CENTRAL RESERVE BANK OF PERU

Summary Inflation Report

December 2018

In the next two years, **global economic activity** would show a more moderate pace of growth, slowing down from a rate of 3.8 percent in 2018 to rates of 3.6 percent in 2019 and 2020 as a result of tighter international financial conditions. This slowdown in growth, which has been observed since the middle of this year –although not in an homogeneous manner in the different economies–, has been accentuated by an increase in trade tensions and by their impacts on world trade, agents' confidence, and volatility in financial and commodity markets.

The **terms of trade** would remain relatively stable this year, with the prices of exports and imports showing growth rates of around 6 percent. In the next two years, the **terms of trade** are expected to fall slightly (less than 1 percent). Export prices would decline in 2019 due to the impact of commercial tensions and lower global growth, although this would be offset in part by the fall foreseen in the price of oil due to a higher-than-expected growth in supply.

The **deficit in the current account** of the balance of payments, which showed an extraordinarily low level in 2017 (1.1 percent of GDP) due to an increase in the terms of trade and the low growth of domestic demand, will rise to 1.9 percent of GDP in 2018, rate below the average level observed since 2006 (2.1 percent of GDP).

In the forecast horizon, the downward correction of the export prices of metals will imply a lower surplus in the trade balance and a greater current account deficit than that projected in the Inflation Report of September. The current account deficits of 1.6 and 1.7 percent of GDP projected for 2019 and 2020, respectively, are sustainable and historically low levels. **Long-term external capital flows for the**

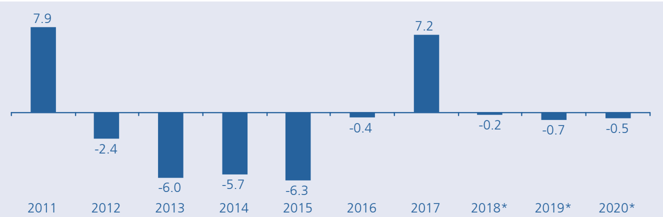
This Inflation Report was prepared using data on the balance of payments and the gross domestic product as of the third quarter of 2018 and data on monetary accounts, the operations of the non-financial public sector, inflation, financial markets, and the exchange rate as of November 2018.

WORLD GDP GROWTH
(Annual % change)

	PPP%[1/]	Trading Peru %[1/]	2017	2018* IR Sep.18	2018* IR Dec.18	2019* IR Sep.18	2019* IR Dec.18	2020* IR Dec.18
Advanced economies	**41.3**	**42.9**	**2.3**	**2.3**	**2.3**	**2.0**	**2.0**	**1.8**
Of which:								
1. United States	15.3	20.2	2.2	2.9	3.0	2.2	2.2	2.0
2. Eurozone	11.6	12.8	2.5	2.1	2.0	1.9	1.8	1.6
Germany	3.3	2.7	2.5	2.0	1.8	1.9	1.7	1.6
France	2.2	0.8	2.3	1.7	1.6	1.6	1.6	1.6
Italy	1.8	1.8	1.5	1.2	1.0	1.1	1.0	1.0
Spain	1.4	4.0	3.0	2.7	2.6	2.2	2.2	2.0
3. Japan	4.3	4.0	1.7	1.1	1.0	1.0	1.0	0.4
4. United Kingdom	2.3	1.3	1.7	1.4	1.3	1.4	1.4	1.5
5. Canada	1.4	2.6	3.0	2.0	2.0	1.9	1.9	1.8
Emerging market and developing economies	**58.7**	**57.1**	**4.7**	**4.9**	**4.8**	**4.9**	**4.7**	**4.8**
Of which:								
1. Developing Asia	32.4	34.9	6.5	6.6	6.6	6.4	6.3	6.4
China	18.2	27.9	6.9	6.6	6.6	6.3	6.2	6.2
India	7.4	3.8	6.7	7.4	7.4	7.5	7.5	7.6
2. Commonwealth of Independent States	4.5	0.5	2.1	2.2	2.2	2.2	2.1	2.1
Russia	3.2	0.5	1.5	1.7	1.7	1.7	1.5	1.5
3. Latin America and the Caribbean	7.7	21.6	1.3	1.3	1.2	2.1	1.8	2.3
Brasil	2.5	5.4	1.0	1.4	1.4	2.5	2.4	2.3
Chile	0.4	3.3	1.5	4.0	4.0	3.6	3.5	3.3
Colombia	0.6	2.9	1.8	2.7	2.7	3.2	3.2	3.3
Mexico	1.9	3.0	2.0	2.2	2.1	2.1	1.9	2.1
Argentina	0.7	1.5	2.9	-2.2	-2.4	-0.1	-1.0	1.3
Peru	0.3	-	2.5	4.0	4.0	4.0	4.0	4.0
World Economy	**100.0**	**100.0**	**3.7**	**3.8**	**3.8**	**3.7**	**3.6**	**3.6**
Memo:								
Peru's trading partners [1/ 2/]	65.9		3.5	3.8	3.8	3.6	3.5	3.4

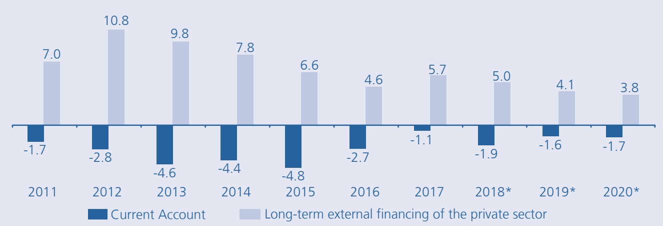
* Forecast.
1/ 2017.
2/ Basket of Peru's 20 main trading partners.
Source: Bloomberg, IMF, and Consensus Forecast.

TERMS OF TRADE: 2011-2020
(Annual average % change)



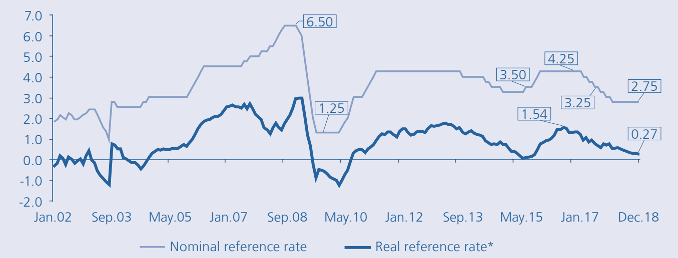
* Forecast.
Source: BCRP.

CURRENT ACCOUNT AND LONG-TERM EXTERNAL FINANCING OF THE PRIVATE SECTOR: 2011-2020 [1/]
(% GDP)



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

NOMINAL AND REAL* REFERENCE INTEREST RATE
(%)

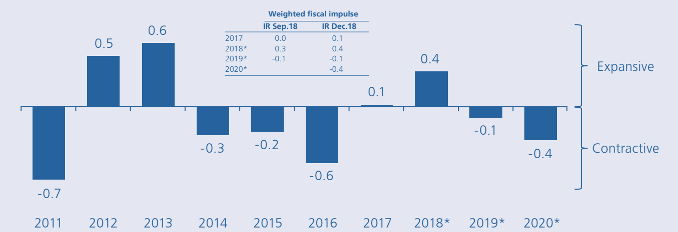


* With expectation of inflation.

CREDIT TO THE PRIVATE SECTOR
(Annual growth rate)

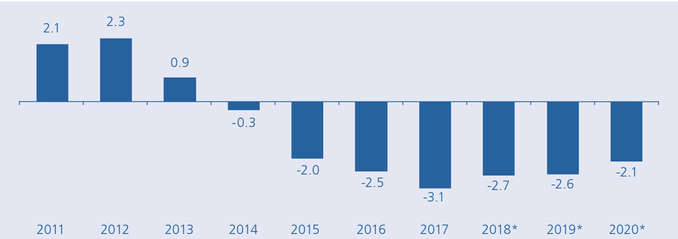
	Dec.17	Mar.18	Jun.18	Sep.18	Nov.18
Businesses	**5.4**	**6.6**	**7.9**	**7.3**	**6.3**
Corporate and large companies	6.0	7.9	10.5	9.9	8.0
Medium-sized enterprises	0.7	1.9	2.5	2.8	2.6
Small business and Microbusinesses	9.5	8.8	8.1	6.3	6.2
Individuals	**8.7**	**9.7**	**10.8**	**11.2**	**11.1**
Consumer	8.8	10.4	11.7	12.4	13.1
Car loans	-4.2	-0.6	-2.7	-1.6	-4.5
Credit cards	3.0	3.8	5.9	8.4	11.2
Rest	13.0	14.8	15.7	15.2	15.2
Mortgage	8.6	8.7	9.5	9.5	8.3
TOTAL	**6.6**	**7.8**	**9.0**	**8.8**	**8.1**

WEIGHTED FISCAL IMPULSE [1/]
(% Potential GDP)



1/ The weighted impulse takes account the multiplier model of changes in the incomes, current expensives and public investment.
* Forecast.

OVERALL BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR: 2011-2020
(% GDP)



* Forecast.

GDP AND DOMESTIC DEMAND
(Real % change)

	2017	2018*		2019*		2020*
		IR Sep.18	IR Dec.18	IR Sep.18	IR Dec.18	IR Dec.18
Domestic demand	**1.4**	**4.4**	**4.4**	**4.0**	**3.9**	**4.0**
Private consumption	2.5	3.8	3.7	3.6	3.7	3.9
Public consumption	-0.2	3.4	1.8	3.2	2.9	1.8
Private investment	0.2	5.5	4.7	6.5	6.5	6.0
Public investment	-2.3	9.9	9.9	2.8	2.8	3.4
Change on inventories (contribution)	-0.1	0.0	0.4	0.0	-0.2	0.0
Exports	**7.8**	**3.5**	**2.1**	**4.6**	**4.7**	**4.8**
Imports	**4.1**	**5.0**	**3.6**	**4.7**	**4.3**	**5.1**
GDP	**2.5**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**

* Forecast.
IR: Inflation Report.

private sector will continue to be the main source of financing the balance of payments, exceeding by far the requirements of the current account.

The BCRP Board has maintained the **benchmark interest rate** at 2.75 percent since March, which is compatible with an expansionary monetary policy stance (real rate of 0.3 percent) in a context of inflation of around 2.0 percent and a negative output gap.

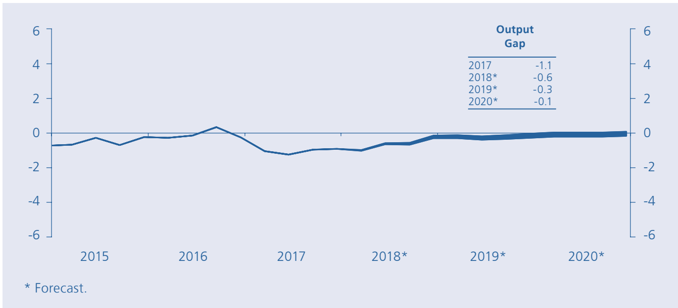
In line with the expansionary monetary stance of BCRP, **credit to the private sector** grew at a year-on-year rate of 8.1 percent in November, this rate being observed in both the segments of business loans and personal loans. In the forecast horizon, the ratio of credit to the private sector-to GDP would increase from 42 percent in 2018 to 44 percent in 2020. This projection takes into account flexible monetary conditions and the recovery of domestic demand's growth rate.

The fiscal scenario considers an expansionary weighted fiscal impulse in 2018 and a contractionary fiscal impulse in the following years, in line with the current fiscal consolidation process. In annual terms, the **fiscal deficit** fell from 3.1 percent of GDP in 2017 to 2.3 percent of GDP in November 2018, the increase in the current revenues of the general government accounting for the improvement observed in the fiscal result.

Thus, the projection of the fiscal deficit in 2018 has been revised down by 0.1 percentage points of GDP to 2.7 percent, mainly due to higher tax revenues. This projection considers the execution of works of Lima Metro's Line 2, the Pan American Games, and the reconstruction works carried out as part of the Reconstruction with Changes Integral Plan. The projection of the fiscal deficit in 2019 remains at 2.6 percent of GDP and a deficit of 2.1 percent is expected for 2020 as part of the fiscal consolidation process.

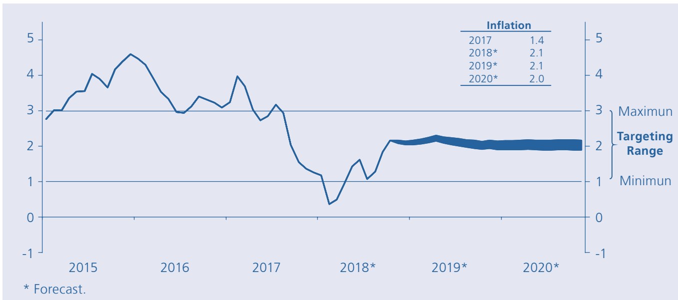
After showing high levels of **economic activity** in the first semester of 2018 (4.4 percent), the Peruvian economy recorded a temporary slowdown in the third quarter (2.3 percent) due to a lower pace of investment in a context of falling commodity prices, to lower mining and hydrocarbon

OUTPUT GAP: 2015-2020
(% Potential GDP)



* Forecast.

INFLATION FORECAST: 2015 - 2020
(Last 12-month % change)



* Forecast.

production associated with supply factors, and to domestic uncertainty. Economic indicators show a clear recovery in the fourth quarter, which will be reflected in an annual growth rate of 4.0 percent in 2018 and a negative output gap of around half a percentage point.

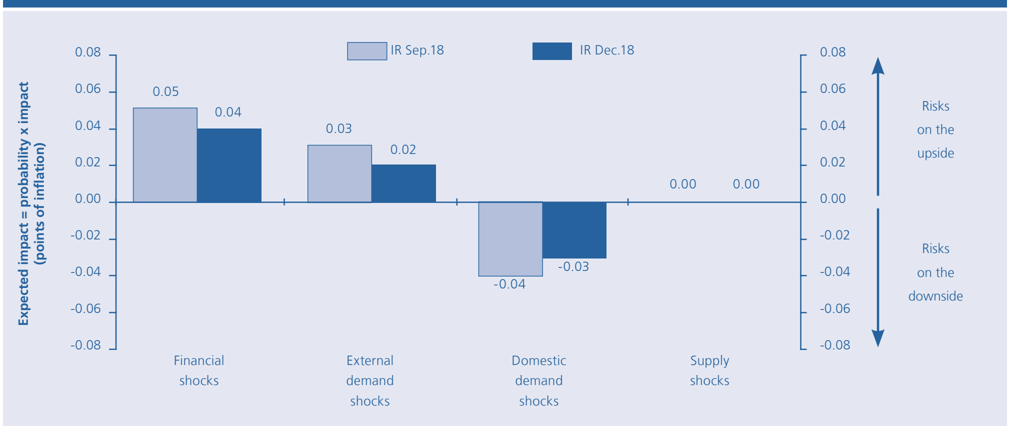
The product gap would be completely closed in the forecast horizon. A slight moderation is expected in domestic demand in 2019 as a result of lower public spending after the start of the fiscal consolidation process and the change of subnational authorities, although this is foreseen to be offset in part by the normalization of mining production and by higher private expenditure. By 2020, domestic demand would show higher growth, in line with the advance of private spending on mining megaprojects and infrastructure works.

Year-on-year **inflation** rose from 1.1 percent in August to 2.2 percent in November, around the midpoint of the target range. This trend would culminate the reversal of the supply shocks observed in the previous year as the increase in food and energy prices has risen from 0 to 2.2 percent, while inflation excluding food and energy has remained at around 2 percent. Inflation expectations, which have remained within the target range since March 2017, showed a rate of 2.5 percent in November and are estimated to decrease gradually towards 2 percent in the forecast horizon.

Balance of risk

The balance of **risk factors** considered in this Report –external demand shocks (lower growth of global activity due to intensified trade tensions), greater volatility in international financial markets, and domestic demand shocks– translates into a slight positive bias in the inflation forecast.

BALANCE OF RISKS AGAINST THE BASE SCENARIO



SUMMARY OF INFLATION REPORT FORECAST

	2016	2017	2018[1/]		2019[1/]		2020[1/]
			IR Sep.18	IR Dec.18	IR Sep.18	IR Dec.18	
Real % change							
1. Gross Domestic Product	4.0	2.5	4.0	4.0	4.0	4.0	4.0
2. Domestic demand	1.1	1.4	4.4	4.4	4.0	3.9	4.0
a. Private consumption	3.3	2.5	3.8	3.7	3.6	3.7	3.9
b. Public consumption	-0.3	-0.2	3.4	1.8	3.2	2.9	1.8
c. Fixed private investment	-5.4	0.2	5.5	4.7	6.5	6.5	6.0
d. Public investment	-0.2	-2.3	9.9	9.9	2.8	2.8	3.4
3. Exports (good and services)	9.4	7.8	3.5	2.1	4.6	4.7	4.8
4. Imports (good and services)	-2.2	4.1	5.0	3.6	4.7	4.3	5.1
5. Economic growth in main trading partners	2.9	3.5	3.8	3.8	3.6	3.5	3.4
Memo:							
Output gap[2/] (%)	-0.3; 0.2	-1.4; -0.8	-0.9; -0.2	-0.9; -0.2	-0.6; 0.2	-0.6; 0.2	-0.5; 0.5
% change							
6. Inflation	3.2	1.4	2.2	2.1	2.0	2.1	2.0
7. Expected inflation[3/]	-	-	2.2	2.2	2.5	2.5	2.5
8. Expected depreciation[3/]	-	-	1.9	4.1	0.8	0.3	0.4
9. Terms of trade[4/]	-0.4	7.2	1.0	-0.2	-2.9	-0.7	-0.5
a. Export prices	-3.4	13.0	7.4	6.3	-2.2	-2.1	1.2
b. Import prices	-3.0	5.4	6.3	6.5	0.7	-1.4	1.7
Nominal % change							
10. Currency in circulation	6.5	6.7	8.1	8.6	8.5	8.5	8.5
11. Credit to the private sector[5/]	5.6	6.6	9.0	8.5	9.0	9.0	9.0
% GDP							
12. Gross fixed investment	22.9	21.8	22.3	22.5	22.9	23.0	23.4
13. Current account of the balance of payments	-2.7	-1.1	-1.6	-1.9	-1.5	-1.6	-1.7
14. Trade balance	1.0	3.1	3.1	2.8	2.4	2.7	2.6
15. Long-term external financing of the private sector[6/]	4.6	5.7	5.0	5.0	4.0	4.1	3.8
16. Current revenue of the general government	18.6	18.1	19.1	19.3	19.3	19.3	19.4
17. Non-financial expenditure of the general government	20.0	20.1	20.5	20.6	20.4	20.4	20.0
18. Overall balance of the non-financial public sector	-2.5	-3.1	-2.8	-2.7	-2.6	-2.6	-2.1
19. Balance of total public debt	23.8	24.9	25.7	25.9	26.9	26.7	26.9
20. Balance of net public debt	6.8	9.5	11.4	11.1	13.5	13.0	14.0

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.