CENTRAL RESERVE BANK OF PERU

Summary Inflation Report

December 2017

Global growth this year will be the highest since 2011, both in the developed economies and in the emerging market economies. The dynamism of domestic demand, supported by higher employment rates and expansionary monetary conditions, stands out in the developed countries during the year, while growth in the developing countries has been favored mostly by international financial conditions and higher commodity prices. Because of these better than expected outcomes, the projection of global growth for 2017 has been revised up from 3.6 in the previous report to 3.7 percent, in line with recent data of some global indicators on manufacturing activity, services, and global trade. This level of growth is foreseen to continue in 2018 and to fall then slightly to 3.6 percent in 2019.

Moreover, because the recovery of commodity prices –particularly the prices of metals– has also been higher than estimated in the September report, the increase in the **terms of trade** is also corrected up from 7.0 percent to 8.2 percent in 2017. The terms of trade would continue showing a recovery in 2018 (2.8 percent), stabilizing thereafter in 2019.

Year-to-date, the deficit in the current account of the balance of payments has continued to decline basically due to the recovery in the terms of trade, higher mining production, and the low dynamism of domestic demand observed during the first half of the year. In the forecast horizon, export prices are expected to remain high and growth in our trading partners is also expected to continue showing a faster pace, which would imply a current account deficit of 1.6 percent of GDP in 2017 and 2018, and a current account deficit of 1.7 percent of GDP in 2019, in line with the expected recovery of domestic demand. The **long term financial account** will continue to be the main source of financing of the balance of payments, exceeding largely the requirements of the current account.

Economic activity has been recovering since the second quarter of the year after the reversal of the shocks that affected the economy at the beginning of this year. In

This ***Inflation Report*** was prepared using data on the Balance of Payments and GDP at Q3-2017 while data on the Monetary Accounts, operations of the Non-Financial Public Sector, Inflation, Financial Markets, and the Exchange Rate at November 2017.

WORLD GDP GROWTH
(Annual % change)

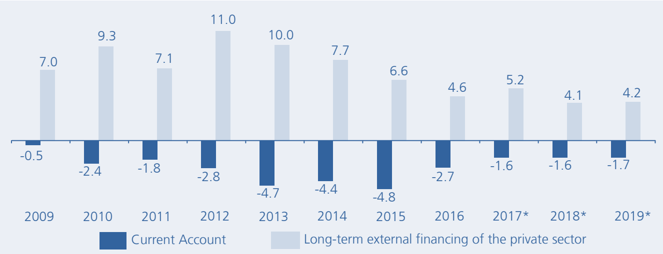
	Structure %[1/]	Trading Perú %[2/]	2016	2017* IR Sep.17	2017* IR Dec.17	2018* IR Sep.17	2018* IR Dec.17	2019* IR Sep.17	2019* IR Dec.17
Advanced economies	**41.9**	**47.3**	**1.7**	**2.0**	**2.2**	**1.9**	**2.0**	**1.8**	**1.9**
Of which:									
1. United States	15.5	18.0	1.5	2.2	2.3	2.1	2.3	2.0	2.0
2. Eurozone	11.8	11.2	1.8	1.9	2.1	1.7	2.1	1.6	1.8
Germany	3.3	2.7	1.8	1.8	2.1	1.6	2.1	1.4	1.8
France	2.3	0.7	1.2	1.5	1.6	1.6	1.8	1.5	1.7
Italy	1.9	1.7	0.9	0.9	1.3	1.0	1.3	0.9	1.0
Spain	1.4	2.6	3.2	3.0	3.0	2.3	2.3	2.2	2.1
3. Japan	4.4	3.1	1.0	1.3	1.5	1.0	1.1	1.0	1.0
4. United Kingdom	2.3	1.2	1.8	1.5	1.5	1.3	1.3	1.4	1.3
5. Canada	1.4	3.2	1.4	2.3	2.8	2.0	2.1	1.8	1.9
Emerging market and developing economies	**58.1**	**52.7**	**4.2**	**4.8**	**4.8**	**4.9**	**4.9**	**4.8**	**4.9**
Of which:									
1. Developing Asia	31.6	28.0	6.4	6.6	6.6	6.4	6.5	6.3	6.4
China	17.8	22.9	6.7	6.7	6.8	6.2	6.4	6.0	6.2
India	7.2	2.4	7.1	7.4	7.0	7.6	7.6	7.6	7.9
2. Commonwealth of Independent States	4.5	0.6	0.4	1.8	2.1	2.2	2.2	2.2	2.2
Russia	3.2	0.5	-0.2	1.6	1.8	1.7	1.7	1.7	1.7
3. Latin America and the Caribbean	7.9	21.9	-0.5	1.4	1.4	2.4	2.4	2.6	2.7
Brazil	2.6	4.5	-3.4	0.6	0.7	1.8	2.5	2.0	2.4
Chile	0.4	3.0	1.7	1.5	1.5	2.7	2.9	2.7	2.7
Colombia	0.6	2.6	1.6	1.8	1.8	2.9	2.9	3.0	3.0
Mexico	1.9	2.9	2.4	2.0	2.1	2.3	2.0	2.7	2.5
Peru	0.3	-	4.0	2.8	2.7	4.2	4.2	4.2	4.2
World Economy	**100.0**	**100.0**	**3.1**	**3.6**	**3.7**	**3.6**	**3.7**	**3.5**	**3.6**
Memo: Peru's trading partners [1/ 2/]	64.8		2.8	3.3	3.4	3.3	3.4	3.2	3.3

1/ 2016.
2/ Basket of Peru's 20 main trading partners.
* Forecast.
Source: Bloomberg, IMF, and Consensus Forecast.

TERMS OF TRADE: 2001-2019
(Annual average % change)

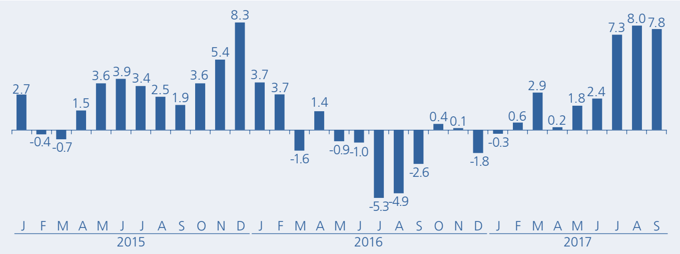
* Forecast.
Source: BCRP.

CURRENT ACCOUNT AND LONG-TERM EXTERNAL FINANCING OF THE PRIVATE SECTOR: 2009-2019 [1/]
(% GDP)



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

SEASONALLY ADJUSTED DOMESTIC DEMAND WITHOUT INVENTORIES
(% change - annualized quarterly moving)



Source: BCRP.

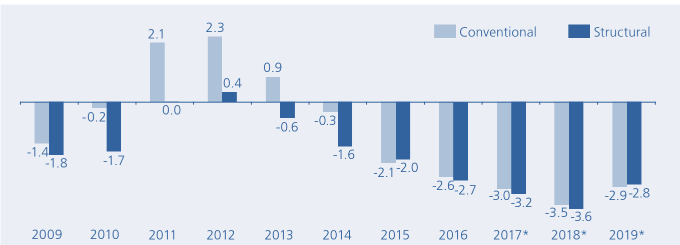
GDP AND DOMESTIC DEMAND
(Real % change)

	2016	Jan.-Sep. 2017	2017* IR Sep.17	2017* IR Dec.17	2018* IR Sep.17	2018* IR Dec.17	2019* IR Sep.17	2019* IR Dec.17
Domestic demand	**1.1**	**0.5**	**2.3**	**2.2**	**4.2**	**4.4**	**4.2**	**4.3**
Private consumption	3.3	2.4	2.6	2.5	3.3	3.3	3.8	3.8
Public consumption	-0.5	-3.0	2.3	2.4	3.6	3.6	2.0	2.0
Private investment	-5.9	-1.0	-1.0	0.6	5.3	6.5	7.5	7.5
Public investment	0.6	-4.5	7.0	6.0	15.0	12.5	4.0	4.0
Change on inventories (contribution)	0.2	-0.4	0.2	-0.1	0.0	0.1	0.0	0.0
Exports	**9.5**	**10.2**	**5.0**	**6.4**	**3.8**	**3.5**	**4.4**	**3.8**
Imports	**-2.2**	**3.2**	**3.3**	**4.7**	**4.1**	**4.3**	**4.6**	**4.3**
GDP	**4.0**	**2.4**	**2.8**	**2.7**	**4.2**	**4.2**	**4.2**	**4.2**
Memo:								
Public expenditure	-0.2	-3.4	3.6	3.4	6.9	6.2	2.6	2.6
Domestic demand withouth inventories	0.9	1.6	2.1	2.3	4.3	4.4	4.3	4.3

* Forecast.
IR: Inflation Report.

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

CONVENTIONAL AND STRUCTURAL ECONOMIC BALANCE OF THE NON FINANCIAL PUBLIC SECTOR: 2009-2019
(% GDP)



* Forecast.

TOTAL CREDIT TO THE PRIVATE SECTOR IN NATIONAL CURENCY
Annual % change

the third quarter, **domestic demand** grew 2.4 percent, driven by the recovery of private investment (after it showed 14 consecutive quarters of decline) in a context of higher terms of trade and increased public expenditure (after it recorded 3 consecutive quarters of decline). At the sector level, the growth of the construction sector –which had been declining for 4 consecutive quarters– is worth pointing out, in line with the better evolution of public and private investment.

This recovery of activity is in line with the projections discussed in the Inflation Report of September, with some adjustments on the upside for private investment and exports. However, taking into account the anticipated impact of the recent cooler sea temperatures on the fishing industry in the fourth quarter of this year, the growth rate projected for this year has been revised slightly down, from 2.8 to 2.7 percent. The GDP growth forecast for the next two years remains unchanged at 4.2 percent, in a context of accelerating private investment and increased public expenditure associated with the Reconstruction Plan and the Pan American Games.

In November, the **fiscal deficit** accumulated in the last 12 months was equivalent to 3.0 percent of GDP, higher than the deficit of 2.6 percent of GDP registered in December 2016. This higher deficit reflects mainly the reduction of current revenues resulting mostly from the decline of tax revenues and from higher tax rebates, which showed historic levels. In addition to this, after staying close to 15.0 percent in the first three quarters of the year, current expenditure rose to 15.1 percent of GDP while gross capital formation reached 4.0 percent, showing a recovery from the third quarter of the year.

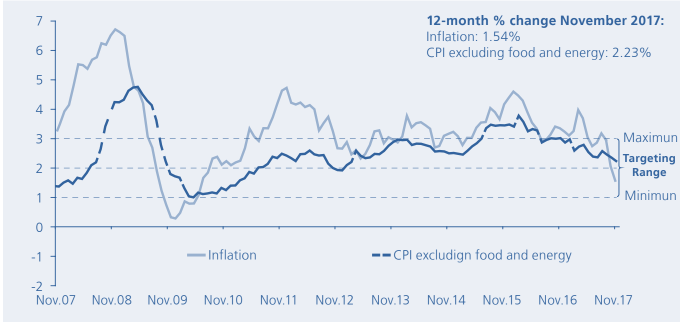
Revenue is expected to recover in the forecast horizon, driven by the better performance of domestic demand and by the repatriation of capital. The growth of public investment will also show a faster pace due to the beginning of the reconstruction works after the damages caused by El Niño Costero as well as due to the works to be carried out for the Pan American Games. Thus, the fiscal deficits projected for 2017 and 2018 remain at 3.0 and 3.5 percent of GDP, respectively. In 2019, the deficit is expected to decrease to 2.9 percent of GDP, in line with fiscal consolidation. This projection implies a positive weighted fiscal stimulus in 2017-2018 (concentrated in the next year), which would reverse with fiscal consolidation in 2019, coinciding with the closure of the output gap.

Credit to the private sector grew 5.6 percent year on year in October, this growth rate being explained mainly by the growth of personal loans (7.9 percent), particularly mortgages, in a context of recovery in the demand of the private sector. The growth of credit to the private sector in the 2017-2019 forecast horizon is expected to evolve in line with the pace of growth of domestic demand.

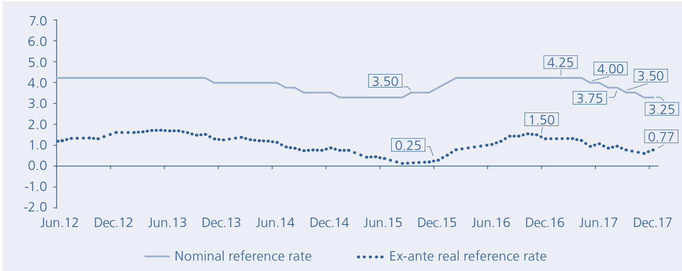
Inflation decreased from 3.17 percent in August to 1.54 percent in November due mainly to the rapid reversal of the persistent supply shocks that affected agricultural products, i.e. the water deficit registered in late 2016 and El Niño Costero in the first quarter of 2017. Moreover, expectations of inflation in twelve months have also continued to decline and remain within the inflation target range since March of this year. In this context, the Board of BCRP lowered the benchmark rate, for the fourth time this year, to 3.25 percent in November. This reduction in the benchmark interest rate is consistent with a convergence of inflation to 2.0 percent, once the effect of the reversal of the supply shocks that led inflation to the lower band of the target range disappears.

Inflation would continue showing levels below 2.0 percent at end 2017 and during the first half of 2018 due to the correction of the supply shocks that increased prices at the end of 2016 and during the first half of 2017. Moreover, inflation without food and energy and inflation expectations are also expected to continue declining to 2 percent, in a context which would show no inflationary pressures on the side of demand and moderate levels of imported inflation.

INFLATION AND INFLATION TARGET
(% change last 12 -month)

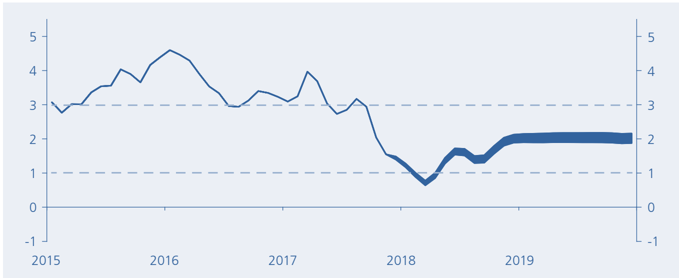


NOMINAL AND REAL* REFERENCE INTEREST RATE
(%)



* With expectation of inflation.

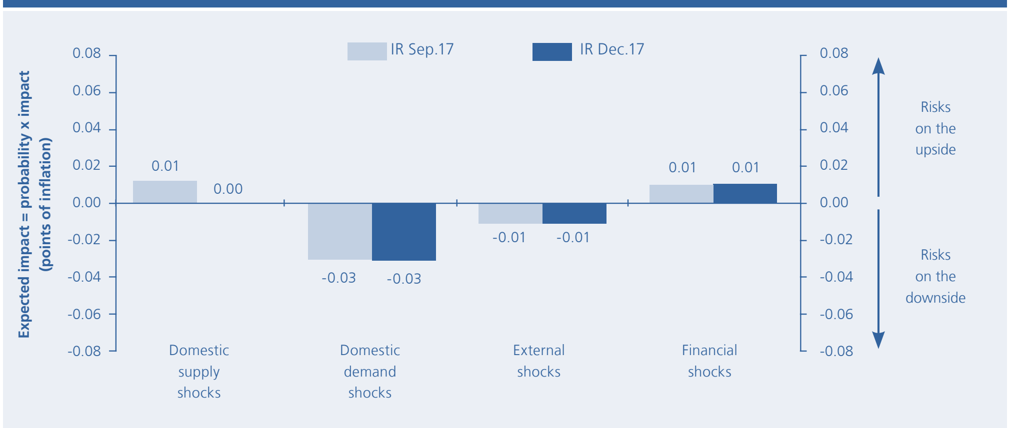
INFLATION FORECAST: 2015 - 2019
(Last 12-month % change)



Risk balance

The **risk factors** considered in this Report –demand shocks (a more gradual recovery of private and public investment), greater volatility in international financial markets, and a decline in the terms of trade– have a slight downward bias on the inflation forecast. In other words, the impact of factors that could affect inflation on the downside is higher than the impact of factors that could affect inflation on the upside.

BALANCE OF RISKS AGAINST THE BASE SCENARIO



SUMMARY OF INFLATION REPORT FORECAST

	2015	2016	2017[1/]		2018[1/]		2019[1/]	
			IR Sep.17	IR Dec.17	IR Sep.17	IR Dec.17	IR Sep.17	IR Dec.17
Real % change								
1. Gross domestic product	3.3	4.0	2.8	2.7	4.2	4.2	4.2	4.2
2. Domestic demand	2.9	1.1	2.3	2.2	4.2	4.4	4.2	4.3
a. Private consumption	4.0	3.3	2.6	2.5	3.3	3.3	3.8	3.8
b. Public consumption	9.8	-0.5	2.3	2.4	3.6	3.6	2.0	2.0
c. Fixed private investment	-4.3	-5.9	-1.0	0.6	5.3	6.5	7.5	7.5
d. Public investment	-9.5	0.6	7.0	6.0	15.0	12.5	4.0	4.0
3. Exports (good and services)	4.0	9.5	5.0	6.4	3.8	3.5	4.4	3.8
4. Imports (good and services)	2.4	-2.2	3.3	4.7	4.1	4.3	4.6	4.3
5. Economic growth in main trading partners	3.2	2.8	3.3	3.4	3.3	3.4	3.2	3.3
Memo:								
Output gap [2/] (%)	-1.0 ; 0.0	-1.0 ; 0.1	-1.5 ;- 0.5	-1.0;- 0.5	-1.0 ; 0.0	-0.5 ; 0.0	-0.5 ; 0.0	-0.5 ; 0.0
% change								
6. Inflation	4.4	3.2	2.0 - 2.5	1.3 - 1.7	2.0	2.0	2.0	2.0
7. Expected inflation [3/]	-	-	2.8	2.2	2.7	2.5	2.7	2.7
8. Expected depreciation [3/]	-	-	-2.5	-3.2	1.6	1.4	1.3	0.6
9. Terms of trade [4/]	-6.3	-0.7	7.0	8.2	2.0	2.8	0.0	0.0
a. Export prices	-14.9	-3.6	12.0	13.8	2.2	4.0	1.0	1.0
b. Import prices	-9.2	-3.0	4.7	5.1	0.1	1.2	1.0	1.0
Nominal % change								
10. Currency in circulation	3.8	6.5	5.0	5.0	5.9	6.0	5.9	6.0
11. Credit to the private sector [5/]	8.0	5.6	5.5	5.5	7.0	7.0	7.0	7.0
% GDP								
12. Gross fixed investment	24.3	22.6	21.6	21.9	22.2	22.5	22.9	23.1
13. Current account of the balance of payments	-4.8	-2.7	-2.0	-1.6	-2.0	-1.6	-2.1	-1.7
14. Trade balance	-1.5	1.0	2.3	2.6	2.8	3.1	2.7	2.9
15. Long-term external financing of the private sector [6/]	6.6	4.6	5.0	5.2	4.0	4.1	4.2	4.2
16. Current revenue of the general government	20.0	18.5	18.1	18.1	18.3	18.3	18.4	18.5
17. Non-financial expenditure of the general government	21.3	19.9	20.0	20.1	20.4	20.5	19.9	20.0
18. Overall balance of the non-financial public sector	-2.1	-2.6	-3.0	-3.0	-3.5	-3.5	-2.9	-2.9
19. Balance of total public debt	23.3	23.8	24.9	24.5	26.9	26.2	27.7	27.4
20. Balance of net public debt	5.5	6.9	10.0	9.6	13.0	12.6	15.4	15.0

1/ Forecast.
2/ Differential between GDP and potential GDP (%).
3/ Survey on expectations to the analysts and financial entities.
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.