

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.

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