Peru: Revised Multiannual Macroeconomic Framework 2017-2019

Executive Summary

The Revised Multiannual Macroeconomic Framework (Revised MMF) presents the government's official projections, and was approved by the Council of Ministers on August 26th, 2016, with prior opinion of the Fiscal Council. Projections of the Revised MMF are used for the elaboration of the public budget for fiscal year 2017.

The Peruvian economy is currently accelerating. Nevertheless this acceleration phase is still not broad-based:: is primarily driven by a temporary positive shock of the mining sector but in a context of declining private investment for the third year in a row and without creating new formal jobs. In this scenario, potential growth is estimated around 3.7%, with a negative contribution (-0.5%) of total factor productivity (TFP).

In the medium term, in a scenario without structural reforms, a zero contribution of TFP is expected. In this context, this administration proposes a plan of structural reforms oriented towards capital accumulation (physical and human) and productivity gains.

On the fiscal side, from 2017 onwards, a process of gradual fiscal consolidation will take place. The fiscal deficit convergence is designed to support the recovery of a still weak private domestic demand and give adequate fiscal space to implement the structural reforms mentioned above, aligned with a strong commitment with fiscal sustainability and to the legal ceiling for public debt of 30.0% of GDP.

Global economic outlook

The global economy will continue to grow at a slow pace but it faces different sources of uncertainty. Therefore, a 3.0% GDP growth is estimated, similar to the rate determined in the April MMF but with a slight change on the growth drivers. On one hand, an increase in the Chinese annual GDP growth due to short-term expansionary policies and on the other hand, a slower growth rate in advanced economies, especially United States and the Eurozone in a scenario of high uncertainty (due to the Brexit fallout), a sluggish domestic demand and the lack of structural reforms in the medium term.

In this scenario, an increase in global liquidity is expected as a result of the expansionary monetary policies of advanced economies (United States, Eurozone, United Kingdom and Japan) that will improve financial conditions for governments and private companies. However, periods of volatility with risk premiums not aligned with their fundamental values are not ruled out.

Meanwhile, growth in Latin America will continue to shrink in 2016 (-0.8%) at a similar pace than the one expected in the April MMF (-0.7%), although the medium-term outlook is relatively better due to the greater global liquidity and the lower political noise in Brazil to implement the required reforms to end its recession.

Regarding commodities, the outlook of commodity prices have improved slightly compared to the April MMF in a context of greater demand of China (short term), higher global liquidity and slower pace in the strengthening of the dollar. For 2017, the forecast for copper, gold and crude oil prices are ¢US$/lb. 215 (2016: ¢US$/lb. 215), US$/oz.tr. 1,280 (2016: US$/oz.tr. 1,250) and US$/bar. 45 (2016: US$/bar. 40), respectively.

Domestic economic outlook

The Peruvian economy will grow 4.0% in 2016, on the upper limit of the estimated range of the April MMF, boosted by a higher mining production (20.1%) and a moderate expansionary fiscal policy through an increase in public investment (9.1%). However, this economic recovery is still driven by the primary sector. Private investment, a key variable to secure a high and sustained growth, is declining for the third year in a row, while formal employment is stuck at the same level. This does not allow the economy to reactivate this virtuous cycle of investment-employment-consumption that would ensure a sustainable economic recovery.

Nonetheless, the outlook for private investment is promising. For 2017, a recovery of 5.0% is expected due to a rebound effect of the confidence of private companies and the recent Government's announcements to improve business environment conditions.

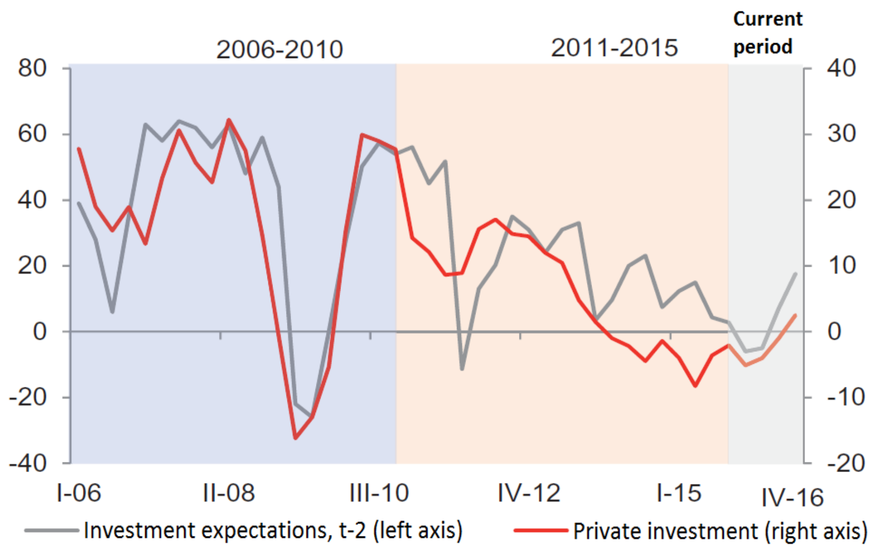
An important point to take into account is that the rebound of the confidence of private companies experienced during this year is far from the reality of other countries in the region. Thus, according to our own estimates, 85% of the recent rebound of business confidence is explained by domestic factors, which in turn can boost investment not related to mining or oil, which represents 78% of total private investment in Peru.

In a context of lower commodity prices (which discourages investment on mining and oil projects) it is vital to sustain this recovery in business confidence and focus investment on non-tradable sectors of the economy. Regarding this, a survey carried out in June by APOYO Consultoria showed that 95% and 62% of surveyed businessmen stated that unlocking big investment projects and administrative streamlining, respectively, should be prioritized measures by this Government to boost private confidence.

Taking this into account, the economy will grow 4.8% in 2017 lead by private investment (5.0%) in a context of improving domestic confidence, unlocking infrastructure projects, an increase in global liquidity, low financing costs, and diminishing depreciation pressures. Moreover, the greater consolidation of fiscal policies established on the April MMF will contribute to boost economic growth and guarantee a real recovery of the private domestic demand. Due to this, we expect that public expenditure will grow 3.6% in 2017, instead of the 1% growth projected in the April MMF Finally, exports of non-financial goods and services will grow 8.0% (traditional exports: 11.2%: non-traditional: 3.0%) due to a higher mining and fishing production, and the recovery of external demand from Latin America.

In the medium term, in a scenario with no additional reforms and an international context of sluggish economic activity, the growth of potential output of the Peruvian economy would converge to 4.0%, well below the 2006-2010 average (6.4%) and with no contribution from total factor productivity.

Graph N° 1. Private investment and investment expectations (real % change yoy, points)[1/]



1/ Percentage of private companies expecting to boost its investment, minus companies expecting to reduce it in the next six months.
Sources: APOYO Consultoria, Central Reserve Bank of Peru, Ministry of Economy and Finance of Peru.

Graph N° 2. Peru: GDP by the expenditure side (real % change, yoy)

	% Structure of 2015 GDP	2015	1S-16	2S-16	2016	2017	2018	2019
1. Domestic Demand	102,5	2,9	1,1	2,9	2,0	3,8	4,4	4,4
a. Private consumption	63,5	3,4	3,5	3,5	3,5	3,7	4,2	4,5
b. Public consumption	13,0	9,5	6,8	4,7	5,7	3,0	3,5	2,7
c. Private investment	19,3	-4,5	-4,6	0,9	-1,7	5,0	5,5	5,9
d. Public investment	5,0	-7,5	16,5	5,3	9,1	5,0	6,2	5,4
2. Exports[2/]	21,1	3,5	8,3	5,6	6,9	8,0	4,2	3,0
3. Imports[2/]	23,6	2,1	-3,7	1,7	-0,9	4,2	4,8	4,3
4. GDP	**100,0**	**3,3**	**4,1**	**3,9**	**4,0**	**4,8**	**4,3**	**4,1**
Memo: Public expenditure	18,1	4,2	9,0	4,9	6,6	3,6	4,3	3,5

2/ Non-financial goods and services
Sources: APOYO Consultoria, Central Reserve Bank of Peru, Ministry of Economy and Finance of Peru.

Public Finances

Fiscal position for 2016 is slightly expansive, with an overall fiscal deficit of 3.0% of GDP, above the estimated 2.5% of GDP in the April MMF and the deficit registered in 2015 (2.1% of GDP). This higher deficit is explained mainly by tax returns (to exporters and to big investment projects not planned by SUNAT[1] for the April MMF) and a higher public investment at a sub-national level.

It is important to note that, through July, the yoy fiscal deficit reached to 3.3% of GDP, which will converge to 3.0% of GDP at the end of this year due to a faster growth of private domestic demand that will boost fiscal income and a lower growth of public expenditure. This lower pace of expenditure responds to specific causes not presented this year.

It is also of importance to point that this reduction of fiscal deficit between August and December will not compromise the expansion of public investment (2016: 9.1%). Thus, unlike past periods of changes in administrations, there will not be a severe contraction of public investment as a result of the learning curve of new governors. This is thanks to the dynamism showed by sub-national investments and the continuing development of large infrastructure projects such as the Lima Metro Line 2 and the modernization of the Talara refinery.

From 2017 on, we start a more gradual process of fiscal consolidation than the one planned in the previous MMF. In this way, the Act that establishes the trajectory of the structural fiscal outcome for the Non-Financial Public Sector (NFPS) for the years 2017 to 2021[2] sets the path for a structural fiscal deficit for 2016 from 2.4% of the estimated potential GDP to 1.0% of GDP in 2021. This will allow us to avoid a sudden withdrawal of the fiscal stimulus in 2017 that would negatively affect the recovery of the GDP in a context of a still weak dynamism of domestic demand and multiple external risks. For 2017, the guideline states a structural fiscal balance of -2.2% of the potential GDP, which is consistent with an observed fiscal deficit of 2.5% of GDP.

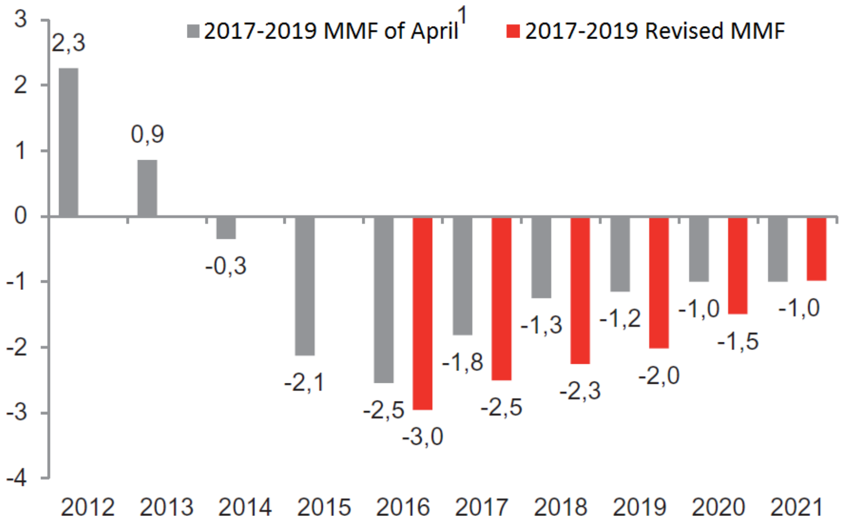
This new fiscal trajectory will allow us to put in place our plan of structural reforms that will position our potential growth at around 5.0%. This, in turn, will create more formal jobs; will expand the tax base and fiscal revenues required to continue the fiscal consolidation in the medium term without compromising public expenditure or economic growth.

At the same time, the new fiscal trajectory is consistent with a more responsible fiscal management because the public debt does not go over the legal limit of 30.0% of GDP (27.0% of GDP for 2021) and maintains at levels well below the median of countries with a A3/BBB+ credit rating given by Moody's (52.7% of GDP for 2019).

[1] SUNAT is the public body in charge of domestic taxes and activities related to exports and imports.

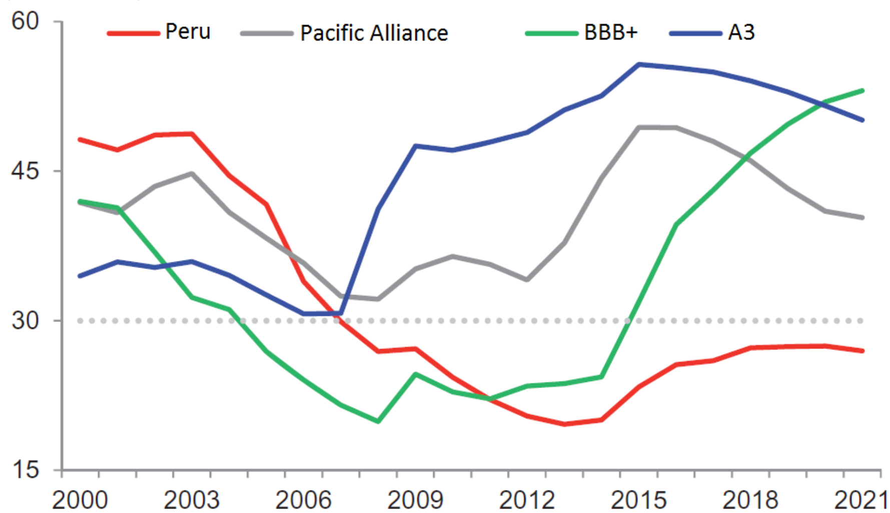
[2] Act N˚ 30499, approved on August 25, 2016.

Graph N° 3. Overall Fiscal Balance of the Non-Financial Public Sector (% of GDP)



1/ For 2020 and 2021, the observed and structural economic outcome are -1.0% of GDP.
Sources: Central Reserve Bank of Peru, Ministry of Economy and Finance of Peru, Moody's, Forecasts by MEF.

Graph N° 4. Evolution of public debt for Peru, The Pacific Alliance and BBB+/A3 countries [2, 3] (% of GDP)



2/ BBB+ and A3 shows the median of countries with a credit rating of BBB+ and A3 according to Moody's.
3/ It refers to The Pacific Alliance excluding Peru.
Sources: Central Reserve Bank of Peru, Ministry of Economy and Finance of Peru, Moody's, Forecasts by MEF.

Macroeconomic Balances

The stabilization of commodity prices, a higher mining activity and the expected recovery of Latin America will gradually reduce the current account deficit from -3.6% of GDP in 2016 to -2.7% of GDP in 2019.

After three consecutive years of high current account deficit around 4.4% of GDP, its reduction is a signal of less external vulnerability for the Peruvian economy. This added to the greater global liquidity from expansionary monetary policies put in place in advanced economies and the improving outlook of our economy will allow us to finance the current account deficit with long-term capital flows.

It is worth noting that this reduction of the deficit in the current account allows a more gradual consolidation of the fiscal policy proposed, one that guarantees the real recovery of private demand, without risking the macroeconomic equilibrium.

Reforms' strategy for 2016-2021

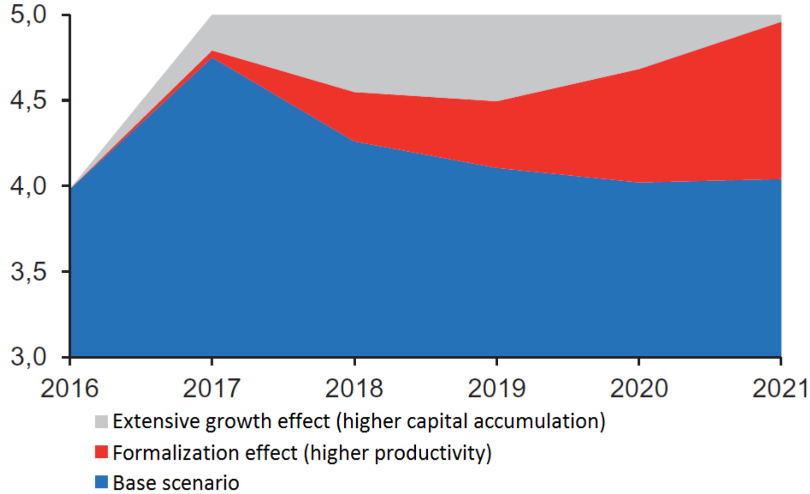
The current administration will perform a plan of structural reforms to achieve a potential growth of 5.0% in the medium term through higher capital accumulation (unlocking infrastructure projects and streamlining the investment systems) and productivity gains (greater formalization). Thus, the strategy to expand formalization consists of three key points:

- Reduction of barriers to formalization, i.e. reduction of costs to do business and improved benefits to formalization (tax simplification, improvements in the protection of the workers, pension reform, credit access, among others).
- Improved access and quality of public services (education, healthcare, productive and social infrastructure and safety).
- Pro-formalization regulatory policies through the institutionalization of a body in charge of taking measures to generate more incentives to formalization, like the National Council for Competitiveness and Formalization.

The implementation of the mentioned structural reforms will allow that the per capita GDP PPP reaches $16,897 by 2021, a higher level than the one reached by Colombia in 2015 ($13,450) and near the level of Mexico ($17,150). In the same way, the poverty rate might decrease 7 percentage points between 2015 and 2021, so 2.1 millions of Peruvians will get out of poverty. It should be noted that according to the latest annual survey by APOYO Consultoria, 95% of surveyed people consider that Peru will be better in 2021 regarding State management and business climate, while 80% and 84% of people think our country will be better by 2021 regarding formalization and poverty reduction, respectively.

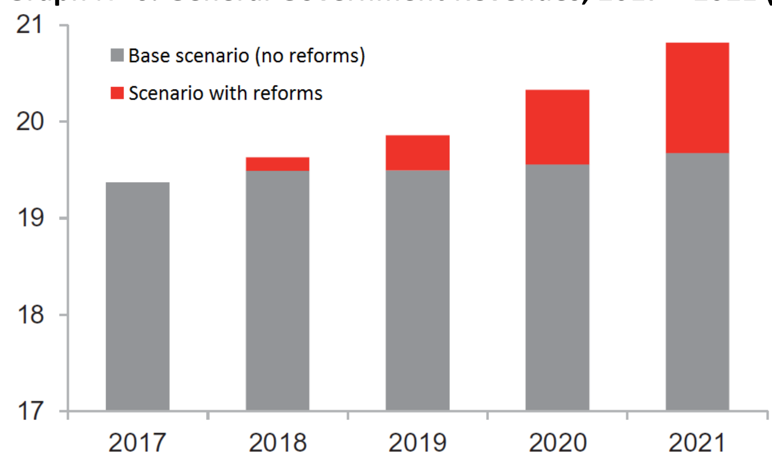
Finally, these structural reforms will allow us to widen the permanent base of tax revenues by approximately 2.0% of GDP compared to the current level (18.9% of GDP) and to reach our planned fiscal trajectory, maintaining the growth of public expenditure.

Graph N° 5. Effect of reforms on economic growth (% var. yoy)



Source: Forecast by MEF.

Graph N° 6. General Government Revenues, 2017 – 2021 (% of GDP)



Source: Forecast by MEF.

Main Macroeconomic Indicators

	2015	2017 - 2019 April MMF				2017 - 2019 Revised MMF			
		2016	2017	2018	2019	2016	2017	2018	2019
GDP TRADING PARTNERS									
World (Real percent change)	3,1	3,0	3,2	3,4	3,5	3,0	3,0	3,2	3,4
United States (Real percent change)	2,4	2,5	2,5	2,4	2,3	1,7	2,0	2,1	2,2
Euro Zone (Real percent change)	1,6	1,5	1,5	1,5	1,4	1,4	1,3	1,2	1,2
China (Real percent change)	6,9	6,0	5,5	5,0	5,0	6,5	5,7	5,2	5,0
Trading partners (Real percent change)	1,8	1,4	1,8	2,0	2,1	1,1	1,6	2,0	2,1
COMMODITY PRICES									
Gold (US$/oz.tr.)	1 160	1 200	1 250	1 280	1 280	1 250	1 280	1 300	1 300
Copper (cUS$/lb.)	250	215	210	220	225	215	215	220	225
Lead (cUS$/lb.)	81	75	80	85	88	80	85	90	92
Zinc (cUS$/lb.)	88	80	85	90	90	80	85	90	90
Crude oil (US$/bar.)	49	35	40	45	50	40	45	48	48
PRICES									
Inflation (Cumulative percent change)[1]	4,4	3,5	3,0	2,9	2,0	3,1	2,8	2,6	2,0
Average Exchange rate (Soles per US dollar)[2]	3,19	3,57	3,68	3,73	3,75	3,37	3,48	3,55	3,55
Terms of Trade Percent change)	-6,3	-0,2	-2,7	0,5	0,3	-1,9	-0,3	0,0	0,2
Exports nominal price index (Percent change)	-14,9	-6,1	0,3	2,8	1,8	-5,2	2,4	1,4	0,9
Imports nominal price index (Percent change)	-9,2	-5,9	3,0	2,4	1,5	-3,3	2,7	1,4	0,7
GROSS DOMESTIC PRODUCT									
Gross Domestic Product (billions of Soles)	612	657	703	752	800	659	708	757	806
Gross Domestic Product (Real percent change)	3,3	3,8	4,6	4,0	4,0	4,0	4,8	4,3	4,1
Domestic Demand (Real percent change)	2,9	2,5	3,5	4,0	4,0	2,0	3,8	4,4	4,4
Private Consumption (Real percent change)	3,4	3,2	3,6	4,0	4,2	3,5	3,7	4,2	4,5
Public Consumption (Real percent change)	9,5	4,3	-1,2	0,0	3,0	5,7	3,0	3,5	2,7
Private Investment (Real percent change)	-4,5	-1,2	4,5	4,7	4,9	-1,7	5,0	5,5	5,9
Public Investment (Real percent change)	-7,5	7,4	6,7	4,6	4,1	9,1	5,0	6,2	5,4
Private investment (Percent of GDP)	19,3	18,4	18,6	18,7	18,9	18,5	18,6	18,9	19,2
Public Investment (Percent of GDP)	5,0	5,2	5,4	5,4	5,4	5,3	5,3	5,4	5,5

EXTERNAL SECTOR									
Current Account (Percent of GDP**)**	-4,8	-3,7	-3,5	-3,2	-2,9	-3,6	-3,1	-3,0	-2,7
Trade Balance (millions of US dollars)	-3 150	-1 508	-1 151	-921	-819	-834	776	717	613
Exports (millions of US dollars)	34 236	34 056	36 230	38 493	40 304	34 736	38 680	40 715	42 248
Imports (millions of US dollars)	-37 385	-35 564	-37 382	-39 413	-41 124	-35 569	-37 905	-39 998	-41 635
NON-FINANCIAL PUBLIC SECTOR									
General Government Revenues (Percent of GDP)	20,1	19,5	19,6	19,7	19,7	18,9	19,4	19,5	19,5
Interest Payments (Percent of GDP)	1,1	1,2	1,3	1,3	1,3	1,1	1,3	1,3	1,3
Primary Balance **(**Percent of GDP**)**	-1,1	-1,3	-0,5	0,1	0,1	-1,8	-1,2	-0,9	-0,7
Overall Fiscal Balance **(**Percent of GDP**)**	-2,1	-2,5	-1,8	-1,3	-1,2	-3,0	-2,5	-2,3	-2,0
Structural Fiscal Balance (Percent of GDP)[3]	-1,6	-2,0	-1,5	-1,0	-1,0	-2,4	-2,2	-2,0	-1,8
PUBLIC DEBT									
Foreign (Percent of GDP)	11,1	12,6	12,8	12,1	11,8	11,5	11,5	11,4	10,9
Domestic (Percent of GDP)	12,2	12,6	13,1	13,7	13,6	14,1	14,4	15,8	16,5
Total (Percent of GDP)	23,3	25,2	25,9	25,9	25,4	25,6	26,0	27,3	27,4

1/ 2016-2018, taken from the Monthly Survey of Macroeconomic Expectations: July 2016 – Central Reserve Bank, published on August 5 2016. For 2019 is consistent with the middle of the target range of the Central Reserve Bank.

2/ 2016-2018, consistent with the exchange rate at the end of the period of the Monthly Survey of Macroeconomic Expectations: July 2016 – Central Reserve Bank, published on August 5 2016. For 2019, it is assumed the same value of 2018.

3 The calculations consider the official methodology for structural fiscal accounts approved by Ministerial Resolution No. 024-2016-EF/15.

Sources: IMF, Central Reserve Bank, Ministry of Economy and Finance, Forecasts by MEF.