CENTRAL RESERVE BANK OF PERU

Summary Inflation Report

September 2017

During the second quarter of 2017, **global growth** has shown has highest rates in the past five years. This pace of growth has been characterized by a synchronization in the evolution of growth in both the developed economies and the emerging market economies. Growth in the former has continued to be driven by the dynamism of the labor market, favorable financial conditions, and slight inflationary pressures which rule out an abrupt adjustment of monetary stimulus, while growth in the latter has also shown a better outcome, favored in part by the recovery of commodity prices and monetary stimuli. Because of this, the projection of global growth for 2017 has been revised up from 3.5 percent in the previous report to 3.6 percent, the Eurozone, Japan, and China accounting for the major corrections in this projection. This level of growth would continue in 2018, falling slightly thereafter to 3.5 percent in 2019.

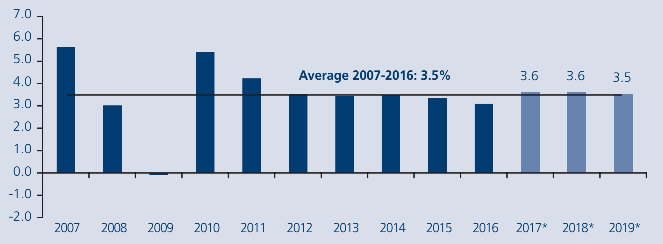
Since the recovery of commodity prices has been higher than expected in the June report, the increase in the **terms of trade** has been corrected on the upside, from 5.5 percent to 7.0 percent in 2017. The increase in the terms of trade would continue in 2018 (2.0 percent) and then stabilize in 2019.

The reduction of the deficit in the **current account of the balance of payments** accelerated in the first half of this year, reflecting the slowdown of domestic demand and higher terms of trade. In the forecast horizon, export prices are expected to remain at average levels close to those observed during this year.

In line with these developments, the current account deficit would be around 2.0 percent in 2017-2019. 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.

This ***Inflation Report*** was prepared using data on the Balance of Payments and GDP at Q2-2017 while data on the Monetary Accounts, operations of the Non-Financial Public Sector, Inflation, Financial Markets, and the Exchange Rate at August 2017.

WORLD ECONOMY: 2007-2019
(Annual % change)



* Forecast.

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

* Forecast.
Source: BCRP.

BALANCE OF PAYMENTS
(Million US$)

	2015	2016	H1 2017	2017* IR Jun.17	2017* IR Sep.17	2018* IR Jun.17	2018* IR Sep.17	2019* IR Sep.17
I. CURRENT ACCOUNT BALANCE	**-9,169**	**-5,303**	**-1,470**	**-4,527**	**-4,389**	**-4,491**	**-4,558**	**-5,076**
% GDP	*-4.8*	*-2.7*	*-1.4*	*-2.1*	*-2.0*	*-2.0*	*-2.0*	*-2.1*
1. Trade Balance	-2,916	1,888	2,437	4,876	5,051	6,199	6,400	6,434
a. Exports	34,414	37,020	20,666	42,611	43,173	45,409	45,940	48,457
b. Imports	-37,331	-35,132	-18,229	-37,736	-38,122	-39,209	-39,540	-42,024
2. Services	-2,040	-1,974	-476	-1,674	-1,515	-2,377	-2,209	-2,266
3. Investment income	-7,544	-9,184	-5,293	-11,394	-11,636	-12,031	-12,516	-13,091
4. Current transfers	3,331	3,967	1,862	3,665	3,712	3,717	3,768	3,848
Of which: Remittances	2,725	2,884	1,476	2,979	3,042	3,134	3,194	3,238
II. FINANCIAL ACCOUNT	**9,242**	**5,472**	**2,171**	**6,354**	**7,059**	**6,491**	**6,558**	**7,076**
Of which:								
1. Private Sector	6,132	2,815	-1,189	959	3,220	3,617	3,749	4,895
a. Long-term	8,792	3,709	-557	1,479	3,569	3,617	3,749	4,895
b. Short-term	-2,660	-894	-632	-520	-349	0	0	0
2. Public Sector	3,110	2,657	3,360	5,395	3,840	2,874	2,809	2,181
III. BALANCE OF PAYMENTS (=I+II)	**73**	**168**	**701**	**1,827**	**2,671**	**2,000**	**2,000**	**2,000**
Memo: Long-term external financing of the private sector (% GDP)	6.6	4.6	3.7	3.7	5.0	3.8	4.0	4.2

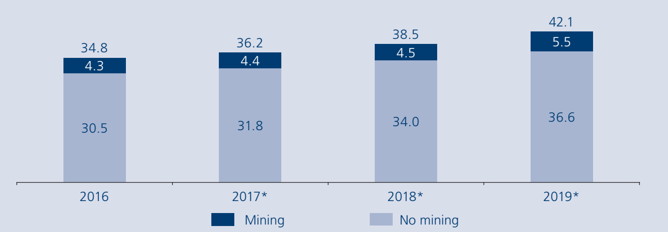
* Forecast.
IR: Inflation Report.

GDP AND DOMESTIC DEMAND
(Real % change)

	2015	2016	H1 2017	2017* IR Jun.17	2017* IR Sep.17	2018* IR Jun.17	2018* IR Sep.17	2019* IR Sep.17
I. Domestic demand	**2.9**	**1.0**	**-0.3**	**1.9**	**2.3**	**4.0**	**4.2**	**4.2**
1. Private expenditure	**2.7**	**1.3**	**0.8**	**1.6**	**2.0**	**3.5**	**3.7**	**4.6**
Consumption	3.4	3.4	2.2	2.5	2.6	3.0	3.3	3.8
Private fixed investment	-4.3	-5.9	-4.2	-1.8	-1.0	5.3	5.3	7.5
Change on inventories (contribution)	*1.1*	*0.1*	*0.0*	*0.0*	*0.2*	*0.0*	*0.0*	*0.0*
2. Public expenditure	**3.6**	**-0.2**	**-6.7**	**3.6**	**3.6**	**6.5**	**6.9**	**2.6**
Consumption	9.8	-0.5	-5.4	2.3	2.3	3.0	3.6	2.0
Investment	-9.5	0.6	-10.4	7.0	7.0	15.0	15.0	4.0
General government	*-14.6*	*-3.3*	*-9.2*	*11.1*	*11.1*	*16.3*	*16.4*	*3.4*
Public entitites	*62.6*	*30.0*	*-16.0*	*-15.7*	*-15.3*	*5.4*	*4.6*	*8.8*
II. Net external demand								
1. Exports	**4.0**	**9.5**	**12.8**	**5.9**	**5.0**	**4.4**	**3.8**	**4.4**
2. Imports	**2.4**	**-2.2**	**2.5**	**2.9**	**3.3**	**3.5**	**4.1**	**4.6**
III. GDP	**3.3**	**4.0**	**2.3**	**2.8**	**2.8**	**4.2**	**4.2**	**4.2**
Memo:								
Public expenditure (contribution)	*0.6*	*0.0*	*-1.0*	*0.6*	*0.6*	*1.1*	*1.1*	*0.4*
Domestic demand without inventories	*1.8*	*1.0*	*-0.3*	*1.9*	*2.1*	*4.0*	*4.3*	*4.3*

* Forecast.
IR: Inflation Report.

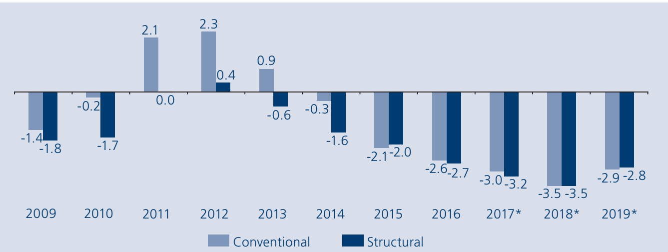
PRIVATE INVESTMENT
(Billion US$)



* Forecast.
Source: BCRP and MINEM.

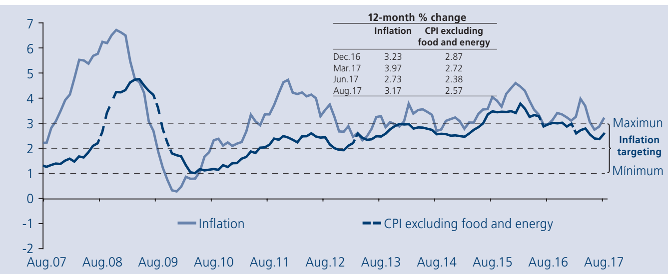
ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR
(Accumulate last 4 quarters - % GDP)

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



* Forecast.

INFLATION AND INFLATION TARGETING
(% change last 12 month)



Economic activity has been slowing down since the last quarter of 2016 due to the decline of domestic demand resulting mainly from the contraction of private and public investment after the impact of the fiscal consolidation measures, the corruption cases associated with Brazilian construction companies, and *El Niño Costero* (especially between February and April 2017).

Since May there has been a recovery of domestic demand, in line with the recovery of business confidence and the terms of trade, as well as a smaller contraction of public spending, associated with the government's efforts to unlock public investment. Moreover, have exports continued to be the main source of GDP growth.

Because of this, the projected rate of GDP growth for this year remains at 2.8 percent and at 4.2 percent for 2018. This level of growth would continue in 2019, in a context of a faster pace of growth of private investment and a lower pace of growth of mining production and public investment.

At August, the **fiscal deficit** accumulated in the last 12 months was 2.9 percent of GDP –slightly higher than at the end of December (2.6 percent of GDP)–, which reflected the declining trend of current revenues in line with the slowdown of economic activity, increased tax rebates, and recent tax cut measures. On the other hand, current spending, especially spending in gross capital formation, has shown a slower pace of decline since the second quarter of the year.

Therefore, the projections of the fiscal deficit for 2017 and 2018 remain at 3.0 and 3.5 percent of GDP as in the previous report, these levels of deficit allowing the fiscal space for the increased spending required for reconstructing the infrastructure affected by *El Niño Costero*. In 2019, the deficit is expected to decrease to 2.9 percent of GDP, in line with fiscal consolidation.

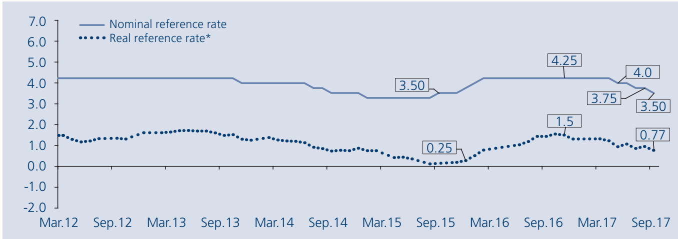
The downward trend of inflation observed since April was briefly disrupted by the rise in the price of lemons (July/August) and the rise in water rates (August), which led inflation to register 3.17 percent in August, above the target range. Despite this, expectations of inflation in 12 months have continued declining and have shown levels within the target range over the past three months, which reflects that economic agents have correctly understood the temporality of the recent supply shock. In this context, the Board of BCRP lowered the benchmark rate to 3.75 percent in July, maintained it at this level in August, and reduced it to 3.50 percent in September.

With this decrease in the benchmark interest rate, BCRP has expanded the expansionary monetary policy stance, this position being consistent with inflation's convergence to the 2.0 percent target with economic growth without inflationary pressure on the side of demand.

Credit to the private sector grew 5.3 percent year on year in July, slightly less than at the end of 2016 (5.6 percent). This evolution of credit is associated with the slowdown of the domestic demand of the private sector, reflected in the slowdown observed in lending to medium-sized enterprises and consumer loans via credit cards. 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 is projected to show rates within the target range during the fourth quarter of this year and to converge sustainedly to 2.0 percent during 2018. This forecast considers a rapid reversal in the prices of food products affected by *El Niño Costero* (excessive rainfall) during the first quarter of 2017 and in its impact on the supply of these foodstuffs in the third quarter of the year.

NOMINAL AND REAL REFERENCE RATE
(%)

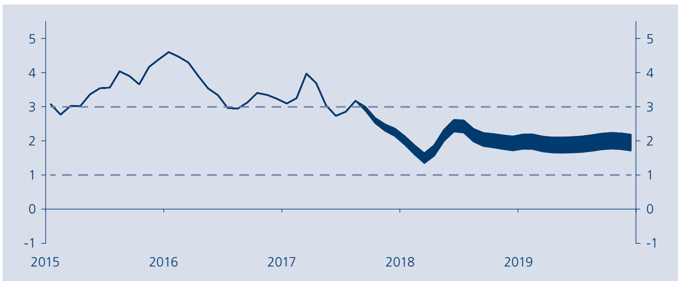


* With expectation of inflation.

RATIO CREDIT/GDP
(%)

* Forecast.

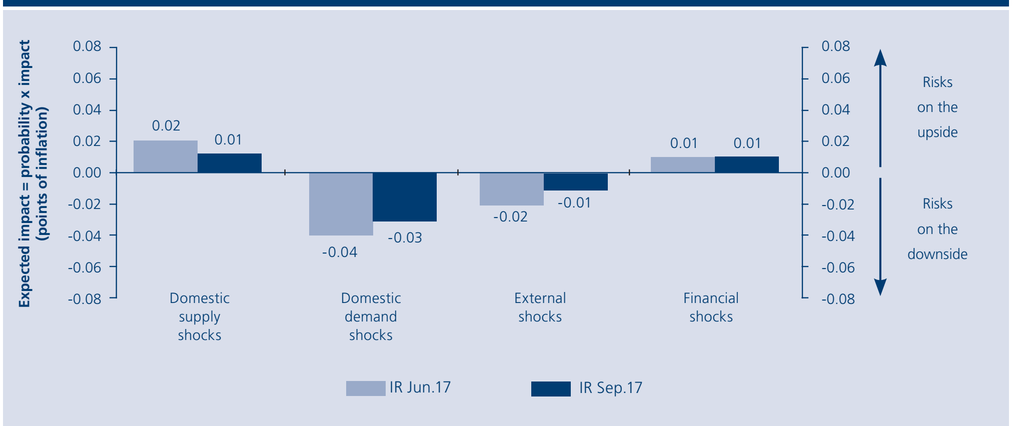
INFLATION FORECAST: 2015 - 2019
(Last 12-month % change)



Risk balance

The **risk factors** considered in this Report –supply shocks, demand shocks, increased volatility in international financial markets, and a decline in the terms of trade– have a 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 Jun.17	IR Sep.17	IR Jun.17	IR Sep.17	IR Sep.17
Real % change							
1. Gross Domestic Product	3.3	4.0	2.8	2.8	4.2	4.2	4.2
2. Domestic demand	2.9	1.0	1.9	2.3	4.0	4.2	4.2
a. Private consumption	3.4	3.4	2.5	2.6	3.0	3.3	3.8
b. Public consumption	9.8	-0.5	2.3	2.3	3.0	3.6	2.0
c. Fixed private investment	-4.3	-5.9	-1.8	-1.0	5.3	5.3	7.5
d. Public investment	-9.5	0.6	7.0	7.0	15.0	15.0	4.0
3. Exports (good and services)	4.0	9.5	5.9	5.0	4.4	3.8	4.4
4. Imports (good and services)	2.4	-2.2	2.9	3.3	3.5	4.1	4.6
5. Economic growth in main trading partners	3.2	2.8	3.2	3.3	3.3	3.3	3.2
Memo:							
Output gap 2/ (%)	-1.0 ; 0.0	-1.0 ; 0.1	-1.7 ; 0.0	-1.5 ; -0.5	-1.2 ; 0.0	-1.0 ; 0.0	-0.5 ; 0.0
% change							
6. Inflation	4.4	3.2	2.0 - 2.5	2.0 - 2.5	2.0 - 2.2	2.0	2.0
7. Expected inflation 3/	-	-	3.0	2.8	2.8	2.7	2.7
8. Expected depreciation 3/	-	-	-2.7	-2.5	1.5	1.6	1.3
9. Terms of trade 4/	-6.4	-0.7	5.5	7.0	0.0	2.0	0.0
a. Export prices	-15.0	-3.6	10.2	12.0	0.6	2.2	1.0
b. Import prices	-9.2	-3.0	4.5	4.7	0.6	0.1	1.0
Nominal % change							
10. Currency in circulation	3.8	6.5	5.0	5.0	5.9	5.9	5.9
11. Credit to the private sector 5/	8.0	5.6	5.0	5.5	6.2	7.0	7.0
% GDP							
12. Gross fixed investment	24.3	22.5	21.6	21.6	22.3	22.2	22.9
13. Current account of the balance of payments	-4.8	-2.7	-2.1	-2.0	-2.0	-2.0	-2.1
14. Trade balance	-1.5	1.0	2.3	2.3	2.7	2.8	2.7
15. Long-term external financing of the private sector 6/	6.6	4.6	3.7	5.0	3.8	4.0	4.2
16. Current revenue of the general government	20.0	18.5	18.3	18.1	18.2	18.3	18.4
17. Non-financial expenditure of the general government	21.3	20.0	20.2	20.0	20.4	20.4	19.9
18. Overall balance of the non-financial public sector	-2.1	-2.6	-3.0	-3.0	-3.5	-3.5	-2.9
19. Balance of total public debt	23.3	23.8	25.8	24.9	26.6	26.9	27.7
20. Balance of net public debt	6.6	8.0	10.4	10.0	13.4	13.0	15.4

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.