BBVA | Research

Peru Economic Outlook

1st QUARTER 2018 | PERU UNIT

Contents

Closing date: **19 January 2018**

1. Summary

Available indicators point to economic growth having suffered a dip at the end of 2017. The suspension of anchoveta fishing, not lifted until January 2018, apparently led to an overall contraction in activities relating to the extraction and processing of natural resources, the first in three years. In this context, **we estimate that GDP grew by between 2.0% and 2.5% YoY in the fourth quarter of last year, perhaps closer to the lower part of that range, bringing GDP growth for the whole year to around 2.3%**. It is important to mention that despite the temporary dip at year-end, the composition of growth continues to change, being increasingly driven by domestic demand, as exports slow, with the boom in copper production tending to lose impetus.

For 2018 we see GDP growing by around 3.5% (and 3.8% in 2019). The **increase of just over a percentage point in growth will come about in a context in which the international panorama continues to be favourable for the Peruvian economy**. For example prices of the metals that Peru exports will remain at attractive levels, and this will favour investment in the mining sector. World growth will accelerate, (particularly Peru's main trading partners), while the monetary adjustments in developed economies will continue to be only gradual. **On the domestic front, as well as the return to normal of weather conditions, there will be a fiscal stimulus associated with the increased expenditure on rebuilding infrastructure damaged by the *El Niño Costero* weather phenomenon of early 2017 and to accelerate construction of new infrastructure**, such as that needed for the Pan American Games of 2019 and the second Lima metro line. However, this growth forecast for 2018 is somewhat lower than it was three months ago (3.9%). Following the debate in Congress on the impeachment of President Kuczynski (the motion was defeated) and the subsequent pardoning of former president Fujimori, the sense of precarious political stability has increased; in this context of greater uncertainty, our new baseline scenario incorporates greater reticence in spending on the part of businesses and households as well as in public spending. In other words the fiscal stimulus continues to act as a significant underpinning of growth in 2018, but less than in our previous report. The downward revision is attenuated by the improvement in the external panorama compared with the one we presented three months ago (greater world growth and higher metal prices).

The acceleration in public spending will take the fiscal deficit temporarily from 3.2% in 2017 to 3.4% in 2018. This will be the biggest deficit in eighteen years. Later on, from 2019, the government has the objective of consolidating the fiscal accounts. Fulfilling that commitment will require an effort to contain current spending, but we believe it is possible to achieve, bearing in mind that the increase in public spending in 2018 is specially on the investment side and it's transitory (reconstruction of infrastructure, Pan American Games), that revenues will have ceased to shrink as a percentage of GDP (recovery of domestic demand), and that tax refunds are starting to return to normal. This tendency towards consolidating the fiscal accounts has been incorporated into our projected baseline scenario, but the pace of consolidation that we assume is somewhat less ambitious than that announced by the government. As a result, gross public debt will stabilise at a level equivalent to just over 29% of GDP in the medium term.

In the financial markets, prices of Peruvian assets continue to strengthen. The increase in political noise on the domestic front only had a temporary negative effect. In the specific case of the Peruvian currency, it continues to come under appreciative pressure in a context of strong trade surplus - which we estimate grew to US$5.8 billion in 2017 - and capital inflows (to acquire sovereign bonds, for example), as a result of the abundance of liquidity globally, expectations that the central banks of the most developed economies will withdraw monetary stimulus measures but only gradually and with forewarning, improvement in external accounts and continuing solidity of the public finances. The central bank's intervention in the foreign exchange market is containing the appreciative pressure on the PEN. **Looking ahead, we see the panorama on the forex market remaining qualitatively similar, albeit with a trade surplus and capital inflows gradually moderating, and with a central bank continuing to be active. In that context, the PEN will end the year at a similar level of the one of year-end 2017**, but will subsequently tend to depreciate somewhat.

On the price side, inflation has fallen quickly and significantly in the past few months, ending in 2017 at 1.4%, the lowest level in the past seven and a half years. Contributory factors were the return to normal of certain food prices which had spiked with the abnormal weather conditions associated with *El Niño Costero* phenomenon, the appreciation of the currency and the cyclical weakness of the economy. We estimate that the bulk of the food price corrections had already taken place. Even so, due to the high base for year-on-year comparison, **inflation will continue to fall in the first quarter of 2018 and for a short time will be below the target range. Later on, however, it will tend to move closer to the middle of the target range, which we estimate will reach towards year-end**. The forecast takes account of the fact that the rate of year-on-year increase in food prices, which declined sharply last year, will return to normal and that the exchange rate will hold relatively steady, in contrast to what happened in 2017 when it fell by 4% (i.e. fewer PEN per USD) and thus reduced inflation. These effects will be attenuated by the slack still remaining in certain sectors of the economy and by the lower YoY rate at which we estimate oil prices will increase in 2018.

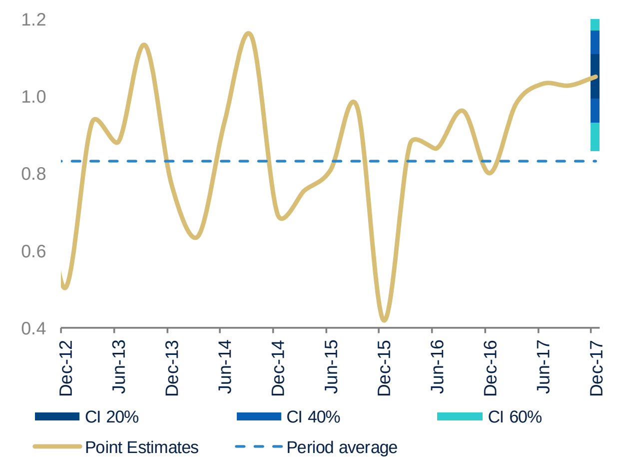
In this environment of sharply falling inflation – which is leading inflationary expectations down the same path, albeit more slowly – **and the cyclical weakness of the economy, the central bank has continued with cuts to its reference interest rate in the past few months**. It currently stands at 3.0%. **We do not rule out the possibility of an additional cut of 25 bps in the next two or three months** if GDP growth surprises the economic authorities negatively, which we think will happen with the 4Q figures, if fiscal stimulus takes longer than expected to materialise (and is thus below forecast), if increased political noise translates into further loss of business confidence, or if inflationary expectations fall below 2%. **Our baseline scenario incorporates this cut and assumes that the base rate will be held at 2.75% at least until mid-2019**.

2. Global growth reaffirms

Solid, sustained global growth in 2017

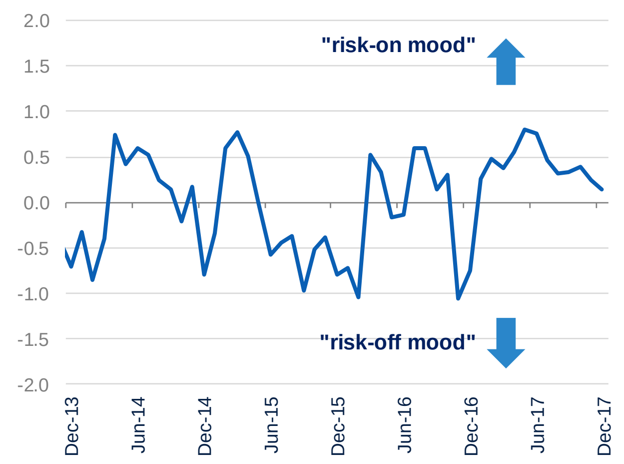
World economic growth consolidated in late 2017 at around 1% QoQ (Figure 2.1), reflecting improved results in all major regions and prospects of holding firm for the next few quarters. The support of economic policy, especially in the developed economies, has at last had a clear impact on the real economy, with recovery in investment gaining traction, underpinned by increased demand and an upturn in world trade, which in turn continues to drive the recovery of the manufacturing sector. Meanwhile, private consumption continues to perform well in the advanced economies, while gaining momentum in emerging economies. Prospects and confidence in many emerging economies have also been favoured by the increase in commodity prices, as well as by the relative calm in financial markets. On the financial markets, in the absence of any negative global shocks, the fundamentals have continued to support risk-taking by investors (Figure 2.2), as a result of which capital continues to flow into emerging economies, albeit with some gradual moderation in recent months. Thus world growth may have increased by 0.4 pp to around 3.7% in 2017, 0.2 pp more than was forecast three months ago.

Figure 2.1 World GDP growth. Forecasts based on BBVA-GAIN (% QoQ)



Source: BBVA Research

Figure 2.2 Risk appetite indicator (global factor using EPFR flows)



Source: BBVA Research based on EPFR

In the past three months, reasons for maintaining a degree of optimism on all the major regions have increased. In the US, the recovery consolidated over the course of the year, with growth rates somewhat higher than expected and improvements in the labour market. Tax reforms were finally passed, which may slow cyclical recovery. Nevertheless, they will not have a significant impact in the long-term. Meanwhile, recent Federal Reserve appointments point to an unchanged monetary policy, which should be reflected by a very gradual approach to normalisation. In China, the measures passed by the authorities stabilised the economy while also implementing structural reforms and approving an economic strategy that focuses more on getting fiscal imbalances under control and less on meeting growth targets. Finally, the euro zone has registered higher than expected growth in 2017, underpinned by an improved global environment and stronger domestic demand, which is benefiting from the reduced political uncertainty.

This scenario of increased growth and higher demand has been accompanied so far by subdued inflation, despite the expansionary measures adopted by the major central banks and the gradual reduction in idle capacity in the developed economies. In any case, the increased growth and higher oil prices should push inflation up in the short term, facilitating advances in the normalisation of central bank policy in developed economies, while many emerging economies still have room for manoeuvre when it comes to using monetary policy to bolster growth.

Our forecasts point to global growth accelerating slightly in the 2018-19 two-year period by around 0.1 pp to 3.8%, implying an upward revision of some 0.3 pp relative to the scenario presented three months ago. This change is in response to the higher growth projected for the US, China and the euro zone in 2018, due mainly to greater economic activity in the past few quarters, but also to the economic measures being implemented in the US and China. In particular, we now expect the US to grow by 2.6% in 2018 (0.4 pp more than three months ago) and by 2.5% in 2019, boosted by the effects of the tax reform and improved external and domestic fundamentals. For China, we foresee a more moderate slowdown thanks to the improved international environment and the economic policy strategy following the 19th Communist Party Congress, with growth of 6.3% in 2018 and 6.0% in 2019, compared with 6.7% in 2017. As for the euro zone, we have revised our growth forecast upwards by 0.4 pp for 2018, to 2.2%, followed by 1.8% in 2019, underpinned by the strength of domestic demand and the positive contribution of net exports. Lastly, in the Latin American economies we now expect to see a stronger recovery this year, due to the upward revision of global demand and higher commodity prices. Despite the foreseeable stability of world growth, we still expect a certain tempering of growth in developed economies in 2019, while in the majority of emerging economies the recovery will continue to consolidate.

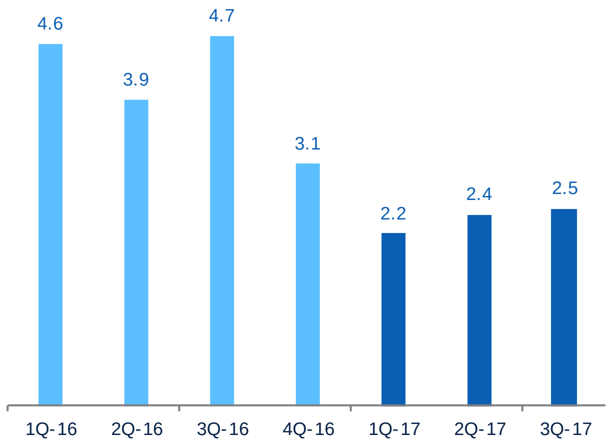
The risks to this relatively benign world panorama continue to exist, although they have declined since three months ago. Prominent above all are risks of a political and geopolitical nature, which may influence business confidence and the behaviour of the financial markets.

3. Peru: we have revised our growth forecasts for 2018 and 2019 downwards

During the third quarter of 2017 the economy continued to show signs of improvement, favoured by a recovery in domestic demand and the tailwinds from the international environment

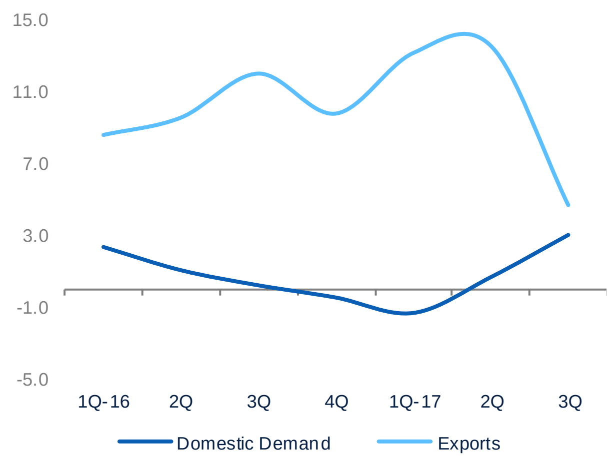
GDP grew by 2.5% YoY in the third quarter of 2017. This suggests that activity is improving (see Figure 3.1) after suffering the negative impact of *El Niño Costero* weather phenomenon and the postponement of major infrastructure projects such as the Southern Gas Pipeline. The improvement in activity is nonetheless moderate.

Figure 3.1 GDP
(change % YoY)



Source: Central Reserve Bank of Peru and BBVA Research

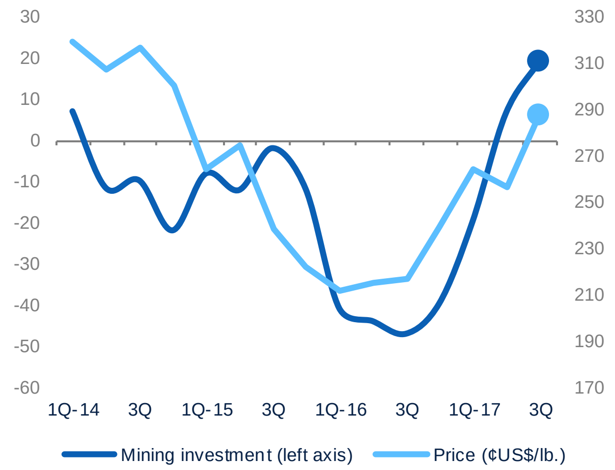
Figure 3.2 Domestic demand* and Exports
(in real terms, change % YoY)



* Excludes change in inventories
Source: Central Reserve Bank of Peru and BBVA Research

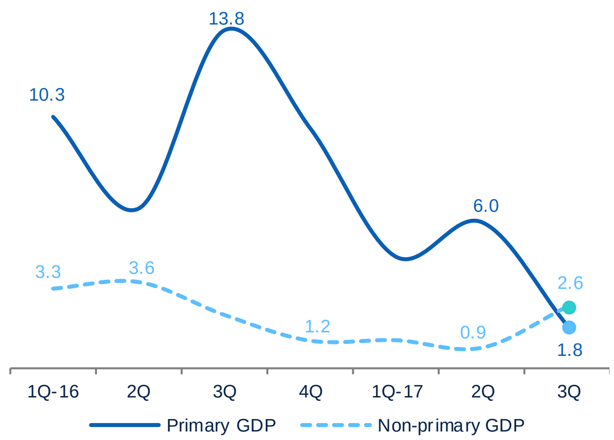
Within GDP there were some interesting changes in the third quarter, in line with what we anticipated in our previous report. On the expenditure side, domestic demand is recovering (see Figure 3.2), especially investment. Private sector investment for example started growing again after fourteen consecutive quarters of contraction, in an environment in which on the one hand mining investment is finding support in the favourable external conditions (attractive metal prices; see Figure 3.3) and on the other, non-mining investment is starting to regain strength little by little following the dissipation of the negative effects of *El Niño Costero* and in an environment of greater impetus from countercyclical economic policy. For its part public investment grew by 5% in the third quarter. This was its first positive figure for a year. Notable items were the increased spending on sanitation infrastructure and on the 2019 Pan American Games and the acceleration of the construction works for Line 2 of the Lima Metro. Exports weakened however, in contradistinction to domestic demand. This reflects the significant slowing in the rate of growth in copper exports, in a context in which it seems that companies may have been making temporary use of their inventories for exports, taking advantage of the increase in international copper prices (otherwise it is difficult to explain such strong first-half exports despite low 1H production figures), which would have ended in the second half of the year. In terms of sectors, the shift towards greater dynamism in domestic demand and a slowdown in exports was reflected in an improvement in non-primary activities such as construction, commerce and services, whereas primary activities as a whole, namely those linked to the extraction of natural resources, showed a weaker performance (see Figure 3.4).

Figure 3.3 Mining investment and Price of copper (change % YoY; USD¢/lb)



Source: Central Reserve Bank of Peru, MINEM (Ministry of Energy & Mines) and BBVA Research

Figure 3.4 Primary and non-primary GDP* (change % YoY)

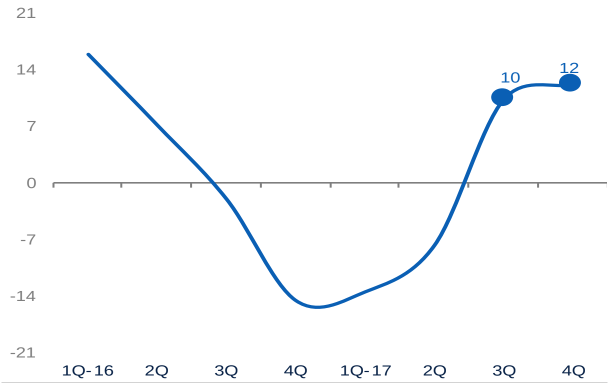


* Non-primary GDP excludes import duties and taxes.
Source: INEI (National Statistics Institute), Central Reserve Bank of Peru and BBVA Research

During the fourth quarter however, activity suffered a temporary dip according to our estimates, growing by between 2.0% and 2.5% YoY

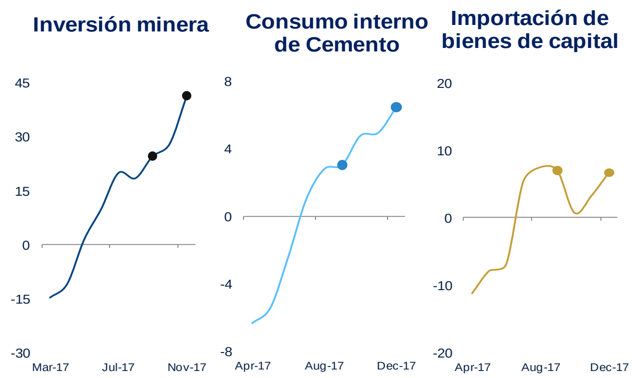
Available information for Q4 2017 suggests two things. Firstly, continuation and indeed accentuation of the main trends of the previous quarter, namely shifts in the growth drivers in favour of domestic demand and slowdown in exports. Public investment for example again showed strong dynamism (see Figure 3.5), while available indicators for private investment (see Figure 3.6) point that it has expanded at a similar rate to that seen in the previous quarter. Secondly, that the rate of GDP growth, which had been increasing, suffered a dip and came in at below 2.5% YoY. This result reflected above all the difficulties faced by the second anchoveta fishing season in the central-north coastal zone (suspension of fishing because a significant proportion of fish were under-size), which had a negative effect on primary fishing and manufacturing in terms of sectors and on exports as regards spending. If this had not occurred, and if a similar volume of anchoveta had been caught to that of 2016, GDP would have grown in Q4 by just over 3.0% YoY according to our estimates.

Figure 3.5 Public expenditure*
(change % YoY)



* Relates only to the central government, so it does not include state-owned enterprises.
Source: Central Reserve Bank of Peru and BBVA Research

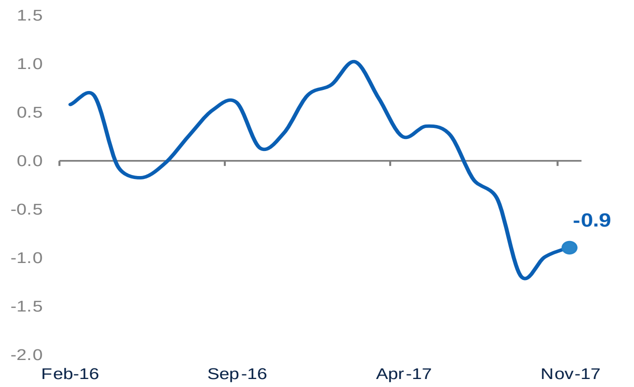
Figure 3.6 Indicators of private investment
(moving three-month average, change % YoY)



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

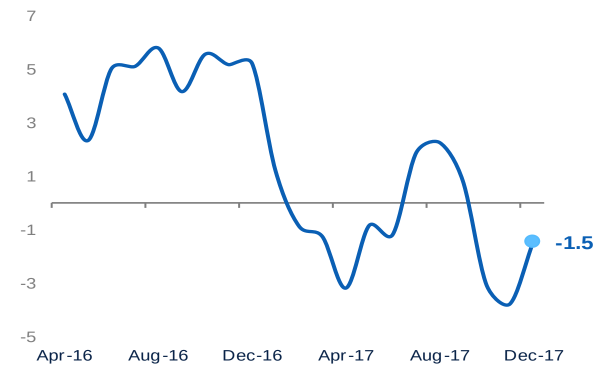
We should mention that despite the reduced dynamism shown by domestic demand in the second half of last year, and especially in the fourth quarter, this has not translated into an increase in formal employment (see Figure 3.7). Businesses, especially medium and large ones, are still not feeling confident enough to start hiring. Perhaps they still have some slack and do not yet need to increase their workforce; perhaps they have opted to implement technological improvements in their processes, seeking to reduce costs, which limits the need to hire personnel for the time being; or perhaps they will not venture to do so until they see that the recovery in activity is significant and sustained and that it extends to more sectors (construction has taken off, but services and commerce are showing only tepid improvement, while non-primary manufacturing continues to contract). In any case, the rigidity of Peru's labour market makes businesses cautious about formal hiring. This weakness in job creation has had a similar effect on total payrolls (see Figure 3.8), making it hard for private consumption to progress.

Figure 3.7 Formal employment*
(change % YoY)



* Employment with private businesses with more than 10 workers in urban areas. Not including the construction sector.
Source: MTPE (Ministry of Labour and Employment Promotion)

Figure 3.8 Total payroll*
(in real terms, change % YoY)



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

With the growth in economic activity that we anticipate for the fourth quarter of 2017, **GDP will have grown by around 2.3% for the year**, a year in which although the international environment was favourable and on the home front economic policies started to be more counter-cyclical, particularly in the second half, activity nevertheless suffered two significant negative shocks, in the form of *El Niño Costero* phenomenon and the postponement of major infrastructure projects.

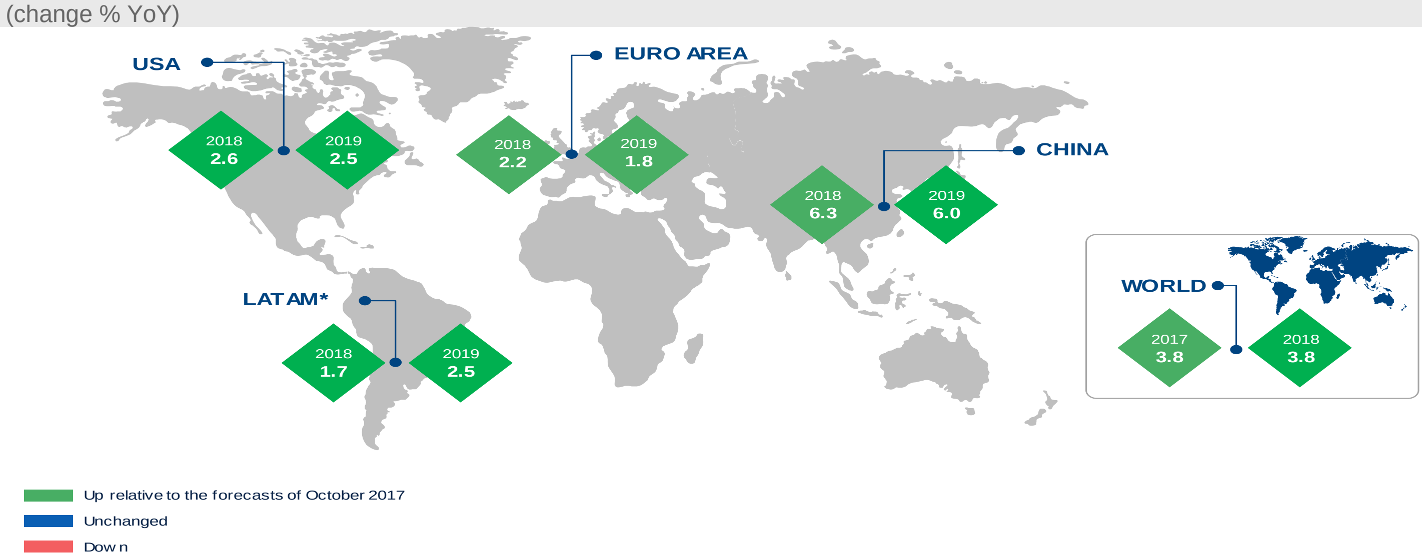
Compared with what we foresaw in our previous report, the increased uncertainty linked to the political tensions will put the brakes on growth in 2018 and 2019, despite the improved external environment

In addition to the trends currently exhibited by the Peruvian economy, our projected baseline scenario also takes account of the following.

On **the external front**, more favourable conditions than those anticipated in our previous report (October) due to:

- **an upward revision of GDP growth projections for the US, China and Latin America** (see Figure 3.9). The rate of expansion of global economic activity will consolidate at around 3.8% in the next two years and will be more synchronised. We should mention that in the case of China we have corrected the economic growth forecasts upwards not only for 2018 and 2019 but for the following years too. This reflects the fact that the measures approved by the authorities have succeeded in stabilising the economy, while at the same time certain structural reforms have been embarked upon and, the National Congress of the Chinese Communist Party in October approved an economic strategy that is more focused on controlling the imbalances.

Figure 3.9 World growth
(change % YoY)

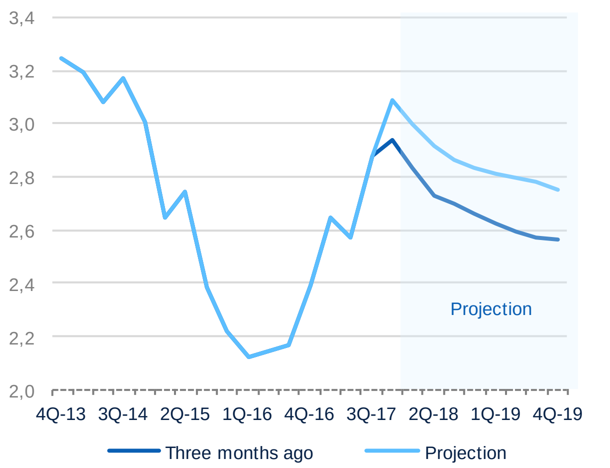


Corresponds to "LatAm7": Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. Source: BBVA Research

- **Upward revision of commodity prices**. It is worth pointing out that the recovery shown by international metal prices in the past few months has been accompanied by a recovery in mining investment in Peru (see Figure 3.3). In this context, small- and medium-size mining projects representing more than US$4 billion have become viable. We estimate that construction starts will have a positive economic impact in 2018 and appreciably more so from the following year (see Table 3.1).

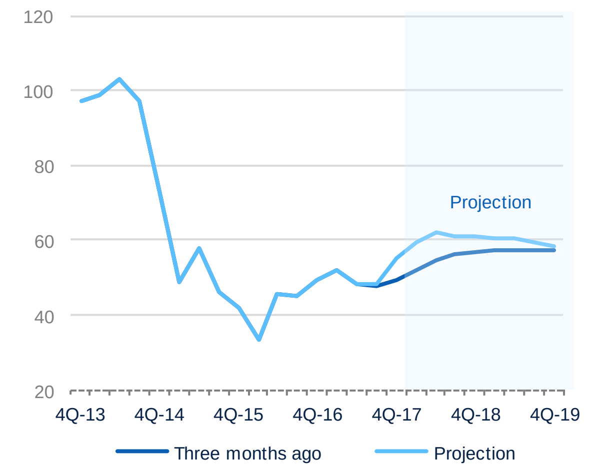
  In the particular case of the price of copper, we have revised the entire projection path upwards (see Figure 3.10) consistently with the increased growth forecast for China. Thus for 2018 the average price will increase to US$2.90 per pound (from US$2.79/lb in 2017). Currently copper is trading at above US$3.10/lb, so the implied trajectory over the course of 2018 (and thereafter) is toward the low. This is based on the view that China's growth will moderate in the next few quarters, the dollar will appreciate in multilateral terms and non-trading agents currently present in the market (with speculative positions in favour of copper) will gradually withdraw. Towards the end of the forecast horizon (2022) the price of copper will tend towards a level of US$2.70/lb, above the US$2.52/lb mentioned in our exercise of three months ago.

Figure 3.10 Price of copper
(US$/lb)



Source: Bloomberg and BBVA Research

Figure 3.11 Price of oil WTI
(US$/barrel)

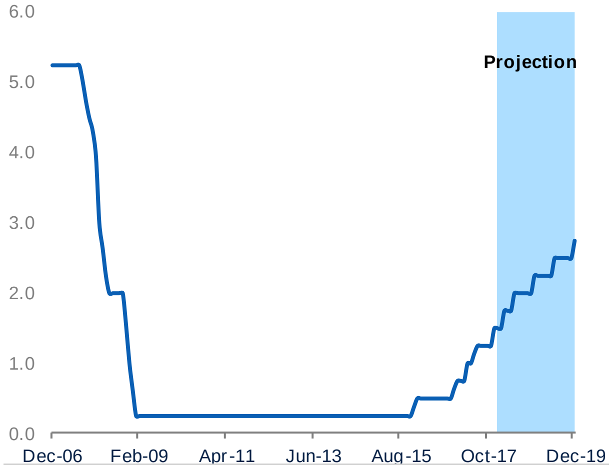


Source: Bloomberg and BBVA Research

As regards the price of oil (Peru is a net importer) our baseline scenario assumes that it will be around US$61 a barrel in 2018, above the average for the previous year (US$51) and above our forecast of three months ago (US$55), taking account of the upward adjustment in world growth (more demand), the extension of agreements on production cuts by many of the main producers (less supply), and the introduction of a risk premium on account of political events in Saudi Arabia. As the production cut agreements expire, high prices encourage increases in volumes supplied to the market and the risk premium for Saudi Arabia fades, the price of oil will tend to fall (see Figure 3.11), most likely starting in 2019.

- **Only gradual normalisation, with forewarning, of the monetary policy position in the most developed economies**, in particular the US. Our baseline scenario assumes that the US Federal Reserve will only gradually raise its base rate, which will facilitate its assimilation by the markets (see Figure 3.12). The increase will be 75 bps in 2018 (our previous forecast was for two hikes of just 25 bps each) with a further 50 bps in 2019, which is consistent with the greater growth forecast for the US economy. Our baseline scenario further assumes that the Federal Reserve will implement its balance sheet reduction process in accordance with its announcement. As regards the ECB, it will reduce its asset purchases in 2018 (by half, although the purchasing programme will probably not end until September); rate hikes will not start until 2019.

Figure 3.12 US Federal Reserve: monetary policy rate (%)



Source: Bloomberg and BBVA Research

Table 3.1 Mining investment in new concession projects (USD millions)

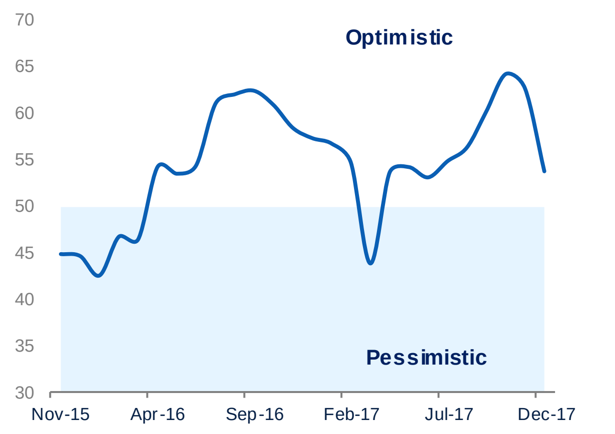
Project	Annual Production	Year 2018	Year 2019
Mina Justa	110000 TMF/Cu	236	636
Toromocho Ampl.	75000 TMF/Cu		650
San Gabriel	150000 OZ		250
Pukaqaqa	40600 TMF/Cu		353
Magistral	60000TMF/Cu		250
Total		**236**	**2,139**

Source: MINEM and BBVA Research

In contrast with the improvement we foresee for external conditions, on the **domestic front** we are assuming that, compared with our previous report (October), the domestic context will be more difficult going forward.

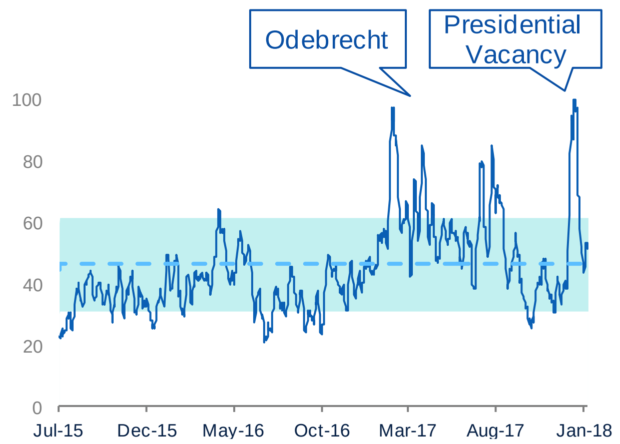
- The political noise and fatigue generated by the impeachment process and the pardon of former president Fujimori heightened the feeling of precarious political stability and therefore also uncertainty. The political scene will take some time to settle down again after this strong tremor. During that period **businesses will be more reticent in spending (business confidence weakened**, as we are already starting to see; see Figures 3.13 and 3.14**) as will households; and the public sector too**. As the new political context becomes clearer, we could of course revise our forecasts accordingly.

Figure 3.13 Business confidence
(index, in points)



Source: Central Reserve Bank of Peru

Figure 3.14 Indicator of political tensions in Peru
(100 = 28 Dec 2017, the highest point in the sample)



Source: GDELT and BBVA Research.

- **The fiscal impetus will be less pronounced**. In our revised forecasts we are incorporating a reduced degree of dynamism in works to rehabilitate and reconstruct infrastructure damaged by *El Niño Costero*, not only in view of the greater reticence in public expenditure, but also because we have not seen any of the expected increases in this spending. We are also being more conservative now about some of the biggest infrastructure works such as Line 2 of the Lima Metro, while in the case of the construction of the facilities for the 2019 Pan American Games we have not made any major adjustments. All the same, the impetus from increased public spending still explains a significant part of the acceleration of economic growth in 2018.

  It is important to mention that, due to the constant postponements, we are no longer assuming a restart of the construction of the Southern Gas Pipeline within the forecast horizon, as we did up until our last report, when we assumed it would restart in 2019.

In the baseline scenario described for 2018, without the abnormal weather events of the previous year, there will still be tailwinds from the international environment (favouring private investment, especially in mining, and demand for exports with more added value), and public spending will accelerate (on reconstruction and on infrastructure for the 2019 Pan American Games, although less than we estimated three months ago), GDP will grow by approximately 3.5% this year (previous forecast published in October: 3.9%). Later, in 2019, private sector expenditure will continue to gain traction, especially in mining investment, with the construction of small and medium projects (see Table 3.1). Non-mining private investment for its part will show a tentative improvement, in an environment in which work will accelerate on certain major projects such as the expansion of Lima Airport, the increased monetary stimulus will be fully passed on to the real economy, the political situation will clear up and – we suppose – political tensions will relax at least partly; all in a context in which there will be some improvement in employment and therefore in private consumption. The public sector spending on the other hand will slow, which is consistent with the start of the process of fiscal consolidation to which the government has alluded. On balance, we estimate that GDP growth will continue to accelerate and will grow by around 3.8% in 2019 (previous forecast published in October: 4.0%).

In 2018 in particular, the most outstanding activities will be fisheries and construction, the former thanks to the normalisation of anchoveta catches and the latter thanks to the impetus of public sector spending on infrastructure

We estimate that primary activities as a whole, i.e. those linked most closely to the extraction of natural resources[1], will be the most dynamic in 2018, growing by around 6% (see Table 3.2). Within that, the most outstanding sector will be fisheries. Here we are assuming two relatively good anchoveta fishing seasons in the central-north coastal zone which will each yield between 4.0 and 4.5 million metric tons. This will also favour the preparation of fish-meal and oil, i.e. primary manufacturing. Our baseline scenario also assumes that certain mines which produced less than their potential last year, such as Antamina, Toquepala and Cuajone, will return to normal levels of production this year. Finally, we are assuming that the northern gas pipeline will be operative from the beginning of the year, which will favour oil production, and an uptick in agricultural and livestock production once the effects of *El Niño Costero* have dissipated and in an environment of more normal weather conditions.

Turning to non-primary activities, which are more geared to attending to domestic demand and which represent more than 70% of the production of goods and services, we estimate that they will continue to recover in 2018. Construction will stand out, in a context in which works on infrastructure (for example the reconstruction of infrastructure damaged by *El Niño Costero* and new infrastructure for the 2019 Pan American Games). This will tend to stimulate other sectors of the economy that serve the demand from construction activity or complement it, such as services and primary manufacturing. These three activities will also benefit from the increase in mining investment.

Table 3.2 GDP by productive sector (change % YoY)

	2016	2017 (e)	2018 (p)	2019 (p)
Agriculture and livestock	2.6	1.5	3.7	3.2
Fishing	-10.1	4.7	8.8	13.6
Mining and fuel	16.3	3.1	6.3	1.0
Metals	21.2	4.1	5.5	0.5
Fuel	-5.4	-2.4	11.4	4.1
Manufacturing	-1.4	-1.0	2.5	4.8
Primary	-0.6	1.0	8.0	7.0
Non Primary	-1.6	-1.8	0.7	4.0
Electricity and water	7.3	1.2	3.9	4.7
Construction	-3.1	2.6	4.0	6.0
Commerce	1.8	1.0	1.8	3.5
Other services	4.4	3.2	3.4	4.3
GDP	**4.0**	**2.3**	**3.5**	**3.8**
Primary sectors	10.0	2.5	6.0	2.5
Non-primary sectors	2.5	2.0	2.8	4.3

* Excludes import rights and taxes
Source: Central Reserve Bank of Peru and BBVA Research.

Table 3.3 GDP on the expenditure side (change % YoY)

	2016	2017 (e)	2018 (p)	2019 (p)
1. Domestic Demand	**1.1**	**1.8**	**3.4**	**3.8**
a. Private Consumption	3.3	2.5	2.7	3.3
b. Public Consumption	-0.5	1.1	5.0	2.3
c. Gross Domestic Investment	-3.9	0.4	4.4	6.0
Gross Fixed Investment	-4.6	0.7	4.0	5.7
- Private	-5.9	0.5	3.0	6.7
- Public	0.6	1.7	8.0	2.2
2. Exports	9.5	6.1	3.2	2.7
3. PIB	**4.0**	**2.3**	**3.5**	**3.8**
4. Imports	-2.2	4.3	2.8	2.6
Note:				
Domestic Demand (less inventoriess)	*0.9*	*1.9*	*3.3*	*3.7*
Private Expense (less inventories)	*1.1*	*2.0*	*2.8*	*4.0*
Public Expense (consumption and investment)	*-0.2*	*1.3*	*5.9*	*2.3*

Source: Central Reserve Bank of Peru and BBVA Research

1 Agriculture and livestock, fisheries, mining, oil and gas and primary manufacturing.

This sector performance will be reflected on the expenditure side in greater dynamism of domestic demand compared with the previous year (see Table 3.3), underpinned by the increase in public spending and private investment, especially in mining. In qualitative terms there are thus no major changes relative to our forecast of three months ago. However, we have moderated the growth in public spending, as explained previously, and we have made some adjustments within private investment. In this latter case, the pace of growth in mining investment is now greater than we predicted in our previous report (and than our estimate for 2017) due to the fact that we now expect prices of metals, particularly copper, to be higher throughout the forecast period. In this context, we have incorporated into the baseline scenario greater investment in exploration and the construction of a number of small- and medium-size mines (see Table 3.1) which will start in 2018 but the effect of which will be felt more in the following year. Non-mining investment on the contrary has corrected downwards (and will progress at a pace not very different from last year) due to the private sector's more cautious attitude to spending as a result of the political environment in the country, which naturally limits the creation of employment on appropriate terms.

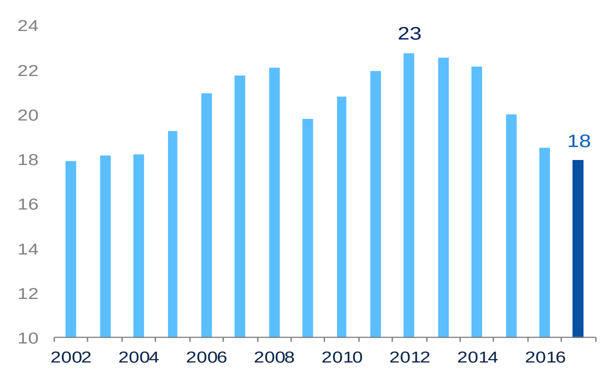
In the medium term, GDP growth will be around 3.5%, which is not enough to break free of the "middle-income trap"

The uncertainty associated with the increase in political noise and above all the growing sense that political stability is precarious, could have implications for growth in the medium term. In the first place, because the environment is less favourable for doing business and accumulating capital. And in the second place because it is less likely that a consensus will be reached to approve and implement measures to boost productivity and competitiveness. Our baseline scenario for the period 2020-2022 assumes average annual GDP growth of 3.6%. This is consistent with gross fixed investment (private and public) stabilising at a level equivalent to just under 23% of GDP, below the highest levels seen in the strong growth period of 2002-2013 (approximately 27% of GDP) and also below those posted in economies that experienced phases of rapid growth such as those of East Asia.

4. Fiscal policy: the major challenge continues to be increasing government revenues

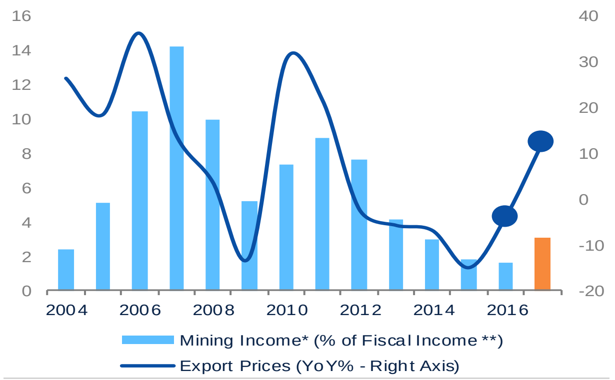
The fiscal deficit increased in 2017 to 3.2% of GDP (2.6% the year before). The increase in the deficit was due mainly to the fall in tax revenues (as a percentage of GDP, see Figure 4.1). This fall was in spite of the improved performance of domestic demand and the improvement in the terms of trade, as a result of which revenues from mining increased (see Figure 4.2), and is related to the measures put in place to make the formal economy more attractive (for example the introduction of the tax regime for micro and small firms and the "fair IGV" (general sales tax)), which have had a negative impact on tax revenues, at least in the short term.

Figure 4.1 Current revenues of the central government (% of GDP)



Source: Central Reserve Bank of Peru and BBVA Research

Figure 4.2 Tax revenues from mining and export prices



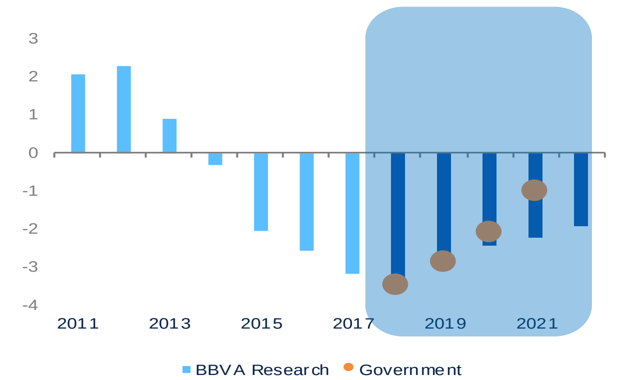
*Corresponds to income tax (3rd category), duty and special tax on mining.** Current revenues of the central government
Source: Central Reserve Bank of Peru, SUNAT (Customs and Tax Administration Authority) and BBVA Research

For 2018 we project that the government deficit will increase temporarily to 3.4% of GDP. This will be the highest level in eighteen years. The increased fiscal deficit that we expect is consistent with the increase there will be in the spending for the reconstruction of the infrastructure damaged by *El Niño Costero* (US$950 million more than the year before), the construction of infrastructure for the 2019 Pan American Games (US$635 million more) and the acceleration of work on the major public infrastructure projects (increase of US$640 million), particularly on the second line of the Lima Metro. This means that non-financial public sector expenditure will increase by nearly 6% in real terms, a more conservative boost than that projected in our previous report for the reasons explained above.

Turning to revenues, we estimate that they will start to recover (as a percentage of GDP) due to the fact that domestic demand will continue to strengthen, metal prices will be higher on average than in the previous year (that of copper in particular), and tax refunds will start to return to normal (having peaked at the beginning of last year and since having stabilised and even started to fall). Moreover, this year there will be no downward effect from the "fair IGV" scheme (its impact having been temporary by its very nature when it was introduced). All these factors will more than offset the additional personal income tax deductions that will start in 2018 and the fact that our projection does not envisage exceptional revenues such as those of last year (execution of the Southern Gas Pipeline operator's bond and tax amnesty for declaration of funds and income from abroad).

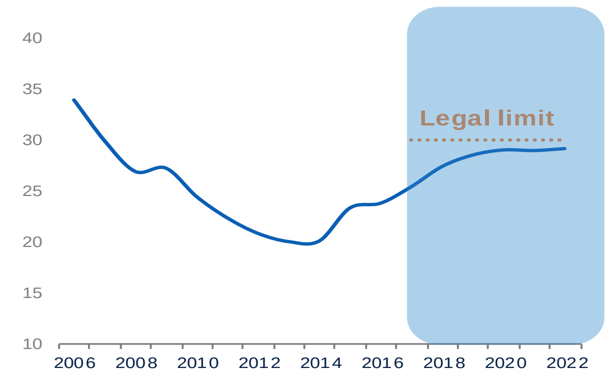
The government has committed to start a process of fiscal consolidation from 2019. Although this commitment will require effort, it seems realistic as long as the increase in the public spending in 2018 will be mainly by way of investment and of a temporary nature (reconstruction of infrastructure, Pan American Games); added to this is the fact that revenues will have ceased to decline as a percentage of GDP and tax refunds are starting to return to normal. This trend towards consolidation of the fiscal accounts has been factored in to our baseline scenario. However, in our scenario the pace of consolidation is less ambitious than the government's. We are more conservative as regards expenditure, allowing a little more flexibility for infrastructure spending, and also for current spending although the adjustment here is less marked); on the revenue side, we assume that the tax measures put in place in 2017 to make it more attractive for firms to enter the formal economy will have only a limited effect on tax revenues. Thus the fiscal deficit will start to narrow from 2019 (see Figure 4.3) and will stand at around 2.0% of GDP towards 2021. It is important to mention that the trend towards consolidation of the fiscal accounts from next year, together with gross public debt which we think will stabilise at around 29% of GDP in the medium term (below the maximum limit of 30% of GDP established in the Fiscal Transparency and Responsibility Act; see Figure 4.4), are essential for maintaining the credibility of the Peruvian State and hence its sovereign credit rating.

Figure 4.3 Fiscal result
(% of GDP)



Source: MEF (Ministry of Economy and Finance) and BBVA Research

Figure 4.4 Gross public debt
(% of GDP)



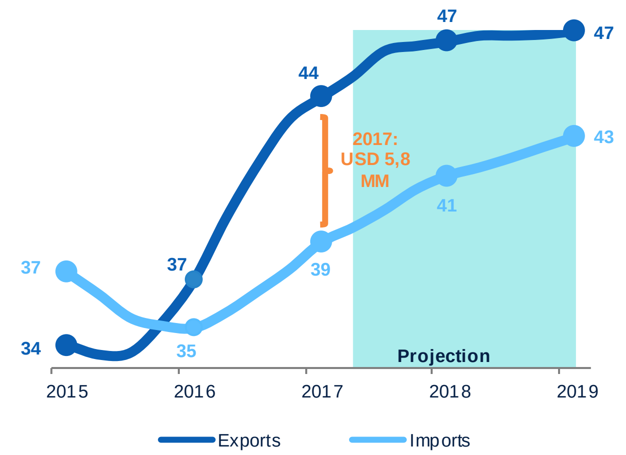
Source: Central Reserve Bank of Peru and BBVA Research

We do not rule out the possibility of the government's implementing measures (or reinstating some of those it has removed in recent years) to raise the level of tax revenues, which as a percentage of GDP have fallen by five percentage points since 2012. The recovery of revenues will be important for ensuring that the fiscal deficit is reduced and that public investment (a less rigid component of public spending than current expenditure) is not squeezed. It will also be an important contributory factor in ensuring that the country's sovereign credit rating is not revised downwards.

5. Small current account deficit: strength in an environment of moderating capital inflows

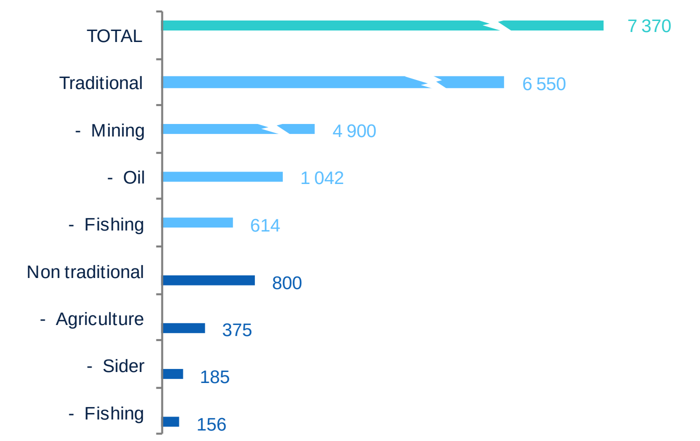
The balance of trade improved in 2017 due to the sharp increase in export values (see Figure 5.1). Higher export prices and improved world demand (including from within Latin America) were the two main factors favourably affecting this performance. The former meant that exports of traditional products, especially mining products (see Figure 5.2), increased strongly, while the latter was more pertinent for non-traditional exports, which improved, albeit to a more limited extent. We estimate than in this context Peru's trade surplus was around US$5.8 billion in 2017, the biggest since 2012. The higher export prices however also meant more profit for mining companies and consequently, at the macroeconomic level, more repatriation of profits and dividend payments. Our balance of greater trade surplus but also greater payments of dividends and profit remittances leads us to a current account deficit that will have further decreased in 2017, to around 1.3% of GDP.

Figure 5.1 Trade balance (USD billions)



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

Figure 5.2 Annual increase in exports in 2017 (US$ millions; estimated)



Source: Central Reserve Bank of Peru and BBVA Research

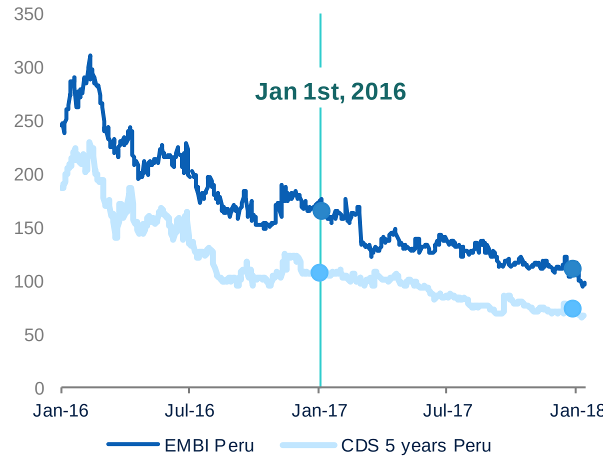
For 2018 we foresee some deterioration in the external deficit to a level equivalent to 1.8% of GDP. This will come about in a context in which the greater dynamism of domestic demand will boost imports and the average price of oil will rise, both of which will be attenuated by the higher average prices of the metals that Peru exports. Later on, despite the small- and medium-size mining projects starting to produce from 2021, the downward correction in metal prices and the consolidation of domestic demand will take the current account deficit of the balance of payments to around 2% of GDP.

These external deficits are relatively small, which limits external financing requirements. This places the Peruvian economy in a relatively strong position to face the decline in capital inflows to emerging economies, which is worth highlighting given the trend towards a less accommodative monetary policy stance in the most developed economies (leading to a narrowing of the relative profitability differential in favour of emerging market assets) and the tax measures to be implemented by the Trump administration in the US (the sharp cut in income tax and the incentives to repatriate capital may lead to greater American and foreign investment in the US).

6. Financial markets: assets continue to perform well, albeit with bouts of short-term volatility

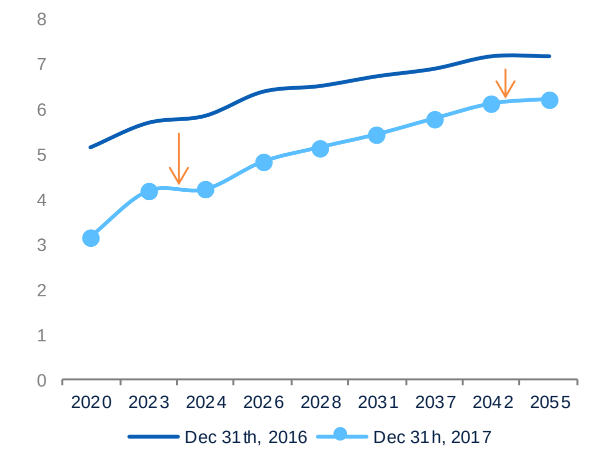
In the last quarter of 2017 Peruvian financial assets continued to strengthen, not without some short-lived upsets, such as the one caused at year-end by the motion to impeach the president, which to many people's surprise did not succeed in the end. The annual evaluation was also positive: risk indicators declined even further (the EMBI for example decreased by 35%; see Figure 6.1), yields demanded on sovereign debt securities declined (by between 100 and 200 basis points; see Figure 6.2), Peruvian companies plucked up the courage to increase their debt issues in the international markets (even issuing in domestic currency; see Table 6.1), and equities gained (stock indices for some sectors rose by more than 25%; see Figure 6.3).

Figure 6.1 Risk indicators (basis points)



Source: Bloomberg

Figure 6.2 Yield curve for sovereign bonds (%)



Source: Bloomberg

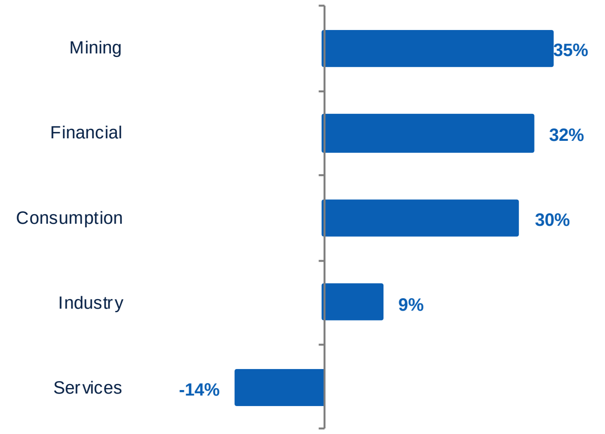
This good performance took place in an environment of abundant global liquidity, expectations that the central banks of the most developed economies will withdraw monetary stimulus measures but only gradually and with forewarning, increased export prices that strengthened the external accounts and continuing solidity of the public finances.

Figure 6.3 Bond issues by Peruvian companies in the international market, 2017

	Issue month	Amount (mills. US$)	Term (years)	Rate (%)
Non-financial sector		**3840**		
Private		**1840**		
Orazul	April	550	10	5.6
Cerro del Águila	August	650	10	4.1
San Miguel Industrias	September	300	5	4.5
Fenix Power Perú	September	340	10	4.3
Public		2000		
Petróleos del Perú	June	1000	15	4.8
Petróleos del Perú	June	1000	30	5.6
Financial sector		**1522**		
Private		**918**		
Intergroup	October	300	10	4.1
Banco de Crédito del Perú[1]	October	618	3	4.9
Public		605		
Fondo Mivivenda[1]	February	455	6	7.0
Fondo Mivivenda	February	150	7	3.5
Total		**5362**		

1/ Issues in PEN. Source: Central Reserve Bank of Peru

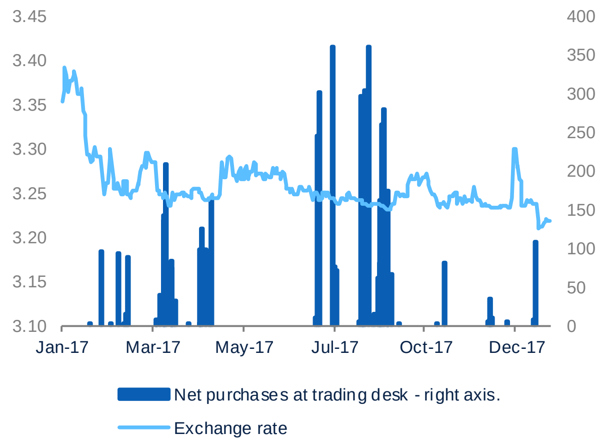
Table 6.1 Sector stock market indices, 2017 (Measured in PEN, change % YoY)



Source: Lima Stock Exchange

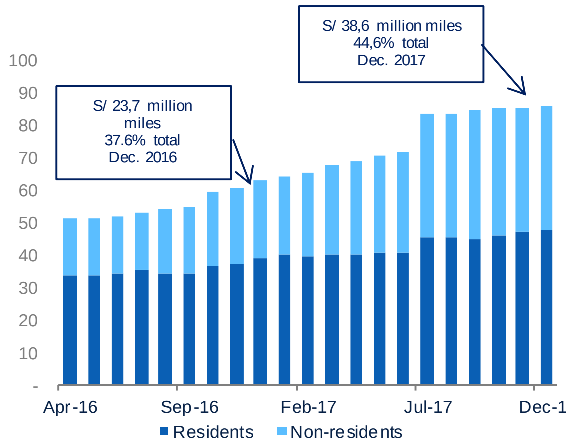
These factors also favoured the appreciation of the Peruvian currency (PEN). It strengthened by 4% during the year despite the central bank's interventions with various instruments including direct purchases of foreign currency in the market (see Figure 6.4), which amounted to just over US$5 billion over the course of the year.

Figure 6.4 Exchange rate and direct purchases of dollars by the central bank in the market (PEN per USD; US$ millions)



Source: Bloomberg and Central Reserve Bank of Peru

Figure 6.5 Holdings of sovereign bonds by non-resident investors (billions of soles (PEN))



Source: MEF

Two of the main mechanisms through which downward pressure on the USDPEN exchange rate found expression in 2017 were the trade surplus - which increased by US$1.9 billion in 2016 to US$5.8 billion last year according to our estimates - and the inflow of capital. As regards the latter, it is interesting to note that there was great appetite on the part of non-resident investors for sovereign bonds: their holdings of these securities increased in 2017 by the equivalent of more than US$7 billion (see Figure 6.5), many of those purchases possibly not being hedged against currency risk bearing in mind that banks sold dollars in the forward market in the same period (without delivery) for just US$1.4 billion.

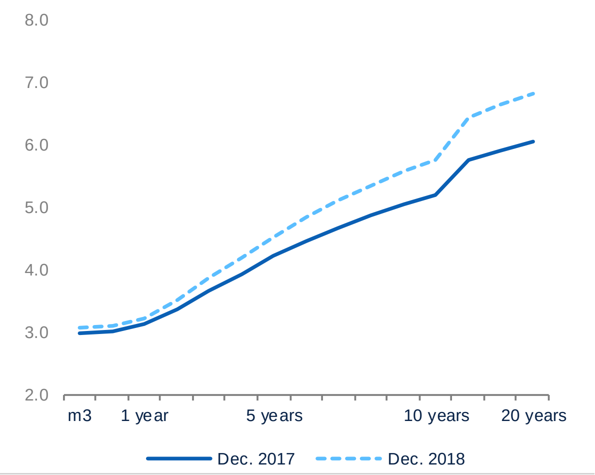
The trade surplus and the influx of capital to acquire private and public Peruvian financial assets will be maintained in 2018, although they will be more moderate. This moderation is explained by the fact that we foresee China's growth losing some of its dynamism, metal prices starting to soften and monetary policy in the more developed economies gradually tightening. Assuming that the central bank will remain active in the domestic market, we estimate that the exchange rate will end 2018 at a not far level from the previous year (around 3.24 or 3.25; see Figure 6.6). The moderation of the trade surplus and of capital inflows to acquire financial assets will continue beyond this year, so that the national currency will show a certain tendency to depreciate in 2019.

We should mention that our baseline scenario projecting macroeconomic variables is consistent with an increase in 2018 in the returns demanded on sovereign bonds. Compared with those observed towards the end of last year, the increases in returns demanded will be limited in the very short tranches, more related to monetary policy (which still has space in which to cut rates), whereas in the longer tranches there could be increases up to 80 basic points. Thus the yield curve will steepen (see Figure 6.7).

Figure 6.6 Exchange rate projection (PEN/USD)

Source: Bloomberg and BBVA Research

Figure 6.7 Yield curve for sovereign bonds* (%)

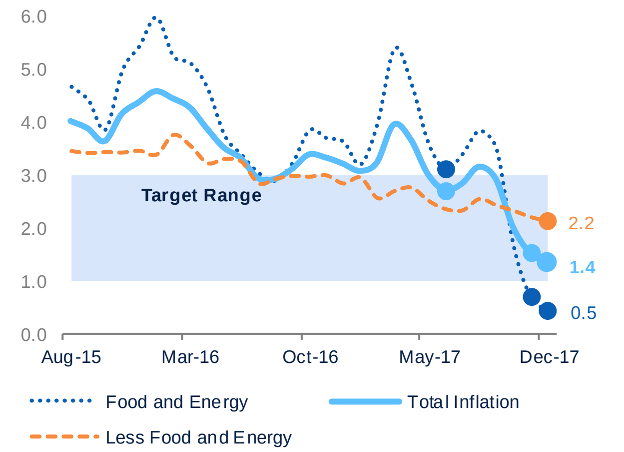


*Projection carried out using the Affine methodology (dynamic factor model), based on Nelson, C. and Siegel A. F. (1987): "Parsimonious Modeling of Yield Curves", Journal of Business 60 (4), pp. 473-789.
Source: Bloomberg and BBVA Research

7. Inflation will bottom out at the end of this quarter, but will then tend to move towards the middle of the target range

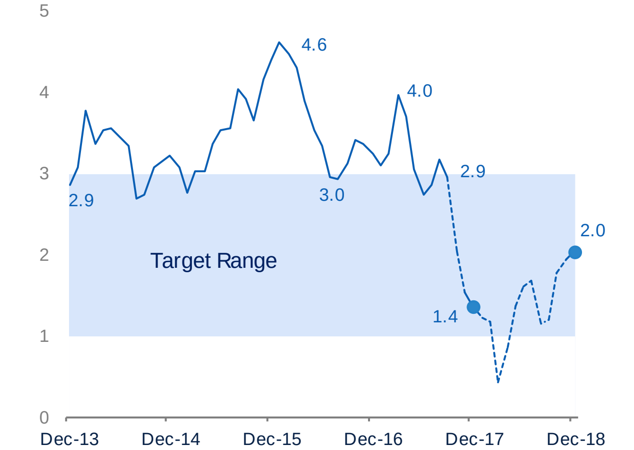
In the last quarter of 2017, inflation fell sharply, from 2.9% in September to 1.4% in December. The prices of some foodstuffs, which had risen temporarily with the impact of *El Niño Costero*, tended to return to normal. The latest inflation figure is the lowest for seven and a half years. Indicators of inflationary trends also showed a declining trajectory in the last few months and over the course of the year, probably as a reflection of the appreciation of the national currency and the weakness of economic activity.

Figure 7.1 Inflation: total; without food and energy; and only food and energy (change % YoY)



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

Figure 7.2. Inflation (change % YoY of the CPI)



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

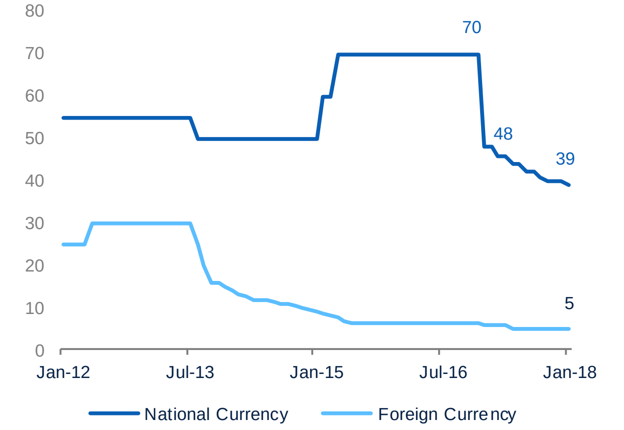
We estimate that the bulk of the food price corrections had already taken place. Even so, due to the high base for year-on-year comparison, inflation will continue to fall in the first quarter of 2018 and for a short time will be below the target range (see Figure 7.2). Later on, however, it will tend to move closer to the middle of the target range, which we estimate will reach towards year-end. This reflects four things. Firstly, that the rate of YoY food price increases, which fell sharply last year, will return to normal. Thus the projection assumes no supply-side shocks in this respect. Secondly, that the exchange rate will hold relatively steady, in contrast to what happened in 2017, when it fell (in terms of PEN per USD) by 4%, bringing inflation down with it. Thirdly, and rather containing price increases, although the economic activity will continue gaining traction, there will still be slacks in the economy. Lastly, and also partly offsetting the first two factors, the rate of YoY increase in the price of oil will slow in the middle part of this year, generating downward pressure on domestic inflation.

8. Monetary policy: More easing on the way?

In the environment of sharply falling inflation – which is leading inflationary expectations down the same path, albeit more slowly – and cyclical weakness of the economy, the central bank has continued with cuts to its reference interest rate. In the last quarter of last year it cut the rate by 25 bps, on top of the three previous cuts (in May, July and September). As a result, the reference interest rate ended the year at 3.25%. Furthermore, it continued to reduce reserves in dollars (see Figure 8.1), seeking to offset the rise in international interest rates and so mitigate the impact on lending.

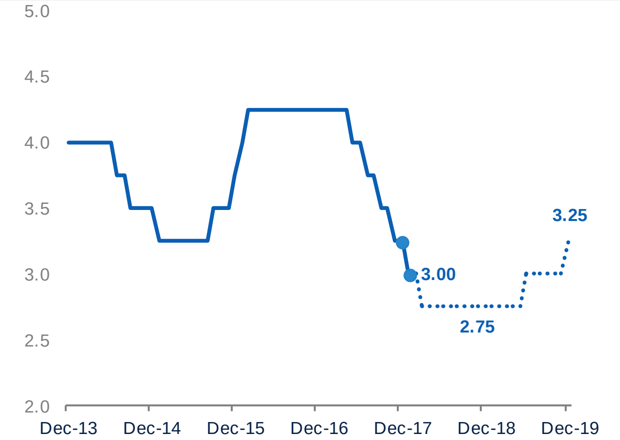
In January 2018 the central bank cut its base rate by a further 25 bps, to 3.00%. It was reasonable for the central bank to do so in view of the performance of inflation in the past few months, the room that inflationary expectations still have to continue falling (according to central bank calculations, in December they were at 2.3%), the cyclical weakness of the economy, a fiscal boost that it is taking longer than expected to make itself felt, the uncertainty engendered by the increase in political noise (already reflected in a significant decline in business confidence), and the relative stability of the exchange rate. We do not rule out the possibility of an additional cut of 25 bps in the next two or three months if GDP growth surprises the economic authorities negatively, which we think will happen with 4Q figures, if the fiscal stimulus is less than expected, if increased political noise translates into further loss of business confidence, or if inflationary expectations fall below 2% (the middle of the target range). After that, with inflation tending to move towards the middle of the target range and inflationary expectations positioned around it, with private sector spending slowly gaining traction, and with monetary policies in the US and Europe more clearly geared towards normalisation, we estimate that the central bank will opt to hold its key rate at 2.75% (see Figure 8.2) and will not start to raise it until the second half of next year.

Figure 8.1 Marginal reserve rate in domestic and foreign currency (% of obligations subject to reserves)



Source: Central Reserve Bank of Peru and BBVA Research

Figure 8.2. Reference rate (%)



Source: Central Reserve Bank of Peru and BBVA Research

9. Growth projection for 2018 with high degree of uncertainty pending clarification of the new political scene

Our baseline scenario for GDP in 2018 assumes on the external front that the slowing of growth in China will be moderate, that the normalisation of monetary conditions in the most developed economies will continue to be smooth, without jolts, and that in this context prices of metals, and copper in particular, will remain at attractive levels which will favour mining investment (in exploration and the start of construction of a number of small- and medium-size mines. On the domestic front, the baseline scenario for 2018 is consistent with the acceleration in public spending to reconstruct the infrastructure damaged by *El Niño Costero*, to construct the infrastructure required for the 2019 Pan American Games and the major infrastructure projects such as the second line of the Lima Metro. If what finally materialises for each of these external and domestic factors turns out to be different from what is projected, this will naturally lead the GDP for 2018 to also be different from what we expect (growth of 3.5%). The specific risks identified in each of these elements are as follows.

- **Growth of China's economy.** The baseline scenario assumes that China will grow by 6.3% in 2018 (having grown by around 6.7% in 2017). The slowdown is moderate and growth should still give good support to commodity prices. The risk is that this slowdown could be sharper due to a greater impact of regulatory tightening and reduced support from monetary and fiscal policies. If that happens, there will be a negative impact on world growth and on commodity prices. On the home from, the advance in economic activity (mining investment and confidence) will suffer and asset prices will fall (greater risk premium, less capital inflow), among them the national currency.

- **Monetary conditions in the most developed economies**. The baseline scenario assumes that the US Federal Reserve will continue to raise rates in 2018 in an orderly and foreseeable manner (+75 bps in the year) and that it will continue to adjust its balance sheet in accordance with its announcements, while the ECB will reduce its asset purchases this year. This will mean a moderate decline in appetite for financial assets of emerging economies, among them Peru. However there is a risk that these adjustments could be more intense. In the case of the US, for example, this could happen if inflationary pressures increase sharply (in an environment of reduced slack in the labour market and tax cuts) or if the signs of over-valuation shown by certain assets intensify. In this risk scenario, commodity prices would probably fall (with the consequent negative impact on mining investment), risk premiums would increase and there would be negative effects on domestic financing conditions, whether in foreign or domestic currency, which would have an adverse effect on economic activity.

- **Boost from public spending**. The risk here is that this boost is less than that assumed in the baseline scenario, for example in the reconstruction of the areas affected by *El Niño Costero* and in the major infrastructure projects, even in spite of the downward revision that we have already incorporated. There is also the risk that the judicial investigations that may be faced by some construction firms will inhibit the authorities from signing the necessary addenda for public works in general to move forward or calling for tenders for new projects. In this scenario, the reduction in fiscal boost would have a direct impact on economic activity and also an indirect one through loss of confidence and reduced dynamism in the rest of the economy.

An additional factor, and an important one, on which our growth projection for 2018 also depends, is the domestic political situation. The baseline scenario incorporates a degree of caution in spending by both businesses and households, as well as in public spending, following the political noise and fatigue generated by the presidential impeachment process and the pardon of former president Fujimori last December. These events seem to have increased the sense that political stability is precarious and hence to uncertainty. The significant rise in our indicator of political stresses at the end of December and the sharp fall in business confidence in the same month point in that direction. However, it is still too soon to know how the domestic political scene will be resolved following the events of late last year or what the implications of that resolution will be. Nor can we yet anticipate the extent or implications of the next steps in the “Lava Jato” (“Operation Car Wash”) investigation. All of those represent an additional risk of GDP growth in 2018 deviating from our forecasts.

10. Tables

Table 10.1 Macroeconomic forecasts

	2015	2016	2017	2018	2019
GDP (change % YoY)	3.3	4.0	**2.3**	**3.5**	**3.8**
Domestic demand (change % YoY)	2.9	1.1	**1.8**	**3.4**	**3.8**
Private consumption (% YoY)	4.0	3.3	**2.5**	**2.7**	**3.3**
Public consumption (% YoY)	9.8	-0.5	**1.1**	**5.0**	**2.3**
Gross fixed investment (% YoY)	-5.3	-4.6	**0.7**	**4.0**	**5.7**
Inflation (YoY, %, EOP)	4.4	3.2	1.4	**2.0**	**2.4**
Exchange rate (vs. USD, EOP)	3.39	3.40	3.25	**3.25**	**3.28**
Policy interest rates (%, EOP)	3.75	4.25	3.25	**2.75**	**3.25**
Fiscal balance (% of GDP)	-2.1	-2.6	**-3.2**	**-3.4**	**-2.7**
Current account (% of GDP)	-4.8	-2.7	**-1.3**	**-1.8**	**-2.0**

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

Table 10.2 Quarterly macroeconomic forecasts

	GDP (change % YoY)	Inflation (YoY, %, EOP)	Exchange rate (vs. USD, EOP)	Policy interest rate (%, EOP)
Q1 16	4.6	4.3	3.41	4.25
Q2 16	3.9	3.3	3.32	4.25
Q3 16	4.7	3.1	3.38	4.25
Q4 16	3.1	3.2	3.40	4.25
Q1 17	2.2	4.0	3.27	4.25
Q2 17	2.4	2.7	3.27	4.00
Q3 17	2.5	2.9	3.25	3.50
Q4 17	**2.2**	1.4	3.25	3.25
Q1 18	**4.4**	**0.4**	**3.22**	**2.75**
Q2 18	**4.0**	**1.6**	**3.24**	**2.75**
Q3 18	**2.4**	**1.2**	**3.24**	**2.75**
Q4 18	**3.3**	**2.0**	**3.25**	**2.75**
Q1 19	**3.9**	**2.0**	**3.25**	**2.75**
Q2 19	**3.8**	**2.1**	**3.26**	**3.00**
Q3 19	**3.6**	**2.2**	**3.27**	**3.00**
Q4 19	**3.8**	**2.4**	**3.28**	**3.25**

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

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