BBVA Research

Peru Economic Outlook

3Q18

July 2018

Projections with information at 11 July

Creating Opportunities

Key messages

- GDP continued to pick up pace in the second quarter, more than we forecast in our last report. On the expenditure side, the main support for this acceleration came from domestic demand, and within this, investment. This was due in part to the low base for year-on-year comparison, but we also see an underlying improvement in expenditure indicators.
- We are projecting GDP to grow by 3.6% in 2018 (2.5% last year) and 3.9% in 2019. The forecasts take account of the fact that the positive effect of the low base for year-on-year comparison will fade from the second half of the year, that external conditions will tighten, and that the election of new authorities at regional and local levels in October 2018 could entail a slowdown in public spending from the end of this year. On the other hand, the baseline scenario assumes that construction will start on some medium- and large-size mines, including Quellaveco, that the pace of reconstruction of areas affected by the *Niño Costero* weather phenomenon will speed up and that business spirits will remain optimistic in general. It also assumes that global trade tensions will not escalate that much.
- Our growth forecasts for 2018 and 2019 are 0.4 pp higher than they were three months ago, in the case of 2018 due to the positive surprise of the second quarter and the underlying improvement in the spending indicators, and in the case of 2019 above all due to the inclusion of Quellaveco in the baseline scenario.

Key messages

- The start of the process of consolidation of the public accounts seems to have been brought forward to 2018. The fiscal deficit has diminished so far this year, and it has done so faster than anticipated. This is explained by an improvement in tax revenue. We foresee the deficit ending this year below 3% of GDP (3.1% at year-end 2017) and continuing to fall in the next few years. The projected deficits are smaller than those we anticipated three months ago and are consistent with gross public debt moving towards a level equivalent to 27% of GDP.

- Good performance of the PEN despite a more uncertain and volatile international environment. This is a reflection of Peru's sound macroeconomic fundamentals. In the projection, we anticipate that the increased supply of dollars will continue both on the trade side (the balance of trade will show a surplus of nearly US$7 billion this year, despite the fall in metal prices) and on the financial side (foreign direct investment in the mining sector, for example). The factors will mitigate the effects of the increase in the US Federal Reserve's monetary policy rate. In this context, we foresee the USD/PEN exchange rate ending both 2018 and 2019 in a range of between 3.25 and 3.30.

- Monetary policy rate on hold until well into next year in order to consolidate recovery in private spending. After that, from mid-2019, once the recovery is consolidated and with a positive sol-dollar interest rate differential close to closing, gradual normalisation towards a more neutral level.

- Risks to growth forecasts. Escalation of protectionist measure, more aggressive monetary adjustment by the US Federal Reserve, more marked moderation of growth in China, and, at home, less progress on the construction of public infrastructure. Positive risk: that the underlying improvement in the spending indicators seen in 2Q18 are sustained.

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01

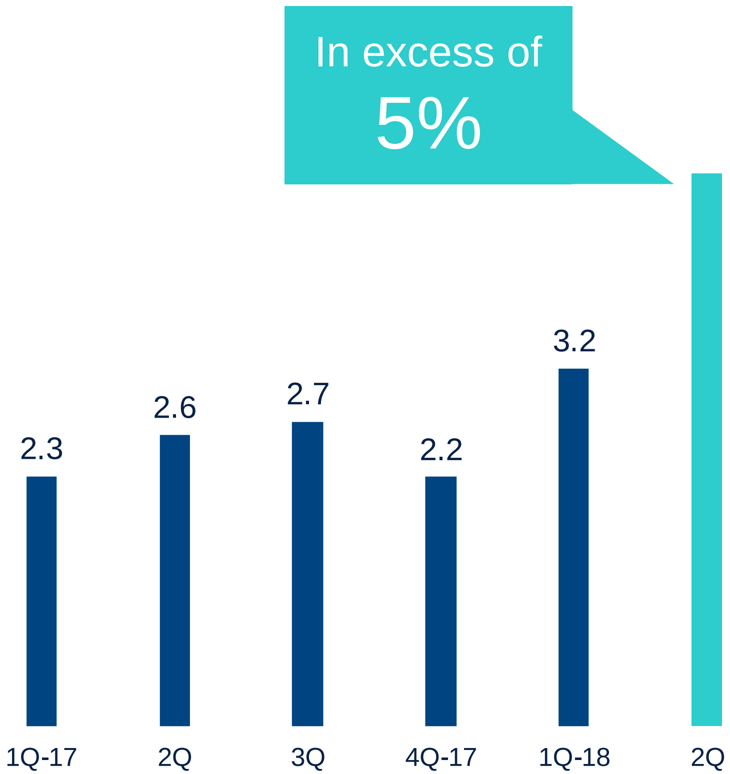
Economic activity

Recent trends in economic activity

The economy is starting to settle into improved performance, linked to private spending

Activity and spending indicators point to GDP growth having accelerated in the second quarter

GDP
(% change YoY)

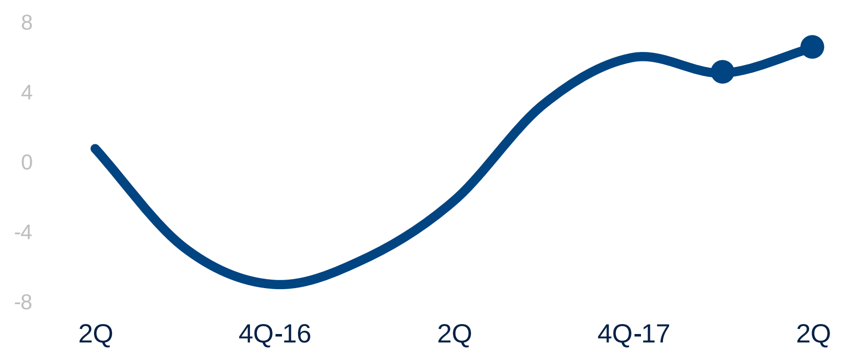


- Main basis for this growth: Domestic demand
- Positive effect of the low base for YoY comparison (On domestic demand)…
- … but also underlying improvement in the private spending indicators, especially in investment
- Added to this is a bigger anchoveta haul (This year's quota was higher)

* 2Q18 projected
Source: Central Reserve Bank of Peru and BBVA Research

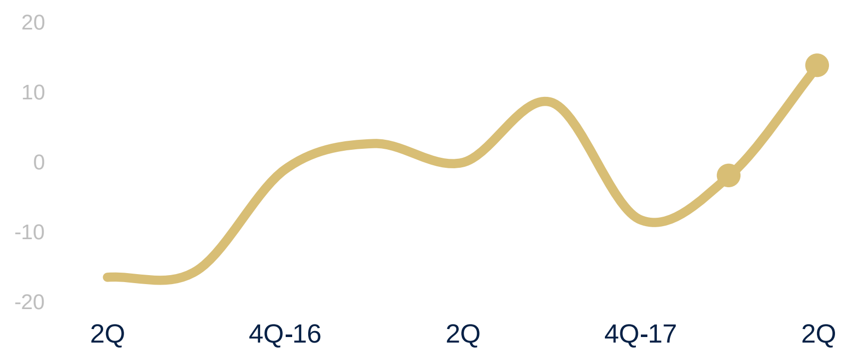
Various indicators linked to private investment show good performance (and acceleration) in the second quarter…

Domestic consumption of cement
(% change YoY)



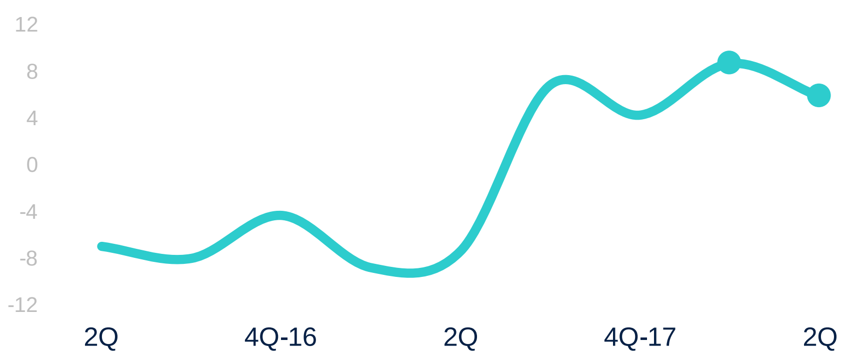
2Q18: Data to May
Source: INEI (National Statistics & IT Institute) and BBVA Research

Production of machinery and equipment
(% change YoY)



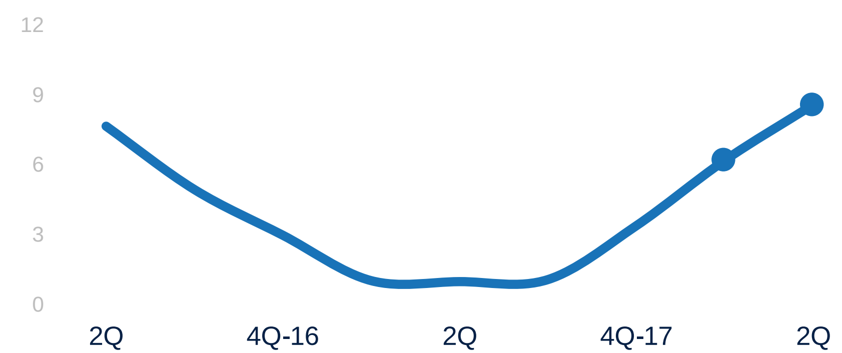
2Q18 includes data for April only
Source: INEI (National Statistics & IT Institute) and BBVA Research

Imports of capital goods*
(% change YoY)



* Volume
Source: SUNAT (Peruvian Revenue and Customs Office), Central Bank of Peru and BBVA Research

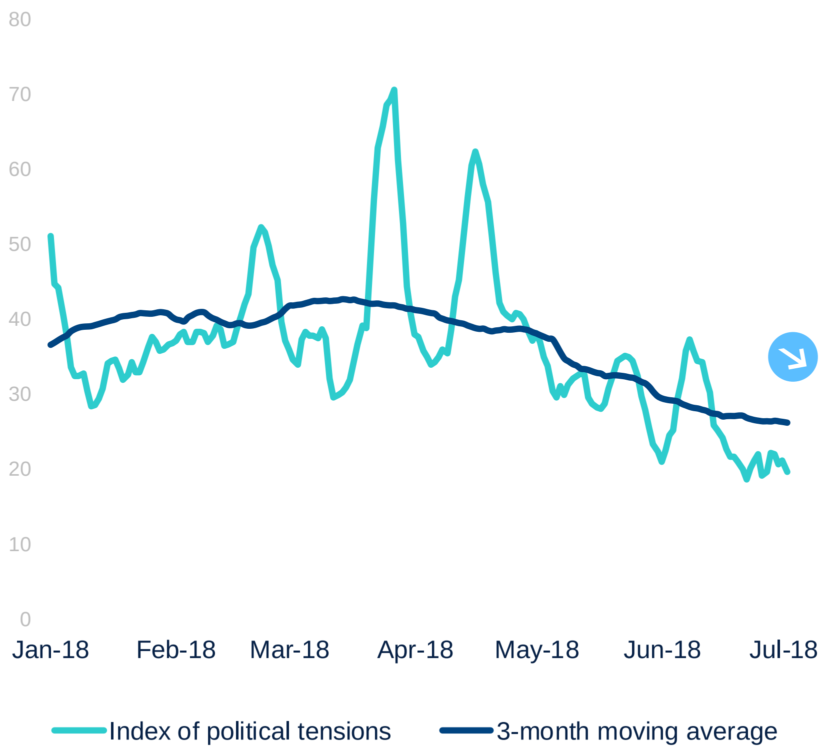
Loans granted to businesses*
(% change YoY)



* Loans granted by banks. 2Q18 data to May
Source: ASBANC (Peruvian Banking Association) and BBVA Research

… which is consistent with reduced political tension, improved business confidence and interest rates that continue to be attractive

Political stress index
(22 March 2018 = 100)



Source: BBVA Research

Business confidence
(Points)

Source: Central Reserve Bank of Peru

We are starting to see signs of recovery in the labour market

Formal employment in urban areas
(% change YoY)

Source: MTPE (Ministry of Labour and Employment Promotion)

Formal private sector jobs*
(% change YoY)

* Information from electronic scorecard
Source: Central Reserve Bank of Peru and Peruvian Revenue and Customs Office (SUNAT)

Projection

We are projecting GDP to grow by 3.6% in 2018 and 3.9% in 2019

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Projections for the remainder of 2018 and for next year are consistent with…

GDP

External factors

- Global trade tension will not escalate much further
- The US will grow by 2.8% in 2018 and 2019, underpinned by fiscal stimulus, while China's growth will moderate to 6.3% in 2018 and slightly more in 2019
- The US Federal Reserve will continue its process of monetary normalisation
- Metal prices will tend to fall in the next few quarters, among them that of copper

Internal factors

- Construction will start on some medium- and large-size mines, with an impact on GDP growth that will be more appreciable from 2019
- *Niño Costero*-related reconstruction and work on the second line of the Lima Metro will speed up, but the impetus from the construction of infrastructure for the 2019 Pan-American Games and the Talara refinery will tend to diminish.
- To judge from previous instances, it is possible that public spending may temporarily dip after the regional and local elections

Furthermore, the positive effect of the low base for YoY comparison will fade

External factors. Baseline scenario assumes that global trade tensions will not escalate much further

Recent developments

Trump is fulfilling his protectionist promises… while the countries affected are reacting…

China among the countries most affected. And China means demand for metals

Trade tensions have caused metal prices to fall and emerging market currencies to depreciate

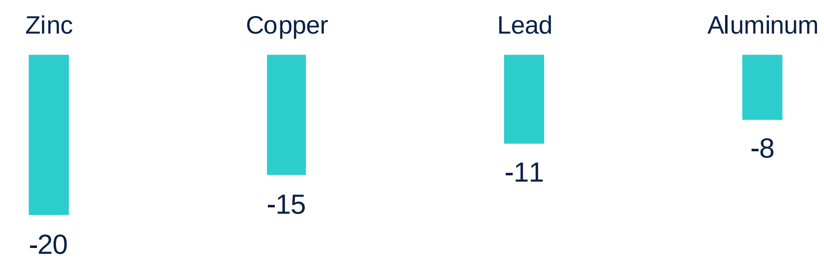
Impact focused on financial variables for the time being. Tariff increases already approved have little direct impact, but the indirect effects (on confidence, for example) could be seen in the second half of the year

Risks

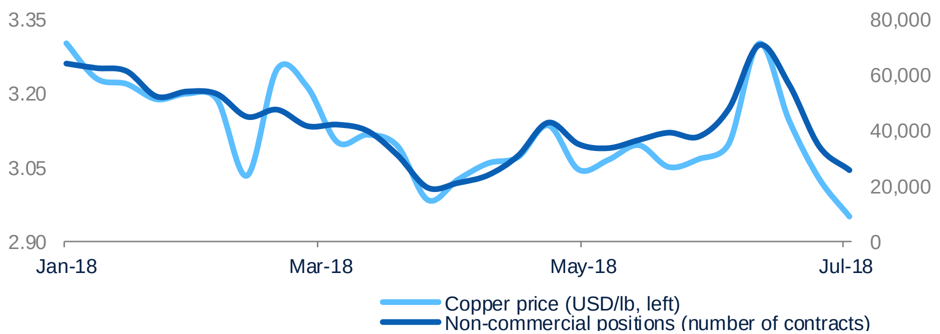
Even greater protectionist escalation (implementation of measures being discussed), which would have a significant negative impact, on the US too. World GDP could be reduced by around 0.2 pp through the trade channel alone

Impact

Metal prices
(% change relative to one month ago)

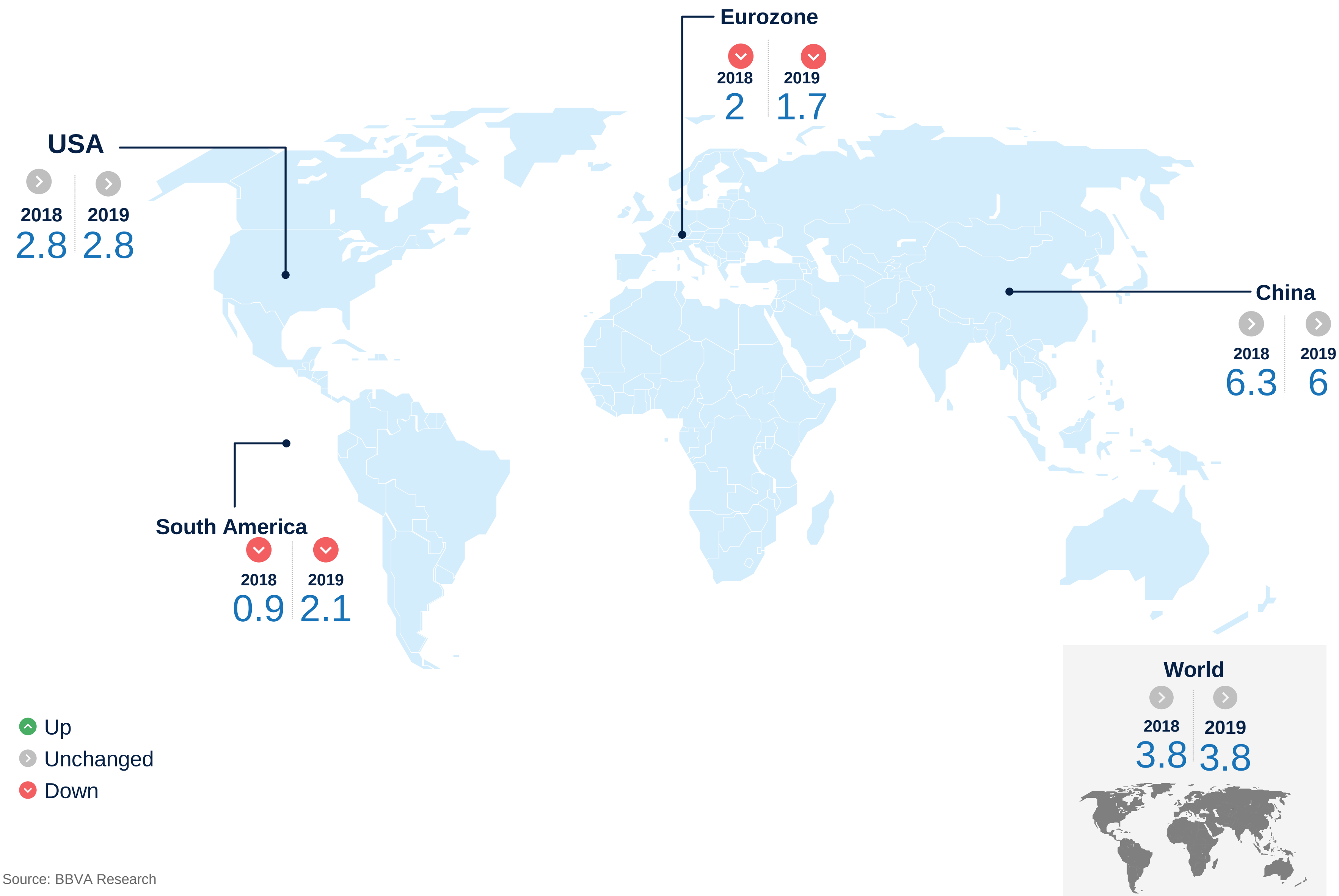


Copper: price and net non-trading positions



Source: Bloomberg and BBVA Research

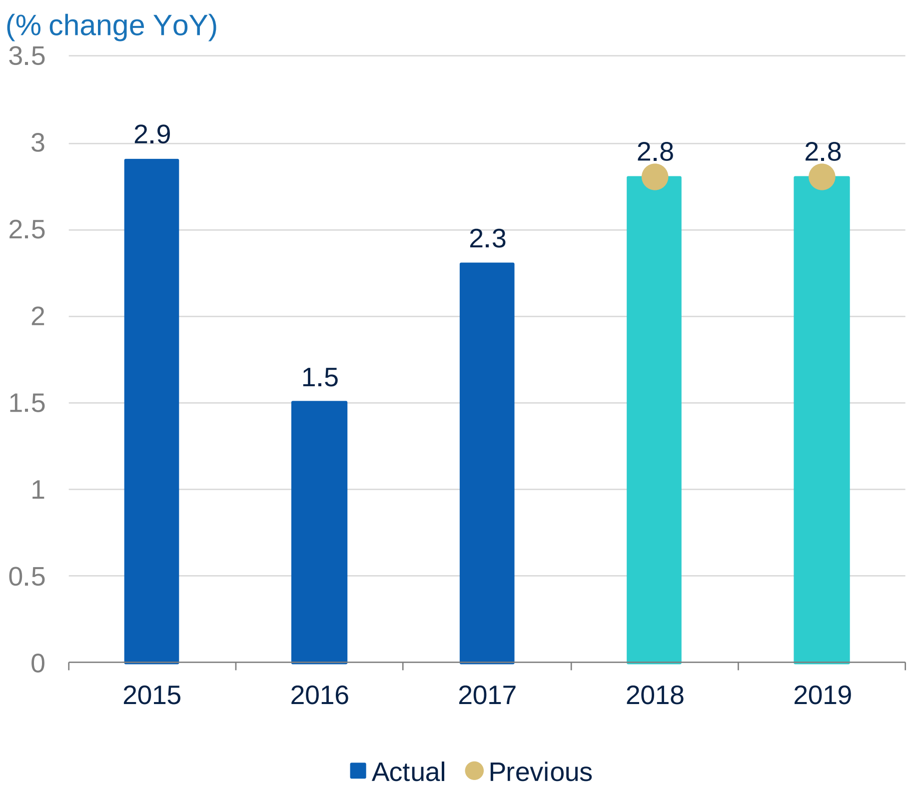
External factors. Global growth is holding up, but the synchronicity among geographical regions is weakening…



Source: BBVA Research

... In the US: growth supported by fiscal stimulus, but approaching the end of the expansive phase

USA: GDP growth

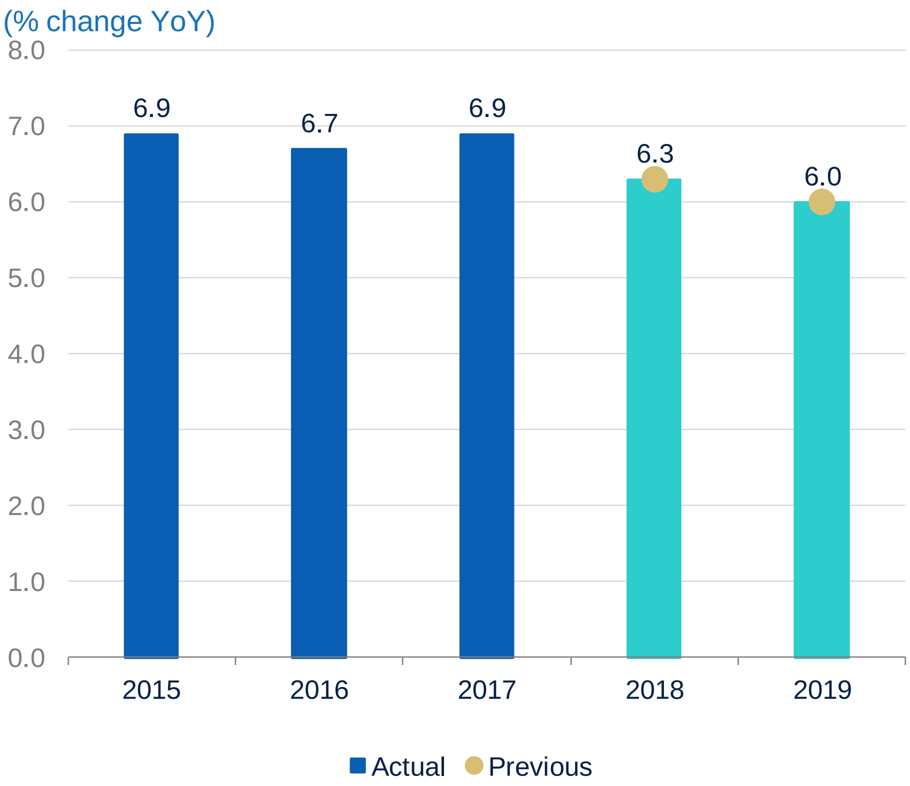


- Growth has accelerated in the first half of the year, boosted by the fiscal stimulus and the improvement in the labour market
- Trade tensions could weigh down on production and global demand
- The absorption of the idle capacity of the economy foreshadows the end of the expansive phase of the cycle
- Inflation will temporarily exceed the Fed’s target due to higher energy prices, but inflation expectations remain anchored

Source: BBVA Research based on BEA (Bureau of Economic Analysis) figures

… In China: moderation of growth, but relatively gentle thanks to greater stimulus measures

China: GDP growth

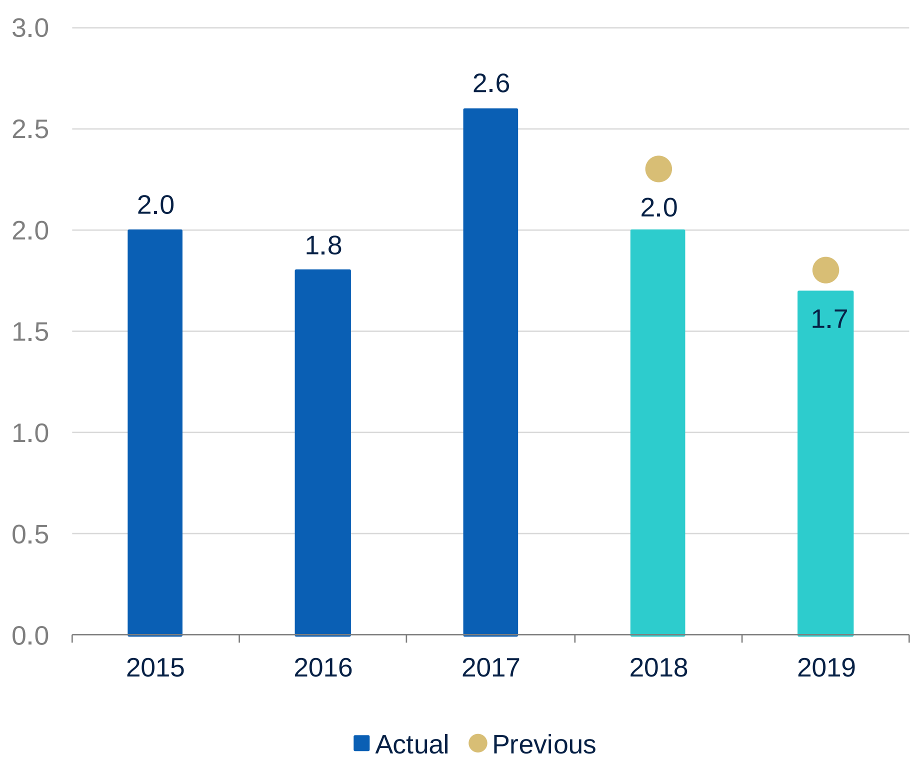


Source: BBVA Research based on CEIC data

- The slowdown in growth will continue in the second half of the year, although the figures so far are somewhat more positive than expected
- Policies to tackle financial vulnerabilities continue, but are softened by fiscal and monetary stimulus measures to sustain growth
- Protectionism threatens the sustainability of exports, as well as the restructuring of the economy

...In the euro zone: rapid transition towards more moderate growth rates

Euro zone: GDP growth
(% change YoY)



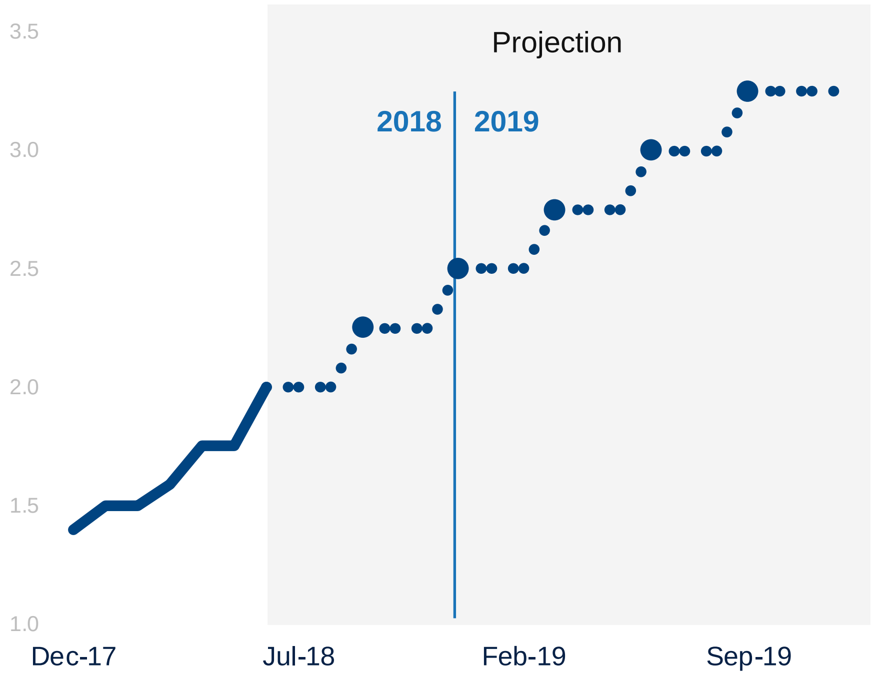
Source: BBVA Research based on Eurostat figures

- The increase in uncertainty and higher oil prices are having an impact on activity, but domestic demand remains solid
- The depreciation of the euro and global demand will continue to support exports
- Economic policies will be somewhat more accommodative: lower rates for longer periods and fiscal loosening in some countries
- Despite the rebound of inflation in the short term, the core rate will increase only gradually, especially in 2019

External factors. The US Federal Reserve will continue with its process of monetary normalisation

USA Federal Reserve rate

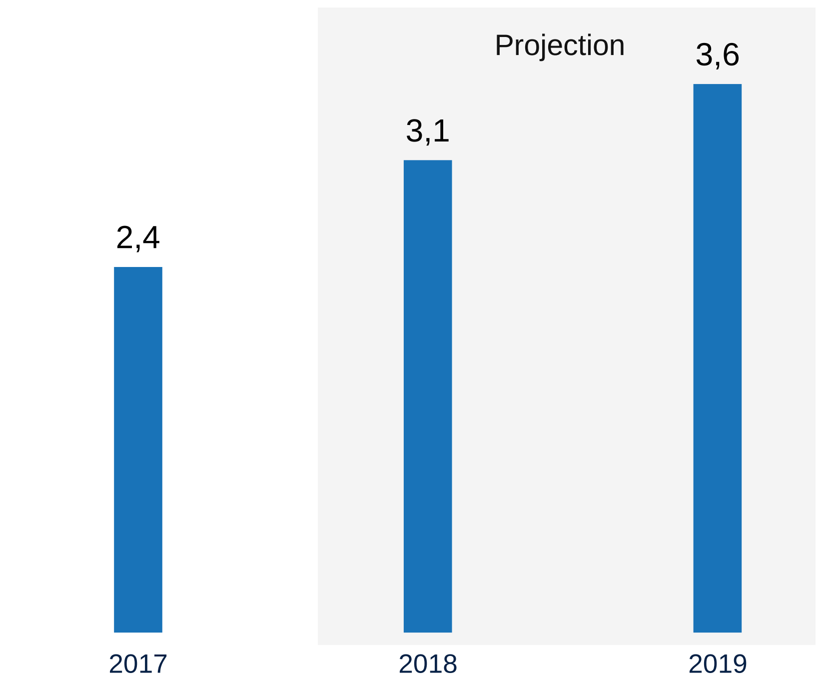
(%)



Source: Bloomberg and BBVA Research

USA Yield on ten-year Treasuries*

(%)

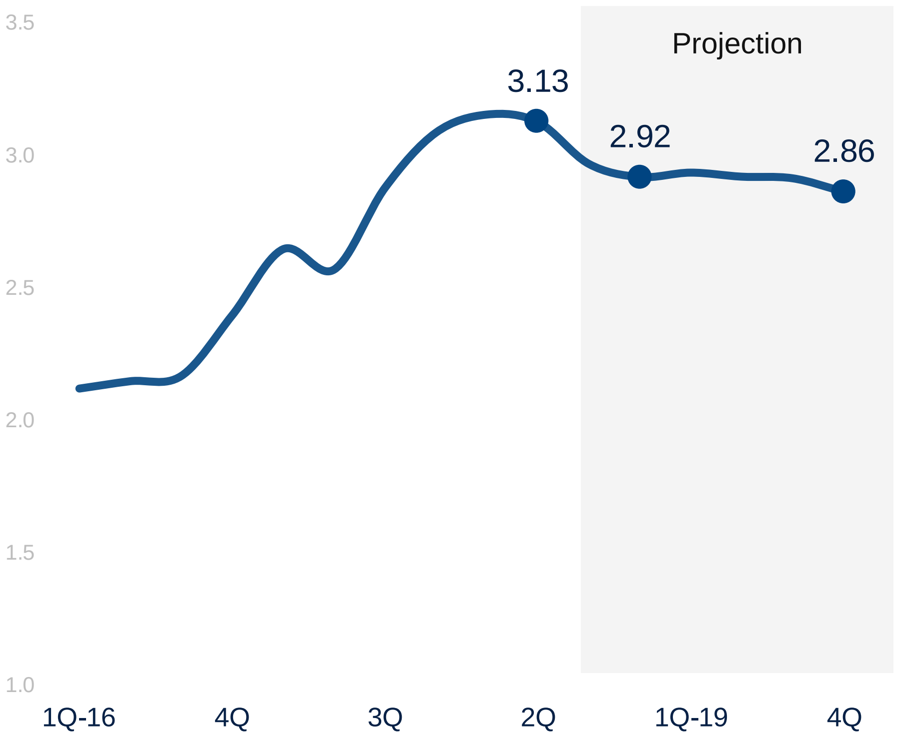


* End of period
Source: Bloomberg and BBVA Research

- **2018**:two hikes in the Fed's rate in the second half of the year
- **2019**: three rate hikes (March, June and September). Implies one hike more than in the previous forecast

External factors. Metal prices will tend to fall in the next few quarters, among them that of copper

Price of copper
(US$ per lb.)



Annual average price:

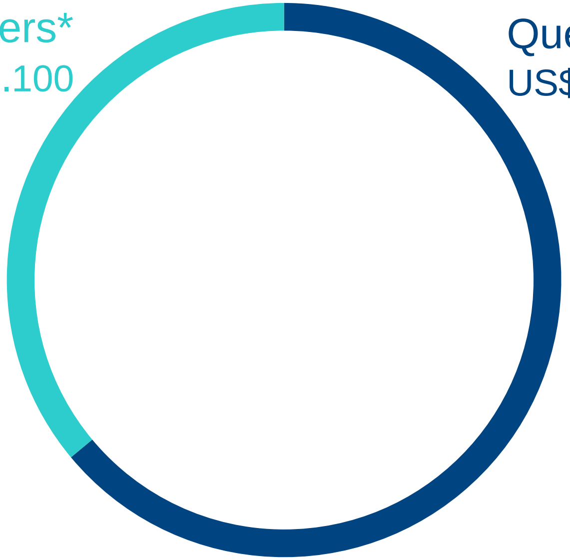
2017: 2.80, 2018: 3.04, 2019: 2.91

Source: Bloomberg and BBVA Research

- The price of copper has fallen sharply in the past few weeks, in particular because of global trade tensions
- Part of the fall is over-reaction. If trade tensions do not escalate much more, we estimate that the price will recover to an average of around US$2.94 per lb. in the second half of the year
- After that, tendency to fall in a context in which China's growth moderates and monetary policies in advanced countries are adjusted
- Levels that we estimate the price of copper will reach at the end of 2019, continuing to provide support to mining investment

Internal factors. Construction will start on some medium- and large-size mines, with an impact on growth in 2019

Portfolio of mining projects that we expect will start construction in 2018 and 2019
(US$ millions)



Total US$8.6 billion

* Includes Mina Justa (US$1.35 billion) and the expansion of Toromocho (US$1.3 billion)

Source: MINEM (Ministry of Energy and Mines), Apoyo Consultoría and BBVA Research

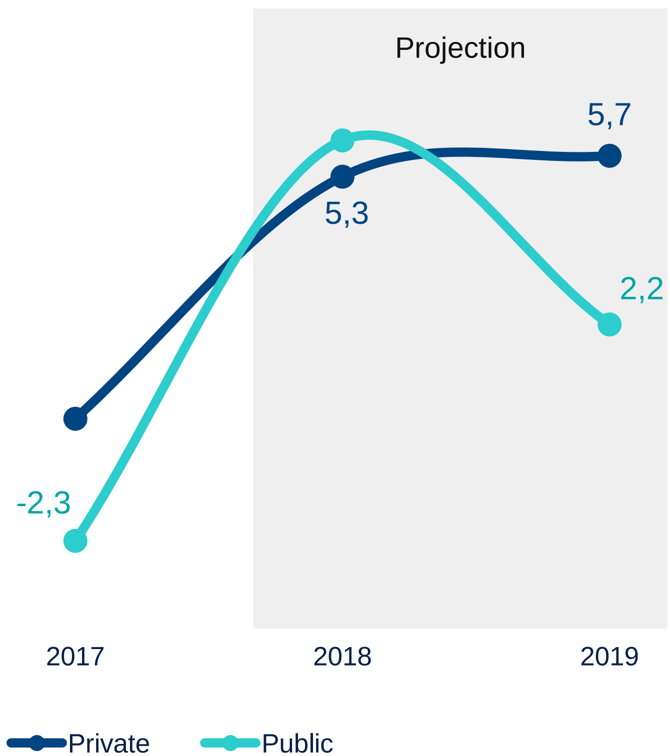
Quellaveco project*

- Location: Moquegua
- Company: Anglo American (60%) / Mitsubishi (40%)
- Annual output: 300,000 FMT/Cu
- Cash cost (C1): US$1.10 per lb.
- Current situation:
  - The necessary construction permits have been obtained
  - The project has been accepted on a local, regional and national level
  - Pending: approval of the Anglo American Shareholders (expected to be resolved in 3Q)
  - The company says production will start in 2022

* Press release, 14 June 2018
Source: Anglo American

Internal factors. Progress on some public investment projects will accelerate, while with others the impetus will gradually decline

Investment
(% change YoY)



Source: Central Reserve Bank of Peru and BBVA Research

What is considered as the baseline scenario for investment?

Government investment

- Lima Metro line 2
- Reconstruction

- 2019 Pan American Games
- Regional and local authorities
- Talara Refinery

Private investment

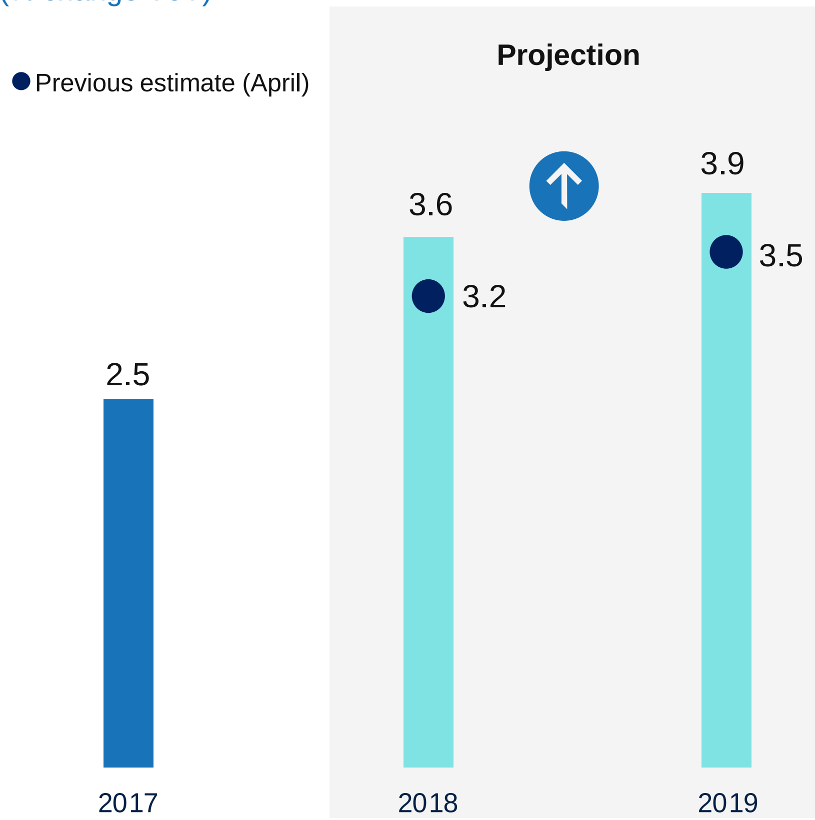
- Portfolio of mining projects [1]
- Other infrastructure projects [2]

1. Quellaveco, Mina Justa, expansion of Toromocho, and others
2. Expansion of Lima Airport, Puerto Salaverry, and shopping centres

Source: BBVA Research

As a result, we project that GDP will grow by 3.6% this year and 3.9% next, which implies an upward revision of 0.4% per year

GDP
(% change YoY)



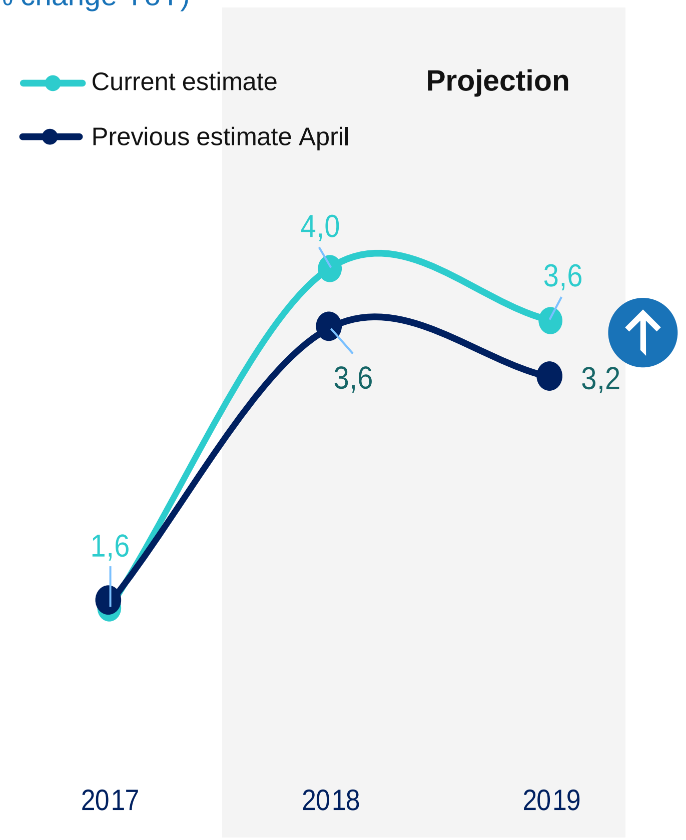
Relative to our April estimate, we have revised our forecast upwards…

2018: Positive surprise of 2Q18 and underlying improvement of private spending

2019: We expect construction to start on the Quellaveco mine

Source: BBVA Research

Domestic demand
(% change YoY)

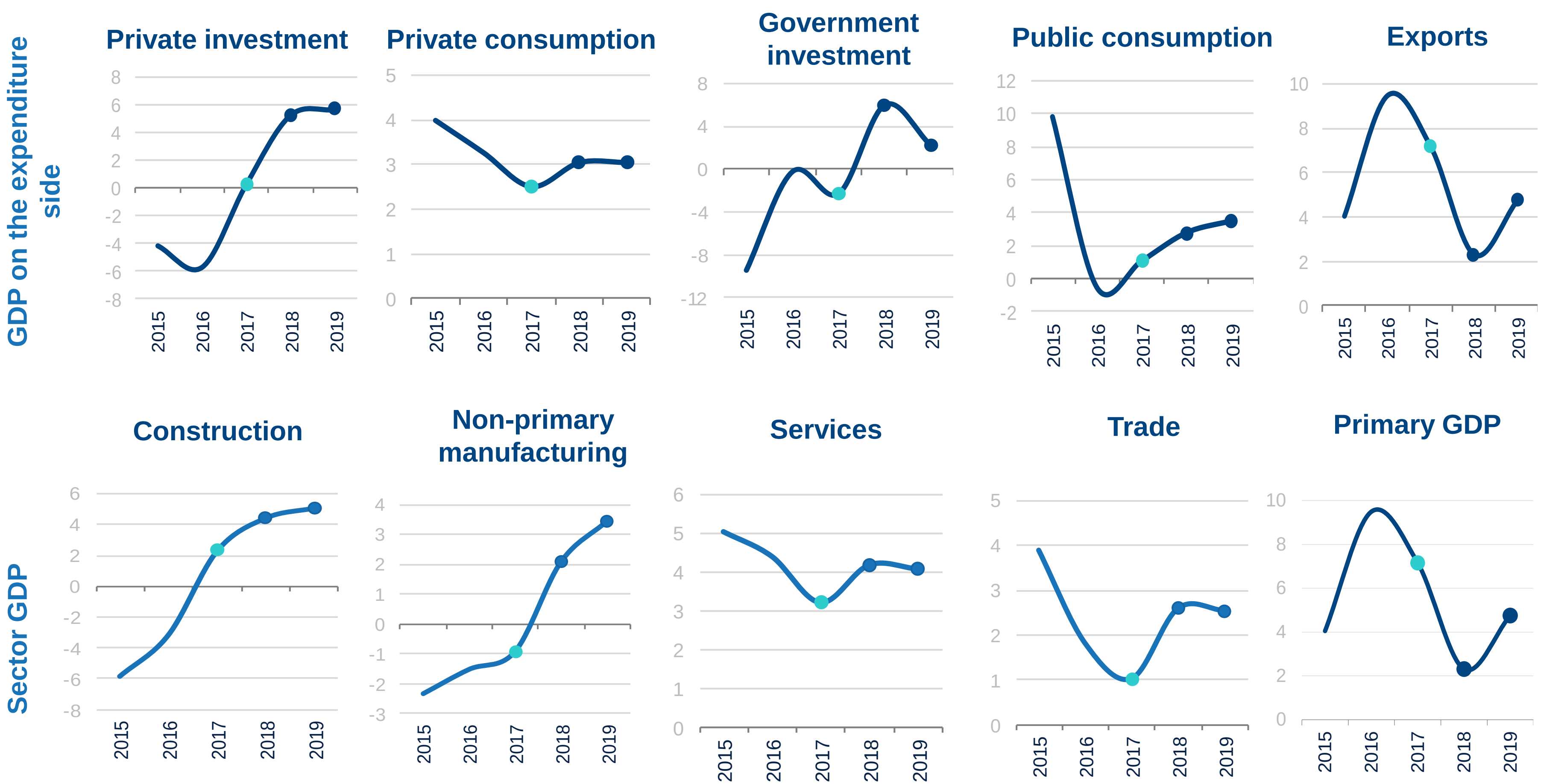


Source: BBVA Research

Private sector spending will become more dynamic, especially investment, which will be reflected in the Construction, Services and Manufacturing sectors

GDP by component

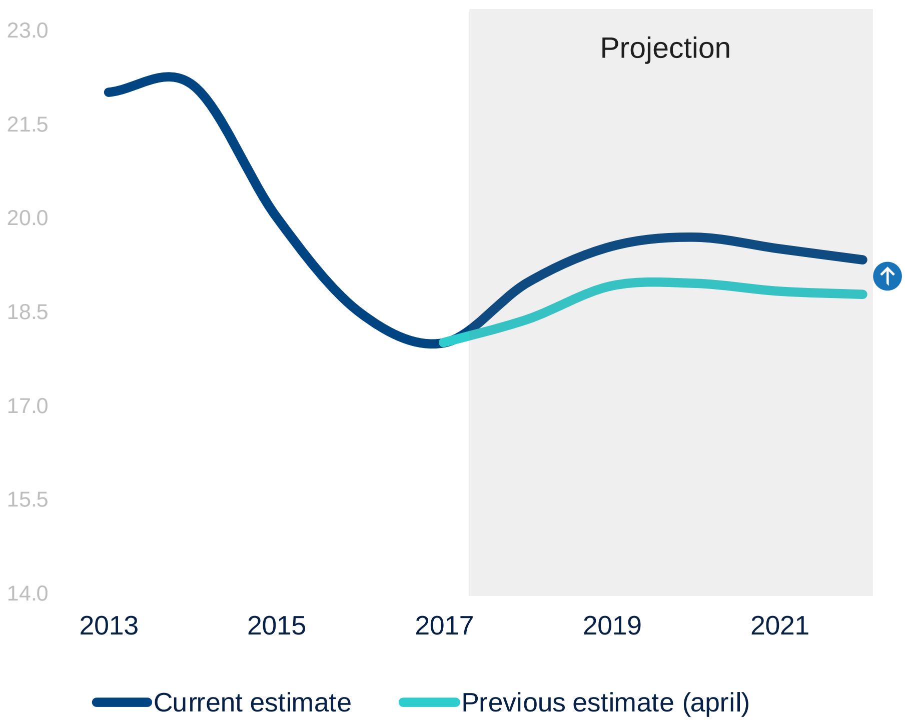
(% change YoY)



Source: Central Reserve Bank of Peru and BBVA Research

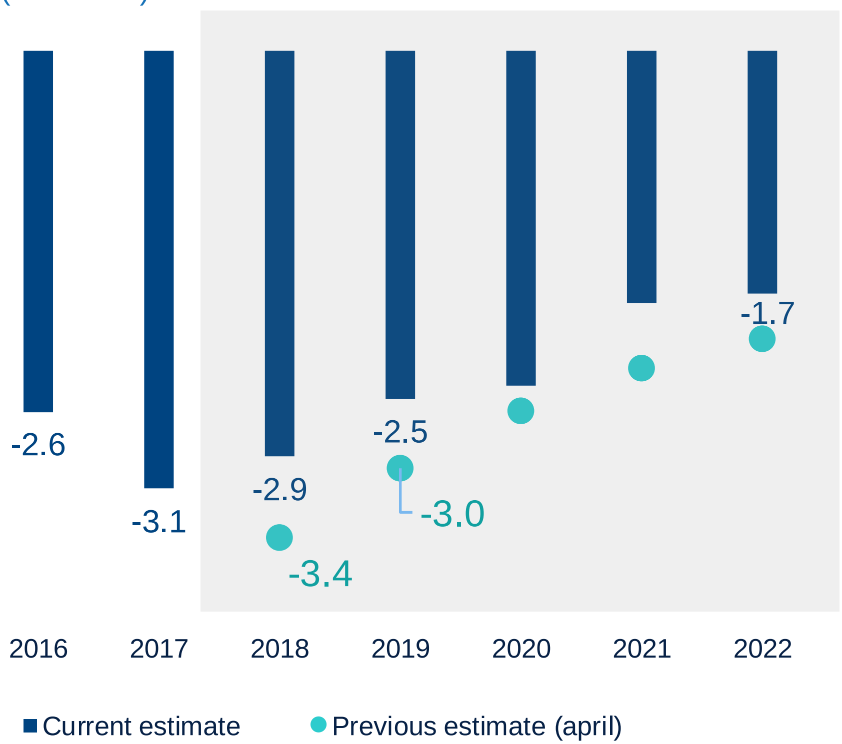
Consolidation of the fiscal accounts will start in 2018 and will be faster than we foresaw three months ago

Tax revenues
(% of GDP)



Source: Central Reserve Bank of Peru and BBVA Research

Fiscal result*
(% of GDP)



Gross public debt will stabilise at around 27% of GDP in the next few years

* Non-finance public sector

Source: Central Reserve Bank of Peru and BBVA Research

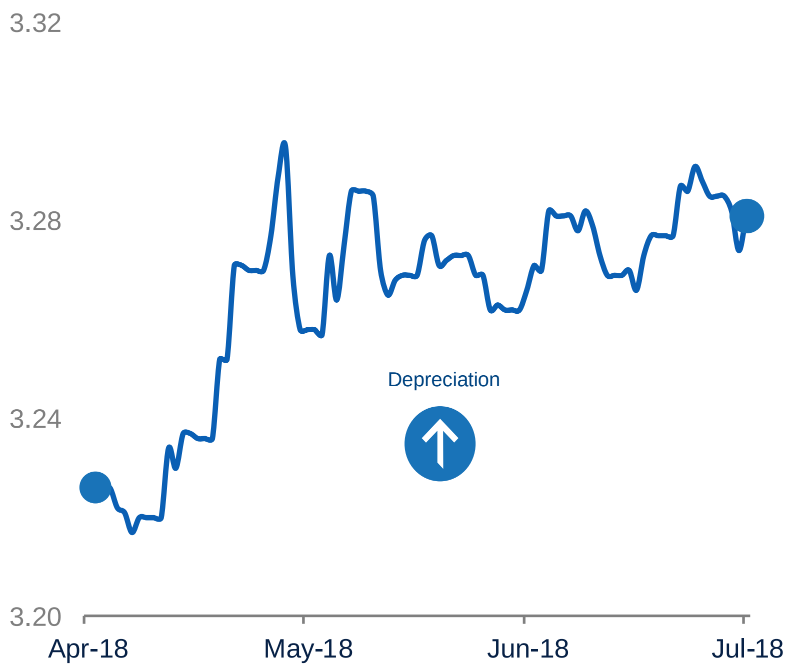
02

Financial markets

External factors affect the national Forex market. The Peruvian sol will be at between 3.25 and 3.30 at the end of this year and next

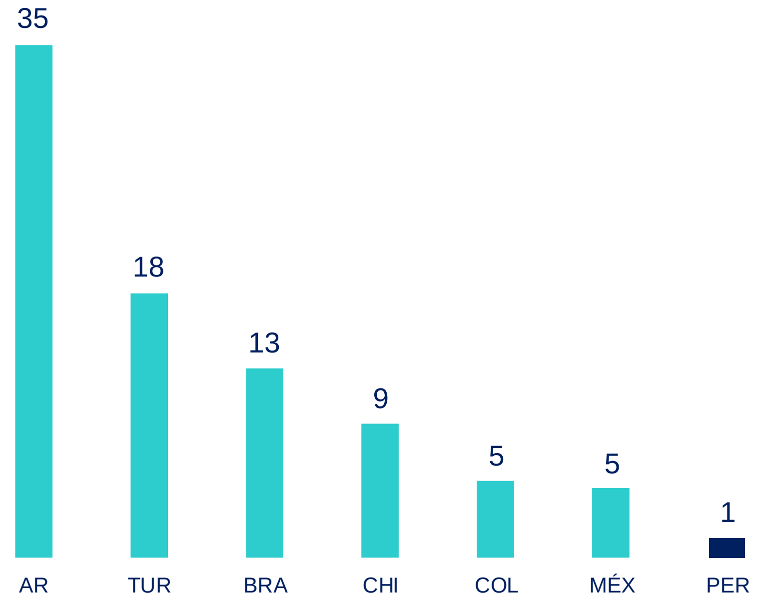
Forex market: greater volatility in the past few months, reflecting external factors, but the PEN has held up better than other currencies

Exchange rate
(USD/PEN)



Source: Bloomberg and BBVA Research

Selected emerging markets: currency depreciation* (%)



* Compared with three months ago

Source: Bloomberg and BBVA Research

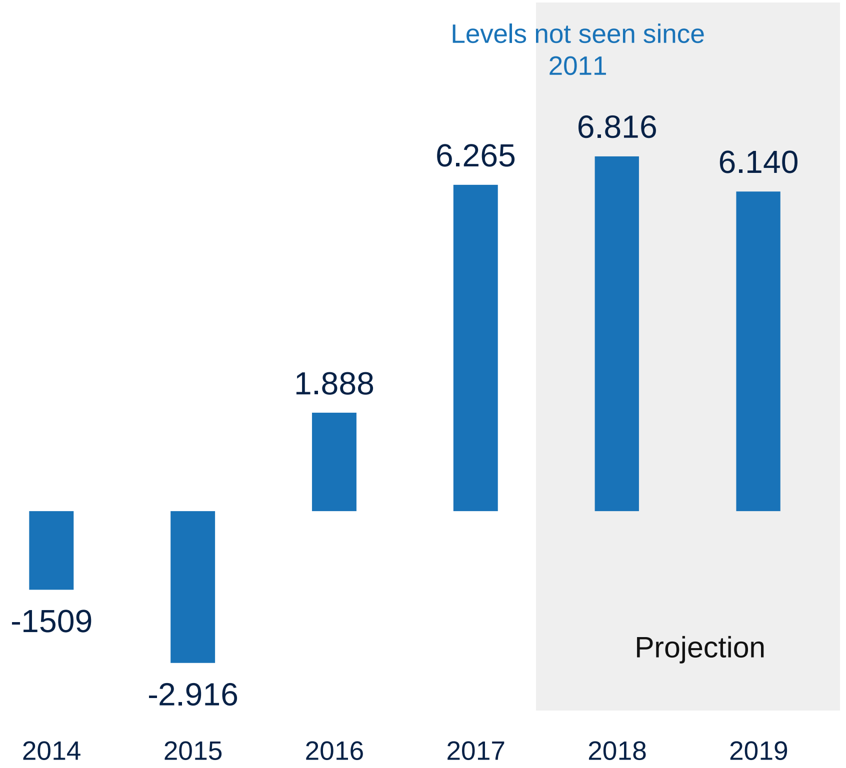
- **Perception that the Fed will be more aggressive in its process of monetary normalisation**
- **Greater uncertainty due to the possibility of a global trade war**

The greater resistance of the PEN reflects Peru's good macroeconomic fundamentals, among them fiscal solidity and a limited external deficit

Peru's good macroeconomic fundamentals

- Fiscal deficit: currently below 2.5% of GDP
- Gross government debt: below 24% of GDP (1Q18)
- Public debt: nearly 60% in local currency, nearly 90% at fixed rates of interest, and with an average maturity of 12 years
- Current account deficit: 1.3% of GDP (1Q18)
- External debt: below 35% of GDP (1Q18)
- BCR NIRs / short-term external liabilities: more than six times

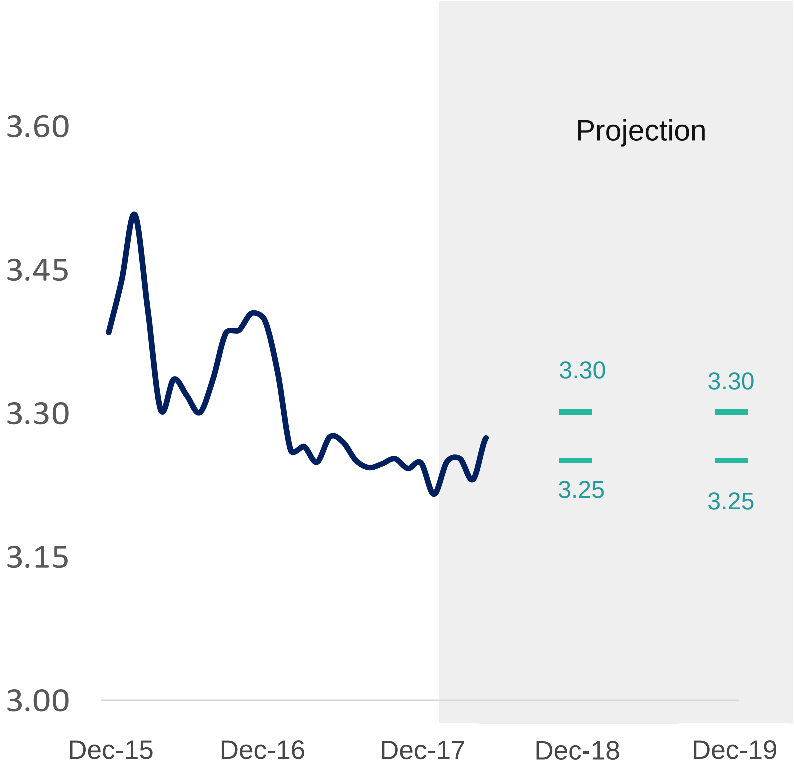
Balance of trade
(US$ millions)

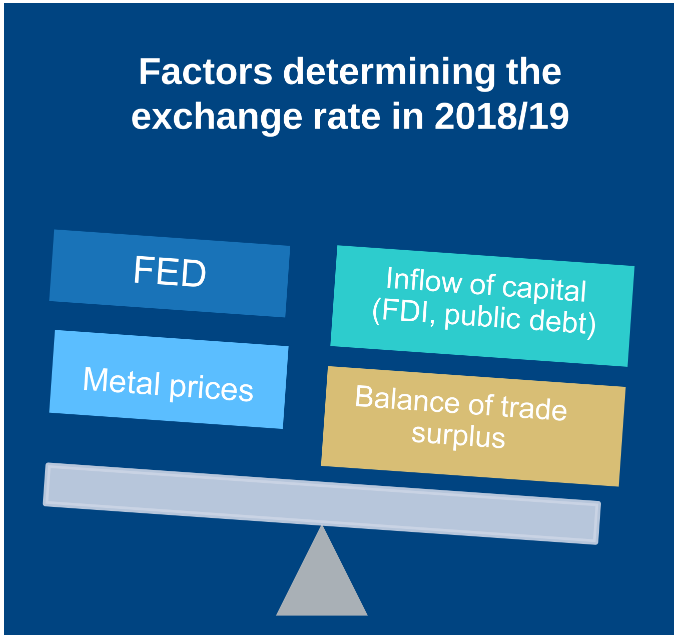


Source: Central Reserve Bank of Peru and BBVA Research

If trade protectionism does not escalate much more, we forecast that the exchange rate will be between 3.25 and 3.30 at the end of 2018 and 2019

Exchange rate
(USD/PEN)





Source: Central Reserve Bank of Peru and BBVA Research

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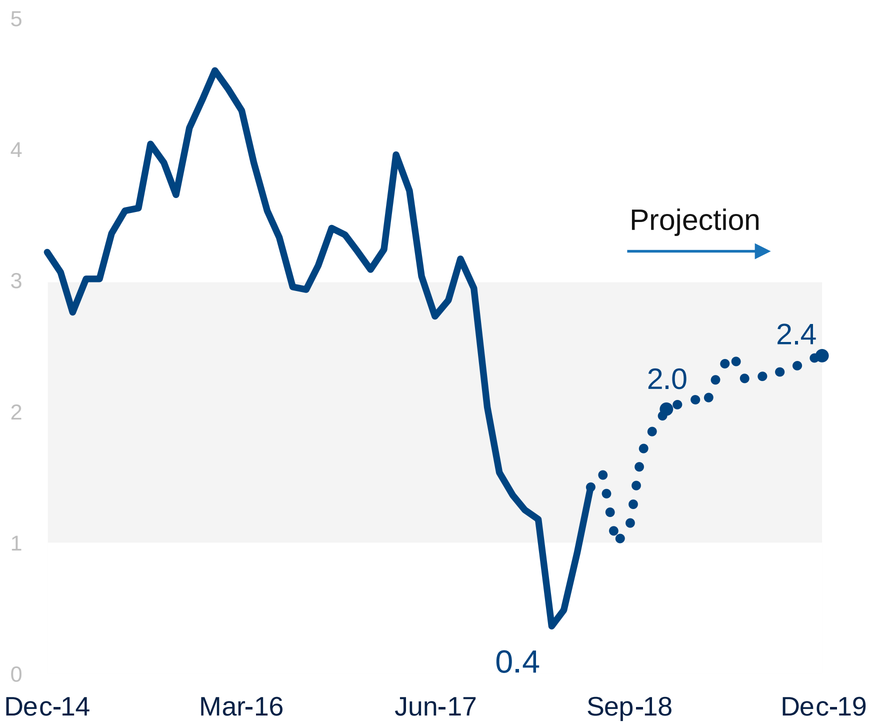
03

Inflation
and monetary policy interest rate

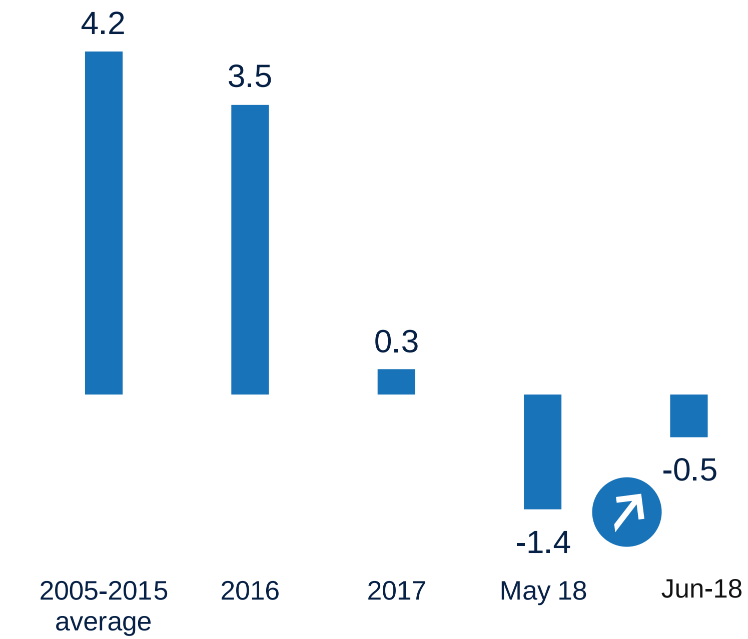
In June inflation returned to the target range and we predict that at year-end it will be at around 2%

Total inflation
(% change YoY CPI)



Source: Central Reserve Bank of Peru and BBVA Research

Food and drink prices
(% change YoY)



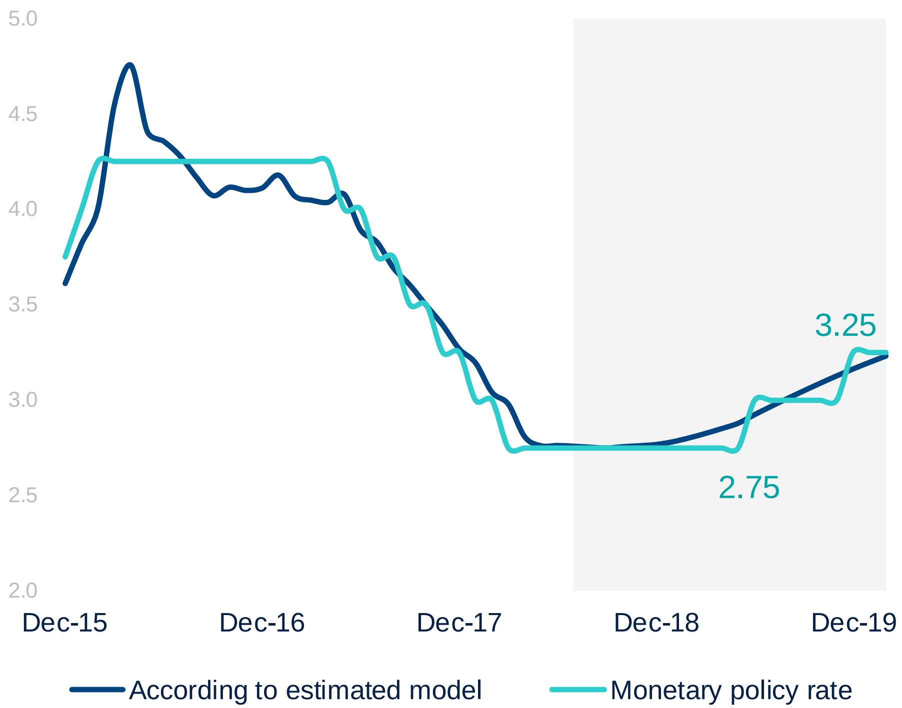
Food and drink prices have started to normalise, and this will push inflation up in the next few months

Source: Central Reserve Bank of Peru and BBVA Research

Monetary policy: base rate on hold until mid-2019, then starting gradual normalisation towards a more neutral level

Monetary policy reference rate (%)

(%)



- The current stance of monetary policy is expansive. Real rate around 0.5% (neutral level around 1.5%)
- Necessary to ensure consolidation of private spending
- We estimate that the consolidation of activity and reduced sol/dollar interest rate differential will lead the central bank to raise rates in 2H19

Source: Central Reserve Bank of Peru and BBVA Research

04

Risks

Risks to the growth projection for 2018 and 2019

External

- More aggressive adjustment by the US Federal Reserve (inflation)
- Sharper slowdown in China
- Escalation of protectionist measures

Domestic

- Less progress on public infrastructure projects (reconstruction after *Niño Costero* damage and construction of second line of the Lima Metro)
- Greater dynamism in private sector spending

Upside risk Downside risk

Macroeconomic projections

	2014	2015	2016	2017	2018 (p)	2019 (p)
GDP (%YoY)	2.4	3.3	4.0	2.5	3.6	3.9
Domestic demand (excl. inventories, %YoY)	2.5	2.2	0.8	1.7	3.6	3.6
Private Spending (%YoY)	1.9	2.7	1.4	1.9	4.1	3.7
Private Consumption (%YoY)	3.9	4.0	3.3	2.5	3.0	3.0
Private Investment (%YoY)	-2.2	-4.2	-5.7	0.3	5.3	5.7
Public Spending (var.%)	3.6	3.6	-0.5	0.1	3.7	3.1
Public Consumption (var.%)	6.0	9.8	-0.6	1.0	2.8	3.5
Public Investment (var.%)	-1.1	-9.5	-0.2	-2.3	6.0	2.2
Exchange rate (vs. USD, EOP)	2.96	3.38	3.40	3.25	3.26	3.30
Inflation (%YoY, EOP)	3.2	4.4	3.2	1.4	2.0	2.4
Interest rates * (%, EOP)	3.50	3.75	4.25	3.25	2.75	3.25
Fiscal Balance (% GDP)	-0.3	-2.0	-2.5	-3.1	-2.9	-2.5
Current Account (% GDP)	-4.4	-4.8	-2.7	-1.3	-1.3	-1.8
Exports (billions of USD)	39.5	34.4	37.0	44.9	49.3	50.3
Imports (billions of USD)	41.0	37.3	35.1	38.7	42.5	44.2

*Monetary policy rate
Closing date for forecasts: 11 July 2018
Source: Central Reserve Bank of Peru and BBVA Research Peru

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