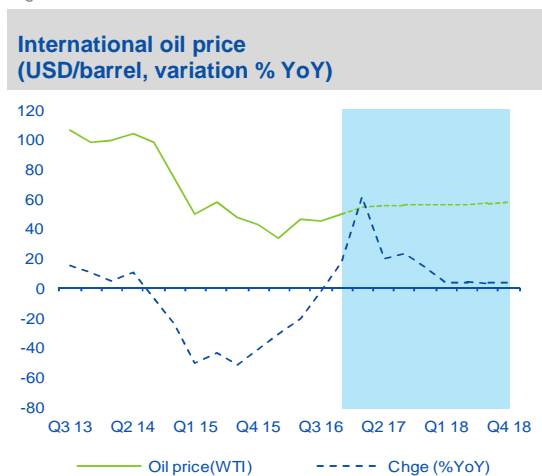


## 5. Inflation will fall in the second half of the year. Does this imply a policy rate cut?

Inflation continued above the target range (2%, +/- 1pp) at the beginning of the year, at 3.1%. This behaviour reflects, for example, that the prices of certain services such as Education and Health continue to advance at around 5% YoY, perhaps due to supply-side difficulties. It also shows the strong increase in the international oil price since the first quarter of last year, which has been transmitted to local fuel prices. On the other hand, the appreciation of the local currency, which has been reflected in lower rents and rates linked to the exchange rate (electric energy, for example) and a more moderate increase in the prices of certain foods (chicken, potatoes, eggs) have attenuated inflationary pressures. It should be mentioned that the rate at which inflation advances in inter-annual terms is not very different from the average observed over the last five or ten years (above 3%).

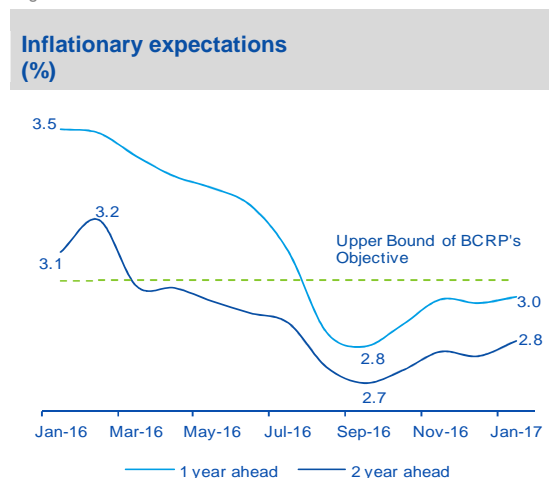
Our forecast is that for much of 2017 inflation will keep fluctuating around the ceiling of the target range or even somewhat above this. This projection considers that even if the international oil price does not already have much additional upward movement, as explained in Section 3, in inter-annual terms it will continue to push inflation upwards (through local fuel prices), especially during the first half of the year (see Figure 5.1). The projection also incorporates some upward momentum in the short term on the food side, which is related to recent climatic anomalies that we now consider as transient. The moderate expansion of household spending projected for 2017 and the relative exchange rate stability we anticipate during the first half will offset these inflationary pressures. This forecast is consistent with the inflationary expectations of the public (see Figure 5.2).

Figure 5.1



Source: Bloomberg and BBVA Research

Figure 5.2

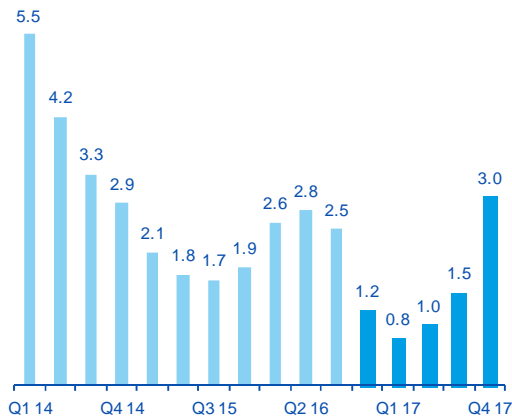


Source: Central Bank of Peru and BBVA Research

In the second half of the year, when the effect of higher oil prices dissipate and food prices advance at a more contained rate, inflation will tend to decline. However, this decline will be resisted by the gradual (although still limited) improvement we envisage for economic activity (see Figure 5.3) and the increase in the exchange rate. The balance of these factors suggests that inflation will return to the target range, standing at around 2.7% at the end of the year (see Figure 5.4).

Figure 5.3

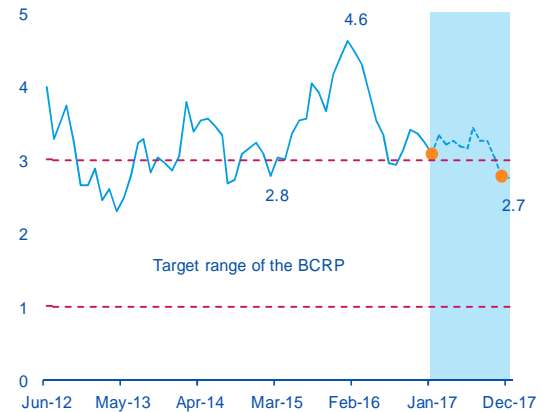
**Domestic demand (excluding inventories, accumulated in last four quarters, variation % YoY)**



Source: Central Bank of Peru and BBVA Research

Figure 5.4

**Inflation (variation % inter-annual CPI)**



Source: Central Bank of Peru and BBVA Research

In this scenario, where spending by companies and families is still weak and where inflation will go down, we cannot rule out that the Central Bank will be encouraged to cut its benchmark interest rate in the second half of 2017. This would anticipate the smaller space in which the public sector is likely to continue to support the growth of economic activity from next year.

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