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BBVA Research

Peru Economic Outlook 2Q18

April 2018

Creando Oportunidades

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Key messages

- **A difficult start to the year for the economy.** Political tensions and problems in some sectors (mining, oil & gas and construction) had a negative impact on the performance of economic activity
- **We are projecting growth of 3.2% in 2018 and 3.5% for next year.** The forecasts take into account a favourable international environment for Peru. On the domestic front we are assuming a calmer political scenario, a fiscal stimulus in 2018 and a commencement of the deficit reduction by the government next year.
- **The new administration faces some significant challenges.** In the short term, reactivating the economy and adopting measures to ensure fiscal sustainability. In the long term, the agenda for boosting productivity remains outstanding.
- **Financial markets continued to perform well in the first quarter in spite of the volatile environment.** In particular, we expect the Peruvian currency to continue its slight tendency to appreciate in a context of substantial trade surpluses and capital inflows on the financial side. We are projecting a year-end exchange rate of between S/.3.20 and S/.3.25 to the US dollar
- **Central Bank in pause mode in the short term** In a context without inflationary or exchange rate pressures and in which much depends on the gradual recovery of domestic demand, we estimate that Central Reserve Bank of Peru (BCRP) will hold its base rate at 2.75% for the next few months.
- **The risks of deviation from our growth forecasts for 2018 and 2019 are balanced.** Externally, downward bias if Federal Reserve makes more aggressive adjustments, China's growth slows and/or protectionism intensifies. Domestically, upward bias if the political environment improves and if any large-scale mining project is carried out

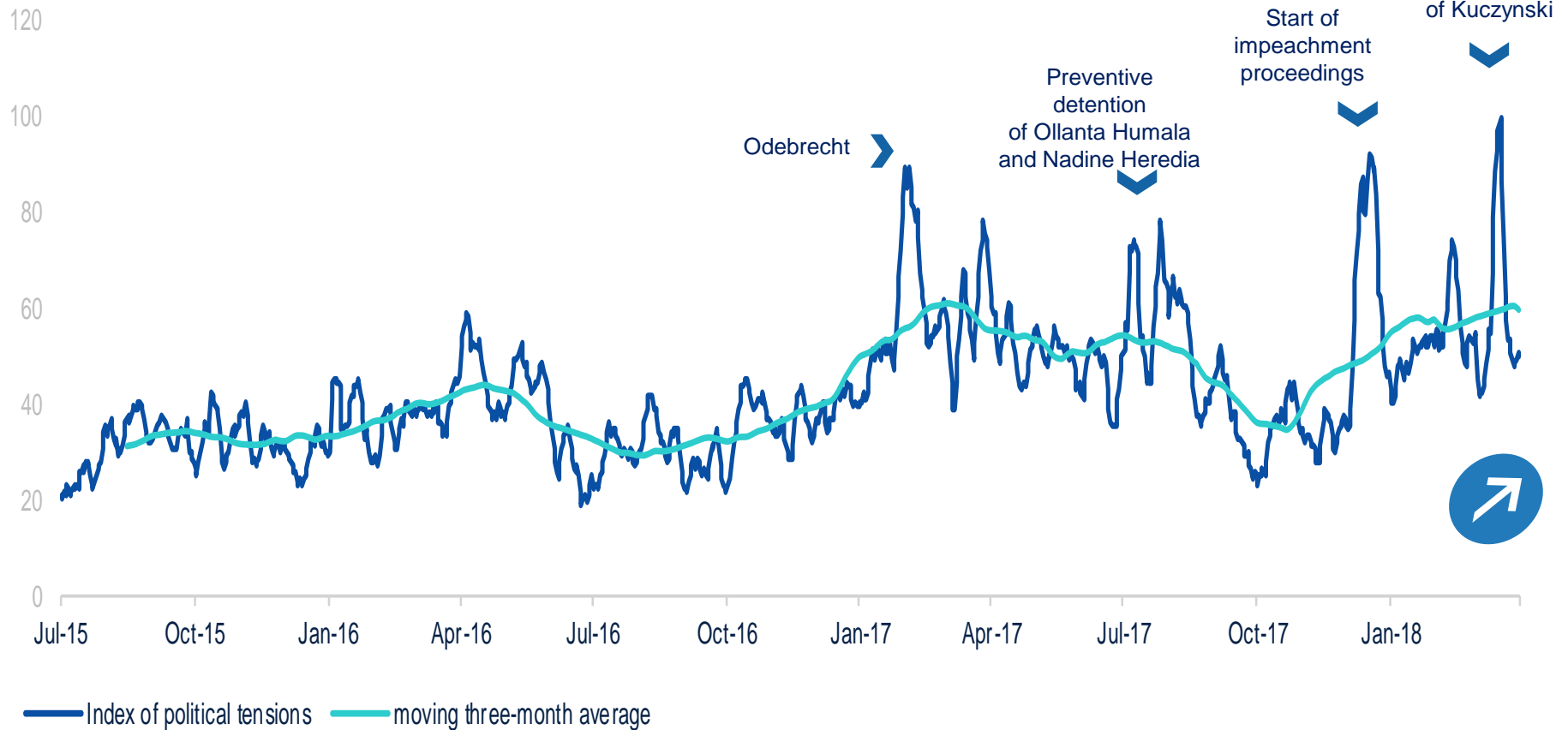


01

Economic activity

A difficult start to the year for the economy: (i) high political tensions, uncertainty and...

Peru: political tension index



...(ii) problems in some sectors

Mining

Maintenance of the Cuajone (Southern) plant and lower grade ore in some

Oil and gas

Rupture of TGP LNG pipeline in February

Construction

“Construction Club” (corruption investigation)

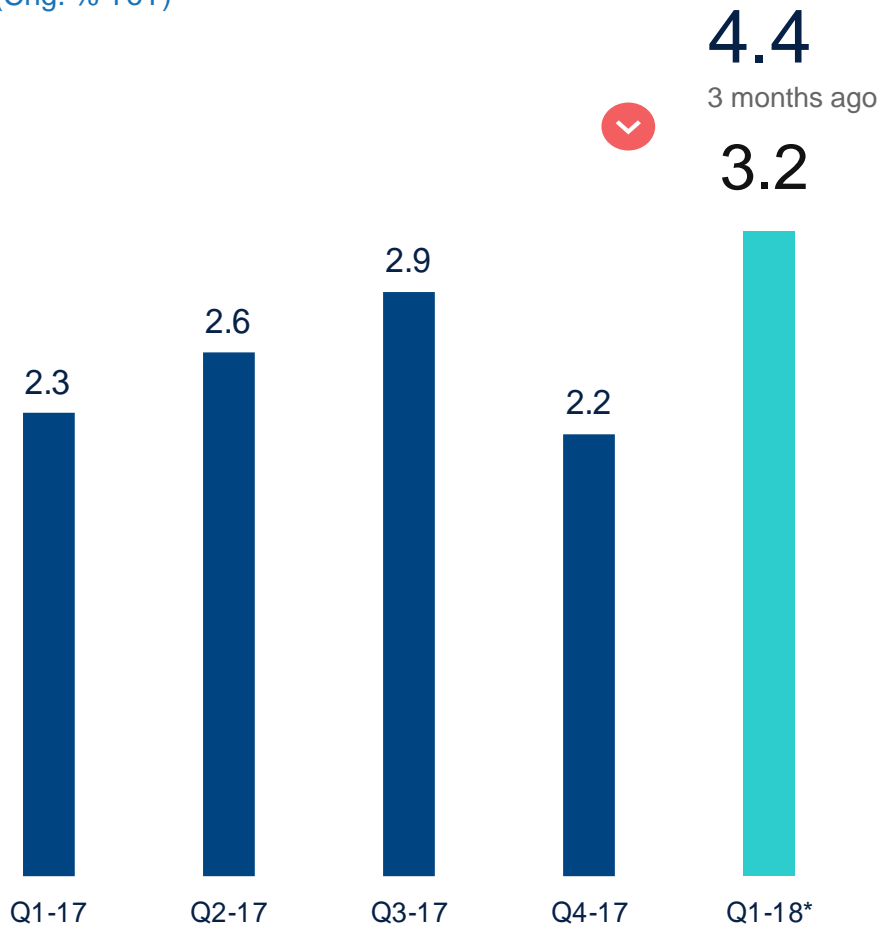
Cautela entre bancos para
dar cartas fianza a
empresas investigadas

La Asociación de Bancos señaló que nada garantiza la solvencia futura de las compañías en el contexto actual

‘Correo’ daily newspaper, 6 March

In this context, first quarter growth will be lower than was forecast three months ago

GDP 2018 (Chg. % YoY)

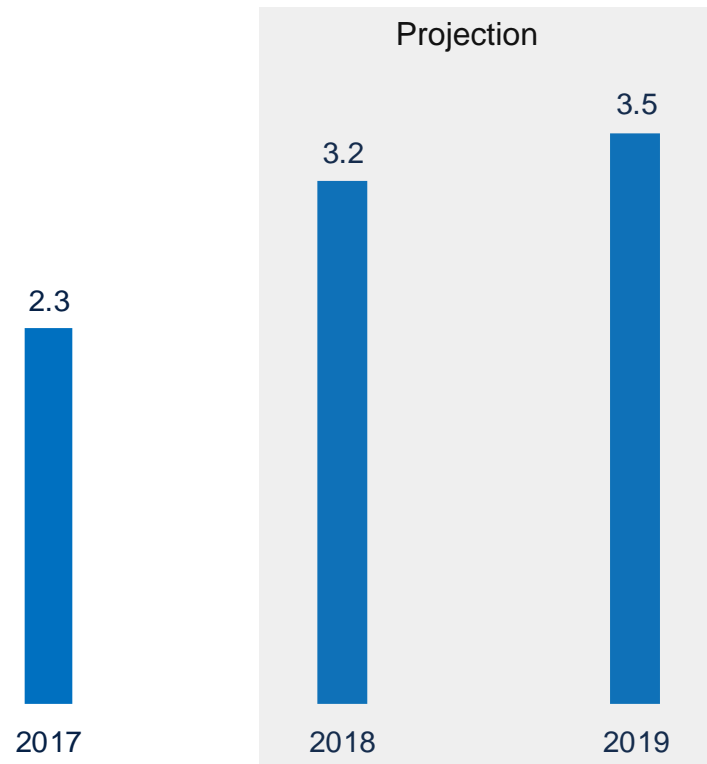


- Political tensions
- Problems in sectors:
 - Mining
 - Oil and gas
 - Construction

We project that GDP will grow by 3.2% in 2018 and 3.5% in 2019

GDP 2018

(chg.% real YoY)



These projections assume:

01 External factors

- Robust and synchronised global growth
- Attractive metal prices
- Fed continues with monetary stimulus

02 Internal factors

- Political détente, at least in the short term
- Acceleration in public spending in the remainder of the year
- Consolidation of fiscal accounts starting in 2019

External factors: (i) robust and synchronised global growth

...but with greater uncertainty

01

The pace of global growth continues...

...thanks to the recovery in investment and trade

02

Economic policies are extending the cyclical recovery

The US fiscal stimulus could underpin the other areas

03

Greater financial volatility

The unusual environment of low volatility has been left behind

04

Normalisation of central banks' monetary policy somewhat faster than expected at the Federal Reserve, while the ECB has already taken the first steps

05

Uncertain effect of US protectionist measures

The direct effect of those already been approved has been limited, but they could herald more aggressive measures

06

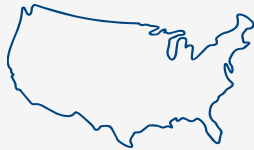
Global risks

Greater in the short term due to a possible escalation of protectionist measures

External factors: (i) robust and synchronised global growth

Upward revision in the US and the euro zone

USA



The tax reform will have a direct positive effect on growth

The Fed will continue to normalise its monetary policy

Risk of protectionism

CHINA



The headwinds deriving from politics and trade could moderate growth in 2018

New economic and political goals

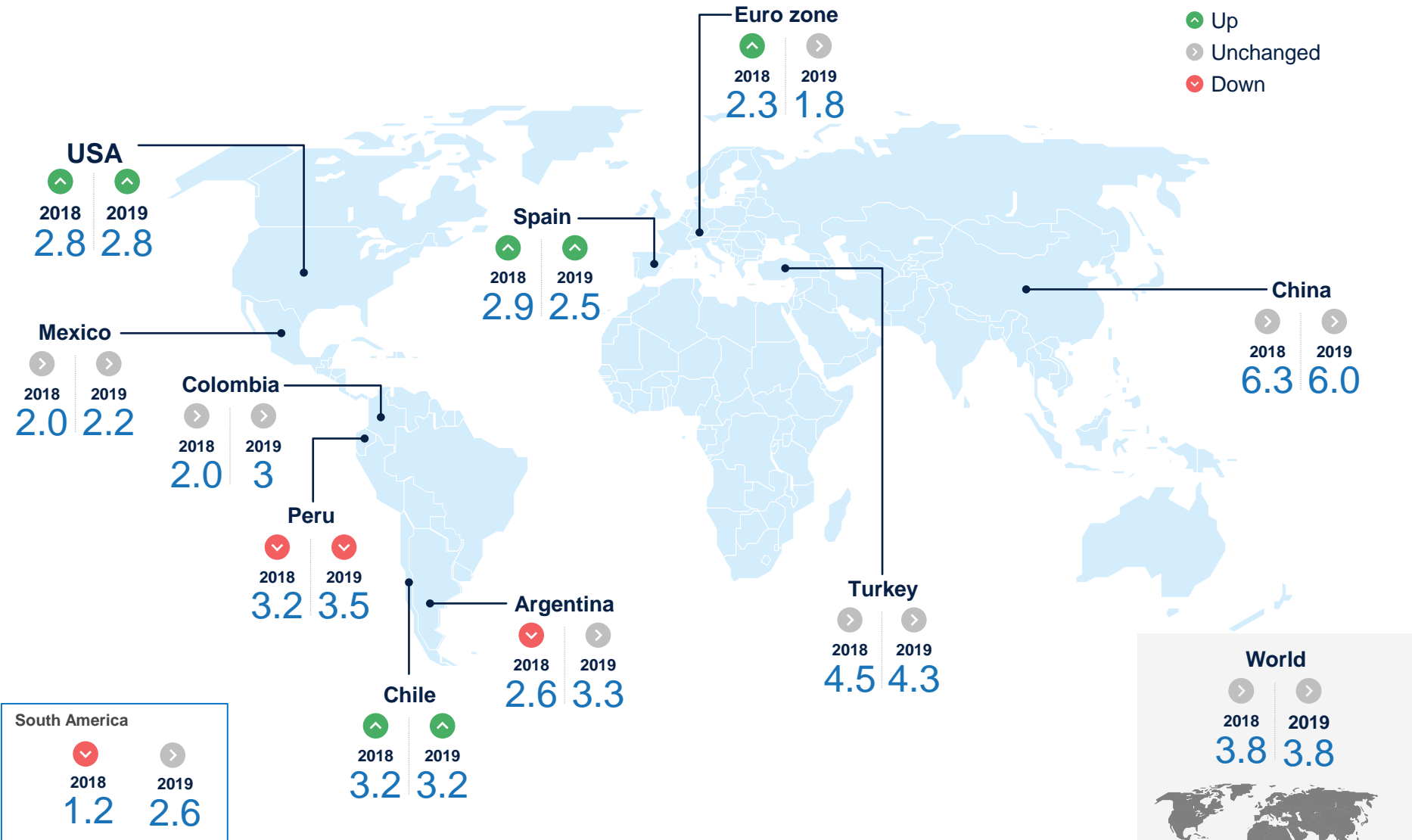
EURO ZONE



Progress in the ECB's exit from QE, avoiding the generation of tensions

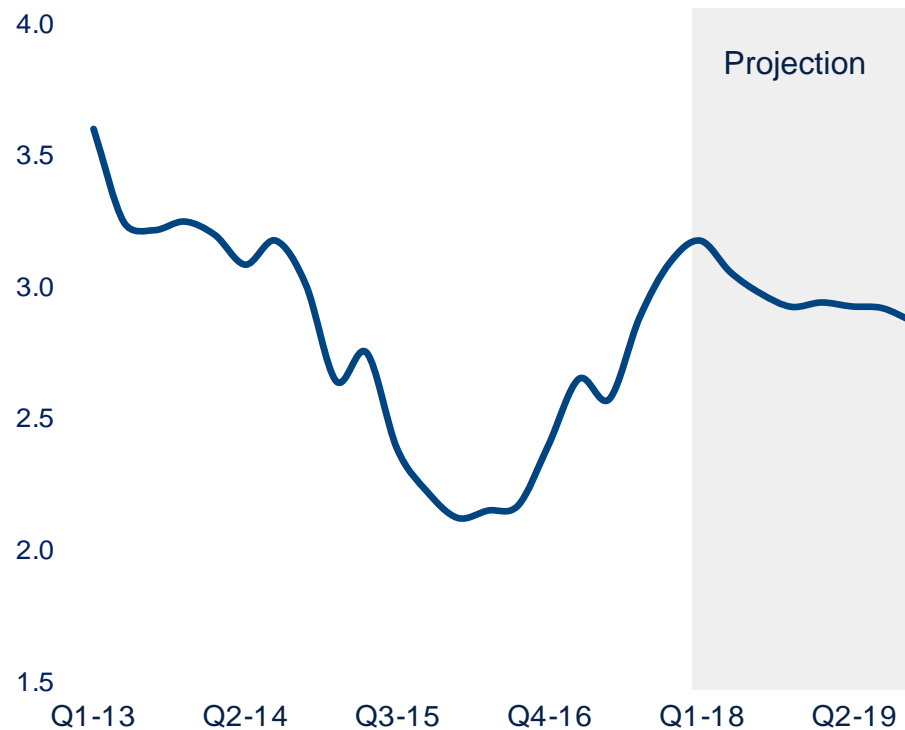
Trade and investment favour the expansive cycle in 2018

External factors: (i) robust and synchronised global growth



External factors: (ii) metal prices at attractive levels

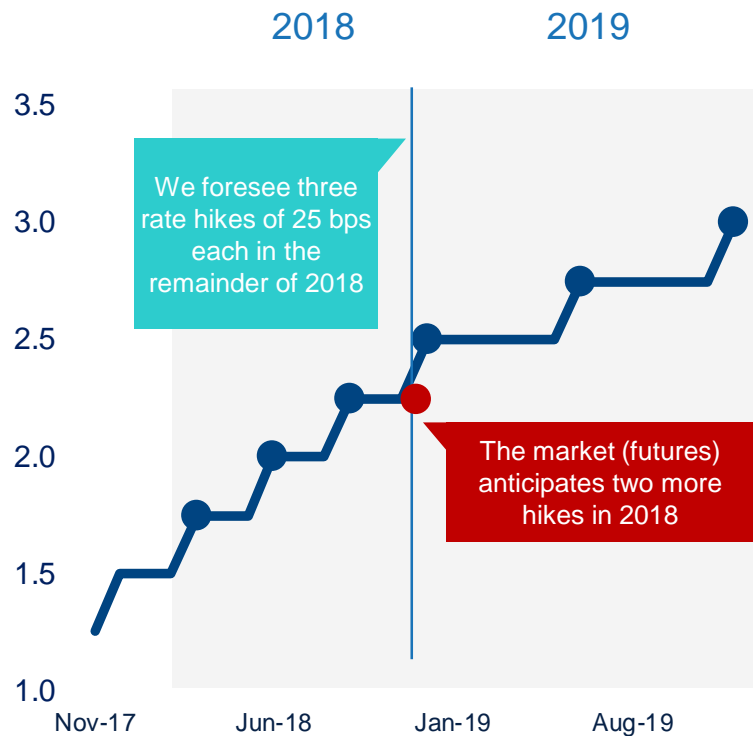
Copper price
(dollars per pound)



- Global growth provides support to industrial metals (average prices higher than in 2017)
- Nonetheless over the course of the year prices will gradually correct downwards as non-trading positions unwind (in the case of copper)
- **Domestic effects on activity** This will favour private sector investment in mining

External factors: (iii) Federal Reserve continues with the process of monetary adjustment

US Federal Reserve rate (%)



- ▲ **Increased public spending.** Since there is very little slack in the US economy, this boost will be transmitted to prices, requiring the Fed to become more aggressive
- ▲ **Domestic effects on activity.** Increased cost of financing investment

Internal factors



01 Political détente, at least in the short term



02 Acceleration in public spending in the remainder of the year

Reconstruction

Panamerican Games

Major infrastructure projects (Line 2 of the Lima Metro)

Implementing provision needed for Law No. 30737
(on reparations for corruption)

Growth in activity in 2018: Construction will stand out among sectors, and Investment will be the leading expenditure item

Drivers

Sectors

- Construction and non-primary manufacturing (fiscal boost)
- Services (boosted by the Construction sector)
- Fisheries (bigger anchoveta catch)

Demand

- Public investment (fiscal boost)
- Private investment (especially in the mining sector)

GDP
(chg. % real)

3.2%
2018

Growth in activity in 2019: greater dynamism of Construction and private sector investment

Drivers

Sectors

- Construction and non-primary manufacturing (greater investment in mining)

Demand

- Private investment (greater investment in mining: Mina Justa and expansion of Toromocho, among others)

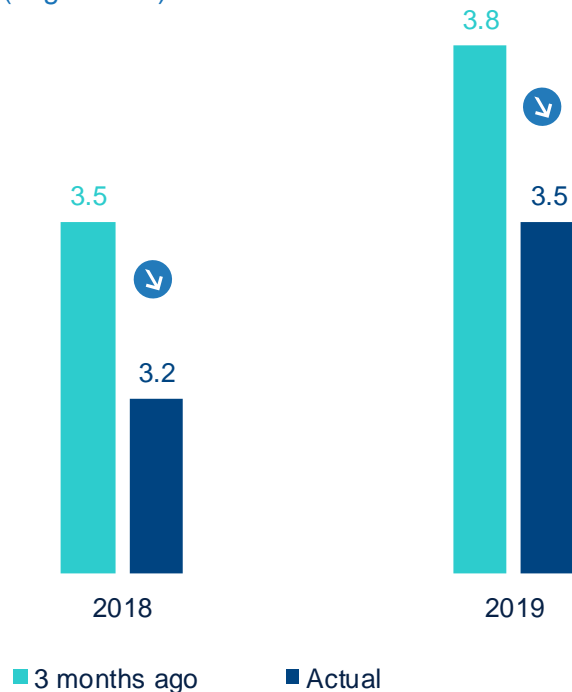
GDP

(chg. % real)

3.5%
2019

The new growth forecasts for 2018-2019 have been revised downwards relative to those projected three months ago

GDP (chg. % real)



- 2018
First-quarter growth, at 3.2%, less than forecast (4.4%):
- 2019
More conservative forecast, waiting for steady improvement to set in in the climate for doing business

Short- and long-term challenges faced by the new administration

- Short-term challenges:

Reactivating the economy and ensuring fiscal sustainability

- Long-term challenges:

Agenda for boosting productivity remains outstanding

Short-term challenges: (i) reactivating the economy



Need to normalise the Construction sector



Law 30737 better than Urgent Decree DU-003
Why?



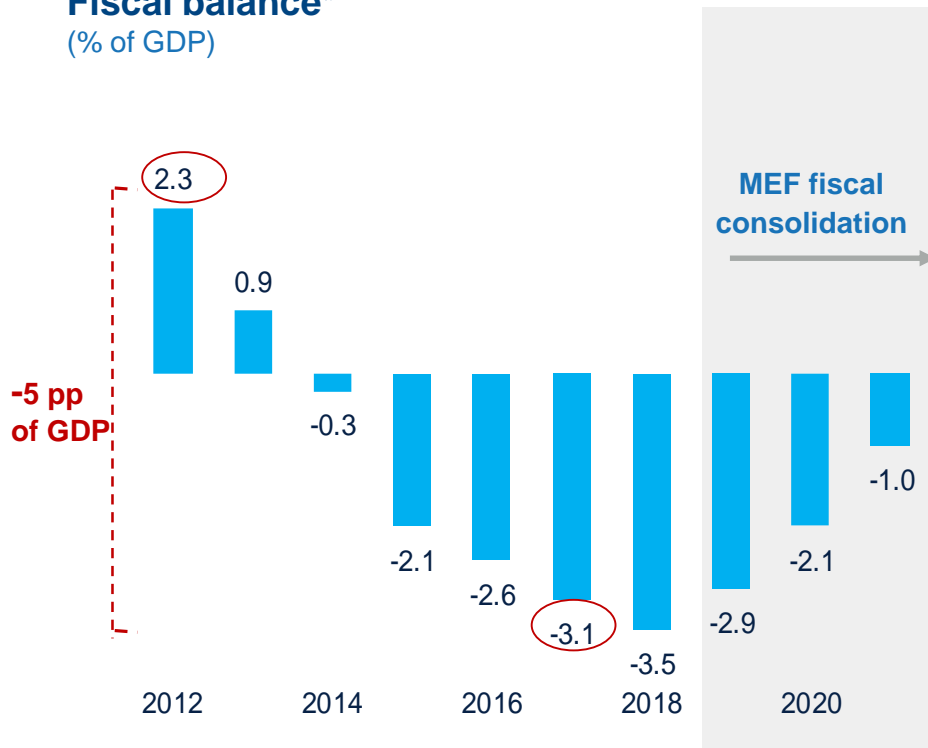
Implementing regulations needed



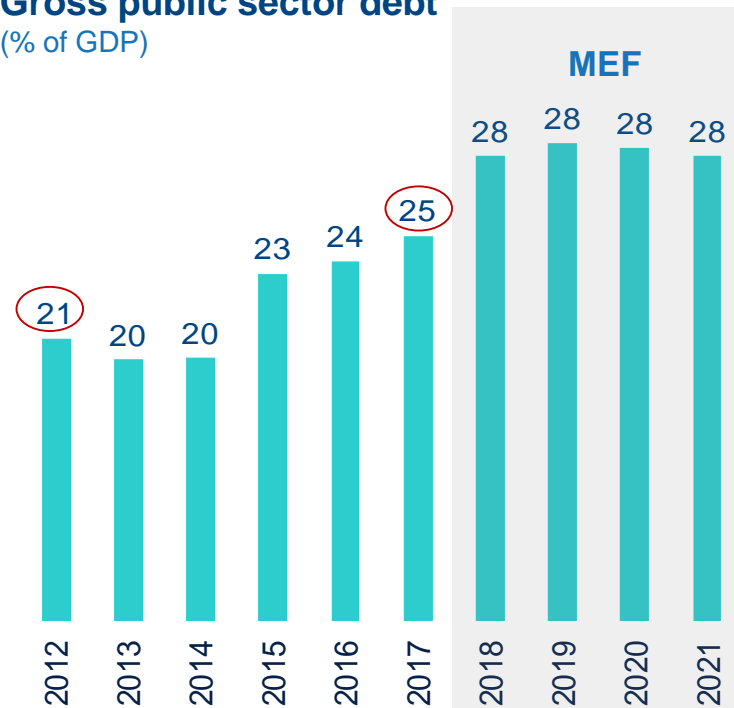
- 01 Greater reach by type of business affected
- 02 Reparations to be withheld: in what form? how much? and how?
- 03 Incentives to collaborate with the authorities

Short-term challenges: (ii) ensuring fiscal sustainability

Fiscal balance*
(% of GDP)



Gross public sector debt
(% of GDP)

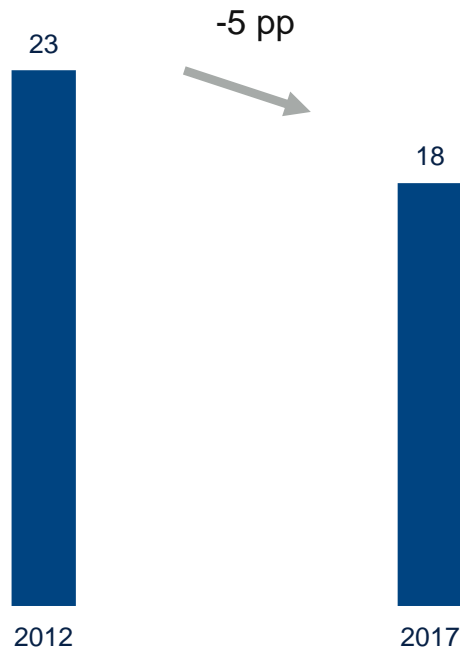


*Non-financial public sector.
Source: MEF

Source: MEF

Short-term challenges: (ii) ensuring fiscal sustainability requires increasing government revenues and...

Tax revenues* (% of GDP)



* General Government
Source: Central Reserve Bank of Peru

■ The decline in revenues is explained by:

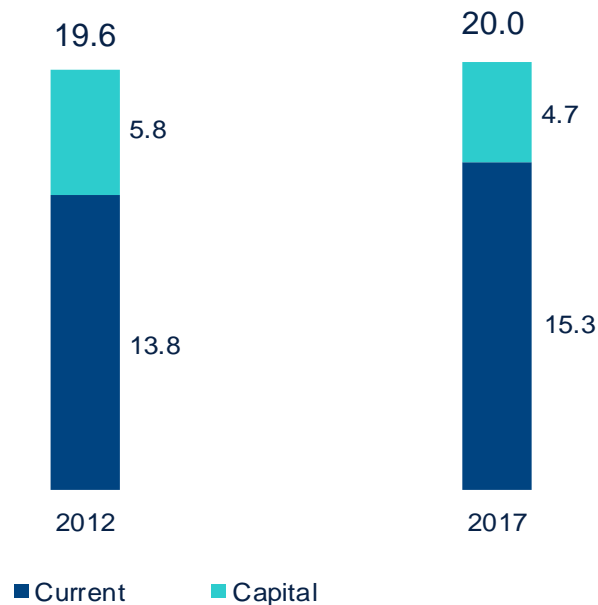
- Deterioration in terms of trade
- Decline in economic growth
- Tax measures implemented between 2012 and 2016
- Greater tax delinquency
- Increased tax refunds

■ What can be done?

- Approve the implementing regulations of the General Anti-Tax Evasion Act
- Rationalise tax exemptions (the Government foregoes revenues equivalent to 2.2% of GDP)

Short-term challenges: ...containing increases in current spending

Fiscal expenditure* (% of GDP)



▲ Increase in current spending explained by:

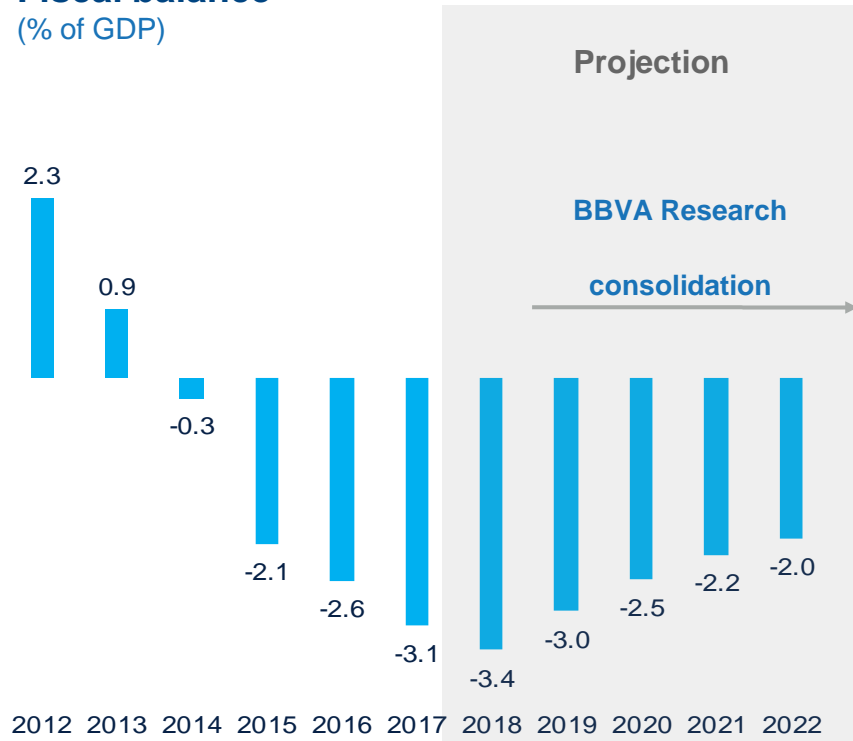
- Wage increases in the education, healthcare and defence sectors
- Increase in hiring of CAS (administrative service contract) workers

▲ What can be done?

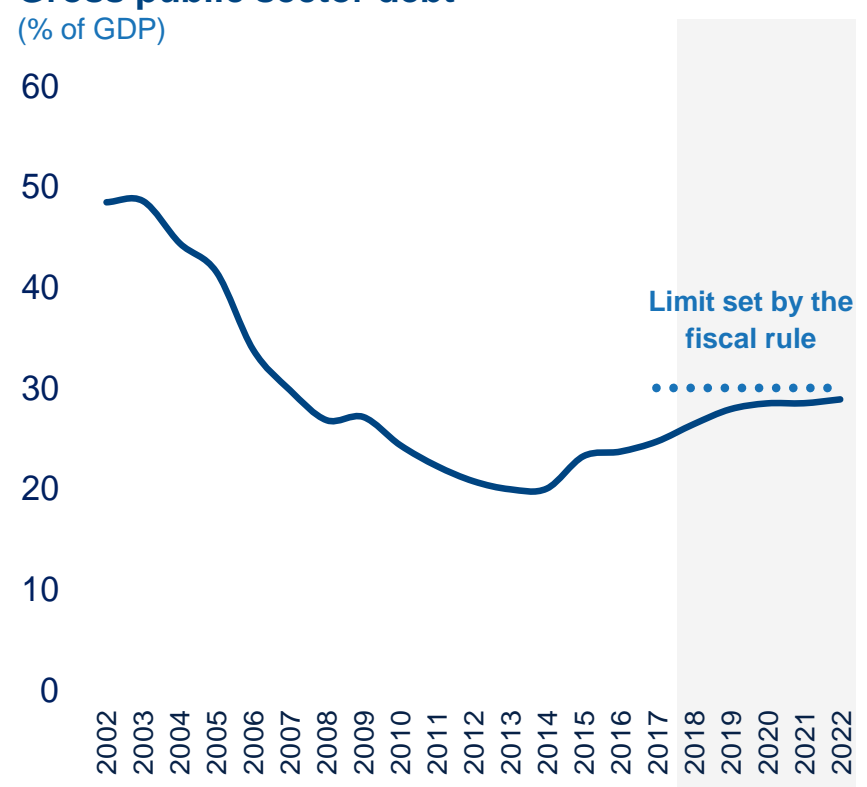
- Review with Congress the inclusion of 276,000 CAS workers in the State workforce (cost: 0.4% of GDP)
- Review the standardisation of military and police pensions (cost: 0.1% of GDP)

Short-term challenges: We therefore estimate that fiscal consolidation will be more gradual

Fiscal balance*
(% of GDP)



Gross public sector debt
(% of GDP)



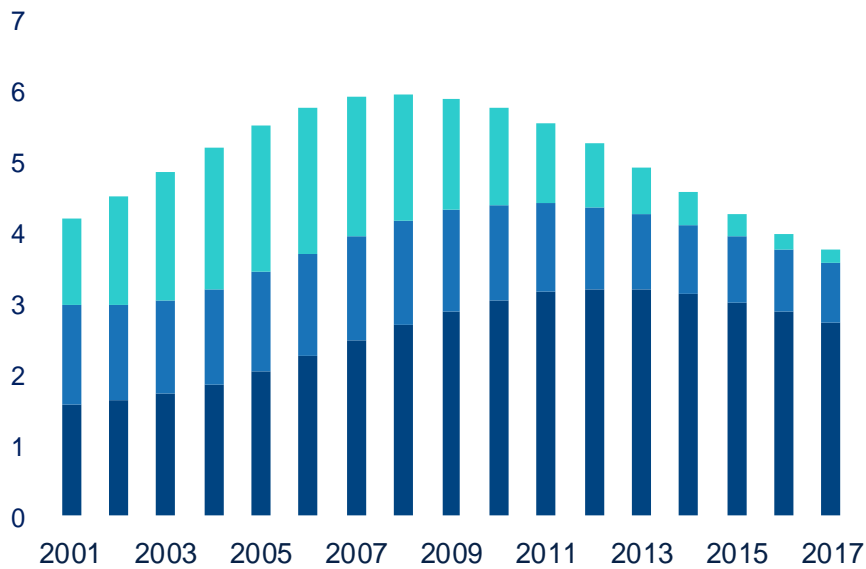
*Non-financial public sector.
Source: Central Reserve Bank of Peru and BBVA Research

Source: Central Reserve Bank of Peru and BBVA Research

Long-term challenges: ensuring higher sustainable growth

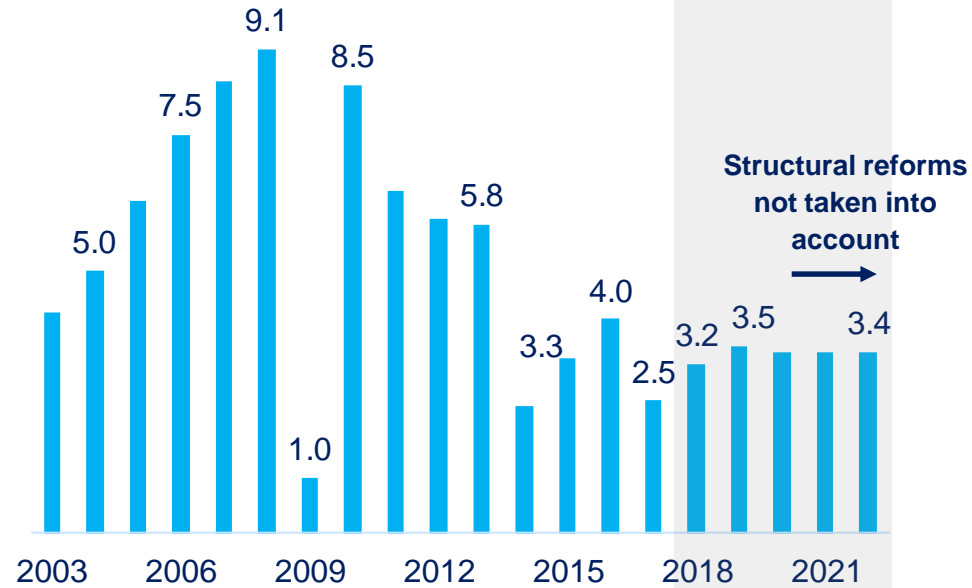
Contribution to potential GDP growth
(percentage points)

■ Capital ■ Labor ■ Total factor productivity



Source: BBVA Research

GDP
(Chg. % YoY)



Source: Central Reserve Bank of Peru and BBVA Research



02

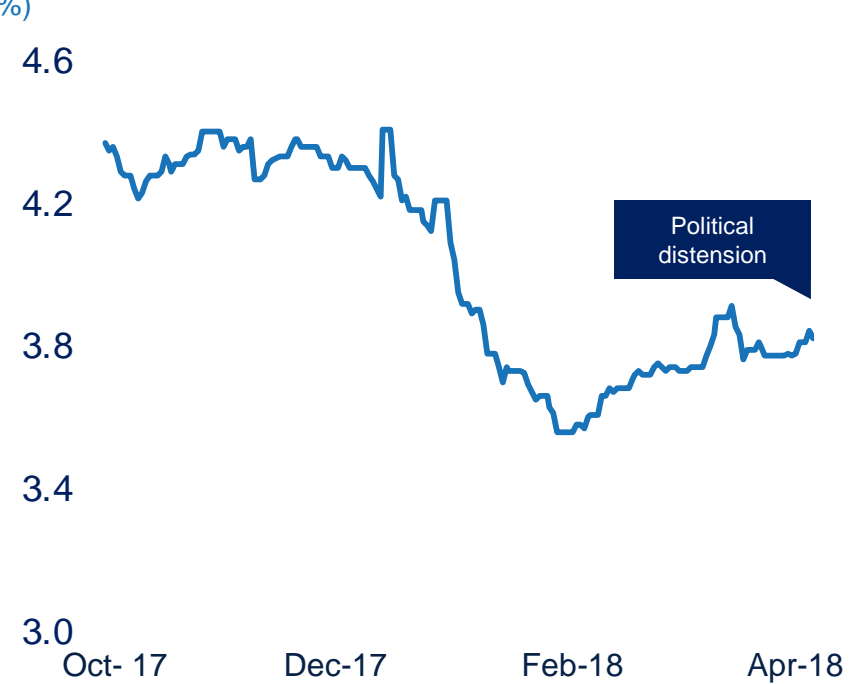
Financial markets

Solidity of macro fundamentals lend support to domestic financial markets

Exchange rate
(USD/PEN)

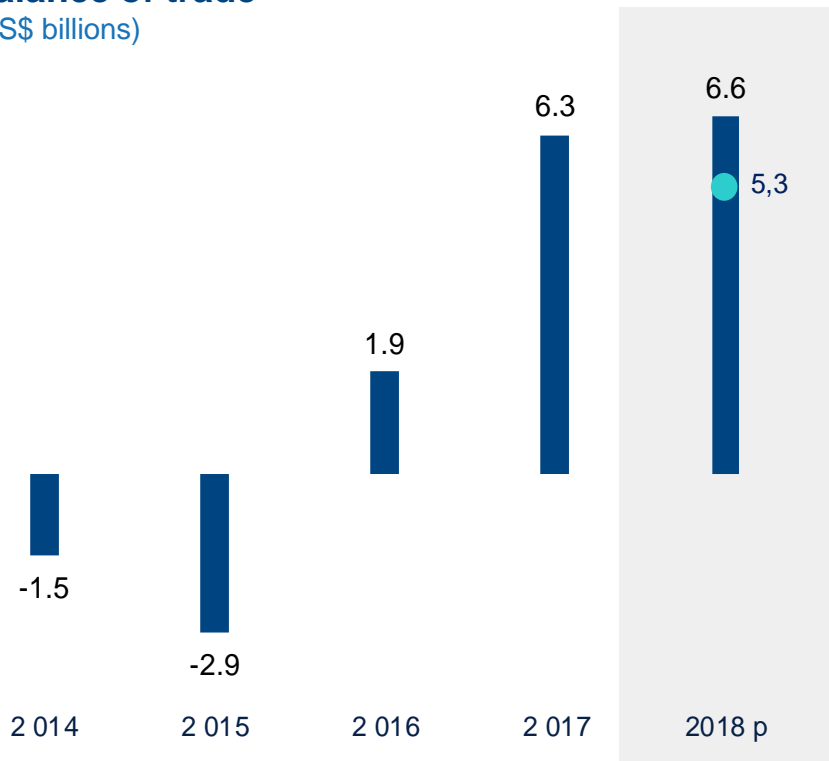


Rate of Sovereign Bond 2023
(%)



Going forward? Pressure on the PEN to appreciate due to the significant trade surplus and...

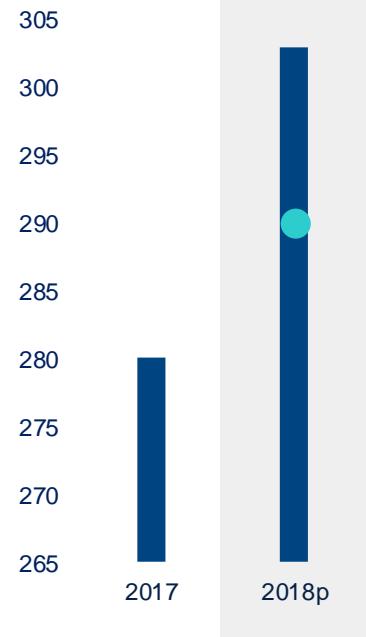
Balance of trade
(US\$ billions)



● Previous projection

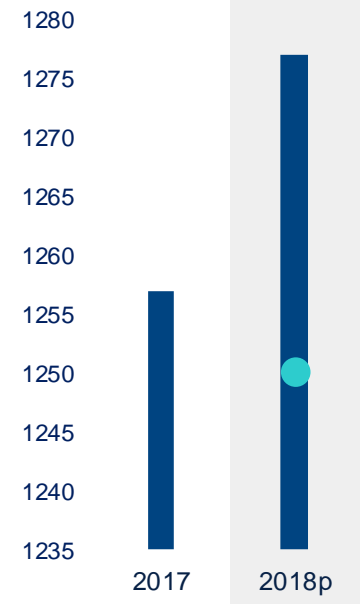
Commodity prices

Copper
(US\$cents/lb)



● Previous projection

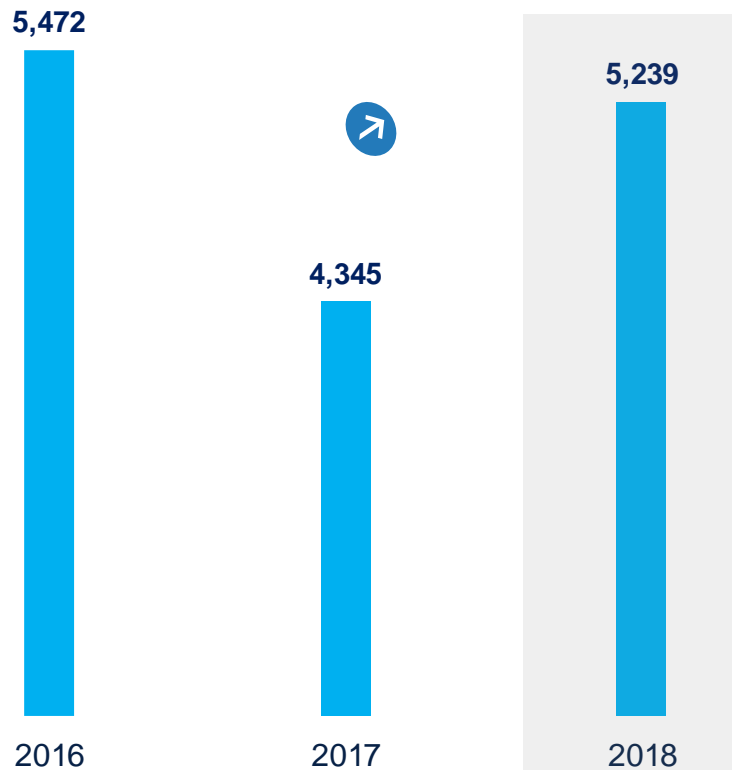
Gold
(USD/troy ounce)



... the capital inflows on the financial side

Financial account*

(US\$ million)



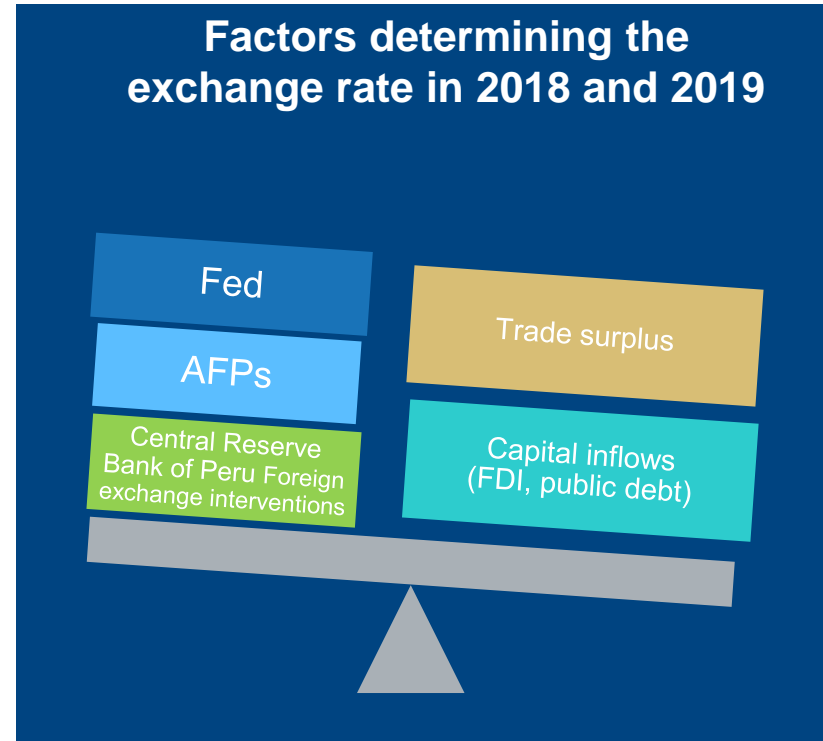
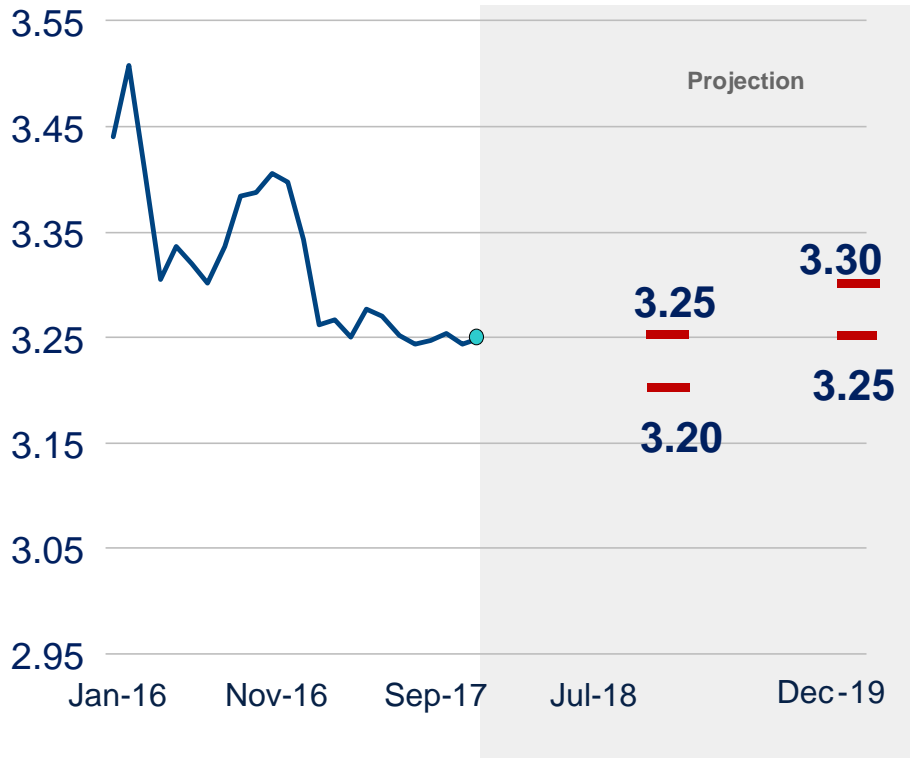
- **FDI in mining** (reinvestment of profits)
- **Fiscal deficit** (greater supply of public debt, with demand coming partly from non-residents)

Attenuated by...

- **Rather more aggressive Fed** (four rate hikes in 2018, each of 25 bps)
- **AFPs (pension funds)** (increase in limit on investment abroad)
- **Central bank intervention on the currency market**

We project that the exchange rate will hold fairly steady in 2018, showing a slight upward trend in the following year

Exchange rate
(USD/PEN)



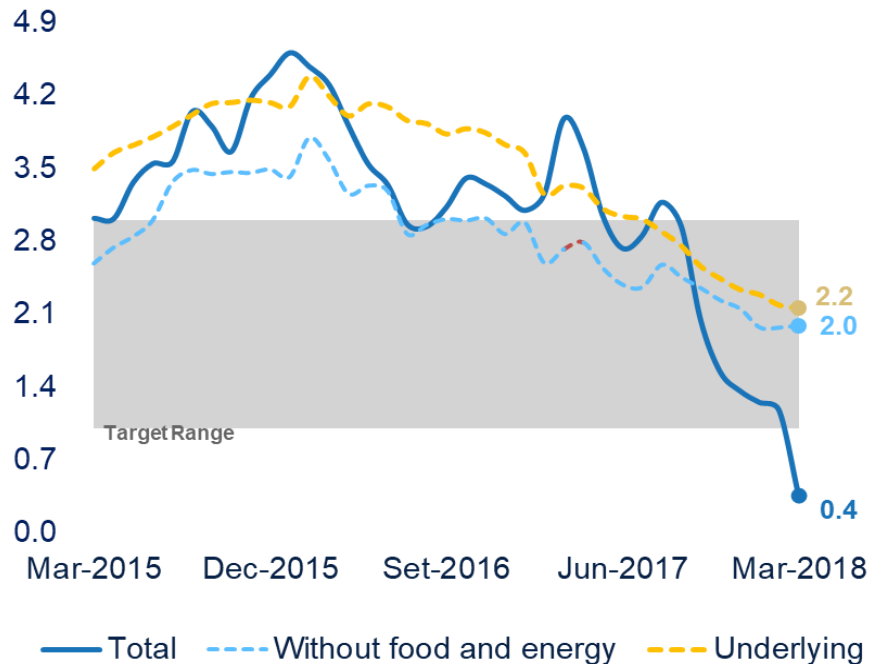


03

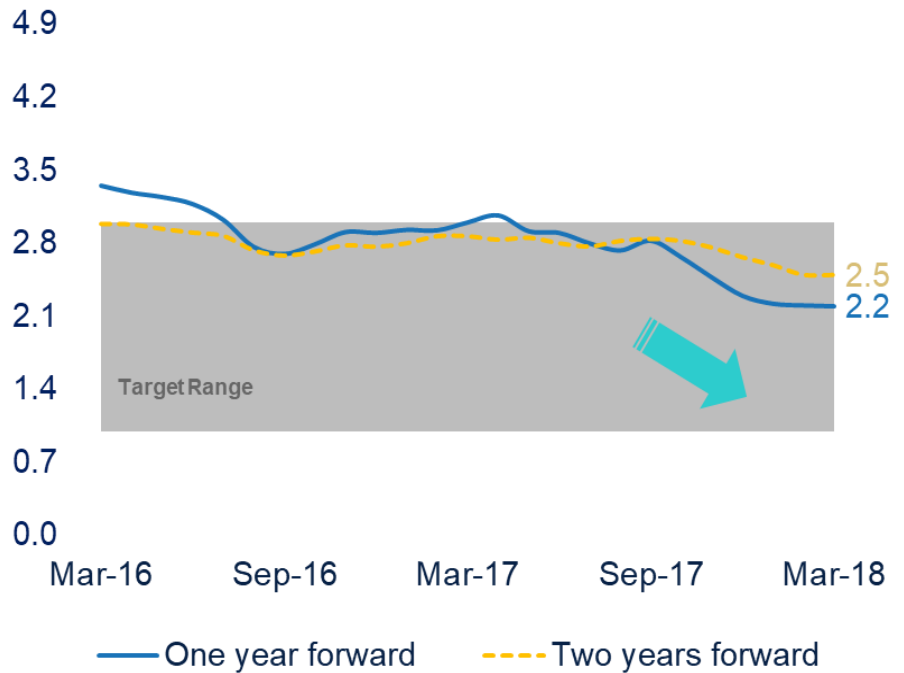
Inflation

Inflation is temporarily below the lower limit of the target range, and inflationary expectations are holding steady

Inflation: Headline, Minus food and energy, and Core (Chg. % YoY in CPI)



Inflationary expectations at one- and two-year horizons* (%)



In the remainder of the year we expect inflation to tend towards the centre of the target range

Inflation

(chg. % YoY CPI)



- Normalisation of prices especially food prices
- Demand pressures will remain limited
- Exchange rate relatively steady



04

Monetary policy

Central Bank has been accentuating the monetary stimulus since the second quarter of last year

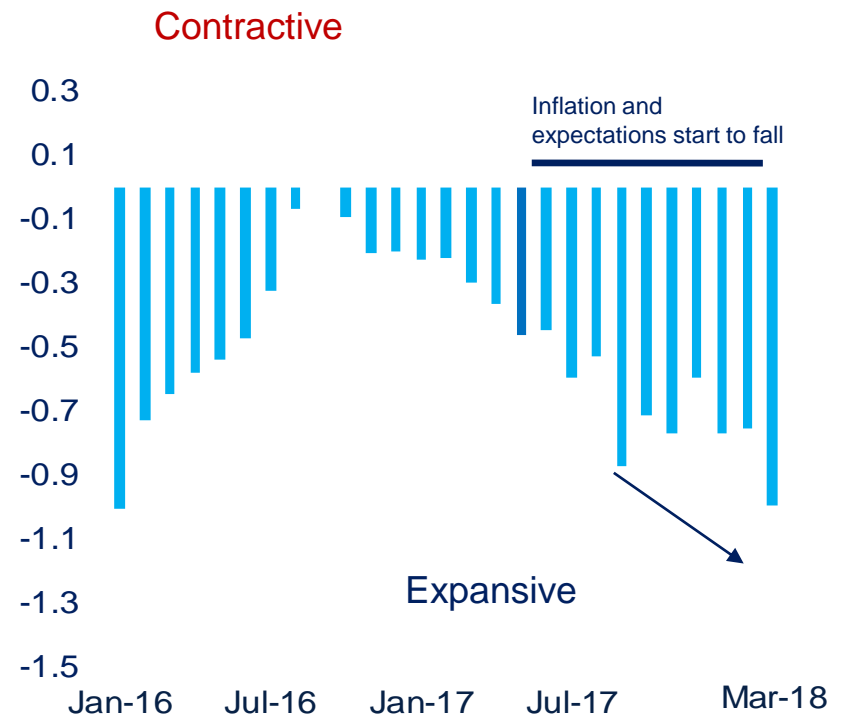
Real interest rate*

(%)



Position of monetary policy

(difference between the real rate and the neutral rate in percentage points)

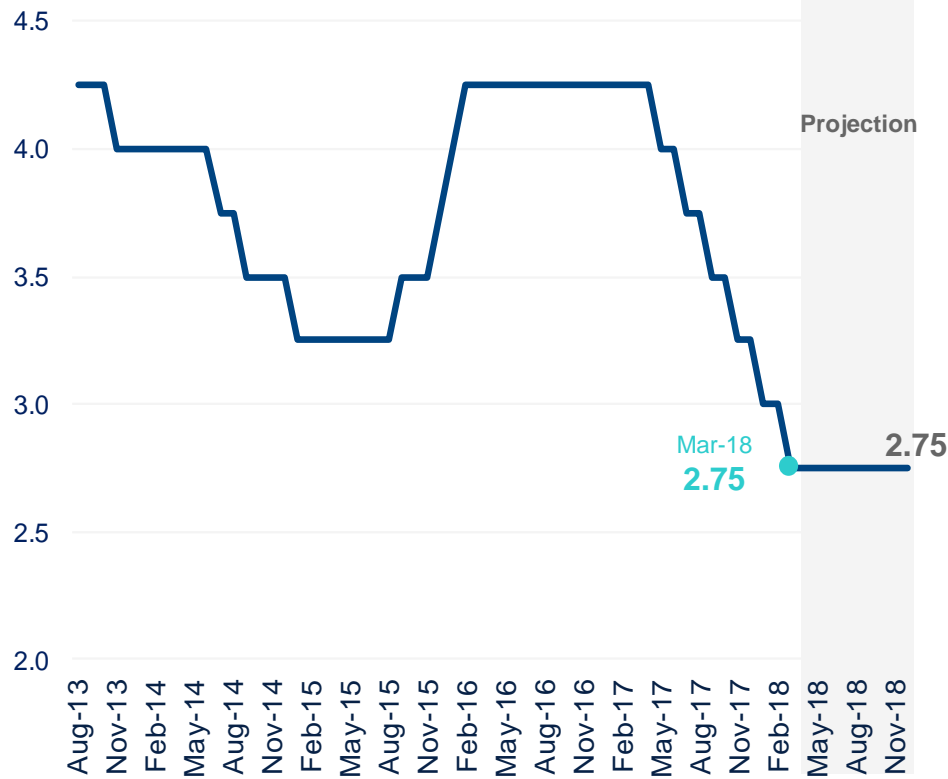


*Ex ante (with expectations of inflation at one year)
Source: Central Reserve Bank of Peru and BBVA Research

Source: Central Reserve Bank of Peru and BBVA Research

Monetary pause for the rest of the year

Monetary policy reference rate (%)



- **Baseline scenario:** rate at 2.75% in the next few months
- Involves **boost in public spending, beyond mere normalisation**
- Involves measures tending to **increase inflation** and inflationary expectations around 2%
- If fiscal momentum is weaker than forecast, the **Central Bank could offset it with a greater monetary stimulus**



05

Risks

Risks of deviation from growth forecasts for 2018 and 2019

External

- Intensification of trade war
- More aggressive Fed
- Sharper slowdown in China



Domestic

- Improvement in the political environment
- Slower normalisation of the Construction sector
- Development of major mining projects such as Quellaveco



 Downward bias

 Upward bias



We consider that these risk factors are balanced

Summary of projections

Macroeconomic projections

	2012	2013	2014	2015	2016	2017	2018 (p)	2019 (p)
GDP (% YoY)	6.0	5.8	2.4	3.3	4.0	2.5	3.2	3.5
Domestic demand (excl. inventories, % YoY)	9.8	6.4	2.5	2.2	0.9	1.7	3.3	3.3
Private Spending (% YoY)	6.5	7.2	1.9	2.7	1.3	2.0	3.3	3.3
Private Consumption (% YoY)	7.4	5.7	3.9	4.0	3.3	2.5	2.7	3.0
Private investment (% YoY)	15.6	7.1	-2.2	-4.2	-5.7	0.3	3.0	4.5
Public spending (% YoY)	11.6	8.1	3.6	3.6	-0.3	-0.1	6.1	2.7
Public spending (% YoY)	8.1	6.7	6.0	9.8	-0.5	1.0	6.1	2.3
Public investment (% YoY)	19.5	11.1	-1.1	-9.5	0.2	-2.8	6.0	3.8
Exchange rate (vs. USD, EOP)	2.57	2.79	2.96	3.39	3.40	3.25	3.23	3.26
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	-3.1	-3.4	-3.0
Current Account (% GDP)	-2.8	-4.7	-4.4	-4.8	-2.7	-1.3	-1.3	-1.8
Exports (billions of USD)	47.4	42.9	39.5	34.4	37.0	44.9	48.3	49.2
Imports (billions of USD)	41.0	42.4	41.0	37.3	35.1	38.7	41.7	43.3

*Monetary policy rate

Forecast closing date: 12 April 2018

Source: Central Reserve Bank of Peru and BBVA Research Peru

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