

CENTRAL RESERVE BANK OF PERU

INFLATION REPORT: RECENT DEVELOPMENTS AND PROSPECTS August 2004

| | |
|--|----|
| EXECUTIVE SUMMARY | 2 |
| I. RECENT INFLATION BEHAVIOUR AND MACROECONOMIC CONDITIONS | 3 |
| I.1 Inflation | 3 |
| I.2 Exchange rate | 12 |
| I.3 Domestic demand and GDP | 20 |
| I.4 External accounts..... | 26 |
| I.5 Government expenditure and fiscal accounts..... | 28 |
| I.6 Interest rates..... | 31 |
| I.7 Liquidity and credit..... | 38 |
| II. FORECASTS..... | 40 |
| II.1 Economic activity | 40 |
| II.2 External sector..... | 45 |
| II.3 Fiscal accounts | 55 |
| II.4 Inflation..... | 57 |
| III. BALANCE OF RISKS..... | 58 |
| CONCLUSIONS | 60 |

CENTRAL RESERVE BANK OF PERU

EXECUTIVE SUMMARY

- This inflation report is an analysis of monetary policy during the year so far and macroeconomic forecasts for the 2004 - 2005 period.

The rate of inflation has been higher than that envisaged in the previous inflation report for May 2004 because supply shocks affecting Peru's economy were greater and lasted longer. By their very nature these shocks have a transitory effect on the inflation rate as they are the result of higher international prices for certain foodstuffs (wheat and soybean oil) and oil and higher domestic prices for some agriculture & livestock produce caused by adverse weather conditions.

- Given the transitory nature of these shocks, monetary policy remained stable (interbank rate at 2,5 percent) until July 2004. In August the Central Bank tightened monetary policy through an increase in the reference interest rate of 25 basis points (interbank interest rate of 2,75 percent).
- Over the following months of 2004, it is forecast that the 12 month accumulated rate of inflation will revert its growing tendency and fall to around the upper limit of the target range (3,5 percent) by the close of the year. The partial reversal of supply shocks expected for next year will place the inflation rate at around the target level (2,5 percent).

Favorable external conditions for the Peruvian economy are still expected, as far as inflation forecasts for 2004 are concerned, although with lower growth in terms of trade caused by higher international fuel prices. Prospects for a recovery in the world economy have also consolidated; a trend that could diminish during 2005 as United States interest rates rise in line with a gradual tightening of that country's monetary policy.

- GDP growth forecasts for 2004 have been revised upwards from 4,0 to 4,3 percent and the forecast of 4,5 percent for 2005 is maintained. Economic activity has been more dynamic in 2004 as the result of higher growth in private investment (from 7,2 to 9,1 percent) and in exports (from 7,9 to 9,0 percent). This growth should continue in 2005 driven by exports (5,4 percent) and private investment (7,2 percent). This behaviour by the components of aggregate expenditure suggest that the economy is continuing to expand its production capacity (potential GDP) and access to foreign markets, which is leading to sustained rates of growth without inflationary pressures or putting at risk the viability of the balance of payments.

These forecasts consider scenarios involving a diminishing fiscal deficit contemplated in the Multi-annual Macroeconomic Framework for the 2005 - 2007 period.

- Factors that could affect forecast inflation and the level of economic activity contained in this report are found mainly on the supply side.

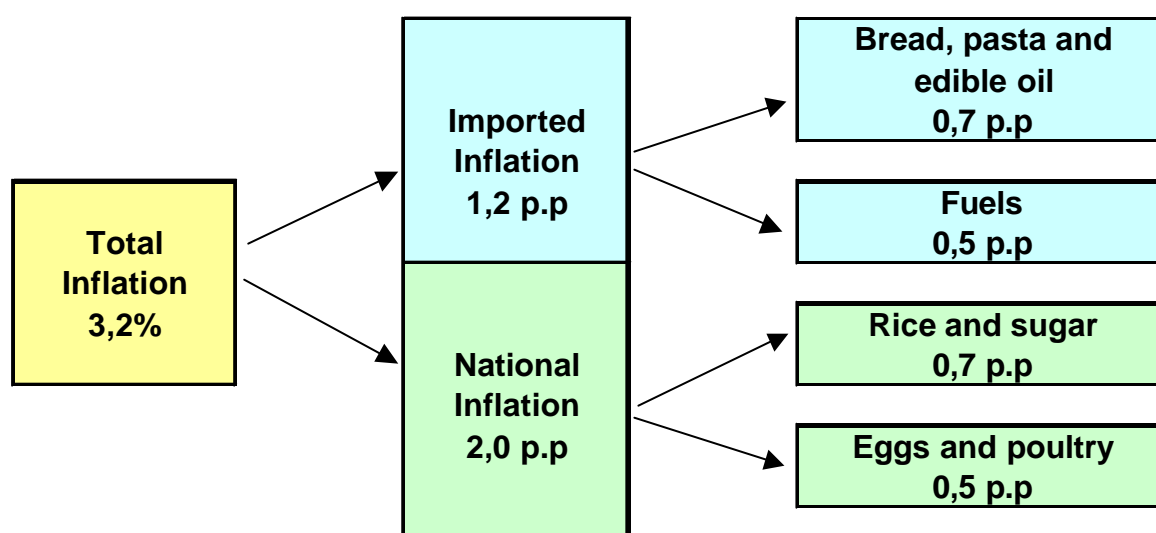
CENTRAL RESERVE BANK OF PERU

I. RECENT INFLATION BEHAVIOUR AND MACROECONOMIC CONDITIONS

I.1 Inflation

- Accumulated **inflation** between January and August this year has been influenced by factors on the supply side, all of which can be classed as transitory. Thus, of an accumulated increase in the consumer prices index (CPI) of 3,2 percent, 1,2 percentage points are explained by the effect of increases in the prices of imported goods and 2,0 percentage points by domestic inflation. Of the later, 0,7 percentage points are accounted for by price rises for rice and sugar, products affected by import restrictions and a period of drought.

The following diagram shows the effects of supply shocks on the prices of products making up 18 percent of the basket of consumer goods, which contribute 2,4 points to accumulated inflation for January to August (3,2 percent).



(*) p.p: percentage points.

Chart 1

WEIGHTED CONTRIBUTION TO INFLATION: JANUARY – AUGUST 2004
(Percentage points)

| Item | Weighting | % change | Positive contribution | Item | Weighting | % change | Negative contribution |
|-----------------------------|-----------|----------|-----------------------|---------------------|-----------|----------|-----------------------|
| Bread, noddles & edible oil | 5,4 | 11,2 | 0,65 | Potatoes | 1,5 | -9,6 | -0,18 |
| Fuels | 3,9 | 11,2 | 0,54 | Personal care items | 4,5 | -2,5 | -0,11 |
| Sugar | 1,4 | 35,2 | 0,44 | Citrus fruit | 0,7 | -15,8 | -0,10 |
| Rice | 2,3 | 13,7 | 0,30 | Grapes | 0,1 | -26,9 | -0,06 |
| Eggs | 0,7 | 36,3 | 0,27 | Cigarettes | 0,1 | -13,9 | -0,03 |
| Chicken | 4,0 | 6,8 | 0,24 | | | | |
| Total | | | 2,44 | | | | -0,48 |

Source: INEI

- Imported **inflation**, which consists of those items in the basket of consumer goods that are affected, either directly or indirectly, by international prices and the exchange

CENTRAL RESERVE BANK OF PERU

rate, varied 9,0 percent over the period January - August 2004 (1,2 percent over the same period in 2003). The principal changes in imported inflation were caused by foodstuffs such as bread, pasta and edible oil, and fuels.

Chart 2
IMPORTED & DOMESTIC INFLATION
(Cumulative percentage change)

| | Weighting | 2003 | | 2004 |
|-------------------------|--------------|-------------|-------------|-------------|
| | | Jan-Aug | Jan-Dec | Jan-Aug |
| I. IMPORTED CPI | 12,1 | 1,21 | 3,03 | 9,03 |
| Food | 5,4 | -1,26 | -0,10 | 11,22 |
| Fuel | 3,9 | 5,22 | 8,94 | 11,25 |
| Electrical appliances | 1,0 | -1,57 | -1,91 | -2,49 |
| Others | 1,4 | 1,25 | 1,74 | 3,27 |
| | 0,4 | -0,39 | 0,29 | -0,98 |
| II. Domestic CPI | 87,9 | 1,11 | 2,40 | 2,31 |
| III. CPI | 100,0 | 1,12 | 2,48 | 3,20 |

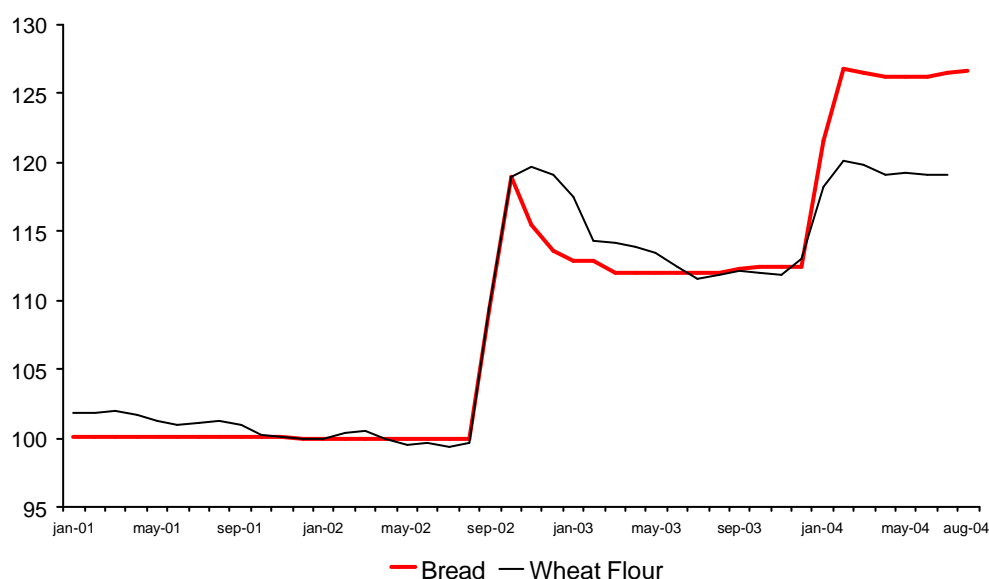
Source: INEI

- a. Bread (3,7 percent of the basket): The increase in the price of bread took place mainly in January and February 2004, caused by an increase in the international price of wheat from US\$ 116 per metric ton in July 2003 to US\$ 147 per M.T. in January 2004 and the effect of this on the domestic price of flour.

This increase in the international wheat price is explained by reduced production in the United States and Europe, caused by weather conditions which affected sowing and yields, together with an increase in demand from China. Consequently, world inventories fell to their lowest levels in the last five years. Nevertheless, better production in the 2004 - 2005 growing season corrected the price rise and by August 2004 it was US\$ 122 per M.T., with a falling trend.

Figure 1

PRICE OF BREAD AND WHEAT FLOUR
(Index: December 2001 = 100)

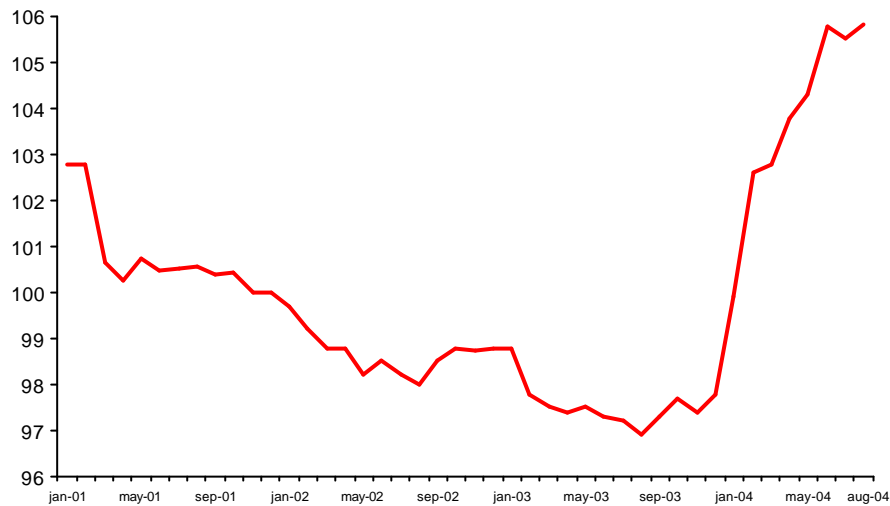


CENTRAL RESERVE BANK OF PERU

- b. Pasta (1,0 percent of the basket): Between January and August 2004, the price of pasta rose 8,2 percent, mainly in January and February (4,9 percent) and to a lesser extent in April and June. Compared to bread, the effect of the international price of wheat and domestic price of flour on the retail price of pasta was lower and occurred later.

Figure 2

PASTA PRICES
(Index: December 2001 = 100)

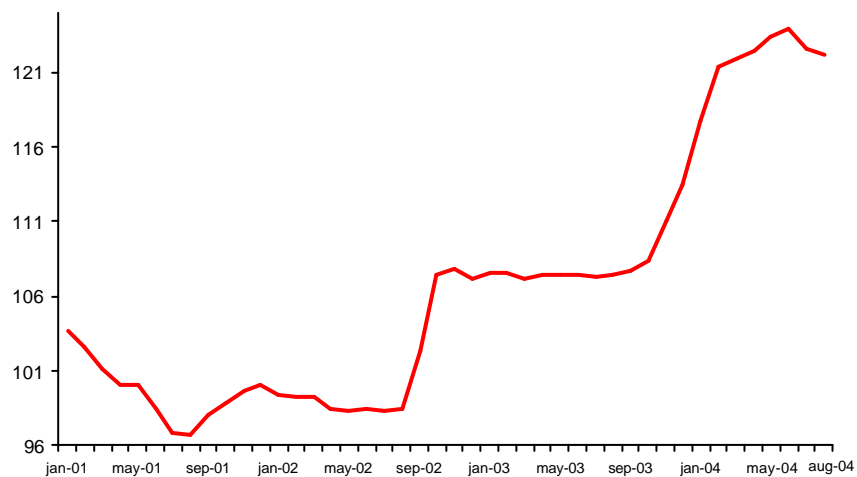


- c. Edible oil (0,8 percent of the basket): The price of edible oil rose principally between November 2003 and February 2004 (12 percent) and reflects the behaviour of the international price of soybean oil, which rose from US\$ 445 per M.T. in August 2003 to US\$ 754 per M.T. in March 2004 before falling to US\$ 565 per M.T. in August.

The change in the international price of soy is explained by greater demand from China, despite higher world production.

Figure 3

EDIBLE OIL PRICES
(Index: December 2001 = 100)



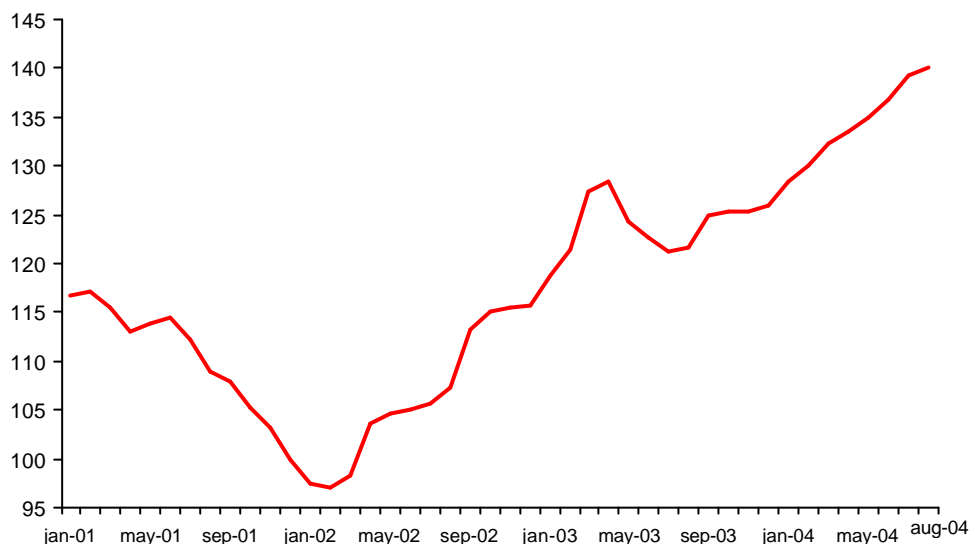
CENTRAL RESERVE BANK OF PERU

- d. Fuels (3,9 percent of the basket): The international price of West Texas Intermediate (WTI) rose from US\$ 32,1 a barrel in December 2003 to US\$ 44,9 a barrel in August 2004 (a 40 percent increase). This increase was caused by supply restrictions imposed by the main producing countries, security problems in the Middle East and speculation, in a context of higher world demand.

Figure 4

FUEL PRICES

(Index: December 2001 = 100)



In this context, domestic fuel prices increased, on average, 11,2 percent between January and August 2004. In order to avoid further domestic price increases, the government enacted Emergency Decree 003-2004 to establish a means for stabilizing the price of fuels derived from petroleum.

Chart 3

FUEL PRICES INCLUDED IN CPI

(Monthly percentage variation)

| | 2003 | | | | | | | 2004 | | | | | | | | |
|---------------------|------|------|-------|------|------|------|-----------|------|------|------|------|------|------|------|------|-----------|
| | Jul. | Aug. | Sep. | Oct. | Nov. | Dec. | Jan.-Dec. | Jan. | Feb. | Mar. | Apr. | May. | Jun. | Jul. | Aug. | Jan.-Aug. |
| Fuels | -1,1 | 0,3 | 2,8 | 0,2 | 0,1 | 0,5 | 8,9 | 1,9 | 1,3 | 1,8 | 1,0 | 1,0 | 1,5 | 1,8 | 0,6 | 11,2 |
| Gasoline | -2,4 | 0,2 | 5,4 | -0,5 | -0,2 | 0,2 | 9,7 | 0,8 | 0,8 | 2,4 | 1,1 | 1,6 | 2,0 | -0,2 | 0,7 | 9,6 |
| Gas | -0,3 | 0,6 | 0,1 | 0,1 | 0,2 | 0,1 | 4,2 | 2,7 | 2,2 | 1,2 | 0,7 | 0,2 | 0,7 | 5,5 | 0,0 | 14,0 |
| Kerosene | -0,4 | 0,2 | 2,4 | 1,2 | 0,4 | 1,2 | 13,0 | 2,5 | 0,9 | 1,6 | 1,0 | 0,9 | 1,6 | 0,6 | 0,9 | 10,5 |
| WTI Price 1/ | | | | | | | | | | | | | | | | |
| US\$ / barrel | 30,8 | 31,6 | 28,3 | 30,3 | 31,1 | 32,1 | | 34,2 | 34,8 | 36,7 | 37,1 | 40,3 | 38,3 | 40,7 | 44,9 | |
| % Var. | 0,1 | 2,7 | -10,4 | 7,1 | 2,7 | 3,0 | 8,9 | 6,8 | 1,5 | 5,5 | 1,1 | 8,5 | -4,9 | 6,3 | 10,2 | 40,0 |

1/ West Texas Intermediate

CENTRAL RESERVE BANK OF PERU

BOX 1

FUEL PRICE STABILISATION MECHANISM

In order to prevent rising international fuel prices from having a further effect on domestic prices, on the 27th of May the government enacted Emergency Decree 003-2004, establishing a mechanism to stabilize prices for 120 days, which consists of offsetting rises in the international price by reductions in excise tax (ISC) on fuels.

This mechanism sets an upper and lower price band for each type of fuel. The upper band is set on the basis OSINERG's last reference price before the 27th of May. If the prices calculated by OSINERG exceed the upper band for 14 days, ISC is reduced.

REFERENCE PRICES PUBLISHED BY OSINERG & REDUCTION IN ISC

(In S/. per gallon)

| | Lower Band 1/ | At 10th August 2/ | Upper Band 1/ | Reduction in ISC | | | |
|---------------|---------------------|-------------------------|---------------------|------------------|----------|-----------|-------------------------|
| | | | | 17th Jul. | 4th Aug. | 17th Aug. | Accumulate reduction |
| Gasoline 84 | 4,91 | 4,58 | 5,45 | | | | |
| Gasoline 90 | 5,18 | 4,93 | 5,76 | | | | |
| Gasoline 95 | 5,50 | 5,32 | 6,11 | | | | |
| Gasoline 97 | 5,59 | 5,44 | 6,21 | | | | |
| Kerosene | 4,44 | 5,15 | 4,93 | | | 0,07 | 0,07 |
| Diesel 2 | 4,03 | 4,90 | 4,48 | 0,05 | 0,08 | 0,06 | 0,19 |
| Residual 6 | | 2,87 | | | | | |
| Residual 500 | | 2,71 | | | | | |
| Liquefied gas | 3,20 | 4,03 | 3,55 | | 0,20 | 0,06 | 0,26 |

1/. Established by D.U. 003-2004 (27/05/04). The upper band corresponds to the OSINERG reference price at 21-5-2004

2/. Average of last 10 quotations, includes cost of importing and profit margin.

Source: OSINERG

In this way, up to the 17th of August, the date of the last adjustment to ISC, the rule had been applied three times reducing ISC for diesel 2 by a total of S/. 0,19 per gallon, that on kerosene by S/. 0,07 per gallon and that on liquefied gas by S/. 0,26 per gallon.

This measure prevented a 3 percent rise in the price of diesel, a 1 percent rise in that of kerosene and a 5 percent rise in that of gas.

Though the oil prices' stabilization mechanism would raise a smaller excise tax contribution, this effect is compensated by a greater contribution from value-added tax, vehicle tax and tariffs as a result of higher prices that have caused an increase in the base with respect to what was projected initially. It is estimated that the net effect in 2004 will be nil.

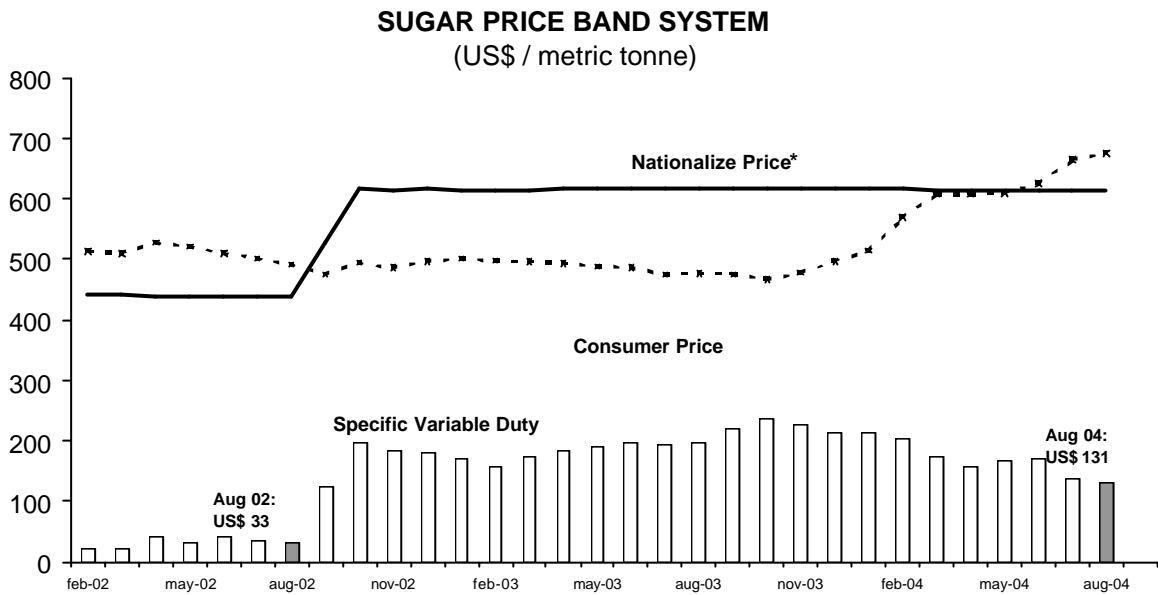
3. The **inflation deriving from domestic components** of the basket rose 2,3 percent over the period January - August 2004 (1,1 percent over the same period of 2003), explained principally by rises in the price of foodstuffs such as sugar, rice, eggs and poultry.
 - a. Sugar (1,4 percent of the basket): The price of sugar has been rising since November 2003 as production has fallen due to weather conditions affecting yields as well as financial and management problems that have paralysed certain

CENTRAL RESERVE BANK OF PERU

agribusinesses. For these reasons production fell by 21 percent between January and July 2004, compared to the same period in 2003.

Imports did not have a regulating effect on prices because of a significant increase in protectionist measures applied to sugar. Thus specific variable duty increased from US\$ 33 per M.T. in August 2002 to US\$ 131 per M.T. in the first fortnight of August 2004, transferring the reduction in supply to prices.

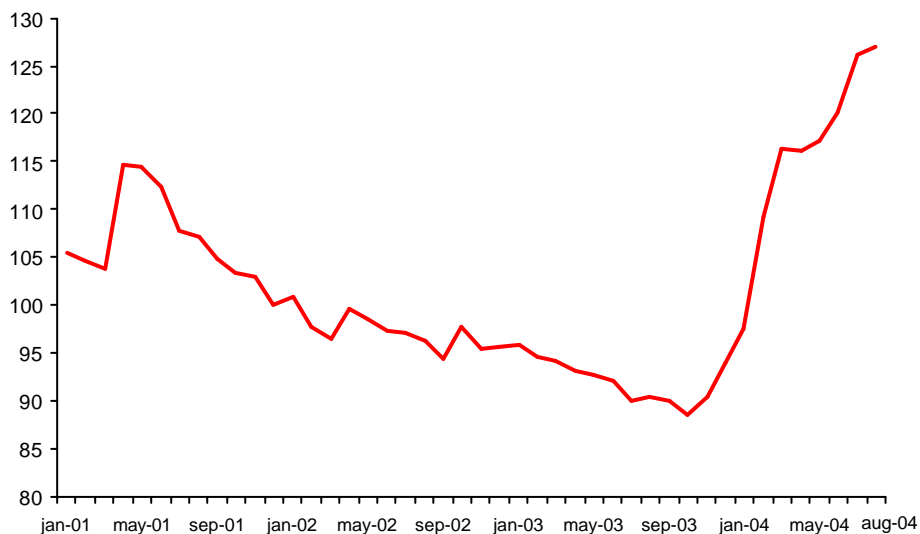
Figure 5



* Includes the reference price, duty, additional specific taxes, specific variable duty, value-added tax and general import

Figure 6

SUGAR PRICE
(Index: December 2001 = 100)



CENTRAL RESERVE BANK OF PERU

b. Rice (2,3 percent of the basket): An increase in the price of rice recorded principally between November 2003 and March 2004 (18 percent), is a reflection of reduced production as less land was sown with this crop due to a water shortage on Peru's north coast, especially in Lambayeque and Piura. For this reason hulled rice production fell 21 percent in the period January - July 2004 compared to the same period in 2003.

Figure 7

HULLED RICE PRODUCTION (Thousands of metric tons)

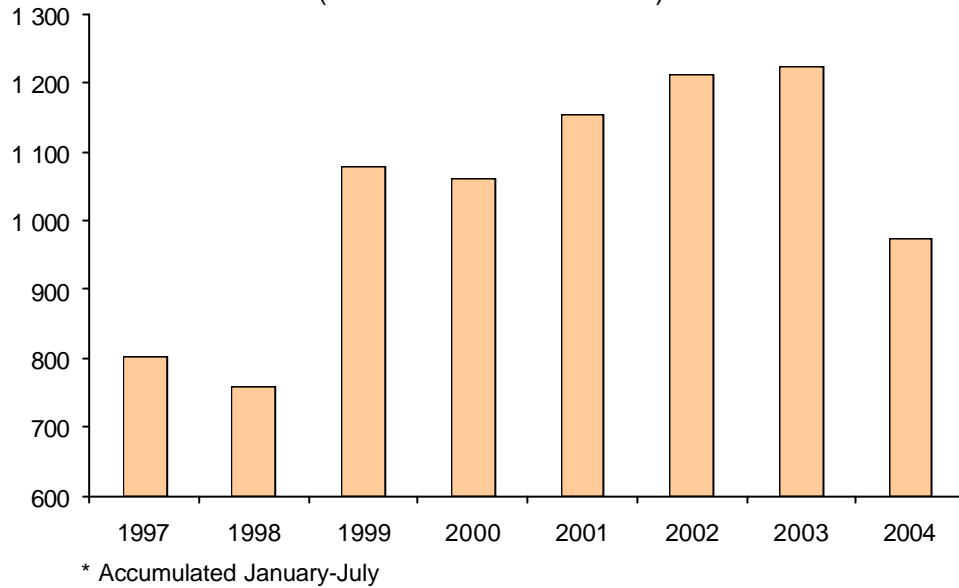
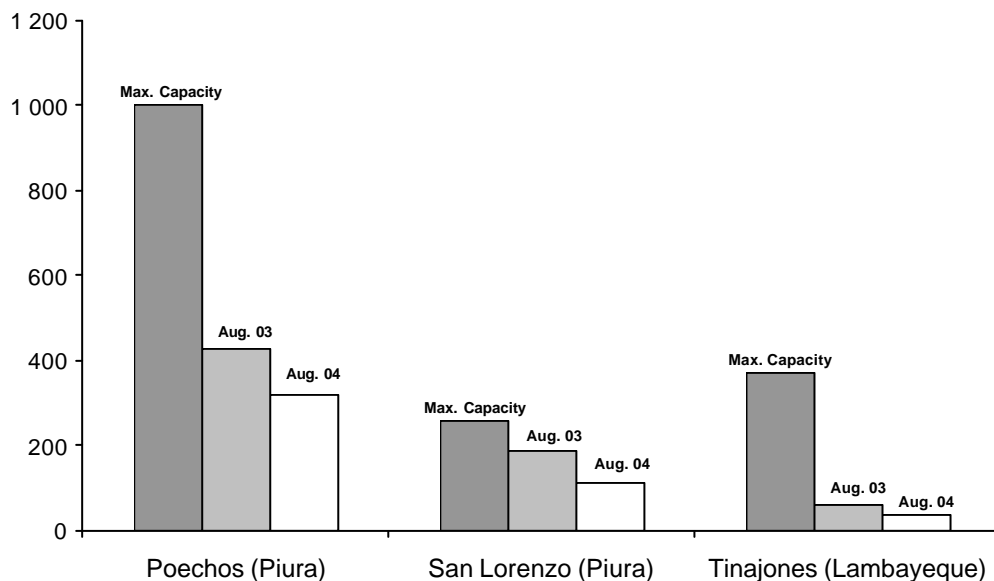


Figure 8

WATER VOLUME IN PRINCIPAL RESERVOIRS (Thousands of metric tons)



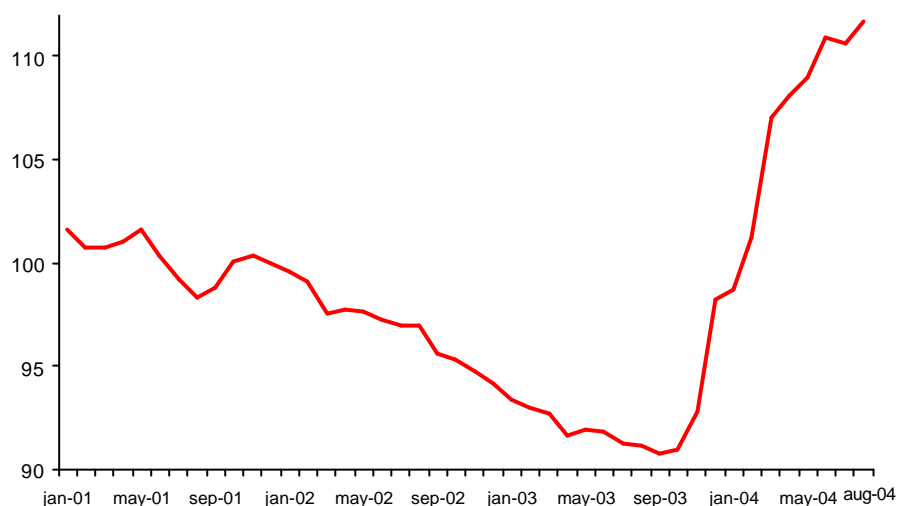
CENTRAL RESERVE BANK OF PERU

In this case also, imports failed to regulate consumer prices because of a prohibition on the issue of health certificates for rice imports from Asia. In March 2004 Health Authority Resolution N° 064-2004-AG-Senasa, established this prohibition for 90 days in order to prevent the risk of avian influenza from Asia and the measure was extended in June (for 60 days) and again in August of this year (45 days) by Resolutions 141 and 194-2004-AG-Senasa.

Figure 9

PRICE OF RICE

(Index: December 2001 = 100)



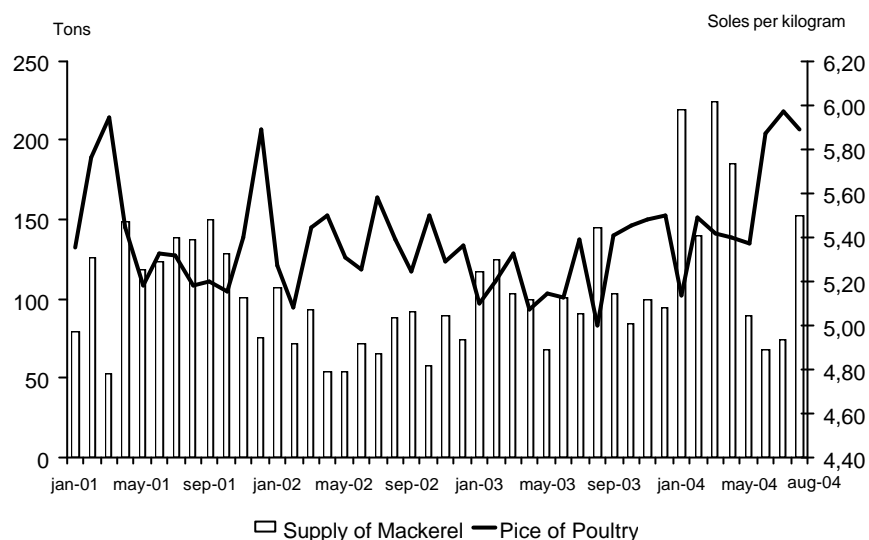
- c. Eggs (0,7 percent of the basket): The price of eggs rose 36 percent between January and August 2004 after a reduction of 9 percent during 2003. This increase is explained by a reduction in the number of laying hens (an 8 percent fall between January 2003 and August 2004).
- d. Poultry (4,0 percent of the basket): The price rise occurred in the months of June and July 2004 and was the result principally of two factors: rising demand in the absence of substitutes such as jack mackerel and, to a lesser degree, an accumulated increase in the cost of production (an increase in the price of corn).

On the one hand, adverse sea conditions and better yields of anchovy catches implied a reduction in jack mackerel landings. On the other hand, an increase in the international price of corn, which rose by 31 percent between July 2003 and April 2004, caused a delayed rise on the production costs of poultry companies. It is worth pointing out that the wholesale price of this product in the domestic market increased 5,0 percent between January and August 2004.

CENTRAL RESERVE BANK OF PERU

Figure 10

SUPPLY OF MACKEREL AND PRICE OF POULTRY



Core inflation and non-core inflation

4. **Core inflation**, an indicator of inflation trend that excludes foodstuffs (fuels, public services and transport) that showed greater price variation between 1995 and 2001, recorded an accumulated increase of 2,3 percent between January and August 2004. It should be mentioned that core inflation was also influenced by imported inflation.

The non-core **inflation rate** recorded an accumulated variation between January and August 2004 of 5,1 percent, caused by higher food and fuel prices, which were responsible for 3,2 and 1,6 percentage points of this variation respectively.

Chart 4

INFLATION (Accumulated percentage variation)

| | Weighting | 2003 | | 2004 | |
|----------------------------------|--------------|--------------|-------------------|-------------|-------------------|
| | | Jan-Aug | Aug 02/ Aug 03 | Jan-Aug | Aug 03/ Aug 04 |
| I. CORE INFLATION | 68,3 | 0,24 | 1,38 | 2,25 | 2,79 |
| Goods | 41,8 | -0,37 | 1,22 | 2,81 | 3,49 |
| Food & beverages | 20,7 | -1,38 | 1,67 | 6,03 | 7,43 |
| Textiles & footwear | 7,6 | 0,61 | 0,72 | 0,85 | 1,15 |
| Electrical appliances | 1,0 | -1,57 | -1,78 | -2,49 | -2,83 |
| Other industrial products | 12,5 | 0,81 | 1,04 | -0,94 | -1,05 |
| Services | 26,6 | 1,20 | 1,62 | 1,38 | 1,71 |
| Eatina out | 12,0 | 0,75 | 1,49 | 1,43 | 1,94 |
| Education | 5,1 | 2,82 | 3,02 | 3,43 | 3,63 |
| Health | 1,3 | 1,41 | 2,87 | -0,04 | 0,73 |
| Rents | 2,3 | 0,89 | 0,30 | -0,26 | -0,17 |
| Other services | 5,9 | 0,78 | 0,87 | 0,40 | 0,47 |
| II. NON CORE INFLATION | 31,7 | 3,03 | 3,02 | 5,14 | 8,38 |
| Food | 14,8 | -0,69 | -3,59 | 7,27 | 13,68 |
| Fuels | 3,9 | 5,22 | 13,36 | 11,25 | 15,18 |
| Transport | 8,4 | 10,47 | 11,02 | -0,02 | 0,44 |
| Public services | 4,6 | -0,90 | 0,42 | 2,02 | 0,91 |
| III. INFLATION | 100,0 | 1,12 | 1,89 | 3,20 | 4,59 |
| Note: | | | | | |
| Inflation without food and fuels | 62,8 | 1,86 | 2,32 | 0,62 | 0,73 |

Source: INEI.

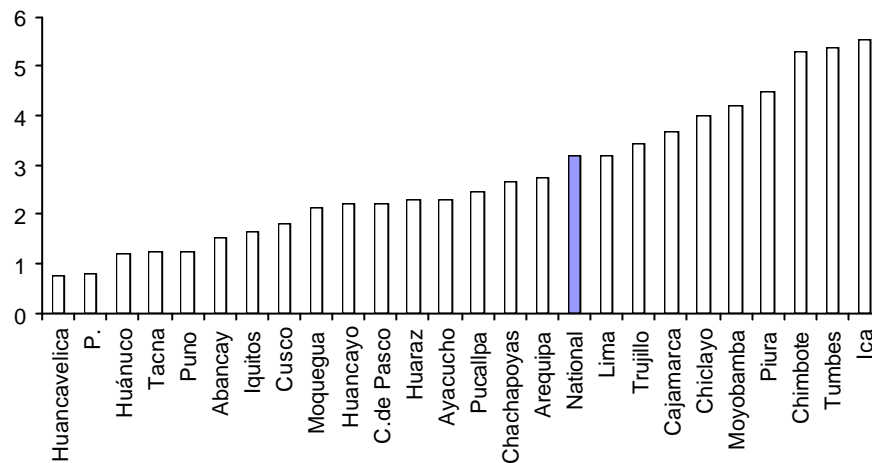
CENTRAL RESERVE BANK OF PERU

National inflation

- Since January 2003, the INEI has produced an aggregate national consumer prices index based on prices recorded in 25 cities. The accumulated increase in prices between January and July 2004 was 3,2 percent, similar to the figure for Metropolitan Lima. In 16 cities the CPI was lower than the national average whilst in the remaining 9 cities this index of inflation was higher than the national average.

Figure 11

INFLATION
(Accumulated percentage variation)



Source: INEI

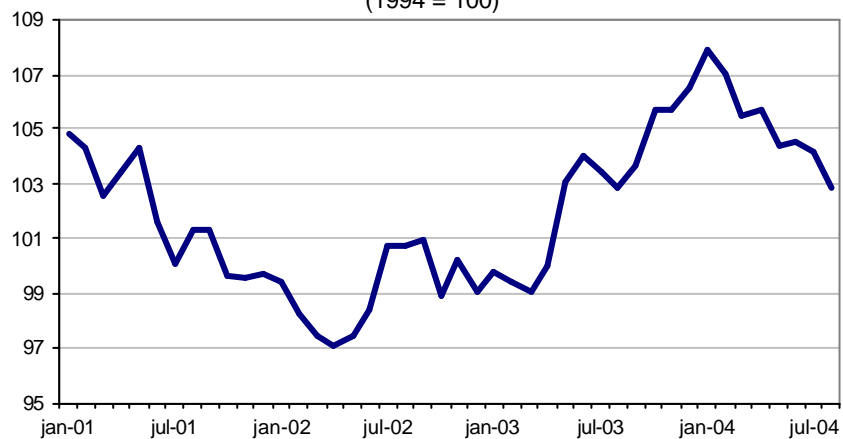
I.2 Exchange rate

- Between January and August 2004, there was a fall in the nominal exchange rate of 2,2 percent compared to December 2003. In real terms the fall was 3,4 percent, resulting from the nominal appreciation mentioned above and the difference between domestic inflation at 3,2 percent and the variation in external prices, estimated at 1,9 percent. Compared to August last year, the real multilateral exchange rate has remained constant.

Figure 12

REAL MULTILATERAL EXCHANGE RATE INDEX

(1994 = 100)



CENTRAL RESERVE BANK OF PERU

7. The variation in the external prices index reflects changes in the dollar exchange rates of the currencies of Peru's main trading partners. Between January and August, the dollar strengthened against the yen (2,1 percent) the euro (0,8 percent) the Canadian dollar (0,7 percent) and some of the region's currencies; but depreciated against sterling (4,0 percent) and Asian currencies (2,9 percent against the Korean currency). In the region, the dollar appreciated against the bolivar (20 percent), the Chilean peso (5,3 percent), the Brazilian real (2,6 percent), the Mexican peso (1,1 percent), the Bolivian peso (1,6 percent) and the Argentinian peso (3,1 percent); but depreciated against the Colombian peso (7,6 percent).

Chart 5

| | | BILATERAL EXCHANGE RATES (S/. per currency unit) | | | | | |
|------------------|------------|---|------------------|------------------|------------------------------|------------------|------------------|
| | | % Var. in nominal exchange rate | | | % Var. in real exchange rate | | |
| | Weighting* | Aug.04 Dec.96 | Aug.04 Aug.03 | Aug.04 Dec.03 | Aug.04 Dec.96 | Aug.04 Aug.03 | Aug.04 Dec.03 |
| USA | 25,1% | 31,3 | -2,4 | -2,2 | 20,6 | -4,1 | -2,4 |
| Euro zone | 20,1% | 26,7 | 6,8 | -3,0 | 12,2 | 4,0 | -4,6 |
| Japan | 10,3% | 35,5 | 5,2 | -4,2 | 3,0 | 0,3 | -7,2 |
| Brazil | 6,4% | -54,6 | -2,4 | -4,7 | -40,1 | -0,1 | -3,0 |
| UK | 5,8% | 43,5 | 11,4 | 1,7 | 33,1 | 9,3 | 0,1 |
| Chile | 4,8% | -12,7 | 8,1 | -7,1 | -13,4 | 4,9 | -8,1 |
| China | 4,3% | 31,6 | -2,4 | -2,2 | 5,9 | -1,4 | -1,9 |
| Colombia | 4,0% | -49,4 | 7,8 | 5,9 | -18,4 | 9,4 | 7,6 |
| Mexico | 3,4% | -9,2 | -8,1 | -3,3 | 37,3 | -8,2 | -4,3 |
| Argentina | 3,4% | -56,5 | -7,0 | -5,1 | -50,7 | -6,2 | -4,1 |
| Korea | 3,3% | -4,9 | -0,7 | 0,7 | -3,4 | -0,5 | 1,0 |
| Taiwan | 2,5% | 6,1 | -1,6 | -2,2 | -14,4 | -3,8 | -3,5 |
| Venezuela | 2,5% | -67,5 | -18,7 | -18,5 | 30,0 | -5,0 | -9,7 |
| Canada | 2,4% | 36,2 | 3,8 | -2,2 | 22,5 | 1,3 | -3,4 |
| Bolivia | 1,8% | -14,4 | -5,2 | -3,8 | -13,8 | -5,3 | -4,3 |
| Basket | | 4,1 | 1,2 | -2,9 | 3,5 | 0,0 | -3,4 |

* Weighted with respect to trade in 1994.

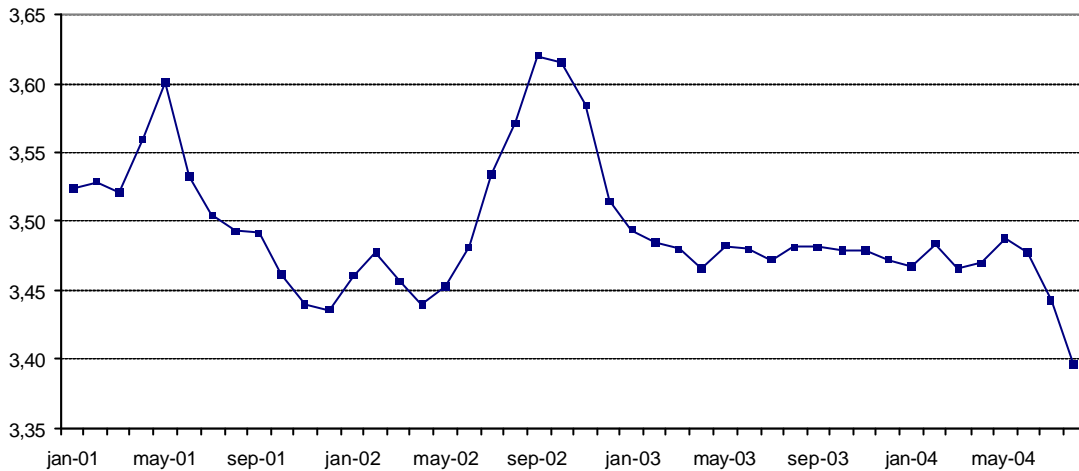
Source: IMF, SBS and Reuters.

8. During the period January to August 2004, the nominal exchange rate fluctuated between S/. 3,36 and S/. 3,52 to the dollar. Up until the middle of the year the exchange rate was stable, varying between S/. 3,45 (in January) and S/. 3,52 (in February). A clear downward trend was observed from the middle of June and this accentuated from July onwards. On the 31st of August the nuevo sol reached its lowest quotation this year (S/. 3,359 to the dollar).

CENTRAL RESERVE BANK OF PERU

Figure 13

MONTHLY SELLING EXCHANGE RATE

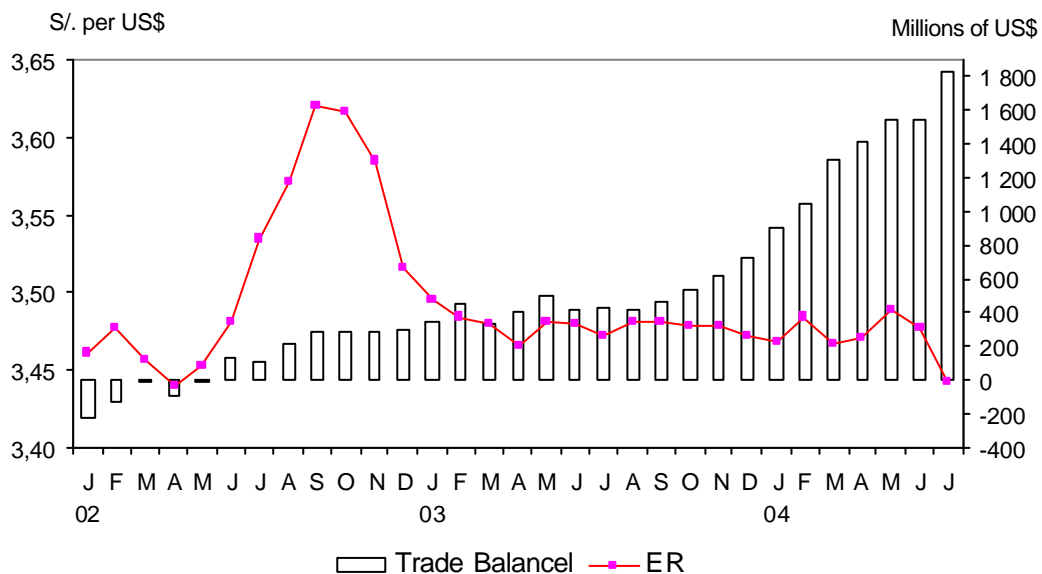


9. The strengthening of the sol is related to an improvement in the country's external accounts whilst the trend became more pronounced in August because, in addition, economic agents began converting their portfolios into Peruvian currency, particularly institutional investors and banks. The factors that have contributed to the strengthening of the nuevo sol are:

- a. **Improved export prices and volumes.** There was an increase in the trade surplus of US\$ 187 million to US\$ 1 009 million between the first half of last year and the first half of this. This improvement was associated with a 20 percent increase in export prices and a 10 percent increase in export volumes.

Figure 14

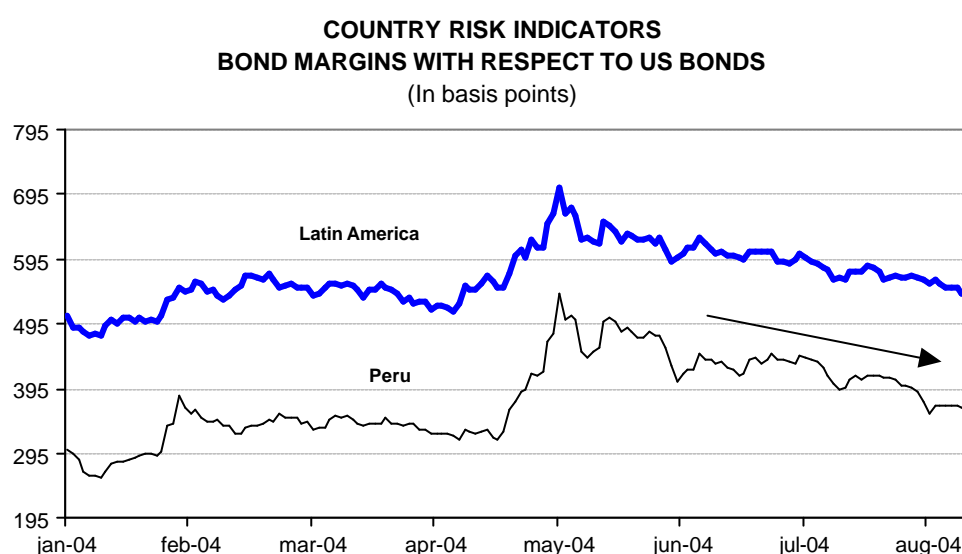
EXCHANGE RATE AND ANNUAL TRADE BALANCE



CENTRAL RESERVE BANK OF PERU

- b. Higher remittances from families living abroad:** There were also significantly higher remittances from Peruvians living abroad, these are recorded in the balance of payments' current transfers and rose from US\$ 380 million in the first six months of last year to US\$ 500 million in the first six months of this year (an increase of 32 percent).
- c. Reduction in the perception of country risk:** Another factor contributing in recent months to variations in the exchange rate was the reduction in debt *spreads*. In addition, progress by Brazil towards strengthening its fiscal position had a beneficial effect on the region. In June S&P improved its classification of Peru's sovereign debt from BB- to BB, two levels below investment grade; this improvement was based on stronger economic fundamentals. It should be mentioned that this improvement occurred after ratings agency Fitch changed its outlook for Peru's debt from "stable" to "positive".

Figure 15



The change in expectations in recent months concerning the FED's interest rate policy also had an impact on the reduction in debt *spreads* and the strengthening of the region's currencies in the last two months (July and August). The market is expecting a rate of 2 percent by the end of this year, after the FED announced that interest rate increases will be gradual and the publication of indicators that produced expectations of lower growth and less inflationary pressure in the United States.

Chart 6

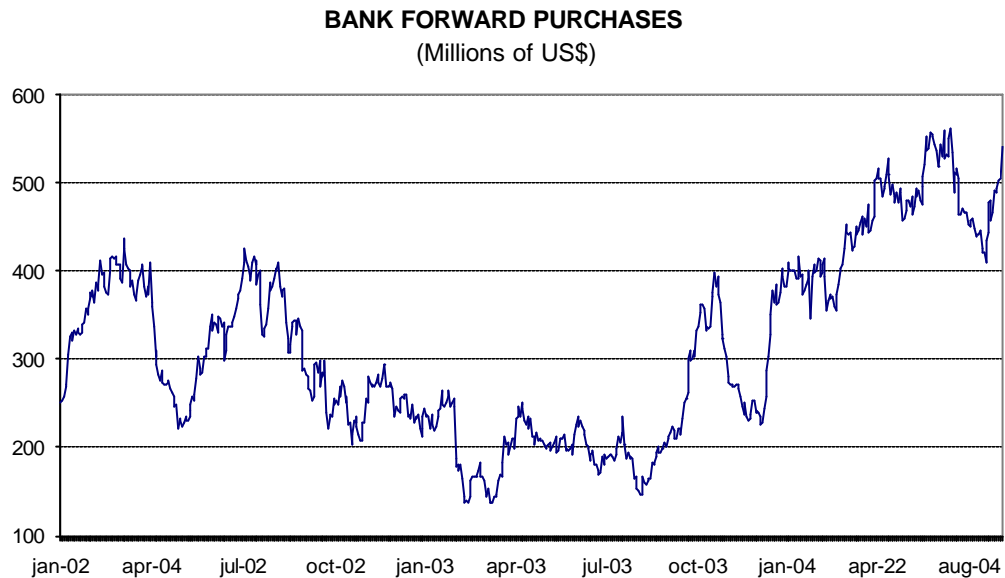
EVOLUTION OF THE CURRENCIES OF THE REGION
(Monetary unit/US\$)

| | | End of period | | | | % Var. | |
|------------------|-----------|---------------|--------|--------|--------|-------------|-------------|
| | | Dec.03 | Jun.04 | Jul.04 | Aug.04 | Jun04/Dec03 | Aug04/Jun04 |
| BRASIL | Real | 2,89 | 3,08 | 3,04 | 2,93 | 6,7% | -5,1% |
| ARGENTINA | Peso | 2,95 | 2,96 | 2,97 | 3,00 | 0,2% | 1,6% |
| MEXICO | Peso | 11,23 | 11,49 | 11,39 | 11,387 | 2,3% | -0,9% |
| CHILE | Peso | 592,9 | 633,8 | 642,8 | 626,0 | 6,9% | -1,2% |
| COLOMBIA | Peso | 2 779 | 2 688 | 2 613 | 2 534 | -3,3% | -5,7% |
| PERU | Nuevo Sol | 3,462 | 3,468 | 3,418 | 3,357 | 0,2% | -3,2% |

CENTRAL RESERVE BANK OF PERU

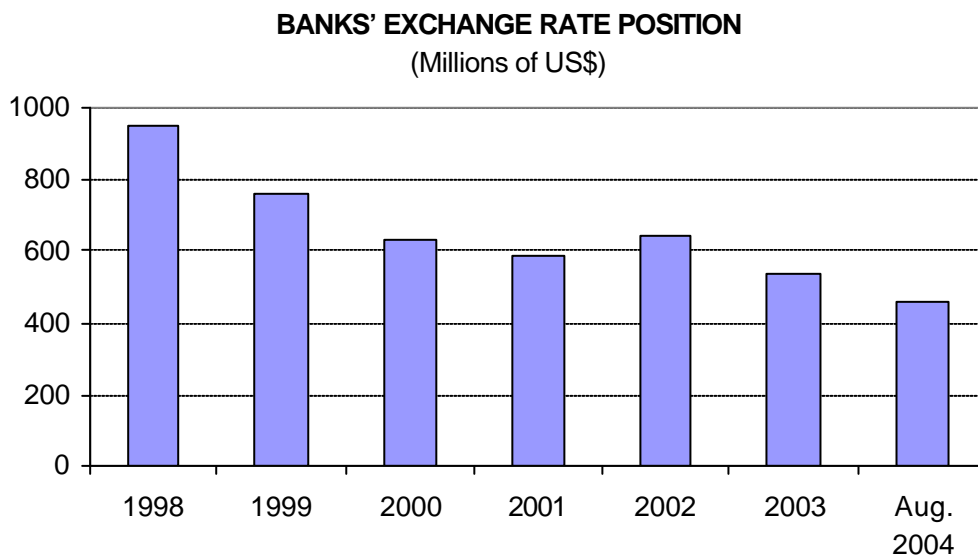
- d. **Higher sales of dollars** by economic agents in order to cover the risk of a stronger sol implied a higher supply of dollars in the *spot* market. In effect, the balance of these covering operations (*forward* bank purchases) rose from US\$ 227 million in December 2003 to US\$ 454 million in July and US\$ 493 million in August. This meant that the balance of net forward sales by banks fell by US\$ 72 million (from US\$ 607 to US\$ 535 million) in this period.

Figure 16



- e. **Dedollarization of banks' foreign exchange positions**, which fell by US\$ 75 million between January and August this year (from US\$ 536 to US\$ 461 million).

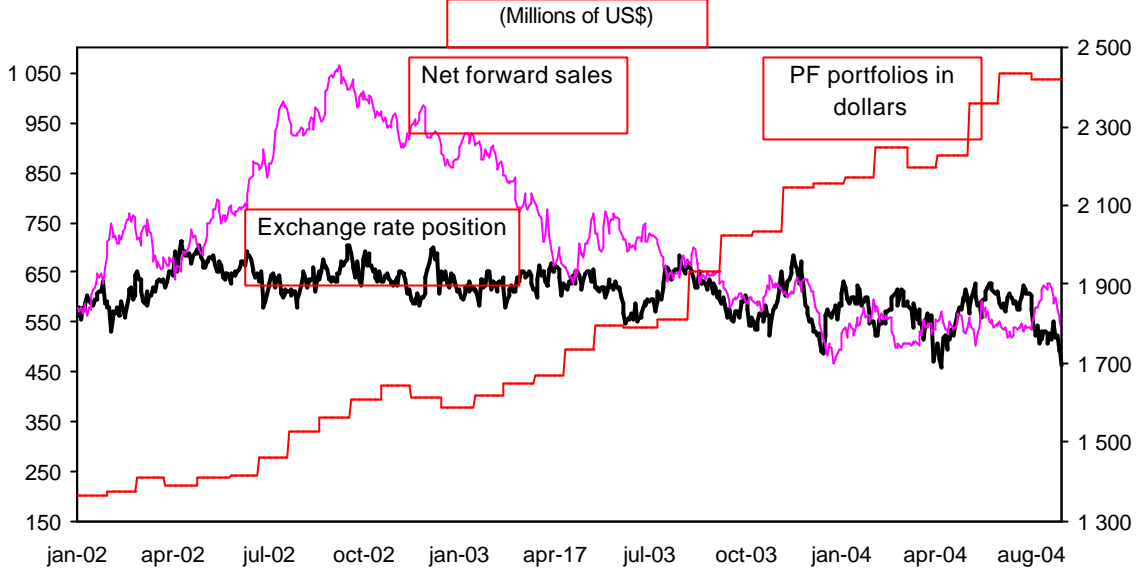
Figure 17



CENTRAL RESERVE BANK OF PERU

Figure 18

EXCHANGE RATE POSITION & NET FORWARD SALES BY BANKS AND PENSION FUNDS PORTFOLIOS IN DOLLARS



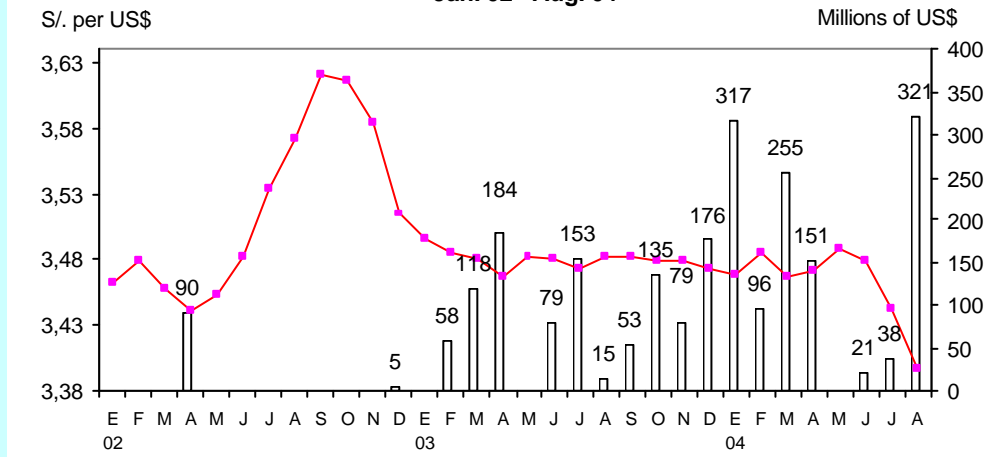
BOX 2

INTERVENTION IN THE FOREIGN EXCHANGE MARKET

During periods of volatility in the foreign exchange market (important highs or lows in the value of the dollar), the BCRP buys or sells dollars in order to modify these fluctuations, but with no commitment to a given exchange rate. Between January and August, the BCRP bought US\$ 1 198 million in the foreign exchange market.

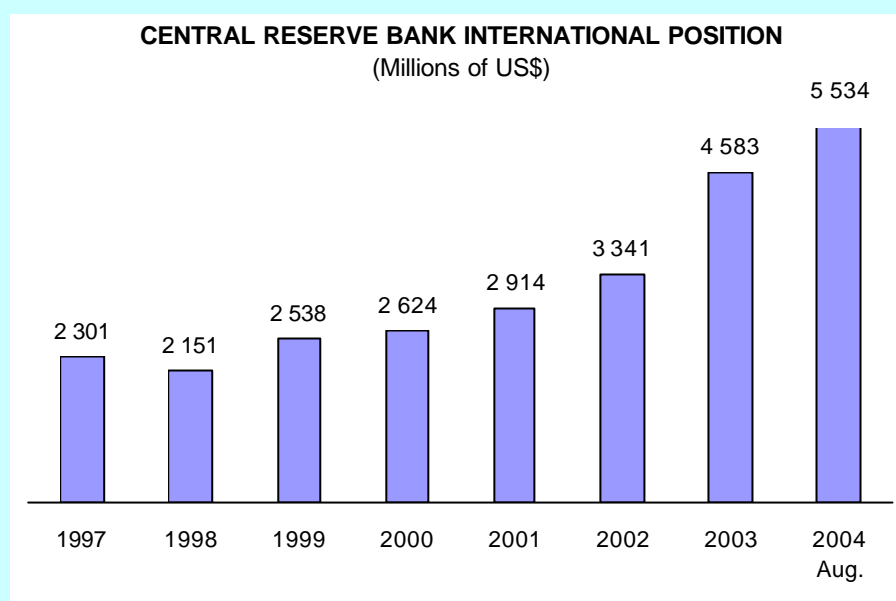
EXCHANGE RATE AND MONTHLY INTERVENTION BY BCRP:

Jan. 02 - Aug. 04



Part of this purchase was used to meet the public sector demand for dollars, amounting to US\$ 307 million, making net purchases by the BCRP US\$ 890 million between January and August. These purchases and other operations by the bank (principally net interest earned) enabled the BCRP to accumulate an international position of US\$ 951 million over this period, making a balance of US\$ 5 534 million by the 31st of August.

CENTRAL RESERVE BANK OF PERU



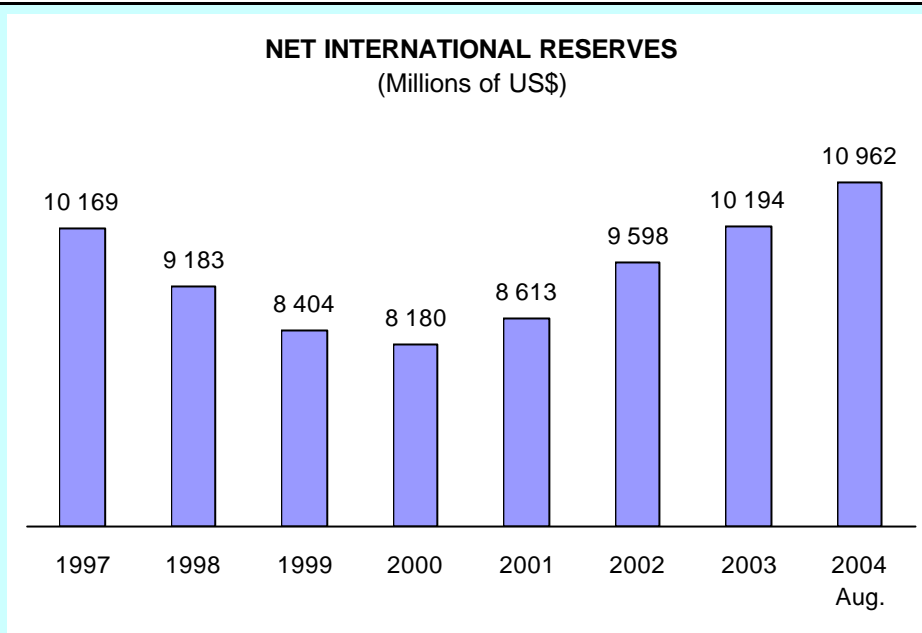
| The BCRP's international position represents: | Dec. 2001 | Dec. 2002 | Dec. 2003 | Aug. 2004 |
|--|-----------|-----------|-----------|-----------|
| Number of times monetary base | 1,6 | 1,7 | 2,1 | 2,4 |
| Number of times the sum of monetary base and total CDBCRPs | 1,3 | 1,4 | 1,4 | 1,3 |

This increase in the international position enabled the accumulation of international reserves amounting to US\$ 768 million. Other operations that affected the international reserve evolution were higher dollar deposits by financial intermediaries in the BCRP, amounting to US\$ 109 million, and a reduction in public sector dollar deposits in the BCRP amounting to US\$ 297 million, as a result of which the figure for NIR was US\$ 10 962 million as of the 31st of August.

Thus the Central Bank maintains a high level of international reserves to cover contingencies such as capital outflows and withdrawal of dollar deposits, considering the volatility of international financial markets and the dollarization of the economy, respectively.

In terms of coverage indicators for an economy, this level of international reserves is one of the highest in the region. For example, NIR represent more than twice total foreign short term obligations (including public and private sector one year amortizations). In addition, international reserves cover 50 percent of total foreign short term obligations as well as all obligations by the banking system to the public.

CENTRAL RESERVE BANK OF PERU



| The NIR represent: | Dec. 2001 | Dec. 2002 | Dec. 2003 | Aug. 2004 |
|--|-----------|-----------|-----------|-----------|
| International short term liabilities including amortizations due (times) | 1,7 | 2,2 | 2,2 | 2,3 |
| Short term liabilities plus total banking system obligations to private sector (times) | 0,4 | 0,5 | 0,5 | 0,5 |

As has been mentioned, the bank follows a foreign exchange floating regime, intervening in the market to reduce abrupt fluctuations in the exchange rate but without affecting trends that respond to structural factors of the economy.

In the very short term, the exchange rate may show considerable oscillations as a result of significant portfolio movements from one currency to another by economic agents. The bank's method of intervening in the foreign exchange market is based on quantities, taking into account market conditions, and participating as another agent in the interbank foreign exchange market.

The bank uses a centralized mechanism for real time negotiation with other banks to carry out its foreign exchange operations. By this means, participants register their buying and/or selling rates and the bank intervenes at current market prices.

The BCRP's interventions are sterilized, in other words purchases of dollars imply an injection of liquidity in soles in the banking system, which is removed from circulation by the placement of BCRP deposit certificates (CD BCRP), aimed at maintaining the interbank interest rate near to the reference level (currently 2,75 percent).

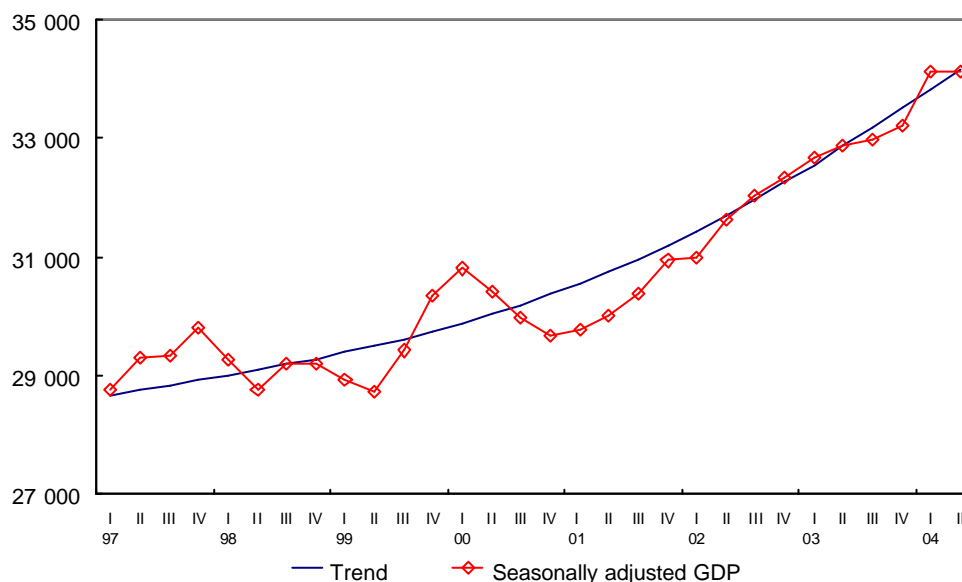
CENTRAL RESERVE BANK OF PERU

I.3 Domestic demand and GDP

10. In 2004 so far, economic activity has been boosted by favorable conditions of terms of trade, increased external demand and continued favorable financial conditions.
11. It should be pointed out that one of the factors driving this sustained growth in economic activity is higher private investment, which has been increasing since the second half of 2002. The increase in this variable has enabled the productive capacity of the economy to expand, helping to maintain growth without further inflationary pressure.
12. During the first six months of 2004, gross domestic product increased 4,2 percent, with an increase of 4,9 percent in the first quarter and 3,6 percent in the second. Growth in the second quarter in particular, was driven by an 11,7 percent increase in private investment and growth in exports amounting to 5,4 percent.

Figure 19

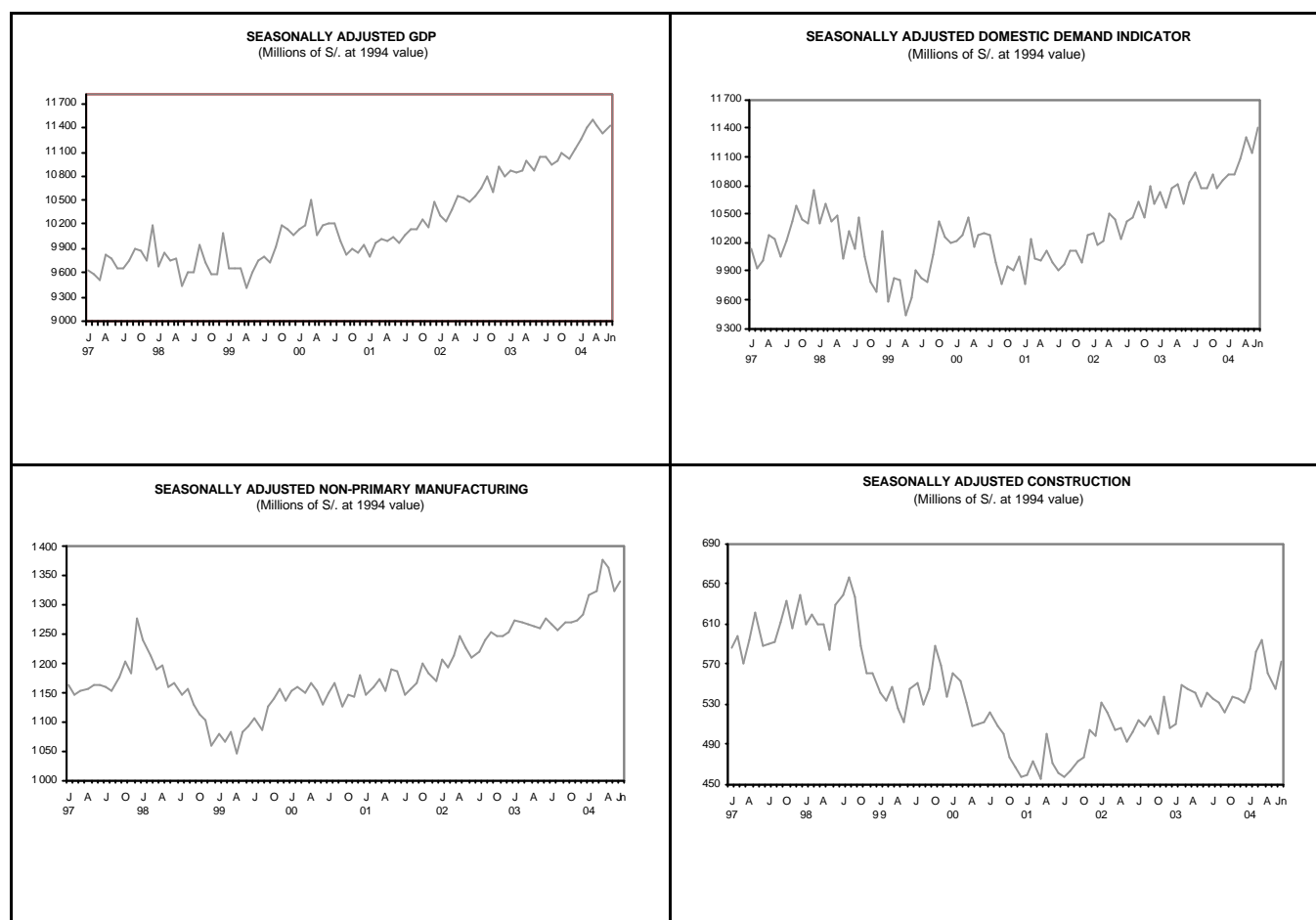
QUARTERLY SEASONALLY ADJUSTED GDP (Millions of S/. at 1994 value)



13. In seasonally adjusted terms, during the first half of the year GDP continued the upward trend observed since 2001. Although a slight deceleration was observed in April and May, reflected in non-primary manufacturing and construction (in the latter case the reduction was caused by the end of construction for the Camisea project), growth resumed in June. This behaviour was accompanied by a growth in domestic demand.

CENTRAL RESERVE BANK OF PERU

Figure 20



14. Private **investment** was increasingly dynamic during the first half of the year. Growth of 8,0 percent in the first quarter was followed by a rate of 11,7 percent in the second quarter, confirming the tendency towards increasing private investment that began in the third quarter of 2002. Among the factors explaining the recovery in private investment are the development of mining and fuel projects, an increase in company profits and cheaper financing.

In the second quarter of the year investment in the mining sector, plant expansions and acquisitions of new machinery in addition to imports for the telecommunications sector were behind the increase in capital goods imports. The latter, excluding construction materials grew by a nominal 25 percent. Private investment represented 14,9 percent of GDP in the first half of 2004, a higher level than for the same period of the previous year (14,5 percent of GDP).

CENTRAL RESERVE BANK OF PERU

Chart 7

GLOBAL SUPPLY AND DEMAND

(Real percentage values compared to same period in previous year)

| | 2003 | | | 2004 | | |
|--------------------------------|-------------------------|-------------------------|----------------------|-------------------------|-------------------------|----------------------|
| | 1 st quarter | 2 nd quarter | 1 st half | 1 st quarter | 2 nd quarter | 1 st half |
| I. GLOBAL DEMAND (1+2) | 5.9 | 3.3 | 4.5 | 4.4 | 4.7 | 4.6 |
| 1. Domestic demand 1/ | 5,5 | 2,4 | 3,9 | 2,7 | 4,6 | 3,7 |
| a. Private consumption | 4,3 | 2,8 | 3,5 | 3,1 | 2,8 | 3,0 |
| b. Public consumption | 4,7 | 1,4 | 2,9 | -0,3 | 3,1 | 1,5 |
| c. Fixed private investment | 7,3 | 5,3 | 6,3 | 8,0 | 11,7 | 9,8 |
| d. Public investment | 5,0 | 1,9 | 3,2 | -11,9 | -14,6 | -13,4 |
| 2. Exports | 7,8 | 8,3 | 8,1 | 13,8 | 5,4 | 9,4 |
| II. GLOBAL SUPPLY (3+4) | 5.9 | 3.3 | 4.5 | 4.4 | 4.7 | 4.6 |
| 3. GDP | 5,7 | 3,6 | 4,5 | 4,9 | 3,6 | 4,2 |
| 4. Imports | 7,0 | 1,5 | 4,2 | 1,5 | 12,4 | 6,9 |

1/ Includes inventory changes.

Source: INEI and BCRP.

15. Real **exports** of goods and services grew more in the first half of 2004 (9,4 percent) than in the same period of 2003 (8,1 percent) because of higher exports of traditional mineral products during the first quarter of 2004. In the second quarter of 2004, exports were driven mainly by non-traditional products (33 percent in dollars), by increases in all groups particularly steel and jewellery, non-metallic minerals and textiles, as well as the higher export value of copper, among the traditional products.

On the other hand, the increase in real **imports** of goods and services (6,9 percent) consisted mainly of materials for industry and farming and capital goods imports (vehicles, industrial and agricultural machinery).

16. **Private consumption** continued to growth in the first six months at a rate of 2,8 percent in the second quarter. This growth was associated with an increase in **national disposable income** of 5,3 percent in the first six months of 2004. In both periods these rates were higher than GDP as a result of better terms of trade. Remittances from non-residents also increased by 4,7 percent.

Chart 8

NATIONAL DISPOSABLE INCOME

(Real percentage values compared to same period in previous year)

| | 2003 | | | 2004 | | |
|----------------------------------|-------------------------|-------------------------|----------------------|-------------------------|-------------------------|----------------------|
| | 1 st quarter | 2 nd quarter | 1 st half | 1 st quarter | 2 nd quarter | 1 st half |
| I. Gross domestic product (GDP) | 5,7 | 3,6 | 4,5 | 4,9 | 3,6 | 4,2 |
| II. Gross national product (GNP) | 4,2 | 3,5 | 3,8 | 3,5 | 2,2 | 2,8 |
| III. Gross national income (NI) | 4,8 | 3,0 | 3,8 | 5,8 | 4,4 | 5,0 |
| IV. National disposable income | 4,8 | 3,1 | 3,9 | 6,0 | 4,6 | 5,3 |

1/ Excludes net income paid to non-domiciled productive factors

2/ GDP and GNP are isolated from changes in foreign trade terms

3/ Net transfers from non-residents added to NI

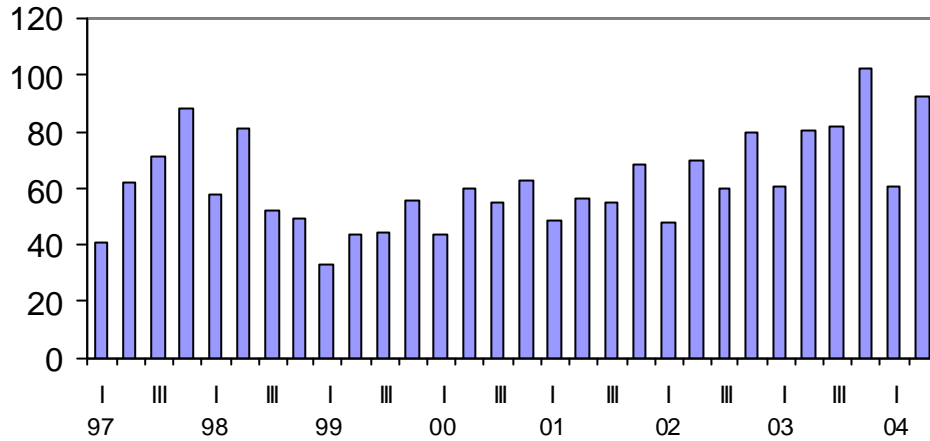
Source: INEI and BCRP

CENTRAL RESERVE BANK OF PERU

The positive evolution of private consumption was reflected in a number of indicators, such as an 18,0 growth in consumer loans from finance companies and a 14,1 percent increase in new vehicle sales. There was also a 9 percent increase in white goods imports.

Figure 21

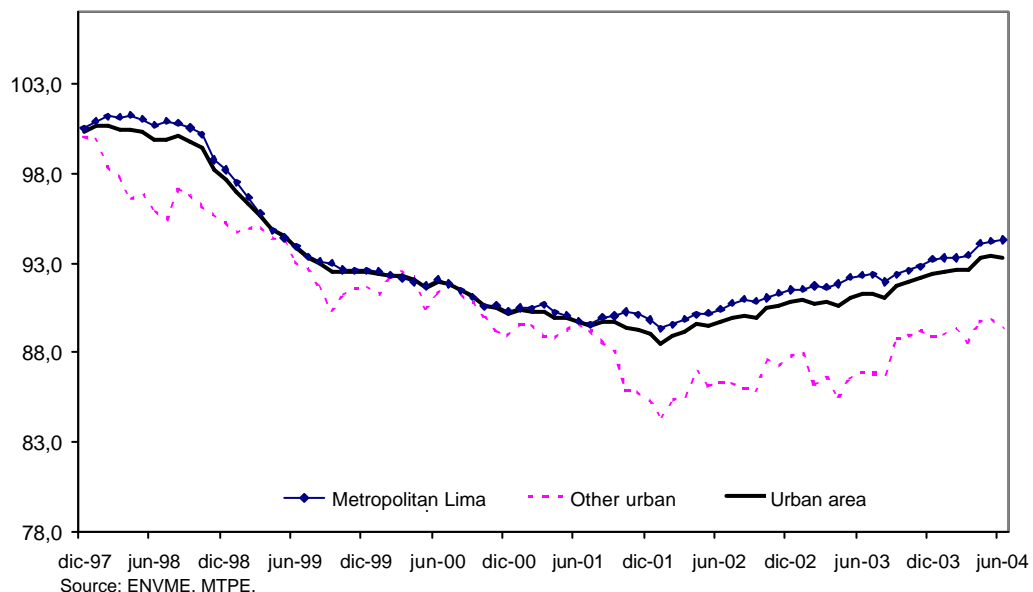
ELECTRICAL APPLIANCES IMPORTS (Millions of US\$)



The growth in private consumption was also associated with an increase of employment in urban areas. According to the Ministry of Labor, there was a 2,3 percent increase in jobs in companies with 10 or more employees during the first six months of the year principally because of expansion in the provinces (3,2 percent), which was higher than the growth in Metropolitan Lima (2,1 percent). Paita, Ica, Piura and Trujillo were the cities where employment growth was stronger.

Figure 22

EMPLOYMENT IN COMPANIES WITH MORE THAN 10 EMPLOYEES (Seasonally adjusted index, October 1997 = 100)



CENTRAL RESERVE BANK OF PERU

Chart 9
URBAN EMPLOYMENT IN MAIN CITIES
COMPANIES WITH MORE THAN 10 EMPLOYEES
 (Annual percentage variation)

| | June 2004/ June 2003 | Jan. - Jun. 2004/ Jan. - Jun. 2003 |
|-------------------|-------------------------|---------------------------------------|
| Urban Peru | 2,3 | 2,3 |
| Metropolitan Lima | 2,2 | 2,1 |
| Other urban | 2,8 | 3,2 |
| | | |
| Arequipa | 2,9 | 2,0 |
| Cajamarca | 7,7 | 4,0 |
| Chiclayo | -1,2 | -0,3 |
| Chimbote | 5,9 | 5,4 |
| Chincha | 2,1 | 4,0 |
| Cusco | 0,1 | -0,4 |
| Huancayo | 6,4 | 2,6 |
| Ica | -8,6 | 8,0 |
| Iquitos | 6,1 | 3,7 |
| Paita | 15,8 | 12,2 |
| Pisco | 1,5 | -2,1 |
| Piura | 8,8 | 6,0 |
| Pucallpa | -0,1 | -1,1 |
| Puno | -5,2 | -5,7 |
| Tacna | -1,0 | -2,7 |
| Tarapoto | 1,1 | -0,7 |
| Trujillo | 1,2 | 5,8 |

Source: MTPE, Monthly Statistical Report

17. **Public consumption** grew 1,5 percent in the first six months, influenced by an increase in salaries and offsetting the fall in expenditure on goods and services, whilst **public investment** fell by 13,4 percent because of a spending lag resulting from the process of transferring projects from the central government to local and regional governments and reduced expenditure on road building.

GDP by sector

18. The **non-primary** drove the growth in GDP in the first six months of the year, principally non-primary manufacturing, electricity and water, and construction. As far as the **primary sectors** are concerned, a slowdown in growth was observed during the half year, from 5,8 percent in the first quarter to zero in the second as the result of a fall in the agriculture and livestock sector caused by the weather, this was attenuated by growth in metal mining, fishing and primary manufacturing.

In the first six months, a fall of 2,1 percent in the **agricultural & livestock sector** reflected the drought in Lambayeque and Piura which affected the production of rice (20 percent down) sugar cane (19 percent down) and hard yellow corn (8 percent down). The central highlands also suffered snow and warm spells that affected the production of potatoes and amilaceous corn (12 percent and 11 percent down respectively). Lower production of these foodstuffs was attenuated by greater dynamism in the livestock sub-sector and higher coffee and cotton production (15 and

CENTRAL RESERVE BANK OF PERU

16 percent up respectively). Production of these crops benefited from an increase in international prices for "other smooth arabica" coffees and short staple cotton (by 19 and 21 percent, respectively compared to the same half of the previous year), which was reflected in an increase in farm gate prices (22 and 12 percent).

Chart 10

GROSS DOMESTIC PRODUCT

(Real percentage values compared to same period in previous year)

| | 2003 | | | 2004 | | |
|---------------------------------------|-------------------------|-------------------------|----------------------|-------------------------|-------------------------|----------------------|
| | 1 st quarter | 2 nd quarter | 1 st half | 1 st quarter | 2 nd quarter | 1 st half |
| Agriculture and livestock | 2,2 | 4,0 | 3,3 | 1,8 | -4,6 | -2,1 |
| Fishing | -12,8 | -13,8 | -13,4 | 13,1 | 26,0 | 21,3 |
| Mining and fuel | 4,5 | 10,3 | 7,4 | 12,4 | 2,5 | 7,3 |
| Metal mining | 5,0 | 11,1 | 8,0 | 13,9 | 3,1 | 8,4 |
| Natural gas and oil | -6,2 | -1,2 | -3,7 | -5,4 | -4,3 | -4,8 |
| Manufacturing | 5,6 | 0,8 | 3,1 | 4,7 | 6,2 | 5,5 |
| Based on raw materials | -0,7 | -2,3 | -1,6 | 1,5 | 7,1 | 4,6 |
| Non-primary industries | 7,2 | 1,7 | 4,4 | 5,5 | 5,9 | 5,7 |
| Electricity & water | 4,6 | 4,0 | 4,3 | 4,7 | 4,3 | 4,5 |
| Construction | 4,0 | 6,0 | 5,0 | 7,2 | 4,1 | 5,7 |
| Commerce | 8,0 | 3,6 | 5,6 | 3,1 | 1,7 | 2,3 |
| Other services | 5,4 | 3,5 | 4,4 | 5,3 | 4,1 | 4,7 |
| <u>GROSS ADDED VALUE (GAV)</u> | <u>5.3</u> | <u>3.6</u> | <u>4.4</u> | <u>5.2</u> | <u>3.0</u> | <u>4.0</u> |
| Taxes on products and import duties | 9,6 | 3,2 | 6,3 | 2,6 | 10,0 | 6,3 |
| <u>GLOBAL GDP</u> | <u>5.7</u> | <u>3.6</u> | <u>4.5</u> | <u>4.9</u> | <u>3.6</u> | <u>4.2</u> |
| Primary GAV | 2,2 | 4,1 | 3,3 | 5,8 | 0,0 | 2,5 |
| Non-primary GAV | 6,1 | 3,4 | 4,7 | 5,0 | 3,9 | 4,4 |

Source: INEI

The **fishing sector** grew by 21,3 percent due to increased landings of anchovy. This result was influenced by an increase in the anchovy biomass caused by a higher number of juveniles added to adult population and an increase in the number of effective fishing days on the north and central coasts.

The **mining and fuel** sector recorded an increase of 7,3 percent resulting from higher copper production, because of the richer ore from Antamina, the restarting of production at Tintaya and expansion by Southern Peru; gold production rose because a larger quantity of mineral was processed by Yanacocha; while iron ore production rose in response to greater demand from China. In contrast, zinc production fell 8,2 percent resulting from poorer ore at Antamina and a reduction in operations by Volcan. The fall in crude oil production (-7,9 percent) was partially counteracted by increased natural gas production (55,6 percent) to be used to produce electricity.

Manufacturing production increase 5,5 percent, with a significant increase in non-primary manufacturing (5,7 percent) resulting from increased production of knitted apparel; furniture; cement; explosives, natural and chemical essences and electrical

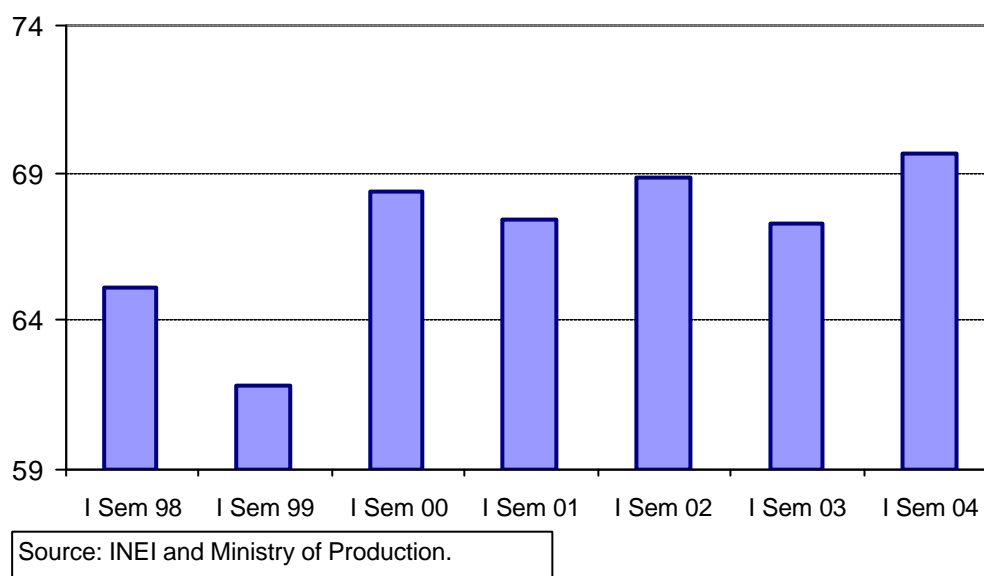
CENTRAL RESERVE BANK OF PERU

machinery. This is the result of an increase in non-traditional exports (33,4 percent), the development of certain mining projects, the dynamism of the construction industry and an increase in domestic demand driven by the appearance of new products.

Higher production meant increased use of installed capacity. The indirect indicator of the rate of use of installed capacity in the manufacturing sector shows an increase in the first half of the year, which was greater for the non-metallic mineral, textiles, leather and footwear, paper and printing sectors.

Figure 23

INDIRECT INDICATOR OF THE RATE OF EMPLOYMENT OF INSTALLED CAPACITY IN THE MANUFACTURING SECTOR (Percentage)



The **construction** sector grew by 5,7 percent associated with mortgage loans, especially the Mivivienda program, which continued to drive house building, in addition to local infrastructure construction, the extension of sports facilities, hotel building in the north of the country and mining projects.

I.4 External accounts

- Exports continued to fuel the growth in economic activity during the first six months of 2004. Increased demand for Peru's export products was favoured by growth in the world economy and trade agreements, particularly the Andean Trade Promotion and Drug Eradication Act (ATPDEA). In addition, the improvement in our terms of trade enabled increased growth in aggregate demand.

Trade balance

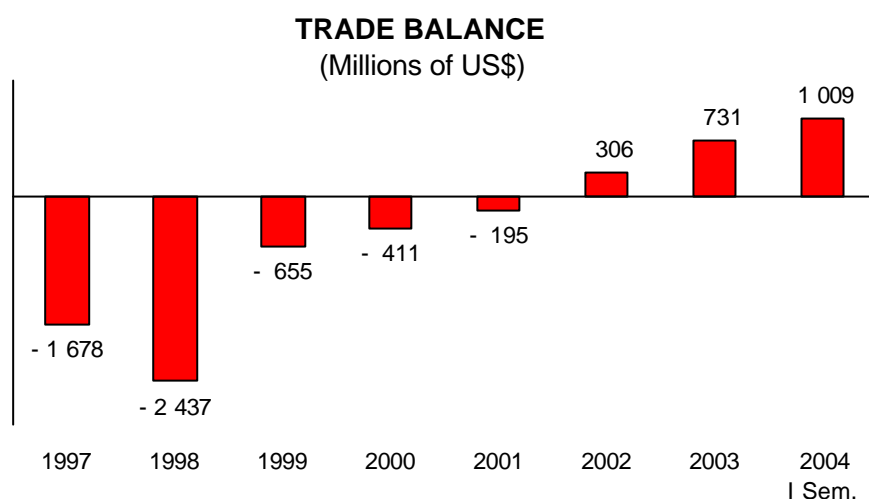
- After 6 consecutive semesters of surplus, the trade balance in the first half of 2004 showed a surplus of US\$ 1 009 million, US\$ 822 million higher than in the first half of 2003. This increase is explained by a 32 percent growth in exports against a 13 percent increase in imports.
- In the period under analysis, **exports** reached US\$ 5 551 million, 32 percent higher than in the first half of 2003, due to an increase in traditional exports (32 percent) and non-traditional exports (33 percent). The increase in traditional exports is explained

CENTRAL RESERVE BANK OF PERU

principally by higher metal prices and larger export volumes of copper and gold. As far as non-traditional exports are concerned, in the period January-June all sectors recorded growth, the most noteworthy being steel and jewellery at 67 percent, agricultural & livestock at 33 percent, textiles at 32 percent and chemicals at 31 percent.

The increase in **imports** during the first six months of 2004 is explained principally by raw materials purchases (18 percent), consisting of acquisitions of fuels, lubricants and related items (20 percent) whose prices and volumes increased by 6 percent and 11 percent respectively.

Figure 24



Terms of trade

22. Two clear trends in international prices could be observed in the first half of the year. The first, which lasted until March, was a significant growth in prices of the principal *commodities* within a context of increased economic dynamism in China and the United States. In the second quarter of the year this trend changed and a slow-down in price increases was seen after announcements that China would restrict credit (in order to prevent its economy overheating) and interest rate increases in the United States, which reduced growth expectations in both countries.

Terms of trade recorded an increase of 13,6 percent in the first half of the year, despite a slight slow-down in international price increases from April onwards, because the increase in prices for Peru's exports (20,1 percent) exceeded that of the country's imports (5,7 percent). For exports, the increase was driven by higher prices for copper (66 percent up), lead (72 percent), tin (75 percent), silver (40 percent) and gold (15 percent). Similarly, imported products whose prices rose in the first half of the year were soy (35 percent), rice (22 percent), wheat (18 percent), sugar (16 percent), meat (16 percent), dairy products (13 percent), corn (11 percent) and petroleum and its derivatives (6 percent).

Current account balance and capital flows

23. In the first half of 2004 the balance of payments **current account** recorded a deficit of US\$ 310 million, less than that recorded in the first half of 2003 (US\$ 707 millions) due not only to the increased trade surplus but also to higher remittances from Peruvians living abroad.

CENTRAL RESERVE BANK OF PERU

Chart 11

BALANCE OF PAYMENTS (Million of US\$)

| | 2003 | | | 2004 | | |
|---|-------------------------|-------------------------|----------------------|-------------------------|-------------------------|----------------------|
| | 1 st quarter | 2 nd quarter | 1 st half | 1 st quarter | 2 nd quarter | 1 st half |
| I. CURRENT ACCOUNT BALANCE | - 514 | - 193 | - 707 | - 71 | - 239 | - 310 |
| (% of GDP) | -3,6 | -1,2 | -2,3 | -0,5 | -1,3 | -0,9 |
| 1. Trade balance | - 18 | 205 | 187 | 605 | 404 | 1 009 |
| a. Exports | 2 024 | 2 188 | 4 212 | 2 735 | 2 816 | 5 551 |
| b. Imports | - 2 041 | - 1 983 | - 4 024 | - 2 130 | - 2 412 | - 4 542 |
| 2. Services | - 250 | - 234 | - 484 | - 248 | - 276 | - 525 |
| 3. Investment income | - 509 | - 447 | - 956 | - 752 | - 710 | - 1 462 |
| 4. Current transfers | 263 | 282 | 545 | 324 | 343 | 667 |
| II. CAPITAL ACCOUNT | 1 364 | - 278 | 1 086 | 278 | 680 | 957 |
| 1. Private sector 1/ | 768 | 42 | 809 | 314 | 415 | 729 |
| 2. Public sector | 597 | - 320 | 277 | - 36 | 265 | 229 |
| III. EXCEPTIONAL FINANCING | 1 | 2 | 3 | 2 | 1 | 3 |
| IV. NET FLOW OF CRBP RESERVES (1-2) | - 851 | 470 | - 382 | - 209 | - 441 | - 650 |
| (Increment carries negative sign) | | | | | | |
| 1. Variation in NIR balance | - 845 | 446 | - 399 | - 217 | - 444 | - 661 |
| 2. Effect of valuation and monetarization of gold | 6 | - 23 | - 18 | - 8 | - 3 | - 11 |

1/ Includes short term capitals and net errors and omissions.

Source: BCRP, MEF, SUNAT and companies.

The capital account showed a flow of US\$ 957 million in the first half of 2004, US\$ 129 million less than in the same period in 2003. As far as foreign direct investment was concerned, the flow for the first half year was US\$ 833 millions, principally as a result of the Camisea project and reinvestment of profits.

I.5 Government expenditure and fiscal accounts

24. During the first six months of 2004 the **economic results for the non-financial public sector** (NFPS) recorded a surplus equivalent to 0,9 percent of GDP, a figure that contrasts with the deficit of 0,8 percent of GDP recorded in the same period of 2003. This result was due to a reduction in non-financial expenditure from 13,6 percent of GDP in the first half of 2003 to 12,6 percent of GDP in the first half of this year, as well as an increase in tax revenue from 14,5 percent to 14,9 percent of GDP in the same period.
25. The central government's **current** revenue increased 9,5 percent in real terms compared to the first half of 2003 due to increased central government tax revenue (a real increase of 11,3 percent). This improvement is explained mainly by an increase in revenue from value-added tax (IGV) associated with a one percentage point increase in the tax rate from 16 percent to 17 percent in August 2003; and the inclusion of new goods and services into the withholding system from the second half year of 2003 onwards; as well as application of the Perception Regime of IGV to imports introduced in the middle of November 2003. Income tax payments on account also increased, associated with higher coefficients and income declared by principal taxpayers.

CENTRAL RESERVE BANK OF PERU

Finally, the financial transaction tax added S/. 266 million to tax revenue for the period.

Chart 12

NON-FINANCIAL PUBLIC SECTOR
(Millions of nuevos soles)

| | 2003 | | | 2004 | | |
|-------------------------------------|-------------------------|-------------------------|----------------------|-------------------------|-------------------------|----------------------|
| | 1 st quarter | 2 nd quarter | 1 st half | 1 st quarter | 2 nd quarter | 1 st half |
| 1. CURRENT REVENUE | 7 458 | 7 912 | 15 370 | 8 204 | 9 167 | 17 371 |
| (% of GDP) | 15,1 | 14,0 | 14,5 | 15,1 | 14,7 | 14,9 |
| Real % var. | 17,0 | 6,4 | 11,3 | 6,8 | 12,0 | 9,5 |
| 2. Non-financial expenditure | -6 766 | -7 622 | -14 389 | -6 788 | -7 898 | -14 686 |
| (% of GDP) | -13,7 | -13,4 | -13,6 | -12,5 | -12,7 | -12,6 |
| Real % var. | 7,8 | 3,5 | 5,5 | -2,6 | 0,2 | -1,1 |
| 3. Others | 175 | 267 | 441 | 477 | 484 | 962 |
| (% of GDP) | 0,4 | 0,5 | 0,4 | 0,9 | 0,8 | 0,8 |
| 4. Primary balance | 866 | 557 | 1 422 | 1 893 | 1 753 | 3 646 |
| (% of GDP) | 1,8 | 1,0 | 1,3 | 3,5 | 2,8 | 3,1 |
| 5. Interest | -1 215 | -1 003 | -2 218 | -1 414 | -1 150 | -2 565 |
| (% of GDP) | -2,5 | -1,8 | -2,1 | -2,6 | -1,8 | -2,2 |
| Of which: | | | | | | |
| Pension reform bonds | -174 | 54 | -120 | -204 | -86 | -289 |
| External debt (Millions of US\$) | -\$252 | -\$255 | -\$507 | -\$311 | -\$255 | -\$566 |
| 6. Overall balance | -349 | -447 | -796 | 479 | 602 | 1 082 |
| (% of GDP) | -0,7 | -0,8 | -0,8 | 0,9 | 1,0 | 0,9 |
| (Millions of US\$) | -\$100 | -\$128 | -\$229 | \$138 | \$173 | \$311 |

26. Central government **non-financial expenditure** fell from 13,6 to 12,6 percent of GDP between the first half of 2003 and the first half of 2004, which was reflected both in lower current non-financial spending (which fell from 12,0 to 11,5 percent of GDP) and lower capital spending (from 1,6 to 1,1 percent of GDP).

Non-financial current expenditure increased in real terms (2,1 percent) due principally to salary increases awarded in the second half of 2003 and in April 2004 (a special assignation to teachers) as well as increased spending on goods and services associated with social programs (PRONAA) and commissions payable to Sunat, among others; which were offset by lower current transfers, mainly to the Pensions Office (ONP), which paid pensions accrued in the first half of 2003.

As far as capital expenditure was concerned, the reduction of 25,4 percent mainly reflects reduced spending on projects (at 0,3 percent of GDP) partly caused by a lag in the process of transferring functions to regional and local governments as well as weather problems that delayed road building projects in the first quarter of 2004. The largest reductions could be seen in the transport sector (road building and improvements), labor (emergency social projects), Foncodes and Inade. The following chart shows the fall in central government capital spending broken down by sector and by project:

CENTRAL RESERVE BANK OF PERU

Chart 13

BREAKDOWN OF CENTRAL GOVERNMENT CAPITAL SPENDING

(Millions of nuevos soles)

| | 1 st half 2003 | 1 st half 2004 | VARIATION |
|--|------------------------------|------------------------------|-------------|
| Ministry of Transport, Communications, Housing & Construction | 407 | 360 | -47 |
| Road repairs | 101 | 198 | 97 |
| Road building & improvement | 152 | 61 | -91 |
| Rural road building & improvement | 65 | 59 | -6 |
| El Niño phenomenon repairs & reconstruction | 33 | 0 | -33 |
| Public health | 12 | 28 | 15 |
| Telecommunications | 4 | 3 | -1 |
| Project management | 40 | 12 | -27 |
| Ministry of Agriculture | 168 | 103 | -65 |
| El Niño phenomenon repairs & reconstruction | 11 | 0 | -11 |
| Irrigation projects | 15 | 29 | 14 |
| Management of natural resources in the highlands | 3 | 2 | -1 |
| Land tenure and titles program | 23 | 31 | 8 |
| Soil conservation program | 21 | 19 | -1 |
| Farm production support | 33 | 19 | -13 |
| Others | 63 | 2 | -60 |
| Ministry of Economy and Finance | 35 | 41 | 6 |
| El Niño phenomenon repairs & reconstruction Project management | 11 | 0 | -11 |
| Improvements to public investment planning mechanisms | 12 | 33 | 21 |
| Others | 13 | 8 | -5 |
| Ministry of Energy and Mines | 53 | 51 | -2 |
| Energy distribution infrastructure | 21 | 12 | -9 |
| Project management | 1 | 5 | 3 |
| Energy transmission and mining infrastructure | 15 | 31 | 16 |
| Others | 15 | 3 | -12 |
| Ministry of Education | 41 | 51 | 11 |
| Special program for improving the quality of primary education | 35 | 23 | -12 |
| Others | 6 | 28 | 22 |
| Ministry of Health | 28 | 25 | -3 |
| Support programme for health sector reform | 23 | 15 | -8 |
| Rehabilitation of hospital services | 3 | 2 | -1 |
| Others | 2 | 8 | 6 |
| Ministry of Labour | 121 | 61 | -60 |
| Emergency productive social program | 108 | 55 | -53 |
| Youth training | 13 | 6 | -7 |
| Ministry for Women and Social Development | 7 | 18 | 11 |
| Wawa Wasi program | 7 | 18 | 11 |
| National Development Institute | 95 | 32 | -63 |
| Promotion of agricultural production | 7 | 13 | 6 |
| Project management | 22 | 10 | -12 |
| Defence against earthquakes | 4 | 1 | -3 |
| Rural promotion and outreach | 7 | 4 | -2 |
| Others | 56 | 3 | -53 |
| Regional governments – Ctars | 138 | 198 | 60 |
| Road building and repairs | 39 | 54 | 15 |
| Social support and emergency works | 46 | 23 | -23 |
| Construction and improvement of education, research and support units | 17 | 21 | 4 |
| Agricultural sector support | 12 | 66 | 54 |
| Project management | 25 | 35 | 10 |
| National Compensation & Social Development Fund | 115 | 14 | -101 |
| Emergency productive social programs | 58 | 11 | -47 |
| Social development in the highlands and jungle | 54 | 0 | -54 |
| Economic and social investment | 4 | 3 | -1 |
| Organization, Reconstruction & Development in the South | 2 | 0 | -2 |
| Program for the Formalization of Informal Landholdings | 18 | 16 | -2 |
| National Institute of Health | 8 | 2 | -6 |
| Educational and nutritional support | 8 | 2 | -6 |
| State universities | 40 | 44 | 4 |
| Construction and extension of teaching units | 40 | 44 | 4 |
| Rest of government | 118 | 129 | 11 |
| TOTAL | 1 394 | 1 145 | -249 |

CENTRAL RESERVE BANK OF PERU

27. Total financing requirements were lower than those for the first half of the previous year. The financing requirement amounted to US\$ 696 million, covered by disbursements from abroad of US\$ 905 million, of which US\$ 780 million consisted of freely available resources and US\$ 125 million earmarked for investment projects. Sovereign bonds equivalent to US\$ 270 million were also placed and privatization produced income of US\$ 76 million.

Chart 14

NON-FINANCIAL PUBLIC SECTOR FINANCING

| | 2003 | | | 2004 | | |
|--|-------------------------|-------------------------|----------------------|-------------------------|-------------------------|----------------------|
| | 1 st quarter | 2 nd quarter | 1 st half | 1 st quarter | 2 nd quarter | 1 st half |
| 1. Overall balance (Millions of nuevos soles) | -349 | -447 | -796 | 479 | 608 | 1 087 |
| (% of GDP) | -0,7 | -0,8 | -0,8 | 0,9 | 1,0 | 0,9 |
| Millions of US\$ | -\$100 | -\$128 | -\$229 | \$138 | \$173 | \$311 |
| 2. Amortization (Millions of US\$) | -\$378 | -\$424 | -\$802 | -\$423 | -\$585 | -\$1 007 |
| Redemption of pension reform bonds | -\$52 | -\$66 | -\$117 | -\$51 | -\$77 | -\$128 |
| Internal repayments | -\$72 | -\$77 | -\$149 | -\$72 | -\$179 | -\$252 |
| External repayments | -\$254 | -\$282 | -\$535 | -\$299 | -\$328 | -\$628 |
| 3. Borrowing requirements (Millions of US\$) | \$478 | \$553 | \$1 031 | \$285 | \$412 | \$696 |
| External disbursements | \$838 | \$81 | \$919 | \$260 | \$645 | \$905 |
| Freely available | \$750 | \$0 | \$750 | \$201 | \$579 | \$780 |
| Investment projects | \$88 | \$81 | \$169 | \$59 | \$66 | \$125 |
| Domestic bonds | \$48 | \$175 | \$223 | \$173 | \$97 | \$270 |
| Privatisation | \$6 | \$4 | \$10 | \$71 | \$5 | \$76 |
| Others * | -\$414 | \$293 | -\$122 | -\$219 | -\$335 | -\$554 |

* Includes cash flows, changes in public sector deposits and indexation of pension reform bonds

Source: MEF, BN and BCRP

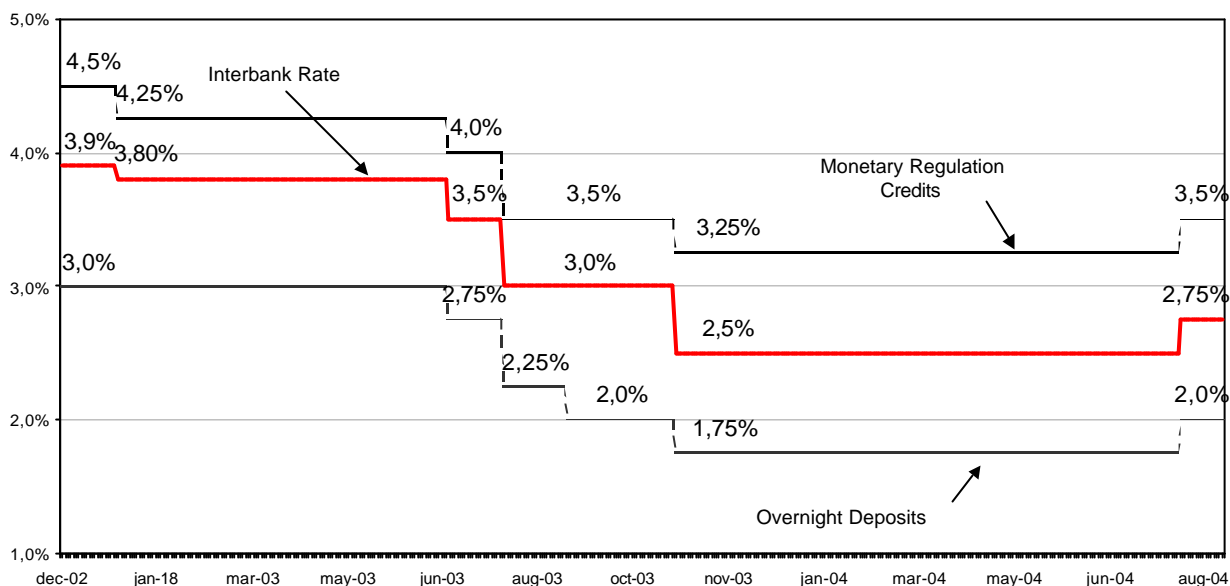
I.6 Interest rates

28. The May inflation report anticipated that the 12-month inflation rate would be slightly above the upper limit of the target range (3,5 percent), principally because of successive supply shocks occurring during the first half of the year (foodstuffs and fuel). The July Monetary Program Press Release said that the bank would give special attention to inflationary pressure in the following months in order to take preventive measures ensuring that the inflation target would be met. Later, in the August Monetary Program it was agreed to increase the reference interest rate by 25 basis points (the interbank rate of 2,75 percent), taking into account that for 2004 was forecast to reach a level close to the upper limit of the target range (3,5 percent).

CENTRAL RESERVE BANK OF PERU

Figure 25

REFERENCE INTEREST RATES
(December 2002 – August 2004)



Thus reference interest rates for monetary operations rose to 3,5 percent for direct repos agreements and rediscounts (the previous rate was 3,25 percent); and to 2,0 percent for *overnight* deposits (the previous rate was 1,75 percent). Open market currency operations could be such as to place the interbank rate around the center of the reference range (2,75 percent).

Chart 15

INTERBANK INTEREST RATES IN SOLES
(In percentages)

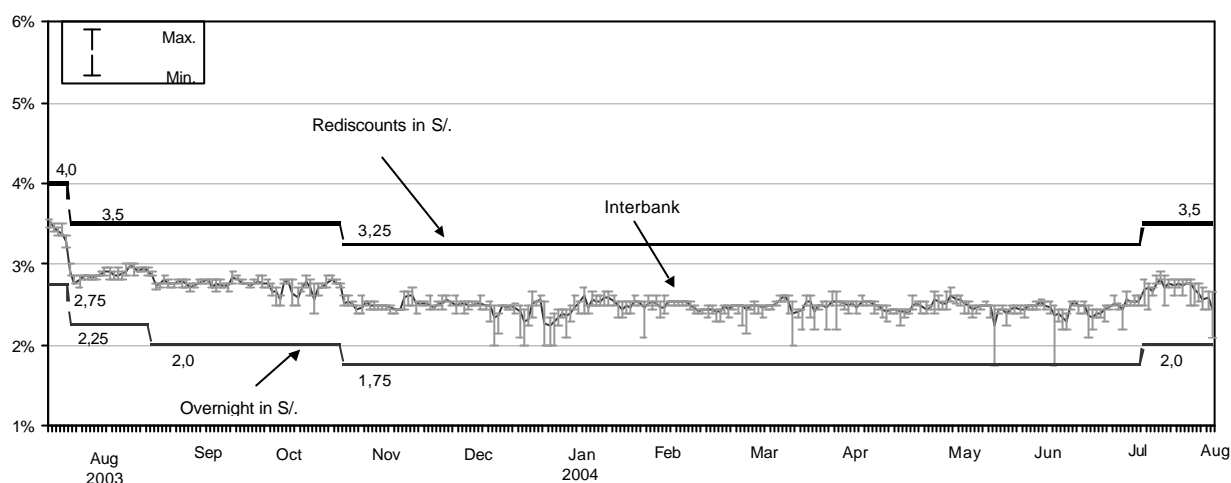
| | Jan. | Feb. | Mar. | Apr. | May. | Jun. | Jul. | Aug. | Sep. | Oct. | Nov. | Dec. |
|------------------------|------|------|------|------|------|------|------|------|------|------|------|------|
| 2003 | | | | | | | | | | | | |
| Average | 3,75 | 3,80 | 3,82 | 3,84 | 3,78 | 3,74 | 3,47 | 3,01 | 2,77 | 2,71 | 2,55 | 2,51 |
| Standard deviation | 0,13 | 0,10 | 0,06 | 0,05 | 0,07 | 0,05 | 0,09 | 0,25 | 0,06 | 0,08 | 0,11 | 0,05 |
| Variability coeff. (%) | 3,6 | 2,6 | 1,6 | 1,3 | 1,8 | 1,3 | 2,5 | 8,2 | 2,2 | 2,9 | 4,3 | 2,0 |
| 2004 | | | | | | | | | | | | |
| Average | 2,41 | 2,52 | 2,48 | 2,49 | 2,48 | 2,46 | 2,44 | 2,67 | | | | |
| Standard deviation | 0,10 | 0,04 | 0,04 | 0,06 | 0,05 | 0,07 | 0,08 | 0,10 | | | | |
| Variability coeff. (%) | 4,2 | 1,7 | 1,5 | 2,6 | 1,9 | 2,7 | 3,1 | 3,8 | | | | |

Source: BCRP.

CENTRAL RESERVE BANK OF PERU

Figure 26

DOMESTIC CURRENCY INTEREST RATES
(August 2003 – August 2004)



As a result, the interbank interest rate rose from 2,44 percent in July to 2,67 percent in August. The average standard deviation of the interbank interest rate so far this year has remained at 0,1 percentage points, similar to the figure for the previous year.

Chart 16

LEVEL AND VOLATILITY OF INTERBANK INTEREST RATE
(In percentage points)

| Year | Average level | Standard deviation |
|--------------------|---------------|--------------------|
| 1998 | 19,0 | 6,45 |
| 1999 | 14,9 | 4,65 |
| 2000 | 12,7 | 2,66 |
| 2001 | 8,6 | 0,91 |
| 2002 | 3,2 | 0,48 |
| 2003 | 3,4 | 0,09 |
| 2004 ^{1/} | 2,5 | 0,07 |

^{1/} January - August.

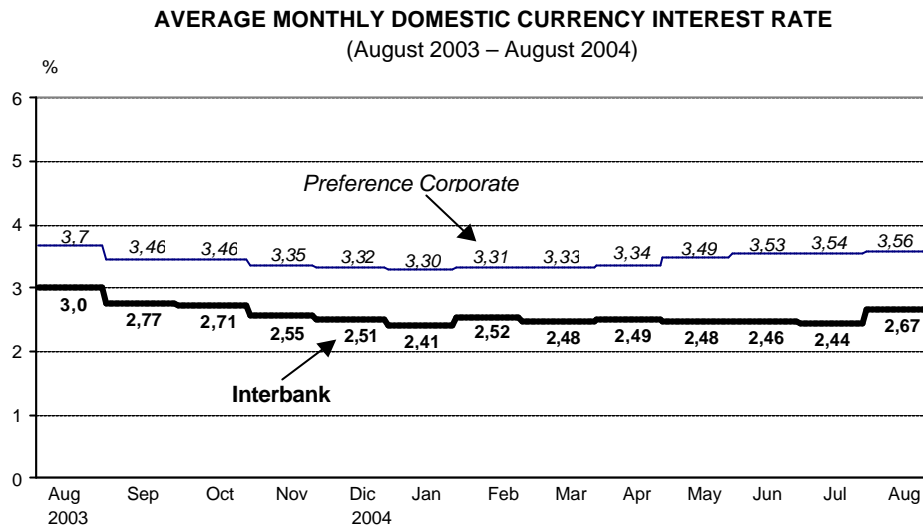
Source: BCRP.

29. From May onwards an increase was observed in the slope of the curve for yields in soles, in other words there was a higher differential between the interbank rate and other long-term interest rates. In effect, the longer-term rates began to rise whilst the interbank rate remained stable. These increases were related at first to expectations that the United States Federal Reserve would begin to raise interest rates in July, which also coincided with an increase in country risk both for Peru and for the region. The United States federal funds rate has increased by 50 basis points between July and August from 1,0 to 1,5 percent).

A gradual increase in the interest rate for 90 day loans to low-risk clients was observed from May onwards. The rate rose from 3,34 percent in April to 3,54 percent in July and 3,57 percent in August.

CENTRAL RESERVE BANK OF PERU

Figure 27

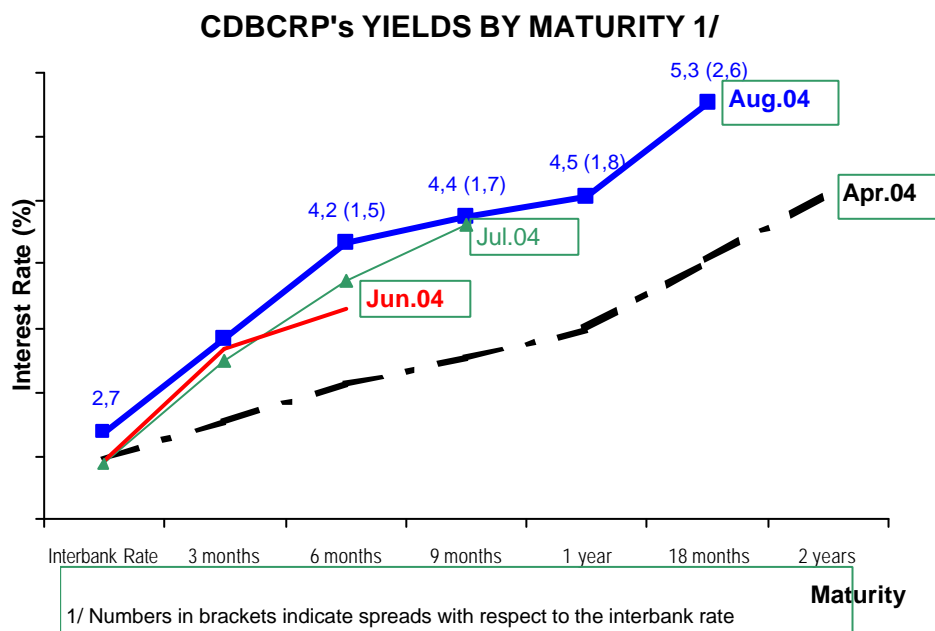


30. Given the context of an increase in the slope of the yield curve for central bank deposit certificates (CD BCRP) between April and July 2004, the bank reduced the average maturity of placements.

Because of the seasonal nature of public finances, between April and May the BCRP regulated bank liquidity using repos and one week CD BCRPs. In June CD BCRP placements gradually resumed with longer maturities. In that month an increase in 3 and 6 month interest rates occurred, following an upward trend that continued in July for 6 and 9 month rates.

In August, after an increase of 25 basis points in BCRP reference interest rates, there was greater demand for longer terms and a lower gradient for the CD BCRP yield curve, especially for the 6 to 9 month section. It should be mentioned that in August the first placements at 1 year and 18 month maturities were made, from April and March respectively.

Figure 28



CENTRAL RESERVE BANK OF PERU

With the seasonal reduction in public sector deposits with the BCRP in July and a renewal of exchange rate interventions in July and August, the balance of CD BCRPs increased from S/. 5 188 million in June to S/. 6 100 million in August 2004 in order to sterilize the monetary impact of these operations.

Chart 17
CDBCRP BALANCE BY MATURITY
(Millions of nuevos soles)

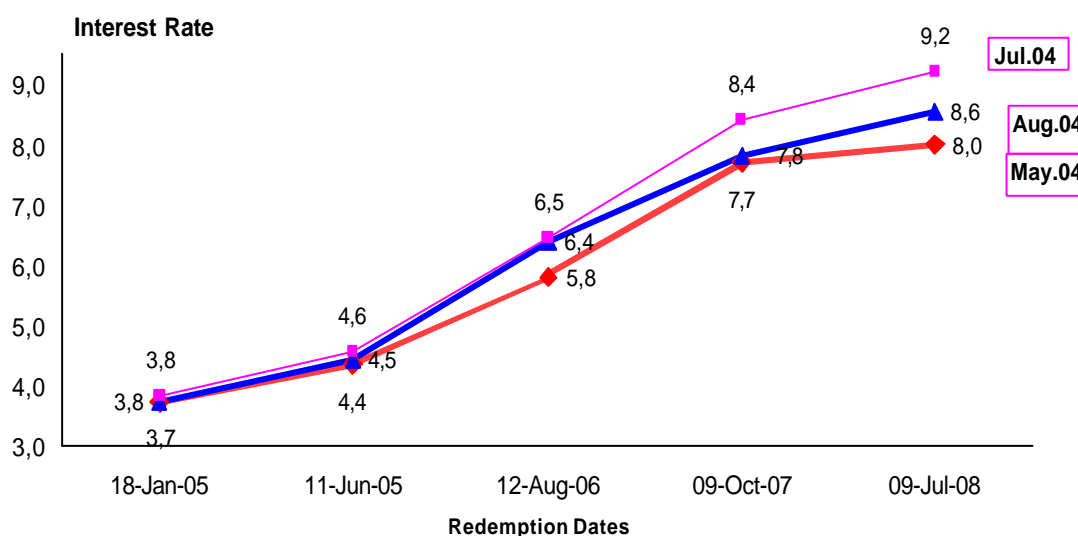
| | 2003 | 2004 | | | |
|--------------------------------------|--------------|--------------|--------------|--------------|--------------|
| | Dec. | Mar. | Jun. | Jul. | Aug. |
| Up to 18 weeks | 32 | 305 | 130 | 356 | 395 |
| 4 to 6 months | 790 | 955 | 615 | 565 | 425 |
| 7 to 10 months | 180 | 523 | 393 | 590 | 1 290 |
| 1 year to 18 months | 2 280 | 3 031 | 2 816 | 2 216 | 2 756 |
| 2 & 3 years | 815 | 1 185 | 1 235 | 1 235 | 1 235 |
| Total | 4 097 | 5 998 | 5 188 | 4 961 | 6 100 |
| NB: | | | | | |
| Average CDBCRP balance interest rate | 3,9% | 3,7% | 3,8% | 3,7% | 3,9% |

Source: BCRP.

31. The yield curve of treasury bonds (TB) evolved in a similar manner to those for CD BCRPs. In August, coinciding with the reduction in country risk, the slope of the yield curve for TBs was reduced (particularly for those having a maturity greater than 3 years). Thus, for example, the rate for bonds maturing in July 2008 increased from 8,0 percent in May to 9,2 percent in July before falling to 8,7 percent in August. It should be mentioned that this reduction also applies when TBs are not quoted so regularly in the secondary market, such as the issue maturing in March 2010 (which fell from 11,0 percent to 10,5 percent in August).

Figure 29

PUBLIC TREASURY BOND'S YIELD CURVE



CENTRAL RESERVE BANK OF PERU

32. Between June and August, the government placed sovereign bonds (TBs) valued at a total of S/. 498 million, under the market makers scheme. This period was notable for the placement of a bond denominated in soles with a nominal 7-year maturity (effective rate 12,6 percent) and VAC sol-denominated bonds maturing in 15 years (real rate 7,5 percent). The total for these placements (S/. 498 million) included a bond exchange operation valued at S/. 192 million carried out in August, in bonds maturing in October 2004 were amortized early and replaced by VAC bonds maturing in February 2011 (6,5 years). The balance of sol-denominated sovereign bonds at the close of August was S/. 3 039 million, a higher figure than for December 2003 (S/. 2 660 million).

Chart 18

SOVEREIGN BOND INTEREST RATES IN THE SECONDARY MARKET BY DATE OF MATURITY

(In percentages)

| | Jan.05 | Jun.05 | Aug.05 | Oct.07 | Jul.08 |
|-------------|--------|--------|--------|--------|--------|
| 2003 | | | | | |
| August | 3,67 | 3,95 | 4,62 | - | 7,70 |
| September | 3,65 | 3,95 | 4,27 | - | 6,77 |
| October | 3,65 | 4,01 | 4,71 | 5,98 | 6,80 |
| November | 3,30 | 3,65 | 4,81 | 6,10 | 6,61 |
| December | 3,27 | 3,66 | 4,67 | 5,96 | 6,55 |
| 2004 | | | | | |
| January | 3,45 | 3,75 | 4,75 | 5,79 | 6,45 |
| February | 3,29 | 3,56 | 4,67 | 5,55 | 6,35 |
| March | 3,28 | 3,54 | 4,61 | 5,50 | 6,26 |
| April | 3,40 | 3,95 | 5,07 | 5,75 | 6,55 |
| May | 3,90 | 4,70 | 6,15 | 7,73 | 8,00 |
| June | 3,75 | 4,35 | 6,30 | 8,10 | 9,14 |
| July | 3,87 | 4,63 | 6,65 | 8,53 | 9,23 |
| August | 3,51 | 4,25 | 6,04 | 7,54 | 8,15 |

33. Between June and August 2004 there was an increase in fixed income securities in the private sector, both in soles and in dollars. In soles the net value was S/. 343 million, higher than for the same period in 2003 (S/. 214 660 million). The net value of dollar placements was US\$ 256 million, compared to a net redemption of US\$ 8 million for the same period in 2003. Particularly noteworthy was an issue of corporate bonds by Transportadora de Gas del Peru (TGP) on the 20th of August for the equivalent of US\$ 270 million. This operation consisted of two tranches: a 15 year dollar-denominated bond valued at US\$ 200 million and a 25 year VAC bond valued at S/. 237 million (equivalent to US\$ 70 million). It is worth mentioning that the placement of a VAC sol-denominated bond with a 25-year maturity has the longest maturity of any bond ever issued in Peruvian currency.

Private companies issuing bonds in soles included Corporacion Financiera Internacional (IFC) (S/. 50 million), Edelnor (S/. 40 million VAC), Telefonica del Peru (S/. 30 million) Edegel (S/. 20 million), all of these bonds were placed in June. Between April and June an increase in interest rates was also observed. For example, in June a corporate bond issue maturing in 3 years obtained an effective interest rate of 7,46 percent, against 5,63 percent at the end of April. Given this upward trend for rates in soles with maturities of more than one year, no sol-denominated bonds were

CENTRAL RESERVE BANK OF PERU

issued in July. In August issues recommenced with the issue mentioned above, having a record 25 year maturity.

34. Bank interest rates continued the downward trend seen in recent years. It should be mentioned that these rates change somewhat after changes in short-term interest rates and they are determined also by microeconomic factors such as increased competition and reductions in bank delinquency rates.

The average bank's lending rate in Peruvian currency fell slightly from 18,8 percent to 18,7 percent between May and August 2004. Broken down by components, the average rate for consumer loans fell from 39,4 percent in May to 38,5 percent in August; whilst the rate charged for loans to small businesses fell from 52,8 to 51,4 percent in the same period. Meanwhile the rate for commercial loans rose slightly from 9,1 to 9,4 percent.

Figure 30

DOMESTIC CURRENCY INTEREST RATES FOR CONSUMER AND COMMERCIAL LOANS AND LOANS TO MICROBUSINESSES

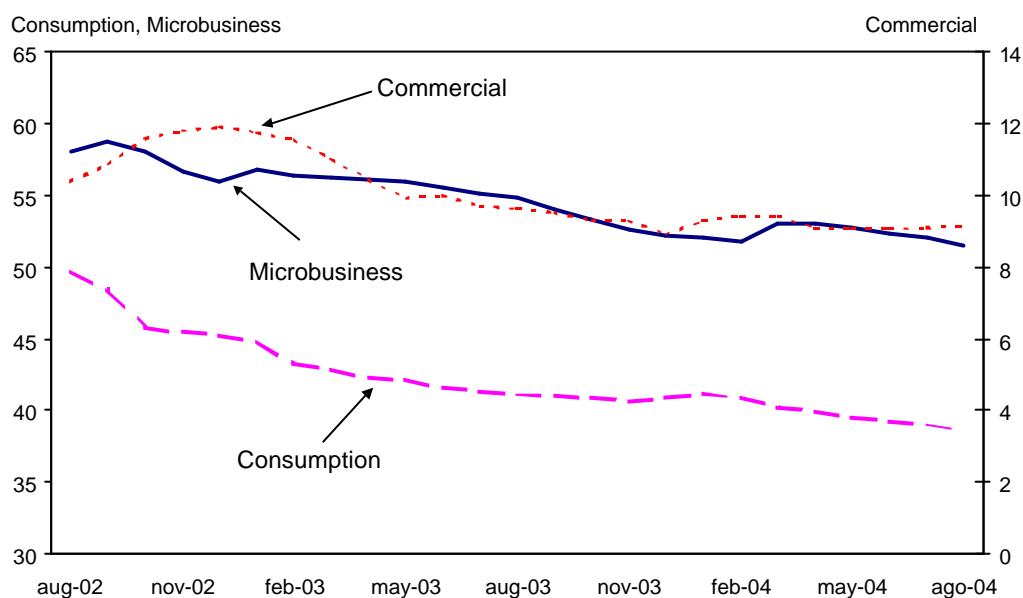


Chart 19

INTEREST RATES FOR SOL-DENOMINATED OPERATIONS (In percentages)

| | 2002 | | | | 2003 | | | | 2004 | | | |
|--|------|------|------|------|------|------|------|------|------|------|------|------|
| | Mar. | Jun. | Sep. | Dec. | Mar. | Jun. | Sep. | Dec. | Mar. | Jun. | Jul. | Aug. |
| 1. Interbank | 2,5 | 2,6 | 5,4 | 3,8 | 3,8 | 3,7 | 2,8 | 2,5 | 2,5 | 2,5 | 2,4 | 2,7 |
| 2. Savings deposits | 1,8 | 1,7 | 1,7 | 1,7 | 1,7 | 1,5 | 1,3 | 1,3 | 1,4 | 1,3 | 1,2 | 1,2 |
| 3. Preferential lending | 3,9 | 3,7 | 6,8 | 5,1 | 4,7 | 4,6 | 3,5 | 3,3 | 3,3 | 3,5 | 3,6 | 3,6 |
| 4. 360 day average lending | 15,5 | 14,1 | 14,0 | 14,8 | 14,3 | 14,0 | 14,3 | 14,0 | 14,8 | 14,7 | 14,5 | 14,4 |
| 5. Average lending, constant structure | 25,0 | 23,6 | 22,5 | 22,3 | 21,1 | 20,1 | 19,6 | 19,0 | 19,3 | 18,7 | 18,6 | 18,7 |
| 6. CD | | | | | | | | | | | | |
| Balance | 5,4 | 4,8 | 4,1 | 4,7 | 4,7 | 4,8 | 4,3 | 3,9 | 3,7 | 3,8 | 3,7 | 3,9 |
| Average for monthly placements (in months) | 6 | 6 | -,- | 8 | 12 | 7 | 15 | 11 | 11 | 3 | 5 | 11 |

1/ Excludes one week CD placements.

Source: BCRP.

CENTRAL RESERVE BANK OF PERU

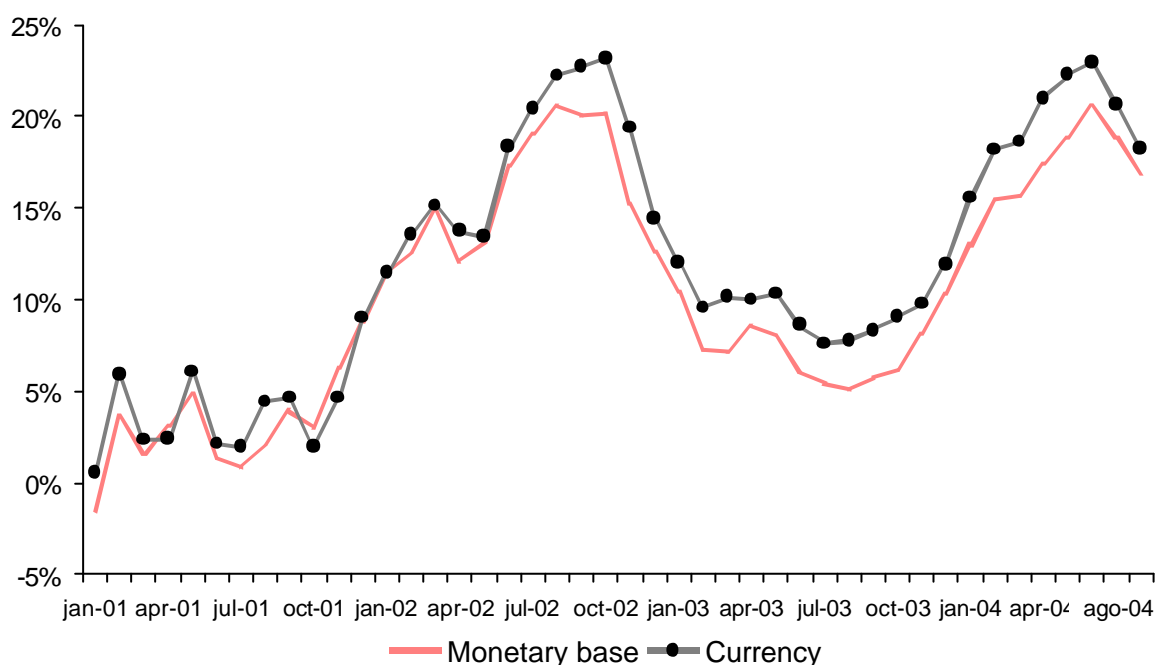
I.7 Liquidity and credit

35. During the first half of this year, annual growth rates for monetary base and currency continued the upward trend recorded since the middle of the previous year, associated with the reduction in reference interest rates in the second half of 2003. Thus the annual rate of variation of currency in the last 12 months rose from 12 percent in December to 23 percent in June 2004. The average monetary base balance also showed an annual rate of growth of 10 percent in December, before increasing to 21 percent in June of this year. Nevertheless, from July onwards there was a change in trend. The annual rate of change in the last 12 months of the average primary issue balance fell to 19 percent and 17 percent respectively in July and August.

Figure 31

CURRENCY AND MONETARY BASE GROWTH: JANUARY 2001 – AUGUST 2004

(Rate of variation compared to the same month of the previous year)

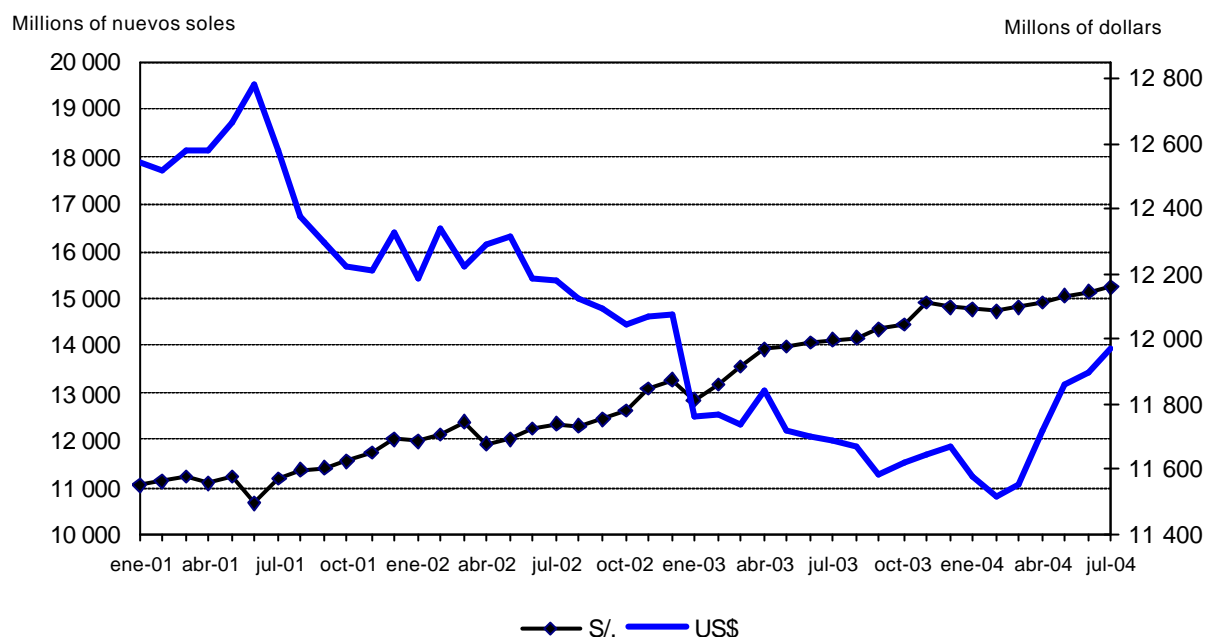


36. Between May and July 2004, financial system loans to the private sector increased in both soles (1,5 percent) and dollars (0,9 percent). During recent months the annual rate of growth of sol-denominated loans accelerated from 7,7 percent in May to 8 percent in July. Likewise, the annual rate of growth of dollar-denominated loans rose from 1,2 percent in May to 2,4 percent in July.

CENTRAL RESERVE BANK OF PERU

Figure 32

BANK LOANS TO THE PRIVATE SECTOR



37. The expansion of credit in soles between May and July was explained by the Banco de la Nacion (S/. 66 million); because of higher loans to public sector workers; institutional investors (S/. 62 million), banks (S/. 57 million) and microfinance institutions (S/. 23 660 million). The annual rate of growth of loans to the private sector from microfinance institutions fell from 17,4 percent in May to 14,7 percent in July 2004. As far as loans to the private sector from institutional investors was concerned, the annual rate of growth fell from 37,8 percent to 28,7 percent in that period.

Chart 20

EVOLUTION OF DOMESTIC CURRENCY BANK LOANS TO THE PRIVATE SECTOR

| | Balance in millions of soles | | Rate of growth |
|-------------------------------------|------------------------------|---------------|----------------|
| | jul03 | jul04 | Jul.04/Jul.03 |
| Banks 1/ | 8 150 | 8 082 | -0,8 |
| Banco de la Nacion | 463 | 815 | 75,9 |
| Microfinance institutions | 3 288 | 3 773 | 14,7 |
| Banks (microfinance loans) | 671 | 966 | 43,9 |
| Municipal savings and loans | 952 | 1 186 | 24,6 |
| Rural savings and loans | 155 | 215 | 39,0 |
| Cooperatives | 423 | 451 | 6,6 |
| Edpymes | 151 | 185 | 22,0 |
| Finance companies | 937 | 770 | -17,8 |
| Institutional investors 2/ | 1 790 | 2 303 | 28,7 |
| AFPs | 1 220 | 1 498 | 22,8 |
| Insurance companies | 498 | 627 | 25,9 |
| Mutual funds | 72 | 178 | 148,3 |
| Leasing companies and others | 430 | 281 | -34,7 |
| Total for financial system | 14 121 | 15 254 | 8,0 |

1/ Excludes microfinance loans.

2/ Mainly securities issued by the private sector.

CENTRAL RESERVE BANK OF PERU

38. The increase in dollar-denominated loans was explained by the higher loans from banks (US\$ 121 million), and to a lesser extent microfinance institutions (US\$ 20 million), was offset by a reduction in bond holdings by institutional investors (US\$ 33 million) and fewer loans by leasing companies and others (US\$ 4 million).

Chart 21
EVOLUTION OF FOREIGN CURRENCY BANK LOANS TO THE PRIVATE SECTOR

| | Balance in millions of dollars | | Rate of growth |
|-------------------------------------|--------------------------------|---------------|----------------|
| | jul03 | jul04 | Jul.04/Jul.03 |
| Banks 1/ | 9 500 | 9 613 | 1,2 |
| Banco de la Nacion | 23 | 22 | -1,4 |
| Microfinance institutions | 453 | 568 | 25,5 |
| Banks (microfinance loans) | 85 | 101 | 18,6 |
| Municipal savings and loans | 147 | 217 | 48,3 |
| Rural savings and loans | 44 | 48 | 9,8 |
| Cooperatives | 106 | 130 | 22,0 |
| Edpymes | 36 | 43 | 19,5 |
| Finance companies | 35 | 29 | -17,0 |
| Institutional investors 2/ | 1 042 | 1 152 | 10,6 |
| AFPs | 537 | 572 | 6,6 |
| Insurance companies | 45 | 63 | 39,2 |
| Mutual funds | 460 | 518 | 12,5 |
| Leasing companies and others | 671 | 610 | -9,0 |
| Total for financial system | 11 688 | 11 966 | 2,4 |

1/ Excludes microfinance loans.

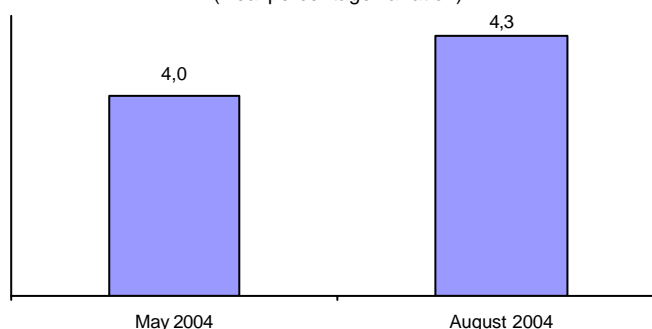
2/ Mainly securities issued by the private sector.

II. FORECASTS

II.1 Economic activity

39. With respect to the May Report, the forecast for economic growth in 2004 has been revised upwards. In effect, if there are no adverse shocks GDP growth this year should be 4,3 percent rising to 4,5 percent next year.
40. A survey of expectations carried out by the BCRP shows that expected GDP growth for 2004 is 4,4 percent among economic analysts, 4,3 percent among finance companies and 4,0 percent among non-financial companies. It should be said that according to the *Consensus Forecast*, GDP growth expectations for 2004 have risen from 4,0 percent in May to 4,3 percent in August.

Figure 33
GDP GROWTH EXPECTATIONS FOR 2004
(Real percentage variation)



CENTRAL RESERVE BANK OF PERU

41. Greater economic activity in 2004 is the result of a higher than forecast growth in private investment (from 7,2 percent to 9,1 percent) and in exports (from 7,9 to 9,0 percent). This growth should continue in 2005, driven by private investment (7,2 percent) and exports (5,4 percent). This evolution of the components of aggregate expenditure suggests that the economy is continuing to expand its production capacity and access to foreign markets, which should allow higher rates of sustained growth.

Chart 22

GLOBAL SUPPLY AND DEMAND
(Real percentage variations compared to same period of previous year)

| | 2003 | 2004* | 2005* |
|--------------------------------|-------------------|-------------------|-------------------|
| I. GLOBAL DEMAND (1+2) | <u>3,7</u> | <u>4,8</u> | <u>4,4</u> |
| 1. Domestic demand 1/ | 3,3 | 4,0 | 4,3 |
| a. Private consumption | 3,1 | 3,5 | 4,0 |
| b. Public consumption | 2,9 | 4,0 | 3,2 |
| c. Fixed private investment | 5,4 | 9,1 | 7,2 |
| d. Public investment | 5,0 | 4,7 | 5,4 |
| 2. Exports | 5,9 | 9,0 | 5,4 |
| II. GLOBAL SUPPLY (3+4) | <u>3,7</u> | <u>4,8</u> | <u>4,4</u> |
| 3. GDP | 3,8 | 4,3 | 4,5 |
| 4. Imports | 3,3 | 7,5 | 4,0 |

1/ Includes changes in inventories

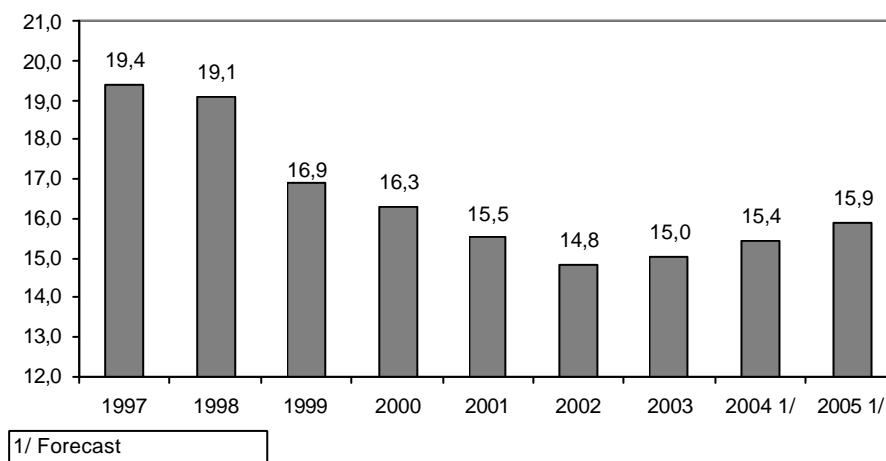
* Forecast

Source: INEI and BCRP estimates.

42. Nevertheless, although levels of private investment are still low, a gradual recovery has been seen in private investment's share of gross domestic product since 2003.

Figure 34

GROSS FIXED PRIVATE INVESTMENT
(Percentage of nominal GDP)

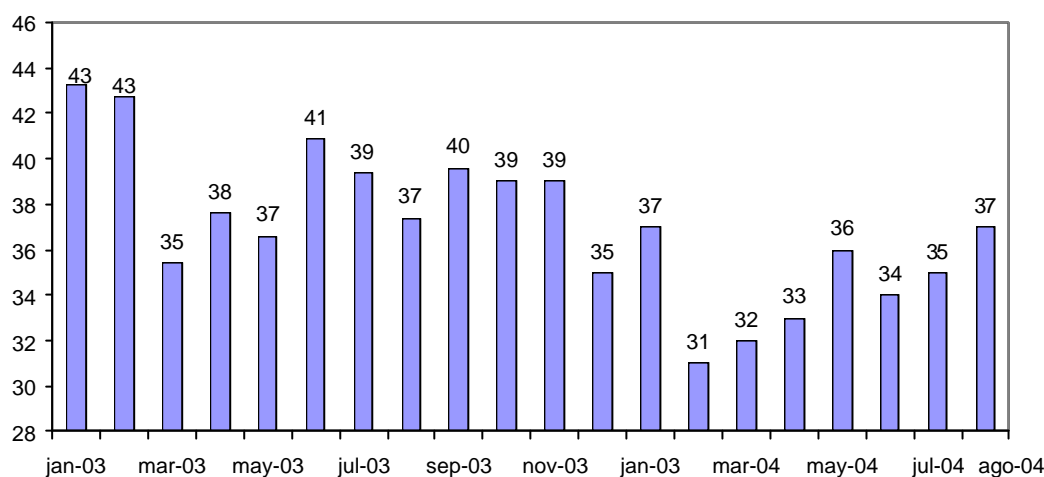


CENTRAL RESERVE BANK OF PERU

43. Growth in private consumption should reach 3,5 percent in the year, a figure consistent with the recovery that can be observed in consumer confidence in Metropolitan Lima which, according to Apoyo, has been positive throughout the year reaching a level of 37 points in August, the highest for the year and equal to the figure for January. Similarly, consumer confidence at national level also recovered in August, the month in which the INDICCA index reached a level of 36 points, higher than the 33 points observed in December 2003 and the 32 points in April 2004.

Figure 35

CONSUMER CONFIDENCE INDEX INDICCA



Source: Apoyo.

In 2004 **exports** should show a real increase of 9,0 percent, the highest rate of growth since 1997 when the figure was 13,1 percent. The expansion in 2004 is likely to be caused by higher exports of traditional products such as copper and fishmeal, as well as non-traditional products, whose nominal value should increase 22,5 percent with textiles, agriculture & livestock produce, steel, jewellery and chemical products in the vanguard.

It is expected that public consumption over the year will increase 4,0 percent whilst public investment could reverse the fall shown in the first half, to close the year with real growth of 4,7 percent.

44. In 2004 the non-primary sectors grew by 4,4 percent whilst primary sectors grew by 3,4 percent.

A slight fall is forecast for the **agriculture & livestock sector** because of adverse weather conditions (drought, snow and warm spells) affecting potato, rice, hard yellow corn and amilaceous corn crops. The **fishing sector** could grow 18,3 percent as good catches of anchovy continue and total landings of 8 million tons are forecast, assuming that current sea conditions remain the same for the rest of the year. The **mining and fuel** sector could grow 7,6 percent due to higher production of copper (higher metal concentrations at Antamina, the re-commencement of operations at Tintaya and expansion by Southern Peru), gold (the commencement of operations at Cerro Negro, Yanacocha and greater dynamism among medium-sized mining companies) and iron ore (greater demand from China) as well as the start of gas and gas liquids production from Camisea in the third quarter of the year.

CENTRAL RESERVE BANK OF PERU

In 2004, **manufacturing** production could rise 5,5 percent. The primary resources processing industry could record growth of 5,1 percent because of a production increase by the fishing industry as anchovy is plentiful, and, to a lesser extent, an increase in production of non-ferrous metals and refined petroleum. Sugar production could fall because of drought. Non-primary manufacturing production could rise 5,6 percent, with the following industries fore: knitted textiles, furniture; cement and construction materials, explosives, natural and chemical essences and electrical machinery.

The **construction** sector should continue as dynamic as has been observed in the first half year to reach a rate of 5,3 percent because of an expansion in house building as a result of incentives generated by the MiVivienda and Techo Propio programs, new roads and mining projects such as Alto Chicama and Cerro Negro.

Chart 23
GROSS DOMESTIC PRODUCT

(Real percentage variations compared to same period of previous year)

| | 2003 | 2004* | 2005* |
|---------------------------------------|-------------------|-------------------|-------------------|
| Agriculture & livestock | 2,3 | -1,0 | 1,3 |
| Fishing | -12,6 | 18,3 | 0,0 |
| Mining & fuel | 6,9 | 7,6 | 4,8 |
| Metals | 7,7 | 6,4 | 3,5 |
| Fuel | -4,5 | 17,9 | 25,1 |
| Manufacturing | 2,1 | 5,5 | 5,2 |
| Based on raw materials | -1,8 | 5,1 | 2,1 |
| Non-primary | 3,2 | 5,6 | 6,0 |
| Electricity & water | 4,2 | 4,2 | 4,2 |
| Construction | 4,2 | 5,3 | 6,6 |
| Commerce | 3,8 | 3,6 | 4,8 |
| Other services | 4,0 | 4,3 | 4,5 |
| <u>GROSS VALUE ADDED (GVA)</u> | <u>3,6</u> | <u>4,2</u> | <u>4,5</u> |
| Taxes on products and import duties | 5,3 | 5,3 | 4,9 |
| <u>GLOBAL GDP</u> | <u>3,8</u> | <u>4,3</u> | <u>4,5</u> |
| Primary GVA | 2,8 | 3,4 | 2,7 |
| Non-primary GVA | 3,8 | 4,4 | 5,0 |

* Forecast.

Source: INEI and BCRP estimates.

45. The rate of GDP growth should continue to rise in 2005 (4,5 percent) driven by increased domestic demand. This in turn is caused by growing private consumption associated with a 4,4 percent rise in national disposable income and reflected in an

CENTRAL RESERVE BANK OF PERU

increase of more than 8 percent in consumer goods imports. A recovery in public investment is also expected within the context of increased private investment. In this respect, capital goods imports excluding construction materials could rise by around 13 percent, principally due to investment in the manufacturing sector.

Chart 24

NATIONAL DISPOSABLE INCOME

(Real percentage variation compared with same period of previous year)

| | 2003 | 2004* | 2005* |
|----------------------------------|------|-------|-------|
| I. Gross domestic product (GDP) | 3,8 | 4,3 | 4,5 |
| II. Gross national product (GNP) | 2,9 | 3,4 | 4,6 |
| III. Gross national income (NI) | 3,4 | 5,2 | 4,5 |
| IV. National disposable income | 3,6 | 5,4 | 4,4 |

1/ Excludes net income paid to non-resident productive factors.

2/ GDP and GNP are isolated from changes in foreign trade terms.

3/ Net transfers from non-residents added to NI.

* Forecast.

Source: INEI and BCRP estimates.

Growth in exports could reach 5,4 percent given the dynamism of traditional export products (principally gold and zinc) as well as of exports of non-traditional products, principally agriculture & livestock produce, textiles and chemicals.

Imports should increase 4,0 percent in 2005 with significant industrial purchases of both capital goods (13,7 percent) and raw materials (8,6 percent), which should accompany the growth in imports of consumer goods, both durable and non-durable otherwise.

46. In 2005 the non-primary sectors should remain dynamic with growth of 5,0 percent, growth of 2,7 percent is forecast for the primary sectors.

A recovery in the agriculture & livestock sector in 2005 (1,3 percent) could result from higher potato and cotton yields as a result of better prices in 2004, and rice yields after more land in the jungle has been planted with this crop to counteract the reductions in Lambayeque, according to farmers' intentions revealed by a Ministry of Agriculture survey. Livestock production is also expected to be buoyant, as is the production of fruit and vegetables for export.

The **fishing** sector could grow 1,5 percent and anchovy landings are forecast to be close to the average for the last five years (7,8 million tons). This slight fall compared to last year could be offset by a recovery in both canned fish production as the result of higher catches of suitable species and in frozen fish production for which increases in whiting quotas are being considered, and satisfactory catches of giant squid, as well as increased fish farming activity.

The **mining and fuel** sector could grow 4,8 percent due principally to higher hydrocarbon production (Camisea operating all year) and gold production. As far as gold is concerned, it is expected that the Alto Chicama gold project in La Libertad (Barrick) will come on stream by the middle of the year and that the Yanacocha's

CENTRAL RESERVE BANK OF PERU

Cerro Negro mine will be operational throughout the year. Nevertheless, production from Piernina (Barrick) could continue to fall off as reserves are exhausted. The production of zinc, lead and silver should show moderate growth as Volcan and other medium-sized mining companies recover because of higher metal prices.

In 2005 **manufacturing** production is forecast to rise 5,2 percent. The primary resources processing industry could record growth of 2,1 percent whilst non-primary could expand 6,0 percent. This forecast increase in primary resources processing is explained by an increase in production of canned and frozen fish; and, to a lesser extent, an increase in production of non-ferrous metals and refined petroleum. Fishmeal and sugar production could fall slightly, the latter still affected by drought. Non-primary production could increase 6,0 percent driven by increases in non-traditional exports, the development of mining projects, dynamism in the construction sector and the development of the Camisea gas project.

The **construction** sector could grow 6,6 percent because of private investment, particularly in house building and mining projects.

II.2 External sector

47. The international economic environment so far this year has been characterized by a significant increase in the price of oil, the beginning of a series of interest rate increases by the FED and the introduction of measures to prevent the Chinese economy overheating. This, in the context of political uncertainty associated with the situation in the Middle East (Iraq in particular) and rising insecurity caused by terrorist attacks.

For the rest of this year and next, the international context will depend on the evolution of these external factors, the application of a less expansive monetary policy in the main developed economies and the economic development of the most important emerging nations (China and India). To this should be added the impact of elections in the United States.

48. Prospects for growth among our main trading partners in 2004 remain almost unchanged from those described in the May Inflation Report (4,3 percent compared to 4,2 percent previously). Growth forecasts for the United States, our principal trading partner (28 percent of Peru's trade) have been revised lightly downwards.

The United States economy grew by 3,0 percent last year and higher growth is expected this year. Nevertheless, as various indicators have shown a certain deceleration in growth in the second quarter, partly due to a sluggish labor market and a reduction in consumer confidence growth forecasts have been reduced (from 4,6 percent previously to 4,4 percent).

To this can be added geopolitical uncertainty, high oil prices and the FED's interest rate response to the threat of inflation. Thus growth forecasts for the US economy in 2005 have also been revised downwards compared to the May 2004 Inflation Report (from 3,8 to 3,6 percent).

49. Furthermore 2004 saw a slight recovery in European countries. In the second quarter of the year, the German economy experienced a slight expansion driven by its export sector; whilst France saw growth generated by increased private consumption. In addition, the United Kingdom experienced high economic growth and pressure on the housing market, which caused the Bank of England to raise its reference interest rate

CENTRAL RESERVE BANK OF PERU

to 4,75 percent. In 2005 it is estimated that European countries will see a reduced rate of growth.

Chart 25

GROWTH AMONG PERU'S MAIN TRADING PARTNERS

(In percentages)

| | 2003 | Forecasts | | | |
|--|------------|------------------------------|------------|---------------------------------|------------|
| | | May 2004 Inflation Report | | August 2004 Inflation Report | |
| | | 2004 | 2005 | 2004 | 2005 |
| <u>Average for trading Partners</u> | 2,5 | 4,2 | 3,6 | 4,3 | 3,5 |
| North America | 2,9 | 4,4 | 3,8 | 4,3 | 3,6 |
| <i>United States</i> | 3,0 | 4,6 | 3,8 | 4,4 | 3,6 |
| Europe | 1,3 | 2,3 | 2,3 | 2,5 | 2,3 |
| <i>Germany</i> | -0,1 | 1,6 | 1,7 | 1,8 | 1,6 |
| <i>France</i> | 0,5 | 1,8 | 2,1 | 2,3 | 2,1 |
| Asia | 4,9 | 5,5 | 4,6 | 6,0 | 4,5 |
| <i>China</i> | 9,1 | 8,6 | 7,7 | 8,8 | 7,7 |
| <i>Japan</i> | 2,7 | 3,1 | 1,8 | 4,3 | 1,9 |
| <i>South Korea</i> | 3,1 | 5,6 | 5,2 | 5,2 | 4,9 |
| Latin America | 1,4 | 4,9 | 4,0 | 5,2 | 4,1 |
| <i>Brazil</i> | -0,2 | 3,2 | 3,4 | 3,6 | 3,4 |
| <i>Chile</i> | 3,3 | 4,8 | 4,9 | 5,0 | 5,0 |

Source: Consensus Forecast (August 2004)

It is worth pointing out that both Asian countries and the regions with which they have a significant flow of trade are optimistic about their prospects for growth. GDP growth forecasts for 2005 have increased from 5,5 to 6,0 percent for Asia and from 4,9 to 5,2 percent for the Latin America region.

This greater dynamism is explained by strong growth in China despite measures aimed at preventing its economy from overheating, and by a recovery and consolidation of growth in Japan (the fall observed in the second quarter notwithstanding). Latin American countries are also being affected by economic growth in Brazil (influenced by that country's trade balance, progress with reforms and access to international financial markets) and in Chile (benefiting from the rise in the price of copper).

Prospects for international interest rates

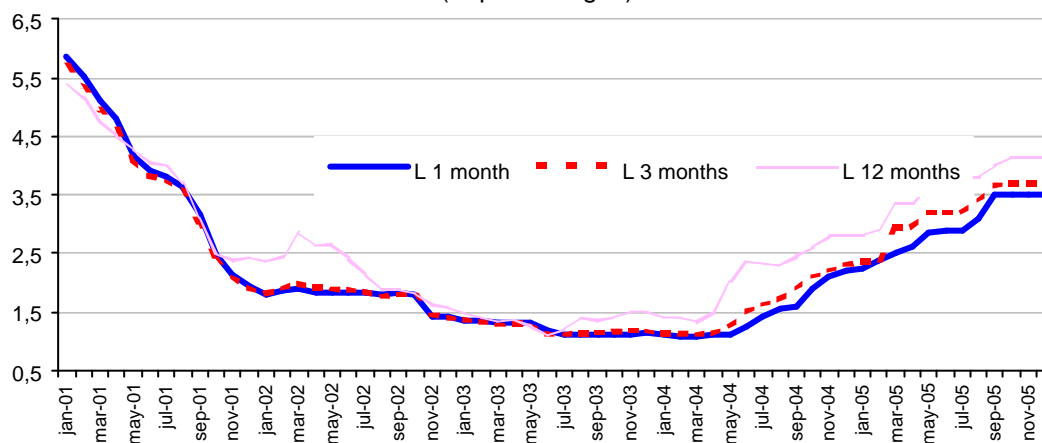
50. In June the FED began a cycle of interest rate increases after a policy of reducing rates that has been in force since the middle of 2000. At its meeting on the 30th of June it raised the rate by 25 basis points to 1,25 percent, then on the 10th of August raised it again by 25 basis points. The market had already discounted this increase so its impact was not great. Investors' expectations of interest rate rises helped the relative stability of financial markets in Latin America (particularly emerging debt markets).

CENTRAL RESERVE BANK OF PERU

51. It should be mentioned that the FED is optimistic about the economy although the rate of growth is expected to be moderate. In addition, the perceived balance between the risk of inflation and GDP growth means that a certain gradualism is expected in the cycle of interest rate rises.
52. Nevertheless, given changes in the rates of GDP growth in the United States and other recent economic indicators (a fall in the index of leading indicators and a reduction in durable goods orders) there is a certain uncertainty regarding the outlook for future interest rate rises. At a meeting on the 21st of September the futures market expected a rise of 25 basis points; although there was less agreement about future increases at subsequent meetings. This Inflation Report maintains the forecast for libor 3 month rates at 2,3 percent for December 2004 and 3,7 percent by December 2005.

Figure 36

LIBOR RATE CURVE (In percentages)



Source: Investment banks.

Terms of trade

53. An improvement in the terms of trade increases aggregate demand by generating higher incomes for the public and private sectors.

For **2004** an annual average change in the terms of trade of 7,2 percent is forecast. This level, though lower than that forecast in the May Inflation Report (9,1 percent), still constitutes the highest gain in terms of trade since 1995. The reduction was due to smaller increases in export prices and higher increases in the price of imports. The smaller increase in export prices (15,6 percent versus 16,0 percent) is explained basically by smaller increases in zinc and gold prices, offsetting the larger increase in the price of copper. Import prices could increase by 7,8 percent, higher than the 6,3 percent forecast in May, mainly because of the higher than expected increase in fuel prices (27,8 percent versus 15,9 percent). Thus in May the price of WTI crude was forecast to be US\$ 33,7 by the end of 2004, but the current forecast is US\$ 40,2. It should be said that these estimates can be considered conservative.

CENTRAL RESERVE BANK OF PERU

Chart 26

TERMS OF TRADE (Annual variation)

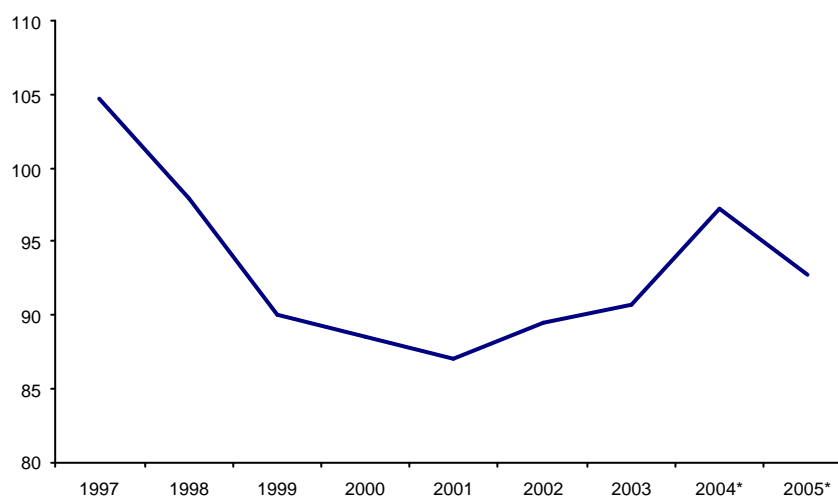
| | 2003 | Forecasts | | |
|-----------------------|------|---------------------------|------------------------------|------|
| | | May 2004 Inflation Report | August 2004 Inflation Report | |
| | | 2004 | 2004 | 2005 |
| Terms of trade | 1,4 | 9,1 | 7,2 | -4,4 |
| Export prices index | 7,1 | 16,0 | 15,6 | -2,4 |
| Import prices index | 5,6 | 6,3 | 7,8 | 2,1 |

Source: BCRP.

54. Thus for **2005** it is forecast that there will be a 4,4 percent reduction in terms of trade resulting in a 2,4 percent drop in export prices and a 2,1 percent increase in import prices. Among export prices, copper (10,8 percent), lead (6,4 percent), tin (4,2 percent) and iron ore (3,7 percent) are significant. Nevertheless, the level of terms of trade for 2005 could exceed the average for the last 5 years by 2,5 percent.

Figure 37

INDEX OF TERMS OF TRADE



* Forecast.

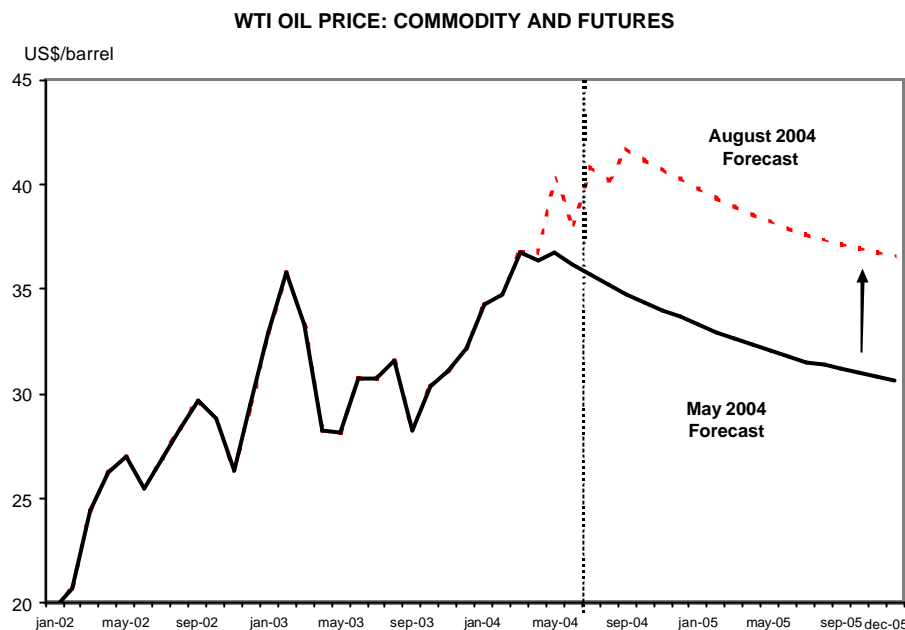
55. Oil prices reached record levels in August at US\$ 48,7 per barrel on the 19th when Iraq's production fell by half as a result of military action, and the trend was accentuated by fears of a reduction in Russian exports because of tax problems faced by its main exporter Yukos Oil Co. It should be pointed out that Iraq's normal production amounts to 2,2 percent of world production while that of Yukos represents 1,2 percent.

Various other factors such as those mentioned above, low oil stocks and higher demand for crude from the United States, India and China in a context in which OPEC is operating at close to maximum production, ensured that the average price of oil so far this year is US\$ 38 per barrel. Nevertheless, this price is lower in real terms than that reached during the Iranian revolution in 1980 (US\$ 80 per barrel at today's

CENTRAL RESERVE BANK OF PERU

prices) but the August price was higher than that reached during the first oil shock in 1974 (US\$ 43 per barrel at today's prices).

Figure 38

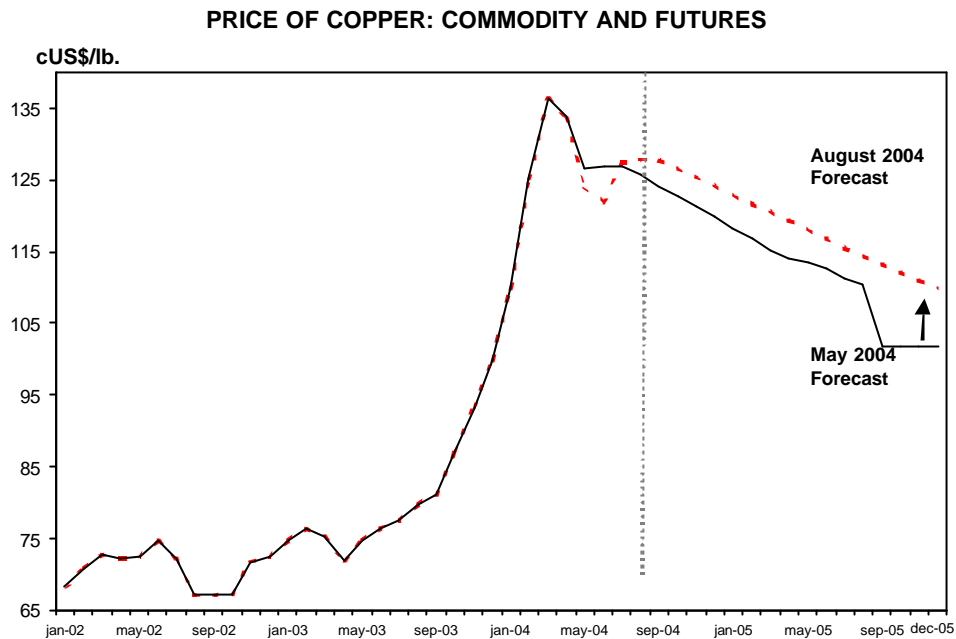


As far as imports are concerned, the average annual change in the price of WTI crude has been adjusted upwards from 13,3 to 24,7 percent for 2004 raising the average price at the close of the year from US\$ 38,8 to US\$ 40,3 per barrel. The May Inflation Report forecast an average price for 2004 of US\$ 35,2 and US\$ 33,7 per barrel respectively. This increase is explained by unfavourable market circumstances with higher world demand and the supply problems already mentioned. The price of WTI crude is expected to fall to US\$ 37 by the end of 2005, higher than that forecast in the May Inflation Report (US\$ 33 per barrel).

As far as copper is concerned, the imbalance between supply and demand has become more acute. This is because of strikes at mines owned by Grupo Mexico (La Caridad and Cananea) affecting supply whilst demand from China has increased in spite of the measures taken to prevent that country's economy from overheating (the energy sector, an intensive user of the metal should continue to grow significantly). Thus, *Phelps Dodge* forecasts a global deficit of 70,000 metric tons (last April it forecast a 600,000 ton deficit), *SG Commodities Research* estimates the deficit for this year at 750,000 tons while *Metalbulletin Research* says it will be 746 tons. That is why copper stocks are at their lowest level for 14 years. This has forced an upward revision of the price of copper for 2004 from US\$/lb 1,25 to US\$/lb 1,26 and for 2005 from US\$/lb 1,10 to US\$/lb 1,16.

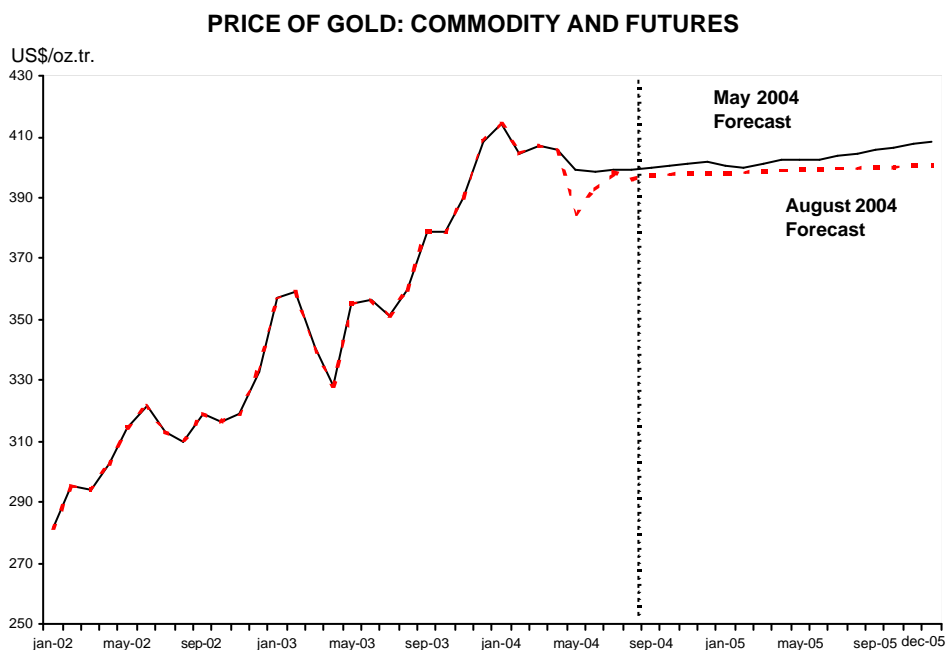
CENTRAL RESERVE BANK OF PERU

Figure 39



With respect to the price of gold, the slight strengthening of the dollar associated with interest rate rises in the USA caused a slight fall in the price forecast. Thus the forecast price of gold for 2004 fell from US\$/ounce 402,6 to US\$/ounce 399,5 and for 2005 from US\$/ounce 403,8 to US\$/ounce 399,2. Nevertheless it should be noted that the price and forecast future prices for gold have shown a certain volatility given its characteristics as a store of value in a time of world geopolitical tension.

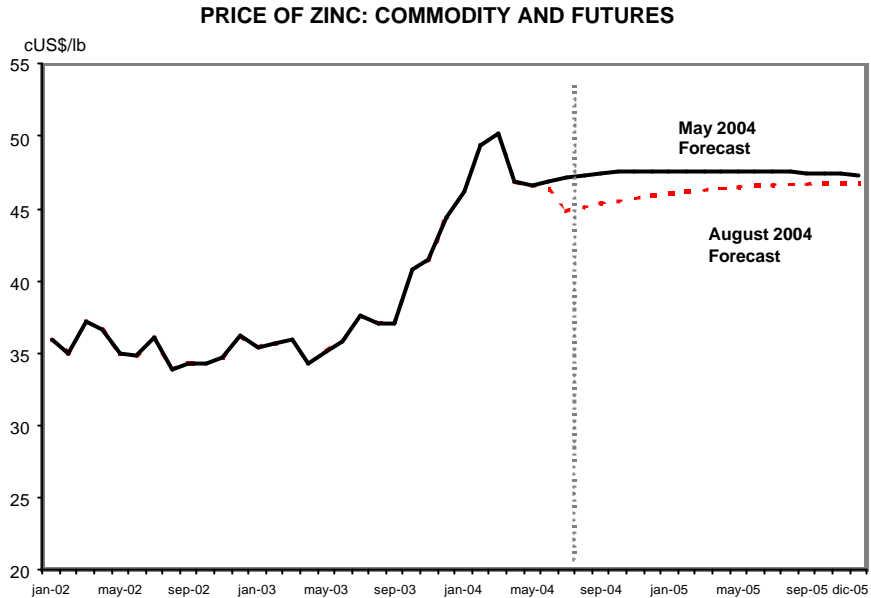
Figure 40



CENTRAL RESERVE BANK OF PERU

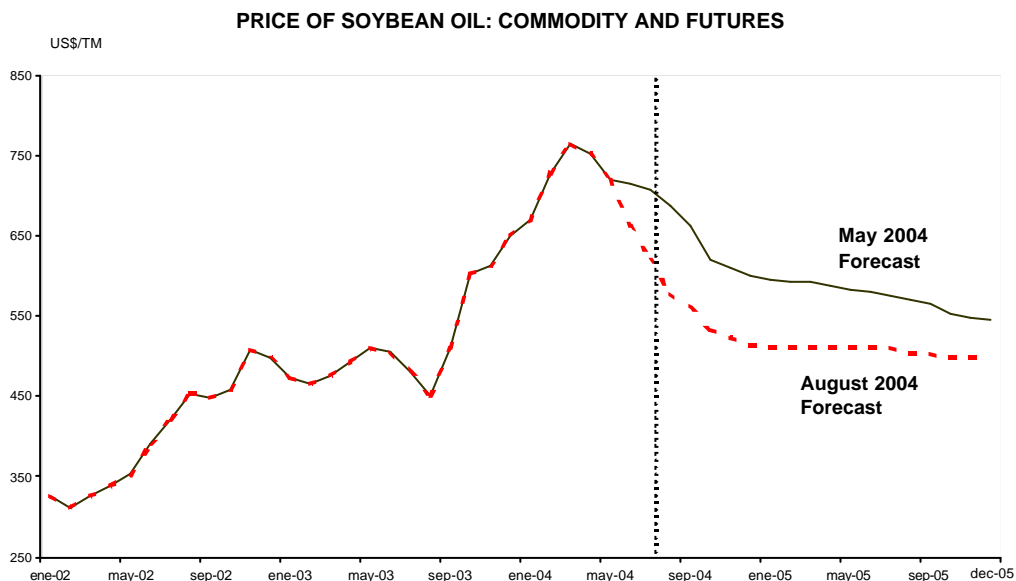
The forecast price of zinc fell compared with the May forecast. Stocks in the main metals markets remained high and there is no clear sign yet of a recovery in consumption that would reduce the surplus. The zinc price forecast for 2004 fell from US\$/lb 47,5 to US\$/lb 64,5 and for 2005 from US\$/lb 47,5 to US\$/lb 46,5.

Figure 41



Price forecasts for soybean oil were revised downwards because of lower imports by China and higher production after good harvests in the USA, Brazil and Argentina. Thus the average annual price of US\$ 687,0 per metric ton for 2004 forecast in May has been corrected to US\$ 635,6 per ton. For 2005 the forecast has been adjusted from US\$ 574,4 per ton to US\$ 506,5 per ton.

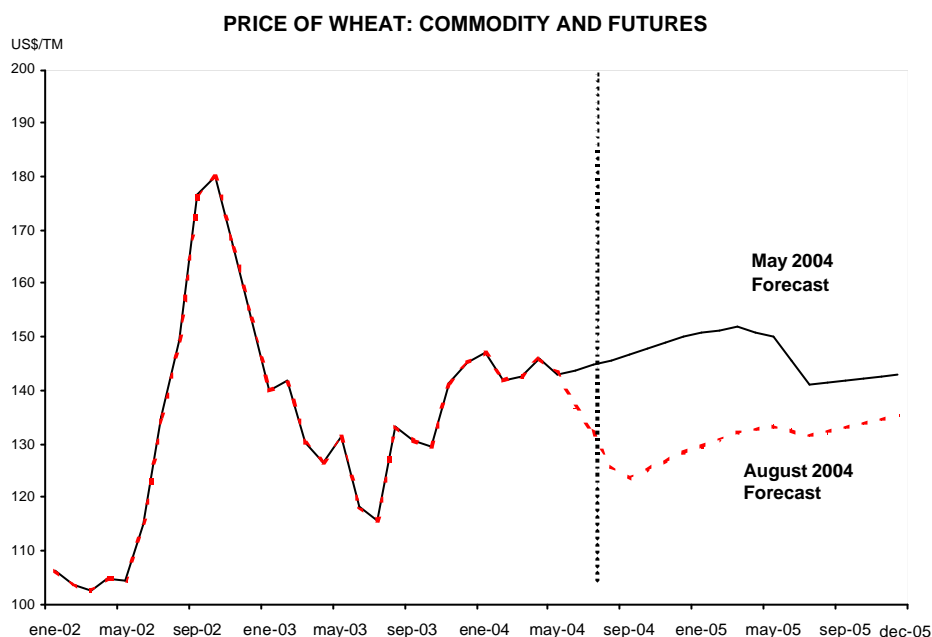
Figure 42



CENTRAL RESERVE BANK OF PERU

In May the forecast price of wheat assumed a near zero rise in world production; however lower demand from China in recent weeks has forced the price down and provoked a correction in international grain prices, this was helped by good yields of Winter wheat in the US. Good weather has favoured the harvest. Therefore, the average annual price of US\$ 148,4 per metric ton for 2004 forecast in May has been revised downwards to US\$ 135,0 per ton. The forecast for 2005 has fallen from US\$ 146,1 to US\$ 132,6 per ton.

Figure 43



Trade balance

56. Taking into account the evolution of terms of trade and the world economy, it is estimated that there will be a trade surplus for 2004 of US\$ 2 049 million, compared to the US\$ 2 318 million forecast in the May Inflation Report. This downward revision is explained by higher imports forecast for 2004 resulting from higher estimated GDP growth and higher oil prices.
57. It is expected that exports will grow at a rate of 28,1 percent in 2004 (US\$ 11 510 million) because of higher international mineral prices and higher mineral exports, especially of copper (as a result of higher production by Antamina which plans to treat more ore with high copper and low zinc content in 2004) as well as an increase in clothing sales which benefited from the Andean Trade Promotion and Drug Eradication Act (ATPDEA). Traditional exports should rise by 30,8 percent (US\$ 1 928 million) explained by higher sales abroad of mineral products (US\$ 1 774 million). Among the traditional minerals, an increase in copper (US\$ 1 036 million) and gold (US\$ 233 million) stand out as a result of higher international prices for both products and higher despatches of copper.

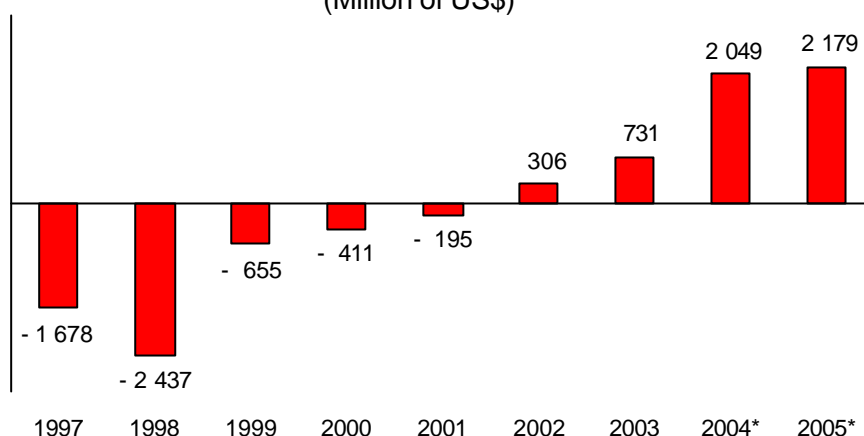
For **2005** exports could reach US\$ 12 084 million, a figure 5,0 percent higher than the estimated value for 2004, because of a 2,4 percent increase in traditional exports and an 11,7 percent increase in non-traditional exports.

CENTRAL RESERVE BANK OF PERU

Figure 44

TRADE BALANCE

(Million of US\$)



58. It is estimated that the value of imports in 2004 will be US\$ 9 461 million, 14,6 percent higher than imports in 2003. This growth is higher than that forecast in the May Inflation Report (10 percent), because of high average crude price forecasts (25 percent compared to 13 percent forecast in May).

In **2005** imports are expected to grow 4,7 percent, driven by capital goods acquisitions by industry (14 percent industry) and raw materials purchases by industry (9 percent), offset by reduced purchases of fuels as gas from the Camisea project, which began operating in the first week of August replaces petroleum derivatives.

Chart 27

TRADE BALANCE

(Millions of US\$)

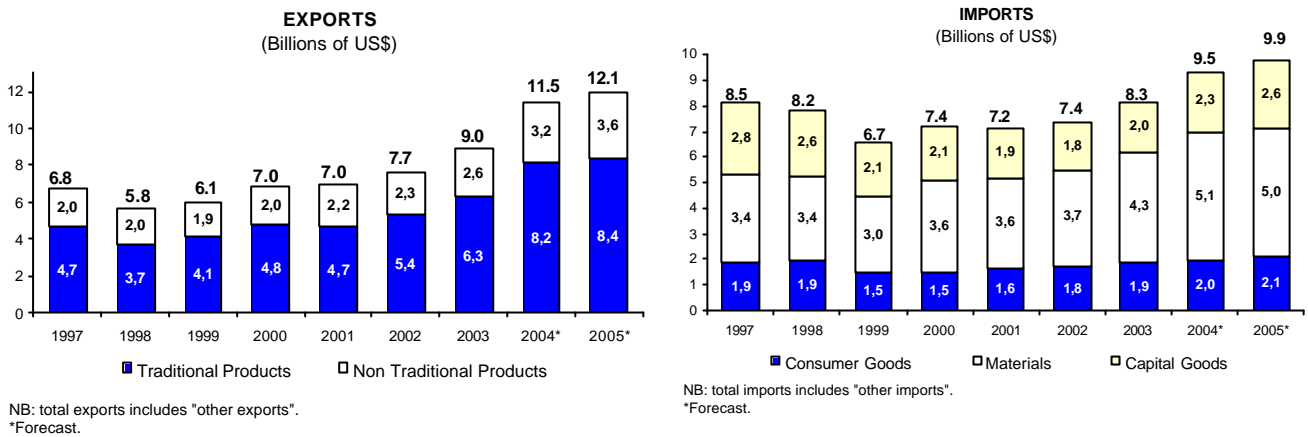
| | 2003 | 2004 * | 2005 * | % variation | |
|--------------------------------|-------------------|---------------------|---------------------|-------------|------------|
| | | | | 2004 * | 2005 * |
| 1. EXPORTS | 8 986 | 11 510 | 12 084 | 28,1 | 5,0 |
| Traditional products | 6 267 | 8 195 | 8 391 | 30,8 | 2,4 |
| Non-traditional products | 2 602 | 3 187 | 3 560 | 22,5 | 11,7 |
| Others | 117 | 128 | 133 | 10,0 | 3,5 |
| 2. IMPORTS | 8 255 | 9 461 | 9 905 | 14,6 | 4,7 |
| Consumer goods | 1 851 | 1 954 | 2 122 | 5,6 | 8,6 |
| Raw materials | 4 344 | 5 058 | 5 031 | 16,4 | -0,5 |
| Capital goods | 1 984 | 2 340 | 2 639 | 18,0 | 12,7 |
| Other goods | 75 | 109 | 113 | 44,3 | 3,8 |
| <u>3. TRADE BALANCE</u> | <u>731</u> | <u>2 049</u> | <u>2 179</u> | | |

* Forecast.

Source: BCRP and SUNAT.

CENTRAL RESERVE BANK OF PERU

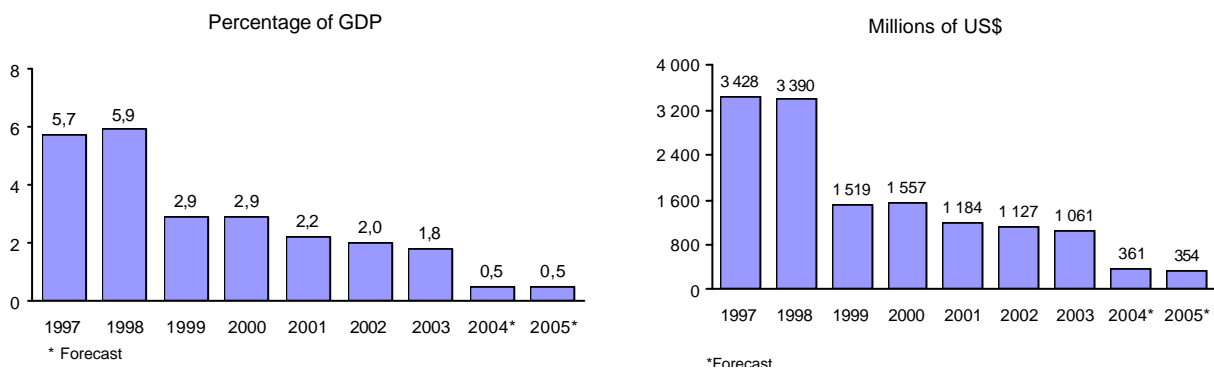
Figure 45



Balance of payments current account and capital flows

59. In **2004** the balance of payments current account should show a deficit of US\$ 361 million, equivalent to 0,5 percent of GDP, slightly higher than the May forecast (US\$ 267 million or 0,4 percent) because of a lower forecast trade surplus and higher profits generated by companies with foreign shareholders, partly offset by higher remittances from Peruvians living abroad.

Figure 46
BALANCE OF PAYMENTS CURRENT ACCOUNT DEFICIT



As far as private sector financing is concerned, a requirement of US\$ 1 868 million is forecast for 2004, slightly higher than the figure included in the May Report (US\$ 1 829 million).

CENTRAL RESERVE BANK OF PERU

Public capital should reach a total of US\$ 542 million, similar to the figure in the May Report (US\$ 557 million). An increase in net international reserves of US\$ 500 million is forecast for the end of the year.

For **2005** a current account deficit of US\$ 354 million is forecast, US\$ 167 million less than the figure forecast in May. This difference is accounted for mainly by higher remittances from Peruvians living abroad, partly offset by increased profits for companies with foreign shareholders.

External financing for the private sector should amount to US\$ 1 997 million, similar to the figure forecast in May (US\$ 2 015 million) whilst public sector financing should be US\$ 863 million, also higher than that given in the May Report (US\$ 748 million). Net international reserves are forecast to reach US\$ 100 million.

II.3 Fiscal accounts

60. Forecasts for the public sector accounts show that fiscal policy will continue, reducing pressure on public debt and the perception of macroeconomic risk. Thus it is expected that the **fiscal deficit** will fall to 1 percent of GDP in 2005. The forecast for 2004 remains at an estimated deficit of 1,4 percent of GDP, in line with the figure envisaged in the Multi-annual Macroeconomic Framework.
61. Central government **current revenue** should amount to 15,2 percent of GDP in 2004, implying an improvement of 7,3 percent in real terms compared to 2003. These figure imply an improvement of 0,2 percentage points in GDP (S/. 325 million) compared to the forecast in the May Report. This improvement is the response to improved revenue from IGV, resulting from improved payment coefficients for companies, better administration of IGV and increased economic activity. During the third quarter of the year a fuel price stabilisation system was implemented, involving reductions in ISC. It is also expected that the extraordinary solidarity tax (IES) will be eliminated in the fourth quarter of this year.

For 2005 it is estimated that current revenue will be 15,5 of GDP, which would mean a real increase of 6,7 percent. These figures imply a 0,3 percent improvement in GDP compared to the May forecast, mainly due to improved income tax revenue and royalties paid by the mining industry, together with greater economic activity. It is worth mentioning that this fiscal year should see the effects of an increase in company income tax, from 27 to 30 percent, as well as increased royalties from the Camisea project.

62. Central government **non-financial expenditure** for fiscal year 2004 should amount to 14,7 percent, representing a real increase of 4,2 percent of GDP. This growth is similar to that estimated in May, suggesting that, given the reduced expenditure in the first half year, spending should have increased significantly in the second half of the year to meet the provisions of the Multi-annual Macroeconomic Framework (approximately 9 percent in real terms compared to the second half of 2003).

In 2005 expenditure could amount to 14,6 percent of GDP, thus generating an increase of 4,1 percent in real terms. The largest increase should be seen in the capital expenditure component, which is expected to show growth of 7 percent in real terms in public investment. Also, 2005 should see the full effect of wage rises to teachers and the defence sector in the second half of 2004.

CENTRAL RESERVE BANK OF PERU

Figure 47

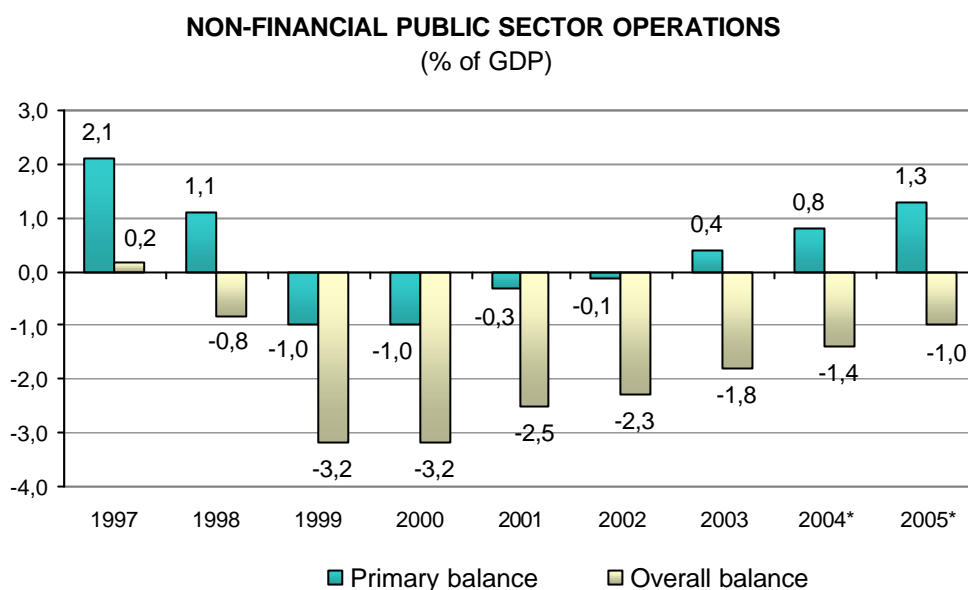


Chart 28

NON-FINANCIAL PUBLIC SECTOR
(Millions of nuevos soles)

| | 2003 | 2004 * | 2005 * |
|-------------------------------------|----------------|----------------|----------------|
| 1. Current revenue | 31 551 | 35 123 | 38 310 |
| (% of GDP) | 15,0 | 15,2 | 15,5 |
| Real % var. | 8,0 | 7,3 | 6,7 |
| 2. Non-financial expenditure | -31 460 | -34 000 | -36 157 |
| (% of GDP) | -14,9 | -14,7 | -14,6 |
| Real % var. | 5,2 | 4,2 | 4,1 |
| 3. Others | 814 | 653 | 970 |
| (% of GDP) | 0,4 | 0,3 | 0,4 |
| 4. Primary balance | 905 | 1 777 | 3 123 |
| (% of GDP) | 0,4 | 0,8 | 1,3 |
| 5. Interest | -4 633 | -5 016 | -5 521 |
| (% of GDP) | -2,2 | -2,2 | -2,2 |
| Of which: | | | |
| Pension reform bonds | -235 | -364 | -236 |
| External (Millions of US\$) | -\$1 082 | -\$1 156 | -\$1 314 |
| 6. Overall balance | -3 728 | -3 239 | -2 397 |
| (% of GDP) | -1,8 | -1,4 | -1,0 |
| Millions of US\$ | -\$1 072 | -\$945 | -\$679 |

* Forecast.

63. The **financing requirement** for 2004 is estimated at US\$ 909 million, a figure similar to that forecast in May. The borrowing requirement will be met mainly by disbursements from abroad amounting to US\$ 1 905 million, with US\$ 1 460 million being freely available and US\$ 444 million tied to investment projects. Domestic bonds will also be issued for the equivalent of US\$ 497 million.

CENTRAL RESERVE BANK OF PERU

In 2005, the requirement should amount to US\$ 2 968 million, a higher figure than the US\$ 59 million recorded in 2004. This is the result of higher public debt repayments, mainly domestic, because this year saw repayment of bonds issued by the Deposit Insurance Fund. The requirement will be met by US\$ 2 284 million in external disbursements, of which US\$ 1 784 million are freely available and US\$ 500 millions tied to investment projects. Placement of domestic bonds was equivalent to US\$ 600 million.

Chart 29
FINANCING OF NON-FINANCIAL PUBLIC SECTOR
(Millions of US\$)

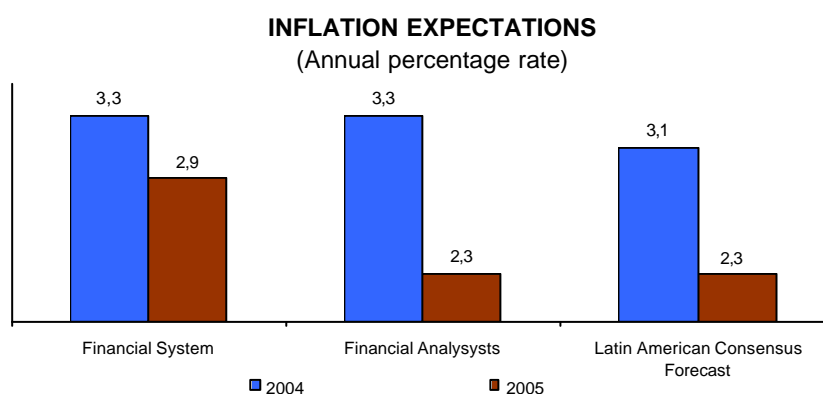
| | 2003 | 2004 * | 2005 * |
|--|-----------------|-----------------|-----------------|
| 1. Overall balance (Millions of nuevos soles) | -3 728 | -3 239 | -2 397 |
| (% of GDP) | -1,8 | -1,4 | -1,0 |
| Millions of US\$ | -\$1 072 | -\$945 | -\$679 |
| 2. Amortization (Millions of US\$) | -\$1 743 | -\$1 964 | -\$2 289 |
| Redemption of pension reform bonds | -\$172 | -\$233 | -\$185 |
| Internal | -\$385 | -\$381 | -\$694 |
| External | -\$1 187 | -\$1 350 | -\$1 410 |
| 3. Borrowing requirement (Millions of US\$) | \$2 815 | \$2 909 | \$2 968 |
| External financing | \$2 101 | \$1 905 | \$2 284 |
| Free disposal funds | \$1 765 | \$1 460 | \$1 784 |
| Investment projects | \$336 | \$444 | \$500 |
| Domestic bonds | \$508 | \$497 | \$600 |
| Privatisation | \$52 | \$100 | \$43 |
| Others | \$154 | \$407 | \$41 |

* Forecast.

II.4 Inflation

64. In this report the inflation forecast for 2004 and 2005 remain within the target range set as part of monetary policy. Thus for 2004 surveys of expected inflation in the financial system economic analysts produce a figure of 3,3 percent (2,7 percent in May), whilst the figure for 2005 falls between 2,3 and 2,9 percent (2,5 percent in May). These expectations incorporate observed supply shocks.

Figure 48



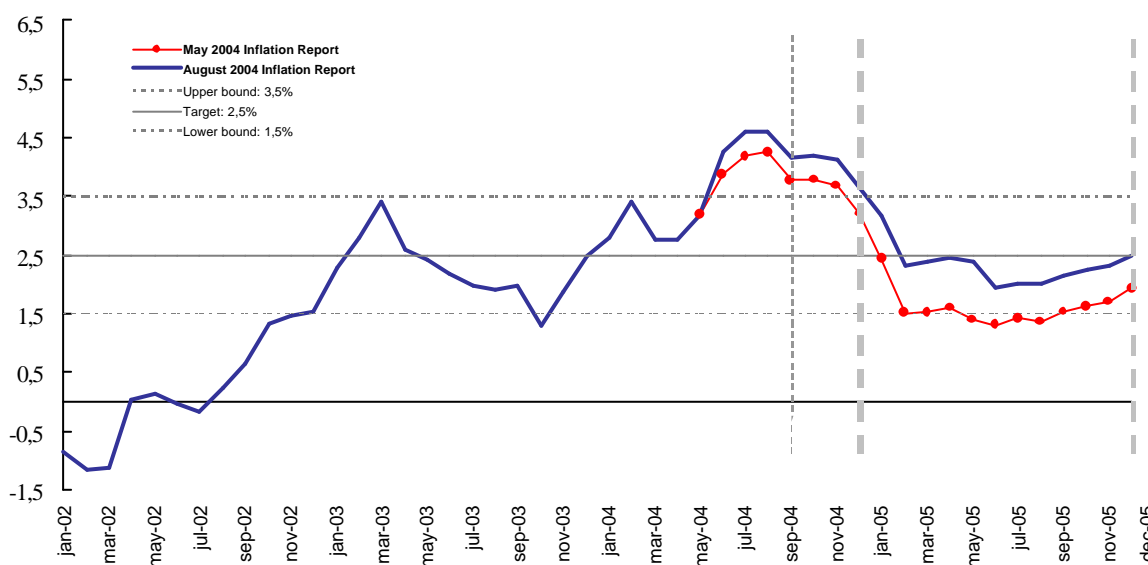
Source: BCRP Surveys and Consensus Economics.

CENTRAL RESERVE BANK OF PERU

65. The nominal exchange rate has appreciated 2,4 percent in July and August. This appreciation partially offsets the inflationary effects deriving from increased imported inflation. The increase in international oil prices was one of the principal components of this increased imported inflation. The oil price has reached levels comparable with those of 1973 and it is expected - though there is considerable uncertainty on this point - that they will fall by 2005.
66. During 2004 agriculture & livestock produce supply shocks were more powerful and persistent than was envisaged in the May Report. The baseline of the forecast indicates higher foodstuff prices in 2005 than those considered in the May Report because of greater uncertainty over the weather and, especially, rainfall.
67. Inflation for 2004 is forecast to be near the upper limit of the target range (3,5 percent). The Central Reserve Bank's action will aim to return inflation to the target range, although it is possible that this may be achieved not in December of this year because of the magnitude of supply shocks, but in January next year.
68. The partial reversion of international price shocks expected for 2005 will bring the inflation rate to around the target rate (2,5 percent). The higher levels of inflation compared to those in the May Report for both and for 2005 are due mainly to the upward revision of the magnitude of the supply shocks and their effect on inflation.

Figure 49

INFLATION FORECAST
(Accumulated change in CPI over 12 months)



III. BALANCE OF RISKS

69. The baseline of the forecast is considered the most likely for the next few months given stable monetary policy over the time period covered by the forecast. The results of this forecast are sensitive to changes in the external variables considered, which could affect the proposed baseline. The central Bank's balance of risks enables a probability analysis to be carried out of divergence in external variables compared to the baseline. The result is the distribution of forecast inflation assuming that the

CENTRAL RESERVE BANK OF PERU

current monetary policy position remains unchanged. the external variables considered to have a greater impact on the balance of risks are future changes in international oil prices, world economic activity and the internal supply of agriculture & livestock produce :

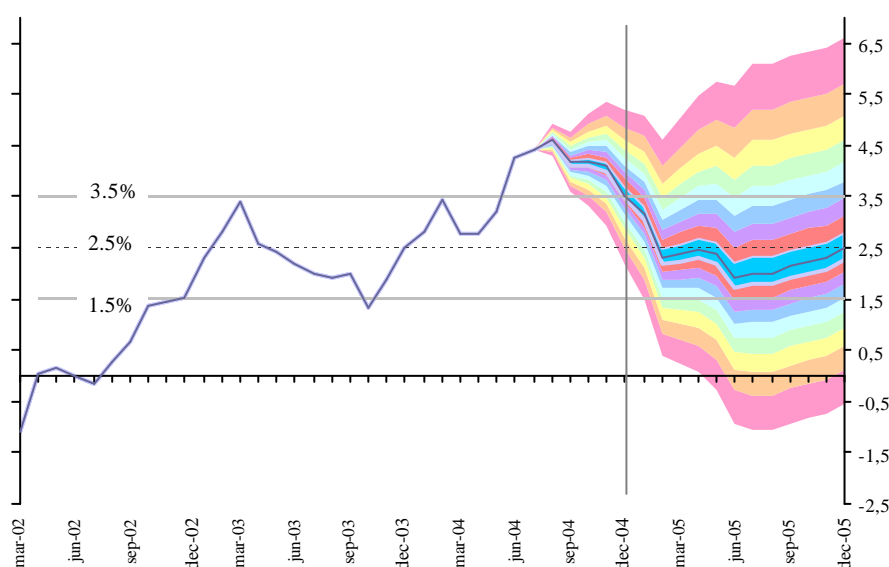
- **Higher international oil prices:** Changes in international oil prices affect internal inflation directly through the items that make up the CPI (fuels and public transport services) and indirectly through production and distribution costs. The forecast's baseline assumes that oil prices will start to fall to historically more sustainable levels from September 2004 onwards. Nevertheless, insofar as the world scenario has become less certain, the probability that the oil price will remain above the proposed baseline is high. This means that there is latent risk of inflationary pressure from imported inflation.
- **Lower world economic growth:** Growth in the world economy could slow down and this will slow domestic growth. This slowdown in the world economy is linked to the higher oil prices considered in this forecast. Lower growth in the world economy will put downward pressure on domestic growth and, therefore, result in a downward pressure on internal inflation.
- **Further deterioration in the domestic supply of agriculture & livestock produce:** Foodstuffs are an important component of inflation, and the baseline also includes the possibility of reduced price increases during 2005. Nevertheless, it is possible that water shortages could create pressure on these prices. In addition, continued restrictions on imports of some of these products could have a detrimental effect on supplies and this could generate inflationary pressure.

The following figure shows the central 12 month inflation forecast for the period 2004 - 2005. The strongest colour indicates the most probable result, assuming that current monetary policy set by the Board of Directors of the Bank is maintained until the end of next year.

Figure 50

INFLATION FORECAST

(Accumulated change in CPI over 12 months)



CENTRAL RESERVE BANK OF PERU

CONCLUSIONS

70. In this Report, inflation is forecast to be around the upper limit of the target range for 2004 (1,5 - 3,5 percent) and in the center of that range in 2005 (2,5 percent). These developments will occur under circumstances that are favourable to economic development and reversion of the negative supply shocks. The baseline described above could turn less favourable, principally because international oil prices may rise with the resulting effect on domestic fuel prices and public transport fares, and the possibility of adverse conditions affecting the supply of foodstuffs. It should be mentioned that these forecasts assume that current monetary policy will remain unchanged throughout the period covered by the forecast.

CENTRAL RESERVE BANK OF PERU

STATISTICAL ANNEX

INFLATION REPORT FORECASTS: AUGUST 2004 v. MAY 2004

| | 2002 | 2003 | 2004 ^{1/} | | 2005 ^{1/} | |
|--|------|------|--------------------|--------------------|--------------------|--------------------|
| | | | 2004 May Report | August 2004 Report | 2004 May Report | August 2004 Report |
| Real % Variation | | | | | | |
| 1. Gross domestic product | 4,9 | 3,8 | 4,0 | 4,3 | 4,5 | 4,5 |
| 2. Domestic demand | 4,0 | 3,3 | 3,4 | 4,0 | 4,4 | 4,3 |
| a. private consumption | 4,4 | 3,1 | 3,5 | 3,5 | 4,2 | 4,0 |
| b. Public consumption | 0,2 | 2,9 | 4,4 | 4,0 | 1,1 | 3,2 |
| c. Fixed private investment | 0,1 | 5,4 | 7,2 | 9,1 | 6,0 | 7,2 |
| d. Public investment | -4,8 | 5,0 | 8,1 | 4,7 | 4,0 | 5,4 |
| 3. Exports of goods and services | 6,8 | 5,9 | 7,9 | 9,0 | 6,0 | 5,4 |
| 4. Imports of goods and services | 2,1 | 3,3 | 4,4 | 7,5 | 5,7 | 4,0 |
| 5. Growth among Peru's trading partners | 1,6 | 2,5 | 4,2 | 4,3 | 3,6 | 3,5 |
| % Variation | | | | | | |
| 7. Inflation | 1,5 | 2,5 | 3,2 | 3,5 | 1,9 | 2,5 |
| 8. Nominal depreciation | 2,3 | -1,2 | 1,1 | -0,9 | 1,1 | 2,3 |
| 9. Real (multilateral) depreciation | -0,6 | 7,5 | 0,6 | -2,3 | 0,7 | 2,1 |
| 10. Terms of trade | 2,8 | 1,4 | 9,1 | 7,2 | -3,0 | -4,4 |
| Millions of US\$ | | | | | | |
| 11. Net international reserves (flow) | 985 | 596 | 100 | 500 | 100 | 100 |
| % of GDP | | | | | | |
| 12. Balance of payments current account | -2,0 | -1,8 | -0,4 | -0,5 | -0,7 | -0,5 |
| 13. Trade balance | 0,5 | 1,2 | 3,5 | 3,1 | 3,1 | 3,1 |
| 14. Gross private sector external borrowing | 4,7 | 3,2 | 2,8 | 2,8 | 0,0 | 2,8 |
| 15. Primary balance of non-financial public sector | -0,1 | 0,4 | 0,7 | 0,7 | 1,3 | 1,3 |
| 16. Overall balance of non-financial public sector | -2,3 | -1,8 | -1,4 | -1,4 | -1,0 | -1,0 |
| 17. Central government tax revenue | 11,9 | 13,0 | 13,3 | 13,4 | 13,4 | 13,5 |
| 18. Foreign debt balance | 36,7 | 37,6 | 35,2 | 34,6 | 34,6 | 33,9 |
| Nominal % variation | | | | | | |
| 19. Central government non-financial expenditure | 2,3 | 7,6 | 6,7 | 8,1 | 4,2 | 6,3 |
| 20. Average annual monetary base | 15,8 | 7,4 | 14,5 | 16,5 | 8,5 | 8,0 |
| 21. Bank loans to private sector | 0,1 | -4,5 | 3,3 | 4,7 | 4,2 | 5,0 |

1/ Forecast.

2/ Includes foreign direct investment & long-term private sector disbursements.

3/ Excludes tax on state shares.