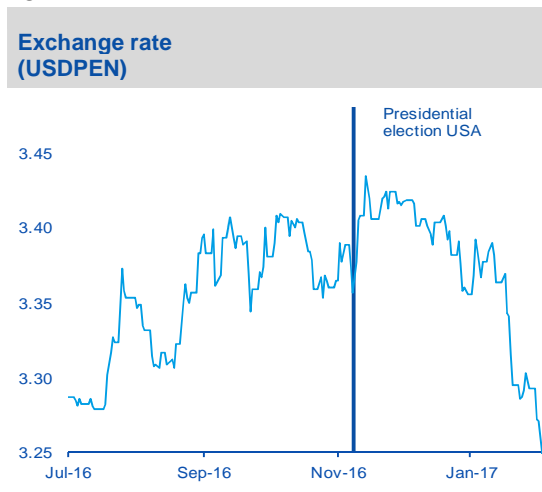


4. Local financial markets – revaluation of the currency and sovereign bonds at the beginning of the year

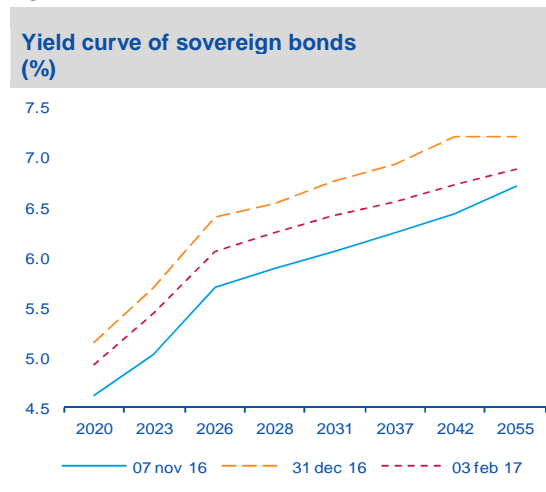
After the election results in the United States (November 8 last year), there were episodes of tension in the local financial markets, with falls in the Peruvian currency (PEN) and some assets. However, these losses were quickly reversed. In the case of the PEN, in particular, depreciation was about 1% after the US election result. After this, it tended to appreciate and in January alone it did so by 2% (see Figure 4.1). A similar correction occurred in the yields required on sovereign bonds (see Figure 4.2).

Figure 4.1



Source: Bloomberg and BBVA Research

Figure 4.2



Source: Bloomberg and BBVA Research

Part of the explanation for the favourable trends in local assets would be linked to the perception that the fundamentals of the country remain relatively solid and have even recently improved. As described above, the deficit in the current account of the balance of payments decreased significantly last year and the fiscal deficit has been set on the path of consolidation. Compared to other large economies in the region, Peru stands out as the one with the highest economic growth, the lowest fiscal deficit and among those with the lowest inflation and current account deficit. If you add to this the statements of incoming administration officials in the US, who point out that they are not comfortable with a strong dollar, positive economic data from China, the significant increase in metal prices (see Figure 4.5) and the perception that the Fed will raise its rate only gradually, it is not surprising that local financial assets, and in particular the PEN, have performed well.

Figure 4.3

Price of raw materials: copper and zinc (USD/lb)

Source: Bloomberg and BBVA Research

Figure 4.4

Exchange rate (USDPEN)

Source: Bloomberg and BBVA Research

However, our forecast is that the local currency will tend to depreciate, probably more clearly in the second half of the year and that it will close the year between 3.40 and 3.45 soles per dollar (see Figure 4.6). This implies that, compared to the level reached at the end of last year, the increase in the USDPEN exchange rate in 2017 will be quite limited. This projection is consistent with six elements, most of which were described in the previous section. Firstly, dollar interest rates at the global level will be on the rise, albeit gradually. The Fed will continue to raise its policy rate (a cumulative 50bp increase in 2017), probably from the end of the first half of the year, in an environment where US labour market slack is small, inflation is rising and where anticipation exists that the incoming administration will boost the economy in the short term on the fiscal side and with deregulatory measures. We also expect that the European Central Bank will begin to evaluate tapering towards the end of the year, which will then begin in early 2018. In this context, the demand for assets of emerging economies will moderate.

Our exchange rate projection is also consistent with some other measures that the incoming administration in the US has pointed out, including tax cuts to the corporate sector, which will make investment in that country more attractive and, therefore, also moderate demand for assets of emerging economies. Third, speculative positions in the copper market will tend to normalise, which will lead to a downward price correction, from the current 2.60 USD/lb to something more around 2.35 USD/lb in the fourth quarter. As a fourth element, we expect China's growth to decline in a context in which the country's economic authorities will seek primarily to address financial vulnerabilities. This deceleration will not only have a downward impact on the price of metals, but also on the perception of risk in economies such as Peru. Fifth, there is not much more room for exported volumes to continue to increase at the pace they have been doing so lately because the momentum of mining production will decline, perhaps more clearly from the second half of the year. Finally, domestic demand will start to gain traction, which will boost imports.

In short, we anticipate that in the coming quarters there will be some increase in the deficit in the current account of the balance of payments, while capital inflows will decrease. This is consistent with the trend we

envisage for the exchange rate – which currently stands at around 3.25 – in the following months. However, there will probably be episodes of volatility along the way, which could be associated, for example, with uncertainty about the election results that will take place in Europe – they could have an impact on the future of the common currency – or with the measures that the new administration in the USA finally choose to implement.

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