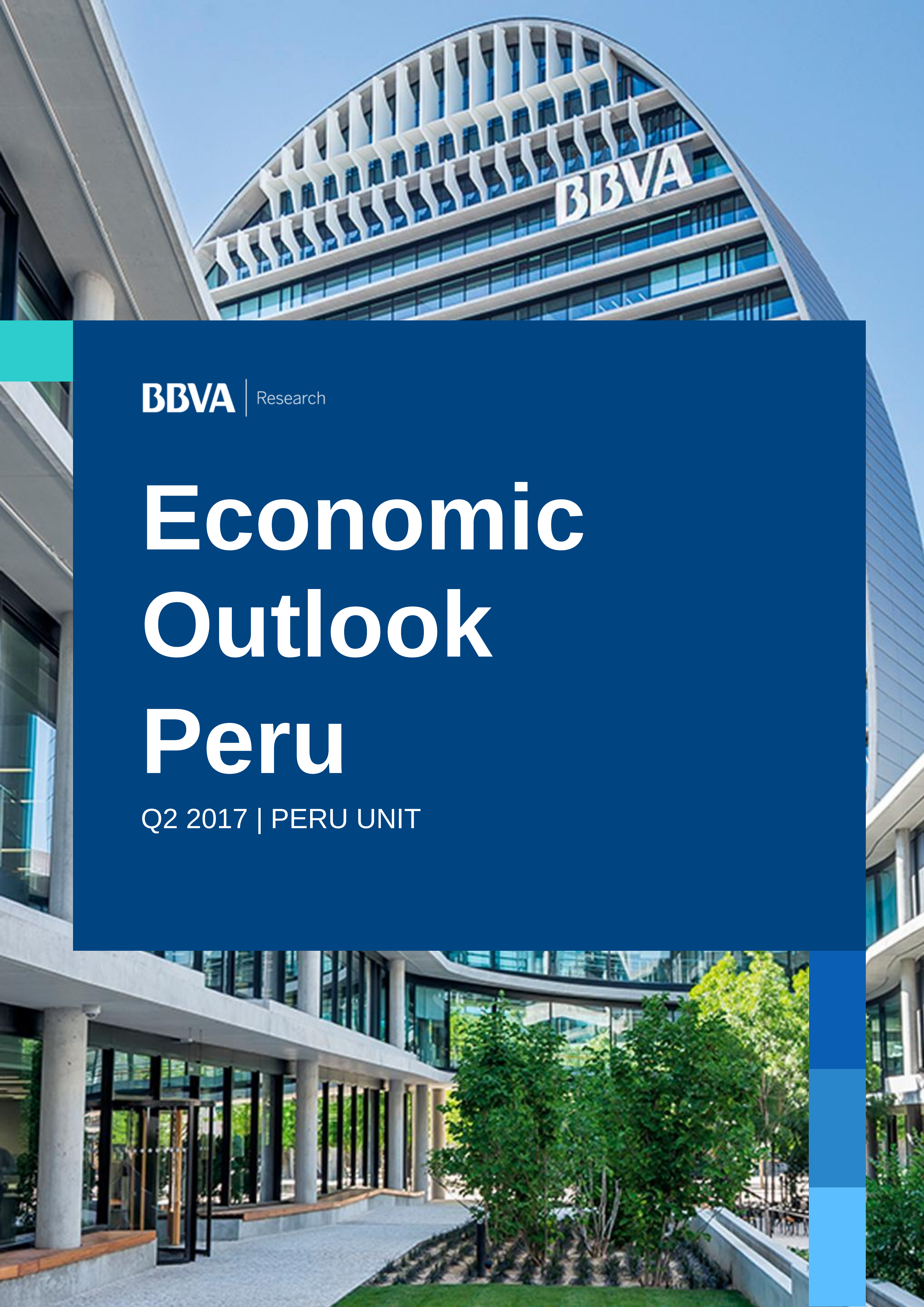


BBVA | Research

Economic Outlook Peru

Q2 2017 | PERU UNIT

Contents

Closing date: 19 April 2017

1. Summary

Economic growth continues to strengthen worldwide in an environment in which both confidence and global trade are improving, the latter aided by monetary and fiscal incentives in China. There is also somewhat greater clarity regarding the US economy: the scenarios that augured a speedy recovery of inflation endorsed by a fiscal boost or a swift turn towards protectionism are at present less likely (or will at least will be held off). This, along with the tranquillity apparent on global financial markets, has encouraged the central banks of the more developed economies to gradually progress towards stabilisation in their monetary policies. Looking ahead, our baseline forecast considers that the international setting will continue to be relatively positive for the Peruvian economy. The US will consolidate its recovery over the 2017/18 period at a sustained growth rate of 2.3% to 2.4%. Meanwhile, Latin America will start to expand again this year, an expansion that will speed up next year. The eurozone will progress slightly beyond its potential, whereas China will continue to parry its exposure and moderate its growth rate to more sustainable values. Given such a context, the FED will continue stabilising its monetary position, albeit gradually, with two further increases to its rate policy this year and another two in 2018, until it stands at 2%.

On the domestic front, we have revised our growth projection for this year by a percentage point to 2.5%. This adjustment reflects the fact that the three local risks we indicated in our February report have finally materialised: the weather problems continued and had a significant impact on economic activity, particularly in March, the delay in the major infrastructure construction projects continued, meaning they will fail to contribute GDP growth this year and finally, business confidence dropped even further and is now viewed with pessimism. There was also a twenty-day strike in the biggest copper mine in the country – Cerro Verde – while mining investment continued to fall. The measures announced by the government to boost public expenditure and to restore and rebuild infrastructure damaged on account of the weather problems somewhat offset the downward revision of the GDP growth for 2017. Accordingly, the greater public expenditure this year will constitute an important basis for growth on the demand side. For 2018, in a context in which mining activities bounce back owing to the stabilisation of weather conditions, reconstruction work on the damaged infrastructure caused by the latter is increasingly noted and the construction of major infrastructure projects accelerates, we have raised the GDP growth forecast by 0.3% to 3.9%.

The boost that public expenditure will afford growth on the demand side means that the fiscal consolidation process in our projections will be put back. We expect the deficit to hover around a level equivalent to 3% of GDP, in both 2017 and 2018 (2.6% in 2016), which stands above that which was agreed with parliament last year (2.5% in 2017 and 2.3% in 2018), a target which, at least for the time being, is holding up. However, any deviation that may arise will, we feel, be related to servicing the emergency situation caused by a natural disaster and, afterwards, restoring or rebuilding the damaged infrastructure. This does not reflect bad fiscal behaviour. Quite the contrary, the government seems to be strongly committed to the sustainability of public finances, as attested to by the adjustment made in the final quarter last year to guide deficit towards consolidation, despite the cost in terms of lower economic growth. Our fiscal estimates for Peru in 2017, 2018 and thereafter, continue to compare well against the other big

Latin American economies and suggest that gross national debt will not exceed a level equivalent to 28% of the GDP in the next five years.

As far as local financial markets are concerned, they have performed well so far this year. This has given rise to a context in which the international prices for the metals that Peru exports, such as, for example, gold and copper, have been high, thus favouring the improvement in the trade balance. This is also a context in which the gradual pace of the monetary adjustment in the more developed economies has continued to inspire a strong appetite for investors in Peruvian financial assets. The local currency has appreciated by over 3% so far this year. We expect, however, that this will tend to depreciate from here on in, albeit to a limited extent and most likely more clearly in the second half of the year, closing at 3.35 to 3.40 soles per US dollar. This forecast is in keeping with the expectation that in the coming quarters, capital inflows to emerging economies will tend to slow down in an environment where the FED gradually raises interest rates and the central banks of other developed countries start to consider reducing their quantitative easing. It is also consistent with the fact that monetary policies in the emerging countries – particularly in Peru – are being rendered more flexible. The increase in the exchange rate will be limited, as the smaller gap between the interest rates in the local and foreign currency will be offset by the improvement to the trade balance (mainly because copper production will continue to rise throughout the rest of the year, albeit at a more moderate pace).

As far as prices are concerned, we expect inflation to remain above the 3.5% mark in YoY terms until the third quarter, thus deviating from the Central Bank's target range. This forecast takes two factors into account. Firstly, even if there is little room for any additional rises in the international oil price, the YoY comparison will continue pushing inflation upwards (by way of local fuel prices), especially in the course of what is left of the first half of the year. And secondly, even though the recent rises in food prices (on account of the weather problems) are provisional, and as such should fall again, part of these rises might remain uncorrected because of some farming areas that will take time to recover. It is also quite likely that there has been a certain contamination in inflationary expectations, which will impose a certain inertia on inflation. Looking now at the second half of the year, we feel that internal demand and the expenditure of the private sector will continue to be weak, the international price of oil will remain relatively stable and food prices will continue to stabilise, while inflation will tend to drop. We expect that it will end the year in or around the target ceiling range.

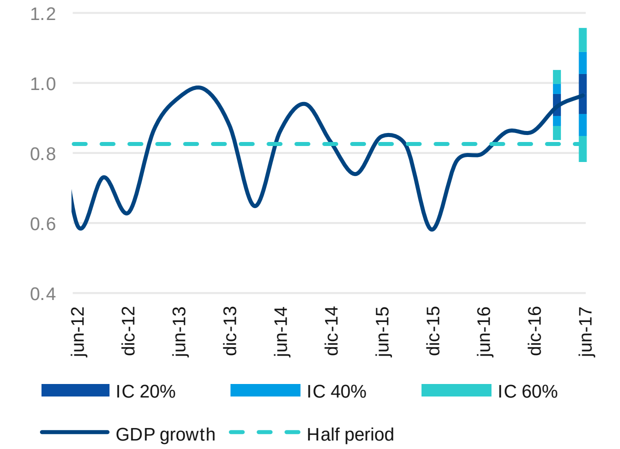
Given this weak growth and pessimistic confidence setting, it is quite likely that the Central Bank will not wait for inflation to return to the target range to cut its policy rate but will bring this forward. Our interpretation of the most recent monetary policy statement leads us to foresee that there will be a reduction in the interest rate as soon as inflation stops rising. This cut in interest rates could take place in May or June. Our baseline scenario incorporates an interest rate reduction of 25% in the second quarter and another reduction in the fourth quarter.

Lastly, our forecasts for 2017 are subject to certain risks. On the external side, China's financial exposure and the uncertainty that still surrounds the policies to be implemented by the incoming US administration. On the domestic front, that the delay in commencing the infrastructure work will continue, that the confidence of businesses and consumers alike will not be recovered and that public expenditure will fail to materialise as planned.

2. Global environment: global growth consolidates but there are still risks

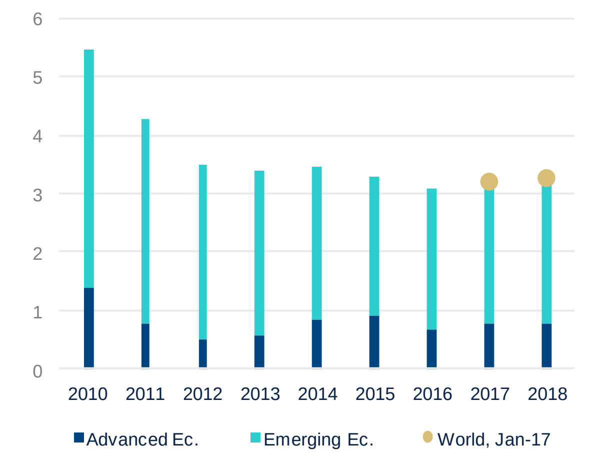
The pace of GDP growth worldwide continues to increase, up to rates of around 1% QoQ, thus surpassing the 0.8% average since 2011. This acceleration has been followed by general improved confidence, coupled with advances in global trade, stimulated largely by monetary and fiscal stimuli in China. The performance of countries in the developed world continues to be very strong. In the USA the recovery is strengthening and in Europe growth is occurring at rates that exceed potential. In contrast, Latin America will emerge from this year in recession, although there will be some moderate growth.

Figure 2.1 World GDP growth. Forecasts based on BBVA-GAIN (QoQ % variation)



Source: BBVA Research

Figure 2.2 Global Growth and Contributions by Region (YoY % variation)



Source: BBVA Research

We have revised the increase in global growth, which will rise from 3.1% in 2016 to 3.3% in 2017 and 3.4% in 2018.

Improved performance worldwide is accompanied by greater clarification regarding the US economy, where expectations of rapid recovery of inflation based on a fiscal boost and those of a scenario characterised by a swift turn towards protectionism have lessened, or at least been delayed. Nevertheless, the difficulty of carrying out a reform of the health care system has also revealed problems in getting other measures approved, such as those associated with tax cuts or the infrastructure spending plan. This eliminates the probability of a strong short term impetus.

With regard to the **financial markets,** over the last few months these **have remained calm**, recording low volatility in spite of the high uncertainty. In this context, the central banks are making gradual progress in the process of standardising monetary policy. The FED, which is leading this process, maintains its message of gradual release, so we predict there will be two additional interest rate hikes this year and another two in 2018, up to 2%. At the same time, there are already plans to undertake the third phase of the exit strategy, in other words, the reduction of the balance sheet, something which probably will not happen until next year and will be put in place passively. The ECB also appears more optimistic about growth, but is not yet confident about inflation and will continue to lag behind the FED's exit pace. Given this process of monetary policy stabilisation, a global rise in the cost of financing globally can be expected going forward.

Overall, our forecasts for growth in 2017-18 have been revised only marginally. The best starts to the year have occurred in the Eurozone and especially China (where growth of 6.3% and 5.8% in 2017 and 2018 respectively is expected, around 0.5 percentage points more than three months ago), while the rates for the Latin American countries are slightly more negative this year (with the notable exception of Mexico). In the US, we continue to predict growth of 2.3% this year and 2.4% in 2018, based on the boost in investment. As a result, expected worldwide growth is 3.3% and 3.4% for 2017-18, which, in both cases, is 0.1% higher than our previous forecasts.

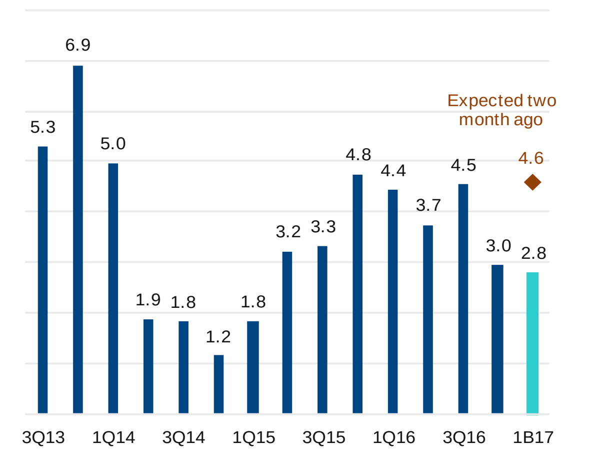
The risks of a downturn continue. Apart from the uncertainty that is still associated with the measures that are finally to be approved in the USA, above all in the business sector, there are doubts regarding the election results in France and Italy, due to the highly negative impact they could have on eurozone stability in the (unlikely) event of a victory for the fiercely anti-European elements. There is also the risk associated with the Chinese economy, where recent strong investment may slow down the reduction in imbalances. Other significant elements of risk are the Brexit negotiations (which have not started off on the right footing), the many geopolitical risks and the risks associated with the standardisation of monetary policy, above all in the USA.

3. We have cut back our 2017 growth forecast from 3.5% to 2.5%

Weaker data in the first two months allied to the heavy coastal rains have taken their toll

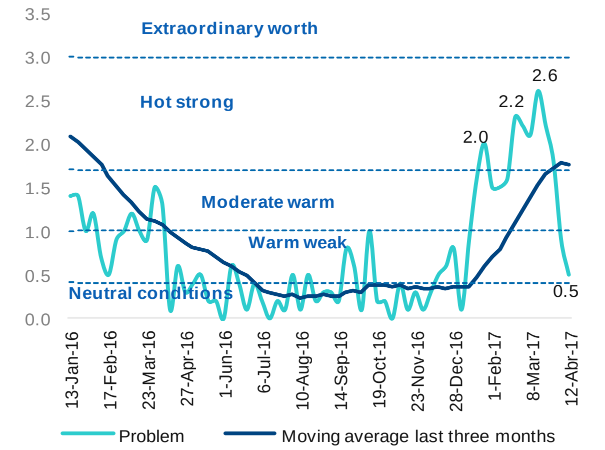
Economic activity rose by 2.8% QoQ in the first two months, which is lower than what we expected in our previous report (see Figure 3.1). This weaker dynamism at the beginning of the year occurred in a context that had seen the risks we pointed out in that report come true: firstly, the weather problems persisted (see Figure 3.2), and secondly, progress was slow in the building of infrastructures, among which second underground line in Lima figures. Investment in the mining sector also continues to fall. The lower economic growth in the first two months knocked two decimal points off our prediction as regards GDP expansion for 2017.

Figure 3.1. GDP
(YoY % variation)



Source: INEI, Central Bank of Peru and BBVA Research.

Figure 3.2 Temperature problem in the Peruvian sea*
(in °C)



* Covers the 1+2 zone (Peruvian coast)
Source: NOAA and BBVA Research

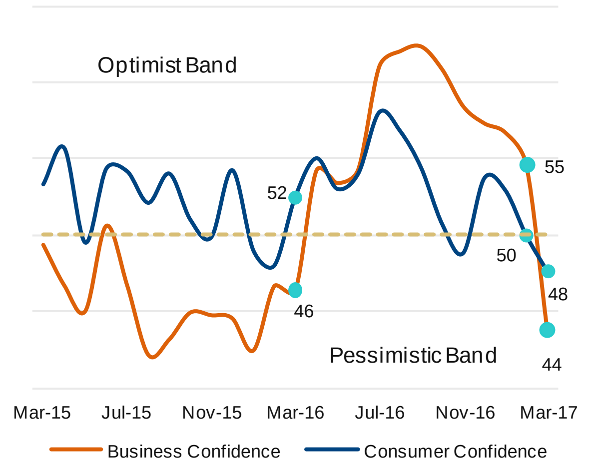
The drastic sea temperature problem, known as *El Niño Costero*, not only extended into February, but even intensified in March (see Figure 3.2). It caused heavy rains along the country's coast, leading to flooding rivers and mud and rock slides, wreaking havoc on farming areas and infrastructure, such as housing, roads, bridges, irrigation canals and schools. Our forecasts suggest that, at the close of this report, the damage in farming areas and infrastructure will amount to a little over USD 4 thousand million (see Table 3.1). This damage, in turn, affected both agricultural, business, industrial and building activities as well as transport services. We estimate that the reduced dynamism of these activities will knock six decimal points off the GDP growth we had estimated for 2017. The sea temperature problem subsided at the beginning of April.

Table 3.1 Damage to infrastructure caused by the heavy rains brought by *El Niño Costero** (USD million)

Infrastructure	Measure	Total units**	(USD millions)
Roads	Km	8,951	1,424
Housing	Units	278,123	944
Bridges	Units	839	474
Farming areas	Ha	82,083	234
Schools	Units	2,165	152
Irrigation canals	Km	23,176	628
Country tracks	Km	12,843	68
Health centres	Units	742	91
Total			**4,016**

* BBVA estimate based on information correct as of 18 April.
** Reflects the sum total per type of infrastructure involved, regardless of its degree of damage.
Source: INDECI and BBVA Research.

Figure 3.3 Business confidence and Consumer confidence* (index, in points)



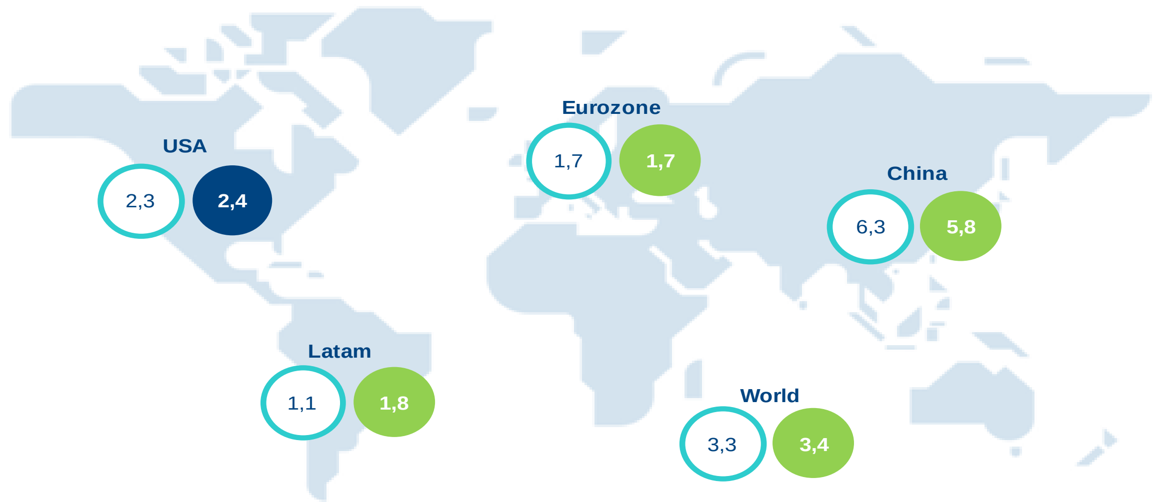
* Values over (under) 50 indicate an expectation of a better (worse) performance of the economy in the next three months.
Source: Central Reserve Bank of Peru and BBVA Research.

Owing to this scenario of weak growth, slow progress in infrastructure building and serious weather problems (causing serious economic impact), the confidence of economic agents has weakened. Particularly in March there was a sharp drop in business confidence, seeing it fall into the pessimistic bracket (see Figure 3.3). This business sector caution augurs a drop in the investment dynamism of the private sector. It should also be added that consumer spending forecasts are also now erring toward pessimism (see Figure 3.3).

The decline in the vigour of economic activity over the first two months and the intensification of the weather problems in March have seen 8% knocked off the 2017 GDP growth forecasts we made two months ago (3.5%). Our new baseline scenario also takes the following into consideration.

- Externally, relatively favourable conditions for the Peruvian economy.
  - Worldwide growth. It will continue to grow owing to the improved performance of the developed economies and a slowdown in China which we now perceive as more contained (see Figure 3.4).

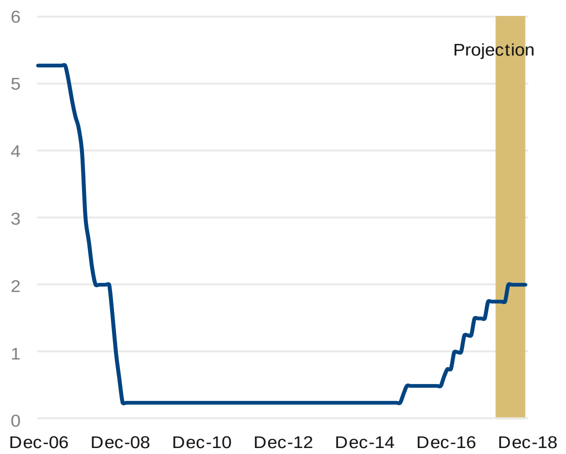
Figure 3.4 Estimated worldwide growth by geographical areas for 2017 and 2018(1) (YoY % variation)



(1) For 2018, green when growth accelerates in comparison to our February report, blue when it remains practically unchanged and red when it decreases.
Source: BBVA Research

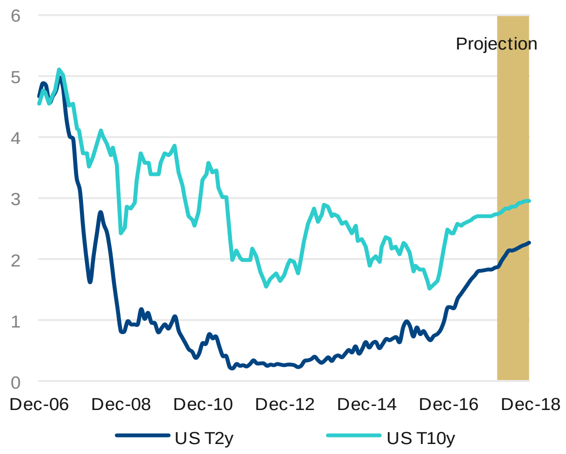
- FED rate. It will continue to adjust gradually. We expect to see two 0.25% rises in 2017 and a further two in 2018 (see Figure 3.5). This will mean increases in interest rates over longer periods (see Figure 3.6), albeit more reduced than in the case of short-term ones, with the yield curve levelling off.

Figure 3.5 US: FED rate (%)



Source: Bloomberg and BBVA Research

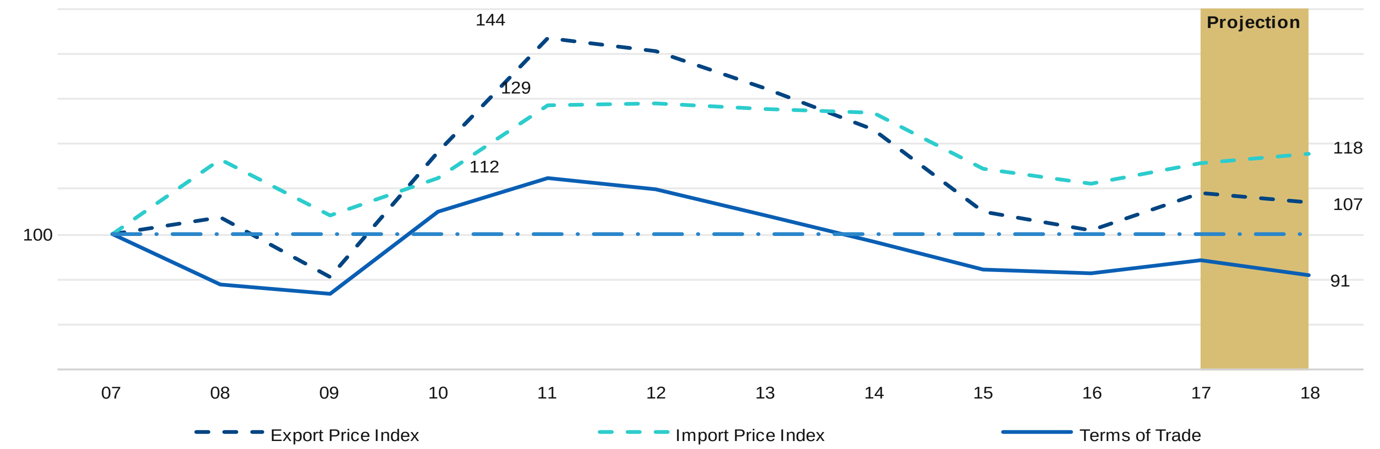
Figure 3.6 US: yield on 2-year and 10-year treasury bonds (%)



Source: Bloomberg and BBVA Research

- Terms of trade. These will improve in 2017 (see Figure 3.7). For example, on the export prices side, we predict that the average copper price will be 15% higher than last year and that the price of zinc in 2017 will be slightly over 20% higher than in 2016. These higher export prices will be offset in part by the increase in import prices, which in the case of the international price of WTI oil will rise by around 30%.

Figure 3.7 Terms of trade (2007 index = 100, year's average)



Source: Central Reserve Bank of Peru and BBVA Research

- On the domestic front, the panorama is more challenging and entails the following.
  - Infrastructure construction. In addition to the slow-moving progress in the first two months of the year, we have incorporated into the baseline scenario the fact that the pace of expenditure implementation will also be lower for the rest of the year (in comparison to the projections in our previous report). The new expenditure level forecast for the major construction projects means that there will be no great increase with respect to last year's figure. Consequently, it will make no contribution to GDP growth in 2017 (two months ago we had estimated a half percentage point contribution).
  - Business confidence. We assumed that business confidence would remain in the optimistic bracket in our previous estimates and so drive private investment. This has not been the case: business confidence fell sharply in March (see Figure 3.3), which has most likely picked up on the uncertainty as to the magnitude of the impact left by *El Niño Costero*. Our new baseline scenario considers that, to the extent that the effects of this weather problem dissipate and are assimilated, business confidence will gradually improve, heading towards the 50 point threshold. The new path foreseen for business confidence means that support for private investment has weakened and, therefore, for economic activity in general, knocking two decimal points off the GDP growth rate for 2017 that we foresaw a couple of months ago (see Table 3.2).

Table 3.2 Breakdown of the change in the GDP growth forecast for 2017 (percentage points)

	Percentage points
Weaker data than those expected for the first two months of 2017	-0.2
Effects of “El Niño Costero”	-0.6
Less business confidence	-0.2
Less expenditure on major infrastructure projects	-0.5
Higher public expenditure (emergency / restoration / reconstruction)	+0.5
Total	**-1**

Source: BBVA Research

- Copper production levels will continue to rise to the end of the year, albeit at an increasingly lower rate. We estimate it will contribute 0.5% to the GDP in 2017, which is less than last year's 2%.
- The fiscal deficit will stand at around 2.9% of the GDP in 2017 and 2018 (see the section on fiscal policy for greater detail).

In the baseline scenario we foresee a growth of 2.5% for the GDP in 2017. In terms of sectors (see Table 3.3), primary activities will once again prove to be the most dynamic (with a joint growth of 3.9%), underscoring progress in Fisheries, Oil and Gas, Metal Mining and Primary Manufacturing. As far as non-primary sectors are concerned (activities that are more linked to internal demand), Electricity and Services are set to be the most dynamic, whereas progress in Construction and Business will be more discreet, while it is expected that Non-primary Manufacturing will contract.

Table 3.3 GDP by productive sector (YoY % variation)

	2015	2016	2017 (e)	2018 (p)
Farming	3.2	1.8	2	3.9
Fisheries	15.8	-10.1	17	13.1
Mining and oil and gas	9.5	16.3	4.2	6.2
Metal mining	15.7	21.2	4.1	5.3
Oil and gas	-11.6	-5.4	4.8	11.2
Manufacturing	-1.5	-1.6	0.1	3.1
Primary	1.3	-0.5	4.3	5.7
Non-primary	-2.4	-1.9	-1.4	2.1
Electricity and water	5.9	7.3	4	4.7
Construction	-5.8	-3.1	0.8	6.6
Trade	3.9	1.8	0.9	2.1
Other services	5.1	4.3	3.2	3.8
Total GDP	**3.3**	**3.9**	**2.5**	**3.9**
Primary GDP	6.8	9.8	3.9	5.7
Non-primary GDP*	2.7	2.4	2	3.6

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

On the demand side (see Table 3.4), the total public expenditure expansion (consumption and investment) of over 6% will stand out, which contrasts with the 0.5% drop recorded last year (see the fiscal policy section for greater detail). Progress in government expenditure will be lessened by the slowdown of family consumption and a new slump in private sector investment, a fall-off that comes about in a context of low growth expectations and expansion possibilities for businesses, caution by employers and a new decline in mining investment.

Table 3.4 GDP on the expenditure side (YoY % variation)

	2015	2016	2017 (e)	2018 (p)
1. Domestic demand	**3.1**	**0.9**	**2.1**	**3.2**
a. Private consumption	3.4	3.4	2.7	3
b. Public consumption	9.8	-0.5	5.4	2
c. Gross domestic investment	-0.7	-4.9	-1.4	4.2
Gross fixed investment	-5	-5	0.4	5.3
- Private	-4.4	-6.1	-1.5	4.2
- Public	-7.3	-0.5	8	9
2. Exports	3.5	9.7	2.2	4.3
3. GDP	**3.3**	**3.9**	**2.5**	**3.9**
4. Imports	2.5	-2.3	0.5	1.2
Private spending (excl. inventories)	*1.4*	*1.1*	*1.7*	*3.3*
Public spending (consumption and investment)	*4.4*	*-0.5*	*6.1*	*4*

(e): estimated (p): projected.
Source: Central Reserve Bank of Peru, INEI (National Statistics and IT Institute) and BBVA Research

For 2018, in a context in which mining activities bounce back owing to the stabilisation of weather conditions, reconstruction work on infrastructure is felt more and the construction of major infrastructure projects speeds up, we have raised the GDP growth forecast by 0.3% to 3.9%.

Going forward, the re-activation of infrastructure projects brought to a halt and the restoration of infrastructure damaged by *El Niño Costero* will be important factors in maintaining the growth rate above the 3.5% mark

We estimate an annual growth of 3.8% for the 2019-2021 period, peaking at 4% in 2019, assuming that construction work will be resumed on Peru's Southern Gas Pipeline. 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.

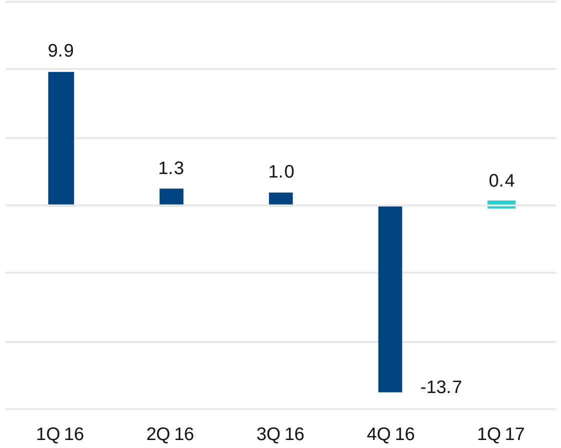
Both of the aforementioned elements are essential to creating an environment with greater confidence that encourages investment decisions. Intensifying the measures implemented at the start of the year by the government to speed up investment and to simplify administrative procedures may also improve the climate for business.

It is important to emphasise that capital accumulation must be speeded up quickly. Otherwise, the medium-term potential growth of the Peruvian economy will be compromised and could fall below the 3.5% mark.

4. Fiscal policy: the public deficit will rise temporarily owing to expenditure on infrastructure reconstruction

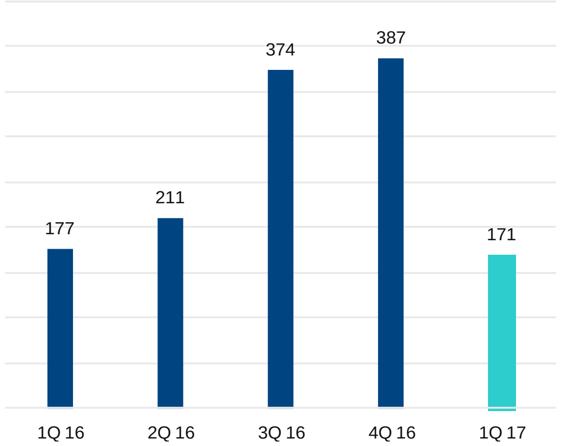
First quarter government expenditure was lower than forecast in our previous report (see Figure 4.1). This can partly be explained by the less than expected execution of the infrastructure programmes in which the government is involved (e.g. Line 2 of the Lima Underground, see Figure 4.2). Our new baseline scenario assumes that expenditure on these projects will increase in the coming quarters, but not as much as we estimated two months ago. Moreover, the baseline scenario assumes that this lower public expenditure on infrastructure will be offset by spending on servicing the damages caused by *El Niño Costero*: emergency and rehabilitation (public consumption) mainly, as well as infrastructure reconstruction (public investment). Accordingly, in nominal terms, our public expenditure projection practically remains unchanged with respect to that foreseen two months ago.

Figure 4.1 Public expenditure* (YoY % variation)



(*) Central Government
Source: Central Reserve Bank of Peru and BBVA Research

Figure 4.2 Line 2 Lima Subway* (millions of soles)



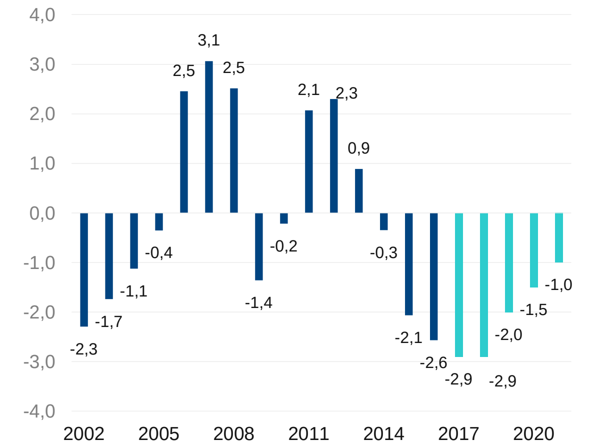
*As of 10 April, 9% of the budgeted amount had been implemented (S/ 2 thousand million). Source: MEF – SIAF.

On the revenue side, however, the projection has been revised downwards. Higher tax refunds and less revenue owing to slower economic activity growth explain this revision.

As a result, the projected fiscal deficit for this year has been raised to 2.9% of the GDP (2.5% in the previous forecast) and is expected to remain at a similar level next year (2.3% estimated two months ago), the latter for an environment in which it is expected that there will be a speed-up in the reconstruction effort. This increase in the fiscal deficit forecast is in keeping with the request the government is expected to submit to the parliament to expand deficit targets for 2017 and 2018.

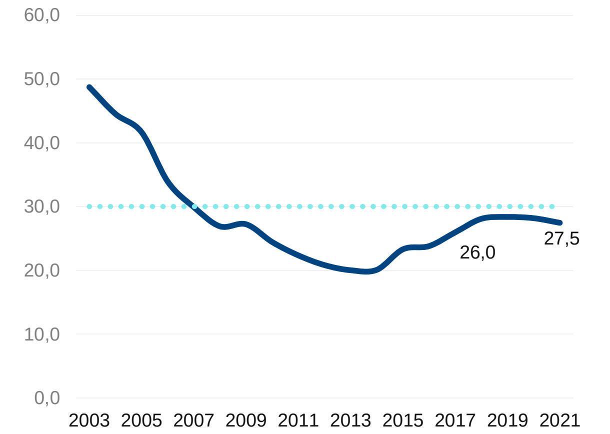
We are assuming that the forthcoming years will see a restart of the fiscal consolidation process, in line with the path marked out by the government to reduce the deficit prior to the natural disasters in March (see Figure 4.3). This means that in 2019 the deficit will be reduced to 2% of the GDP (from the predicted 2.9% for the previous year), an adjustment that we consider to be feasible given that by that time the provisional emergency and rehabilitation expenditure will be considerably less (or down to zero). The consolidation process is expected to culminate in a GDP deficit of 1% for 2021. Given the expected trend for fiscal deficit and our economic growth projections for the forthcoming years, we estimate that gross national debt will stabilise at around 28% of the GDP, below the 30% threshold established in the Fiscal Transparency and Responsibility Act (see Figure 4.4).

Figure 4.3 Fiscal result (% of the GDP)



(*) Projection
Source: Central Reserve Bank of Peru and BBVA Research

Figure 4.4 Gross national debt (% of the GDP)

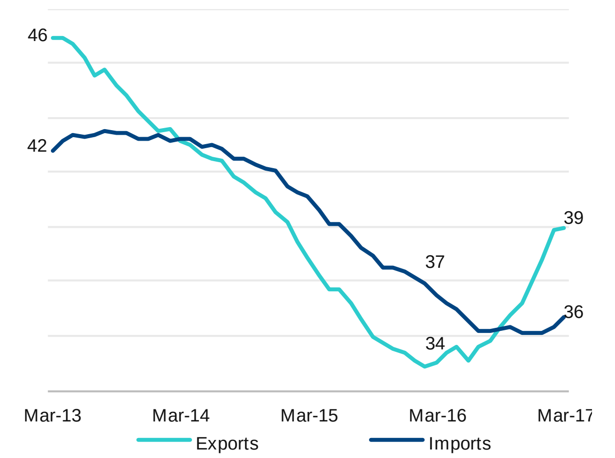


Source: Ministry of Economy and Finance of Peru, Central Reserve Bank of Peru and BBVA Research

5. Trade improvement takes the balance of payments current account to sustainable levels

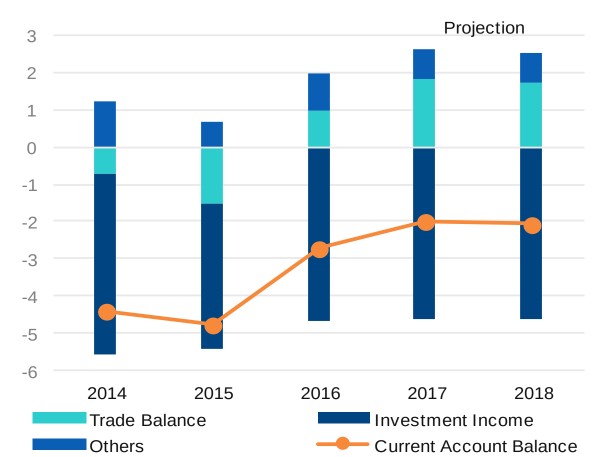
The trade balance has considerably improved in recent months. It has changed from a deficit (accumulated over the last twelve months) of USD 2.5 billion in March last year to a surplus of around USD 3 billion in March this year (see Figure 5.1). This improvement can be explained by the increase in the value of exported goods (increase in the volume of mining exports, particularly copper and higher metal prices), in addition to the drop in imports (a reflection of lower private investment and of the slowdown in household spending, as well as the increase in the price of oil).

Figure 5.1 Exports and imports (accum. over the last twelve months, USD thousands of millions)



Source: Central Reserve Bank of Peru and Peruvian Revenue and Customs Office (SUNAT)

Figure 5.2 Balance of payments current account (% of GDP)



Source: Central Reserve Bank of Peru and BBVA Research

It should be pointed out that the positive performance on the trade side exceeded the higher expenditure on the factor income side (which increased owing to the higher profit remittances, mainly in the mining and services sectors). We therefore forecast that the deficit in the balance of payments current account at the cost of the first quarter this year (accumulated in last four quarters) would have stood a little above the 2% GDP (4.7% a year ago, which represents a considerable adjustment to the external gap).

Finally, on the financial side, accumulated capital inflow in the last four quarters greatly aided the financing of the current account deficit. Since the third quarter of last year, this has translated into an accumulation of international reserves and an appreciation of the local currency (see the section on Financial Markets below).

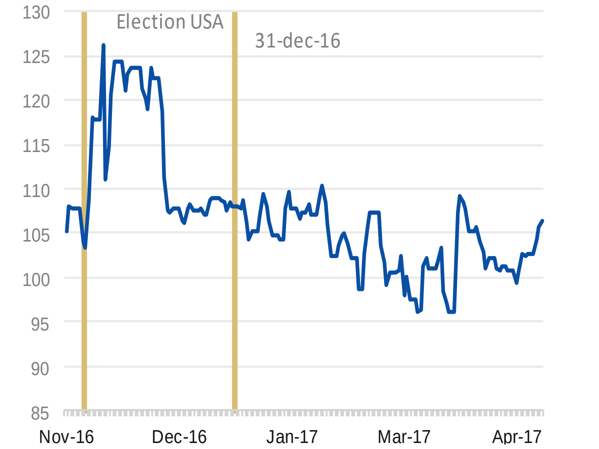
Going forward, we expect that the favourable balance of trade trend will hold up, with the balance of trade current account deficit standing at around 2% of the GDP in 2017 and 2018 (see Figure 5.2).

6. Positive tone of financial markets at the beginning of the year

Assets showed a slight improvement in the first quarter, but we foresee an adjustment going forward

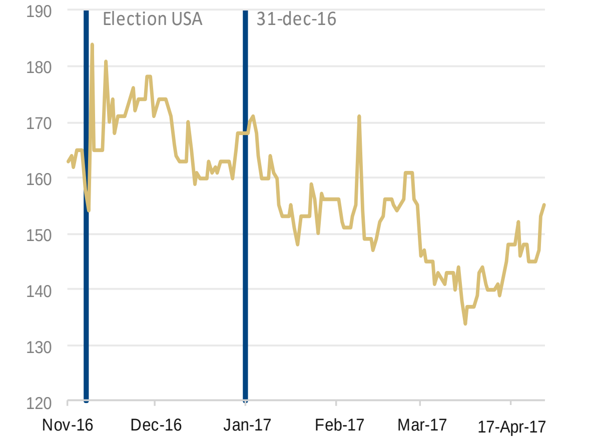
So far this year local financial markets have performed well. After the first results of the US elections came through, tension arose in local financial markets, but these soon dissipated. Country risk indicators for Peru, as well as the CDS Peru at 5 years and the EMBIG-country were better before the US elections. Accordingly, so far this year the former has fallen by 2% while the second has dropped by 8% (see Figures 6.1 and 6.2).

Figure 6.1. CDS-Peru at 5 years (basis points)



Source: Bloomberg and BBVA Research

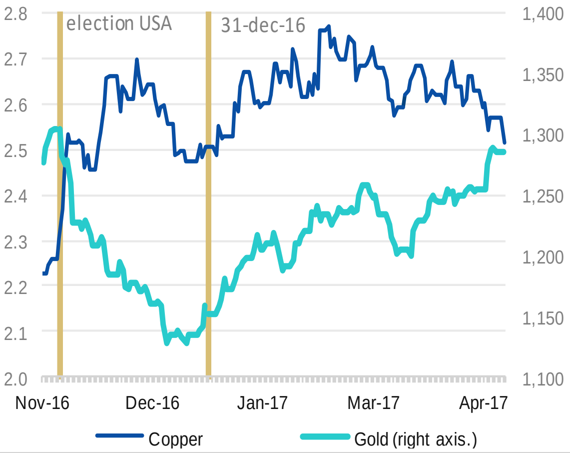
Figure 6.2. EMBIG-Peru (basis points)



Source: Bloomberg and BBVA Research

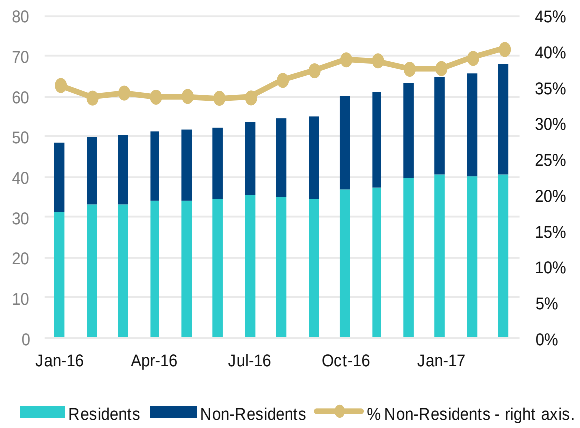
In line with this, local assets and the Peruvian currency appreciated in the first quarter. This took place in a context in which China has maintained solid growth, expectations of extreme scenarios arising from policies that may be adopted by the US government have moderated, the prices of metals Peru exports(such as gold and copper) have remained at high levels (see Figure 6.3), favouring the improvement in the balance of trade. The gradual monetary adjustment in the most developed economies has also continued to whet a strong appetite for Peruvian financial assets, such as sovereign bonds, among others (see Figure 6.4). These factors have seen the yield of these sovereign bonds fall, returning to their pre-US election levels (early November, see Figure 6.5), whereas the USD to PEN (Peruvian sol) exchange rate has been pushed downward.

Figure 6.3. Raw material prices: copper and gold (USD/pound and USD/troy ounce)



Source: Bloomberg and BBVA Research

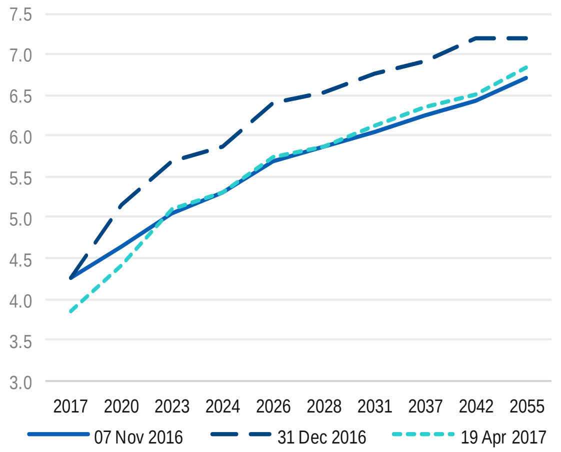
Figure 6.4. Holding of sovereign bonds according to investor origin (PEN thousands of millions)



Source: Bloomberg and BBVA Research

We forecast that the exchange rate will tend to adjust upwards in the coming months, perhaps more clearly in the second half of the year. This will happen within a context in which the difference between interest rates in Peruvian soles and interest rates in dollars will tend to fall. We foresee the central bank of Peru cutting back on its monetary policy rate (see Section 8 for greater detail) while the FED will continue to raise its rates. Depreciation of the local currency will, however, be limited, because this reduction in rate difference will be tempered by the improvement in the balance of trade. Consequently, our baseline scenario provides for an exchange rate to close the year of 3.35 to 3.40 Peruvian soles per dollar (see Figure 6.6).

Figure 6.5. Yield curve of sovereign bonds (%)



Source: Bloomberg

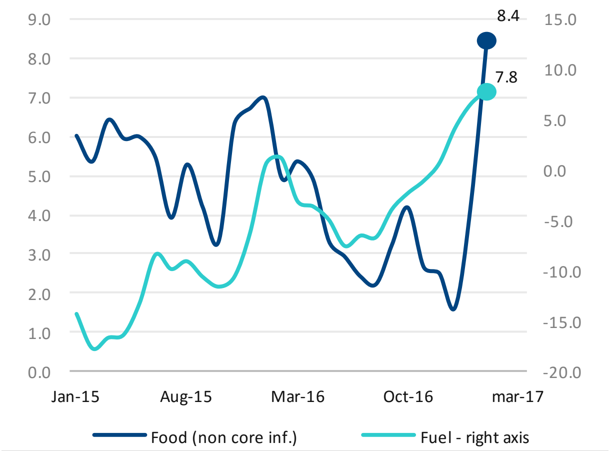
Figure 6.6. Projection of the USD PEN exchange rate (Soles per Dollar)

Source: Central Reserve Bank of Peru and BBVA Research

7. Temporary speeding up of inflation due to impact from the supply side

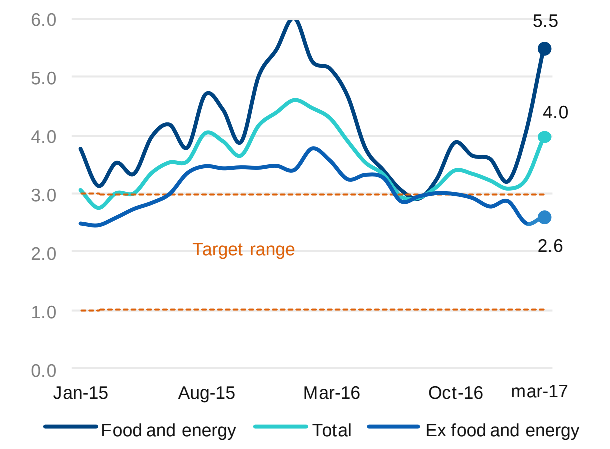
Prices rose in March by 1.3% in comparison to the previous month, the biggest monthly rise in the last 19 years. This result was greatly affected by the sharp rise in the prices of several food items (see Figures 7.1 and 7.2), owing to the temporary lack of supply caused by the heavy rains and flooding that devastated the country, damaging transport infrastructure and some crops. The YoY inflation rate rose to 4% (3.2% in February), distancing itself even further from the target range (from 1% to 3. It should be pointed out that the YoY inflation rate has been above that target range since September last year.

Figure 7.1 Inflation: selected items (YoY % variation)



Source: Central Bank of Peru

Figure 7.2 Inflation: total, without food or energy, only food and energy (YoY % variation)



Source: Central Bank of Peru

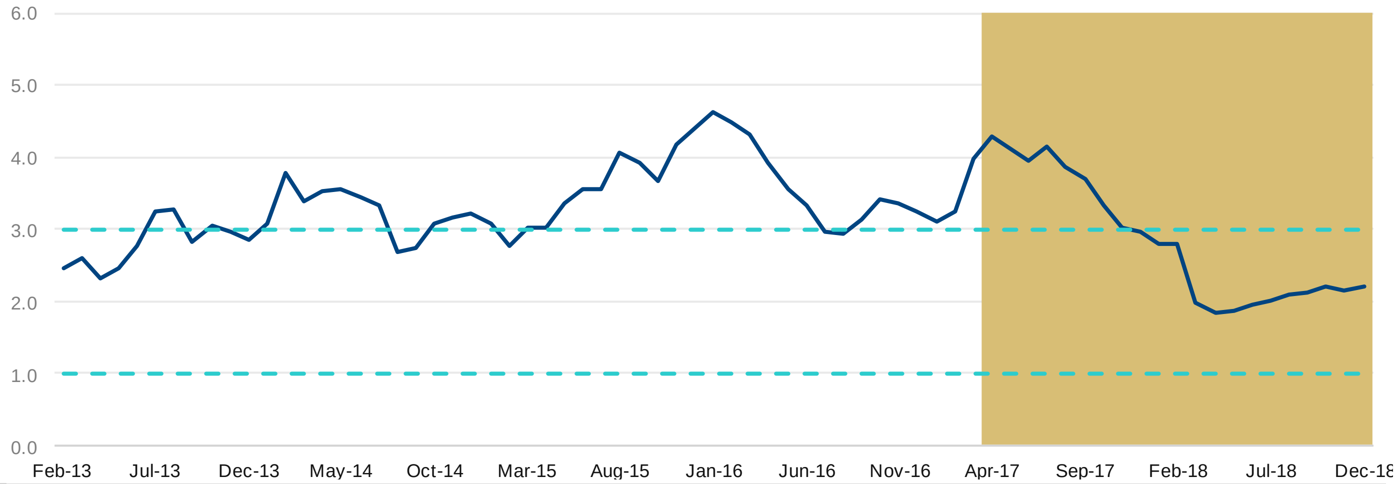
However, this rise in inflation is temporary and is closely linked to a lack of supply of food items. Inflation figures excluding food and energy have remained within the target range (see Figure 7.2). As the supply of food items to the markets returns to normal, this will bring with it downward price adjustment, which will see inflation yield. In fact, since the last week of March a drop in the wholesale price of foodstuffs such as vegetables and citrus fruits has been noted (see Table 7.1), which could later be passed on to the end consumer. Nonetheless, it should be pointed out that in spite of the provisional nature of the rise in inflation, there has been a certain contamination of inflationary forecasts, which has imposed a certain inertia on the price formation process.

Table 7.1 Wholesaler price indicators (Monthly % variation)

		Aggregate indicator	Vegetables and tubers	Fruit	Chicken	Eggs	Fish	Groceries
Weighted in CPI		12.5	2.6	1.6	2.6	0.6	0.5	4.7
January	Week 1	-2.5	3.9	3.5	-19.9	-6.2	12.5	0.3
	Week 2	-2	-3.9	2.9	-4.7	-12.5	-2.3	0.1
	Week 3	-0.5	-5.6	-1.1	3.3	9.4	-11.7	0.4
	Week 4	3.4	13.3	2.9	-5.9	26.4	5.5	0.1
February	Week 1	0.6	-1.1	-1	2.9	6.1	-1.1	0.2
	Week 2	1.9	-0.1	0.6	8.9	-2.2	-0.5	0.4
	Week 3	0.6	1.8	-4.4	3.8	-5.1	6.6	0.1
	Week 4	1.7	-1.9	-3.8	15	-4.2	-8	0.1
March	Week 1	-0.4	0	-5.1	2.4	-1.4	-3.4	-0.2
	Week 2	2.9	11.8	2.5	-0.8	5.1	4.2	0
	Week 3	9.5	30.2	9.4	4	12.7	-4.1	2.1
	Week 4	-1.4	-16.6	4.8	0	16.9	-0.4	1.5
April	Week 1	-2.5	-8	1	-7.6	8.5	6	-0.2

Source: Central Reserve Bank of Peru, Peru Ministry of Agriculture and Produce

Figure 7.3. Projected inflation (YoY % variation)



Source: Central Reserve Bank of Peru and BBVA Research

We expect to see inflation rising slightly in April falling back later, fluctuating around the 4% mark for the rest of Q2. Later on, into the second half of the year, it will begin to fall more clearly in a context in which internal demand – particularly private sector expenditure – will still be weak, oil prices will remain relatively stable and food prices will continue to return to normal. Accordingly, we predict a rate of inflation of around 3% at the close of the year (see Figures 7.3).

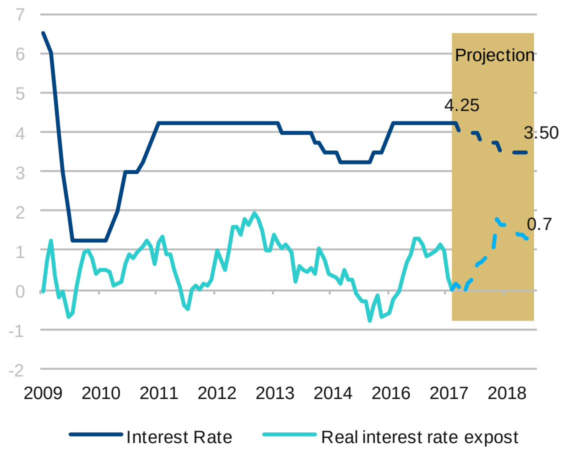
8. Monetary policy: Central bank reveals a more dovish stance

As expected, at its meeting early in April the Central Reserve Bank held its reference rate at 4.25%. The most noteworthy event at the same, however, came in a statement issued after the meeting. In it, the Central Reserve Bank indicated that it is waiting for the recent supply impact that affected inflation to cut its monetary policy rate in the short term.

Indeed, in the YoY inflation figure in March stood at 4%, a percentage point above the target rate, provisionally speeding up owing to food supply shortages (see Section 7 for greater detail). The macroeconomic environment facing the Central Bank is also characterised by the weakness of the economy, which has worsened throughout the first quarter, particularly in March, owing to weather problems. We should also add here the significant drop in business confidence, which fell from 55 points in February to 44 points in March (in the pessimistic bracket). Finally, given that the fiscal incentive tied to restoration and reconstruction work on the infrastructure damaged by *El Niño Costero* is going to be delayed, the counter-cyclical policies are currently falling on the Central Bank.

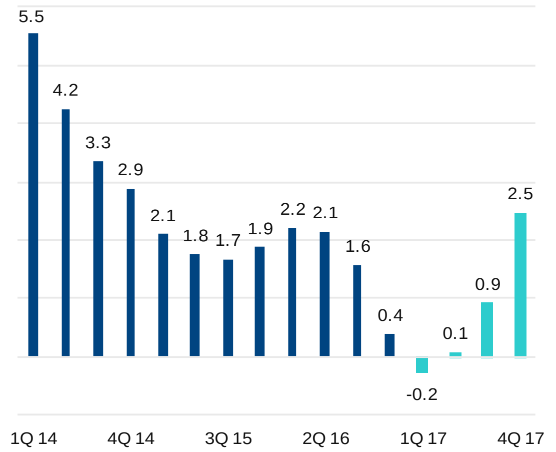
The weakness of the economy, the drop in business confidence and the delay in implementing the fiscal drive suggest that the Central Bank needs to cut back on its rate to enable it to support private sector expenditure. However, the speeding up of the inflation rate – albeit for provisional supply shortages, but which is contaminating inflationary expectations – is complicating the the monetary authority's decision. We believe that the key to when we might see a cutback on the reference rate lies in identifying the moment in which the YoY inflation figure will begin to fall. According to our inflation predictions for the coming months, it is likely that this will speed up in April but will later begin to fall back in May. Consequently, bearing in mind (i) the dovish trend disclosed by the Central Reserve Bank (rendering monetary policy flexible in the short term, conditioning it on a reversion of the supply impact that has provisionally increased inflation) and (ii) our inflation forecasts, we believe that we are likely to see a cut of 0.25% in the reference rate in June (see Figure 8.1). Given the greater cyclical weakness shown by the economy (see Figure 8.2), we also expect a further 0.25% reduction in the second half of the year.

Figure 8.1 Reference interest rate (%)



Source: Central Reserve Bank of Peru and BBVA Research.

Figure 8.2 Internal demand (accumulated over the last four quarters, excluding inventories, YoY % variation)



Source: Central Reserve Bank of Peru and BBVA Research.

9. Risks to our economic growth forecast for 2017

There are five main risks, two of them 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 there fails to progress and domestic financial vulnerabilities have sharpened, vulnerabilities that include parallel banking activity, high corporate debt and inefficient public companies. Should these vulnerabilities fail to be plugged and end up derailing the ordered process of slowing down the Chinese economy, this would considerably affect world growth and the prices of raw materials. On the domestic front, the impacts would be reflected in a slower pace of foreseen activity and a further decline in financial assets, including the local currency.

The second external risk is in the United States and, in particular, in the ongoing uncertainty surrounding the measures that will be implemented by the new administration in that country. Even though it is true that in some cases the tone of radical changes has lowered somewhat and as regards others it seems that these will not be easy to undertake, which reduces the likelihood of risk scenarios arising, it still remains unclear what will finally be done in fiscal policy, trade policy, deregulation and immigration matters. What is finally done could eventually have real and financial impacts different to those considered in the baseline scenario.

On the domestic front, **one of the main risks is that of continuing delays in the major infrastructure projects.** This risk was already factored into the projections we made two months ago. The risk then materialised, so in our new baseline we have incorporated some of these delays, such as, the delay in the construction of the second subway line in Lima. In spite of this, risk persists. Our new baseline scenario assumes that, moving forward, the construction work on big infrastructure projects will speed up. This involves a release from interference, the expropriation of land and assurances given concerning the financing of the works. If this is not finally achieved in time, the growth of economic activity we are predicting will suffer.

A second domestic risk is business and consumer confidence not recovering or even worsening. Our baseline scenario projection includes a gradual recovery of this confidence - currently at pessimistic levels – as the weather problems recede and work is started on restoring and rebuilding the infrastructure damaged by *El Niño Costero*. However for example, if people see that economic activity (beyond the mining of natural resources) fails to recover after the drop in the first quarter, that the infrastructure projects are not unfettered, that social conflicts worsen or that restoration or rehabilitation work after *El Niño Costero* does not progress, it is then quite likely that current business and consumer pessimism remains or even worsens, jeopardising the gradual recovery of private sector expenditure predicted in our baseline scenario.

Finally, there is a risk of planned public spending not taking place. What happened in the first quarter and the fact that a lot of the restoration or rehabilitation work on public infrastructure damaged by *El Niño Costero* will have to be undertaken at sub-central government level, resulting in procedural delays, means risking delays to the work which would negatively affect public expenditure expansion, the main support of growth on the expenditure side in 2017.

10. Tables

Table 10.1 Macroeconomic forecasts

	2014	2015	2016	2017	2018
GDP (YoY % variation)	2.4	3.3	3.9	2.5	3.9
Domestic demand (YoY % variation)	2.2	3.1	0.9	2.1	3.2
Inflation (YoY, %, EOP)	3.2	4.4	3.2	3	2.2
Exchange rate (per USD, EOP)	2.96	3.39	3.4	3.36	3.46
Policy interest rates (%, EOP)	3.5	3.75	4.25	3.75	3.5
Private consumption (% YoY)	3.9	3.4	3.4	2.7	3
Public consumption (% YoY)	6.1	9.8	-0.5	5.4	2
Gross fixed investment (% YoY)	-2.5	-5	-5	0.4	5.3
Fiscal balance (% GDP)	-0.3	-2.1	-2.6	-2.9	-2.9
Current account (% GDP)	-4.4	-4.8	-2.7	-2	-2.1

Forecast closing date: 19 April 2017
Source: Central Reserve Bank of Peru and BBVA Peru Research

Table 10.2 Quarterly macroeconomic forecasts

	GDP (YoY % variation)	Inflation (YoY, %, EOP)	Exchange rate (vs. USD, EOP)	Policy interest rate (%, EOP)
Q1 16	4.4	4.3	3.41	4.25
Q2 16	3.7	3.3	3.32	4.25
Q3 16	4.5	3.1	3.38	4.25
Q4 16	3	3.2	3.4	4.25
Q1 17	1.8	4.	3.27	4.25
Q2 17	2.8	4	3.29	4
Q3 17	2	3.7	3.33	4
Q4 17	3.2	3	3.36	3.75
Q1 18	4.6	2	3.38	3.75
Q2 18	4.5	2	3.41	3.5
Q3 18	3.3	2.1	3.44	3.5
Q4 18	3.4	2.2	3.46	3.5

Forecast closing date: 19 April 2017
Source: Central Reserve Bank of Peru and BBVA Peru Research

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