CENTRAL RESERVE BANK OF PERU

Summary Inflation Report

June 2018

Between January and May 2018, the indicators of **global economic activity** show that the foreseen pace of global economic growth would continue, but that a lower degree of synchronized growth would be seen among the major economies. The Eurozone shows indicators of a slowdown that contrast with the increased dynamism registered in the United States as well as with China's high and stable pace of growth. Therefore, the projections of global growth for 2018 and 2019 remain at 3.8 percent and 3.7 percent, respectively, in line with a lower monetary stimulus in the developed economies and with the convergence of their growth rates to their potential growth levels.

In the first quarter of 2018, **the terms of trade** grew 7.1 percent, reflecting mostly the higher prices of commodity exports (12.8 percent). Since April, however, the prices of our imports –particularly the price of crude– have increased at a magnitude not foreseen in our previous Inflation Report, driven by supply constraints and by a sound growth in the world economy. In this context, the projected growth of the **terms of trade** in 2018 has been revised on the downside, from 7.4 to 4.9 percent, mainly due to the upward adjustment of oil prices and to the revision of the estimated growth of the prices of some metals (lead and zinc), which have been affected by commercial tensions and by the appreciation of the dollar. In 2019, the terms of trade would increase by 1.3 percent.

In the first quarter of 2018, the deficit in the **current account of the balance of payments** was 2.4 percent of GDP. The trade balance continued to be favored by a positive international context (higher terms of trade and sustained growth in global trade) and showed a surplus for the seventh consecutive quarter (this surplus was 0.9 percentage points of GDP higher than that recorded in the same period in 2017).

In the forecast horizon, the current account deficit would be 1.2 percent of GDP in 2018 and 2019, in line with the increased non-traditional exports foreseen for 2018 and with higher terms of trade in 2019. The **long term flow of external private capital** (equivalent to 4.8 percent of GDP in 2018 and 2019) will continue to be the main source of

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

WORLD GDP GROWTH
(Annual % change)

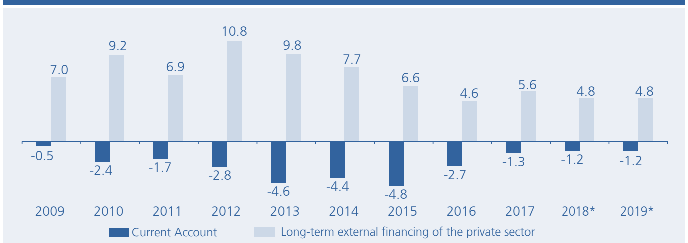
	PPP%[1/]	Trading Peru %[1/]	2016	2017	2018*		2019*	
					IR Mar.18	IR Jun.18	IR Mar.18	IR Jun.18
Advanced economies	**41.3**	**42.9**	**1.7**	**2.3**	**2.3**	**2.3**	**2.0**	**2.0**
Of which:								
1. United States	15.3	20.2	1.5	2.3	2.7	2.8	2.2	2.2
2. Eurozone	11.6	12.8	1.8	2.5	2.3	2.2	2.0	2.0
Germany	3.3	2.7	1.8	2.5	2.4	2.2	2.0	2.0
France	2.2	0.8	1.2	1.9	2.0	1.9	1.8	1.8
Italy	1.8	1.8	0.9	1.5	1.4	1.3	1.2	1.2
Spain	1.4	4.0	3.2	3.1	2.5	2.5	2.2	2.2
3. Japan	4.3	4.0	1.0	1.8	1.3	1.3	1.0	1.0
4. United Kindgom	2.3	1.3	1.8	1.8	1.4	1.4	1.4	1.4
5. Canada	1.4	2.6	1.4	2.8	2.1	2.0	1.9	1.9
Emerging market and developing economies	**58.7**	**57.1**	**4.2**	**4.7**	**4.9**	**4.9**	**4.9**	**5.0**
Of which:								
1. Developing Asia	32.4	34.9	6.4	6.6	6.5	6.6	6.5	6.6
China	18.2	27.9	6.7	6.9	6.5	6.6	6.3	6.4
India	7.4	3.8	7.1	6.7	7.4	7.4	7.8	7.8
2. Commonwealth of Independent States	4.5	0.5	0.4	2.2	2.2	2.2	2.2	2.2
Russia	3.2	0.5	-0.2	1.8	1.7	1.7	1.7	1.7
3. Latin America and the Caribbean	7.7	21.6	-0.5	1.4	2.2	2.2	2.7	2.7
Brazil	2.6	5.4	-3.4	1.0	2.5	2.5	2.4	2.9
Chile	0.4	3.3	1.7	1.5	3.0	3.6	3.0	3.5
Colombia	0.6	2.9	1.6	1.8	2.9	2.6	3.0	3.0
Mexico	1.9	3.0	2.4	2.0	2.2	2.2	2.5	2.3
Peru	0.3	-	4.0	2.5	4.0	4.0	4.0	4.2
World Economy	**100.0**	**100.0**	**3.1**	**3.7**	**3.8**	**3.8**	**3.7**	**3.7**
Memo: Peru's trading partners [1/ 2/]	65.9		2.8	3.6	3.7	3.8	3.5	3.6

1/ The weights (PPP purchasing power parity) correspond to the year 2017.
2/ Basket of Peru's 20 main trading partners.
* Forecast.
Source: Bloomberg, IMF, and Consensus Forecast.

TERMS OF TRADE: 2001-2009
(Annual average % change)

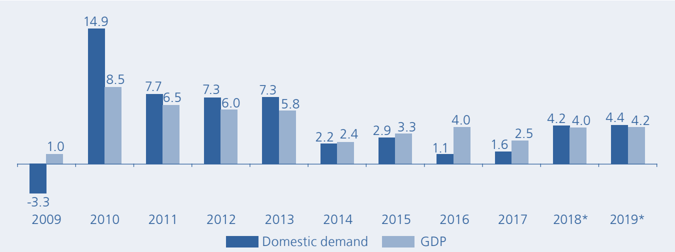
* Forecast.
Source: BCRP.

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.

DOMETIC DEMAND AND GDP: 2009-2019
(Real % change)



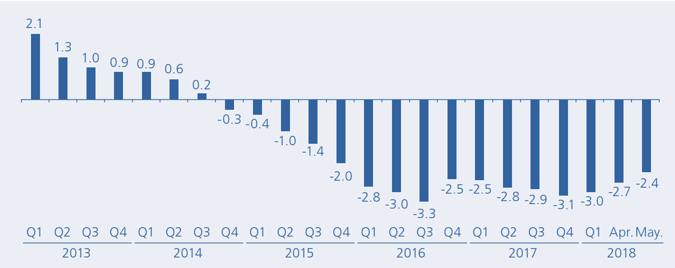
* Forecast.

GDP AND DOMESTIC DEMAND
(Real % change)

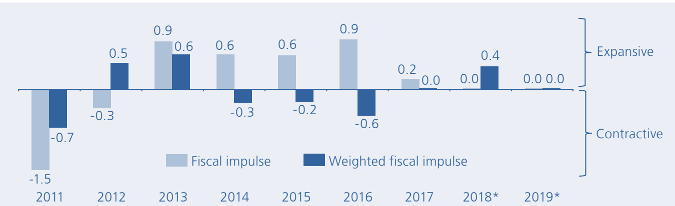
	2017		2018*			2019*	
	Q1	Year	Q1	IR Mar.18	IR Jun.18	IR Mar.18	IR Jun.18
Domestic demand	**-0.4**	**1.6**	**3.9**	**4.2**	**4.2**	**4.2**	**4.4**
Private consumption	2.2	2.5	3.2	3.2	3.4	3.6	3.7
Public consumption	-8.4	1.0	5.2	4.0	3.8	2.5	2.5
Private investment	-5.3	0.3	5.3	5.5	5.5	7.5	7.5
Public investment	-17.4	-2.3	4.0	14.2	12.6	5.0	5.0
Change on inventories (contribution)	0.6	-0.1	0.1	0.0	0.0	0.0	0.0
Exports	**11.1**	**7.2**	**4.3**	**3.2**	**4.4**	**3.6**	**3.9**
imports	**0.4**	**4.0**	**7.1**	**4.0**	**5.1**	**4.3**	**4.5**
GDP	**2.3**	**2.5**	**3.2**	**4.0**	**4.0**	**4.0**	**4.2**
Memo:							
Public expenditure	*-10.5*	*0.1*	*5.0*	*6.8*	*6.2*	*3.2*	*3.2*
Domestic demand without inventories	*-1.1*	*1.7*	*3.8*	*4.2*	*4.2*	*4.2*	*4.4*

* Forecast.
IR: Inflation Report.

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

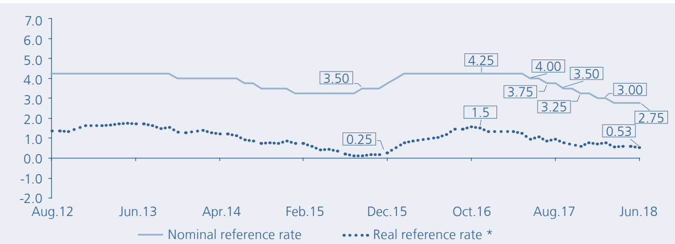


WEIGHTED FISCAL IMPULSE [1/]
(% Potential GDP)



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

NOMINAL AND REAL* REFERENCE INTEREST RATE
(%)



* Considers expectation of inflation.

financing of the balance of payments, exceeding largely the requirements of the current account.

Economic activity grew 3.2 percent in the first quarter of 2018 –the highest rate observed since the third quarter of 2016 (4.7 percent)–, supported by a recovery in the **domestic demand**, which grew 3.9 percent and thus offset the impacts of the negative shocks that affected the economy in 2017. The higher pace of public expenditure (associated mostly with reconstruction and maintenance projects) stands out together with an improvement in private investment which reflected better terms of trade. In turn, this had a positive impact on non-primary sectors (which grew 3.6 percent), especially on the sectors of construction and services.

In the forecast horizon, the GDP growth rate projected for 2018 remains at 4.0 percent, while the growth rate projected for 2019 has been revised up from 4.0 to 4.2 percent, in line with the dynamism of domestic demand, especially private consumption and private investment, due to the recovery of business confidence and to the fiscal stimulus associated with the Reconstruction Plan and with investment for the Pan American Games.

After reaching a peak of 3.1 percent of GDP in 2017, the **fiscal deficit** initiated a downward trend and recorded an annual rate of 2.4 percent of GDP in May 2018. This rate of deficit reflected mainly a recovery in the current revenues of the general government as a result of increased revenue from the regularization of the income tax, which registered a maximum record this year.

Revenue is expected to continue showing a positive trend in the forecast horizon, driven by the better performance of domestic demand, increased revenue from mining, lower tax refunds, and by the increase in the excise tax. On the other hand, current expenditure would moderate the pace of growth observed early in the year while public investment would increase due to the reconstruction works after the damages caused by El Niño Costero and due to the projects being carried out for the Pan American Games. As a result, the fiscal deficit in 2018 would reach 3.1 percent of GDP and would decline in 2019 to 2.9 percent of GDP, in line with fiscal consolidation. This projection implies a positive weighted fiscal impulse in 2018 and a nil impulse in 2019, which would coincide with the closure of the output gap.

In this context of recovery of economic activity and with forecasts indicating a level of inflation in the midpoint of the target range, the Board of BCRP maintained the **benchmark rate** at 2.75 percent in the second quarter of the year. This rate is equivalent to a real interest rate of 0.5 percent, which reflects an expansionary monetary policy stance in a context in which no demand pressures are foreseen.

Credit to the private sector recorded a YoY growth rate of 8.6 percent in April 2018, in a context of recovery of the demand of the private sector. In the forecast horizon, credit to the private sector is expected to evolve in line with the pace of growth of domestic demand, with growth rates of 8.5 percent and 8.8 percent being expected for 2018 and 2019, respectively. This is consistent with the monetary easing measures implemented, that is, with the reduction of both the benchmark interest rate and the rates of reserves requirements in both domestic currency and foreign currency.

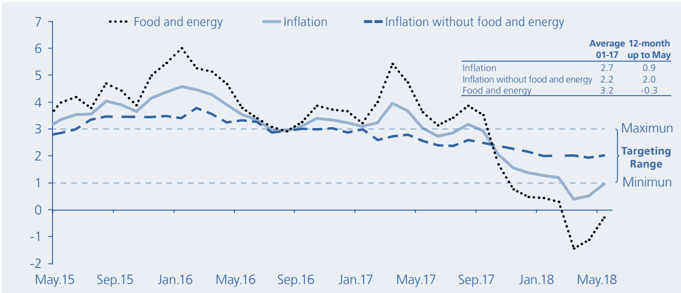
Inflation decreased from 1.18 percent in February to 0.93 percent in May due mainly to the evolution of inflation in the group of Food and Energy prices, which still shows a decline due to the reversal of the supply shocks that affected agricultural products in 2017. The CPI without Food and Energy recorded a variation of 2.0 percent, in line with the midpoint of the inflation target. Moreover, remaining within the inflation target range since March 2017, expectations of inflation in twelve months continued to decline and reached an annual rate of 2.2 percent.

Inflation is forecast to show levels below 2.0 percent during the first half of 2018 due to the correction of the supply shocks that increased prices between the last months of 2016 and the first half of 2017, and to converge gradually thereafter towards 2 percent. Moreover, inflation without Food and Energy and inflation expectations are also expected to show levels around 2 percent in the forecast horizon, in a context in which no inflationary pressures are foreseen on the side of demand and moderate levels of imported inflation are expected.

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

	Dec.16	Dec.17	Mar.18	Apr.18
Business	**4.8**	**5.4**	**6.6**	**7.6**
Corporate and large companies	4.5	6.0	8.0	9.3
Medium-sized enterprises	2.7	0.7	1.9	3.0
Small business and Microbusinesses	7.8	9.5	8.6	8.8
Individuals	**7.2**	**8.7**	**9.6**	**10.2**
Consumer	8.7	8.8	10.3	11.1
Car loans	-6.9	-4.2	-0.6	-0.2
Credit cards	8.2	3.0	3.8	4.9
Rest	10.2	13.0	14.6	15.2
Mortgage	5.0	8.6	8.7	9.0
TOTAL	**5.6**	**6.6**	**7.7**	**8.6**

INFLATION
(% change last 12 -month)

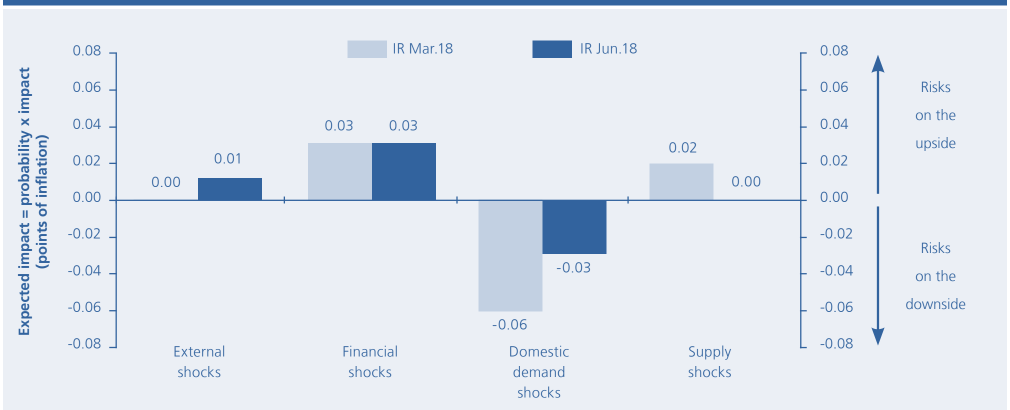


INFLATION FORECAST: 2015 - 2019
(Last 12-month % change)

Balance of risks

The balance of the **risk factors** considered in this Report –domestic demand shocks (a more gradual recovery of private and public investment), volatility in international financial markets, external demand shocks (lower global growth due to the additional protectionist measures of the United States and commercial retaliation of some of their trading partners), and supply shocks (increase in the prices of fuels and some imported food products) translates into a neutral balance, which means that the impact of factors that could affect inflation on the upside is counterbalanced by the impact of factors that could affect inflation on the downside.

BALANCE OF RISKS AGAINST THE BASE SCENARIO



SUMMARY OF INFLATION REPORT FORECAST

	2016	2017	2018[1/]		2019[1/]	
			IR Mar.18	IR Jun.18	IR Mar.18	IR Jun.18
Real % change						
1. Gross Domestic Product	4.0	2.5	4.0	4.0	4.0	4.2
2. Domestic demand	1.1	1.6	4.2	4.2	4.2	4.4
a. Private consumption	3.3	2.5	3.2	3.4	3.6	3.7
b. Public consumption	-0.6	1.0	4.0	3.8	2.5	2.5
c. Fixed private investment	-5.7	0.3	5.5	5.5	7.5	7.5
d. Public investment	-0.2	-2.3	14.2	12.6	5.0	5.0
3. Exports (good and services)	9.5	7.2	3.2	4.4	3.6	3.9
4. Imports (good and services)	-2.2	4.0	4.0	5.1	4.3	4.5
5. Economic growth in main trading partners	2.8	3.6	3.7	3.8	3.5	3.6
Memo:						
Output gap [2/] (%)	-0.3 ; 0.2	-1.4 ; -0.8	-1.0 ; -0.3	-0.9 ; -0.2	-0.7 ; 0.0	-0.4 ; 0.4
% change						
6. Inflation	3.2	1.4	2.0	2.2	2.0	2.0
7. Expected inflation [3/]	-	-	2.2	2.2	2.5	2.5
8. Expected depreciation [3/]	-	-	0.8	1.6	1.1	1.5
9. Terms of trade [4/]	-0.7	7.3	7.4	4.9	0.2	1.3
a. Export prices	-3.6	13.1	12.0	11.6	0.1	1.9
b. Import prices	-3.0	5.4	4.3	6.4	-0.1	0.6
Nominal % change						
10. Currency in circulation	6.5	6.7	7.6	7.6	8.0	8.5
11. Credit to the private sector [5/]	5.6	6.6	7.5	8.5	7.8	8.8
% GDP						
12. Gross fixed investment	22.8	21.7	22.2	22.1	22.8	22.7
13. Current account of the balance of payments	-2.7	-1.3	-1.2	-1.2	-1.3	-1.2
14. Trade balance	1.0	2.9	4.3	3.9	4.2	4.1
15. Long-term external financing of the private sector [6/]	4.6	5.6	4.4	4.8	4.4	4.8
16. Current revenue of the general government	18.5	18.0	18.3	18.7	18.5	18.8
17. Non-financial expenditure of the general government	19.9	20.0	20.3	20.4	20.0	20.3
18. Overall balance of the non-financial public sector	-2.6	-3.1	-3.5	-3.1	-2.9	-2.9
19. Balance of total public debt	23.8	24.8	25.3	25.2	26.3	26.1
20. Balance of net public debt	6.8	9.5	12.3	11.8	14.8	14.1

IR: Inflation Report.
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.