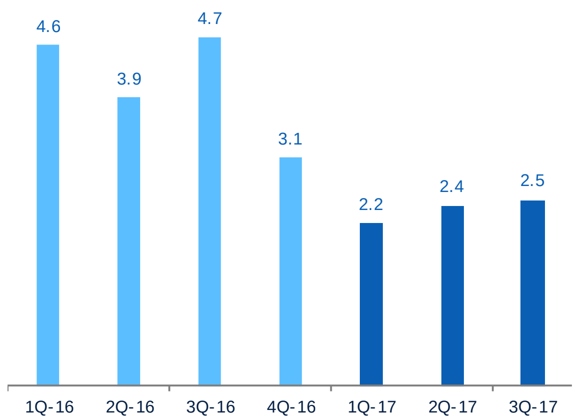
3. Peru: we have revised our growth forecasts for 2018 and 2019 downwards

During the third quarter of 2017 the economy continued to show signs of improvement, favoured by a recovery in domestic demand and the tailwinds from the international environment

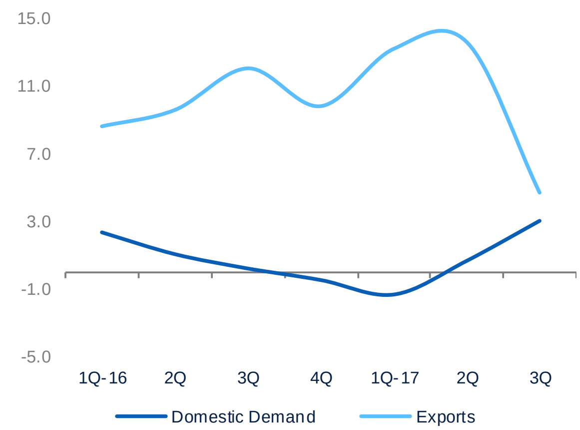
GDP grew by 2.5% YoY in the third quarter of 2017. This suggests that activity is improving (see Figure 3.1) after suffering the negative impact of *El Niño Costero* weather phenomenon and the postponement of major infrastructure projects such as the Southern Gas Pipeline. The improvement in activity is nonetheless moderate.

Figure 3.1 GDP
(change % YoY)



Source: Central Reserve Bank of Peru and BBVA Research

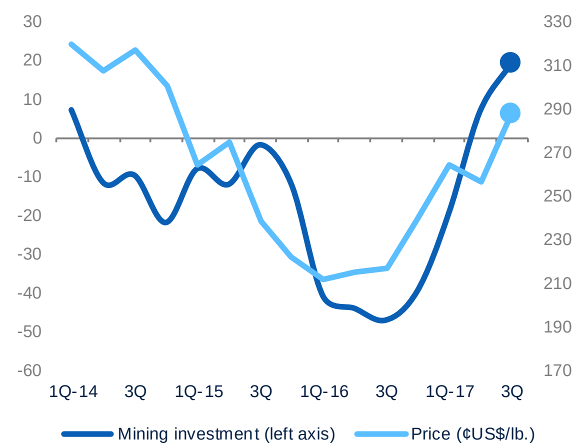
Figure 3.2 Domestic demand* and Exports
(in real terms, change % YoY)



* Excludes change in inventories
Source: Central Reserve Bank of Peru and BBVA Research

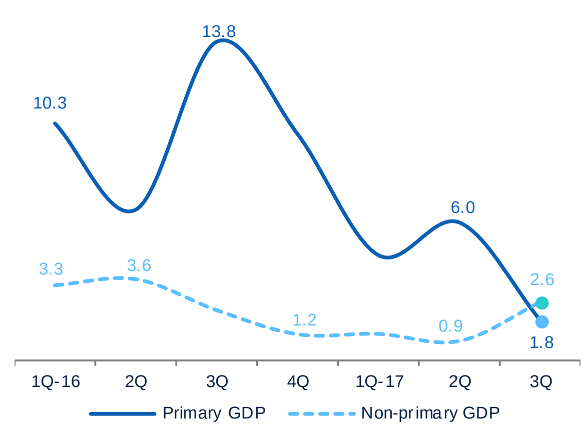
Within GDP there were some interesting changes in the third quarter, in line with what we anticipated in our previous report. On the expenditure side, domestic demand is recovering (see Figure 3.2), especially investment. Private sector investment for example started growing again after fourteen consecutive quarters of contraction, in an environment in which on the one hand mining investment is finding support in the favourable external conditions (attractive metal prices; see Figure 3.3) and on the other, non-mining investment is starting to regain strength little by little following the dissipation of the negative effects of *El Niño Costero* and in an environment of greater impetus from countercyclical economic policy. For its part public investment grew by 5% in the third quarter. This was its first positive figure for a year. Notable items were the increased spending on sanitation infrastructure and on the 2019 Pan American Games and the acceleration of the construction works for Line 2 of the Lima Metro. Exports weakened however, in contradistinction to domestic demand. This reflects the significant slowing in the rate of growth in copper exports, in a context in which it seems that companies may have been making temporary use of their inventories for exports, taking advantage of the increase in international copper prices (otherwise it is difficult to explain such strong first-half exports despite low 1H production figures), which would have ended in the second half of the year. In terms of sectors, the shift towards greater dynamism in domestic demand and a slowdown in exports was reflected in an improvement in non-primary activities such as construction, commerce and services, whereas primary activities as a whole, namely those linked to the extraction of natural resources, showed a weaker performance (see Figure 3.4).

Figure 3.3 Mining investment and Price of copper (change % YoY; USD¢/lb)



Source: Central Reserve Bank of Peru, MINEM (Ministry of Energy & Mines) and BBVA Research

Figure 3.4 Primary and non-primary GDP* (change % YoY)

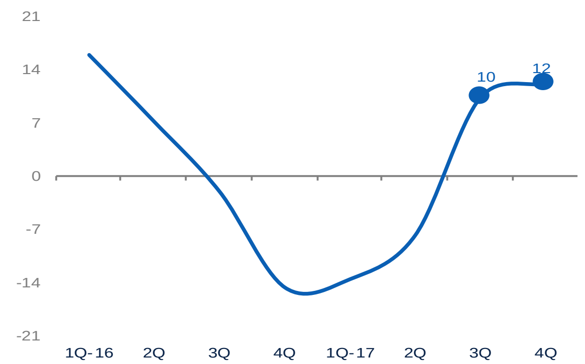


* Non-primary GDP excludes import duties and taxes.
Source: INEI (National Statistics Institute), Central Reserve Bank of Peru and BBVA Research

During the fourth quarter however, activity suffered a temporary dip according to our estimates, growing by between 2.0% and 2.5% YoY

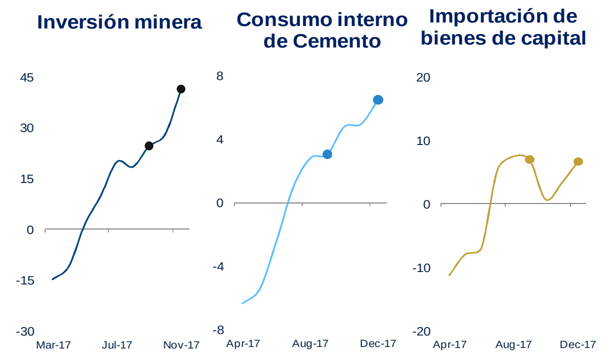
Available information for Q4 2017 suggests two things. Firstly, continuation and indeed accentuation of the main trends of the previous quarter, namely shifts in the growth drivers in favour of domestic demand and slowdown in exports. Public investment for example again showed strong dynamism (see Figure 3.5), while available indicators for private investment (see Figure 3.6) point that it has expanded at a similar rate to that seen in the previous quarter. Secondly, that the rate of GDP growth, which had been increasing, suffered a dip and came in at below 2.5% YoY. This result reflected above all the difficulties faced by the second anchoveta fishing season in the central-north coastal zone (suspension of fishing because a significant proportion of fish were under-size), which had a negative effect on primary fishing and manufacturing in terms of sectors and on exports as regards spending. If this had not occurred, and if a similar volume of anchoveta had been caught to that of 2016, GDP would have grown in Q4 by just over 3.0% YoY according to our estimates.

Figure 3.5 Public expenditure*
(change % YoY)



* Relates only to the central government, so it does not include state-owned enterprises.
Source: Central Reserve Bank of Peru and BBVA Research

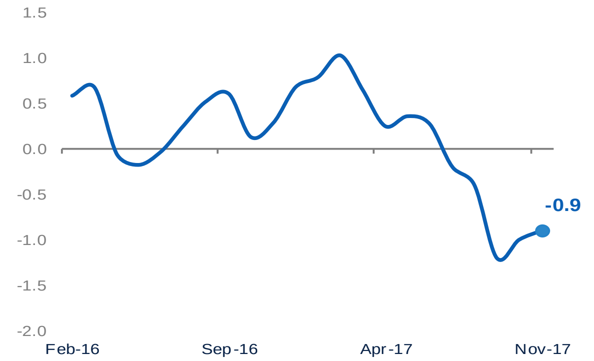
Figure 3.6 Indicators of private investment
(moving three-month average, change % YoY)



Source: MINEM, INEI, Central Reserve Bank of Peru and BBVA Research

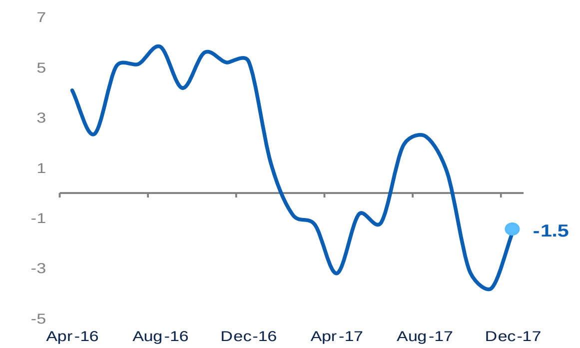
We should mention that despite the reduced dynamism shown by domestic demand in the second half of last year, and especially in the fourth quarter, this has not translated into an increase in formal employment (see Figure 3.7). Businesses, especially medium and large ones, are still not feeling confident enough to start hiring. Perhaps they still have some slack and do not yet need to increase their workforce; perhaps they have opted to implement technological improvements in their processes, seeking to reduce costs, which limits the need to hire personnel for the time being; or perhaps they will not venture to do so until they see that the recovery in activity is significant and sustained and that it extends to more sectors (construction has taken off, but services and commerce are showing only tepid improvement, while non-primary manufacturing continues to contract). In any case, the rigidity of Peru's labour market makes businesses cautious about formal hiring. This weakness in job creation has had a similar effect on total payrolls (see Figure 3.8), making it hard for private consumption to progress.

Figure 3.7 Formal employment*
(change % YoY)



* Employment with private businesses with more than 10 workers in urban areas. Not including the construction sector.
Source: MTPE (Ministry of Labour and Employment Promotion)

Figure 3.8 Total payroll*
(in real terms, change % YoY)



* Calculated by multiplying the EAP in employment by monthly average real income. Using information from Lima Metropolitana. The figure for each month corresponds to the moving quarterly average ending in the month. Source: National Institute of Statistics and Informatics (INEI)

With the growth in economic activity that we anticipate for the fourth quarter of 2017, **GDP will have grown by around 2.3% for the year**, a year in which although the international environment was favourable and on the home front economic policies started to be more counter-cyclical, particularly in the second half, activity nevertheless suffered two significant negative shocks, in the form of *El Niño Costero* phenomenon and the postponement of major infrastructure projects.

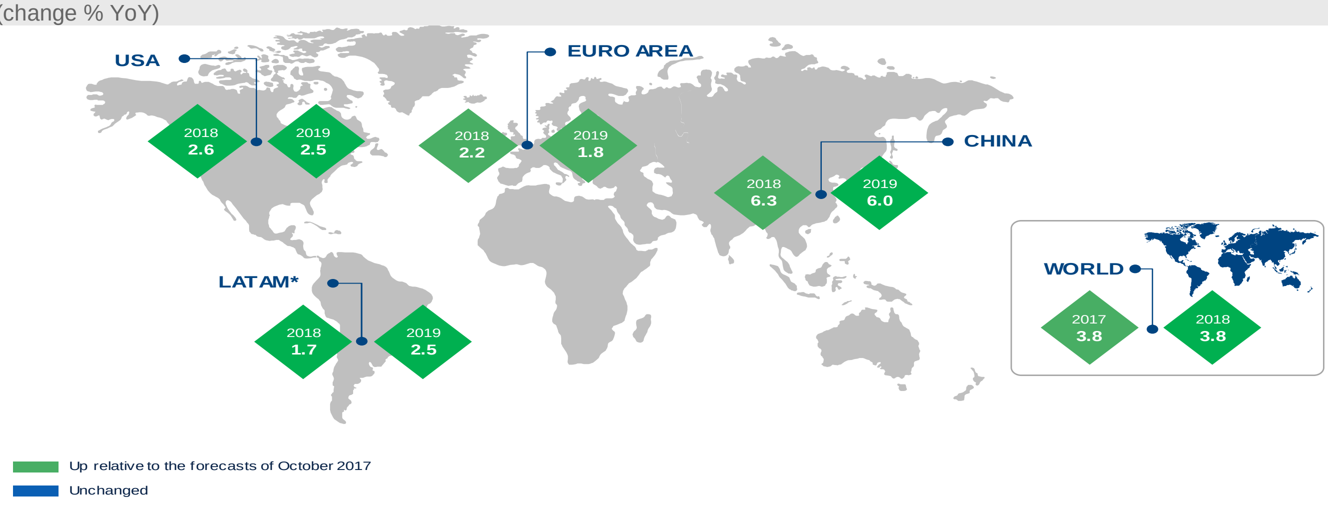
Compared with what we foresaw in our previous report, the increased uncertainty linked to the political tensions will put the brakes on growth in 2018 and 2019, despite the improved external environment

In addition to the trends currently exhibited by the Peruvian economy, our projected baseline scenario also takes account of the following.

On **the external front**, more favourable conditions than those anticipated in our previous report (October) due to:

- **an upward revision of GDP growth projections for the US, China and Latin America** (see Figure 3.9). The rate of expansion of global economic activity will consolidate at around 3.8% in the next two years and will be more synchronised. We should mention that in the case of China we have corrected the economic growth forecasts upwards not only for 2018 and 2019 but for the following years too. This reflects the fact that the measures approved by the authorities have succeeded in stabilising the economy, while at the same time certain structural reforms have been embarked upon and, the National Congress of the Chinese Communist Party in October approved an economic strategy that is more focused on controlling the imbalances.

Figure 3.9 World growth
(change % YoY)

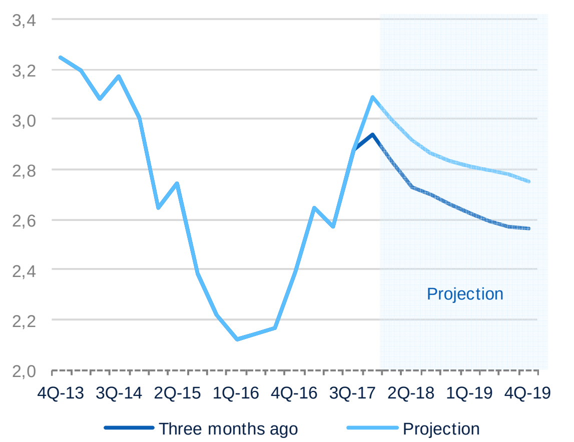


Corresponds to “LatAm7”: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. Source: BBVA Research

- **Upward revision of commodity prices**. It is worth pointing out that the recovery shown by international metal prices in the past few months has been accompanied by a recovery in mining investment in Peru (see Figure 3.3). In this context, small- and medium-size mining projects representing more than US$4 billion have become viable. We estimate that construction starts will have a positive economic impact in 2018 and appreciably more so from the following year (see Table 3.1).

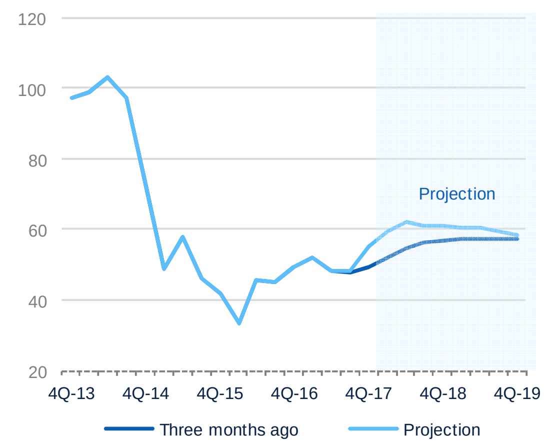
  In the particular case of the price of copper, we have revised the entire projection path upwards (see Figure 3.10) consistently with the increased growth forecast for China. Thus for 2018 the average price will increase to US$2.90 per pound (from US$2.79/lb in 2017). Currently copper is trading at above US$3.10/lb, so the implied trajectory over the course of 2018 (and thereafter) is toward the low. This is based on the view that China's growth will moderate in the next few quarters, the dollar will appreciate in multilateral terms and non-trading agents currently present in the market (with speculative positions in favour of copper) will gradually withdraw. Towards the end of the forecast horizon (2022) the price of copper will tend towards a level of US$2.70/lb, above the US$2.52/lb mentioned in our exercise of three months ago.

Figure 3.10 Price of copper (US$/lb)



Source: Bloomberg and BBVA Research

Figure 3.11 Price of oil WTI (US$/barrel)

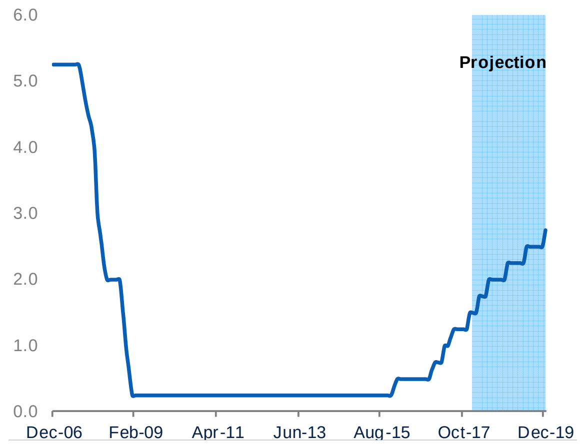


Source: Bloomberg and BBVA Research

As regards the price of oil (Peru is a net importer) our baseline scenario assumes that it will be around US$61 a barrel in 2018, above the average for the previous year (US$51) and above our forecast of three months ago (US$55), taking account of the upward adjustment in world growth (more demand), the extension of agreements on production cuts by many of the main producers (less supply), and the introduction of a risk premium on account of political events in Saudi Arabia. As the production cut agreements expire, high prices encourage increases in volumes supplied to the market and the risk premium for Saudi Arabia fades, the price of oil will tend to fall (see Figure 3.11), most likely starting in 2019.

- **Only gradual normalisation, with forewarning, of the monetary policy position in the most developed economies**, in particular the US. Our baseline scenario assumes that the US Federal Reserve will only gradually raise its base rate, which will facilitate its assimilation by the markets (see Figure 3.12). The increase will be 75 bps in 2018 (our previous forecast was for two hikes of just 25 bps each) with a further 50 bps in 2019, which is consistent with the greater growth forecast for the US economy. Our baseline scenario further assumes that the Federal Reserve will implement its balance sheet reduction process in accordance with its announcement. As regards the ECB, it will reduce its asset purchases in 2018 (by half, although the purchasing programme will probably not end until September); rate hikes will not start until 2019.

Figure 3.12 US Federal Reserve: monetary policy rate (%)



Source: Bloomberg and BBVA Research

Table 3.1 Mining investment in new concession projects (USD millions)

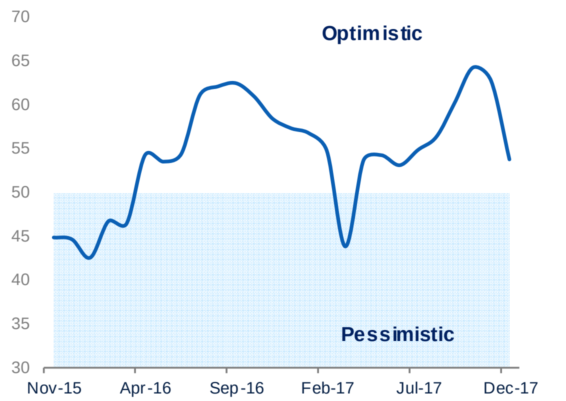
Project	Annual Production	Year 2018	Year 2019
Mina Justa	110000 TMF/Cu	236	636
Toromocho Ampl.	75000 TMF/Cu		650
San Gabriel	150000 OZ		250
Pukaqaqa	40600 TMF/Cu		353
Magistral	60000TMF/Cu		250
Total		**236**	**2,139**

Source: MINEM and BBVA Research

In contrast with the improvement we foresee for external conditions, on the **domestic front** we are assuming that, compared with our previous report (October), the domestic context will be more difficult going forward.

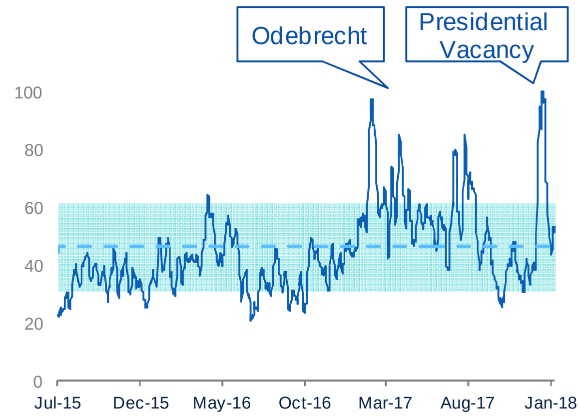
- The political noise and fatigue generated by the impeachment process and the pardon of former president Fujimori heightened the feeling of precarious political stability and therefore also uncertainty. The political scene will take some time to settle down again after this strong tremor. During that period **businesses will be more reticent in spending (business confidence weakened**, as we are already starting to see; see Figures 3.13 and 3.14**) as will households; and the public sector too**. As the new political context becomes clearer, we could of course revise our forecasts accordingly.

Figure 3.13 Business confidence
(index, in points)



Source: Central Reserve Bank of Peru

Figure 3.14 Indicator of political tensions in Peru
(100 = 28 Dec 2017, the highest point in the sample)



Source: GDELT and BBVA Research.

- **The fiscal impetus will be less pronounced**. In our revised forecasts we are incorporating a reduced degree of dynamism in works to rehabilitate and reconstruct infrastructure damaged by *El Niño Costero*, not only in view of the greater reticence in public expenditure, but also because we have not seen any of the expected increases in this spending. We are also being more conservative now about some of the biggest infrastructure works such as Line 2 of the Lima Metro, while in the case of the construction of the facilities for the 2019 Pan American Games we have not made any major adjustments. All the same, the impetus from increased public spending still explains a significant part of the acceleration of economic growth in 2018.

  It is important to mention that, due to the constant postponements, we are no longer assuming a restart of the construction of the Southern Gas Pipeline within the forecast horizon, as we did up until our last report, when we assumed it would restart in 2019.

In the baseline scenario described for 2018, without the abnormal weather events of the previous year, there will still be tailwinds from the international environment (favouring private investment, especially in mining, and demand for exports with more added value), and public spending will accelerate (on reconstruction and on infrastructure for the 2019 Pan American Games, although less than we estimated three months ago), GDP will grow by approximately 3.5% this year (previous forecast published in October: 3.9%). Later, in 2019, private sector expenditure will continue to gain traction, especially in mining investment, with the construction of small and medium projects (see Table 3.1). Non-mining private investment for its part will show a tentative improvement, in an environment in which work will accelerate on certain major projects such as the expansion of Lima Airport, the increased monetary stimulus will be fully passed on to the real economy, the political situation will clear up and – we suppose – political tensions will relax at least partly; all in a context in which there will be some improvement in employment and therefore in private consumption. The public sector spending on the other hand will slow, which is consistent with the start of the process of fiscal consolidation to which the government has alluded. On balance, we estimate that GDP growth will continue to accelerate and will grow by around 3.8% in 2019 (previous forecast published in October: 4.0%).

In 2018 in particular, the most outstanding activities will be fisheries and construction, the former thanks to the normalisation of anchoveta catches and the latter thanks to the impetus of public sector spending on infrastructure

We estimate that primary activities as a whole, i.e. those linked most closely to the extraction of natural resources[1], will be the most dynamic in 2018, growing by around 6% (see Table 3.2). Within that, the most outstanding sector will be fisheries. Here we are assuming two relatively good anchoveta fishing seasons in the central-north coastal zone which will each yield between 4.0 and 4.5 million metric tons. This will also favour the preparation of fish-meal and oil, i.e. primary manufacturing. Our baseline scenario also assumes that certain mines which produced less than their potential last year, such as Antamina, Toquepala and Cuajone, will return to normal levels of production this year. Finally, we are assuming that the northern gas pipeline will be operative from the beginning of the year, which will favour oil production, and an uptick in agricultural and livestock production once the effects of *El Niño Costero* have dissipated and in an environment of more normal weather conditions.

Turning to non-primary activities, which are more geared to attending to domestic demand and which represent more than 70% of the production of goods and services, we estimate that they will continue to recover in 2018. Construction will stand out, in a context in which works on infrastructure (for example the reconstruction of infrastructure damaged by *El Niño Costero* and new infrastructure for the 2019 Pan American Games). This will tend to stimulate other sectors of the economy that serve the demand from construction activity or complement it, such as services and primary manufacturing. These three activities will also benefit from the increase in mining investment.

Table 3.2 GDP by productive sector (change % YoY)

	2016	2017 (e)	2018 (p)	2019 (p)
Agriculture and livestock	2.6	1.5	3.7	3.2
Fishing	-10.1	4.7	8.8	13.6
Mining and fuel	16.3	3.1	6.3	1.0
Metals	21.2	4.1	5.5	0.5
Fuel	-5.4	-2.4	11.4	4.1
Manufacturing	-1.4	-1.0	2.5	4.8
Primary	-0.6	1.0	8.0	7.0
Non Primary	-1.6	-1.8	0.7	4.0
Electricity and water	7.3	1.2	3.9	4.7
Construction	-3.1	2.6	4.0	6.0
Commerce	1.8	1.0	1.8	3.5
Other services	4.4	3.2	3.4	4.3
GDP	**4.0**	**2.3**	**3.5**	**3.8**
Primary sectors	10.0	2.5	6.0	2.5
Non-primary sectors	2.5	2.0	2.8	4.3

* Excludes import rights and taxes
Source: Central Reserve Bank of Peru and BBVA Research.

Table 3.3 GDP on the expenditure side (change % YoY)

	2016	2017 (e)	2018 (p)	2019 (p)
1. Domestic Demand	**1.1**	**1.8**	**3.4**	**3.8**
a. Private Consumption	3.3	2.5	2.7	3.3
b. Public Consumption	-0.5	1.1	5.0	2.3
c. Gross Domestic Investment	-3.9	0.4	4.4	6.0
Gross Fixed Investment	-4.6	0.7	4.0	5.7
- Private	-5.9	0.5	3.0	6.7
- Public	0.6	1.7	8.0	2.2
2. Exports	9.5	6.1	3.2	2.7
3. PIB	**4.0**	**2.3**	**3.5**	**3.8**
4. Imports	-2.2	4.3	2.8	2.6
Note:				
Domestic Demand (less inventoriess)	*0.9*	*1.9*	*3.3*	*3.7*
Private Expense (less inventories)	*1.1*	*2.0*	*2.8*	*4.0*
Public Expense (consumption and investment)	*-0.2*	*1.3*	*5.9*	*2.3*

Source: Central Reserve Bank of Peru and BBVA Research

1 Agriculture and livestock, fisheries, mining, oil and gas and primary manufacturing.

This sector performance will be reflected on the expenditure side in greater dynamism of domestic demand compared with the previous year (see Table 3.3), underpinned by the increase in public spending and private investment, especially in mining. In qualitative terms there are thus no major changes relative to our forecast of three months ago. However, we have moderated the growth in public spending, as explained previously, and we have made some adjustments within private investment. In this latter case, the pace of growth in mining investment is now greater than we predicted in our previous report (and than our estimate for 2017) due to the fact that we now expect prices of metals, particularly copper, to be higher throughout the forecast period. In this context, we have incorporated into the baseline scenario greater investment in exploration and the construction of a number of small- and medium-size mines (see Table 3.1) which will start in 2018 but the effect of which will be felt more in the following year. Non-mining investment on the contrary has corrected downwards (and will progress at a pace not very different from last year) due to the private sector's more cautious attitude to spending as a result of the political environment in the country, which naturally limits the creation of employment on appropriate terms.

In the medium term, GDP growth will be around 3.5%, which is not enough to break free of the "middle-income trap"

The uncertainty associated with the increase in political noise and above all the growing sense that political stability is precarious, could have implications for growth in the medium term. In the first place, because the environment is less favourable for doing business and accumulating capital. And in the second place because it is less likely that a consensus will be reached to approve and implement measures to boost productivity and competitiveness. Our baseline scenario for the period 2020-2022 assumes average annual GDP growth of 3.6%. This is consistent with gross fixed investment (private and public) stabilising at a level equivalent to just under 23% of GDP, below the highest levels seen in the strong growth period of 2002-2013 (approximately 27% of GDP) and also below those posted in economies that experienced phases of rapid growth such as those of East Asia.

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This report has been produced by the Peru Division

Chief Economist, Peru
Hugo Perea
hperea@bbva.com
+51 1 2092042

Francisco Grippa
fgrippa@bbva.com

Ismael Mendoza
ismael.mendoza@bbva.com

Yalina Crispin
yalina.crispin@bbva.com

Marlon Broncano
marlon.broncano@bbva.com

Vanessa Belapatiño
vanessa.belapatiño@bbva.com

BBVA Research

Chief Economist BBVA Group
Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Long-Term Global Modelling and Analysis
Julián Cubero
juan.cubero@bbva.com

Innovation and Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems and Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

International Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Spain and Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States
Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Middle East, Asia and Geopolitical
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

ENQUIRIES TO: BBVA Research Peru Av. República de Panamá 3055, San Isidro, Lima 27, Peru. Tel: + 51 12092042-bbvaresearch@bbva.com
www.bbvaresearch.com