

The logo for BBVA Research, featuring the word "BBVA" in a bold, white, sans-serif font, followed by the word "Research" in a smaller, lighter weight sans-serif font. A small teal square is positioned to the right of the word "Research".

BBVA Research

Peru Economic Outlook 4Q18

Projections with information at 12 October

Creating Opportunities

Key messages

- **Growth in activity moderated in the past few months.** Mining and oil & gas output declined, and public investment slowed. More generally, the positive effect of the low YoY base for comparison faded. On the other hand this was offset, albeit only in part, by the continuing buoyancy of household spending indicators. On this basis, we estimate GDP growth of between 2.0% and 2.5% YoY in the third quarter. Thus the third quarter will be the weakest of the year
- **The slowdown in growth will be temporary.** The fourth quarter will see the start of the second anchovy fishing season, and by then the transitory factors that have affected certain activities such as oil and gas production will have dissipated. The increases in anchovy hauls and oil and gas output will have a positive effect on primary manufacturing. In this context, we foresee GDP growth of between 3.5% and 4.0% YoY in the last quarter of the year. This will bring growth for the whole year to around 3.6%, with a certain upward bias. This forecast for 2018 is similar to that presented in our previous report, but it incorporates greater growth in private sector spending (consumption in particular) and less in public sector spending

Key messages

- The baseline scenario for the forecasts assumes a less favourable environment on the external side. World growth will remain robust, but it will also be rather more moderate than in 2018 and less synchronised geographically. Furthermore interest rates in foreign currencies will be higher. With more moderate world growth, increased financing costs and trade tensions between the US and China, the average price of metals will tend to fall, leading to deterioration in the terms of trade
- Domestically, the main support to growth in 2019 will come from the construction of new mines such as Quellaveco and Mina Justa and the expansion of Toromocho, which will involve an increase of US\$2 billion in mining investment next year, equivalent to almost one percentage point of GDP. The baseline scenario also assumes (i) that business confidence will remain relatively favourable for investment despite the increased political noise; (ii) that there will be no *Niño Costero* weather phenomenon in the (Southern hemisphere) summer, or if there is one it will be of low intensity, (iii) that in general the advance in public infrastructure construction will remain slow until well into 2019; and (iv) that the change in regional authorities from the beginning of next year will probably act as a temporary brake on investment at that level of government, as happened on previous occasions

Key messages

- In a context of strongly increasing investment in mining, the persistently slow advance of public infrastructure construction and less favourable external conditions, **we estimate that GDP growth in 2019 will be around 3.9%**. This figure is similar to the one we presented in July, but it incorporates greater growth in private sector spending (especially consumption) and slower growth in public sector spending (delays in infrastructure construction), with two of the risks that we pointed to in our last report thus materialising
- **The Peruvian currency continues to weaken.** The depreciation of the PEN, however, has been limited, compared with that of other emerging economies' currencies. The greater resistance of the PEN reflects Peru's solid macroeconomic fundamentals. The year-end 2018 forecast for the exchange rate is 3.33 (adjusted upwards in view of the deteriorating terms of trade) and for year-end 2019 it is 3.30. Next year's reduction is based on a strong trade surplus (despite the lower metal prices) and foreign direct investment in the mining sector
- **The outlook for prices remains positive.** In this context, the central bank is maintaining an expansive monetary policy stance in order to support the recovery of private spending. We anticipate that the pause in the base rate will extend until the first quarter of 2019, after which it will start to move towards a more neutral level



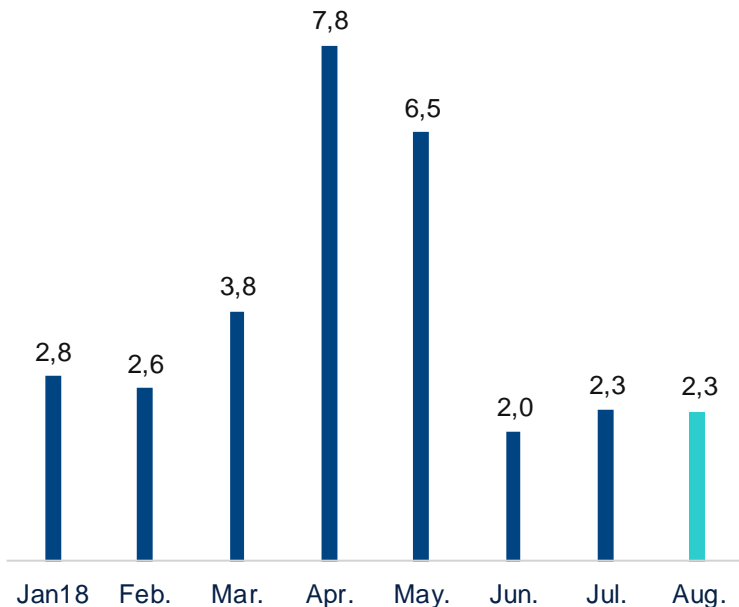
01

Economic activity

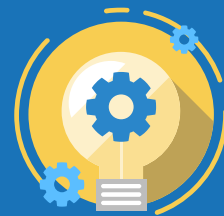
Growth in activity moderated in the past few months

GDP

(chge. % YoY)



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



Primary sectors

In decline due to the lower extraction of metals, oil and gas

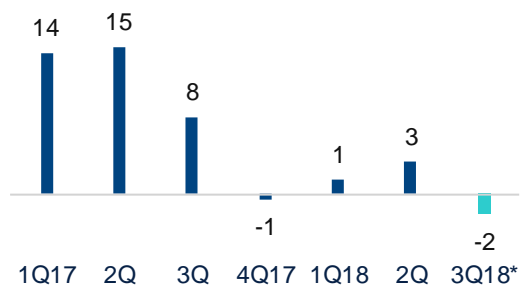
Non-primary sectors

Growing at a rate of just over 3.5%. However, the slowdown in construction activity stands out

On the expenditure side, available indicators for the third quarter point to a moderation of all components of GDP

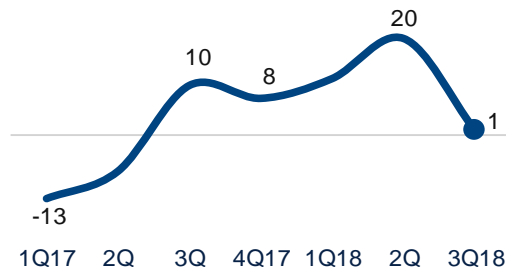
Exports

(Volume, chge. % YoY)



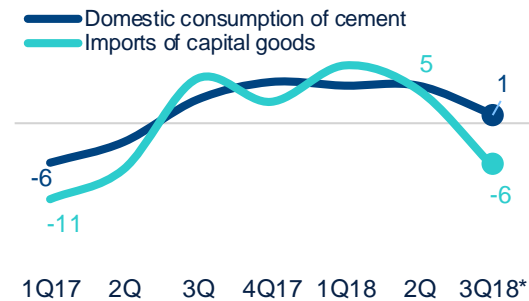
Public investment

(Central Government, real, chge. % YoY)



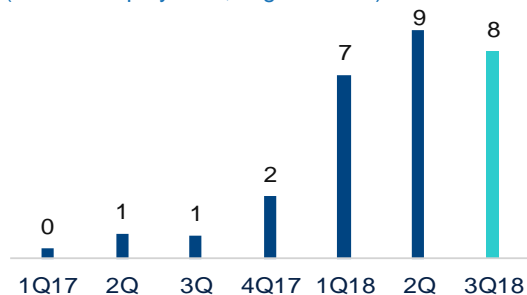
Private investment indicators

(Chge. % YoY)



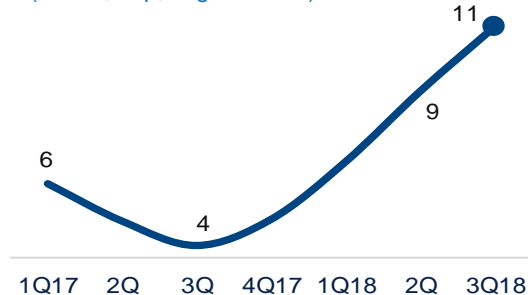
Total payroll

(Formal employment, chge. % YoY)



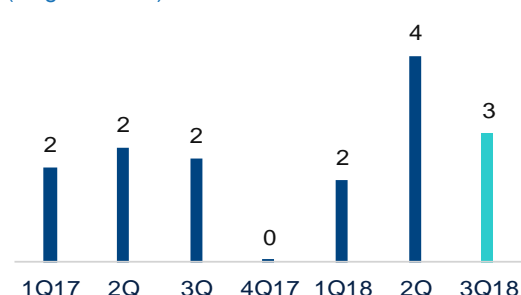
Consumer credit

(Banks, eop, chge. % YoY)



Electricity production

(Chge. % YoY)



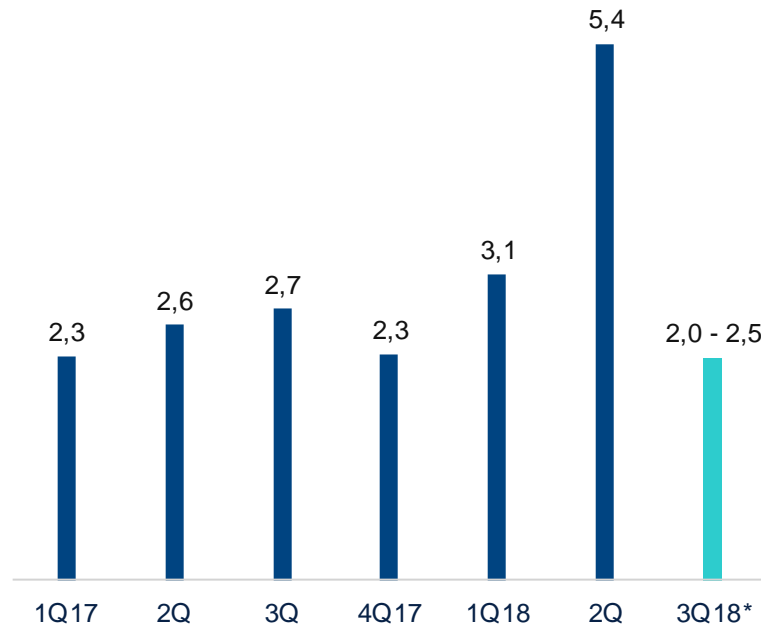
(*) Estimated on the basis of available information.

Source: INEI (National Statistics & IT Institute), COES (An organization of national grid generators, users, etc.), MINTRA (Ministry of Labour), MEF (Ministry of Economy & Finance), SUNAT (Tax Agency), BCRP (Peru's Central Bank) and BBVA Research

The third quarter is likely to be the weakest of the year. Is this something temporary or will it persist?

GDP

(Chge. % YoY)



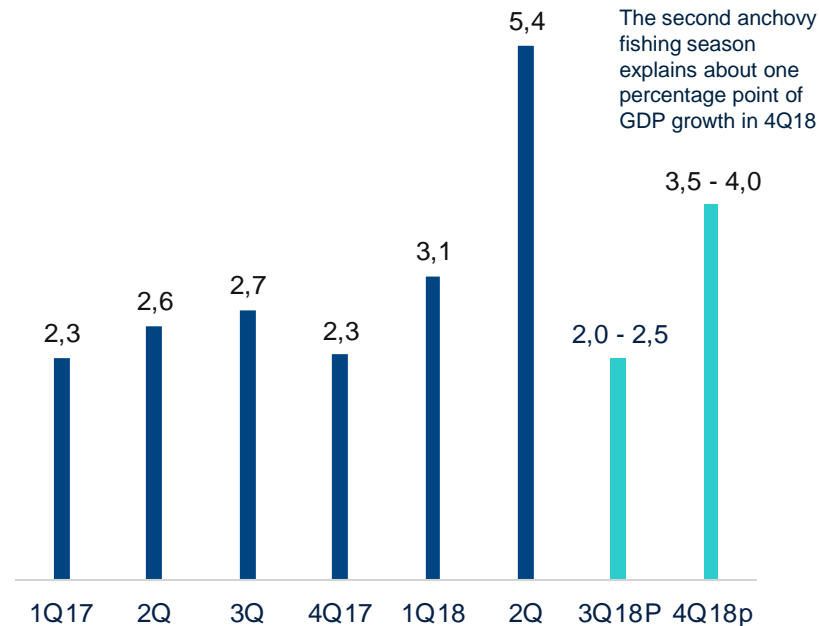
- In the third quarter the decrease in mining activity was accentuated (exploitation of zones with low mineral content)
- Oil and gas production declined temporarily due to problems with the Northern pipeline and lower output of block 56
- Lower growth of public investment
- In general, the positive effect of the low YoY base for comparison is dissipating

(*) Estimated for the third quarter

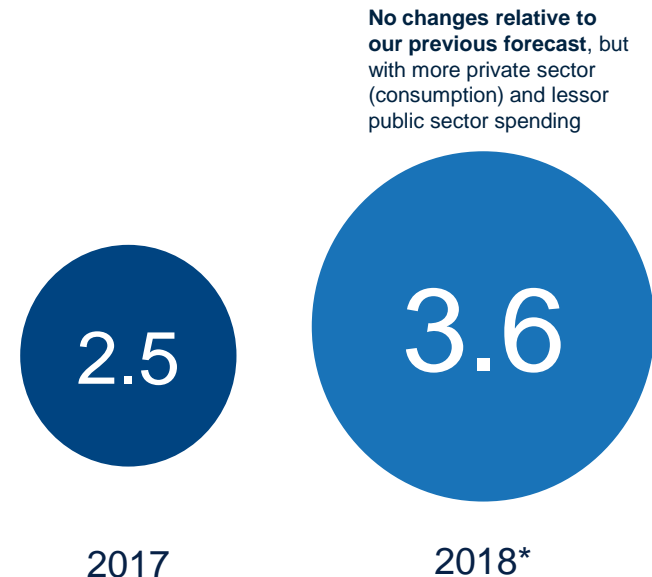
Source: Central Reserve Bank of Peru and BBVA Research

The moderation in activity will be transitory: We expect to see a recovery in the last quarter of the year, bringing whole-year GDP growth to around 3.6% for 2018

GDP (Chge. % YoY)



GDP (Chge. % YoY)





What do we foresee for 2019?

The baseline macroeconomic scenario for 2019 assumes...

01

Global growth still robust, albeit more moderate and less synchronised

02

Developed economies will continue to withdraw monetary stimulus measures

03

Deteriorating terms of trade, mainly due export prices

04

Strong increase in mining investment (Quellaveco, Mina Justa)

05

Business confidence relatively favourable for investment

06

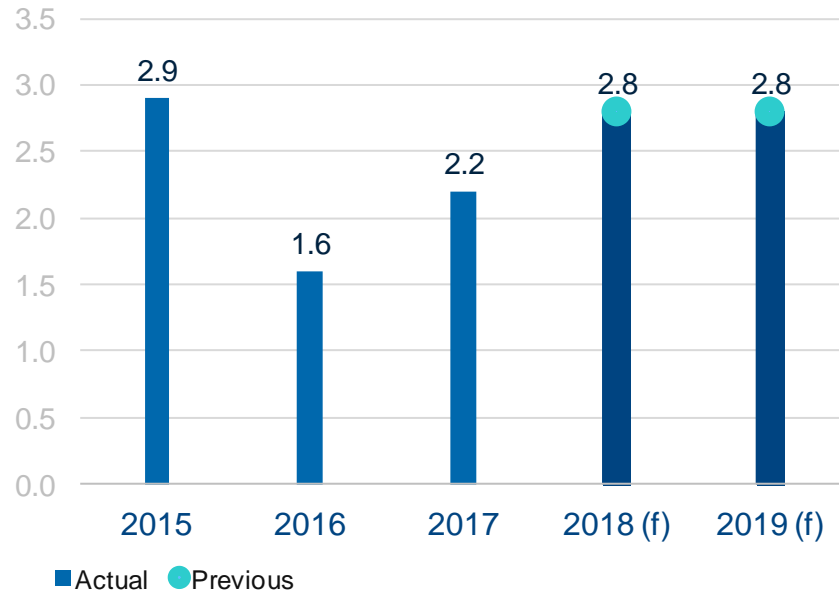
No Niño Costero (or only a low-intensity one)

07

Difficulties in executing public investment (infrastructure, regional governments)

In the US, increased consumption and solid investment underpin growth, but with signs of stabilization

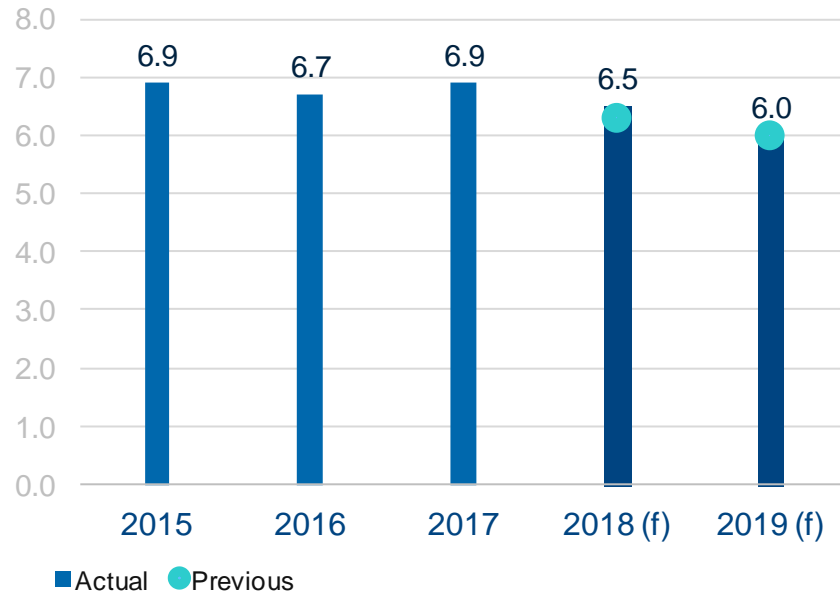
USA: GDP (% change YoY)



- The acceleration of the economy in 2Q18 seems to be transitory, following a strong boost from the external sector, and some moderation is expected in the coming quarters
- Headline inflation is moderating and core inflation remains stable at around 2%, which reduces the probability of a high inflation scenario

In China, more accommodative economic policies are being implemented, in an effort to counter the headwinds

China: GDP
(Chge. % YoY)



- ▲ Upward revision of growth in 2018 (+0.2 pp) due to better performance in 1H18, but clearer signs of moderation going forward
- ▲ Fiscal and monetary stimulus measures are being implemented to support growth, but for now they are moderate, so as not to exacerbate financial vulnerabilities
- ▲ Protectionism remains the main risk, especially if it slows down the deleveraging of the economy or leads to a sharp depreciation of China's currency

Monetary policy will continue to normalize and will be divergent between the Fed and the ECB



Balance sheet

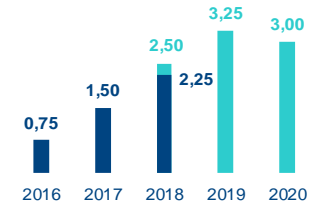


Interest rates



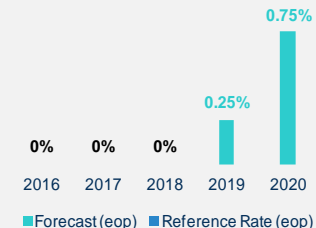
Balance sheet reduction continues (US\$450 billion in 2018)

More rate hikes in 2019, but the cycle is ending (neutral level)



End of QE (December 2018)
Total reinvestment at least until December 2020

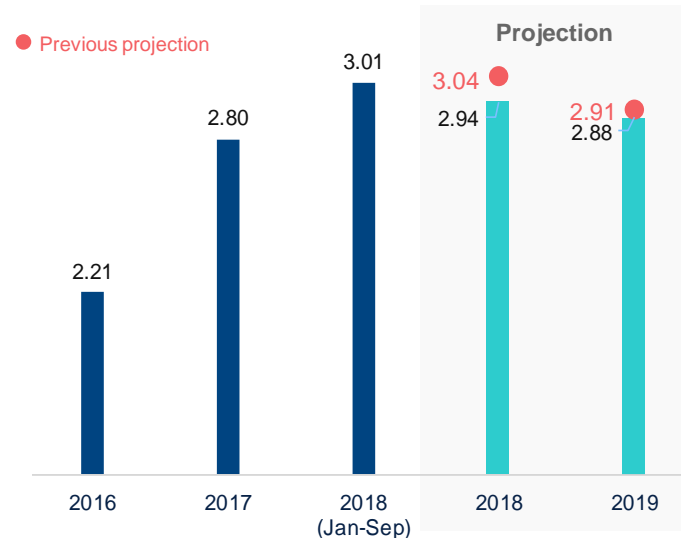
Expectations of low rates anchored for a prolonged period. **No interest rate increases expected before September 2019**



Price of copper tending to fall (as an annual average), while oil prices will hold up better

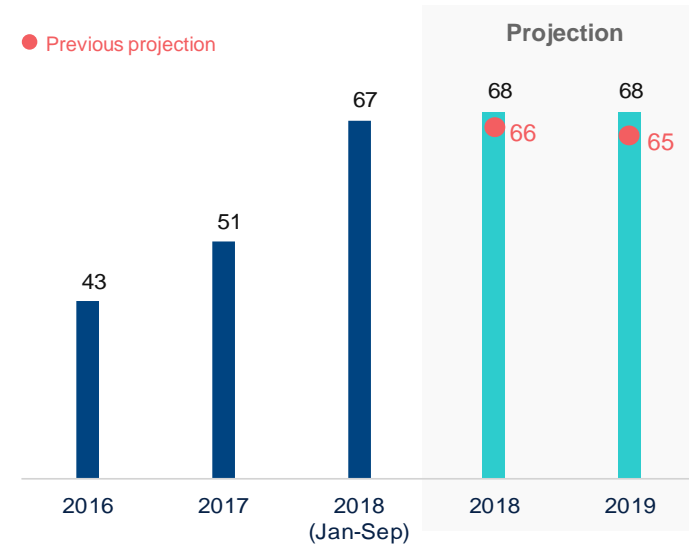
Copper price

(US\$/lb, average for the period)



WTI oil price

(US\$ per barrel, average for the period)



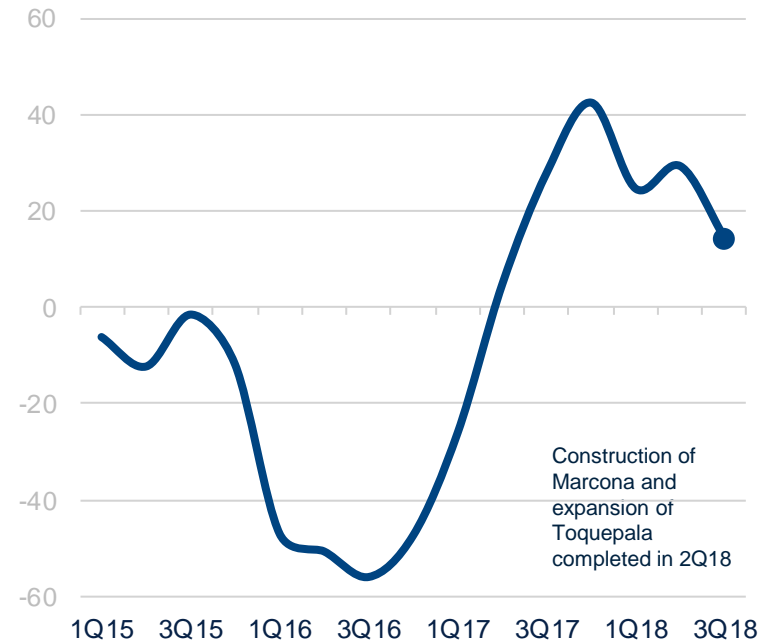
Source: Bloomberg and BBVA Research

Copper: the decline in price in 2019 is explained by moderating growth in China and tougher international financing conditions. But price levels will continue to provide support for investment in mining. The forecast has been adjusted downwards

Domestically, the main support to growth in 2019 will come from the construction of new mines

Mining investment*

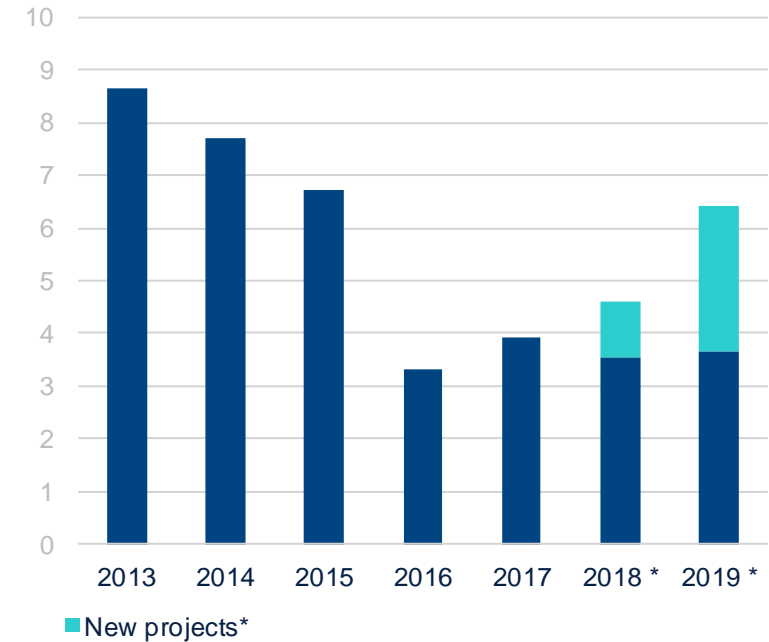
(in real terms, % chge. YoY)



(*) 3Q18 estimated on the basis of data available for July and August
Source: MINEM (Ministry of Energy & Mines) and BBVA Research

Mining investment

(US\$ billions)

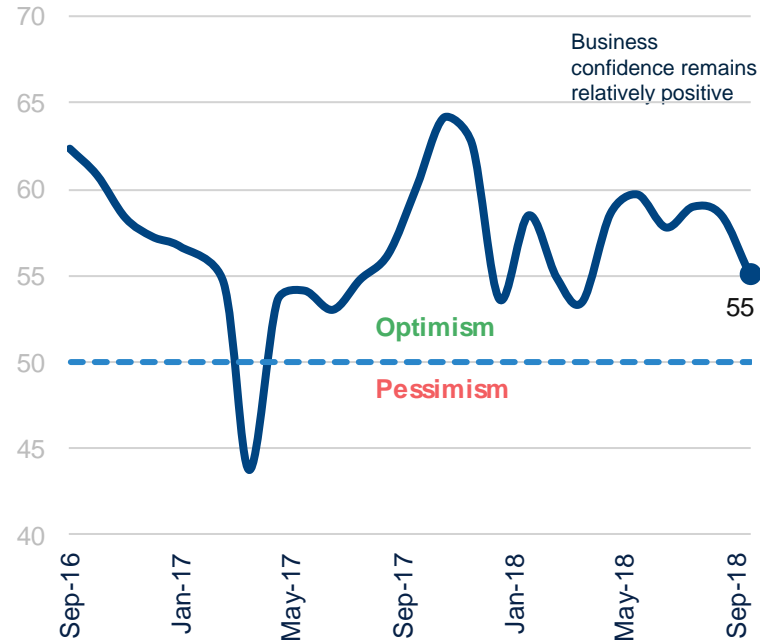


(*) Investment in new projects refers to Quellaveco, Mina Justa, the expansion of Toromocho and two other smaller mines

The forecasts also assume that business confidence will be relatively favorable for investment

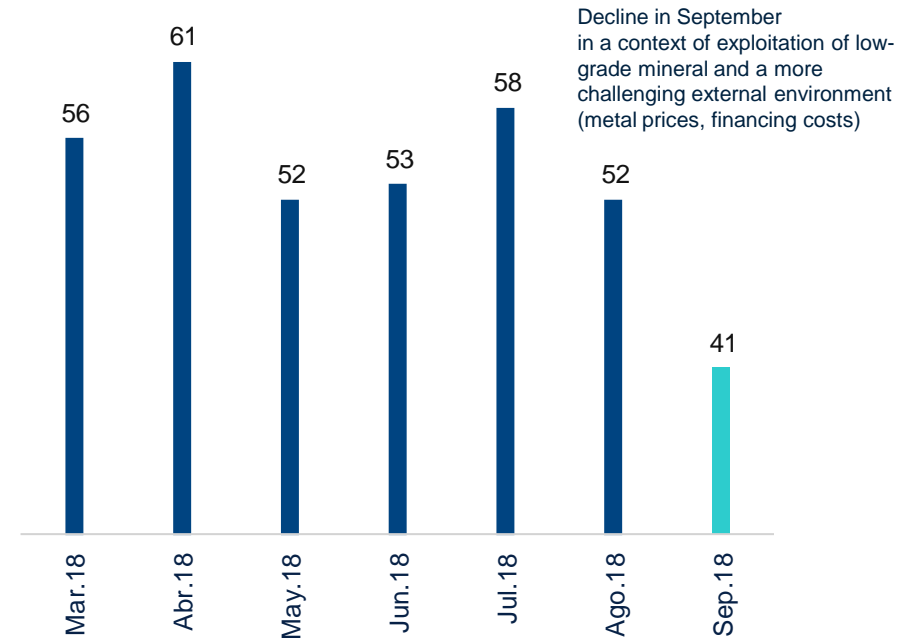
Business confidence

(Points)



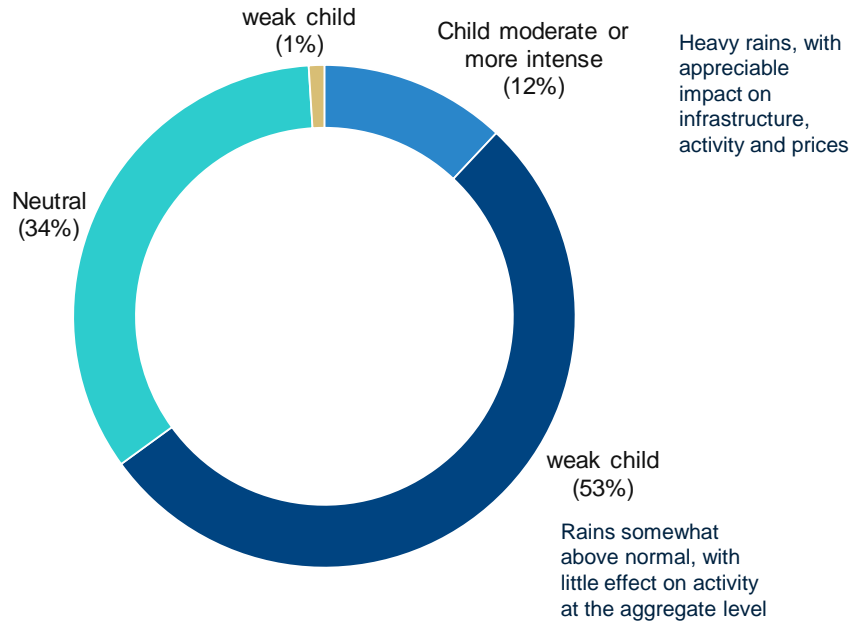
Business confidence in the Mining, Oil & Gas sector

(Points)

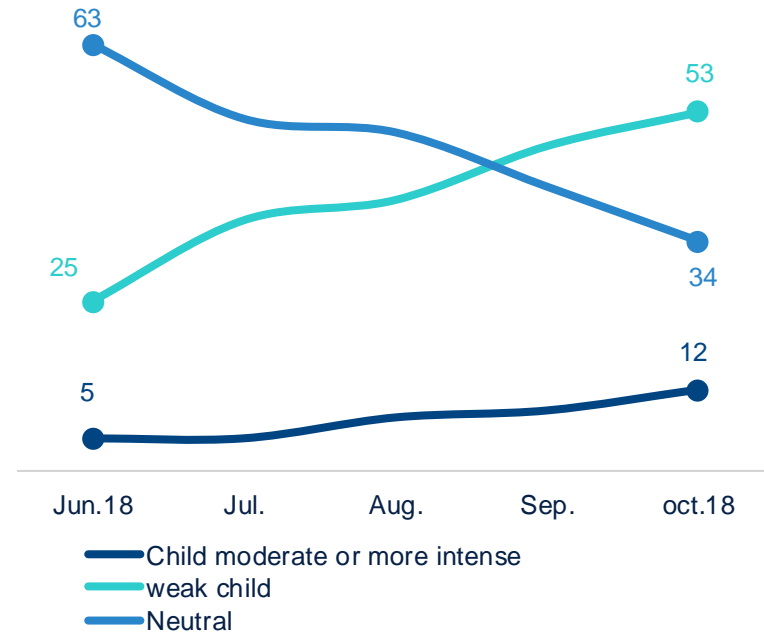


The baseline scenario assumes that there will be no Niño Costero (or that if there is one it will be low-intensity)

Probability of a Niño Costero in the summer of 2019 (%)



Source: ENFEN (official oceanography agency)



Source: ENFEN

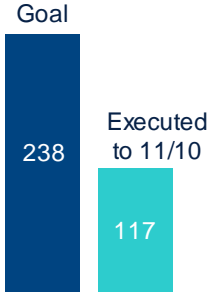
Apart from this, public infrastructure construction is likely to remain slow in the first few months of 2019 before gaining traction later in the year

Spending on construction of certain public infrastructure projects in 2018 (US\$ millions)

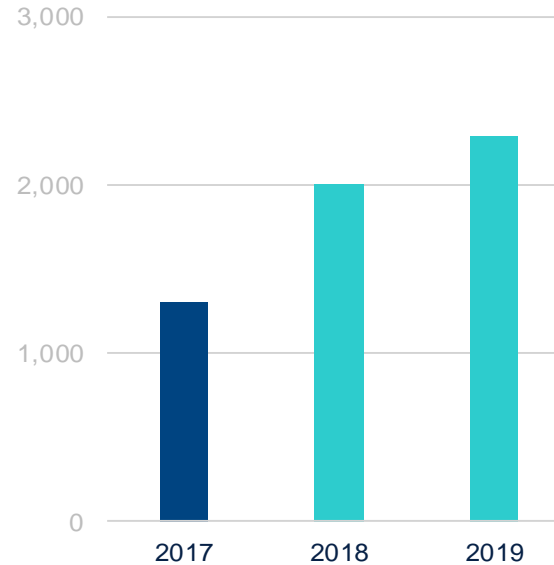
Reconstruction in the North of the country



Second metro line for Lima



Spending on construction of public infrastructure* (US\$ millions)



Drivers of public infrastructure construction in 2019

- ↑ Reconstruction in the North of the country
- ↓ Lima Metro Line 2
- ▀ 2019 Pan American Games

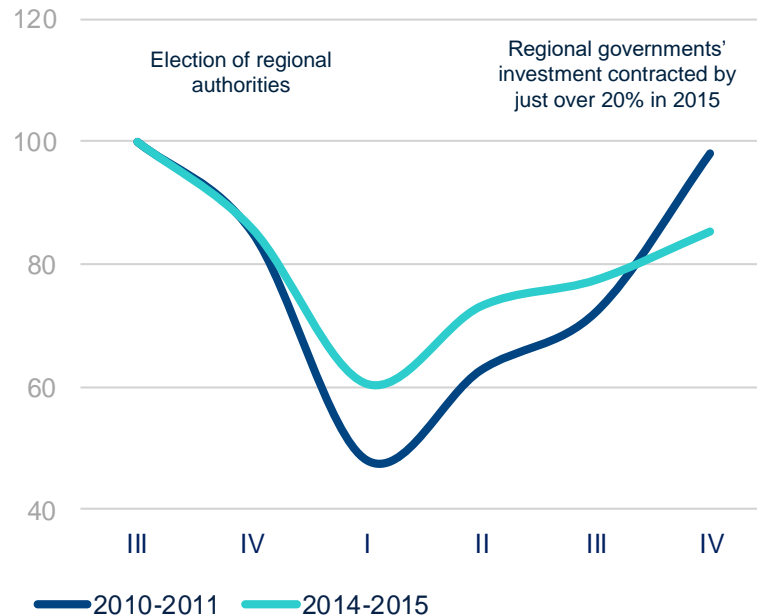


Construction of public infrastructure has been adjusted downwards

Furthermore, the change of regional authorities is likely to act, as on previous occasions, as a temporary brake on public investment

Regional governments' investment*

(In real terms, seasonally adjusted, index, quarter before the elections = 100)



- Following the elections in 4Q18, change of regional authorities from January 2019
- In the past, changes like this led to contraction of investment at these levels of government
- New authority gradually gets to know the processes for executing expenditure, reviews the works in progress and possibly decides not to embark upon some of those planned by the previous administration (and plans others)
- There is little reason to suppose that this time around will be any different, especially considering that the regional authorities could not be re-elected this time

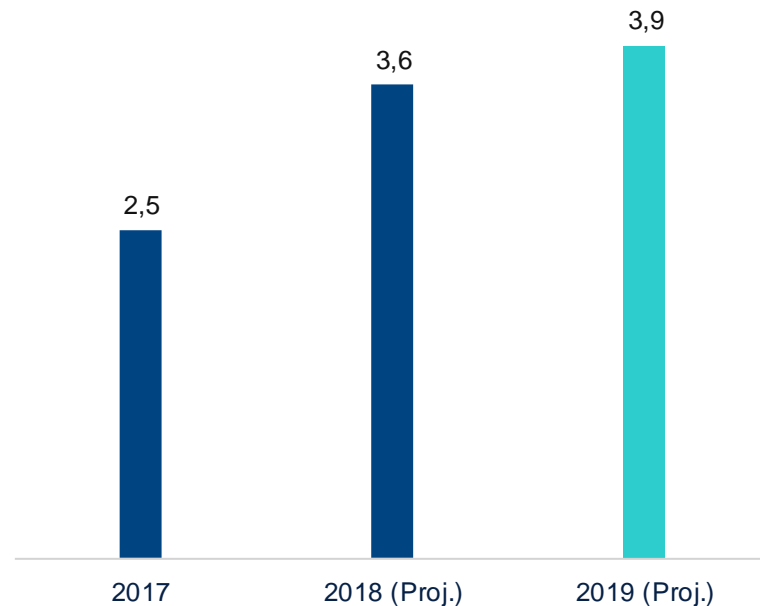
(*) Includes regional and local governments, which together carry out approximately 60% of the Central Government's public investment

Source: BBVA Research

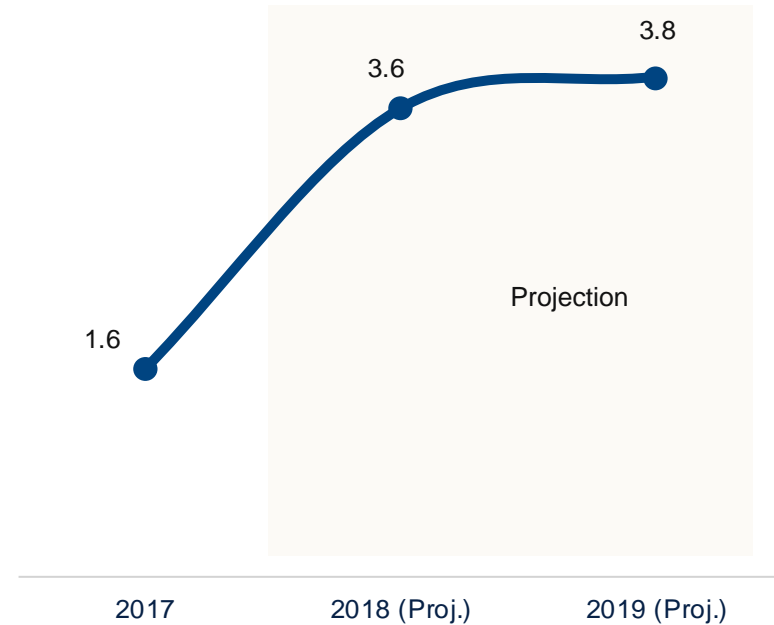
In this context, we estimate that GDP will grow by 3.9% in 2019, unchanged from the previous forecast...

... but with more private sector (especially consumer) and less public sector (infrastructure) spending

GDP
(chge. % YoY)



Domestic sales
(Domestic demand excluding build-up of inventories, chge. % YoY)



Greater dynamism of private investment (mining) in 2019, which will be reflected in the non-primary Construction and Manufacturing sector

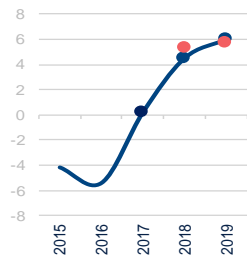
GDP: selected components by expenditure and sector

(In real terms, chge. % YoY; projected for 2018 and 2019)

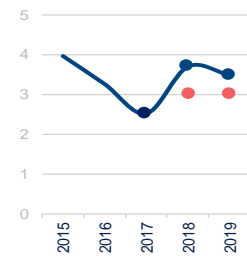
GDP on the expenditure side

● Previous projection

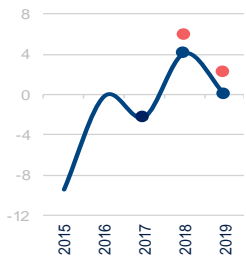
Private investment



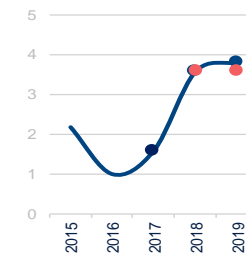
Private consumption



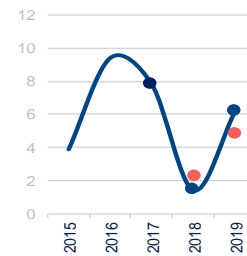
Government investment



Domestic sales*

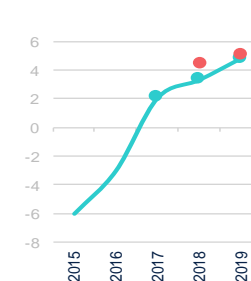


Exports



Sector GDP

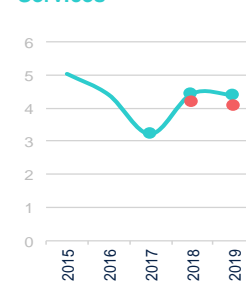
Construction



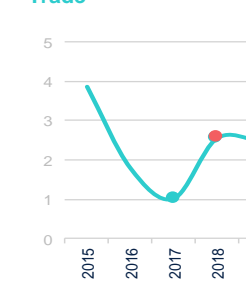
Non-primary manufacturing



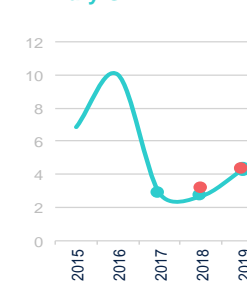
Services



Trade



Primary GDP



(*) Corresponds to domestic demand, but excludes build-up of inventories

Source: Central Reserve Bank of Peru and BBVA Research



02

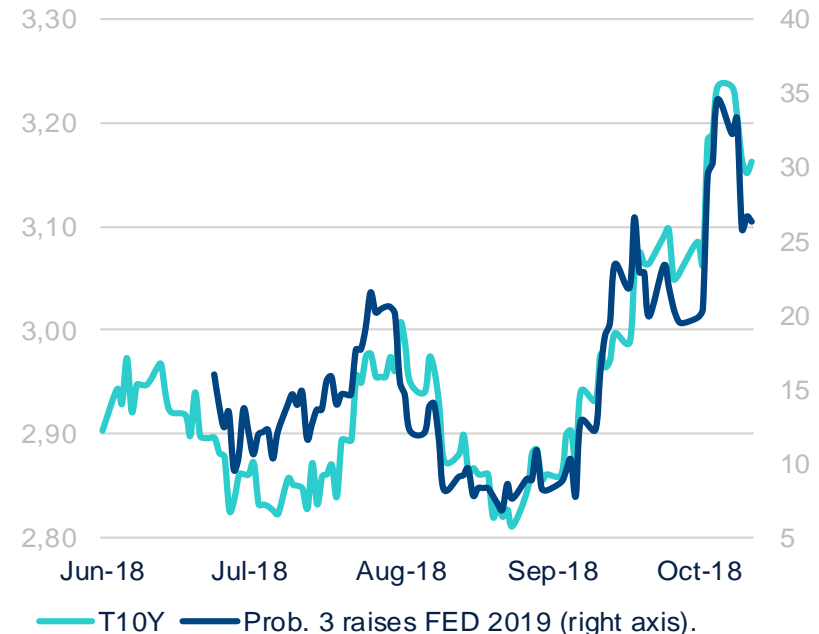
Financial markets

The Peruvian currency continued to weaken, in an environment in which an adjustment to the monetary position in the US became more likely

Exchange rate
(PEN/USD)

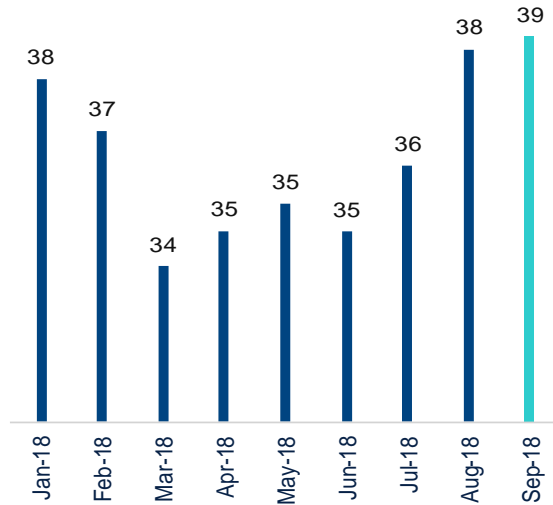


Probability of increases in FED interest rate and yield on the US 10Y Treasury (%)



Foreign appetite for Peru's sovereign bonds continues. Exchange pressures in the forward market. Pension funds increase their investments abroad

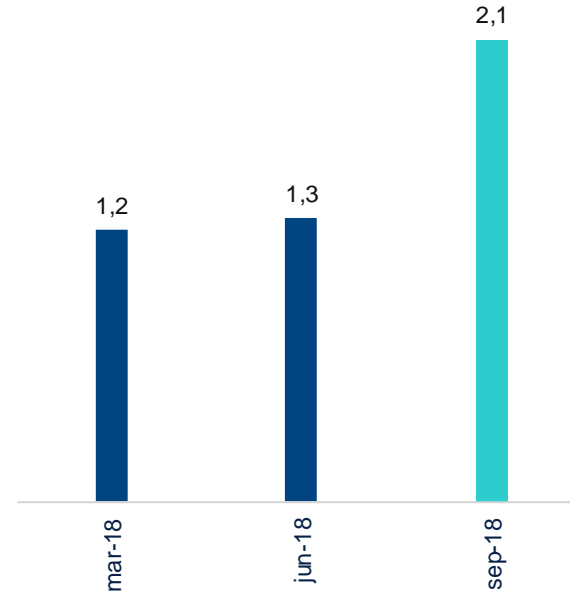
Holding of sovereign bonds by foreigners
(PEN billions)



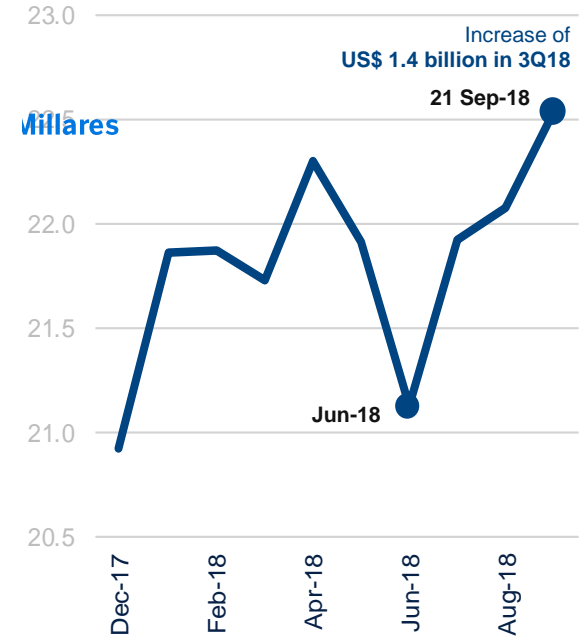
Share of foreigners in holdings of sovereign bonds

	Mar.18	Jun.18	Set.18
	39%	39%	42%

Net balance of *non-delivery forwards*
(Sales less purchases, from the point of view of the banks, in US\$ billions)



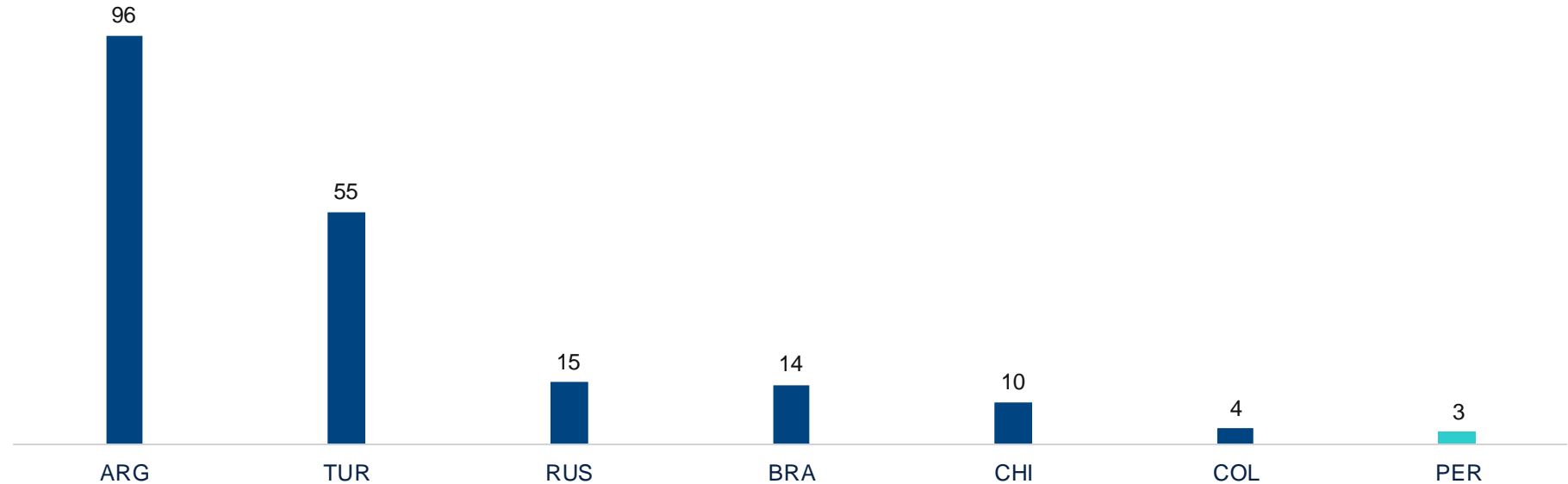
Pension funds: investments abroad
(US\$ billions)



The depreciation of Peru's currency has been relatively limited

Increase in the exchange rate in selected emerging markets

(Exchange rate in terms of units of local currency per US dollar, chge. % YTD*)



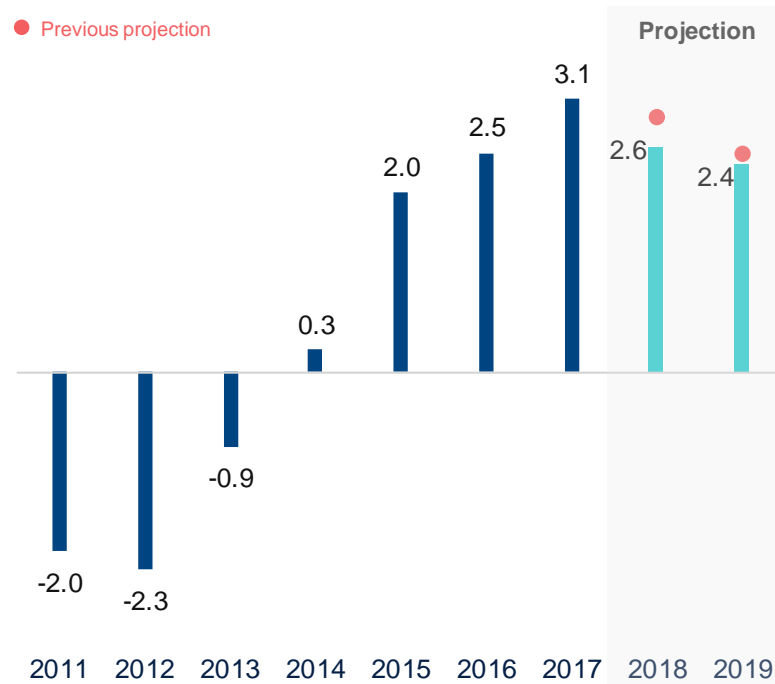
(*) To 12 October.
Source: Bloomberg

The greater resistance of the PEN reflects Peru's good macroeconomic fundamentals, among them fiscal solidity...

Fiscal deficit*

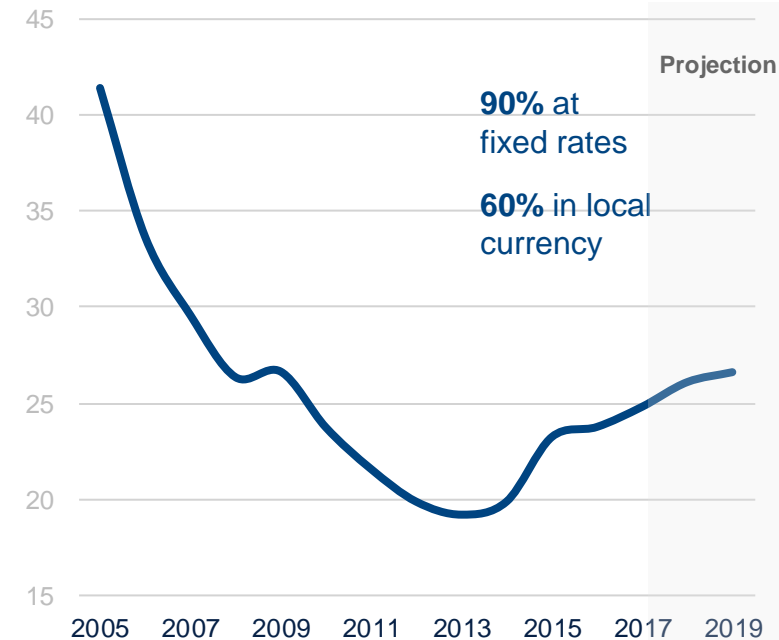
(Cumulative in the last four quarters, as % of GDP)

● Previous projection



Gross public debt*

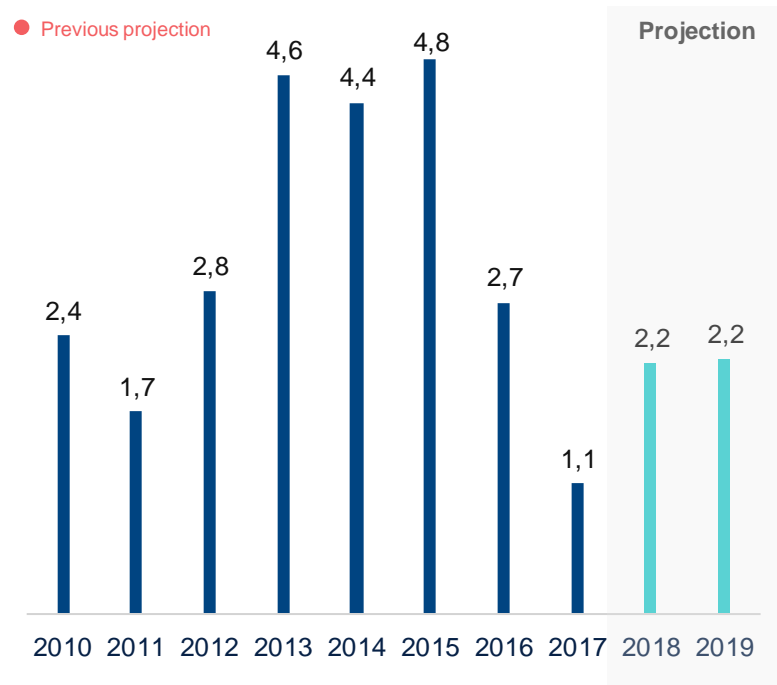
(% of GDP)



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

Current account deficit

(Cumulative in the last four quarters, as % of GDP)



Net international reserves, Balance of short-term external liabilities, and Current account deficit

(% of GDP)

Net international reserves



2018*

Short-term external liabilities and current account deficit



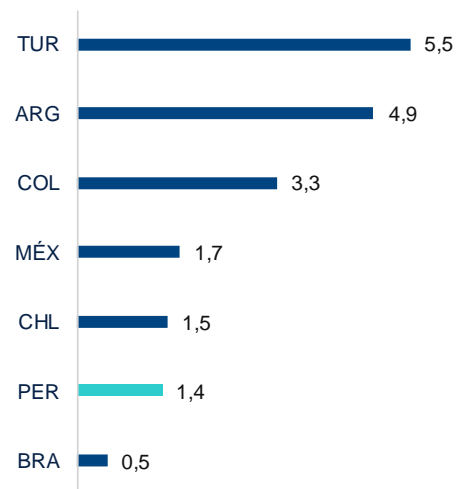
2018*

(*) Estimated figures

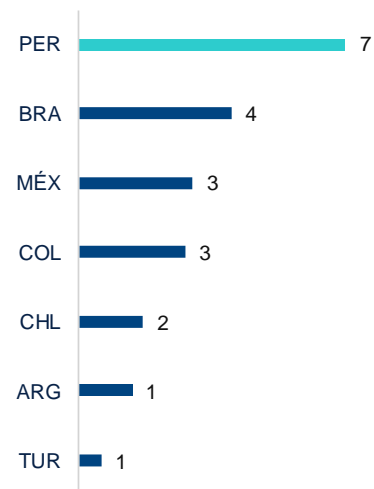
Source: Central Reserve Bank of Peru and BBVA Research

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

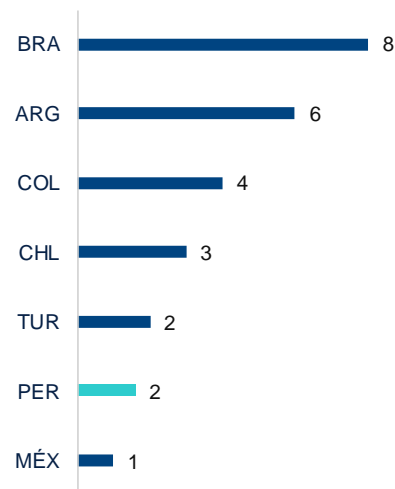
Current account deficit
(% of GDP, year-end 2017*)



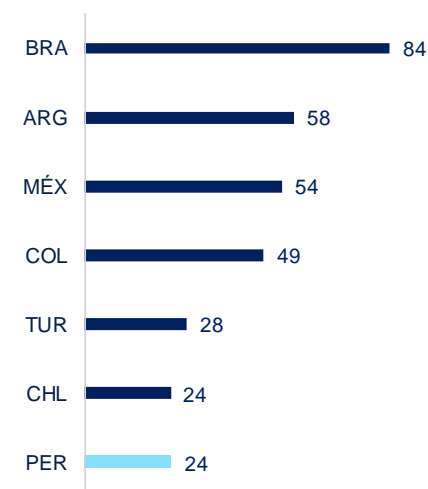
International reserves / short-term external liabilities
(Times, in 1Q18*)



Fiscal deficit
(% of GDP, year-end 2017*)



Gross government debt
(% of GDP, year-end 2017*)



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

Moody's mantiene calificación de Perú en A3

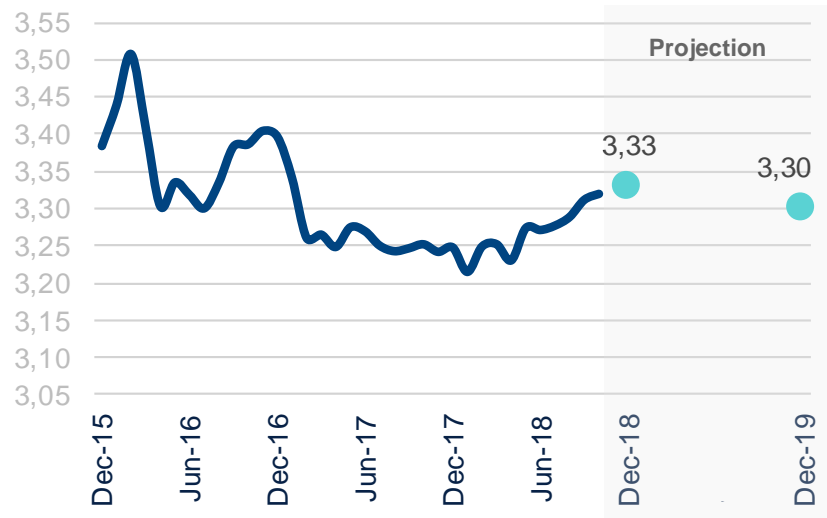
ELECONOMISTA AMÉRICA - 13:02 - 29/09/2018

Fitch mantiene calificación crediticia de Perú en 'BBB+' con perspectiva estable

REDACCIÓN GESTIÓN / 27.09.2018 - 01:20 PM

In this context, we estimate that the exchange rate will be around 3.33 at year-end 2018 and 3.30 at year-end 2019

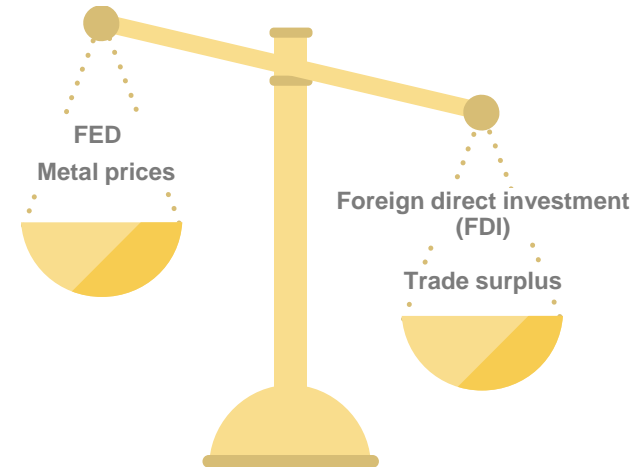
Exchange rate (PEN/USD)



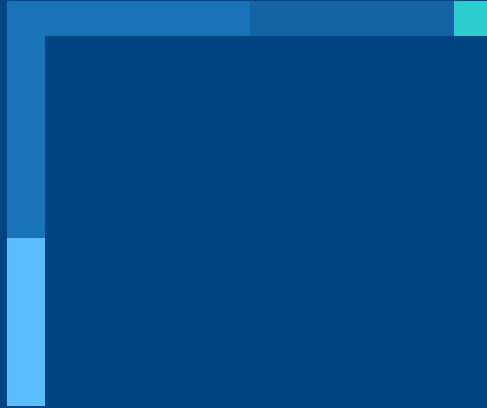
Source: Central Reserve Bank of Peru and BBVA Research

Factors determining the exchange rate in 2018/19

Factors determining the exchange rate in 2018/19



Current forecast implies an upward adjustment (especially in the short term) due to worsening terms of trade

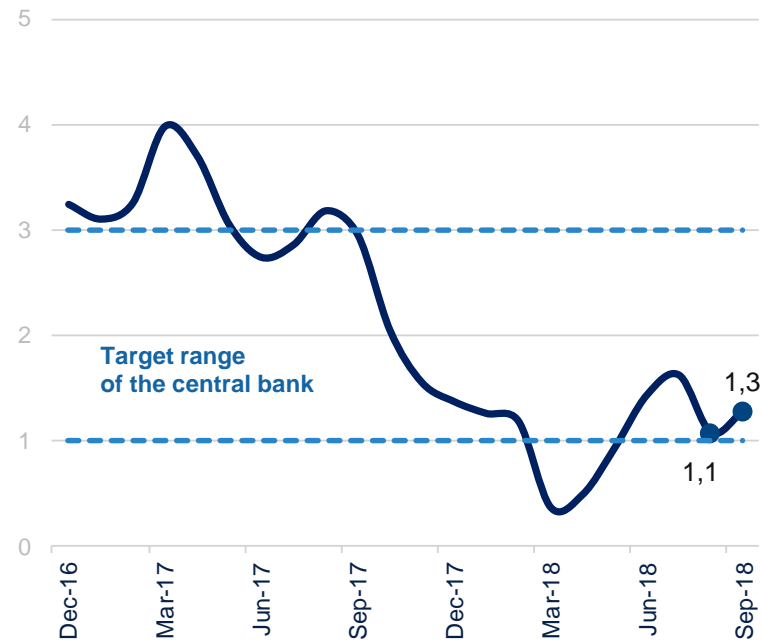


03

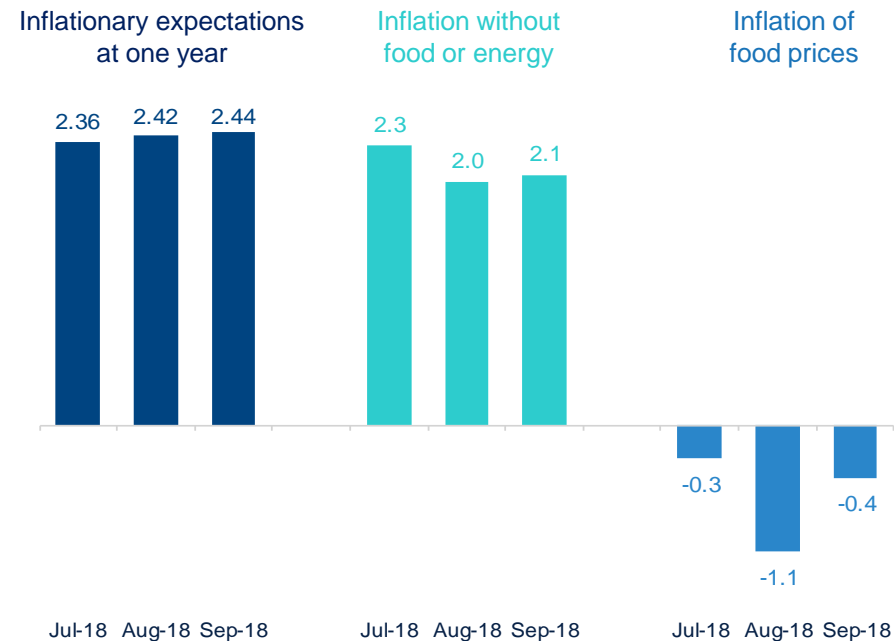
Inflation and monetary policy interest rate

The outlook for prices remains positive

Total inflation (Chge. % YoY of CPI)



Other inflationary pressure measures (Chge. % YoY)



We estimate that inflation will soon reach the centre of the target range, at 2.3% at year-end 2018 and 2.1% at year-end 2019

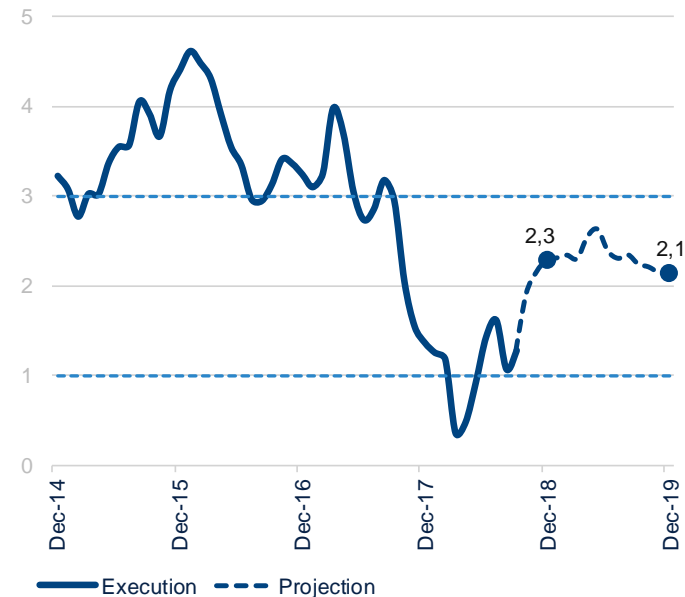
In the short term...

- Normalisation of food prices
- Faster depreciation of the national currency
- Absence of extreme weather events

As 2019 advances...

- PEN will tend to strengthen
- Oil prices will recede
- Slack in certain sectors will diminish

Total inflation
(Chge. % YoY of CPI)



In this context, the central bank maintains an expansive monetary stance

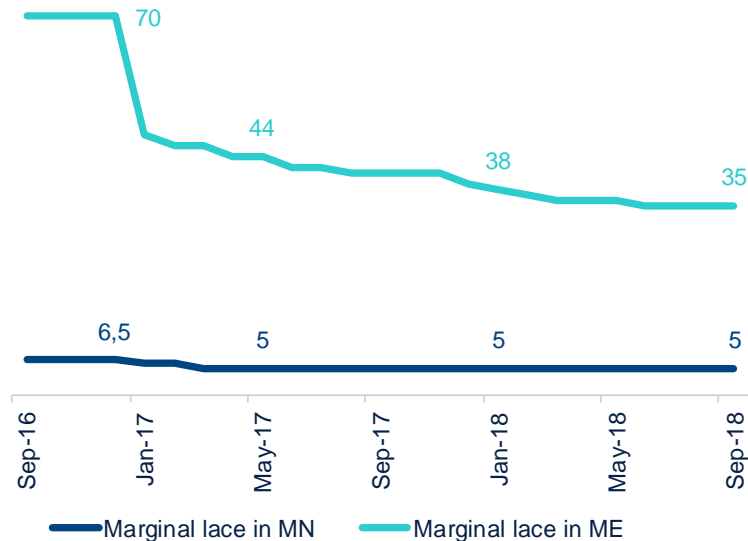
Price outlook is positive

Slack in certain sectors of the economy

Growth moderated in 3Q18

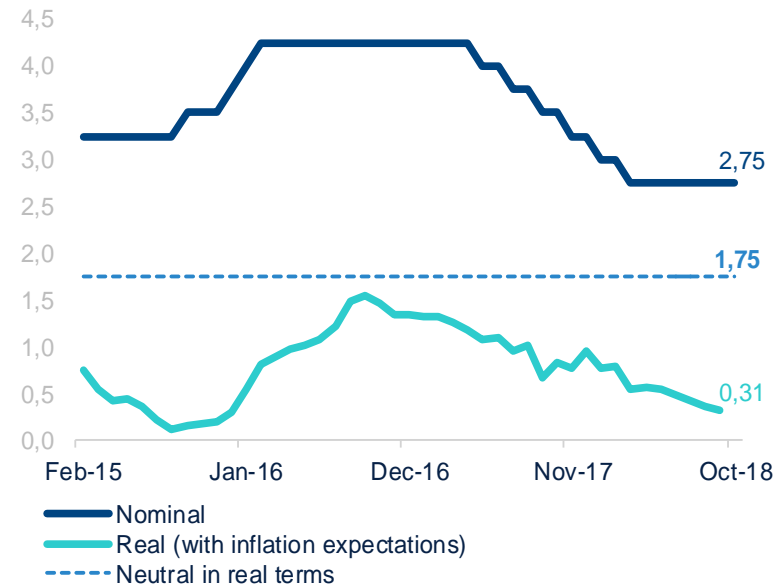
Marginal minimum reserve requirements rate

(% of total liabilities subject to reserves)



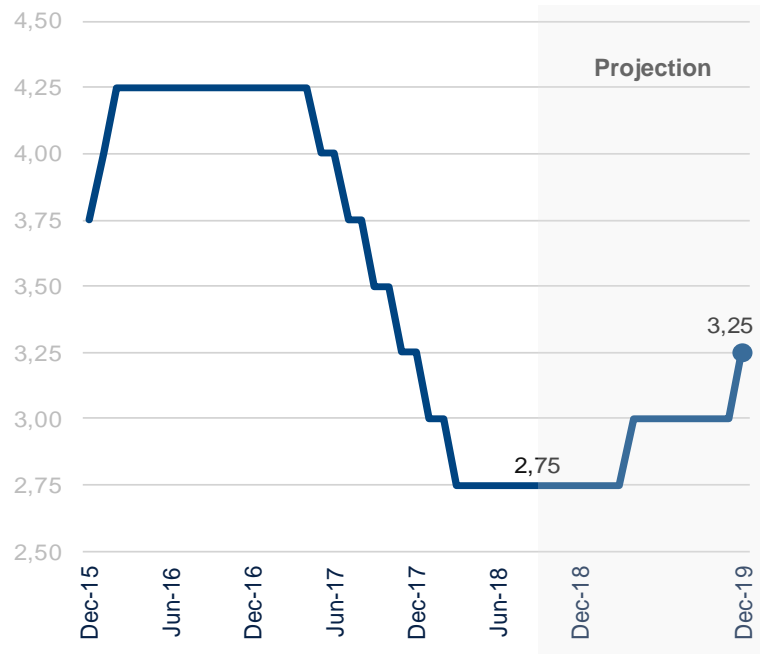
Monetary policy reference rate

(%)



We anticipate a pause in the reference rate until 1Q19, after which it will start to normalize gradually towards a more neutral level

Monetary policy rate (%)



Central Bank will maintain the **expansive tone of monetary policy** until inflation approaches the middle of the target range, inflationary expectations are anchored and GDP is close to its potential level

BBVA projection?

- Policy rate at its current level of 2.75% until well into 2019 to consolidate economic recovery
- Consolidation of activity and lesser differential in sol/dollar interest rates will lead the central bank to raise the rate in mid-2019 (to 3.25% by the end of the year)



04

Risks

Risks to the baseline scenario for 2018 and 2019

External

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

Domestic

- ↓ Less progress on public infrastructure projects (reconstruction after *Niño Costero* damage and construction of second line of the Lima Metro)
- ↓ More appreciable negative impact of political noise on business confidence
- ↓ *Niño Costero* of moderate or strong intensity
- ↑ Bigger anchovy catches in the second season of 2018

Macroeconomic projections

	2014	2015	2016	2017	2018 (f)	2019 (f)
GDP (var.%)	2.4	3.3	4.0	2.5	3.6	3.9
Domestic demand (excl. inv., var.%)	2.5	2.2	0.8	1.7	3.6	3.8
Private expenditure (excl. Inv., Var.%)	2.3	1.9	1.2	2.0	3.8	4.0
Consumption (var.%)	3.9	4.0	3.3	2.5	3.7	3.5
Investment (var.%)	-2.2	-4.2	-5.4	0.2	4.0	6.0
Public expenditure (var.%)	3.6	3.6	0.1	-0.5	2.5	2.6
Consumption (var.%)	6.0	9.8	0.2	0.2	1.9	3.6
Investment (var.%)	-1.1	-9.5	-0.2	-2.3	4.0	0.0
Exchange rate (vs. USD, FDP)	2.96	3.38	3.40	3.25	3.33	3.30
Inflation (% a / a eop)	3.2	4.4	3.2	1.4	2.3	2.1
* Interest rates (% , FDP)	3.50	3.75	4.25	3.25	2.75	3.25
Fiscal Result (% GDP)	-0.3	-2.0	-2.5	-3.1	-2.6	-2.4
Current account (% of GDP)	-4.4	-4.8	-2.7	-1.1	-2.2	-2.2
Exports (thousands of millions of USD)	39.5	34.4	37.1	45.3	48.5	50.9
Imports (thousands of millions of USD)	41.0	37.3	35.1	38.7	42.5	45.0

(*) Monetary policy rate

Closing date for forecasts: 12 October 2018

Source: Central Reserve Bank of Peru and BBVA Research Peru

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