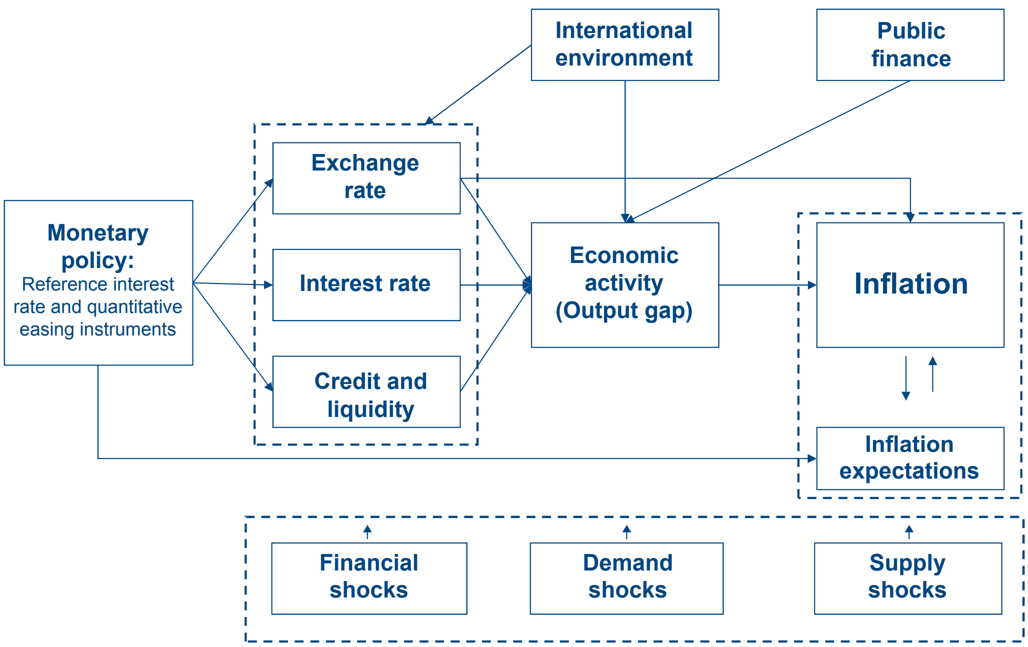
# INFLATION REPORT:

## Recent trends
## and macroeconomic forecasts 2014-2016

*July 2014*




Central Reserve Bank of Peru
441-445 Antonio Miro Quesada. Lima 1
Telephone: 613-2000 - Fax: 613-2525
Mail: webmaster@bcrp.gob.pe

INFLATION REPORT
Recent trends and macroeconomic forecasts

CENTRAL RESERVE BANK OF PERU

# INFLATION REPORT:

## Recent trends
## and macroeconomic forecasts 2014-2015

### *July 2014*

## CONTENT



**RECUADROS**



This ***Inflation Report*** was drawn up using data on the balance of payments and gross domestic product at Q1-2014 and data on the non-financial public sector, monetary accounts, inflation, financial markets, and the exchange rate at June 2014.

# Foreword

- According to the Constitution of Peru, the Central Reserve Bank of Peru (BCRP) is a public autonomous entity whose role is to preserve monetary stability.

- In order to consolidate this goal, the Bank's monetary policy is based on an inflation targeting scheme, with an inflation target of 2.0 percent, plus or minus one percentage point (between 1.0 and 3.0 percent). The Central Bank's inflation target is aimed at anchoring inflation expectations at a similar level to the inflation rate observed in developed economies and reflects the BCRP's permanent commitment with monetary stability.

- Each month, and according to a previously announced schedule, the Board of BCRP sets a reference rate for the interbank loan market. Since this interest rate, which is the monetary operational target, affects the rate of inflation through several channels in different timeframes, it is established on the basis of macroeconomic forecasts and simulations.

- The Central Bank anticipates inflationary or deflationary pressures, taking also into account that inflation may be influenced by factors beyond the control of monetary policy actions, such as domestic supply shocks or fluctuations in the prices of imported products, which may result in transitory deviations of inflation from the target. In its evaluations BCRP considers the annual increase in the consumer price index registered each month and not only end-of-year figures.

- Additionally, the Central Bank implements preventive measures to preserve financial stability and monetary policy transmission mechanisms. Through interventions in the foreign exchange market, the Central Bank reduces excessive volatility in the exchange rate and accumulates international reserves, thus developing strengths to face negative events in an economy with still high levels of financial dollarization. The Central Bank also uses other monetary policy tools that affect the volume of liquidity and credit in a more direct manner, such as reserve requirements in domestic currency and in foreign currency, to avoid excessive credit or credit constraints.

- This Inflation Report includes macroeconomic forecasts that support the monetary policy decisions of BCRP as well as the risk factors that can modify these forecasts.

# Summary


i. The forecast on **global growth** in 2014 has been revised downwards, from 3.4 to 3.1 percent, due mainly to lower growth in the United States, Latin America, and Eastern Europe. A recovery of the global economy with a growth rate of 3.8 percent is still forecast for 2015 and 2016.

ii. The **GDP growth rate** projected for 2014 has been revised down from 5.5 percent (Inflation Report of April 2014) to 4.4 percent, due mainly to the downward revision of primary activity from 3.1 to 0.9 percent. A lower output is estimated both in the fishing sector, given that higher sea temperatures are expected towards the end of the year, and in the sub-sector of metal mining due to lower metal contents. In addition to this, lower terms of trade and the lower dynamism of public investment have brought about lower-than-expected growth rates in the first months of the year. Economic activity is expected to recover in the 2015-2016 horizon as the transitory supply factors that affected production in primary sectors reverse, supported by global economic recovery and by a more moderate downward trend in terms of trade as well.

iii. The projected balance in the **current account of the balance of payments** for this year has been revised from an estimated deficit of 4.3 percent of GDP (Inflation Report of April) to a deficit of 4.8 percent mainly as a result of lower exports of gold. The onset or a faster pace of production of export products, especially in the sectors of mining and hydrocarbons, would contribute to reduce the current account deficit, particularly in 2016 (3.5 percent).

iv. The **economic balance of the non-financial public sector** projected for 2014 has been revised down to 0.2 percent of GDP, with non-financial expenditure showing an increased participation of current expenditure (up from 14.3 to 15.0 percent of GDP). Deficits of 0.3 percent and 0.5 percent of GDP are estimated for 2015 and 2016, respectively. These projections are consistent with a fiscal impulse of 0.6 and 0.1 percent of GDP in 2014 and 2015, respectively.

v. The Board of the Central Bank decided to lower the monetary policy **benchmark interest rate** from 4.0 to 3.75 percent. This level of the policy rate is compatible with a projection of inflation's convergence to the target range in 2014 and to 2.0 percent in 2015. The decision takes into account that: (i) inflation expectations remain anchored within the target range; (ii) the pace of GDP growth continues to show lower rates than the potential output, which is expected to be temporary; (iii) recent indicators show mixed signals of global economic recovery, and (iv)

the supply shocks that increased inflation are slowing down. The BCRP also continued lowering the rate of **required reserves** in soles to provide greater sources of funding for credit in domestic currency. The most recent cut of the rate of required reserves in soles, from 12.0 to 11.5 percent, became effective in July.

vi. The **rate of inflation** in the first half of 2014 was transitorily above the target range, influenced by the presence of adverse climate conditions that generated higher prices, especially in some food products, as well as by the rise in electricity rates. Inflation would continue to decline in the coming months and would reach a rate of 2 percent in the 2015-2016 forecast horizon. This scenario considers that there would be no demand inflationary pressures in the forecast horizon and inflation expectations would remain anchored within the target range.

vii. The main risks that could divert the rate of inflation from the baseline forecast scenario are similar to those considered in the Inflation Report of April; that is, risks associated with lower global growth, a possible greater slowdown in domestic demand than the one considered in the baseline scenario, and the occurrence of both domestic supply shocks and external supply shocks. In addition, a new risk considered in this report is greater volatility in international financial markets.

a. **Volatility in international financial markets**

The baseline forecast scenario includes a progressive withdrawal of monetary stimulus by the U.S. Federal Reserve. However, there is the risk that high volatility could be generated in international interest rates, as occurred in mid-2013, which could lead to movements in capital flows and depreciations in the currencies of emerging countries, increasing at the same time the risk perceived in these economies.

b. **Lower global growth**

The baseline scenario considers a recovery in the global economy in 2014-2016. However, there is the risk that this economic recovery could take longer or be slower and that terms of trade could deteriorate further, which would reflect in a lower external impulse and would generate reductions in the output gap and a lower inflation rate than the one considered in the baseline scenario.

c. **Demand shocks**

Economic activity could recover more slowly if investment projects are postponed, which would imply a more negative output gap and, therefore, lower inflation in the forecast horizon.

d. **Supply shocks**

The risk of a stronger El Niño event than the one considered in the baseline scenario remains, even though this risk has declined.

viii. The effects of the risk factors that push inflation downwards are estimated to be greater than the effects of the risk factors that push it upwards. Therefore, **the balance of these risks is on the downside** for the inflation forecast in the forecast horizon.

## FORECAST SUMMARY

| | 2013 | 2014 [1/] | | 2015 [1/] | | 2016 [1/] |
|---|---|---|---|---|---|---|
| | | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **Real % change** | | | | | | |
| 1. GDP | 5.8 | 5.5 | 4.4 | 6.7 | 6.0 | 6.3 |
| 2. Domestic demand | 7.0 | 5.4 | 4.7 | 6.1 | 5.7 | 5.2 |
| a. Private consumption | 5.3 | 5.1 | 4.9 | 5.4 | 5.0 | 5.2 |
| b. Public consumption | 6.7 | 6.1 | 8.5 | 4.7 | 6.0 | 6.0 |
| c. Private fixed investment | 6.4 | 6.0 | 3.2 | 6.6 | 6.2 | 6.5 |
| d. Public investment | 12.1 | 15.5 | 6.7 | 12.5 | 8.9 | 11.0 |
| 3. Exports (goods and services) | -0.9 | 3.3 | -0.4 | 8.2 | 5.5 | 10.8 |
| 4. Imports (goods and services) | 3.6 | 3.3 | 1.0 | 5.6 | 4.7 | 5.9 |
| 5. Economic growth in main trading partners | 2.6 | 3.0 | 2.5 | 3.2 | 3.1 | 3.2 |
| **Memo**: | | | | | | |
| Output gap 2/ (%) | 0.0 | -0.5 ; +0.5 | -1.0 ; +0.0 | -0.5 ; +0.5 | -0.5 ; +0.5 | -0.5 ; +0.5 |
| **% change** | | | | | | |
| 6. Inflation | 2.9 | 2.5 - 3.0 | 2.5 - 3.0 | 1.5 - 2.5 | 1.5 - 2.5 | 1.5 - 2.5 |
| 7. Average price of crude oil | 4.0 | -0.4 | 2.9 | -8.3 | -7.3 | -6.1 |
| 8. Nominal exchange rate 3/ | 8.5 | 2.3 | 1.2 | 0.9 | 1.7 | 1.2 |
| 9. Real multilateral exchange rate 3/ | 0.7 | -0.3 | -1.1 | -0.2 | 0.0 | 1.5 |
| 10. Terms of trade | -4.7 | -2.8 | -4.7 | 0.3 | 0.4 | -0.4 |
| a. Export price index | -5.5 | -3.2 | -4.6 | -0.1 | -0.2 | 0.2 |
| b. Import price index | -0.8 | -0.4 | 0.1 | -0.5 | -0.6 | 0.6 |
| **Nominal % change** | | | | | | |
| 11. Currency in circulation | 9.3 | 10.6 | 10.6 | 14.5 | 12.0 | 12.0 |
| 12. Credit to the private sector 4/ | 13.2 | 14.2 | 14.0 | 14.7 | 14.0 | 14.0 |
| **% GDP** | | | | | | |
| 13. Gross fixed investment rate | 26.6 | 27.4 | 26.8 | 27.7 | 26.9 | 27.3 |
| 14. Current account of the balance of payments | -4.5 | -4.3 | -4.8 | -3.9 | -4.8 | -3.5 |
| 15. Trade balance | 0.0 | -0.4 | -1.2 | 0.1 | -1.0 | -0.1 |
| 16. Gross external financing to the private sector 5/ | 9.5 | 7.4 | 7.6 | 6.3 | 6.4 | 5.5 |
| 17. Current revenue of the general government | 22.1 | 22.5 | 22.6 | 22.0 | 22.1 | 22.1 |
| 18. Non-financial expenditure of the general government | 20.5 | 21.0 | 21.3 | 21.3 | 21.3 | 21.3 |
| 19. Overall balance of the non-financial public sector | 0.9 | 0.3 | 0.2 | -0.3 | -0.3 | -0.5 |
| 20. Total public debt balance | 19.6 | 19.0 | 19.2 | 18.3 | 18.6 | 18.0 |

IR: Inflation Report.
1/ Forecast.
2/ Differential between GDP and potential GDP (%).
3/ Survey on exchange rate expectations.
4/ Includes loans made by banks' branches abroad.
5/ Includes Foreign Direct Investment, portfolio investment, and private sector's long-term disbursement.

# I. International Scenario

## Output

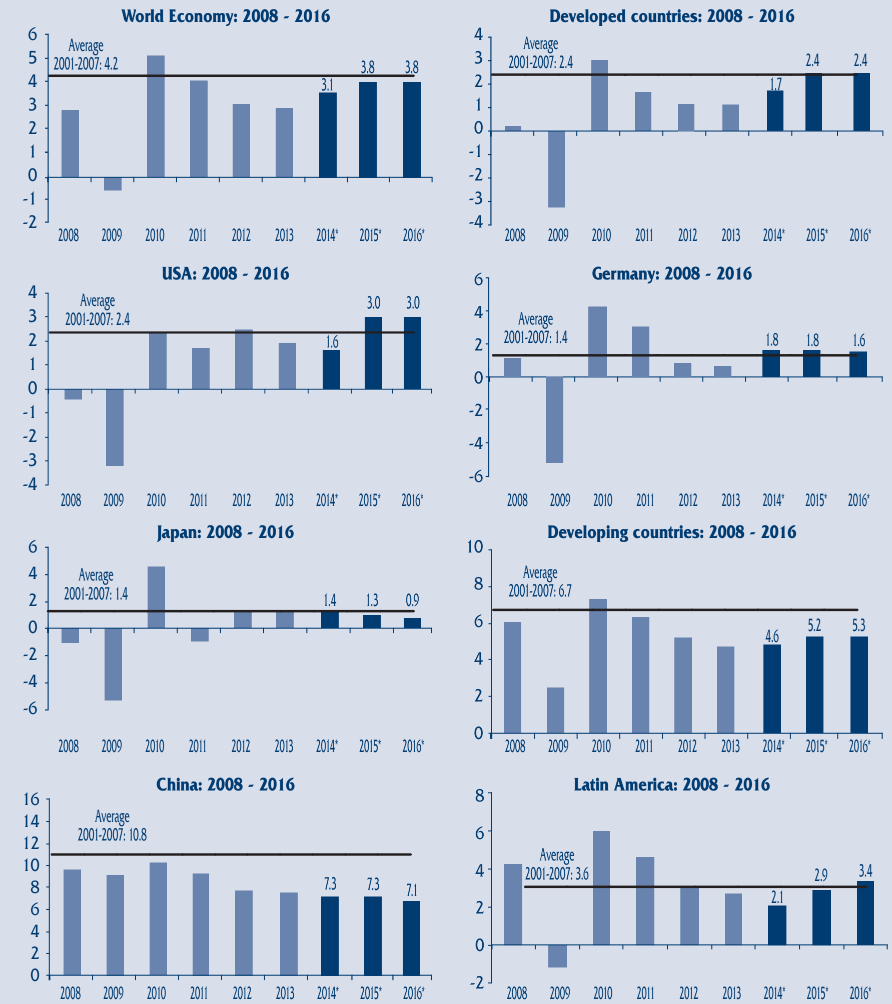
1. The forecast on global growth in 2014 has been revised downwards, from 3.4 to 3.1 percent, due mainly to lower growth in the United States, Latin America, and Eastern Europe. A recovery of the global economy with a growth rate of 3.8 percent is still forecast for 2015 and 2016.

**Table 1**
**WORLD GDP GROWTH**
(Annual % change)

| | PPP % | Executed | | 2014 | | 2015 | | 2016 |
|---|---|---|---|---|---|---|---|---|
| | 2012 | 2012 | 2013 | IR Apr. | IR Jul. | IR Apr. | IR Jul. | IR Jul. |
| **Advanced economies** | **50.4** | **1.4** | **1.3** | **2.2** | **1.7** | **2.4** | **2.4** | **2.4** |
| *Of which:* | | | | | | | | |
| 1. United States | 19.5 | 2.8 | 1.9 | 2.8 | 1.6 | 3.0 | 3.0 | 3.0 |
| 2. Eurozone | 13.5 | -0.7 | -0.4 | 1.1 | 1.1 | 1.5 | 1.5 | 1.6 |
| Germany | 3.8 | 0.7 | 0.4 | 1.6 | 1.8 | 1.8 | 1.8 | 1.6 |
| France | 2.7 | 0.0 | 0.2 | 1.0 | 0.7 | 1.4 | 1.4 | 1.5 |
| Italy | 2.2 | -2.4 | -1.9 | 0.6 | 0.3 | 0.9 | 1.1 | 1.1 |
| Spain | 1.7 | -1.6 | -1.2 | 0.8 | 1.1 | 1.2 | 1.5 | 1.5 |
| 3. Japan | 5.5 | 1.4 | 1.6 | 1.2 | 1.4 | 1.1 | 1.3 | 0.9 |
| 4. United Kingdom | 2.8 | 0.3 | 1.7 | 2.7 | 3.0 | 2.6 | 2.7 | 2.4 |
| **Emerging market and developing economies** | **49.6** | **5.1** | **4.7** | **4.7** | **4.6** | **5.3** | **5.2** | **5.3** |
| *Of which:* | | | | | | | | |
| 1. Developing Asia | 25.1 | 6.7 | 6.7 | 6.5 | 6.5 | 6.8 | 6.8 | 6.7 |
| China | 14.7 | 7.7 | 7.7 | 7.3 | 7.3 | 7.4 | 7.3 | 7.1 |
| India | 5.7 | 4.7 | 5.0 | 5.4 | 5.4 | 6.3 | 6.3 | 6.5 |
| 2. Commonwealth of Independent States | 4.2 | 3.4 | 2.1 | 2.1 | 1.3 | 2.8 | 2.5 | 3.4 |
| Russia | 3.0 | 3.4 | 1.3 | 1.5 | 0.5 | 2.2 | 1.8 | 2.2 |
| 3. Latin America and the Caribbean | 8.7 | 3.0 | 2.6 | 2.8 | 2.1 | 3.3 | 2.9 | 3.4 |
| Brazil | 2.8 | 1.0 | 2.3 | 2.0 | 1.5 | 2.4 | 2.0 | 2.7 |
| **World Economy** | **100.0** | **3.2** | **3.0** | **3.4** | **3.1** | **3.8** | **3.8** | **3.8** |
| **Memo:** | | | | | | | | |
| Peru's trading partners 1/ | 64.1 | 2.8 | 2.6 | 3.0 | 2.5 | 3.2 | 3.1 | 3.2 |
| BRICs 2/ | 26.3 | 5.8 | 5.8 | 5.6 | 5.5 | 6.0 | 5.9 | 5.9 |

1/ Basket of Peru's 20 main trading partners.
2/ Brazil, Russia, India, and China.
Source: Bloomberg, IMF, and Consensus Forecast.

**Graph 1**
**GDP GROWTH**
(Annual % change)




* Forecast.
Source: BCRP.

2. A slowdown was observed in the economy of the **United States** at the beginning of 2014 mainly due to the adverse effects of climate conditions. The output shrank 2.9 percent in annualized terms in Q1 –the lowest rate in 5 years– with a slowdown in consumption, a significant reduction in inventories, and a decline in residential investment. Recent indicators show a recovery of activity and the labor market, and some improvement in the housing market.

In the first quarter consumption increased 1.0 percent, a lower rate than the one recorded over the past four years, with climatic factors that affected especially the consumption of non-durable goods accounting for this lower rate. The recent improvement observed in some indicators, such as retail sales and consumer confidence, is explained by the reversal of this factor. While the improvement in indicators has been lower than expected, the fundamentals supporting consumption –such as employment and wealth– follow the positive trend noted in our previous reports.

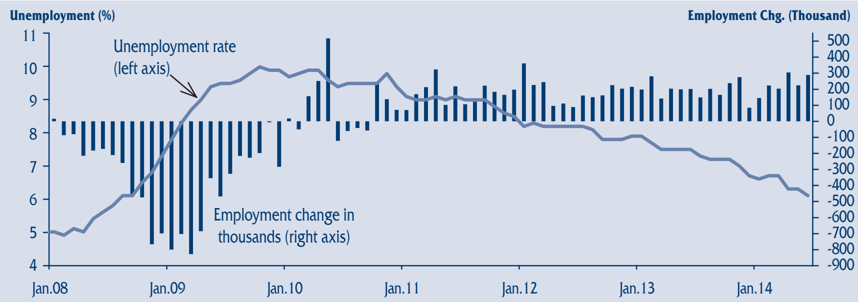
For example, in the labor market, the monthly rate of jobs created so far this year is 231 thousand –higher than the average rate of 194 thousand recorded in 2013–, while the unemployment rate has fallen to 6.1 percent in June, which would imply that the jobs lost during the crisis (8 million) would already have been widely recovered. Moreover, the positive impact of families' wealth on consumption has been supported by the continuous rise of the stock indices, which reached record highs in July. The impact of a slow but sustained reversal of the deleveraging process is also noteworthy.

**Table 2**
**USA: GDP**
(Seasonally adjusted annualized quarterly rates)

| | 2013 | | | | 2014 | |
|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2* |
| Private consumption | 2.3 | 1.8 | 2.0 | 3.3 | 1.0 | 1.5 |
| Fixed investment | -1.5 | 6.5 | 5.9 | 2.8 | -1.8 | 7.2 |
| Change on inventories ** | 0.9 | 0.4 | 1.7 | 0.0 | -1.7 | 1.1 |
| Net exports ** | -0.3 | -0.1 | 0.1 | 1.0 | -1.5 | -0.3 |
| **GDP** | **1.1** | **2.5** | **4.1** | **2.6** | **-2.9** | **3.0** |
| **Memo** | | | | | | |
| Unemployment rate *** | 7.5 | 7.5 | 7.2 | 6.7 | 6.7 | 6.1 |

* Forecast.
** Contribution to growth.
*** End-of-period.
Source: BEA, BLS, and JPM.

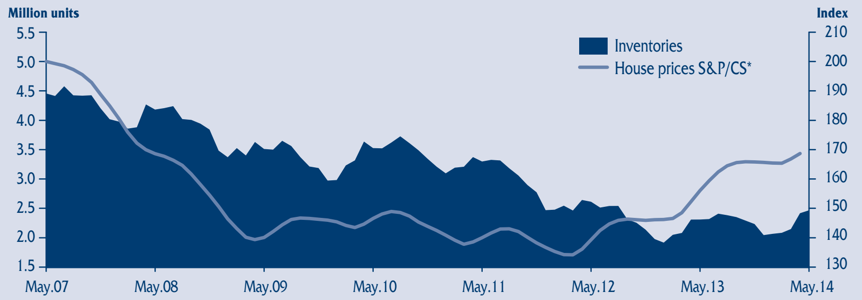
**Graph 2**
**USA: EMPLOYMENT AND UNEMPLOYMENT RATE**




Source: Bloomberg.

Investment in Q1 was also affected by the climate as well as by the significant decrease of inventories (which had reached a record level in Q4-2013). Moreover, residential investment continued to slow down, affected also by the increase in mortgage interest rates in 2013, higher house prices, and tighter credit conditions. However, the demand for homes has recovered and the number of approved mortgages has increased in recent months, supported by some stability in the prices of homes –in line with a slight increase in net inventories– and mortgage rates.

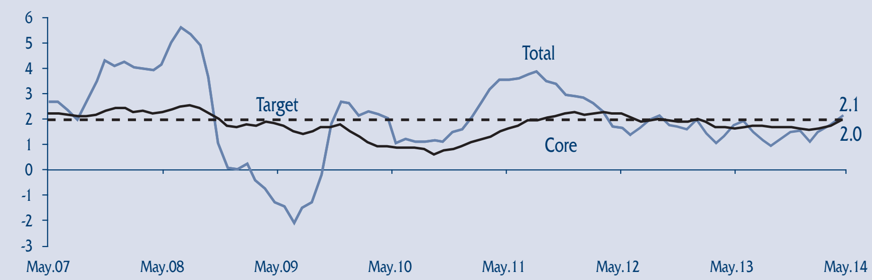
**Graph 3**
**USA: HOUSE PRICES (S&P/CS*) AND INVENTORIES**




*S&P/CS: S&P/Case-Shiller Home Price Index.
Source: Bloomberg.

The rate of annual inflation rate rose from 1.5 percent (in March) to 2.1 percent and core inflation –which excludes fuel and food– increased from 1.7 percent to 2.0 percent, within the Fed's long term target levels. Despite the higher inflationary pressures observed, the Fed believes that these pressures would be temporary and that they would not be a risk factor for price stability.

**Graph 4**
**USA: CPI**
(12 month % change)

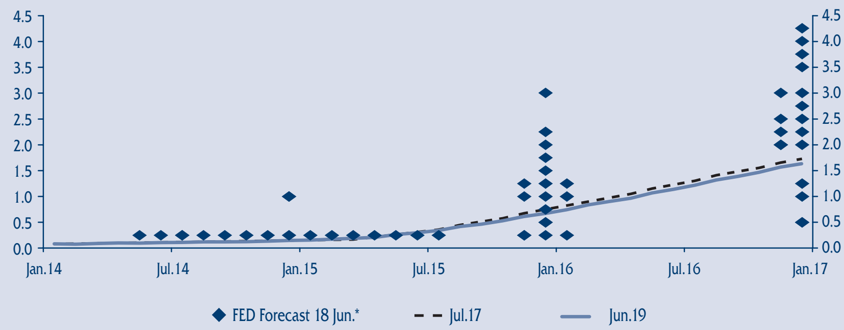



Source: Bloomberg.

3. The Fed continued tapering its monthly bond purchases with the cuts it initiated in January 2014, reducing its bond purchases from US$ 55 billion in March to US$ 35 billion in July. In addition to this, the Fed has to decide when and how much it will raise the policy interest rate first in order not to generate great disturbances in financial markets. The market expects the first rate increase to occur in the second half of 2015.

   Assuming that the withdrawal of Quantitative Easing (QE) will take place as expected, QE would come to an end at the meeting of the Federal Open Market Committee (FOMC) in October. Rate projections at the FOMC's meeting of June showed a slight increase, both for 2015 and for 2016 compared to the rates in March, in line with the improvement observed in the labor market indicators which has generated greater expectations of rate increases.

**Graph 5**
**FUTURE MARKET: FED INTEREST RATE (%)**
(Jan. 2014 - Dec. 2016)

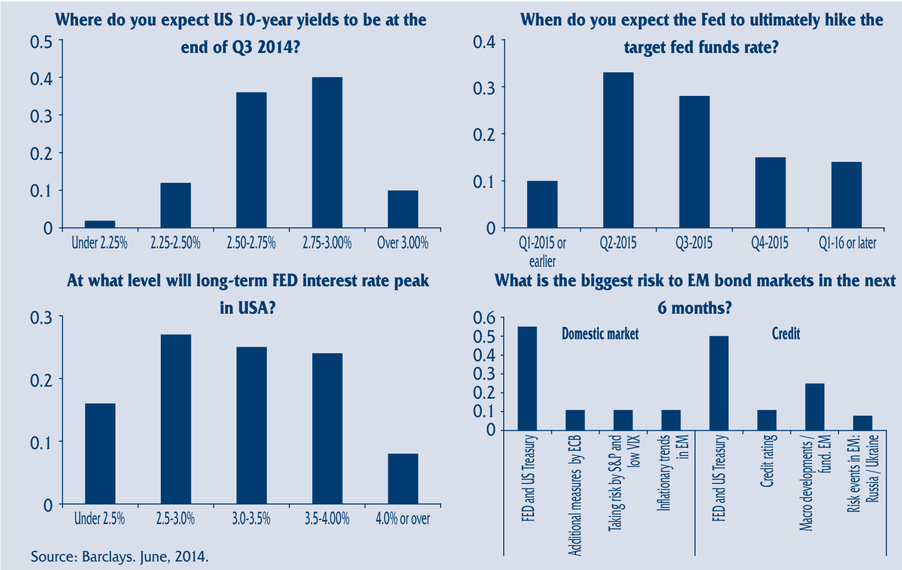



* Each point represents the individual forecast of the Members of the Board of FED at the end of period. Median is 1.125% in 2015 and 2.5% in 2016.
Source: Bloomberg and FED.

Barclays survey shows that one-third of investors expects an increase of rates in the second quarter of 2015, with great uncertainty on the new level that the rates will reach since expectations are equally concentrated in the ranges of 2.5-3.0 percent, 3.0-3.5 percent, and 3.5-4.0 percent. The increase in rates is the dominant factor in bond markets in the emerging market economies.

It is expected that most of the FOMC members will have a neutral position in 2015 due to the rotation of voting members of the Federal Reserve Chairmen, but an increase of rates in the second half of 2015 may be still expected in line with the Fed projections given that the large size of the Fed's balance sheet remains.

**Graph 6**
**BARCLAYS GLOBAL SURVEY**




Source: Barclays. June, 2014.

4. In line with the results obtained in Q1, it is estimated that the U.S. economy will grow 1.6 percent in 2014, 3.0 percent in 2015, and 3.0 percent in 2016. This projection assumes that the effect of the climate in Q1 will have dissipated and that the economy will continue recovering in the next quarters of the year. The risk associated with the possibility that there will be a disorderly adjustment in the financial markets after the Fed increases its interest rate remains.

**Graph 7**
**EUA: DEFICIT AND PUBLIC DEBT**
(% GDP)


Source: FMI, "Fiscal Monitor", April 2014.

5. Indicators in the **Eurozone** continue to reflect a moderate recovery in the region. However, different degrees of recovery are observed at the country level. Spain stands out among the peripheral countries after showing a better-than-expected recovery in Q1. On the other hand, Germany showed a slowdown after having a

favorable outcome in Q1 when, in contrast to what happened in other countries, it was favored by construction due to a more beneficial climate. On the other hand, economic activity in France remained weak.

**Table 3**
**EUROZONE: PURCHASING MANAGER INDICES (PMI) OF JP MORGAN**

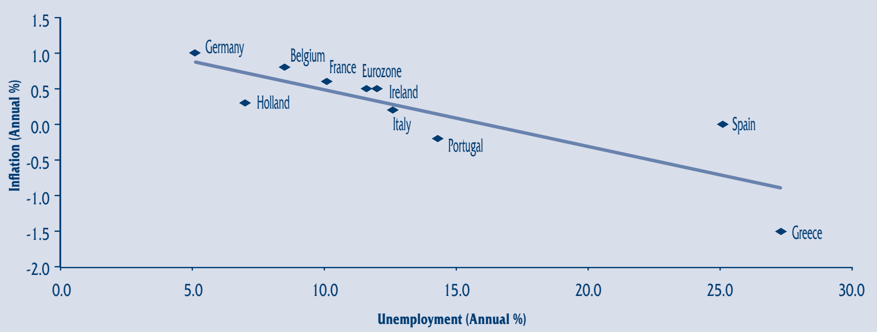
| | Dec.12 | Dec.13 | Jan.14 | Feb.14 | Mar.14 | Apr.14 | May.14 | Jun.14 |
|---|---|---|---|---|---|---|---|---|
| **Composite** | | | | | | | | |
| Eurozone | 47.2 | 52.1 | 52.9 | 53.3 | 53.1 | 54.0 | 53.5 | 52.8 |
| **Services** | | | | | | | | |
| Eurozone | 47.8 | 51.0 | 51.6 | 52.6 | 52.2 | 53.1 | 53.2 | 52.8 |
| Germany | 52.0 | 53.5 | 53.1 | 55.9 | 53.0 | 54.7 | 56.0 | 54.8 |
| France | 45.2 | 47.8 | 48.9 | 47.2 | 51.5 | 50.4 | 49.1 | 48.2 |
| Italy | 45.6 | 47.9 | 49.4 | 52.9 | 49.5 | 51.1 | 51.6 | 53.9 |
| Spain | 44.3 | 54.2 | 54.9 | 53.7 | 54.0 | 56.5 | 55.7 | 54.8 |
| **Manufacturing** | | | | | | | | |
| Eurozone | 46.1 | 52.7 | 54.0 | 53.2 | 53.0 | 53.4 | 52.2 | 51.8 |
| Germany | 46.0 | 54.3 | 56.5 | 54.8 | 53.7 | 54.1 | 52.3 | 52.0 |
| France | 44.6 | 47.0 | 49.3 | 49.7 | 52.1 | 51.2 | 49.6 | 48.2 |
| Italy | 46.7 | 53.3 | 53.1 | 52.3 | 52.4 | 54.0 | 53.2 | 52.6 |
| Spain | 44.6 | 50.8 | 52.2 | 52.5 | 52.8 | 52.7 | 52.9 | 54.6 |

Source: Bloomberg.

As regards spending, in contrast with what happened in Q1 where growth was led by investment, now private consumption would be showing a greater recovery although still at moderate rates. This is reflected in consumers' confidence in the region (which has remained high despite the slight recoil of June), low inflation (0.5 percent annual in June), and the stabilization of unemployment (11.6 percent in May). On the other hand, private investment would be slowing down, as reflected in the decline of the various business confidence indices, the stagnation of the industrial production of durable consumer goods, and the contraction of capital goods.

This evolution has been accompanied by low inflation and still tight credit conditions. In June, the annual inflation rate in the region was 0.5 percent, below 1 percent for nine straight months (a rate in the "danger zone" according to the ECB). In addition, projections indicate that inflation would remain low at least until mid-2015 due to the significant high levels of unemployment which would maintain wages low, particularly in some peripheral economies where wage cuts have occurred.

**Graph 8**
**EUROZONE: HARMONIZED ANNUAL INFLATION (AS OF JUNE) AND UNEMPLOYMENT RATE (AS OF MAY)**




Source: Bloomberg.

In May, bank credit to the private sector fell again after twenty-four consecutive months of decline, although a slower pace of contraction was observed in the last three months. Loans to the non-financial private sector fell 0.9 percent in annual terms, with loans to the non-financial corporate sector falling 2.5 percent while loans to households grew marginally 0.5 percent in annual terms. This contraction of credit to the corporate sector continues to be concentrated in some Eurozone countries (such as Spain, Portugal, and Greece) and in SMEs. Moreover, bank credit has been replaced with the issuance of corporate bonds given its lower cost, but SMEs are not particularly favored by this source of funding since they have less access to this alternative.

In this context, the ECB said at its meeting of June that it would take several actions to reduce the risks of deflation and correct financial fragmentation in credit markets, including the following measures:

(i) Reduce the refinancing interest rate by 10 bps to 0.15 percent, the interest rate for marginal loans by 35 bps to 0.40 percent, and interest rate for deposits by 10 bps to -0.10 percent (a negative rate for the first time) and said that the interest rates will remain low for a long period of time;

(ii) Maintain the fixed-rate full allotment (FRFA) procedure, which was due to expire in June 2015, at least until the end of 2016;

(iii) Inject liquidity for up to € 400 billion through special long-term repo operations (TLTRO) which will expire in September 2018 (4 years approximately), but which will be linked to bank lending to the Eurozone (except mortgage loans and loans to the public sector);

(iv) Extend the existing eligibility of additional assets eligible as collateral until at least September 2018;

(v) Suspend the sterilization of the balance of sovereign bonds held under the old SMP program (Securities Markets Program, currently at €164.5 billion), which involves a liquidity injection for the same amount and increase the balance sheet of the ECB, and

(vi) Prepare a program of simple purchases of securitized assets –asset-backed securities (ABS)– to support the proper operation of monetary transmission mechanisms using the liabilities of the Eurozone non-financial private sector as underlying bonds.

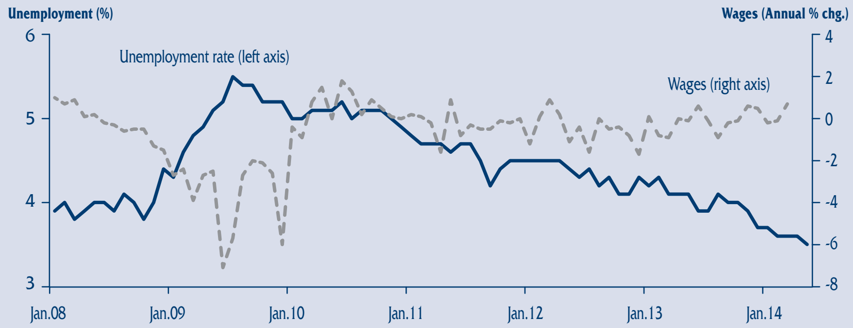
With these measures the ECB expects to anchor inflation expectations and boost bank lending. In this context, the growth forecast for 2014 is still 1.1 percent and 1.5 percent in 2015, and a rate of 1.6 percent is projected for 2016. These rates would reflect the slow recovery foreseen in this region.

6. **Japan's economy** grew 6.7 percent (annualized quarterly rate) in Q1. This growth rate reflected an acceleration in spending on consumption and investment in anticipation of the increase in the sales tax scheduled for April. Private consumption grew 9.2 percent and capital investment grew 34.2 percent. On the other hand, inventories and net exports registered a negative contribution to growth.

The acceleration of consumption and investment in anticipation to the tax hike would lead to a contraction of the output in Q2. In April consumption showed the greatest fall in 20 years, although indicators such as retail sales would be indicating that this contraction has moderated. A rather more favorable scenario is expected in the case of investment, in line with the improvement in business confidence. Additionally, the increase in machinery orders for public works suggests an early implementation of government spending in line with the government's declarations about an earlier implementation of spending in the fiscal year 2014 budget to support the growth of domestic demand.

On the other hand, inflation excluding food has increased from 1.3 percent in February to 3.4 in May, the highest rate in three decades. The Bank of Japan estimates inflation at 1.4 percent excluding the effect of the increase in the sales tax.

**Graph 9**
**JAPAN: UNEMPLOYMENT RATE AND WAGES**




Source: Bloomberg.

Considering these developments, the Japanese economy is estimated to grow 1.4 percent in 2014, 1.3 percent in 2015, and 0.9 percent in 2016. This forecast assumes that the dynamism of investment would continue over the year and that consumption would show a moderate recovery, supported by the improvement in the labor market (the unemployment rate in May was 3.5 percent, the lowest level in 17 years).

The main risk to growth is still the impact that the increase in the sales tax may have on consumption in the next quarters of 2014 and the effectiveness of fiscal stimulus actions and structural reforms enacted by Prime Minister Abe. The market does not expect the Bank of Japan to increase its bond repurchase program in the short term given its optimism regarding the recovery of the economy.

7. In the **emerging economies**, signals about **China** have been positive and have been confirming expectations that activity would be surmounting the strong drop recorded in Q1, when it grew below an annualized rate of 6 percent in seasonally adjusted terms. Thus, the levels of activity, industrial production, and retail sales have shown a recovery, and inflation's rise to an annual rate of above 2.0 percent would also reflect a recovery in demand.

   This dynamism would be explained by the fiscal and monetary measures applied. Early in April the government launched a mini fiscal version of stimulus measures based on urban and railway infrastructure projects, housing construction projects for low-income households, and tax cuts on small businesses, which would be in force until 2016. In addition to these tax measures, the central bank cut the ratio of reserves (by 50 bps) on two occasions (in April and June) to support the banks that support agriculture and small and medium-sized enterprises. Moreover, at the end of June the banking supervisor entity (CBRC) adjusted the calculation of the ratio of loans to deposits –with a limit of 75 percent– which would give banks more room to expand their lending.

**Table 4**
**CHINA'S ECONOMIC INDICATORS**

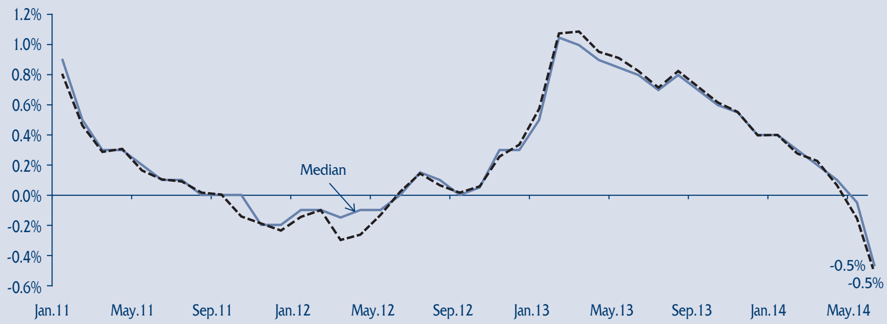
| Indicators | 2013 | | | | 2014 | | | |
|---|---|---|---|---|---|---|---|---|
| | Mar. | Jun. | Sep. | Dec. | Mar. | Apr. | May. | Jun. |
| Manufacturing PMI index (50 neutral level) | 50.9 | 50.1 | 51.1 | 51.0 | 50.3 | 50.4 | 50.8 | 51.0 |
| Service PMI index (50 neutral level) | 55.6 | 53.9 | 55.4 | 54.6 | 54.5 | 54.8 | 55.5 | 55.0 |
| Industrial Production (12 month % change) | 8.9 | 8.9 | 10.2 | 9.7 | 8.8 | 8.7 | 8.8 | 9.2 |
| Investment in fixed assets (Accum. annual % change) | 20.9 | 20.1 | 20.2 | 19.6 | 17.6 | 17.3 | 17.2 | 17.3 |
| Retail sales (12 month % change) | 12.6 | 13.3 | 13.3 | 13.6 | 12.2 | 11.9 | 12.5 | 12.4 |
| Exports (12 month % change) | 10.0 | -3.1 | -0.3 | 4.3 | -6.6 | 0.9 | 7.0 | 7.2 |
| Imports (12 month % change) | 14.1 | -0.8 | 7.5 | 8.3 | -11.3 | 0.8 | -1.6 | 5.5 |
| New loans (Billion yuan) | 1,063 | 863 | 787 | 483 | 1,050 | 775 | 871 | 1,080 |
| New financing (Billion yuan) | 2,550 | 1,038 | 1,411 | 1,232 | 2,070 | 1,550 | 1,405 | 1,970 |
| Consumer Price Index (12 month % change) | 2.1 | 2.7 | 3.1 | 2.5 | 2.4 | 1.8 | 2.5 | 2.3 |
| Producer Price Index (12 month % change) | -1.9 | -2.7 | -1.3 | -1.4 | -2.3 | -2.0 | -1.4 | -1.1 |

Source: Bloomberg.

However, the risks reported in our previous inflation report remain. The signs of the real estate market –which represents 17 percent of GDP– continue to be negative: funding for property developments continued to slow down; new construction of homes and residential home sales continued to fall significantly; sales of commercial properties grew at a lesser rate, and the prices of new homes dropped for the first time in two years (in both May and June). The recent measures adopted by the government (and other actions that would be taken to boost mortgage demand) are expected to contribute to offset the contraction in the real estate market in the second half of the year.

In this sense, the evolution of this sector remains the main risk factor for growth. On the other hand, the risk that global credit will show a sharp contraction has declined substantially since our last inflation report was published. This variable has stabilized (due to other non-bank funding sources like bonds) and thus fears of a contraction of financing through shadow banking (which represents 16 percent of GDP) and the associated financial risks have also declined.

**Graph 10**
**CHINA: NEW HOUSE PRICES IN 70 MAIN CITIES**
**(AVERAGE AND MEDIAN)**
(Monthly % change)




Source: Bloomberg.

In this context of better indicators of activity, but with growing risks in the real estate market, the growth rate projected for 2014 is still estimated at 7.3 percent. The economy would continue to grow at this rate in 2015, slowing down thereafter to 7.1 percent in 2016.

8. In Q1-2014, growth slowed down in most of the **Latin American** countries with inflation targeting, except Colombia, due to the lower impulse of domestic demand, mainly private investment.

**Table 5**
**LATIN AMERICA: GDP GROWTH**
(12 month % change)

| | Brazil | Chile | Colombia | Mexico | Peru |
|---|---|---|---|---|---|
| Q1.13 | 1.9 | 4.9 | 2.9 | 0.6 | 4.6 |
| Q2.13 | 3.5 | 3.8 | 4.6 | 1.6 | 6.3 |
| Q3.13 | 2.4 | 5.0 | 5.8 | 1.4 | 5.3 |
| Q4.13 | 2.2 | 2.7 | 5.3 | 0.7 | 6.9 |
| Q1.14 | 1.9 | 2.6 | 6.4 | 1.8 | 4.8 |

Source: Central banks and statistical institutions.

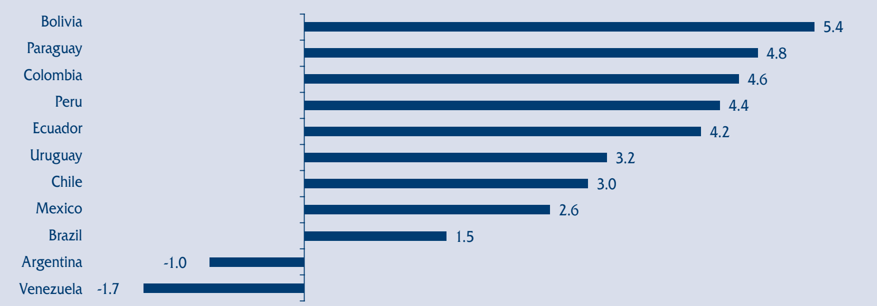
9. Investment declined 5.0 percent in Chile, 2.1 percent in Brazil and 0.8 percent in Mexico compared to the first quarter of 2013 (and for the third consecutive quarter in the cases of Chile and Mexico). In addition, continuing with the trend observed since the beginning of 2013, these three countries continue showing a slowdown in private consumption. On the other hand, growth in Colombia was driven by an increase in investment of 16.9 percent due mainly to higher spending in civil works and in machinery and equipment.

**Table 6**
**LATIN AMERICA: INVESTMENT GROWTH**
(12 month % change)

| | Brazil | Chile | Colombia | Mexico | Peru |
|---|---|---|---|---|---|
| Q1.13 | 2.2 | 8.2 | 0.8 | -1.0 | 9.7 |
| Q2.13 | 7.7 | 10.2 | 1.8 | 0.8 | 13.3 |
| Q3.13 | 6.7 | -1.5 | 10.7 | -3.7 | 6.6 |
| Q4.13 | 4.0 | -12.3 | 7.4 | -3.0 | 2.4 |
| Q1.14 | -2.1 | -5.0 | 16.9 | -0.8 | 2.5 |

Source: Central banks and statistical institutions.

**Graph 11**
**LATIN AMERICA: GDP GROWTH 2014**
(% change)




Source: Latin America Consensus Forecast (June 2014) and BCRP (Peru).

10. With the exception of Mexico, inflation in Latin American countries with inflation targeting schemes has shown an upward trend due both to the pass-through effect of the depreciation of their currencies and to internal and external supply shocks.

**Table 7**
**LATIN AMERICA: INFLATION**
(Last 12 month % change)

| | Brazil | Chile | Colombia | Mexico | Peru |
|---|---|---|---|---|---|
| **Target range 2014** | **2.5-6.5** | **2.0-4.0** | **2.0-4.0** | **2.0-4.0** | **1.0-3.0** |
| Jan.14 | 5.6 | 3.0 | 2.1 | 4.5 | 3.1 |
| Feb.14 | 5.7 | 3.4 | 2.3 | 4.2 | 3.8 |
| Mar.14 | 6.2 | 3.9 | 2.5 | 3.8 | 3.4 |
| Apr.14 | 6.3 | 4.3 | 2.7 | 3.5 | 3.5 |
| May.14 | 6.4 | 4.7 | 2.9 | 3.5 | 3.6 |
| Jun.14 | 6.5 | 4.3 | 2.8 | 3.8 | 3.5 |

Source: Bloomberg.

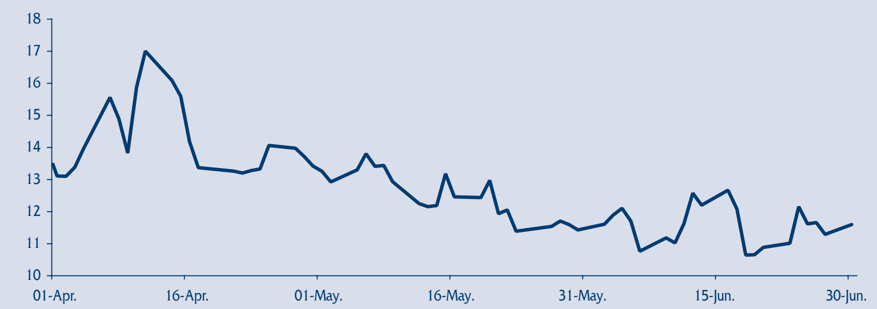
## Financial Markets

11. In Q2-2014 international financial markets –particularly variable-income bond markets– have been favored by prospects of an improvement in the pace of

growth in the United States and China after these countries registered unfavorable economic activity in the first quarter. The markets have also been favored by the Fed signals indicating that the Fed benchmark rates will remain low and by the monetary stimulus measures adopted by the European Central Bank in June, which signal the ECB support to economic recovery in the Eurozone.

In this context, risk aversion –measured by the VIX index– recorded its lowest level in the post-crisis period, although this could be reflecting an excess of confidence of investors. Despite this, some factors generated volatility in financial markets during this period, including the geopolitical tensions between Ukraine and Russia at the beginning of the quarter, which declined after the elections in Ukraine, and the internal conflict in Iraq, which generated uncertainty during the month of June due to the possibility of a cut in oil production.

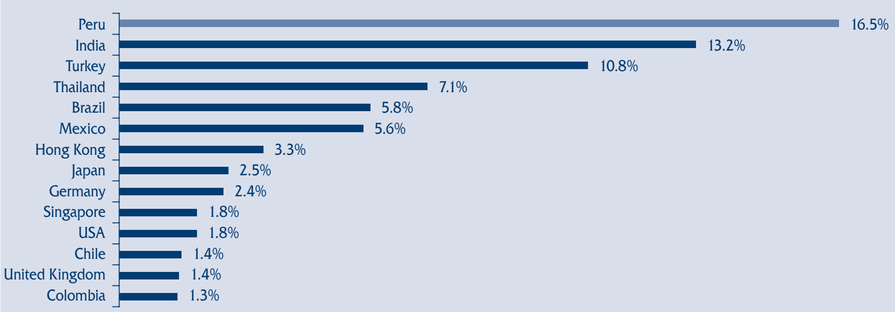
**Graph 12**
**RISK AVERSION COEFFICIENT: VIX (S&P'500)**
(April 2014 - June 2014)




Source: Bloomberg.

12. The **stock yields** were positive in Q2, and the Dow Jones index reached successive all-time highs. In addition, the markets that benefited the most were the emerging market economies.

**Graph 13**
**STOCK MARKET YIELDS**
(April 2014- June 2014)



13. The **public debt markets** in the developed economies evolved showing positive results. In the United States the statements of the Fed Chair Janet Yellen dispelled speculations of a possible increase in the policy interest rate earlier than expected given the better prospects for growth in the U.S. economy. In the **Eurozone**, the events were also positive and included the following:

    (i) in the **financial arena**, the ECB measures of June, the signing in May of the agreement of the European Union countries (except the United Kingdom and Sweden) about the Single Resolution Fund (SRF), which complements the legislation of the Single Resolution Mechanism of (SRM), and the EU regulators' unveiling in April of the details of the stress tests that the ECB and the European Banking Authority (EBA) will apply to 124 banks of the EU during June-September;

    (ii) in the **fiscal arena**, the change of leadership and policy priorities of the new European Commission (EC) generated optimism in the block, particularly for countries whose fiscal restrictions could affect their still delicate recovery, such as France, Italy and Spain, without affecting the fulfilment of the long-term goals and within the flexibility already existing in the treaties (Fiscal Pact and Growth and Stability Pact). Different paces of events were observed at the country level. The positive progress made in the fiscal accounts by Portugal and Ireland raised the probabilities that both countries will meet their fiscal targets without any difficulty. Moreover, Portugal ended in June its EU/IMF program without requesting a preventive credit line (as Ireland did) and also without receiving the last disbursement of the program (€ 2.6 billion). On the other hand, the advance of the fiscal accounts in Greece was also positive, but the country did not meet the agreement of implementing the reform program, thus putting at risk the program commitments and the next disbursements. On the other hand, the recent measures adopted in Italy (2014-17 budget), France (fiscal measures for 2014-17) and Spain (tax reform) have put at risk the fulfilment of their fiscal targets for this year and for the next year.

    In this context, the yields of the 10-year U.S. Treasury bonds fell about 19 basis points between March and June 2014. In addition, the yields of sovereign securities of Germany, the United Kingdom, and Japan also showed reductions.

    In the economies of Southern Europe (i.e. Portugal, Greece, Italy, and Spain), the 10-year yields and credit spreads (CDS) declined significantly (which was associated to better political, fiscal, and financial conditions). In line with this, the main agencies improved some ratings, as was the case of Greece, Portugal, Ireland, and Spain.

**Table 8**
**DEVELOPED COUNTRIES: TREASURY YIELDS (10 YEARS) AND SOVEREIGN SPREADS (CDS)**

| | End of period | | | | Difference in basis points | |
|---|---|---|---|---|---|---|
| | Jun.13 | Dec.13 | Mar.14 | Jun.14 | Jun.14-Dec.13 | Jun.14-Mar.14 |
| **10 Year Treasury yields (%)** | | | | | | |
| USA | 2.49 | 3.03 | 2.72 | 2.53 | -50 | -19 |
| Japan | 0.85 | 0.74 | 0.64 | 0.57 | -18 | -8 |
| United Kingdom | 2.44 | 3.02 | 2.74 | 2.67 | -35 | -7 |
| Germany | 1.73 | 1.93 | 1.57 | 1.25 | -68 | -32 |
| France | 2.35 | 2.56 | 2.08 | 1.70 | -86 | -38 |
| Italy | 4.55 | 4.13 | 3.29 | 2.85 | -128 | -45 |
| Spain | 4.77 | 4.15 | 3.23 | 2.66 | -149 | -57 |
| Ireland | 4.11 | 3.51 | 3.02 | 2.36 | -116 | -66 |
| Portugal | 6.45 | 6.13 | 4.07 | 3.65 | -248 | -43 |
| Greece | 10.98 | 8.42 | 6.57 | 5.96 | -246 | -61 |
| **CDS - 5 Years (bps)** | | | | | | |
| USA | 28 | 28 | 18 | 17 | -11 | -1 |
| United Kingdom | 50 | 26 | 23 | 19 | -7 | -4 |
| Germany | 32 | 25 | 23 | 20 | -5 | -2 |
| France | 80 | 54 | 49 | 40 | -14 | -10 |
| Italy | 284 | 168 | 132 | 95 | -73 | -37 |
| Spain | 284 | 154 | 103 | 67 | -87 | -36 |
| Ireland | 166 | 120 | 78 | 45 | -75 | -32 |
| Portugal | 401 | 352 | 185 | 165 | -187 | -20 |
| Greece | 1,144 | 675 | 482 | 470 | -205 | -12 |

Source: Bloomberg.

The debt markets in **Latin American** countries also showed a favorable evolution, in line with development in other emerging economies, following the reduction of risk aversion and the improvement observed in the economic prospects for China as a result of the stimulus measures implemented by the government to stimulate its economy through both monetary actions (reduction of required reserves in April and June) and fiscal actions (Mini program of measures in April). This was in part offset by the slowdown of growth in most countries in the region associated with a lower boost of domestic demand. In this scenario, the yields of emerging economies the bonds and credit default spreads (CDs) continued to decline and at a greater magnitude than in the previous quarter.

**Table 9**
**EMERGING COUNTRIES: SOVEREIGN CDS- 5 YEARS**

| | End of period | | | | Difference in basis points | |
|---|---|---|---|---|---|---|
| | Jun.13 | Dec.13 | Mar.14 | Jun.14 | Jun.14-Dec.13 | Jun.14-Mar.14 |
| **CDS Spreads (in basis points)** | | | | | | |
| Brazil | 187 | 193 | 171 | 144 | -49 | -27 |
| Chile | 100 | 80 | 79 | 63 | -16 | -16 |
| Colombia | 143 | 118 | 109 | 80 | -38 | -29 |
| Mexico | 132 | 92 | 89 | 67 | -25 | -22 |
| Peru | 145 | 133 | 112 | 81 | -53 | -32 |
| Hungary | 321 | 260 | 234 | 165 | -95 | -69 |
| Poland | 104 | 79 | 68 | 56 | -23 | -11 |
| Russia | 196 | 166 | 216 | 179 | 13 | -38 |
| Turkey | 191 | 244 | 216 | 177 | -67 | -39 |
| China | 119 | 80 | 91 | 77 | -3 | -13 |
| Israel | 127 | 103 | 89 | 78 | -25 | -11 |
| South Africa | 218 | 205 | 192 | 178 | -27 | -14 |

Source: Bloomberg.

## Foreign Exchange Rates

14. According to the Fed index, the dollar depreciated 0.8 percent between April and June 2014, reversing the appreciatory trend observed in the previous quarter due mainly to the strengthening of the yen, the pound, and the currencies of the emerging market economies. The strengthening of the yen was influenced mostly by the recovery of activity in Japan in Q1 and by declining expectations that the Bank of Japan will adopt additional stimulus measures, while the strengthening of the pound was associated with a favorable economic outlook for the United Kingdom which would imply an earlier-than-expected rise of the interest rates. It is worth pointing out that the dollar appreciated against the euro following the ECB actions and the Fed signals, reversing the trend observed until May.

**Graph 14**
**US DOLLAR INDEX***
(January 2008 - June 2014)


*A rise in the index represents an appreciation of the US dollar.
Source: FED.

Most of the emerging currencies appreciated against the dollar due to a lower perception of risk which led investors to seek assets with greater yields and due to the fact that tapering has not had additional impacts in the emerging economies since the Fed has continued purchasing bonds for US$ 10 billion each month, in line with what was expected. On the contrary, capital flows to the emerging economies have increased in Q2, offsetting in part the liquidation of assets of these economies registered at the beginning of the year.

**Table 10**
**EXCHANGE RATE**

| | End-of-period (US$/c.u.) | | | | Jun.14 % chg. compared to: | |
|---|---|---|---|---|---|---|
| | Jun.13 | Dec.13 | Mar.14 | Jun.14 | Dec.13 | Mar.14 |
| Canada | 1.05 | 1.06 | 1.10 | 1.07 | 0.4 | -3.5 |
| Japan | 99.12 | 105.30 | 103.19 | 101.30 | -3.8 | -1.8 |
| United Kingdom (US$/c.u.) | 1.521 | 1.656 | 1.666 | 1.710 | 3.3 | 2.6 |
| Eurozone (US$/c.u.) | 1.301 | 1.375 | 1.377 | 1.369 | -0.4 | -0.6 |
| Switzerland (US$/c.u.) | 0.94 | 0.89 | 0.88 | 0.89 | -0.7 | 0.3 |
| | | | | | | |
| Brazil | 2.23 | 2.36 | 2.27 | 2.21 | -6.3 | -2.5 |
| Chile | 507 | 525 | 548 | 552 | 5.1 | 0.7 |
| Colombia | 1,920 | 1,929 | 1,971 | 1,879 | -2.6 | -4.7 |
| Mexico | 12.94 | 13.03 | 13.06 | 12.97 | -0.5 | -0.7 |
| Argentina | 5.39 | 6.52 | 8.00 | 12.10 | 85.7 | 51.3 |
| Peru | 2.78 | 2.80 | 2.81 | 2.80 | 0.0 | -0.3 |
| | | | | | | |
| Hungary | 227 | 216 | 223 | 226 | 4.6 | 1.4 |
| Poland | 3.32 | 3.01 | 3.02 | 3.04 | 0.8 | 0.4 |
| Russia | 32.83 | 32.89 | 35.03 | 33.98 | 3.3 | -3.0 |
| | | | | | | |
| Turkey | 1.93 | 2.15 | 2.14 | 2.12 | -1.3 | -1.0 |
| China | 6.14 | 6.05 | 6.22 | 6.20 | 2.5 | -0.2 |
| India | 59.52 | 61.80 | 60.01 | 60.05 | -2.8 | 0.1 |
| Israel | 3.64 | 3.47 | 3.49 | 3.43 | -1.3 | -1.7 |
| South Africa | 9.83 | 10.45 | 10.52 | 10.63 | 1.8 | 1.1 |
| | | | | | | |
| FED basket | 102.6 | 102.1 | 103.0 | 102.1 | 0.0 | -0.8 |

Source: Reuters and Bloomberg.

### Interest Rate Decisions

15. Between April and June, most central banks maintained their interest rates unchanged. Among the developed economies, only the Eurozone lowered interest rates by 10 bps due to the slow and uneven recovery of the economy and to the risk of deflationary pressures. Some emerging economies –i.e. Serbia, Mexico, Hungary, Chile, and Thailand– reduced their policy rates, continuing with the trend of previous months, in response to the low dynamism of economic activity in a context of contained inflationary pressures.

**Table 11**
**MONETARY POLICY INTEREST RATE**

| | Dec.12 | Sep.13 | Dec.13 | Feb.14 | Jun.14 | Differences in basis points Jun.14 respect to: Feb.14 | Dec.13 | Dec.12 |
|---|---|---|---|---|---|---|---|---|
| Serbia | 11.25 | 11.00 | 9.50 | 9.50 | 8.50 | -100 | -100 | -275 |
| Mexico | 4.50 | 3.75 | 3.50 | 3.50 | 3.00 | -50 | -50 | -150 |
| Hungary | 5.75 | 3.60 | 3.00 | 2.70 | 2.30 | -40 | -70 | -345 |
| Chile | 5.00 | 5.00 | 4.50 | 4.25 | 4.00 | -25 | -50 | -100 |
| Thailand | 2.75 | 2.50 | 2.25 | 2.25 | 2.00 | -25 | -25 | -75 |
| Eurozone | 0.75 | 0.50 | 0.25 | 0.25 | 0.15 | -10 | -10 | -60 |
| Turkey | 9.00 | 7.75 | 7.75 | 12.00 | 12.00 | 0 | 425 | 300 |
| Pakistan | 9.50 | 9.50 | 10.00 | 10.00 | 10.00 | 0 | 0 | 50 |
| India | 8.00 | 7.50 | 7.75 | 8.00 | 8.00 | 0 | 25 | 0 |
| Indonesia | 5.75 | 7.25 | 7.50 | 7.50 | 7.50 | 0 | 0 | 175 |
| Iceland | 6.00 | 6.00 | 6.00 | 6.00 | 6.00 | 0 | 0 | 0 |
| South Africa | 5.00 | 5.00 | 5.00 | 5.50 | 5.50 | 0 | 50 | 50 |
| Peru | 4.25 | 4.25 | 4.00 | 4.00 | 4.00 | 0 | 0 | -25 |
| Philippines | 3.50 | 3.50 | 3.50 | 3.50 | 3.50 | 0 | 0 | 0 |
| Malaysia | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 0 | 0 | 0 |
| South Korea | 2.75 | 2.50 | 2.50 | 2.50 | 2.50 | 0 | 0 | -25 |
| Poland | 4.25 | 2.50 | 2.50 | 2.50 | 2.50 | 0 | 0 | -175 |
| Australia | 3.00 | 2.50 | 2.50 | 2.50 | 2.50 | 0 | 0 | -50 |
| Norway | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 0 | 0 | 0 |
| Canada | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 0 | 0 | 0 |
| Israel | 2.00 | 1.00 | 1.00 | 0.75 | 0.75 | 0 | -25 | -125 |
| United Kingdom | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0 | 0 | 0 |
| United States | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0 | 0 | 0 |
| Switzerland | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0 | 0 | 0 |
| Romania | 5.25 | 4.25 | 4.00 | 3.50 | 3.50 | 0 | -50 | -175 |
| Sweden | 1.00 | 1.00 | 0.75 | 0.75 | 0.75 | 0 | 0 | -25 |
| Taiwan | 1.88 | 1.88 | 1.88 | 1.88 | 1.88 | 0 | 0 | 0 |
| Brazil | 7.25 | 9.00 | 10.00 | 10.75 | 11.00 | 25 | 100 | 375 |
| Colombia | 4.25 | 3.25 | 3.25 | 3.25 | 4.00 | 75 | 75 | -25 |
| New Zealand | 2.50 | 2.50 | 2.50 | 2.50 | 3.25 | 75 | 75 | 75 |

Source: Reuters and Bloomberg.

On the other hand, Brazil, Colombia, and New Zealand raised their rates. In Brazil, the central bank increased the rate by 25 bps as a result of which this rate accumulates an increase of 375 bps since April 2013, while inflation and inflation expectations are around the upper band of the target (2.5-6.5 percent).

In Colombia, where the rate was increased by 75 bps, economic activity continues to accelerate –exceeding expectations, the output grew 6.4 percent in Q1– and inflation is coming close to the 3 percent target (in June inflation increased to 2.8 percent from 2.5 in March). Moreover, the Central Bank of New Zealand raised the rate by 75 bps. Activity has been growing significantly, favored in part by the high prices of dairy products and by domestic demand. According to the central bank, this would be leading the economy to a level of activity above its potential level.

# II. Economic Activity

### Sector GDP

16. In the first half of the year, Peru's GDP has been growing at a rate of 3.2 percent, below the level of 5.5 percent observed in the same period in 2013. To a great extent, this slower pace of growth has been associated with various supply shocks that have affected the evolution of activity especially in the primary sectors. The indicators show that these conditions would have intensified during Q2. Non-primary sectors also show, in general, more modest growth rates, in line with the deterioration of terms of trade, the deterioration of external conditions, and economic agents' less optimistic expectations. An improvement is foreseen in the second half of the year in the conditions that negatively impacted the evolution of some of the primary sectors. Together with the reversal of expectations and with the positive impact of the measures announced by the authorities, this improvement would be reflected in a greater boost of economic activity.

    On the side of primary sectors, the production sectors that have contributed the most to the slowdown have been the sectors of mining and hydrocarbons, due mainly to the lower production of gold and copper as a result lower contents of metal in the most important mines and to the lower production of oil, on the one hand, and the sector of agriculture, due to a lower production of coffee, associated with the effect of the yellow rust plague, and to a lower production of rice as a result of lack of rains at the beginning of the year, on the other hand. On the side of non-primary sectors, the sectors that have contributed the most to the slowdown have been construction, due to a lower physical progress of public works, and non-primary manufacturing, due to the production of metal products, machinery and equipment, and textiles as a result of lower demand.

**Graph 15**
**GDP**
(12 month % change)

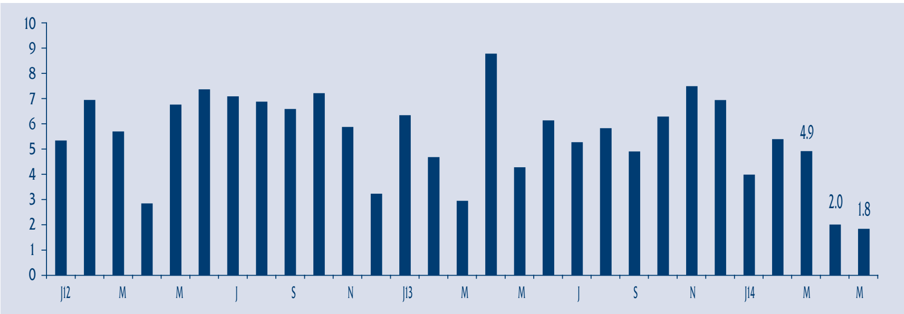


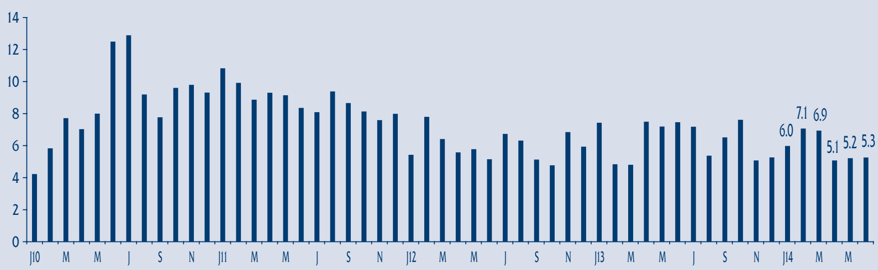
**Table 12**
**GDP BY PRODUCTION SECTOR**
(Real % change)

| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **Agriculture and livestock** | **1.9** | **1.4** | **0.2** | **1.6** | **1.7** | **4.0** | **2.2** | **3.5** |
| **Fishing** | **-5.5** | **18.1** | **-4.6** | **6.4** | **-1.6** | **2.5** | **-2.2** | **35.7** |
| **Mining and hydrocarbons** | **2.9** | **4.9** | **-1.3** | **2.8** | **0.3** | **13.4** | **8.5** | **10.8** |
| Metallic mining | 0.4 | 4.2 | -2.3 | 1.9 | -1.0 | 15.6 | 9.0 | 10.7 |
| Hydrocarbons | 12.2 | 7.2 | 2.2 | 7.2 | 5.7 | 5.3 | 7.0 | 11.4 |
| **Manufacturing** | **3.7** | **5.7** | **0.9** | **4.6** | **2.7** | **4.9** | **4.2** | **4.5** |
| Based on raw materials | -0.4 | 9.8 | 4.5 | 6.2 | 2.1 | 6.4 | 3.2 | 3.6 |
| Non-primary industries | 5.0 | 4.4 | -0.1 | 4.0 | 2.8 | 4.5 | 4.5 | 4.8 |
| **Electricity and water** | **5.3** | **5.5** | **5.2** | **5.8** | **5.7** | **6.1** | **6.1** | **6.3** |
| **Construction** | **13.3** | **8.9** | **2.1** | **7.6** | **5.0** | **8.0** | **8.0** | **7.5** |
| **Commerce** | **5.7** | **5.9** | **4.6** | **6.1** | **5.4** | **5.7** | **5.7** | **5.8** |
| **Other services** | **6.4** | **6.1** | **5.3** | **6.3** | **6.0** | **6.1** | **6.2** | **5.8** |
| **GDP** | **5.5** | **5.8** | **3.2** | **5.5** | **4.4** | **6.7** | **6.0** | **6.3** |
| Memo: | | | | | | | | |
| **Primary GDP** | **1.9** | **5.0** | **-0.1** | **3.1** | **0.9** | **9.6** | **5.8** | **8.5** |
| **Non-Primary GDP** | **6.5** | **6.1** | **4.1** | **6.1** | **5.3** | **6.0** | **6.0** | **5.8** |

* Forecast.
IR: Inflation Report.

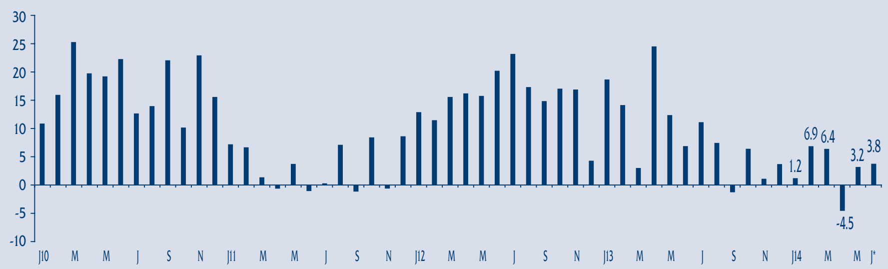
17. Current and advanced indicators of economic activity show that the pace of growth of economic activity (3.2 percent) has slowed down in the first half of 2014 relative to the same period of the previous year (5.5 percent). For example, the production of electricity in the first half of 2014 shows a growth rate of 5.9 percent, while in the same period in 2013 it grew 6.7 percent. A similar behavior is observed in the domestic consumption of cement, which showed a pronounced drop in the month of April. Thus, the growth rate accumulated in the first half of 2014 (2.0 percent) is significantly lower than the one registered in the same period of the previous year (13.0 percent).

**Graph 16**
**PRODUCTION OF ELECTRICITY: 2010-2014**
(12 month % change)




* Preliminary.
Source: COES.,

**Graph 17**
**DOMESTIC CONSUMPTION OF CEMENT: 2010-2014**
(12 month % change)




* Preliminary.
Source: ASOCEM and cement companies.

18. The GDP growth rate projected for 2014 has been revised down from 5.5 percent (Inflation Report of April 2014) to 4.4 percent, due mainly to the slower growth registered in the primary sectors. In 2014, growth would be driven by the expansion of non-primary sectors, namely construction, trade, and services.

    Moreover, the growth of GDP estimated for 2015 has been revised down from 6.7 to 6.0 percent due to a lower production of the sub-sector of metal mining, whose growth rate has been revised from 15.6 to 9.0 percent mainly as a result of the postponement of the onset of Las Bambas project. In 2016 GDP would grow 6.3 percent, driven by the mining sector, due to the onset of operations at Las Bambas and to the expansion of Cerro Verde, as well as by the fishing sector, which is foreseen to recover completely after El Niño event.

    a) The **agriculture sector** is estimated to have grown 0.2 percent in the first half of the year, with the agriculture sub-sector having shrunk 1.4 percent due to a lower production of rice (-11.6 percent) associated with the water constraints experienced at the beginning of the year as well as with lower harvests of coffee (-22.2 percent) due to the effect of coffee rust. On the other hand, the livestock sub-sector would have grown 2.9 percent, in line with an increased production of poultry (4.9 percent).

       The growth forecast for the agriculture sector in 2014 has been revised slightly upwards to 1.7 percent, due mainly to the increase observed in the production of various agro-export products such as olives, grapes, and avocados. On the other hand, the projection for 2015 is revised down from 4.0 to 2.2 percent since a lower production of potatoes and lemons is estimated in the agriculture sector due to the possible impact of a moderate El Niño event that could occur between Q4-2014 and early 2015. Furthermore, the negative impact of the yellow rust on coffee production would persist during 2015, even though the intensity of this pest is expected to decline.

It is expected that the effects of El Niño event on agricultural production as well as the impact of the yellow rust plague on coffee production will have vanished entirely by 2016.

b) The output in the **fishing sector** dropped 4.6 percent in the first half of 2014 due to the lower catch of anchovies registered during the month of January, 2014, given that 91 percent of the fishing quota established for the second fishing season in the North-Central area had already been reached by the end of 2013. Another factor that contributed to this drop was the lower extraction of anchovy during the months of May and June associated with unfavorable weather conditions as a result of the arrival of the Kelvin wave.

The fishing sector in 2014 is projected to show a fall of 1.6 percent, taking into account the lesser extraction of anchovy being observed during the first fishing season of the year as well as the effects that an El Niño event would have during the second fishing season. The projection assumes that a moderate El Niño event would take place and that its impact would remain until 2015. A full recovery of the sector is expected by 2016, since the reproductive cycle of the anchovy would not be affected by the anomalous sea temperatures during 2015.

An analysis of the effects produced by severe El Niño episodes are offered in Box 1 and contrasted with the scenario of the moderate El Niño event considered in this report.

c) In the first half of 2014, it is estimated that **metallic mining** production will decline 2.3 percent compared to the same period of the previous year, due mainly to the lower production of gold at Yanacocha associated with its mining plan which includes the expansion of El Tapado Oeste, and due to the lower metal content obtained by Antamina according to its mining plan.

The growth projection of this sector for 2014 has been revised from 1.9 to -1.0 percent due mainly to the lower gold production of Madre de Dios as a result of the intensification of interdiction measures. In addition to this, the lower metal content of the gold extracted during the first half of 2014 would be affecting the production of this metal and this situation would continue to be observed in 2015 and 2016. Two new projects, Inmaculada and Invicta, are foreseen to start operating in 2015 and the onset of Shahuindo project is foreseen for 2016.

In Toromocho, on the other hand, after the testing period, the company revised down its estimated production for the year. A higher production of copper is expected in 2015 and 2016 after Constancia and Las Bambas projects start operating.

The growth of production in the case of zinc in 2014 has been revised down due to the lower grades of the metal extracted, but a higher level of production is foreseen in some companies like Antamina.

**Table 13**
**MINING PRODUCTION**
(% change)

| | 2013 | 2014* | 2015* | 2016* |
|---|---|---|---|---|
| Gold | -3.3 | -13.4 | -4.9 | -5.0 |
| Copper | 7.4 | 5.2 | 14.5 | 21.2 |
| Zinc | 5.5 | -6.3 | 8.6 | 0.5 |

* Forecast.

d) It is estimated that the production of **hydrocarbons** would increase by 2.2 percent in the first half of 2014 relative to the same period of 2013 as a result of the higher production of oil resulting from the onset of operations at Perenco's Lot 67. The output projected for 2014 is revised to 5.7 percent considering a lower oil production at Lot I-AB and lower exports of gas from Lot 56, both of which belong to Pluspetrol. The growth of the sector in the rest of the year and in 2015 would be supported by Perenco's project in Lot 67, which would contribute with a daily production of 12,000 barrels of oil.

As regards the production of natural gas, in 2014-2015 the production of natural gas liquids would increase due to the start of operations of Repsol's Lot 57 which would produce 83 million cubic feet of natural gas per day. On the other hand, the increase in the production of liquids and natural gas in 2016 is associated with the onset of operations of Camisea's compressor plant. This project has two phases. During the first one, the production capacity would increase by 310 MCFD by June 2015, while during the second one the production capacity would increase by another 100 MCFD by December 2015, according to the information provided by reported by the Transportadora de Gas del Perú to Osinergmin.

e) The **manufacturing sector** would have grown 0.9 percent in the first half of the year. Manufacturing based on the processing of raw materials would show an growth rate of 4.5 percent as a result of increased production in the industry of refining of non-ferrous metals given the higher production of copper anodes and cathodes by Southern and Cerro Verde in the first months of the year (this increase is in part associated with a base effect resulting from the technical problems they reported in 2013). The fishing industry would show an increase in the production of canned seafood and a decrease in the production of fishmeal, while the production of refined crude oil, meat products, and sugar would show moderate increases.

Non-primary manufacturing would register a decline of 0.1 percent in the first half of the year due to the slowdown in the industrial branches associated with investment, particularly industrial services, electrical machinery, and transport equipment. Other industries that would also show a decrease include the textile industry, affected by a lower internal and external demand; the industry of non-metallic minerals, mainly the glass industry due to a lower demand for containers for beverages and pharmaceutical products, and the wood and furniture industries, due to lower domestic and external demand. In contrast, a higher production would be observed in the branches of food and beverages, especially in miscellaneous food products; chemicals, rubber and plastics, due to a greater demand for vanity products, and the paper and printing industry due to higher printing production.

Slower growth is projected in manufacturing based on the processing of raw materials in 2014, in line with lower fisheries production due to the smaller catch of anchovy, and with a lower output in the refining of non-ferrous metals due to the closure of Doe Run. This situation would continue to be seen during 2015 given that a moderate El Niño episode would affect fishing, while the lower production of metal mining would be in part offset by an increase in oil production. As for non-primary manufacturing, a downward revision is anticipated in the projection of growth for 2014 associated with the lower dynamism of domestic demand, whereas the projection of growth for 2015 remains at 4.5 percent.

## Expenditure-Side GDP

19. In the first half of 2014 domestic demand is estimated to have grown 3.7 percent due to a lower expansion of spending components, both in the case of private spending –which fell from 8.2 percent in the first half of 2013 to 3.4 percent in first half of 2014– and in the case of public spending, which fell from 11.8 percent in the first half of 2013 to 5.0 percent in the same period of 2014.

**Table 14**
**GDP AND DOMESTIC DEMAND**
(Real % change)

| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **I. Domestic demand** | **8.7** | **7.0** | **3.7** | **5.4** | **4.7** | **6.1** | **5.7** | **5.2** |
| 1. Private expenditure | 8.2 | 6.7 | 3.4 | 4.6 | 4.1 | 5.8 | 5.5 | 4.6 |
| Consumption | 5.2 | 5.3 | 4.9 | 5.1 | 4.9 | 5.4 | 5.0 | 5.2 |
| Private fixed investment | 9.6 | 6.4 | -0.3 | 6.0 | 3.2 | 6.6 | 6.2 | 6.5 |
| 2. Public expenditure | 11.8 | 8.4 | 5.0 | 9.3 | 7.9 | 7.5 | 6.9 | 7.7 |
| Consumption | 7.7 | 6.7 | 7.0 | 6.1 | 8.5 | 4.7 | 6.0 | 6.0 |
| Investment | 22.3 | 12.1 | 0.5 | 15.5 | 6.7 | 12.5 | 8.9 | 11.0 |
| **II. Net external demand** | | | | | | | | |
| 1. Exports | -4.9 | -0.9 | -3.6 | 3.3 | -0.4 | 8.2 | 5.5 | 10.8 |
| 2. Imports | 6.8 | 3.6 | -1.1 | 3.3 | 1.0 | 5.6 | 4.7 | 5.9 |
| **III. GDP** | **5.5** | **5.8** | **3.2** | **5.5** | **4.4** | **6.7** | **6.0** | **6.3** |

* Forecast.
IR: Inflation Report.

**Table 15**
**GDP AND DOMESTIC DEMAND**
(Contributions to the real % change)

| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **I. Domestic demand** | **8.7** | **7.1** | **3.8** | **5.5** | **4.8** | **6.2** | **5.9** | **5.3** |
| 1. Private expenditure | 7.1 | 5.7 | 3.1 | 3.9 | 3.5 | 4.9 | 4.7 | 3.9 |
| Consumption | 3.2 | 3.3 | 3.1 | 3.1 | 3.0 | 3.3 | 3.0 | 3.1 |
| Private fixed investment | 2.1 | 1.4 | -0.1 | 1.4 | 0.7 | 1.5 | 1.4 | 1.5 |
| Change on inventories | 1.8 | 1.0 | 0.1 | -0.5 | -0.2 | 0.1 | 0.2 | -0.7 |
| 2. Public expenditure | 1.6 | 1.4 | 0.7 | 1.6 | 1.3 | 1.3 | 1.2 | 1.4 |
| Consumption | 0.7 | 0.7 | 0.7 | 0.7 | 0.9 | 0.5 | 0.7 | 0.7 |
| Investment | 0.8 | 0.7 | 0.0 | 0.9 | 0.4 | 0.8 | 0.5 | 0.7 |
| **II. Net external demand** | | | | | | | | |
| 1. Exports | -1.3 | -0.2 | -0.9 | 0.8 | -0.1 | 2.0 | 1.3 | 2.6 |
| 2. Imports | 1.9 | 1.0 | -0.3 | 0.9 | 0.3 | 1.5 | 1.2 | 1.5 |
| **III. GDP** | **5.5** | **5.8** | **3.2** | **5.5** | **4.4** | **6.7** | **6.0** | **6.3** |

* Forecast.
IR: Inflation Report.

This result would be associated with a slower pace of expansion of private investment, which would show a negative growth rate of 0.3 percent after having growing 9.6 percent in the first half of 2013 and with the lower dynamism of public investment, which showed a growth rate of 0.5 percent in the first six months of the year (a lower rate than the 22.3 percent recorded in the same period of 2013).

Private investment is expected to improve its dynamism in the second half of 2014, which would initiate a process of recovery of domestic demand. In addition, an improvement is also expected in the evolution of exports as a result of a greater capacity for production and export in Toromocho.

20. Consumers and producers' indicators of confidence continue to be on the optimistic side in the first half of the year, although showing lower levels than in April 2014, which could have contributed to reduce the boost of spending in consumption and investment in the private sector.

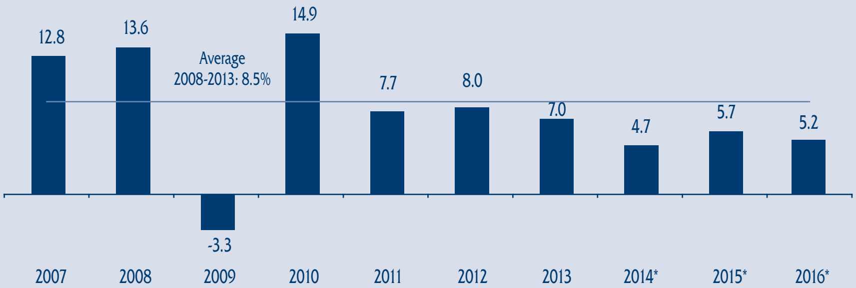
21. The growth of domestic demand projected for 2014 has been revised down from 5.4 percent to 4.7 percent. This is explained by the lower dynamism foreseen for private investment, whose growth rate has been revised from 6.0 percent to 3.2 percent, in line with the data available at May. In addition, the growth projection of public spending is revised downward to 7.9 percent, in line with a lower estimate of public investment, especially in the case of the subnational governments.

In 2015 domestic demand is expected to growth 5.7 percent, less than estimated in our previous report, due mainly to the slower growth of public investment and to the lower dynamism of private spending in consumption. Moreover, in 2016 domestic demand would grow 5.2 percent considering that private investment would grow 6.5 percent given the investment projects and the concessions announced.

**Graph 18**
**GDP: 2007-2016**
(Real % change)


* Forecast.

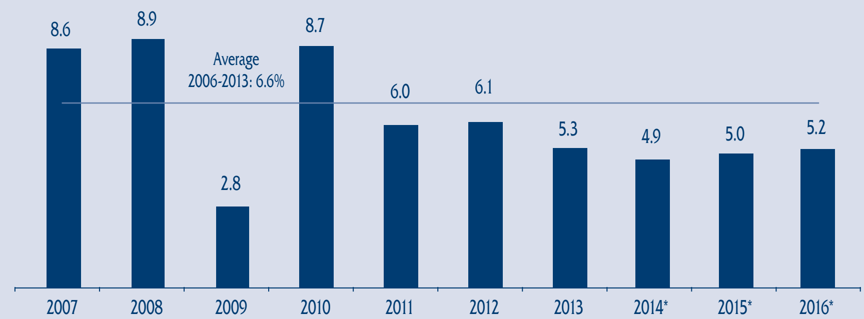
**Graph 19**
**DOMESTIC DEMAND: 2007-2016,**
(Real % change)




* Forecast.

22. The growth rates of private consumption continue to show a moderate pace below the average observed in 2007-2013. Private consumer spending would grow 4.9 percent in the first half of 2014, less than in the same period of the previous year. Recent indicators reflecting the evolution of private consumption show that, for example, consumer confidence in June remained on the optimistic side, although to a lesser extent than in April. Moreover, consumer loans to natural persons continue recording moderate expansion rates below the average in 2010-2013 and vehicle sales have dropped 7.6 percent between April and June.

**Graph 20**
**PRIVATE CONSUMPTION: 2007-2016**
(Real % change)

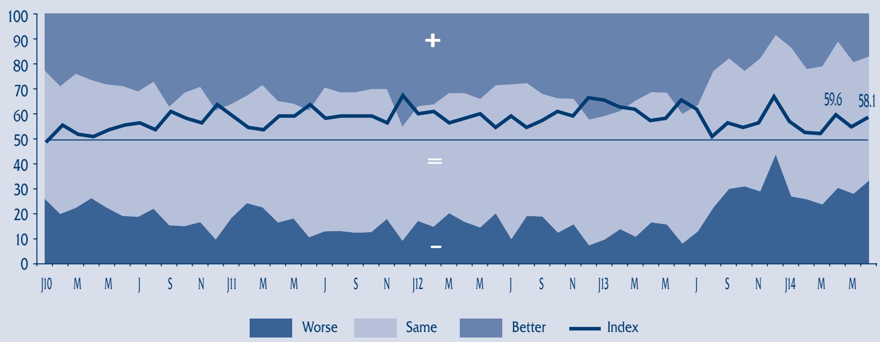



* Forecast.

Some indicators that reflect the dynamics of private consumer spending are provided below.

a. In June the consumer confidence index was on the optimistic side with a level of 58 points. This indicator has maintained an average of 55 points during the first half of the year, a lower level than the one observed in the same period in 2013.

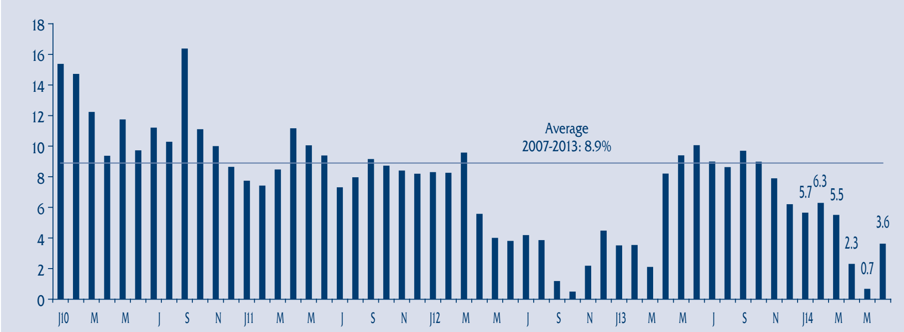
**Graph 21**
**¿CONSUMER CONFIDENCE INDEX:**
**HOUSEHOLDS' ECONOMIC SITUATION?**




Source: Apoyo.

b. The growth rate of the labor force employed (4.0 percent) was lower than the one recorded in the same period in the previous year (6.1 percent).

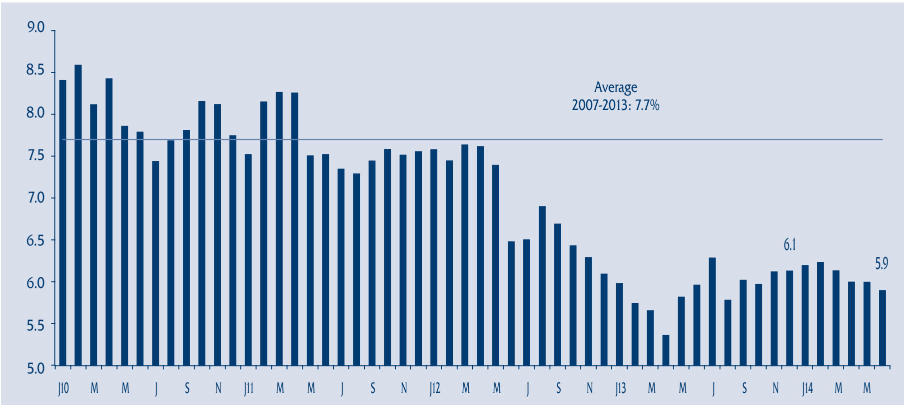
**Graph 22**
**LABOR FORCE EMPLOYED: JAN.10 - JUN14**
(Quarterly moving 12 month % change)




Source: INEI.

c. The unemployment rate, indicator reflecting the percentage of total workforce who are unemployed and looking for a paid job, was slightly below the unemployment rate in the same period of the previous year and went from 6.1 percent in December 2013 to 5.9 percent in June 2014. The seasonally-adjusted rate of unemployment had a slightly declining trend in the first half of the year.

**Graph 23**
**UNEMPLOYMENT RATE: JAN.10 - JUN.14**
(Seasonally adjusted- moving quarterly)



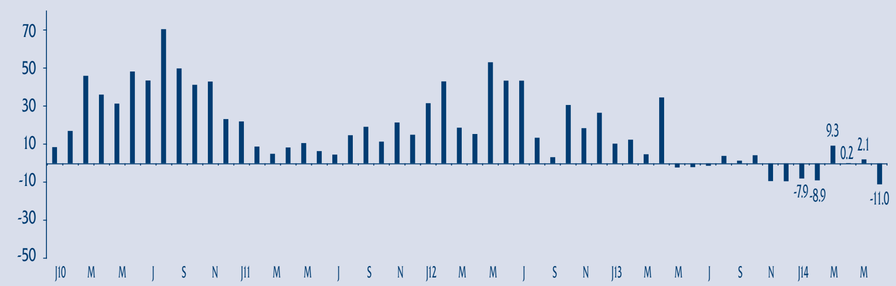

d. The growth of credit to individuals, which includes consumer loans and mortgages, continues to moderate compared to the rates observed during 2013. This indicator grew 13.1 percent in May, a lower rate than the average rate observed in 2010-2013.

**Graph 24**
**CREDIT TO INDIVIDUALS: JAN.10 - MAY.14**
(12 month % change)


Source: BCRP.

e. The volume of imports of durable consumer goods dropped by 11.0 percent in June.

**Graph 25**
**VOLUME OF IMPORTS OF DURABLE CONSUMER GOODS: JAN. 10 - MAR.14**
(12 month % change)




Source: SUNAT.

f. The sale of new family cars fell 2.8 percent in June and accumulated a decline of 5.8 percent in the first six months of the year.

**Graph 26**
**SALE OF FAMILIAR VEHICLES: JAN.10 - JUN.14**
(12 month % change)


Source: Araper.

g. The national disposable income would grow 2.5 percent in the first half of the year (versus 6.1 percent in the same period of 2013). In 2015 and 2016 the national disposable income is estimated to grow 5.7 and 6.7 percent, respectively, in line with the expected recovery of the output.

**Table 16**
**NATIONAL DISPOSABLE INCOME**
(Real % change)

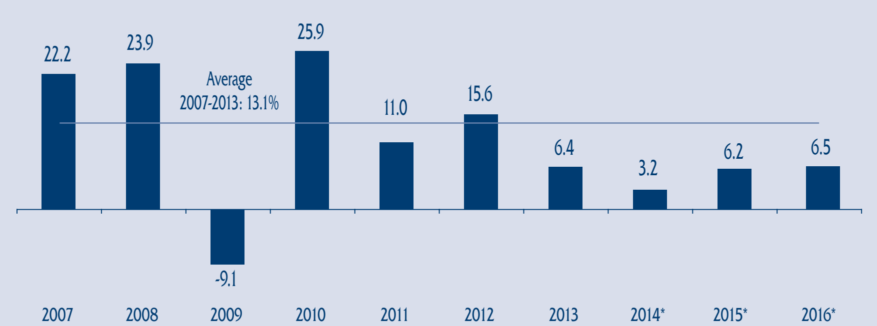
| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| 1. GDP | 5.5 | 5.8 | 3.2 | 5.5 | 4.4 | 6.7 | 6.0 | 6.3 |
| 2. Gross National Product | 7.0 | 7.3 | 3.7 | 5.8 | 4.9 | 7.0 | 6.3 | 6.8 |
| 3. Gross National Income | 6.3 | 6.0 | 2.3 | 5.3 | 4.1 | 7.0 | 6.3 | 6.7 |
| **4. National Disposable Income 1/** | **6.1** | **5.9** | **2.5** | **5.8** | **4.6** | **6.5** | **5.7** | **6.7** |

1/ Including factor income, net profits by terms of trade, and net transfers received for non-residents.
* Forecast.
IR: Inflation Report.

Based on these indicators, the growth of consumption in 2014 has been revised from 5.1 percent to 4.9 percent. A gradual increase is expected in its growth rate in the following years, in line with the anticipated evolution of income.

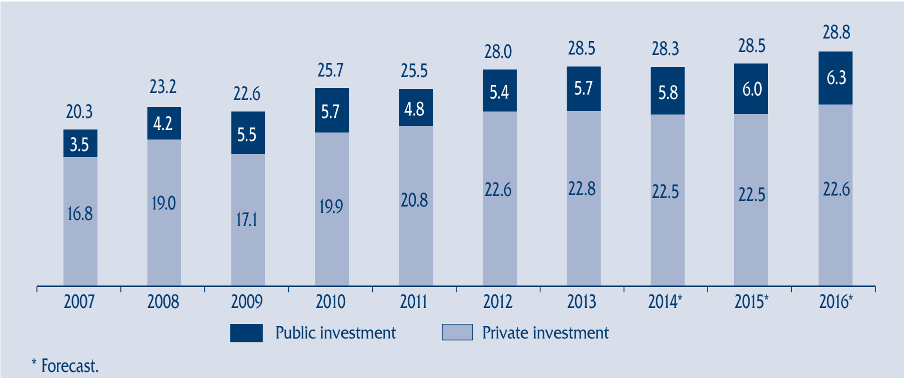
23. The growth of private investment projected for 2014 has been revised down from 6.0 to 3.2 percent. Taking into account the investment projects announced and the announcements of future concessions, in 2015 and 2016 private investment would grow at rates of 6.2 and 6.5 percent, respectively. Thus, the ratio of total gross fixed investment to GDP, which includes both the private and public sectors, would go from 28.3 percent in 2014 to 28.5 percent in 2015 and to 28.8 percent in 2016.

**Graph 27**
**PRIVATE INVESTMENT: 2007-2016**
(Real % change)




* Forecast.

**Graph 28**
**GROSS FIXED INVESTMENT: 2007 - 2016***
(% real GDP)

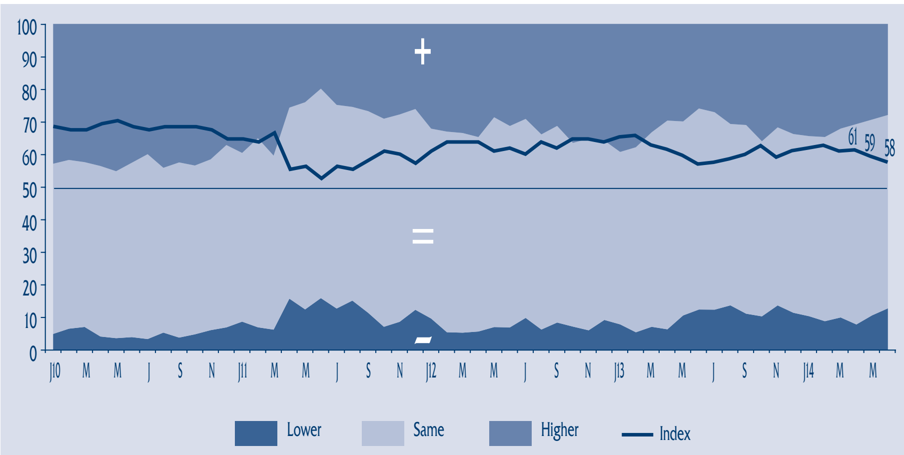



* Forecast.

Moreover, some indicators that reflect the recent evolution of private investment are discussed below:

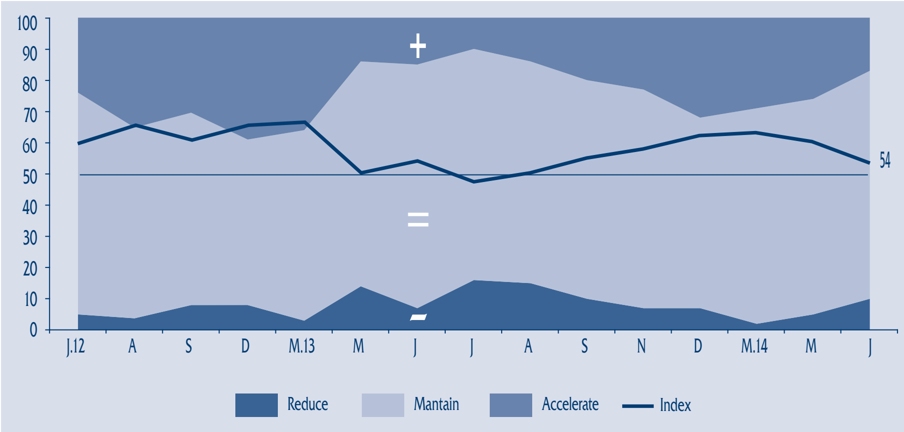
a. Expectations about demand in the three months ahead remain on the optimistic side with a level of 58 points in June and an average of 61 points in the first half of 2014. This level is 1 point lower than the one observed in the first half of 2013.

**Graph 29**
**EXPECTATION ABOUT DEMAND IN THE THREE MONTHS AHEAD**



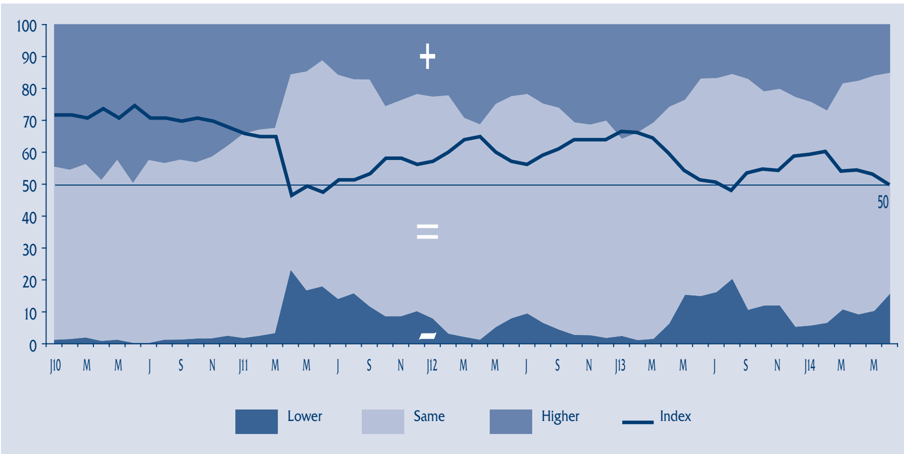

b. Expectations of investment in the following 6 months registered a level of 54 points in June and continues to be on the optimistic segment, although showing lower levels than in the previous months.

**Graph 30**
**INVESTMENT EXPECTATIONS ON YOUR COMPANY IN THE SIX MONTHS AHEAD**




c. Business expectations on the economic situation in the three months ahead declined to 50 points in June and show a neutral level.

**Graph 31**
**BUSINESS EXPECTATIONS ON THE SITUATION OF THE ECONOMY IN THE THREE MONTHS AHEAD**




d. The survey on economic expectations shows that economic agents have revised down their expectations of GDP growth in 2014. Thus, between April and July 2014, financial entities have revised down the GDP rate they expect from 5.4 to 4.8 percent; economic analysts have revised down their projections from 5.4 to 5.0 percent, and non-financial firms have revised them down from 5.2 to 5.0 percent.

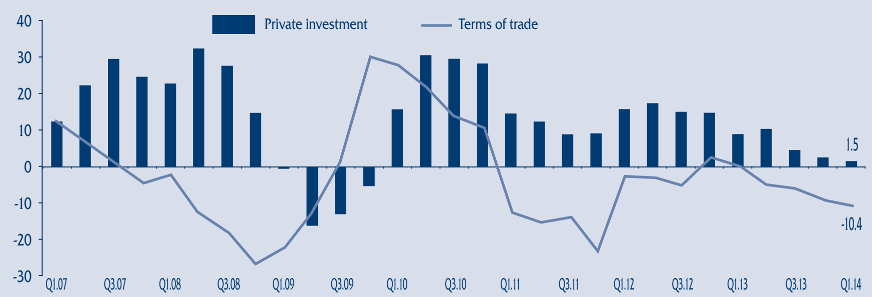
**Table 17**
**SURVEY ON MACROECONOMIC EXPECTATIONS: GDP GROWTH**
(% change)

| | Expectations about: | | |
|---|---|---|---|
| | IR Dec.13 | IR Apr.14 | IR Jul.14* |
| **Financial entities** | | | |
| 2014 | 5.6 | 5.4 | 4.8 |
| 2015 | 5.9 | 5.5 | 5.4 |
| 2016 | -.- | -.- | 5.2 |
| **Economic analysts** | | | |
| 2014 | 5.7 | 5.4 | 5.0 |
| 2015 | 6.0 | 5.7 | 5.7 |
| 2016 | -.- | -.- | 6.0 |
| **Non-financial firms** | | | |
| 2014 | 5.5 | 5.2 | 5.0 |
| 2015 | 5.8 | 5.5 | 5.0 |
| 2016 | -.- | -.- | 5.5 |

* Survey conducted during June 20, 2014.
IR: Inflation Report.

e. The slowdown observed in the pace of growth of private investment –whose growth rate has declined from 8.8 percent in Q1-2013 to 1.5 in Q1-2014– is associated with the evolution of terms of trade, which fell 10.4 percent in Q1-2014 and continue showing the declining trend observed since the second quarter of 2013.

**Graph 32**
**PRIVATE INVESTMENT AND TERMS OF TRADE**
(12 month % change)




Source: INEI.

Private investment projects announced to be carried out in the period of 2014-2016 amount to US$ 46 billion.

**Table 18**
**PRIVATE INVESTMENT PROJECTS ANNOUNCED**
(Million US$)

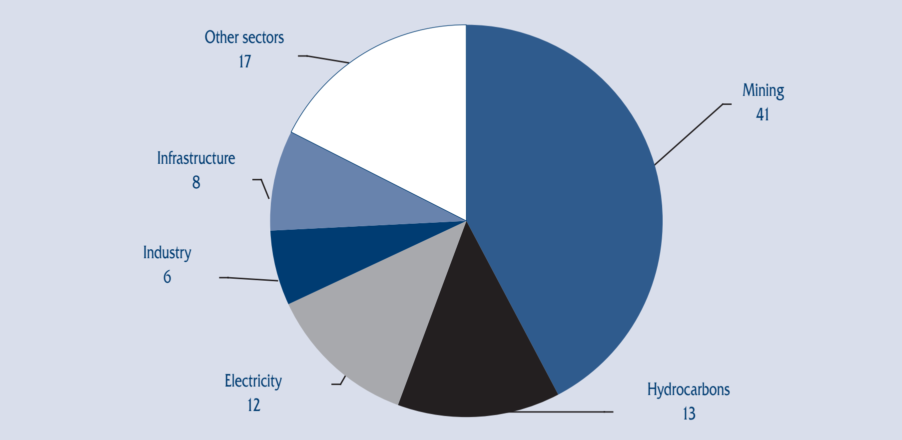
| | 2014-2016 | | |
|---|---|---|---|
| | IR Apr.14 | IR Jul.14 | Differences |
| Mining | 18,989 | 19,031 | 42 |
| Hydrocarbons | 5,589 | 6,226 | 637 |
| Electricity | 5,443 | 5,785 | 342 |
| Industry | 2,762 | 2,932 | 170 |
| Infrastructure | 3,627 | 3,763 | 136 |
| Other sectors | 7,425 | 8,192 | 767 |
| **Total** | **43,835** | **45,929** | **2,094** |

IR: Inflation Report.

Investment projects announced to be carried out in the **mining and hydrocarbons** sectors represent 54 percent of total investment announced for the period 2014-2016. Investments worth pointing out in the hydrocarbons sector include the investment announced by Repsol, operator of Lot 57 with a share of 53.8 percent, which plans to invest US$ 592 million in 2014-2018, as well as the investment in 2D seismic lines, and the sixth exploration phase that started in April this year which is estimated to bring US$ 174 million investment in a period of 24 months.

It should be pointed out that the subsidiary Petrobras Energia was sold to China National Petroleum (CNPC) at the end of 2013. The assets included in this transaction consist of 100 percent of the exploitation rights on Lot X, 46.16 percent of the rights on Lot 57, and 100 percent of the rights on Lot 58.

**Graph 33**
**FORESEEN INVESTMENT PROJECTS: 2014-2016**
(% share)



In the electricity generation sector, the concession of the 220 Kv Moyobamba-Iquitos Transmission Line was awarded to Consorcio Isolux Transmisora Peruana, integrated by Isolux Ingenería of Spain and Isolux of Mexico. This project, which will be implemented in 55 months, involves an estimated investment of US$ 434 million.

In the infrastructure sector, the Chinchero International Airport project was awarded in the month of April to Consortium Kuntur Wasi, integrated by Andino Investment Holding and Corporación América. The project includes the design, financing, construction, operation, and maintenance of the airport with an estimated investment of US$ 658 million. Moreover, the concession of General San Martín Port Terminal, which involves an investment of US$ 102 million, was awarded to Consorcio Paracas. The project consists of the design, construction, financing, maintenance, and exploitation of the terminal for a period of 30 years.

As for investment in other sectors, new investment plans of housing and office projects have been announced together with the initiation of new projects of expansion and redevelopment of shopping centers in different parts of the country.

**Table 19**
**MAIN PROJECTS TO BE IMPLEMENTED THROUGH CONCESSION ARRANGEMENTS IN 2014**
(Million US$)

| Estimated investment | |
|---|---|
| **A. Awarded** | **9,980** |
| Line 2 and Faucett Ave. - Gambetta Ave. of the Basic Network of the Metro of Lima and Callao | 5,168 |
| International Airport of Chinchero - Cusco (AICC) | 658 |
| Improvements of the National Energy Security and development of the South Peruvian Pipeline | 3,600 |
| 220 Kv Moyobamba - Iquitos Transmission Line and associated substations | 434 |
| General San Martín ( Pisco) Port Terminal | 102 |
| Cable cars to Kuelap | 18 |
| | |
| **B. To be called** | **1,012** |
| Main works and conduction of drinkable water supply for Lima | 400 |
| LNG Supply System for the Domestic Market | 250 |
| 220 Kv Azangaro - Juliaca Transmission Line and associated substations | 69 |
| Amazonía waterway | 69 |
| 220 kV and 60 kV Transmission Line and Nueva Lurin Substation 220/60 kV | 50 |
| Choquequirao Cable car | 54 |
| Chillon river water supply works | 45 |
| 220 kV Friaspata - Mollepata Transmission Line and Orcotuna Substation 220/60 kV | 44 |
| First stage substations Carapongo and associated line | 31 |
| | |
| **C. Total Projects (A) + (B)** | **10,992** |

Source: Proinversión.

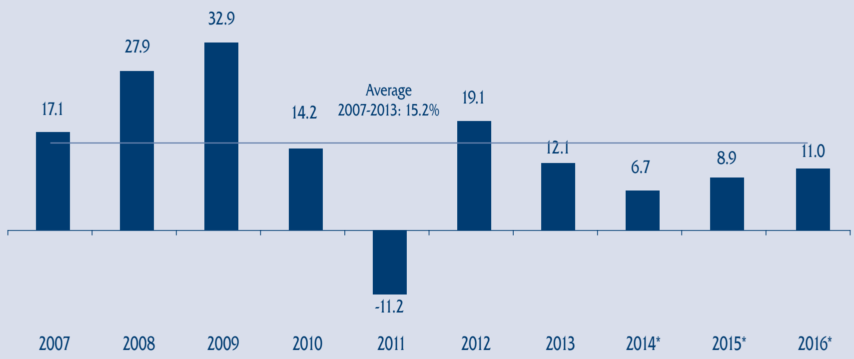
**Table 20**
**MAIN INVESTMENT PROJECTS ANNOUNCED: 2014-2016**

| SECTOR | COMPANIES | PROJECT |
|---|---|---|
| Mining | Freeport-Macmoran Copper | Expansion of Cerro Verde |
| | Aluminium Corp of China Ltd. (Chinalco) | Expansion of Toromocho |
| | Grupo Milpo | Expansion of Cerro Lindo and El Porvenir |
| | Shougang Corporation | Expansion of Marcona mine |
| | Compañía de Minas Buenaventura S.A.A. | Expansion of Colquijirca mine |
| | Volcan Compañia Minera S.A.A. | Expansion of Chungar mine |
| | Rio alto Mining Ltd. | La Arena (Phase II) |
| | Consorcio Mmg, Guoxin International Investment | Las Bambas |
| | Hudbay Minerals Inc.; Norsemont Mining Inc. | Constancia |
| | Anglo American Plc. | Quellaveco |
| | Minera Irl Limited | Ollachea |
| | Compañía de Minas Buenaventura S.A.A. | Tambomayo |
| | Hochschild Mining S.A. | Inmaculada |
| | Antares Minerals Inc. | Haquira |
| | Sulliden Gold Corp. | Shahuindo |
| | Andean American Mining Corp. | Invicta |
| | AQM Copper | Zafranal |
| | Hochschild Mining S.A. | Crespo |
| | Volcan Compañia Minera S.A.A. | Oxide-Stockpiles Pyrite-Alpamarca Stockpiles- Pallanga river |
| Hydrocarbons | Savia Perú S.A. | Lot Z-2B: Perforation, exploration and other investments |
| | Perenco | Exploration of Lot 67 |
| | Petrobras Energia Peru S.A; Repsol YPF S.A. | Exploration of Lot 39 (21 well) |
| | Karoon Gas Autralia; Vietnam American | Exploration: Lot Z - 38 |
| | Pluspetrol Perú Corp. S.A. | Exploration of Lots 88 and 56 |
| | Petrobras Energia Peru S.A; Repsol YPF S.A. | Lot 57 - Kinteroni |
| | Enagas;Transportadora de Gas del Perú S.A. | Expansion of gas and capacity of transportation |
| | Calidda Gas Natural del Perú | Supply System of LNG for the domestic market |
| | China National Petroleum Corporation | Exploration of Lot 58 and 2D seismic lines |
| | Sk Energy | Exploration of Lot z 46 |
| | Gran Tierra Energy; Petrolífera Petroleum | Exploration Oil, Well Bretaña Norte 95-2-1 XD |
| | Interoil | Improvement Lots III and IV |
| Electricity | Energía Azul S.R.L. | Hydroelectric Power Plant of Santa María |
| | Enersur; Kallpa Generación | Electric Node in the South of Peru |
| | Odebrecht S.A.C. | Hydroelectric Power Plant of Cerro de Chaglla |
| | Quimpac S.A.; Inkia Energy | Hydroelectric Power Plant of Cerro del Águila |
| | Odebrecht S.A.C. | Hydroelectric Power Plant of Chadin II |
| | Interconexión Eléctrica | Transmission Line 500 KV |
| | Consorcio Isolux Transmisora Peruana | Transmission Line Moyobamba-Iquitos |
| | Volcan Compañia Minera S.A.A. | Hydroelectric Power Plant of Belo Horizonte |
| | Gdf Suez | Hydroelectric Power Plant of Quitaracsa I |
| | Inevarante | Hydroelectric Power Plant of Acco Pucará |
| | Corsan-Corviam, Engevix, and Enex | Hydroelectric Power Plant of Molloco |
| | Termochilca S.A.C. | Thermal power: Santo Domingo de Olleros |
| | Mota Engil | Hydroelectric Power Plant of Marañón |
| | SN Power Perú S.A. | Hydroelectric Power Plant of Cheves |
| | Norwind | Wind energy park Cerro Chocan |
| | Genrent do Brasil Ltda. | Supply energy for Iquitos |
| Industry | Repsol YPF S.A. | Expansion of La Pampilla plant |
| | Corporación JR Lindley | Expansion and new plants |
| | Mitsubishi; Hochschild Mining S.A. | Phospates projects |
| | Grupo Hochschild | New cement plant in Piura |
| | Grupo de Pilkington Limited | Manufacture plant of float glasses |
| Infrastructure | Consorcio Nuevo Metro de Lima | Line 2 Network Metro Lima (Electric Train) |
| | Odebrecht S.A.C. | New highways in Lima |
| | Consorcio Consierra II | Longitudinal de la Sierra road project, Section 2 |
| | Grupo Ronmero | Expansion of Matarani port |
| | Covisol | Trujillo-Sullana: Sol Highway |
| | OAS S.R.L. | Parque Rimac express way |
| | Graña y Montero S.A. | South express way |
| | Covinca | Expansion of Panamericana Sur express way |
| Other sectors | Grupo Telefónica | 4G mobile phone service |
| | Tv Azteca - Tedai | National Fiber Optics Backbone |
| | Grupo Falabella | Expansion and New shopping centers |
| | Grupo Interbank | Expansion and New shopping centers: Real Plaza |
| | Inversiones Centenario S.A.A.; Parque Arauco | Shopping center Camino Real |
| | Graña y Montero Vivienda | Real estate |
| | Holding Banmédica | Health center: San Felipe |
| | Besalco S.A. | Real estate |
| | Edifica | Residential projects: Piura, Arequipa, and Lima |
| | Inmobiliaria S.A | Corporate offices and houses |
| | Ripley | Expansion and New stores |
| | Grupo San Pablo | Expansion of new health centers: Lima and regions |
| | Grupo Brescia | Expansion of health center / Strip center |

Source: Press media and business information.

24. **Public investment** grew 0.5 percent in the first half of 2014, a lower growth rate than the one recorded in the same period of 2013 (22.3 percent), which is explained by lower investment spending in regional and local governments. The growth projected for public investment in 2014 and 2015 is revised down taking into account lower levels of spending, especially in sub-national governments.

**Graph 34**
**PUBLIC INVESTMENT: 2007-2016**
(Real % change)

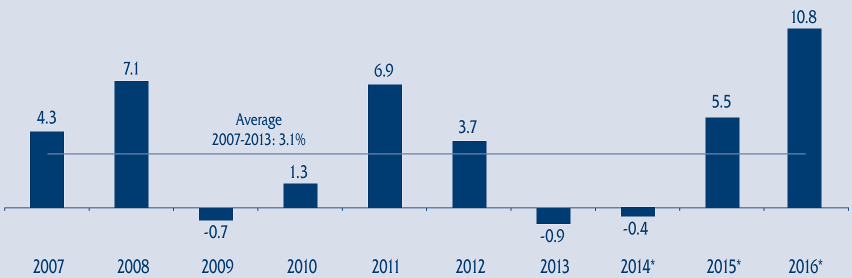



* Forecast.

25. In the first half of 2014 **real exports** of goods and services would register a decrease of 3.6 percent as a result of a drop in exports of traditional products due mainly to lower exports of gold, copper, crude oil and oil derivatives. On the other hand, the exports of non-traditional products, such as farming and fishery products, would show positive growth rates, offsetting in part the decline seen in the volume of traditional export products.

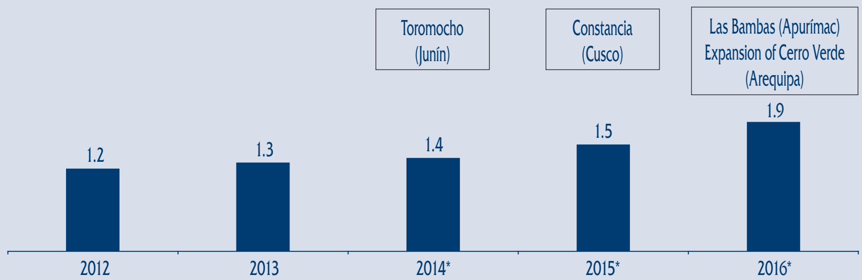
A decrease of 0.4 percent is projected in real exports in 2014 taking into account the decline in exports of traditional products, in line with the trend foreseen in mining production and in line with the lower growth anticipated in the global economy. In 2015 exports would recover, but to a lesser extent than expected in our previous report considering the effect of a possible El Niño event on fishmeal exports, as well as the delay in the implementation of Las Bambas copper project. In 2016, exports are estimated to grow 10.8 percent, mainly as a result of the expansion of copper production due to the onset of operations of Las Bambas mining project that year.

**Graph 35**
**EXPORTS OF GOODS AND SERVICES: 2007-2016**
(Real % change)




* Forecast.

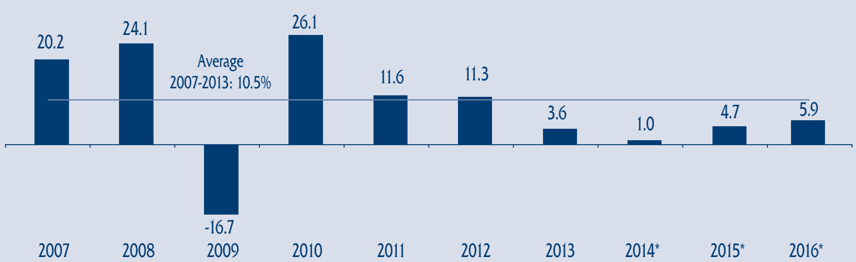
**Graph 36**
**COPPER PRODUCTION**
(Million FMT)




* Forecast.

26. **Imports** of goods and services would fall 1.1 percent in the first half of 2014, due mainly to the lower dynamism of imports of industrial supplies and capital goods. In 2014 imports would grow 1.0 percent, recovering thereafter in 2015 with a growth rate of 4.7 percent –a lower rate than estimated in the previous report–, which is consistent with the GDP growth forecast for that year. In 2016 imports are estimated to grow 5.9 percent, in line with the foreseen evolution of domestic demand.

**Graph 37**
**IMPORTS OF GOODS AND SERVICES: 2007-2016**
(Real % change)




* Forecast.

**Box 1**
**IMPACTS OF EL NIÑO EVENTS**

The El Niño episodes of 1982-83 and 1997-98 are considered to be the most intense events that have occurred recently in the country. Although the magnitude in both episodes is considered to have been severe, the impact of the 1997-98 El Niño event was lower because it did not cause a drought in the South of the country, which reduced agricultural losses. Furthermore, because it was forecast earlier, prevention works were carried out anticipating its occurrence which partially mitigated the negative impacts of the event.

## I. The 1982-83 El Niño Event

The impact of the 1982-83 El Niño event on production sectors is estimated at 5.3 percent of GDP, agriculture being the most strongly affected sector due to the occurrence of floods in the North of the country and a strong drought in the South.

**FALL IN PRODUCTION BY EL NIÑO 1982-1983**

| | GDP 1983 | Contribution to growth | |
|---|---|---|---|
| | % chg. | Weather conditions | Rest |
| Agriculture and livestock | -7.8 | -1.5 | 0.5 |
| Fishing | -40.0 | -0.3 | -0.1 |
| Mining | -7.4 | -0.4 | -0.3 |
| Manufacturing | -17.3 | -1.1 | -2.8 |
| Construction | -21.4 | -.- | -1.2 |
| Government | 2.3 | -.- | 0.2 |
| Other sectors | -11.5 | -2.0 | -2.7 |
| **GDP** | **-11.8** | **-5.3** | **-6.5** |

Source: BCRP.

Damages to infrastructure were estimated at US$ 456 million –2.5 percent of GDP–, the most affected sectors being transport and communications and the sector of hydrocarbons. Nationwide damages in the former included 2,600 kilometers of roads, 47 bridges, and 4 airports, while damages in the latter included the destruction of several sections of the North Peruvian Oil Pipeline and the disruption of oil production.

**DAMAGES TO INFRASTRUCTURE 1982-1983**

| Sector | Million US$ | % GDP |
|---|---|---|
| Agriculture and livestock | 79 | 0.4 |
| Fishing | 7 | 0.0 |
| Industry | 2 | 0.0 |
| Energy | 13 | 0.1 |
| Hydrocarbons | 113 | 0.6 |
| Transportation and Communications | 189 | 1.0 |
| Tourism | 1 | 0.0 |
| Health and sanitation | 1 | 0.0 |
| Education | 6 | 0.0 |
| Houses | 44 | 0.2 |
| Internal | 1 | 0.0 |
| **Total** | **456** | **2.5** |

Source: INDECI.

**II. The 1997-98 El Niño Event**

According to estimates of the Andean Development Corporation (CAF), the economic impact of the 1997-98 El Niño Event on the country's production sectors amounted to US$ 1.62 billion –2.9 percent of GDP–, the sectors of industry and agriculture being the most severely affected.

**IMPACT OF EL NIÑO EVENT 1997-1998**
(% GDP 1998)

| | |
|---|---|
| **Production sectors:** | **2.9** |
| Agriculture and livestock | 1.1 |
| Fishing | 0.0 |
| Mining | 0.1 |
| Industry | 1.2 |
| Commerce | 0.5 |

Source: CAF and CEPAL.

According to INEI, the economic impact of this event on the basic infrastructure of the State in all the sectors was S/. 3.61 billion (equivalent to 2.2 percent of GDP in 1998 and to S/. 5.4 billion in 2013).

**DAMAGES TO INFRASTRUCTURE 1997-98**
(Million Nuevos Soles)

| | |
|---|---|
| **Total** | **3,608** |
| *Of which:* | |
| Transportation, Communications, Housing and Construction | 1,266 |
| Agriculture | 702 |
| Education | 598 |
| Presidency | 462 |

Source: INEI.

The **sector of transport, communications, housing, and construction** was the most affected sector, with damages amounting to S/. 1.27 billion.

**INFRASTRUCTURE AFFECTED 1997-98**

| | Amount | | Valuation |
|---|---|---|---|
| | Units | Kilometers | (Million S/.) |
| **Total** | **228** | **6,578** | **1,266** |
| I. Bridges 1/ | 146 | - | 194 |
| II. Roads and highways,1/ | - | 6,395 | 850 |
| Cold pavement | | 441 | 161 |
| Warm pavement | | 622 | 385 |
| Surface treatment | | 26 | 7 |
| Firmly pavement | | 4,683 | 281 |
| Non-firmly pavement | | 623 | 16 |
| III. Railways | 57 | 183 | 212 |
| IV. Airports | 7 | - | 10 |
| V. Communications | 18 | - | 0 |

1/ Valuation corresponds to infrastructure before El Niño event (replacement value). The information corresponds to May 1998.
Source: Ministry of Transport, Communication, and Construction, and INEI.

El Niño event affected 146 bridges across the country, with damages being estimated at S/. 194 million and the departments of Cusco (24 bridges damaged), Ancash (23 bridges damaged), and Piura (19 bridges damaged) being the most strongly affected ones. This episode of El Niño also affected 6.4 thousand kilometers of roads, with damages estimated at S/. 850 million. Ancash was the department with more kilometers of roads affected (980 km), followed by Cusco (796 km.), Junín (614 km.), and Arequipa (536 km), among others. However, in terms of value, damages reached the highest levels in the departments of Lambayeque (S/. 291 million), Piura (S/. 116 million); and Cajamarca (S/. 105 million).

In other sectors, the major infrastructure damage was observed in the sector of agriculture, with damages amounting to S/. 702 million mainly as a result of lost and affected areas, and the sector of education, with damages in 2,873 affected school premises being estimated at a total of S/. 598 million.

**Box 2**

**TERMS OF TRADE, PRIVATE INVESTMENT, AND ECONOMIC ACTIVITY**

Private sector investment is one of the main components of the output and aggregate demand. In relative terms, the ratio of private investment to GDP rose from 14 percent of GDP in 2004 to 21 percent of GDP in 2013. Private investment is also one of the most volatile components of GDP because its evolution is associated both with business expectations regarding the future evolution of the economy and with the availability of resources and financial sources required to finance the projects of enterprises.

Several theoretical explanations link the conduct of private investment to fluctuations in aggregate economic activity. For example, the investment accelerator model assumes that the amount of capital desired is a constant fraction of the output and predicts that investment is proportional to GDP growth. Other approaches recognize that the balance of capital conforms slowly towards its desired level, since projects take time to be approved, financed, and implemented.

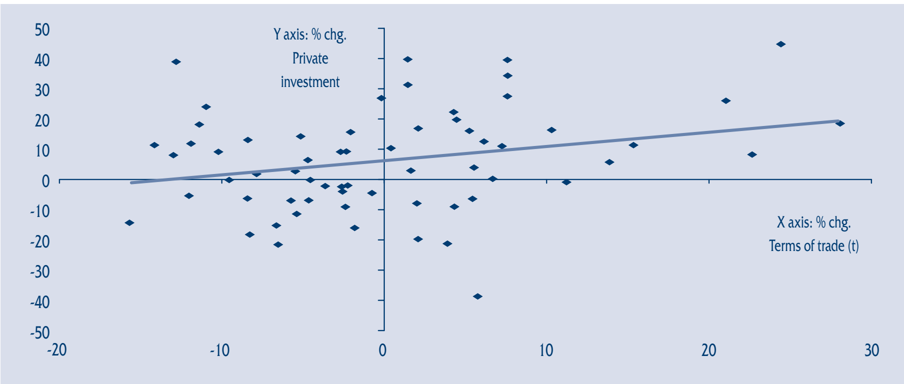
Fluctuations in the terms of trade also influence investment. First of all, the terms of trade determine the purchasing power of exports and therefore they affect a country's level of wealth. Greater wealth increases the capacity of consumption in the economy, influencing business decisions to expand the capacity of their facilities. A second mechanism operates through the higher profits that enterprises can obtain. An increase in the expected price of exports is a major determinant of the expected return on investment for companies in the export sector. Therefore, increases in terms of trade also generate an expansion of demand for investment in these sectors. Third, when enterprises use imported capital goods or inputs in their production processes –in the case of crude oil, for example–, rises in the terms of trade generated by a fall in the prices of imports increase the profitability of operations and investments.

Conversely, in periods with sharp declines in terms of trade we see important decreases in economic activity, which reduces the revenues of companies, deteriorate business expectations, and can even hinder credit conditions, all of which may have a negative impact on private investment in the following periods.

In this regard, Aquino and Espino[1] (2013) find that 25 percent of investment volatility can be explained by unforeseen changes in export prices. According to other estimates, the elasticity of private investment relative to terms of trade show positive values within the range of 0.2 and 0.5, as we shall see further below.

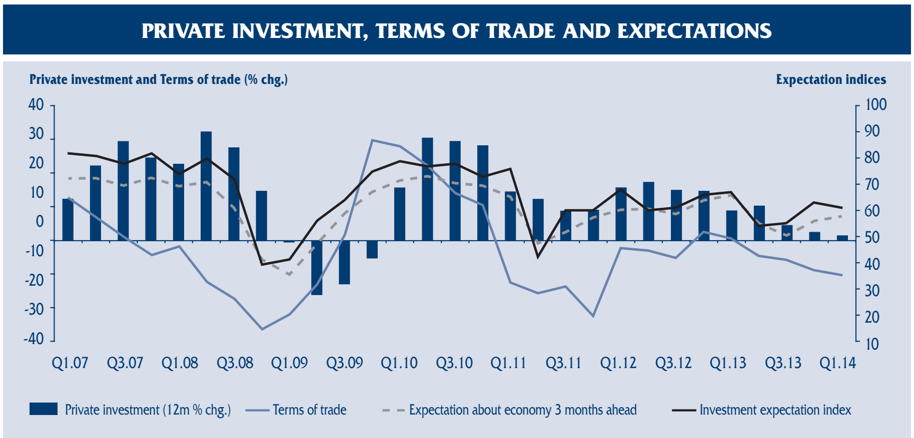
Although terms of trade have increased significantly over the past decade, their behavior has been volatile, with growth rates of up to 28 percent in 2006 and falls of up to 11 percent in 2008. A moderation of growth has been observed since 2011 and negative growth rates have been registered in the last two years. The graphs below show that there is a direct relationship between private investment fluctuations and variations in terms of trade. Private investment grew 11 percent on average in the period 2002-2012, in the context of an annual increase of 6 percent in the terms of trade. In 2013 private investment grew 6.4 percent –a lower rate than in 2012 (15.6 percent)– while terms of trade fell 4.7 percent. Using a regression with annual data since 1950, it is estimated that an increase of one percentage point in the rate of growth of the terms of trade in a given year would increase the growth of private investment by about 0.5 percentage points in the same year.

**PRIVATE INVESTMENT AND TERMS OF TRADE**




The relationship between terms of trade and private investment remains positive when higher-frequency data are used. We can also incorporate other variables related to the evolution of business sentiment, such as the index of economic expectations or expectations of demand 3 months ahead, obtained on the basis of the BCRP Survey of Macroeconomic Expectations, and the index of investment expectations 6 months ahead, based on the survey carried out by Apoyo. These measurements are dissemination indices, with values ranging between 0 and 100. A value of 50 is considered neutral, whereas a value above (below) 50 corresponds to optimistic (pessimistic) expectations about the state of the economy in the case of the first indicator and to an acceleration (deceleration) of investment in the case of the second indicator. The following graph shows the evolution of these variables. Not only was a decline observed in terms of trade in 2013, but also a deterioration of expectations. These factors have reflected in the slowdown of private investment, which shows lower growth rates after having grown at two-digit rates in previous years.

1 Aquino and Espino (2013), "Terms of Trade and Current Account Fluctuations: a Vector Autoregression Approach", DT. N° 2013-008, Banco Central de Reserva del Perú.




Using a regression which includes economic expectations of indicators three months ahead, the expected rate of growth of investment 6 months ahead –as measured by Apoyo–, and the rate of growth in terms of trade as explanatory variables, it is estimated that an increase of one percentage point in the rate of growth of terms of trade would increase the growth of private investment by about 0.2 percentage points in the quarter ahead. Moreover, the effect of a variation of 1 percentage point in the indices of economic expectations 3 months ahead and in the expected levels of investment 6 months ahead would be a growth of 0.3 and 0.7 percentage points in private investment a quarter ahead and two quarters ahead, respectively.

The terms of trade have also shown a significant correlation with the evolution of GDP, particularly in recent years. Castillo and Salas[2] (2012) found that the increase in the terms of trade account for 2.2 percentage points of the average GDP growth of 5.8 percent observed in the period 2001-2007.

The terms of trade affect GDP through various channels, the most important operating through the income effect they generate in aggregate consumption and through the impact they have on profitability in the export sector, which affects private investment. These impacts are greater when the changes in terms of trade are more persistent, because the wealth effect generated in these cases increases. Moreover, in periods of high volatility these effects are enhanced given that greater uncertainty about the future evolution of export prices makes agents more cautious in their spending and investment decisions, which enhances the impact of terms of trade on economic activity.

Using a similar method to the one used in the works of Aquino and Espino (2013), we have re-estimated the impact of terms of trade on economic activity. In addition to the terms of trade, the model estimated includes GDP, gross fixed investment, and private consumption in seasonally adjusted quarterly growth rates. The results of the analysis show that a reduction of 10 percentage points in terms of trade would generate a decline of 1.4 percentage points in GDP growth and a decline of 4.6 and 0.9 percentage points in investment and private consumption, respectively, in a period of one year.

2 See Castillo and Salas (2012), "Los términos de intercambio como impulsores de fluctuaciones en economías en desarrollo: estudio empírico". Premio Rodrigo Gómez, 2010, CEMLA.

| MEDIUM IMPACT OF ONE INCREASE OF 10% ON THE TERMS OF TRADE | In 1 year | 2 years |
|---|---|---|
| GDP | 1.4 | 1.7 |
| Consumption | 0.9 | 1.2 |
| Investment | 4.6 | 5.9 |

Memo: Results are generated using VAR model, with quarterly growth rate in terms of trade , GDP, investment, and consumption, with 2 lags.

Additionally, this method allows us to make a historical breakdown of GDP and investment and to identify the importance of terms of trade in its evolution. As the table below shows, the terms of trade have had a positive contribution to the evolution of GDP and investment, especially prior to 2008, when they contributed by nearly 3 percentage points to the growth of investment and by 1 percentage point to GDP growth, whereas their contribution was strongly negative during 2009, when the terms of trade fell significantly. The estimates suggest that the contribution of terms of trade to GDP growth in 2013 would have been negative by 0.5 percentage points and that their contribution to investment would have negative by 1.1 percentage points.

**CONTRIBUTIONS FROM TERMS OF TRADE TO GDP GROWTH AND INVESTMENT**

| | Total investment | | GDP | |
|---|---|---|---|---|
| | Observed | Terms of trade contribution | Observed | Terms of trade contribution |
| 2004 | 4.6% | 2.3% | 5.0% | 0.8% |
| 2005 | 12.1% | 1.9% | 6.3% | 0.7% |
| 2006 | 18.3% | 4.6% | 7.5% | 1.7% |
| 2007 | 21.3% | 2.1% | 8.5% | 0.6% |
| 2008 | 24.6% | -2.3% | 9.1% | -1.0% |
| 2009 | -1.6% | -9.6% | 1.0% | -3.2% |
| 2010 | 23.1% | 2.0% | 8.5% | 0.8% |
| 2011 | 6.0% | 1.7% | 6.5% | 0.6% |
| 2012 | 16.3% | -0.7% | 6.0% | -0.2% |
| 2013 | 7.6% | -1.1% | 5.8% | -0.5% |

In summary, the conclusion of the studies carried out is that a decline of 10 percentage points in terms of trade would cause a contraction of between 5 and 8 percentage points in investment and that the pace of GDP growth would decline by 1 to 2 percentage points.

**Box 3**

**MEASURES TO PROMOTE INVESTMENT**

In the first two weeks of July 2014, the Government enacted legislation containing a series of measures aimed at stimulating greater dynamism in economic activity within a multi-sector strategy. These measures, which are intended to improve the conditions of aggregate supply, encourage investment, and reduce cost overruns to economic activity, include the following: (i) Law 30230 (which establishes tax measures and simplifies procedures and permits to promote and encourage investment in the country); and (ii) Law 30222 (which amends the Safety and Health at Work Act).

Measures contained in Law 30230 that are worth highlighting include the following:

i. Administrative measures to encourage investment:

- Foster transparency in the administrative procedures of public agencies at the national and subnational levels.

- Special procedures are established for the physical and legal clearing of land/property for investment projects and to facilitate the implementation of road infrastructure. The regulations authorize COFOPRI and Superintendencia Nacional de Bienes Estatales to carry out legal procedures to declare the physical and legal clearing of properties involved in priority public or private investment projects.

- Provisions to facilitate private investment in the real estate sector. For example, environmental impact studies (EIS) will be no longer required for the construction of homes, offices and shopping areas.

- The framework law of operation licenses and permits is amended. A business may be issued a license to operate even if it has not got a safety technical inspection certificate (ITSE), provided that the inspector's report was favorable and that the municipality has not issued the corresponding ITSE certificate within the established period of 3 business days. Stands inside a food market are only required a safety technical inspection after they start operating.

- The authorization of the Ministry of Culture will not be required to obtain an operation license for business activities in buildings considered monuments if the Ministry of Culture has been involved in the stages of previous works in this building.

- Fund MIPYME is established to strengthen the productive development of the micro, small and medium-sized enterprises.

- Provisions are enacted to allow the extra-judicial recovery of State properties. A special mechanism is created for the recovery of State-owned plots with the support of law enforcement agents. State officials are required to initiate actions for the recovery of real estate at risk. In addition, the possibility that claims be filed in connection with the expropriation of infrastructure deemed of national interest is eliminated. Finally, expropriation procedures which are currently being directly negotiated are allowed to continue.

- The revenues obtained from fines by the control institutions of the Executive Branch are now considered regular resources.

- Regulations to improve the monitoring and promotion of investment.

ii. Environmental Measures:

- Reduction of the fines that the Environmental Evaluation and Control Agency (Organismo de Evaluación y Fiscalización Ambiental – OEFA) can impose. The OEFA will give priority to the correction of environmental offences during 3 years and the amount charged as penalties will not exceed 50 percent of the respective fine, with some exceptions.

- The law specifies the hierarchy of the type of regulation required to declare an area as a protected areas. Thus, a Reserved Zone is established by a Supreme Decree, with the approval vote of the Council of Ministers.

- The law also specifies the hierarchy of the type of regulation required to declare areas as environmental economic zones (Zonificación Ecológica Económica - ZEE), as well as the non-exclusive nature of activities in an area. Thus, the national policy of Territorial Management (OT) is approved by Supreme Decree with the approval vote of the Council of Ministers. Neither the ZEE nor the OT assign specific uses to areas or exclude uses.

- Any binding or non-binding opinions of other public sector entities –other than the entity responsible for approving the EIS– shall be issued within a period of not more than 45 business days.

Law 30222 also establishes the following labor-related measures:

- The fines that the SUNAFIL can impose are reduced and priority is given to prevention actions and correction of offending behavior for a period of 3 years. The fines imposed will not exceed 35 percent of the respective fine.

- The frequency of medical examinations is reduced to every two years and medical examinations at the termination of employment are declared optional. Workers who will perform high risk tasks are required to take medical examinations when their employment period starts.

- Criminal sanctions are reduced. The employer will be liable for failures considered intentional and for which the worker is not responsible.

# III. Balance of Payments

### Trade Balance

27. Between January and June, the trade balance showed a deficit of US$ 2.57 billion, higher than the one registered in the same period of 2013, due to the decline of exports (down 12.5 percent) resulting from both lower prices and lower volumes of exports. This was in part offset by a reduction of 2.1 percent in imports.

28. The projected balance in the trade balance in 2014 is revised to a deficit of US$ 2.6 billion due to lower exports –exports would drop 5.2 percent relative to the projection of April–, partially offset by lower imports (down 1.2 percent relative to the projection of April). The main factor accounting for the downward revision of the balance in the trade balance is the decline in the volume of exports of traditional products, which in April was projected to register an increase of 1.9 percent and is now expected to decrease by 3.8 percent taking into account the data available until May. The decline in shipments of gold from those projected in the Inflation Report of April are explained by the lower content of mineral obtained in the major gold mines and by lower volumes of this metal obtained from informal production.

**Table 21**
**TRADE BALANCE**
(Million US$)

| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **EXPORTS** | **20,281** | **42,177** | **17,738** | **42,006** | **39,836** | **45,446** | **41,846** | **46,751** |
| *Of which:* | | | | | | | | |
| Traditional products | 14,999 | 30,954 | 12,223 | 30,050 | 28,105 | 32,569 | 29,259 | 32,849 |
| Non-traditional products | 5,137 | 10,985 | 5,409 | 11,700 | 11,495 | 12,598 | 12,333 | 13,625 |
| **IMPORTS** | **20,758** | **42,217** | **20,313** | **42,952** | **42,447** | **45,183** | **44,044** | **46,952** |
| *Of which:* | | | | | | | | |
| Consumer goods | 4,154 | 8,837 | 4,248 | 9,084 | 9,113 | 9,646 | 9,569 | 10,278 |
| Inputs | 9,608 | 19,512 | 9,252 | 18,953 | 18,888 | 19,699 | 19,071 | 20,097 |
| Capital goods | 6,901 | 13,654 | 6,618 | 13,980 | 13,681 | 14,703 | 14,268 | 15,428 |
| **TRADE BALANCE** | **-477** | **-40** | **-2,574** | **-945** | **-2,611** | **263** | **-2,198** | **-202** |

IR: Inflation Report.
* Forecast.

**Graph 38**
**TRADITIONAL EXPORTS: 2014**
(% change)

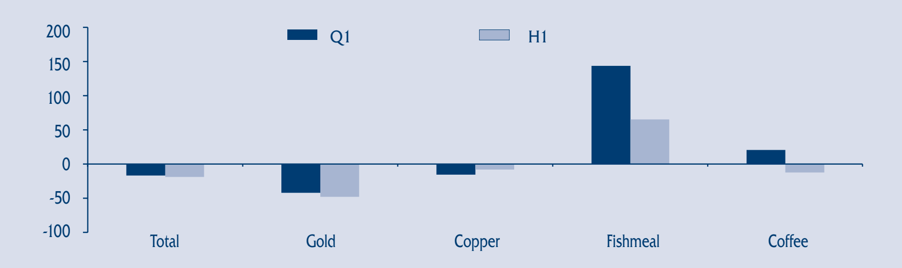



**Table 22**
**TRADE BALANCE**
(% change)

| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **1. Value:** | | | | | | | | |
| Exports | -10.0 | -9.0 | -12.5 | -0.4 | -5.6 | 8.2 | 5.0 | 11.7 |
| Traditional products | -12.0 | -11.1 | -18.5 | -2.9 | -9.2 | 8.4 | 4.1 | 12.3 |
| Non-traditional products | -3.2 | -1.9 | 5.3 | 6.5 | 4.6 | 7.7 | 7.3 | 10.5 |
| Imports | 6.0 | 2.6 | -2.1 | 1.7 | 0.5 | 5.2 | 3.8 | 6.6 |
| **2. Volume:** | | | | | | | | |
| Exports | -7.8 | -3.8 | -4.5 | 2.9 | -1.0 | 8.3 | 5.2 | 11.5 |
| Traditional products | -9.5 | -4.4 | -8.4 | 1.9 | -3.8 | 9.2 | 4.6 | 13.1 |
| Non-traditional products | -2.2 | -1.5 | 4.4 | 6.0 | 3.7 | 6.0 | 6.2 | 7.2 |
| Imports | 6.4 | 3.5 | -1.7 | 2.2 | 0.4 | 5.7 | 4.4 | 5.9 |
| **3. Price:** | | | | | | | | |
| Exports | -2.4 | -5.5 | -8.4 | -3.2 | -4.6 | -0.1 | -0.2 | 0.2 |
| Traditional products | -2.8 | -7.0 | -11.0 | -4.7 | -5.6 | -0.8 | -0.5 | -0.7 |
| Non-traditional products | -1.0 | -0.4 | 1.2 | 0.5 | 0.9 | 1.6 | 1.1 | 3.0 |
| Imports | -0.4 | -0.8 | -0.5 | -0.4 | 0.1 | -0.5 | -0.6 | 0.6 |

IR: Inflation Report.
* Forecast.

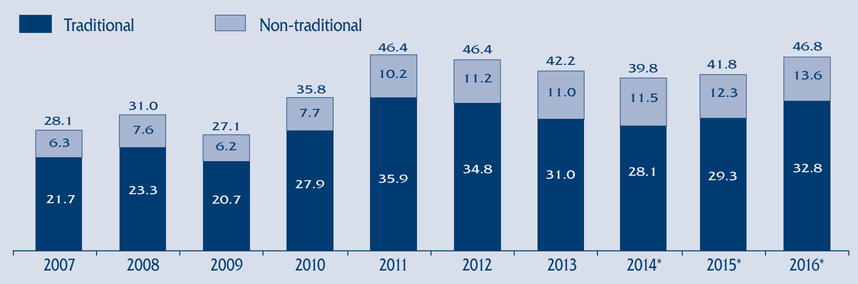
29. Exports in **2014** and **2015** would amount to US$ 39.8 billion and US 41.8 billion, respectively, both amounts being lower than those estimated in our April report (US$ 42.0 and US$45.4 billion, respectively). This downward revision is explained primarily by lower mining exports estimated for both years, as well as by the effect of lower sales of fishery products in 2015 considering the possible effects of an El Niño episode.

The projection for 2014 considers a lower gold production as a result of the effect of interdiction measures in Madre de Dios, as well as due to the lower grades of gold obtained in the mineral mined in some important mines in operation. Lower grades of mineral are also expected in copper mining, even though an increasing pace is considered in the production of copper and copper exports from Toromocho (Junín) as from the second half of the year when this mining project is expected to reach full capacity. Lower exports are foreseen for 2015 given that project Las Bambas (Apurímac) is now considered to start operations only in 2016, whereas in our previous report it was expected to start operating in 2015.

A recovery of mining exports is expected in **2016** associated with the onset of operations in projects such as Las Bambas and with increased estimated copper output at Cerro Verde as a result of the expansion of its mining unit in Arequipa. Furthermore, higher shipments of fishery products are also expected in 2016 assuming that climatic conditions will normalize entirely.

In line with the lower global growth projected, the growth rate of non-traditional exports in **2014** has been revised down, the smaller volumes of exports of iron and steel products, textiles, and chemicals. In **2015** and **2016** exports are expected to show a rising path both in terms of volumes –associated with the expected recovery of external demand which would favor a recovery in shipments of textiles and iron and steel products– and in term of prices.

**Graph 39**
**EXPORTS OF GOODS: 2007-2016**
(Billion US$)

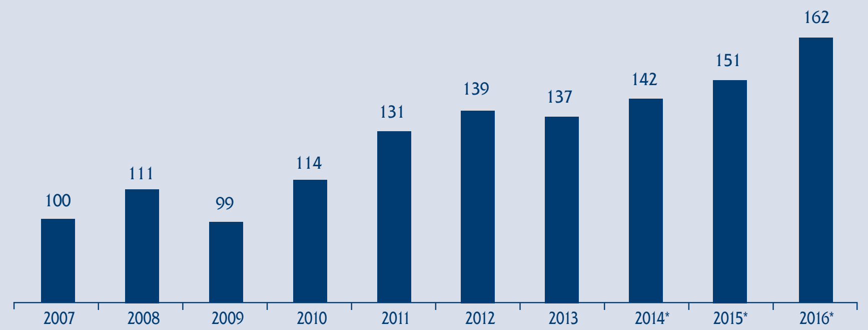



Memo: Total exports also includes other exports.
* Forecast.

**Graph 40**
**VOLUME OF COPPER EXPORTS**
(Index 2007=100)


* Forecast.

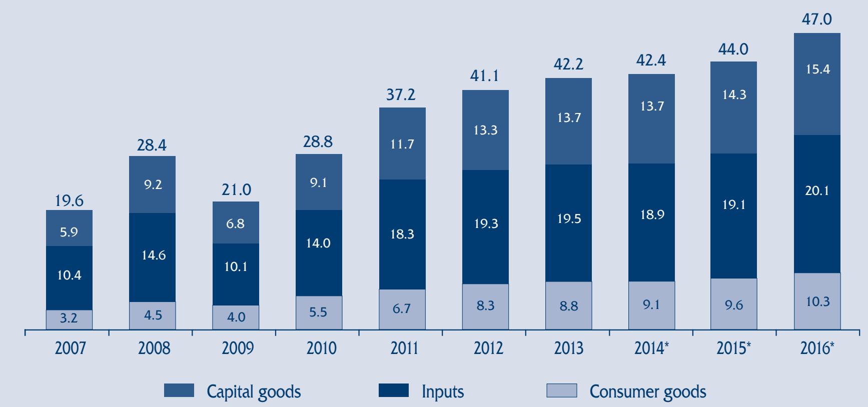
**Graph 41**
**NON-TRADITIONAL EXPORTS VOLUME**
(Index 2007=100)




* Forecast.

30. Imports in **2014** are estimated to amount to US$ 42.4 billion, which would imply a growth of 0.4 percent in terms of volume from 2013. This growth would be lower than the one expected in April due to slower growth in imports of capital goods, in line with the slowdown observed in the growth of domestic demand, offset in part by the slight increase expected in import prices in the year. In **2015** imports are foreseen to reach US$ 44.0 billion, which is consistent with a growth rate of 4.4 percent in terms of volume –less than anticipated in the report of April– due to slower-than-expected growth of imports of industrial inputs and capital goods, in line with the projected growth of investment. On the other hand, imports in **2016** which would total US$ 47.0 billion, would grow 6.6 percent.

**Graph 42**
**IMPORTS OF GOODS: 2007-2016**
(Billion US$)

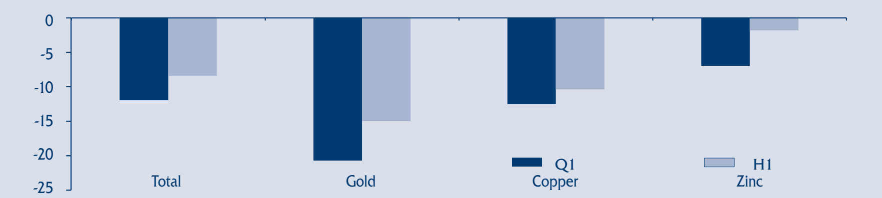



Memo: Total imports also includes other imports.
* Forecast.

## Terms of Trade

31. In the first six months of 2014, the terms of trade index dropped by 8.0 percent relative to the first six months of 2013, although the level of terms of trade was 3.0 percent higher than the average level in the period 2004-2013. The index of export prices fell 8.4 percent, while the index of import prices fell 0.5 percent compared to the same period of 2013. The export product which showed the greatest price drop was gold, this price reduction being associated with less tensions between Russia and Ukraine and with less market uncertainty.

**Graph 43**
**PRICE OF EXPORTS INDEX: 2014**
(% change)




Source: Bloomberg.

32. The variation projected in terms of trade in 2014 has been revised from -2.8 to -4.7 percent, whereas on the other hand an increase of 0.4 percent is projected for 2015. The projected average price of copper in 2014 has been revised up from US$ 3.09 per pound to US$ 3.15 per pound, in line with the recovery of copper in Q2, while the projected price of gold has been revised down from US$ 1,310 per ounce to US$ 1,288 per ounce since the impacts of geopolitical tensions and lower world demand are expected to be temporary.

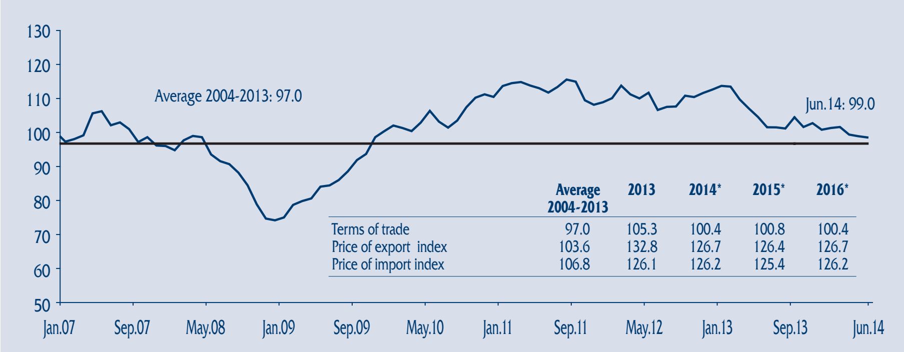
The international prices of imports would rise by 0.1 percent on average as a result of higher oil prices.

**Table 23**
**TERMS OF TRADE: 2012-2016**
(Annual average data)

| | 2012 | 2013 | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | | | Jan-Jun | IR Apr. 14 | IR Jul. 14 | IR Apr. 14 | IR Jul. 14 | IR Jul. 14 |
| **Terms of trade** | **-2.1** | **-4.7** | **-7.9** | **-2.8** | **-4.7** | **0.3** | **0.4** | **-0.4** |
| **Price of exports** | **-2.2** | **-5.5** | **-8.4** | **-3.2** | **-4.6** | **-0.1** | **-0.2** | **0.2** |
| *Copper (US$ cents per pound)* | 361 | 332 | 314 | 309 | 315 | 308 | 315 | 315 |
| *Zinc (US$ cents per pound)* | 88 | 87 | 93 | 92 | 95 | 93 | 95 | 95 |
| *Lead (US$ cents per pound)* | 94 | 97 | 95 | 95 | 97 | 96 | 99 | 99 |
| *Gold (US$ per ounce)* | 1,670 | 1,411 | 1,291 | 1,310 | 1,288 | 1,300 | 1,280 | 1,280 |
| **Price of imports** | **-0.2** | **-0.8** | **-0.5** | **-0.4** | **0.1** | **-0.5** | **-0.6** | **0.6** |
| *Oil (US$ per barrel)* | 94 | 98 | 101 | 98 | 101 | 89 | 93 | 88 |
| *Wheat (US$ per ton)* | 276 | 266 | 262 | 276 | 263 | 278 | 265 | 266 |
| *Maize (US$ per ton)* | 273 | 235 | 175 | 187 | 175 | 194 | 181 | 181 |
| *Soybean oil (US$ per ton)* | 1,125 | 992 | 865 | 877 | 877 | 883 | 902 | 900 |

* Forecast.

**Graph 44**
**TERMS OF TRADE INDEX: JAN.07 - JUN.14**
(2007=100)




| | Average 2004-2013 | 2013 | 2014* | 2015* | 2016* |
|---|---|---|---|---|---|
| Terms of trade | 97.0 | 105.3 | 100.4 | 100.8 | 100.4 |
| Price of export index | 103.6 | 132.8 | 126.7 | 126.4 | 126.7 |
| Price of import index | 106.8 | 126.1 | 126.2 | 125.4 | 126.2 |

* Forecast.

**Graph 45**
**TERMS OF TRADE: 2001-2016**
(% change)


* Forecast.

## Copper

33. In the past three months the price of **copper** reversed part of the drop it had registered in Q1, recovering from a minimum low in the year of US$ 2.92 per pound on Thursday, March 20, and closing June with a monthly average price of US$ 3.09 per pound.

The partial recovery of the copper price is explained by the fact that the supply surplus estimated at the beginning of the year did not occur. On the contrary, the market remained tight after registering a deficit of production in Q1[3] and a fall in inventories on global metal exchange markets. In addition to this, it is estimated that the Chinese Government has bought copper for the equivalent of the surplus projected for this year to increase its strategic reserves.

3 As reported by the International Copper Study Group (ICSG) on June 23, 2014.

Despite the tight market, the price of copper did not recover to the levels observed at the end of 2013 due to fears that inventories in China customs warehouses[4] would be sold. Uncertainty arose after the Chinese Government ordered an investigation in the warehouses of the port of Qingdao to determine whether there had been a misuse of copper as a collateral in financial operations. Investment banks estimate that much of the over-the-counter inventories held in China would be moved to the warehouses of the London Metal Exchange, pushing the price down in Q3.

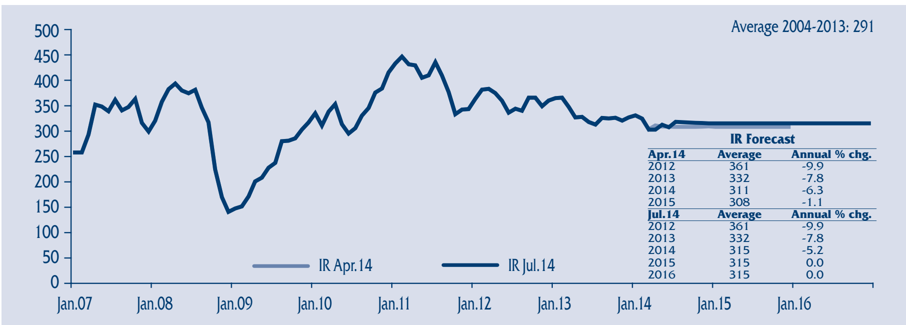
**Table 24**
**WORLD REFINED COPPER USAGE AND SUPPLY**
(Thousand metric tons)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| World mine production | 16,054 | 16,077 | 16,711 | 18,080 | 18,904 | 20,283 |
| World refined production (Primary+Secondary) | 18,985 | 19,596 | 20,131 | 20,961 | 22,362 | 23,335 |
| World refined usage | 19,129 | 19,697 | 20,390 | 21,258 | 21,957 | 22,740 |
| Refined balance 1/ | -144 | -101 | -258 | -297 | 405 | 595 |

1/ Not includes unreported inventories for China apparent usage.
Source: ICSG.

China's demand is expected to continue recovering in the forecast horizon given the stimulus measures that are being implemented by the Chinese Government, which would contribute to maintain the market tight as this would offset a higher supply. In line with this context, the estimated copper prices remain unchanged for the forecast horizon.

**Graph 46**
**COPPER: JANUARY 2007 - DECEMBER 2016**
(US$ cents/pd.)




4 Investment banks estimate that inventories in China customs warehouses would amount to around 800 thousand tons of refined copper. Metal Bulletin estimates that between 50 thousand to 600 thousand tons of these inventories could be liquidated, which generates a great deal of uncertainty in the market.

## Zinc

34. The average price of **zinc** increased 7.7 percent in the first half of the year, reaching a monthly average price of US$ 0.96 in June 2014. This price increase has been more pronounced in the past three months.

The price rise continued to be supported by expectations that the market would show a global deficit in the next 5 years due to the closing of mines. The global supply deficit grew in the first four months of the year after having shown a surplus[5] during the same period of the previous year. The materialization of this greater than expected deficit also contributed to the strong increase in the demand of China and South Korea, although part of this demand would be associated with the accumulation of inventories in both countries. Moreover, the tight market reflected also in the reduction of global inventories in the same period.

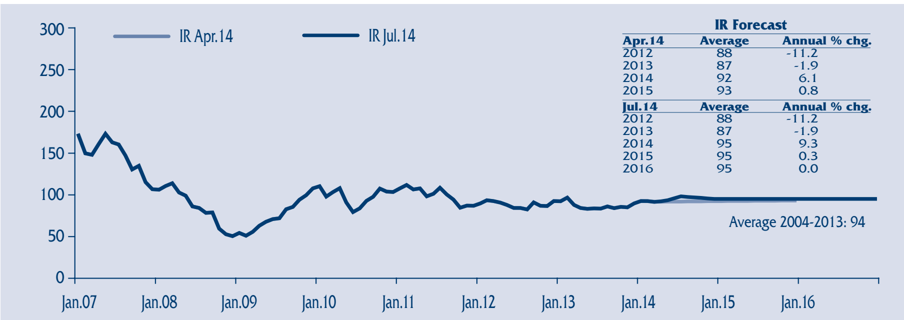
**Table 25**
**REFINED ZINC: SUPPLY AND DEMAND**
(Million metric tons)

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| World mine production | 11.60 | 12.35 | 12.64 | 13.13 | 13.20 | 13.57 |
| World refined production | 11.28 | 12.90 | 13.07 | 12.63 | 12.89 | 13.46 |
| World refined usage | 10.91 | 12.65 | 12.70 | 12.39 | 12.98 | 13.58 |
| Refined balance (thousand) | 366 | 247 | 375 | 243 | -91 | -120 |

Source: ILZSG.

The zinc market fundamentals continue to point out a slightly tighter market in the short term. A similar perspective is observed in the medium term since the production of refined zinc would not recover at the same pace that the growth in consumption would, which would create upward pressures. Therefore, it is expected that the international prices of zinc in the forecast horizon will be slightly above the levels estimated in the inflation report of April.

**Graph 47**
**ZINC: JANUARY 2007 - DECEMBER 2016**
(US$ cents/pd.)




5 As reported by the International Lead and Zinc Study Group (ILZSG) on June 16, 2014.

## Gold

35. The price of **gold** increased 4.6 percent in the first half of 2014, closing the month of June with a monthly average price of US$ 1,279 per troy ounce. However, after increasing 9.3 percent in Q1, the price of gold reversed in part this increase recording a fall of 4.3 percent in Q2. The recent decline is explained by the reduction of investors' positions after the Fed decided to continue with the tapering process at its meetings of April and June. The fall in the price of gold was offset by geopolitical risks associated with the crisis between Ukraine and Russia and by the internal conflict in Iraq, whose effects are expected to be temporary.

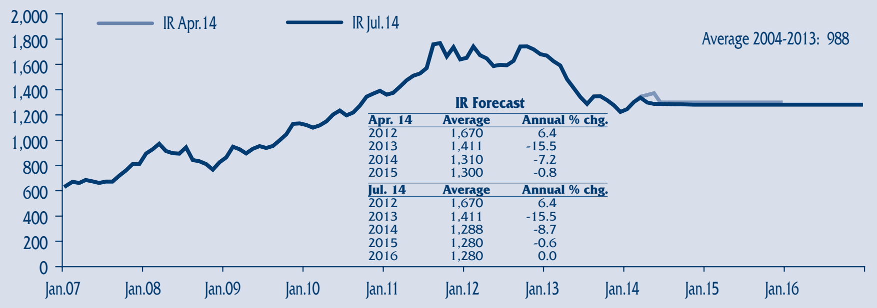
**Table 26**
**GOLD: SUPPLY AND DEMAND**
(Tons)

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| World mine production | 2,848.9 | 2,824.4 | 2,968.5 |
| Gold recycling | 1,649.4 | 1,590.8 | 1,371.4 |
| **Total supply** | **4,498.3** | **4,415.2** | **4,339.9** |
| | | | |
| Jewelry | 1,975.1 | 1,950.7 | 2,197.9 |
| Technology | 451.7 | 407.5 | 404.8 |
| Investment | 1,698.5 | 1,568.1 | 773.3 |
| Central banks 1/ | 456.8 | 544.1 | 368.6 |
| **Gold demand** | **4,582.1** | **4,470.4** | **3,744.6** |
| | | | |
| OTC investments and stock market flows 2/ | -83.8 | -55.2 | 595.4 |
| **Total demand** | **4,498.3** | **4,415.2** | **4,340.0** |
| | | | |
| **Market balance** | **0.0** | **0.0** | **0.0** |

1/ Net purchases.
2/ OTC- Over The Counter.
Source: World Gold Council.

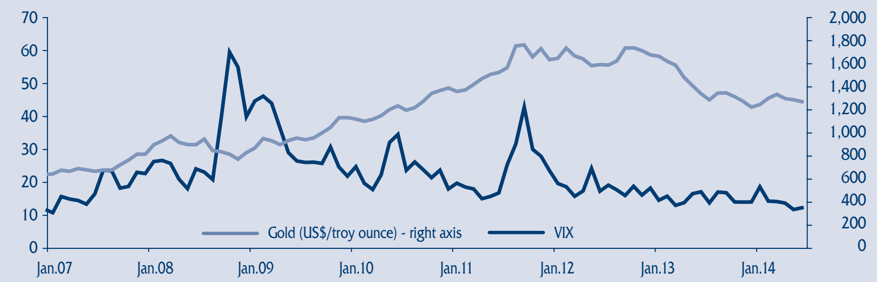
In the medium term, the price of gold would be subject to downward pressures by the prospects of a stronger dollar, better prospects in stock markets, low inflation in the developed economies, and expectations that the Fed will raise its interest rate next year. The effect of these factors on the demand would be offset by the low rates of supply growth associated with the depletion of mines and with difficulties for investment in a context of low prices and rising costs. Because these factors would continue to affect prices in the forecast horizon, the projected price of gold is revised slightly downwards relative to the projection in our previous report.

**Graph 48**
**GOLD: JANUARY 2007 - DECEMBER 2016**
(US$/tr.oz.)




| Apr. 14 | Average | Annual % chg. |
|---|---|---|
| 2012 | 1,670 | 6.4 |
| 2013 | 1,411 | -15.5 |
| 2014 | 1,310 | -7.2 |
| 2015 | 1,300 | -0.8 |
| **Jul. 14** | **Average** | **Annual % chg.** |
| 2012 | 1,670 | 6.4 |
| 2013 | 1,411 | -15.5 |
| 2014 | 1,288 | -8.7 |
| 2015 | 1,280 | -0.6 |
| 2016 | 1,280 | 0.0 |

**Graph 49**
**GOLD PRICE AND VIX INDEX S&P-500**
(January 2007 - June 2014)




Source: Bloomberg.

## Current Account Balance and Financing

36. In the first half of 2014 the current account would show a higher deficit (6.8 percent of GDP) than the one recorded in the same period of the previous year as a result of the deterioration of the trade balance, which would reflect lower exports of traditional products, particularly gold.

37. The deficit in the current account of the balance of payments projected for this year would be higher than the one estimated in the inflation report of April (US$ 10.1 billion instead of US$ 9.0 billion), due mainly to the lower balance registered in the trade balance which reflects to a great extent the evolution of trade in the first five months of the year.

    Thus, as a percentage of GDP, the deficit in the current account of the balance of payments would increase to 4.8 percent in 2014 and 2015. On the other hand, a lower deficit is projected for 2016 as a result of the boost expected from exports in that year.

**Table 27**
**BALANCE OF PAYMENTS**
(Million US$)

| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **I. CURRENT ACCOUNT BALANCE** | **-5,289** | **-9,126** | **-6,799** | **-9,021** | **-10,116** | **-8,920** | **-10,793** | **-8,547** |
| *% GDP* | *-5.3* | *-4.5* | *-6.8* | *-4.3* | *-4.8* | *-3.9* | *-4.8* | *-3.5* |
| 1. Trade balance | -477 | -40 | -2,574 | -945 | -2,611 | 263 | -2,198 | -202 |
| a. Exports | 20,281 | 42,177 | 17,738 | 42,006 | 39,836 | 45,446 | 41,846 | 46,751 |
| b. Imports | -20,758 | -42,217 | -20,313 | -42,952 | -42,447 | -45,183 | -44,044 | -46,952 |
| 2. Services | -948 | -1,801 | -966 | -1,966 | -1,802 | -1,971 | -1,824 | -1,913 |
| 3. Investment income | -5,461 | -10,631 | -5,065 | -10,430 | -10,183 | -10,893 | -10,398 | -10,218 |
| 4. Current transfers | 1,597 | 3,346 | 1,806 | 4,321 | 4,481 | 3,681 | 3,627 | 3,786 |
| Of which: Remittances | 1,324 | 2,707 | 1,399 | 3,031 | 2,933 | 3,125 | 3,014 | 3,142 |
| **II. FINANCIAL ACCOUNT** | **9,395** | **12,033** | **5,576** | **10,021** | **10,975** | **11,420** | **11,793** | **10,547** |
| Of which: | | | | | | | | |
| 1. Private Sector | 10,319 | 13,378 | 5,635 | 9,498 | 9,625 | 10,146 | 10,493 | 9,515 |
| a. Long-term | 9,945 | 14,881 | 4,049 | 10,260 | 10,649 | 10,124 | 10,344 | 9,380 |
| b. Short-term 1/ | 375 | -1,503 | 1,586 | -762 | -1,023 | 22 | 148 | 135 |
| 2. Public Sector 2/ | -925 | -1,345 | -59 | 523 | 1,350 | 1,274 | 1,300 | 1,032 |
| **III. BALANCE OF PAYMENTS (=I+II)** | **4,106** | **2,907** | **-1,224** | **1,000** | **860** | **2,500** | **1,000** | **2,000** |
| Memo: | | | | | | | | |
| Long-term external financing of the private sector (% GDP) 3/ | 12.5 | 9.5 | 7.8 | 7.4 | 7.6 | 6.3 | 6.4 | 5.5 |
| GDP (Billion US$) | 100.1 | 202.4 | 99.3 | 211.1 | 209.2 | 229.6 | 225.9 | 244.8 |

1/ Includes net erros and omissions.
2/ Includes exceptional financing.
3/ Includes net foreign investments, portfolio investment and private sector's long-term disbursement.
IR: Inflation Report.
* Forecast.

38. The ratio of investment to GDP would increase from 26.6 percent of GDP in 2013 to 26.8 percent in 2014 and to 26.9 percent in 2015. This increase is covered mainly by domestic savings of the domestic private and public sectors, which together accounted for savings equivalent to 22.1 percent of GDP in 2013 and are projected to reach levels of 21.9 and 22.1 percent of GDP in 2014 and 2015, respectively. Because a lower current account deficit is projected for 2016, domestic savings is expected to increase its share as a financing source of investment and to cover over 80 percent of investment.

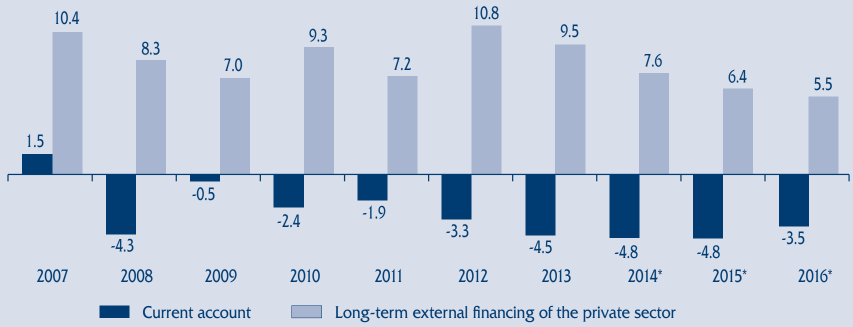
**Table 28**
**SAVINGS -INVESTMENT GAP**
(% GDP)

| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **1. Gross fixed investment** | **25.0** | **26.6** | **24.8** | **27.4** | **26.8** | **27.7** | **26.9** | **27.3** |
| **2. Net domestic savings 1/** | **19.7** | **22.1** | **17.9** | **23.1** | **21.9** | **23.8** | **22.1** | **23.8** |
| a. Private | 10.2 | 15.4 | 8.8 | 16.4 | 15.7 | 17.4 | 16.3 | 17.8 |
| b. Public | 9.5 | 6.7 | 9.1 | 6.7 | 6.2 | 6.4 | 5.8 | 6.0 |
| **3. External savings** | **5.3** | **4.5** | **6.8** | **4.3** | **4.8** | **3.9** | **4.8** | **3.5** |

1/ Excluding change on inventories.
* Forecast.

39. Given the declining path observed in the current account deficit, a similar trend is expected in long-term financing from private sources in the forecast horizon. However, reflecting the dynamism of investment especially in sectors associated with exports, this long-term financing will continue to exceed the gap in the current account in 2014-2016.

**Graph 50**
**CURRENT ACCOUNT AND LONG-TERM EXTERNAL FINANCING OF THE PRIVATE SECTOR: 2007-2016 1/**
(% GDP)




1/ Includes net foreign investments, portfolio investment, and private sector's long-term disbursement.
* Forecast.

40. In **2014** the net flow of private long-term external financing would amount to US$ 10.6 billion, with residents' investments abroad amounting to a total of US$ 2.8 million –AFPs' investments in securities standing out– and non-residents' investment in the country amounting to a total of US$ 13.5 billion. The net inflow of private long term capital has been revised up in this report considering increased external financing through loans from the financial sector and to a lesser extent a greater flow of foreign direct investment.

Positive flows of US$ 10.3 billion and US$ 9.4 billion, equivalent to 4.6 and 3.8 percent of GDP, are estimated for **2015** and **2016**, respectively. This revision is consistent with the requirements of external financing, especially the requirements of the non-financial sector which are associated with the investment required for the implementation of big projects such as Line II of Lima's Metro, the Chinchero airport, and the expansion of Cerro Verde. A lower flow is estimated for 2016 when the interest rates in the international markets are expected to start increasing.

**Table 29**
**LONG-TERM FINANCIAL ACCOUNT OF THE PRIVATE SECTOR**
(Million US$)

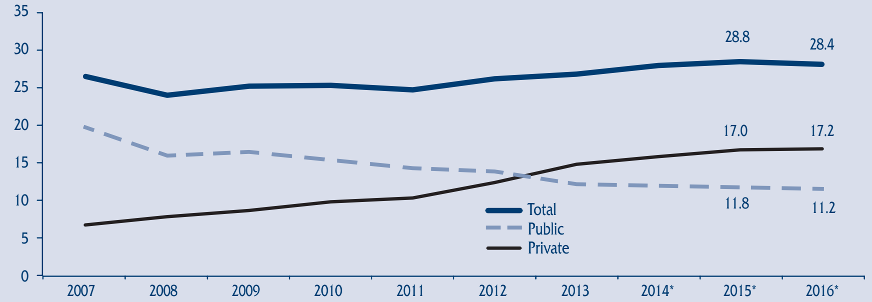
| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **1. ASSETS** | **-651** | **-1,291** | **-2,458** | **-3,197** | **-2,815** | **-2,895** | **-2,874** | **-2,529** |
| **2. LIABILITIES** | **10,595** | **16,173** | **6,507** | **13,457** | **13,464** | **13,042** | **13,218** | **11,909** |
| Foreign direct investment in the country | 5,729 | 9,298 | 4,758 | 9,638 | 10,092 | 8,029 | 8,200 | 8,200 |
| Non-financial sector | 1,224 | 2,657 | 1,048 | 3,586 | 2,172 | 3,813 | 3,518 | 2,709 |
| *Long-term loans* | *-419* | *651* | *133* | *985* | *217* | *1,421* | *1,318* | *626* |
| *Portfolio investment* | *1,643* | *2,006* | *915* | *2,601* | *1,955* | *2,391* | *2,200* | *2,083* |
| Financial sector | 3,643 | 4,217 | 700 | 232 | 1,200 | 1,200 | 1,500 | 1,000 |
| *Long-term loans* | *88* | *347* | *-52* | *-738* | *78* | *400* | *700* | *500* |
| *Portfolio investment* | *3,555* | *3,870* | *752* | *970* | *1,122* | *800* | *800* | *500* |
| **3. NET FLOW (1+2)** | **9,945** | **14,881** | **4,049** | **10,260** | **10,649** | **10,146** | **10,344** | **9,380** |
| *% GDP* | *9.9* | *7.4* | *4.1* | *4.9* | *5.1* | *4.4* | *4.6* | *3.8* |

IR: Inflation Report.
* Forecast.

41. Between January and March, the **public sector financial account** showed a negative flow of US$ 721 million, explained mostly by the decrease observed in non-residents' holdings of sovereign bonds and by the amortization of the external debt. Substantial disbursements destined to finance several investment projects, such as the modernization of the refinery in Talara and co-financing the implementation of of Line II, are expected in the forecast horizon.

42. In 2013, the ratio of private sector external indebtedness (15.0 percent of GDP) was for the first time higher than the ratio of external indebtedness of the public sector (11.9 percent of GDP). Given that this trend is expected to continue to be observed over the forecast horizon, it is estimated that the external public debt, including domestic bonds held by non-residents, would decline from 12.1 percent of GDP in 2014 to 11.8 percent of GDP in 2015 and up to 11.2 percent of GDP in 2016.

**Graph 51**
**MEDIUM- AND LONG-TERM EXTERNAL DEBT: 2007-2016**
(% GDP)




* Forecast.

43. The soundness of the balance of payments face negative events in the world economy is reflected in the position of Peru's international reserves relative to the balance of its short term external liabilities or the total of these liabilities plus the current account deficit. The levels registered by the Peruvian economy in these indicators evidence the high levels achieved in its economic fundamentals over the years, which make it one of the soundest economies in the region.

**Table 30**
**NIR INDICATORS**

| As a % of: | 2004 | 2009 | 2014* |
|---|---|---|---|
| GDP | 19.2 | 27.2 | 31.9 |
| Short-term external debt | 171.8 | 297.1 | 821.9 |
| Short-term external debt plus Current account deficit | 173.2 | 281.6 | 365.8 |

* Forecast.

**Graph 52**
**NET INTERNATIONAL RESERVES: 2007-2016**
(Million US$)


* Forecast.

# IV. Public Finances

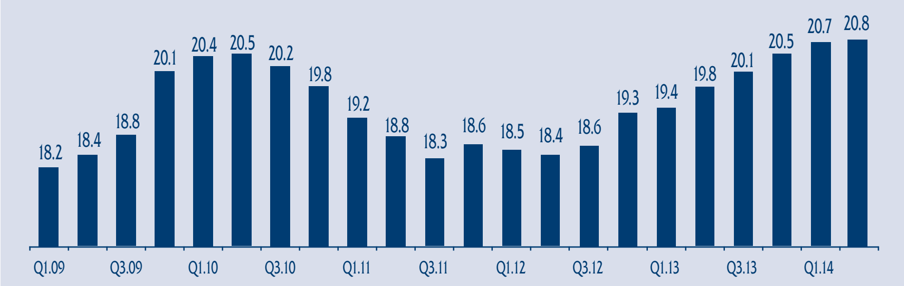
## Economic Balance

44. The economic balance of the non-financial public sector in the first half of 2014 was equivalent to 4.9 percent of GDP –a ratio slightly lower than the one recorded in the first half of 2013 (5.2 percent of GDP)– due to the higher level of non-financial expenditure (17.9 percent of GDP), while the ratio of revenue of the general government was equivalent to 23.7 percent of GDP. Moreover, in annual terms, the economic balance of the non-financial public sector at June represented 0.8 percent of GDP. This balance results from a higher level of non-financial expenditure –which reached 20.8 percent of GDP– while the ratio of revenue of the general government remained at 22.4 percent of GDP.

**Graph 53**
**ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR**
(Accumulate last 4 quarters - % GDP)


**Graph 54**
**CURRENT REVENUES OF THE GENERAL GOVERNMENT**
(Accumulate last 4 quarters - % GDP)

**Graph 55**
**NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT**
(Accumulate last 4 quarters - % GDP)



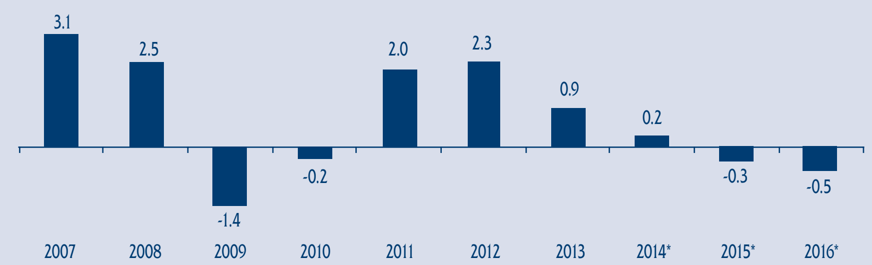

45. The economic balance of the non-financial public sector projected for 2014 has been revised down from 0.3 percent (Inflation Report of April) to 0.2 percent of GDP as a result of the slower growth of current revenue which would show a real variation of 5.8 percent instead of a rate of 6.5 percent. The forecast for 2014 also considers the effect of extraordinary tax revenue coming mainly from income tax associated with the sale of corporate shares. The projected rate of the non-financial expenditure has also been revised from 21.0 to 21.3 percent of GDP.

**Table 31**
**NON-FINANCIAL PUBLIC SECTOR**
(% GDP)

| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **1. General government current revenues 1/** | **23.2** | **22.1** | **23.7** | **22.5** | **22.6** | **22.0** | **22.1** | **22.1** |
| *Real % change* | *1.6* | *3.7* | *4.5* | *6.5* | *5.8* | *4.1* | *3.4* | *6.1* |
| **2. General government non-financial expenditure 2/** | **17.1** | **20.5** | **17.9** | **21.0** | **21.3** | **21.3** | **21.3** | **21.3** |
| *Real % change* | *12.8* | *11.2* | *6.8* | *7.8* | *7.8* | *7.7* | *6.3* | *6.1* |
| Of which: | | | | | | | | |
| Current expenditure | 12.7 | 14.3 | 13.6 | 14.3 | 15.0 | 14.2 | 15.0 | 14.7 |
| Real % change | 10.5 | 10.6 | 8.9 | 4.2 | 8.7 | 6.1 | 5.6 | 4.4 |
| Gross capital formation | 4.2 | 5.6 | 4.1 | 6.1 | 5.6 | 6.4 | 5.7 | 6.0 |
| Real % change | 19.2 | 10.0 | 0.0 | 13.6 | 3.4 | 11.9 | 8.5 | 10.6 |
| **3. Others** | **0.3** | **0.3** | **0.1** | **-0.1** | **-0.1** | **-0.1** | **-0.1** | **-0.2** |
| **4. Primary balance (1-2+3)** | **6.4** | **2.0** | **5.9** | **1.3** | **1.2** | **0.6** | **0.7** | **0.5** |
| **5. Interests** | **1.2** | **1.1** | **1.0** | **1.0** | **1.0** | **1.0** | **1.0** | **1.0** |
| **6. Overall Balance** | **5.2** | **0.9** | **4.9** | **0.3** | **0.2** | **-0.3** | **-0.3** | **-0.5** |
| Memo: (billion S/.): | | | | | | | | |
| 1. General government current revenues | 61 | 121 | 66 | 132 | 132 | 140 | 139 | 150 |
| 2. General government non-financial expenditure | 45 | 112 | 50 | 124 | 124 | 136 | 134 | 145 |
| 3. Nominal GDP | 262 | 547 | 277 | 588 | 583 | 639 | 629 | 682 |

1/ The central government includes the ministries, national universities, public agencies and regional governments. The general government has a wider coverage that includes the central government, social security, regulators and supervisors, government charity organizations and local governments.
2/ Includes accrued payments by Net payments of the Fuel Price Stabilization Fund.
* Forecast.
IR: Inflation Report.

**Graph 56**
**ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR: 2007-2016**
(% GDP)




* Forecast.

## Fiscal Revenues

46. The current revenue of the general government grew 4.5 percent in the first half of 2014 due mainly to increased revenues from the value added tax (5.2 percent) and import duties (6.7 percent), although this growth was lower than the one recorded in 2013. The increase in the income tax (3.2 percent) is explained by greater revenues from the regularization of tax payments, which in the period increased by 19.1 percent, as well as by some exceptional revenue associated with the sale of shareholdings. Another factor contributing to this outcome was the lower amounts of tax rebates (down by 12.7 percent).

**Table 32**
**CURRENT REVENUES OF THE GENERAL GOVERNMENT**
(Real % change)

| | 2012 | | | 2013 | | | 2014 |
|---|---|---|---|---|---|---|---|
| | H1 | H2 | Year | H1 | H2 | Year | H1 |
| **TAX REVENUES** | **6.0** | **9.1** | **7.5** | **0.6** | **6.7** | **3.6** | **5.5** |
| Income tax | 8.7 | 4.7 | 6.9 | -7.5 | -1.0 | -4.7 | 3.2 |
| Value added tax | 4.4 | 5.8 | 5.1 | 4.7 | 6.5 | 5.6 | 5.2 |
| Excise tax | -6.3 | 8.0 | 0.5 | 11.5 | 5.5 | 8.4 | -7.9 |
| Import duties | 4.8 | 8.4 | 6.7 | 1.8 | 14.8 | 8.7 | 6.7 |
| Other tax revenues | 20.5 | 31.8 | 26.2 | 14.8 | 33.5 | 24.7 | 1.7 |
| Tax returns | 13.5 | -2.5 | 5.3 | 1.1 | 6.1 | 3.5 | -12.7 |
| **NON-TAX REVENUES** | **6.7** | **6.1** | **6.4** | **4.9** | **3.4** | **4.2** | **1.8** |
| **TOTAL** | **6.2** | **8.4** | **7.2** | **1.6** | **5.9** | **3.7** | **4.5** |

47. In this context, in **2014** current revenues would increase by 5.8 percent in real terms –less than estimated in the Inflation Report of April (6.5 percent)–, reflecting the lower dynamism of economic activity this year. This variation includes the

effect of extraordinary payments to the treasury in the second half of the year from the sale of shareholdings that would generate capital gains in several companies. Thus, a rate of 22.6 percent will be reached in 2014. In **2015** this ratio would decline to 22.1 percent given that no extraordinary revenue is foreseen, while in **2016** revenues would register a growth rate of 6.1 percent. This figure is consistent with a growth of economic activity in that year, during which the share of tax revenue will reach 22.1 percent of GDP.

**Table 33**
**CURRENT REVENUES OF THE GENERAL GOVERNMENT**
(% GDP)

| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **TAX REVENUES** | **17.4** | **16.8** | **18.0** | **17.2** | **17.2** | **16.8** | **16.8** | **16.9** |
| Income tax | 7.6 | 6.7 | 7.7 | 7.0 | 7.1 | 6.5 | 6.5 | 6.6 |
| Value added tax | 8.8 | 8.7 | 9.1 | 8.8 | 8.8 | 9.0 | 8.9 | 8.9 |
| Excise tax | 1.0 | 1.0 | 0.9 | 1.0 | 1.0 | 1.0 | 1.0 | 0.9 |
| Import duties | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| Other tax revenues | 1.9 | 2.1 | 1.9 | 2.0 | 2.0 | 2.0 | 2.0 | 1.9 |
| Tax returns | -2.2 | -2.1 | -1.9 | -2.0 | -1.9 | -1.9 | -1.8 | -1.8 |
| **NON-TAX REVENUES** | **5.8** | **5.4** | **5.8** | **5.4** | **5.4** | **5.2** | **5.3** | **5.2** |
| **TOTAL** | **23.2** | **22.1** | **23.7** | **22.5** | **22.6** | **22.0** | **22.1** | **22.1** |

* Forecast.
IR: Inflation Report.

**Graph 57**
**CURRENT REVENUES OF THE GENERAL GOVERNMENT: 2007-2016**
(% GDP)


* Forecast.

Revenue from the income tax in the forecast horizon would be equivalent to 7.1 percent of GDP in **2014**. In **2014**, the revenue from the VAT would represent 8.8 percent of GDP, while in **2015** and **2016** the revenue from this tax would increase slightly to 8.9 percent of GDP in each of these years.

## Evolution of Public Spending

48. In the first half of 2014, the non-financial expenditure of the general government increased 6.8 percent, less than the increase registered in the three previous semesters, with current spending (8.9 percent) accounting for this growth rate in the first six months of 2014. By level of government, this growth was driven by the spending of the national Government (11.2 percent), both in terms of current expenditures (11.8 percent) and in terms of gross capital formation (5.0 percent). On the other hand, a decrease was observed in investment expenditure in regional and local governments (down by 2.1 and 2.3 percent, respectively), which is explained in part by the implementation of administrative measures, effective as from January 2014, which improve expenditure evaluation, but delay its execution. In order that accrued expenditure is approved, the executing unit must keep the cost of a project and its feasibility in the AFIS system up to date. The temporary suspension of the accounts of some sub-national governments have also contributed to this decrease.

**Table 34**
**NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT**
(Real % change)

| | 2012 | | | 2013 | | | 2014 |
|---|---|---|---|---|---|---|---|
| | H1 | H2 | Year | H1 | H2 | Year | H1 |
| **Current expenditure** | **-0.7** | **10.3** | **5.3** | **10.5** | **10.6** | **10.6** | **8.9** |
| *National Government* | *-7.7* | *10.0* | *1.7* | *10.8* | *14.4* | *12.9* | *11.8* |
| *Regional Governments* | *11.2* | *10.3* | *10.7* | *12.5* | *5.9* | *8.8* | *3.8* |
| *Local Governments* | *23.5* | *11.7* | *16.7* | *6.3* | *-1.2* | *2.1* | *3.2* |
| **Capital expenditure** | | | | | | | |
| **Gross capital formation** | **16.1** | **15.3** | **15.6** | **19.2** | **5.4** | **10.0** | **0.0** |
| *National Government* | *-37.4* | *0.3* | *-16.5* | *20.4* | *6.2* | *11.0* | *5.0* |
| *Regional Governments* | *49.3* | *33.5* | *38.2* | *25.6* | *-5.3* | *4.5* | *2.1* |
| *Local Governments* | *115.7* | *18.4* | *39.8* | *15.1* | *10.9* | *12.3* | *-2.3* |
| **Others** | **-29.6** | **33.0** | **7.0** | **37.1** | **61.3** | **54.7** | **9.3** |
| TOTAL | 2.2 | 12.2 | 8.0 | 12.8 | 10.1 | 11.2 | 6.8 |
| *National Government* | *-13.3* | *9.1* | *-1.2* | *12.3* | *14.9* | *13.8* | *11.2* |
| *Regional Governments* | *18.1* | *18.5* | *18.3* | *16.5* | *1.6* | *7.5* | *1.4* |
| *Local Governments* | *57.3* | *14.5* | *27.8* | *10.9* | *6.1* | *7.9* | *0.1* |

49. In **2014** the non-financial expenditure of the general government would grow by a real 7.8 percent, a similar rate to that estimated in our report of April. This estimate assumes that the investment of the general government would show a faster pace in the second half of the year after having overcome some of the administrative difficulties faced by the sector budgets in the first half of the year. The forecast considers a slower growth of public investment in subnational governments.

It is worth pointing out that an internal debt operation for a total of S/. 700 million was approved in the month of May (Supreme Decree No. 098-2014-EF). Thus, sovereign bonds were issued to support the financing of public investment projects approved by the SNIP which are being implemented by regional governments. This measure was taken in order to mitigate the effect of the fewer resources transferred to this government levels for mining and oil royalties, sobrecanon, among other sources of revenues.

The Government decreed some measures to boost public spending in the second half of the year, including those contained in Emergency Decree 001-2014 (dated July 11, 2014) which are aimed at increasing current spending. A supplementary credit of S/. 1.74 billion has been established to pay the accruals of the benefits authorized by Emergency Decree 037-94 (S/. 1.36 billion) and to pay a special bonus for public servants in the month of July (S/. 200 for each public servant, in service or retired, which amounts to a total of S/. 376 million). The same regulation establishes that the agencies of the national, regional, and local governments may reallocate their investment budgets to maintenance costs until August 15, 2014. A program of infrastructure maintenance and furnishing of school premises for up to S/. 400 million has also been authorized by reallocating a part of the Ministry of Education spending budget.

**Table 35**
**NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT**
(% GDP)

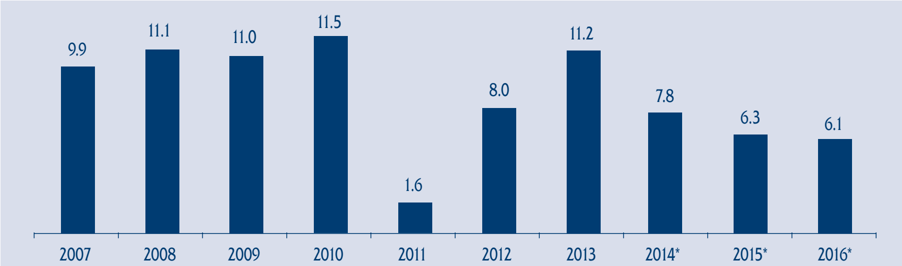
| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **Current expenditure** | **12.7** | **14.3** | **13.6** | **14.3** | **15.0** | **14.2** | **15.0** | **14.7** |
| *National Government* | *8.3* | *9.7* | *9.1* | *9.4* | *10.3* | *9.5* | *10.3* | *10.1* |
| *Regional Governments* | *2.6* | *2.8* | *2.7* | *3.0* | *2.8* | *2.9* | *2.9* | *2.9* |
| *Local Governments* | *1.8* | *1.8* | *1.8* | *1.8* | *1.8* | *1.7* | *1.9* | *1.8* |
| **Capital expenditure** | | | | | | | | |
| **Gross capital formation** | **4.2** | **5.6** | **4.1** | **6.1** | **5.6** | **6.4** | **5.7** | **6.0** |
| *National Government* | *1.3* | *1.7* | *1.3* | *1.9* | *1.8* | *1.9* | *2.0* | *2.0* |
| *Regional Governments* | *1.0* | *1.3* | *1.0* | *1.4* | *1.3* | *1.5* | *1.2* | *1.3* |
| *Local Governments* | *1.9* | *2.6* | *1.8* | *2.8* | *2.5* | *3.0* | *2.5* | *2.7* |
| **Others** | **0.2** | **0.5** | **0.3** | **0.7** | **0.6** | **0.7** | **0.6** | **0.6** |
| **TOTAL** | **17.1** | **20.5** | **17.9** | **21.0** | **21.3** | **21.3** | **21.3** | **21.3** |
| *National Government* | *9.8* | *11.9* | *10.7* | *12.0* | *12.7* | *12.0* | *12.8* | *12.7* |
| *Regional Governments* | *3.7* | *4.1* | *3.7* | *4.4* | *4.1* | *4.5* | *4.1* | *4.1* |
| *Local Governments* | *3.6* | *4.5* | *3.6* | *4.6* | *4.4* | *4.8* | *4.4* | *4.5* |

* Forecast.
IR: Inflation Report.

50. In **2015** the non-financial expenditure of the general government would rise to 21.3 percent of GDP mainly as a result of an increase in capital expenditure, whose ratio in GDP terms would increase from 6.2 percent of GDP in 2014 to 6.4 percent in 2015 and to 6.6 percent in 2016. It is worth pointing out that the Reinforcement of Accountability and Fiscal Transparency Act (Law 30099 dated October 31, 2013) establishes that as from 2015 "the non-financial expenditure

of the national government in terms of permanent or temporary staff, regardless of their contract and pension regime, cannot be higher than the cap resulting from applying the potential GDP growth rate in nominal terms to the estimated limit of non-financial expenditure in personnel and pensions the previous year".

**Graph 58**
**NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT: 2007-2016**
(Real % change)



* Forecast.

51. It should be pointed out that S/. 1.53 billion –US$ 547 million– was transferred to the Fiscal Stabilization Fund (FSF) in the month of June. This transfer to the FSF is the balance of the Treasury's unrestricted funds of its Regular Resources budget for FY 2013, which was affected by Law 30191 which allocated S/. 3.30 billion to different government levels (S/. 3.1 billion as supplementary credit and a transfer of S/. 200 million to Fondo de Promoción del Riego en la Sierra -Mi Riego). The balance of the Fiscal Stabilization Fund (FSF) at the end of June is US$ 9.15 billion, which is equivalent to 4.4 percent of GDP projected for 2014. Resources exceeding 4.0 percent may be used for the prepayment of the debt.

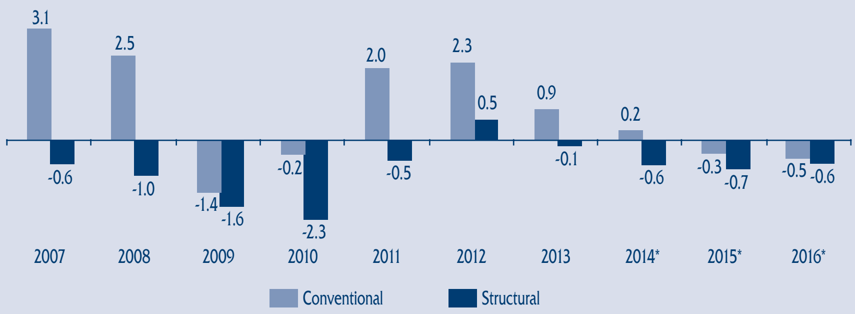
## Fiscal Impulse

52. The **structural economic balance** is an indicator defined as the balance that fiscal accounts would show if the level of economic activity remained at its trend level and if the international prices of the country's main exports of minerals and oil were similar to their benchmark levels. In 2014 the structural economic balance would show a deficit of 0.6 percent of GDP, while in 2015 and 2016 the structural deficit would be equivalent to 0.7 and 0.6 percent of GDP, respectively.

The **fiscal impulse**, which reflects changes in the structural primary balance, shows a countercyclical fiscal policy position in 2014 and in the projections for 2015 and 2016 that would offset the weakening of private expenditure in a scenario of greater uncertainty in the international environment.

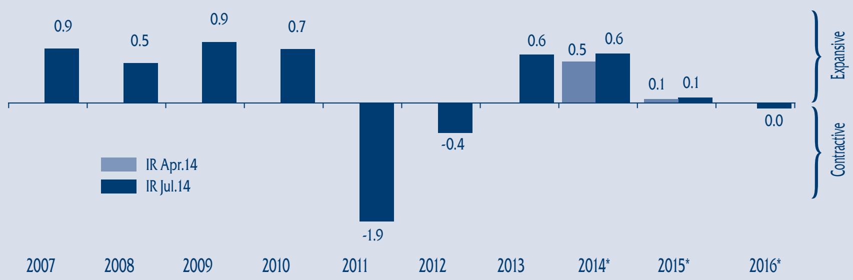
53. It should be pointed out that the Reinforcement of Accountability and Fiscal Transparency Act (Law 30099 dated October 31, 2013) establishes that the balance of the operations of the non-financial public sector in **2014** cannot register a deficit, while the goal ex ante for the structural fiscal balance in **2015** and **2016** is a deficit of 1 percent of GDP. The fiscal projections contained in this report are consistent with these rules.

**Graph 59**
**CONVENTIONAL AND STRUCTURAL ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR: 2007-2016**
(% GDP)




* Forecast.

**Graph 60**
**FISCAL IMPULSE 1/: 2007-2016**
(% GDP)




1/ The fiscal impulse is the change in the primary structural balance, which is an indicator of how the fiscal position affects the economic cycle.
* Forecast.

## Public Debt

54. The economic balance of 0.2 percent of GDP implies that financial requirements would amount to S/. 2.9 billion, a figure slightly higher than the one estimated in the Inflation Report of April. This financing requirements will be met with external disbursements and bond placements, which more than cover the financial

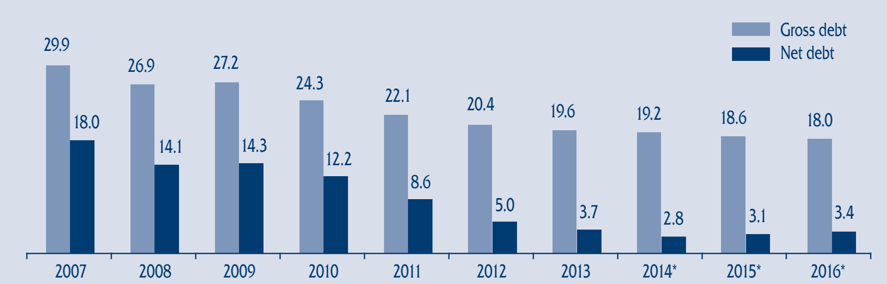
requirements of the public sector and contribute to strengthen the financial position of the Treasury. Therefore, the balance of the gross debt of the non-financial public sector is expected to decline in the forecast horizon.

**Table 36**
**FINANCIAL REQUIREMENTS OF THE NON-FINANCIAL PUBLIC SECTOR AND ITS FUNDING**
(Million S/.)

| | 2013 | | 2014* | | | 2015* | | 2016* |
|---|---|---|---|---|---|---|---|---|
| | H1 | Year | H1 | IR Apr.14 | IR Jul.14 | IR Apr.14 | IR Jul.14 | IR Jul.14 |
| **I. USES** | **-7,600** | **3,028** | **-12,069** | **2,033** | **2,880** | **8,149** | **8,088** | **8,244** |
| 1. Amortization | 5,969 | 7,859 | 1,388 | 4,053 | 4,030 | 5,916 | 5,916 | 5,129 |
| 2. Overall Balance | -13,569 | -4,832 | -13,457 | -2,020 | -1,150 | 2,233 | 2,172 | 3,115 |
| (negative sign indicates surplus) | | | | | | | | |
| **II. SOURCES** | **-7,600** | **3,028** | **-12,069** | **2,033** | **2,880** | **8,149** | **8,088** | **8,244** |
| 1. External | 244 | 954 | 664 | 3,040 | 3,306 | 5,681 | 5,795 | 4,154 |
| 2. Bonds 1/ | 3,190 | 4,025 | 1,878 | 2,404 | 3,682 | 2,350 | 2,350 | 5,220 |
| 3. Internal 2/ | -11,034 | -1,952 | -14,612 | -3,412 | -4,108 | 118 | -57 | -1,131 |
| Memo: | | | | | | | | |
| NFPS gross debt | | | | | | | | |
| Billions S/. | 99.2 | 107.0 | 103.6 | 111.6 | 111.9 | 116.8 | 117.3 | 123.1 |
| % GDP | 18.9 | 19.6 | 18.4 | 19.0 | 19.2 | 18.3 | 18.6 | 18.0 |
| NFPS net debt 3/ | | | | | | | | |
| Billions S/. | 11.6 | 20.4 | 7.5 | 19.5 | 16.2 | 22.8 | 19.3 | 23.0 |
| % GDP | 2.2 | 3.7 | 1.3 | 3.3 | 2.8 | 3.6 | 3.1 | 3.4 |

1/ Includes domestic and external bonds.
2/ A positive sign indicates a withdrawal or overdraft and a negative sign indicates higher deposit.
3/ Defined as the difference between gross public debt and NFPS deposits.
* Forecast.
IR: Inflation Report.

**Graph 61**
**NON-FINANCIAL PUBLIC SECTOR DEBT: 2007-2016**
(% GDP)




* Forecast.

**Box 4**
**RECENT FISCAL MEASURES**

A series of multisector rules intended to foster investment and boost economic activity has recently been approved by the Executive. These rules also included a series of tax measures to improve the efficiency of the tax system, as well as public spending-related measures to stimulate aggregate demand. The provisions approved include the following:

**Tax Measures**

*Update of Tax Debts*: The annual capitalization of interest on tax debt from December 31, 1998 to December 31, 2005, is eliminated.

*New Tax Stability Rules:* Investment requirements to be eligible for the Tax Stability Agreements –Convenios de Estabilidad Tributaria (CET)– granted in the framework of the General Mining Law are raised both for new investment and for expansion projects. Moreover, a new type of CET for investments of over US$ 500 million and for expansion projects of over US$ 250 million has been established. The latter stabilizes the conditions of initial investment granting a period of 15 years with said tax treatment conditions.

*Suspension of the Antiavoidance Rule:* The Norma Antielusiva General will not apply on acts which took place prior to the approval of the Supreme Decree that sets the criteria and parameters for its application.

*Interests on Arrears during Appeals and Precautionary Guarantees:* No default interest shall be applied to a tax debt appealed before the Tax Court after the period established to resolve the appeal has expired. This eliminates a cost to the taxpayer which arose without being actually connected to the taxpayer's actions. In addition, when a "preventive" judicial review is requested, the taxpayer will have to provide a guarantee for 60 percent of the tax debt if the amount of the debt exceeds 15 tax units. A guarantee for 100 percent of the debt was previously required for debts exceeding 5 tax units.

*Tax Withholding Rules:* To reduce the financial cost of tax withholding on taxpayers, SUNAT has lowered the rate of tax withholdings on "Other business services" and "Other services subject to VAT" from 12 to 10 percent in the tax withholding regime denominated Detracciones. As a result, taxpayers would benefit from a reduction in advanced tax withholdings of around S/. 1.8 billion.

Furthermore, additional criteria –i.e. market share and position in the production and distribution chain– have been established for the designation of Withholding Agents in the case of another type of advanced tax withholding denominated Percepciones. Moreover, to consider a firm as a final consumer, SUNAT is authorized to set differentiated tax withholding amounts by type of goods, and the MEF is empowered to determine in which cases advanced tax withholding no longer applies to purchases of goods accounted for by sales tickets. The aim of this measure is to reduce the cost of this tax withholding regime for taxpayers.

*Taxes, Fees and Municipal Licenses:* Taxes in excess of the cost of a service provided and those imposed as a result of control of activities are improper and therefore are subject to rebate. Rates in excess are illegal bureaucratic barriers that can be punished by INDECOPI and controlled by the Comptroller's Office.

*Customs Law:* Document maintenance and document preservation costs are reduced given that customs agencies are allowed to destroy documents once the 5-year conservation period established by law has expired. This documentation was previously sent to SUNAT.

**Provisions on Public Spending and Increased Resources for Private Spending**

*Payment of Legal Debts and Extraordinary Bonus for Public Servants:* A supplementary credit (D.U. 001-2014) for up to S/. 1.74 billion was approved to pay the debt to public servants caused by the D.U 037-94 (up to a total of S/. 1.36 billion), as well as to pay a special bonus of S/. 200 to public servants –active and retired– and to pensioners under Law 19990 (up to a total of S/. 376 million).

*Increase in the Availability of CTS:* Workers included in the compensation for time of services (CTS) regime may freely dispose of 100 percent of the surplus of 4 gross wages deposited in their CTS bank accounts until December 31, 2014.

*Maintenance Costs:* All the entities of the national government, the regional governments and local governments may reallocate their investment budget to maintenance costs until August 15, 2014. The Ministry of Education has reallocated S/. 400 million to repair bathroom facilities at schools and to paint school facilities in the country, and the Ministry of Health will carry out procurement processes for the maintenance of health infrastructure and the replacement of equipment in health facilities.

Both ministries may use the simplified procurement process established in the Disaster Prevention Act (Law 30191, published on May 9, 2014) to purchase prefabricated modules for public schools and health facilities in the tender processes carried out until December 31, 2014.

*Temporary Executing Units in Subnational Governments:* An Extraordinary, Transient and Special Executing Unit is established for a renewable period of 60 working days in each regional or local government in which the bank account operations of the subnational government were temporarily suspended. The Executing Unit will manage the resources of the subnational government to ensure the provision of services to the population.

*New Law on Government Procurement of Goods and Services:* a new Government Procurement Law in which monitoring and control will focus on the results of procurement management rather than on procedures has been approved. The law introduces a series of changes, such as new tender procedures, a higher threshold for purchases outside the scope of the law –from 3 to 8 tax units–, the removal of the reference value in purchases of goods and services, and relying more on government officials’ discretionary decisions.

# V. Monetary Policy

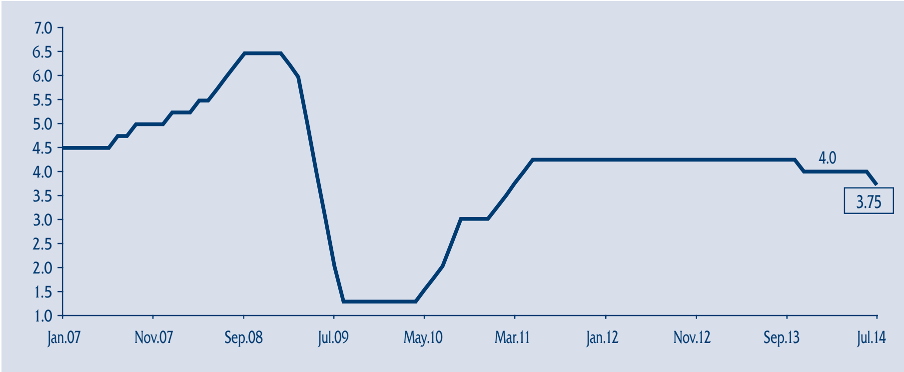
55. Since the publication of last Inflation Report, the upward risks on inflation in the inflation forecast have declined significantly. On the one hand, imported inflation has slowed down as a result of the drop observed in the international prices of the main food commodities and is expected to remain low in the forecast horizon. On the other hand, the output gap shows no inflationary pressures on the side of demand, and is estimated to be more negative than was estimated in our previous report given to the slower pace of growth of investment and exports. Furthermore, the supply factors affecting inflation in Q1 are dissipating and the risk of being affected by a strong El Niño event has decreased.

    In this context, the Board of BCRP approved to lower the benchmark interest rate from 4.0 percent to 3.75 percent in July. This level of the benchmark rate is consistent with inflation's convergence to a rate of 2.0 percent in 2015 in a context of a weaker-than-expected economic cycle.

    In addition to this, the Central Bank of Peru has continued adopting measures to ease its regime of reserve requirements in domestic currency in order to provide banks with liquidity in soles to finance the expansion of credit in this currency in a context in which deposits in soles were showing a slower pace of growth. The last reduction of the rate of required reserves –from 12.0 to 11.5 percent– came into effect in July. In addition and complementing this measure, the BCRP continued injecting liquidity into the financial system through auctions of 24 month-FX-swaps and 3 month-Repos. These operations allow a better term matching between banks' assets and their liabilities.

56. The policy communiqués of the Board of the Central Bank in recent months have highlighted that the expected rates of inflation are within the target range and that the 12-month inflation rate will converge to the target range in the coming months as the supply conditions that affected inflation temporarily continue to normalize. The Board has also highlighted that it oversees the inflation forecast and inflation determinants to take additional measures to ease its monetary policy instruments if it is necessary.

**Graph 62**
**BCRP REFERENCE INTEREST RATE**
(%)




## Interest Rates and Monetary Operations

57. The interest rates in the money market during Q2 were influenced by: (a) banks' greater demand for deposits in soles to meet the growing demand for credit in this currency, (b) a greater availability of short-term liquidity, particularly as from June, due to the maturity of CDRs associated with lower foreign exchange rate volatility, and (c) liquidity injection operations carried out by BCRP through auctions of term FX swaps and cuts in the rate of reserve requirements.

    The liquidity injection measures mentioned above have contributed to reduce the impact of the increased demand for credit in soles on the different interest rates on term operations in this currency, in a context of low growth of deposits in soles. On the other hand, the maturity of CDR-BCRP has contributed to increase banks' availability of liquidity in the short term, which has reflected in lower interest rates in the money market.

    Thus, the interbank interest rate remained very close to the level of the benchmark rate, while the 90-day corporate prime rate has dropped 8 basis points to 4.92 percent in late June after having climbed up to 5.0 percent in April and May.

58. The lending rates in domestic currency for the segment of loans to large businesses increased by 53 basis points on average –from 6.96 to 7.49 percent– between March and June of this year, while the interest rates for mortgage and corporate loans increased by 15 and 9 basis points, respectively. This trend is explained

mainly by the increased demand for credit in domestic currency in a context of de-dollarization of credit.

**Table 37**
**INTEREST RATE BY TYPE OF LOANS IN DOMESTIC CURRENCY 1/**
(%)

| | Corporate | Large companies | Medium-sized enterprises | Small businesses | Microbusinesses | Consumer | Mortgage |
|---|---|---|---|---|---|---|---|
| Dec.10 | 5.05 | 6.12 | 10.14 | 23.68 | 31.52 | 37.78 | 9.46 |
| Dec.11 | 6.02 | 7.36 | 11.15 | 23.15 | 33.02 | 38.45 | 9.39 |
| Dec.12 | 5.78 | 7.36 | 10.96 | 22.45 | 33.15 | 41.16 | 8.76 |
| Mar.13 | 5.79 | 7.43 | 10.82 | 22.04 | 31.40 | 39.33 | 9.22 |
| Jun.13 | 5.30 | 7.21 | 10.60 | 21.20 | 31.58 | 41.34 | 9.11 |
| Sep.13 | 5.53 | 7.07 | 10.86 | 21.46 | 31.59 | 41.65 | 9.29 |
| Dec.13 | 5.41 | 7.05 | 10.14 | 21.03 | 33.10 | 42.26 | 9.03 |
| Mar.14 | 5.82 | 6.96 | 10.80 | 21.21 | 32.50 | 42.93 | 9.20 |
| Apr.14 | 5.84 | 7.01 | 10.74 | 21.19 | 32.32 | 42.50 | 9.18 |
| May.14 | 5.85 | 7.55 | 10.80 | 21.16 | 32.48 | 43.65 | 9.31 |
| Jun.14 | 5.91 | 7.49 | 10.76 | 21.06 | 32.12 | 42.69 | 9.35 |
| **Accumulated change (bps)** | | | | | | | |
| Jun.14-Mar.14 | 9 | 53 | -4 | -15 | -38 | -24 | 15 |
| Jun.14-Dec.13 | 50 | 44 | 62 | 3 | -98 | 43 | 32 |
| Jun.14-Jun.13 | 61 | 28 | 16 | -14 | 54 | 135 | 24 |

1/ Annual active interest rates on the operations carried out in the last 30 working days.
Source: SBS and BCRP.

A wide availability of liquidity in foreign currency continued to be seen in Q2-2014 as a result of reduced demand for credit in dollars and a greater preference for saving in this currency, especially in the case of institutional investors and businesses. This increased liquidity in foreign currency was reflected in a decreasing trend in lending and deposit interest rates in dollars. Thus, in Q2 the 90-day corporate prime interest rate declined by 1 basis point relative to March to a level of 0.62 percent, while the interbank interest rate fell by 4 basis points.

The rates for mortgage loans declined by 78 basis points, while the rates for loans to large companies fell 43 basis points and the ones for small companies fell 33 basis points. In contrast, the rates for consumer loans continued to rise due to the increase registered in delinquency in Q2 (up 15 basis points). A slight decrease was observed in the rates of loans to medium-sized companies.

**Table 38**
**INTEREST RATE BY TYPE OF LOANS IN FOREIGN CURRENCY 1/**
(%)

| | Corporate | Large companies | Medium-sized enterprises | Small businesses | Consumer | Mortgage |
|---|---|---|---|---|---|---|
| Dec.10 | 3.3 | 5.5 | 8.5 | 14.2 | 19.3 | 8.1 |
| Dec.11 | 3.0 | 5.4 | 8.9 | 16.0 | 22.0 | 8.2 |
| Dec.12 | 4.1 | 6.4 | 9.0 | 15.5 | 22.4 | 8.0 |
| Mar.13 | 4.6 | 7.5 | 10.1 | 14.8 | 24.1 | 8.2 |
| Jun.13 | 2.9 | 6.2 | 9.2 | 14.0 | 25.1 | 8.6 |
| Sep.13 | 3.0 | 6.0 | 8.8 | 13.7 | 25.5 | 8.8 |
| Dec.13 | 2.4 | 5.5 | 8.3 | 13.2 | 26.1 | 8.5 |
| Mar.14 | 2.3 | 5.2 | 8.6 | 13.3 | 26.7 | 8.5 |
| Apr.14 | 2.0 | 5.1 | 8.2 | 13.7 | 26.5 | 8.0 |
| May.14 | 2.0 | 5.1 | 8.5 | 13.2 | 26.7 | 7.8 |
| Jun.14 | 2.3 | 4.8 | 8.5 | 13.0 | 27.1 | 7.7 |
| **Accumulated change (bps)** | | | | | | |
| Jun.14-Mar.14 | -1 | -43 | -6 | -33 | 40 | -78 |
| Jun.14-Dec.13 | -11 | -70 | 23 | -20 | 101 | -72 |
| Jun.14-Jun.13 | -60 | -142 | -73 | -97 | 194 | -81 |

1/ Annual active interest rates on the operations carried out in the last 30 working days.
Source: SBS.

59. On the other hand, the interest rates on less than 30-day deposits in national currency declined 34 basis points, while the interest rates on longer-term deposits increased between 37 and 27 basis points, depending on the term. This evolution reflects mainly the behavior of interest rates for corporate deposits, which are more volatile than the interest rates of the deposits of natural persons. In this period, the latter have remained relatively stable.

**Table 39**
**INTEREST RATES IN NUEVOS SOLES**
(%)

| | Deposits up to 30 days | On 31 to 180-day term deposits | On 181 to 360-day term deposits |
|---|---|---|---|
| Dec.12 | 3.6 | 3.8 | 4.2 |
| Mar.13 | 3.1 | 3.6 | 4.1 |
| Jun.13 | 3.3 | 3.4 | 3.9 |
| Sep.13 | 3.7 | 3.5 | 3.8 |
| Dec.13 | 3.8 | 3.5 | 3.9 |
| Mar.14 | 4.1 | 3.7 | 3.9 |
| Apr.14 | 4.0 | 3.8 | 4.0 |
| May.14 | 3.8 | 4.0 | 4.1 |
| Jun.14 | 3.7 | 4.0 | 4.2 |
| **Accumulated change (bps)** | | | |
| Jun.14-Mar.14 | -34 | 37 | 27 |
| Jun.14-Dec.13 | -4 | 51 | 32 |
| Jun.14-Jun.13 | 39 | 62 | 29 |

Source: BCRP.

As for interest rates for deposits in foreign currency, a reduction was observed in the rates for 31-day to 360-day deposits –3 and 11 basis points, respectively–, while a slight increase was observed in the interest rate of 30-day deposits.

**Table 40**
**INTEREST RATES IN US DOLLARS**
(%)

| | Deposits up to 30 days | On 31 to 180-day term deposits | On 181 to 360-day term deposits |
|---|---|---|---|
| Dec.12 | 1.8 | 1.3 | 1.7 |
| Mar.13 | 2.6 | 1.3 | 1.7 |
| Jun.13 | 0.4 | 1.3 | 1.7 |
| Sep.13 | 0.2 | 1.0 | 1.5 |
| Dec.13 | 0.2 | 0.7 | 1.3 |
| Mar.14 | 0.1 | 0.5 | 1.1 |
| Apr.14 | 0.1 | 0.5 | 1.0 |
| May.14 | 0.1 | 0.5 | 1.0 |
| Jun.14 | 0.1 | 0.5 | 1.0 |
| **Accumulated change (bps)** | | | |
| Jun.14-Mar.14 | 1 | -3 | -11 |
| Jun.14-Dec.13 | -4 | -24 | -33 |
| Jun.14-Jun.13 | -26 | -78 | -70 |

Source: BCRP.

60. The operations of the Central Bank were mainly oriented to maintaining adequate levels of liquidity and ensuring the flow of operations in the money market. This took place in a context of greater availability of short term liquidity in local currency due to the maturities of CDRBCRP, partially offset by net placements of CDBCRP. Between April and June, net placements of CDBCRP amounted to S/.1.48 billion and net maturities of CDRBCRP amounted to S/.3.17 billion.

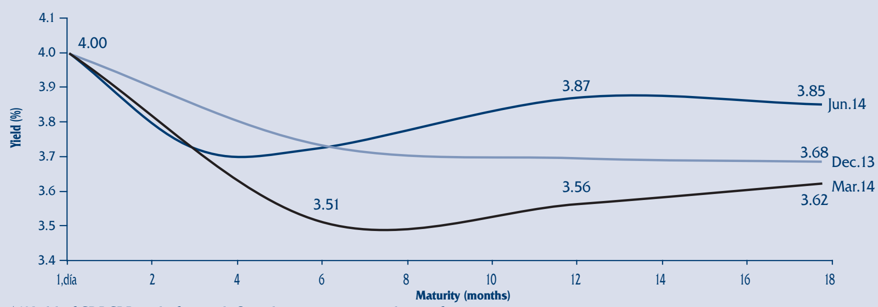
In this period the Central Bank continued making fx-swaps, with 3-month to 24-month fx swaps amounting to a total of S/. 3.2 billion. Through these operations, the BCRP injects liquidity in soles into the financial system by providing soles to banks at a pre-set rate and accepting dollars as collateral. In this way, banks' foreign exchange position is not affected given that these operations are not foreign exchange transactions, but rather liquidity injection operations. Furthermore, the fact that these are long-term operations allows banks to have a better match between the terms of their assets and liabilities, while easing banks' management of liquidity at the same time. The BCRP carried out these operations previously in 2009 with maturity terms of up to twelve months.

**Table 41**
**SWAPS PLACEMENT**
(Million Nuevos Soles)

| | Term | Amount | Average rate |
|---|---|---|---|
| 21.Mar.14 | 18 months | 300 | 4.28% |
| 4.Apr.14 | 18 months | 300 | 4.43% |
| 16.Apr.14 | 18 months | 300 | 4.51% |
| 2.May.14 | 2 years | 300 | 4.83% |
| 9.May.14 | 3 months | 100 | 4.31% |
| 16.May.14 | 18 months | 300 | 4.64% |
| 30.May.14 | 2 years | 300 | 4.22% |
| 13.Jun.14 | 2 years | 300 | 4.37% |
| 27.Jun.14 | 2 years | 300 | 3.99% |
| 3.Jul.14 | 3 months | 200 | 3.91% |
| 4.Jul.14 | 3 months | 200 | 3.83% |
| 11.Jul.14 | 24 months | 300 | 3.67% |
| **TOTAL** | | **3,200** | |

The BCRP also continued carrying out its regular auctions of 6-month, 12-month, and 18-month CDBCRP three times a week, placing certificates of deposit for a total of S/.100 million per auction in order to increase the volume of these certificates and provide more liquidity to the secondary market of CDs. As a result of this, in June the yield curve of CDBCRP showed rates below 4 percent in all the maturity terms, but increased 25 basis points on average in the segment of 6 to 18 months compared to March.

**Graph 63**
**YIELD CURVE OF CENTRAL BANK SECURITIES 1/**




1/ Yield of CDBCRP end of period. One day rate corresponds to reference rate.

As a result of the these liquidity operations, the ratio of instruments issued by the BCRP relative to total liabilities of the Central Bank decreased from representing 13.2 percent of international reserves in December 2013 to 9.6 percent in June 2014. Furthermore, the ratio of reserve requirements declined from 31.0 to 28.2 percent in the same period. The share of required reserves in soles dropped from 9.1 to 7.0 percent of NIRs while the share of required reserves in dollars fell from 21.9 to 21.2 percent. Public sector deposits, which continued to be the largest source of sterilization, went from representing 36.3 percent of reserves in December 2013 to 40.5 percent of reserves in June 2014.

**Table 42**
**SIMPLIFIED BALANCE SHEET OF THE BCRP**
(As % of Net International Reserves)

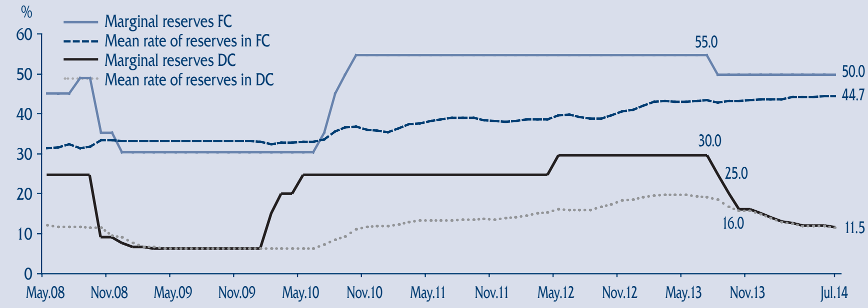
| | | Dec.13 | Jun.14 |
|---|---|---|---|
| **Net assets** | | | |
| **I.** | **Net International Reserves** | **100.0%** (US$ 65,663 mills) | **100.0%** (US$ 64,581 mills) |
| **Net liabilities** | | | |
| **II.** | **Total public sector deposits** | **36.3%** | **40.5%** |
| | In domestic currency | 19.9% | 24.0% |
| | In foreign currency | 16.4% | 16.5% |
| **III.** | **Total reserve requirements** | **31.0%** | **28.2%** |
| | In domestic currency | 9.1% | 7.0% |
| | In foreign currency | 21.9% | 21.2% |
| **IV.** | **BCRP instruments** | **13.2%** | **9.6%** |
| | CD BCRP | 10.3% | 9.0% |
| | CDR BCRP | 1.7% | 0.4% |
| | Overnight deposits | 1.7% | 1.7% |
| | Term deposits | 0.0% | 0.0% |
| | Swaps | 0.0% | -1.4% |
| | Repos | -0.5% | -0.1% |
| **V.** | **Currency** | **19.2%** | **18.6%** |
| **VI.** | **Others** | **0.3%** | **2.1%** |

## Reserve Requirements

61. The BCRP has been adopting several measures to ease reserve requirements in domestic currency in order to provide banks with liquidity in soles to finance the expansion of the credit in this currency in a context in which deposits in soles showed a slower pace of growth. Thus, the Central Bank has gradually reduced mean reserve requirements from 20.0 percent in May 2013 to 11.5 percent in July 2014, thus releasing liquidity for a total of S/. 9 billion. In April the rate of mean reserve requirements in domestic currency was lowered from 12.5 to 12.0 percent and in July it was lowered from 12.0 to 11.5 percent.

62. In addition to this, in order to encourage long-term funding in soles, in May the Central Bank approved to raise as from July the limit of accruals and long-term bonds exempted from reserve requirements from 2.5 to 3.0 times the effective equity of banks at December 31, 2012 or the amount of S/. 400 million –whichever was the largest amount– provided that the bank's liabilities in foreign currency do not exceed the equivalent to 2 times the bank's regulatory capital.

**Graph 64**
**RATES OF RESERVE REQUIREMENTS IN DOMESTIC AND FOREIGN CURRENCY 1/**
(As % of total obligations subject to legal requirements)




1/ Preliminary (May and June 2014) and forecast (July 2014).

**Table 43**
**RESERVE REQUIREMENTS MEASURES**

| | Domestic currency | | | Foreign currency | | | |
|---|---|---|---|---|---|---|---|
| | | | | General regime | | | Foreign liabilities |
| | Marginal reserve requirement on deposits | Increase in the mean reserve requirement | Maximum of mean reserve requirement | Marginal reserve requirement on deposits | Increase in the mean reserve requirement | Maximum of mean reserve requirement | Short-term |
| May.12 | 30% | 0.50% | | 55% | 0.50% | | 60% |
| Sep.12 | 30% | 0.50% | | 55% | 0.50% | | 60% |
| Oct.12 | 30% | 0.50% | | 55% | 0.50% | | 60% |
| Nov.12 | 30% | 0.75% | | 55% | 0.75% | | 60% |
| Jan.13 | 30% | 0.25% | | 55% | 0.75% | | 60% |
| Feb.13 | 30% | -.- | | 55% | 1.00% | | 60% |
| Mar.13 | 30% | -.- | | 55% | 0.50% | | 60% |
| Apr.13 | 30% | -.- | | 55% | 0.25% | | 60% |
| May.13 | 30% | -.- | | 55% | -.- | | 60% |
| Jun.13 | 30% | -.- | 20% | 55% | -.- | | 60% |
| Aug.13 | 25% | -.- | 19% | 50% | -.- | 45% | 50% |
| Sep.13 | 20% | -.- | 17% | 50% | -.- | 45% | 50% |
| Oct.13 | 16% | -.- | 16% | 50% | -.- | 45% | 50% |
| Dec.13 | 15% | -.- | 15% | 50% | -.- | 45% | 50% |
| Jan.14 | 14% | -.- | 14% | 50% | -.- | 45% | 50% |
| Feb.14 | 13% | -.- | 13% | 50% | -.- | 45% | 50% |
| Mar.14 | 12.5% | -.- | 12.5% | 50% | -.- | 45% | 50% |
| Apr.14 | 12% | -.- | 12% | 50% | -.- | 45% | 50% |
| Jul.14 | 11.5% | -.- | 11.5% | 50% | -.- | 45% | 50% |

## Liquidity and Credit

63. Between March and June 2014, the mean currency in circulation showed a slower pace of growth declining from a rate of 8.9 to 7.0 percent annually, which reflected the slowdown observed in economic activity and greater dollarization in deposits, especially in corporate deposits. The demand for currency is expected to increase over the next months to levels closer to 10 percent, reflecting both a recovery in the pace of growth of economic activity and a reversal in the process of dollarization of deposits.

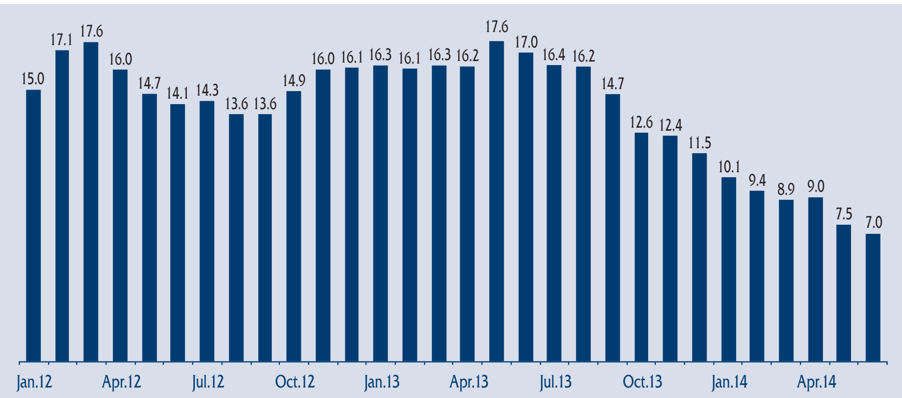
Liquidity in domestic currency continued showing less dynamism in Q2, recording an annual growth rate of 4.1 percent in May (5.7 percent in March). This was associated with the decline observed in the rate of growth of deposits in domestic currency, especially corporate deposits.

**Table 44**
**MONETARY ACCOUNTS (END-OF-PERIOD)**
(12 month % change)

| | Dec.09 | Dec.10 | Dec.11 | Dec.12 | Mar.13 | Jun.13 | Sep.13 | Dec.13 | Mar.14 | Apr.14 | May.14 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Currency in circulation | 11.0 | 25.4 | 13.0 | 18.3 | 17.6 | 16.2 | 13.3 | 9.3 | 8.5 | 7.5 | 7.8 |
| Deposits in domestic currency | 16.3 | 32.4 | 17.8 | 24.7 | 23.9 | 21.7 | 13.8 | 10.8 | 4.1 | 3.5 | 2.2 |
| Broad money in domestic currency | 14.4 | 30.7 | 16.6 | 23.1 | 22.7 | 20.3 | 14.1 | 10.8 | 5.7 | 5.1 | 4.1 |
| Broad money 1/ | 10.9 | 23.2 | 16.8 | 14.1 | 13.9 | 13.8 | 13.8 | 11.3 | 10.2 | 8.8 | 8.6 |
| Credit to the private sector | | | | | | | | | | | |
| in domestic currency | 17.9 | 21.2 | 20.4 | 16.0 | 15.9 | 17.6 | 20.3 | 22.5 | 25.3 | 24.3 | 24.0 |
| Credit to the private sector | 8.9 | 21.2 | 19.4 | 15.4 | 14.1 | 12.8 | 12.8 | 13.2 | 14.6 | 14.9 | 15.4 |

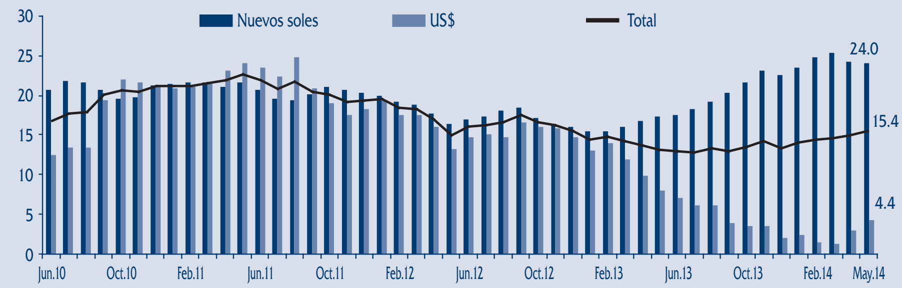
1/ Includes foreign currency.

**Graph 65**
**AVERAGE CURRENCY IN CIRCULATION**
((% change respect to the similar period of previous year)




64. So far in Q2, credit to the private sector shows a higher rate of growth. In May, credit to the private sector grew 15.4 percent, registering greater dynamism than in March (14.6 percent). Credit in domestic currency grew at an annual rate of 24.0 percent at May (25.3 percent in March), while credit in dollars grew 4.4 percent (1.3 percent in March). The expansion of credit in dollars reflects mostly the higher demand for credit in the corporate sector.

**Graph 66**
**CREDIT TO THE PRIVATE SECTOR**
(12 month % change)




| | | Dec.09 | Dec.10 | Dec.11 | Dec.12 | Dec.13 | Jan.14 | Feb.14 | Mar.14 | Apr.14 | May.14 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Nuevos soles | Monthly flows (Million S/.) | 569 | 1,514 | 1,669 | 1,660 | 1,430 | 851 | 2,231 | 2,619 | 1,153 | 1,472 |
| | Monthly % change | 1.0 | 2.2 | 2.1 | 1.8 | 1.2 | 0.7 | 1.9 | 2.2 | 0.9 | 1.2 |
| | Annual % change | 17.9 | 21.2 | 20.4 | 16.0 | 22.5 | 23.6 | 24.8 | 25.3 | 24.3 | 24.0 |
| US$ | Flujos,mensuales,(Million US$) | 343 | 368 | 570 | 370 | -23 | -40 | -158 | -62 | 297 | 439 |
| | Monthly % change | 2.0 | 1.8 | 2.3 | 1.3 | -0.1 | -0.1 | -0.5 | -0.2 | 1.0 | 1.5 |
| | Annual % change | -0.1 | 21.3 | 18.2 | 14.7 | 2.0 | 2.3 | 1.5 | 1.3 | 3.0 | 4.4 |
| Total | Monthly flows (Million S/.) | 1,530 | 2,543 | 3,264 | 2,697 | 1,366 | 739 | 1,788 | 2,445 | 1,985 | 2,700 |
| | Monthly % change | 1.5 | 2.0 | 2.2 | 1.6 | 0.7 | 0.4 | 0.9 | 1.2 | 1.0 | 1.3 |
| | Annual % change | 8.9 | 21.2 | 19.4 | 15.4 | 13.2 | 14.0 | 14.3 | 14.6 | 14.9 | 15.4 |

65. By type of credit, credit to businesses showed a greater dynamism than credit to individuals. Thus, corporate loans grew 16.8 percent in May relative to the same month of 2013 (14.9 percent in March). Corporate loans and credit to large companies showed the greater expansion in this segment.

**Table 45**
**CREDIT TO THE PRIVATE SECTOR**
(12 month % change)

| | Dec.12 | Mar.13 | Jun.13 | Sep.13 | Dec.13 | Mar.14 | May.14 |
|---|---|---|---|---|---|---|---|
| **Businesses** | **13.3** | **12.5** | **10.9** | **11.9** | **13.2** | **14.9** | **16.8** |
| Corporate and large companies | 8.5 | 8.8 | 10.6 | 17.2 | 21.6 | 22.8 | 27.8 |
| Medium-sized enterprises | 18.4 | 18.4 | 11.7 | 9.2 | 10.4 | 15.6 | 14.5 |
| Small business and Microbusinesses | 16.7 | 12.8 | 10.6 | 5.8 | 2.3 | 1.8 | 1.3 |
| **Individuals** | **19.4** | **17.1** | **16.2** | **14.5** | **13.4** | **14.0** | **13.1** |
| Consumption | 15.3 | 12.8 | 12.1 | 11.3 | 11.4 | 12.6 | 12.4 |
| Car loans | 25.2 | 26.8 | 23.2 | 18.7 | 14.5 | 10.6 | 8.1 |
| Credit cards | 13.4 | 8.9 | 7.5 | 8.2 | 8.2 | 10.2 | 11.2 |
| Mortgage | 25.7 | 23.5 | 22.3 | 19.0 | 16.2 | 15.9 | 14.1 |
| **Total** | **15.4** | **14.1** | **12.8** | **12.8** | **13.2** | **14.6** | **15.4** |

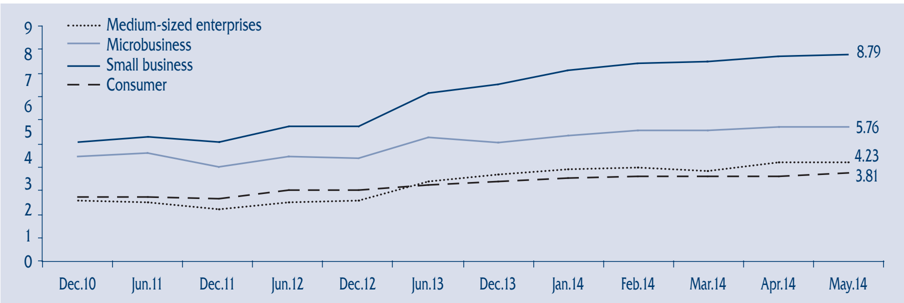
Credit to small and micro businesses continued slowing down in Q2. The growth rate of total credit to this sector in the last 12 months was 1.3 percent in May (1.8 percent in March and 2.3 percent in December 2013). The greatest contraction of credit in this segment is observed in banks (-7.8 percent in May), where credit has dropped both in domestic currency and in foreign currency, although the fall in the latter has been more pronounced as a result of banks' increased perception of risk in this portfolio due to the rising delinquency rates observed.

**Table 46**
**LOANS TO SMALL BUSINESSES AND MICROBUSINESSES BY CURRENCY**

| | Annual flows | | | Growth rate % | | |
|---|---|---|---|---|---|---|
| | Dec.13 | Mar.14 | May.14 | Dec.12/Dec.13 | Mar.13/Mar.14 | May.13/May.14 |
| **Small businesses and microbusinesses** | | | | | | |
| **Banks** | **-698** | **-1,168** | **-1,234** | **-4.4** | **-7.4** | **-7.8** |
| DC | 141 | -255 | -541 | 1.1 | -2.1 | -4.3 |
| FC | -300 | -326 | -248 | -23.8 | -26.8 | -21.4 |
| **Rest** | **1,436** | **1,724** | **1,654** | **9.0** | **10.8** | **10.2** |
| DC | 1,640 | 1,795 | 1,718 | 11.3 | 12.3 | 11.6 |
| FC | -73 | -25 | -23 | -13.7 | -5.1 | -4.7 |
| **Total** | **738** | **556** | **420** | **2.3** | **1.8** | **1.3** |
| DC | 1,781 | 1,540 | 1,178 | 6.6 | 5.7 | 4.3 |
| FC | -373 | -351 | -270 | -20.8 | -20.6 | -16.5 |

In May the delinquency ratios registered in depository institutions continued showing an upward trend. The default rate of credit to businesses rose to 3.19 percent in May from a level of 3.10 percent in March. In the segment of corporate loans, credit to medium-sized companies showed the greatest increase in the default rate since March, climbing from 3.88 to 4.23 percent, while this rate in credit to small businesses went from 8.54 percent in March to 8.79 percent in May and from 5.57 percent in March to 5.76 percent in May in the case of micro businesses. As for credit to individuals, the default rate also continued to rise and reached a level of 2.63 percent in May, a higher level than the 2.51 percent level registered in March this year.

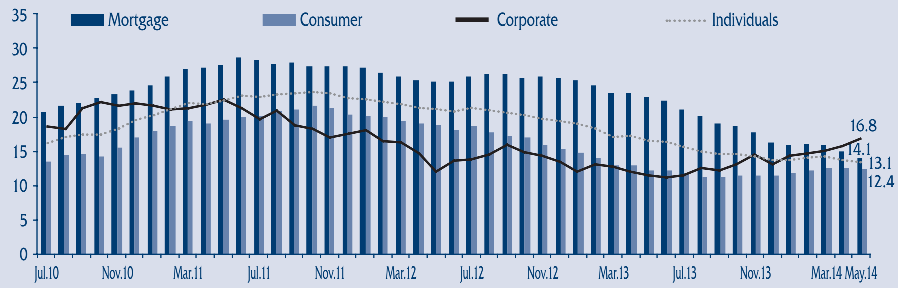
**Graph 67**
**CREDITS: DELINQUENCY RATES**
(As % of portfolio)




The annual growth rate of credit to individuals showed a slight slowdown both in April and in May, reflecting people's increased caution against taking loans. Thus, mortgage loans recorded an annual growth rate of 14.1 percent in May (15.9

percent in March), while consumer loans showed an annual rate of 12.4 percent (12.6 percent in March). Furthermore, car loans showed a lower growth rate in May (8.1 percent versus an annual growth rate of 10.6 percent in March).

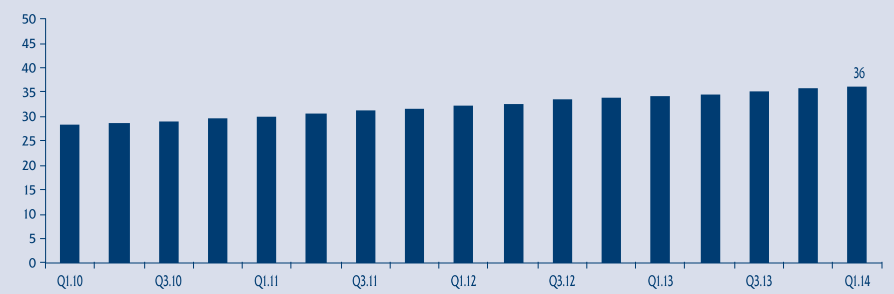
**Graph 68**
**CREDIT BY TYPE OF LOANS: APR.10 - FEB.14**
(12 month % change)




| | | Dec.12 | Dec.13 | Jan.14 | Feb.14 | Mar.14 | Apr.14 | May.14 |
|---|---|---|---|---|---|---|---|---|
| Corporate | Monthly flows (Million S/.) | 1,735 | 478 | 309 | 1,108 | 1,825 | 1,363 | 1,851 |
| | Monthly % change | 1.6 | 0.4 | 0.2 | 0.9 | 1.4 | 1.0 | 1.4 |
| | Annual % change | 13.3 | 13.0 | 14.2 | 14.6 | 14.9 | 15.7 | 16.8 |
| Individuals | Monthly flows (Million S/.) | 962 | 686 | 436 | 681 | 621 | 623 | 849 |
| | Monthly % change | 1.6 | 1.0 | 0.8 | 1.0 | 0.9 | 0.9 | 1.2 |
| | Annual % change | 19.4 | 13.4 | 13.5 | 13.8 | 14.0 | 13.5 | 13.1 |
| Consumer | Monthly flows (Million S/.) | 498 | 507 | 165 | 339 | 225 | 383 | 560 |
| | Monthly % change | 1.4 | 1.3 | 0.7 | 0.8 | 0.5 | 0.9 | 1.3 |
| | Annual % change | 15.3 | 11.4 | 11.9 | 12.1 | 12.6 | 12.5 | 12.4 |
| Mortgage | Monthly flows (Million S/.) | 464 | 180 | 270 | 342 | 395 | 240 | 289 |
| | Monthly % change | 1.8 | 0.6 | 1.0 | 1.1 | 1.3 | 0.8 | 0.9 |
| | Annual % change | 25.7 | 16.2 | 15.8 | 16.1 | 15.9 | 14.9 | 14.1 |

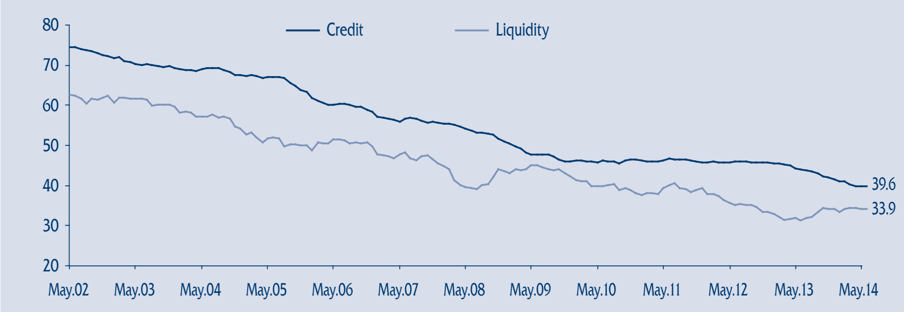
66. Credit is projected to grow around 14.0 percent in 2014, driven primarily by credit in domestic currency which is foreseen to continue being the most dynamic type of credit. This projection is consistent with an estimated GDP growth rate of 4.4 percent in 2014 and with the forecast that the use of direct external financing by the corporate sector would be lower in 2014 than in 2013. Should the growth rate of deposits in soles continue to decrease, the BCRP will evaluate the possibility of continue reducing the rate of required reserves in soles with the aim of providing a more permanent source of expansion of liquidity in order that banks' interest rates for operations in domestic currency are not affected. Therefore, the ratio of credit to GDP is expected to continue increasing during 2014.

**Graph 69**
**RATIO: CREDIT/GDP**
(%)



67. The ratio of dollarization of credit rose from 39.5 percent in March to 39.6 percent in May, in line with the trend observed over the year. On the other hand, the dollarization of liquidity decreased from 34.1 to 33.9 percent in the same period. This reverses the trend observed in Q1, although the ratio remains above the level observed in December (33.0 percent).

**Graph 70**
**DOLLARIZATION RATIO: 2002-2014**
(%)




By type of credit, mortgage loans show a higher rate of de-dollarization (down from 36.5 to 35.4 percent between March and May of 2014), which would be reflecting in part the reserve requirement measures conditional to the expansion of mortgage loans and car loans in foreign currency that the BCRP implemented in March 2013, while the rate of de-dollarization in the case of credit to businesses went from 49.6 to 50.1 percent in the same period, the de-dollarization rate of credit to medium-sized companies being higher.

**Table 47**
**DOLLARIZATION RATIO OF CREDIT TO THE PRIVATE SECTOR**

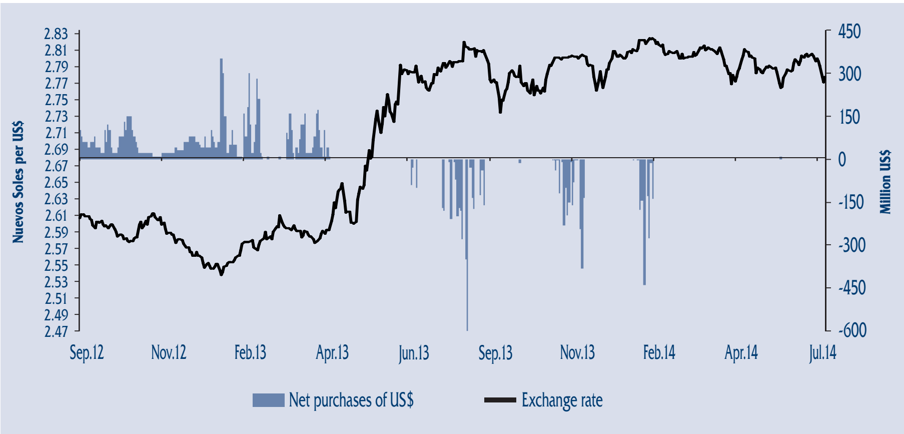
| | Dec.12 | Dec.13 | Mar.14 | May.14 |
|---|---|---|---|---|
| **Business** | **56.1** | **51.2** | **49.6** | **50.1** |
| Corporate and large companies | 74.2 | 65.7 | 62.6 | 63.2 |
| Medium-sized enterprises | 68.0 | 62.3 | 61.0 | 60.2 |
| Small business and Microbusiness | 15.8 | 12.2 | 11.8 | 11.9 |
| **Individuals** | **25.6** | **22.0** | **21.1** | **20.5** |
| Consumer | 10.5 | 9.8 | 9.6 | 9.6, |
| Car loans | 78.1 | 74.8 | 72.8 | 72.0 |
| Credit cards | 7.0 | 6.8 | 6.8 | 7.0 |
| Mortgage | 47.1 | 38.5 | 36.5 | 35.4 |
| **TOTAL** | **45.3** | **40.8** | **39.5** | **39.6** |

## Exchange Rate and Intervention in the Foreign Exchange Market

68. The exchange rate has fluctuated during Q2-2014, in line with the evolution of international markets which reflected lower risk aversion regarding the emerging

economies. Between April and June, the exchange rate appreciated 0.4 percent, from S/. 2.81 per dollar at the end of March to S/. 2.80 per dollar at the end of June, in line with the developments observed in the emerging economies of the region (Brazil, Mexico, Colombia, and Chile). However, a depreciation trend was observed in the local currency in June, when it fell from S/. 2.77 per dollar at the end of May to S/. 2.80 per dollar in June. This trend reversed in the first week of July, reflecting the impact of Moody's upgrading its risk rating from Baa2 to A3.

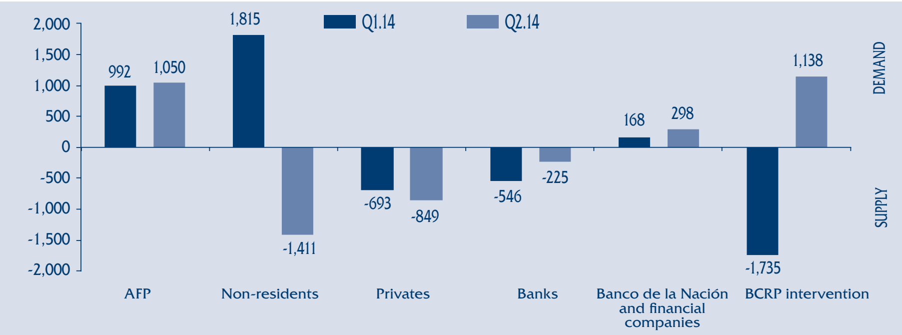
**Graph 71**
**INTERVENTION IN THE FOREIGN EXCHANGE MARKET AND EXCHANGE RATE**




In contrast with what happened in the first quarter of the year, a net offer of dollars of US$ 1.14 billion provided mainly by non-residents which shifted their market position from a buy-position in Q1 (US$ 1.81 billion, of which US$ 1.49 billion reflected in a net demand in the spot market to a sell-position in Q2 (US$ 1.41 billion) was observed in the second quarter of 2014. This offer was mainly observed in the market of derivatives –US$ 1.96 billion– which reflected increased maturities of purchases of forwards and led to a drop in non-residents' ratio of coverage –net balance of forwards to portfolio of sovereign bonds– from around 50 percent at the end of March to around 26 percent in June. On the other hand, other agents (AFP, private investors, banks and financial agencies) have maintained their position with similar amounts in both quarters.

In this context, the BCRP intervened in the foreign exchange market less frequently and with lower amounts (purchases of FC in the spot market amounted to US$ 10 million, while net maturities of CDRBCRP amounted to US$ 1.13 billion).

**Graph 72**
**FOREX MARKET FLOWS - SPOT AND FORWARD: H1.14**
(Million US$)




69. The BCRP survey on macroeconomic expectations shows that all the economic agents expect a moderate depreciation of the nuevo sol this year and next year, but the depreciation is expected to be lower than the one estimated in our previous inflation report. Financial entities have lowered the US/nuevo sol exchange rate they expect at end-2014 from S/. 2.85 per dollar in March (Inflation Report of April) to S/.2.83 per dollar at end-June, which is consistent with the trend observed in the foreign exchange market in Q2.

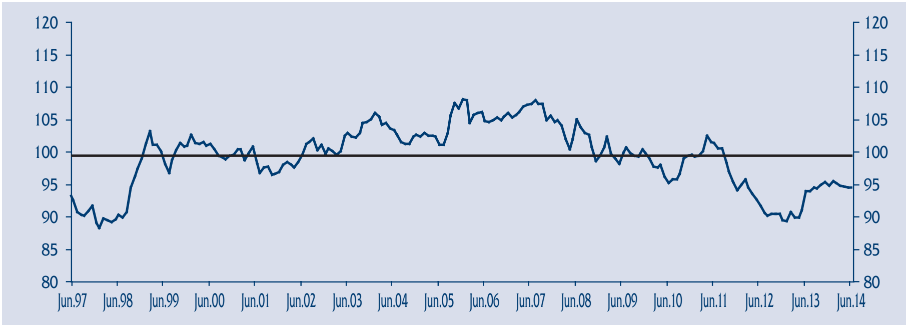
**Table 48**
**SURVEY ON MACROECONOMIC EXPECTATIONS: EXCHANGE RATE**
(Nuevos Soles per US$)

| | Expectations about: | | |
|---|---|---|---|
| | IR Dec.13 | IR Apr.14 | IR Jul.14* |
| **Financial entities** | | | |
| 2014 | 2.85 | 2.85 | 2.83 |
| 2015 | 2.85 | 2.85 | 2.88 |
| 2016 | -.- | 2.87 | 2.90 |
| **Economic analysts** | | | |
| 2014 | 2.90 | 2.85 | 2.84 |
| 2015 | 2.90 | 2.90 | 2.88 |
| 2016 | -.- | 2.90 | 3.03 |
| **Non-financial firms** | | | |
| 2014 | 2.82 | 2.85 | 2.80 |
| 2015 | 2.85 | 2.88 | 2.85 |
| 2016 | -.- | 2.90 | 2.90 |
| **Average** | | | |
| 2014 | 2.86 | 2.85 | 2.82 |
| 2015 | 2.87 | 2.88 | 2.87 |
| 2016 | -.- | 2.89 | 2.94 |

*Survey conducted during the second fortnight of June 2014.
IR: Inflation Report.

70. The multilateral real exchange rate index has remained stable around 95 between December 2013 and June 2014. In the last 12 months there has been a real depreciation of 0.6 percent.

**Graph 73**
**MULTILATERAL RER**
(Index 2009=100)



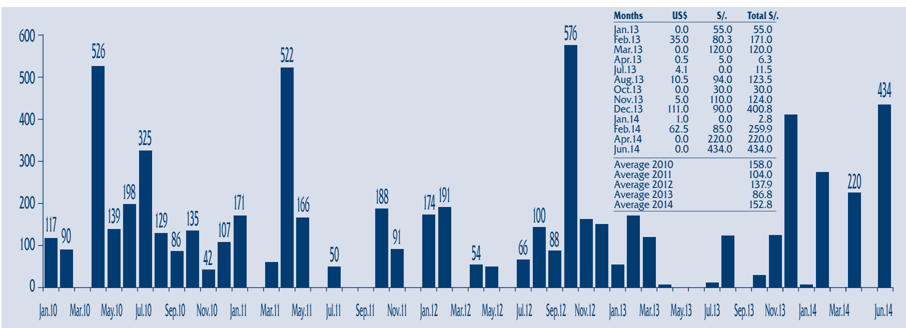

## Capital Market

71. Between March and June 2014, non-financial companies issued securities for a total of S/. 654 million. No securities denominated in foreign currency were issued. Increased dynamism is observed so far this year in the pace of non-financial companies' placements of bonds in the local market.

On the other hand, security issuances in the international market show less dynamism than in Q1-2014. Bonds worth US$ 1.31 billion were issued at coupon rates between 6.88 to 9.88 percent in dollars, at 1.25 percent in Swiss francs, at 8.38 percent in new Peruvian soles, and at 5.25 percent in nuevos soles VAC between April and June, their maturities ranging between 3 and 29 years. In the first days of July, the Peruvian company InRetail Shopping Mall issued 7-year bonds for a total of US$ 350 million at a coupon rate of 6.5 percent, Banco de Crédito issued 4-year bonds for a total of US$ 225 million (at a coupon rate of 2.75 percent), and COFIDE made two issuances for US$ 300 million each (with maturities of 5 to 15 years and rates of 3.25 and 5.25 percent, respectively).

.

**Graph 74**
**BONDS ISSUED BY NON-FINANCIAL FIRMS***
(Million S/.)




| Months | US$ | S/. | Total S/. |
|---|---|---|---|
| Jan.13 | 0.0 | 55.0 | 55.0 |
| Feb.13 | 35.0 | 80.3 | 171.0 |
| Mar.13 | 0.0 | 120.0 | 120.0 |
| Apr.13 | 0.5 | 5.0 | 6.3 |
| Jul.13 | 4.1 | 0.0 | 11.5 |
| Aug.13 | 10.5 | 94.0 | 123.5 |
| Oct.13 | 0.0 | 30.0 | 30.0 |
| Nov.13 | 5.0 | 110.0 | 124.0 |
| Dec.13 | 111.0 | 90.0 | 400.8 |
| Jan.14 | 1.0 | 0.0 | 2.8 |
| Feb.14 | 62.5 | 85.0 | 259.9 |
| Apr.14 | 0.0 | 220.0 | 220.0 |
| Jun.14 | 0.0 | 434.0 | 434.0 |
| Average 2010 | | | 158.0 |
| Average 2011 | | | 104.0 |
| Average 2012 | | | 137.9 |
| Average 2013 | | | 86.8 |
| Average 2014 | | | 152.8 |

* Emissions are measured in dollars at the rate of change of last month. Includes titulization bonds.

**Table 49**
**BONDS ISSUED IN THE INTERNATIONAL MARKET**

| Business | Date | Amount (Million US$) | Maturity (Years) | Rate |
|---|---|---|---|---|
| **Year 2013** | | **6,389** | | |
| | | | | |
| **Non-financial sector** | | **4,153** | | |
| Copeinca | Jan 11 | 75 | 5 | 9.00% |
| Exalmar | Jan 25 | 200 | 7 | 7.38% |
| Cementos Pacasmayo | Feb 1 | 300 | 10 | 4.63% |
| Alicorp | Mar 15 | 450 | 10 | 3.88% |
| Gas Natural de Lima y Callao - Cálidda | Mar 21 | 320 | 10 | 4.38% |
| Compañía Minera Milpo | Mar 21 | 350 | 10 | 4.63% |
| Corporacion Lindley | Apr 9 | 260 | 10 | 4.63% |
| Ferreyrcorp | Apr 19 | 300 | 7 | 4.88% |
| Transportadora de Gas del Perú | Apr 23 | 850 | 15 | 4.25% |
| Consorcio Transmantaro | Apr 30 | 450 | 10 | 4.38% |
| Inkia Energy | Sep 9 | 150 | 8 | 8.38% |
| San Miguel Industrias | Oct 30 | 200 | 7 | 7.75% |
| Andino Investment Holding | Nov 7 | 115 | 7 | 11.00% |
| Planta de Reserva Fría de Generación de Eten | Nov 28 | 133 | 20 | 7.65% |
| | | | | |
| **Financial sector** | | **2,236** | | |
| BBVA Banco Continental | Jan 22 | 300 | 4 | 2.31% |
| Fondo MiVivienda | Jan 24 | 500 | 10 | 3.50% |
| Banco de Credit | Mar 25 | 716 | 10 | 4.25% |
| BBVA Banco Continental | Apr 3 | 500 | 5 | 3.25% |
| Banco de Credit | Apr 5 | 170 | 14 | 6.13% |
| | | | | |
| **Year 2014** | | **4,081** | | |
| | | | | |
| **Non-financial sector** | | **2,177** | | |
| Compañía Minera Ares | Jan 15 | 350 | 7 | 7.75% |
| Minsur | Jan 31 | 450 | 10 | 6.25% |
| Abengoa Transmisión Sur | Apr 8 | 432 | 29 | 6.88% |
| Camposol | Apr 24 | 75 | 3 | 9.88% |
| Rutas de Lima** | Jun 27 | 370 | 22 | 8.38% |
| Rutas de Lima*** | Jun 27 | 150 | 25 | 5.25% |
| InRetail Shopping Mall | Jul 1 | 350 | 7 | 6.50% |
| | | | | |
| **Financial sector** | | **1,904** | | |
| Banco de Credit | Jan 15 | 200 | 13 | 6.13% |
| Interbank | Mar 11 | 300 | 15 | 6.63% |
| Fondo MiVivienda | Mar 26 | 300 | 5 | 3.38% |
| Fondo MiVivienda* | May 15 | 279 | 4 | 1.25% |
| Banco de Credit | Jul 1 | 225 | 4 | 2.75% |
| COFIDE | Jul 8 | 300 | 5 | 3.25% |
| COFIDE | Jul 8 | 300 | 15 | 5.25% |

* Emission in Swiss Franc.
** Emission in Nuevos Soles.
*** Emission in Nuevos Soles VAC.

72. The yields of sovereign bonds decreased considerably in Q2-2014 (53 basis points), in line with the downward trend shown by the yields of the U.S. Treasury bonds and Peruvian global bonds, as well as in line with greater stability in financial markets given expectations that the Federal Reserve will maintain interest rates at their historic record lows for an extended period of time and with lower risk in the emerging economies after fears of a rapid slowdown in the Chinese economy subsided. Between March and June 2014, the yields of U.S. Treasury bonds yields declined 9 basis points on average, while the rates of global bonds decreased 30 basis points.

**Table 50**
**PERU GLOBAL AND SOVEREIGN BOND YIELDS AND US TREASURY BONDS BY MATURITY**
(At the end of period, % points)

| | | | | | Variation (In bps) | |
|---|---|---|---|---|---|---|
| | Dec.12 (4) | Dec.13 (3) | Mar.14 (2) | Jun.14 (1) | Jun.14 / Dec.13 (1)-(2) | Jun.14 / Mar.14 (1)-(3) |
| **Sovereign bonds (S/.)** | | | | | | |
| PERU 2013 | 2.61 | | | | | |
| PERU 2015 | 2.75 | 4.00 | 3.75 | 3.77 | -23 | 2 |
| PERU 2017 | 3.05 | 4.22 | 4.20 | 4.00 | -22 | -20 |
| PERU 2020 | 3.83 | 5.29 | 5.74 | 4.96 | -33 | -78 |
| PERU 2023 | 4.10 | 5.60 | 5.99 | 5.28 | -32 | -71 |
| PERU 2026 | 4.24 | 6.23 | 6.31 | 5.61 | -62 | -70 |
| PERU 2029 | | 6.68 | 6.85 | 6.04 | -64 | -81 |
| PERU 2031 | 4.79 | 6.93 | 6.82 | 6.23 | -70 | -59 |
| PERU 2037 | 4.91 | 7.03 | 6.99 | 6.49 | -54 | -50 |
| PERU 2042 | 5.09 | 7.18 | 7.07 | 6.59 | -59 | -48 |
| **Global bonds (US$)** | | | | | | |
| PERU 2015 | 1.05 | 0.67 | 1.02 | 0.87 | 21 | -15 |
| PERU 2016 | 1.24 | 1.53 | 1.46 | 1.09 | -44 | -37 |
| PERU 2019 | 1.93 | 2.85 | 2.63 | 2.32 | -52 | -30 |
| PERU 2025 | 3.06 | 4.50 | 4.13 | 3.78 | -71 | -35 |
| PERU 2033 | 3.70 | 5.36 | 4.99 | 4.67 | -69 | -31 |
| PERU 2037 | 3.72 | 5.48 | 5.06 | 4.76 | -72 | -29 |
| PERU 2050 | 4.11 | 5.69 | 5.31 | 4.96 | | -35 |
| **US Treasury** | | | | | | |
| 2 Years bond | 0.25 | 0.38 | 0.42 | 0.46 | 8 | 4 |
| 3 Years bond | 0.35 | 0.77 | 0.87 | 0.87 | 10 | 0 |
| 5 Years bond | 0.72 | 1.74 | 1.72 | 1.63 | -11 | -9 |
| 10 Years bond | 1.76 | 3.03 | 2.72 | 2.53 | -50 | -19 |
| 30 Years bond | 2.95 | 3.97 | 3.56 | 3.36 | -61 | -20 |

Source: Bloomberg.

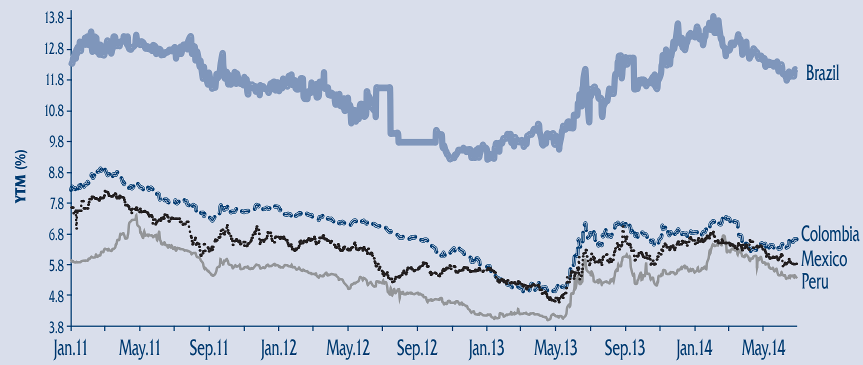
73. Thus, at the end of June 2014 the yield curve has flattened in all its sections compared to March.

**Graph 75**
**YIELD CURVE OF SOVEREIGN BONDS IN THE SECONDARY MARKET 1/**


1/ End of month yield.

74. Peruvian sovereign bonds continue to show some of the lowest yield rates of bonds in the region: the yield of Peru's 10-year sovereign bond is 5.28 percent, while the yields of the sovereign bonds of Brazil, Colombia and Mexico for the same maturity term are 12.10, 6.58 and 5.77 percent, respectively.

**Graph 76**
**LATAM YIELD CURVE OF 10 YEAR SOVEREIGN BONDS**

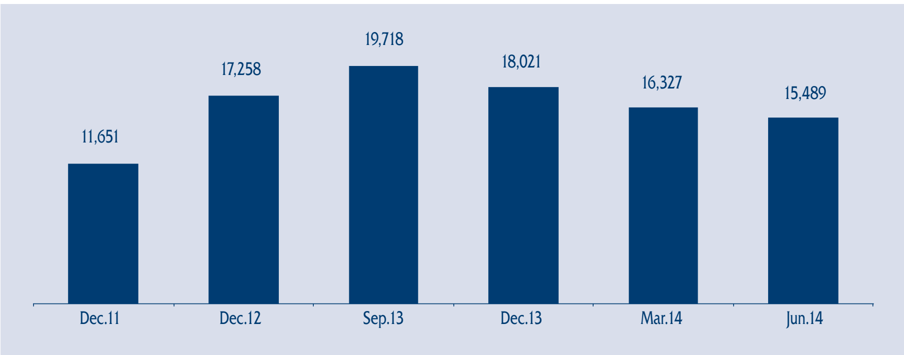



75. Moreover, credit default swaps (CDS) continued to decline in Q2-2014. Thus, the spreads of Peru's 5-year and 10-year sovereign bonds decreased by 33 and 34 basis points to 82 and 128 basis points, respectively, showing a similar conduct to the one recorded by the Peru EMBIG, which fell 17 basis points. On July 2, CDS recorded their historical minimum values since July 2007 –when the subprime crisis started– due to the upgrading from Baa2 to A3 with a stable outlook assigned by Moody's to Peru's debt in foreign currency.

**Graph 77**
**CREDIT DEFAULT SWAPS OF SOVEREIGN PUBLIC DEBT**
(Basis points)

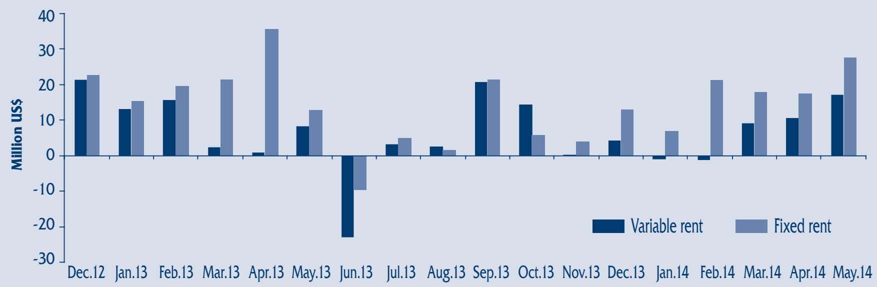

76. Non-residents' holdings of sovereign bonds declined from S/. 16.33 billion in March to S/.15.49 billion in June, in line with the decrease observed in investment flows to the region. Thus, BTPs held by non-resident investors fell from 46 to 44 percent of the total balance, which has not affected the continuous decline in the yields of sovereign bonds.

**Graph 78**
**NON-RESIDENTS' HOLDINGS OF SOVEREIGN BONDS**
(Million S/.)




77. Fixed income and variable income capital flows to emerging markets grew by US$ 9.7 million and US$ 7.9 million, respectively, between March and May of 2014. A recovery has been observed in capital inflows to the region since September 2013 after a significant capital outflow took place in May and June 2013 following the announcement of the Federal Reserve that it would start reducing the pace of its asset-purchase program and after the recent decline registered earlier this year.

**Graph 79**
**EMERGING MARKETS: NET FLOWS OF FUNDS**




Source: Institute of International Finance.

78. Pension Funds increased from S/. 103.16 billion to S/. 106.12 billion between March and May. In the same period, investments abroad increased by US$ 1.07 billion compared to March 2014 and by US$ 1.79 billion compared to end-2013. As a result, the percentage of AFPs investment abroad rose from 35.2 percent in December 2013 to 38.2 percent in May 2014, while the limit established by the Central Bank increased from 36.5 percent to 39.0 percent. In July, this limit was raised to 40 percent.

**Table 51**
**PORTFOLIOS MANAGED BY FINANCIAL INSTRUMENTS AND AFP**
(Million S/.)

| | Dec.13 | | Mar.14 | | May.14 | |
|---|---|---|---|---|---|---|
| | **Amount** | **%** | **Amount** | **%** | **Amount** | **%** |
| **I. DOMESTIC INVESTMENT** | **66,461** | **65.1** | **64,835** | **62.9** | **65,358** | **61.6** |
| 1. Government | 13,746 | 13.5 | 13,130 | 12.7 | 13,900 | 13.1 |
| Certificates and term deposits of BCRP 1/ | 2,191 | 2.1 | 861 | 0.8 | 501 | 0.5 |
| Bonds of Central Government | 11,555 | 11.3 | 12,252 | 11.9 | 13,384 | 12.6 |
| 2. Financial entities | 22,672 | 22.2 | 22,919 | 22.2 | 22,540 | 21.2 |
| Shares and Securitised Shares | 2,934 | 2.9 | 2,626 | 2.5 | 2,174 | 2.0 |
| 3. Non-financial firms | 20,207 | 19.8 | 18,923 | 18.3 | 19,025 | 17.9 |
| Shares and Securitised Shares | 13,965 | 13.7 | 12,341 | 12.0 | 12,768 | 12.0 |
| 4. Fund managers | 4,308 | 4.2 | 4,220 | 4.1 | 4,281 | 4.0 |
| 5. Securitization companies | 5,528 | 5.4 | 5,643 | 5.5 | 5,611 | 5.3 |
| **II. FOREIGN INVESTMENTS** | **35,920** | **35.2** | **38,108** | **36.9** | **40,506** | **38.2** |
| 1. Government | 1,341 | 1.3 | 1,481 | 1.4 | 1,750 | 1.6 |
| 2. Financial entities | 2,732 | 2.7 | 2,909 | 2.8 | 3,351 | 3.2 |
| 3. Non-financial firms | 6,752 | 6.6 | 5,596 | 5.4 | 4,831 | 4.6 |
| 4. Fund managers | 25,095 | 24.6 | 28,122 | 27.3 | 30,575 | 28.8 |
| 5. Securitization companies | - | - | 0 | - | 0 | - |
| **III. OPERATIONS IN TRANSIT** | **-304.3** | **-0.3** | **213.2** | **0.2** | **255.3** | **0.2** |
| **TOTAL** | **102,077** | **100.0** | **103,157** | **100.0** | **106,119** | **100.0** |
| Foreign investment / Portfolio managed | 35.2% | | 36.9% | | 38.2% | |

1/ Includes Overnight deposits and BCRP Certificates of Deposit with Restricted Negotiation (CDBCRP-NR).
Source: SBS.

During this period, the AFPs also continued to increase the percentage of their investments in dollars, as a result of which the ratio of dollarization rose from 58.0 percent in March 2014 to 60.6 percent in May 2014.

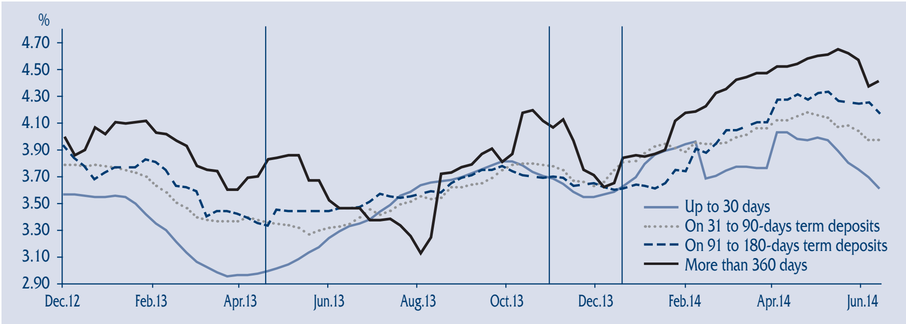
**Table 52**
**AFP INVESTMENT**
(Million US$)

| Date | Total | | | |
|---|---|---|---|---|
| | Abroad | | In US$ | |
| | Amount | % Portfolio | Amount | % Portfolio |
| Dec.12 | 11,177 | 29.4 | 19,646 | 51.7 |
| Jan.13 | 11,814 | 30.6 | 20,113 | 52.1 |
| Mar.13 | 12,230 | 31.6 | 20,684 | 53.4 |
| Jun.13 | 12,091 | 35.2 | 19,841 | 57.6 |
| Jul.13 | 12,080 | 34.6 | 20,626 | 59.0 |
| Aug.13 | 11,594 | 33.8 | 20,013 | 58.3 |
| Sep.13 | 11,874 | 33.7 | 20,478 | 58.1 |
| Oct.13 | 12,661 | 34.8 | 21,226 | 58.4 |
| Nov.13 | 12,474 | 34.8 | 21,476 | 59.9 |
| Dec.13 | 12,852 | 35.2 | 19,872 | 54.4 |
| Jan.14 | 12,442 | 34.8 | 20,174 | 56.4 |
| Feb.14 | 13,173 | 35.9 | 21,591 | 58.9 |
| Mar.14 | 13,571 | 36.9 | 21,295 | 58.0 |
| Apr.14 | 13,989 | 37.4 | 22,731 | 60.7 |
| May.14 | 14,644 | 38.2 | 23,255 | 60.6 |

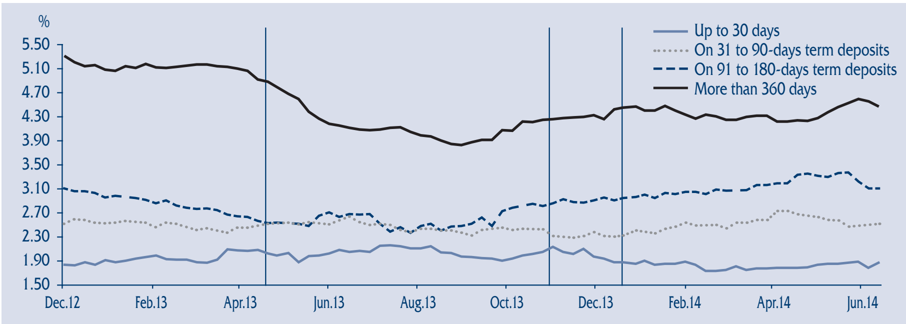
### Box 5
### DOLLARIZATION OF DEPOSITS AND EVOLUTION OF DEPOSIT INTEREST RATES

As a result of an increased perception of foreign exchange risk associated with the Fed's tapering of its asset purchase program, a change in the composition of deposits reflected in a greater preference for deposits in dollars and an increase in demand for credit in soles has been observed since May 2013, which has affected deposit interest rates in domestic currency. The lower availability of funding for credit in soles over the past few quarters has reflected in the evolution of passive interest rates in domestic currency in the financial system. As the graph below shows, the interest rates paid by banks to enterprises reached their minimum levels between December 2012 and April 2013, period during which the flow of deposits in soles exceeded the demand for credit in this currency. However, as from May 2013, this trend has begun to reverse, a gradual increase being observed in deposit interest rates in soles and in the flow of credit in soles compared to the flow of deposits in this currency.

**DEPOSIT INTEREST RATE OF BUSINESS - BANKS**
(%)




**DEPOSIT INTEREST RATE OF INDIVIDUALS - BANKS**
(%)




However, a reversal was observed in the downward trend of deposit interest rates, especially in corporate rates, since early December 2013. It should be pointed out that during this period, the spread between the interest rates of over 360-day deposits and 30-day deposits registered its greatest increase –around 50 basis points–, reflecting also banks' increased demand for over 30-day funding, in line with the new liquidity requirements established by Superintendencia de Banca, Seguros y AFPs (SBS) –in force since January 2014– that encourage banks to maintain longer-term funding sources.

This evolution in the passive interest rates of corporate deposits was not observed in the deposit interest rates of individuals' deposits. The latter showed a lower volatility in all the deposit terms –0.20 percent on average– while the former showed a greater volatility –0.32 percent on average–.

**STANDARD DEVIATION FROM DEPOSIT INTEREST RATE**

| | < 30 days | 31-90 days | 91-180 days | > 360 days |
|---|---|---|---|---|
| Individuals | 0.28% | 0.14% | 0.11% | 0.28% |
| Businesses | 0.29% | 0.28% | 0.30% | 0.41% |

The different conduct of the interest rates for corporate deposits and for people's deposits reflects mainly the different behavior shown by these two types of agents face the increased foreign exchange risk perceived since May 2013. While companies and institutional investors reacted dollarizing their deposits, individuals continued increasing their deposits in recent months. Thus, companies' deposits in domestic currency went from a positive average monthly flow of S/. 602 million between April 2013 and December 2012 to a negative average monthly flow of S/. 450 million between May and December 2013, while natural persons' flow of deposits went from a monthly average of S/. 939 million to a monthly average of S/. 873 million in the same period.

**DEPOSITS IN DOMESTIC CURRENCY**
Monthly average flows in million nuevos soles

| | Apr.13/Dec.12 | Dec.13/Apr.13 | May.14/Dec.13 |
|---|---|---|---|
| **TOTAL** | **1,541** | **423** | **-7** |
| | | | |
| **Individuals** | **939** | **873** | **508** |
| Demand | 74 | 45 | -67 |
| Saving | 433 | 285 | 14 |
| Term | 432 | 543 | 561 |
| Of which: CTS | -66 | 340 | 173 |
| | | | |
| **Businesses** | **602** | **-450** | **-515** |
| AFP - Mutual funds | 257 | -274 | 9 |
| Rest | 345 | -177 | -524 |

It is worth pointing out that the effect of the dollarization of companies and institutional investors' deposits on passive interest rates has moderated due to the liquidity injection measures taken by the BCRP, which has cut the mean rate of reserve requirements from 20 percent to 11.5 percent since April 2013, releasing in this way S/. 9 billion soles. More recently, the BCRP has started making auctions of up to 2-year FX-repos on a regular basis –twice a month– with the aim of helping banks to match better the terms of their assets and liabilities.

**Box 6**

**DOLLARIZATION OF CREDIT, RESERVE REQUIREMENT MEASURES, AND FOREIGN EXCHANGE VOLATILITY**

Since 2002 the Peruvian economy had been going through a continuous process of de-dollarization of credit, but this process slowed down in 2012. To reverse this deceleration, the Central Bank decided to take additional reserve requirement measures associated with the expansion of credit. Thus, a measure linking reserve requirements with the evolution of mortgage loans and car loans in dollars was implemented in March 2013 to moderate the expansion of these types of credit and to encourage their substitution for credits in soles. To reinforce this measure, in October 2013 the BCRP implemented another reserve requirement measure that links required reserves with the evolution of total credit in dollars.

These measures are aimed at reducing the dollarization of credit and at reducing at the same time the latent risk of a deterioration of the financial situation of companies and families associated with an excess of volatility in the exchange rate. Thus, following the intervention of the Central Bank, the dollarization of credit has resumed a decreasing path. As we can see, all the components of credit have reduced their ratios of dollarization during 2013 and this trend has continued so far in 2014. The ratio of dollarization of total credit declined from 45.3 percent in December 2012 to 39.6 percent in May 2014.

**CREDIT TO THE PRIVATE SECTOR BY TYPE OF LOANS AND CURRENCY**

| | Annual flows | | | | 12-month growth rate | | | |
|---|---|---|---|---|---|---|---|---|
| | Dec.12 | Dec.13 | Apr.14 | May.14 | Dec.12 | Dec.13 | Apr.14 | May.14 |
| **Corporate and large companies and Medium-sized enterprises** | | | | | | | | |
| Total | 8,789 | 14,194 | 17,626 | 18,905 | 12.1 | 17.4 | 21.2 | 22.7 |
| DC | 1,445 | 11,063 | 13,405 | 13,658 | 6.7 | 48.2 | 54.0 | 54.5 |
| FC | 2,623 | 1,118 | 1,507 | 1,874 | 14.3 | 5.3 | 7.3 | 9.0 |
| *Dolarization* | *71.9* | *64.5* | *62.0* | *62.1* | | | | |
| **Small businesses and Microbusinesses** | | | | | | | | |
| Total | 4,564 | 738 | 395 | 420 | 16.7 | 2.3 | 1.2 | 1.3 |
| DC | 4,213 | 1,781 | 1,278 | 1,178 | 18.6 | 6.6 | 4.7 | 4.3 |
| FC | 125 | -373 | -315 | -270 | 7.5 | -20.8 | -18.8 | -16.5 |
| *Dolarization* | *15.8* | *12.2* | *11.8* | *11.9* | | | | |
| **Total credit businesses** | | | | | | | | |
| Total | 13,353 | 14,932 | 18,020 | 19,325 | 13.3 | 13.2 | 15.7 | 16.8 |
| DC | 5,657 | 12,844 | 14,683 | 14,836 | 12.8 | 25.8 | 28.2 | 28.3 |
| FC | 2,748 | 746 | 1,192 | 1,603 | 13.7 | 3.3 | 5.3 | 7.1 |
| *Dolarization* | *56.1* | *51.2* | *49.6* | *50.1* | | | | |
| **Consumption** | | | | | | | | |
| Total | 4,889 | 4,188 | 4,685 | 4,728 | 15.3 | 11.4 | 12.5 | 12.4 |
| DC | 4,254 | 4,032 | 4,627 | 4,680 | 14.8 | 12.3 | 13.8 | 13.8 |
| FC | 227 | 56 | 21 | 17 | 19.6 | 4.0 | 1.5 | 1.2 |
| *Dolarization* | *10.5* | *9.8* | *9.6* | *9.6* | | | | |
| **Mortgage** | | | | | | | | |
| Total | 5,278 | 4,188 | 4,055 | 3,901 | 25.7 | 16.2 | 14.9 | 14.1 |
| DC | 3,402 | 4,800 | 5,063 | 4,965 | 33.2 | 35.1 | 33.8 | 32.2 |
| FC | 670 | -218 | -360 | -380 | 18.2 | -5.0 | -8.2 | -8.7 |
| *Dolarization* | *47.1* | *38.5* | *36.5* | *35.4* | | | | |
| **Total credit individuals** | | | | | | | | |
| Total | 10,167 | 8,376 | 8,740 | 8,629 | 19.4 | 13.4 | 13.5 | 13.1 |
| DC | 7,655 | 8,832 | 9,690 | 9,646 | 19.7 | 19.0 | 20.0 | 19.5 |
| FC | 897 | -163 | -339 | -363 | 18.6 | -2.8 | -5.9 | -6.2 |
| *Dolarization* | *25.6* | *22.0* | *21.1* | *20.5* | | | | |
| **Total credit** | | | | | | | | |
| Total | 23,520 | 23,308 | 26,760 | 27,954 | 15.4 | 13.2 | 14.9 | 15.4 |
| DC | 13,313 | 21,675 | 24,372 | 24,482 | 16.0 | 22.5 | 24.3 | 24.0 |
| FC | 3,646 | 583 | 853 | 1,240 | 14.7 | 2.0 | 3.0 | 4.4 |
| *Dolarization* | *45.3* | *40.8* | *39.5* | *39.6* | | | | |

In order to determine the impact of the **policy measures taken by the BCRP since March 2013**, we used the vector autoregression (VAR) method to estimate the impact of these measures on the flow of mortgage and vehicle loans in both domestic currency and in foreign currency by means of a dummy variable (activated from March 2013), controlling the volatility of the exchange rate. The coefficient associated with the measure was estimated and its statistical significance in the models was assessed to specify both types of credit.

The results for both types of credit show that the policy measures had a positive impact on placements in nuevos soles and a negative impact on placements in foreign currency. As we can be seen in the table below, the empirical analysis reveals that the dummy variable associated with the policy actions implemented accounts for 7.7 percentage points in the reduction of the dollarization ratio of mortgage loans and for 2.2 points in the case of car loans.

**CREDIT DOLLARIZATION: MAY 2013**

| | Mortgage | Car loans |
|---|---|---|
| Executed | 35.4 | 72.0 |
| Contrafactual 1/ | 43.1 | 74.2 |

1/ Simulation results in case of reserve measures announced by the BCRP at the end of February 2013 have not been made.

An additional estimation was made considering the annual variation of the dollarization ratio of total private credit and the annual variance of the depreciation rate of the foreign exchange rate. Furthermore, the impact of the reserve requirement policy measures aimed at promoting the de-dollarization of credit implemented by the Central Bank in March 2013 were also introduced to the model through a dummy variable capturing the period of such intervention. On the basis of this model we found that the increase in exchange rate volatility observed since 2013 would explain a decline of 2 percentage points in the dollarization of total credit, while the policy measures implemented by the BCRP would account for a decline of 3 percentage points in the ratio of dollarization.

In conclusion, the changes adopted by the Central Bank in reserve requirements have contributed to mitigate financial risks and promoted a faster process of de-dollarization of credit discouraging intermediation in foreign currency, which reduces financial vulnerabilities arising from financial dollarization.

# VI. Inflation

## Report to June

79. In June the consumer price index (CPI) for Metropolitan Lima showed a variation of 3.45 percent relative to June 2013 and a variation of 2.23 percent relative to December 2013.

80. The rate of inflation accumulated in the last 12 months and the rate of inflation accumulated in the first six months of the year reflected mostly rises in the prices of food, fuel, and electricity rates. The increase registered in the component of food and energy represented a contribution of 1.94 percent in the rate of 12 month-inflation and a contribution of 1.44 percent in the first half of the year. Inflation without food and energy –i.e., isolating the impact of these goods with high price volatility– showed a rate of 2.77 percent in the year and a rate of 1.45 percent in the first half of 2014.

**Graph 80,**
**INFLATION AND INFLATION TARGET**
(Last 12 month % change)

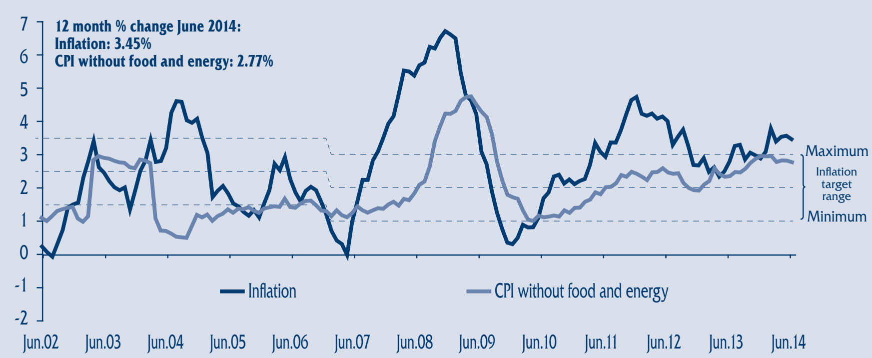



**Table 53**
**INFLATION**
(% change)

| | Weight | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 June | 2014 Jan.-Jun. | 2014 12 months |
|---|---|---|---|---|---|---|---|---|---|
| **CPI** | **100.0** | **0.25** | **2.08** | **4.74** | **2.65** | **2.86** | **0.16** | **2.23** | **3.45** |
| **1. CPI without food and energy** | **56.4** | **1.71** | **1.38** | **2.42** | **1.91** | **2.97** | **0.11** | **1.45** | **2.77** |
| a. Goods | 21.7 | 2.31 | 1.07 | 2.37 | 1.60 | 2.62 | 0.16 | 1.49 | 2.81 |
| b. Services | 34.8 | 1.24 | 1.58 | 2.45 | 2.10 | 3.18 | 0.07 | 1.42 | 2.75 |
| **2. Food and energy** | **43.6** | **-0.86** | **2.98** | **7.70** | **3.55** | **2.73** | **0.22** | **3.18** | **4.26** |
| a. Food and beverages | 37.8 | 0.57 | 2.41 | 7.97 | 4.06 | 2.24 | 0.28 | 3.00 | 3.55 |
| b. Fuel and electricity | 5.7 | -10.40 | 6.80 | 6.01 | 0.22 | 6.09 | -0.19 | 4.34 | 9.08 |
| Fuel | 2.8 | -12.66 | 12.21 | 7.54 | -1.48 | 5.95 | -0.60 | 2.02 | 6.71 |
| Electricity | 2.9 | -4.56 | 1.36 | 4.30 | 2.19 | 6.23 | 0.24 | 6.90 | 11.70 |

**Table 54**
**INFLATION**
(Weighted contribution)

| | Weight | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | June | Jan.-Jun. | 12 months |
| **CPI** | **100.0** | **0.25** | **2.08** | **4.74** | **2.65** | **2.86** | **0.16** | **2.23** | **3.45** |
| **1. CPI without food and energy** | **56.4** | **0.74** | **0.78** | **1.36** | **1.05** | **1.62** | **0.06** | **0.79** | **1.51** |
| a. Goods | 21.7 | 0.43 | 0.23 | 0.51 | 0.34 | 0.54 | 0.03 | 0.31 | 0.58 |
| b. Services | 34.8 | 0.30 | 0.55 | 0.85 | 0.71 | 1.08 | 0.02 | 0.48 | 0.93 |
| **2. Food and energy** | **43.6** | **-0.49** | **1.30** | **3.38** | **1.60** | **1.24** | **0.10** | **1.44** | **1.94** |
| a. Food and beverages | 37.8 | 0.28 | 0.91 | 3.03 | 1.59 | 0.89 | 0.11 | 1.18 | 1.41 |
| b. Fuel and electricity | 5.7 | -0.77 | 0.38 | 0.35 | 0.01 | 0.35 | -0.01 | 0.26 | 0.53 |
| Fuel | 2.8 | -0.68 | 0.34 | 0.23 | -0.05 | 0.18 | -0.02 | 0.06 | 0.20 |
| Electricity | 2.9 | -0.09 | 0.04 | 0.12 | 0.06 | 0.17 | 0.01 | 0.20 | 0.32 |

81. The items that contributed the most to increase inflation in the period of January-June 2014 were education costs, meals outside the home, onions, and electricity rates.

**Education costs –tuition and fees–** increased by 4.2 percent as a result of the rises observed in tuition at both private schools (6.3 percent) and public schools (1.5 percent) in the month of March at the beginning of the school year, as well as in the fees of private schools (6.6 percent) and in tuition at private universities (3.7 percent). Education costs show a variation of 4.3 percent in the last twelve months.

Showing a higher percentage change than the general price index (2.2 percent), **meals outside the home** accumulated a variation of 2.6 percent. In the last twelve months, the prices of meals outside the home have increased 5.2 percent more than the prices of food consumed in the household (2.8 percent).

The rise in the price of **onions** (102.4 percent), which accounts for 0.25 percentage points of the inflation accumulated in this period, also stands out because this price rose 62.1 percent in the last twelve months. The highest increases were recorded in the months of March and April due to climate disturbances in Arequipa, which is the main supplier area of onions. Crops declined 11 percent in the August-January farming season compared to the previous crop, affected by the lack of humidity and warmer daytime conditions, but this situation was offset since May with the start of the harvest period in Camaná.

The price of **eggs** rose 18.4 percent in the January-June period and 8.1 percent in the last 12 months. The highest increases were observed in March and April due to the increased demand for eggs associated with the beginning of the school year and lunch boxes as well as with the relative lower price of eggs in comparison to the rest of food products with high protein contents.

The item "**other vegetables**", which includes produce such as lettuce and broccoli, increased 21.3 percent in the January-June period and 16.6 percent in the last 12 months. Warmer temperatures in the valleys of Lima affected the supply of these products, which require mild climate conditions.

The increase in the price of **chicken meat** (3.0 percent) was associated with the irregular supply of a substitute product –i.e. fish–, affected by varying weather conditions, and with the rising prices of corn, which is the main component of the production cost of poultry. The international price of this input rose from US$ 161.4 per ton in December 2013 to US$ 170 per ton in June 2014. However, in the last twelve months the price of chicken meat decreased 2.7 percent, influenced by an increasing supply as a result of greater placements of baby chickens (3.5 percent) and the improvement of the supply of fish in some months.

**Electricity rates** increased by 6.9 percent in the first six months of the year and 11.9 percent in the last 12 months, the higher increases being observed in the months of February and April. The price adjustments were associated with the incorporation of new transmission lines, as well as with updating the costs of power generation in concession contracts.

On the other hand, the items that contributed the most to reduce the rate of inflation were citrus fruits and domestic fares.

The drop in the prices of **citrus fruits** reflected the lower prices of tangerines due to the increased seasonal supply of the Satsuma variety from the valleys of Lima.

**Interprovincial fares** fell 11.9 percent on average, showing a similar result to the one observed in the period of January-June 2013 (-11.7 percent. In the last twelve months, they increased 4 percent, but registered a series of fluctuations over the period analyzed. Rises were observed especially in April, during Easter, as a result of increasing demand, while price falls were observed afterwards due to the subsequent normalization of fare rates.

**Table 55**
**ITEM WITH THE HIGHEST WEIGHTED CONTRIBUTION TO INFLATION: JANUARY - JUNE 2014**

| Positive | Weight | % Chg. | Contribution | Negative | Weight | % Chg. | Contribution |
|---|---|---|---|---|---|---|---|
| Education (fees and tuition) | 8.8 | 4.2 | 0.40 | Citrus fruits | 0.5 | -17.2 | -0.12 |
| Meals outside the home | 11.7 | 2.6 | 0.34 | National transportation | 0.3 | -11.9 | -0.05 |
| Onion | 0.4 | 102.4 | 0.25 | Avocado | 0.1 | -25.1 | -0.04 |
| Electricity rates | 2.9 | 6.9 | 0.20 | Airplane fares | 0.4 | -3.8 | -0.01 |
| Eggs | 0.6 | 18.4 | 0.10 | Tomato | 0.2 | -6.4 | -0.01 |
| Other vegetables | 0.4 | 21.3 | 0.10 | Grapes | 0.1 | -10.3 | -0.01 |
| Poultry meat | 3.0 | 3.0 | 0.09 | Soft-drink | 0.2 | -4.6 | -0.01 |
| Purchases of vehicles | 1.6 | 4.2 | 0.06 | Sweet potato | 0.1 | -9.7 | -0.01 |
| Other fresh fruits | 0.4 | 15.1 | 0.06 | Olluco and alike | 0.1 | -9.5 | -0.01 |
| Toiletries | 4.9 | 1.2 | 0.06 | Internet services and other | 0.8 | -1.0 | -0.01 |
| **Total** | | | **1.66** | **Total** | | | **-0.28** |

**Table 56**
**ITEM WITH THE HIGHEST WEIGHTED CONTRIBUTION TO INFLATION: JULY 2013 - JUNE 2014**

| Positive | Weight | % Chg. | Contribution | Negative | Weight | % Chg. | Contribution |
|---|---|---|---|---|---|---|---|
| Meals outside the home | 11.7 | 5.2 | 0.66 | Poultry meat | 3.0 | -2.7 | -0.08 |
| Education (fees and tuition) | 8.8 | 4.5 | 0.42 | Carrot | 0.1 | -34.2 | -0.08 |
| Electricity rates | 2.9 | 11.7 | 0.32 | Telephone rates | 2.9 | -1.7 | -0.04 |
| Urban fares | 8.5 | 3.1 | 0.26 | Fresh and frozen fish | 0.7 | -2.6 | -0.02 |
| Onion | 0.4 | 62.1 | 0.19 | Fresh legumes | 0.2 | -7.5 | -0.02 |
| Gasoline and oil | 1.3 | 9.0 | 0.14 | Corn | 0.1 | -11.4 | -0.02 |
| Medicinal products | 2.1 | 5.1 | 0.10 | Spices and seasonings | 0.5 | -2.7 | -0.02 |
| Purchases of vehicles | 1.6 | 5.5 | 0.08 | Beans | 0.1 | -6.8 | -0.01 |
| Other vegetables | 0.4 | 16.6 | 0.08 | Garlic | 0.1 | -9.4 | -0.01 |
| Toiletries | 4.9 | 1.7 | 0.08 | Internet services and other | 0.8 | -1.0 | -0.01 |
| **Total** | | | **2.33** | **Total** | | | **-0.31** |

## Forecast of International Prices

82. The price of crude oil is expected to decrease during the forecast period and to reach an average price of US$ 101 per barrel in 2014, US$ 93 per barrel in 2015, and US$ 88 per barrel in 2016, in a context of growth in the supply of crude oil, especially in the USA. These price levels are higher than those estimated in our previous report due to geopolitical factors that have increased the price of crude oil.

    On the other hand, the prices of maize and wheat have been revised down because it is estimated that global final inventories will increase due to favorable climate conditions in the USA that improve the prospects of yields.

    a. **Energy**

    The price of WTI **oil** increased 7.6 percent in the first half of 2014, recording an average monthly price of US$ 105.2 per barrel in June, intensifying the rising trend observed in Q1.

    The upward conduct in the price of crude oil was influenced by growing unplanned production cuts and by the increased geopolitical risks associated with the fears generated by the crisis between Russia and Ukraine, Libya's restriction on exports, and the internal crisis in Iraq. Another factor that is foreseen to conduct is the seasonal growth in demand in the third quarter. Market tightness was reflected in the decline of OECD oil inventories.

    It should be pointed out that the Brent price was more affected by these geopolitical events, which has led the spread between both quotes to expand from is US$ 5.4 per barrel in March 2014 to US$ 7.95 per barrel in May and to decline thereafter to US$ 6.72 per barrel in June.

**Graph 81**
**DIFFERENTIAL BETWEEN BRENT AND WTI PRICES**
(US$ per barrel)

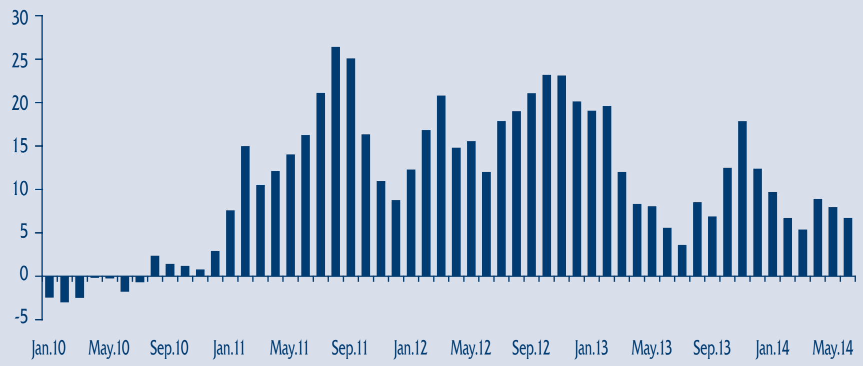



**Table 57**
**OIL AND LIQUID FUELS: SUPPLY AND DEMAND**
(Million barrels per day)

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Supply | 87.53 | 89.15 | 90.25 | 91.78 | 93.18 |
| OPEP | 35.25 | 36.59 | 36.14 | 36.13 | 36.30 |
| Non-OPEP | 52.28 | 52.56 | 54.11 | 55.66 | 56.88 |
| Consumption | 88.88 | 89.07 | 90.48 | 91.79 | 93.12 |
| OECD | 46.79 | 46.13 | 46.02 | 46.00 | 45.99 |
| Non-OECD | 42.10 | 42.94 | 44.46 | 45.79 | 47.12 |
| Market balance | -1.35 | 0.08 | -0.23 | -0.01 | 0.06 |
| **Inventories at the end of period (million barrels per day)** | | | | | |
| Inventories USA | 1,026 | 1,055 | 1,064 | 1,085 | 1,095 |
| Inventories OECD | 2,606 | 2,664 | 2,548 | 2,563 | 2,577 |

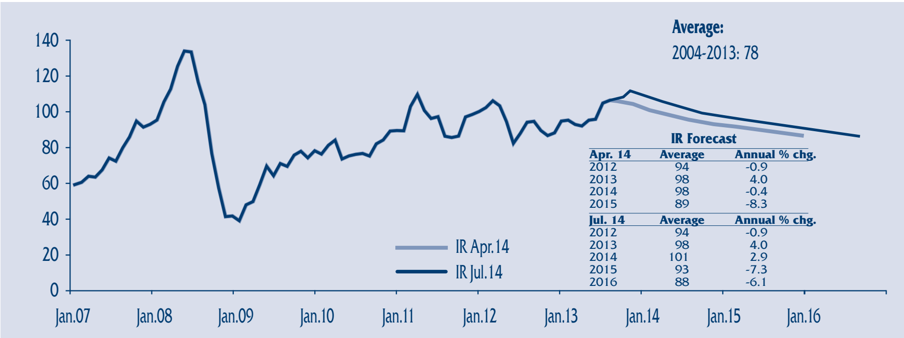
Source: EIA.

In this context, the price of WTI oil is expected to decline during the forecast period (although the price levels are corrected upwards relative to the estimates contained in our April Inflation Report). This downward trend is explained by the expected growth of the crude oil output in non-OPEC countries which would exceed the growth of consumption in the next two years[6]. Most of this growth would come from the increase of oil production in the United States, so it is estimated that the demand for crude from OPEC countries will decline in 2015.

6 According to the report Short-Term Energy Outlook of June, 2014, published by the U.S. Energy Information Administration.

The risk factors on both the upside and on the downside remain high. The likelihood of price increases remains high due to the recurring political tensions in the Middle East, especially in Iraq (the internal conflict would affect investments in the sector affecting production growth forecasts). On the other hand, the probability that prices may fall is associated with a higher than expected growth in the output of United States and with the impossibility of refining the increasing domestic production, which will result in increasing inventories in the Gulf of Mexico. In this context, the forecast price of crude oil is revised upwards compared to the previous inflation report.

**Graph 82**
**WTI OIL: JANUARY 2007 - DECEMBER 2016**
(US$/bl)

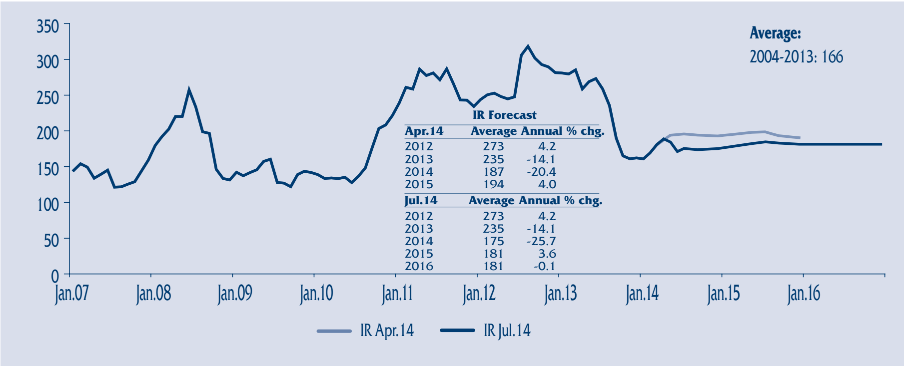



b. **Maize**

In June, the average international price of **maize** was US$ 170 per ton, 5.9 percent lower than the average at the close of March 2014. This variation reflects mainly the fall in prices in the month of June (7.5 percent compared to May). The downward trend in these prices was driven by rains in the U.S. Corn Belt which improved the outlook for the crop yield.

Between March and June, the U.S. Department of Agriculture (USDA) revised up global final corn inventories of the 2013/2014 crop year from 158.5 million tons in March to 169.1 million tons in June due to the higher world output associated with better weather conditions. The USDA estimates final inventory record levels of around 182 million tons for the 2014/2015 crop year. Because of this, the price of maize is foreseen to show lower levels than the ones estimated in our previous report.

**Graph 83**
**MAIZE: JANUARY 2007 - DECEMBER 2016**
(US$/MT)




c. **Wheat**

At June, the international price of **wheat**, which closed at an average level of US$ 262 per ton, showed a decline of 5.1 percent relative to March. This lower price reflects mainly the price fall recorded in June (-8.9 percent from May) after having increased in April and May.

The price of wheat fell in June due to the USDA upward revision of production and final inventories of the 2014/2015 crop year. In addition to this, greater yields are expected due to the rains in the producing area in the USA. Based on these factors, it is estimated that the price of wheat will register lower levels than the ones estimated in our previous report.

**Graph 84**
**WHEAT: JANUARY 2007 - DECEMBER 2016**
(US$/MT)

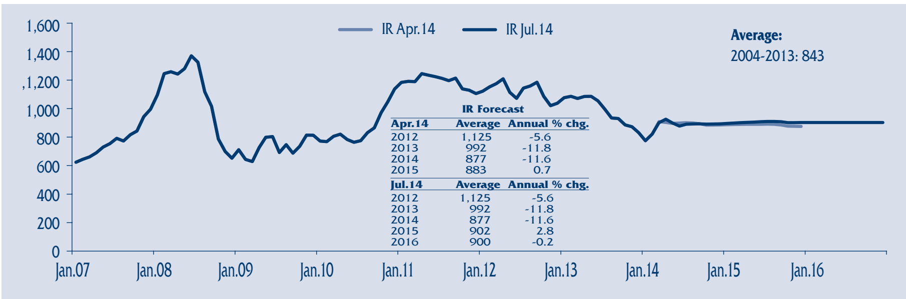
d. **Soybean Oil**

The average price of **soybean oil** was US$ 878 per ton in June, 2.4 percent lower than the average level at March. The average price of soybean fell during the months of May and June as a result of favorable climate conditions in the United States which led the USDA to raise its estimate of final inventories of soybean for the new 2014/2015 crop season.

However, the price of soybean oil has shown an upward trend since early June due to the increase in the price of crude oil following geopolitical tensions in Iraq and lower physical inventories in the U.S. markets.

Considering these factors, prices are expected to stabilize in the forecast horizon, in line with the higher oil prices projected.

**Graph 85**
**SOYBEAN OIL: JANUARY 2007 - DECEMBER 2016**
(US$/MT)




## Inflation Forecast

83. The rate of annual inflation would reach 2.8 percent at end-2014, thus falling within the target range. The most important rises would be seen in the prices of energy (6.3 percent), which includes fuel prices and electricity rates, while the price of food would grow 3.0 percent. Inflation without food and energy would show a level of 2.3 percent.

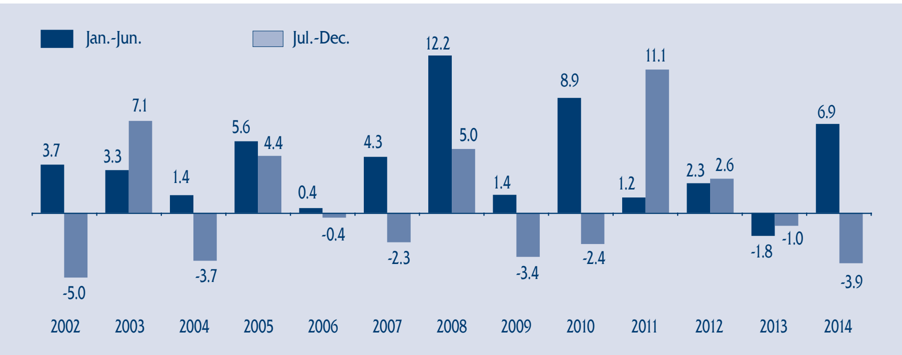
**Table 58**
**INFLATION**
(12 month % change)

| | Weight | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | June | IR Apr.14 | IR Jul.14 |
| **CPI** | **100.0** | **0.2** | **2.1** | **4.7** | **2.6** | **2.9** | **3.4** | **2.9** | **2.8** |
| **Food and energy** | **43.6** | **-0.9** | **3.0** | **7.7** | **3.6** | **2.7** | **4.3** | **3.3** | **3.4** |
| a. Food | 37.8 | 0.6 | 2.4 | 8.0 | 4.1 | 2.2 | 3.6 | 2.8 | 3.0 |
| b. Energy | 5.7 | -10.4 | 6.8 | 6.0 | 0.2 | 6.1 | 9.1 | 6.9 | 6.3 |
| **CPI without food and energy** | **56.4** | **1.7** | **1.4** | **2.4** | **1.9** | **3.0** | **2.8** | **2.5** | **2.3** |

Rises expected in food prices would include the prices of rice and potatoes. The rise in the case of the former would be associated with lower levels of production than in the previous year due to the delay seen in the farming season in the North Coast. The price of potatoes, on the other hand, would increase at the end of the year due to the postponement of crops on the coast due to the higher temperatures registered in these areas in Q2-2014.

As for perishable produce, the prices of these food products are expected to decline between July and December due to the reversal of domestic shocks and to seasonal factors, as well as to less severe climate disturbances that would arise from a moderate El Niño episode, as announced by the committee in charge of studying El Niño events (Comité Multisectorial Encargado del Estudio del Fenómeno El Niño).

**Graph 86**
**PERISHABLE FOOD PRODUCTS**
(% change)




84. The rate of inflation in Q2-2014 was temporarily above the target, influenced by the evolution of supply factors that affected especially some food prices. Inflation would continue to fall in the coming months and is forecast to reach a rate of 2 percent in the 2014-2016 forecast horizon. This scenario considers that there would be no inflationary pressures on the side of demand in the forecast horizon and that inflation expectations would remain within the target range.

85. As foreseen in our previous report, **food and energy inflation**, which showed a monthly average rate of 0.4 percent in Q2, would decrease to monthly average levels around -0.1 percent during the last quarter of the year, in line with the seasonality of food prices. As a result, the rise in the prices of food and energy would lead this category of inflation to show rates in the upper band of the target range.

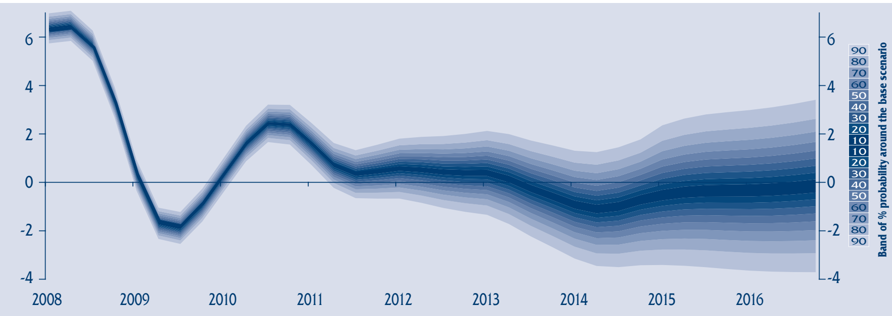
**Inflation excluding food and energy** has been at levels close to 2.8 percent in the last 12 months. However, a monthly average rate of 0.15 percent was already observed in Q2, this rate being equivalent to 1.8 percent in annual terms. Therefore, inflation without food and energy is expected to be between 2.0 and 2.5 percent at the end of this year and at 2.0 percent in 2015. Inflation's convergence to the target range will be influenced by a negative output gap due to the deterioration of terms of trade to the growth of our trading partners below their potential levels, as well as due to lower expectations of inflation in the coming months, and a moderate evolution of imported inflation.

86. The **output gap** reflects cyclical fluctuations in economic activity that become inflationary pressures on the demand side. This gap is affected by various kinds of impulses: the external impulse, the fiscal impulse, and the monetary impulse.

On the external front, the external impulse is expected to be lower than that estimated in our previous report given that the growth rate projected in our trading partners has been revised down and that a greater decline is foreseen in the terms of trade. Moreover, this forecast scenario also considers a positive fiscal impulse in the second half of 2014 and a recovery in consumers' and business confidence.

Finally, the baseline forecast scenario considers that monetary conditions will remain more flexible. A suitable monetary policy position contributes to maintain inflation expectations anchored, especially in the context of persistent significant shocks that affect sensitive products of the CPI basket.

**Graph 87**
**OUTPUT GAP: 2008 - 2016**
(% potential GDP)




**Memo**: Output gap is not an observable variable and has to be estimated. Because of this, the graph shows uncertainty about its value, inclusive for periods with information of GDP (until first quarter 2014). As in the case of the output gap, each pair of bands concentrate a probability of occurrence of 10% and total bands represent a probability of occurrence of 90%. The risk scenario to the output gap forecast is in the chapter of balance of risk and are used for the inflation forecast.

87. The baseline forecast scenario considers that the Peruvian economy would grow 4.4 percent in 2014 as a result of a slower pace of growth of private investment

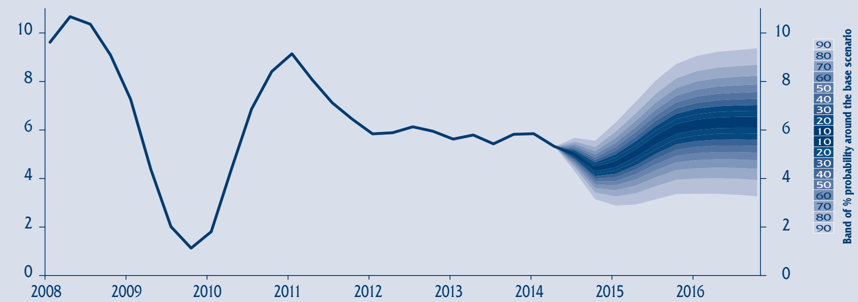
and exports, which has generated a negative output gap. Moreover, the lower productivity observed in the primary sector is expected to reverse by 2015 as large scale investment projects, mainly in the mining sector, start being implemented as originally planned. Furthermore, a moderate growth is expected in the non-primary sector as a result of the greater dynamism that the construction sector would show. In 2015, GDP is forecast to grow 6.0 percent.

88. Every growth forecast is subject to the occurrence of unanticipated events that may divert it from its central scenario. In this context of uncertainty, the materialization of some risks could imply a different GDP growth rate than the one forecast originally.

A scenario of domestic risks could include adverse demand shocks which could lead to lower public investment or to a slower recovery of private investment, which could be negatively affected by a decline in business confidence. Moreover, the probability that the recovery in the world economy will be slower or that it will take longer remains high. Recent signs point to a slowdown of growth in the emerging economies as well as to the possibility that the Fed will raise its benchmark rate earlier than expected.

The balance of risks for GDP growth is on the downside. In other words, the probability that the growth of GDP will divert below the forecast in the baseline scenario is higher than the probability that it will divert above this forecast.

**Graph 88**
**FORECAST OF GDP GROWTH 1/, 2014 - 2016**
(Interanual % change)




**Memo**: The graph shows the probability of occurrence of GDP growth forecasts in the future, the values of which were established combining statistical analysis (using data as of April 2014) and the risk balance of the BCRP. Thus, in each period of the forecast horizon, each pair of bands with the same shade concentrates a probability of 10%. This can be interpreted as that 10 of every 100 possible future values of GDP growth are expected to fall within the darkest bands (located in the center), that contain the baseline scenario trajectory.
1/ GDP growth is defined as the percentage change of the moving average in four quarters compared to the same quarter of the previous year. Thus, the figure in Q4 coincides with the GDP growth rate in the year.

**Box 7**

**HISTORICAL DECOMPOSITION OF INFLATION**

In the first half of 2014, the rate of total inflation in the last twelve months has been above the upper band of the inflation target range. In its recent policy communiqués, the Board of the Central Bank has informed the public that the temporary rise in prices, above 3 percent, has been in part due to supply shocks that are expected to subside in the near future.

Based on the model proposed by McCarthy (2007)[7], we studied the sensitivity of consumer prices across the economy's distribution chain between January 2002 and June 2014, which allowed us to decompose the level of total inflation observed in each of its components (e.g., expectations of inflation, supply shocks, the nominal depreciation of the domestic currency, inflation in imported goods, and demand shocks).

The table below shows the historical decomposition of inflation deviations from the 2 percent inflation target in the period of 2011-2014. As we can see, in the month of June 2014, the diversion of total inflation in the last twelve months from the target is 1.5 percent, which is explained mainly by supply shocks, imported inflation, inflation expectations, and nominal depreciation. Moreover, as explained in the BCRP communiqués, the low dynamism of economic activity reflects in a negative contribution to inflation in the first half of the year.

**HISTORICAL BREAKDOWN OF DEVIATION FROM INFLATION LAST 12 MONTHS RESPECT TO INFLATION TARGETING**
(End of period)

| Year | Inflation deviation 1/ | Inflation expectation | Supply shocks | Nominal depreciation | Imported inflation | Demand shocks |
|---|---|---|---|---|---|---|
| 2011 | 2.7 | 1.0 | 0.5 | -0.3 | 1.0 | 0.5 |
| 2012 | 0.6 | 0.4 | 1.1 | -0.1 | -0.8 | 0.1 |
| 2013 | 0.9 | 0.6 | 0.5 | 0.9 | -0.6 | -0.5 |
| 2014 2/ | 1.5 | 0.5 | 0.6 | 0.3 | 0.5 | -0.5 |

1/ Respect to 2 percent.
2/ As of June 2014.

7 McCarthy, J. (2007). "Pass-through of exchange rates and import prices to domestic inflation in some industrialized economies". Eastern Economic Journal, 33(4), 511-537.

# VII. Balance of Risks

89. The main risks that could divert the rate of inflation from the baseline forecast scenario are similar to those considered in the Inflation Report of December; that is, risks associated with lower global growth, a possible greater slowdown in domestic demand than the one considered in the baseline scenario, and the occurrence of both domestic supply shocks and external supply shocks. In addition, a new risk considered in this report is greater volatility in international financial markets.

a. **Volatility in international financial markets**

The baseline forecast scenario includes a progressive withdrawal of monetary stimulus by the U.S. Federal Reserve. However, there is the risk that high volatility could be generated in international interest rates, as occurred in mid-2013, which could lead to movements in capital flows and depreciations in the currencies of emerging countries, increasing at the same time the risk perceived in these economies.

b. **Lower global growth**

The baseline scenario considers a recovery in the global economy in 2014-2016. However, there is the risk that this economic recovery could take longer or be slower and that terms of trade could deteriorate further, which would reflect in a lower external impulse and would generate reductions in the output gap and a lower inflation rate than the one considered in the baseline scenario.

c. **Demand shocks**

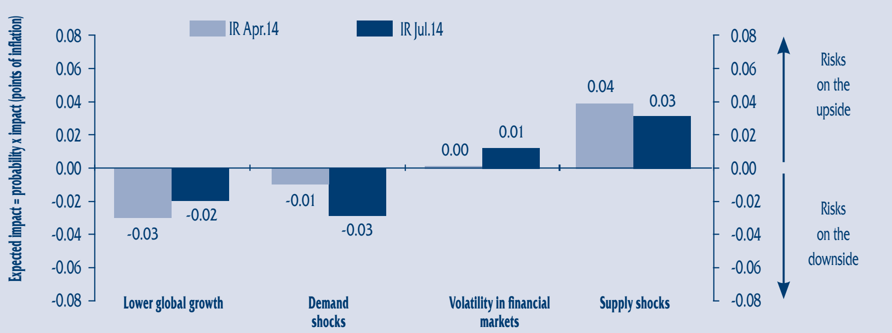
Economic activity could recover more slowly if investment projects are postponed, which would imply a more negative output gap and, therefore, lower inflation in the forecast horizon.

d. **Supply shocks**

The risk of a stronger El Niño event than the one considered in the baseline scenario remains, even though this risk has declined.

90. The effects of the risk factors that push inflation downwards are estimated to be greater than the effects of the risk factors that push it upwards. Therefore, **the balance of these risks is on the downside** for the inflation forecast in the forecast horizon.

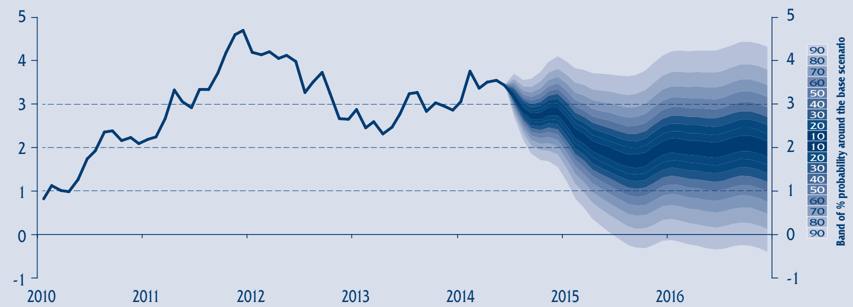
**Graph 89**
**BALANCE OF RISKS AGAINST THE BASE SCENARIO**




**Memo**: The risk assessment describes how exogenous factors would affect the rate of inflation forecast for 2 years ahead if such risks materialized. Each bar in the graph illustrates the magnitude and direction of the effect of these factors, i.e., the expected impact in alternative forecast scenarios. This impact is calculated as the difference between the inflation forecast in the baseline scenario and inflation projections in several scenarios considering different assumptions, multiplying this difference by the probability of occurrence assigned to such alternative assumptions. The sum of the bars –the risk balance– indicates how these risk factors as a whole would divert inflation from the baseline scenario in the medium term.
The balance of these risks is on the downside: The probability that inflation will be below the forecast considered in the baseline scenario is higher than the probability that inflation will be above the forecast level. So, the addition of bars is lower than zero.

91. The incidence of the above-mentioned risks on the inflation forecast for the 2014-2016 horizon is illustrated in the graph below. The information available at June 2014 indicates that the probability that inflation will be below 3 percent is 79 percent.

**Graph 90**
**INFLATION FORECAST: 2014-2016**
(Last 12 months % change)




**Memo**: The graph shows the probability of occurrence of inflation values in the future: These values were established combining statistical analysis and the balance of risk of BCRP. Thus, in each period of the forecast horizon, each pair of bands with the same shade concentrates a probability of 10%. This can be interpreted as that 10 of every 100 possible future values of inflation are expected to fall within the darkest bands (located in the center), that contain the baseline scenario trajectory.

## Conclusion

92. Inflation would continue declining in the next months until it reaches a rate of 2 percent in the 2015-2016 forecast horizon. The balance of risks shows a bias on the downside, which is consistent with GDP growing at lower rates than the economy's potential output, influenced by a lower-than-expected demand, a smaller fiscal impulse, and flexible monetary conditions.

    The Central Bank will continue to pay careful attention to developments in the world economy and in the domestic economy, as well as to inflation expectations. If it is necessary, the Central Bank stands ready to adjust its monetary stance to ensure that inflation converges to the target range and remains within the inflation target range.