

Peru Macro Update

MAIN EVENTS — INFRASTRUCTURE

The Cabinet has approved a S/ 23.5bn (US\$7bn) 3-year spending plan for post-Niño reconstruction. The details will be available possibly by early September. Approximately 75% (US\$5.4bn) of this is earmarked for infrastructure projects, including roads, homes and schools. Most of the spending will take place along the Northern Coast.

Although the bulk of spending will be in 2018-2019, construction of homes will begin in 2017.

The largest of the 8 infrastructure projects for the Panamerican Games to be held in Lima in 2019 will be tendered between September and December 2017. The process is under the control of the British government through a bilateral agreement. Total investment is S/ 1.7bn (US\$500mn).

The first project to be tendered, the Olympic Village, is scheduled for September 8th. Seven finalists are competing, including locals Cosapi and ICCGSA.

The information provided by the government so far could mean an increase in public sector investment between 15% and 20% in calendar year 2018, compared to our prior forecast of 10%.

The government announced that it had signed a new amendment to the PPP contract to expand the Lima airport, which would allow work to begin in 4Q18. The expansion is a US\$1.5bn project over 5 years. Financing must still be secured.

MAIN EVENTS — METAL PRICES

All major export metals have put in strong, above-expectations, performances this past month, led by copper, which surpassed US\$3.00 and zinc, US\$1.40. Both metals together represent 35% of total exports (all metals are 60% of exports).

As a result, the trade surplus is now trending at over US\$5bn, the highest since 2012, and over double our initial estimates for the year. In 2Q17, the current account deficit fell to 1.8% of GDP, the lowest level since 2011.

More importantly, there is a strong correlation between terms of trade and private investment (consequently, also GDP). This correlation is not playing out quite yet, but should in the near future. Mining exploration and capital goods imports have both begun rising again.

GROWTH

The GDP rose 3.6%, YoY, in June. This came after 3.4% growth in May, and signals that the economy has rebounded out of the El Niño slump (February to April). However, fishmeal production accounted for much of headline growth. This is temporary, and future GDP growth will be more in line with domestic demand, which continues growing to date at only 2%.

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There are, however, signs that a turning point has been reached in domestic demand. Key indicators, including cement sales, electricity, retail sales, value-added tax revenue, and government investment, have all begun turning up since June.

INFLATION AND MONETARY POLICY

Twelve-month inflation to July rose mildly to 2.8%, within the Central Bank (CB) target range. The CB has expressed some concern over the belated impact of El Niño on certain food prices, which is expected to continue in August. However, this will be an only temporary interruption of inflation's downward decline. The CB continues to be on-message to lower its reference rate another 25 to 50bps this year.

FX

The last time Peru's external accounts were as strong as now, in 2011-2012, the sol was appreciating. The only thing holding the sol back from appreciating now is strong ongoing Central Bank intervention. The pressure in favor of a stronger sol has risen strongly in recent weeks, and the risk is that at some point the CB will stop putting a floor in the FX market and allow the sol to appreciate. When and how much is uncertain, however. Currently, our FX forecast of 3.25 for year-end 2017, and 3.20 for 2018 are under revision to the downside.

FISCAL ACCOUNTS

The expected deficit is 2.8% of GDP largely because government spending, although improving, continues to be weak. Aggressive government spending plans going forward are likely to outpace improving revenue linked to higher metal prices, driving the deficit up. The government needs to ensure that this does not jeopardize the legal deficit target for 2018 of 3.5% of GDP.

POLITICS

A widespread teachers' strike that has closed most public schools for as long as two months is beginning to weaken after the government used a combination of carrot and stick to entice teachers back to classes. Nonetheless, the strike has been yet another cause for acrimony between the Executive and Congress.

On a more positive note, Luis Galarreta (opposition, Fuerza Popular) was elected to preside over Congress. In his new role, Galarreta has toned down his criticism of the PPK government significantly.

Lava Jato (Car Wash) continues making noise. Recent information suggests that Keiko Fujimori may also have received campaign funds from Odebrecht.

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