

Peru Outlook

Fourth quarter 2017

October 2017



Summary

1 The economic outlook is improving in the second half of the year. The Peruvian economy will grow at around 2.5% YoY in the second half of the year (and at around the same rate for 2017 as a whole), with increased support from domestic demand

2 GDP will grow at close to 4% YoY next year. This forecast is subject to the fiscal stimulus.

3 Although somewhat weaker, Peru will still enjoy tailwinds from the global environment. Jointly with the fiscal stimulus, it will facilitate improved private sector spending

4 In the coming months, the foreign exchange will trend upwards, albeit in a limited fashion: both the Fed and ECB will gradually normalise their monetary policy stance, China's growth rate will moderate, and metal prices will see a downward correction

5 Inflation returned to within the target range in September. In the absence of supply-side shocks, it will gravitate downwards in the next few months and end the year below 2.5%YoY. It will transitorily keep going down at the beginning of 2018

6 The Central Bank has been loosening its monetary policy stance by lowering both reserve requirements and the policy rate. We do not rule out a further rate cut over the rest of 2017 to underpin the recovery of private spending

**How will the year close in
terms of economic activity?**

The economic outlook is improving in the second half of the year

First half

El Niño coastal flooding



Lava Jato scandal



Infrastructure
Construction delays



Second half



External scene

Positive: world growth, metal prices, Fed (tightening only gradual)



El Niño coastal flooding

Adverse effects are wearing off



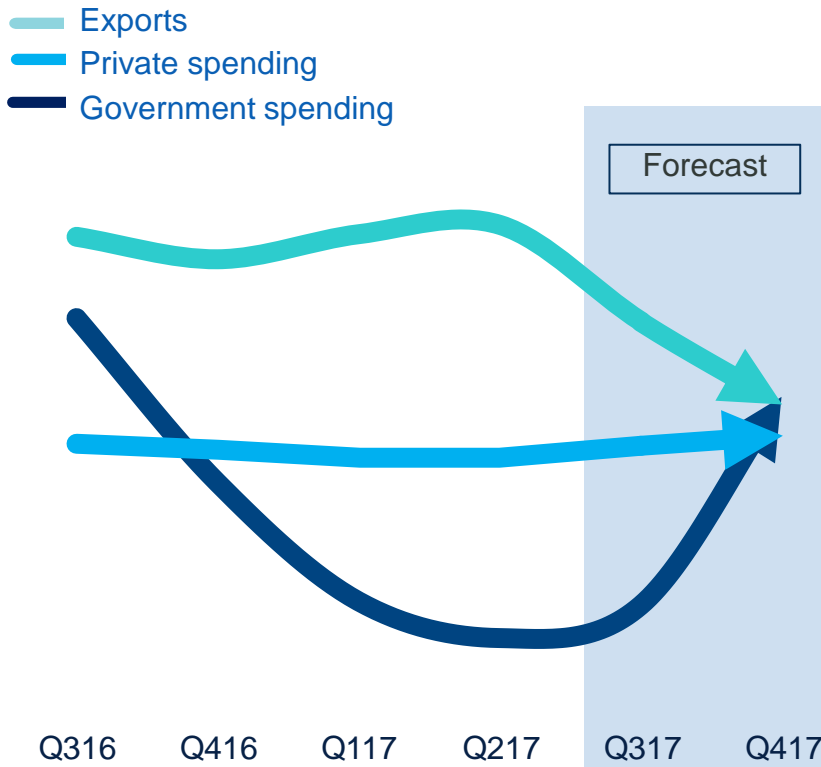
Economic policy

Counter-cyclical vein

Given this setting...

... what do we foresee in the second half of the year? Improved domestic demand, bolstered in particular by public spending

Forecast trends: Domestic demand and exports



GDP growth
No major differences to the first half

GDP structure
Domestic demand gains strength; exports slow down

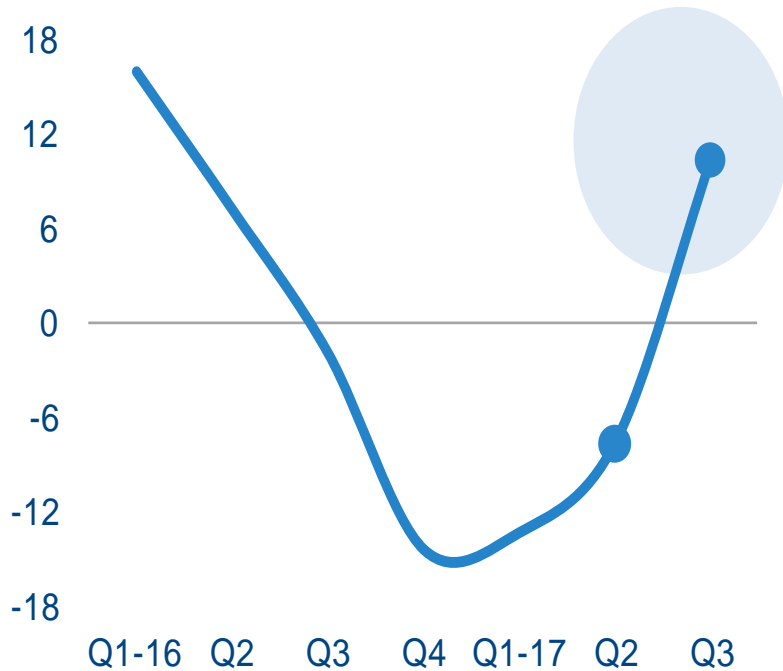
Government spending
Increasing in 3Q17, even more notably in 4Q17

Private spending
Private investment will grow again, with consumption lagging slightly

Source: BBVA Research

What do the third quarter activity indicators tell us? Government investment is reviving

Government investment*
(% change YoY)



* Gross Capital Formation of general government

Source: Central Bank - Ministry of Economy and Finance (IFMS)

Sub-national governments
Increased spending on sanitation

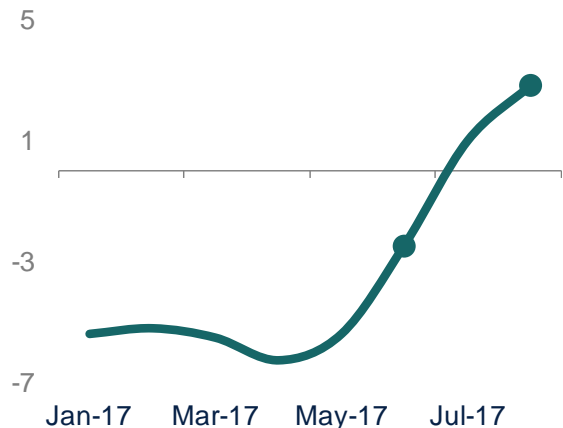
The 2019 Pan American Games

Lima Metro Line 2
Work has picked up speed since August

Reconstruction?
Still not much

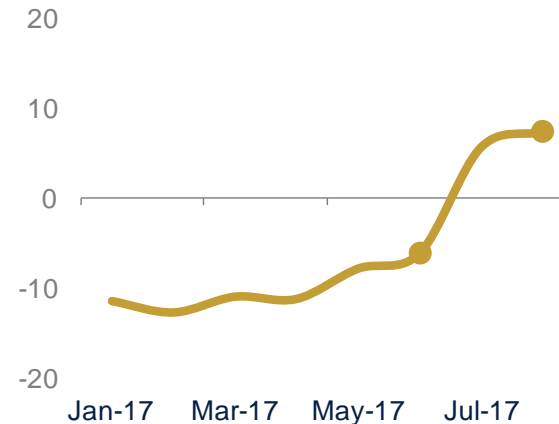
What do the third quarter activity indicators tell us? Upturn in private investment

Domestic cement consumption
(3-month moving average, % change YoY)



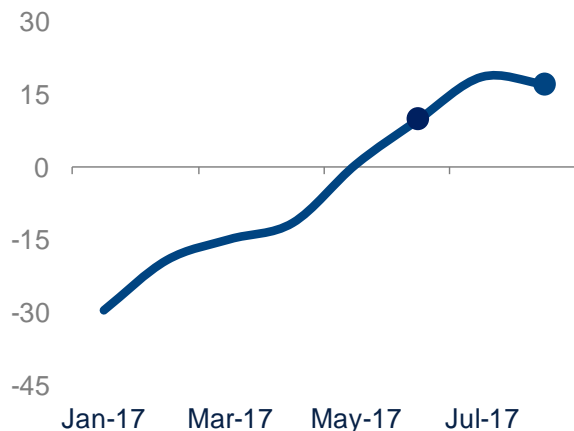
Source: National Institute of Statistics and Informatics (INEI)

Capital goods imports
(volumes, 3-month moving average, % change YoY)



Source: Central Bank

Mining investment
(USD million, 3-month moving average, % change YoY)



Source: Ministry of Energy and Mines (MINEM)

Business confidence
(points)

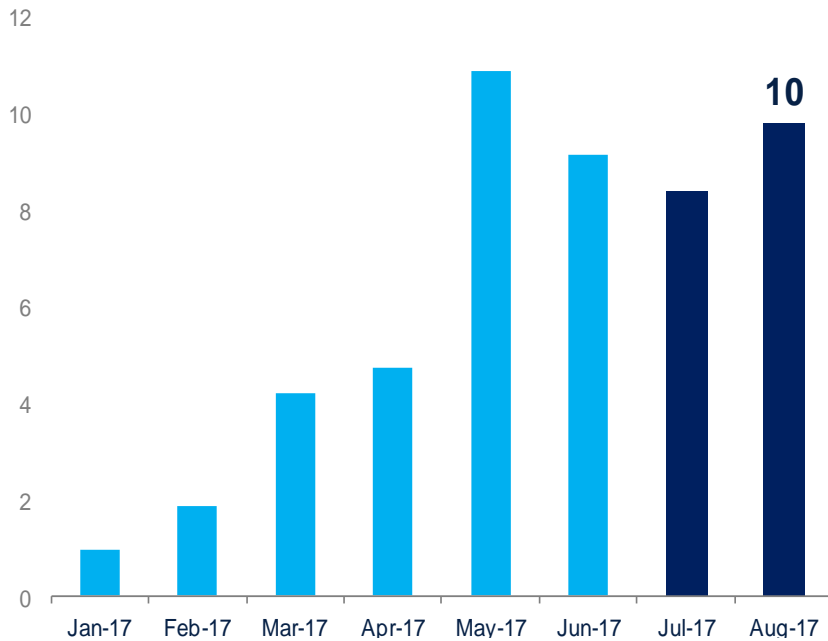


Source: Central Bank

What do the third quarter activity indicators tell us? The outlook for private consumption is unclear...

Sales of consumer durables have improved; the total wage bill is also starting to rise, **but...**

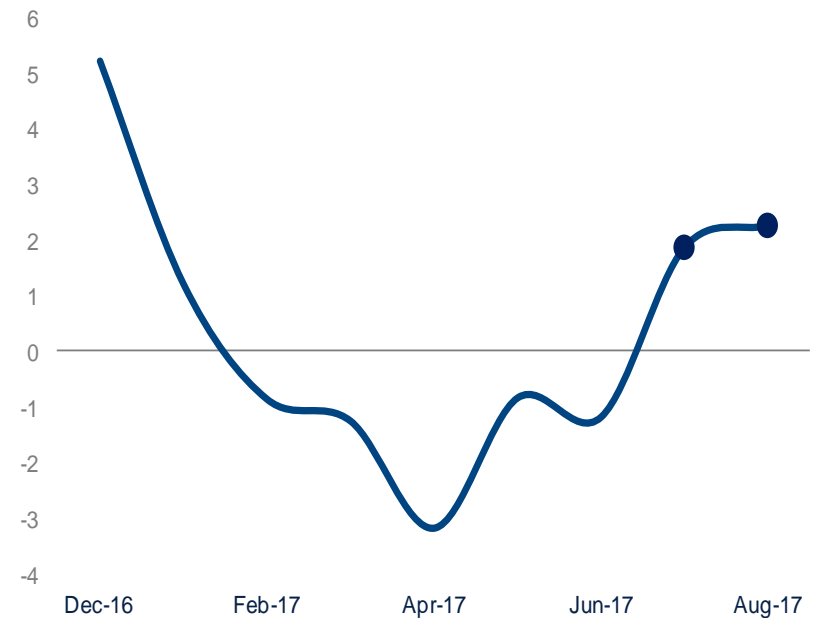
New family car sales
(% change YoY)



Source: Peruvian Association of Automobile Representatives (ARAPER) and Central Bank

Total wage bill

(Lima, actual, 3-month moving average, % change YoY)

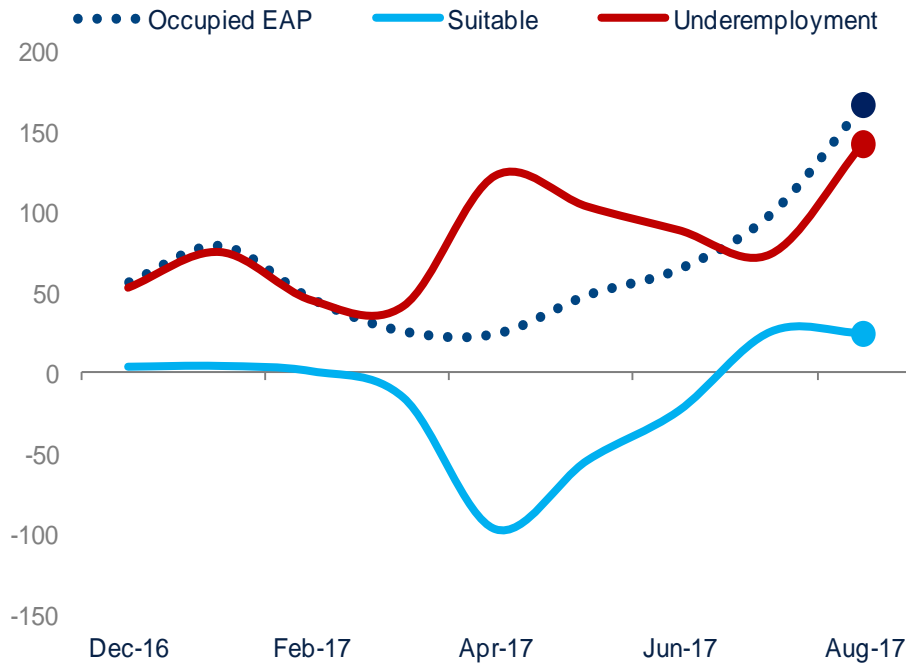


Source: National Institute of Statistics and Informatics (INEI)

What do the third quarter activity indicators tell us? The outlook for private consumption is unclear...

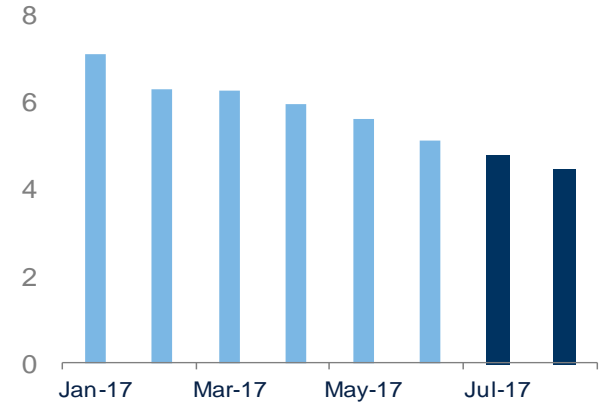
Job creation

(Lima, 3-month moving average, change YoY, thousands of persons)



Source: National Institute of Statistics and Informatics (INEI)

Bank consumer loans (% change YoY)



Source: Superintendency of Banking, Insurance and Pension Funds (SBS)

Consumer confidence (points)

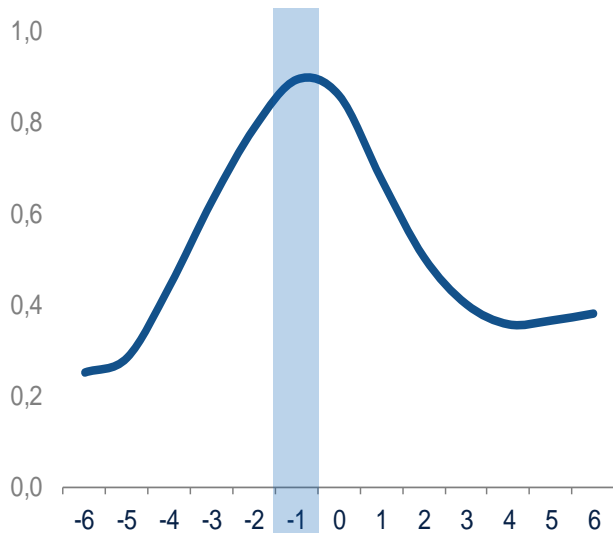


Source: APOYO Consultoría

...although private consumption usually reacts to an upturn in investment with something of a lag



Correlation between private consumption and investment lags (quarters)



The evidence points to private consumption reacting to investment with something of a lag

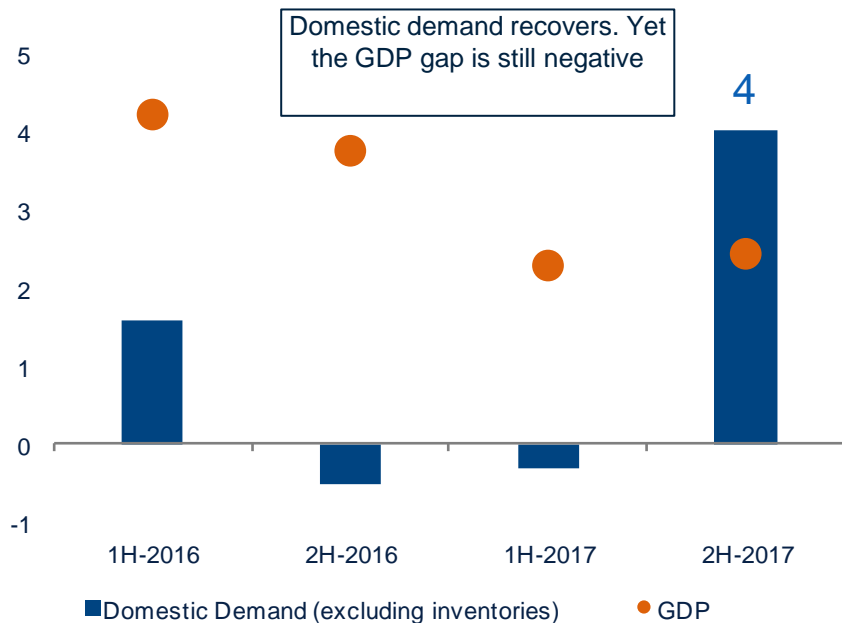
GFI* and private consumption (% change YoY)



*Includes government and private investment but not inventory accumulation. Has a lag of one quarter

The latest indicators are therefore consistent with forecasts we have for the second half of the year

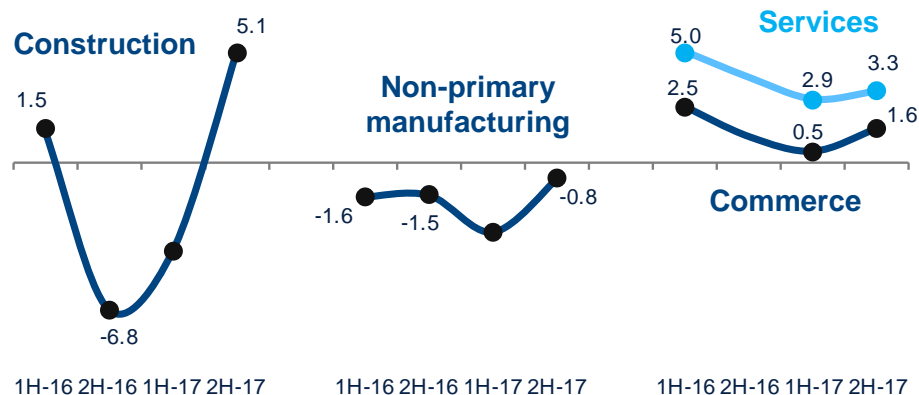
Domestic demand and GDP* (% change YoY)



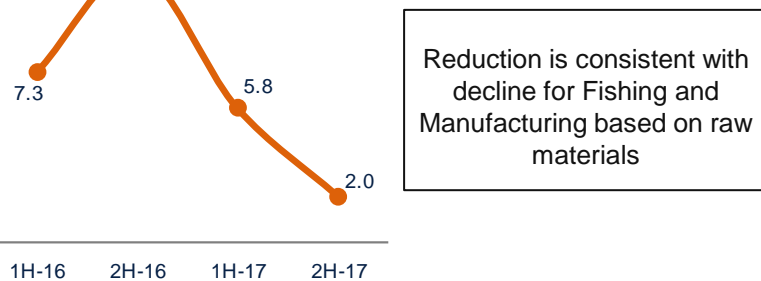
*Figures for the second half of 2017 are estimates

Source: Central Bank and BBVA Research

GDP by economic sector (% change YoY)



Primary GDP



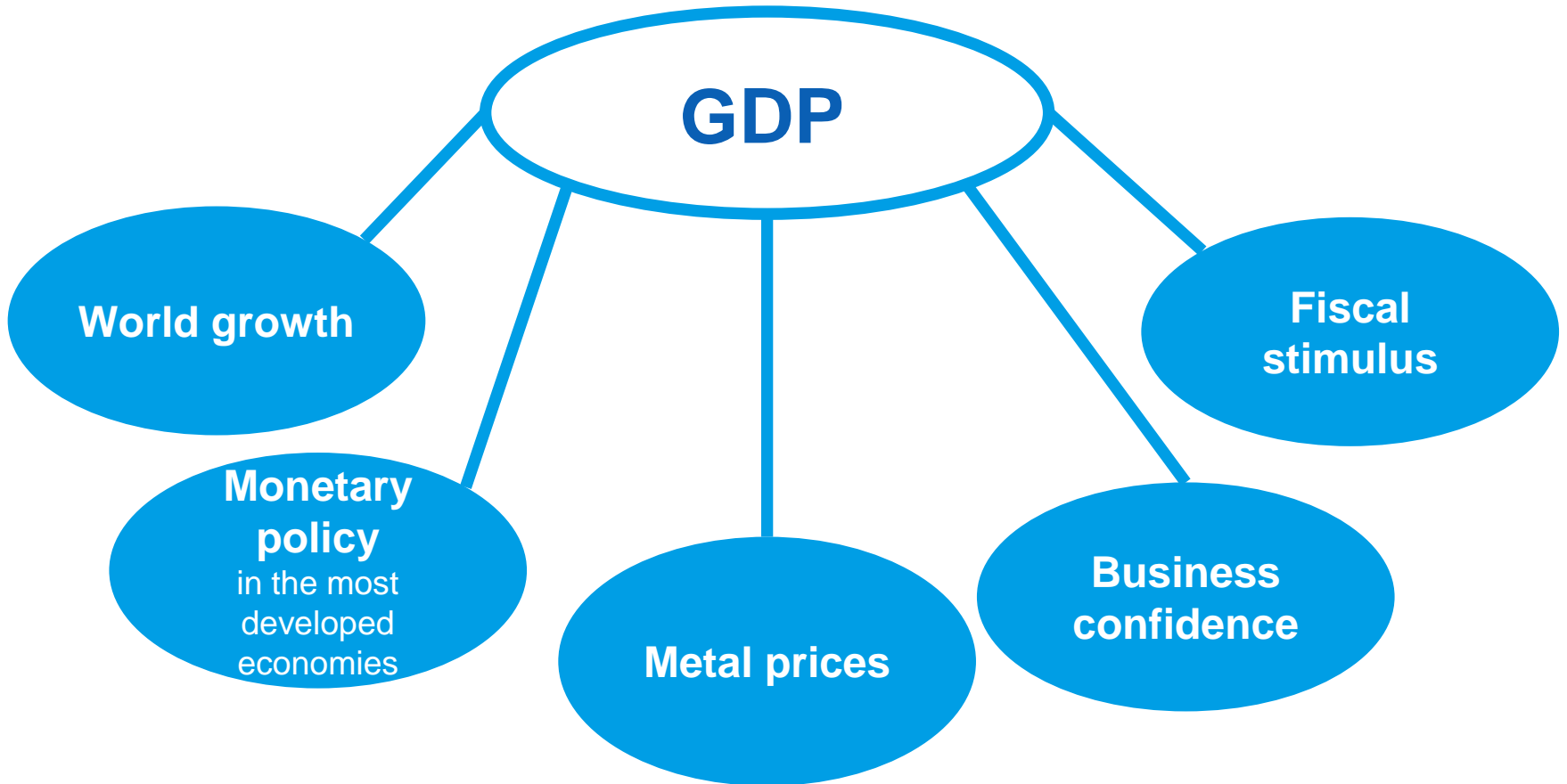
Source: Central Bank and BBVA Research

2017 GDP: +2.4%

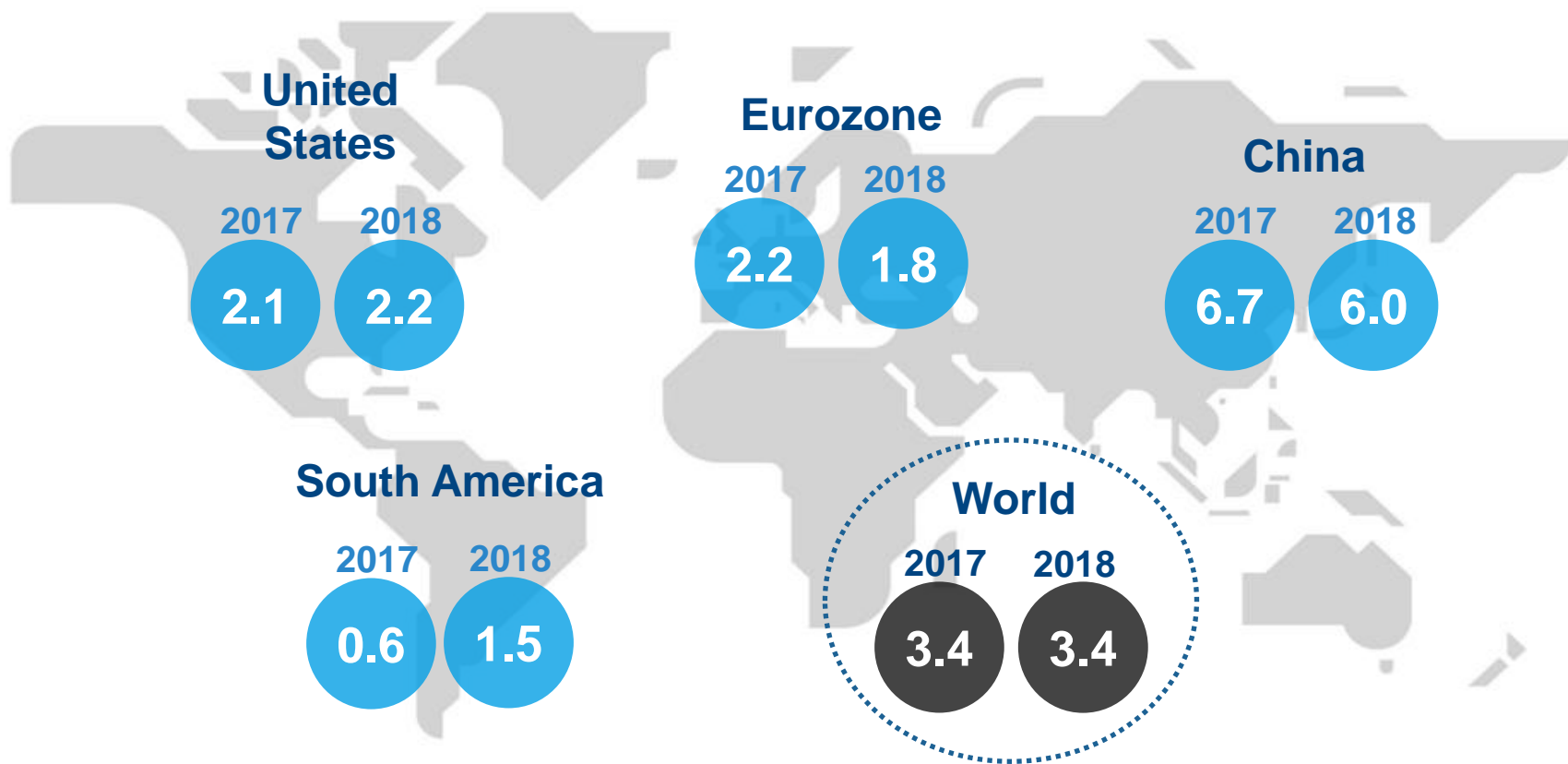
What do we expect for next year?

Key factors which underlie our projected base scenario...

Key factors which underlie our projected base scenario...



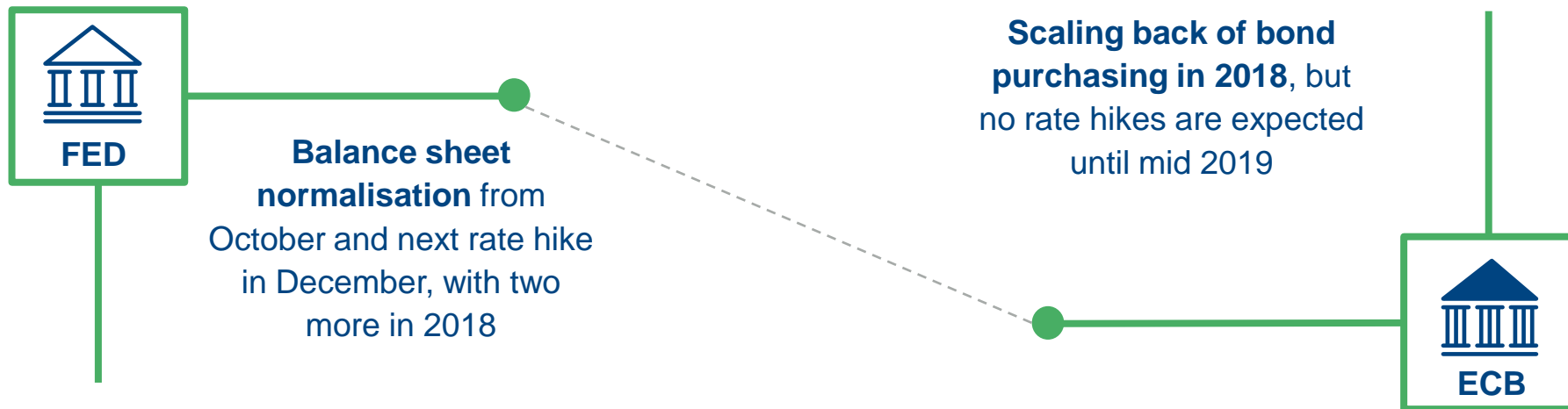
1 World growth remains robust but embraces more regions



Source: BBVA Research

2 Global financial markets will still favour emerging economies, although increasingly less so...

Central Banks are moving towards a very gradual normalisation process



High degree of uncertainty:



- In the **United States** due to slowing inflation and the expected change to the FOMC in 2018

- In the **Eurozone**, bias towards more gradual tapering (euro strength) and a delay to the rate hike cycle (low inflation)

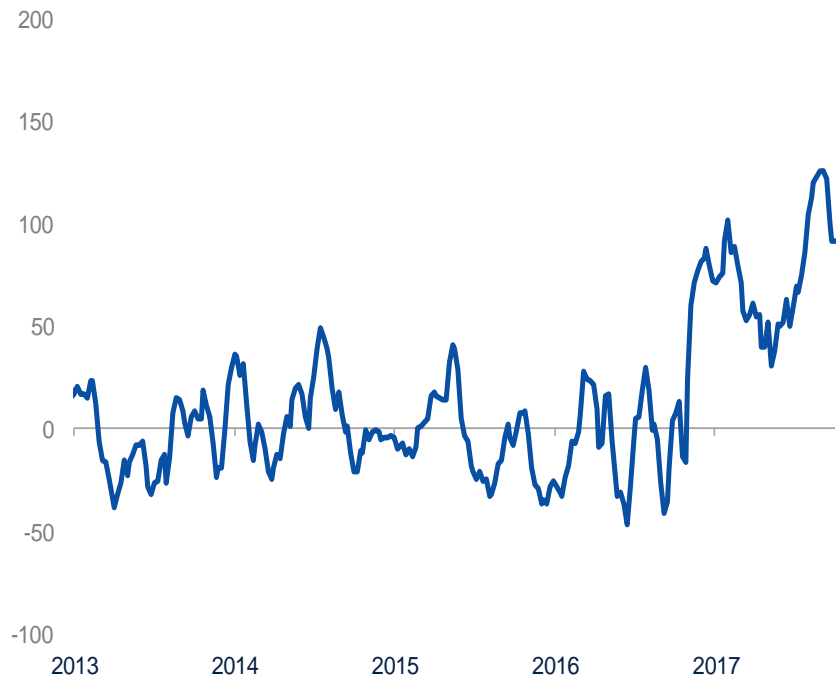
3

Metal prices, particularly copper?

It will drift back over 2018 because the tail winds driving world financial markets are dying down and China's growth rate is slowing down

Non-commercial copper positions

(thousands of contracts)



Source: Bloomberg and BBVA Research

Copper price

(USD/lb)

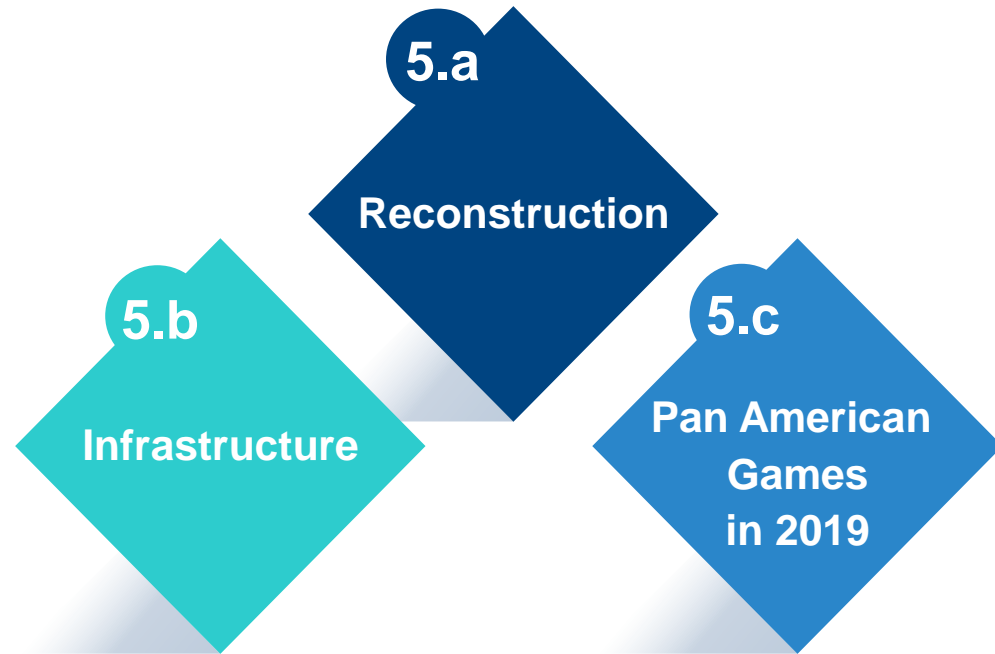


Source: Bloomberg and BBVA Research

4 and **5** **Locally...**

4 Business confidence
Within the range denoting
optimism (as in 2017, on average)

5 Fiscal stimulus



5.a Reconstruction

Investment
 USD 7.4 billion
 (3.6% of GDP)

Time horizon
 4 years (2017-20)

Funding
 About half using public savings

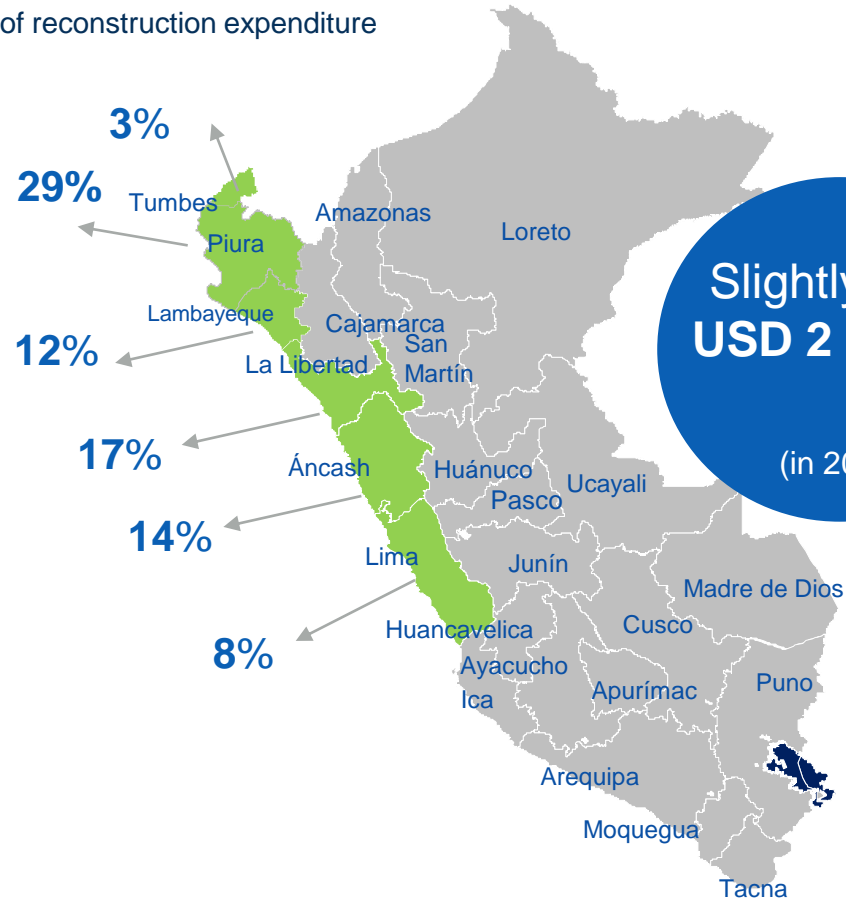
Sectors
 Transport and education account for more than 60%

Impact
 on 2018 GDP

1p.p.

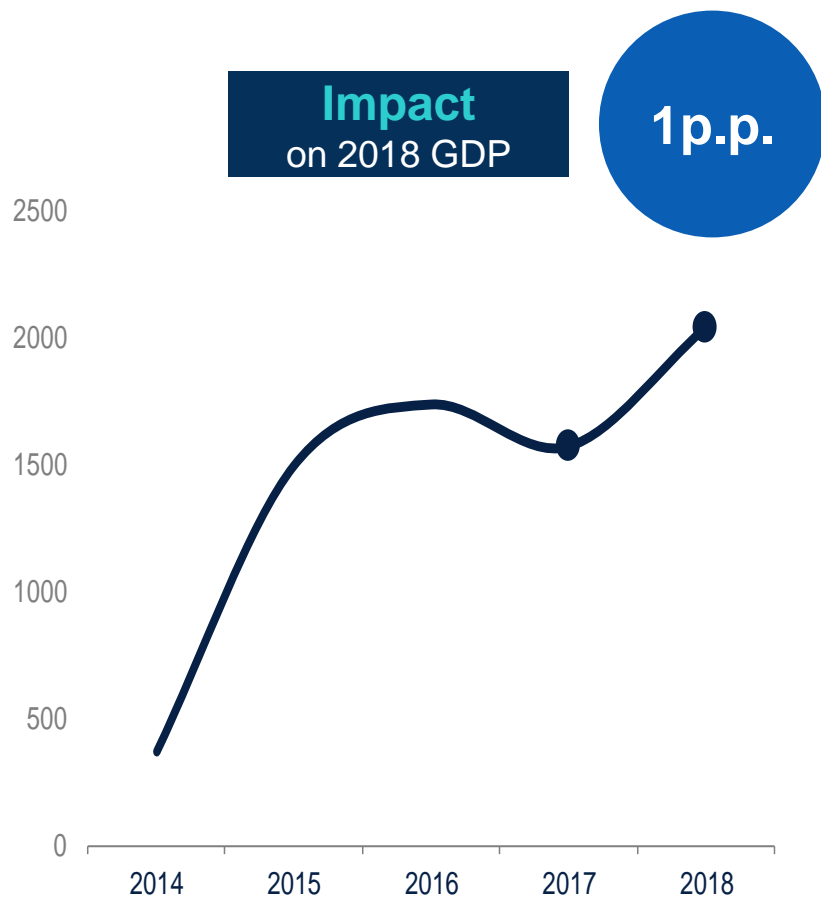
Share of regions in reconstruction expenditure (% of total)

■ 83% of reconstruction expenditure



5.b Infrastructure

Investment in infrastructure* (USD million)



Lima metro Line 2

**Overall investment
USD 5.7 billion**



2018: USD 800 million (0.4% of GDP)

Construction of five stations

The government hopes to complete the freeing up of 85% of the land

Talara refinery

**Overall investment
USD 5.5 billion**



2018: USD 880 million (0.4% of GDP)

Project has been executed as expected (construction has progressed 63%) and does not show funding problems

*Selected projects

Source: Proinversion, Ministry of Economy and Finance, Central Bank and BBVA Research

5.c

2019 Pan American Games

Investment

Approximately USD 900 million

Time horizon

2017 – July 2019

Construction

Eight venues and transport infrastructure

Expenditure in 2018

USD 700 million

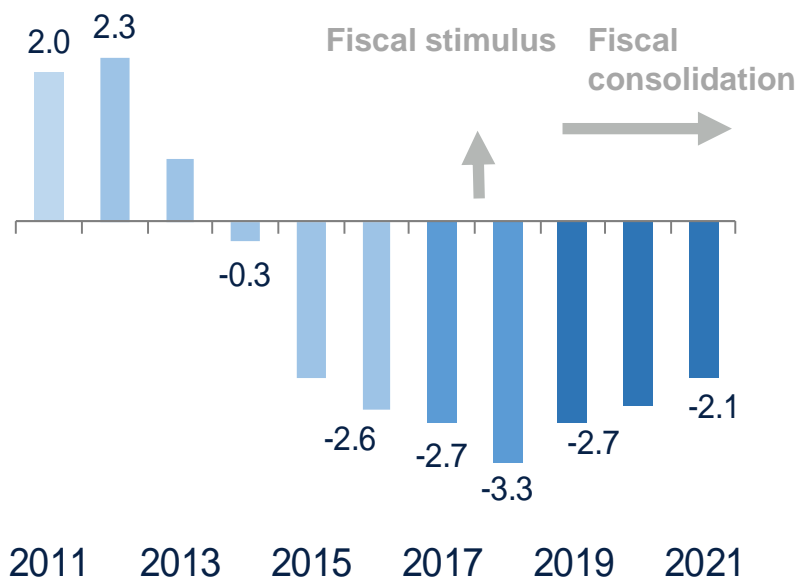


Impact
on 2018 GDP

0.3p.p.

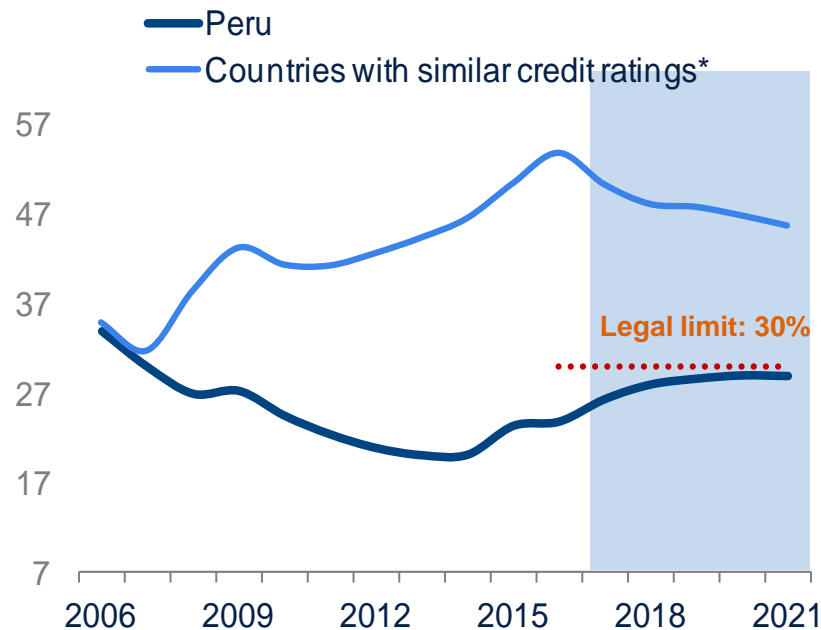
5 Fiscal stimulus in 2018 will boost activity but increase the deficit, although this will only be temporary

Fiscal balance
(% of GDP)



Source: Central Bank and BBVA Research

Gross government debt
(% of GDP)



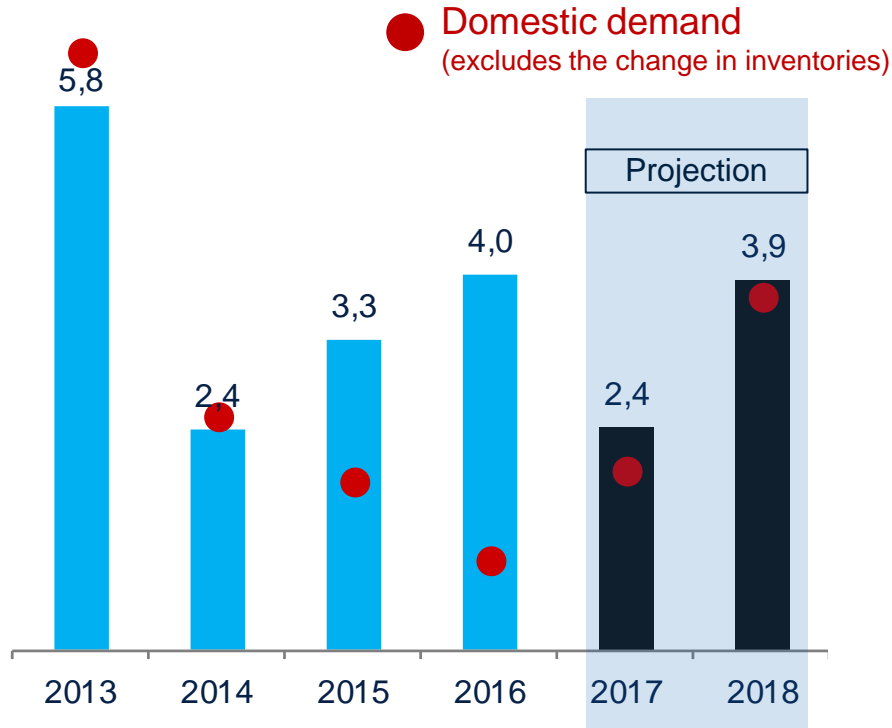
*Includes countries which Fitch, S&P and Moody's consider as having a similar sovereign credit rating to that of Peru. Uses the median for this group of countries

Source: IMF, Central Bank and BBVA Research

**In these circumstances, what
do we forecast for 2018 in
terms of economic activity?**

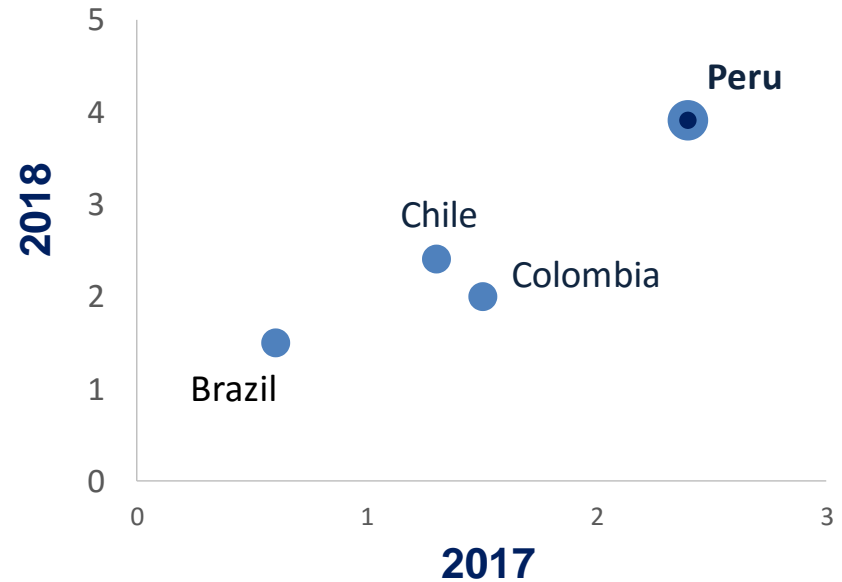
We estimate that economic activity will grow at about 4% in 2018, which means that Peru is set to continue at the forefront in the region

GDP and domestic demand
(% change YoY)



Source: Central Bank and BBVA Research

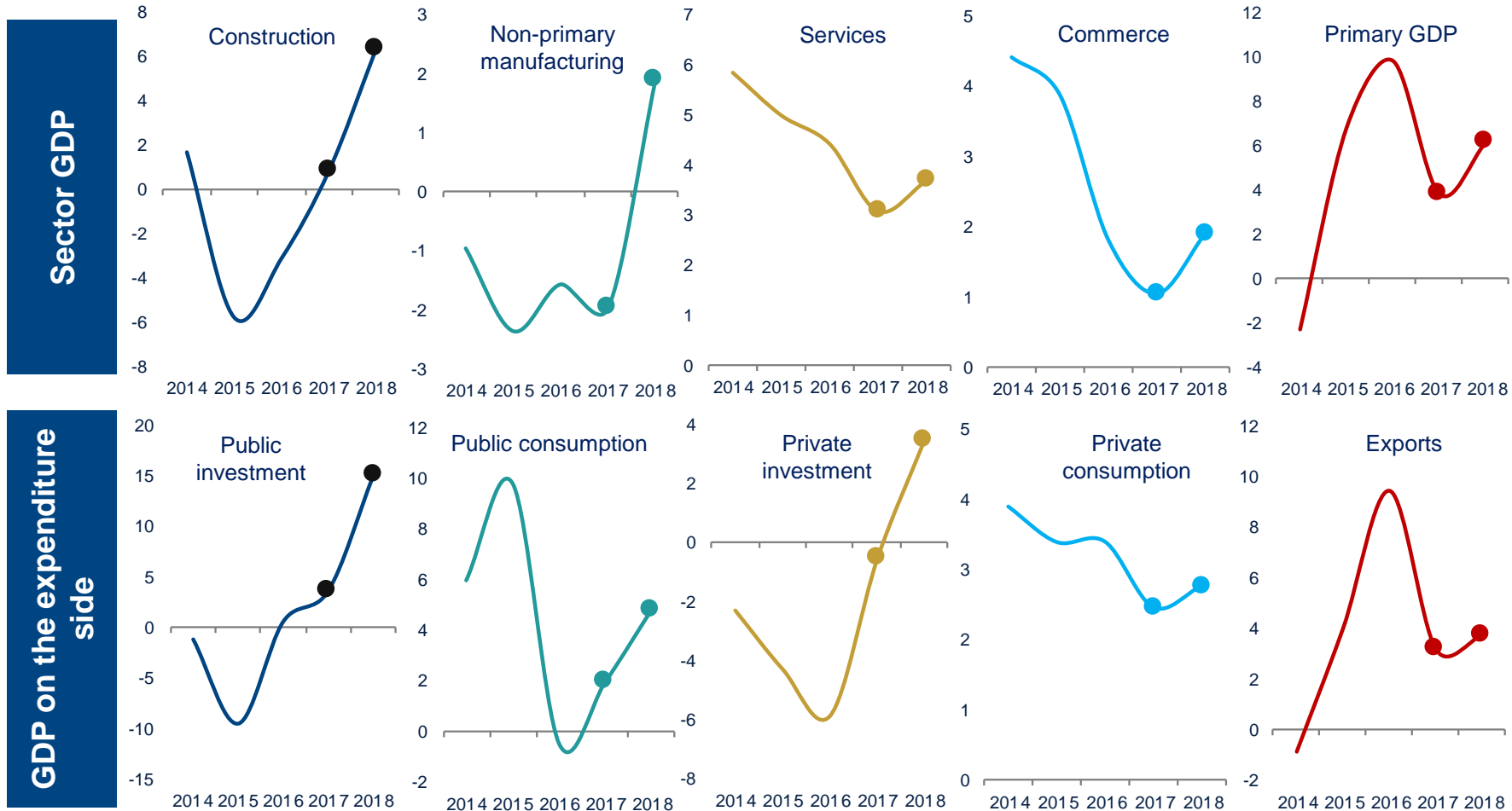
GDP
(% change YoY)



Source: BBVA Research

The improvement in Construction and Non-Primary Manufacturing sectors is notable, as is investment on the expenditure side

GDP by component
(% change YoY)

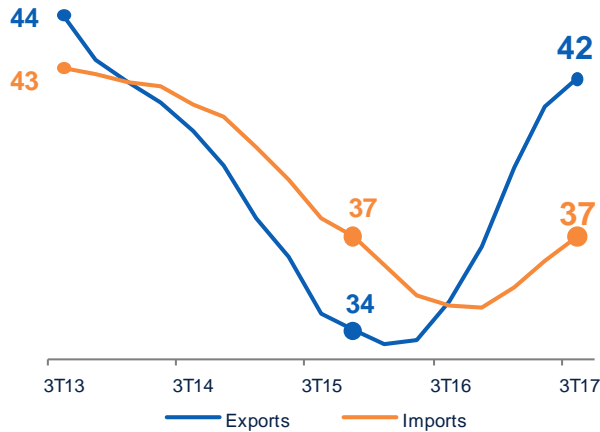


Source: BBVA Research

What do we foresee for the exchange rate?

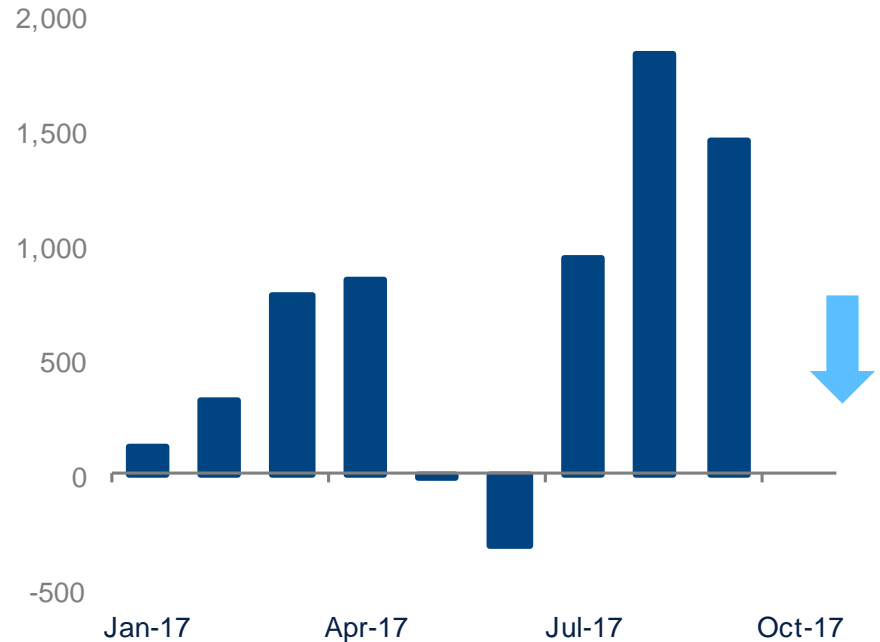
Pressure on the local currency to appreciate in recent months due to...

Peru: trade balance
(acum. over the last twelve months, in USD billion)



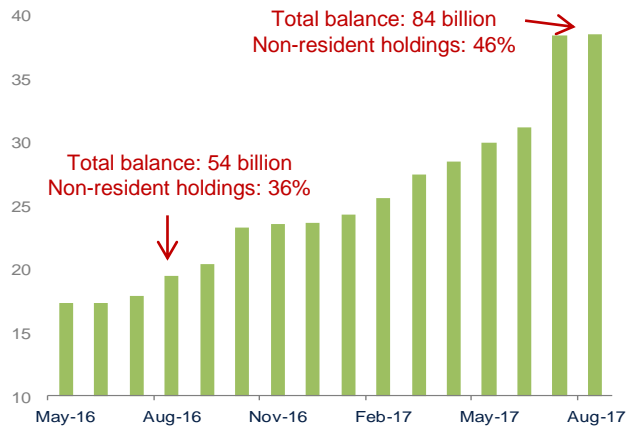
Source: Central Bank

Forex market: Central Bank buying intervention
(USD million)



Source: Central Bank

Non-resident holdings of Sovereign Bonds
(PEN billion)



Source: Bloomberg

These pressures have eased in recent weeks though, with the PEN trending slightly weaker from now on

Why will the PEN trend weaker?

FED
Gradual monetary tightening

China
Slowdown in economic growth

Copper price
Downward correction

Domestic demand
Will gain traction and so will imports

Exchange rate
(USD/PEN)

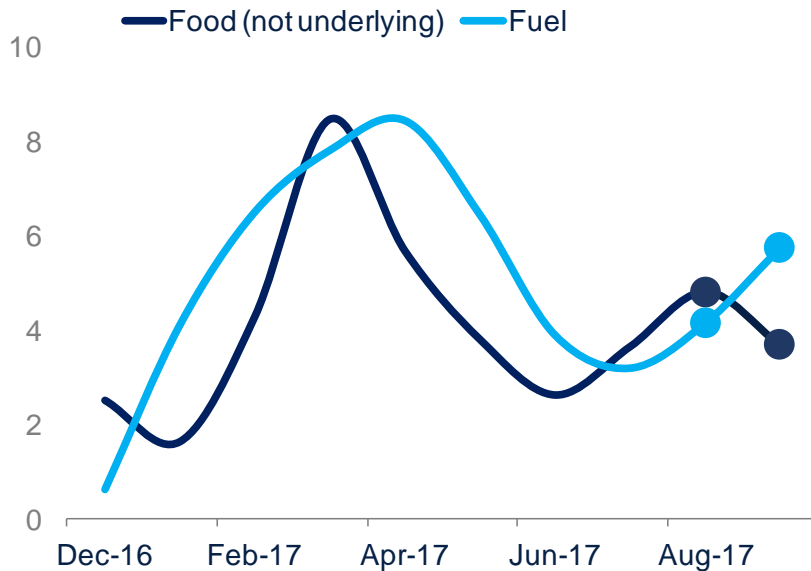


Source: Central Bank and BBVA Research

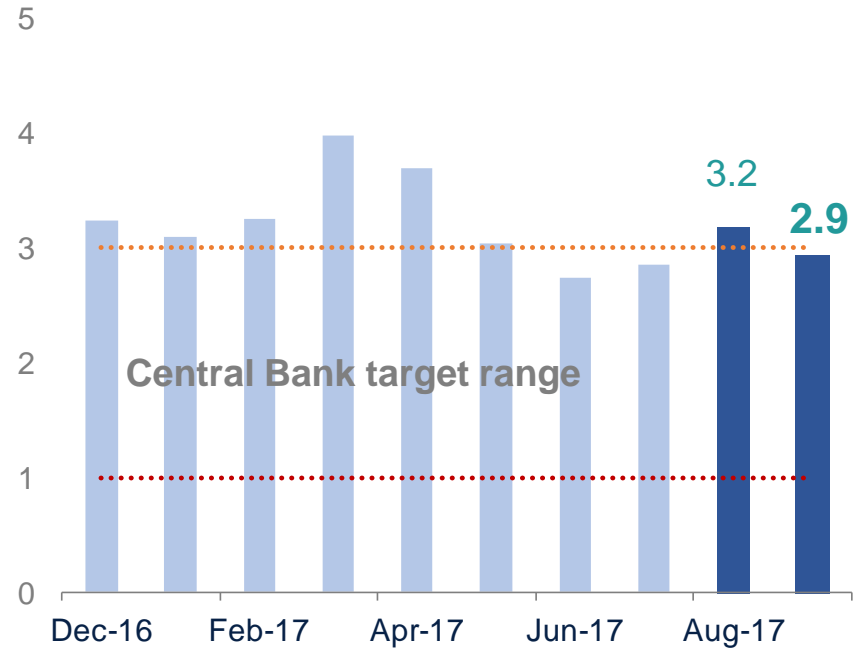
**What do we predict for
inflation over the rest of the
year and into the next?**

Inflation returned to within the target range in September: foods are experiencing a downward correction

Food and fuel prices
(% change YoY)



Inflation
(% change YoY)



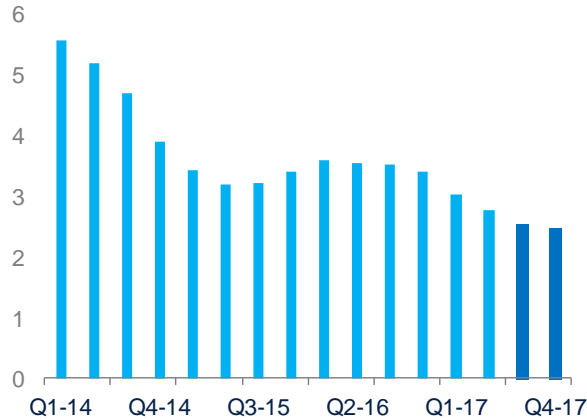
Source: Central Bank and BBVA Research

Source: Central Bank and BBVA Research

In the absence of supply-side shocks, inflation will remain on a downward course over the next few months and see out the year at a shade under 2.5%

Private consumption

(acum. over the last four quarters, % change YoY)



Source: Central Bank and BBVA Research

Lemon price

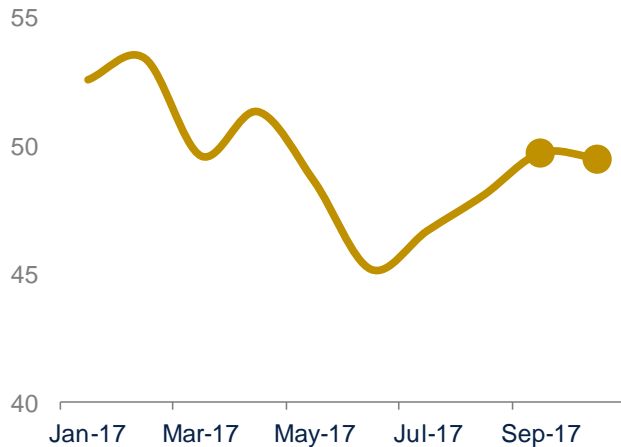
(PEN per kilo)



Source: Minagri

WTI price

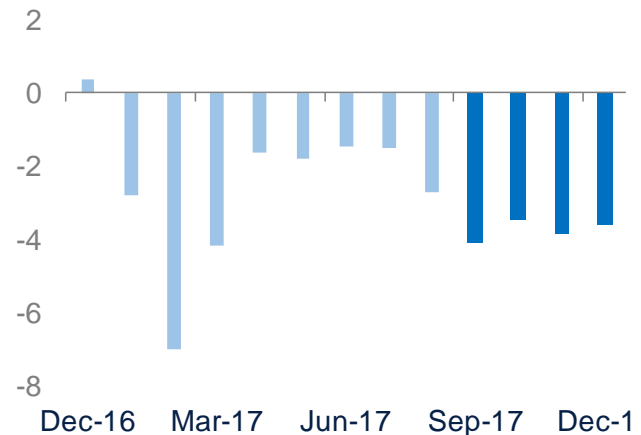
(USD/BR)



Source: Central Bank and BBVA Research

Exchange rate

(% change YoY)



Source: Central Bank

Going into 2018 inflation will continue to fall back, but further ahead, and towards the end of the year, it will stand at a level similar to that in 2017

Positive base effect
El Niño coastal flooding in 1Q16

Slack in the economy
 There will still be some in certain sectors

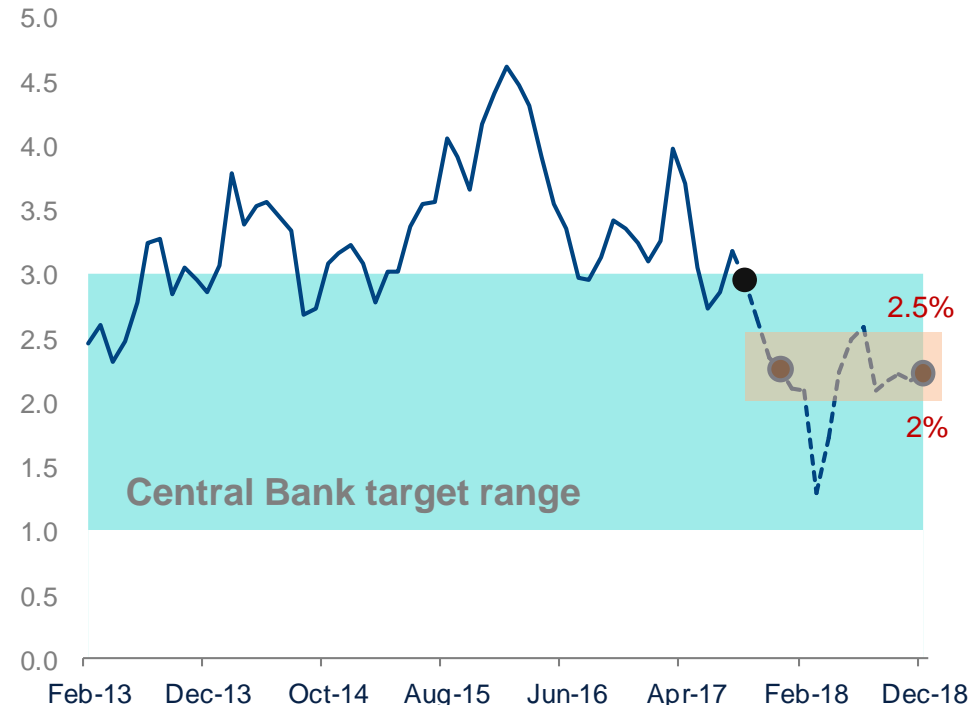
Abnormal weather?
 It will be a more “normal” year

Exchange rate
 Mild depreciation (< 2%)

Commodity prices
 Increase in the oil price

Financial costs
 Moderate rise in dollar rates

Inflation
 (% change YoY of the CPI)

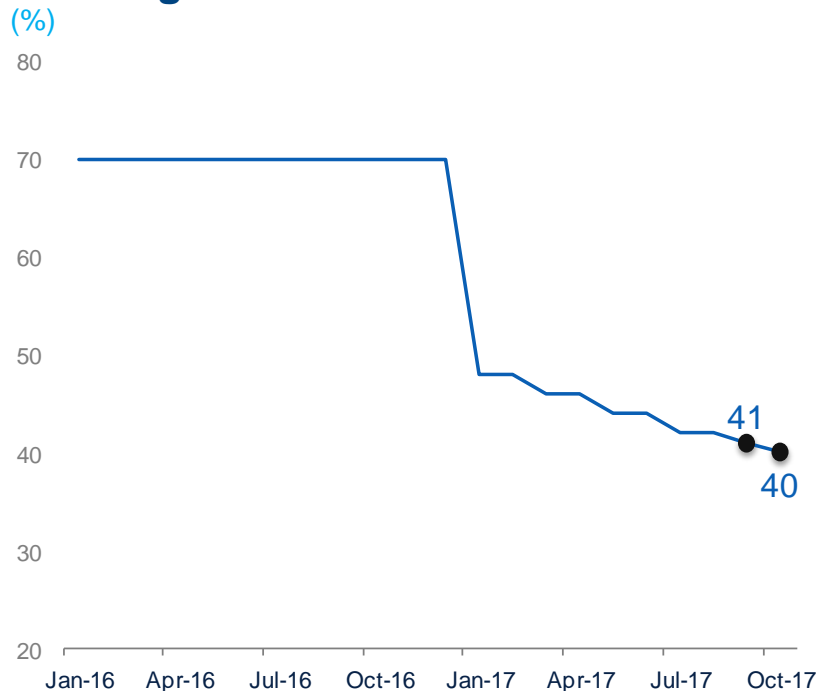


Source: Central Bank and BBVA Research

Further reference rate cuts?

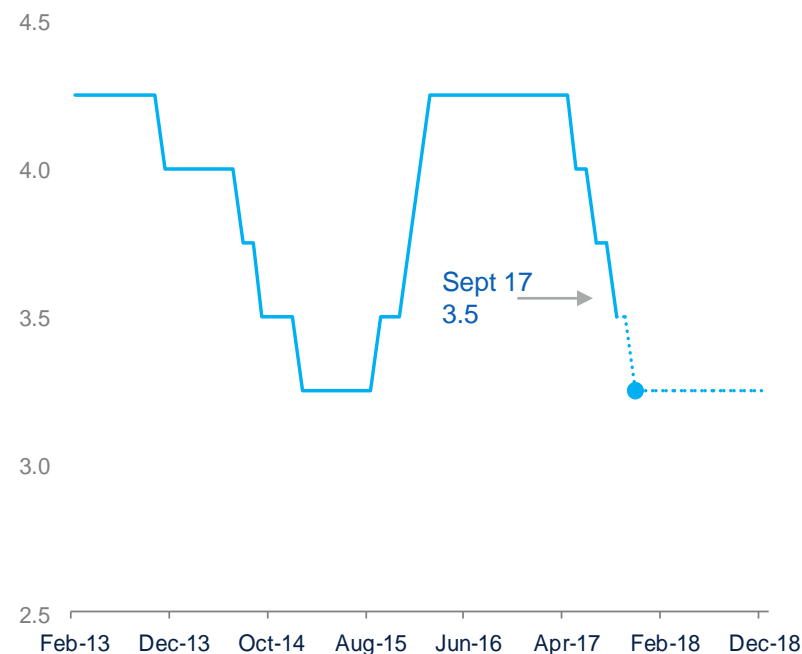
The Central Bank has been loosening monetary conditions: lowering reserve requirements and the policy rate

Marginal reserve requirement for foreign exchange (%)



Source: Central Bank

Reference rate (%)



Source: Central Bank and BBVA Research

We do not rule out a further rate cut over the rest of the year

Weak private spending (will grow at around 2% this year), slack in the economy, weak credit, falling inflation, the PEN's depreciation will be limited; this ought to supplement the stimulus on the fiscal side

Chief risks to forecasts

Chief risks to forecasts

External

FED

China

Local

Delays to construction on infrastructure projects

Friction that hampers a swift implementation of spending on reconstruction

Falling confidence

Summary of projections

Macroeconomic projections for 2017 and 2018

	2012	2013	2014	2015	2016	2017 (estimated)	2018 (forecast)
GDP (% YoY)	6.0	5.8	2.4	3.3	4.0	2.4	3.9
Domestic demand (excl. inventories, % YoY)	9.8	6.4	2.5	1.8	1.0	1.9	3.8
Private spending (% YoY)	6.5	7.2	1.9	2.7	1.3	2.2	2.9
Private consumption (% YoY)	7.4	5.7	3.9	3.4	3.4	2.5	2.8
Private investment (% YoY)	15.5	6.9	-2.3	-4.3	-5.9	-0.5	3.5
Public spending (% YoY)	11.6	8.1	3.6	3.6	-0.2	2.5	7.8
Public consumption (% YoY)	8.1	6.7	6	9.8	-0.5	2.0	4.9
Public investment (% YoY)	19.5	11.1	-1.1	-9.5	0.6	3.7	15.1
Exports (% YoY)	5.8	-1.3	-0.9	4	9.5	3.2	3.8
Imports (% YoY)	10.7	4.2	-1.4	2.4	-2.2	2.8	3.0
Exchange rate (vs. USD, EOP)	2.57	2.79	2.96	3.39	3.4	3.28	3.34
Inflation (% YoY, EOP)	2.6	2.9	3.2	4.4	3.2	2.3	2.2
Reference rates (% EOP)	4.25	4	3.5	3.75	4.25	3.25	3.25
Fiscal balance (% of GDP)	2.3	0.9	-0.3	-2.1	-2.6	-2.7	-3.3
Current account (% of GDP)	-2.8	-4.7	-4.4	-4.8	-2.7	-1.7	-1.9

Forecast closing date: 6 October 2017

Source: Central Reserve Bank of Peru and BBVA Peru Research

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