INFLATION REPORT

June 2016

Recent trends and macroeconomic forecasts 2016-2018

CENTRAL RESERVE BANK OF PERU

INFLATION REPORT:

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and macroeconomic forecasts 2016-2018

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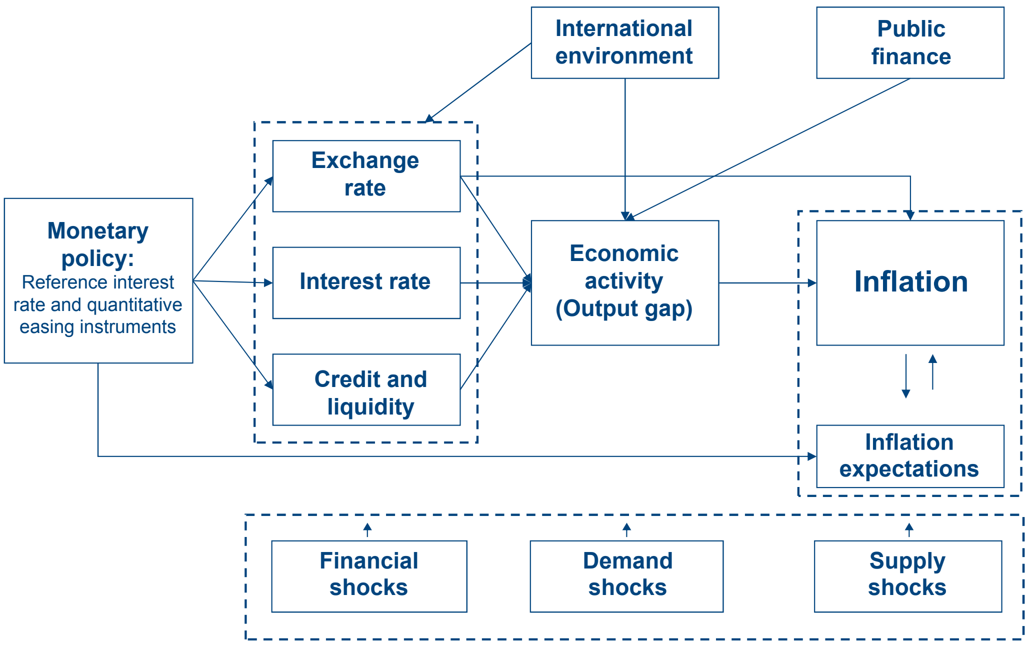

Central Reserve Bank of Peru
441-445 Antonio Miro Quesada. Lima 1
Telephone: 613-2000 - Fax: 613-2525
Mail: webmaster@bcrp.gob.pe

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BOXES

This ***Inflation Report*** was prepared using data on the Balance of Payments as of Q1-2016, data on Gross Domestic Product and Monetary Accounts as of April 2016, and data on the operations of the Non-Financial Public Sector, Inflation, Financial Markets, and the Exchange Rate as of May 2016.

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. The BCRP is responsible for regulating the money supply and credit in the financial system, for managing the country's international reserves, and for reporting on the nation's finances.

- In order to consolidate this goal, the Bank's monetary policy is based on an inflation targeting scheme, with an inflation target 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 benchmark rate for the interbank lending market. Since this interest rate, which is the monetary operational target, affects the rate of inflation through several channels in different timeframes, this rate is set based on inflation forecasts and forecasts of inflation determinants.

- The Central Bank takes into account that inflation may be influenced by factors beyond the control of monetary policy actions, such as shocks that may affect the supply of goods and services like fluctuations in the prices of imported products or climate factors, which may result in transitory deviations of inflation from the target. It is also worth pointing out that the effectiveness of monetary policy is evaluated in terms of the success in returning and maintaining inflation expectations within the target range.

- Additionally, the Central Bank implements preventive actions 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 in periods of capital inflows or high export prices, 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 and composition of 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.

- This Inflation Report was approved by the Board of Directors of BCRP on June 9, 2016.

Summary

i. The global economy is projected to grow this year at the same rate as in 2015 (3.1 percent), the lowest growth rate recorded since 2009. This downward revision of our previous forecast (3.3 percent, Inflation Report of March) is explained by the evolution of growth in both the developed countries and in the emerging market economies, the lower growth estimated in the United States and the deterioration of growth prospects in Japan and the United Kingdom standing out in the case of the former and the revision of Brazil's GDP growth rate on the downside standing out in the case of the latter. Global growth in 2017 and 2018 would show a gradual recovery, with growth rates of 3.5 and 3.6 percent respectively being estimated for these years.

   In line with this outlook for global growth, the terms of trade are expected to decline (for the fifth consecutive year) to 2.6 percent in 2016, a more moderate rate than in previous years. More stable terms of trade are expected thereafter.

ii. Peru's GDP grew 3.9 percent in the first four months of 2016, driven mainly by the primary sectors which grew 7 percent. Thus, the GDP growth rate forecast for 2016 in this report remains at 4.0 percent. The forecast considers a higher growth of government spending, offset by a decline of private investment which is explained mostly by the execution of spending in the first quarter.

   In 2017 and 2018 GDP would show growth rates of 4.6 percent and 4.2 percent, respectively, growth being driven mainly by the primary sectors. A faster pace of growth is foreseen by 2018 in the non-primary sectors, which would be driven by a higher growth rate in construction (due to the implementation of infrastructure projects) and by the recovery of non-primary manufacturing (due to increased external demand and to increased demand associated with higher private investment).

iii. The projected evolution of the output gap is determined by the evolution of external conditions, the monetary policy stance and other financial conditions, the fiscal impulse and economic agents' confidence in the course of the economy. Thus, the forecast of economic growth for the 2016-2018 horizon is consistent with the gradual recovery of the output gap and with a potential GDP level close to 4.0 percent.

iv. The deficit in the current account of the balance of payments would start declining this year from 4.4 percent of GDP in 2015 to 3.8 percent in 2016, decreasing thereafter to around 3 percent in the next two years as a result of increased volumes of exports. Exports would be driven in all of this period by the greater dynamism of exports of minerals as well as by a greater contribution of exports of non-traditional goods by the end of the period, in line with increased access to external markets and with the expansion of the agricultural frontier. This reduction of the external deficit would take place in a context in which long-term capital flows would continue financing the balance of payments, in line with the implementation of investment projects in infrastructure, hydrocarbons and energy.

v. The fiscal deficit in the first quarter registered an annual rate of 2.9 percent of GDP, a higher rate than the 2.1 percent rate recorded in 2015. The increase in the deficit reflects basically the decline in tax revenues during this period (down 0.5 percentage points) and the increase of 0.2 percentage points of GDP in current expenditure.

    The fiscal deficit projected in this report for 2016 and 2017 is higher than that estimated in the Inflation Report of March, in line with the execution registered at May and the level of investment spending considered in the Multiannual Macroeconomic Framework for 2017-2019. The projection considers a recovery in sub-national governments' spending after two years of contraction as well as the continuation of the modernization works of the Refinery of Talara. A gradual reduction of the deficit over the next 3 years to 2.5 percent in 2018 is considered in the forecast scenario.

vi. Inflation accumulated in the last twelve months fell from 4.5 percent in February to 3.5 percent in May 2016 as a result of the reversal of the domestic supply shocks associated with El Niño. Moreover, the decline in the rate of inflation would also be associated with the reduction of inflation expectations and with the appreciation of the domestic currency since February.

    As pointed out in our last Inflation Report, the upside risks to the inflation forecast have been reversing, with the inflationary effect of the depreciation of the PEN having moderated and with inflation expectations declining gradually. In addition to this, the supply shocks that temporarily affected inflation continue to reverse.

    In this context, the Board of the BCRP kept the benchmark interest rate in 4.25 percent since March. The Board also reiterated that the BCRP oversees inflation forecasts and inflations determinants and stands ready to make further adjustments in the policy rate, if necessary, to lead inflation to converge to the target range.

vii. The balance of risks remains neutral in the inflation forecast, which means that the probability of the occurrence of factors that affect inflation on the upside is equal to the probability of the occurrence of factors that imply a lower price increase. there are no signals indicating an upward or a downward bias of the inflation forecast. Among the events that could divert the rate of inflation from the baseline scenario, the following stand out:

a. Lower global growth

The baseline scenario considers a slower recovery in the world economy in 2016-2018 than the one estimated in our Inflation Report of March, due mainly to lower growth in the United States, Japan, and in some emerging economies. However, if such recovery were to take even longer, the resulting lower external impulse would translate into a lower output gap and into lower domestic inflation.

b. Negative domestic demand shocks

Economic recovery could take longer than expected if the implementation of investment projects were postponed, which would imply a more negative output gap and lower inflation in the forecast horizon. The probability of occurrence of such scenario has decreased in comparison with our previous report due to the recovery of public investment.

c. Increased volatility in international financial markets

This risk could materialize if unanticipated rises in the policy rate of the U.S. Federal Reserve brought about volatility in international financial markets. In such case, this could generate capital outflows from the emerging markets and depreciation pressures on the currencies of these countries, which could lead to higher inflation. However, this risk has become more moderate, as reflected in the change of expectations about a rise in the Fed interest rate.

FORECAST SUMMARY

	2015	2016[1/]		2017[1/]		2018[1/]
		IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
% chg. real						
1. GDP	3.3	4.0	4.0	4.6	4.6	4.2
2. Domestic demand	2.9	2.5	2.5	3.8	3.8	3.8
a. Private consumption	3.4	3.5	3.5	3.8	3.8	4.0
b. Public consumption	9.5	4.0	4.7	3.0	1.0	0.8
c. Private fixed investment	-4.4	0.0	-1.0	4.0	4.0	4.2
d. Public investment	-7.5	7.4	10.3	5.0	7.9	6.0
3. Exports (goods and services)	3.5	6.4	6.4	6.7	6.4	4.9
4. Imports (goods and services)	2.2	0.7	0.3	3.5	3.5	3.5
5. Economic growth in main trading partners	3.1	2.9	2.8	3.2	3.1	3.3
Memo:						
Output gap [2/] (%)	-1.5 ; -0.5	-1.5 ; 0.0	-1.5 ; 0.0	-1.0 ; 0.0	-1.0 ; 0.0	-0.5 ; 0.0
% chg.						
6. Inflation	4.4	3.0 - 3.5	2.7 - 3.2	2.0 - 2.2	2.0 - 2.2	2.0 - 2.2
7. Expected inflation	-	3.5	3.5	3.2	3.0	2.8
8. Expected depreciation	-	7.3	2.9	1.8	1.9	1.7
9. Terms of Trade [3/]	-6.3	-2.6	-2.6	0.1	0.9	0.0
a. Export price index	-14.9	-5.2	-4.8	2.3	2.8	0.9
b. Import price index	-9.2	-2.7	-2.3	2.2	1.9	0.9
Nominal % chg.						
10. Currency in circulation	3.8	4.6	5.5	5.0	6.0	6.0
11. Credit to the private sector [4/]	9.6	8.0	7.0	7.0	7.0	6.5
% GDP						
12. Gross fixed investment	24.3	23.9	24.0	24.0	24.3	24.4
13. Current account of the balance of payments	-4.4	-3.9	-3.8	-3.0	-3.0	-2.8
14. Trade balance	-1.6	-0.9	-0.8	-0.4	-0.2	0.0
15. Long-term external financing to the private sector [5/]	5.3	3.8	4.1	4.3	4.3	4.1
16. Current revenue of the general government	20.0	19.5	19.3	19.5	19.3	19.3
17. Non-financial expenditure of the general government	21.3	20.8	21.1	20.6	20.7	20.4
18. Overall balance of the non-financial public sector	-2.1	-2.6	-3.0	-2.3	-2.8	-2.5
19. Total public debt balance	23.3	24.7	25.5	24.0	26.6	28.0
20. Net public debt balance	6.6	8.6	10.1	10.1	13.1	15.5

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

I. International Environment

Output

1. The growth forecast for 2016 has been revised down from 3.3 percent to 3.1 percent. This downward revision is explained by the evolution of growth in both the developed countries and in the emerging market economies. The lower growth estimated in the United States (due basically to a lower-than-expected performance in Q1) and the deterioration of growth prospects in Japan and the United Kingdom stand out in the case of the former, while the revision of Brazil's GDP growth rate on the downside stands out in the case of the latter.

   Global growth in 2017 and 2018 would show a gradual recovery, with growth rates of 3.5 and 3.6 percent respectively being estimated for these years.

Table 1
WORLD GDP GROWTH
(Annual % change)

	PPP % 2015	Trading Peru % 2015	2014	2015	2016 IR Mar.16	2016 IR Jun.16	2017 IR Mar.16	2017 IR Jun.16	2018 IR Jun.16
Advanced economies	**42.4**	**47.4**	**1.8**	**1.9**	**1.9**	**1.8**	**2.0**	**1.9**	**1.9**
Of which									
1. United States of America	15.8	17.5	2.4	2.4	2.2	2.0	2.3	2.0	2.2
2. Eurozone	11.9	11.0	0.9	1.6	1.5	1.6	1.7	1.7	1.6
Germany	3.4	2.8	1.6	1.5	1.5	1.7	1.5	1.6	1.5
France	2.3	0.9	0.2	1.1	1.2	1.4	1.6	1.6	1.6
Italy	1.9	1.7	-0.3	0.8	1.1	1.1	1.2	1.2	1.1
Spain	1.4	2.5	1.4	3.2	2.7	2.8	2.1	2.2	2.0
3. Japan	4.3	3.0	0.0	0.5	0.9	0.5	0.6	0.6	0.6
4. United Kingdom	2.4	1.1	2.9	2.2	2.1	1.9	2.2	2.1	2.2
5. Canada	1.4	4.4	2.5	1.2	1.6	1.7	2.2	2.3	2.2
Emerging market and developing economies	**57.6**	**52.6**	**4.6**	**4.0**	**4.3**	**4.1**	**4.7**	**4.6**	**4.8**
Of which									
1. Developing Asia	30.6	26.9	6.8	6.6	6.4	6.4	6.3	6.3	6.3
China	17.1	22.2	7.3	6.9	6.5	6.5	6.2	6.2	6.0
India	7.0	2.2	7.2	7.6	7.4	7.4	7.6	7.6	7.6
2. Commonwealth of Independent States	4.6	0.7	1.1	-2.8	0.0	-0.3	2.0	1.5	1.9
Russia	3.3	0.5	0.7	-3.7	-1.1	-0.8	1.2	1.2	1.4
3. Latin America and the Caribbean	8.3	23.2	1.3	0.0	-0.4	-0.6	1.8	1.9	2.4
Brazil	2.8	4.1	0.1	-3.8	-3.5	-3.8	0.0	0.2	1.2
Chile	0.4	3.2	1.8	2.1	2.2	1.8	2.7	2.5	2.7
Colombia	0.6	3.0	4.4	3.1	2.4	2.4	3.2	3.0	3.7
Mexico	2.0	3.4	2.3	2.5	2.6	2.6	2.9	2.7	2.8
Peru	0.3	-	2.4	3.3	4.0	4.0	4.6	4.6	4.2
World Economy	**100.0**	**100.0**	**3.4**	**3.1**	**3.3**	**3.1**	**3.6**	**3.5**	**3.6**
Memo:									
Peru's trading partners 2015[1/]	65.7		3.6	3.1	2.9	2.8	3.2	3.1	3.3
BRICs[2/]	30.2		5.8	4.9	5.0	5.0	5.4	5.4	5.5

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

2. This forecast is consistent with the recent evolution of global indicators of activity (PMI) in the sectors of manufacturing and services. The global manufacturing PMI fell from 50.6 in March to 50.0 –a decline explained in part by the lower dynamism of global trade–, while the services PMI also showed a slight reduction in the same period (from 51.5 to 51.4), the decline recorded in China standing out.

Graph 1
JP MORGAN GLOBAL ACTIVITY INDICES*

* PMI indices.
Source: Bloomberg.

Services

	Dec.14	Mar.15	Jun.15	Sep.15	Dec.15	Mar.16	Apr.16	May.16
Global	**52.5**	**55.2**	**53.6**	**53.3**	**52.9**	**51.5**	**51.9**	**51.4**
USA	53.3	59.2	54.8	55.1	54.3	51.3	52.8	51.3
China	53.4	52.3	51.8	50.5	50.2	52.2	51.8	51.2
Eurozone	51.6	54.2	54.4	53.7	54.2	53.1	53.1	53.3
Japan	51.7	48.4	51.8	51.4	51.5	50.0	49.3	50.4

Source: Bloomberg and JP Morgan.

Manufacturing

	Dec.14	Mar.15	Jun.15	Sep.15	Dec.15	Mar.16	Apr.16	May.16
Global	**51.4**	**51.5**	**50.9**	**50.4**	**50.7**	**50.6**	**50.1**	**50.0**
USA	53.9	55.7	53.6	53.1	51.2	51.5	50.8	50.7
China	49.6	49.6	49.4	47.2	48.2	49.7	49.4	49.2
Eurozone	50.6	52.2	52.5	52.0	53.2	51.6	51.7	51.5
Japan	52.0	50.3	50.1	51.0	52.6	49.1	48.2	47.7

Source: Bloomberg and JP Morgan.

3. After growing 1.4 percent in the previous quarter, the U.S. GDP grew 0.8 percent in Q1-2016. Investment dropped 6.2 percent, a second consecutive contraction explained, on the one hand, by the decline of growth rates in the energy sector affected by low oil prices and, on the other hand, by lower corporate profits. Affected by the strength of the dollar and weak global demand, net exports also had a negative contribution to growth in the first three months of the year.

   This was offset by moderate growth in consumption (1.9 percent) and strong growth in residential investment (17.1 percent). Consumption grew less than personal income, which was reflected in an increase in saving which reached a rate of 5.9 percent in March as a ratio of disposable personal income.

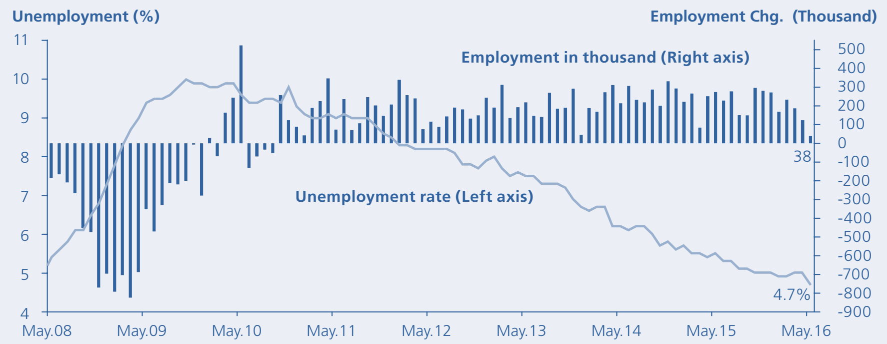
Table 2
USA: GDP
(Seasonally adjusted annualized quarterly rate)

	2015				2016
	Q1	Q2	Q3	Q4	Q1
Private consumption	1.8	3.6	3.0	2.4	1.9
Fixed investment	3.3	5.2	3.7	0.4	-1.5
Change on inventories *	0.9	0.0	-0.7	-0.2	-0.2
Net exports *	-1.9	0.2	-0.3	-0.1	-0.2
GDP	**0.6**	**3.9**	**2.0**	**1.4**	**0.8**
Memo					
Unemployment rate **	5.5	5.3	5.1	5.0	5.0

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

Greater dynamism is expected in the second half of the year in consumption –spending component representing approximately 70 percent of GDP– given the sustained improvement observed in the disposable income and better conditions in the labor market. Moreover, 150 thousand jobs have been created each month on average in the year, and in May the rate of unemployment fell to 4.7 percent. In line with the improvement of the labor market, various indicators linked to consumption, such as retail sales and consumer confidence have shown a recovery in April.

Graph 2
USA: EMPLOYMENT AND UNEMPLOYMENT RATE

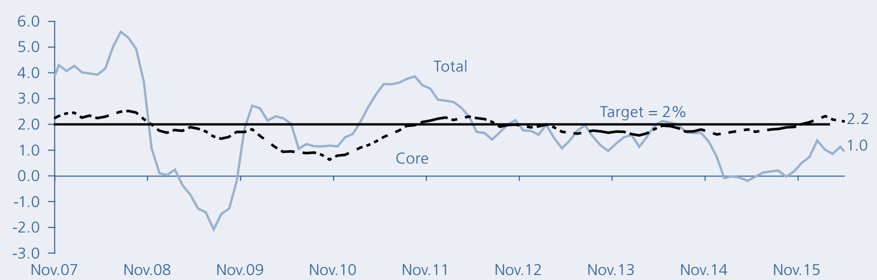


Source: Bloomberg.

In the context of the higher-than-expected slowdown observed in Q1, the economy would grow less than projected in the previous Inflation Report, both in 2016 and in 2017. In the period 2016-2018, the U.S. economy is estimated to grow 2 percent.

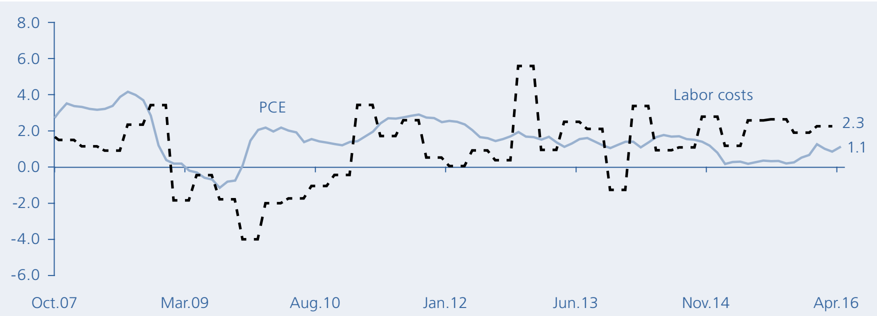
4. Inflation in the United States has maintained its rising trend in 2016, reversing the nearly constant rates observed in 2015. In May, the inflation rate was 1.0 percent and core inflation –which excludes the prices of food and energy– registered 2.2 percent. This is in line with increased pressures in salaries, which showed an annual increase of 2.5 percent in April.

Graph 3
USA: CPI
(12 month % change)



Source: Bloomberg.

Graph 4
USA: PCE PRICE INDEX AND LABOR UNIT COSTS
(12 month % change)

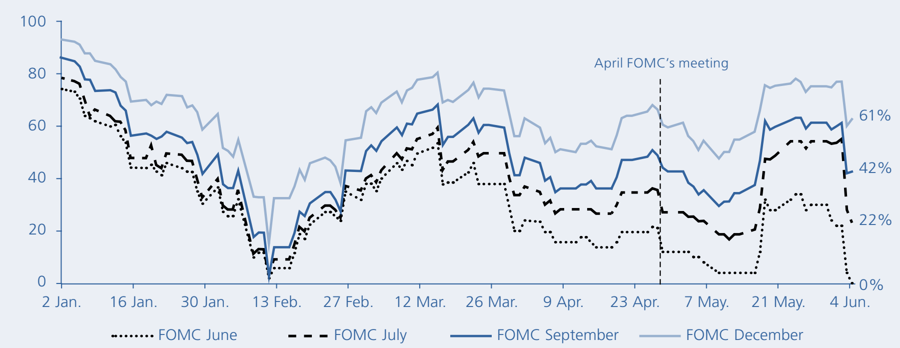


Source: Bloomberg. * PCE is Personal Consumption Expenditure.

5. The Fed statement released after the Fed policy meeting of April emphasized favorable conditions in consumption and in the labor market, softening concerns about global and financial conditions. In line with this, the Fed minutes said that an increase of rates was possible in the coming months, which was reiterated in several occasions by Fed officials, increasing the likelihood of a rise in rates in June and

July. This was also supported by positive real estate and consumption indicators. However, this probability decreased significantly again after the publication of employment data in May.

Graph 5
FED: FUTURE - PROBABILITY OF POLICY RATE HIKE
(%)



Source: Bloomberg.

Finally, the Fed decided to maintain its interest rate unchanged at its policy meeting of June15 and revised its growth forecasts slightly downwards. The projection of interest rates for 2016-2018 show a slower adjustment than estimated in March, but disorderly adjustments in financial markets as a result of a cycle of hikes in the Fed interest rates would imply risks to growth on the downside.

6. In the **Eurozone**, after recording a favorable GDP growth trend in the first quarter of this year, recent indicators of activity show again moderate growth rates. In addition, risks of slower growth and low inflation have increased, especially in a context marked by the possibility that Great Britain may exit the European Union (Brexit) –the referendum taking place on June 23– and by greater indications of global economic slowdown.

   In contrast with previous quarters, the GDP growth rate in Q1 of this year was 2.2 percent, the highest rate in a year. Domestic demand continued to be the most dynamic factor, reflecting better credit conditions –the ECB support– and the continued positive effects of maintaining low energy prices. Public spending continued to show positive, but more moderate growth rates in response to the influx of refugees, whereas net exports, on the other hand, had again a negative contribution to growth since the upturn in exports was accompanied by a faster growth of imports.

Table 3
EUROZONE: GDP GROWTH
(Seasonally adjusted annualized quarterly rate)

	2015				2016
	Q1	**Q2**	**Q3**	**Q4**	**Q1**
Private consumption	1.6	1.3	2.2	1.3	2.2
Fixed investment	6.2	0.3	2.0	5.9	3.4
Change on inventories *	0.7	-1.0	0.8	0.6	0.4
Net exports *	-1.0	1.5	-1.4	-1.2	-0.4
Government expenditure	2.1	1.1	1.2	2.0	1.6
GDP	**2.2**	**1.5**	**1.3**	**1.7**	**2.2**
Memo					
Unemployment rate **	11.2	11.0	10.7	10.4	10.2

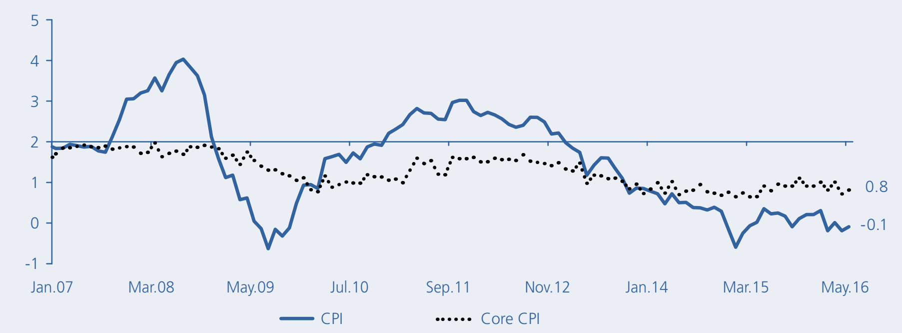
* Contribution to growth.
** End-of-period.
Source: Eurostat.

The most recent indicators of activity point to a slowdown of growth, particularly in the economies that in the previous quarters had grown at higher rates than the two most important ones (Germany and France). The activity indices (PMI) in April and May have decreased from the levels reached in March and economic confidence indices have been affected by the signals of global slowdown and fears about a possible Brexit. On the spending side, investment and consumption would be affected by the recoil of confidence and government spending would slow down more due to the stabilization of spending on immigrants.

In this context, it is estimated that growth in the Eurozone would continue showing moderate rates in 2016-18 (between 1.6 and 1.7 percent), which would imply a slight correction upward (0.1 percent) in our previous growth projection for 2016 associated with the favorable evolution of growth in Q1.

This evolution of economic activity has taken place in a context marked by low inflation and even deflationary risks. Inflation in the region returned to negative grounds in April and May (as it did in February of this year) and core inflation has remained low. In addition, these risks have extended across the Eurozone economies. Of the 19 countries integrating the Eurozone, 10 reported negative inflation, 8 showed inflation levels not higher than 1 percent and only one country (Belgium) registered an inflation rate over 1 percent.

Graph 6
EUROZONE: ANNUAL INFLATION
(%)



Source: Bloomberg.

Graph 7
EUROZONE: UNEMPLOYMENT RATE
(%)

Source: Bloomberg.

Inflation expectations have remained low. After the minimum levels registered at the end of February, inflation expectations show annual rate levels below 1.5 percent.

Graph 8
EUROZONE: EXPECTATION OF INFLATION IN THE LONG-TERM
(5-year forward of 5-year inflation swap)

Source: Bloomberg.

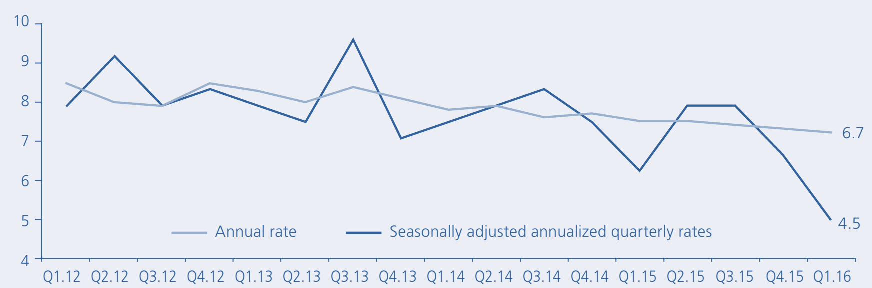
In this context, in order to ensure an inflation path consistent with the medium-term goals, the ECB has hinted repeatedly that it will do everything necessary to fulfill its mandate of long-term price stability. The ECB minutes of April showed increased concern over low inflation given the second round effects on salaries and other prices, and recognized that other policy areas should contribute more in the implementation of the economic reforms. The new Corporate Sector Purchase Program (CSPP) and the first injection of special liquidity (TLTRO2) will not start until June.

7. As for the growth outlook in other developed economies, the growth rates projected for Japan and the United Kingdom have been revised down. In the case of Japan, the growth forecast has been revised down due to the lower dynamism of consumption and net exports (affected by the continued appreciation of the yen), which has led the authorities to postpone increasing the sale taxes from April 2017 to October 2019. In the case of the UK, the revision is due to uncertainty associated with the impact of the possibility of Brexit on confidence and investment.

8. In **China**, growth data in Q1 and indicators of activity in May have confirmed that the economic slowdown has continued and shows more moderate rates of growth, in line with the new model of growth based more on private consumption and on the services sector. This slowdown has been accompanied by increased risks of lower growth, especially due to the financial risks associated with the corporate sector.

The GDP growth rate recorded in Q1-2016 (4.5 percent in annualized quarterly terms) was the lowest rate since the seasonally adjusted quarterly series is published (2011) and the lowest in annual terms (6.7 percent) since Q1-2009. At the sector level, the slowdown became widespread, although the sector of services continued to grow at high rates (7.6 percent). In terms of spending, the figures show a more domestic demand-based growth: while consumption and investment account for 85 and 36 percent of growth, net exports had a negative contribution of 21 percent.

Graph 9
CHINA: QUARTERLY GDP
(Seasonally adjusted annualized rate and annual rate)



Source: Bloomberg.

Indicators and data in May confirm this moderation of growth. The indicators of activity (PMIs and industrial production indices) and expenditure (retail sales, investment, and net exports) continued showing lower growth rates (even when the seasonal effects associated with the festivities of the Chinese Lunar New Year were isolated). Moreover, public investment (which represents one third of total investment) grew almost 23.3 percent in accumulated annual terms as of May (versus 3.9 percent in private investment), especially in infrastructure.

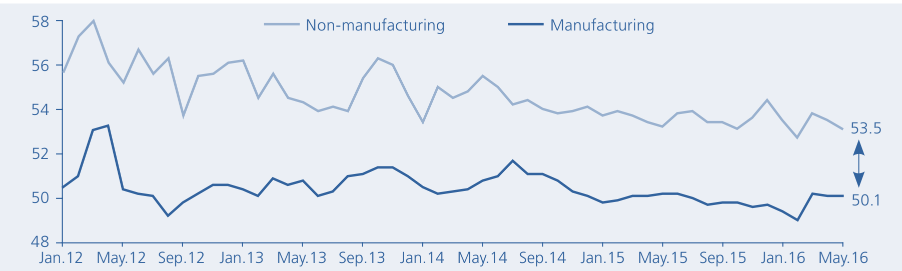
In contrast with the situation described in our previous report, these signs of slowdown have been accompanied by lower deflationary pressures. In May of this year, inflation recorded an annual rate of 2.0 percent, indicating a slight moderation in food prices, while core inflation rose to 1.6 percent. In addition, reflecting the recent rise in the prices of commodities (especially in fuel prices), producer prices showed a lower decline.

Table 4
CHINA'S ECONOMIC INDICATORS

	2014	2015				2016		
Indicators	**Dec.**	**Mar.**	**Jun.**	**Sep.**	**Dec.**	**Mar.**	**Apr.**	**May.**
Industrial Production (12 month % change)	7.9	5.6	6.8	5.7	5.9	6.8	6.0	6.0
Investment in fixed assets (Accum. annual % change)	15.7	13.5	11.4	10.3	10.0	10.7	10.5	9.6
Investment in infrastructure (Accum. annual % change)	21.5	23.1	19.1	18.1	17.2	19.6	19.0	20.0
Real estate Investment (Accum. annual % change)	10.5	8.5	4.6	2.6	1.0	6.2	7.2	7.0
Average price of houses (Monthly % change)	-0.4	-0.2	0.2	0.2	0.2	0.9	1.1	n.d.
Average price of houses (Annual % change)	-4.5	-6.4	-5.7	-2.1	0.3	3.1	4.3	n.d.
Retail sales (12 month % change)	11.9	10.2	10.6	10.9	11.1	10.5	10.1	10.0
Exports (12 month % change)	9.7	-15.0	2.8	-3.7	-1.4	11.5	-1.8	-4.1
Imports (12 month % change)	-2.4	-12.7	-6.1	-20.4	-7.6	-7.6	-10.9	-0.4
New loans in yuans (Annual %)	13.6	14.0	13.4	15.4	14.3	14.7	14.4	14.4
Total new financing (Annual %)	14.4	12.8	11.7	12.1	11.7	13.4	13.1	12.7
M2 (Annual %)	12.2	11.6	11.8	13.1	13.3	13.4	12.8	11.8
Consumer Price Index (12 month % change)	1.5	1.4	1.4	1.6	1.6	2.3	2.3	2.0
Wholesale Price Index (12 month % change)	-3.3	-4.6	-4.8	-5.9	-5.9	-4.3	-3.4	-2.8

Source: Bloomberg and FMI.

Graph 10
CHINA: OFFICIAL PMI MANUFACTURING AND NON-MANUFACTURING



* Includes services and construction.
Source: Bloomberg.

China is still forecast to grow 6.5 percent in 2016 and 6.2 percent in 2017, while in 2018 it is estimated to grow 6.0 percent given the process of economic adjustment that is being implemented in this country. This scenario considers a moderate support from fiscal policy (in line with the deficit target of 3 percent established for this year). As for monetary policy, additional cuts in the interest rate or in the rate of reserve requirements could still be implemented, provided that such measures are consistent with the objective of moderating the annual growth of bank credit and total social financing (official projections assume a growth rate of 13 percent in these aggregates).

This forecast is subject to risks, the probability of occurrence of some of which has increased in comparison with our previous report. The recent slowdown –although it is in line with the aim of reorienting growth towards domestic sources of growth– may increase the risks associated with excess leverage in the corporate sector which has registered some events of default in recent months. This risk has risen since late April, affecting especially the markets of corporate bonds (with yield lifts and lower emissions). Moreover, fears that the growth rates of domestic credit remain high with respect to growth rates of the nominal GDP is still a significant risk in terms of medium-term growth. On the other hand, the risks of a sharp correction of the housing bubble and a sharp depreciation of the yuan have decreased with respect to our previous report.

9. In Q1-2016, the main **Latin American** countries with inflation targeting showed slightly higher growth rates than those expected, except for Brazil which recorded a contraction in its levels of activity. Monthly indicators in Q2 of the year –i.e. industrial production, economic confidence, aggregate indices of economic activity, among others– show that this trend of moderate recovery would continue.

Table 5
LATIN AMERICA: QUARTERLY GDP GROWTH
(%)

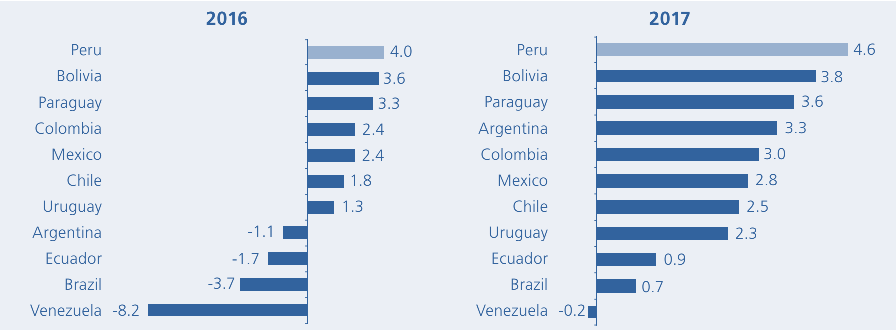
	Brazil	Chile	Colombia	Mexico
Q1.15	-1.2	1.0	0.8	0.5
Q2.15	-2.0	0.0	0.8	0.6
Q3.15	-1.6	0.3	1.1	0.8
Q4.15	-1.3	0.1	0.6	0.6
Q1.16	-0.3	1.3	0.2	0.8

Source: Bloomberg.

In Q1-2016, **Chile's** GDP was better than expected and higher than in the previous quarter due to the impulse of government spending and the positive contribution of net exports (reduction of imports). However, private consumption remains weak and increased investment in construction explains the growth of investment. In **Mexico**, the growth rate of the GDP was better than expected in the first three months of the year due to the recovery of the industrial sector, which recorded its highest rate since Q2-2015, while the services sector maintained a moderate pace of growth. On the other hand, the GDP in **Brazil** shrank for the fifth consecutive quarter –although less than expected– due to the collapse of industrial production and the contraction of the sectors of services and agriculture. On the demand side, household consumption decreased due to high unemployment, falling income and high inflation, and investment declined in the midst of a political crisis.

Because of the reasons above and because a worse recessive scenario is foreseen in Brazil, the projected growth in the region is revised down from -0.4 percent to -0.6 percent. Venezuela and Argentina would also grow at a slower pace than foreseen in our previous report.

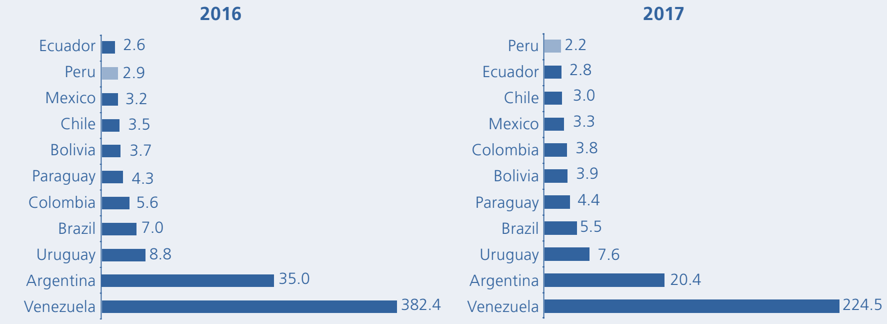
Graph 11
LATIN AMERICA: GDP GROWTH
(% change)



Source: Latin American Consensus Forecast (May 2016) and BCRP (Peru).

The inflation rates in the Latin American countries with inflation targeting schemes have slowed down in recent months, but remain above the target range, except for Mexico where the inflation rate remains within the target range. This is consistent with lower depreciation pressures on the currencies of the region as well as with the lag in the impact of central banks' response. In general, inflation expectations remain anchored, or are converging towards the inflation target.

Graph 12
INFLATION
(Dec./Dec.)



Source: Latin American Consensus Forecast (May 2016) and BCRP (Peru).

Financial Markets

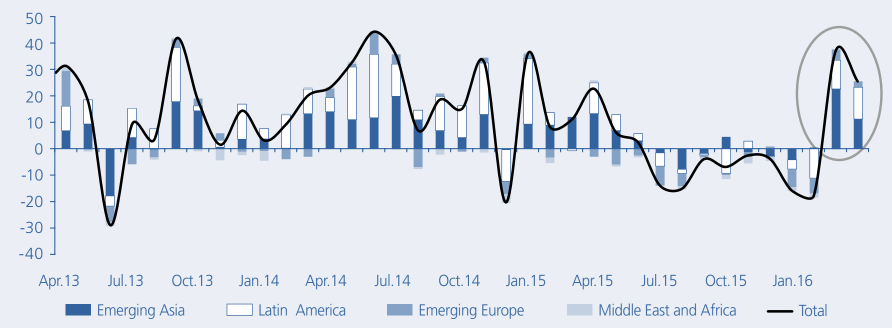
10. Conditions in international markets showed greater stability and lower risk aversion. This trend was supported by a significant recovery in the price of oil, the measures announced by the ECB in March –to be implemented since June–, and the less likely departure –until mid-May– of the United Kingdom from the European Union (Brexit). However, this probability has increased at the time of writing this report. In addition to this, uncertainty associated with the elections in the United States and in Spain could generate volatility in the markets in the near future.

Graph 13
VIX INDEX*
(June 2015 - May 2016)

Source: Bloomberg.

In the emerging markets, greater risk appetite and the favorable evolution of commodity prices until May reversed the negative trend observed in capital flows since 2015. According to estimates of the Institute of International Finance (IIF), the flow of capital has been positive (US$ 25.5 billion) between January and May, Asia and Latin America being the main destinations.

Graph 14
FLOWS OF NON-RESIDENTS INVESTMENT PORTFOLIO TO EMERGING COUNTRIES
(Billion US$)



Source: IIF.

11. In the **foreign exchange markets**, the dollar appreciated 2.3 percent between March and May, according to the Fed index. However, the trend has not been uniform. At first, uncertainty about the evolution of the US economy reduced expectations of a prompt second hike of rates. This weakened the dollar, which recorded a depreciation of 2.35 percent between the end of March and the beginning of May, continuing in this way with the trend pointed out in our last Inflation Report.

    Subsequently, unfavorable indicators of activity in China and the downward revision of macroeconomic projections for the Eurozone led the dollar to resume the appreciation trend observed in previous months, supported by increased expectations of rate hikes in the second half of May. Thus, after reaching a minimum seven-month level on May 2, the dollar appreciated 1.25 percent, but without reversing the appreciation recorded early in the year.

Graph 15
US DOLLAR BASKET INDEX*
(May 2015 - May 2016)

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

In the emerging countries, greater expectations of rate rises by the Fed and uncertainty over global growth reversed the appreciation trend of their currencies which, until the beginning of May, had been favored by the increase observed in commodity prices (especially oil, gold, and copper).

Table 6
EXCHANGE RATE

		May.16 (1)	Mar.16 (2)	Dec.15 (3)	% chg. (1)/(2)	% chg. (1)/(3)
FED Index*	C.U. per US$	122.17	119.43	122.98	2.3	-0.7
Eurozone	US$ per Euro	1.113	1.138	1.086	-2.2	2.5
Japan	Yen	110.74	112.59	120.34	-1.6	-8.0
United Kingdom	US$ per Pound	1.448	1.436	1.474	0.8	-1.8
Brazil	Real	3.612	3.595	3.962	0.5	-8.9
Chile	Peso	693	671	709	3.3	-2.3
Colombia	Peso	3,090	3,002	3,180	3.0	-2.8
Mexico	Peso	18.47	17.28	17.19	6.9	7.4
Peru	Sol	3.38	3.32	3.42	1.8	-1.3
Israel	Shekel	3.85	3.75	3.90	2.7	-1.1
South Africa	Rand	15.72	14.77	15.49	6.4	1.5
Turkey	Lira	2.95	2.82	2.92	4.7	1.1
China	Yuan	6.59	6.45	6.50	2.1	1.4
Philippines	Peso	46.79	45.96	46.95	1.8	-0.3
Indonesia	Rupee	13,585	13,180	13,790	3.1	-1.5
Malaysia	Ringgit	4.13	3.91	4.30	5.7	-3.9
Thailand	Bath	35.78	35.12	36.04	1.9	-0.7

* Last day May 31.
Source: Reuters and FED.

12. **Stock exchange** markets were also favored by lower risk aversion from end-March to April. In this period, the indices of exchange markets in emerging countries recorded a rise of 11 percent, while the exchange market indices in developed countries rose 3.9 percent. This rising trend was favored by the increase in the price of oil and metals associated with activity data in China in Q1 and by expectations of a more gradual adjustment of rates by the Fed.

    Since the end of April, this upward trend was reversed by the events mentioned above (data of activity in China in the month of April and the statements of the ECB and the IMF regarding the outlook for global growth). Greater expectations of rate hikes by the Fed also affected the performance of the stock exchanges.

13. The **public debt markets** showed different evolutions. While increased expectations that the Fed would raise its rates this year influenced rising yields in U.S. sovereign bonds and in the bonds of other emerging economies (tighter financial conditions), lower risk aversion (associated with the rise of commodity prices) influenced the decline of some emerging yields (more sensitive to commodity prices). Moreover,

the better economic conditions observed in some economies of the Eurozone, the deployment of the new measures of the ECB in June, and advances in Greece's rescue program contributed to influence a fall in European yields.

Table 7
YIELDS ON 10-YEAR TREASURY BONDS
(%, end-of-period)

	May.16	Mar.16	Dec.15	Dec.14	Dec.12	Public debt (% GDP 2015)
USA	1.85	1.77	2.27	2.17	1.76	106
Germany	0.14	0.15	0.63	0.54	1.31	71
France	0.48	0.49	0.99	0.82	1.99	97
Italy	1.35	1.22	1.59	1.88	4.49	133
Spain	1.47	1.43	1.77	1.60	5.23	99
Greece	7.18	8.48	8.07	9.42	11.68	178
United Kingdom	1.43	1.41	1.96	1.76	1.83	89
Japan	-0.12	-0.04	0.26	0.32	0.79	248
Brazil	12.99	13.97	16.51	12.36	9.17	74
Colombia	8.04	8.20	8.66	7.10	5.48	49
Chile	4.58	4.43	4.66	3.99	5.49	17
Mexico	6.14	5.94	6.26	5.83	5.36	54
Peru	**6.30**	**6.95**	**7.31**	**5.41**	**4.09**	**23**
South Africa	9.39	9.11	9.76	7.96	6.78	50
Israel	1.82	1.85	2.10	2.31	3.99	65
Turkey	9.73	9.71	10.46	7.86	6.55	33
China	2.97	2.89	2.86	3.65	3.59	44
South Korea	1.81	1.81	2.08	2.63	3.17	36
Indonesia	7.83	7.63	8.69	7.75	5.15	27
Thailand	2.31	1.69	2.49	2.69	3.51	43
Malaysia	3.93	3.79	4.19	4.12	3.50	57
Philippines	4.47	4.69	4.22	3.83	4.42	37

Source: Bloomberg and FMI.

II. Balance of Payments

Current Account Balance

14. Decreasing from the deficit observed in Q1-2015 (5.9 percent of GDP), the **current account** of the balance of payments recorded a deficit of 4.5 percent of GDP (US$ 2.0 billion) in Q1-2016. Lower volumes of imports (mainly of capital goods) and the effect of increased extraordinary revenue for asset sale operations between non-residents offset the fall in the value of exports. The volume of exports increased 9 percent due to higher traditional exports (mainly coffee, fishmeal, and copper), offsetting a 12.9 percent drop in average export prices.

15. A current account deficit of 3.8 percent of GDP is foreseen for **2016**. This deficit, which is lower than the one estimated in our March report (3.9 percent of GDP) would be explained by a greater volume of traditional exports but also by a greater contraction of non-traditional exports (associated with lower growth in the countries of the region). In **2017** the current account deficit would be similar to that projected in the previous report (3.0 percent of GDP). In line with the foreseen increase in mining exports and with a recovery in export prices, the current account deficit is projected to decline from 3.0 percent in 2017 to 2.8 percent of GDP in **2018**.

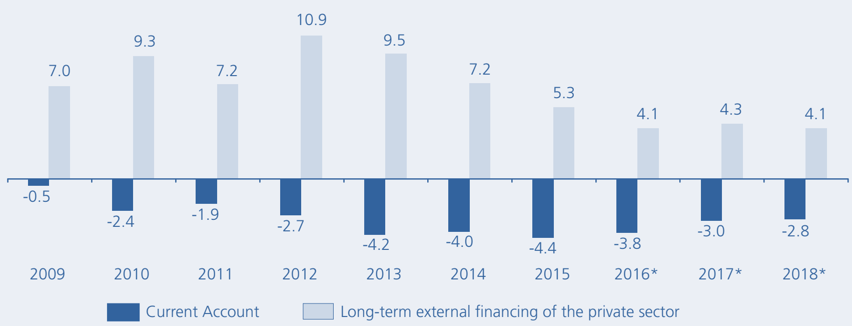
16. Long-term financing from private sources is expected to be around 4 percent of GDP in 2016-2018. This estimated level is lower than that observed in recent years, which would be associated with the end of the cycle of large mining investments, but would continue to be higher than the gap in the current account, foreign direct investment being the main component of long-term financing.

Table 8
BALANCE OF PAYMENTS
(Million US$)

	2015		2016*			2017*		2018*
	Q1	Year	Q1	IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
I. CURRENT ACCOUNT BALANCE	**-2,705**	**-8,373**	**-2,009**	**-7,405**	**-7,308**	**-6,014**	**-6,035**	**-5,902**
% GDP	-5.9	-4.4	-4.5	-3.9	-3.8	-3.0	-3.0	-2.8
1. Trade Balance	-1,093	-3,150	-630	-1,742	-1,584	-713	-465	41
a. Exports	8,164	34,236	7,751	34,494	34,834	37,559	37,859	39,970
b. Imports	-9,256	-37,385	-8,380	-36,236	-36,418	-38,272	-38,324	-39,929
2. Services	-524	-1,732	-431	-1,538	-1,574	-1,224	-1,260	-1,395
3. Investment income	-1,850	-6,823	-1,937	-7,556	-7,769	-7,643	-7,905	-8,191
4. Current transfers	762	3,331	988	3,431	3,619	3,566	3,595	3,644
Of which: Remittances	628	2,725	665	2,819	2,818	2,923	2,921	2,936
II. FINANCIAL ACCOUNT	**2,262**	**8,446**	**1,539**	**8,055**	**8,192**	**6,514**	**7,535**	**7,402**
Of which:								
1. Private sector	1,863	4,490	476	4,158	4,749	4,853	4,859	5,017
a. Long-term	2,213	7,296	207	4,158	4,627	4,853	4,859	5,017
b. Short-term 1/	-351	-2,807	269	0	122	0	0	0
2. Public sector 2/	399	3,956	1,063	3,897	3,443	1,661	2,676	2,385
III. TOTAL (=I+II)	**-443**	**73**	**-470**	**650**	**885**	**500**	**1,500**	**1,500**
Memo: Long-term external financing of the private sector (% GDP) 3/	6.4	5.3	5.0	3.8	4.1	4.3	4.3	4.1

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

Graph 16
CURRENT ACCOUNT AND LONG-TERM EXTERNAL FINANCING OF THE PRIVATE SECTOR: 2009-2018 1/
(% GDP)



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

17. The reduction of the current account deficit in 2016-2018 is consistent with a greater participation of domestic savings, which would increase from 20.2 percent of GDP in 2016 to 21.6 percent of GDP in 2018. Investment would also show an increase, but would have a more infrastructure-oriented composition.

Table 9
SAVINGS -INVESTMENT GAP
(% GDP)

	2014	2015	2016*		2017*		2018*
			IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
1. Gross fixed investment	**25.7**	**24.3**	**23.9**	**24.0**	**24.0**	**24.3**	**24.4**
2. Net domestic savings 1/	**21.7**	**20.0**	**20.0**	**20.2**	**21.1**	**21.3**	**21.6**
a. Private	16.4	17.1	17.4	17.9	18.1	18.6	18.5
b. Public	5.2	2.9	2.7	2.3	2.9	2.7	3.1
3. External savings	**4.0**	**4.4**	**3.9**	**3.8**	**3.0**	**3.0**	**2.8**

1/ Excluding change on inventories.
* Forecast.

Trade Balance

18. In Q1-2016 the trade balance recorded a deficit equivalent to US$ 630 million, a lower deficit than the one recorded in the same period of 2015. This deficit reflects a reduction of 9.5 percent in imports, offset by decline of 5.1 percent in exports. The latter was mainly associated with the decrease of the prices of traditional exports (most exporters of commodities continue to be affected by the reduction of the prices of the major commodities), together with the effect of lower volumes of exports of non-traditional products (the lower demand of the countries of the region standing out). On the side of imports, the reduction was particularly noteworthy in imports of inputs and capital goods and associated mostly the contraction of investment.

    The projected balance in the trade balance for **2016** has been revised from a deficit of US$ 1.7 billion (IR of March) to a deficit of US$ 1.6 billion in this report, taking into account the effect of higher traditional exports associated with a greater volume of these goods than that estimated in the previous report. In particular, the volumes of exports of gold and coffee have been revised on the upside, in line with the latest data and production announcements. On the other hand, exports of non-traditional goods have been revised down, especially in the case of fishery products (due to the lower availability of squid) and in the case of textiles (due to the slower pace of growth estimated in the main countries of destination of these goods).

19. The projection for **2017** considers a faster-than-expected normalization in the prices of traditional export products and a slower recovery in the volumes of non-traditional exports because of the international context.

Exports are also estimated to grow significantly in **2018** due to the increased production of major copper projects (Southern and Las Bambas), the stabilization of metal prices, greater volumes of exports of fishmeal, and to a recovery of non-traditional exports (in line with the recovery of growth in our main trading partners).

Table 10
TRADE BALANCE
(Million US$)

	2015		2016*			2017*		2018*
	Q1	Year	Q1	IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
Exports	**8,164**	**34,236**	**7,751**	**34,494**	**34,834**	**37,559**	**37,859**	**39,970**
Of which:								
Traditional products	5,392	23,291	5,266	23,895	24,222	26,502	26,831	28,268
Non-traditional products	2,752	10,857	2,464	10,506	10,506	10,967	10,915	11,585
Imports	**9,256**	**37,385**	**8,380**	**36,236**	**36,418**	**38,272**	**38,324**	**39,929**
Of which:								
Consumer goods	2,119	8,791	2,046	8,604	8,782	8,886	9,046	9,270
Inputs	4,001	15,923	3,474	15,405	15,314	16,510	16,338	17,151
Capital goods	2,945	12,007	2,746	11,895	12,019	12,715	12,868	13,489
Trade Balance	**-1,093**	**-3,150**	**-630**	**-1,742**	**-1,584**	**-713**	**-465**	**41**

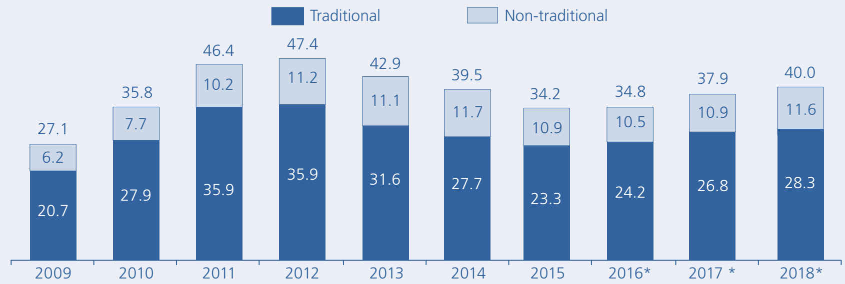
* Forecast.
IR: Inflation Report.

Table 11
TRADE BALANCE
(% change)

	2015		2016*			2017*		2018*
	Q1	Year	Q1	IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
1. Value:								
Exports	-16.5	-13.4	-5.1	1.0	1.7	8.9	8.7	5.6
Traditional products	-21.4	-15.9	-2.3	2.7	4.0	10.9	10.8	5.4
Non-traditional products	-3.8	-7.0	-10.5	-2.8	-3.2	4.4	3.9	6.1
Imports	-7.0	-8.7	-9.5	-3.0	-2.6	5.6	5.2	4.2
2. Volume:								
Exports	-3.6	1.8	9.0	6.6	6.9	6.4	5.8	4.7
Traditional products	-4.3	5.7	18.8	9.4	11.3	7.9	6.8	4.6
Non-traditional products	-1.5	-5.3	-8.2	0.5	-2.2	3.4	3.0	5.0
Imports	1.6	0.9	-3.0	-0.6	-0.6	3.2	3.2	3.3
3. Price:								
Exports	-13.4	-14.9	-12.9	-5.2	-4.8	2.3	2.8	0.9
Traditional products	-17.9	-20.4	-17.8	-6.1	-6.6	2.8	3.7	0.7
Non-traditional products	-2.3	-1.8	-2.5	-3.3	-1.0	0.9	0.8	1.0
Imports	-8.4	-9.5	-6.7	-2.7	-2.3	2.2	1.9	0.9

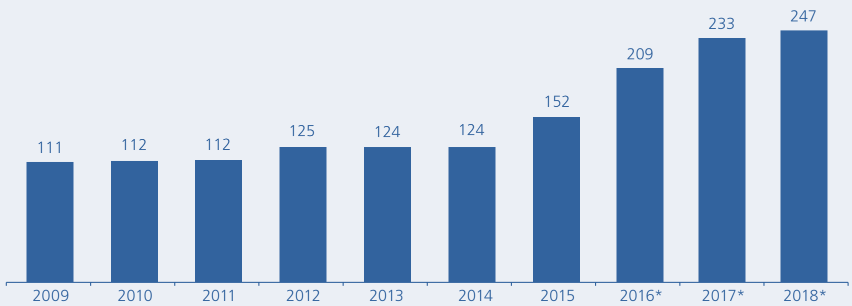
IR: Inflation Report.
* Forecast.

Graph 17
EXPORTS OF GOODS: 2009-2018
(Billion US$)



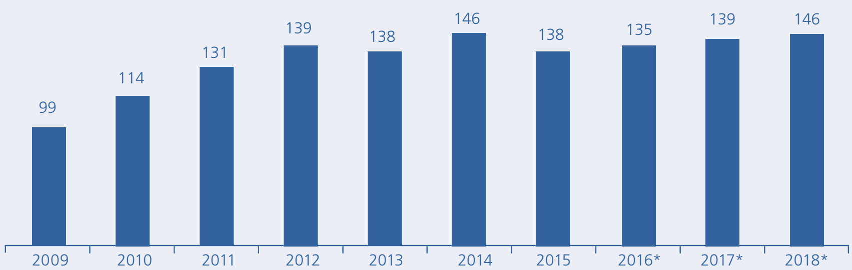
Memo: Total exports also includes other exports.
* Forecast.

Graph 18
VOLUME OF COPPER EXPORTS
(Index 2007 = 100)



* Forecast.

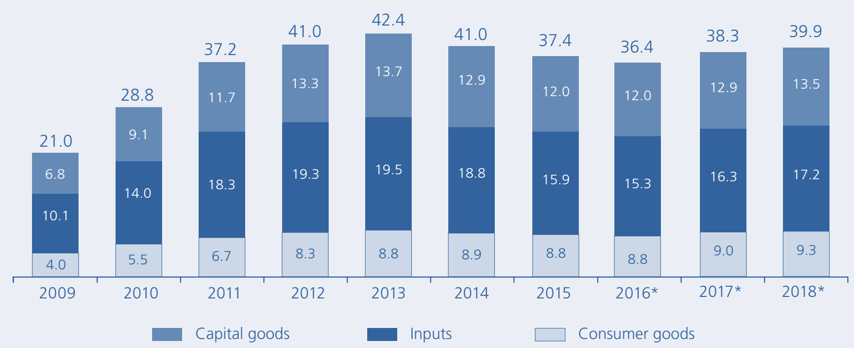
Graph 19
NON-TRADITIONAL EXPORTS VOLUME
(Index 2007 = 100)



* Forecast.

20. In **2016** the volume of imports of capital goods is expected to fall due to the decline of investment anticipated for this year (investment was estimated to show a zero growth rate in our previous report), whereas in **2017-2018** imports would record growth in real terms, in line with the growth of domestic demand.

Graph 20
IMPORTS OF GOODS: 2009-2018
(Billion US$)



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

Terms of Trade

21. In 2016 the terms of trade are estimated to fall by 2.6 percent –a similar rate to that estimated in the previous IR–, but showing a lower drop in the indices of import and export prices. This lower drop is in line with the recovery in the prices of commodities observed since March. On the side of exports, a slight rise would be seen in the prices of basic metals, although this trend has been recently affected by the appreciation of the dollar and by concerns about China's demand. On the other hand, on the side of imports, the outlook considers the rise in the price of oil (26 percent so far this year).

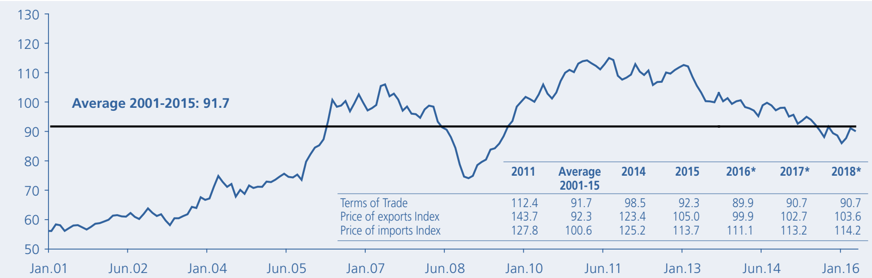
The terms of trade are expected to stabilize in 2017 and 2018 in a context in which both the prices of imports and exports would show limited rises associated with rising prospects of a recovery of global growth.

Table 12
TERMS OF TRADE: 2014 - 2018
(Annual average data)

	2014	2015	2016*		2017*		2018*
	Year	Year	IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
Terms of Trade	**-5.4**	**-6.3**	**-2.6**	**-2.6**	**0.1**	**0.9**	**0.0**
Price of exports	**-6.9**	**-14.9**	**-5.2**	**-4.8**	**2.3**	**2.8**	**0.9**
Copper (US$ cents per pound)	*311*	*250*	*215*	*215*	*216*	*216*	*220*
Zinc (US$ cents per pound)	*98*	*88*	*77*	*81*	*78*	*83*	*85*
Lead (US$ cents per pound)	*95*	*81*	*80*	*79*	*80*	*77*	*76*
Gold (US$ per ounce)	*1,266*	*1,160*	*1,200*	*1,232*	*1,200*	*1,209*	*1,200*
Price of imports	**-1.5**	**-9.2**	**-2.7**	**-2.3**	**2.2**	**1.9**	**0.9**
Oil (US$ per barrel)	*93*	*49*	*35*	*43*	*42*	*47*	*48*
Wheat (US$ per ton)	*243*	*186*	*172*	*171*	*195*	*197*	*207*
Maize (US$ per ton)	*155*	*141*	*145*	*147*	*155*	*159*	*164*
Soybean oil (US$ per ton)	*812*	*667*	*692*	*697*	*717*	*726*	*725*

Source: BCRP.
* Forecast.

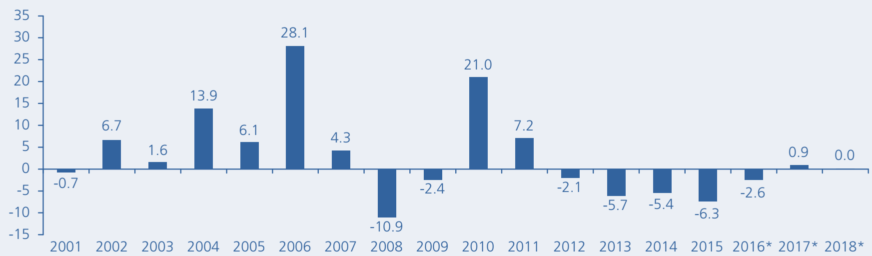
Graph 21
INDICES OF TERMS OF TRADE: FEBRUARY 2001 - APRIL2016
(2007=100)



	2011	Average 2001-15	2014	2015	2016*	2017*	2018*
Terms of Trade	112.4	91.7	98.5	92.3	89.9	90.7	90.7
Price of exports Index	143.7	92.3	123.4	105.0	99.9	102.7	103.6
Price of imports Index	127.8	100.6	125.2	113.7	111.1	113.2	114.2

* Forecast.
Source: BCRP.

Graph 22
TERMS OF TRADE: 2001 - 2018
(% change)



* Forecast.
Source: BCRP.

Copper

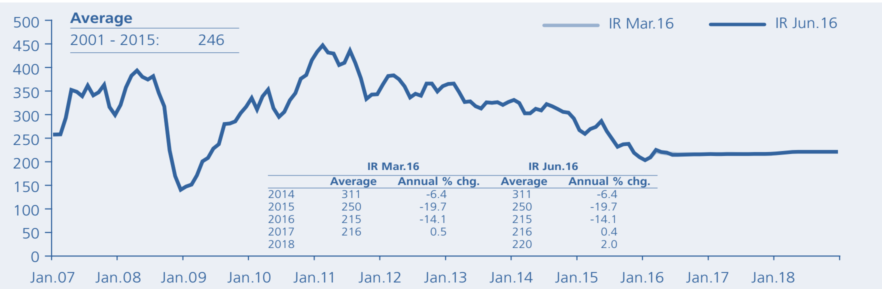
22. The price of **copper** rose 2.0 percent in the first five months of 2016, reaching a monthly average price of US$ 2.14 per pound in May. However, since April the price of copper has been declining from the maximum level it recorded in March, when the return of investors to commodity markets and the stimulus measures adopted by the Chinese government influenced a price rise.

    The recent downward pressures on the price of copper are explained by the rapid withdrawal of investors in response to the change in expectations regarding the Federal Reserve cycle of interest rate adjustments. Another factor contributing to the recent downward pressures has been the correction of optimistic expectations about Chinese demand after reports showed that various indicators of activity were lower than expected, the fall of Chinese imports of copper standing out among them.

    In the forecast horizon, the estimated prices of copper continue to be those pointed out in our previous report. China's demand is expected to continue being favored by the public sector's high investment in infrastructure and by the recovery of real estate investment. This demand would absorb the higher available supply associated with China's increased smelting capacity and with the onset of production of mega mining projects in the rest of the world, particularly in Peru and Zambia.

    The risk on the upside is associated with a higher-than-expected growth of China's demand as a result of the stimulus measures implemented by the Chinese Government. On the other hand, the downside risks are associated with the resurgence of financial instability (which would reduce non-commercial positions), the possibility of a sharp depreciation of the yuan, and possible measures to cool the growth of credit in China.

Graph 23
COPPER: JANUARY 2007 - DECEMBER 2018
(US$ cents/pd.)



	IR Mar.16		IR Jun.16	
	Average	Annual % chg.	Average	Annual % chg.
2014	311	-6.4	311	-6.4
2015	250	-19.7	250	-19.7
2016	215	-14.1	215	-14.1
2017	216	0.5	216	0.4
2018			220	2.0

Source: Bloomberg and BCRP.

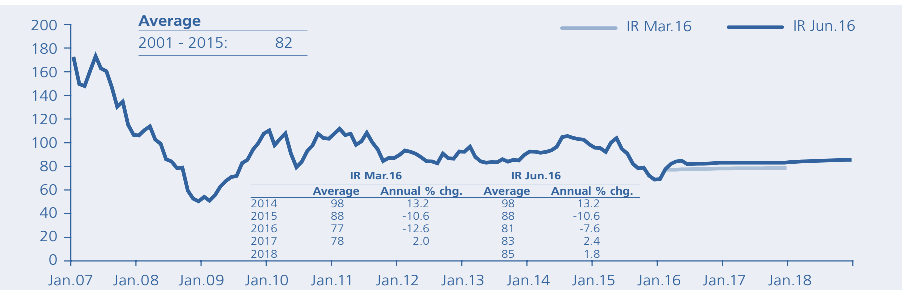
Zinc

23. The average price of **zinc** rose 23 percent in the first five months of the year, reaching a monthly average price of US$ 0.85 per pound in May 2016. The price continued to increase in recent months although at a slower pace, affected by the change in expectations about the cycle of interest rate adjustments of the Federal Reserve.

    The rise in the price of zinc was supported by the Government in China's spending in infrastructure, which showed a pace of growth not seen since the global financial crisis. In addition, supporting the growth of global demand, the demand for galvanized steel –which uses zinc as coating– has continued to increase in the United States and Europe, while the supply has continued adjusting due to the definite closing of Vedanta's mine Lisheen and MMG's Century mine, and the production cuts announced by several producers, as reflected in the drop of inventories of concentrate zinc in the main Chinese smelters.

    In this context, the price of zinc in the forecast horizon has been revised up due to a higher-than-expected growth of China's demand and prospects of lower global supply.

Graph 24
ZINC: JANUARY 2007 - DECEMBER 2018
(US$ cents/pd.)



	IR Mar.16		IR Jun.16	
	Average	Annual % chg.	Average	Annual % chg.
2014	98	13.2	98	13.2
2015	88	-10.6	88	-10.6
2016	77	-12.6	81	-7.6
2017	78	2.0	83	2.4
2018			85	1.8

Source: Bloomberg and BCRP.

Gold

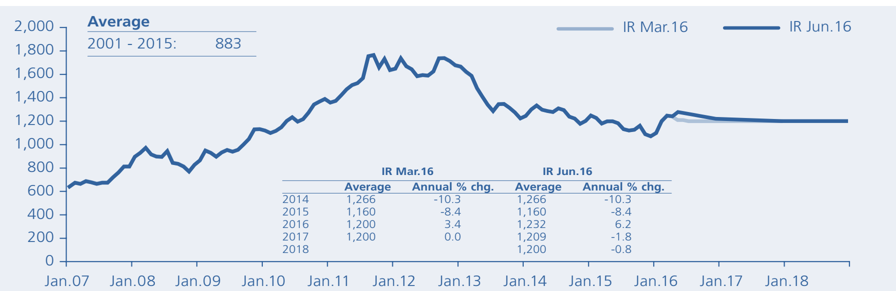
24. The price of **gold** rose 18 percent in the first five months of 2016, reaching a monthly average price of US$ 1,259 per troy ounce in May. The increase in the price of gold so far this year is explained by the depreciation of the dollar and weak real interest rates associated with expectations that the Fed rate adjustments will

be as sharp as previously estimated. Moreover, investors' non-commercial positions in gold reached record highs. In this context, despite the fall in China and India's demand for gold for jewelry and the lower purchases from central banks, the global demand for gold reached an all-time high in Q1-2016, driven by investment demand.

Since the second half of May, however, the price of gold has decreased due to the possibility that the Fed will raise its interest rate in the months of June or July.

In line with these developments, the price of gold in the forecast horizon has been revised up given that it is expected that the Fed cycle of rate hikes will be more gradual than foreseen in our previous report. The risks to this forecast are associated mostly with the evolution of the dollar and, therefore, with the future decisions of the Fed. The evolution of the real demand for gold, on the other hand, depends on the prospects of China and India's demand.

Graph 25
GOLD: JANUARY 2007 - DECEMBER 2018
(US$/tr.oz.)



	IR Mar.16		IR Jun.16	
	Average	Annual % chg.	Average	Annual % chg.
2014	1,266	-10.3	1,266	-10.3
2015	1,160	-8.4	1,160	-8.4
2016	1,200	3.4	1,232	6.2
2017	1,200	0.0	1,209	-1.8
2018			1,200	-0.8

Source: Bloomberg and BCRP.

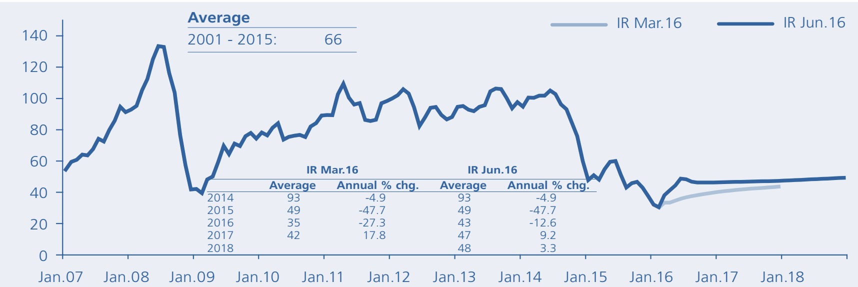
Crude Oil

25. The price of WTI **oil** accumulated an increase of 26 percent in the first five months of 2016 and closed with a monthly average price of US$ 46.9 per barrel in May. In recent months the oil price has showed a faster pace of recovery, recording a peak of US$ 49.5 a barrel on May 26.

The recovery of the oil price is due to a greater than expected fall in production and to a solid recovery of demand. The former was associated not only with the closing of higher cost operations (especially the production of non-conventional fuels in the United States and Canada) and the fall of production in China and India, but also with a series of unplanned production cuts, mainly in Nigeria, Libya, and Canada. As for the latter, markets have been surprised by a greater than expected growth of demand, mainly due to the strong increase observed in the demand of China and India.

In this context, the forecast of the price of WTI oil is revised up relative to our previous Inflation Report. Low prices have contributed to a further decline in production, enhanced by the prospects that unplanned production cuts will remain at high levels in the rest of the year. In addition to this, the growth of demand has been revised on the upside due to the increased seasonal demand for fuel anticipated because of the start of the holiday period in the countries of the Northern Hemisphere.

Graph 26
WTI OIL: JANUARY 2007 - DECEMBER 2018
(US$/bl)



	IR Mar.16		IR Jun.16	
	Average	Annual % chg.	Average	Annual % chg.
2014	93	-4.9	93	-4.9
2015	49	-47.7	49	-47.7
2016	35	-27.3	43	-12.6
2017	42	17.8	47	9.2
2018			48	3.3

Source: Bloomberg and BCRP.

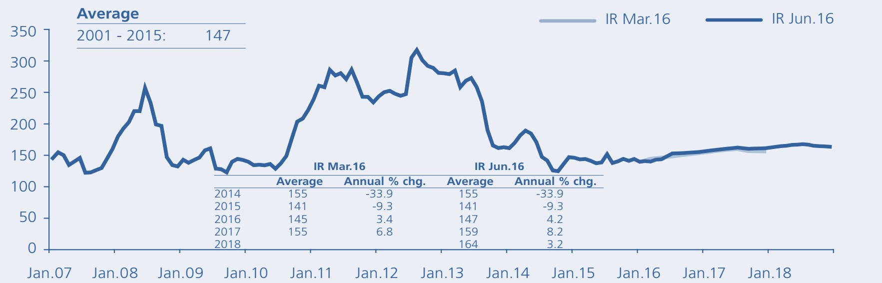
Maize

26. In May 2016, the average international price of **maize** was rose 5.6 percent to US$ 147 per ton compared to February 2016. The average price of maize accumulates an increase of 4.4 percent in the year.

The price of maize rose, affected by bad weather conditions in Argentina and Brazil, which led private agencies and the U.S. Department of Agriculture (USDA) to revise down their crop estimates in these countries. In addition, expectations were also generated about purchases of U.S. crops by Brazil as well as about the replacement of maize crops for soybean crops in the United States. Another factor that favored the rise in the price of maize was the increase in the price of oil.

Because of these reasons, the price of maize is estimated to show slightly higher levels than those forecast in our previous report.

Graph 27
MAIZE: JANUARY 2007 - DECEMBER 2018
(US$/TM)



	IR Mar.16 Average	IR Mar.16 Annual % chg.	IR Jun.16 Average	IR Jun.16 Annual % chg.
2014	155	-33.9	155	-33.9
2015	141	-9.3	141	-9.3
2016	145	3.4	147	4.2
2017	155	6.8	159	8.2
2018			164	3.2

Source: Bloomberg and BCRP.

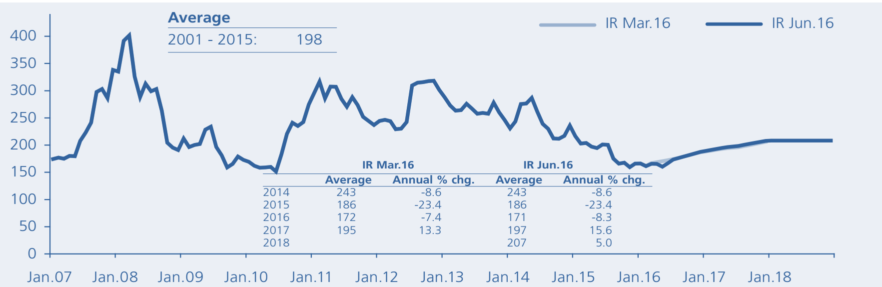
Wheat

27. In May, the average international price of **wheat** showed a decline of 1.0 percent compared to February 2016, closing with an average price of US$ 158.0 per ton. Moreover, the average monthly price of wheat accumulates a fall of 3.7 percent relative to December 2015.

The price of wheat was affected by the evolution of the supply. The USDA raised its estimates of the expected U.S. wheat production and global wheat production above the levels foreseen in 2015/2016 crop year. Another bearish factor for wheat prices was the good rate of progress and the good conditions of crops in the States of Kansas, Oklahoma, and Nebraska. However, globally, the USDA projected a reduction of total production in the 2016/2017 crop year.

Because of these factors, in the following years the price of wheat is foreseen to show higher levels than those considered in our previous Inflation Report.

Graph 28
WHEAT: JANUARY 2007 - DECEMBER 2018
(US$/MT)



	IR Mar.16 Average	IR Mar.16 Annual % chg.	IR Jun.16 Average	IR Jun.16 Annual % chg.
2014	243	-8.6	243	-8.6
2015	186	-23.4	186	-23.4
2016	172	-7.4	171	-8.3
2017	195	13.3	197	15.6
2018			207	5.0

Source: Bloomberg and BCRP.

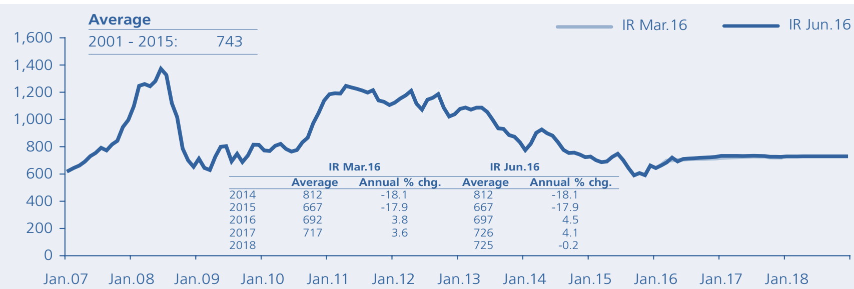
Soybean Oil

28. The average price of **soybean oil** in May was US$ 677 per ton, 3.1 percent higher than the average price level recorded in February 2016. Year-to-date, the average price of soybean oil has increased 3.3 percent.

    The price of soybean oil quoted in the U.S. was favored in April by the appreciation of the Brazilian real against the dollar, which increased the demand for U.S. exports with respect to Brazilian exports. Moreover, the price rise was also propelled by the increase in the prices of Malaysia's production of palm tree oil due to the drought caused by El Niño as well as by the rise in oil prices. Furthermore, poor weather conditions in Brazil (drought) and Argentina (excess rainfalls) were the factors that supported the price of soybean oil.

    Because of these factors, it is estimated that the price of soybean oil will show higher levels than those considered in our previous Inflation Report.

Graph 29
WHEAT: JANUARY 2007 - DECEMBER 2018
(US$/TM)



	IR Mar.16		IR Jun.16	
	Average	Annual % chg.	Average	Annual % chg.
2014	812	-18.1	812	-18.1
2015	667	-17.9	667	-17.9
2016	692	3.8	697	4.5
2017	717	3.6	726	4.1
2018			725	-0.2

Source: Bloomberg and BCRP.

External Financing

29. The net flow of private long-term external financing would amount to US$ 4.6 billion in **2016**. This level of net financing, which is greater than that estimated in our previous report, reflects mainly the acquisition of foreign assets by domestic investors in Q1. A gradual recovery is foreseen in the net inflow of long-term capital in **2017-2018**, with positive net flows amounting to US$ 4.9 billion (2.4 percent of GDP) and US$ 5.0 billion (2.3 percent of GDP), respectively, direct investment continuing to be the most important component. This recovery considers the implementation of infrastructure, hydrocarbons, and energy projects, with Lima'

Metro Line 2, Gasoducto Sur Peruano, and Nodo Energético del Sur standing out among them.

Table 13
FINANCIAL ACCOUNT OF THE PRIVATE SECTOR
(Million US$)

	2015		2016*			2017*		2018*
	Q1	Year	Q1	IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
a. **Long-term**	**2,213**	**7,296**	**207**	**4,158**	**4,627**	**4,853**	**4,859**	**5,017**
% GDP	*4.8*	*3.8*	*0.5*	*2.2*	*2.4*	*2.4*	*2.4*	*2.3*
1. Assets	**-655**	**-224**	**-721**	**-1,146**	**-770**	**-1,419**	**-1,498**	**-1,688**
2. Liabilities	**2,869**	**7,520**	**928**	**5,304**	**5,397**	**6,272**	**6,357**	**6,705**
Foreign direct investment in the country	2,833	6,861	1,027	4,625	4,596	4,847	4,849	4,996
Non-financial sector	218	1,828	373	944	1,445	1,426	1,675	1,852
Long-term loans	*117*	*2,410*	*264*	*360*	*688*	*416*	*532*	*701*
Portfolio investment	*100*	*-582*	*109*	*584*	*757*	*1,010*	*1,143*	*1,151*
Financial sector	-182	-1,169	-472	-265	-644	0	-167	-144
Long-term loans	*-184*	*-1,155*	*-472*	*-265*	*-644*	*-161*	*-228*	*-194*
Portfolio investment	*2*	*-14*	*0*	*0*	*0*	*161*	*61*	*50*
b. **Short-term** 1/	**-351**	**-2,807**	**269**	**0**	**122**	**0**	**0**	**0**
c. **Private sector (A + B)**	**1,863**	**4,490**	**476**	**4,158**	**4,749**	**4,853**	**4,859**	**5,017**

1/ Includes net erros and omissions.
IR: Inflation Report.
* Forecast.

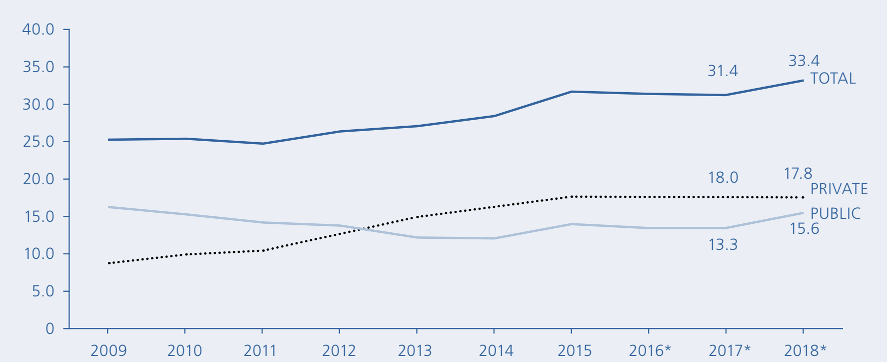
30. The positive flow expected in the **financial account of the public sector** in the next 3 years reflects major disbursements destined to finance several investment projects –i.e. the modernization of the Refinery in Talara and the development of Lima's Metro Line 2–, as well as the treasury's funding needs.

Table 14
PMAIN PROJECTS 2016-2018 WHICH INVOLVE PUBLIC EXTERNAL FINANCING

Projects	**Amount (Million US$)**
Line 2 Network Metro Lima	1,340
Modernization of Refinery Talara	2,600

31. At end-2015, the private sector' external indebtedness represented 17.9 percent of GDP, while the indebtedness of the public sector was equivalent to 13.9 percent of GDP. The private sector is expected to show a higher preference for borrowing from local sources in domestic currency.

Graph 30
MEDIUM- AND LONG-TERM EXTERNAL DEBT
(% GDP)



* Forecast.

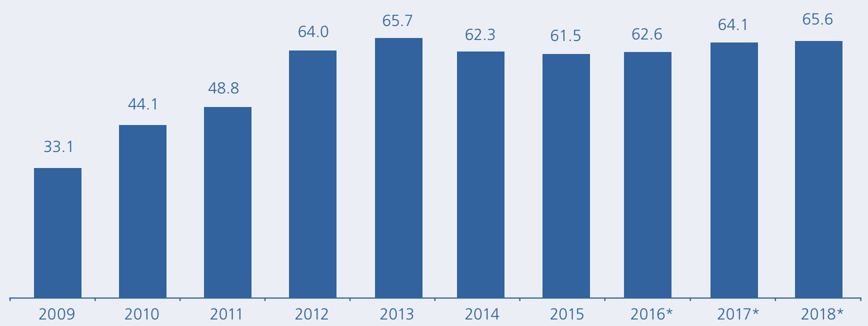
32. The soundness of the balance of payments to face negative events in the global economy is reflected in the position of Peru's international reserves relative to the balance of its short term external liabilities or comparing the total of these liabilities with the country's current account deficit. The high-levels the Peruvian economy registers in these indicators in the region was preventively achieved during the period of time characterized by capital inflows and high commodity prices.

Table 15
NIR INDICATORS

As a % of:	**2006**	**2011**	**2016***
GDP	19.6	28.6	32.4
Short-term external debt 1/	166	471	580
Short-term external debt plus Current account deficit	230	360	346

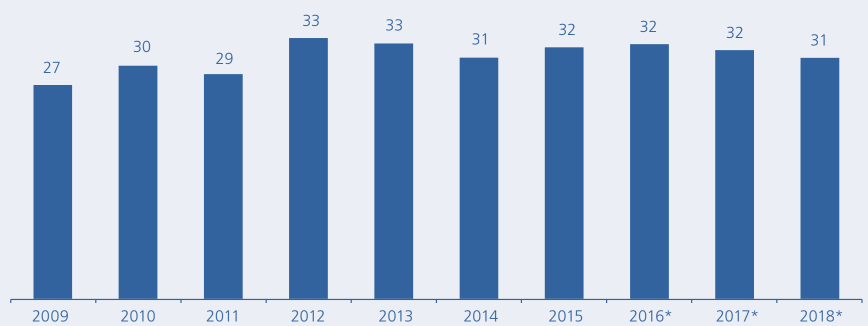
1/ Includes short-term debt balance plus redemption (1-year) of private and public sector.
* Forecast.

Graph 31
NET INTERNATIONAL RESERVES
(Billion US$)



* Forecast.

Graph 32
NET INTERNATIONAL RESERVES
(% GDP)



* Forecast.

III. Economic Activity

33. In Q1-2016, Peru's GDP grew 4.4 percent, the second highest rate in the last eight quarters after the 4.7 percent rate it recorded in the previous quarter. This growth rate in Q1 was influenced by the increase in exports and by the recovery of public spending. Exports grew 7.8 percent, driven by higher volumes of mining products as a result of the onset of production operations in copper projects, offset by the drop in non-traditional exports, while public spending recovered with a growth rate of 15.3 percent, with the recovery of investment in the sub-national governments standing out. This was offset by the fall of private investment (down 4.7 percent) as a result of the decline of the terms of trade and lower mining investment.

    Because of this, the projected rate of GDP growth for **2016** remains at 4.0 percent considering that the terms of trade are foreseen to be relatively stable in the second half of the year and that the dynamism observed in traditional exports and public investment is expected to continue –although showing lower rates than those seen in the first months of the year–, which would offset the fall in non-traditional exports and private investment.

    In **2017**, GDP is projected to grow 4.6 percent, driven by an expansion of primary sectors, mainly mining and fishing, and by a recovery in non-primary sectors. Favored by an international environment with higher global growth in which the terms of trade would increase slightly, a recovery of private investment and non-traditional exports is anticipated.

    In **2018** the non-primary sectors would register higher growth rates, driven by a recovery of non-primary manufacturing as a result of increased global demand and by the growth of domestic demand. This would be coupled as well by higher growth rates in construction as a result of the execution of infrastructure projects. Moreover, non-traditional exports would also continue to grow at higher rates as a result of the expansion of the agricultural frontier associated with the onset of operations in irrigation projects.

Sector GDP

34. Like in the IR of March, the forecast in this report also considers a scenario in which economic activity in 2016 and 2017 would continue to be driven by the primary sectors due to the start of operations in several mining projects. As a result, the output gap is foreseen to close gradually in the forecast horizon.

35. The faster pace of the growth of GDP seen in Q1 (4.4 percent) is explained mainly by the performance of the primary sectors, which grew 10.0 percent. Growth in the subsector of metal mining, which contributed with 2.0 percentage points to the GDP growth, was particularly noteworthy (25.0 percent). However, this dynamism in the primary sectors was offset by the lower output recorded in hydrocarbons (-18.5 percent) and in non-primary manufacturing (-4.0 percent), associated with the lower production of crude oil (due to the rupture of the North Peruvian Pipeline) and with the contraction of investment-oriented goods, respectively. On the other hand, the non-primary sectors recorded a growth rate of 3.0 percent, the highest rate in the last five quarters.

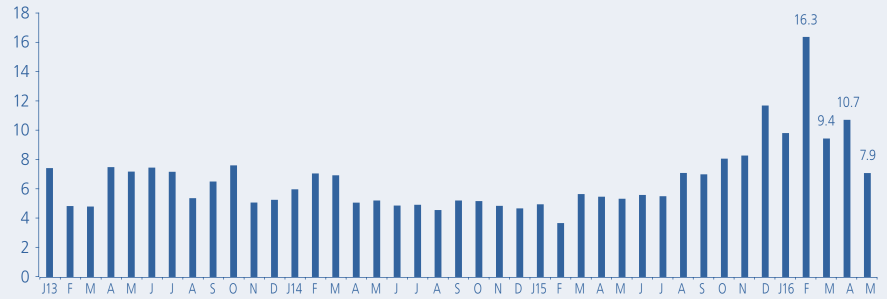
Table 16
GDP BY PRODUCTION SECTOR
(Real % change)

	2015		2016*			2017*		2018*
	Q1	Year	Q1	IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
Agriculture and livestock	**1.0**	**2.8**	**1.6**	**1.6**	**2.3**	**3.7**	**3.9**	**5.0**
Agriculture	-1.5	1.3	1.7	0.4	1.8	3.7	4.0	5.5
Livestock	4.6	5.3	1.4	3.4	2.9	3.6	3.7	4.2
Fishing	**-9.2**	**15.9**	**1.8**	**1.1**	**-2.4**	**25.2**	**29.7**	**4.3**
Mining and hydrocarbons	**4.3**	**9.3**	**15.7**	**14.1**	**14.1**	**8.6**	**8.3**	**4.5**
Metallic mining	6.9	15.5	25.0	17.0	18.2	9.4	8.4	5.1
Hydrocarbons	-4.2	-11.5	-18.5	1.0	-4.1	4.6	8.5	1.5
Manufacturing	**-5.1**	**-1.7**	**-3.0**	**-1.5**	**-1.8**	**4.0**	**3.8**	**4.0**
Based on raw materials	-11.7	1.7	0.9	1.0	-0.9	9.4	10.3	4.0
Non-primary industries	-3.0	-2.7	-4.0	-2.2	-2.0	2.5	2.0	4.0
Electricity and water	**4.6**	**6.2**	**10.6**	**7.6**	**7.8**	**5.5**	**5.5**	**5.0**
Construction	**-6.8**	**-5.9**	**2.1**	**0.0**	**0.0**	**3.5**	**3.5**	**5.5**
Commerce	**3.6**	**3.9**	**2.8**	**3.6**	**3.2**	**3.8**	**3.8**	**3.8**
Services	**4.1**	**4.2**	**4.4**	**3.7**	**3.9**	**3.7**	**3.9**	**3.9**
GDP	**1.8**	**3.3**	**4.4**	**4.0**	**4.0**	**4.6**	**4.6**	**4.2**
Memo:								
Primary GDP	0.7	6.6	10.0	8.9	8.7	7.8	7.9	4.6
Non-Primary GDP	2.1	2.4	3.0	2.7	2.8	3.6	3.6	4.0

* Forecast.
IR: Inflation Report.

36. Short-term indicators in the first months of the year show a better performance than in 2015. For example, electricity production grew 10.7 percent in the first five months of 2016 due mainly to greater activity in the mining sector this year (activity has increased by 25.0 percent between January and March).

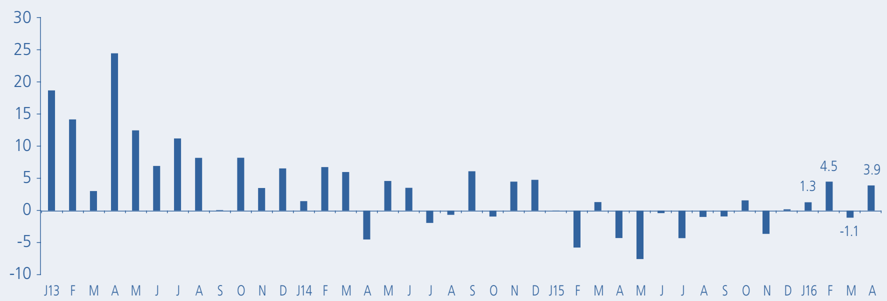
Graph 33
PRODUCTION OF ELECTRICITY: 2013 - 2016
(12-months % change)



Source: COES.

Furthermore, the domestic consumption of cement has grown in three of the first 4 months of 2016, which represents a recovery in comparison with the previous months and is consistent with the 2.1 percent growth rate recorded in the construction sector. This growth was encouraged by the greater public investment carried out mainly by sub-national governments during this period.

Graph 34
DOMESTIC CONSUMPTION OF CEMENT: 2013 - 2016
(12-months % change)

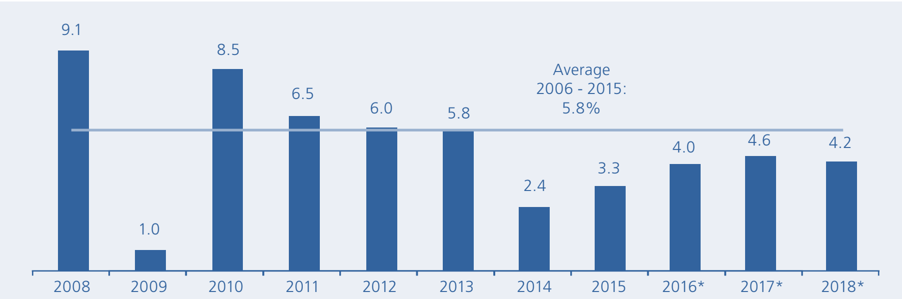


Source: ASOCEM and cement companies.

37. The GDP growth forecast for 2016 and 2017 remains unchanged, although the contribution of the different sectors in 2016 has been corrected. On the side of the

non-primary sectors, the correction results from the lower contribution of trade and non-primary manufacturing, offset by an increased demand for services, according to the outcomes observed in Q1. A GDP growth of 4.2 percent is projected for 2018 considering a further expansion of the non-primary sectors compared to the previous year and a slower pace of growth in the primary sectors once the mining projects in operation come closer to reaching their full capacity.

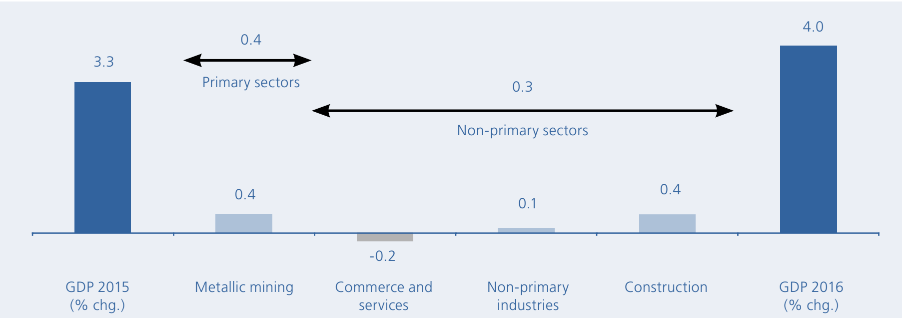
Graph 35
GDP: 2008 - 2018
(Real % change)



* Forecast.

38. Metal mining would account for 0.4 points of the 0.7 percentage points of the faster pace of growth of GDP between 2015 and 2016.

Graph 36
GDP GROWTH: 2016 VS 2015
(% Chg. and % contributions)



a) The **agriculture sector** grew 1.6 percent in Q1-2016, less than anticipated due mainly to the lower production of poultry meat, which was affected by climate anomalies, and due to the lower production of sugar cane as a result of labor problems in some sugar companies. The forecast scenario considers cold but neutral weather conditions, and therefore the growth forecast of the sector in 2016 is revised up from 1.6 to 2.3 percent. This revision considers also a greater production of rice associated with better water conditions than in the previous year, a lower decline in the production of potatoes (affected by droughts in the Sierra areas), and an increased production of olives, with the incorporation of larger cultivated areas.

The sector is expected to show a gradual increase in its pace of growth in 2017 and 2018, boosted by increased production in crops such as sugar cane, avocados, quinoa, grapes, peppers, paprika, asparagus, onions, and cotton, among other crops, as a result of the Olmos project.

b) In Q1-2016 the **fishing sector** grew less than estimated in March due to the lower extraction of scallops and squid for the industry of frozen products because both species were adversely affected by El Niño. Scallop cultivation was affected by lower seeding in October 2015 because of fears of a more severe El Niño event.

The growth forecast for the sector in 2016 has been revised down from a growth rate of 1.1 percent to a decline of 2.4 percent, considering that the first fishing season which usually takes place between April and July has not started yet. Although it is expected that the low level of biomass and the persistence of El Niño conditions will revert soon, the fishing season would be short and would take place between the months of July and August, the projected fishing quota being expected to be lower than the quota of the first fishing season in 2015. However, sea temperatures thereafter should show neutral cold conditions, which would increase the availability of anchovy. Therefore, growth in the sector in 2017 is projected to reach a rate of 29.7 percent and to normalize thereafter in 2018 with a rate of 4.3 percent.

c) The growth rate of the **metal mining sector** projected for 2016 is estimated at 18.2 percent. Growth in this sector in 2016 is expected to be higher than in 2015 due to the boost of greater copper production in Cerro Verde and Las Bambas. However, by 2017 this impulse would be lower and would add to the lower output of gold resulting from the exhaustion of mine Yanacocha, all of which would reflect in a growth rate of 8.4 percent in 2017 and in a growth rate of 5.1 percent in 2018.

Copper production grew 54.2 percent in Q1-2016, a rate unheard of since 2002. This significantly higher production is explained by the expansion of Cerro Verde and the onset of operations at Las Bambas, as well as by the recovery of Antamina. As pointed out in our report of March, copper production would show considerably greater levels in 2016 due to Cerro Verde and Las Bambas, which would become the second largest copper mining company in the country. Taking into account the expansion of Southern's mine of Toquepala, copper production is expected to continue with its growing trend in 2018.

Table 17
COPPER PRODUCTION
(Thousand MTF)

	2015	2016*	2017*	2018*
Antamina	412	438	450	450
Southern	298	296	300	366
Cerro Verde	208	534	575	575
Antapaccay	203	206	210	210
Toromocho	182	171	192	200
Constancia	106	127	130	130
Las Bambas	7	262	462	500
Rest	212	211	223	229
TOTAL	**1,628**	**2,245**	**2,542**	**2,660**

* Forecast.

In Q1-2016 the **production of gold** grew 7.3 percent compared to 2015, supported mainly by the production of the mining projects of Inmaculada and Anama, as well as by the informal production of gold. The production of this metal would decline 2.8 percent during this year because the onset of operations at the new projects of Shahuindo, Invicta, and Tambomayo will not compensate the lower production of Yanacocha and Barrick, which is due to natural depletion of these deposits. This scenario would continue in 2017, reversing thereafter towards 2018 with the increased production of the new gold mining projects mentioned previously.

Table 18
GOLD PRODUCTION
(Thousand MTF)

	2015	2016*	2017*	2018*
Yanacocha	919	672	400	400
Barrick Misquichilca	614	425	309	220
Madre de Dios 1/	391	463	363	363
Buenaventura	218	204	208	208
Inmaculada	59	145	147	147
Anama	74	88	89	89
Shahuindo	0	50	85	85
Invicta	0	25	101	118
Tambomayo	0	4	72	119
Rest	2,388	2,458	2,383	2,421
TOTAL	**4,663**	**4,533**	**4,156**	**4,168**

* Forecast.
1/ Corresponds to informal production of gold estimated by MINEM.

Zinc production dropped 7.0 percent during the first quarter of 2016 due to the lower production of Los Quenuales, associated with the closure of mining unit Iscaycruz. The growth rate projected for the year has been revised down due to the lower expected production of Antamina, whose output was lower than in 2015 when it concentrated its operations in areas with higher grades of zinc.

Table 19
MINING PRODUCTION
(% change)

	2015	2016*	2017*	2018*
Copper	25.8	37.9	13.2	4.7
Gold	3.5	-2.8	-8.3	0.3
Zinc	8.1	-6.5	5.3	0.1

* Forecast.

d) On the other hand, the output in the **subsector of hydrocarbons** dropped 18.5 percent in 2016 due to the rupture of the pipelines of Oleoducto Nor Peruano in February, which has been preventing the exploitation of the oil lot 192 by Pacific Stratus. Because of this, the growth rate projected in the sector in the year is revised down from 1.0 to -4.1 percent. Due to the base effect generated by this lower production during this year, growth in the sector in 2017 increases from 4.6 to 8.5 percent. Moreover, production in the sector would stabilize in 2018.

e) Finally, the projected growth rate of **manufacturing production** in 2016 is revised down from -1.5 percent to -1.8 percent since a lower growth rate is expected in primary manufacturing. The revision downwards is particularly noteworthy in the branches manufacturing canned and frozen fish products, and fishmeal and fish oil, in line with the fall of the fishing output foreseen for this year.

Expenditure-side GDP

Reflecting the growth of the primary sectors and sub national governments' better management in capital spending, exports and government spending were the main sources of acceleration of economic activity in the first quarter of 2016 after having shown seven quarters of decline. Domestic demand, on the other hand, however, grew 1.9 percent in Q1-2016, recording a lower rate than in Q1-2015 due mainly to the negative evolution of private spending.

The GDP growth rate projected for 2016 in this report is still 4.0 percent, but compared with the March report, this forecast considers a greater dynamism of public consumption and a better performance in public investment given the evolution of capital spending at the level of the sub-national governments in the first five months of the year and the progress of implementation of the modernization of the Refinery of Talara.

Likewise, the forecast of the growth rate of exports remains unchanged, but with a different composition of traditional and non-traditional exports. On the one hand, non-traditional exports are estimated to be lower due to the lower demand of our trading partners, especially in the Latin America region, but, on the other hand, a higher rate of growth is estimated for traditional exports as a result of increased mining production and in line with the data of volume of traditional exports observed at April 2016. As for private investment, a negative variation of this component is considered in this report, in line with the data observed until April which reflect a cycle of contraction in mining investment as well as a still-weak recovery in the construction sector.

Table 20
GDP AND DOMESTIC DEMAND
(Real % change)

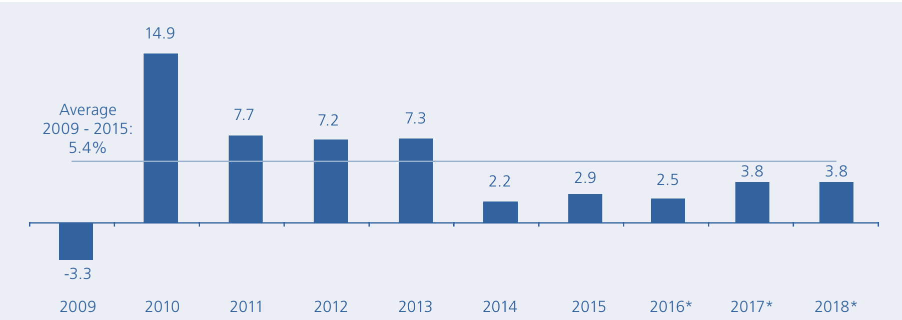
	2015		2016*			2017*		2018*
	Q1	Year	Q1	IR Mar. 16	IR Jun. 16	IR Mar. 16	IR Jun. 16	IR Jun. 16
I. Domestic demand	**2.7**	**2.9**	**1.9**	**2.5**	**2.5**	**3.8**	**3.8**	**3.8**
1. Private expenditure	**3.4**	**2.7**	**-0.3**	**2.0**	**1.7**	**3.8**	**4.0**	**4.1**
Consumption	3.4	3.4	3.6	3.5	3.5	3.8	3.8	4.0
Private fixed investment	-3.9	-4.4	-4.7	0.0	-1.0	4.0	4.0	4.2
Change on inventories**	2.9	1.6	1.3	1.2	1.1	1.2	1.2	1.3
2. Public expenditure	**-1.4**	**4.2**	**15.3**	**4.9**	**6.3**	**3.6**	**3.0**	**2.4**
Consumption	5.7	9.5	11.3	4.0	4.7	3.0	1.0	0.8
Investment	-23.5	-7.5	32.4	7.4	10.3	5.0	7.9	6.0
II. Net external demand								
1. Exports	-1.7	3.5	7.8	6.4	6.4	6.7	6.4	4.9
2. Imports	1.6	2.2	-2.1	0.7	0.3	3.5	3.5	3.5
III. GDP	**1.8**	**3.3**	**4.4**	**4.0**	**4.0**	**4.6**	**4.6**	**4.2**

* Forecast.
** % GDP.
IR: Inflation Report.

39. In 2017 and 2018 domestic demand is expected to grow 3.8 percent, considering that private investment is foreseen to gradually resume a faster pace of growth based on the implementation of the major projects given in concession and considering the announcements of future investment projects as well. Moreover, public investment would also be another important factor that will contribute to a greater dynamism in the domestic demand as a result of the implementation of infrastructure projects. On the exports side, exports are expected to grow 6.4

percent in 2017 and 4.9 percent in 2018, driven by increased mining production and by a recovery in non-traditional exports due to the recovery of global demand. On their side, imports would grow at a rate consistent with the expected performance of domestic demand and the recovery of private investment during 2017 and 2018. Thus, the GDP is expected to grow 4.6 percent in 2017 and 4.2 percent in 2018.

Graph 37
DOMESTIC DEMAND: 2009-2018
(Real % change)

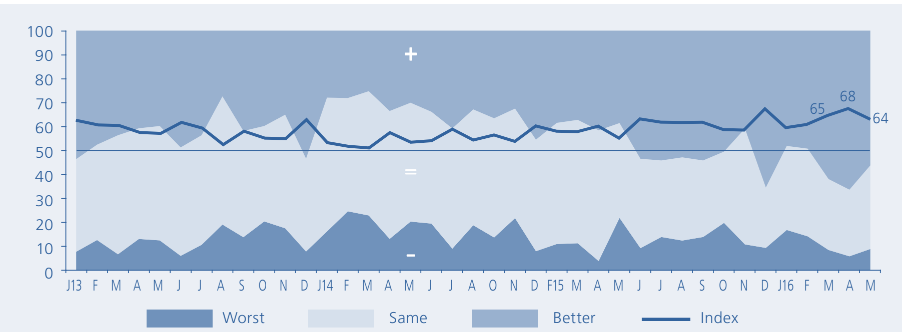


* Forecast.

40. Consumption indicators show results that are consistent with the relatively stable level of growth registered in recent quarters. Some indicators that reflect the recent trend observed in private consumption are given below:

    a) The consumer confidence index showed a rising trend between January and May 2016 recording 64 points, a higher level than in May 2015 (55 points).

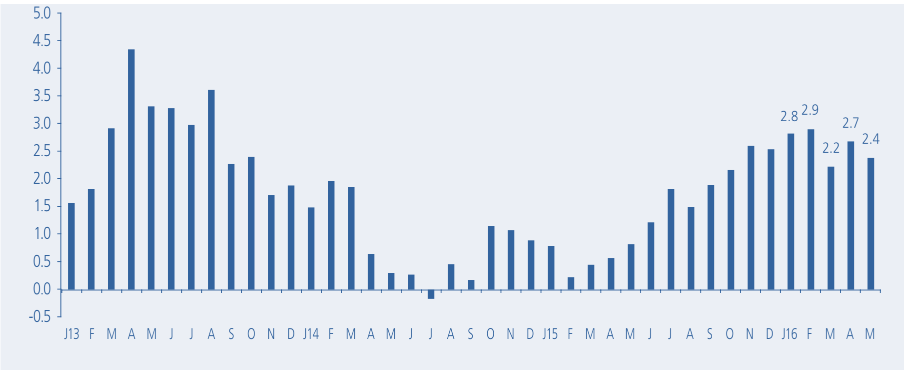
Graph 38
CONSUMER CONFIDENCE INDEX:
HOUSEHOLDS' ECONOMIC SITUATION?



Source: Apoyo.

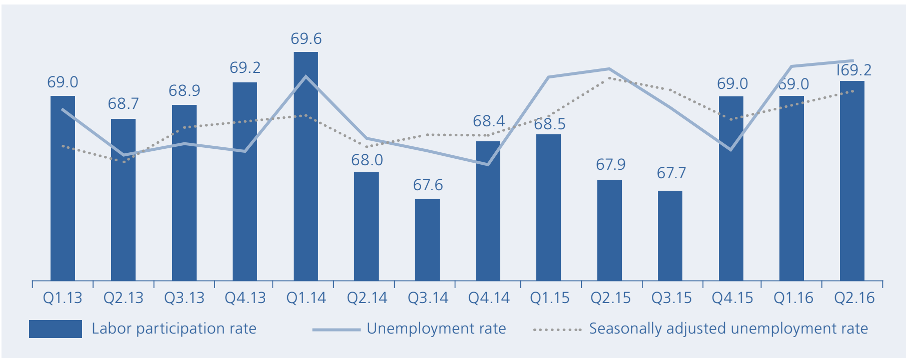
b) The workforce employed in the private sector has been showing a positive evolution with a growth rate of 2.4 percent in May 2016, a higher rate than in May in the previous year (0.8 percent).

Graph 39
EMPLOYED LABOR - INEI METROPOLITAN LIMA: JANUARY 2013 - MAY 2016
(Quarterly moving, 12-month % change)



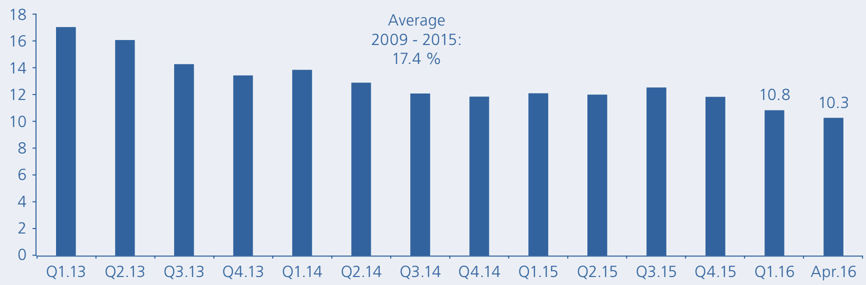
c) The rate of unemployment rose in Q1-2016 compared to Q1-2015, in line with an increase in the ratio of participation in the labor market. The latter indicator shows that more people entered the labor market and were looking for a paid job, but were not absorbed entirely as employed labor force, which led to a rise in the rate of unemployment.

Graph 40
UNEMPLOYMENT AND LABOR PARTICIPATION RATE - METROPOLITAN LIMA
(Survey INEI - quarterly moving)



d) Credit to individuals, which includes consumer loans and mortgage loans, continues to show a moderate pace of growth. Thus, credit to individuals went from recording an annual growth rate of 12.5 percent in April 2015 to a rate of 10.3 percent in April 2016.

Graph 41
CREDIT TO INDIVIDUALS IN DOMESTIC CURRENCY 1/
(12-months % change)



1/ Comprise consumer and mortgage loans.
Source: BCRP.

e) IPSOS' survey Bus Express carried out in the third week of May 2016 shows that households' indebtedness decreased from 2.4 times in January of this year to 2.1 times in May. The debt service also declined from 37 percent of the monthly income in January to 34 percent of the monthly income in May.

Table 21
HOUSEHOLD: PERCENTAGE OF DEBT EQUIVALENT TO THE INCOME

	Total %	Socioeconomic status A %	B %	C %	D %	E %
Aug.12	39	36	40	38	40	49 *
Nov.12	35	35	36	35	35	33
Mar.13	31	41	32	35	31	23
Jun.13	40	38	38	38	38	59 *
Sep.13	30	31	32	31	30	22
Nov.13	33	36	37	33	33	27 *
Apr.14	33	34	36	33	26	36
Jul.14	31	39	34	28	29	32
Mar.15	40	38	39	43	35	39 *
Aug.15	35	29 *	37	38	29	31
Oct.15	36	37	38	38	35	33
Jan.16	37	41	39	38	34	31
May.16	34	35 *	35	35	34	27

* Sample lower 30 people don't apply for the analysis by status.

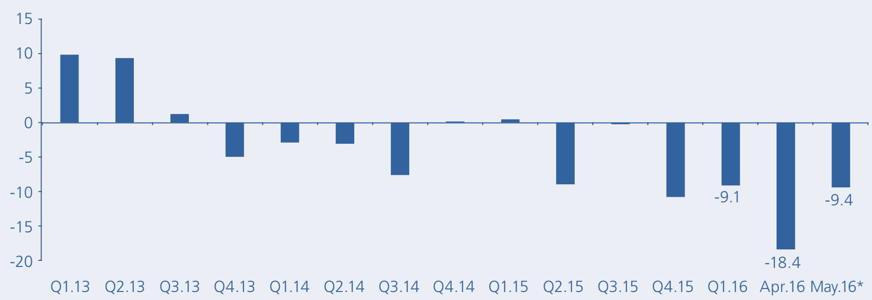
Table 22
HOUSEHOLD: NUMBER OF TIME OF DEBT EQUIVALENT TO THE INCOME

	Number of times	Socioeconomic status				
		A	B	C	D	E
Aug.12	2.4	3.6	2.1	2.1	2.7	3.2*
Nov.12	2.4	2.9	2.4	2.3	2.4	2.7
Mar.13	2.3	3.7	1.9	2.2	2.2	3.1
Jun.13	2.6	3.2	2.8	2.7	2.5	2.7*
Sep.13	2.3	3.4	2.9	2.0	2.0	2.3
Nov.13	2.3	3.1	2.2	2.3	2.1	2.4*
Apr.14	2.2	3.4	2.7	2.2	1.9	1.8
Jul.14	2.3	3.7	2.5	2.2	2.0	2.0
Mar.15	2.3	3.5	2.1	2.3	2.2	1.8*
Aug.15	2.0	1.8*	1.9	2.0	1.9	2.8
Oct.15	1.9	2.4	2.4	1.9	1.8	1.5
Jan.16	2.4	2.7	2.4	2.5	2.2	2.6
May.16	2.1	2.4	2.0	2.2	2.1	1.6

* Sample lower 30 people dont apply for the analysis by status.

f) Finally, the volume of imports of consumer durables accumulated a decline of 11.1 percent between January and May of this year. This decline is higher than that observed in the first five months of 2015 (6.0 percent).

Graph 42
VOLUME OF IMPORTS OF DURABLE CONSUMER GOODS
(12-months % change)



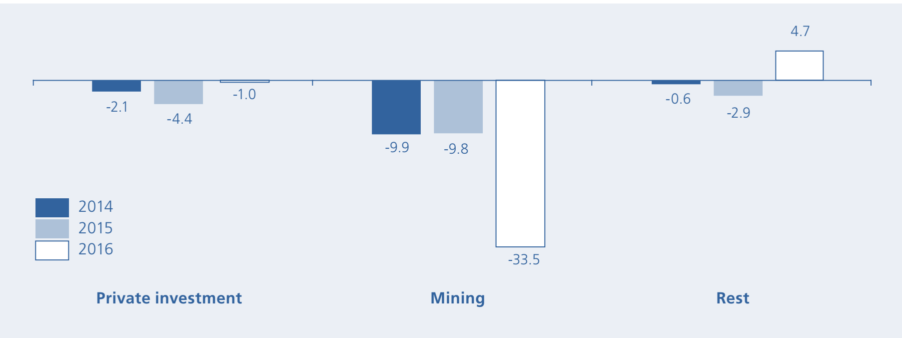
* Preliminary.
Source: SUNAT.

41. Considering these indicators, **private consumption** is estimated to grow 3.5 percent in 2016. A gradual increase is expected in the rate of growth in the

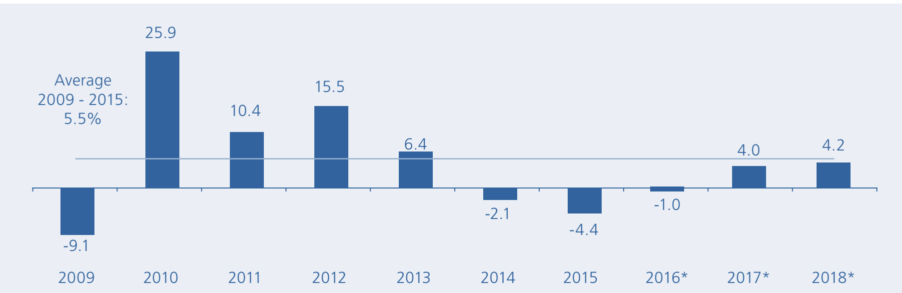
following years, in line with the anticipated evolution of income. It is worth pointing out that the behavior of private consumption in recent years suggests a lower growth in the consumption of durable consumer goods and an increase in the consumption associated with services, including telecommunications. This behavior would continue to be observed in the coming years.

42. **Private investment** would show some decline in 2016 within a context of a global contraction cycle of mining investment due to the lower prices of raw materials, offset by increased investment in infrastructure projects. In 2017-2018, investment is expected to recover, showing rates of 4.0 and 4.2 percent, respectively, with the impulse given by infrastructure projects.

Graph 43
PRIVATE INVESTMENT
(Real % change)

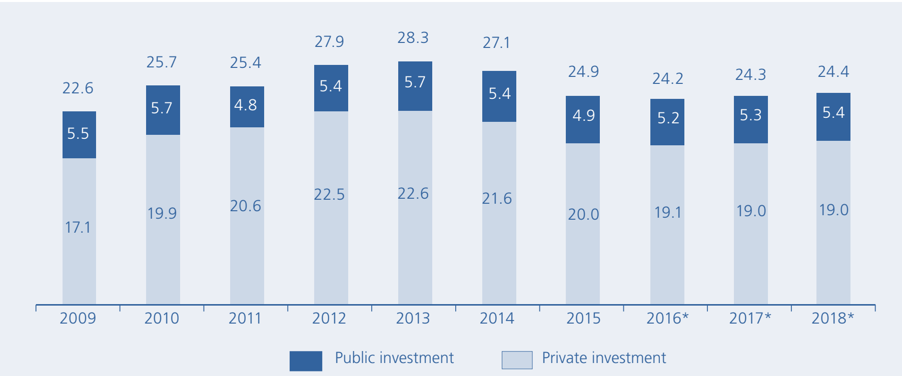


Graph 44
PRIVATE INVESTMENT: 2009 - 2018
(Real % change)



* Forecast.

Graph 45
GROSS FIXED INVESTMENT: PRIVATE AND PUBLIC SECTORS 2009- 2018
(Real % GDP)

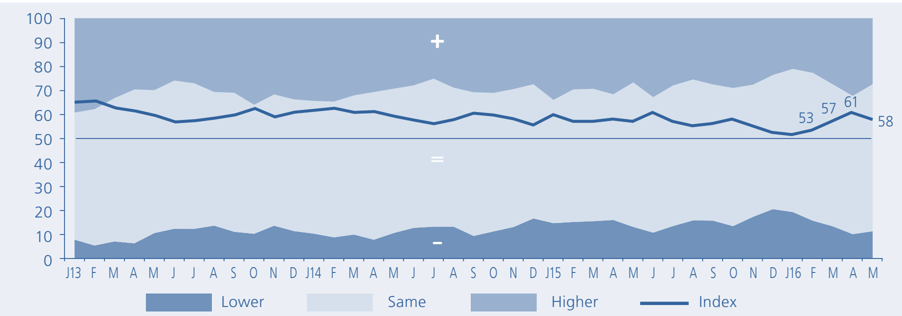


* Forecast.

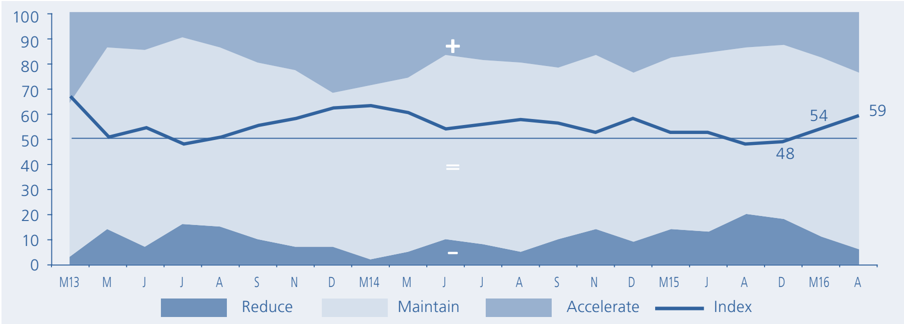
43. Some indicators reflecting the current trends of private investment are given below:

a) Business expectations about demand in three months remain on the optimistic side with a level of 58 points in May. Furthermore, business expectations about the economic situation in three months showed a level of 53 points in May, a higher level than that observed at end-2015. On the other hand, the indicator of investment expectations in six months showed a recovery recording a level of 59 points in April, a higher level than that observed in December 2015 (48 points).

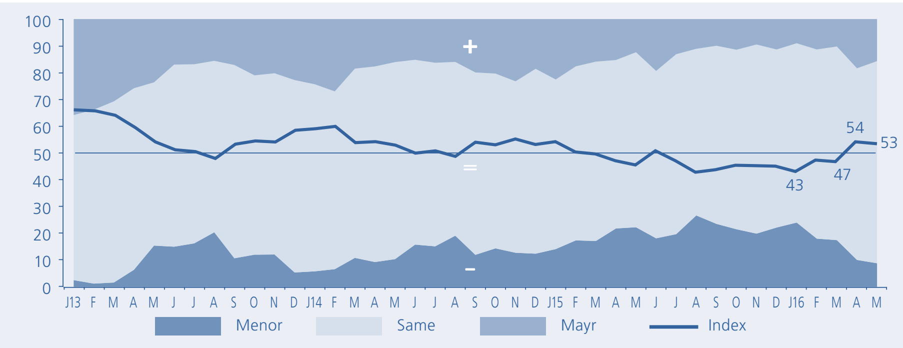
Graph 46
EXPECTATION ABOUT DEMAND IN THE THREE MONTHS AHEAD



Graph 47
INVESTMENT EXPECTATIONS ON YOUR COMPANY IN THE SIX MOTNH AHEAD

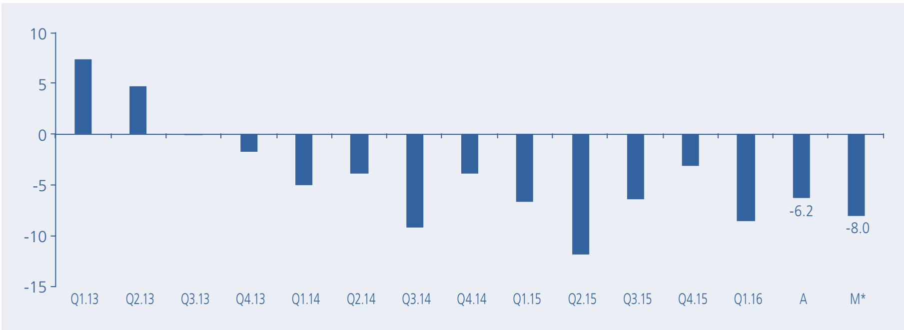


Graph 48
BUSINESS EXPECTATIONS ON THE SITUATION OF THE ECONOMY IN THE THREE MONTHS AHEAD



b) The volume of imports of capital goods –indicator of the demand for investment– fell 6.2 percent in April 2016 and accumulated a drop of 7.9 percent between January and April 2016.

Graph 49
VOLUME OF IMPORTS OF CAPITAL GOODS
(12-months % change)



* Preliminary.

c) The survey on expectations of GDP growth shows that expectations of growth in 2016 have been adjusted upwards: Financial entities have raised their estimates of GDP growth from 3.3 to 3.5 percent between March and June 2016 and economic analysts have raised their estimates from 3.2 to 3.7 percent, while the representatives of non-financial firms expect GDP to show a similar growth rate to that expected in March 2016. All the surveyed economic agents expect GDP to show higher growth rates in 2017 and 2018.

Table 23
SURVEY ON MACROECONOMIC EXPECTATIONS: GDP GROWTH
(% change)

	IR Dec.15	IR Mar.16	IR Jun.16
Financial entities			
2016	3.5	3.3	3.5
2017	4.0	4.0	4.0
2018		4.0	4.4
Economic analysts			
2016	3.2	3.2	3.7
2017	4.0	4.0	4.2
2018		4.2	4.2
Non-financial firms			
2016	3.5	3.5	3.5
2017	4.0	4.0	4.0
2018		4.5	4.5

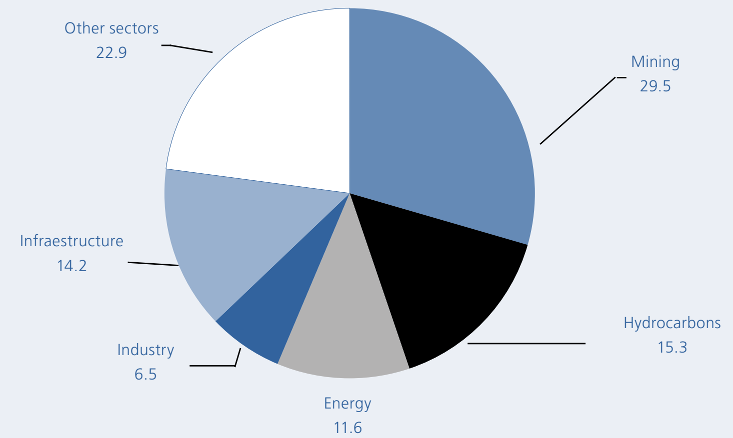
44. The 229 private investment projects that have been announced as projects that will be carried out in the period of 2016-2018 amount to US$ 33.8 billion, with investment projects in the sectors of mining, hydrocarbons, infrastructure, and energy standing out in terms of greater private investment. It is worth mentioning that the amount of investment in mining projects in the next three years is lower than the investment amounts observed in previous years (investments in the mining sector in 2013 amounted to US$ 9.9 billion while in 2014 it amounted to US$ 8.9 billion, for example). The sectors of telecommunications, services, hotels, and trade, among others, concentrate the largest number of projects announced to be carried out in the following years.

Table 24
PRIVATE INVESTMENT PROJECTS ANNOUNCED: 2016-2018
(Million US$)

	Total investment	Number of projects
Mining	9,982	34
Hydrocarbons	5,168	18
Energy	3,920	34
Industry	2,200	12
Infraestructure	4,821	24
Other sectors	7,742	107
TOTAL	**33,833**	**229**

Source: media and Information of companies.

Graph 50
FORESEEN INVESTMENT PROJECTS: 2016-2017
(% share)



According to information of the Ministry of Energy and Mines, investment in the mining sector in Q1-2016 amounted to US$ 1.01 billion, which represents a decline of mining investment of 44.1 percent compared to the same period of 2015. The fall is explained mainly by the completion of the expansion projects of Cerro Verde and Las Bambas, which already started their production stages.

In the hydrocarbons sector, Transportadora de Gas del Perú (TGP), which invested US$ 25 million in Q1, has continued carrying out the works to increase the capacity of the gas transportation system. The project Mejoras a la Seguridad Energética del País y Desarrollo del Gasoducto Sur invested US$ 1.5 billion between April 2015 and April 2016, with investment in the first four months of 2016 amounting to US$ 300 million. So far, 36 percent of the infrastructure works, which includes the deployment and installation of tubes, has been completed. The consortium has decided to slow down the pace of the construction works while awaiting for the project's financial completion. Foreseen private investment in this project in the period 2016-2018 is US$ 2.15 billion.

Infrastructure projects include the progress carried out in the construction works of Lima Metro's Line 2, which show a physical progress of 9 percent. The construction of two ventilation wells between Ate and Santa Anita has been completed as part of the first construction stage. The projected investment of this project in 2016-2018 is US$ 1.06 billion of private investment and US$ 2.04 billion of public investment. Other ongoing construction of infrastructure projects include Vías Nuevas de Lima, the port terminal of Chancay, and the highway Longitudinal de la Sierra, Section 2 (Cajamarca – Trujillo).

In the energy sector, Luz del Sur invested US$ 20 million in Q1-2016 in the improvement and expansion of the electricity grid system, while Edelnor invested US$ 11 million in distribution networks and US$ 12 million in transmission lines. Moreover, the completion and onset of operations of the hydroelectric plants of Cerro del Águila (Huancavelica) by Odebrecht and Chaglla (Huánuco) by Inkia Energy is foreseen for this year, while the construction of projects like Nodo Energético del Sur, the 500 Kv Transmission Line of Mantaro - Marcona - Socabaya - Montalvo and associated substations, would continue in 2017.

Table 25
MAIN INVESTMENTS PROJECTS: 2016-2018

SECTOR	COMPANIES	PROJECT
	Southern Perú Copper Corporation	Expansion of Toquepala
	Chinalco	Expansion of Toromocho
Mining	Shougang Corporation	Expansion of Marcona
	Jinzhao Mining	Pampa del Pongo
	AQM Copper	Zafranal
	Compañía de Minas Buenaventura	Tambomayo
	Enagas, Odebrecht	Enhance energy security country and development of pipeline in the south
Hydrocarbons	China National Petroleum Corporation, Repsol YPF S.A.	Lot 57: Kinteroni
	Pluspetrol	Exploration: Lot 88 and 56
	Calidda Gas Natural del Perú	Massive use of gas
	Karoon Gas Natural	Exploration: Lot Z - 38
	Enersur	Electric Node in the South of Peru
	Quimpac S.A.	Hydroelectric Power Plant of Cerro del Águila
	Inevarante	Hydroelectric Power Plant of Acco Pucará
Electricity	Corsán-Corvian	Hydroelectric Power Plant of Molloco
	Odebrecht	Hydroelectric Power Plant of Belo Horizonte
	Generación Eléctrica Las Salinas	Eolic Park Samaca
	Endesa	Hydroelectric Power Plant of Curibamba
	Corporación Lindley	Storages and infraestructures
	Repsol YPF	Expansion of La Pampilla plant
	Técnicas Reunidas	Modernization of refinery of Talara
Industry	SAB Miller	Investment projects 2016
	Medrock	Production factory of medicine in Lima
	Precor	Plant in Chilca
	Grupo Romero	Warehouses and cryogenic plant
	Consorcio Nuevo Metro de Lima	Line 2 Network Metro Lima (Electric Train)
	Odebrecht	New highways in Lima
	Consorcio Consierra II	Longitudinal de la Sierra road project, Section 2
Infrastructure	APM Terminal	Modernization of Not Pier
	Lima Airport Partners	Expansion of international airport (Jorge Chávez)
	Covisol	Trujillo-Sullana: Sol Highway
	Kuntur Wasi	International airport (Chinchero)
	Graña y Montero	South Expressway
	Grupo Telefónica	Expansion and facilities of net LTE-4G
	Entel	Development of services 4G
	America Movil	Expansion of net 4G
	Grupo Salinas	National Fiber Optics Backbone
Other sectors	Grupo Romero	Storages for minerals
	Grupo Falabella	Expansion and New shopping centers
	Besalco S. A.	Real Estate projects
	Graña y Montero Vivienda (GMV)	Projects of houses
	Grupo Interbank	Expansion and New shopping centers

Source: Information of companies.

Estimated investment in projects awarded in concession between 2015 and 2016 would reach US$ 2.2 billion. On Thursday, May 26, Proinversión awarded Broad Band 698-806 MHz telecommunications projects, which will be used to provide the service of 4G mobile internet. The concession contracts were awarded to America Movil (Claro), Telefónica and Entel, which offered US$ 911 million. According to Proinversión, the investment required to implement these projects is estimated at US$ 1.7 billion.

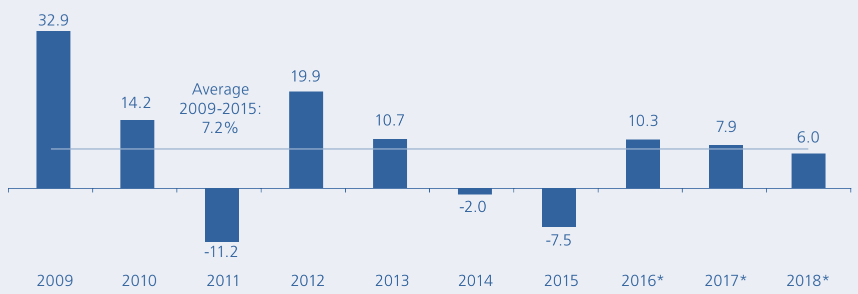
Table 26
MAIN PROJECTS TO BE IMPLEMENTED THROUGH CONCESSION ARRANGEMENTS IN 2015-2016
(Million US$)

	Estimated investment
A. Awarded	**2,217**
698-806 MHZ band	1,680
Broadband Installation for Integral Connectivity and Social Development of Tumbes-Piura-Cajamarca-Cusco Regions	250
Broadband Installation for Integral Connectivity and Social Development of Ayacucho Region	55
Broadband Installation for Integral Connectivity and Social Development of Huancavelica Region	49
First Stage of the Carapongo Substation and Conexion Links to Associated Lines	43
Broadband Installation for Integral Connectivity and Social Development of Apurimac Region	42
220 Kv Azangaro - Juliaca -Puno Transmission Line	37
Comprehensive Broadband Connectivity for the Social Development of the Northern Zone of the Country- Lambayeque Region	32
220 Kv Montalvo - Los Héroes Transmission Line and associated substations	20
Electronic surveillance services through the use of electronic devices	9
B. Called	**2,086**
Headworks and Conduction for the Drinking Water Supply in Lima	600
Longitudinal of the Sierra road project, Section 4: Huancayo-Izcuchaca-Mayocc-Ayacucho/Ayacucho-Andahuaylas-Puente Sahuinto/Dv. Pisco - Huaytará - Ayacucho	446
Massive Use of Natural Gas - Distribution System through a Natural Gas Grid Across The Regions of Apurimac, Ayacucho, Huancavelica, Junin, Cusco, Puno and Ucayali	300
Liquid Petroleum Gas Supply System for Lima and Callao	250
Huancayo - Huancavelica Railway	220
Quillabamba Thermal Power Plant	180
The Amazon Waterway	70
138 Kv Aguaytia-Pucallpa Transmission Line (second circuit)	20

Source: Proinversión.

45. Public investment in 2016 is expected to grow 10.3 percent, a higher rate than that estimated in the previous report (7.4 percent). During the first five months of the year public investment has had a greater growth due to the recovery of sub-national governments' spending. Moreover, investment spending is also expected to continue showing an upward trend in the following months due to the advance of the Talara Refinery project and due to the reorientation of budget resources to ongoing public investment projects being implemented mainly by regional and local governments. The scenario foreseen for 2017 and 2018 considers a slower pace of expenditure of the implementing agencies than that estimated for 2016 and therefore public investment is projected to grow at a rate of 7.9 percent in 2017 and at a rate of 6.0 percent in 2018.

Graph 51
PUBLIC INVESTMENT: 2009-2018
(Real % change)

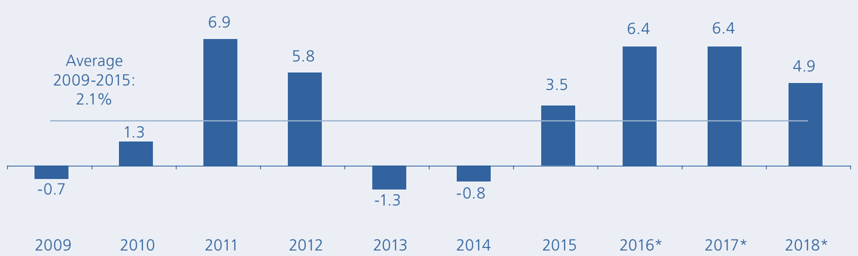


* Forecast.

46. The projected growth rate of **real exports** of goods and services for 2016 remains unchanged at 6.4 percent, considering higher traditional exports, especially higher mining exports, offset by lower non-traditional exports due mainly to lower exports of fisheries (as a result of supply problems) and textiles (as a result of the anticipated lower demand of our trading partners, especially the lower demand in the Latin American region).

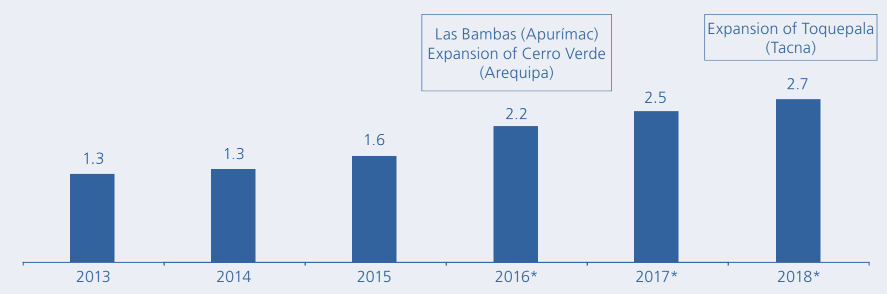
    A growth rate of 6.4 percent is projected for exports in 2017 considering increased mining exports since projects such as Las Bambas and the expansion of Cerro Verde would be close to reaching their maximum production levels. In addition to this, anchovy fisheries and agricultural production would also register higher output levels due to the normalization of climate conditions. In 2018, the pace of growth of traditional exports is foreseen to normalize, while non-traditional exports would show higher growth rates in line with higher global growth.

Graph 52
EXPORTS OF GOODS AND SERVICES: 2009-2018
(Real % change)



* Forecast.

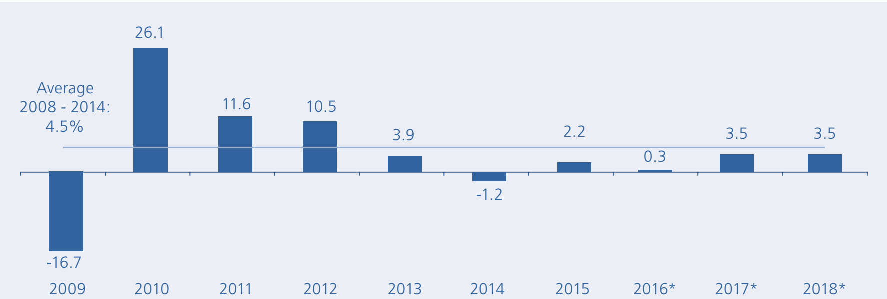
Graph 53
COPPER PRODUCTION
(Million FMT)



* Forecast.

47. On the other hand, imports would show a slower pace of growth associated mostly with a moderate growth of domestic demand, particularly in the investment component. Thus, in this report **imports of goods and services** are estimated to show a growth rate of 0.3 percent in 2016, and to show a gradual recovery in 2017 and 2018, in line with the estimated recovery of GDP in these years.

Graph 54
IMPORTS OF GOODS AND SERVICES: 2009-2018
(Real % change)



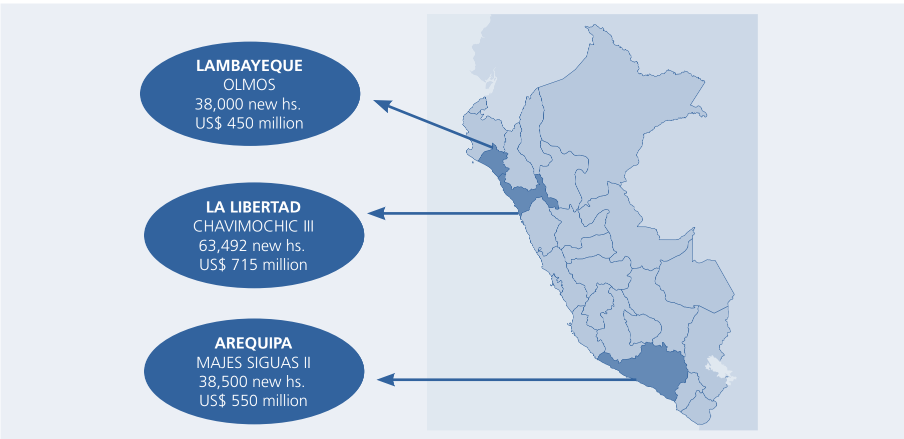
* Forecast.

Box 1
POTENTIAL OUTPUT: IRRIGATION PROJECTS

Large irrigation projects[1] were designed in Peru in the last century to promote sustainable agricultural development[2] and competitiveness in agriculture. These projects consisted in diverting the waters of rivers to extensive dry uncultivated areas in the Peruvian coast. The implementation of many of these projects took a very long time as they used to rely solely on the public budget assigned[3] for their implementation and, in addition to this, their construction involved high investment costs, for they were hydro-energy projects that also involved the construction of power plants. In other words, they were large-scale regional development projects[4].

Many of these projects had auspicious results. Chavimochic Project, for example, whose Stages I and II are already in operation, exported products for nearly US$ 600 million in 2015 and employs over 55 thousand people directly. To continue with this positive experience and in order that funding would not continue to be an obstacle, it was decided that the implementation of three major irrigation projects, Olmos, Chavimochic III and Majes Siguas II, should be carried out under concession contracts. These three projects, whose productions should begin in 2016, 2019, and 2021, respectively, would expand the agricultural frontier by nearly 140 thousand hectares and improve approximately 53,500 hectares.

IRRIGATION PROJECTS 2006-2021



According to PROINVERSIÓN estimates, the hectares currently dedicated to the agro-export would increase twofold due to the existing irrigation projects[5] which would increase agricultural exports by US$ 3.19 billion per annum.

1 According to the World Bank, irrigation projects are essential for the sustainable management of water resources and contribute to adaptation to climate change. Peru is one of the most vulnerable countries to climate change. World Bank (2015) "Peru Portfolio and Climate Change". See: <http://www.bankinformationcenter.org/wp-content/uploads/2015/08/Peru-Climate-Change-full.pdf>

2 Tealdo Alberti, A. (1995) "Proyectos de irrigación en el Perú: Situación, Análisis y Políticas". Lima: Centro de Estudios para el Desarrollo y la Participación.

3 According to Tealdo estimates, if budget allocations remained constant over time, the existing irrigation projects at the time would have been completed in periods ranging between 6 and 100 years. (1995, p.21).

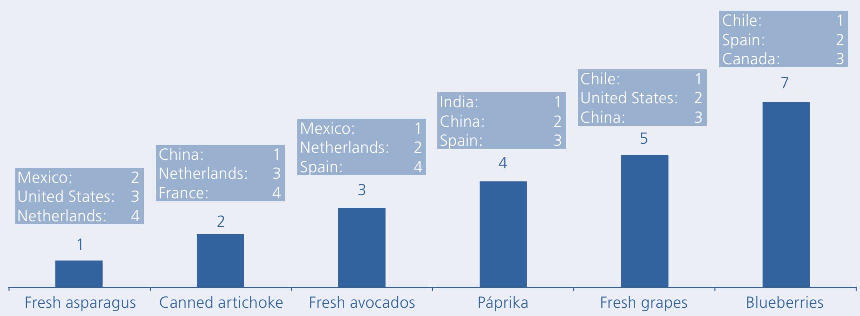
4 The Olmos project even includes the creation of town Charles Sutton to supply labor to the project and the establishment of Parque Agroindustrial de Olmos for the processing of products.

5 ProInversión (2015) "¿Por qué invertir en el Perú?" [Presentation], March 2015. See: http://www.proinversion.gob.pe/RepositorioAPS/0/0/JER/PRESENTACIONES_GENERAL/PPT_Porque invertir en Peru,_marzo2015.pdf

Project	Improved areas (hs.)	New area (hs.)	Total area of benefit (hs.)	Estimated year of first crops	Main crops	Increase of agro-industrial exports (Million US$ per annum)
CHAVIMOCHIC III	48,000	63,492	111,492	2019	Sugar cane, avocado, white and green asparagus, beets, citrus, grapes, sorghum, passion fruit, and corn.	1,200
MAJES SIGUAS II	-	38,500	38,500	2021	Grape, artichoke, paprika, avocado, chili, amaranth, garlic, arverja, onion, tomato, cochineal, and melon.	1,390
OLMOS	5,500	38,000	43,500	2016	Sugar cane, avocado, quinoa, grapes, peppers, paprika, feed corn, asparagus, onion, and cotton.	600

This greater agricultural production would be mainly oriented to external markets[6]. It is worth mentioning that Peru is already a major exporter of avocadoes, asparagus, grapes, blueberries, artichokes, and paprika, which are some of the crops that would be grown in the new irrigated lands. However, this greater production capacity and increased efficiency are expected to allow the country to consolidate or improve its relative position in the international market.

PERU'S RELATIVE POSITION AND MAIN COMPETITORS ACCORDING TO EXPORT PRODUCTS



Source: Comtrade (2015).

Despite the fact that substantial progress has been made by developing large irrigation projects under concession contracts, new factors hinder and distend their implementation. Chavimochic III, for example, has had to deal with land invasions and negotiate the purchase of private properties that interfere with the passage of the irrigation canals, while Majes II[7] has not concluded negotiations yet for the purchase of land in the project area. Moreover, Olmos producers face operating problems, because there is no paved road connecting them to the port of Paita. Therefore, their products have to be transported using a trail of 35 kilometers, which causes losses of up to 30 percent in fragile crops such as grapes and blueberries.

Finally, it should be pointed out that there are new irrigation projects that would start producing after 2021. Among them is the megaproject of Pampas Verdes, which would add 218,015 new hectares in Ica and Arequipa thanks to the waters derived from the Ayacucho rivers of Caracha and Urabamba. Other projects worth mentioning are the projects of Alto Piura and Chira, located in Piura, which will also result in the incorporation of new lands to the agricultural frontier, contributing in this way to continue expanding Peru's agro-export potential.

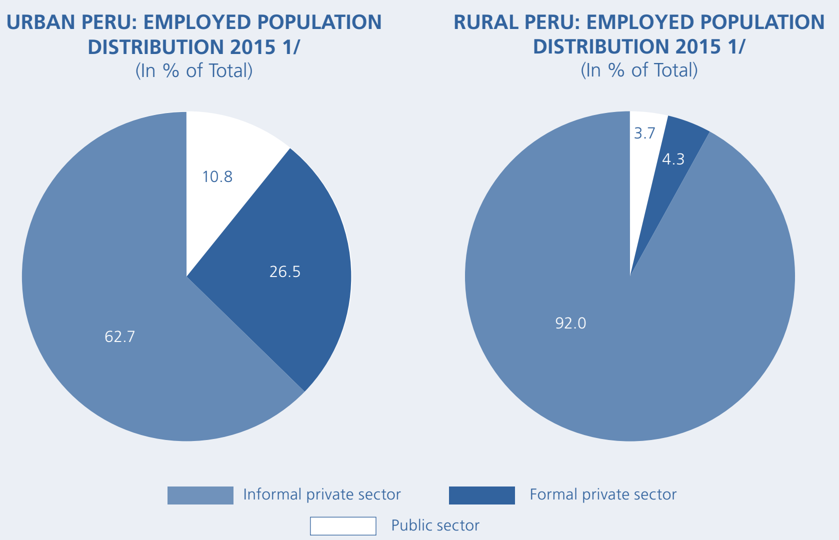
6 Although Olmos and Chavimochic III would also have a significant production of sugarcane for the domestic market.

7 Conflicts over water are also a factor that has caused delays in the concession of Majes II, because Cusco Region has claimed the right over the Apurimac river water to irrigate the farming areas located in the province of Espinar.

Box 2
EMPLOYMENT AND INFORMALITY

Employment in 2004-2015

In 2015, the employed population in urban areas consisted of 62.7 percent of informal workers in the private sector, 26.5 percent of formal workers in the private sector, and 10.8 percent of workers employed in the public sector (a constant rate in the period 2004-2015). The workforce in rural areas was mostly informal workers in the private sector (92.0 percent).



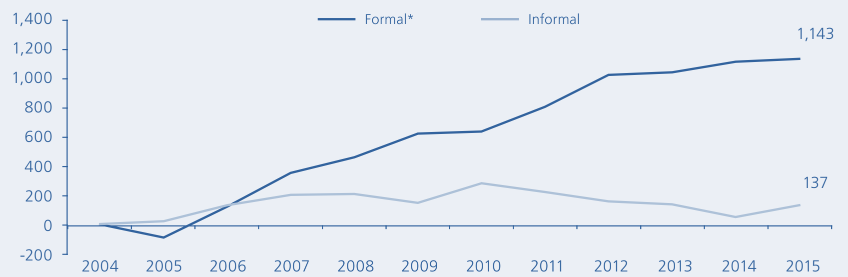
1/ Public sector includes FFAA, PNP, and public enterprises.
* A worker is considered formal if he/she has an insurance in Essalud.
Source: INEI-ENAHO.

Moreover, 2.8 million jobs were created nationwide in this period, of which 1.8 million (62 percent) was jobs in the services sector. One of the factors that explains the greater contribution of this sector to the growth of employment is the increased growing participation of this sector in GDP terms, after the sectors of construction, trade and manufacturing.

1.3 million of the 2.8 million jobs created nationwide are jobs in Lima and Callao (45 percent), while 1.5 million new jobs have been created in the rest of the country (55 percent).

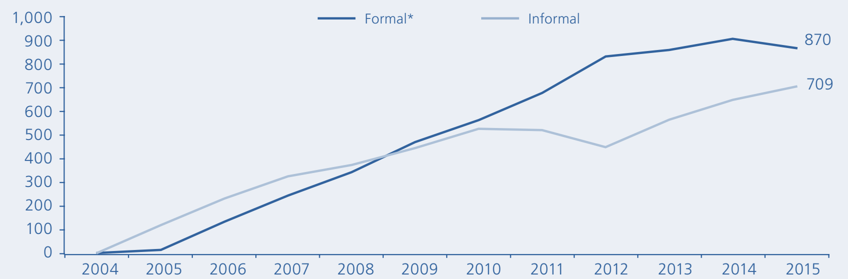
Most of the jobs created in Lima and Callao are part of the formal labor market (89 percent), whereas in other regions, on the other hand, only 0.8 million new jobs were formal (55 percent) and 0.7 million informal (45 percent). Notwithstanding, more formal jobs than informal jobs have been created nationwide (2 million versus 0.8 million). Moreover, of the informal jobs created elsewhere in the country, 7.1 percent are jobs in the sector of agriculture and 92.9 percent are jobs in other sectors.

JOB CREATED IN LIMA AND CALLAO, 2005 - 2015
(Thousand people)



* A worker is considered formal if he/she has an insurance in Essalud
Source: INEI-ENAHO.

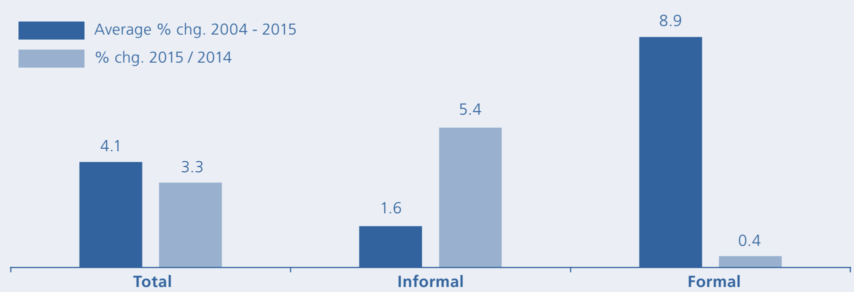
JOB CREATED IN THE REST OF COUNTRY, 2005 - 2015
(Thousand people)



* A worker is considered formal if he/she has an insurance in Essalud
Source: INEI-ENAHO.

The informal employment of dependent workers increased 5.4 percent in 2015, versus 1.6 percent on average in the period 2004-2015. Conversely, formal employment of dependent workers grew less in 2015 than the historical average rate.

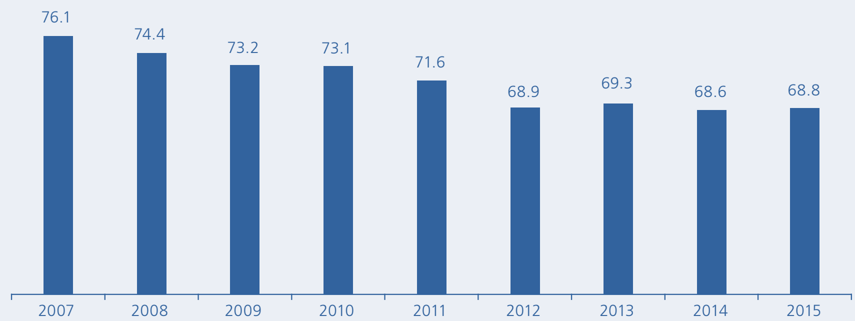
URBAN PERU: EMPLOYMENT OF DEPENDENT OF PRIVATE SECTOR
(2004-2015)



* A worker is considered formal if he/she has an insurance in Essalud
Source: INEI-ENAHO.

The rate of non-agricultural private urban informality[8] nationwide showed a slight increase in 2015, rising from 68.6 percent in 2014 to 68.8 percent in 2015 after having recorded significant decreases in previous years (in 2007, the informal segment accounted for 76.1 percent of the total number of employed workers).

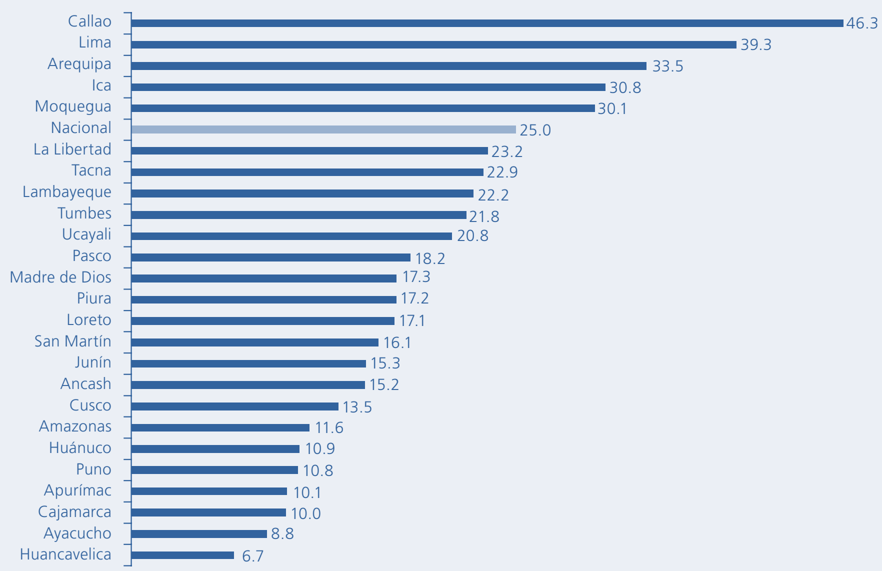
NON-AGRICULTURAL PRIVATE URBAN INFORMALITY: NATION WIDE
(In % of total employed)



* A worker is considered formal if he/she has an insurance in Essalud
Source: INEI-ENAHO.

Callao, Lima, Arequipa, Ica, and Moquegua rank first in terms of formality in the labor market, whereas Huancavelica, Cajamarca, Ayacucho, and Apurímac stand out as the regions with greater informality.

NON-AGRICULTURAL PRIVATE URBAN INFORMALITY, 2015
(In % of total employment)



* A worker is considered formal if he/she has an insurance in Essalud
Source: INEI-ENAHO.

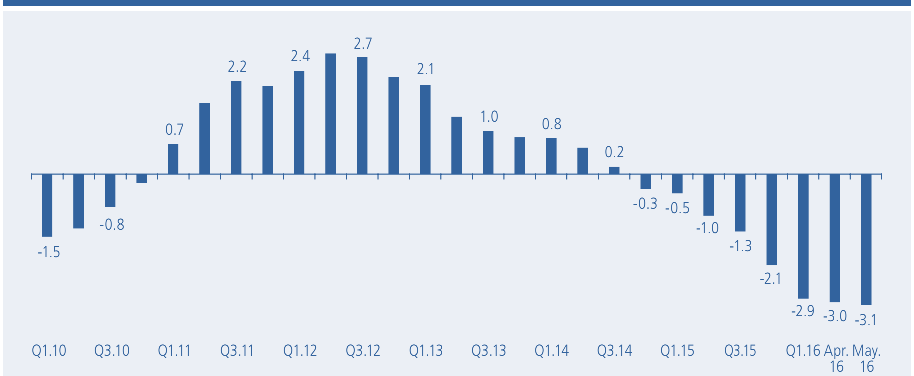
8 According to INEI, every town with over 100 contiguous dwellings (500 inhabitants) is considered an urban settlement or urban population center. Every district capital is also considered an urban area.

IV. Public Finances

48. The forecasts of the public sector accounts have been carried out considering the current tax policy framework and an average annual growth of non-financial expenditure of 2.7 percent between 2016 and 2018. This passive projection also considers that the project of modernization and expansion of the Talara Refinery continues. Thus, the economic balance would show a deficit of 3.0 percent of GDP in 2016, a deficit of 2.8 percent in 2017, and a deficit of 2.5 percent in 2018.

    At May the operations of the non-financial public sector recorded an economic deficit of 3.1 percent of GDP. This higher deficit than the one observed in May 2015 (2.1 percent) reflects mainly the decrease of 0.6 percentage points of GDP in tax revenues and the increase of 0.2 percentage points of GDP in current expenditure. The decline in tax revenues reflects the extraordinary increase observed in tax rebates during the first five months of the year –up by 49 percent between January and May– and to a lesser extent, a decline in non-tax revenues.

Graph 55
ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR
(Accumulate last 4 quarters - % GDP)



49. A fiscal deficit of **3.0 percent** of GDP, higher than that estimated in the March Inflation Report (2.6 percent), is projected for **2016** considering a higher growth rate of public investment, which would increase from 7.4 percent to 10.3 percent in real terms, as a result of the greater spending being observed at the level of sub-

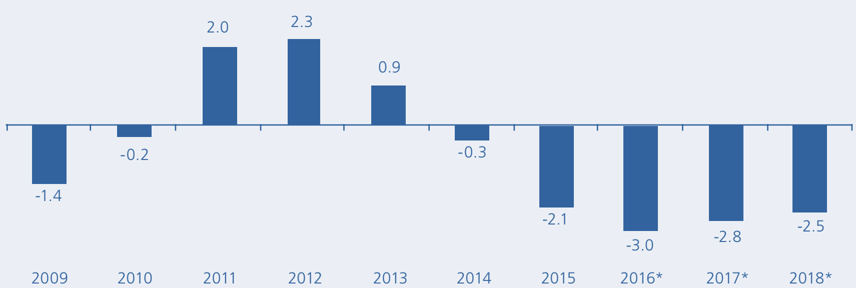
national governments and as a result of the advance of the Talara Refinery project. In **2017** and **2018** the deficit of the Non-Financial Public Sector would show a downward path with rates equivalent to **2.8 percent and 2.5 percent of GDP,** respectively.

Table 27
NON-FINANCIAL PUBLIC SECTOR
(% GDP)

	2015	2016*			2017*		2018*
		Q1	IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
1. General government current revenues[1/]	**20.0**	**20.3**	**19.5**	**19.3**	**19.5**	**19.3**	**19.3**
Real % change	*-7.5*	*-5.8*	*0.8*	*0.2*	*4.4*	*4.2*	*4.1*
2. General government non-financial expenditure[2/]	**21.3**	**17.5**	**20.8**	**21.1**	**20.6**	**20.7**	**20.4**
Real % change	*1.4*	*9.8*	*1.5*	*3.1*	*3.0*	*2.6*	*2.3*
Of which:							
Current expenditure	15.8	14.3	15.7	16.0	15.3	15.4	14.9
Real % change	*4.5*	*10.2*	*2.4*	*4.5*	*2.2*	*1.0*	*1.0*
Gross capital formation	4.7	2.8	4.7	4.7	4.7	4.9	5.0
Real % change	*-12.5*	*19.6*	*3.2*	*4.9*	*5.8*	*8.2*	*6.8*
3. Others	**0.2**	**0.4**	**0.0**	**0.0**	**0.0**	**-0.1**	**-0.1**
4. Primary balance (1-2+3)	**-1.1**	**3.2**	**-1.3**	**-1.9**	**-1.0**	**-1.5**	**-1.2**
5. Interest	**1.0**	**1.6**	**1.2**	**1.2**	**1.3**	**1.3**	**1.3**
6. Cyclic overall balance	**-2.1**	**1.5**	**-2.6**	**-3.0**	**-2.3**	**-2.8**	**-2.5**
Memo:							
Structural overall balance	-1.9		-2.0	-2.8	-1.9	-2.5	-2.3

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.
IR: Inflation Report.
* Forecast

Graph 56
ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR: 2009-2018
(% GDP)



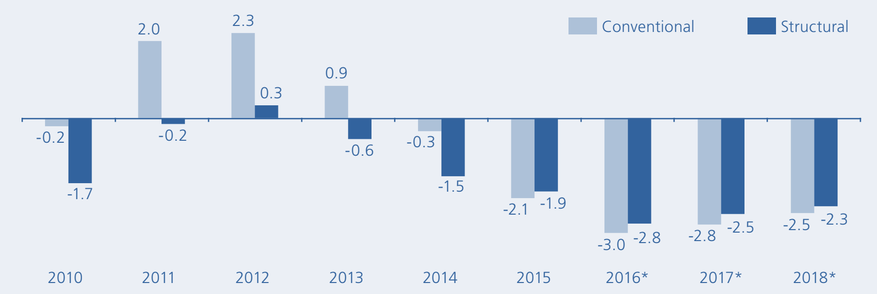
* Forecast.

50. The **structural economic balance** is an indicator calculated isolating the effects of the business cycle and the effects of the prices of the commodities relevant to our economy. In 2015, the structural economic balance showed a deficit of 1.9 percent of GDP, while in 2016 the structural deficit is estimated at 2.8 percent.

Moreover, the deficit is projected to decline thereafter from a rate of 2.5 percent of GDP in 2017 to a rate of 2.3 percent of GDP in 2018.

These results differ from those set forth in the Strengthening of Fiscal Responsibility and Transparency Act which foresees a deficit of 1.5 and 1.0 percent of GDP for 2017 and 2018, respectively. Meeting this target in 2017 would imply a negative fiscal impulse of 1.3 percent of GDP, which would have a negative effect on the recovery of domestic demand. If this negative fiscal impulse were applied only by cutting spending, the negative impact on demand would be between 1.2 and 1.8 percent of GDP (if adjusting only current expenditure or only capital expenditure).

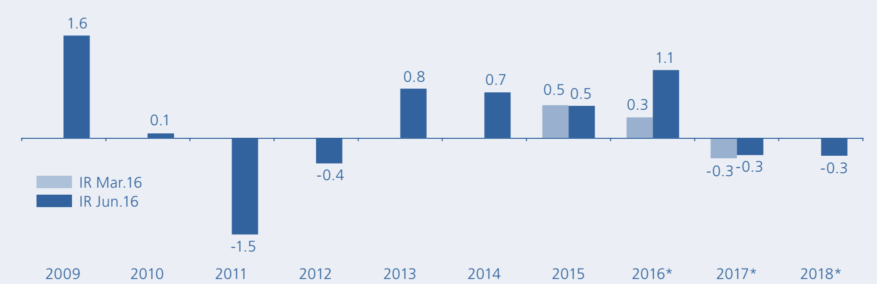
Graph 57
CONVENTIONAL AND STRUCTURAL ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR: 2010-2018
(% GDP)



* Forecast.

This forecast of the fiscal accounts, which includes the tax measures approved so far, is passive in terms of tax collection and includes a reduction of an additional point in the income tax rate. In terms of expenditure, a lower increase than the growth of GDP is considered, which is precisely what allows having a declining projection in the fiscal deficit.

Graph 58
FISCAL IMPULSE[1/]: 2009 - 2018
(% GDP)



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

51. The fiscal impulse can be broken down into its expenditure and revenue components, which in turn can be weighed by their multiplier effect on economic activity. The table below shows that fiscal policy had a contractionary impact of 0.5 percent of GDP in 2015 due to lower capital spending and that rather an expansionary impact of 0.5 percentage point of GDP is expected for 2016.

Table 28
FISCAL IMPULSE

	2015	2016*	2017*	2018*
Impulse fiscal	**0.5**	**1.1**	**-0.3**	**-0.3**
By revenues	1.0	0.7	0.0	0.0
By expenditures[1/]	-0.5	0.4	-0.3	-0.3
Weighted impulse[2/]	**-0.5**	**0.5**	**-0.2**	**-0.2**

1/ Includes public enterprises.
2/ According to estimate of fiscal multiplier.
* Forecast.

Tax Revenues

52. The projection of tax revenue at the end of 2016 has been revised down by 0.2 percentage points of GDP from the projections of the IR of March to 19.3 percent of GDP. It is worth pointing out that, like the projection of the March IR, this projection considers the impact of the measures of tax cuts enacted by the Government in 2014. The impact of these measures on tax collection is estimated at S/ 4.33 billion, a sum equivalent to 0.7 percent of GDP in 2015, and that the cumulative effect would increase to 0.9 percent of GDP in 2018, with the further reduction of the income tax –from 28 to 27 percent– that will be in force as from 2017, as established by Law 30296 dated December 31, 2014.

This revision also includes the higher tax rebates (which grew by 49.2 percent in January-May) and the decline of revenue from the oil canon, oil royalties, and the special levy on mining activities. The projection for the year also includes the positive impact of higher revenue from the income tax paid by non-domiciled companies for the assets sold by companies operating in the electricity sector on the collection of legal entities' income tax. Moreover, as established by S.D. 112-2016-EF, the excise tax on cigarettes rose from S/ 0.07 to S/ 0.18 per unit, which is estimated to increase the revenue from the excise tax by S/ 273 million. Besides these changes, the projection of revenue is a passive projection since it does not take into account new changes in tax legislation. Tax revenues in 2017 and 2018 are projected to be equivalent to 19.2 and 19.3 percent of GDP, respectively.

Graph 59
CURRENT REVENUES OF THE GENERAL GOVERNMENT
(Accumulate last 4 quarters - % GDP)

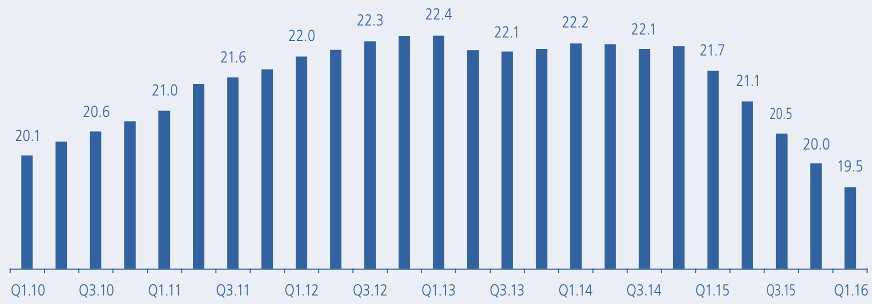
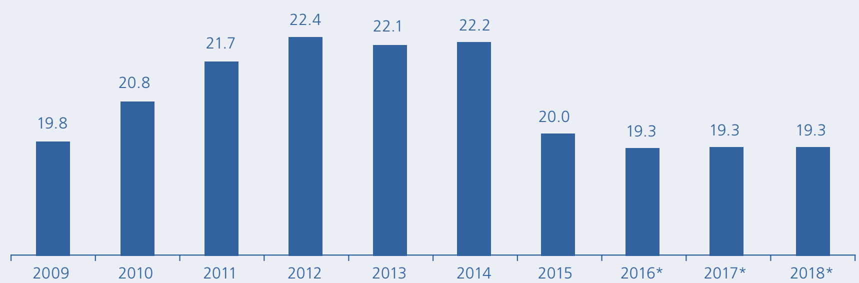


Table 29
CURRENT REVENUES OF THE GENERAL GOVERNMENT
(% GDP)

	2015	2016*		2017*		2018*
		IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
TAX REVENUES	**15.2**	**14.8**	**14.8**	**14.8**	**14.7**	**14.7**
Income tax	5.7	5.5	5.7	5.3	5.5	5.5
Value added tax	8.4	8.4	8.3	8.5	8.2	8.2
Excise tax	0.9	0.9	0.9	0.9	0.9	0.9
Import duties	0.3	0.3	0.3	0.3	0.3	0.3
Other tax revenues	1.8	1.8	1.8	1.8	1.8	1.8
Tax returns	-1.9	-2.1	-2.2	-2.0	-2.0	-2.0
NON-TAX REVENUES	**4.8**	**4.7**	**4.5**	**4.7**	**4.6**	**4.6**
TOTAL	**20.0**	**19.5**	**19.3**	**19.5**	**19.3**	**19.3**

* Forecast.
IR: Inflation Report.

Graph 60
CURRENT REVENUES OF THE GENERAL GOVERNMENT: 2009-2018
(% GDP)



* Forecast.

Evolution of public spending

53. The projected expenditure of the general government has been revised up due mainly to execution of spending observed until the month of May, particularly at the level of the sub-national governments (local governments' investment increased by 38.3 percent in this period). Spending is expected to show moderate rates in the second half of the year taking into account the conduct of spending observed in years when new authorities come to office (2006 and 2011).

Graph 61
NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT
(Accumulate last 4 quarters - % GDP)

Graph 62
GROSS CAPITAL FORMATION OF THE GENERAL GOVERNMENT
(Accumulate last 4 quarters - % GDP)

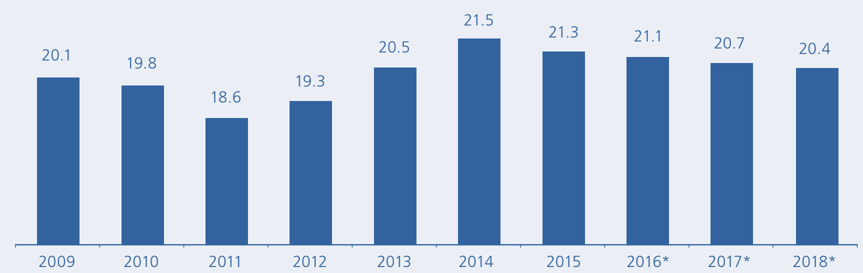
The projections of non-financial government spending for **2017** and **2018** show that this aggregate would amount to 20.7 and 20.4 percent of GDP, which is compatible with a real growth of 2.6 and 2.3 percent in 2017 and 2018, respectively. Considering the trend foreseen in the Multi-Annual Macroeconomic Framework, current spending should slow its pace of growth, while gross capital formation should show a faster pace of growth in 2017 with a rate of 8.2 percent and then grow 6.8 percent in 2018.

Table 30
NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT
(% GDP)

	2015	2016*		2017*		2018*
		IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
Current expenditure	**15.8**	**15.7**	**16.0**	**15.3**	**15.4**	**14.9**
National Government	11.1	10.9	11.1	10.6	10.7	10.4
Regional Governments	3.0	3.1	3.1	3.0	3.0	2.9
Local Governments	1.7	1.7	1.7	1.7	1.7	1.6
Capital expenditure	**5.4**	**5.2**	**5.2**	**5.2**	**5.3**	**5.4**
Gross capital formation	**4.7**	**4.7**	**4.7**	**4.7**	**4.9**	**5.0**
National Government	2.0	1.9	1.9	1.9	2.0	2.1
Regional Governments	0.9	0.9	0.9	0.9	0.9	1.0
Local Governments	1.8	1.9	1.9	1.9	1.9	1.9
Others	**0.7**	**0.5**	**0.4**	**0.5**	**0.4**	**0.4**
TOTAL	**21.3**	**20.8**	**21.1**	**20.6**	**20.7**	**20.4**
National Government	13.8	13.3	13.4	13.0	13.1	12.9
Regional Governments	3.9	4.0	4.0	4.0	4.0	3.9
Local Governments	3.5	3.6	3.7	3.6	3.6	3.6

* Forecast.
IR: Inflation Report.

Graph 63
NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT: 2009-2018
(% GDP)



* Forecast.

As regards the operations of public enterprises, the forecast scenario considers Petroperu's investment in the modernization of the Refinery in Talara. The progress in this project to date represents 38 percent of the total project. The funding required for the continuation of works at the Refinery of Talara this year would be obtained through public external financing (US$ 1 billion).

Public Debt

54. The projected process of gradual fiscal consolidation would imply increasing the gross debt balance from 23.3 percent of GDP in 2015 to 28 percent of GDP in

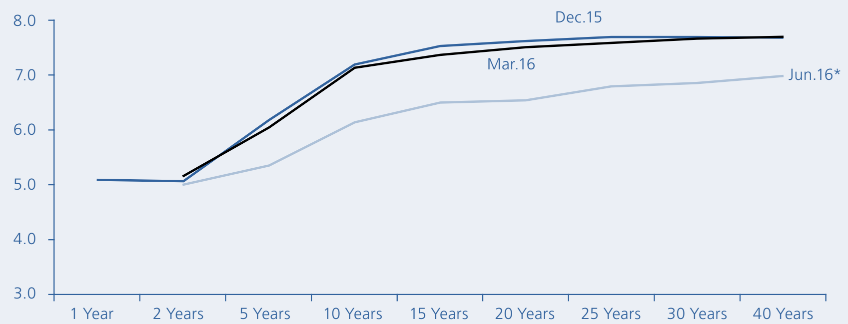
2018 and the net debt from 6.6 to 15.5 percent of GDP in the same period. Moreover, the funding required in 2016 for financing the projected economic balance (a deficit of 3.0 percent of GDP) and for the amortization of debt amounts to S/ 27.0 billion, a sum equivalent to 4.0 percent of GDP. Taking into account the 2016 deficit, the debt is foreseen to increase to 25.5 percent of GDP, while the net public debt would be equal to 10.1 percent of GDP.

Table 31
FINANCIAL REQUIREMENTS OF THE NON-FINANCIAL PUBLIC SECTOR AND ITS FUNDING
(Million S/)

	2014	2015	2016*		2017*		2018*
			IR Mar.16	IR Jun.16	IR Mar.16	IR Jun.16	IR Jun.16
I. USES	**11,061**	**20,961**	**23,469**	**26,566**	**25,182**	**28,038**	**27,689**
1. Amortization	9,059	7,963	6,540	6,564	8,801	8,143	8,824
a. External	4,207	3,859	3,885	3,847	3,092	3,093	4,276
b. Internal	4,160	3,437	2,024	1,883	4,999	4,299	3,754
Of which:							
Recognition bonds	*692*	*666*	*631*	*833*	*709*	*750*	*793*
2. Overall balance	2,002	12,998	1,6,930	20,003	16,382	19,895	18,865
(Negative sign indicates surplus)							
II. SOURCES	**11,061**	**20,961**	**23,469**	**26,566**	**25,182**	**28,038**	**27,689**
1. External	2,654	4,110	5,565	5,225	7,294	7,313	4,451
2. Bonds [1/]	13,002	17,068	18,878	17,933	7,313	15,195	21,159
3. Internal [2/]	-4,595	-217	-974	3,409	10,575	5,530	2,078
Memo:							
% GDP							
Gross debt balance	20.0	23.3	24.7	25.5	24.0	26.6	28.0
Net debt balance [3/]	3.9	6.6	8.6	10.1	10.1	13.1	15.5

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.
IR: Inflation Report.
* Forecast.

Graph 64
YIELD CURVE ON TREASURY BOND
(S/)



* As of June 17.

The gross debt of the non-financial public sector would be equivalent to 28.0 percent of GDP at the end of the forecast horizon, while the net debt would increase to 15.5 percent of GDP by **2018**. The explicit balance of the public sector contingent liabilities is estimated at 8.2 percent of GDP.

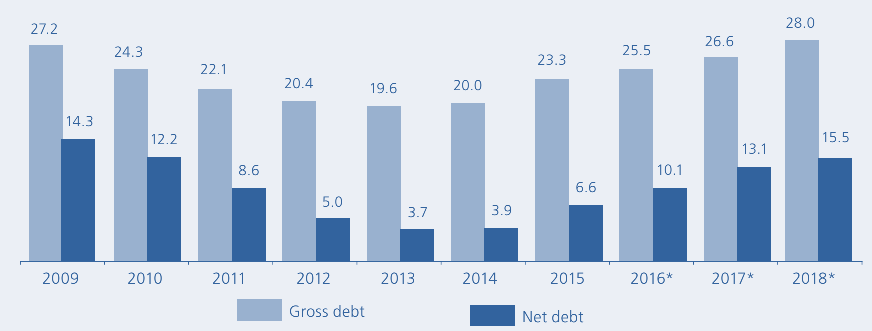
Table 32
CONTINGENT LIABILITIES OF THE NON-FINANCIAL PUBLIC SECTOR
(% GDP)

Contingency Type	MEF
Lawsuits	4.2
International disputes on investment issues	0.8
Guarantees to private contracts Public-Private Partnership	2.7
Guarantees or similar guarantees	0.5
TOTAL	**8.2**

Source: MEF.

In short, the accumulation of economic surpluses in the period of boom in commodity prices has allowed a gradual adjustment of the fiscal deficit in the 2016-2018 forecast horizon without affecting the sustainability of public finances.

Graph 65
NON-FINANCIAL PUBLIC SECTOR DEBT: 2009-2018
(% GDP)



* Forecast.

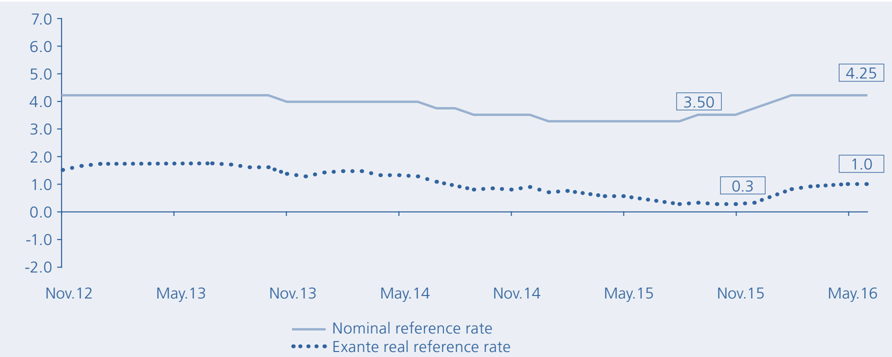
V. Monetary Policy and Financial Markets

Monetary Policy Actions

55. Since March, the factors that raised inflation above the inflation target have been reversing. The inflationary effect of the depreciation of the PEN has moderated and inflation expectations have been declining gradually. In addition to this, the supply shocks that temporarily affected inflation continue reversing.

In this context, the Board of the Central Bank has maintained the benchmark interest rate at 4.25 percent since March and has reiterated that the Central Bank oversees the inflation forecasts and inflation determinants to evaluate the possibility of adjusting its monetary policy rate to lead inflation to the target range.

Graph 66
NOMINAL AND REAL* REFERENCE INTEREST RATE
(%)



* Exante: Considers expectation of inflation.

Lending rates showed mixed behaviors. On the one hand, the rates on loans in the segment of small businesses –one of the segments considered as a segment of greater credit risk– increased by 73 basis points, reflecting in part the higher delinquency rate seen in this segment so far this year, while the rates on consumer loans and loans to medium-sized enterprises decreased by 20 and 3 basis points, respectively.

Table 33
INTEREST RATE BY TYPE OF LOANS IN DOMESTIC CURRENCY 1/
(%)

	Interbank	Credits					
		Corporate	Large companies	Medium-sized enterprises	Small businesses	Consumption	Mortgage
Dec.14	3.80	5.6	6.8	9.5	20.6	43.3	9.0
Mar.15	3.47	5.2	6.6	9.8	21.2	40.6	8.5
Jun.15	3.42	5.1	6.6	9.7	20.8	43.8	8.4
Sep.15	3.67	5.9	7.2	10.2	20.4	42.4	8.6
Dec.15	3.76	6.2	7.1	10.2	20.5	44.0	9.0
Jan.16	3.95	6.2	7.2	10.5	20.5	44.4	9.0
Feb.16	4.47	6.0	7.4	10.5	20.7	42.8	9.1
Mar.16	4.80	6.3	7.2	10.7	20.3	42.9	9.1
Apr.16	4.51	6.3	7.3	10.7	20.8	42.4	9.1
May.16	4.47	6.4	7.4	10.6	21.1	42.7	9.2
Accumulated change (bps)							
May.16 -Mar.16	-33	9	16	-3	73	-20	9
May.16-Dec.15	71	19	25	41	61	-131	24
May.16- Dec.14	67	76	57	119	49	-59	23

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

The deposit interest rates in national currency increased in all of the maturity terms compared to their levels in March: the rate for deposits of less than 30 days, from 31-to-180-day deposits, and from 181-to-360-day deposits increased by 11, 20, and 10 basis points, respectively.

Table 34
INTEREST RATES BY TYPE OF LIABILITIES IN SOLES
(%)

	Deposits up to 30-day	On 31 to 180-day term deposits	On 181 to 360-day term deposits
Dec.14	3.8	3.8	4.3
Mar.15	3.5	3.8	4.4
Jun.15	3.4	4.0	4.4
Sep.15	4.1	4.4	4.4
Dec.15	4.0	4.7	4.7
Jan.16	4.1	4.8	5.0
Feb.16	4.2	4.8	5.0
Mar.16	4.8	4.8	5.1
Apr.16	4.8	4.9	5.2
May.16	4.9	5.0	5.2
Accumulated change (bps)			
May.16-Mar.16	11	20	10
May.16-Dec.15	86	31	45
May.16-Dec.14	106	121	88

Source: BCRP.

56. Most of the interest rates on operations in dollars (both lending and deposit rates) showed declines between March and May, with the reduction in the lending rate for the corporate sector standing out (58 basis points). The rates in the segments of loans

to small businesses, consumer loans, and large businesses increased by 73, 19, and 12 basis points, respectively, in line with the increase observed in their delinquency rates.

Table 35
INTEREST RATE BY TYPE OF LOANS IN FOREIGN CURRENCY [1/]
(%)

	Interbank	Credits						
		Corporate	Large companies	Medium-sized enterprises	Small businesses	Consumer	Consumer
Dec.14	0.15	2.5	5.1	8.3	12.3	27.3	7.6
Mar.15	0.15	2.6	4.9	8.2	13.5	30.9	7.4
Jun.15	0.15	2.2	4.6	8.3	11.7	31.4	7.3
Sep.15	0.15	1.9	5.6	8.5	12.8	32.4	6.8
Oct.15	0.15	1.9	5.6	8.5	10.9	32.2	6.8
Nov.15	0.15	2.2	5.0	8.4	12.5	31.9	7.0
Dec.15	0.20	2.3	5.5	8.1	11.3	32.1	6.7
Jan.16	0.35	2.8	5.6	7.9	10.9	32.0	6.7
Feb.16	0.38	2.1	5.2	7.8	12.8	32.4	6.6
Mar.16	0.38	2.4	5.1	7.8	11.4	32.2	6.7
Apr.16	0.38	2.3	5.3	7.5	10.8	32.0	6.8
May.16	0.40	1.9	5.2	7.8	12.2	32.4	6.6
Accumulated change (bps)							
May.16 -Mar.16	2	-58	12	2	73	19	-5
May.16-Dec.15	20	-48	-30	-22	91	33	-10
May.16- Dec.14	25	-62	17	-44	-12	514	-95

1/ Tasas activas anuales de las operaciones realizadas en los últimos 30 días útiles.

Table 36
INTEREST RATES BY TYPE OF LIABILITIES IN US DOLLAR
(%)

	Deposits up to 30-day	On 31 to 180-day term deposits	On 181 to 360-day term deposits
Dec.14	0.2	0.5	0.8
Mar.15	0.2	0.5	0.8
Sep.15	0.1	0.3	0.6
Dec.15	0.2	0.5	0.6
Jan.16	0.2	0.4	0.6
Feb.16	0.2	0.4	0.6
Mar.16	0.3	0.4	0.6
Apr.16	0.3	0.4	0.6
May.16	0.3	0.4	0.6
Accumulated change (bps)			
May.16-Mar.16	2	2	-1
May.16-Dec.15	5	-2	-2
May.16-Dec.14	10	-4	-26

Source: BCRP.

Monetary Operations

57. The monetary operations of the Central Bank were mainly oriented to maintaining adequate levels of liquidity in domestic currency in a context marked by increased public sector deposits at the BCRP, associated with the regularization of payments of the income tax (S/ 3.01 billion between March and April).

Thus, regular currency repos for a total of S/ 1.70 billion were placed between March and May, and net certificates of deposits for a total of S/ 4.13 billion, of which S/ 4.22 billion was BCRP-CDRs, matured in the same period.

Table 37
MONETARY ACCOUNTS OF THE CENTRAL RESERVE BANK
(Million S/)

	Balance		Flows	
	2015 Dec.31	**2016 May.31**	**2015 Jan-Dec**	**2016 Jan-May**
I. NET INTERNATIONAL RESERVES	**209,663**	**204,287**	**-2,624**	**-2,943**
(Million US$)	**61,485**	**60,619**	**-823**	**-866**
1. Net international position	25,858	24,968	-9,511	-890
2. Deposits of financial intermediaries	22,477	21,875	6,974	-602
a. Current account	12,062	9,372	762	-2,690
b. Overnight deposits	1,718	3,636	479	1,918
c. Restricted deposits	8,697	8,867	5,732	170
3. Deposits of the public sector	13,683	14,242	1,618	559
a. Fiscal Stabilization Fund	7,902	7,904	-1,257	2
b. Rest	5,780	6,338	2,875	558
II. NET DOMESTIC ASSETS (1+2+3)	**-169,021**	**-165,781**	**4,094**	**806**
1. Credit to the financial sector	**-77,181**	**-72,108**	**-3,472**	**4,192**
a. Reverse repos	2,500	1,400	1,200	-1,100
Of which: Special repos	*1,900*	*900*	*1,900*	*-1,000*
b. Currency repos	27,605	28,405	19,005	800
i. Fx- Repo Regular	14,900	15,700	6,300	800
ii. Fx- Repo Expansion	7,900	7,900	7,900	0
iii. Fx- Repo Substitution	4,805	4,805	4,805	0
c. Securities issued	-18,873	-17,324	-5,396	1,550
i. CDBCRP	-11,624	-13,375	-774	-1,750
ii. CDRBCRP	-7,249	-3,949	-4,622	3,300
d. Reserve requirement in domestic currency	-10,649	-9,206	4,044	1,442
e. Other deposits in domestic currency	-1,115	-1,663	-99	-548
f. Deposits in foreign currency	-76,648	-73,719	-22,225	2,047
2. Net assets on the public sector	**-78,455**	**-79,904**	**1,998**	**-1,989**
a. Banco de la Nación	-11,121	-8,798	1,478	2,315
i. Domestic currency	-6,926	-5,219	695	1,706
ii. Foreign currency (Million US$)	-82	-223	63	-141
iii. Securities owned by the Public Sector	-3,917	-2,828	584	1,089
b. Central Government	-67,257	-71,101	217	-4,378
i. Domestic currency	-22,835	-25,833	5,781	-2,998
ii. Foreign currency (Million US$)	-13,027	-13,433	-1,746	-406
c. Others (includes COFIDE)	-77	-4	303	73
3. Other Net Accounts	**-13,384**	**-13,769**	**5,567**	**-1,397**
III. CURENCY (I+II)	**40,643**	**38,506**	**1,470**	**-2,137**

58. At May 2016, the ratio of public sector deposits in the Central Bank's net assets was higher than the ratio of these deposits in December 2015 (34.4 percent vs. 31.5 percent) due to increased seasonal tax revenues in this period. This increased fiscal sterilization was offset by a decline in the ratio of the BCRP sterilization operations through BCRP-CDR, which fell from 3.0 to 1.7 percent of net assets during the first five months of the year.

Table 38
SIMPLIFIED BALANCE SHEET OF THE BCRP
(As % of Net Assets)

			Dec.14	Dec.15	May.16
I.	**Net assets**		**100.0%**	**100.0%**	**100.0%**
	Net International Reserves		**94.9%**	**87.4%**	**87.3%**
			(US$ 62,307 mills.)	(US$ 61,485 mills.)	(US$ 60,619 mills.)
	Repos		**5.1%**	**12.6%**	**12.7%**
II.	**Net liabilities**		**100.0%**	**100.0%**	**100.0%**
	1.	**Total public sector deposits**	**36.9%**	**32.7%**	**34.4%**
		In domestic currency	18.7%	13.0%	13.9%
		In foreign currency	18.2%	19.7%	20.5%
	2.	**Total financial system deposits**	**27.0%**	**37.1%**	**36.3%**
		In domestic currency	7.7%	4.5%	4.0%
		In foreign currency	19.4%	32.6%	32.3%
	3.	**BCRP instruments**	**9.8%**	**10.0%**	**9.5%**
		CD BCRP	8.0%	6.5%	7.0%
		CDR BCRP	1.3%	3.0%	1.7%
		Term deposits	0.0%	0.4%	0.5%
		Overnight deposits	0.5%	0.1%	0.2%
	4.	**Currency and others**	**26.2%**	**20.3%**	**19.8%**

59. The BCRP continued carrying out liquidity injection operations in local currency mainly through currency repos and auctions of public deposit funds. Between March and May 2016, the BCRP placed currency repos for a total of S/ 290 million and auditioned public deposit funds of S/ 300 million.

Graph 67
CURRENCY REPO OPERATIONS

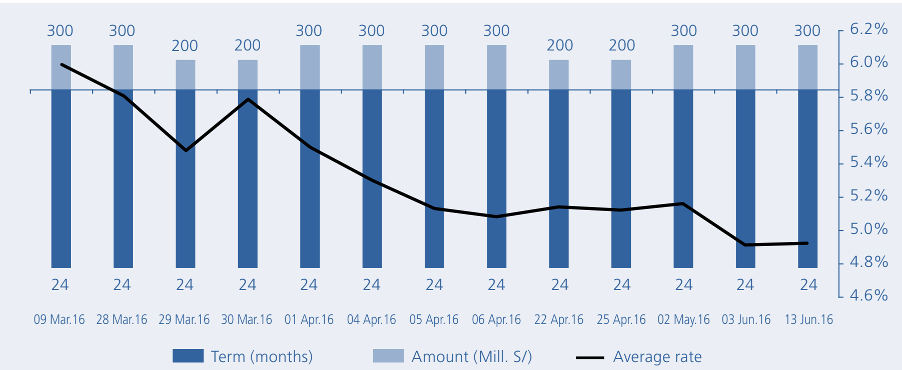
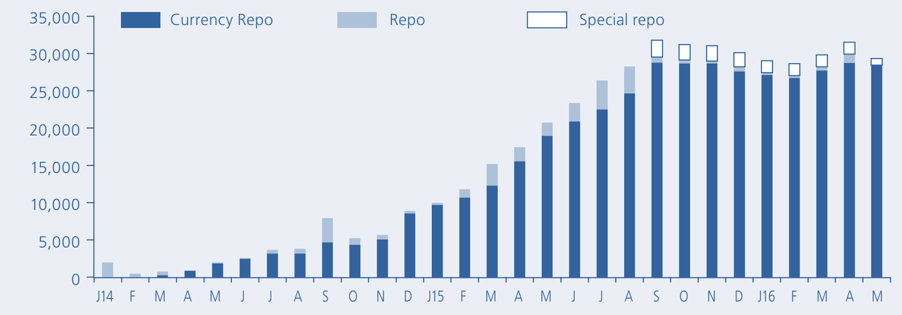


Table 39
AUCTION OF PUBLIC DEPOSIT OPERATIONS
(Million S/)

Date	Operation	Term	Amount	Average rate
Mar 2, 2016	Treasury	6-months	300	6.05%
TOTAL			**300**	**6.05%**

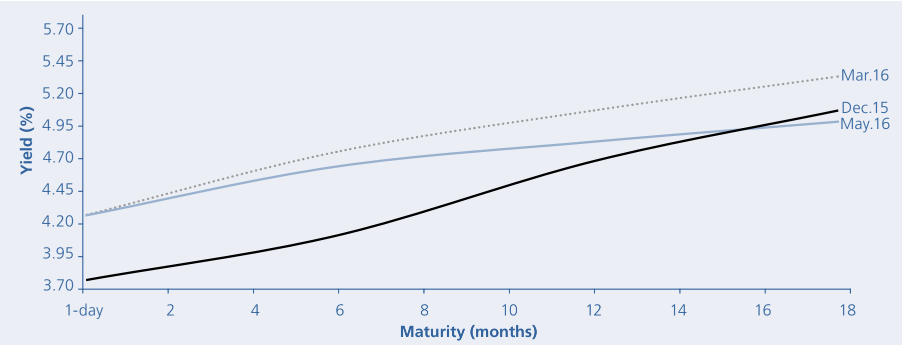
Graph 68
BALANCE OF REPO OPERATIONS: TERM AT THE END OF MONTH
(Million S/)



60. The BCRP also continued with its regular auctions of 6-month, 12-month, and 18-month BCRP-CDs three times a week, placing S/. 30 million each time in order to increase the volume of these certificates and provide more liquidity to the secondary market of BCRP-CDs to contribute to the development of the short-term yield curve in soles. Between March and May, the Central Bank placed BCRP-CDs for a total of S/. 5.87 billion and maturities amounted to S/. 7.42 billion, as a result of which the balance of BCRP-CDs decreased by S/ 1.54 billion to S/ 16.20 billion.

The yield curve of BCRP-CDs declined 23 basis points on average between March and May2016, period during which the BCRP policy interest rate has remained at 4.25 percent. This would be reflecting market expectations of a more gradual withdrawal of monetary stimulus by BCRP.

Graph 69
YIELD CURVE OF CENTRAL BANK SECURITIES [1/]



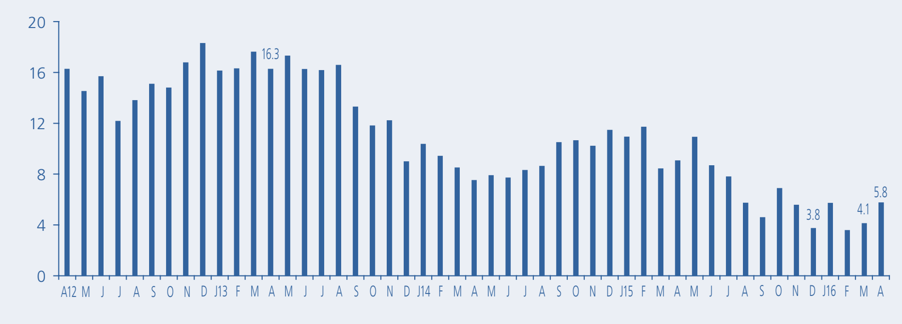
1/ Yield of CDBCRP end of period. One day rate corresponds to reference rate.

Liquidity and Credit

61. Currency in circulation grew 5.8 percent in April 2016 in the last twelve months, a higher rate than the one recorded at end-2015 (3.8 percent) and in Q1-2016

(4.1 percent). This would be reflecting a gradual recovery in the level of economic activity and therefore, this pace of annual growth is expected to continue over the year.

Graph 70
CURRENCY
(% change last 12-month)



Deposits in domestic currency grew at an annual rate of 4.2 percent in April 2016, showing a higher growth rate than that observed at the end of 2015 (2.6 percent) and higher than that observed in the first quarter of the year. However, deposits in foreign currency have continued showing a greater dynamism than deposits in soles. Thus, the ratio of dollarization of non-financial private agents' deposits rose from 42.2 percent in December 2015 to 42.9 percent in April 2016.

A gradual recovery is expected in the pace of growth of deposits in soles in 2016 as public spending resumes a faster pace of growth and the Treasury withdraws part of its deposits at the BCRP. The decline of depreciation expectations is another factor that would also contribute to the recovery of deposits in domestic currency as such a decline would lead institutional investors to de-dollarize their deposits and substitute their long positions in dollars.

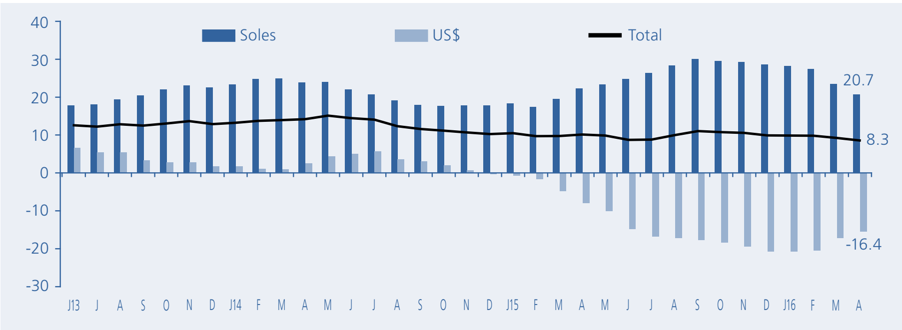
Table 40
MONETARY ACCOUNTS (END-OF-PERIOD)
(12-month % change)

	Dec.14	Mar.15	Jun.15	Sep.15	Dec.15	Mar.16	Apr.16
1 Currency in circulation	11.5	8.4	8.7	4.6	3.8	4.1	5.8
2 Deposits in domestic currency	9.6	6.6	4.0	0.9	2.6	3.0	4.2
3 Broad money in domestic currency	10.6	7.2	5.8	2.3	3.0	3.8	5.3
4 Total broad money [1/]	7.3	5.4	5.5	7.7	6.3	6.8	6.5
5 Credit to the private sector in domestic currency	17.7	19.5	24.8	30.0	28.6	23.4	20.7
6 Credit to the private sector	10.1	9.6	8.5	10.9	9.7	9.1	8.3

1/ Includes foreign currency.

62. Recording a lower growth rate than that recorded in Q4-2015 (9.7 percent) and in Q1-2016, credit to the private sector grew 8.3 percent in annual terms in April 2016. This result would be associated with the evolution of private investment which has been reflected in the lower dynamism of credit to the corporate sector and with the lower demand for durable consumer goods, which is reflected in the slowdown of car loans. By currencies, credit in domestic currency continued showing a greater dynamism, with an annual growth rate of 20.7 percent, while credit in foreign currency continued declining although at a slower pace (15.4 percent in April 2016), reflecting the process of de-dollarization of credit supported by the measures taken by the BCRP at end-2014 and expectations of a strengthening of the dollar. At end-2016, total credit to the private sector is expected to show growth rates around 7.0 percent, in line with the evolution foreseen in economic activity.

Graph 71
CREDIT TO THE PRIVATE SECTOR
(12-month % change)



63. By types of credit, personal loans continued growing at a steady pace of around 10.3 percent. The more dynamic segment within this type of credit was consumer loans, which recorded a year-to-year growth rate of 12.1 percent in April 2016. On the other hand, mortgage loans grew 7.8 percent, a slightly lower growth rate than in Q4-2015.

Table 41
CREDIT TO THE PRIVATE SECTOR
(12-month % change)

	Dec.14	Mar.15	Jun.15	Sep.15	Dec.15	Mar.16	Apr.2016
Businesses	**9.2**	**8.2**	**6.6**	**10.0**	**8.4**	**8.1**	**7.3**
Corporate and large companies	10.5	16.0	15.5	19.7	16.1	12.8	10.7
Medium-sized enterprises	13.7	1.1	-3.2	0.5	-0.8	3.0	3.7
Small business and Microbusinesses	1.6	1.5	0.3	1.0	3.2	3.4	3.4
Individuals	**11.8**	**12.1**	**12.0**	**12.5**	**12.2**	**10.8**	**10.3**
Consumer	11.4	12.6	13.8	14.8	14.8	13.0	12.1
Car loans	6.7	2.8	0.5	-0.7	-5.0	-4.7	-4.9
Credit cards	15.0	18.2	21.8	23.5	23.9	21.3	19.0
Mortgage	12.4	11.4	9.6	9.5	8.6	8.0	7.8
Total	**10.1**	**9.6**	**8.5**	**10.9**	**9.7**	**9.1**	**8.3**

On the side of business loans, the segment of corporate loans and loans to large enterprises grew at an annual rate of 10.7 percent in April, while the segment of loans to small- and micro businesses grew 3.4 percent and the segment of loans to medium-sized companies recovered compared to December 2015 (3.7 percent versus -0.8 percent).

64. Between April 2015 and May 2016, the flow of credit to the private sector in domestic currency was S/ 37.87 billion, which represents a growth rate of 21.7 percent compared to April 2015. This demand for credit has been funded mainly through private sector deposits (S/ 8.81 billion) and by the reduction of the exchange position of financial institutions (S/ 5.70 billion). Moreover, the BCRP has injected liquidity for a total of S/ 14.08 billion through its monetary instruments.

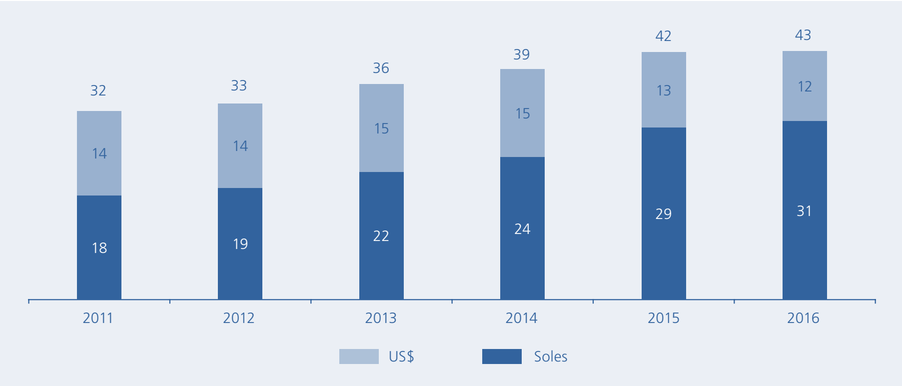
Table 42
CREDIT IN DC OF DEPOSITORY CORPORATIONS: SOURCES OF EXPANSION
(Million S/)

	Year		2016*
	2014	2015	Apr.15-May.16
Credit in domestic currency	**20,950**	**39,738**	**37,871**
12-month % change	17.7	28.6	21.7
Source of expansion	**20,950**	**39,738**	**37,871**
1. Private sector deposits	8,851	3,309	8,810
2. Public sector deposits	-2,292	2,576	2,096
2.1 Public sector deposits	-2,292	26	196
Of which: Auctions of Treasury deposits	0	2,550	1,900
3. BCRP	13,823	23,741	14,381
3.1 Monetary instruments	11,723	19,698	14,082
a. CD+DP to day	2,252	-507	1,478
b. Repos	350	1,200	-3,500
c. Currency repos	8,600	19,005	16,105
3.2 Reserve requirements	2,100	4,044	299
4. Accounting exchange position	-2,422	6,427	5,701
5. Rest	2,990	3,685	6,883

65. In 2016, credit is forecast to grow 7.0 percent, considering a growth rate of 11.5 percent in credit in soles associated with a lower dynamism in investment and in the consumption of durable goods as well as with the amortization of loans by economic agents who opted for the release of their pension funds. Because of these reasons, the ratio of credit-to-GDP is foreseen to remain at 42 percent in 2016.

The growth of credit to the private sector in the 2017-2018 forecast horizon is expected to be close to the rate of growth of nominal GDP (around 6 percent), with credit in domestic currency showing greater dynamism. In addition to this, total liquidity is foreseen to show a greater degree of de-dollarization as a result of a greater dynamism of deposits in domestic currency as expectations of depreciation of the sol stabilize.

Graph 72
RATIO CREDIT/GDP
(%)



Progress in the De-dollarization of Credit

66. At the end of 2014, the BCRP established the Credit De-dollarization Program with the aim of reducing economic agents' risks associated with the high levels of dollarization of credit in the country. The program establishes additional reserve requirements in foreign currency with the aim of increasing the cost of funding in this currency. Particularly, the program sought to reduce banks' balances of loans in dollars: (i) in the case of total loans[9], banks had to show in December 2015 a balance of loans in dollars equal to 90 percent of such balance at September 2013, while for end-2016 the requirement was 80 percent of the balance of September 2013; and (ii) in the case of car loans and mortgage loans, banks were required to show in December 2015 a balance equal to 85 percent of the balance of these loans in February 2013, while at the end of 2016 the required balance was 70 percent of the balance recorded in February 2013.

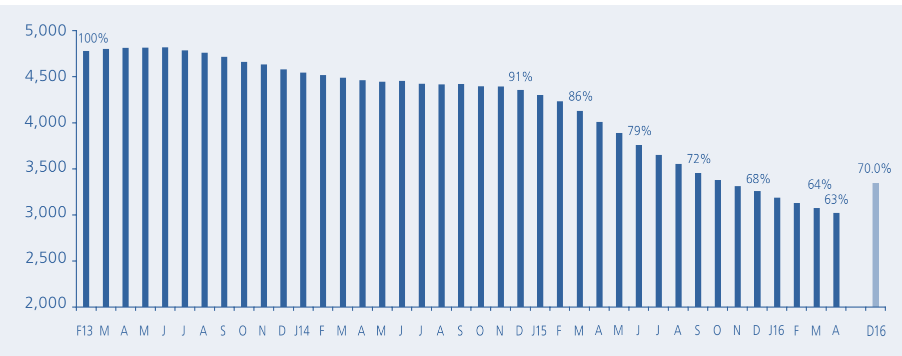
    As a result of these measures and of the higher-than-expected depreciation, the balance of credit in dollars declined and these loans were replaced by loans in soles. The balance of total loans fell from a balance of US$ 23.47 billion in December 2014 to US$ 16.54 billion in April 2016 (a reduction of US$ 6.93 billion). Such balance is equal to 71 percent of the credit balance that banks had in September 2013 (reflecting that the requirements set for both December 2015 and 2016 have been met).

9 Excluding loans for foreign trade operations and loans of over US$ 10 million and for terms of over 3 years established as from January 1, 2015.

Graph 73
BANK'S CREDIT IN US$ EXCLUDING FOREIGN TRADE
(Million US$)

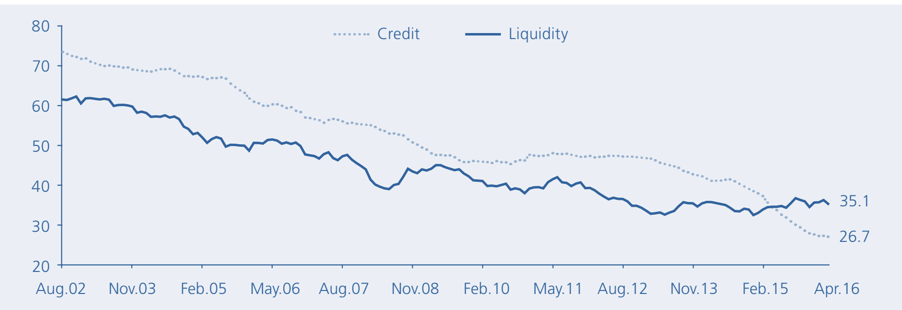
67. The evolution of car loans and mortgage loans has been similar. Between December 2014 and January 2016, the balance of these loans shows a contraction of US$ 1.33 billion to a balance of US$ 3.02 billion (which is equivalent to 63.3 percent of the balance of these loans in February 2013).

Graph 74
BANK'S LOANS IN US$: CAR AND MORTGAGE
(Million US$)



68. As a result of these credit measures, the ratio of the dollarization of credit has dropped from 38.3 percent in December 2014 to 26.7 percent in April 2016.

Graph 75
DOLLARIZATION RATIO: 2002 - 2016
(%)



69. By type of credit, lower ratios of dollarization of credit are now observed in all the segments of credit. In mortgage loans, the ratio of dollarization declined from 33.9 in December 2014 to 22.3 percent in April 2016, while the de-dollarization of car loans was 34 percentage points in the same period. As for business loans, the dollarization ratio of loans to corporate enterprises and large companies dropped by 17 percentage points, but has remained around 43 percent between December 2015 and April 2016. On its side, the ratio of dollarization of loans to medium-sized companies declined by 18 percentage points between December 2014 and April 2016.

Table 43
DOLLARIZATION RATIO OF CREDIT TO THE PRIVATE SECTOR

	Dec.13	Dec.14	Sep.15	Dec.15	Mar.15	Apr.16
Businesses	**52.7**	**48.4**	**38.0**	**35.4**	**34.9**	**34.7**
Corporate and large companies	67.1	59.8	45.8	42.8	42.7	42.6
Medium-sized enterprises	63.7	59.3	47.0	44.2	42.5	41.8
Small business and Microbusiness	13.0	11.5	8.2	7.8	7.0	6.8
Individuals	**23.1**	**20.0**	**15.3**	**14.2**	**13.3**	**13.1**
Consumer	10.5	9.5	7.5	7.0	6.6	6.5
Car loans	75.9	68.9	48.4	41.3	35.6	34.3
Credit cards	7.2	6.6	5.8	5.6	5.5	5.6
Mortgage	40.0	33.9	25.9	24.2	22.8	22.3
TOTAL	**42.2**	**38.2**	**29.8**	**27.6**	**27.0**	**26.7**

It is worth mentioning that these lower levels of dollarization of credit increase the financial system's robustness face external shocks that generate high volatility in the exchange rate and also reduce the negative effects of foreign exchange volatility on the balance sheets of companies and households.

70. Furthermore, the dollarization ratio of private sector deposits has declined slightly compared to the end of Q1-2016 (to 45.5 percent in April from 46.5 percent in

March 2016). By type of deposits, the ratio of dollarization has declined in most segments compared to Q1-2016, this declined being particularly noteworthy in the deposits of companies (savings and term deposits), personal deposits (term deposits), and the deposits of pension funds and mutual funds.

Table 44
DOLLARIZATION RATIO OF DEPOSITS

	Dec.13	Dec.14	Mar.15	Jun.15	Sep.15	Dec.15	Mar.16	Apr.16
Businesses	**53.8**	**50.8**	**53.6**	**53.6**	**57.0**	**52.2**	**56.5**	**54.2**
Demand deposits	48.4	47.1	49.2	50.1	52.0	47.2	51.9	51.6
Savings deposits	44.9	63.6	62.1	62.2	75.6	66.0	65.4	58.0
Term deposits	67.8	61.8	69.1	64.6	71.2	68.9	70.6	62.7
Individuals	**35.3**	**33.7**	**35.2**	**36.4**	**38.0**	**37.1**	**37.0**	**36.9**
Demand deposits	48.7	48.2	49.7	50.3	52.1	47.2	51.9	51.9
Savings deposits	35.6	35.2	36.6	38.2	38.8	37.5	39.1	39.6
Term deposits	33.3	30.8	32.3	33.1	35.6	35.4	33.0	32.2
Pension funds	**83.8**	**88.6**	**82.3**	**85.5**	**94.2**	**92.3**	**94.5**	**89.8**
Mutual funds	**59.6**	**54.6**	**57.3**	**53.0**	**56.0**	**48.7**	**43.4**	**42.1**
Total	**46.0**	**42.4**	**44.2**	**44.8**	**47.9**	**45.4**	**46.5**	**45.5**

71. In April, the rate of non-performing loans was 3.12 percent. The ratio of default of credit to businesses was 4.94 percent, higher than in March 2016 (4.84 percent) and in December 2015 (4.65 percent). By credit segments, the default rate of credit to large, medium-sized, and small enterprises rose by 6, 9 and 5 basis points, respectively, compared to Q1-2016, while the default rate of credit to individuals remained at 2.88 percent, although this rate is higher by 23 basis points than that recorded in December 2015 (2.65 percent). By components, however, the increase is particularly noteworthy in the rate of default in car loans and credit cards (up by 10 basis points and 9 basis points, respectively).

Table 45
NON-PERFORMING LOANS INDEX OF THE DEPOSITORY CORPORATIONS

	Dec.13	Dec.14	Dec.15	Mar.16	Apr.16
Businesses	**2.70**	**3.14**	**4.65**	**4.84**	**4.94**
Corporate	0.00	0.00	0.02	0.03	0.16
Large companies	0.38	0.68	1.00	1.08	1.14
Medium-sized enterprises	3.72	4.79	5.28	5.71	5.79
Small business	7.56	8.72	8.51	9.14	9.19
Microbusinesses	5.08	5.39	4.66	5.14	5.14
Individuals	**2.32**	**2.46**	**2.65**	**2.88**	**2.88**
Consumer	3.39	3.34	3.32	3.60	3.60
Car loans	3.37	4.25	4.41	4.75	4.85
Credit cards	4.71	4.23	4.10	4.61	4.71
Mortgage	1.04	1.44	1.84	2.00	2.01
Average non-performing	**2.57**	**2.91**	**2.87**	**3.07**	**3.12**

By currency, the default rate in domestic currency has remained around 3 percent, a lower rate than that observed in loans in dollars (3.26 percent). The latter has risen by 1.8 percentage points since December 2013, reflecting the effects of the depreciation of the dollar/sol exchange rate on the payment capacity of borrowers with currency mismatches. By type of credit, the default rate for repaying loans in foreign currency has risen between March and April 2016, especially in the case of loans to small and micro-businesses (about 72 basis points) and car loans.

Table 46
NON-PERFORMING LOANS INDEX OF THE DEPOSITORY CORPORATIONS: DOMESTIC CURRENCY

	Dec.13	Dec.14	Dec.15	Mar.16	Apr.16
Businesses	**3.93**	**4.03**	**5.11**	**5.31**	**5.34**
Corporate	0.00	0.00	0.03	0.04	0.03
Large companies	0.24	0.47	0.48	0.50	0.50
Medium-sized enterprises	4.88	5.63	5.04	5.43	5.39
Small business	7.66	8.55	7.83	8.41	8.46
Microbusinesses	5.12	5.44	4.61	5.07	5.07
Individuals	**2.57**	**2.57**	**2.53**	**2.73**	**2.73**
Consumer	3.47	3.33	3.23	3.49	3.49
Car loans	6.07	4.61	1.91	1.97	2.00
Credit cards	4.82	4.31	4.20	4.73	4.83
Mortgage	0.98	1.33	1.46	1.59	1.59
Non-performing loans	**3.33**	**3.40**	**2.87**	**3.07**	**3.07**

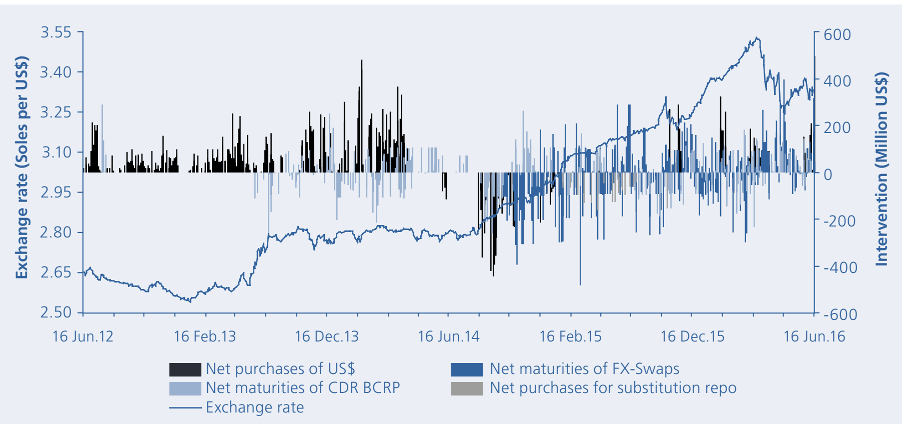
Table 47
NON-PERFORMING LOANS INDEX OF THE DEPOSITORY CORPORATIONS: FOREIGN CURRENCY

	Dec.13	Dec.14	Dec.15	Mar.16	Apr.16
Businesses	**1.48**	**2.14**	**3.89**	**4.00**	**4.21**
Corporate	0.00	0.00	0.01	0.00	0.35
Large companies	0.45	0.81	1.52	1.73	1.84
Medium-sized enterprises	3.02	4.22	5.55	6.04	6.30
Small business	6.99	9.90	16.33	19.29	20.01
Microbusinesses	3.84	4.01	7.91	10.49	11.19
Individuals	**1.47**	**2.06**	**3.28**	**3.73**	**3.81**
Consumer	2.62	3.42	4.58	5.33	5.40
Car loans	2.46	4.09	7.52	9.26	9.83
Credit cards	3.16	3.07	2.62	2.90	2.88
Mortgage	1.12	1.64	2.88	3.25	3.33
Average non-performing	**1.48**	**2.13**	**2.87**	**3.06**	**3.26**

Exchange Rate and BCRP Interventions in the Foreign Exchange Market

72. Between March and May 2016, the dollar/PEN exchange rate reversed the upward trend it had shown since Q2-2014. This reversal was due to the improvement observed in commodity prices as a result of the better outlook for global growth and lower uncertainty associated with the monetary policy of the Federal Reserve and with a less uncertain local political scenario. Between the end of February and April 19, the dollar/PEN exchange rate appreciated 7.7 percent, after which, until May 31, the exchange rate depreciated 3.8 percent, exchange rate reached S/ 3.738 per 1 US dollar, accumulating an appreciation of 1.1 percent in the year.

Graph 76
INTERVENTION IN THE FOREIGN EXCHANGE MARKET AND EXCHANGE RATE



73. The net demand for dollars observed between March and May 2016 amounted to US$ 4.34 billion. The supply came mainly from the sector of non-residents (US$ 4.49 billion in the period), while the demand originated in the BCRP interventions in the foreign exchange market, mainly through the net maturities of FX swaps (US$ 3.36 billion) and BCRP-CDR (US$ 1.14 billion).

74. It is worth mentioning that, as of March 29, BCRP decided to accept the unwinding of currency swaps if banks were willing to reduce their positions more quickly. At end-May, the amount of these operations accepted was equivalent to US$ 2.89 billion, which contributed to reduce the balance of FX swaps to the equivalent of US$ 5. 67 billion.

Graph 77
NDF NET SALES AND FOREIGN EXCHANGE INSTRUMENTS OF THE BCRP
(Million US$)

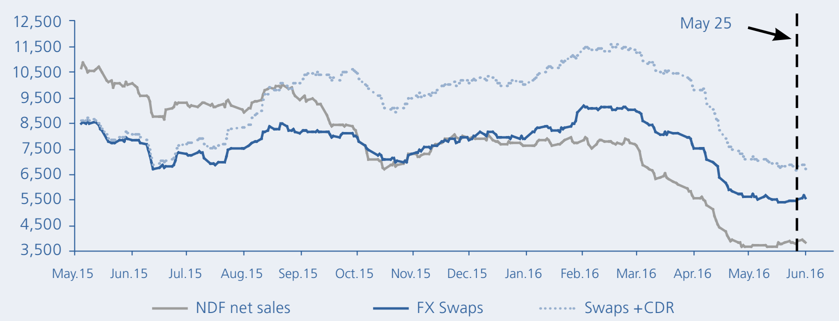


Table 48
FOREIGN EXCHANGE FLOWS
(Million US$)

Net demand in FC 1/	**2015**	**2016 Jan-Feb**	**2016 Mar-May**
1. Reduction on credits in FC	5,968	419	-49
2. Increase on deposits in FC	3,853	760	-1,128
3. Non-residents	388	695	-4,494
4. AFPs	2,304	97	93
5. Financial sector	1,594	-2	-108
6. Non-financial sector	-952	-484	1,346
BCRP Intervention 2/	**2015**	**2016 Jan-Feb**	**2016 Mar-May**
1. Net sale spot	8,064	332	164
2. Net placement of FX-Swaps	2,320	1,027	-3,360
3. Net placement of CDR BCRP	1,241	126	-1,144
4. Sale for substitution repo	1,529		
TOTAL	**13,154**	**1,485**	**-4,340**
Balance of FX swaps (end-of-period)	*7,906*	*9,063*	*5,674*

1/ Negative sign means supply of US$.
2/ Positive sign means supply of US$.

75. The multilateral real exchange rate index (RER) decreased by 0.79 percent compared to the same period in 2015, which reflects a multilateral nominal depreciation of 5.83 percent, a domestic inflation of 3.54 percent, and an estimated external inflation of 2.02 percent (YoY change).

Graph 78
MULTILATERAL RER
(Index 2009=100)

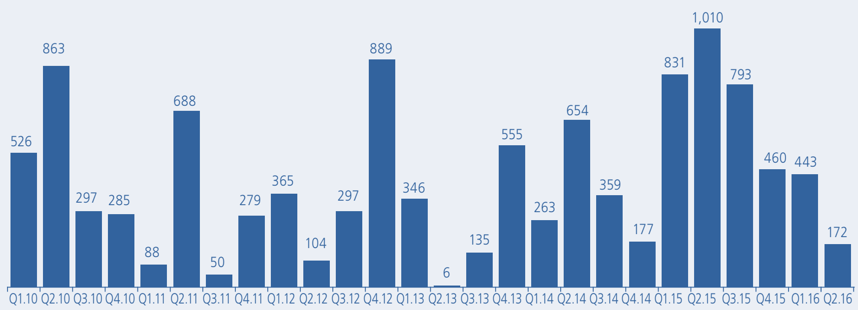
Capital Market

76. Securities issued in the local capital market by Peruvian non-financial companies have increased in the last three months. Between December 2015 and February 2016 non-financial companies have issued securities for a total of S/ 512 million (versus S/ 386 million in the previous quarter). On the other hand, financial companies have issued securities for a total of S/ 146 million (versus S/ 164 million in the previous quarter).

    Securities for a total of S/ 3.09 billion were issued in 2015, which represents a growth rate of 113 percent compared to 2014. By currencies, 90 percent of the total securities issued in this year was issued in soles.

    As for the rest of 2016, issuers are expected to continue showing greater preference for securities in domestic currency given the current context of volatility in international financial markets due to expectations of future rises in the Federal Reserve interest rate and expectations regarding growth in China.

Graph 79
BONDS ISSUED BY NON-FINANCIAL FIRMS*
(Million S/)



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

Table 49
BONDS ISSUED BY NON-FINANCIAL FIRMS
(Millions)

Month	US$	S/.	Total S/.
Dec.13	111.0	90.0	400.8
Jan.14	1.0		2.8
Feb.14	62.5	85.0	259.9
Apr.14		220.0	220.0
Jun.14		434.0	434.0
Jul.14	20.0		55.9
Sep.14	50.0	160.0	303.5
Nov.14	21.0		61.3
Dec.14		116.0	116.0
Jan.15	10.0	500.0	530.6
Feb.15		300.0	300.0
Apr.15	6.0		18.8
May.15		502.0	502.0
Jun.15	154.0		489.3
Jul.15		435.0	435.0
Sep.15	16.0	306.0	357.6
Oct.15	2.0	2.0	8.6
Nov.15	6.0		20.2
Dec.15	117.0	32.0	431.1
Jan.16		1.2	1.2
Feb.16	26.0	2.0	93.6
Mar.16		348.0	348.0
Apr.16	1.0		3.3
May.16	50.0		168.6
Average 2010			158.0
Average 2011			104.0
Average 2012			137.9
Average 2013			86.8
Average 2014			145.3
Average 2015			257.8
Average 2016			122.9

77. After a pause of 10 months in this type of debt operations, two Peruvian companies issued bonds in the international market in May 2016.

First, the company Kallpa Generación made its first issuance of bonds in the international market, placing bonds for a total amount of US$ 350 million below their face value with a maturity of 10 years. The bid-to-cover ratio amounted to 4 approximately, with non-resident investors standing out as the major bidders (73 percent). The rate of return of these securities was 4.86 percent, higher by 155 basis points than the rate of return of a Peruvian global bond with a similar maturity term. On the other hand, the agribusiness company Camposol swapped bonds maturing on February 2, 2017 for bonds maturing on May 17, 2021. In total, bonds with a maturity term of 5 years for a total amounts of US$ 147 million were issued.

As of May 2016, the balance of bonds issued by Peruvian companies in the international market amounts to US$ 20.36 billion. In the two next years, the total of maturities of bonds issued in the international market will be equal to US$ 353 million, of which US$ 300 million are bonds issued by financial entities and US$ 53 million are bonds issued by the tradable sector. The small amount of maturities does not represent a potential refinancing risk for issuers.

Table 50
BONDS ISSUED IN THE INTERNATIONAL MARKET

Business	Emission date	Amount (Million US$)	Maturity (Years)	Rate
Year 2014		**5,510**		
Non-financial sector		**3,306**		
Compañía Minera Ares	15-Jan	350	7	7.75%
Minsur	31-Jan	450	10	6.25%
Abengoa Transmisión Sur	8-Apr	432	29	6.88%
Camposol	24-Apr	75	3	9.88%
Rutas de Lima**	27-Jun	370	22	8.38%
Rutas de Lima***	27-Jun	150	25	5.25%
InRetail Shopping Mall	1-Jul	350	7	6.50%
InRetail Consumer	7-Oct	300	7	5.25%
Unión Andina de Cementos	28-Oct	625	7	5.88%
Energia Eólica	15-Dec	204	20	6.00%
Financial sector		**2,204**		
Financial sector Private		1,025		
Banco de Credit	15-Jan	200	13	6.13%
Interbank	11-Mar	300	15	6.63%
Banco de Credit	1-Jul	225	4	2.75%
BBVA Banco Continental	15-Sep	300	15	5.25%
Financial sector Public		1,179		
Fondo MiVivienda	26-Mar	300	5	3.38%
Fondo MiVivienda*	15-May	279	4	1.25%
COFIDE	8-Jul	300	5	3.25%
COFIDE	8-Jul	300	15	5.25%
Year 2015		**4,510**		
Non-financial sector		**3,361**		
GyM Ferrovias***	3-Feb	206	25	4.75%
Southern Copper Corporation	17-Apr	500	10	3.88%
Southern Copper Corporation	17-Apr	1,500	30	5.88%
Consorcio Nuevo Metro de Lima	10-Jun	1,155	19	5.88%
Financial sector		**1,149**		
Financial sector Private		349		
Intercorp	3-Feb	250	10	5.88%
Interbank**	3-Feb	99	15	7.66%
Financial sector Public		800		
COFIDE	7-Jul	200	4	3.25%
COFIDE	7-Jul	600	10	4.75%
Year 2016		**497**		
Non-financial sector		**497**		
Kallpa Generación	19-May	350	10	4.88%
Camposol ****	20-May	147	5	10.50%

* Emission in Swiss Franc.
** Emission in Soles.
*** Emission in Soles VAC.
**** Bond swapping 2017 per 2023.

Box 3

THE INDEPENDENCE OF THE CENTRAL RESERVE BANK OF PERU

Since the late 1980s, several countries worldwide have begun to give greater independence to their central banks, including New Zealand (1989), Chile (1989), Colombia (1992), Peru (1993), Mexico (1993), and England (1997), for example. The emphasis in a central bank's independence has strong economic fundamentals because it is associated to greater price stability, which reflects in better conditions for investment and long-term growth.

Economic literature highlights the concept of the independence of central banks to refer to the shield that central banks have regarding the decisions of the other State powers, which typically entail an inflation bias due to the multiplicity of objectives that are beyond price stability, or fiscal dominance, that is, the intention of financing the fiscal deficit through loans of the central bank.

In an influential article, Cukierman, Webb, and Neyapti (1992)[10] quantified the legal independence of central banks conferred to them by legislation and found a negative relationship between this legal independence and the rate of inflation, particularly in developed countries between 1950 and 1990. Legal independence is based on four major pillars, namely, the characteristics of the mandate of the governor of the central bank, monetary policy, the central bank's objectives, and the limits on loans from the central bank to the government (see table below).

LEGAL AND EFFECTIVE INDEPENDENCE OF CENTRAL BANKS

Criteria	Legal Independence	Criteria	Effective Independence
	CEO		
1	a. Term of office	1	Tenure of central bank CEO overlap with political
2	b. Who appoints CEO?		
3	c. Dismissal	2	Limitations on lending in practice
4	d. May CEO hold other offices in government?		
		3	Resolution of conflict
	Policy formulation		
5	a. Who formulates monetary policy?	4	Financial independence
6	b. Who has final word in resolution of conflict?		**a. Determination of the central bank's budget**
7	**c. Role in the government's budgetary process**		**b. Determination of the salaries of high bank officials and the allocation of bank profits**
8	Objectives of the central bank		
		6	Intermediate policy targets
	Limitations on lending to the government		a. Quantitative monetary stock target
9	a. Advances (limitation on nonsecuritized lending)		b. Formal or informal interest rate targets
10	b. Securitized lending		
11	c. Terms of lending (maturity, interest, amount)	7	Actual priority given to price stability
12	d. Potential borrowers from the bank		
13	e. Limits on central bank lending defined in	8	Function as a development bank, granting credit at subsidy rates?
14	f. Maturity of loans		
15	g. Interest rates on loans must be		
16	h. Central bank prohibited from buying or selling government securities in the primary market?"		

Source: Cukierman. Webb and Neyapti (1992).

The authors also develop an index of effective independence using variables related with the overlap of the governor's mandate and that of the political authorities, financial independence, and the real importance of price stability, among

10 Cukierman, Alex, Steven Webb y Bilin Neyapti (1992). Measuring the independence of central banks and its effects on policy outcomes, The World Bank Economic Review 6(3): 353-398.

other criteria, and shows that central banks in developing countries are typically less independent than their peers in developed countries (in fact, Jacome and Vasquez, 2008[11], quantified the negative relationship that exists between effective independence and the inflation rate in the case of Latin America and Caribbean countries).

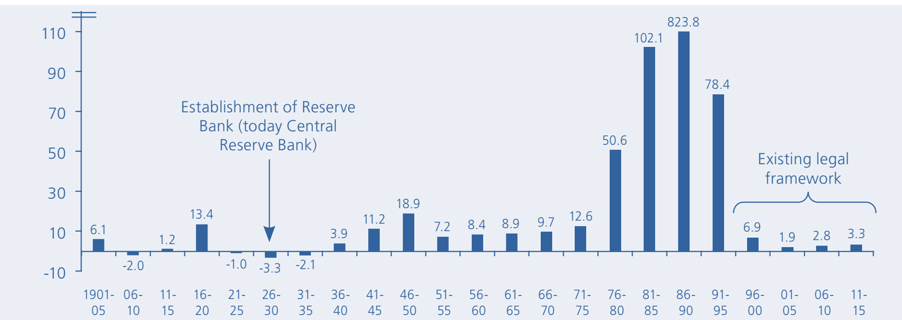
It is important to highlight that the financial independence of the central bank in the definition of effective independence has to do with the flexibility of its balance sheet to comply with the objective of price stability. If a central bank were restricted to some extent in its budget, it would have difficulties, for example, in accompanying the monetary policy measures it could invoke –the costs of sterilizing currency or foreign exchange interventions, for example– and could lose credibility.

Beblavy (2003)[12] and Bini (2007)[13] suggest financial independence is essential because if the other State powers determine the budget allocated to the staff and the operating costs of a central bank, there is a significant risk that these factors may influence the decisions of the central bank officials. In fact, Bini (2007) points out that the European Central Bank has argued that central banks' finances must not depend on the Government or Congress or any other entity.

In summary, economic literature emphasizes that the independence of central banks should not only be established by law (de jure independence), but also that it must translate into effective independence in practice (de facto independence); that is, it must include a set of formal and informal arrangements that make price stability a recognized objective (Cukierman, 2006[14]).

The emphasis on the effective autonomy is important to understand the periods of high inflation observed in Peru since Banco de Reserva del Peru was founded in 1922 –this bank later become BCRP in 1931– to date (see the graph below). The evidence suggests that there is a link between the episodes of monetary instability and transgressions of the effective independence of BCRP (see Orrego, 2007[15]).

INFLATION
(Average period, %)



Memo: Graph has not scale in the period 1986-1990.
Source: INEI and BCRP.

11 Jacome, Luis y Francisco Vásquez (2008). Is there any link between legal central bank independence and inflation? Evidence from Latin America and the Caribbean. European Journal of Political Economy 24: 788-801.

12 Beblaby, Miroslav (2003). Central bankers and central bank Independence. Scottish Journal of Political Economy 50(1): 61-68.

13 Bini, Lorenzo (2007). Central bank Independence: From theory to practice. Speech given at the Conference Good Governance and Effective Partnership, Budapest, Hungarian National Assembly.

14 Cukierman, Alex (2006). Independencia del banco central e instituciones responsables de la política monetaria: Pasado, presente y futuro. Economía Chilena 9(1): 5-23.

15 Orrego, Fabrizio (2007). Autonomía del Banco Central de Reserva del Perú: Una perspectiva histórica, Revista Moneda 135: 16-22.

It is no coincidence that periods of high inflation in the history of the BCRP have been accompanied by legal frameworks and practices that exposed the Board of BCRP to external pressures, not necessarily related to the preservation of price stability. Unfortunately, the periods of low economic growth in the past 60 years typically have been accompanied not only by high inflation, but also by high price volatility (see table below).

INFLATION AND REAL GDP GROWTH
(%)

Period	Average Inflation	Volatility of inflation 1/	Average GDP growth
1951-1960	7.8	2.4	5.5
1961-1970	9.3	4.8	5.3
1971-1980	30.2	23.0	3.7
1981-1990	332.1	2,428.4	-1.0
1991-2000	38.1	124.9	3.9
2001-2010	2.4	1.5	5.6
2011-2015	3.3	0.3	4.7

1/ SD of inflation in the period.
Source: BCRP.

Today, monetary policy actions take place within the framework of the organic law of BCRP of 1992 and the political Constitution of 1993, which establishes that the Central Bank of Peru is a legal entity with and that its sole purpose is to preserve monetary stability.

Article 86 of the Organic Law of BCRP establishes that the Bank has independence in terms of its budget and that it is responsible for the programming, formulation, approval, implementation, extension, modification, and control of the institutional budget. The Board sets the remuneration of the governor of the Bank, its general manager, and approves the salary structures for the senior officials and workers in general proposed by the general manager. The latter also hires the staff required to fulfill the functions of the Bank in accordance with the Bank's by-laws and with the policies established by the Board of Directors, as well as with requirements of job openings[16].

Therefore, the strong effective independence of BCRP is also an important element that underpins the recent success of BCRP in controlling inflation (inflation in Peru registers an average annual rate of 2.7 percent in the past fifteen years).

16 Moreover, article 92 establishes that 75 percent of the Bank's net profits must be part of a reserve which can be used for capitalization. In addition, article 93 establishes that in the event that the Bank shows losses, the losses will be covered by the above-mentioned reserve and that if this reserve were insufficient, the Treasury will issue and give the Bank negotiable interest-bearing debt securities for the amount non-covered within thirty days after the Balance has been approved.

Box 4
LONG-TERM OUTLOOK FOR DOLLARIZATION IN PERU

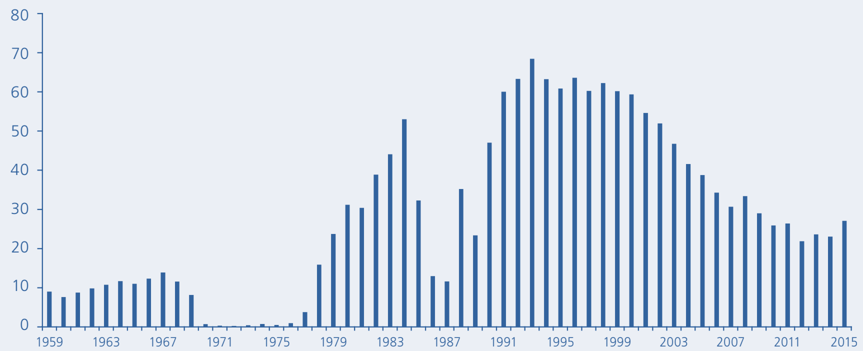
Dollarization started in Peru in the 1940s and deepened in the 1980s in response to high, persistent, and increasing levels of inflation. For economic agents, dollarization represented the possibility of protecting the value of their savings and reducing the loss in the value of nominal assets that inflation also implies. Brazil and Chile experienced high inflation as well, but their economies did not become dollarized.

AVERAGE INFLATION RATE
(%)

	1975-1980	1981-1990	1991-2000	2001-2015
Bolivia	29	251	9	5
Brazil	61	336	200	7
Chile	93	20	9	3
Colombia	24	24	20	5
Costa Rica	11	26	16	8
Dominican Republic	13	23	10	9
El Salvador	14	19	8	3
Honduras	9	8	18	7
Mexico	23	65	18	4
Panama	5	2	1	3
Paraguay	15	28	13	7
Peru	46	1,046	38	3
Uruguay	58	61	35	9

In Peru, interest rate limits and the lack of availability of indexing instruments led to dollarization, whereas in other countries in the region the high levels of inflation generated the indexing of prices, wages, and financial assets. This was the case of Chile and Brazil in the region.

RATIO OF DOLLARIZATION IN THE FINANCIAL SYSTEM 1/
(1965-2015)



1/ Liquidity in foreign currency / Total liquidity.

When inflation is high, the domestic currency loses its function as a store of value vis-à-vis a currency that keeps its value (in this case, the dollar). Because savings are more vulnerable to inflation, they are what is first dollarized. This leads financial entities to offer loans in dollars to avoid mismatches in their balance sheets. Then, if inflation persists, foreign currency begins to be accepted as a means of payment. If revenues are converted into dollars (to preserve their value), people start trading in dollars and finally, prices are set in dollars.

Hysteresis

Although the paragraph above explains why dollarization appears, the question that we still have to answer is why dollarization persists once inflation has decreased. This phenomenon is known as hysteresis.

The program of stabilization and liberalization of the economy implemented in the early 1990s included a series of measures aimed at easing the use of foreign currency in a context marked by strong lack of confidence in the domestic currency and low levels of financial intermediation (credit came to represent only 9.4 percent of GDP in 1991). Restrictions on the purchase and sale of foreign currency were eliminated and, in order to simplify currency exchange procedures, financial entities were authorized to do these transactions and to transfer foreign currency, the only requirement being the presentation of an affidavit (this requirement was also eliminated later). All the restrictions on capital flows to other countries were also eliminated, which allowed both national and foreign residents to open bank accounts in the country and abroad, and the country returned again to a situation that allowed the free holding of accounts in foreign currency.

As a result of these changes, economic agents learned how to use foreign currency and financial entities learned about investment to reduce the transaction costs associated with it, generating in this way a bi-monetary banking and payment system that persists today. This widespread use of foreign exchange and the accumulation of social and physical capital that reduces the cost of trading in foreign currency is in line with the explanation proposed by Uribe (1997) as a theory to explain the hysteresis in dollarization.

Dollarization with Low Inflation

Since the cost of exchanging money from a currency to another currency is minimal for private agents in Peru, the decision of using soles or dollars for financial assets and liabilities becomes a portfolio decision.

For companies that export goods abroad, dollar-denominated loans are a natural choice because their revenue is in dollars, while other companies that require imported inputs have deposits in dollars to have some degree of coverage.

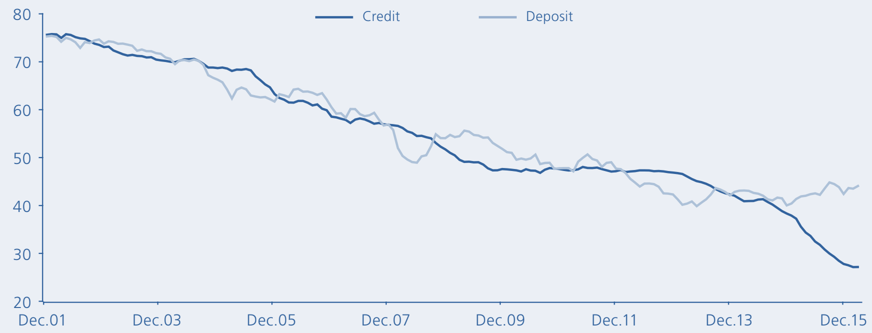
Households have a part of their savings in dollars to buy durable assets priced in dollars (e.g., apartments, houses, and land) or as a hedge against dollar fluctuations affecting the prices indexed to the dollar in the basket of goods they consume.

In this context of strong dollarization, the Central Bank has initiated a de-dollarization program, encouraging de-dollarization in several ways:

- Maintaining domestic inflation at similar rates to those observed abroad to encourage economic agents to save in soles.
- Establishing higher reserve requirements in foreign currency for domestic agents to make them internalize the risk that using foreign currency implies for financial stability.
- Establishing conditional reserve requirements to the evolution of total credit in foreign currency as well as to car loans and mortgage loans in foreign currency with the aim of reducing the balance of these loans in the financial system.

Even though the ratio of dollarization in both loans and deposits has decreased significantly in recent years as a result of these measures, it is worth pointing out that there is still room to reduce further the dollarization of credit (in segments such as car loans and mortgage loans, for example) as well as the dollarization of deposits.

RATIO OF DOLLARIZATION OF CREDIT AND DEPOSITS
(%)



BCRP will continue paving the way so that the domestic currency continues gaining ground. In the case of deposits, continuing with the de-dollarization process will require another type of measures, which could include, for example, promoting financial literacy in schools so that students learn about the risks of dollarization, promoting regulations to discourage setting the prices of final goods and inputs in dollars or requiring that prices be displayed in soles as well –the consumer protection code of 2010 already includes such a regulation–, and deepen the capital market in domestic currency to provide companies with greater financing options.

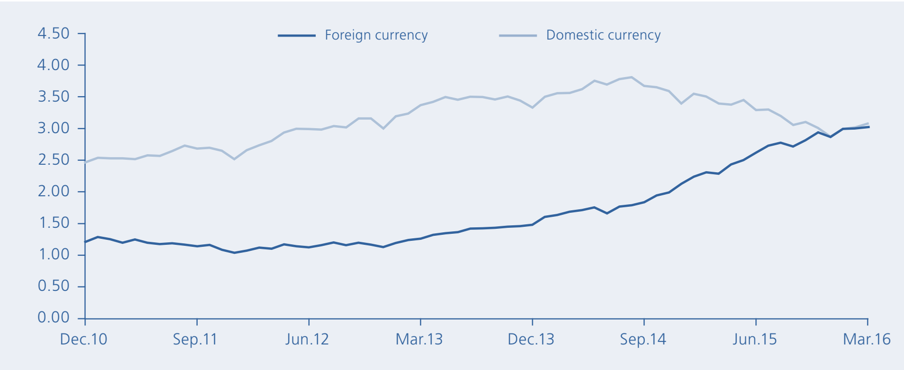
It should be pointed out that some of these measures go beyond the scope of monetary policy and require the cooperation of other government institutions.

Box 5

BANK DELINQUENCY RATES AND THE DOLLARIZATION OF CREDIT

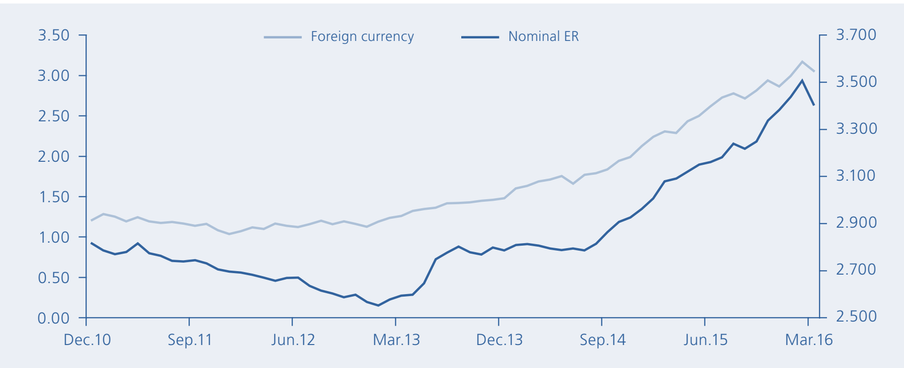
This box explores the relationship between non-performing loans rates and the dollarization of credit since end-2010. The delinquency rate of loans in local currency has shown an upward trend in recent years, rising from 2.5 percent in December 2010 to 3.8 percent in August 2014, but has then recorded a downward movement (3.1 percent in March 2016). On the other hand, the delinquency rate of loans in dollars showed some stability until December 2013 (1.5 percent, from 1.3 percent in December 2010), but has recently recorded a rising trend (3.1 percent in March 2016) that coincides with the period of exchange-rate depreciation.

DEPOSITORY CORPORATION: INDEX OF NON-PERFORMING



As illustrated in the graph below, the increase in the non-performing rates of loans in dollars shows a faster pace with the exchange rate depreciation, particularly since mid-2014, and reverses slightly at the end of the period analyzed, which also coincides with the appreciation of the sol observed since the end of February 2016.

DEPOSITORY CORPORATION:
NON-PERFORMING LOANS IN FOREIGN CURRENCY AND EXCHANGE RATE



The rise in the rates of non-performing loans in dollars extends to all types of credit, but is particularly noteworthy in the case of credit to the segment of small and micro-enterprises, whose delinquency rates increased from 4.7 and 3.7 percent in 2010 to 19.3 and 10.5 percent, respectively, in March 2016. An increase in also observed in the portfolio of non-performing consumer loans and mortgage loans, whose rates rise from 2.1 and 1.1 percent in 2010 to 5.3 and 3.3 percent, respectively, in March 2016.

DEPOSITORY CORPORATION: NON-PERFORMING LOANS IN FOREIGN CURRENCY

	Total	Large companies	Medium-sized enterprise	Small business	Micro-businesses	Consumer	Mortgage
2010	1.2	0.2	2.5	4.7	3.7	2.1	1.1
2011	1.0	0.2	2.1	4.4	2.1	1.9	0.9
2012	1.1	0.4	2.3	4.6	1.7	2.0	0.8
2013	1.5	0.4	3.0	7.0	3.8	2.6	1.1
2014	2.1	0.8	4.2	9.9	4.0	3.4	1.6
2015	2.9	1.5	5.5	16.3	7.9	4.6	2.9
Mar.16	3.1	1.7	6.0	19.3	10.5	5.3	3.3

This delinquency behavior would be reflecting the effect of the depreciation of the domestic currency on borrowers' capacity to repay the loans due to the currency mismatches underlying these loans. When there are currency mismatches, depreciation increases both the amount of the debt and the need for cash flows to pay the principals and the interests on them. Even though the current ratio of non-performing loans to total loans is low and does not compromise banks' solvency, the increase in the delinquency rates of loans in dollars illustrates the risks of the dollarization of credit and corroborates the need to continue supporting the process of de-dollarization of banks' loan portfolios, particularly in the higher risk segments, such as loans to people.

In this line, in November of 2015 the BCRP announced that the de-dollarization of credit program that started a year earlier would continue in 2016 and established that banks' balance of car loans and mortgage loans should be reduced by 10 percentage points per annum until the banks' balances of these loans reached a sum equivalent to 5 percent of banks' assets.

The significant de-dollarization of credit recorded during 2015 and so far in 2016, which has involved a reduction of the balance of credit in dollars of around US$ 6 billion, has limited the effects of the exchange rate depreciation on non-performing loans and has also offset through this mechanism the effects on the soundness of the financial system, strengthening the system's resilience to face significant depreciation shocks. An econometric analysis corroborates these arguments demonstrating the statistical significance of the de-dollarization program, the impact of reserve requirements in dollars on the reduction of non-performing loans in dollars, and the strong effect of the exchange-rate depreciation on the delinquency indicator.

The analysis estimates a linear model using ordinary least squares (OLS). The dependent variable is the rate of growth of non-performing loans[17] and the regressors are exogenous variables, such as the program of de-dollarization and the Fed interest rate. In the case of the exchange rate, the exogeneity test carried out provided evidence in favor of this hypothesis. The results show statistical significance both in the reserve requirement measures (negative sign) and in the nominal exchange rate (positive sign) as well as in the de-dollarization program (negative sign), which is statistical evidence supporting the hypothesis that periods of depreciation of the domestic currency generate upward pressures on the rates of the portfolio of non-performing loans in foreign currency. The results also show that the reserve requirement measures and the program of de-dollarization have contributed to offset the increase in the delinquent portfolio by tightening credit conditions in dollars. It is estimated that if the de-dollarization of credit program had not been introduced, the amount of the debt in the delinquent portfolio in dollars would have been 50 percent higher than the one observed, as a result of which the rate of banks' non-performing loans would have been 2 percentage points higher than its current rate.

17 Defined as refinanced loans, due loans, or debt in judicial collection.

REGRESSION MCO

Variable dependent: Growth rate of non-performing loans
Sample period: December 2010 - March 2016 (Monthly)

Regresors:	Coefficient	p-value
Constant	0.21	0.00
Reserve requirement in FC	-0.01	0.00
Nominal exchange rate 1/	0.19	0.02
De-dollarization Program 2/	-0.03	0.00
FED interest rate	0.06	0.24
Statistics:		
R2	0.28	
Durbin-Watson	2.56	
Exogeneity Test - p-value: Null of exogeneity of Nominal Exchange rate is non rejected	0.45	

1/ In differences.
2/ Variable dummy, 0 (until December 2014), from 0 to 1 (between January and June 2015), and after setting in 1.

VI. Inflation

Execution to May 2016

78. The rate of inflation accumulated in the last twelve months declined from 4.47 percent in February 2016 to 3.54 percent in May 2016 as a result of the reversal of the supply shocks caused by El Niño, the reduction of expectations of inflation, and the appreciation of the sol observed since February.

Graph 80
INFLATION AND INFLATION TARGETING
(Last 12-month % change)

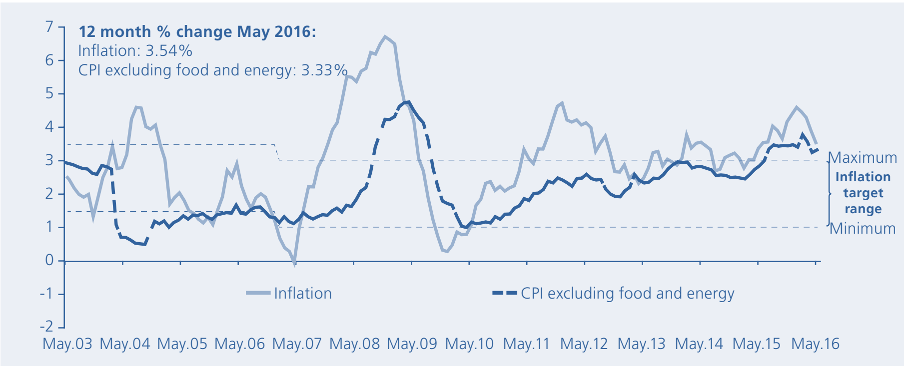


Table 51
INFLATION
(% change)

	Weighted	2011	2012	2013	2014	2015	2016 Jan.-May.	2016 12-months
CPI	**100.0**	**4.74**	**2.65**	**2.86**	**3.22**	**4.40**	**1.37**	**3.54**
1. CPI excluding food and energy	**56.4**	**2.42**	**1.91**	**2.97**	**2.51**	**3.49**	**1.51**	**3.33**
a. Goods	21.7	2.37	1.60	2.62	2.43	3.57	1.63	3.58
b. Services	34.8	2.45	2.10	3.18	2.55	3.44	1.44	3.18
2. Food and energy	**43.6**	**7.70**	**3.55**	**2.73**	**4.08**	**5.47**	**1.21**	**3.78**
a. Food and beverages	37.8	7.97	4.06	2.24	4.83	5.37	1.63	4.10
b. Fuel and electricity	5.7	6.01	0.22	6.09	-0.85	6.20	-1.71	1.59
Fuel	2.8	7.54	-1.48	5.95	-5.59	-6.33	-4.46	-5.03
Electricity	2.9	4.30	2.19	6.23	4.37	18.71	0.47	7.20

Table 52
INFLATION
(Weighted contribution)

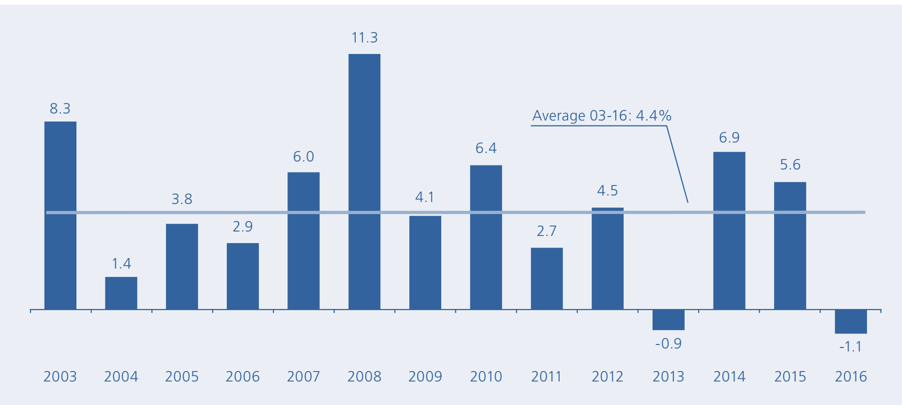
	Weighted	2011	2012	2013	2014	2015	2016 Jan.-May.	2016 12-months
CPI	**100.0**	**4.74**	**2.65**	**2.86**	**3.22**	**4.40**	**1.37**	**3.54**
1. CPI excluding food and energy	**56.4**	**1.36**	**1.05**	**1.62**	**1.37**	**1.89**	**0.81**	**1.80**
a. Goods	21.7	0.51	0.34	0.54	0.50	0.73	0.33	0.73
b. Services	34.8	0.85	0.71	1.08	0.87	1.16	0.48	1.06
2. Food and energy	**43.6**	**3.38**	**1.60**	**1.24**	**1.86**	**2.51**	**0.56**	**1.74**
a. Food and beverages	37.8	3.03	1.59	0.89	1.91	2.15	0.66	1.65
b. Fuel and electricity	5.7	0.35	0.01	0.35	-0.05	0.36	-0.10	0.09
Fuel	2.8	0.23	-0.05	0.18	-0.18	-0.18	-0.12	-0.13
Electricity	2.9	0.12	0.06	0.17	0.12	0.54	0.02	0.23

79. The decrease observed year-to-date in the prices of perishable agricultural foodstuffs is the result of price corrections after the strong price rises registered in 2015 due to El Niño, the prices of potatoes and vegetables showing the biggest reversals.

Table 53
CPI AND PERISHABLE AGRICULTURAL FOOD
(Monthly % change)

	January - May
2002-2015	
CPI	0.31
Perishable agricultural food	0.98
2015	
CPI	0.44
Perishable agricultural food	1.10
2016	
CPI	0.27
Perishable agricultural food	-0.22

Graph 81
PERISHABLE FOOD
(% change, January- May)



80. In the period of January – May, the items with the higher positive contribution to inflation were education costs (tuition and fees) and meals outside the home. On the other hand, the items with the higher negative contribution to inflation were gasoline and foodstuffs, such as potatoes.

Table 54
ITEM WITH THE HIGHEST WEIGHTED CONTRIBUTION TO INFLATION: JANUARY - MAY 2016

Positive	Weight	% chg.	Contribution	Negative	Weight	% chg.	Contribution
Education costs (tuition and fees)	8.8	4.8	0.46	Potato	0.9	-27.8	-0.37
Meals outside the home	11.7	2.9	0.39	Gasoline and lubricants	1.3	-10.4	-0.12
Other fresh fruits	0.4	24.0	0.10	National transportation	0.3	-18.6	-0.07
Other vegetables	0.4	15.7	0.08	Fresh legumes	0.2	-14.1	-0.05
Toiletries	4.9	1.6	0.07	Avocado	0.1	-24.1	-0.04
Eggs	0.6	13.7	0.07	Olluco and alike	0.1	-26.4	-0.03
Tomatoes	0.2	32.9	0.07	Corn	0.1	-11.9	-0.02
Onion	0.4	22.1	0.07	Poultry meat	3.0	-0.6	-0.02
Medicinal products	2.1	2.5	0.05	Papaya	0.2	-7.1	-0.01
Cigarettes	0.1	29.0	0.05	Grapes	0.1	-9.5	-0.01
Total			**1.41**	**Total**			**-0.74**

Education Costs

81. Prices in the category **"Education: tuition and fees"** increased 4.8 percent, the highest rises being observed in the months of February (1.4 percent) and March (3.1 percent) when the school year starts. Tuition prices rose in February in both public and private schools, and education fees increased in private schools in March (8.0 percent versus 6.4 percent in March 2015). The variation of prices registered in this category in the last twelve months is 5.4 percent, higher than the one observed in the general price index (3.5 percent).

Meals Outside the Home

82. In the first five months of 2016, prices in the category "**meals outside the home"** rose 2.9 percent, showing a higher increase than that recorded in the prices of food consumed in the household (1.0 percent) and higher than that observed in the general price index (1.37 percent). This result reflected consumers' greater preference for this service. In the last twelve months, the prices in this category show an increase of 5.4 percent, higher than the inflation rate (3.5 percent) and higher than the price rise registered in total food consumed in the household (3.4 percent).

Medicines and Personal Care Items

83. In January-May, rises were observed in the prices of goods with a high imported content or in the prices of products that are set according to the evolution of the

dollar, such as **medicines** (2.5 percent) and personal care items (1.6 percent). However, in the last twelve months the price of medicines has increased 5.4 percent, while the prices of personal care items have increased 3.3 percent, showing lower rates than devaluation (5.9 percent).

Cigarettes

84. In May the Government increased the rate of the excise tax on tobacco and black tobacco by 157 percent, from S/ 0.07 to S/ 0.18 per cigarette (D.S. 112-2016-EF, enacted on May 5, 2016). This had an impact on the price of **cigarettes**, which increased 23.0 percent in May (29.0 percent in the period of January-May).

Gasoline and Lubricants

85. In January-May, the prices in the category **gasoline and lubricants** decreased on average 10.4 percent, in line with the evolution of the ex plant prices set by local refineries. The price variation in this category in the last twelve months was negative (-13.9 percent), but lower than that recorded in the international price of WTI oil (-20.9 percent), which would be associated with the commercial policy of each company and with the evolution of the exchange rate. Another factor that plays a role in fuel prices is the benchmark prices set by Osinergmin based on the international price of crude oil and the evolution of fuel prices in the U.S. market. In May these reference prices increased due to the higher seasonal consumption of fuel in the U.S. coast and due to the operative stoppages in the Gulf refineries, which would have affected mainly the prices of petroleum diesel (4.5 percent) and gasoline (4.0 percent) in the local market. Moreover, the international price of WTI oil rose from US$ 41.0/barrel in April to US$ 46.9/barrel in May, the highest price observed since July 2015 (US$ 51.2 a barrel).

Foodstuffs

Other Fresh Fruits

86. In the period of January-May the prices in the category **"other fresh fruits"** showed a variation of 24.0 percent, with the price rises recorded in March (8.9 percent) and April (8.6 percent) standing out. The biggest rise was recorded in the price of strawberries, a product grown in the valleys of Lima whose supply declined due to seasonal factors. Rises were also observed in the prices of mangos and pineapples due mainly to the higher demand for these products in the summer. The prices in this category show a variation of 2.0 percent in the last twelve months, which is explained mainly by the seasonal fall in prices in the second half of 2015.

Other Vegetables

87. In the first five months of the year, the prices of "**other vegetables"** increased 15.7 percent mainly as a result of the increase in the price of goods such as broccoli,

lettuce, and leek. These crops are cultivated in the valleys of Lima and require temperate climates. Their prices were affected not only by seasonal factors, but also by warmer temperatures that affected their cultivation and by higher losses during the marketing process due to heat. In the last twelve months this category showed a negative variation of -5.0 percent, which reflected a higher seasonal supply in the second half of 2015.

Eggs

88. In the first five months of the year, the price of **eggs** rose 13.7 percent. The greatest increases were observed in the months of March (7.4 percent) and April (12.0 percent). In a context of increased supply –egg production is estimated to have grown 2.6 percent in January-April compared to the same period of 2015–, this is explained by a higher seasonal demand and by the relative lower price of this product in comparison with other foodstuffs with high protein content. In the last twelve months the price of eggs fell 1.7 percent, which is associated with the high level of supply observed.

Tomatoes

89. In January-May the price of **tomatoes** recorded a 32.0 percent increase, due mainly to the decline of areas cultivated with this crop in Lima, the main supplier area (down by 9 percent in November-January compared to the same period in the previous crop year). In addition, higher temperatures in the summer months would also have affected the quality of this crop. The national production of tomatoes dropped 14.0 percent in the period January-April compared to the same period in the previous year. The variation in the price of tomatoes was 23.0 percent in the last twelve months.

Onions

90. The price of **onions** recorded an increase of 22.1 percent in the first five months of the year, the higher rises being observed in the months of March and April (6.9 and 12.3 percent, respectively), which is consistent with the seasonal evolution of onions. In addition to this, warmer weather conditions in Arequipa and limited humidity in the soil during most of the farming season would have affected the quality of the crop, increasing the wholesale price of first-quality onions. In the last twelve months, onions showed a negative price variation (-6.6 percent) due to increased seasonal supply during the second half of 2015.

Potatoes

91. The price of **potatoes** was one of the prices that showed negative variations (-27.8 percent). Factors contributing to this included the greater supply recorded in the months of February to April as result of earlier crops in some areas of Huánuco as

well as the supply of potatoes from Junín and Ayacucho, which was similar to the supply of these areas in the previous crop year. In addition to this, the supply was also favored by the improvement of weather conditions in recent months (light rainfall and mild temperature variations).

Forecast for 2016

92. In 2016 inflation is expected to return to the target range, favored not only by a lower imported inflation in a context of lower exchange rate pressures, but also by the improvement being observed in inflation expectations and by the reversal of the supply shocks that affected the prices of perishable agricultural foodstuffs last year (0.0 percent increase is expected this year, whereas in 2015 these prices increased 13.3 percent).

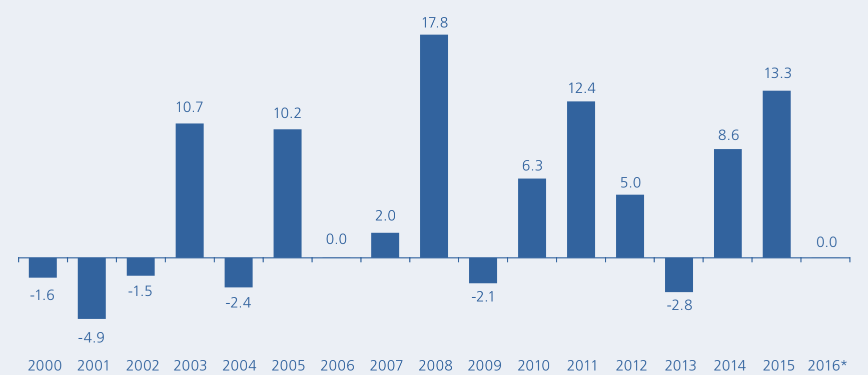
    Thus, inflation is expected to register a rate of 2.9 percent, a rate below the upper limit of the target range and lower than the 4.4 percent rate recorded in 2015.

Table 55
INFLATION 2009-2016
(12 month % change)

	Weighted	2009	2010	2011	2012	2013	2014	2015	2016*
CPI	**100.0**	**0.2**	**2.1**	**4.7**	**2.6**	**2.9**	**3.2**	**4.4**	**2.9**
Food and energy	**43.6**	**-0.9**	**3.0**	**7.7**	**3.6**	**2.7**	**4.1**	**5.5**	**2.6**
a. Food	37.8	0.6	2.4	8.0	4.1	2.2	4.8	5.4	3.0
b. Energy	5.7	-10.4	6.8	6.0	0.2	6.1	-0.9	6.2	-0.1
CPI excluding food and energy	**56.4**	**1.7**	**1.4**	**2.4**	**1.9**	**3.0**	**2.5**	**3.5**	**3.2**

* Forecast

Graph 82
PRICE OF PERISHABLE FOOD
(% change)



*Forecast

VII. Inflation Forecast and Balance of Risks

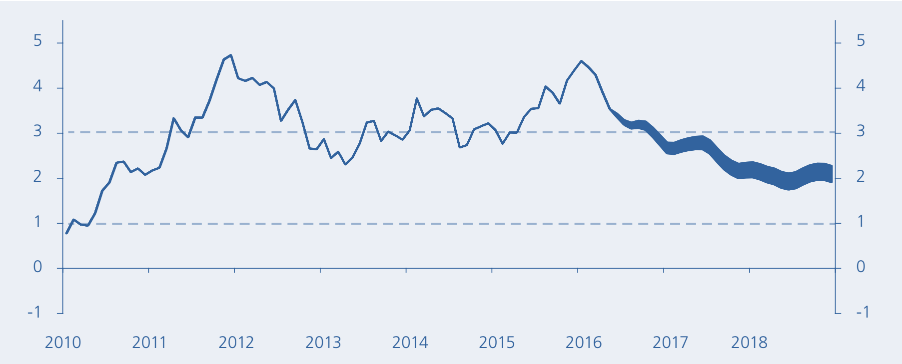
Forecast

93. The BCRP monetary policy actions are based on inflation forecasts and on projections of inflation determinants prepared using the macroeconomic data available at the time a policy action is decided. Indicators standing out as inflation determinants include inflation expectations, imported inflation, and inflationary pressures, all of which are quantified through the concept of the output gap (the difference between GDP and GDP's potential level).

94. In this context, **inflation** is forecast to **fall within the target range by the end of 2016** and to gradually converge to **two percent during 2017 - 2018**. The convergence path foreseen for inflation is similar to that forecast in the Inflation Report of March, in line with the accelerated decline observed in imported inflation in response to the recent appreciation trend registered by the sol in Q2. Inflation's convergence to the target during the forecast horizon is also consistent with a sustained decline of inflation expectations towards the target range during the period as a result of monetary policy actions, as well as with the reversal of the supply shocks on food prices that affected inflation at the beginning of the year, and with economic growth without inflationary pressures on the side of demand.

95. The **risk** that the inflation rate in 2016 will divert from the rate forecast for 2016 has become more moderate in comparison with the Inflation Report of March since factors such as the reversal of the supply shocks, the decline in expectations of depreciation, and the stabilization of commodity prices would ease a more rapid convergence of inflation to the target range. The central forecast considers that, together with the measures taken by the Bank Central, the convergence of inflation expectations towards the target range will contribute to boost inflation's gradual convergence to the inflation target during the monetary policy horizon.

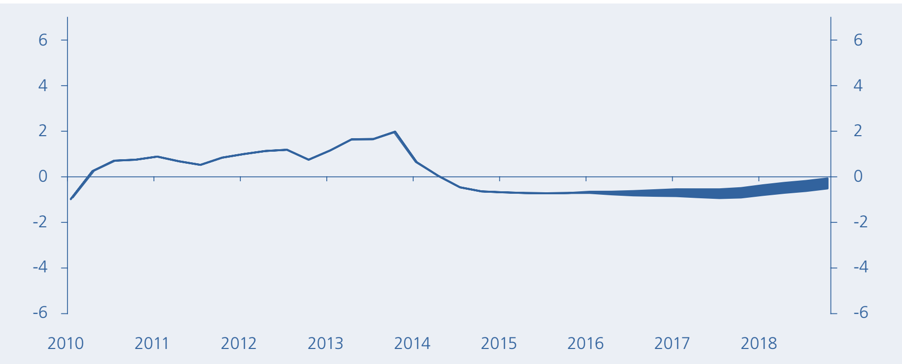
Graph 83
INFLATION FORECAST: 2010 - 2018
(Last 12-month % change)



96. Some aspects of the **determinants of the inflation forecast** are discussed below:

a) The economy would grow at the rate of the potential GDP during 2016 and the **output** would grow at a higher rate than the potential output in 2017 and 2018, which is consistent with a recovery path in the output gap towards its neutral level. This growth would take place without demand inflationary pressures, as indicated by a negative output gap. External conditions would continue to be adverse this year, but would be more moderate during 2017 and 2018 as the prices of commodities stabilize and economic growth in our trading partners shows a faster pace of growth. A positive fiscal impulse on aggregate demand and still expansionary monetary conditions in domestic currency are also expected in 2016.

Graph 84
OUTPUT GAP: 2010 - 2018
(% potential GDP)



Based on the information available to date, it is estimated that the economy will go towards a neutral economic cycle in the forecast horizon. The main determinants of the forecast of the output gap include the following:

- **Business confidence**: A faster recovery in business confidence than that estimated in our previous report is foreseen due to the recent evolution of the domestic economy.

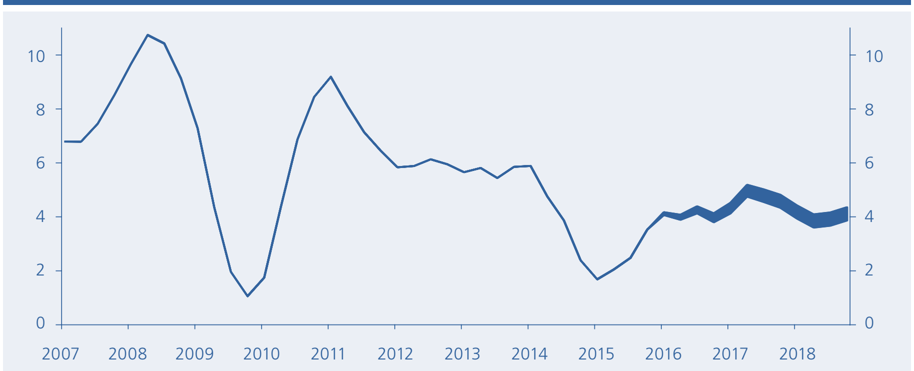
- **External conditions**: More restrictive external conditions than those considered in the Inflation Report of March are now foreseen due to the lower global growth rates and the lower growth estimated in Peru's trading partners: weaker levels of economic activity are expected in the United States and in the Latin American countries, while expectations about growth in China remain unchanged. Moreover, the terms of trade are still estimated to show a moderate deterioration, but lower than that foreseen in our previous report.

- **Fiscal impulse**: The fiscal impulse estimated for 2016 would be positive and higher than that foreseen in the Inflation Report of March, in line with higher-than-expected spending in recent months. In the forecast horizon, the fiscal impulse is expected to show a gradual reduction as from 2017.

- **Monetary conditions**: Monetary conditions in soles are still one of the factors that contribute to the recovery of the output gap. On the other hand, monetary conditions in dollars are anticipated to show a contraction due to the withdrawal of the Fed monetary stimulus programs and to rises in its monetary policy rate.

The growth forecast for the 2016-2018 forecast horizon is consistent with the gradual recovery of the output gap and with a potential output of around 4.0 percent.

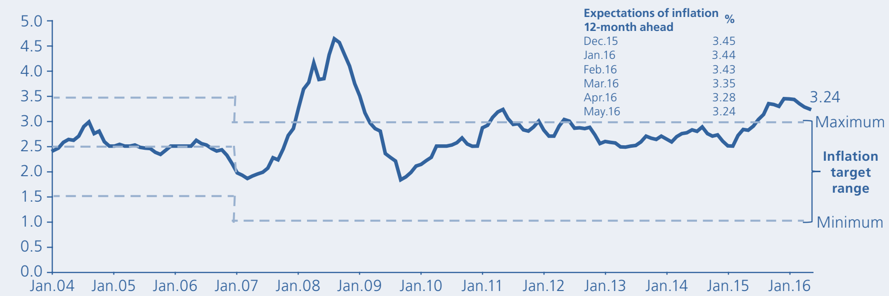
Graph 85
GDP GROWTH FORECAST: 2007 - 2018
(Annual % change)



b) **Expectations of inflation** in 2016 still remain above the inflation target range, but are expected to continue showing a declining pattern towards this range in the following quarters.

The Central Bank will continue to pay close attention to the evolution of inflation expectations in the forecast horizon and will take appropriate monetary policy measures that contribute to ensure inflation's convergence to the target range.

Graph 86
EXPECTATIONS OF INFLATION FOR THE NEXT YEAR*
(%)



* Corresponds to the average of the expectations of the financial system and economic analysts.

Table 56
SURVEY ON MACROECONOMIC EXPECTATIONS: INFLATION
(% change)

		Expectation about:		
		IR Dec.15	**IR Mar.16**	**IR Jun.16***
Financial entities				
	2016	3.3	3.5	3.4
	2017	2.8	3.2	2.9
	2018		3.0	2.5
Economic analysts				
	2016	3.2	3.5	3.5
	2017	3.0	3.0	3.0
	2018		2.9	2.9
Non-financial firms				
	2016	3.1	3.5	2.5
	2017	3.0	3.5	3.2
	2018		3.0	3.0

*Survey conducted during the second fortnight of February 2016.

c) **Imported inflation** reflects the evolution of import prices and the evolution of the exchange rate. Thus, because the estimated nominal depreciation has been revised down, imported inflation is foreseen to be lower than expected in the March Inflation Report.

As regards **international prices**, the prices of the main imported commodities are foreseen to show a higher upward trend than that forecast in the previous report, especially the price of oil.

As for **expectations of depreciation**, the recent survey on expectations about the dollar-nuevo sol exchange rate shows that economic agents expect lower rates of depreciation of the sol during the forecast horizon, in line with an international environment that is different from the one observed at the end of February and in March 2016. The monetary stimulus programs of the European Central Bank and the change in expectations about the rise in the Fed policy interest rate have favored the currencies of commodity-exporting emerging countries. This has become tangible with non-resident investors' adjustment of their positions in dollars as well as with residents' lower demand for dollars.

Table 57
SURVEY ON MACROECONOMIC EXPECTATIONS: EXCHANGE RATE
(Soles per US$)

		Expectation about:		
		IR Dec.15	IR Mar.16	IR Jun.16*
Financial entities				
	2016	3.50	3.65	3.50
	2017	3.50	3.70	3.60
	2018		3.70	3.65
Economic analysts				
	2016	3.50	3.65	3.45
	2017	3.53	3.70	3.53
	2018		3.75	3.58
Non-financial firms				
	2016	3.50	3.60	3.50
	2017	3.50	3.70	3.52
	2018		3.70	3.60

*Survey conducted during the second fortnight of February 2016.

d) The **supply shocks** that affected inflation in 2015 and in early 2016 have been reversing. This trend is expected to remain during the forecast horizon.

Balance of Risks in the 2016 – 2018 Horizon

97. Every forecast is subject to the occurrence of unanticipated events that may divert the forecast from the central scenario. In a context of uncertainty, the materialization of some risks may imply a different rate of inflation than the one forecast originally. As regards the inflation forecast, the events that could most likely divert the inflation rate from the baseline scenario include the following:

a. **Lower global growth**

The baseline scenario considers a slower recovery in the world economy in 2016-2018 than the one estimated in our Inflation Report of March, due mainly to lower growth in the United States, Japan, and in some emerging economies. However, if such recovery were to take even longer, the resulting lower external impulse would translate into a lower output gap and into lower domestic inflation.

b. **Negative domestic demand shocks**

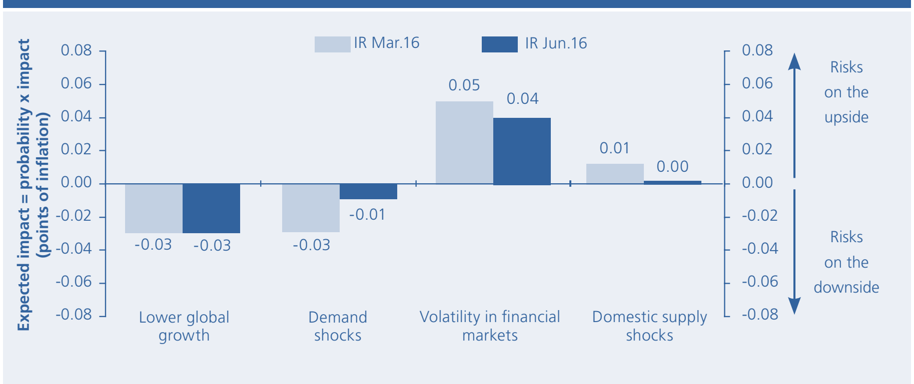
Economic recovery could take longer than expected if the implementation of investment projects were postponed, which would imply a more negative output gap and lower inflation in the forecast horizon. The probability of occurrence of such scenario has decreased in comparison with our previous report due to the recovery of public investment.

c. **Increased volatility in international financial markets**

This risk could materialize if unanticipated rises in the policy rate of the U.S. Federal Reserve brought about volatility in international financial markets. In such case, this could generate capital outflows from the emerging markets and depreciation pressures on the currencies of these countries, which could lead to higher inflation. However, this risk has become more moderate, as reflected in the change of expectations about a rise in the Fed interest rate.

98. The balance of the above-mentioned risks remains neutral for the inflation forecast, so the probability that factors will affect inflation on the upside is equal to the probability that factors will imply a lower price increase.

Graph 87
BALANCE OF RISKS AGAINST THE BASE SCENARIO



Conclusions

99. Inflation is still forecast to converge towards the inflation target range in the 2016-201 forecast horizon, which is consistent with economic growth without demand inflationary pressures, the reversal of supply shocks, a declining trend in inflation expectations, and with lower rates of imported inflation.

    The Central Bank will continue to pay careful attention to the evolution of inflation expectations and other inflation determinants. The BCRP stands ready to adjust its monetary stance, should it be necessary, to ensure inflation's convergence to the inflation target range.

Box 6

INFLATION TARGETING SCHEMES AND COUNTERCYCLICAL MONETARY POLICIES

This box discusses recent empirical evidence that shows a significant change in the nature of central banks' response to external shocks in the emerging market countries. In countries with inflation targeting schemes, like those used by a large number of central banks in the world, including the Central Bank of Peru, the monetary policy response to shocks that divert inflation from the target range depends on the nature of the inflation targeting scheme used.

Thus, when there is a shock on the side of demand, the central bank can implement an anti-inflationary monetary policy which is at the same time countercyclical (expansionary during the period of economic slowdown and restrictive during a boom episode). This is so because when the economy is facing demand shocks: a negative (positive) shock will cause an economic slowdown and deflationary (inflationary) pressures and the central bank responds reducing (increasing) the interest rate, which stabilizes both inflation and growth. Economic literature denominates this situation the 'divine coincidence' (Blanchard and Galí, 2005)[18].

However, when the shocks are on the side of supply, that is, when increases in inflation and economic slowdown are observed simultaneously, monetary policy cannot reach in the short term a recovery in the pace of growth of economic activity and reduce inflation as well. Much of the supply shocks are transitory and therefore, their effects on inflation reverse rapidly and there are no significant effects on activity. In these cases, there is usually no monetary policy response. However, when supply shocks are persistent (and include lower growth of the potential output), the response of monetary policy must maintain inflation expectations anchored to preserve the credibility of the central bank's inflationary policy. In this context, an expansionary monetary policy cannot stimulate the economy without generating inflation and, therefore, greater future costs to control inflation.

In the past, the lack of credibility of central banks in the Latin American region led central banks to react raising their interest rates in response to negative external shocks, thus being procyclical in their policy responses. This was the response given to avoid strong depreciations in the exchange rate, which typically resulted in high inflation rates given the high pass-through of the exchange rate to inflation or in that the stability of the financial system were affected when the balance sheet effects were significant.

Fortunately, about a third of the emerging countries have "graduated" in terms of pro-cyclicality during the past 15 years (Vegh and Vuletin, 2012[19]). In the case of monetary policy, these authors argue that significant depreciation scenarios have become less harmful because the independence of central banks enhances their credibility and macro-prudential measures reduce foreign exchange mismatches, which allows central bank to reduce the benchmark interest rate during adverse events.

While it can be argued that, on average, Latin American countries have graduated in terms of policy responses against adverse events (policies have become more countercyclical), this average hides the heterogeneity among countries. On the one hand, there are countries like Chile and Peru which have counter-cyclical monetary policies while, on the other hand, Argentina, Uruguay, and Venezuela are still characterized by their pro-cyclical monetary policies.

18 Blanchard, O y Galí, J. (2005). Real Wage Rigidities and the New Keynesian Model. Journal of Money, Credit, and Banking, supplement to vol. 39 (1), 2007, 35-66

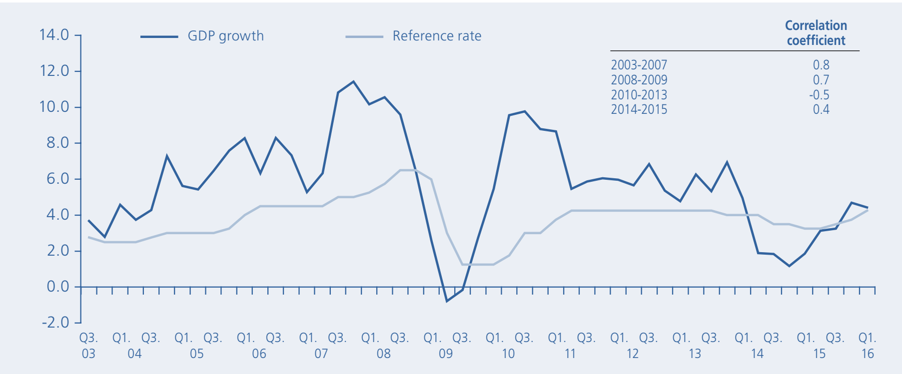
19 Vegh, Carlos, and Vuletin, Guillermo (2012), "Overcoming the fear of free falling: Monetary policy graduation in emerging markets," in The role of Central Banks in financial stability: How has it changed? Federal Reserve Bank of Chicago.

CYCLICALITY OF THE MONETARY POLICY DURING CRISES EPISODIES		
Country	Cyclicality of the monetary policy	
	Before 1998	After 1998
Argentina	-0.55	-0.56
Brazil	-0.17	0.08
Chile	0.08	0.65
Colombia		0.35
Mexico	-0.62	-0.22
Peru	0.11	0.75
Uruguay	-0.52	-0.58
Venezuela		-0.06
Region	-0.28	0.05

(-) Means cyclicality.
Source: Vegh and Vulentin (2014).

In Peru, the Central Bank's independence and the transparency of the inflation targeting scheme have contributed to enhance the credibility of monetary policy and to anchor inflation expectations. In addition to this, the adverse effects of significant depreciation episodes have been offset by a macroeconomic solvency that has evolved positively over the past decade and by macro-prudential policies (particularly, the cyclic use of the instrument of reserve requirements), which has allowed Peru to be one of the countries that uses countercyclical monetary policies in negative scenarios.

GDP GROWTH AND REFERENCE RATE
(2003-2016)



The credibility that monetary policy has gained in recent decades in Peru has allowed it to implement effective monetary policy responses face the global financial crisis, a period in which BCRP used both the benchmark rate –which fell to 1.25 percent, its all-time low– as well as a comprehensive set of monetary instruments to inject liquidity into the financial system, which allowed maintaining expansionary monetary and credit conditions in the country that were essential to minimize the impact of the financial crisis (which contrasts with what happened during the Russian crisis, which had a greater impact on our economy) and led to a rapid recovery of economic activity. All of this allowed to maintain inflation expectations within the target range during the following years.

PERU: INDICATORS OF MACROECONOMIC SOUNDNESS DURING CRISES EPISODIES

		Unity	Russian crisis		Gobal financial crisis	
			Jun.98	1999	Jun.08	2010
Central Bank	NIR /GDP	%	18.3	16.3	30.9	25.0
Banks	Ratio of liquidity in domestic currency	%	21,1	15,0	57,9	48,9
	Ratio of liquidity in foreign currency	%	34,3	39,8	39,8	39,8
	Ratio of dollarization of credit	%	79,1	81,7	52,4	43,3
	Short-term external liabilities / loans	%	19,5	12,7	11,2	2,6
	Shrot-term capital/GDP	%	2,8	-3,0	0,5	-0,2
	Ratio de morosidad de la banca	%	6,1	8,3	1,2	1,5
Public sector	Public debt/GDP	%	44.7	47.1	26.8	23.5
	Dollarization of public debt	%	88.0	87.6	61.2	60.2
	Average term of public debt	Years	7.0	7.5	11.2	12.5
Real depreciation during crises episodies		%	13.0		-9.2	
Nominal depreciation during crises episodies		%	34.3		-12.7	

More recently, face a significant external shock characterized by a persistent decline in the terms of trade and lower capital inflows which generated higher inflation and a slowdown in economic growth in most of the countries in the region, the monetary policy implemented by BCRP was aimed at maintaining inflation expectations within the target range, thereby promoting the growth of economic activity at a level close to that of its potential output. The monetary policy response has been consistent with the nature of this shock, which in contrast to that observed during the international financial crisis which generated a decline in both inflation and growth, shows now in this period a slowdown of growth with higher inflation, which is more consistent with a pattern of a persistent supply shock (and lower growth of the potential output). An appropriate monetary policy response must dispense the monetary impulse in order that inflation expectations remain anchored and the credibility of the central bank is strengthened.

Moreover, the BCRP active use of reserve requirements with macro-prudential purposes has buffered the impact of negative shocks on the financial system while the use of foreign exchange interventions and the accumulation of international reserves have reduced the impact of a depreciation of the exchange rate in economic agents' balance sheets. The use of a greater variety of macro-prudential instruments generates greater space for the use of counter-cyclical monetary policies.

Box 7

ESTIMATION OF THE NATURAL INTEREST RATE

Since BCRP adopted an inflation targeting scheme, monetary policy decisions have been taken anticipating the scenarios foreseen in order that the quantitative inflation target announced may be achieved. Monetary policy decisions are translated into movements in the benchmark interest rate based on and in accordance with macroeconomic conditions. However, knowing whether the benchmark rate will be raised or lowered is not enough to determine if the monetary policy position is expansionary or contractionary. In order to do so, it is necessary to compare this rate with the real "equilibrium" interest rate, and monetary policy would be expansionary (contractionary) if the benchmark rate is below (above) this rate.

The "equilibrium" rate is the short-term real interest rate that is consistent with an economy operating at its potential level and with price stability (Laubach, 2015)[20]. In other words, it is the interest rate we would see if the output gap is zero and if there were no inflationary or deflationary pressures that divert the rate of inflation from its trend. This rate is known as the Natural rate of interest (NI).

Along the same lines, the NI may be understood e TN as the price that balances the demand for loans for investment goods and the offer of real savings (Winkelried and Ledesma, 2010)[21]. Thus, the NI responds gradually to changes in the structure of the economy affecting demand/supply, such as changes in total productivity of factors, external conditions, among other factors.

A benchmark interest rate below the natural interest rate (NI) is considered to reflect an expansionary position, since it induces a positive output gap with the consequent demand inflationary pressures. The NI rate is not directly observable, but measuring it is essential for a proper design of monetary policy. Because of this, central banks have become particularly interested in developing theories and empirical strategies to model and estimate this rate. The Central Bank of Peru monitors estimates on the trends that the NI could show, a task that has become even more relevant in the current context in which constant changes in external conditions have a direct impact on the structure of the Peruvian economy.

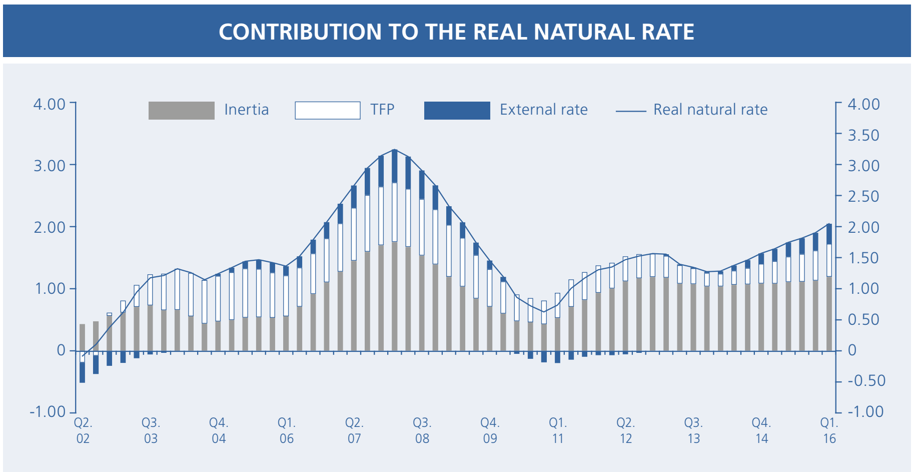
In general, the estimates are the result of statistical techniques used to identify the path of a non-observable variable on the basis of the behavior of related observable variables. In this case, the results displayed are based on the use of an estimate that captures the tendency of the NI from the observed values of the interbank rate and the behavior of its two major determinants: the external real interest rate and total factor productivity.

Prior to determining the estimation results, we can define the sign of the relationships between the NI and its determinants on the basis of the theoretical framework presented. First, we would expect the relationship between the external rate and the NI to be positive, given that, in the context of a small open economy with free capital mobility, there should not be a systematic deviation between the latter and the rate in the international market. On the other hand, the relationship with total factor productivity (TFP) should be also positive, since an increase in TFP raises the expectations of investors on their future return, creating current pressures on aggregate demand and, consequently, on the NI rate.

The graph below shows the results of the estimation of the NI and the contribution of its determinants in each period.

20 Laubach, T., & Williams, J. (2003). Measuring the Natural Rate of Interest. The Review of Economics and Statistics, 1063-1070.

21 Winkelried, D., & Ledesma, A. (2010). Tasa Neutral de Interés. Revista Moneda, 13-17



As we can see, the NI has increased since 2014, driven by higher real external rates. A decline was observed in the potential output in 2014 due to lower production in the primary sector, but this decline in the primary output has begun to reverse in 2015 and in the first quarter of 2016. On the other hand, the external real rates have increased in recent months in line with the interest rate increase approved by the U.S. Federal Reserve. Monetary policy during 2015 has been expansionary since the benchmark rate has been below its natural level. This is consistent with the recovery in the GDP observed in 2015 compared to the previous year.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