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Peru Outlook

THIRD QUARTER 2017 | PERU UNIT

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Closing date: 7 July 2017

1 Summary

Peru's economy will grow by 2.2% this year and rebound to 3.9 in 2018, dependent on spending to rebuild and refurbish the areas of the country affected by flooding, and faster progress in infrastructure construction. We estimate that GDP will grow in 2017, but at the slowest rate since the 2009 international financial crisis, against a backdrop in which the "El Niño Costero" weather effect caused havoc in several parts of the country (flooding), and infrastructure construction has not managed to fill the gap left by falling copper production as the driver of activity.

The **growth forecast for this year is consistent with a second half in which weather conditions will be much more normal and work will start to repair some of the infrastructure damaged by the El Niño Costero**. Against this backdrop, we expect **domestic demand to perform more strongly than in the first half of 2017**. Public expenditure will tend to normalise following the fiscal adjustment at the end of last year. Part of this will be used for repair work in the north of the country. Spending by households and companies will also see a certain improvement, but this will be limited. This stronger performance by domestic demand in the second half of 2017 will be offset by slower progress on export volumes, particularly for mining products. We therefore expect GDP to grow at rates similar to those seen in the first half of the year (between 2.0% and 2.5%). **Looking further ahead, when reconstruction work begins in 2018, and depending on work on the largest infrastructure projects - Line 2 of the Lima Metro and the 2019 Pan-American Games - economic activity will pick up to around 3.9%**. On the expenditure side, the public sector will once again lead growth, whilst demand from households and companies will continue to recover. By sectors, Construction and Non-primary Manufacturing will return to growth after several years, whilst Trade and Services will be weaker: all of this will foster job creation.

As the **forecasts for economic growth in our baseline scenario are strongly dependent on the fiscal stimulus from reconstruction spending for infrastructure damaged by the El Niño Costero**, it is important to mention how we believe that this spending will crystallise. **We take a positive view of the mechanism (the Authority for Reconstruction with Changes, or ARCC) for planning and implementing this spending**: (i) a new agency has been created that is specifically charged with, and focused on, designing the reconstruction plan; (ii) this agency is headed by an executive chairman with ministerial rank; (iii) ARCC's governance is simple, with a Directorate that comprises four line ministers, in addition to the executive chairman; (iv) the structure for allocating the recovery funds is clearly defined; and (v) contracting procedures have been simplified ("fast track" mechanisms). Some of the features of the design of the ARCC are similar to those of other bodies set up in response to natural disasters, such as the successful experiences in Mexico (1985) and Colombia (1999). Whilst there will of course be risks in implementing the expenditure, the agency has political support, an appropriate structure and the funds to carry out its mission - largely from fiscal savings. This suggests that the reconstruction expenditure will ultimately take place.

Turning to local financial markets, these have performed positively so far this year, despite political noise and some deterioration of fiscal robustness. This has given rise to a context in which international prices for the metals exported by Peru - such as gold and copper - have remained high. In addition, the gradual pace of monetary adjustment in

more developed economies has continued to inspire a **strong appetite for Peruvian financial assets among investors**. **Risk premiums have been compressed.** The **local currency has appreciated by around 4% so far this year**. **However, our projection is that it will continue to depreciate in future, although more slowly**, ending the year above 3.35 soles per dollar (around 3.45 in 2018). This forecast is in keeping with the expectation that in the coming quarters capital inflows to emerging economies will tend to slow in an environment where the FED gradually raises interest rates and starts to reduce its balance sheet, and the central banks of other developed countries start to taper their quantitative easing, whilst monetary policies in emerging economies – particularly Peru – become more flexible. Against this backdrop, **risk premiums will tend to correct upwards**. The increase in the exchange rate will be limited because the smaller gap between local-currency and foreign interest rates will be softened by the surplus on the trade balance.

On the price side, the speed of the retreat of inflation as a result of the normalisation of food prices following the El Niño Costero has been a surprise. Inflation has returned to its target range, **currently standing at 2.7%**. We are likely to see inflation fluctuating between this level and the ceiling of the target range (or perhaps slightly higher than this) over the coming months, before **slowing again in the fourth quarter**. Demand pressures on prices are contained, the depreciation of the local currency we expect to see over the coming months is limited, and we do not expect a marked recovery in oil prices. Absent any significant shocks from foodstuffs, **inflation is likely to end the year around the middle of its target range**, with perhaps even a downward trend at the start of 2018. The **inflation outlook is relatively benign**.

Considering the current panorama for activity (weak), the downward trend we expect for inflation and that most of the spending for reconstruction in the north of the country will only impact activity during the coming year, monetary policy will have to bear the weight of countercyclical efforts at present. Against this backdrop, the Central Bank has started to relax its monetary position through cuts in its base rate, which it cut by 25 bp to 4.0% in May. **Our baseline scenario includes two further 25 bp cuts in the base rate this year, one in the third quarter and one in the fourth**. It also includes an additional cut at the start of 2018, when inflation is close to the floor of its target range and reconstruction spending in the north of the country is still only starting to kick in.

Our forecasts of economic growth for 2017 and 2018 are subject to certain risks. On the international front, these include financial vulnerabilities in **China** and the pace at which the **FED** will adjust its monetary position. Locally, there could be **additional delays in infrastructure construction**, **friction in implementing public expenditure on reconstruction in the north of the country** and **falling confidence among businesses and consumers** because of increasing political noise and social conflicts, for example.

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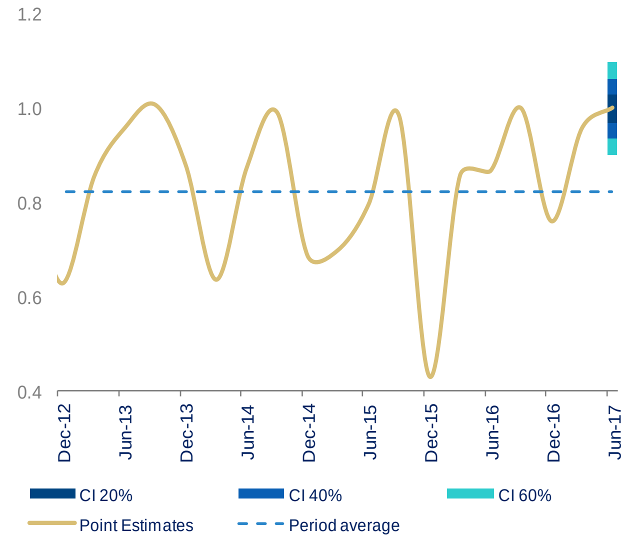
2 Global environment: global growth is consolidating but risks remain

The world economy has been picking up in recent quarters and has approached growth rates of 1% QoQ (Figure 2.1), although it is trending towards stabilisation. In global terms the confidence figures are clearly positive, above all in advanced economies, and appear to have become entrenched at the high end. World trade has recovered rapidly from the very weak levels in the middle of last year. All of this has also led to a rekindling of industrial activity and investment globally.

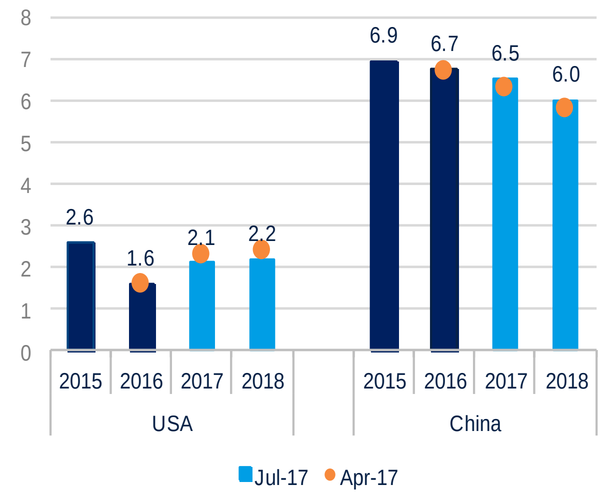
This positive dynamic is attributable to the prime factor behind expansion of late, namely the spurs provided by economic policy in China, which have driven its economy and led to a knock-on affect among other Asian countries as well as the rest of the world economy. Other supports for strong cyclical behaviour - such as extremely accommodative monetary policies in most advanced economies, recent neutral or expansionary fiscal policy and relatively moderate commodity prices - have helped the global recovery, against a backdrop of calm in financial markets.

Figure 2.1 World GDP growth. Forecasts based on BBVA-GAIN (% QoQ)



Source: BBVA Research

Figure 2.2 GDP growth in the US and China (%)



Source: BBVA Research

This improvement - which affects the advanced economies in particular - has been accompanied by a degree of rebalancing from the USA to Europe. Emerging economies have performed less positively, and less consistently, with a slower than expected exit from the slowdown in Latin America, and more diverse performance, in response to dependence on commodity revenues.

The tone in financial markets has been upbeat, with volatility at historic lows in spite of persistent economic, political and geopolitical uncertainty, as well as the correction to expectations of a fiscal boost in the United States. This means that long term interest rates have remained anchored and corrected a portion of the rises in previous quarters, while the appreciation of the dollar has been halted. The big question is whether the markets are being too lenient, particularly bearing in mind that the major central banks are progressing the normalisation process. The tone of monetary policy is still accommodative, but in the last quarter additional steps in this process have been taken, in tandem with the improvement in the economy.

We maintain our outlook of increasing global growth, which will increase from 3.1% in 2016 to 3.3% in 2017 and 3.4% in 2018.

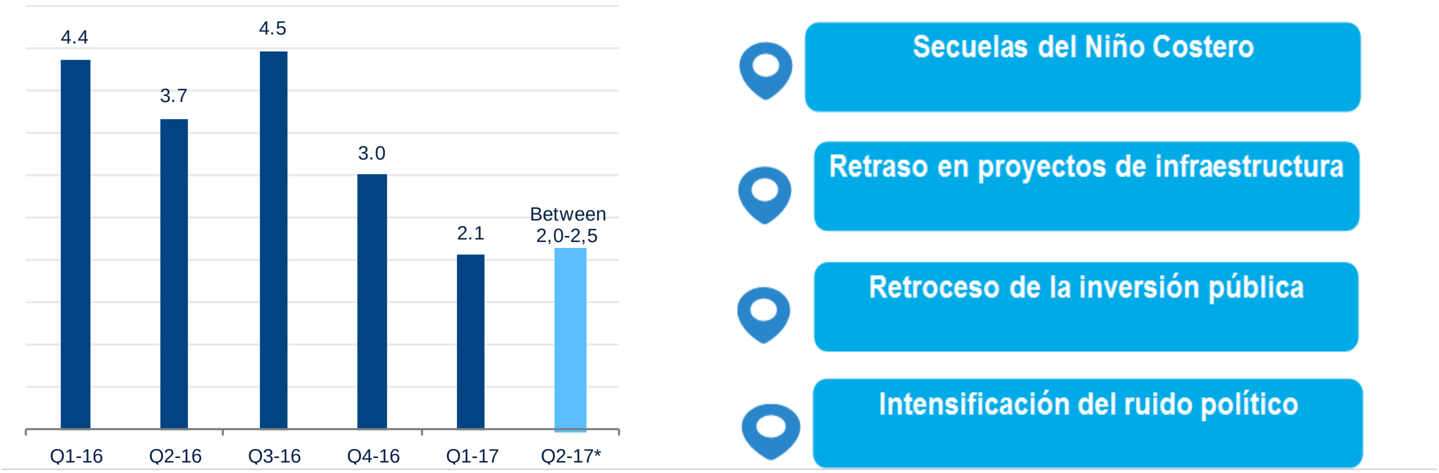
Our new forecasts imply that global growth will remain at 3.3% in 2017 and 3.4% in 2018. We have revised forecast GDP growth in China upwards by around 0.2 pp for 2017-18, which would mean the authorities achieving their target of 6.5% in 2017, although we still predict a slowdown to 6% in 2018 (Figure 2.2). We have also revised our growth forecasts for Europe upwards by three tenths of a percentage point to 2% for 2017, driven by exports and investment, with a slight slowdown in 2018, to 1.7%. On the other hand, we have revised our forecast for the USA downwards slightly, to 2.1% in 2017 and 2.2% in 2018 (Figure 2.2), due to weaker than expected performance in the first quarter and difficulties in approving expansionary fiscal measures and implementing reform. In Latin America, increased domestic uncertainty in several countries has meant that emerging from recession is taking longer than had been foreseen.

3 We expect slow growth this year and a rebound in 2018, in response to reconstruction and infrastructure spending

The economy remained weak in the second quarter. We do not expect any major changes over the rest of the year, with 2017 growth coming in at 2.2%. We forecast growth of 3.9% in 2018.

Economic activity has been affected by a number of exogenous factors over the last three months (see Figure 3.1):

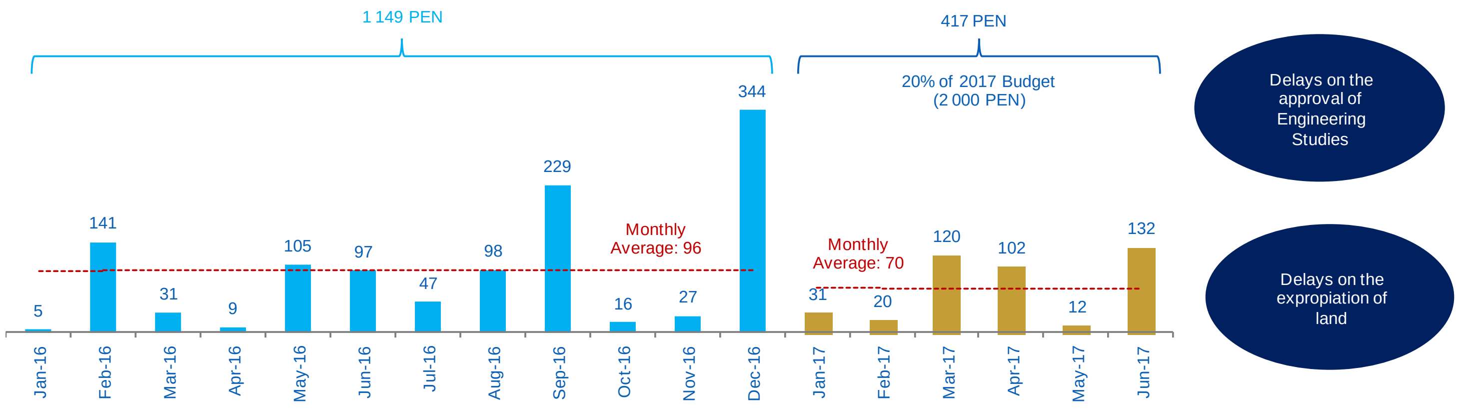
Figure 3.1. GDP
(% YoY change)



*Estimated.
Source: INEI, Central Bank of Peru and BBVA Research

- **Effects of "El Niño Costero"**. The effects of abnormal weather conditions arising from the "El Niño Costero" - heavy rains on the coast, rivers bursting their banks and landslides - have had negative impacts, for example, on the trade sector, which remains flat, and some services, such as financial services, transport, accommodation and hospitality.
- **Delays in execution of infrastructure projects**. Slow progress in the construction of some major infrastructure projects - such as Line 2 of the Lima metro, which had achieved only 20% of its budgeted progress for the year at the end of the first half (see Figure 3.2) - has impacted the construction sector and some non-primary manufacturing, such as production of iron and steel, metal products and machinery. In fact, we estimate that non-primary manufacturing contracted by around 4% in the second quarter, the sharpest fall for five quarters.

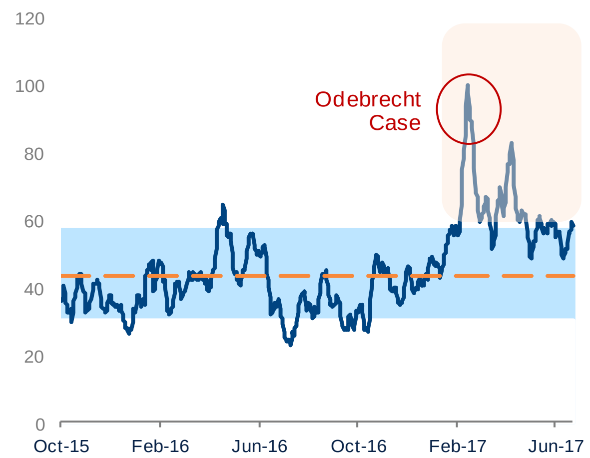
Figure 3.2 Line 2 of the Lima Subway*
(millions of soles)



Source: Ministry of Economy and Finance of Peru-SIAF and BBVA Research

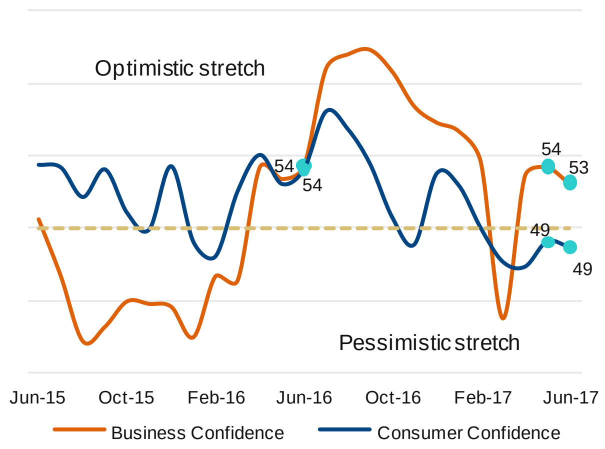
- **Fall in public investment**. Despite contracting less than in the first quarter, gross general government capital formation continues to fall. We estimate the fall in the second quarter to have been around 7% (13% in Q1).
- **Intensification of political noise**. Frictions between the executive and the opposition, which controls Congress, remain high (see Figure 3.3), making it more difficult to implement an agenda of consensus for fostering initiatives and changes to promote growth, in the short term, at least. In addition, persistent political noise over the last year has been one of the factors keeping confidence indicators relatively low (see Figure 3.4).

Figure 3.3 Political tensions index*
(average over last 10 days)



* Information as of 23 June 2017.
Source: GDELT and BBVA Research.

Figure 3.4 Business and consumer confidence*
(index, in points)

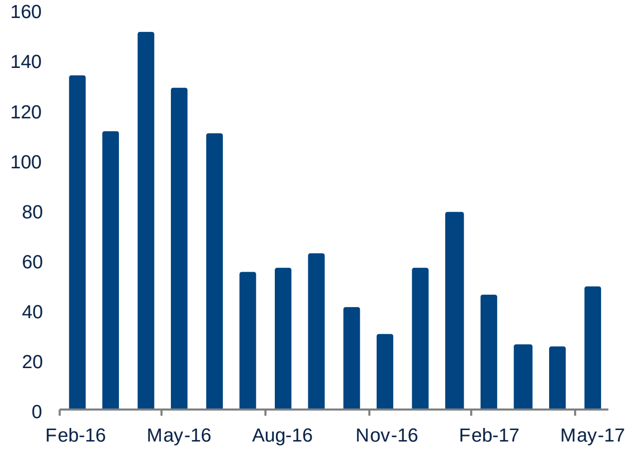


* Values over (under) 50 indicate an expectation of a better (worse) performance by the economy in the next three months.
Source: Apoyo Consultoría, Central Bank of Peru and BBVA Research

On the positive side, activity continues to be underpinned by the performance of primary sectors, i.e. those involving extraction of natural resources. In particular, the start of the anchovy season - 22 April - was favourable, with a positive impact on fishing and primary manufacturing (preparation of fish oil and flour), adding some 1.5 percentage points to growth in the second quarter.

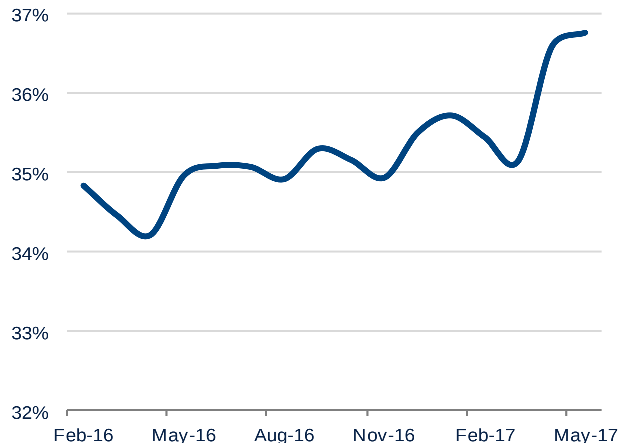
Against this backdrop, there have been no signs of improvement in the labour market. Job creation has slowed (see Figure 3.5) and quality has deteriorated (with an increase in the under-employment rate and destruction of adequate jobs, see Figure 3.6). In addition, average salaries have been falling in real terms.

Figure 3.5 Job creation*
(YoY change, thousands of people)



* Calculated as the difference between the EAP in work in a moving quarter, less the EAP in work in the same quarter of the previous year. Considering the Greater Lima area.
Source: INEI (National Statistics & IT Institute) and BBVA Research.

Figure 3.6 Underemployment rate*
(% of EAP in work)



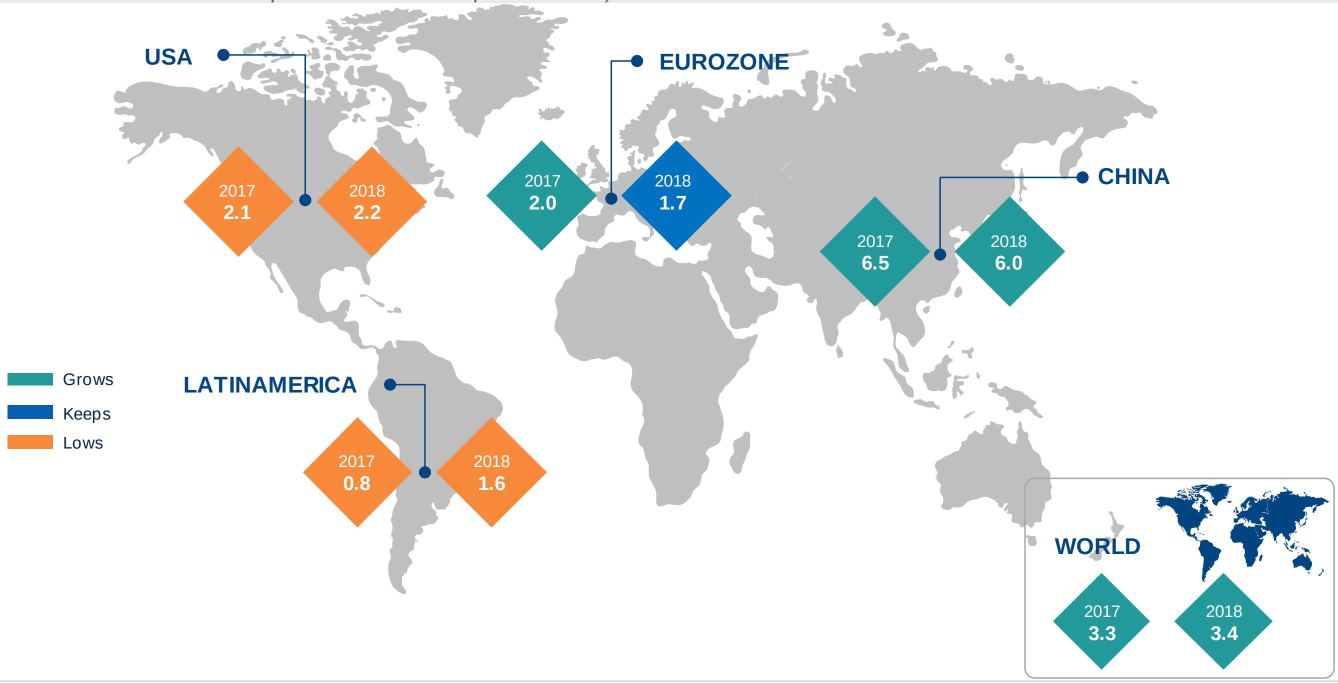
* Greater Lima area.
Source: INEI (National Statistics & IT Institute) and BBVA Research.

In addition to the current trends observed in Peru's economy, our baseline scenario for the rest of the year and going forward considers:

Internationally, relatively favourable conditions similar to those prevailing in our April report:

- **Growth in global economic activity consolidating at more than 3% in 2017 and 2018**, explained, in the main, by improved performance by advanced economies (see Figure 3.7). We also expect the slowdown and rebalancing of China's economy to gradually continue. Finally, we estimate that Latin America will record positive - though moderate - growth, following two consecutive years of contraction.

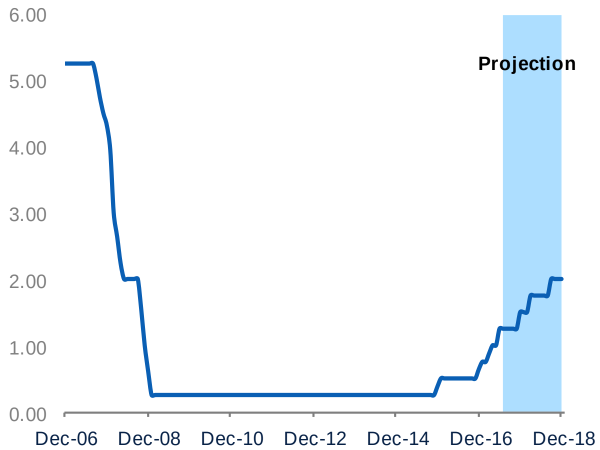
Figure 3.7 Global growth
(% YoY. The colours are comparisons with the April Forecast)



Source: BBVA Research

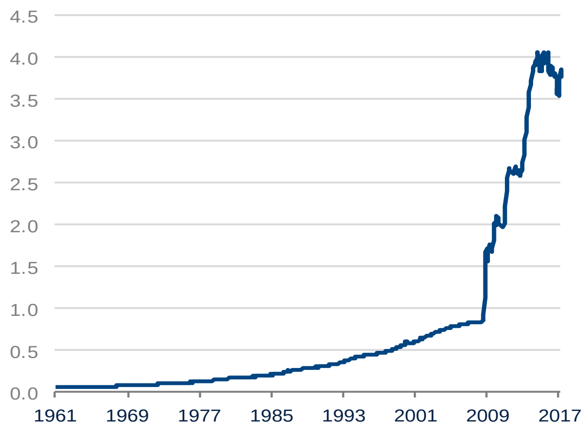
- **The FED will continue its normalisation of monetary conditions in the USA, in an orderly and announced fashion, making it easier for the market to digest.** In particular, our baseline scenario considers an increase of 25 basis points over the remainder of the year, and two similar increases in 2018 (see Figure 3.8). We are also assuming that the FED will start reducing its balance sheet in this year (see Figure 3.9).

Figure 3.8 Forecast FED rate
(%)



Source: Bloomberg and BBVA Research

Figure 3.9 Monetary base
(trillions of dollars)



Source: FED and BBVA Research.

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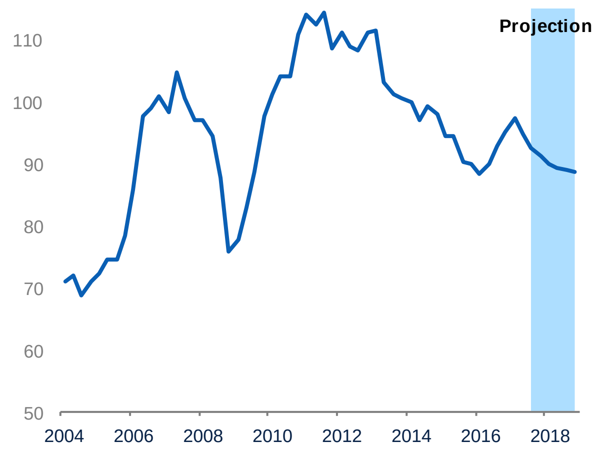
- **The average terms of trade will recover slightly in 2017, after five consecutive years of falls. However, we expect this variable to correct downwards in 2018**, before then remaining relatively stable (see Figure 3.10).

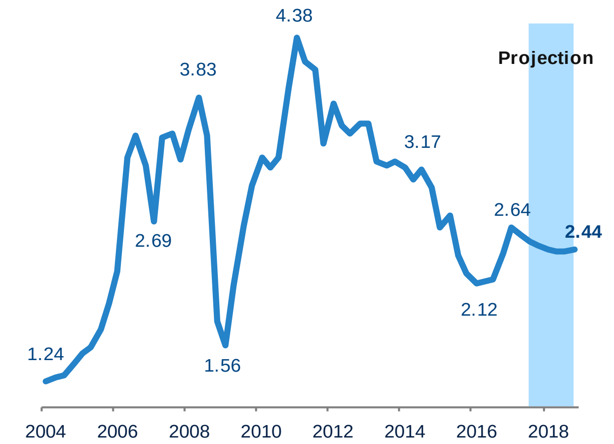
The fluctuations in the terms of trade this year and next mainly reflect the expected performance of copper prices (see Figure 3.11). We project the average annual copper price to increase by slightly over 15% in 2017. This forecast is mainly explained by the high levels seen in the first part of the year against a backdrop of expectations that the new US administration would implement a boost to infrastructure spending. However, these expectations have been weakening since the second quarter, which, together with a fall in speculative demand (a fall in net non-commercial positions), has led to prices falling. In 2018, we expect the balance of the global copper market to be in slight surplus, due to the normalisation of production in major mines, such as Escondida, and new sources of supply in the Congo. This will lead to a fall in average copper prices. In the medium term, we will continue to see convergence of the copper price to levels of USD 2.50 per lb.

Figure 3.10 Terms of trade
(Index base 2007 = 100)



Source: Central Reserve Bank of Peru and BBVA Research

Figure 3.11 Copper price
(USD/lb)



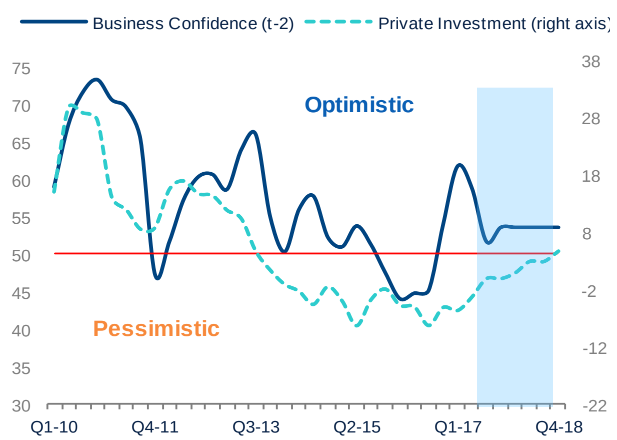
Source: Bloomberg and BBVA Research

Peru is a net importer of oil. We expect the average WTI price for this year to be around USD 50 per barrel. Whilst this is an increase on the previous year, it is lower than we expected two months ago, due to increasing scepticism about the effectiveness of OPEC's actions, high levels of stocks and increasing output in the USA. Going forward, we continue to discount a gradual adjustment of current imbalances, towards USD 57 per barrel. Among other factors, the oil price will be supported by: (i) the extension of production cuts by OPEC until March 2018, relieving pressure on stock accumulation over the remainder of the year; and (ii) in the medium term, global economic growth and the lagged effects of lower investment in the sector. The possibility of higher prices is restricted by a more competitive market, and the transition to more environmentally-friendly energy sources.

On the domestic front:

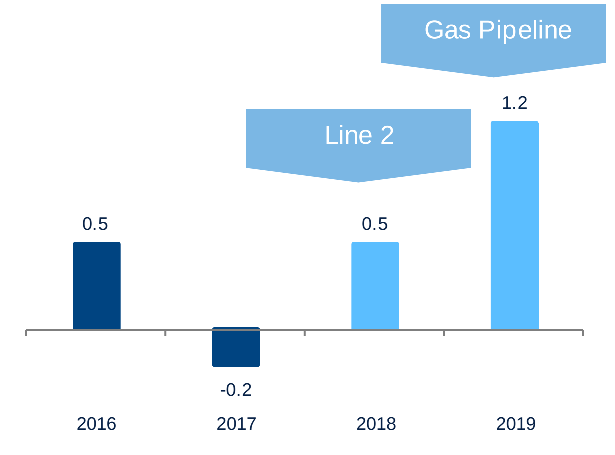
- **Confidence indexes will remain around current levels, i.e. fluctuating around a neutral reading of 50 points** (the threshold between optimism and pessimism, see Figure 3.12).

Figure 3.12 Business confidence* and private investment (index, points)



Source: Central Reserve Bank of Peru and BBVA Research.

Figure 3.13 Main infrastructure projects: contribution to GDP growth (percentage points)



Source: BBVA Research

- **Reconstruction work on infrastructure damaged by the Niño Costero will have a more pronounced economic impact from the second half of the coming year, and will be implemented without further disruptions**. We consider that the institutional design of the Authority for Reconstruction with Changes (ARCC), the government body recently created to deal with this issue, is adequate, increasing the probability that execution of this expenditure will materialise (see the Fiscal Policy section).

- Given this, **fiscal policy will be more expansionary, particularly in 2018**. For the period 2017-2019, we have assumed that the government will follow the path it has announced for the deficit (peaking at 3.5% in 2018), with fiscal consolidation being more gradual from then on (refer to the Fiscal Policy section).
- **Expenditure on construction of the largest infrastructure projects will be lower than that executed last year, but we assume that we will see an improvement in execution in 2018 and 2019**. We estimate that infrastructure spending on the largest projects over these two latter years will contribute 0.5 percentage points and 1.2 percentage points to growth, respectively (see Figure 3.13). Construction of infrastructure for the 2019 Pan-American Games will also make a contribution.

In the baseline scenario, we expect 2.2% GDP growth in 2017 and 3.9% in 2018. By sectors (see Table 3.1), primary activities (faring and agriculture, fishing, mining and hydrocarbons and primary manufacturing) will continue to be the most dynamic. We forecast that these activities will grow by 3.5% in 2017 and over 6% in 2018. In 2017, the fishing sector will expand rapidly (more than 30%), impacting positively on industries that process fishery products. This means that primary manufacturing will expand by more than 7% this year. In 2018, the acceleration in primary activities will be explained by mining for metals (the mines that produced less than their capacity this year will recover) and hydrocarbon output (this assumes that normal operation of the Norperuano pipeline will be re-established).

We project that non-primary activities (which are more strongly related to domestic demand, representing slightly more than 70% of all output of goods and services) will again be weak, growing overall by 1.7%, with falls in the construction and non-primary manufacturing sectors, due to weaker public and private spending. However, we project that non-primary GDP will accelerate in 2018, due to the boost from spending on reconstruction work, which will be reflected in an increase in building and service sector activity.

Table 3.1 GDP by productive sector
(% YoY change)

	2015	2016	2017(e)	2018(p)
Agriculture and Livestock	3.2	2.0	1.2	4.0
Fishing	15.9	-10.1	31.8	4.1
Mining and fuel	9.5	16.3	2.8	7.5
Metals	15.7	21.2	3.0	6.3
Fuel	-11.6	-5.4	1.8	14.5
Manufacturing	-1.7	-1.7	0.5	2.6
Based on raw materials	1.0	-0.8	7.3	4.4
Non-primary	-2.6	-1.9	-1.8	1.9
Electricity and water	6.0	7.3	2.9	4.5
Construction	-5.8	-3.0	-0.7	6.4
Commerce	4.0	1.8	0.8	1.9
Other services	5.1	4.2	3.0	3.7
GDP	**3.3**	**3.9**	**2.2**	**3.9**
Primary sectors	6.8	9.8	3.5	6.2
Non- primary sectors*	2.7	2.4	1.7	3.4

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

Table 3.2 GDP on the expenditure side
(% YoY change)

	2015	2016	2017 (e)	2018 (p)
1. Domestic Demand	**3.1**	**0.9**	**1.3**	**3.2**
a. Private Consumption	3.4	3.4	2.6	2.8
b. Public Consumption	9.8	-0.5	3.4	4.7
c. Gross Domestic Investment	-0.7	-4.9	-3.3	3.7
Gross Fixed Investment	-5.0	-5.0	-0.9	5.6
- Private	-4.4	-6.1	-2.2	3.0
- Public	-7.3	-0.5	4.0	15.0
2. Exportas	3.5	9.7	4.0	4.0
3. GDP	**3.3**	**3.9**	**2.2**	**3.9**
4. Imports	2.5	-2.3	0.5	1.2
Note:				
Domestic Demand (excl. inventories)	*1.9*	*0.9*	*1.8*	*3.6*
Private Expenditures (excl. inventories)	*1.4*	*1.1*	*1.5*	*2.8*
Public Expenditures (consumtion and investment)	*4.4*	*-0.5*	*3.5*	*7.6*

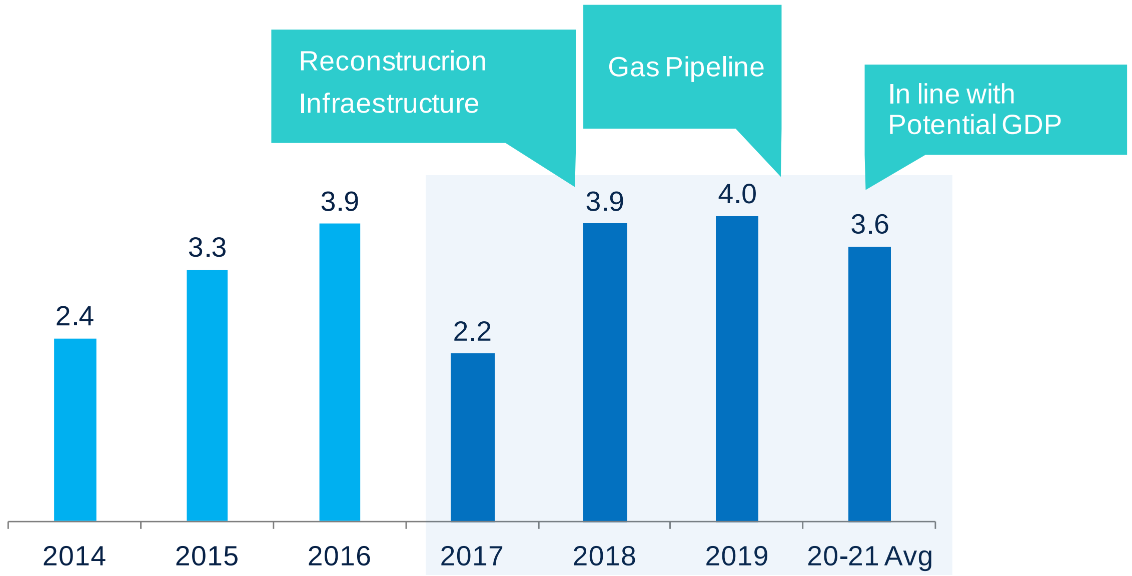
Source: Central Reserve Bank of Peru and BBVA Research

On the demand side (see Table 3.2), this year we expect to see a marked slowdown by families, with private-sector investment contracting for the fourth consecutive year. Public spending will recover over the rest of the year and accelerate next year, due to higher spending on reconstruction and refurbishment work on the infrastructure affected by the El Niño Costero. It should be noted that the fiscal boost expected for 2018 is an important factor in our growth forecasts for that year. We estimate that the contribution of public spending to growth will be 1.3 percentage points, meaning that one third of our projected growth for 2018 will be explained by increased fiscal expansion. Moreover, the boost to activity and the labour market that will be generated by this fiscal stimulus will support the projected increase in consumption (due to higher employment) and private investment (a more dynamic domestic market will foster a more suitable environment for business expansion).

Going forward, the political environment will be an important factor in reducing uncertainty and building consensus on economic measures to re-launch growth

We estimate annual growth of 3.8% for 2019-2021, peaking at 4.0% in 2019, assuming that construction work will be resumed on Peru's Southern Gas Pipeline (see Figure 3.14). This scenario also considers that the infrastructure affected by the country's recent heavy rains and flooding will be quickly rebuilt in 2018 and 2019.

Figure 3.14 GDP*
(% YoY change)



Source: BBVA Research

It should be noted that average growth over the three years 2019-2021 could accelerate in the event of rapid execution of the major investment projects in the pipeline that have a degree of likelihood of being announced next year (see Table 3.3): (i) Quevalleco (a project in the Anglo American portfolio, with a value of around USD 5000 million), (ii) Line 3 of the Lima Metro (USD 5,600 million) and (iii) the outer ring road (USD 2,050 million). The government plans to award tenders for the latter two projects at the end of the year.

Table 3.3 Investment projects

Miners	Transports
USD 9 000 - 9 500	USD 8 500
Quellaveco (USD 500 - 6 000)	Line 3 (USD 5 600)*
Mina Justa (USD 1 500)	Peripheral Road Ring (USD 2 050)*
Toromocho Extension (USD 1 300)	Sierra Longitudinale Section 4* (USD 460)
Pukuqaqa (USD 480)	Huancayo - Huancavelica Railway* (USD 200)
Magistral (USD 300)	Salaverry Port Terminal* (USD 220)

*To be put out to tender.
Source: Apoyo Consultoría and Proinvestment.

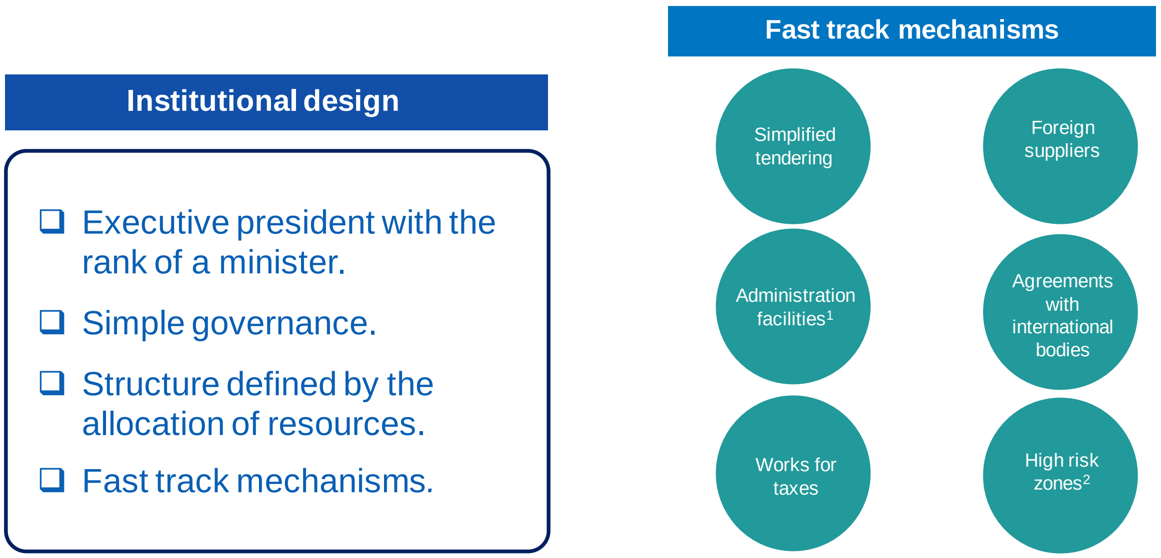
The probability of these major projects being established and executed rapidly will be increased if it is possible to create an environment of greater political understanding. This would reduce uncertainty and attract the support that these investments will require.

An improved political atmosphere will also be important for establishing a minimum agenda of measures and reforms to re-launch growth in the medium term. However, without the support of political players, the economy could slow persistently, making it more difficult to create quality jobs, continue reducing poverty, combat the informal economy, improve the availability of public goods and services and, in general, continue generating inclusion.

4 Fiscal policy: the institutional framework for reconstruction increases the likelihood that the fiscal stimulus will take place in 2018

As we have already mentioned, our growth forecasts for next year are highly dependent upon the fiscal stimulus from spending on the reconstruction of infrastructure damaged by the El Niño Costero, which devastated the centre-northern coast of the country in the first quarter. In our opinion, the law creating the Authority for Reconstruction with Changes (ARCC) is well drafted, increasing the likelihood that public spending in this area will actually materialise.

Table 4.1 Institutional design of the Authority for Reconstruction with Changes



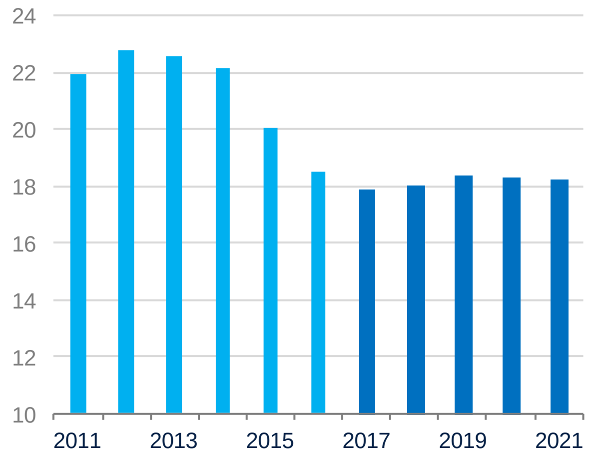
1. The administrative procedures required to execute the Plan will be cost free, and take a maximum of 7 working days, and will be considered approved in the event of administrative silence.
2. People living in areas of high risks that cannot be mitigated must renounce ownership to access benefits under the Plan.
Source: Central Reserve Bank of Peru and BBVA Research

The positive features of the design of the ARCC - some of which are similar to those of other bodies set up in response to natural disasters, such as the successful experiences in Mexico (1985) and Colombia (1999) - include (see Table 4.1): (i) creation of a new agency specifically charged with designing the reconstruction plan; (ii) an executive chairman with ministerial rank; (iii) simple governance, with a Directorate that comprises four line ministers, in addition to the chairman; (iv) a clearly defined structure for allocating the funds for the actions identified; and (v) simplified contracting procedures (“fast track” mechanisms).

It should be noted that Peru's economy has no powerful, automatic stabilisation mechanisms - such as flexible prices and wages, unemployment insurance that supports the consumption of people who lose their jobs or a wide-reaching income tax structure - that would help to return growth to levels more in tune with its potential growth rate. This makes intervention through counter-cyclical policies even more necessary. In particular, a significant fiscal stimulus (note: backed by the monetary side) is needed to end the current vicious cycle of low growth leading to low investment (why invest if the market is not growing?) leading to low growth, etc. The serious effect of not breaking this cycle is that the lack of short-term demand (due to low investment and low employment) impacts in the longer term on the supply side, undermining the economy's potential growth. The ARCC's efforts will be decisive in this regard.

Whilst the positive aspects of the ARCC make it likely that public spending will ultimately accelerate, we see worrying trends on the revenue side (see Figure 4.1). The path of fiscal consolidation announced by the government could be complicated from 2019 or 2020, if no measures are taken to increase collections or growth remains relatively low.

Figure 4.1 General Government revenues (% of GDP)



Source: Central Reserve Bank of Peru and BBVA Research.

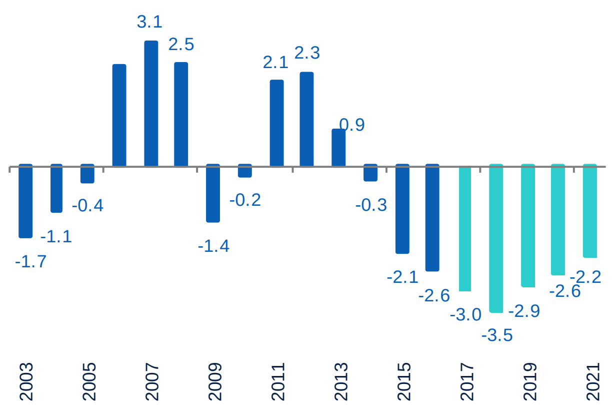
Table 4.2 Tax measures to increase collections

Aspects considered by MEF for increase the collection
1. Rationalization of tax exonerations
2. Property tax increase
3. Reduction of VAT and Income Tax evation

Source: MEF (Macroeconomic Forecast Update Report) and BBVA Research.

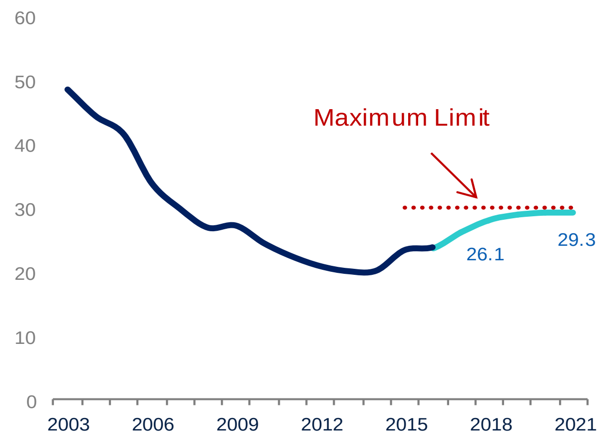
Therefore, given this, we are assuming that the deficit will be as announced by the government in the period 2017-2019 (see Figure 4.2). However, assuming no measures are implemented to increase government revenues, we consider that the deficit will adjust more gradually in 2020-2021, and will not converge on the limit of 1% of GDP established in the Fiscal Responsibility and Transparency Act. As a result, we expect gross public debt to rise and approach the 30% limit set in the Act (see Figure 4.3).

Figure 4.2 Fiscal result
(% of GDP)



Source: Central Reserve Bank of Peru and BBVA Research.

Figure 4.3 Gross national debt
(% of GDP)



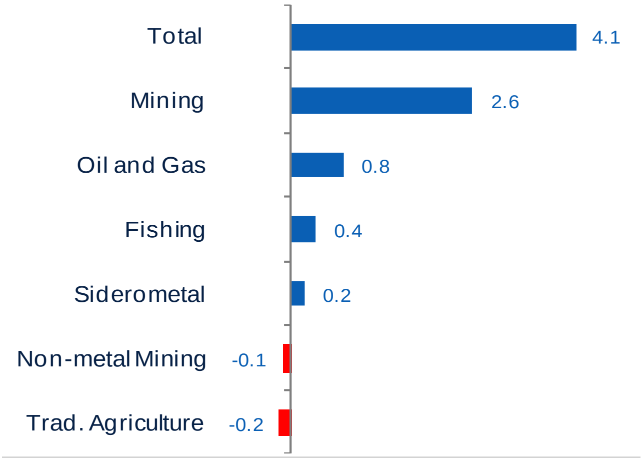
Source: Central Reserve Bank of Peru and BBVA Research.

5 External sector: the current account deficit will remain low and stable

We project a noteworthy improvement in the trade balance this year, due, mainly, to the strong performance of the value of exports, through higher prices for Peru's commodity exports. This progress will be reflected particularly in traditional exports, particularly mining and hydrocarbons (see Figure 5.1). Likewise, shipments from the fisheries sector will expand due to increased catches of anchovies. We expect a recovery in non-traditional exports, although this will be somewhat weaker due to the slowdown in countries in the region (the main markets). This strong performance on the trade side will result in a current account deficit on the balance of payments equivalent to 2% of GDP (see Figure 5.2).

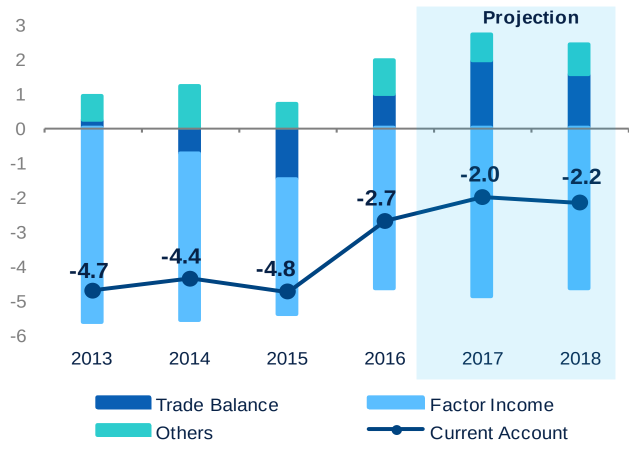
This deficit will remain similar to 2017 levels going forward. This will result in external liabilities stabilising at around current levels (as a percentage of GDP). The low current account deficit also implies that needs for external funding will be relatively limited, strengthening the position of Peru's economy in the face of any volatility that might arise from abroad.

Figure 5.1 Projected export flow in 2017
(US$ billion, 2017 vs. 2016)



Source: Central Reserve Bank of Peru and Peruvian Revenue and Customs Office (SUNAT)

Figure 5.2 Balance of payments, current account
(% of GDP)



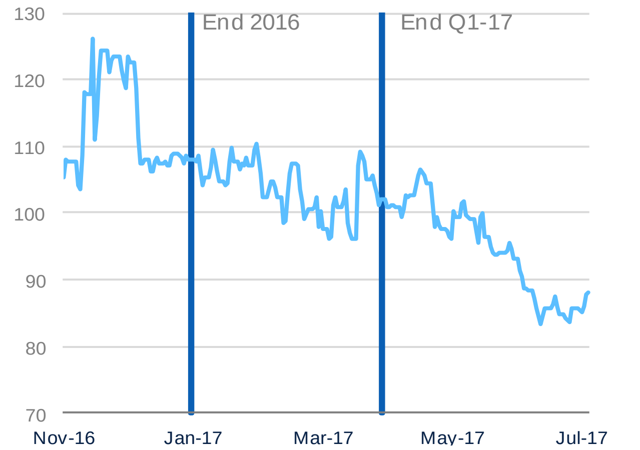
Source: Central Reserve Bank of Peru and BBVA Research.

6 Financial markets remain positive, but correction expected

Low risk premiums and continuing appetite for domestic assets, although we expect some correction going forward

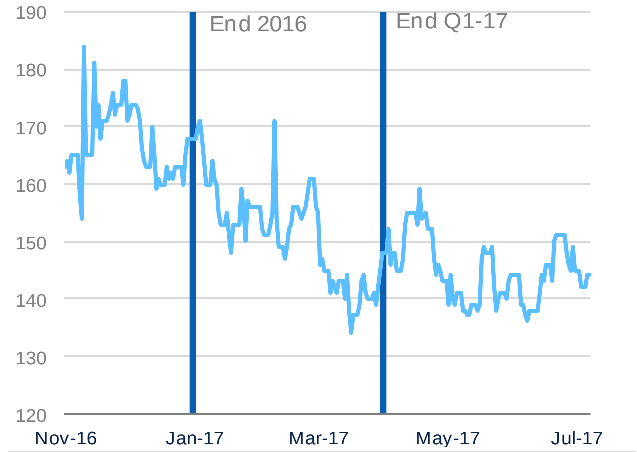
Local financial markets performed positively in the first half of the year. Risk indicators remain contained and on a positive trend, despite local political tensions in the initial months of the year and a degree of deterioration in the robustness of Peru's fiscal position. Country risk indicators for Peru, such as the 5 year CDS and the EMBIG-Peru, are stronger than at the end of the first quarter, with the former having fallen by 14% and the latter by 3% since the end of March (see Figures 6.1 and 6.2).

Figure 6.1. Peru: Peru 5 year CDS
(basis points)



Source: Bloomberg and BBVA Research

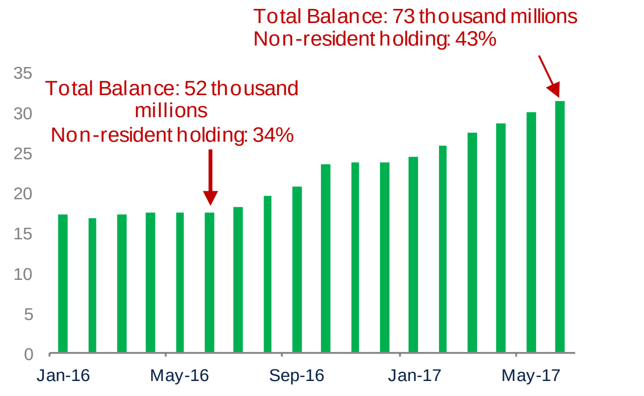
Figure 6.2. EMBIG-Peru
(basis points)



Source: Bloomberg and BBVA Research

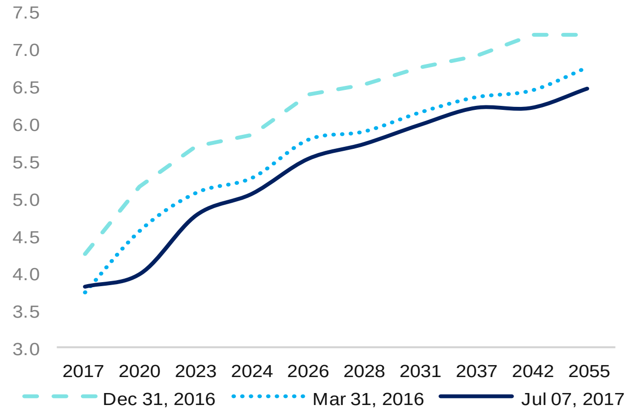
In this regard, the Peruvian currency has remained relatively stable, with local financial assets revaluing. This is supported by the prices of the metals Peru exports - such as gold and copper - which have remained high, and the strong appetite of foreign investors for local financial assets. The latter is reflected in holdings of sovereign bonds by non-resident investors, which have increased by around 80% (14 billion soles) in the last year, to 42% (34% one year ago, see Figure 6.3). The yield curve has also shifted downwards this year (see Figure 6.4). As a result, yields on the most heavily traded sovereign bonds are below their average for the last few years (see Figure 6.5).

Figure 6.3. Holdings of sovereign bonds by non residents (billion soles)



Source: Bloomberg and BBVA Research

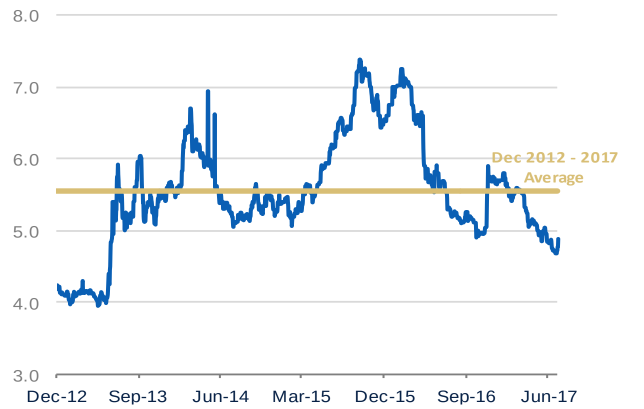
Figure 6.4. Peru: Sovereign bond yield curve (%)



Source: Bloomberg and BBVA Research

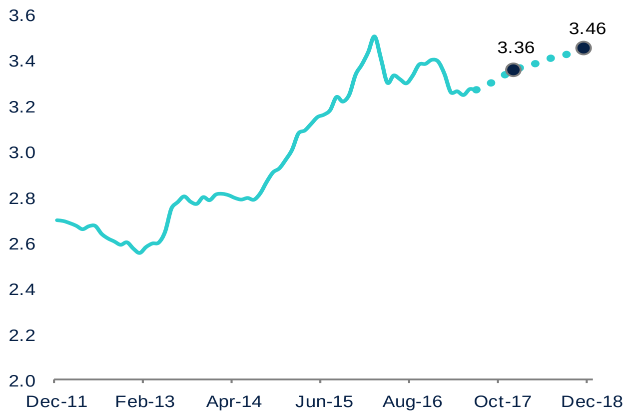
The local currency has remained relatively stable, despite domestic political noise and a degree of deterioration in the fundamentals of the Peruvian economy (such as reduced fiscal robustness and a slowdown in productivity). We therefore consider the Peruvian currency to be somewhat overvalued. We expect a reversal over the coming quarters. This is apparent from the decrease we are discounting in the terms of trade in 2018, the increase in the interest rate spread between soles and dollars (Peru will cut its monetary policy rate, whilst the FED will increase its), and the reduction in the size of the FED's balance sheet. However, these will be counterbalanced to an extent by Peru's continuing balance of trade surplus. On balance, we expect a slight correction in the prices of local financial assets, such as sovereign bonds, and a gradual depreciation of the local currency over the coming quarters. Consequently, our baseline scenario provides for an exchange rate slightly in excess of 3.35 at year-end 2017, and around 3.45 in 2018, see Figure 6.6.

Figure 6.5. Peru: Sovereign bond yield 2023 (%)



Source: Bloomberg and BBVA Research

Figure 6.6. Projection of the USDPEN (soles per dollar exchange rate)



Source: Central Reserve Bank of Peru and BBVA Research

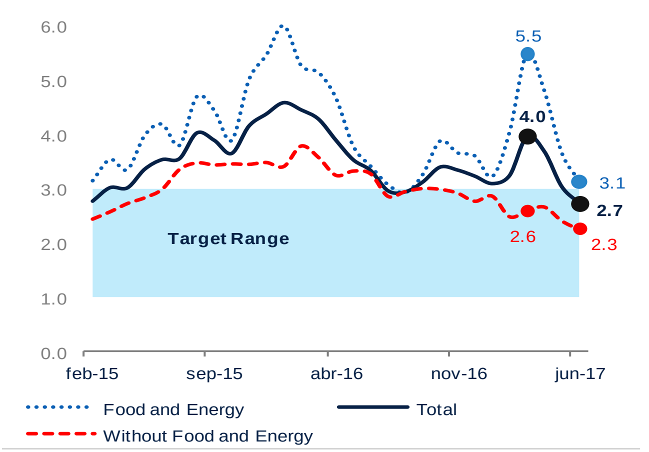
7 Inflation will continue to fall over the coming months

The downward trend could even reach the floor of the target range in the first quarter of 2018

Having peaked at 4.0% YoY in March, inflation fell over the following months, to 2.7% in June (see Figure 7.1). This fall includes the reversal of the supply shock to the prices of some foodstuffs during the El Niño Costero - which has been quicker and more intense than expected - a more contained rise in fuel prices, and a downward trend in other components of the consumer basket excluding food and fuel, in part reflecting the continuing weakness of domestic demand. Inflation has returned to its target range.

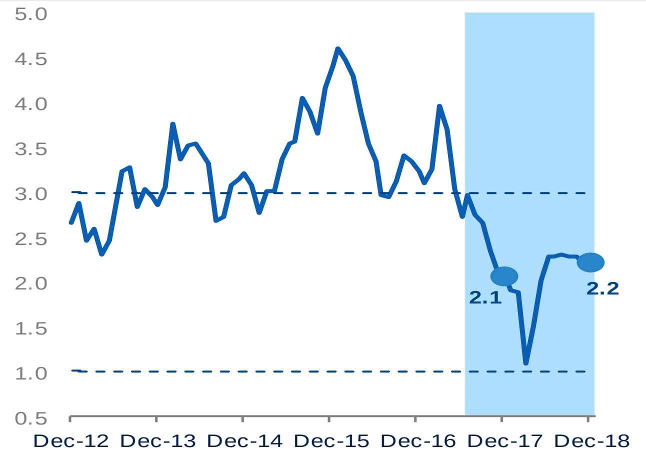
We are likely to see inflation fluctuating between this level and the ceiling of the target range (or perhaps slightly higher than this), falling again in the fourth quarter (due to the high base for the year-on-year comparison). Demand pressures on prices are contained, the depreciation of the local currency we expect to see over the coming months is limited, and we do not expect a marked recovery in oil prices. Absent any significant shocks from foodstuffs, inflation is likely to end the year around the middle of its target range, with perhaps even a downward trend at the start of 2018 (see Figure 7.2). The outlook for inflation is relatively benign and gives the Central Bank some scope to increase the flexibility of monetary policy (refer to the Monetary Policy section).

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



Source: INEI, Central Bank of Peru and BBVA Research

Figure 7.2. Projected inflation (% YoY change)

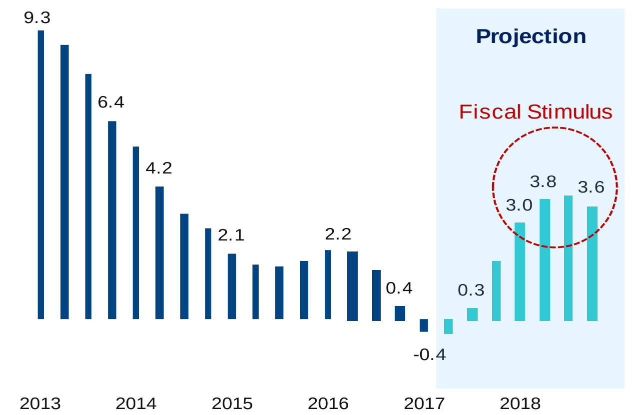


Source: INEI, Central Bank of Peru and BBVA Research

8 Monetary policy: a suitable scenario for the Central Bank to embark upon more aggressive monetary stimulus

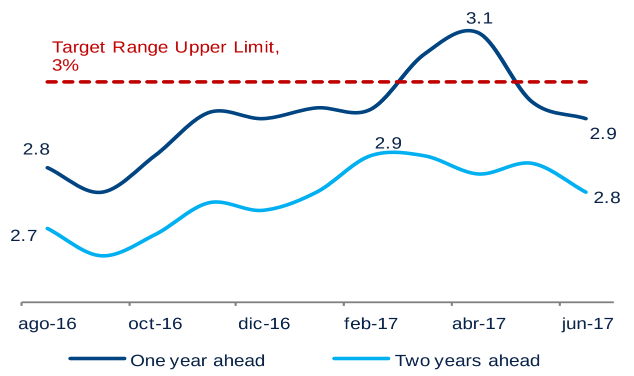
The outlook for activity and prices described in the previous sections suggests there is both a need to increase the flexibility of the monetary policy position, and room to do this. But, what do we mean when say there is a need to adopt a more expansionary monetary position? GDP growth rates have fallen below 1% YoY in the last three months. Growth in activity is weak, particularly domestic demand (see Figure 8.1). The picture in the labour market is similar: not only has the creation of new jobs slowed (see Figure 3.5), but the quality of the jobs created has deteriorated. Whilst it is true that larger anchovy catches will increase the GDP growth rate for May and June, this will be a temporary effect and does not reflect a significant improvement in spending by businesses and households. This situation is exacerbated by increased political noise. Countercyclical economic policies are therefore required to shake activity out of this lethargy, with fiscal and monetary stimuli that will pass through to businesses and households. Unfortunately, no fiscal stimulus is taking place, and it seems unlikely that there will be any major boost in the coming months. Most of the spending on reconstruction in the coast northern of the country will not impact activity until next year. And while it is true that a significant expansion in public spending is expected in the fourth quarter, this is mainly due to the basis for the year-on-year comparison being low due to the fiscal adjustment at the end of 2016, meaning that spending levels are only returning to normal. Finally, there is also no room for the state to spend more, as its revenues have fallen as a percentage of GDP and this will limit the expansion of spending, if it wishes to meet its 2017 fiscal deficit target (3% of GDP). This leads us to state that monetary policy will take centre stage in countercyclical efforts at present.

Figure 8.1 Internal demand (accumulated over the last four quarters, excluding inventories, YoY % variation)



Source: Central Reserve Bank of Peru and BBVA Research.

Figure 8.2 Inflation expectations (%)



Source: Central Reserve Bank of Peru and BBVA Research.

But, does the Central Bank have room for a more expansionary monetary position? Expectations of inflation are within the target range and have continued to fall (see Figure 8.2). The picture for inflation, and inflation excluding food and energy, is similar. We are likely to see inflation fluctuating between its current level (2.7%) and the ceiling of the target range (or perhaps slightly higher than this) over the coming months, before slowing again in the fourth quarter. Demand pressures on prices are contained, the depreciation of the local currency we expect to see over the coming months is limited, and we do not expect a marked recovery in oil prices. Our inflation forecast for the end of the year is closer to the centre of the target range, and the downward trend may continue in early 2018. It appears that there is some room to increase the flexibility of the monetary position.

Against this backdrop, the Central Bank has started to relax its monetary policy position through cuts in its base rate, which it reduced by 25 bp in May, to 4.0%. However, this was followed by a surprise pause in June, when the outlook for activity and prices still seemed to be pointing to further flexibility in monetary conditions. Our baseline scenario includes two further 25 bp cuts in the base rate this year, one in the third quarter and one in the fourth. It also includes an additional cut at the start of 2018, when inflation is close to the floor of its target range and reconstruction spending in the north of the country is still only starting to kick in (see Figure 8.3).

Figure 8.3 Reference interest rate
(%)

Source: Central Reserve Bank of Peru and BBVA Research

9 Risks to our growth forecasts for 2017 and 2018

There are five main risks to our baseline scenario for economic activity in 2017 and 2018 - two external and three domestic. **The first of these is linked to the Chinese economy.** The strength of that country's economic growth continues to be fed by greater borrowing and driven by investment. In this context, the reshaping of the sources of growth in the country is not progressing and domestic financial vulnerabilities - including parallel banking activity and mounting local government debt - have sharpened. Should these vulnerabilities fail to be plugged and end up derailing the deceleration of the Chinese economy, this would affect global growth and the prices of raw materials. On the domestic front, the impacts would be reflected in a slower than expected pace of activity and a further decline in financial asset prices, including the local currency.

The second external risk is the United States, and in particular the FED's adjustment of monetary policy. Our baseline scenario for 2017-18 includes a gradual increase in the US base rate (a 25 bp increase in 2017 and two 25 bp increases next year), together with the start of measures to run down the FED's balance sheet towards the end of this year. However, if the monetary adjustment process is more aggressive than expected, this could impact negatively on funding conditions in foreign and domestic currency, and this would feed through into economic activity. The impact on funding in the domestic currency would arise from non-resident holders of sovereign bonds seeking to divest themselves of such assets in the thin market for Peruvian sovereign bonds.

Domestically, **one of the main risks is any further delay to infrastructure construction.** This has become a recurrent risk in macroeconomic forecasts for Peru. We have taken this opportunity to include slower progress with Line 2 of the Lima Metro and other smaller projects in our baseline scenario for 2017, compared to our previous report. In spite of this, the risk remains. If the pace of progress with infrastructure construction is slower than expected, this will impact growth in economic activity in 2017 and 2018.

A second domestic risk is friction in implementing public spending on reconstruction in the north of the country. However, we take a positive view of the mechanism planned for implementing this spending (the Authority for Reconstruction with Changes). It also has the funds for this. It therefore seems likely to us that this expenditure will materialise. This is one of the main factors explaining the acceleration in economic activity in our baseline scenario next year. However, if the reconstruction does not pan out as expected, public spending will not develop as forecast, negatively impacting our economic growth projections, particularly for 2018.

Finally, there is a risk of business and consumer confidence deteriorating. Our baseline forecast scenario considers confidence remaining at similar levels to at present (around 50 points for consumers and 55 points for businesses). This implies a gradual pick up in spending by businesses and households over the coming quarters. Greater progress in work on major infrastructure projects - such as Line 2 of the Lima Metro, the start of rehabilitation and reconstruction work in parts of the country affected by the El Niño Costero, and infrastructure construction for the 2019 Pan-American Games - will support confidence going forward. However, this will probably be weakened by any amplification of political noise, frictions between the executive and the legislature, and social conflicts. Weaker confidence would compromise the gradual recovery in private sector spending that we anticipate in our baseline scenario.

10 Tables

Table 10.1 Macroeconomic forecasts

	2014	2015	2016	2017	2018
GDP (% YoY change)	2.4	3.3	3.9	2.2	3.9
Domestic demand (% YoY change)	2.2	3.1	0.9	1.3	3.2
Inflation (YoY, %, EOP)	3.2	4.4	3.2	2.1	2.2
Exchange rate (per USD, EOP)	2.96	3.39	3.40	3.36	3.46
Policy interest rates (%, EOP)	3.50	3.75	4.25	3.50	3.25
Private consumption (% YoY)	3.9	3.4	3.4	2.6	2.8
Public consumption (% YoY)	6.1	9.8	-0.5	3.4	4.7
Gross fixed investment (% YoY)	-2.5	-5.0	-5.0	-0.9	5.6
Fiscal result (% of GDP)	-0.3	-2.1	-2.6	-3.0	-3.5
Current account (% of GDP)	-4.4	-4.8	-2.7	-2.0	-2.2

Forecast closing date: 07 July 2017
Source: Central Reserve Bank of Peru and BBVA Peru Research

Table 10.2 Quarterly macroeconomic forecasts

	GDP (% YoY change)	Inflation (YoY, %, EOP)	Exchange rate (vs. USD, EOP)	Policy interest rate (%, EOP)
Q1 16	4.4	4.3	3.41	4.25
Q2 16	3.7	3.3	3.32	4.25
Q3 16	4.5	3.1	3.38	4.25
Q4 16	3.0	3.2	3.40	4.25
Q1 17	2.1	4.0	3.27	4.25
Q2 17	2.2	2.7	3.27	4.00
Q3 17	2.0	2.7	3.31	3.75
Q4 17	2.4	2.1	3.36	3.50
Q1 18	4.8	1.1	3.38	3.25
Q2 18	4.6	2.3	3.41	3.25
Q3 18	2.9	2.3	3.44	3.25
Q4 18	3.4	2.2	3.46	3.25

Forecast closing date: 07 July 2017
Source: Central Reserve Bank of Peru and BBVA Peru Research

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Este informe ha sido elaborado por la unidad de Perú

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