Peru Economic Outlook
First Quarter 2018

January 2018

Summary

1
We have revised our economic growth projection for 2018 downwards from 3.9% to 3.5%, due to the increased uncertainty associated with the political noise

2
An important support for growth this year is a more positive external environment than was envisaged three months ago, which will favour mining investment and appetite for domestic financial assets

3
Exchange rate around 3.25 at year-end: monetary position in the developed economies will continue to be normalised, metal prices will correct downwards and the Peruvian central bank will continue to intervene in the foreign exchange market

4
Absence of inflationary pressures in 2018. Inflation will be temporarily below the target range at the end of the first quarter but will subsequently move closer to the middle of the target range

5
We foresee a further cut in the base rate in the next two to three months, in a context of lower inflationary expectations, difficulties in making fiscal stimulus a reality, and political uncertainty

Towards the end of last year economic activity showed some favourable trends. As a result, GDP may have grown by 2.3% in 2017.

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More recent indicators are in line with our forecast that GDP will have grown by around 2.3% in 2017
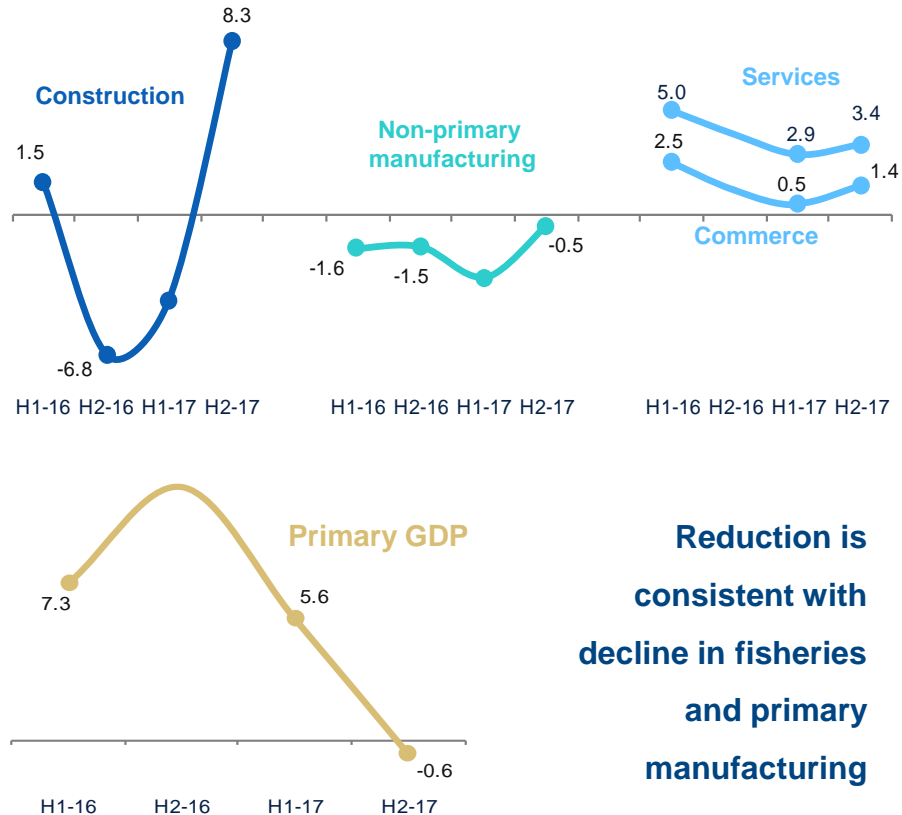
GDP and domestic demand*
(% chge. YoY)

- ■ GDP
- ● Domestic Demand (less inventories)
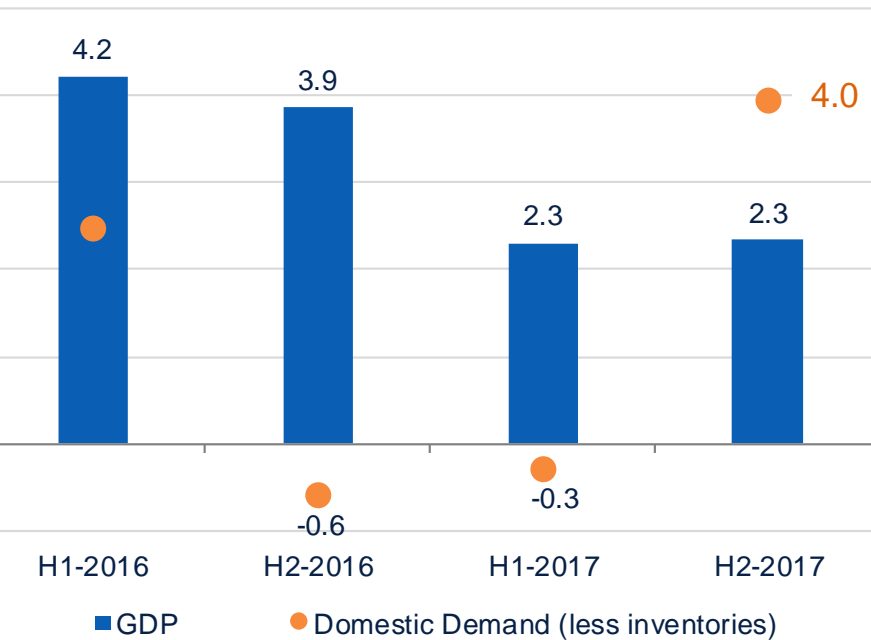
2017 GDP: **+2.3%**

*Figures for the second half of 2017 are estimates

Source: Central Reserve Bank of Peru and BBVA Research

GDP by economic sector
(% chge. YoY)

Construction
- 1.5
- -6.8
- 8.3

Non-primary manufacturing
- -1.6
- -1.5
- -0.5

Services
- 5.0
- 2.9
- 3.4

Commerce
- 2.5
- 0.5
- 1.4

H1-16 H2-16 H1-17 H2-17   H1-16 H2-16 H1-17 H2-17   H1-16 H2-16 H1-17 H2-17

Primary GDP
- 7.3
- 5.6
- -0.6

H1-16   H2-16   H1-17   H2-17

Reduction is consistent with decline in fisheries and primary manufacturing

Source: Central Reserve Bank of Peru and BBVA Research

4

What do the latest activity indicators show?
Private consumption affected by weakness of the labour market

Generation of formal employment*
(% chge. YoY)

-0.9

Feb-16   Sep-16   Apr-17   Nov-17

Total wage bill*
(in real terms, chge. % YoY)
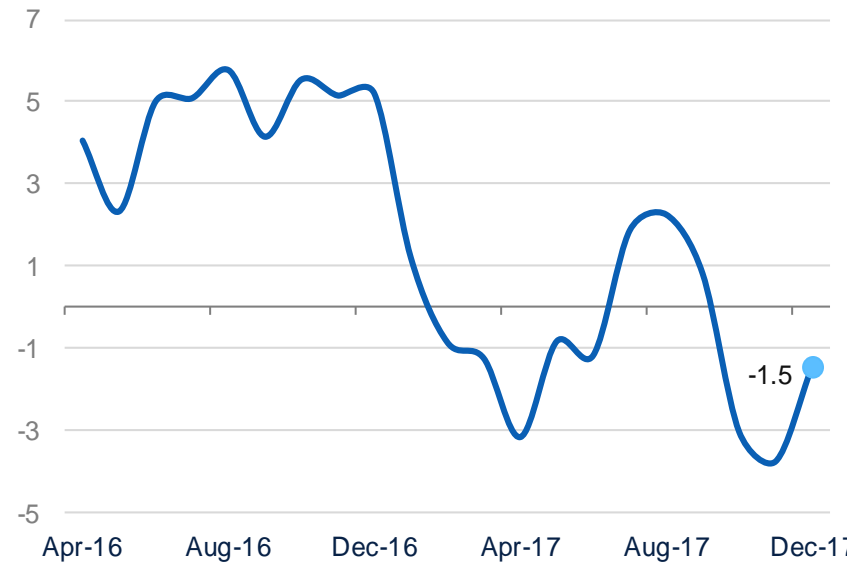
-1.5

Apr-16   Aug-16   Dec-16   Apr-17   Aug-17   Dec-17

*Employment in private businesses with more than ten workers in urban areas, not including the construction sector.
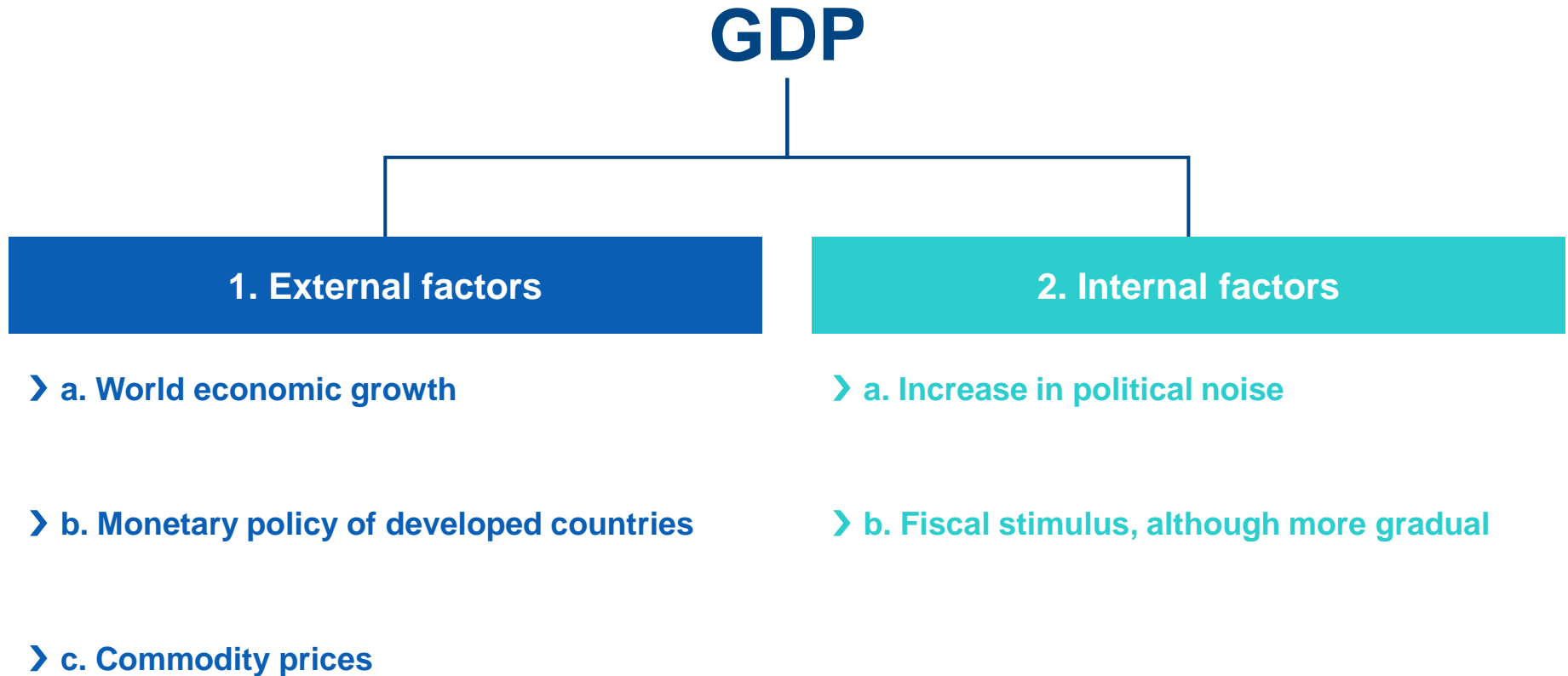Source: MTPE (Ministry for Employment)

*Calculated by multiplying the EAP in employment by the monthly average real wage. Using information from Lima Metropolitana. The figure for each month is the quarterly moving average ending in that month.
Source: National Institute of Statistics and Informatics (INEI)

The improvement in domestic demand in the latter part of the year was not accompanied by a more favourable performance of the labour market

Growth forecasts for 2018 and 2019

Key factors on which our projected base scenario for 2018 and 2019 depend

GDP

1. External factors	2. Internal factors

> **a. World economic growth**

> **b. Monetary policy of developed countries**

> **c. Commodity prices**

> **a. Increase in political noise**

> **b. Fiscal stimulus, although more gradual**

1. External factors: more favourable environment for the Peruvian economy

01 **Improved forecasts for the US, China and the euro area**
There is less short-term uncertainty

02 **More positive prospects for emerging countries**
Greater global demand and increase in the price of raw materials

03 **Central banks continue moving towards standarisation**
Reasons to withdraw stimulus measures are materialising (process announced). Expectations of less liquidity may reduce flows to emerging markets

04 **Commodity prices forecasts revised upwards**
Increased world demand underpins prices

1.a Optimism in the major regions, although with caution

USA

Growth revised upwards
Improvements in the labour market
Approval of the tax reform
Continuity in changes at the Fed

Positive impact: price of oil, global demand and weakness of the dollar on exports and investment

Positive effect (limited) of fiscal reform

Monetary policy will continue to be accommodative

CHINA

Moderate slowdown
Some reforms already under way
Positive conclusions at the 19th Congress of the CPC
Greater growth potential

Good economic performance reduces the risk of abrupt adjustment in the short term

Eliminating the growth objective limits the building up of imbalances

Measures to open up the economy will stimulate structural reforms and potential GDP

EURO AREA

Greater growth than expected
More robust domestic demand
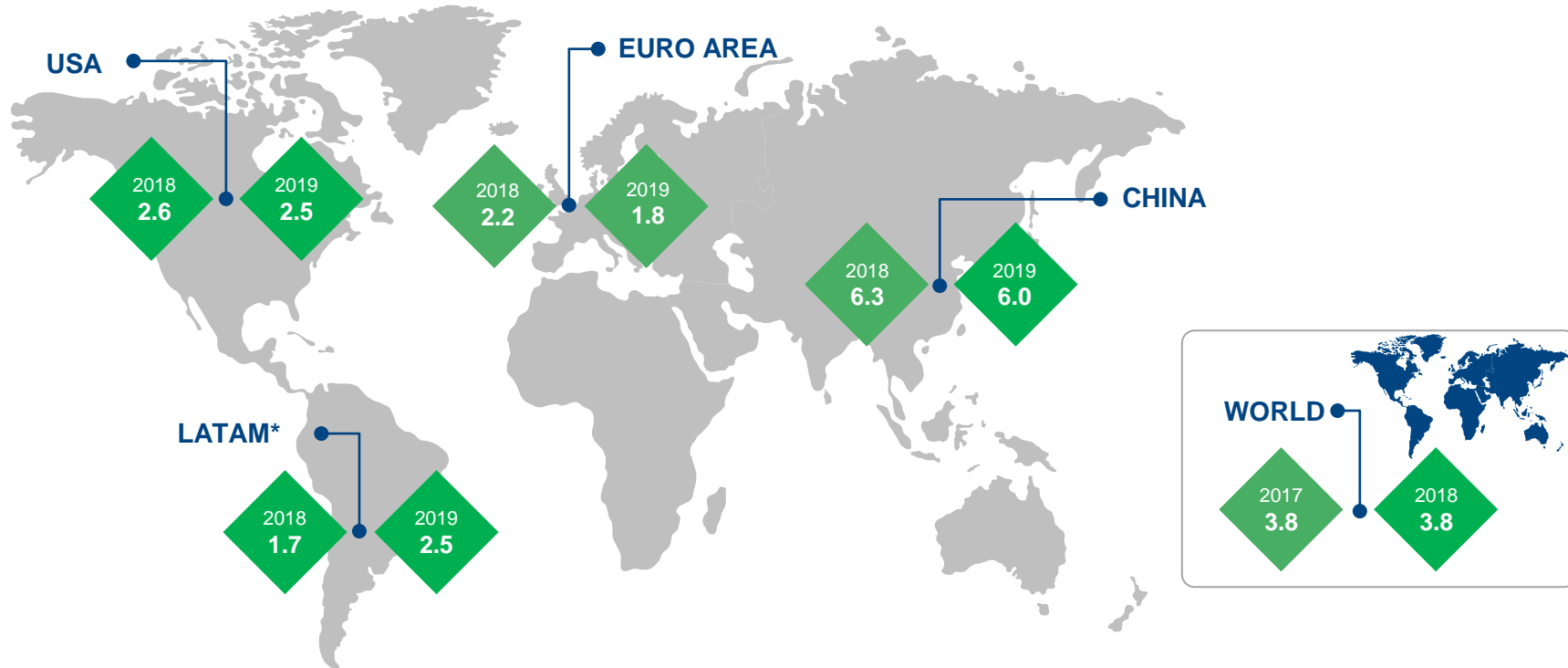Less political uncertainty
Plans for greater integration

Increase in disposable income encourages consumption

Greater support from global demand

Reduced uncertainty and increased earnings will underpin investment

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1.a Generalised upward revision of economic growth

World growth
(% chge. YoY)

USA

2018 **2.6**
2019 **2.5**

EURO AREA

2018 **2.2**
2019 **1.8**

CHINA

2018 **6.3**
2019 **6.0**

LATAM*

2018 **1.7**
2019 **2.5**

WORLD

2017 **3.8**
2018 **3.8**

Up relative to the forecasts of October 2017

Unchanged

Down

*Corresponds to LatAm7: * Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela
Source: BBVA Research

1.b The Fed accelerates standardisation while the ECB keeps it gradual

FED

Hawkish rate cycle and balance sheet reduction under way

75 bps rate hike foreseen for 2018, to 2.25%, and balance sheet reduction as announced (USD 420 billion).

ECB

QE reduction, but extended to September 2018
No interest rate increases before 2019

Focus: gain room for manoeuvre

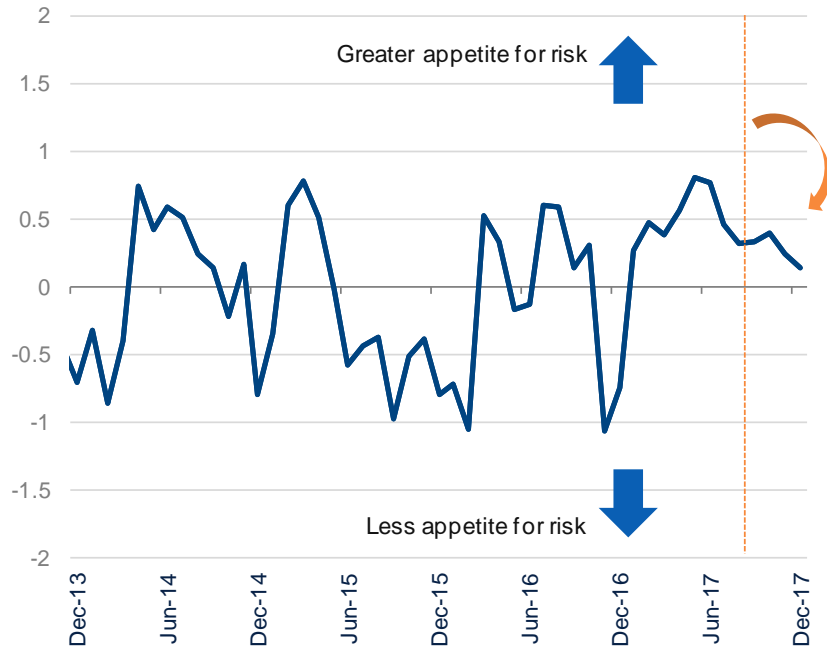*Focus: avoid sudden jump in long-term interest rates*

Elements of uncertainty:

Macro: possible surprises in inflation

Markets: long-term rates and slope of the curve

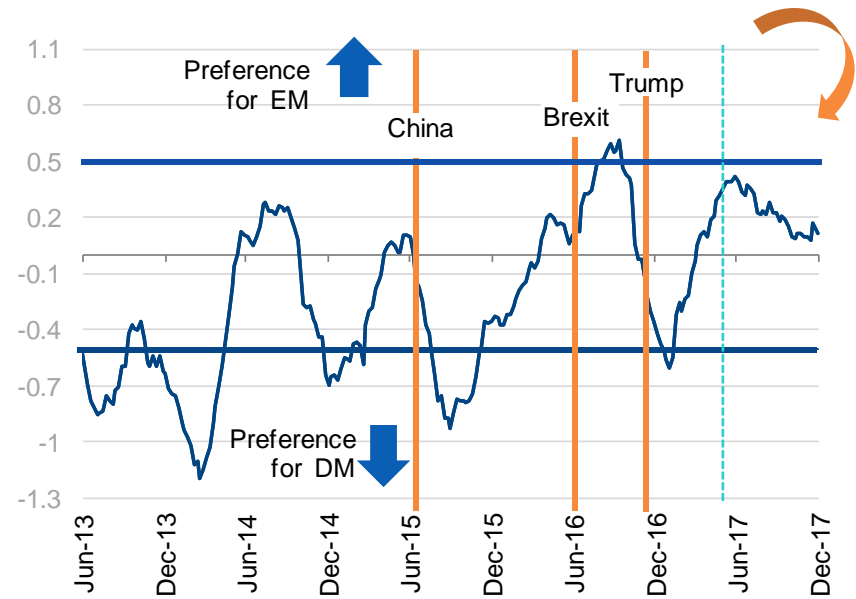# 1.b Gradual moderation of flows to emerging markets

Risk appetite indicator
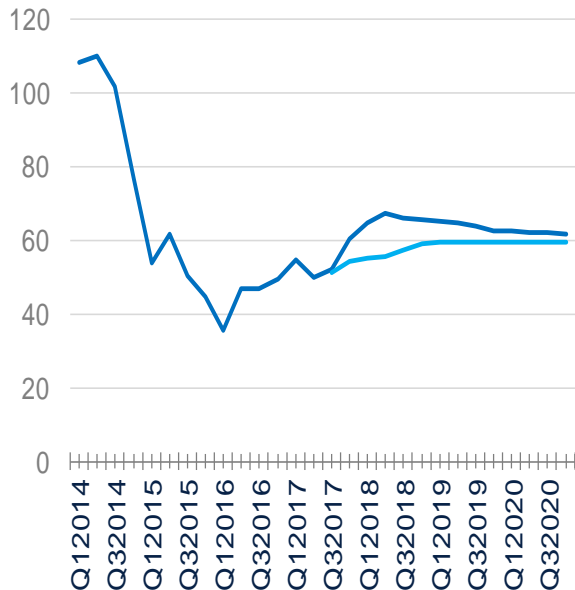(Factor 1 (global), EPFR flow analysis)

Investor appetite for emerging markets (EM) vs. developed markets (DM)
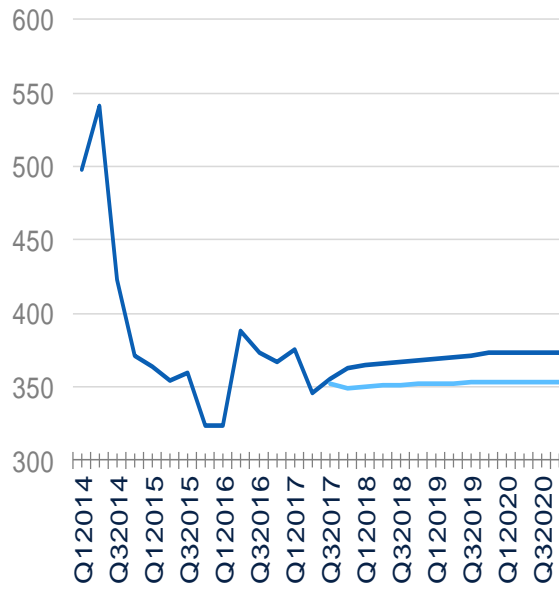(Inflow of funds to EM vs. DM in % of AUM)

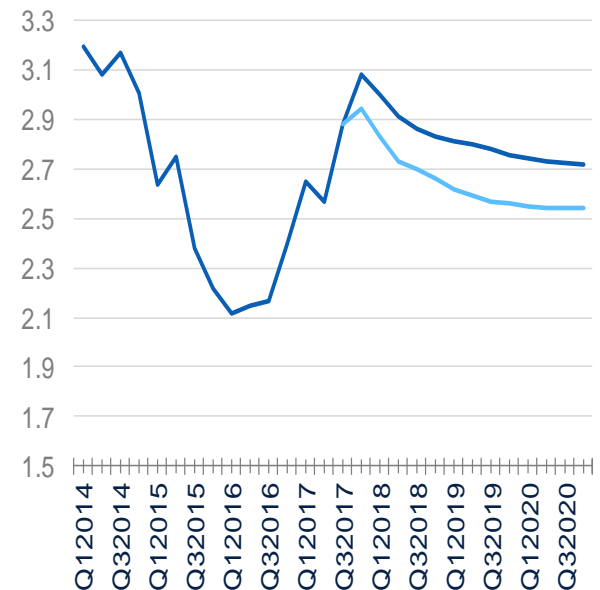# 1.c Upward revision of commodity price forecasts in view of greater world demand

Brent Crude
(USD per barrel)

Soybeans
(USD per metric ton)

Copper
(USD per lb.)

—— Baseline Sep 2017 —— Baseline Dec 2017

Source: BBVA Research and Bloomberg

The price of oil reflects increased demand but also supply factors, geopolitical risks and correction of inventories. However we continue to anticipate a long-term price of USD 60 per barrel due to increased competition

The price of copper increased significantly due to increased demand and the impetus from financial factors. These should gradually fade going forward

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2. Internal factors: a more complex context than anticipated three months ago

01 **Increasing political noise**
Increased uncertainty, leading to a decline in confidence.

02 **Fiscal stimulus will provide support, but less than previously anticipated**
We expect the spending to accelerate due to (i) reconstruction, (ii) construction of facilities for the Pan American Games, and (iii) Line 2 of the Lima Metro

2.a Political tensions making it difficult to consolidate the favourable trends of the later part of 2017 and giving rise to uncertainty

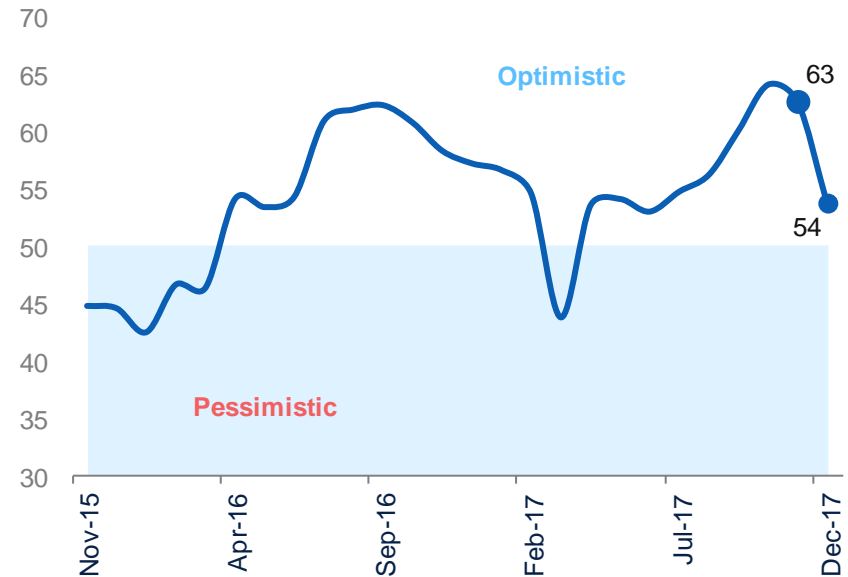## Political stress indicator
(100 = 27 Dec. 2017, the high point in the sample)
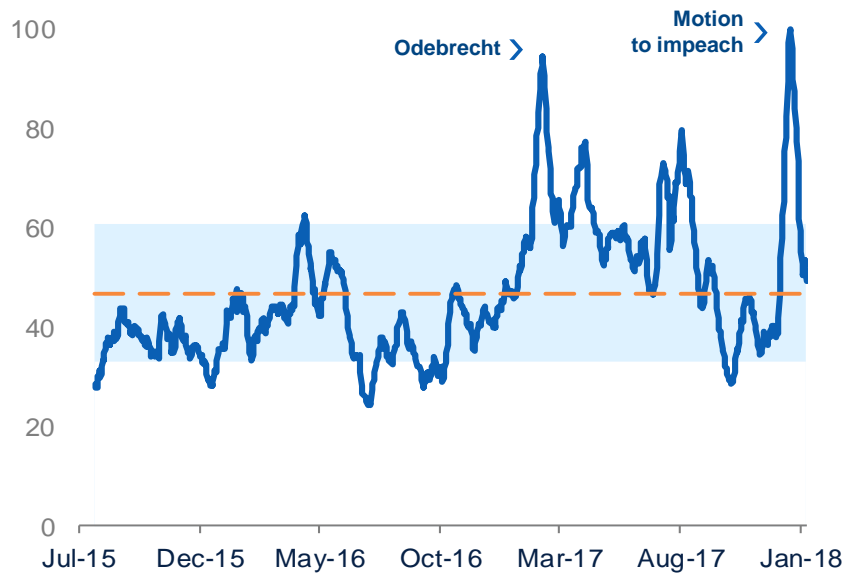
Source: GDELT and BBVA Research.

Business confidence
(index, in points)

Source: Central Reserve Bank of Peru

If the political noise persists, this year's and next year's growth will be affected by an environment of greater uncertainty. There could even be a medium-term negative impact

2.b Reconstruction

Investment
USD 7.4 billion
(3.6% of GDP)

Time horizon
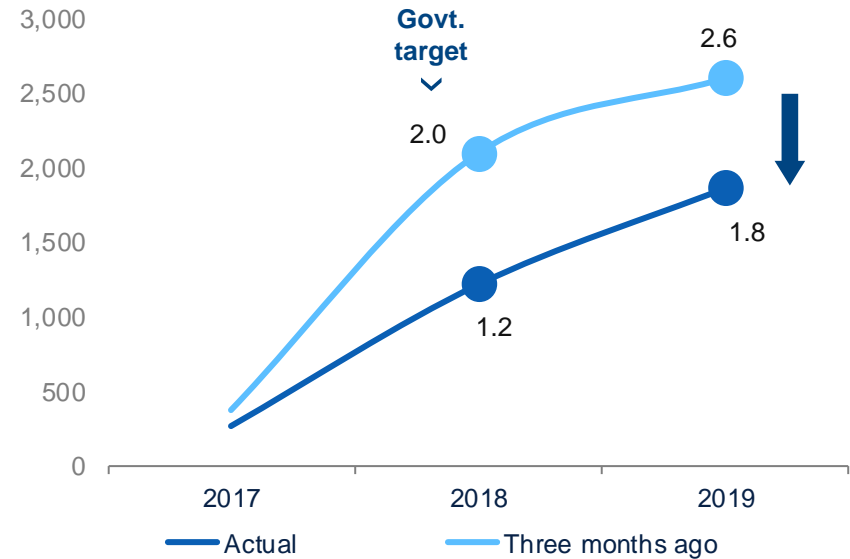Assumption: 5 years (2017/21)

Funding
About half using public savings

Sectors
Transport and education account for
more than 60%

Investment in reconstruction works
(USD millions)

Govt.
target

2.6

2.0

1.8

1.2

| | 2017 | 2018 | 2019 |

— Actual   — Three months ago

Source: Reconstruction Plan (Law 30556 passed on 12 September) and
BBVA Research

Contribution to growth
of 2018 GDP ❯ 0.4 **pp**

0.3 **pp** ❮ **Contribution to growth**
of 2019 GDP

2.b 2019 Pan American Games

Investment
Approximately USD 1 billion

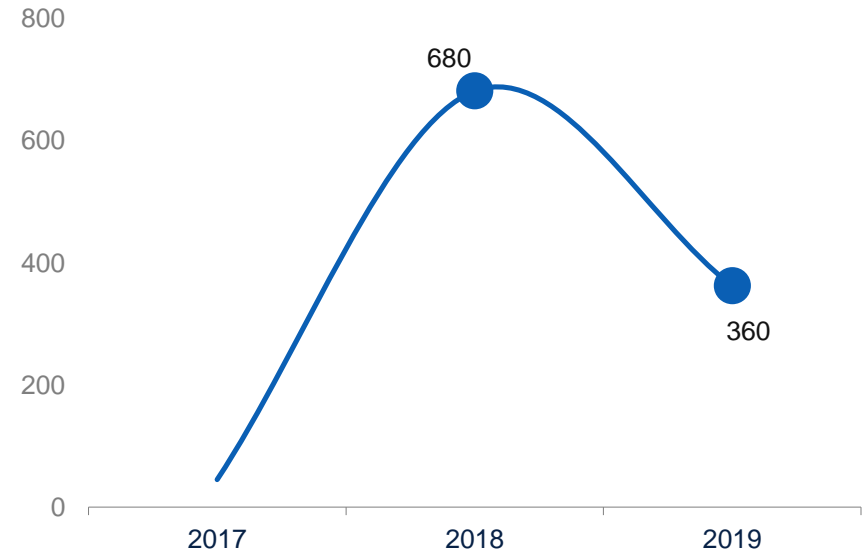## Time horizon
2017 – July 2019

Funding
Eight venues and transport infrastructure

Sectors
- The Villa Panamericana (Athlete's Village) has been awarded USD 110 million.
- Extension and improvement of La Videna complex, USD 159 million

Investment in the Pan American Games
(USD millions)

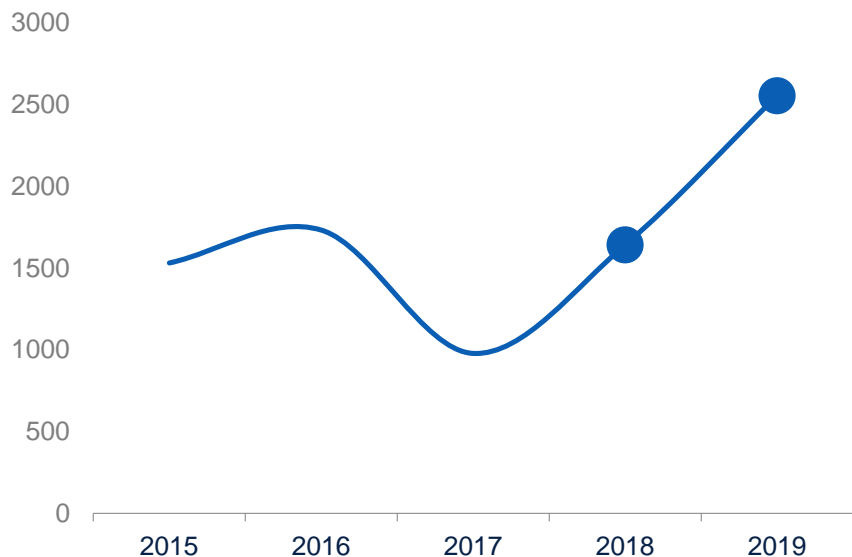**Contribution to growth** of 2018 GDP ❯ **0.3 pp**

-0.1 pp ❮ **Contribution to growth** of 2019 GDP

*New infrastructure and renovation of facilities: USD 604 million, preparation and holding of the event: USD 437 million plus Operation and maintenance: USD 46 million

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2.c Infrastructure

Investment in infrastructure*
(USD million)

Contribution to growth of 2018 GDP ❯ **0.3 pp**

> **Lima Metro Line 2**

Overall investment
USD 5.7 billion

2018: USD 700 million (0.3% of GDP)
2019: USD 1.2 billion (0.5% of GDP)
This year it is expected that the construction of five stations will be completed. It is also expected that 85% of the land will be freed up.

> **Talara Refinery**

Overall investment
USD 5.5 billion

2018: USD 880 million (0.4% of GDP)
2019: USD 550 million (0.2% of GDP)
Project has been executed as expected (construction has progressed 65%) and does not present funding problems.

**Also…starting in 2019: acceleration of investment expenditure on the extension of Jorge Chávez Airport (private sector project)**

**0.4 pp** ❮ **Contribution to growth** of 2019 GDP

*Selected projects
Source: Proinversión, Ministry of Economy and Finance, Central Reserve Bank of Peru and BBVA Research

2.c Fiscal stimulus will take deficit to a maximum in 2018, but thereafter a process of fiscal consolidation is assumed

Fiscal balance
(% of GDP)

Fiscal stimulus

Fiscal consolidation

2.3 -2.1 -3.2 -3.4 -2.5 -2.0

Source: Central Reserve Bank of Peru and BBVA Research
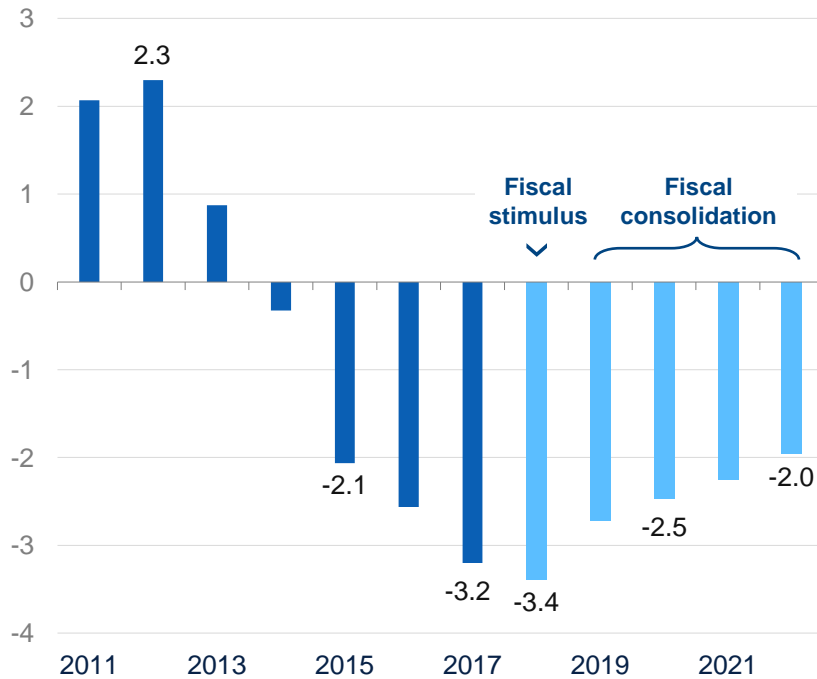
Gross government debt
(% of GDP)

Legal limit: 30%
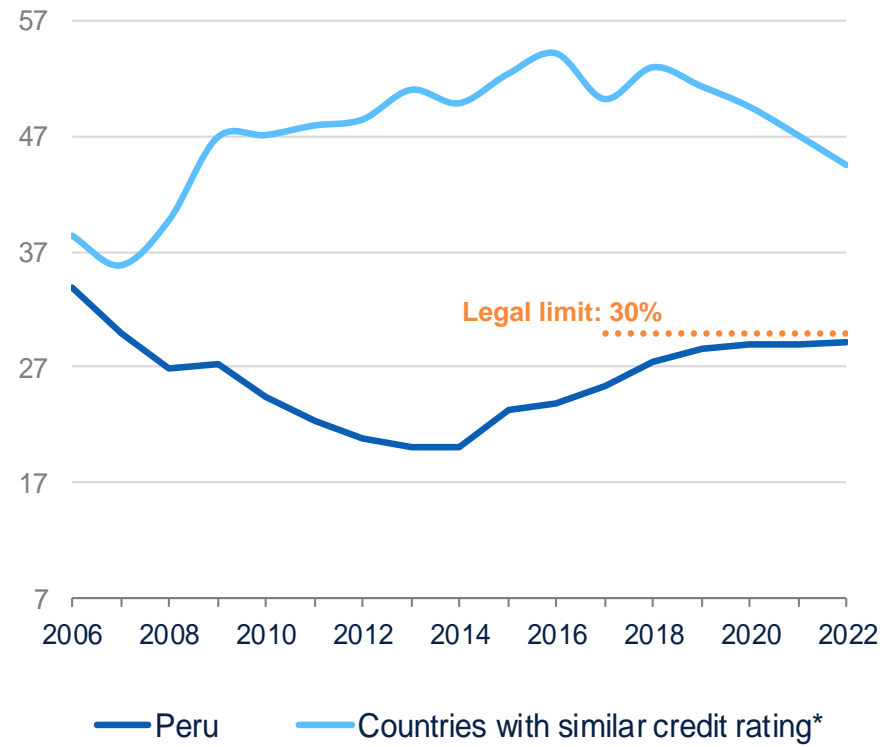
Peru — Countries with similar credit rating*

*Includes countries which Fitch, S&P and Moody's consider as having a similar sovereign credit rating to that of Peru. Uses the median for this group of countries
Source: IMF, Central Reserve Bank of Peru and BBVA Research

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In our baseline scenario we project GDP growth of 3.5% in 2018 and 3.8% in 2019

GDP and domestic demand
(% chge. YoY)

Projection

5,8
2,4
3,3
4,0
2,3
3,5
3,8

2013   2014   2015   2016   2017   2018   2019

● Domestic demand (excluding changes in inventory)
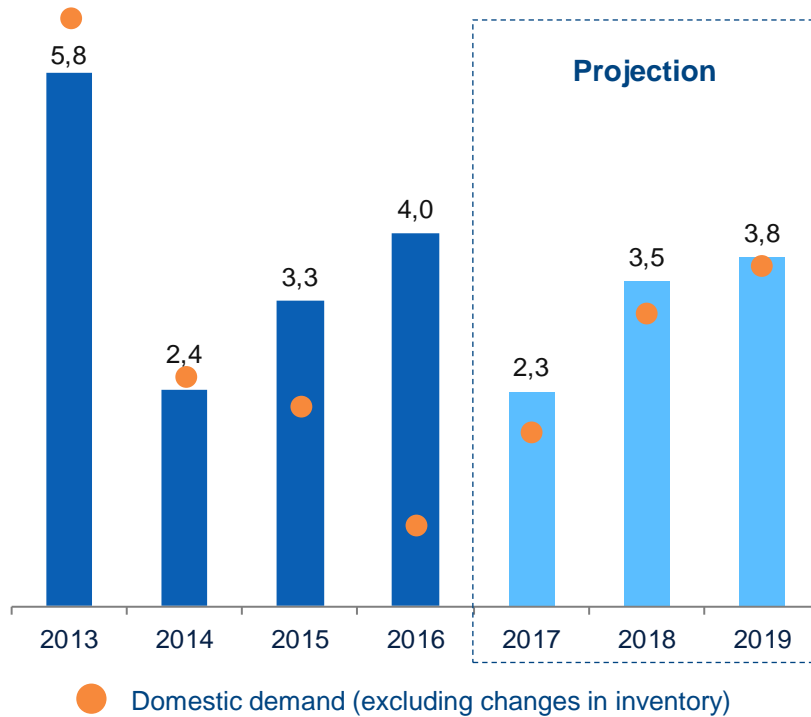
Source: Central Reserve Bank of Peru and BBVA Research

GDP
(% chge. YoY)

Peru

Argentina

Brazil

Colombia

Chile

2019
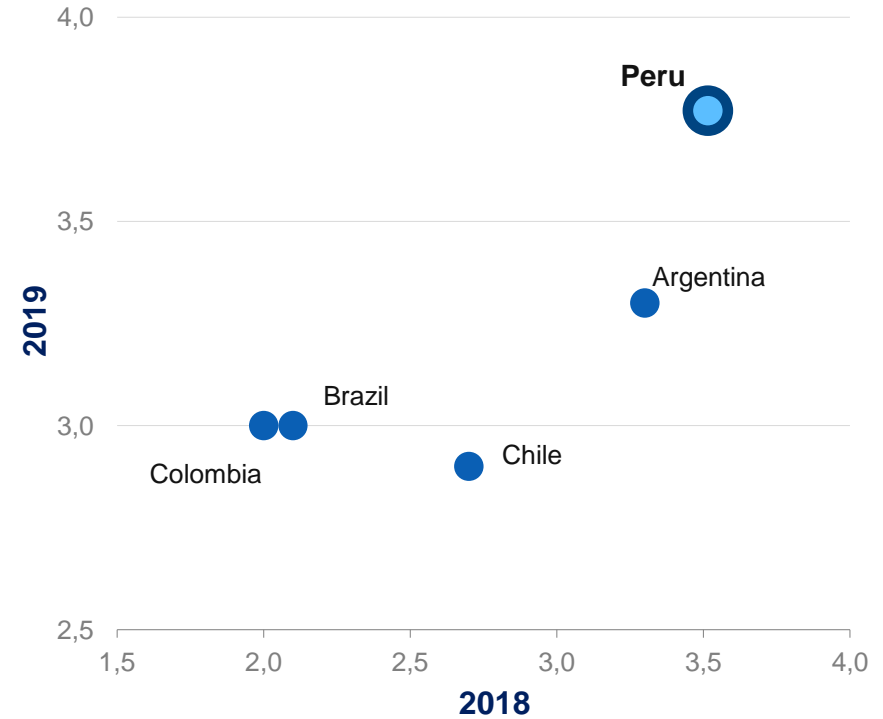
2018

Source: BBVA Research

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The improvement in Construction and Non-Primary Manufacturing sectors is notable, as is investment on the expenditure side

GDP by component
(% change YoY)

Sector GDP

Construction / Non-primary manufacturing / Services / Commerce / Primary GDP

GDP on the expenditure side

Government investment / Government consumption / Private investment / Private consumption / Exports

Source: BBVA Research

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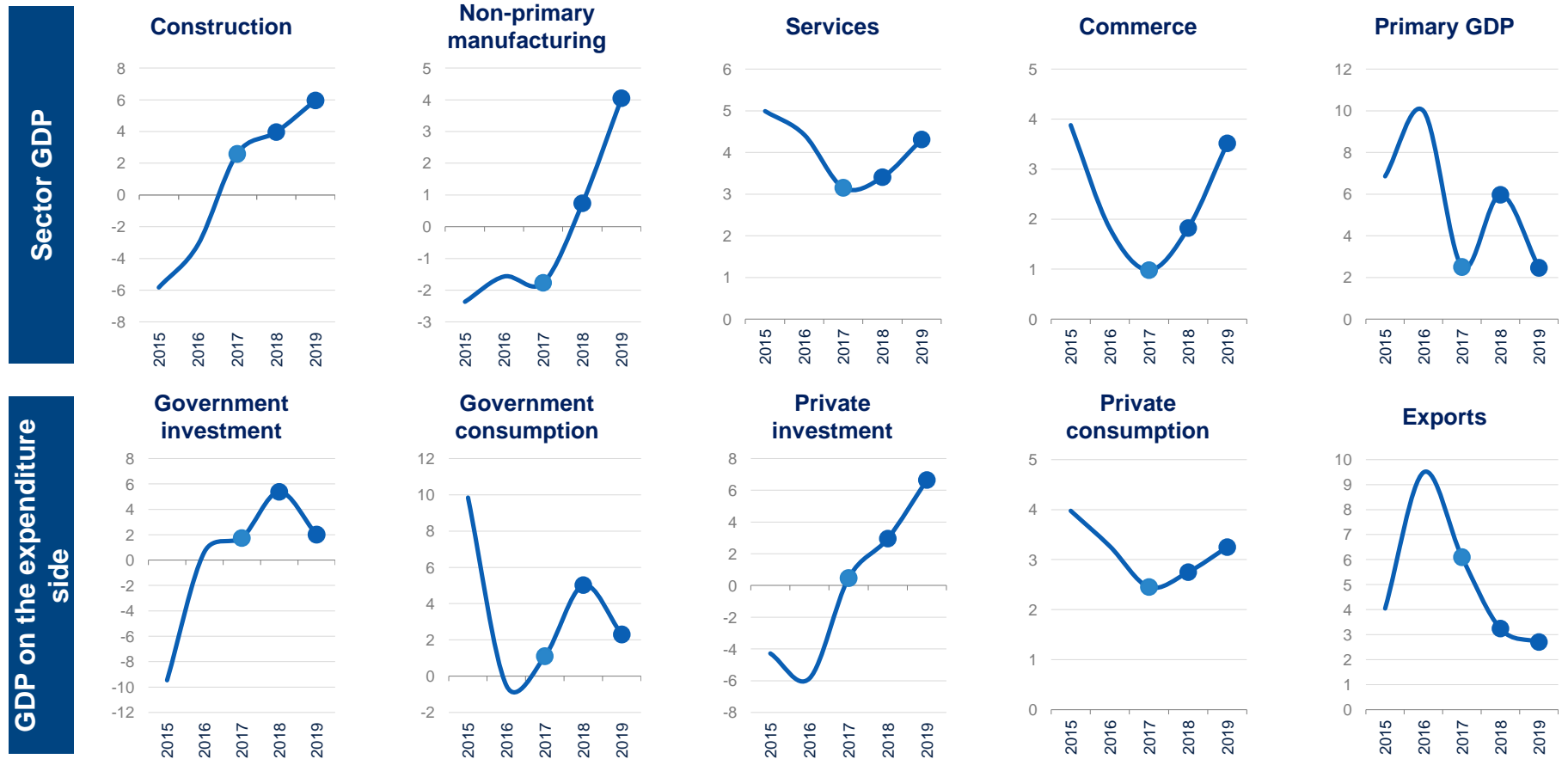
Main risks to the growth forecasts for 2018 and 2019

External	Domestic
China	Political environment
FED	Additional delays in reconstruction works
	Delays in execution of infrastructure projects

In the domestic financial markets there has
been a revaluation of assets.
What do we see looking ahead?

In the past few months, domestic financial assets and the Peruvian currency have increased in value

Sovereign bond yield curve

	Change in basic points
	Jan 19th, 2018 **vs** Oct 31th, 2017
Sovereign 2023	-67
Sovereign 2024	-78
Sovereign 2026	-67
Sovereign 2028	-65
Sovereign 2031	-59
Sovereign 2037	-60
Sovereign 2042	-50
Sovereign 2055	-46

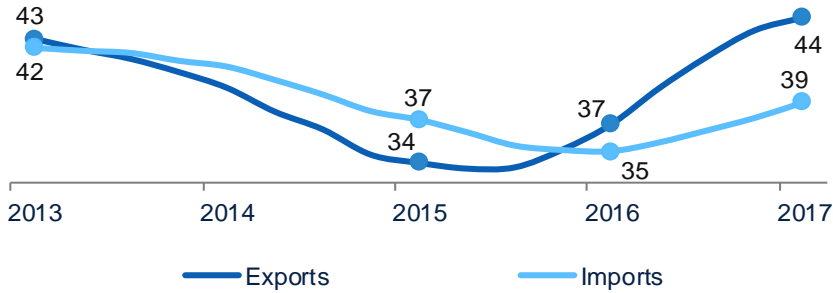Source: Bloomberg

Exchange rate
(soles per dollar)

Source: Bloomberg

Appreciative pressures on the national currency due to trade balance and financial inflows

Peru: trade balance
(USD billion)

Exports
Imports
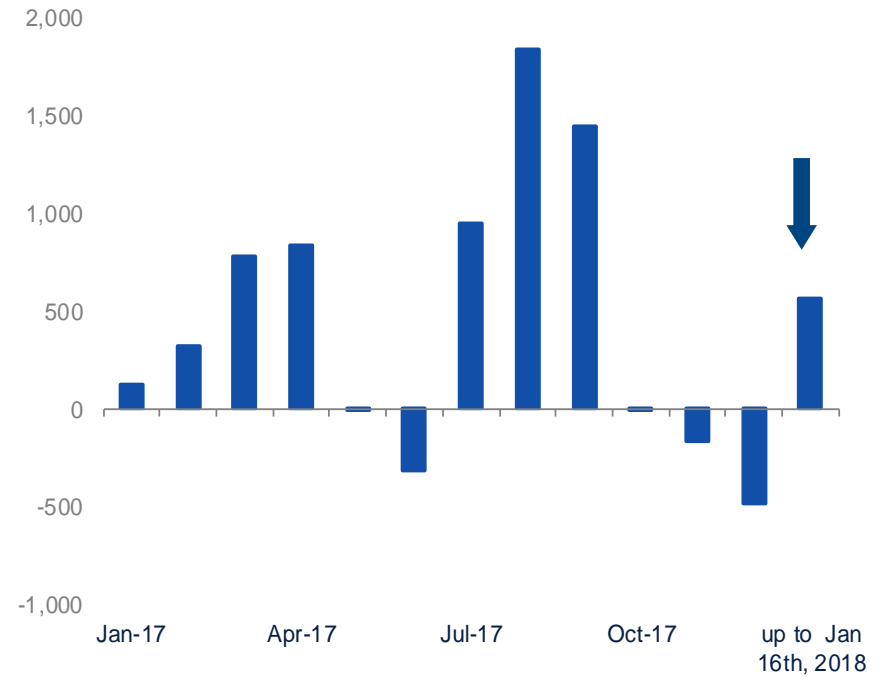
Source: Central Reserve Bank of Peru and Peruvian Revenue and Customs Office (SUNAT)

Non-resident holdings of sovereign bonds
(PEN billion)

Total balance: **63 billion**
Non-resident holdings: **38%**

Total balance: **86 billion**
Non-resident holdings: **45%**
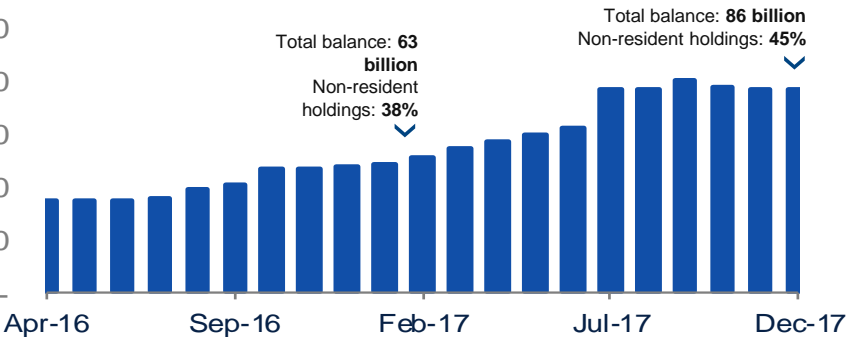
Source: MEF

Forex market: central bank buying intervention
(USD millions)

Source: Central Reserve Bank of Peru

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During this year we foresee an environment of relative stability on the currency front

Factors that will affect the value of the PEN

China
Gentle slowdown

Copper price
Gradual downward correction

> Reduction of trade balance surplus

Central banks of developed economies
Less monetary flexibility

> Decline in appetite for domestic financial assets

Exchange rate
(USD PEN)

Source: Central Reserve Bank of Peru and BBVA Research

What do we foresee for inflation
for this year and next?

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Inflation tending to fall, due mainly to movements in food prices

Inflation
(chge. % YoY CPI)

- Food and Energy
- Total Inflation
- Less food and energy

Source: Central Reserve Bank of Peru and BBVA Research
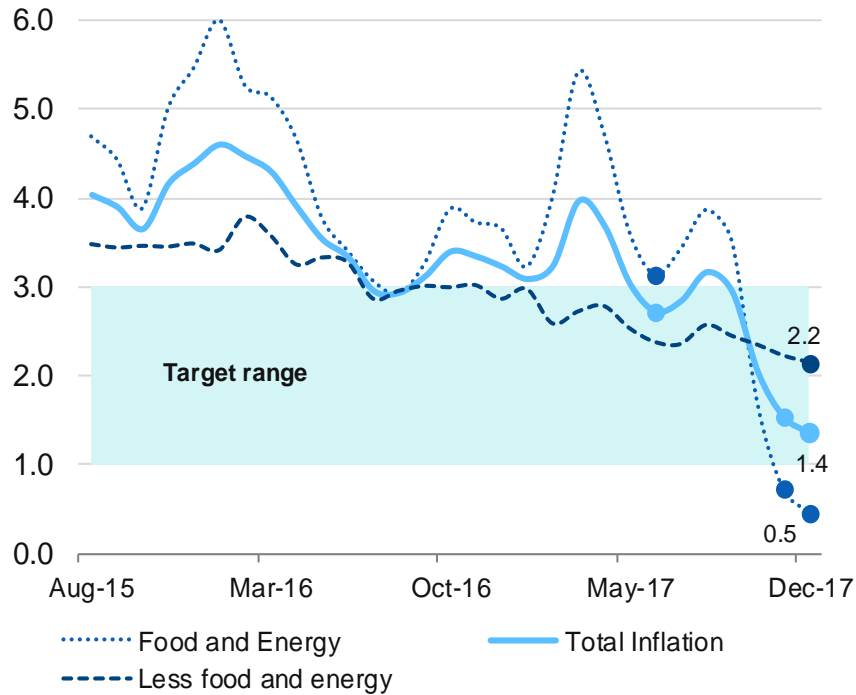
CPI food non-core
(chge. % YoY)
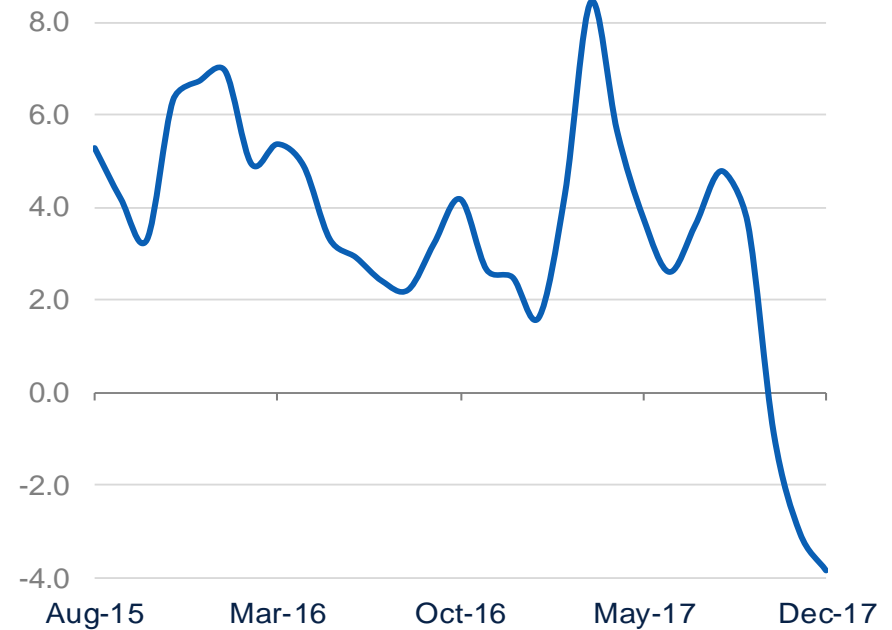
Source: Central Reserve Bank of Peru and BBVA Research

Inflation will fall in the remainder of the quarter against the high base for comparison but the fall due to supply factors will gradually fade

Lemon Price*
(soles per kilo, average for the month)

15.4
Reversal of supply shocks

Average of last 5 years 3.8

3.3

3.4

3.3

Jan-16   May-16   Sep-16   Jan-17   May-17   Sep-17   Jan-18

*January 2018 Price information as at 18th of the month.
Source: MINAGRI and BBVA Research
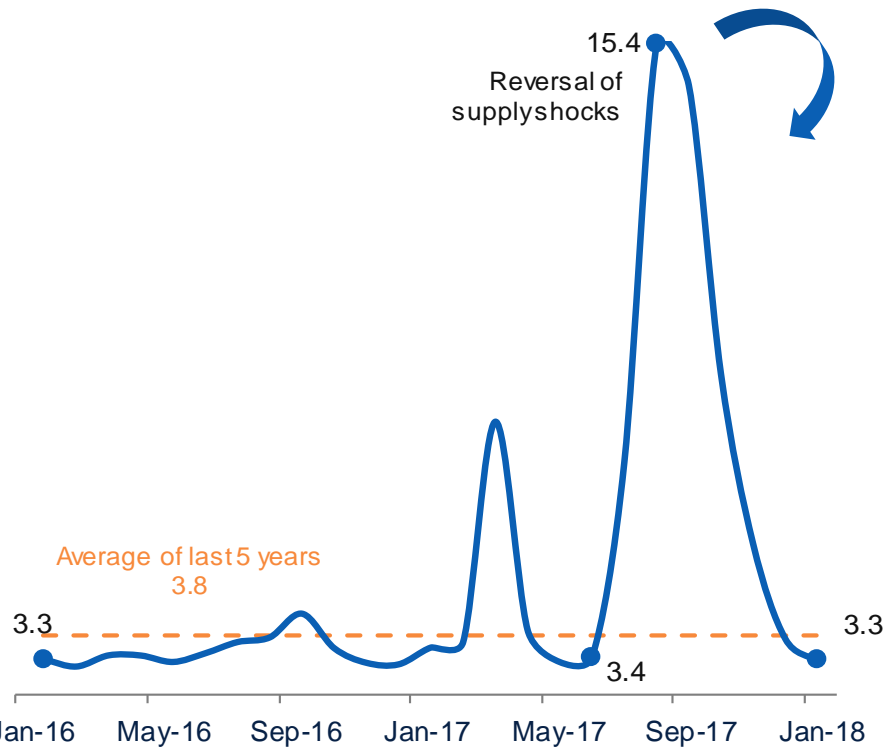
Average potato price
(soles per kilo, average for the month)

3,7

3,2

Excess supply of potatoes

Average of last 5 years 2.4

2,4

2,2

2,0

Jan-16   May-16   Sep-16   Jan-17   May-17   Sep-17   Jan-18

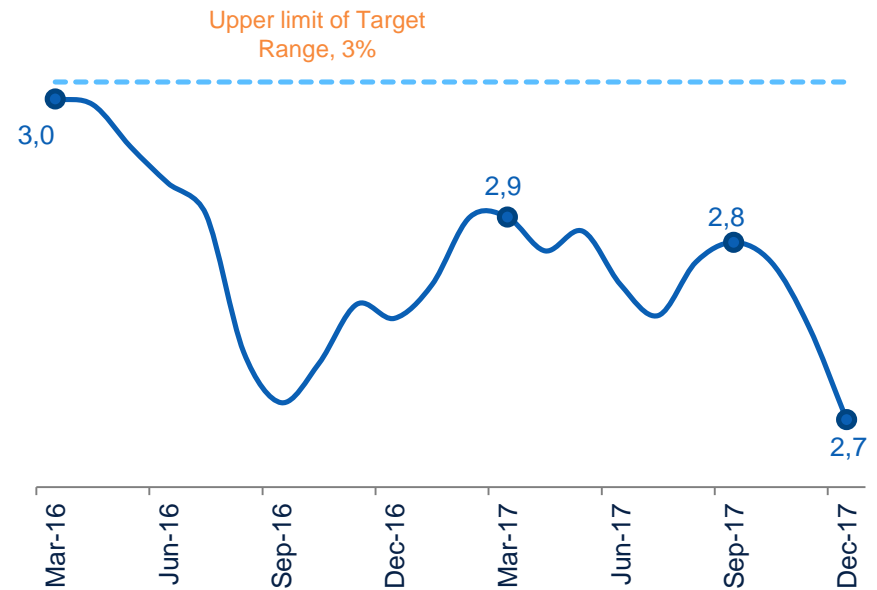*January 2018 Price information as at 18th of the month.
Source: MINAGRI and BBVA Research

Moreover, expectations are consolidating within the target range and…

Inflationary expectations at one year*
(points)
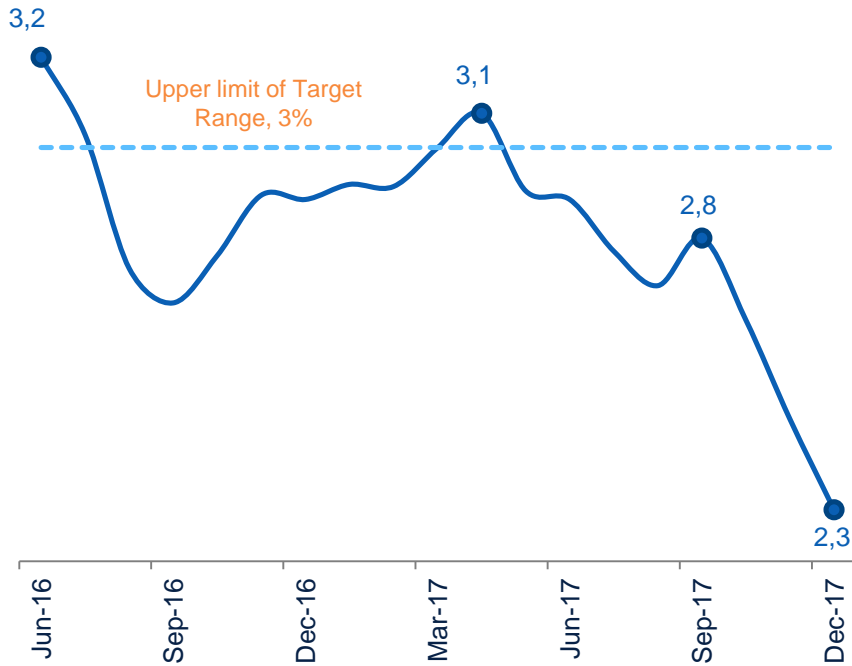
3,2

Upper limit of Target
Range, 3%

3,1

2,8

2,3

Jun-16 · Sep-16 · Dec-16 · Mar-17 · Jun-17 · Sep-17 · Dec-17

*Corresponds only to economic analysts and financial system.
Source: Central Reserve Bank of Peru and BBVA Research

Inflationary expectations at two years*
(points)

Upper limit of Target
Range, 3%

3,0

2,9

2,8

2,7

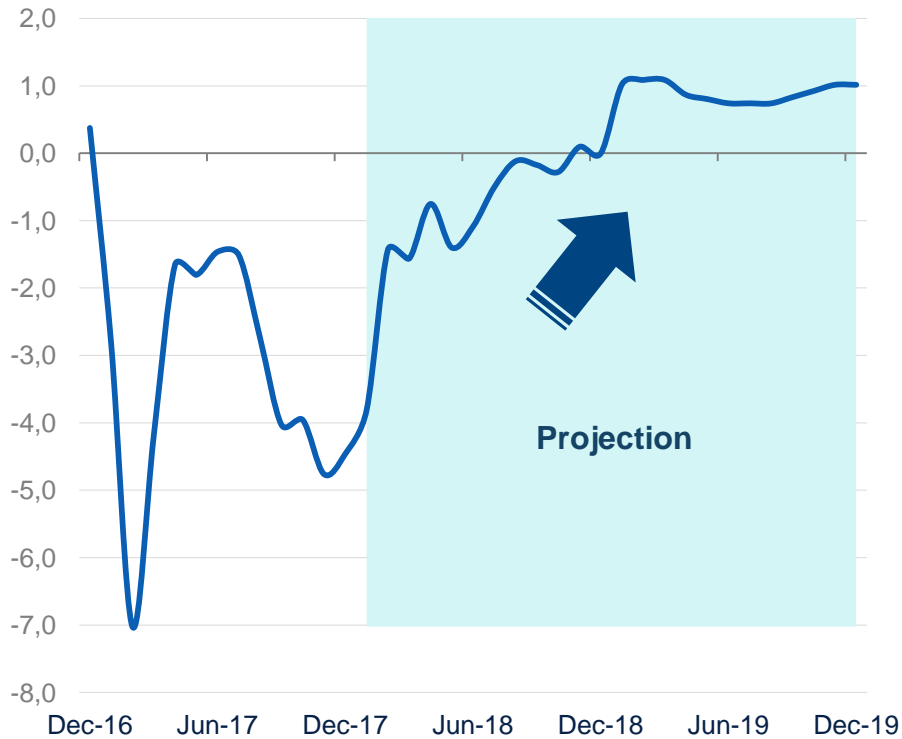Mar-16 · Jun-16 · Sep-16 · Dec-16 · Mar-17 · Jun-17 · Sep-17 · Dec-17

*Corresponds only to economic analysts and financial system.
Source: Central Reserve Bank of Peru and BBVA Research

... Looking ahead we foresee a situation with no major pressures from either exchange rates or demand

Exchange rate
(chge. % YoY, soles per dollar)

Projection

Indicator of demand pressures[1]
(% of non-primary potential output)

Upward pressures on prices

Projection

Downward pressures on prices

Source: Central Reserve Bank of Peru and BBVA Research
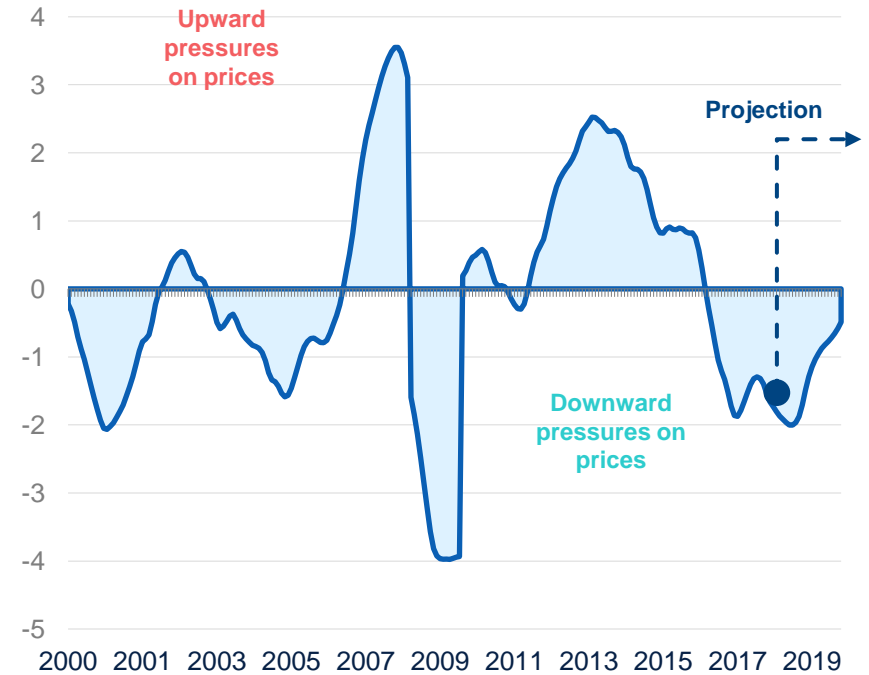
(1) Non-primary output gap as a percentage of the trend. Estimate using monthly information and the Tramo-Seats filter.
Source: Central Reserve Bank of Peru and BBVA Research

In this context, inflation will remain within the target range in 2018 and 2019

Standardisation of prices
Especially foodstuffs

Activity will gain traction
"Slack in the economy will gradually decrease"

Exchange rate
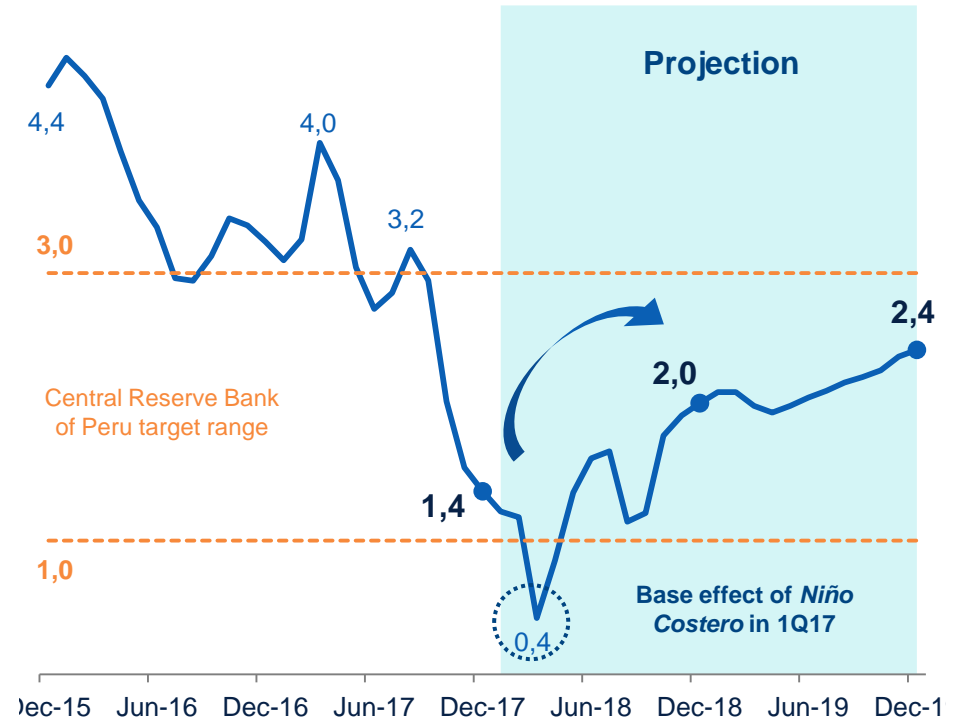Relatively stable (vs. 2017: -4.0%)

Commodity prices
Slowdown in the price of oil

Inflation
(% change YoY of the CPI)

Source: Central Reserve Bank of Peru and BBVA Research

Monetary policy:
Is there room for more
cuts in the base rate?

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Central bank has been easing monetary policy: we do not rule out an additional cut in the base rate

Monetary policy reference rate

(%)

Reference Rate
Real Interest Rate (with inflation expectations*)
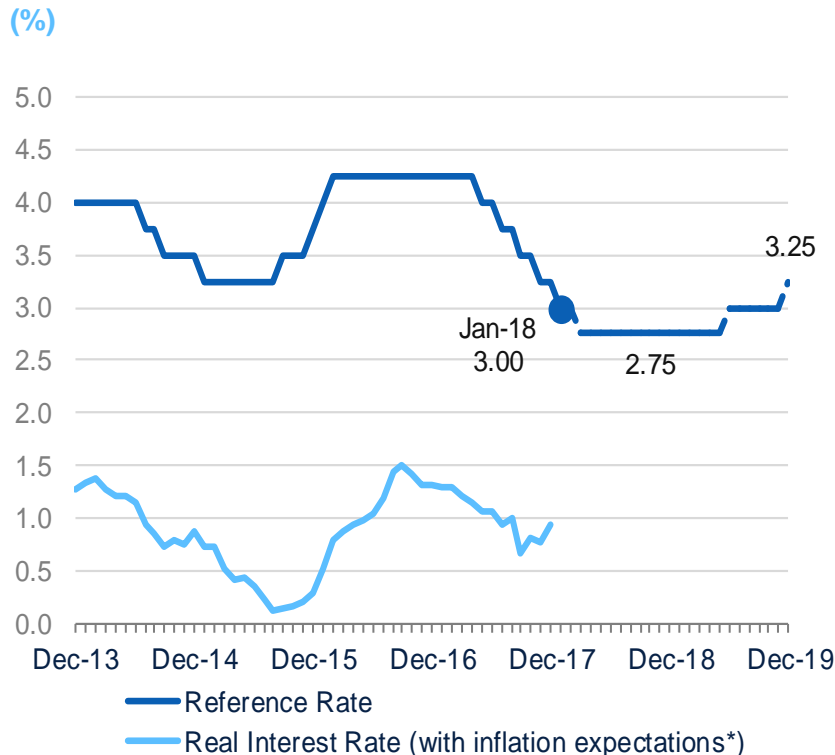
2018

An additional cut in the base rate

◆ Inflation and expectations around the middle of the target range

◆ Cyclical weakness of the economy

◆ Lag in fiscal stimulus

◆ Exchange rate relatively stable

2019

Level of base rate in line with improvement in private spending

*Expectations of inflation at one year taken into account.
Source: Central Reserve Bank of Peru and BBVA Research

Summary of projections

Macroeconomic projections

	2012	2013	2014	2015	2016	2017 (f)	2018 (f)	2019 (f)
GDP (% YoY)	6.0	5.8	2.4	3.3	4.0	2.3	3.5	3.8
Domestic demand (excl. inventories, % YoY)	9.8	6.4	2.5	2.2	0.9	1.9	3.3	3.7
Private Spending (% YoY)	6.5	7.2	1.9	2.7	1.3	1.9	3.1	4.1
Private Consumption (% YoY)	7.4	5.7	3.9	4.0	3.3	2.5	2.7	3.3
Private investment (% YoY)	15.5	6.9	-2.3	-4.3	-5.9	0.5	3.0	6.7
Public spending (% YoY)	11.6	8.1	3.6	3.6	-0.2	1.3	5.9	2.3
Public Consumption (% YoY)	8.1	6.7	6.0	9.8	-0.5	1.1	5.0	2.3
Public investment (% YoY)	19.5	11.1	-1.1	-9.5	0.6	1.7	8.0	2.2
Exports (% YoY)	5.8	-1.3	-0.9	4.0	9.5	6.1	3.2	2.7
Imports (% YoY)	10.7	4.2	-1.4	2.4	-2.2	4.3	2.8	2.6
Exchange rate (vs. USD, EOP)	2.57	2.79	2.96	3.39	3.40	3.25	3.25	3.28
Inflation (% YoY, EOP)	2.6	2.9	3.2	4.4	3.2	1.4	2.0	2.4
Interest rates (%, eop)	4.25	4.00	3.50	3.75	4.25	3.25	2.75	3.25
Fiscal Balance (% GDP)	2.3	0.9	-0.3	-2.1	-2.6	-3.2	-3.4	-2.7
Current Account (% GDP)	-2.8	-4.7	-4.4	-4.8	-2.7	-1.3	-1.8	-2.0

Forecast closing date: 19 January 2018
Source: Central Reserve Bank of Peru and BBVA Peru Research

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