CENTRAL RESERVE BANK OF PERU

INFLATION REPORT:
EVOLUTION AND PERSPECTIVES
August 2003

Contents

CENTRAL RESERVE BANK OF PERU

EXECUTIVE SUMMARY

- This Report reviews the inflation outlook for 2003-2004. The central inflation projection for this year has been revised downwards from 1.8 percent presented in the May Report to 1.5 percent. In addition, the 2004 projection was reduced from 2.1 percent to 2.0 percent.
- One of the factors explaining the lower inflation is the increased agriculture supply in the second quarter of this year, resulting from higher yields and from a shift in harvest generated by the El Niño weather oscillation at the beginning of the year. Through July, food prices had dropped 0.3 percent. Consequently, inflation forecasts were adjusted downwards for years 2003 and 2004, incorporating also the effect of slower domestic demand growth than the initially foreseen and the domestic currency's appreciation.
- Projected growth rates of domestic demand for 2003 and 2004 were revised from 4 to 3.6 percent and from 4.4 to 3.8 percent, respectively. This review is mainly linked to a lower growth of private expenditure in consumption and investment.
- We maintain our GDP growth projection of 4.0 percent for 2003 published in the May Report based on slower growth of domestic demand set off by larger net exports figures. Nonetheless, GDP figures for 2004 were revised downwards to 4.0 percent, from a previous 4.5 percent, as a consequence of a lower investment growth.
- In view of recent and expected evolution of inflation, the Central Reserve Bank of Peru (CRB) reduced its reference interest rates for rediscounts and overnight deposits in July and August, by 25 and 50 basic points, respectively. As a consequence, the interbank interest rate fell from 3.8 percent in December 2002 to 3.5 percent in July 2003 and 3.0 percent in August. Recent cuts in Central Bank reference interest rates seek to counteract the decreasing inflation trend.
- Despite a more flexible monetary policy adopted recently, the inflation rate is expected to fall in the lower portion of the inflation target range, to start rising only in the second quarter of 2004. Monetary policy decisions in the following months will emphasize the need to keep inflation within the 1.5 to 3.5 percent target range.
- The Inflation Report's forecasts are subject to certain risks that may modify the forecast on the cost of living, and in certain cases lead the CRB to adopt actions to ensure reaching the inflation targets. This Report takes into account certain risks including reduced consumer confidence implying lower domestic demand and an international economic slowdown, and on the contrary, sustained high oil prices and financial market turbulence. At the time of preparing this Report, none of these risks were considered to introduce either an upward or downward bias in the projected inflation for 2003 and 2004.

CENTRAL RESERVE BANK OF PERU

INTRODUCTION

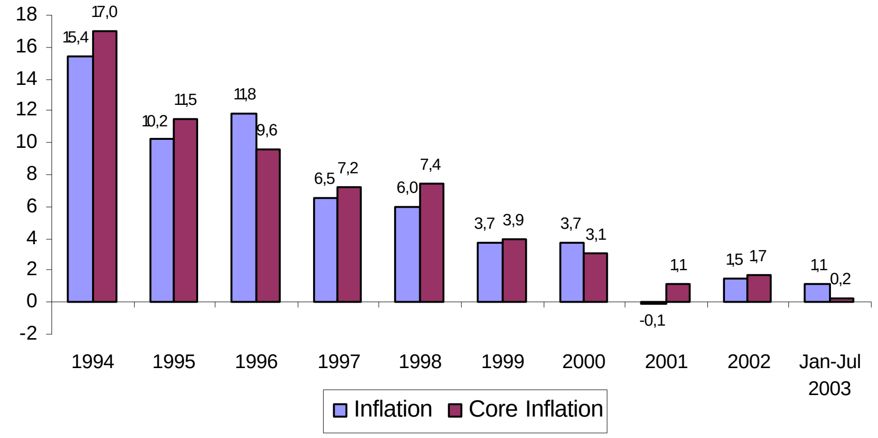
1. The Monetary policy of the Central Reserve Bank of Peru aims at keeping annual inflation at 2.5 percent with a margin of one percentage point up or down. In this way, the decisions adopted by the CRB's Board of Directors seek to simultaneously face both inflationary and deflationary pressures.
2. Monetary policy decisions are adopted and disseminated by the Central Bank's Board of Directors on the first Thursday of every month. As published in the January Inflation Report, these decisions are announced as reference interest rates for active (rediscounts and direct *repos*) and passive (overnight deposits) monetary transactions with banks. These announcements serve as a guideline for interbank interest rates. The total balance of current accounts held by banks at the CRB is published as a projection and is not therefore a policy target.
3. To inform about recent inflation developments, its outlook and its implication on monetary policy, the Central Bank has prepared the third Inflation Report for this year. This Report includes the macroeconomic forecasts for 2003-2004.
4. The first part of the Report reviews the evolution of the inflation rate and the macroeconomic variables that affected its performance so far this year. The second part of the document includes macroeconomic forecasts for 2003-2004. Finally, this Report includes a balance of the risks that may have an impact on the inflation forecasts.

I. EVOLUTION OF MACROECONOMIC VARIABLES

I.1 Inflation

5. From January to July 2003, cumulative inflation measured by the change in the Consumer Price Index (CPI) of Metropolitan Lima reached 1.1 percent, compared to 0.7 percent obtained in the same period a year ago.

GRAPH 1
INFLATION AND CORE INFLATION
(Cummulative change)



Source: National Institute of Statistics.

6. The <u>CPI's core inflation</u>—that excludes highly volatile items—rose 0.2 percent. **Goods** in the core inflation dropped 0.4 percent while **services** in this category rose 1.1 percent.

   Among goods prices, food and beverages dropped 1.4 percent mainly after the fall of rice by 3 percent, bread by 1 percent, soft drinks by 5 percent, and beer by 4 percent. Prices of electric household appliances dropped 1.8 percent linked to the Nuevo Sol's appreciation. Service rates followed the overall inflation rate evolution.

7. The CPI's non-core component includes highly volatile items because of their relationship with changes in goods supply and international price fluctuations. From January to July, non-core inflation reached 3.2 percent reflecting mainly 11 percent higher transportation rates and 5 percent higher fuel prices. Food prices and utility rates dropped 0.3 percent and 1.6 percent, respectively.

Two stages are discerned in the evolution of non-core inflation. From January to April, cumulative variation reached 5.3 percent while from May to July it dropped 2.1 percent. Developments in fuel and potato prices mainly account for these results. In addition, from May to July drops were recorded in prices for fresh and other vegetables, sugar and citrus fruits, among others. This evolution was explained by larger crops as a consequence of favorable weather and the delay of crop schedule after earlier announcements of a likely El Niño weather anomaly.

TABLE 1
INFLATION
(Percentage change)

	Weighting	2001		2002		2003
		Cummulative to July	Year	Cummulative to July	Year	Cummulative to July
I. CORE INFLATION	68,3	0,67	1,06	0,45	1,69	0,16
Goods	**41,8**	**0,20**	**0,66**	**0,10**	**1,76**	**-0,44**
Food and beverages	20,7	-1,10	-0,59	-0,92	2,07	-1,39
Textiles and footwear	7,6	1,46	1,94	0,78	1,06	0,66
Electrical appliances	1,0	1,06	-0,19	2,89	3,42	-1,78
Other industrial products	12,5	1,97	2,39	1,18	1,54	0,61
Services	**26,6**	**1,36**	**1,65**	**1,00**	**1,57**	**1,10**
Restaurants	12,0	0,87	1,29	0,45	1,28	0,72
Education	5,1	3,53	3,97	2,40	2,70	2,82
Health	1,3	2,48	3,02	1,82	3,31	0,97
Rents	2,3	0,61	-0,37	1,20	1,00	0,69
Other services	5,9	1,48	2,14	0,65	1,02	0,54
II. NON-CORE INFLATION	31,7	0,62	-2,82	1,06	1,16	3,17
Food	14,8	1,99	-1,16	0,77	-2,35	-0,30
Fuels	3,9	-2,56	-13,14	5,70	15,60	4,90
Transportation	8,4	-0,54	-0,02	-0,24	0,11	10,89
Utilities	4,6	0,99	-2,73	0,39	1,96	-1,62
III. INFLATION	100,0	0,66	-0,13	0,65	1,52	1,11

8. From January to July, the six items with the largest contribution to the inflation rate accounted for 1.5 percent points of the total rate, in particular city transport fares and potato prices. The six items making the largest negative contribution to inflation accounted for 0.5 percent points, mostly falling prices of both citrus fruits and sugar.

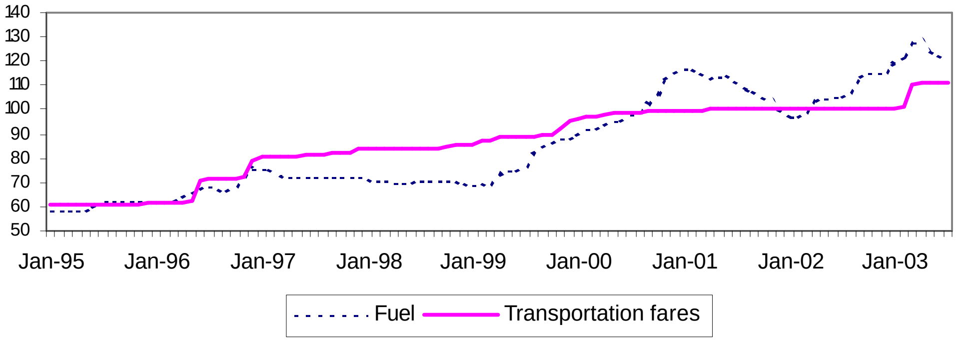
TABLE 2
WEIGHTED CONTRIBUTION TO INFLATION: JANUARY - JULY 2003
(Percentage points)

Items	Weight	% Changes	Positive Contribution	Items	Weight	% Changes	Negative Contribution
Transportation fares	8,0	11,1	0,88	Citrus fruits	0,7	-19,9	-0,12
Potatoes	1,5	17,9	0,24	Sugar	1,4	-5,9	-0,08
School enrollment fees and tuition	5,1	2,8	0,15	Electricity	2,2	-3,0	-0,07
Kerosene	1,2	7,1	0,10	Rice	2,3	-3,1	-0,07
Restaurants	10,2	0,8	0,08	Bread	3,7	-1,4	-0,06
Gasoline and lubricants	1,5	4,6	0,08	Soft drinks	1,0	-5,1	-0,05
Total			**1,53**	**Total**			**-0,45**

Inflation by item

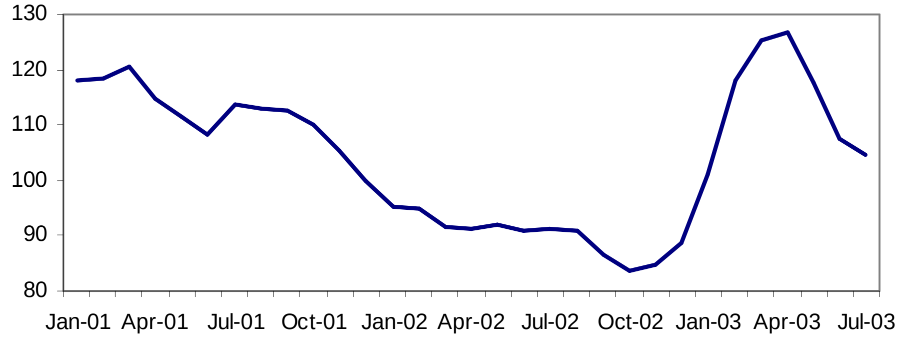
- **Urban transportation fares:** due to the increase of fuel prices—mainly as a consequence of the Iraq conflict—urban transportation fares rose 11 percent between February and April 2003, after having remained stable since November 2000.

GRAPH 2
FUEL AND TRANSPORTATION FARES
(December 2001=100)



- **Potato:** Potato prices rose 18 percent between January and July. Prices rose 43 percent in the first four months this year compared to the same period of 2001, after the 10 percent drop in cultivated land between August and October 2002. However, between May and July, prices dropped 18 percent after cultivated land from November 2002 and February 2003 increased by 8 percent.

GRAPH 3
POTATO PRICE
(December 2001=100)

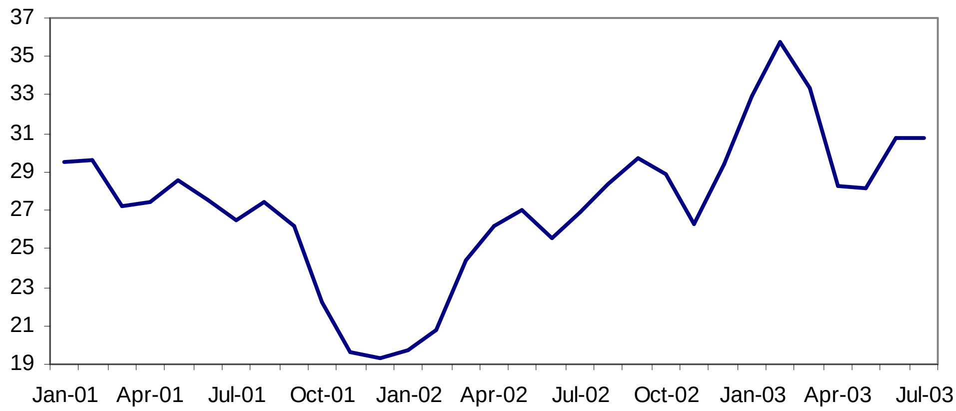


- **School enrollment fees and tuition:** Education services increase seasonally between February and March as the new school year starts. Price changes this year reached 3 percent, similar to last year's increases.
- **Fuels**: Fuel prices rose 4.9 percent. This change reflects higher kerosene (7 percent), gasoline (5 percent) and gas (3 percent) prices. Two stages may be discerned. From January to April fuel prices rose 11 percent while from May to July they dropped 6 percent. Evolution of West Texas Intermediate (WTI) crude prices accounts for this fluctuation. WTI quotations rose 36 percent from December 2002 to February 2003 while they dropped 14 percent from March to July.

TABLE 3
FUEL PRICES
(Monthly percentage change)

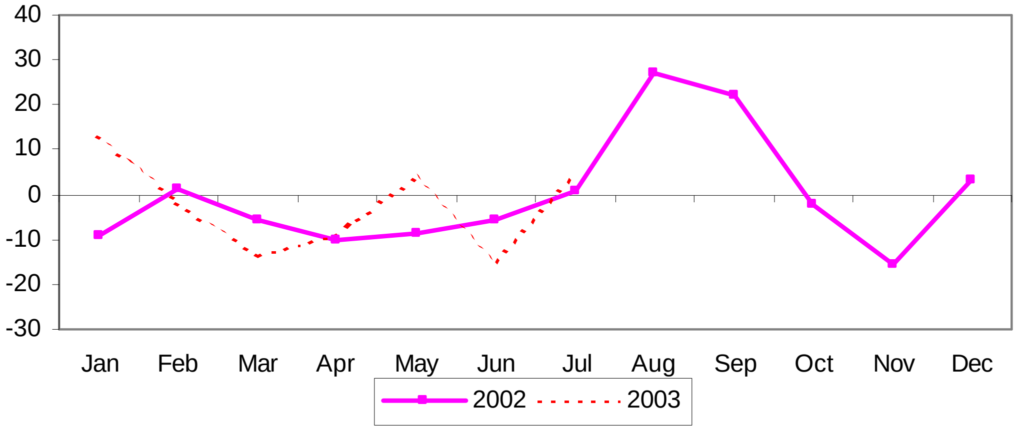
	2002	2003							
	Dec.	**Jan.**	**Feb.**	**Mar.**	**Apr.**	**May.**	**Jun.**	**Jul.**	**Jan.-Jul.**
Fuels	**0,1**	**2,7**	**2,4**	**4,9**	**0,8**	**-3,2**	**-1,4**	**-1,1**	**4,9**
Gasoline	0,0	1,0	3,3	8,7	1,5	-5,3	-1,7	-2,4	4,6
Gas	0,7	6,9	1,8	1,0	-0,8	-3,2	-2,0	-0,3	3,1
Kerosene	-0,6	0,3	1,8	4,5	1,6	-0,4	-0,5	-0,4	7,1
WTI quotation in US$	12,0	11,9	8,6	-6,8	-15,3	-0,3	9,2	0,1	4,5

GRAPH 4
WTI OIL INTERNATIONAL QUOTATION
(US$ per barrel)



- **Citrus fruits:** Prices in this category fell 20 percent reflecting lower prices for mandarins (32 percent), navel oranges (43 percent), and juice oranges (3 percent), a fall softened by 2 percent higher lime prices. Overall, these fluctuations generally match this category's seasonal fluctuations, as may be inferred from the graph.

GRAPH 5
PRICE OF CITRUS FRUITS 2002-2003
(Monthly percentage change)



- **Sugar:** Prices fell 6 percent after higher sugar output. From January to June this year, output rose 17 percent compared to a year ago. International sugar quotations have dropped a cumulative 19 percent also compared to a year ago.
- **Electricity rates**: Power rates fell 3 percent after Osinerg, the industry regulator, ordered last May lower rates for the May-October 2003 period, and the downward review in June and July of the potential power demand.

TABLE 4
PUBLIC SERVICES
((Monthly percentage change)

	2002	2003							
	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Jan.- Jul.
Utilities	**-0,3**	**-0,8**	**0,0**	**0,1**	**0,0**	**-0,3**	**-0,2**	**-0,5**	**-1,6**
Electricity	0,1	-1,5	0,1	0,6	0,1	-0,6	-0,7	-1,0	-3,0
Telephone	-1,4	0,0	0,0	-0,9	0,0	0,0	0,4	0,0	-0,4
Water	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0

- **Rice:** A 3 percent fall continued to reflect the sliding trend already observed in the last two years linked to growing rice output. In 2002, rice output reached its highest level in the last decade.

GRAPH 6
RICE OUTPUT AND IMPORTS

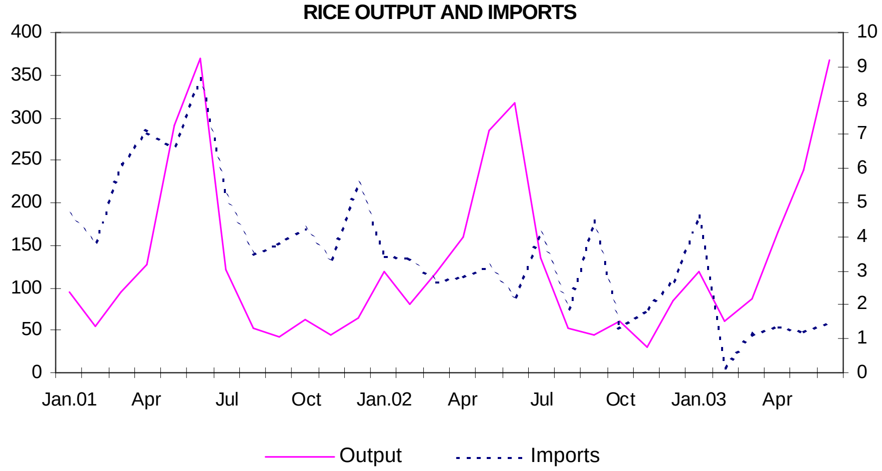


TABLE 5
OUTPUT AND IMPORTS OF MAIN FOOD
(Thousand m.t.)

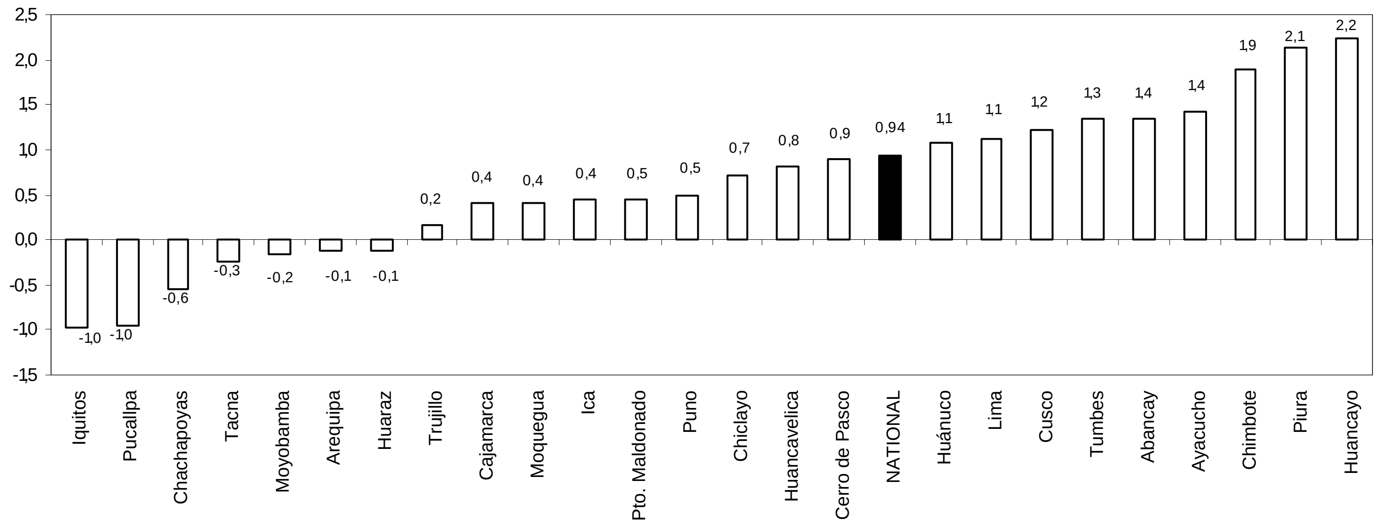
	2001	2002	January - June 2001	January - June 2002	January - June 2003	Jan. - Jun. % change 2002/2001	Jan. - Jun. % change 2003/2002
Rice							
output	1 419,6	1 486,4	1 031,6	1 077,2	1 038,8	4,4	-3,6
import	62,5	34,0	36,9	17,7	9,9	-52,0	-44,1
Sugar							
output	759,8	877,4	308,2	381,7	445,2	23,8	16,6
import	187,3	138,1	113,0	87,9	8,3	-22,2	-90,6
Corn							
output	1 062,5	1 036,9	497,8	461,1	562,8	-7,4	22,1
import	885,4	931,8	426,0	398,4	376,2	-6,5	-5,6
Wheat							
output	181,9	186,3	42,7	47,6	53,4	11,5	12,2
import	1408,9	1336,1	729,0	660,3	624,8	-9,4	-5,4
Dairy products							
output 1/	1 115,0	1 194,3	574,3	599,9	623,6	4,5	3,9
import 2/	21,1	17,9	10,2	8,3	5,0	-18,6	-39,8

1/ Fresh milk output
2/ Includes whole milk powder, skimmed milk powder and anhydrus milk fat.

- **Bread:** A 1 percent drop in bread prices reflects the continued downward adjustment of bread prices experienced between January and March. By mid-September 2002, bread prices had increased by 19 percent reflecting the 54 percent increase of international wheat quotation between May and September that year. Subsequently, between November 2002 and March 2003, international wheat quotations fell 27 percent.
- **Soft drinks**: The 5 percent drop is explained by more intense competition in this industry as new segments and presentations enter the beverages market. Output grew 7 percent.

9. Since January 2003, the National Institute of Statistics (INEI) prepares a nationwide aggregate consumer price indicator based on price indexes for 25 cities. This indicator reveals a 0.9 percent cumulative price increase for January-July 2003.

GRAPH 7
INFLATION BY CITY: JANUARY-JULY 2003
(Percent change)



I.2 Interest rates and monetary aggregates

Interbank interest rate

10. To soften downward inflation pressures, the Central Reserve Bank adopted a more flexible monetary policy in July and August reducing the benchmark interest rates for its active (direct *repos* and rediscounts) and passive (overnight deposits) operations with commercial banks. Daily monetary operations to either absorb or reduce liquidity made it easier for the interbank interest rate to fall within the band created by these benchmark interest rates.

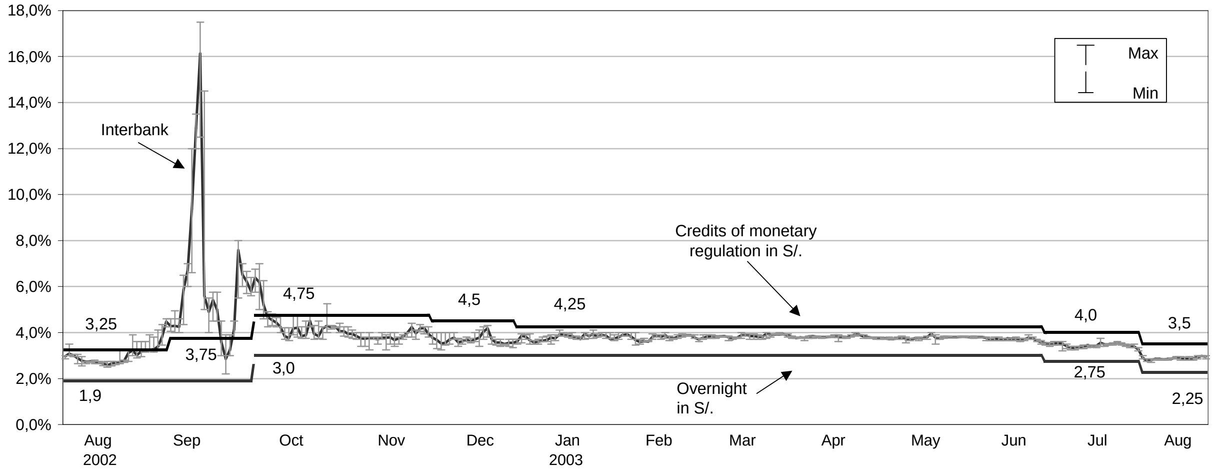
    CRB's active benchmark interest rate dropped from 4.25 percent in June (a level kept constant since December 2002) to 4.0 percent in July and 3.5 percent in August. Likewise, the passive benchmark interest rate dropped from 3.0 percent in June to 2.75 percent in July and 2.25 percent in August.

    The more flexible monetary policy led to a lower interbank interest rate in soles, that fell from about 3.8 percent in the first half to 3.5 percent in July and 3.0 percent in August.

11. Lower interbank interest rates induced lower overall market interest rates in soles (including deposits, loans and securities). Corporate Prime rates for 90-day loans fell from 4.6 percent in June to 3.7 percent in August.

    The interest rates in domestic currency the banking system charges to the microfinance segment have continued to fall in recent years, in particular rates charged to small businesses and on consumer loans. Interest rates for loans to small businesses have fallen from 59.2 percent in 2001 to 54.8 percent in August 2003, while consumer loan rates dropped from 49,0 percent to 41.1 percent over the same period.

GRAPH 8
INTEREST RATES IN DOMESTIC CURRENCY
(August 2002 - August 2003)

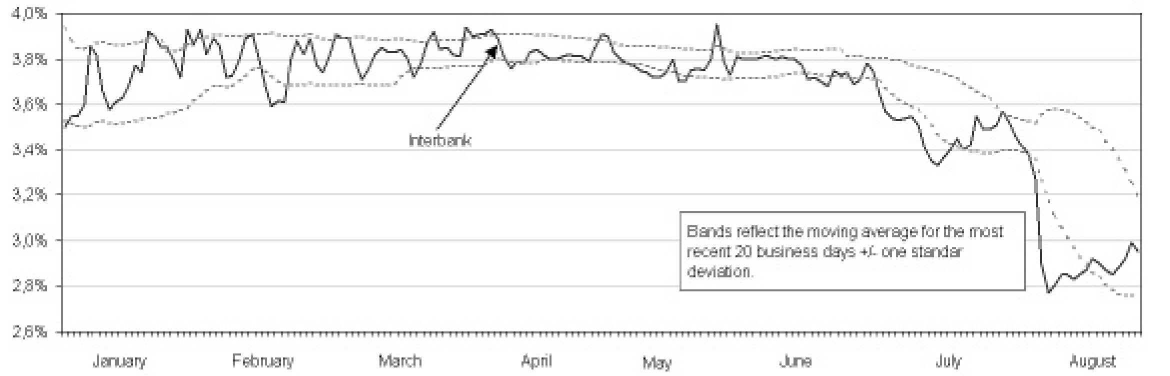


CENTRAL RESERVE BANK OF PERU

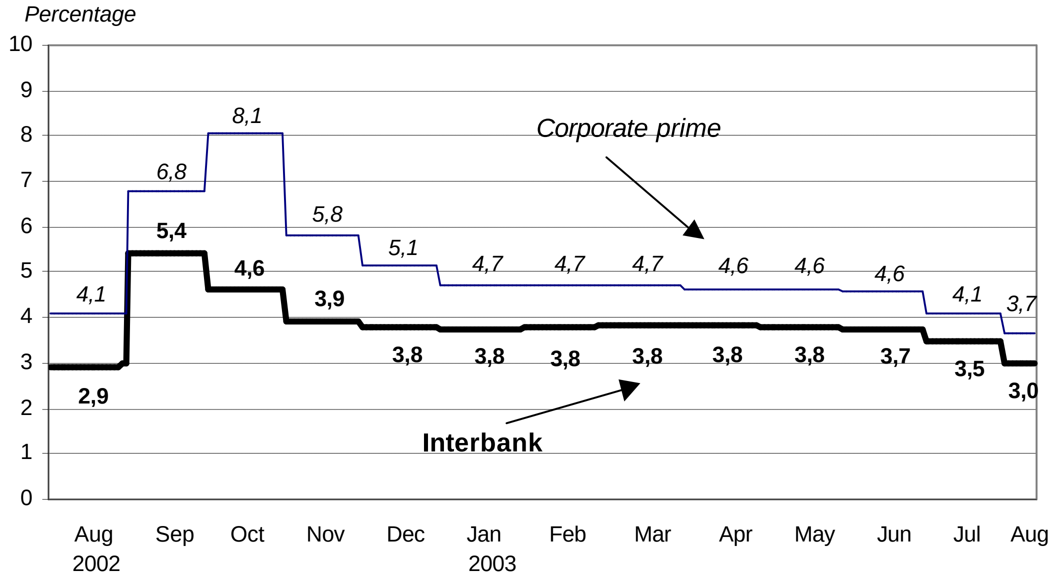
TABLE 6
INTERBANK INTEREST RATE IN DOMESTIC CURRENCY

	Jan	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
2002												
Average	2,69	2,59	2,51	2,52	2,47	2,65	2,94	2,93	5,35	4,62	3,93	3,78
Standard deviation	0,2	0,3	0,1	0,1	0,1	0,1	0,2	0,2	2,1	0,7	0,2	0,2
Variability coefficient (%)	9,1	11,2	5,3	2,9	2,9	4,5	6,0	8,2	39,3	15,8	5,3	5,3
2003												
Average	3,75	3,80	3,82	3,84	3,78	3,74	3,47	3,01				
Standard deviation	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,3				
Variability coefficient (%)	3,6	2,6	1,6	1,3	1,8	1,3	3,0	8,2				

GRAPH 9
INTERBANK INTEREST RATE IN DOMESTIC CURRENCY
(January - August 2003)



GRAPH 10
AVERAGE MONTHLY INTEREST RATES IN DOMESTIC CURRENCY
(August 2002 - August 2003)



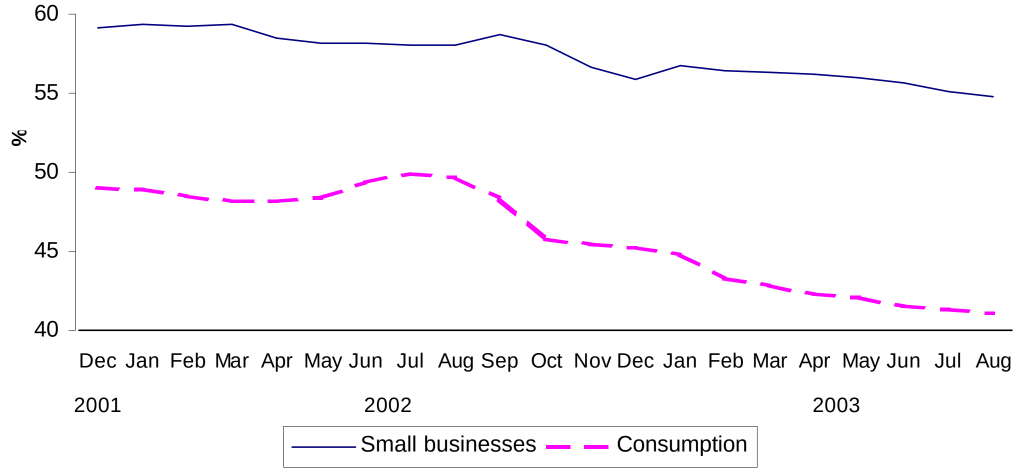
CENTRAL RESERVE BANK OF PERU

TABLE 7
INTEREST RATES FOR DOMESTIC CURRENCY TRANSACTIONS
(in percentages)

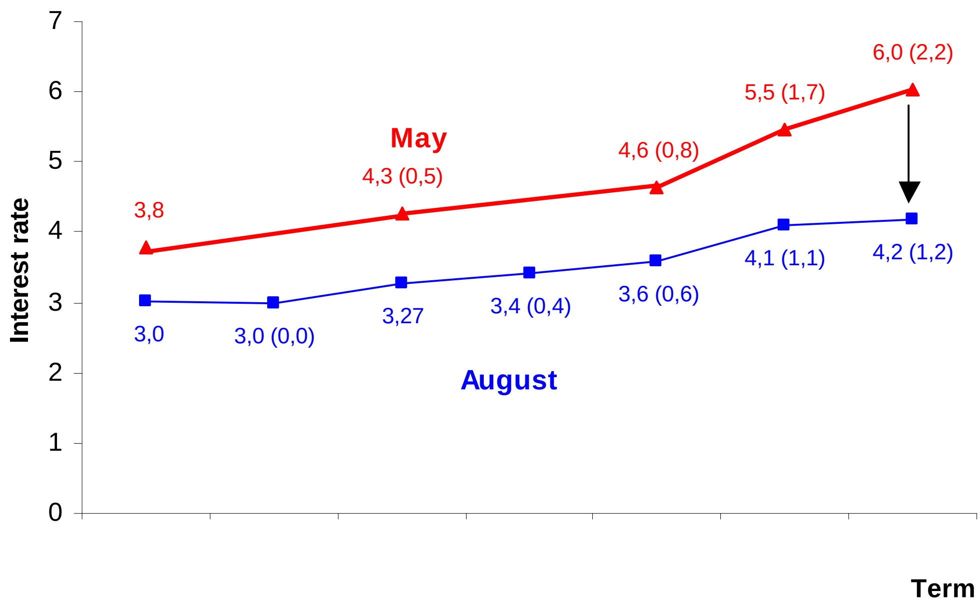
	2001				2002				2003			
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Jul.	Aug.
1. Interbank	10,3	16,0	5,9	3,1	2,5	2,6	5,4	3,8	3,8	3,7	3,5	3,0
2. Savings	6,8	6,6	5,2	3,0	1,8	1,7	1,7	1,7	1,7	1,5	1,4	1,4
3. Corporate prime	12,4	13,2	9,4	5,0	3,9	3,7	6,8	5,1	4,7	4,6	4,1	3,7
4. Loans and discounts up to 360 days	21,3	21,2	19,4	17,2	15,5	14,1	14,0	14,8	14,3	14,0	14,3	14,4
5. CDBCRP												
On the balance	12,6	12,4	10,8	7,5	5,4	4,8	4,1	4,7	4,7	4,8	4,7	4,4
Placement of the month [1/]	6	7	6	6	6	6	-	8	12	7	9	13

1/ Excludes one week term placements of CDBCRP.

GRAPH 11
LOAN INTEREST RATES FOR SMALL BUSINESSES AND CONSUMPTION



GRAPH 12
CDBCRP YIELD CURVE



1/ The numbers in parenthesis reflect spreads compared to interbank rates.

12. Between May and August this year, the yield curve of the Central Bank Deposit Certificates (CDBCRP) moved downwards reflecting lower benchmark interest rates. Likewise, the curve became flatter for longer terms. For one-year terms, interest rates dropped one percent compared to May while for two-year terms the reduction reached 1.8 percent points. This greater reduction in CDBCRP interest rates for periods equal to or longer than one year (i.e. as reflected in the flatter curve)— compared to the evolution of the interbank rate—may point to market expectations of greater stability in domestic currency interest rates for this period.

13. Through August—within the Sovereign Bond Placement (BTP) Program under the Market Makers Program launched this year—bond placements reached S/. 1 122 million. This Program allowed increasing government securities liquidity and creating market benchmarks for issuing longer term debt. Within the Treasury Bills Program (LTP in Spanish) S/. 150 million worth of 6-month term bills were placed in April, S/. 100 million worth of 2-month bills in June, and S/. 100 million of one-month bills in August.

TABLE 8
GOVERNMENT SECURITIES PRIMARY MARKET YIELDS

	PRIMARY ISSUES									
	Nominal Sovereign Bonds						VAC Bonds	Treasury Bills		
	Jun. 2004	Oct. 2004	Jan. 2005	Jun. 2005	Aug.2007	Jul. 2008	Jun. 2010	1 month	2 month	6 month
March	5,89									
April		5,90								4,61
May		5,70	6,09							
June				5,98			6,81		3,72	
July				4,69		9,69				
August					5,04			3,02		

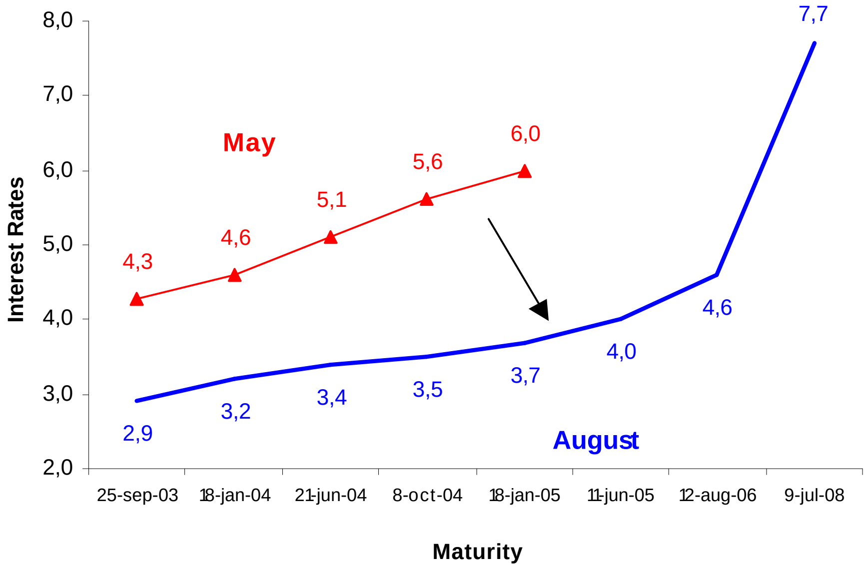
14. Longer maturity terms for CDBCRPs up to two years (initiated in February this year), and the placement of sovereign bonds up to five years have set a benchmark for fixed rate private securities issues in domestic currency. In March, private corporate bond placements with 2-year maturity reached S/. 162 million at an average yield of 6.5 percent, while placements in June for a similar term reached S/. 170 million at an average rate of 5.7 percent. In August, Telefónica launched its first ever 5-year nominal bond issue for S/ 63 million at an effective interest rate of 8.10 percent.

TABLE 9
REFERENCE RATES FOR 2-5 YEAR INSTRUMENTS

	CORPORATE BONDS				CDBCRP	SOVEREIGN BONDS			
	2 year			5 year					
	Backus	Edegel	Telefonica	Telefonica	Feb.05	Jan.05	Jun.05	Aug.06	Jul.08
January 2003	-	-	-	-	-	-	-	-	-
February	-	-	-	-	6,05	7,50	-	-	-
March	6,48	-	6,61	-	6,28	6,80	-	-	-
April	-	-	6,28	-	5,85	5,90	-	-	-
May	-	-	-	-	5,70	6,00	-	-	-
June	-	6,09	5,25	-	5,70	4,70	4,95	-	-
July	-	-	-	-	-	4,13	4,35	-	9,00
August	-	-	-	8,10	4,00	3,67	3,95	4,62	7,70

15. Treasury Sovereign Bonds' interest rates in the secondary market have also shown a downward trend, with the yield curve becoming flatter in particular for longer terms. The January 2004 Sovereign Bonds' interest rates dropped 1.4 percent points between May and August, while the January 2005 Sovereign Bond interest rate dropped 2.3 percent points over the same period.

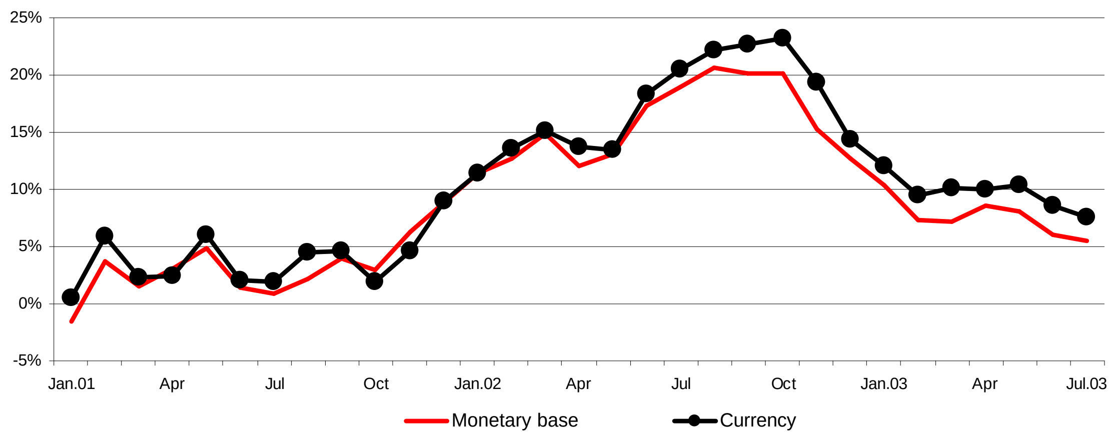
GRAPH 13
SECONDARY MARKET FOR SOVEREIGN BONDS OF PUBLIC TREASURY



Monetary aggregates

16. The monetary base and currency annual growth rates have gradually slowed down since October 2002. Currency growth rates increased significantly since end 2001 due to lower interest rates over that period. However, increasing interest rates in the second half of 2002 had attenuated the currency growth. Thus, the annual change for this variable dropped from 23 percent in October 2002 to 14 percent in December that year and 8 percent in August 2003. The average monetary base balance[1] reached a 20 percent annual growth rate in October 2002 and 13 percent in December that year, and then dropped to 5 percent in August 2003.

GRAPH 14
CURRENCY AND MONETARY BASE GROWTH: JANUARY 2001 - AUGUST 2003
(Monthly Y o Y percentage change)



[1] Includes currency and reserve requirement´s in soles.

17. From March to July 2003, financial system credit in soles to the private sector grew 4.1 percent while credit in dollars fell 0.1 percent. Larger credits in soles by S/. 559 million were mainly accounted for microfinance organizations (S/. 202 million), banks (S/. 187 million) and institutional investors (S/. 121 million).

The slump in foreign currency credits (US$ 17 million) was mainly in banks (US$51 million) and other financial institutions (US$ 105 million), a fall softened by expanding credit of institutional investors (US$139 million). It is worthwhile noting the expansion of corporate bond issues that rose from S/. 4 148 million in December 2002 to S/. 5 025 million in June 2003.

GRAPH 15
FINANCIAL SYSTEM CREDIT TO THE PRIVATE SECTOR

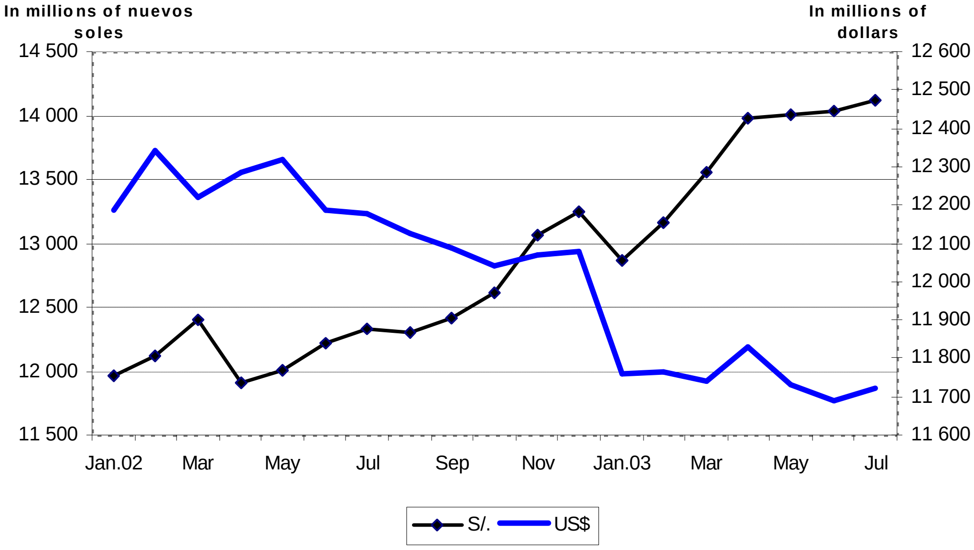


TABLE 10
FINANCIAL SYSTEM CREDITS TO THE PRIVATE SECTOR IN DOMESTIC CURRENCY

	Balances in millions of nuevos soles			Growth rates	
	31 Dec. 02	31 Mar. 03	31 Jul. 03	Jul.03/ Jul.02	Jul.03/ Mar.03
Banks 1/	7660	7779	7967	8,3	2,4
Banco de la Nación	434	426	465	15,4	9,0
Microfinance organizations	3107	3278	3481	32,7	6,2
Banks (MiBanco and Banco del Trabajo)	774	817	894	38,8	9,4
Municipal S&Ls	848	915	938	36,5	2,5
Rural S&Ls	135	145	148	42,0	2,7
Savings and loans Cooperatives	381	410	423	23,9	3,1
Edpymes	130	141	142	30,4	0,3
Financial Companies	840	850	937	26,9	10,2
Institutional investors 2/	1653	1676	1798	4,1	7,3
AFPs	1102	1115	1220	8,2	9,5
Insurance Companies	493	505	506	-1,5	0,3
Mutual funds	58	57	72	-15,9	26,1
Leasing and other companies	393	395	403	89,1	2,0
Total Financial System	13248	13555	14114	14,5	4,1

1/ Excluding Banco del Trabajo and MiBanco banks.
2/ Mainly private sector securities.

TABLE 11
FINANCIAL SYSTEM CREDITS TO THE PRIVATE SECTOR IN FOREIGN CURRENCY

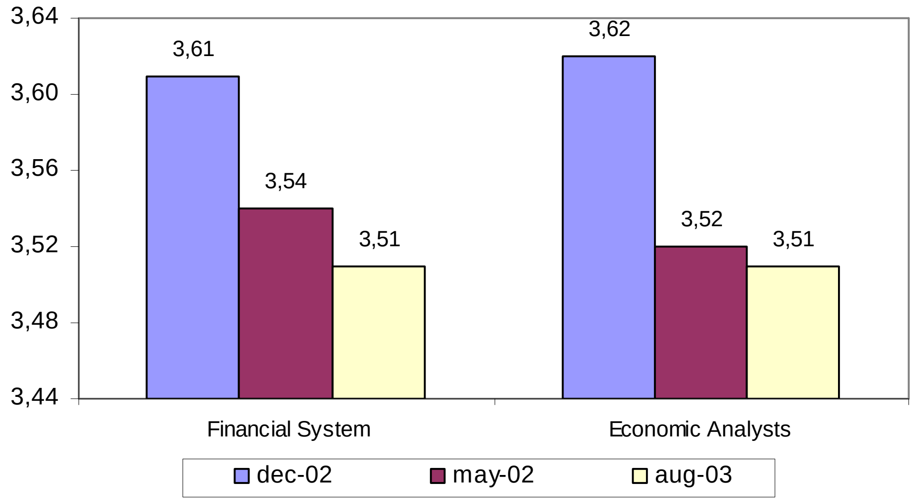
	Balances in millions of nuevos soles			Growth rates	
	31 Dec. 02	31 Mar. 03	31 Jul. 03	Jul. 03/ Jul. 02	Jul. 03/ Mar. 03
Banks 1/	10 014	9 668	9 618	-6	-1
Banco de la Nación	36	36	23	-38	-37
Microfinance organizations	368	381	388	22	2
Banks (MiBanco and Banco del Trabajo)	35	39	37	42	-5
Municipal S&Ls	111	122	133	54	9
Rural S&Ls	44	43	42	0	-3
Savings and loans Cooperatives	101	104	106	19	2
Edpymes	31	34	34	29	1
Financial Companies	45	39	35	-25	-10
Institutional investors 2/	800	895	1 035	60	16
AFPs	445	468	537	61	15
Insurance Companies	37	33	38	-7	15
Mutual funds	318	393	460	68	17
Leasing and other companies	858	760	660	-26	-13
Total Financial System	12 077	11 740	11 724	-4	0

1/ Excluding Banco del Trabajo and MiBanco banks.
2/ Mainly private sector securities.

I.3 Exchange rate

18. Depreciation expectations remained on a downward trend in the first half of 2003, as reflected in CRB surveys among financial organizations and economic analysts. Expected exchange rates for the end of 2003 dropped from an average S/. 3.62 in December 2002 to S/. 3.51 in August this year. Likewise, the implicit depreciation rate of three-month forwards transactions fell from 3.3 to 2.3 percent over the same period.

GRAPH 16
EXPECTED EXCHANGE RATE: DECEMBER 2003



Source: BCR surveys and Consensus Economics.

19. As of July, the average exchange rate reached S/. 3.472 per dollar, implying a 1.2 percent nominal appreciation since December 2002. Over the same period the real exchange rate fell 4 percent following the change in the nominal exchange rate (-1.2 percent), domestic inflation (-1.1 percent) and the change in the foreign price index (6.9 percent).

TABLE 12
NUEVO SOL NOMINAL AND REAL DEPRECIATION WITH RESPECT TO THE MAIN COMMERCIAL PARTNERS OF PERU
(Growth rates as of July 2003)

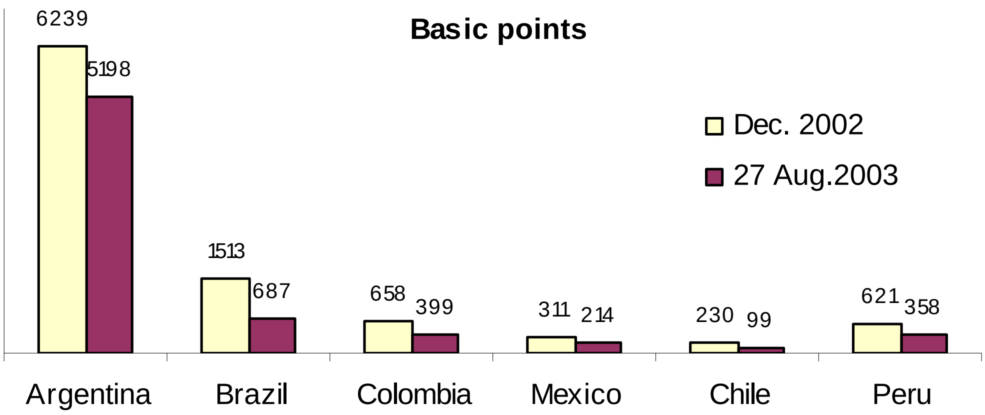
	Weights	Nominal Exchange Rate			Real Exchange Rate		
		From 1998	From July 2002	From Dec. 2002	From 1998	From July 2002	From Dec. 2002
United States	25,1	28	-2	-1	25	-2	-1
Euro Zone	20,1	21	13	10	26	12	10
Japan	10,3	39	-2	2	17	-4	1
Brazil	6,4	-51	0	24	-36	14	33
United Kingdom	5,8	25	3	1	21	4	2
Chile	4,8	-20	-3	-1	-19	-2	-2
China	4,3	28	-2	-1	4	-3	-2
Colombia	4,0	-42	-14	-3	-12	-10	1
Mexico	3,4	-1	-8	-4	37	-6	-3
Argentina	3,4	-54	25	21	-45	33	24
Korea	3,3	60	-1	1	62	-0	2
Taiwan	2,5	20	-5	-0	22	-7	-2
Venezuela	2,5	-60	-18	-18	6	7	-4
Canada	2,4	32	10	12	29	10	12
Bolivia	1,8	-11	-8	-4	-11	-7	-4
Currency		15	4	4	11	3	4

* Weighting according to 1994 trade. Since the Euro was in force since 1999, for 1998 currency quotations of each country was used (Mark, French Franc, Belgian Franc, Italian lire, Dutch Florin and the Peseta).

20. An appreciation trend observed in the domestic currency this year stems from the positive evolution of external accounts and a stable regional environment for most of this period. In the first half of 2003, the trade balance recorded a US$186 million surplus while net foreign currency reserves increased US$399 million over the same period.

In the Region, Brazil's outlook also improved for most of the period under review, mainly linked to fiscal reforms. This evolution prompted capital inflows and greater demand for emerging economies' debt securities. In addition to creating downward pressures on regional currencies, such capital inflows may have led to reduce spreads. Peru's EMBI+ spread reached a low record of 358 basis points on August 27.

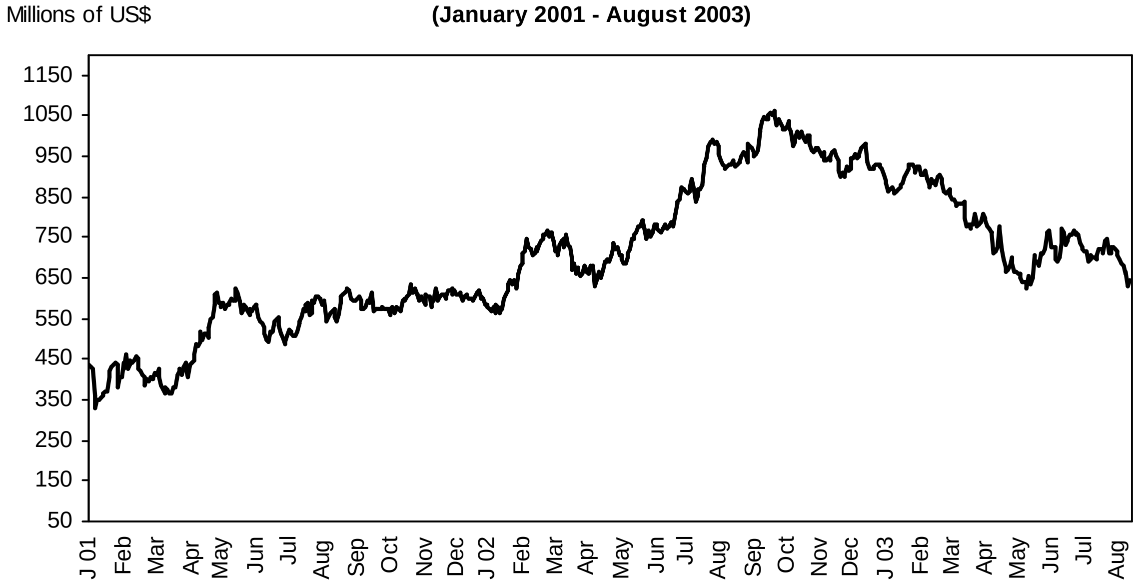
GRAPH 17
SOVEREIGN BONDS SPREADS
Basic points



Source: Reuters

21. Reduced depreciation expectations were also reflected in lower operations in forward markets, in particular for term renewals. Between end-December 2002 and August this year, the net balance of forward transactions dropped US$230 million (from US$905 million to US$ 675 million). Banks' foreign exchange position over the same period was not significantly modified, as it changed from US$643 million to US$646 million.million

GRAPH 18
FORWARD NET BALANCES
(January 2001 - August 2003)



22. Lower depreciation expectations that increased preference for domestic currency assets were reflected by greater placements of Treasury bonds, both through the Market Makers Program (Global Bond Issues) and Treasury Bill issues. Private Pension Funds (AFPs) have also increased their domestic currency assets in their portfolio from 68 percent at the end of 2002 to 70 percent in July.

23. In this context of appreciation of the Nuevo Sol, the Central Bank bought US$ 607 million in the foreign exchange market between January and August. Most operations took place in March, April and June, when seasonal factors created substantially larger appreciation pressures—stemming from greater demand of domestic currency for tax and workers' bonus payments— and thus stressing the effect of the reduction in forwards transactions. These dollar purchases were sterilized through CDBCRPs .

I.4 Domestic demand and GDP

24. Domestic demand grew 4.0 percent during the first half of 2003 compared to a rate of 3.1 percent reached during the same period of last year. Rising private investment (5.8 percent up), which in the first half of 2002 had fallen 3.1 percent, contributed to GDP expansion. Such evolution of private investment was partially offset by the lower dynamism of private consumption which grew 3.7 percent compared to 3.9 percent of the previous year. Domestic demand grew 5.8 percent in the first quarter, and slowed down to 2.4 percent growth in the second quarter following a seasonal slowdown of private consumption in April and May. However, in June it resumed its pace at the beginning of the year.

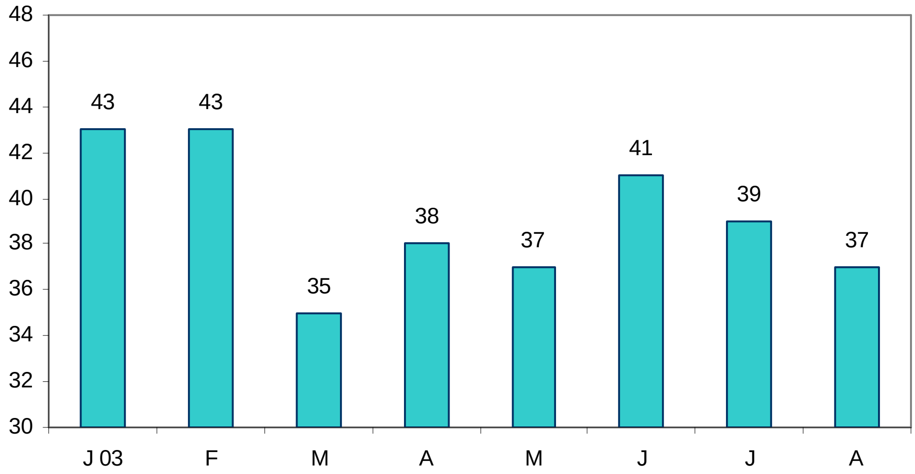
25. **Private consumption** grew 4.5 percent in the first quarter and 3.0 percent in the second. This slower pace reflected reduced consumer confidence in March and April, as reflected by the Consumer Confidence Indicator (INDICCA) prepared by Apoyo pollsters that gauges present and future perceptions about Peru, including households, the labor market, prices and the durable goods market. Among factors working against consumer

confidence are higher transportation prices that rose 9.5 percent in March; various industry stoppages (agriculture workers, transportation, teachers and construction workers) that hurt product distribution and incomes, and slowed down job creation. Higher city transportation fares had a greater impact on lower income households where this item may account for as much as 15 percent of total expenses.

TABLE 13
GROSS DOMESTIC PRODUCT
(Real percentage change, compared to the same period of the previous year)

	2002			2003		
	I Q.	**II Q.**	**I Sem.**	**I Q.**	**II Q.**	**I Sem.**
I. GLOBAL DEMAND (1 + 2)	**1,6**	**6,2**	**4,0**	**6,0**	**3,1**	**4,5**
1. Domestic Demand	0,6	5,4	3,1	5,8	2,4	4,0
a. Private consumption	2,8	4,9	3,9	4,5	3,0	3,7
b. Public consumption	2,9	0,1	1,4	6,7	2,1	4,3
c. Gross domestic investment	-9,5	10,1	0,7	11,2	0,3	4,9
Gross Fixed Investment	-4,6	-1,4	-3,0	7,6	3,4	5,4
- Private	-5,9	-0,1	-3,1	6,9	4,8	5,8
- Public	4,7	-7,4	-2,6	11,9	-3,1	3,3
2. Exports	8,3	10,9	9,7	7,2	7,6	7,4
II. GLOBAL SUPPLY (3 + 4)	**1,6**	**6,2**	**4,0**	**6,0**	**3,1**	**4,5**
3. Gross domestic product	**2,7**	**6,7**	**4,8**	**5,8**	**3,4**	**4,5**
4. Imports	-4,5	3,0	-0,8	7,3	1,4	4,3

GRAPH 19
"APOYO" CONSUMER INDEX: INDICCA



Private investment increased 5.8 percent in the first half of 2003 after decreasing 3.1 percent in the first half of 2002. Growth was driven by the Camisea gas project, equipment renewals in some non primary manufacturing industries, in particular the textile, chemicals, food and beverages, non metal mineral, and the construction of new commercial and entertainment centers. As a whole, this translated into a 14.7 percent increase in capital goods imports, excluding construction materials, and 4.1 percent expansion in the construction in the first half.

Exports grew 7.4 percent in real terms with increases in traditional exports (through larger volume of gold, copper, zinc, lead and silver in the mining industry and coffee that softened the impact of the fishmeal exports fall due to adverse weather conditions), as well as in non-traditional exports (textiles, chemicals, plastic containers, bus and truck tires and agriculture and fishing products such as avocados, asparagus, mango, paprika and squid and giant squid).

26. In the first half of 2003, GDP increased 4.5 percent. Non-primary industries drove economic expansion with a 4.6 percent growth rate, while primary sectors grew 2.9 percent. Among non-primary industries, a stronger non-primary manufacturing (4.8 percent) and construction (4.1 percent) led the growth, while mining (7.7 percent) and agriculture and livestock (3.3 percent) led the growth among primary industries.

TABLE 14
GROSS DOMESTIC PRODUCT
(Percentage change, compared to the same period of the previous year)

	2002			2003		
	I Q.	II Q.	I Sem.	I Q.	II Q.	I Sem.
Agriculture and livestock	6,2	7,2	6,8	2,5	3,9	3,3
Fishing	-21,5	7,5	-5,3	-15,7	-19,0	-17,8
Mining and fuel	25,9	18,7	22,2	4,5	10,8	7,7
Metallic mining	27,7	20,3	23,9	5,6	12,0	8,8
Natural gas and oil	5,2	0,5	2,8	-6,2	-1,2	-3,7
Manufacturing	-0,8	4,3	1,9	5,5	0,7	3,0
Based on raw materials	-3,6	-2,3	-2,9	-5,6	-2,6	-4,0
Non-primary industries	0,0	6,4	3,2	8,3	1,6	4,8
Electricity and water	6,1	6,3	6,2	4,9	3,9	4,4
Construction	10,4	7,9	9,2	3,5	4,7	4,1
Commerce	0,3	6,5	3,6	7,2	2,3	4,5
Other services	1,3	5,8	3,6	5,6	3,6	4,5
GROSS AGGREGATED VALUE (GAV)	**3,2**	**6,7**	**5,1**	**5,2**	**3,3**	**4,2**
Taxes on products and import duties	-1,6	6,3	2,4	11,9	4,2	7,9
GDP	**2,7**	**6,7**	**4,8**	**5,8**	**3,4**	**4,5**
Primary GAV	9,4	8,4	8,8	1,4	4,0	2,9
Non-primary GAV	1,6	6,2	4,0	6,2	3,1	4,6

I.5 Government expenditure and fiscal accounts

27. In the first half of 2003, the Non-Financial Public Sector Deficit reached 1 percent of GDP, 0.5 percent lower than in the same period a year ago. The lower deficit was the consequence of better primary results while financial expenses (government debt interest) kept their share of GDP.

28. Improving government accounts mainly reflected the 11.5 percent real increase in central government revenues (0.9 percent of GDP) partially offset by deteriorating results in the rest of the public sector entities that totaled 0.4 percent of GDP. Tax measures introduced in the second half of 2002 led to improved tax collection (including withholding, retention, and collection of the general sales tax (IGV), and additional anticipated Income Tax), increased Income Tax regularization payments, and the impact of a growing economy. In addition, declining accounts at the rest of the public sector entities reflected greater redemption of Pension Reform Bonds from the Pension Reserves Consolidated Fund (FCR) and the adverse impact of international oil price fluctuations on Petroperú.

Central government non-financial expenses grew 5.1 percent in real terms in the first half of 2003 compared to the same period a year ago. This expanded growth mainly reflected increased current expenses linked to wage increases in certain areas (the judiciary, universities, education and regional governments), appointments of previously contract workers (in education and health sectors) and larger transfers to the Pension Administration Office (ONP) to pay for accrued pensions.

29. Despite a reduced fiscal deficit, larger expenses resulting from public debt amortization increased the Non-Financial Public Sector gross funding requirements from US$ 922 million in the first half of 2002 to US$ 1019 million in the first half of 2003. Larger funding requirements were paid for through foreign fund disbursements for US$ 917 million, local bond issues worth US$ 223 million, pardoned foreign debt for US$ 19 million, and private investment promotion resources for US$ 10 million.

TABLE 15
OPERATIONS OF THE NON-FINANCIAL PUBLIC SECTOR
(Percentage of GDP)

	2002			2003		
	I Q.	II Q.	I Sem.	I Q.	II Q.	I Sem.
1. Central government current revenues	**13,4**	**13,5**	**13,5**	**14,7**	**14,1**	**14,4**
2. Central government non-financial expenditure	**13,1**	**13,4**	**13,3**	**13,3**	**13,4**	**13,4**
Current	*11,8*	*11,4*	*11,6*	*11,9*	*11,8*	*11,8*
Capital	*1,3*	*1,9*	*1,6*	*1,4*	*1,6*	*1,5*
3. Other	**0,7**	**0,0**	**0,3**	**-0,3**	**0,1**	**-0,1**
4. Primary balance	**0,9**	**0,1**	**0,5**	**1,0**	**0,8**	**0,9**
5. Interests	**2,0**	**1,9**	**2,0**	**2,1**	**1,9**	**2,0**
6. Overall Balance	**-1,1**	**-1,8**	**-1,5**	**-1,0**	**-1,1**	**-1,0**
7. Net financing	**1,1**	**1,8**	**1,5**	**1,0**	**1,1**	**1,0**
- External	3,7	0,3	1,9	4,3	-1,9	1,0
- Domestic	-2,9	0,9	-0,9	-3,3	2,9	0,0
- Privatization	0,3	0,5	0,4	0,0	0,0	0,0

I.6 External accounts

Trade balance

30. At US$ 186 million, the trade surplus in the first half of 2003 was US$ 151 million higher than a year before. Such improved figures are explained by growing exports that rose 19 percent while imports expanded 15 percent.

In the period under review, exports reached US$ 4,205 million, through increases in both traditional (22 percent) and non-traditional exports (up 12 percent). Larger **traditional exports** are basically explained by increased gold exports. Meanwhile, the largest growing non-traditional exports in the January to June period were textiles (up 21 percent), chemicals (21 percent growth) and fisheries industries sales (16 percent up). Machine tools, and wood and paper exports fell 17 percent and 8 percent respectively.

Increases in **imports** in the first half of 2003 came principally from expanding input purchases (up 20 percent) resulting from larger fuel, lubricant and related by product purchases (63 percent up), which prices increased 32,4 percent.

Terms of trade in the first half dropped 1 percent after increases in imports' prices (7 percent) higher than export prices (6 percent). Increased exports prices were recorded principally in gold (16 percent), copper (10 percent), oil and oil by-products (23 percent), and tin (24 percent). On the side of imports, the highest increases were recorded in oil and its by-products (32 percent), soy (17 percent), corn (13 percent), and wheat (9 percent).

Current account and capital flows

31. In the first half of 2003 the Balance of Payments' current account recorded a US$ 648 million deficit, similar to the US$ 645 million gap a year before.

Capital account flows reached US$ 1 011 million in the first half of 2003, US$39 million lower than a year before. First-half foreign direct investment reached US$587 million, in particular after investments in the Camisea project (US$294 million) and TIM Perú (approximately US$150 million).

TABLE 16

BALANCE OF PAYMENTS

(Millons of U.S. dollars)

	2002			2003		
	I Q.	II Q.	I Sem.	I Q.	II Q.	I Sem.
I. CURRENT ACCOUNT BALANCE	**- 388**	**- 257**	**- 645**	**- 464**	**- 184**	**- 648**
1. Trade balance	- 69	104	35	- 20	206	186
a. Exports	1 574	1 966	3 540	2 023	2 183	4 205
b. Imports	- 1 643	- 1 862	- 3 505	- 2 043	- 1 976	- 4 019
2. Services	- 253	- 231	- 484	- 271	- 242	- 513
3. Investment income	- 310	- 383	- 693	- 443	- 427	- 871
4. Current transfers	244	253	497	270	280	550
II. FINANCIAL ACCOUNT	**489**	**561**	**1 050**	**1 314**	**- 303**	**1 011**
1. Private sector 1/	- 0	515	515	719	33	752
2. Public sector	489	45	534	595	- 336	259
III. EXCEPTIONAL FINANCING	**0**	**0**	**0**	**2**	**17**	**19**
IV. BCR INTERNATIONAL RESERVES FLOW (1 - 2)	**- 101**	**- 304**	**- 405**	**- 851**	**470**	**- 382**
(Increase with negative sign)						
1. Change in Central Bank reserves	- 173	- 340	- 513	- 845	446	- 399
2. Valuation changes and monetization of gold	- 72	- 36	- 108	6	- 23	- 18

1/ Includes short-term capital and net errors and omissions.

Source : BCR, MEF, SUNAT and companies.

II. FORECASTS

32. This Report maintains the 4.0 percent GDP growth projection for 2003. Slower domestic demand was set off by better net exports. Lower expected growth in domestic demand compared to the May Inflation Report is linked to slower private sector consumption during the second quarter. For 2004, projected GDP growth was revised downward from 4.5 percent to 4.0 percent to reflect the lower private investment growth.

Inflation estimates for 2003 were also corrected downwards to fold in the lower trench of the target band (1.5-2.5 percent). Inflation has slipped since April once the impact of significant increases in international oil prices was absorbed.

TABLE 17
FORECASTS IN THE INFLATION REPORT

	2001	2002	2003 [1/]		2004 [1/]	
			May Report	August Report	May Report	August Report
Real % change						
1. GDP	0,6	5,3	4,0	4,0	4,5	4,0
2. Domestic Demand	-0,1	4,7	4,0	3,6	4,4	3,8
a. Private Consumption	1,8	4,4	4,3	3,6	4,0	3,6
b. Public Consumption	-0,3	1,6	2,3	4,0	1,1	2,1
c. Private Fixed Investment	-5,7	0,5	5,4	5,1	7,4	5,7
d. Public Investment	-22,9	-5,0	4,7	2,3	5,2	4,7
3. Exports (goods & services)	6,7	6,3	5,0	4,7	7,3	6,8
4. Imports (goods & services)	0,7	2,5	4,9	2,7	6,8	5,3
5. Main Trade Partner´s Economic Growth	1,2	1,6	1,9	1,9	3,4	3,4
% change						
7. Annual Inflation	-0,1	1,5	1,8	1,5	2,1	2,0
8. Nominal Cumulative Depreciation	-2,4	2,3	1,1	-0,3	2,5	2,5
9. Real Cumulative Depreciation (multilateral)	-4,3	-0,6	3,3	5,6	2,3	1,8
10. Terms of Trade	-2,0	2,5	0,7	-0,4	1,3	1,6
% of GDP						
11. Balance of Payments Current Account	-2,0	-2,1	-1,9	-2,0	-2,1	-1,9
12. Trade Balance	-0,2	0,4	0,8	0,8	0,9	1,2
13. Private Capital Flow [2/]	2,2	1,6	1,5	1,7	1,3	0,9
14. Non-financial Public Sector Primary Balance	-0,3	-0,3	0,1	0,1	0,6	0,6
15. Non-financial Public Sector Overall Balance	-2,5	-2,3	-2,0	-2,0	-1,5	-1,5
16. Central Government´s Tax Revenues [3/]	12,1	11,8	12,3	12,7	12,5	13,0
17. External Public Debt Balance	35,0	36,4	36,0	35,8	35,3	35,6
Nominal % change						
18. Central Government Non-Financial Expenditure	-2,3	2,5	4,5	6,3	4,1	4,7
19. Monetary base	3,2	15,8	8,0	7,5	7,0	7,0
20. Bank's Loans to the Private Sector	-4,5	0,1	5,5	1,2	6,5	6,5

[1/] Forecast.
[2/] Includes short-term capital and net errors and omission
[3/] Excludes the tax on Public Assets.

In 2003, the Balance of Payment's current account may show a 2.0 percent of GDP deficit, slightly higher than the May estimate (1.9 percent). The capital accounts forecasts were corrected downwards from US$ 1 796 million in the May report to US$ 1 595 million to reflect reduced public capital inflows by US$ 370 million, partially offset by US$ 169 million larger private capital arrivals (including privatization receipts). Highlights in private capital inflows include US$ 735 million investments in the Camisea gas project. Estimated growth of net international reserves for this year was corrected downwards from US$ 625 million to US$350 million in line with lower expected privatization receipts.

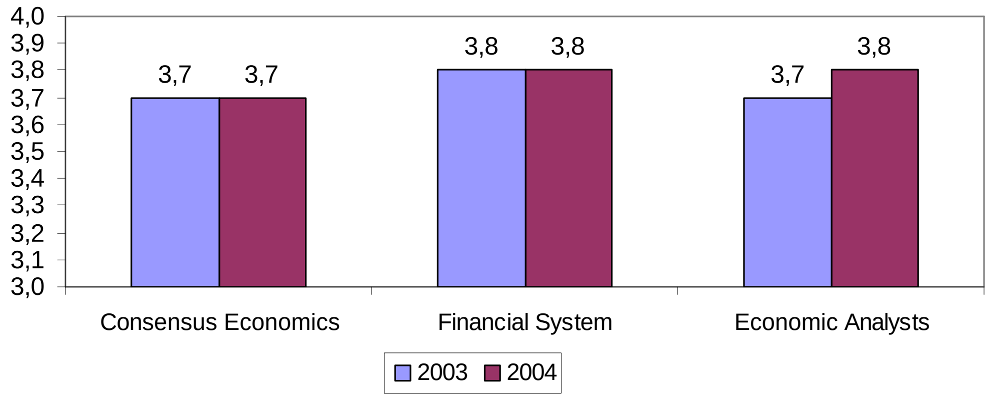
In 2004 the current account deficit is expected to fall to 1.9 percent of GDP, or US$ 1 230 million, while both public and private capital inflows would reach US$ 1 330 million, thus accumulating US$ 100 million of net international reserves.

Public Sector deficit forecasts for 2003 and 2004 are similar to the May Report, despite the increased non-financial central government expenditures that are expected to be financed through larger revenues from increased tax rates, including the Value Added Tax (IGV) from 18 to 19 percent, the cancellation of tax exemptions, and the increase in tax receipts resulting from an improved collection. Consequently, estimated central government current revenues for 2003 have been corrected upwards from 14.2 percent of GDP in the May report, to 14.5 percent, while the 2004 estimate likewise rises from 14.3 to 14.8 percent.

II.1 Economic Activity

33. Economic agent expectations reflected in the CRB surveys among financial organizations and economic analysts, as well as *Consensus Economics* polls, point to 3.7 percent output growth in 2003, and 3.8 percent in 2004.

GRAPH 20
GDP GROWTH EXPECTATIONS



Source: Consensus Economics and Central Bank Survey on macroeconomic expectations.

34. For the second half of 2003, 3.4 and 4.3 percent growth rates are expected for private consumption and investment, respectively, leading to 3.6 percent annual **domestic demand** growth.

TABLE 18
AGGREGATE DEMAND AND SUPPLY
(Real percentage change)

		2002	2003 *	2004*
I.	Total Demand (1+2)	4,9	3,8	4,2
	1. Domestic Demand	4,7	3,6	3,8
	a. Private consumption	4,4	3,6	3,6
	b. Public consumption	1,6	4,0	2,1
	c. Private investment	0,5	5,1	5,7
	d. Public investment	-5,0	2,3	4,7
	2. Exports	6,3	4,7	6,8
II.	Total Supply (3+4)	4,9	3,8	4,2
	3. GDP	**5,3**	**4,0**	**4,0**
	4. Imports	2,5	2,7	5,3

* Forecast.

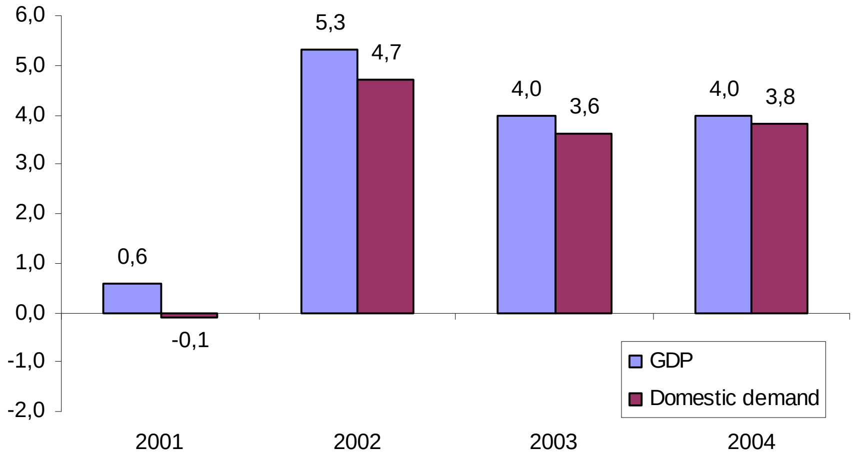
Private consumption is expected to grow 3.6 percent in 2003 and 2004, driven by rising national incomes,, lower unemployment and reduced cost of credit.

Private investment may grow 5.1 percent in 2003 and 5.7 percent in 2004 after larger corporate earnings. Earnings of listed manufacturing company grew 57 percent in 2002 and 17 percent in the first half of 2003, respectively. Larger investment may be linked to various projects, including Camisea, Alto Chicama, Southern Peru Copper Corporation and Antamina expansions, Minas Conga, Tim Perú, Lima Airport Partners, and shopping mall projects both in Lima and the interior.

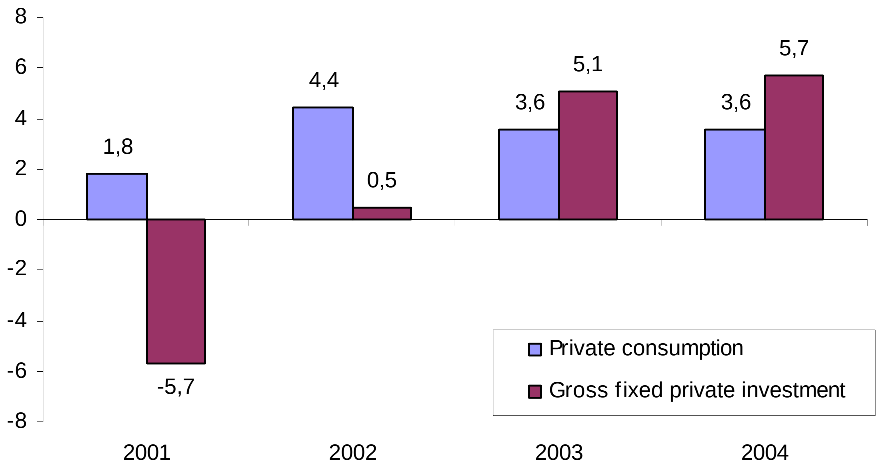
Public consumption and investment is expected to grow 4.0 and 2.3 percent in 2003, compared to 1.6 and –5.0 percent in 2002. Public consumption in 2004 is expected to grow 2.1 percent while public investment should increase by 4.7 percent.

Goods and services **exports** are expected to grow at 4.7 and 6.8 percent rates in 2003 and 2004, respectively, through larger mineral exports, in particular, gold and copper, as well as increased foreign sales of apparel through the Andean Trade Preference and Drug Eradication Act (ATPDEA).

GRAPH 21
GDP AND DOMESTIC DEMAND: 2001-2004
(Real percentage change)



PRIVATE CONSUMPTION AND INVESTMENT: 2001-2004
(Real percentage change)



35. Economic growth in 2004 (4 percent) may be driven by primary industry (4.5 percent up) in particular as fisheries rebounds 7 percent, mining grows 5.5 percent, and primary resource manufacturing expands 5.3 percent. Non-primary industry overall may grow 3.9 percent linked to better non-primary manufacturing (4 percent up) and construction (5 percent larger) performance.

TABLE 19
GROSS DOMESTIC PRODUCT
(Real percentage change)

	2002	2003 *	2004 *
Agriculture and livestock	5,8	3,4	3,4
Fishing	3,1	-6,4	7,0
Mining and fuel	11,3	5,1	5,5
Manufacturing	4,2	3,5	4,2
Construction	8,3	5,0	5,0
Commerce	3,8	4,2	3,8
Services	4,5	3,8	3,7
GROSS AGGREGATED VALUE	5,1	3,9	4,0
Taxes on products and import duties	7,5	5,1	4,3
GDP	**5,3**	**4,0**	**4,0**
Primary sectors gross aggregated value	6,4	3,1	4,5
Non-primary sectors gross aggregated value	4,8	4,1	3,9

* Forecast.

36. Achieving growth rates above the present trend may depend on faster public infrastructure development through increased private sector involvement, larger Camisea project exports as US fuel demand increases, and signing of free trade agreements to penetrate larger markets.

BOX 1

CAMISEA PROJECT

Shell corporation started exploring the Camisea natural gas fields in Cuzco back in 1983. The contract to develop these fields was signed in 1990, but because of its sheer size and infrastructure requirements, the project was split into workings, on the one hand, and transportation and distribution on the other.

Workings comprise gas extraction and carrying it to Malvinas, in Cuzco, where a natural gas liquids separation plant and a compression plant for injection and transportation were planned. Two pipelines built in the second stage would carry gas from Malvinas to the Lurín citygate and other to carry liquids to Pisco, where the fractioning and condensates plants will produce fuels for export. A pipe network extending from the City Gate to Ventanilla through Lima is planned for gas distribution. The Camisea project's pre-operation stage, comprising both workings and transportation and distribution, will conclude in July 2004. Operations are scheduled for August 2004.

Through June 2003 project investments reached US$ 990 million with total investment planned to reach at US$ 1 635 million.

Camisea: Preoperative investment
(Milllons of US dollars)

Phase	Actual Investment				Projected investment			Total Investment
	2001	2002	2003 Jan-Jun	Total	2003 Jul-Dec	2004	Total	
Exploration	48	301	116	465	184	48	232	697
Transportation	67	260	168	495	232	146	378	873
Distribution	0	21	9	30	25	10	35	65
Total	**115**	**582**	**293**	**990**	**441**	**204**	**645**	**1 635**

Once Camisea goes on line the US$ 450 million oil trade gap recorded in 2002 may drop to US$ 200 million in 2005, while contributing to increase overall economic productivity, reduce energy costs and enhance competitiveness.

In addition to the aforementioned investments, other investments will be needed to export liquefied natural gas (LNG) to the southern US, taking advantage of the fields' output surplus. This latter project would involve investing an additional US$1.8 billion of which US$1 billion would be required for building a liquefaction plant. Such investment amount would modify the activity estimates described in this Inflation Report.

BOX 2

ECONOMIC CYCLES AND GROWTH

Economic activities fluctuate around their central trend line. Generally, trend GDP growth is linked to economic structural or supply factors, such as investment, productivity, human capital, etc. On the other hand, output fluctuations around its trend line are linked to temporary (positive or negative) shocks. Fiscal and monetary policies determine the magnitude and duration of such fluctuations or economic cycles. In the expansion phase, aggregate expenditure growth picks up (in particular, private investment) and thus sales to companies.

The expansion phase concludes once negative expectations emerge among agents about the effective economic evolution compared to trend growth, or when a negative shock has an impact on future economic evolution. Fiscal and monetary policies must be directed at reducing the amplitude of economic cycles.

Based on data from 1965 to 2002, the various phases of Peru's economic cycle were reviewed, thus allowing to identify 5 expansion periods when GDP rose above the growth trend, and another 5 recession periods when current output fell below the growth trend. Two phases were defined for each period, i.e. generation (when the expansion or recession phase is born) and transition (from expansion to recession or conversely).

- Expansion generation phases typically feature output growth above 6 percent, private consumer demand growth above 5 percent and fixed gross investment growth rates larger than 15 percent.
- In the transition from the expansion phase, output growth does not exceed 5 percent, private consumption growth is below 4.5 percent and fixed gross investment increases may top 14 percent.
- Public expenditure (consumption plus investment) follows a pro-cyclic pattern.

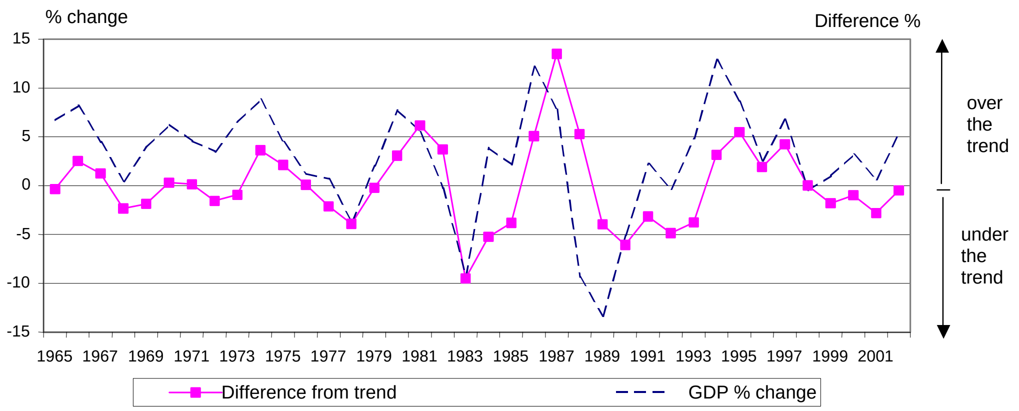
Growth periods above the trend

Years	Phase		GDP (% change)	Private consume (% change)	Total fixed net investment (% change)	Public expenditure (% change)	Inflation (% change)
1965-67	*Generation*	*1965-66*	7,4	8,2	15,8	8,1	11,2
	Transition	*1967*	4,4	7,9	-8,0	-1,6	19,0
1974-76	*Generation*	*1974*	8,8	6,8	26,6	22,2	19,1
	Transition	*1975-76*	2,8	3,0	-5,2	6,0	34,3
1980-82	*Generation*	*1980-81*	6,6	5,7	25,4	16,5	66,4
	Transition	*1982*	-0,3	-0,9	-3,9	7,1	72,9
1986-88	*Generation*	*1986-87*	9,9	11,0	19,4	3,2	88,7
	Transition	*1988*	-9,4	-8,3	-14,7	-20,2	1 722,3
1994-98	*Generation*	*1994-95*	10,7	9,7	27,8	9,1	12,8
	Transition	*1996-98*	2,9	2,2	3,7	4,2	8,1

Economic growth periods below the trend

Years	Phase		GDP (% change)	Private consume (% change)	Gross fixed investment (% change)	Public expenditure (% change)	Inflation (% change)
1968-73	*Generation*	*1968*	0,4	1,0	-15,0	1,7	9,8
	Transition	*1969-73*	4,9	4,1	13,8	8,7	7,4
1977-79	*Generation*	*1977-78*	-1,6	-3,7	-8,6	-7,7	53,2
	Transition	*1979*	2,0	-2,7	9,8	-2,3	66,7
1983-85	*Generation*	*1983*	-9,3	-2,5	-30,2	-9,6	125,1
	Transition	*1984-85*	2,9	3,4	-9,3	-4,3	134,9
1989-93	*Generation*	*1989-90*	-9,3	-8,8	-5,9	-13,1	5212,5
	Transition	*1991-93*	2,2	2,2	4,5	6,3	78,5
1999-2003	*Generation*	*1999-2001*	1,5	1,8	-8,5	-1,2	2,4
	Transition	*2002-2003*	4,6	3,8	2,3	3,3	2,0

GDP trend differential and real GDP % change: 1965-2002



Moderate consumer demand and investment growth rates in the present cycle phase are characteristic of a transition to expansion but at lower rates than those observed in an economic expansion stage.

II.2 Monetary Aggregates

37. Projected growth of monetary aggregates in domestic currency for 2003 included in this Report follows trends published in previous reports. In particular, the faster dynamics of monetary aggregates in soles observed since 2001 is projected to continue. To December 2003, the domestic currency liquidity is projected to grow 11 percent, compared to a foreign currency liquidity projected to remain constant compared to December 2002. Domestic and foreign currency projected liquidity growth rates for 2004 should reach 12.5 percent and 2.1 percent, respectively.

Domestic currency bank loan to the private sector is expected to grow 14 percent in 2003, while foreign currency loans would fall 2 percent. This reduced share of foreign currency credit to private sector by the banking system may be linked to ongoing stability in local financial markets.

38. The average monetary base is expected to grow 7.5 and 7 percent in 2003 and 2004, respectively, based on expected nominal increases in economic transactions as GDP grows a nominal 6 percent both in 2003 and in 2004.

TABLE 20
LIQUIDITY AND CREDIT ANNUAL GROWTH RATE
(Percent YoY change for end-period balances)

	Dec. 2001	Dec. 2002	Dec.2003 January report	Dec.2003 May report	Dec.2003 August report	Dec 2004 May report	Dec 2004 August report
1. Currency	9,0	13,5	9,2	9,0	9,0	6,5	6,5
2. Liquidity in soles	13,5	9,9	12,0	13,0	11,0	13,5	12,5
3. Credit in soles							
Banking system	2,7	7,2	11,3	14,0	14,0	17,5	14,8
Financial system	9,3	10,3	13,5	14,0	15,0	18,0	15,0
4. Credit in US$							
Banking system	-3,8	-3,5	5,1	1,9	-2,0	1,9	1,5
Financial system	-4,1	-1,9	5,0	2,0	0,0	2,0	1,5

II.3 International outlook

World economic growth

39. International economic growth forecasts were **slightly** corrected downwards, mainly due to a slower European economy. World economic growth forecasts by the IMF point to a 3.1 percent rate in 2003 and 4.0 percent in 2004. Overall, US economic recovery is expected to consolidate in 2004 and thus drive world economic activity.

Despite a slower world economy, projected economic growth among Peru’s main economic partners, weighted by their share in our foreign trade, has been estimated at 1.9 percent, while projected growth in 2004 may reach 3.4 percent, in line with May’s Inflation Report.

TABLE 21
PROJECTED ECONOMIC GROWTH AMONG TRADING PARTNERS

	Actual 2002	May 2003	May 2004	August 2003	August 2004
World *	3,0	3,3	4,2	3,1	4,0
Main trading partners **	**1,6**	**1,9**	**3,4**	**1,9**	**3,4**
North America	2,4	2,3	3,6	2,3	3,7
Europe	1,2	1,5	2,2	1,2	2,1
Asia	4,1	3,7	4,1	3,8	4,1
Latin America	-1,1	0,4	3,9	0,6	3,8

* World Economic Outlook (April and August 2003)
** Consensus Forecast (May and August 2003)

40. Consensus Forecasts’ projected US growth remains at 2.3 percent for 2003. A faster economy should result from that nation’s fiscal drive gets together with low interest rates,

in particular towards year end and throughout 2004, with growth estimated at 3.7 percent next year.

Europe’s projected growth was corrected downwards from 1.5 to 1.2 percent in 2003, and from 2.2 to 2.1 percent in 2004.

Latin America’s growth estimates for 2003 remained at 0.6 percent. However, growth rates have changed with Brazil and Mexico slowing down and higher projected growth in Argentina, where growth was corrected upwards from 3.9 percent in May’s Inflation Report to 5.3 percent for 2003 now. Overall growth for Latin America in 2004 has been estimated at 3.8 percent.

International interest rates

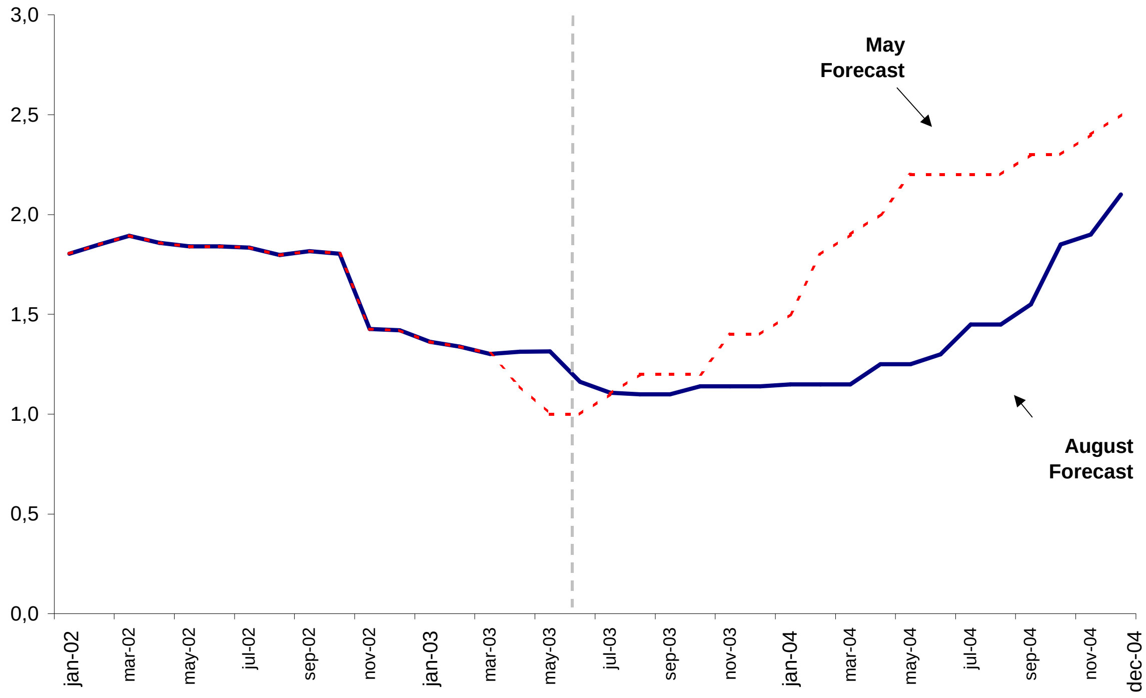
41. International interest rates impact domestic demand through the real interest rate in foreign currency and fluctuations of the nominal exchange rate. International interest rates have pursued an uninterrupted downward sliding trend in recent years, as developed economies slowed down.

To the extent the United States is expected to take the path of strong economic growth only in 2004, Libor is expected to stay at its present levels until the beginning of next year. Since the last Inflation Report, the US Fed once more cut the federal funds rate from 1.25 to 1.0 percent (on June 25), its lowest value in the last 45 years. In addition, at that meeting, an announcement was made that low interest rates would be maintained, mainly to contain observed deflation pressures and promote a faster US economic recovery.

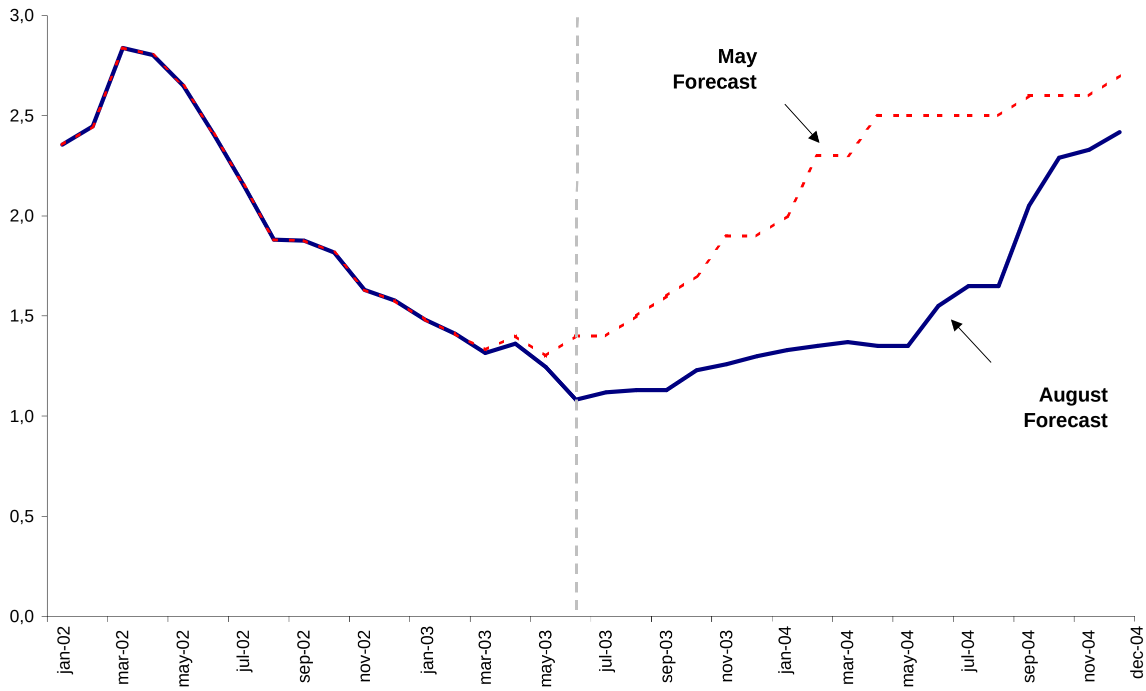
On June 5, the Central European Bank also cut its policy interest rate from 2.5 to 2.0 percent. Nevertheless, markets expected an even larger cut in the policy rate to foster domestic demand.

Interest rates are expected to rise in 2004, in particular, starting in the second half, as the world’s economy picks up.

GRAPH 22
1 MONTH LIBOR: ACTUAL AND FORECAST



12-MONTH LIBOR: ACTUAL AND FORECAST



BOX 3

INTERNATIONAL DEFLATION RISK

Deflation is defined as the ongoing overall reduction of an economy's prices, including asset prices, in a severe recession environment.

Present slower growth in the world's main economies has put downward pressure on inflation rates. Although the risk of global deflation is low, central banks has cut interest rates and announced as did the US Federal Reserve (Fed), their willingness to enforce such monetary policy until deflation risks are overcome.

When nominal interest rates are close to cero, deflation pressures constrain monetary policies because central banks lack the ability to modify interest rates ("liquidity trap").

Certain mechanisms may increase the intensity and duration of the recession cycle during deflation, including shrinking private expenditure as families see the value of their assets reduced, sliding value of loan collaterals and subsequent loan contraction, increased default rates leading to banking crises, and a significant rise in unemployment given wages' lack of downward flexibility.

In the present context of slower growth, the main economies worldwide have experienced a fall of their respective inflation rates and, as a response, those nations' central banks have cut interest rates to face the likely effects of deflation.

A recent (2003) IMF document[1] holds the US faces a moderate inflation risk, compared to Germany and Japan that face a likely general price drop. Falling prices in China reflect that country's potential GDP accelerated growth stemming from positive supply shocks. This type of deflation is different from events in the previously mentioned countries where the downward sliding price trend takes place during an economic recession.

An international recession and low imported inflation would have the direct effect of hurting Peruvian aggregate demand (as foreign demand for our export products falls) and aggregate supply (through reduced inflation pressure resulting from lower imports prices). In addition, lower international interest rates would flow through the local financial market to increase demand for credits in foreign currency and financial savings for foreign currency loan takers. Such circumstances would mitigate the direct impacts described above.

In sum, deflation imposes a number of burdens on a nation's economy by hurting its output, increasing unemployment and introducing undesirable redistribution effects. In this case, central banks will respond by introducing more flexible monetary policies.

[1] IMF (2003), "Deflation: Determinants, Risks, and Policy Options"- Occasional Paper 221

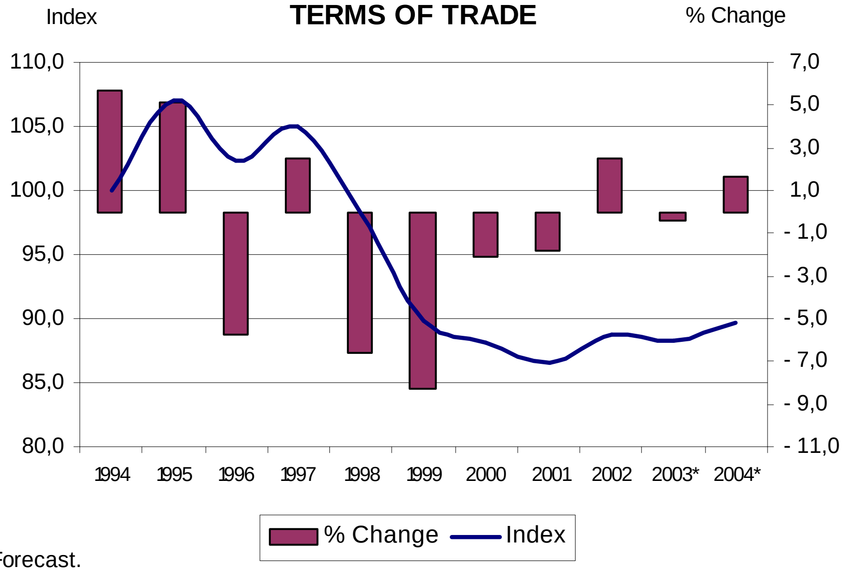
Terms of trade

42. Improved terms of trade will expand aggregate demand through higher relative prices for our exports compared to imports.

An annual terms of trade average fluctuation of –0.4 percent in 2003, compared to the 0.7 percent projection of the May report, despite a larger increase in exports' goods (5.2 percent vis-à-vis 4.6 percent) is expected basically as a consequence of higher gold prices. Imports' prices may rise 5.7 percent higher than the May projection, principally stemming from greater increases in fuel prices that rose 19.7 percent, compared to a prior 11.7 percent. In May, WTI oil price was projected to reach US$ 25.2 at the end of 2003. This estimate was corrected upwards to US$29.3 in the most recent estimate.

A 1.6 percent increase was projected for 2004, resulting from a 1.2 percent increase in exports' prices, mainly for increases in copper, gold, zinc and coffee principally. Also contributing to this would be the 0.4 percent fall of imports prices, principally accounted for oil quotations.

GRAPH 23
TERMS OF TRADE



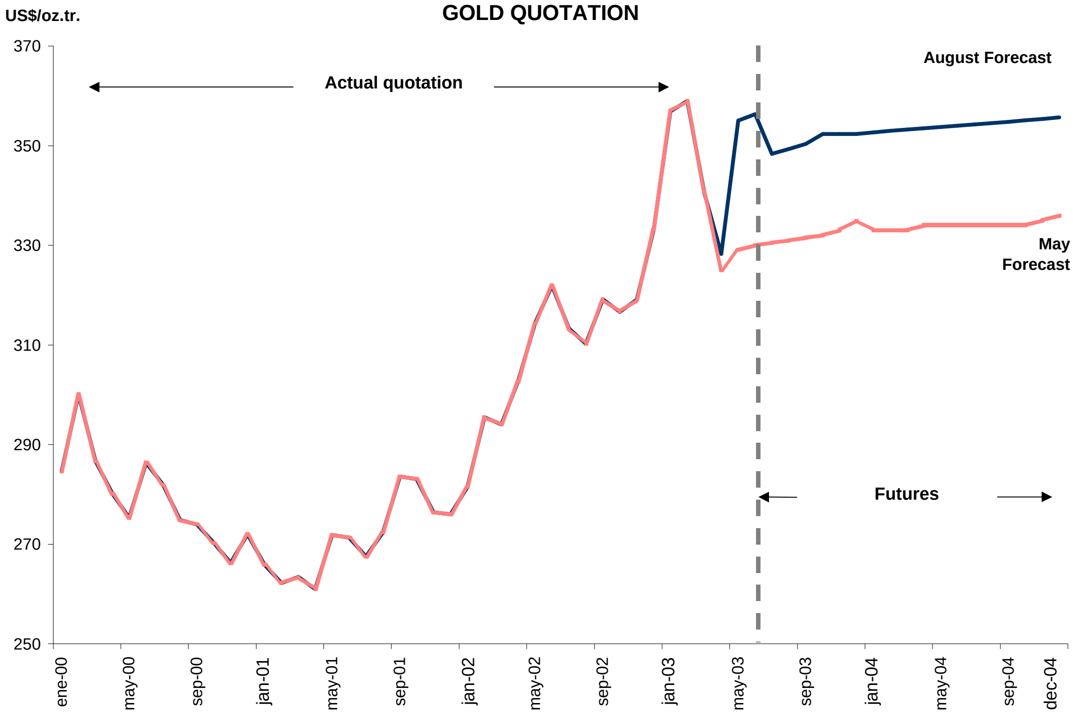
* Forecast.

TABLE 22
TERMS OF TRADE ANNUAL CHANGES FORECASTS

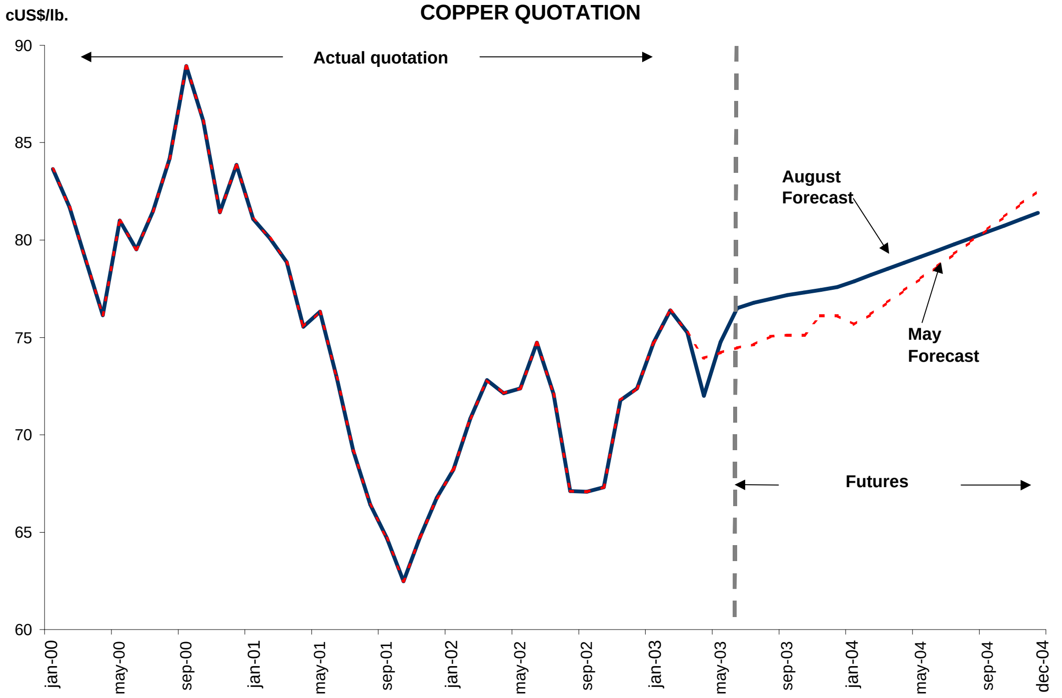
	Forecasts			
	May		August	
	2003	2004	2003	2004
Terms of Trade	**0,7**	**1,3**	**-0,4**	**1,6**
Exports price index	4,6	0,9	5,2	1,2
Imports price index	3,9	-0,4	5,7	-0,4

An uncertain recovery of the world's major economies is having a positive impact on gold prices, leading to an upward price correction from 8 percent to 12.9 percent in 2003, and from a 0.6 percent drop to a 1.0 percent rise in 2004. An average quotation between US$ 350 and US$ 354 per troy ounce is expected. Likewise, uncertainty has also pushed copper price estimates downwards, with refined copper average price estimates falling from US$/lb 0.80 to US$/lb 0.78.

GRAPH 24
GOLD QUOTATION

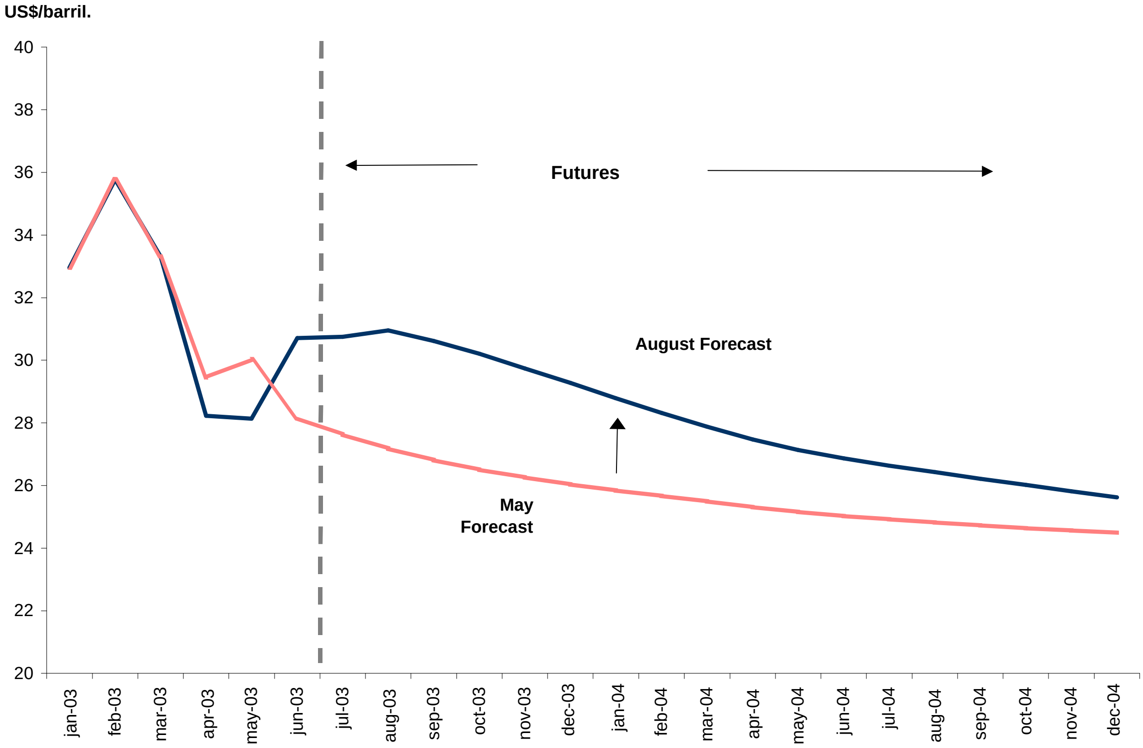


GRAPH 25
COPPER QUOTATION



Regarding imports, the average fluctuation of WTI oil prices was corrected upwards from 8.7 percent to 18.4 percent in 2003. The average price for 2003 is expected to reach US$30.9 while the 2003 end-of-period price should reach US$29.3 per barrel. The corresponding prices quoted in the May Inflation Report were US$ 28.4 and US$ 25.2 per barrel. The higher estimate results from uncertainty created by Iraq's low output and exports and low US gasoline inventories.

GRAPH 26
WTI OIL PRICES



II.4 Foreign Trade

Trade Balance

43. After taking into account the above developments in Peru's terms of trade and the world economy, the trade balance is expected to record a US$466 million surplus in 2003.

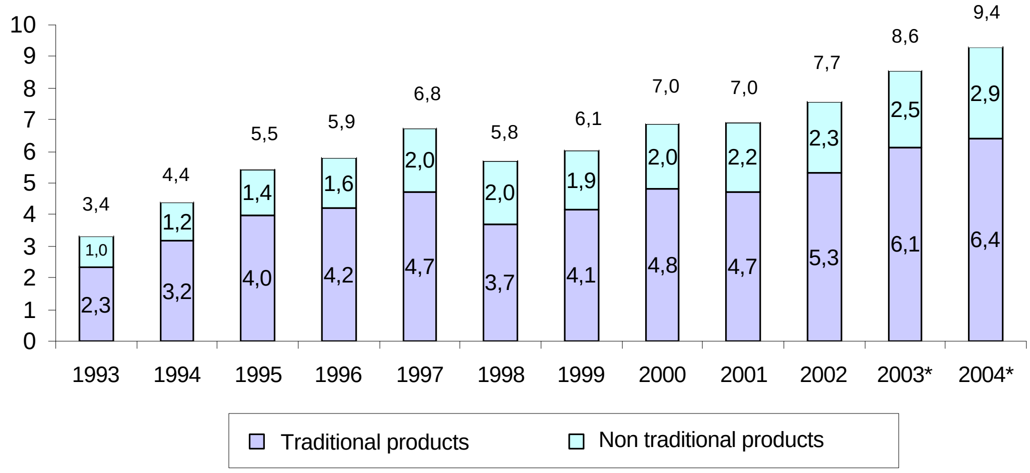
CENTRAL RESERVE BANK OF PERU

TABLE 23
TRADE BALANCE
(Millions of U.S. dollars)

				% Change	
	2002	**2003 ***	**2004 ***	**2003 ***	**2004 ***
1. EXPORTS	**7647**	**8646**	**9361**	**13,1**	**8,3**
Traditional exports	5312	6099	6422	14,8	5,3
Non-traditional exports	2260	2469	2858	9,2	15,8
Other	75	78	81	4,7	4,0
2. IMPORTS	**7440**	**8180**	**8607**	**9,9**	**5,2**
Consumer goods	1770	1880	2116	6,2	12,6
Raw materials and intermediate goods	3747	4293	4320	14,6	0,6
Capital goods	1843	1901	2061	3,2	8,4
Other	80	105	110	31,3	4,3
3. TRADE BALANCE	**207**	**466**	**754**		

* Forecast.

GRAPH 27
EXPORTS
(In billions of US$)

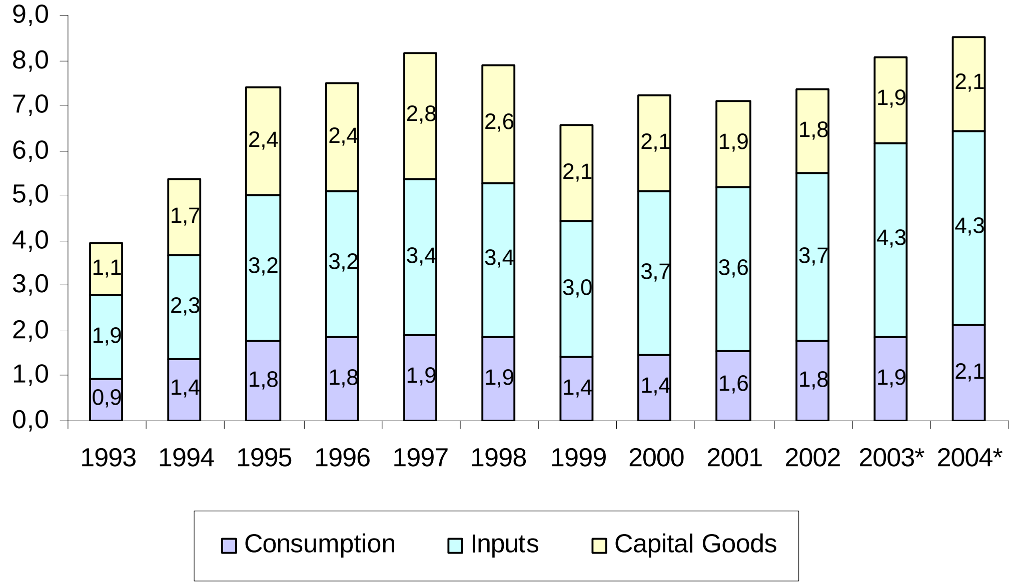


Note: The total exports include other exports.
* Forecast.

44. Exports are expected to grow by 13.1 percent and 8.3 percent in 2003 and 2004 through larger exports of minerals, in particular gold and copper, and increased sales of apparel thanks to the Andean Trade Preference and Drug Eradication Act (ATPDEA). In 2003, exports may reach US$8646 million. Traditional exports are expected to grow through larger foreign sales of mineral and oil products by US$656 million and US$145 million, respectively. The largest increases in foreign sales of traditional mineral products may be in gold (US$383 million) and copper (US$87 million), resulting from both better quotations and larger shipments.

In 2004, exports may reach US$9361 million, or 8 percent higher than the estimated value for 2003. This increase may be reached through a 5 percent increase in traditional exports and 16 percent larger non-traditional foreign sales.

GRAPH 28
IMPORTS
(In billions of US$)



45. Imports in 2003 have been estimated at US$8180 million, or 10 percent more than in 2002. This growth is slightly larger than the May Report's 9 percent projection, principally due to higher average prices for imported crude, which were forecast to grow 12 percent but now may rise 19 percent, in view of the new international oil scenario, as was already mentioned.

In 2004, imports are expected to grow 5 percent driven by 9 percent larger purchases of capital goods for industry and a 12 percent growth of input purchases. However, fuel purchases are expected to drop 23 percent, as oil by-products are gradually replaced by natural gas from the Camisea project, scheduled to go in line in August 2004, and also by cheaper crude imports.

Balance of payments' current account and capital flows

46. In 2003, the balance of payments' current account may record a US$ 1 245 million deficit, or 2.0 percent of GDP and slightly higher than the 1.9 percent May projection. Additionally, the financial account forecasts of US$ 1 796 million published in the May report were corrected downwards to US$ 1 595 million in this Report, reflecting an expected lower inflow of public capital by US$ 370 million, a drop partially offset by US$ 169 million larger private capital inflows (including privatizations). Outstanding among private flows is the Camisea project, with a US$ 735 million contribution. Simultaneously, the increase of net international reserves was also corrected downwards from US$ 625 million to US$ 350 million.

TABLE 24
BALANCE OF PAYMENTS
(Millions of US dollars)

	2002	2003 *	2004 *
I. CURRENT ACCOUNT BALANCE	**- 1 206**	**- 1 245**	**- 1 230**
(Percentage of GDP)	*-2,1*	*-2,0*	*-1,9*
II. CAPITAL ACCOUNT	**2 191**	**1 595**	**1 330**
1. Private sector	903	1 049	570
2. Privatization	186	10	10
3. Public sector	1 102	536	750
III. CHANGE IN NET INTERNATIONAL RESERVES (Increases shown in negative)	**- 985**	**- 350**	**- 100**

* Forecast.

In 2004, the current account deficit may reach US$1230 million, or 1.9 percent of GDP. Financial account flows may reach a positive US$1330 million, of which US$579 million may come from private sources, linked to various projects, including Alto Chicama and Camisea, with another US$750 million from public sources. International reserves are expected to grow US$100 million in 2004.

Forecasts in this Inflation Report point to a sustainable evolution of the balance of payments, without financing constraints, and thus contributing to a better country-risk rating.

II.5 Fiscal Accounts

47. In 2003, the fiscal gap is expected to reach 2.0 percent of GDP, below the 2.3 percent result in 2002. Improved government accounts reflect mainly increased central government current revenues, which may grow 6.7 percent in real terms to 14.5 percent of GDP in 2003. Tax measures introduced in the second half of 2002 (i.e. anticipated income tax payments and new sales tax mechanisms), as well as the increase of the sales tax to 19 percent in force since August 2003 all account for such results.

An additional drop in the public deficit is expected in 2004, to reach 1.5 percent of GDP and in line with goals set in the Multiannual Macroeconomic Framework for 2004-2006. This narrower fiscal gap would originate in greater tax collection stemming from the higher sales tax and economic growth, and also from enforcement of restraints to the general government’s non-financial expenditures included in the Fiscal Responsibility and Transparency Act.

TABLE 25
NON-FINANCIAL GOVERNMENT OVERALL BALANCE
(Percentage of GDP)

	2002	2003 *	2004 *
I. Central government current revenues	14,2	14,5	14,8
of which: Tax revenues 1/	*11,8*	*12,7*	*13,0*
II. Central government non-financial expenses	-14,5	-14,5	-14,3
III. Other government agencies	0,1	0,1	0,1
IV. Interest	-2,1	-2,1	-2,1
OVERALL BALANCE (I+II+III+IV)	**-2,3**	**-2,0**	**-1,5**

* Forecast.
1/ Excludes the tax on Public Assets.

48. The central government's non-financial expenses may remain at the 14.5 percent share of product recorded in 2002, or a real 4.0 percent increase. Meanwhile, Law 28019 suspended in 2003 its restrictions to real-term growth of the general government's non-financial expenses (set at 3 percent), as prescribed by the Fiscal Responsibility and Transparency Act. A 3 percent real growth rate in non-financial general government expenditures is expected for 2004.

49. Gross financial needs in the Non-Financial Public Sector may reach US$2704 million in 2003, or US$308 million higher than in 2002, due to increased repayments of both foreign and domestic government debt. The financial gap may be bridged with foreign resources for US$1911 million, including US$1.5 billion worth of freely available disbursements, US$33 million for pardoned foreign debt, domestic bond placements for US$516 million, and privatization proceeds for US$157 million.

Gross financing needs in 2004 may fall to US$2585 million, to be covered mainly with foreign sources.

TABLE 26
GOVERNMENT DEFICIT FINANCING
(Millions of US$ dollars)

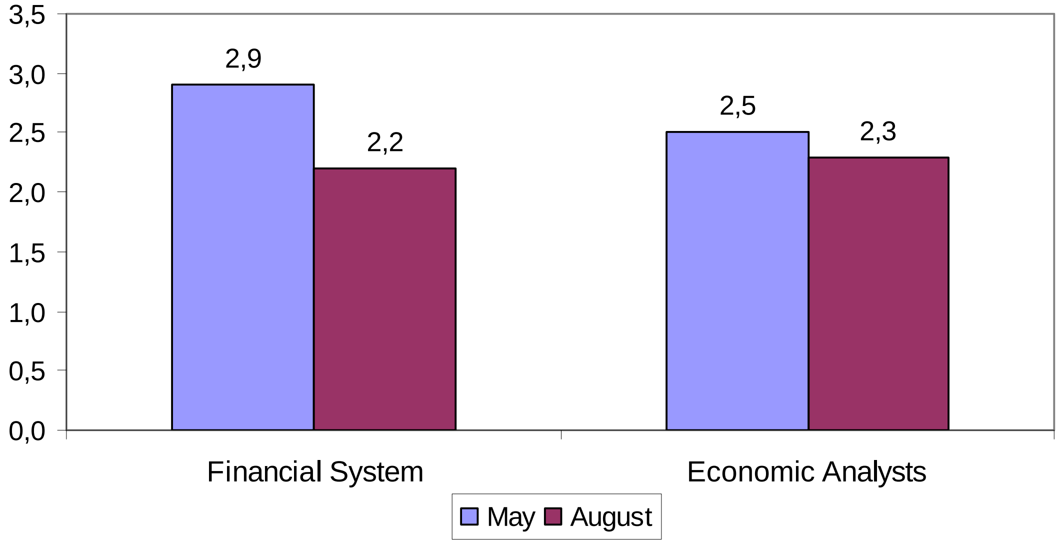
	2002	2003*	2004*
I. OVERALL BALANCE	**- 1 322**	**- 1 191**	**- 956**
(Percentage of GDP)	*-2,3*	*-2,0*	*-1,5*
II. AMORTIZATION	**- 1 074**	**- 1 512**	**- 1 629**
1. Internal	- 138	- 371	- 350
2. External	- 936	- 1 141	- 1 279
III. FINANCING REQUIREMENT	**2 396**	**2 703**	**2 585**
1. External	1 960	1 911	2 050
2. Internal	436	793	535

* Forecast.

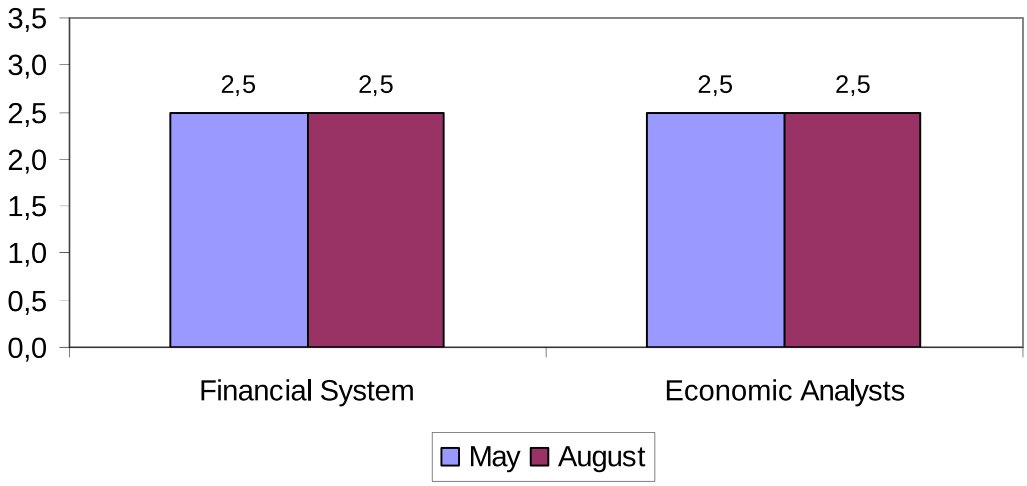
II.6. Inflation Outlook

50. A review of CRBP's surveys among financial organizations and economic analysts allowed gathering the market's inflation expectations for 2003 and 2004. Compared to the May surveys, inflation expectations for 2003 have dropped to their present value around 2.2 percent. For 2004, economic analysts and financial organizations report inflation expectations in line with the CRBP's inflation target.

GRAPH 29
EXPECTED INFLATION (% CHANGE): 2003
May and August Surveys

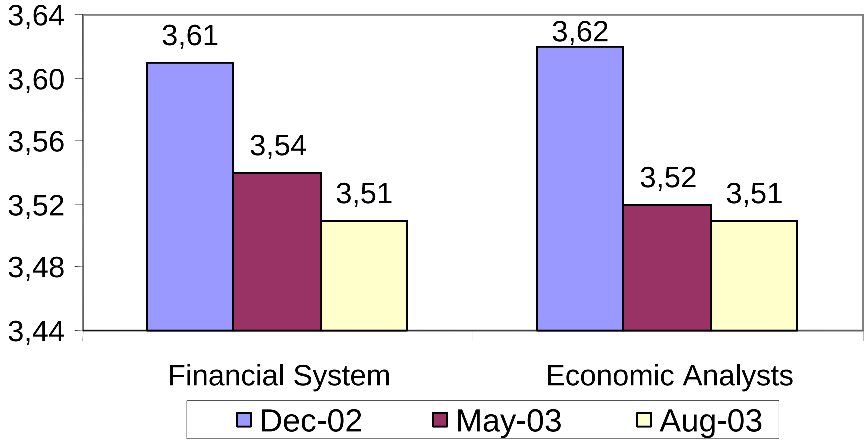


EXPECTED INFLATION (% CHANGE): 2004
May and August Surveys



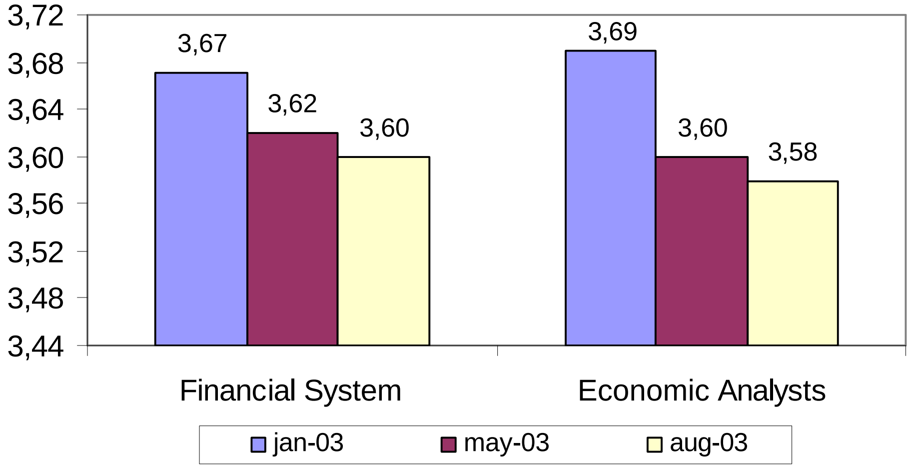
GRAPH 30

EXPECTED EXCHANGE RATE: DECEMBER 2003



Source: CRBP and Consensus Economics Surveys.

EXPECTED EXCHANGE RATE: DECEMBER 2004



Source: CRBP and Consensus Economics Surveys.

51. This Report's projected inflation from the following assumptions:

a. The monetary policy stance remains unchanged during the projected period. Such methodological assumption allows evaluating likely inflationary events if the monetary policy does not react to the macroeconomic scenario projected for subsequent months.

b. The exchange rate behaves consistently with the local and international interest rate differential, and the floating exchange rate scheme adopted by the Central Bank to occasionally step into the exchange market and mitigate sudden exchange rate fluctuations.

c. Macroeconomic scenario forecasts are based on the following considerations:

- A 3.0 percent non-core inflation in 2003 accounted for price changes for fuel and transportation. In 2004, non-core inflation is expected to reach just 0.9 percent, principally reflecting the expected behavior pattern for food prices (3 percent) and mitigated by 4.1 percent lower fuel rates.

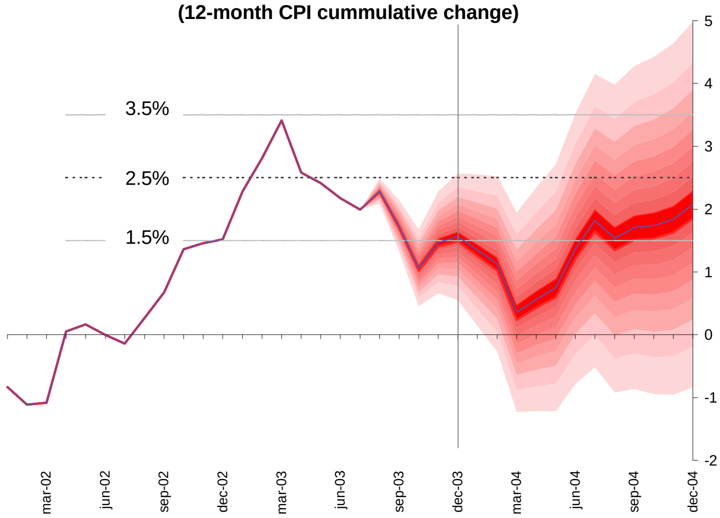
Non-core inflation forecasts were corrected downwards compared to the May Report. For 2003, the reason may be found in larger agricultural supplies leading to falling food prices this year. Highlights include significantly lower potato prices in June and July as planting went back into schedule. For 2004, the correction results from lower fuel prices originating in forecasts of a somewhat steeper slide of international oil quotations next year.

- The fiscal position reflects the scenario described in the Multiannual Macroeconomic Framework, i.e. a government deficit reaching 2.0 percent of GDP in 2003 and 1.5 percent in 2004.

- Given prospects of low growth and moderate inflation in the United States and Europe, international interest rates are expected to remain stable in 2003 and increase gradually starting in the second half next year.

52. In view of the above considerations, the following graph shows inflation forecasts for 2003 and 2004. It will be noticed that the central projection line is near the lower edge of the target range in 2003, and around 2 percent at 2004-close. The brighter band reflects the most likely outcomes in 2003 and 2004, assuming a stable monetary policy stance, as set by the Central Bank's Board, through the end of next year.

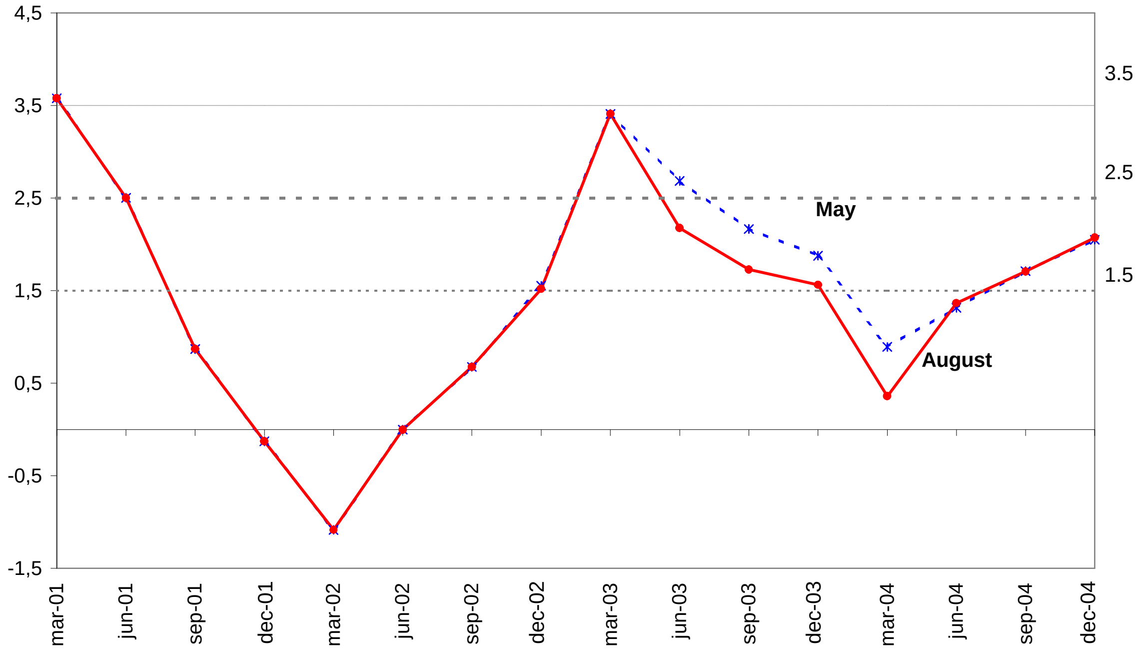
Graph 31
INFLATION FORECAST
(12-month CPI cummulative change)



53. Compared to the May Report, the projected inflation rate is lower for 2003 but has not been modified for 2004. A lower projected inflation rate for 2003 stems from the slower inflation observed in recent months.

As already described, the slower pace of inflation may result from larger agriculture output, a slower domestic demand growth and the Nuevo Sol's appreciation.

GRAPH 32
CENTRAL FORECAST ACCORDING TO INFLATION REPORTS
(12-months CPI cum. change)



54. The present annual inflation trend—reflected in the cumulative 12-month CPI change—points to inflation below the lower limit of the tolerance range for the year's inflation target (1.5 percent) from February to June, 2004. A statistical effect is brought to bear when comparing inflation for those months and high rates recorded in the same months in 2003, particularly during February and March when rates reached 0.5 percent and 1.1 percent, respectively. In the second half, the annual inflation rate is expected to fall back into the lower trench of the target range of 1.5 to 2.5 percent. The inflation target is defined as each year's cumulative percent change.

III. BALANCE OF RISKS

55. January's Inflation Report this year held the main source of uncertainty when projecting 2003's inflation was the likely income of a sustained major rise in fuel quotations originating in the Middle East war conflict. Consequently, the January projection corrected the inflation risk upwards.

As that risk factor dissipated, the May Inflation Report considered a lower inflation projection for this year, in the lower range of the 1.5-2.5 percent target range. The main source of uncertainty cited in that Report was a reduced local consumer and investor confidence, and its likely negative repercussions on aggregate demand and inflation.

56. Although the macroeconomic scenario described in this document is considered to be also the most likely one, various sources of risk and uncertainty may modify the Report's inflation forecasts:

- **Reduced consumer confidence.** Forecasts are based on events in the second quarter and slower estimated demand growth in 2003 and 2004 (3.6 percent in either instance) accounting for the downward correction compared to the last Report (4.3 percent and 4.0 percent).

However, the slowdown may be even more significant if consumer confidence drops more sharply, reducing economic momentum and exerting increased downward pressure on inflation. Under these circumstances, monetary policy may become more flexible to prevent the risk of annual inflation rates falling below the bottom limit of the target tolerance range.

- **A slower than expected world economic recovery.** Uncertainty about the speed of the world economic recovery remains. Many major world economies continue to face recession with some facing the threat of deflation. Against this background, central banks have introduced flexible monetary policies.

  In particular in the United States, a wide-ranging tax cut programs is expected to foster private consumption. However, economic indicators do not yet point conclusively to the end of the recession stage. A postponed world economic recovery would mean for Peru less favorable terms of trade and slower exports, with the subsequent adverse impact on aggregate demand and economic activity. Once again, the Central Bank may adopt a more flexible monetary position.

- **A smaller oil price reduction**. Our main scenario is underpinned by a sliding oil quotation. However, the present world oil prices have remained at their level during the Iraq conflict, in view of uncertainty about that country's oil recovery. If international oil prices do not fall as expected, the non-core inflation component would be subject to upward pressures. If so, the Central Bank's monetary policy position would remain unaltered, unless changes in the price of fuels also affect other prices throughout the economy.

- **Tax on bank transactions.** A tax on bank transactions is currently debated. Such tax would foster replacing other payment arrangements for the local financial system's payment mechanisms. If so, economic transactions may escape the influence of monetary policies resulting in their reduced ability to control inflation.

- **Changes in the sovereign risk perception linked to expansive fiscal policies.** This scenario is built on the forecasts included in the Multiannual Macroeconomic Framework. They imply following the macro-fiscal guidelines introduced by the Fiscal Responsibility and Transparency Act. A larger fiscal deficit may adversely impact the perceived sovereign risk and create financial market turmoil. If so, the Central Bank may choose a less flexible position to attenuate financial volatility.

57. At the time of preparing this Report, none of these risks was considered to create an upward or downward bias on our inflation estimates for 2003 and 2004.

Conclusion

58. This Report's inflation estimate falls on the bottom band of the 2003 and 2004 target range between 1.5 and 2.5 percent. These forecasts are underpinned by the methodological principle that the monetary policy stance will remain constant throughout the projection's period. Forecasts were based on data available to date. Meanwhile, the Central Bank will remain watchful of new information on macroeconomic evolutions that may change the course of inflation.