

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 of the same font. A small teal square is positioned to the right of the word "Research".

BBVA Research

Peru Economic Outlook

1Q19

24 January 2019

Creating Opportunities

Projections with information at 17 January

Key messages

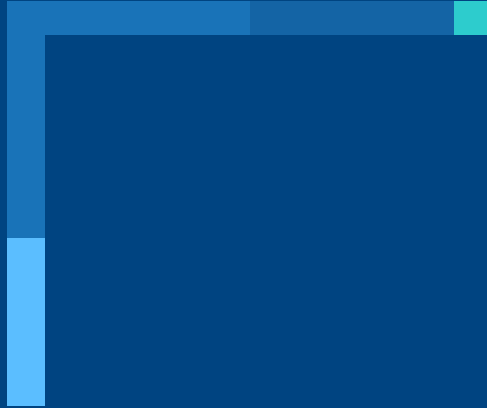
- **Economic activity gathered pace in the fourth quarter of last year.** Increased landings of anchoveta favoured fisheries and primary manufacturing. Construction also performed very well, within a panorama in which both the public and private investment improved. We estimate that **growth was 4.6% in 4Q18 and 3.9% for full-year 2018**
- **The baseline scenario for 2019 assumes** a less favourable environment on the external side: **global growth will moderate, the Fed will continue with the normalisation of its monetary policy,** and annual average **prices of metals and oil will fall. There will not** however be any **additional escalation of trade tensions**
- **On the home front,** our baseline scenario assumes that **investment in the mining sector will increase** (despite the fall in metal prices), **mining production will return to normal** after the problems faced last year, **business sentiment will remain generally favourable for investment, spending on reconstruction will accelerate** (especially in the second half of the year), and the **effect of the Coastal Niño will be mild**

Key messages

- **Against this backdrop, we forecast GDP growth of 3.9% in 2019.** This is a **similar forecast to last year** (in October): world growth in 2019 is now lower, but this is offset by lower interest rates in dollars, better terms of trade and the improved performance being shown by domestic demand
- **For 2020, the growth forecast is 3.7%.** There will thus be a degree of moderation relative to the two previous years due to the fact that **the boost from investment in mining will dissipate** and **world growth will continue to slow**. This will be partly offset by **recovery in public investment as regional governments' spending returns to normal** and construction of public infrastructure speeds up. This **growth forecast for 2020 is 0.2% lower than that of the previous year** (October) because world growth has been revised downwards
- On the currency markets, **the increased investment in mining** and the still **large trade surplus** will offset the effects of monetary normalisation in the US, such that the **Peruvian currency will tend to appreciate in 2019**. As a result, the exchange rate will end the year at around 3.30 soles to the dollar (3.37 in 2018). Bouts of exchange rate volatility cannot be ruled out

Key messages

- As for prices, **inflation finally returned to the middle of the target range**, ending 2018 at 2.2%. With a negative output gap that will gradually close, the remaining room for food prices to normalise, and the expected recovery in oil prices (at the end of the period), there will be some **upward pressure in 2019 on inflation**, which will be curbed by the appreciation of the Peruvian currency, **closing the year at 2.3%**
- The current monetary policy stance is expansive. With inflation back on target and an output gap that is closing, **little by little the conditions are falling into place for an initial increase in the reference interest rate, which we estimate will take place in the second quarter of the year (+ 0.25% to 3%)**, when the view of some of the current external risks will be somewhat clearer
- The **main risks to growth in 2019 and 2020 are external**: escalation of **trade protectionism**, a **more pronounced slowdown of China's economy** linked to financial deleveraging, and **the US going into recession**



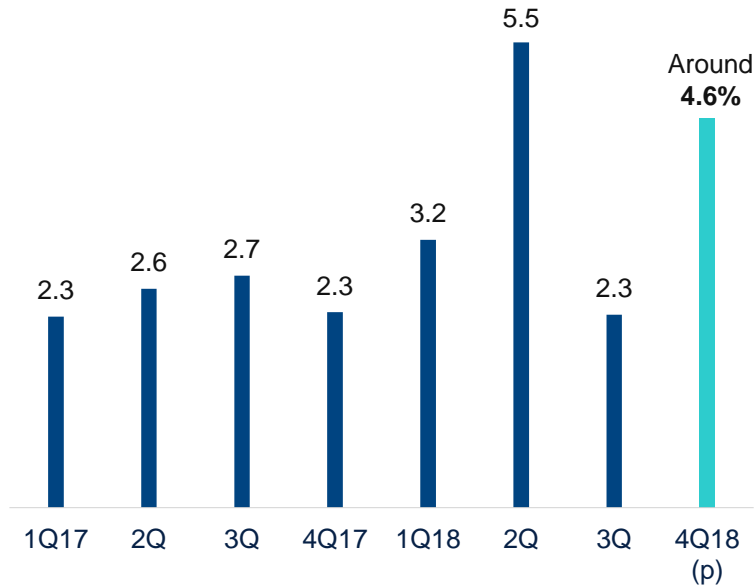
01

Economic activity

After a temporary moderation in the third quarter, growth in economic activity gathered pace in the last few months of 2018

GDP

(% change YoY)



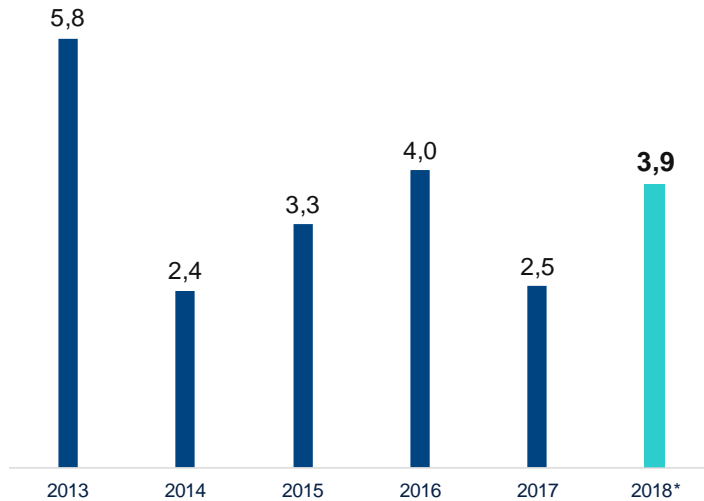
(p) Projection.

Source: Central Reserve Bank of Peru and BBVA Research

- Increased landings of anchoveta favoured fisheries and primary manufacturing in the fourth quarter, with a positive effect on quarterly GDP growth of between 1% and 1.5%
- Marked increase in construction, reflecting investment performance, particularly public investment
- Mining again declined due to difficulties in certain copper mines and the exhaustion of some gold seams
- On the expenditure side, as well as the surprising improvement in public investment, the improvement in private sector spending also stood out, both consumption and investment

As a result, GDP grew by around 3.9% in 2018

GDP (% change YoY)



* Estimated.

Source: Central Reserve Bank of Peru and BBVA Research



External environment

- Divergent performance from one half-year to the next.
- First half of the year with good performances from developed economies and China, with high metal prices.
- Second half with escalating trade tensions, moderating global growth, increased concerns about this, the Fed continuing to normalise its monetary policy and falling metal prices.



Domestic environment

- Normalisation of weather conditions after the Coastal Niño of 2017
- Ample monetary stimulus maintained
- Recovery of public and private investment
- Decline in mining output: transitory exploitation of low-grade ore and technical problems at major mines
- Political noise



**What do we forecast
for 2019 (and 2020)?**

The baseline scenario of macroeconomic forecasts for 2019 assumes that trade tensions will not escalate further and...

01

Moderation of world growth

02

Developed economies will continue to withdraw monetary stimulus measures

03

Slight improvement in terms of trade

04

Strong increase in investment in mining

05

Recovery of mining production

06

Business confidence relatively favourable for investment

07

Less fiscal and monetary stimulus

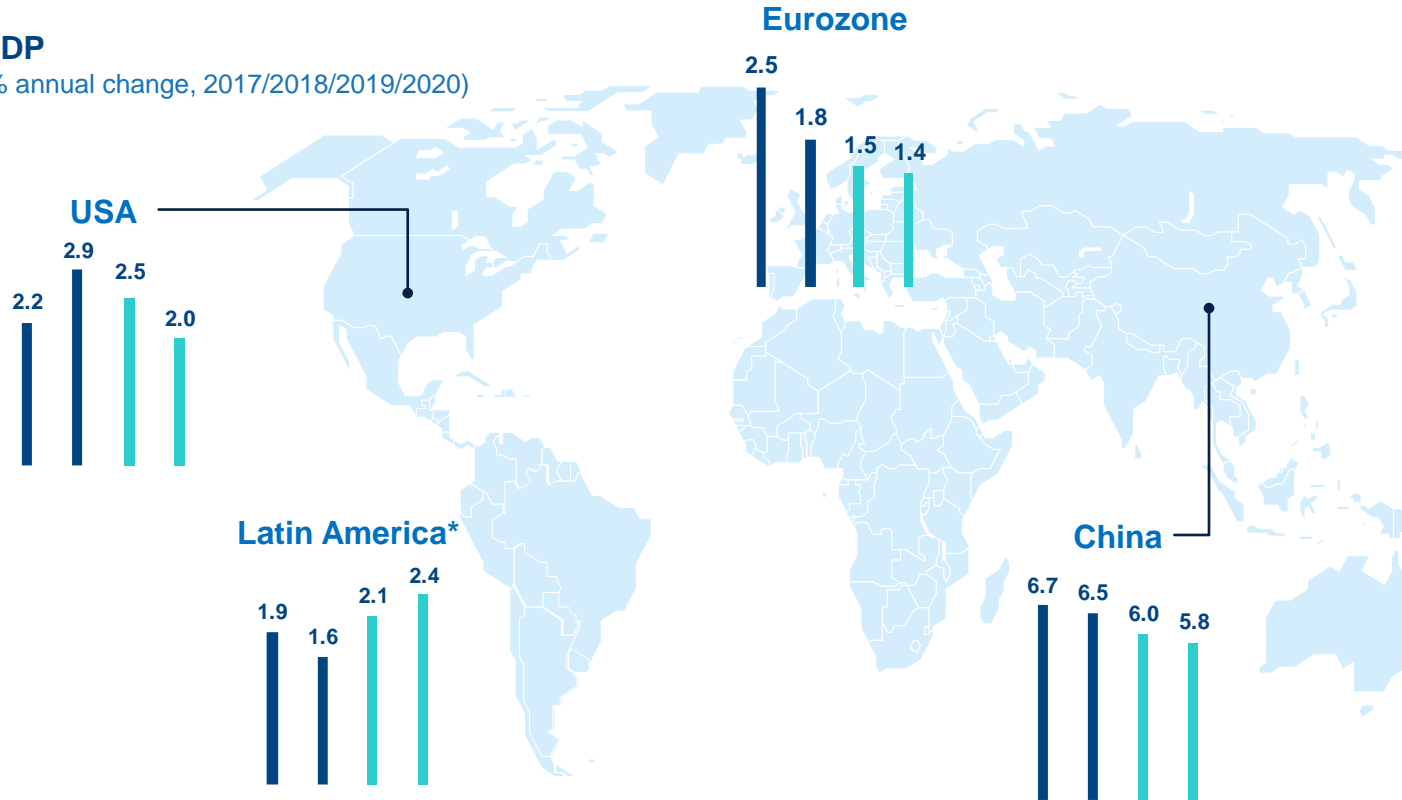
08

Mild Coastal Niño

World growth will moderate

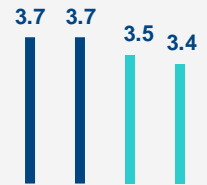
GDP

(% annual change, 2017/2018/2019/2020)



The forecast of world growth for 2019 and 2020 has been corrected downwards by 0.1 pp and 0.2 pp respectively to reflect similar revisions in the US, the eurozone and Latin America

World

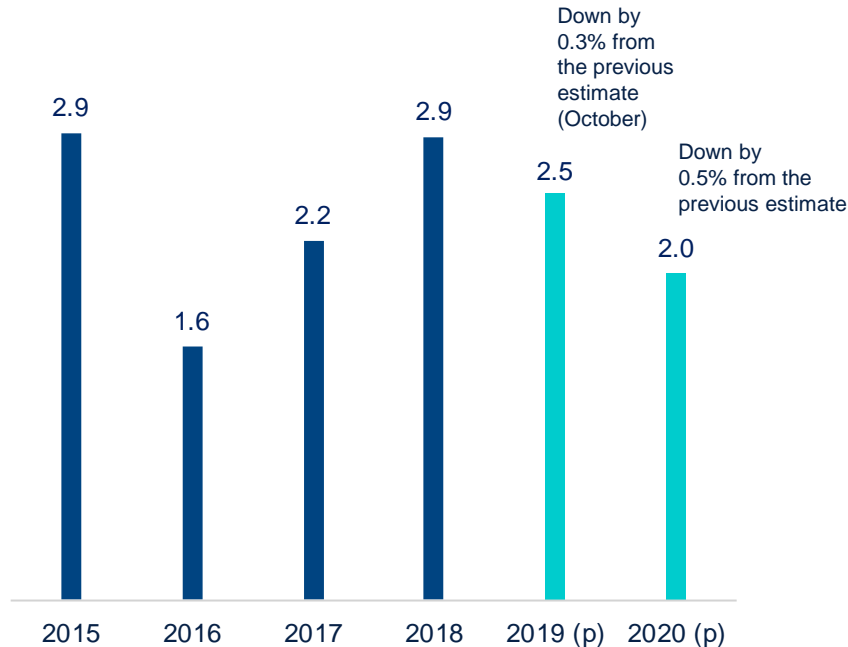


*Includes Argentina, Brazil, Chile, Colombia, Paraguay, Peru, Mexico and Uruguay

In the US in particular, growth will moderate as the effect of the fiscal stimulus fades, monetary tensions increase and the global environment weakens

USA GDP

(% change YoY)



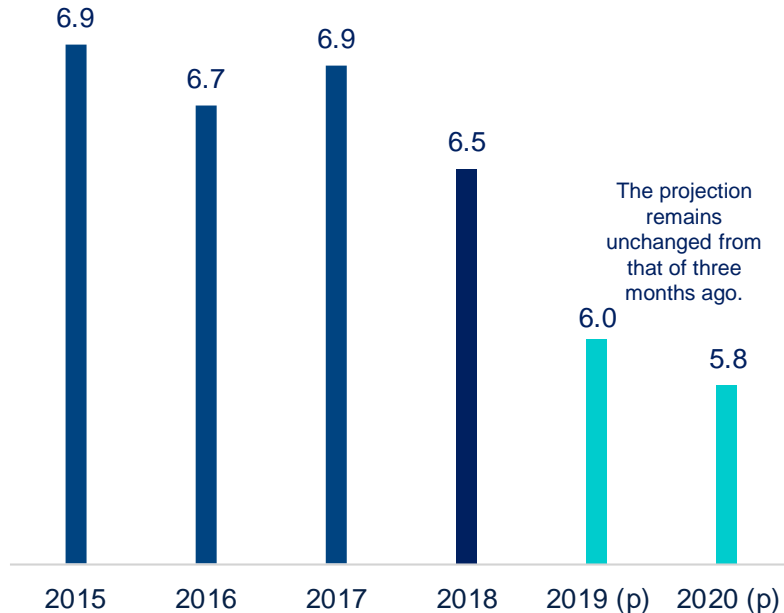
(p) Projection.

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

- Downward revision of GDP in view of **less optimistic outlook for private investment and public spending**
- **Private consumption will moderate** as the stimulus from the tax cut fades, despite the current strength of the labour market
- **Inflation remains above target, but will gradually fall until it is slightly below it in 2020**
- The downside risks have increased due to the worsening global environment. The **risk of recession is greatest at the two-year horizon**

In China, growth continued to slow in the fourth quarter, with the authorities' priority that of avoiding a sharp adjustment

China. GDP (% change YoY)



(p) Projection.

Source: BBVA Research based on CEIC data

- The growth forecasts are held unchanged in view of the implementation of greater stimulus measures to counter the intensification of the slowdown
- The support measures, both fiscal and monetary, are being extended, but at the same time the authorities are trying not to exacerbate existing financial vulnerabilities
- Protectionism remains the main risk. If it has to be offset by increased stimulus measures, this acts as a brake on the much-needed deleveraging process and may lead to a sharp depreciation of the renminbi

Developed countries' central banks, and in particular the Fed, will continue with monetary normalisation, but cautiously



Central bank balance sheet



- Balance sheet reduction continues (US\$550 billion in 2019)

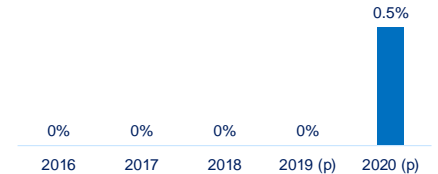
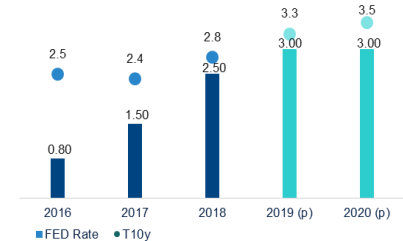
- End of QE (December 2018)
- Maturing QE instruments fully re-invested even after the start of the rate increases.



Interest rates

- The pause in the cycle of rate hikes is closer: two 0.25% hikes in 2019 (not three as in the previous forecast).

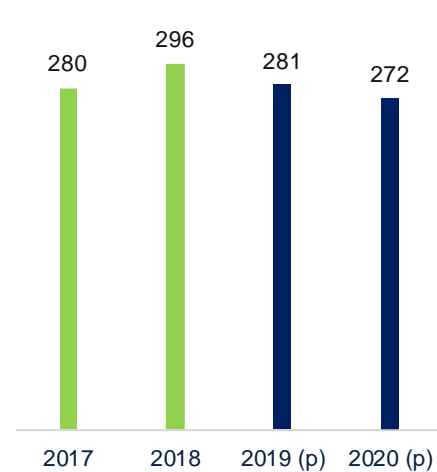
- Rate hike cycle deferred due to less favourable global outlook and greater risks.



Slight improvement in terms of trade in 2019 – although metal prices will slip, oil prices will fall by more

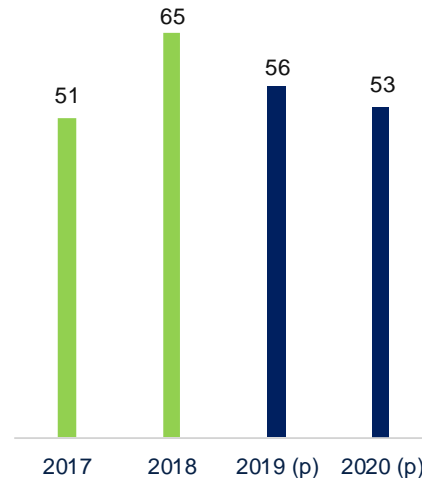
Price of copper

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



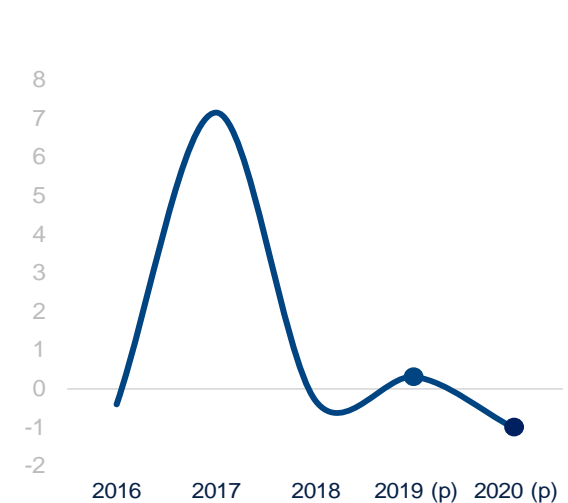
WTI oil price

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



Terms of trade

(Average for the period, % change YoY)



(p) Projection.

Source: Bloomberg, Central Bank of Peru and BBVA Research

Copper: lower prices in 2019 due to moderation of world growth, in particular that of China, and higher international interest rates. Low levels of inventory provide support

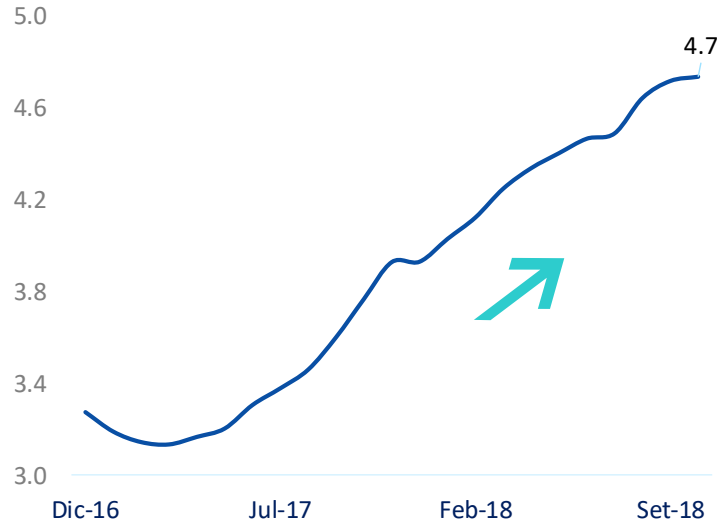
Oil: fall in prices in 2019 due to increased US supply and lower global demand

Relative to the previous forecast, projected prices for copper and oil in 2019 are lower. The adjustment is more intense in the latter, for which reason the terms of trade improve (previously they worsened in 2019)

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

Investment in mining

(Cumulative over the past twelve months, US\$ billions)



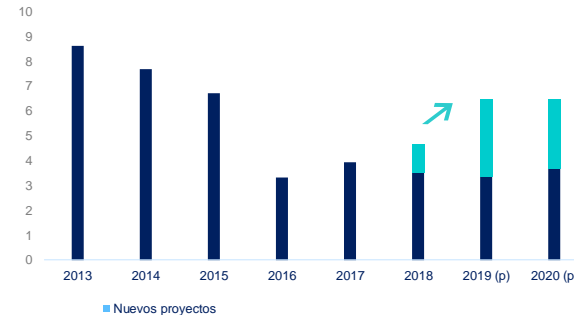
Source: MINEM and BBVA Research

Main mines currently under construction (US\$ millions)

Project	Estimated investment	Construction period
Quellaveco	5,300	2S18 - 2021
Mina Justa	1,600	2S18 - 2019
Toromocho Extension	1,300	2S18 - 2019

Investment in mining

(US\$ billions)



Production costs of mines under construction,

approximated by the cash cost, stand at **between US\$1.00 and US\$1.40 per pound of copper** (the price of copper is currently just over US\$2.60 per pound).

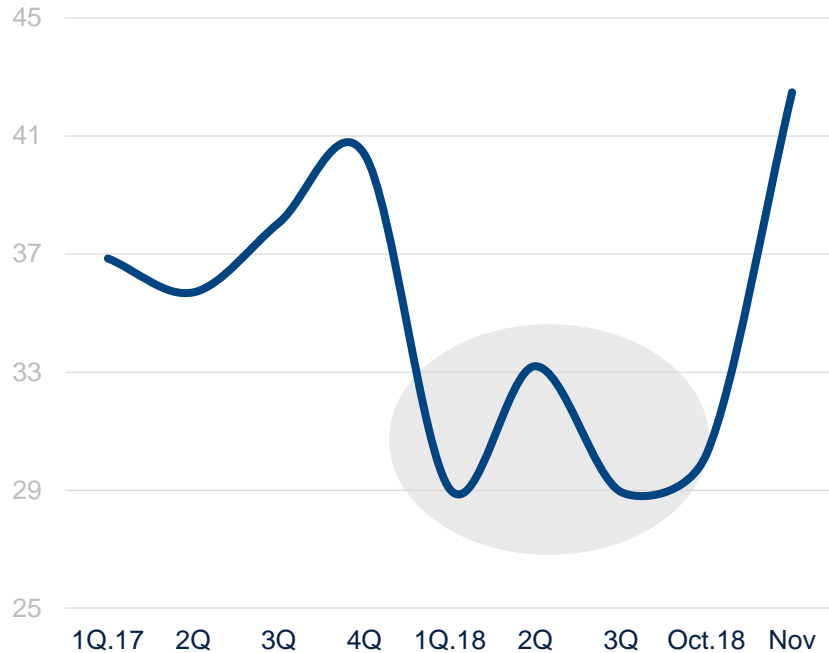
* Investment in new projects refers to Quellaveco, Mina Justa, the expansion of Toromocho and two other smaller mines.

(p) Projection.

Source: MINEM and BBVA Research

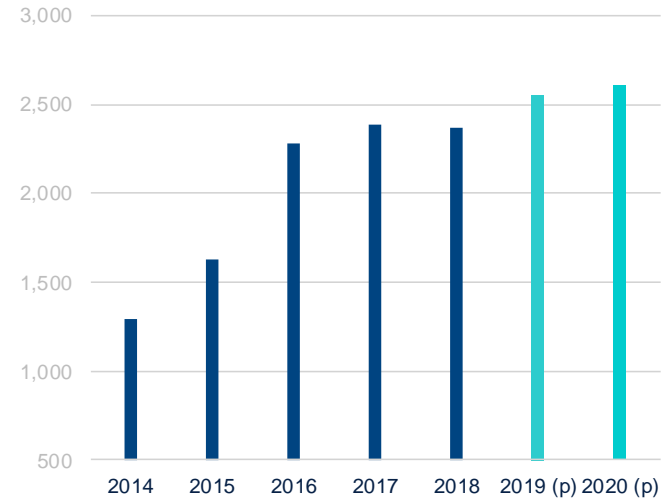
Added to this is the normalisation of mining output in 2019 after the problems faced last year in certain copper mines

Copper production of Las Bambas
(thousands of metric tons, monthly average)



Source: MINEM and BBVA Research

Copper production*
(thousands of metric tons)



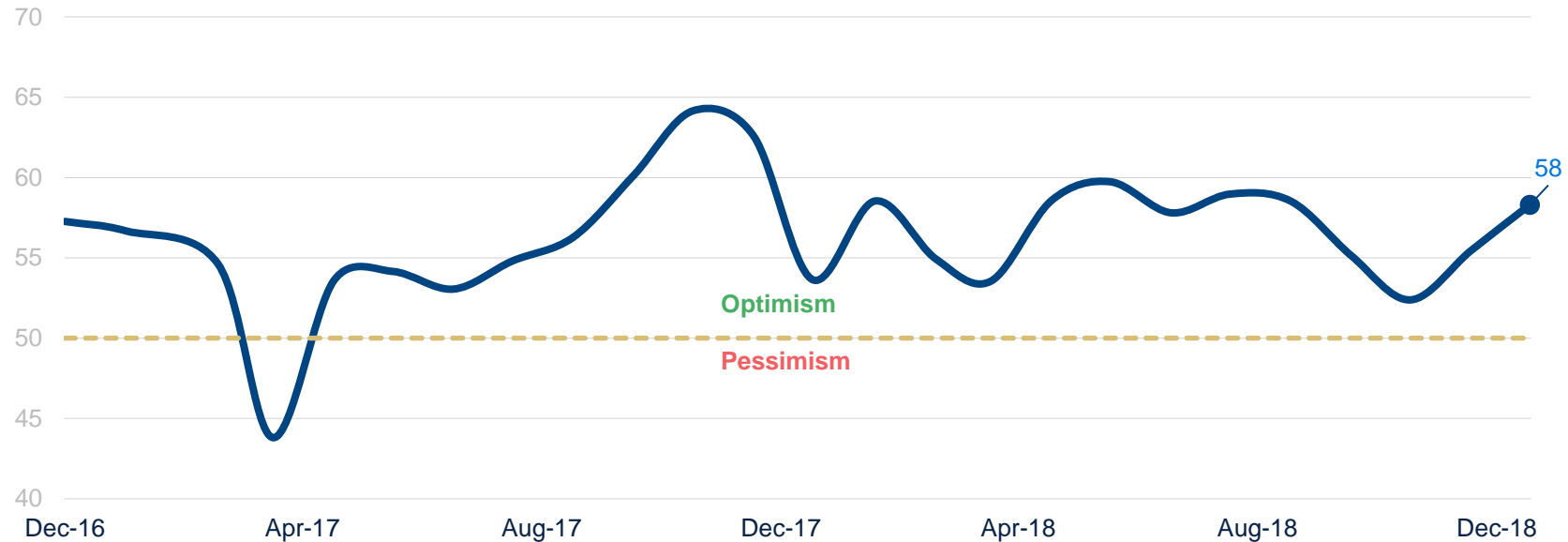
Takes account of the **increased output of Toquepala** due to extension of the mine and the **normalisation of production at Las Bambas**

(p) Projection.
Source: MINEM and BBVA Research

Forecasts also assume that business confidence will be relatively favourable for investment

Business confidence

(Points)



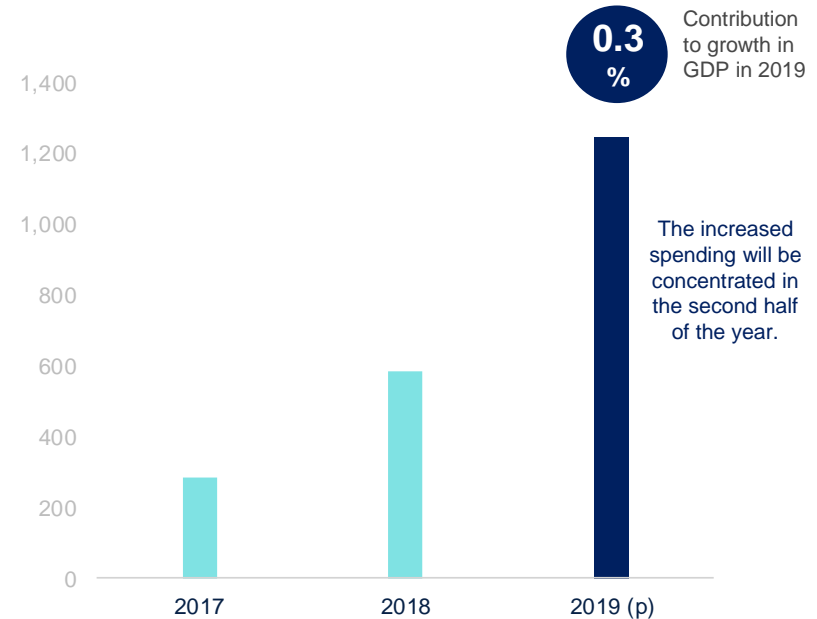
... and that spending on reconstruction of the North of the country will accelerate, especially in the second half of the year

Spending on reconstruction of the North of the country
(USD millions)



Source: MEF-SIAF (Integrated Financial Administration System)

Spending on reconstruction of the North of the country
(USD millions)



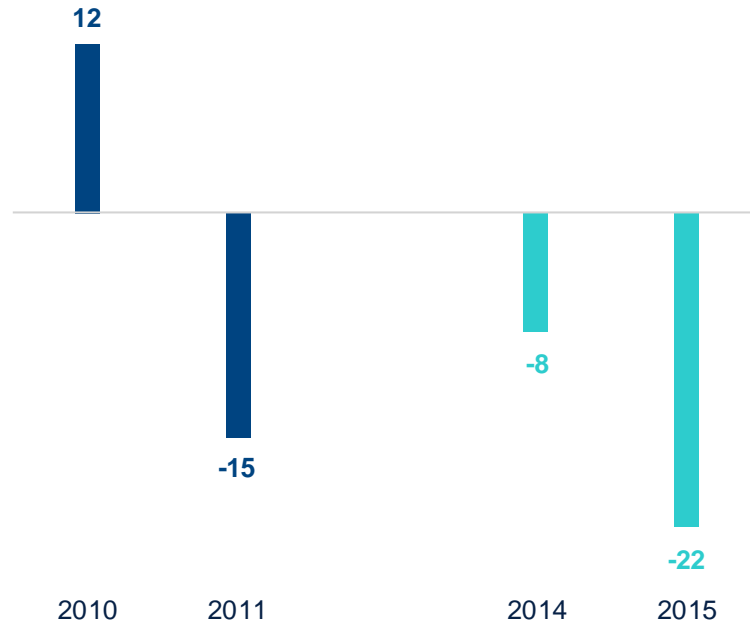
(p) Projection.

Source: MEF-SIAF (Integrated Financial Administration System)

However, the change of regional authorities is likely to act, as on previous occasions, as a temporary brake on public investment in 2019

Regional authorities' investment in the year in which new authorities are elected and the next*.

(in real terms, % change YoY)



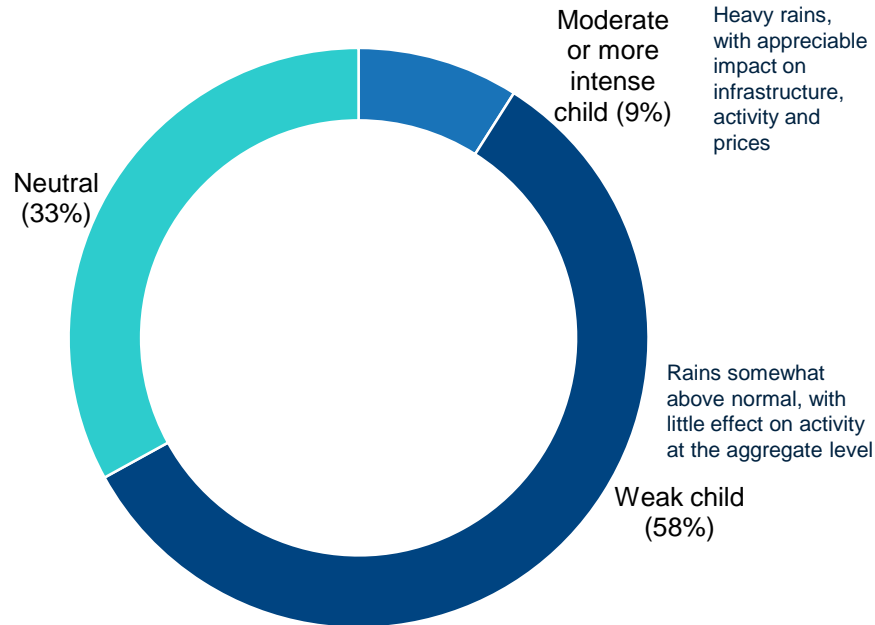
* Includes regional and local governments, which together are responsible for approximately 60% of the Central Government's public investment.

Source: Central Reserve Bank of Peru and BBVA Research

- 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 on this occasion

Finally, the baseline scenario assumes a weak Coastal Niño

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



Source: ENFEN (official body for the study of El Niño), December 2018



ENFEN OFFICIAL STATEMENT No. 02-2019

Callao, January 18, 2019

State of alert system: **Alert for El Niño**

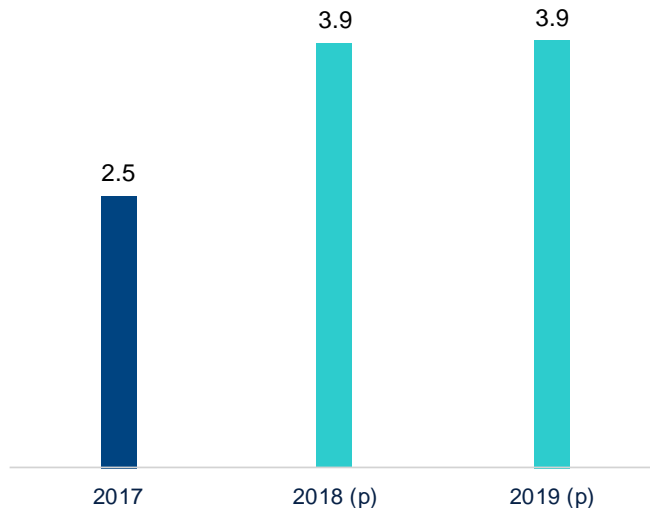
ENFEN, the Multisectoral Commission, maintains active the status Alert for an El Niño phenomenon of weak magnitude, due to the expected arrival of a warm Kelvin wave and abnormal weakening of the South Pacific anticyclone in March, according to forecasts.

In the remainder of the summer, the northern coast of Peru is more likely to experience the occurrence of rainfall within the normal to superior range, but not extraordinary as that developed in the years 1983, 1998 and 2017. In addition, we do not rule out the possibility of specific events with rainy days, particularly in March.

In this context, we project that GDP will grow by 3.9% in 2019

GDP

(% change YoY)

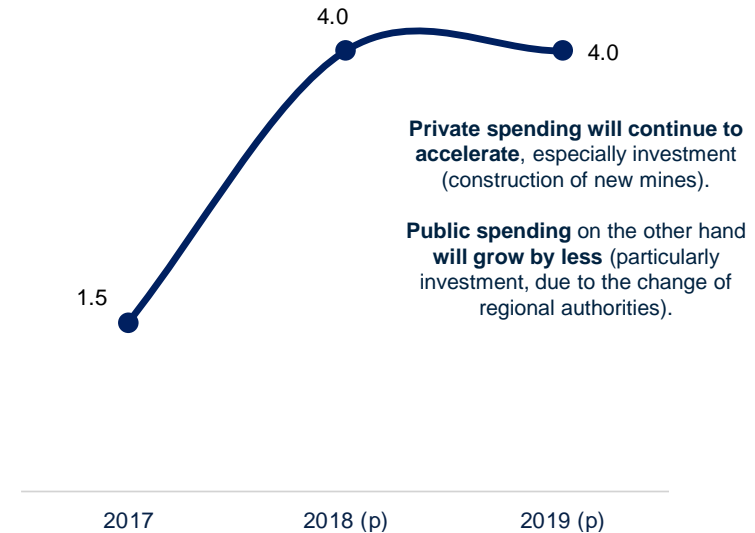


(p) Projection.

Source: Central Reserve Bank of Peru and BBVA Research

Domestic sales

(Domestic demand excluding build-up of inventories, % change YoY)



(p) Projection.

Source: Central Reserve Bank of Peru and BBVA Research

Private spending will continue to accelerate, especially investment (construction of new mines).

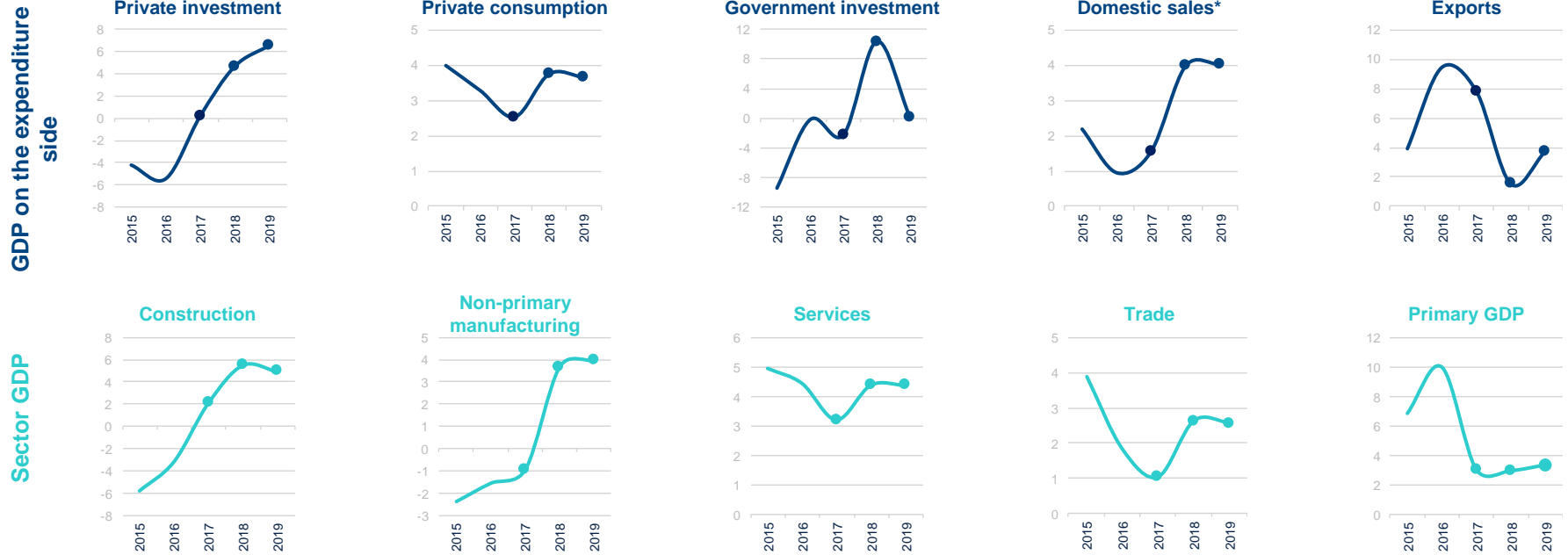
Public spending on the other hand will grow by less (particularly investment, due to the change of regional authorities).

There are no changes in the growth projection for 2019, which is held at 3.9% since although world growth has been adjusted downwards, dollar interest rates will be lower, the terms of trade have improved and growth in domestic demand is becoming more robust

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

GDP: selected components by expenditure and sector

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



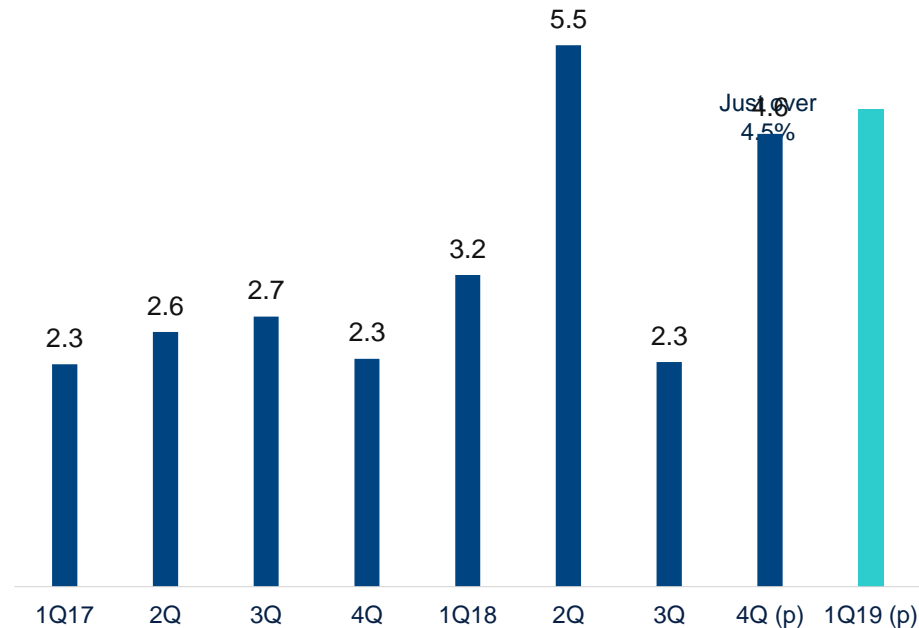
* Corresponds to domestic demand, but excludes build-up of inventories

Source: Central Reserve Bank of Peru and BBVA Research

First quarter of the year? We estimate that growth will not be very different from that of the previous quarter

GDP

(change % YoY)



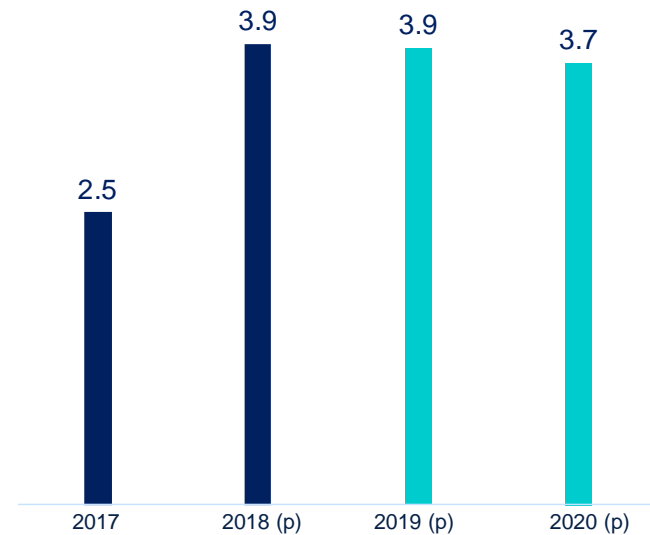
- In the first quarter, there will be a more appreciable impact on activity of investment in new mining projects
- Uptick in mining output: normalisation of copper production.
- Positive statistical effect of Holy Week, which in 2019 falls in April (low YoY comparative base in March)
- Less growth in public investment in a context of changes taking place within the regional authorities

(p) Projection.

Source: Central Reserve Bank of Peru and BBVA Research

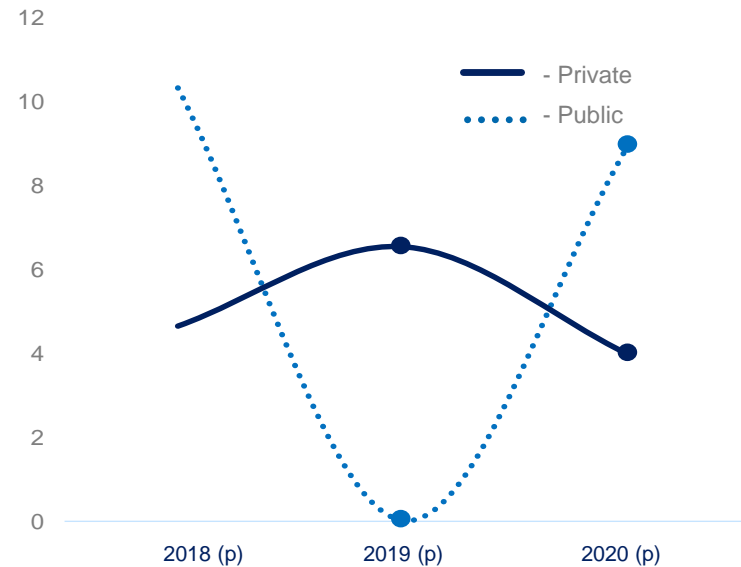
In 2020 growth will moderate relative to the two previous years...

GDP (% change YoY)



The growth forecast for 2020 is **0.2% lower than that of the previous year** (October) as world growth has been revised downwards

Investment (% change YoY)



(p) Projection.

Source: Central Reserve Bank of Peru and BBVA Research

...due to the fact that the **boost from investment in mining will dissipate** and **world growth will continue to slow**. This will be partly offset by a **recovery in public investment** as regional authorities' spending returns to normal and construction of public infrastructure accelerates

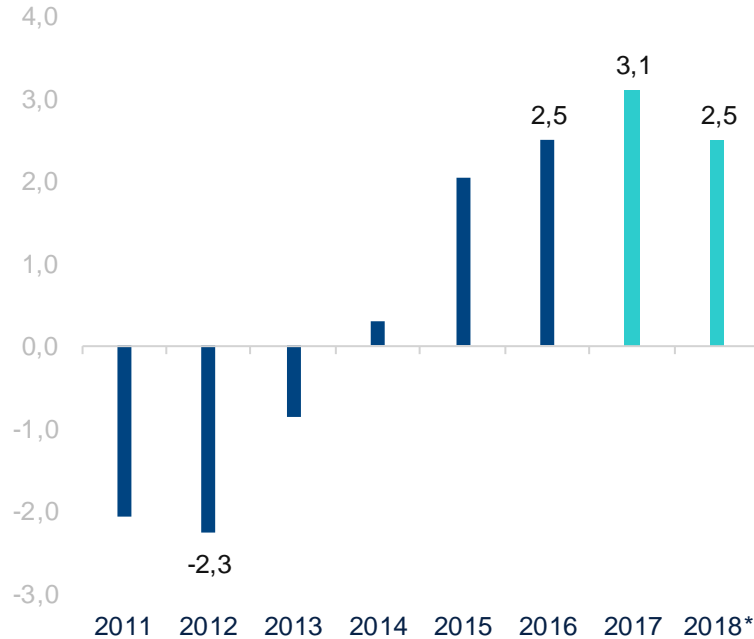


02

Fiscal and external accounts

On the fiscal side, the deficit was reduced in 2018, due in particular to the improvement in revenues

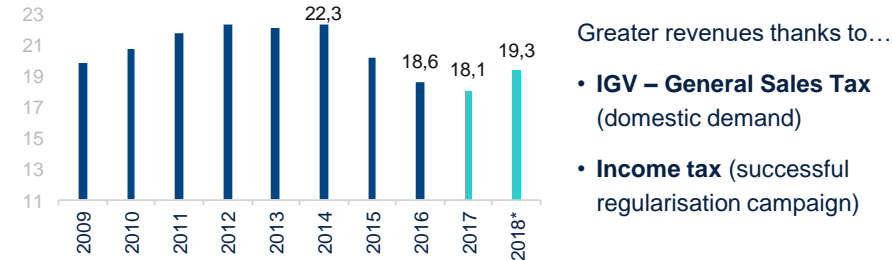
Fiscal deficit (% of GDP)



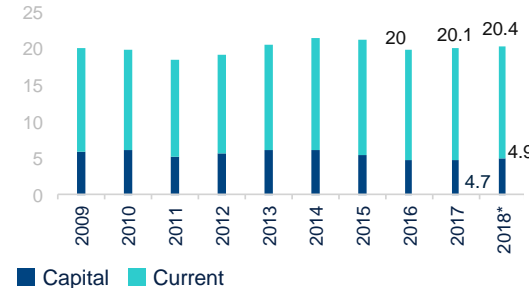
*Estimated

Source: Central Reserve Bank of Peru and BBVA Research

Central government tax revenues (% of GDP)

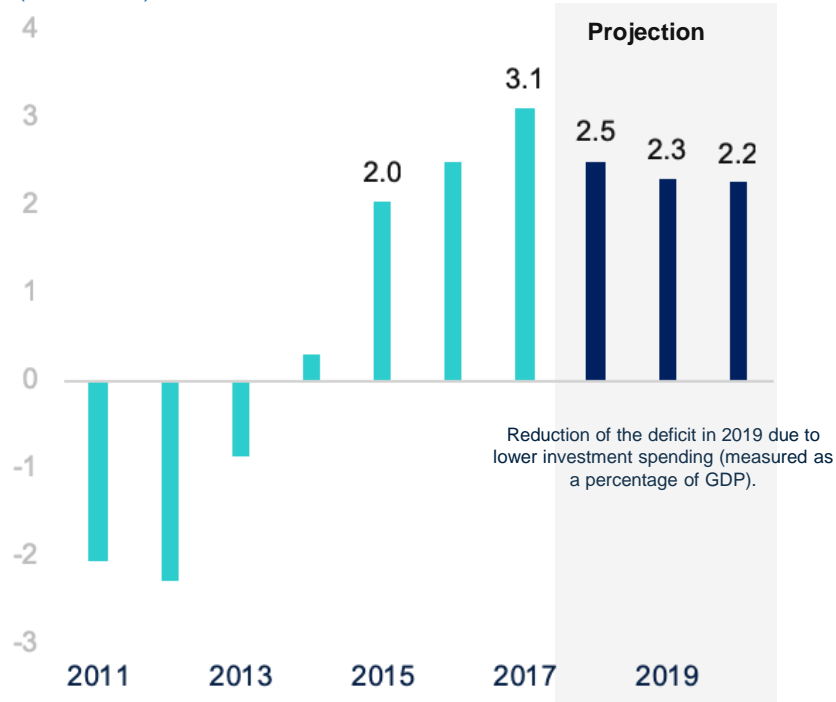


Central government fiscal expenditure (% of GDP)



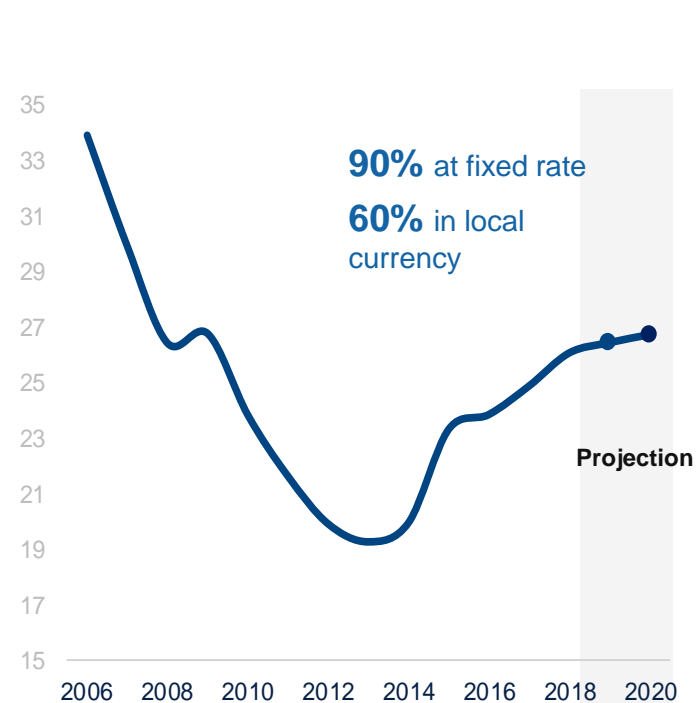
We estimate that the process of fiscal consolidation that started last year will continue going forward

Fiscal deficit (% of GDP)



Source: Central Reserve Bank of Peru and BBVA Research

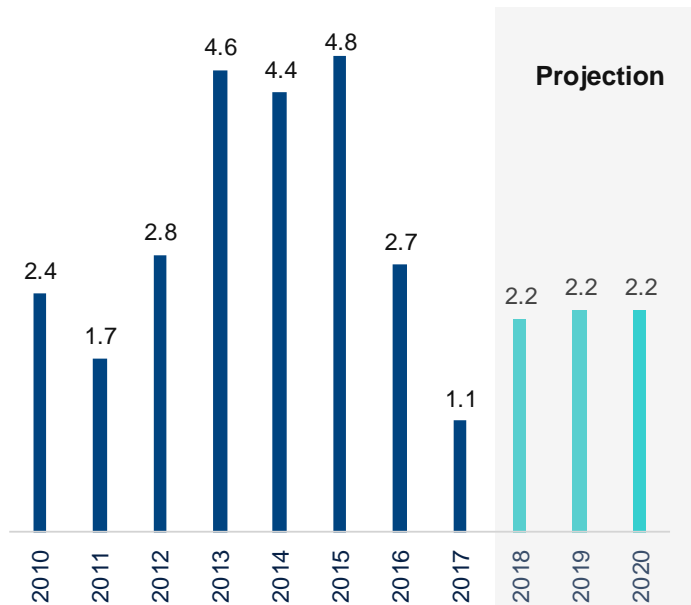
Gross public debt (% of GDP)



Source: Central Reserve Bank of Peru and BBVA Research

External accounts: limited current account deficit consistent with a large trade surplus

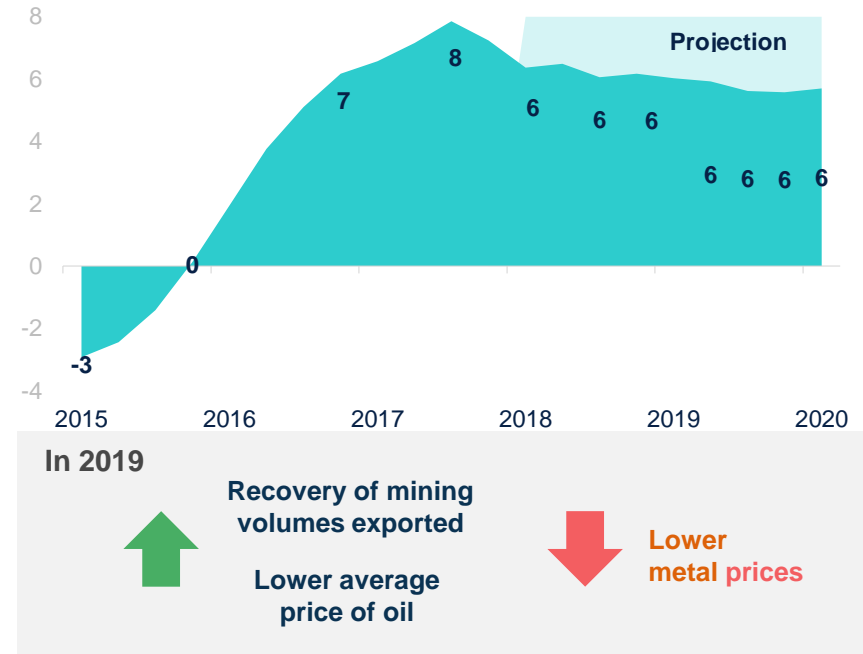
Current account deficit (% of GDP)



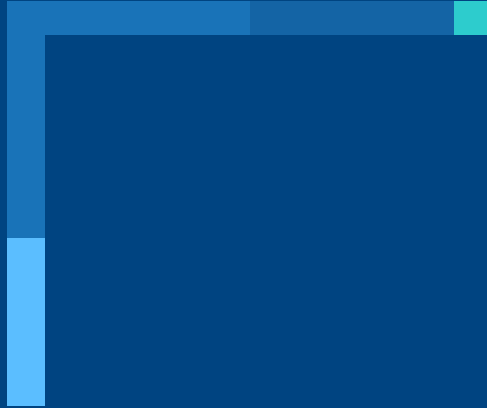
Source: Central Reserve Bank of Peru and BBVA Research

Balance of trade

(US\$ billions, cumulative for the last four quarters)



Source: Central Reserve Bank of Peru and BBVA Research

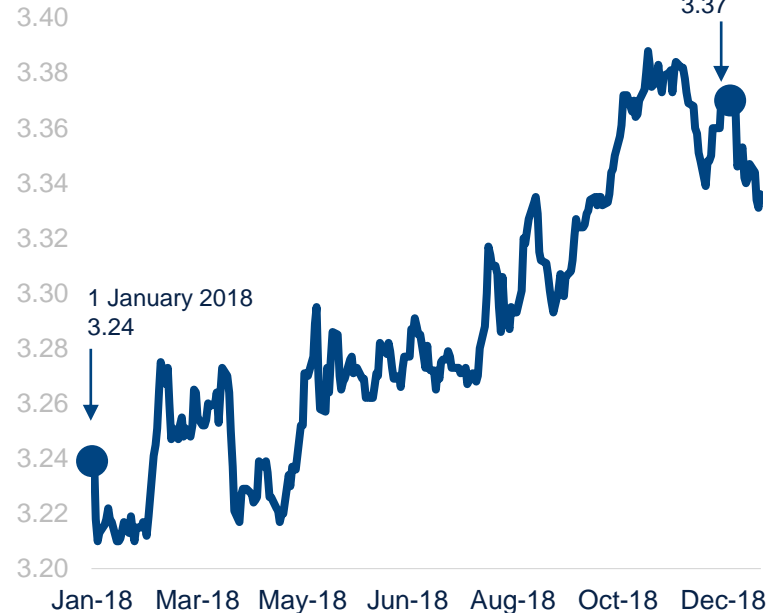


03

Currency markets

PEN tending to depreciate in 2018, especially due to external factors, but the situation improved at the beginning of this year

Exchange rate (USD/PEN)



*At 17 January.
Source: Bloomberg

2018

Depreciatory pressures due to external factors:

- Normalisation of monetary policy in the US
- Uncertainty as to the worldwide impact of trade tensions
- Concerns about the slowdown in global growth

Depreciation curbed by solid macroeconomic fundamentals.

There were interventions by the Central Bank, but these were few and far between.

2019

The PEN has strengthened in a context in which...

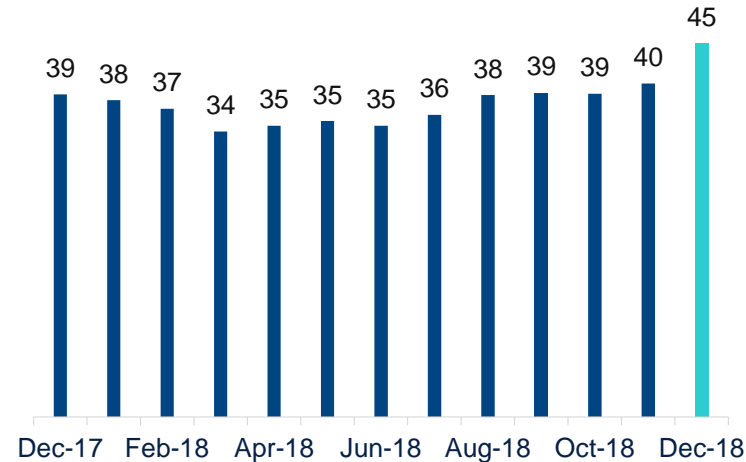
- The Fed is being more cautious about upcoming rate hikes.
- China is implementing monetary stimulus measures and has announced a fiscal stimulus.
- Expectations are that trade tensions will not escalate further.

The Central Bank has allowed many of the currency swaps it carried out to mature.

Currency pressures originating in the forward currency market, since in the sovereign debt market foreigners have continued to increase their holdings

Holdings of sovereign bonds by foreigners

(PEN billions)

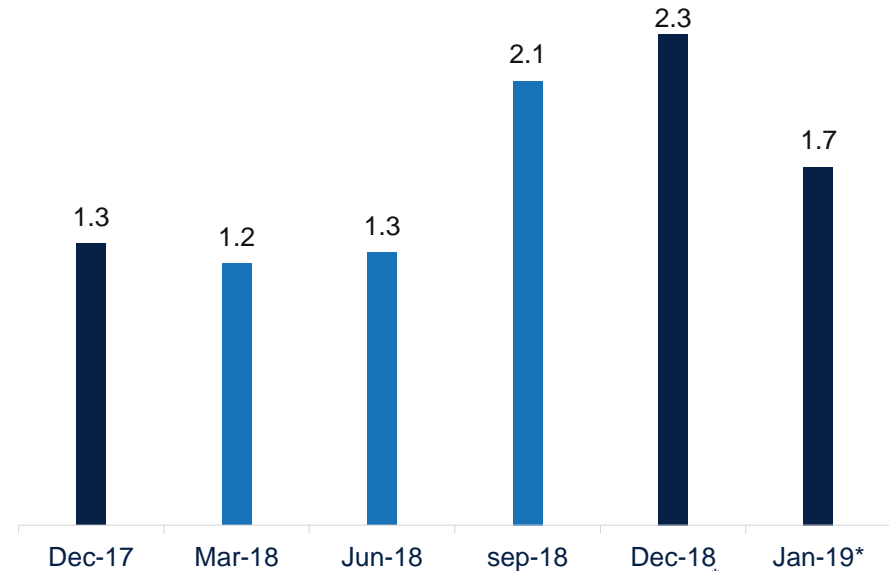


Share of foreigners in holdings of sovereign bonds

December 2017	March 2018	June 2018	September 2018	December 2018
45%	39%	39%	42%	44%

Net balance of non-delivery forwards

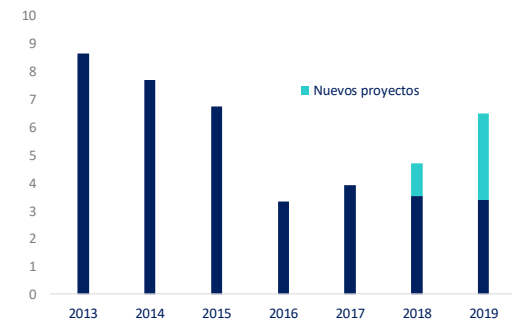
(Sales less purchases, from the point of view of the banks, in US\$ billions)



Looking ahead, various factors point to the PEN tending to appreciate in 2019

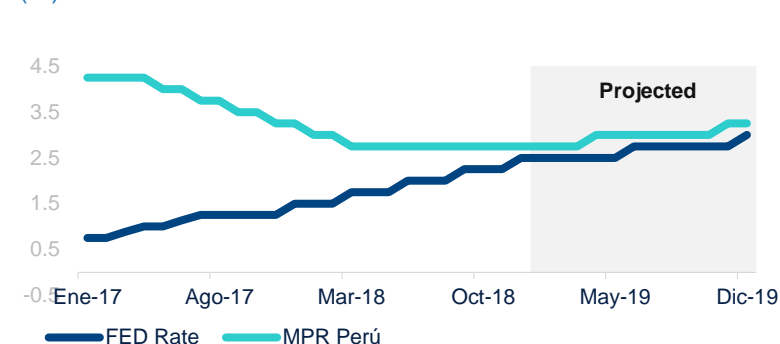
Investment in mining

(US\$ billions)



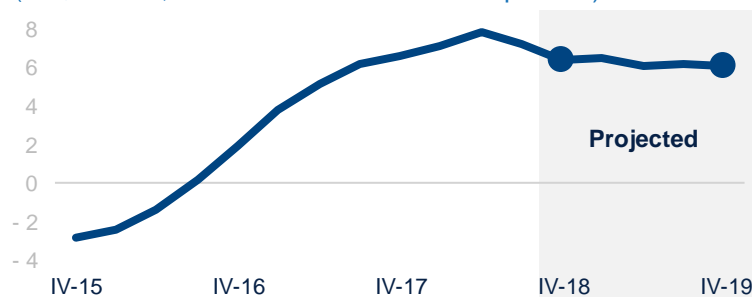
Monetary policy rate

(%)



Trade surplus

(US\$ billions, cumulative for the last four quarters)

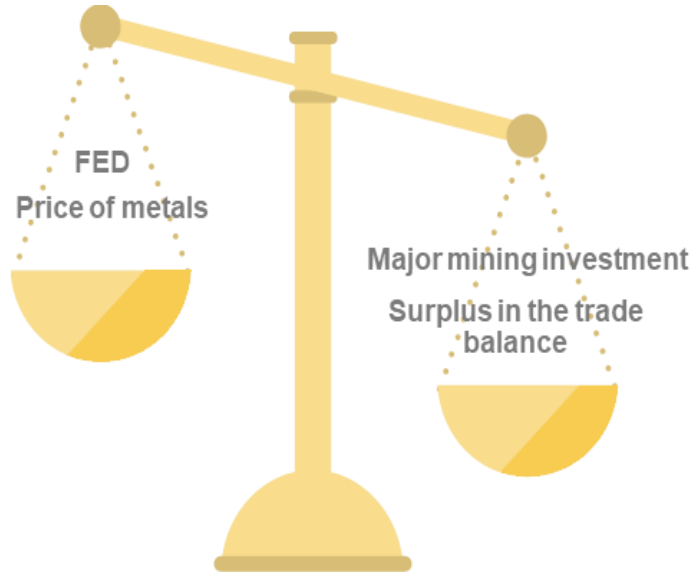


Macroeconomic fundamentals remain solid

Trade tensions will ease, and with them uncertainty at a global level, especially in the second half of 2019

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

Factors determining the exchange rate in 2019



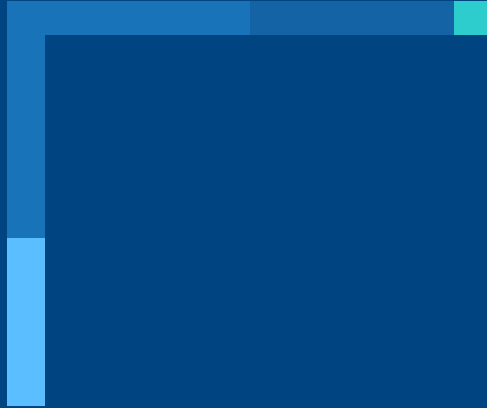
Source: Central Reserve Bank of Peru and BBVA Research

Exchange rate (USD/PEN, monthly average)



Source: Central Reserve Bank of Peru and BBVA Research

Possible bouts of high volatility on the currency markets cannot be ruled out



04

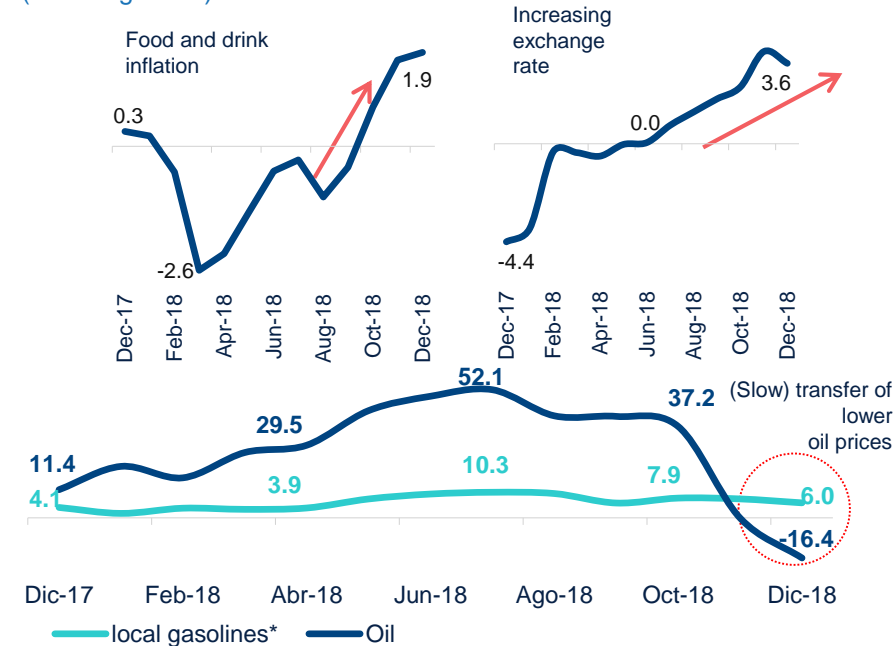
Inflation

The outlook for prices is relatively positive...

Total inflation
(% change YoY CPI)



The normalisation of inflation in the past few months reflects...
(% change YoY)



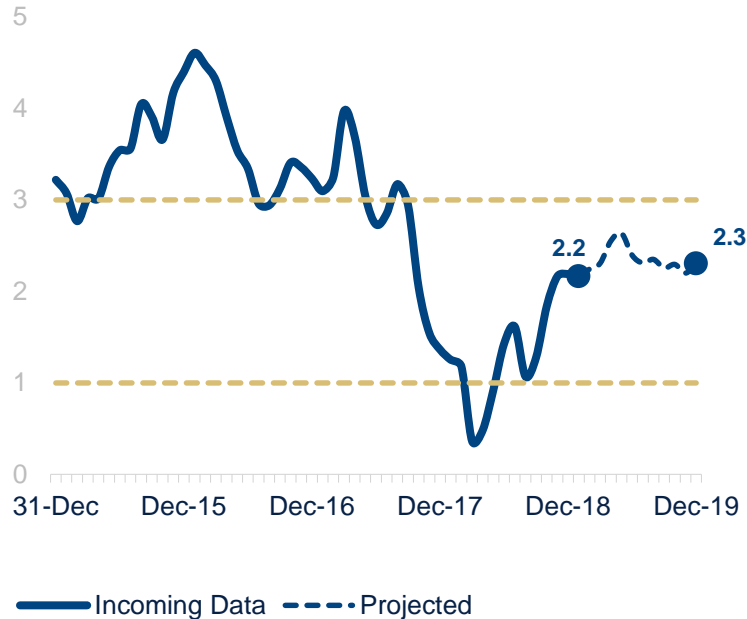
Source: INEI (National Statistics & IT Institute) and BBVA Research

* Approximated with the "Cost of use of vehicles" component of the CPI
Source: INEI (National Statistics & IT Institute) and BBVA Research

... and we expect this to continue in 2019

Total inflation

(% change YoY CPI)



Source: Central Reserve Bank of Peru and BBVA Research

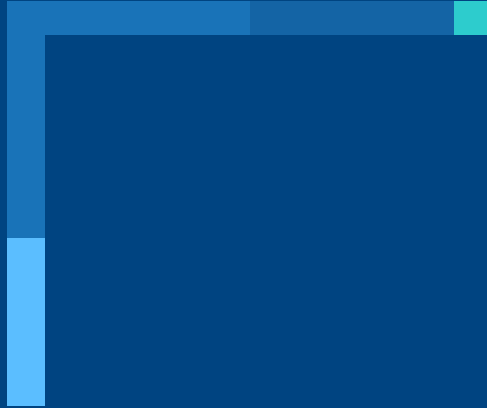


Factors pushing upwards

- **Negative output gap** will continue to close
- There is still some room for further correction in **food prices** (in the past few years this heading increased at an average of just over 3%).
- **Normalisation of the oil price** (end of the period) following the sharp fall at the end of 2018 (although the impact on domestic fuel prices will be moderate, affecting margins more).

Factors pushing downwards

- **Appreciation** of the local currency

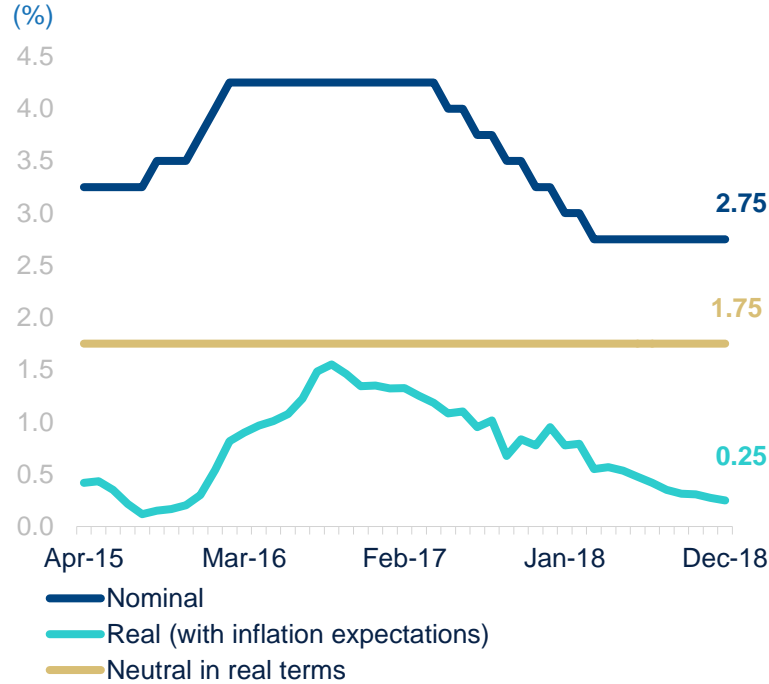


05

Monetary policy rate

The monetary policy stance is currently expansive, and the Central Bank seems to feel at ease with this for the time being

Monetary policy reference rate

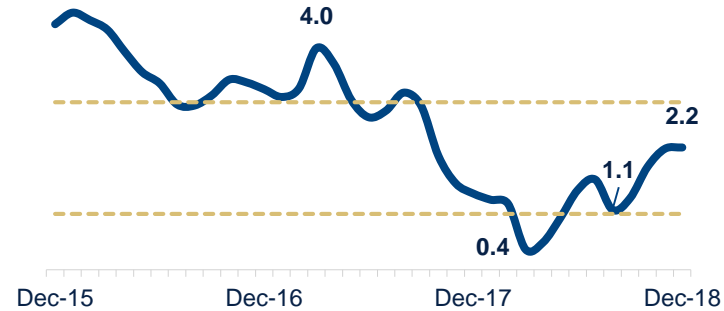


- Inflation has returned to its target level
- Inflationary trend measures and inflationary expectations between 2% and 2.5%
- Although growth is accelerating, the output gap is still negative...
- ... and there is uncertainty about world growth

Little by little the conditions are falling into place for an initial increase in the policy rate...

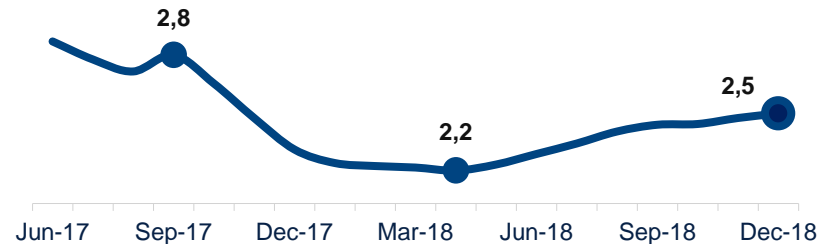
Total inflation

(% change YoY CPI)



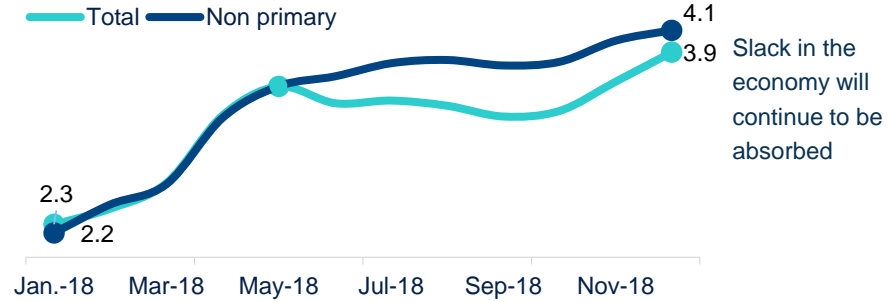
Inflationary expectations one year ahead

(%)



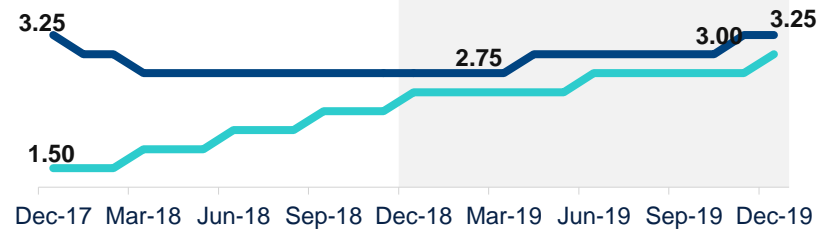
GDP

(cumulative in the past twelve months, % change YoY)



Monetary policy rate

(%)



... which we continue to foresee in the second quarter, to be followed by another rise at year-end

Monetary policy rate



BBVA Research projection?

- Policy rate at its current level of 2.75% until 1Q19 to consolidate the economic recovery and in a context of external uncertainty
- Consolidation of activity and gradual easing of external uncertainty will lead the central bank to raise its interest rates in 2Q19 (and again by 25 bps in 4Q19)



06

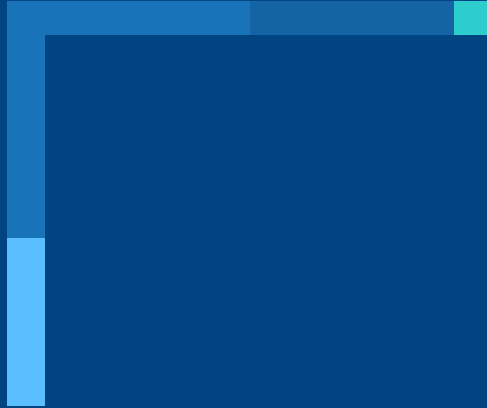
Summary of macroeconomic projections

Macroeconomic projections

	2014	2015	2016	2017	2018 (f)	2019 (f)	2020 (f)
GDP (% change)	2.4	3.3	4	2.5	3.9	3.9	3.7
Domestic demand (excl. inventory, % change)	2.5	2.2	0.9	1.5	4	4	3.9
Private spending (% change)	2.3	1.9	1.2	2	3.9	4.3	3.6
Private consumption (% change)	3.9	4	3.3	2.5	3.7	3.6	3.6
Private investment (% change)	-2.2	-4.2	-5.4	0.2	4.7	6.5	4
Public spending (% change)	3.6	3.6	-0.3	-0.8	4.1	2.6	4.8
Public consumption (% change)	6	9.8	-0.3	-0.2	1.7	3.7	3.1
Public investment (% change)	-1.1	-9.5	-0.2	-2.3	10.3	0	9
Exchange rate (vs. USD, EOP)	2.96	3.39	3.4	3.25	3.37	3.3	3.34
Inflation (% YoY, EOP)	3.2	4.4	3.2	1.4	2.2	2.3	2.5
Policy interest rate (% , EOP)	3.5	3.75	4.25	3.25	2.75	3.25	3.5
Fiscal balance (% of GDP)	-0.3	-2	-2.5	-3.1	-2.5	-2.3	-2.2
Balance of payments: current account (% of GDP)	-4.4	-4.8	-2.7	-1.1	-2.2	-2.2	-2.2
Exports (US\$ billions)	39.5	34.4	37.1	45.3	48.5	49	49.8
Imports (US\$ billions)	41	37.3	35.1	38.7	42.1	43	44.1

Forecast closing date: 17 January 2019.

Source: Central Reserve Bank of Peru and BBVA Research Peru



07

Risks

Main risks to the baseline scenario of macro projections for 2019 and 2020



External



Trade protectionism



Imbalances in China (disorderly deleveraging)



Economic recession in the US



Domestic



Less progress on public infrastructure projects



More political noise, with an appreciable impact on business confidence and investment in general



A moderate or strong Coastal Niño



08

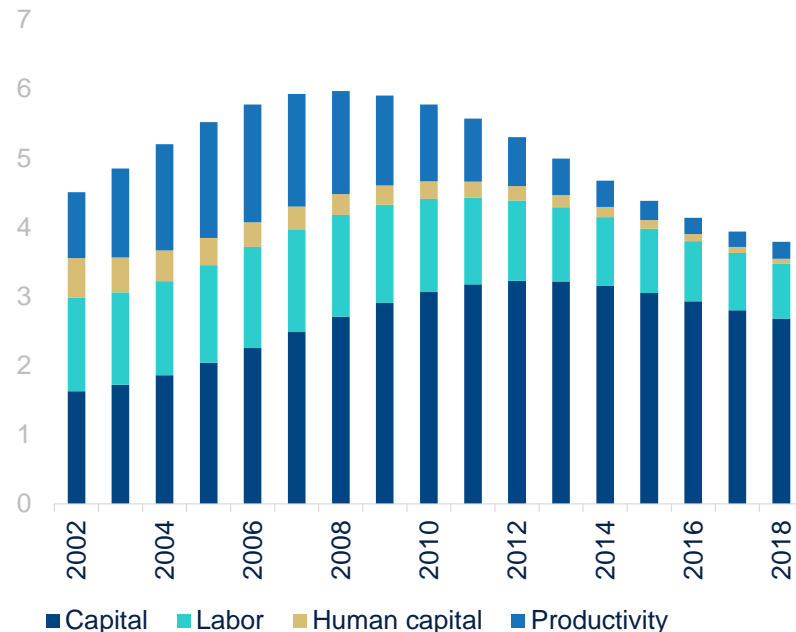
**Economic growth in
the medium/long term**

We estimate that the potential growth rate of the Peruvian economy has declined in the past ten years to currently stand at 3.7%

Productivity gains are constantly declining. Moreover, the country's competitiveness has also declined

Potential GDP

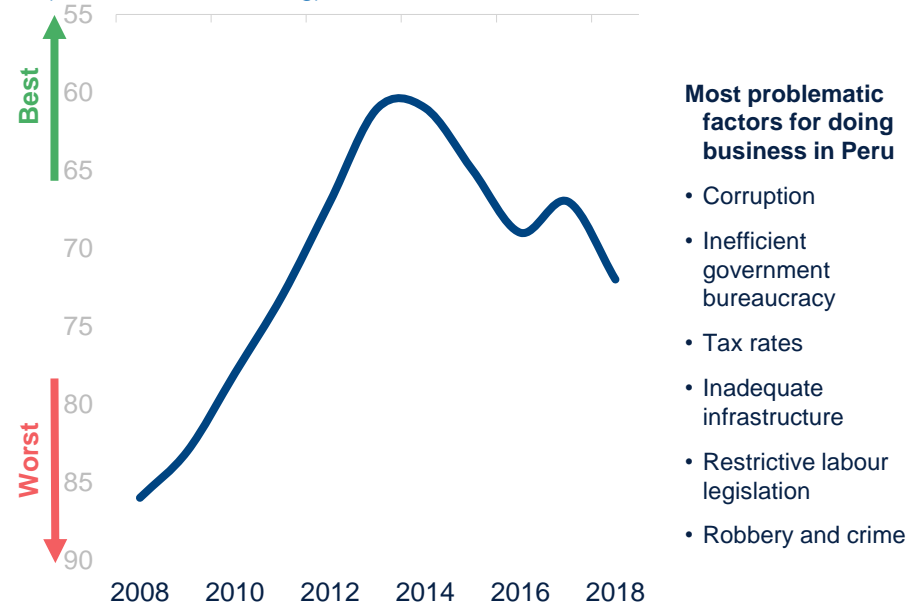
(% change YoY; contribution to growth of potential GDP in percentage points)



Source: BBVA Research, [Peru Economic Watch 14 April 2016](#) (available in Spanish only)

Peru in the Global Competitiveness Index

(Position in the ranking)



Source: World Economic Forum

In this context, the government promulgated the National Competitiveness and Productivity Plan (PNCP)

Infrastructure



To equip the country with quality economic and social infrastructure by means of efforts directed to planning and efficient prioritisation of infrastructure. Incorporates a regional approach geared to the efficient exploitation of the country's comparative advantages.

Human capital



To strengthen human capital by prioritising the optimisation of services for the strengthening of skills and for the certification of workplace skills

Innovation



To generate the development of capacity for innovation, adoption and transfer of technological improvements

Funding



To promote domestic and external financing mechanisms by generating financial instruments that meet business needs.

Labour market



To create the conditions for a dynamic and competitive labour market so as to generate formal employment.

Business environment



To generate the conditions in which to develop a productive business environment by means of administrative simplification and the improvement of instruments of productive development and partnership and cooperation.

Foreign trade



To facilitate the conditions for foreign trade by developing a diversified and competitive range of exports.

Institutions



To strengthen the country's institutions by improving the administration of justice and passing measures to promote public integrity and facilitate the combating of corruption.

Environmental sustainability



To promote environmental sustainability in economic activities by promoting the circular economy in the markets.

The coming to the **fore of the issue** in both the public and the private sector is an **important development**

What must follow is **how to implement the plans**, establishing concrete measures, with progress indicators and possible priorities. The **people implementing these plans have to be duly empowered**

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