Economic Analysis

Peru Economic Outlook. First quarter 2019

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After the downturn in the third quarter, **the year-on-year growth rate of economic activity increased in the last months of 2018**. Three things stood out **sectorally**. Firstly, the landings of anchovy increased with the start of the second season of capture of this species in the north-central zone of the coast, which began earlier than the previous year and had a good rate of daily extraction. This was reflected in the strong expansion of **Fishing** and had a positive impact on **primary manufacturing** (processing of fishmeal and fish oil). We estimate that the contribution (direct and indirect) of the largest landings of anchovy on quarterly GDP growth was between 1.0 and 1.5 percentage points. In second place, **construction** also stood out, reflecting the good performance of investment, especially public investment. On the other hand, mining fell back again due to the continuous difficulties in some copper mines (geotechnical instability in a large mine, exploitation of areas with low mineral content) and the exhaustion of gold units. **On the expenditure side**, in addition to the **surprising improvement in public investment**, the **good progress of private sector spending on consumption and investment** stood out. In this context, we estimate that **GDP advanced around 4.6% year-on-year in the fourth quarter of last year**. As a result, **activity growth in 2018 would have been 3.9%**.

The good performance of local activity in the last months of 2018 contrasted with the external situation. Global economic growth decelerated in the second half of last year while recent activity and confidence indicators have provided mostly negative surprises. This is clearer in the indicators linked to the industrial sector and international trade. The rise in protectionist risks and the fear of a speedy global slowdown also triggered a sharp spike in financial tensions at the end of 2018, particularly in advanced economies, with brusque stock market falls and rising prices in safe-haven assets. Against that backdrop of greater uncertainty about the global scenario, the main central banks, above all the US Federal Reserve, have reacted, showing signs of caution in their monetary policy normalisation plans, which has been a determinant in the containment and partial reversal of the tensions noted since the beginning of 2019.

Our forecasts for Peru take into account this international environment and are based on the assumption that high financial volatility may continue during the first months of the year as long as some of the uncertainties weighing on the global outlook are not dispelled, including some type of agreement between the US and China that prevents a further increase in tariffs, confirmation of a slower tone in the pace of adjustment of the US monetary policy, and signs that the slowdown in the Chinese economy will be orderly.

With all this, **we project that global growth will go from 3.7% in 2018 to 3.5% in 2019 (and 3.4% in 2020)**, which implies a downward adjustment of one tenth of a percentage point (two tenths in 2020) with respect to the forecast in our previous report. Within this forecast it is contemplated that in the case of China, the deceleration will continue in a context in which the authorities of that country seek to balance the necessary deleveraging but without this implying an abrupt adjustment of growth, so that after expanding 6.6% in 2018 we estimate that the economy will advance 6.0% in 2019 (and 5.8% in 2020). In the case of the US, the base scenario considers a moderation in growth, from 2.9% in 2018 to 2.5% in 2019 (and to 2.0% in 2020), which combines fiscal stimulus depletion, monetary tightening, and a weaker global environment. In this scenario, we project that **in 2019 there will be two Federal Reserve interest rate increases (25 bps each), with a long pause until June to assess the situation and then another until December.** The FED’s actions will depend very much on the data that appear (the FED is in the final phase of the rate increases cycle and will seek to calibrate its next actions well). This forecast implies a more cautious FED than in our previous report, when we looked at three policy rate increases in 2019 (up to 3.25%). Finally, the base scenario incorporates on the external side a **slight improvement in the**

terms of trade of Peru in 2019: although average metal prices will decrease (that of copper, in particular, will go from USD/pound 2.96 in 2018 to around USD/pound 2.80 in 2019), the decrease in the price of oil (Peru is a net importer of this input) will be greater. In the balance sheet, **the international environment will henceforth give less support to the growth of activity in Peru**.

Locally, the base scenario of projections contemplates the **increase of mining investment** as **the main support of GDP expansion in 2019**. Construction has begun on three copper mines (Quellaveco, Mina Justa and the Toromocho expansion) which, together with two other smaller mines, imply according to our estimates an increase in spending on the economy equivalent to just under one percentage point of GDP this year. The mines under construction will have relatively low production costs for the industry, which is important in an environment where the price of copper has declined. The base scenario also considers that in 2019 **mining production will normalise** after the problems faced last year in some copper units, that **business sentiment will continue to be relatively favourable for investment** in general (reflecting the improvement seen in the last months of last year), and that **monetary and fiscal stimuli will be lower**. Regarding the latter, an acceleration of public investment spending in the reconstruction of the northern part of the country (hit by the *Niño Costero* in 2017) -something that was already observed in the second half of last year-, which will be more sensitive in the second half of 2019; it is also considered, however, that the recent change of regional authorities (after the election at the end of 2018) will temporarily put a brake on public investment at this level of government, especially during the first half of the year, as observed in previous opportunities. In the balance of these two elements, progress in public investment in 2019 will be null. Finally, the base scenario incorporates the ***Niño Costero*** weather phenomenon in the (southern) summer **of weak intensity**, with limited impact at the macroeconomic level.

In this context of strong increase in mining investment, but also of more contained public spending and less favourable external conditions, we estimate that **GDP will advance 3.9% in 2019**. On the expenditure side, the main growth support will be private investment; on the sectoral side, the activities more oriented to meet the demand for mining investment will stand out, such as Construction, non-primary Manufacturing, and Services, as well as the activities that faced transitory difficulties in 2018 and that this year will operate under more normal conditions (Mining and Hydrocarbons, which on the expenditure side will be reflected in exports). The GDP growth forecast for 2019 is similar to that of our previous report (October): global growth in 2019 is now lower, but this is compensated by lower interest rates in dollars, greater terms of trade, and the better performance shown by the domestic demand.

By 2020 we project economic activity to grow 3.7%. There will thus be some moderation with respect to the previous two years because the momentum of mining investment will dissipate and global growth will continue to decline. In part, this will be offset by a recovery in public investment as regional government spending normalises and public infrastructure construction accelerates. This growth forecast for 2020 is two tenths of a percentage point lower than the previous year (October) because global growth has been revised in the same direction.

On the fiscal side, the deficit decreased in 2018 and we estimate that it closed the year at a level equivalent to 2.5% of GDP (3.1% in 2017). The decrease in the deficit was mainly due to the increase in revenues, which occurred in a context of recovery of domestic demand. **We estimate that the process of fiscal consolidation already initiated will continue in the following years**; in 2019, in particular, the deficit will be at a level equivalent to 2.3% of GDP, although this time the decrease will reflect the slowdown in investment. As a result, government gross debt will stand at around 26% of GDP over the next two years.

In the local exchange market, the Peruvian currency continued to show a tendency to depreciate at the end of 2018, mainly due to external factors: escalation of trade protectionist measures and greater concerns about the global growth deceleration, all this in an environment in which monetary policy in the United States was still in its course of adjustment. This situation changed somewhat in early 2019 as the FED has given cautious signals in its monetary normalisation plans, China is implementing economic stimuli to moderate the slowdown in activity, and trade tensions are perceived not to escalate further. In projection, we are considering that in 2019 there will be a significant supply of dollars on the commercial side (the surplus in the trade balance will be USD 6 billion, despite the decline in metal prices) and financial side (foreign direct investment to finance increased mining investment), as well as that the difference between the monetary policy interest rate of Peru and that of the United States will not continue to decrease (both interest rates will increase by 50 basis points this year). In this context, **the Peruvian currency will tend to appreciate in 2019 and will end the year at around 3.30**. We do not rule out, however, some episodes of volatility in the foreign exchange market.

On the price side, the outlook was relatively benign last year. In recent months inflation returned to the centre of the target range (2%, +/- one percentage point) and closed 2018 at 2.2%. With an output gap that is currently negative but will gradually close, a certain space that food prices still have to normalise, and the expected recovery of the WTI oil price (from USD/barrel 48 in December 2018 to USD/barrel 57 by the end of 2019), there will be some upward pressure on inflation in 2019, which will be constrained by the strengthening of the local currency. As a result, we expect **prices to rise at a rate of 2.3% by the end of this year**.

With inflation below 2% for much of 2018, inflationary expectations anchored around the target, and a negative output gap, the **Central Bank has continued to maintain the benchmark interest rate at 2.75%**. This level implies that the ex-ante real interest rate is 0.25%, so that **the monetary position is expansive** (the neutral real interest rate is around 1.75%). For the moment, the Central Bank seems to feel comfortable, especially considering the uncertainty about global growth. However, with inflation back on target and a negative output gap that will continue to close gradually (the activity is growing above its potential pace and will continue to do so in 2019), little by little, conditions are happening to start reducing the monetary stimulus. In this context, **we continue to foresee that the first increase in the policy rate (+25 bps, to 3.0%) will take place in the second quarter, when the outlook for some of the external risks currently in place will be somewhat clearer**, followed by another of the same magnitude towards the end of the year.

Lastly, as with any projection, there are risks that economic growth may deviate in 2019 and 2020 from what we are anticipating in our baseline scenario. The main ones are external: that protectionist measures continue to escalate in global trade, that the slowdown in the Chinese economy is even more accentuated than the one we are contemplating in the base scenario (due to disorderly deleveraging), and that there is an economic downturn in the US. In these cases, not only would the growth of local activity suffer due to lower external demand, lower prices of exported metals, and higher risk premiums, but financial variables such as the exchange rate would also be affected. The main risks on the local side are that progress in the construction of public infrastructure is even less than we are considering, that the weather anomalies per the *Niño Costero* are finally more intense, and that political noise increases and has a significant impact on business confidence and on investment in general.

Table 1 Peru | Macroeconomic projections

	2014	2015	2016	2017	2018 (f)	2019 (f)	2020 (f)
GDP (% chge.)	**2.4**	**3.3**	**4.0**	**2.5**	**3.9**	**3.9**	**3.7**
Domestic demand (excludes invent., % chge.)	**2.5**	**2.2**	**0.9**	**1.5**	**4.0**	**4.0**	**3.9**
Private spending (% chge.)	**2.3**	**1.9**	**1.2**	**2.0**	**3.9**	**4.3**	**3.6**
Private consumption (% chge.)	3.9	4.0	3.3	2.5	3.7	3.6	3.6
Private investment (% chge.)	-2.2	-4.2	-5.4	0.2	4.7	6.5	4.0
Public spending (% chge.)	**3.6**	**3.6**	**-0.3**	**-0.8**	**4.1**	**2.6**	**4.8**
Public consumption (% chge.)	6.0	9.8	-0.3	-0.2	1.7	3.7	3.1
Public investment (% chge.)	-1.1	-9.5	-0.2	-2.3	10.3	0.0	9.0
Exchange rate (vs USD, eop)	**2.96**	**3.39**	**3.40**	**3.25**	**3.37**	**3.30**	**3.34**
Inflation (YoY %, eop)	**3.2**	**4.4**	**3.2**	**1.4**	**2.2**	**2.3**	**2.5**
Policy interest rate (%, eop)	**3.50**	**3.75**	**4.25**	**3.25**	**2.75**	**3.25**	**3.50**
Fiscal balance (% GDP)	**-0.3**	**-2.0**	**-2.5**	**-3.1**	**-2.5**	**-2.3**	**-2.2**
Balance of payments: current account (% GDP)	**-4.4**	**-4.8**	**-2.7**	**-1.1**	**-2.2**	**-2.2**	**-2.2**
Exports (billions of USD)	39.5	34.4	37.1	45.3	48.5	49.0	49.8
Imports (billions of USD)	41.0	37.3	35.1	38.7	42.1	43.0	44.1

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