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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