INFLATION REPORT

January 2015

Recent trends and macroeconomic forecasts 2014-2016

CENTRAL RESERVE BANK OF PERU

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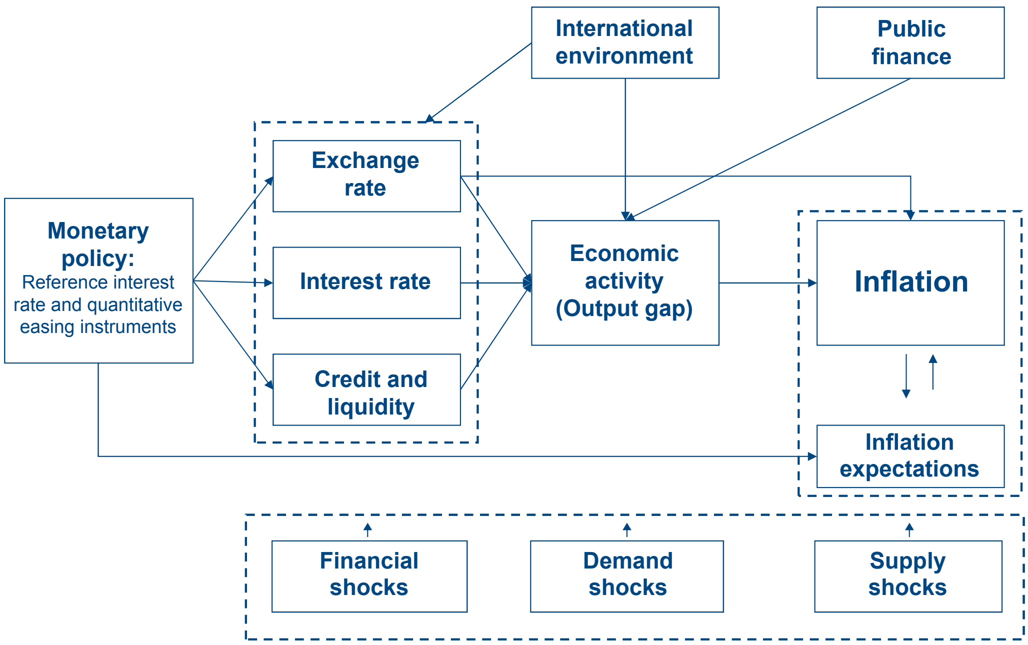

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CONTENT

This ***Inflation Report*** was prepared using data on the Balance of Payments and Gross Domestic Product at Q3-2014 and data on the Non-Financial Public Sector, Monetary Accounts, Inflation, Financial Markets, and the Exchange Rate at December 2014.

Foreword

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

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

- Each month, and according to a previously announced schedule, the Board of BCRP sets a reference rate for the interbank loan market. Since this interest rate, which is the monetary operational target, affects the rate of inflation through several channels in different timeframes, it is established on the basis of macroeconomic forecasts and simulations.

- The Central Bank anticipates inflationary or deflationary pressures, taking also into account that inflation may be influenced by factors beyond the control of monetary policy actions, such as domestic supply shocks or fluctuations in the prices of imported products, which may result in transitory deviations of inflation from the target. In its evaluations BCRP considers the annual increase in the consumer price index registered each month and not only end-of-year figures.

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

- This Inflation Report includes macroeconomic forecasts that support the monetary policy decisions of BCRP as well as the risk factors that can modify these forecasts.

Summary

i. The rate of **global economic** growth declined for the third consecutive year in 2014 (3.1 percent), although the U.S. economy registered a strong recovery in terms of consumption and private investment. Even though the world economy is foreseen to show a recovery this year and next year (3.5 percent and 3.7 percent, respectively) given the positive trends observed in economic indicators in the United States, mainly, this recovery would be more moderate than expected in our previous Inflation Report due to the slower pace of growth recorded in the emerging countries, especially in China and Latin America.

ii. In 2014 the Peruvian economy registered a significant slowdown, its growth rate falling from 5.8 percent in 2013 to 2.4 percent. Factors accounting for this slowdown included (i) the lower growth of consumption and investment given the decline in the terms of trade over the past three years, (ii) the reduction of public expenditure, associated mainly with difficulties in the implementation of investment programs by regional and local governments, and (iii) transitory supply factors, such as adverse climate effects on the agriculture and fisheries output and the lower grades of mineral ores, which would have caused the primary GDP to show the most pronounced decline (-2.1 percent) since 1992.

This slowdown would have been higher than the one estimated in the Inflation Report of October (3.1 percent) due to transitory factors that would have affected the Q4-2014 results, such as a lower growth rate in the sector of manufacturing given that the processing of primary resources was strongly affected by the suspension of the second anchovy fishing season in the last quarter of the year.

The GDP is expected to recover in 2015 and to rise from 2.4 to 4.8 percent due to a partial reversal of the supply shocks observed in 2014, as well as due to a recovery on the side of demand based on a greater public expenditure, a recovery in business confidence, and the continuation of a flexible monetary stance. In 2016 the growth would accelerate to 6.0 percent driven by exports, mainly by exports of traditional products associated with mining projects, such as Constancia and Las Bambas.

iii. The **current account of the balance of payments** would show a deficit of 4.4 percent of GDP in 2014, slightly lower than in 2013 (4.5 percent) and lower than estimated in the previous report due mainly to an adjustment in terms of the demand for imports. A similar deficit is foreseen in **2015** since the increase in net exports would offset the decline in the terms of trade (-0.7 percent). On the other hand, the current account deficit is expected to decrease in **2016** (3.7 percent) as a result of the onset of operations at Las Bambas, which would bring about an increase of exports that year.

iv. Declining from a surplus of 0.9 percent, the economic balance of the **non-financial public sector** would show a deficit of 0.1 percent of GDP in 2014 due to higher non-financial expenditure and lower current income. A fiscal deficit of 2.0 percent is forecast for **2015** and **2016** due to the decline of the current income resulting from the series of measures taken in Q4-2014 –especially the reduction of the income tax– as well as from the drop in the oil price.

v. The Board of the Central Bank approved to lower the **monetary policy benchmark interest rate** to 3.25 percent in January. This level of the policy rate is compatible with an inflation forecast in which inflation converges more rapidly to 2.0 percent in 2015 considering that the lower international prices of oil have begun to reflect in the domestic market, thus giving greater scope for monetary policy actions taking into account that economic activity is still below its potential level. The BCRP also continued easing the regime of **required reserves** in soles to facilitate the expansion of credit in this currency in a context in which deposits in domestic currency have grown at a lower pace than credit. The most recent reduction in the rate of required reserves in soles –from 9.5 to 9.0 percent– became effective in January 2015. These actions will be complemented in 2015 with new schemes for injecting liquidity in domestic currency with the aim of facilitating the dedollarization of credit.

vi. In 2014 **inflation** registered a rate of 3.2 percent, reflecting mainly rises in the prices of food and electricity rates. However, isolating the impact of high volatility prices, inflation without food and energy recorded a rate of 2.5 percent. Inflation is still forecast to reach the 2 percent target in the 2015-2016 forecast horizon. This scenario considers that there would be no demand inflationary pressures in the forecast horizon and that inflation expectations would remain within the target range showing a declining trend towards 2 percent.

vii. As regards the inflation forecast, the events that could most likely divert the inflation rate from the baseline scenario include greater volatility in international financial markets, a further slowdown of domestic demand, slower global growth, and the occurrence of supply shocks.

a. Lower global growth

The baseline scenario considers a slower recovery in the world economy in 2015-2016 than the one estimated in our Inflation Report of October. However, if such recovery were to take even longer and if the terms of trade deteriorated even further, the expected external impulse would be lower and would translate into a higher reduction of the output gap and into a lower inflation rate.

b. Slowdown in domestic demand

Economic recovery could take longer if the implementation of both public and private investment projects were to be postponed. This would lead to a more negative output gap and therefore to lower inflation in the forecast horizon.

c. Volatility in international financial markets

This risk could occur if the Federal Reserve's withdrawal of monetary stimulus brought about high volatility in international financial markets. In such a scenario, this could generate capital outflows from the emerging countries and tighten credit conditions in these economies.

d. Supply shocks

The low international prices of crude could have a stronger downward effect on inflation if the international prices of crude do not recover in the second half of the year.

viii. The balance of the risks mentioned above to the inflation forecast is tilted on the **downside**, which contrasts with the neutral balance of risks of our Inflation Report of October. This is explained mainly by increased risks of lower oil prices considered in this report.

FORECAST SUMMARY

	2013	2014[1/]	2015[1/]		2016[1/]	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
Real % change						
1. GDP	5.8	2.4	5.5	4.8	6.3	6.0
2. Domestic demand	7.0	2.5	5.0	4.7	5.5	5.2
a. Private consumption	5.3	4.3	4.7	4.5	5.2	4.8
b. Consumption Public	6.7	6.4	6.0	6.6	6.0	6.0
c. Private fixed investment	6.4	-1.5	5.2	3.0	6.3	5.2
d. Public investment	12.1	-3.6	8.8	12.0	11.6	11.6
3. Exports (goods and services)	-0.9	-2.2	6.5	3.4	9.4	9.4
4. Imports (goods and services)	3.6	-1.3	4.2	2.9	5.9	5.9
5. Economic growth in main trading partners	2.7	2.4	3.0	2.7	3.2	3.0
Memo:						
Output gap [2/] (%)	0.0	-2.0 ; -1.0	-2.0 ; -1.0	-2.0 ; -1.0	-1.0 ; 0.0	-1.0 ; 0.0
% change						
6. Inflation	2.9	3.2	1.5 - 2.5	1.5 - 2.5	1.5 - 2.5	1.5 - 2.5
7. Average price of crude oil	4.0	-4.9	-7.8	-45.1	-3.6	13.5
8. Nominal exchange rate expected [3/]	8.5	6.4	1.3	3.5	0.6	2.2
9. Real multilateral exchange rate [3/]	0.7	3.2	-1.1	0.7	0.2	0.7
10. Terms of trade	-4.7	-5.8	1.2	-0.7	-0.5	-1.0
a. Export price index	-5.5	-7.3	-0.6	-7.7	0.2	0.9
b. Import price index	-0.8	-1.5	-1.8	-7.1	0.7	1.9
Nominal % change						
11. Currency in circulation	9.3	10.4	11.5	10.8	12.0	11.5
12. Credit to the private sector [4/]	13.2	10.8	13.1	12.0	13.7	13.0
% GDP						
13. Gross fixed investment	26.6	25.6	25.7	25.4	26.1	25.6
14. Current account of the balance of payments	-4.5	-4.4	-4.3	-4.4	-3.5	-3.7
15. Trade balance	0.0	-1.4	-0.7	-1.3	-0.1	-0.9
16. Long-term external financing to the private sector [5/]	9.5	7.0	6.4	5.9	5.5	5.2
17. Current revenue of the general government	22.1	22.2	21.9	20.7	21.9	20.8
18. Non-financial expenditure of the general government	20.5	21.3	21.3	21.7	21.3	21.8
19. Overall balance of the non-financial public sector	0.9	-0.1	-0.3	-2.0	-0.5	-2.0
20. Total public debt balance	19.6	19.7	18.7	19.6	18.2	19.3

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, portfolio investment, and private sector's long-term disbursement.

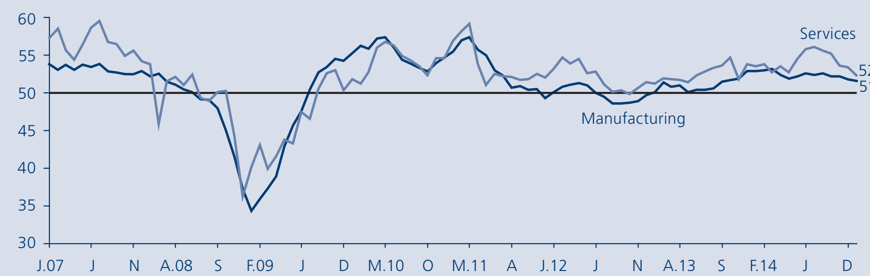
I. International Environment

Output

1. The recent evolution of most countries has been different and the growth forecasts vary in most cases. While economic recovery has been consolidating in the United States, the prospects for growth in some developed countries –particularly the Eurozone and Japan– and in several emerging economies have deteriorated.

   The global manufacturing PMI index has been declining slightly over the past two months, but remains above the 50 threshold, that is, in the expansion area. The index of services, on the other hand, also shows levels higher than the threshold, but shows a declining trend as well since August last year.

Graph 1
JP MORGAN GLOBAL PMI MANUFACTURING AND SERVICES*
(January 2007 - December 2014)



* Indices PMI.
Source: Bloomberg.

2. Global GDP is estimated to show growth rates of 3.1 percent in 2014, 3.5 percent in 2015, and 3.7 percent in 2016. The growth forecasts for 2015 have been revised down due to slower growth in developing countries –down from 5.0 to 4.4 percent– since the growth outlook for China has been revised from 7.2 to 7.0 percent and the growth outlook for Latin America has been revised from 2.6 to 1.7 percent.

Table 1
WORLD GDP GROWTH
(Annual % change)

	PPP % 2012	2013	2014* IR Oct.14	2014* IR Jan.15	2015* IR Oct.14	2015* IR Jan.15	2016* IR Oct.14	2016* IR Jan.15
Advanced economies	**44.4**	**1.3**	**1.8**	**1.8**	**2.3**	**2.3**	**2.4**	**2.3**
Of which:								
1. United States	16.6	2.2	2.2	2.4	3.0	3.1	3.0	3.0
2. Eurozone	12.7	-0.5	0.7	0.8	1.2	1.1	1.6	1.5
Germany	3.5	0.1	1.5	1.5	1.5	1.1	1.5	1.5
France	2.6	0.3	0.4	0.4	1.0	0.9	1.4	1.3
Italy	2.1	-1.9	-0.3	-0.4	0.4	0.3	1.1	1.0
Spain	1.5	-1.2	1.1	1.3	1.5	1.7	1.5	1.7
3. Japan	4.7	1.6	1.1	0.2	1.3	1.3	0.9	1.0
4. United Kingdom	2.3	1.7	3.0	2.6	2.7	2.7	2.4	2.4
Emerging market and developing economies	**55.6**	**4.7**	**4.3**	**4.2**	**5.0**	**4.4**	**5.3**	**4.9**
Of which:								
1. Developing Asia	27.8	6.6	6.4	6.4	6.7	6.5	6.7	6.5
China	15.2	7.7	7.2	7.4	7.2	7.0	7.0	6.8
India	6.5	5.0	5.4	5.4	6.3	6.3	6.5	6.5
2. Commonwealth of Independent States	4.9	2.2	0.8	0.8	1.9	-1.7	3.4	0.7
Russia	3.5	1.3	0.3	0.3	1.0	-4.0	2.2	-1.5
3. Latin America and the Caribbean	8.8	2.8	1.4	1.0	2.6	1.7	3.4	2.8
Brazil	3.0	2.5	0.3	0.2	1.3	0.6	2.7	2.0
World Economy	**100.0**	**3.3**	**3.0**	**3.1**	**3.6**	**3.5**	**3.8**	**3.7**
Memo:								
Peru's trading partners[1/]	64.1	2.7	2.4	2.4	3.0	2.7	3.2	3.0
BRICs[2/]	26.3	5.8	5.3	5.3	5.7	4.8	5.8	5.1

* Forecast.
1/ Basket of Peru's 20 main trading partners.
2/ Brazil, Russia, India, and China.
Memo: Forecast IR January Includes new weights from WEO-FMI october 2014.
IR: Inflation Report
Source: Bloomberg, IMF, and Consensus Forecast.

3. Some of the risk factors discussed in our previous inflation report have increased.

   a. Even though the **sharp fall in the oil price** would have a positive impact on global consumption, it increases the risk of crises in some oil-exporting economies, which could raise risk aversion and deteriorate credit conditions for the emerging economies.

   b. Still existing **risks of deflation in the Eurozone and Japan** could intensify with the recent correction in the price of crude oil. However, these pressures increase the probability of new stimulus programs.

   c. A higher-than-expected **slowdown in China** is still a risk factor in a context in which the probability of a deflation has increased in recent months.

d. Finally, the risk of a **disorderly adjustment in financial markets after the Fed raises its interest rates remains**.

Graph 2
GDP GROWTH
(Annual % change)

* Forecast.
Source: BCRP.

4. In the **United States**, the economy continued showing a strong recovery with growth rates of 4.6 percent in Q2 and 5.0 percent in Q3, supported by the dynamism of investment which registered growth rates of 9.5 and 7.7 percent in these quarters.

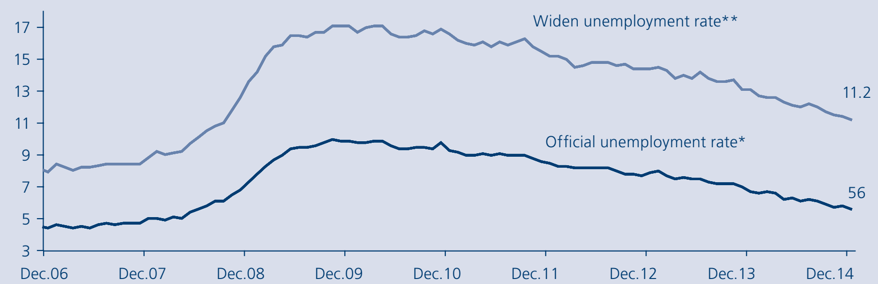
Table 2
USA: GDP
(Seasonally adjusted annualized quarterly rates)

	2013				2014		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Private consumption	3.6	1.8	2.0	3.7	1.2	2.5	3.2
Fixed investment	2.7	4.9	6.6	6.3	0.2	9.5	7.7
Change on inventories*	0.7	0.3	1.5	-0.3	-1.2	1.4	0.0
Net exports*	-0.1	-0.5	0.6	1.1	-1.7	-0.3	0.8
GDP	**2.7**	**1.8**	**4.5**	**3.5**	**-2.1**	**4.6**	**5.0**
Memo:							
Unemployment rate**	7.5	7.5	7.2	6.7	6.7	6.1	5.9

* Contribution to growth.
** End-of-period.
Source: BEA and BLS.

5. Recent indicators –employment, industrial production, retail sales, consumer confidence, among others– show a positive trend in Q4. It is estimated that the greatest contribution to growth would come from consumption, which is still driven by low oil prices and favorable conditions in the labor market. The official rate of unemployment (U3) and the one based on a broader definition of unemployment (U6) have reached minimum levels since June and October 2008, respectively.

Graph 3
USA: UNEMPLOYMENT MEASURES
(%)



Memo:
* U-3: Total unemployed, as a percent of the civilian labor force (official unemployment rate).
** U-6: Total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force.
Persons marginally attached to the labor force are those who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the past 12 months.
Source: Bloomberg.

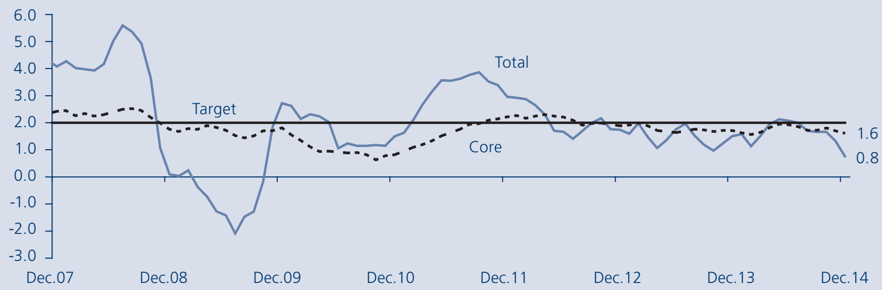
On the other hand, a lower contribution of net exports is expected due to the strengthening of the dollar and the economic slowdown observed in the Eurozone, Japan, and China. In addition, the contribution of fixed investment would be lower than in Q3 due to the effect that the low prices of oil would have on investment in the energy sector.

6. In line with the higher output growth in Q3 and with recent indicators, the U.S. economy is estimated to grow 2.4 percent in 2014, 3.1 percent in 2015, and 3.0

percent in 2016. These rates are higher than the projected in the Inflation Report of October. This forecast considers that the momentum of lower oil prices on growth will be higher than the negative impact of the appreciation of the dollar.

7. The rate of annual inflation fell from 1.7 percent in August to 0.8 percent in December and the rate of core inflation –which excludes fuels and food– fell slightly to 1.6 percent. Inflation would remain at low levels, although temporarily, due to the drop of oil prices and the strengthening of the dollar.

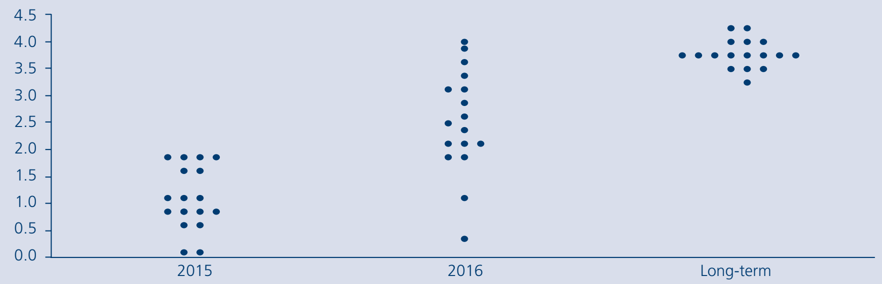
Graph 4
USA: CPI
(12 month % change)



Source: Bloomberg.

In this context of sustained recovery, the Fed ended its monthly bond buying program –Quantitative Easing (QE)– in October, in line with market expectations. At the Federal Open Market Committee meeting of December, the Fed tweaked its guidance of low-interest rates "for a considerable time" and emphasized that its interest rate policy would depend on the evolution of economic conditions, in line with what the Fed had said previously. The futures market estimated that the Fed would begin its cycle of rate hikes towards Q3-2015.

Graph 5
FORECASTING FED POLICY RATE IN DECEMBER 2014
(%)

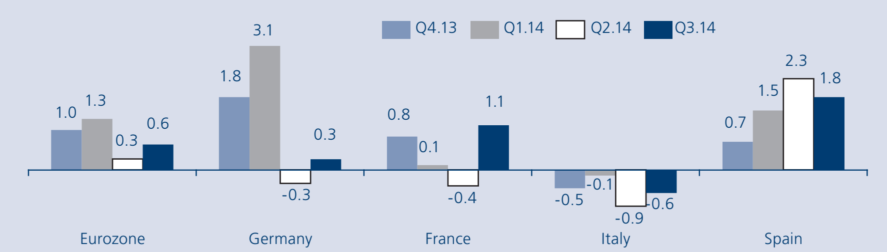


*Each point represents the individual forecast of the Members of the Board of FED at the end-of-period. Median is 1.125% in 2015, 2.5% in 2016, and 3,75% in long-term.
Source: Fed.

8. Economic recovery in the **Eurozone** during 2014 has been weak and uneven, as pointed out in previous reports. The low level of growth –0.6 percent in Q3– has been accompanied by declining inflation, which has increased the risks of deflation in several countries of the region.

At the country level, weak economic growth extended to Germany, the largest economy in the Eurozone, which was affected by the fall in business confidence. In contrast, Spain and Ireland have shown a positive growth trend as a result of the reforms adopted when the crisis started.

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



Source: Bloomberg.

9. The low level of growth in the Eurozone is mainly explained by the slow recovery of domestic demand.

Favored by the stabilization of unemployment rates and by low inflation rates, consumption has had a positive contribution. Despite this, the deleveraging of the private sector, which has continued in recent quarters, has offset the recovery. On the other hand, investment has fallen in the last two quarters, the drop in business confidence associated with the slowdown of growth in China and the geopolitical crisis between Russia and Ukraine accounting significantly for this fall.

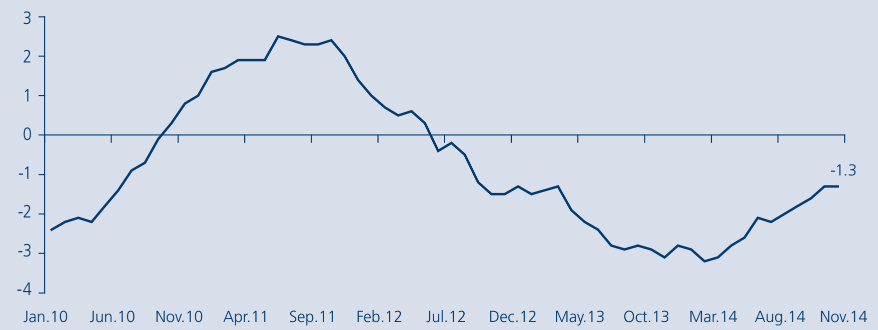
Table 3
EUROZONE: GDP GROWTH
(Seasonally adjusted annualized quarterly rates)

	2013				2014		
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**
Private consumption	-0.9	0.5	0.5	0.6	0.6	1.1	1.9
Fixed investment	-8.8	2.7	2.4	2.7	1.2	-2.6	-1.2
Change on inventories*	0.8	-0.7	1.2	-1.2	0.5	-0.4	-0.5
Net exports*	-0.4	1.6	-1.6	0.8	0.1	0.4	0.1
GDP	**-1.5**	**1.3**	**0.7**	**1.0**	**1.3**	**0.3**	**0.6**
Memo:							
Unemployment rate**	12.0	12.0	12.0	11.8	11.7	11.6	11.5

* Contribution to growth.
** End-of-period.
Source: Eurostat.

10. In addition to this, while credit conditions have improved, they are still restrictive. At November 2014, bank lending to the private non-financial corporate sector had shrank 1.3 percent, a result explained mainly by conditions in the peripheral economies (Italy, Spain, Portugal, Greece, and Ireland). Moreover, the latest survey of bank credit conditions showed that banks had eased their conditions by Q3-2014, but that they still have restrictive levels far away from their historical average levels.

Graph 7
EUROZONE: LOANS TO NON-FINANCIAL CORPORATIONS
(12 month % change)



Source: Bloomberg.

11. At the sector level, the indexes of activity (PMI) in December showed signals of some improvement both in services and manufacturing after the low levels observed in November. The greatest momentum in manufacturing took place in Germany, while in the case of services it extended also to other peripheral economies, with the exception of Italy.

Table 4
EUROZONE: ACTIVITY INDICES PMI JP MORGAN

	Dec.13	Mar.14	Jun.14	Sep.14	Oct.14	Nov.14	Dec.14
Composite							
Eurozone	**52.1**	**53.1**	**52.8**	**52.0**	**52.1**	**51.1**	**51.4**
Services							
Eurozone	**51.0**	**52.2**	**52.8**	**52.4**	**52.3**	**51.1**	**51.6**
Germany	53.5	53.0	54.6	55.7	54.4	52.1	52.1
France	47.8	51.5	48.2	48.4	48.3	47.9	50.6
Italy	47.9	49.5	53.9	48.8	50.8	51.8	49.4
Spain	54.2	54.0	54.8	55.8	55.9	52.7	54.3
Manufacturing							
Eurozone	**52.7**	**53.0**	**51.8**	**50.3**	**50.6**	**50.1**	**50.6**
Germany	54.3	53.7	52.0	49.9	51.4	49.5	51.2
France	47.0	52.1	48.2	48.8	48.5	48.4	47.5
Italy	53.3	52.4	52.6	50.7	49.0	49.0	48.4
Spain	50.8	52.8	54.6	52.6	52.6	54.7	53.8

Source: Bloomberg.

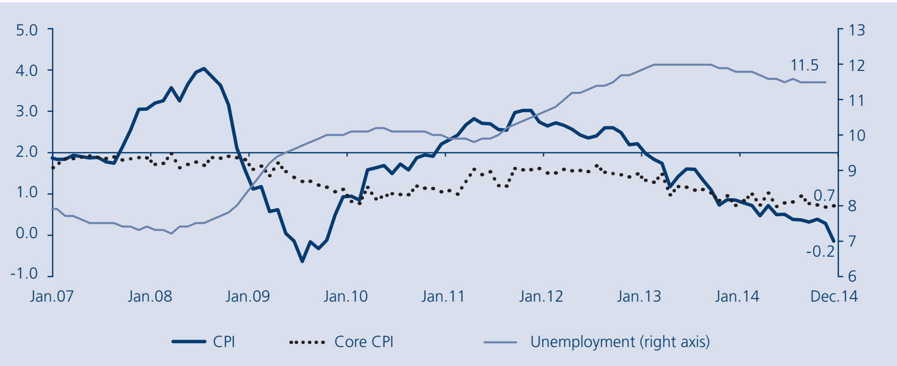
12. Activity in the Eurozone would continue to show weak levels in 2015 and improve only in 2016 due in part to the recovery of business confidence. The growth forecast for the Eurozone in 2015 has been revised down from 1.2 to 1.1 percent, and from 1.6 to 1.5 percent in 2016, due mainly to the growth trends foreseen in the three major economies of the zone (Germany, France and Italy). On the other hand, the growth forecast in the case of Spain has been revised upwards from 1.5 to 1.7 percent for both years.

    This forecast considers that the decrease in the oil price would have a positive impact on growth, although there is the risk that this may intensify existing deflationary pressures and affect the economic recovery.

    Furthermore, the risks associated with the geopolitical and economic situation of Russia remain, as do also those associated with uncertainty about the political situation in Greece, where holding the elections earlier –in the month of January– has jeopardized EU/IMF program.

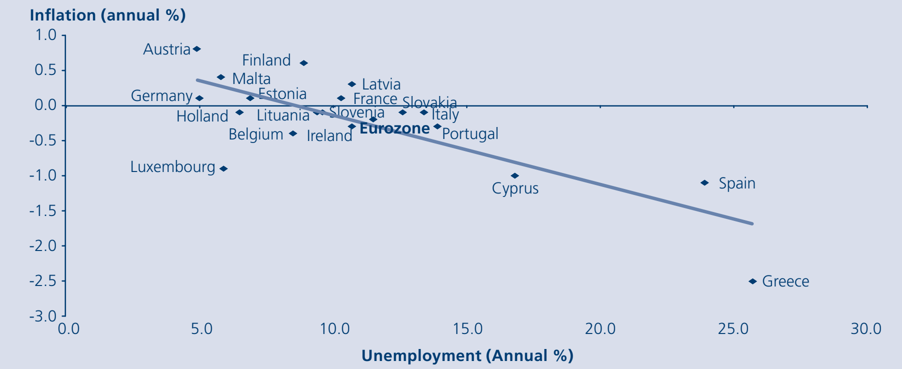
13. In December, falling for the first time in negative terrain since October 2009, annual inflation in the Eurozone recorded a rate of -0.2 percent. Although the fall is explained by the prices of fuels, core inflation has remained below 1 percent for 16 consecutive months. At the country level, 12 of the 19 countries integrating the block –Lithuania became part of the union as from January 2015– reported negative inflation rates and 7 reported inflation rates below 1 percent.

Graph 8
EUROZONE: INFLATION AND UNEMPLOYMENT RATE
(12 month % change)



Source: Bloomberg.

Graph 9
EUROZONE: INFLATION AND UNEMPLOYMENT RATE
(%)



Source: Bloomberg.

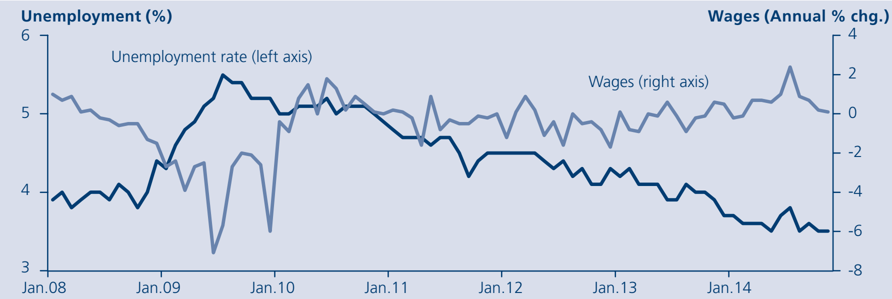
14. In this context with high risks of deflation, expectations that the ECB would launch further stimulus programs crystallized in an asset-purchase program that the ECB approved in its January policy meeting, which involves a significantly higher amount of funds –60 billion euros per month– and a greater variety of assets. This action adds to the measures adopted between June and September.

15. In **Japan**, the economy went into technical recession in Q3-2014 due to the negative impact generated by the increase of the sales tax in April. The output shrank 6.7 percent in Q2 and 1.9 percent in Q3.

    The weakness of the economy led the Central Bank to announce an extension of its bond purchase program –Quantitative and Qualitative Easing (QQE)– in October and to increase the annual amount for bond purchases to 80 trillion yen (from the 60-70 trillion previously announced).

    The economy is expected to have recovered moderately in Q4-2014, favored by consumption. This recovery would have been supported by the improvement of the labor market, positive prospects for corporate profits, and the fall of oil prices. An increase in real exports associated with the depreciation of the yen is also expected. However, residential investment would have continued being affected by the increase of the sales tax.

Graph 10
JAPAN: UNEMPLOYMENT RATE AND WAGES



Source: Bloomberg.

Inflation –excluding fresh food– registered a rate of 2.1 percent in November, but the inflation rate excluding the impact of the increase in the sales tax was only 0.7 percent. The Central Bank expects inflation to reach the 2 percent inflation target in fiscal year 2016 (between April 2016 and March 2017), which is supported by an outlook of higher inflation in the long run.

In November, the government postponed the second increase of the sales tax (from 8 to 10 percent) originally scheduled for October 2015 to April 2017. On the other hand, it approved the tax reform plan that will reduce the corporate tax rate by 2.51 percentage points since April (to 32.1 percent). The possibility of implementing additional fiscal measures is favored by the new composition of the Parliament following the elections held in December.

In line with recent developments and recent indicators, the Japanese economy is expected to grow 0.2 percent in 2014, 1.3 percent in 2015, and 1.0 percent in 2016. This forecast is offset by still weak consumer and business confidence. The main risk for growth is still a slowdown in the Eurozone and China, as well as doubts about the sustainability of its debt in the long run. Japan's public debt is estimated to represent 245 percent of GDP in 2014.

16. The **emerging economies** have shown signs of a slowdown and are now estimated to grow 4.2 percent in 2014, which represents a slight revision downwards compared to the growth rate forecast in our previous report. In 2015, the emerging economies would grow 4.4 percent, less than estimated in the October inflation report.

17. The signs of an economic slowdown in **China** intensified in the last quarter of 2014, as did also the pressures of low inflation rates, raising the risks of slower growth as well as expectations of further stimulus from the government.

Table 5
CHINA'S ECONOMIC INDICATORS

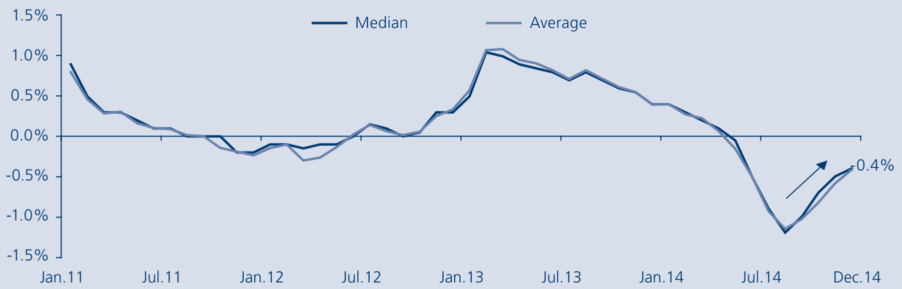
Indicators	2012	2013	2014					
	Dec.	Dec.	Mar.	Jun.	Sep.	Oct.	Nov.	Dec.
Quarterly GDP (Seasonally adjusted annualized growth rates)		7.0	6.1	8.2	7.8	-	-	6.1
Industrial production (12 month % change)	10.3	9.7	8.8	9.2	8.0	7.7	7.2	7.9
Investment in fixed assets (Accum. annual % change)	20.6	19.6	17.6	17.3	16.1	15.9	15.8	15.7
Real estate investment (Accum. annual % change)	16.2	19.8	16.8	14.1	12.5	12.4	11.9	10.5
Price of houses (Monthly % change)	0.3	0.4	0.2	-0.5	-1.0	-0.8	-0.6	-0.4
Price of houses (Annual % change)	-0.1	9.7	7.7	4.3	-1.2	-2.6	-3.7	-4.5
Retail sales (12 month % change)	15.2	13.6	12.2	12.4	11.6	11.5	11.7	11.9
Exports (12 month % change)	14.1	4.3	-6.6	7.2	15.3	11.6	4.7	9.7
Imports (12 month % change)	6.0	8.3	-11.3	5.5	7.0	4.6	-6.7	-2.4
New loans in yuans (Annual %)	15.0	14.1	13.9	14.0	13.2	13.2	13.4	13.6
M2 (% anual)	13.8	13.6	12.1	14.7	12.9	12.6	12.3	12.2
Consumer Price Index (12 month % change)	2.5	2.5	2.4	2.3	1.6	1.6	1.4	1.5

Source: Bloomberg.

On the side of spending, domestic demand continued to be affected by the slowdown in investment. At the sector level, manufacturing showed an unfavorable evolution affected mainly by excess capacity in the heavy industry sectors, as reflected in the manufacturing indices (PMI) –both the official source (CFLP) and the private source (Markit)– which showed this trend.

The construction sector has been affected by the correction of property prices which continued in recent months although at a more moderate pace. Since October, the monthly fall in prices has declined due to government measures aimed at easing the restrictions affecting the demand for housing (basically for purchases of a second-home). The impact of the situation in the real estate sector has been offset by greater public investment in infrastructure. In October the government announced further investment projects in information networks, water conservation, and environment protection projects and announced new measures to boost families' consumption and the housing market.

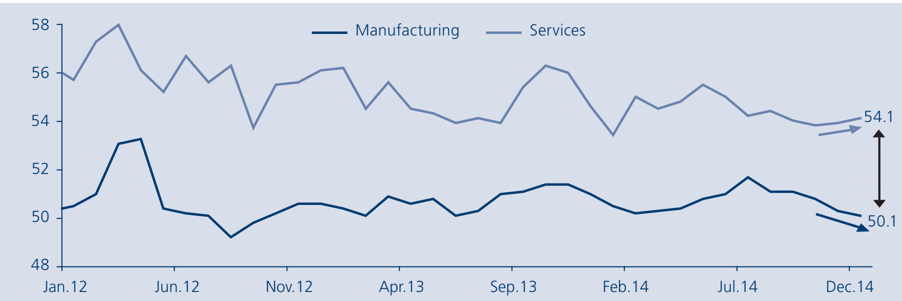
Graph 11
CHINA: HOUSE PRICES IN 70 MAIN CITIES
(AVERAGE AND MEDIAN)
(Monthly % change)



Source: Bloomberg.

18. In contrast with the sectors of construction and manufacturing, the service sector continued recording significant growth rates that enhanced the gap with the manufacturing sector and increased its weight in GDP terms. According to the recent revision of the 2013 GDP, the tertiary sector raised its ratio from 46.1 to 46.9 percent of GDP (while the ratio of the secondary sector fell from 43.9 to 43.7 percent). Moreover, the favorable evolution of services has played a role in the stability of employment, neutralizing the losses associated with lower manufacturing activity.

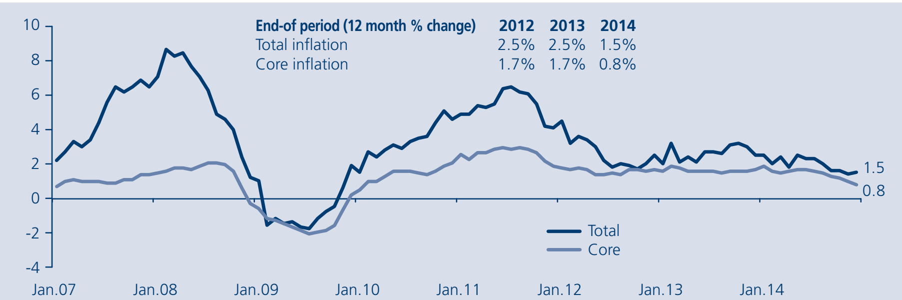
Graph 12
CHINA: OFFICIAL PMI MANUFACTURING AND SERVICES INDICES



Source: Bloomberg.

The weakness of domestic demand and low commodity prices reflected in low levels of inflation. The rate of inflation fell from 1.6 percent at the end of September to 1.5 percent at the end of December and core inflation showed a similar trend, reaching its lowest level since January 2010. The reduction in inflation has raised expectations that the government will give further stimulus.

Graph 13
CHINA: TOTAL AND CORE INFLATION
(12 month % change)



Source: Bloomberg.

19. In line with these events, during the last quarter of the year the Central Bank adopted further measures to lower the cost of credit, particularly for small businesses. At the end of November, the Central Bank reduced for first time since July 2012 the rates on 1-year loans and deposits from 6.0 to 5.6 percent and from 3.0 to 2.75 percent,

respectively. In addition, as a signal of its aim to reinforce interest rate flexibility, the Central Bank raised the ceiling of the rates that banks can offer to savers from 1.1 to 1.2 times the rate of the benchmark deposit, and eliminated the benchmark guidance for the 5-year savings rate. In late December, the Central Bank eased lending requirements by modifying the calculation of the loans-to-deposits ratio –included interbank deposits and others as eligible deposits– in a context of more tight liquidity conditions associated with lower capital inflows, with end-of-the-year seasonal factors, and with the rise in stock indexes.

These measures are estimated to have had a positive impact on bank credit. Unlike shadow credit, bank credit in yuan has registered a slight slowdown due in part to the measures implemented by the Central Bank. Bank credit in domestic currency has registered annual growth rates around 13 percent (vs. 15 percent in December 2012). On the other hand, the contraction of shadow banking (given greater regulation and the weak demand of its traditional customers. i.e. property developers and industries with excessive capacity), lower capital inflows, and the increase of unprofitable loans account for the strong moderation of total credit.

20. In this context of greater economic slowdown, in line with a more balanced long-term growth consistent with the government goals, the growth forecast has been revised slightly down from 7.2 to 7.0 percent annually in 2015 and from 7.0 to 6.8 percent in 2016. On the other hand, the growth rate projected for 2014 has been revised upward from 7.2 to 7.4 percent, in line with the growth of GDP in Q4-2014 and with the most recent data.

21. In **Russia**, the economy is heading towards a strong recession. In addition to the increase of Western countries' sanctions as a result of the conflict in Ukraine, the economy has also been strongly affected by the fall in the price of oil given that this product represents around 60 percent of Russia's exports and 50 percent of its tax revenue. Together with the increase in the yield rates in the United States and Europe, these developments have caused a strong shortage of currency in the system and led the dollar to appreciate 85 percent against the ruble in 2014. The dollar has appreciated significantly against the ruble despite the fact that the policy interest rate was subject to successive increases during 2014 and accumulated an increase of 1,150 bps during the year, and despite the fact that the international reserves decreased from US$ 511 billion at the end of 2013 to US$ 388 billion at January of this year.

    Thus, our growth forecast in this case has been revised downward from 1.0 to -4.0 percent due to the contraction estimated for the first half of this year. In 2016, GDP would fall 1.5 percent.

22. In Q3-2014, most **Latin American** countries continued showing an economic slowdown, explained mainly by a lower boost from domestic demand,

and particularly from private investment which, in countries like Chile and Brazil, has been accumulating a contraction in the first nine months of the year.

23. In Q3-2014, GDP in **Brazil** fell 0.2 percent in annual terms, affected by the contraction of investment and by a greater slowdown in the pace of growth of private consumption. The government has announced that it is necessary to make a fiscal adjustment during 2015 to restore confidence in public finances. On the other hand, the Central Bank's space for an expansionary monetary policy is limited due to persistent inflation. Both factors explain that the outlook for growth in 2015 be moderate. In Chile, the 0.8 percent annual growth rate is mainly explained by the contraction of investment in annual terms for five consecutive quarters. It is expected that the fiscal stimulus measures adopted will help economic activity to resume a faster pace of growth next year.

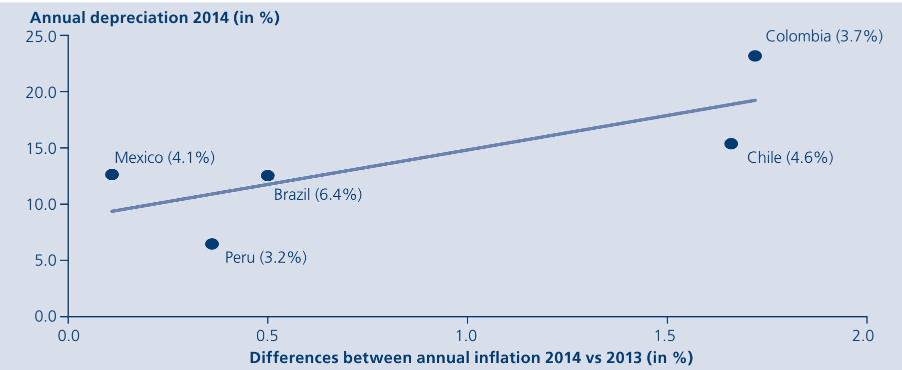
    For its part, **Mexico** showed an annual growth rate of 2.2 percent due to the impulse of the external sector, in line with the recovery of the United States, as well as due to an improvement in private consumption. **Colombia** grew 4.2 percent, which indicates a slight slowdown due in part to a negative contribution from the external sector. The growth of these two countries, both net exporters of oil, would be affected by the lower prices of crude oil in 2015.

Graph 14
LATIN AMERICA: GDP GROWTH 2015
(% Change)

Source: Latin America Consensus Forecast (January 2015) and BCRP (Peru).

24. During 2014, inflation showed an upward trend in the Latin American countries with inflation targeting schemes. This upward trend was associated mainly with the pass-through effect of the depreciation of the local currencies, as well as with domestic and external shocks. It is worth pointing out that in all of the cases the inflation rates at the end of the year was close to the upper limit or outside the target ranges established by the central banks.

Graph 15
LATIN AMERICA: DEPRECIATION AND INCREASE OF INFLATION IN 2014



Source: Bloomberg. Level of inflation 2014 in parentheses.

In 2015, inflation in the countries of the region is expected to moderate and to show lower rates than in 2014, in line with lower oil prices.

Graph 16
INFLATION: 2015

Source: Latin America Consensus Forecast (January 2015) and BCRP (Peru).

Financial Markets

25. International financial markets had a less favorable evolution in Q4-2014 than in Q3-2014, which is explained in part by the lower prospects for global growth, as reflected in the downward revision of the forecasts of global growth in 2015. With the exception of the United States, the outlook for growth in the developed economies, as well as in several emerging economies, has deteriorated.

    Another factor has been the strong fall in the price of oil. This sharp correction has been interpreted as a sign of weakness of the global economy, the sign being reinforced by the cut in the projected demand for 2015 by the OPEC and the International

Energy Agency (IEA). The fall in the oil price has also generated further uncertainty about the situation of several oil-exporting emerging economies, particularly Russia.

A third factor that affected markets towards the end of the year was the political situation in Greece after the country decided to hold elections in January 2015. It is quite likely that a party opposed to the current reforms and the agreements signed by Greece with the international agencies will win the elections, so this has generated not only uncertainty about the country's outlook, but also doubts about whether it will remain within the euro monetary union or not.

In this context, the level of risk aversion, measured by the VIX index, recorded significant increases and showed periods of high volatility in October and December after having reached its lowest level in July since the international financial crisis unfolded.

Graph 17
RISK AVERSION COEFFICIENT: VIX (S&P'500)
(July 2014 - December 2014)

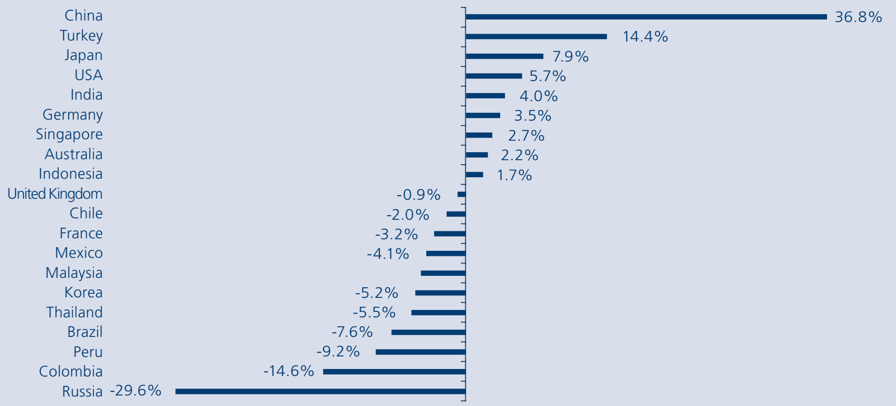
Source: Bloomberg.

26. The **stock yields** in Q4-2014 showed a mixed evolution, but this evolution was less favorable in general terms than the one foreseen in our previous report.

On the one hand, the U.S. stock markets registered a positive trend, supported by mostly favorable economic data. In Japan, the market was supported by the depreciation of the yen which basically favored exporting companies; in Germany, the stock exchange was favored by expectations of further stimulus from the European Central Bank at the beginning of 2015, while in China the stimulus of the Central Bank of China –and expectation of additional stimulus– boosted this market.

On the other hand, stock exchange markets in most emerging economies were affected by a lower demand for risky assets due to the factors discussed above (economic slowdown in China and problems in Russia, among others). The 30 percent fall registered in the stock market of Russia in Q4 is worth pointing out.

Graph 18
STOCK MARKET YIELDS
(Setiembre 2014 - December 2014)



Source: Bloomberg.

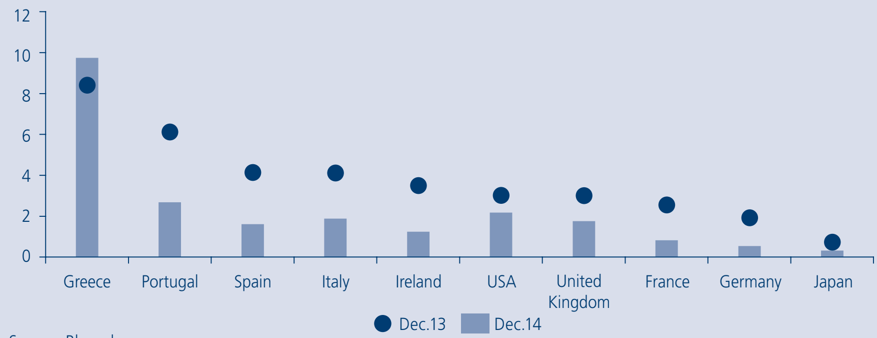
27. Most of the **public debt markets** in the developed economies recorded an increased demand, which caused a reduction in yields –greater than in Q3– in a context of less favorable prospects for the global economy and political uncertainty regarding Greece.

    In the **USA**, yields continued showing the downward trend observed over the year. This is explained in part by the demand of foreign investors (who hold 50 percent of the Treasury bonds) given that they want safe assets because of the context of greater uncertainty and find Treasury bonds more attractive than other very low risk bonds with lower yields (such as German bonds or Japanese bonds). However, in December the yields increased slightly when the economy continued showing signs of recovery and after the Fed released a communiqué that generated greater expectations that it would raise interest rates in 2015.

28. In the **Eurozone**, the weak evolution of activity and expectations that the ECB would launch an asset purchase program in 2015 –the program was announced at the ECB meeting in January– have contributed to influence a downward trend in the sovereign yields of the Eurozone. The yields of the bonds of Germany and France reached minimum levels, in line with the increased demand for safe assets.

    On the other hand, the yields of riskier assets (peripheral economies) have been affected by the crisis in Russia and by recent political uncertainty in Greece. In the latter country, the yields have even risen significantly in the last three months (by more than 5 percent after having reached a minimum low of 5.57 percent).

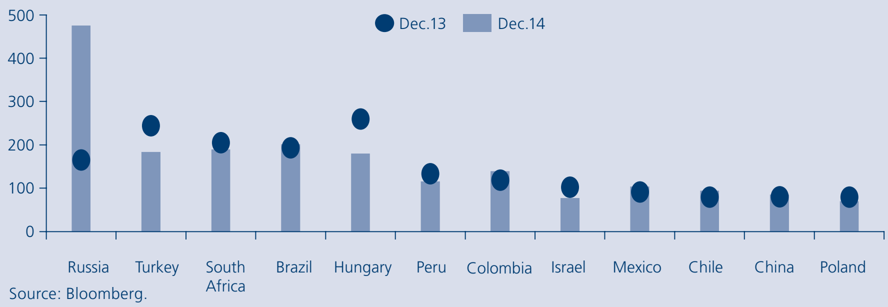
Graph 19
DEVELOPED COUNTRIES: 10-YEAR TREASURY YIELDS
(%)



Source: Bloomberg.

29. In line with debt markets in other emerging economies, the **Latin American** debt markets showed an unfavorable evolution, affected by the economic problems in Russia, signs of a slowdown in China, and expectations that the Fed will raise its interest rates. Other factors contributing to this were the low growth figures recorded in most of the economies of the region and the fall in commodity prices. In this context, the credit spreads (CDS) registered a rise in Q4.

Graph 20
DEVELOPED COUNTRIES: 5-YEAR SOVEREIGN CDS



Source: Bloomberg.

In 2014, the debt issued in foreign currency by emerging economies reached a record value. According to Reuters, the total debt issued (sovereign and corporate) amounted to around US$ 480 billion (vs. US$ 439 billion in 2013). Taking advantage of the context of low rates, these bond issuances were mostly corporate and reached US$ 367 billion.

Exchange Rates

30. Continuing with the trend of a widespread appreciation of the dollar observed in the previous quarter –when it appreciated 3.9 percent–, according to the Fed index the

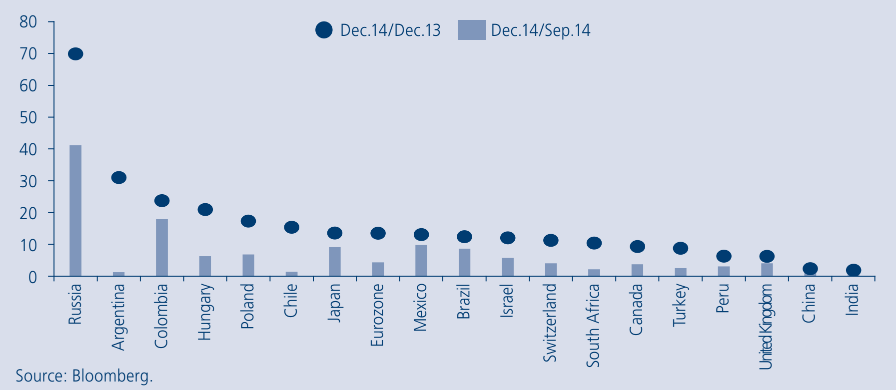
dollar appreciated 4.7 percent between October and December 2014. This has taken place in context marked by market expectations of a rise in the Fed rate in 2015 and simultaneously further monetary stimulus in other economies, namely the Eurozone and Japan, where macroeconomic prospects have deteriorated. Thus, the dollar has appreciated 9.3 percent against the yen and 4.5 percent against the euro. It is worth highlighting that, in contrast with this trend, the Swiss franc strengthened against the dollar in January after the Swiss central bank eliminated the exchange-rate floor for the euro.

As regards the currencies of emerging countries, the 48 percent depreciation of the ruble stands out in Q4-2014. This currency has been affected by the drastic fall in the price of oil and by the sanctions imposed by the United States and the Eurozone. Together with the negative signals from China, all of these factors have affected emerging currencies. In the region, the currencies that depreciated more were the Colombian peso and the Mexican peso (17.9 and 9.9 percent, respectively).

Graph 21
US DOLLAR INDEX*
(January 2008 - December 2014)

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

Graph 22
EXCHANGE RATE (C.U./US$)
(% change)



Source: Bloomberg.

Interest Rate Decisions

31. Although most central banks maintained their policy interest rates unchanged, an important group of countries reduced their rates between October and December. Only three countries have raised them in recent months.

The countries that lowered their interest rates have experienced an economic slowdown which, in most cases, has been accompanied by declining inflation levels or by a fall in price levels (as in Sweden, where inflation has been negative since the month of August). The exception has been Chile, where the interest rate cut took place in a context of inflation being above its target range (but with prospects for inflation's convergence towards the target in 2015).

On the other hand, Brazil, Indonesia, and Russia raised their interest rates. In Brazil the interest rate was raised in a context in which both inflation and inflation expectations for 2015 are above the target range (2.5-6.5 percent). In Indonesia, there have been upward pressures on prices due to the depreciation of the rupee and the elimination of fuel subsidies, and Russia raised rates on several occasions during the quarter, which resulted in an accumulated increase of 900 bs in the quarter. This rise of rates took place in a context of marked depreciation pressures associated with the depreciation of the rouble and with uncertainty about Russia's economy as a result of the significant fall in the price of oil.

Table 6
MONETARY POLICY INTEREST RATE

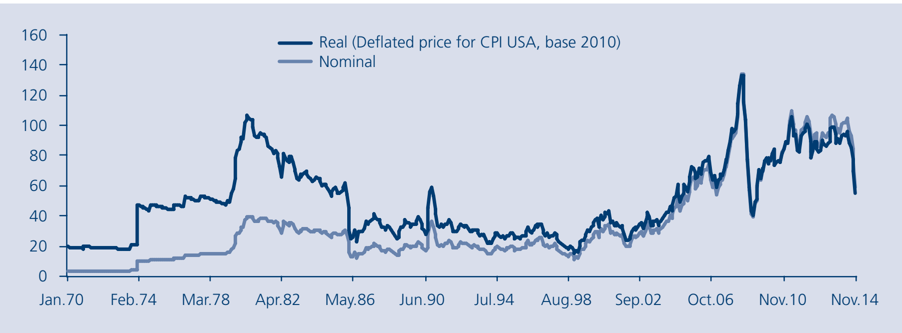
	Dec.12	Dec.13	Sep.14	Dec.14	Differences in basis points Dec.14 respect to:		
					Sep.14	Dec.13	Dec.12
Iceland	6.00	6.00	6.00	5.25	-75	-75	-75
Serbia	11.25	9.50	8.50	8.00	-50	-150	-325
Poland	4.25	2.50	2.50	2.00	-50	-50	-225
Chile	5.00	4.50	3.25	3.00	-25	-150	-200
South Korea	2.75	2.50	2.25	2.00	-25	-50	-75
Sweeden	1.00	0.75	0.25	0.00	-25	-75	-100
Norway	1.50	1.50	1.50	1.25	-25	-25	-25
Pakistan	9.50	10.00	10.00	10.00	0	0	0
China	6.00	6.00	6.00	6.00	0	0	-40
Turkey	9.00	7.75	11.25	11.25	0	350	225
India	8.00	7.75	8.00	8.00	0	25	0
Colombia	4.25	3.25	4.50	4.50	0	125	25
Philippines	3.50	3.50	4.00	4.00	0	50	50
New Zealand	2.50	2.50	3.50	3.50	0	100	100
Peru	4.25	4.00	3.50	3.50	0	-50	-75
Mexico	4.50	3.50	3.00	3.00	0	-50	-150
Australia	3.00	2.50	2.50	2.50	0	0	-50
Hungary	5.75	3.00	2.10	2.10	0	-90	-365
Thailand	2.75	2.25	2.00	2.00	0	-25	-75
Taiwan	1.88	1.88	1.88	1.88	0	0	0
Canada	1.00	1.00	1.00	1.00	0	0	0
United Kingdom	0.50	0.50	0.50	0.50	0	0	0
United States	0.25	0.25	0.25	0.25	0	0	0
Romania	5.25	4.00	3.00	3.00	0	-100	-225
Eurozone	0.75	0.25	0.05	0.05	0	-20	-70
Switzerland	0.00	0.00	0.00	0.00	0	0	0
Israel	2.00	1.00	0.25	0.25	0	-75	-175
South Africa	5.00	5.00	5.75	5.75	0	75	75
Malaysia	3.00	3.00	3.25	3.25	0	25	25
Indonesia	5.75	7.50	7.50	7.75	25	25	200
Brazil	7.25	10.00	11.00	11.75	75	175	450
Russia	n.a.	5.5	8.00	17.00	900	1,150	n.a.

Box 1
DROP IN OIL PRICES: TRANSMISSION CHANNELS

In some of our previous inflation reports we pointed out that there was a relatively slack global crude oil market due to the growth of supply in the United States and, to a lesser extent, to a slowdown in demand, particularly in China, among other factors. This was reflected in an increase in oil inventories, which in Q4-2014 showed levels higher by 69 million barrels than in Q4-2013. Despite this, however, markets did not expect the price of oil to decrease, because the geopolitical problems observed, namely social unrest and strikes in Libya, the internal conflict in Nigeria, conflicts with the Islamic State, and the conflict between Russia and Ukraine, offset the downward pressures on the price of oil.

That is why the magnitude and speed of the price adjustment observed since July have exceeded any forecast. This has also been reflected in market expectations: between October and December, both the International Energy Agency (IEA) and the US Department of Energy revised significantly down the demand for crude oil and increased at the same time their estimates of projected oil supply. Oil prices dropped 43.8 percent between July and December. Except for the adjustment made during the international financial crisis and for the price reduction made by Saudi Arabia by the end of 1985, this has been the greater adjustment implemented in a period of five months.

NOMINAL AND REAL WTI OIL PRICE



This abrupt adjustment in the prices of crude oil is affecting the global economy through various transmission channels:

a. **Transferring resources to countries with higher consumption:** A fall in the price of oil implies a transfer of resources from oil-exporting countries to oil-importing countries. Considering a production of 90 million barrels per day, the fall of US$ 40 in the price of oil implies a transfer of resources of approximately US$ 1.6 billion annually. Because the beneficiary countries have a higher marginal propensity to consume more, global consumption would increase as a result of this transfer of resources. According to IMF estimates, a permanent drop in the price of oil could have an impact equivalent to 0.9 percentage points in terms of global growth, with China and several developed economies benefiting the most from this situation.

b. **Less resources from sovereign funds:** Four of the five major sovereign wealth funds are sovereign funds of oil-exporting countries (United Arab Emirates, Norway, Saudi Arabia, and Kuwait). These sovereign wealth funds inject resources into the global economy through their investments, which improves overall financing conditions and reduce international interest rates. Oil-exporting countries are the fourth largest foreign holder of US Treasury bonds, for example. Therefore, if oil-exporting countries have lower surpluses, this would imply that their sovereign wealth funds have fewer resources to inject into international markets and that they could even withdraw funds from international markets by closing some positions.

c. **Deterioration of fundamentals in oil-exporting economies:** The fiscal and external position of many oil-exporting economies –e.g. Russia, Venezuela, Nigeria, and several Arab countries– depends significantly on oil exports. In Russia, for example, the ruble has lost about 80 percent of its value against the dollar in 2014. This depreciation has affected domestic demand due to the high level of external indebtedness of the country's corporate sector.

In the case of the Arab countries, various estimates show that the oil price which allows them to finance their spending is significantly above the current prices of oil. In other words, this means that they would have to reduce their spending significantly or that they will have to resort to borrowing to maintain their current levels of spending.

d. **Risk of spillover to other emerging economies:** Uncertainty about the sustainability of these economies could increase risk aversion and lead to a lower demand for the assets of the emerging economies, which are usually considered assets of a relative higher risk. This would imply that even some of the emerging economies that may benefit from lower oil prices could be affected by the deterioration of financing conditions. This could be the case of Turkey, for example, given that this country is a net importer of oil, but has a high deficit in current account.

e. **Increase the risk of a deflation in some developed economies:** Several developed countries, such as Japan, Sweden, and several countries in the Eurozone, currently face deflationary pressures that could affect the incipient process of economic recovery they are experiencing today. The fall in the price of oil would accentuate these pressures, although these economies are expected to maintain expansionary monetary policies or increase them in order to reverse these additional pressures.

These impacts would materialize if this shock is permanent. While there is a slack market that would justify a downward correction in prices, there are doubts over whether the recent adjustment is in line with economic fundamentals. For example, many projects are not profitable with current oil prices, which is an unforeseen constraint on the supply side (especially in the medium term). Moreover, the recent conflicts in the Middle East could affect production in the short term and affect also investment, generating an impact on the supply in a longer horizon. However, a higher-than-expected global economic slowdown would offset these risks.

II. Economic Activity

Sector GDP

32. In 2014 the Peruvian economy is estimated to have grown 2.4 percent, less than forecast in the Inflation Report of October (3.1 percent) due to the strong persistence of demand factors and supply shocks, which continued to have a negative impact on growth during the last quarter of the year.

    As for demand, the impact of three years with declining terms of trade (-12.1 percent accumulated) became evident in variables such as investment and private consumption. On the side of the public sector, lower spending, especially at the level of subnational governments, would have prevented a higher growth in non-primary sectors such as construction, which was strongly affected by the slower physical implementation of public works during the year.

    On the side of supply, the occurrence of transitory shocks such as the lower grades of mineral ores in the major mines of gold and copper, the impact of the yellow rust pest on coffee production, and the effect of climate alterations associated with a mild El Niño event on fishing and agriculture continued contracting significantly activity in the primary sectors.

33. The impact of supply shocks on production would imply a 2.1 percent fall of GDP in the primary sectors –the biggest contraction observed since 1992–, the most affected sectors being fishing and primary manufacturing (associated mainly to the availability of anchovy), mining (due to lower mineral grades in some mines), and agriculture (due to climate problems).

Graph 23
PRIMARY GDP
(12 month % change)

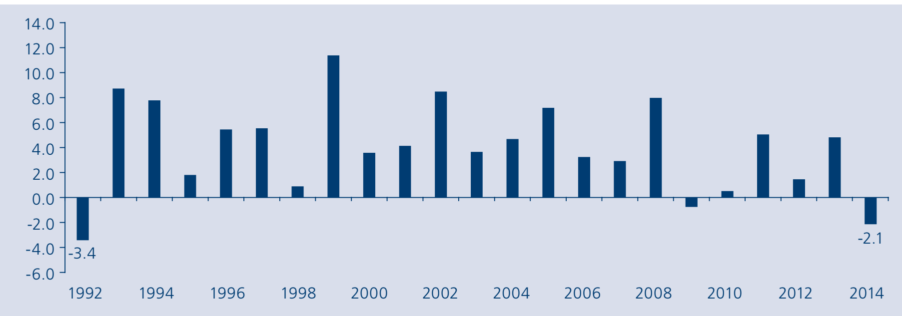


Table 7
FORECAST OF GDP: 2014
(% change)

	2013	Forecast of 2014 with information to: December 2013	Forecast of 2014 with information to: January 2015
I. Supply shocks			
Rice	0.1	2.7	-6.3
Anchovy	27.2	21.2	-52.0
Fishoil and fishmeal	44.9	37.5	-62.6
Gold	-3.3	1.4	-10.2
Copper	7.4	17.3	0.6
Zinc	5.4	4.8	-2.8
II. Demand shocks			
Construction	8.9	7.3	2.1
Inventories (contribution to GDP)	0.9	-0.1	-0.2
III. GDP	**5.8**	**6.0**	**2.4**
Primary GDP	5.7	5.2	-2.1
Non-primary GDP	5.8	6.1	3.6

34. In 2014, the sector that contributed most to the slowdown of primary activities seems to be primary manufacturing (0.8 percentage points), followed by the sector of mining and hydrocarbons (0.7 percentage points). In the case of manufacturing based on the processing of raw materials, the decline in the production of fishmeal and fish oil strongly affected the growth of this sub-sector, implying a sharp decrease in the sector in Q4-2014. The strong decline in the production of fishmeal and fish oil was associated with the suspension of the second fishing season in the north-central area due to scarcity of anchovy during the last quarter of the year.

Table 8
GDP BY PRODUCTION SECTOR
(Real % change)

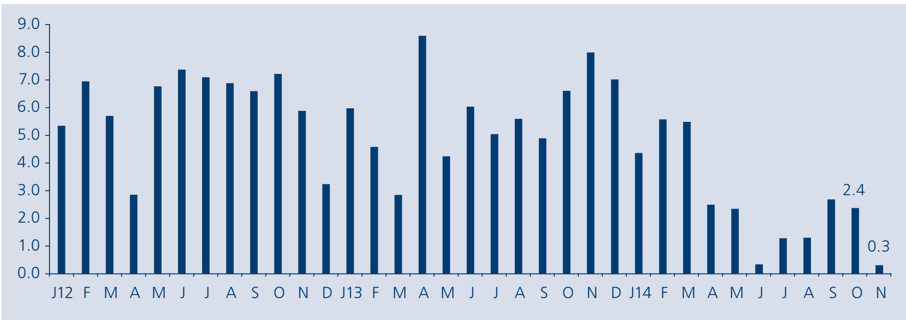
	2013	2014*		2015*		2016*	
	Year	IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
Agriculture and livestock	**1.6**	**1.5**	**1.4**	**2.3**	**2.6**	**3.5**	**3.5**
Fishing	**18.1**	**-6.8**	**-25.3**	**23.1**	**17.2**	**16.9**	**18.1**
Mining and hydrocarbons	**4.9**	**-1.6**	**-0.9**	**6.5**	**5.6**	**10.8**	**10.5**
Metallic mining	4.3	-2.8	-2.2	6.5	6.3	12.3	12.1
Hydrocarbons	7.2	3.2	3.9	6.6	3.2	5.6	5.0
Manufacturing	**5.1**	**-0.7**	**-2.9**	**4.5**	**3.7**	**4.8**	**4.7**
Based on raw materials	14.9	-2.4	-8.9	6.2	5.4	5.4	5.5
Non-primary industries	2.3	0.2	-0.9	4.0	3.2	4.7	4.5
Electricity and water	**5.5**	**5.4**	**4.9**	**5.5**	**5.3**	**6.1**	**6.1**
Construction	**8.9**	**2.9**	**2.1**	**7.0**	**5.7**	**7.5**	**7.0**
Commerce	**5.9**	**4.9**	**4.4**	**5.5**	**4.9**	**5.8**	**5.5**
Services	**6.2**	**5.2**	**4.8**	**5.6**	**4.9**	**5.8**	**5.5**
GDP	**5.8**	**3.1**	**2.4**	**5.5**	**4.8**	**6.3**	**6.0**
Memo:							
Primary GDP	5.7	-1.1	-2.1	5.8	5.0	8.3	8.2
Non-Primary GDP	5.8	4.1	3.6	5.5	4.7	5.8	5.5

* Forecast.
IR: Inflation Report.

As for mining, the sub-sector of metal mining would be showing a negative contribution to growth of 0.2 percentage points, mainly as a result of the lower production of informal gold in the region of Madre de Dios. This fall in the sub-sector would be reversed during 2015 due mainly to a higher copper production resulting from the onset of operations in new projects and project expansions, which would allow the sector to resume its growth trend in the next years.

35. Current and advanced economic indicators show that economic activity slowed down in Q2-2014, but that there has been some recovery in these indicators in the last quarter of the year. Thus, in 2014 GDP is estimated to have grown 2.4 percent.

Graph 24
GDP
(12 month % change)



36. In 2014 the production of electricity would show a growth rate of 5.4 percent (a rate of 6.3 percent was observed in 2013).

Graph 25
PRODUCTION OF ELECTRICITY
(12 month % change)

Source: COES.

The domestic consumption of cement during 2014 (2.4 percent) would have been lower than in 2013 (8.6 percent) due to a slower pace in the implementation of public works and in the implementation of private real estate projects, particularly in the northern areas of the country. However, in December this indicator would have grown at a higher rate than in most other months of the year.

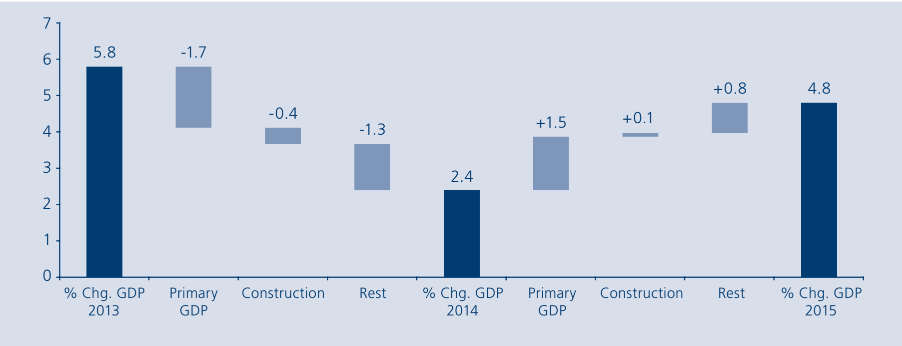
Graph 26
DOMESTIC CONSUMPTION OF CEMENT
(12 month % change)

* Preliminary.
Source: ASOCEM and cement companies.

37. The GDP growth rate projected for 2014 has been revised down from 3.1 percent (Inflation report of October) to 2.4 percent due to the greater-than-anticipated effect of transitory factors on Q4 results. Particularly, this revision of the downside is mostly explained by slower growth in the manufacturing sector, given that the sub-sector of processing of raw materials would have been strongly affected in the last quarter of the year by the suspension of the second season for anchovy fishing.

38. GDP is expected to recover in 2015, with the GDP growth rate rising from 2.4 to 4.8 percent. Factors contributing to this recovery would include, on the one hand, a partial reversal of the supply shocks observed during 2014, with which primary GDP would go from a fall of 2.1 percent to a growth of 5.0 percent, and, on the other hand, a recovery on the side of demand based on higher public spending (the latter would grow 8.3 percent in 2015 after having slowed down from 8.4 percent in 2013 to 3.0 percent in 2014). The demand would also be boosted by the recovery of business confidence and by the continuation of a flexible monetary position.

Graph 27
GDP GROWTH: 2013 - 2015
(% Chg. and % contributions)



39. On the industry side, the recovery in the output rate in 2015 (4.8 percent) would be associated with the recovery of manufacturing (3.7 percent) and the sector of mining and hydrocarbons (5.6 percent). The growth of manufacturing would be supported both by primary manufacturing –given that the weather events that affected fishing during 2014 would almost disappear this year– and by non-primary manufacturing, mainly as a result of the recovery of business confidence since the end of 2014. The recovery in the sector of mining and hydrocarbons would be mostly associated with the recovery of copper and zinc production.

a) The **agriculture sector** is estimated to have recorded a growth rate of 1.4 percent in 2014 (vs. 1.5 percent projected in the previous inflation report). This decline would be due to a lower production of asparagus for exports in Ica during the last quarter of the year.

   In 2015 the agriculture sector is expected to grow 2.6 percent. The sector's recovery in 2015 would be favored by an improvement in coffee production. A higher coffee production has been obtained since the end of 2014 in the regions of Cajamarca, San Martín, and Amazonas due to a better agronomic management of crops as well as to a better protection of crops from the yellow rust pest, which would lead to an increase of 10.0 percent in coffee production in 2015. Similarly, rice production in the northern part of the country is expected to increase given that no water problems such as the ones which arose during the summer of 2014 are anticipated, so rice production is expected to grow 3.0 percent in 2015. Finally, in 2016, the sector is forecast to grow 3.5 percent, as estimated in the previous inflation report.

b) The output in the **fishing sector** would have decreased by 25.3 percent in 2014 (vs. the 6.8 percent drop projected in the October inflation report). In addition to the low performance registered in the sector during the first anchovy fishing season in north-central area, this sharp decline would also be explained by the suspension of the second fishing season of this resource in November. This action was taken given that the arrival of successive Kelvin waves of warm water during 2014 affected the reproductive cycle of the anchovy, as evidenced in the low amount of biomass found by the expeditions of Instituto del Mar del Perú (IMARPE), which prevented the extraction of anchovy.

The environmental conditions suitable for the reproduction of anchovy are expected to normalize after the climate anomalies observed during 2014 subside and the sea temperatures normalize gradually. Thus, the sector is expected to grow 17.2 percent this year, this growth being fully explained by the increase in anchovy catch foreseen this year. In 2016, fishing activity is expected to recover completely and therefore to show a growth rate of 18.1 percent.

c) It is estimated that **metal mining** production would show a decline of 2.2 percent in 2014 (instead of -2.8 percent, as estimated in our previous report). This better outcome would be due to a higher production of gold as a result of increased production at Yanacocha, as well as to a greater production of zinc at Antamina.

In 2015, the production of metal mining is expected to grow 6.3 percent as a result of a greater production of copper (10.7 percent) and zinc (7.3 percent), while gold production would show a slight decline.

The increased production of copper foreseen in 2015 would be due to a greater production at Toromocho mine, which would have almost doubled its production during 2014, as well as to a higher production at Antamina where the grades of metal ores have been recovered. Similarly, the beginning of commercial operations at mine Constancia would have a positive contribution to the growth of the production of this metal. In the case of zinc, a recovery is also foreseen in the sector, which would reach a growth rate of 7.3 percent, driven by higher production at mines Antamina and El Brocal (due to the expansion of the mine capacity).

In 2016 copper production would show a higher rate of growth (23.8 percent) due to the onset of operations at the expansion of mine Cerro Verde and the onset of Las Bambas project. In addition to this, Antamina would recover its grades of mineral contents and reach production levels close to those observed prior to 2014.

Table 9 MINING PRODUCTION (% change)	2013	2014*	2015*	2016*
Gold	-3.3	-10.2	-5.4	-8.6
Copper	7.4	0.6	10.7	23.8
Zinc	5.4	-2.8	7.3	3.0

* Forecast.

d) The production of **hydrocarbons** in 2014 would show a rate of 3.9 percent, a higher rate than projected in the October inflation report (3.2 percent). The increase would be due to increased production of natural gas in Pluspetrol's Lot 56.

Some oil companies would have decided to modify their investment and production plans for 2015 in order to maintain their operating margins in view of the decrease in the price of crude oil. Therefore, the growth forecast of the sub-sector for this year (3.2 percent) is lower than that for 2014, whereas higher growth is expected in 2016 (5.0 percent) since activity in the sector would be driven by a higher production of liquid hydrocarbons as a result of a greater production of natural gas at Pluspetrol's Lot 88 considering the expansion of the pipeline's transport capacity.

e) The output of the **primary manufacturing** sector would have dropped 8.9 percent in 2014 due mainly to a drop in the production of fishmeal and fish oil (62.6 percent) resulting from the suspension of the second anchovy fishing season in Q4-2014. Moreover, the output in non-primary manufacturing would have decreased 0.9 percent in 2014, the most affected sectors being those connected to the sector of capital goods.

The growth forecasts of the manufacturing sector in 2015 and 2016 (3.7 percent and 4.7 percent) consider a recovery in the demand for consumer goods and inputs, in line with the recovery of economic activity and a higher external demand for non-traditional industrial products.

The growth forecast for **construction** in 2014 has been revised down from 2.9 percent to 2.1 percent due to the slowdown registered in public investment, as well as due to the decline observed in the development of real estate projects.

Expenditure-Side GDP

40. Given the effects of a weak economic cycle and the lower investment foreseen, the growth forecast for 2014 has been revised down from 3.1 to 2.4 percent,

while in 2015 the economy is estimated to grow 4.8 percent, showing a rate closer to the potential GDP rate. In this context, the growth of domestic demand in 2014 is revised down from 3.3 to 2.5 percent, in line with the dynamics of private investment, whose growth rate has been revised from -0.4 to -1.5 percent. Moreover, public expenditure is estimated to have grown 3.0 percent, less than expected in the previous report.

Table 10
GDP AND DOMESTIC DEMAND
(Real % change)

	2013	2014*	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
I. Domestic demand	7.0	2.5	5.0	4.7	5.5	5.2
1. Private expenditure	6.7	2.4	4.6	3.9	5.0	4.7
Consumption	5.3	4.3	4.7	4.5	5.2	4.8
Private fixed investment	6.4	-1.5	5.2	3.0	6.3	5.2
2. Public expenditure	8.4	3.0	6.9	8.3	7.9	7.9
Consumption	6.7	6.4	6.0	6.6	6.0	6.0
Investment	12.1	-3.6	8.8	12.0	11.6	11.6
II. Net external demand						
1. Exports	-0.9	-2.2	6.5	3.4	9.4	9.4
2. Imports	3.6	-1.3	4.2	2.9	5.9	5.9
III. GDP	5.8	2.4	5.5	4.8	6.3	6.0

* Forecast.
IR: Inflation Report.

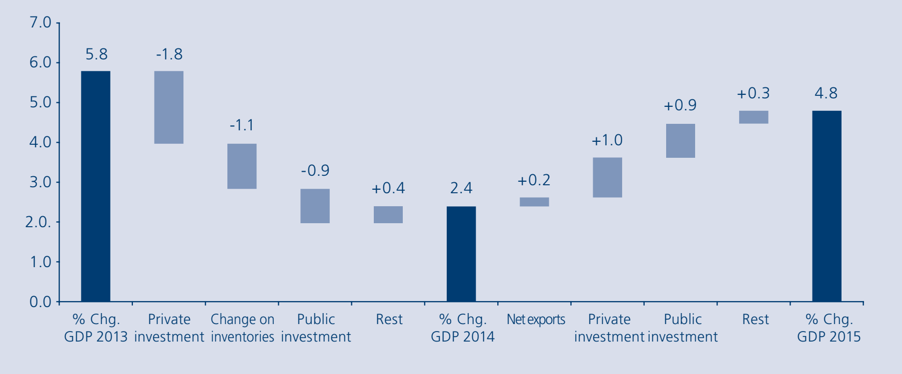
Table 11
GDP AND DOMESTIC DEMAND
(Contribution to the real % change)

	2013	2014*	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
I. Domestic demand	7.1	2.6	5.1	4.8	5.6	5.3
1. Private expenditure	5.7	2.1	3.9	3.4	4.2	3.9
Consumption	3.3	2.6	2.9	2.8	3.2	3.0
Private fixed investment	1.4	-0.4	1.1	0.6	1.4	1.1
Change on inventories	1.0	-0.2	-0.1	0.0	-0.4	-0.1
2. Public expenditure	1.4	0.5	1.2	1.4	1.4	1.4
Consumption	0.7	0.7	0.7	0.8	0.7	0.7
Investment	0.7	-0.2	0.5	0.6	0.7	0.7
II. Net external demand						
1. Exports	-0.2	-0.6	1.5	0.8	2.3	2.2
2. Imports	1.0	-0.4	1.1	0.8	1.5	1.5
III. GDP	5.8	2.4	5.5	4.8	6.3	6.0

* Forecast.
IR: Inflation Report.

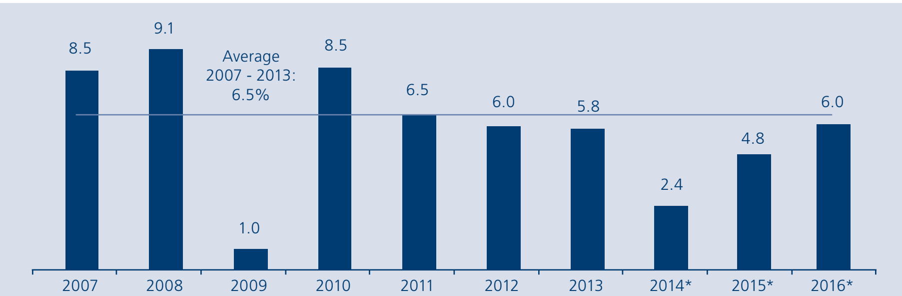
41. The recovery of GDP foreseen for 2015 would be supported by a greater boost of exports, especially of mining exports, in a context of recovery of mining production. Likewise, the investment projects announced and the projects awarded in concession would be reflecting a positive growth rate of private investment that would reverse the decline observed in 2014.

Graph 28
GDP GROWTH: 2013 - 2015
(% Chg. and % contributions)



42. In 2015 domestic demand is expected to show a recovery, with a growth rate estimated at 4.7 percent (a higher rate than the one that would be recorded in 2014) as a result of a greater expected dynamism of both private and public investment. Taking into account the investment projects announced as well as the projects awarded in concession, in 2016 domestic demand is estimated to grow 5.2 percent considering that private investment would grow 5.2 percent.

Graph 29
GDP: 2007 - 2016
(Real % change)



* Forecast.

Graph 30
DOMESTIC DEMAND: 2007 - 2016
(Real % change)

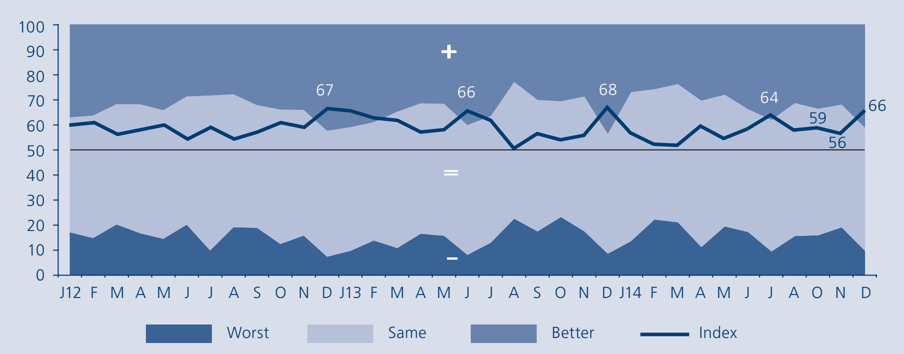
43. Private consumption has continued to show growth rates indicating a moderate slowdown until Q4-2014. Personal consumption expenditures would have grown 4.3 percent in 2014, less than in the previous year (5.3 percent). Recent indicators reflect the evolution of private consumption.

Graph 31
PRIVATE CONSUMPTION: 2007 - 2016
(Real % change)

Some indicators reflecting the recent evolution of personal consumption expenditures are included below.

a. In 2014 the consumer confidence index registered an optimistic level with an average value of 58 points, even though this value was lower than in the previous year (60 points).

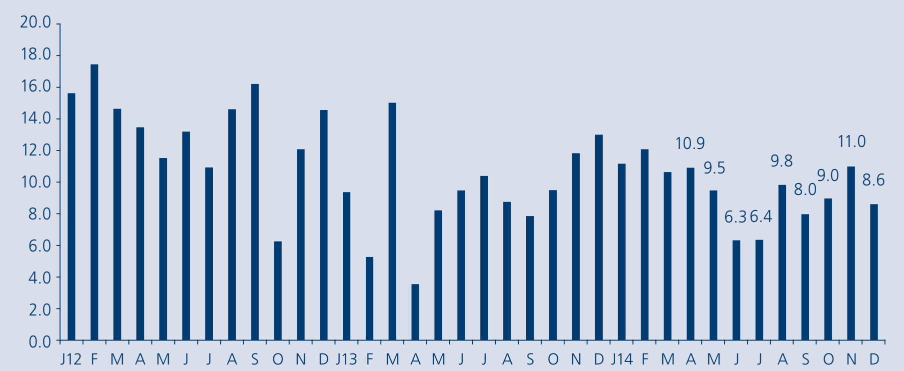
Graph 32
CONSUMER CONFIDENCE INDEX:
HOUSEHOLDS' ECONOMIC SITUATION?



Source: Apoyo.

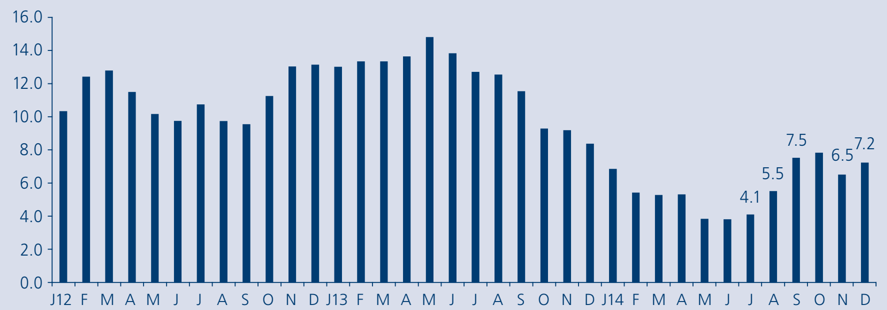
b. Sales in supermarkets showed an accumulated rate of 9.4 percent in 2014, a rate slightly higher than in the previous year (9.3 percent).

Graph 33
SALES IN SUPERMARKETS
(12 month % change)



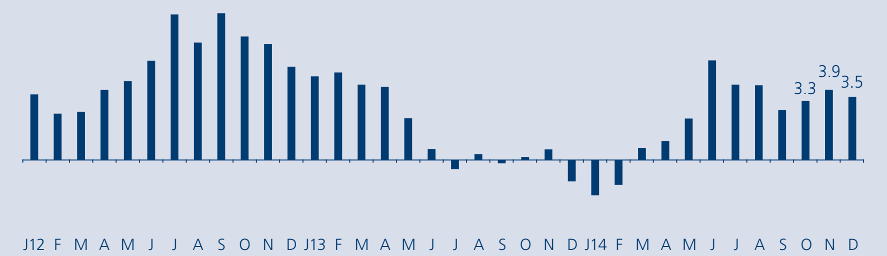
c. Another factor that explains the conduct of consumption expenditures is the growth of currency. This indicator recorded a growth rate of 7.2 percent in December 2014, which reflects a greater availability of liquidity associated with a moderate growth of consumption in aggregate terms.

Graph 34
REAL CURRENCY IN CIRCULATION
(Annual % change)



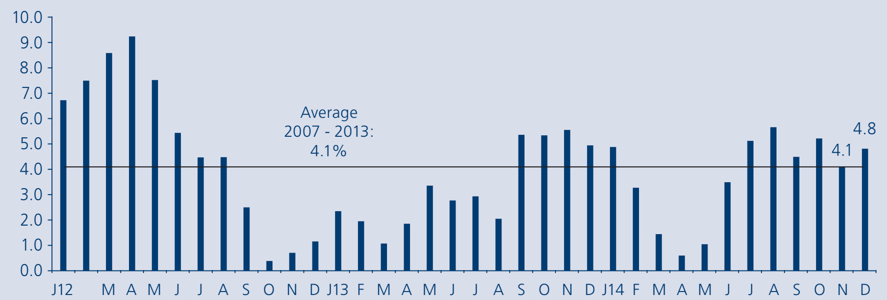
d. The data of Instituto Nacional de Estadística e Informática (INEI) show that the growth rate of the salaried workforce in 2014 (2.3 percent) was higher than in the previous year (1.6 percent). Moreover, actual income recorded in December 2014 a growth rate higher than the average rate for the period 2007-2013 (4.1 percent).

Graph 35
EAP SALARIED WORKFORCE - INEI QUARTERLY MOVING METROPOLITAN LIMA
(IR Month % change)



Source: INEI.

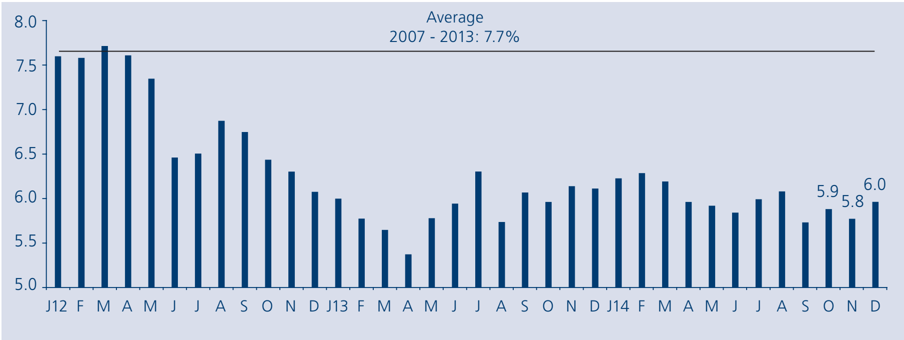
Graph 36
MAIN AVERAGE INCOME: JAN.12 - DEC.14
(Nominal 12 month % change-moving quarterly)



Source: INEI.

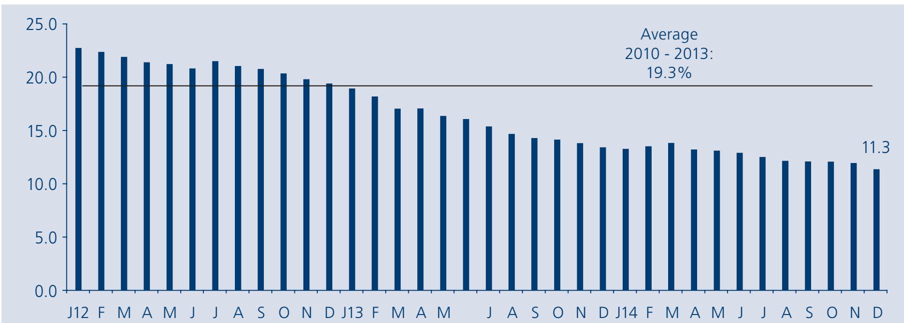
e. The unemployment rate, indicator reflecting the percentage of the total labor force who are unemployed and looking for a paid job, recorded 5.9 percent in 2014, the same rate as in 2013. This result is explained by the fact that in 2014 both the number of unemployed people and the labor force grew 1.0 percent.

Graph 37
UNEMPLOYMENT RATE: JAN.12 - DEC.14
(Seasonally adjusted- moving quarterly)



f. The growth of credit to individuals, which includes consumer loans and mortgages, continues to show a moderate pace of growth. Credit to individuals, which accumulated a growth rate of 13 percent in 2014 –less than in 2013 (16 percent)–, recorded a rate of 11.3 percent in December 2014.

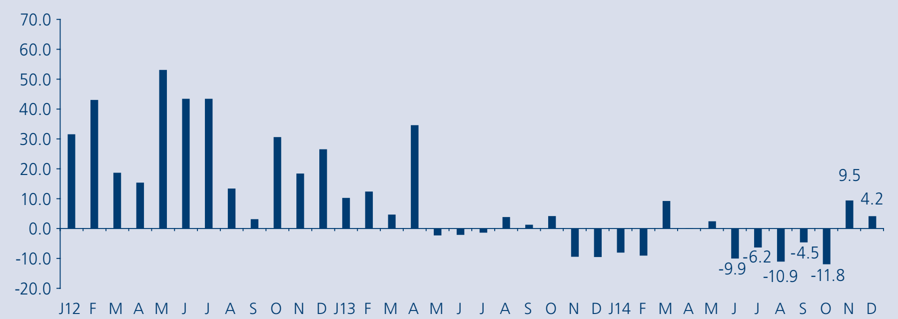
Graph 38
CREDIT TO INDIVIDUALS: JAN.12 - DEC.14
(12 month % change)



Source: BCRP.

g. The volume of imports of consumer goods has been showing a declining trend since late 2013. In 2014 it accumulated a decline of 3.1 percent, which contrasts with the growth rate it recorded in 2013 (2.9 percent).

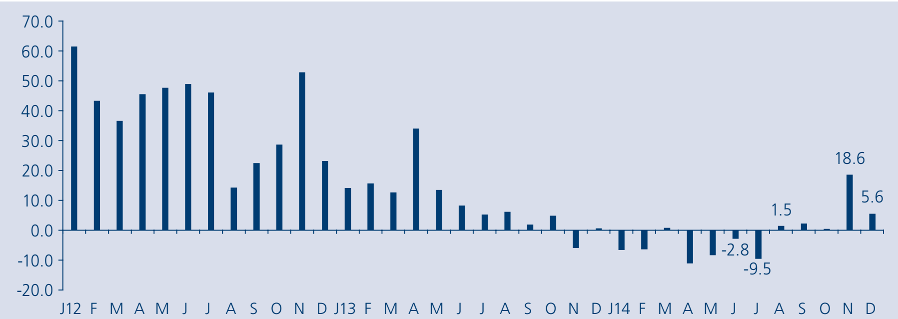
Graph 39
VOLUME OF IMPORTS OF DURABLE CONSUMER GOODS: JAN. 12 - DEC.14
(12 month % change)



Source: SUNAT.

h. Families' acquisition of consumer durables has recovered in the months of November and December, reflecting the increased degree of consumer confidence observed in the last quarter of 2014. Sales of new family cars recorded an increase of 12.4 percent during these months, after having shown negative rates in the first months of the year.

Graph 40
SALE OF FAMILIAR VEHICLES: JAN.12 - DEC.14
(12 month % change)



Source: Araper.

i. The national disposable income is estimated to have grown 2.3 percent in 2014, less than in 2013 (5.9 percent). In 2015 and 2016 the national disposable income would grow 4.6 and 6.0 percent, respectively, in line with the expected recovery of the output.

Table 12
NATIONAL DISPOSABLE INCOME
(Real % change)

	2013	2014*	2015*		2016*	
	Year	Year	IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
1. Gross Domestic Product	5.8	2.4	5.5	4.8	6.3	6.0
2. Gross National Product	7.2	3.3	5.8	5.3	6.7	6.3
3. Gross National Income	6.0	1.7	6.0	5.2	6.6	6.1
4. National Disposable Income[1/]	**5.9**	**2.3**	**5.4**	**4.6**	**6.5**	**6.0**

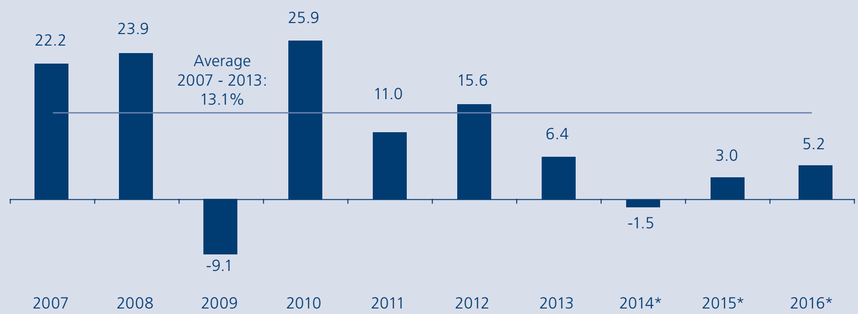
* Forecast.
1/ Including factor income, net profits by terms of trade, and net transfers received for non-residents.
IR: Inflation Report

Based on these indicators, the estimated growth of private consumption in 2014 has been revised from 4.6 percent to 4.3 percent. A gradual increase of this growth rate is expected in the following years, in line with the anticipated evolution of income.

44. The growth rate of private investment would show a decline of 1.5 percent in 2014, due mostly to the weak performance of most economic sectors, reflected mainly in the declining trend and negative rates observed in imports of capital goods throughout 2014. Moreover, even though investors' expectations remain on the optimistic side, they continue to show lower levels than in previous years.

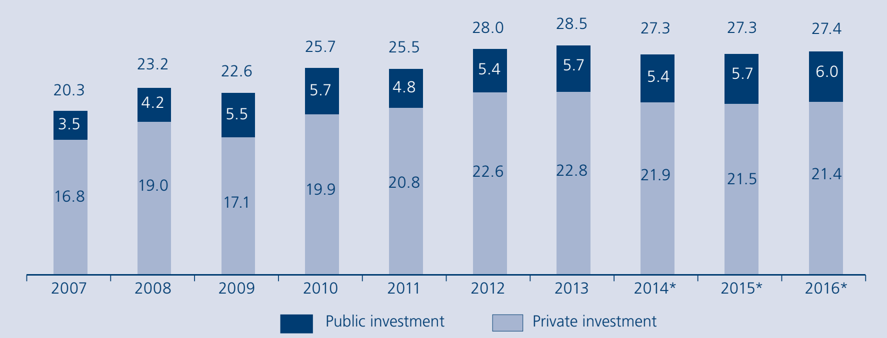
Taking into account the investment projects announced and the announcements of future concessions, in 2015 and 2016 investment is estimated to grow 3.0 and 5.2 percent, respectively. Thus, the ratio of total gross fixed investment to GDP, which includes both the private and public sectors, would rise from 27.3 percent in 2015 to 27.4 percent in 2016.

Graph 41
PRIVATE INVESTMENT: 2007 - 2016
(Real % change)



* Forecast.

Graph 42
GROSS FIXED INVESTMENT: 2007 - 2016*
(% real GDP)

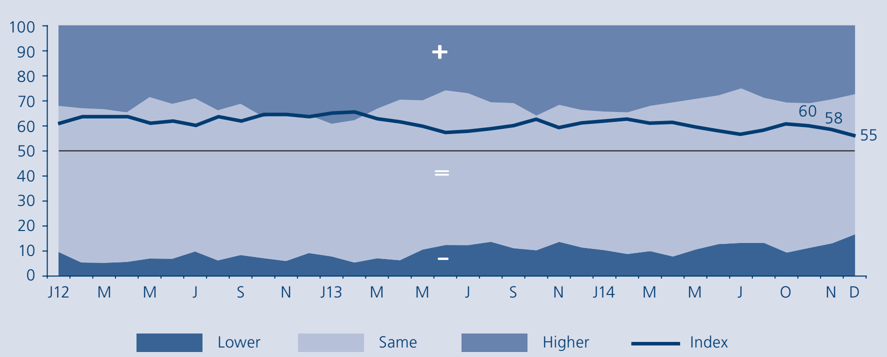


* Forecast.

Some indicators that reflect the evolution of private investment are included below:

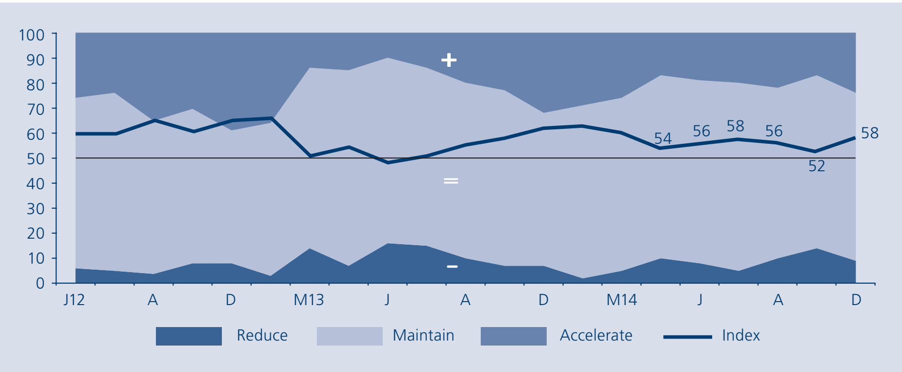
a. Expectations about demand in the three months ahead remain on the optimistic side with a level of 55 points in December. This indicator recorded an average level of 59 points in 2014, a level 2 points lower than the one observed in 2013.

Graph 43
EXPECTATION ABOUT DEMAND IN THE THREE MONTHS AHEAD



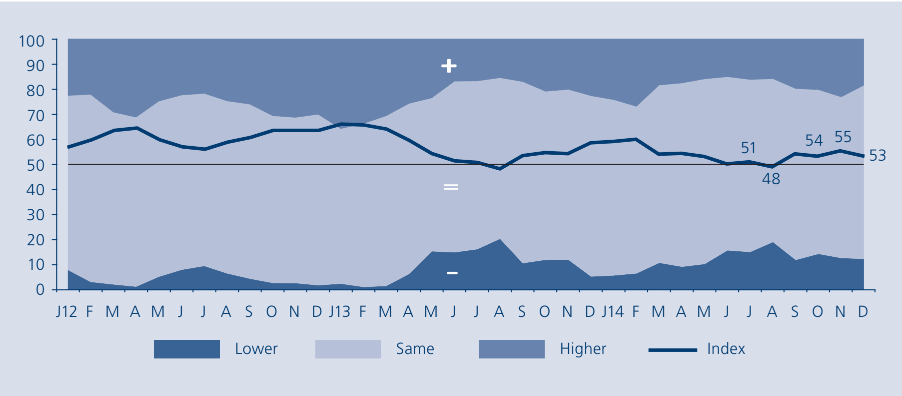
b. Expectations of investment in the following 6 months continued to be on the optimistic segment with a level of 58 points in December, a higher level than in September although lower than the one recorded in the first months of the year.

Graph 44
INVESTMENT EXPECTATIONS ON YOUR COMPANY TO 6 MONTHS AHEAD



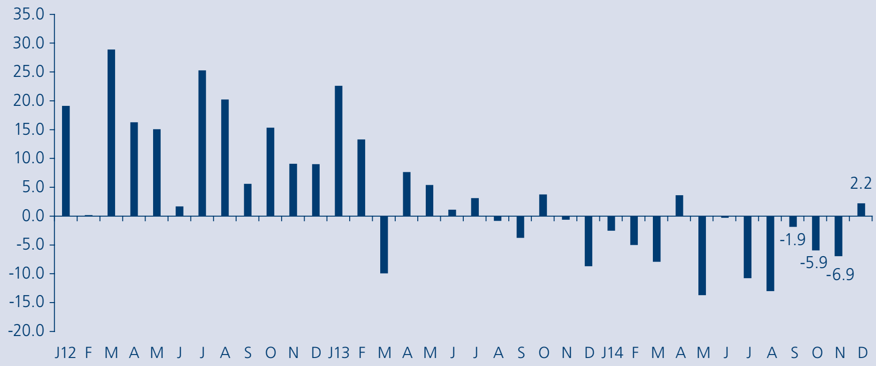
c. Business expectations on the economic situation in the three months ahead registered 53 points in December and remain on the optimistic segment.

Graph 45
BUSINESS EXPECTATIONS ON THE SITUATION OF THE ECONOMY IN THE THREE MONTHS AHEAD



d. Contrasting with the growth rate recorded in 2013 (2.3 percent), the volume of imports of capital goods –indicator of the demand for investment– fell 5.4 percent in 2014.

Graph 46
VOLUME OF IMPORTS OF CAPITAL GOODS
(12 month % change)



Source: Araper.

e. The survey on economic expectations shows that economic agents have revised down their expectations of GDP growth in 2015. Thus, between October and December 2014, financial entities have revised down the GDP rate they expect from 5.0 to 4.5 percent; economic analysts have revised down their projections from 5.3 to 4.5 percent, and non-financial firms have revised their growth estimates from 5.0 to 4.5 percent.

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

	Expectations about:		
	IR Jul.14	**IR Oct.14**	**IR Jan.15**
Financial entities			
2015	5.4	5.0	4.5
2016	5.2	5.5	5.0
Economic analysts			
2015	5.7	5.3	4.5
2016	6.0	5.5	5.2
Non-financial firms			
2015	5.0	5.0	4.5
2016	5.5	5.2	5.0

IR: Inflation Report.

45. Private investment projects announced to be carried out in the period of 2015-2016 total US$ 31.7 billion. This amount is 1.1 billion higher than the total considered in the Inflation Report of October.

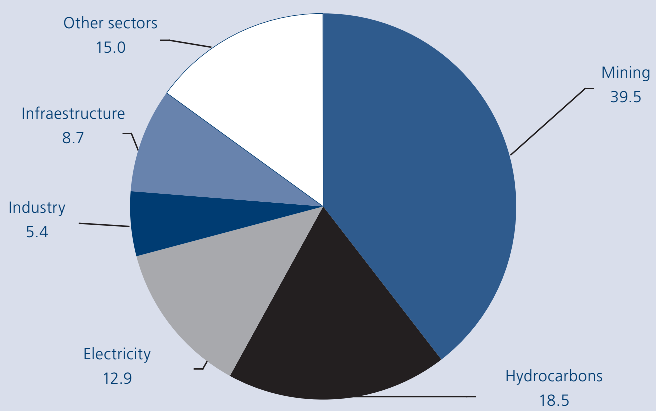
Table 14
PRIVATE INVESTMENT PROJECTS ANNOUNCED: 2015-2016
(Million US$)

	Total investment			Number of projects
	IR Oct.14	**IR Jan.15**	**Difference**	
Mining	12,768	12,549	-219	33
Hydrocarbons	5,368	5,856	488	21
Electricity	3,612	4,080	468	31
Industry	1,577	1,715	138	13
Infrastructure	2,767	2,767	0	20
Other sectors	4,545	4,767	222	89
Total	**30,637**	**31,734**	**1,097**	**207**

IR: Inflation Report.

Investment projects in the mining and hydrocarbons sectors represent 58 percent of total investment projects announced for the period 2015-2016. According to the Ministry of Energy and Mines, investments in the mining sector at November 2014 amounted to US$ 7.71 billion. It is worth pointing out that the government approved in December the environmental program for the expansion of Southern's copper mine in Toquepala. This 2-year project, which involves an investment of US$ 1.2 billion, will allow Southern to double its production capacity to 120 thousand metric tons per day through the installation of a new concentration plant. Among other factors, investment projects announced in the mining sector have declined relative to the figures announced in our previous report given that Buenaventura's project San Gabriel –previously called Chucapaca– has been downscaled. The investment required for this project is now estimated at US$ 450 million –US$ 550 million less than previously projected– given that underground exploitation will be used instead of an open pit exploitation. It is estimated that annual production would be around 200 thousand ounces of gold and that the mine will start operations in 2018.

Graph 47
FORESEEN INVESTMENT PROJECTS: 2015-2016
(% share)



In the hydrocarbons sector, Consorcio Gasoducto Sur Peruano has estimated a greater investment of US$ 600 million due to costs not provided for, such as refining the soil studies and works to build 400 kilometers of road to transport the pipes needed for this project. The total investment would now be US$ 4.1 billion. It is worth mentioning that the first batch of pipes for the construction of the first segment of the pipeline has already been imported. In December, the Ministry of Energy and Mines approved the plan of the environmental impact study (EIS) of Kuntur, which will accelerate the construction and completion of the project. On the other hand, Graña y Montero was awarded the exploitation of lots III and IV in Talara for 30 years, and announced explorations in both lots involving investments of around US$ 560 million.

Projects awarded in concession during 2014 involved around US$ 10 billion in investment. According to Proinversión, 17 other projects involving an investment of US$ 4.6 billion would be awarded in 2015.

Table 15
MAIN PROJECTS TO BE IMPLEMENTED THROUGH CONCESSION ARRANGEMENTS IN 2014-2015
(Million US$)

	Estimated investment	
	2014	**2015**
A. Awarded	**9,979**	
Line 2 and Faucett Ave. - Gambetta Ave. of the Basic Network of the Metro of Lima and Callao	5,075	
Improvements of the National Energy Security and development of the South Peruvian Pipeline	3,643	
International Airport of Chinchero - Cusco (AICC)	537	
220 Kv Moyobamba - Iquitos Transmission Line and associated substations	499	
General San Martín (Pisco) Port Terminal	129	
220 kV Friaspata - Mollepata Transmission Line and Orcotuna Substation 220/60 kV	39	
220 kV La Planicie - Industriales Transmission Line and associated substations	35	
Cable cars to Kuelap	18	
Provision of Technological Security Services in Prisons	4	
B. To be called		**4,632**
Power Supply from New Hydroelectric Plants: 2020-2021		2,700
Headworks and Conduction for the Drinking Water Supply in Lima		400
Longitudinal of the Sierra - Section 4		340
Massive Use of Natural Gas		300
LNG Supply System for the Domestic Market		250
Quillabamba Thermal Power Plant		180
Chillon river water supply works		70
Amazonía waterway		69
220 Kv Azangaro - Juliaca -Puno Transmission Line		69
Broadband Installation for Integral Connectivity and Social Development of Ayacucho Region		55
Broadband Installation for Integral Connectivity and Social Development of Huancavelica Region		47
Choquequirao Cable car		43
Broadband Installation for Integral Connectivity and Social Development of Apurimac Region		42
First Stage of the Carapongo Substation and Conexion Links to Associated Lines		40
Comprehensive Broadband Connectivity for the Social Development of the Northern Zone of the Country- Lambayeque Region		19
Huayday Ambara Mining Prospect		8
C. Total Projects (A) + (B)	**9,979**	**4,632**

Source: Proinversión.

Table 16
MAIN INVESTMENT PROJECTS ANNOUNCED

SECTOR	COMPANIES	PROJECT
Mining	Freeport-Macmoran Aluminium Corporation	Expansion of Cerro Verde
	Aluminium Corp of China Ltd.	Expansion of Toromocho
	Southern Copper Corporation	Tia Maria
	Southern Copper Corporation	Expansion of Toquepala
	MMG Limited	Las Bambas
	Shougang Corporation	Expansion of Marcona
	Río tinto Plc.	La Granja
	Grupo Milpo	Expansion of Cerro Lindo and El Porvenir
	Bear Creek Mining Corporation	Corani
	Compañía de Minas Buenaventura S.A.A.	Tambomayo
	Compañía de Minas Buenaventura S.A.A.	San Gabriel (Ex Chupacapa)
	Hochschild Mining S.A.	Inmaculada
	Miinera IRL Limited	Ollachea
	Hochschild Mining S.A.	Crespo
Hydrocarbons	Consorcio Gasoducto Sur Peruano	Enhance energy security country and development of pipeline in the south
	China National Petroleum Corporation	Exploration of Lot 39 (21 well)
	Karoon Gas Autralia; Vietnam American	Exploration: Lot Z - 38 (20 well)
	Pluspetrol Perú Corp. S.A.	Exploration of Lots 88 and 56
	China National Petroleum Corporation	Lot 57 - Kinteron:
	Calidda Gas Natural del Peru	Massive use of Natural Gas
	Graña y Montero Petroleo	Improving Lots III - IV
Electricity	Energía Azul S.R.L.	Hydroelectric Power Plant of Santa María
	Enersur; Kallpa Generación	Electric Node in the South of Peru
	Quimpac S.A.; Inkia Energy	Hydroelectric Power Plant of Cerro del Águil
	Interconexión Eléctrica Isa Perú SA.	500 KV Mantaro - Marcona - Socabaya - Montalvo Transmission Line and associated substations
	Odebrecht S.A.C.	Hydroelectric Power Plant of Cerro Chaglla
	Grupo Económico Endesa S. A.	Hydroelectric Power Plant of Curibamba
	Corsán-Corviam; Engevix y Enex	Hydroelectric Power Plant of Molloco
	Volcan Compañia Minera S.A.A.	Hydroelectric Power Plant of Belo Horizonte
	Termochilca S.A.C.	Thermal Power Plant of Santo Domingo de Olleros - Combined cycle
	Grupo Cobra	Wind Power Plant of Tres Hermanas (Nazca)
Industry	Corporación JR Lindley	Expansion and new plants: Trujillo, Pucusana, Cusco, and Iquitos
	Repsol YPF S.A.	Expansion of La Pampilla plant
	Mitsubishi; Hochschild Mining PLC	Phospates projects
	Grupo Hochschild	New cement plant in Piura
	Técnicas Reunidas S.A.	Modernization of Talara refinery
Infrastructure	Consorcio Nuevo Metro de Lima	Line 2 Network Metro Lima (Electric Train)
	Odebrecht S.A.C.	New highways in Lima
	Consorcio Consierra II	Longitudinal de la Sierra road project, Section 2
	Consorcio Angostura Siguas II	Majes Siguas II
	Grupo Romero	Expansion of Matarani port
	Graña y Montero S.A.; Odebrecht S.A.C.	Chavimochic (third stage)
	Consorcio Kuntur Wasi	Chinchero international airport
	Consorcio Paracas	General San Martin port
	OAS S.R.L.	Parque Rimac express way
Other sectors	Grupo Telefónica	Investment plans 2015 - 2016
	Inversiones Centenario S.A.A.; Parque Arauco	Shopping center Camino Real
	Grupo Telefónica	Satellite Broadband 4G
	Grupo Salinas	National Fiber Optics Backbone
	Grupo Falabella	Expansion and New shopping centers
	Grupo Interbank	Expansion and New shopping centers
	Graña y Montero Vivienda	Real Estate project
	Besalco S.A.	Real Estate project
	Grupo Suma	Real estate: Nuevo Paracas
	Yota del Perú SAC	Expansion and facilities of net LTE-4G
	Holding Grupo Wong	Shopping center and land terminal
	Inmobiliaria S.A	Corporate offices Stratego
	Grupo Gloria	Casagrande, Cartavio and San Jacinto - Olmos project
	Ingenieros Civiles Asociados	Fleet and equipments

Source: Press media and company information.

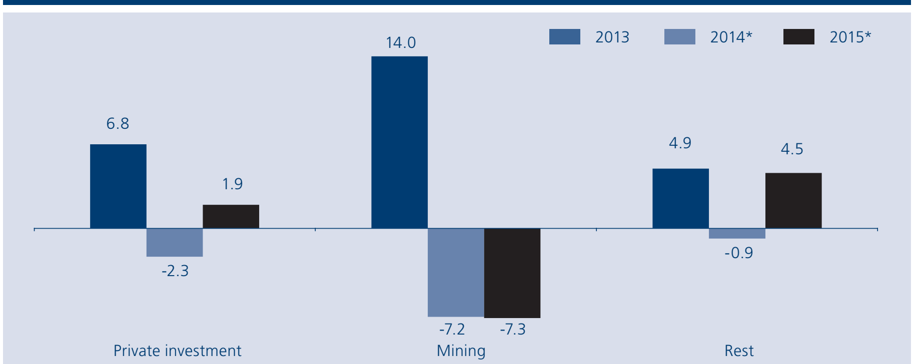
Works on Line 2 of Lima's Metro and the preparations works for the construction of Gasoducto Sur Peruano –the gas pipeline for the southern regions– began in December 2014. The latter includes the expansion and repair of access roads and the implementation of the camps. On the other hand, Consortium Kuntur Wasi will submit the engineering projects associated with the construction of the new International Airport of Chinchero and the environmental impact study to the Ministry of Transport and Communications in March and April of 2015.

In the sector of energy, Proinversion will tender electricity provision projects that involve the construction of new power plants, which should start operating in the next decade. The provision of energy is estimated to involve an investment of US$ 2.7 billion as from 2016.

In the other sectors, important announcements continue to be made regarding the implementation of new projects and/or the expansion and upscale of projects at the national level. Thus, for example, investments will be made by the Olo/ISP to expand and improve internet services with LTE-4G stations in Lima and in the provinces, while schools and universities such as the Interbank group's Innova Schools and the Technological University of Peru will continue to expand to have a nationwide scope. It is worth mentioning that Universidad de Ingeniería y Tecnología of the Hochschild group, a project developed with an investment of US$ 100 million, was inaugurated in December 2014.

In 2014 private investment decreased compared with the previous year, affected by the reduction of investment in the mining sector, by the completion of projects such as Toromocho and Antapaccay, and by lower investment in companies such as Southern and Antamina. In 2015 investment in mining projects would decline for the second consecutive year after the construction of the Constancia project is completed. The growth of private investment in 2015 would be rather associated with increased investment in other sectors, such as infrastructure, oil and industry, among others. Projects worth pointing out include those such as Gasoducto del Sur Peruano, Hoschshild's phosphate plant, Nodo Energético del Sur, investments in the expansion of the telecommunications networks of Telefónica, Entel, Claro and Olo, the Mantaro-Socabaya-Montalvo transmission line, and the construction of shopping malls, among other projects.

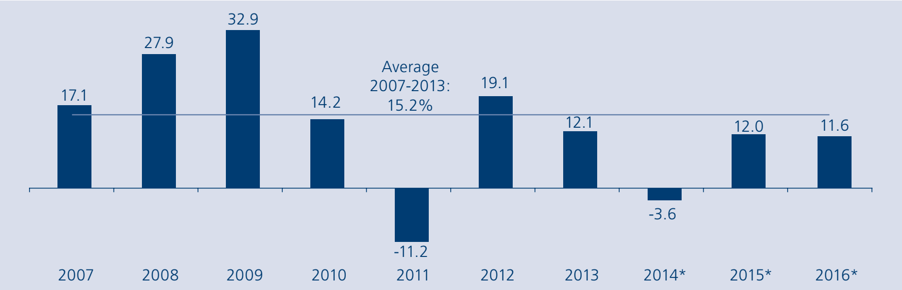
Graph 48
GROWTH RATE OF PRIVATE INVESTMENT
(In US$)



* Forecast.
Source: Minag and company announcements.

46. In 2014 **public investment** recorded a negative annual change of 3.6 percent (12.1 percent in 2013). This result is explained by lower expenditure in investment projects in the subnational governments. In 2015 the rate of expenditure of the implementing agencies is expected to be greater than that observed in 2014 and, therefore, public investment would show a growth rate of 12.0 percent. A similar growth rate would be observed in 2016.

Graph 49
PUBLIC INVESTMENT
(Real % change)

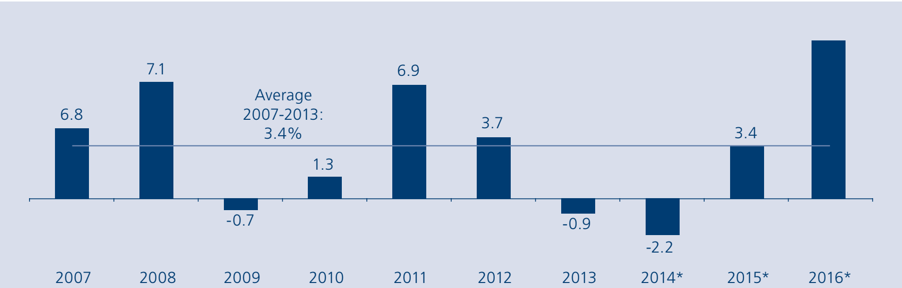


* Forecast.

47. **Real exports** of goods and services would show a fall of 2.2 percent in 2014 due mainly to the decrease registered in exports of traditional export products, such as gold, copper, and coffee. On the other hand, exports of non-traditional products, e.g. agricultural and fishery products, would show positive growth rates that would in part offset the reduction in the volume of exports of traditional products.

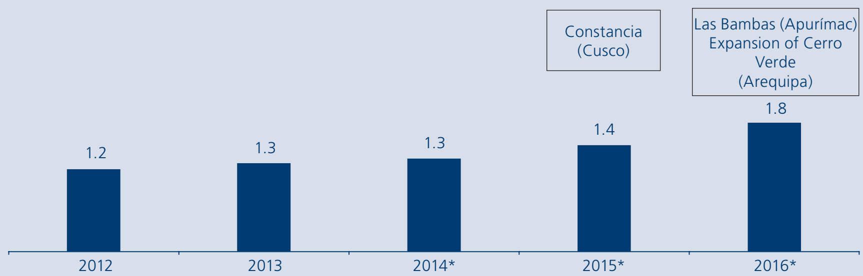
The growth of exports is expected to recover in 2015 due to increased mining exports as a result of a greater production at Toromocho, the start of operations of project Constancia, and the better mineral grades obtained at some mining units. In 2016 exports are estimated to grow 9.4 percent –as forecast in our previous report–, this growth of exports being supported by the onset of operations at Las Bambas mining project and by the expansion of Cerro Verde.

Graph 50
EXPORTS OF GOODS AND SERVICES
(Real % change)



* Forecast.

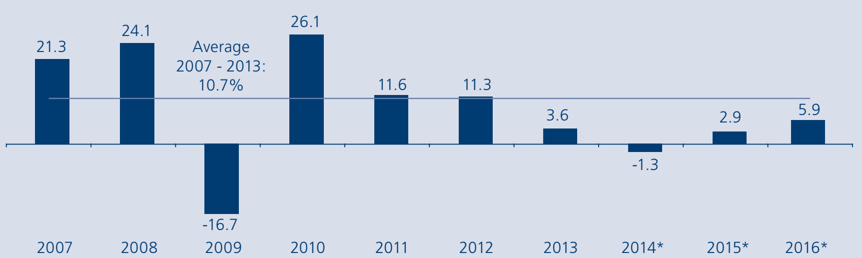
Graph 51
COPPER PRODUCTION
(Million FMT)



* Forecast.

48. On the other hand, **imports** of goods and services would have fallen 1.3 percent in 2014, mainly as a result of the lower pace of growth of imports of capital goods and, to a lesser extent, of imports of industrial inputs. The growth of imports would recover by 2.9 percent in 2015, in line with the projected GDP growth rate, while the projected rate of imports in 2016 remains at 5.9 percent, in line with the anticipated evolution of domestic demand.

Graph 52
IMPORTS OF GOODS AND SERVICES
(Real % change)



* Forecast.

Box 2

MEASURING TOTAL FACTOR PRODUCTIVITY (TFP)

The concept of total factor productivity (TFP) is related to the efficient use of production factors in an economy. Typically, 3 reasons explain the growth of TFP: i) technical progress or technological advance, ii) improvement in a third factor (other than capital and/or labor) that is not directly considered in the production function, but has a direct impact on it, and (iii) improvement in the quality of the factors, which is not captured in the measurement of the quantities of the factors used to estimate production.

The literature on economic growth points out that the increase in TFP explains the growth of a country's incomes in the long term[1]. Empirically, the variation of TFP is calculated based on the so-called growth accounting, which allows us to break down the contributions of capital, labor, and TFP on the growth of the output.

To understand how this accounting is derived, we use a production function with Cobb-Douglas technology, that is, a function of:

$$Y = AK^{\alpha}L^{1-\alpha}$$

This function assumes constant returns to scale, where increases in capital (K) and labor (L) generate an increase in output (Y) in the same proportion. Parameter A in this case reflects TFP, which captures the effect of everything that may affect output in addition to the contribution of capital and labor, while exponents α and 1-α represent the ratios of participation of production factors in output.

The expression can be transformed to growth rates for each of the variables considered using logarithms first and then differentiating them in terms of time, which leads to the following expression:

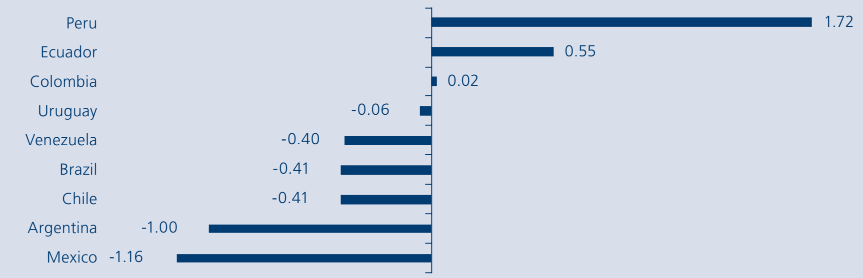
$$\Delta\%A = \Delta\%Y = \alpha\Delta\%K - (1-\alpha)\Delta\%L$$

The advantage of this expression is that the measurements of the output, capital, and labor are directly measurable from the data of the national accounts. TFP growth is estimated as the difference in the growth of the output and the growth of production factors (the so-called Sollow residual).

According to the growth accounting estimated by The Conference Board, Peru led TFP growth in the region between 2001 and 2012 with an annual TFP growth rate of 1.7 percent. In the same period, countries like Colombia did not show any improvement in terms of TFP, while other countries, such as Argentina and Mexico, recorded TFP contractions of over 1 percent.

1 For additional information on this matter, see Barro, R. and X. Sala-i-Martin, Crecimiento Económico, Reverté 2009, Barcelona.

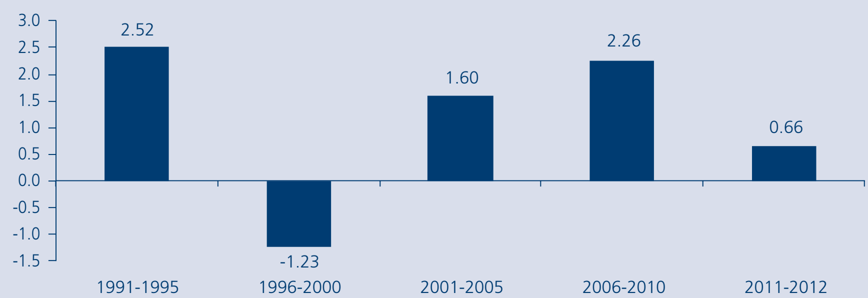
ANNUAL AVERAGE VARIATION OF TOTAL FACTOR PRODUCTIVITY: 2001-2012
(% points)



Source: The Conference Board.

In the case of Peru, based on the information available from 1991 to 2012, we see that TFP grew significantly in the first half of the 1990s after the first-generation reforms were implemented. This was interrupted in the period 1996-2000, during which a severe El Niño event occurred and several international financial crises took place. TFP resumed their growth path thereafter, recording an annual growth rate of 2.26 percent in the 2006-2010 period. However, the data for the last 2 years show that the dynamism of the TFP has slowed down.

ANNUAL AVERAGE VARIATION OF TOTAL FACTOR PRODUCTIVITY IN PERU
(% points)



Source: The Conference Board.

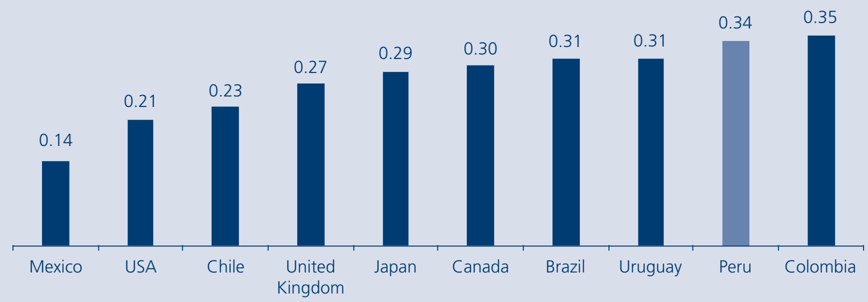
As pointed out at the beginning of this article, TFP reflect the effect of variables that affect the output, but are not directly measured by growth accounting. The literature providing empirical evidence of growth calls these variables growth determinants. Therefore, a country's prospects for growth in the long term are based on the strengthening of these determinants.

The productivity measures used by several organizations –e.g. the World Economic Forum– are related to the theory of economic growth and point out how productivity (and long term growth) determinants evolve over time. In contrast with the growth accounting method, the method used by these organizations does not measure productivity in a residual manner, but rather approximate it through the variables determining growth in the long term, which are grouped in various categories such as institutions, education, macroeconomic environment, market size, development of financial markets, innovation, etc.

According to the recently published World Economic Forum report on global competitiveness 2014, Peru has lost 4 positions in the competitiveness ranking and declined from position 61 to position 65. Therefore, some reforms are required to resume a trend of sustained long-term growth, particularly reforms oriented to correcting the poor institutional framework of the economy and low efficiency in both the goods market and the labor market. Reforms in the former should include simplifying requirements and permits for new investments as well as reducing the burden of government regulations that generate cost overruns to investors, while reforms in the latter should include increasing flexibility in hiring and firing practices –of the 144 countries considered in this index, Peru ranks 130 in this aspect– since the lack of such flexibility encourages informality. In addition, reforms aimed at increasing workers' productivity are also required.

Moreover, according to the most recent Doing Business report, the minimum wage in Peru is equivalent to one-third of the value added per worker, which is a ratio higher than the one observed in other countries in the region, such as Uruguay, Brazil, or Chile and in developed countries, such as the USA and Canada. Given the current level of minimum wage in Peru, this indicates that a significant increase is required in the country's productivity to compete better with other countries.

RATIO MINIMUM LEGAL WAGE OVER OUTPUT PER WORKER 1/



1/ If indicator is lower, productivity per worker will be higher compared to Minimum Legal Wage payment.
Source: Doing Business 2014.

III.Balance of Payments

Trade Balance

49. The trade balance in 2014 would show a deficit of US$ 2.8 billion as a result of the continuous decline recorded in the terms of trade, whose negative impact on the trade balance since 2011 is estimated at 2.6 percentage points of GDP. The deficit has been revised down due to the effect of increased exports (which were 0.2 percent higher than projected in October) and lower imports (0.3 percent lower than estimated in October). This revision on the downside considers a greater decrease in imports of capital goods, in line with an estimated more negative growth rate of investment in that year.

50. In 2015 the deficit in the trade balance would be similar to that registered in the previous year. Lower imports of inputs as well as lower imports of oil and oil derivatives, associated with the lower international prices of crude oil, would offset the decline in exports, particularly exports of traditional products, in a context of greater-than-anticipated fall of export prices. Moreover, in 2016 the trade deficit is expected to show a gradual reduction, driven by the improvement foreseen in the volumes of mining exports (copper) and fishing exports (fish meal).

Table 17
TRADE BALANCE
(Million US$)

	2013	2014*	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
Exports	**42,177**	**37,994**	**40,182**	**36,090**	**44,286**	**39,871**
Of which:						
Traditional products	30,954	26,230	27,742	23,779	30,676	26,671
Non-traditional products	10,985	11,524	12,219	12,030	13,372	12,962
Imports	**42,217**	**40,809**	**41,804**	**38,903**	**44,588**	**41,918**
Of which:						
Consumer goods	8,837	8,882	9,048	9,510	9,635	10,095
Inputs	19,512	18,812	18,186	15,045	19,263	16,251
Capital goods	13,654	12,922	13,435	12,513	14,541	13,692
TRADE BALANCE	**-40**	**-2,815**	**-1,622**	**-2,813**	**-302**	**-2,047**

* Forecast.
IR: Inflation Report.

Table 18
TRADE BALANCE
(% change)

	2013	2014*	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
1. Value:						
Exports	-9.0	-9.9	6.0	-5.0	10.2	10.5
Traditional products	-11.1	-15.3	6.1	-9.3	10.6	12.2
Non-traditional products	-1.9	4.9	5.7	4.4	9.4	7.8
Imports	2.6	-3.3	2.2	-4.7	6.7	7.8
2. Volume:						
Exports	-3.8	-2.9	6.7	2.9	9.9	9.5
Traditional products	-4.4	-6.3	7.5	1.1	11.1	10.8
Non-traditional products	-1.5	5.8	5.4	5.4	7.0	6.5
Imports	3.5	-1.8	4.0	2.6	5.9	5.8
3. Price:						
Exports	-5.5	-7.3	-0.6	-7.7	0.2	0.9
Traditional products	-7.0	-9.5	-1.3	-10.3	-0.5	1.3
Non-traditional products	-0.4	-0.9	0.3	-1.0	2.3	1.2
Imports	-0.8	-1.5	-1.8	-7.1	0.7	1.9

* Forecast.
IR: Inflation Report.

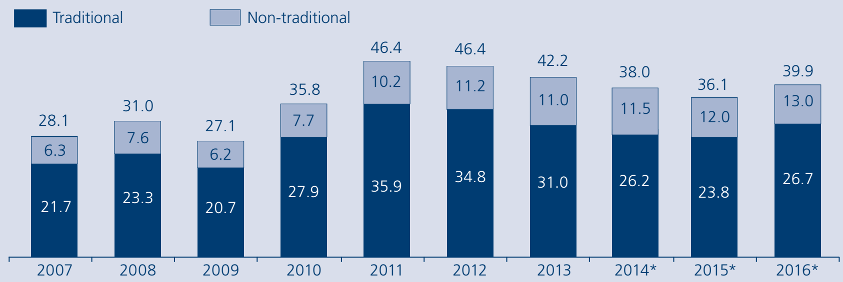
51. Exports in 2014 are estimated to be similar to those projected in our previous report, that is, 9.9 percent lower than in 2013. This would be explained mainly by a decline in exports of traditional products, which dropped by US$ 4.72 billion compared to 2013. It is worth pointing out that the decline in gold exports by gold exporting companies account for approximately US$ 1.98 billion of this amount and that this decline resulted from ban actions against illegal mining.

52. Exports in **2015** and **2016** would amount to US$ 36.1 billion and US$ 39.9 billion, respectively. The forecast for 2015 considers lower exports of oil products reflecting the drop in the international price of oil observed since mid-2014, as well as an increase in mining exports, mainly copper.

    In 2016 mining exports would show a recovery as a result of the onset of operations of copper projects such as Las Bambas, the expansion of Cerro Verde, and a recovery of production at Antamina. In addition to this, fishing exports would also register a recovery given that normal weather conditions are anticipated during this year.

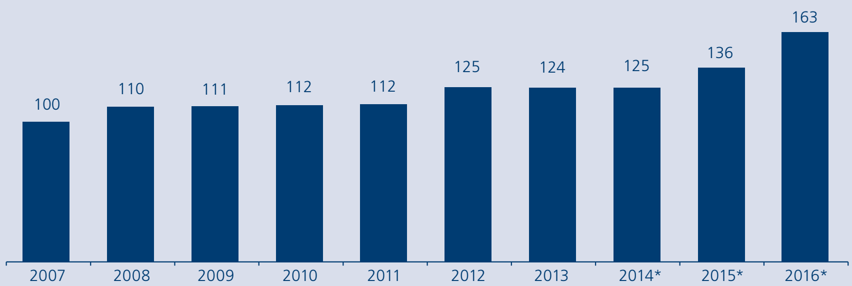
    Non-traditional exports in **2015** would grow at a lower rate than in the previous year, reflecting both lower volumes and lower prices. The volumes of agricultural and fishing exports would continue showing a positive although more moderate trend than in 2014. On the other hand, in **2016** non-traditional exports would amount to US$ 13.0 billion, reflecting the recovery of prices and volumes relative to the levels observed in the previous two years, in line with better prospects for global growth than in 2014.

Graph 53
EXPORTS OF GOODS: 2007-2016
(Billion US$)



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

Graph 54
VOLUME OF COPPER EXPORTS: 2007-2016
(Index 2007=100)



* Forecast.

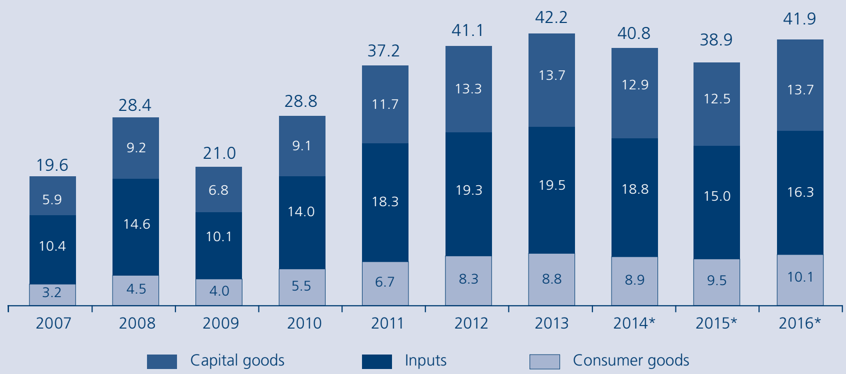
Graph 55
NON-TRADITIONAL EXPORTS VOLUME: 2007-2016
(Index 2007=100)

* Forecast.

53. Imports in **2014** would amount to US$ 40.8 billion, less than estimated in the Inflation Report of October. The estimate has been revised down due mainly to lower volumes of imports of capital goods –in line with the evolution of investment– and due to a more pronounced price drop that reflected in part the greater decline registered in the international price of oil. In addition, a recovery of the volume of imports is expected in **2015**, particularly in imports of inputs and capital goods –in line with the growth of manufacturing and investment foreseen for this year– as well as in imports of consumer goods as a result of the recovery of private consumption. In addition, a greater contraction would be observed in terms of prices in line with the conduct anticipated in the international price of oil, which could have an impact on the price of some imported inputs.

    Considering growth rates in the volume of imports consistent with the evolution and recovery of economic activity, in **2016** imports would grow 7.8 percent.

Graph 56
IMPORTS OF GOODS: 2007-2016
(Billion US$)



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

54. It is estimated that the decline in the price of oil would have a positive impact on Peru's trade balance given that the country is a net importer of crude oil. Thus, the deficit in the oil balance would decrease from US$ 1.74 billion in 2014 to US$ 1.16 billion in 2015 and close 2016 with a deficit of US$ 1.32 billion.

Table 19
OIL NET BALANCE[1/]
(Million US$)

	2013	2014*	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
Exports	3,834	3,822	4,117	2,507	4,232	2,878
Imports	6,200	5,557	5,823	3,663	5,854	4,196
Net balance	**-2,366**	**-1,736**	**-1,707**	**-1,155**	**-1,622**	**-1,319**

1/ Includes crude petroleum and derivatives.
* Forecast.
IR: Inflation Report.

Terms of trade

55. In Q4-2014, the terms of trade index would record an average level of 98.3, a level 3.5 percent lower than the one registered in Q4-2013. The index of export prices would have decreased 8.1 percent, while the index of import prices would have decreased 4.8 percent in the same period.

Based on these indicators, it is estimated that in 2014 the terms of trade would have dropped 5.8 percent, the fall in export prices (7.3 percent) being partially offset by the fall in import prices (1.5 percent).

56. The drop in international prices was practically a generalized price drop, with the sharp decline in the price of oil standing out in Q4-2014 in a context of an increased supply of crude oil (especially in the United States) and prospects of lower demand. This trend accelerated in the first days of January due to greater signs pointing to a market surplus in 2015. The fall in the price of oil affected the prices of food on the downside, but these downward pressures were offset by Russia's restrictions on exports of wheat and corn. The decline in the prices of imports, on the other hand, is explained by lower oil prices, coupled by the impact of the appreciation of the dollar on external inflation.

On the side of exports, the fall in the prices of basic metals is mainly explained by lower prospects for global growth, especially in China and the Eurozone, as well as by a market surplus in the case of copper. The decline in projected exports of gold is explained by expectations of a strengthening of the dollar associated with expectations that the Fed will raise its rates, on the one hand, and by low inflation problems in several developed economies, on the other hand. In contrast, the price of fish meal showed an upward trend as a result of the suspension of the second anchovy fishing season in the North-Central area of Peru.

57. After the correction of the terms of trade in 2014, it is estimated that they would decline 0.7 percent in 2015 and 1.0 percent in 2016, which would imply lower price levels for most products than those estimated in the report of October. The prices

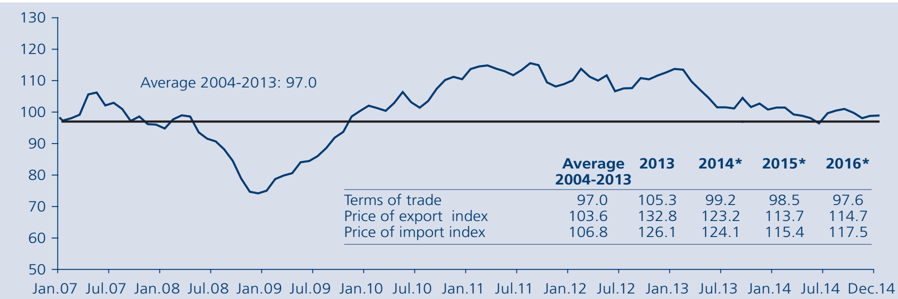
showing the greater downward revision are the prices of crude oil and copper, as stated above.

Table 20
TERMS OF TRADE: 2012 - 2016
(Annual average data)

	2012	2013	2014*		2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
Terms of trade	**-2.1**	**-4.7**	**-5.1**	**-5.8**	**1.2**	**-0.7**	**-0.5**	**-1.0**
Price of exports	**-2.2**	**-5.5**	**-5.7**	**-7.3**	**-0.6**	**-7.7**	**0.2**	**0.9**
Copper (US$ cents per pound)	361	332	314	311	310	269	308	270
Zinc (US$ cents per pound)	88	87	96	98	95	98	96	99
Lead (US$ cents per pound)	94	97	98	95	99	87	99	90
Gold (US$ per ounce)	1,670	1,411	1,278	1,266	1,255	1,210	1,255	1,210
Price of imports	**-0.2**	**-0.8**	**-0.7**	**-1.5**	**-1.8**	**-7.1**	**0.7**	**1.9**
Oil (US$ per barrel)	94	98	98	93	90	51	87	58
Wheat (US$ per ton)	276	266	241	243	213	241	220	243
Maize (US$ per ton)	273	235	154	155	141	163	149	169
Soybean oil (US$ per ton)	1,125	992	809	812	741	717	744	718

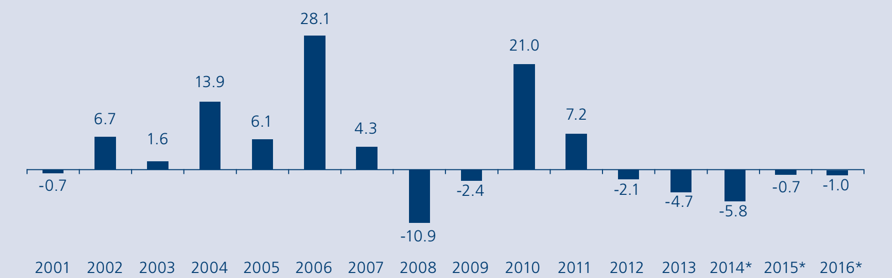
* Forecast.
IR: Inflation Report.
Source: BCRP.

Graph 57
TERMS OF TRADE INDEX: JAN.07 - DEC.16
(2007=100)



* Forecast.
Source: BCRP.

Graph 58
TERMS OF TRADE: 2001 - 2016
(% change)



* Forecast.
Source: BCRP.

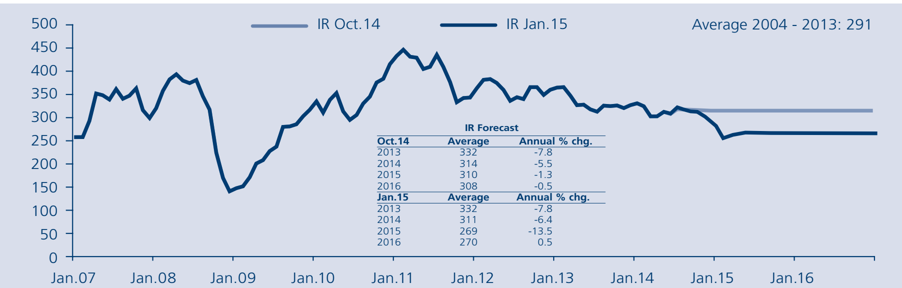
Copper

58. The price of **copper** dropped 6.6 percent in the last three months of 2014 and closed with a monthly average price of US$ 2.91 per pound in December. As a result of this, the price of copper accumulated a fall of 10.9 percent in 2014.

    The decline in the price of copper in the quarter was influenced by the change observed in terms of the economic prospects of China and the Eurozone. On the supply side, China's production of refined copper continued to grow and reached record levels for the fourth consecutive month in November, the rapid growth of China's production of refined copper being explained by the reopening of refineries that had been closed for maintenance or due to breakdowns in the first half of the year. The decline in the price of copper was offset by some supply factors associated with strikes in Indonesia and Peru, power supply restrictions, and the lower mineral content obtained from extracted ores.

    In the first days of January, the price of copper continued showing a downward trend, reaching a minimum low of US$ 2.55 per pound on January 14. A slight recovery in this price is expected in the forecast horizon, with copper being estimated to reach an average of US$ 2.69 in 2015 and US$ 2.70 in 2016. These lower estimates than those considered in our previous report would be reflecting the lower growth in China's demand and an increase in the production of copper concentrates, which would generate a market surplus in these years. However, unforeseen cuts in the supply and the economic recovery of the United States could give some support to the price of this metal.

Graph 59
COPPER: JANUARY 2007 - DECEMBER 2016
(US$ cents/pd.)



Source: Bloomberg and BCRP.

Zinc

59. During the last three months, the price of **zinc** fell 5.4 percent, closing December with an average monthly price of US$ 0.98 per pound. However, the price of zinc accumulated an increase of 9.9 percent in 2014 due to a reduction

in global inventories and expectations of a supply deficit during most of the year.

China's slowdown, particularly in the construction sector, has partially reversed the price increase recorded in the first three quarters of the year. In addition to this, the fall of oil prices has contributed to reduce the price of zinc, one of the most oil-intensive metals to produce.

The zinc market fundamentals show a tighter market in the forecast horizon due to the continuous increase of demand and fears of lower future production, although tempered by China's economic slowdown and the high levels of global inventories. The international price of zinc is expected to be slightly above the levels estimated in the October Inflation Report in the forecast horizon.

Graph 60
ZINC: JANUARY 2007 - DECEMBER 2016
(US$ cents/pd.)

Source: Bloomberg.

Gold

60. In the past three months, the price of **gold** dropped 3.2 percent, reversing in part the upward trend registered in the first months of the year. With this, the price of gold accumulated a decline of 2.0 percent in 2014, closing December with a monthly average price of US$ 1,199 per ounce. The price of gold showed an increase in the first days of 2015 due to higher demand for this metal as a hedge asset and due to greater physical demand in China and India.

The drop in the price of gold in recent months was associated with the strengthening of the dollar against several currencies. The appreciation of the dollar reflected rising expectations that the Fed will give signals that it will raise its interest rates after having completed the withdrawal of quantitative easing. Another factor that contributed to the drop in the price of gold was fear of a deflation in most developed countries as a result of economic slowdown in the Eurozone and Japan, as well as due to sharp decline in the price of crude.

This drop was partially offset by signals of a growing physical demand after the Indian government unexpectedly reduced restrictions on gold imports.

In this context, the price of gold is expected to remain relatively stable in the forecast horizon due mainly to the anticipated onset of the cycle of Fed interest rate rises and the improvement of economic activity in the United States. Both factors will contribute to the strengthening of the dollar, discouraging the demand for gold as an investment asset.

Graph 61
GOLD: JANUARY 2007 - DECEMBER 2016
(US$/tr.oz.)

Source: Bloomberg and BCRP.

Crude Oil

61. In the last three months, the average monthly price of **WTI oil** dropped 36.6 percent, reaching an average price of US$ 59.1/barrel in December. Thus, the price of oil accumulated a decline of 39.6 percent in 2014. In the first days of 2015 the price of oil continued showing a downward trend falling to US$ 45.9/barrel, its lowest level in five years, due to greater signals indicating a market surplus in 2015.

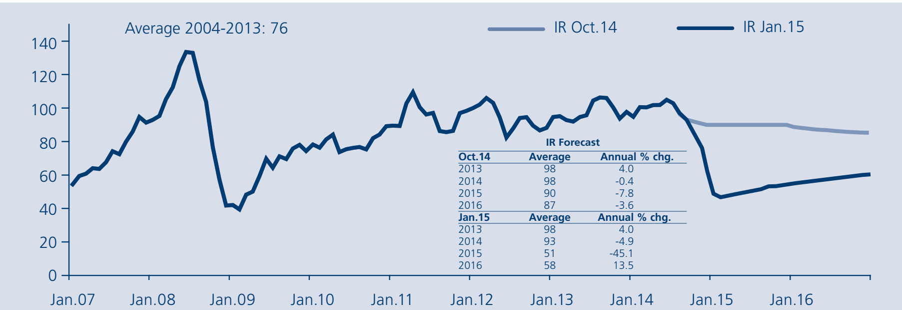
    Oil prices, which had been falling since the end of June, dropped further due to evidence of surplus in the global market for crude oil, particularly signs that the growth of production in the non-OPEC countries would be higher than the growth of global demand. Much of this increased supply is explained by the growth of oil production in the United States, which has caused a reduction in the U.S. demand for imports of crude oil.

    Several agencies have continued revising down their estimates of global demand for crude oil. In December, the International Energy Agency cut its demand projection for 2015, for the fourth time in the past 5 months, and raised its projection of oil production in non-OPEC countries for next year.

In this context, in its November meeting the OPEC decided to keep its production quota at 30 million barrels per day, although in practice the OPEC production of oil continues to be above the agreed limit. The OPEC has chosen to try to maintain its market share and to prevent the U.S. production of non-conventional fuel from continue growing and from becoming more cost-efficient, even though the OPEC has reduced its estimate of demand for oil to 28.9 MBD in 2015, the lowest level in 12 years.

In this scenario, the international price of WTI oil is expected to show lower levels in the forecast horizon than those estimated in the previous inflation report. However, both upward and downward risk factors remain high. On the one hand, the likelihood of price increases remains high due to worries that the price fall was excessive as well as due to the recurring political tensions in some OPEC member countries. On the other hand, the probability of falling prices is associated with a higher-than-estimated production of crude oil in the United States and with the settlement of the conflicts in the Middle East, Libya, and Nigeria in the near future.

Graph 62
WTI OIL : JANUARY 2007 - DECEMBER 2016
(US$/bl)



Oct.14	Average	Annual % chg.
2013	98	4.0
2014	98	-0.4
2015	90	-7.8
2016	87	-3.6
Jan.15	**Average**	**Annual % chg.**
2013	98	4.0
2014	93	-4.9
2015	51	-45.1
2016	58	13.5

Source: Bloomberg and BCRP.

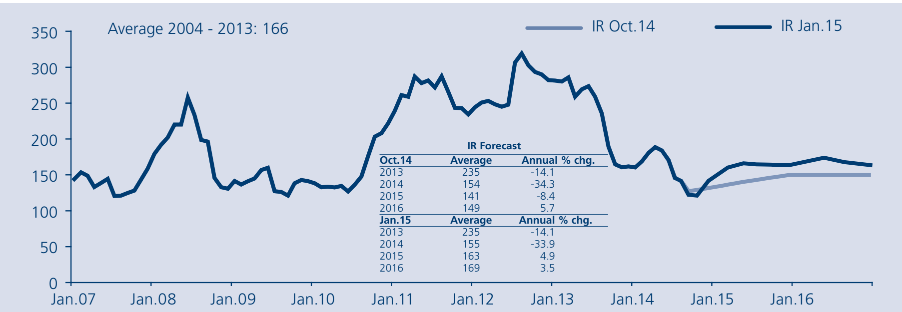
Maize

62. In December, the average international price of **maize** was US$ 149.0 per ton, 17.4 percent higher than the average price at the end of September 2014. Thus, the average price of this grain in 2014 was US$ 155.1 per ton, 33.9 percent lower than the average price in 2013.

This variation reflects mainly the price increases recorded in November and December (9.5 percent and 8.2 percent, respectively). This upward trend was driven by unforeseen downward revisions of final inventories in the 2014-2015 crop year in the U.S. –from 50.84 million tons to 50.75 million tons in December) and by the downward revision of the U.S. harvest due to lower yields in October. In addition, rising unfavorable weather conditions which delayed harvests added pressures to this. This bullish trend in the price of maize was in part offset by the fall in the price of oil which limited an increased demand for ethanol, as well as by the appreciation of the dollar against the euro.

Based on the factors discussed above, the price of maize is estimated to show levels higher than those considered in the previous inflation report.

Graph 63
MAIZE: JANUARY 2007 - DECEMBER 2016
(US$/MT)



Oct.14	Average	Annual % chg.
2013	235	-14.1
2014	154	-34.3
2015	141	-8.4
2016	149	5.7
Jan.15	**Average**	**Annual % chg.**
2013	235	-14.1
2014	155	-33.9
2015	163	4.9
2016	169	3.5

Source: Bloomberg and BCRP.

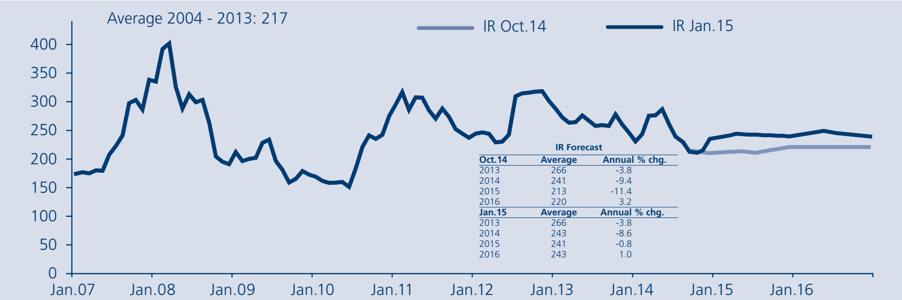
Wheat

63. In December 2014, the international price of **wheat** showed an increase of 11.4 percent compared to September and registered an average level of US$ 235 per ton at the close of the year. The average price of wheat in 2014 was US$ 243 per ton, which represents a drop of 8.6 percent relative to the average price in 2013.

As in the case of maize, this higher price reflects the price increases observed in November (2.5 percent compared to October) and especially in December (8.8 percent compared to November). This increase in the price of wheat is mainly explained by Russia's restrictions on its exports, which translated into stronger administrative requirements (sanitary inspections) and taxes on wheat exports.

Moreover, the USDA revised down its projections of final inventories for the 2014/2015 crop year from 196.38 million tons in September to 194.90 million tons in December given that global consumption was revised on the upside. Because of this, it is estimated that the price of wheat will show higher levels than those considered in the Inflation Report of October.

Graph 64
WHEAT: JANUARY 2007 - DECEMBER 2016
(US$/MT)



Source: Bloomberg and BCRP.

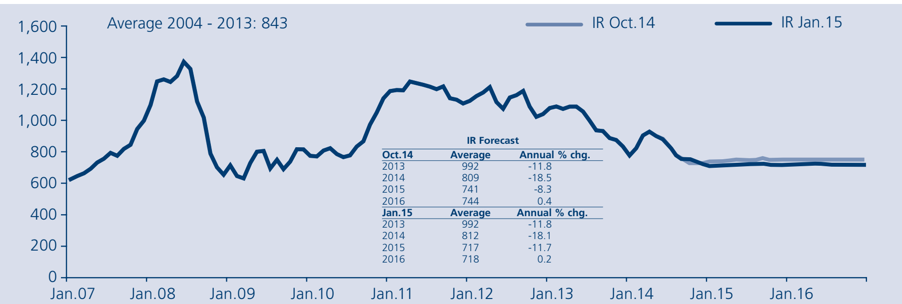
Soybean oil

64. The average price of **soybean oil** in December was US$ 718 per ton, 4.2 percent lower than in September. This decline is mostly explained by price drops in the months of November (1.9 percent compared to October) and December (2.6 percent compared to November).

    In contrast with maize and wheat, the price of soybean oil was affected by the fall in the price of oil and by favorable climate conditions for crops in South America that generated expectations of a record harvest in the region. Moreover, the USDA revised up both the global harvest and the U.S. harvest in the last three months, which added more downward pressures in the short term. Despite this, the USDA has cut its estimates of global and U.S. final inventories for the 2014/2015 crop year due to the upward revision of global consumption reflected in China's higher demand for U.S. soybean.

    Considering the above factors, the prices of soybean oil are expected to stabilize slightly below our previous estimate in the forecast horizon.

Graph 65
SOYBEAN OIL: JANUARY 2007 - DECEMBER 2016
(US$/MT)



Source: Bloomberg and BCRP.

Current Account Balance and Financing

65. In **2014** the current account of the balance of payments would show a deficit of 4.4 percent, a lower deficit than the one observed in 2013. Moreover, the current account deficit would be lower than estimated in our previous report due mainly to lower remittances abroad in a year with a stronger-than-expected fall of export prices as well as with lower imports.

The current account deficit in **2015** is expected to be similar to that of the previous year since the increase in net exports would offset the decline in the terms of trade (-0.7 percent), whereas a gradual recovery is expected in the current account balance in **2016** following the onset of operations of Las Bambas, which would explain the increase of exports foreseen for that year.

Table 21
BALANCE OF PAYMENTS
(Million US$)

	2013	2014*	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
I. CURRENT ACCOUNT BALANCE	**-9,126**	**-8,975**	**-9,712**	**-9,355**	**-8,462**	**-8,490**
% GDP	-4.5	-4.4	-4.3	-4.4	-3.5	-3.7
1. Trade Balance	-40	-2,815	-1,622	-2,813	-302	-2,047
a. Exports	42,177	37,994	40,182	36,090	44,286	39,871
b. Imports	-42,217	-40,809	-41,804	-38,903	-44,588	-41,918
2. Services	-1,801	-1,610	-1,493	-1,572	-1,593	-1,506
3. Investment income	-10,631	-9,151	-10,224	-8,604	-10,352	-8,702
4. Current transfers	3,346	4,601	3,627	3,634	3,786	3,765
Of which: Remittances	2,707	2,727	2,900	2,860	3,024	2,968
II. FINANCIAL ACCOUNT	**12,032**	**6,277**	**10,712**	**9,355**	**10,462**	**9,290**
Of which:						
1. Private Sector	13,378	6,784	9,313	7,803	9,387	8,070
a. Long-term	14,881	7,032	9,610	7,787	9,373	8,079
b. Short-term[1/]	-1,503	-248	-297	16	14	-9
2. Public sector[2/]	-1,345	-507	1,399	1,552	1,075	1,220
III. BALANCE OF PAYMENTS (=I+II)	**2,907**	**-2,698**	**1,000**	**0**	**2,000**	**800**
Memo:						
Long-term external financing of the private sector (% GDP)[3/]	9.5	7.0	6.4	5.9	5.5	5.2
GDP (Billion US$)	202.3	204.0	224.3	212.7	242.9	229.5

1/ Includes net erros and omissions.
2/ Includes exceptional financing.
3/ Includes net foreign investments, portfolio investment and private sector's long-term disbursement.
* Forecast.
IR: Inflation Report.

66. Investment at end-2016 would show a ratio of 25.6 percent in GDP terms, covered mainly by private and public domestic savings, which together are estimated to reach levels around 21.9 percent of GDP in 2016. Given the lower levels of deficit in the

current account estimated for the forecast horizon, domestic saving is expected to increase its ratio as a source of financing investment, covering over 80 percent of investment.

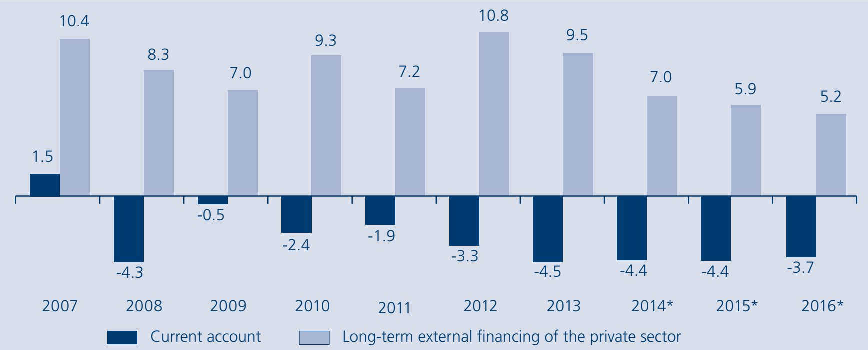
Table 22
SAVINGS -INVESTMENT GAP
(% GDP)

	2013	2014*	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
1. GROSS FIXED INVESTMENT	**26.6**	**25.6**	**25.7**	**25.4**	**26.1**	**25.6**
2. NET DOMESTIC SAVINGS 1/	**22.1**	**21.2**	**21.4**	**21.0**	**22.6**	**21.9**
a. Private	15.4	15.9	15.9	17.1	16.9	17.7
b. Public	6.7	5.4	5.5	3.9	5.7	4.2
3. EXTERNAL SAVINGS	**4.5**	**4.4**	**4.3**	**4.4**	**3.5**	**3.7**

1/ Excludes change on inventories.
* Forecast.
IR: Inflation Report.

67. Private sources are expected to show a decreasing trend in long-term financing towards 2016 as a result, on the one hand, of the end of the cycle of large mining investments due in part to the end of the period of high growth rates in the prices of raw materials and, on the other hand, as a result of a context marked by higher international interest rates, in line with market expectations that the Fed will adjust its rates approximately since mid-2015. In spite of this, private long-term financing will continue to exceed the gap in the current account in 2014-2016.

Graph 66
CURRENT ACCOUNT AND LONG-TERM EXTERNAL FINANCING OF THE PRIVATE SECTOR: 2007-2016 1/
(% GDP)



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

68. The net flow of private long-term external financing would amount to US$ 7.0 billion in **2014**, including residents' investments abroad for a total of US$ 4.2 billion and non-residents' investments in the country for a total of US$ 11.3

billion. This level of net financing is lower than the one estimated in our previous report. This revision estimates that the non-financial sector received higher flows of loans and portfolio investment flows taking advantage of still favorable external financial conditions in comparison with historical average conditions, which would offset the lower flows of foreign direct investment and financing of the financial sector.

A slower pace of private long-term capital inflows is expected in **2015**, mainly given that the flow of external portfolio financing of both the financial sector and the non-financial sector would be lower, in line with less attractive external financial conditions in view of anticipated rises in international interest rates.

A net positive flow of US$ 8.1 billion, equivalent to 3.5 percent of GDP and higher than the one expected in 2015, is estimated for **2016**. Residents are expected to purchase a lower amount of external assets in a context of stabilization of external financial conditions taking into account that the effects of the likely higher international interest rates would reflect mostly in 2015.

Table 23
FINANCIAL ACCOUNT OF THE PRIVATE SECTOR
(Million US$)

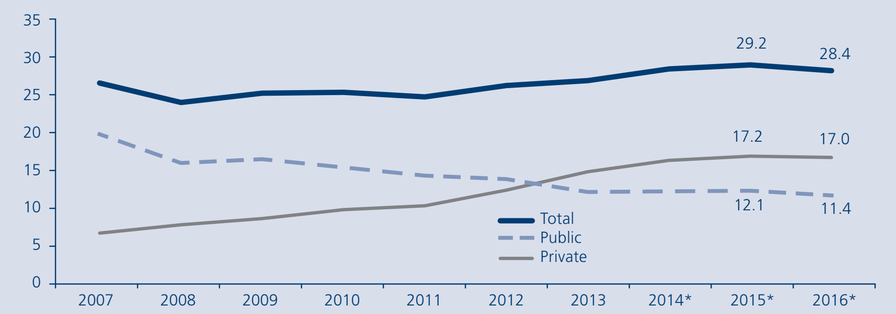
	2013	2014*	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
A. LONG-TERM	14,881	7,032	9,610	7,787	9,373	8,079
% GDP	7.4	3.4	4.3	3.7	3.9	3.5
1. ASSETS	-1,291	-4,232	-2,917	-2,759	-2,479	-2,258
2. LIABILITIES	16,173	11,264	12,527	10,546	11,853	10,337
Foreign direct investment in the country	9,298	7,829	8,010	7,685	8,174	7,754
Non-financial sector	5,551	3,163	3,018	2,361	2,678	2,083
Long-term loans	1,211	718	817	580	607	308
Portfolio investment	4,340	2,445	2,200	1,781	2,072	1,775
Financial sector	1,323	271	1,500	500	1,000	500
Long-term loans	-212	-212	700	100	500	0
Portfolio investment	1,536	483	800	400	500	500
B. SHORT-TERM[1/]	-1,503	-248	-297	16	14	-9
C. PRIVATE SECTOR (A+B)	13,378	6,784	9,313	7,803	9,387	8,070

1/ Includes net erros and omissions.
* Forecast.
IR: Inflation Report.

69. The **financial account of the public sector** would show a positive flow of US$ 1.55 billion and US$ 1.22 billion in 2015 and 2016, respectively. Major outlays to finance various investment projects such as the expansion of the refinery in Talara and the development of the Line 2 of Lima's Metro are expected in the forecast horizon.

70. At end 2013, the external debt of the private sector represented 15 percent of GDP, while the external debt of the public sector was equivalent to 11.9 percent of GDP. Considering that this trend is expected to remain unchanged in the forecast horizon, the external public debt, including domestic bonds held by non-residents, would decline from 12 percent of GDP in 2014 to 11.4 percent of GDP in 2016.

Graph 67
MEDIUM- AND LONG-TERM EXTERNAL DEBT: 2007-2016
(% GDP)



* Forecast.

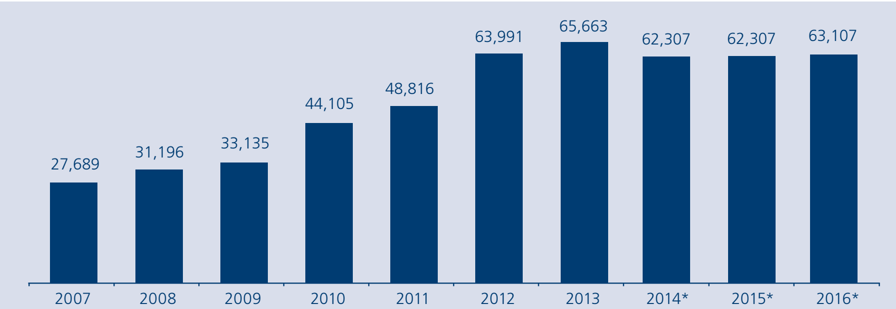
71. The soundness of the balance of payments face negative events in the world economy is reflected in the position of Peru's international reserves relative to the balance of its short term external liabilities or comparing the total of these liabilities with the current account deficit. The high levels of Peru's indicators in the region, which have also been improving over the years, evidence the soundness of the Peruvian economy.

Table 24
NIR INDICATORS

As a % of:	2004	2009	2014*
GDP	19.2	27.2	30.5
Short-term external debt	171.8	297.1	732.5
Short-term external debt plus Current account deficit	173.2	281.6	356.4

* Forecast.

Graph 68
NET INTERNATIONAL RESERVES: 2007-2016
(Million US$)



* Forecast.

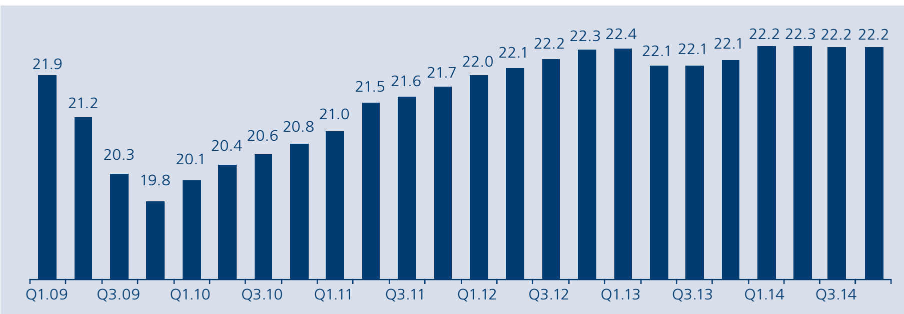
IV. Public Finances

Economic Balance

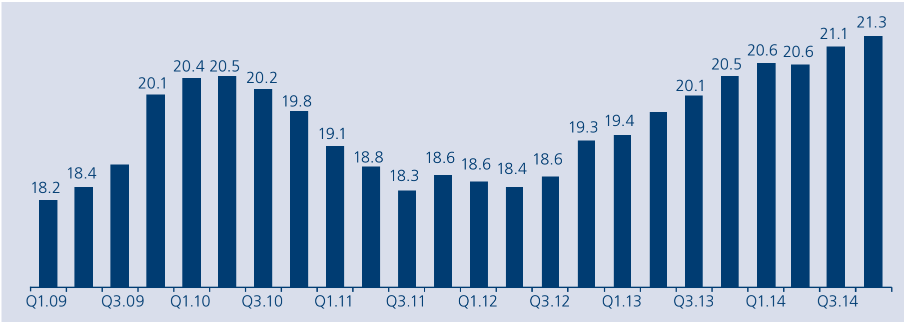
72. In 2014 the balance of the non-financial public sector showed a deficit of 0.1 percent of GDP, a balance that contrasts with the surplus of 0.2 percent estimated in the Inflation Report of October. This balance is explained by the growth of non-financial expenditure, which increased from 21.2 percent of GDP to 21.3 percent, and by lower current revenue, which declined from 22.3 percent to 22.2 percent. Moreover, current expenditure increased by 0.3 percentage points of GDP relative to our previous estimates as a result of the fiscal measures implemented, while the increase in revenue (2.8 percent of GDP) was lower than expected due to the slowdown of economic activity.

Graph 69
ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR
(Accumulate last 4 quarters - % GDP)

Graph 70
CURRENT REVENUES OF THE GENERAL GOVERNMENT
(Accumulate last 4 quarters - % GDP)



Graph 71
NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT
(Accumulate last 4 quarters - % GDP)



By government levels, this lower economic balance in 2014 is explained mainly by the operations of the national government, whose balance declined from a surplus of 0.9 percent to a deficit of 0.4 percent. This was in part offset by a slight improvement in the balances of subnational governments, which rose from an overall negative balance of 0.2 percent to a positive balance of 0.3 percent as a result of the slower pace of spending associated with some difficulties faced in the implementation of their investment programs. Contrasting with the surplus of 0.1 percent they recorded in 2013, the State-owned enterprises, on the other hand, showed a nil balance.

Graph 72
GROSS CAPITAL FORMATION OF THE GENERAL GOVERNMENT
(Accumulate last 4 quarters - % GDP)

73. A negative economic balance of 2.0 percent is projected for both **2015** and **2016**, which implies a deterioration in the fiscal position compared to the balance registered in 2014. This is explained basically by the fall of current revenue as a result of the series of measures adopted in Q4-2014 –mainly the reduction of the income tax for individuals and companies–, as well as by the decrease in the

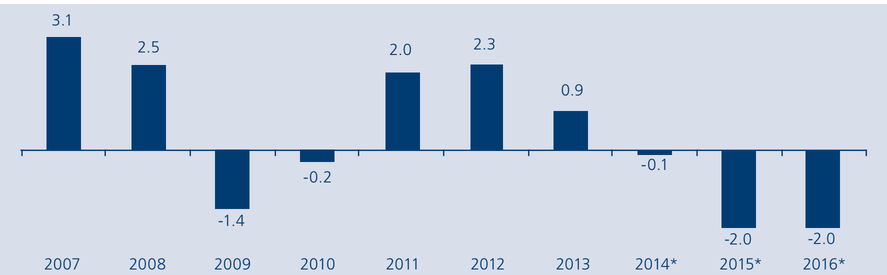
price of oil which affects significantly tax revenues from royalties in the sector of hydrocarbons.

Table 25
NON-FINANCIAL PUBLIC SECTOR
(% GDP)

	2013	2014	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
1. General government current revenues[1/]	**22.1**	**22.2**	**21.9**	**20.7**	**21.9**	**20.8**
Real % change	*3.7*	*2.8*	*3.8*	*-2.7*	*6.2*	*6.4*
2. General government non-financial expenditure[2/]	**20.5**	**21.3**	**21.3**	**21.7**	**21.3**	**21.8**
Real % change	*11.2*	*6.9*	*6.1*	*6.2*	*6.3*	*6.2*
Of which:						
Current	14.3	15.4	15.2	15.6	14.9	15.4
Real % change	*10.6*	*10.4*	*6.4*	*5.4*	*4.4*	*4.4*
Gross capital formation	5.6	5.4	5.5	5.5	5.7	5.8
Real % change	*10.0*	*-1.0*	*5.6*	*5.6*	*11.3*	*11.2*
3. Others	**0.3**	**0.1**	**-0.1**	**-0.1**	**-0.2**	**-0.2**
4. Primary balance (1-2+3)	**2.0**	**0.9**	**0.6**	**-1.1**	**0.4**	**-1.2**
5. Interests	**1.1**	**1.1**	**0.9**	**0.9**	**0.9**	**0.9**
6. Overall Balance	**0.9**	**-0.1**	**-0.3**	**-2.0**	**-0.5**	**-2.0**

1/ The central government includes the ministries, national universities, public agencies and regional governments. The general government has a wider coverage that includes the central government, social security, regulators and supervisors, government charity organizations and local governments.
2/ Includes accrued payments by Net payments of the Fuel Price Stabilization Fund.
* Forecast.
IR: Inflation Report

Graph 73
ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR: 2007-2016
(% GDP)



* Forecast.

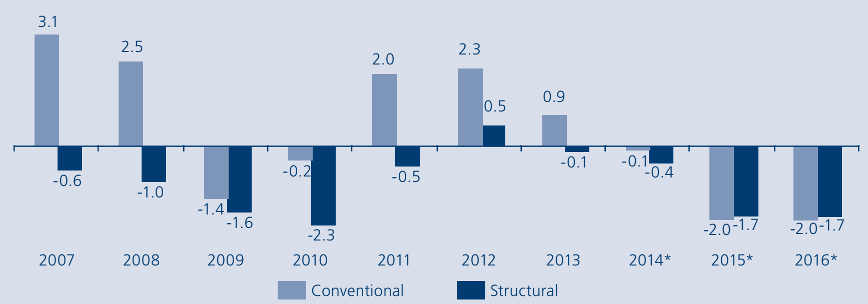
Fiscal Impulse

74. The **structural economic balance** is an indicator that shows the effect of fiscal policy decisions isolating the effects of the business cycle and the effects of the prices of

the commodities relevant to our economy from the conventional economic balance. Thus, for example, an increase in effective revenues is not part of the structural revenues if the increase results from a temporary rise in the prices of minerals. In 2014 the structural economic balance showed a deficit of 0.4 percent of GDP. In 2015 and 2016 the structural balance would be equivalent to a deficit of 1.7 percent each year.

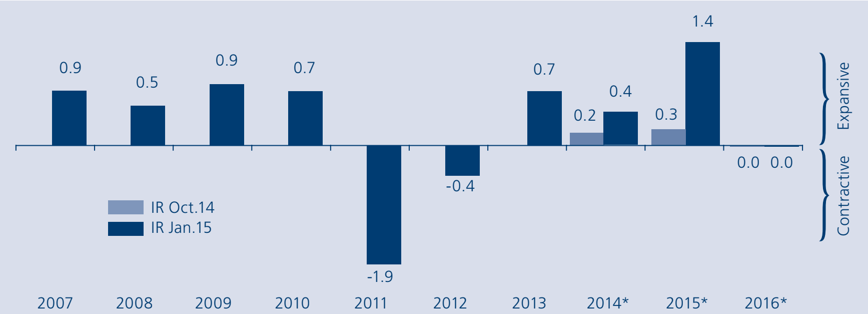
The **fiscal impulse**, the indicator that allows us to identify changes in the fiscal position isolating the effects of the business cycle, was 0.4 percent in 2014, which indicates a slightly expansionary fiscal position that is consistent with greater non-financial expenditure in the general government, particularly current expenditures. In 2015, the fiscal impulse would be 1.4 percent of GDP, in line with an expansionary fiscal stance, while in 2016 the fiscal impulse would converge to zero.

Graph 74
CONVENTIONAL AND STRUCTURAL ECONOMIC BALANCE OF THE NON-FINANCIAL PUBLIC SECTOR: 2007-2016
(% GDP)



* Forecast.

Graph 75
FISCAL IMPULSE[1/]: 2007 - 2016
(% GDP)



1/ The fiscal impulse is the change in the primary structural balance, which is an indicator of how the fiscal position affects the economic cycle.
* Forecast.

Tax revenues

75. In **2014**, the current revenue of the general government grew 2.8 percent. This increase is explained mainly by the growth of revenues from the income tax (6.5 percent), especially by exceptional revenue associated with the income tax paid by non-residents (approximately S/. 3.4 billion, equivalent to 0.6 percent of GDP, which implied a growth rate of 104.7 percent in this revenue) for capital earnings generated by the indirect sale of shareholdings of companies incorporated in the country. In contrast, on the other hand, the revenue from income tax-third category (corporate income tax) fell 8.5 percent reflecting lower tax payments in the sectors of mining, trade, and manufacturing. Moreover, revenues from the value added tax (VAT) showed a growth rate of 2 percent, reflecting the lower rates registered in Q3 and Q4 (1.4 percent and 0.6 percent, respectively).

Table 26
CURRENT REVENUES OF THE GENERAL GOVERNMENT
(Real % change)

	2012	2013	2014
TAX REVENUES	**7.5**	**3.6**	**3.3**
Income tax	6.9	-4.7	6.5
Value added tax	5.1	5.6	2.0
Excise tax	0.5	8.4	-9.2
Import duties	6.7	8.7	1.6
Other tax revenues	26.2	24.7	-6.1
Tax returns	5.3	3.5	-7.9
NON-TAX REVENUES	**6.4**	**4.2**	**1.2**
TOTAL	**7.2**	**3.7**	**2.8**

Table 27
INCOME TAX BY CATEGORY

	Million S/.			Real % change	
	2012	2013	2014	2013	2014
TOTAL	**37,278**	**36,512**	**40,157**	**-4.7**	**6.5**
First category	243	310	373	23.9	16.5
Second category	1,136	1,275	1,214	9.3	-7.8
Third category	20,744	19,633	18,536	-7.9	-8.5
Fourth category	637	744	834	13.6	8.5
Fifth category	7,054	7,820	8,473	7.9	4.9
Non-domiciliated	2,244	2,848	6,027	23.3	104.7
Regularization	4,779	3,450	4,232	-29.7	18.7
Others		441	432	468	-4.5

76. In **2015** the ratio of revenues would decrease to 20.7 percent due to the effect of the tax measures taken in Q4-2014. The most important were the reduction of the

corporate tax rate from 30 to 28 percent in fiscal years 2015 and 2016, the increase of the rate applicable to dividends (from 4.1 to 6.8 percent in the same years). Additionally, taxation on income from work has been restructured, which implies a change in the rates and in the sections of taxable income.

The revenue from import duties was also affected by the reduction of the tariffs of 1,085 items to a zero tariff (D.S. 314-2014-EF dated November 18, 2014), which basically involved imports of inputs with tariff rates of 6 and 11 percent. The same regulation established a reduction of the refund rate of customs duties –drawback– from 5 to 4 percent in 2015 and 3 percent in 2016. In addition to this, the excise tax on fuels (gasoline and gasohol), which was S/. 1.31 per gallon on average, was lowered to S/. 0.95 per gallon (D.S. 316-2014-EF, dated November 21, 2014).

The tax withholding systems of Detracciones[2] and Percepciones have been simplified. The number of goods and services subject to detracciones was reduced from 39 to 26 –and goods such as sugar, cotton, asparagus, fish oil, among others, are no longer included in these systems– while the rate of detracciones on 16 items with rates ranging from 4 to 12 percent was lowered to a range of 1.5-10 percent. As regards the tax withholding system of percepciones, the number of items subject to this system was reduced by 29 items, as a result of which currently only 12 goods –e.g. wheat flour, containers, caps for bottles and jars, among others– remain under this system. The regulation does not affect the system of percepciones on imports and fuels.

Because of the reduction of both the amounts and the time during which resources are withheld, these actions contribute to improve companies' indicators of liquidity especially in small and medium-size companies, while reducing their borrowing costs and encouraging a greater dynamism of economic activity.

A special scheme for an early refund of the VAT to micro-enterprises has been established exceptionally. Through this system, small businesses can obtain a refund of the VAT paid when they bought new capital goods that had not been exhausted

2 The regime of **detracciones** is a tax withholding system whereby the buyer of a good or service included in this regime deducts the established tax percentage from the sale price of the good or service rendered and deposits it on behalf of the seller of the good or service provider in an account of Banco de la Nación. The seller of the good or the service provider may then use these funds to pay their tax debts. With the regime of **percepciones**, the seller authorized to act as "withholding agent" will charge the purchaser the tax percentage on the sale price of the goods subject to this tax withholding regime. The purchaser can then use the amounts withheld to pay VAT obligations.

as tax credit over a period of three months. This measure will be valid for three years.

The series of measures described above represent a revenue reduction of approximately 0.7 percentage points of GDP for tax revenue in 2015, which, together with the lower prices of oil affecting mainly non-tax revenues, would imply a ratio of 20.7 percent of GDP for the general government revenue in 2015.

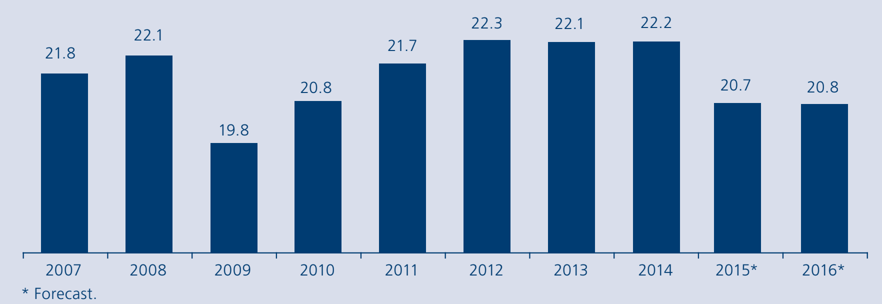
77. In **2016** revenues would register a growth rate of 6.4 percent, in line with the growth of economic activity in that year, which would imply a ratio of tax revenue of 20.8 percent of GDP.

Table 28
CURRENT REVENUES OF THE GENERAL GOVERNMENT
(% GDP)

	2013	2014	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
TAX REVENUES	**16.8**	**16.9**	**16.6**	**15.6**	**16.6**	**15.7**
Income tax	6.7	6.9	6.5	5.9	6.6	5.9
Value added tax	8.7	8.7	8.7	8.6	8.7	8.6
Excise tax	1.0	0.9	0.9	0.8	0.9	0.8
Import duties	0.3	0.3	0.3	0.3	0.3	0.3
Other tax revenues	2.1	1.9	1.9	1.9	1.9	1.9
Tax returns	-2.1	-1.8	-1.9	-1.8	-1.8	-1.8
NON-TAX REVENUES	**5.4**	**5.3**	**5.4**	**5.0**	**5.4**	**5.1**
TOTAL	**22.1**	**22.2**	**21.9**	**20.7**	**21.9**	**20.8**

* Forecast.
IR: Inflation Report.

Graph 76
CURRENT REVENUES OF THE GENERAL GOVERNMENT: 2007-2016
(% GDP)



Evolution of Public Spending

78. In **2014**, the non-financial expenditure of the general government grew 6.9 percent, with higher current spending (10.4 percent) accounting for this growth rate, while

spending in gross capital formation dropped by 1.0 percent. By levels of government, this growth was driven by spending in the national government (12.7 percent), including both current expenditures (12.1 percent) and spending in gross capital formation (18.1 percent). Moreover, spending in regional governments grew 1.3 percent due to increased current spending (up 10.1 percent), which contrasted with the decline observed in gross capital formation (17.0 percent). On the other hand, spending in local governments fell 3.1 percent.

The slow implementation of investment expenditure, especially at the level of sub-national governments, is partly explained by the management problems faced by regional and local governments, which in some cases led to the temporary suspension of their accounts.

Table 29
NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT
(Real % change)

	2012	2013	2014
Current expenditure	**5.3**	**10.6**	**10.4**
National Government	1.7	12.9	12.1
Regional Governments	10.7	8.8	10.1
Local Governments	16.7	2.1	1.5
Capital expenditure	**15.0**	**12.6**	**-1.1**
Gross capital formation	**15.6**	**10.0**	**-1.0**
National Government	-16.5	11.0	18.1
Regional Governments	38.2	4.5	-17.0
Local Governments	39.8	12.3	-5.8
Others	**7.0**	**54.7**	**-2.4**
TOTAL	**8.0**	**11.2**	**6.9**
National Government	-1.2	13.8	12.7
Regional Governments	18.3	7.5	1.3
Local Governments	27.8	7.9	-3.1

In addition to the actions taken between Q2 and Q3 to boost government expenditure, mainly current expenditure, a series of other measures were adopted in Q4-2014 that implied a supplementary credit of S/. 964 million earmarked mainly for current expenditure, which included the payment of an extraordinary bonus of S/. 300 in December for active public servants and public sector pensioners, the payment of accruals authorized by Decreto de Urgencia 037-94, as well as an extraordinary grant of S/. 100 to the beneficiaries of social programs Juntos and Pensión 65. In addition, the same regulation authorized several budget amendments amounting to S/. 636 million to boost public spending.

Table 30
NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT
(% GDP)

	2013	2014	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
Current expenditure	**14.3**	**15.4**	**15.2**	**15.6**	**14.9**	**15.4**
National Government	9.7	10.6	10.3	10.6	10.1	10.5
Regional Governments	2.8	3.0	3.0	3.1	3.0	3.1
Local Governments	1.8	1.8	1.8	1.9	1.8	1.9
Capital expenditure	**6.1**	**5.9**	**6.1**	**6.1**	**6.4**	**6.4**
Gross capital formation	**5.6**	**5.4**	**5.5**	**5.5**	**5.7**	**5.8**
National Government	1.7	2.0	2.0	2.0	2.0	2.1
Regional Governments	1.3	1.1	1.1	1.1	1.2	1.2
Local Governments	2.6	2.4	2.4	2.4	2.5	2.5
Others	**0.5**	**0.5**	**0.6**	**0.6**	**0.6**	**0.6**
TOTAL	**20.5**	**21.3**	**21.3**	**21.7**	**21.3**	**21.8**
National Government	11.9	13.1	12.9	13.2	12.7	13.1
Regional Governments	4.1	4.1	4.2	4.1	4.2	4.2
Local Governments	4.5	4.2	4.3	4.3	4.3	4.4

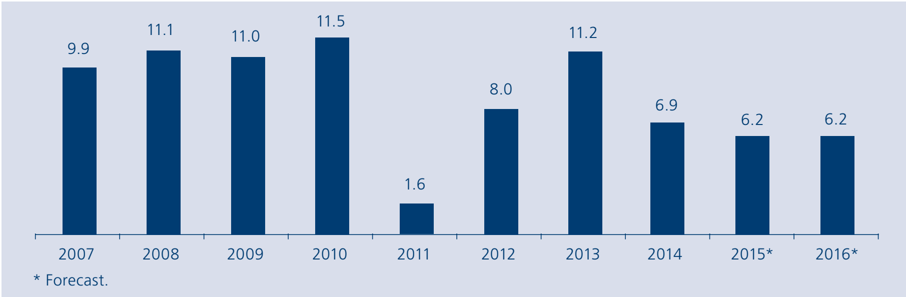
* Forecast.
IR: Inflation Report.

79. In **2015** the non-financial expenditure of the general government is estimated to be equivalent to 21.7 percent of GDP as a result of both increased current spending, whose ratio in GDP terms would rise from 15.4 percent in 2014 to 15.6 percent of GDP in 2015, and increased capital spending, whose ratio would from 5.9 to 6.1 percent of GDP in these years. It should be pointed out that the pace of execution of public investment in 2015 could be affected by the change of authorities in regional and local governments.

The projection of capital spending not only includes the resources allocated to public projects, but also some resources to be used in projects implemented through public-private partnerships (PPPs), such as Chavimochic stage III, Stretch 2 of Longitudinal de la Sierra, Line 2 of Lima's Metro, and section Av. Faucett-Gambeta de la Red Básica del Metro de Lima y Callao, project to which the 2015 budget has allocated S/. 1.14 billion.

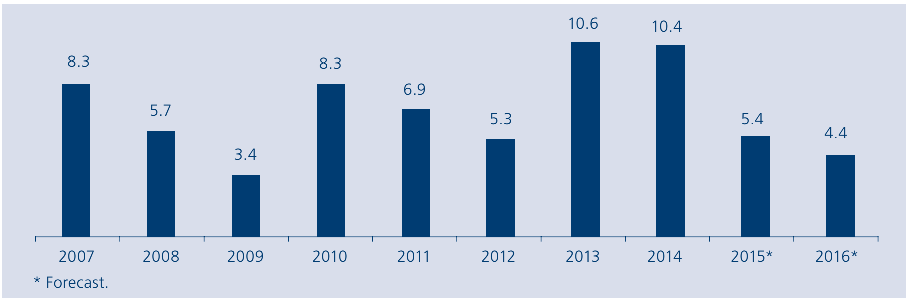
A series of measures affecting public spending in 2015 were published in Q4-2014 (Emergency Decree 005-2014, dated November 21), including a domestic issuance of sovereign bonds for up to S/. 3 billion to finance public investment projects in all the government levels, but which will be prioritized by the national government. Moreover, regional and local governments and public universities have also been authorized to use up to 40 percent of the resources obtained from the canon, sobrecanon and mining royalties (previously 20 percent), as well as the balance sheet balances generated by these revenues for maintenance actions, and the Ministry of Desarrollo e Inclusión Social (MIDIS) has been authorized to make the budget changes required to finance the acquisition of uniforms and complementary garment items for the members of Policía Nacional del Perú for a total of approximately S/. 243 million.

Graph 77
NON-FINANCIAL EXPENDITURE OF THE GENERAL GOVERNMENT: 2007-2016
(Real % change)



Within the level of expenditure projected, and considering that the new authorities elected as regional and local governments will be able to successfully face the management problems new authorities usually have to deal with during their first year in office, the pace of current expenditure is foreseen to slow down to a rate of 4.4 percent in 2016, while gross capital formation would show a faster pace and reach 11.2 percent in 2016.

Graph 78
CURRENT EXPENDITURE OF THE GENERAL GOVERNMENT: 2007-2016
(Real % change)



Graph 79
GROSS CAPITAL FORMATION OF THE GENERAL GOVERNMENT: 2007 - 2016
(Real % change)

Public Debt

80. At end-2014, the non-financial debt of the public sector would amount to 19.7 percent of GDP, which represents a ratio slightly higher than the one recorded at end-2013 (19.6 percent). This balance includes the effect of the debt management operation approved by S.D. 298-2014-EF of October 30, 2014, which involved repo and/or swap operations of global bonds 2015, 2016 and 2019 (with a nominal value of US$ 485 million) and sovereign bonds maturing in 2015 and 2020 (with a nominal value of S/. 3.56 billion). This operation was funded with the issuance of Sovereign Bonds 2024 for a nominal value of S/. 7.13 billion, amount which in addition to covering the above-mentioned buyback, provided S/. 1.44 billion to pre-finance the requirements of year 2015. In addition to this, Global Bond 2050 for a total of US$ 500 million was issued at the same time also to pre-finance 2015 requirements. In short, this operation contributed to improve the debt profile since the ratio of debt in domestic currency in total liabilities increased from 50.7 percent to 52.1 percent.

81. The economic balance projected for 2015 (2.0 percent of GDP) implies that financial requirements would amount to S/. 17.3 billion, a higher amount than that estimated in the Inflation Report of October. These financial requirements will be met only in part with external disbursements and bond placements, which would imply using some of the treasury's deposits this year.

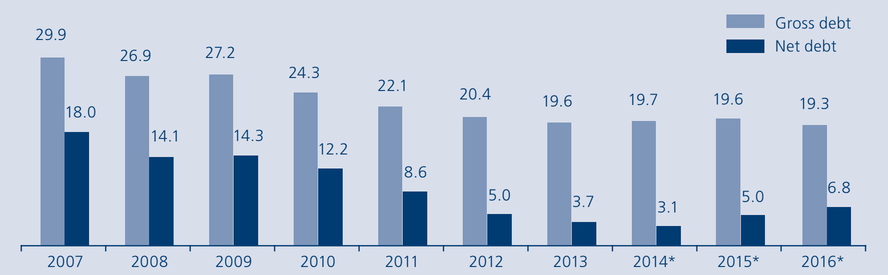
Table 31
FINANCIAL REQUIREMENTS OF THE NON-FINANCIAL PUBLIC SECTOR AND ITS FUNDING
(Million S/.)

	2013	2014	2015*		2016*	
			IR Oct.14	IR Jan.15	IR Oct.14	IR Jan.15
I. Uses	**3,028**	**9,799**	**8,304**	**17,310**	**9,342**	**18,455**
1. Amortization	7,859	9,044	6,183	4,943	6,148	4,814
a. External	6,223	4,167	2,464	2,481	3,636	3,140
b. Domestic	1,637	4,877	3,720	2,461	2,512	1,675
Of which: Recognition bonds	*448*	*692*	*768*	*801*	*763*	*797*
2. Overall Balance (Negative sign indicates surplus)	-4,832	755	2,120	12,367	3,194	13,641
II. Sources	**3,028**	**9,799**	**8,304**	**17,310**	**9,342**	**18,455**
1. External	954	1,651	5,278	6,451	4,719	5,493
2. Bonds[1/]	4,025	13,002	2,883	3,427	4,951	5,002
3. Internal[2/]	-1,952	-4,854	143	7,431	-328	7,960
Memo:						
% GDP						
Gross debt balance	19.6	19.7	18.6	19.6	18.2	19.3
Net debt balance[3/]	3.7	3.1	3.1	5.0	3.5	6.8

* Forecast.
1/ Includes domestic and external bonds.
2/ A positive sign indicates a withdrawal or overdraft and a negative sign indicates higher deposit.
3/ Defined as the difference between gross public debt and NFPS deposits.
IR: Inflation Report.

82. The balance of the gross debt of the non-financial public sector is expected to decline in the forecast horizon to 19.6 percent of GDP in 2015 and to 19.3 percent in 2016, which reflects the soundness of the Treasury's financial stance in these years.

Graph 80
NON-FINANCIAL PUBLIC SECTOR DEBT: 2007-2016
(% GDP)



* Forecast.

Box 3
CHANGES IN INCOME TAX RATES

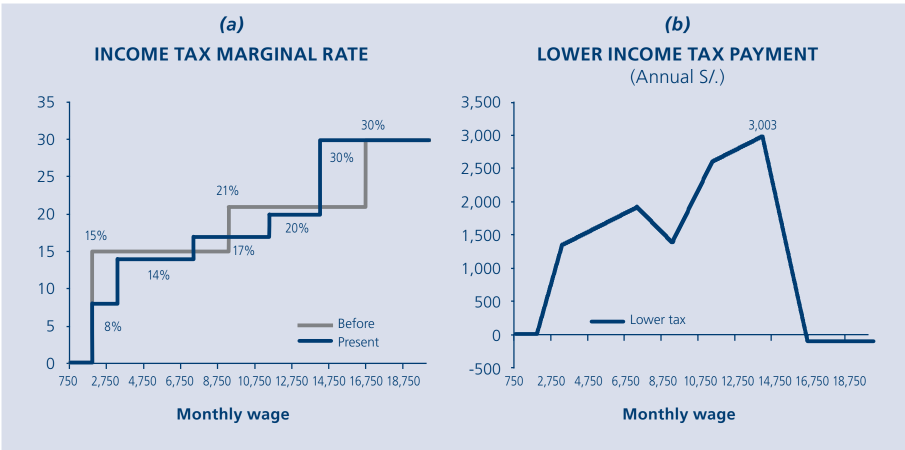
The Government has recently enacted Law 30296 approving a series of changes to the income tax, applicable as from fiscal year 2015 (FY 2015), to mitigate the slowdown in economic activity.

These measures will increase the disposable income of natural persons and companies' profitability after tax payment, which is expected to stimulate consumption and investment decisions.

Individuals

This new regulation has modified the progressive scale that taxes individuals' labor income and income from foreign sources[3]. The new scale has five brackets (with marginal rates of 8, 14, 17, 20 and 30 percent) instead of three (with marginal rates of 15, 21 and 30 percent), but has maintained the minimum non-taxable income at 7 tax units (UIT), equivalent to S/. 1,925 per month in FY 2015[4]. As a result, the new initial marginal rate is lower and the income level above which the maximum marginal rate of 30 percent applies has been reduced (Graph 1 (a)).

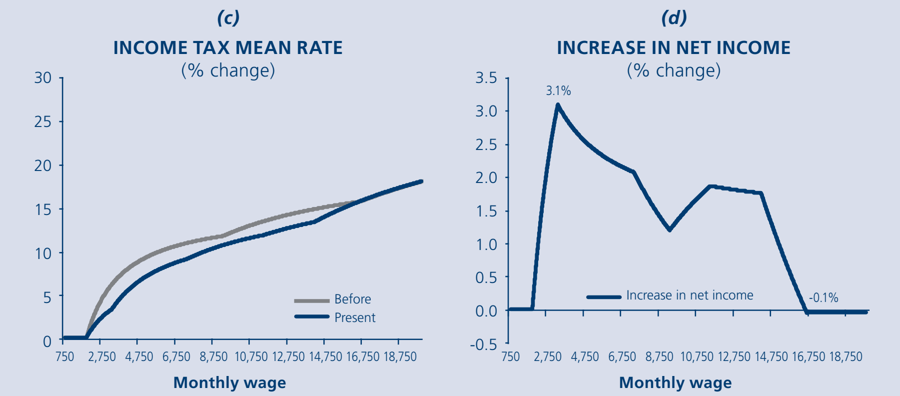
Graph 1



In addition, as a result of this change in the tax scale, the average tax rate is reduced in the low income stretches and increases slightly in the higher ones. Thus, people with incomes below S/. 16,684 will pay a lower tax, while the tax for those with higher incomes increases by up to a maximum of S/. 115 annually. In terms of absolute tax saving, the greatest reduction is approximately S/. 3,000 per year for incomes of S/. 14,300 per month (Graph 1 (b)).

3 With the exception of profits obtained by participating in the MILA stock markets.
4 Considering fourteen salaries per year and a tax unit value of S/. 3,850 for this fiscal year.

Graph 2



Both the previous and the current scale are progressive given that the average tax rate increases with the level of gross remuneration (Graph 2 (a)). The greatest percentage increase in net tax income is 3.1 percent and applies to incomes of about S/. 3,000 a month (Graph 2 (b)). Because this percentage decreases in general with the level of gross income, this tax modification increases the progressivity of the income tax.

It is estimated that this measure will benefit about one million taxpayers with a reduction of added tax payment of S/. 1.3 billion per annum, which represents 0.4 percent of private consumption.

Corporations

A gradual reduction has been established in the rate of the corporate income tax (third category income tax), as a result of which the rate will decline from 30 percent in FY 2014 to 26 percent as from FY 2019.

This lower corporate tax rate will be accompanied by an increase in the tax rate on investors' dividends –currently 4.1 percent– so that the final tax rate applied to corporate income remains stable.

INCOME TAX RATE

	Before	Law 30296		
		2015-2016	2017-2018	2019 ahead
Third category	30.0%	28.0%	27.0%	26.0%
Dividends	4.1%	6.8%	8.0%	9.3%
Combined rate	32.9%	32.9%	32.8%	32.9%

This tax restructuring is aimed at encouraging companies to decide to maintain a higher level of retained earnings, which should provide companies with internal resources that facilitate making investments[5].

For example, if a company distributes 100 percent of its net profits, the tax burden on the company's income would be 32.9 percent. But if its rate of dividend distribution were lower, for example 30 percent, then the tax rate on shareholders would decrease to 29.5 percent. Thus, the shareholders of a company may reduce their tax burden in the short term if they reduce the proportion of net earnings distributed as dividends. However, in the long term, the incentive for new corporations would be lower as the total tax burden on distributed earnings will remain constant.

Any credit that companies may give to its shareholders shall be considered distribution of earnings and therefore taxed by the tax on dividends[6]. The regulation also includes the reduction of the coefficients of advanced tax payments of companies and individuals with fourth category incomes –independent workers– in order that the lower tax burden be perceived immediately.

These income tax changes are effective as from January 1, 2015. The regulation establishes that the rates on dividends apply to earnings generated as from FY 2015, which means that distributed earnings generated in 2014 will be subject to a tax rate of 4.1 percent when paid in 2015.

The impact of the reduction of the third category income tax on revenue is estimated at around of S/. 1.8 billion in FY 2015.

5 This would be more relevant in the segments with restrictions in terms of access to the credit market.

6 Under previous regulations, credits to shareholders were only considered as distributed earnings if the obligation of repaying the loan had been established or if the deadline for repaying the loan exceeded 12 months or if the loan had not been repaid after the deadline.

V. Money and Financial Markets

Monetary Policy Actions

83. Since October –when our previous report was published–, the upward risks on the inflation forecast have declined. On the one hand, the fall in the international price of oil has started to reflect in the domestic prices of fuels. On the other hand, the output gap shows no inflationary pressures on the side of demand and is expected to remain negative and to recover slowly in 2015. Also, supply shocks that affected inflation in 1S-2014 continued to reduce.

    In this context, the Board of BCRP approved to reduce the benchmark interest rate by 25 bps to 3.25 percent as from January 2015. This level of the policy rate is compatible with an inflation forecast in which inflation converges more rapidly to the 2.0 percent target in 2015, given that the lower international prices of crude have begun to translate into domestic prices. Because the level of economic activity is still below its potential level, this has generated greater space for monetary policy actions.

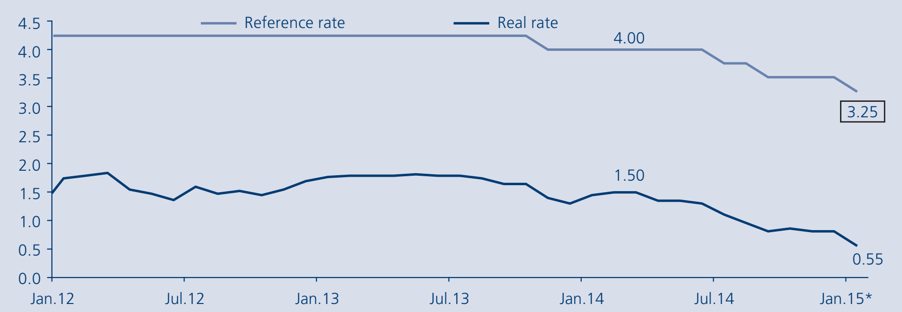
    Additionally, the BCRP continued easing its regime of reserve requirements in domestic currency in order to provide banks with liquidity in soles to facilitate the expansion of credit in this currency, in a context in which deposits in soles showed a slower pace of growth than credit. The rate of required reserves was last lowered from 9.5 to 9.0 percent in January 2015.

    On the other hand, in December 2014 the BCRP raised the marginal reserve requirements of the general regime of reserve requirements in foreign currency from 50 to 60 percent and established new measures of additional required reserves in foreign currency, replacing the scheme of additional reserve requirements according to the growth of credit in foreign currency by a scheme aimed at reducing the balance of loans in this currency. These measures seek to discourage credit in dollars and to accelerate the process of de-dollarization of credit as well.

    These actions have been complemented with the establishment of new facilities to inject liquidity in domestic currency to the financial system through currency swaps and/or repos with maturities of up to 3 years. There are two types of operations: one type of operations is aimed at replacing currency in order that the financial entity can maintain an appropriate balance between its liabilities and assets in dollars without losing liquidity in soles, and the other type of operations, though which banks can expand their liquidity in soles using funds of their reserve requirements in dollars, is aimed at expanding credit.

84. The Board's policy communiqués in recent months have highlighted that the expected rates of inflation are anchored within the target range and that the 12-month inflation rate will converge to the target range in the coming months as long as the supply conditions that affected inflation continue to normalize and there are no demand pressures. The Board has also highlighted that the Central Bank oversees the inflation forecast and inflation determinants to take additional actions to ease its monetary policy instruments should this be required.

Graph 81
NOMINAL AND REAL REFERENCE INTEREST RATE
(%)

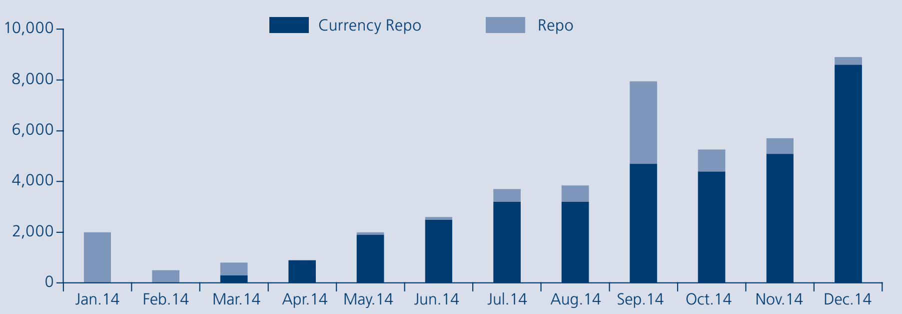


* Estimation.

Interest Rates and Monetary Operations

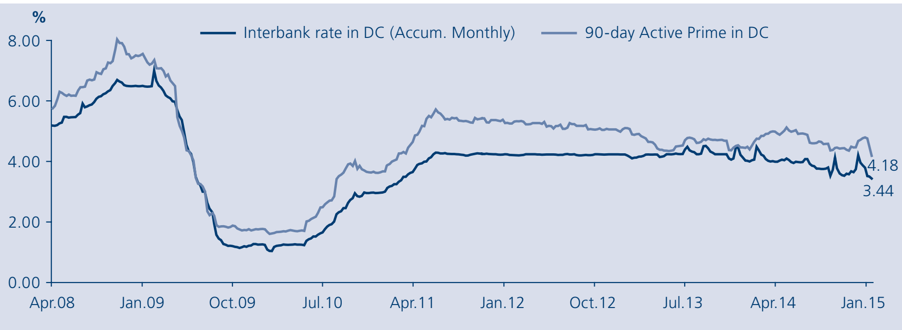
85. The interest rates in the money market during Q4 increased slightly, influenced by pressures on liquidity in domestic currency associated with an appetite for acquiring foreign currency due to high volatility in the foreign exchange market. To mitigate the effects of this greater demand for foreign currency, the BCRP sought to reinforce the interest rate pass-through mechanism and to preserve monetary conditions in soles through the injection of liquidity via repos with term securities and repos in foreign currency.

Graph 82
BALANCE OF REPO OPERATIONS: TERM AT THE END OF MONTH
(Million S/.)



With these liquidity injection operations, the BCRP was able to reverse the temporary increase in the interbank interest rate and the preferential rate corporate. Thus, on January 20, the interbank interest rate registers the same level as the policy interest rate –3.25 percent–, while the 90-day corporate prime rate registers a level of 4.18 percent.

Graph 83
90-DAY CORPORATE PRIME RATE VERSUS INTERBANK OVERNIGHT RATE IN DOMESTIC CURRENCY: MAR.08 - JAN.15



86. The evolution of money market rates has not affected lending interest rates in domestic currency, which decreased in most of the credit segments during the last quarter. For the segments of medium-sized companies, small businesses, mortgage, large enterprises and microenterprises, lending interest rates declined by 135, 41, 24, 9, and 1 basis points, respectively. On the other hand, the interest rates for the segments of corporate loans and consumer loans increased, reflecting the transitory rise registered in the corporate prime rate in the month of December.

Table 32
INTEREST RATE BY TYPE OF LOANS IN DOMESTIC CURRENCY[1/]
(%)

	Corporate	Large companies	Medium-sized enterprises	Small businesses	Microbusinesses	Consumer	Mortgage
Dec.12	5.8	7.4	11.0	22.5	33.2	41.2	8.8
Dec.13	5.4	7.1	10.1	21.0	33.1	42.3	9.0
Jan.14	6.0	7.1	10.8	21.6	32.8	42.9	9.2
Mar.14	5.8	7.0	10.8	21.2	32.5	42.9	9.2
Jun.14	5.9	7.5	10.8	21.1	32.1	42.7	9.4
Jul.14	5.8	7.0	10.8	20.8	32.1	43.5	9.3
Aug.14	5.6	7.0	11.2	21.3	32.2	44.1	9.3
Sep.14	5.3	6.9	10.8	21.0	33.0	43.0	9.2
Oct.14	5.5	7.1	10.6	20.9	32.8	42.7	9.1
Nov.14	5.8	7.1	10.5	21.2	32.8	42.4	9.0
Dec.14	5.6	6.8	9.5	20.6	33.0	43.3	9.0
Accumulated change (bps)							
Dec.14-Sep.14	32	-9	-135	-41	-1	27	-24
Dec.14-Dec.13	20	-25	-69	-46	-14	105	-7
Dec.14-Dec.12	-17	-56	-151	-188	-19	215	20

1/ Annual active interest rates on the operations carried out in the last 30 working days.
Source: SBS and BCRP.

A further reduction of the lending interest rates is expected in the next months due to the recent measures taken by the BCRP to support the growth of credit in domestic currency. On the other hand, the interest rates on deposits in national currency for terms of 31 to 180 days fell 13 basis points, while the interest rates on deposits of less than 30 days and deposits with terms between 181 days and 360 days increased by 24 and 8 basis points, respectively.

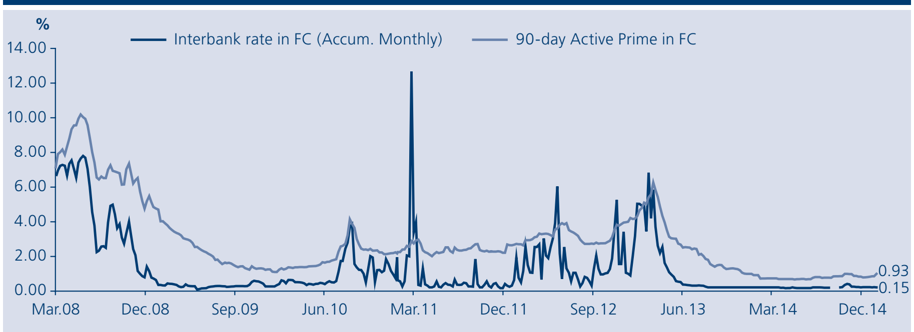
Table 33
INTEREST RATES IN NUEVOS SOLES
(%)

	Deposits up to 30 days	On 31 to 180-day term deposits	On 181 to 360-day term deposits
Dec.12	3.6	3.8	4.2
Dec.13	3.8	3.5	3.9
Jan.14	3.9	3.5	3.9
Mar.14	4.1	3.7	3.9
Jun.14	3.7	4.0	4.2
Jul.14	3.7	4.1	4.2
Aug.14	3.5	4.0	4.2
Sep.14	3.6	3.9	4.2
Oct.14	3.5	3.8	4.2
Nov.14	3.6	3.8	4.1
Dec.14	3.8	3.8	4.3
Accumulated change (bps)			
Dec.14-Sep.14	24	-13	8
Dec.14-Dec.13	4	25	44
Dec.14-Dec.12	20	-2	12

Source: BCRP.

87. Liquidity in foreign currency continued being widely available in Q4-2014. Most of the interest rates on lending and deposit operations in dollars decreased even though banks used their excess of liquidity in foreign currency to make currency swaps with the Central Bank to increase their availability of liquidity in domestic currency. Thus, the corporate prime interest rate for 90-day loans fell 2 basis points compared to September and registered a level of 0.79 percent.

Graph 84
90-DAY CORPORATE PRIME RATE VERSUS INTERBANK OVERNIGHT RATE IN FOREIGN CURRENCY: MAR.08 - JAN.15



However, the rates for loans in dollars increased compared to the previous quarter, particularly the rates in the segments of large enterprises (66 basis points), corporate loans (25 basis points, and medium-sized companies (15 basis points). The rates for loans to micro-enterprises, small firms, consumer loans and mortgages continued declining.

The interest rates on deposits in foreign currency also fell slightly, especially in the case of deposits with terms longer than 31 days (4 basis points).

Table 34
INTEREST RATE BY TYPE OF LOANS IN FOREIGN CURRENCY1/
(%)

	Corporate	Large companies	Medium-sized enterprises	Small businesses	Microbusinesses	Consumer	Mortgage
Dec.12	4.1	6.4	9.0	15.5	19.3	22.4	8.0
Dec.13	2.4	5.5	8.3	13.2	19.2	26.1	8.5
Jan.14	2.9	5.5	8.5	14.2	19.6	26.7	8.5
Mar.14	2.3	5.2	8.6	13.3	19.0	26.7	8.5
Jun.14	2.3	4.8	8.5	13.0	18.3	27.1	7.7
Jul.14	2.9	4.6	8.4	13.3	18.6	27.6	7.8
Aug.14	2.6	4.8	8.4	13.5	19.3	27.5	7.7
Sep.14	2.2	4.4	8.1	13.0	18.8	27.3	7.6
Oct.14	2.1	4.6	7.6	12.6	20.0	27.5	7.6
Nov.14	2.6	4.7	7.8	12.7	18.0	28.2	7.5
Dec.14	2.5	5.1	8.3	12.3	16.9	27.3	7.6
Accumulated change (bps)							
Dec.14-Sep.14	25	66	15	-69	-187	-4	-2
Dec.14-Dec.13	9	-40	1	-91	-228	121	-90
Dec.14-Dec.12	-158	-129	-74	-321	-240	486	-41

1/ Annual active interest rates on the operations carried out in the last 30 working days.
Source: SBS and BCRP.

Table 35
INTEREST RATES IN US DOLLAR
(%)

	Deposits up to 30 days	On 31 to 180-day term deposits	On 181 to 360-day term deposits
Dec.12	1.8	1.3	1.7
Dec.13	0.2	0.7	1.3
Jan.14	0.1	0.7	1.2
Mar.14	0.1	0.5	1.1
Jun.14	0.1	0.5	1.0
Jul.14	0.2	0.5	0.9
Aug.14	0.2	0.5	0.9
Sep.14	0.2	0.5	0.9
Oct.14	0.2	0.5	0.8
Nov.14	0.2	0.5	0.8
Dec.14	0.2	0.5	0.8
Accumulated change (bps)			
Dec.14-Sep.14	-1	-4	-4
Dec.14-Dec.13	2	-28	-48
Dec.14-Dec.12	-159	-83	-84

Source: BCRP.

88. The operations of the Central Bank were mainly oriented to maintaining adequate levels of liquidity in a context of strong demand associated with expectations of a depreciation and at reducing excessive volatility in the exchange rate. Thus, between October and December 2014, the BCRP injected liquidity placing currency repos for a total of S/. 5.99 billion and 3-month repos for a total of S/. 315 million. Most of the currency repos operations, which had 12-month and 18-month maturities, were carried out in December (S/. 5.1 billion). These instruments were placed at an average rate of 4.3 percent.

Table 36
LIQUIDITY INJECTION OPERATIONS
(Million S/.)

Date	Operation	Term	Amount	Average rate
01-Oct-14	Repo	1 week	1,000	3.81%
01-Oct-14	Repo	3 months	15	3.55%
01-Oct-14	Currency Repo	3 months	92	3.65%
02-Oct-14	Repo	1 week	1,000	3.81%
13-Oct-14	Repo	1 week	1,000	3.60%
20-Oct-14	Repo	1 week	500	3.57%
17-Nov-14	Repo	1 week	1,000	4.69%
18-Nov-14	Repo	1 week	1,000	4.05%
19-Nov-14	Currency Repo	3 months	300	3.85%
28-Nov-14	Currency Repo	1 year	500	4.51%
01-Dec-14	Currency Repo	1 year	500	4.31%
05-Dec-14	Currency Repo	1 year	300	4.52%
05-Dec-14	Repo	3 months	300	4.62%
15-Dec-14	Currency Repo	1 year	400	4.38%
16-Dec-14	Currency Repo	1 year	400	4.36%
17-Dec-14	Currency Repo	1 year	400	4.34%
18-Dec-14	Repo	1 week	1,000	3.81%
18-Dec-14	Currency Repo	1 year	500	4.27%
18-Dec-14	Currency Repo	1 year	500	4.05%
19-Dec-14	Currency Repo	1 year	400	3.85%
23-Dec-14	Currency Repo	1 year	500	4.44%
24-Dec-14	Currency Repo	1 year	400	4.38%
26-Dec-14	Currency Repo	1 year	300	4.41%
31-Dec-14	Currency Repo	18 months	500	4.22%
TOTAL			**12,807**	

With the aim of offering a greater diversity of liquidity injection instruments to financial institutions, as from January the BCRP will provide new term liquidity-injection instruments in soles by auctioning two types of currency repos: credit substitution repos and credit expansion repos.

The aim of the first type of instrument auctioned is to support the conversion of loans in dollars into loans in domestic currency, this repo operation involving the BCRP selling dollars in the spot market to the financial institution. The aim of the second type of instrument auctioned is to support the growth of credit in soles, since the operation consists of a currency repos (whereby a bank obtains liquidity in soles provided by the BCRP) in exchange for an equivalent amount of its reserve requirements in dollars. Banks can use up to a maximum of 10 percent of their total assets subject to reserve requirements for these operations.

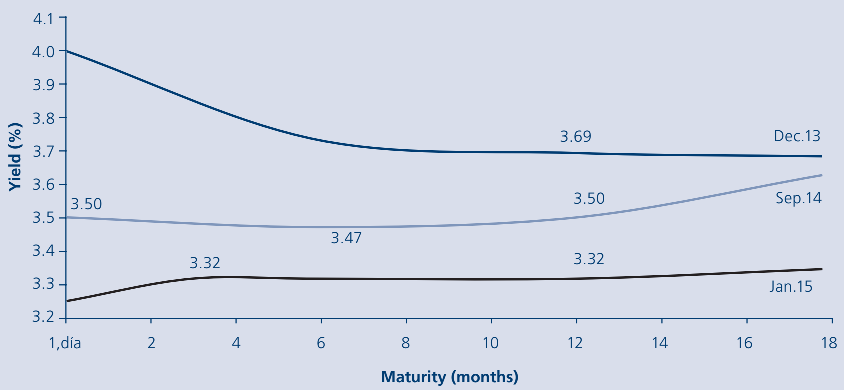
In the foreign exchange market, signals of a recovery in the U.S. economy and the drop in the prices of raw materials have raised expectations of a depreciation of the nuevo sol among institutional agents and financial entities, generating pressures on the exchange rate in both the spot market and the forward market of foreign currency.

In this context, the BCRP intervened in the spot market, with a net sale of US$ 2.18 billion. A new instrument of intervention in the foreign exchange market, the FX swap, was also introduced in this quarter. Through this instrument the BCRP can intervene in the market of derivatives without affecting banks' availability of liquidity. FX swaps for a net total of US$ 5.71 billion were placed during this period in order to reduce pressure in the forward market and prevent that a high NDF rate spread would contaminate monetary conditions in soles. These placements of FX swaps replaced net maturities of BCRP-CDRs for an amount equivalent to US$ 1.51 billion.

The BCRP also continued with its regular auctions of 6-month, 12-month, and 18-month BCRP-CDs three times a week, placing CDs for a total of S/. 100 million each time in order to increase the volume of these certificates and provide more liquidity to the secondary market of these instruments. In addition, between October and December, the Central Bank placed CDs for a total of S/. 3.44 billion and maturities amounted to S/. 5.43 billion. As a result of the latter, the balance of BCRP-CDs decreased by S/. 1.99 billion.

Moreover, the yield curve of BCRP-CDs increased 2 basis points on average compared to Q3. The stability of the rates for CDs with maturities of up to 6 months would be reflecting market expectations that the Central Bank's policy rate will remain at its current level. On the other hand, the inverted curve in the section of CDs with maturities exceeding 12 months could be interpreted as expectations that the policy rate will decrease in a year.

Graph 85
YIELD CURVE OF CENTRAL BANK SECURITIES[1/]



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

As a result of the these liquidity injection operations, the ratio of instruments issued by the BCRP relative to total liabilities of the Central Bank decreased from representing 8.4 percent of international reserves in September 2014 to representing 5.0 percent in December. Most of this change resulted from the increase in the balance of currency repos. Moreover, the ratio of reserve requirements increased from 27.1 to 28.4 percent in the same period. Public sector deposits, which continued to be the largest source of sterilization, went from representing 43.6 percent of international reserves in September to 38.8 percent in December. In addition, net placements of FX swaps increased the balance of these instruments to 9.0 percent of international reserves.

Table 37
SIMPLIFIED BALANCE SHEET OF THE BCRP
(As % of Net International Reserves)

		Dec.13	Dec.14
Net assets			
I.	**Net International Reserves**	**100%** (US$ 65,663 mills)	**100.0%** (US$ 62,307 mills)
Net liabilities			
II.	**Total public sector deposits**	**36.3%**	**38.8%**
	In domestic currency	19.9%	19.7%
	In foreign currency	16.4%	19.1%
III.	**Total reserve requirements**	**31.0%**	**28.4%**
	In domestic currency	9.1%	8.1%
	In foreign currency	21.9%	20.4%
IV.	**BCRP instruments**	**13.2%**	**5.0%**
	CD BCRP	10.3%	8.4%
	CDR BCRP	1.7%	1.4%
	Overnight deposits	1.7%	0.5%
	Currency repos	0.0%	-4.6%
	Repos	-0.5%	-0.7%
V.	**Currency**	**19.2%**	**20.9%**
VI.	**Others**	**0.3%**	**6.9%**

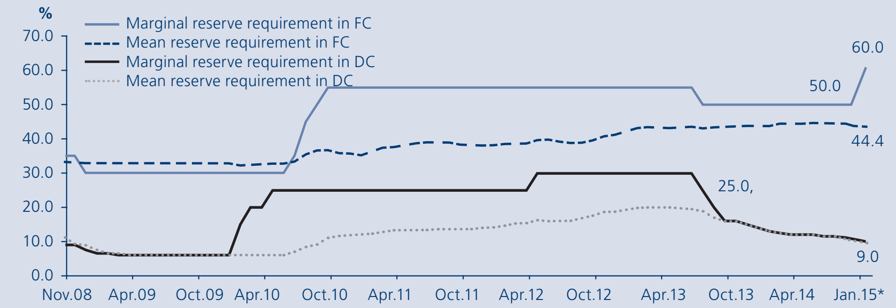
Reserve Requirements

89. During 2014, the BCRP continued implementing measures to ease its regime of reserve requirements in domestic currency in order to provide banks with liquidity in soles so that they could meet the increased demand for credit in soles, in a context in which deposits in this currency had been growing at low rates relative to the dynamism of credit in this currency. Thus, the Central Bank gradually reduced mean reserve requirements from 20.0 percent in May 2013 to 9.0 percent in January 2015.

In January 2015 the BCRP also reduced the minimum requirement in current account for reserve requirement funds from 3.0 percent to 2.0 percent to make the cuts in the rate of mean reserve requirements effective and not generate upward pressures on interest rates in soles. These measures have released liquidity for a total of approximately S/. 11.61 billion.

90. As for the regime of reserve requirements in foreign currency, the BCRP has adopted several measures to discourage credit in dollars and accelerate the de-dollarization of credit. Among other, these measures included eliminating the limit on the rate of mean reserve requirements in foreign currency and increasing the rate of marginal reserve requirements from 50 percent to 60 percent in December. These measures seek to increase banks' incentives to attract deposits in domestic currency.

Graph 86
RATES OF RESERVE REQUIREMENTS IN DOMESTIC AND FOREIGN CURRENCY
(As % of total obligations subject to legal requeriments)



* Forecast.

91. Additionally, in order to contribute to the dedollarization of credit, the BCRP replaced its reserve requirements scheme based on the growth of credit in foreign currency to a scheme of reserve requirements based on the reduction of the balance of credit in dollars. In other words, as from June 2015, additional reserve requirements in dollars will be established for financial institutions that do not reduce their credit balance in dollars (excluding foreign trade loans and loans of over 4 years and amounts exceeding US$ 10 million) by at least 5 percent of their balance of loans in foreign currency at September 30, 2013. The rate of additional reserve requirements will be 30 percent of the percentage deviation relative to this threshold on total liabilities in foreign currency.

A similar change has been established for reserve requirements associated with the balance of car loans and mortgages in foreign currency: the financial institutions that have failed to reduce their balance of car loans and mortgage loans by 10 percent of their balance of such loans at February 2013 will be subject to additional reserve requirements. Banks that have not reduced their balances as required will have additional reserve requirements equivalent to 15 percent of the spread from the threshold applied to their total liabilities in foreign currency (for more details on these measures, see Box 5).

The threshold for both schemes of additional reserve requirements will become more demanding in December 2015. In the case of total loans, banks will be required to reduce their balance by at least 10 percent of their balance at September (equivalent to 90 percent of the balance at September), while in the case of car loans and mortgage loans the reduction will have to be 15 percent of the balance at February 2013 (equivalent to 85 percent of the balance at February 2013).

Graph 87

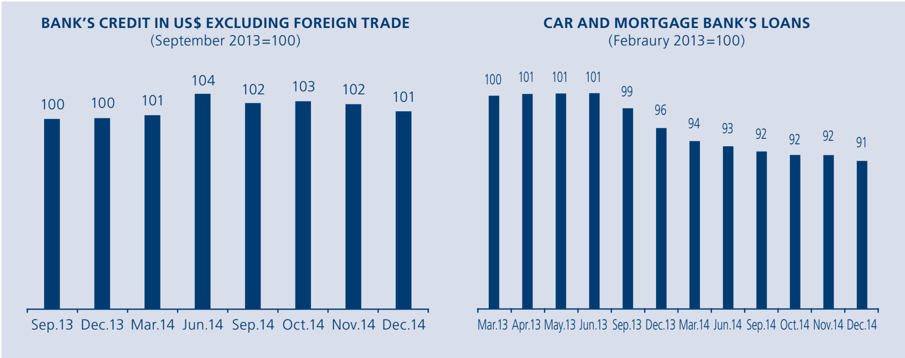


Table 38
RESERVE REQUIREMENTS MEASURES

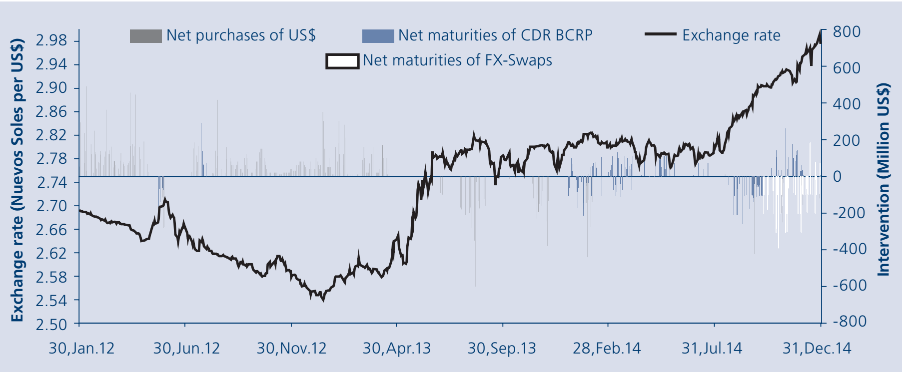
	Domestic Currency				Foreign currency				
					General regime		Foreign liabilities		
	Marginal reserve requirement on deposits	Deposits on current account	Maximum of mean reserve requirement	Liabilities lower 2 years	Marginal reserve requirement on deposits	Maximum of mean reserve requirement	Short term	Foreign trade	Liabilities lower 2 years indexed
May.12	30%	3.00%		120%	55%		60%	60%	120%
Sep.12	30%	3.00%		120%	55%		60%	25%	120%
Oct.12	30%	3.00%		120%	55%		60%	25%	120%
Nov.12	30%	3.00%		120%	55%		60%	25%	120%
Jan.13	30%	3.00%		120%	55%		60%	25%	120%
Feb.13	30%	3.00%		120%	55%		60%	25%	120%
Mar.13	30%	3.00%		120%	55%		60%	25%	120%
Apr.13	30%	3.00%		120%	55%		60%	25%	120%
May.13	30%	3.00%		120%	55%		60%	25%	120%
Jun.13	30%	3.00%	20%	120%	55%		60%	25%	120%
Aug.13	25%	3.00%	19%	120%	50%	45%	50%	20%	120%
Sep.13	20%	3.00%	17%	120%	50%	45%	50%	20%	120%
Oct.13	16%	3.00%	16%	120%	50%	45%	50%	20%	120%
Dec.13	15%	3.00%	15%	120%	50%	45%	50%	20%	120%
Jan.14	14%	3.00%	14%	120%	50%	45%	50%	14%	120%
Feb.14	13%	3.00%	13%	120%	50%	45%	50%	13%	120%
Mar.14	12.5%	3.00%	12.5%	120%	50%	45%	50%	0%	120%
Apr.14	12%	3.00%	12%	120%	50%	45%	50%	0%	120%
Jul.14	11.5%	3.00%	11.5%	120%	50%	45%	50%	0%	120%
Sep.14	11.0%	3.00%	11.0%	120%	50%	45%	50%	0%	120%
Oct.14	10.5%	3.00%	10.5%	120%	50%	45%	50%	0%	120%
Nov.14	10.0%	3.00%	10.0%	120%	50%	45%	50%	0%	120%
Dec.14	9.5%	2.50%	9.5%	9.5%	50%	45%	50%	0%	9.5%
Jan.15	9.0%	2.0%	9.0%	9.0%	60%	-.-	50%	0%	9.0%

Exchange Rate and BCRP Intervention in the Foreign Exchange Market

92. During Q4-2014, the exchange rate maintained an upward trend due to signals indicating a more robust pace of growth in the USA, which would imply the reduction of QE in this country. The US dollar/nuevo sol exchange rate went from S/. 2.891 per dollar at the end of September to S/. 2.980 per dollar at the end of

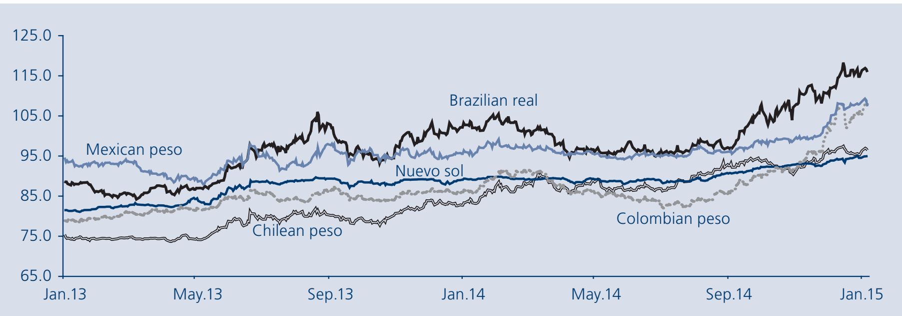
the year, which represents a depreciation of 3.1 percent –slightly lower than the one recorded in Q3 (3.3 percent–, in line with the depreciation rate registered by other currencies in the region.

Graph 88
INTERVENTION IN THE FOREIGN EXCHANGE MARKET AND EXCHANGE RATE



Even though all of the region's currencies depreciated in Q4, each currency was affected by different shocks and contexts. The Colombian peso showed the greater depreciation (17.9 percent), followed by the Mexican peso, which depreciated 9.9 percent. This depreciation was associated with the significant reduction recorded in the price of oil, which dropped about 50 percent in the same period. On the other hand, the depreciation of the Brazilian real (8.7 percent) is explained by a lower capital inflow associated with a lower growth outlook.

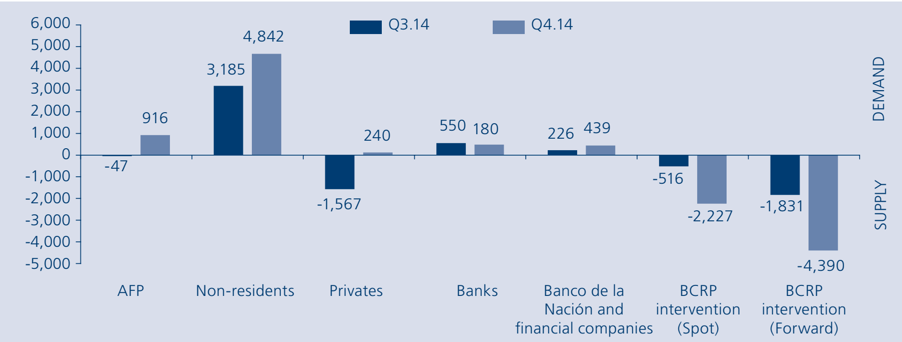
Graph 89
EXCHANGE RATE INDICES - C.U. PER US$
(December 2008=100)



A net demand for dollars was also observed in Q4. This demand for dollars, which was higher than the one registered in Q3 –US$ 6.62 billion in Q4 vs. US$ 2.35 billion in Q3–, came mainly from non-residents' increased demand (US$ 4.84 billion, US$ 1.66 billion more than in Q3-2014).

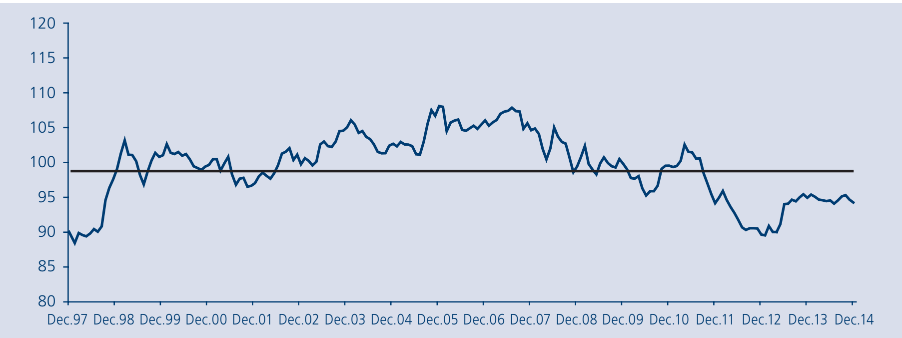
In this context, the BCRP intervened in the foreign exchange market selling US$ 2.18 billion in the spot market and also began interventions using a new instrument, FX swaps. Net placements of FX swaps in Q4 amounted to US$ 5.71 billion.

Graph 90
FOREX MARKET FLOWS - SPOT AND FORWARD
(Million US$)



93. The multilateral real exchange rate index showed a slight depreciation of 0.9 percent between September 2014 and December 2014. Compared to December 2014, the multilateral real exchange rate index has depreciated 0.7 percent as a result of a higher depreciation of the nuevo sol.

Graph 91
MULTILATERAL RER
(Index 2009=100)



Liquidity and Credit

94. Currency in Q4 grew at a similar rate than in Q3 and recorded an annual growth rate of 11.8 percent in December 2014, in line with the slight recovery of economic activity observed in the second half of the year. In 2015 currency would show an annual rate around 12 percent, reflecting greater dynamism in in the pace of growth of economic activity.

Deposits in domestic currency maintained a greater dynamism than in the first half of the year, but showed a slower pace of growth in comparison with the end of Q3 (8.5 percent in December 2014 vs. 9.9 in September). Liquidity in domestic currency followed a similar evolution (9.4 percent in December 2014 vs. 9.9 percent in September 2014).

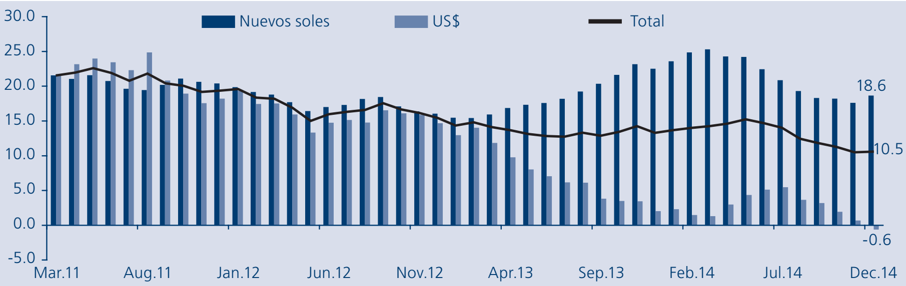
Table 39
MONETARY ACCOUNTS (END-OF-PERIOD)
(12 month % change)

	Dec.09	Dec.10	Dec.11	Dec.12	Dec.13	Mar.14	Jun.14	Sep.14	Oct.14	Nov.14	Dec.14
Currency in circulation	11.0	25.4	13.0	18.3	9.0	8.5	7.7	10.5	10.7	10.2	11.8
Deposits in domestic currency	16.7	32.3	17.7	28.6	11.3	4.3	4.7	9.5	9.4	7.4	8.5
Broad money in domestic currency	14.4	30.7	16.6	23.1	10.9	5.6	5.4	9.9	9.8	8.2	9.4
Broad money[1/]	10.9	23.2	16.8	13.7	11.5	10.3	8.5	6.0	7.5	5.7	6.0
Credit to the private sector in domestic currency	17.9	21.2	20.4	16.0	22.3	25.3	22.4	18.3	18.2	17.6	18.6
Credit to the private sector	8.9	21.2	19.3	15.4	12.9	14.2	14.6	11.7	11.2	10.4	10.5

1/ Includes foreign currency.

95. Total credit to the private sector showed a slower pace of annual growth, declining from a rate of 11.7 percent at the end of Q3 to 10.5 percent in December 2014. This slowdown in the pace of growth of credit reflects mainly the lower dynamism of economic activity observed in Q2. By currencies, credit in domestic currency continued to be more dynamic, with an annual growth rate of 18.6 percent, while credit in foreign currency shrank 0.6 percent in 2014. In 2015 credit to the private sector would register a recovery, in line with the increased dynamism anticipated in the economy. Total credit would grow 12.0 percent, due mainly to the greater dynamism of credit in soles.

Graph 92
CREDIT TO THE PRIVATE SECTOR
(12 month % change)



		Dec.12	Mar.13	Jun.13	Sep.13	Dec.13	Mar.14	Jun.14	Sep.14	Oct.14	Nov.14	Dec.14
Nuevos soles	Monthly flows (Million S/.)	1,660	1,748	2,330	2,685	1,266	2,619	1,060	2,111	2,402	2,955	2,712
	Monthly % change	1.8	1.8	2.3	2.5	1.1	2.2	0.8	1.6	1.8	2.2	2.0
	Annual % change	16.0	15.9	17.6	20.3	22.3	25.3	22.4	18.3	18.2	17.6	18.6
US$	Monthly flows (Million US$)	370	-13	298	-188	-9	-62	532	-328	-243	-166	-388
	Monthly % change	1.3	0.0	1.1	-0.6	0.0	-0.2	1.8	-1.1	-0.8	-0.6	-1.3
	Annual % change	14.7	11.8	7.1	3.8	2.1	1.3	5.1	3.2	2.0	0.7	-0.6
Total	Monthly flows (Million S/.)	2,763	1,708	3,218	2,124	1,237	2,434	2,647	1,133	1,679	2,461	1,557
	Monthly % change	1.5	0.9	1.7	1.1	0.6	1.2	1.2	0.5	0.8	1.1	0.7
	Annual % change	15.4	14.0	12.6	12.5	12.9	14.2	14.6	11.7	11.2	10.4	10.5

96. By type of loans, the most dynamic segments of credit included credit to medium-sized companies, which grew 13.6 percent in December, and the segment of corporate loans and loans to large enterprises, which grew 12.7 percent in the same period, whereas the segment of credit to small- and micro businesses grew only 1.0 percent in annual terms.

The marked slowdown in the expansion of credit to small and micro businesses reflects in part banks' lower supply of credit for this credit segment, offset in part by a higher growth rate of credit in other depository institutions (municipal, rural, or financial saving banks). Moreover, credit in foreign currency for this segment of credit continued contracting in both cases.

Table 40
CREDIT TO THE PRIVATE SECTOR
(12 month % change)

	Dec.12	Dec.13	Mar.14	Jun.14	Sep.14	Oct.14	Nov.14	Dec.14
Businesses	**13.4**	**12.6**	**14.4**	**15.6**	**11.6**	**10.7**	**9.6**	**10.0**
Corporate and large companies	8.7	20.2	21.6	21.4	14.0	14.2	12.3	12.7
Medium-sized enterprises	18.4	10.1	15.1	21.4	16.3	13.8	13.5	13.6
Small business and Microbusinesses	16.6	2.4	1.8	0.1	2.1	1.0	0.4	1.0
Individuals	**19.4**	**13.4**	**13.8**	**12.9**	**12.1**	**12.0**	**11.9**	**11.3**
Consumption	15.4	11.8	12.7	12.4	11.7	11.6	11.6	10.7
Car loans	25.8	14.3	10.2	8.3	6.2	5.0	5.2	6.3
Credit cards	13.4	8.3	10.2	12.1	12.7	14.0	14.9	14.8
Mortgage	25.4	15.7	15.3	13.6	12.6	12.6	12.4	12.2
Total	**15.4**	**12.9**	**14.2**	**14.6**	**11.7**	**11.2**	**10.4**	**10.5**

Table 41
LOANS TO SMALL BUSINESSES AND MICROBUSINESSES

	Annual flows							Annual growth rate					
	Dec.13	Mar.14	Jun.14	Sep.14	Oct.14	Nov.14	Dec.14	Mar.14	Jun.14	Sep.14	Oct.14	Nov.14	Dec.14
Individuals and microbusinesses													
Banks	**-697**	**-1,167**	**-1,083**	**-1,248**	**-1,482**	**-1,702**	**-1,270**	**-7.4**	**-6.9**	**-8.0**	**-9.4**	**-10.7**	**-8.4**
DC	141	-255	-575	-820	-985	-1 217	-882	-2.1	-4.6	-6.5	-7.7	-9.3	-7.1
FC	-299	-326	-181	-153	-177	-173	-139	-26.8	-16.3	-14.1	-16.9	-16.8	-14.4
Rest	**1,536**	**1,808**	**1,168**	**1,956**	**1,861**	**1,860**	**1,620**	**11.3**	**6.9**	**11.8**	**11.0**	**10.8**	**9.2**
DC	1,700	1,877	1,260	2,031	1,944	1,948	1,758	12.9	8.1	13.3	12.4	12.2	10.9
FC	-59	-25	-33	-27	-30	-31	-50	-5.0	-6.6	-5.8	-6.4	-6.8	-10.5
Total	**839**	**641**	**85**	**708**	**379**	**158**	**350**	**2.0**	**0.3**	**2.2**	**1.2**	**0.5**	**1.1**
DC	1,841	1,622	685	1,211	959	731	876	6.0	2.4	4.3	3.4	2.5	3.1
FC	-358	-351	-214	-180	-207	-204	-188	-20.5	-13.3	-11.6	-13.7	-13.7	-13.1

On the other hand, personal loans recorded lower growth rates than in Q3 and lower rates than in the first half of 2014. The more dynamic segment within this type of credit was credit cards, which recorded a rate of 14.8 percent, and mortgage loans, which grew at an annual rate of 12.2 percent. In contrast, car loans continued slowing down.

Although showing a slower pace of growth, the delinquency rates continued recording an upward trend in December. The default rate of credit to businesses rose from 3.15 percent in September to a level of 3.21 percent in December. Within this segment, credit to medium-sized and small companies showed the greatest increase in the default rate. The former climbed by 38 basis points to 4.82 percent of this loan portfolio, while the latter rose by 7 basis points to a ratio of 8.97 percent. On the other hand, the default rate in the segment of micro businesses fell by 16 basis points to 5.83 percent of the total of these loans. Moreover, the default rate in credit to individuals also fell by 5 basis points to 2.48 percent in December, reflecting the reduction in the default rate of consumer loans –down by 19 basis points–, whereas the default rate in mortgage loans rose slightly (by 10 basis points).

Graph 93
CREDITS: DELINQUENCY RATES
(As % of portfolio)

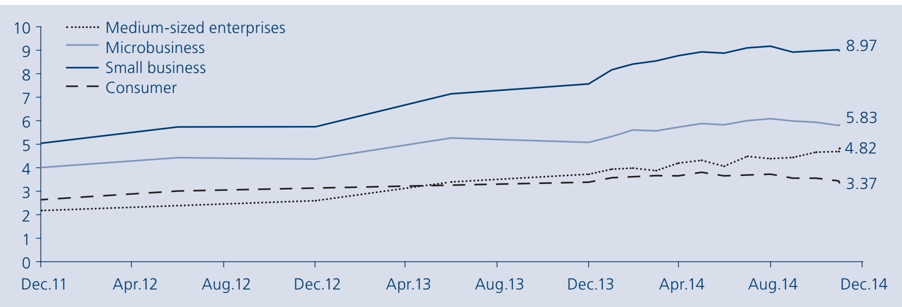


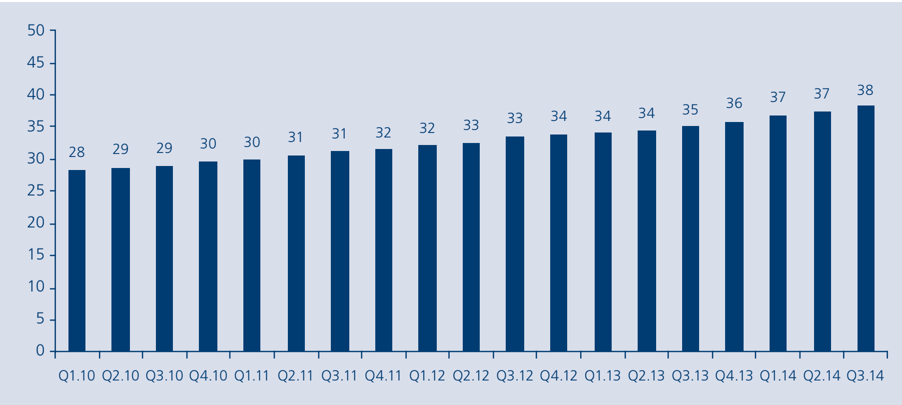
Table 42
CREDITS DELINQUENCY INDEX OF THE DEPOSITORY CORPORATIONS

	Dec.11	Dec.12	Dec.13	Mar.14	Jun.14	Sep.14	Oct.14	Nov.14	Dec.14
Business	**1.88**	**2.21**	**2.70**	**2.97**	**3.04**	**3.15**	**3.20**	**3.22**	**3.21**
Corporate	0.04	0.00	0.00	0.02	0.13	0.00	0.00	0.00	0.00
Large companies	0.21	0.40	0.38	0.54	0.43	0.73	0.74	0.77	0.68
Medium-sized enterprises	2.18	2.60	3.72	3.88	4.06	4.44	4.66	4.69	4.82
Small business	5.05	5.74	7.56	8.54	8.86	8.90	8.96	9.01	8.97
Microbusiness	4.01	4.36	5.08	5.57	5.83	5.99	5.93	5.80	5.83
Individuals	**1.89**	**2.08**	**2.32**	**2.52**	**2.55**	**2.53**	**2.55**	**2.48**	**2.48**
Consumer	2.64	3.05	3.39	3.66	3.65	3.56	3.56	3.44	3.37
Car loans	2.84	2.79	3.37	3.76	3.99	4.21	4.34	4.26	4.27
Credit cards	3.40	4.10	4.71	5.07	4.90	4.69	4.64	4.46	4.26
Mortgage	0.86	0.83	1.04	1.16	1.26	1.34	1.38	1.37	1.44
Average delinquency	**1.84**	**2.17**	**2.57**	**2.82**	**2.88**	**2.94**	**2.98**	**2.97**	**2.96**

97. At end-2014, credit grew 10.5 percent, driven primarily by credit in domestic currency. In 2015 credit is foreseen to grow 12.0 percent, with credit in soles being forecast to grow 22.4 percent, while credit in foreign currency would decrease 5.8 percent, reflecting the actions taken by the BCRP to promote the dedollarization of credit. This projected evolution of credit is consistent with a recovery of economic activity, with private agents' preference for borrowing in soles, and with the BCRP measures to support the dedollarization of credit. Deposits in domestic currency are projected to grow 7.1 percent in the year, while liquidity in foreign currency would grow 1.5 percent. Thus, the ratio of credit-to-GDP is expected to continue increasing during 2015.

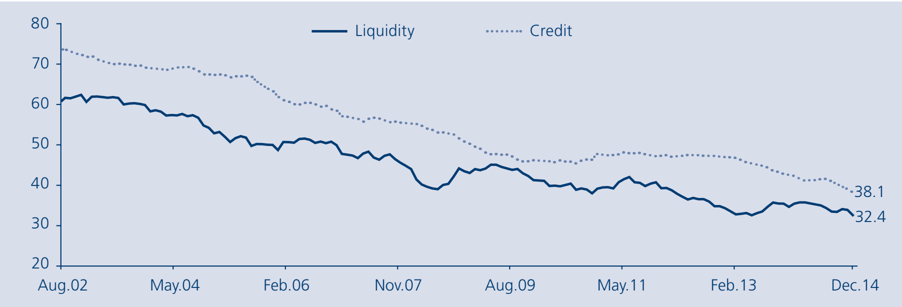
In addition to continue lowering the rate of reserve requirements in soles with the aim of providing a more permanent source of expansion of liquidity so that the financial system's interest rates for operations in domestic currency are not affected, the BCRP has established additional liquidity injection measures through currency repos.

Graph 94
RATIO CREDIT / GDP
(%)



98. The ratio of dollarization of credit declined from 40.2 percent in September to 38.1 percent in December, in line with the trend observed over the year. The dollarization of liquidity decreased from 33.2 to 32.4 percent in the same period, maintaining the trend observed in Q3. The ratio of dollarization of credit remains below the level observed in December 2013 (34.4 percent).

Graph 95
DOLLARIZATION RATIO: 2002 - 2014
(%)



The ratio of dollarization of credit declined by 2.1 percentage points from its level in September 2014, reflecting business increased preference for credit in soles. By type of credit, the ratio of dollarization decreased in each segment of credit: mortgage loans continue showing a de-dollarization trend (down from 35.3 to 33.9 percent between September and December 2014), which would be reflecting in part the reserve requirement measures conditional to the expansion of mortgage loans and car loans in foreign currency that the BCRP implemented in March 2013. The new reserve requirement measures established this year are associated with the reduction of credit in foreign currency and are aimed at consolidating the process of dedollarization.

Table 43
DOLLARIZATION RATIO OF CREDIT TO THE PRIVATE SECTOR

	Dec.11	Dec.12	Dec.13	Mar.14	Jun.14	Sep.14	Oct.14	Nov.14	Dec.14
Business	**57.5**	**57.7**	**52.9**	**51.2**	**52.1**	**50.8**	**50.1**	**49.2**	**48.2**
Corporate and large companies	72.6	75.4	67.4	64.2	65.6	63.6	62.2	60.7	59.1
Medium-sized enterprises	70.1	69.3	63.7	62.4	61.7	60.7	60.7	60.4	59.3
Small business and Microbusiness	18.0	16.6	13.0	12.4	12.6	12.3	11.7	11.5	11.2
Individuals	**27.0**	**26.8**	**23.1**	**22.1**	**21.3**	**20.8**	**20.5**	**20.2**	**19.9**
Consumer	10.7	11.1	10.5	10.2	10.0	9.7	9.6	9.5	9.3
Car loans	71.7	79.2	75.9	74.1	72.9	71.9	71.2	70.2	68.9
Credit cards	6.9	7.4	7.2	7.2	7.3	7.1	7.1	7.0	6.6
Mortgage	51.6	48.7	40.0	37.9	36.4	35.3	34.8	34.4	33.9
TOTAL	**47.1**	**46.8**	**42.4**	**41.0**	**41.3**	**40.2**	**39.5**	**38.9**	**38.1**

Moreover, the process of de-dollarization is also reflected in the annual flows of credit. In the corporate sector, the ratio of dollarization of credit flows to large and medium-sized enterprises has declined steadily (from 28.7 percent in Q3 to 5.3 percent in Q4-2014; in the segment of small and micro enterprises, there has also been a decrease in the annual flows of credit in foreign currency; in the case of consumer loans, annual credit flows and their ratios of dollarization have remained low (0.8 percent in October and 0.6 percent in November), and in the segments of mortgages and car loans, credit in foreign currency has shrunk steadily during the year.

Table 44
DOLLARIZATION OF ANNUAL FLOW OF CREDIT TO THE PRIVATE SECTOR BY TYPE

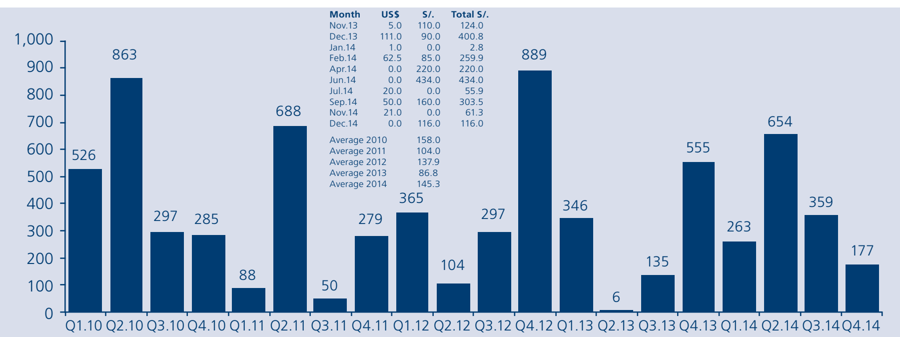
	Annual flow (million US$)						
	Dec.13	**Mar.14**	**Jun.14**	**Sep.14**	**Oct.14**	**Nov.14**	**Dec.14**
Corporate and large companies and Medium-sized enterprises							
FC	1,118	1,027	2,034	1,349	1,004	612	222
Dollarization (%)	*23.1*	*18.5*	*32.0*	*28.7*	*22.1*	*14.6*	*5.3*
Small business and Microbusiness							
FC	-373	-351	-214	-180	-207	-204	-174
Dollarization (%)	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Consumer							
FC	56	31	13	21	13	10	-9
Dollarization (%)	*4.0*	*1.9*	*0.8*	*1.4*	*0.8*	*0.6*	*n.a.*
Mortgage							
FC	-218	-328	-362	-278	-239	-211	-199
Dollarization (%)	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Car							
FC	-218	-328	-362	-278	-239	-211	-199
Dollarization (%)	*53.2*	*20.0*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
TOTAL							
FC	52	15	-4	-14	-19	-21	-21
Dollarization (%)	*7.4*	*4.3*	*15.8*	*11.8*	*7.6*	*2.9*	*n.a.*

Capital Market

99. In Q4-2014, non-financial companies issued bonds for a total of S/. 177 million in the local market, of which S/. 116 million was securities in nuevos soles. In annual terms, the average of bond issuances in 2014 is higher than the one recorded in the past three years.

Corporate bonds issued in the international market between October and December amounted to US$ 1.13 billion –US$ 1.48 billion in the previous quarter–, with coupon rates ranging between 5.88 percent and 6.00 percent and maturities ranging between 7 and 20 years.

Graph 96
BONDS ISSUED BY NON-FINANCIAL FIRMS*
(Million S/.)



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

Table 45
BONDS ISSUED IN THE INTERNATIONAL MARKET

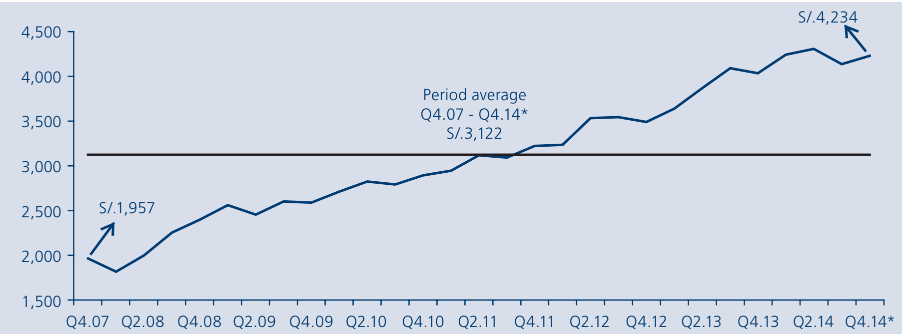
Business	Emission date	Amount (Million US$)	Maturity (Years)	Rate
Year 2013		**6,389**		
Non-financial sector		**4,153**		
Copeinca	11-jan	75	5	9.00%
Exalmar	25-jan	200	7	7.38%
Cementos Pacasmayo	01-feb	300	10	4.63%
Alicorp	15-mar	450	10	3.88%
Gas Natural de Lima y Callao - Cálidda	21-mar	320	10	4.38%
Compañía Minera Milpo	21-mar	350	10	4.63%
Corporacion Lindley	09-apr	260	10	4.63%
Ferreyrcorp	19-apr	300	7	4.88%
Transportadora de Gas del Perú	23-apr	850	15	4.25%
Consorcio Transmantaro	30-apr	450	10	4.38%
Inkia Energy	09-sep	150	8	8.38%
San Miguel Industrias	30-oct	200	7	7.75%
Andino Investment Holding	07-nov	115	7	11.00%
Planta de Reserva Fría de Generación de Eten	28-nov	133	20	7.65%
Financial sector		**2,236**		
Private financial sector		1,736		
BBVA Banco Continental	22-jan	300	4	2.31%
Banco de Crédito	25-mar	716	10	4.25%
BBVA Banco Continental	03-apr	500	5	3.25%
Banco de Crédito	05-apr	170	14	6.13%
Interbank		50	10	7.50%
Public financial sector		500		
Fondo MiVivienda	24-jan	500	10	3.50%
Year 2014		**5,510**		
Non-financial sector		**3,306**		
Compañía Minera Ares	15-jan	350	7	7.75%
Minsur	31-jan	450	10	6.25%
Abengoa Transmisión Sur	08-apr	432	29	6.88%
Camposol	24-apr	75	3	9.88%
Rutas de Lima**	27-jun	370	22	8.38%
Rutas de Lima***	27-jun	150	25	5.25%
InRetail Shopping Mall	01-jul	350	7	6.50%
InRetail Consumer	07-oct	300	7	5.25%
Unión Andina de Cementos	28-oct	625	7	5.88%
Energía Eólica	15-dec	204	20	6.00%
Financial sector		**2,204**		
Private financial sector		1,025		
Banco de Crédito	15-jan	200	13	6.13%
Interbank	11-mar	300	15	6.63%
Banco de Crédito	01-jul	225	4	2.75%
BBVA Banco Continental	15-sep	300	15	5.25%
Public financial sector		1,179		
Fondo MiVivienda	26-mar	300	5	3.38%
Fondo MiVivienda*	15-may	279	4	1.25%
COFIDE	08-jul	300	5	3.25%
COFIDE	08-jul	300	15	5.25%

* Emission in Swiss Franc.
** Emission in Nuevos Soles
*** Emission in Nuevos Soles VAC

Real Estate Market

100. In Q4-2014, the price of property per square meter in ten districts of Lima Metropolitana (La Molina, Miraflores, San Borja, San Isidro, Surco, Jesús María, Lince, Magdalena, Pueblo Libre, and San Miguel) in constant soles increased 2.2 percent compared with the previous quarter. The graph below shows the evolution of the median of quarterly sale prices of departments per square meter at 2009 constant soles.

Graph 97
MEDIANS OF QUARTERLY SALE PRICES IN SOLES PER SQUARE METER OF APARTMENTS
(Base 2009 = 100)



* Preliminary.

The price-to-earnings ratio (PER), indicator reflecting the number of years a property would have to be rented to recover its acquisition value, has showed a stable trend in recent years and remains within the normal range, according to the criteria considered by Global Property Guide[7].

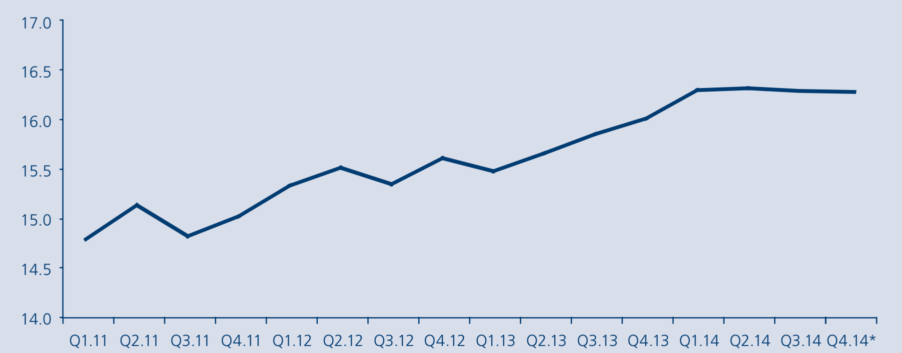
Table 46
PER: PRICE TO EARNING RATIO[1/]

	Q4.12	Q1.13	Q2.13	Q3.13	Q4.13	Q1.14	Q2.14	Q3.14	Q4.14*
Jesús María	14.9	15.0	15.6	15.7	16.2	16.9	16.0	15.5	15.0
La Molina	11.6	13.7	14.7	15.5	16.4	17.2	16.9	16.2	16.4
Lince	16.4	14.1	14.6	15.4	15.5	16.2	15.2	15.2	14.9
Magdalena	16.0	14.0	14.5	15.1	15.0	15.0	15.0	15.3	15.1
Miraflores	15.0	14.8	16.5	16.3	15.9	16.8	17.4	15.8	15.5
Pueblo Libre	16.0	14.1	14.3	15.3	16.1	16.3	16.5	15.9	16.3
San Borja	18.2	18.6	17.5	17.1	16.7	17.2	17.9	18.8	19.1
San Isidro	18.4	18.0	17.2	17.3	17.7	17.8	18.2	17.5	17.8
San Miguel	15.6	14.4	14.8	14.7	15.0	15.5	14.7	15.0	15.4
Surco	15.0	16.8	16.3	16.5	16.6	17.0	17.6	18.5	17.1
Aggregated Average	15.7	15.3	15.6	15.9	16.1	16.6	16.5	16.4	16.2

* Preliminary.
1/ Rates have been calculated using the sale price median and rent of each district.
Source: BCRP.

7 Global Property Guide ranks the real estate market following the PER index as Undervalued (5.0-12.5), Normal (12.5-25.0) and Overvalued (25.0-50.0).

Graph 98
PER: PRICE TO EARNING RATIO



* Preliminary.

Box 4

NEW INSTRUMENTS USED BY THE BCRP TO INJECT LIQUIDITY IN SOLES

In order to speed up the process of dedollarization of credit in Peru, the Central Bank has established a series of measures, among which is the modification of additional reserve requirements according to the evolution of credit as of June this year.

In a context of the slowdown observed in deposits in national currency, a further expansion of credit in soles, associated with economic recovery and with substituting credit in foreign currency by credit in domestic currency, might unduly generate pressures on monetary conditions in soles raising interest rates.

Therefore, adequate funding sources are required to be provided to accompany the dedollarization policy driven by the BCRP. With this aim, the Central Bank has established the following currency repos schemes to gradually inject liquidity in soles as from 2015:

a. **Repos for credit-expansion:** This instrument has been designed to support the growth of credit in domestic currency. Financial institutions requiring sources of liquidity in soles to boost lending in this currency can make repurchase agreements –or currency repos– with the Central Bank using part of their reserve requirements in foreign currency, which would held at the Central Bank as a restricted deposit until the maturity of the repo operation. Financial institutions can reduce their reserve requirement in foreign currencies for up to an amount equivalent to 10 percent of their total liabilities subject to reserve requirements in foreign currency.

To illustrate how this mechanism works, we simulate a scenario in which financial institutions withdraw reserve requirements for a total of US$ 100 million to finance an expansion of credit in soles. This amount of reserves becomes a restricted deposit at the Central Bank and financial institutions receive in exchange liquidity in local currency as a repurchase agreement. In this way, the foreign exchange position of financial institutions is not affected since they do not sell dollars, but only have them deposited as a collateral at the Central Bank. Likewise, neither the foreign exchange position of the BCRP nor its level of international reserves is affected since the Central Bank does not have to sell dollars in the spot market.

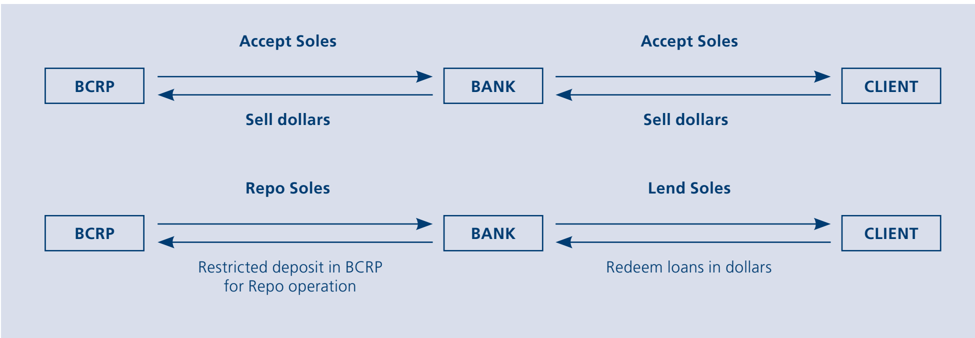
SCHEME OF REPOS FOR CREDIT EXPANSION

BANKS			
Reserve requirement in FC (Mill. US$)	-100	Currency Repo (Mill S/.)	+300
Restricted deposit in BCRP (Mill. US$)	+100		
Current account in DC (Mill. S/.)	+300		
Accounting exchange position (Mill US$)	0		
CENTRAL BANK			
Currency Repo (Mill S/.)	+300	Reserve requirement in FC (Mill. US$)	-100
		Restricted deposit in BCRP (Mill. US$)	+100
Exchange position (Mill US$)	0	Current account in DC (Mill. S/.)	+300

This facility could generate up to S/. 9 billion as funding sources for the expansion of credit in soles.

Banks will require to use less this facility to match the expansion of credit as soon as credit in soles starts generating a greater growth of deposits in soles.

b. **Repos for credit substitution**: The purpose of this instrument is to support the conversion of loans in foreign currency into loans in domestic currency. Financial institutions that convert their loans in foreign currency into loans in domestic currency will have access to two simultaneous operations, a sale of dollars from the Central Bank, and a currency repo, which will allow banks to obtain long-term liquidity in domestic currency using their dollar deposits at the Central Bank as collateral. As a result, the client will now have a loan in soles, the bank will maintain the same amount of assets in dollars –this time as a restricted deposit at the Central Bank replacing the credit originally agreed in dollars– and the Central Bank reduces its foreign exchange position but not its international reserves position.



To illustrate the implementation of this mechanism, we simulate a scenario in which credit in domestic currency increases by S/. 300 million replacing credit in foreign currency, while the latter shrinks by US$ 100 million. As we can see, banks' accounting exchange position does not change as a result of the dedollarization of credit to the private sector, while the exchange position of the Central Bank decreases.

SCHEME OF REPO FOR CREDIT SUBSTITUTION

BANKS			
ASSET		**LIABILITY**	
Credit in DC (Mill. S/.)	+300	Currency Repo (Mill S/.)	+300
Credit in FC (Mill. US$)	-100		
Restricted deposit in BCRP (Mill. US$)	+100		
Accounting exchange position (Mill US$)	0		
CENTRAL BANK			
ASSET		**LIABILITY**	
Currency Repo (Mill S/.)	+300	Restricted deposit in BCRP (Mill. US$)	+100
Exchange position (Mill US$)	-100		
Sale of foreign currency (Mill US$)	+100		

The BCRP aims to adequately finance the process of dedollarization of credit with these new liquidity facilities, accompanying these measures with the new reserve requirements measures to be applied as from June this year.

Box 5

RECENT ACTIONS TAKEN BY THE BCRP TO ACCELERATE THE DEDOLLARIZATION OF CREDIT

The dollarization of credit has declined significantly in recent years (from 46 percent at end-2010 to 37.4 percent at end-2014). Most of this decline of 8.6 percent has taken place in the last two years. Despite this, the ratio of dollarization is still high in some market segments, which implies risk and a potential vulnerability for the economy in the event that a sharp depreciation of the nuevo sol were to occur in the following months.

DOLLARIZATION BY TYPE OF CREDIT
(%)

		Nov.14
Total		**37.4%**
A.	**Businesses**	**47.6%**
	Corporate	57.1%
	Large companies	61.1%
	Medium-sized enterprises	58.9%
	Small business	13.0%
	Microbusiness	5.2%
B.	**Individuals**	**19.3%**
	Consumer	9.0%
	Car loans	68.9%
	Mortgage	33.0%

The measures taken by the BCRP seek to foster the dedollarization of credit by aligning the incentives of financial institutions. Even though financial institutions seek to reduce their exposure to credit risk by demanding additional guarantees from their clients, banks are not fully aware of the second-round effects that a sharp depreciation might cause in other companies related to the bank's borrowers. Thus, even if a company is not very exposed to foreign exchange credit risk on an individual basis, the weakening effect of the exposure to foreign exchange credit risk on the balances of other companies (customers, suppliers, competitors, etc.) enhances the negative effect associated with currency mismatches.

Thus, in order to reduce the economy's vulnerability to a volatile international context and contribute to consolidate the process of dedollarization of credit, the BCRP has established additional reserve requirements in foreign currency.

One of the additional reserve requirements measures is based on the reduction of the balance of total credit in foreign currency (excluding foreign trade operations as well as operations with longer terms than 4 years and with amounts of over US$ 10 million). As from June 2015, the financial institutions that fail to reduce their loans in foreign currency by at least 5 percent of the balance they showed on September 30, 2013, will have an additional reserve requirement on their total liabilities in foreign currency (including accruals, bonds, and total liabilities subject to reserve requirements).

These additional reserve requirements on credit in dollars can be applied using two formulas:

(i). First, if the balance of credit at December 2014 is higher than the bank's effective equity, the following formula is applied:

$$\text{Additional reserve requirements} = 0{,}3 \times \left(\frac{C_t}{C_{se13}} - 0{,}95\right) \times P\ T \quad \text{(a)}$$

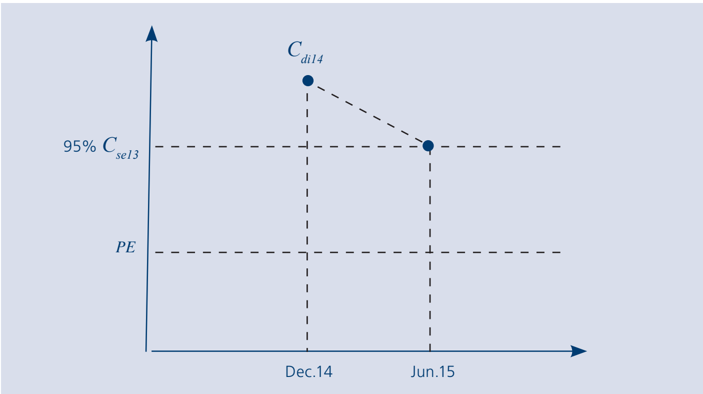
Where: C_t represents average total loans in foreign currency without including foreign trade operations carried out in the period of reserve requirements and C_{se13} is the balance of this type of credit at September 30, 2013.

(ii). Second, if the balance of this type of credit at December 2014 is lower than the bank's effective equity, the additional reserve requirements will be calculated using the following formula:

$$\text{Additional reserve requirements} = 0,3 \times \left(\frac{C_t}{P\ E} - 1 \right) \times P\ T \qquad \text{(b)}$$

The following cases can help us to understand better how these additional reserve requirements rules will apply. The graph below illustrates the case of a financial institution whose balance of loans in foreign currency at December 2014 (C_{di14}) is higher than the bank's equity on the same date. In this case, the level that total credit should reach is given by 95 percent of the bank's credit balance at September 30, 2013.

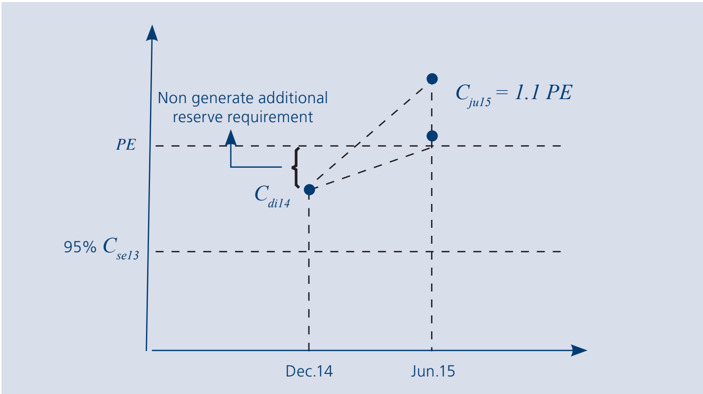
If credit does not reach this level by June 2015, additional reserve requirements will be established according to formula (a). These reserve requirements would then be equivalent to 30 percent of the gap between the bank's credit in dollars and the threshold established by the Central Bank and would apply on the bank's total liabilities in foreign currency. For example, if the gap were 5 percent, the additional reserve requirements would be 1.5 percent of total liabilities.



The graph below illustrates a case in which total credit at December 2014 is less than the bank's capital in the same period.

In this case, if such balance exceeds the regulatory capital at June 2015 (for example, if the balance was equal to 1.1 times its regulatory capital), the bank would be subject to additional reserve requirements determined using formula (b). In this way, the percentage difference between the balance of loans in foreign currency and the regulatory capital is 10 percent. The additional reserve requirements would be 30 percent of this gap (30% × 10%= 3%).

The additional reserve requirements scheme established allows banks with a small volume of loan placements in foreign currency or banks that have recently entered the market (and therefore have a rather small volume of loans in foreign currency) to expand their credit in foreign currency up to the level of their regulatory capital without being subject to additional reserve requirements.



Is worth mentioning that if a bank reduces credit in foreign currency more than required, this does not imply that a part of its reserve requirements are released, but just that additional reserve requirements do not apply.

The other measure of additional reserve requirements is associated with the reduction of car loans and mortgage loans. In this case, the limit that defines which formula will be used is 20 percent of the bank's total net worth instead of a bank's total net worth. Moreover, the percentage of credit reduction that banks are required to reach in June is 10 percent of the balance registered at February 2013. Thus:

(i). If the balance of these loans at December 2014 exceeds 20 percent of the regulatory capital at the same date, the additional reserve requirements are determined using the following formula:

$$\text{Additional reserve requirements} = 0{,}15 \times \left(\frac{CHV_t}{CHV_{fe13}} - 0{,}90\right) \times PT \qquad \text{(c)}$$

Where: CHV_t is the average of car loans and mortgage loans in foreign currency during the period of reserve requirements and CHV_{fe13} is the balance of this type of loans at February 28, 2013.

(ii). (ii) On the other hand, if the balance of these loans at December 2014 is equal to or lower than 20 percent of the regulatory capital at the same date, the additional reserve requirements is determined using the following formula:

$$\text{Additional reserve requirements} = 0{,}15 \times \left(\frac{CHV_t}{PE} - 0{,}2\right) \times PT \qquad \text{(d)}$$

As from December 2015, these two measures will be more demanding. In the case of total credit in foreign currency, the reduction will no longer be a reduction in the balance of 5 percent, but rather a reduction of 10 percent relative to the balance recorded in September 2013. On the other hand, the reduction on car loans and mortgage loans will be increased from 10 percent to 15 percent of the balance of these loans at February 2013.

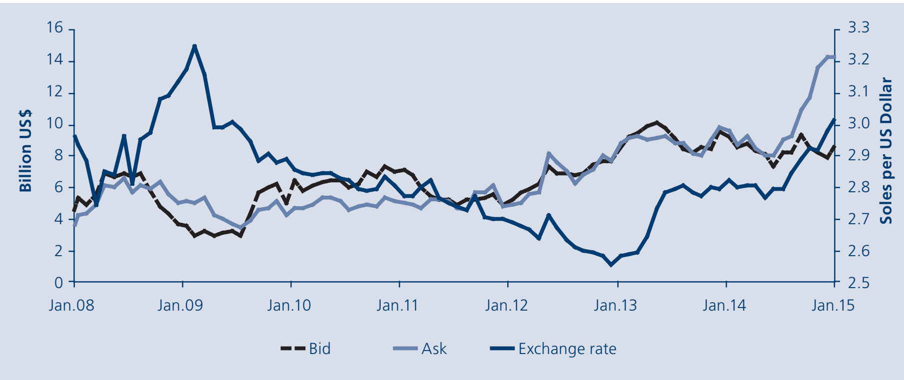
Box 6

LIMITS ON DERIVATIVES POSITIONS: INTERNATIONAL EMPIRICAL EVIDENCE

Reserve requirements on financial derivatives in foreign currency have been used recently as a macro-prudential instrument to contribute to mitigate the risks that may compromise macroeconomic and financial stability. These instruments have been used all over the world after the international financial crisis of 2008 with the aim of reducing speculation against the value of a domestic currency, given that this magnifies the volatility of the exchange rate even though such volatility is not linked to an economic fundamental. The experiences of some countries in using reserve requirements on financial derivatives in foreign currency as a prudential measure is discussed below.

In Peru, the BCRP has recently established reserve requirements on derivatives in foreign currency to prevent that overreactions in the FX market affect the exchange rate in excess. The graph below shows that the balance of forward sales in foreign currency has been growing well above the balance of forward purchases since May 2014, generating pressures in the foreign exchange market.

BALANCE OF BID-ASK FORWARD AND SWAP TO PUBLIC



International experiences

South Korea was one of the pioneer countries in using this type of macro-prudential policies. During the period prior to the Lehman Brothers crisis, the won appreciated steadily, but the unfolding of the crisis brought about a sharp depreciation. Companies with derivatives that expected the won to appreciate were forced to turn to the spot market, increasing upward pressures on the exchange rate. It is estimated that around 520 small and medium-sized companies that bought options lost US$ 2 billion and fell into insolvency in this period. This event revealed the vulnerability of the South Korean banking system generated by over-exposure to short-term debt and derivative instruments in foreign currency. The table below shows the regulatory policies of financial prudence that South Korea began to use in November 2009.

SOUTH KOREA: WON - USD EXCHANGE RATE AND FINANCIAL REGULATION MEASURES

FINANCIAL REGULATION MEASURES BY COUNTRIES

Country	Year	Main measures
South Korea	2009-2012	• Higher foreign currency liquidity standards to reduce the maturity mismatch of banks' foreign currency assets and liabilities and to improve the quality of their liquid assets. • A 125 percent cap (relative to underlying export revenues) on forward foreign exchange contracts between banks and exporters. • A ceiling on resident banks' FX derivatives contracts of no more than 50 percent and for foreign bank branches of no more than 250 percent of their capital in the previous month. • A limit on banks allowing them to provide only 100 percent of underlying transactions for forward contracts with exporters (previously 125 percent). • A stipulation that resident banks' FX loans and held-to-maturity securities (equal to or more than one-year maturity) must be covered by at least 100 percent of FX borrowing with maturity of more than one year. • Reintroduction of a 14 percent withholding tax on nonresidents' purchases of treasury and monetary stabilization bonds, bringing the tax back in line with the tax on the residents' bond purchases. Foreign corporations and nonresidents are subject to the withholding tax, but those based in countries that have double taxation treaties with Korea and official investors are exempt. • Levy on FX liabilities • Limits on bank´s FX derivatives tightened
Brazil	2009-2011	• Financial transaction tax (IOF) on non-resident equity and fixed income portfolio inflows. • IOF on margin requirements on FX derivatives transactions. • Non-interest reserve requirement equivalent to 60 percent of bank's short dollar positions in the FX spot market that exceed US$ 3 billion or their capital base, whichever is smaller. • Increase of the IOF on new foreign loans (banking loans and securities issued abroad) with maturities of up to a year. • Excessive long positions on BRL of all agents pay a financial tax of 1 percent.
Israel	2011	• Rate of 10 percent of reserve requirements was established for foreign currency transactions made by non-residents. • Foreign exchange derivatives transactions made by residents and non-residents were required to be reported. • Trades of BCI bonds made by non-residents had to be reported.

Source: Prates and Fritz (2013).

Brazil began implementing a program of macro-prudential measures in October 2009 to halt the appreciation of the exchange rate. Although the main cause was the financial crisis of 2008, there were also some domestic factors associated with economic growth and high interest rates in the country that generated strong capital inflows and consequently appreciatory pressures on the real.

The initial regulation focused on margin requirements for operations with derivatives in foreign currency but this measure was insufficient to halt the appreciatory trend of the real, because private agents eluded these measures through carry trade operations of derivatives.[8] A tax was then applied to financial operations (TFO) on portfolio investment, but this encouraged more the accumulation of long positions in reales/short positions in dollars in the local market of derivatives. In addition, a new non-interest bearing type of reserve requirements was imposed and a TFO was established on short-term external borrowing because banks and companies circumvented the regulations on short-term external debt. The TFO was then immediately extended to the long-term loans that agents made in a context of excess liquidity and reach for yield in international financial markets.

BRAZIL: REAL - USD EXCHANGE RATE AND FINANCIAL REGULATION MEASURES

As pointed out above, it was the establishment of several regulations on FX derivatives and a financial tax on the excess long position of the Brazilian real in the market of FX derivatives that allowed to protect the financial system against the reversal trend in the exchange rate and the sharp depreciation observed at the end of 2011 (see graph above).

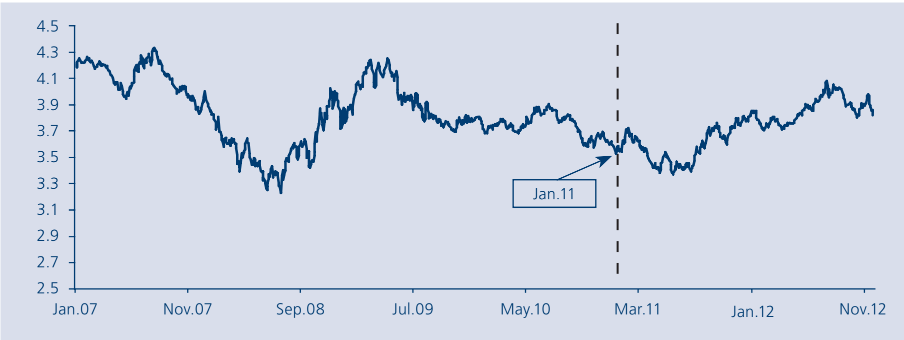
Israel. The financial crisis brought about a spread of interest rates which stimulated international capital flows to the emerging markets. An indicator of this is the proportion of bonds of the Central Bank of Israel (CBI) held by foreign investors relative to the total number of CBI bonds, which increased from 1 percent prior to the global financial crisis to 34 percent in January 2011. On the other hand, non-residents' transactions in foreign currency derivatives increased significantly, mainly due to higher purchases of short-term instruments. All of this generated concerns in the CBI about the possible loss of ability to maintain financial stability as a result of exchange rate pressures that could be generated in a country open to capital flows and with financial institutions exposed to foreign currency

8 Fritz, B. & D. Prates, (2013). "Beyond capital controls: the regulation of foreign currency derivatives markets in South Korea and Brazil after the global financial crisis," Competence Centre on Money, Trade, Finance and Development 1307, Hochschule fuer Technik und Wirtschaft, Berlin.

risks. The significant growth of short-term capital inflows and the consequent appreciation of the real exchange rate led the CBI to implement the following macro-prudential measures in January 2011: (i) a rate of 10 percent of reserve requirements was established for foreign currency transactions made by non-residents, (ii) foreign exchange derivatives transactions made by residents and non-residents were required to be reported, and (iii) trades of BCI bonds made by non-residents had to be reported.

With these measures, CBI sought to discourage short-term capital inflows. After they were implemented, capital inflows slowed down considerably.

ISRAEL: NIS - USD EXCHANGE RATE AND FINANCIAL REGULATION MEASURES



In October 2014, the CBI decided to suspend reserve requirements on FX operations with non-residents due to the low level of the CBI interest rate which implied a low effective cost of reserve requirements. In addition, with Basel III provisions for liquidity, withdrawing reserve requirements to these operations would avoid duplicating required reserves early in 2015 and generate a greater availability of liquid assets for the banking system.

Empirical evidence

Several studies have been carried out to assess the effects of reserve requirements to financial foreign exchange derivatives on foreign exchange distortions and foreign exchange volatility.

Baumann and Gallagher (2013) found that the effects of the measures implemented in South Korea are significant,[9] one of the major effects being a reduction in the volatility of the exchange rate. On the other hand, Bruno and Shin (2013) study the impact of limits to derivatives positions, established in South Korea in June 2010.[10] These authors found that the sensitivity of capital flows to Korea to global banking liquidity conditions declined sharply after the implementation of these above measures.

9 Baumann, B. & K. Gallagher, (2013). "Post-Crisis Capital Account Regulation in South Korea and South Africa," WP 320, Political Economy Research Institute, University of Massachusetts at Amherst.

10 Bruno, V., & Shin, H. S. (2013). Assessing Macro prudential Policies: Case of Korea (N°.19084). NBER.

Chamon, M., and Garcia, M. (2013) analyzed the impact of the prudential measures adopted in Brazil since 2009[11] and found that these measures were effective. Although it is difficult to isolate the effects, there was a drop in liquidity in foreign currency (through the FX exchange coupon) and an increase in the ADR spread, which measures the spread between the price of a stock listed in both the local stock exchange and the American stock exchange markets. These restrictions contributed to establish a partial segmentation of the domestic financial market vis-à-vis the international market. The authors also found that these prudential measures have also contributed to prevent financial bubbles.

Del Giudice Rodríguez, M. & Wu, T. (2013) studied the effectiveness of prudential foreign exchange (FX) measures on exchange rate stability,[12] estimating a panel data model for the period 2009-2011. The authors found that reinforcing prudential measures on non-residents eliminates daily exchange rate fluctuations at the expense of increasing the probability of a monetary crisis, and, on the other hand, that softening prudential measures on residents actually improves the exchange rate stability associated with the distribution of the future exchange rates expected which are less volatile and more symmetrical with thinner tails.

11 Chamon, Marcos, and Marcio Garcia. "Capital controls in Brazil: effective?" PUC Río, Departamento de Economía, (2013).

12 Del Giudice Rodriguez, M., & Wu, T. (2013)."The Effect of Capital Controls and Prudential FX Measures on Options -Implied Exchange Rate Stability" (N°. 2013-20). Federal Reserve Bank of San Francisco.

Box 7

ESTIMATION OF THE EQUILIBRIUM REAL EXCHANGE RATE

The multilateral real exchange rate (MRER) is an important relative price that measures the cost of a representative basket of goods of our trading partners and compares it with the cost of a similar basket of goods in the domestic economy. Thus, if the MRER registers an increase/decrease, the basket of foreign goods becomes relatively more expensive/cheaper than the basket of domestic goods, which would be reflecting lower production costs in the domestic economy and, therefore, greater competitiveness of our local producers vis-à-vis their external competitors.

This relative price can temporarily divert from its long-term equilibrium level (ERER) due to various reasons. One of them is the cyclical position of the economy relative to that of our trading partners', or transitory changes in domestic productivity versus the productivity level of our trading partners. In the former case, if the economy is growing at a higher rate than its trading partners, the MRER declines and is temporarily below its equilibrium level. This level of equilibrium is a non-observable variable that varies according to the evolution of its fundamentals. The fundamental determinants of the ERER for Peru and its recent trends are discussed in this box.

Driver and Westaway (2005) review various methods used to approach the equilibrium level of the MRER. The analysis used herein is based on estimates obtained using the Behavioural Effective Exchange Rate methodology (BEER), which seeks to correlate the MRER and widely studied theoretical foundations through a cointegration exercise, which is a standard econometric methodology developed from the seminal work of Johansen and Juselius (1988).

Fundamentals of the Real Exchange Rate

There is some consensus in the literature on the fundamental variables of the MRER based on different theoretical models (see Caputo et al. (2007) for various references on this matter). Five fundamentals of the MRER for Peru are considered in this article: relative productivity, net external liabilities, terms of trade, trade liberalization, and public spending.

- **Relative productivity:** An improvement in domestic productivity relative to the productivity level of our trading partners would lead to an increase in the demand for labor and, thus, to higher real wages. In turn, the higher wages would lead to an increase in the demand for local goods that would increase domestic prices and result in a real appreciation of the local currency.

- **Net external liabilities:** The effect of this fundamental is ambiguous. First, an increase in net foreign liabilities would result from inflows of external capital which would imply higher payments to other countries in the future. Therefore, in order not to compromise the sustainability of the balance of payments, it is necessary to generate a trade surplus, which requires a real depreciation. Second, a capital inflow could be associated with an increase in future productivity and, therefore, with a real appreciation.

- **Terms of trade:** In a primary export-oriented economy, an increase in the terms of trade translates into higher incomes that tend to increase aggregate demand. This pushes up the price of domestic goods and, given the external prices, there is a real appreciation.

- **Trade liberalization:** the effect of this fundamental is also ambiguous. First, an increase of trade liberalization resulting from a tariffs reduction generates an increase in the demand for importable goods and hence pushes prices upwards. Since the prices of these goods are determined in external markets, there would be a real depreciation. Second, the import-price elasticity may be low, in which case there would be a positive income effect that would increase demand for domestic goods that would induce a real appreciation.

- **Public spending:** The public sector purchases are typically oriented to goods produced in the country. Thus, a fiscal expansion would generate demand pressures for these goods, increase their price, and tend to appreciate the currency.

Recent Trend of the Equilibrium Real Exchange Rate

Given the uncertainty characterizing econometric estimations to measure the average impact of fundamentals in the ERER –included in the table below–, we estimate several specifications of the ERER model to make these estimations more robust.

ESTIMATION OF AVERAGE ELASTICITY[1/]

Determinants	Elasticity[2/]
Net external liabilities / GDP	-0.04
Terms of trade	-0.09
Trade liberalization [3/]	-0.04
Ratio public spending / GDP	-0.08
Relative productivity / partners [4/]	-0.63

1/ Average elasticity in a lot of possible estimations.
2/ Elasticity indicates a percentage that would increase (depreciation) or reduce (appreciation) the equilibrium real exchange rate if there is an increase of 1% in one determinant.
3/ Trade liberalization: An increase of trade liberalization would be a tariff reduction.
4/ Relativity productivity Peru / Partners: Ratio GDP per capita in Peru between trading partners.

The results of this estimation show that **relative productivity** is the fundamental that has greater impact on the MRER. The **terms of trade** are also important, but their impact is relatively lower. The estimation results also show that the real exchange rate was below its equilibrium level in 2012, but that it has increased and converged towards its equilibrium level since 2013. Moreover, the estimate for 2014 shows that the MRER is within the confidence bands in the estimations made.

VI. Inflation

Report to December 2014

101. In 2014 the consumer price index (CPI) for Metropolitan Lima showed a variation of 3.22 percent. The rate of inflation reflected mainly rises in the prices of food products and electricity rates, the component of food and energy increasing by 4.08 percent. Inflation without food and energy –that is, the rate of inflation isolating the impact of these goods with high price volatility– showed a rate of 2.51 percent.

Graph 99
INFLATION AND INFLATION TARGET
(Last 12 month % change)

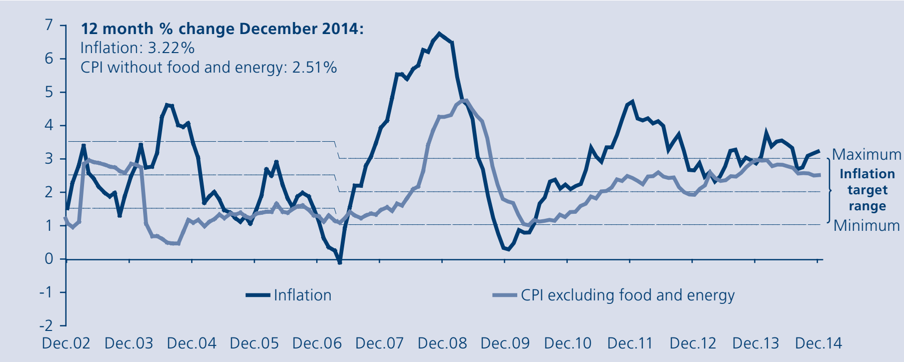


Table 47
INFLATION
(% change)

	Weight	2007	2008	2009	2010	2011	2012	2013	2014 December	2014 Year
CPI	**100.0**	**3.93**	**6.65**	**0.25**	**2.08**	**4.74**	**2.65**	**2.86**	**0.23**	**3.22**
1. CPI without food and energy	**56.4**	**1.49**	**4.25**	**1.71**	**1.38**	**2.42**	**1.91**	**2.97**	**0.49**	**2.51**
a. Goods	21.7	1.79	3.21	2.31	1.07	2.37	1.60	2.62	0.23	2.43
b. Services	34.8	1.33	4.97	1.24	1.58	2.45	2.10	3.18	0.66	2.55
2. Food and energy	**43.6**	**5.91**	**8.58**	**-0.86**	**2.98**	**7.70**	**3.55**	**2.73**	**-0.08**	**4.08**
a. Food and beverages	37.8	6.02	9.70	0.57	2.41	7.97	4.06	2.24	0.32	4.83
b. Fuel and electricity	5.7	5.21	1.65	-10.40	6.80	6.01	0.22	6.09	-2.81	-0.85
Fuel	2.8	6.45	-0.04	-12.66	12.21	7.54	-1.48	5.95	-5.46	-5.59
Electricity	2.9	1.92	6.31	-4.56	1.36	4.30	2.19	6.23	-0.02	4.37

Table 48
INFLATION
(Weighted contribution)

	Weight	2007	2008	2009	2010	2011	2012	2013	2014	
									December	Year
CPI	**100.0**	**3.93**	**6.65**	**0.25**	**2.08**	**4.74**	**2.65**	**2.86**	**0.23**	**3.22**
1. CPI without food and energy	**56.4**	**0.67**	**1.88**	**0.74**	**0.78**	**1.36**	**1.05**	**1.62**	**0.27**	**1.37**
a. Goods	21.7	0.35	0.62	0.43	0.23	0.51	0.34	0.54	0.05	0.50
b. Services	34.8	0.34	1.24	0.30	0.55	0.85	0.71	1.08	0.22	0.87
2. Food and energy	**43.6**	**3.24**	**4.80**	**-0.49**	**1.30**	**3.38**	**1.60**	**1.24**	**-0.04**	**1.86**
a. Food and beverages	37.8	2.84	4.67	0.28	0.91	3.03	1.59	0.89	0.13	1.91
b. Fuel and electricity	5.7	0.40	0.13	-0.77	0.38	0.35	0.01	0.35	-0.17	-0.05
Fuel	2.8	0.36	0.00	-0.68	0.34	0.23	-0.05	0.18	-0.17	-0.18
Electricity	2.9	0.04	0.13	-0.09	0.04	0.12	0.06	0.17	0.00	0.12,

102. The items that contributed more to increase inflation were meals outside the home, education costs, chicken meat, urban fares, and electricity rates.

Table 49
ITEM WITH THE HIGHEST WEIGHTED CONTRIBUTION TO INFLATION: 2014

Positive	Weight	% Chg.	Contribution	Negative	Weight	% Chg.	Contribution
Meals outside the home	11.7	4.7	0.60	Gasoline and lubricants	1.3	-12.5	-0.20
Education costs (tuition and fees)	8.8	4.6	0.43	Potato	0.9	-4.0	-0.04
Poultry meat	3.0	8.7	0.25	Tomato	0.2	-15.0	-0.03
Urban fare	8.5	2.3	0.20	Telephone rates	2.9	-1.0	-0.02
Electricity rates	2.9	4.4	0.12	Internet services and other	0.8	-2.2	-0.02
Purchases of vehicles	1.6	7.3	0.11	Soft-drink	0.2	-5.6	-0.01
Citric fruits	0.5	13.0	0.09	Sweet potato	0.1	-10.1	-0.01
Toiletries	4.9	1.8	0.09	Oil	0.5	-1.0	-0.01
Onion	0.4	34.1	0.08	Other cereal	0.1	-6.3	-0.01
Eggs	0.6	14.1	0.07	Various insurances	0.3	-0.6	0.00
Total			**2.04**	**Total**			**-0.35**

103. During 2014 the supply of food products and expectations about the prices of these goods were affected by climate anomalies that are characteristic of a mild El Niño event.

Agriculture production was negatively affected by warmer weather conditions and by a lower availability of water, which affected the normal cycle of some crops and delayed their cultivation. In the fishing sector, the arrival of mostly warm Kelvin waves throughout the year altered the availability of some sea species which in turn affected the prices of substitute products such as chicken meat and eggs.

The item with the highest weighed contribution to inflation was **meals outside the home** (4.7 percent), which accounted for 0.6 percentage points of inflation.

The percentage change in the year was similar to that of food and beverages consumed in the household (4.9 percent).

The price of **chicken meat** increased 8.7 percent due to the rising prices of imported yellow maize, the main component of production costs. The price of this input in nuevos soles increased approximately 25 percent since December 2013. Another factor that contributed to the rise in the price of chicken meat was the irregular supply of fish –the main substitute of poultry– since fishing was affected by varying weather conditions and anomalous waves. This rising trend in the price of poultry was observed in a context of greater supply of chicken meat since the placement of baby chickens during 2014 increased 4 percent relative to the previous year.

The price of **citrus fruits** increased 13.0 percent on average, recording peaks in the months of October (21.4 percent) and November (13.1 percent). The largest rise in October was observed in the price of lemons (48.3 percent), which reflected a rise in wholesale prices (95.3 percent) as a result of the irregular supply of lemons from Piura where this crop was affected by higher temperatures. On the other hand, tangerines showed the largest price rise in November (18.6 percent) as a result of the end of the harvest season for some varieties of tangerines in the valleys of Lima.

The price of **onions** increased 34.1 percent, the highest rises being recorded in the months of March (39.2 percent) and April (34.8 percent) as a result of lower yields due to lesser rainfall in the highlands of Arequipa. The cultivation of onions in this region dropped 11 percent in the August-February crop year compared to the previous year, but the supply of onions improved since June due to the contributions of Camana and Piura's onion production. The prices of onions showed negative variations thereafter as a result of increased production in the valleys of Arequipa and Caylloma.

The price of **eggs** increased 14.1 percent, the highest rise being observed in the month of March (12.7 percent) given increased demand associated with the beginning of the school year as well as with the lower relative price of eggs in comparison to other food products with high protein contents. Between January and November, the production of eggs grew 2.2 percent compared with the same period in the previous year.

On the other hand, the decline in the price of **potatoes** (-4.0 percent) stands out among the food items that showed lower prices. The price falls observed in potatoes in the months of January (-3.0 percent) and February (-2.3 percent) were associated with increased cultivated areas in Huánuco and Lima (up 4.2 and 17.0 percent in July-November compared with the same period in 2013). Then the price increased in the following months due to lower crops in the Central areas (-6.7

percent in October-February compared to the same period of the previous year), but this situation reversed as from July due to a greater supply that came both from the Coast and from Junín and Ayacucho, where favorable climate conditions were observed (normal to warm temperatures at the end of the cultivation period). Nonetheless, the price of potatoes closed the year with an increase of 4.6 percent due to lower crops in Lima (-35.3 percent in June-October compared with the same period in the previous year) as a result of farmers' concerns that warmer weather conditions could affect the yield of this crop.

The price of **tomatoes** (-15.0 percent) was affected in the first months of the year by lower supply due to fewer cultivated areas in Lima (-10 percent in the period December-March relative to the same period in 2013). This situation improved since August when tomatoes from Ica, Arequipa, Lambayeque and La Libertad contributed to offset the insufficient supply. A recovery of the supply from the Lima valleys was observed in November due to better climate conditions as well as due to increased planted areas (up 21 percent in the period of May-September compared with the previous year).

Table 50
WEIGHTED CONTRIBUTION TO INFLATION

		2013		2014	
Item	**Weight**	**% chg.**	**Weighted cont.**	**% chg.**	**Weighted cont.**
Inflation	**100.0**	**2.9**	**2.86**	**3.2**	**3.22**
Meals inside the home	**26.1**	**0.4**	**0.23**	**5.2**	**1.30**
Of which					
Poultry meat	3.0	-3.6	-0.11	8.7	0.25
Citric fruits	0.5	10.2	0.07	13.0	0.09
Onion	0.4	-24.4	-0.08	34.1	0.08
Other fresh fruits	0.4	-1.2	-0.01	14.8	0.06
Papaya	0.2	-15.3	-0.03	35.5	0.06
Carrot	0.1	-10.5	-0.01	36.8	0.04
Pumpkin	0.1	-11.6	-0.01	25.0	0.02
Meals outside the home	**11.7**	**5.2**	**0.66**	**4.7**	**0.60**
Gasoline, urban fare, and electricity	**14.3**	**4.6**	**0.65**	**1.0**	**0.15**
Gasoline	2.8	6.0	0.18	-5.6	-0.18
Urban fare	8.5	3.5	0.30	2.3	0.20
Electricity	2.9	6.2	0.17	4.4	0.12
Associated to exchange rate	**4.5**	**6.5**	**0.25**	**4.3**	**0.18**
Purchase of vehicles	1.6	8.7	0.12	7.3	0.11
House rent	2.4	3.5	0.07	2.6	0.06
Airplane fare	0.4	15.4	0.05	2.2	0.01
Tour	0.0	7.1	0.00	8.8	0.00
Education	**9.9**	**4.6**	**0.47**	**4.3**	**0.44**
Education costs (tuition and fees)	8.8	4.9	0.45	4.6	0.43
Teaching in various areas	0.3	0.0	0.00	0.0	0.00
Books and school books	0.7	2.6	0.02	1.3	0.01
Rest	**33.5**	**1.9**	**0.60**	**1.7**	**0.55**

104. **Education costs –tuition and fees–** increased by 4.6 percent, due mainly to the adjustment carried out in the month of March (3.8 percent), at the beginning of the school year. Other rises were recorded in the tuition fees of universities and higher education institutes.

Urban fares increased 2.3 percent, the rises in colectivo and taxi fares standing out (13.7 percent and 4.7 percent, respectively) due mainly to the seasonal rise registered in December.

Electricity rates rose 4.4 percent. The rises recorded in February (5.1 percent) and April (2.2 percent) were associated with the incorporation of new transmission lines, as well as with the update of generation costs. The price adjustment carried out in October reflected mainly the update of electricity generation and distribution costs. The variation in the prices of the following components relative to September was considered by Osinergmin to make the adjustment in October: exchange rate (1.7 percent), the wholesale price index (0.3 percent), and the price of aluminum (0.9 percent).

The prices of **cars** showed an increase of 7.3 percent, affected by the exchange rate (6.4 percent). In 2013, the prices of cars increased 8.7 percent, while the nuevo sol showed a depreciation of 8.5 percent.

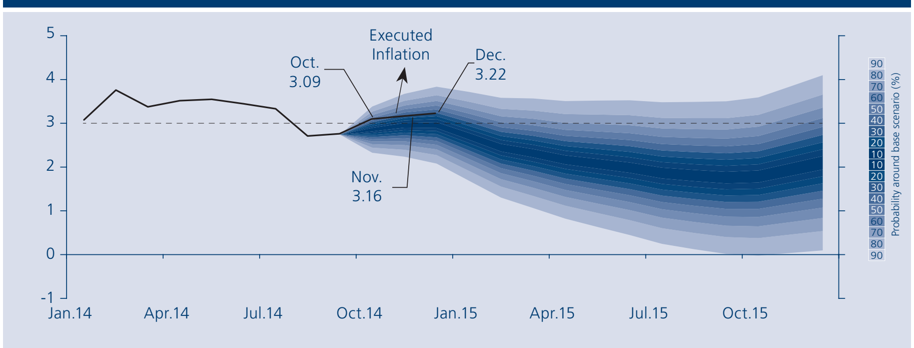
The price of **gasoline** dropped 12.5 percent, reflecting the decline in the prices of refineries to sellers (-18 percent) and the decline in the price of WTI oil (36.6 percent in the last three months and 39.6 percent in 2014).

VII. Monetary Policy and Inflation Forecast

105. The BCRP monetary policy actions are based on forecasts of inflation and inflation determinants prepared using the macroeconomic information available at the time a policy action is decided. These forecast also include a confidence interval, which quantifies the degree of uncertainty associated with each of them. On the other hand, indicators standing out as inflation determinants include the evolution of inflation expectations, imported inflation, and demand inflationary pressures, all of which are quantified through the concept of the output gap. It is worth mentioning that the output gap is the difference between GDP and GDP's potential level. Because this indicator anticipates the evolution of demand-pull inflation, the output gap is an indicator that allows the BCRP to adjust its monetary policy stance on a timely basis. Thus, when GDP falls below its potential value, the output gap shows a negative value, which suggests that it is quite likely to ease the monetary policy stance.

106. The inflation forecast for 2014 in our Inflation Report (IR) of October was that inflation would show an annual rate of 3.0 percent, which was lower than the actual rate of 3.2 percent recorded in the year. This difference is explained by a higher imported inflation resulting from a greater-than-expected nominal depreciation, which was in part offset by a more negative output gap and by lower external prices than the ones forecast, especially in the case of oil.

Graph 100
INFLATION EXECUTED AND FORECAST IR OCT.14
(12 month % change)



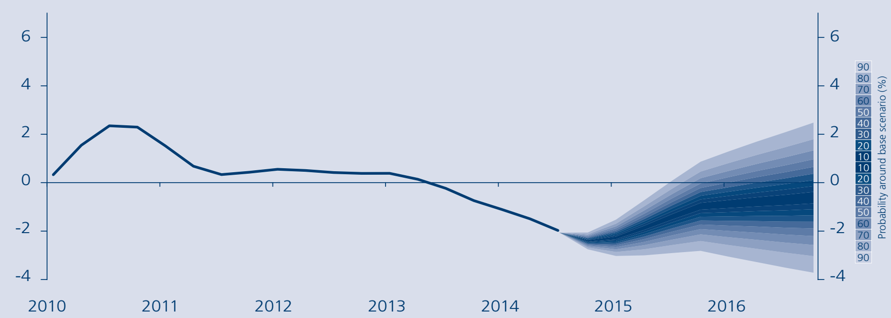
107. In 2015 and 2016 annual inflation is expected to show a rate around 2.0 percent. This decline in inflation would be associated with expectations of lower inflation,

a moderate imported inflation –in which the pass-through effect of the exchange rate would be offset by lower fuel prices–, and by a gradual recovery in the output gap.

Some aspects of these determinants of the inflation forecast are discussed below:

- The **output gap** has remained negative in 2014 and is expected to recover gradually, although at a slower pace than the one considered in the IR of October due to the effect of lower terms of trade. Thus, based on the new information available at December 2014, the output gap in Q4 is estimated to range between -2.6 and -2.2 percent, with a confidence interval of 70 percent (vs. a range between -2.5 and -1.6 percent estimated in the IR of October). The effect of less expansionary monetary conditions has also been considered. The factors that will have a positive impact on the output gap during 2015 include expansionary monetary conditions in soles and a greater fiscal impulse than the one observed in 2014, both of which are expected to favor a gradual recovery in business confidence.

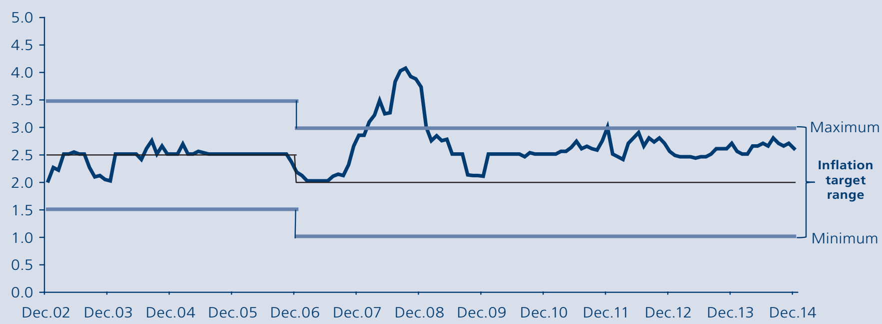
Graph 101
OUTPUT GAP: 2010 - 2016
(% potential GDP)



Memo: Each pair of bands concentrate a probability of occurrence of 10% and total bands represent a probability of occurrence of 90%. The risk scenario to the output gap forecast is in the chapter of balance of risk and are used for the inflation forecast.

- **Expectations of inflation** have been revised slightly downwards. The BCRP Survey on Macroeconomic Expectations shows that expectations are within the target range and that inflation is forecast to decline gradually to 2 percent in the 2015-2016 forecast horizon. A suitable monetary policy position contributes to maintain inflation expectations anchored within the target range.

Graph 102
EXPECTATIONS OF INFLATION FOR THE NEXT YEAR*
(%)



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

- **Imported inflation**, which reflects the evolution of import prices and the evolution of the exchange rate. The downward trend observed in the **international prices** of commodities is expected to continue, offset by the impact of the recent trend observed in the exchange rate. A higher reduction than the one foreseen in the IR of October is expected in the domestic prices of fuels.

As regards expectations about the dollar-nuevo sol exchange rate, the BCRP survey shows that all of the economic agents expect a moderate depreciation of the nuevo sol this year and next year. Financial entities have raised the depreciation level they expect at the end of 2015, increasing their estimates of the exchange rate from S/. 2.90 per dollar in October (IR of October) to S/. 3.10 per dollar at the end of December (this IR).

Table 51
SURVEY ON MACROECONOMIC EXPECTATIONS: EXCHANGE RATE
(Nuevos Soles per US$)

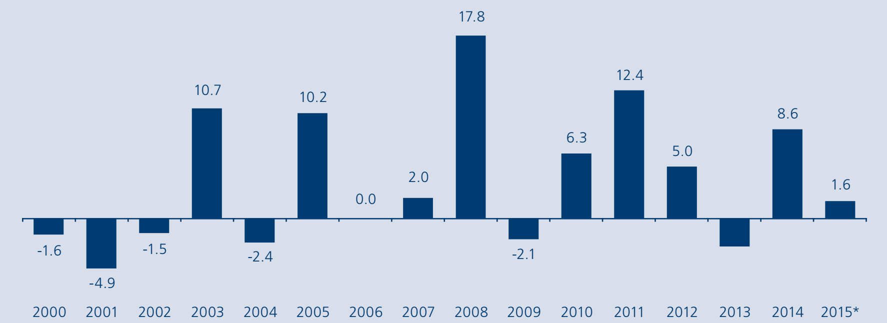
		IR Dec.13	IR Jul.14	IR Oct.14	IR Jan.15*
Financial entities					
	2014	2.79	2.83	2.89	2.98
	2015	2.83	2.88	2.90	3.10
	2016	2.85	2.90	2.95	3.15
Economic analysts					
	2014	2.79	2.84	2.90	2.98
	2015	2.87	2.88	2.95	3.10
	2016	2.90	2.90	2.95	3.15
Non-financial firms					
	2014	2.80	2.80	2.85	2.96
	2015	2.85	2.85	2.90	3.00
	2016	2.86	2.90	2.90	3.10
Average					
	2014	2.79	2.82	2.88	2.97
	2015	2.85	2.87	2.92	3.07
	2016		2.90	2.93	3.13

* Survey conducted during the second fortnight of December 2014.
IR: Inflation Report

- The **supply shocks** that affect inflation through their impact on **food and energy prices**. These prices would show an average increase of 2.0 percent in 2015, due mainly to the evolution of energy prices (-1.3 percent) –including fuel prices and electricity rates–, while food prices would increase 2.5 percent. Because no additional supply shocks are anticipated in the baseline forecast horizon, inflation is estimated to converge to the 2 percent target.

  Inflation without food and energy would show a rate of 1.9 percent. It is estimated that the prices of perishable agricultural food products would increase 1.6 percent, less than in the previous year due to the reversal of domestic shocks.

Graph 103
PRICE OF PERISHABLE FOOD PRODUCTS
(% change)



* Forecast.

108. The evolution of the **output gap** is determined by developments in external conditions, the monetary policy stance, the fiscal impulse, and by economic agents' confidence in the course of the economy. In 2014, external factors such as the decline of the terms of trade, lower growth in our trading partners, and less expansionary monetary conditions in dollars, had a negative effect on the output gap.

     A gradual reversal is foreseen in the output gap in the 2015-2016 forecast horizon. This forecast is mainly based on the following determinants:

     - **Business confidence**, which is expected to increase supported by economic recovery and by the implementation of investment projects, as well as by the reforms undertaken to increase economic efficiency.

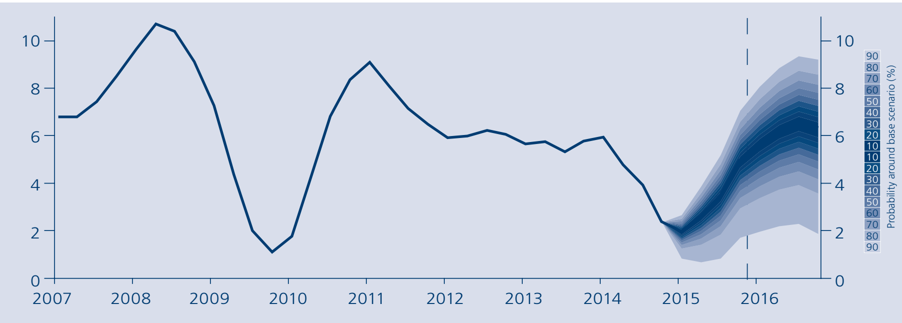
     - **External conditions**: global growth would show a recovery, driven by a greater dynamism in the economy of the United States, even though economic growth in the Eurozone and the emerging economies would be weak. Moreover, lower terms of trade than the ones foreseen in the IR of October are now considered, in line with the recent trend observed in the prices of raw materials.

- The **fiscal impulse** estimated for this year would be equivalent to 1.4 percent of GDP (vs. 0.3 percent estimated in the IR of October) due mainly to the impact of the fiscal stimulus actions approved by the government.

- **Monetary conditions**: Monetary conditions in soles are still one of the factors that have a positive contribution to the level of the output gap, and reflect the impact of the decisions taken recently by the Central Bank. On the other hand, monetary conditions in dollars are expected to show a contraction by 2015 due to the withdrawal of monetary stimulus by the U.S. Federal Reserve and the beginning of a series of anticipated rises in its monetary policy rate.

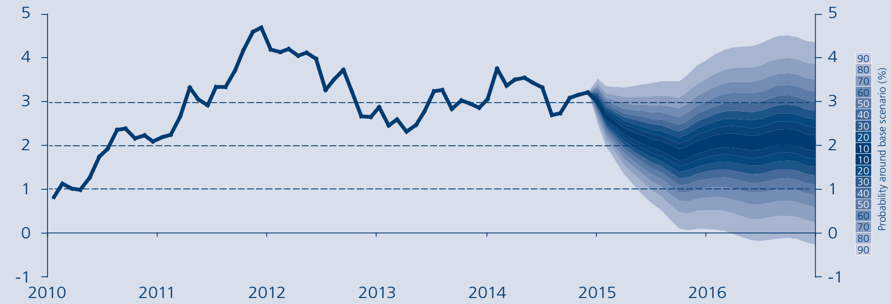
109. The growth forecast for the 2015-2016 horizon (4.8 and 6.0 percent) is consistent with a potential GDP growth rate of around 5.0 percent and with a reversal of the output gap.

Graph 104
GDP GROWTH FORECAST: 2014 - 2016
(Annual % change)



110. The risks to the inflation forecast on the upside have declined since our last inflation report was published. On the one hand, the output gap shows no inflationary pressures on the demand side and the supply factors have slowed down. On the other hand, the recent drop observed in the international prices of oil counterbalances the pass-through effect of the exchange rate on inflation. All of these factors have tilted the inflation forecast on the downside.

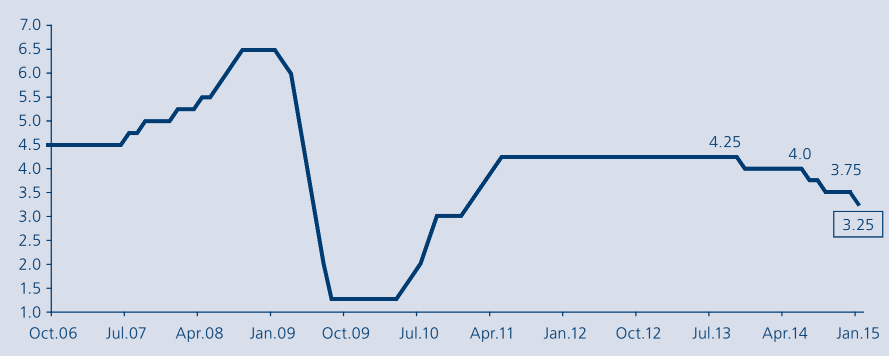
Graph 105
INFLATION FORECAST: 2014 - 2016
(Last 12 months % change)



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

111. In this context, the Board approved to lower the policy interest rate to 3.25 percent in January and emphasized that the Central Bank pays careful attention to the inflation forecast and inflation determinants to adopt additional measures to ease its monetary policy stance if required.

Graph 106
BCRP REFERENCE INTEREST RATE
(%)



VIII. Balance of Risks

112. Every GDP growth forecast and inflation forecast is subject to the occurrence of unanticipated events that may divert the forecast from the central scenario. In a context of uncertainty, the materialization of some risks may imply a different GDP growth rate or a different inflation rate than the one forecast originally.

Balance of Risks in the 2015 – 2016 horizon

113. The balance of risks for GDP growth is on the downside. In other words, the probability that the growth of GDP will divert below the forecast in the baseline scenario is estimated to be higher than the probability that it will divert above this forecast.

The scenario of domestic risks considers possible delays in investment processes, especially in mining and infrastructure projects, which could have a negative effect on private investment and, therefore, on business confidence.

On the other hand, a scenario of deflation in the Eurozone which could lead to a long recession (similar to that observed in Japan) stands out in terms of external risks. Recent signals would be indicating a slowdown of growth in the emerging economies.

114. As for the inflation forecast, the main risks that could divert the rate of inflation from the baseline scenario include greater volatility in international financial markets, lower global growth, and the occurrence of supply shocks.

a. Lower global growth

The baseline scenario considers a slower recovery in the world economy in 2015-2016 than the one estimated in our Inflation Report of October. However, if such recovery were to take even longer and if the terms of trade deteriorated even further, the expected external impulse would be lower and would translate into a higher reduction of the output gap and into lower inflation.

b. A slowdown in domestic demand

Economic recovery could take longer if the implementation of both public and private investment projects were to be postponed. This would lead to a more negative output gap and therefore to lower inflation in the forecast horizon.

c. Volatility in international financial markets

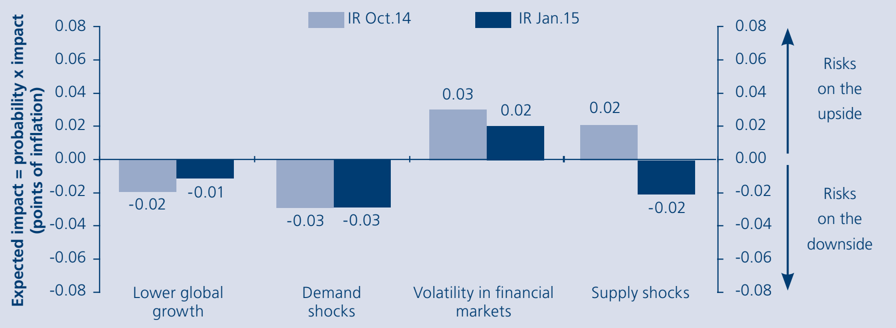
This risk could occur if the Federal Reserve's withdrawal of monetary stimulus brought about high volatility in international financial markets. In such a scenario, this could generate capital outflows from the emerging countries and generate upward pressures on the exchange rates in the emerging economies.

d. Supply shocks

The low international prices of crude oil could have a stronger downward effect on inflation if the international prices of crude do not recover in the second half of the year.

115. The balance of the risks mentioned above to the inflation forecast is tilted on the **downside**, which contrasts with the neutral balance of risks of our Inflation Report of October. This is explained mainly by increased risks of lower oil prices considered in this report.

Graph 106
BALANCE OF RISKS AGAINST THE BASE SCENARIO



Memo: The risk assessment describes how exogenous factors would affect the rate of inflation forecast for 2 years ahead 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 the medium term.
The balance of these risks is downward: The probability that inflation will be below the forecast considered in the baseline scenario is higher than the probability that inflation will be above the forecast level. So, the addition of bars is lower than zero.

Conclusions

116. The forecast is still that Inflation will continue declining in the following months and reach a rate of 2 percent in the 2015-2016 horizon, which is consistent with expectations of lower inflation, fewer supply shocks, and the gradual closing of the negative output gap in the 2015-2016 forecast horizon.

The Central Bank will continue to pay careful attention to developments in the world economy and in the domestic economy, as well as to inflation expectations. If it is necessary, the Central Bank stands ready to adjust its monetary stance to ensure that inflation remains within the inflation target range.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