1. Summary

Available indicators point to economic growth having suffered a dip at the end of 2017. The suspension of anchoveta fishing, not lifted until January 2018, apparently led to an overall contraction in activities relating to the extraction and processing of natural resources, the first in three years. In this context, **we estimate that GDP grew by between 2.0% and 2.5% YoY in the fourth quarter of last year, perhaps closer to the lower part of that range, bringing GDP growth for the whole year to around 2.3%**. It is important to mention that despite the temporary dip at year-end, the composition of growth continues to change, being increasingly driven by domestic demand, as exports slow, with the boom in copper production tending to lose impetus.

For 2018 we see GDP growing by around 3.5% (and 3.8% in 2019). The **increase of just over a percentage point in growth will come about in a context in which the international panorama continues to be favourable for the Peruvian economy**. For example prices of the metals that Peru exports will remain at attractive levels, and this will favour investment in the mining sector. World growth will accelerate, (particularly Peru's main trading partners), while the monetary adjustments in developed economies will continue to be only gradual. **On the domestic front, as well as the return to normal of weather conditions, there will be a fiscal stimulus associated with the increased expenditure on rebuilding infrastructure damaged by the *El Niño Costero* weather phenomenon of early 2017 and to accelerate construction of new infrastructure**, such as that needed for the Pan American Games of 2019 and the second Lima metro line. However, this growth forecast for 2018 is somewhat lower than it was three months ago (3.9%). Following the debate in Congress on the impeachment of President Kuczynski (the motion was defeated) and the subsequent pardoning of former president Fujimori, the sense of precarious political stability has increased; in this context of greater uncertainty, our new baseline scenario incorporates greater reticence in spending on the part of businesses and households as well as in public spending. In other words the fiscal stimulus continues to act as a significant underpinning of growth in 2018, but less than in our previous report. The downward revision is attenuated by the improvement in the external panorama compared with the one we presented three months ago (greater world growth and higher metal prices).

The acceleration in public spending will take the fiscal deficit temporarily from 3.2% in 2017 to 3.4% in 2018. This will be the biggest deficit in eighteen years. Later on, from 2019, the government has the objective of consolidating the fiscal accounts. Fulfilling that commitment will require an effort to contain current spending, but we believe it is possible to achieve, bearing in mind that the increase in public spending in 2018 is specially on the investment side and it's transitory (reconstruction of infrastructure, Pan American Games), that revenues will have ceased to shrink as a percentage of GDP (recovery of domestic demand), and that tax refunds are starting to return to normal. This tendency towards consolidating the fiscal accounts has been incorporated into our projected baseline scenario, but the pace of consolidation that we assume is somewhat less ambitious than that announced by the government. As a result, gross public debt will stabilise at a level equivalent to just over 29% of GDP in the medium term.

In the financial markets, prices of Peruvian assets continue to strengthen. The increase in political noise on the domestic front only had a temporary negative effect. In the specific case of the Peruvian currency, it continues to come under appreciative pressure in a context of strong trade surplus - which we estimate grew to US$5.8 billion in 2017 - and capital inflows (to acquire sovereign bonds, for example), as a result of the abundance of liquidity globally, expectations that the central banks of the most developed economies will withdraw monetary stimulus measures but only gradually and with forewarning, improvement in external accounts and continuing solidity of the public finances. The central bank's intervention in the foreign exchange market is containing the appreciative pressure on the PEN. **Looking ahead, we see the panorama on the forex market remaining qualitatively similar, albeit with a trade surplus and capital inflows gradually moderating, and with a central bank continuing to be active. In that context, the PEN will end the year at a similar level of the one of year-end 2017**, but will subsequently tend to depreciate somewhat.

On the price side, inflation has fallen quickly and significantly in the past few months, ending in 2017 at 1.4%, the lowest level in the past seven and a half years. Contributory factors were the return to normal of certain food prices which had spiked with the abnormal weather conditions associated with *El Niño Costero* phenomenon, the appreciation of the currency and the cyclical weakness of the economy. We estimate that the bulk of the food price corrections had already taken place. Even so, due to the high base for year-on-year comparison, **inflation will continue to fall in the first quarter of 2018 and for a short time will be below the target range. Later on, however, it will tend to move closer to the middle of the target range, which we estimate will reach towards year-end**. The forecast takes account of the fact that the rate of year-on-year increase in food prices, which declined sharply last year, will return to normal and that the exchange rate will hold relatively steady, in contrast to what happened in 2017 when it fell by 4% (i.e. fewer PEN per USD) and thus reduced inflation. These effects will be attenuated by the slack still remaining in certain sectors of the economy and by the lower YoY rate at which we estimate oil prices will increase in 2018.

In this environment of sharply falling inflation – which is leading inflationary expectations down the same path, albeit more slowly – **and the cyclical weakness of the economy, the central bank has continued with cuts to its reference interest rate in the past few months**. It currently stands at 3.0%. **We do not rule out the possibility of an additional cut of 25 bps in the next two or three months** if GDP growth surprises the economic authorities negatively, which we think will happen with the 4Q figures, if fiscal stimulus takes longer than expected to materialise (and is thus below forecast), if increased political noise translates into further loss of business confidence, or if inflationary expectations fall below 2%. **Our baseline scenario incorporates this cut and assumes that the base rate will be held at 2.75% at least until mid-2019**.

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