CENTRAL RESERVE BANK OF PERU

Summary Inflation Report

September 2018

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

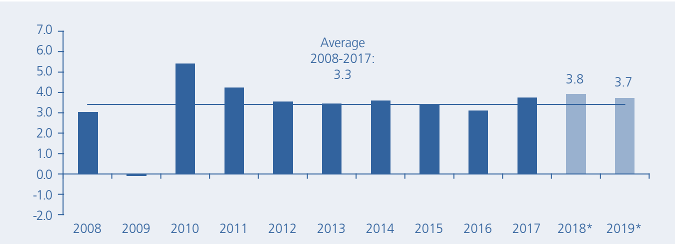
Although recent indicators of **global economic activity** continue to point to the growth rate foreseen for this year (3.8 percent), as anticipated in our Inflation Report of June, global growth will be less synchronized and will show higher risks. Slightly lower growth rates than those observed this year are expected for 2019 due mainly to a lower dynamism in the United States and in other developed economies, in line with lower monetary stimulus and the convergence of their growth rates to their potential growth levels.

The **terms of trade** grew 7.5 percent in the first half of 2018, reflecting the higher prices of commodity exports (14.8 percent). However, between July and mid-September, the prices of minerals have registered a downward correction, affected by increased uncertainty as a result of the intensification of trade tensions (particularly tensions between the US and China), the appreciation of the dollar, and fears of lower growth in China. In this context, the projected growth of the **terms of trade** in 2018 has been revised on the downside, from 4.9 to 1.0 percent. In 2019, the terms of trade are expected to decline by 2.9 percent, although they still would show higher levels than those observed in 2017.

In the first half of 2018, the deficit in the **current account of the balance of payments** was 1.9 percent of GDP, higher than the rate recorded in the same period of 2017, mainly as a result of the higher factor income (associated with the higher profits obtained from the high prices of minerals) and service income (due to extraordinary income for insurance and reinsurance in 2017). On the other hand, 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 1.1 percentage points of GDP higher than that recorded in the same period in 2017.

In the forecast horizon, the downward correction of metal prices observed since July of this year will imply a lower surplus in the trade balance and a higher current account deficit than projected in the Inflation Report of June. The

WORLD GROWTH
(Annual % change)



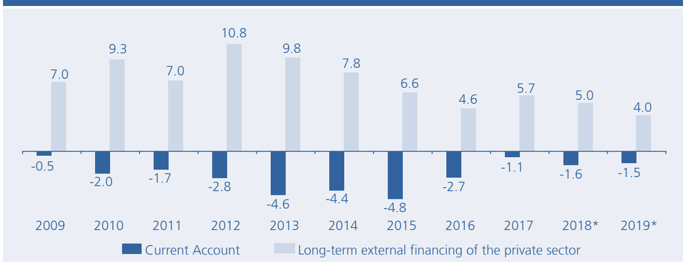
* Forecast.
Source: Bloomberg, IMF, and Consensus Forecast.

TERMS OF TRADE

	2017	2018*		2019*	
		IR Jun.	IR Sep.	IR Jun.	IR Sep.
Terms of Trade (Annual % chg.)	**7.2**	**4.9**	**1.0**	**1.3**	**-2.9**
Price of exports (Annual % chg.)	**13.0**	**11.6**	**7.4**	**1.9**	**-2.2**
Copper (US$ cents per pound)	280	319	295	329	275
Zinc (US$ cents per pound)	131	146	131	142	111
Lead (US$ cents per pound)	105	112	103	113	94
Gold (US$ per troy ounce)	1,257	1,314	1,264	1,335	1,225
Price of imports (Annual % chg.)	**5.4**	**6.4**	**6.3**	**0.6**	**0.7**
Oil (US$ per barrel)	51	65	67	63	66
Wheat (US$ per ton)	145	186	192	198	207
Maize (US$ per ton)	131	145	135	162	151
Soybean oil (US$ per ton)	707	674	640	713	653
Soybean meal (US$ per ton)	348	402	381	384	354

* Forecast.
IR: Inflation Report.

CURRENT ACCOUNT AND LONG-TERM EXTERNAL FINANCING OF THE PRIVATE SECTOR 1/
(% GDP)



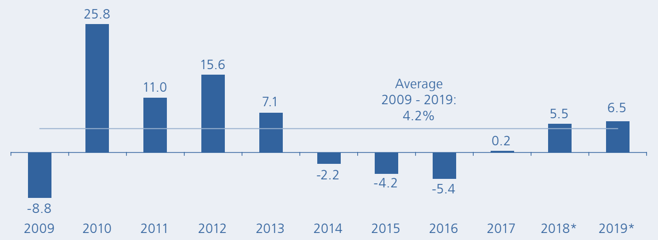
1/ Includes net foreign investments, portfolio investment, and private sector's long-term disbursement.
* Forecast.

GDP AND DOMESTIC DEMAND
(Real % change)

	2017		2018*			2019*	
	I Sem.	Year	I Sem.	IR Jun.18	IR Sep.18	IR Jun.18	IR Sep.18
Domestic demand	**-0.2**	**1.4**	**5.3**	**4.2**	**4.4**	**4.4**	**4.0**
Private consumption	2.4	2.5	3.8	3.4	3.8	3.7	3.6
Public consumption	-5.3	0.2	3.0	3.8	3.4	2.5	3.2
Private investment	-4.0	0.2	6.9	5.5	5.5	7.5	6.5
Public investment	-10.9	-2.3	7.6	12.6	9.9	5.0	2.8
Change on inventories (contribution)	0.0	-0.2	0.8	0.0	0.0	0.0	0.0
Exports	**12.6**	**7.8**	**3.2**	**4.4**	**3.5**	**3.9**	**4.6**
Imports	**2.5**	**4.1**	**6.8**	**5.1**	**5.0**	**4.5**	**4.7**
GDP	**2.4**	**2.5**	**4.3**	**4.0**	**4.0**	**4.2**	**4.0**
Memo:							
Public expenditure	*-6.6*	*-0.5*	*4.0*	*6.2*	*5.2*	*3.2*	*3.1*
Domestic demand without inventories	*-0.2*	*1.6*	*4.4*	*4.2*	*4.3*	*4.4*	*4.0*

* Forecast.
IR: Inflation Report.

PRIVATE INVESTMENT
(Real % change)



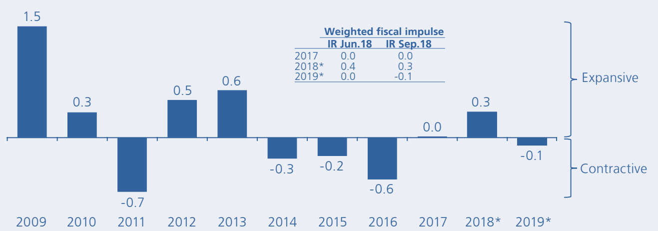
* Forecast.

NON-FINANCIAL PUBLIC SECTOR
(% GDP)

	2017		2018*			2019*	
	I Sem.	Year	I Sem.	IR Jun.18	IR Sep.18	IR Jun.18	IR Sep.18
1. General government current revenues 1/	**19.0**	**18.1**	**20.7**	**18.7**	**19.1**	**18.8**	**19.3**
Real % change	*-2.5%*	*0.4%*	*16.5%*	*9.6%*	*10.4%*	*5.0%*	*4.5%*
2. General government non-financial expenditure 2/	**17.8**	**20.1**	**17.8**	**20.4**	**20.5**	**20.3**	**20.4**
Real % change	*-0.2%*	*4.2%*	*6.3%*	*7.3%*	*6.7%*	*4.0%*	*3.2%*
Of which:							
Current expenditure	14.2	15.4	14.2	15.4	15.6	15.3	15.7
Real % change	*-0.3%*	*3.9%*	*6.9%*	*6.0%*	*6.3%*	*4.0%*	*4.1%*
Gross capital formation	2.8	4.0	3.1	4.3	4.3	4.2	4.1
Real % change	*-10.1%*	*1.6%*	*16.9%*	*14.5%*	*11.8%*	*2.6%*	*0.0%*
3. Others	**-0.2**	**0.1**	**-0.2**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
4. Primary balance (1-2+3)	**0.9**	**-1.9**	**2.8**	**-1.8**	**-1.5**	**-1.6**	**-1.3**
5. Interests	**1.2**	**1.2**	**1.4**	**1.3**	**1.3**	**1.3**	**1.3**
6. Overall Balance	**-0.3**	**-3.1**	**1.4**	**-3.1**	**-2.8**	**-2.9**	**-2.6**
Memo:							
Weighted fiscal impulse	0.1	0.0	-0.5	0.4	0.3	0.0	-0.1
Output gap	-1.1	-1.1	-1.0	-0.6	-0.6	0.0	-0.3

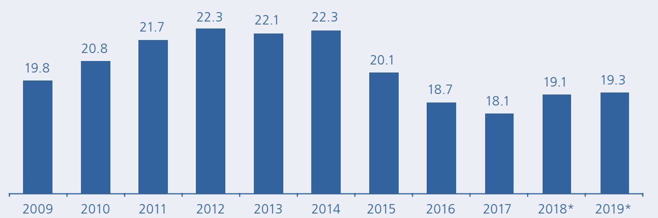
1/ The central government includes the ministries, national universities, public agencies and regional governments. The general government has a wider coverage that includes the central government, social security, regulators and supervisors, government charity organizations and local governments.
2/ Includes net accrued expenses to FEPC.
* Forecast.
IR: Inflation Report.

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.

CURRENT REVENUES OF THE GENERAL GOVERNMENT
(% GDP)



* Forecast.

current account deficit would reach 1.6 percent of GDP in 2018 and 1.5 percent of GDP in 2019, lower than the levels observed in 2012-2016. In line with the projected levels of private investment, the **long-term flow of external private capital** (5.0 percent of GDP in 2018 and 4.0 percent of GDP in 2019) will continue to be the main source of financing the balance of payments, exceeding largely the requirements of the current account.

Economic activity grew 4.3 percent in the first half of 2018, driven by the favorable evolution of domestic demand which grew 5.3 percent, in line with the growth of formal jobs and the payroll. The improvement observed in the prices of minerals contributed to accelerate private investment, particularly that associated with mining. A faster pace of growth was also observed in public expenditure due to the implementation of infrastructure, reconstruction, and maintenance projects after El Niño Costero. Moreover, because the primary sectors are foreseen to show a transitory slowdown associated with a lower mining production in the third quarter, GDP in 2018 is estimated to grow 4.0 percent.

The same GDP growth rate is expected in 2019 (4.0 percent). Private investment will continue to be driven by the execution of mining and infrastructure projects, while public expenditure will slow down due to the change of government in the subnational governments.

After reaching a peak of 3.1 percent of GDP in 2017, the **fiscal deficit** in annual terms (last twelve months) fell to 2.1 percent of GDP in August 2018. The main factor explaining this improvement in the fiscal balance is the increase in the current revenues of the general government as a result of increased revenue from the regularization of the income tax. In 2018 and 2019 the fiscal deficit would decline to 2.8 and 2.6 percent of GDP respectively. This projection implies a positive weighted fiscal impulse of 0.3 percent of GDP in 2018 and a slightly negative fiscal impulse in 2019, which would coincide with the reduction in the output gap.

The revenue expected in 2018 has been corrected on the upside due to the better performance of tax revenue observed so far this year. On the other hand, current expenditure will continue to show the rising pace of growth observed early in the year while public investment will be determined by the implementation of the projects considered in the Reconstruction with Changes Plan, the progress in the implementation of Line 2 of Lima's Metro, and the projects for the Pan American Games. In 2019, tax revenues are expected to increase in line with the measures announced by the government to increase tax collection, with a moderation in tax refunds, and with an increase in excise tax.

Credit to the private sector recorded a YoY growth rate of 8.7 percent in August 2018, in line with the recovery of household consumption and private investment. 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 9.0 percent being expected for both 2018 and 2019. This is consistent with the monetary easing measures implemented in terms of lowering both the benchmark interest rate and the rates of reserves requirements in domestic currency and in foreign currency.

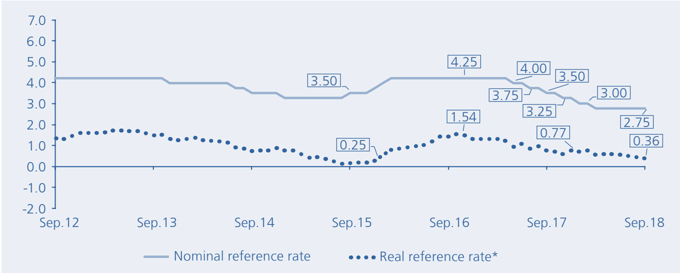
The Board of BCRP maintained the **benchmark rate** at 2.75 percent. This rate is equivalent to a real interest rate of 0.4 percent, which reflects an expansionary monetary policy stance in a context with a negative output gap and in which no demand pressures are foreseen.

Inflation returned to the target range in June 2018 showing a rate of 1.1 percent in August as a result of the gradual normalization of food prices, while the CPI without food and energy recorded a rate in the midpoint of the target range, 2.0 percent. Expectations of inflation, which have remained within the inflation target range since March 2017, showed a rate of 2.4 percent in August. It is estimated that the rates of both inflation and inflation expectations will continue to converge gradually to 2 percent in the forecast horizon.

CREDIT TO THE PRIVATE SECTOR
(Annual growth rate)

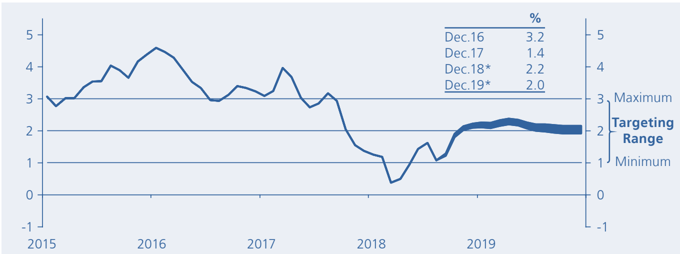
	Dec.17	Mar.18	Jun.18	Jul.18	Aug.18
Businesses	**5.4**	**6.6**	**7.9**	**7.2**	**7.1**
Corporate and large companies	6.0	7.9	10.5	9.4	9.3
Medium-sized enterprises	0.7	1.9	2.5	1.8	2.0,
Small business and Microbusinesses	9.5	8.8	8.1	8.0	7.6
Individuals	**8.7**	**9.7**	**10.7**	**11.0**	**11.3**
Consumer	8.8	10.4	11.6	12.1	12.5
Car loans	-4.2	-0.6	-2.7	-2.4	-1.7
Credit cards	3.0	3.8	5.9	7.8	8.2
Rest	13.0	14.8	15.6	15.4	15.7
Mortgage	8.6	8.7	9.5	9.5	9.6
TOTAL	**6.6**	**7.8**	**9.0**	**8.6**	**8.7**

NOMINAL AND REAL* REFERENCE INTEREST RATE
(%)



* With expectation of inflation.

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

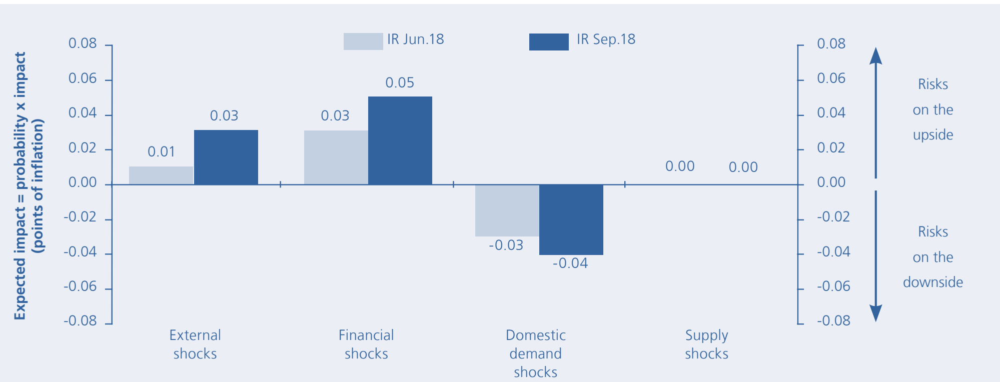


* Forecast.

Balance of risks

The balance of the **risk factors** considered in this Report –external demand shocks (lower global growth due to the new trade protectionist measures of the United States and China), higher volatility in international financial markets, and domestic demand shocks (lower-than-expected growth of private and public investment)– translates into a positive bias in the inflation forecast.

BALANCE OF RISKS AGAINST THE BASE SCENARIO



SUMMARY OF INFLATION REPORT FORECAST

		2016	2017	2018 1/		2019 1/	
				IR Jun.18	IR Sep.18	IR Jun.18	IR Sep.18
Real % change							
1.	Gross Domestic Product	4.0	2.5	4.0	4.0	4.2	4.0
2.	Domestic demand	1.1	1.4	4.2	4.4	4.4	4.0
	a. Private consumption	3.3	2.5	3.4	3.8	3.7	3.6
	b. Public consumption	0.2	0.2	3.8	3.4	2.5	3.2
	c. Fixed private investment	-5.4	0.2	5.5	5.5	7.5	6.5
	d. Public investment	-0.2	-2.3	12.6	9.9	5.0	2.8
3.	Exports (good and services)	9.4	7.8	4.4	3.5	3.9	4.6
4.	Imports (good and services)	-2.2	4.1	5.1	5.0	4.5	4.7
5.	Economic growth in main trading partners	2.8	3.6	3.8	3.8	3.6	3.6
Nota:							
	Output gap 2/ (%)	-0.3 ; 0.2	-1.4 ; -0.8	-0.9 ; -0.2	-0.9 ; -0.2	-0.4 ; 0.4	-0.6 ; 0.2
% change							
6.	Inflation	3.2	1.4	2.2	2.2	2.0	2.0
7.	Expected inflation 3/	-	-	2.2	2.2	2.5	2.5
8.	Expected depreciation 3/	-	-	1.6	1.9	1.5	0.8
9.	Terms of trade 4/	-0.4	7.2	4.9	1.0	1.3	-2.9
	a. Export prices	-3.4	13.0	11.6	7.4	1.9	-2.2
	b. Import prices	-3.0	5.4	6.4	6.3	0.6	0.7
Nominal % change							
10.	Currency in circulation	6.5	6.7	7.6	8.1	8.5	8.5
11.	Credit to the private sector 5/	5.6	6.6	8.5	9.0	8.8	9.0
% GDP							
12.	Gross fixed investment	22.9	21.8	22.1	22.3	22.7	22.9
13.	Current account of the balance of payments	-2.7	-1.1	-1.2	-1.6	-1.2	-1.5
14.	Trade balance	1.0	3.1	3.9	3.1	4.1	2.4
15.	Long-term external financing of the private sector 6/	4.6	5.7	4.8	5.0	4.8	4.0
16.	Current revenue of the general government	18.7	18.1	18.7	19.1	18.8	19.3
17.	Non-financial expenditure of the general government	20.0	20.1	20.4	20.5	20.3	20.4
18.	Overall balance of the non-financial public sector	-2.5	-3.1	-3.1	-2.8	-2.9	-2.6
19.	Balance of total public debt	23.8	24.9	25.2	25.7	26.1	26.9
20.	Balance of net public debt	6.8	9.5	11.8	11.4	14.1	13.5

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.