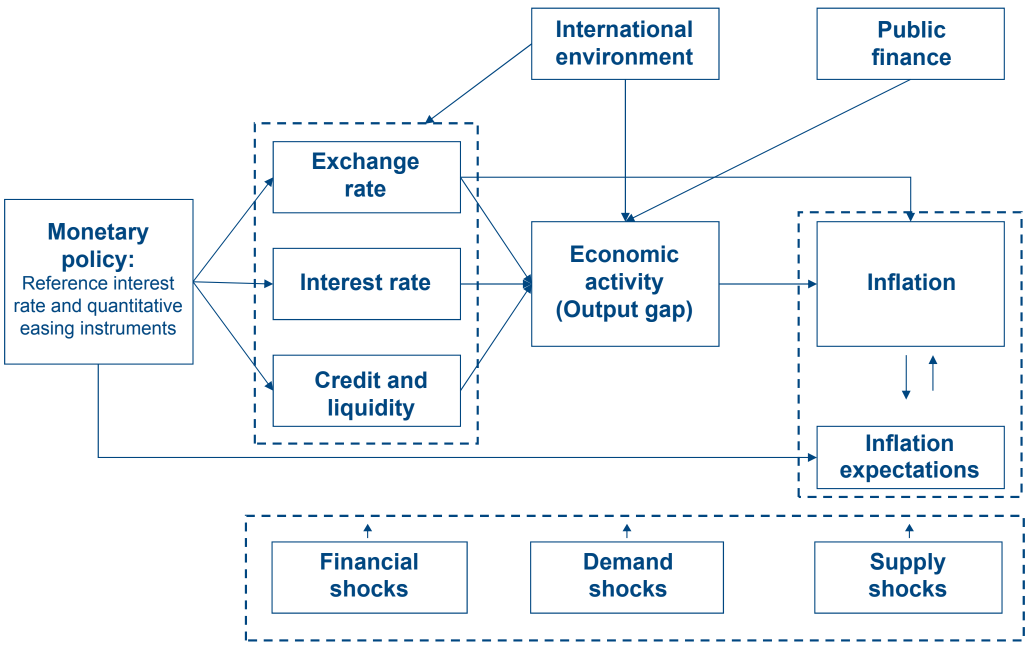
INFLATION REPORT:

Recent trends and macroeconomic forecasts 2012-2013



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INFLATION REPORT
Recent trends and macroeconomic forecasts

CENTRAL RESERVE BANK OF PERU

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March 2012

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 December 2011, and data on monetary accounts, inflation, financial markets, and foreign exchange rate as of February 2012.

Foreword

- According to 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 percent and 3.0 percent). The Central Bank's inflation target is aimed at anchoring inflation expectations at a similar level to the inflation rate in developed countries and reflects the BCRP's permanent commitment with monetary stability.

- The nature of monetary policy is preventive and therefore is 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 Central Bank considers the annual increase in the consumer price index recorded in each month and not only at year's end.

- Each month, and according to a previously announced schedule, the Board of the BCRP approves a reference rate for the interbank lending market. 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 a high level 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 June 2012.

Summary

i. Uncertainty in financial markets associated with the debt crisis in the Eurozone has declined since December due to the agreement reached regarding a second bailout program for Greece and due to the liquidity supply policy adopted by the European Central Bank. This decline in uncertainty has also been favored by the better-than-expected data of economic activity in developed countries (especially in the United States).

   Although the probability of a new global recession has decreased significantly, there are still risks associated with the problems in the Eurozone and with the rise in the price of oil registered recently. In this scenario, the rate of global growth in 2012 is still forecast at 3.3 percent. Even though growth in developed countries has been revised on the upside, this increase is offset by the slightly lower growth forecast in the emerging economies.

ii. During 2011, the Peruvian economy grew at a rate of 6.9 percent, showing a growth rate similar to the average one observed in the last eight years. After registering a rate of 8.8 percent in 2010, the pace of growth moderated during 2011 towards levels closer to the rate of the potential output, in line with the decline registered in the growth rate of domestic demand.

   A growth rate of 5.7 percent is estimated in the central forecast scenario for 2012 (5.5 percent in our previous Report) considering the higher terms of trade anticipated and the improvement foreseen in consumer and business expectations relative to our last Report. In 2013 GDP is forecast to grow 6.3 percent.

iii. In contrast with the deficit registered in 2010 (0.3 percent), in 2011 the non financial public sector (NFPS) recorded an economic surplus of 1.9 percent of GDP. This balance was associated, on the one hand, with the increase in the current revenues of the general government and, on the other hand, with the slowdown in the pace of growth of expenditure. A fiscal surplus of 1.1 percent of GDP is forecast for 2012. This projected surplus, which is similar to the one considered in our December Report and in the Multiannual Macroeconomic Plan (1.0 percent of GDP), implies a positive fiscal impulse of about 0.7 percentage points of GDP.

   For 2013, this report's baseline scenario considers a balance similar to the fiscal surplus of 1.4 percent of GDP estimated in the Revised Multiannual Macroeconomic Plan. This projection includes changes in revenue and expenditure consistent with a long term trend.

iv. The current account deficit in 2012 has been revised downwards and is now projected at 1.5 percent of GDP (2.2 percent in our December Report). This revision is mainly due to the improvement observed in terms of trade as a result of the rise in commodity prices, although this would be offset by an increased factor income associated with higher export prices. In 2013 the deficit in the current account would increase to 1.8 percent of GDP, a lower figure than the one estimated in our December Report (2.1 percent of GDP).

v. Showing transitorily levels above the inflation target, inflation in 2011 recorded a rate of 4.74 percent. This result was influenced by both external and domestic shocks that affected the prices of food products and fuels. Climate anomalies added onto the rise in the international prices of commodities observed since the last months of 2010, affecting the supply of some perishable farming products especially in the second semester of 2011. The 12-month change in the consumer price index declined from 4.74 percent in December 2011 to 4.17 percent in February 2012, reflecting the beginning of the reversal of the shocks that were observed in the previous year.

   Inflation excluding food and fuels –an indicator used internationally to exclude supply shocks–showed a rate of 2.4 percent in 2011 and declined to 2.2 percent at February of this year.

   As stated in our Inflation Report of December, the rate of inflation is expected to gradually converge to the target range since Q3-2012 if the cost pressures generated by significant increases in commodity prices subside and if inflation expectations remain within the target range. Moreover, the upward revision in the projection of fuel prices is considered in the inflation forecast.

vi. Between December and March the Board of the Central Bank maintained the reference interest rate at 4.25 percent, the same rate level maintained since May 2011. This level of the reference rate reflects a monetary policy position consistent with persisting uncertainty in international financial markets and with the reversal of the supply shocks that increased the rate of inflation during 2011.

   In contrast with our previous Report which considered a downward bias in the balance of risks in terms of inflation, a neutral balance of risks is considered in this report for inflation. This change takes into account the recent evolution of the world economy, the increased uncertainty about the evolution of oil prices, and the better prospects of the Peruvian economy.

vii. The **downward** risks in the inflation forecast are both external and domestic. The external risks are associated with the possibility that an international financial crisis may unfold, while the domestic risks are associated with a context of slower demand growth due to the postponement of some investment projects.

a. Uncertainty about the evolution of the world economy

The baseline scenario considers a lower growth rate in the world economy this year (3.3 percent vs. 3.7 percent in 2011) and a rate of 3.8 percent in 2013 after a recovery in the economy. The risk of a global recession has decreased in recent months due to the less pessimistic view that international markets have adopted in general vis-à-vis the Eurozone financial and fiscal problems. However, should such an adverse scenario develop, this situation would contribute to weaken external demand and affect the domestic economy through the financial and trade channels.

This scenario describes a drop in global economic activity coupled by a decline in the terms of trade. Additionally, a rise in global uncertainty could create panic among investors internationally and unfold a sudden reversal of external capitals with a real depreciation and an increase in the country risk indicator.

If these risks materialized, the Central Bank would use its available international reserves and the various mechanisms it has to inject liquidity in both domestic and foreign currency to offset the impact of such shocks on domestic financial conditions. The monetary policy stance in the forecast horizon would be expansionary to prevent deflationary risks.

b. Evolution of domestic demand.

In a scenario of higher uncertainty, there is the risk that domestic agents' expectations may deteriorate, especially in the case of investment, which could generate a lower dynamism in aggregate demand and lead the economy to grow below its potential growth rate generating downward pressures on core inflation. In this scenario, the Central Bank would ease its monetary position in order that inflation falls within the inflation target range.

On the other hand, there are two **risks on the upside** for inflation associated mainly with higher foreign capital inflows and higher commodity prices.

c. Increased capital inflows

The high availability of liquidity in international markets due to the aggressive expansion of central banks' balances in developed countries, together with the scarce attractive investment options observed in today's context of high global uncertainty, could lead to a flow of foreign capitals to emerging countries such as Peru, generating a similar situation to the one observed prior to the crisis that started towards the end of 2008. On the one hand, an increased capital inflow would accelerate the expansion of credit, thus stimulating aggregate demand

and inflation. On the other hand, this would cause appreciatory pressures on the foreign exchange rate that would translate into lower domestic inflation. It is estimated that the net effect of an increased capital inflow on inflation would be slightly positive.

In this scenario, the Central Bank would adjust its monetary policy including macroprudential policy instruments, such as the rates of reserve requirements, if a pace of credit expansion that could affect monetary and financial stability is perceived.

d. Imported inflation or adverse climate conditions

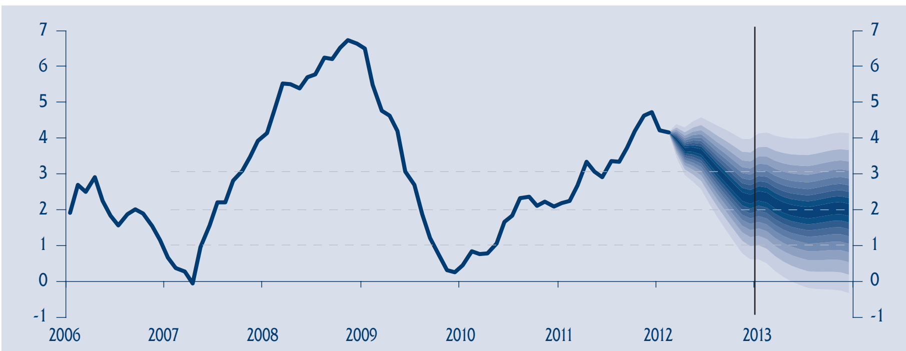
There is the risk that global inflationary pressures will be more persistent than currently estimated in the baseline scenario. Uncertainty about how policy makers will cope with financial problems, especially in the Eurozone, is having a strong impact on the level of global economic activity. A more determined and credible economic policy in most developed countries could generate a confidence shock, which could lead to higher global demand. If the shocks are persistent, they may affect the evolution of domestic inflation through higher imported costs, which could generate inflationary pressures.

The risk that oil and oil derivatives will show higher international prices has also increased due to the political tensions observed in the Middle East recently. In the domestic area, there is still the risk that adverse climate conditions may affect the normal supply of agricultural products.

In this scenario, the Central Bank would adjust its monetary position only if imported inflation affected economic agents' expectations of inflation.

In summary, the balance of these risks shows a neutral balance in the inflation forecast for end 2012.

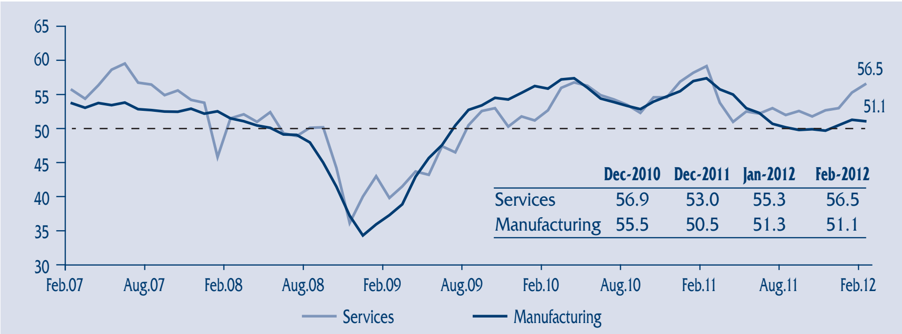
INFLATION FORECAST: 2012 - 2013
(Last 12 month % change)



I. International environment

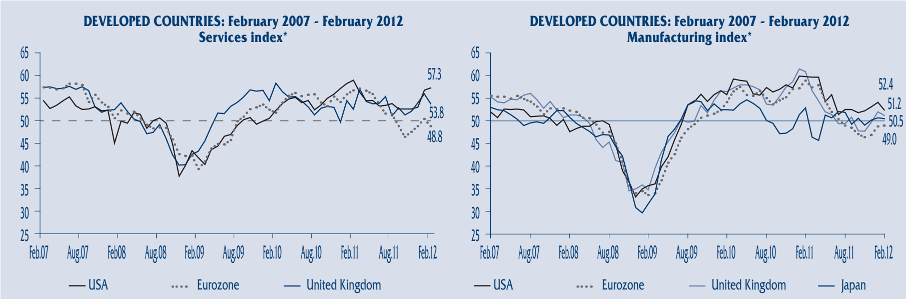
1. Global economic activity has had a positive evolution since our last Inflation Report was published. Aggregate indicators of activity, such as the global purchasing managers' index (PMI) recorded its highest level in a year, while the manufacturing index and the services index remained en the expansion area (over 50) for three and twelve consecutive months, respectively.

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



Source: Bloomberg.

Graph 2

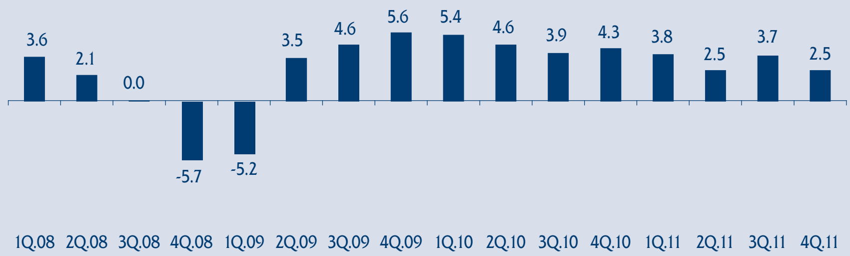


* PMI index.
Source: Bloomberg.

* PMI index.
Source: Bloomberg.

Other indicators of activity in the major developed countries –United States (USA), Germany, and Japan– show, in general terms, a better evolution than previously anticipated. Consumer confidence has improved due to expectations that low interest rates will be observed for quite a while, as well as due to the additional stimulus implemented in some economies. In line with this, global growth would have registered a recovery in Q1-2012 after having experienced a slowdown in Q4-2011.

Graph 3
QUARTERLY SEASONALLY ADJUSTED WORLD GDP GROWTH: 2008 -2011
(Annualized rates)



Source: JP Morgan.

2. As in our previous Inflation Report, the world economy is forecast to grow 3.3 percent in 2012 and 3.8 percent in 2013. The slightly higher growth rate estimated in developed countries –due to the evolution of activity in the United States and Germany, as reflected in recent indicators of activity– would be offset by a lower dynamism in emerging countries which, in many cases, continue to show inflationary pressures. Moreover, the estimated average GDP of our main trading partners has been revised on the upside from 2.7 to 2.9 percent for 2012 and from 3.1 to 3.2 percent for 2013.

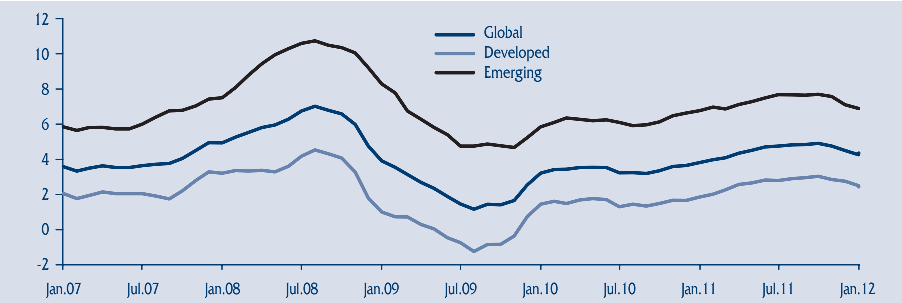
Table 1
WORLD GDP GROWTH
(Annual % change)

	2008	2009	2010	2011	2012		2013	
					IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
Developed countries	**0.1**	**-3.6**	**3.2**	**1.5**	**1.3**	**1.4**	**1.9**	**2.0**
Of which								
1. United States	-0.3	-3.5	3.0	1.7	1.8	2.3	2.1	2.4
2. Eurozone	0.4	-4.2	1.9	1.4	-0.6	-0.6	0.9	0.8
Germany	1.1	-5.1	3.7	3.0	0.1	0.2	1.2	1.2
France	-0.1	-2.7	1.5	1.7	-0.3	-0.2	0.8	0.8
3. Japan	-1.0	-5.5	4.4	-0.9	2.0	1.9	1.9	1.9
4. United Kingdom	-1.1	-4.4	1.8	0.9	0.9	0.3	1.6	1.2
Developing countries	**6.0**	**2.8**	**7.4**	**6.0**	**5.5**	**5.4**	**5.8**	**5.7**
Of which								
1. Developing Asia	7.8	7.2	9.5	7.7	7.4	7.2	7.6	7.5
China	9.6	9.2	10.4	9.2	8.2	8.2	8.4	8.2
India	6.2	6.8	10.1	7.1	7.5	7.1	7.7	7.7
2. Central and Eastern Europe	3.1	-3.6	4.5	4.9	2.8	2.2	3.5	3.3
3. Latin America and the Caribbean	4.3	-1.7	6.1	4.3	3.5	3.7	3.8	3.8
Brazil	5.2	-0.6	7.5	3.0	3.4	3.4	4.0	4.0
World Economy	**2.8**	**-0.6**	**5.2**	**3.7**	**3.3**	**3.3**	**3.8**	**3.8**
Memo:								
Trading partners 1/	2.6	-1.3	4.5	3.5	2.7	2.9	3.1	3.2
BRICs 2/	7.7	5.4	9.2	7.4	6.9	6.9	7.2	7.1

Source: Bloomberg, IMF, Consensus Forecast.
1/ Basket of Peru's 20 main trading partners.
2/ Brazil, Russia, India, and China.

The risks of a global recession have decreased compared to context discussed in our previous Inflation Report, even though uncertainty about some Eurozone countries remains, which implies a downward risk. A new risk factor is the increase in the price of crude which would imply a negative supply shock and higher inflationary pressures.

Graph 4
12 MONTH INFLATION: January 2007 - January 2012 (%)



Source: FMI.

Graph 5
GDP GROWTH: 2001-2013

* Forecast.

3. In **USA**, several indicators of activity, employment, and confidence confirm a better evolution than the one previously foreseen. Consumption continued recovering in Q4-2011 (with an expansion of 2.1 percent) and recent indicators of confidence show a positive evolution.

   These indicators are in line with the favorable evolution of employment, given that over 400 thousand jobs were created between January and February. Even though nearly 3.5 million jobs have been created since 2010, this figure represents only 40 percent of the jobs lost during the crisis.

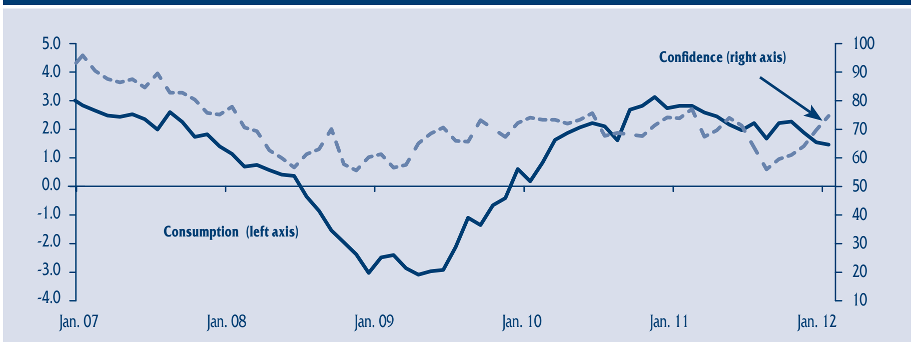
   Investment grew 20.6 percent in Q4-2011, although a significant part of this increase is explained by the accumulation of inventories. In contrast with other quarters, residential investment was more dynamic even though it was coupled by drops in the prices of houses in the month of January. Non-residential investment, on the other hand, declined in Q4.

Table 2
USA: SEASONALLY ADJUSTED GDP GROWTH (1Q.09-4Q.11)
(Quarterly annualized rates)

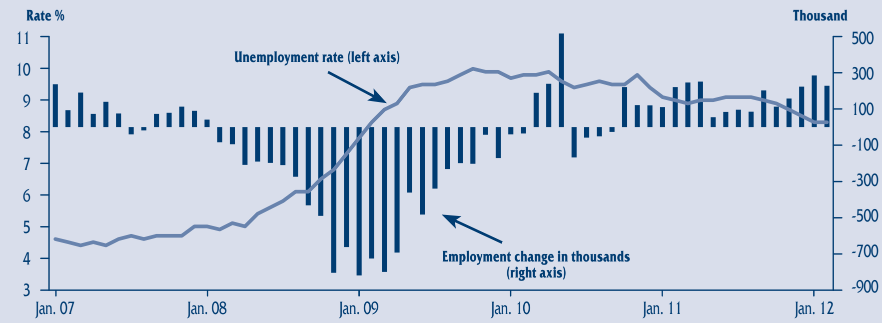
	1Q.09	2Q.09	3Q.09	4Q.09	1Q.10	2Q.10	3Q.10	4Q.10	1Q.11	2Q.11	3Q.11	4Q.11
GDP	**-6.7**	**-0.7**	**1.7**	**3.8**	**3.9**	**3.8**	**2.5**	**2.3**	**0.4**	**1.3**	**1.8**	**3.0**
Personal consumption	-1.5	-1.9	2.3	0.4	2.7	2.9	2.6	3.6	2.1	0.7	1.7	2.1
Durable	2.4	-4.0	20.3	-4.8	9.9	7.8	8.8	17.2	11.7	-5.3	5.7	15.3
Non Durable	-1.0	-1.5	2.0	3.1	4.8	1.9	3.0	4.3	1.6	0.2	-0.5	0.4
Services	-2.3	-1.7	-0.1	0.4	1.0	2.5	1.6	1.3	0.8	1.9	1.9	0.7
Gross investment	-46.7	-22.8	2.9	36.8	31.5	26.4	9.2	-7.1	3.8	6.4	1.3	20.6
Fixed investment	-32.2	-17.0	0.7	-3.8	1.2	19.5	2.3	7.5	1.2	9.2	13.0	4.3
Non Residential	-31.3	-15.8	-3.3	-3.7	6.0	18.6	11.3	8.7	2.1	10.3	15.7	2.8
Residential	-35.4	-21.3	17.8	-3.8	-15.3	22.8	-27.7	2.5	-2.4	4.2	1.3	11.5
Exports	-29.0	-0.5	13.9	23.5	7.2	10.0	10.0	7.8	7.9	3.6	4.7	4.3
Imports	-34.0	-15.0	16.3	17.4	12.5	21.6	12.3	-2.3	8.3	1.4	1.2	3.8
Government expenditure	-1.7	5.9	1.3	-0.9	-1.2	3.7	1.0	-2.8	-5.9	-0.9	-0.1	-4.4

Source: U.S. Bureau of Economic Analysis (BEA).

Graph 6
USA: REAL PERSONAL CONSUMPTION (12 month % change) AND CONSUMER CONFIDENCE (Index of Univ. Michigan)



Graph 7
USA: EMPLOYMENT AND UNEMPLOYMENT RATE



Source: Bloomberg.

These better indicators of activity, employment, and confidence were observed in a context of lower inflationary pressures. Total CPI inflation closed 2011 recording a rate of below 3 percent and core inflation showed a rate of 2.3 percent, while inflation expectations remained stable at 3 percent. In its last communiqué, the Federal Reserve (FED) confirmed that it would probably maintain low interest rates at least until end 2014.

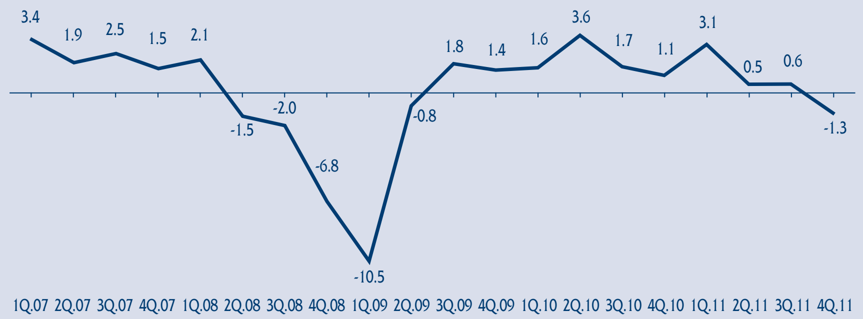
Monetary stimulus will continue to be maintained in a context of a reduction of the fiscal deficit during the next years. It should be pointed out that the fiscal consolidation measures for the next 10 years are still in the process of being discussed. Lack of political agreement in this area, which could lead to a disorderly adjustment of fiscal accounts, is a risk factor for growth.

In this context, the forecast on growth in USA in 2012 has been revised upwards, from 1.8 percent (Inflation Report of December 2011) to 2.3 percent, in line with the execution in Q4-2011, with the gradual improvement of the labor market and of activity and confidence indicators, with the Federal Reserve's continued monetary stimulus, and with lower uncertainty in the Eurozone countries.

4. Growth prospects in the **Eurozone** have been affected by the sovereign debt crisis. The worsening of financial conditions, the fiscal adjustments implemented, and the deterioration of confidence explain this unfavorable evolution of activity in this region. Most investors estimate that the contraction registered in Q4-2011 would extend at least until the first semester of this year.

   In Q4-2011, GDP in the Eurozone recorded a contraction of 1.3 percent (annual quarterly rate). Moreover, recent indicators of activity in the areas of manufacturing and services also show that recession has continued affecting this region in Q1-2012.

Graph 8
EUROZONE: QUARTERLY GDP EVOLUTION
(Seasonally adjusted annualized rates)



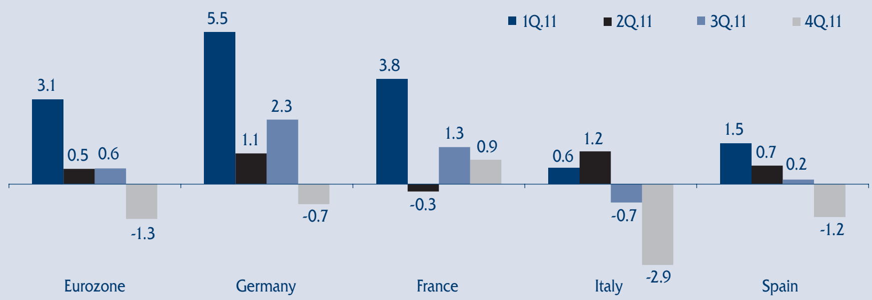
Source: Bloomberg.

However, significant differences are observed by countries. The most important economies, Germany and France, had a better-than-expected performance in Q4-2011: economic activity in France grew 0.9 percent, whereas Germany showed a slight contraction that was lower than anticipated (0.7 percent versus 1.2 percent).

In Germany, the growth of investment –especially investment in construction– has been a determining factor in the GDP result in Q4-2011, while the recovery of investors' confidence and the maintenance of conditions in the labor market have played a role in recent months. However, German exports in Q4-2011 and manufacturing export orders in the first two months of this year would be indicating that risks for growth remain in the region's major economy.

On the other hand, the economies with debt problems have recorded significant contractions that are higher than expected in the market (Portugal's contraction of 5 percent stands out in this sense). Recent indicators show that these different trends have continued so far this year.

Graph 9
EUROZONE: QUARTERLY GROWTH
(Seasonally adjusted annualized quarterly rates)



Source: Bloomberg.

In line with these developments, a slight contraction (0.6 percent) is still forecast in the Eurozone in 2012, Germany being the only exception as this country would be the only one to show some expansion. Our forecasts on growth in Germany and France, the two largest economies in this region, have been corrected slightly upwards relative to our previous Report. Even though the risk is lower than in our previous report, the main risk for this forecast is still the sovereign debt crisis since uncertainty about the fiscal sustainability of some economies persists despite the improvements made recently.

5. The growth of GDP in **Japan** was negative in 2011 (-0.9 percent) due mainly to the natural disasters that affected the country in March (earthquake) and in October (floods in Thailand interrupted the logistics supply chain, affecting exports in the entire Asian region). Only in Q3 was a positive growth rate observed in the economy (7 percent in annual terms) due to the fiscal and monetary stimulus implemented. Activity contracted again in Q4-2011 (2.3 percent) due to Europe's financial problems and to the natural disasters that Thailand continued to suffer.

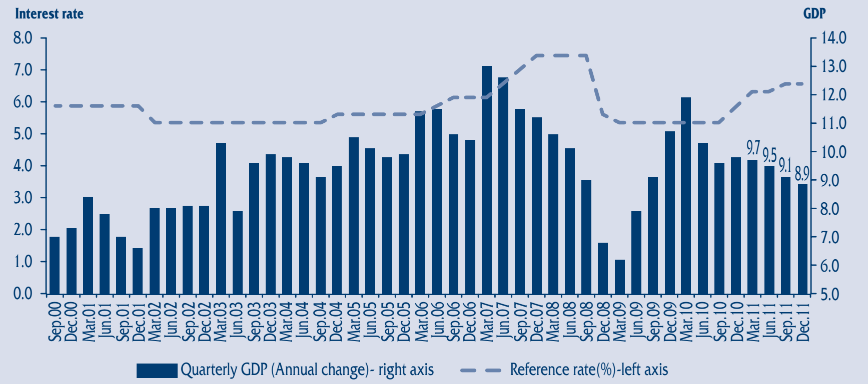
   Japan is expected to resume its growth path in 2012 as soon as the problems in Europe start being resolved and the effects of natural disasters are overcome. For these reasons, the growth forecast for Japan in 2012 and 2013 remains at 1.9 percent.

6. Emerging countries are expected to continue growing at high rates during 2012 and 2013 due mainly to the growth of investment in emerging Asian countries. This region is estimated to continue growing at rates of over 7 percent.

   In 2012 **China** would continue showing high growth rates (8.2 percent) due to the dynamism of public and private investment, but would slow down compared to 2011 (9.2 percent) due to the lower dynamism of the external sector –a third of China's trade is carried out with Europe– and due to the measures adopted by the authorities in order to prevent the formation of price bubbles in the assets markets. China implemented a series of measures in 2011 due to the likelihood of an overheating in the real estate sector, the growth of bank credit, and rising inflation. Among others, these measures included restrictions on purchases of a second or third house, higher mortgage installments, limits on bank loans by banking entity, and increasing interest rates and the rates of reserve requirements.

   More recently, the Chinese authorities have revised their estimated growth rate for 2012 from 8.0 to 7.5 percent in their XII Five-Year Plan (2012-2017). This rate is not an objective, but this is a sign that is telling the market that the dynamism of the Chinese economy must gradually decline. In the last decade, for example, China grew at an average rate of 9.4 percent (8.7 percent in 2000-2005 and 10.2 percent in 2006-2010), while the rate announced by the government was 8.0 percent.

Graph 10
CHINA: QUARTERLY GDP GROWTH AND REFERENCE RATE



Source: Bloomberg.

TABLE 3
CHINA'S ECONOMIC INDICATORS: 2010 - 2012

	2010	2011				2012
	December	March	June	September	December	February
Manufacturing PMI (50 neutral level)	53.9	53.4	50.9	51.2	50.3	51.0
Industrial Production (12 month % change)	13.5%	14.8%	15.1%	13.8%	12.8%	11.5%
Inverstment in fixed assets (12 month % change)	24.5%	25.0%	25.6%	24.9%	23.8%	21.5%
Retail sales (12 month % change)	19.1%	17.4%	17.7%	17.7%	18.1%	14.7%
Exports(12 month % change)	17.9%	35.8%	17.9%	17.1%	13.4%	18.4%
Imports (12 month % change)	25.6%	27.3%	19.3%	20.9%	11.8%	39.6%
New loans (Billions of yuan)	481	679	634	470	641	711
CPI (12 month % change)	4.6%	5.4%	6.4%	6.1%	4.1%	3.2%
Food prices (12 month % change)	9.6%	11.7%	14.4%	13.4%	9.1%	6.5%

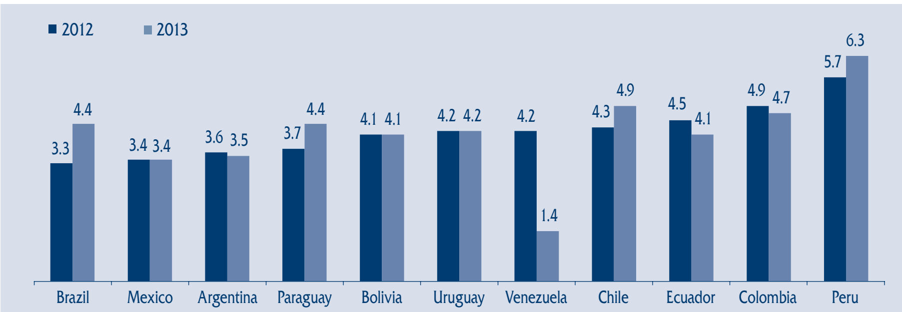
Source: Bloomberg.

7. In **Latin America**, monthly indicators of activity and industrial production show some slowdown of growth during the first two months of the year. The region is expected to grow 3.7 percent in 2012, showing a lower rate than the one recorded last year (4.3 percent).

   These results reflect the continuation of the trend that started in 2011 when the pace of economic growth slowed down over the year. Growth, which was led by domestic demand, was offset by the increasingly lower external stimulus and growth of the industrial sector. Of the countries with inflation targeting, Chile and Colombia registered the highest growth rates in comparison with the previous year. In Brazil, growth slowed down due to the weakening of consumption and private investment.

Inflationary pressures (due both to supply and to demand factors) have also been observed in the region. Because of this, many Latin American countries have decided to raise interest rates during the first semester of 2011 and make a pause in the withdrawal of monetary stimulus as from the second semester. However, the different degrees of slowdown of these economies have determined different policy reactions. Thus, while Brazil has cut its policy rate by 225 bps since August, the Central Bank of Colombia has raised it by 50 bps so far this year.

Graph 11
LATIN AMERICA: GDP GROWTH FORECAST*



* Consensus Economics and BCRP (Peru).

Eastern Europe registered on average a moderate growth in 2011, with marked differences as in the cases of Hungary and Turkey, which are estimated to have grown 1.6 and 8.1 percent, respectively. In 2012 and 2013 this region would grow at lower rates due mainly to the evolution of the Eurozone, this effect being partially offset by the high prices of commodities such as oil and gas.

Financial markets

8. Financial markets were strongly influenced by uncertainty about Greece and other Eurozone countries with debt problems. At the time of writing this report, market volatility has declined. The VIX index has dropped from levels of 23 at end 2011 to 18 in early March. In addition to lower risk aversion after the arrangement reached with Greece, this result would be reflecting better prospects for global growth, and particularly for some of the major developed economies, such as USA and Germany. The indicators of the sovereign debt, money, foreign exchange, and global stock exchange markets have reflected this lower risk aversion.

Graph 12
RISK AVERSION COEFFICIENT: VIX (S&P'500)
(January 2008 - March 2012)

Source: Bloomberg.
1 / The coefficient of implied volatility is derived from options market in the S&P'500. The ratio measures measures the risk aversion in the stock markets.

9. Financial conditions in **sovereign debt** markets have improved significantly, and especially in the case of Italian markets which were being affected by fears of contagion. The fiscal adjustment measures and structural reforms announced, and the new fiscal agreement and the monetary policy measures adopted by the European Central Bank (ECB) have positively influenced the evolution of these markets, although without reaching yet the conditions observed prior to the debt crisis.

Table 4
SOVEREIGN SPREADS OF DEVELOPED COUNTRIES

	End of period					Change in bps			
	Dec.08 (5)	Dec.09 (4)	Dec.10 (3)	Dec.11 (2)	Mar.12* (1)	Dec.11 (1)/(2)	Dec.10 (1)/(3)	Dec.09 (1)/(4)	Dec.08 (1)/(5)
CDS (pbs)									
USA	67	38	42	49	32	-17	-10	-6	-35
United Kingdom	107	83	74	98	61	-37	-13	-22	-46
Germany	46	26	59	102	72	-31	12	45	26
France	54	32	107	220	174	-46	67	142	120
Spain	101	113	348	380	405	24	57	291	304
Italy	157	109	238	484	366	-118	128	257	209
Greece	232	283	1,026	8,786	25,423	16,636	24,396	25,139	25,191
Portugal	96	92	497	1,082	1,323	242	826	1,232	1,227
Ireland	181	158	619	724	632	-93	12	474	451
10 Year Treasury yields (%)									
USA	2.21	3.84	3.29	1.88	2.28	40	-101	-156	7
United Kingdom	3.02	4.02	3.40	1.98	2.37	39	-103	-165	-65
Germany	2.95	3.39	2.96	1.83	1.97	14	-99	-142	-98

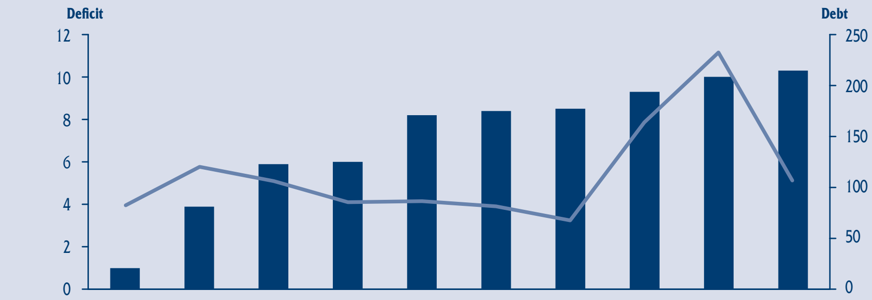
Source: Bloomberg.
*Up to March 15.

Financial conditions in the countries with bailout programs (Greece, Portugal, and Ireland) show no sign of recovery and continue reflecting a weak position. There is still uncertainty about long term financial soundness in Greece, Portugal, and Ireland.

In Greece, the debt restructuring and other additional fiscal adjustment measures have not been able to reverse fears of insolvency. In Portugal and Ireland, despite the positive results obtained in the evaluation of the programs carried out with the IMF/EU/ECB (the fiscal goals are being met), there are still fears that Portugal will need a Private Sector Involvement (PSI) program similar to the one implemented with Greece and that the result in Ireland's next referendum on a new fiscal treaty will prevent, in the future, Ireland's access to the European Stability Mechanism (ESM), the European bailout fund. The signature of a new fiscal treaty is a requirement to receive resources from the European fund. The fiscal treaty implies a structural fiscal deficit limit of 0.5 percent of GDP for each country, which will imply a penalty of up to 0.1 percent of GDP if the limit is not met, and a gradual reduction of the debt ratio to 60 percent of GDP. This treaty was approved by the main European leaders in February and ratified in the summit in March.

Financial conditions in Spain improved significantly until late February. However, since March, market conditions worsened when the fiscal deficit goal for this year was modified from its original level of 4.4 percent to 5.3 percent of GDP (after having a level of 8.5 percent in 2011) following the negotiation between the government and the European leaders.

Graph 13
DEVELOPED COUNTRIES DEFICIT AND DEBT: 2011*
(% of GDP)



	Germany	Italy	Portugal	France	USA	UK	Spain	Greece	Japan	Ireland
Deficit	1.0	3.9	5.9	6.0	8.2	8.4	8.5	9.3	10.0	10.3
Debt	82	120	107	85	86	81	69	165	233	105

* Preliminary data.
Source: Moody´s, IMF and Investment banks.

Table 5
INDICATORS OF SOME EUROPEAN COUNTRIES

	2008	2009	2010	2011
Countries under the EU/IMF program				
Greece				
Growth (%)	-0.2	-3.3	-3.5	-6.9
CDS Spreads (bps) 1/	232	286	1,010	8,786
Fiscal result (% of GDP)	-10.0	-15.7	-10.6	-9.3
Debt ratio (% of GDP)	113	129	145	165
Annual average inflation (%)	4.1	1.2	4.7	3.3
Unemployment (%)	8.9	10.2	14.8	21.0
Ireland				
Growth (%)	-3.0	-7.0	-0.4	0.9
CDS Spreads (bps) 1/	181	158	609	724
Fiscal result (% of GDP)	-7.3	-14.2	-31.3	-10.3
Debt ratio (% of GDP)	44	65	93	105
Annual average inflation (%)	4.1	-4.5	-1.0	2.6
Unemployment (%)	8.6	13.1	14.6	14.3
Portugal				
Growth (%)	0.0	-2.9	1.4	-1.6
CDS Spreads (bps) 1/	96	92	501	1,082
Fiscal result (% of GDP)	-3.7	-10.1	9.8	-5.9
Debt ratio (% of GDP)	72	83	93	107
Annual average inflation (%)	2.6	-0.8	1.3	3.7
Unemployment (%)	7.8	10.1	11.1	14.0
Countries without the EU/IMF program				
Spain				
Growth (%)	0.9	-3.7	-0.1	0.7
CDS Spreads (bps) 1/	101	114	350	380
Fiscal result (% of GDP)	-4.1	-11.1	-9.2	-8.5
Debt ratio (% of GDP)	40	53	61	69
Annual average inflation (%)	4.1	-0.2	2.0	3.2
Unemployment (%)	13.9	18.8	20.3	22.9
Italy				
Growth (%)	-1.2	-5.5	1.8	0.4
CDS Spreads (bps) 1/	157	109	240	484
Fiscal result (% of GDP)	-2.7	-5.3	-4.6	-3.9
Debt ratio (% of GDP)	106	116	119	120
Annual average inflation (%)	3.3	0.8	1.5	2.8
Unemployment (%)	6.9	8.3	8.3	8.1

1/ End of period data.
Source: Eurostat, IMF, Moody's and others.

10. Lower risk aversion has also favored the evolution of Latin American countries' debt markets. Reversing the trend observed in Q4-2011, credit spreads in the region show a downward trend since January. The greatest corrections in the EMBIG and CDS spreads have been observed in Brazil and Chile, respectively.

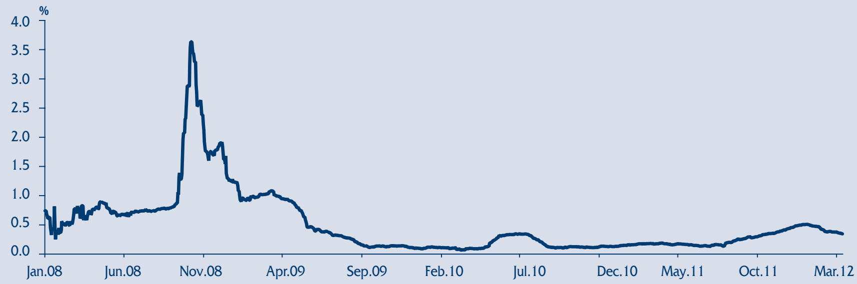
Table 6
SOVEREIGN SPREADS OF EMERGING MARKETS

	End of period data						Difference of March against to:			
	Dec.07	Dec.08	Dec.09	Dec.10	Dec.11	Mar.12	Dec.11	Dec.10	Dec.09	Dec.08
EMBIG (bps.)										
Peru	178	509	165	165	216	152	-64	-13	-13	-357
Brazil	220	429	189	189	225	169	-56	-20	-20	-260
Chile	151	343	95	115	172	146	-26	31	51	-197
Colombia	195	498	203	172	191	142	-49	-30	-61	-356
Emerging	255	724	294	289	426	323	-104	34	28	-402
CDS (bps.)										
Peru	116	303	124	113	172	121	-51	8	-3	-181
Brazil	103	299	123	111	161	121	-39	10	-2	-177
Chile	30	203	69	84	132	89	-43	5	20	-114
Colombia	130	308	144	113	154	110	-44	-3	-34	-198
Mexico	70	292	134	113	153	113	-40	0	-21	-179

Source: Bloomberg.
*Up to March15.

11. Conditions in **money markets** have improved substantially, particularly in European markets. As reported in our December Report, conditions in the U.S. money market continued reflecting the low interest rates in USA and the limited exposure of American banks to the European debt crisis.

Graph 14
SPREAD BETWEEN THE 3-MONTH US$-LIBOR RATE AND O/N OF SWAP MARKET (OIS) (%)
(January 2008 - March 2012)



Source: Bloomberg.
1/ These spreads measure the conditions in interbank markets in the respective currency. A higher spread indicates worse conditions in the interbank markets.

On the other hand, conditions in European markets have improved significantly. European interbank rates have been declining due to the two 3-year liquidity injection operations made by the ECB (489 billion in December 2011 and 530 billion in February 2012) and the easing of credit requirements for the collaterals used by banks.

This increased expansion of liquidity by the ECB has implied that its balance has reached record levels (€3 trillion) and that, in GDP terms (32 percent), it has exceeded that of the major central banks (FED: 19 percent, Bank of England: 21 percent, Bank of Japan: 30 percent). With this, the balance of ECB loans to banks (through its main refinancing operations) has reached a record level of € 1.2 trillion and registered an average maturity of 976 days. The banks that have favored the most have been the Spanish and Italian banks. Moreover, this expansion of liquidity has, for the time being, returned to the ECB as remunerated overnight (O/N) deposits. After the second injection of liquidity by the ECB, banks' overnight deposits at the European Central Bank reached a record level of € 821 billion.

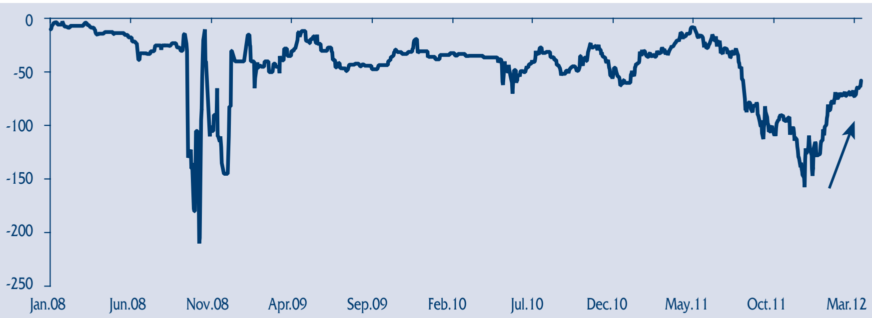
Banks in countries without bailout programs have started to get credit in the market. For example, the market of US funds has increased again its share in French banks since January of this year.

In this context, the main indicators of the money market reflect lower bank credit risks. The spread between the interbank rates (Euribor) and the overnight rates in the swaps market (OIS) have decreased. As previously observed, the spreads of the foreign exchange swap rates have also improved for credit in dollars.

Graph 15
SPREAD BETWEEN THE 3-MONTH EURO-LIBOR RATE AND O/N OF SWAP MARKET (OIS) (%)
(January 2008 - March 2012)

Source: Bloomberg.
1/ These spreads measure the conditions in interbank markets in the respective currency. A higher spread indicates worse conditions in the interbank markets.

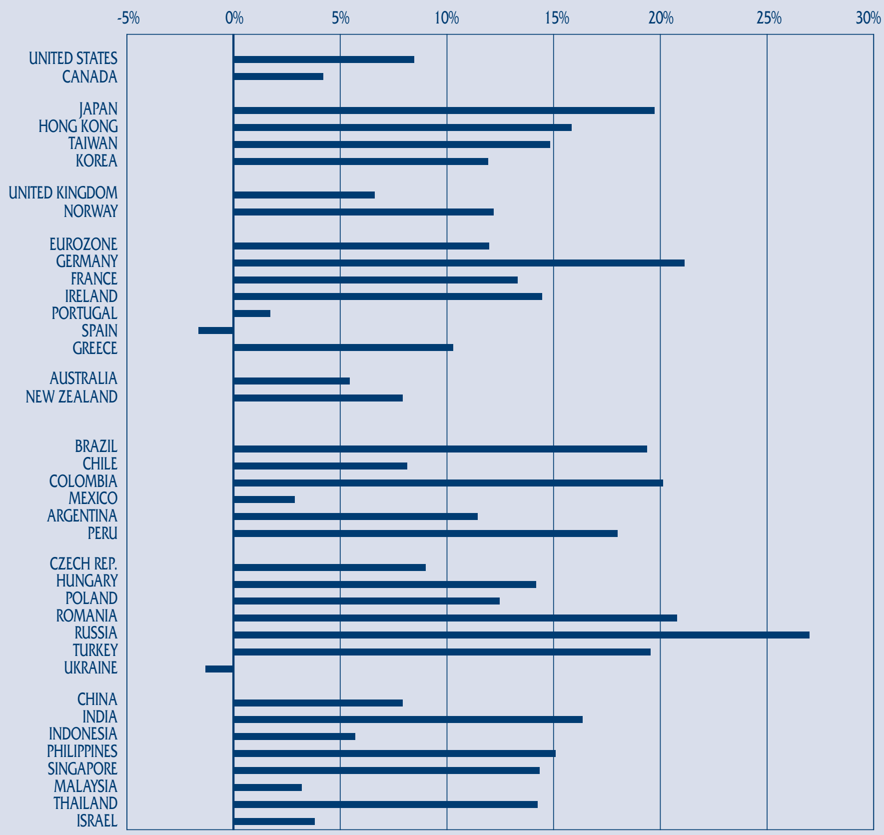
Graph 16
3 MONTH EURO/DOLAR BASIS SWAP 1/
(January 2008 - March 2012)



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

12. Year-to-date, the main stock markets have registered gains and, in some cases, have been able to reverse the losses observed in 2011. In developed countries, the positive results of Japan's Stock Exchange (in part due to the depreciation of the yen) and Germany's Stock Exchange (in part due to the better financial conditions associated with the evolution of the debt crisis) stand out, while in the emerging countries the stock markets with better results in the Latin American region include the bourses of Colombia, Brazil, and Peru, as well as the bourses of Russia and Turkey in Europe. The rise in the prices of commodities (metals and crude) and lower risk aversion would account for this better evolution in the stock markets of emerging economies.

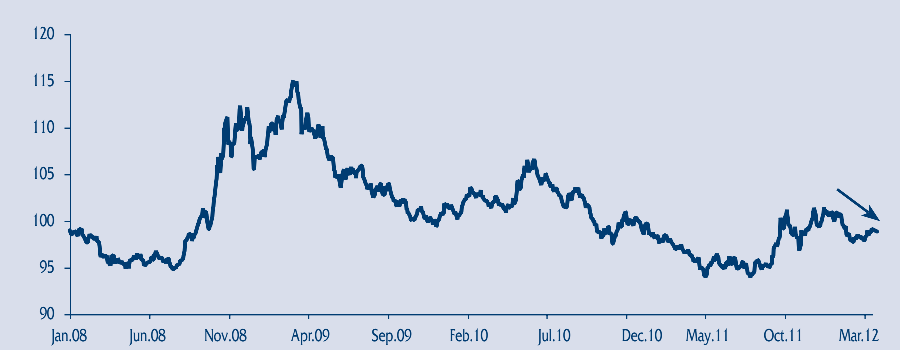
Graph 17
STOCK MARKETS
(End of period; % Chg. Mar.12 respect to Dec.11)



Source: Bloomberg.

13. The US dollar has started to reverse slightly the appreciation observed during 2011 due basically to the reduction of risk aversion and to low interest rates in USA. According to the currency basket elaborated by the FED (considering the currencies of USA's main trading partners), the dollar has depreciated around 2 percent so far this year.

Graph 18
US DOLLAR INDEX*
(January 2008 - March 2012)



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

Moreover, the dollar's depreciatory trend against the currencies of the main developed countries has been limited basically by the monetary easing measures adopted by the major central banks. Thus, for example, the depreciation of the dollar against the pound and the euro (about 1 percent) was limited by the measures implemented by the ECB and the BoE. To counterbalance the effects of the sovereign debt crisis in the Eurozone, the former has been increasing liquidity significantly (since end 2011) and the latter has increased its asset purchase program by £50 billion (from £275 billion to £325 billion).

On the other hand, the dollar has appreciated 5 percent against the yen. The reasons accounting for this included that the BoJ increased its asset purchase program (by 10 trillion yens, the Japanese government's signals of foreign exchange intervention to prevent the appreciation of the yen, and the worsening of growth prospects for Japan.

14. With the exception of the Argentine peso, year-to-date the currencies of Latin American countries have appreciated against the dollar due to the higher net inflow of capitals, lower risk aversion, and the rise in the prices of commodities. The appreciation of the Colombian peso (8.1 percent) and the Mexican peso (6.8 percent) are worth pointing out. The evolution of the Colombian peso is explained by the rise in the price of oil, by the decision of the Central Bank of Colombia to raise its policy rate (50 bps. so far this year), and by significant investment flows. On the other hand, the Mexican currency has appreciated mainly due to the better prospects of the U.S. economy.

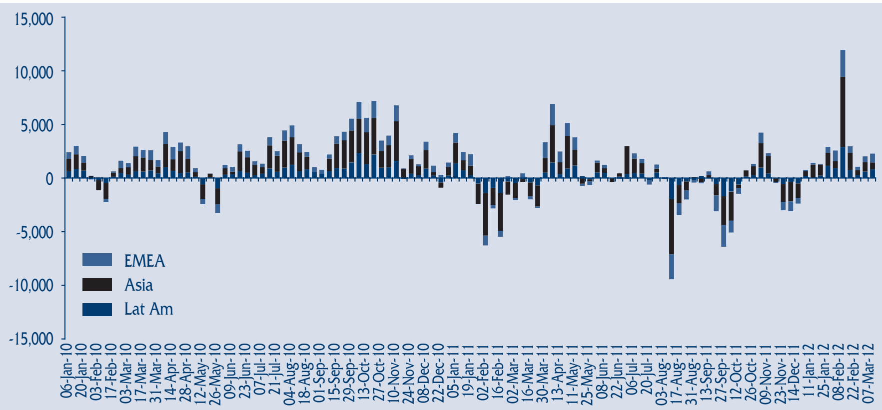
In this context, the central banks in the region have taken measures to offset appreciatory pressures. Colombia has activated again the program of daily spot purchases of US$ 20 million, extending it until August of this year. In Brazil, the Central Bank has repeatedly intervened in the foreign exchange market and in the spot and derivatives market to counterbalance the appreciation of the local currency and the government has adopted other measures to offset capital inflows to the country, such as including foreign loans and bonds as part of the operations subject to a tax on financial operations.

Table 7
EXCHANGE RATE
(End of período)

	c.u. per US$						% Chg. compared to:	
	Dec.07	Dec.08	Dec.09	Dec.10	Dec.11	Mar.12 *	Dec.11	Dec.10
Canada	0.996	1.217	1.052	0.997	1.019	0.992	-2.7	-0.5
Japan	111.33	90.60	92.90	81.15	76.94	83.50	8.5	2.9
United Kingdom (US$/c.u.)	1.985	1.463	1.616	1.560	1.554	1.571	1.1	0.7
Eurozone (US$/c.u.)	1.459	1.398	1.432	1.338	1.295	1.308	1.0	-2.2
Switzerland	1.1335	1.0669	1.0355	0.9335	0.938	0.923	-1.6	-1.2
Brazil	1.779	2.313	1.743	1.659	1.863	1.798	-3.5	8.4
Chile	497.7	635.5	507.2	467.8	519.3	481.9	-7.2	3.0
Colombia	2,017	2,246	2,040	1,915	1,936	1,760	-9.1	-8.1
Mexico	10.89	13.65	13.06	12.36	13.95	12.66	-9.3	2.4
Argentina	3.151	3.454	3.799	3.979	4.302	4.353	1.2	9.4
Peru	2.999	3.136	2.890	2.808	2.697	2.673	-0.9	-4.8
Hungary	172.83	188.30	187.96	208.15	243.28	222.14	-8.7	6.7
Poland	2.47	2.96	2.86	2.96	3.44	3.15	-8.5	6.5
Russia	24.57	30.53	30.31	30.57	32.19	29.35	-8.8	-4.0
Turkey	1.17	1.54	1.50	1.54	1.88	1.80	-4.7	16.8
China	7.30	6.82	6.83	6.59	6.29	6.33	0.5	-4.0
India	39.38	48.58	46.40	44.70	53.01	50.28	-5.1	12.5
Israel	3.85	3.78	3.79	3.52	3.81	3.77	-1.1	6.9

Source: Bloomberg and Reuters.
* Up to March 15.

Graph 19
PORTFOLIO FLOWS TO EMERGING ECONOMIES*
(Weekly flows. Millions of US$)



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

Monetary policy decisions

15. So far in 2012, most central banks have maintained their interest rates unchanged in a context of uncertainty about the evolution of Europe's financial crisis. Of the 32 countries we do a follow-up on, 14 did not modify their interest rates and 8 lowered their rates (Brazil stands out in the latter group with a rate cut of 125 bps.). In contrast, so far this year Colombia has raised its rate by 50 bps. due to the dynamism of its economic activity since Q4-2011 and to the accelerated growth of credit.

Table 8
MONETARY POLICY INTEREST RATE

							Accumulated change (bps.)			
	Sep.08	Dec.08	Dec.09	Dec.10	Dec.11	Mar.12	Dec.11	Dec.10	Dec.09	Sep.08
Countries that have kept rates in the first quarter of 2012										
Australia	7.00	4.25	3.75	4.75	4.25	4.25	0	-50	50	-275
BCE	4.25	2.50	1.00	1.00	1.00	1.00	0	0	0	-325
Canada	3.00	1.50	0.25	1.00	1.00	1.00	0	0	75	-200
South Korea	5.25	3.00	2.00	2.50	3.25	3.25	0	75	125	-200
United States	2.00	0.25	0.25	0.25	0.25	0.25	0	0	0	-175
Hungary	8.50	10.00	6.25	5.75	7.00	7.00	0	125	75	-150
India	9.00	6.50	4.75	6.25	8.50	8.50	0	225	375	-50
Iceland	15.50	18.00	10.00	4.50	4.75	4.75	0	25	-525	-1,075
Japan	0.50	0.10	0.10	0.10	0.10	0.10	0	0	0	-40
Malaysia	3.50	3.25	2.00	2.75	3.00	3.00	0	25	100	-50
Mexico	8.25	8.25	4.50	4.50	4.50	4.50	0	0	0	-375
New Zealand	7.50	5.00	2.50	3.00	2.50	2.50	0	-50	0	-500
Pakistan	13.00	15.00	12.50	14.00	12.00	12.00	0	-200	-50	-100
Peru	6.50	6.50	1.25	3.00	4.25	4.25	0	125	300	-225
Poland	6.00	5.00	3.50	3.50	4.50	4.50	0	100	100	-150
United Kingdom	5.00	2.00	0.50	0.50	0.50	0.50	0	0	0	-450
South Africa	12.00	11.50	7.00	5.50	5.50	5.50	0	0	-150	-650
Switzerland	2.75	0.50	0.25	0.25	0.25	0.25	0	0	0	-250
Taiwan	3.50	2.00	1.25	1.63	1.88	1.88	0	25	63	-163
Turkey	16.75	15.00	6.50	6.50	5.75	5.75	0	-75	-75	-1,100
Countries that have increased rates in the first quarter of 2012										
Colombia	10.00	9.50	3.50	3.00	4.75	5.25	50	225	175	-475
Countries that have reduced rates in the first quarter of 2012										
Brazil	13.75	13.75	8.75	10.75	11.00	9.75	-125	-100	100	-400
Chile	8.25	8.25	0.50	3.25	5.25	5.00	-25	175	450	-325
Philippines	6.00	5.50	4.00	4.00	4.50	4.00	-50	0	0	-200
Indonesia	9.25	9.25	6.50	6.50	6.00	5.75	-25	-75	-75	-350
Israel	4.25	2.50	1.25	2.00	2.75	2.50	-25	50	125	-175
Norway	5.75	3.00	1.75	2.00	1.75	1.50	-25	-50	-25	-425
Serbia	15.75	17.75	9.50	11.50	9.75	9.50	-25	-200	0	-625
Sweden	4.75	2.00	0.25	1.25	1.75	1.50	-25	25	125	-325
Thailand	3.75	2.75	1.25	2.00	3.50	3.00	-50	100	175	-75
Countries that have not met in the first quarter of 2012										
China	7.20	5.31	5.31	5.81	6.56	6.56	0	75	125	-64
Uruguay	7.25	7.75	6.25	6.50	8.75	8.75	0	225	250	150

Source: Reuters and Bloomberg.

Terms of trade and prices of commodities

16. During 2011 the prices of commodities were favored by the high international levels of liquidity, low inventory levels, and some supply constraints, particularly in the first semester of the year. This trend was offset by the liquidation of non commercial positions generated by the higher risk aversion associated with the Eurozone crisis and fears of lower global growth.

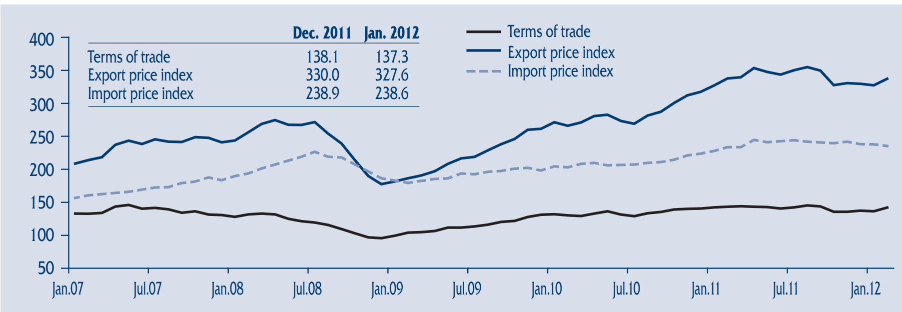
In 2011 the **terms of trade** increased 5 percent given that the prices of our exports products rose more than the prices of our imports, particularly in the first semester of the year. In Q4-2011, the recovery of terms of trade is explained by the greater downward correction observed in the prices of imports, especially food imports.

The prices of our exports recorded a rise of 20 percent in 2011. The rise in the price of gold stands out since this rise was favored by investors' increased demand for gold as a hedge asset in a context of high international liquidity and global risk aversion. The prices of imports rose 14 percent, mainly due to the rise in the prices of crude and food products such as maize and soybean oil.

So far this year, terms of trade have continued to show the upward trend initiated in November, mainly as a result of the rising price of copper that is driven by favorable data of growth and manufacturing activity in USA and China. Because a slight price correction is estimated for the rest of the year, terms of trade are foreseen to decline by 1.4 percent on average in 2012 and to rise by 0.4 percent in 2013.

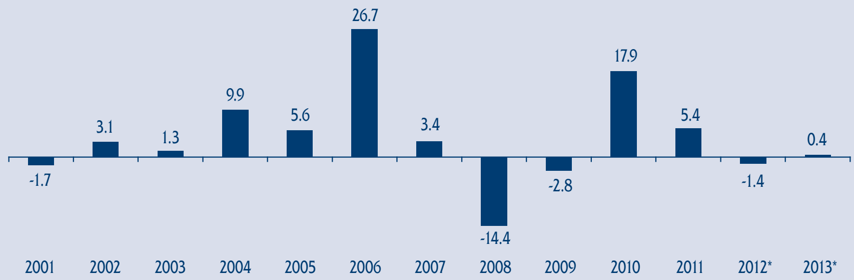
On average, export prices would register a lower decline in 2012 due mainly to the higher prices of copper expected today in comparison to the ones estimated in our Report of December. On the other hand, import prices would show a slightly higher decline than previously estimated, in line with the lower external inflation expected which would be partially offset by the upward adjustment in food prices.

Graph 20
TERMS OF TRADE, EXPORT AND IMPORT PRICE INDICES: JANUARY 2007 - FEBRUARY 2012
(1994=100)



	Dec. 2011	Jan. 2012
Terms of trade	138.1	137.3
Export price index	330.0	327.6
Import price index	238.9	238.6

Graph 21
TERMS OF TRADE: 2001 - 2013
(% change)



* Forecast.

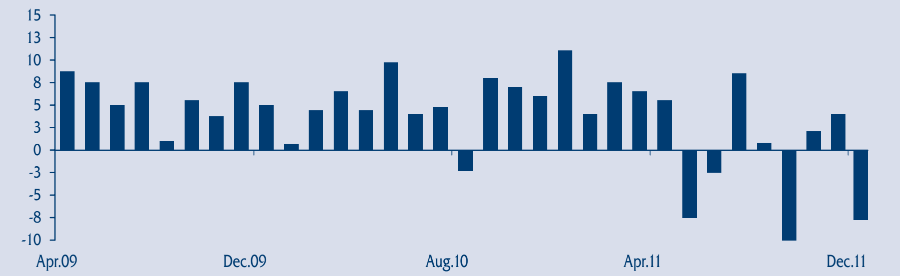
Table 9
TERMS OF TRADE: 2010 - 2013
(Annual average data)

	Executed		2012		2013	
	2010	2011	IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
Terms of trade 1/	**17.9**	**5.4**	**-5.8**	**-1.4**	**0.6**	**0.4**
Price of exports 1/	**29.9**	**20.0**	**-6.1**	**-1.9**	**1.2**	**0.9**
Copper (US$ cents per pound)	342	400	345	382	346	385
Zinc (US$ cents per pound)	98	100	91	93	94	95
Lead (US$ cents per pound)	98	109	94	97	97	100
Gold (US$ per ounce)	1,225	1,570	1,675	1,675	1,675	1,675
Price of imports 1/	**10.1**	**13.8**	**-0.3**	**-0.5**	**0.6**	**0.5**
Oil (US$ per barrel)	79	95	100	105	100	106
Wheat (US$ per ton)	195	280	249	257	259	272
Maize (US$ per ton)	157	262	232	243	221	223
Soybean oil (US$ per ton)	859	1,191	1,102	1,200	1,107	1,217

1/Average annual % change.

17. The high availability of international liquidity as a result of low interest rates allowed the demand for commodities as alternative investment assets to increase in the first half of 2011. However, the deterioration of the international context associated with fears that the European crisis might intensify generated net outflows of these markets in September and December. An outflow of US$ 7.7 billion of the funds that manage investments in commodities was observed in December, as a result of which the amount of investments in 2011 was US$ 15 billion (vs. US$ 67 billion in 2010), the lowest level registered since 2002. However, this lower flow was not reflected in declines in the prices of commodities, since the latter found support in supply constraints (metals and food products) and in geopolitical tensions (crude). The investment funds with investments in commodities recovered in January 2012 when a net inflow of US$ 3.7 billion was registered. In today's context of high availability of liquidity, non commercial positions are expected to increase in the market this year.

Graph 22
COMMODITIES INVESTMENT FLOWS
(Billions of US$)



Source: Bloomberg and Barclays Capital.

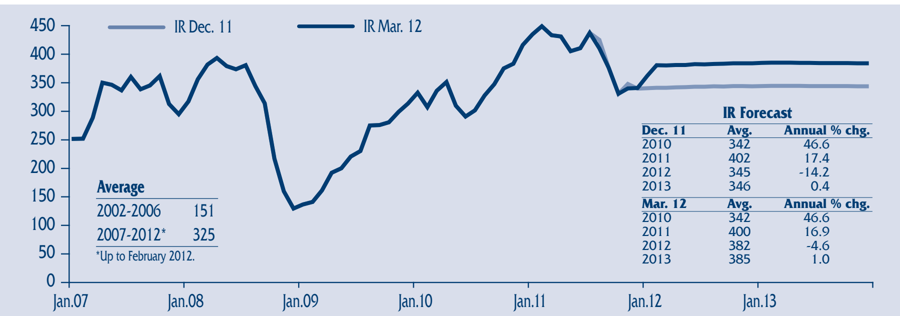
Copper

18. In 2011 the price of **copper** increased 17 percent and recorded an average price of US$ 3.43 per pound in December, but showed a downward trend during a great part of the year. In the first two months of this year, the price of copper has reversed this trend rising 11 percent.

After reaching a historical nominal average record of US$ 4.48 a pound in February 2011 due to supply constraints in producing countries like Chile, Indonesia, China, and Peru, the price of copper registered a downward trend until November given fears of a global recession associated with the worsening of Europe's debt crisis. In November-December 2011, this price recovered due to supply problems in producing countries (temporary closure of mine Grasberg in Indonesia, production interruptions due to a strike in mine Cerro Verde in Peru and to technical failures in mine Collahuasi in Chile).

So far this year, the price of copper has been favored by better-than-expected data of growth and manufacturing activity in USA and China and therefore it is estimated that this price will stabilize in the forecast horizon at a higher level than the one considered in our previous Inflation Report.

Graph 23
COPPER: JANUARY 2007 - DECEMBER 2013
(ctv. US$/pd.)



Zinc

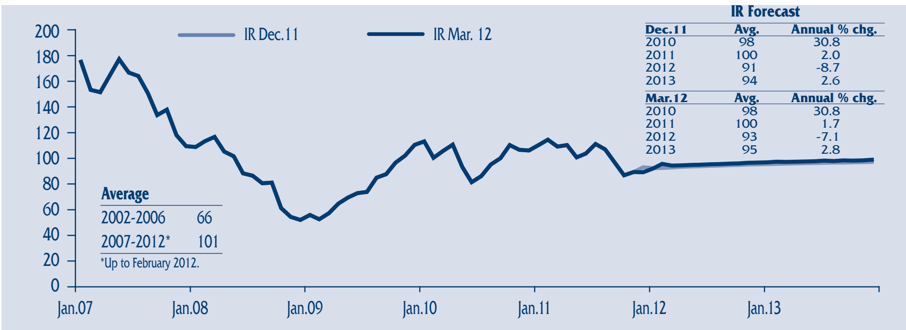
19. The average price of **zinc** in February 2012 was US$ 0.93/pound, which reflects an increase of 8 percent so far this year (that is, a higher rise than the 1 percent rise registered in 2011).

    Like the price of copper, the price of zinc showed a downward trend during most of 2011, affected by fears of lower global economic activity and by a higher production of refined zinc, as well as by the lower dynamism of consumption in Japan in a context in which inventories registered their maximum historical levels. This downward trend was offset by supply constraints in China (due to environmental regulations) and in Australia and USA (due to technical problems).

    The rise in the price of zinc in the first two months of the year is explained by a higher speculative demand supported by the annountcement that some large mines will be closed in Canada and Ireland in the next two years, as well as by a more positive outlook for general economic activity in USA.

    It is estimated that the price of zinc will stabilize around its current price (as foreseen in our previous report). The supply constraints in producing countries like China would be offset by China and USA's higher production of refined zinc estimated for 2012.

Graph 24
ZINC: JANUARY 2007 - DECEMBER 2013
(ctv. US$/pd.)



Gold

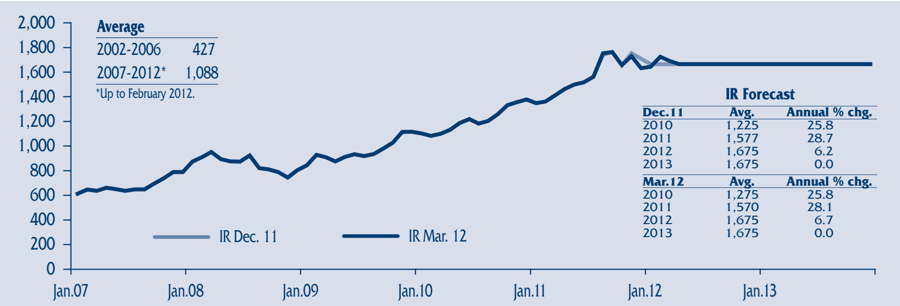
20. The price of **gold** recorded an increase of 28 percent in 2011 and closed the year with an average price of US$ 1,642/troy ounce in December 2011. In the first two months of 2012, the price of gold rose 6 percent.

    The upward trend that gold showed during most of 2011 was sustained by the increased demand for this metal as an alternative investment asset and as a hedge asset in a context of rising uncertainty about the recovery of the global economy due to Europe's debt crisis. The price of gold reached a maximum level in September (with an average price of US$ 1,773/troy ounce) due to the worsening of the crisis in Europe and to the U.S. credit downgrading. Then, in the last quarter of the year, the price corrected downwards reflecting the strong sales associated with close of books, portfolio adjustments, and lower demand from jewelers and the industrial sector, as well as by a greater preference for liquidity and the liquidation of non commercial contracts in December.

The increase in the price of gold so far this year is explained by the depreciation of the dollar and by the perception of risk generated by the delay in the approval of the second rescue package for Greece. Moreover, prices were also propelled by fears of inflation generated by the rise in the price of oil.

The price of gold is estimated to remain high in the forecast horizon in a context of uncertainty and increased purchases of this metal by emerging countries.

Graph 25
GOLD: JANUARY 2007 - DECEMBER 2013
(US$/tr.oz.)

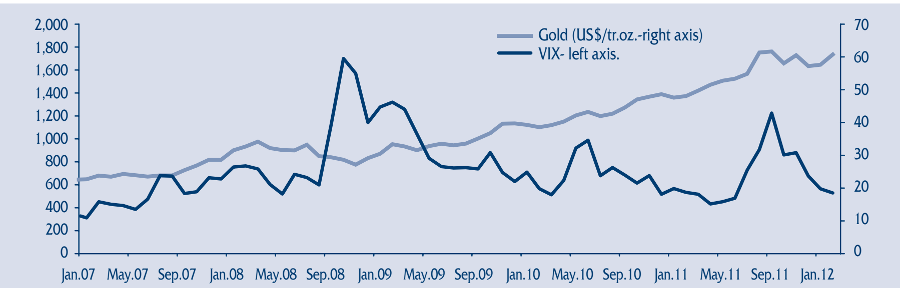


IR Forecast

Dec.11	Avg.	Annual % chg.
2010	1,225	25.8
2011	1,577	28.7
2012	1,675	6.2
2013	1,675	0.0

Mar.12	Avg.	Annual % chg.
2010	1,275	25.8
2011	1,570	28.1
2012	1,675	6.7
2013	1,675	0.0

Graph 26
GOLD PRICE AND S&P-500 VIX INDEX
(January 2007 - February 2012)



Source: Bloomberg.

Oil

21. The price of WTI oil rose 20 percent in 2011, recording an average of US$ 98 per barrel in December. In the first two months of 2012, the price of oil rose 4 percent.

The price rise in 2011 is explained by the contraction of supply associated with social conflicts in the Middle East and North Africa (especially in Libya, where oil exports were drastically reduced), terrorist attacks in Nigeria, and geopolitical tensions between Iran and the West.

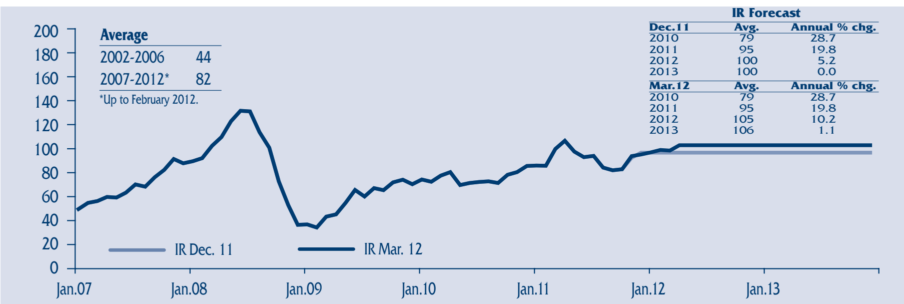
The price of crude reached its peak in April (US$ 110 per barrel on average), declining gradually thereafter until it posted an average level of US$ 86 a barrel in September due to expectations of lower global demand in OECD countries, especially in the EU due to the impact of the debt crisis. On the supply side, the recovery of Libya's production and exports towards the end of November contributed to reduce the price of oil.

Since end 2011 the price of crude was boosted by the geopolitical situation between Iran and the West. In February of this year, Iran announced a ban on oil sales to European oil companies, generating in this way expectations of a lower supply of crude.

In the forecast horizon the price of oil is expected to show similar levels to those observed today, but higher than the ones estimated in the Inflation Report of December. The worsening of the tensions between Iran and the West represent a risk factor on the upside in this central scenario.

In contrast with 2008, when the prices of crude reached historical maximum levels, the global economy is currently more vulnerable to a sharp price rise since economic recovery could be affected.

Graph 27
WTI OIL: JANUARY 2007 - DECEMBER 2013
(US$/bl)

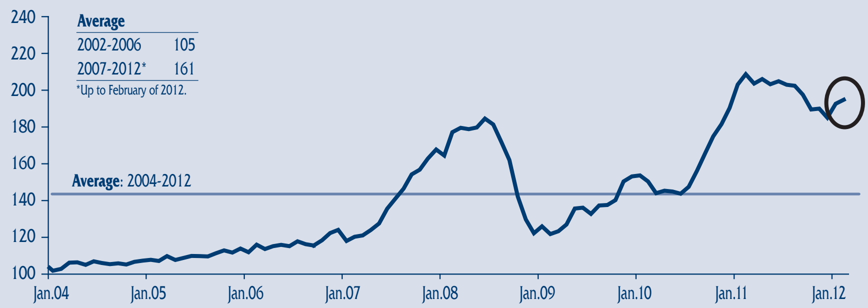


Food products

22. In 2011, the prices of **foodstuffs** recorded increased explained both by supply factors (climate factors and constrains in producing countries) and by the demand of emerging countries in a context of high liquidity and tight global inventories. However, like in the case of other commodities, the prices of food products were affected in the second half of the year by the deterioration of the global risk balance

which led investors to liquidate their positions in risky assets. Thus, in 2011, FAO's index of real food prices registered an average increase of 26 percent. In the first two months of 2012, food prices continue showing an upward trend and FAO's index has risen 5 percent so far this year.

Graph 28
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.

According to the World Agricultural Supply and Demand Estimates of the US Department of Agriculture (USDA) of March 2012, the situation in global food markets shows an improvement (less tightness) in the case of wheat given that global inventories at the end of the 2011/2012 farming period would increase 5 percent compared with the previous crop year. On the other hand, the global market of soybean oil would show tighter conditions this farming period since inventories would decline by 9 percent.

Table 10
USDA: BALANCE OF GLOBAL SUPPLY AND DEMAND
(Millions tons)

	2009/10 (3)	2010/11 (2)	2011/12 (1)	% change (2) / (3)	% change (1) / (2)
MAIZE					
Initial stock	147.5	144.2	129.1	-2.3	-10.5
Production	819.2	829.2	865.0	1.2	4.3
Global supply	**966.8**	**973.4**	**994.0**	**0.7**	**2.1**
Total consumption	822.6	844.4	869.5	2.6	3.0
Final stock	144.2	129.1	124.5	-10.5	-3.5
WHEAT					
Initial stock	167.1	202.3	199.5	21.1	-1.4
Production	685.6	651.5	694.0	-5.0	6.5
Global supply	**852.6**	**853.8**	**893.5**	**0.1**	**4.6**
Total consumption	650.3	654.4	683.9	0.6	4.5
Final stock	202.3	199.5	209.6	-1.4	5.1
SOYBEAN OIL					
Initial stock	2.9	3.1	3.0	3.7	-1.6
Production	38.8	38.8	38.8	0.0	0.0
Global supply	**41.8**	**41.9**	**41.8**	**0.3**	**-0.1**
Total consumption	38.2	41.0	42.1	7.2	2.7
Final stock	3.1	3.0	2.7	-1.6	-9.0

Source: US Department of Agriculture -World Agricultural Supply and Demand Estimates (WASDE) March 2012.

Maize

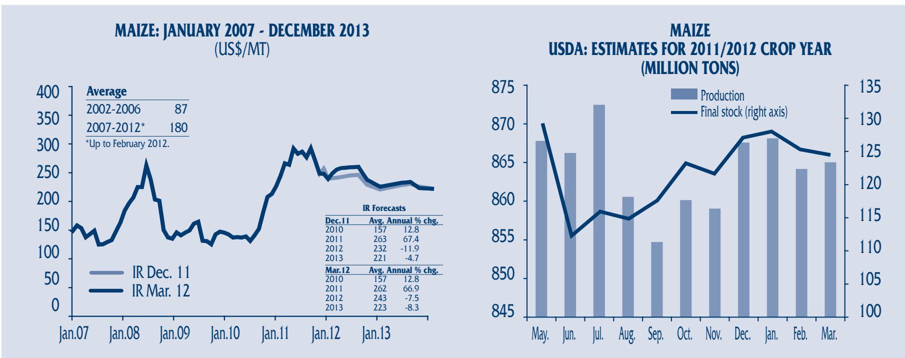
23. In 2011 the price of **maize** recorded an increase of 67 percent. In December, the average price was US$ 234 per ton and in February 2012 it hit US$ 251, as a result of which it has registered a variation of 7 percent so far this year.

In early 2011 the price of maize was boosted by the intensification of the effects of La Niña in some of the main producing countries and then by USA and China's growing demand for maize to produce ethanol. In the second half of the year, the price of maize corrected downwards in line with higher risk aversion.

Since the last months of 2011, the price of maize has been favored by expectations of a lower global supply due to fears of a lower production in South American producing countries (mainly Argentina) as a result of the lower yields that would be caused by La Niña event.

However, since maize-sown areas are expected to increase in USA this year, the prices of maize in the forecast horizon are estimated to show a downward correction to similar levels to those foreseen in our Inflation Report of December 2011, that is, to decline 8 percent relative to the average price in 2011.

Graph 29



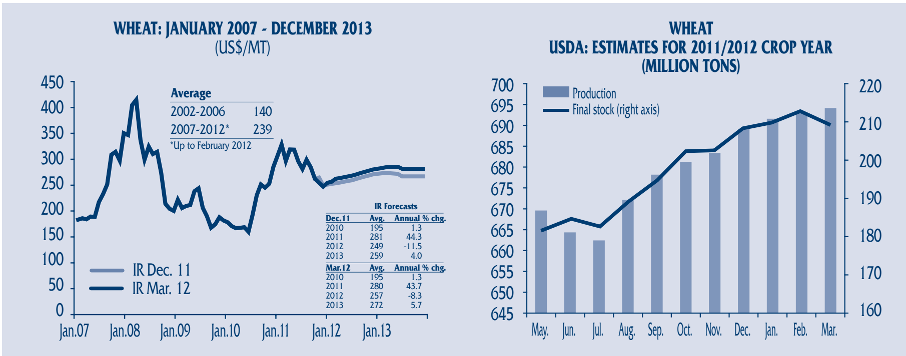
Wheat

24. The international price of **wheat** rose 44 percent in 2011, recording an average price of US$ 236 per ton at the close of December. In the first two months of 2012, the price of wheat has risen 4 percent.

In the first part of 2011, the price of wheat was favored by the evolution of the price of maize (a substitute product), as well as by Russia and Ukraine's restrictions on their exports. However, the international price of wheat showed a downward trend during the year due to the USDA's successive upward revisions of global production and due to increased competition in international markets.

Year-to-date, the price of wheat has resumed a rising trend as a result of unfavorable climate conditions in European producing countries and expectations that Russia and Ukraine will establish restrictions on their exports (only Ukraine implemented them). The price of wheat is therefore expected to increase slightly relative to its current levels and the ones estimated in our last Inflation Report. Nonetheless, on average terms, in 2012 the price of wheat would decline 8 percent compared to the average price in 2011, in line with the expected global inventories of 210 million tons estimated by USDA for the 2011/2012 crop year (this figure is close to the record level obtained in the 1999/2000 crop year).

Graph 30



Soybean oil

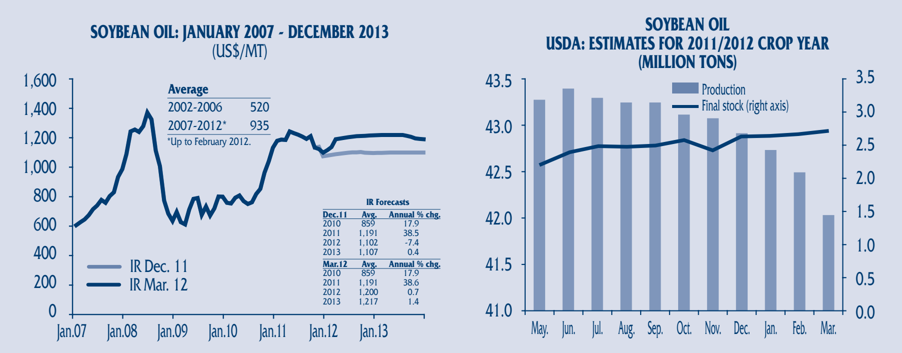
25. The price of **soybean oil** showed an average increase of 39 percent in 2011 and recorded a level US$ 1,107/ton in December. During the first two months of 2012, the price of soybean oil has risen 4 percent.

The rise observed in this price in 2011 is mainly explained by the increases registered in the first months of the year (due to the effects of La Niña and to the rises in the price of crude), because the average price of soybean oil followed a downward trend since May –except in September–that intensified in October when this price fell 6 percent due to the favorable soybean yield obtained in USA.

In January-February 2012, the price of soybean oil has shown a rising conduct, in line with expectations of a lower soybean production in South American countries. Like in the case of maize (especially in Argentina and Brazil), there are concerns that the adverse climate conditions of La Niña event may have affected the yield of soybean.

It is estimated that the level of prices of soybean oil will be similar to those observed today, but higher than the ones considered in our previous Report due to the higher prices of oil foreseen and the lower production of soybean expected by USDA for the 2011/2012 period.

Graph 31



BOX 1
GREECE'S SECOND BAILOUT PACKAGE AND DEBT RESTRUCTURING PROGRAM

A transaction to restructure the public debt with the private sector, known as the PSI (Private Sector Involvement), was agreed in the second half of February between the European Union (EU), the International Monetary Fund (IMF), and a committee representing private holders of Greek bonds as part of the conditions that will allow Greece's access to a package of €130 billion. The approval of this package by the European Union and the IMF should take place prior to the maturity of bonds for €14.5 billion on March 20. The new program is expected to reduce the debt to GDP ratio from 164 percent (2011) to 120.5 percent by 2020.

To this end, the Greek government had to meet a series of preconditions, including the following: approve measures to further reduce the fiscal deficit by €325 million; initiate the process required to constitutionally prioritize the repayment of debt; have the terms of PSI passed by Parliament, including the retroactive introduction of collective action clauses (CACs) under which the bonds will be restructured, among others.

PSI terms

After the PSI transaction was approved by Parliament, on February 24 the Greek government launched the offer for the restructuring of eligible bonds –under the Greek law or under international law– for a total of €206 billion, which represents approximately 60 percent of the debt balance in 2011. The main terms of the PSI are:

- The bonds will be exchanged with a nominal discount of 53.5 percent. Of the remaining 46.5 percent face amount, 15 percent will be exchanged by short-term instruments (1-2 years) of the European Financial Stability Facility (EFSF) and 31.5 percent will be exchanged by new Greek bonds maturing in 30 years.
- The amortization of the new Greek bonds will begin in 2023 (year 11) and will end in 2042 (year 30).

- The new bonds have a step-up coupon (with a grace period of one year): 2 percent in the first three years (2013-2015), 3 percent between 2016 and 2020, 3.65 percent in 2021, and 4.3 percent from 2022 onwards.
- Some retroactive CACs have been introduced under the Greek law to ensure a high participation of the private sector, given that the program requires that at least 90-95 percent of the eligible debt with the private sector is restructured. If it were necessary to activate the CACs, a quorum of 50 percent of bond holders and a majority of two thirds of the eligible debt holders are required. In the case of international bonds governed by international laws, the majority required to introduce a CAC is a quorum of 75 percent of bond holders.
- There is an additional warrant associated with the evolution of GDP. According to this instrument, 1 percent of the additional coupon will be paid as from 2015 if Greece's GDP shows a positive growth above certain level (this level has not been specified yet).
- The new bonds will be issued under the UK Law.

A nominal reduction of around €110 billion in the Greek debt is expected to be achieved with the PSI. In terms of the net present value (NPV), it is calculated that this would imply a reduction of the debt of between 72-76 percent (reduction above the 70 percent estimated previously).

On March 9, after the process of voluntary restructuring of the debt written under the Greek law ended, the results indicated a participation of 86 percent (€ 152 billion of the €177 billion eligible bonds). With this result, the government activated the CAC, which would involve the full participation of creditors under the Greek law. In addition to this, it was reported that so far bondholders of about €20 billion –of the €29 billion in eligible bonds– of the debt written under international law had already decided to join the process, as a result of which total participation was 96 percent. What still remains to be seen is the participation of creditors with debt written under international law who will decide to join the process before the expiration date (March 23), as well as whether the participation rate enables the activation of international CACs or not, and whether the government decides to exercise them or not.

Official participation

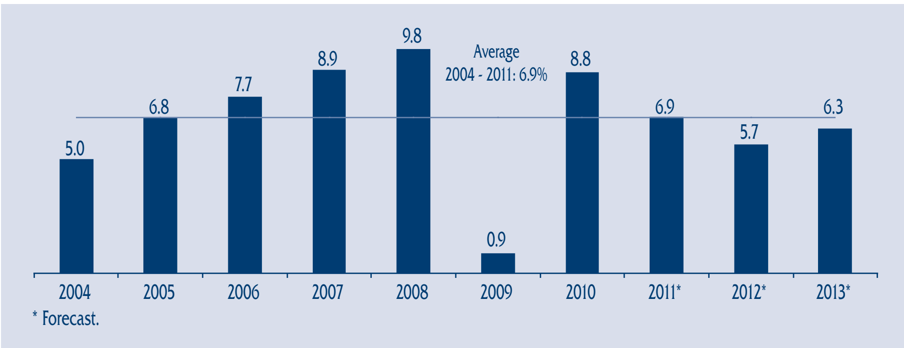
The Greek bonds purchased by the European Central Bank and the central banks in the Eurozone under the Security Market Program (SMP), which have an estimated value of €45 billion, were swapped by new Greek bonds (with the same conditions they had before) to prevent that they be included as part of the debt eligible for the PSI.

Since these bonds were purchased at a discount on the secondary market, the earnings generated because of this discount would be returned to the Greek government in the way of a discount on the interest rate on the loans granted by EU governments as part of their first aid package of €110 billion. It is estimated that this reduction would contribute to reduce the debt-to-GDP ratio by 1.8 percentage points towards 2020 and that it would reduce financing requirements by €1.8 billion during the rescue program.

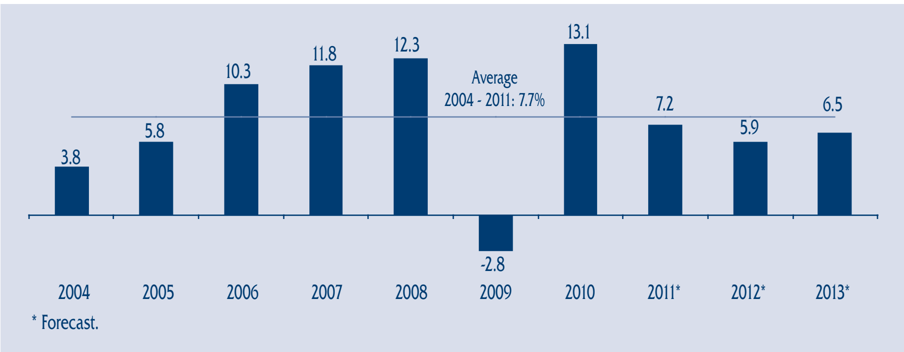
II. Economic activity

26. In spite of the less favorable international context observed due to the debt crisis affecting several countries in the Eurozone, in 2011 the Peruvian economy grew 6.9 percent. After growing at a rate of 7.8 percent in the first semester, economic activity in the country grew 6.1 percent in the second semester, converging in this way towards rates closer to the economy's potential output level.

Graph 32
GDP: 2004-2013
(Real % change)

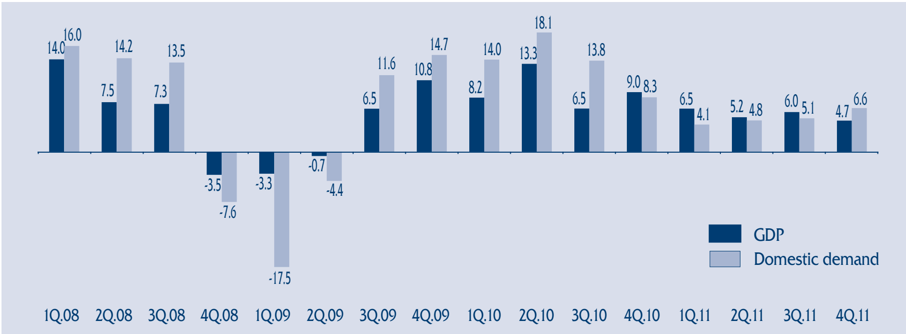


Graph 33
DOMESTIC DEMAND: 2004 - 2013
(Real % change)



In seasonally adjusted terms, GDP recorded an annual growth of 4.7 percent in Q4-2011, after having registered a growth rate of 6.0 percent in the previous quarter.

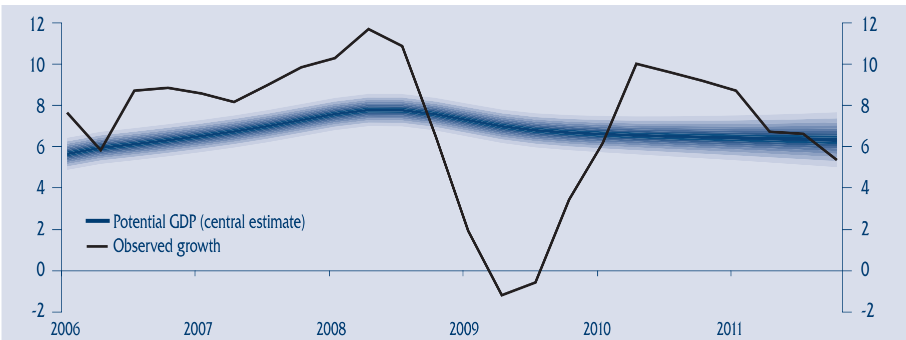
Graph 34
SEASONALLY ADJUSTED GDP AND DOMESTIC DEMAND: 2008 - 2011
(Annualized % change)



27. The rate of growth of GDP in 2011 (6.9 percent) was slightly higher than the rate projected in our December Report (6.8 percent). The central forecast scenario for the Peruvian economy in 2012 considers a growth rate of 5.7 percent, considering better terms of trade and an improvement in consumers' and investors' expectations relative to the ones considered in our previous Report. In 2013 the Peruvian economy is still projected to grow 6.3 percent.

28. As previously mentioned, the economy's potential growth was slightly above 6.0 percent at end 2011 and the growth of GDP and domestic demand are forecast to be close to their potential growth rate in the next two years.

Graph 35
GDP: POTENTIAL GROWTH AND ACTUAL GROWTH: 2005-2011
(% 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 5% and total bands represent a probability of occurrence of 90%.

Potential growth is estimated using statistical methods of signals extraction simultaneously with the estimation of the output gap (see Graph 101).

Projected evolution of expenditure components

29. In 2012 **domestic demand** would continue to show a more moderate pace of growth after having declined from a growth rate of 13.1 percent in 2010 to a rate of 7.2 percent in 2011. Domestic demand in 2012 is estimated to record a rate of 5.9 percent due mainly to the lower pace of growth that private consumption and private investment would register in comparison with 2011. This would be offset by a greater dynamism of public investment, which is estimated to grow 34.3 percent. With this, the contribution of public expenditure to growth would rise from a negative value of -0.7 percentage points to a positive value of 2.1 percentage points.

Table 11
GDP AND DOMESTIC DEMAND
(Real % change)

	2010	2011	2012*		2013*	
			IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
1. Domestic demand	**13.1**	**7.2**	**5.6**	**5.9**	**6.1**	**6.5**
a. Private consumption	6.0	6.4	5.6	5.8	5.8	5.8
b. Public consumption	10.0	4.8	5.3	5.3	4.9	5.1
c. Private investment	22.1	11.7	7.0	8.2	8.3	8.7
d. Public investment	27.3	-17.8	33.1	34.3	7.3	7.3
2. Exports	**1.3**	**8.8**	**6.0**	**7.5**	**7.7**	**7.7**
3. Imports	**24.0**	**9.8**	**6.5**	**8.3**	**6.6**	**8.3**
4. GDP	**8.8**	**6.9**	**5.5**	**5.7**	**6.3**	**6.3**
Memo						
Government expenditure	*16.3*	*-4.2*	*14.7*	*15.2*	*5.9*	*6.0*

IR: Inflation Report.
* Forecast.

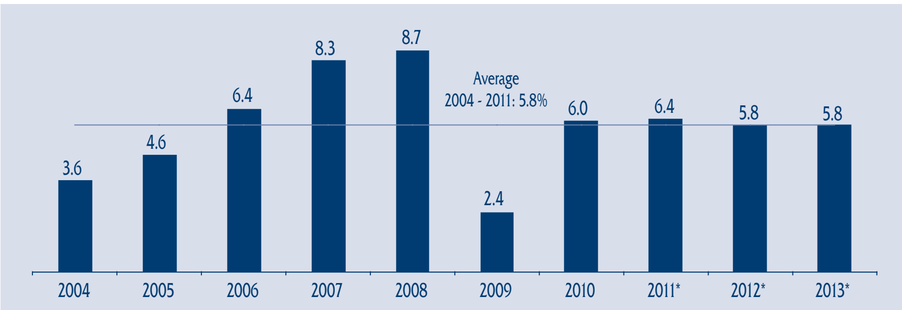
Table 12
GDP AND DOMESTIC DEMAND
(Contributions to the real % change)

	2010	2011	2012*		2013*	
			IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
1. Domestic demand	**13.1**	**7.5**	**5.8**	**6.2**	**6.4**	**6.8**
a. Private consumption	4.1	4.2	3.7	3.9	3.8	3.8
b. Public consumption	0.9	0.5	0.5	0.5	0.5	0.5
c. Private investment	4.2	2.5	1.6	1.8	1.9	2.0
d. Public investment	1.5	-1.1	1.6	1.6	0.4	0.4
e. Inventory variation 1/	0.2	1.4	0.2	-0.2	-0.2	-0.1
2. Exports	**0.2**	**1.6**	**1.1**	**1.4**	**1.4**	**1.4**
3. Imports	**4.5**	**2.1**	**1.4**	**1.8**	**1.5**	**1.9**
4. GDP	**8.8**	**6.9**	**5.5**	**5.7**	**6.3**	**6.3**
Memo						
Government expenditure	*2.4*	*-0.7*	*2.1*	*2.1*	*0.9*	*0.9*

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

30. In 2011 **private consumption** grew at a higher rate than in 2010 and registered a growth rate of 6.4 percent (6.0 percent in 2010). This increase is based on the dynamism of the national disposable income (7.1 percent), on high consumer confidence levels, and on the growth of credit (20.4 percent) and employment (5.4 percent). The growth of private consumption is estimated to moderate in the next years, registering levels closer to the average level observed in 2004 - 2011.

Graph 36
PRIVATE CONSUMPTION: 2004 - 2013
(Real % change)

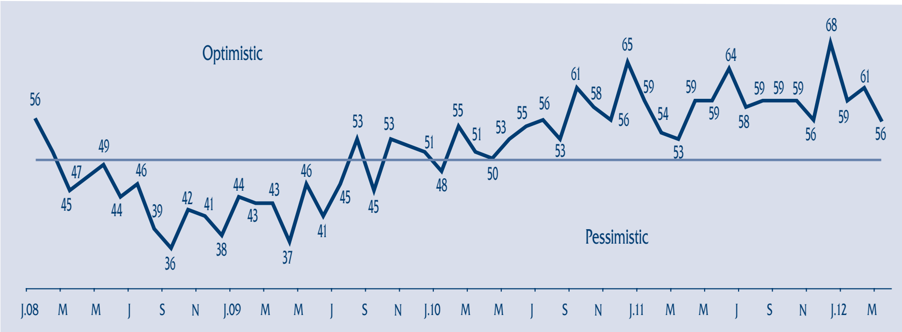


* Forecast.

Several indicators reflect the recent evolution of private consumption:

a. The Consumer Confidence Index has been on the optimistic side for 23 consecutive months.

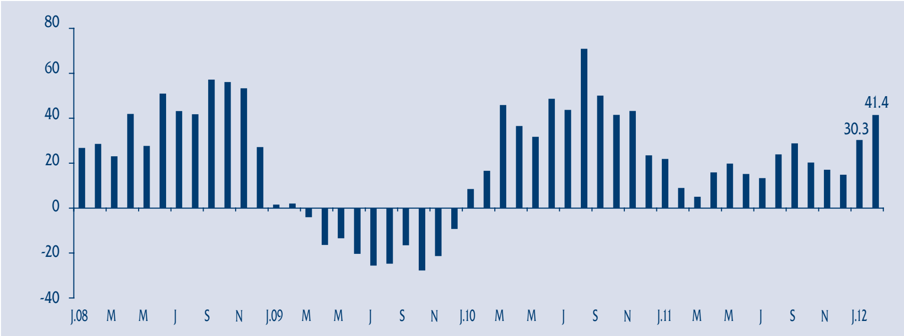
Graph 37
CONSUMER CONFIDENCE INDEX: 2008 - 2012
Households' economic situation



Source: Ipsos APOYO.
Elaboration: BCRP.

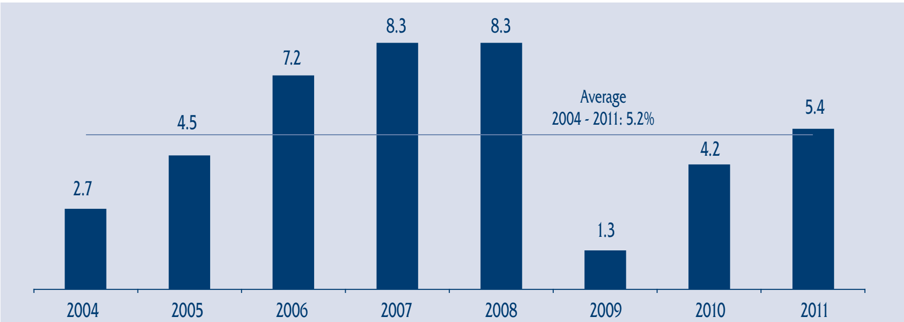
b. The volume of imports of durable consumer goods has shown a faster pace of growth in the first two months of 2012, recording a rate of 30 percent in January and a rate of 41 percent in February.

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



c. The growth of employment in urban areas, in firms with 10 and more workers, showed a faster pace in 2011, rising from a rate of 4.2 percent in 2010 to a rate of 5.4 percent in 2011. This rate was higher than the average growth rate of urban employment in the period 2004 – 2011.

Graph 39
URBAN EMPLOYMENT: 2004 - 2011
(% change)



Source: MTPE.

31. **Private investment** grew 11.7 percent in 2011. A moderation of growth was observed over the year in this variable, which recorded two-digit rates until Q2 and lower rates thereafter in a context of international uncertainty that led enterprises to delay their decisions of investments. It is estimated that private investment would register a lower growth rate in 2012 than in 2011, in line with the moderation of the growth of demand foreseen for this year.

Several indicators reflect the evolution of private investment:

a. Business expectations of the economic situation in the three months ahead have gradually improved during the second semester of 2011 and have recorded their highest level in 11 months in February.

Graph 40
EXPECTATIONS ABOUT THE ECONOMY IN THE NEXT 3 MONTHS: 2008 - 2012

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

b. Economic agents forecast that GDP will grow between 5.0 and 5.5 percent in 2012. A rate of between 5.6 and 6.0 percent is estimated for 2013 since greater dynamism is expected in the economy in this year.

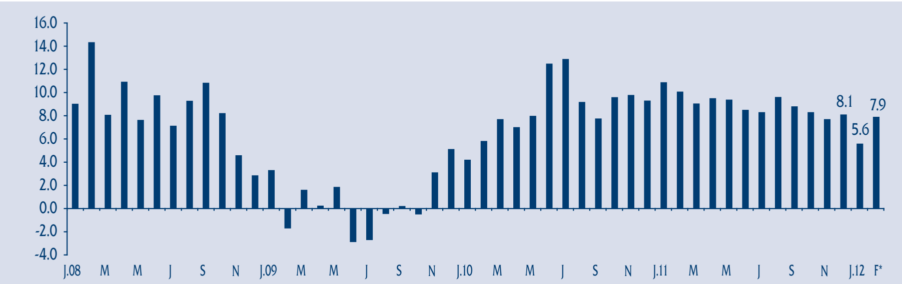
Table 13
SURVEY ON MACROECONOMIC EXPECTATIONS: GDP GROWTH(
(%)

	Expectations up to:		
	IR Sep.11	IR Dec.11	IR Mar.12*
Financial entities			
2012	5.8	5.5	5.3
2013	6.0	6.0	5.6
Economic analysts			
2012	5.6	5.4	5.0
2013	5.9	5.5	5.6
Non-financial firms			
2012	6.0	6.0	5.5
2013	6.0	6.0	6.0

* Survey made during the second half of February 2012.

c. The production of electricity continues to show a high pace of growth, although with lower rates than the ones observed in the first semester of 2011.

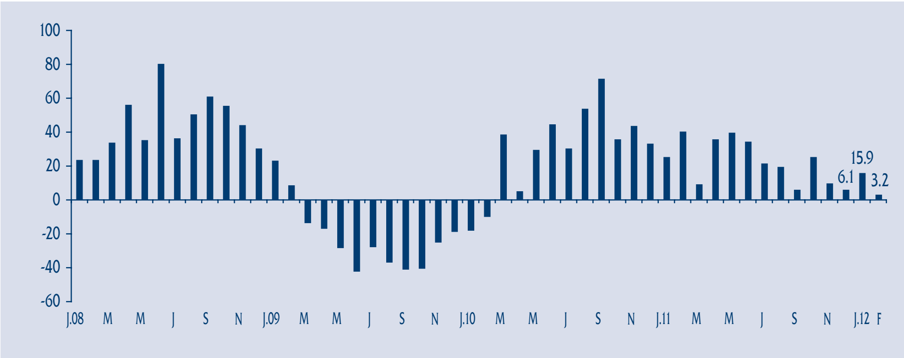
Graph 41
ELECTRICITY PRODUCTION: 2008 - 2012
(12 month % change)



* Preliminary.

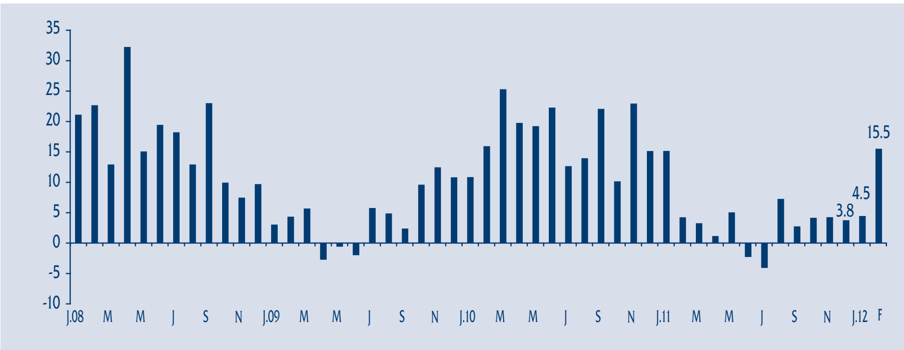
d. The volume of imports of capital goods also shows lower growth rates than the ones observed in 2011.

Graph 42
VOLUME OF IMPORTS OF CAPITAL GOODS: 2008 - 2012
(12 month % change)



e. Construction has shown signs of a recovery in the last months, as reflected in the domestic consumption of cement.

Graph 43
DOMESTIC CONSUMPTION OF CEMENT: 2008 - 2012
(Annual % change)



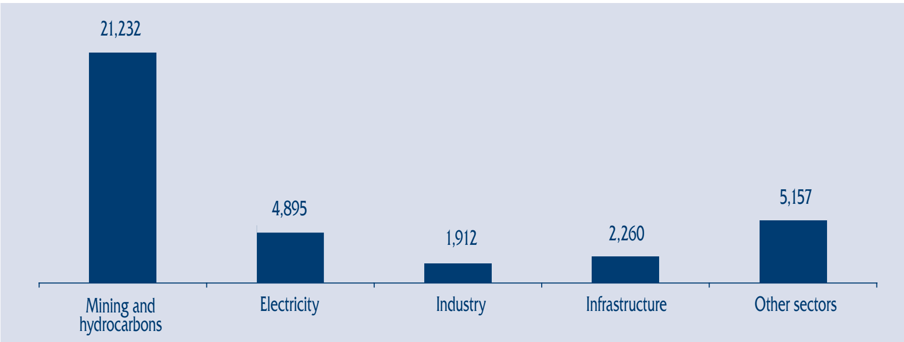
32. The investment projects announced for the period 2012–2013 amount to US$ 35.5 billion, a higher figure than the one reported in December (US$ 33.5 billion). Considering the evolution of business expectations and the announced investment, the forecast on the growth of private investment in 2012 has been revised upwards from 7.0 to 8.2 percent. If these investment projects crystallized, the growth rate of investment in the period 2012–2013 would be higher than 8 percent; that is, higher than the GDP growth rate.

Table 14
ANNOUNCED INVESTMENT PROJECTS
(Millions of US$)

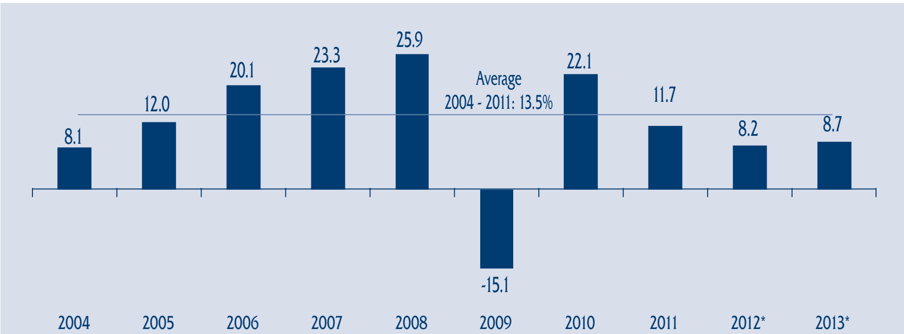
	2012		2013		2012 - 2013	
	IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
Mining	7,360	7,242	7,857	9,002	15,217	16,244
Hydrocarbons	2,170	2,232	3,072	2,756	5,242	4,988
Electricity	2,714	2,606	2,224	2,289	4,938	4,895
Industry	1,040	1,082	640	830	1,680	1,912
Infrastructure	1,055	1,211	895	1,049	1,950	2,260
Other sectors	2,533	3,045	1,962	2,112	4,495	5,157
TOTAL	**16,872**	**17,418**	**16,650**	**18,038**	**33,522**	**35,456**

Source: Press media and information companies.

Graph 44
ANNOUNCED INVESTMENT PROJECTS: 2012-2013
(Millions of US$)



Graph 45
PRIVATE INVESTMENT: 2004 - 2013
(Real % change)



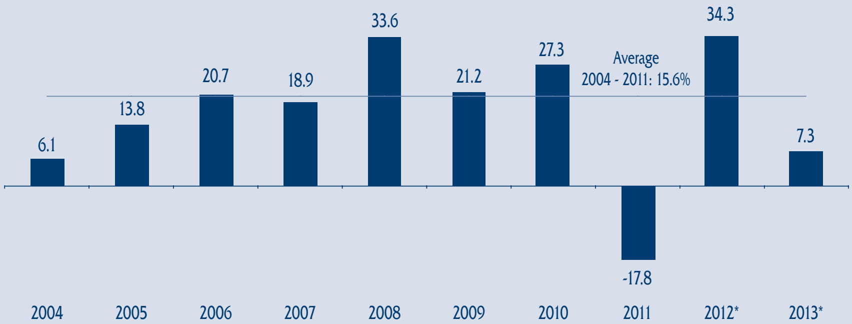
* Forecast.

Table 15
ANNOUNCED MAIN INVESTMENT PROJECTS: 2012 - 2013

Sector	Company	Project name
Mining	Xstrata Perú S.A.	Las Bambas
	Minera Yanacocha S.R.L.	Minas Conga
	Sociedad Minera Cerro Verde S.A.A.	Cerro Verde
	Jinzhao Mining Perú S.A.	Pampa del Pongo
	China Minmetals Corporation and Jiangxi Copper Company Limited	El Galeno
	Anglo American Quellaveco S.A	Quellaveco
	Minera Chinalco Perú S.A.	Toromocho
	Xstrata Perú S.A.	Antapaccay
	Compañía Minera Antamina S.A.	Expansion: Antamina
	Southern Perú Copper Corp. Peru branch	Los Chancas
	Shougang Hierro Perú S.A.A.	Marcona
	HudBay Minerals Inc.	Constancia
	Candente Copper Perú S.A.	Cañariaco Norte
	Gold Fields La Cima S.A.A.	Chucapaca
	Marcobre S.A.C.	Mina Justa
	Southern Perú Copper Corp. Peru branch	Toquepala
	Mitsui Mining & Smelting Co. Ltda. Peru branch	Quechua
	Minera Barrick Misquichilca S.A.	Expansion: Lagunas Norte
	Volcan Compañía Minera S.A.A.	Expansion: Volcan
	Compañía Minera Milpo S.A.A.	Magistral
	Minera Yanacocha S.R.L.	Chaquicocha
	La Arena S.A.	La Arena
	Volcan Compañía Minera S.A.A.	Rondoni
Hydrocarbons	Savia Perú S.A.	Lot Z-2B: Perforation, exploration and others
	Perenco Peru Limited	Exploration Lot 67 and pipeline
	Petrobras Energía Perú S.A.	Lot 58 and Lot X
	Pluspetrol Perú Corp. S.A.	Expansion of Pisco and Malvinas plants
	Cálidda Gas Natural del Perú	Expansion of main grid
	Transportadora of Gas del Perú S.A. (TgP)	Expansion of gas and capacity of transportation
	SK Energy	Exploration Lot Z 46
	Pluspetrol Perú Corp. S.A.	Exploration Lots 88 and 56
	Contugas	Ica pipeline
	Repsol YPF S.A	Lot 57 - Kinteroni
Electricity	Energía Azul S.R.L.	Hydroelectric plant Santa María
	Generación Huallaga S.A.	Hydroelectric plant of Cerro de Chagila
	Kallpa Generación S.A.	Hydroelectric plant of Cerro del Águila
	Fénix Power Perú S.A.	Combined cycle thermal power plant (natural gas)
	Norwind	Wind energy park Cerro Chocan
	Enersur S.A.	Expansion of Chilca 1
	SN Power Perú S.A.	Hydroelectric plant Cheves
	Kallpa Generación S.A.	Kallpa IV
	Egecusco	Hydroelectric plants Acco Pucará
	Empresa Administradora Chungar S.A.C.	Hydroelectric plant Belo Horizonte
	Luz del Sur S. A. A.	Grid and infraestructure expansion
Industry	Corporación Aceros Arequipa S.A.	Expansion of lamination plant (N° 2)
	Cemento Andino	Plant expansion in Tarma
	Cementos Portland	Cement plant
	Textiles Camones	Expansion of production lines
	Cementos Lima	Expansion of installed capacity
	Cementos Otorongo	Contruction of cement plant
	Cementos Interoceánicos	Cement plant Arequipa
	Cementos Pacasmayo	Expansion of plant
	Americas Potash Peru	Phospates plant
	TASA	Modernization of plants and purchase of new ships
Infrastructure	Consorcio APM Terminals Callao	Modernization of North Pier
	Línea Amarilla S.A.C.	Parque Rimac express way
	Odebrecht Perú Ingeniería y Construcción S.A.C.	IIRSA SouthSection 3: Inambari - Iñapari
	Chancay Port S.A.	Multipurpose pier
	Concesionaria Vial del Sol S.A. - COVISOL	Trujillo-Sullana Sol Highway
	Autopista del Norte SAC	Pativilca – Port of Salaverry Road Network No. 4
	Tren Lima Línea 1	Operation and Maintenance: Acquisition of rolling material
	Terminal Internacional del Sur	Expansion of Port of Matarani
	Covi Peru	Road N° 6: Pucusana - Cerro Azul - Ica
	Terminales Portuarios Euroandinos	Expansion of Port Paita
Other sectors	Telefónica del Perú S.A.	Optical fiber project at Los Andes
	América Móvil Perú S.A.C.	Expansion of infrastructure, capacity and technological innovation
	Graña y Montero Vivienda (GMV)	Housing projects
	Besalco S.A.	Real state
	Cencosud	New superpmarkets and malls

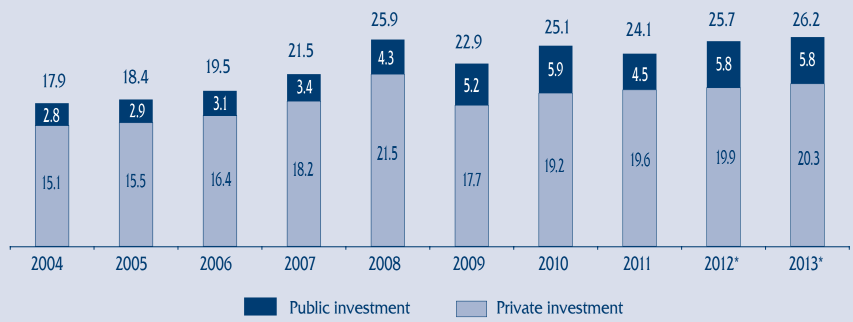
33. **Public investment** declined 17.8 percent in 2011. A greater level of implementation was observed in the investment projects of regional and local governments, as foreseen in our previous Inflation Report. Public investment would show a significant recovery in 2012, returning to more sustainable growth rates in 2013. Considering the evolution of private investment and public investment, it is estimated that the ratio of fixed gross investment-to-GDP would be over 26 percent in 2013.

Graph 46
PUBLIC INVESTMENT: 2004 - 2013
(Real % change)



* Forecast.

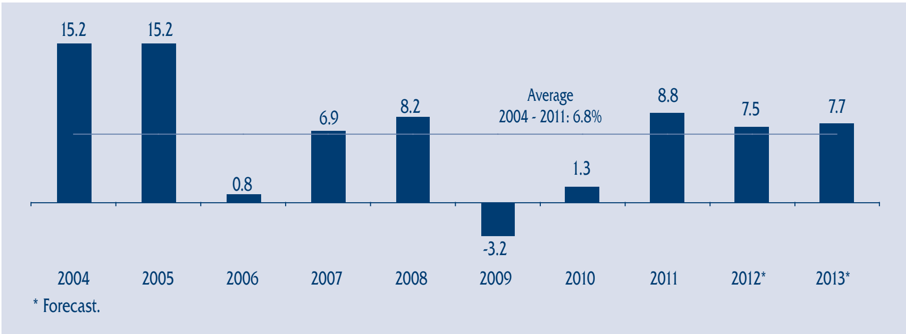
Graph 47
GROSS FIXED INVESTMENT: 2004 - 2013
(% of GDP)



* Forecast.

34. The forecast on the growth of **exports** shows a slightly growing trend after the 8.8 percent increase registered in 2011, which was influenced by a 20.2 percent growth in non traditional exports. The forecast considers the onset of operations in some copper mining projects –i.e., the expansions of Southern and Antamina– and the evolution of external demand, as a result of which exports would grow at a higher rate than the average rate in 2004–2011. The moderation of growth of domestic demand, on the other hand, would be reflected in a lower demand for **imports**.

Graph 48
EXPORTS OF GOODS AND SERVICES: 2004 - 2013
(Real % change)



Graph 49
IMPORTS OF GOODS AND SERVICES: 2004 - 2013
(Real % change)

GDP by sectors

35. Showing a faster pace of growth than the average growth rate in the period 2004 – 2010 (3.7 percent), the production of **primary sectors** grew 4.4 percent in 2011. A differentiated conduct was observed in the different sectors. Fishing recorded a growth rate of 29.7 percent, showing an increase in fish catch for both human and industrial consumption. The production in the subsector of agriculture also grew despite the cold weather conditions that affected the production of some crops, especially in the second half of the year, while the production in the livestock subsector grew 5.2 percent reflecting mainly a higher consumption of beef. On the other hand, growth in metallic mining decreased for the second consecutive year due to a lower production of zinc, silver, and lead.

The rate of growth of primary sectors in 2012 has been revised downwards from 4.6 percent in our previous report to 3.3 percent. The factors considered for this downward revision in the agricultural sector include the adverse effects of longerthan-normal periods of cold temperatures and the intensity of rains during the months of February and March on some crops. For example, the low production of mango due to the negative effect of La Niña on the yield of this crop was aggravated by intense rains. Nonetheless, other crops like rice were favored by the greater availability of water. Moreover, some export-oriented crops such as coffee, olive, grapes, and cotton would show high growth rates.

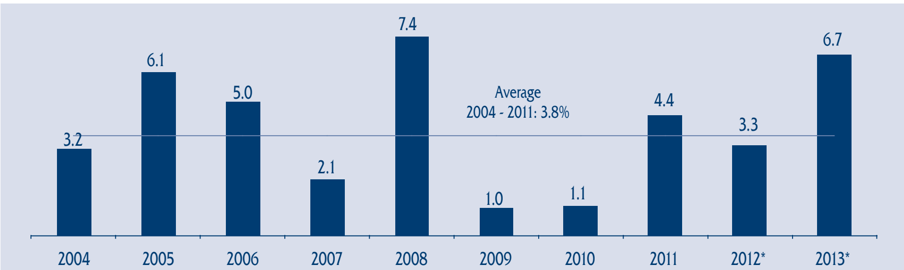
According to information provided by Imarpe and some fishing companies, the fishing sector would reduce its quota of anchovy catch to about 6 million tons, after having extracted nearly 7 million metric tons of anchovy in 2011.

The mining and hydrocarbons sector would register a lower rate than foreseen in our previous Report due to lower production in the case of both metallic mining and hydrocarbons extraction despite the expansion of Southern and Antamina, the onset of operations at Xstrata Tintaya's copper project of Antapaccay, and the production of gold at Tantahuatay and La Arena. The lower volumes considered in the case of other metals are based on the production recorded in the first months of the year and on the estimates of the companies involved.

The production of the subsector of hydrocarbons was also revised downwards due to the lower extraction of crude projected given the exhaustion of Pluspetrol's lot I-AB in Loreto. This lower extraction of crude would be offset by a higher production of natural gas in Pluspetrol's lots 88 and 56.

Production in primary sectors would recover towards 2013 as a result of both the onset of mining projects, such as Toromocho, and normal climate conditions that would allow a moderate growth in the sector of agriculture and a recovery in the fishing sector.

Graph 50
PRODUCTION IN PRIMARY SECTORS: 2004 - 2013
(Real % change)



* Forecast.

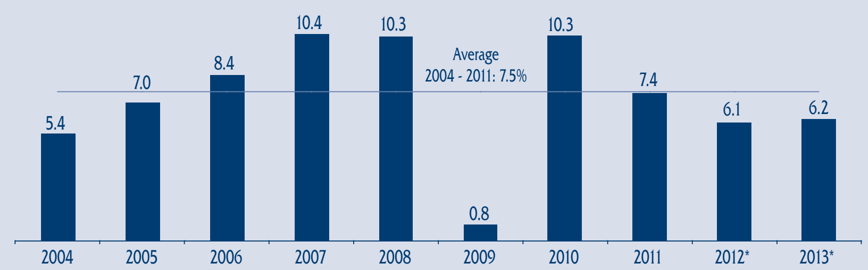
36. **Non-primary sectors** grew 7.4 percent in 2011, showing a slightly lower rate than the average rate of 7.5 percent registered in 2004–2010. The growth rates of non-primary sectors moderated over the year after the high rates recorded in 2010, especially in the sectors of non-primary manufacturing and construction.

The prospects for growth in the sector of manufacturing in 2012 are based on the better terms of trade considered today and on the trend registered by domestic demand in both consumption and investment. The demand for consumer goods such as food products, beverages, and textiles would be driven by better consumer expectations and by better incomes for the population, while the implementation of works by local and regional governments would be driven mainly by increased government spending. Moreover, the announcements of increased investments in housing compounds and malls would bring about a higher production of construction materials, such as cement, glass, iron, and steel.

In this context of higher spending in public and private investment, growth in the construction sector has been revised upwards due to the signs of recovery observed during the first months of the year.

The dynamism of non-primary sectors is expected to continue in 2013 when these sectors would register growth rates close to the economy's potential growth.

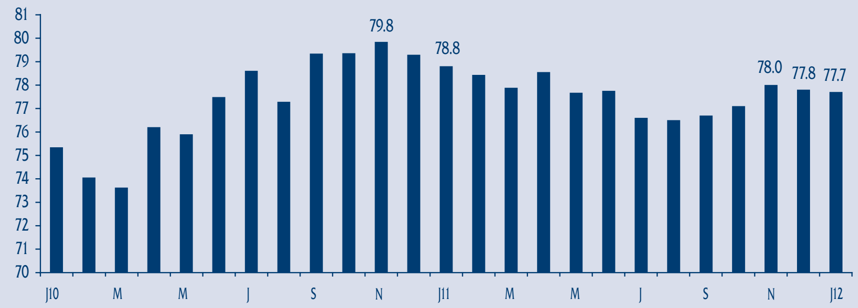
Graph 51
PRODUCTION IN NON PRIMARY SECTORS: 2004 - 2013
(Real % change)



* Forecast.

As reflected in the BCRP survey on macroeconomic expectations, in January the indicator of utilization of installed capacity in non-primary manufacturing showed a slightly lower level than in the previous two months, with a rate close to the average rate in the second semester of 2011.

Graph 52
RATE OF INSTALLED CAPACITY UTILIZATION OF NON PRIMARY MANUFACTURING
(%)



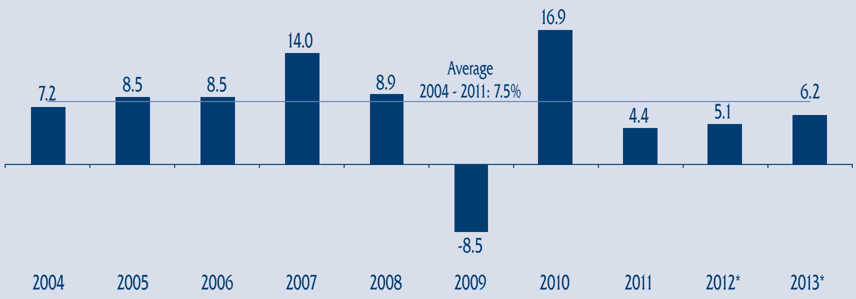
Source: BCRP's Survey of Macroeconomic Expectations .

Table 16
GROSS DOMESTIC PRODUCT BY ECONOMIC SECTORS
(Real % change)

	2010	2011	2012*		2013*	
			IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
Agriculture and livestock	**4.3**	**3.8**	**5.2**	**4.0**	**4.3**	**4.3**
Agriculture	4.2	2.8	5.8	3.8	3.7	3.7
Livestock	4.4	5.2	4.8	4.6	4.8	4.8
Fishing	**-16.4**	**29.7**	**-2.0**	**-4.7**	**2.8**	**2.8**
Mining and hydrocarbons	**-0.1**	**-0.2**	**4.4**	**2.8**	**10.6**	**10.7**
Metallic mining	-4.9	-3.6	4.3	3.2	9.7	9.0
Hydrocarbons	29.5	18.1	5.3	1.0	14.0	18.5
Manufacturing	**13.6**	**5.6**	**4.9**	**4.9**	**6.2**	**6.2**
Raw materials	-2.3	12.3	4.0	3.4	6.3	6.3
Non-primary industries	16.9	4.4	5.1	5.1	6.2	6.2
Electricity and water	**7.7**	**7.4**	**5.5**	**5.5**	**5.6**	**5.9**
Construction	**17.4**	**3.4**	**8.8**	**11.3**	**7.6**	**7.6**
Commerce	**9.7**	**8.8**	**5.7**	**5.9**	**5.4**	**5.4**
Other services	**8.0**	**8.3**	**5.3**	**5.8**	**6.3**	**6.3**
GDP	**8.8**	**6.9**	**5.5**	**5.7**	**6.3**	**6.3**
Memo:						
Primary GDP	1.1	4.4	4.6	3.3	6.6	6.7
Non-Primary GDP	10.3	7.4	5.6	6.1	6.2	6.2

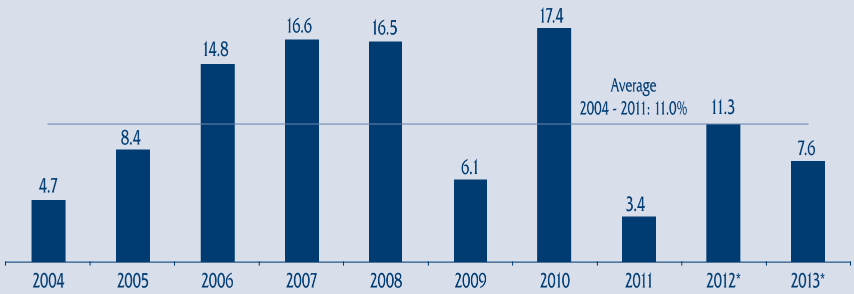
IR: Inflation Report.
* Forecast.

Graph 53
NON-PRIMARY MANUFACTURING: 2004 - 2013
(Real % change)



* Forecast.

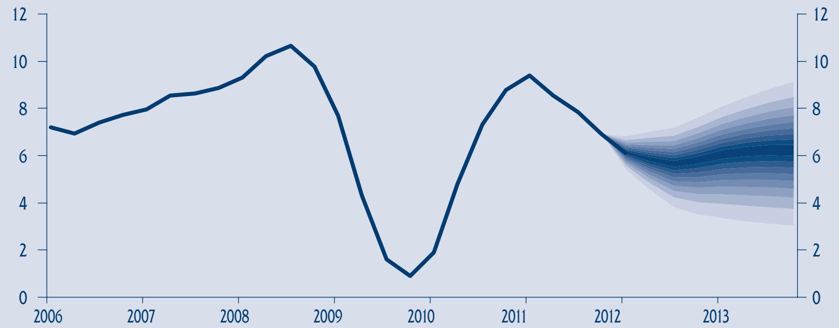
Graph 54
CONSTRUCTION: 2004 - 2013
(Real % change)



* Forecast.

37. Every growth forecast may be affected by possible events that can divert the forecast from its central scenario. In the current context of increased uncertainty, the materialization of some risks could imply a different GDP growth rate than the one originally forecast. In a scenario of risks that have a domestic origin, both household and business expectations deteriorate and generate a negative effect on the growth of consumption and investment. Likewise, a more critical international environment would imply a lower global growth that would affect both traditional and non-traditional Peruvian exports and would generate a negative impact on the country's economic activity. The risk scenarios considered in this Report are discussed in the chapter Balance of Risks.

Graph 55
FORECAST OF GDP GROWTH: 2012-2013
(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 December 2011) and the subjective perception of the BCRP. 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.

The graph consists of 18 bands, each band with a probability of 5% that the projected value may fall within it. 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), 10 are expected to fall within the clearer bands adjacent to the darkest ones, other 10 are expected to fall within the even clearer bands located above and below the second group of bands, and so on until 90 of the 100 values are distributed in the graph. The remaining 10 values would fall outside the bands.

The baseline scenario path is contained in the darker bands. The chapter on the balance of risks discusses the risk scenarios used for the inflation forecast in Graph 104. The balance of risks for GDP growth at end-2012 shows a slight downward bias, that is, the probability that GDP growth will be below the forecast considered in the baseline scenario is slightly higher than the probability that it will be above this forecast.

BOX 2
ELECTRICITY SECTOR:
SUPPLY - DEMAND BALANCE AT THE NATIONAL AND REGIONAL LEVELS, 2012 - 2013

In 2011 the effective power of Sistema Eléctrico Interconectado Nacional (SEIN) amounted to 6,444 MW. Given that the maximum demand in 2011 was 4,961 MW, the system' reserve margin at year end was 30 percent[1].

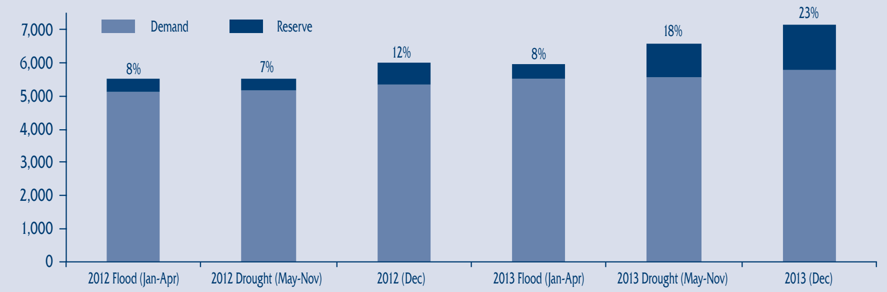
The reserve margin measures excess supply as a percentage of demand: a positive reserve margin implies a surplus of electricity that guarantees an unlimited power supply at the national level under optimal conditions of operation and without any weather, operational, or transmission constraints.

However, the supply that may actually be provided is negatively affected over the year by different factors, such as a sub-optimal operation of the system (e.g. generation or transmission failures), hydrological conditions (e.g. dry season or scarce rains between May and November), operational

1 (Effective power – maximum demand) / (Maximum demand).

conditions (e.g. maintenance programs and constraints in the supply of fuel/transportation of natural gas), as well as by limitations in the capacity of the transmission system. According to the Comité de Operación Económica del Sistema (COES), the reserve margin would range between 8 and 12 percent in 2012 and between 8 and 23 percent in 2013.

SEIN: SUPPLY - DEMAND
(MW, Reserve margin in %)

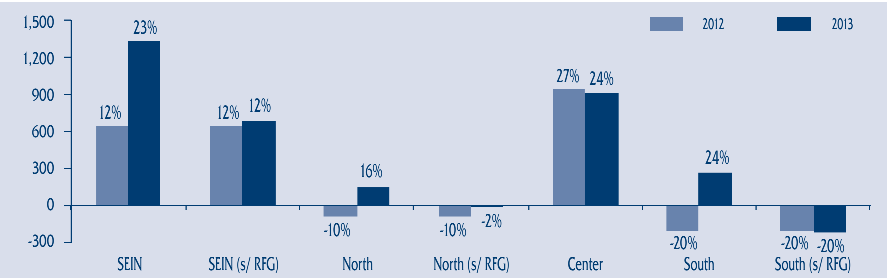


Memo: The supply and the reserve margin are adjusted by climatological and operational constraints.
Source: COES. Elaboration: BCRP.

These reserve estimates include the energy that will be generated with the onset of operations at two cold reserve power generation plants –one plant in the north area[2], in Talara (200 MW) and the other plant in the south area[3], in Ilo (564 MW)– since September 2013. These dual thermal generators –which operate both with diesel and natural gas– are expected to reinforce SEIN's capacity to secure a continuous supply of electricity given that, despite their higher-than-average fixed and variable costs, their startup and synchronization time to provide electricity in case of contingencies is only 30 minutes.

As regards the SEIN areas, deficits between the regional maximum demand and local generation of electricity would be observed in the north and south regions of the system during 2012. Because SEIN has a positive reserve margin nationally due to the surplus registered in the center region[4] which would by far offset any regional deficit, no risk of an electricity rationing is foreseen if the system operates under optimal conditions and if there are no electricity transmission constraints.

SEIN – ZONES NORTH, CENTER AND SOUTH: SUPPLY – DEMAND
(MW, Reserve margin in %)



Memo: The supply used to calculate the reserve was adjusted by a factor of 15 percent due to operational and hydrological conditions.
Source: COES. Elaboration: BCRP.

2 Tumbes, Piura, Lambayeque, Cajamarca, La Libertad, and Ancash.
3 Apurimac, Cuzco, Arequipa, Puno, Moquegua, and Tacna.
4 Huanuco, Ucayali, Lima, Pasco, Junin, Ica, Huancavelica, and Ayacucho.

These regional deficits would be reversed at end 2013 with the onset of operations at the cold generation reserve plants (CGR), as well as with several wind generation projects in the north (110 MW) and the hydroelectric power plant of Machu Picchu II (100 MW) in the south. Assuming that there will be no restrictions for the transmission of electricity in the north and south regions, this additional supply in 2013 could actually be supplied and there would be no risk of rationing. However, the lower relative efficiency of CGRs compared to other power generation technologies, such as hydroelectric power plants or combined cycle power plants, will imply an impact on electricity rates.

In order to complement the CGR, it is essential to ensure in the short-term that the SEIN networks are able to transmit the electricity required to and within the north and south areas in a timely and secure manner. However, risks of partial interruptions of supply are observed today mainly in the south region due to the congestion registered by the main transmission grids of this area to import electricity from the center region and to transmit energy in the southern region.

Without new investments in transmission projects, this situation would become more severe in the future given that the demand for electricity in the south will increase in the medium-term with the onset of operations of several mining projects in the next five years.

SEIN: MINING PROJECTS IN THE SOUTH
(Demand, MW)

Project	Departament	2012	2013	2014	2015	2016
Total - South		**98**	**105**	**318**	**837**	**1,005**
Antapaccay	Cusco	90	90	90	90	90
Expan. Concentr. Toquepala and Cuajone	Moquegua	8	8	44	44	44
Las Bambas	Apurímac		7	61	147	147
Expan. Cerro Verde	Arequipa			100	440	440
Constancia	Cusco			23	90	90
Quellaveco	Moquegua				10	114
Chucapaca - Cañahuire	Moquegua				9	35
Chapi	Moquegua				7	26
Quechua	Cusco					19

Source: COES. Elaboration: BCRP.

Therefore, it is essential to ensure the implementation of three transmission projects in the southern region of SEIN that currently show delays in the operation of the transmission lines involved. These projects are necessary to strengthen the transmission of electricity to and inside this region.

- <u>Center – South Flow</u>: Reinforcement of the coastal interconnection between the center (Lima) and south regions (Moquegua) required for the sustainability of SEIN.

- <u>Intra – South Transmission Grid</u>: Required to transmit the electricity generated by new generation projects due to start operations between 2013 and 2015 (C.H. Machu Picchu II, C.H. Santa Teresa, and C.T. Quillabamba) and to reinforce the flow between Cuzco and Arequipa.

SEIN: PROJECTS OF TRANSMISSION LINES WITH DELAYS (South)			
Line	**Tension**	**Coverage**	**Start***
Machu Picchu – Abancay - Cotaruse	220 kV	Intra-South: Cusco - Apurímac	Feb. 2013
Tintaya – Socabaya	220 kV	Intra-South: Cusco - Arequipa	Apr. 2013
Chilca – Marcona – Montalvo	500 kV	Centro-South: Lima - Moquegua	Aug. 2013

* Date of entry into operation of concession contracts as.
Source: COES. Elaboration: BCRP.

Some of the main reasons accounting for the delays of not less than six months that these projects show in their implementation are uncertainty about the scope and application of the Prior Consultation Law (Chilca - Marcona - Montalvo) and about the implications of the expansion of protected areas of the Machu Picchu-Choquequirao reserve approved by the Ministry for Environmental Affairs (Machu Picchu - Abancay - Cotaruse).

Even with the operation of the CRG at end 2013, the postponement of these transmission projects, together with the limitations observed today in the transportation of gas natural, shows a balance in which there are considerable risks of partial and transitory rationing of electricity for major clients during 2012 and 2013 due to transmission constraints and/or to SEIN failures.

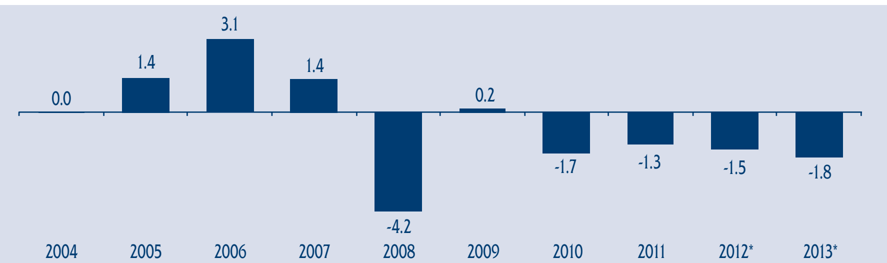
III. Balance of payments

38. Peru's external accounts continue to show low deficit levels in the current account due both to the high prices of commodities observed since the middle of the previous decade and due to the increase recorded in the volume of exports –particularly non-traditional exports– in the country's current context of diversification of products and markets. Between 2006 and 2011, the current account deficit has been 0.4 percent of GDP on average. This deficit has been coupled by significant flows of long term private capitals, which have contributed to ensure the sustainability of the balance of payments in the medium term.

39. In 2011 the current account deficit in the balance of payments amounted to US$ 2.267 billion, a figure equivalent to 1.3 percent of GDP (in 2010 the deficit was equivalent to 1.7 percent of GDP). To a great extent, this result reflects the better evolution of exports, which grew 8.5 percent in terms of volume and 20.0 percent in terms of prices compared to the previous year. On the side of the financial account, the flows of foreign direct investment and disbursements for projects maintained similar levels to those observed in 2010, but there was a lower flow of long term bank disbursements and of non-residents' purchases of assets.

40. A current account deficit of 1.5 percent of GDP is forecast for **2012**. This lower deficit than the one foreseen in our December report (2.2 percent) reflects mainly the improvement observed in the terms of trade due to the rise in the price of commodities, which would be offset by a higher factor income associated with the higher prices of exports. In 2013 the current account deficit would be equivalent to 1.8 percent of GDP, lower than the one estimated in our Report of December (2.1 percent of GDP).

Graph 56
CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS: 2004-2013
(% of GDP)



* Forecast.

Table 17
BALANCE OF PAYMENTS
(Millions of US$)

	2010	2011	2012*		2013*	
			IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
I. CURRENT ACCOUNT BALANCE	**-2,625**	**-2,267**	**-4,258**	**-2,955**	**4,418**	**-3,935**
% of GDP	*-1.7*	*-1.3*	*-2.2*	*-1.5*	*-2.1*	*-1.8*
1. Trade Balance	6,750	9,302	6,862	9,065	8,152	9,968
a. Exports	35,565	46,268	45,093	48,660	49,548	53,425
b. Imports	-28,815	-36,967	-38,231	-39,595	-41,397	-43,456
2. Services	-2,345	-2,132	-2,342	-2,409	-2,489	-2,722
3. Investment Income	-10,055	-12,636	-12,245	-13,028	-13,774	-14,825
4. Current transfers	3,026	3,200	3,467	3,416	3,694	3,643
Of which: Remittances	2,534	2,697	2,955	2,903	3,181	3,129
II. FINANCIAL ACCOUNT	**13,595**	**6,978**	**7,058**	**9,955**	**7,218**	**7,935**
Of which:						
1. Private Sector (long and short term)	13,887	8,467	6,626	8,714	7,261	8,049
2. Public Sector	-1,022	-104	412	886	-48	-118
III. BALANCE OF PAYMENTS (=I+II)	**10,970**	**4,711**	**2,800**	**7,000**	**2,800**	**4,000**
Memo:						
Gross long-term external private financing						
Millions US$	12,090	11,309	8,873	9,837	11,080	11,050
% of GDP	7.9%	6.4%	4.6%	4.9%	5.3%	5.1%
Balance of NIRs						
Millions US$	44,105	48,816	52,405	55,816	55,205	59,816
% of GDP	28.7%	27.6%	27.1%	28.0%	26.3%	27.7%

IR: Inflation Report.
* Forecast.

41. **Exports** in 2011 amounted to US$ 46.268 billion, which represents an increase of 30.1 percent compared to 2010. The volume of exports grew 8.5 percent due to the growth of exports of fishmeal (19.3 percent), coffee (27.8 percent), and non-traditional products (20.1 percent), especially agricultural, fishing, and chemical products.

Peru's exports have increasingly diversified in recent years and Latin American countries have become the main destination of Peruvian non-traditional exports. Because of this, the country's share of exports-to-GDP has risen from 13 percent at the beginning of the 2000s to 26.2 percent in 2011, the highest level registered during all this period.

Table 18
TRADE BALANCE
(% change)

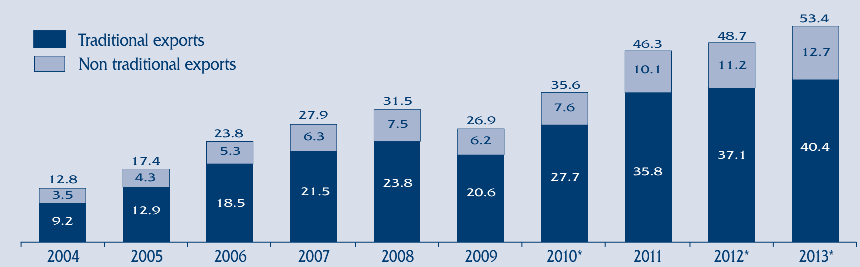
	2010	2011	2012*		2013*	
			IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
1. Value:						
Exports	31.9	30.1	-0.8	5.2	9.9	9.8
Traditional products	34.2	29.5	-3.6	3.5	9.1	8.9
Non-traditional products	23.5	32.6	8.5	10.7	12.5	12.9
Imports	37.1	28.3	4.5	7.1	8.3	9.8
2. Volume:						
Exports	1.9	8.5	5.6	7.3	8.6	8.9
Traditional products	-2.5	5.2	5.4	6.6	8.4	8.6
Non-traditional products	16.2	20.1	6.3	9.5	9.2	9.5
Imports	24.5	12.8	5.7	7.8	7.7	9.2
3. Price:						
Exports	29.9	20.0	-6.1	-1.9	1.2	0.9
Traditional products	37.5	23.2	-8.6	-2.9	0.6	0.2
Non-traditional products	6.0	10.6	2.0	1.1	3.0	3.1
Imports	10.1	13.8	-0.3	-0.5	0.6	0.5

IR: Inflation Report.
* Forecast.

42. The forecast for **exports** in 2012 has been revised upwards from US$ 48.5 billion to US$ 48.7 billion, due mainly to a price effect resulting from the higher prices of commodities relative to the ones considered in our previous Report. Exports in 2013 are estimated to amount to US$ 53.4 billion.

In terms of volume, exports would increase 7.3 percent in 2012 (5.6 percent was estimated in our previous Report), given that higher volumes of exports of fishmeal and fish oil and of non traditional products are expected in a scenario of higher growth in our trading partners. In 2013, the volumes of exports would grow 8.9 percent, mainly as a result of the onset of operations in some new mining projects, such as Toromocho.

Graph 57
EXPORTS OF GOODS: 2004-2013
(Billions of US$)



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

In 2012-2013 the volume of non traditional exports is expected to grow at an average rate of 9.5 percent due to the recovery of the global economy and to Peru's greater access to international markets as a result of the trade agreements already signed or currently being negotiated (15 agreements are already in force, 5 will be effective in the near future, and 4 are being negotiated). With this, the volume of exports in 2013 would be equivalent to 2.7 times the volume of exports registered in 2003.

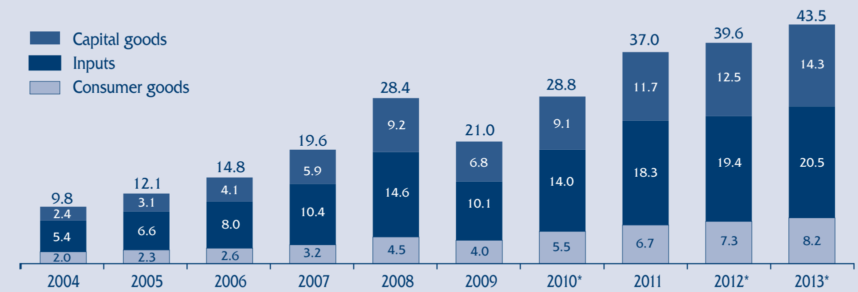
Graph 58
NON TRADITIONAL EXPORTS
Volume index (1994=100)

* Forecast.

43. **Imports** in 2011 were 28.3 percent higher than in 2010 and amounted to US$ 36.967 billion. The average volume of imports grew 12.8 percent, mainly as a result of higher volumes of imports of durable consumer goods, industrial inputs, and capital goods (excluding construction materials). This increase in the volume of imports is consistent with an economy in expansion that needs to increase its investment levels and acquire or renew capital, as well as with the population's better levels of income that reflect in an increased demand for durable consumer goods.

In 2012 the value of imports would reach US$ 39.6 billion due to the growth of imports in terms of volume –8 percent, a higher growth than previously estimated–, especially in the case of capital goods, in line with the higher private investment and higher private consumption foreseen. Imports in 2013 would amount to US$ 43.5 billion, reflecting an increase of 9.2 percent in the volume of imports of capital goods.

Graph 59
IMPORTS OF GOODS: 2004 - 2013
(Billions of US$)



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

44. Therefore, the forecast on the surplus in the **trade balance** in 2012 has been revised upwards considering that better terms of trade and higher volumes than the ones estimated in our previous Report are now projected. Thus, the trade surplus forecast has been revised from US$ 6.9 billion (Inflation Report of December) to US$ 9.1 billion.

In 2013, the trade surplus would rise to US$ 10.0 billion in a context where terms of trade would remain stable and the world economy would grow at a higher rate than in 2012.

Graph 60
TRADE BALANCE 2004-2013
(Millions of US$)

* Forecast.

Table 19
TRADE BALANCE
(Millions of US$)

	2010	2011	2012*		2013*	
			IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
Exports	**35,565**	**46,268**	**45,093**	**48,660**	**49,548**	**53,425**
Of which:						
Traditional products	27,669	35,837	34,011	37,105	37,117	40,400
Non-traditional products	7,641	10,130	10,709	11,212	12,048	12,659
Imports	**28,815**	**36,997**	**38,231**	**39,595**	**41,397**	**43,456**
Of which:						
Consumer goods	5,489	6,692	7,195	7,290	7,810	8,187
Inputs	14,023	18,255	18,033	19,428	19,078	20,516
Capital goods	9,074	11,665	12,564	12,472	14,048	14,328
TRADE BALANCE	**6,750**	**9,302**	**6,862**	**9,065**	**8,152**	**9,968**

IR: Inflation Report.
* Forecast.

Financial account

45. In 2011 the long term private financial account, which amounted to US$ 9.930 billion, was lower by US$ 3.421 billion than in 2010. This drop in the financial account resulted both from the decline observed in loans to the financial sector (down by US$ 1.544 billion) in a context of international uncertainty and from the decline registered in terms of non-residents purchases of government bonds in the domestic market (down by US$ 2.504 billion).

A reduction was observed in banks' short term external liabilities in a context of banks' re-composition of their external funding aimed at increasing long term and reducing short term funding. An increase was also observed in the external assets of the non-financial sector. These two movements resulted in a negative flow of about US$ 1.463 billion in the short term capitals account.

The financial account in 2012 would be higher than estimated in our December report (US$ 6.6 billion) and would amount to US$ 8.6 billion. This difference is explained mainly by the evolution observed in the first quarter so far this year: significant capital inflows from portfolio operations carried by private firms, long term disbursements for the financial sector, and non-residents' acquisition of both sovereign bonds and of other assets in the secondary market.

Given these capital inflows and with the purpose of preventing excessive volatility in the foreign exchange market, the Central Bank intervened in this market buying FC for a total of US$ 3.678 billion in the first two months of the year and another US$ 800 million in the first days of March.

Graph 61
PRIVATE SECTOR EXTERNAL FINANCING 1/
(Billions of US$)

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

Graph 62
FOREIGN PORTFOLIO INVESTMENTS IN THE COUNTRY
(Millions of US$)

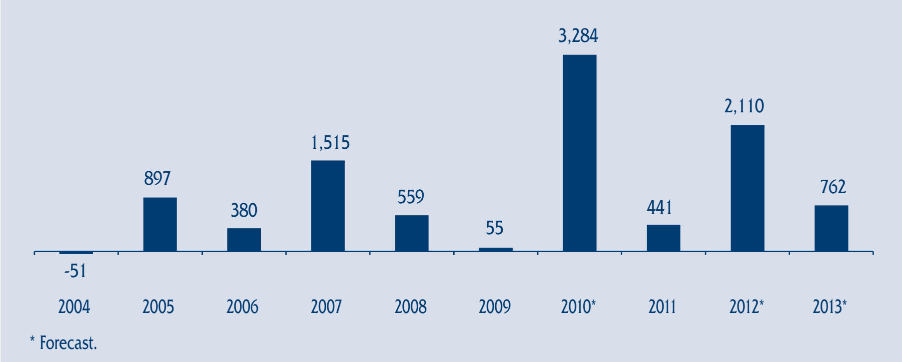


Table 20
PRIVATE SECTOR FINANCIAL ACCOUNT FLOWS
(Millions of US$)

	2010	2011	2012*		2013*	
			IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
1. ASSETS	**-1,051**	**-856**	**-1,617**	**-2,361**	**-3,232**	**-2,672**
Direct investment abroad	-215	-111	0	0	0	0
Portfolio investment abroad	-836	-745	-1,617	-2,361	-3,232	-2,672
2. LIABILITIES	**14,402**	**10,786**	**8,243**	**10,915**	**10,493**	**10,721**
Foreign direct investment in the country	7,328	7,659	7,335	6,731	8,772	8,150
Foreign portfolio investment in the country	3,284	441	362	2,110	462	762
Capital participation	87	147	0	0	0	0
Other liabilities	3,198	293	362	2,110	462	762
Long-term loans	3,790	2,687	546	2,074	1,259	1,808
Disbursements	4,977	3,760	1,538	3,106	2,308	2,900
Amortization	-1,187	-1,074	-992	-1,032	-1,050	-1,092
3. Total	**13,351**	**9,930**	**6,626**	**8,554**	**7,261**	**8,049**

* Forecast.

46. At February 2012, international reserves amounted to US$ 53.94 billion. This level of reserves, which gives the Peruvian economy a high response capacity to face possible real and financial shocks, is equivalent to 30.4 percent of GDP, backs up 90.8 percent of total liquidity in depository entities, and is equivalent to 6.1 times public and private external debt short term liabilities. Peru's international reserves are among the highest in the region.

Table 21
NIR INDICATORS

	2006	2010	2011	Feb. 2012
Net International Reserves (NIR, millions of US$)	17,275	44,105	48,816	53,940
NIR/GDP* (%)	18.7	28.7	27.7	30.4
NIR/Short term debt* (# of times)	2.9	5.2	5.3	6.1
NIR/Total Liquidity (%)	80.2	90.6	89.1	90.8

* Accumulated at the previous quarter.

BOX 3
GROWTH AND DIVERSIFICATION OF NON-TRADITIONAL EXPORTS (1996 – 2011)

The economic literature highlights the role of the growth and diversification of exports with added value as a factor that contributes to sustained economic growth[5]: contexts of increasing openness and trade diversification are based on firms domiciled in Peru which create more efficient processes, carry out innovations, adapt technology, adopt more demanding quality standards, and invest in human and physical capital.

Non-traditional exports (NTX) may be defined as those export products which have a higher degree of transformation or increase in added value. In comparison to traditional exports (TX), which are mainly the result of the exploitation of primary resources, NTX tend to generate a greater impact on GDP, productivity, incomes, and employment. The significant growth and diversification of Peru's NTX observed in the last fifteen years is worth analyzing in more detail.

Growth of exports with added value

Peru has been showing increasing trade openness in recent years: total exports and imports of goods and services as a percentage of GDP has recorded unprecedented levels with this ratio rising from 31.2 in 1996 to 53.4 percent in 2011. Exports account significantly for the country's increasing trade openness since they have grown by a real annual rate of 7.1 percent on average during this period, showing a higher growth rate than GDP in the same period (4.9 percent).

This growth of exports is partially due to the positive performance of NTX. Between 1996 and 2011, NTX recorded an annual average growth of 13.1 percent and the value of NTX, which increased

5 Various studies suggest that trade openness is a positive factor for the growth of productivity and for economic growth (Edwards, 1997; Frankel and Romer, 1999). On the other hand, the literature highlights the role of diversification of the supply of exportable goods as a means to reduce risks and decrease the volatility of traditional trade flows (Ghost and Ostry, 1994; Bleaney and Greenaway, 2001). Moreover, several studies suggest that the concentration of exports on a limited group of products (e.g. primary goods) can have a negative effect on economic growth (Sachs and Warner, 2000; Al-Marhubi, 2000; Hesse, 2006; Lederman and Maloney, 2007; Illescas and Jaramillo, 2011.

over six-fold in the past 15 years –from US$ 1.59 billion in 1996 to US 10.13 billion in 2011–, now exceeds US$ 10 billion. In contrast with TX, the evolution in the value of NTX is mainly explained by the greater volumes of these exports, which reflects a growing real penetration of Peruvian products with added value in international markets.

Diversification of exports with added value

The diversification of NTX is two-fold: there is a diversification of NTX in terms of new markets and a diversification of NTX in terms of new products. In the last fifteen years, the diversification of Peruvian exports has been marked by the strong growth of the supply of exports through new products. In 2011, goods that were not exported in 1996 accounted for 29 percent (US$ 2.98 billion) of the total value of NTX (as reflected in tariff sub-items).

EXPORTS OF NON-TRADITIONAL PRODUCTS BY COUNTRY OF DESTINATION
(Millions of US$)

Country	1996	2001	2006	2011	Change96/11 Flow
United States	482	793	1,760	2,340	1,858
Venezuela	58	115	328	892	834
Colombia	83	113	396	824	741
Ecuador	58	96	229	615	557
Chile	73	138	233	594	521
Spain	101	147	299	485	384
Netherlands	71	40	149	430	359
Bolivia	77	90	180	428	351
Brazil	36	50	149	353	317
China	3	20	137	331	328
France	44	48	157	232	188
Mexico	30	64	127	218	188
Italy	36	50	126	188	152
Germany	94	59	78	178	84
United Kingdom	36	40	103	169	133
Belgium - Luxemburg	32	11	47	143	111
Argentina	20	16	40	136	116
Japan	68	48	73	134	66
Canada	13	16	43	96	83
South Korea	14	13	48	94	80
Panama	12	24	28	91	80
Hong Kong	25	18	38	81	56
Haiti	0	9	39	72	72
Dominican Republic	3	13	29	59	57
Russia	3	3	6	59	56
Others	162	216	577	1,251	1,089
Total	**1,590**	**2,183**	**5,279**	**10,130**	**8,541**

Source: Aduanas. Elaboration: BCRP.

As regards exports' diversification in terms of markets of destination, the number of countries to which Peru exports non-traditional products has increased from 139 to 183 in the last 15 years. While the destination of Peruvian exports was already quite diversified in 1996, today 44 new countries import Peruvian products with added value, even though these new markets import relatively small amounts of NTX (a total of US$ 53 million in 2011).

Therefore, the main destinations of NTX in 2011 are similar to the main destinations of these exports in 1996. The United States and Andean countries –CAN, including Venezuela– are still very important destinations for Peruvian NTXs: their contribution to the growth of NTX was 52 percent. Other destinations that have contributed significantly to the growth of non-traditional exports are Chile (US$ 594 million in 2011), Spain (US$ 485 million), the Netherlands (US$ 430 million), Brazil (US$ 353 million), China (US$ 331 million), France (US$ 232 million), and Mexico (US$ 218 million). These countries account for over 75 percent of growth recorded by non-traditional exports since 1996.

It is also important to highlight the growth of NTX to some countries, such as China, South Korea, and Canada, which were not among the main destinations of Peruvian NTX in 1996 and now are among the 25 most important destinations of these exports. Coincidentally, all of these countries have signed trade agreements with Peru over the past few years.

As mentioned previously, the diversification of Peruvian NTX is mainly explained by exports of new products. In 1996, exports included 2,676 different items, while in 2011 this number reached 4,429 (growth of 65 percent). Moreover, 1,753 of these new items concentrated 29 percent of NTX in 2011.

If we analyze the main 50 tariff sub-items of non-traditional exports, it is clear that their composition has changed significantly between 1996 and 2011. The evolution of the main exports is characterized by their:

- Diversification: 15 of the 50 tariff sub-items with higher export value in 2011 did not register exports in 1996. Today these sub-items show an export value of US 1.26 billion and account for 15 percent of the total growth of NTX in this period.

- Strong growth: the top 50 tariff sub-items include 17 sub-items which have recorded an accumulated growth of over 5,000 percent (28 percent of average annual growth). Some of these tariff sub-items, whose export value amounts to US$ 1.99 billion, account for 22 percent of the total growth of NTX in the period.

EXPORTS OF NON TRADITIONAL PRODUCTS BY PRODUCT
(Millions of US$)

Item	1996	2001	2006	2011	Change 96/11 Flow
Fresh grapes	4	11	51	301	297
Copper wire	25	40	242	298	273
Fresh asparagus	27	64	187	292	266
Phosphates of calcium, unmilled	1	0	0	236	235
Frozen giant squid	0	29	91	231	231
Other cotton t-shirts (men and women)	0	23	82	200	200
Zinc: of lesser purity	0	1	99	200	200
Frosen giant squid	1	1	56	199	198
Cotton T-shirts - monochromatic (men and women)	60	83	212	174	114
Fresh avocado	0	3	39	164	164
Prepared asparagus	92	81	105	141	49
Frozen vieras	0	11	37	135	135
Colour lacques (carmine)	20	11	20	131	111
Canned artichokes	0	1	66	123	123
Other plates, print sheets and polymers strip of propylene	0	0	0	119	119
Fresh Mangos	11	27	59	115	104
Food for shrimps and prawns	0	10	35	94	94
Evaporated milk	1	5	52	94	93
Paprika	0	16	74	87	87
Sulfuric acid	6	3	3	87	80
T-shirts and shirts of cotton (men) - with partial opening (monochromatic)	33	19	37	85	51
Zinc oxide	7	7	60	82	75
Coloring matter of cochineal (carminic acid)	7	5	16	82	75
Other frozen fish (ex.anchovy and mackerel)	0	0	0	78	78
Ceramic floors	4	4	19	69	65
Prepared piquillo peppers	0	0	0	66	66
Organic banana	0	2	27	64	64
Raw cocoa: other uses	0	0	0	63	63
Tails of frozen shelled shrimp	33	6	34	58	25
Bars of refined copper	3	13	28	57	54
Frozen fillets of other hake species	0	0	0	56	56
Rips and friezes for parquet flooring of other species	0	0	0	56	56
Articles for the conveyance or packing of plastic	1	31	49	56	55
Other t-shirts and blouses (women / girls)	12	18	61	56	44
Printed sheet of polyethylene	0	1	16	56	56
Iron bars for construction	3	7	21	55	52
Other vegetables prepared in vinegar (ex. chilli peppers)	0	2	11	50	50
Noodles	0	6	10	49	48
Other compounds of silver	0	0	3	48	48
Polyethylene of ethylene	0	0	12	48	48
Frozen asparagus	12	15	27	48	36
T-shirts and shirts of cotton (men) - with partial opening (polychromatic)	0	9	27	47	47
Other prepared vegetables	0	0	0	46	46
Commercial catalogs	0	5	28	46	45
Tops of alpaca	0	0	28	44	44
Fresh onions	6	12	17	43	37
Mresh mandarins	1	4	15	40	40
Sweet cookies	0	4	21	40	40
T-shirts and shirts of cotton (men) - without partial opening	36	34	115	39	3
T-shirt Interiors (except of acrylic fibers)	0	1	15	36	36
Others	1,185	1,558	3,073	5,048	3,863
Total	**1,590**	**2,183**	**5,279**	**10,130**	**8,541**

Source: Aduanas. Elaboration: BCRP.

Non-traditional exports: Fundamentals and pending agenda

For a small open economy like Peru, the growth and diversification of exports with added value depends basically on endogenous factors, such as the country's degree and evolution of competitiveness, at the macro level, and of business competitiveness, at the micro level.

Peru's exports began to grow at a faster pace in the 1990s when some first generation reforms (e.g. unilateral tariff reduction) were introduced and then grew substantially in the last decade with the consolidation of trade openness as a State policy (e.g. free trade agreements). In this way, at the macro level trade liberalization was consolidated with macroeconomic stability (fiscal and monetary discipline), stable regulations for investment, financial soundness, and the improvement of national competitiveness, all of which contributed to gradually generate a business climate in the country oriented towards a model of growth based on private investment and exports. In addition to this, at the micro-level the country saw improvements in productivity and a gradual modernization of the private export sector towards business models based on quality and differentiation, which have been key to explain the growth of NTX. However, there are still many outstanding challenges in this area since, just as in 1996, most companies export less than US$ 5 million.

NUMBER OF COMPANIES ACCORDING TO THE VALUE OF THEIR NON TRADITIONAL EXPORTS

Sales range	1996	2001	2006	2011
Lower than US$ 5 Millions	3,321	4,033	6,112	7,006
Between US$ 5 and 10 Millions	45	37	85	158
Between US$ 10 and 20 Millions	21	32	55	83
Between US$ 20 and 30 Millions	4	14	18	26
Between US$ 30 and 40 Millions	4	5	10	19
Between US$ 40 and 50 Millions	0	2	7	15
More than US$ 50 Millions	0	0	14	25
Total companies	**3,395**	**4,123**	**6,301**	**7,332**
Non-traditional Exports (US$ Millions)	**1,590**	**2,183**	**5,279**	**10,130**

Source: Aduanas. Elaboration: BCRP.

in the case of exports of a few products or in the case of exports for a few destinations, recent empirical evidence on Peru's exports suggests that variations in the real foreign exchange rate have had no significant impact on the growth of Peruvian NTX. Furthermore, this possible effect has even been reduced due precisely to the growing diversification that Peruvian export firms are developing in terms of countries and of the products they export[6].

However, given their still high potential of growth –only 22 percent of Peruvian exports are non-traditional products–, the pending agenda to foster this growth is wide and requires the implementation of pending reforms (e.g. property rights, judicial system, quality of education, infrastructure, technology, competition in the financial system, flexible labor laws, elimination of bureaucratic barriers), as well as the generation and consolidation of opportunities to strengthen production linkages.

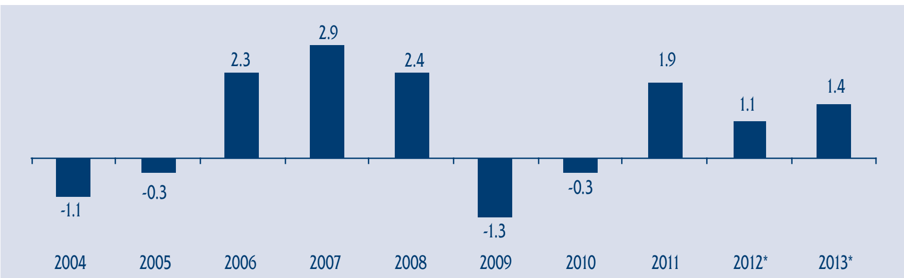
6 Potencial y Limitantes de las Exportaciones No Tradicionales, Nota de Estudios No. 15, BCRP, 2008.

IV. Public finances

47. Year 2011 was characterized by a growth of government revenues consistent with the good performance of economic activity and the high prices of our commodities. Some limits on public spending were established in the first months of the year to recover a fiscal space deemed necessary in a scenario of high uncertainty in international markets associated with the evolution of the external financial crisis, especially in Europe. Some measures were adopted towards the end of the year to reverse the negative growth rates of public expenditure, especially investment, which had been registered until Q3. These measures and the risk that the unspent resources would not be reallocated to the budgets of different government ministries led to a strong growth of spending in December.

As a result of this, in **2011** the non financial public sector (NFPS) recorded an **economic surplus of 1.9 percent of GDP**, which contrasts with the deficit registered in 2010 (0.3 percent). This balance resulted, on the one hand, from the increase of the current revenues of the general government (up by a real 13.6 percent) and, on the other hand, from the slowdown in the growth of spending, which grew by a real 1.9 percent (versus 11.8 percent in 2010).

Graph 63
ECONOMIC BALANCE OF THE NON FINANCIAL PUBLIC SECTOR: 2004-2013
(% of GDP)



* Forecast.

48. A fiscal surplus of **1.1 percent of GDP** is forecast for **2012**. This balance is consistent with a moderate growth of current revenues and with a growth of non financial expenditure that would be reflecting that both local and regional governments are overcoming the budget implementation problems they faced in 2011 given that new authorities took office in province and regional municipalities. The result estimated for this year is slightly higher than the one considered in our December

Report (1.0 percent of GDP) due to the higher growth expected in the current revenues of the general government as a result of the higher prices foreseen for our exports of minerals.

Table 22
NON FINANCIAL PUBLIC SECTOR
(% of GDP)

	2010	2011	2012* IR Dec.11	2012* IR Mar.12	2013* IR Dec.11	2013* IR Mar.12
1. General government current revenues 1/	**20.0**	**21.0**	**21.0**	**21.2**	**21.0**	**21.2**
Real % change	*18.6*	*13.6*	*4.6*	*5.5*	*6.6*	*6.3*
2. General government non financial expenditure	**19.2**	**18.1**	**18.9**	**18.9**	**18.4**	**18.7**
Real % change	*11.8*	*1.9*	*10.7*	*9.6*	*3.6*	*5.4*
Of which:						
a. Current	13.1	13.0	12.8	12.9	12.4	12.7
Real % change	*8.4*	*7.2*	*2.6*	*3.6*	*3.1*	*4.5*
b. Gross capital formation	5.5	4.7	5.7	5.6	5.6	5.7
Real % change	*20.8*	*-7.7*	*33.6*	*25.1*	*4.8*	*7.1*
3. Others	**0.0**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**
4. Primary balance (1-2+3)	**0.9**	**3.0**	**2.1**	**2.3**	**2.6**	**2.4**
5. Interests	**1.2**	**1.2**	**1.2**	**1.1**	**1.1**	**1.1**
6. Overall Balance	**-0.3**	**1.9**	**1.0**	**1.1**	**1.5**	**1.4**
Memo:						
1. Central government current revenues (billions of S/.)	87.0	102.1	109.0	111.2	118.3	120.6
2. Central government non-financial expenditure (billions of S/.)	83.4	87.8	98.0	99.4	103.5	106.8

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.

The forecast scenario estimates a balance of 1.4 percent of GDP in the NFPS in **2013**, taking into account variations in revenues and expenditures that are more consistent with a long term trend. It is worth pointing out, however, that the scenario on which this forecast is based may be affected by the evolution of the prices of our commodities and by the demand for our exports. If any of the latter declined, this would imply deterioration in the results foreseen.

Evolution of fiscal revenues

49. **In 2011 the current revenues of the general government** amounted to 21.0 percent of GDP, which means that these revenues grew by a real 14 percent. Within tax revenues –which grew 13 percent–, income tax showed the highest

growth (26 percent), favored by the rise in the price of commodities in the case of the mining and hydrocarbons sectors. The income tax also showed an important growth in the sectors of manufacturing (28 percent), commerce (25 percent), and other services (22 percent).

Table 23
THIRD CATEGORY INCOME TAX 1/
(Millions of nuevos soles)

	2010	2011	Real % change
TOTAL REVENUES	**14,652**	**19,321**	**27.6**
Mining	4,831	6,290	26.0
Other Services 2/	4,526	5,716	22.2
Manufacturing	1,891	2,505	28.2
Commerce	1,926	2,492	25.2
Hydrocarbons	864	1,474	65.1
Construction	507	706	34.7
Fishing	80	87	5.2
Agriculture and livestock	26	50	86.1

1/ Non including income tax regularization, non residential rents.
2/ Includes real estate activities, of business and rent, telecommunications, financial intermediation, health, social services, tourism and hospitality, generation of electricity and water, and others.
Source: Sunat.

50. Moreover, in 2011 the VAT grew 10 percent in real terms. This growth, which was the result of a 9 percent growth in the domestic VAT and a 12 percent growth in the external VAT, was registered although the VAT rate was reduced from 19 to 18 percent since March 1, 2011. Non-tax revenues also showed a remarkable growth (16 percent), particularly in the case of oil, gas, and mining royalties which grew by a real 44 percent due to the effect of the high prices of crude and minerals.

It should be pointed out that these royalties were increased in Q4-2011 when the tax treatment to royalties on mining[7] were modified and that therefore this increase is partially reflected in this quarter. The revenues from the new mining royalty, the special levy on mining, and the special tax on mining amounted to S/.265 million. This amount corresponds to the accruals of obligations of October which were recorded in the months of November and December, as well as some advanced payments that mining companies made for their accrued operations in November.

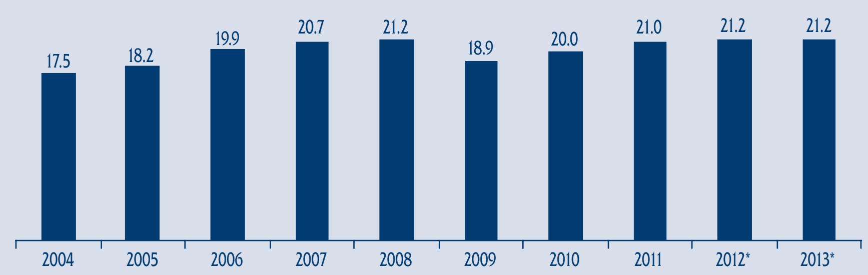
7 The law modifying the Law on Mining Royalties (Law N° 29788), the law establishing the Special Tax on Mining (Law N° 29789) and the law establishing the legal framework for the Special Levy on Mining (Law N° 29790) were published on September 28, 2011.

Table 24
GENERAL GOVERNMENT CURRENT REVENUES
(% of GDP)

	2010	2011	2012*		2013*	
			IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
TAX REVENUES	**15.2**	**15.9**	**15.8**	**15.9**	**15.8**	**15.9**
Income tax	5.9	6.9	6.7	6.8	6.7	6.7
Value added tax	8.2	8.3	8.5	8.5	8.5	8.5
Excise tax	1.1	1.0	1.0	0.9	1.0	0.9
Import duties	0.4	0.3	0.3	0.3	0.3	0.3
Other tax revenues	1.4	1.4	1.5	1.5	1.5	1.5
Tax returns	-1.8	-2.0	-2.0	-2.1	-2.0	-2.1
NON TAX REVENUES	**3.0**	**3.3**	**3.4**	**3.5**	**3.5**	**3.5**
CONTRIBUTIONS	**1.8**	**1.9**	**1.8**	**1.8**	**1.8**	**1.8**
TOTAL	**20.0**	**21.0**	**21.0**	**21.2**	**21.0**	**21.2**

* Forecast.

Graph 64
GENERAL GOVERNMENT CURRENT REVENUES: 2004-2013
(% of GDP)



* Forecast.

In **2012** the current revenues of the general government would grow by a real 5.5 percent, as a result of which the revenue-to-GDP ratio would be 21.2 percent, slightly higher than in 2011 (21.0 percent). The pace of growth projected for the current revenues of the general government in this Report is higher than the one considered in our Report of December due to the higher prices foreseen for our main mineral exports. The variation projected for 2012 considers that the impact of the tax measures adopted in 2011 would be fully observed, that is, observed in the twelve months of the year, only in the tax revenues of 2012.

In **2013** the current revenues-to-GDP ratio would remain at 21.2 percent in a context in which the economy would grow at rates close to its potential level of growth. It is worth pointing out that the forecasts for 2012 and 2013 consider the current tax structure.

51. Increasing significantly compared to 2010 (5.9 percent of GDP), revenues from the **income tax** amounted to 6.9 percentage points of GDP in 2011. This increase

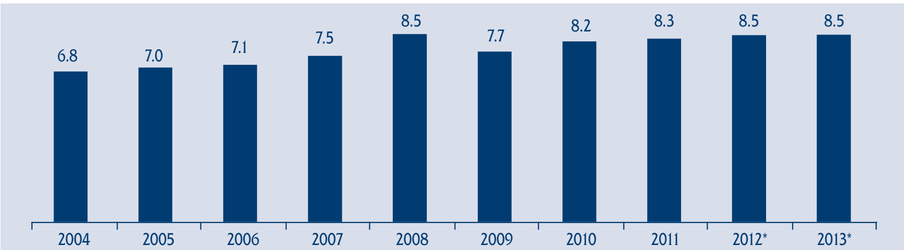
was associated, on the side of legal entities, with the higher payment of taxes from mining companies due to the higher prices of export metals, as well as with the higher ratios used by companies for payments on account[8] of this tax during the year. Additionally, revenues from work-related income tax also showed positive results due to the growth of formal employment during 2011. A slightly downward trend is estimated for 2012 and 2013 in the revenues from this tax in GDP terms due to the expected evolution of the prices of minerals in these years.

Graph 65
INCOME TAX AND EXPORT PRICE INDEX: 2004-2013

* Forecast.

52. Revenues from the **value added tax** (VAT), the main source of tax revenues, grew by a real 10 percent, as a result of which the ratio of this tax grew from 8.2 to 8.3 percent in GDP terms in 2011 even though the rate of this tax was lowered from 19 to 18 percent this year. The positive performance of the Peruvian economy and the measures adopted to expand the tax base, among which the extension of the tax withholding system to other products stands out, have counterbalanced the impact of the reduction of this tax rate. The measures aimed at expanding the tax base will reflect in the following years, allowing the VAT to increase in GDP terms by 0.2 percentage points in 2012 and 2013 in comparison with the level recorded in 2011.

Graph 66
VALUE ADDED TAX
(% of GDP)

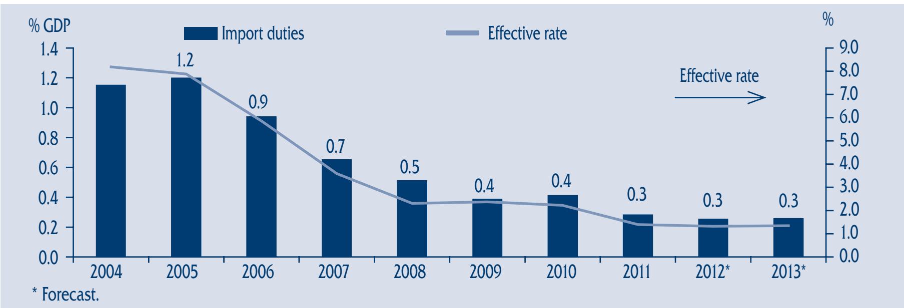


* Forecast.

8 The monthly payments that companies make as payments on account of the income tax are determined on the basis of a ratio applied to the net income in the month. The ratio, in this case, is obtained by dividing the tax for fiscal year 2010 by the company's total net income in the same period.

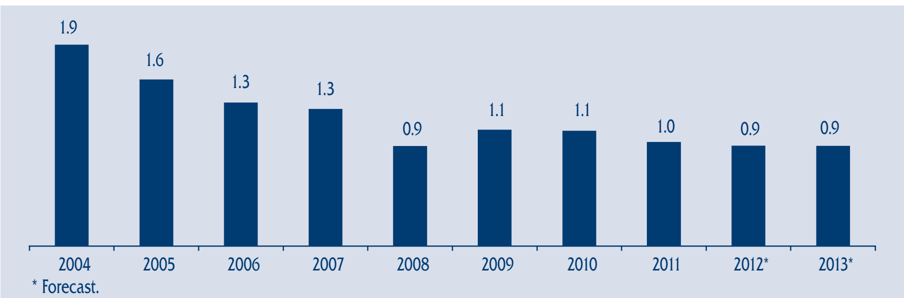
53. In 2011 revenues from **tariffs on imports** fell from 0.4 to 0.3 percent of GDP (26 percent in real terms), reflecting the reductions of tariff rates implemented in December 2010 and April 2011, which reduced the effective tariffs by up to 1.3 percent. The trade agreements signed with other countries, which implied nil or very low tariff rates for some products have also affected the evolution of these revenues, although to a lower extent. These effects have been partially offset by the growth of imports during the year. The revenues from import duties are expected to remain at similar levels in the next years since no further tariff reduction is foreseen.

Graph 67
IMPORT DUTIES AND EFFECTIVE RATE: 2004-2013



54. The revenue from the **excise tax**, which was equivalent to 1.0 percent of GDP in 2011, was lower by 0.1 percentage points than the recorded in 2010. In real terms, this represents a decline of 2 percent as a result of the drop registered in revenue from the excise tax on fuels (10 percent) due to the two reductions established on the rate of this tax in January and June of last year. This effect was partially offset by a higher collection of the excise tax on other goods –particularly beers, liqueurs, soft drinks, and cigarettes–, which rose 7 percent. In 2012 the excise tax is expected to decline in GDP terms given that the reduction of the rate of the excise tax on fuels in June 2011 implies a negative variation in the revenues from this tax in the first semester of 2012.

Graph 68
EXCISE TAX
(% of GDP)



Evolution of public expenditure

55. In **2011** the non financial expenditure of the general government was equal to 18.1 percent of GDP, an amount that represented a drop of 1.1 percentage points compared to the one registered in 2010 (19.2 percent). This drop was basically recorded in the gross capital formation of the general government, which fell from 5.5 percent of GDP to 4.7 percent. Even though this decline of expenditure was observed in the three levels of government –national, regional, and local–, local governments registered the highest drop (16 percent). The decline in the case of regional governments was 10 percent and 4 percent in the case of the national government.

Table 25
GENERAL GOVERNMENT NON FINANCIAL EXPENDITURE
(Real % change)

	2010					2011				
	1Q.	2Q.	3Q.	4Q.	Year	1Q.	2Q.	3Q.	4Q.	Year
I. CURRENT EXPENDITURE	**21.5**	**9.2**	**3.0**	**3.3**	**8.4**	**3.4**	**7.9**	**8.1**	**8.6**	**7.2**
National government	26.0	9.6	1.6	2.1	8.5	6.9	9.6	11.3	3.6	7.7
Regional governments	6.0	3.7	2.7	0.8	3.2	-0.2	2.2	1.3	21.4	6.9
Local governments	24.2	16.1	11.5	14.6	16.1	-11.8	6.9	2.4	17.8	5.3
II. CAPITAL EXPENDITURE	**25.6**	**49.0**	**21.3**	**5.0**	**20.2**	**-22.3**	**-15.9**	**-21.5**	**5.5**	**-9.6**
National government	31.2	85.8	25.6	19.1	35.7	7.3	3.6	-6.5	-11.1	-3.5
Regional governments	50.9	45.1	26.9	-5.4	17.6	-10.4	-26.4	-28.2	13.3	-9.5
Local governments	11.7	17.0	15.6	-2.1	8.1	-59.7	-38.7	-30.5	19.5	-16.4
III. TOTAL EXPENDITURE	**22.3**	**19.3**	**8.2**	**3.9**	**11.8**	**-2.0**	**0.3**	**-1.2**	**7.4**	**1.9**
National government	26.7	22.1	5.5	6.1	13.5	6.9	8.1	7.8	-0.4	5.2
Regional governments	12.9	13.7	9.6	-1.7	7.4	-2.3	-6.7	-8.5	18.2	1.6
Local governments	17.9	16.6	13.9	3.3	11.3	-34.7	-17.7	-17.3	18.9	-7.3

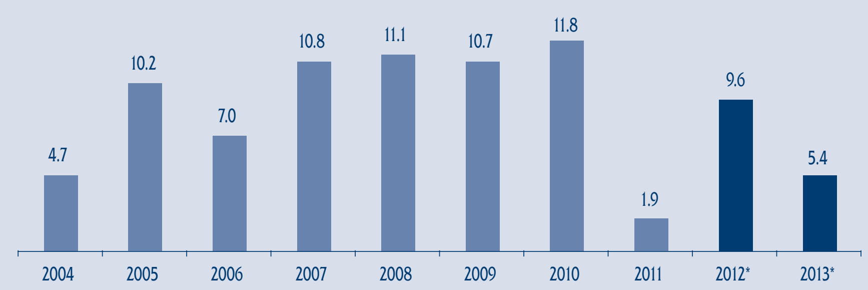
Table 26
GENERAL GOVERNMENT NON FINANCIAL EXPENDITURE
(Contribution to the real % change)

	2010					2011				
	1Q.	2Q.	3Q.	4Q.	Year	1Q.	2Q.	3Q.	4Q.	Year
I. CURRENT EXPENDITURE	**17.1**	**6.9**	**2.2**	**2.1**	**5.9**	**2.7**	**5.4**	**5.6**	**5.4**	**4.9**
National government	13.9	4.8	0.8	0.9	4.1	3.8	4.5	5.2	1.5	3.6
Regional governments	1.0	0.6	0.4	0.1	0.4	0.0	0.3	0.2	2.4	0.9
Local governments	2.2	1.5	1.0	1.1	1.4	-1.1	0.6	0.2	1.4	0.5
II. CAPITAL EXPENDITURE	**5.2**	**12.5**	**6.0**	**1.9**	**5.9**	**-4.7**	**-5.1**	**-6.8**	**2.1**	**-3.0**
National government	2.6	8.5	2.5	2.6	3.9	0.7	0.6	-0.7	-1.8	-0.5
Regional governments	1.6	2.2	1.6	-0.4	1.0	-0.4	-1.5	-1.9	1.0	-0.6
Local governments	1.1	1.8	2.0	-0.3	1.0	-5.0	-4.1	-4.1	2.8	-2.0
III. TOTAL EXPENDITURE	**22.3**	**19.3**	**8.2**	**3.9**	**11.8**	**-2.0**	**0.3**	**-1.2**	**7.4**	**1.9**
National government	16.5	13.3	3.2	3.5	8.0	4.4	5.0	4.4	-0.2	3.1
Regional governments	2.6	2.7	1.9	-0.3	1.5	-0.4	-1.3	-1.7	3.4	0.3
Local governments	3.2	3.3	3.0	0.7	2.4	-6.0	-3.5	-3.9	4.3	-1.5

The measures adopted by the government in the first half of 2011 to ensure that the fiscal rule established in the Financial Balance Act would be met –a surplus of 2 percent of GDP in the first semester–, together with the difficulties faced by the new authorities of the regional and local governments in the execution of their budgets –particularly in terms of investments– led to negative growth rates in expenditure in most of the year. Two emergency decrees[9] were enacted in September and in October to stimulate government spending and reverse the declining trend of expenditure.

These measures, associated in turn with the risk that the budgets of the different government sectors would not be allocated the resources assigned to them, contributed also to the fact that expenditure in the general government registered high rates of growth in December (local governments increased their spending by a real 39 percent, regional governments increased it by 29 percent, and the national government by 12 percent). These significant variations translated into a growth of 7 percent in the non financial expenditure of the general government in Q4-2011, thus allowing the reversal of the negative trend that expenditure showed until then. Finally, non financial expenditure at end 2011 was 2 percent. By components, current expenditure grew 7 percent, while capital expenditure declined 10 percent due to a weak execution of investment projects.

Graph 69
GENERAL GOVERNMENT NON FINANCIAL EXPENDITURE: 2004-2013
(Real % change)



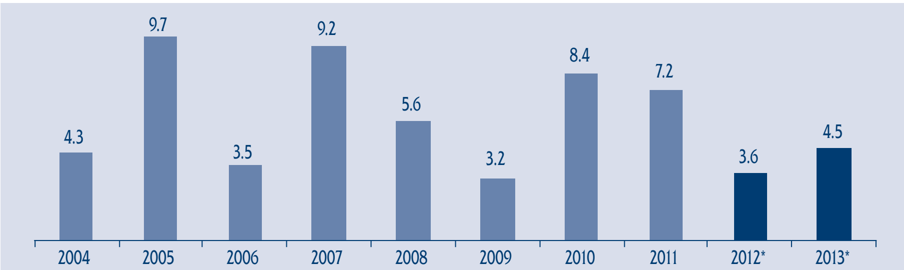
* Forecast.

56. A real growth of 10 percent is estimated in non financial public expenditure in 2012. The nominal amount projected is consistent with the one considered in the revised Multiannual Macroeconomic Plan of August 2011, and also includes an additional expenditure for the execution of the fiscal contingency plan expressed in emergency decrees 054 and 058. It is worth pointing out that the scope of these decrees involved not only year 2011, but also year 2012, and therefore included

9 Emergency Decree N° 054-2011 dated September 20 and Emergency Decree N° 058-2011 dated October 26, 2011.

measures such as moving forward the processes of selection of projects for 2012 and establishing the continuity of investments, which means that the resources for investment projects that have not been accrued by December 31, 2011, may be included in the 2012 budget. In 2013 non financial expenditure would grow 5 percent, in line with a long term growth trend. It should be pointed out that the forecasts on public expenditure considered in this baseline scenario are consistent with the fiscal rules on the deficit and growth of expenditure contained in the Fiscal Responsibility and Transparency Act.

Graph 70
NON FINANCIAL CURRENT EXPENDITURE OF THE GENERAL GOVERNMENT: 2004-2013
(Real % change)



* Forecast.

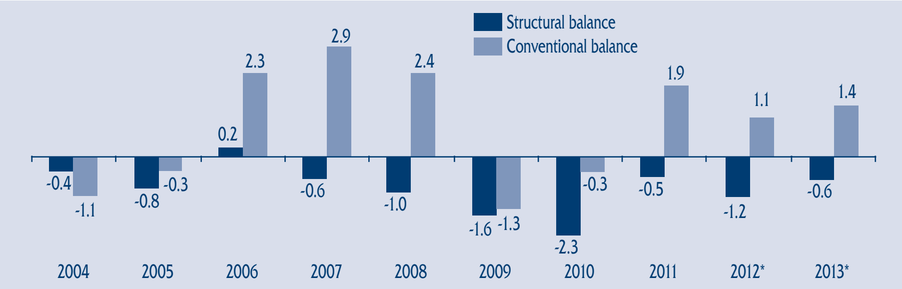
Graph 71
GENERAL GOVERNMENT CAPITAL EXPENDITURE: 2004-2013
(Real % change)

* Forecast.

Structural economic balance and fiscal impulse

57. The **structural economic balance** is the balance that would be obtained if GDP were at its trend level and if the prices of mineral and hydrocarbons exports were at their long term values. This balance is calculated isolating the effects that the business cycle and the higher prices of mining and hydrocarbon exports have on the revenues of the general government. This indicator was negative by 0.5 percent of GDP in 2011. It is estimated that in 2012 this balance would deteriorate and show a deficit of 1.2 percent of GDP, resuming a downward trend thereafter in 2013.

Graph 72
CONVENTIONAL AND STRUCTURAL BALANCE OF THE NON FINANCIAL PUBLIC SECTOR: 2004-2013
(% of GDP)

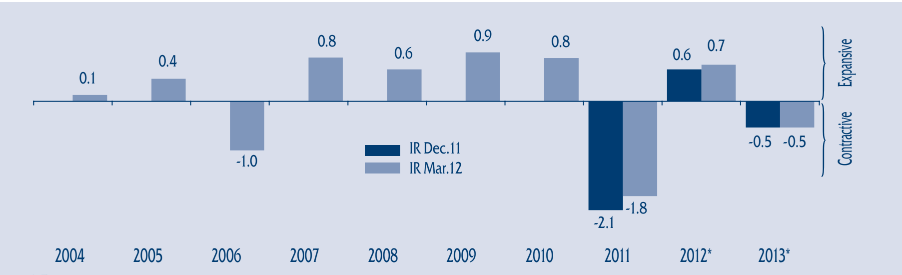


* Forecast

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.

58. The change in the structural balance determines the fiscal impulse. This indicator allows us to isolate the effect of fiscal policy on domestic demand excluding the effects of the economic cycle. In 2011 the fiscal policy has played a contractive role due to the slowdown registered in the pace of growth of public expenditure. The opposite situation, that is, an expansionary fiscal position would be observed in 2012 given the growth of public spending projected for this year.

Graph 73
FISCAL IMPULSE: 2004-2013
(% 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

59. Because of the lower financial requirements of the public sector associated with the fiscal surplus recorded in 2011, no external financing was obtained via bond issuances. The **financing requirements of the public sector** for 2012 and 2013 would be negative by US$ 534 million and US$ 1.09 billion, respectively, in line with the positive fiscal results that would be obtained in these years.

Table 27
FINANCIAL REQUIREMENTS OF THE NON-FINANCIAL PUBLIC SECTOR AND ITS FINANCING 1/
(Millions of US$)

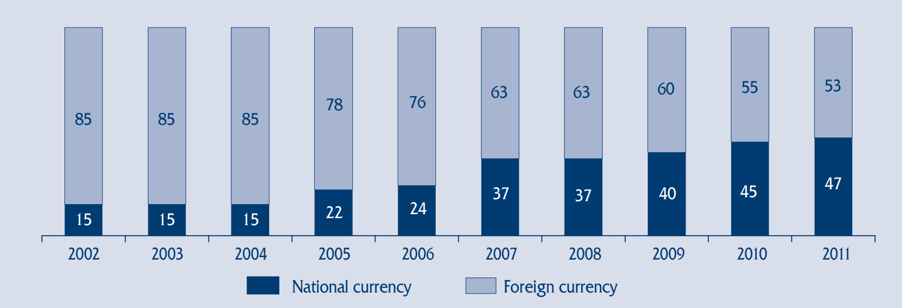
	2010	2011	2012*		2013*	
			IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
I. Uses	**2,000**	**-1,851**	**-136**	**-534**	**-1,595**	**-1,088**
1. Amortization	1,496	1,365	1,672	1,634	1,566	1,852
a. External debt	952	831	1,170	1,164	946	1,227
b. Domestic debt	543	535	503	470	620	625
Of which: Recognition bonds	263	193	255	242	210	210
2. Overall balance (negative sign indicates surplus)	504	-3,217	-1,809	-2,168	-3,161	-2,940
II. Sources	**2,000**	**-1,851**	**-136**	**-534**	**-1,595**	**-1,088**
1. External	1,532	1,108	1,221	1,228	1,130	1,128
2. Bonds 2/	835	436	1,487	1,598	576	585
3. Internal 3/	-367	-3,395	-2,843	-3,361	-3,302	-2,801
Memo:						
Balance of gross public debt						
Billions of US$	36.0	38.3	38.8	39.6	39.0	39.5
% of GDP	23.4	21.7	20.1	19.9	18.6	18.3
Balance of gross public debt 4/						
Billions of US$	17.8	14.5	12.4	12.2	8.6	8.8
% of GDP	11.5	8.2	6.4	6.1	4.1	4.1

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, MEF.

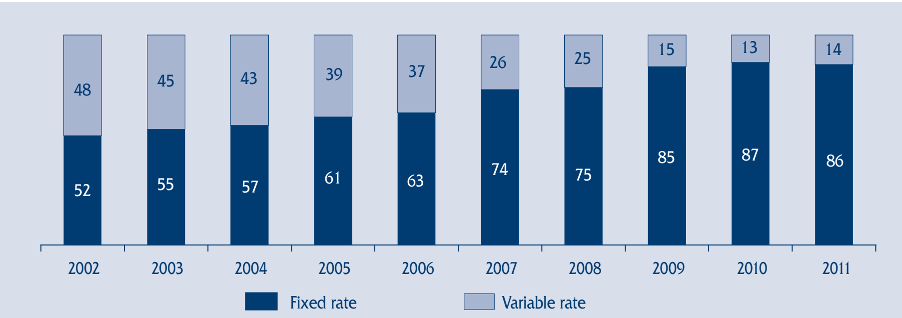
60. In January 2012, the Ministry of Finance (MEF) placed bonds in the international market for an equivalent of US$ 1.1 billion, of which US$ 500 million corresponded to the reopening of Peru's 2050 Global Bond and US$ 600 million to the reopening of the 2031 Sovereign Bond. The 2050 Global Bond, the debt instrument with the longest maturity issued by our country, concentrated the highest market demand. The yield rate of this bond was 5.372 percent, while the yield rate of the sovereign bond was 6.875 percent.

61. As regard the composition of the debt by currencies, market risks associated with fluctuations in the foreign exchange rate have been decreasing since the share of the debt in foreign currency declined to 53 percent at end 2011. As regards the type of rate, in 2011 the fixed rate debt represented 86 percent of the total debt, a ratio very close to the one recorded in 2009 and 2010.

Graph 74
PUBLIC DEBT BALANCE BY CURRENCY
(%)

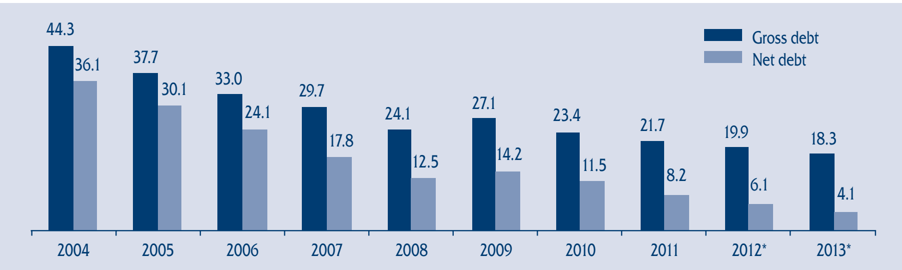


Graph 75
PUBLIC DEBT BALANCE BY RATE TYPE
(%)



62. The gross and the net debt will continue to decline due to the growth of both economic activity and public sector deposits. At end 2012 the gross debt is expected to reach 19.9 percent of GDP, while in 2013 this ratio would be 18.3 percent of GDP. The net debt would also reproduce this trend, declining from 8.2 percent of GDP in 2011 to 4.1 percent of GDP in 2013.

Graph 76
PUBLIC DEBT: 2004-2013
(% of GDP)



* Forecast.

BOX 4

METHOD USED TO CALCULATE THE STRUCTURAL BALANCE

The structural balance is a non-observable variable that measures the economic balance that the accounts of the non financial public sector (NFPS) would show if economic activity and the prices of mineral and hydrocarbon exports were at their trend or potential levels. The following methodological criteria are taken into account to estimate the structural balance:

- The structural balance is estimated for the overall balance of the NFPS.
- The tax revenue base used to make the adjustment for the price cycle of metal and hydrocarbon exports includes the third category income tax and the royalties from the sectors of mining and hydrocarbons.
- No cyclical adjustment is made in the general government expenditures and the primary balance of State-owned enterprises.
- The reference price used to calculate structural revenue is the average of the international prices of minerals and hydrocarbons in 15 years.

Implementation

The revenues of the general government (IGG_t) are broken down into revenues from the mining and hydrocarbons sectors (IM_t) and the rest of the general government income ($RIGG_t$).

In turn, the revenues from the mining and hydrocarbons consist of payment on account and regularization of the corporate income tax –third category income tax– paid by these sectors $PCIRM_t$ and $RIRM_t$, respectively) and royalties (RM_t).

These resources are adjusted by the cycle of the international prices of minerals and hydrocarbons to obtain their structural value. Thus, the "structural" level of these variables can be expressed as:

$$PCIRM_t^e = PCIRM_t\left(\frac{PM_t^e}{PM_t}\right)^{\alpha}$$

$$RIRM_t^e = RIRM_t\left(\frac{PM_{t-1}^e}{PM_{t-1}}\right)^{\alpha}$$

$$RM_t^e = RM_t\left(\frac{PM_t^e}{PM_t}\right)^{\gamma}$$

Where $PCIRM_t^e$, $RIRM_t^e$ and RM_t^e are the "structural" component of payment on account of tax income, regularization of tax income, and royalties paid by the sectors of mining and hydrocarbons, respectively, PM_t is the price index of mining (and hydrocarbon) exports[10] and xxxxx is the reference or long-term value, which is estimated as a moving average of export

10 A Laspeyres index with 2010 as base year is used for the prices of mining exports, while the price of crude oil in the Gulf Coast (West Texas Intermediate price) is used for the prices of hydrocarbons.

prices in a period of 15 years[11]. In this way, the ratio $\frac{PM_t^e}{PM_t}$ reflects the gap of export prices relative to the reference value

It should be noted that both the payment on account and the regularization of income tax are adjusted with an elasticity (α) estimated based on regressions of tax revenue and international prices. The value of this parameter is currently 2.7 for the mining sector and 2.1 for the hydrocarbons sector. Furthermore, the regularization of income tax is adjusted for the price gap existing in the previous period to reflect the fact that it is a payment that corresponds to the operations carried out at the time.

On the other hand, revenue from mining and gas royalties, which does not include payments for regularization to tax payments, is adjusted considering a unitary elasticity (i.e. γ=1).

The revenues of the general government (IGG_t) are adjusted for the effects of the business cycle as follows:

$$IGG_t^e = IGG_t \left(\frac{Y_t^e}{Y_t}\right)^{\beta_t}$$

Where IGG_t^e is the structural component of the revenues of the general government, Y_t is real GDP, and Y_t^e is real potential GDP. In this expression the ratio $\frac{Y_t^e}{Y_t}$ reflects the output gap, which measures the business cycle. Thus, if economic activity is above the potential level, structural revenues will be lower than the ones observed, and vice versa.

Parameter β_t measures the elasticity of the revenue of the general government relative to GDP. This elasticity changes in each period according to the composition of tax revenues. The elasticity for 2012 is estimated at 1.2[12].

The economic balance of the non-financial public sector can be expressed as:

$$RE_t = IGG_t - GNF_t + RPEE_t - IDP_t$$

Where GNF_t, $RPEE_t$ and IDP_t represent the non-financial expenditure of the general government, the primary balance of State-owned enterprises, and the service of public debt interests, respectively. These variables are not adjusted by the economic cycle or export prices.

Therefore, the structural economic balance of the non-financial public sector can be defined as:

$$RE_t^e = RE_t + (PCIRM_t^e - PCIRM_t) + (RIRM_t^e - RIRM_t) + (RM_t^e - RM_t) + (IGG_t^e - IGG_t)$$

In other words, the structural economic balance is the value of the economic balance after deducting the cyclical components of tax revenues that depend on the business cycle and on international prices.

11 The average is calculated based on the actual prices of export commodities, deflated by the US CPI.

12 This elasticity is the weighted average of the elasticities of income tax, tariffs, VAT, excise tax, other taxes, social contributions, tax returns, non-tax revenues, and capital income. The weight given to the elasticity of each element reflects the resource's share in terms of the total revenues of the general government.

The primary structural balance of the non-financial public sector is estimated as:

$$RP_t^e = RE_t^e + IDP_t$$

Finally, the fiscal impulse, indicator measuring the expansionary or contractionary fiscal policy position during a specific period, is estimated as:

$$IF_t = -(RP_t^e - RP_{t-1}^e)$$

In other words, if the structural primary balance increases, this would imply that discretionary measures are being implemented to consolidate fiscal accounts and that the fiscal policy position is contractionary (negative fiscal impulse), whereas if the structural primary balance declines, the fiscal policy position is expansionary (positive fiscal impulse).

BOX 5
RECENT AMENDMENTS TO THE FUEL PRICE STABILIZATION FUND

The Fuel Price Stabilization Fund[13] (FPSF) operates under a "price band" scheme set on a bi-monthly basis by OSINERGMIN, the entity supervising investments in energy and mining. The rule to determine the magnitude of adjustment in the price bands specifies that the impact of such adjustment on consumer prices should not be higher than 5 percent, except in the case of LPG where the limit is 1.5 percent.

OSINERGMIN publishes every week the benchmark price for each type of fuel that is used to determine the compensations paid by the FPSF or the contributions paid to the Fund. This benchmark price is based on the concept of import parity price (IPP), except in the case of LPG which uses an ad-hoc parity price. The IPP is calculated by adding all the costs associated with an efficient operation of importing fuel to the country to the average price of a fuel in the relevant market (the U.S. Gulf Coast) in a period of ten days. In the case of LPG, the reference price is the FOB price of exports in Pisco (which is assumed to be equal to the price of LPG in Mont Belvieu, USA), plus the cost of more efficient transport, storage, and dispatch operations to deliver this fuel to the port of Callao.

The FPSF plays an important role in macroeconomic terms since it mitigates the volatility of the domestic prices of fuels. On the one hand, it contributes to stabilize the production costs of many industries, thereby reducing the distortions in relative prices that are generated when fuel prices vary and the prices of end products are not adjusted rapidly because of nominal rigidities. On the other hand, since fuels are part of the consumer basket, the Fund mitigates changes in households' real incomes, smoothing consumption and increasing wellbeing.

13 The FPSF was created by Emergency Decree 010-2004 in September 2004. According to E.D. 060-2011 of December 2011, the Fund is effective until December 31, 2012.

FUELS PRICES IN THE THIRD WEEK OF MARCH
(S/. per gallon)

	Internal price of Refinery	Price Band		Parity Price Osinergmin	Forward(+) / Lagged (-) %	Net weekly Compensation Factor (S/. per gallon)	Compensation(+)/ Contributions(-)		Collection 2/ Weekly by ISC (Mill. of S/. per week)
		Lower bound	Higher bound				(Mill. of S/. per week)	Participation %	
Gasoline 84	7.86	7.76	7.86	8.70	-10.7%	0.84	0.8	3.3%	1.2
Gasoline 90	8.24	8.14	8.24	9.04	-9.7%	0.80	0.3	1.2%	0.6
Gasoline 95 1/	9.35								0.0
Gasoline 97 1/	9.51								0.0
Gasohol 84	7.98	7.88	7.98	8.62	-8.0%	0.64	1.8	7.2%	3.1
Gasohol 90	8.35	8.23	8.33	8.94	-7.1%	0.61	2.2	9.0%	5.5
Gasohol 95 1/	9.49								1.3
Gasohol 97 1/	9.64								1.1
Diesel B5 2500 ppm	9.37	9.27	9.37	9.77	-4.3%	0.40	7.3	29.4%	24.3
Diesel B5 50 ppm	9.62	9.27	9.37	9.77	-1.6%	0.40	2.5	10.2%	6.4
Residual N°6 1/	7.77								0.3
Residual N°500 1/	7.68								0.5
Liquified gas	3.65	3.57	3.69	4.56	-24.9%	0.87	9.2	37.2%	0.0
Fuels Used for Electricity Generation									
Diesel B5 GE	9.03	8.93	9.03	9.77	-8.2%	0.74	0.3	1.3%	0.5
Residual 6 GE	6.83	6.73	6.83	7.77	-13.8%	0.94	0.3	1.1%	0.1
Total							**24.8**	**100.0%**	**44.9**

1/ Currently these fuels are outside of the coverage of the Fund of Stabilization of Prices of Fuels.
2/ Estimates based on annual demand of fuels.

The literature is clear in pointing out a negative relationship between the growth of the international prices of fuels and economic activity[14]. This may be verified in the case of the Peruvian economy where it is estimated that a fuel price shock of 10 percent can reduce the economy's rate of annual growth of by up to 0.3 percentage points.

The government has opted to reduce the coverage of the FPSF to improve the focus of its impact: 95 and 97 octane gasoline and gasohol were withdrawn from the Fund's coverage in October and all industrial oils and petrol were withdrawn from this coverage in December. LPG has been the only product which has had no price adjustments last year because there have been no price adjustments in its price bands. This has raised the amount of compensations associated with this product.

Additional amendments to the FPSF have been approved at end February:

- Residual petroleum fuels: These fuels used in isolated electricity generation systems are again included in the coverage of the Fund.

14 The woks of Hamilton (2008) *Oil and the macroeconomy,* **New Palgrave Dictionary of Economics** and Kilian (2008) *The Economic Effects of Energy Price Shocks*, **Journal of Economic Literature.** Vol. 46 offer a comprehensive revision of the existing literature.

- LPG: The price bands of LPG for vehicles and for direct use will be adjusted up to a maximum variation of 5 percent in the bands (from April 2012), while the price bands of bottled LPG will be adjusted up to a maximum 1.5 percent in the end price (from August 2012).

- FPSF coverage: From August, if the reference price of gasoline and LPG for vehicle and direct use is higher than the price band by less than 5 percent, such products will not be covered by the Fund. In addition to this, as from August the Fund will only cover diesel for vehicle use and for the generation of electricity in isolated systems.

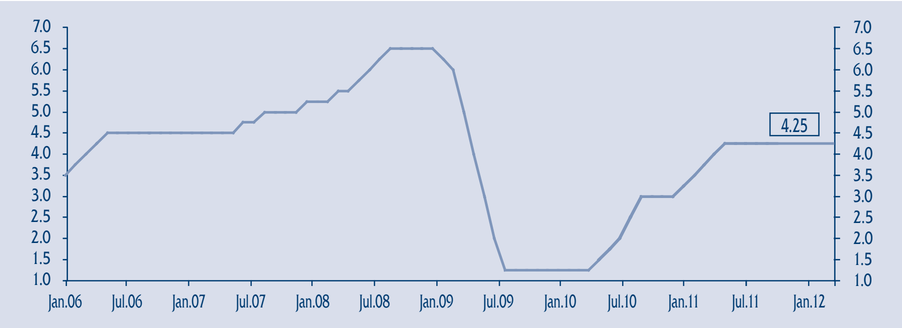
- Social inclusion: Criteria, amounts, and mechanisms will be established to deliver compensations to vulnerable families that use LPG in containers of up to 10 Kg. This mechanism, which will start operating after the implementation of the price band adjustment in August, will be financed through the budget of the Ministry of Energy and Mines.

V. Monetary policy

63. Between December and March the Board of the Central Bank maintained the reference rate at 4.25 percent. This level of the policy rate, which reflects a monetary stance consistent with the anticipated convergence of inflation towards the tolerance range in the second half of this year, takes into account the lower dynamism projected in the world economy, the persistence of uncertainty in international financial markets, and the reversal of the supply shocks that affected inflation during 2011.

The BCRP communiqués on the monetary program have also emphasized that future adjustments in the reference interest rate will depend on the evolution of inflation and its determinants, which reflects a more neutral balance of risks for inflation than the one considered in our Inflation Report of December 2011. This change in the balance of risks takes into account the recent evolution of the global economy, which has shown a better-than-expected performance even though considerable levels of uncertainty are still observed vis-à-vis the evolution of international financial markets and the outlook for global growth in the year.

Graph 77
BCRP REFERENCE INTEREST RATE
(%)



RECENT EVOLUTION OF THE POLICY INTEREST RATE:
January – March 2012

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

This decision takes into account the lower growth being recorded by some components of expenditure, the current international financial risks, and the fact that the rise of inflation has been mainly associated with temporary supply factors. Future adjustments in the reference interest rate will depend on the evolution of inflation and its determinants.

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

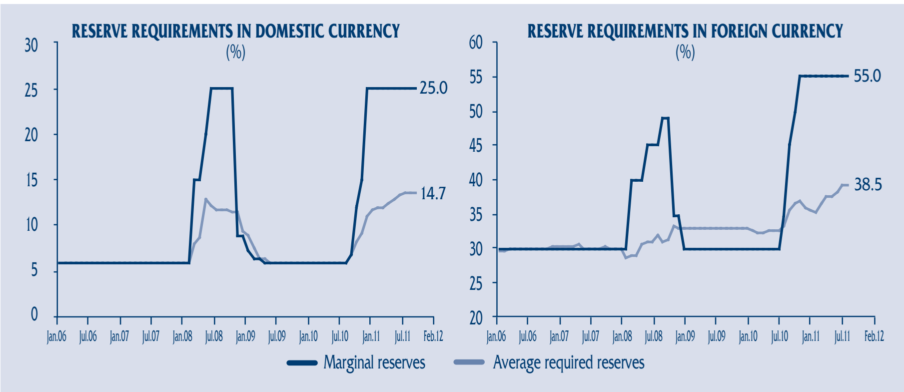
This decision takes into account the lower growth being recorded by some components of expenditure, the current international financial risks, and the fact that the rise of inflation has been mainly associated with temporary supply factors. Future adjustments in the reference interest rate will depend on the evolution of inflation and its determinants.

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

This decision takes into account the lower growth being recorded by some components of expenditure, the current international financial risks, and the rise of inflation associated mainly with temporary supply factors. Future adjustments in the reference interest rate will depend on the evolution of inflation and its determinants.

64. The Central Bank has also maintained the rates of reserve requirements in domestic currency and foreign currency unchanged since mid-2011. At the close of February the average rate of reserve requirements in nuevos soles was 14.5 percent while this rate in dollars was 38.6 percent. These rates have contributed to moderate the growth of credit and increase the financial system's capacity to face possible scenarios with severe liquidity constraints.

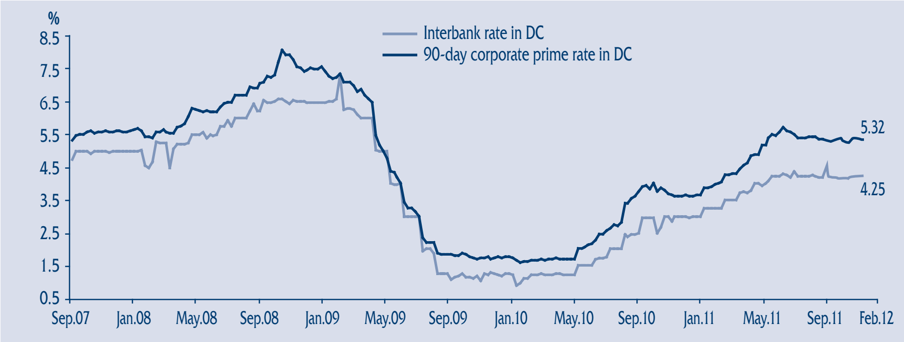
Graph 78



65. Between December 2011 and February 2012 the short term prime rates in domestic currency remained stable around 5.3 percent, a level consistent with the monetary policy position. There is a greater relationship between this segment's interest rate and the monetary policy interest rate because there is a

lower premium for credit risk associated with this type of credit and also because it is short term credit.

Graph 79
90-DAY CORPORATE PRIME RATE VERSUS INTERBANK OVERNIGHT RATE IN DOMESTIC CURRENCY: SEPTEMBER 2007 - FEBRUARY 2012



66. Most of the other lending rates in the financial system also remained at similar levels, without showing significant changes. The exceptions included the rate on loans to micro businesses, which increased from 23.2 percent in December to 23.7 percent in February, and the rate on consumer loans, which fell from 38.5 to 35.7 percent in the same period. The variations in these types of credit reflect the evolution of credit risk and competition conditions in the respective credit markets. The interest rate on mortgages remained stable around 9.4 percent.

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

	Domestic currency						
	Corporate	Large enterprises	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
Oct.11	6.0	7.8	10.8	23.2	32.8	37.2	9.6
Nov.11	6.0	7.4	11.1	23.0	32.9	38.3	9.5
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
Accumulated change (bps)							
Feb.12-Jan.12	9	-17	-3	79	20	-155	-1
Feb.12-Dec.10	146	138	108	44	593	-492	6

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

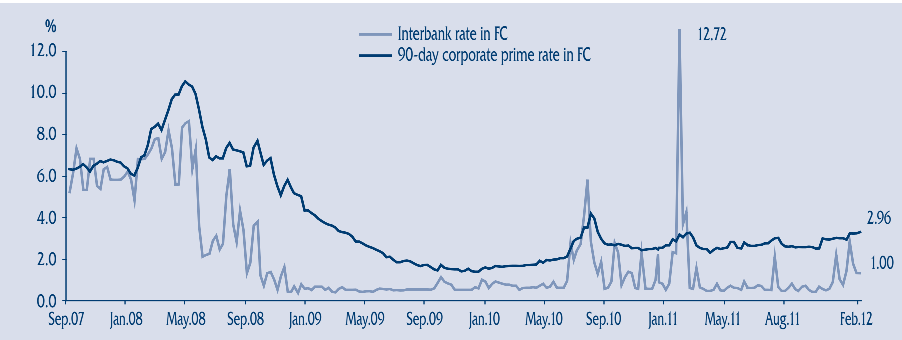
67. Short term deposit rates in domestic currency declined slightly in January and February. Thus, the interest rate on 30-day deposits fell from 3.9 to 3.7 percent, while the interest rates on 31-day to 180-day deposits fell from 4.1 to 4.0 percent.

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
Jul.11	4.2	3.9	4.5
Aug.11	4.1	4.2	4.6
Sep.11	4.1	4.3	4.6
Oct.11	4.1	4.3	4.7
Nov.11	4.0	4.2	4.7
Dec.11	3.9	4.1	4.7
Jan.12	3.8	4.0	4.7
Feb.12	3.7	4.0	4.7
Difference (bps) (Feb.12-Dec.11)	-13.8	-9.8	0.2

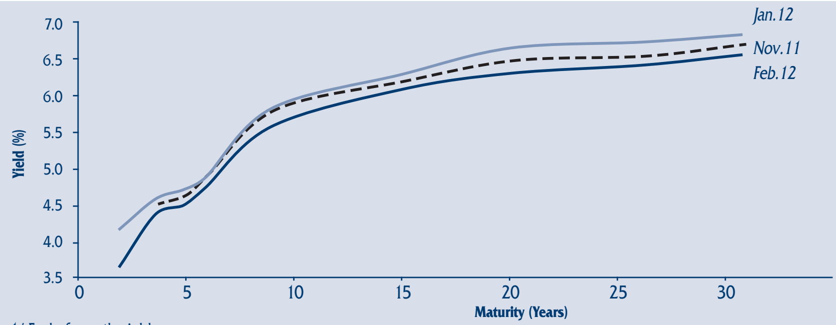
68. The corporate prime rate in foreign currency rose from 2.60 percent in December 2011 to 2.96 percent in February, reflecting banks' lower availability of liquidity in foreign currency due in part to the BCRP purchases of dollars in the foreign exchange rate market. In the first months of the year the Central Bank bought foreign currency for a total of US $3.68 billion.

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



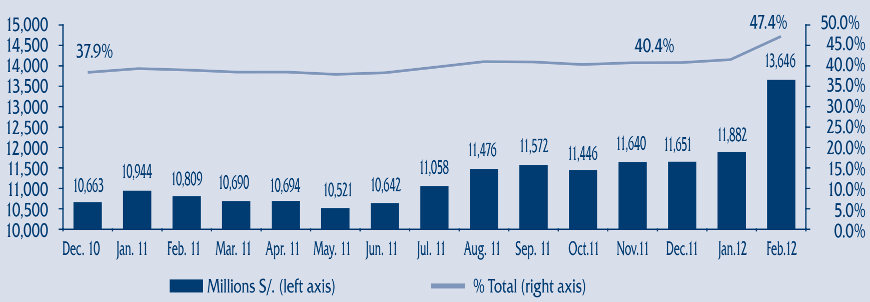
69. In January Peru placed bonds for US$ 1.1 billion in the international market, of which the equivalent of US$ 600 million was placed in domestic currency at a rate of 6.875 percent and with a maturity of 19 years, which increased the yield curve of sovereign bonds to some extent. Around 80 percent of this placement was purchased as Global Depositary Notes (GDN) by non resident investors. Reflecting the increased risk perceived in emerging countries, a downward movement was observed in the yield curve since February.

Graph 81
SECONDARY MARKET OF SOVEREIGN BONDS [1/]



1/ End of month yield.

Graph 82
SOVEREIGN BOND (BTP) HOLDINGS BY NON RESIDENTS
(Millions of nuevos soles)



70. Long term rates in dollars also rose. The interest rates on corporate loans, credit to large and to medium-sized companies rose from 3.0 to 3.6 percent, from 5.4 to 5.5 percent, and from 8.9 to 9.3 percent, respectively. Moreover, the rate on consumer loans increased from 22.0 percent in December 2011 to 22.8 percent in February.

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

	Corporate	Large enterprises	Medium-size firms	Small businesses	Microbusinesses	Consumption	Mortgages
Foreign currency							
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
Oct.11	3.0	5.3	8.4	15.1	19.0	21.7	8.2
Nov.11	3.1	5.3	8.6	15.4	17.4	22.4	8.2
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
Accumulated change (bps)							
Feb.12-Jan.12	7	7	27	10	3	39	-8
Feb.12-Dec.10	32	-5	68	125	398	339	5

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

71. Furthermore, 90-day deposit interest rates in foreign currency increased from 0.7 percent in December to 1.0 percent in February, reflecting a lower availability of liquidity in dollars which is in part explained by the lower growth of deposits in foreign currency due to the lower pace of dollarization of deposits observed in the first months of 2012. Banks' increased demand for dollars as a result of the dynamism of credit in FC observed particularly in January added onto this lower availability of funding in FC.

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
Jul.11	0.6	1.0	1.7
Aug.11	0.7	1.0	1.6
Sep.11	0.8	1.0	1.6
Oct.11	0.6	1.0	1.6
Nov.11	0.6	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
Difference (bps) (Feb.12-Dec.11)	36.3	12.7	3.0

Currency in circulation and credit

72. Showing a recovery compared to January, average currency has been growing at a rate of 17.1 percent in the last 12 months at February, in line with some indicators of economic activity. In 2012 currency would grow 17.5 percent, which is consistent with the growth of GDP and the dedollarization of banks' liabilities that is being observed in this quarter.

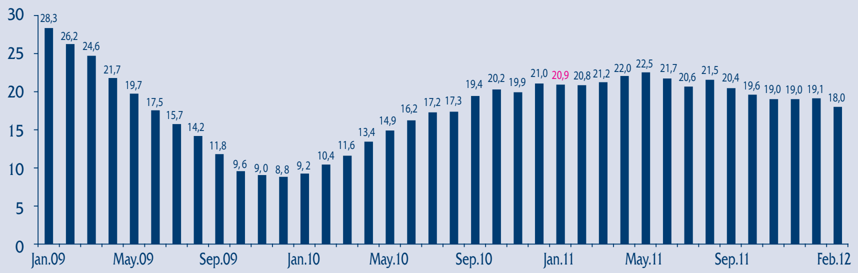
Graph 83
CURRENCY AVERAGE
(% change compared to the same period of the previous year)

CURRENCY	Dec.07	Dec.08	Jun.09	Dec.09	Jun.10	Dec.10	Mar.11	Jun.11	Oct.11	Nov.11	Dec.11	Jan.12	Feb.12*
Original series (millions of nuevos soles)	13,971	16,705	15,926	18,342	19,394	23,007	22,606	23,356	24,732	24,789	26,179	26,705	26,616
Monthly flows (millions of nuevos soles)	1,219	886	127	1,266	301	1,481	-121	243	53	57	1,389	526	-88
Annual % change (millions of nuevos soles)	28.0	19.6	4.3	9.8	21.8	25.4	23.0	20.4	17.7	15.2	13.8	15.0	17.1
Monthly seasonally adjusted % change	2.0	-0.6	1.4	0.7	2.0	0.5	0.5	1.3	0.7	0.3	-0.7	3.2	2.3
Monthly % change	9.6	5.6	0.8	7.4	1.6	6.9	-0.5	1.1	0.2	0.2	5.6	2.0	-0.3

* Preliminary.

73. In 2011, credit to the private sector grew 18.9 percent. This pace of growth has declined slightly in the first months of 2012, this indicator recording an annual growth of 18.0 percent in February. By currencies, in February credit to the private sector in nuevos soles recorded an annual growth rate of 19.0 percent, a higher growth rate than the one recorded by credit in dollars (16.7 percent).

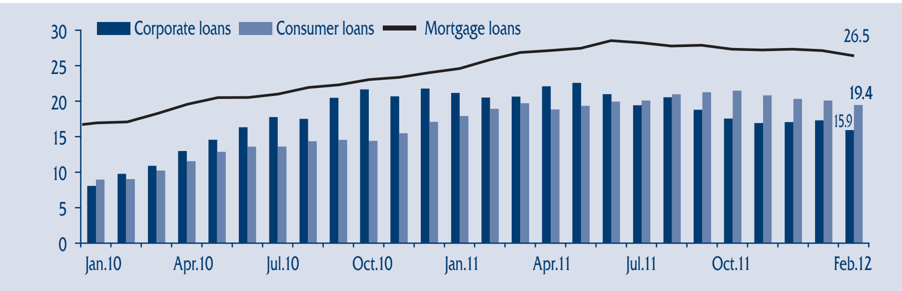
Graph 84
CREDIT TO THE PRIVATE SECTOR
(% change compared to the same period of the previous year)



	Credit	Dec.09	Dec.10	Mar.11	Jun.11	Sep.11	Oct.11	Nov.11	Dec.11	Jan.12	Feb.12
Nuevos Soles	Monthly Flow	422	1,537	1,165	1,158	962	1,571	1,660	1,706	213	759
	Annual % change	17.6	21.2	21.3	20.7	20.2	21.1	20.6	20.4	19.6	19.0
	Monthly % change	0.7	2.3	1.6	1.5	1.2	2.0	2.1	2.1	0.3	0.9
US Dollars	Monthly Flow	304	432	372	83	106	106	272	561	252	-142
	Annual % change	0.0	20.8	21.0	22.8	20.6	17.8	17.1	17.3	18.4	16.7
	Monthly % change	1.7	2.0	1.7	0.3	0.4	0.4	1.1	2.2	1.0	-0.6
Total	Monthly Flow	1,242	2,704	2,168	1,381	1,250	1,857	2,393	3,220	894	374
	Annual % change	8.8	21.0	21.2	21.7	20.4	19.6	19.0	19.0	19.1	18.0
	Seasonally adjusted monthly % change	-0.8	1.9	0.3	0.4	1.4	1.6	1.6	1.3	0.0	3.0
	Monthly % change	1.2	2.1	1.7	1.0	0.9	1.3	1.6	2.2	0.6	0.2

Like in 2011, credit to households has been showing greater dynamism than credit to enterprises so far this year. This is particularly evident in the case of mortgages, which have grown by 1.6 and 1.5 percent in January and February, respectively (and recording an annual growth of 27.2 and 26.5 percent). The greater dynamism of credit to households reflects not only high consumer confidence, but also the improvement registered in terms of disposable incomes, which has been favored by the sustained growth of formal employment and by historically low interest rates. On the other hand, credit to companies grew 0.4 and -0.3 percent in the first two months of the year and accumulated an annual growth rate of 17.2 and 15.9 percent. This lower pace of growth is mainly explained by the lower dynamism of credit for foreign trade activities, which grew by 3.5 percent in January and 0.7 percent in February.

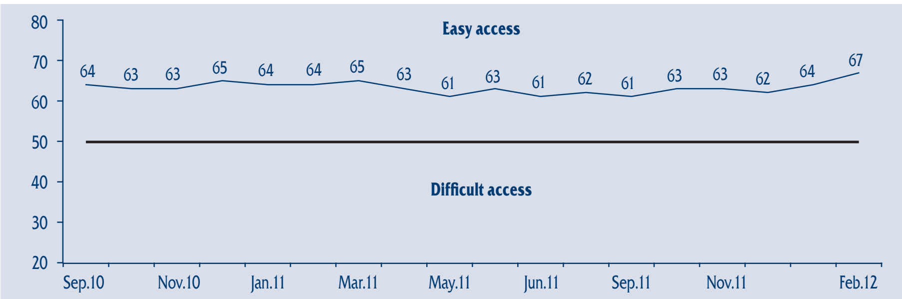
Graph 85
CREDIT BY TYPE OF LOANS: JANUARY 2010 - FEBRUARY 2012
(12 month % change)



Excluding credit for foreign trade operations, corporate loans increased 18.7 percent in annual terms in January and 17.4 percent in February. It is worth pointing out that credit to small and medium-sized enterprises recorded growth rates of 27.5 and 21.5 percent, respectively, in the month of February.

74. In addition to low interest rates in the financial system and the recovery of business confidence, this evolution reflects the access of domestic firms to credit. According to the access-to-credit indicator elaborated on the basis of the surveys carried out by BCRP, firms' access to credit has improved and gone from a level of 62 in December 2011 to a level of 67 in February 2012.

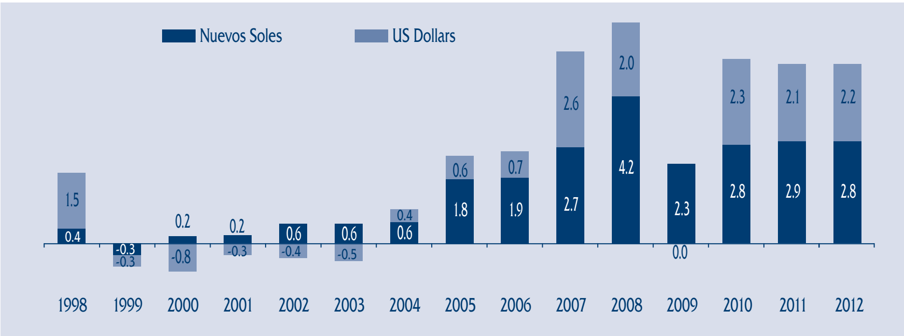
Graph 86
STATUS OF ACCESS TO CREDIT OF THE COMPANIES



It should also be pointed out that between January and February 2012, a group of Peruvian non-financial companies issued securities in the international market to finance some of their investments. Mining company Volcan issued bonds for US$ 600 millions –of which US$ 35.5 million were placed in the local market– at an interest rate of 5.375 percent and with a maturity of 10 years, reaching a demand of US$ 5 billion. Camposol become the first Peruvian agroindustrial company to issue bonds in the international market with an issuance of US$ 125 million in 5-year bonds at a rate of 9.875 percent. Moreover, Cementos Pacasmayo placed American Depositary Shares (ADS) for US$ 230 million in the New York Stock Exchange, increasing its capital by 17.5 percent.

The accumulated flow of credit to the private sector in the last 12 months as a percentage of GDP has remained at 5.0 percent, a similar level to the one observed at end 2010 and in 2011. Thus, credit to GDP at end February has remained around 30 percent of GDP.

Graph 87
ANNUAL FLOW OF CREDIT TO THE PRIVATE SECTOR
(% of GDP)

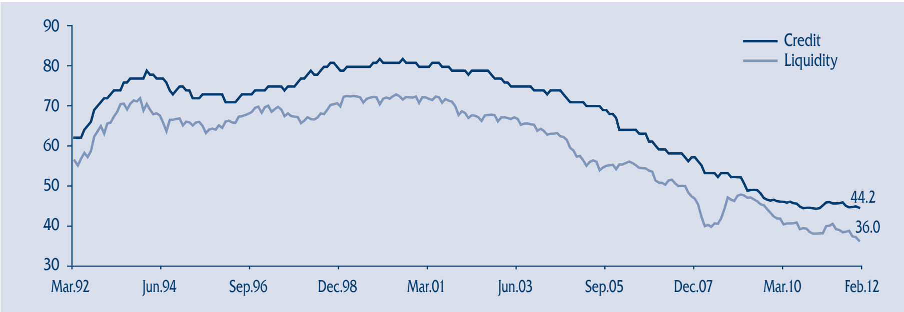


Credit is estimated to grow 14.5 percent this year, in line with an expansion of 5.7 percent in economic activity and with increased access to banking services in the country (the latter would grow 32 percent).

75. In 2011, the dollarization of credit to the private sector fell from 46.3 percent at end 2010 to 45.2 percent, with credit to households showing the highest decline in terms of dollarization ratio (down from 26.0 percent to 25.1 percent). In this credit group, the segment of mortgage loans was the one that registered the fastest pace of dedollarization (the dollarization ratio declined from 51.6 percent to 48.8 percent). Moreover, the dollarization ratio of corporate loans fell from 56.3 percent to 55.6 percent.

In February the dollarization ratio of credit continued to fall and recorded 44.2 percent, in line with the trends observed in the dollarization of liquidity, which declined from 37.2 percent in December 2011 to 36.0 percent in February 2012. The faster pace of dedollarization observed in liquidity in the first months of the year reflects, in part, higher confidence in the domestic currency after uncertainty partially subsided in international financial markets, as well as a reversal in the increased demand for foreign currency observed last year due to higher uncertainty generated by the elections.

Graph 88
PERU: LIQUIDITY AND CREDIT DOLLARIZATION RATIO: 1992 - 2012
(% of total credit and total liquidity)



Monetary operations

76. The Central Bank's operations were mainly oriented at maintaining adequate liquidity levels and the flow of operations in the money market. High levels of liquidity in the banking system, which was reflected in banks' increased preference for acquiring BCRP Certificates of Deposit (CDBCRP) with maturities of up to 1 year, contributed to this.

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

Net Assets	Dec. 11	Feb.12
I. Net International Reserves	100% (US$ 48,816 mills.)	100% (US$ 53,315 mills.)
Net Liabilities		
II. Total public sector deposits	**38.0%**	**37.8%**
In domestic currency	24.3%	23.7%
In foreign currency	13.8%	14.1%
III. Total reserve requirements	**27.7%**	**24.6%**
In domestic currency	9.7%	9.2%
In foreign currency 1/	18.0%	15.4%
IV. BCRP Instruments	**13.1%**	**18.1%**
CD BCRP	10.3%	13.4%
CDV BCRP	0.0%	0.0%
CDR BCRP	0.0%	0.0%
CDLD BCRP	0.0%	0.0%
Term deposits	2.8%	4.8%
V. Currency	**20.7%**	**18.6%**
VI. Other	**0.5%**	**0.8%**

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

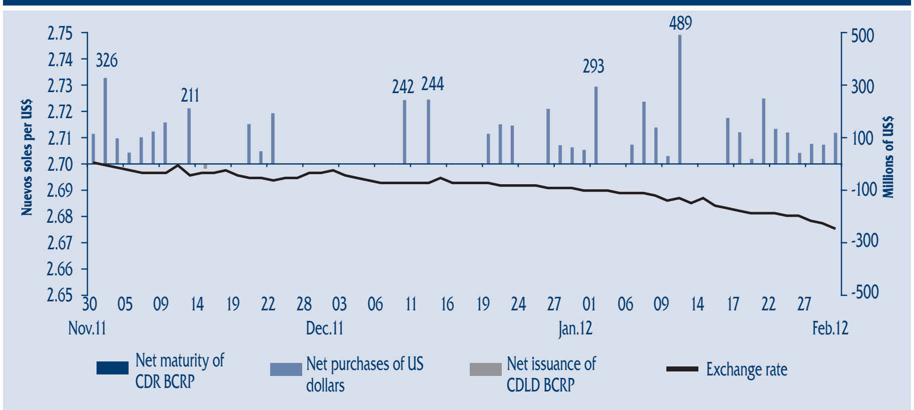
In this context, between December 2011 and February 2012, the Central Bank withdrew liquidity for a total of S/. 8.64 billion, mainly through issuances of BCRP certificates of deposit (S/. 5.49 billion) and through operations of overnight deposits (S/. 3.15 billion). In this period, the public sector increased its deposits at the Central Bank by S/. 3.82 billion.

As a result of these operations, the share of BCRP-issued instruments in total liabilities increased. As the table above shows, the share of monetary instruments in the international reserves increased from 13.1 percent in December to 18.1 percent in February 2012. On the other hand, the share of total deposits for reserve requirements declined from 27.7 to 24.6 percent, mainly due to the decline of deposits in foreign currency since the latter fell from 18.0 to 15.4 percent as a result of the higher BCRP intervention amount in the foreign exchange market and the dedollarization of liabilities. (CHECK).

Foreign exchange rate

77. Between the end of November and the end of February, the nuevo sol appreciated 1.0 percent in nominal terms against the dollar (the exchange rate moved from S/. 2.701 per dollar to S/. 2.675 per dollar). Two trends contributed to this: on the one hand, the higher pace of dedollarization observed in deposits, especially in the case of the deposits of firms associated with the mining sector and in the deposits of small depositors and, on the other hand, lower global risk aversion which contributed to strengthen most of the currencies of emerging countries after some of the most severe risks associated with the debt crisis in the Eurozone subsided.

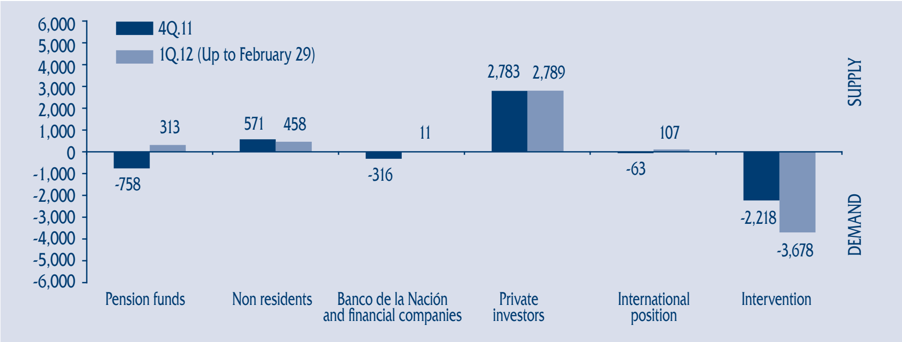
Graph 89
INTERVENTION IN THE FOREIGN EXCHANGE MARKET AND EXCHANGE RATE



78. During this period, the supply of dollars in the local market came mainly from private companies, whose net sales of foreign currency amounted to US$ 2.93 billion, and, to a lesser extent, from non resident investors and pension funds, whose net sales of foreign currency amounted to US$ 458 million and US$ 313 million, respectively.

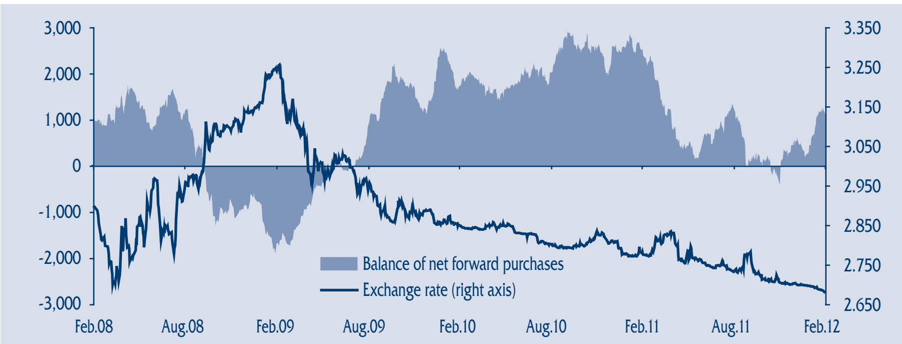
On the other hand, banks reduced their foreign exchange position generating an additional supply of dollars of US$ 107 million. In this context, the BCRP intervened in the foreign exchange market purchasing dollars for a total of US$ 3.82 billion with the aim of reducing the volatility of the exchange rate.

Graph 90
FOREX MARKET FLOWS
(Millions of US$)



79. In the forward market, banks' net purchases of dollars increased significantly during the period due mainly to the maturity of forward sales contracts negotiated in the period when the European crisis deepened in September 2011. Thus, between end November and end February, the balance of net forward purchases of foreign currency increased by US$ 1.29 billion, from a negative balance of US$ 163 million to a positive balance of US$ 1.12 billion.

Graph 91
BALANCE OF NET FORWARD PURCHASES AND EXCHANGE RATE
(Balance in millions of US$ and exchange rate in soles / US dollar)



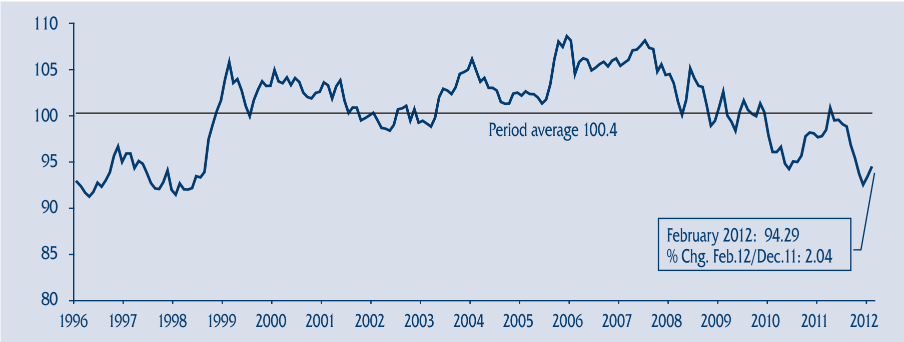
80. The BCRP survey on macroeconomic expectations for 2012-2013 shows that the financial system expects a foreign exchange rate of between S/. 2.65 and S/. 2.68 per dollar in 2012 and of between S/. 2.64 and S/. 2.66 per dollar in 2013.

Table 33
SURVEY ON MACROECONOMIC EXPECTATIONS: EXCHANGE RATE
(S/. per US$)

	Survey as of:		
	Sep.11	**Dec.11**	**Feb.12**
Financial entities			
2012	2.70	2.70	2.65
2013	2.70	2.68	2.65
Economic analysts			
2012	2.65	2.65	2.65
2013	2.70	2.64	2.64
Non-financial firms			
2012	2.70	2.70	2.68
2013	2.80	2.75	2.69
Average			
2012	2.68	2.68	2.66
2013	2.73	2.69	2.66

81. Between December 2011 and February 2012, the real multilateral exchange rate rose from 92.4 to 94.3, which represented a depreciation of 2.0 percent in real terms. This was due to the fact that the nuevo sol appreciated less than the other currencies. Thus, while the nuevo sol appreciated 1 percent in this period, the Brazilian real appreciated 8.0 percent, the Chilean peso appreciated 7.7 percent, and the Colombian peso appreciated 8.8 percent.

Graph 92
MULTILATERAL RER
(Index December 2001=100)

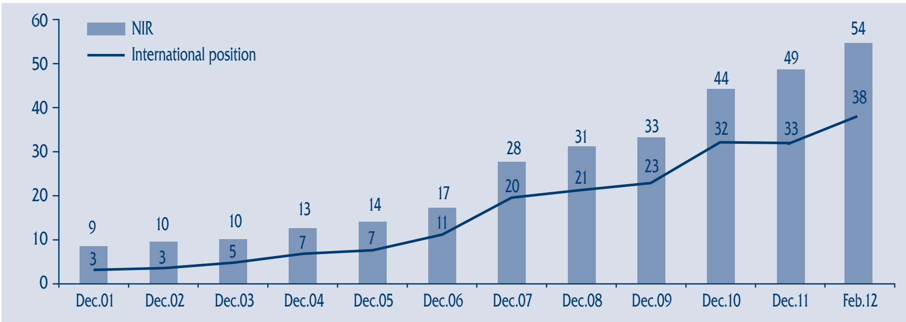


82. Between December 2011 and February 2012, Peru's international reserves increased by US$ 4.26 billion and amounted to US$ 53.31 billion on February 29, 2012. These high levels of international reserves provide the country with adequate levels of international liquidity to face possible scenarios of turbulence in international financial markets.

This increase in international reserves, which was mainly the result of purchases of foreign currency by the Central Bank (US$ 5.13 billion) and public sector's higher deposits at the BCRP (US$ 768 million), was offset by the withdrawal of banks' deposits (US$ 1.72 billion).

As regards the composition of international reserves, at the close of February the foreign exchange position of the Central Bank represented 70 percent of international reserves, while banks' deposits and public sector's deposits represented 15 and 14 percent of international reserves, respectively.

Graph 93
NET INTERNATIONAL RESERVES
(Billions of US$)



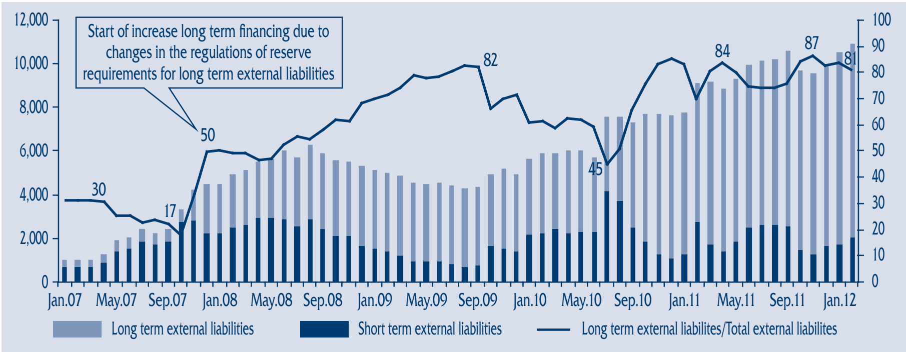
BOX 6
DEBT AND SYSTEMIC RISK: THE ROLE OF MACROPRUDENTIAL INSTRUMENTS

Because of the international financial crisis, central banks all over the world have become increasingly aware of the importance of implementing measures that can reduce the formation of systemic risk in the financial system. One of the aspects that has generated more concern among monetary authorities is the rapid growth of financial institutions' degree of leverage, especially if this leverage is generated by a rapid growth of short-term liabilities in foreign currency

In Peru, with the purpose of preventing and limiting the formation of such risks in the financial system, the Central Bank maintains a rate of 60 percent of reserve requirements for local banks' short term liabilities (up to 2 years) with foreign banks. This rate of reserve requirements has not only enabled banks in the domestic financial system to accumulate a higher level of liquidity in foreign currency, but has also generated incentives for financial institutions to change the composition of their external liabilities from short-term to long-term liabilities

As the following graph shows, after reserve requirements were raised since the mid-2010s, the share of long-term liabilities relative to total external liabilities has increased from 45 percent in July 2010 to 81 percent in February 2012. This higher share of long-term liabilities in terms of banks' external funding has played an important role in offsetting the impact of European banks' credit constraints associated with the process of deleveraging generated by increased regulatory requirements in the Eurozone.

EXTERNAL LIABILITIES OF THE BANKING
(Balance in millions of US$ and ratio in %)



This constraint in European banks' supply of credits generated a cut in short term loans for emerging countries in Q4-2011. In the case of Peru, banks' lower dependence on short-term external credit significantly offset the impact of this shock on domestic financial conditions. The interest rates on short term loans in foreign currency have remained stable during this period and, most importantly, the supply of credits has not been affected.

In the same way as a rapid growth in banks' leverage through short-term liabilities exposes financial entities to abrupt and unforeseen cuts in capital flows, increasing the likelihood of a greater systemic risk, a rapid growth of firms and households' deleveraging through short term loans in dollars also increases the likelihood of cuts in the supply of credit as well as the possibility of unexpected increases in the foreign exchange rate.

In Peru, credit in foreign currency has increased 17.4 percent in the last year, showing a greater pace of growth than in previous years –particularly in the case of corporate loans– favored by the low international interest rates and by greater access to financial markets. This growth of credit in dollars highlights the importance of implementing other macro-prudential measures aimed at promoting firms' and families' awareness of the risks of borrowing in foreign currency. Given the greater exposure to systemic risk that the nature of loans in dollars generates for businesses and households, such measures may include, for example, limits on loan-to-value ratios or limits on loans based on the income of borrowers and increased provisions for loans in foreign currency.

BOX 7

FINANCIAL DOLLARIZATION:

DIFFERENCE BETWEEN NATURAL PERSONS AND LEGAL ENTITIES

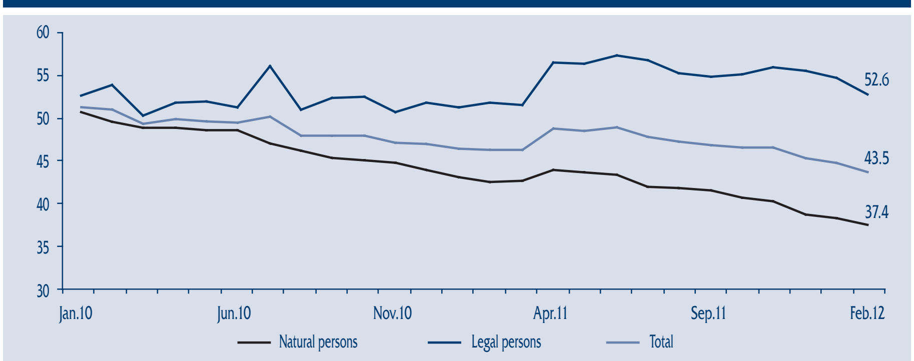
Financial dollarization has been declining persistently in Peru since the 1990s and more intensely since the 2000s, when inflation targeting was adopted by the Central Bank of Peru. Monetary stability –low inflation levels– makes the domestic currency more attractive both as means of payment and as a store of value. This is reflected in the reduction of the ratio of financial dollarization, which has fallen from 78 percent in 2000 to 44 percent in February 2012 in the case of credit and from 65 percent to 36 percent in the case of liquidity in the same period.

In spite of this clear trend, some market segments show a transient reversal of this tendency during periods of high uncertainty, such as during the international financial crisis in 2008 and 2009 and, more recently, when the fiscal problems in the Eurozone worsened. It should be pointed out, however, that not all economic agents have reacted in the same way vis-à-vis these transitory episodes of greater uncertainty.

As illustrated in the graph bellow, legal entities have shown greater sensitivity to episodes of increased uncertainty in financial markets in 2011, as reflected in the fact that their ratios of dollarization increased by 6 percentage points between March and June 2011 (and from 50 percent in December 2010 to 56 percent in June 2011). By type of deposits, term deposits have shown greater volatility in their ratio of dollarization, which soared by almost 10 percentage points in the same period. Natural persons, on the other hand, have continued to de-dollarize their deposits, the ratio of dollarization of these deposits having declined from 43 percent at the end of 2010 to 38 percent in December 2011. The deposits of natural persons reflect very little sensitivity to the episodes of greater uncertainty discussed above.

More recently, between December 2011 and February 2012, legal entities have reversed in part the increase observed in their ratios of dollarization as they have returned to the level observed in October 2010.

DOLLARIZATION OF DEPOSITS OF NATURAL AND LEGAL PERSONS: 2010-2012
(%)



BOX 8
MICROPRUDENTIAL AND MACROPRUDENTIAL INSTRUMENTS

The goal of achieving financial stability was initially sought through the implementation of microprudential policies that contributed to control events of financial stress that were specific to different financial institutions. The aim was to protect consumers from the impacts of these events. Afterwards, and as a result of events associated with financial crises, macroprudential policies have been implemented with the aim of preventing and controlling the systemic financial risks that could affect the level of real economic activity if these risks materialized.

The recent international financial crisis has highlighted how essential it is for central banks and regulatory organizations to adopt macro prudential policies and to go beyond the purely microeconomic approach of traditional prudential regulations. Empirical evidence shows that the individual soundness of banks is not enough to ensure the overall soundness of the financial system and to achieve financial stability as a result of this.

Acknowledging the necessity of macroprudential policies is based on accepting the fact that financial markets have limitations in regulating themselves and on recognizing the fact that systemic risks may arise from an excessive pro-cyclicality in the financial system and from very large and highly interdependent institutions in the global financial system. In the emerging countries, the crises experienced previously –the Asian crisis, the Russian crisis, the Mexican crisis, and the Argentine crisis– have made macroprudential regulation more relevant. The definition, scope, and implications of the term “macroprudential” are currently being discussed in academic and political forums.

The term “macroprudential” and the objectives of macroprudential policies

Although there is no official record of when the term was first used, Clement (2010) suggests that this happened in 1979 in a meeting of the Cooke Committee, the forerunner of today’s Basel Committee on Banking Supervision. Even though the term is relatively new, the concerns inherent to it were not. In the 1970’s politicians were worried about the implications that the rapid growth of the financial system could have on macroeconomic and financial stability. A feature of the term macroprudential is that it regains importance after events of economic crises, as the figure below illustrates:

NUMBER OF SEARCH OF THE TERM “MACROPRUDENTIAL”
(Thousands)

Source: Google.

Objectives of macroprudential and microprudential policies

The most important goal of macroprudential policies is to promote financial stability, the latter being understood as the soundness required by the financial system to be able to face internal and external shocks.

In terms of specific objectives, macroprudential policy seeks to address two specific dimensions of systemic risk[15]: a time dimension, which involves analyzing how risk has evolved over time, and a cross-sectional dimension, which has to do with how risk is distributed within the financial system at any point in time.

According to Borio (2003), the microprudential and macroprudential approaches to regulation and supervision differ in terms of objectives and in terms of the model used to describe the risk. As regards the objectives of these policies, while the macroprudential approach seeks to limit episodes and the cost of aggregate financial distress at the level of GDP, the microprudential approach seeks to limit situations of financial distress at the level of individual institutions. Thus, while macroprudential regulation is developed in the frame of a macro-economic tradition, microprudential regulation is mainly understood in terms of depositor/investor protection.

As regards the model used to describe the risk, macroprudential regulation assumes that the risk is endogenous to the behavior of the financial system, whereas microprudential regulation assumes that this risk is exogenous. Other aspects to be considered are the similar exposures that institutions have within the financial system as well as the interconnection between these financial institutions, and the calibration of prudential tools to prevent or control systemic risk.

MACRO AND MICRO PRUDENTIAL PERSPECTIVE

	Macroprudential	Microprudential
Next goal	Limiting situations of financial stress at system level	Limiting situations of financial stress at individual level
Last goal	Avoid losses at GDP level	Consumer protection
Risk model	Endogenous (Partly)	Exogenous
Correlations and common exposures across institutions	Important	Unimportant
Calibration of prudential controls	In terms of situations of financial stress at system level: top-down	In terms of situations of financial stress at individual level: bottom-up

Source: Borio (2003).

Macroprudential tools

Macroprudential instruments can be of two types: tools specifically designed to mitigate systemic risk in its time and cross-sectional dimensions, and tools that can be calibrated with the specific and

15 Additional references on these subjects may be found in Clement (2010), Burunnermeier (2009), Bank of England (2009), and Borio (2003).

explicit goal of reducing systemic risk. Specific macroprudential tools can be classified according to the taxonomy proposed by BIS in 2008.

MACROPRUDENTIAL INSTRUMENTS	
1. Methods of measurement of risk	6. Limits to risk concentratino
2. Financial reports	7. Compensation schemes
3. Regulatory capital	8. Restrictions to the distribution of profits
4. Liquidity funding standards	9. Insurance mechanism
5. Guarantee agreements	10. Resolution and management of flaws

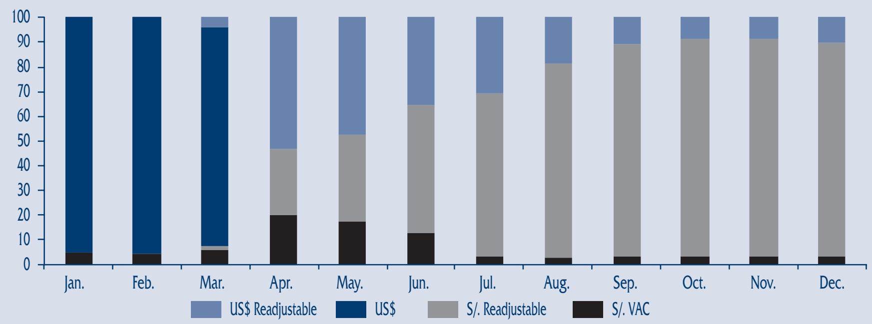
Source: Adapted BIS (2008).

This variety of instruments seeks to minimize the ex-ante and ex-post impact of financial crises. The empirical evidence on the effectiveness of macro-prudential instruments is not abundant and is still being discussed.

BOX 9
DEDOLLARIZATION OF THE PENSIONS INCLUDED IN THE PRIVATE PENSION SYSTEM

The introduction of adjustable fixed-rate pensions in soles as from 2011 has brought about a rapid process of pensions' dedollarization. Since Q2-2011, new pensioners in the private pension system (SPP) are choosing mostly the pension plan that offers an adjustable pension in soles at an annual fixed-rate of no less than 2 percent. In Q4-2011, for example, 90 percent of new pensioners chose pension plans in nuevos soles for their annuities (most chose the fixed-rate option). This preference for pension plans in soles implies a reversal of the trend observed until Q1-2011, when over 90 percent of new pensioners chose pension plans in dollars.

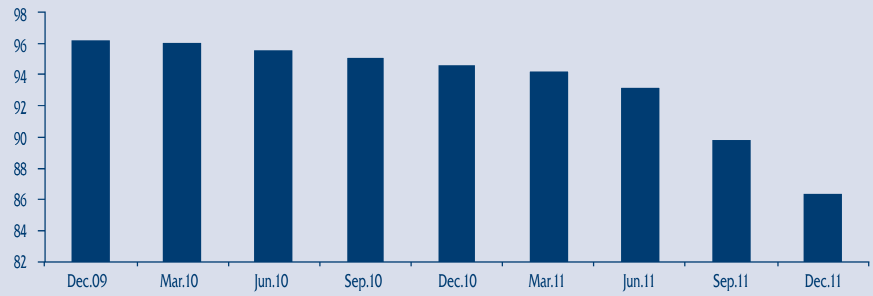
SPP: FLOWS OF CONTRACTS OF PENSION OF RETIREMENT ANNUITY
(%. 2011)



Source: SBS.

As a result of this, the ratio of dollarization of pension annuities shows a steep decline after having dropped from 94 percent in March 2011 to 87 percent in December 2011.

SPP: DOLLARIZATION OF RETIREMENT PENSIONS OF ANNUITY GRANTED[1]
(%. Dec. 2009 – Dec. 2011)



1/ The ration considers the modalities of family annuity and temporary income with deferred annuity.
Source: SBS. Elaboration: BCRP.

Until 2010, pensioners who chose annuity as their pension plan only had the annuity options of pensions in nominal US dollars, inflation-indexed pensions in soles, or a combination of both. Because insurance companies, which are the organizations that provide annuities, did not find enough inflation-indexed securities to cover their pension obligations, they offered an inflation-indexed pension that was lower than the pension in US dollars (which did not require to be adjusted by inflation). This led pensioners to choose the latter option due to the greater income they would receive in the initial stage of their life as pensioners (monetary illusion). However, this generated two problems: on the one hand, pensioners received lower pensions than the ones they should receive due to the appreciatory trend of the foreign exchange rate observed in recent years and, on the other hand, this promoted dollarization in other areas of the economy.

Today, current legislation is neutral in terms of currencies since pensions in nuevos soles may also be upgraded to an annual fixed rate of no less than 2 percent. Because of this, insurance companies can be more certain about the temporal profile of their liabilities in that currency and can therefore obtain coverage for their obligations purchasing fixed-rate bonds. They can also provide adjustable pensions in soles that are more competitive with the pensions in US dollars, which since 2011 must also be adjustable. Furthermore, disability and survivorship pensions will also be included in this new pension scheme as from this year.

PENSIONS: FORMS OF BENEFIT PAYMENT AT RETIREMENT AND CURRENCIES

Forms of Benefit Payment	Before	After
Programmed Withdrawal Nuevos Soles	X	X
Family Life Annuity Inflation-indexed nuevos soles	X	X
Family Life Annuity Fixed-rate indexed nuevos soles		X
Family Life Annuity US dollars	X	
Family Life Annuity Fixed-rate indexed US dollars		X
Temporary Income with Deferred Life Annuity Nuevos soles (TI) and inflation-indexed soles (DLA)	X	X
Temporary Income with Deferred Life Annuity Nuevos soles (TI) and US dollars (DLA)	X	
Temporary Income with Deferred Life Annuity Nuevos soles (TI) and fixed-rate indexed nuevos soles (DLA)		X
Temporary Income with Deferred Life Annuity Nuevos Soles (TI) and fixed-rate indexed US dollars (DLA)		X
Mixed Income Nuevos soles (PW) and US dollars (FLA)	X	
Mixed Income Nuevos Soles (RP) and fixed-rate indexed US dollars (FLA)		X
Life Annuity in soles and dollars Inflation-indexed nuevos soles, and US dollars	X	
Life Annuity in soles and dollars Inflation-indexed or fixed-rate indexed nuevos soles, and fixed-rate indexed US dollars		X

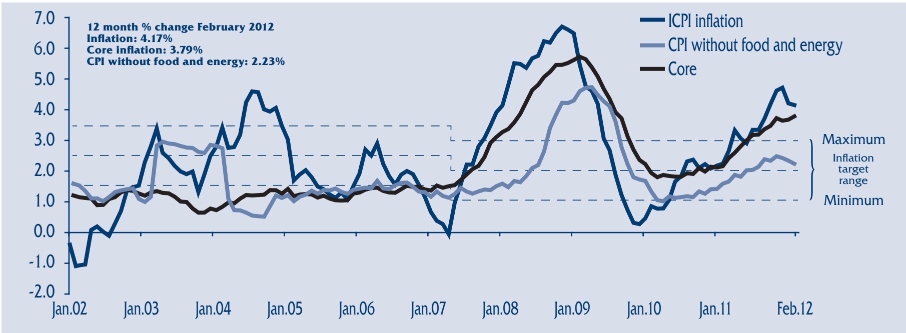
Notes:
- TI: Temporary income; DLA: Deferred life annuity; PW: Programmed withdrawal, and FLA: Family life annuity.
- In the Programmed withdrawal option, the pension is granted by the AFP. The pension varies according to the Fund's profitability.
- The Temporary Income with Deferred Life Annuity option consists of a Temporary Income in nuevos soles and a Deferred Life Annuity in inflation-indexed or fixed-rate indexed nuevos soles, or a deferred life annuity in fixed-rate indexed US dollars.
- In the Mixed Income option, the pensioner receives a monthly payment that combines two forms of benefit payment: Programmed withdrawal (in nuevos soles) and Life Annuity in fixed-rate indexed US dollars. The option of Programmed withdrawal and Life Annuity in fixed-rate indexed nuevos soles is not available.
- In the option of Life Annuity in soles and dollars, the pensioner chooses a combination of two simultaneous forms of benefit payment: Life Annuity in inflation-indexed or fixed-rate indexed nuevos soles, and Life Annuity in fixed-rate indexed US dollars.

Source: SBS. Elaboration: BCRP.

VI. Inflation

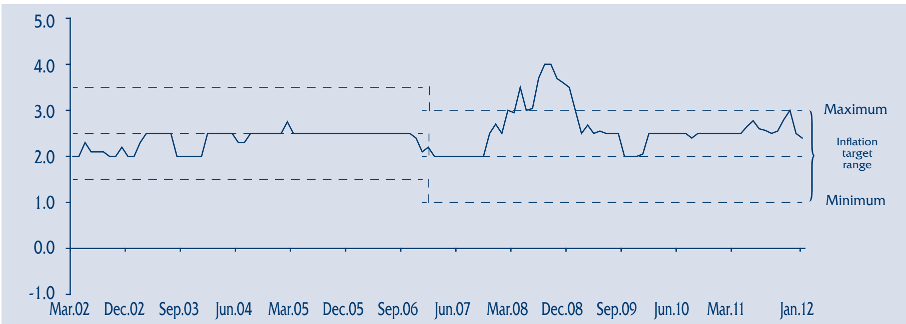
83. In the first months of the year, last 12-month inflation has been declining as a result of the beginning of the reversal of supply shocks. Inflation in February recorded a rate of 4.17 percent, a level above the upper band of the target range. The gradual decline of inflationary pressures which is currently being observed is also consistent with a neutral economic cycle during 2012, which will favor inflation's convergence towards the target.

Graph 94
INFLATION AND INFLATION TARGET
(Last 12 month % change)



84. Inflation expectations for 2013 –a relevant time horizon for monetary policy actions– continue to be within the target range and have been declining in the last months, in line with the lower rate of inflation observed.

Graph 95
INFLATION EXPECTATIONS FOR THE NEXT YEAR*
(% points)



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

85. Inflation in the first quarters of the year is usually higher than in the rest of the year given that it is not uncommon that some transitory supply factors may arise in the first months of the year and generate upward pressures on some prices, especially

on food prices. In the last decade, for example, while the annual average inflation rate in the first quarters was 4.6 percent, this rate declined to 1.8 percent as an annual average in the next months –April to December–, reflecting mainly the higher seasonal inflation of perishable farming food products in the first months of the year.

Table 34
CPI AND PERISHABLE AGRICULTURAL FOOD
Annualized average change of period 2001-2011

	January-March	April-December	Year
CPI	4.6	1.8	2.5
Perishable agricultural food	23.6	-1.6	4.2

86. The **non-core component** of inflation, which grew 6.8 percent in annual terms at December 2011, declined to 4.9 percent in February following the evolution of the prices of food products and fuels which grew 7.8 and 3.9 percent, respectively. On the other hand, **core inflation** rose slightly from 3.65 percent in December to 3.79 percent in February, reflecting the price rises in foods outside the home –because of the higher prices of food– and in education (tuition and fees).

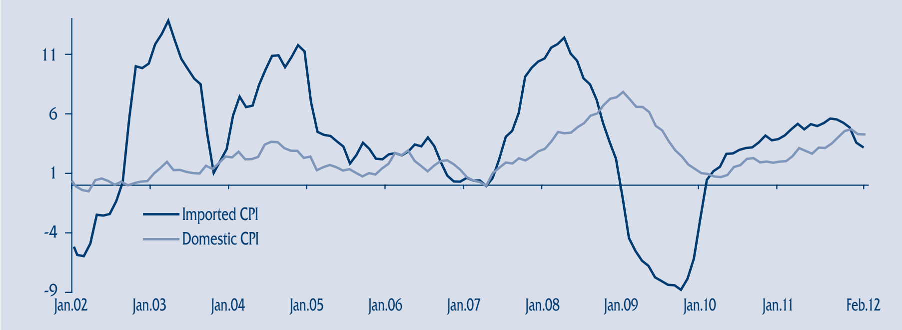
87. Inflation without food and energy, indicator excluding the shocks in the prices of food and fuels, dropped from 2.42 percent in December 2011 to 2.23 percent in February 2012.

Table 35
INFLATION
(% change)

	Weight 2009=100	2006	2007	2008	2009	2010	2011	2012 Jan.-Feb.	2012 12 month
I. INFLATION	**100.0**	**1.14**	**3.93**	**6.65**	**0.25**	**2.08**	**4.74**	**0.22**	**4.17**
II. CPI WITHOUT FOOD AND ENERGY	**56.4**	**1.28**	**1.49**	**4.25**	**1.71**	**1.38**	**2.42**	**-0.06**	**2.23**
III. CORE INFLATION	**65.2**	**1.37**	**3.11**	**5.56**	**2.35**	**2.12**	**3.65**	**0.54**	**3.79**
Goods	32.9	0.97	3.30	5.32	2.17	1.53	3.17	0.46	3.36
Services	32.2	1.85	2.88	5.86	2.56	2.72	4.13	0.62	4.23
IV. NON CORE INFLATION	**34.8**	**0.83**	**5.07**	**8.11**	**-2.54**	**2.00**	**6.79**	**-0.35**	**4.86**
Food	14.8	2.06	7.25	10.97	-1.41	1.18	11.50	-0.65	7.82
Fuels	2.8	-1.50	6.45	-0.04	-12.66	12.21	7.54	-0.69	3.91
Transportation	8.9	1.12	0.82	5.86	0.19	1.94	3.61	-0.95	3.44
Utilities	8.4	-3.22	0.24	7.48	-4.56	0.01	1.50	1.05	1.31

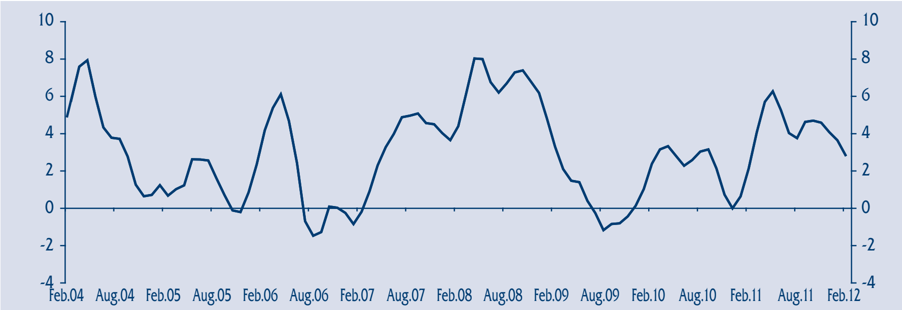
88. Imported inflation also fell from 4.9 percent in December 2011 to 3.23 percent in February 2012, the rise in the prices of core goods and services being offset with the evolution of the non-core components of inflation in a context of nominal appreciation of the nuevo sol.

Graph 96
DOMESTIC AND IMPORTED INFLATION
(Last 12 month % change)



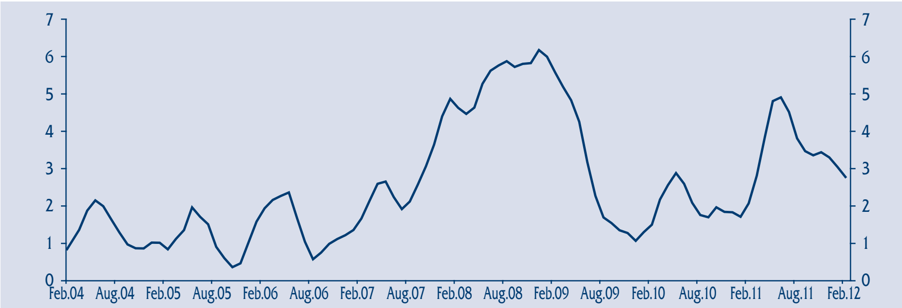
89. In annual terms, quarterly inflation declined in February from 3.7 to 2.8 percent. Quarterly core inflation fell from 3.0 to 2.8 percent, while inflation without food and energy fell from 2.1 to 1.9 percent.

Graph 97
CPI
(Annualized percent change of mobile quarter)



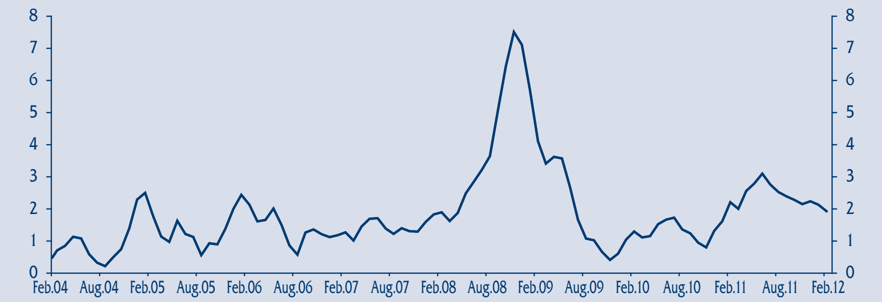
CPI	Dec.10	Jan.11	Feb.11	Mar.11	Apr.11	May.11	Jun.11	Jul.11	Aug.11	Sep.11	Oct.11	Nov.11	Dec.11	Jan.12	Feb.12
Indices	102.2	102.6	103.0	103.7	104.4	104.4	104.5	105.3	105.6	105.9	106.3	106.7	107.0	106.9	107.3
12 month % change	2.1	2.2	2.2	2.7	3.3	3.1	2.9	3.4	3.3	3.7	4.2	4.6	4.7	4.2	4.2
Annualized quarterly % change	0.0	0.6	2.1	4.1	5.7	6.3	5.3	4.0	3.8	4.7	4.7	4.6	4.1	3.7	2.8

Graph 98
CORE INFLATION
(Annualized percent change of mobile quarter)



Core inflation	Dec.10	Jan.11	Feb.11	Mar.11	Apr.11	May.11	Jun.11	Jul.11	Aug.11	Sep.11	Oct.11	Nov.11	Dec.11	Jan.12	Feb.12
Indices	102.4	102.6	102.8	103.4	103.9	104.2	104.6	104.8	105.1	105.4	105.7	106.0	106.2	106.4	106.7
12 month % change	2.1	2.1	2.1	2.4	2.6	2.8	3.0	3.2	3.2	3.4	3.5	3.7	3.6	3.7	3.8
Annualized quarterly % change	1.8	1.7	2.0	2.8	3.8	4.8	4.9	4.5	3.8	3.5	3.4	3.4	3.3	3.0	2.8

Graph 99
CPI WITHOUT FOOD AND ENERGY
(Annualized percent change of mobile quarter)



CPI without food and energy	Dec.10	Jan.11	Feb.11	Mar.11	Apr.11	May.11	Jun.11	Jul.11	Aug.11	Sep.11	Oct.11	Nov.11	Dec.11	Jan.12	Feb.12
Indices	101.6	101.6	101.7	102.1	102.4	102.5	102.8	103.0	103.1	103.4	103.5	103.7	104.1	103.9	104.0
12 month % change	1.4	1.4	1.6	1.6	1.9	1.8	2.0	2.0	2.1	2.4	2.3	2.5	2.4	2.3	2.2
Annualized quarterly % change	1.3	1.6	2.2	2.0	2.5	2.8	3.1	2.7	2.5	2.4	2.3	2.1	2.2	2.1	1.9

90. The items that most contributed to increase inflation between January and February were meals outside the home, electricity, and agricultural products, such as papaya and onion. In addition to meals outside the home and electricity, another item worth pointing out for its contribution to increase inflation in the last 12 months was education (tuition and fees).

Table 36
ITEM WITH THE HIGHEST WEIGHTED CONTRIBUTION TO INFLATION:
January - February 2012

Positive	Weight	% Chg.	Contribution	Negative	Weight	% Chg.	Contribution
Meals outside the home	11.7	1.4	0.17	Fresh and frozen fish	0.7	-11.7	-0.09
Electricity	2.9	4.8	0.13	Poultry	3.0	-2.5	-0.07
Papaya	0.2	20.8	0.05	Telephone rates	2.9	-2.1	-0.05
Other vegetables	0.4	9.1	0.04	National transportation	0.3	-10.6	-0.04
Onion	0.4	11.3	0.03	Urban fares	8.5	-0.5	-0.04
Sodas	1.3	1.6	0.02	Grape	0.1	-22.8	-0.03
Carrots	0.1	7.8	0.01	Corn	0.1	-16.8	-0.03
Education (fees and tuition)	8.8	0.1	0.01	Avocado	0.1	-11.7	-0.02
Evaporated milk	1.6	0.8	0.01	Rice	1.9	-0.8	-0.01
Textbooks and school supplies	0.7	1.6	0.01	Peach	0.1	-13.0	-0.01
Total			**0.48**	**Total**			**-0.39**

Table 37
ITEM WITH THE HIGHEST WEIGHTED CONTRIBUTION TO INFLATION:
March 2011 - February 2012

Positive	Weight	% Chg.	Contribution	Negative	Weight	% Chg.	Contribution
Meals outside the home	11.7	7.1	0.86	Telephone rates	2.9	-5.3	-0.14
Education (fees and tuition)	8.8	4.3	0.39	Citrics	0.5	-5.0	-0.04
Urban fares	8.5	3.3	0.28	Cleaning items	0.9	-2.5	-0.02
Electricity	2.9	7.5	0.21	Olluco and alike	0.1	-19.1	-0.02
Poultry	3.0	7.2	0.20	Garlic	0.1	-23.4	-0.02
Toiletries	4.9	3.6	0.18	Sugar	0.5	-1.9	-0.02
Rice	1.9	7.5	0.13	Fresh and frozen fish	0.7	-1.3	-0.01
Papaya	0.2	65.8	0.13	Apparatus of recreation and culture	0.9	-0.9	-0.01
Gasoline and oil	1.3	8.2	0.13	Internet service and others	0.8	-0.8	-0.01
Garment for men and kids aged 12 or older	1.5	7.9	0.12	Gas	1.4	-0.4	-0.01
Total			**2.63**	**Total**			**-0.30**

Inflation components

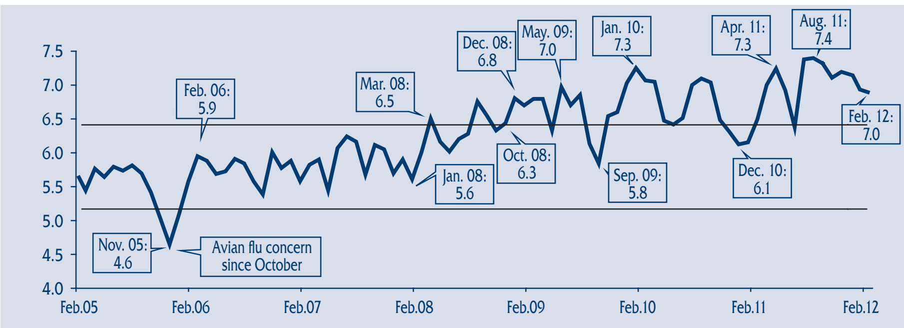
91. When we analyze the main components that have affected the evolution of inflation at February, we see that meals outside the home registered a growth of 7.1 percent in the last 12 months associated with the higher prices of food products. Education costs also rose 4.3 percent due to the rises registered in the tuition and fees of universities and higher education institutes. Electricity recorded a rise of 7.5 percent as a result of the quarterly adjustment in electricity generation rates and the increase in the prices of crude, natural gas, and the wholesale price index.

The prices of other food products, such as papaya, rose 65.8 percent in the last 12 months after having risen 90.2 percent in 2011 when the supply of this product to Lima fell 33 percent because of the strong rains and the river outflows and floods that affected the harvest and transportation of this products in the main producing areas of Ucayali and San Martín in the first quarter. The presence of crops pests and increased seasonal demand in the summer months also contributed to this rise.

Continuing with the update in the band price of fuels, the government adjusted the prices of fuels at end February 2012, while the price of crude reached US$ 102.3 in the international market.

Other products, such as chicken meat, showed lower rates of growth compared to 2011. The price of chicken did not increase as much due to the appropriate level of the supply of fish, the main substitute for poultry.

Graph 100
PRICE OF CHICKEN
(Nuevos soles per kg)



Inflation forecast

92. In February inflation in the last 12 months showed a level above the upper band of the target range recording a rate of 4.17 percent. As in the Inflation Report

of December, the central forecast scenario considers that inflation will gradually converge towards the target range since Q3-2012, provided that all the cost pressures generated by the significant rises in commodity prices disappear and that inflation expectations remain within the target range. The inflation forecast takes into account the upward revision in the forecast on the prices of fuels and also considers the risks of a more persistent increase in the price of crude.

Non core inflation is forecast to show a rate close to 2.0 percent in 2012 after having reached a level of 6.8 percent in December 2011. The conduct of non core inflation in 2011 reflected cost pressures associated with shocks in the international prices of food and fuels. In 2012, the conditions constraining the global supply of food are expected to disappear, which would offset the upward revision in the forecast on the price of crude. Moreover, it is also expected that the negative trend observed in inflation's imported component will continue over 2012, which would reduce the upward pressures of external prices on the dynamics of inflation in the forecast horizon. This is consistent with the lower growth foreseen in the global economy.

93. The forecasts on economic growth are consistent with a neutral economic cycle in the forecast horizon –output gap close to zero (see graph 101)– and therefore no major demand pressures on inflation are anticipated in this period.

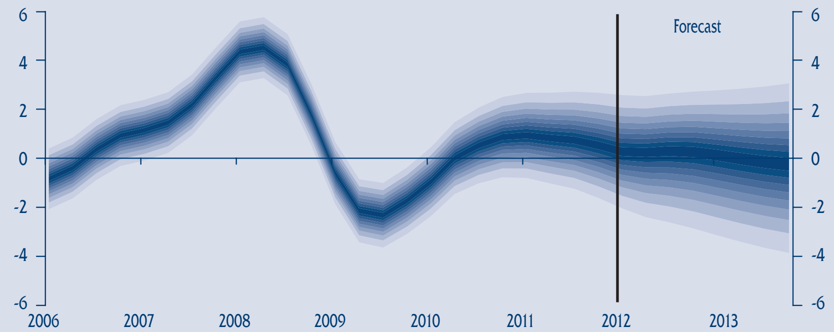
This scenario considers that both the positive fiscal impulse foreseen for 2012 –which is consistent with the forecast of higher public spending– and the expansionary monetary and credit conditions in dollars that would be observed in international markets will have a positive contribution on the output gap. This would be offset by the lower growth expected in our main trading partners.

94. Inflation expectations are also expected to converge from their current levels of 2.5 – 3.0 percent to a level of 2.0 percent, thus remaining anchored within the inflation target range. The higher levels of inflation expected during 2011 reflected the high rates of inflation observed in that period –above the target range– as a result of persistent supply shocks on the prices of food and fuels. This temporary rise in the level of expected inflation should subside as the impact of these shocks on inflation reverses, inflation returning thereafter to its path of convergence towards the inflation target of 2 percent.

95. Like in the Inflation Report of December, the baseline forecast scenario in this report considers that the monetary policy position will not be substantially different in the short term from today's monetary position. An appropriate monetary stance contributes to maintain inflation expectations anchored to the target, particularly in a context of persistent significant shocks that affect sensitive CPI products. Therefore, the Central Bank will continue to oversee the evolution of the global and

the domestic economy and stands ready to adjust its monetary position, should this be required, to ensure inflation's convergence to the target range.

Graph 101
OUTPUT GAP: 2006 - 2013
(% of potential GDP)

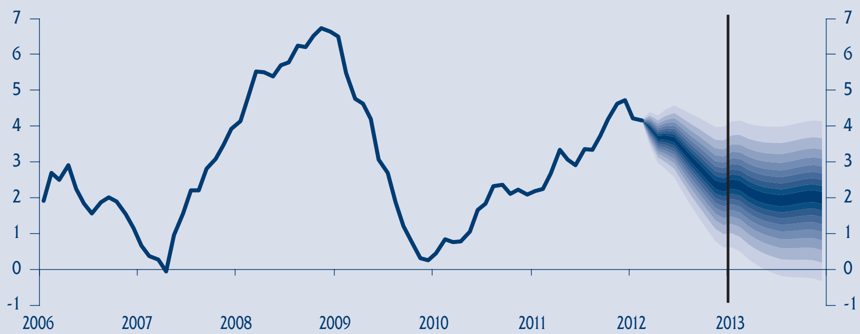


Memo: The output gap is not an observable variable and has to be estimated. Because of this, the graph shows uncertainty about its value, even in periods for which there is information on GDP (e.g. until 4Q-2011). As in Graph 102, each band concentrates a probability of occurrence of 10% and total bands represent a probability of occurrence of 90%.

The output gap is estimated using statistical methods of signals extraction. A set of equations that relate unobservable variables with observed data are specified. Two equations should be pointed out: the first one is the identity that equates (the logarithm of) GDP with the sum of (the logarithm of the) potential GDP plus the output gap; the second is an equation of aggregate supply (known as the Phillips curve) that describes inflation as a function of several determinants, the output gap among them. Therefore, the output gap is interpreted as the transitory component of GDP that is more closely related to inflation over the economic cycle.

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 - 2013
(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.

The graph consists of 18 bands, each band with a probability of 5% that the projected value may fall within it. 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), 10 are expected to fall within the clearer bands adjacent to the darkest ones, other 10 are expected to fall within the even clearer bands located above and below the second group of bands, and so on until 90 of the 100 values are distributed in the graph. The remaining 10 values would fall outside the bands.

The baseline scenario path is contained in the darker bands, described in the text. The chapter on the balance of risks discusses the risk scenarios underlying the inflation forecast in this graph. The balance of risks for inflation by the end of 2012 is neutral: it is contemplated that the probability of it to be below the Forecast of baseline scenario is equal to the probability to be above.

Table 38
SUMMARY OF INFLATION REPORT FORECASTS

	2010	2011	2012,1/		2013,1/	
			IR Dec.11	IR Mar.12	IR Dec.11	IR Mar.12
Real % change						
1. GDP	8.8	6.9	5.5	5.7	6.3	6.3
2. Domestic demand	13.1	7.2	5.6	5.9	6.1	6.5
a. Private consumption	6.0	6.4	5.6	5.8	5.8	5.8
b. Public consumption	10.0	4.8	5.3	5.3	4.9	5.1
c. Fixed private investment	22.1	11.7	7.0	8.2	8.3	8.7
d. Public investment	27.3	-17.8	33.1	34.3	7.3	7.3
3. Exports (goods and services)	1.3	8.8	6.0	7.5	7.7	7.7
4. Imports (goods and services)	24.0	9.8	6.5	8.3	6.6	8.3
5. Economic growth in main trading partners	4.5	3.5	2.7	2.9	3.1	3.2
Memo:						
Output gap 2/ (%)	0.1	0.8	-1.0 ; 0.0	-0.5 ; +0.5	-0.5 ; +0.5	-0.5 ; +0.5
% change						
6. Forecast inflation	2.1	4.7	1.5-2.5	2.0-3.0	1.5-2.5	1.5-2.5
7. Average price of crude	28.7	19.8	5.2	10.2	0.0	1.1
8. Nominal exchange rate 3/	-2.1	-4.3	0.0	-1.5	0.4	0.0
9. Nominal exchange rate 3/	-3.0	-5.8	1.0	0.1	0.4	1.0
10. Terms of trade	17.9	5.4	-5.8	-1.4	0.6	0.4
a. Export price index	29.9	20.0	-6.1	-1.9	1.2	0.9
b. Import price index	10.1	13.8	-0.3	-0.5	0.6	0.5
Nominal % change						
11. Currency in circulation	25.4	12.9	14.5	17.5	11.5	13.0
12. Credit to the private sector 4/	21.0	18.9	13.5	14.5	11.5	12.5
% GDP						
13. Gross fixed investment rate	25.1	24.1	25.6	25.7	26.1	26.2
14. Current account of the balance of payments	-1.7	-1.3	-2.2	-1.5	-2.1	-1.8
15. Trade balance	4.4	5.3	3.6	4.5	3.9	4.6
16. Gross external financing to the private sector 5/	7.9	6.4	4.6	4.9	5.3	5.1
17. Current revenue of the general government	20.0	21.0	21.0	21.2	21.0	21.2
18. Non-financial expenditure of the general government	19.2	18.1	18.9	18.9	18.4	18.7
19. Overall balance of the non-financial public sector	-0.3	1.9	1.0	1.1	1.5	1.4
20. Total public debt	23.4	21.7	20.1	19.9	18.6	18.3

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

96. 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, alternative 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 base, 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.

97. 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, and the impact of the prices of commodities. Graph 103 shows the expected impact of each of these risk factors on the inflation forecast.

The **downward risks** in the inflation forecast are both external and domestic. The external risks are associated with the possibility that an international financial crisis may unfold, while the domestic risks are associated with a context of slower demand growth due to the postponement of some investment projects.

a. Uncertainty about the evolution of the world economy

The baseline scenario considers a lower growth rate in the world economy this year (3.3 percent vs. 3.7 percent in 2011) and a rate of 3.8 percent in 2013 after a recovery in the economy. The risk of a global recession has decreased in recent months due to the less pessimistic view that international markets have adopted in general vis-à-vis the Eurozone financial and fiscal problems. However, should such an adverse scenario develop, this situation would contribute to weaken external demand and affect the domestic economy through the financial and trade channels.

This scenario describes a drop in global economic activity coupled by a decline in the terms of trade. Additionally, a rise in global uncertainty could create panic among investors internationally and unfold a sudden reversal of external capitals with a real depreciation and an increase in the country risk indicator.

If these risks materialized, the Central Bank would use its available international reserves and the various mechanisms it has to inject liquidity in both domestic and foreign currency to offset the impact of such shocks on domestic financial conditions. The monetary policy stance in the forecast horizon would be expansionary to prevent deflationary risks.

b. Evolution of domestic demand

In a scenario of higher uncertainty, there is the risk that domestic agents' expectations may deteriorate, especially in the case of investment, which could generate a lower dynamism in aggregate demand and lead the economy to grow below its potential growth rate generating downward pressures on core inflation. In this scenario, the Central Bank would ease its monetary position in order that inflation falls within the inflation target range.

On the other hand, there are two **risks on the upside** for inflation associated mainly with higher foreign capital inflows and higher commodity prices

c. Increased capital inflows

The high availability of liquidity in international markets due to the aggressive expansion of central banks' balances in developed countries, together with the scarce attractive investment options observed in today's context of high global uncertainty, could lead to a flow of foreign capitals to emerging countries such as Peru, generating a similar situation to the one observed prior to the crisis that started towards the end of 2008. On the one hand, an increased capital inflow would accelerate the expansion of credit, thus stimulating aggregate demand and inflation. On the other hand, this would cause appreciatory pressures on the foreign exchange rate that would translate into lower domestic inflation. It is estimated that the net effect of an increased capital inflow on inflation would be slightly positive.

In this scenario, the Central Bank would adjust its monetary policy including macroprudential policy instruments, such as the rates of reserve requirements, if a pace of credit expansion that could affect monetary and financial stability is perceived.

d. Imported inflation or adverse climate conditions

There is the risk that global inflationary pressures will be more persistent than currently estimated in the baseline scenario. Uncertainty about how policy makers will cope with financial problems, especially in the Eurozone, is having a strong impact on the level of global economic activity. A more determined and credible economic policy in most developed countries could generate a confidence shock, which could lead to higher global demand. If the shocks are persistent, they may affect the evolution of domestic inflation through higher imported costs, which could generate inflationary pressures.

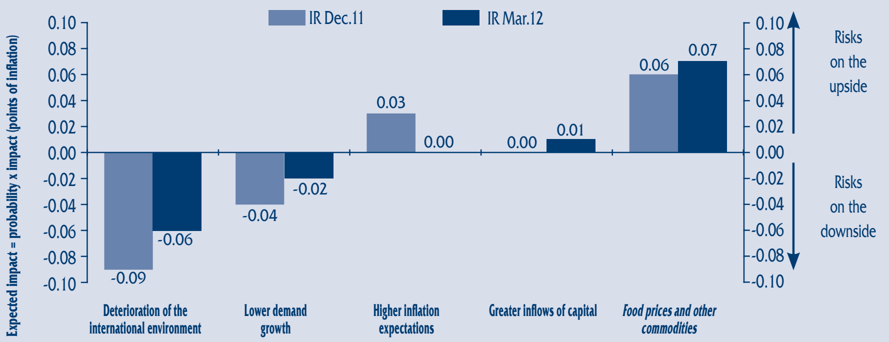
The risk that oil and oil derivatives will show higher international prices has also increased due to the political tensions observed in the Middle East recently. In the domestic area, there is still the risk that adverse climate conditions may affect the normal supply of agricultural products.

In this scenario, the Central Bank would adjust its monetary position only if imported inflation affected economic agents' expectations of inflation.

98. Our Inflation Report of December included in its balance of risks the possibility that the expectations of inflation of households and businesses would persistently remain above the inflation target given that the information gathered through the BCRP surveys showed a slight increase in the level of inflation expected towards the end of 2011. However, according to the latest survey carried out, this increase has reversed, which would be indicating that the risk of higher inflation due to expectations of higher inflation will not materialize.

99. The effects of the risk factors pushing inflation upwards would be counterbalanced by the effects of the risk factors pushing inflation downwards. In summary, the balance of these risks is neutral for the inflation forecast for end 2012; that is, there is the same probability that inflation will fall above or below the forecast considered in the baseline scenario.

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.

In this Report the balance of inflation risks is neutral: the probability of that inflation will be below the Forecast of baseline scenario is equal to the probability to be located above. Thus why the graph bars sum zero.

CONCLUSION

100. The recent evolution of the output gap and inflation expectations indicates that the risks of demand pressures are subsiding. Moreover, the cost pressures generated by the rises in the prices of some commodities are expected to offset in the short term. Therefore, inflation is expected to reverse from its current level (above the target range) and to converge towards the target range in the second half of 2012.

    The Central Bank will continue to oversee the evolution of the global economy and the domestic economy, and stands ready to adjust its monetary position, should this be required, to ensure inflation's convergence to the target range.