Overview

The Peruvian economy grew 3.0% YoY in Q4 2016, representing a slowdown in comparison to Q3 2016 (4.5% YoY). This slowdown was driven by decreased government consumption as well as a decline in investment. For 2016 as a whole, Peru grew at 3.9%, the highest growth rate among all members of the Pacific Alliance Bloc.

Growth in Peru is expected to accelerate in 2017. This is due to higher expected prices of commodities, better terms of trade, and an overall improvement in the global economy.

During the last quarter of 2016, a fiscal consolidation strategy began that prioritizes public expenditure in capital investment for 2017, while decreasing current expenditure. It is expected that the fiscal deficit will continue to fall in 2017 due to the continued effects of the fiscal consolidation plan.

Peru’s YoY inflation rate in January was 3.1%, just above the inflation target of 3.0%. The Central Bank expects the inflation rate for 2017 to be below the inflation target of 3.0%. Given the current situation, the Central Bank decided in its last meeting to maintain interest rates at 4.25%.
1. GDP, Economic activity

The Peruvian economy grew at 3.0% YoY in Q4 2016, representing a slowdown in comparison to the Q3 2016 and the same period in 2015 (4.8% YoY) (Figure 1), this slowdown was driven by decreased government consumption as well as a decrease in investment. Despite the slowdown in the fourth quarter, Peru had an annual growth rate of 3.9% in 2016, the highest among members of the Pacific Alliance Bloc\(^1\). This represents an uptick from the previous two years (3.3% in 2015 and 2.4% in 2014).

GDP by Sector

The expansion of economic activity during Q4 2016 is explained by the favorable evolution of most of the sectors, however almost all of them had a slowdown compared to the previous quarter (Figure 2). Copper production was the principal driving force behind growth in Q4 2016, even though it saw a decrease in dynamism compared to Q3 2016. This expansion was principally due to increased production in “las Bambas.”\(^2\) Construction suffered a contraction that is consistent with the decreased dynamism seen in investment and government consumption during Q4 2016.

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\(^1\) The Pacific Alliance is an initiative of regional integration comprised by Chile, Colombia, Mexico and Peru.

\(^2\) Las Bambas is a cooper mine holds one of the largest cooper reserves in the world. Currently it is under concession to the Chinese company MMG.
Consumption

On the domestic demand side, household consumption expanded by 3.1% YoY in Q4 of 2016 (Figure 3) but showed mixed results during 2016 as a whole. This Q4 growth rate represented a deceleration when compared to both the previous quarter (4.1% YoY) and the same period in 2015 (3.6% YoY). The unemployment rate increased during 2016 and reached 6.3% in Q4 2016, an increase from 5.7% in Q4 2015. Despite the increase in unemployment, there was an increase in household income of 5.1% in 2016 (cumulative variation), which could help to explain the growth that household consumption had both in Q4 and throughout 2016 (3.5%). Government consumption decreased 3.1% YoY in the last quarter of 2016, the sharpest fall in government consumption since 2007. The fiscal consolidation policy that came into force during the last quarter of 2016 was the principal reason for this result and resulted in a fall in the purchase of goods and services by the government (-8.6%).

Investment, Exports and Imports

Gross Fixed Capital Formation (GFCF) declined 6.1% YoY in Q4 2016 (Figure 4) and a total of 4.2% in 2016. GFCF has been affected by weak private investment that contracted by 6.1% in both, Q4 of 2016 and the entire year. This contraction was the result of the completion of two large projects in the mining sector: at Las Bambas and Cerro Verde and delays in other non-mining projects, such as the International airport of Chinchero, the Metro line in Lima, and an oil pipeline in southern Peru.

Exports increased by 12.3% YoY in Q4 2016, due to an increase in mineral exports (15.0%), oil (50.6%) and agricultural products (24.7%), principally coffee. Terms of trade improved by 6% YoY in Q4 2016 as a result of

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3 Government consumption is defined as current expenditures of the government, including the purchase of goods and services and salary payments.
4 China and the United States are the main export partners, and during the last quarter of 2016, exports directed to these two countries comprised 26.1% and 17.8%, respectively, of total Peruvian exports.
increases in commodities prices. Imports increased by 2.3% YoY in Q4 2016 due to an increase of commodities (6.6%) and consumption goods (1.3%) that offset the decrease in capital goods and construction materials (-1.6%).

**Outlook**

The Peruvian economy is expected to accelerate in 2017 due to an expected increase in commodity prices, better terms of trade, an overall improvement in the global economy.

The fiscal consolidation strategy, where the government will prioritize capital investment while reducing current expenditure, will lead to healthy public finances and help economic growth indirectly by allowing Peruvians to access cheaper credit spurring the economic activity in the medium term.

There are some risks that could affect the rate of growth and potentially harm the Peruvian economy. The continued drought that is affecting several provinces in Peru could further affect the agricultural sector, although the monetary authority thinks this effect is transitory in nature and that it will not cause a significant impact on overall growth in 2017. The corruption scandal currently affecting the construction of the new metro line in Lima⁵ (one of the largest private investments in Peru) has already caused delays in construction and led to a significant decrease in private investment. While unlikely, this scandal could lead to increased political turmoil that could affect the overall economy, much like what happened in Brazil. Although the company declared that all payments of bribes ceased in 2014 and there is no evidence implicating the current government, the current president was the minister of finance in the previous president’s (Toledo) administration (the company claims they paid him over 20 million dollars). If this scandal continues to percolate, it could have a significant impact on the demand side, mainly via investment and business confidence.

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⁵ Odebrecht Case, the Brazilian company in charge of building the metro line, revealed that they paid over 29 million dollars to important public authorities between 2005-2014 with the goal of winning investment projects. This is the same company that was a catalyst for much of the political turmoil in Brazil that took place during 2016 as a result of various corruption scandals.
2. Fiscal Policy

The fiscal deficit began to fall in October 2016 as a result of the fiscal measures implemented through its fiscal consolidation plan in the last quarter of 2016. The fiscal deficit in Q4 2016 was 2.6% of GDP (Figure 5).

In October 2016, the new administration\(^6\) and Congress approved a Supreme Decree\(^7\) that prioritized public expenditure in capital investment for 2017, while reducing current expenditure. Total government expenditures (including public investment) for 2017 are expected to increase by 4.7% in nominal terms, a lower rate of increase than that of 2016 (12.3%).

A gradual fiscal consolidation has begun under the new administration that seeks to ensure healthy debt dynamics. The plan seeks a gradual reduction of the fiscal deficit over the coming years until it reaches 1% of GDP by 2021. This fiscal consolidation plan will allow the public debt to drop under the 30% of GDP ratio, a ratio that is below that of other economies with similar credit ratings (BBB+, A3). Peru’s government hopes that these plans allow it to increase its credit rating, thereby allowing the country access to cheaper credit.

Fiscal revenues deteriorated in 2016 (from 15.1% to 14.0% of GDP). This was the result of weak domestic demand that particularly affected the general sales tax (from 8.4% to 8.0% of GDP) and an increase in refunds\(^8\) of taxes related to exports (from 1.9% to 2.5% of GDP). The government expects income tax receipts to increase in 2017 due to an increase in the tax rate of large corporations from 28% to 29.5%.

The fiscal deficit is expected to improve in 2017 due to the fiscal consolidation plan the new government began implementing in the fourth quarter of 2016 and the increase in tax rates mentioned above.

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\(^6\) Pedro Pablo Kuczynski, Peru’s President since July 28, 2016.

\(^7\) Supreme Decree 291-2016-EF Macro Fiscal Policy.

\(^8\) Peru has four types of tax refunds: (1) export tax refunds – exporters don’t pay any tax to export their product and if they acquire products to elaborate their final product, the government will refund the taxes they paid for the general sales tax (IGV). This refund accounts for the 70% of the total. (2) Early repayment of the IGV – this applies to investors in sectors such as mining and oil that develop large investment projects. Generally they don’t begin to produce immediately, but they acquire the machinery to build their plants, and as a result they pay the IGV that is subsequently refunded. (3) Drawback – a customs return that applies to exporters that import products in order to produce their final product to export. (4) Income tax refund – if people pay more income tax that they should, they received the surplus in return.
3. Monetary Policy and Financial Markets

The YoY inflation rate in January 2017 was 3.1% and slightly above the inflation target of 3.0% (Figure 6). This rate was driven by moderate growth in the prices of food and fuel. Inflation expectations are still within the Central Bank’s target range and are demonstrating a tendency to decrease.

The monetary authority, in its most recent meeting in January, decided to maintain the interest rate at 4.25% for the twelfth consecutive month.

Despite the positive indications coming from the Peruvian economy, the Central Bank highlighted that while the world economy is showing signs of recuperation, there are certain uncertainties regarding policy changes in several countries that could affect the Peruvian economy. The Central Bank also highlighted the risk that climate change could affect prices of food, one of the main drivers of inflation. Currently, 17 of the 26 regions in Peru are highly affected by severe droughts, and although the Central Bank expects this to be temporary, it is still a risk. Nevertheless, the inflation expectation for 2017 is 2.9%.

Interest rates are forecast to remain unchanged throughout 2017. However, there are certain variables that could affect this trend. First, if the Federal Reserve of the United States decides to increase interest rates in the United States, the Central Bank of Peru could decide to increase interest rates as well in order to make investment more attractive. It is also possible that the exact opposite occurs and the Central Bank decides it must invigorate the weak internal demand that existed in 2016 and may decide to cut rates.

The Peruvian Peso had not had a clear tendency during 2016 (Figure 7). Although it was affected by the US elections and depreciated somewhat towards the end of the year, in January 2017 it saw a modest appreciation of 3% YoY due to a more favorable economic environment.

It is expected that the Peruvian currency will experience a modest depreciation during 2017 due to the high likelihood that the Federal Reserve of the United States increases interest rates.
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