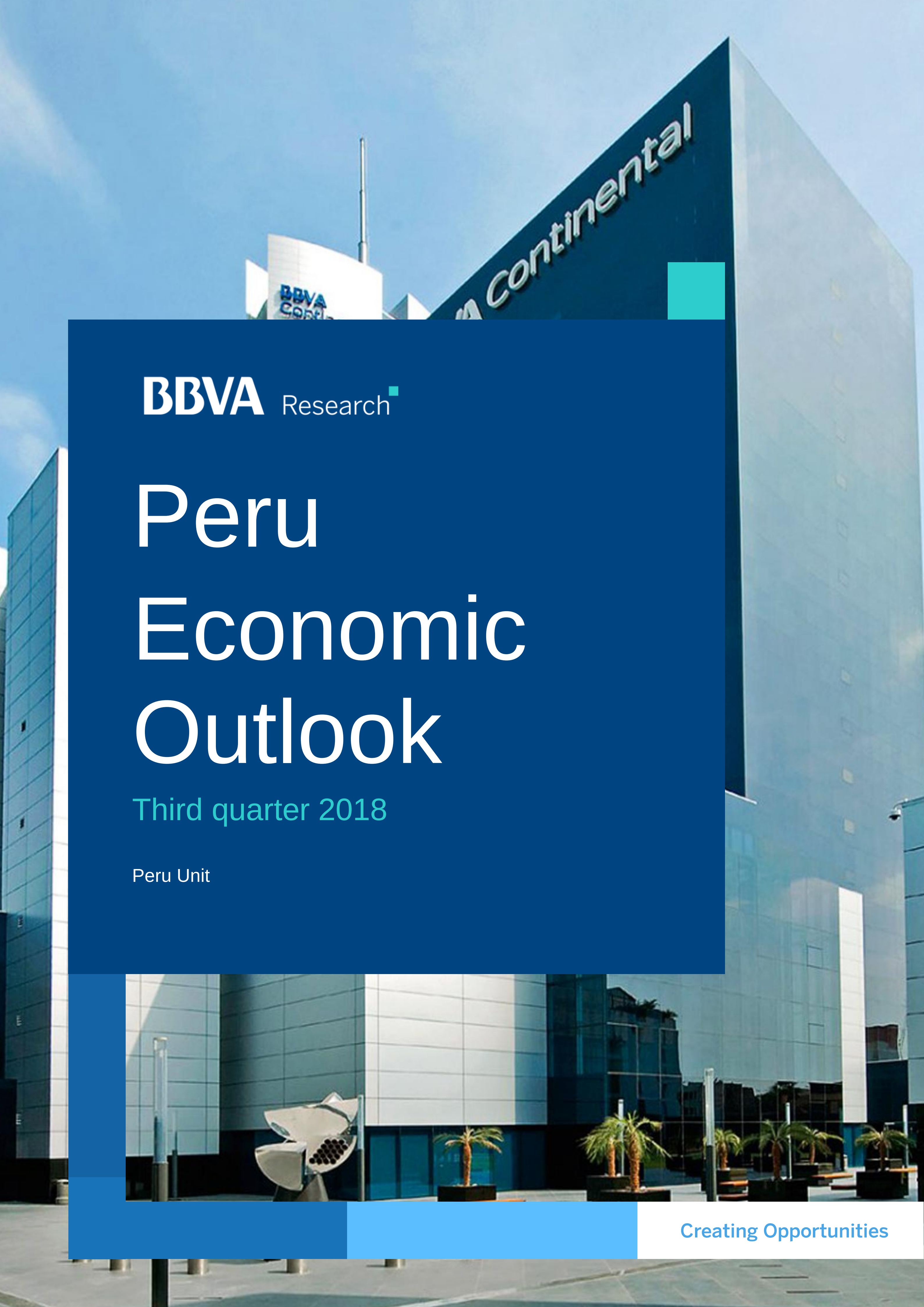


BBVA Research

Peru Economic Outlook

Third quarter 2018

Peru Unit

Creating Opportunities

Contents

Closing date: **11 July 2018**

1. Summary

The Peruvian economy continued to accelerate its pace in the second quarter, faster than we anticipated in our previous report. According to our estimates, after growing 3.2% in the first three months of 2018, the pace of expansion of economic activity is expected to have reached more than 5% in year-on-year terms, a rate that has not been observed for five years. **On the expenditure side, the main support for this acceleration was domestic demand, and within it, investment.** This was reflected on the sectoral side in the improved performance of non-primary activities such as Construction, Non-Primary Manufacturing, and Services. It is true that **part of the expansion of domestic demand (and investment) is due to a low year-on-year comparison base, but there is also an underlying improvement in spending indicators** in a context in which political tension has decreased, business confidence has gone up, and interest rates in Peruvian soles and US dollars continue to be attractive. The greater dynamism of domestic demand adds to the higher quota for the anchovy catch, which had a positive impact on Fisheries and Primary Manufacturing. With the result expected for the second quarter, the economy should have grown more than 4% year-on-year in the first half of 2018.

From now on, however, some things will be changing. Firstly, the positive effect of the low year-on-year comparison base will dissipate, with growth rates tending to be more moderate. Secondly, external conditions will be tightened: global interest rates will increase gradually, China will moderate its growth in the coming quarters, and metal prices will decline. Thirdly, the election of new subnational authorities will probably slow down public spending from the end of this year and into the next, as it did following previous elections. And lastly, the impetus from infrastructure construction for the Pan American Games of 2019 and the refinery in Talara will diminish. These last three elements will also tend to moderate GDP growth rates. On the contrary, our baseline forecast scenario takes into account that three medium and large mines will begin to be built, including Quellaveco; that spending on the construction of the second metro line in Lima and the reconstruction of the areas of the country affected in the first half of last year by El Niño Costero will be accelerated; and that the business mood will remain optimistic in general. **In the balance of these elements, and assuming that trade tensions at global level will not escalate much more, output growth in the second semester will be lower than in the first, so that GDP will increase by 3.6% in 2018 (2.5% last year)**, while **in 2019**, when the positive impact of the construction of new mines will be more sensitive, **output growth will increase to 3.9%**. These **forecasts for 2018 and 2019 are 0.4 pp higher than those we had three months ago**, in the first case due to the positive surprise of the second quarter and the underlying improvement in the expenditure indicators, and in the second, mainly because of the incorporation of Quellaveco in our baseline scenario.

On the fiscal side**, the deficit has been decreasing so far this year** (in the equivalent to almost one percentage point of GDP), **faster than anticipated**. This is explained by the improvement in revenues: the payment for the annual regularisation of income tax saw a positive surprise (especially from mining companies); collection from the general sales tax (equivalent to VAT in other countries) increased in a context in which domestic demand accelerated, detraction rates increased, and the transitory downward effects of the “IGV justo” and of the postponement of tax obligations that occurred last year due to El Niño Costero are dissipating; the rates of the selective consumption tax on certain products rose; and tax rebates were reduced. In this environment, **the beginning of the process of fiscal consolidation seems to have been brought forward to 2018**. In our baseline scenario, we anticipate that the **deficit will be below 3% of GDP this year (3.1% in 2017) and that it will continue to decrease in the upcoming years**. The projected deficits are lower than those we anticipated three months ago because of the favourable surprise we have had in 2018, the increase in the rates of the selective consumption tax on certain products, and the higher growth in GDP this year and next. The new fiscal consolidation path that we are estimating is consistent with a gross public debt that will converge to a level equivalent to 27% of GDP in the coming years and is favourable for the country especially in a context in which international financing conditions will be tightened and in which external risks have increased.

In the local exchange market, the most notable thing in recent months has been the increase in volatility, which has mainly reflected external factors such as the perception that the Fed will be more aggressive in its monetary normalisation process and the greater uncertainty due to the possibility of a global trade war. Despite this context, the depreciation of the Peruvian currency has been limited and lower than that registered by the currencies of other emerging economies. This greater resistance reflects the good macroeconomic fundamentals of the country, including fiscal soundness and a relatively low external deficit (deficit in the current account of the balance of payments equivalent to 1.3% of GDP in 2017, which we estimate will be similar this year and will be kept at relatively low levels next year). In projection, we anticipate that the increased supply of US dollars will continue on both the trade side (the trade balance will be a surplus of almost US$7 billion this year, despite the decline in metal prices) and on the financial side (foreign direct investment, for example in the mining sector). These elements will attenuate the effects of the increase in the Fed's monetary policy rate. In this context, we expect **the USDPEN to end both 2018 and 2019 in a range between 3.25 and 3.30, this year closer to the bottom of that range and the next one closer to the top**.

As for **prices**, these **have been evolving as expected**. Inflation has begun to normalise and in June stood at 1.4%, hence returning to the target range after four months. Expectations and measures of inflationary trends, meanwhile, are between 2.0% and 2.5%. For the rest of the year, we expect inflation to continue rising, especially due to the normalisation that is already beginning to occur in the year-on-year increase in food prices (at the moment they are falling in year-on-year terms due to the high comparison base due to El Niño Costero of 1H17, but in recent years they have advanced at an average rate of more than 3%). Taking into account that demand pressures are contained (there is slack in the economy), we estimate that **inflation will close the year around 2% and that it will be around 2.4% by the end of 2019**, very similar to the forecast we made three months ago.

On the side of monetary policy, the Central Bank has continued to reduce reserves requirements in foreign currency to mitigate the impact of higher interest rates in dollars globally and has placed the **reference interest rate at 2.75% since March**. According to our calculations, the current position of monetary policy gives adequate support to the consolidation of private sector spending in the coming quarters in an environment in which the outlook on the price side is favourable. Later on, **from the middle of next year**, when the recovery of economic activity is more consolidated, inflation will be somewhat above the centre of the target range, and the positive differential of sol/dollar interest rates will be almost closed, we expect **the Central Bank to begin raising its reference rate and gradually orient it towards a more neutral level**.

Lastly, as with any projection, there are **risks that output growth may deviate from what we are anticipating in our baseline scenario**. On the external side, there are three main risks: that the **protectionist measures to global trade escalate** (including the possibility that this could generate uncertainty and affect investment), that the **monetary adjustment in the US will be more aggressive** (due to a more pronounced acceleration of inflation) and that this tightens the conditions of international financing even more, and that the **moderation of China's growth may be more marked than we have anticipated**. On the local side, there is a risk of **less progress in the construction of the public infrastructure we are considering**, such as the reconstruction works and the second metro line in Lima. All of these are bearish risks on the economic growth forecasts for 2018 and 2019. As a **rising risk** factor, however, we have a local element: **that the underlying improvement in the spending indicators that was observed in the second quarter is sustained**, leading to GDP growth in the second half of this year being better-than-expected, and that this momentum is maintained next year.

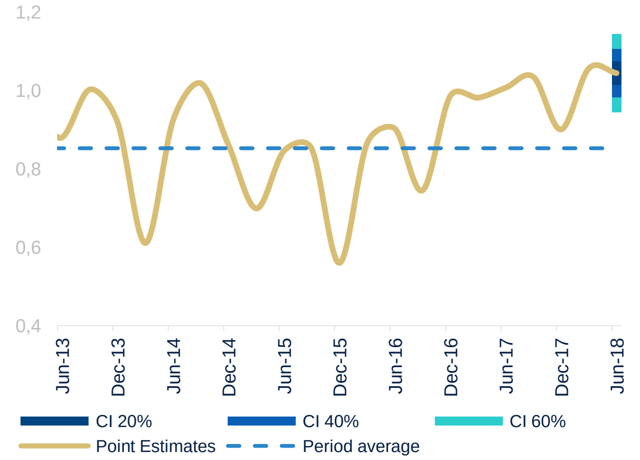
2. Global economy: robust growth but with certain signs of moderation and intensification of risks

The international economy remains subject to the tensions of disparate forces, between the good economic performance in recent quarters, now prolonged by the fiscal stimulus of the US economy and the stability of the Chinese economy, and several potentially negative factors that have been generated gradually in the first half of this year, but which so far have not been directly reflected in activity.

World growth is expected to have slowed slightly in the second quarter of the year (Figure 2.1). Although the pace of expansion remains solid, it is occurring in a less synchronised manner, with accelerating growth in the US that contrasts with certain signs of moderation in China and some emerging economies and in a more intense way in the Eurozone.

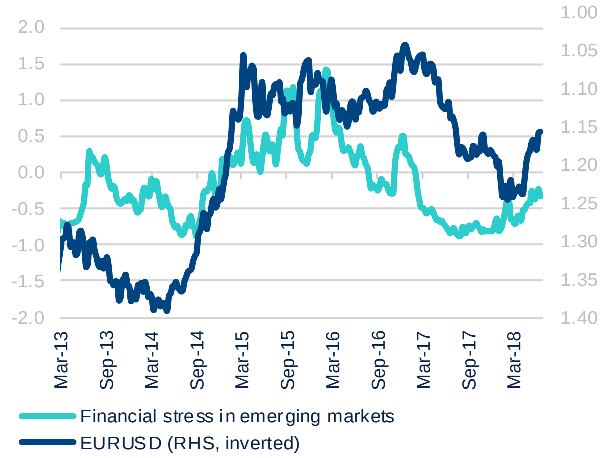
The increased growth of the US economy, driven by fiscal measures and the recovery of global trade at the beginning of the year, continues to sustain the strength of the global recovery. However, some of the supports to growth have been fading in the last few years, while uncertainty has increased.

Figure 2.1 World GDP growth.
(change % QoQ)



Source: BBVA Research

Figure 2.2 EUR-USD exchange rate and BBVA index of financial tensions in emerging markets



Source: BBVA Research based on Bloomberg

The first factor is the withdrawal of the United States from the nuclear agreement with Iran, which caused a supply shock in the oil market that has increased the price of oil by around 20% so far this year. This will place additional upward pressure on inflation and has already encouraged the central banks to take another step towards the normalisation of monetary policy. This is particularly the case with the Fed, which so far this year has accumulated a rise of 50 basis points in its reference interest rates to reach 2% and plans to raise them to 2.50% by the end of the year and to 3.25% by the end of 2019. The interest rate differential and favourable growth in the US compared to the rest of the world has resulted in a widespread appreciation of the dollar.

An additional uncertainty factor during the last few months is associated with the increase in trade tensions. It is still too early to know which measures will finally prevail of those already approved by the US administration, those that were previously announced and the possible countermeasures from their trading partners, nor is it easy to discern their impact on trade and activity. In principle, the direct effect through the trading channel of the measures announced up to now would be limited. However, additional measures by the US are under discussion at this time. and possible retaliation on the part of the affected countries, with an effect on growth that would already be significant, to which we should add potential indirect effects on the confidence of financial markets and economic agents depending on the magnitude of the commercial conflict.

As a consequence of these uncertainties, there has already been a readjustment in the perception of global risk, especially in the emerging countries. Financial tensions in emerging countries have increased generally (Figure 2.2), due to the depreciation of currencies and the widening of risk premiums, although countries with higher external financing needs have been differentiated negatively.

The global forecasts for the next two years remain unchanged, at 3.8%, supported by solid US growth. Nevertheless, the lower degree of synchronisation observed recently is reflected in a downward revision in the growth expected for 2018-19 for both the euro zone and South America (mainly Argentina and Brazil), while we maintain the forecasts for the coming years in US and China, after recording a good economic performance in the first part of the year and with the fundamentals still being solid for domestic demand.

The global scenario continues to be subject to mostly negative risks, which in recent months have increased. On the one hand, the risk of a trade war has intensified in the wake of the latest measures adopted by the United States and the response from China, mainly, and to a lesser extent, from the rest of the countries affected. Added to this are new protectionist threats that would involve the interests of important sectors in other regions, such as the automobile sector in Europe, Mexico, Canada and Japan. While the direct impact of the measures, as discussed above, would be limited, the risk of a trade war could act as a drag on confidence, increase risk aversion in the markets and curb global flows of direct investment, with the consequent impact on the potential of global growth.

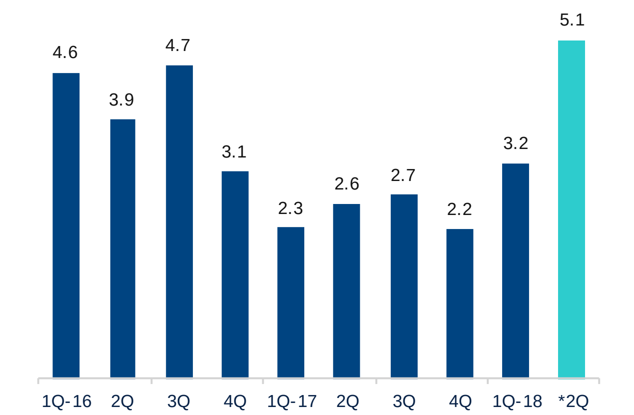
In addition, in a more volatile financial environment, systemic risk would increase in emerging economies. The combination of a greater protectionist risk added to those posed by a more accelerated normalisation of monetary policy in the United States and a possible slowdown in the global economy could trigger the perception of risk in emerging financial markets, raising the likelihood of a sudden-stop or even reversion of capital flows. In this context, the risk of an abrupt adjustment in the Chinese economy remains, since some measures to respond to a possible trade war could limit and delay the process of deleveraging and restructuring of the Chinese economy.

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

The economy begins to consolidate its improved performance

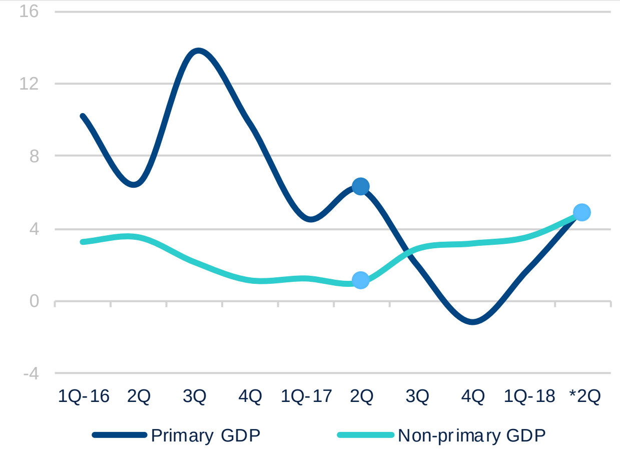
The Peruvian economy continued to accelerate its pace in the second quarter, faster than we anticipated in our previous report. According to our estimates, after growing 3.2% in the first three months of 2018, the pace of expansion of economic activity is expected to have reached more than 5% in year-on-year terms (see Figure 3.1), a rate that has not been observed for five years.

Figure 3.1 GDP*
(change % YoY)



* Estimated for the second quarter of 2018
Source: Central Reserve Bank of Peru and BBVA Research

Figure 3.2 GDP: primary component (extractive) and non-primary* (chg. % YoY)



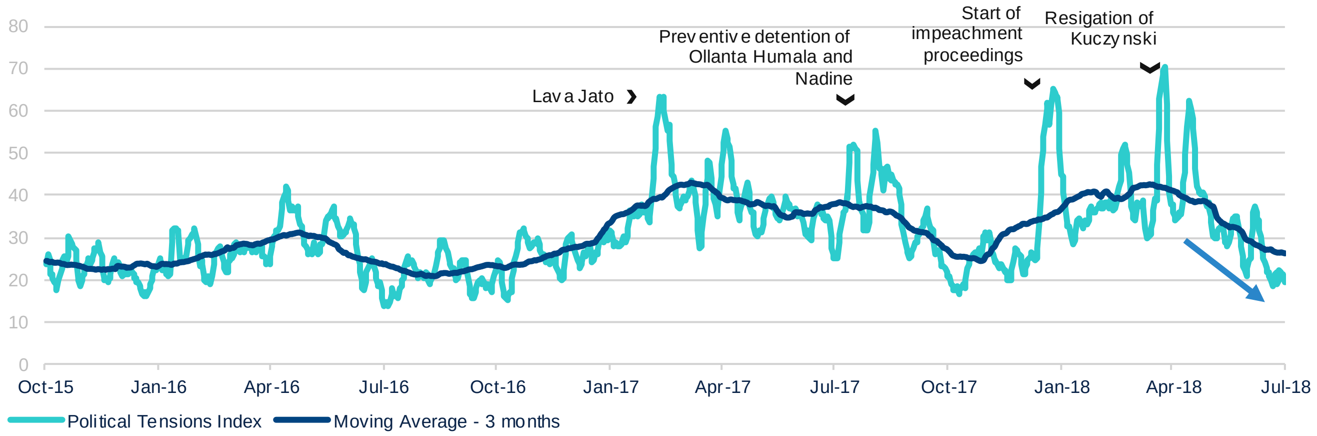
*Estimated. Non-primary GDP excludes import duties.
Source: Central Reserve Bank of Peru and BBVA Research

On the sectoral side, we estimate that in the second quarter there was an almost generalised improvement in the performance of the different economic activities. In addition, there was more balanced growth within the set of primary (oriented mainly toward the extraction of natural resources) and non-primary activities. The latter, which represent more than 70% of the economy and respond more to the behaviour of domestic demand, would have expanded together around 5%, their biggest advance in a quarter since four years ago (see Figure 3.2). On the side of the set of primary activities there was also an acceleration, thus recovering from the slump at the end of last year.

Within the group of non-primary activities, construction and non-primary manufacturing stood out, not only because of the growth rates they are expected to have reached (between 7% and 8% in the first case and between 6% and 7% in the second), but also because they were the ones that accelerated with the greatest intensity, probably reflecting a significant expansion of investment on the spending side. Services and Commerce, on the other hand, maintained an upward trend, more accentuated in the first case by the financial services and services provided to companies, in a manner consistent with the greater dynamism of domestic demand, and by transportation services (which could be reflecting the temporary increase in passenger transport linked to the football World Cup).

On the other hand, highlights within the set of primary activities were fishing and the agricultural sector. The most important support of Fishing (we estimate that it grew close to 30% in the quarter) was the increased anchovy catch. The quota assigned for the first season of anchovy catch in the north-central zone of the coast (3.3 million tonnes) was greater than last year, this season began earlier in the quarter, and it was possible to catch everything in that period (last year, from the quota of 2.8 million tonnes, only 2.4 million tonnes were caught and some of this occurred in the third quarter). The greater anchovy catch not only affected Fishing favourably, but also in the industry that then processes this resource to process fishmeal and fish oil (Primary manufacture). In the case of the agricultural sector (we estimate that it grew between 9% and 10%), important issues were the normalisation of the weather conditions after El Niño Costero of the first half of last year, the greater availability of water and the incorporation of new areas of cultivation aimed at agricultural export.

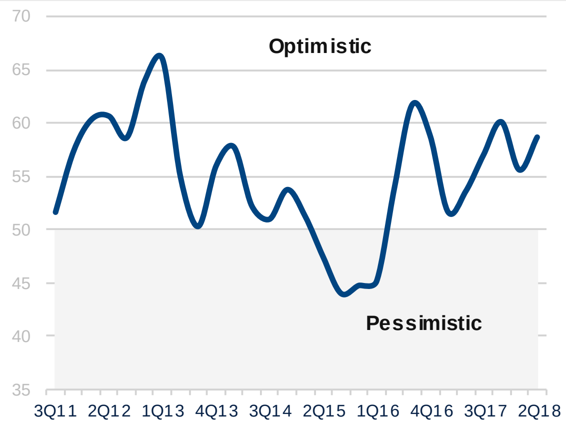
Figure 3.3 Indicator of political tensions in Peru
(100 = 22 March 2018, the highest point in the sample)



Source: GDELT (Global Database of Events, Language, and Tone) and BBVA Research.

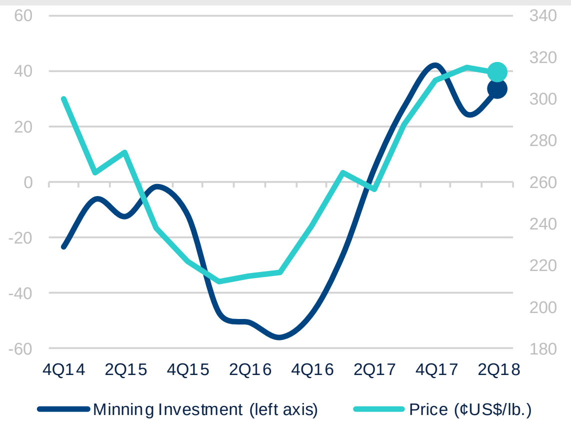
In terms of spending, the main support for the acceleration of GDP in the second quarter was domestic demand, and within this, investment. It is true that part of the expansion of domestic demand (and investment) is due to a low year-on-year comparison base, but there is also an underlying improvement in spending indicators in a context in which political tension has decreased (see Figure 3.3), business confidence has increased (see Figure 3.4), and interest rates in Peruvian soles and US dollars continue to be attractive.

Figure 3.4 Business confidence
(index, in points)



Source: Central Reserve Bank of Peru and BBVA Research

Figure 3.5 Mining investment* and Price of copper
(change % YoY; USD¢/lb)



* With official data of April and May; June is estimated.
Source: Central Reserve Bank of Peru, MINEM (Ministry of Energy & Mines) and BBVA Research

We estimate that private investment, in particular, would have expanded by around 8%, its best result in a quarter since mid-2013, which is consistent with the performance observed in domestic cement consumption, machinery production and equipment, credit granted to companies, and imports of capital goods. Within private investment, the strong dynamism of the mining investment is continuing, supported by the expansion works of the Marcona mine and the still-attractive prices of metals (see Figure 3.5), and the increase of non-mining investment, which according to our estimates would have grown around 5% in the quarter.

Public investment, on the other hand, also accelerated its pace in the second quarter in a context in which, in addition to the low year-on-year comparison base, there was progress in the construction of infrastructure to celebrate the Pan American Games of 2019 and the related roadworks.

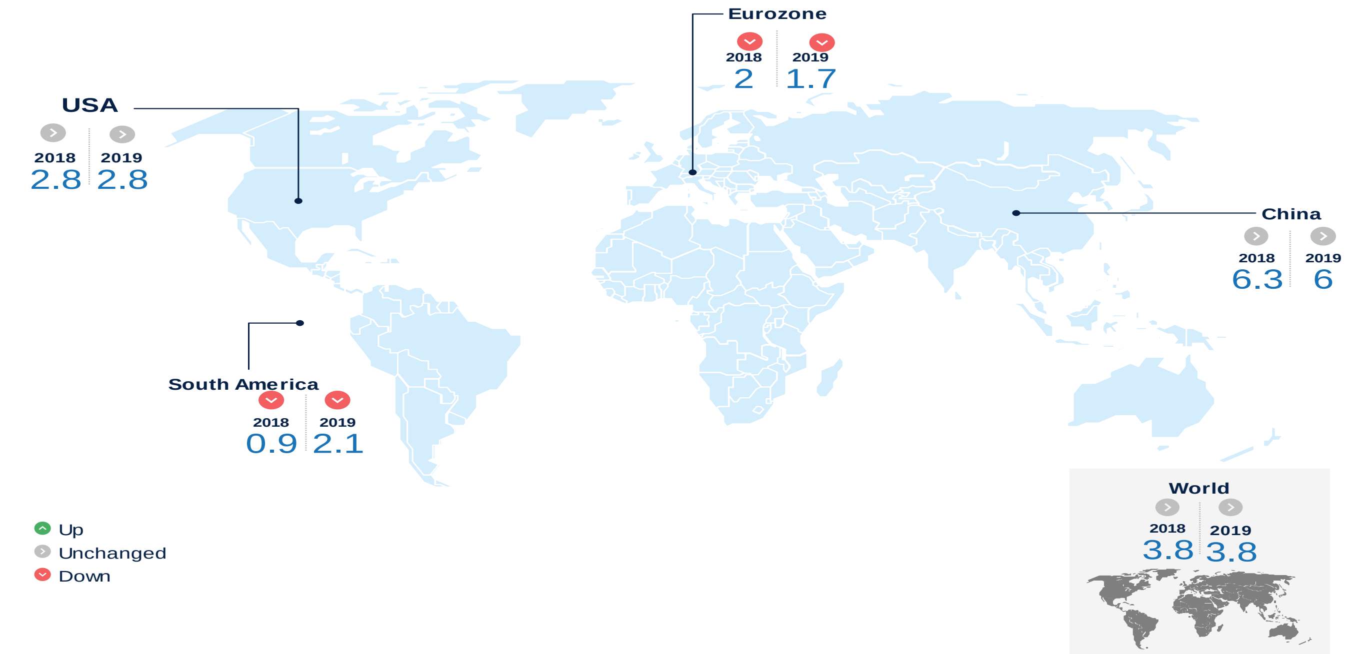
With the result expected for the second quarter, the economic activity is expected to have expanded more than 4% year-on-year in the first half of 2018.

Baseline scenario projections for the remainder of 2018 and for next year

The baseline scenario considers, on **the external side**:

- **Global growth that will remain robust but will be less synchronised in terms of geographical areas**. World growth forecasts remain at 3.8% for this and next year (see Figure 3.6). In the case of the US, the expansion of activity is supported by fiscal stimulus and the improvement of the labour market, which will prevail over the tightening of monetary policy and protectionist measures, and growth will accordingly be sustained at 2.8% this year and next. In China, the slowdown in the pace of economic expansion will continue in the coming quarters, tempered by monetary and fiscal stimulus measures, such that we expect GDP to increase by 6.3% and by 6.0% next year.

Figure 3.6 World growth
(change % YoY)

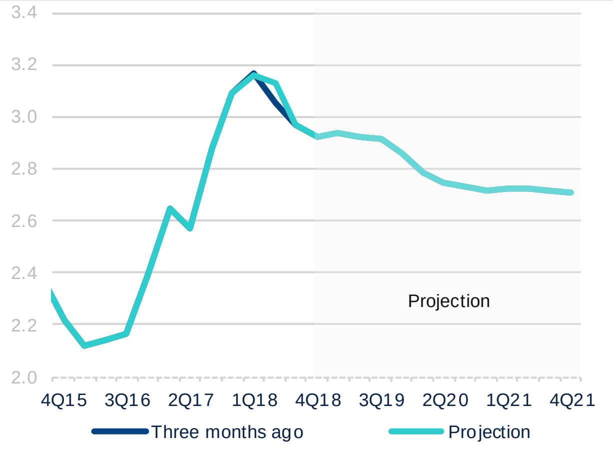


Source: BBVA Research

- **The continuation of the process of withdrawal of the monetary stimulus from the main central banks of the world**. We estimate that the Fed, after placing the federal funds rate at 2.0% by the end of the first half of this year, will bring it up to 2.5% by the end of 2018 (two increases of 25 basis points each), 3.25% at the end of 2019 (three increases of 25 bps each, an higher increase than we predicted three months ago), while the European Central Bank will gradually complete the quantitative easing of its balance sheet in the second half of this year and will begin to raise rates in the second half of next year. As a result of this global monetary adjustment, the financing conditions for Peru will tend to increase to a certain extent. We do not rule out episodes of financial volatility linked to this adjustment process, although they will probably be transitory due to the soundness of Peru's macroeconomic fundamentals.

- **Terms of trade that will decrease in future**. In the particular case of the price of **copper**, we foresee a decrease similar to the one we considered three months ago (see Figure 3.7). This decrease is supported by the projected slowdown for the Chinese economy and the continued monetary adjustment of the Fed. Thus, in the second half of this year the average price of copper will be US$2.94/lb. (US$3.14 in the first half) and decrease to US$2.91/lb. next year (in end-of-period terms, it will reach a level of US$2.86/lb.) Although they will be lower, these prices will continue to be attractive for mining investment, favouring the construction of new mines, especially from next year (see Table 3.1).

Figure 3.7 Price of copper
(US$/lb.)



Source: Bloomberg and BBVA Research

Table 3.1 Mining investment in new concession projects
(US$ millions)

Project	Annual Production	Investment USD Millions	Year 2019	Year 2020
Quellaveco	225 000 TMF/Cu	5,500	1,125	1,125
Mina Justa	110 000 TMF/Cu	1,348	636	476
Amp.Toromocho	75 000 TMF/Cu	1,300	650	650
Quecher Main	200 000 Oz/Au	300	200	
B2 de Minsur	5 000 TM/Sn	200	80	
Total		**3,148**	**2,691**	**2,251**

Source: MINEM and BBVA Research

Regarding the price of **oil** (Peru is a net importer of this raw material), our baseline scenario considers that the WTI will be around US$66 per barrel in 2018 (so in the second half of the year it will reach an average level which is not very different from the first half), above the average level of last year (US$51 per barrel) and that we anticipated three months ago (US$61 per barrel). This takes into account global growth and the introduction of a risk premium for geopolitical events between the US and Iran. In 2019, the price of oil will not be very different from that observed this year and will average US$65 per barrel, to later converge to its long-term equilibrium level (around US$58 per barrel) as the growth in demand is adjusted to the historical trend and as US export capacity expands, something that in our baseline scenario is more likely to occur from 2020.

On **the local side**, an environment is being considered that is generally more positive than the one predicted three months ago. Among the main elements taken into account are the following:

- Construction of some medium and large mines (see Table 3.1), with more of an impact from next year. Among these is Quellaveco. The total investment in the construction of this mine is greater than US$5.5 billion, of which we foresee that just over US$1.1 billion will be invested in 2019 (equivalent to 0.5 pp of GDP). This project already has practically all the permits and studies and even preliminary works and hiring are being carried out, so we are taking its commencement as given. We understand that its public launch will be made in the third quarter. This project was not considered in our previous forecasts.

- Acceleration of the reconstruction works on the infrastructure damaged in the first half of 2017 by El Niño Costero and of the works on the second line of the Lima metro, which in the first half of 2018 in both cases saw a modest advance when comparing the expenditure made with the budget for the year. On the contrary, it will tend to diminish the impetus on the GDP of the construction of infrastructure for the Pan American Games of 2019 and the refinery in Talara, especially next year. In addition, the baseline scenario assumes that after the election of the new subnational authorities (in October 2018) public spending will probably slow down in those instances until 2019, as was the case following previous elections.

- The business mood, in general, will remain optimistic, perhaps somewhat below current levels (in recent months business confidence was close to 60 points, see Figure 3.4) but will continue to favour non-mining private investment.

The baseline forecast scenario also reflects that the positive effect of the low year-on-year comparison base will be dissipated in the future, which will tend to moderate GDP growth rates, and assumes that global trade tensions will not escalate much further.

In this context, we now project that GDP will expand this year by 3.6% and by 3.9% in 2019

In the balance of these elements, and assuming that trade tensions at global level will not escalate much more, the growth of the activity in the second semester will be lower than in the first, meaning GDP will increase by 3.6% in 2018, while in 2019, when the positive impact of the construction of new mines will be more sensitive, growth will increase to 3.9%. These forecasts for 2018 and 2019 are 0.4 pp higher than those we had three months ago, in the first case due to the positive surprise of the second quarter and the underlying improvement in the expenditure indicators, and in the second, mainly because of the incorporation of Quellaveco in our baseline scenario.

In our baseline scenario, growth in the second half of 2018 will be lower than in the first, mainly because the positive effect of the low year-on-year comparison base will dissipate and because external conditions will be less favourable. Despite this, the expansion in GDP that we estimate will be reached in the year marks a recovery when compared with that of 2017 (2.5%). By sector, the expected improvement is across the board (see Table 3.2), except for metal mining, which has faced some temporary shutdowns due to maintenance and strikes, and which has in some cases found areas that are more difficult to exploit. Something similar is happening on the expenditure side (see Table 3.3), especially in the investment sector, both private and public, which is recovering after several years of contraction (or almost zero growth). This recovery of investment in 2018 is consistent with the greater dynamism of activities such as Construction, Non-Primary Manufacturing, and Services.

By 2019, we expect GDP to grow by 3.9%, mainly due to the construction of three new medium and large mines: Quellaveco, Mina Justa, and the expansion of Toromocho. This will lead to private investment accelerating even more, up to almost 6%, which in sectoral terms will be reflected in the greater dynamism of Construction and Non-Primary Manufacturing. Public investment, on the other hand, will lose traction because we are assuming, as has been observed on previous occasions, that spending will slow down after the election of new subnational authorities and because the construction of infrastructure related to the 2019 Pan American Games and the refinery in Talara will decrease. The lower dynamism of public investment will attenuate the sectoral impact of the increased private investment. It is worth mentioning that in 2019 mining production of metals will be normalised after the problems mentioned above, which will entail a larger expansion of exports.

Table 3.2 GDP by productive sector
(change % YoY)

	2017	2018 (e)	2019 (p)
Agriculture and Livestoc	2.8	4.7	3.4
Fishing	4.8	31.1	-3.8
Mining and fuel	3.2	0.3	5.5
Metals	4.2	0.1	4.8
Fuel	-2.3	2.1	10.0
Manufacturing	-0.3	4.4	3.1
Primary	1.5	11.3	2.2
Non-primary	-0.9	2.1	3.5
Electricity and water	1.1	4.1	4.3
Construction	2.3	4.5	5.1
Commerce	1.0	2.6	2.5
Other services	3.2	4.2	4.1
GDP	**2.5**	**3.6**	**3.9**
Primary sectors	2.9	3.2	4.4
Non-primary sectors*	2.1	3.7	3.8

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

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

	2017	2018 (e)	2019 (p)
1. Domestic Demand	**1.6**	**4.0**	**3.6**
a. Private Consumption	2.5	3.0	3.0
b. Public Consumption	1.0	2.8	3.5
c. Gross Domestic Investment	-0.7	7.4	5.3
Gross Fixed Investment	-0.3	5.4	5.0
- Private	0.3	5.3	5.7
- Public	-2.3	6.0	2.2
2. Exports	7.2	2.3	4.8
3. GDP	**2.5**	**3.6**	**3.9**
4. Imports	4.0	3.8	3.9
Note:			
Domestic Demand (less inventories)	1.7	3.6	3.6
Private Expense (less inventories)	2.0	3.5	3.6
Public Expense (consumption and investment)	0.1	3.7	3.1

Source: Central Reserve Bank of Peru and BBVA Research

Beyond the recovery that the economy has been showing, it is necessary to take measures to prop up medium-term growth

Our forecasts for the period 2020-2022 assume average annual GDP growth of 3.6%. In this context, gross fixed investment (private and public), as a percentage of GDP, will stabilise at around 23%, below the highest levels (of approximately 27%) seen in the period of strong economic growth from 2002 to 2013, and also below those recorded by economies that experienced phases of rapid growth, such as those of Eastern Asia.

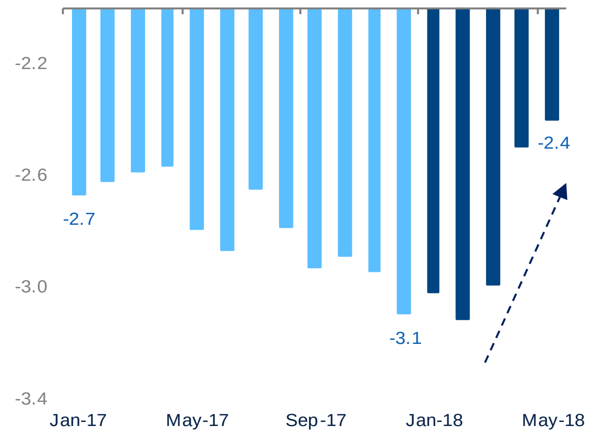
Therefore, there is room to boost medium-term growth through the accumulation of capital. Measures that improve the climate for business are moving in that direction. In addition, productivity could improve with a boost to innovation. Currently there is a pending agenda involving the development of innovation and the country is still lagging behind its peers in the region. Although the efforts from the public and private sectors are reflected in the increased expenditure aimed at supporting it, the task of strengthening the institutional framework that supports it and improving the organisation between both sectors and research centres is still present.

4. Fiscal policy: the improvement that revenues have been showing will favour a faster-than-anticipated decrease in the deficit

The fiscal deficit has been decreasing so far this year and has done so faster than anticipated (see Figure 4.1). This is explained by the improvement in collection (see Figure 4.2): the payment for the annual regularisation of income tax saw a positive surprise (especially from mining companies[1]); revenues from the general sales tax[2] increased in a context in which domestic demand accelerated, detraction rates increased, and the transitory downward effects of the "fair IGV" and of the postponement of tax obligations that occurred last year due to El Niño Costero are dissipating, and tax rebates were reduced[3]. In addition, the rates of the selective consumption tax on certain products rose[4].

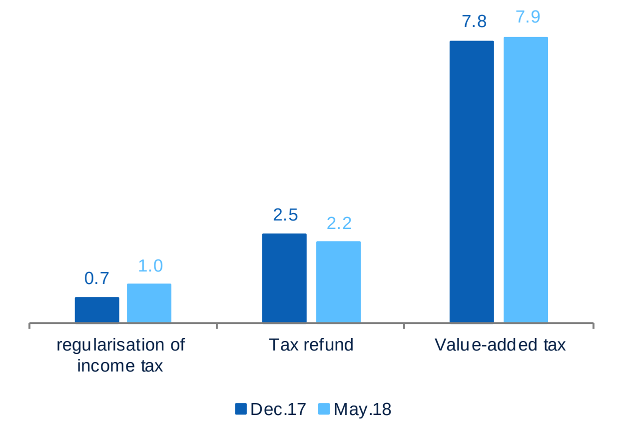
For the remainder of 2018 we estimate that the fiscal deficit will be expanded to some extent because it will accelerate spending on the reconstruction of the zones affected by El Niño Costero[5], and on infrastructure, such as the Pan American Games of 2019[6] and the second metro line from Lima. In addition, there will no longer be extraordinary income such as the repatriation of capital at the end of 2017. Despite this, we forecast that the fiscal deficit will come down below 3% of GDP (3.1% in 2017), so the consolidation of public accounts will have begun this year.

Figure 4.1 Fiscal result
(accumulated in last twelve months, % of GDP)



Source: Central Reserve Bank of Peru

Figure 4.2 General Government Tax Revenues
(accumulated in last twelve months, % of GDP)



Source: Central Reserve Bank of Peru

The path that is forecast for the coming years continues to foresee a decrease in the fiscal deficit. For 2019, for example, it is considered that collection will improve (see Figure 4.3) in a context of greater dynamism of the activity and higher rates of the selective consumption tax on certain products (these higher rates, introduced in May

1: Corresponding to the 2017 financial year. Between March and April more than S/5 billion came from the regularisation of the 2017 financial year. This is a record level and S/2.3 billion more than was collected for the 2016 financial year (50% of this increase is explained by the collection from the mining sector).

2 Equivalent to VAT in other countries.

3: Mainly for the return of taxes to exporters.

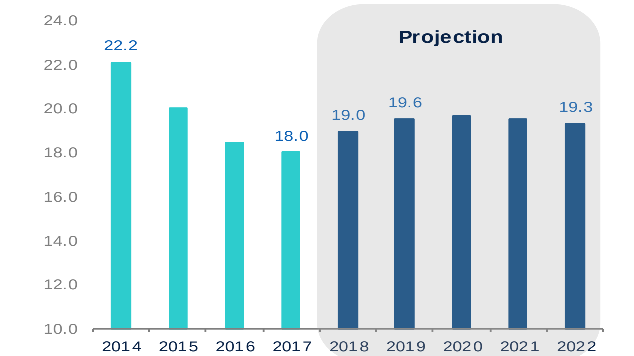
4: In the second week of May, the ISC rates for sugary drinks, cigarettes, alcoholic beverages, fuels and vehicles, among others, were modified.

5: It is considered that the new Legal Framework for Reconstruction approved at the end of May (Law 30776) will allow the work to be accelerated. This new scheme allows for the following: simplifying the cycle of investments and hiring, expanding contracting procedures to include a similar form to that of the Pan American Games when the works are complex (through State-to-State agreements), and establishing exceptions in issues of environmental and archaeological regulation.

6: The construction works at the eight sporting venues encompass a budget for this year of just over one billion soles.

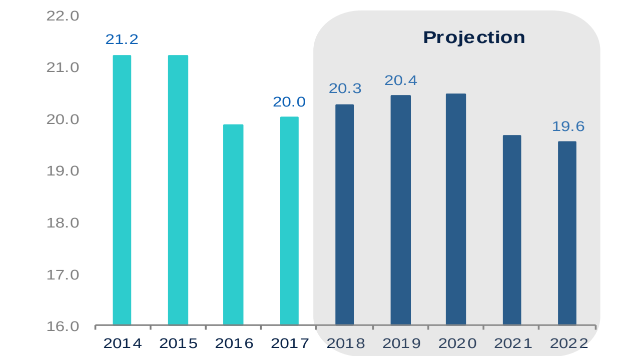
2018, will be now valid throughout the year and not only in part of it), while public spending will advance more slowly. Accordingly, the deficit will decrease up to 2.5% of GDP. In the baseline scenario that we have, without additional measures on the side of tax revenues and considering that part of the expenditure that is currently being made is transitory (reconstruction and Pan American Games, for example, see Figure 4.4), the deficit will converge to a level equivalent to 1.7% of GDP in 2022 (see Figure 4.5).

Figure 4.3 Fiscal revenues*
(as a percentage of GDP)



*For the Central Government.
Source: Central Reserve Bank of Peru and BBVA Research

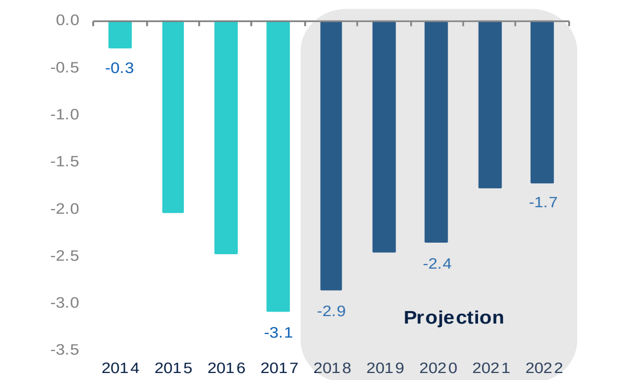
Figure 4.4 Fiscal expenditure*
(as a percentage of GDP)



*For the Central Government.
Source: Central Reserve Bank of Peru and BBVA Research

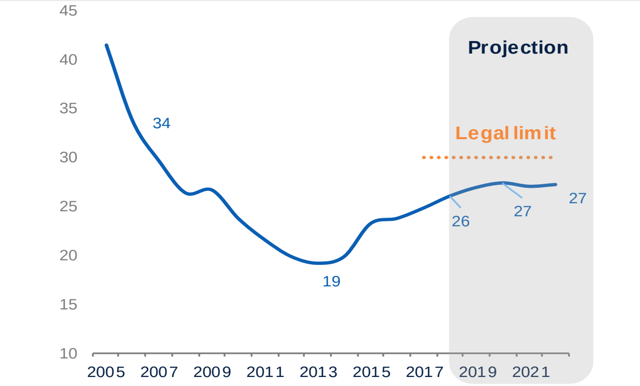
It should be noted that this scenario of fiscal consolidation is more favourable than the one forecast three months ago. The decrease in projected deficits is explained by the positive surprise we have had in 2018, the increase in the rates of the selective consumption tax on certain products, and the increased growth of GDP this and next year. The new trajectory of fiscal consolidation is consistent with a gross public debt that will converge to a level equivalent to 27% of GDP[7] in the coming years (see Figure 4.6) and is favourable for the country especially in a context in which international financing conditions will be tightened and in which external risks have increased.

Figure 4.5 Fiscal result*
(as a percentage of GDP)



*For the non-finance public sector
Source: Central Reserve Bank of Peru and BBVA Research

Figure 4.6 Gross public debt*
(as a percentage of GDP)



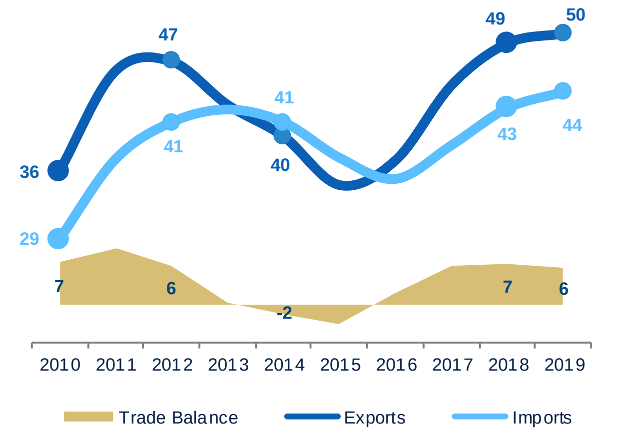
*For the non-finance public sector
Source: Central Reserve Bank of Peru and BBVA Research

7: It should be noted that one of the most important macroeconomic strengths of Peru is its fiscal soundness. Not only is public debt relatively low, but exposure to the exchange rate has also been reduced (close to 60% is denominated in soles) and variations in interest rates (almost 90% is agreed to at a fixed interest rate) and has a half-life of twelve years.

5. External sector: trade surplus strengthens the position of the Peruvian economy in the face of episodes of international volatility

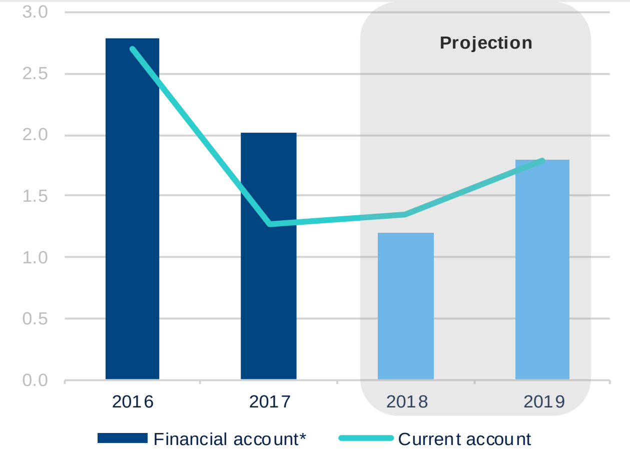
We expect that the annual export values will continue to improve in 2018, reaching record levels close to US$49 billion (see Figure 5.1). The two main elements that favour this performance are the higher average export prices —in 2018, for example, the average price of copper will exceed US$3.00/lb, while last year it was US$2.80/lb— and the advance of global demand. The former are having a positive effect on exports of traditional products, in particular mining products, while the latter will be more relevant for non-traditional exports. Although the amount of imports will also register a significant increase in line with the recovery of domestic demand, it will not fully offset the increase in exports. In this context Peru's trade surplus will be close to US$7 billion this year, the highest figure since 2011.

Figure 5.1 Trade Balance
(USD billions)



Source: Central Reserve Bank of Peru and BBVA Research

Figure 5.2 Financial account and Current account deficit
(% of GDP)



*Includes exceptional financing.
Source: Central Reserve Bank of Peru and BBVA Research

The higher export prices will also mean more profit for mining companies and consequently, at the macroeconomic level, more repatriation of profits and dividend payments. On the balance sheet, and taking into account some other elements, the deficit in the current account of the balance of payments will remain relatively stable in 2018, standing at a level equivalent to 1.3% of GDP. Later, in 2019, with the consolidation of the growth of domestic demand (which will favour imports) and metal prices that will decrease, the deficit will increase to a level equivalent to 1.8% of GDP (see Figure 5.2), a level that will continue to be limited.

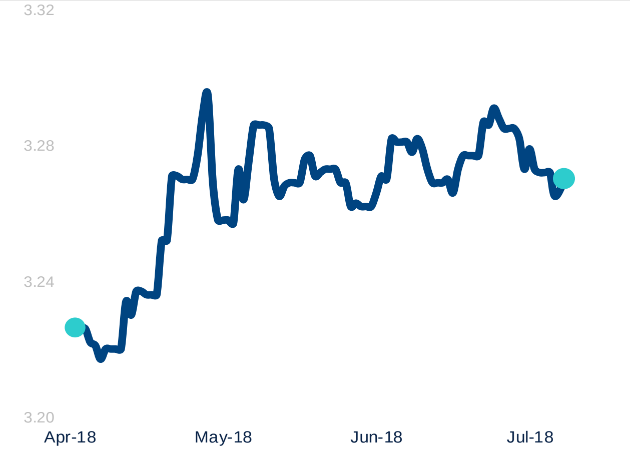
On the financial side, we estimate that this year capital inflows will increase, mainly as a result of mining companies reinvesting profits and, to a lesser degree, to holdings of Peruvian bonds by foreign investors (supply of public debt to finance the fiscal deficit). These factors will be mitigated by the impact of the higher interest rates in the US in a context in which the process of monetary normalisation continues in that country and by the increase in the limit of investment abroad for pension fund administrators. On balance, we forecast a positive balance in the financial account component of the balance of payments equivalent to 1.3% of GDP, which would mean a dollar inflow of close to US$2.7 billion (see Figure 5.2).

It should be noted that the relatively limited deficit in the current account of the balance of payments suggests that the country's external financing needs are also limited. In this context, our baseline scenario is consistent with a stabilisation of the country's external liabilities (considering the total of medium and long-term liabilities of the public and private sectors) at a level equivalent to 32% of GDP, similar to the current level. The relatively low deficit in the current account of the balance of payments, external liabilities and short-term external liabilities (as a percentage of net international reserves) strengthens the position of the Peruvian economy to face risk scenarios such as a possible decrease in capital flows to emerging economies due to the withdrawal of monetary stimuli in the most advanced economies or the escalation of trade tensions at global level.

6. Local financial markets respond well to the process of revaluation of risk in emerging economies

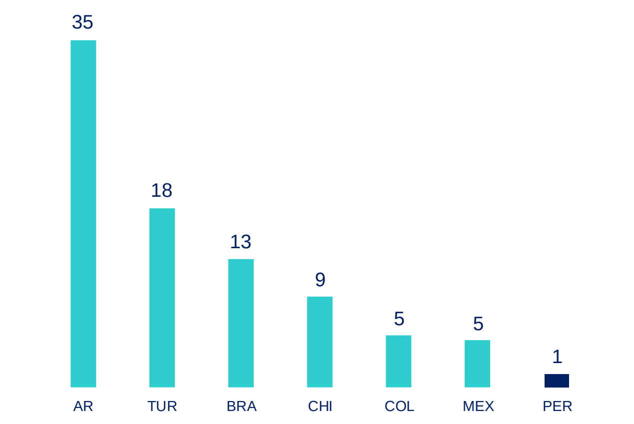
In recent months, international financial markets have been agitated by the perception that the Fed will be more aggressive in its process of monetary normalisation and the uncertainty generated by the possibility of escalation of global trade tensions[8]. The local currency has not been unaware of this and in the last three months it depreciated, going from 3.23 at the end of the first quarter to the current 3.27, even climbing at times to 3.30 (see Figure 6.1).

Figure 6.1 Exchange rate (USD/PEN)



Source: Bloomberg

Figure 6.2 Selected emerging markets: depreciation of currencies against the USD* (%)



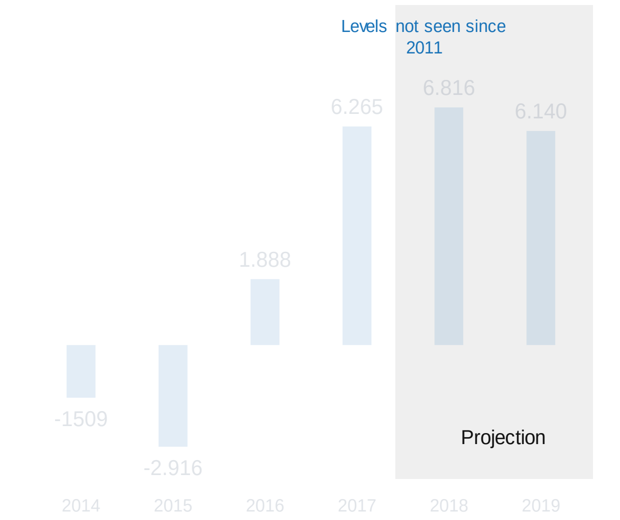
Compared to three months ago
Source: Bloomberg

The depreciation of the Peruvian currency, however, has been limited compared to what has been observed in other emerging economies (see Figure 6.2). This greater resistance reflects the good macroeconomic fundamentals of the country, including fiscal soundness (see section 4) and a relatively low external deficit (see section 5).

In projection, we anticipate that the greater supply of dollars will continue both on the trade side (see Figure 6.3) and on the financial side (direct foreign investment, for example in the mining sector). These elements will attenuate the effects of the increase in the Fed's monetary policy rate. In this context, we expect the USD/PEN rate to end both 2018 and 2019 in a range between 3.25 and 3.30, this year closer to the bottom of that range and the next one closer to the top.

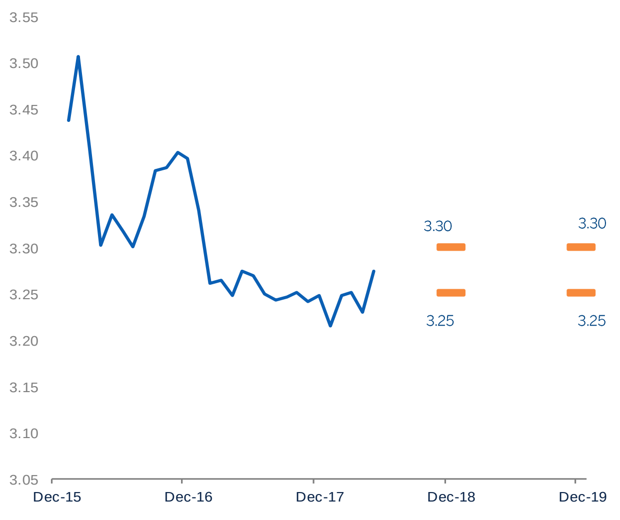
8: In this context, the price of copper fell sharply in recent weeks. Non-trade positions have declined significantly. Part of it is an overreaction. In a scenario in which trade tensions do not escalate much further, we estimate that the price of copper will revert and on average it will be around US$2.94 per pound in the second half of the year.

Figure 6.3 Trade balance
(US$ millions)



Source: Central Reserve Bank of Peru and BBVA Research

Figure 6.4 Exchange rate
(PEN/USD)



Source: Central Reserve Bank of Peru and BBVA Research

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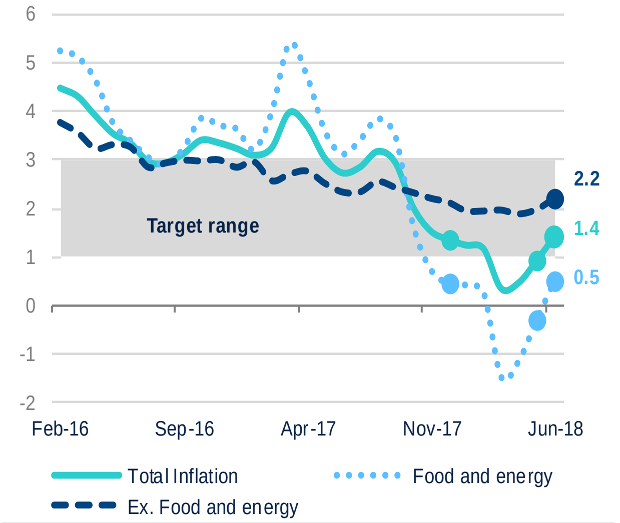
7. Inflation: moving forward, environment without pressure on prices and convergence towards the middle of the target range

In recent months, prices have continued to evolve as expected. Inflation is beginning to leave behind the downward effect of the high year-to-year comparison base (El Niño Costero in early 2017) and thus tends to be normalised. The increase in the rates of the selective consumption tax on certain products also had an impact on prices, especially in June. As a result, at the end of the first half of the year, inflation has returned to the target range after being situated below it for four months (see Figure 7.1). Inflationary trend indicators, such as inflation without food or energy, and inflation expectations are between 2.0% and 2.5%.

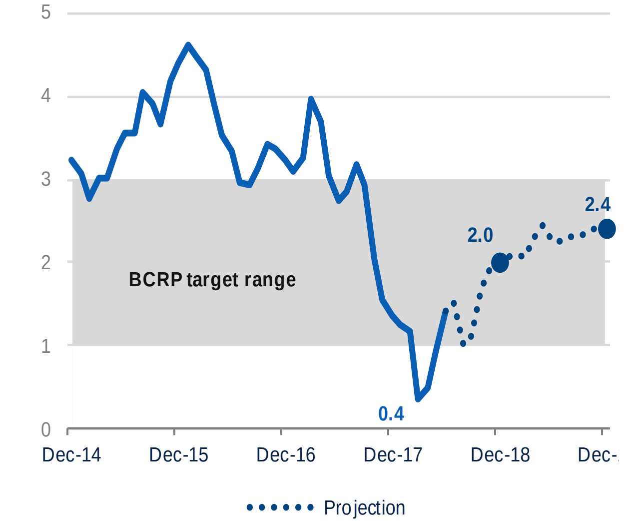
According to our estimates, inflation will continue to increase over the rest of the year. The main element behind this forecast is that the rate of year-on-year increase in food prices will be normalised. Currently the interannual variation of these prices is negative (El Niño Costero), but over the last ten or fifteen years it has been, on average, higher than 3%. We do not expect such a strong correction this year, but we consider there will be one. The correction has actually started, and we estimate that it will continue, especially in the fourth quarter of the year. Taking into account that demand-side pressures are still contained (there is slack in the economy), we expect inflation to close around 2% in 2018 and that it will be around 2.4% by the end of 2019 (see Figure 7.2).

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



Source: Central Reserve Bank of Peru and BBVA Research

Figure 7.2 Inflation (change % YoY CPI)



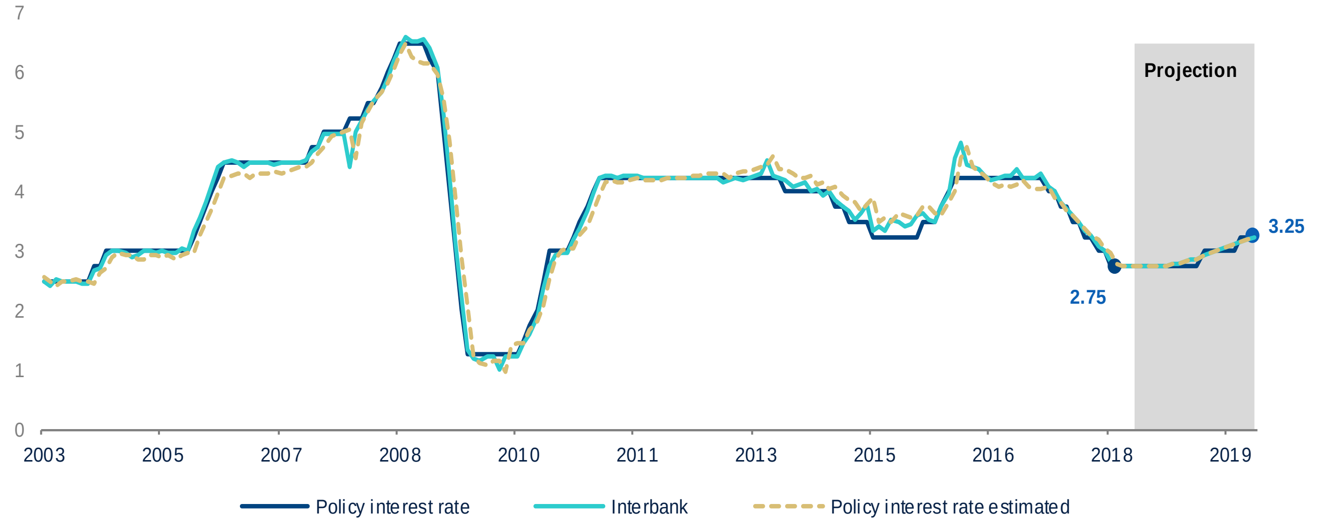
Source: INEI (National Statistics & IT Institute) and BBVA Research

8. Monetary policy: end of the easing cycle of the policy rate

The Central Bank has continued to reduce reserves in foreign currency to mitigate the impact of higher interest rates in dollars globally and has placed the reference interest rate at 2.75% since March. This implies that the policy interest rate is located in real ex-ante terms at a level of 0.5%, below its neutral level (BBVA: 1.5%; BCRP: 1.75%). According to our calculations, the current position of monetary policy gives adequate support to the consolidation of private sector spending in the coming quarters in an environment in which the outlook on the price side is favourable. Taking that into account and the volatility observed in the international financial markets, it seems prudent not to accentuate the monetary stimulus.

In our baseline scenario, the reference interest rate will remain at 2.75% until well into next year (see Figure 8.1). Later on, from the middle of 2019, when the recovery of activity is more consolidated, inflation will be somewhat above the centre of the target range, and the positive differential of sol/dollar interest rates will be closed, we expect the Central Bank will begin to raise its monetary policy rate to gradually orient it towards a more neutral level. This forecast is consistent with the function we have estimated to characterise the manner in which the Central Bank of Peru reacts throughout the economic cycle ("Estimated monetary policy rate" in Figure 8.1).

Figure 8.1 Monetary policy interest rate*
(%)



* The "Estimated monetary policy rate" refers to the one that is developed in [Peru | The BCRP and the economic cycle:the end of monetary policy rate reductions?]
Source: Central Reserve Bank of Peru and BBVA Research

9. Risks to our output growth forecasts for 2018 and 2019

Among the main **external risk factors** that could deviate our growth forecasts with respect to the baseline scenario are those that follow.

- The deployment of additional protectionist measures by the United States and the possible responses of the affected countries. In this context, we would have a trade war, which would reduce the exchange of goods and services globally, and which among other things would slow world economic activity and the positive drag-along effect this has. For example, if the measures that are under discussion are implemented (US increase of tariffs on cars and Chinese imports worth US$200 billion), according to our estimates the global GDP would be reduced by around 0.2 pp just in the trade channel. To this we should add negative indirect impacts such as the blow to confidence to invest and consume, which is more difficult to estimate. The risk of a protectionist escalation has increased in recent weeks, but in our forecasts it remains as such and is not part of our baseline scenario. On the other hand, we estimate that the measures already announced will have fairly insignificant direct impacts on the Peruvian economy in 2018 and 2019.

- A surprise increase in aggressiveness of the US Federal Reserve's monetary policy adjustment, due to an acceleration of inflation. Under this risk scenario, we would have a stronger dollar, higher global interest rates for Peru, lower copper prices, and probably lower growth in Peru's main trading partners, which would also lead to lower GDP growth locally.

- A more marked slowdown in China's economy The probability of this scenario occurring is limited by the resilience that is being shown by the Chinese economy and by the monetary and fiscal stimulus measures that are being implemented to sustain growth.

On the local side, the main risk factors that could derail our growth forecasts are those that follow.

- On the downside, less progress in the construction of the public infrastructure that we are considering, such as the reconstruction works and the second metro line in Lima.

- An upward risk factor, however, is that the underlying improvement in the spending indicators that was observed in the second quarter would be sustained, leading to GDP growth in the second half of this year being better than expected, and that this momentum would be maintained next year.

10. Tables

Table 10.1 Macroeconomic forecasts

	2015	2016	2017	2018	2019
GDP (change % YoY)	3.3	4.0	2.5	**3.6**	**3.9**
Domestic demand (change % YoY)	2.9	1.1	1.6	**4.0**	**3.6**
Private consumption (change % YoY)	4.0	3.3	2.5	**3.0**	**3.0**
Public consumption (change % YoY)	9.8	-0.5	1.0	**2.8**	**3.5**
Gross fixed investment (change % YoY)	-5.2	-4.7	-0.3	**5.4**	**5.0**
Inflation (YoY, %, EOP)	4.4	3.2	1.4	**2.0**	**2.4**
Exchange rate (vs. USD, EOP)	3.39	3.40	3.25	**3.26**	**3.30**
Policy interest rate (%, EOP)	3.75	4.25	3.25	**2.75**	**3.25**
Fiscal balance (% of GDP)	-2.0	-2.5	-3.1	**-2.9**	**-2.5**
Current account (% of GDP)	-4.8	-2.7	-1.3	**-1.3**	**-1.8**
Trade Balance (USD billions)	-2.9	1.9	6.3	**6.8**	**6.1**

Forecast closing date: 11 July 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)	Monetary policy interest rate (%, EOP)
1Q16	4.6	4.3	3.41	4.25
2Q16	3.9	3.3	3.32	4.25
3Q16	4.7	3.1	3.38	4.25
4Q16	3.1	3.2	3.40	4.25
1Q17	2.3	4.0	3.27	4.25
2Q17	2.6	2.7	3.27	4.00
3Q17	2.9	2.9	3.25	3.50
4Q17	2.2	1.4	3.25	3.25
1Q18	**3.2**	0.4	3.25	2.75
2Q18	**5.1**	**1.4**	**3.27**	**2.75**
3Q18	**2.8**	**1.1**	**3.28**	**2.75**
4Q18	**3.4**	**2.0**	**3.26**	**2.75**
1Q19	**4.8**	**2.1**	**3.27**	**2.75**
2Q19	**3.5**	**2.3**	**3.28**	**3.00**
3Q19	**3.5**	**2.3**	**3.29**	**3.00**
4Q19	**3.9**	**2.4**	**3.30**	**3.25**

Forecast closing date: 11 July 2018.
Source: Central Reserve Bank of Peru and BBVA Research Peru

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