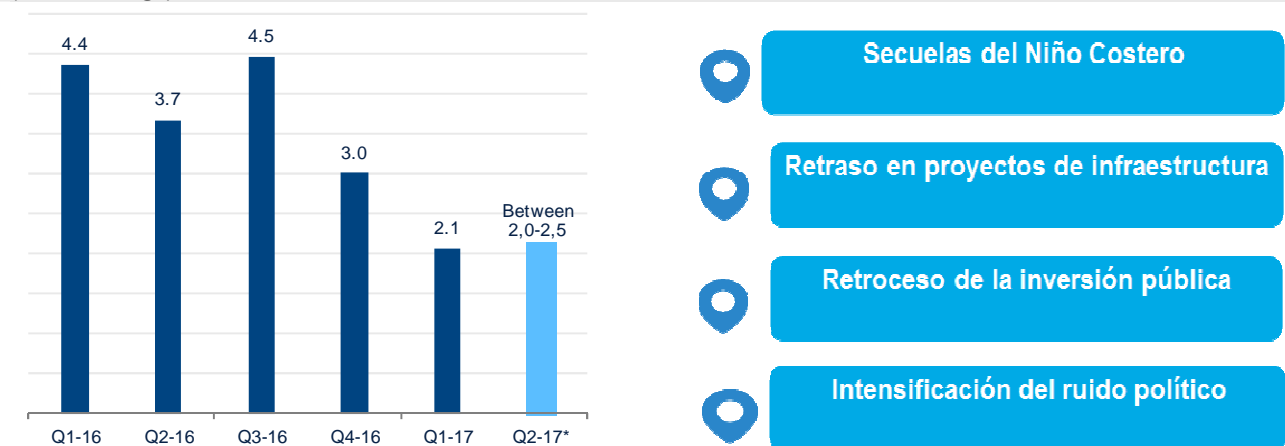


3 We expect slow growth this year and a rebound in 2018, in response to reconstruction and infrastructure spending

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):

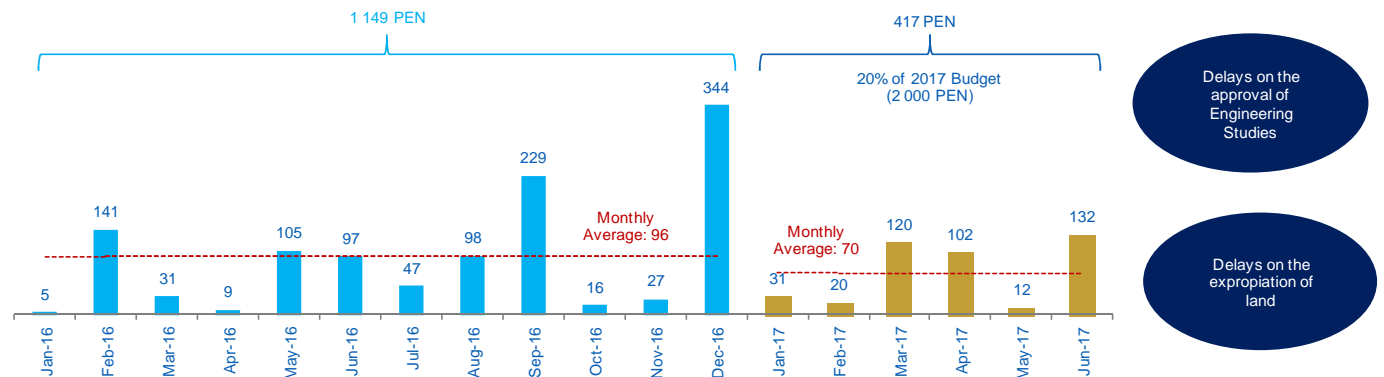
Figure 3.1. GDP
(% YoY change)



*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.

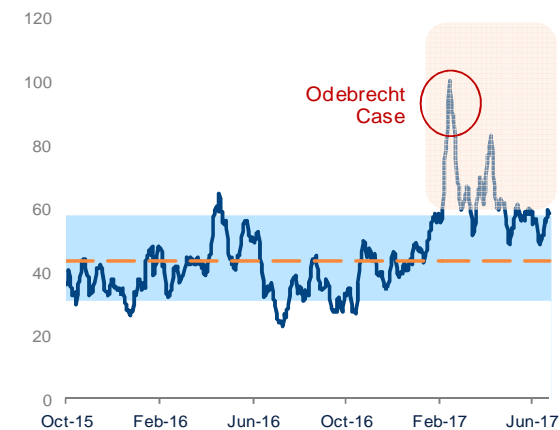
Figure 3.2 Line 2 of the Lima Subway*
(millions of soles)



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

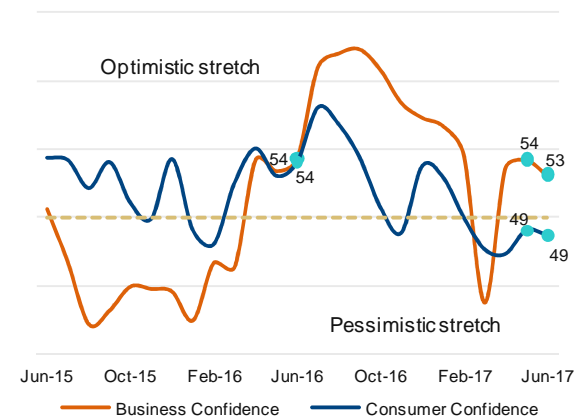
- **Fall in public investment.** Despite contracting less than in the first quarter, gross general government capital formation continues to fall. We estimate the fall in the second quarter to have been around 7% (13% in Q1).
- **Intensification of political noise.** Frictions between the executive and 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)

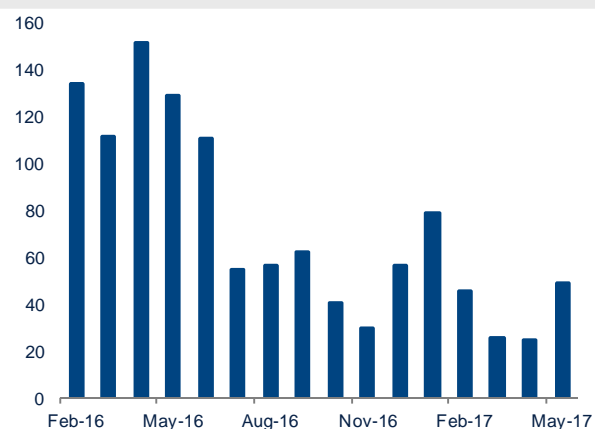


* Values over (under) 50 indicate an expectation of a better (worse) performance by the economy in the next three months.
Source: Apoyo Consultoría, Central Bank of Peru and BBVA Research

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.

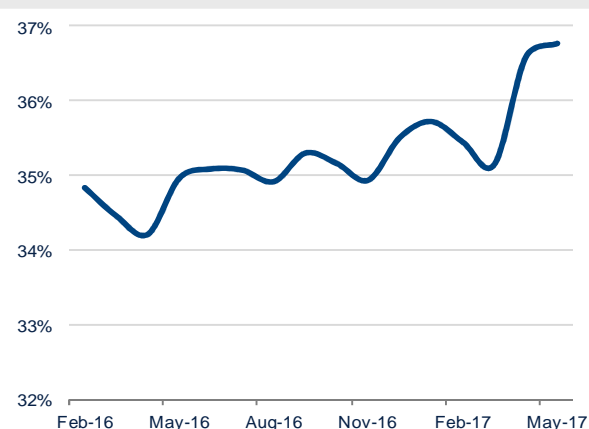
Against this backdrop, there have been no signs of improvement in the labour market. Job creation has slowed (see Figure 3.5) and quality has deteriorated (with an increase in the under-employment rate and destruction of adequate jobs, see Figure 3.6). In addition, average salaries have been falling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



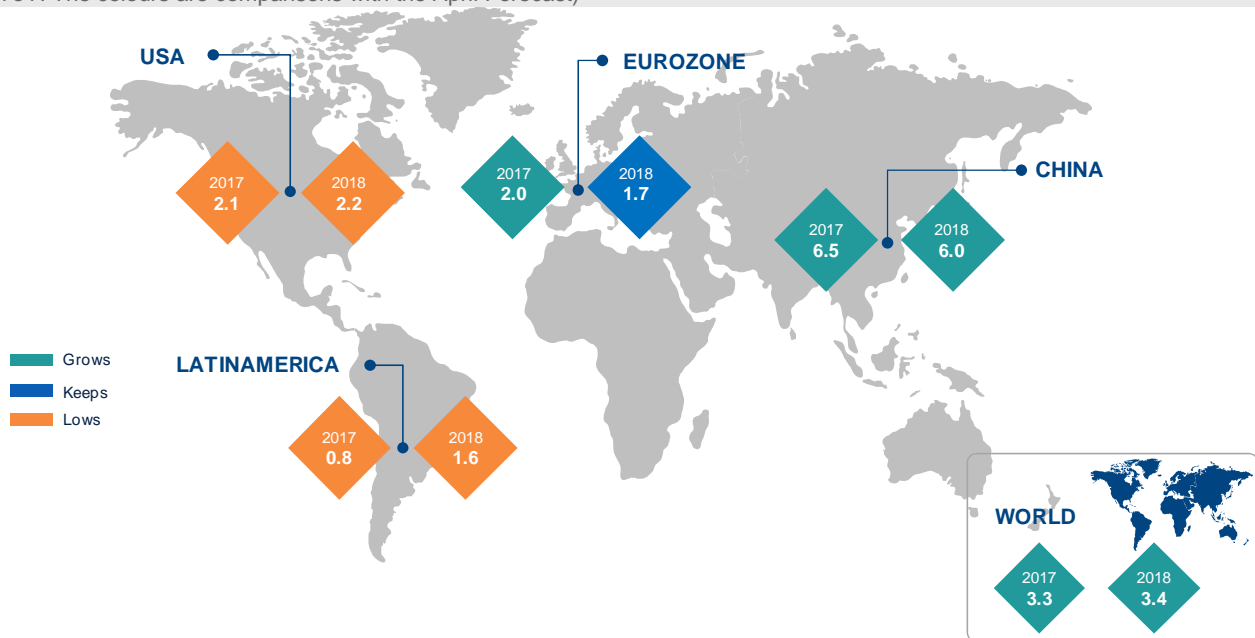
* Greater Lima area.
Source: INEI (National Statistics & IT Institute) and BBVA Research.

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.

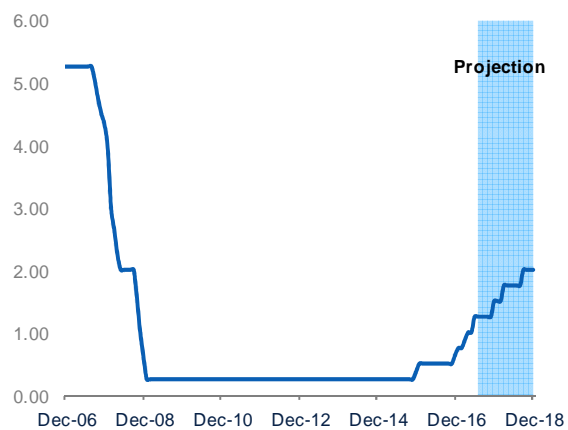
Figure 3.7 Global growth
(% YoY. The colours are comparisons with the April Forecast)



Source: BBVA Research

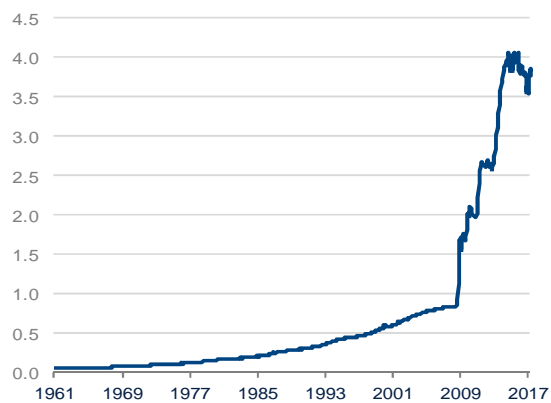
- **The FED will continue its normalisation of monetary conditions in the USA, in an orderly and announced fashion, making it easier for the market to digest.** In particular, our baseline scenario considers an increase of 25 basis points over the remainder of the year, and two similar increases in 2018 (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)



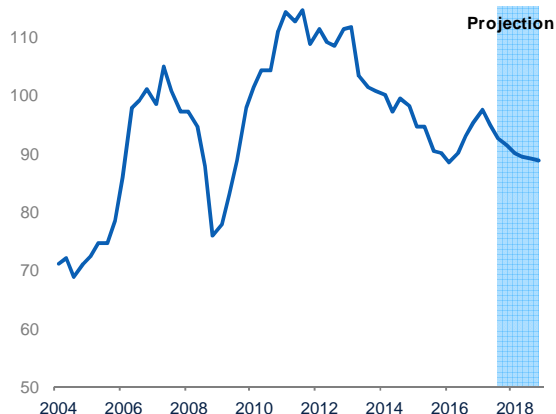
Source: FED and BBVA Research.

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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)



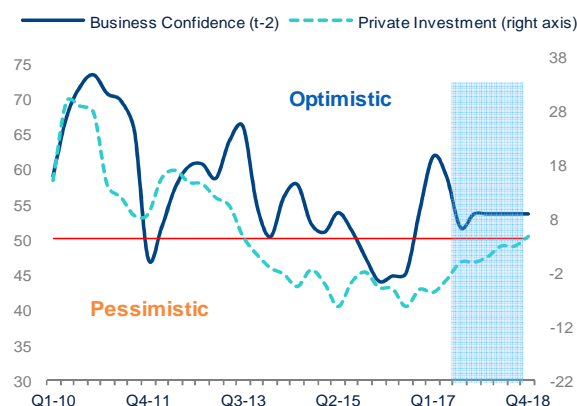
Source: Bloomberg and BBVA Research

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:

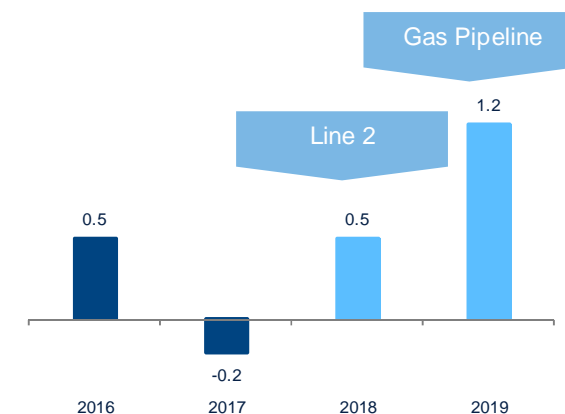
- **Confidence indexes will remain around current levels, i.e. fluctuating around a neutral reading of 50 points** (the threshold between optimism and pessimism, see Figure 3.12).

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 (farming 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 (consumption and investment)	4.4	-0.5	3.5	7.6

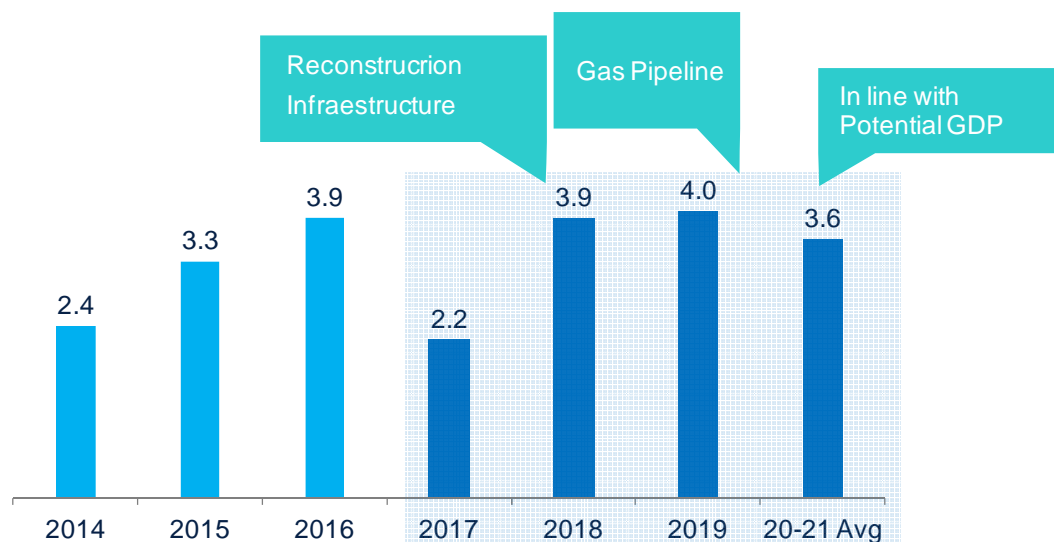
Source: Central Reserve Bank of Peru and BBVA Research

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 Longitudinal 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.

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