BBVA Research

Peru Economic Outlook
2Q19

25 April 2019

Creando Oportunidades

Forecasts with information at 4 April

Key messages

- Activity slowed at the beginning of the year due to the decline in public investment and mining production, in addition to the high year-to-year comparison base in anchoveta fishing. These are temporary factors. We estimate that growth in Q1 will be between 2.5% and 3.0%

- For 2019, the baseline forecast scenario shows, on the external front, an environment in which world growth will slow, a more accommodating shift in monetary policy in the US and new stimuli in China, and an improvement in terms of trade (although metal prices will decrease, the decline in oil prices will be greater). In addition, it assumes that trade tensions will not continue to escalate

- On the local front, the base scenario considers that the macro impacts of El Niño Costero were limited, a business spirit favouring investment will be maintained, mining investment will continue to increase, fiscal stimulus will be lower than in 2018, and mining production will begin to normalise

Key messages

- In this context, we project that GDP will grow by 3.9% in 2019. This forecast is similar to the forecast for the previous year (January), expect for we now have lower world growth and, locally, lower public spending and a more moderate normalisation of mining production; on the other hand, global interest rates are now lower, terms of trade are higher, and the performance of primary activities (except mining) is expected to improve. Growth forecast for 2019 has a downwards bias due mainly to the negative surprise in Q1

- Growth is predicted to reach 3.7% by 2020. There will thus be some moderation with respect to the previous two years because the momentum of mining investment will dissipate. In part, this will be offset by a recovery in public investment as regional government spending normalises and public infrastructure construction accelerates. This growth forecast for 2020 is similar to the previous year

- In the foreign exchange market, the higher mining investment and the continued high trade surplus support the appreciation of the local currency in 2019. We estimate that the exchange rate at year close will be between 3.25 and 3.30 (3.37 at the end of 2018). Exchange rate volatility episodes are not ruled out.

Key messages

- In terms of prices, inflation is increasing and is currently at 2.2% (and is likely to continue to rise in the very short term), as measures of inflation trend also continue to increase. In the second half, however, we predict a drop in the pace of YoY increase in oil prices and the exchange rate, which will lead to inflation at the close of the year of around the current level. In 2020, upwards pressures on inflation will grow again, in an environment in which gaps in the economy dissipate

- The monetary policy rate has been at 2.75% for just over a year. The monetary position remains expansive and the central bank seems comfortable with it. However, the context has changed in the past year: inflation and inflation trend measures have increased and non-primary GDP is growing above 4% (the negative output gap is closing)

- Estimates of the central bank's reactive function point to an initial rate increase (+25 basis points to 3.0%) between the ends of Q2 and Q3, with two additional increases before the end of 2020. Our base scenario is consistent with this. What about risk? Concerns about global growth and slow local activity could lead to the first rise being delayed

01

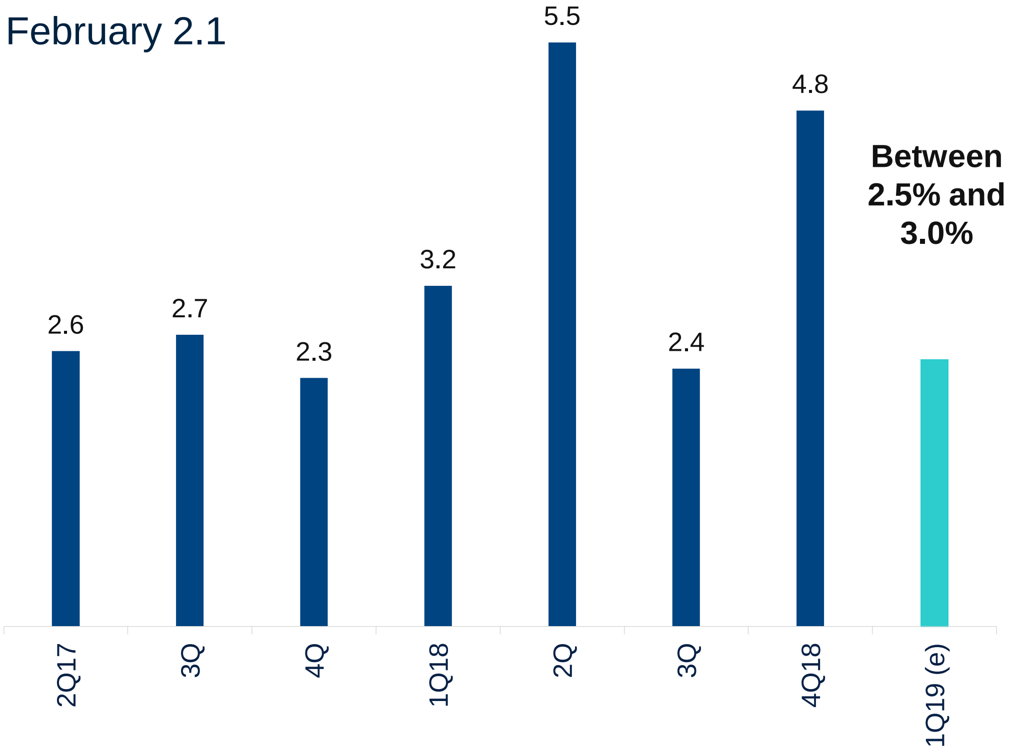
Economic activity

Activity lost dynamism at the beginning of the year

GDP
(YoY change, %)

January 1.6

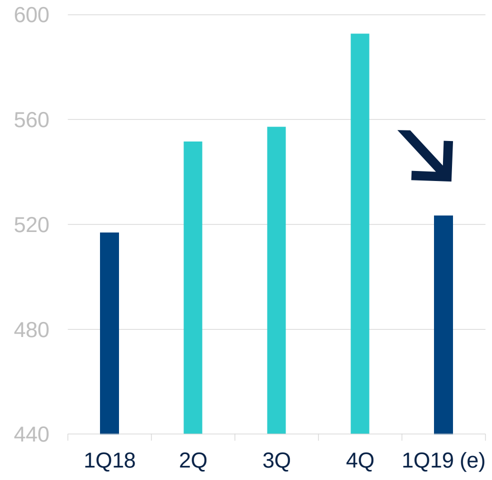
February 2.1



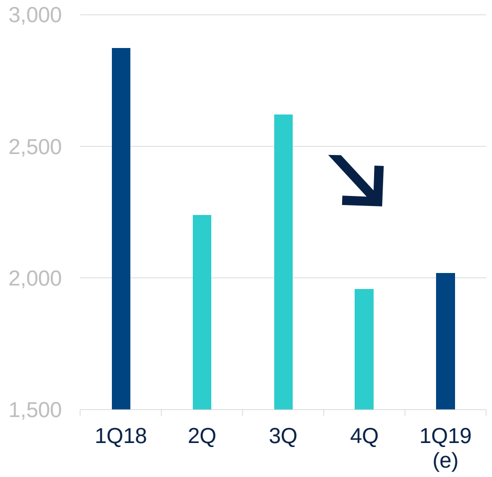
Cuts to public investment

Lower mining production

Copper production
(thousand metric tonnes)



Iron production
(thousand metric tonnes)



Anchoveta fishing
High year-on-year comparison base

(e) Estimate.
Source: BCRP, MINEM and BBVA Research

What do we expect for 2019 (and 2020)?

The revised base scenario considers…

01

Slowdown in global growth

Downwards revision in relation to the previous forecast (January)

02

Monetary policy shift in the US and new stimuli in China

Greater caution on the part of central banks

03

Improvement in terms of trade

Somewhat more pronounced than in the previous forecast

04

The macro impacts of El Niño Costero were limited

Even more limited than was forecast three months ago

05

Business confidence relatively favourable for investment

Not very different to that seen in January

06

Increase in mining investment

Not very different to that seen in January

07

Less fiscal stimulus than in 2018

In comparison with the January forecast, it will be somewhat lower

08

Mining production begins to normalise

Downwards revision of what was seen in Q1

On the external front, action by central banks and an absence of "accidents" would ensure only a mild slowdown in global growth

More signs of global slowdown > **New stimulus policies**

Assumption based on the evolution of the global environment, without "accidents"

01
Protectionism:
despite the delay, an agreement between the US and China remains likely

02
Brexit:
greater uncertainty over a longer period

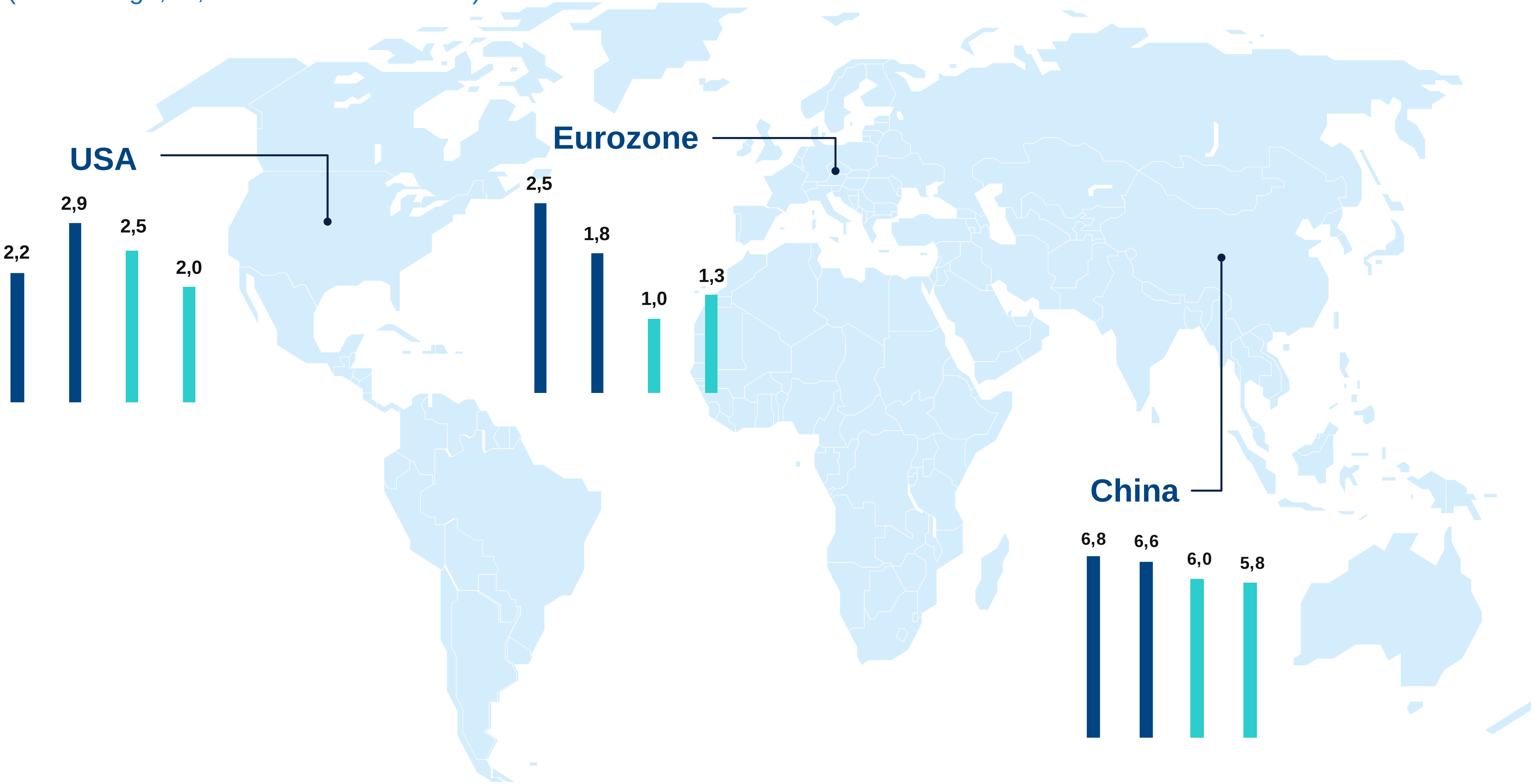
03
Financial markets:
volatility limited by action from central banks

04
Oil
slowdown in prices following recent spike

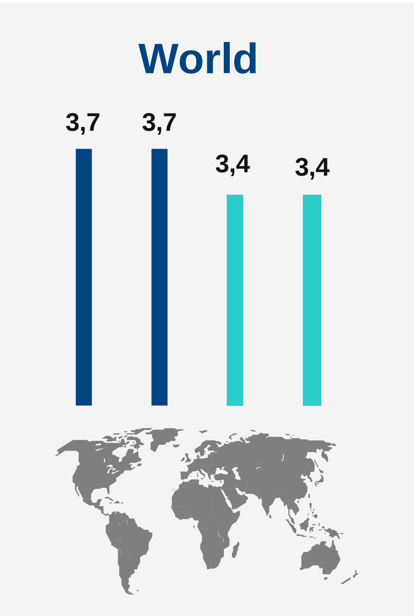
Global growth gradually softens

1 Slowdown in global growth

GDP
(YoY change, %, 2017/2018/2019/2020)

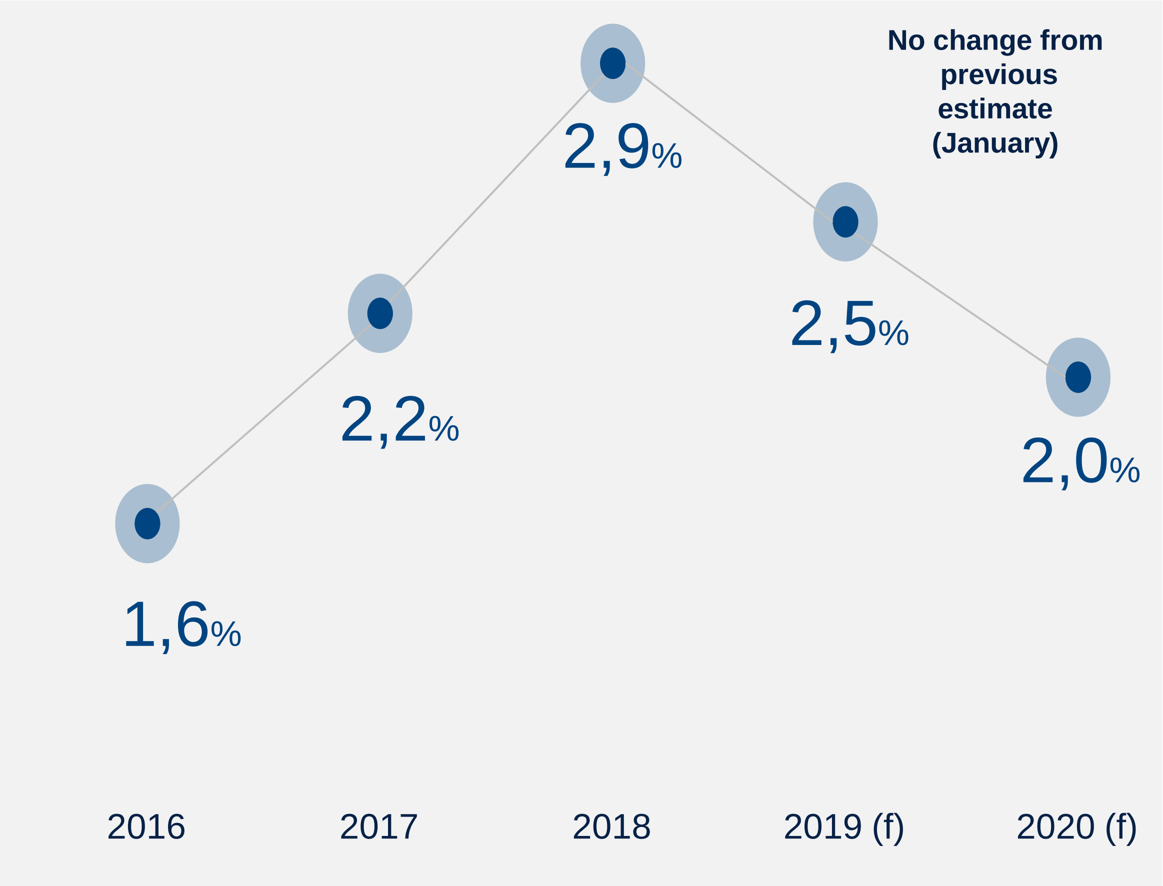


World growth in 2019 has been adjusted downwards by one tenth of a percentage point (due to the Eurozone)



USA Cyclical slowdown in growth, moving towards potential pace

USA GDP
(YoY change, %)

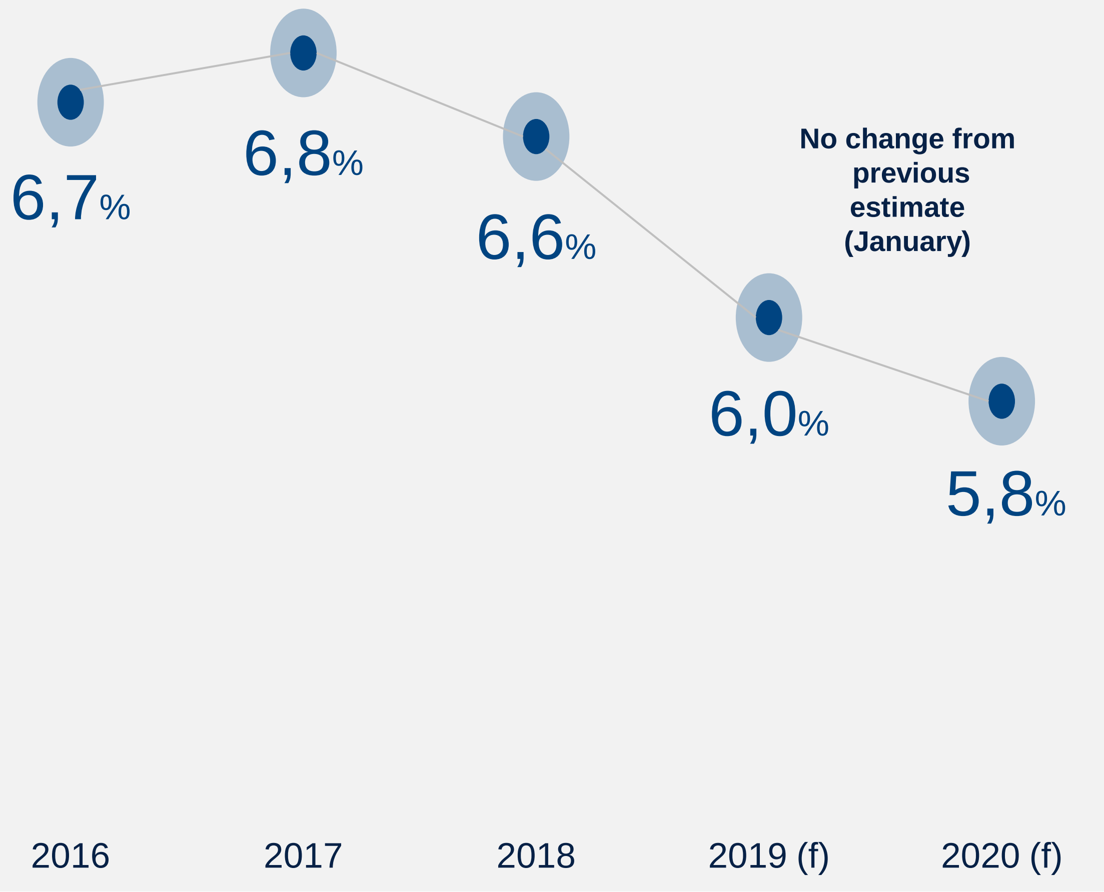


Forecast (f).
Source: BBVA Research based on BEA (Bureau of Economic Analysis)

- Activity will gradually slow, moving towards potential rates as fiscal stimulus decreases
- Compared to the previous forecast there are no changes, but the risk of a downwards trend in world growth is greater
- Inflation is expected to remain below 2% in 2019

China A trade agreement with the US and moderately more expansionary economic policies will allow a soft landing for activity

China GDP
(YoY change, %)



Forecast (f).
Source: BBVA Research based on BEA (Bureau of Economic Analysis)

- The growth of the Chinese economy will continue to slow, in line with the slowdown in consumption
- Monetary stimulus: cuts in reference rates and bank swap requirements
- Fiscal stimulus: VAT-focused tax cuts, equivalent to 2% of GDP
- The growth target for 2019 was reduced to 6.0% to 6.5%
- No changes with respect to the previous forecast

2 Monetary policy shift in the US and new stimuli in China

Fed

- **Long pause in the increase of interest rates**, but it could turn upwards at the end of the year
- **The normalisation (reduction) of the balance sheet will be completed earlier than expected** (September 2019)

ECB

- **Delay in monetary normalisation**
- **Lower rates** for longer and **more liquidity** (TLTROs)
- **No interest rate increases** expected before December 2020

China

- **Additional monetary stimulus:** tax and swap cuts
- **Tax cut** (equivalent to 2% of GDP)
- **Fiscal deficit increased** to 2.8% in 2019

LATAM and other emerging economies

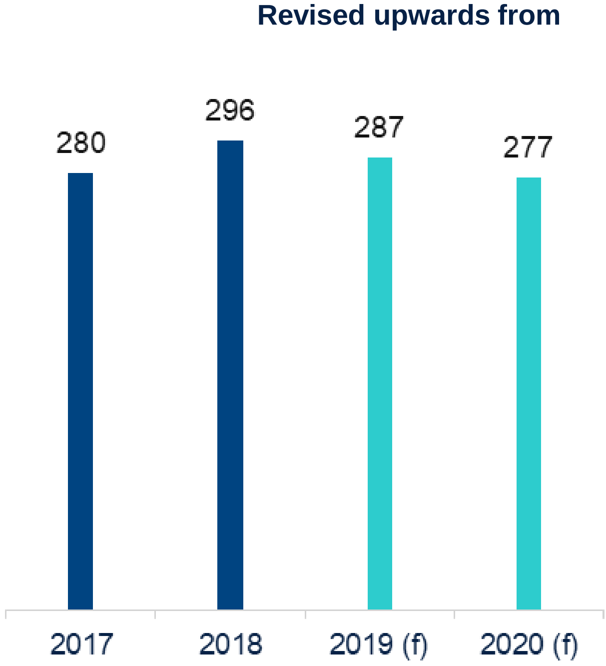
- Margin for a **laxer monetary policy**

Greater caution on the part of the central banks

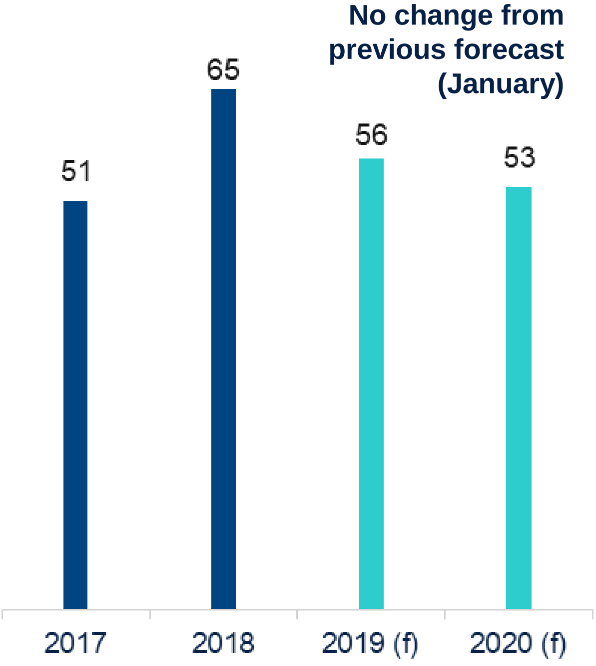
Lower interest rates than in the previous forecast, which favours local private spending

3 Improvement of terms of trade in 2019

Copper price
(USD/lb, average for the period)



Price of oil WTI
(USD/barrel, average for the period)



Terms of trade
(average for the period, YoY change, %)

Forecast (f).
Source: Bloomberg, BCRP, and BBVA Research

Copper
Price decrease in 2019 due to a slowdown in China's growth. It is less pronounced than in the previous forecast due to more accommodating monetary policies and the lower production of a major mine in Indonesia

Oil
Price drop in 2019 due to lower world growth and an increase in US supply

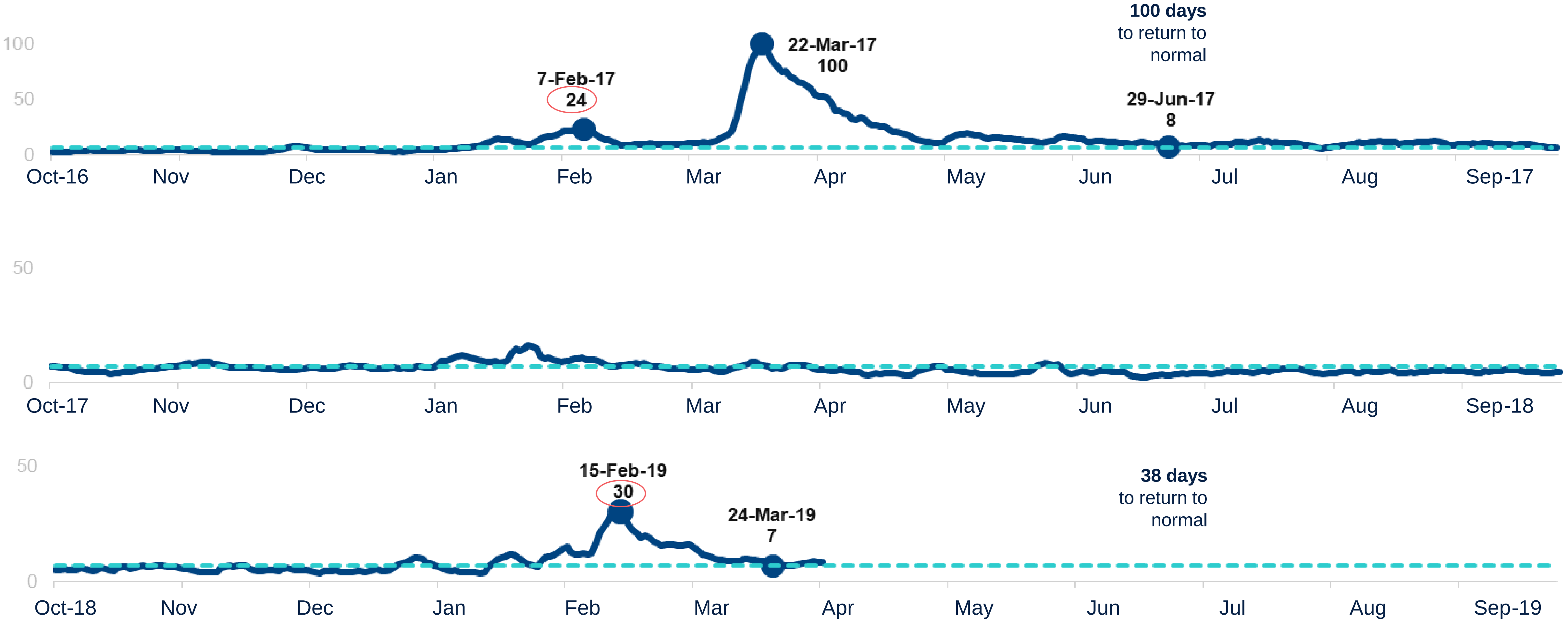
Terms of trade
Revised upwards in 2019 due to upwards revision of metal prices (including copper)

In the balance, the external environment is slightly more favourable than in our previous forecast

		Changes to the external environment	Local impact
World GDP 	↓	**Lower worldwide growth (due to Eurozone and Latin America)**	GDP (external demand) Interest rates
Monetary policy	↑	**Central banks are more cautious**	Interest rates GDP (investment) Exchange rate
Terms of trade	↑	**Improvement to terms of trade**	Balance of trade Exchange rate

4 On the domestic front, the macro impacts of El Niño Costero were limited; even more limited than expected three months ago…

News about "rain and floods" in Peru*



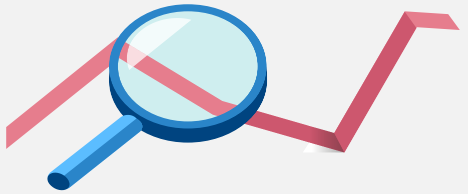
* This is an indicator that is calculated by dividing the number of Internet news stories related to "natural disasters caused by rains and floods" in Peru by the total number of news stories in Peru. 100 used for 22 March 2017
Source: Global Database of Events, Language, and Tone (GDELT) and BBVA Research

4 …which leads us to be more positive in the growth forecast for some primary activities in 2019

Positive impact on primary activities

Farming

Fisheries



Primary manufacturing

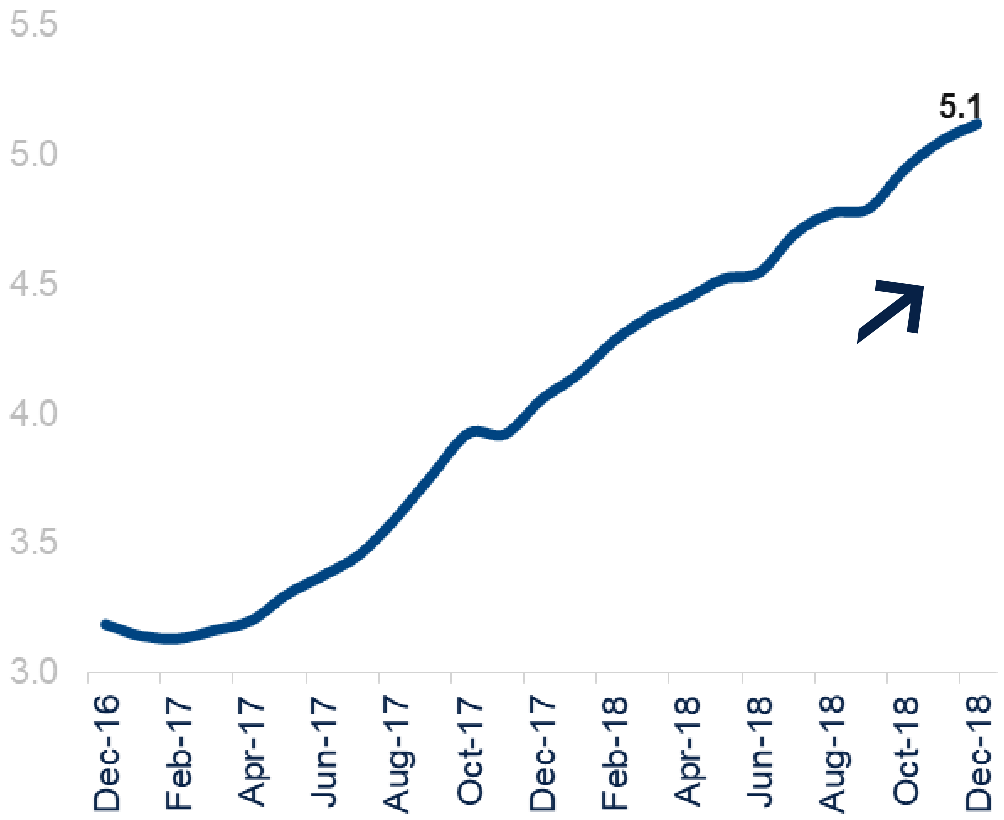
5 Business confidence relatively favourable for investment

Business confidence
(points)

Source: BCRP and BBVA Research

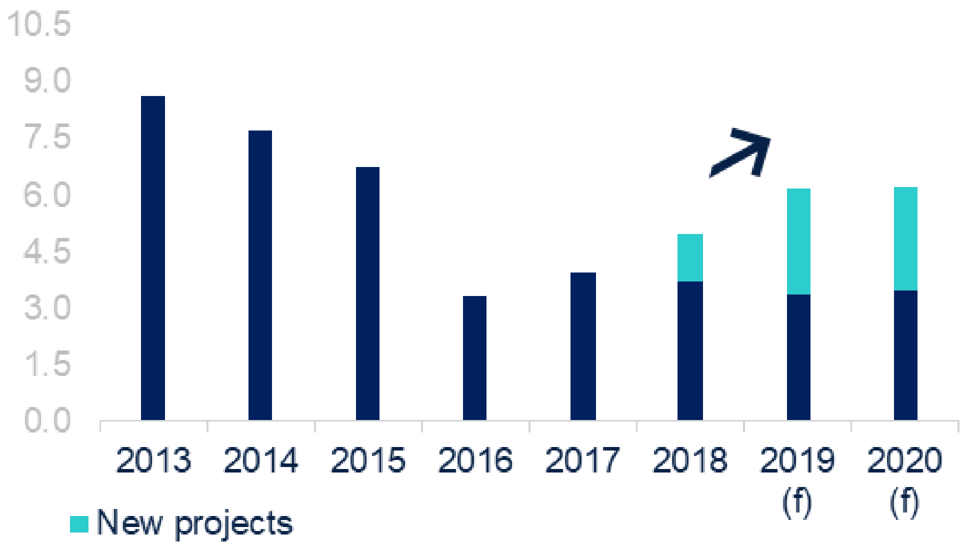
6 Increase in mining investment

Mining investment
(accumulated over the last twelve months, USD billions)



Source: MINEM and BBVA Research

Mining investment
(USD billions)



Production costs of mines under construction, approximated by cash cost, are between **USD 1.0 and 1.4 per pound of copper** (the price of copper is currently around USD 2.90 per pound)

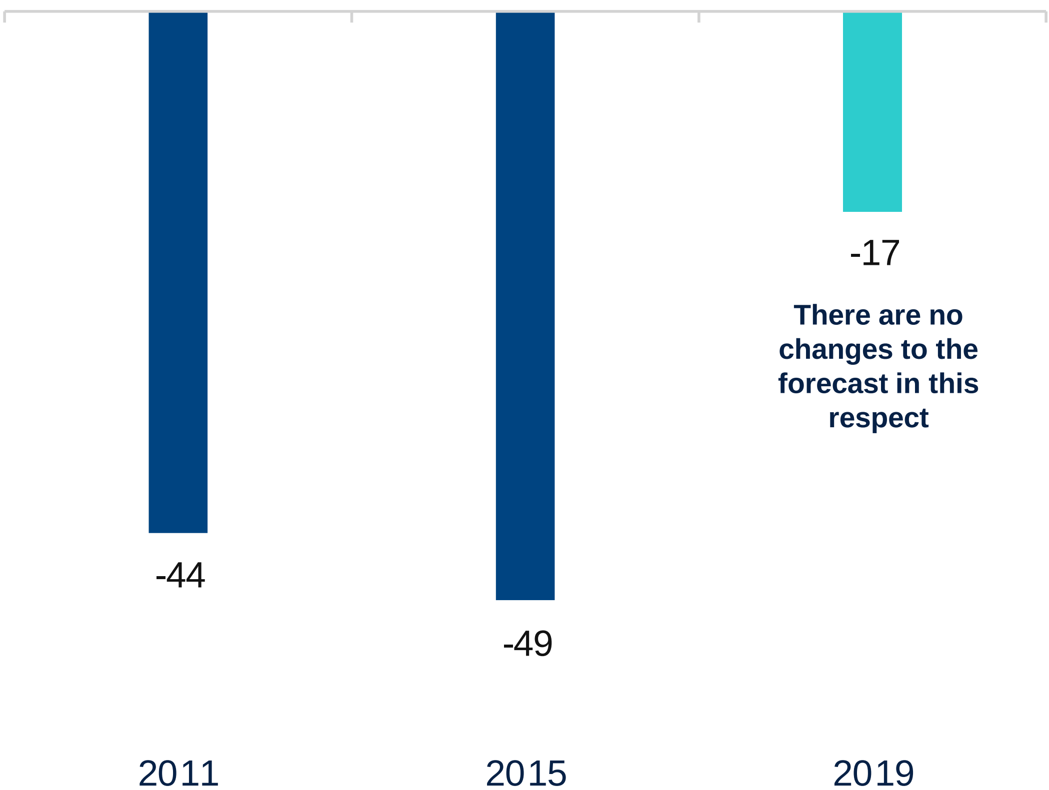
* Investment in new projects refers to Quellaveco, Mina Justa, the expansion of Toromocho and two other smaller mines.
(f) Forecast

No major changes from previous forecast

Mining investment was somewhat lower than expected at the beginning of the year, but the forecast for 2019 includes greater annual investment in Mina Justa (+USD 200 million to USD 800 million)

7 Less fiscal stimulus than in 2018: A slowdown in public investment after the election of new regional authorities, but…

Investment by regional governments during Q1 of the management by the new authorities*
(in real terms, YoY change, %)

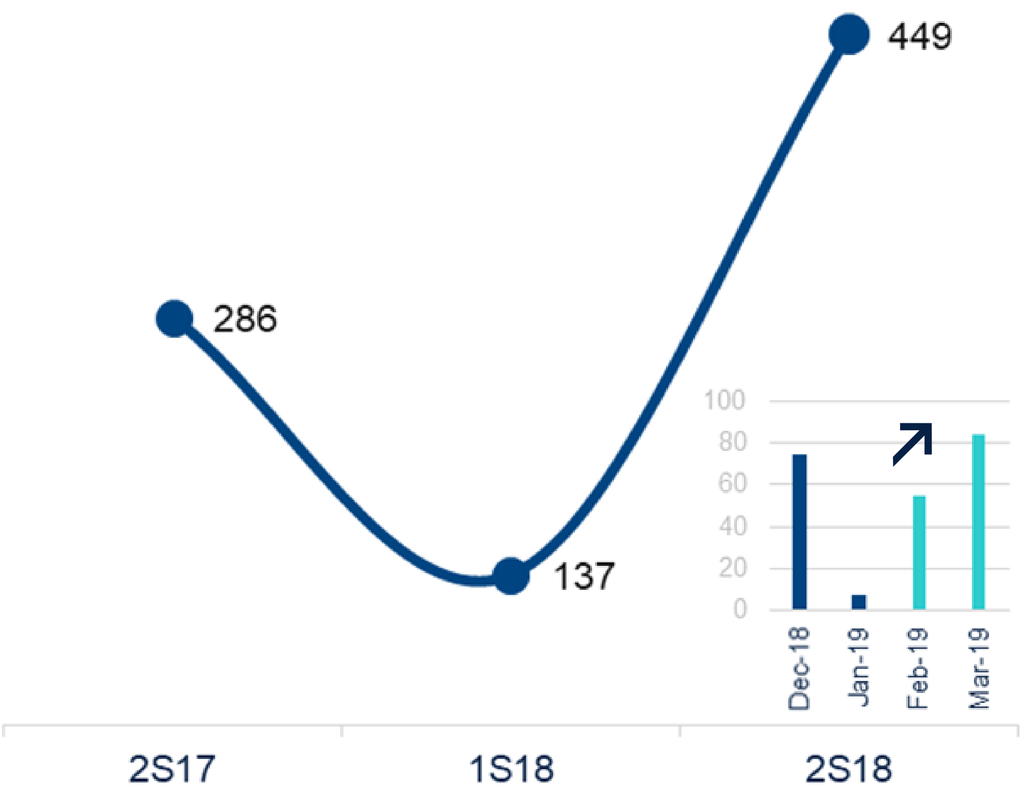


* Includes regional and local governments, which together carry out approximately 60% of the Central Government's public investment.
Source: BCRP, MEF-SIAF (Ministry of Economy and Finance Integrated Financial Administration System) and BBVA Research

- A change in regional authorities such as the recent one (January 2019) usually leads to a temporary slow in investment at those levels of government
- This time has been no different. However, the reversal has been less pronounced than in the past
- Regional public investment will gradually recover. This is established in the base scenario of projections
- One factor that supports this forecast is that the payment of fees to regional governments was brought forward (this time it was done in February, when it is usually done at the beginning of the second semester)

7 … acceleration of reconstruction spending

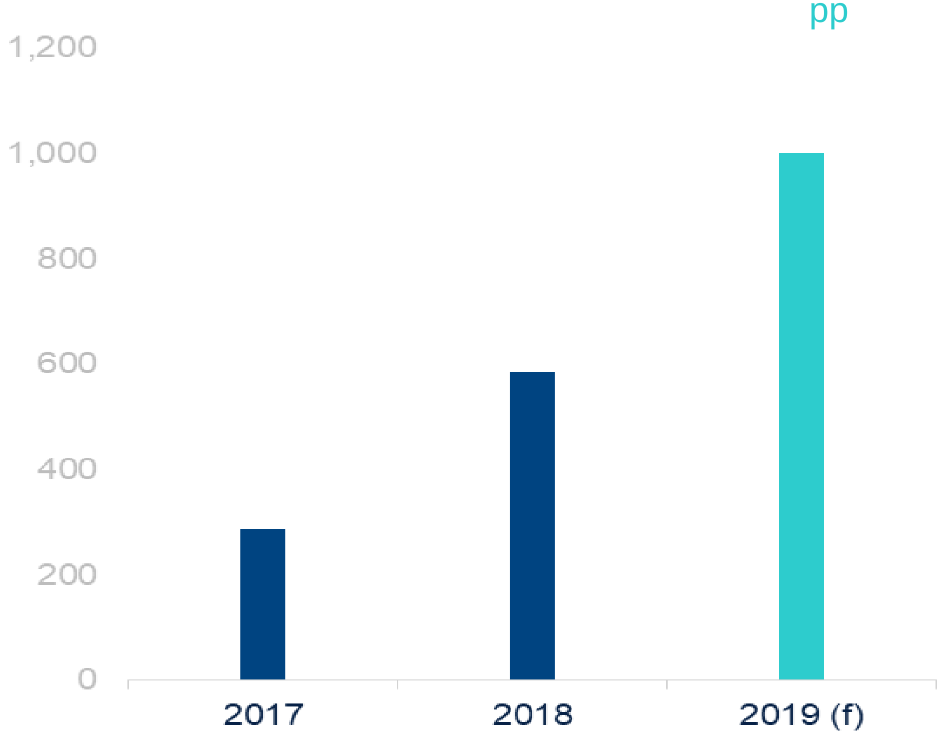
Expenditure on reconstruction in the north of the country
(USD millions)



Expenditure on reconstruction in the north of the country
(USD millions)

0.2 pp

Increase in annual expenditure as % of GDP

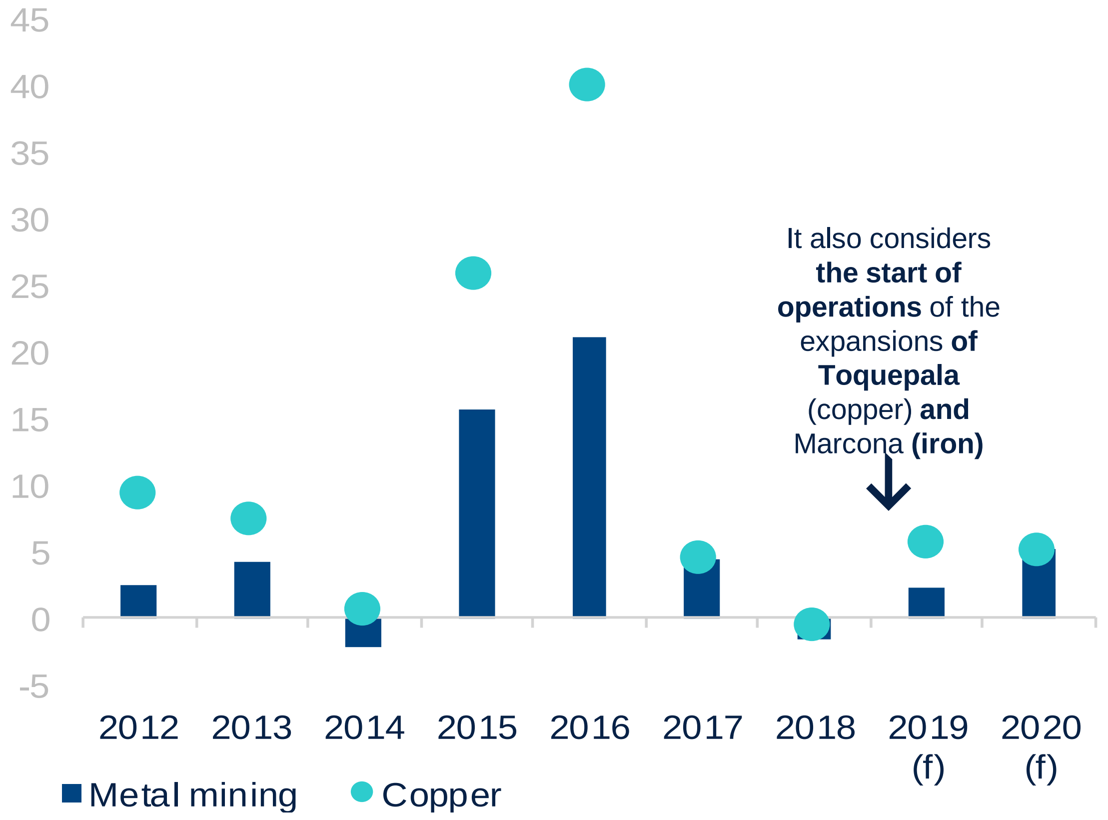


Downwards adjustment to the forecast in his regard due o a somewhat less pronounced recovery than was forecast three months ago

Forecast (f).
Source: Ministry of Economy and Finance of Peru-SIAF and BBVA Research

8 Mining production begins to normalise

Metal and copper mining production
(YoY change, %)



Forecast (f).
Source: MINEM and BBVA Research

- After the problems faced last year, copper production will begin to normalise in 2019.
- According to our estimates, metal mining fell in 1Q19
- However, in comparison with the previous forecast, some new mines are reaching their full capacity faster than anticipated, partially offsetting the negative surprise of Q1

The new base scenario maintains the normalisation of mining production in 2019, but this will no longer be completed this year (mainly due to problems in Q1)

In short, in comparison with our previous base scenario, we now have…

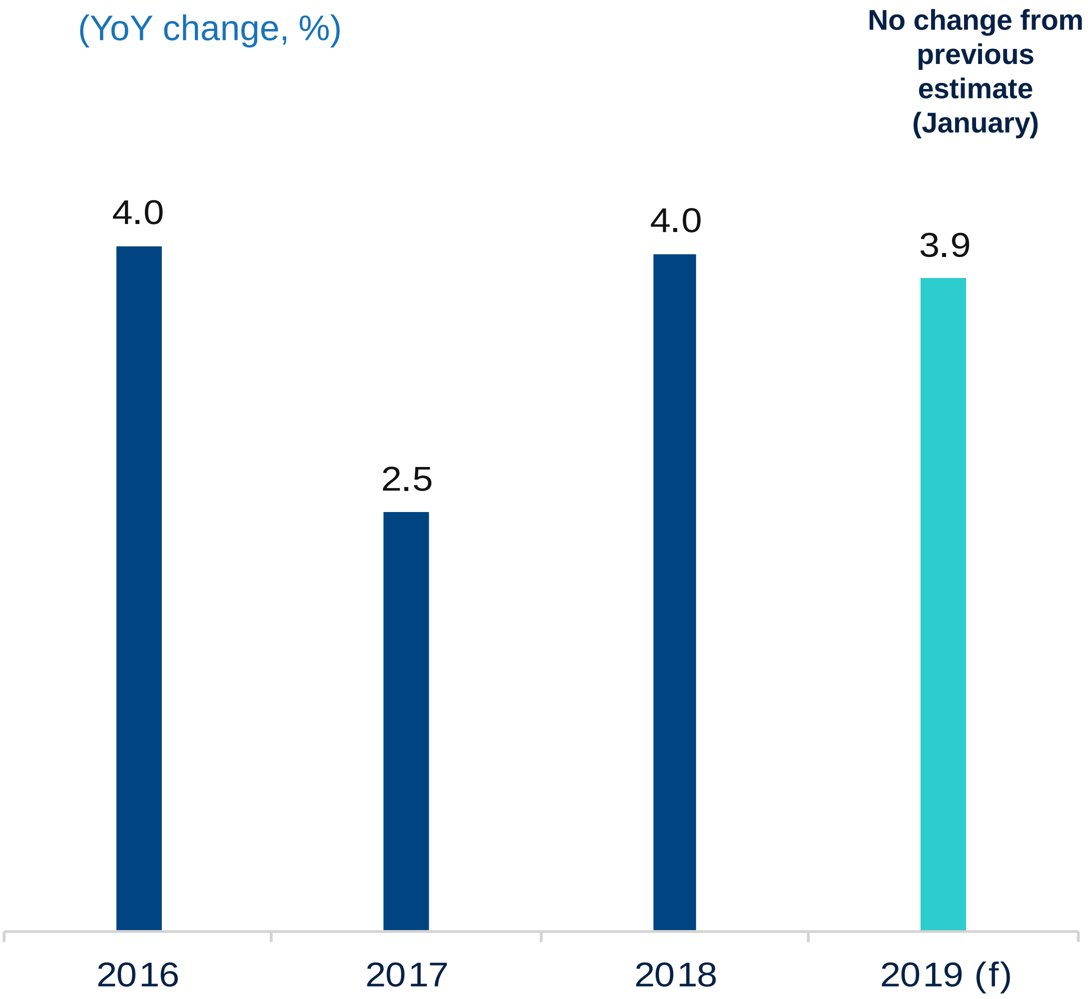
Impact on the
growth forecast for 2019

- Lower interest rates
- Higher metal prices
- Increased growth in primary activities

- Lower global growth
- Lower public spending (reconstruction)
- Slower normalisation of mining production

In this context, we expect GDP to grow by 3.9% in 2019, a similar projection to the previous year, but with a downwards bias

GDP
(YoY change, %)



Forecast (f).
Source: BCRP and BBVA Research

Domestic sales
(domestic demand excluding build-up of inventories, YoY change, %)

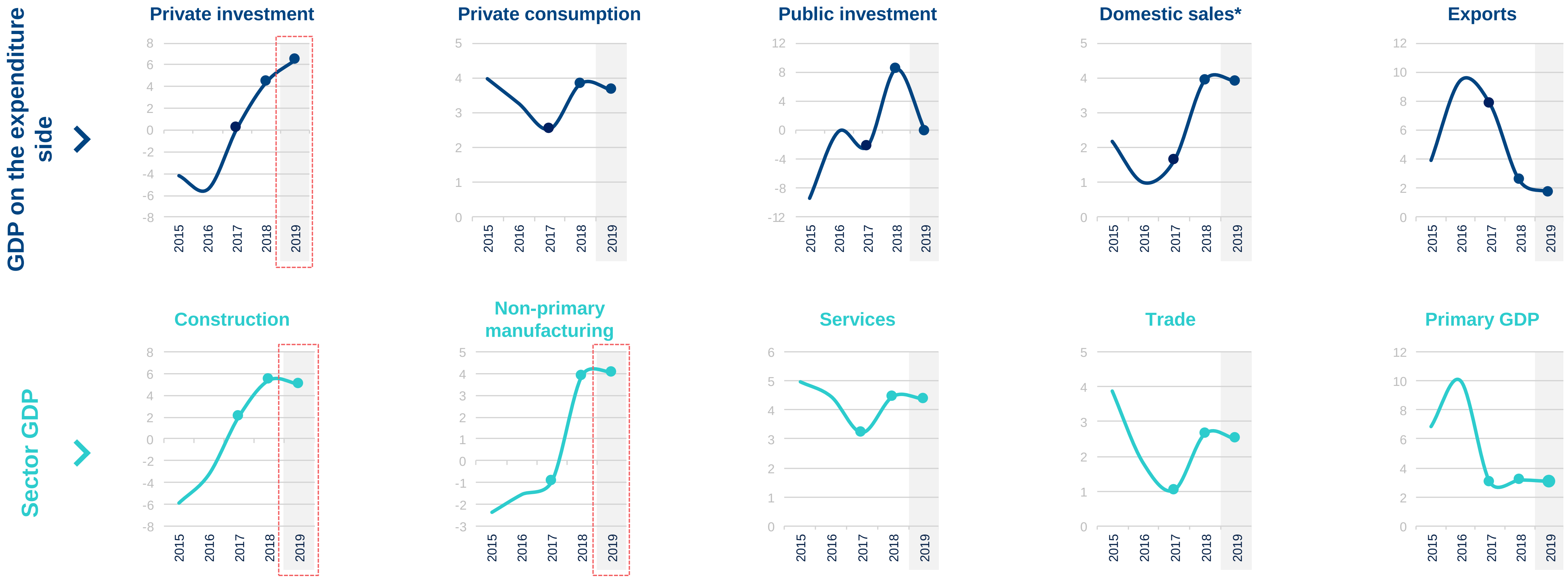
Private spending will continue to accelerate, especially investment (construction of new mines).

Public spending, on the other hand, **will have less progress** (in particular investment due to the change of regional authorities).

Greater dynamism of private investment (mining) in 2019 will be reflected in the non-primary Construction and Manufacturing sector

GDP: selected components by expenditure and sector

(in real terms, YoY change, %; 2019)

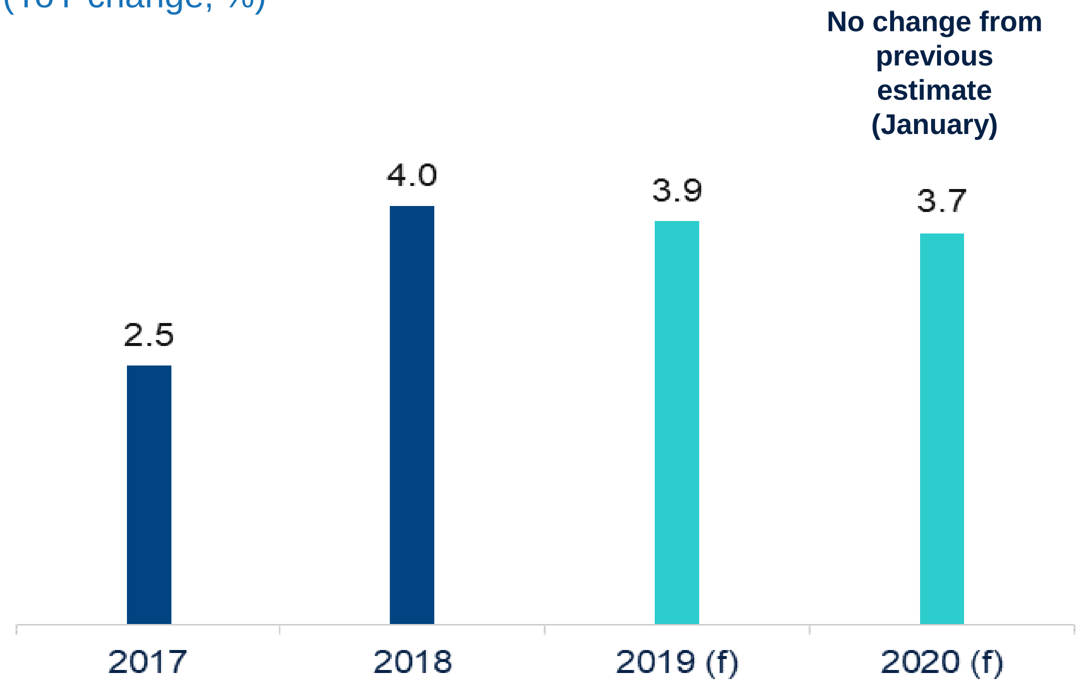


* Corresponds to domestic demand, but excludes build-up of inventories.

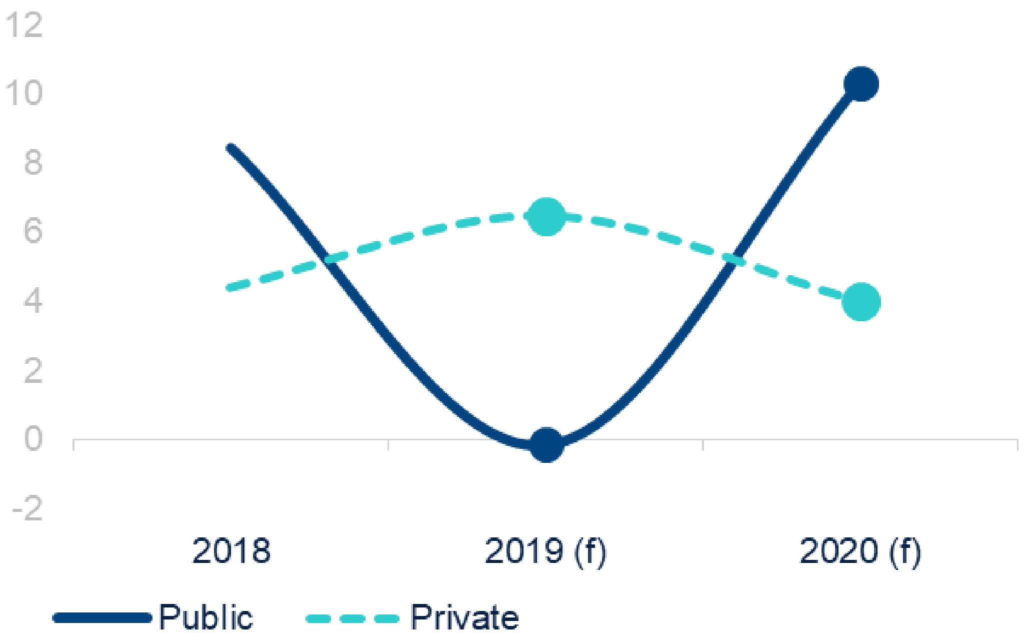
Source: BCRP and BBVA Research

In 2020 growth will be held back compared to the previous two years…

GDP
(YoY change, %)



Investment
(YoY change, %)



Forecast (f).
Source: BCRP and BBVA Research

… because **the momentum in mining investment will dissipate**. In part, this will be offset by a **recovery in public investment as regional government spending normalises** and public infrastructure construction accelerates.

Main risks to the baseline scenario for economic growth

External

- US economic downturn
- China's imbalances (disorderly deleveraging)
- Trade protectionism

Local

- Escalating social conflicts
- Reduced progress of public infrastructure projects
- Increased political noise, with a noticeable impact on business confidence and overall investment

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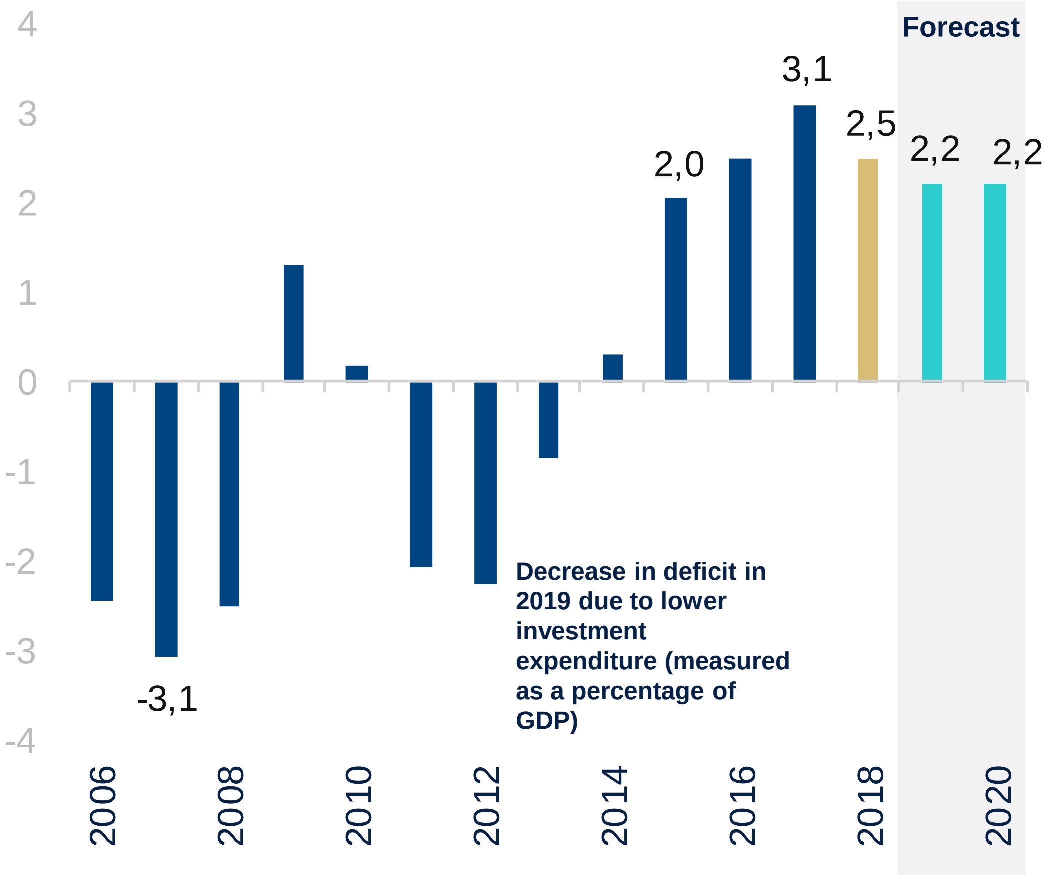
02

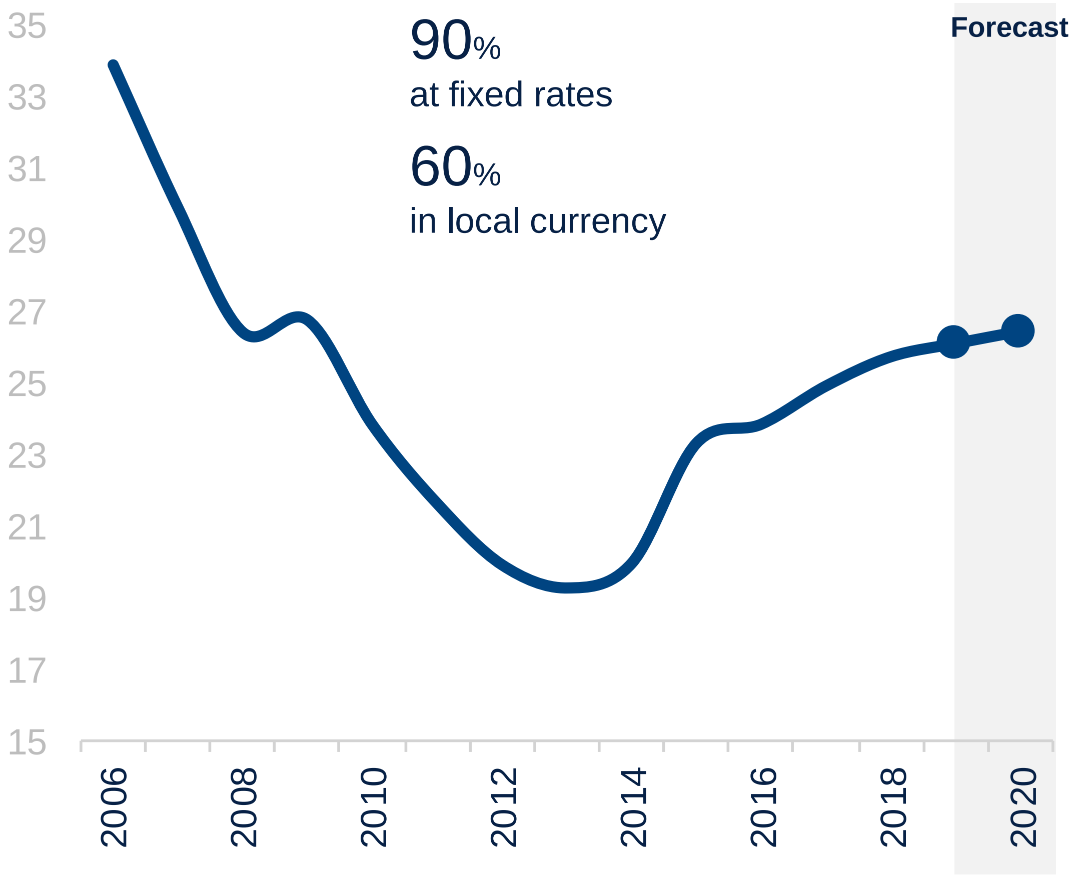
Fiscal and external accounts

We estimate that the fiscal consolidation process that began last year will continue, with deficit falling below 2% as of 2021

Fiscal deficit
(% of GDP)



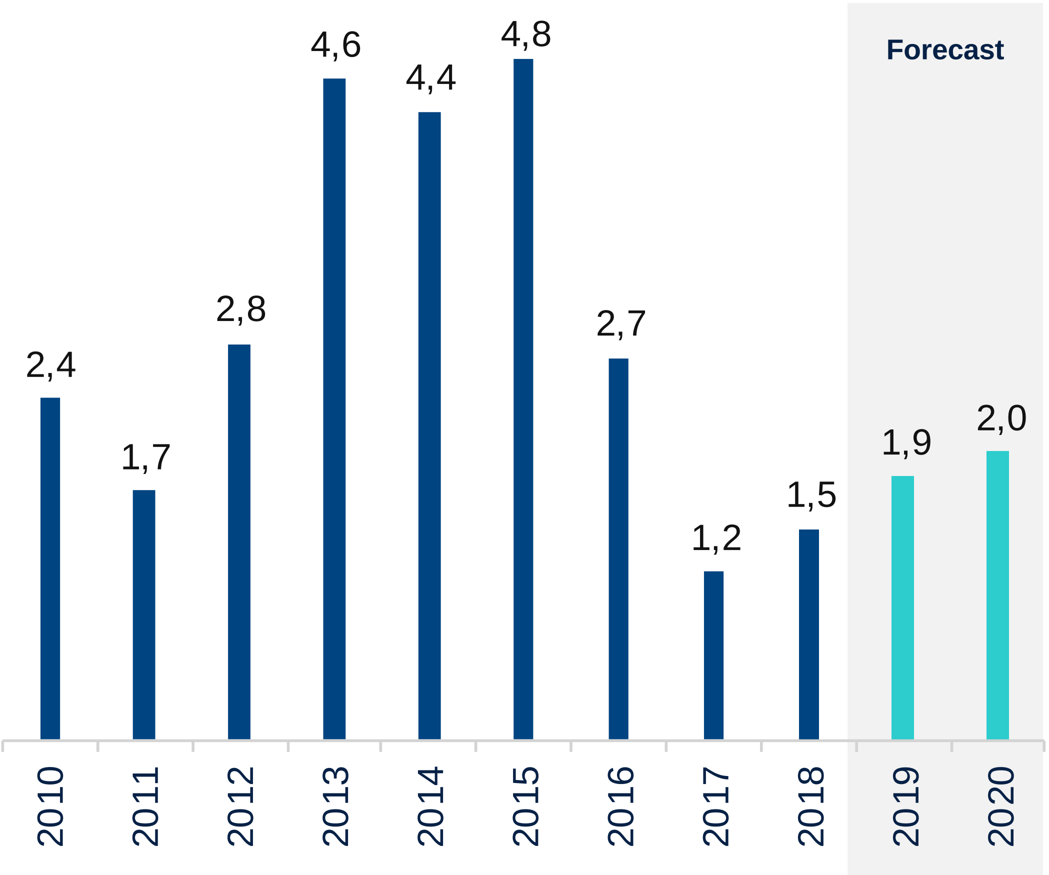
Gross public debt
(% of GDP)



Source: BCRP and BBVA Research

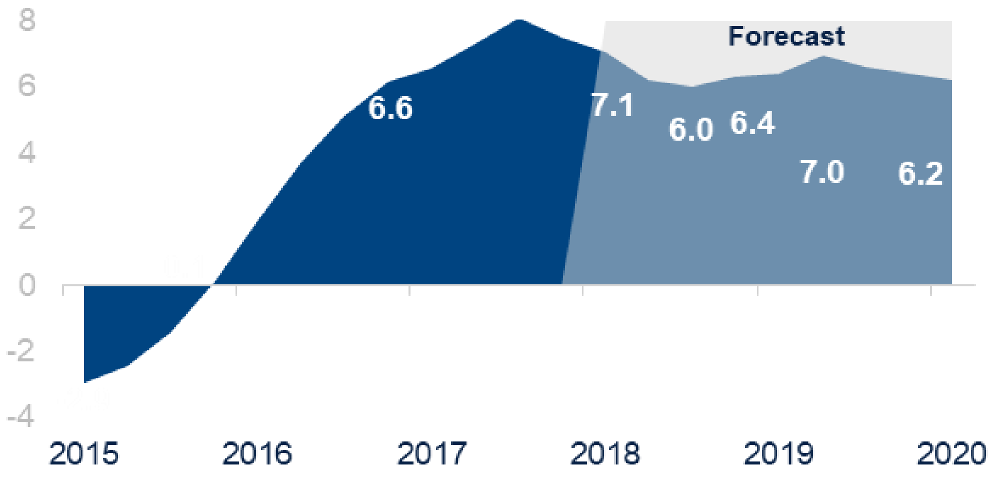
External accounts: a limited deficit in the current account of the balance of payments, consistent with a high trade surplus

Current account deficit of the balance of payments
(as a % of GDP)



Source: BCRP and BBVA Research

Balance of trade
(USD billions, accumulated over the last four quarters)



Along the forecast path…

The price of oil drops

Metal prices decrease

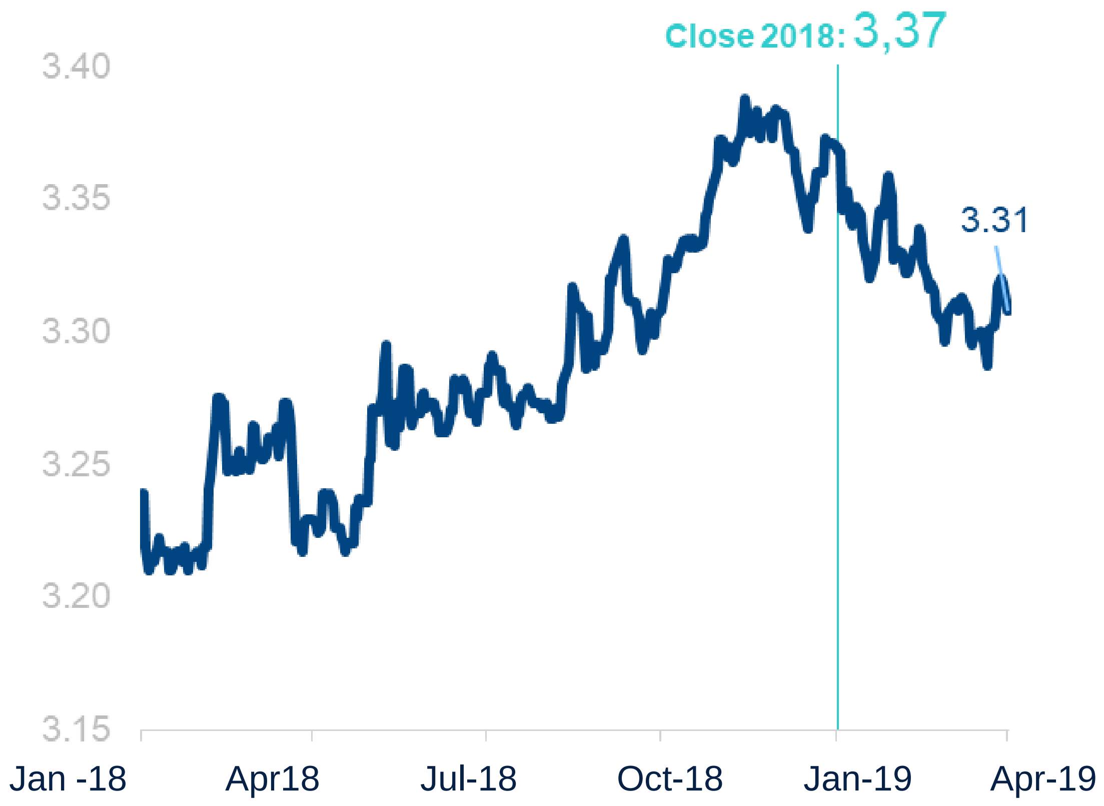
Compared to the previous baseline scenario, the balance of trade shows a higher surplus (improved terms of trade)

03

Foreign exchange market

Strengthening of local currency over the year, reflecting factors such as the continued appetite for sovereign bonds

Exchange rate
(USDPEN)



Source: Bloomberg

Favourable external environment

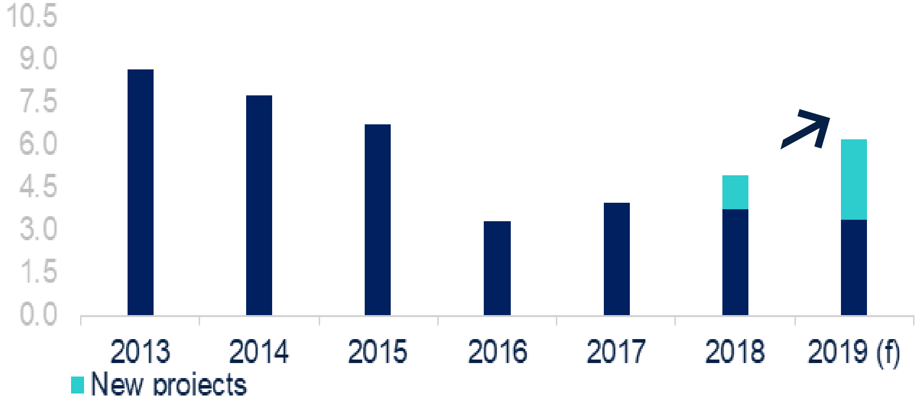
- Central banks postpone policy rate increases (*dovish bias*) due to concerns around global growth
- Trade negotiations between the US and China are progressing
- Increase in metal prices
- Less global risk aversion

Locally…

- Decreased country risk indicators
- Appetite for sovereign bonds

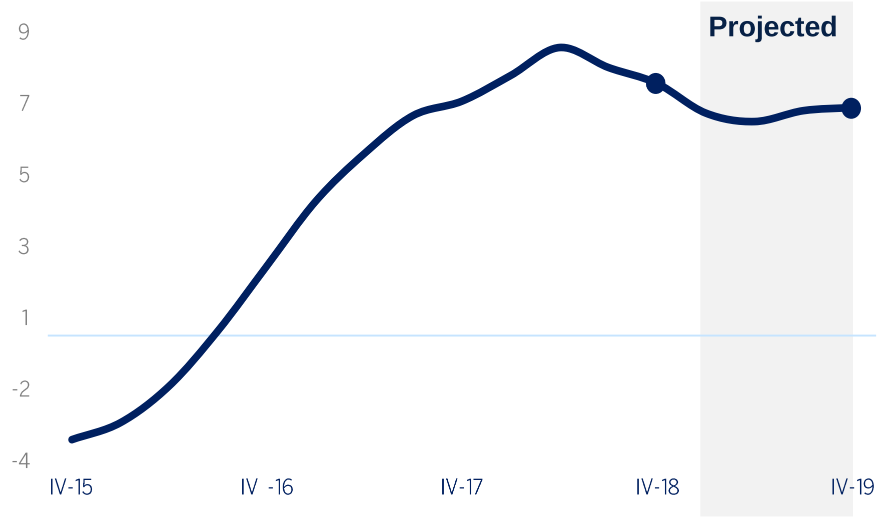
What are the main factors that will affect the behaviour of the exchange rate in the coming months?

Mining investment
(USD billions)



* New projects: Quellaveco, Toromocho Expansion, Mina Justa, Quecher and B2.

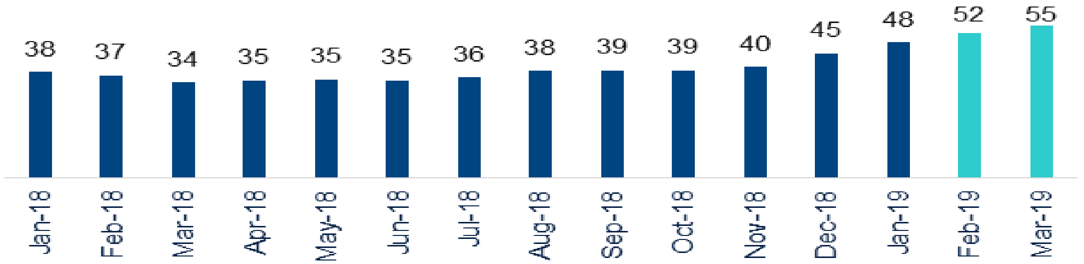
Trade surplus
(USD billions, accumulated over the last four quarters)



Macroeconomic fundamentals remain solid

Trade tensions ease

Sovereign bonds held by foreigners
(PEN billions)



Source: MINEM, BCRP, MEF and BBVA Research

In this context, what will be the exchange rate by year-end? Between 3.25 and 3.30 (average for December 2019)

Factors determining the exchange rate in 2019

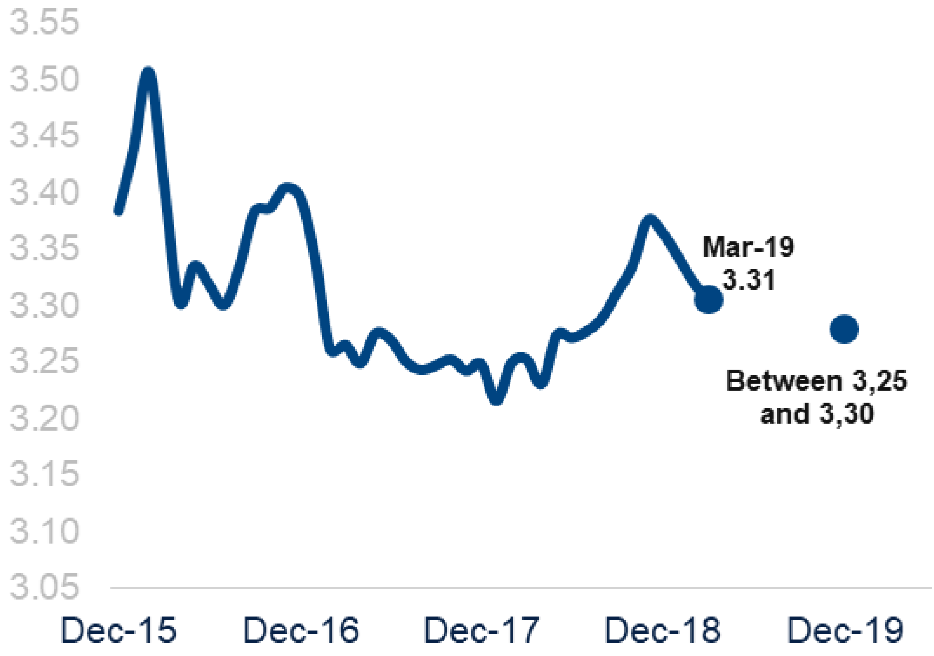
Increased investment in mining

Trade surplus
(Greater than USD 6 billion)

Trade tensions ease

Moderation of global growth
(risk premiums in emerging countries)

Exchange rate
(USDPEN, monthly average)



Source: BCRP and BBVA Research

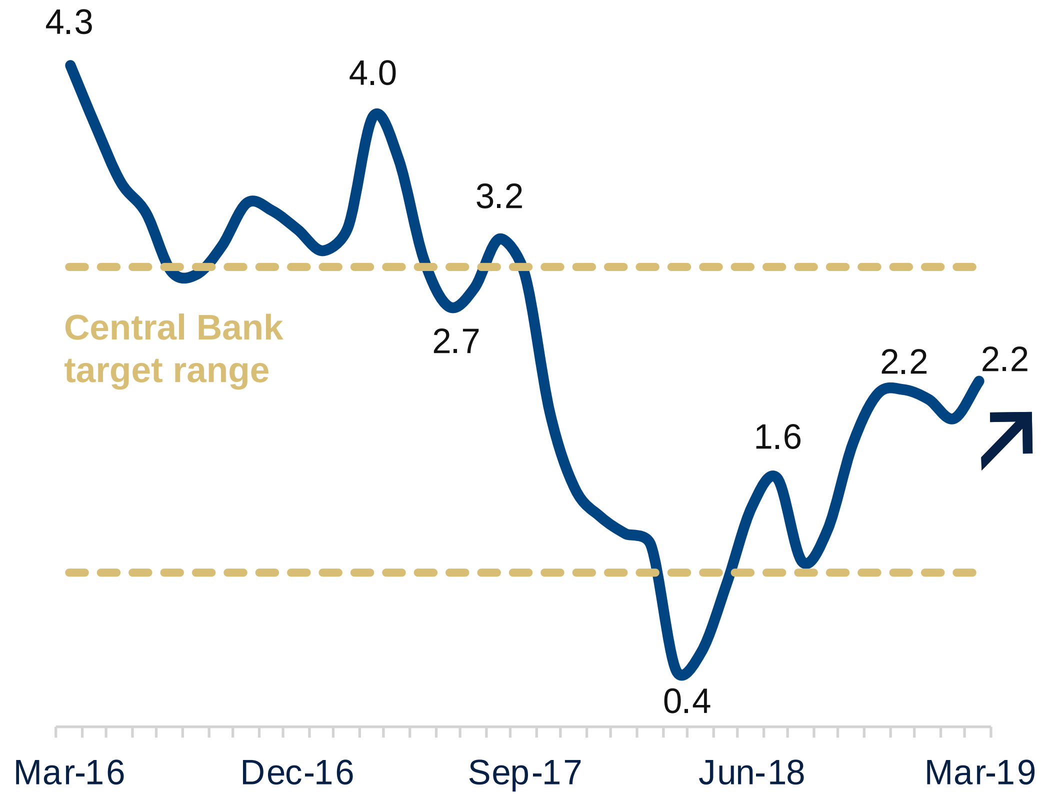
Possible episodes of high volatility in the exchange market are not ruled out.

04

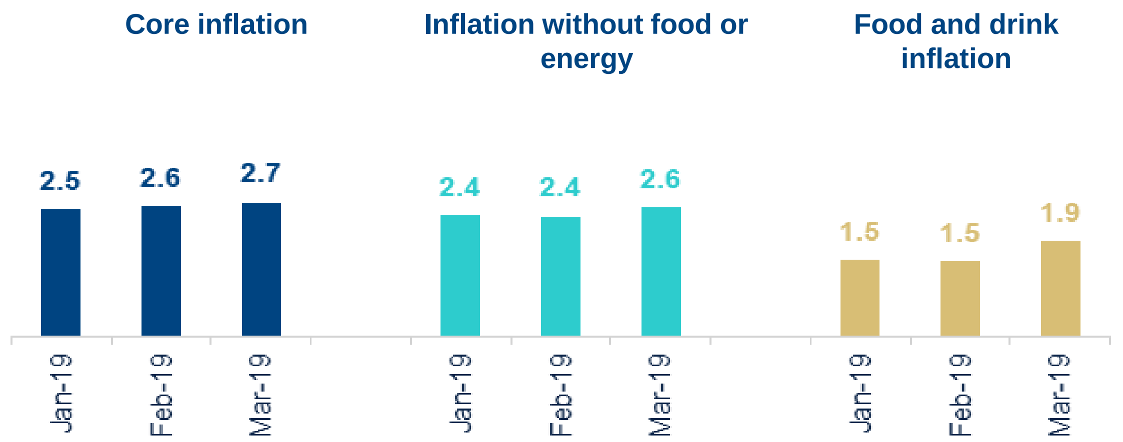
Inflation

Inflation is increasing…

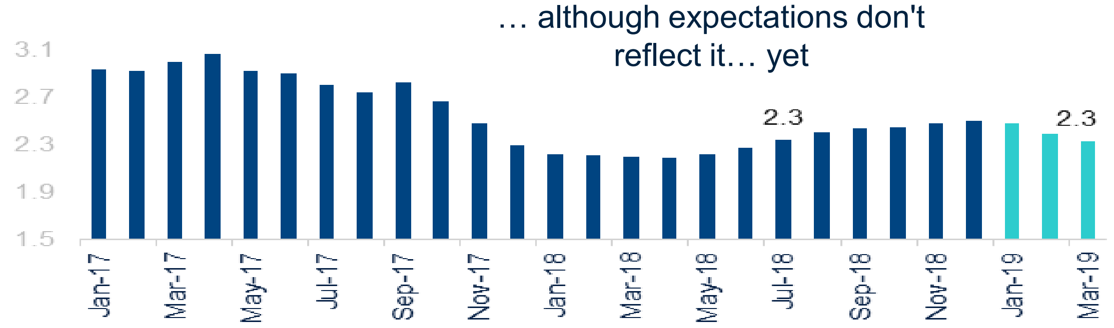
Total inflation
(YoY change, %, of CPI)



Other measures of inflation
(YoY change, %)



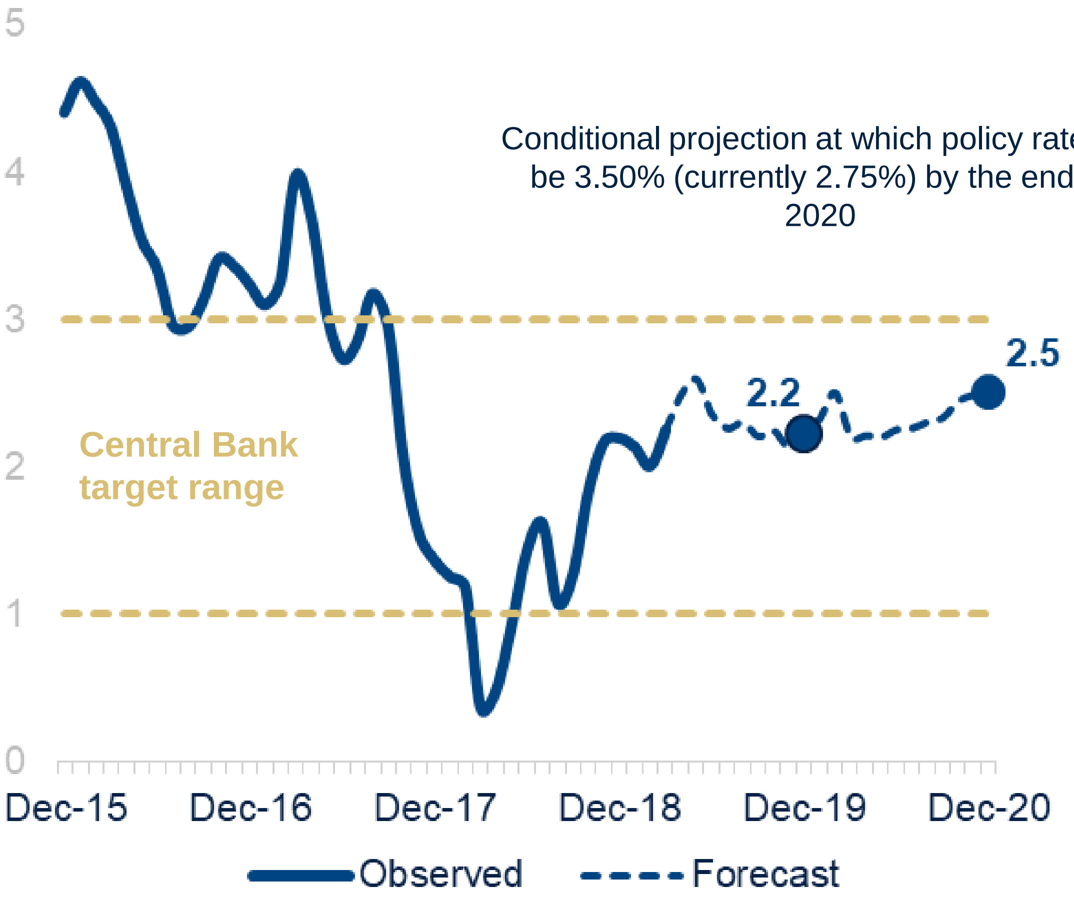
Inflation forecasts one year from now
(%)



Source: INEI (Peruvian National Statistics Institute), BCRP, and BBVA Research

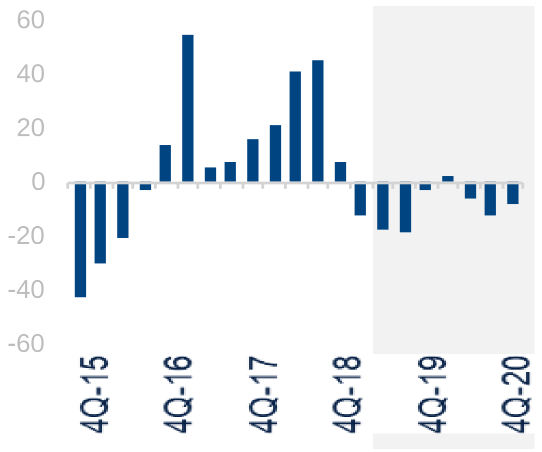
… and it will continue to increase in the short term. It will probably ease off in the second half of the year, but it will increase again in 2020

Total inflation
(YoY change, %, of CPI)

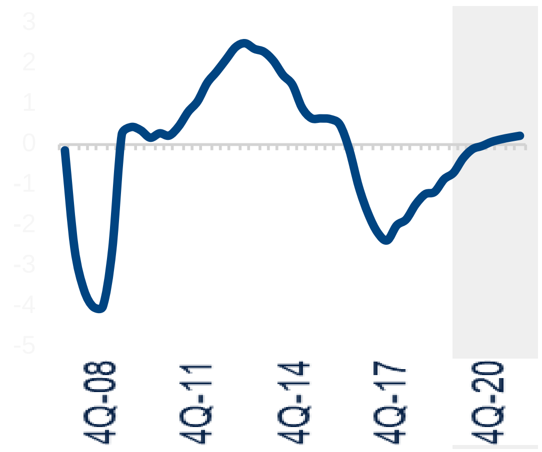


Factors that will influence inflation

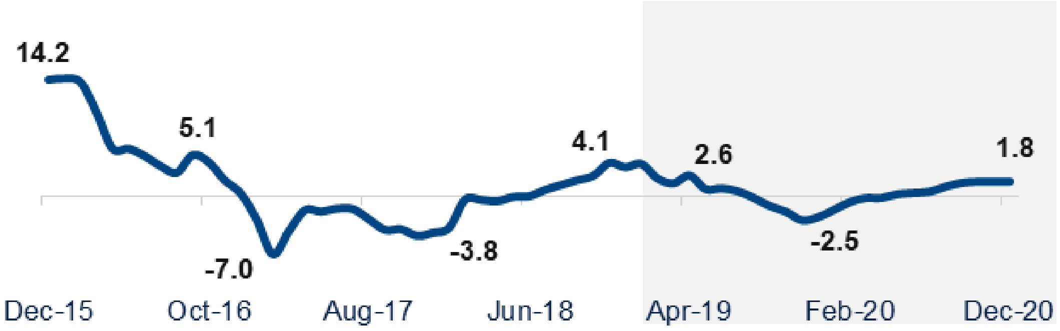
Oil price (YoY change, %)



Output gap (% of potential GDP)



Exchange rate (YoY change, %)



Source: BCRP and BBVA Research

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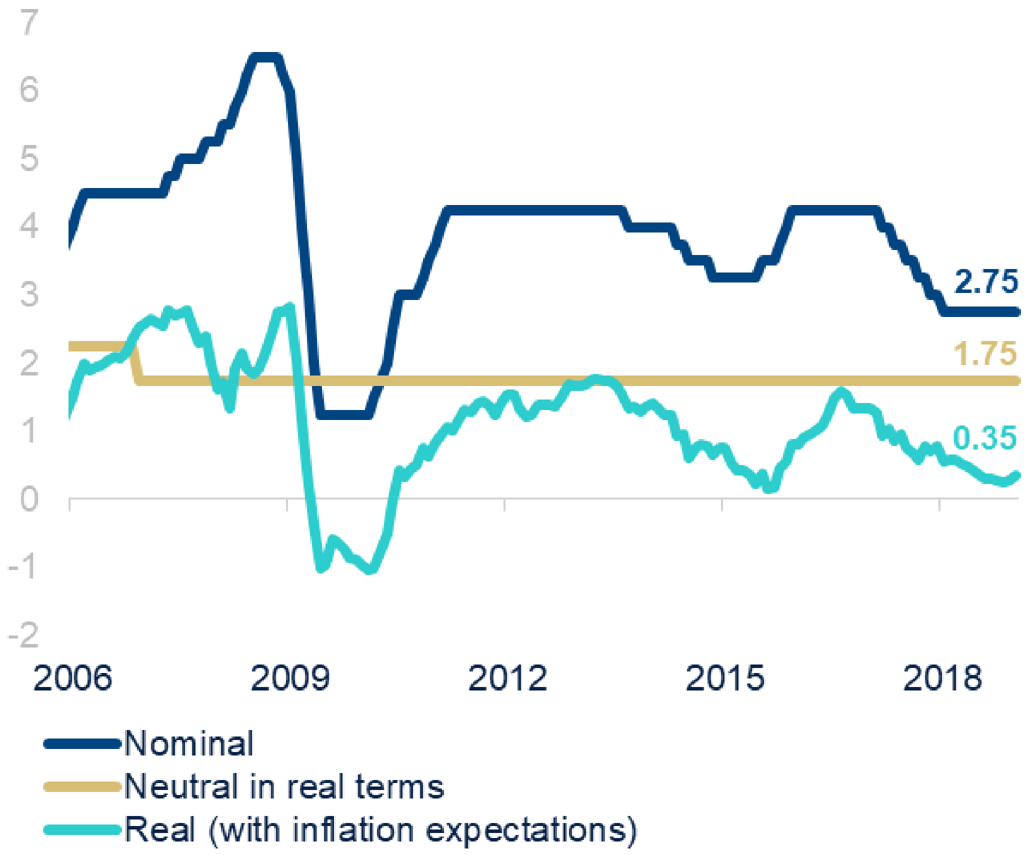
05

Monetary policy rate

Position of monetary policy: It remains expansive and the central bank seems comfortable that way

Monetary policy benchmark interest rate
(%)

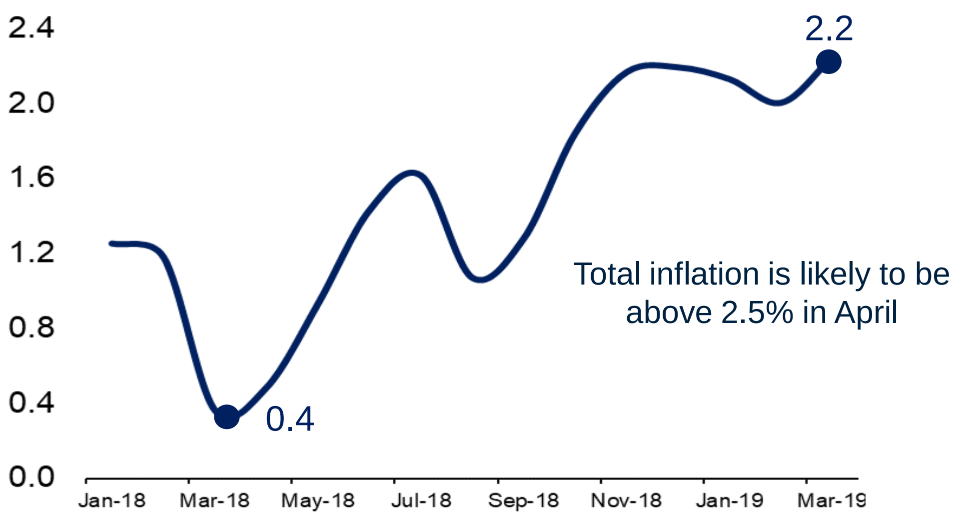


Source: BCRP and BBVA Research

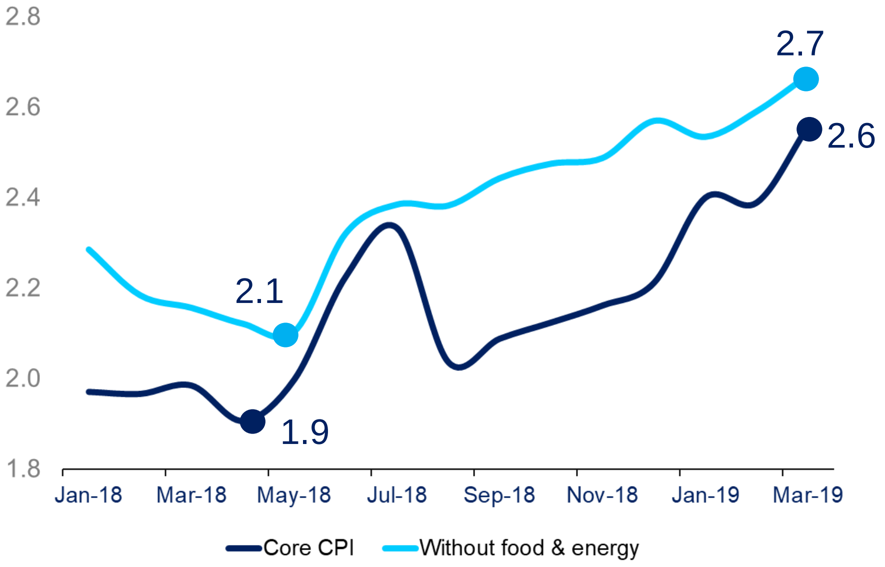
- The policy rate has been at 2.75% for just over a year
- There have been no major changes in the last four press releases by the central bank. In April it mentions that:
  - Inflation remains at the centre of the target range
  - Inflationary expectations reduced to 2.3%
  - Non-primary activity indicators continue to show dynamism, but the output gap is still negative
  - While volatility in financial markets has decreased, the uncertainty surrounding global growth remains, although this risk is no longer associated with trade tensions

However, the context has changed over the last year…

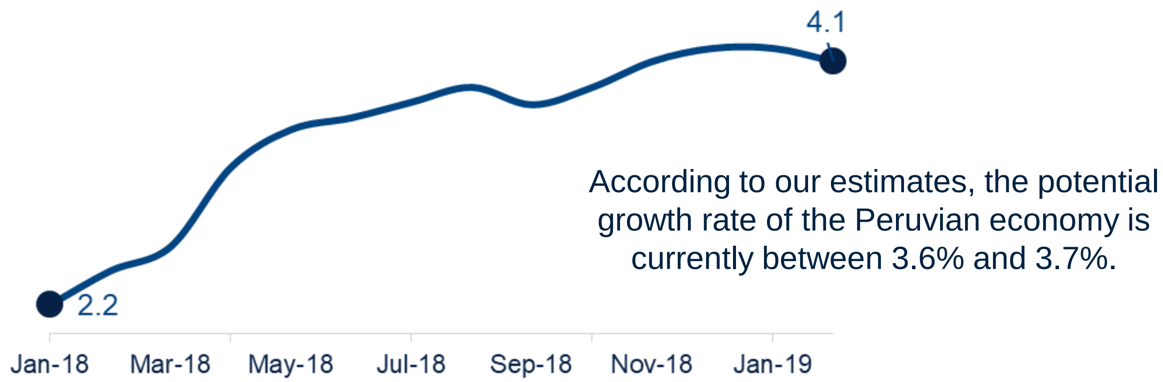
Total inflation
(YoY change, %, of CPI)



Measures of inflationary trend
(YoY change, %)



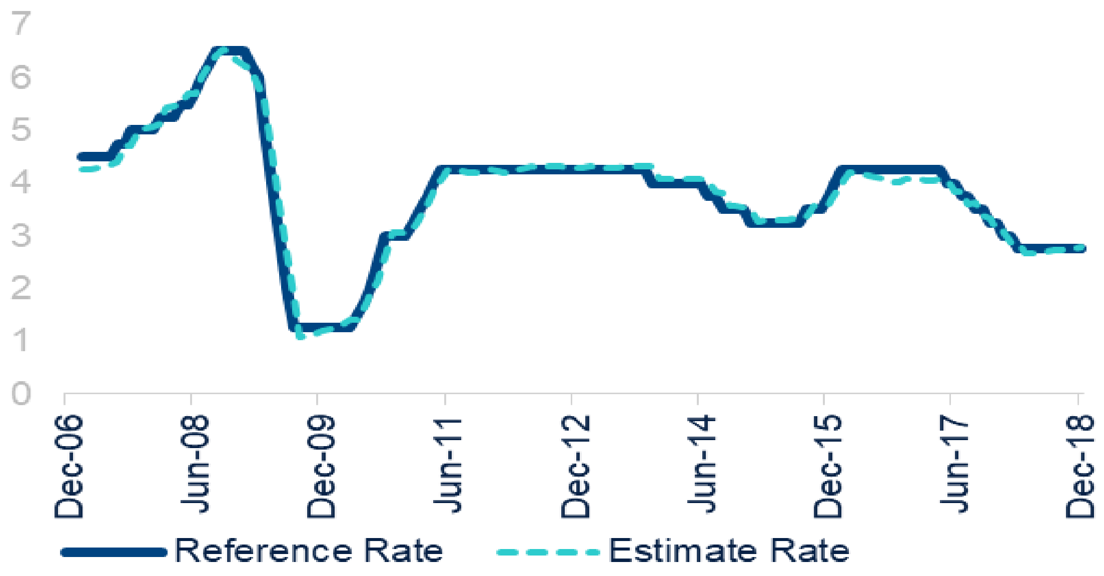
Non-primary GDP
(accumulated over the last twelve months, YoY change, %)



Source: BCRP and BBVA Research

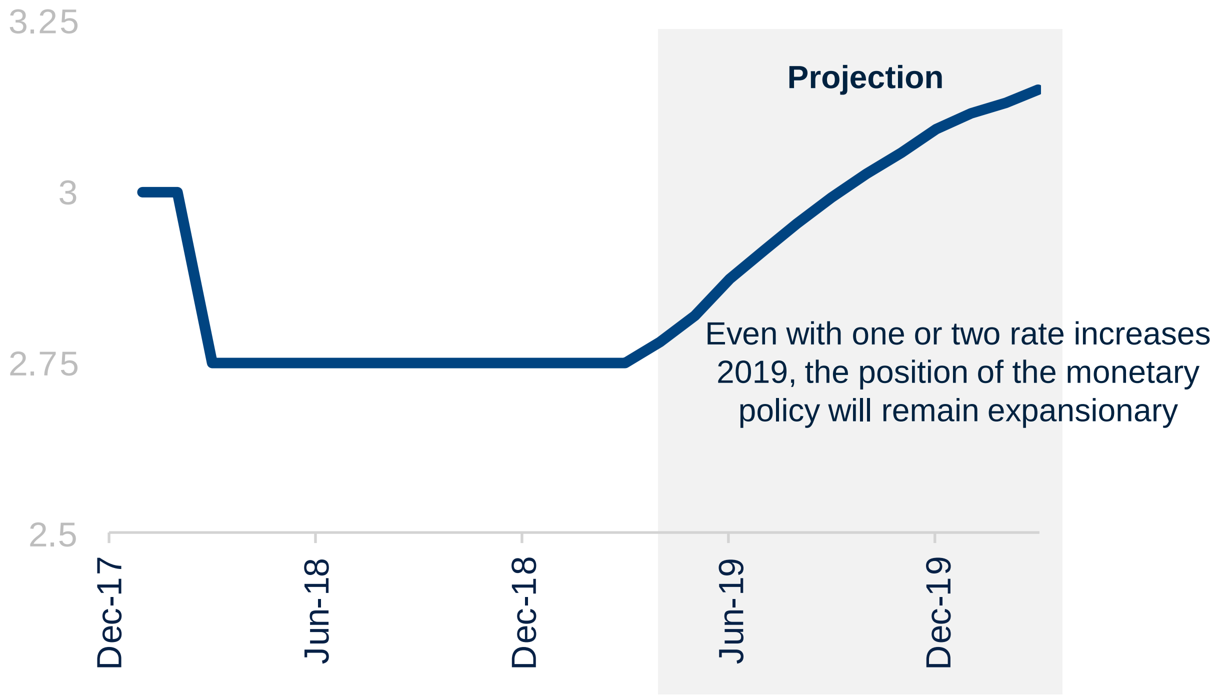
Estimations of the BCRP's reaction function continue to point to a rise in interest rates between the ends of Q2 and Q3.

Reference rate
(%)



Estimate based on (i) the difference between inflation expectation and inflation target and (ii) the non-primary GDP gap.
Source: BCRP and BBVA Research

Reference rates: projected
(according to the estimated reaction function, in %)



BBVA Research baseline projection scenario

Consistent with an initial rate increase between the ends of Q2 and Q3 (+25bp, at 3.0%), closing the 2020 financial year at 3.50%. What about risk? Concerns about global growth and the lack-lustre local activity at the beginning of the year could delay the first rise. Meanwhile, a longer monetary pause increases the risk of the need to later increase the rate more quickly.

06

Summary of macroeconomic projections

Macroeconomic Forecast

	2014	2015	2016	2017	2018	2019 (f)	2020 (f)
GDP (var.%)	**2.4**	**3.3**	**4.0**	**2.5**	**4.0**	**3.9**	**3.7**
Domestic demand (excl. inv., var.%)	**2.5**	**2.2**	**1.0**	**1.6**	**3.9**	**3.9**	**3.9**
Private expenditure (var.%)	**2.3**	**1.9**	**1.2**	**2.0**	**4.0**	**4.3**	**3.7**
Private consumption (var.%)	3.9	4.0	3.3	2.5	3.8	3.6	3.6
Private investment (var.%)	-2.2	-4.2	-5.4	0.2	4.4	6.5	4.0
Public expenditure (var.%)	**3.6**	**3.6**	**0.1**	**-0.3**	**3.8**	**2.0**	**5.2**
Public consumption (var.%)	6.0	9.8	0.3	0.5	2.0	2.9	3.2
Public investment (var.%)	-1.1	-9.5	-0.2	-2.3	8.4	-0.2	10.3
Exchange rate (vs. USD, fdp)	**2.96**	**3.39**	**3.40**	**3.25**	**3.37**	**3.28**	**3.34**
Inflation (% a/a, fdp)	**3.2**	**4.4**	**3.2**	**1.4**	**2.2**	**2.2**	**2.5**
Interest rates (%, fdp)	**3.50**	**3.75**	**4.25**	**3.25**	**2.75**	**3.25**	**3.50**
Fiscal Result (% GDP)	**-0.3**	**-2.0**	**-2.5**	**-3.1**	**-2.5**	**-2.2**	**-2.2**
Current account (% of GDP)	**-4.4**	**-4.8**	**-2.7**	**-1.2**	**-1.5**	**-1.9**	**-2.0**
Exports (thousands of millions of USD)	39.5	34.4	37.1	45.3	48.9	49.3	50.2
Imports (thousands of millions of USD)	41.0	37.3	35.1	38.7	41.9	42.9	44.0

Forecast closing date: 4 April 2019.
Source: BCRP and BBVA Research Peru