

Peru Outlook Third quarter 2017

July 2017



Summary

1



We project low growth this year with a rebound in 2018, driven by reconstruction and infrastructure spending

2



Fiscal policy: the institutional framework for reconstruction increases the probability that the fiscal boost will take place in 2018

3



Financial markets: low risk premiums for domestic assets. We expect a degree of correction going forward

4



Inflation will continue to fall over the coming months, and could hit the floor of the target range in the first quarter of 2018

5



Monetary policy: a favourable backdrop for the Central Bank to implement a more aggressive stimulus

6



Risks: (i) abroad, related to slower growth in China; and (ii) domestically, delays in reconstruction and infrastructure projects

Contents

1. Economic activity
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3. Inflation
4. Monetary policy
5. Risks

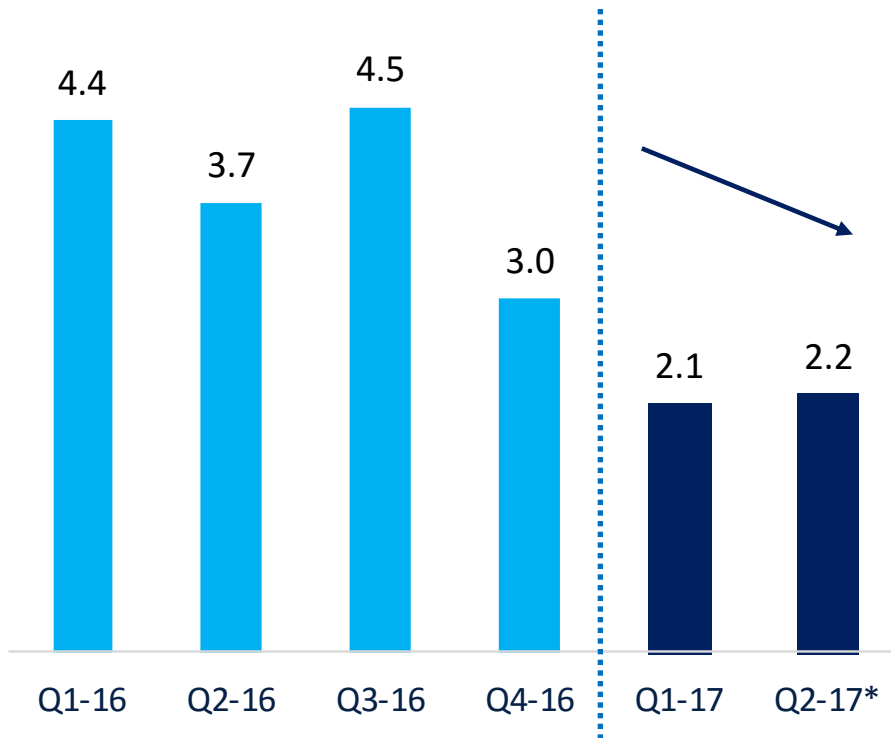


01. Economic activity



Economic activity remained weak in the second quarter

GDP
(% YoY change)



- 

Hangover from "El Niño Costero"
- 

Delays in infrastructure projects
- 

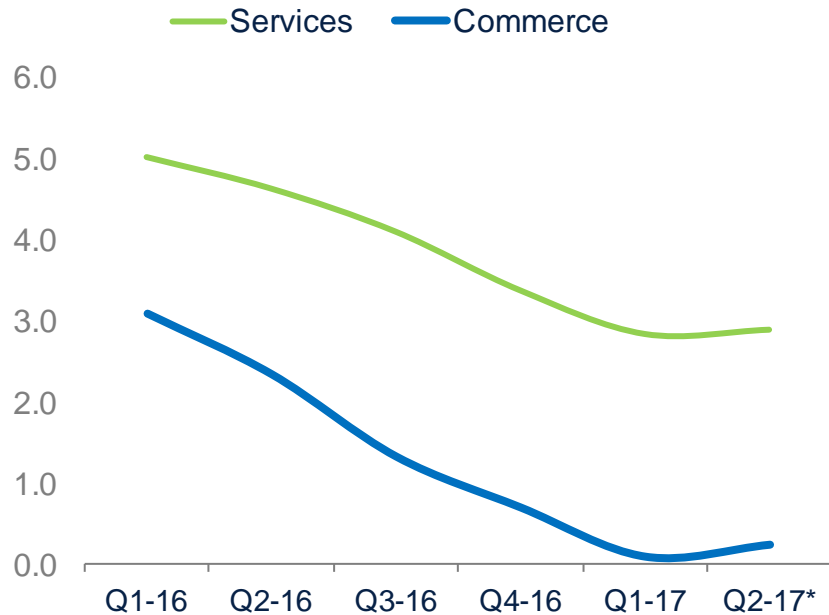
Weak public investment
- 

Increased political noise

*Estimated
Source: Central Reserve Bank of Peru and BBVA Research

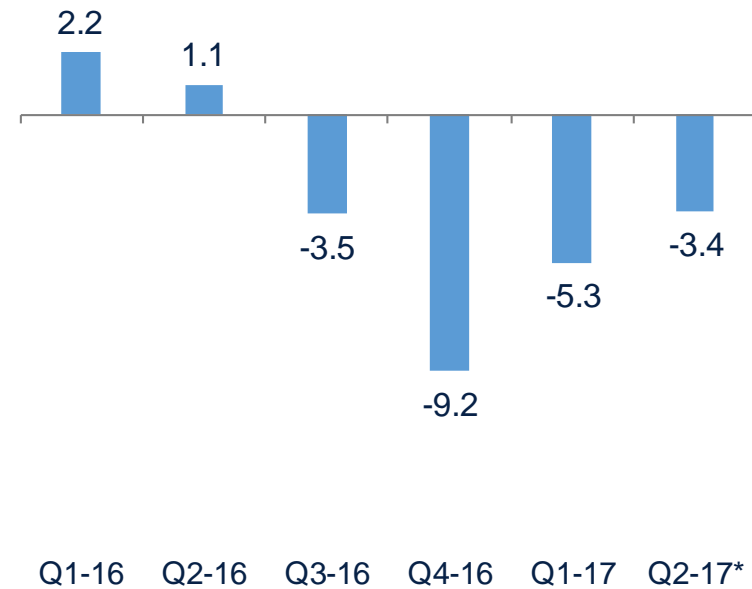
Economic activity remained weak in the second quarter: i) after-effects of “El Niño Costero” weather phenomenon

Trade and Services (% YoY change)



*Estimated
Source: Central Reserve Bank of Peru and BBVA Research

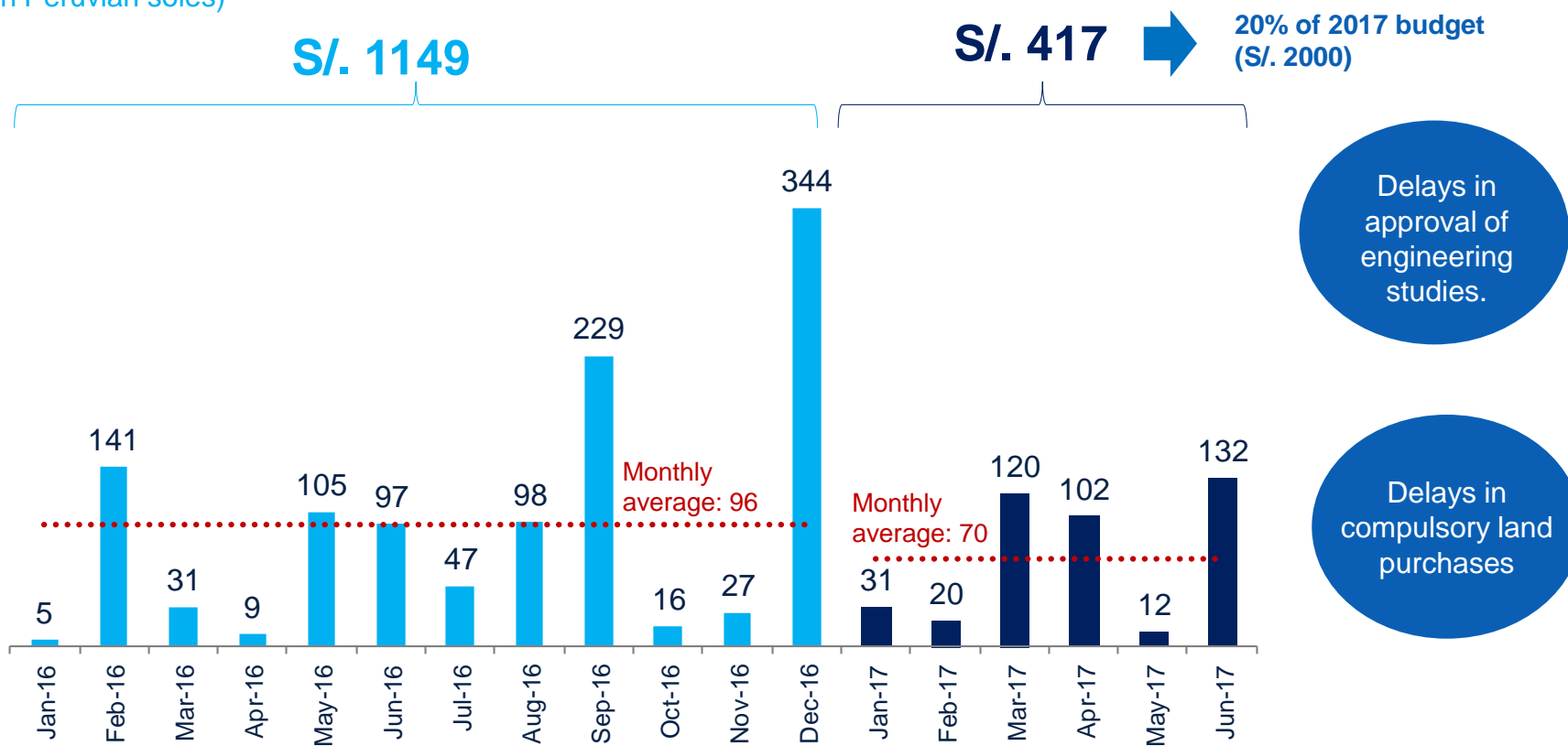
Construction (% YoY change)



*Estimated
Source: Central Reserve Bank of Peru and BBVA Research

Economic activity remained weak in the second quarter: ii) delays in infrastructure projects

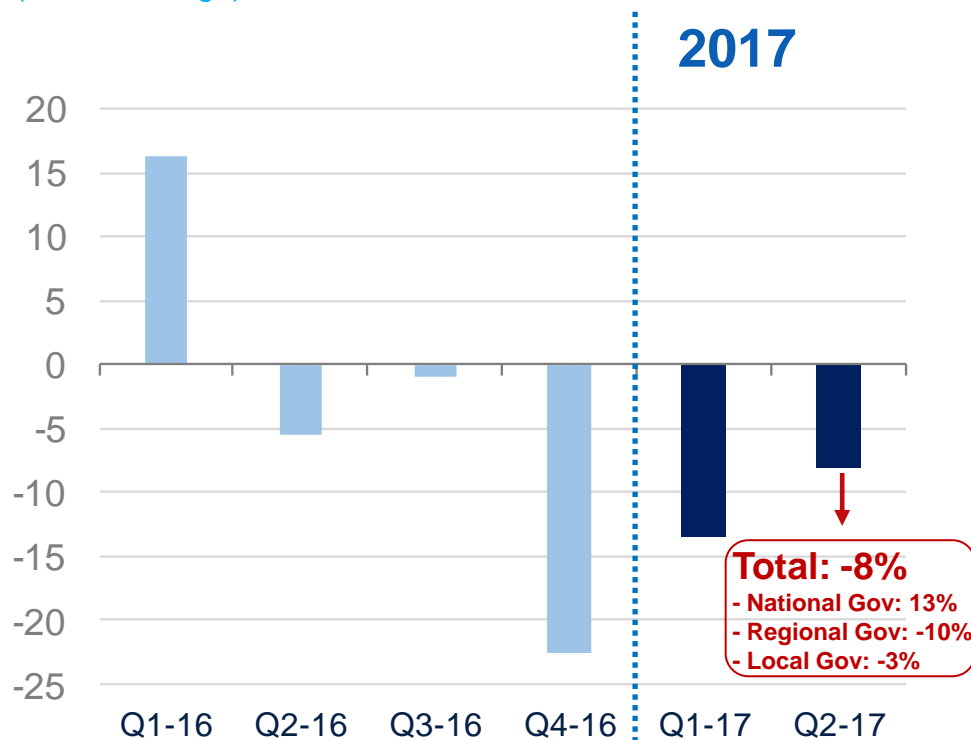
Lima Metro line 2
(million Peruvian soles)



Source: MEF – SIAF.

Economic activity remained weak in the second quarter: iii) weak public investment

Public investment*
(% YoY change)



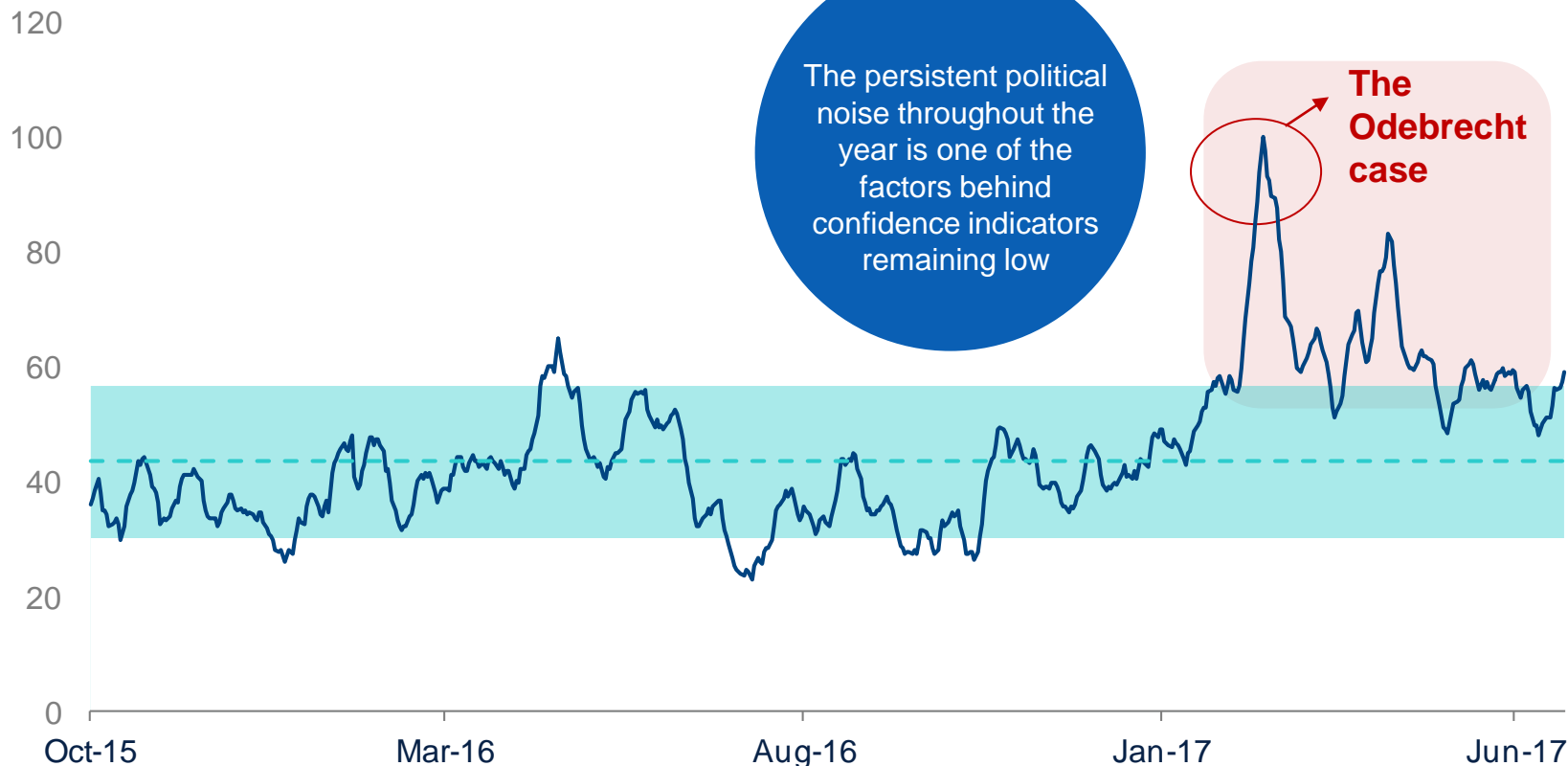
Investment spending has not taken off...

...due to slow execution of infrastructure projects

*General Government
Source: MEF - SIAF.

Economic activity remained weak in the second quarter: iv) increased political noise

Peru: political tension index*
(average for last 10 days)



* Up to 22 June 2017

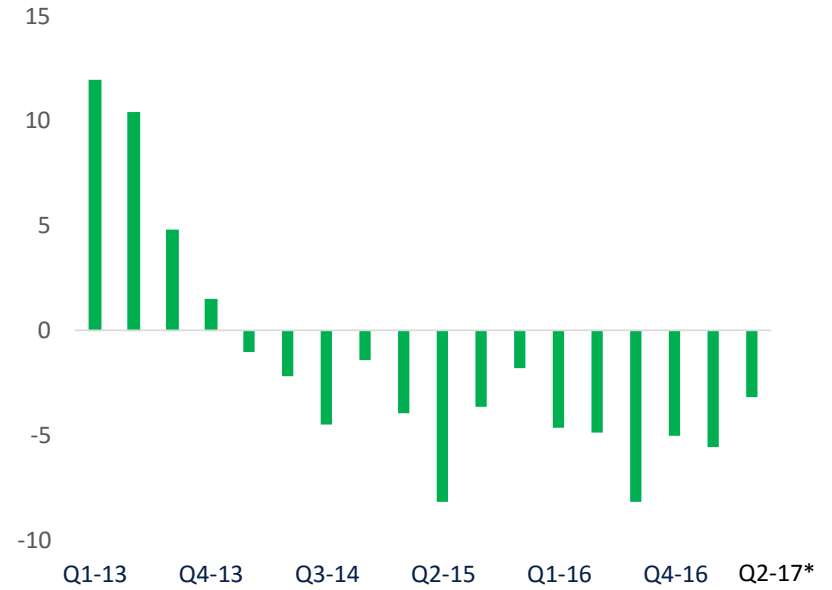
Source: BBVA Research

...which has impacted confidence indicators

Business confidence
(points)



Private investment
(YoY % change)

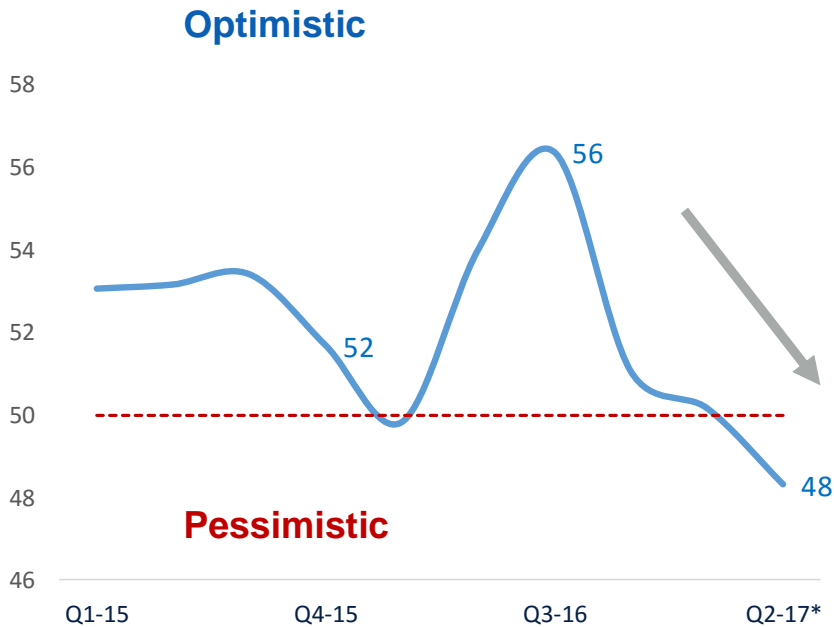


Source: Central Reserve Bank of Peru and BBVA Research

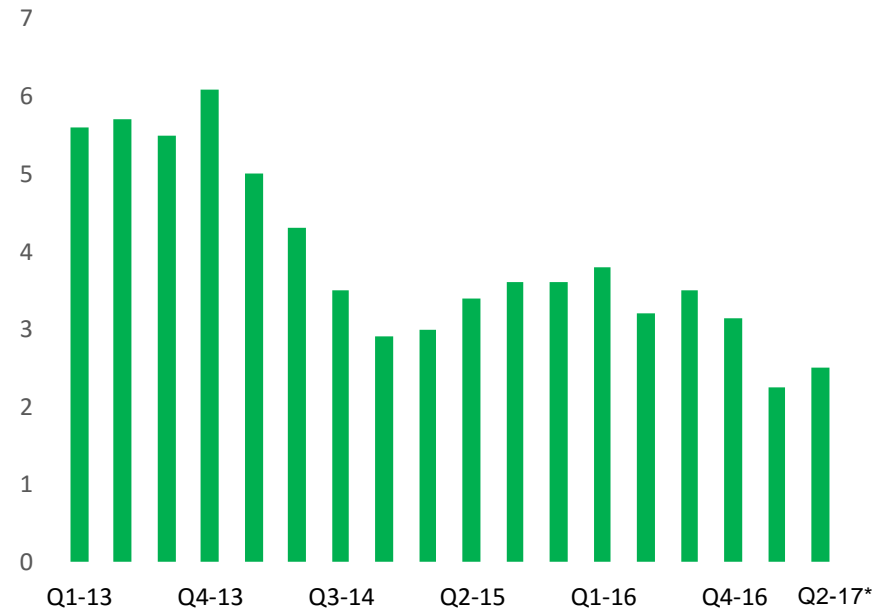
*Estimated
Source: Central Reserve Bank of Peru and BBVA Research

...which has impacted confidence indicators

Consumer confidence
(points)



Private consumption
(YoY % change)

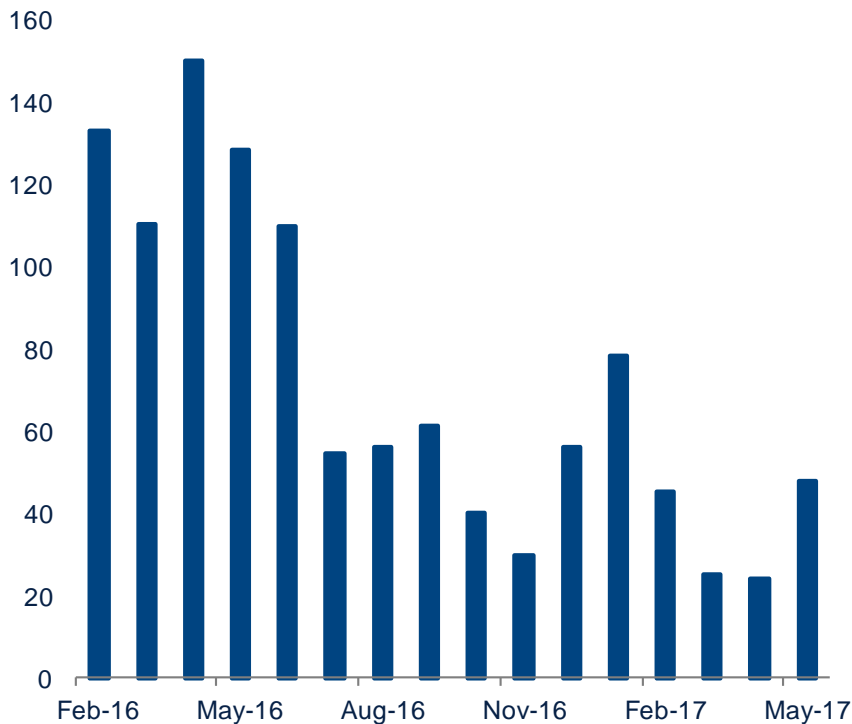


Source: Central Reserve Bank of Peru and BBVA Research

*Estimated
Source: Central Reserve Bank of Peru and BBVA Research

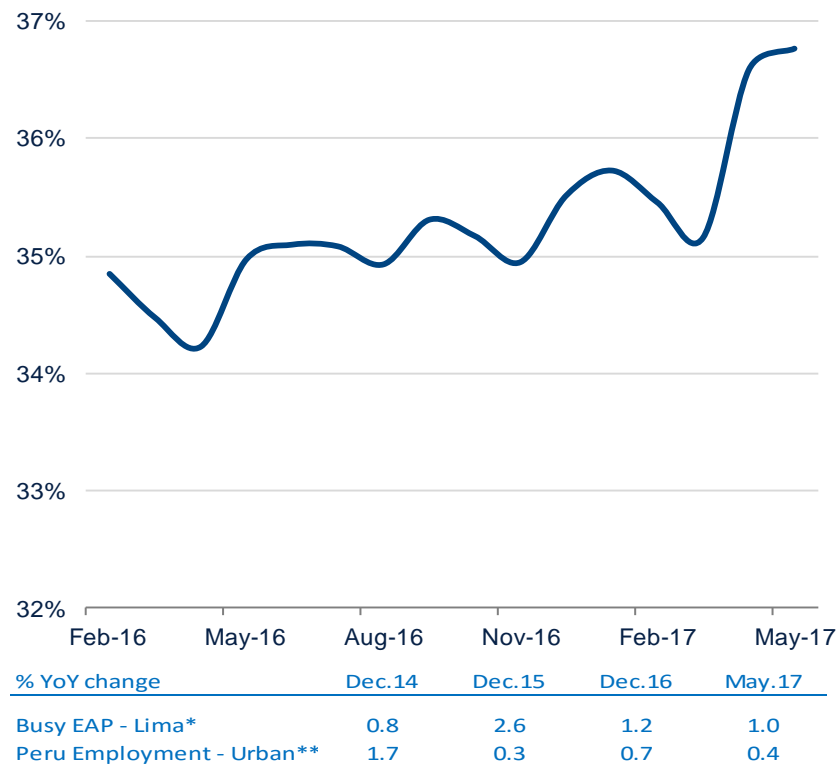
Against this backdrop, the labour market shows no sign of improvement

New jobs*
(thousands of jobs)



* Greater Lima area. This figure is the difference in the economically active population in work between two similar months in two consecutive years
Source: INEI

Underemployment rate*
(% of economically active population in work)



*Greater Lima area. ** Formal employment
Source: INEI and MTPE

Going forward, our baseline scenario considers

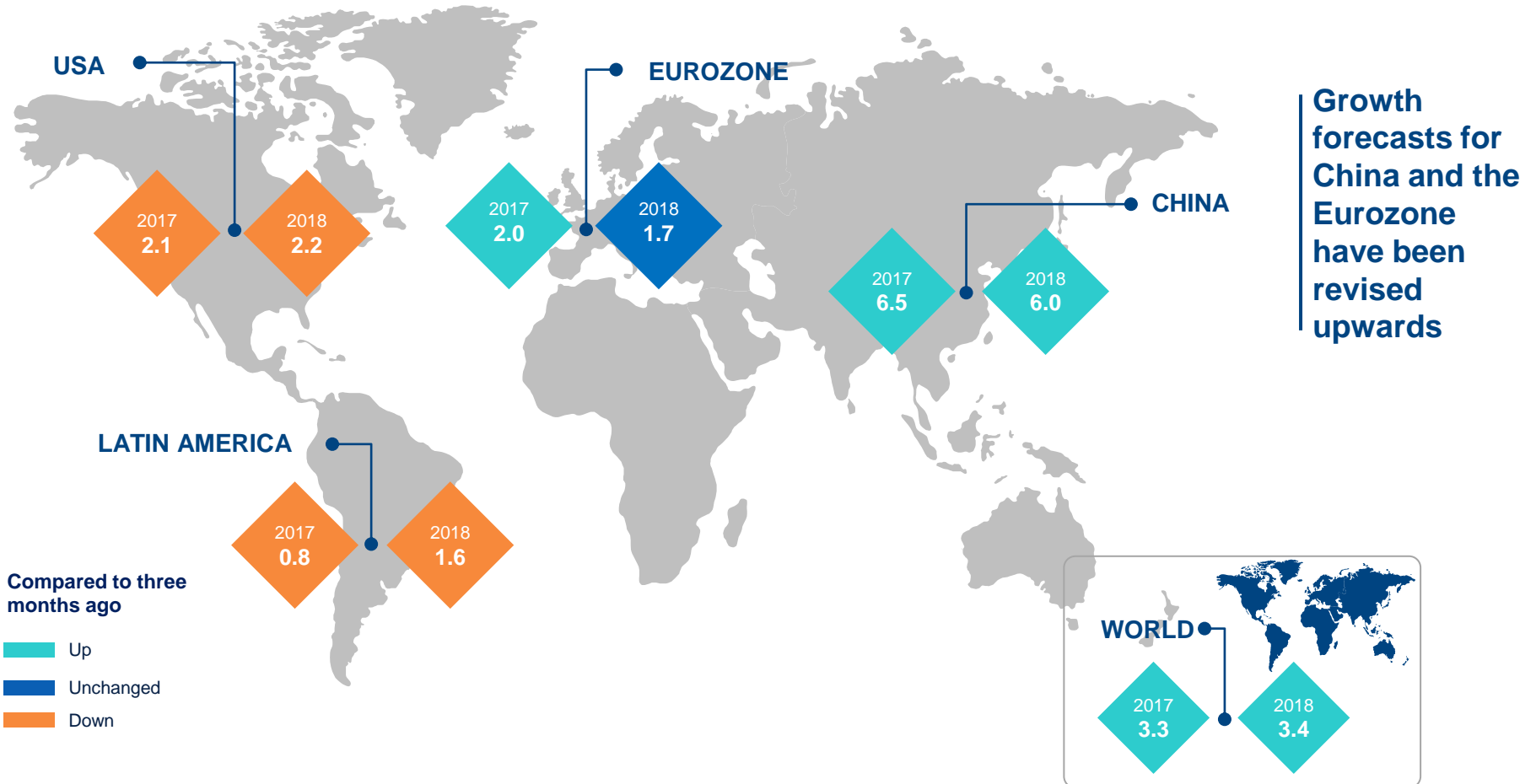
On the external side

- ❑ Growth in global activity will consolidate at over 3% in 2017 and 2018.
- ❑ The FED will continue normalising monetary conditions in an orderly fashion, as announced.
- ❑ The terms of trade will recover in 2017, but will correct downwards in 2018, remaining stable going forward.

On the domestic side

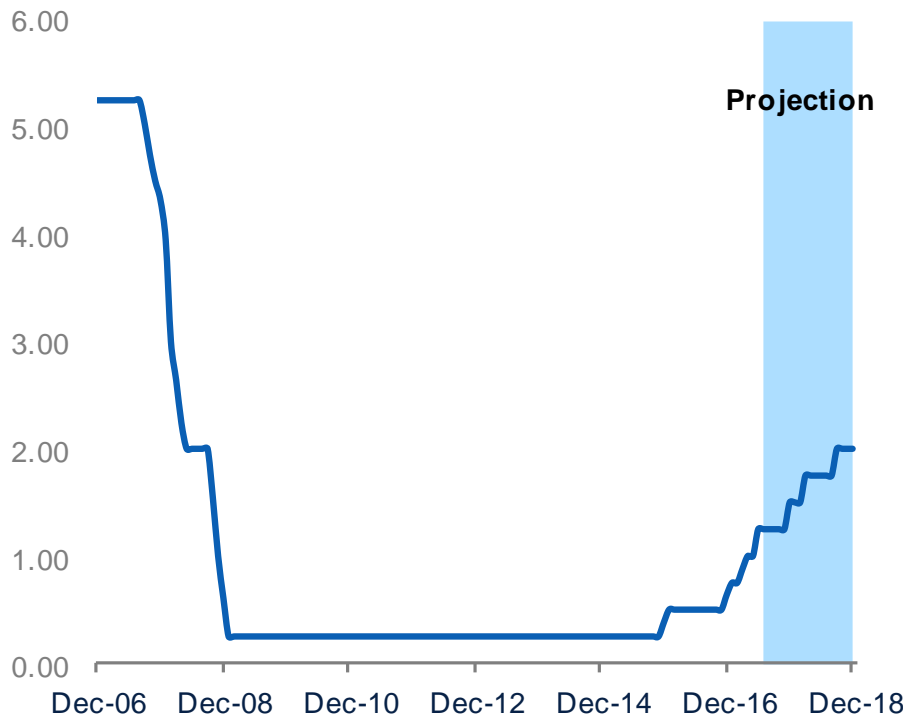
- ❑ Confidence indices will remain mostly unchanged.
- ❑ The institutional design of the Reconstruction Authority increases the probability that the spending will take place.
- ❑ Fiscal consolidation will be more gradual than announced by the Government.
- ❑ Improvements in execution of infrastructure projects from 2018. Work for the Pan-American Games will also have a positive impact.

On the external front: (i) global growth will consolidate at over 3%



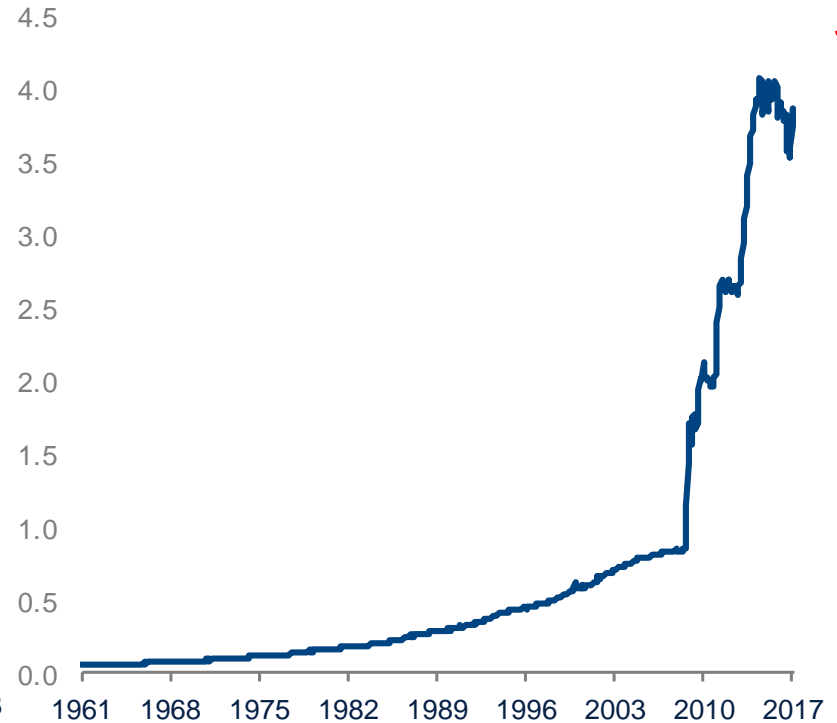
On the external front: (ii) The FED continues to adjust its monetary policy

FED interest rate
(%)



Source: Bloomberg and BBVA Research

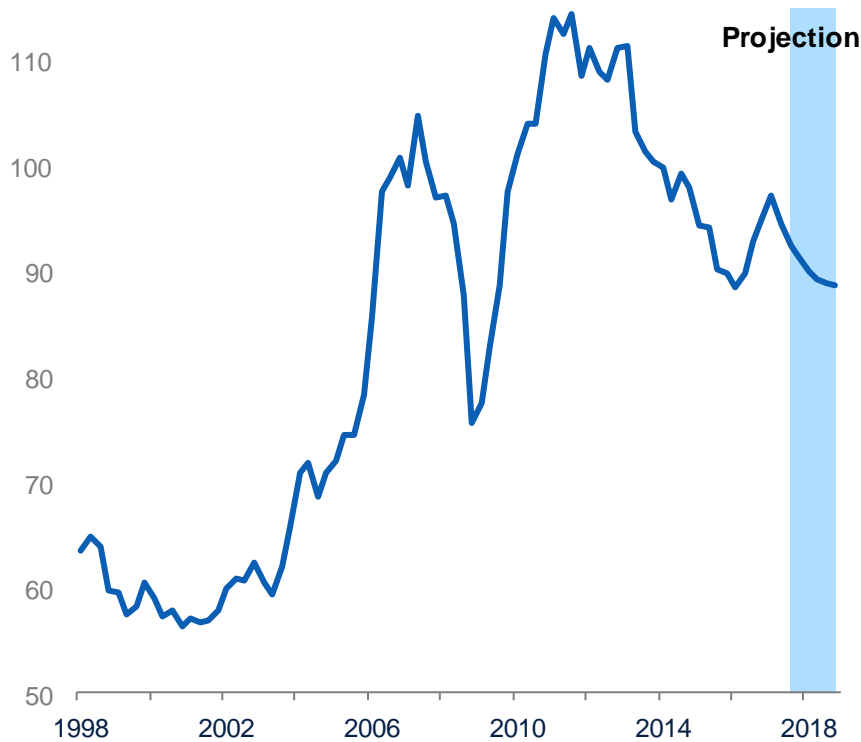
FED: monetary base
(US\$ trillion)



Source: Bloomberg

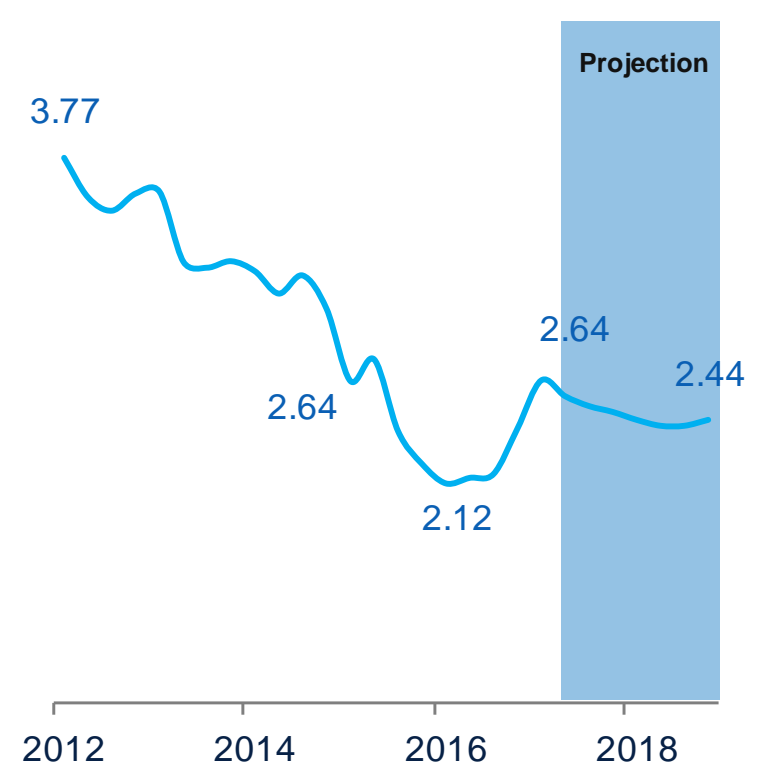
On the external front: (iii) terms of trade will recover in 2017, but correct downwards in 2018

Terms of trade
(2007 = 100)



Source: Central Reserve Bank of Peru and BBVA Research

Price of copper
(US\$/Lb.)



Source: Bloomberg and BBVA Research

On the domestic front: (i) business confidence will remain at current levels

Business confidence and private investment (points and % YoY change)



Private investment

Year	% YoY change
2014	-2.3
2015	-4.4
2016	-6.1
2017	-2.2
2018	3.0

On the domestic front: (ii) The institutional design of the Reconstruction Authority increases the probability that the spending will take place

Institutional design

- ❑ Executive president with the rank of a minister.
- ❑ Simple governance.
- ❑ Structure defined by the allocation of resources.
- ❑ Fast track mechanisms.

Fast track mechanisms

Simplified tendering

Foreign suppliers

Administration facilities¹

Agreements with international bodies

Works for taxes

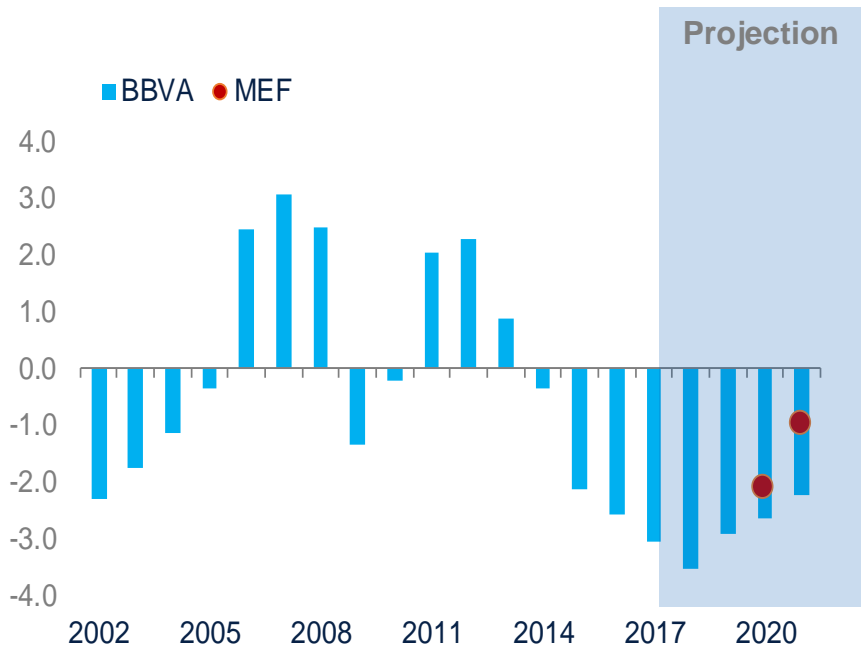
High risk zones²

1. All necessary administrative procedures for implementation of the Comprehensive Plan will be free of charge and completed in a maximum of 7 working days, being considered approved in the event of "administrative silence". 2. People living in high risk zones that cannot be mitigated must surrender their properties to access the benefits under the Plan.

Source: Central Reserve Bank of Peru

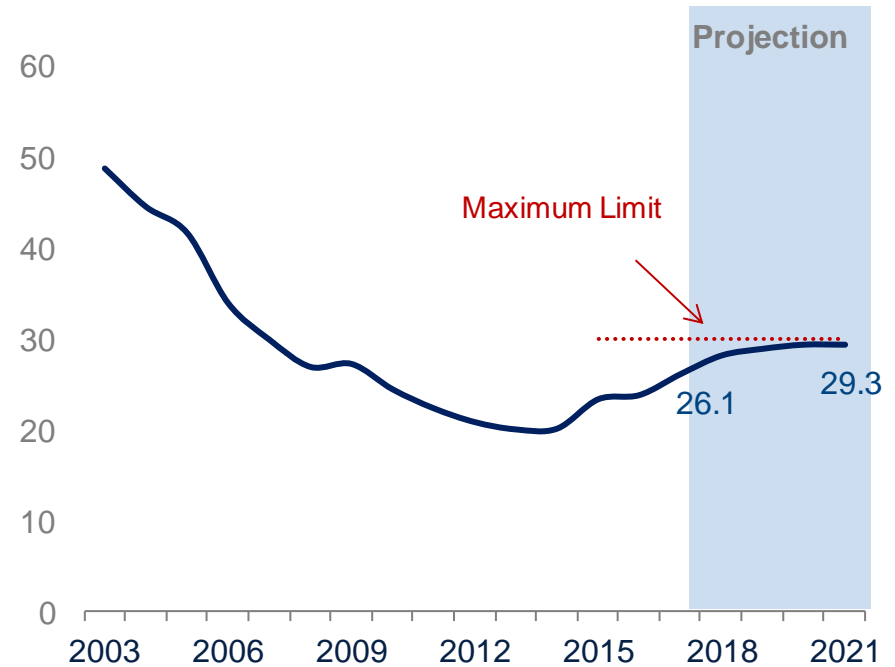
On the domestic front: (iii) fiscal consolidation will be more gradual than announced by the government

Fiscal result
(% of GDP)



Source: Central Reserve Bank of Peru and BBVA Research

Gross public debt
(% of GDP)

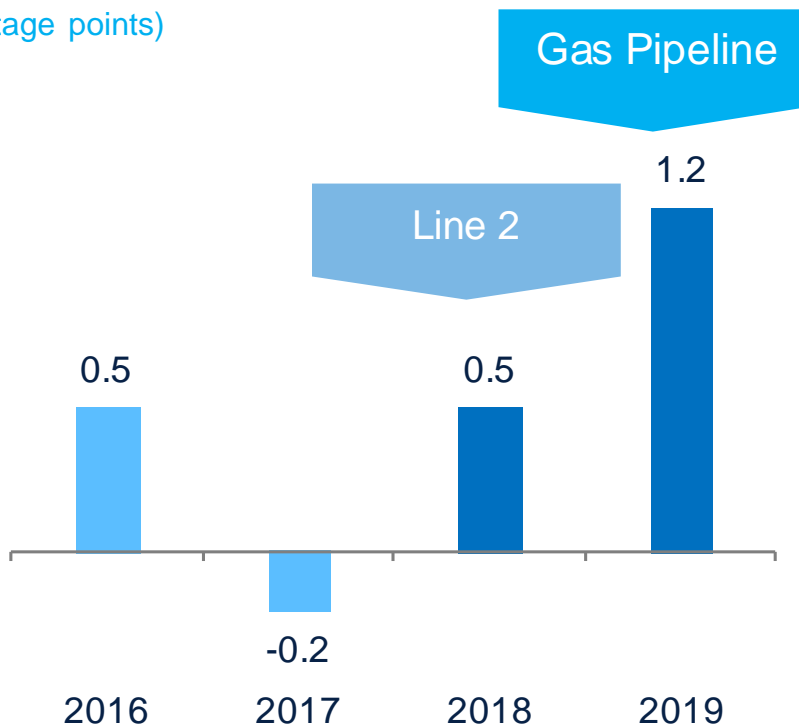


Source: Central Reserve Bank of Peru and BBVA Research

On the domestic front: iv) improvements in execution of infrastructure projects from 2018.

Infrastructure projects: contribution to GDP growth*

(percentage points)

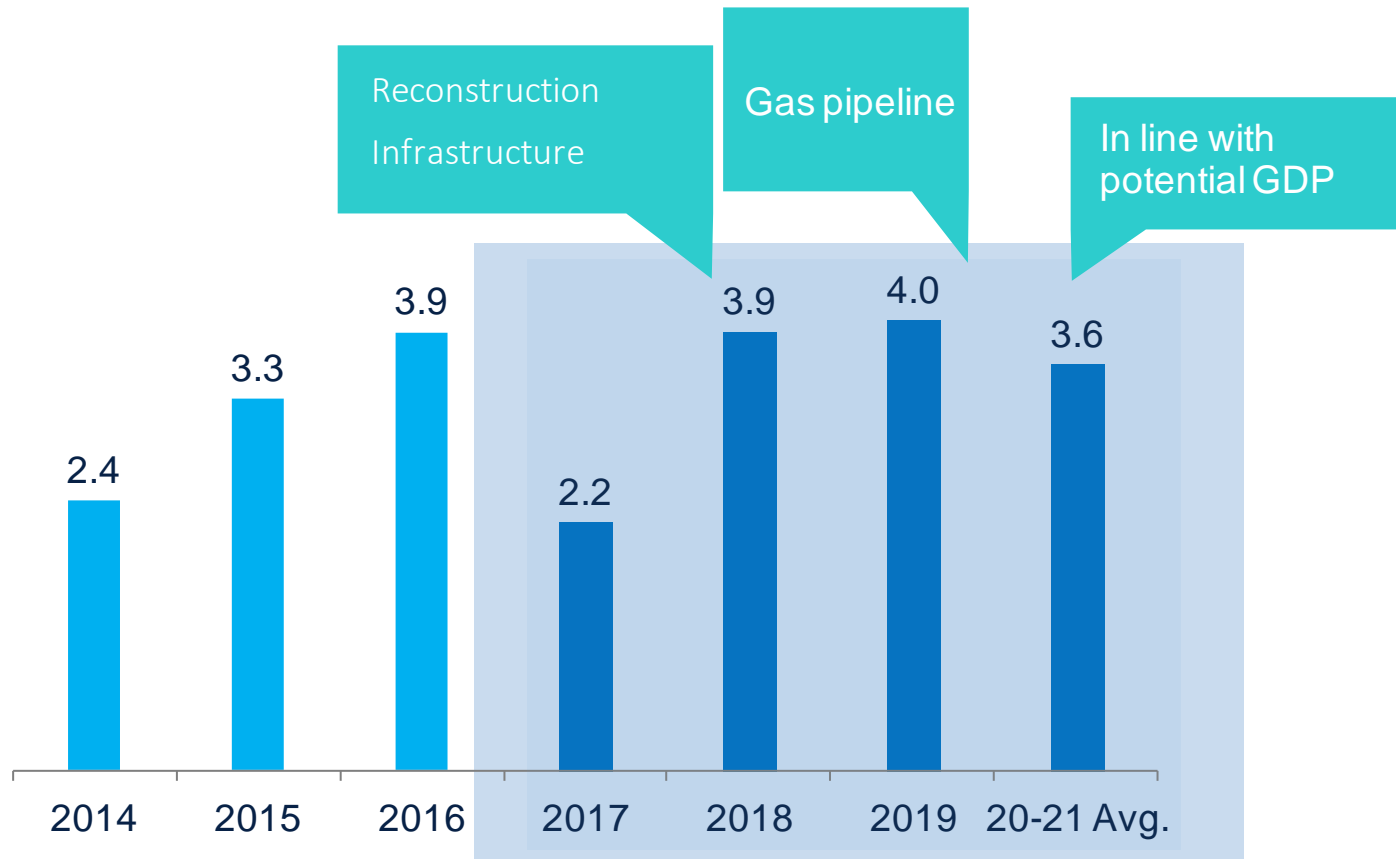


The contribution of projects to economic growth will be boosted by the start of the gas pipeline in 2019

*Lima Metro line 2, Majes Siguan, Chavimochic, the Talara refinery and expansion of the Jorge Chávez airport, the gas pipeline and Chinchero

In this context, we forecast that GDP will grow by 2.2% in 2017 and 3.9% in 2018

GDP
(% YoY change)



Peru: GDP growth by sector

GDP by sector (% YoY change)

	2016	2017	2018
Agriculture	2.0	1.2	4.0
Fishing	-10.1	31.8	4.1
Mining and fuel	16.3	2.8	7.5
Metals	21.2	3.0	6.3
Fuel	-5.4	1.8	14.5
Manufacturing	-1.7	0.5	2.6
Based on raw materials	-0.8	7.3	4.4
Non-primary	-1.9	-1.8	1.9
Electricity and water	7.3	2.9	4.5
Construction	-3.0	-0.7	6.4
Commerce	1.8	0.8	1.9
Other services	4.2	3.0	3.7
Global GDP	3.9	2.2	3.9
Primary sectors	9.8	3.5	6.2
Non-primary sectors	2.4	1.7	3.4

Due to the re-opening of oil pipeline in the North of Peru

Progress on infrastructure projects (Line 2) and reconstruction works

Source: BBVA Research

Peru: GDP growth from expenditure side

GDP from expenditure point of view (% YoY change)

	2016	2017	2018
1. Domestic Demand	0.9	1.3	3.2
a. Private Consumption	3.4	2.6	2.8
b. Public Consumption	-0.5	3.4	4.7
c. Gross Domestic Investment	-4.9	-3.3	3.7
Gross Fixed Investment	-5.0	-0.9	5.6
- Private	-6.1	-2.2	3.0
- Public	-0.5	4.0	15.0
2. Exports	9.7	4.0	4.0
3. GDP	3.9	2.2	3.9
4. Imports	-2.3	0.5	1.8
<hr/>			
<i>% YoY change</i>			
<i>Private Expenditures without Inventories</i>	1.1	1.5	2.8
<i>Public Expenditures</i>	-0.5	3.5	7.6

Progress with infrastructure projects (Line 2) and reconstruction works

Source: Central Reserve Bank of Peru and BBVA Research

Growth could accelerate if large projects currently in the pipeline are awarded rapidly and work starts quickly

Mining

USD 9000 – 9500 million

Quellaveco (USD 5000 – 6000)

Mina Justa (USD 1500)

Toromocho expansion (USD 1300)

Pukaqaqa (USD 480)

Magistral (USD 300)

Transport

USD 8500 million

Line 3 (USD 5600)*

Outer ring road (USD 2050)*

Longitudinal de la Sierra highway stretch 4* (USD 460)

Huancayo – Huancavelica railway* (USD 200)

Salaverry port terminal* (USD 220)

*To be put out to tender.

02. Financial markets



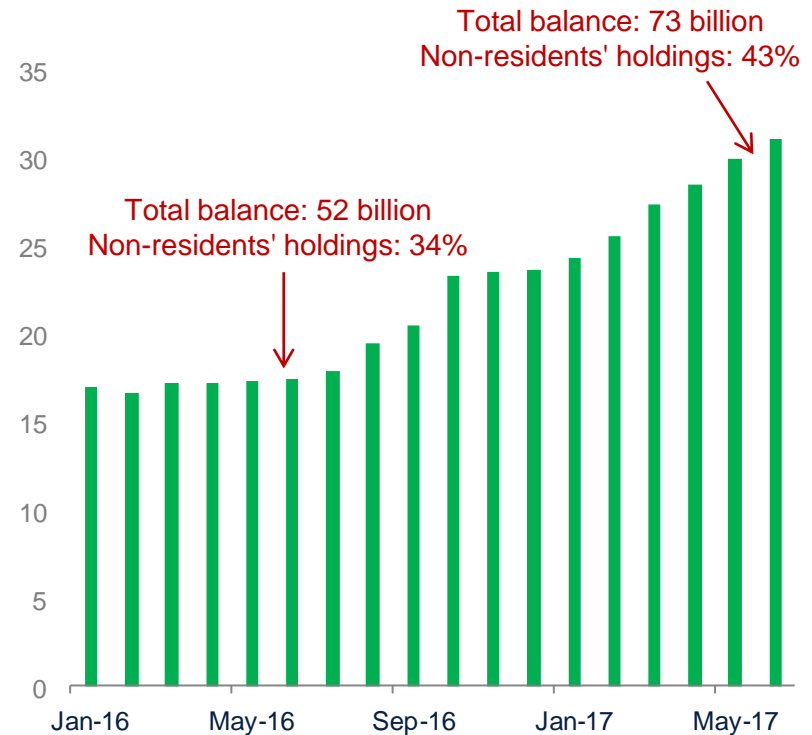
Risk premiums remain low, with increasing appetite for local financial assets

Peru: 5 year CDS
(basis points)



Source: Bloomberg

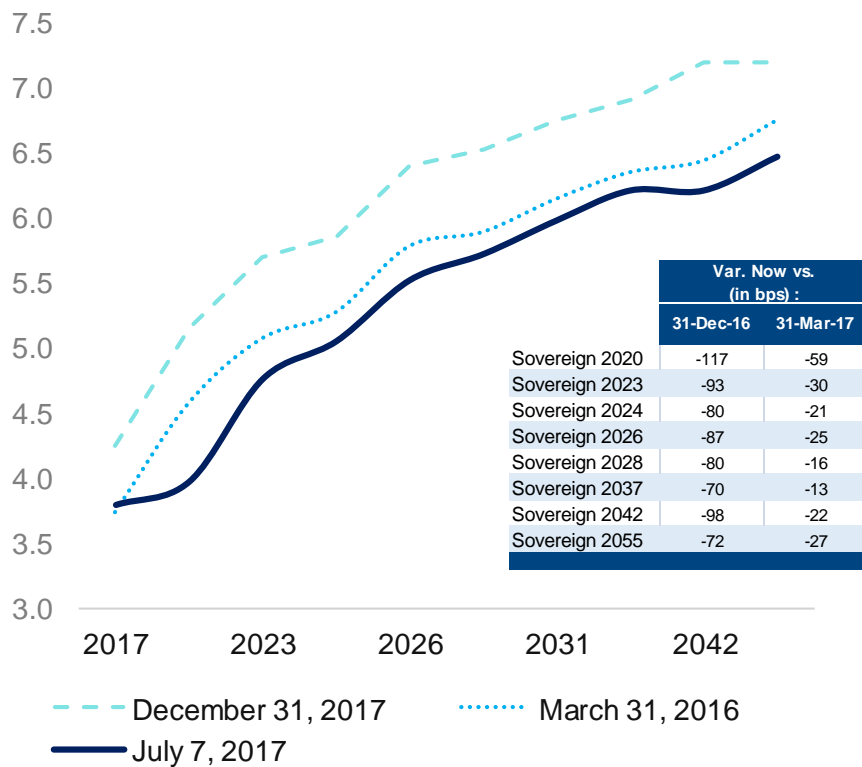
Non-residents' holdings of Sovereign Bonds
(billion)



Source: MEF

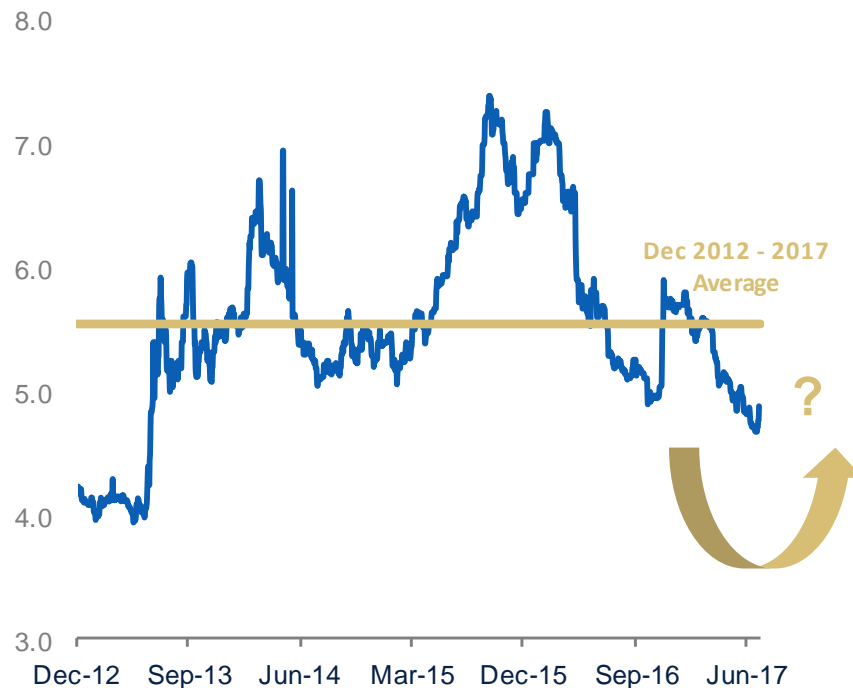
We expect a correction going forwards

Peru: Sovereign bond yield curve (%)



Source: Bloomberg

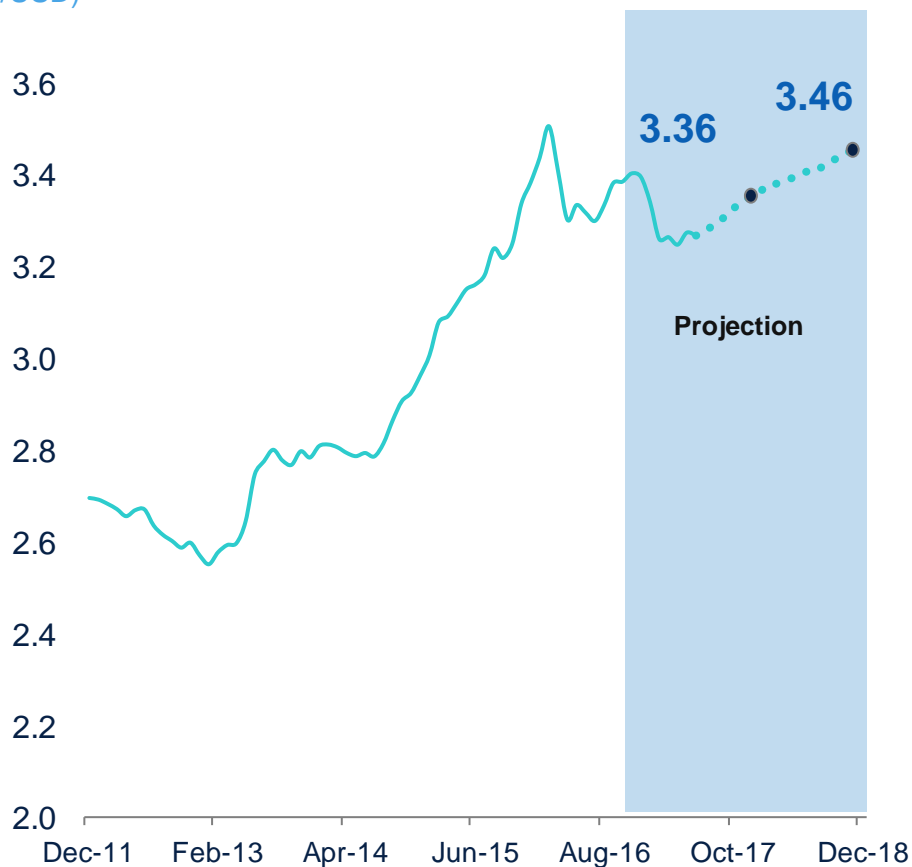
Peru: Sovereign bond yield 2023 (%)



Source: Bloomberg

Exchange rate: we forecast a gradual depreciation of the local currency

Exchange rate
(PEN/USD)



- ◆ Depreciation of the PEN due to reduction in the spread of rates (FED monetary adjustment while additional cuts in Peru's policy rate)
- ◆ The increase in the exchange rate will be softened by the trade balance: exports will continue to grow over the rest of the year.

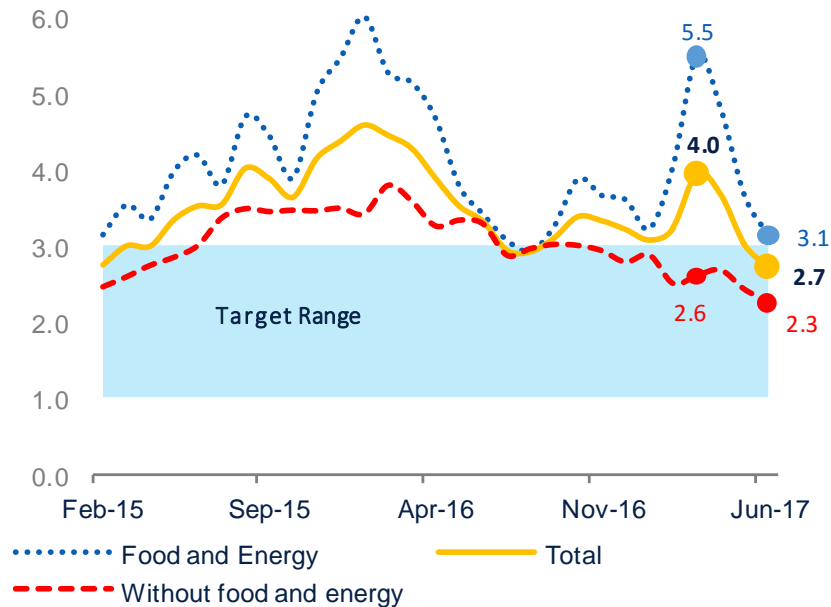
03. Inflation



Inflation has returned to the target range: prices for various foodstuffs affected by El Niño Costero have normalised

Prices of foodstuffs affected by El Niño Costero*

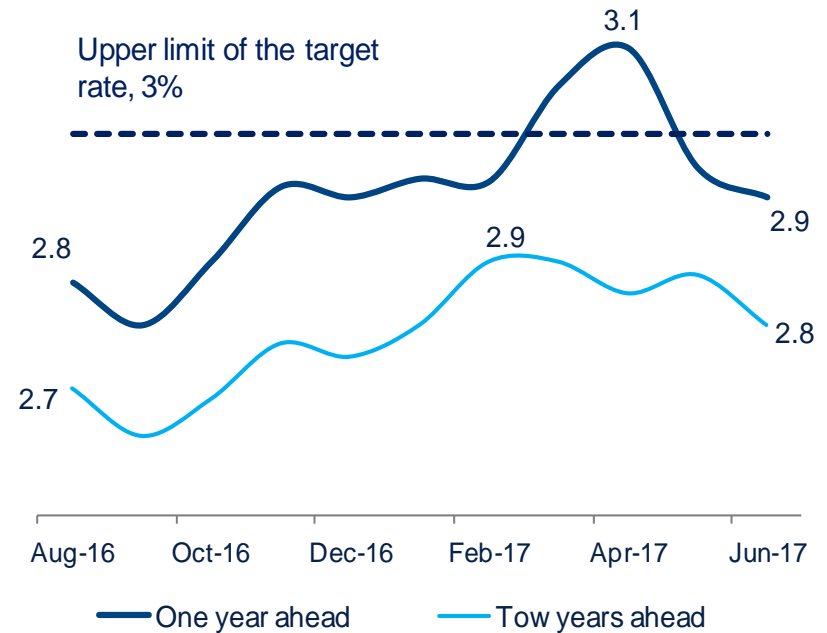
(% YoY change)



*Includes foodstuffs such as poultry, vegetables, legumes, fruit and sugar.
Source: INEI, Central Bank of Peru and BBVA Research

Inflation expectations

(% YoY change)

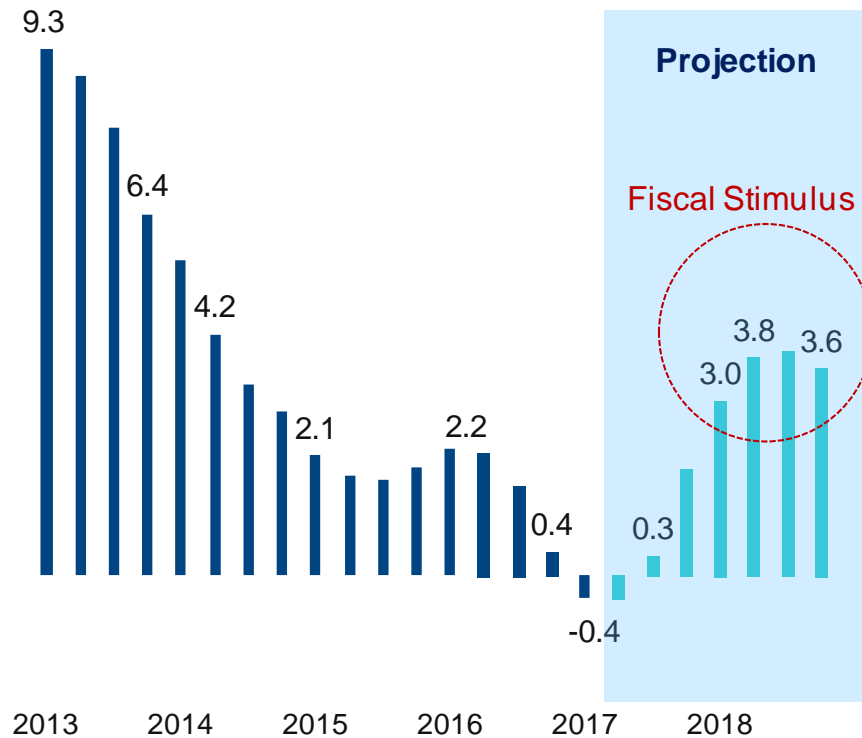


Source: INEI, Central Bank of Peru and BBVA Research

Going forward, lack of inflationary and exchange rate pressures will see inflation moving down and closing the year around 2%

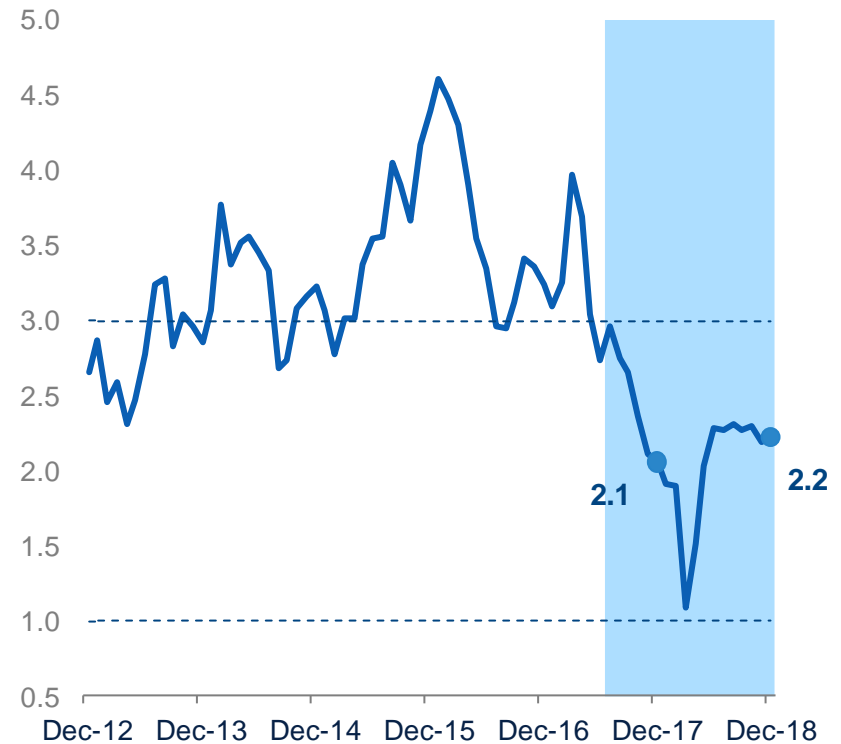
Domestic demand*

(% YoY change, accumulated, last 4 quarters)



Inflation

(% YoY change in CPI)



*Inventories not included.
Source: Central Reserve Bank of Peru and BBVA Research

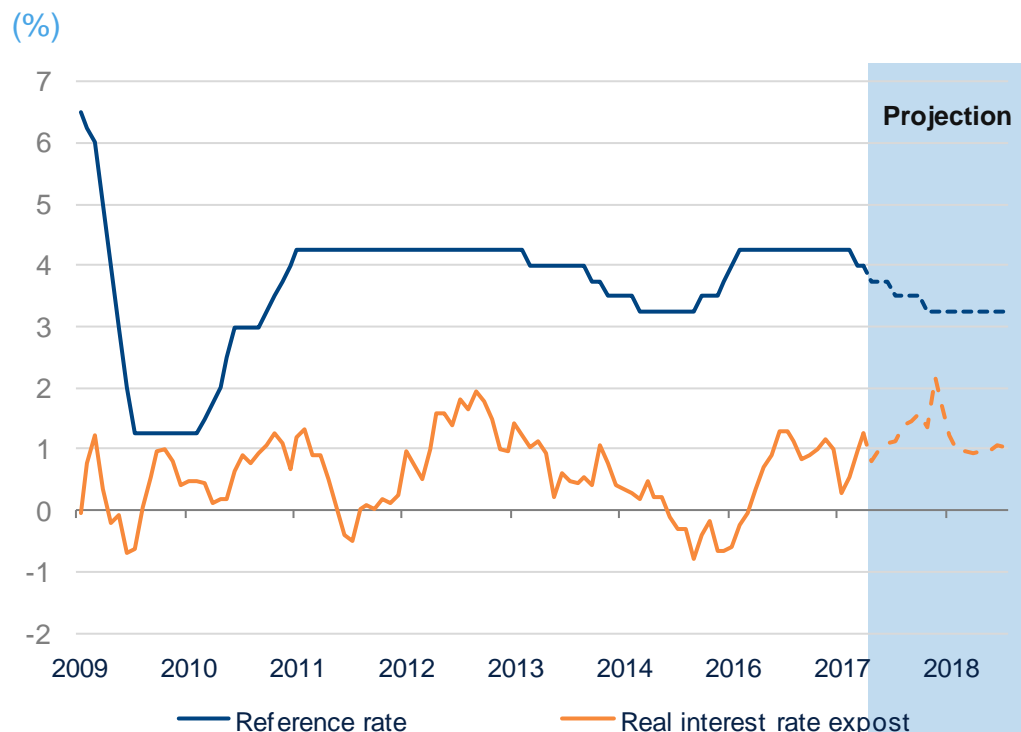
Source: INEI, Central Reserve Bank of Peru and BBVA Research

04. Monetary policy rate



We expect a more aggressive monetary stimulus, consistent with the macro environment

Monetary policy reference rate



Inflation within the target range, anchored inflation expectations and weakness of demand will lead the Central Bank to cut its policy rate twice more this year (by 25 bp each time), and once more in 1Q 2018

Risks



Peru: risks to output growth forecasts in 2017/18

External

Marked slowdown in China's economy

More aggressive adjustment by the FED

More delays in construction of major infrastructure projects

Domestic

Falling confidence

Frictions in rapid execution of reconstruction expenditure

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Appendix



Macroeconomic forecasts for 2017 and 2018

Main macroeconomic variables

	2014	2015	2016	2017	2018
GDP YoY	2.4	3.3	3.9	2.2	3.9
Domestic Demand YoY	2.2	3.1	0.9	1.3	3.2
Inflation (% a/a, fdp)	3.2	4.4	3.2	2.1	2.2
Exchange Rate (vs. USD, fdp)	2.96	3.39	3.40	3.36	3.46
Interest Rate (% , fdp)	3.50	3.75	4.25	3.50	3.25
Private Consumption (% a/a)	3.9	3.4	3.4	2.6	2.8
Public Consumption(% a/a)	6.1	9.8	-0.5	3.4	4.7
Gross Fixed Investment (% a/a)	-2.5	-5.0	-5.0	-0.9	5.6
Fiscal Outcome (% GDP)	-0.3	-2.1	-2.6	-3.0	-3.5
Current Account (% GDP)	-4.4	-4.8	-2.7	-2.0	-2.2

Source: Central Reserve Bank of Peru, INEI (National Statistics and IT Institute), MEF and BBVA Research

Examples of successful reconstruction experiences

Country/year	Entity	Comments
Mexico – 1985 (Mexico City earthquake)	Renovación Habitacional Popular (RHP)	<ul style="list-style-type: none"> • A new agency formed by personnel from ministries with no previous experience of reconstruction. • Planning of construction of multi-family homes. • Adequately funded, built 48 thousand homes.
Colombia – 1999 (Armenia earthquake)	Fondo para la Reconstrucción Económica y Social del Eje Cafetalero (FOREC)	<ul style="list-style-type: none"> • A new entity with functional and regulatory independence. • A Directorate comprising central and local government and the private sector. • Rapid assessment of damage. • Planning of actions to offset risks. • Adequate funding. • Use of sub-national government capacity for land administration. • Decentralised implementation based on NGOs and, to a lesser extent, local government.
Iran - 2003 (Bam earthquake)	Steering Committee	<ul style="list-style-type: none"> • Work group based on line ministries. • Free to establish reconstruction policies, which included redesign of the areas affected and implementation by the national housing body.

Source: Central Bank of Peru Inflation report (June 2017). Box 1. “Extraordinary reconstruction measures following disasters” (page 62).