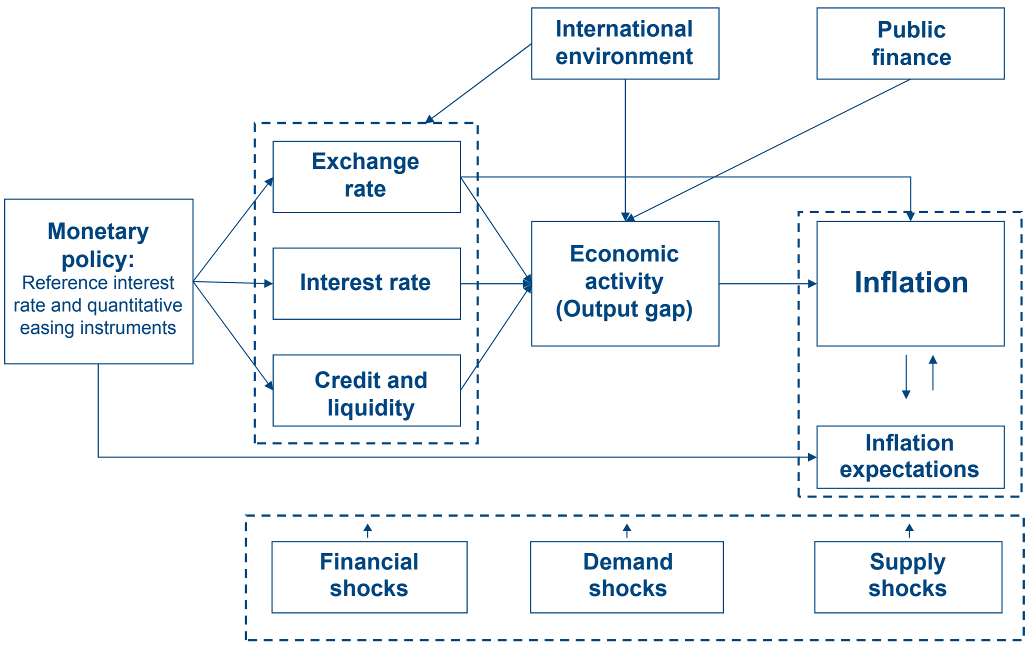
INFLATION REPORT:

Recent trends and macroeconomic forecasts 2012-2014

June 2012



Central Reserve Bank of Peru
441-445 Antonio Miro Quesada. Lima 1
Telephone: 613-2000 - Fax: 613-2525
Mail: webmaster@bcrp.gob.pe

INFLATION REPORT
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CENTRAL RESERVE BANK OF PERU

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CONTENT

This ***Inflation Report*** was drawn up using data on gross domestic product, balance of payments, and operations of the non-financial public sector as of March 2012, monetary accounts and inflation as of May 2012 and data on financial markets and foreign exchange rate as of June 2012.

Foreword

- In accordance with the Peruvian Constitution, the Central Reserve Bank of Peru (BCRP) is a public autonomous entity whose role is to preserve monetary stability.

- In order to consolidate this goal, the Bank's monetary policy is based on an inflation targeting scheme, with an inflation target of 2.0 percent, plus or minus one percentage point (between 1.0 and 3.0 percent). The Central Bank's inflation target is aimed at anchoring inflation expectations at a similar level to the inflation rate observed in developed economies and reflects the BCRP's permanent commitment with monetary stability.

- The nature of monetary policy is preventive and therefore aimed at anticipating inflationary or deflationary pressures, taking into account that inflation may be influenced by factors beyond the control of the Central Bank, such as supply shocks or the prices of imported products, which may result in transitory deviations of inflation from the target. The BCRP considers the annual increase in the consumer price index recorded each month and not only at year end.

- Each month, and according to a previously announced schedule, the Board of the BCRP approves a reference rate for the interbank lending markets. This interest rate, which is the monetary operational target, affects the rate of inflation through several channels in different timeframes and, therefore, is determined on the basis of macroeconomic forecasts and simulations.

- Additionally, the Central Bank implements preventive measures to preserve financial stability and monetary policy transmission mechanisms. Through interventions in the foreign exchange market, the Central Bank reduces excessive volatility in the exchange rate and accumulates international reserves thus developing strengths to face negative events in an economy with still high levels of financial dollarization. The Central Bank also uses other monetary policy tools that affect the volume of liquidity and credit in a more direct manner, such as reserve requirements in domestic currency and in foreign currency.

- The forecasts on which monetary policy decisions are based are disseminated through the Inflation Report to show the consistency of the decisions adopted with the aim that economic agents' expectations take these forecasts into account. The Central Bank also disseminates the studies analyzing the risk factors that may cause deviations in the forecasts of the economic variables considered.

- The Central Bank will publish its next Inflation Report in September 2012.

Summary

i. After the BCRP published its Inflation Report of March indicating that the risks associated with the debt crisis in the Eurozone had declined, fears about Greece's fiscal sustainability and the possibility of a contagion of the crisis to other economies in the region started being observed again. In addition to this, various indicators of economic activity in some developed countries and also in some emerging economies showed an unfavorable evolution.

   In this context of increased uncertainty and lower growth in some economies, the forecast of global growth has been revised down from 3.3 to 3.2 percent for 2012 and from 3.8 to 3.7 percent for 2013 in the central forecast scenario. The world economy would show again signs of recovery in 2014 and global growth would then rise to 3.9 percent.

ii. In the first quarter of 2012, Peru's economy grew 6.0 percent, driven mainly by the dynamism shown not only by consumption and private investment but also by exports. After having contracted during 2011, public investment returned again to positive growth rates. A more moderate pace of growth is expected in the rest of the year due to the present international context of uncertainty.

   The growth forecast for 2012 has been revised up from 5.7 percent (Inflation Report of March) to 5.8 percent due to the higher private investment foreseen for this year, while the growth forecast for 2013 has been revised down from 6.3 to 6.2 percent due to lower global growth. In 2014, the growth rate would rise to 6.3 percent, in line with the recovery of growth foreseen in the global economy.

iii. The forecasts on the non-financial public sector (NFPS) consider the compliance with the new rule for the structural economic balance established in the Multiannual Macroeconomic Framework published in May 2012, according to which the economic balance should be consistent with a reduction of the structural deficit of at least 0.2 percentage points each year as from 2013.

   Thus, a surplus of 1.1 percent of GDP continues to be estimated for 2012, while the surplus in 2013 has been revised down from 1.4 to 1.0 percent and a fiscal surplus of 1.0 percent is forecast for 2014.

iv. The forecast on the current account deficit for 2012 has been revised upwards from 1.5 percent of GDP (Inflation Report of March) to 2.7 percent of GDP. This revision considers a lower level of commodity prices, especially in the case of metals, as well as a lower volume of exports of fishmeal and non traditional products, especially fishing and textile products.

Likewise, the current account deficit for 2013 has also been revised upwards from 1.8 (Inflation Report of March) to 2.8 percent of GDP as a result of the lower value of mining exports. A current account deficit of 2.9 percent of GDP is forecast for 2014.

v. Inflation in the last twelve months fell from 4.74 percent in December 2011 to 4.14 percent in May 2012 due to the lower increase observed in food prices, especially in those with a high imported content, as a result of the lower prices of commodities in the international market. Core inflation in the last twelve months showed a rate of 3.77 percent, while the CPI without food and energy recorded a rate of 2.59 percent.

Like in our Inflation Report of March, the central forecast scenario considers that inflation will gradually converge towards the target and fall within the target range in 2012. Inflation's convergence towards the target would be favored both by the reversal of the supply shocks that affected inflation in 2011, especially by the moderation of fuel prices as a result of the recent drop observed in the international price of crude, and by a lower output gap.

vi. Between March and June, the Board of the Central Bank decided to maintain the reference rate at 4.25 percent. This decision was made considering, on the one hand, the impact that lower terms of trade and lower global growth would have on future inflation in a context of increased uncertainty and worsening of the Eurozone crisis and, on the other hand, that inflation would continue converging towards the target range in the next months due to the reversal of supply shocks in a context of growth without demand pressures.

vii. Taking into account the effects of the different risk factors considered in this forecast scenario results in a balance of risks with a slightly downward bias, in contrast with the neutral balance of risks estimated in our previous Report. This change in the balance of risks is mainly explained by the recent evolution of the world economy and by uncertainty about the future evolution of the Eurozone crisis and its possible contagion effect.

viii. The downward risks in the inflation forecast are both external and domestic. The former are associated with the Eurozone debt problems and the latter are associated with the risk of a slower growth of domestic demand due to the postponement of investment projects.

a. Uncertainty about the evolution of the global economy.

The baseline scenario considers a lower rate of growth in the world economy than the one considered in our Inflation Report of March (3.2 percent versus 3.3 percent for 2012 and 3.7 percent versus 3.8 percent for 2013). Uncertainty in international markets, which intensified again in May as a result of the sovereign debt problems and fiscal restraints in the Eurozone, would contribute to weaken external demand, affecting the domestic economy through the trade and financial channels.

This scenario describes a drop in global economic activity coupled by a reduction in the terms of trade. In addition to this, the increase of global uncertainty could generate panic among investors and trigger a gradual reversal of foreign capital, causing a real depreciation and an increase in the country risk indicator.

If these risks materialized, the Central Bank would use some of its considerable amount of international reserves and several liquidity injection mechanisms in both national and foreign currency to offset the impact of this shock on domestic financial conditions. The monetary policy stance would be expansionary in the forecast horizon to prevent deflationary risks.

b. Evolution of domestic demand

The possibility that investment projects are either postponed or cancelled is analyzed in this scenario. If this happened, it would generate less dynamism in the aggregate demand and, in the short term, a rate of economic growth below potential growth which would generate downward pressures on inflation. In this scenario, the Central Bank would increase the monetary stimulus with the aim of leading inflation to be within the target range in the forecast horizon.

On the other hand, there is an upward risk factor for inflation associated mainly with external supply shocks (higher commodities prices) and domestic supply shocks (adverse climate factors in our country).

c. Higher commodities prices or adverse climate conditions

Even though the prices of food commodities and fuels would show a downward trend, there is a risk that global inflationary pressures may be more persistent than what has been considered in the baseline scenario. Uncertainty about how economic authorities will solve the challenges and problems, especially in the Eurozone, and concerns about the future economic and political landscape have a strong effect on the level of global economic activity. A more decisive and credible economic policy in most advanced economies could generate a confidence shock that could lead to increased global demand. This could affect the dynamics of domestic inflation through higher imported costs and lower margins for local companies, which could generate inflationary pressures. In contrast with what was foreseen in our March Inflation Report, the risk of higher international prices of oil and oil derivatives has declined due to recent developments in this market.

In the domestic arena, the risk remains that adverse weather conditions could affect the normal development of production and the supply of food products (especially fisheries and agricultural products).

In this scenario, the Central Bank would adjust its monetary position only if these inflationary shocks affected economic agents' expectations about inflation.

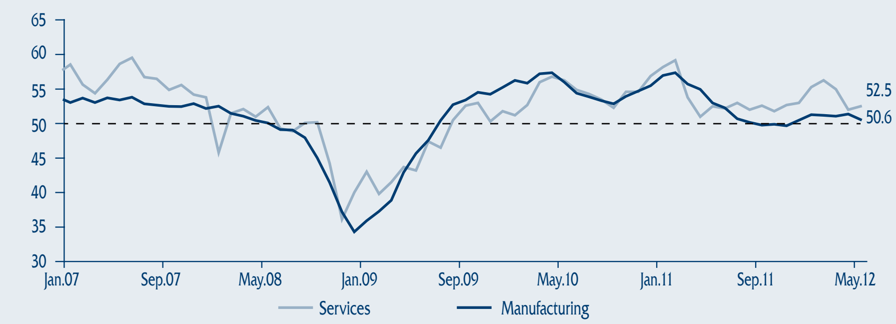
INFLATION FORECAST: 2012 - 2014
(Last 12 month % change)

I. International Environment

Growth

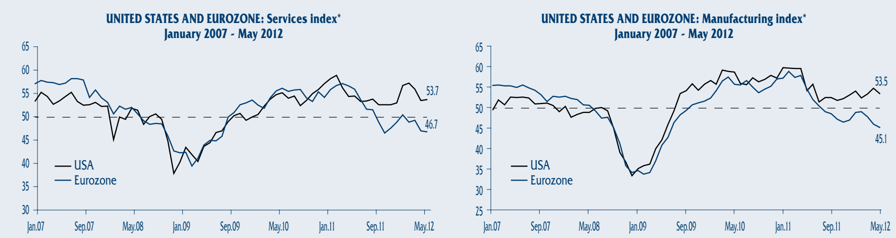
1. So far this year, the global economy has shown moderate growth although some slowdown has been observed in recent months. The global manufacturing and services index, based on surveys of purchasing managers around the world, remained on the expansion zone (over 50) for indicators of both manufacturing and services, even though both indicators are in the contraction zone in the Eurozone. Other recent indicators of activity also show a mostly positive evolution in most large developed economies, a deterioration in some economies of the Eurozone, and some slowdown in the emerging economies of Asia and Latin America.

Graph 1
JP MORGAN GLOBAL PMI MANUFACTURING AND SERVICES
(January 2007- May 2012)



Source: Bloomberg.

Graph 2



* PMI index.
Source: Bloomberg.

* PMI index.
Source: Bloomberg.

2. In line with these developments, the world economy is expected to grow 3.2 and 3.7 percent in 2012 and 2013, respectively, recording slightly lower rates than the

ones considered in our previous report. Even though growth in some developed economies has been revised upwards in line with the executed data, this higher growth would be nearly offset by a slight downward revision in the growth of the rest of emerging economies, particularly China, India, and Brazil.

Table 1
WORLD GDP GROWTH
(Annual % change)

	2011	2012		2013		2014
		IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
Developed countries	**1.6**	**1.4**	**1.3**	**2.0**	**1.9**	**2.1**
Of which:						
1. United States	1.7	2.3	2.2	2.4	2.4	2.5
2. Eurozone	1.5	-0.6	-0.5	0.8	0.5	1.3
Germany	3.0	0.2	0.8	1.2	1.2	1.5
France	1.7	-0.2	0.0	0.8	0.5	1.4
Italy	0.4	-1.3	-1.8	0.3	-0.3	0.5
Spain	0.7	-1.5	-1.8	0.4	-0.5	1.2
3. Japan	-0.7	1.9	2.1	1.9	1.9	1.5
4. United Kingdom	0.7	0.3	0.2	1.2	1.1	1.5
Developing countries	**6.0**	**5.4**	**5.3**	**5.8**	**5.7**	**5.9**
Of which:						
1. Developing Asia	7.7	7.3	7.1	7.6	7.5	7.8
China	9.2	8.4	8.0	8.4	8.5	8.7
India	7.2	7.1	6.7	7.7	7.3	7.5
2. Central and Eastern Europe	4.9	2.2	2.0	3.3	3.0	3.4
3. Latin America and the Caribbean	4.4	3.7	3.5	3.8	3.8	3.9
Brazil	2.7	3.4	3.0	4.0	3.9	4.0
4. Sub-Saharan Africa	4.7	4.2	4.3	5.4	5.4	5.4
5. Middle East and Northern Africa	3.1	3.2	3.5	3.6	3.7	3.7
World Economy	**3.7**	**3.3**	**3.2**	**3.8**	**3.7**	**3.9**
Memo:						
Trading Partners 1/	3.6	2.9	2.8	3.2	3.2	3.4
BRICs 2/	7.4	7.0	6.6	7.2	7.2	7.3

Source: IMF (executed data) and BCRP (forecast).
IR: Inflation Report.
1/ Basket of Peru's 20 main trading partners.
2/ Brazil, Russia, India, and China.

3. This central scenario assumes that the Eurozone debt crisis does not extend to larger economies such as Italy and Spain and that volatility in financial markets will not increase significantly, even though it should be pointed out that this risk has increased relative to when our previous Inflation Report was released. On the other hand, the risk that a sudden rise may be seen in the price of oil has declined, in line with the downward correction recorded in this price in recent months.

Graph 3
GDP GROWTH

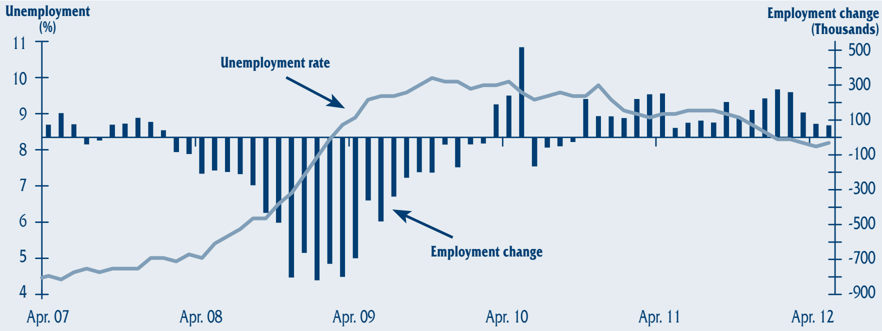
* Forecast.
Source: BCRP.

4. The **developed countries** have had different evolutions over the past months. In the larger economies, consumption has recovered favored by the improvement of employment and by the maintenance of monetary stimulus. On the other hand, other economies, particularly some in the Eurozone, have been affected by fiscal adjustments, high unemployment, and the growing deterioration of financial conditions. In aggregate terms, developed countries are expected to grow 1.3 percent in 2012 and about 2 percent in 2013 and 2014.

5. In the **USA**, the main indicators of activity showed a mostly favorable evolution during the first six months of the year. Indicators such as retail sales, higher credit consumption, and greater consumer confidence –which has increased for

eight consecutive months– stand out in terms of consumption, in line with the improvements observed in the labor market given that 900 thousand new jobs have been created between January and May and that the rate of unemployment rate has declined from 8.3 to 8.2 percent.

Graph 4
USA: EMPLOYMENT AND UNEMPLOYMENT RATE



Source: Bloomberg.

Investment also showed a favorable evolution, as reflected in the faster pace of growth of residential investment, which recorded a rate close to 20 percent in the first quarter of 2012. Indicators of the real estate market, such as inventories, sales of homes, and residential construction corroborate this acceleration. However, house prices continue correcting downwards: the S&P/Case Shiller index, estimated for 20 cities, recorded an average decline of 3 percent in the first quarter of 2012.

Table 2
USA: SEASONALLY ADJUSTED GDP GROWTH (Q1.10 - Q1.12)
(Quarterly annualized rates)

	Q1.10	Q2.10	Q3.10	Q4.10	Q1.11	Q2.11	Q3.11	Q4.11	Q1.12
GDP	**3.9**	**3.8**	**2.5**	**2.3**	**0.4**	**1.3**	**1.8**	**3.0**	**1.9**
Personal consumption	2.7	2.9	2.6	3.6	2.1	0.7	1.7	2.1	2.7
Durable	9.9	7.8	8.8	17.2	11.7	-5.3	5.7	16.1	14.3
Non Durable	4.8	1.9	3.0	4.3	1.6	0.2	-0.5	0.8	2.3
Services	1.0	2.5	1.6	1.3	0.8	1.9	1.9	0.4	1.0
Gross investment	31.5	26.4	9.2	-7.1	3.8	6.4	1.3	22.1	6.3
Fixed investment	1.2	19.5	2.3	7.5	1.2	9.2	13.0	6.3	4.9
Non Residential	6.0	18.6	11.3	8.7	2.1	10.3	15.7	5.2	1.9
Residential	-15.3	22.8	-27.7	2.5	-2.4	4.2	1.3	11.6	19.4
Exports	7.2	10.0	10.0	7.8	7.9	3.6	4.7	2.7	7.2
Imports	12.5	21.6	12.3	-2.3	8.3	1.4	1.2	3.7	6.1
Government expenditure	-1.2	3.7	1.0	-2.8	-5.9	-0.9	-0.1	-4.2	-3.9

Source: BEA.

Graph 5
USA: REAL PERSONAL CONSUMPTION (12 month % change)
AND CONSUMER CONFIDENCE (Index of Univ. Michigan)

Source: Bloomberg.

Lower inflationary pressures have also been observed in the first months of the year. Inflation fell from an annual rate of 3.0 percent in December 2011 to 1.7 percent in May 2012, while core inflation remained relatively stable at 2.3 percent. Moreover, inflation expectations remained close to 3.0 percent between January and April. The Federal Reserve (FED) confirmed at its meetings of January, March, and April that it would maintain low rates at least until the end of 2014.

The projection of growth in the USA has been revised slightly downwards for 2012, from 2.3 to 2.2 percent, and remains at 2.4 percent for 2013, in line with the results of the first quarter of the year, the recent evolution of economic indicators, and the Federal Reserve's maintenance of monetary stimulus. The financial crisis in the Eurozone, the slowdown of growth in China, and the lack of political agreement on how to achieve fiscal consolidation are among the risk factors that could affect the US economy.

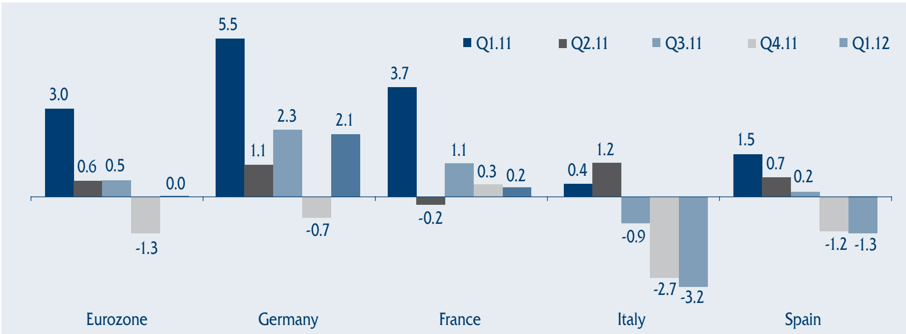
6. The **Eurozone** continued to be affected by the sovereign debt crisis of some of its member countries. Although growth in the first quarter exceeded market expectations, recent indicators of activity show that the risks of recession persist and that the differences between the economies of the North (Germany and France) and the South (Italy and Spain) have deepened.

   In the first quarter, the Eurozone recorded a nil quarterly growth rate of GDP in annual terms, a result explained mainly by the fact that the growth of Germany (2.1 percent) and France (0.2 percent) was offset by the contraction of the peripheral countries. Spain registered a technical recession showing a contraction for the second consecutive quarter while Italy recorded a contraction for the third consecutive quarter.

   Moreover, the manufacturing and services indices and the confidence indices in April and May indicate a greater weakness of activity in these months as a result of the deterioration of financial conditions since May. If this trend were to continue in June, the region could experience a contraction in the second quarter of 2012.

Political developments in Greece, which have increased the likelihood that this country will exit from the Eurozone, have increased the risks of contagion in the region.

Graph 6
EUROZONE: QUARTERLY GROWTH
(Seasonally adjusted annualized quarterly rates)



Source: Bloomberg and Eurostat.

Considering the results of the first quarter of the year, the projection of economic activity in the Eurozone in 2012 has been corrected slightly upwards (from -0.6 to -0.5 percent). Growth in Germany and France has been revised slightly upwards compared to the forecasts of our last report, but the contraction estimated for other countries remains unchanged. The projection of economic growth for 2013 has been revised down from 0.8 to 0.5 percent.

The main risk that could affect this projection is still the sovereign debt crisis, especially with the possibility that Greece may leave the European monetary union and with the deepening of the crisis of banks in Spain –in view of which the EU has granted Spain a loan of up to €100 billion–, which could aggravate the delicate sovereign fiscal position in this region. However, despite the fact that the Eurozone as a region has been facing significant financial pressures –high and volatile rates, high fiscal deficits, significant debt maturities, and high financial requirements–, its direct impact on global growth has been limited so far.

Given their financial and trade links, the region that has been affected the most by the crisis in the Eurozone has been emerging European countries, particularly Eastern Europe. According to the IMF, emerging Europe has committed nearly 40 percent of its output in liabilities with Eurozone banks and over 12 percent of its output in exports with this region.

As regards uncertainty factors in the Eurozone, in the **political arena**, the election of parliament in Greece (17 June) will be decisive to determine whether the country will maintain its agreement with the IMF/EU or not; a rejection of the agreement may involve the country's exit of the Eurozone. Moreover, parliament elections in

France will also determine the support that will be given to the new administration in its proposal in favor of easing the Eurozone fiscal goals a little and adopting measures to stimulate growth. At the domestic levels, the ratification of the Fiscal Pact and other decisions taken at the level of EU leaders –a constitutional agreement is required in some cases– are also pending.

As regards the **actions to deal with the crisis**, meetings at the level of leaders and ministers are scheduled to be held to define some aspects of the stabilization funds. First of all, the size of the fund is crucial to determine the support that could be provided to larger economies. The possibility of implementing institutional reforms to create a fiscal and financial union has also been discussed as part of the measures to reduce the risk of contagion. These measures would imply the possibility of issuing Eurobonds, the creation of a joint bank deposit insurance scheme, and the implementation of a bank resolution scheme. Besides issuing Eurobonds, which would improve the credit profile of the highly indebted economies, a joint fund of debt repayment has been proposed. These proposals have not reached consensus yet.

Measures related to the "**growth pact**" must also be discussed. These measures include possible capital increases for the European Investment Bank, the issuance of bonds to finance infrastructure projects, the use of the EU structural funds, and eventually postponing some of the fiscal targets agreed in November 2011.

The sustainability of fiscal policy depends also strongly on the **duration and intensity of the recession** in the Eurozone. Some of the factors associated with these aspects could deepen the recession and complicate the fiscal position of some economies. These factors include the reduction of bank assets associated with the higher capital requirements demanded by the European Central Bank (by June 2012) and by Basel III (as from 2013), which would imply an additional reduction of bank credit to the one already observed. Another risk factor, especially in Spain, is that the real estate adjustment has not concluded and that this will affect the balance sheet of banks.

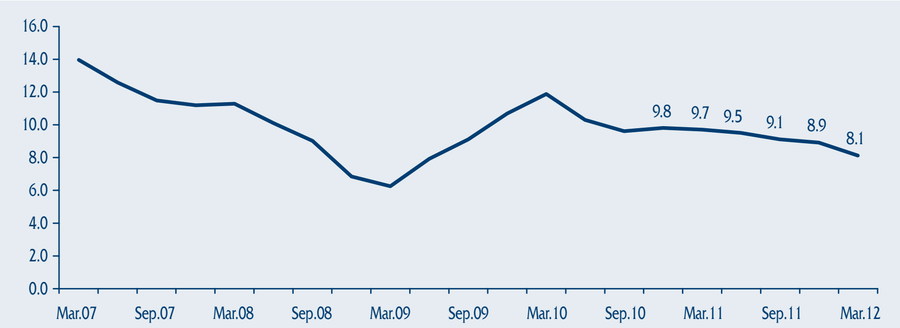
In the arena of **monetary policy**, the market assigns a high probability to future interest rate cuts in the ECB interest rate (currently at 1.0 percent). It also remains to be seen if the ECB will carry out new 3-year liquidity injection operations (like the ones made in December and February this year), if it will resume the purchase of sovereign bonds (interrupted since March of this year), and it will ease the collateral conditions it requires for its operations with banks.

7. **Japan** grew 1.0 percent in the first quarter of the year. This growth rate, which was higher than expected, is explained by the higher public investment associated with reconstruction projects after the natural disasters of March and October. On the monetary side, the Central Bank of Japan extended its asset purchase program. It is estimated that after growing 2.1 percent in 2012 –the growth forecast for 2012 has been revised upwards–, Japan would grow 1.9 percent in 2013 and 1.5 percent in 2014.

8. The **emerging economies**, on their side, continued showing signs of a moderate slowdown due to a lower external stimulus and to the deceleration of domestic demand which, in several cases, was coupled by lower inflationary pressures. It is estimated that in 2012 these economies would have an average growth of 5.3 percent.

In **China**, recent indicators –i.e. fixed investment, industrial production, and retail sales, among other indicators– confirm a slowdown associated with the monetary tightening measures and the withdrawal of fiscal stimulus implemented in 2011. This trend is expected to continue until the end of the second quarter of 2012. A considerable decline was observed in the annual variation of both exports (4.9 percent) and imports (0.3 percent) in April due to the deterioration of the international context and the stagnation of investment, respectively. Mixed results were observed then in May: the annual growth of exports and imports recovered (to 15.3 and 12.7 percent, respectively), although the variation of investment in fixed assets remained around 20 percent and industrial production rose modestly to 9.6 percent (9.3 percent in April).

Graph 7
CHINA: QUARTERLY GDP 1Q.07 - 1Q.12
(Annual change)



Source: Bloomberg.

Table 3
CHINA'S ECONOMIC INDICATORS: 2010 - 2012

	2010	2011				2012		
	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Apr.	May.
Manufacturing PMI (50 neutral level)	53.9	53.4	50.9	51.2	50.3	53.1	53.3	50.4
Industrial Production (12 month % change)	13.5%	14.8%	15.1%	13.8%	12.8%	11.9%	9.3%	9.6%
Investment in fixed assets (12 month % change)	24.5%	25.0%	25.6%	24.9%	23.8%	20.9%	20.2%	20.1%
Retail sales (12 month % change)	19.1%	17.4%	17.7%	17.7%	18.1%	15.2%	14.1%	13.8%
Exports(12 month % change)	17.9%	35.8%	17.9%	17.1%	13.4%	8.9%	4.9%	15.3%
Imports (12 month % change)	25.6%	27.3%	19.3%	20.9%	11.8%	5.3%	0.3%	12.7%
New loans (Billions of yuan)	481	679	634	470	641	1,010	682	793
CPI (12 month % change)	4.6%	5.4%	6.4%	6.1%	4.1%	3.6%	3.4%	3.0%
Food prices (12 month % change)	9.6%	11.7%	14.4%	13.4%	9.1%	7.5%	7.0%	6.4%

Source: Bloomberg.

In this context, the Chinese Government has confirmed its intention to implement stimulus measures in the next months to counter the slowdown in the economy and has already announced monetary measures, such as the reduction of the rate of reserve requirements and interest rates as well as the easing of credit conditions.

However, given that there is consensus about the fact that the impact of monetary policy could be limited in the short term, the government has given emphasis to fiscal measures to boost growth. The policies announced focus on stimulus to consumption and support to investment, with emphasis in energy saving and environmental protection:

- **Support to consumption:** The government has announced subsidies for approximately 30 billion yuan to promote the sale of energy-saving electrical appliances (air conditioning equipments, flat screen TVs, washing machines, water heaters, etc.). In addition to this, the use of energy-saving lights, automobiles, and electronic machinery will be encouraged.

- **Public investment:** The government is speeding up the approval and launching of key investment projects, especially in the areas of railways, environment and energy saving, infrastructure in rural areas and in the west region, education and health, and information technology. These projects are considered priority projects in the XII Five-Year Plan. In this line, this includes the approval of 20 projects in seven “strategic emerging industries” (saving energy and environmental protection, information technology, biology, manufacture of advanced equipment, new energy, new materials, and vehicles based on new energy sources).

- **Private investment:** The government supports private investment in the sectors of railways, finance, urban infrastructure, telecommunications, health and education, although the details of this support have not been announced yet. The government will also expand the application of the VAT –a pilot scheme is currently being implemented in Shanghai– and will reduce the tax burden on service companies and SMEs. Moreover, a greater participation of foreign agents in the local stock exchanges has been announced in order to develop the capital market and facilitate the financing of SMEs through bond issuances.

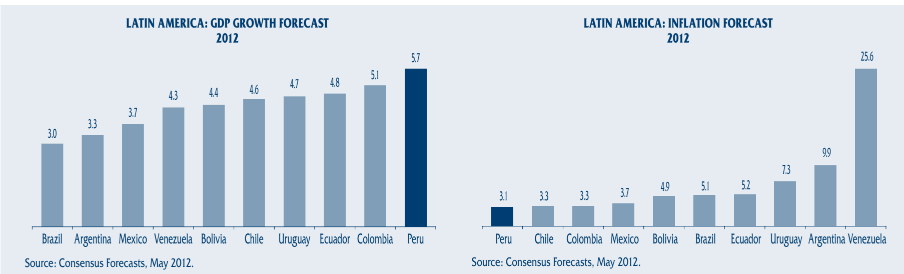
Because of these signals, markets estimate that the slowdown would be temporary and expect a recovery from the second half of the year. It is estimated that China would grow 8.0 and 8.5 percent in 2012 and 2013, respectively.

9. So far this year, **Latin American** countries continue to grow at high rates. Mexico and Chile, for example, have recorded higher growth rates in Q1-2012 than

at the end of last year. In other countries, however, high frequency indicators of activity show that, on average, the pace of economic growth has declined compared to the one observed last year in a context in which the growth of domestic demand has been moderating down and factor markets are beginning to show signs of slack. In Brazil, given the fact that the economy continues to show little momentum and that the industrial sector shows a greater slowdown, both the government and the central bank have adopted expansionary policies.

On the other hand, the decline of inflation that began to be observed since the beginning of the year has continued over the last two months due to the partial reversal of the supply shocks registered at end 2011 as well as due to the moderation of demand inflationary pressures in a context of downward corrections in the international prices of some food products and crude. The decline of inflation rates in Brazil, Chile, and Mexico stands out, given that inflation has returned to the target range in these countries.

Graph 8



10. Year-to-date, the growth of economic activity in **Eastern Europe** has been lower than expected. The first quarter figures were below expectations: the low rates of Hungary and the Czech Republic stand out, given that GDP dropped 5.1 and 4.0 percent respectively compared to Q4-2011. Russia was a particular case since it grew by an annual 4.9 percent in Q1-2012, maintaining in this way the economic growth trend observed in 2011 (4.8 percent). A lower growth is expected for the rest of the year due to the anticipated worsening of both the external front (lower demand and lower oil prices) and the domestic front (high interest rates and restrictions on access to foreign loans).

Less optimistic prospects for the rest of Europe (the main destination of this region's exports), the urgent need to consolidate its fiscal accounts, the withdrawal of foreign capitals, and the widespread decline in levels of confidence are signs that this region is slowing down. Because of this, the growth projections for Eastern Europe have been revised downwards from 2.2 to 2.0 percent for 2012 and from 3.3 to 3.0 percent for 2013.

Financial markets

11. In recent months, the evolution of financial markets has been characterized by an increase in risk aversion, reflecting mainly the uncertainty generated by the debt crisis in the Eurozone and, to a lesser extent, the signs of economic slowdown in the major emerging economies. This has reversed the relative stability observed in financial markets in the first months of the year, which was explained by favorable growth data in the major developed economies and by the agreement regarding the second program for Greece which involved restructuring the country's debt with the private sector.

    The recent increase registered in risk aversion –reflected in the rise of the VIX indicator– affected all financial markets in general and particularly European markets. In May, the sovereign debt markets, money markets, foreign exchange markets and global stock exchange markets reversed the positive evolution observed until the end of April. Some European stock markets and sovereign debt markets even reversed completely the gains they had achieved at December 2011.

Table 4

Events related to the increase in volatility in the financial markets		I	II	III	IV
Record levels obtained during volatility scenarios		Sub-prime crisis Jul.08/Jul.09	First IMF/EU Greek Program May./Aug.10	Second IMF/EU Greek Program Aug./Dec.11	Eurozone crisis May./Jun.12
Stock markets					
VIX	Volatility	81	46	48	27
DAX	German stock exchange	3,666	5,670	5,072	5,969
DJ	US stock exchange	6,547	9,686	10,655	12,101
Sovereign debt markets (safe assets)					
10 Year bond yields	US Treasury	2.05	2.47	1.72	1.45
10 Year bond yields	GermanTreasury	2.89	2.12	1.67	1.17
Commodities markets					
Gold price	Safe asset	1,213	1,261	1,895	1,664
Copper price	Industrial activity asset/risks	1.26	2.76	3.08	3.29
Short-term money markets - financing conditions					
Spread Libor-OIS	3 months US$	3.64	0.34	0.50	0.32
Spread Libor-OIS	3 months €	2.07	0.41	1.01	0.41
Spread of €/US$ basis swap	3 months	-210	-70	-157	-59
Foreign exchange markets spot					
US$ per €	Safe asset	1.246	1.192	1.294	1.235
Reales per US$	Risky asset	2.512	1.882	1.904	2.09
Sovereign debt markets with risk					
EMBIG	Emerging bond spread	891	370	490	441
CDS Spain	Spain sovereign risk	170	276	493	608
CDS Italy	Italy sovereign risk	201	245	595	570

Source: Bloomberg.

Graph 9
RISK AVERSION COEFFICIENT: VIX (S&P'500)
(January 2008 - June 2012)

Source: Bloomberg.

12. Since May, the **sovereign debt markets** have registered strong volatility as a result of political developments in Greece. The results of the parliamentary elections of May 6 in this country have brought about the possibility of forming a government that opposes the UE/IMF program. According to the position of the Eurozone leaders, expressed at the recent meeting of the Eurogroup, lack of knowledge about the program could imply the exit of Greece from the Eurozone. This political uncertainty would only come to an end with the new parliamentary elections of June 17 in Greece. The major investment firms have pointed out that there is a high possibility that Greece may withdraw from the Eurozone.

The delicate position of the Spanish banking sector has added onto these Greece related problems. The heavy losses of Bankia –the fourth largest bank in the system– associated with its exposure in the real estate market, and its subsequent nationalization, have generated uncertainty about the real financial position of the rest of Spanish banks and about the government's capacity to recapitalize the banks given its limited resources.

In this scenario, fears of contagion to other economies with debt problems have increased again. There are worries that Portugal and Ireland, like Greece did, may need a second rescue program and that Italy and Spain may require a similar bailout program to the ones provided to Greece, Portugal and Ireland in the near future. In Spain, fears that the regional governments will fail to meet the fiscal targets (after the fiscal deficit in 2011 was revised up from 8.5 to 8.9 percent of GDP) have also influenced the upsurge of concerns. It should be pointed out that, together with Japan and USA, Europe's peripheral countries are the ones whose public sector have the highest financial requirements for year 2012.

In this context, sovereign markets registered an unfavorable evolution since May, with the exception of the sovereign markets of USA, Germany, and the UK, which were favored by their condition of risk free assets.

Thus, the spread of Greece's sovereign CDS –credit default swaps, a premium against the risk of default– which had significantly declined with the restructuring of the debt in March, rose again. The biggest increases were observed in the countries with UE/IMF programs (Portugal and Ireland) and in those with higher risks of contagion, such as Italy and Spain (the spread of Spain reached a new record of 608 on June 5).

Moreover, the yields on 10-year sovereign bonds rose significantly: the yield on Greece's sovereign bonds recorded a new record (29 percent on May 24) and the yields of Spain's bonds have remained at over 6 percent since May 9. In contrast, the yield on German bonds declined significantly (and reached a minimum level of 1.17 percent on June 1), just like the yields on UK and USA bonds.

Table 5
SOVEREIGN SPREADS OF DEVELOPED COUNTRIES

	End of period						Difference in basis points				
	Dec. 08 (6)	Dec. 09 (5)	Dec.10 (4)	Dec.11 (3)	Mar.12 (2)	Jun.12* (1)	Mar.12 (1)-(2)	Dec.11 (1)-(3)	Dec.10 (1)-(4)	Dec.09 (1)-(5)	Dec.08 (1)-(6)
CDS (pbs)											
USA	67	38	42	49	30	49	19	0	7	11	-19
United Kingdom	107	83	74	98	63	75	12	-23	1	-8	-32
Germany	46	26	59	102	74	109	35	7	50	83	63
France	54	32	107	220	168	217	49	-3	110	185	163
Spain	101	113	348	380	436	607	171	226	259	493	506
Italy	157	109	238	484	395	564	169	80	326	455	407
Greece 1/	232	283	1,026	8,786	25,423	8,770	-16,653	-17	7,743	8,486	8,538
Portugal	96	92	497	1,082	1,070	1,029	-42	-53	531	937	932
Ireland	181	158	619	724	573	681	108	-43	62	523	500
10 Year Treasury yields (%)											
USA	2.21	3.84	3.29	1.88	2.21	1.67	-55	-21	-163	-217	-55
United Kingdom	3.02	4.02	3.40	1.98	2.20	1.70	-51	-28	-170	-232	-132
Germany	2.95	3.39	2.96	1.83	1.79	1.42	-37	-41	-154	-196	-153

Source: Bloomberg.
* Up to June 12.
1/ Proceeds from the Greek debt restructuring the Greek spread was reduced to a level of 5,730 basis points.

In the debt markets of emerging countries, the increased risk aversion of recent months led credit spreads in the region to increase, reversing the trend recorded during Q1-2012. The greatest increases of the EMBIG and CDS spreads were observed in Argentina after the government decided to nationalize the oil company YPF.

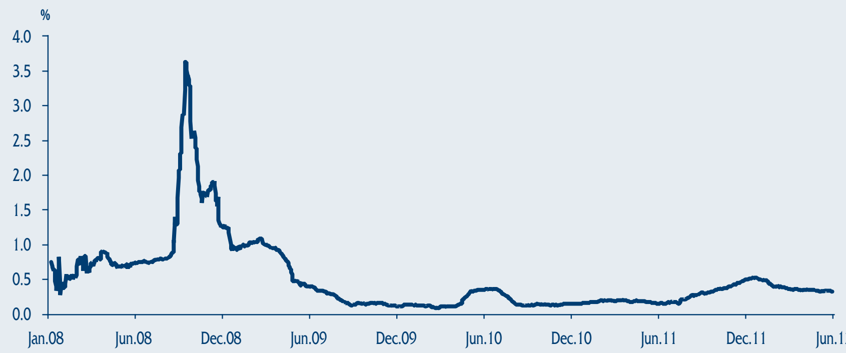
Table 6
SOVEREIGN SPREADS OF EMERGING MARKETS

	End of period data						Difference in basis points				
	Dec.08 (6)	Dec.09 (5)	Dec.10 (4)	Dec.11 (3)	Mar.12 (2)	Jun.12* (1)	Mar.12 (1)-(2)	Dec.11 (1)-(3)	Dec.10 (1)-(4)	Dec.09 (1)-(5)	Dec.08 (1)-(6)
EMBIG (bps)											
Peru	509	165	165	216	157	188	31	-28	23	23	-321
Brazil	429	189	189	225	177	217	40	-8	28	28	-212
Chile	343	95	115	172	148	180	32	8	65	85	-163
Colombia	498	203	172	191	141	170	29	-21	-2	-33	-328
Emerging	724	294	289	426	342	393	51	-34	104	98	-332
CDS (bps)											
Peru	303	124	113	172	121	161	40	-11	48	37	-141
Brazil	299	123	111	161	121	159	38	-2	48	36	-140
Chile	203	69	84	132	92	122	30	-11	38	53	-82
Colombia	308	144	113	154	108	148	40	-6	35	5	-159
Mexico	292	134	113	153	117	148	31	-4	35	14	-144

Source: Bloomberg.
* Up to June 12.

13. **Money markets** have been less affected. The stability of short term rates in European markets has been favored by the ECB injection of liquidity via three-year long term refinancing operations (LTROs) carried out in December 2011 and February 2012 and low policy interest rates. It should be pointed out that a slight rise has been observed in European banks' financing conditions in US dollars since May. The spreads of currency swaps rates –which measure the exchange risk– recorded in May a slight reversal of the trend they had been showing until April.

Graph 10
SPREAD BETWEEN THE 3-MONTH US$-LIBOR RATE AND O/N OF SWAP MARKET (OIS)
(January 2008 - June 2012)

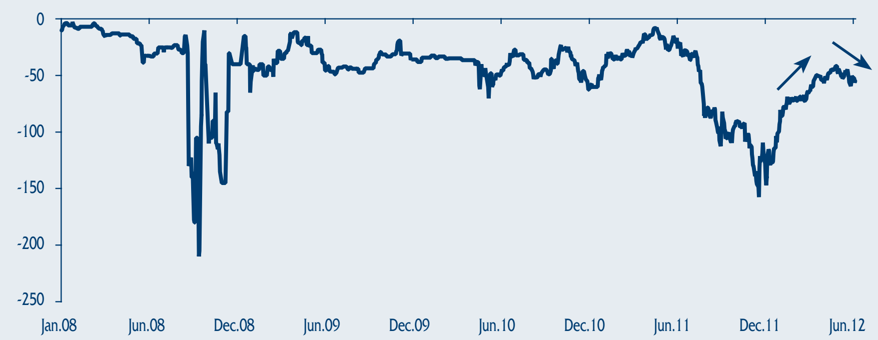


Source: Bloomberg.

Graph 11
SPREAD BETWEEN THE 3-MONTH EURO-LIBOR RATE AND O/N OF SWAP MARKET (OIS)
(January 2008 - June 2012)

Source: Bloomberg.

Graph 12
3 MONTH EURO/DOLAR BASIS SWAP 1/
(January 2008 - June 2012)



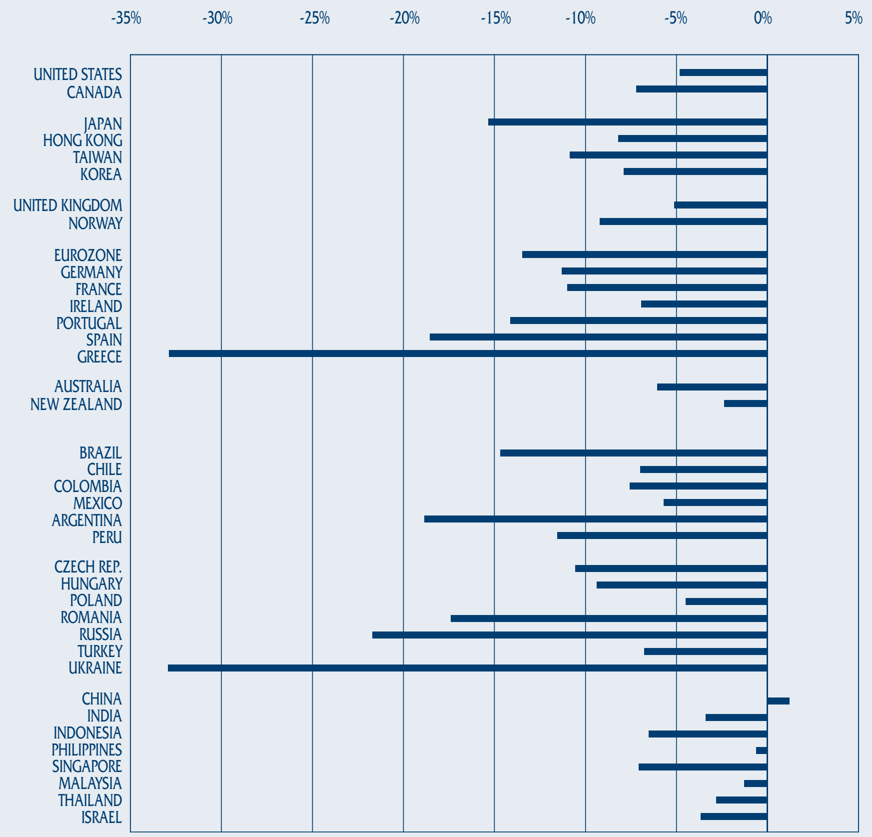
Source: Bloomberg.
1/ It reflects the exchange rate risk in the variable rate debt in euro agains the variable rate debt in dollars.

14. The major **stock markets** maintained a favorable evolution until April as a result of lower risk aversion. Since May, with the deepening of the Eurozone debt crisis, the markets have registered significant and widespread losses (except for China's Stock Exchange which gained 1 percent between the months of March and May).

As regards the countries more closely related to the Eurozone and which show the greatest risks of contagion, the recent losses have reversed the earnings obtained in the first months of the year. These losses have concentrated in the banking sector, which is the segment most affected by the sovereign debt crisis. However, the gains accumulated in the stock exchange of Germany until April have neutralized the losses registered in May, basically due to the favorable growth outlook for this economy and to lower fears of contagion as well.

In the case of emerging countries, the stock markets of Brazil and Argentina have recorded losses so far this year. In the case of the former, this was associated with the country's economic slowdown, the greater exposure of its economy to China, and with the capital outflows observed since May, and in the case of the latter, this was observed after the nationalization of the oil company YPF (previously owned by Repsol).

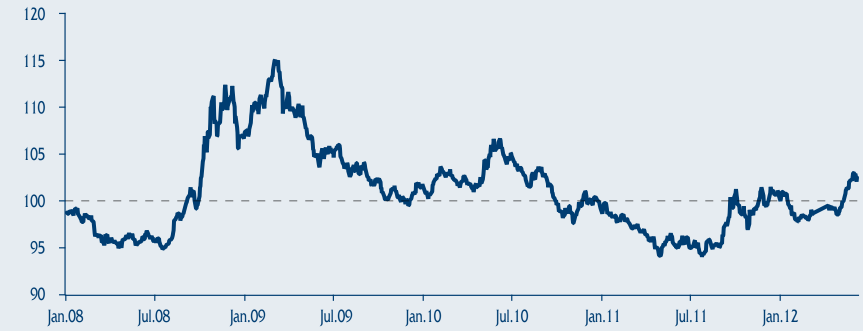
Graph 13
STOCK MARKETS
(End of period; % chg. Jun.12 respect to Mar.12)



Source: Bloomberg.

15. The dollar has shown an appreciatory trend against most currencies in Q2-2012. The **US dollar** basket index of the Federal Reserve indicates that the U.S. currency appreciated 4 percent on average against the currencies of USA's major trading partners. This trend accelerated in May when risk aversion increased in global financial markets.

Graph 14
US DOLLAR INDEX*
(January 2008 - June 2012)



*A rise in the index represents an appreciation of the US dollar.
Source: FED.

The dollar appreciated against the **euro** due to higher risk as a result of the political crisis in Greece and reached levels unheard of since July 2010 (on May 31, it reached US$ 1.236). As a result of this, the dollar reversed the depreciation it experienced in the first months of the year and accumulated an appreciation of 3 percent compared to the close of 2011.

Table 7
EXCHANGE RATE
(End of period)

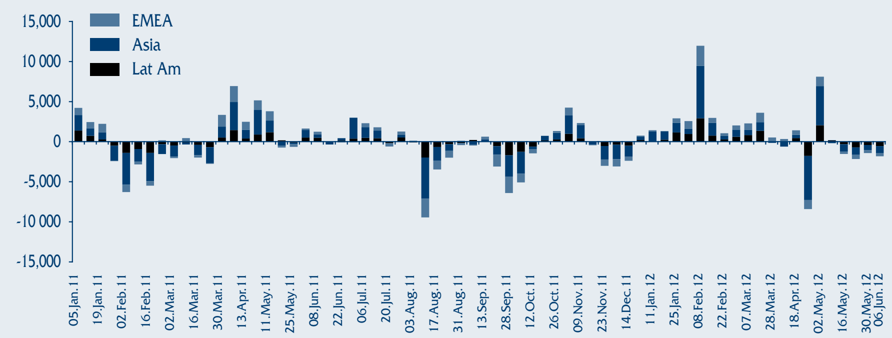
	Dec.08	Dec.09	Dec.10	Dec.11	Mar.12	Jun.12*	% chg. compared to: Mar.12	Dec.11	Dec.10
Canada	1.217	1.052	0.997	1.019	0.998	1.026	2.8	0.6	2.9
Japan	90.60	92.90	81.15	76.94	82.79	79.54	-3.9	3.4	-2.0
United Kingdom (US$/c.u.)	1.463	1.616	1.560	1.554	1.601	1.557	-2.8	0.2	-0.2
Eurozone (US$/c.u.)	1.398	1.432	1.338	1.295	1.334	1.250	-6.3	-3.4	-6.6
Switzerland	1.0669	1.0355	0.9335	0.938	0.902	0.960	6.4	2.4	2.8
Brazil	2.313	1.743	1.659	1.863	1.826	2.068	13.2	11.0	24.6
Chile	635.5	507.2	467.8	519.3	488.1	503.3	3.1	-3.1	7.6
Colombia	2,246	2,040	1,915	1,936	1,787	1,778	-0.5	-8.1	-7.1
Mexico	13.65	13.06	12.36	13.95	12.80	13.96	9.1	0.1	13.0
Argentina	3.454	3.799	3.979	4.302	4.377	4.486	2.5	4.3	12.7
Peru	3.136	2.890	2.808	2.697	2.669	2.681	0.4	-0.6	-4.5
Hungary	188.30	187.96	208.15	243.28	220.49	237.06	7.5	-2.6	13.9
Poland	2.96	2.86	2.96	3.44	3.10	3.45	11.3	0.4	16.9
Russia	30.53	30.31	30.57	32.19	29.32	33.02	12.6	2.6	8.0
Turkey	1.54	1.50	1.54	1.88	1.78	1.82	2.4	-3.3	18.5
China	6.82	6.83	6.59	6.29	6.30	6.37	1.2	1.2	-3.3
India	48.58	46.40	44.70	53.01	50.87	55.80	9.7	5.3	24.8
Israel	3.78	3.79	3.52	3.81	3.70	3.88	4.7	1.8	10.1

Source: Bloomberg and Reuters.
* Up to June 12.

In the last two months, the currencies of emerging economies have depreciated. This is particularly noteworthy in the cases of the currencies of Brazil, Mexico, Poland, Russia and India. The depreciation of the first three currencies has been in line with the high current account deficits that these economies show.

Most of the **currencies in the region** have also depreciated against the dollar, reversing the appreciation accumulated in Q1 due to the downward correction of the prices of some commodities, higher risk aversion, and the lower capital inflows. These two last factors are generated due to the uncertainty associated with the political, fiscal, and financial situation in the Eurozone. The depreciation of the Brazilian real has reached 13 percent and the depreciation of the Mexican peso 9 percent.

Graph 15
PORTFOLIO FLOWS TO EMERGING ECONOMIES*
(Weekly flows. Millions of US$)



* Includes dedicated and not-dedicated funds.
Source: Barclays.

The depreciation of the real, which is associated with capital outflows (due to the financial operations registered since March) and with expectations of new policy rate cuts, has been offset by the interventions of the central bank (sale of foreign exchange swaps). The depreciation of the Mexican peso, on the other hand, reflects mainly fears about a worsening of the debt crisis in Europe and the slow recovery of activity in USA.

Monetary policy decisions

16. Most economies have not modified their policy rates over the past few months. In Q2-2012, of the 32 economies that we keep track of, 25 maintained their rates, 3 raised them (Iceland, Poland and Serbia), and 4 lowered them (Australia, Brazil, China, and India).

In most of the developed countries interest rates have maintained minimum levels, in line with low inflationary pressures and with a slow economic recovery. The Central Bank of Japan announced in April that it would extend its asset purchase program of ¥ 10 trillion (US$ 124 billion)[1], while other economies, such as USA, did not modify their non-conventional stimulus measures.

In the emerging economies, the pause in the reduction of rates –and in some cases, the rate cuts– occurs in a context of moderate slowdown of growth (albeit from high growth rates), slight correction of inflationary pressures, and high uncertainty in the international environment. The case of Brazil stands out, since it has reduced its rate by 125 basis points in recent months, thus accumulating a reduction of 250 basis points in the year, in a context of strong economic slowdown and moderation of inflationary pressures.

Table 8
MONETARY POLICY INTEREST RATE

							Accumulated change (bps.)			
	Sep.08	Dec.10	Dec.11	Mar.12	May.12	Jun.12	Mar.12	Dec.11	Dec.10	Sep.08
Countries that have kept rates in the second quarter of 2012										
BCE	4.25	1.00	1.00	1.00	1.00	1.00	0	0	0	-325
Canada	3.00	1.00	1.00	1.00	1.00	1.00	0	0	0	-200
Chile	8.25	3.25	5.25	5.00	5.00	5.00	0	-25	175	-325
Colombia	10.00	3.00	4.75	5.25	5.25	5.25	0	50	225	-475
South Korea	5.25	2.50	3.25	3.25	3.25	3.25	0	0	75	-200
United States	2.00	0.25	0.25	0.25	0.25	0.25	0	0	0	-175
Philippines	6.00	4.00	4.50	4.00	4.00	4.00	0	-50	0	-200
Hungary	8.50	5.75	7.00	7.00	7.00	7.00	0	0	125	-150
Indonesia	9.25	6.50	6.00	5.75	5.75	5.75	0	-25	-75	-350
Israel	4.25	2.00	2.75	2.50	2.50	2.50	0	-25	50	-175
Japan	0.50	0.10	0.10	0.10	0.10	0.10	0	0	0	-40
Malaysia	3.50	2.75	3.00	3.00	3.00	3.00	0	0	25	-50
Mexico	8.25	4.50	4.50	4.50	4.50	4.50	0	0	0	-375
Norway	5.75	2.00	1.75	1.50	1.50	1.50	0	-25	-50	-425
New Zealand	7.50	3.00	2.50	2.50	2.50	2.50	0	0	-50	-500
Pakistan	13.00	14.00	12.00	12.00	12.00	12.00	0	0	-200	-100
Peru	6.50	3.00	4.25	4.25	4.25	4.25	0	0	125	-225
United Kingdom	5.00	0.50	0.50	0.50	0.50	0.50	0	0	0	-450
South Africa	12.00	5.50	5.50	5.50	5.50	5.50	0	0	0	-650
Sweden	4.75	1.25	1.75	1.50	1.50	1.50	0	-25	25	-325
Switzerland	2.75	0.25	0.25	0.25	0.25	0.25	0	0	0	-250
Thailand	3.75	2.00	3.50	3.00	3.00	3.00	0	-50	100	-75
Taiwan	3.50	1.63	1.88	1.88	1.88	1.88	0	0	25	-163
Turkey	16.75	6.50	5.75	5.75	5.75	5.75	0	0	-75	-1,100
Countries that have increased rates in the second quarter of 2012										
Iceland	15.50	4.50	4.75	5.00	5.50	5.50	50	75	100	-1,000
Poland	6.00	3.50	4.50	4.50	4.75	4.75	25	25	125	-125
Serbia	15.75	11.50	9.75	9.50	9.50	10.00	50	25	-150	-575
Countries that have reduced rates in the second quarter of 2012										
Australia	7.00	4.75	4.25	4.25	3.75	3.50	-75	-75	-125	-350
Brazil	13.75	10.75	11.00	9.75	8.50	8.50	-125	-250	-225	-525
China	7.20	5.81	6.56	6.56	6.56	6.31	-25	-25	50	-89
India	9.00	6.25	8.50	8.50	8.00	8.00	-50	-50	175	-100
Countries that have not met in the second quarter of 2012										
Uruguay	7.25	6.50	8.75	8.75	8.75	8.75	0	0	225	150

Source: Reuters and Bloomberg.

1 In addition, the BoJ announced the withdrawal of ¥ 5 trillion from the fund destined to market operations. With this, the purchase and loan program of BoJ increases to ¥ 70 trillion.

Terms of trade and commodity prices

17. International prices have been showing a downward trend since Q2, affected mainly by increased global risk associated with fears that the Eurozone crisis will worsen. This has taken place in a context of appreciation of the dollar, fears of lower growth in Europe and China, a relief of geopolitical tensions in the Middle East, and expectations of favorable climate conditions in the case of some food products. All of these factors have partially reversed the price increases observed in the first months of the year.

    In the forecast horizon, the terms of trade are expected to decline 3.6 percent on average in 2012. This decline is higher than the one considered in our previous report given the increased downward correction in the prices of exports, which would be partially offset by the decline in the prices of imports.

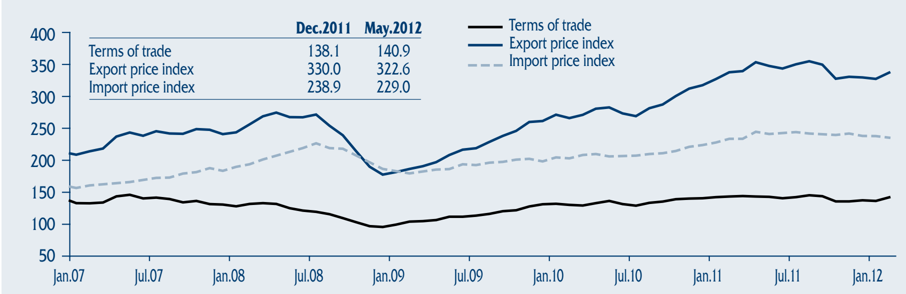
    In 2012 the prices of exports would drop 6.2 percent –a higher drop than the one estimated in our previous report–, in line with the slowdown of global demand. The prices of imports would decline 2.6 percent due to the lower prices of oil and food, as well as due to lower global inflation.

Table 9
TERMS OF TRADE: 2010 - 2014
(Annual average data)

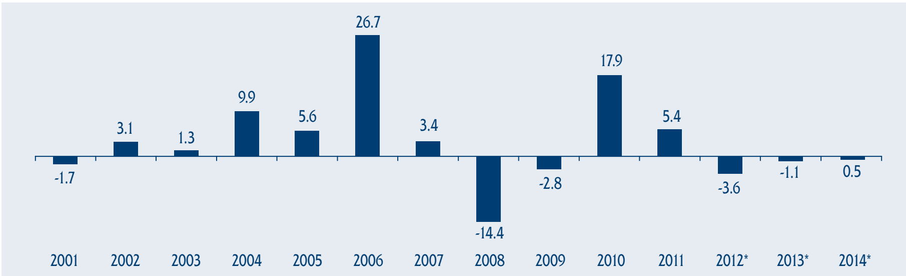
	Executed		2012		2013		2014
	2010	2011	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
Terms of trade 1/	**17.9**	**5.4**	**-1.4**	**-3.6**	**0.4**	**-1.1**	**-0.5**
Price of exports 1/	**29.9**	**20.0**	**-1.9**	**-6.2**	**0.9**	**-1.2**	**1.5**
Copper (US$ cents per pound)	342	400	382	357	385	348	347
Zinc (US$ cents per pound)	98	100	93	88	95	88	88
Lead (US$ cents per pound)	98	109	97	91	100	89	89
Gold (US$ per ounce)	1,225	1,570	1,680	1,624	1,675	1,600	1,600
Price of imports 1/	**10.1**	**13.8**	**-0.5**	**-2.6**	**0.5**	**-0.1**	**2.0**
Oil (US$ per barrel)	79	95	105	98	106	95	95
Wheat (US$ per ton)	195	280	257	251	272	277	282
Maize (US$ per ton)	157	262	243	234	223	214	209
Soybean oil (US$ per ton)	859	1,191	1,200	1,140	1,217	1,143	1,132

IR: Inflation Report.
1/ Average annual % change.

Graph 16
TERMS OF TRADE, EXPORT AND IMPORT PRICE INDICES: JANUARY 2007 - MAY 2012
(1994=100)



Graph 17
TERMS OF TRADE: 2001 - 2014
(% change)

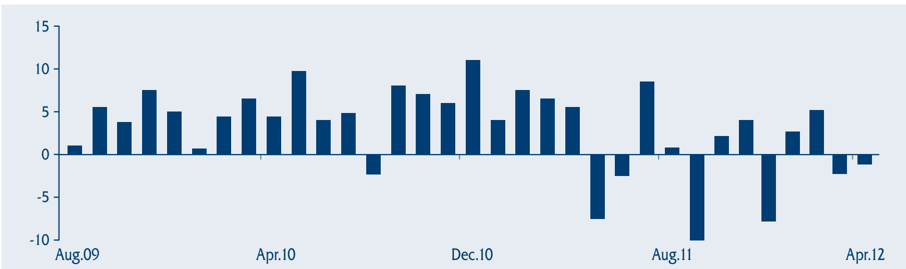


* Forecast.

Non-commercial positions

18. Even though the high international liquidity associated with low interest rates allowed a recovery of the demand for commodities as alternative investment assets in the first months of the year, the deterioration of the international context due to the worsening of the European crisis generated net outflows in March and April. The non-commercial positions of investment funds declined by US$ 1.0 billion in April.

Graph 18
COMMODITIES INVESTMENT FLOWS
(Billions of US$)



Source: Bloomberg and Barclays Capital.

Copper

19. The price of **copper** has been showing a downward trend since April which has partially reversed the upward evolution observed in Q1. However, year-to-date the price of copper has increased 5 percent, closing with an average price of US$ 3.60 per pound in May.

After reaching this year a maximum high of US$ 3.927 per pound on February 28, the price of copper fell affected by the investors' liquidation of positions that was brought about by fears about the European sovereign debt and the slowdown of China's demand due to the higher than expected adjustment in its economic growth.

It is estimated that prices would stabilize in the forecast horizon at a lower level than the one considered in our previous Inflation Report, in line with the slowdown of China's demand and the contraction of demand in the European Union. This lower demand would decline the pressure on prices caused by the low supply growth rates which maintain the market in a deficit. The International Copper Study Group (ICSG), which has revised down its projection of mining production for 2012, estimates that this would be the third consecutive year with a production deficit in this market.

Graph 19
COPPER: JANUARY 2007 - DECEMBER 2014
(ctv. US$/pd.)

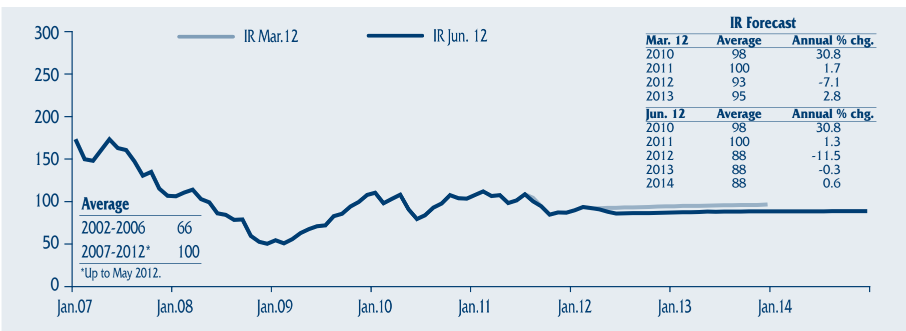
Zinc

20. So far this year, the average price of **zinc** has increased 1 percent, encouraged by the higher demand of USA and China, as well as by the lower than expected decline of demand in Europe. The price of zinc has also been supported by the growth of the transport sector in USA.

However, the price of zinc has dropped 6 percent in the last three months and has closed with an average price of US$ 0.88 per pound in May. This price drop has been associated with the reduction of positions due to uncertainty associated with Europe's sovereign debt crisis in a context of rising inventories at the London Metal Exchange (LME). Moreover, the International Zinc and Lead Study Group (ILZG) reported an unexpected increase in global production in February: the production of zinc grew in all the regions, especially in China.

Because of these factors, in the forecast horizon the price of zinc is expected to fall slightly relative to the price levels estimated in our previous Inflation Report.

Graph 20
ZINC: JANUARY 2007 - DECEMBER 2014
(ctv. US$/pd.)



Gold

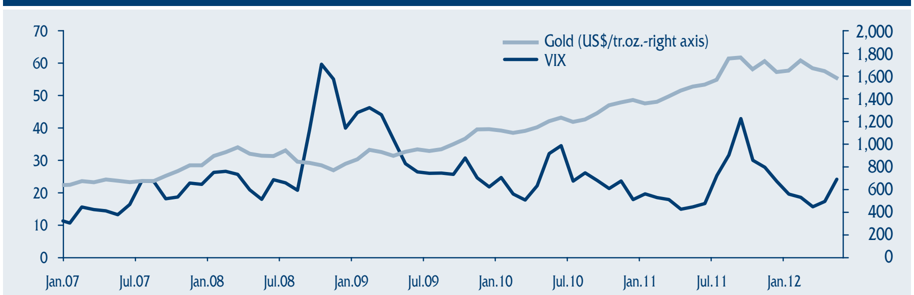
21. The price of **gold**, which has registered a decline of 3 percent so far this year, closed at an average level of US$ 1,590 per troy ounce in May. Gold initiated a downward trend in March, reversing in this way the rise observed in the first two months of the year.

This decline in the price of gold was in line with the downward revision of the World Gold Council's estimates of demand for Q1-2012, which is mainly explained by the drop of demand for jewelry –affected by a jewelers' strike in India– and partially offset by a higher investment demand. Another factor that contributed to this decline was the appreciation of the dollar, especially in the months of April and May.

The price of gold is expected to remain high in the forecast horizon in a context of uncertainty due to the situation in Europe. The price of gold would recover also due to central banks' purchases of this metal and to a reduction in the supply of recycled gold, although a greater recovery would be offset by the lower growth of the physical demand in Italy (the largest exporter of jewelry in Europe), India (due to the depreciation the rupee which would increase the price of imports), and China (due to the economic slowdown).

Graph 21
GOLD: JANUARY 2007 - DECEMBER 2014
(US$/tr.oz.)

Graph 22
GOLD PRICE AND S&P-500 VIX INDEX
(January 2007 - May 2012)



Source: Bloomberg.

Oil

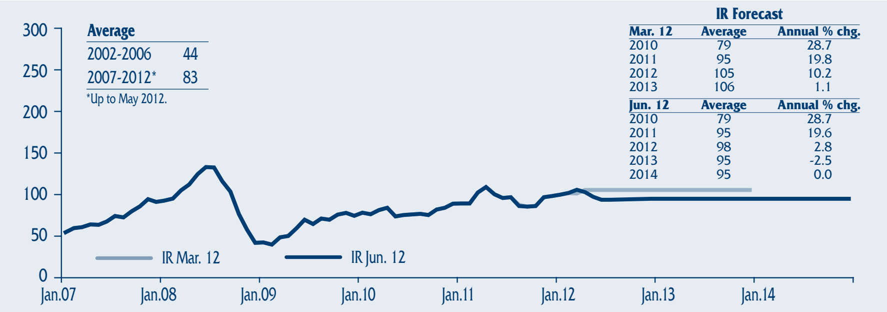
22. The average price of WTI **oil** has been falling in the last two months, reversing the upward trend observed at the beginning of 2012. As a result of this, the price of WTI oil has accumulated a drop of 4 percent in the first five months of the year, recording an average level of US$ 95 per barrel in May.

    This fall in the price of oil is associated with renewed fears about Europe's sovereign debt, a warmer than normal weather in the Northern Hemisphere in Q1, and lower geopolitical risks after Iran allowed the inspection of its nuclear program by western experts.

    However, the supply and demand indicators show a balanced market. The International Energy Agency (IEA) reported that the market is well supplied with OPEC production, which has registered its highest level in more than three years, and that there is an increasing demand of Japan due to the closure of its nuclear power plants.

The price of oil in the forecast horizon is expected to show similar levels to the ones observed today, but lower than those estimated in our previous Inflation report. Despite this downward correction, there are still risks associated with a higher than expected consumption of OECD countries, the recovery of refinery production, and the possible resurgence of geopolitical conflicts.

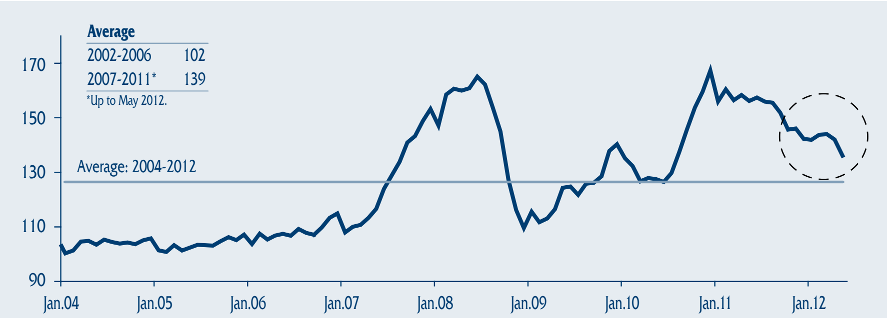
Graph 23
WTI OIL: JANUARY 2007 - DECEMBER 2014



Food

23. In the first five months of this year, **food** prices showed mixed behaviors. On the supply side, the prices of some food products were favored by the lower production expected of South America and the adverse weather conditions in certain producer countries, while others were affected by earlier harvests. On the demand side, the demand in Asian emerging economies was a factor that pushed the prices of some food commodities upwards. Like in the case of other commodities, the increase in food prices was offset by the uncertainty generated in the international financial markets. At May, the real price index of FAO decreased 4.4 percent from its level at the end of 2011 and showed monthly negative growth rates in April (1.4 percent) and May (4.4 percent).

Graph 24
FAO REAL FOOD PRICE INDEX*
(Base 2002 - 2004 = 100)



* The real price index is the index of nominal prices deflated by the unit value of manufactures of the World Bank.

Even though the international food prices are expected to remain relatively stable in general in the forecast horizon, these prices could increase more than expected due to a likely El Niño event, which could affect the production of countries such as USA, Australia, and South American countries.

Maize

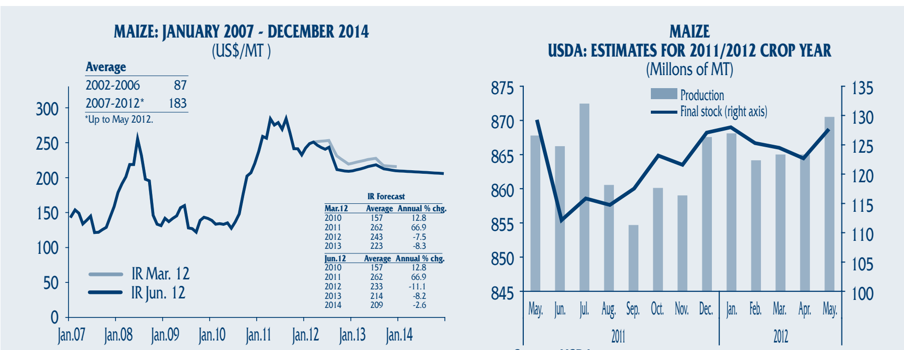
24. The average price of **maize**, which registered an increase of 5 percent in the first five months of the year, was US$ 245 per ton in May. This increase reflected mainly the price rise observed at the beginning of the year, in line with the fears of lower production in South American producing countries due to La Niña. The price of maize was favored over the year by China's continued demand given its low level of inventories and its need to replenish them through higher imports.

However, this increase in the price of maize was offset by expectations of a greater harvest in the USA as a result of both better crop yields and increased cultivated areas. Moreover, the price of maize was also affected by the early and accelerated pace of planting of maize in USA, which even led to a fall in the average price of this crop in April.

In its last world food balance, the US Department of Agriculture (USDA) says that it expects less tight conditions in the maize market for this season and for the next one. The USDA raised the estimated production of Brazil for the 2011/12 crop year and expects a record global production for the sixth consecutive year in the 2012/13 crop year due to a record harvest foreseen mainly in USA.

Because of this, and also because of the lower prices of oil anticipated in this report, the price of maize is estimated to correct downwards in the forecast horizon and to register lower levels than the ones considered in our Inflation Report of March 2012.

Graph 25



Source: USDA.

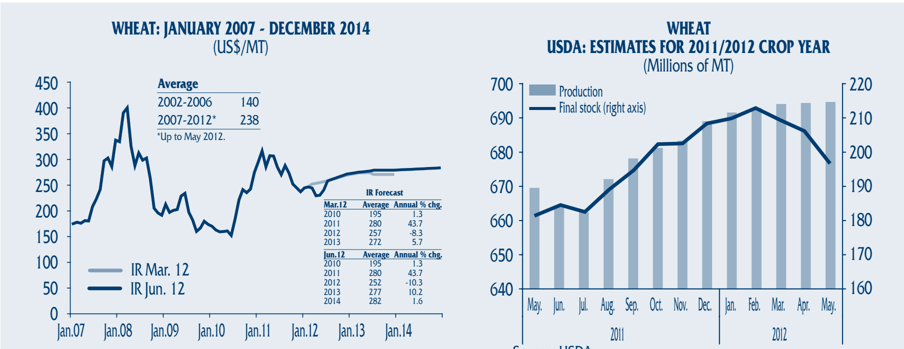
Wheat

25. The international price of **wheat** has dropped 3 percent so far this year, closing at an average price of US$ 229 per ton in May. At the end of Q1, the price of wheat accumulated an increase of 3 percent, declining thereafter in the last two months due to larger cultivated areas, expectations of record yields, and favorable climate conditions in the producing areas of USA.

However, since mid-May the price of wheat has resumed the upward trend observed in the first months of the year due to unfavorable weather conditions in major producing and exporting countries (Russia, Ukraine, Australia, and USA). In addition to this, a lower domestic production is expected in China, which would imply a higher demand. Moreover, the USDA expects the final global inventories to decline in the next crop season, which would be pointing to tighter market conditions.

Because of these reasons, the price of wheat is expected to follow a rising path, recording slightly higher levels than the ones considered in our previous report.

Graph 26



Source: USDA.

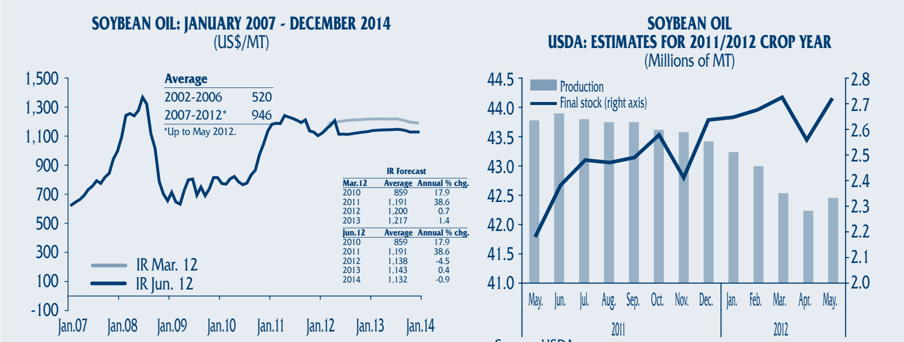
Soybean oil

26. The price of **soybean oil**, which has increased 1 percent on average so far this year, closed in May at an average price of US$ 1,116 per ton. This increase is explained by the rises registered in the first four months of the year, since the prices corrected downwards in May.

The price of soybean oil had a rising conduct in the first four months of the year, in line with expectations of a lower production of soybean in Latin American countries due to the lower yields anticipated in producing areas. The prices corrected downwards in May due to the drop registered in the price of oil, as well as due to investors' profit taking.

In regard to expected market conditions, the USDA estimates that global production would recover in general in 2012/13 as a result of the higher yields expected in USA and Latin America. Based on these assumptions, the price of soybean oil is estimated to show similar levels to the ones observed today, but lower than those forecast in our previous report due to the lower prices of crude considered too.

Graph 27



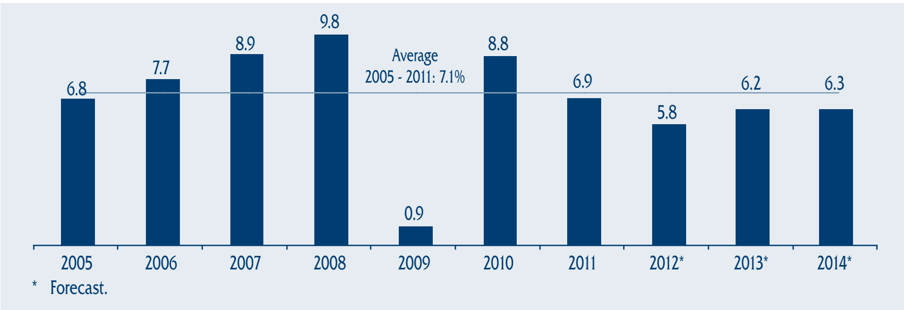
Source: USDA.

II. Economic Activity

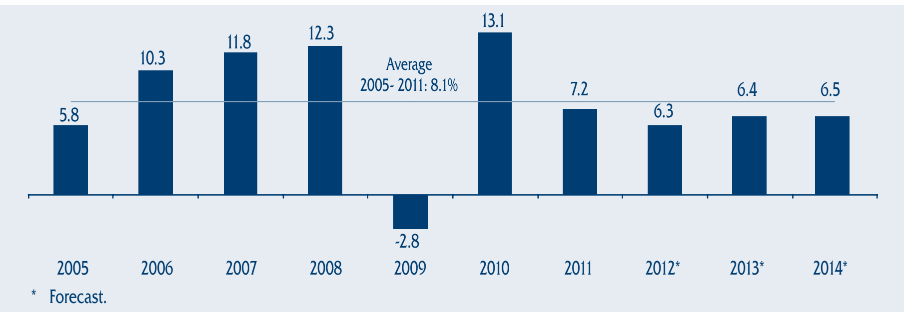
27. Showing a higher rate than the one registered in the previous quarter (5.5 percent), **GDP** grew 6.0 percent in Q1-2012. The growth of exports (14.8 percent) and the increase of private investment (13.7 percent) and public investment (36.9 percent) are worth pointing out.

Domestic demand grew 5.6 percent in Q1-2012, below the growth rate of GDP. On the one hand, the growth of demand was driven by public investment, due to the higher spending of subnational governments, and by private investment, which grew in line with the favorable evolution of business confidence. On the other hand, consumption showed a more moderate pace of growth since it went from registering growth rates of around 6.4 percent throughout 2011 to recording a rate of 6.0 percent in Q1-2012. The growth of domestic demand in Q1 was also offset by the transitory decline of 0.7 percent in public sector consumption due to lower spending in the maintenance of road infrastructure.

Graph 28
GDP: 2005-2014
(Real % change)

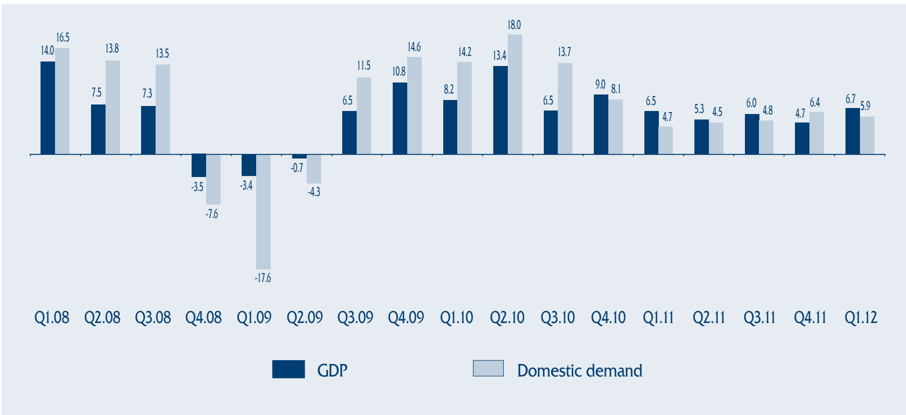


Graph 29
DOMESTIC DEMAND: 2005 - 2014
(Real % change)



In **seasonally adjusted terms**, GDP showed a faster pace of growth than in Q4-2011. The seasonally adjusted annual rate of growth of GDP in Q1 was 6.7 percent, higher than the rates observed in 2011.

Graph 30
SEASONALLY ADJUSTED GDP AND DOMESTIC DEMAND: 2008 - 2012
(Annualized % change)



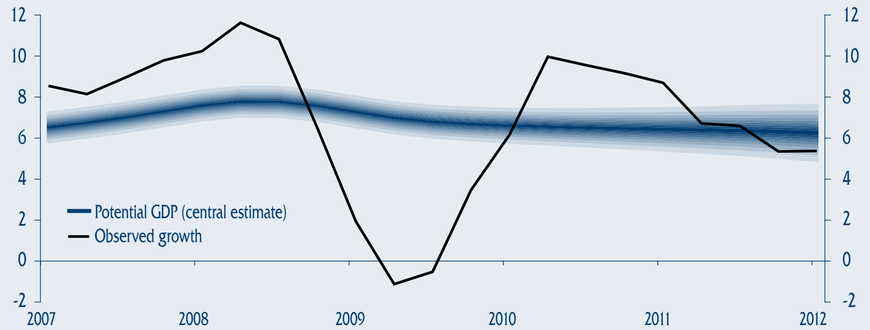
28. Considering the growth of Peru's economy in Q1 and particularly the growth of private investment, the forecast on GDP growth for 2012 is revised upwards from 5.7 percent (Inflation Report of March) to 5.8 percent.

    On the other hand, in line with the downward revision of the estimated global growth and the terms of trade, the GDP growth forecast for 2013 has been revised down from 6.3 percent to 6.2 percent. Moreover, given that better external conditions are foreseen for 2014, GDP would grow 6.3 percent in this year.

    The growth rates of GDP and domestic demand foreseen for the forecast horizon are below the average growth of these variables in the period 2005–2011 and therefore are closer to the economy's potential growth.

29. The growth forecast is consistent with a neutral economic cycle in which the economy will continue to grow at quarterly rates similar to the economy's potential growth and the output gap will remain close to zero, showing a slightly positive level in 2012 and a slightly negative level in 2013.

Graph 31
GDP POTENTIAL GROWTH AND ACTUAL GROWTH: 2007-2014
(% change in the last 4 quarters)



Memo: Potential GDP is not an observable variable and has to be estimated. Because of this, the graph shows uncertainty about its growth rate. As in the case of the output gap (Graph 101) and the inflation forecast (Graph 102), each band concentrates a probability of occurrence of 10% and total bands represent a probability of occurrence of 90%.

Expenditure components

30. The growth rate of **domestic demand** in 2012 has been revised up from 5.9 percent (Inflation Report of March) to 6.3 percent due to the greater growth expected in private investment, whose growth rate has been revised from 8.2 percent to 10.2 percent.

Table 10
GDP AND DOMESTIC DEMAND
(Real % change)

	2011		2012*			2013*		2014*
	Q1	Year	Q1	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
1. Domestic demand	**10.5**	**7.2**	**5.6**	**5.9**	**6.3**	**6.5**	**6.4**	**6.5**
a. Private consumption	6.4	6.4	6.0	5.8	5.8	5.8	5.6	5.8
b. Public consumption	5.2	4.8	-0.7	5.3	6.0	5.1	4.9	6.3
c. Private investment	15.4	11.7	13.7	8.2	10.2	8.7	8.7	8.7
d. Public investment	-5.8	-17.8	36.9	34.3	31.0	7.3	10.0	9.3
2. Exports	**4.2**	**8.8**	**14.8**	**7.5**	**5.7**	**7.7**	**7.7**	**8.5**
3. Imports	**13.3**	**9.8**	**11.0**	**8.3**	**8.3**	**8.3**	**8.3**	**8.9**
4. GDP	**8.8**	**6.9**	**6.0**	**5.7**	**5.8**	**6.3**	**6.2**	**6.3**
Memo:								
Government expenditure	*2.1*	*-4.2*	*9.2*	*15.2*	*14.5*	*6.0*	*6.9*	*7.5*

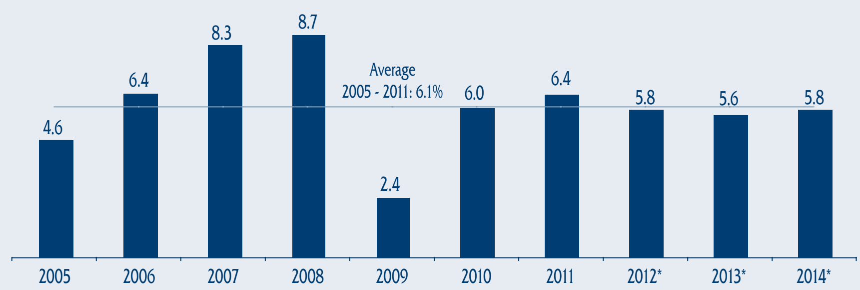
IR: Inflation Report.
* Forecast.

Table 11 GDP AND DOMESTIC DEMAND (Contributions to the real % change)								
	2011		2012*			2013*		2014*
	Q1	Year	Q1	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
1. Domestic demand	**10.9**	**7.5**	**5.9**	**6.2**	**6.6**	**6.8**	**6.7**	**6.8**
a. Private consumption	4.5	4.2	4.1	3.9	3.9	3.8	3.7	3.8
b. Public consumption	0.5	0.5	-0.1	0.5	0.6	0.5	0.5	0.6
c. Private investment	3.4	2.5	3.2	1.8	2.3	2.0	2.0	2.1
d. Public investment	-0.2	-1.1	1.2	1.6	1.5	0.4	0.6	0.6
e. Inventory variation 1/	1.0	1.4	-1.3	-0.2	-0.1	-0.1	-0.2	-0.4
2. Exports	**0.7**	**1.6**	**2.5**	**1.4**	**1.0**	**1.4**	**1.4**	**1.6**
3. Imports	**2.8**	**2.1**	**2.4**	**1.8**	**1.8**	**1.9**	**1.9**	**2.1**
4. GDP	**8.8**	**6.9**	**6.0**	**5.7**	**5.8**	**6.3**	**6.2**	**6.3**
Memo								
Government expenditure	*0.3*	*-0.7*	*1.1*	*2.1*	*2.0*	*0.9*	*1.1*	*1.2*

IR: Inflation Report.
* Forecast.
1/ % of GDP.

31. The growth rates of **private consumption** remain close to the average rate observed in 2005 – 2011. Showing a more moderate pace of growth than in 2011, private consumption grew 6.0 percent in Q1-2012. The evolution of household consumption is associated with the increase registered in the national disposable income –which grew 6.7 percent in Q1–, high consumer confidence levels, the growth of credit (20 percent), and the growth of employment (3.6 percent). In the forecast horizon, private consumption would maintain a moderate pace of growth, in line with a rising trend in domestic saving.

Graph 32
PRIVATE CONSUMPTION: 2005 - 2014
(Real % change)

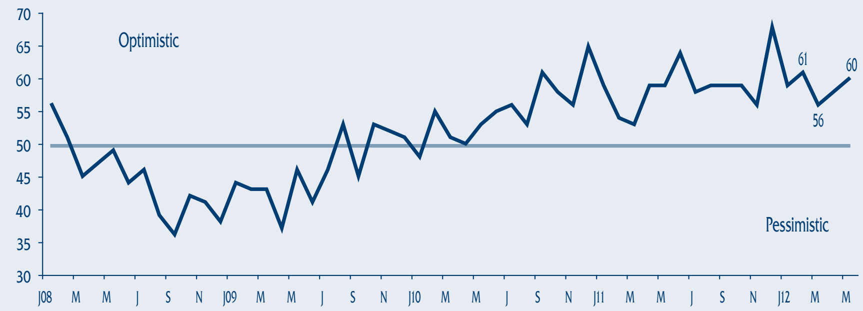


* Forecast.

The recent evolution of private consumption is reflected in several indicators:

a. The Consumer Confidence Index remains on the optimistic segment and has registered a significant rise in May.

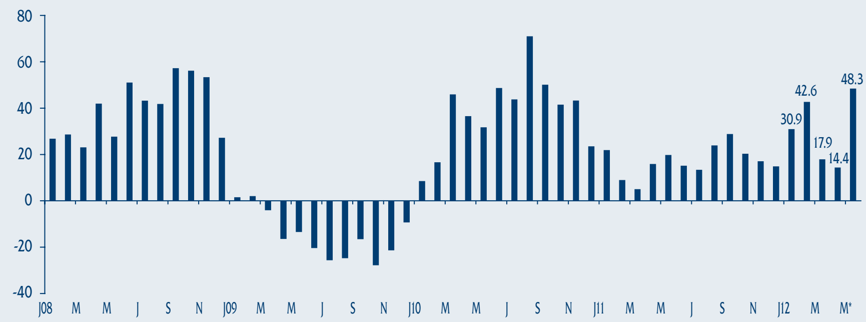
Graph 33
CONSUMER CONFIDENCE INDEX: 2008 - 2012
Households' economic situation



Source: Ipsos APOYO.
Elaboration: BCRP.

b. The volume of imports of durable consumer goods continues to grow at high rates after having transitorily declined in March and May, when they registered lower rates than in the first months of the year. Preliminary data at May indicate a faster pace of growth.

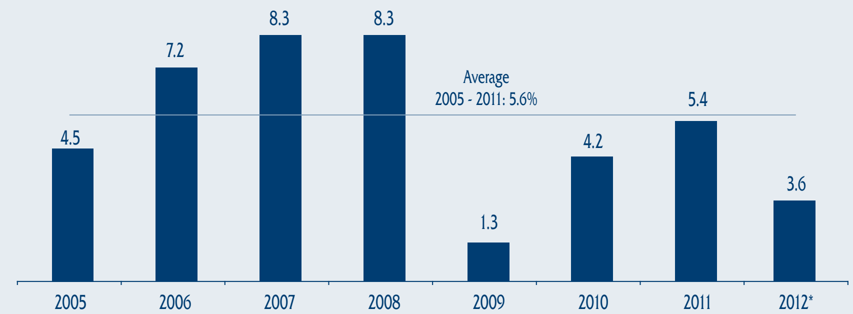
Graph 34
VOLUME OF IMPORTS OF DURABLE GOODS: 2008 - 2012
(12 month % change)



* Preliminary.

c. Urban employment in firms with 10 and more workers grew 3.6 percent in Q1-2012.

Graph 35
URBAN EMPLOYMENT: 2005 - 2012
(% change)

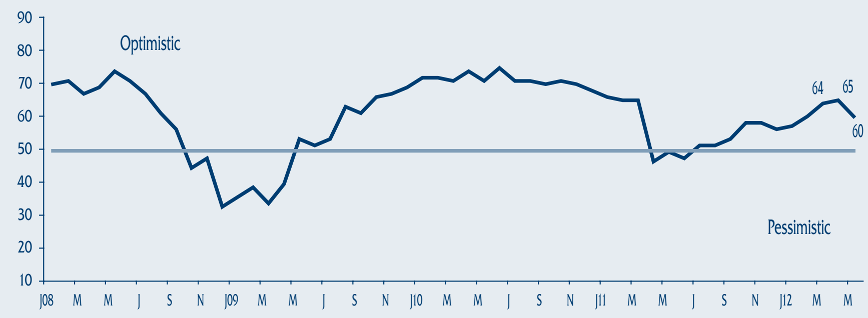


* January - March.
Source: MTPE.

32. **Private investment** recorded a faster pace of growth in Q1 than in 2011, in line with positive business expectations. Several indicators reflect the evolution of private investment:

   a. Business expectations on the situation of the economy in the three months ahead continue to be on the optimistic side. However, in May this indicator corrected downwards after rising for four consecutive months.

Graph 36
EXPECTATIONS ABOUT THE ECONOMY IN THE NEXT 3 MONTHS: 2008 - 2012



Survey of Macroeconomic Expectations, BCRP. Survey conducted during the second fortnight of May 2012.

   b. Compared to March, economic agents have raised the rates of GDP growth they expect for 2012 and 2013 and now expect a growth rate of 6.0 percent in those years. Moreover, they estimate GDP growth rates of between 6.0 and 6.2 percent in 2014.

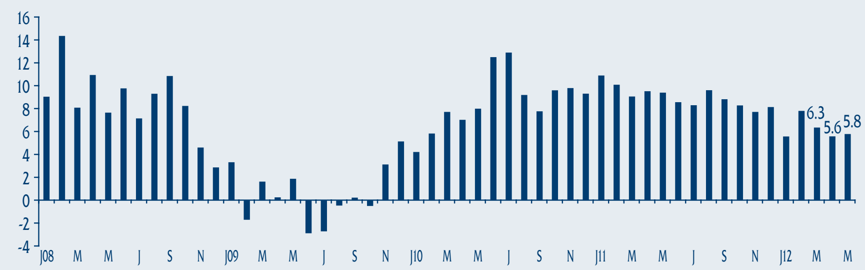
Table 12
SURVEY ON MACROECONOMIC EXPECTATIONS: GDP GROWTH
(%)

	IR Dec.11	IR Mar.12	IR Jun.12*
Financial entities			
2012	5.5	5.3	6.0
2013	6.0	5.6	6.0
2014	-.-	-.-	6.0
Economic analysts			
2012	5.4	5.0	6.0
2013	5.5	5.6	6.0
2014	-.-	-.-	6.2
Non-financial firms			
2012	6.0	5.5	6.0
2013	6.0	6.0	6.0
2014	-.-	-.-	6.0

* Survey made during the second half of May 2012.

c. The production of electricity continues to show a strong dynamism, with rates of 5.6 percent and 5.8 percent in April and May, respectively. These rates are close to the GDP growth rate.

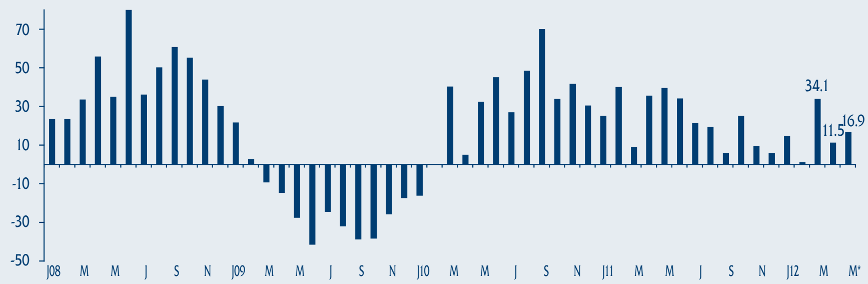
Graph 37
ELECTRICITY PRODUCTION: 2008 - 2012
(12 month % change)



Source: COES.

d. The volume of imports of capital goods shows a faster pace of growth and has recorded two-digit rates in the past three months.

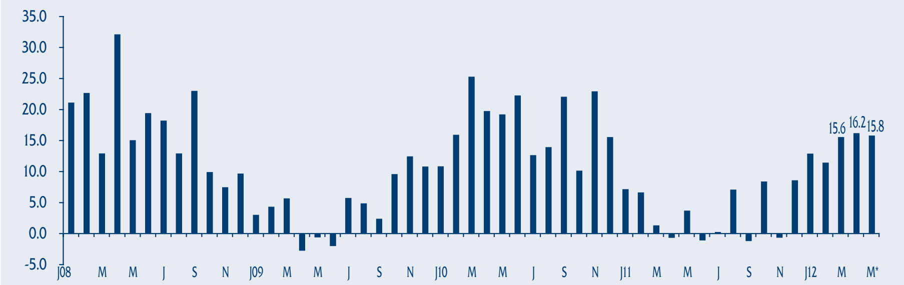
Graph 38
VOLUME OF IMPORTS OF CAPITAL GOODS: 2008 - 2012
(12 month % change)



* Preliminary.

e. The domestic consumption of cement has been showing two-digit rates since January, reflecting the consolidation of its recovery relative to the conduct observed in 2011.

Graph 39
DOMESTIC CONSUMPTION OF CEMENT: 2008 - 2012
(12 month % change)



* Preliminary.

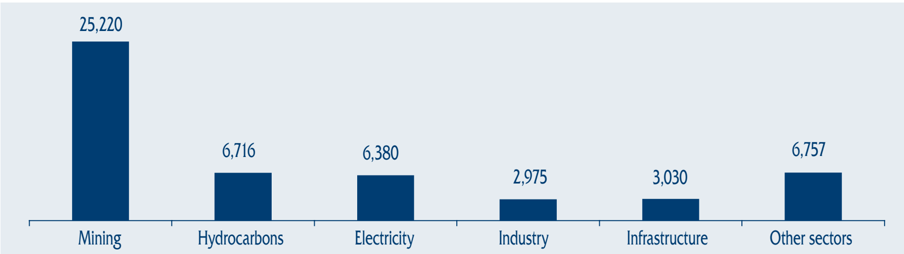
33. Private investment would grow at a rate of 8.7 percent in 2013 and 2014. This forecast considers the implementation of important investment projects in all the different sectors in a context of macroeconomic stability and sustained growth. The major investment projects announced for the period 2012-2014 amount to US$ 51.1 billion.

Table 13
ANNOUNCED INVESTMENT PROJECTS
(Millions of US$)

	2012	2013	2014	2012-2014
Mining	6,940	8,814	9,466	25,220
Hydrocarbons	2,250	2,756	1,710	6,716
Electricity	2,616	2,309	1,455	6,380
Industry	1,217	946	812	2,975
Infrastructure	1,495	959	576	3,030
Other sectors	3,483	2,411	863	6,757
TOTAL	**18,001**	**18,195**	**14,882**	**51,078**

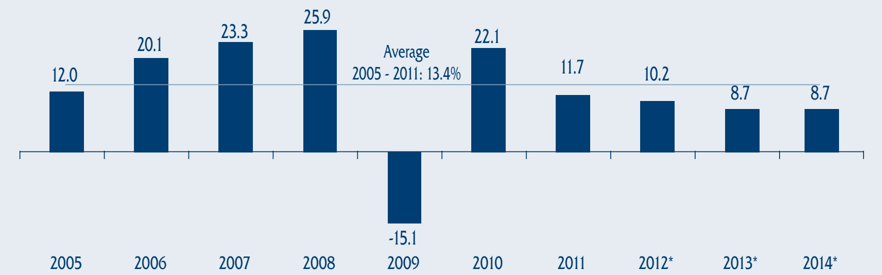
Source: Press media and information companies.

Graph 40
ANNOUNCED INVESTMENT PROJECTS: 2012-2014
(Millions of US$)



Source: Press media and information companies.

Graph 41
PRIVATE INVESTMENT: 2005 - 2014
(Real % change)



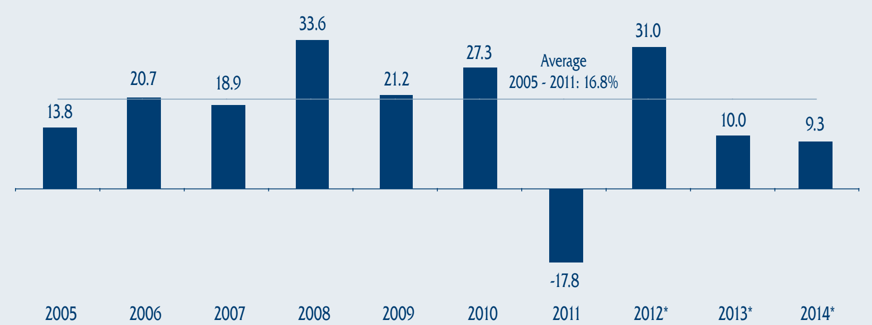
* Forecast.

Table 14
ANNOUNCED MAIN INVESTMENT PROJECTS: 2012-2014

Sector	Company	Project name
Mining	Xstrata Copper	Las Bambas
	Sociedad Minera Cerro Verde S.A.	Cerro Verde
	Jinzhao Mining Perú S.A.	Pampa del Pongo
	Anglo American Plc.	Quellaveco
	Minera Yanacocha S.R.L.	Minas Conga
	China Minmetals Corporation and Jiangxi Copper Company Limited	El Galeno
	Southern Perú Copper Corp. Peru branch	Los Chancas
	Candente Copper Corp.	Cañariaco Norte
	Gold Fields La Cima S.A.A.	Chucapaca
	HudBay Minerals Inc.	Constancia
	Marcobre S.A.C.	Mina Justa
	Bear Creek Mining Corporation	Corani
	Xstrata Tintaya S.A.	Antapaccay
	Southern Perú Copper Corp. Peru branch	Toquepala
	Minera Barrick Misquichilca S.A.	Expansion: Lagunas Norte
	Grupo Milpo	Expansion: Cerro Lindo and El Porvenir
	Hochschild Mining	Inmaculada
	Aluminium Corp of China Ltd. (Chinalco)	Toromocho
	Mitsui Mining & Smelting Co. Ltda. Peru branch	Quechua
	Río Alto Mining Ltd.	La Arena
	Compañía Minera Milpo S.A.	Magistral
	Shougang Corporation	Marcona
	Volcan Compañía Minera S.A.	Expansion: Volcan 2012-2014
	Compañía Minera Antamina S.A.	Expansion: Antamina
Hydrocarbons	Conduit Capital Partners	Andino del Sur pipeline
	Pluspetrol Perú Corp. S.A.	Expansion of Pisco and Malvinas plants
	Savia Perú S.A. (ex Petro-Tech Peruana S.A.)	Expansion of Pisco and Malvinas plants
	Petrobras	Lot 58 and Lot X
	Transportadora de Gas del Perú S.A. (TgP)	Expansion of gas and capacity of transportation
	Cálidda Gas Natural del Perú	Expansion of main grid
	Perenco	Exploration Lot 67 and pipeline
	Pluspetrol Perú Corp. S.A.	Exploration Lots 88 and 56
	SK Energy	Exploration Lot Z 46
	Repsol YPF S.A.	Lot 57 - Kinteroni
Electricity	Odebrecht S.A.	Hydroelectric plant of Cerro de Chaglla
	Kallpa Generación S.A.	Hydroelectric plant of Cerro del Águila
	Norwind	Wind energy park Cerro Chocan
	Enersur S.A.	Expansion of Chilca 1
	SN Power Perú S.A.	Hydroelectric plant Cheves
	Fénix Power Perú S.A.	Combined cycle thermal power plant (natural gas)
	Energía Azul S.R.L.	Hydroelectric plant Santa María
	Kallpa Generación S.A.	Kallpa IV
	Empresa Administradora Chungar S.A.C.	Hydroelectric plant Belo Horizonte
	Energía Eólica S.A.	Wind powerplant Cupisnique
	Solarpack and T-Solar	Solar powerplant
	Enersur S.A.. Endesa	Ilo - Talara Cold reserve
Industry	Corporación Aceros Arequipa S.A.	Expansion of lamination plant (N° 2)
	SAB Miller	Investment plan 2012-2014
	Repsol YPF	Expansion of La Pampilla plant
	Hochschild Mining	Phospates plant
	Corporación JR Lindley	Expansion and new plants
	Cementos Portland	Expansion of plant
	Cementos Interoceánicos	Expansion of plant in Puno
	Yura S.A.	Production lines, hydroelectric plant, among others.
Infrastructure	OAS S.R.L.	Parque Rimac express way (ex Línea Amarilla)
	Consorcio APM Terminals Callao	Modernization of North Pier
	Covisol	Trujillo-Sullana Sol Highway
	Consorcio Transportadora Callao	Minerals Pier
	Terminal Internacional del Sur (TISUR)	Expansion of Port of Matarani
	Autopista del Norte SAC	Red Vial N° 4: Pativilca - Puerto Salaverry
	Terminales Portuarios Euroandinos (TPE)	Expansion of Port Paita
	H2Olmos S.A.	Olmos irrigation
	Consorcio Desarrollo Vial del Perú	IIRSA Center - Amazonas - Center: Track 2
Other sectors	Grupo Brescia	Malls, green buildings, expansion of clinics and other health centers, and prime offices
	Grupo Falabella	Expansion and new malls
	Grupo Interbank	Expansion and new malls
	Telefónica del Perú S.A.	Optical fiber project at Los Andes
	América Móvil Perú S.A.C.	Expansion of infrastructure, capacity and technological innovation

34. **Public investment** in Q1 grew 36.9 percent due to the faster pace of implementation of investment projects adopted by subnational governments, both local and regional governments. This faster pace is explained by the greater experience acquired by the implementing authorities, as well as by the incentives offered by the national government through an incentive bonus for the effective implementation of investment (Bono de Incentivo por la Ejecución Eficaz de Inversiones- BOI). Thus, public investment would recover in 2012 after the fall it recorded in 2011. A moderation in the pace of growth of public investment is expected for 2013 and 2014.

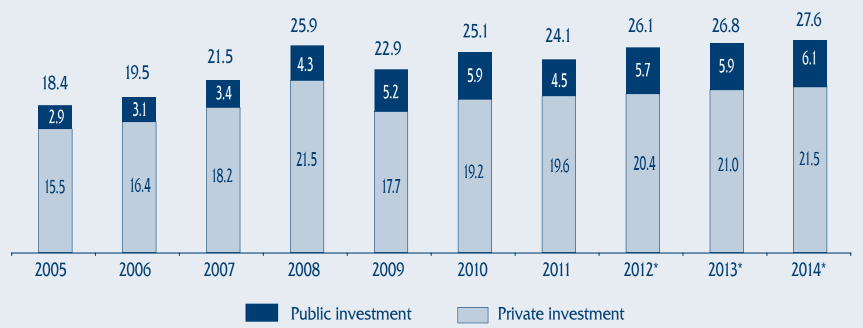
Graph 42
PUBLIC INVESTMENT: 2005 - 2014
(Real % change)



* Forecast.

35. Considering the evolution of private investment and public investment, the ratio of fixed gross investment to GDP would increase to 26 percent in 2012.

Graph 43
GROSS FIXED INVESTMENT: 2005 - 2014
(% of GDP)



* Forecast.

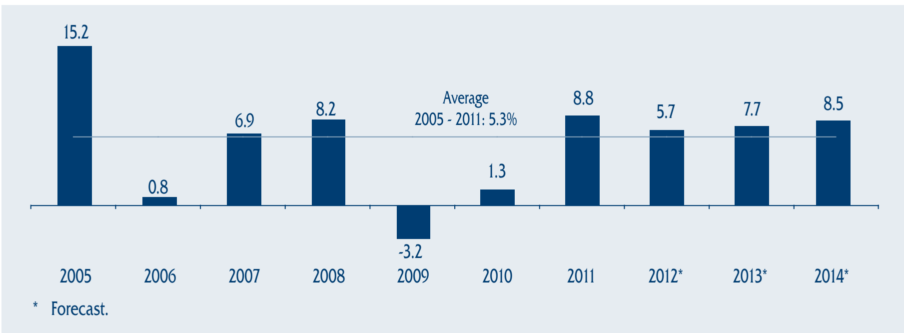
36. Although **exports** have had an important dynamism in Q1, traditional and non-traditional exports have shown differentiated behaviors. In the case of the former, after having registered a growth rate of 5.2 percent in 2011, the volume of traditional exports grew 17.2 percent in Q1. The higher exported volume of products such as fishmeal, coffee, iron ore, copper, and lead stands out in this

period. In the case of the latter, the volume of non-traditional exports showed a slowdown and declined from a rate of 20.2 percent in 2011 to a rate of 10.2 percent in Q1. However, the forecast on the growth of exports in 2012 has been revised down due to the lower volumes of gold exported by traders, as well as due to the lower dynamism registered by non-traditional products, particularly textiles.

The growth of exports in the period 2012-2014 would be higher than the average recorded in 2005-2011, with a sustained evolution due to the onset of operations of some copper mining projects, such as the expansion of Southern and Antamina, as well as due to the evolution of external demand.

On the other hand, **imports** in the forecast horizon are expected to show lower growth rates than those recorded in 2011, in line with the moderation in the growth of private spending, both consumption and investment, given that private spending will continue its course of convergence towards rates in line with the potential growth of the economy.

Graph 44
EXPORTS OF GOODS AND SERVICES: 2005 - 2014
(Real % change)



Graph 45
IMPORTS OF GOODS AND SERVICES: 2005 - 2014
(Real % change)

Sector GDP

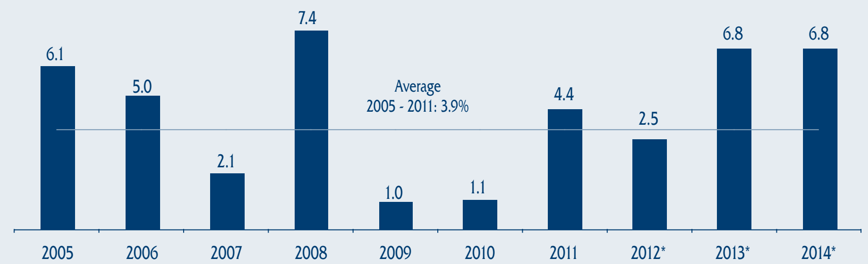
37. In Q1 **primary sectors** recorded a slight growth given that the higher rates registered in the sectors of agriculture and mining were offset by the decline registered in the fishing sector as a result of the lower quota established for anchovy catch and of the lower production of fishmeal and fish conserves.

A normalization of the rainy season is expected in the sector of agriculture after the delay of rains registered in 2011. Under these conditions, the sector would continue to be led by production for the external market and agro-industry, with a positive production of olives, a recovery in the production of asparagus, and a higher production of avocado and grapes. The alternation of crops would determine a more dynamic production for the domestic market than for the external market in 2013. A growth rate close to the average of the last decade is projected for 2014.

The forecast on the growth of the fishing sector has been revised downwards considering the lower quota of anchovy catch established in 2012 due to the reduction of the biomass of this species. The sector would return to a positive path in the next years as a result of the recovery and increased presence of species used for human consumption. Moreover, the capture of anchovy would also return to its long term level of extraction, which is close to 6 million tons per year.

The evolution of the sector of mining and hydrocarbons is associated mainly with the onset of the operational stage of important investment projects, including copper projects in Toromocho, Antapaccay, Constancia, and Las Bambas, as well as the expansion of Antamina and Southern's unit of Toquepala. On the other hand, projects in the field of hydrocarbons include the expansion of project "Loop Sur", which would make it possible to expand the capacity of Transportadora de Gas del Perú to transport natural gas by up to 650 million cubic feet per day and the capacity to transport natural gas liquids by up to 120 thousand barrels per day. Moreover, the operation of the new plant unit "Planta Compresora KP 127" of Transportadora de Gas Natural, which would expand the capacity of transporting natural gas to nearly 920 million cubic feet per day, is also included in the projection for the forecast horizon.

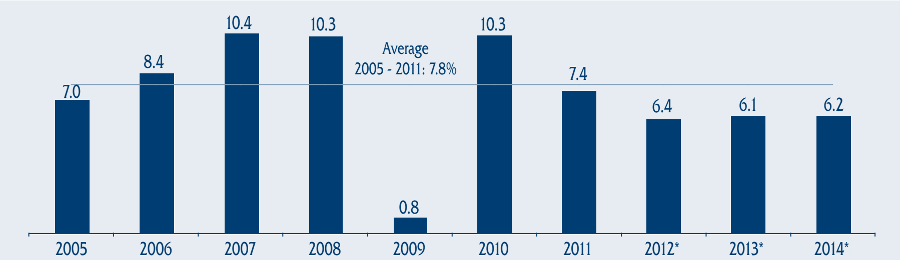
Graph 46
PRODUCTION IN PRIMARY SECTORS: 2005 - 2014
(Real % change)



* Forecast.

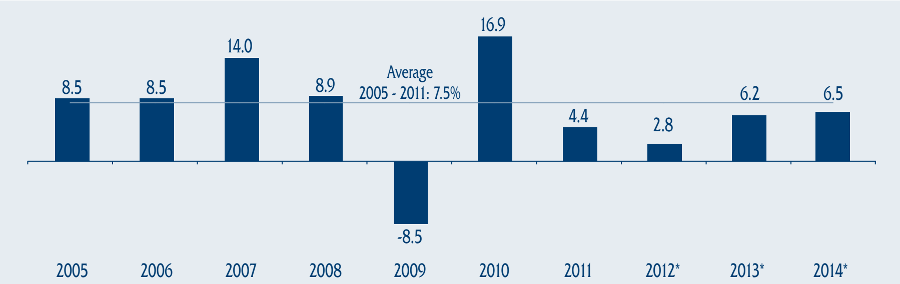
38. **Non-primary sectors** grew at a higher rate than GDP in Q1, due mainly to the higher growth of construction which resumes two-digit growth rates, as well as to the higher growth of commerce and services. It is estimated that in the following years growth in the non-primary sectors would remain close to the potential growth of the economy.

Graph 47
PRODUCTION IN NON PRIMARY SECTORS: 2005 - 2014
(Real % change)



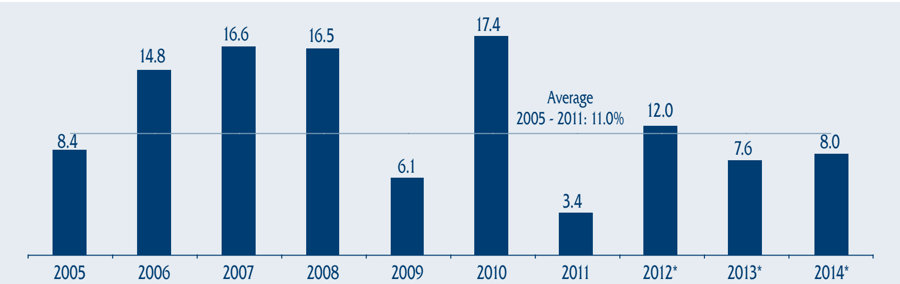
* Forecast.

Graph 48
NON-PRIMARY MANUFACTURING: 2005 - 2014
(Real % change)



* Forecast.

Graph 49
CONSTRUCTION: 2005 - 2014
(Real % change)



* Forecast.

Table 15
GROSS DOMESTIC PRODUCT BY ECONOMIC SECTORS
(Real % change)

	2011		2012*			2013*		2014*
	Q1	Year	Q1	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
Agriculture and livestock	**3.0**	**3.8**	**2.3**	**4.0**	**4.0**	**4.3**	**4.3**	**4.2**
Agriculture	0.3	2.8	0.5	3.8	3.8	3.7	3.7	4.1
Livestock	6.6	5.2	4.5	4.6	4.6	4.8	4.6	4.6
Fishing	**12.3**	**29.7**	**-7.6**	**-4.7**	**-8.9**	**2.8**	**2.8**	**2.5**
Mining and hydrocarbons	**-0.3**	**-0.2**	**2.1**	**2.8**	**3.1**	**10.7**	**11.2**	**12.1**
Metallic mining	-5.6	-3.6	1.7	3.2	3.7	9.0	9.5	12.1
Hydrocarbons	34.6	18.1	3.7	1.0	0.6	18.5	18.9	12.4
Manufacturing	**12.3**	**5.6**	**-0.9**	**4.9**	**2.1**	**6.2**	**6.2**	**6.2**
Raw materials	11.6	12.3	-2.6	3.4	-1.5	6.3	6.0	4.2
Non-primary industries	12.4	4.4	-0.6	5.1	2.8	6.2	6.2	6.5
Electricity and water	**7.3**	**7.4**	**6.4**	**5.5**	**5.7**	**5.9**	**5.9**	**7.0**
Construction	**8.1**	**3.4**	**12.5**	**11.3**	**12.0**	**7.6**	**7.6**	**8.0**
Commerce	**10.3**	**8.8**	**7.9**	**5.9**	**6.6**	**5.4**	**5.4**	**5.9**
Other services	**9.3**	**8.3**	**7.8**	**5.8**	**6.5**	**6.3**	**6.1**	**5.9**
GDP	**8.8**	**6.9**	**6.0**	**5.7**	**5.8**	**6.3**	**6.2**	**6.3**
Memo:								
Primary GDP	**3.5**	**4.4**	**1.1**	**3.3**	**2.5**	**6.7**	**6.8**	**6.8**
Non-Primary GDP	**9.8**	**7.4**	**6.9**	**6.1**	**6.4**	**6.2**	**6.1**	**6.2**

IR: Inflation Report.
* Forecast.

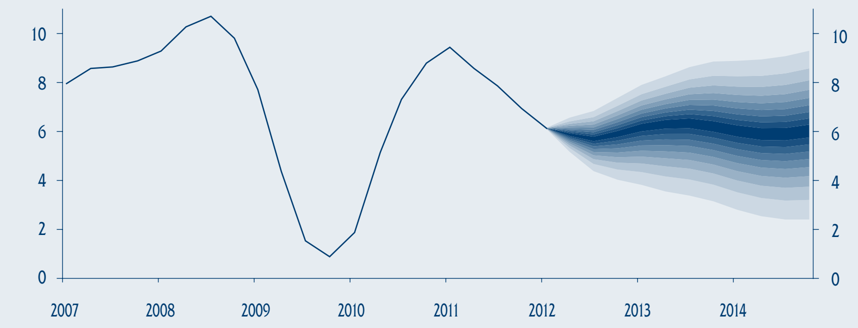
39. The central forecast scenario considers that the Peruvian economy would register a growth rate of 5.8 percent in 2012, showing a slightly higher rate than the one estimated in our Inflation Report of March. Although this forecast considers a higher pace of growth in private investment as a result of increased business confidence and higher-than-expected growth rates in some sectors, i.e. construction and services, for the rest of the year, lower quarterly growth rates than the ones observed in Q1 are expected due mainly to lower terms of trade and to the lower growth of our trading partners, offset in part by a higher fiscal impulse (0.5 percent) than the one considered in the Inflation Report of March (0.3 percent).

    The forecast on GDP growth in 2013 has been revised down from 6.3 percent (Inflation Report of March) to 6.2 percent considering lower terms of trade and lower growth rates in our trading partners.

40. Every growth forecast is subject to potential events that may divert it from the central scenario. In today's' context of increased uncertainty, the materialization of some risks could lead GDP to register different growth rates than the ones projected originally. The domestic risk scenario considers adverse demand shocks associated with the impact of social conflicts on private investment, as well as the negative effects of unfavorable climate conditions. On its side, growing uncertainty

in the global economy would contribute to deteriorate macroeconomic conditions. The risk scenarios considered in this report are discussed in the chapter Balance of risks.

Graph 50
FORECAST OF GDP GROWTH[1/], 2012 - 2014
(Interanual % change)



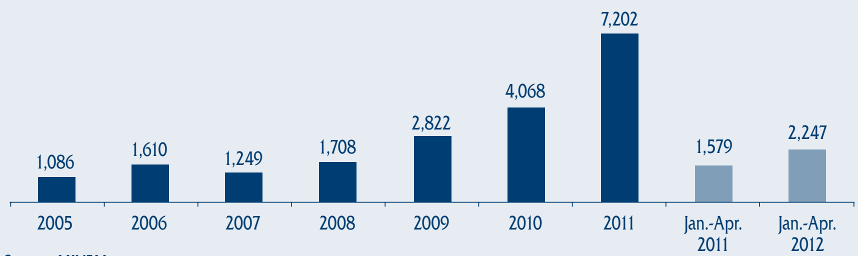
Memo: The graph shows the probability of occurrence of GDP growth forecasts in the future, the values of which were established combining statistical analysis (using data as of March 2012) and the subjective perception of the BCRP. Thus, in each period of the forecast horizon, each pair of bands with the same shade concentrates a probability of 10%. This can be interpreted as that 10 of every 100 possible values of future GDP growth values are expected to fall within the darkest bands (located in the center).

1/ GDP growth is defined as the percentage change of the moving average in four quarters compared to the same quarter of the previous year. Thus, the figure in Q4 coincides with the GDP growth rate in the year.

BOX 1
PROJECTIONS FOR THE MINING SECTOR: INVESTMENT AND PRODUCTION

According to the Ministry of Energy and Mines, mining investment between January and April of 2012 reached US$ 2.25 billion. This growth in mining investment (up 42 percent compared to the same period in 2011) is mainly explained by the capital expenditure executed by Xstrata Las Bambas, Chinalco, Antamina, and Yanacocha.

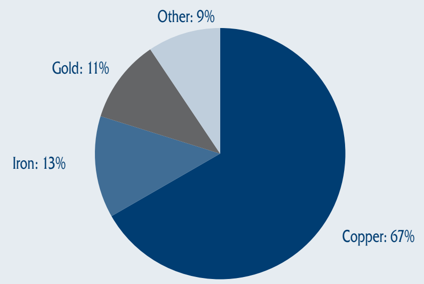
MINING SECTOR INVESTMENT: 2005 - 2012
(Millions of US$)



Source: MINEM.

The mining investment portfolio for this decade includes 48 projects which together represent US$ 53 billion. Nearly 70 percent of this amount is explained by copper prospecting projects, followed by iron and gold mining projects.

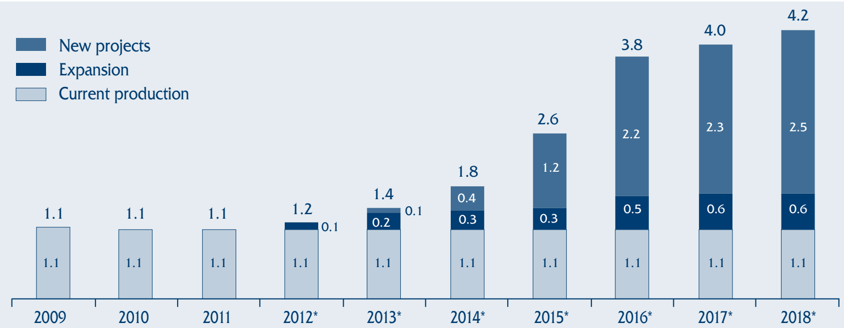
DISTRIBUTION OF INVESTMENT BY MINERAL



Source: MINEM.

Given that the relative importance of copper projects would increase in the coming years, the share of copper would represent more than one third in the GDP of the mining sector since the production of copper would increase from 1.1 million fine metric tons (MFT) in 2011 to 4.2 million FMT in 2018. The new projects that would be the main source of this growth of mining production include Antapaccay, Toromocho, Las Bambas, Constancia, La Granja, Galeno, Cañariaco, Haquira, Quellaveco, and Michiquillay, which together represent a total investment of US$ 21 billion.

COPPER PRODUCTION: 2009 - 2018
(Millions of fine metric tons)



* Forecast.

On the other hand, the investment in the expansion of current copper operations would amount to US$ 6 billion, which includes the capital investment of Antamina, Southern in Cuajone and Toquepala, and Cerro Verde.

Iron would be the second product to increase its participation in the sector due to the onset of operations of Shougang expansion and to the implementation of Pampa del Pongo and Hierro Apurimac projects.

III. Balance of Payments

41. In Q1-2012 the current account deficit in the balance of payments was US$ 982 million, a figure equivalent to 2.1 percent of GDP. This deficit, which is lower than the one recorded in Q1-2011 (3.0 percent of GDP), reflects the higher surplus registered in the trade balance due to the growth of exports as a result of the greater volume of exports of both traditional and non-traditional products.

42. The central forecast scenario for the current account in 2012 considers a lower level of commodity prices, especially in the case of minerals, as well as a lower volume of exports of fishmeal and non-traditional products, mainly fisheries and textiles. Because of this, the projected deficit in the current account has been revised up from 1.5 percent of GDP (Inflation Report of March) to 2.7 percent of GDP.

    In 2013 the deficit in the current account is expected to be higher than estimated in our previous report (2.8 percent of GDP instead of 1.8 percent of GDP) due to the lower value of mining exports as a result of the decline expected in the prices of copper, gold, and zinc in this period. The latter would be offset by lower imports as a result of the lower prices of the main food imports. A current account deficit of 2.9 percent of GDP is foreseen for 2014.

Graph 51
CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS: 2005-2014
(% of GDP)

* Forecast.

Table 16
BALANCE OF PAYMENTS
(Millions of US$)

	2011		2012*			2013*		2014*
	Q1	Year	Q1	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
I. CURRENT ACCOUNT BALANCE	**-1,235**	**-3,341**	**-982**	**-2,955**	**-5,341**	**-3,935**	**-5,970**	**-6,905**
% of GDP	*-3.0*	*-1.9*	*-2.1*	*-1.5*	*-2.7*	*-1.8*	*-2.8*	*-2.9*
1. Trade Balance	1,906	9,302	2,115	9,065	6,740	9,968	6,676	6,971
a. Exports	10,106	46,268	11,680	48,660	45,750	53,425	49,255	54,879
b. Imports	-8,200	-36,967	-9,564	-39,595	-39,010	-43,456	-42,578	-47,908
2. Services	-532	-2,132	-562	-2,409	-2,373	-2,722	-2,744	-3,025
3. Investment income	-3,372	-13,710	-3,331	-13,028	-13,069	-14,825	-13,446	-14,458
4. Current transfers	762	3,200	796	3,416	3,362	3,643	3,544	3,607
Of which: Remittances	634	2,697	669	2,903	2,842	3,129	2,997	3,033
II. FINANCIAL ACCOUNT	**2,944**	**8,065**	**7,653**	**9,955**	**16,040**	**7,935**	**9,970**	**9,905**
Of which:								
1. Private Sector (long and short term)	2,449	8,313	4,907	7,541	13,091	7,749	9,817	9,750
2. Public Sector	211	848	1,705	2,549	2,046	404	148	147
III. BALANCE OF PAYMENTS (=I+II)	**1,709**	**4,724**	**6,671**	**7,000**	**10,700**	**4,000**	**4,000**	**3,000**
Memo:								
Gross long-term external private financing								
Millions US$	3,334	12,005	5,070	9,837	14,247	11,050	11,565	12,055
% of GDP	8.1%	6.8%	10.9%	4.9%	7.2%	5.1%	5.4%	5.1%
Balance of NIRs								
Millions US$	46,127	48,816	55,789	55,816	59,816	59,816	63,816	66,816
% of GDP	28.9%	27.6%	30.6%	28.0%	30.1%	27.7%	29.6%	28.5%

IR: Inflation Report.
The figures for March IR include the approach used in the registration of debt securities in domestic and foreign markets.
* Forecast.

43. The current account of the balance of payments has been corrected down in the forecast horizon in a context of lower terms of trade. Moreover, from the point of view of macroeconomic gaps, the higher fixed gross investment in both the private and the public sectors would imply a higher requirement of external saving even though domestic saving has been showing a rising trend between 2012 and 2014.

Table 17
SAVING INVESTMENT GAP
(% of nominal GDP)

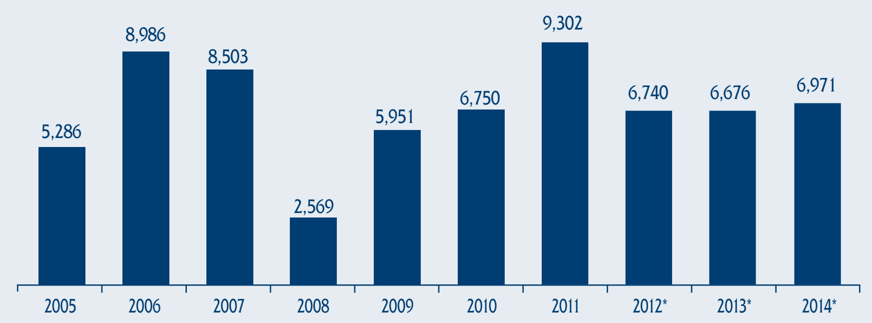
	2011		2012*			2013*		2014*
	Q1	Year	Q1	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
TOTAL INVESTMENT	**26.5**	**25.5**	**26.7**	**25.5**	**25.9**	**26.0**	**26.6**	**27.2**
Gross fixed investment	25.5	24.1	28.0	25.7	26.1	26.2	26.8	27.6
Inventories change	1.0	1.4	-1.3	-0.2	-0.1	-0.2	-0.2	-0.4
TOTAL SAVINGS	**26.5**	**25.5**	**26.7**	**25.5**	**25.9**	**26.0**	**26.6**	**27.2**
External savings	3.0	1.9	2.1	1.5	2.7	1.8	2.8	2.9
Domestic savings	23.5	23.6	24.6	24.0	23.2	24.2	23.9	24.2

IR: Inflation Report.
* Forecast.

44. Considering the greater decline foreseen today in terms of trade for 2012, the projected surplus in the **trade balance** has been revised downwards from US$ 9.1 billion (Inflation Report of March) to US$ 6.7 billion.

The trade surplus in 2013 would amount to US$ 6.7 billion (vs. US$ 10.0 billion estimated in our previous report) due to the downward revision of export prices for this period, while the trade surplus in 2014 would rise to US$ 7.0 billion due to the higher volume of exports foreseen, especially in the case of mining exports due to the onset of operations of some copper mining projects.

Graph 52
TRADE BALANCE: 2005-2014
(Millions of US$)



* Forecast.

Table 18
TRADE BALANCE
(Millions of US$)

	2011		2012*			2013*		2014*
	Q1	Year	Q1	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
EXPORTS	**10,106**	**46,268**	**11,680**	**48,660**	**45,750**	**53,425**	**49,255**	**54,879**
Of which:								
Traditional products	7,774	35,837	8,994	37,105	34,658	40,400	36,759	41,049
Non-traditional products	2,253	10,130	2,596	11,212	10,748	12,659	12,124	13,442
IMPORTS	**8,200**	**36,967**	**9,564**	**39,595**	**39,010**	**43,456**	**42,578**	**47,908**
Of which:								
Consumer goods	1,426	6,692	1,846	7,290	7,569	8,187	8,461	9,676
Inputs	4,024	18,255	4,536	19,428	18,586	20,516	19,405	21,350
Capital goods	2,654	11,665	3,109	12,472	12,522	14,328	14,358	16,505
TRADE BALANCE	**1,906**	**9,302**	**2,115**	**9,065**	**6,740**	**9,968**	**6,676**	**6,971**

IR: Inflation Report.
* Forecast.

45. The forecast on the value of **exports** in 2012 has been revised down to around US$ 46 billion, which represents a decline of 1.1 percent compared to 2011. This downward correction of the forecast considered in our previous report stems from a price effect due to a higher-than-expected decline in commodity prices than foreseen in our March report.

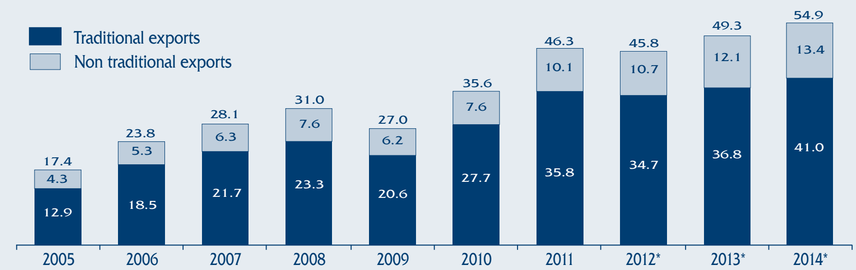
In terms of volume, exports would grow 5.4 percent in 2012 –versus 7.3 percent estimated in our previous Report– due to the lower exports of gold made by trading firms and to lower exports of non-traditional products, especially textiles. This would be partially offset by the increase of copper exports associated with the expansion of operations at Antamina carried out in Q1.

Table 19
TRADE BALANCE
(% change)

	2011		2012*			2013*		2014*
	Q1	Year	Q1	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
1. Value:								
Exports	27.5	30.1	15.6	5.2	-1.1	9.8	7.7	11.4
Traditional products	24.3	29.5	15.7	3.5	-3.3	8.9	6.1	11.7
Non-traditional products	40.3	32.6	15.2	10.7	6.1	12.9	12.8	10.9
Imports	29.4	28.3	16.6	7.1	5.5	9.8	9.1	12.5
2. Volume:								
Exports	2.3	8.5	15.5	7.3	5.4	8.9	8.9	9.8
Traditional products	-3.4	5.2	17.2	6.6	5.5	8.6	8.6	10.5
Non-traditional products	25.7	20.2	10.2	9.5	4.7	9.5	9.9	7.7
Imports	14.6	12.8	11.9	7.8	8.4	9.2	9.2	10.3
3. Price:								
Exports	24.4	20.0	0.2	-1.9	-6.2	0.9	-1.2	1.5
Traditional products	28.0	22.9	-1.1	-2.9	-9.4	0.2	-2.9	0.5
Non-traditional products	11.6	10.4	4.7	1.1	1.4	3.1	2.6	2.9
Imports	13.1	13.8	4.2	-0.5	-2.6	0.5	-0.1	2.0

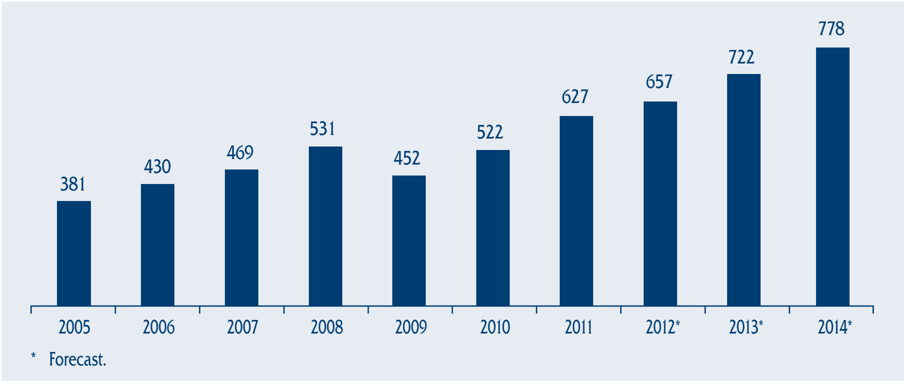
IR: Inflation Report.
* Forecast.

Graph 53
EXPORTS OF GOODS: 2005-2014
(Billions of US$)



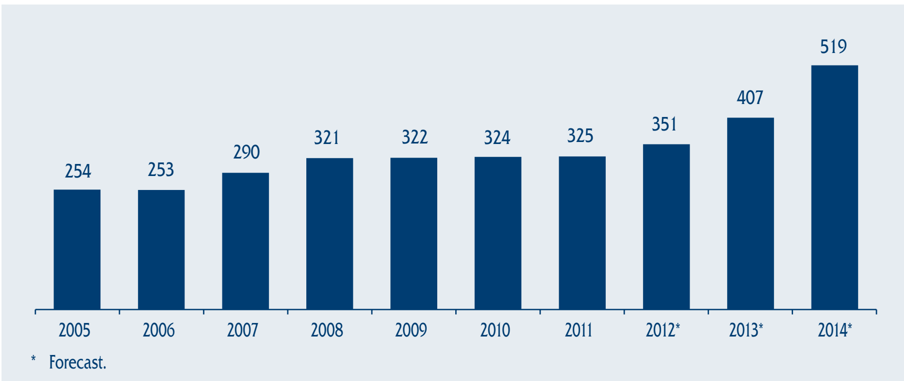
Memo: Total exports also includes other exports.
* Forecast.

Graph 54
NON TRADITIONAL EXPORTS VOLUME
(Index 1994=100)



In 2013 exports would amount to US$ 49 billion –a lower figure than the one considered in our Report of March– as a result of the lower prices foreseen for copper, gold, and zinc, while in 2014 they would amount to about US$ 55 billion due to higher exports of mining products, especially copper and molybdenum as a result of the onset of operations of Toromocho, Las Bambas, and the expansion of Southern's operations in Cuajone and Toquepala. Higher exports of iron ore are also foreseen due to the expansion of Shougang's mining projects in Marcona, some of which will start operating in 2013.

Graph 55
VOLUME OF COPPER EXPORTS
(Index 1994=100)

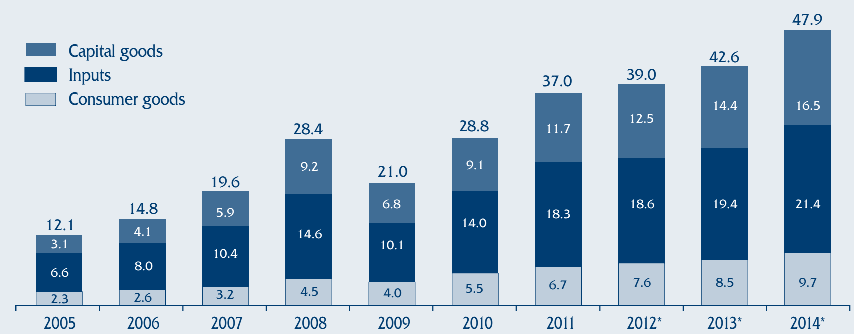


46. The forecast on **imports** in 2012 has also been revised down to US$ 39 billion, which represents an increase of 5.5 percent compared to 2011. The lower value of imports foreseen in this report reflects mainly the downward revision in the price of oil from a level of US$ 105 to US$ 98 per barrel.

Imports would grow 8.4 percent in terms of volume in 2012 –a higher rate than the one estimated in our previous report (7.8 percent)– due to a greater volume of imports of capital goods, offset in part by a lower volume of imports of industrial inputs and crude.

Imports in 2013 would amount to US$ 43 billion and to US$ 48 billion in 2014. In this forecast horizon, the volume of imports would continue to show high rates of growth (9.2 percent in 2013 and 10.3 percent in 2014), in line with the evolution of domestic demand.

Graph 56
IMPORTS OF GOODS: 2005 - 2014
(Billions of US$)



Memo: Total imports also includes other imports.
* Forecast.

Financial account

47. In Q1-2012 the **long term financial account of the private sector** amounted to US$ 5.21 billion, a figure US$ 1.94 billion higher than the one recorded in Q1-2011. This increase is associated with higher foreign direct investment (up by US$ 1.31 billion), as well as with higher placements of private sector bonds abroad (US$ 725 million), which offset the greater portfolio investment of AFPs and insurance companies in foreign assets.

The long term financial account of the private sector in 2012 would amount to US$ 12.6 billion, a higher amount than the one estimated in our Report of March (US$ 7.4 billion). This revision is explained by the foreign direct investment executed in Q1, the evolution of capital inflows derived from the issuance of bonds made by private resident companies abroad –a trend that would continue in the forecast horizon–, and by the higher liabilities of commercial banks with foreign organizations.

A positive flow of US$ 9.3 billion is projected for each year in 2013 and 2014 due to the higher requirements of external financing to develop private investment projects. This would be offset by local institutional investors' purchase of assets abroad.

Graph 57
PRIVATE SECTOR EXTERNAL FINANCING 1/
(Billions of US$)

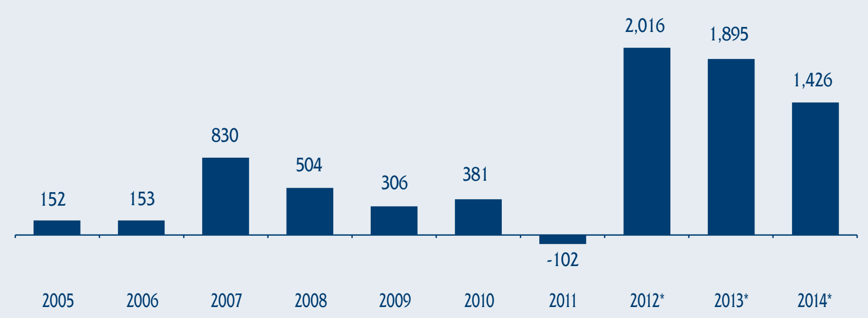
1/ Foreign direct investments plus long term disbursements.
* Forecast.

Table 20
PRIVATE SECTOR FINANCIAL ACCOUNT FLOWS
(Millions of US$)

	2011		2012*			2013*		2014*
	Q1	Year	Q1	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
1. ASSETS	**62**	**-1,298**	**-477**	**-2,361**	**-2,925**	**-2,672**	**-2,809**	**-2,677**
Direct investment abroad	34	-113	0	0	-300	0	0	0
Portfolio investment abroad	28	-1,185	-478	-2,361	-2,626	-2,672	-2,809	-2,677
2. LIABILITIES	**3,207**	**10,918**	**5,687**	**9,742**	**15,481**	**10,421**	**12,131**	**12,002**
Foreign direct investment in the country	2,299	8,233	3,610	6,731	10 006	8,150	8,242	8,739
Foreign portfolio investment in the country	30	-102	802	937	2,016	462	1,895	1,426
Capital participation	30	147	78	0	154	0	170	165
Other liabilities	0	-249	725	937	1,863	462	1,725	1,261
Long-term loans	879	2,787	1,274	2,074	3,459	1,808	1,995	1,837
Disbursements	1,002	3,886	1,460	3,106	4,541	2,900	3,323	3,316
Amortization	-124	-1,099	-186	-1,032	-1,170	-1,092	-1,328	-1,479
3. Total	**3,270**	**9,620**	**5,209**	**7,381**	**12,555**	**7,749**	**9,322**	**9,325**

IR: Inflation Report.
The figures for March IR includes the approach used in the registration of debt securities in domestic and foreign markets.
* Forecast.

Graph 58
PORTFOLIO INVESTMENT IN THE COUNTRY
(Millions of US$)



* Forecast

48. The **financial account of the public sector** showed a positive net flow of US$ 1.7 billion in Q1. This sum is higher than the US$ 211 million recorded in Q1-2011 due to the greater acquisition of T-bonds in the domestic market by non-residents after the government's placement of sovereign bonds in Q1-2012. With this, a positive flow of US$ 2.0 billion is projected for the end of the year, while flows of US$ 148 and US$ 147 million are estimated for 2013 and 2014, respectively, in the absence of new bond issuances.

49. In Q1-2012 the **short-term capital** account showed a negative net flow of US$ 302 million. This balance, which was due mainly to the higher deposits in foreign currency made by the non-financial sector abroad (US$ 977 million), was offset by the increase recorded in the banks' net external liabilities (US$ 730 million). A positive flow of US$ 536 million is projected for 2012, reflecting banks' higher obligations abroad.

50. Because of capital inflows and in order to prevent excessive volatility in the foreign exchange market, the Central Bank intervened in this market purchasing FC for a total of US$ 5.56 billion in Q1, as a result of which international reserves at May 2012 amounted to US$ 56.88 billion. This level of reserves, which provides the Peruvian economy with high capacity levels to respond to eventual real and financial shocks, represents 30.2 percent of GDP, backs up 93.9 percent of total liquidity in depository institutions, and is equivalent to 6 times the liabilities of the short-term external public debt and private debt. These levels of coverage of Peru's international reserves are among the highest in the region.

Table 21
NIR INDICATORS

	May.02	May.07	May.12
Net International Reserves (NIR, millions of US$)	9,163	21,271	56,882
BCRP International Position (Millions of US$)	3,173	15,067	40,533
NIR/GDP* (%)	16.9	22.2	30.2
NIR/Short term debt* (# of times)	1.6	2.9	6.0
NIR/Total Liquidity (%)	78.0	94.3	93.9

* Accumulated at the previous quarter.

IV. Public Finance

51. In **Q1-2012** the operations of the non-financial public sector (NFPS) recorded an economic surplus of 7.0 percent of GDP. This surplus, which is 1.0 percentage point higher than the one recorded in Q1-2011, is mainly associated with the increased registered in the current revenues of the general government (7.4 percent), as well as with the weak growth of non-financial expenditure (up only 3.1 percent) due, on the one hand, to the decline of current expenditure (-3.2 percent) and, on the other hand, to the strong increase of gross capital formation observed in the quarter (41.3 percent).

The accumulated operations of the NFPS in the last four quarters show a positive economic balance of 2.2 percent. This balance, which is higher than the one recorded at end 2011 (1.9 percent), is explained by the performance of current revenues, which increased from 21.0 to 21.1 percent of GDP in the last four quarters, and the non-financial expenditure of the general government, which dropped from 18.1 to 17.9 percent of GDP.

Table 22
NON FINANCIAL PUBLIC SECTOR
(% of GDP)

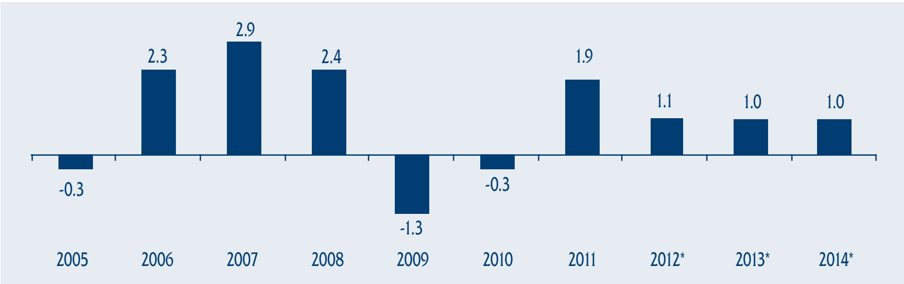
	2011		2012*			2013*		2014*
	Q1	Year	Q1	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
1. General government current revenues 1/	**22.0**	**21.0**	**22.4**	**21.2**	**21.1**	**21.2**	**21.2**	**21.2**
Real % change	*15.5*	*13.6*	*7.4*	*5.5*	*4.7*	*6.3*	*6.0*	*6.6*
2. General government non financial expenditure	**14.5**	**18.1**	**14.2**	**18.9**	**19.1**	**18.7**	**19.2**	**19.3**
Real % change	*-2.1*	*1.9*	*3.1*	*9.6*	*9.6*	*5.4*	*6.8*	*6.8*
Of which:								
a. Current	12.1	13.0	11.1	12.9	13.0	12.7	12.9	12.8
Real % change	*3.4*	*7.2*	*-3.2*	*3.6*	*3.6*	*4.5*	*4.9*	*5.7*
b. Gross capital formation	2.2	4.7	2.9	5.6	5.7	5.7	6.0	6.1
Real % change	*-17.7*	*-7.7*	*41.3*	*25.1*	*25.5*	*7.1*	*10.9*	*9.3*
3. Others	**0.2**	**0.1**	**0.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
4. Primary balance (1-2+3)	**7.6**	**3.0**	**8.4**	**2.3**	**2.1**	**2.4**	**2.0**	**1.9**
5. Interests	**1.6**	**1.2**	**1.4**	**1.1**	**1.1**	**1.1**	**1.0**	**1.0**
6. Overall Balance	**6.0**	**1.9**	**7.0**	**1.1**	**1.1**	**1.4**	**1.0**	**1.0**
Memo:								
1. Central government current revenues (billions of S/.)	25.0	102.1	28.0	111.2	111.0	120.6	120.3	131.0
2. Central government non-financial expenditure (billions of S/.)	16.5	87.8	17.8	99.4	100.0	106.8	109.3	119.2

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.
IR: Inflation Report.
* Forecast.

52. A fiscal surplus of 1.1 percent of GDP is foreseen for 2012 (a similar result was estimated in our Inflation Report of March). A counter-cyclical fiscal position is considered for 2013 and 2014, which would reflect in a negative fiscal impulse in those years, in line with current regulations. Law N° 29854 published on April 20 of 2012 establishes that the structural deficit of the NFPS shall decline by at least 0.2 percent of GDP as from year 2013.

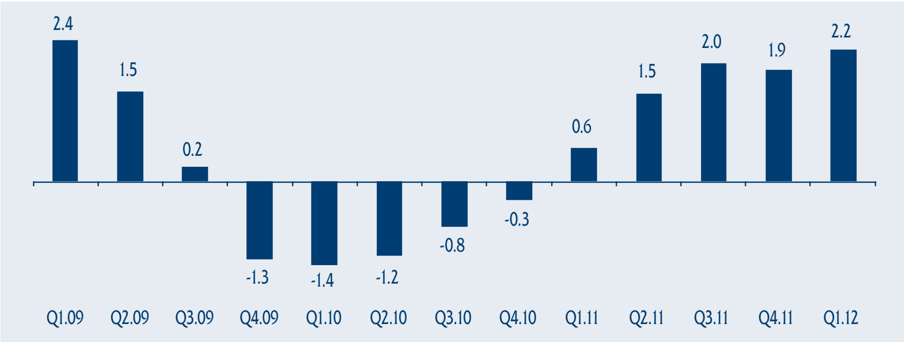
A surplus of 1.0 percent of GDP is forecast for the economic balance of each 2013 and 2014. The estimated balance for 2013 is lower than the one considered in our Report of March (1.4 percent of GDP) due mainly to the higher growth expected in the non-financial expenditure of the general government. As in previous reports, the forecasts included in this report are associated with a baseline scenario which may be affected by the evolution of the prices of our main export products, as well as by the demand for our exports.

Graph 59
ECONOMIC BALANCE OF THE NON FINANCIAL PUBLIC SECTOR: 2005-2014
(% of GDP)

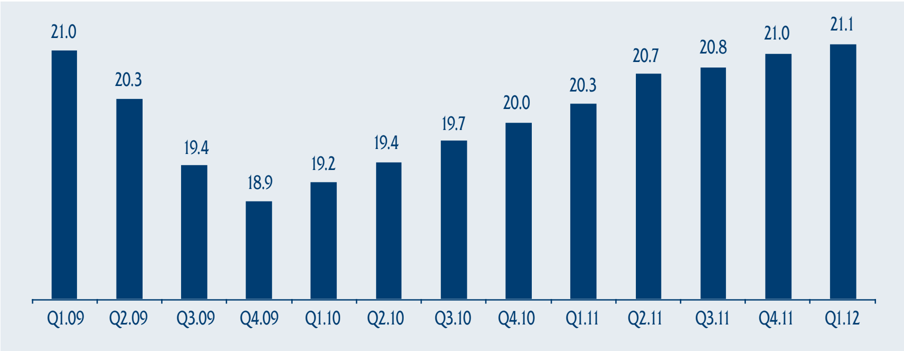


* Forecast.

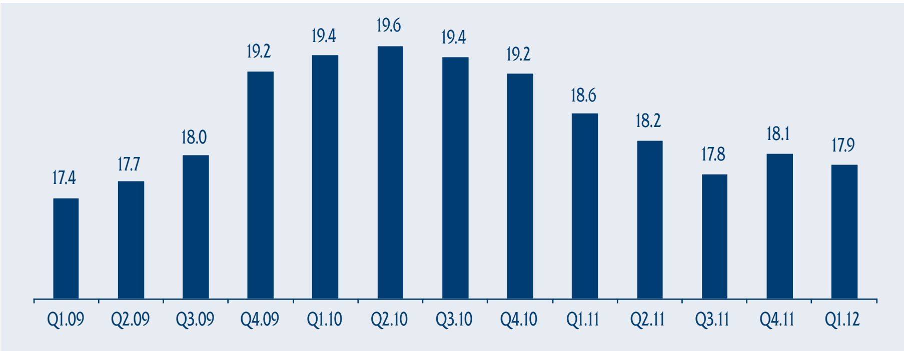
Graph 60
ECONOMIC BALANCE OF THE NON FINANCIAL PUBLIC SECTOR: Q1.09 - Q1.12
(% GDP - accumulated in the last 4 quarters)



Graph 61
GENERAL GOVERNMENT CURRENT REVENUES: Q1.09 - Q1.12
(% GDP - accumulated in the last 4 quarters)



Graph 62
GENERAL GOVERNMENT NON FINANCIAL EXPENDITURE: Q1.09 - Q1.12
(% GDP - accumulated in the last 4 quarters)

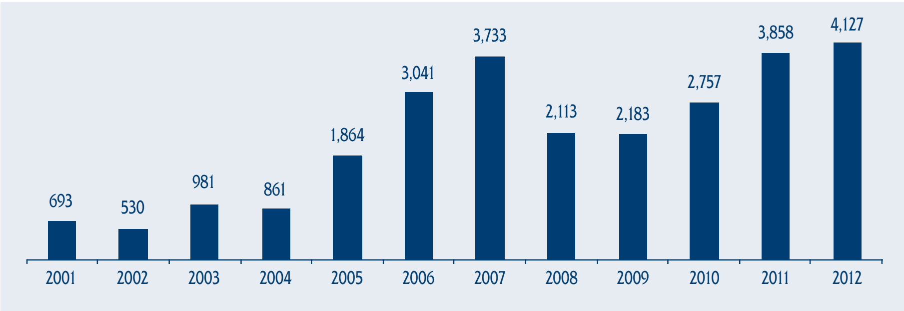


Fiscal revenues

53. In **Q1-2012 the current revenues of the general government** amounted to 22.4 percent of GDP. This balance is higher by 0.4 percentage points to the once recorded in Q1-2011 and represents a growth of 7.4 percent in real terms. The growth of the income tax (14 percent) was noteworthy among tax revenues, which grew 8 percent. The growth of the income tax was driven by higher payments on account of the income tax of both individuals and legal entities. The higher payments of individuals were associated with the growth of employment and with higher payments for profit distribution. On the other hand, the higher payments of legal entities were led by the sectors of financial intermediation, commerce, hydrocarbons, and manufacturing.

It is worth pointing out that revenues from the regularization of the income tax collected as of the month of April amounted to S/. 4.13 billion, which represents a record in terms of tax collection as this amount is S/. 269 million higher than the one registered in the same period in 2011. Of the total revenue obtained from the regularization of payments of the income tax, S/. 3.82 billion was payments of legal entities and S/. 307 million was payments of individuals.

Graph 63
REGULARIZATION OF THE INCOME TAX: JANUARY - APRIL
(Millions of nuevos soles)



54. On the other hand, revenues from the value added tax (VAT) increased 7 percent in real terms in Q1-2012. This increase is made up by 8 percent from the domestic VAT and 5 percent from the external VAT. Moreover, VAT revenues in this quarter are still reflecting the reduction of the VAT rate from 19 to 18 percent. However, this reduction has been offset by the positive evolution of domestic demand, the expansion of the tax base, and some extraordinary revenues obtained as a result of said expansion. The excise tax on consumption (ISC) continues to show negative growth rates (-4 percent), reflecting the reduction of the excise tax rates on fuels approved in June 2011. Furthermore, non-tax revenue showed an increase of 6 percent.

It should be pointed out that due to the amendment of the tax treatment for the mining sector in terms of royalties[2], the revenues obtained from the new mining royalty, the special levy on mining, and the special mining tax amounted to S/. 458 million in Q1-2012. With this amount and the S/. 265 million collected in Q4-2011 for the same taxes, the total amount of revenues from the operations of mining companies in Q4-2011 is S/. 723 million.

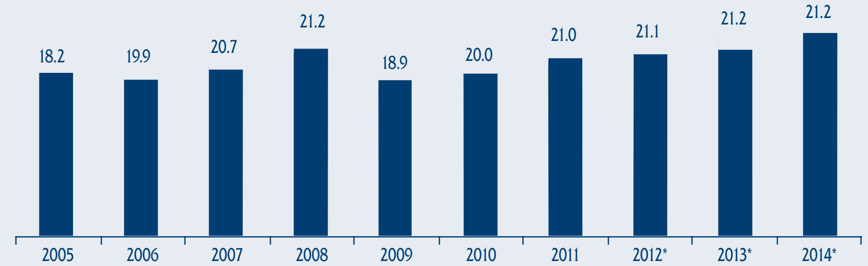
2 The law amending the Law on Mining Royalties (Law N° 29788), the law establishing the Special Mining Tax (Law N° 29789), and the law establishing the legal framework for the Special Levy on Mining (Law N° 29790) were published on September 28, 2011.

Table 23
GENERAL GOVERNMENT CURRENT REVENUES
(% of GDP)

	2011		2012*			2013*		2014*
	Q1	Year	Q1	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
TAX REVENUES	**16.8**	**15.9**	**17.2**	**15.9**	**16.0**	**15.9**	**16.0**	**16.1**
Income tax	7.6	6.9	8.2	6.8	7.0	6.7	6.9	6.9
Value added tax	8.5	8.3	8.6	8.5	8.4	8.5	8.5	8.5
Excise tax	1.1	1.0	1.0	0.9	0.9	0.9	0.9	0.9
Import duties	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other tax revenues	1.2	1.4	1.3	1.5	1.5	1.5	1.5	1.5
Tax returns	-1.9	-2.0	-2.2	-2.1	-2.1	-2.1	-2.1	-2.1
NON TAX REVENUES	**3.2**	**3.3**	**3.2**	**3.5**	**3.3**	**3.5**	**3.3**	**3.3**
CONTRIBUTIONS	**2.0**	**1.9**	**2.0**	**1.8**	**1.9**	**1.8**	**1.9**	**1.9**
TOTAL	**22.0**	**21.0**	**22.4**	**21.2**	**21.1**	**21.2**	**21.2**	**21.2**

(*) Forecast.

Graph 64
GENERAL GOVERNMENT CURRENT REVENUES: 2005 - 2014
(% of GDP)



* Forecast.

A real growth of the current revenues of the general government of 4.7 percent is estimated for **2012**, as a result of which the revenue-to-GDP ratio would be 21.1 percent, higher than the ratio of 21.0 percent registered in 2011, although slightly lower than the one estimated in the March report (21.2 percent).

Growth rates of 6.0 and 6.6 percent are expected for **2013** and **2014**, respectively, as the growth of revenues is expected to be close to the economy's potential growth rate. The share of current revenue in terms of GDP would be 21.2 percent in 2013 and 2014. The baseline scenario used to estimate these projections considers the tax structure observed today.

However, it should be pointed out that by Law N° 29884 (of June 9, 2012) the Executive has been granted powers to legislate in the fields of taxes, customs, and tax and customs offences for a period of 45 days in order to raise the existing levels of tax collection, although without creating new taxes or increasing the rates of existing ones. The measures derived from the amendments which could be introduced in the regulation and administration of the tax system could result in additional resources to those considered in this estimate.

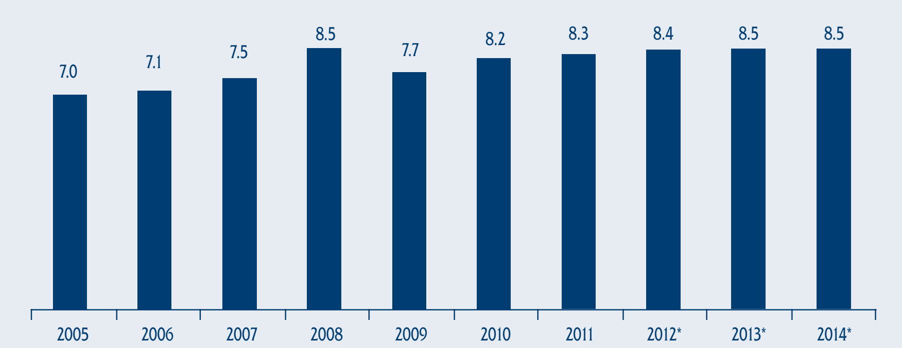
55. Revenues from the **income tax** would amount to 7.0 percentage points of GDP in 2012, which represents a slight growth in these revenues compared to 2011 (6.9 percent of GDP). This increase would be mainly explained by higher collection associated with the growth of formal employment, as well as with increased resources associated in part with the distribution of profits. Corporate income tax would maintain its share in GDP terms in 2012. A slight downward trend reflecting the evolution in the prices of minerals is estimated for 2013 and 2014 in terms of GDP.

Graph 65
INCOME TAX AND EXPORT PRICE INDEX: 2005-2014

* Forecast.

56. Revenues from the **value added tax (VAT),** the main tax revenue, would amount to 8.4 percent in terms of GDP in 2012, a slightly higher ratio than the one observed in 2011. It should be pointed out that this result has been obtained even though the effects of the reduction of the VAT rate from 19 to 18 percent are still reflected in Q1-2012. This tax rate would be raised by 0.1 percentage point in the coming years given the expected positive evolution of the economy and the broadening of the tax base resulting from extending the number of assets subject to the VAT system.

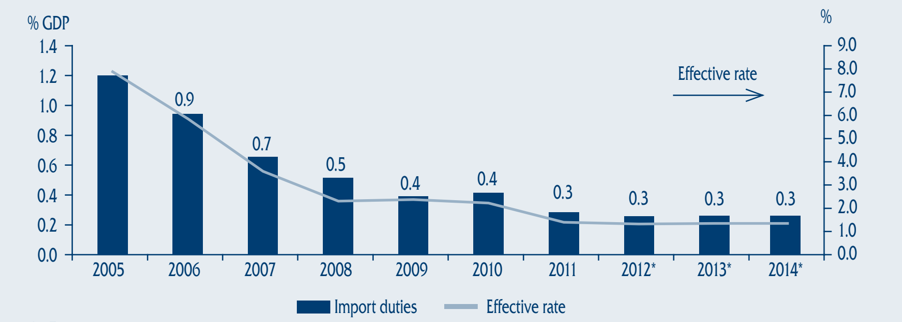
Graph 66
VALUE ADDED TAX: 2005 - 2014
(% of GDP)



* Forecast.

57. Revenues from **tariffs on imports** would continue to amount to 0.3 percent of GDP in 2012 and the next years. The effective tariff rate would remain at 1.3 percent given that no further tariff reduction measures are foreseen in the next years.

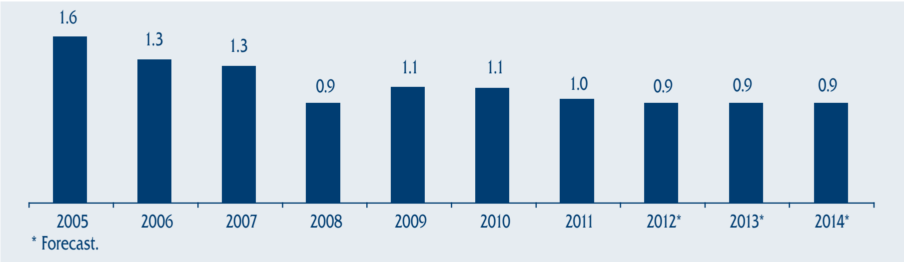
Graph 67
IMPORT DUTIES AND EFFECTIVE RATE: 2005-2014



* Forecast.

58. Revenue from the **excise tax** in 2012 would be 0.1 percentage point lower than in the previous year and would amount to 0.9 percent of GDP. This decline in the excise tax is explained by lower revenue from the excise tax on fuels due to the reduction decreed in this tax rate in June 2011. Revenues from this tax in 2013 and 2014 are estimated to remain at 0.9 percent of GDP since no changes in the structure of this tax are foreseen.

Graph 68
EXCISE TAX: 2005 - 2014
(% of GDP)



Evolution of public spending

59. In **Q1-2012** the non-financial expenditure of the general government was equivalent to 14.2 percent of GDP, which represents a decline of 0.3 percentage points from the level of expenditure recorded in Q1-2011 (14.5 percent). However, this variation implied an increase of 3.1 percent in the non-financial expenditure, broken down as a reduction of 3.2 percent in non-financial current expenditure and an increase of 34.2 percent in capital spending.

60. By levels of government, the national government reduced its levels of spending by 14.6 percent in Q1, while regional and local governments increased their spending by 17.0 and 87.1 percent, respectively, reflecting that the management-related problems faced by the new authorities that took office in the subnational governments in 2011 have been overcome. This effect was also reinforced by the incentives offered by the national government for the effective implementation of investment until March 2012. A total of S/. 400 million would be disbursed by the government as an incentive bonus for the effective implementation of investments and allocated to the maintenance of infrastructure or the development of investment projects. On the other hand, the national government has recorded a more significant decline in capital expenditure (-31.6 percent), explained mostly by the culmination of important investment projects in 2011.

Graph 69
GENERAL GOVERNMENT NON FINANCIAL EXPENDITURE: 2005-2014
(Real % change)

Table 24
GENERAL GOVERNMENT NON FINANCIAL EXPENDITURE
(Real % change)

	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2011 Year	2012 Q1
I. CURRENT EXPENDITURE	**3.4**	**7.8**	**8.1**	**8.6**	**7.2**	**-3.2**
National government	6.8	9.6	11.3	3.6	7.7	-11.8
Regional governments	-0.2	2.2	1.3	21.4	6.9	10.8
Local governments	-11.8	6.9	2.4	17.8	5.3	34.5
II. CAPITAL EXPENDITURE	**-22.3**	**-15.9**	**-21.5**	**5.5**	**-9.6**	**34.2**
National government	7.3	3.6	-6.5	-11.7	-3.7	-31.6
Regional governments	-10.4	-26.4	-28.2	15.1	-8.9	44.0
Local governments	-59.7	-38.7	-30.5	19.5	-16.4	212.8
III. TOTAL EXPENDITURE	**-2.1**	**0.3**	**-1.2**	**7.4**	**1.9**	**3.1**
National government	6.9	8.1	7.8	-0.5	5.2	-14.6
Regional governments	-2.3	-6.7	-8.5	19.0	1.8	17.0
Local governments	-34.7	-17.7	-17.3	18.9	-7.3	87.1

Table 25
GENERAL GOVERNMENT NON FINANCIAL EXPENDITURE
(Contribution to the real % change)

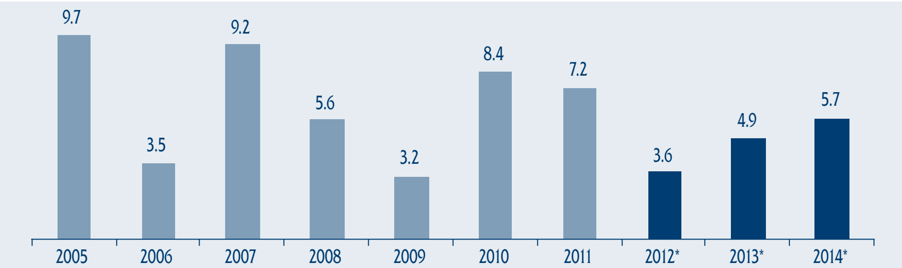
	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2011 Year	2012 Q1
I. CURRENT EXPENDITURE	**2.7**	**5.3**	**5.6**	**5.4**	**4.9**	**-2.6**
National government	3.8	4.4	5.2	1.5	3.6	-7.1
Regional governments	0.0	0.3	0.2	2.4	0.9	1.6
Local governments	-1.1	0.6	0.2	1.4	0.5	2.8
II. CAPITAL EXPENDITURE	**-4.7**	**-5.1**	**-6.8**	**2.1**	**-3.0**	**5.7**
National government	0.7	0.6	-0.7	-1.9	-0.5	-3.1
Regional governments	-0.4	-1.5	-1.9	1.1	-0.5	1.5
Local governments	-5.0	-4.1	-4.1	2.8	-2.0	7.3
III. TOTAL EXPENDITURE	**-2.1**	**0.3**	**-1.2**	**7.4**	**1.9**	**3.1**
National government	4.4	5.0	4.4	-0.3	3.1	-10.2
Regional governments	-0.4	-1.3	-1.7	3.5	0.3	3.2
Local governments	-6.0	-3.5	-3.9	4.3	-1.5	10.1

61. A real growth of 10 percent is estimated in the non-financial public spending in 2012. Capital expenditure would grow 25 percent, while current expenditure would grow only 4 percent. It should be pointed out that in order to assess compliance with the fiscal rule in 2012, Law N° 29854 (dated April 20, 2012) has established that expenditure in the maintenance of infrastructure, the expenditure of social programs in goods and services in the frame of result-oriented budgets,

and expenditure in law enforcement and security equipment are not included in consumer spending.

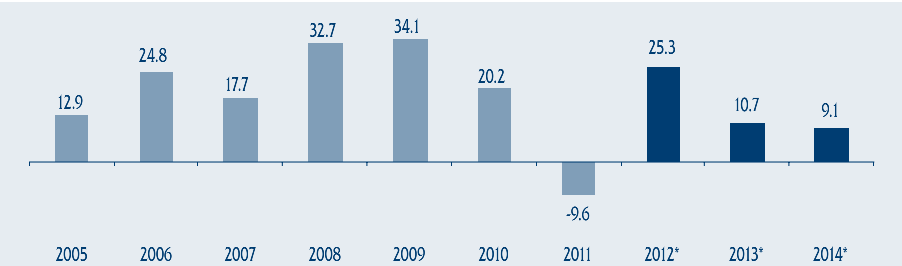
The non-financial expenditure of the general government is projected to grow 6.8 percent in both 2013 and 2014, showing a higher growth in capital spending than in current expenditure.

Graph 70
GENERAL GOVERNMENT CURRENT EXPENDITURE: 2005-2014
(Real % change)



* Forecast.

Graph 71
GENERAL GOVERNMENT CAPITAL EXPENDITURE: 2005-2014
(Real % change)

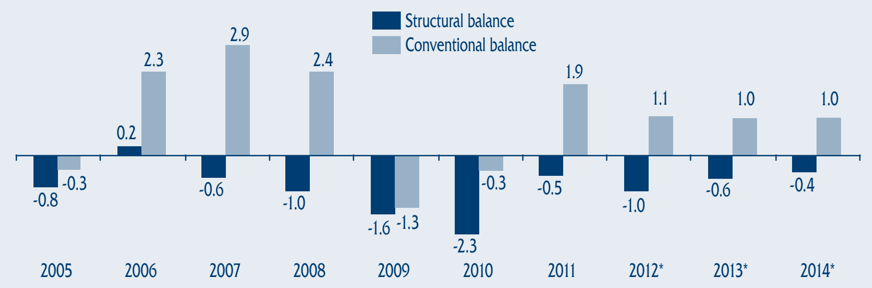


* Forecast.

Structural economic balance and fiscal impulse

62. The **structural economic balance**, indicator that shows the evolution of fiscal policy decisions because it deducts the effects of the economic cycle and the price effects of the major mineral exports from the conventional economic balance, would show a negative rate of 1.0 percent of GDP in 2012. Law N° 29854 has established that as from 2013 the economic balance of the NFPS measured in structural terms must follow a gradual path towards fiscal balance of at least 0.2 percent of GDP per year. In accordance with this, the structural deficit is projected to decline to 0.6 and 0.4 percent in 2013 and 2014, respectively.

Graph 72
CONVENTIONAL AND STRUCTURAL BALANCE OF THE NON FINANCIAL PUBLIC SECTOR: 2005-2014
(% of GDP)

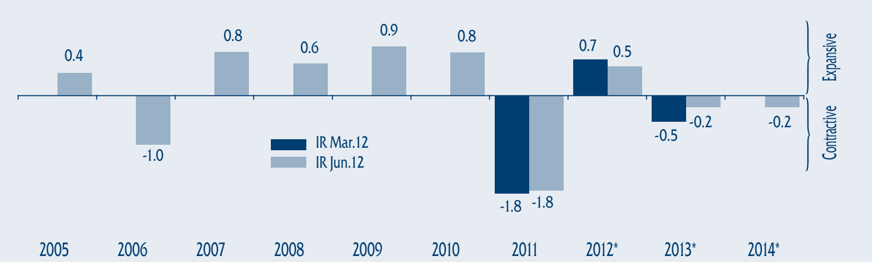


* Forecast.

Memo: The structural balance includes adjustments in the output gap and the terms of trade considering a period of 15 years for the reference price.

63. The change in the structural balance determines the **fiscal impulse**. Through this indicator we can distinguish the effect of fiscal policy on domestic demand isolating the effects of the economic cycle. Fiscal policy would play an expansionary role in 2012 given that a faster pace would be seen in the growth of public spending, especially in investment expenditure, while the opposite situation would be seen in 2013 and 2014, when fiscal policy would have a contractionary position, given the growth in public expenditure projected for those years.

Graph 73
FISCAL IMPULSE: 2005-2014
(% of GDP)



* Forecast.

Memo: The fiscal impulse is the charge in the structural balance, which is an indicator of how the fiscal position affects the economic cycle.

Financial requirements

64. In 2012 the **financial requirements of the public sector** would be negative by US$ 337 million. In other words, the fiscal surplus would be higher than the payment of amortizations in the year. Negative financial requirements of US$ 206 million and US $530 million are also projected for 2013 and 2014, respectively, in line with the positive fiscal balances foreseen for these years.

Table 26
FINANCIAL REQUIREMENTS OF THE NON-FINANCIAL PUBLIC SECTOR AND ITS FINANCING 1/
(Millions of US$)

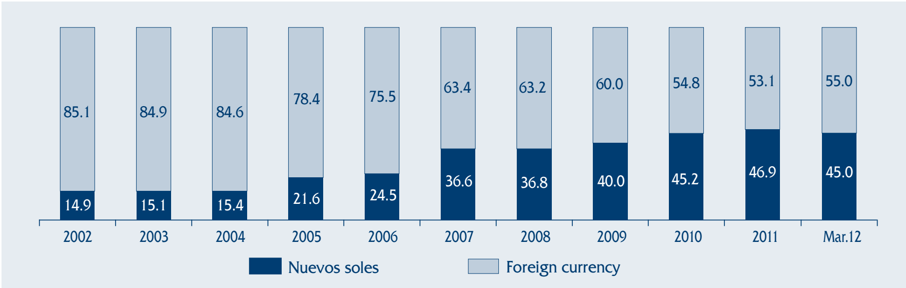
	2011		2012*			2013*		2014*
	1Q	Year	1Q	IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
I. Uses	**-2,189**	**-1,851**	**-2,644**	**-534**	**-337**	**-1,088**	**-206**	**-530**
1. Amortization	280	1,365	624	1,634	1,634	1,852	1,854	1,738
a. External debt	141	831	459	1,164	1,164	1,227	1,184	1,226
b. Domestic debt	138	535	165	470	470	625	670	512
Of which: Recognition bonds	40	193	42	242	208	210	171	170
2. Overall balance (negative sign indicates surplus)	-2,468	-3,217	-3,269	-2,168	-1,972	-2,940	-2,060	-2,268
II. Sources	**-2,189**	**-1,851**	**-2,644**	**-534**	**-337**	**-1,088**	**-206**	**-530**
1. External	302	1,108	76	1,228	804	1,128	1,149	897
2. Bonds 2/	43	436	1,101	1,598	1,406	585	379	379
3. Internal 3/	-2,534	-3,395	-3,820	-3,361	-2,548	-2,801	-1,734	-1,806
Memo:								
Balance of gross public debt								
Billions of S/.	100.2	103.3	101.4	102.4	101.9	104.2	103.4	103.6
% of GDP	22.4	21.2	20.4	19.9	19.4	18.3	18.2	16.8
Balance of gross public debt 4/								
Billions of S/.	43.5	39.3	30.3	31.6	29.0	23.2	24.0	18.1
% of GDP	9.7	8.1	6.1	6.1	5.5	4.1	4.2	2.9

IR: Inflation Report.
* Forecast.
1/ The effect of exchanging treasury bonds for longer-maturity bonds, as well as the effect of placements made for the prepayment of both internal and external operations has been isolated in the case of amortization and disbursements.
2/ Includes domestic and external bonds.
3/ A positive sign indicates a withdrawal or overdraft and a negative sign indicates higher deposits.
4/ Defined as the difference between gross public debt and NFPS deposits.
Source: BCRP and MEF.

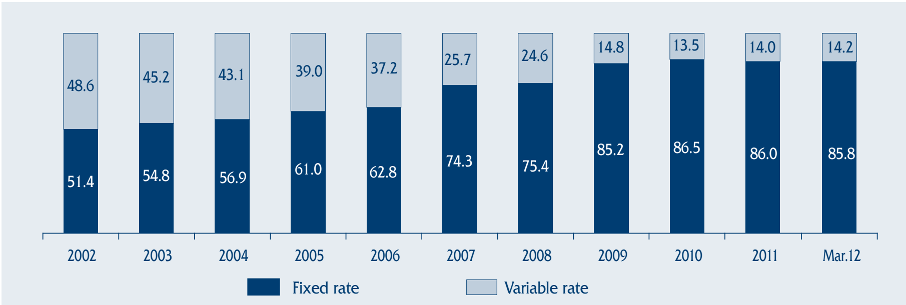
The MEF placed bonds abroad for an equivalent of US$ 1.10 billion in January 2012, of which US$ 500 million was a reopening of the 2050 Global Bond and US$ 600 million a reopening of the 2031 Sovereign Bond. No other bonds have been issued in the following months and only the issuance of sovereign bonds is projected for the next years, reflecting that priority is given to operations that enable to increase the share of debt in local currency in the balance of the public debt.

65. As regards the composition of the debt by currencies and interest rates, the Government has achieved to gradually reduce market risks given that the share of debt in foreign currency at March 2012 was 55.0 percent, while the share of debt contracted at a fixed rate stands 85.8 percent.

Graph 74
PUBLIC DEBT BALANCE BY CURRENCY
(%)

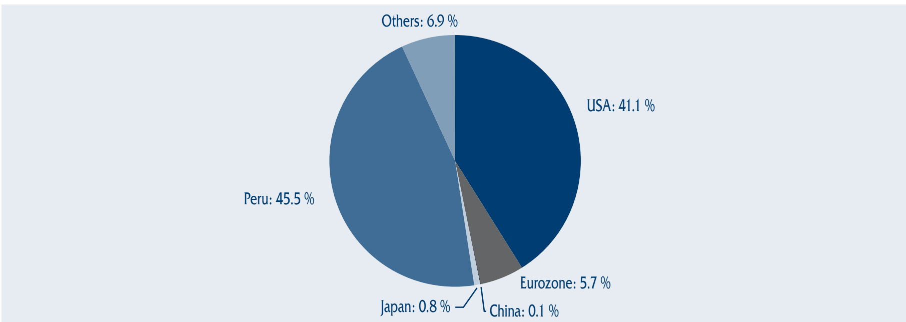


Graph 75
PUBLIC DEBT BALANCE BY RATE TYPE
(%)



66. Moreover, non-residents' holdings of sovereign bonds has increased in recent years. At December 2009 the ratio of total of sovereign bonds purchased abroad relative to the total of bonds issued was about 20 percent, while at April 30, 2012, this ratio was over 54 percent (US$ 16.52 billion). In terms of the origin of bondholders, it is worth pointing out that Americans rank first, with a share of 41.1 percent of the bonds held by non-residents, followed by the members of the Eurozone with a share of 5.7 percent.

Graph 76
HOLDINGS OF SOVEREIGN BONDS BY COUNTRY OF ORIGIN OF THE HOLDER



Moreover, by category of sovereign bonds, non-residents holdings are concentrated in bonds maturing in 2020 (25 percent of the total). Foreign investors also show a preference for Global Depositary Notes (GDNs), which are debt instruments created by a depositary bank of Peruvian sovereign bonds abroad. The characteristic of this financial instrument is that those who acquire GDNs in the international market can repay the service of this debt in dollars, even though the underlying asset (the sovereign bonds) that backs up the issuance of GDNs is denominated in Peruvian nuevos soles (PEN) and is payable locally. Furthermore, 66 percent of the total public debt held by non-residents is GDNs (US$ 10.90 billion), while the remaining 34 percent is sovereign bonds (US$ 5.62 billion).

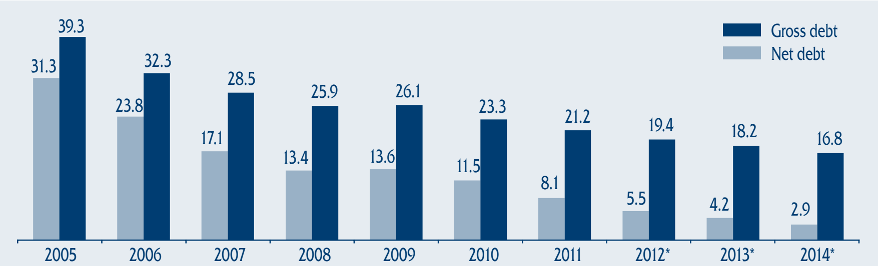
Table 27
PERCENTAGE DISTRIBUTION OF NON RESIDENTS HOLDINGS COMPARED TO THE TOTAL BONDS HOLDINGS OF NON RESIDENTS

Bond	Non residents balance	Sovereign bonds		GDN	
	Mill. S/.	%	Mill. S/.	%	Mill. S/.
2013	485	60.0	290	40.1	194
2015	1,296	42.8	555	57.2	742
2017	670	43.8	293	56.3	377
2020	7,014	37.0	2,594	63.0	4,421
2026	2,210	39.5	872	60.5	1,338
2031	2,723	19.4	527	80.6	2,196
2037	1,497	30.3	454	69.7	1,043
2042	620	5.4	34	94.6	587
TOTAL	**16,516**	**34.0**	**5,619**	**66.0**	**10,897**

Source: MEF.

67. Debt indicators continued to show positive results. The average life of the public debt reached 13.17 years at Q1-2012. The gross and the net debt continued to decline in 2011 and are expected to follow the trend in the next three years. Based on both the increase in economic activity and the increase in public sector deposits, it is estimated that the gross debt would reach 19.4 percent of GDP by end 2012, while this ratio in 2014 would be 16.8 percent of GDP. Replicating the same trend, the net debt would decline to 2.9 percent of GDP in 2014.

Graph 77
PUBLIC DEBT: 2005-2014
(% of GDP)



* Forecast.

BOX 2
FISCAL POLICY IN THE EVENT OF A "SUPER CYCLE"

Several analysts have been developing the hypothesis that since the beginning of this century the global economy has been experiencing a phenomenon known as a "super cycle"[3], which can be defined as "...a period of historically high global growth, lasting a generation or more, driven by increasing trade, high rates of investment, urbanization and technological innovation, characterized by the emergence of large, new economies, first seen in high catch-up growth rates across the emerging world"[4].

According to this hypothesis, the world economy has experienced two "super cycles" before: the first was the result of the technological development brought about by the second Industrial Revolution (1870) and lasted until World War I (1913), while the second "super cycle" started at the end of World War II (1946) and lasted until the first Oil Crisis (1973). The second super cycle would be explained by the spending used for reconstruction in the post war period, new investment spending, and the emergence of both a sizeable middle class in the Western world and exporting countries in Asia, as well as by cultural changes and the effects of the demographic event known as the baby boom[5] in the United States.

The rapid growth experienced by some of the most populated economies in the world, such as East Asian countries, is one of the main features that would be explaining a new super cycle. This cycle would generate the following:

1. The incorporation of a larger proportion of the world population to the global economy, which implies the emergence of a new middle class which would promote an even more dynamic growth in emerging economies.
2. More skilled labor that will foster technological improvements through increased innovations and creativity, generating productivity gains.
3. Trade openness in these economies will allow other emerging and developing economies to benefit from the rapid growth of the former.
4. High saving rates that allow higher rates of investment, which in turn improve productivity and increase the rate of economic growth.
5. A greater global demand for raw materials that will generate an excess of demand for these resources. The solution to this situation will be a combination of an increase in the price of these resources, a higher production of raw materials (which requires investment in new projects), and an improvement in the use of these resources through technological innovation.

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3 See, por example, Cuddington, J and Jerrett D. "Super Cycles in Real Metal Prices? IMF Staff Papers, Vol. 55 N° 4, 2008.

4 Standard Chartered bank "The Super Cycle Report". November 2010.

5 The chronology of the super cycles depends on the method used. Cudington and Jarrett used the Baxter and King filter and find three cycles for metals prices: the first began in the 1880s, the second started after World War II, and the third around 1990.

Peru, a small open economy that exports mainly raw materials, has been affected by this long-term dynamics in global markets throughout its history. After independence, Peru went through a period of low economic activity associated with the effects of the independence war on property and production incentives[6]. Commercial activity and the production of silver –the main product exported at the end of the 18th century– declined. By 1850 the economy experienced a new boom associated with a new exportable product: guano, which began to be marketed around 1840. Economic policy responded to this boom in revenue by reducing or eliminating other sources of fiscal revenues, which increased public finances' dependence on the resources obtained through the exportable product and also increased their vulnerability. The exhaustion of the fiscal resources obtained from guano and nitrate after the War with Chile (1879) left the State virtually broke and forced it to search for permanent sources of fiscal funding.

After the war, the economy went through a period of recovery of demand, with fiscal revenues concentrating in (specific) tariffs[7]. In this context, the country faced the increase in international prices observed during the first decade of the 20th century until the post-era of World War I. The main export products were cotton, sugar, and, to a lesser extent, rubber. This export boom provided revenues to the State, which taxed exporting activities.

The 1929 crisis brought about a significant drop in export prices and a reversal in capital flows to the region, which constrained the State's capability to honor its external debt. As a result of this, the country stopped repaying its debt from 1931 and did not fully regularize or meet its external obligations until after World War II. This was another episode in which temporary revenue was misunderstood as a permanent income and used as collateral to finance infrastructure projects and public services, but which resulted in a fiscal crisis and balance of payments crisis when the temporary rise of international prices reversed.

This experience illustrates that a scenario of high global growth coupled by high prices of raw materials poses new challenges to countries that can potentially benefit from a "super cycle" and that appropriate economic policies are required.

Fiscal policy-makers face the challenge of properly assigning a high flow of fiscal revenue which is both volatile and transient due to the significant fluctuations that may be observed in the prices of exported commodities as well as due to their non-renewable nature.

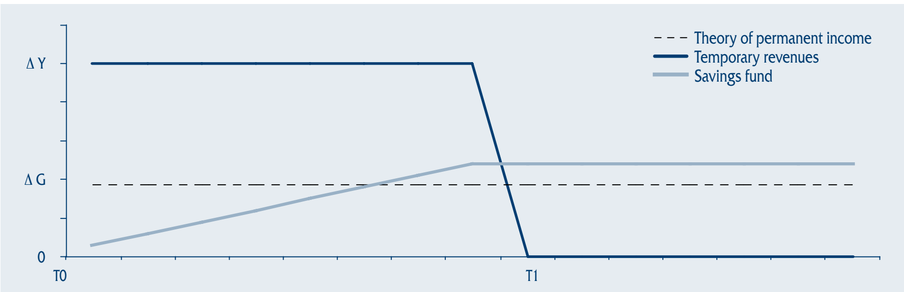
6 Contreras, C. (2010) "El Legado Económico de la Independencia en el Perú". Documento de Trabajo 301. PUCP. October 2010.

7 Thorp and Bertram "Industrialización en una Economía Abierta: El caso del Perú 1890-1940". Documento de trabajo 23. PUCP. December 1974.

In this regard, the traditional theoretical approach, based on the theory of permanent income, suggests that the government should save most extraordinary revenues to achieve in this way a permanent and sustainable increase in the level of expenditure.

The most conservative option within this approach is based on the practice of some countries of Northern Europe and consists of a scheme in which the government saves completely all extraordinary income and uses only the financial return of savings to finance increases in government expenditure. The most emblematic case of this type of public funds is Norway's Savings Fund.

TEMPORARY PUBLIC REVENUES AND HIGHER PUBLIC EXPENDITURE



The graph shows paths of higher public spending funded with revenue of transient nature. The assumption is that transient income is produced from period T_0 to period T_1. According to the theory of permanent income, the government can spend a fraction of those resources but must save the remainder to maintain the increase in public expenditure constant over time. The option of generating a savings fund and use only the interests of these resources makes it possible to finance a greater increase of public expenditure in the long term, even though this increase in the short term is lower than the one proposed by the theory of permanent income.

If the occurrence of a super cycle becomes evident, fiscal policy should be oriented to generating the savings required in order to increase the level of public spending in a sustained and permanent manner, which would in turn contribute to improve the quality of public spending and the priority given to specific areas. After all, the scheme of transferring temporary resources to finance higher spending in the future is an approach that promotes inter-generational equity (in order that the future generations of citizens may also benefit from non-renewable resources).

These savings may be used in the next decades to meet greater spending needs, especially those associated with mitigating the impact of climatic change (less hydroelectric power generation, improve the management of water resources, etc.) and with financing pensions (the minimum pension).

BOX 3
MODIFICATIONS TO FISCAL INSTITUTIONALITY

Among other measures, recently approved Law 29854 creates a commission charged with the revision of the institutionality of fiscal policy to improve the management of public finances by modifying the legal framework of fiscal policy and also establishes the treasury's commitment to reduce the structural deficit in at least 0.2 percent each year as from 2013.

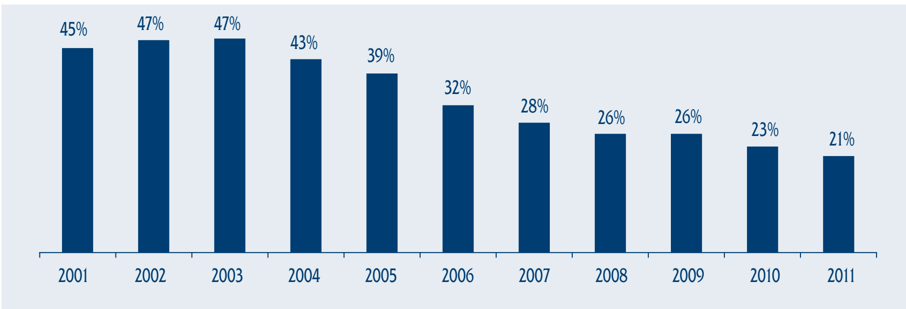
Despite the favorable performance of public finances, it is necessary to review the fiscal rules and to incorporate mechanisms that will allow a timely countercyclical management in fiscal policy.

The Fiscal Prudence and Transparency Act –Law 27245 of December 1999– establishes limits on the deficit of the non-financial public sector deficit (1 percent of GDP)[8] as well as limits on the growth rate of spending, but establishes escape clauses to allow a greater deficit in periods of crisis. The combined effect of these rules is that they facilitate a policy of saving in periods of boom and the implementation of discretionary counter-cyclical policies when conditions allow the use of the escape clauses.

In practice, the counter-cyclical content of the regulation has been reduced because the government has frequently used dispensations, which has generated spending increases in periods of expansion of economic activity.

Despite its limitations in terms of its design, this rule has fostered a continued reduction in the level of public debt as a percentage of GDP.

GROSS DEBT BALANCE
(% of GDP)



The fiscal deficit reduction observed in the period was accompanied by a lower structural deficit in 2000-2005. Fiscal policy was expansionary since 2006 –higher structural deficits were recorded–

8 Even though the Law established limits on the growth of government spending, these limits have not been complied with in practice, except in the last few years when they became more flexible and applied only to the current spending of the national government, excluding expenditure in maintenance.

despite the conventional surpluses that reflected the impact of better terms of trade on fiscal revenues.

ECONOMIC RESULT OF NON FINANCIAL PUBLIC SECTOR: 2000-2011
(% of GDP)

The deterioration of international economic conditions made it necessary to design an economic stimulus plan that reduced the structural balance in 2009 and 2010, after the implementation of which the recovery of fiscal space began in 2011.

This shows that it is important to review the fiscal framework to ensure a sufficiently countercyclical fiscal policy that favors macroeconomic stability in view of the different shocks to which the Peruvian economy is exposed, including:

a. **Terms of trade shocks**: an increase in the prices of raw materials leads to a substantial increase in tax revenues which end up funding an increase in public spending, intensifying the negative effects of the boom on macroeconomic stability. Conversely, if the government has not previously saved enough in the years of boom, a severe contraction in commodity prices can dramatically reduce tax revenues and force the government to make strong cuts in public spending (or force it to engage in debt in unfavorable situations).

b. **Shocks in the international interest rate**: a reduction in the international interest rate generates an interest rate spread that encourages the flow of capitals and generates pressures on aggregate demand. In such a context, fiscal policy must be contractionary to counter the expansion of aggregate demand and contribute in this way to macroeconomic stabilization.

Fiscal regulations could be improved through the implementation of a structural fiscal rule. Such a rule not only isolates temporary income from public spending decisions in the current period but is also a better rule than the one currently in force which establishes limits on the conventional fiscal balance because it:

a. **Eliminates the procyclical bias of fiscal policy**: By allowing savings in periods of boom and deficits in periods of slower growth, the fiscal stance ceases to be pro-cyclical and government spending becomes an element that balances aggregate demand fluctuations.

b. **Ensures fiscal solvency**: Establishing a target for the structural balance makes it easier for the government to follow a strategy of sustained reduction of the public debt, which reduces the vulnerability of public finances to market shocks and mitigates macroeconomic volatility.

c. **Favors a better-quality public spending**: If government spending grows at a steady rate, the State's capacity to plan and identify projects and services which have measurable effects on the quality of life of the population is greater. With a rule like the one currently in force, the level of spending is influenced by the economic cycle and by the international prices, which frequently forces the treasury to increase (or decrease) spending and hampers planning and the priority that should be given to the best social projects.

d. **Improves inter-generational equity**: With the structural rule, the surpluses generated by booms in the international prices can be saved, which allows that the benefits of non-renewable resources reach future generations.

e. **Mitigates appreciatory pressures**: A structural rule would allow the treasury to save the transient component of terms of trade, thereby reducing the impact of terms of trade shocks on the real exchange rate. This would mitigate the adverse impact that a boom in commodity prices has on the return in other tradable sectors.

A structural rule can be implemented in the form of a procedure to determine the level of non-financial expenditure in the budget of the general government based on a projection of income that deducts the transient components associated with the economic cycle and fluctuations in the terms of trade. A simplified version of such a rule may be expressed as:

$$G_t = \overline{T}_t - r_{t-1} B_{t-1} - RPIM^0_t$$

where:

G_t	=	Non-financial expenditure of the general government in period t.
r_{t-1}	=	Real interest debt on the public debt.
B_{t-1}	=	Balance of the public debt.
$\overline{T}_t$	=	Structural revenues.
$RPIM^0_t$	=	Target primary balance in period t.

Government spending in this rule is established according to the structural net income of the debt interests and of the target set as the structural balance. This target level may fluctuate according to the economic cycle, which allows the incorporation of a fiscal policy counter-cyclical response in the rule. This would be achieved, for example, if it is specified that the target primary balance must increase when the output gap is expected to increase.

V. Monetary Policy

68. Between March and June, the Board of the Central Bank decided to maintain the reference rate at 4.25 percent. This decision was made considering, on the one hand, the impact that lower terms of trade and expected lower global growth would have on future inflation in a context of greater uncertainty and deepening of the Eurozone crisis, and, on the other hand, that inflation is expected to continue converging towards the target range in the following months due to the reversal of supply shocks in a context of growth without demand pressures.

    The Board has also emphasized that the Central Bank keeps a close watch on inflation and its determinants to consider adjustments in monetary policy instruments.

Graph 78
BCRP REFERENCE INTEREST RATE
(%)

RECENT EVOLUTION OF THE POLICY INTEREST RATE:
April – June 2012

April: The Board of the Central Reserve Bank of Peru approved to maintain the monetary policy reference rate at 4.25 percent.

This decision is based, on the one hand, on the fact that inflation's deviation from the target has been mainly due to transitory supply factors and, on the other hand, on the fact that the economy's pace of growth is close to its potential rate of growth. Moreover, inflation expectations for this year are anchored within the target range. Future adjustments in the reference interest rate will depend on the evolution of inflation and its determinants.

May: The Board of the Central Reserve Bank of Peru approved to maintain the monetary policy reference rate at 4.25 percent.

This decision is based, on the one hand, on the fact that inflation's deviation from the target has been mainly due to transitory supply factors and, on the other hand, on the fact that the economy's pace of growth is close to its potential rate of growth. Moreover, inflation expectations for this year are anchored within the target range.

Since May, the BCRP has preventively raised the rates of reserve requirements in order to offset the pace of growth of liquidity in a context of acceleration of the dedollarization of deposits, firms' increased indebtedness in dollars, and low interest rates on operations in foreign currency as a result of high international liquidity levels. The Board oversees the forecasts of inflation and its determinants to consider additional adjustments in monetary policy tools.

June: The Board of the Central Reserve Bank of Peru approved to maintain the monetary policy reference rate at 4.25 percent.

This decision is based, on the one hand, on the fact that inflation's deviation from the target has been mainly due to transitory supply factors and, on the other hand, on the fact that the economy's pace of growth is close to its potential rate of growth. In addition, uncertainty in international financial markets has increased again, which is reflected in the drop of the international prices of commodities.

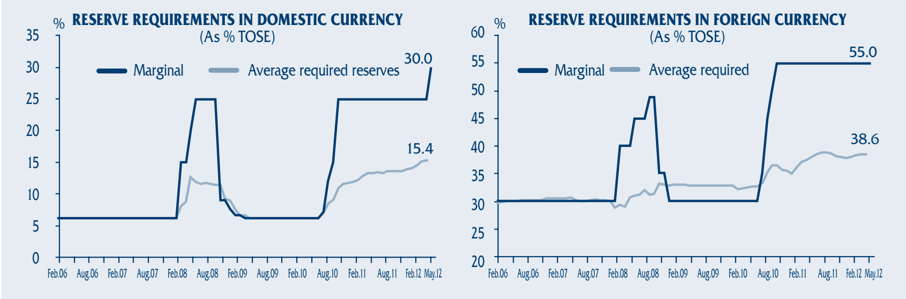
The Board oversees the forecasts of inflation and its determinants to consider additional adjustments in monetary policy tools.

69. Since May the Central Bank raised preventively the rates of reserve requirements in both dollars and nuevos soles. The aim of this measure is to reduce the pace of growth of domestic liquidity in a context of a faster rate of dedollarizacion of deposits, firms' greater indebtedness in dollars, and low interest rates in foreign currency due to high international liquidity.

    At the end of April the average rate of reserve requirements in nuevos soles was 15.4 percent and the rate of reserve requirements in dollars was 38.6 percent. These rates of reserve requirements have contributed to moderate the expansion of credit.

    As from May the mean rate of reserve requirements, both in soles and in dollars, was raised by 0.5 percentage points and the rate of marginal reserve requirements in domestic currency was raised from 25 to 30 percent. Moreover, new short-term external obligations with maturities of 3 years or less were also required to have reserves of 60 percent and a new special reserve of 20 percent was established for exempt long-term obligations and for the issuance of bonds, excluding covered mortgage bonds in national currency exceeding 2.5 times the effective equity of financial institutions.

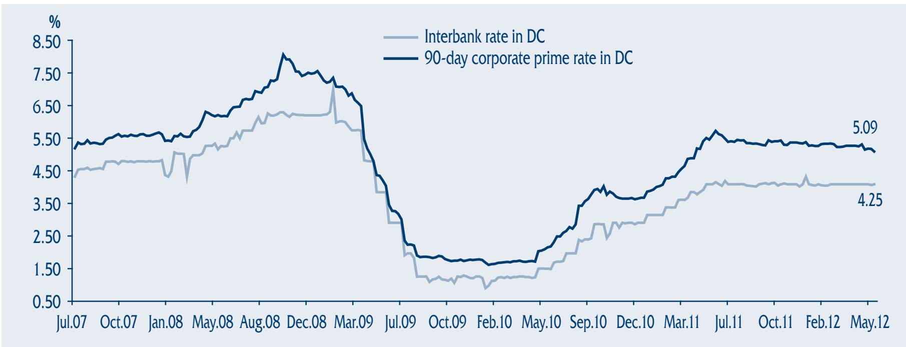
Graph 79



70. Between March and May 2012 monetary conditions in nuevos soles continued to be stable, in line with the evolution of the reference rate, while monetary conditions in dollars were less expansionary than in previous months due both to the impact of the increase in the rate of reserve requirements in dollars and to banks' increased demand for liquidity, associated with greater risk aversion as a result of the deepening of Europe's debt crisis. These factors were reflected in higher short-term interest rates on operations in dollars.

The 90-day corporate prime rate in nuevos soles remained close to 5.1 percent. Because of its lower premium for credit risk and because it is a short-term rate, this is the rate that maintains a greater relationship with the monetary policy rate.

Graph 80
90-DAY CORPORATE PRIME RATE VERSUS INTERBANK OVERNIGHT RATE IN DOMESTIC CURRENCY: JULY 2007 - MAY 2012



71. Financing conditions in the areas of small and medium businesses continued to improve, reflecting the evolution of the credit risk and competition conditions in the respective credit markets. The interest rate on credits to small businesses declined from 23.4 percent in March to 22.9 percent in May, while the interest rate on credits to medium-sized businesses fell from 11.2 to 11.0 percent in the same period. Moreover, the interest rate for mortgage loans fell from 9.4 to 9.3 percent. Slight increases were observed only in the case of interest rates on loans for large companies.

Table 28
INTEREST RATE BY TYPE OF CREDIT [1/]
(%)

	Domestic currency						
	Corporate	Large companies	Medium-size firms	Small businesses	Microbusinesses	Consumption	Mortgages
Dec.10	4.6	5.9	10.3	23.3	27.2	40.7	9.3
Mar.11	5.4	7.5	11.1	24.6	32.5	38.4	9.4
Jun.11	6.4	8.1	10.9	23.6	31.9	39.9	9.7
Sep.11	6.1	7.9	10.9	23.6	32.9	36.1	9.6
Dec.11	6.0	7.4	11.2	23.2	33.0	38.5	9.4
Jan.12	5.9	7.4	11.4	22.9	32.9	37.3	9.4
Feb.12	6.0	7.2	11.4	23.7	33.1	35.7	9.4
Mar.12	6.1	7.0	11.2	23.4	32.9	35.6	9.4
Apr.12	6.0	7.1	10.8	23.0	32.9	35.4	9.3
May.12	6.0	7.3	11.0	22.9	33.1	35.3	9.3
Accumulated change (bps)							
May.12-Apr.12	1	16	19	-14	19	-6	-1
May.12-Dec.10	146	140	67	-44	595	-536	-4

1/ Annual active interest rates on the operations carried out in the last 30 working days.

72. In line with the stable financial conditions in national currency, short-term deposit rates remained at similar levels to those observed in the previous quarter. The interest rate on 181-day to 360-day term deposits declined slightly, from 4.5 to 4.3 percent.

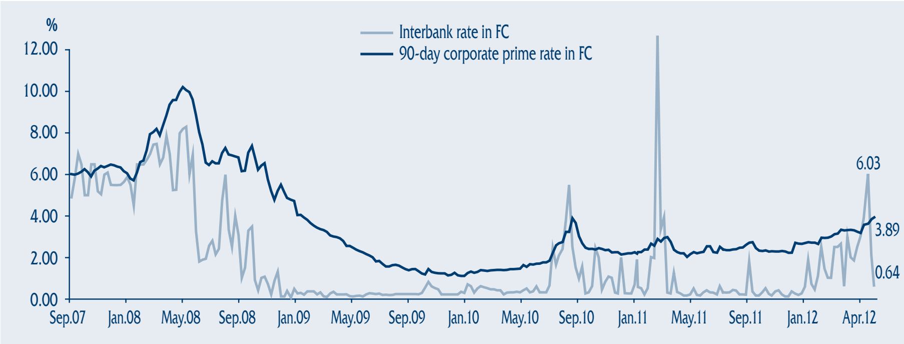
Table 29
INTEREST RATES IN NUEVOS SOLES
(%)

	Deposits up to 30 days	Rate on 31 to 180-day term deposits	Rate on 181 to 360-day term deposits
Dec.10	2.2	2.9	3.8
Mar.11	3.1	3.0	4.0
Jun.11	4.3	3.6	4.3
Sep.11	4.1	4.3	4.6
Dec.11	3.9	4.1	4.7
Jan.12	3.8	4.0	4.7
Feb.12	3.7	4.0	4.7
Mar.12	3.7	3.9	4.5
Apr.12	3.7	3.9	4.4
May.12	3.7	3.9	4.3
Accumulated change (bps)			
May.12-Mar.12	-4	-6	-12
May.12-Dec.10	143	102	56

73. Monetary conditions in foreign currency were less steady, affected by the European debt crisis and by higher reserve requirements. The corporate prime rate in dollars rose to 3.89 percent in May (from 3.25 percent in March) and the interbank interest rate in dollars peaked to 6.03 percent in the quarter. In this scenario of lower availability of liquidity in foreign currency, the Central Bank

made repo operations (with one day and 7-day maturities) in foreign currency for US$ 502 million during the month of may, easing in this way the situation of shortage of dollars.

Graph 81
90-DAY CORPORATE PRIME RATE VERSUS INTERBANK OVERNIGHT RATE IN FOREIGN CURRENCY: SEPTEMBER 2007 - MAY 2012



74. However, the increase in short-term rates in dollars has not affected significantly the other lending interest rates on operations in foreign currency. Thus, the interest rates on loans for medium-sized enterprises fell from 8.9 to 8.8 percent and those on loans for small businesses fell from 16.4 to 15.0 percent. Similarly, the rates on consumer loans and mortgages declined in the quarter from 23.0 and 8.2 percent to 22.5 and 8.0 percent, respectively. The exceptions were the interest rates on loans to micro-enterprises, which increased from 19.3 to 20.1 percent, and the corporate rate, which increased from 3.8 to 4.0 percent.

Table 30
INTEREST RATE BY TYPE OF CREDIT 1/
(%)

	Foreign currency						
	Corporate	Large companies	Medium-size firms	Small businesses	Microbusinesses	Consumption	Mortgages
Dec.10	3.3	5.5	8.6	14.2	14.8	19.4	8.1
Mar.11	3.6	5.6	9.3	16.3	16.7	20.9	8.3
Jun.11	3.6	5.3	9.3	15.6	16.3	21.3	8.5
Sep.11	3.3	5.5	8.8	15.4	19.5	21.2	8.3
Dec.11	3.0	5.4	8.9	15.0	19.2	22.0	8.2
Jan.12	3.6	5.4	9.0	15.4	18.8	22.4	8.3
Feb.12	3.6	5.5	9.3	15.5	18.8	22.8	8.2
Mar.12	3.8	5.7	8.9	16.4	19.3	23.0	8.2
Apr.12	4.1	5.7	8.7	15.5	19.0	22.7	8.2
May.12	4.0	5.7	8.8	15.0	20.1	22.5	8.0
	Accumulated change (bps)						
May.12-Apr.12	-16	2	6	-49	113	-22	-24
May.12-Dec.10	65	20	21	75	531	310	-16

1/ Annual active interest rates on the operations carried out in the last 30 working days.

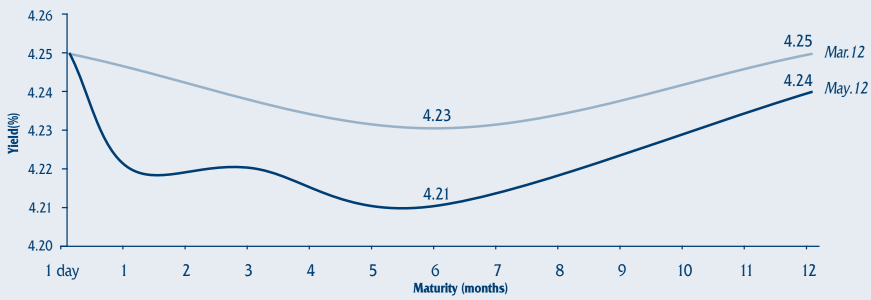
75. On the other hand, deposit interest rates in foreign currency reflected banks' increased liquidity requirements in foreign currency. The average interest rates in foreign currency for up to 30-day terms increased from 1.3 percent in March to 2.1 percent in May. This increase is also explained in part by a lower growth of deposits in foreign currency due to the greater dedollarization of deposits observed in early 2012. Banks' increased demand for foreign currency associated with the dynamism observed in credit in foreign currency, particularly during March and April, and the increased demand for liquidity in dollars due to the greater international uncertainty added to this lower availability of funds in foreign currency.

Table 31
INTEREST RATES IN US DOLLARS
(%)

	Deposits up to 30 days	Rate on 31 to 180-day term deposits	Rate on 181 to 360-day term deposits
Dec.10	0.9	1.2	1.7
Mar.11	1.4	1.1	1.7
Jun.11	0.5	1.1	1.7
Sep.11	0.8	1.0	1.6
Dec.11	0.7	1.0	1.6
Jan.12	0.9	1.1	1.6
Feb.12	1.0	1.1	1.6
Mar.12	1.3	1.2	1.6
Apr.12	1.4	1.2	1.6
May.12	2.1	1.1	1.6
Accumulated change (bps)			
May.12-Mar.12	80	-4	-2
May.12-Dec.10	118	-6	-13

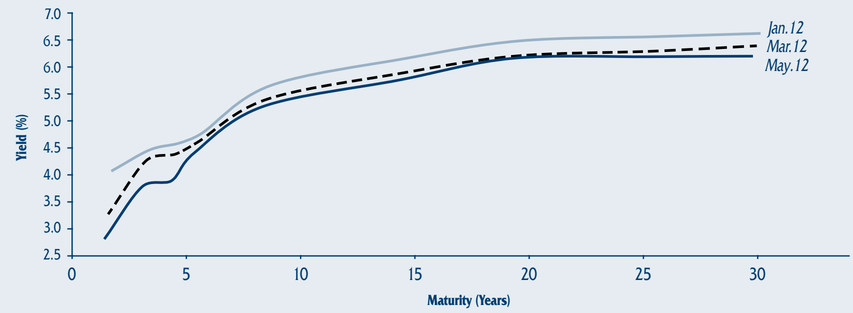
76. The interest rates in the sovereign bond market continued showing their downward trend in the quarter, reflecting the increased demand for these securities, particularly in the long end of the year curve (20 to 30 years) and in the short end of the yield curve (2-5 years). This is also observed in the rates of the instruments with less than one year maturities issued by the Central Bank.

Graph 82
YIELD CURVE OF CENTRAL BANK SECURITIES [1/]



1/ Yield of CDBCRP end of period. One day rate corresponds to reference rate.

Graph 83
SECONDARY MARKET OF SOVEREIGN BONDS [1/]

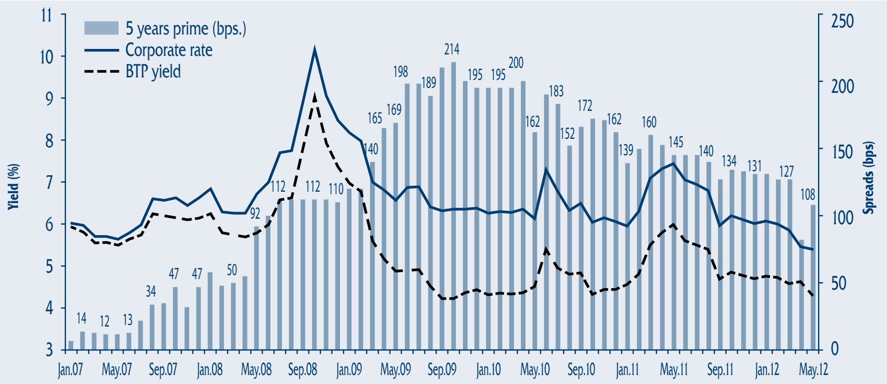


1/ End of month yield.

The demand for sovereign bonds came mainly from non-resident investors, whose holdings of BTPs increased by S/. 1.61 billion between February and May, as a result of which their share in the total of sovereign bonds rose from 47.6 to 53.2 percent.

On the other hand, the reduction of the rates on sovereign bonds has been accompanied by a reduction in the interest rates on private bond issuances, which is translated into a decrease in premiums for risk paid for these bond issuances.

Graph 84
RATES OF SOVEREIGN BONDS, AAA CORPORATE BONDS AND SPREADS [1/] : 5 YEARS



1/ The spread or premium of the risk free correspond to the difference between the yield of the sovereign bond and the 5 year AAA corporate bond.

Monetary operations

77. The operations of the Central Bank were aimed at maintaining appropriate levels of liquidity and at ensuring the flow of operations in the money market. The net maturities of BCRP monetary instruments between March and May 2012 amounted to S/. 402 million, mainly due to net maturities of CDBCRP (S/. 521 million). In the same period, the public sector made net deposits for a total of S/. 5.97 billion, most of which was revenues associated with the regularization of the income tax.

As a result of the above-mentioned operations, the share of instruments issued by the BCRP declined in terms of total liabilities. As shown in the table below, monetary instruments went from representing 18.6 percent of the net international reserves (NIRs) in March to represent 17.6 percent in May 2012. Moreover, the share of public sector deposits increased from 38.3 percent in March to 40.5 percent in May due mainly to the higher share of deposits in national currency, which increased from 24.5 percent in March to 27.8 percent in May.

Table 32
SIMPLIFIED BALANCE SHEET OF THE BCRP
(As % of Net International Reserves)

Net Assets		Mar.12	May.12*
I.	**Net International Reserves**	100% (US$ 55,789 mills.)	100% (US$ 58,002 mills.)
Net Liabilities			
II.	**Total public sector deposits**	**38.3%**	**40.5%**
	In domestic currency	24.5%	27.8%
	In foreign currency	13.7%	12.7%
III.	**Total reserve requirements**	**24.6%**	**23.6%**
	In domestic currency	8.9%	9.2%
	In foreign currency 1/	15.7%	14.5%
IV.	**BCRP Instruments**	**18.6%**	**17.6%**
	CD BCRP	14.2%	13.5%
	CDV BCRP	0.0%	0.0%
	CDR BCRP	0.0%	0.8%
	CDLD BCRP	0.0%	0.0%
	Term deposits	4.4%	3.2%
V.	**Currency**	**17.9%**	**17.0%**
VI.	**Other**	**0.6%**	**1.4%**

1/ Includes banks' overnight deposits at the Central Bank.
* Forecast.

Table 33
USE OF BCRP INSTRUMENTS IN MAY 2012
(Millions)

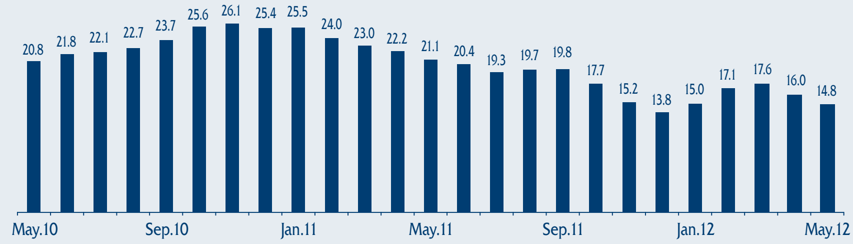
	Month accumulated
CDR BCRP (S/.)	562
Repos in Nuevos Soles (S/.)	7,090
Repos in US Dolllars (US$)	502

Source: BCRP.

Currency and credit

78. Average currency in circulation grew at a rate of 14.8 percent in the last 12 months in May, in line with the evolution of economic activity which has shown a moderation of growth in recent months. In the rest of the year, currency is expected to grow in line with the pace of growth of the economy and the process of dedollarization of deposits.

Graph 85
CURRENCY AVERAGE
(% change compared to the same period of the previous year)



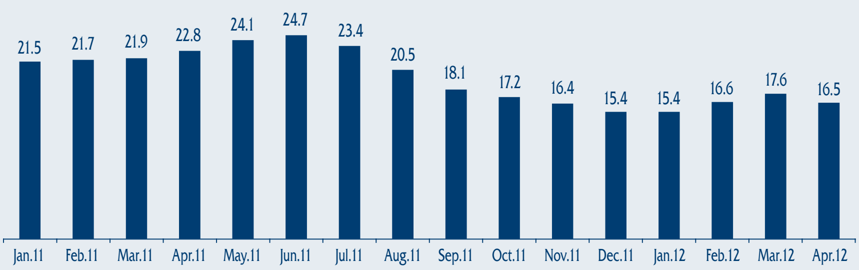
CURRENCY	Dec.07	Dec.08	Dec.09	Dec.10	Mar.11	Jun.11	Sep.11	Dec.11	Jan.12	Feb.12	Mar.12	Apr.12	May.12*
Original series (Millions of Nuevos Soles)	13,971	16,705	18,342	23,007	22,606	23,356	24,679	26,179	26,705	26,612	26,574	26,561	26,524
Seasonally adjusted series (Millions of Nuevos Soles)	13,347	16,045	17,592	22,177	22,792	23,805	24,877	25,251	25,869	26,340	26,706	26,867	26,996
Monthly flows (Millions of Nuevos Soles)	1,219	886	1,266	1,481	-121	243	-13	1,389	527	-93	-38	-13	-37
Monthly seasonally adjusted % change	9.6	5.6	7.4	6.9	-0.5	1.1	-0.1	5.6	2.0	-0.3	-0.1	0.0	-0.1
Quarterly annualized seasonally adjusted % change	31.7	8.3	16.5	28.1	16.5	16.3	17.5	12.1	10.6	13.1	19.4	20.3	17.0

* Preliminary.

79. Credit to the private sector continued to grow, but with a lower pace of growth in the last 12 months. In April, credit to the private sector from depository entities registered an annual growth rate of 16.2 percent.

    This lower annual growth observed is explained in part by the replacement of bank credits by an increased use of non-bank financing sources, such as security issuances by non-financial entities in the domestic and international capital markets. Bonds issued abroad by non-financial companies have increased significantly in the last months, rising from a total of US$ 325 million in all 2011 to US$ 1.13 billion between January and May 2012.

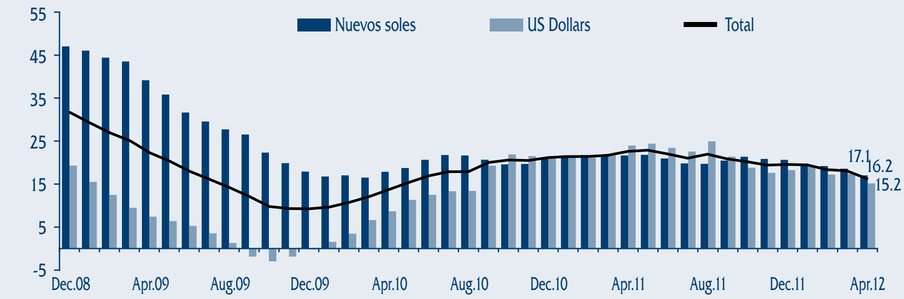
Graph 86
CREDIT TO THE PRIVATE SECTOR
(Quarterly annualized seasonally adjusted % change)



	A.11	M	J	J	A	S	O	N	D	J.12	F	M	A
Billions of nuevos soles	133.8	137.4	138.8	140.4	141.6	142.9	144.7	147.1	150.3	151.2	151.6	153.8	155.5
12 month % change	22.7	23.0	22.1	21.1	22.0	20.9	20.2	19.4	19.6	19.5	18.3	18.1	16.2

By currencies, credit to the private sector in nuevos soles reached an annual growth rate of 17.1 percent, a higher rate than the one registered by credit in dollars which grew 15.2 percent, although the flow of credit in dollars in March and April has been higher than the one in soles. Should this trend persist, the process of dedollarization of credit to the private sector induced by the price stability achieved in the Peruvian economy over the last 10 years could slow down.

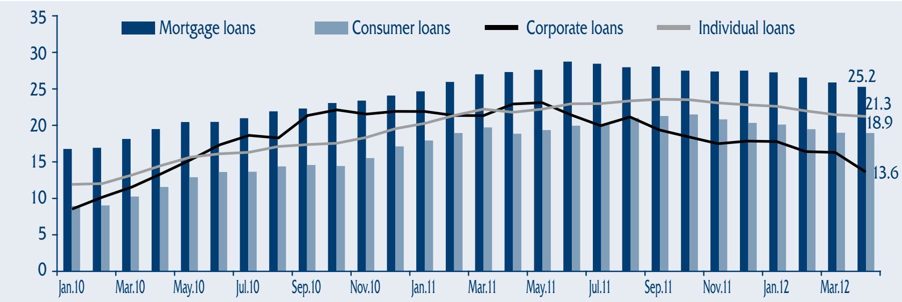
Graph 87
CREDIT TO THE PRIVATE SECTOR
(12-month % change)



	Credit	Dec.09	Dec.10	Mar.11	Jun.11	Sep.11	Oct.11	Nov.11	Dec.11	Jan.12	Feb.12	Mar.12	Apr.12
Nuevos soles	Monthly Flow	569	1,514	1,168	1,171	971	1,566	1,651	1,684	232	796	942	784
	Annual % change	17.9	21.2	21.7	21.0	20.5	21.4	20.9	20.7	19.8	19.2	18.6	17.1
	Monthly % change	1.0	2.2	1.7	1.6	1.3	2.0	2.1	2.1	0.3	1.0	1.1	0.9
US Dollars	Monthly Flow	343	368	373	83	107	106	272	561	256	-164	479	320
	Annual % change	-0.1	21.3	21.8	23.4	21.4	18.8	17.7	18.3	19.1	17.2	17.4	15.2
	Monthly % change	2.0	1.8	1.8	0.4	0.4	0.4	1.1	2.3	1.0	-0.7	1.9	1.3
Total	Monthly Flow	1,495	2,506	2,176	1,394	1,259	1,851	2,385	3,198	922	352	2,236	1,649
	Annual % change	9.0	21.2	21.8	22.1	20.9	20.2	19.4	19.6	19.5	18.3	18.1	16.2
	Monthly % change	1.5	2.0	1.7	1.0	0.9	1.3	1.6	2.2	0.6	0.2	1.5	1.1

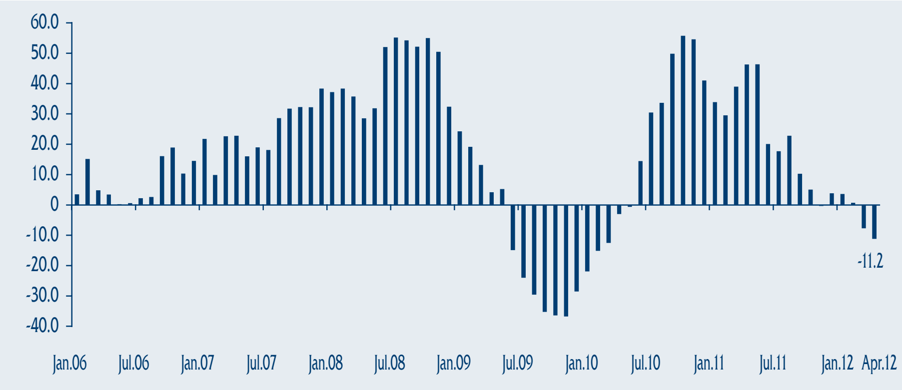
80. In April, credit to individuals continued to show a high dynamism. Consumer and mortgage loans registered annual growth rates of 18.9 and 25.2 percent, respectively, while corporate credit has slowed down, recording a growth rate of 13.6 percent. The evolution observed in bank credit to firms reflects in part the slowdown observed in credit for foreign trade operations given that companies in this segment would have also preferred to diversify their funding sources through direct loans with financial institutions abroad.

Graph 88
CREDIT BY TYPE OF LOANS: JANUARY 2010 - APRIL 2012
(12 month % change)



	Credit	Dec.09	Dec.10	Mar.11	Jun.11	Sep.11	Oct.11	Nov.11	Dec.11	Jan.12	Feb.12	Mar.12	Apr.12
Corporate loans	Monthly Flow	1,016	1,491	1,255	419	399	1,081	1,505	2,062	367	-293	1,352	976
	Annual % change	7.7	22.1	21.5	21.5	19.4	18.5	17.5	17.9	17.8	16.4	16.3	13.6
	Monthly % change	1.5	1.8	1.5	0.5	0.4	1.2	1.6	2.1	0.4	-0.3	1.4	1.0
Individual loans	Monthly Flow	479	1015	921	975	860	770	880	1136	555	645	884	673
	Annual % change	11.6	19.6	22.3	23.1	23.8	23.7	23.2	23.0	22.8	22.1	21.6	21.3
	Monthly % change	1.4	2.5	2.1	2.1	1.8	1.6	1.8	2.2	1.1	1.2	1.7	1.2
Consumer loans	Monthly Flow	313	722	443	626	464	417	466	745	234	347	393	308
	Annual % change	9.2	17.1	19.7	19.9	21.2	21.5	20.8	20.3	20.1	19.4	18.9	18.9
	Monthly % change	1.4	2.8	1.6	2.2	1.6	1.4	1.5	2.4	0.7	1.1	1.2	0.9
Mortgage loans	Monthly Flow	166	293	479	349	395	353	414	391	322	298	491	365
	Annual % change	16.3	24.0	26.9	28.7	28.0	27.4	27.3	27.4	27.2	26.5	25.8	25.2
	Monthly % change	1.3	1.9	2.9	2.0	2.1	1.9	2.1	2.0	1.6	1.5	2.4	1.7

Graph 89
FOREIGN TRADE CREDIT
(12 month % change)



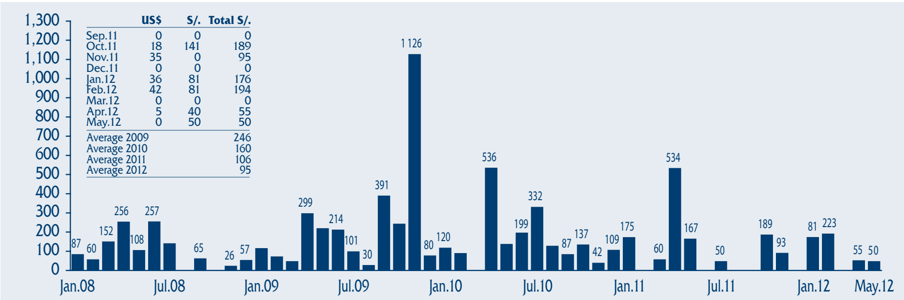
81. This process of diversification of financing sources is generating a greater flow of resources to the country, both for the purpose of financing investment projects and for the purpose of financial intermediation. Between January and May 2012, the amount of bonds issued by domestic companies abroad has reached US$ 1.89 billion, a sum which already exceeds the US$ 1.86 billion bonds issued throughout the year 2011. Moreover, the amount of bonds issued abroad by non-financial entities has risen from US$ 325 million in 2011 to US$ 1.14 billion between January and May 2012. These issuances of bonds by non-financial entities continue to be an important complementary source of banks' credits.

Table 34
PRIVATE COLOCATIONS ABROAD
(Millions of US$)

Company	Ammount
2010	**3,375**
Financial	1,700
Non financial	1,675
2011	**1,855**
Financial	1,530
Non financial	325
2012	**1,885**
Financial	750
Non financial	1,135

Source: Information from issuers.

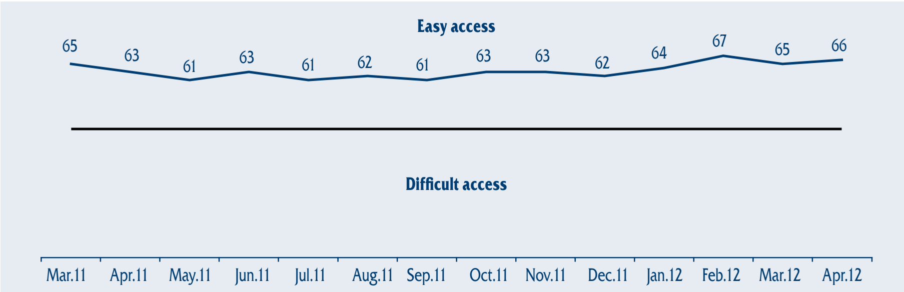
Graph 90
BONDS ISSUANCE OF NON FINANCIAL FIRMS*
(Millions of nuevos soles)



* Emissions are measured in dollars at the rate of change of last month. Includes titulization bonds.

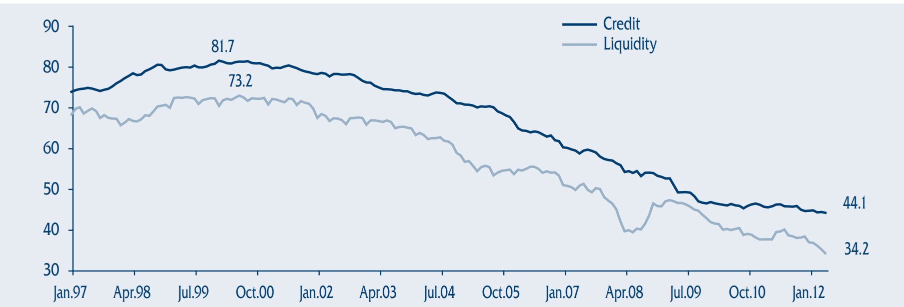
82. In aggregate terms, the dynamism of credit shows flexible financial terms and low financing costs which also reflect low interest rates in the financial system and the recovery of business confidence.

Graph 91
STATUS OF ACCESS TO CREDIT OF THE COMPAN IES



83. The dollarization of credit continued to decline in April, although less than liquidity. The dollarization ratio of credit fell from 44.7 percent in January to 44.1 percent in April, while the dollarization ratio of liquidity fell from 36.8 to 34.2 percent in the same period.

Graph 92
DOLLARIZATION RATIO: 1997 - 2012
(%)



Moreover, the dollarization of credit fell to a lesser extent in the segments of corporate loans, while in the case of deposits the dedollarization of term deposits stands out with a decline of 2.7 percentage points.

Table 35
PRIVATE SECTOR CREDIT DOLLARIZATION COEFFICIENT*

	Dec.08	Dec.09	Dec.10	Mar.11	Dec.11	Mar.12	Apr.12
Corporate credit	**62.0**	**55.8**	**55.9**	**55.8**	**54.9**	**54.8**	**54.7**
Credit to individuals	**34.3**	**29.1**	**26.5**	**26.1**	**25.1**	**25.0**	**24.9**
Consumer loans	15.1	12.2	10.7	10.5	9.8	9.7	9.6
Mortgage loans	67.9	58.0	52.2	51.3	49.2	48.7	48.4
TOTAL	**53.0**	**46.8**	**46.1**	**45.8**	**44.6**	**44.3**	**44.1**

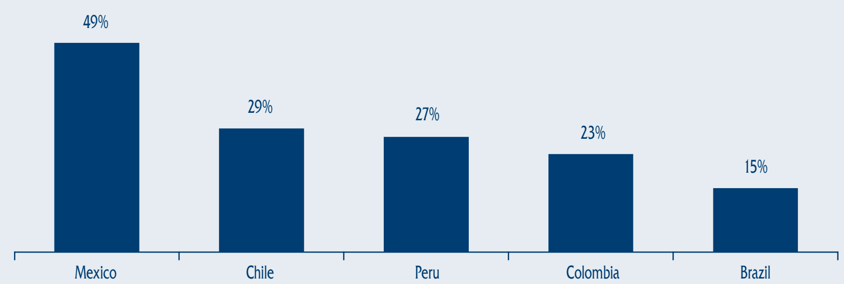
* Includes banks' branches from abroad.

Table 36
DOLLARIZATION OF LIQUIDITY AND DEPOSITS

	Dec.08	Dec.09	Dec.10	Mar.11	Dec.11	Mar.12	Apr.12
Liquidity	**45.8**	**41.9**	**37.6**	**37.6**	**36.9**	**35.2**	**34.2**
Deposits	**55.1**	**50.9**	**46.1**	**45.3**	**45.1**	**42.6**	**41.7**
Demand deposits	52.4	48.9	46.4	46.5	46.6	46.3	46.7
Savings deposits	47.5	46.0	41.5	40.8	39.6	37.8	37.9
Term deposits	61.0	55.4	48.9	47.5	47.8	43.2	40.5

84. In view of the current context of uncertainty associated with the problems in the Eurozone, comparative indicators of European bank's participation in the local market are provided in the graph below. A first approach is to measure the participation of European banks in terms of the total volume of bank credit in the local market, which in the case of Peru gives a rate of 27 percent. This rate, which is similar to the one observed in Chile, is in line with the average rate registered in the main countries of Latin America.

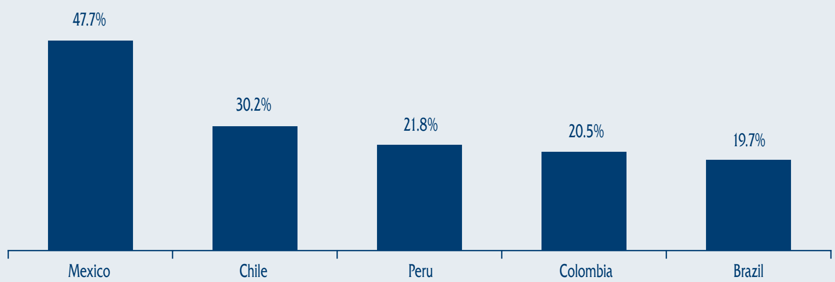
Graph 93
PARTICIPATION OF EUROPEAN BANKS IN LATIN AMERICAN BANKS' CREDIT
(% of total loans)



Source: Latin American Economic Analyst - Goldman Sachs Global Economics. Commodites and Strategy Research.

Another approach is to calculate the participation of European banks in terms of the total amount of bank capital in the local market. In the case of Peru, the ratio is 21.8 percent; that is, lower than the ratios in Mexico and Chile, and close to the ratios registered in Colombia and Brazil. Thus, both approaches suggest that the participation of European banks in the local market is within the average in the region.

Graph 94
PARTICIPATION OF EUROPEAN BANKS IN LATIN AMERICAN BANK SYSTEM
(% of banks capital)



Source: Latin American Economic Analyst - Goldman Sachs Global Economics. Commodites and Strategy Research.

Foreign exchange rate

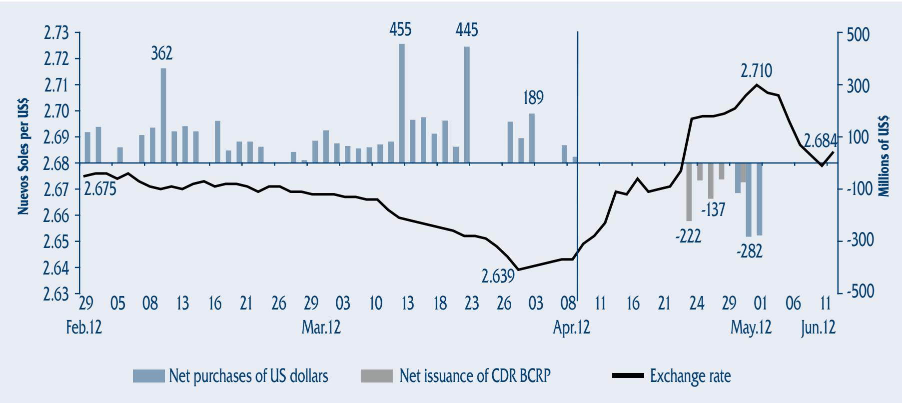
85. The exchange rate showed a greater volatility since March, in line with the higher uncertainty observed in financial markets as a result of the recent worsening of fiscal problems in Europe. This led the Central Bank to intervene in the foreign exchange market in order to reduce the exchange rate volatility.

Between the end of February and May, the nuevo sol/dollar exchange rate recorded a nominal depreciation of 1.3 percent, raising from S/. 2.675 to S/. 2.710 per dollar, even though it showed a differentiated conduct during this period. The exchange rate appreciated 1.2 percent between February 29 and May 8 due to the higher pace of dedollarization of deposits in the financial system and to the lower global risk aversion observed at that time, which contributed to the strengthening of most of the currencies of emerging economies. Thus, the exchange rate reached S/. 2.639 per dollar on 27 April. In this period the BCRP bought US$ 4.40 billion.

However, this trend was quickly reversed as from May 9 as a result of the increase in global risk aversion associated with the problems faced by Greece to remain in the Eurozone and the possible effects this could have on the rest of Eurozone member countries. This led to a change in the portfolio of the main actors involved in the foreign exchange market and to an increase in non-residents' demand for forwards to cover their positions in sovereign bonds. Between May 9 and 31, the sol depreciated 2.5 percent and the BCRP sold US$ 676 million and placed

Certificados de Depósito Reajustables –certificates indexed to the exchange rate– for the equivalent of US$ 562 million.

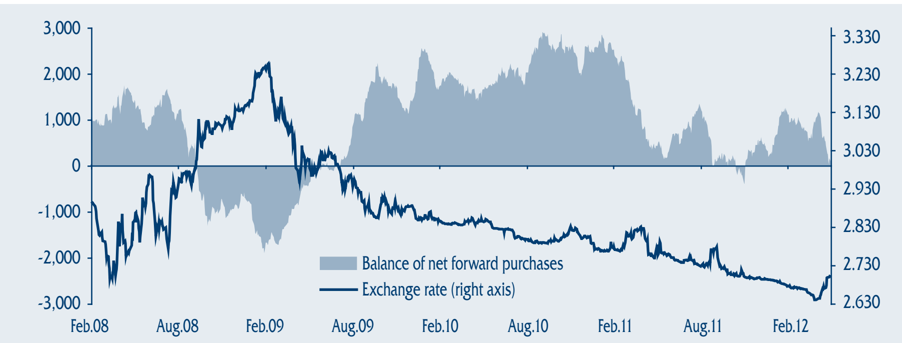
Graph 95
INTERVENTION IN THE FOREIGN EXCHANGE MARKET AND EXCHANGE RATE



The nuevo sol has been showing an appreciatory trend during June even though the exchange rate remains above the levels reached in February of this year, in a context of normalization of liquidity in dollars after the Central Bank injected US$ 502 million in foreign currency through repos towards the end of May.

86. In the forward market, net purchases of dollars by banks decreased significantly in the period. Between the end of February and May, the balance of net purchases of forward declined by US$ 1.01 billion, from US$ 1.21 billion to US$ -85 million. This balance was mainly associated with non-resident investors' increased demand for dollars to cover their positions in sovereign bonds.

Graph 96
BALANCE OF NET FORWARD PURCHASES AND EXCHANGE RATE
(Balance in millions of US$ and exchange rate in soles / US dollar)



87. The survey on the expected levels of the exchange rate in 2013 shows that economic agents expect the appreciatory trend of the exchange rate to continue. According to the latest survey, the rate expected by the surveyed groups in 2012 is S/. 2.65 per dollar –a similar level to the one expected in March–, while economic analysts and financial entities expect the exchange rate to be between S/. 2.60 and S/. 2.62 per dollar in 2013 and 2014.

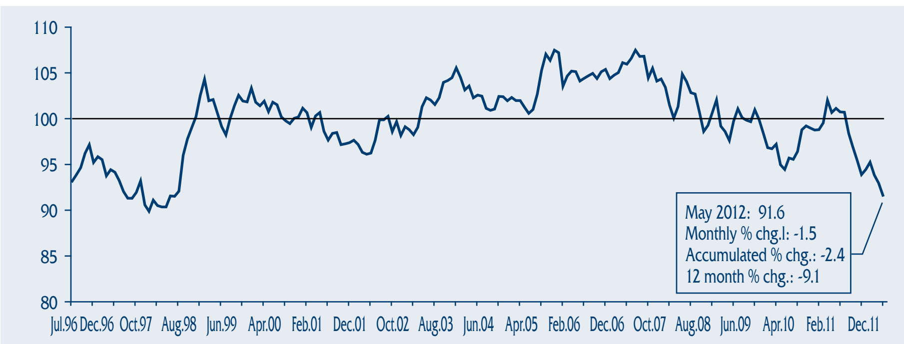
Table 37
SURVEY ON MACROECONOMIC EXPECTATIONS: EXCHANGE RATE
(S/. per US$)

	IR Dec.11	IR Mar.12	IR Jun.12*
Financial entities			
2012	2.70	2.65	2.65
2013	2.70	2.65	2.61
2014	-.-	-.-	2.60
Economic analysts			
2012	2.70	2.65	2.65
2013	2.67	2.64	2.62
2014	-.-	-.-	2.60
Non-financial firms			
2012	2.75	2.68	2.65
2013	2.78	2.69	2.70
2014	-.-	-.-	2.70
Average			
2012	2.72	2.66	2.65
2013	2.72	2.66	2.64
2014	-.-	-.-	2.63

* Survey conducted during the second half of May, 2012.

88. The real multilateral exchange rate declined from 95.2 to 91.6, which represented a real appreciation of 3.8 percent.

Graph 97
MULTILATERAL RER
(Index 2009=100)

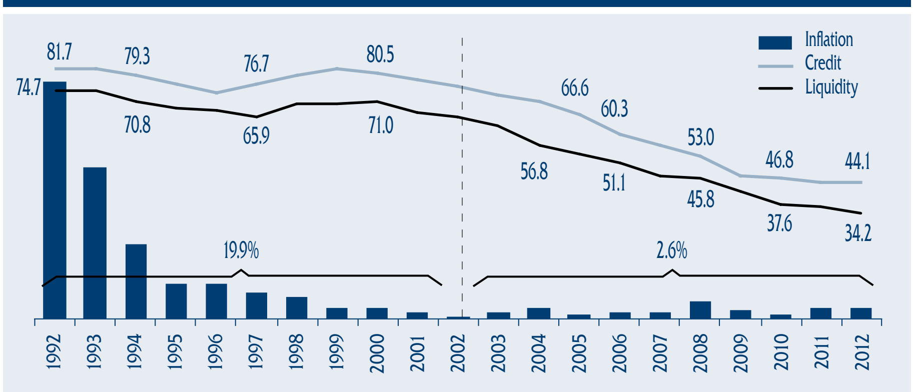


BOX 4
THE EVOLUTION OF THE DOLLARIZATION OF CREDIT: RISKS AND IMPLICATIONS FOR MONETARY POLICY

In recent years, financial dollarization has declined continuously because the inflation rate has stabilized on average at similar levels to those observed in developed countries. This is reflected, for example, in that the ratio of dollarization of liquidity in depository entities has dropped from 71 percent in 2000 to 34.2 percent in April 2012, while the ratio of dollarization of credit to the private sector has fallen from 80.5 to 44.1 percent in the same period.

One of the factors that have contributed to this decline in financial dollarization has been inflation targeting, because this scheme involves a clear and credible long-term commitment with maintaining the purchasing power of the nuevo sol over time. The average rate of inflation in 2002-2012 has been 2.6 percent, a significantly lower rate than the rate of 19.9 percent observed in the period of 1992-2001. The ratio of variability of inflation has also dropped from 1.2 to 0.7 percent in the same period.

DOLLARIZATION AND INFLATION



Despite the fact that the Peruvian economy has been experiencing a significant process of dedollarization, it still shows high levels of dollarization in some sectors of the economy and in certain segments of the credit market.

An analysis by segments shows that there is a dollarization degree of 54.7 percent in corporate credit and that credit for foreign trade operations has the highest level of dollarization with a ratio of 96 percent. This particular segment has low levels of currency mismatch risks given that most of the revenues in this segment are also denominated in foreign currency, which generates a natural match between assets and liabilities.

CREDIT DOLLARIZATION 1/
(%)

	Total Credit	Companies			Individuals			Total Credit without Foreign Trade	Banks	Rest of depository societies
		Total	Foreign Trade	Others	Total	Consumer Loans	Mortgage Loans			
2001	78.4	81.4	-	-	64.3	40.2	94.0	-	81.4	35.0
2002	76.3	80.7	-	-	59.6	33.0	94.2	-	80.5	31.0
2003	73.5	79.1	-	-	56.4	28.1	94.8	-	78.5	30.0
2004	70.8	78.2	-	-	52.8	24.3	95.1	-	76.7	29.4
2005	66.6	73.2	91.9	70.3	52.0	23.5	95.1	64.0	72.6	27.9
2006	60.3	67.9	91.1	64.3	45.5	20.7	88.1	57.3	66.1	25.6
2007	57.0	66.6	90.8	62.8	38.5	18.1	79.4	53.7	62.5	21.0
2008	53.0	62.0	91.3	57.3	34.3	15.1	67.9	49.1	57.8	17.2
2009	46.8	55.8	94.0	52.0	29.1	12.2	58.0	43.8	53.1	12.7
2010	46.1	55.9	95.5	51.4	26.5	10.7	52.2	42.5	52.7	12.7
2011	44.6	54.9	95.9	51.0	25.1	9.8	49.2	41.5	51.2	12.0
2012	44.1	54.7	96.0	51.1	24.9	9.6	48.4	41.3	50.7	11.4

1/ Information available up to April 2012.

In the case of personal credit, the dollarization ratio of consumer loans is 9.6 percent, while the dollarization ratio of mortgage loans is 48.4 percent. The mortgage segment is one of the most vulnerable segments to abrupt depreciation of the national currency because most borrowers of mortgage loans have incomes in the local currency, which generates currency exchange mismatches in the case of abrupt exchange rate variations. It should be pointed out that in Peru there is no limit to the loan-to-(property) value ratio (LTV) and that the latter ranges between 80 and 90 percent. In some countries the most vulnerable segments of mortgage credit are subject to lower LTV levels.

As regards the credit dollarization ratios by economic sector, in 2012 the mining sector maintains the highest level of dollarization, with a ratio of 96.3 percent. However, this sector does not have currency mismatch problems since its production is mainly export-oriented. On the other hand, there are moderate exchange rate mismatches in the manufacturing and commerce sectors, which register dollarization ratios of 71.7 and 54.6 percent, respectively.

The persistence of dollarization in some sectors of the economy requires the implementation of tools that contribute to generate a continued and generalized dedollarization process in all the segments that have currency mismatches. In Peru, measures such as differentiated rates of reserve requirements in national currency and in foreign currency, the development of a long-term debt market in the domestic currency, macroprudential measures (such as increased provisions for loans in foreign currency, and stricter limits on banks' foreign exchange position) seem to be encouraging this process.

DOLLARIZATION OF CREDIT BY ECONOMIC SECTOR
(%)

	2005	2006	2007	2008	2009	2010	2011	2012 *	Average
Agriculture and livestock	76.1	76.0	72.2	67.2	73.5	74.0	72.9	71.7	**73.0**
Fishing	91.0	95.8	96.2	93.6	93.3	91.2	90.0	91.3	**93.0**
Mining	94.5	96.6	96.2	95.7	95.4	96.7	97.3	96.3	**95.3**
Manufacturing industry	77.7	67.8	68.0	67.6	66.2	68.8	69.6	71.7	**68.3**
Electricity, gas and water	67.1	71.5	76.3	85.2	85.2	85.4	87.3	89.8	**80.9**
Construction	82.6	84.4	85.0	71.7	71.2	72.1	68.1	67.6	**75.7**
Commerce	56.8	58.0	58.8	54.8	50.1	55.4	53.6	54.6	**55.3**
Hotels and restaurants	85.5	82.6	77.5	67.7	61.7	53.2	51.0	53.4	**67.6**
Transportation	50.1	52.0	53.7	50.8	43.9	45.2	56.4	56.3	**50.2**
Financial intermediation	50.3	58.4	65.3	44.7	29.1	26.9	27.1	40.0	**44.9**
Real estate	73.0	73.6	72.2	60.8	56.6	61.2	60.0	59.5	**64.5**
Public sector	20.1	8.8	5.7	9.8	7.2	1.0	2.7	3.3	**6.2**
Education	64.3	57.0	44.9	32.9	26.3	22.6	27.3	31.1	**38.3**
Health and social services	57.6	47.2	42.4	43.8	38.7	39.8	39.9	40.0	**44.1**
Communitary services	64.1	58.1	51.5	46.5	42.9	48.0	42.8	41.3	**51.4**
Households	67.6	51.4	45.5	53.7	61.0	41.7	34.6	35.5	**50.3**
Total	**70.4**	**67.2**	**67.5**	**63.5**	**60.4**	**62.1**	**62.6**	**63.3**	

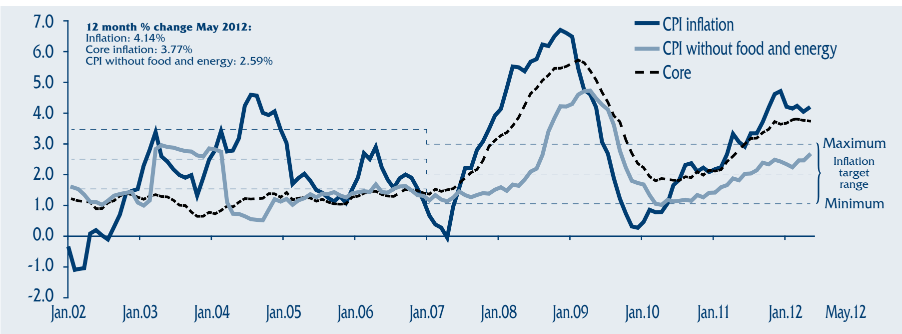
* Up to April 2012.

VI. Inflation

89. At May 2012, inflation in the last twelve months fell from 4.74 percent in December 2011 to 4.14 percent. This positive evolution was associated with the lower increase observe in food prices, especially in food products with a high imported content, as a result of the lower prices of commodities in the international market. Core inflation in the last twelve months showed a variation of 3.8 percent and the CPI without food and energy showed a variation of 2.6 percent.

Between January and May, the highest price increase was registered in education costs (tuition and fees), not only as a result of the beginning of the school year, but also as a result of increases in higher education tuition and fees. The rises in the prices of some perishable foodstuffs affected by climate anomalies also had a strong impact on inflation as these foodstuffs registered higher prices than their usual seasonal prices. Meals outside the home also showed noteworthy price rises.

Graph 98
INFLATION AND INFLATION TARGET
(Last 12 month % change)



90. When inflation is analyzed by periods, we see that inflation is generally higher in the first semester of the year and more specifically in the period of January to May, when higher inflation is observed in perishable farming products reflecting the effect of seasonal factors.

Table 38
CPI AND PERISHABLE AGRICULTURAL FOOD
(Annualized average change of period 2001 - 2011)

	January - May	June - December	Year
CPI	3.4	1.8	2.5
Perishable agricultural food	12.4	-1.3	4.2

Non-core inflation, which reflects the effects of both external and domestic shocks on prices, fell from an annual rate of 6.8 percent in December 2011 to 4.8 percent in May 2012. This decline reflected a deceleration in food prices, which fell from 11.5 percent to 6.5 percent, with a noteworthy decline in the prices of poultry, bread and edible oils due to the lower prices of commodities.

The annual rate of core inflation, which excludes the effects of shocks, rose slightly from 3.7 to 3.8 percent due to the higher prices of education and tickets for entertainment shows. The higher prices of the latter also explain the rise in inflation excluding food and energy, which rose from 2.4 to 2.6 percent.

Table 39
INFLATION
(% change)

	Weight 2009=100	2006	2007	2008	2009	2010	2011	2012 Jan.-May.	2012 12 months
I. INFLATION	**100.0**	**1.14**	**3.93**	**6.65**	**0.25**	**2.08**	**4.74**	**1.57**	**4.14**
II. CPI WITHOUT FOOD AND ENERGY	**56.4**	**1.28**	**1.49**	**4.25**	**1.71**	**1.38**	**2.42**	**1.06**	**2.59**
III. CORE INFLATION	**65.2**	**1.37**	**3.11**	**5.56**	**2.35**	**2.12**	**3.65**	**1.87**	**3.77**
Goods	32.9	0.97	3.30	5.32	2.17	1.53	3.17	1.28	3.05
Services	32.2	1.85	2.88	5.86	2.56	2.72	4.13	2.46	4.48
IV. NON CORE INFLATION	**34.8**	**0.83**	**5.07**	**8.11**	**-2.54**	**2.00**	**6.79**	**1.02**	**4.84**
Food	14.8	2.06	7.25	10.97	-1.41	1.18	11.50	2.11	6.45
Fuels	2.8	-1.50	6.45	-0.04	-12.66	12.21	7.54	1.17	6.22
Transportation	8.9	1.12	0.82	5.86	0.19	1.94	3.61	-0.68	3.58
Utilities	8.4	-3.22	0.24	7.48	-4.56	0.01	1.50	0.71	2.55

Table 40
INFLATION
(Weighted contribution)

	Weight 2009=100	2006	2007	2008	2009	2010	2011	2012 Jan.-May.	2012 12 months
I. INFLATION	**100.0**	**1.14**	**3.93**	**6.65**	**0.25**	**2.08**	**4.74**	**1.57**	**4.14**
II. CPI WITHOUT FOOD AND ENERGY	**56.4**	**0.58**	**0.67**	**1.88**	**0.74**	**0.78**	**1.36**	**0.58**	**1.44**
III. CORE INFLATION	**65.2**	**0.79**	**1.80**	**3.20**	**1.34**	**1.38**	**2.38**	**1.21**	**2.45**
Goods	32.9	0.31	1.05	1.69	0.68	0.50	1.04	0.41	0.99
Services	32.2	0.48	0.75	1.52	0.66	0.88	1.34	0.79	1.46
IV. NON CORE INFLATION	**34.8**	**0.35**	**2.13**	**3.44**	**-1.09**	**0.69**	**2.36**	**0.36**	**1.69**
Food	14.8	0.48	1.69	2.63	-0.35	0.17	1.68	0.33	0.99
Fuels	2.8	-0.09	0.36	0.00	-0.68	0.34	0.23	0.04	0.19
Transportation	8.9	0.10	0.07	0.51	0.03	0.17	0.32	-0.06	0.31
Utilities	8.4	-0.14	0.01	0.30	-0.09	0.00	0.12	0.05	0.20

Imported inflation at May showed a variation of 3.0 percent in the last twelve months, a lower rate than in December 2011 (4.9 percent). The drop in the prices of foodstuffs (bread, oils, and noodles) stands out, since the annual rate fell from 9.6 percent in December 2011 to 2.2 percent in May 2012 due to the effect of the lower prices of imported inputs.

Graph 99
DOMESTIC AND IMPORTED INFLATION
(Last 12 month % change)

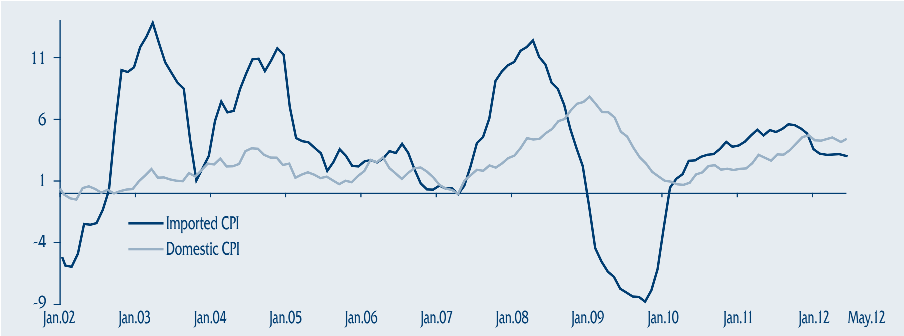


Table 41
DOMESTIC AND IMPORTED INFLATION: 2006 - 2012
(Accumulated % change)

	Weight 2009=100	2006	2007	2008	2009	2010	2011	2012 Jan.-May.	2012 12 months
I. IMPORTED CPI	**10.8**	**0.27**	**10.46**	**2.20**	**-6.25**	**3.78**	**4.87**	**1.01**	**3.00**
Food	3.0	2.08	18.83	4.75	-3.07	0.76	9.59	0.56	2.16
Fuels	2.8	-1.50	6.45	-0.04	-12.66	12.21	7.54	1.17	6.22
Electric appliances	1.3	-1.29	-1.50	-0.06	-2.39	-0.58	-1.13	-0.88	-0.90
Other	3.7	0.64	0.47	0.46	-0.34	1.20	0.83	1.90	2.20
II. DOMESTIC CPI	**89.2**	**1.28**	**2.84**	**7.44**	**1.35**	**1.87**	**4.72**	**1.64**	**4.28**
III. CPI	**100.0**	**1.14**	**3.93**	**6.65**	**0.25**	**2.08**	**4.74**	**1.57**	**4.14**
Exchange rate		**-6.40**	**-7.00**	**4.47**	**-7.59**	**-2.15**	**-4.24**	**-1.00**	**-3.81**
Imported non foodstuffs	6.7	-1.02	4.31	0.06	-9.04	4.93	3.15	1.19	3.32
Domestic food and beverage	42.1	1.72	4.14	10.53	1.14	2.55	7.83	2.37	6.32
Domestic non foodstuffs	45.8	0.89	1.64	4.53	1.55	1.44	2.70	1.14	2.92

91. The items that contributed most to increase the rate of inflation between January and May were education services and meals outside the home. Other rises worth pointing out included the rise in the prices of onions, other vegetables, and eggs. On the other hand, the items that contributed most to reduce the rate of inflation included citrus fruits, telephone rates, and domestic transport fares.

Table 42
ITEM WITH THE HIGHEST WEIGHTED CONTRIBUTION TO INFLATION: January - May 2012

Positive	Weight	% Chg.	Contribution	Negative	Weight	% Chg.	Contribution
Education (fees and tuition)	8.8	4.2	0.38	Citrics	0.5	-16.8	-0.11
Meals outside the home	11.7	2.8	0.35	Telephone rates	2.9	-2.4	-0.06
Onion	0.4	48.3	0.14	National transportation	0.3	-14.6	-0.06
Other vegetables	0.4	25.5	0.11	Fresh and frozen fish	0.7	-6.3	-0.05
Eggs	0.6	17.3	0.10	Corn	0.1	-22.7	-0.04
Electricity	2.9	2.7	0.07	Apparatus of recreation and culture	0.9	-3.4	-0.03
Other fresh fruits	0.4	17.7	0.07	Grapes	0.1	-18.3	-0.03
Gasoline and oil	1.3	3.3	0.05	Avocado	0.1	-16.4	-0.02
Sodas	1.3	3.7	0.05	Rice	1.9	-1.1	-0.02
Toiletries	4.9	1.0	0.05	Gas	1.4	-1.3	-0.02
Total			**1.37**	**Total**			**-0.44**

Table 43
ITEM WITH THE HIGHEST WEIGHTED CONTRIBUTION TO INFLATION: June 2011 - May 2012

Positive	Weight	% Chg.	Contribution	Negative	Weight	% Chg.	Contribution
Meals outside the home	11.7	6.6	0.81	Telephone rates	2.9	-3.6	-0.09
Education (fees and tuition)	8.8	5.9	0.53	Fresh and frozen fish	0.7	-6.6	-0.05
Urban fares	8.5	3.5	0.29	Apparatus of recreation and culture	0.9	-3.9	-0.03
Gasoline and oil	1.3	13.3	0.20	Rice	1.9	-1.5	-0.03
Electricity	2.9	7.0	0.19	Garlic	0.1	-32.2	-0.03
Toiletries	4.9	3.7	0.18	Sugar	0.5	-1.7	-0.01
Poultry	3.0	4.7	0.14	Gas	1.4	-0.9	-0.01
Other vegetables	0.4	30.3	0.12	Rent	2.4	-0.4	-0.01
Eggs	0.6	22.6	0.12	Plane tickets	0.4	-2.2	-0.01
Other fresh fruits	0.4	26.5	0.10	Televisions	0.5	-1.1	-0.01
Total			**2.68**	**Total**			**-0.28**

Inflation components

92. The rise in the prices of meals outside the home and education stand out in the evolution of inflation in the last twelve months at May. The former accumulated a rise of 6.6 percent, associated mainly with the rise in the prices of foodstuffs (5.7 percent), while the latter showed a rise of 5.9 percent due to the rise in the price of education costs in March and April associated with the beginning of the school year.

    Urban fares rose 3.5 percent between June 2011 and May 2012 due to the rise in the prices of diesel and gasoline (20 percent and 13.3 percent, respectively) and electricity rates recorded an increase of 7 percent due mainly to the quarterly adjustments made in the energy generation rates due to the rise in the prices of fuels.

    It is also worth pointing out the contribution to inflation of other vegetables (i.e. spinach, leek, etc.) due to climate factors and the contribution of eggs due to a higher seasonal demand. The price of chicken also showed a lower growth rate due to the decline in the price of maize and the greater availability of fish.

Among the components with a higher negative contribution to inflation in the last months, the following stand out: telephone rates, whose reduction is associated with the application of the productivity factor; recreational and cultural gear; house rents, due to the appreciation of the exchange rate, and foodstuffs, such as rice and fresh fish, due to a higher supply of these products.

93. Compared to March, economic agents have raised the rates of inflation they expect in 2012 and 2013. Inflation in 2012 is expected to show a rate of 3.2 percent, declining thereafter in the forecast horizon to between 2.8 and 3.0 percent in 2013 and to between 2.5 and 3.0 percent in 2014 (within the target range).

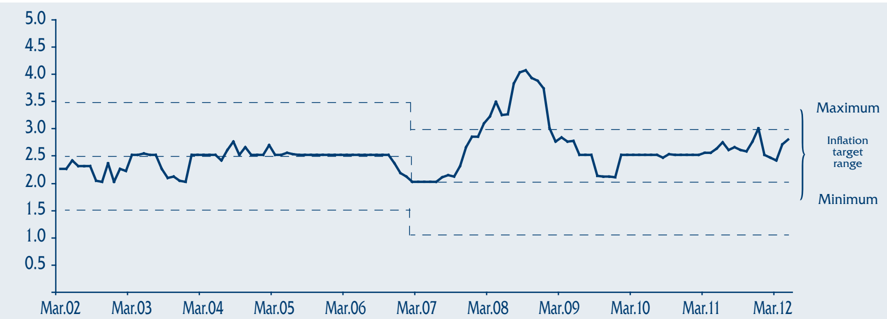
Table 44
SURVEY ON MACROECONOMIC EXPECTATIONS: INFLATION
END OF PERIOD
(%)

	Survey conducted for:		
	IR Dec. 11	IR Mar. 12	IR Jun. 12*
FINANCIAL ENTITIES			
2012	2.7	2.7	3.2
2013	2.5	2.5	2.8
2014	-.-	-.-	2.5
ECONOMIC ANALYSTS			
2012	2.8	2.8	3.2
2013	2.5	2.4	2.8
2014	-.-	-.-	2.5
NON-FINANCIAL FIRMS			
2012	3.0	3.0	3.2
2013	3.0	3.0	3.0
2014	-.-	-.-	3.0

*Survey conducted during the second half of May, 2012.

The rate of inflation expected for next year also shows an upward conduct in the last months and falls within the target range, according to the BCRP Survey on Macroeconomic Expectations.

Graph 100
INFLATION EXPECTATIONS FOR THE NEXT YEAR*
(%)



* Corresponds to the average of the expectations of the financial system and economic analysts.

Inflation forecasts

94. Annual inflation at May showed a rate of 4.14 percent, above the upper level of the target range. As in out Inflation Report of March, the central forecast scenario considers that inflation will gradually converge towards the target range and will be within the target range in 2012. Both the reversal of the supply shocks which affected inflation in 2011 –and particularly the moderation in the price rises of fuels as a result of the recent decline in the international prices of crude– and a lower output gap will contribute to inflation's converge towards the target.

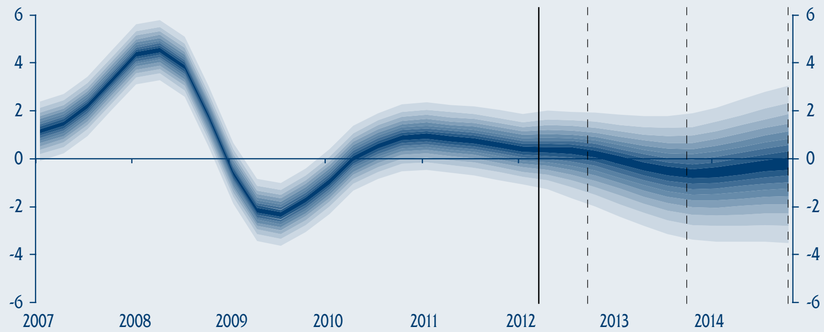
95. The forecasts on economic growth are consistent with a neutral economic cycle in the forecast horizon and therefore no major demand pressures on inflation are foreseen during this period. Factors contributing to this process include, on the one hand, a negative external impulse, characterized by growth rates in our trading partners below their potential levels of growth, and lower terms of trade which are offset by a greater fiscal impulse, increased business and consumer confidence, and expansionary monetary conditions in dollars and neutral conditions in nuevos soles.

    However, it should be pointed out that less expansionary monetary conditions are expected in the near future as a result of the impact of the reserve requirement measures adopted by the BCRP since May, such as the higher demand for dollars given increased uncertainty in international financial markets.

    Moreover, expected inflation should gradually decline in the forecast horizon to the target level of 2 percent. The increase observed so far this year in inflation expectations reflects the recent evolution of inflation. As in previous episodes, inflation is expected to show a more rapid convergence to the target in the next months and inflation expectations should return to the target range.

96. The baseline forecast scenario considers a monetary policy stance that will not be substantially different in the short-term from today's monetary position. An appropriate monetary stance contributes to maintain inflation expectations anchored, especially in a context of persistent significant shocks in sensitive products of the CPI basket. Because of this, the Central Bank will continue to keep a close watch on global and domestic economic developments to adjust, if required, its monetary policy stance in order to ensure inflation's convergence to the target range.

Graph 101
OUTPUT GAP: 2007 - 2014
(% of potential GDP)



Memo: The output gap is not an observable variable and has to be estimated. Because of this, the graph shows uncertainty about its value, even in periods for which there is information on GDP (up to the first quarter 2012). Each band concentrates a probability of occurrence of 10% and total bands represent a probability of occurrence of 90%.

The chapter on the balance of risks discusses the risk scenarios used to forecast the output gap on which the inflation forecast illustrated in Graph 102 is based.

Graph 102
INFLATION FORECAST: 2012 - 2014
(Last 12 month % change)

Memo: The graph shows the probability of occurrence of inflation values in the future: These values were established combining statistical analysis and the subjective perception of the BCRP. Thus, in each period of the forecast horizon, each pair of bands with the same shade concentrates a probability of 10%. This can be interpreted as that 10 of every 100 possible future values of inflation are expected to fall within the darkest bands (located in the center), that contain the baseline escenario trajectory.

Table 45
SUMMARY OF INFLATION REPORT FORECASTS

	2010	2011	2012 1/		2013 1/		2014 1/
			IR Mar.12	IR Jun.12	IR Mar.12	IR Jun.12	IR Jun.12
Real % change							
1. GDP	8.8	6.9	5.7	5.8	6.3	6.2	6.3
2. Domestic demand	13.1	7.2	5.9	6.3	6.5	6.4	6.5
a. Private consumption	6.0	6.4	5.8	5.8	5.8	5.6	5.8
b. Public consumption	10.0	4.8	5.3	6.0	5.1	4.9	6.3
c. Fixed private investment	22.1	11.7	8.2	10.2	8.7	8.7	8.7
d. Public investment	27.3	-17.8	34.3	31.0	7.3	10.0	9.3
3. Exports (goods and services)	1.3	8.8	7.5	5.7	7.7	7.7	8.5
4. Imports (goods and services)	24.0	9.8	8.3	8.3	8.3	8.3	8.9
5. Economic growth in main trading partners	4.6	3.6	2.9	2.8	3.2	3.2	3.4
Memo:							
Output gap 2/ (%)	0.1	0.8	-0.5 ; +0.5	-0.5 ; +0.5	-0.5 ; +0.5	-0.5 ; +0.5	-0.5 ; +0.5
% change							
6. Forecast inflation	2.1	4.7	2.0-3.0	2.0-3.0	1.5-2.5	1.5-2.5	1.5-2.5
7. Average price of crude oil	28.7	19.6	10.2	2.8	1.1	-2.5	0.0
8. Nominal exchange rate 3/	-2.1	-4.3	-1.5	-2.6	0.0	0.0	0.0
9. Real multilateral exchange rate 3/	-3.0	-5.8	0.1	-1.7	1.0	0.4	2.6
10. Terms of trade	17.9	5.4	-1.4	-3.6	0.4	-1.1	-0.5
a. Export price index	29.9	20.0	-1.9	-6.2	0.9	-1.2	1.5
b. Import price index	10.1	13.8	-0.5	-2.6	0.5	-0.1	2.0
Nominal % change							
11. Currency in circulation	25.4	12.9	17.5	17.5	13.0	13.0	13.2
12. Credit to the private sector 4/	21.0	18.9	14.5	14.5	12.5	12.5	12.7
% GDP							
13. Gross fixed investment rate	25.1	24.1	25.7	26.1	26.2	26.8	27.6
14. Current account of the balance of payments	-2.5	-1.9	-1.5	-2.7	-1.8	-2.8	-2.9
15. Trade balance	4.4	5.3	4.5	3.4	4.6	3.1	3.0
16. Gross external financing to the private sector 5/	8.7	6.8	4.9	7.2	5.1	5.4	5.1
17. Current revenue of the general government	20.0	21.0	21.2	21.1	21.2	21.2	21.2
18. Non-financial expenditure of the general government	19.2	18.1	18.9	19.1	18.7	19.2	19.2
19. Overall balance of the non-financial public sector	-0.3	1.9	1.1	1.1	1.4	1.0	1.0
20. Total public debt balance	23.3	21.2	19.9	19.4	18.3	18.2	16.8

IR: Inflation Report.
1/ Forecast.
2/ Differential between GDP and potential GDP (%).
3/ Survey on exchange rate expectations.
4/ Includes loans made by banks' branches abroad.
5/ Includes foreign direct investment and private sector's long term disbursement.

VII. Balance of Risks

97. The baseline scenario for the inflation forecast takes into account relevant data on macroeconomic and financial variables as well as information on the domestic and international environment that is complemented with qualitative information not considered in statistical data.

    Given that the forecast process is not free from uncertainty about future developments in the domestic and in the global economies, other scenarios including shocks that divert inflation from the baseline scenario are also evaluated in the balance of risks.

    The balance of risks results from assessing the relative significance that each of the risk factors has on the inflation forecast. The expected impact of a risk factor on inflation depends on two components: first, the magnitude of deviation of the inflation forecast in the risk scenario compared to the baseline scenario, and second, the probability of occurrence assigned to the risk scenario. Together, these two factors determine the bias of the inflation forecast in the balance of risks.

98. The main risks that could divert the rate of inflation from the baseline scenario in the forecast horizon are associated with uncertainty about the evolution of the global economy, the evolution of domestic demand, the domestic expectations of inflation, and the impact of commodity prices in international markets and adverse climate conditions. The expected impact of each of these risk factors on the inflation forecast at end 2012 is shown in graph 103.

    The **downward risks** in the inflation forecast are both external and domestic. The former are associated with the Eurozone debt problems and the latter are associated with the risk of a slower growth of domestic demand due to the postponement of investment projects.

    a. Uncertainty about the evolution of the global economy

    The baseline scenario considers a lower rate of growth in the world economy than the one considered in our Inflation Report of March (3.2 percent versus 3.3 percent in 2012 and 3.7 percent versus 3.8 percent in 2013). Uncertainty in international markets, which intensified again in May as a result of the sovereign debt problems and fiscal restraints in the Eurozone, would contribute to weaken external demand, affecting the domestic economy through the trade and financial channels.

This scenario describes a drop in global economic activity coupled by a reduction in the terms of trade. In addition to this, the increase of global uncertainty could generate panic among investors and trigger a gradual reversal of foreign capital, causing a real depreciation and an increase in the country risk indicator.

If these risks materialized, the Central Bank would use some of the large amount of its international reserves and several liquidity injection mechanisms in both national and foreign currency to offset the impact of this shock on domestic financial conditions. The monetary policy stance would be expansionary in the forecast horizon to prevent deflationary risks.

b. Evolution of domestic demand

The possibility that investment projects are either postponed or cancelled is analyzed in this scenario. If this happened, it would generate less dynamism in the aggregate demand and, in the short term, a rate of economic growth below potential growth which would generate downward pressures on inflation. In this scenario, the Central Bank would increase the monetary stimulus with the aim of leading inflation to be within the target range in the forecast horizon.

On the other hand, there is an **upward risk** factor for inflation associated mainly with external supply shocks (higher commodities prices) and domestic supply shocks (adverse climate factors in our country).

c. Higher commodities prices or adverse climate conditions

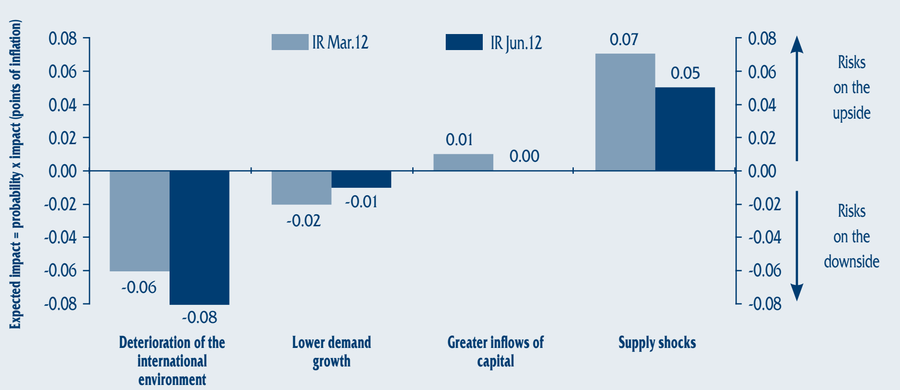
Even though the prices of food commodities and fuels would show a downward trend, there is a risk that global inflationary pressures may be more persistent than what has been considered in the baseline scenario. Uncertainty about how economic authorities, especially in the Eurozone, will solve the challenges and problems, as well as concerns about the future economic and political landscape have a strong effect on the level of global economic activity. A more decisive and credible economic policy in most advanced economies could generate a confidence shock that could lead to increased global demand. This could affect the dynamics of domestic inflation through higher imported costs and lower margins for local companies, which could generate inflationary pressures. In contrast with what was foreseen in our March Inflation Report, the risk of higher international prices of oil and oil derivatives has declined due to recent developments in this market.

In the domestic arena, the risk remains that adverse weather conditions could affect the normal development of production and supply of food products (especially fisheries and agricultural products).

In this scenario, the Central Bank would adjust its monetary position only if these inflationary shocks affected economic agents' expectations about inflation.

99. The assessment of the effects that the various risk factors of this forecast horizon would have on inflation results in a balance of risks with a slight downward bias, in contrast with the balance of risks of our previous report which considered a neutral balance. This change in the balance of risks is mainly associated with recent developments in the world economy and with uncertainty about the future evolution of the Eurozone crisis and its possible contagion effect.

Graph 103
BALANCE OF RISKS AGAINST THE BASE SCENARIO



Memo: The risk assessment describes how exogenous factors would affect the rate of inflation forecast for December 2012 if such risks materialized. Each bar in the graph illustrates the magnitude and direction of the effect of these factors, i.e., the expected impact in alternative forecast scenarios. This impact is calculated as the difference between the inflation forecast in the baseline scenario and inflation projections in several scenarios considering different assumptions, multiplying this difference by the probability of occurrence assigned to such alternative assumptions. The sum of the bars –the risk balance– indicates how these risk factors as a whole would divert inflation from the baseline scenario in December 2012.

The risk balance in this report is on the downside, which indicates that there is a higher probability that inflation will fall below the forecast considered in the baseline scenario. Therefore, the bands in the Graph show a slightly downward asymmetry.

CONCLUSION

100. The recent evolution of the output gap and inflation expectations indicates that the risks of demand pressures are gradually subsiding. Moreover, the lower international prices of food and fuels are expected to contribute to a faster decline

of inflation towards the middle of this year and to offset in part the impact of the recent rise of the minimum wage on inflation. This would lead inflation to reverse its current path above the target range and to converge towards this range in 2012.

The Central Bank will continue to oversee global and domestic economic developments to adjust, if required, its monetary policy stance in order to ensure inflation's convergence to the target range.