CENTRAL RESERVE BANK OF PERU

Summary Inflation Report

March 2018

During 2017, the **world economy** recorded a growth rate of 3.7 percent, the highest rate since 2011. The increased dynamism of domestic demand and better conditions in the labor market and credit stood out in the developed economies, while growth in the developing countries was favored mostly by higher commodity prices and better international financial conditions. In line with recent data of some global indicators on manufacturing activity, services, and global trade, as well as with a gradual withdrawal of monetary stimulus by the Federal Reserve and other central banks, the projections of global growth for 2018 and for 2019 have been revised up, from 3.7 to 3.8 percent in 2018 and from 3.6 to 3.7 percent in 2019.

In 2017 the terms of trade grew 7.3 percent, reflecting mostly the higher prices of commodity exports. So far this year, metal prices have remained high (not seen in our previous Inflation Report), supported by an increased global demand, supply constraints, increased speculative positions, and the depreciation of the dollar. Because of this, the growth of the **terms of trade** in 2018 is also corrected up from 2.8 to 7.4 percent, while the projection of a stabilization of the terms of trade in 2019 remains unchanged.

In 2017, the deficit in the **current account of the balance of payments** declined to 1.3 percent of GDP, reflecting basically a higher trade surplus as a result of the recovery of the terms of trade and sustained growth in our trading partners which translated into a higher volume of exports of both traditional and non-traditional products. In the forecast horizon, the revision of terms of trade on the upside and the higher growth of our trading partners imply a current account deficit of 1.2 and 1.3 percent of GDP in 2018 and 2019, respectively, in line with the expected recovery of domestic demand. The **long term financial account** (equivalent to 4.4 percent of GDP in 2018 and 2019) will continue to be the main source of financing of the balance of payments, exceeding largely the requirements of the current account.

Economic activity continued recovering after the reversal of the shocks that affected the economy at the beginning of last year and showed a growth rate of 2.5 percent, driven by the increase observed in the terms of trade. In 2017, **domestic demand** grew 1.6 percent in annual terms as a result of

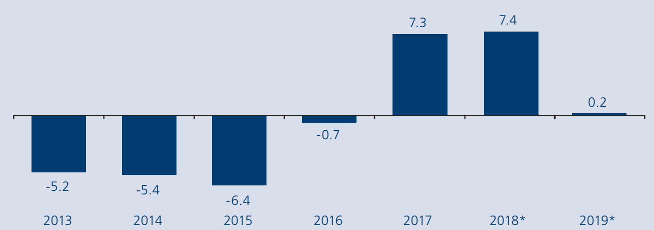
This ***Inflation Report*** was prepared using data on the Balance of Payments and the Gross Domestic Product as of the fourth quarter of 2017, and data on Monetary Accounts, the operations of the Non-Financial Public Sector, Inflation, Financial Markets, and the Exchange Rate as of February 2018.

WORLD GDP GROWTH
(Annual % change)

	PPP% 1/	Trading Peru % 1/	2016	2017*	2018* IR Dec.17	2018* IR Mar.18	2019* IR Dec.17	2019* IR Mar.18
Advanced economies	**41.9**	**47.3**	**1.7**	**2.3**	**2.0**	**2.3**	**1.9**	**2.0**
Of which:								
1. United States	15.5	18.0	1.5	2.3	2.3	2.7	2.0	2.2
2. Eurozone	11.8	11.2	1.8	2.5	2.1	2.3	1.8	2.0
3. Japan	4.4	3.1	1.0	1.7	1.1	1.3	1.0	1.0
4. United Kingdom	2.3	1.2	1.8	1.8	1.3	1.4	1.3	1.4
Emerging market and developing economies	**58.1**	**52.7**	**4.2**	**4.7**	**4.9**	**4.9**	**4.9**	**4.9**
Of which:								
1. Developing Asia	31.6	28.0	6.4	6.5	6.5	6.5	6.4	6.5
China	17.8	22.9	6.7	6.9	6.4	6.5	6.2	6.3
India	7.2	2.4	7.1	6.7	7.6	7.4	7.9	7.8
2. Commonwealth of Independent States	4.5	0.6	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	7.9	21.9	-0.5	1.4	2.4	2.2	2.7	2.7
Brazil	2.6	4.5	-3.4	1.0	2.5	2.5	2.4	2.4
Chile	0.4	3.0	1.7	1.5	2.9	3.0	2.7	3.0
Colombia	0.6	2.6	1.6	1.8	2.9	2.9	3.0	3.0
Mexico	1.9	2.9	2.4	2.1	2.0	2.2	2.5	2.5
Peru	0.3	-	4.0	2.5	4.2	4.0	4.2	4.0
World Economy	**100.0**	**100.0**	**3.1**	**3.7**	**3.7**	**3.8**	**3.6**	**3.7**
Memo:								
Peru's trading partners 1/ 2/	64.8		2.8	3.5	3.5	3.6	3.3	3.4

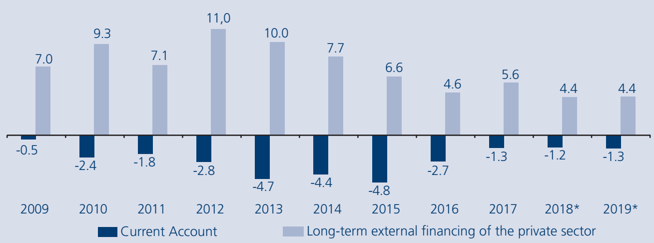
1/ 2016.
2/ Basket of Peru's 20 main trading partners.
* Forecast.
Source: Bloomberg, IMF, and Consensus Forecast.

TERMS OF TRADE: 2013-2019
(Annual average % change)



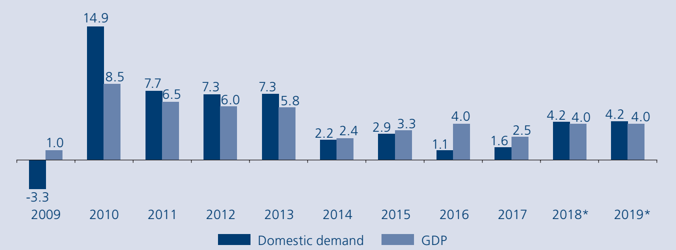
* Forecast.

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)

	2016	2017	2018*		2019*	
			IR Dec.17	IR Mar.18	IR Dec.17	IR Mar.18
Domestic demand	**1.1**	**1.6**	**4.4**	**4.2**	**4.3**	**4.2**
Private consumption	3.3	2.5	3.3	3.2	3.8	3.6
Public consumption	-0.5	1.0	3.6	4.0	2.0	2.5
Private investment	-5.7	0.3	6.5	5.5	7.5	7.5
Public investment	0.2	-2.8	12.5	14.2	4.0	5.0
Change on inventories (contribution)	0.2	0.0	0.1	0.0	0.0	0.0
Exports	**9.5**	**7.2**	**3.5**	**3.2**	**3.8**	**3.6**
Imports	**-2.2**	**4.0**	**4.3**	**4.0**	**4.3**	**4.3**
GDP	**4.0**	**2.5**	**4.2**	**4.0**	**4.2**	**4.0**
Memo:						
Public expenditure	*-0.3*	*-0.1*	*6.2*	*6.8*	*2.6*	*3.2*
Domestic demand without inventories	*0.9*	*1.7*	*4.4*	*4.2*	*4.3*	*4.2*

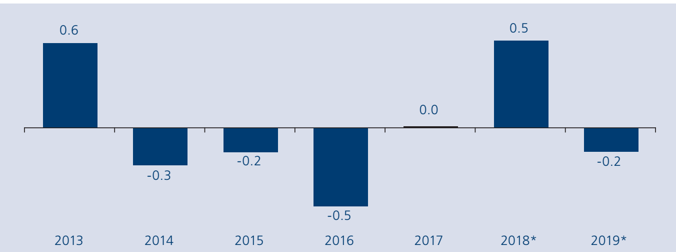
* Forecast.
IR: Inflation Report.

NON-FINANCIAL PUBLIC SECTOR
(% GDP)

	2016	2017	2018*		2019*	
			IR Dec.17	IR Mar.18	IR Dec.17	IR Mar.18
1. General government current revenues	**18.5**	**18.0**	**18.3**	**18.3**	**18.5**	**18.5**
Real % change	*-4.1%*	*0.7%*	*5.9%*	*7.4%*	*5.4%*	*5.6%*
2. General government non-financial expenditure	**19.9**	**20.0**	**20.5**	**20.3**	**20.0**	**20.0**
Real % change	*-2.4%*	*3.9%*	*7.1%*	*7.7%*	*1.6%*	*2.5%*
Of which:						
Current expenditure	15.3	15.3	15.2	15.3	14.8	15.1
Real % change	*0.3%*	*3.9%*	*5.8%*	*5.9%*	*1.4%*	*2.6%*
Gross capital formation	4.1	4.0	4.7	4.3	4.6	4.3
Real % change	*-3.1%*	*1.0%*	*14.0%*	*15.7%*	*3.3%*	*2.9%*
3. Others	**0.0**	**0.1**	**0.1**	**-0.1**	**0.0**	**-0.1**
4. Primary balance (1-2+3)	**-1.5**	**-1.9**	**-2.2**	**-2.2**	**-1.4**	**-1.6**
5. Interests	**1.1**	**1.2**	**1.4**	**1.3**	**1.4**	**1.3**
6. Overall Balance	**-2.6**	**-3.1**	**-3.5**	**-3.5**	**-2.9**	**-2.9**

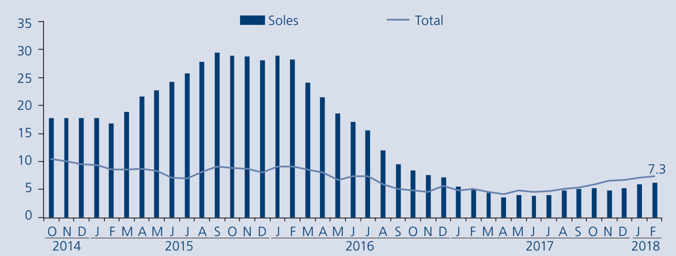
* Forecast.
IR: Inflation Report.

WEIGHTED FISCAL IMPULSE: 2013-2019
(% Potential GDP)



* Forecast.

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



the recovery of private investment in mining a context of higher prices for our mining exports and increased public expenditure during the second half of the year. At the sector level, the growth of the construction sector was noteworthy, in line with the better evolution of public and private investment. The growth of the output, however, was lower than expected since the recovery of investment at the end of the year was lower than anticipated.

The GDP growth rate projected for the forecast horizon has been revised down, from 4.2 in 2018 and 2019 (estimated in the previous report) to 4.0 percent in each of these years, in line with the lower dynamism of private expenditure due to the deterioration of consumer and business expectations. This effect would be offset in part by the positive impact of the increase in the terms of trade. Public expenditure would recover as estimated in the previous report, in line with the fiscal impulse associated with the Reconstruction Plan and the Pan American Games.

In 2017, the **fiscal deficit** increased to 3.1 percent of GDP, after having recorded a rate of 2.6 percent of GDP in 2016. This higher deficit reflected mainly the reduction of 0.5 percent of GDP in current revenues, affected by the slowdown of economic activity, as well as changes in the tax regime (implementation of the new tax regime for MSE and the Fair VAT), and the increase of tax rebates, which showed historic levels. Another element that contributed to this, although to a lesser extent, was the increase of the non-financial expenditure of the general government due to higher current expenditure in wages. It is also worth pointing out the reversal of gross capital formation since the third quarter of 2017.

Revenue is expected to recover in the forecast horizon, driven by the better performance of domestic demand, increased revenue from mining, lower rebates, and a higher tax withholdings rate. Public investment is also expected to show a faster pace of growth due to the beginning of the reconstruction works after the damages caused by El Niño Costero and the projects to be carried out for the Pan American Games. Thus, the fiscal deficit projected for 2018 remains at 3.5 percent of GDP. 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 2018, which would reverse in 2019, coinciding with the closure of the output gap.

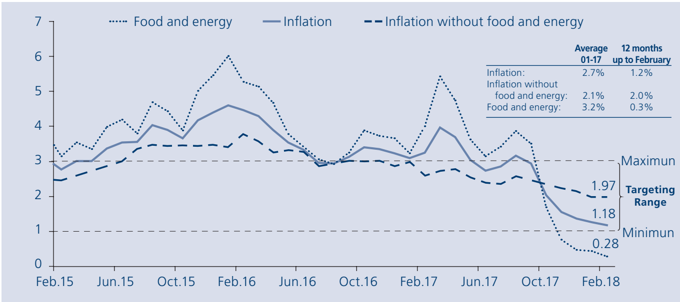
Credit to the private sector recorded a YoY growth rate of 6.6 percent in 2017 and increased to a YoY rate to 7.3 percent in February 2018, this growth rate being explained mainly by the growth of personal loans (9.6 percent) in a context of recovery of the demand of the private sector. In the forecast horizon, credit to the private sector is expected to evolve in line with the pace of growth of domestic demand, with growth rates of 7.5 percent and 7.8 percent being expected in 2018 and 2019, respectively. This is consistent with the monetary easing measures implemented, that is, with the reduction of the benchmark interest rate and with the reduction of the rates of reserves requirements in both domestic currency and foreign currency.

Inflation decreased from 1.54 percent in November to 1.18 percent in February 2018 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, as well as due to the context of a weak economic cycle. Moreover, expectations of inflation in twelve months have also continued to decline and remain within the inflation target range since March 2017.

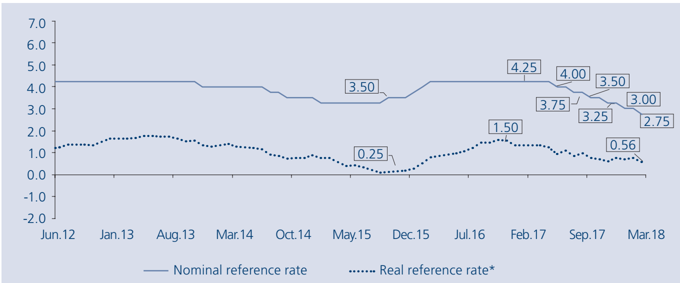
In this context, the Board of BCRP lowered the **benchmark rate**, for the second time this year, to 2.75 percent in March. This reduction in the benchmark interest rate is consistent with inflation's convergence to a rate of 2.0 percent once the effect of the reversal of the supply shocks that led inflation to the lower band of the target range disappears.

Inflation is expected 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 towards 2 percent thereafter. 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.

INFLATION
(% change last 12 -month)

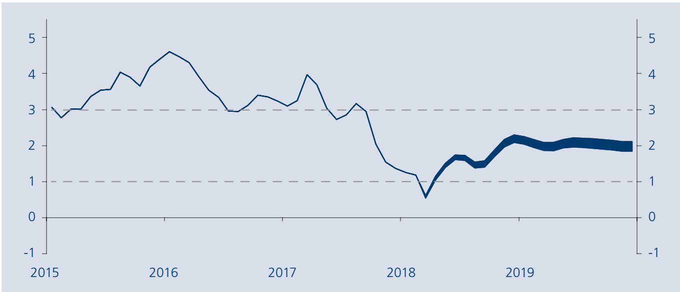


NOMINAL AND REAL* REFERENCE INTEREST RATE
(%)



* With expectation of inflation.

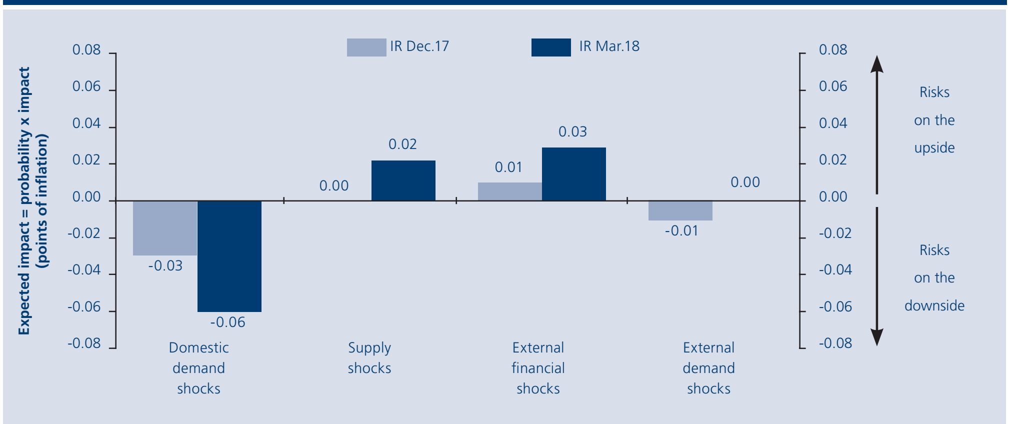
INFLATION FORECAST: 2015 - 2019
(Last 12-month % change)



Balance or risk

The balance of 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 supply shocks (increase in the prices of fuels and in the prices of some imported food products) translates into a slight downward bias on the inflation forecast.

BALANCE OF RISKS AGAINST THE BASE SCENARIO



SUMMARY OF INFLATION REPORT FORECAST

	2016	2017	2018[1/]		2019[1/]	
			IR Dec.17	IR Mar.18	IR Dec.17	IR Mar.18
Real % change						
1. Gross Domestic Product	4.0	2.5	4.2	4.0	4.2	4.0
2. Domestic demand	1.1	1.6	4.4	4.2	4.3	4.2
a. Private consumption	3.3	2.5	3.3	3.2	3.8	3.6
b. Public consumption	-0.5	1.0	3.6	4.0	2.0	2.5
c. Fixed private investment	-5.7	0.3	6.5	5.5	7.5	7.5
d. Public investment	0.2	-2.8	12.5	14.2	4.0	5.0
3. Exports (good and services)	9.5	7.2	3.5	3.2	3.8	3.6
4. Imports (good and services)	-2.2	4.0	4.3	4.0	4.3	4.3
5. Economic growth in main trading partners	2.8	3.5	3.4	3.6	3.3	3.4
Memo:						
Output gap [2/] (%)	-1.0 ; 0.0	-1.3 ; -0.7	-0.5 ; 0.0	-1.0 ; -0.3	-0.5 ; 0.0	-0.7 ; 0.0
% change						
6. Inflation	3.2	1.4	2.0	2.0	2.0	2.0
7. Expected inflation [3/]	-	-	2.5	2.2	2.7	2.5
8. Expected depreciation [3/]	-	-	1.4	0.8	0.6	1.1
9. Terms of trade [4/]	-0.7	7.3	2.8	7.4	0.0	0.2
a. Export prices	-3.6	13.1	4.0	12.0	1.0	0.1
b. Import prices	-3.0	5.4	1.2	4.3	1.0	-0.1
Nominal % change						
10. Currency in circulation	6.5	6.7	6.0	7.6	6.0	8.0
11. Credit to the private sector [5/]	5.6	6.6	7.0	7.5	7.0	7.8
% GDP						
12. Gross fixed investment	22.8	21.6	22.5	22.2	23.1	22.8
13. Current account of the balance of payments	-2.7	-1.3	-1.6	-1.2	-1.7	-1.3
14. Trade balance	1.0	2.9	3.1	4.3	2.9	4.2
15. Long-term external financing of the private sector [6/]	4.6	5.6	4.1	4.4	4.2	4.4
16. Current revenue of the general government	18.5	18.0	18.3	18.3	18.5	18.5
17. Non-financial expenditure of the general government	19.9	20.0	20.5	20.3	20.0	20.0
18. Overall balance of the non-financial public sector	-2.6	-3.1	-3.5	-3.5	-2.9	-2.9
19. Balance of total public debt	23.6	24.7	26.2	25.3	27.4	26.3
20. Balance of net public debt	6.7	9.4	12.6	12.3	15.0	14.8

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.