 0.15% of GDP was also invested in the tax result as a result of the transfer between the two foreign private companies involved in the Línea Amarilla road project[1].

For this year, our baseline scenario assumes that the fiscal deficit will decrease to 2.5% of GDP, in line with the target to which the Government committed itself. We regard the probability of the target being met as being relatively high. We feel that the reduction in the general sales tax rate (IGV) will in the end not happen (one of the proposals during the now President Kuczynski's election campaign was that this rate would be cut). This is because the reduction is conditional on the fact that before the middle of the year, an objective in terms of the collection of net IGV on internal returns (7.2% of GDP) is met[2], which at the moment is located around 6.1% of GDP (see Figure 3.16); the target will be difficult to achieve in a context where domestic demand is only beginning to recover.

Figure 3.16

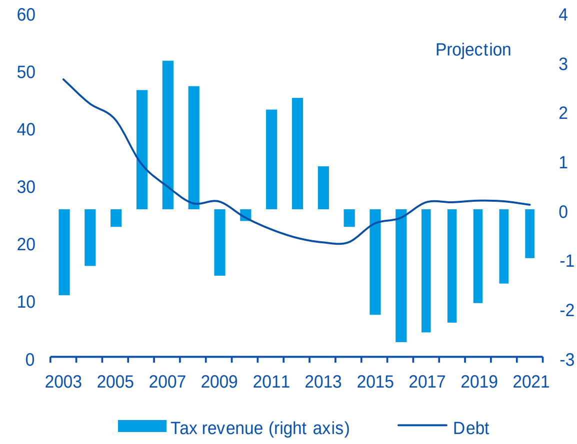
Revenue from general sales tax*
(% of GDP)



*Net returns.
Source: SUNAT, Central Bank of Peru and BBVA Research

Figure 3.17

Fiscal result and gross public debt
(% of GDP)



Source: Central Bank of Peru and BBVA Research

It is important to note that with this fiscal scenario, conditional not only on the IGV rate not being cut but also on the exceptional tax collection that will result from the incentives to repatriate capital from abroad (that to date have not been declared to the tax authority[3] and which we estimate will be equivalent to four tenths of a

1: In the statistical report of the tax authority (SUNAT), the extraordinary payment amounts to S/ 978 million and is recorded under the non-domiciled income tax heading.
2: The legal provision indicates that the IGV rate will be reduced by one percentage point from July 2017, only if the collection (annualised as of May 31 of this year) of the net total IGV of its internal returns reaches a level similar or higher than 7.2% of GDP.
3: A temporary regime is established and substitutes the income tax for taxpayers domiciled in the country who declare or repatriate and invest in the country the undeclared income generated up to 2015. The applicable rate will be 10% on the taxable amount on the part of the money that is repatriated. In the case of repatriation and investment, the rate is 7%. This measure will be in force until 29 December 2017.

percentage point of GDP), there is room for public sector spending to support the growth of economic activity in 2017. However, not only are the funds required to support growth, but also the execution of those funds. To achieve this, the central government performed the transfers to sub-national governments to continue the investments that were not completed by the end of 2016. Although this is undertaken every year, this time it happened earlier and the amount was greater. It has also brought the transfers forward of investment resources corresponding to the 2017 fiscal year, which could help increase the execution of funds available for the year. Finally, there will be weekly monitoring of the progress of the most important spending units, including those related to highways, Lima metro, educational infrastructure, the Pan American Games and urban sanitation. In this context, we anticipate that the contribution of public spending to GDP growth will be higher this year, despite the fact that it will simultaneously be sought to reduce the fiscal deficit.

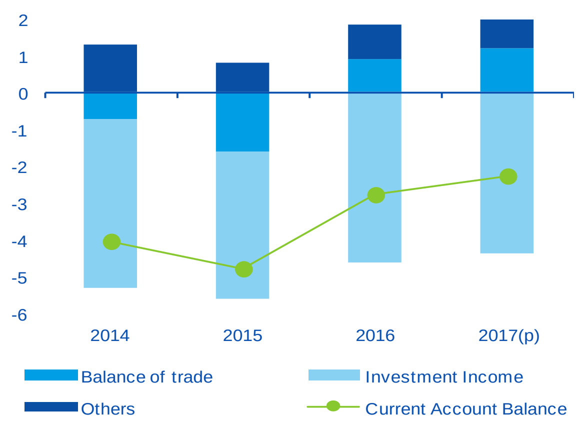
For the next few years, and in a manner consistent with the firm commitment that the Government seems to have regarding the fiscal consolidation process announced, we are taking on the government's projection of a downward trend for the public sector deficit. With this path and our forecasts for economic growth, we estimate that gross public debt as a percentage of GDP will stabilise at around 27% in the following years (see Figure 3.17).

The current account deficit will continue to decline this year thanks to higher copper and fish-meal exports

The deficit in the current account of the balance of payments declined significantly in 2016, retreating by slightly more than two percentage points (see Figure 3.18). The main element that explained this improvement was the reversal in the balance of the trade balance, which became a surplus, a result that has not been seen since 2013. The improvement in the trade balance is due both to an increase in exports (by USD 2.6 billion) and to a decrease in imports (by USD 2.3 billion). In the first case, it mainly reflects the momentum of higher mining production, particularly copper (see Figure 3.12) while in the second, the weakness of domestic demand and the decrease in average prices of inputs that Peru imports, including oil and some food is highlighted.

Figure 3.18

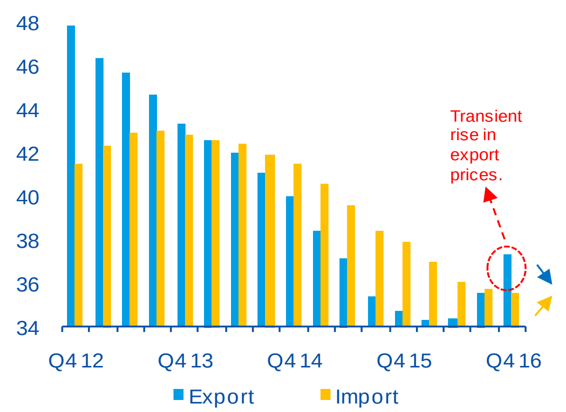
Balance of payments: current account (% of GDP)



(p): projection
Source: Central Bank of Peru and BBVA Research

Figure 3.19

Exports and imports of goods (USD billions, last 12 months accumulated)



Source: Central Bank of Peru and BBVA Research

For this year, we forecast that the current account deficit will decline to a level just below 2.5% of GDP. This will positively affect the increase in the volume of exports, especially traditional exports such as copper and fish-meal. The recovery that domestic demand will begin to register, which will cause imported volumes to perform better in 2017. The additional decline that we estimate for the terms of trade will limit an even more favourable performance from the trade balance as well as from the balance of payments on the current account.

It should be mentioned that in the last quarter of last year the current account deficit fell significantly. According to our estimates, this deficit would almost have closed in that quarter, something that has not happened since 2011, which implies a decline of around three percentage points of GDP compared to the result achieved in the same quarter of 2015 (and around 2% of GDP below the result achieved in the third quarter of 2016). The significant improvement in the current account coincides with the sharp rise in export prices (+7% YoY) - especially metals -, the significant increase in mineral production and exports and the weakness of domestic demand, which together favoured the balance of trade (see Figure 3.19). We consider that this situation is temporary and will soon be rectified, perhaps from the second quarter of this year and more clearly in the third. This is because, as explained above, the price of copper (and other metals) will yield, copper production will moderate its advance significantly, domestic demand will begin to recover and the price of oil will still rise slightly, which together will result in a deterioration of the trade balance and, therefore, of the current account of the balance of payments, in a manner consistent with the deficit that we have projected for this last variable of 2017.

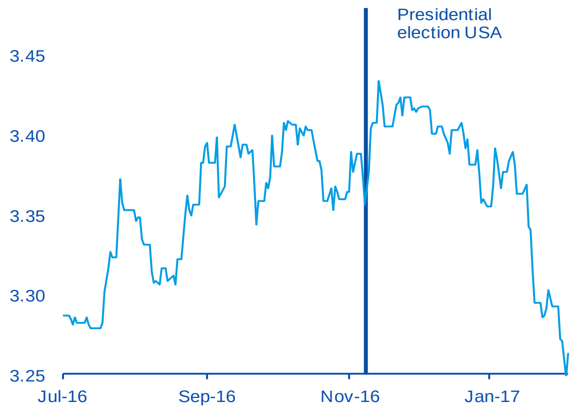
For the next few years, we forecast moderate current account deficits of between 2.4% and 2.8% of GDP. In this way, the country's external financing requirements will also remain relatively contained, which is positive in a context in which capital flows to emerging economies are expected to decline.

4. Local financial markets – revaluation of the currency and sovereign bonds at the beginning of the year

After the election results in the United States (November 8 last year), there were episodes of tension in the local financial markets, with falls in the Peruvian currency (PEN) and some assets. However, these losses were quickly reversed. In the case of the PEN, in particular, depreciation was about 1% after the US election result,. After this, it tended to appreciate and in January alone it did so by 2% (see Figure 4.1). A similar correction occurred in the yields required on sovereign bonds (see Figure 4.2).

Figure 4.1

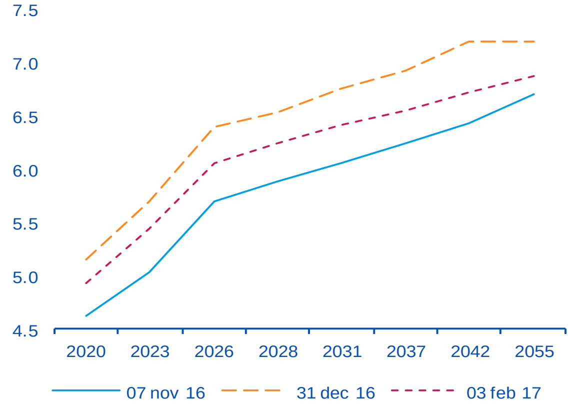
Exchange rate (USDPEN)



Source: Bloomberg and BBVA Research

Figure 4.2

Yield curve of sovereign bonds (%)

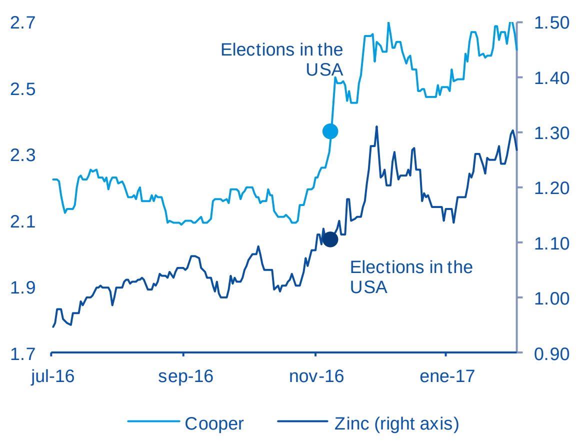


Source: Bloomberg and BBVA Research

Part of the explanation for the favourable trends in local assets would be linked to the perception that the fundamentals of the country remain relatively solid and have even recently improved. As described above, the deficit in the current account of the balance of payments decreased significantly last year and the fiscal deficit has been set on the path of consolidation. Compared to other large economies in the region, Peru stands out as the one with the highest economic growth, the lowest fiscal deficit and among those with the lowest inflation and current account deficit. If you add to this the statements of incoming administration officials in the US, who point out that they are not comfortable with a strong dollar, positive economic data from China, the significant increase in metal prices (see Figure 4.5) and the perception that the Fed will raise its rate only gradually, it is not surprising that local financial assets, and in particular the PEN, have performed well.

Figure 4.3

Price of raw materials: copper and zinc (USD/lb)



Source: Bloomberg and BBVA Research

Figure 4.4

Exchange rate (USDPEN)

Source: Bloomberg and BBVA Research

However, our forecast is that the local currency will tend to depreciate, probably more clearly in the second half of the year and that it will close the year between 3.40 and 3.45 soles per dollar (see Figure 4.6). This implies that, compared to the level reached at the end of last year, the increase in the USDPEN exchange rate in 2017 will be quite limited. This projection is consistent with six elements, most of which were described in the previous section. Firstly, dollar interest rates at the global level will be on the rise, albeit gradually. The Fed will continue to raise its policy rate (a cumulative 50bp increase in 2017), probably from the end of the first half of the year, in an environment where US labour market slack is small, inflation is rising and where anticipation exists that the incoming administration will boost the economy in the short term on the fiscal side and with deregulatory measures. We also expect that the European Central Bank will begin to evaluate tapering towards the end of the year, which will then begin in early 2018. In this context, the demand for assets of emerging economies will moderate.

Our exchange rate projection is also consistent with some other measures that the incoming administration in the US has pointed out, including tax cuts to the corporate sector, which will make investment in that country more attractive and, therefore, also moderate demand for assets of emerging economies. Third, speculative positions in the copper market will tend to normalise, which will lead to a downward price correction, from the current 2.60 USD/lb to something more around 2.35 USD/lb in the fourth quarter. As a fourth element, we expect China's growth to decline in a context in which the country's economic authorities will seek primarily to address financial vulnerabilities. This deceleration will not only have a downward impact on the price of metals, but also on the perception of risk in economies such as Peru. Fifth, there is not much more room for exported volumes to continue to increase at the pace they have been doing so lately because the momentum of mining production will decline, perhaps more clearly from the second half of the year. Finally, domestic demand will start to gain traction, which will boost imports.

In short, we anticipate that in the coming quarters there will be some increase in the deficit in the current account of the balance of payments, while capital inflows will decrease. This is consistent with the trend we envisage for the exchange rate – which currently stands at around 3.25 – in the following months. However, there will probably be episodes of volatility along the way, which could be associated, for example, with uncertainty about the election results that will take place in Europe – they could have an impact on the future of the common currency – or with the measures that the new administration in the USA finally choose to implement.

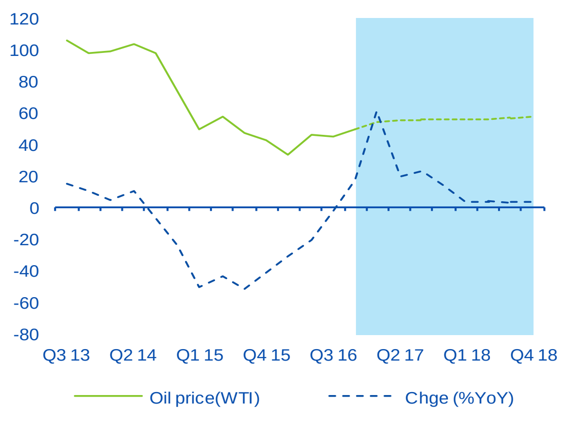
5. Inflation will fall in the second half of the year. Does this imply a policy rate cut?

Inflation continued above the target range (2%, +/- 1pp) at the beginning of the year, at 3.1%. This behaviour reflects, for example, that the prices of certain services such as Education and Health continue to advance at around 5% YoY, perhaps due to supply-side difficulties. It also shows the strong increase in the international oil price since the first quarter of last year, which has been transmitted to local fuel prices. On the other hand, the appreciation of the local currency, which has been reflected in lower rents and rates linked to the exchange rate (electric energy, for example) and a more moderate increase in the prices of certain foods (chicken, potatoes, eggs) have attenuated inflationary pressures. It should be mentioned that the rate at which inflation advances in inter-annual terms is not very different from the average observed over the last five or ten years (above 3%).

Our forecast is that for much of 2017 inflation will keep fluctuating around the ceiling of the target range or even somewhat above this. This projection considers that even if the international oil price does not already have much additional upward movement, as explained in Section 3, in inter-annual terms it will continue to push inflation upwards (through local fuel prices), especially during the first half of the year (see Figure 5.1). The projection also incorporates some upward momentum in the short term on the food side, which is related to recent climatic anomalies that we now consider as transient. The moderate expansion of household spending projected for 2017 and the relative exchange rate stability we anticipate during the first half will offset these inflationary pressures. This forecast is consistent with the inflationary expectations of the public (see Figure 5.2).

Figure 5.1

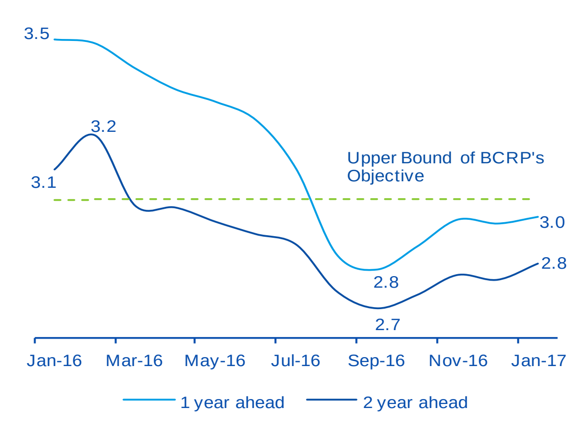
International oil price (USD/barrel, variation % YoY)



Source: Bloomberg and BBVA Research

Figure 5.2

Inflationary expectations (%)

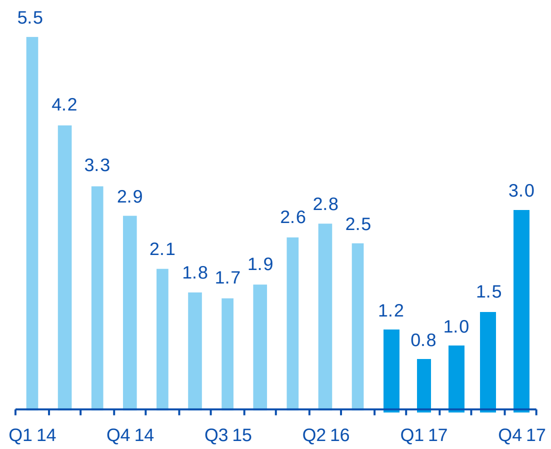


Source: Central Bank of Peru and BBVA Research

In the second half of the year, when the effect of higher oil prices dissipate and food prices advance at a more contained rate, inflation will tend to decline. However, this decline will be resisted by the gradual (although still limited) improvement we envisage for economic activity (see Figure 5.3) and the increase in the exchange rate. The balance of these factors suggests that inflation will return to the target range, standing at around 2.7% at the end of the year (see Figure 5.4).

Figure 5.3

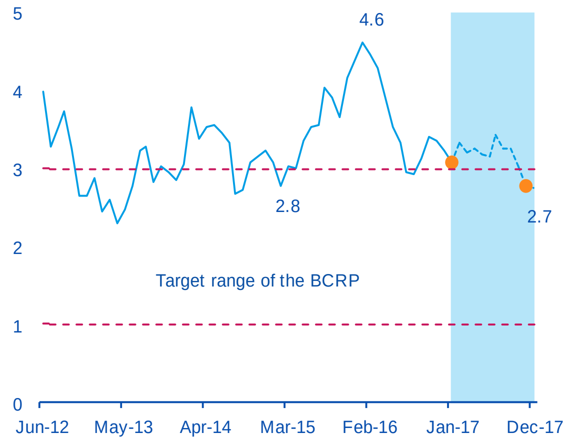
Domestic demand (excluding inventories, accumulated in last four quarters, variation % YoY)



Source: Central Bank of Peru and BBVA Research

Figure 5.4

Inflation (variation % inter-annual CPI)



Source: Central Bank of Peru and BBVA Research

In this scenario, where spending by companies and families is still weak and where inflation will go down, we cannot rule out that the Central Bank will be encouraged to cut its benchmark interest rate in the second half of 2017. This would anticipate the smaller space in which the public sector is likely to continue to support the growth of economic activity from next year.

6. Risks to our output growth forecast for 2017

There are five main risks, two of them external and three domestic. **The first is related to China, and, in particular, to the financial vulnerabilities it presents.** If these are not addressed, they could eventually derail the orderly process of deceleration (and re-composition of the sources of growth) sought by the economic authorities of that country. These vulnerabilities include the activity of parallel banking, high corporate debt, inefficient public companies and the real estate market. In the latter case, for example, prices in the real estate market of different Chinese cities have increased significantly since the middle of last year. There is a risk that these prices are above levels that are consistent with the fundamentals of the economy (housing bubble). A downward correction would have negative effects on the Chinese economy, which in turn would significantly affect world growth and the prices of raw materials[4]. Locally, the impacts would be reflected in a slower pace of activity and a further decline in financial assets, including the local currency.

The second external risk is in the United States and, in particular, in the uncertainty generated by the measures that will be implemented by the new administration in that country. So far, regarding what was said during the campaign, it is not clear what will be carried out in terms of fiscal policy, trade policy, deregulation and immigration. What is finally done could eventually have real and financial impacts different to those considered in the baseline scenario.

On the domestic front, one of the risks is that of continuing delays in the major infrastructure projects. Our baseline scenario assumes that, discounting the pipeline and any other irrigation project, construction work will be accelerated in the other projects. This implies it is necessary for land expropriation to be completed, interference to be eliminated and the financing of the works to be provided. If this is not finally achieved in time, the growth of activity will suffer.

A second risk on the domestic front is that the high expectations initially greeting the new government will become deflated. In other words, 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 this environment, business and consumer confidence is likely to deteriorate, compromising the gradual recovery of private sector spending anticipated in our baseline scenario.

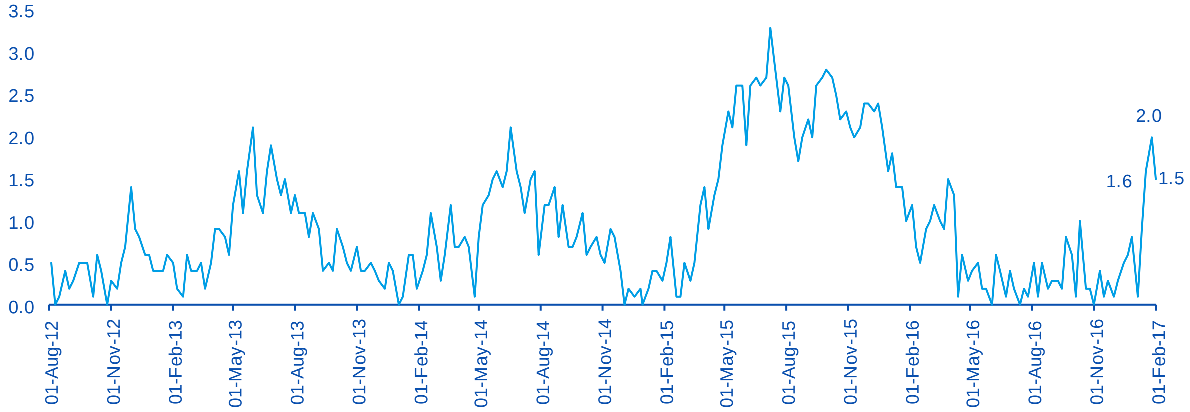
Finally, there is a risk that the recent climatic anomalies will be prolonged and have a negative impact on different productive activities. According to the latest report published by the committee that tracks these anomalies (ENFEN), the conditions for a weak coastal El Niño event have consolidated in the southern hemisphere summer[5]. Since the second week of January, sea surface temperature anomalies have

[4] . China, as well as being the second largest economy in the world, is one of the main users of raw materials. It accounts for about 40% of the world's demand for basic metals such as copper, zinc, tin and lead.
[5] . ENFEN, Official Communiqué No. 03-2017, 2 February 2017. See: https://www.dhn.mil.pe/Archivos/oceanografia/enfen/comunicado-oficial/03-2017.pdf.

increased rapidly (see Figure 7.1), which in the margin even correspond to a more intense El Niño phenomenon. The baseline projection scenario incorporates these anomalies, but assumes that they are only transitory. However, if these abnormalities persist at current levels, it would affect agriculture, fishing, manufacturing, construction, trade and services. There would also create additional inflationary pressures.

Figure 6.1

Anomaly in the sea surface temperature, Niño 1+2 (deviation from historical average, in °C)



Source: BBVA Research based on NOAA

7. Tables

Table 7.1

Macroeconomic Forecasts

	2013	2014	2015	2016	2017	2018
GDP (% YoY)	5.9	2.4	3.3	3.8	3.5	3.6
Inflation (% YoY, eop)	2.9	3.2	4.4	3.2	2.7	2.2
Exchange Rate (per USD, eop)	2.79	2.96	3.39	3.40	3.42	3.53
Interest Rate (% eop)	4.00	3.50	3.75	4.25	4.00	3.75
Private Consumption (% YoY)	5.3	4.1	3.4	3.4	3.0	3.1
Public Consumption (% YoY)	6.7	10.1	9.5	2.0	4.3	1.2
Investment (% YoY)	7.7	-2.2	-5.1	-4.9	2.1	2.9
Tax Revenue (% GDP)	0.9	-0.3	-2.1	-2.7	-2.5	-2.3
Current Account (% GDP)	-4.2	-4.0	-4.8	-2.8	-2.3	-2.4

Source: BCRP and BBVA Research

Table 7.2

Macroeconomic Forecasts

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange Rate (vs. USD, eop)	Interest Rate (% eop)
Q1 15	1.9	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	4.4	3.1	3.38	4.25
Q4 16	2.6	3.2	3.40	4.25
Q1 17	4.2	3.2	3.31	4.25
Q2 17	4.0	3.2	3.34	4.25
Q3 17	2.2	3.3	3.39	4.25
Q4 17	3.5	2.7	3.42	4.00
Q1 18	3.2	2.5	3.46	3.75
Q2 18	3.9	2.5	3.48	3.75
Q3 18	3.5	2.3	3.51	3.75
Q4 18	3.6	2.2	3.53	3.75

Source: BCRP and BBVA Research

DISCLAIMER

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