CENTRAL RESERVE BANK OF PERU

Summary Inflation Report

September 2016

Since June –when our last Inflation Report was released–, international markets have been affected mainly by the referendum in the United Kingdom which determined the exit of the UK from the European Union, as well as by expectations that the Federal Reserve would start normalizing its policy interest rate in the United States. However, since the resulting financial volatility has had a moderate impact on indicators of world economic activity, the global GDP growth rates projected for 2016 and 2017 have been revised slightly down: from 3.1 to 3.0 percent in 2016 and from 3.5 to 3.4 percent in 2017.

Peru's GDP has been growing at a rate closer to its potential output level, recording a growth rate of 4.0 percent from January to July as a result of the dynamism of traditional exports and sub-national governments' investment. In contrast, private investment, particularly mining investment, continued showing a decline in the first half of the year (-4.6 percent). On the other hand, recent surveys have been showing a favorable trend in business confidence, which is explained mostly by indicators pointing to a more sustainable recovery in production, employment, and income, as well as by changes promoting the implementation of private and public projects.

The projected growth rate of GDP in 2016-2018 is consistent with a gradual closing of the output gap, which would be reflecting that activity is reaching its potential level. In 2016 GDP would grow 4.0 percent and in 2017 and 2018 it is projected to grow 4.5 and 4.2 percent, respectively, this growth trend being sustained by the dynamism of consumption which would show growth rates of 3.8 and 4.0 percent, respectively. Private investment, on the other hand, would start to recover in the next 2 years with growth rates of 5 percent.

Inflation has maintained a clear downward trend due to the reversal of price rises in some foodstuffs affected by El Niño as well as due to the strengthening of the domestic currency by 0.6 percent in the first eight months of the

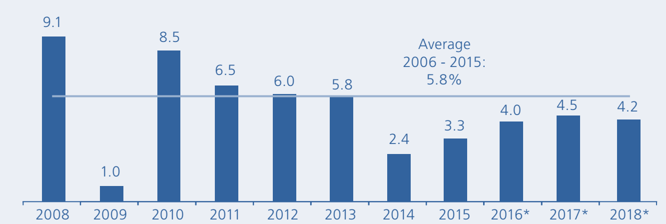
This ***Inflation Report*** was prepared using data on the Balance of Payments at Q2-2016, Gross Domestic Product at June 2016, and Monetary Accounts at July, while data on the operations of the Non-Financial Public Sector, Inflation, Financial Markets, and the Exchange Rate at August 2016.

WORLD GDP GROWTH
(Annual % change)

	Structure % 1/	Trading Peru % 2/	2015	2016* IR Jun.16	2016* IR Sep.16	2017* IR Jun.16	2017* IR Sep.16	2018* IR Jun.16	2018* IR Sep.16
Advanced economies	**42.4**	**47.4**	**2.0**	**1.8**	**1.5**	**1.9**	**1.7**	**1.9**	**1.9**
Of which:									
1. United States	15.8	17.5	2.6	2.0	1.5	2.0	2.1	2.2	2.0
2. Eurozone	11.9	11.0	1.7	1.6	1.6	1.7	1.4	1.6	1.5
Germany	3.4	2.8	1.5	1.7	1.7	1.6	1.4	1.5	1.4
France	2.3	0.9	1.3	1.4	1.3	1.6	1.2	1.6	1.5
Italy	1.9	1.7	0.8	1.1	0.8	1.2	0.9	1.1	1.0
Spain	1.4	2.5	3.2	2.8	2.9	2.2	1.9	2.0	1.9
3. Japan	4.3	3.0	0.5	0.5	0.5	0.6	0.8	0.6	0.8
4. United Kingdom	2.4	1.1	2.2	1.9	1.7	2.1	1.0	2.2	1.7
5. Canada	1.4	4.4	1.1	1.7	1.4	2.3	2.1	2.2	2.2
Emerging market and developing economies	**57.6**	**52.6**	**4.0**	**4.1**	**4.1**	**4.6**	**4.6**	**4.8**	**4.8**
Of which:									
1. Developing Asia	30.6	26.9	6.6	6.4	6.4	6.3	6.3	6.3	6.3
China	17.1	22.2	6.9	6.5	6.5	6.2	6.2	6.0	6.0
India	7.0	2.2	7.6	7.4	7.4	7.6	7.6	7.6	7.6
2. Commonwealth of Independent States	4.6	0.7	-2.8	-0.3	-0.1	1.5	1.4	1.9	1.9
Russia	3.3	0.5	-3.7	-0.8	-0.6	1.2	1.1	1.4	1.4
3. Latin America and the Caribbean	8.3	23.2	0.0	-0.6	-0.4	1.9	1.8	2.4	2.4
Brazil	2.8	4.1	-3.8	-3.8	-3.4	0.2	0.4	1.2	1.2
Chile	0.4	3.2	2.1	1.8	1.7	2.5	2.2	2.7	2.7
Colombia	0.6	3.0	3.1	2.4	2.2	3.0	2.9	3.7	3.7
Mexico	2.0	3.4	2.5	2.6	2.3	2.7	2.5	2.8	2.7
Peru	0.3	-	3.3	4.0	4.0	4.6	4.5	4.2	4.2
World Economy	**100.0**	**100.0**	**3.1**	**3.1**	**3.0**	**3.5**	**3.4**	**3.6**	**3.5**
Memo: Peru's trading partners 2015 2/	65.7		3.1	2.8	2.7	3.1	3.1	3.3	3.2

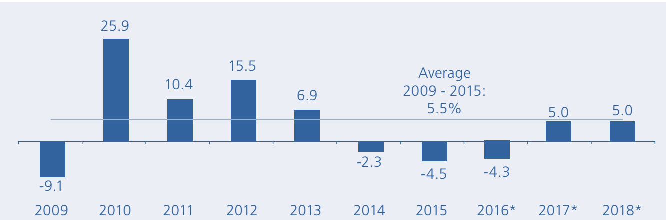
1/ 2015.
2/ Basket of Peru's 20 main trading partners.
* Forecast.
Source: Bloomberg, IMF, and Consensus Forecast.

GDP: 2008-2018
(Real % change)



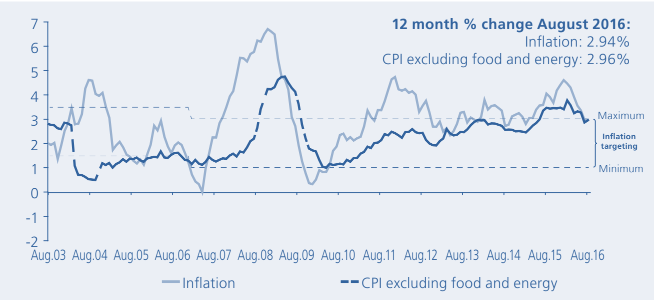
* Forecast.

PRIVATE INVESTMENT: 2009 - 2018
(Real % change)

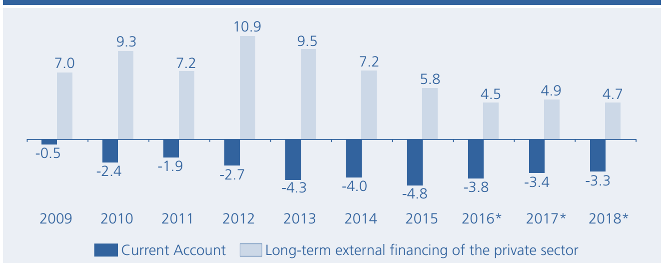


* Forecast.

INFLATION AND INFLATION TARGETING
(% change last 12 month)

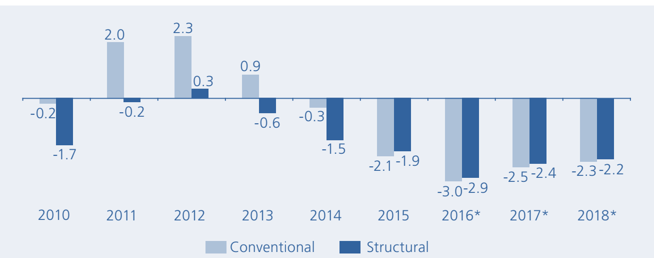


CURRENT ACCOUNT AND LONG-TERM EXTERNAL FINANCING OF THE PRIVATE SECTOR: 2009-2018 1/
(% GDP)



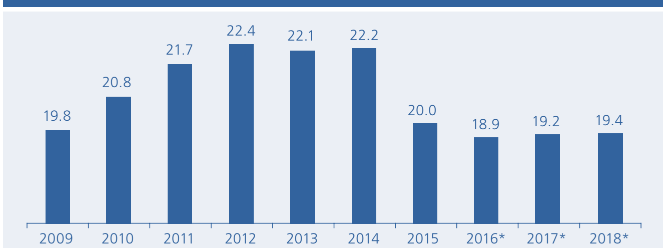
1/ Includes net foreign investments, portfolio investment, and private sector's long-term disbursement.
* Forecast.

ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR: 2010-2018
(% GDP)



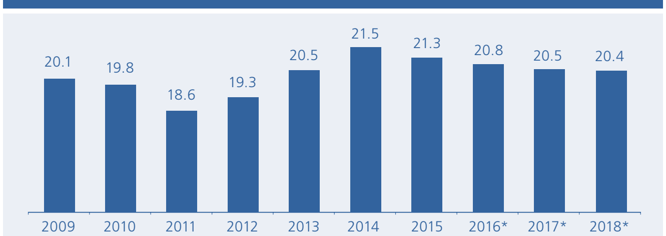
* Forecast.

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



* Forecast.

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



* Forecast.

year. Another factor contributing to this has been the anchoring of inflation expectations within the inflation target range –between 1 and 3 percent–, which also reflects the economy's response to the increases in the BCRP benchmark interest rate in the months of September and December 2015 and in January and February 2016.

The rate of inflation has dropped from 4.4 percent in December 2015 to 2.9 percent in August 2016. It is projected to converge to the upper band of the inflation target in the next months, following a declining path thereafter and reaching a rate of 2 percent by the end of 2017.

The balance of payments continues showing a downward trend in the current account deficit, which declined from 5.4 percent of GDP in the first half of 2015 to 4.4 percent in the first half of 2016. This adjustment was observed particularly in imports, which dropped 10 percent in this period, while exports, on the other hand, showed an increase of 9 percent in terms of volume. The increase observed in exports, which was particularly noteworthy in exports of minerals, was offset by the lower prices of exports (down by 11 percent).

The deficit in the current account is projected to continue declining in 2016, as well as in 2017 and 2018, and to reach 3.3 percent of GDP in 2018, coupled by a gradual improvement in both the volumes and prices of exports. A significant flow of long-term external capital oriented to investment is still foreseen, together with an increase in the BCRP international reserves as from the third quarter of 2016.

An expansionary position is considered in 2016 in the fiscal scenario projected in this Inflation Report, followed by a correction in 2017 and 2018 to ensure fiscal sustainability. In accordance with the Multiannual Macroeconomic Framework, the deficit in the economic balance would be equivalent to 3 percent of GDP in 2016, converging thereafter to 2.5 percent in 2017 and to 2.3 percent in 2018. Moreover, this gap would imply an increase in the public debt, which would represent 27.5 percent of GDP in 2018.

The current revenue of the General Government is projected considering a passive scenario characterized by the existing scheme of tax rates, with which revenue would come to represent 19.2 percent in 2017 and 19.4 percent in 2018.

Moreover, General Government spending would tend to strengthen the capital expenditure component with respect to current expenditure, and would reach 20.8

percent of GDP in 2016, 20.5 percent in 2017, and 20.4 percent in 2018.

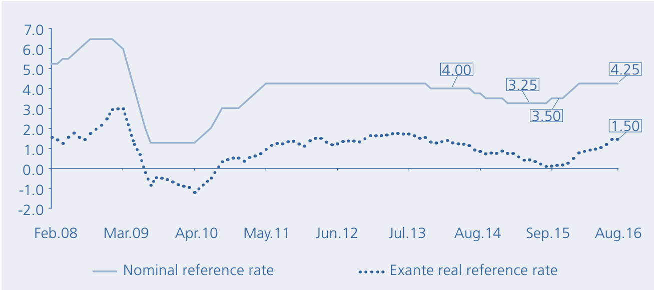
In view of the convergence of inflation and inflation expectations to the inflation target range (between 1 and 3 percent), the Central Bank has maintained the policy interest rate at 4.25 percent since March 2016.

Credit to the private sector has evolved in line with the pace of activity, recording an annual growth rate of 9.4 percent in real terms in December 2015 and a rate of 7.7 percent in July 2016. The balance of currency repos issued to promote the substitution of credit in dollars for credit in soles declined from S/ 28.51 billion in June 2016 to S/ 27.91 billion in August 2016, the growing dynamism of deposits in soles accounting for the lower demand for these operations.

A strengthening of the domestic currency has been observed since the end of February of this year, as a result of which the ratios of de-dollarization of credit and deposits have continued decreasing, recording rates of 26.0 percent and 41,7 percent in the month of July, respectively. A noteworthy reduction has also been observed in non-residents' demand for dollar forwards (down by US$ 8.04 billion) between March and August 2016, which has allowed the Central Bank to reduce the aggregate balance of foreign exchange swaps and BCRP-CDR by US$ 10.40 billion in this period.

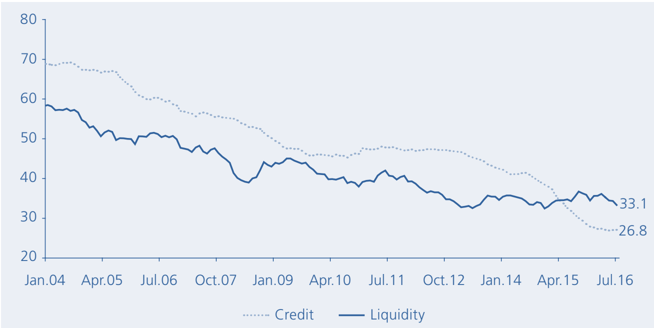
Inflation forecasts for 2016-2018 show no bias on the upside or on the downside. The two diversion factors considered –lower global economic activity and increased financial volatility in international markets– are counterbalanced in terms of their impact on inflation in Peru.

NOMINAL AND REAL* REFERENCE INTEREST RATE
(%)

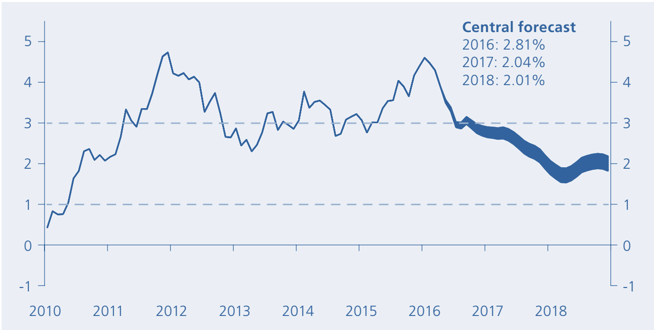


* Ex-ante: With expectation of inflation.

DOLLARIZATION RATIO: 2004 - 2016
(%)



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



Risk Balance

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.

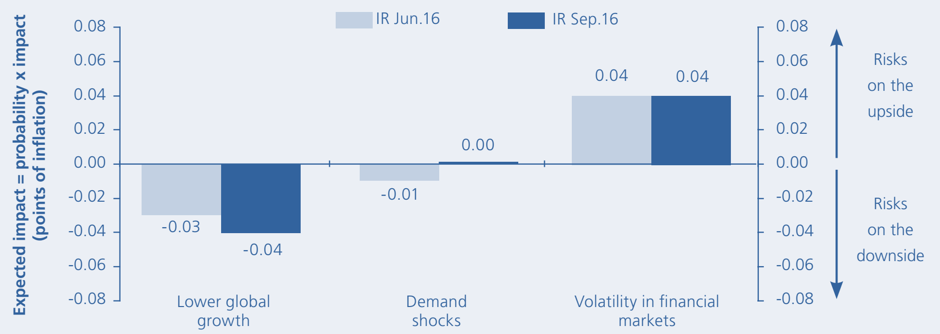
Lower global growth

The baseline scenario considers a slower recovery in the world economy in 2016-2018 than the one estimated in our Inflation Report of June, due mainly to lower growth in the United States and in some developed 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.

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

BALANCE OF RISKS AGAINST THE BASE SCENARIO



SUMMARY OF INFLATION REPORT FORECAST

	2015	2016[1/]		2017[1/]		2018[1/]	
		IR Jun.16	IR Sep.16	IR Jun.16	IR Sep.16	IR Jun.16	IR Sep.16
Real % change							
1. Gross Domestic Product	3.3	4.0	4.0	4.6	4.5	4.2	4.2
2. Domestic demand	2.9	2.5	1.8	3.8	4.0	3.8	4.0
a. Private consumption	3.4	3.5	3.5	3.8	3.8	4.0	4.0
b. Public consumption	9.5	4.7	5.7	1.0	3.0	0.8	3.5
c. Fixed private investment	-4.5	-1.0	-4.3	4.0	5.0	4.2	5.0
d. Public investment	-7.5	10.3	10.3	7.9	4.5	6.0	6.2
3. Exports (good and services)	3.5	6.4	6.9	6.4	5.5	4.9	4.6
4. Imports (good and services)	2.1	0.3	-1.7	3.5	3.6	3.5	3.7
5. Economic growth in main trading partners	3.1	2.8	2.7	3.1	3.1	3.3	3.2
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	-0.5 ; 0.0
% change							
6. Inflation	4.4	2.7 - 3.2	2.6 - 3.1	2.0 - 2.2	2.0 - 2.2	2.0 - 2.2	2.0 - 2.2
7. Expected inflation [3/]	-	3.5	2.9	3.0	2.8	2.8	2.7
8. Expected depreciation [3/]	-	2.9	0.4	1.9	2.3	1.7	1.2
9. Terms of trade [4/]	-6.3	-2.6	-2.2	0.9	1.0	0.0	0.0
a. Export prices	-14.9	-4.8	-4.8	2.8	3.7	0.9	1.2
b. Import prices	-9.2	-2.3	-2.6	1.9	2.7	0.9	1.3
Nominal % change							
10. Currency in circulation	3.8	5.5	5.4	6.0	6.0	6.0	6.0
11. Credit to the private sector [5/]	9.4	7.0	6.5	7.0	7.0	6.5	6.5
% GDP							
12. Gross fixed investment	24.4	24.0	23.4	24.3	23.7	24.4	24.1
13. Current account of the balance of payments	-4.8	-3.8	-3.8	-3.0	-3.4	-2.8	-3.3
14. Trade balance	-1.6	-0.8	-0.2	-0.2	0.2	0.0	0.3
15. Long-term external financing of the private sector [6/]	5.8	4.1	4.5	4.3	4.9	4.1	4.7
16. Current revenue of the general government	20.0	19.3	18.9	19.3	19.2	19.3	19.4
17. Non-financial expenditure of the general government	21.3	21.1	20.8	20.7	20.5	20.4	20.4
18. Overall balance of the non-financial public sector	-2.1	-3.0	-3.0	-2.8	-2.5	-2.5	-2.3
19. Balance of total public debt	23.3	25.5	25.4	26.6	25.9	28.0	27.5
20. Balance of net public debt	6.6	10.1	9.2	13.1	11.7	15.5	13.8

1/ Forecast.
2/ Differential between GDP and potential GDP (%).
3/ Survey on expectations to the economic agents.
4/ Average.
5/ Includes loans made by banks' branches abroad.
6/ Includes net direct investment, portfolio investment and private sector's long term disbursement.
IR: Inflation Report.