INFLATION REPORT:

Recent developments and prospects

August 2005

Central Reserve Bank of Peru
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CONTENTS

FOREWORD 5

EXECUTIVE SUMMARY 7

I. MACROECONOMIC PERFORMANCE IN THE SECOND QUARTER 9

- I.1 Inflation 9
- I.2 Exchange rate 16
- I.3 Domestic demand and GDP 21
- I.4 External accounts 26
- I.5 Public finances 28
- I.6 Interest rates and monetary aggregates 31

II. FORECASTS 2005 - 2006 40

- II.1 International context and external accounts 40
- II.2 Economic activity 54
- II.3 Public finances 57
- II.4 Expectations 61
- II.5 Inflation 62

III. BALANCE OF RISKS 64

CONCLUSION 66

STATISTICAL ANNEX 67

This Inflation Report has been drawn up using information from the second quarter of 2005 on gross domestic product, balance of payments and public sector non-financial operations, data as of July for monetary accounts and as of August for inflation and exchange rate.

FOREWORD

- Since 2002 the monetary policy of the Central Reserve Bank of Peru (CRBP) has been based on an Inflation Targeting framework. The annual inflation target is 2.5 percent, plus or minus one percentage point. This target is measured by the annual variation in the Consumer Prices Index (CPI) for Metropolitan Lima as of end-December each year.
- Transparency is one of the fundamental elements of the Inflation Targeting framework, for which reason the Bank and economic agents share the relevant information used in drawing up monetary policy. As part of this policy the Bank publishes an Inflation Report three times a year in January, May and August. This document informs the public of compliance with its constitutional mandate to preserve monetary stability and the functions set forth in its governing legislation concerning the regulation of the money market and information on the public finances.
- This final report of the year contains a description of the factors explaining inflation in the first eight months of 2005 and the macroeconomic forecasts for 2005 and 2006.
- Since 2001 the CRBP has published the dates of meetings of its board of directors, which are held on the first Thursday of each month and at which monetary policy decisions are taken. The dates of the meetings are published at the beginning of each year together with a press briefing of the January Monetary Program.
- Decisions on the monetary policy position of the Bank's board of directors include a reference interest rate for the interbank lending market. The monetary operations carried out by the CRBP are aimed at maintaining this short-term interest rate at the published reference level, thus affecting the set of economic variables which determine the rate of inflation.
- The dates of the meetings at which the board will approve the monetary program for each month are as follows:

  6th October 3rd November 1st December

  The CRBP will publish its next Inflation Report on the 3rd of February 2006.

EXECUTIVE SUMMARY

- In this third Inflation Report of the year we analyze the implementation of monetary policy during the first eight months of 2005 and the macroeconomic forecasts for 2005 and 2006. These forecasts indicate that inflation will remain within the target range over the period and that economic activity will continue to show sustained growth.
- From January to August 2005, accumulated inflation was 1.0 percent while accumulated inflation over the last twelve months was 1.2 percent. The downward trend in inflation this year is principally the result of a gradual reversal of the external and internal shocks which occurred in 2004 (higher imported inflation and lower agricultural production) which temporarily raised inflation to the upper limit of the target range (3.5 percent) in that year; and the tendency of the nuevo sol to appreciate, especially since the second half of 2004 onwards.
- In this context of low inflation the Central Bank's monetary policy stance with an interbank interest rate of 3.0 percent remains unchanged since October last year.
- Over the following months it is expected that the rate of inflation for the previous twelve months will be around 1.5 percent, the lower limit of the target range, and close 2005 at 1.8 percent. Next year, the twelve-month inflation rate could rise towards 2.5 percent, which would imply an end to the appreciation of the nuevo sol and an economic growth close to 5.0 percent.
- The rate of growth of the economy continued to accelerate from 4.8 percent in 2004 to 5.9 percent in the first six months of this year. Exports have increased in both price and volume beyond the forecasts given in the last Report and there has been solid growth in the non-primary manufacturing sector and greater confidence among consumers and businesses. For this reason, the forecast for the GDP real rate of growth for 2005 has been revised upwards for the second time this year, from 5.0 percent to 5.5 percent. Next year's forecast annual growth rate remains the same at 5.0 percent.
- The international environment remains favorable, with terms of trade increasing 4.3 percent in the first semester after a 9.0 percent increase in 2004. Higher prices for gold, copper, zinc and molybdenum, which are Peru's main export products, more than compensated for the negative impact of higher oil prices.

- From now on a partial reversal of this improvement in the terms of trade is expected (although they should remain higher than those before 2004) if world growth moderates (3.5 percent on average four our trading partners) associated with gradual adjustments in United States (U.S.) interest rates.
- The macroeconomic scenario for 2005 and 2006 considers a fiscal deficit of 1.0 percent of GDP, favored by income caused by high export prices and a solid balance of payments position with no financial pressure on both cases. This macroeconomic environment assumes that financial markets will continue to operate without disturbance. In the event of any future volatility in financial markets, caused by elections in Peru and in the region, the Central Bank has accumulated a high level of international reserves.

I. MACROECONOMIC PERFORMANCE IN THE SECOND QUARTER

I.1 Inflation

The twelve-month inflation rate continued to fall over the period January – August 2005, from 3.48 percent in December 2004 to 1.2 percent in August 2005. This reduced inflation is associated both with the reversal of the supply shocks (reduction in the world prices of raw materials and a recovery in the supply of agricultural products) and with the strengthening of Peru's currency.

1. The rate of inflation, measured by the increase in the Consumer Prices Index over the last 12 months, is slightly below the lower limit of the target range (between 1.5 and 3.5 percent), having fallen from 3.5 percent at the end of 2004 to 1.2 percent in August.

2. The annual inflation target has been met over the three years since the Inflation Targeting framework was introduced (2002

Graph 1
INFLATION AND INFLATION TARGET
January 2004 - August 2005
(% change over the last 12 months)

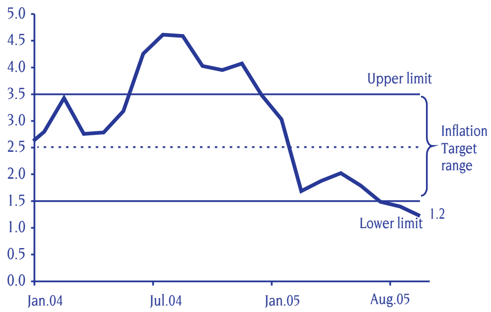


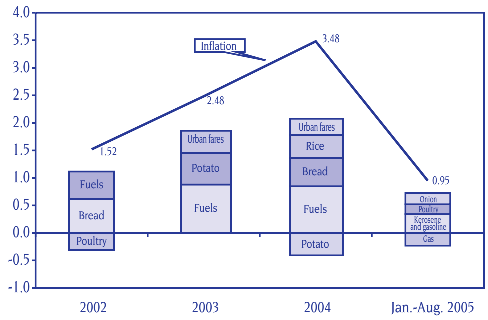
Table 1

INFLATION 2004 - 2005
(Accumulated percentage change)

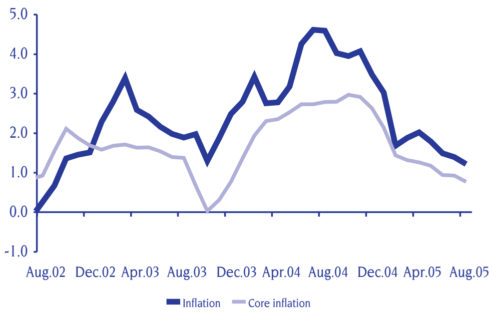
	Weighting	2004 Jan-Aug	2004 Jan-Dec	2005 Jan-Aug	Annual average (% change) Jan02-Aug05 1/
I. CORE INFLATION	**68.3**	**2.25**	**2.63**	**0.40**	**1.49**
Goods	41.8	2.81	3.19	-0.04	1.41
Food & beverages	20.7	6.03	6.82	-0.59	2.20
Textile & footwear	7.6	0.85	1.36	1.15	1.22
Electrical appliances	1.0	-2.49	-2.83	-1.74	-0.86
Other industrial products	12.5	-0.94	-1.24	0.36	0.37
Services	26.6	1.38	1.75	1.09	1.62
Restaurants	12.0	1.43	1.78	0.73	1.37
Education	5.1	3.43	4.63	2.17	3.41
Health	1.3	-0.04	1.18	2.28	2.44
Rent	2.3	-0.26	-1.57	-0.30	0.03
Other services	5.9	0.40	0.48	1.10	0.94
II. NON-CORE INFLATION	**31.7**	**5.14**	**5.20**	**2.08**	**3.98**
Food	14.8	7.27	1.85	4.93	2.59
Fuels	3.9	11.25	17.77	2.09	11.98
Transport	8.4	-0.02	3.49	0.16	3.92
Public services	4.6	2.02	6.19	-3.17	0.75
III. INFLATION	**100.0**	**3.20**	**3.48**	**0.95**	**2.30**

1/ Previous to the Inflation Targeting, a similar period in duration and inflation with an inflation rate lower than 2.3 percent has not been seen since 1936.

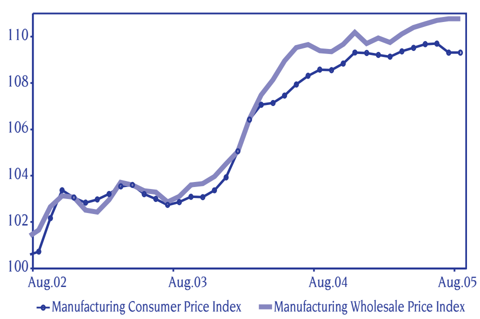
Graph 2
CONTRIBUTION TO INFLATION
(Percentage points)



Graph 3
INFLATION AND CORE INFLATION: AUGUST 2002 - AUGUST 2005
(% change over the last 12 months)



Graph 4
MANUFACTURING CPI AND WPI
(Index December 2001 = 100)



- 2004) and the average annual inflation since January 2002 to August 2005 has been 2.3 percent. Fluctuations in the rate of inflation in recent years were caused by supply shocks, mainly involving fuels and foodstuffs (see Figure 2), which have caused the 12-month inflation rate in certain months to rise above or fall below the target range.

Core inflation

3. In order to isolate the temporary effect of supply shocks on inflation we use a price trend indicator known as core inflation. By August, the core inflation rate for the last 12 months was 0.8 percent. This lower figure for core inflation may be associated with a reduction in costs (lower exchange rate, increased use of natural gas to replace other fuels, among others), a lower expectation of inflation, productivity gains and lower trade and profit margins as activity scales and competition increases. The above-mentioned factors have counteracted the effect of higher world oil prices in a context of recovering economic activity.

a. The exchange rate appreciated 4.1 percent between August 2004 and August 2005 as a result of the favorable position of the external accounts and of de-dollarization. This trend has placed downward pressure on import prices and prices of import substitutes and reduced the cost of raw material and capital goods imports.

b. Industrial goods prices were influenced by increased productivity and competition; the latter is partly reflected by the fact that consumer prices for manufactured goods have risen less than wholesale prices. Thus, in January – August the CPI for manufactured goods remained constant, while the wholesale price index for manufacturing rose 1.0 percent.

4. Within the core CPI, **food and beverages** fell 0.6 percent on average. A breakdown of this group shows reductions in the prices of rice (5.1 percent), cooking oils (5.2 percent) and pasta (2.6 percent).

a. **Rice:** The price of rice fell an accumulated 5.1 percent over the period January - August 2005 because of an increase in hulled rice production, which rose from 35 percent in January - July 2005 compared to the same period in 2004. As more water was available in the northern coastal valleys of Peru, the area sown with rice increased by 24 percent this season compared with the previous one.

b. **Edible oil:** The price of cooking oil fell 5.2 percent between January and August 2005, because the price of soya oil has so far this year remained below the average for the same period in 2004 (US$ 503 per MT compared to US$ 678 per MT in 2004). Another factor contributing to the fall in domestic prices is the strong competition faced by the cooking oil industry in Peru.

c. **Pasta:** Between January and August 2005 the price of pasta fell 2.6 percent, reflecting not only strong competition in the sector but also a fall in the world price of wheat, the main raw material. Wheat prices averaged US$ 125 per MT in this period compared to US$ 139 per MT in 2004.

Non-core inflation

5. Non-core inflation is more sensitive to supply shocks. In the period January - August 2005, the rate of non-core inflation was 2.1 percent because of food price rises (4.9 percent).

Food

6. A breakdown of the foodstuffs classified as non-core shows that increases in the prices of chicken (5.4 percent), papaya (40.1 percent), onions (35.2 percent) and eggs (8.7 percent), were partially offset by a fall in the price of citrus fruits (23.1 percent).

a. **Poultry:** This result is principally a reflection of the increases seen in January and March (6.2 and 5.7 percent, respectively) attributable both to a lack of substitute products (a cattle farmers' strike in January and a reduction in mackerel landings in March) and to higher demand. From January to August sales of chicken by the Peruvian Poultry Association increased by 9.0 percent compared to the same period of the previous year. Sales of chicks, the main indicator of demand level, showed a similar increase.

b. **Papaya:** The biggest increases occurred in June (25.8 percent) and July (34.3 percent) as a result of supply problems arising from a strike by farmers and coca growers in Huanuco and San Martin. According to information from the Ministry of Agriculture, production of papaya fell 9.0 percent between January and July compared to the same period in the previous year.

Fuels

7. Domestic prices for gasoline, kerosene and liquefied gas, the fuels included in the CPI calculation, rose on average 2.1 percent in the period January – August 2005. The increase in the prices of gasoline and kerosene (6.6 and 12.2 percent, respectively) were offset by a fall in the price of gas (14.1 percent). This fall was due to the elimination of the excise tax and the import duty last July.

   During 2004 the price of West Texas Intermediate crude (WTI) rose 27 percent, which was reflected in a 21 percent average rise in international parity prices, with kerosene and diesel fuel rising the highest. Between January and August this year, crude oil prices rose 50 percent and the average price of products increased 36 percent.

Table 2

INTERNATIONAL PRICES OF FUELS

	31 Dec. 2003	31 Dec. 2004	22 Aug. 2005	Changes 2004	Changes Jan-Aug.2005
CRUDE OIL					
WTI S/. barrel	**112.1**	**142.1**	**211.4**	**27%**	**49%**
Exchange rate (S/. US$)	3.47	3.28	3.25	-6%	-1%
WTI US$ barrel	32.3	43.3	65.0	34%	50%
INTERNATIONAL PARITY [1] (S/. PER GALLON)					
Gasoline 84	3.9	4.5	6.5	15%	44%
Gasoline 90	4.1	4.6	6.7	12%	46%
Gasoline 95	4.3	4.7	7.0	10%	48%
Gasoline 97	4.4	4.8	7.1	9%	48%
Kerosene	4.1	5.2	7.2	29%	38%
Diesel 2	4.0	5.1	7.0	30%	37%
Residual 6	2.7	2.9	4.0	6%	39%
Residual 500	2.7	2.7	3.8	2%	40%
Liquefied Gas	3.4	3.8	4.1	11%	8%
Average	**3.7**	**4.4**	**6.0**	**21%**	**36%**

1/ Prepared by OSINERG.

End user prices of fuels during 2004 rose on average less than the net internal price (17 compared to 33 percent) due to a lifting of the heavy tax burden from the final price structure from 44 to 33 percent between December 2003 and December 2004 because the government decided to reduce excise tax. This year fuel prices have risen by 11 percent due to an increase in residual fuel oil, diesel fuel and kerosene, which was partially offset by a 14 percent fall in the price of liquefied gas. In July the import duty and the excise tax on gas, and in August the excise tax on diesel fuel and 90, 95 and 97 octane gasoline were eliminated. If this measure had not been taken, inflation would have been 0.2 percentage points higher.

Table 3

NET DOMESTIC PRICE
(WITHOUT TAXES) (S/. PER GALLON) [1]

	31 Dec. 2003	31 Dec. 2004	22 Aug. 2005	Changes 2004	Changes Jan-Aug.2005
Gasoline 84	3.8	4.9	5.5	29%	13%
Gasoline 90	3.9	5.0	6.0	28%	18%
Gasoline 95	4.1	5.6	6.4	37%	14%
Gasoline 97	4.2	5.7	6.6	36%	16%
Kerosene	3.9	5.2	6.5	33%	25%
Diesel 2	3.9	5.7	6.7	44%	18%
Residual 6	2.7	3.0	3.9	14%	27%
Residual 500	2.6	2.8	3.6	7%	31%
Liquefied Gas	3.3	4.0	3.6	21%	-8%
Average	**3.6**	**4.8**	**5.6**	**33%**	**16%**
Advancement (delay) % [2]	(2.1%)	6.8%	(3.0%)		

1/ Refineries average price.
2/ Includes the contributions of the Price Stabilization Fund.

Table 4

FINAL PRICES (INCLUDES TAXES) (S/. PER GALLON) 1/

	31 Dec. 2003	31 Dec. 2004	22 Aug. 2005	Changes 2004	Changes Jan-Aug.2005
Gasoline 84	8.3	9.7	10.5	16.8%	8.2%
Gasoline 90	9.5	10.9	12.0	15.0%	9.7%
Gasoline 95	10.1	12.0	12.9	19.4%	7.3%
Gasoline 97	10.6	12.5	13.4	18.1%	7.4%
Kerosene	7.2	8.7	10.2	20.2%	17.7%
Diesel 2	7.4	8.8	9.9	18.6%	12.6%
Residual 6	3.2	3.6	4.6	14.2%	27.3%
Residual 500	3.1	3.3	4.3	7.3%	30.8%
Liquefied Gas	4.6	5.1	4.3	10.7%	-14.3%
Average	**6.4**	**7.5**	**8.3**	**16.7%**	**11.2%**
Average without diesel and residuals 2/	7.0	8.1	8.5	15.6%	4.6%

1/ Do not consider the gas station mark-up.
2/ Important concept to measure CPI.

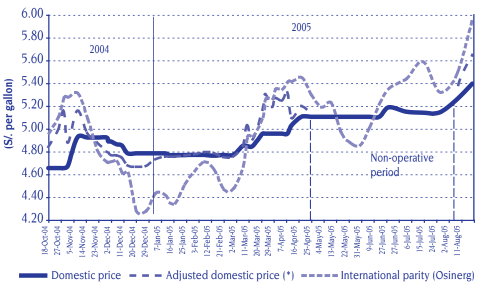
BOX 1

FUEL PRICE STABILIZATION FUND

As world oil prices rose, the Fuel Price Stabilization Fund recommenced operations on the 10th of August this year after lack of funds had paralyzed it since the 2nd of May. The S/. 80 million assigned to the fund was increased to S/. 120 million (operations were re-initiated with S/. 59 million in available funds and S/. 61 million committed).

As can be seen in the figure, the stabilization method partially offset the increase in domestic prices in a context of volatile and rising world fuel prices. This temporary relief for domestic prices (without taxes) can be seen in the Adjusted Domestic Price, which expresses the average domestic price at the refinery plus the net compensation provided by the Fund. In this case the shortfall assumed by the refineries is equal to the difference between parity prices and adjusted domestic prices, which on the 22nd of August was 3 percent.

DOMESTIC PRICES AND INTERNATIONAL PARITY
(Weighted average)



(*) Adjusted domestic price = Domestic price (without taxes) + Compensating factor - Contribution factor

Table 5

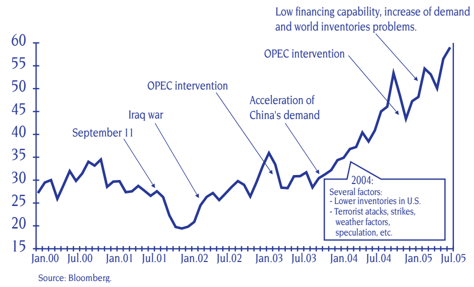
FUEL PRICES: JANUARY 2004 - AUGUST 2005
(Monthly percentage change)

	2004						2005								
	Jan.-Aug.	Sep.	Oct.	Nov.	Dec.	Jan.-Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Jan.-Aug.
Fuels	11.2	0.7	2.6	2.8	-0.3	17.8	-0.9	-0.6	0.8	1.2	0.2	0.8	-1.9	2.6	2.1
Gasoline	9.6	0.9	3.3	3.3	-0.2	17.7	-0.3	-0.6	0.6	1.4	0.3	1.1	1.4	2.4	6.6
Gas	14.0	-0.4	1.7	0.9	-1.1	15.3	-2.6	-1.8	1.1	0.6	-0.2	0.1	-10.2	-1.6	-14.1
Kerosene	10.5	1.4	2.7	4.2	0.2	20.3	0.0	0.5	0.7	1.4	0.2	1.1	1.6	6.2	12.2
WTI price															
US$ per barrel	38.4	45.9	53.2	48.5	43.3	41.5	47.1	48.1	54.3	53.0	49.9	56.4	58.7	64.8	54.0
% change	40.0	2.3	15.9	-8.9	-10.8	34.9	9.0	2.0	12.9	-2.4	-5.8	13.0	4.1	10.4	49.8

Source: INEI, Bloomberg.

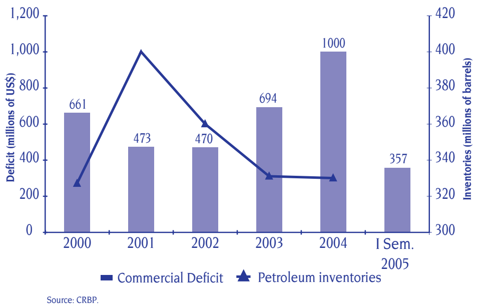
The increase in domestic fuel prices also had an indirect effect on inflation through cost pressure, although part of this is being absorbed by margins and by reductions in other costs. There was a 0.3 percent increase in urban bus fares in the period January - August 2005, while the price of diesel 2, the fuel most widely used by this sector, increased by 10 percent.

PETROLEUM WTI AVERAGE PRICE
(US dollars per barrel)



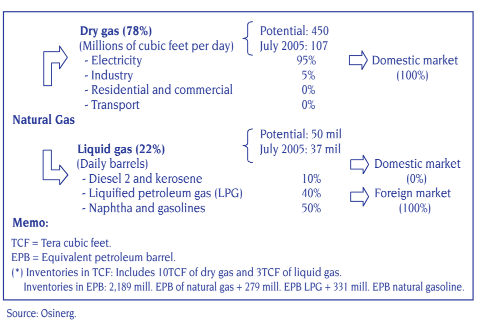
Source: Bloomberg.

FUELS DEFICIT AND PETROLEUM INVENTORIES 2000 - I SEMESTER 2005



Source: CRBP.

CAMISEA: PRODUCTION AND SALES OF NATURAL GAS
(Inventories: 13 TCF = 2,800 millions of EPB)*



Source: Osinerg.

BOX 2

THE GAS MARKET IN PERU

Dependence on oil makes the Peruvian economy more vulnerable to external shocks. In a context in which the price of oil is ever more volatile and Peru's oil stocks are lower than they were, it is even more important to change the country's energy use patterns by making greater use of gas. Thus, between December 2001 and July 2005 the price of oil increased 200 percent and Peru's oil reserves fell by 18 percent.

Since the commencement of operations in August 2004, Camisea has contributed to an improvement in the country's trade balance with an additional 37,000 barrels a day of liquefied gas for export. In the domestic market, 95 percent of dry gas production is used to generate electricity (ETEVENSA). Under current conditions (reserves, technology employed, etc.), Camisea has the potential to produce 450 million cubic feet per day of dry natural gas and 50,000 barrels a day of liquefied gas, it is operating at 25 and 75 percent of its capacity for these fuels respectively.

The market for natural gas in Peru is divided into 4 segments:

1. **Electricity sector:** This is the main user, which at present makes up 95 percent of demand. Natural gas is more efficient and competitive for thermal power generation than other fuels. The impact on the economy can be seen in lower electricity tariffs.

2. **Manufacturing sector:** This demand segment consists mainly of those industries that use large quantities of energy in, for example, furnaces (cement manufacturers, steel works, the ceramic industry, etc.), those which need to generate steam (fishing companies, the paper and textile industries, etc.), among others. The impact on the economy is seen mainly in increased competitiveness for Peruvian manufacturing.

3. **The transport sector:** The demand for natural gas as a vehicle fuel will be one of the most dynamic once service stations were functioning and facilities for the conversion of vehicles be offered. The development of the transport sector could produce a substantial change in the country's vehicles with a consequent reduction in atmospheric pollution.

4. **Residential sector:** Progress in this sector will depend on a reduction in installation costs paid by consumers. Domestic use of gas should result in savings for the family budget.

The agreement entered into in May 2002 between the Peruvian State and GNLC (now Calidda) for the distribution of natural gas In Lima and Callao, established that Calidda must be able to provide the service in accordance with a timetable: 10,000 potential consumers after 2 years, 30,000 potential consumers after 4 years and 70,000 potential consumers after 6 years from the commencement of commercial operations.

A multi-sector commission has been created to draw up suitable mechanisms for encouraging the development of the gas market. More extensive use of gas in Peru will increase productivity, leading to a higher rate of sustained growth.

Public services

8. **Utility** costs fell 3.2 percent in the period January – August 2005 as a result of a fall in electricity prices (3.8 percent) and telephone charges (5.4 percent). The fall in electricity prices was based on a forecast of increased supply by 2007, which includes the conversion of the Ventanilla power station to combined cycle, use of natural gas at the Santa Rosa station, and the commissioning of the Egechilca power station. The fall in telephone charges was due to the application of the quarterly productivity factor calculated by Osiptel.

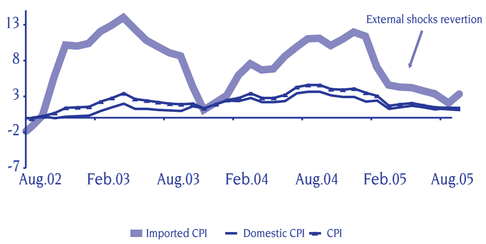
Table 6

PUBLIC UTILITIES RATES: JANUARY 2004 - AUGUST 2005
(Monthly percentage change)

	2004						2005								
	Jan.-Aug.	Sep.	Oct.	Nov.	Dec.	Jan.-Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Jan.-Aug.
Public services	**2.0**	**0.6**	**0.1**	**3.7**	**-0.3**	**6.2**	**-1.1**	**-0.2**	**-0.5**	**0.0**	**-1.9**	**0.5**	**0.2**	**-0.2**	**-3.2**
Electricity	2.6	1.3	0.1	7.4	0.3	12.0	-2.1	-0.3	0.0	0.0	-3.7	2.3	0.2	-0.2	-3.8
Telephone	-0.1	0.0	0.1	0.0	-2.0	-2.0	0.0	-0.2	-2.1	0.0	0.0	-2.6	0.0	-0.6	-5.4
Water	3.0	0.0	0.0	0.0	0.0	3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: INEI.

Graph 5
INFLATION, DOMESTIC AND IMPORTED COMPONENT: August 2002 - August 2005
(% change over the last 12 months)

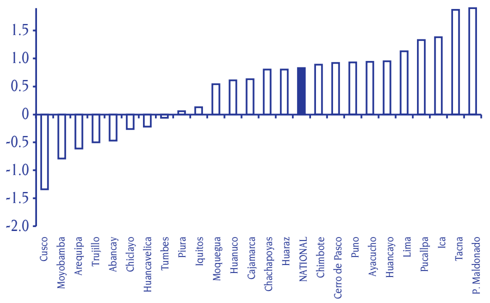


9. Imported **inflation**, consisting of goods included in the Consumer Prices Index that are affected either directly or indirectly by international prices (bread, pasta, cooking oil and fuels) and/or by the exchange rate, showed an accumulated variation of 0.40 percent in the period January – August 2005 (9.0 percent in the same period of 2004), due principally to a normalization of international foodstuff prices and to policies adopted to lessen the effect of world oil price rises on fuels.

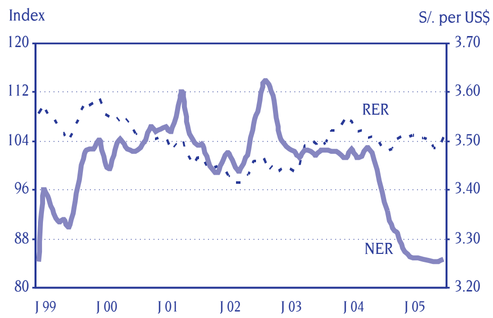
Domestic inflation

10. The national index of accumulated prices between January and July 2005 was 0.83 percent, lower than the figure for Lima (1.13 percent). In 15 cities the CPI was lower than the national average, while in the remaining 10 cities it was higher than the

Graph 6
NATIONAL INFLATION: JANUARY - JULY 2005
(% accumulated change)



Graph 7
NOMINAL AND REAL EXCHANGE RATE
January 1999 - August 2005



national average. It should be noted that since January 2003 the Instituto Nacional de Estadística e Informática (INEI) has been producing a national aggregate of consumer prices based on price indices for 25 cities.

Table 7

IMPORTED & DOMESTIC INFLATION: 2004-2005
(Cumulative percentage change)

	Weighting	2004 Jan-Aug	2004 Jan-Dec	2005 Jan-Aug
I. IMPORTED CPI	**12.1**	**9.03**	**11.33**	**0.41**
Food	5.4	11.22	10.90	-1.07
Fuels	3.9	11.25	17.77	2.09
Electrical appliances	1.0	-2.49	-2.83	-1.74
Others	1.8	2.30	3.23	1.51
II. DOMESTIC CPI	**87.9**	**2.31**	**2.28**	**1.04**
III. CPI	**100.0**	**3.20**	**3.48**	**0.95**
Exchange rate		**-2.18**	**-5.48**	**-0.73**

I.2 Exchange rate

The appreciation of the nuevo sol has contributed to a fall in the rate of inflation.

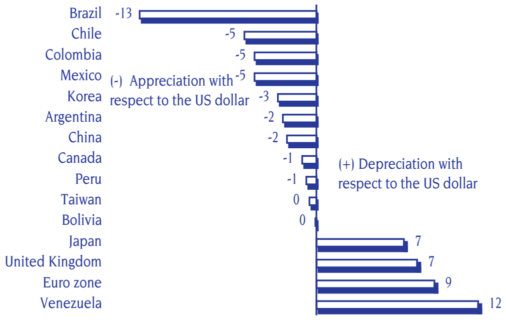
11. The **nominal** average exchange rate fell from S/. 3.28 in December 2004 to S/. 3.26 to the dollar in August this year, implying a 0.7 appreciation against the U.S. dollar and 1.9 percent against the average of the currencies of our main trading partners. In 2004 the nuevo sol appreciated 5.5 percent against the dollar; and 1.5 percent against the currencies of Peru's principal trading partners.

It should be mentioned that the final days of August saw a slight depreciation of the sol, associated with transitory demands by banks and institutional investors that forced the exchange rate up to S/. 3.29 per dollar at the end of the month.

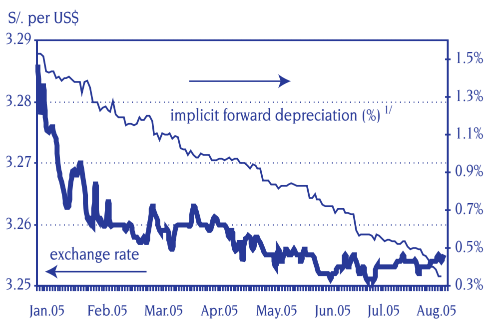
In **real terms**, the nuevo sol has depreciated 1.1 percent against the U.S. dollar so far this year, which is explained by the difference in the two countries' inflation rates (2.8 percent estimated for the United States compared to 0.9 percent for Peru). The nuevo sol has appreciated 0.4 percent against the basket of currencies of our main trading partners.

The **real exchange** rate was influenced by the appreciation of the dollar in international markets (after depreciating in previous years) driven by better expectations of growth in the United States and a higher interest rate differential in favor of the dollar. This performance by the dollar became more marked in June after the referendum results in the Euro Zone.

Graph 8
DEPRECIATION AND APPRECIATION OF NUEVO SOL WITH RESPECT TO THE CURRENCIES OF OUR MAIN TRADE PARTNERS
(Aug.05/Dec.04)



Graph 9
NOMINAL DAILY EXCHANGE RATE AND IMPLICIT FORWARD DEPRECIATION (3 MONTHS)
January - August 2005



1/ Computed as the differential between the interest rate in soles and dollars.

Graph 10
EXCHANGE RATE AND TRADE BALANCE
January 1999 - June 2005

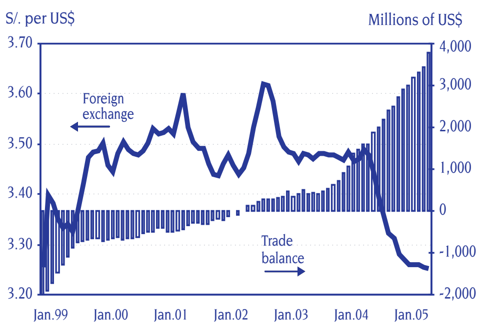


Table 8

NOMINAL AND REAL CHANGES OF THE NUEVO SOL WITH RESPECT TO THE CURRENCIES OF OUR MAIN TRADE PARTNERS AS OF AUGUST 2005

	Nominal		Real	
	Respect to:		Respect to:	
	Aug. 2004	Dec. 2004	Aug. 2004	Dec. 2004
USA	-4.1%	-0.7%	-2.2%	1.1%
Euro zone	-3.1%	-8.7%	-2.3%	-8.1%
Japan	-4.3%	-6.8%	-5.6%	-7.9%
Brazil	21.8%	14.1%	27.1%	16.7%
UK	-5.4%	-7.6%	-4.0%	-7.3%
Chile	11.8%	4.8%	13.7%	6.6%
China	-2.0%	1.4%	-0.8%	3.7%
Colombia	8.1%	4.0%	12.2%	7.4%
Mexico	2.2%	4.0%	5.2%	4.7%
Argentina	-0.3%	1.8%	8.4%	8.8%
Korea	8.8%	2.2%	9.7%	3.7%
Taiwan	1.8%	-0.2%	2.5%	1.1%
Venezuela	-14.3%	-11.3%	-2.5%	-3.2%
Canada	4.5%	0.3%	5.7%	1.1%
Bolivia	-5.1%	-0.7%	-1.2%	1.7%
Basket *	**-0.4%**	**-1.9%**	**1.6%**	**-0.4%**

* Weighted with respect to trade in 1994.

The Central Bank of China's revaluation of the yuan in July could also have partly reduced depreciatory pressures on the dollar against strong currencies. The dollar depreciated in Latin America (with the exception of the Venezuelan bolivar), in a context of favorable macroeconomic indicators and lower country risk for these economies.

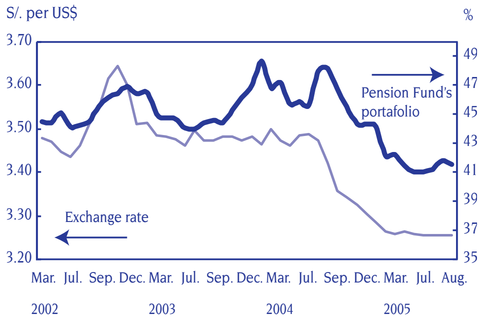
Nevertheless, from August onwards the dollar resumed its depreciation as a result of continuing external imbalances and positive macroeconomic indicators in the Euro Zone and Japan.

12. The continued appreciation of the nuevo sol so far this year was the result of the following factors: favorable external accounts, financial dedollarization and a further reduction in country risk.

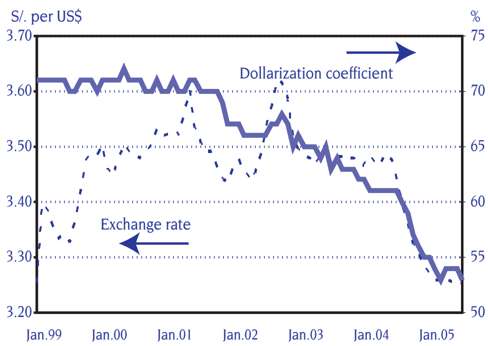
The reduction in the interest rate differential between the sol and the U.S. dollar - because of the stability of the former and an increase in the latter - may have attenuated appreciatory pressures. In line with this lower interest rate differential, expectations of depreciation implicit in forward operations at three months fell from 1.5 to 0.2 percent between January and August.

a. ***Strengthened external accounts.*** The trade surplus continued to increase and in June exceeded US$ 3,800 million in annual terms. As a result, the balance of payments current account for the first semester was in surplus to the tune of US$ 173 million or 0.4 percent of GDP.

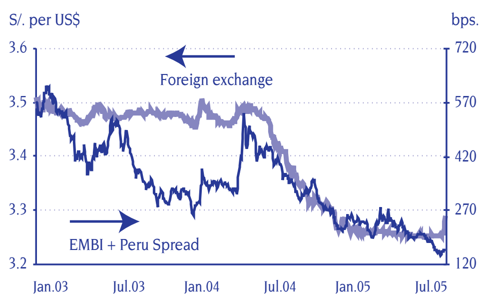
Graph 11
PENSION FUND'S PORTFOLIO IN US$ AND EXCHANGE RATE



Graph 12
BANKING SYSTEM DOLLARIZATION COEFFICIENT:
January 1999 - July 2005



Graph 13
EXCHANGE RATE AND COUNTRY RISK
January 2003 - August 2005



b. **Dedollarization.** Dollarization ratios continued to fall in the first few months of the year. Investment by pension funds in foreign currency denominated assets by the 12th of August (42 percent) and the coefficient of dollarization of the banking system in July (53 percent) were lower than their levels in December 2004 (44 and 55 percent respectively). This reduction occurred in the first quarter of the year and the ratios remained stable in subsequent months.

c. ***Reduction in country risk perceived by investors and appreciation of the region's currencies.*** The spread and that of certain economies in the region – which is a reflection of country risk - reached their lowest levels (basically in July and the first fortnight of August) influenced by: (i) maintenance by the FED of moderated increases in interest rates, (ii) improvement in the main macroeconomic variables of the region's economies; and (iii) the favorable impact of oil and mineral price rises on certain exporting economies.

Among the economies of the region Peru's spread fell significantly. This result was influenced by an improvement in Peru's outlook according to ratings agency S&P (from "stable" to positive") an announcement of an early payment of debt to the Paris Club and market enthusiasm for a placement of bonds to finance this operation, particularly Peruvian currency denominated bonds in the local market.

It is worth mentioning that the Argentine spread fell by 6,498 bp. to around 400 bp. Once the restructuring of Argentine debt was concluded, the default bonds were replaced by new bonds in the JP Morgan Index, which explains this fall. The spread for Brazil rose slightly compared to December 2004 because of political uncertainty.

The reduction in spreads was accompanied by the appreciation of most of the region's currencies. The real appreciated by 13 percent and the Chilean, Mexican and Colombian pesos appreciated by 5 percent, while the Argentine peso appreciated by 2 percent. The strengthening of the real is partly explained by favorable growth forecasts, an increase in the trade surplus and a reduction in political uncertainty.

Table 9

EMERGING MARKETS EMBI+ SPREADS
(End of period, in basis points)

	Dec. 03 (1)	Dec. 04 (2)	May.05 (3)	Jul.05 (4)	Aug.05 (5)
Emerging economies	**418**	**356**	**372**	**290**	**296**
Latin America	**521**	**466**	**455**	**331**	**337**
Brazil	463	382	420	402	413
Colombia	431	396	354	317	309
Mexico	199	180	164	152	152
Argentina	5,632	4,703	6,498	413	439
Peru	312	220	206	173	169

BOX 3

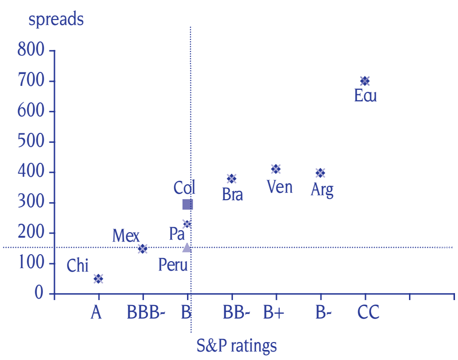
RISK RATING AND SPREADS FOR SOVEREIGN BONDS

The spread on Peruvian sovereign bonds has been gradually reduced. In December 2004 the spread of Peru's EMBI+ was 220 basis points (bps) and at present it is 169 bps, having fallen to 145 bps on the 17th of August.

Although the reduction in spreads is a regional trend favored by high levels of international liquidity and the region's improved macroeconomic situation, it should be pointed out that Peru's spread has decreased the most among the economies of Latin America. Its current level is similar to that of Mexico (which ratings agencies classify as investment grade) and is significantly lower than that of other countries that have a similar risk classification to Peru.

Thus on the 31st of August Peru's spread was 160 bps while that of Mexico was 152 bps Peru's spread is also less than that of those countries with a similar risk classification, like Colombia (to which Moody's has given a higher classification) and Brazil, whose spreads are 309 and 413 bps, respectively.

Spreads and country risks



The favorable perception of the Peruvian economy is based on positive growth perspectives, low inflation, the favorable performance of external accounts, gradual dedollarization of the economy, low fiscal deficit and the development of a domestic market in public debt. The latter has been strengthened recently by an exchange of dollar-denominated domestic debt for debt denominated in soles and the re-profiling of the debt with the Paris Club. These operations demonstrated the ability of the Peruvian State to issue significant amounts of debt in Peruvian currency, with long maturities and with a market preference for nominal rates.

The exchange of domestic debt consisted of the redemption of dollar-denominated bonds (US$ 262 million) in exchange for bonds in soles (S/. 851 million), including a bond with a 10-year maturity. The replacement of external debt consisted of issues which included a 12 year bond (S/. 1,500 million), a 15-year bond (S/. 1,050 million) and an 11 year bond (S/. 69 million). These resources were used for early repayment of debt to the Paris Club. As a result of these operations, the average maturity of the stock of public domestic debt increased from 5.9 years to 8.9 years.

These factors contribute to a reduction in country risk. In this context, in July of this year Standard & Poor's improved its outlook for Peru (from stable to positive) and has said that if prudent macroeconomic management continues, a further improvement could be seen, with the country approaching investment grade.

13. The appreciation of the nuevo sol may have had an influence on the banks' international position (US$ 350 million) and on the deepening of the forward exchange rate market. As at the 31st of August there was a significant increase in the balance of purchase operations (coverage operations against the appreciation of the nuevo sol) which added to sales operations, exceed the amounts seen at the end of December 2004 by more than US$ 500 million.

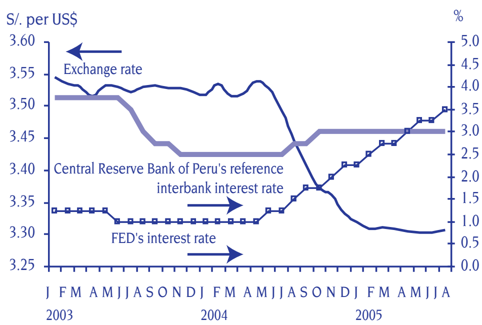
Table 10

BANKS' EXCHANGE POSITION

	Banks' forward balances			CEP 3/
	Purchases 1/	Sales 2/	Sales + Purchases	
Dec-02	236	1,141	1,377	587
Dec-03	227	834	1,061	536
Dec-04	464	1,163	1,627	340
May-05	440	979	1,419	358
Jul-05	763	1,297	2,060	404
Aug-05	891	1,242	2,133	350

1/ Represents coverage against appreciation risk.
2/ Represents coverage against depreciation.
3/ Banks' covered exchange position -CEP- (bank's assets minus liabilities in US dollars, including futures purchases and sales of US dollars).

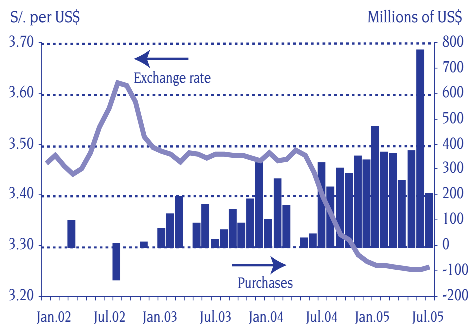
Graph 14
EXCHANGE RATE AND INTEREST RATES OF THE FED AND PERU



14. It should be pointed out that the difference between interest rates in soles and dollars favored yields of assets denominated in foreign currency. This could have reduced the appreciatory trend of the nuevo sol, particularly from July onwards.

15. In the context of appreciation described above, the Central Bank's dollar purchases (US$ 3,097 million between January and August) enabled it to continue to increase its international reserves. The increased purchases made in July (US$ 763 million) were to meet a request from the Treasury for funds to make an advance payment to the Paris Club. Symmetrical sales of foreign currency were made, partially financed by local bond issues.

Graph 15
EXCHANGE RATE AND BCRP'S INTERVENTIONS:
January 02 - August 05

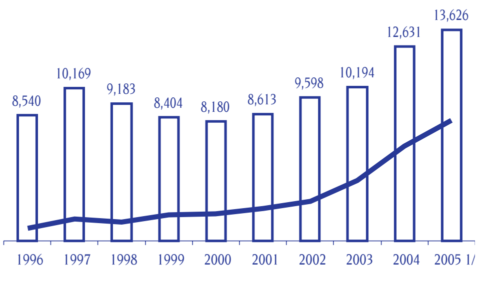


In order to finance early payment of debt to the Paris Club, in July the government issued bonds denominated in domestic currency and valued at US$ 805 million, 58 percent of which were acquired by non-residents.

The CRBP intervened in the foreign exchange market to acquire the foreign currency arising from this external demand and that of the domestic market in order to complete the foreign currency required to make the early payment to the Paris Club.

16. Part the over-the-counter purchases was used to meet a demand for dollars from the public sector (US$ 1,493 million), so that the CRBP's net purchases of dollars between January

Graph 16
NET INTERNATIONAL RESERVES AND INTERNATIONAL POSITION
(Millions of US$)



1/ As of August 2005.

and August amounted to US$ 1,607 million. These net purchases, added to lower public sector deposits amounting to US$ 367 million, explain the US$ 995 million flow of international reserves.

In addition, net purchases of dollars together with net interest earned on deposits and investments abroad, increased the CRBP's international position by US$ 1,577 million to a balance of US$ 8,216 million as at the 31st of August.

I.3 Domestic demand and GDP

Economic growth during the first half of 2005 was characterized by favorable evolution of both domestic demand and exports.

17. Growth in **domestic demand** (4.4 percent) was influenced by greater private consumption associated with higher levels of employment and incomes. In addition, easier access to credit drove the sustained growth in consumer credit. Private investment has shown 5 consecutive semesters of continual growth.

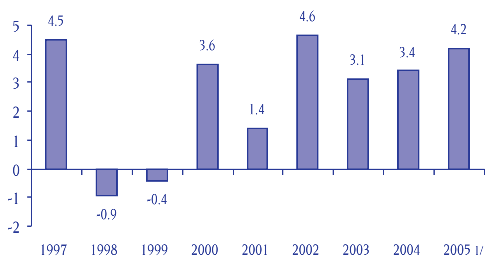
Table 11

GLOBAL SUPPLY AND DEMAND
(Real percentage values compared to same period in previous year)

	2002	2003	2004			2005
			I Sem.	II Sem.	Year	I Sem.
I. GLOBAL DEMAND (1+2)	**4.6**	**3.9**	**4.4**	**6.8**	**5.6**	**6.4**
1. Domestic demand 1/	4.2	3.5	3.5	4.3	3.9	4.4
a. Private consumption	4.6	3.1	3.1	3.8	3.4	4.2
b. Public consumption	0.2	3.8	1.9	5.9	4.1	8.6
c. Fixed private investment	-0.1	5.6	9.4	8.7	9.0	10.0
d. Public investment	-4.0	4.0	-12.3	19.6	5.5	7.2
2. Exports	6.9	6.3	9.7	19.1	14.7	17.2
II. GLOBAL SUPPLY (3+4)	**4.6**	**3.9**	**4.4**	**6.8**	**5.6**	**6.4**
3. GDP	**4.9**	**4.0**	**4.0**	**5.7**	**4.8**	**5.9**
4. Imports	2.6	3.5	7.5	13.2	10.4	9.4

1/ Includes inventory changes.
Source: INEI and CRBP.

Graph 17
PRIVATE CONSUMPTION
(Real % changes)



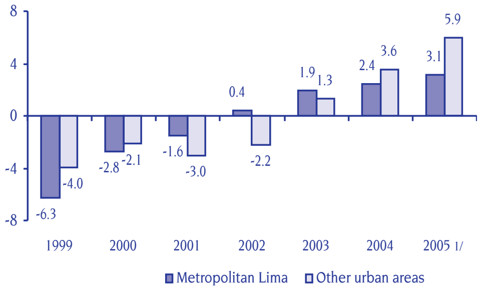
1/ As of the first semester.

18. During the first semester, **gross domestic product** grew 5.9 percent driven by accelerated private spending, which increased 4.2 percent and increased private investment and exports, which grew 10.0 and 17.2 percent respectively.

Growth in **private consumption** was associated with a 5.3 percent increase in **national disposable income**, a rise in employment and higher consumer confidence.

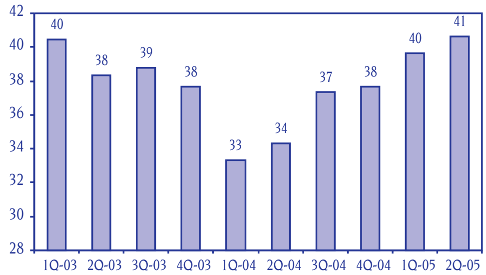
Employment has been growing since 2003 but its rate of growth accelerated in the first half of 2005. Thus, urban

Graph 18
EMPLOYMENT IN COMPANIES WITH 10 OR MORE EMPLOYEES
(Annual % change)



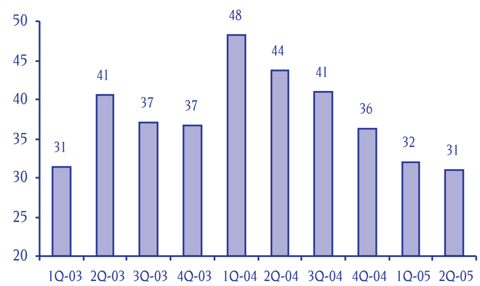
1/ As of the first semester.

Graph 19
INDEX OF CONSUMER CONFIDENCE INDICCA 1/



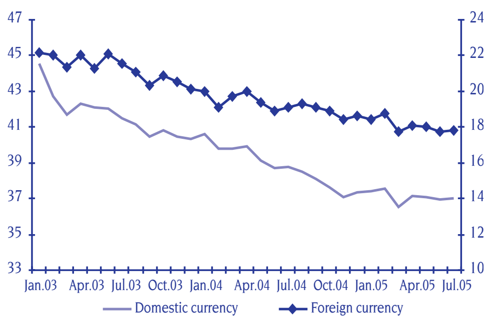
1/ Coverage: Metropolitan Lima.
Source: Apoyo Consultoría S.A.

Graph 20
EXPECTATION THAT THE FAMILY ECONOMIC SITUATION BE FOUND WORSE IN THE NEXT 12 MONTHS



Source : Apoyo Consultoría S.A

Graph 21
CONSUMPTION LOANS' REAL INTEREST RATES



employment in companies with 10 or more employees grew 3.8 percent compared to the first half of 2004. In particular, growth in employment was highest in cities in the interior (5.9 percent) compared to Metropolitan Lima (3.1 percent). Talara, Sullana and Ica experienced job growth in excess of 20 percent in the first half of 2005 compared to the same period in the previous year. Iquitos, Chincha and Piura also experienced more than 10 percent growth in employment during the same period.

The increase in employment in the interior is explained by the dynamism of mining and export-oriented agribusiness. Employment in the transport and services sectors increased 5.0 and 4.0 percent respectively during the period.

Table 12

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

	2002	2003	2004			2005
			I Sem.	II Sem.	Year	I Sem.
I. Gross domestic product (GDP)	4.9	4.0	4.0	5.7	4.8	5.9
II. Gross national product (GNP) 1/	4.4	3.0	2.4	3.9	3.2	4.4
III. Gross national income (NI) 2/	4.6	3.4	4.7	6.0	5.3	5.3
IV. National disposable income (NDI) 3/	4.5	3.6	4.9	6.1	5.5	5.3

1/ Excludes from GDP the net income paid to non-resident productive factors.
2/ GDP and GNP are isolated from changes in foreign terms of trade.
3/ Net transfers from non-residents is added to NI.
Source: INEI and CRBP.

19. The index of consumer confidence has been growing since the beginning of 2004, reaching its maximum level in the second quarter of 2005.

20. **Private consumption** is reflected in various indicators such as the growth of consumer loans by finance companies (23.5 percent in the first half of the year), in a context in which more people have access to credit (table 13) and interest rates are falling (graph 21).

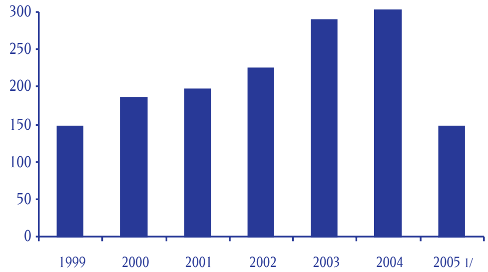
Table 13

NUMBER OF DEBTORS IN THE FINANCIAL SYSTEM
(Thousands)

	Dec-01	Dec-02	Dec-03	Jul-04	Dec-04	Jul-05
Commercial banks	1,397	1,557	1,694	1,902	2,016	2,199
Financial companies	578	724	877	834	908	832
Local savings & Credit unions	348	407	489	530	544	567
Rural savings & Credit unions	39	55	68	76	80	86
Edpymes	40	54	77	95	112	138
Banco de la Nación	136	430	422	427	454	503

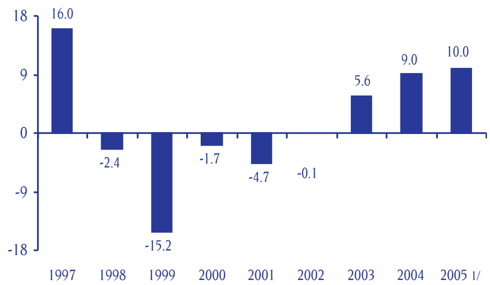
Source: SBS and Banco de la Nación.

Graph 22
ELECTRICAL APPLIANCES IMPORTS
(Millions of US$)



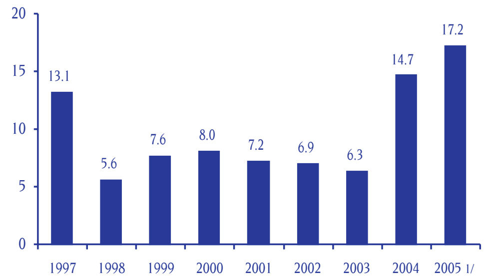
1/ As of the first semester.

Graph 23
PRIVATE INVESTMENT
(Real % changes)



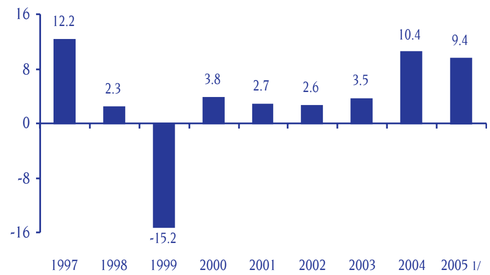
1/ As of the first semester.

Graph 24
EXPORTS
(Real % changes)



1/ As of the first semester.

Graph 25
IMPORTS
(Real % changes)



1/ As of the first semester.

21. There was also a 42.4 percent increase in new vehicle sales and an increase of 8.0 percent in household electrical goods imports.

22. Private investment increased 10.0 percent during the first semester, confirming the upward trend in this indicator. The factors that explain the growth in private investment include lower financing costs and implementation of projects in the mining and hydrocarbons sectors in a climate of business optimism.

    The first semester saw money released for the construction of the Alto Chicama Project and the continuation by Southern Peru Copper Corp. of the Toquepala and Ilo smelter modernization and expansion program, as well as investment in plant by export-oriented agribusiness companies.

    There was a 23.9 percent increase in capital goods imports arising from investment by construction and mining companies, as well as the acquisition of machinery and equipment for civil engineering, heating and refrigeration equipment and vehicle equipment (engines).

23. Real **exports** of goods and services grew further during the first half of 2005 (17.2 percent), because of increased exports of mining products (molybdenum) and fishing sector products (fishmeal), as well as non-traditional products, including textiles (apparel) and agricultural products (fruit).

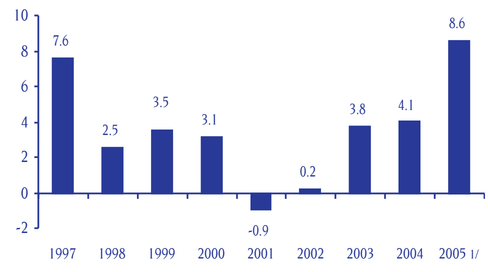
24. Real **imports** of goods and services increased by 9.4 percent, mainly raw materials for industry; fuels, lubricants and related items; and capital goods (vehicles and manufacturing machinery).

25. **Public consumption** grew 8.6 percent in the first half of the year, due principally to an increase in wages and salaries, in particular salary increases for teachers and health workers, in addition to further acquisitions of goods and services by state entities. **Public investment** increased 7.2 percent as a result of increased investment by public companies (Sedapal) and local governments, which received more funds from the central government.

GDP by sector

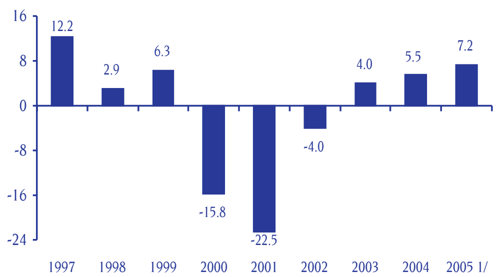
26. Non-primary manufacturing and construction grew 8.3 and 5.1 percent respectively, leading GDP growth in the first semester, which also saw a recovery in the agriculture & livestock sector, which grew 4.8 percent. The least dynamic primary sectors were: processors of primary resources within manufacturing industry, which contracted 0.9 percent as a result of reduced sugar production and a contraction in non-ferrous metal refining, and metal mining as copper production fell because of the exploitation of ores with lower metal content.

Graph 26
PUBLIC CONSUMPTION
(Real % changes)



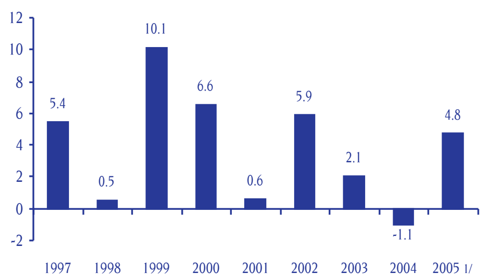
1/ As of the first semester.

Graph 27
PUBLIC INVESTMENT
(Real % changes)



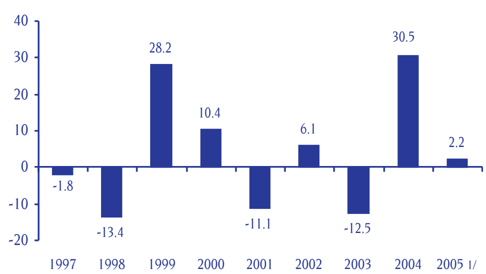
1/ As of the first semester.

Graph 28
AGRICULTURE & LIVESTOCK SECTOR
(Real % changes)



1/ As of the first semester.

Graph 29
FISHING SECTOR
(Real % changes)



1/ As of the first semester.

27. In the first semester growth in the **agriculture & livestock** sector was the result of better weather during planting and increased production of potatoes (13.9 percent), rice (22.3

Table 14

GROSS DOMESTIC PRODUCT: 2004-2005
(Real percentage values compared to same period in previous year)

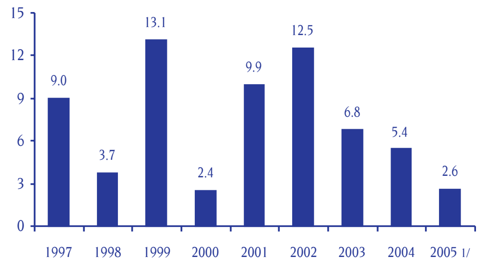
	2002	2003	2004			2005
			I Sem.	II Sem.	Year	I Sem.
Agriculture and livestock	**5.9**	**2.1**	**-2.5**	**0.9**	**-1.1**	**4.8**
Agriculture	6.1	1.6	-4.9	-0.7	-3.2	6.1
Livestock	5.3	3.0	1.7	2.4	2.0	2.5
Fishing	**6.1**	**-12.5**	**27.4**	**34.4**	**30.5**	**2.2**
Mining and fuel	**12.5**	**6.8**	**7.7**	**3.2**	**5.4**	**2.6**
Metal mining	13.6	7.7	8.6	2.2	5.3	0.0
Fuel	0.7	-4.3	-4.8	19.1	7.1	36.0
Manufacturing	**4.1**	**2.4**	**5.6**	**7.7**	**6.7**	**6.5**
Based on raw materials	0.6	-0.1	6.4	5.4	5.9	-0.9
Non-primary industries	5.1	3.1	5.4	8.3	6.9	8.3
Electricity & water	**5.5**	**4.9**	**4.7**	**4.5**	**4.6**	**4.7**
Construction	**7.9**	**4.2**	**5.5**	**3.9**	**4.7**	**5.1**
Commerce	**4.0**	**3.2**	**2.7**	**7.3**	**4.8**	**7.1**
Other services	**4.1**	**4.6**	**3.5**	**5.8**	**4.7**	**6.3**
GROSS VALUE ADDED (GVA)	**5.0**	**3.8**	**3.6**	**5.7**	**4.6**	**5.9**
Taxes on products and import duties	4.0	5.2	7.5	5.4	6.4	6.0
GLOBAL GDP	**4.9**	**4.0**	**4.0**	**5.7**	**4.8**	**5.9**
Primary GVA	**7.1**	**2.9**	**2.9**	**3.3**	**3.1**	**3.0**
Non-primary GVA	**4.5**	**4.1**	**3.8**	**6.3**	**5.1**	**6.7**

percent) and cotton (14.6 percent) causing the prices of these products to fall (by 26, 21 and 17 percent respectively). Increased production of these crops offset a fall in the production of sugar cane (22.7 percent) and coffee (11.4 percent). This growth was accompanied by increased dynamism in the livestock sector as poultry production increased 8 percent.

28. The **fishing** sector expanded 2.2 percent because of higher landings of tuna and chub mackerel for canning and Pacific hake and giant squid for freezing. Peruvian anchovy catches only increased 0.2 percent because of the level of catches in the previous year and the fact that there were fewer effective fishing days this year.

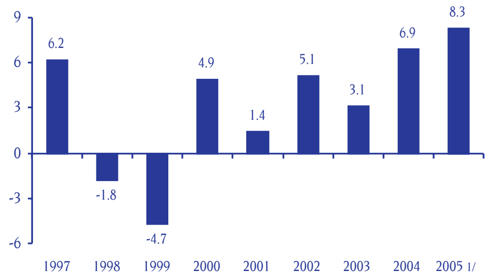
29. The **mining and hydrocarbons sector** grew 2.6 percent as hydrocarbons production increased and the figures for the mining sector remained virtually the same. The growth in hydrocarbons production arose from new production of natural gas and natural gas fluids from Camisea (Block 88). Furthermore, the lack of dynamism in metal mining was

Graph 30
MINING & FUEL SECTOR
(Real % changes)



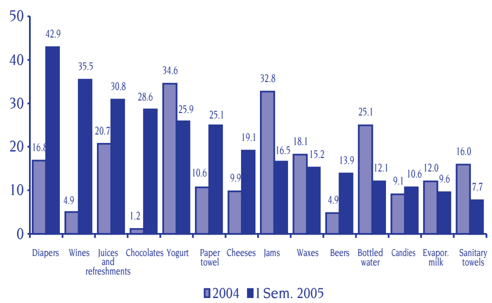
1/ As of the first semester.

Graph 31
NON-PRIMARY MANUFACTURING
(Real % changes)



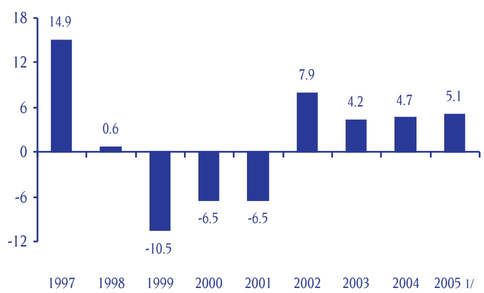
1/ As of the first semester.

Graph 32
FAST-MOVING CONSUMER GOODS
(percentage changes)



Source: Ministerio de la Producción.

Graph 33
CONSTRUCTION SECTOR
(Real % changes)



1/ As of the first semester.

reflected in lower copper production (4 percent) by Southern Peru Copper Corporation (15 percent because of reduced copper content in the ores being exploited) and by Tintaya (16 percent because of a temporary stoppage). This lower copper production was offset by increased production of silver, lead and iron ore.

30. **Manufacturing** production increased 6.5 percent because of an 8.3 percent growth in non-primary manufacturing deriving from growth in both the domestic and export markets. The industries in which growth was highest were: basic chemicals, printing and knitted garments because of higher exports, other apparel, the paper and cardboard industry, other metallic products (cans) and dairy products, which responded to increased domestic demand. As far as ceramic tiles, cement and structural steelwork were concerned, growth was explained by an expansion of the construction industry and of exports.

Non-primary manufacturing grew significantly, driven by an expanding domestic market. Increased production was observed mainly in the fast-moving consumer goods sector, as can be seen in the following illustration:

Nevertheless, increased exports to the U.S. and Andean Pact countries also made an important contribution, as did new markets in Central America.

Table 15

NON-PRIMARY INDUSTRIES: PERCENTAGE CONTRIBUTION TO GROWTH BY MARKETS OF DESTINATION 1/
(In percentage points)

	Domestic market contribution	External market contribution	Total
Year 2004	**4.0**	**2.9**	**6.9**
I Quarter	3.4	2.4	5.8
II Quarter	2.6	2.4	5.0
III Quarter	3.6	3.2	6.8
IV Quarter	6.2	3.6	9.8
Year 2005			
I Quarter	4.4	2.6	7.0
II Quarter	6.1	3.4	9.5

1/ Excludes indirect effects.

31. The **construction** sector grew 5.1 percent, principally housing, responding to an increase in mortgage lending (11.5 percent), particularly the MiVivienda program, and self building; as well as new commercial building, especially in Lima and northern Peru.

I.4 External accounts

During the first semester the international context was favorable, as the terms of trade grew (4.3 percent) and export volumes increased (20 percent). The trade balance and balance of payments current account were in surplus to the tune of US$ 2,083 million and US$ 173 million respectively. This, together with a positive capital flow generated an accumulation of international reserves amounting to US$ 1,187 millions, with the external position remaining solvent.

Trade balance

32. In the first half of 2005 the **trade balance** was in surplus for the eighth consecutive semester, reaching a record level of US$ 2.1 billion. This result, in excess of initial forecasts, is explained by a 38 percent increase in exports, which was more than the increase in imports (25 percent).

33. In the first semester **exports** reached US$ 7.8 billion, US$ 2.1 billion higher than the figure for the same period in 2004. Traditional exports increased 42 percent (US$ 1.7 billion), while non-traditional exports increased by 28 percent (US$ 440 millions). In the first case the improvement is explained by higher prices for mining products, particularly molybdenum, copper and gold, as well as higher volumes shipped (20 percent on average), principally of fishmeal (68 percent), molybdenum (67 percent), zinc (8 percent) and copper (6 percent).

Table 16

BALANCE OF PAYMENTS
(Millions of US$)

	2002	2003	2004			2005
			I Q.	II Q.	Year	I Sem.
I. CURRENT ACCOUNT BALANCE	**- 1,063**	**- 935**	**- 213**	**203**	**- 10**	**173**
(% of GDP)	- 1.9	- 1.5	- 0.6	0.6	- 0.0	0.4
1. Trade balance	292	836	1,073	1,720	2,793	2,083
a. Exports	7,714	9,091	5,620	6,997	12,617	7,751
b. Imports	- 7,422	- 8,255	- 4,548	- 5,277	- 9,824	- 5,668
2. Services	- 941	- 854	- 427	- 416	- 843	- 413
3. Investment income	- 1,457	- 2,144	- 1,531	- 1,890	- 3,421	- 2,284
4. Current transfers	1,043	1,227	672	789	1,461	787
II. CAPITAL ACCOUNT	**1,883**	**1,348**	**904**	**1,432**	**2,336**	**1,170**
1. Private sector 1/	826	718	697	651	1,348	1,380
2. Public sector	1,056	630	207	781	988	- 210
III. EXCEPTIONAL FINANCING	**14**	**64**	**3**	**24**	**26**	**43**
IV. NET FLOW OF CRBP RESERVES (1-2)	**- 833**	**- 477**	**- 694**	**- 1,658**	**- 2,352**	**- 1,385**
(Increment carries negative sign)						
1. Variation in NIR balance	**- 985**	- 596	- 661	- 1,776	- 2,437	- 1,187
2. Effect of valuation and monetarization of gold	**- 152**	- 119	33	- 118	- 85	199

1/ Includes short term capitals and net errors and omissions.
Source: BCRP, MEF, SUNAT and companies.

Table 17

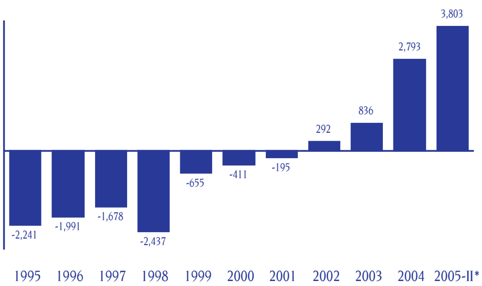
TRADE BALANCE
(Millions of US$)

	2003	2004			2005	% change	
		I Q.	II Q.	Year	I Sem.	2004	I Sem.
1. **EXPORTS**	**9,091**	**5,620**	**6,997**	**12,617**	**7,751**	**38.8**	**37.9**
Traditional products	6,356	3,991	5,036	9,028	5,668	42.0	42.0
Non-traditional products	2,620	1,574	1,902	3,476	2,013	32.6	27.9
Other products	114	55	58	113	69	- 0.8	25.5
2. **IMPORTS**	**8,255**	**4,548**	**5,277**	**9,824**	**5,668**	**19.0**	**24.6**
Consumer goods	1,848	871	1,102	1,973	1,061	6.8	21.8
Raw materials and intermediate goods	4,341	2,505	2,851	5,356	3,129	23.4	24.9
Capital goods	1,984	1,116	1,249	2,365	1,422	19.2	27.3
Other goods	82	55	75	130	57	57.7	2.1
3. **TRADE BALANCE**	**836**	**1,073**	**1,720**	**2,793**	**2,083**		

34. External demand continued to benefit all non-traditional sectors, particularly the agriculture & livestock and textile sectors, which showed increases of 28 and 17 percent respectively. The textile sector expanded despite the fact that China took a higher share of the world market after quotas had been eliminated. It is worth mentioning that on the 10th of June an agreement was entered into between China and the European Union (EU) which set limits for Chinese textile exports to the EU and established a limit to annual growth that varies between 8 and 12.5 percent for 10 categories of products. Furthermore, in May the United States reintroduced quotas for 7 categories of Chinese imports and is evaluating the imposition of safeguards on some other categories, limiting the rate of growth to 7 percent for cotton products.

There was also a significant increase in exports of chemical products (40 percent), arising from higher sales of plastic articles and beauty products, and exports of iron and steel products and jewelry (27 percent) benefiting from higher world prices.

Graph 34
TRADE BALANCE
(Millions of US$)



* Last four quarters.

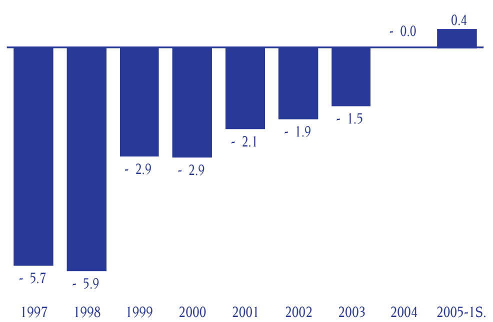
35. **Imports** increased by 24.6 percent in the first semester to reach US$ 5.7 billion arising from increased demand driven by the increase in economic activity and higher world oil prices, which caused an increase in raw materials purchases of 25 percent. There was also considerable growth in imports of capital goods (27 percent) and consumer goods (22 percent), which went hand in hand with the increase in investment and private consumption.

Terms of trade

36. The **terms of trade** increased by 4.3 percent in the first semester, exceeding initial forecasts due to export prices rising 15.4 percent, principally copper (23 percent),

Graph 35
TERMS OF TRADE
1997 - 2005 II QUARTER
(Index 1994 = 100)

Graph 36
CURRENT ACCOUNT BALANCE
(Percentage of GDP)



molybdenum (200 percent) and gold (7 percent), while there was a smaller increase of 10.7 percent in import prices, principally oil (41 percent) which was offset by lower prices for wheat (15 percent) and soya (26 percent).

37. The sustained increase in world prices for the principal raw materials was the result of demand by China in the commodities market; reduced inventory levels which in the case of copper, for example, fell to a 30 year low; and the similarity between supply and demand in the metals and oil markets. A weakened dollar during the year benefited gold as a store of value, causing the world price to rise by an average of 7 percent between January and July compared to the same period in the previous year.

38. Furthermore, better harvests of the main food crops offset the downward trend in prices that began in the second half of 2004, while the price of coffee recovered as world supply fell.

Current account and capital flows

39. The **current account** was in surplus - for the second consecutive semester - to the tune of US$ 173 million or 0.4 percent of GDP, which compares favorably with the deficit of US$ 213 million or 0.6 percent of GDP recorded in the same period of 2004. This improvement is explained by a trade surplus of US$ 2.1 billion and remittances from Peruvians living abroad (US$ 615 million).

40. There was a higher deficit in factor rents because of remittances taken from higher profits generated by companies with foreign shareholders, in a context of high international prices.

41. The **financial account** for the first semester reached US$ 1.2 billion, US$ 266 million higher than in the first half of 2004. The private sector enjoyed higher foreign direct investment associated with profits retained rather than being sent abroad in a context of high international prices; an increase in portfolio investments by non-residents participating in sovereign bond issues as the securities market became more buoyant; and lower investment abroad by the financial sector, which continued to convert its portfolio in favor of Peruvian currency. As far as public capital was concerned, there was a significant reduction in funds available for investment projects and funds freely available from multilateral agencies, as well as increased amortization and a rise in funds deposited abroad by the Peruvian Pensions Office (ONP).

I.5 Public finances

During the first semester the behavior of fiscal variables was positive. The fiscal surplus amounted to 2.5 percent of GDP, a figure 1.5 percentage points higher than in the same period of 2004, because of increased central government income, mainly as a consequence of regularization of income tax payments for fiscal year 2004.

Graph 37
NON-FINANCIAL PUBLIC SECTOR OVERALL BALANCE BY SEMESTER
(Percentage of GDP)

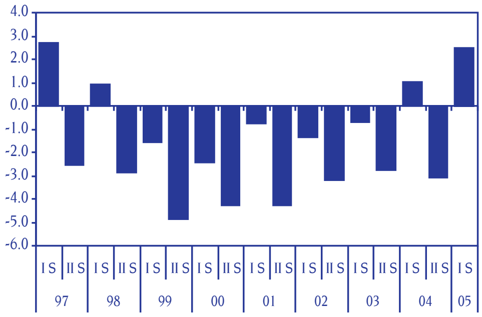
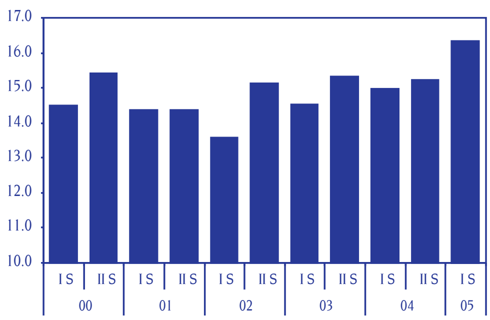


Table 18

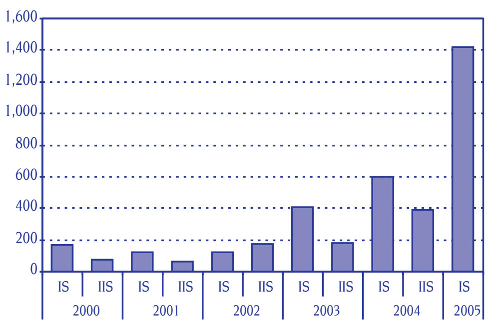
NON-FINANCIAL PUBLIC SECTOR: 2004-2005
(Millions of nuevos soles)

	2002	2003	2004			2005
			I Sem.	II Sem.	Year	I Sem.
1. Central government current revenue	**28,559**	**31,568**	**17,396**	**17,985**	**35,381**	**20,668**
(% of GDP)	14.4	14.9	15.0	15.2	15.1	16.3
Real % var.	5.3	8.1	9.6	6.7	8.1	16.5
2. Central government non-financial expenditure	**-29,241**	**-31,451**	**-14,676**	**-19,489**	**-34,165**	**-16,052**
(% of GDP)	-14.7	-14.9	-12.6	-16.5	-14.6	-12.7
Real % var.	2.1	5.2	-1.2	9.8	4.8	7.3
Current	-25,285	-27,371	-13,417	-16,454	-29,870	-14,721
(% of GDP)	-12.7	-12.9	-11.5	-13.9	-12.8	-11.6
Real % var.	3.6	5.9	2.0	8.1	5.3	7.6
Capital	-3,956	-4,080	-1,259	-3,036	-4,295	-1,330
(% of GDP)	-2.0	-1.9	-1.1	-2.6	-1.8	-1.1
Real % var.	-6.7	0.9	-26.0	20.0	1.5	3.6
3. Others	**468**	**810**	**988**	**196**	**1,184**	**968**
(% of GDP)	0.2	0.4	0.9	0.2	0.5	0.8
4. Primary balance	**-214**	**927**	**3,709**	**-1,308**	**2,400**	**5,584**
(% of GDP)	-0.1	0.4	3.2	-1.1	1.0	4.4
5. Interest	**-4,282**	**-4,606**	**-2,530**	**-2,335**	**-4,865**	**-2,438**
(% of GDP)	-2.2	-2.2	-2.2	-2.0	-2.1	-1.9
Of which:						
External debt (Millions of US$)	-$999	-$1,082	-$561	-$598	-$1,159	-$614
6. Overall balance	**-4,495**	**-3,679**	**1,179**	**-3,644**	**-2,465**	**3,146**
(% of GDP)	-2.3	-1.7	1.0	-3.1	-1.1	2.5
(Millions of US$)	-$1,270	-$1,058	$339	-$1,093	-$754	$965

Graph 38
CENTRAL GOVERNMENT'S REVENUES
(Percentage of GDP)



MINING SECTOR INCOME TAX (THIRD CATEGORY)
(Millions of Nuevos Soles)



42. The **overall balance** for the first semester amounted to 2.5 percent of GDP, a figure 1.5 percentage points higher than for the first half of 2004. The primary balance was equivalent to 4.4 percent of GDP, 1.2 percentage points higher, and interest payments were lower by 0.3 percentage points of GDP.

43. Central government **current revenue** amounted to 16.3 percent of GDP, a figure 1.3 percentage points higher than that obtained in the same period of 2004, which represents an increase in real terms of 16.5 percent. It should be indicated that this positive balance can be largely explained by the annual filing for the corporate income tax (0.7 percent of GDP), due to higher world mineral prices, and the delayed effect of an increase from 27 o 30 percent in the tax rate on companies. The effect of the improved filing was an increase in income tax payments on account by companies in this semester (from 2.1 to 2.3 percent of GDP) resulting from an increase in income tax payment coefficients. Increased economic activity and imports also increased revenue from import duties and value added tax. An increase was also observed in income from royalties and the oil-gas levy, as well as from mining royalties, because of higher mineral and oil prices. On the other hand, income from excise tax on fuels fell as the tax was reduced (18 percent on average) to lessen the impact of world prices.

Table 19

CENTRAL GOVERNMENT'S CURRENT REVENUES
(Percentage of GDP)

	2002	2003	2004			2005
			I Sem.	II Sem.	Year	I Sem.
I. TAX REVENUE	**12.1**	**13.0**	**13.3**	**13.2**	**13.3**	**14.3**
1. Income tax	3.0	3.8	4.1	3.6	3.9	5.1
- Individual	1.1	1.2	1.3	1.1	1.2	1.2
- Corporate	1.6	2.0	2.1	2.4	2.2	2.3
- Clearing	0.3	0.5	0.8	0.1	0.4	1.5
2. Import tax	1.2	1.2	1.1	1.3	1.2	1.2
3. Value-added tax (IGV)	6.3	6.7	6.7	7.1	6.9	6.9
-Domestic	3.8	4.0	4.1	4.1	4.1	4.0
-Imports	2.6	2.7	2.6	3.1	2.9	2.9
4. Excise tax (ISC)	2.1	2.1	2.0	1.8	1.9	1.7
-Fuel	1.5	1.6	1.5	1.3	1.4	1.1
-Others	0.6	0.6	0.5	0.6	0.6	0.6
5. Other tax revenue	0.9	0.7	0.9	1.0	0.9	1.1
6. Tax refund	-1.5	-1.5	-1.4	-1.5	-1.5	-1.6
II. NON-TAX REVENUE	**2.3**	**2.0**	**1.6**	**2.0**	**1.8**	**2.0**
III. TOTAL (I+ II)	**14.4**	**14.9**	**15.0**	**15.2**	**15.1**	**16.3**

44. Accumulated **non-financial expenditure** to June amounted to 12.7 percent of GDP, a figure which exceeded spending during the first half of 2004 by 0.1 percentage points of GDP, due principally to increased current transfers to local governments and higher salaries. In real terms, non-financial expenditure increased 7.3 percent. Current transfers increased 8.7 percent, while salaries increased by 8.1 percent. The increase in salaries was the result of raises awarded from the second half of 2004 and others awarded in the first half of this year (mainly to teachers and health professionals). Capital expenditure, on the other hand, increased 3.6 percent in real terms.

45. The primary balance of the **other public sector operations** amounted to 0.8 percent of GDP, a figure 0.1 percent of GDP lower than that of the same period in the previous year. This was mainly the result of a deterioration in EsSalud, arising from higher current spending on salaries, goods and services.

46. **Interest** amounted to 1.9 percent of GDP, 0.3 percent lower than the figure for the first half of 2004, caused by the effect of lower inflation on bonds and the lower exchange rate for debt denominated in foreign currency.

47. The **borrowing requirement** amounted to US$ 262 million, given that debt repayments (US$ 1.2 billion) were greater than the fiscal surplus (US$ 965 million). These repayments include the exchange of treasury bonds in the financial consolidation program (US$ 262 million) for sovereign bonds

Table 20

NON-FINANCIAL PUBLIC SECTOR FINANCING

	2002	2003	2004			2005
			I Sem.	II Sem.	Year	I Sem.
1. Overall balance (Millions of nuevos soles)	**-4,495**	**-3,679**	**1,179**	**-3,644**	**-2,465**	**3,146**
(% of GDP)	-2.3	-1.7	1.0	-3.1	-1.1	2.5
Millions of US$	-1,270	-1,058	339	-1,093	-754	965
2. Amortization (Millions of US$)	**-1,084**	**-1,743**	**-998**	**-1,070**	**-2,068**	**-1,227**
Redemption of pension reform bonds	-55	-172	-128	-87	-215	-91
Internal repayments	-138	-385	-252	-253	-505	-403
External repayments	-891	-1,187	-618	-730	-1,348	-733
3. Borrowing requirements (Millions of US$)	**2,355**	**2,801**	**659**	**2,163**	**2,822**	**262**
External disbursements	1,961	2,101	905	1,569	2,474	696
Free disposal	1,609	1,765	780	1,378	2,158	589
Investment projects	352	336	125	191	315	107
Domestic bonds	213	508	270	497	766	647
Privatization	421	52	74	40	114	32
Others	-240	139	-589	57	-532	-1,114

denominated in Peruvian currency. External disbursements amounted to US$ 696 million, of which US$ 427 million corresponded to global bonds. Sovereign bond issues amounted to S/. 2.1 billion, equivalent to US$ 647 million, including those issued as part of the exchange mentioned above.

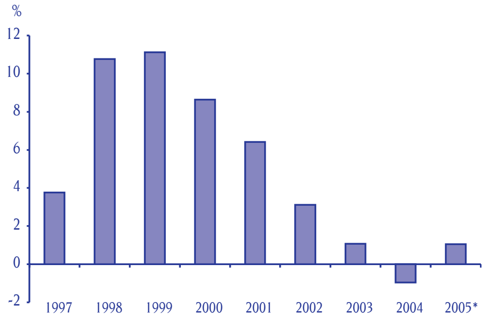
I.6 Interest rates and monetary aggregates

The reference interest rate set by monetary policy has been kept at 3.0 percent since October 2004.

Interest rates

48. Since the inception of the Inflation Targeting framework in January 2002, the interbank interest rate has been set as a monetary stimulus consistent with the inflation target and recovery of economic activity after the recession that preceded the introduction of the regime.

Graph 39
EX-POST REAL INTERBANK INTEREST RATE
(Annual averages)

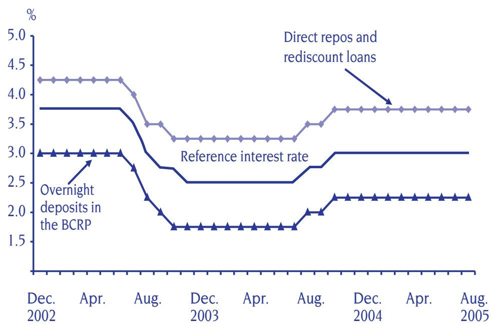


* As of July.

49. The Central Bank has not modified its monetary policy position since October 2004. Thus the reference interest rate for operations in the interbank market remains at 3.0 percent.

50. Given the stability of interbank interest rates in soles and the gradual increase in its dollar equivalent (FED funds rate), the differential between the sol and dollar interest rates for time deposits from 31 to 180 days has fallen from 1.5 percentage points in December 2004 to 1.2 points in July 2005. As far as deposit rates at 181 to 360 days are concerned, the differential has remained relatively stable at around 2.5 percentage points.

Graph 40
CRBP REFERENCE INTEREST RATE



The reduction in the interest rate differential has been greater for corporate preferential lending rates, and in the last few months this position has reversed. Thus, while in December 2004 the corporate preferential lending rate in soles was 1.2 percentage points higher than the same rate in dollars, in July 2005 the dollar rate was 0.3 percentage points higher than the sol rate.

The reduction in the average lending rate differential was 0.7 percentage points between December 2004 and July 2005 (from 8.8 to 8.1 percentage points). This result was not due solely to the increase in dollar interest rates, but also to a fall in interest rates in soles; this is consistent with banks' reduced perception of credit risk applying to economic agents given the recent sustained growth in economic activity, which is expected to continue.

Graph 41
3-MONTH CORPORATE PRIMES

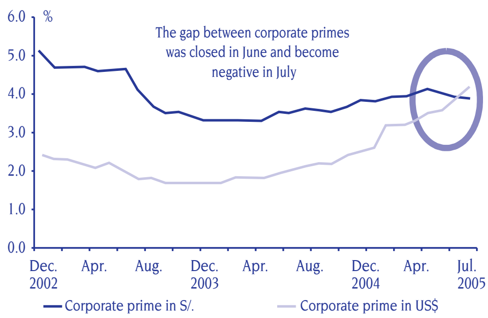


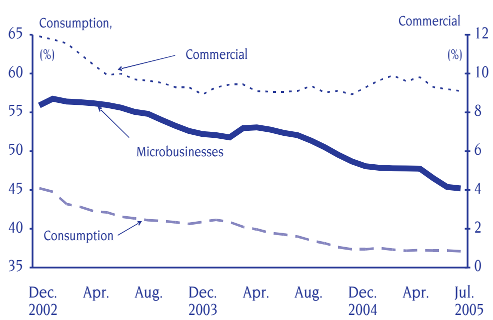
Table 21

INTEREST RATES IN DOMESTIC AND FOREIGN CURRENCY
(In percentage)

	Domestic currency				Foreign currency				Differential			
	Dec. 2003	Dec. 2004	May. 2005	Aug.* 2005	Dec. 2003	Dec. 2004	May. 2005	Aug.* 2005	Dec. 2003	Dec. 2004	May. 2005	Aug.* 2005
1. Interbank and FED funds rate	2.5	3.0	3.0	3.0	1.0	2.2	3.0	3.5	1.5	0.8	0.0	-0.5
2. Term deposits between 31 to 180 days	3.0	3.2	3.4	3.46	1.2	1.7	1.9	2.4	1.8	1.5	1.5	1.2
3. Term deposits between 181 to 360 days	4.2	4.4	4.6	4.7	1.6	1.8	2.1	2.3	2.6	2.6	2.5	2.4
4. Preferential corporate lending	3.3	3.8	4.0	3.8	1.7	2.6	3.6	4.3	1.6	1.2	0.4	-0.5
5. Average lending up to 360 days	14.0	14.7	15.1	15.3	7.2	7.7	8.2	8.7	6.8	7.0	6.9	6.6
6. Average lending, constant structure	19.0	18.2	18.1	17.7	9.4	9.4	9.7	9.8	9.6	8.8	8.4	7.9

* As of August 23.

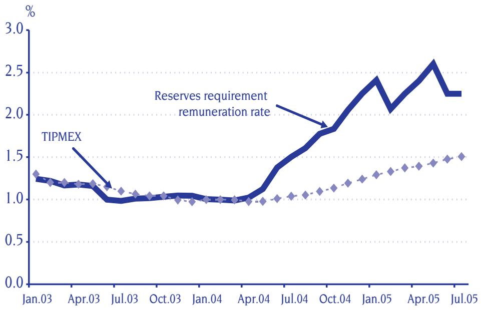
Graph 42
DOMESTIC CURRENCY INTEREST RATES FOR COMMERCIAL, MICROBUSINESSES AND CONSUMPTION LOANS



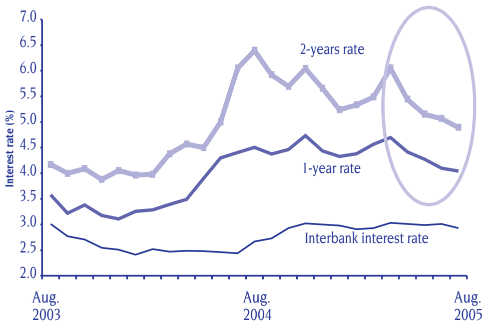
51. To illustrate the reduction in the banks' perception of credit risk it is useful to look at the behavior of interest rates on loans to borrowers perceived to carry a higher risk. The average interest rate charged by banks for loans in soles to microbusinesses fell from 47.7 percent in April to 45.2 percent in July.

In June 2005 it was decided that the interest rate paid to on dollar denominated reserve deposits would be fixed (at present it is 2.25 percent), and would no longer be linked to the three month LIBOR rate for dollar denominated loans. Fixing the interest paid on additional reserve deposits in dollars has prevented it from following the upward trend in international interest rates seen in recent months, providing a disincentive for a future rise in financial dollarization of the economy.

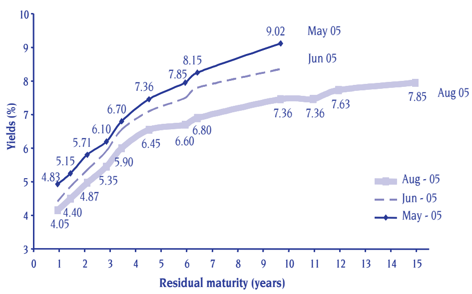
Graph 43
REMUNERATION RATE FOR ADDITIONAL RESERVES REQUIREMENT IN US DOLLARS AND TIPMEX
(In percentages)



Graph 44
PUBLIC STOCKS AVERAGE INTEREST RATES IN NUEVOS SOLES



Graph 45
PUBLIC TREASURY SOVEREIGN BONDS IN THE SECONDARY MARKET 1/



1/ Yields of sovereign bonds recorded in the secondary market as of the closest date to the end of period.

Yield curve

52. Between May and August 2005, interest rates on Certificates of Deposit of the Central Reserve Bank o Peru (CDBCRP) and sovereign bonds issued by the Peruvian Treasury (BTP) fell steadily, reversing the upward trend seen between February and April. In addition, the average maturities of both CDBCRPs and BTPs have increased in recent months.

    This evolution of interest rates for sol-denominated government securities coincides with a downward trend in country risk, which reached a historic low on the 17th of August: 145 bps.

53. As far as Public Treasury Bonds are concerned, there has been a significant reduction in interest rates for the longer maturities. For example, the yield rate for 10-year bonds fell from 9.0 percent in May to 7.4 percent in August. The increased number of non-resident investors in the market and a market preference for nominal bonds (those not indexed to inflation) were two characteristics of the most recent placements of Public Treasury Bonds.

Table 22

SOVEREIGN BONDS PLACED TROUGH THE MARKET MAKERS PROGRAM

Bond Denominated	Residual term	Primary issue Auction date (years)	Amount (mill. S/.)	Interest rate
MAY 2005				
11-Feb-2009	4	5/16/05	50.0	6.75%
31-Jan-2012	7	5/16/05	70.5	8.31%
13-Oct-2024	19	5/16/05	60.0	6.96%+VAC
Total			180.5	
JUNE 2005				
11-Feb-2009	4	6/13/05	45.0	6.60%
31-Jan-2012	7	6/13/05	60.0	7.85%
10-Aug-2011	6	6/14/05	60.0	7.67%
31-Jan-2035	30	6/14/05	45.0	6.98%+VAC
Total			210.0	
JULY 2005				
12-Aug-2017*	12	7/7/05	1,500.0	8.60%
12-Aug-2020*	15	7/15/05	1,050.0	7.84%
Total			2,550.0	
AUGUST 2005				
12-Aug-2016*	11	8/4/05	69.0	7.34%
10-Mar-2010	5	8/15/05	150.0	6.30%
13-Oct-2024	19	8/15/05	150.0	5.74%+VAC
Total			369.0	

* Aimed at prepayment operation to Paris Club debt (D.S. N° 080-2005-EF).

Table 23

INTEREST RATES OF SOVEREIGN BONDS IN THE SECONDARY MARKET
(percentages)

	09Oct07	09Jul08	11Feb09	10Mar10	10Aug11	31Jan12	05May15	12Aug20
2004								
December	6.76	7.11	8.14	8.51	9.60	-	-	-
2005								
January	5.87	6.40	6.97	-	8.70	-	-	-
February	5.63	6.10	6.35	7.30	8.26	8.68	-	-
March	5.69	6.36	6.79	7.68	7.79	8.59	-	-
April	6.03	6.44	6.95	7.80	8.25	8.63	-	-
May	5.83	6.28	6.73	7.56	8.06	8.31	9.30	-
June	5.40	6.03	6.52	7.06	7.65	7.83	8.72	-
July	5.04	5.51	6.08	6.51	7.10	7.21	7.86	7.87

Source: CRBP.

54. It is important to point out that sol denominated bonds at long maturities (10, 12 and 15 years) have been issued in the domestic government debt market for the first time. Placements of these bonds were enthusiastically received by foreign investors, who held 29 percent of the balance of sol denominated sovereign bonds by the end of July.

55. The extended maturities of public sector bonds in the local market was shadowed by the private sector. Thus, one of the private sector (Edelnor) was a 10-year bond (S/. 30 million), the longest maturity of any issue by the private sector.

    Gross placements between May and July amounted to S/. 978 million and amortizations were S/. 585 million, net placements (redemptions) being S/. 394 million.

56. The balance of CDBCRPs in August was S/. 9.9 billion, down from S/. 11.3 billion in March. The improved fiscal position and replacement of external debt with domestic debt made the Treasury an important purchaser of dollars and has contributed to this reduction in the balance of CDBCRPs. In addition, an increase during the year in demand for the monetary base reduced the need for sterilization through the issue of CDBCRPs.

    Placements of CDBCRPs sought to diversify maturities and at the same time to create reference levels for the yield curve in soles. Thus the participation by CDBCRPs with maturities equal to or greater than one year increased from 77 percent in April to 85 percent of the total balance of CDBCRPs in July.

Monetary aggregates

57. During the first half of 2005 there were important changes in the different monetary aggregates, even greater than during the previous year. The percentage rates of growth of the

BOX 4

EARLY PAYMENT OF FOREIGN DEBT TO THE PARIS CLUB

On the 15th of August the Peruvian government made an early debt repayment of US$ 1,555 million to the Paris Club. This amount corresponded to commercial debt repayments falling due in the period September 2005 to December 2009.

This operation extended the duration of the country's foreign debt by repaying a debt of 3.2 years duration financed by bonds maturing in 11, 12, 15 and 20 years (the joint duration of which is 11 years). Furthermore, a partial restructuring of foreign debt for domestic debt was made possible, resulting in lower exchange rate risk for the Treasury. The currency in which public debt is denominated plays an important role in the classification of a country's sovereign debt, as a country is more vulnerable to a depreciation of the real exchange rate caused by a reversion of external capital flows (a fall in the terms of trade) when it relies proportionally more heavily on debt denominated in foreign currency than on that denominated in domestic currency.

This transaction was financed by domestic and external issues of sovereign bonds:

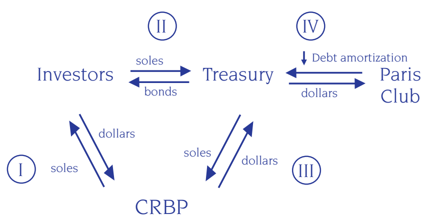
PREPAYMENT OPERATION STRUCTURE TO PARIS CLUB
(Millions of US$)

Commercial debt to prepay	**1,555**
Net financing	**1,555**
Bonds placed in domestic market (S/. 1,500 millions, 12-year term)	462
Bonds placed in domestic market (S/. 1,050 millions, 15-year term)	323
Bonds placed in domestic market (S/. 69 millions, 11-year term)	21
Bonds placed in external market (20-year term)	750

The monetary and exchange rate operations associated with sovereign bond issues in the domestic market for significant amounts in July (S/. 1,500 million on the 7th and S/. 1,050 million on the 15th can be divided into the following stages:

Stage I: Accumulation of domestic currency by potential purchasers. The issue of sovereign bonds attracted the interest of investors, mainly from abroad. These investors had funds in foreign currency, so a significant increase in the supply of dollars in the local foreign exchange market was envisaged on dates prior to each issue liquidation of government securities.

PREPAYMENT OF EXTERNAL DEBT STAGES



The CRBP ensured that soles were available for investors through purchases of dollars in the foreign exchange market. Thus, between the 6th and 18th of July, the period covering both issues (the 8th and 18th of July, respectively), the CRBP purchased US$ 576 million in the foreign exchange market.

Stage II: Placement of sovereign bonds. The Treasury issued the bonds through the market makers (banks). In this context, as part of its duty to regulate the currency market, the CRBP provided temporary liquidity through repos amounting to S/. 553 million on the 8th of July and S/. 400 million on the 18th of July in order to offset withdrawals of funds resulting from the operation and to prevent rises in the interbank interest rate.

Later, the banks would transfer the bonds to local and foreign investors in the secondary market for BTPs.

Stage III: Purchase of foreign currency by the Treasury. The Treasury needed to exchange sol-denominated funds obtained into dollars to make the debt repayment. The CRBP sold foreign currency to the Treasury in order to carry out the operation, without this having an impact on the foreign exchange market.

Stage IV: Early payment of debt to the Paris Club. The Peruvian government made a payment of US$ 1,555 million on the 15th of August 2005.

Graph 46
CDBCRP YIELDS BY MATURITY

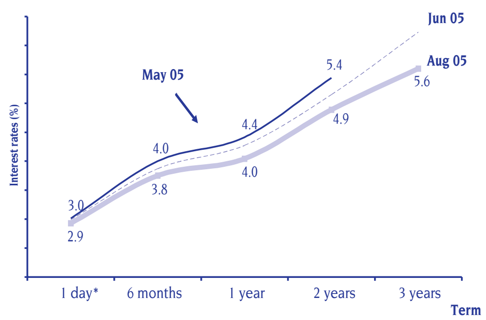


Table 24

CDBCRP BALANCE BY MATURITY
(Millions of nuevos soles)

	2004				2005			
	Mar.	Jun.	Sep.	Dec.	May.		Aug.	
					Amount	%	Amount	%
Up to 3 months	215	130	145	155	160	1.7	25	0.3
4 to 6 months	1,045	425	505	495	614	6.4	340	3.4
7 months to 1 year	2,913	2,758	3,831	4,245	4,599	48.0	4,643	47.0
1 to 2 years	640	640	890	1,610	2,270	23.7	2,705	27.4
2 and 3 years	1,185	1,235	1,360	1,750	1,930	20.2	2,170	22.0
Total	**5,998**	**5,188**	**6,730**	**8,255**	**9,573**	**100.0**	**9,883**	**100.0**
Memo:								
Average CDBCRP balance's interest rate	3.7%	3.8%	4.1%	4.5%	4.6%		4.6%	

Source: CRBP.

narrowest monetary aggregates (money in circulation and the monetary base) were on average in excess of 27 percent during 2005 and have continued to rise since the beginning of the year. This greater demand for money for transactions reflects the continued dynamism of economic activity, lower deposit interest rates in soles and the process of dedollarization, so that growth in the monetary base has not caused any inflationary pressure.

58. Between January and August the monetary base increased by S/. 0.8 billion. Over this period net purchases of dollars amounted to US$ 1.6 billion (US$ 3.1 billion purchased over the counter, offset by sales to the public sector of US$ 1.4 billion), a monetary expansion that was attenuated by

Table 25

MONETARY AGGREGATES OF THE BANKING SYSTEM
(Average percentage change)

	2001	2002	2003	2004	2005*
Currency	3.8	17.3	9.6	21.3	28.0
Monetary base	3.2	15.8	7.4	18.8	27.1
Deposits in domestic currency	8.1	17.1	11.0	14.2	33.8
Liquidity in domestic currency	6.9	17.0	10.7	16.2	32.1
Total liquidity	4.2	4.8	2.8	3.8	11.0
Credit to the private sector in domestic currency	1.8	5.3	8.7	6.7	14.0
Total credit to private sector	-2.6	-1.4	-4.0	-1.1	1.7

* As of July.

increased public sector deposits with the Central Bank (S/. 3.3 billion) and by net placements of CDBCRPs (S/. 1.9 billion).

59. The downward trend shown by indicators of financial dollarization in recent years continued in 2005, although at a slower rate.

60. Between January and July, financial system lending to the private sector increased 10.6 percent in soles and 5.1 percent in dollars. This lifted the annual rate of growth of loans in soles from 11 percent in December 2004 to 19.3 percent in July

Table 26

SOURCES OF VARIATION OF THE MONETARY BASE
(Millions of nuevos soles)

	2002	2003	2004	2005 Jan-Aug
I. FOREIGN EXCHANGE OPERATIONS	**436**	**3,465**	**6,239**	**5,234**
(Millions of US$)	*128*	*998*	*1,854*	*1,607*
1. Over-the-counter net purchases	- 32	1,050	2,340	3,097
2. Public sector	157	- 51	- 487	-1,493
3. Other	3	- 1	2	3
II. MONETARY OPERATIONS	**236**	**-2,783**	**-4,353**	**-4,377**
1. Public sector	- 81	- 921	- 721	-3,057
2. Repos	170	-170	0	0
3. CDBCRP	- 114	-2,143	-4,158	-1,628
4. Other	261	450	526	308
III. TOTAL	**672**	**682**	**1,886**	**857**
End of period percentage change	11.0	10.1	25.3	9.2
Average percentage change	15.8	7.4	18.8	30.7
Note:				
End of year balances				
CDBCRP	1,944	4,097	8,255	9,883
Deposits of public sector	275	1,196	1,918	4,975
Monetary base	6,759	7,441	9,327	10,184

Graph 47
FINANCIAL SYSTEM CREDIT TO THE PRIVATE SECTOR
(Annual rates of growth)

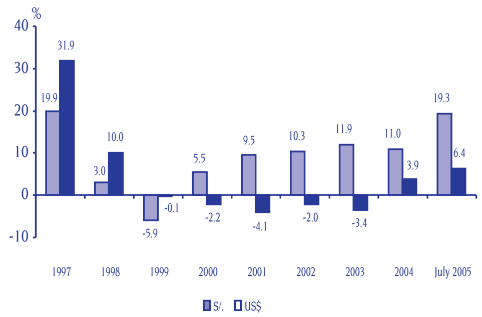


Table 27

FINANCIAL DOLLARIZATION INDICATORS
(In percentages of the total monetary aggregate)

Year	Total liquidity of the Banking System	Credit of the Banking System to the private sector	Credit of the Financial System to the private sector
1993	69	76	77
1994	64	74	74
1995	63	71	72
1996	67	74	72
1997	65	77	75
1998	69	80	79
1999	70	82	82
2000	70	82	81
2001	67	80	78
2002	65	79	76
2003	62	77	73
2004	55	74	71
2005 1/	53	73	69

1/ Up to July 2005.

2005 and that of dollar denominated loans from 3.9 percent in December 2004 to 6.4 percent in July 2005.

61. The expansion of lending in soles between January and July 2005 (S/. 1,744 million) was mainly due to the banks (S/. 766 million), especially consumer loans (S/. 481 million), microfinance institutions (S/. 551 million), and institutional investors (S/. 310 million). Thus, annual growth of bank lending to the private sector accelerated from 3 percent in December 2004 to 14.1 percent in July 2005.

Table 28

EVOLUTION OF DOMESTIC CURRENCY FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR

	Balances in millions of soles			Rates of growth	
	Jul04	Dec04	Jul05	Jul.05/ Jul.04	Jul.05/ Dec.04
Banks 1/	8,087	8,464	9,230	14.1	9.0
Banco de la Nación	814	1,051	1,153	41.7	9.6
Microfinance institutions	**3,772**	**4,329**	**4,880**	**29.4**	**12.7**
Banks (microfinance loans)	966	1,120	1,290	33.5	15.2
Local savings and loans	1,184	1,376	1,571	32.7	14.1
Rural savings and loans	215	253	292	35.3	15.4
Cooperatives	451	511	550	22.1	7.7
Edpymes	186	229	262	40.6	14.1
Finance companies	770	840	916	19.0	9.1
Institutional investors 2/	**2,304**	**2,307**	**2,617**	**13.6**	**13.4**
Pension funds	1,498	1,337	1,539	2.7	15.1
Insurance companies	628	812	808	28.8	-0.5
Mutual funds	178	158	270	51.8	70.7
Leasing companies and others	**280**	**306**	**321**	**14.6**	**5.0**
Total for Financial System	**15,258**	**16,457**	**18,201**	**19.3**	**10.6**

1/ Excludes microfinance loans.
2/ Mainly securities issued by the private sector.

62. The increase in lending in foreign currency (US$ 619 million) was basically the work of the banks (US$ 649 million) mainly because of increased lending for foreign trade (US$ 270 million) and mortgage loans (US$ 162 million), which was partially offset by lower loans to institutional investors (US$ 87 million). It should be pointed out that banks' annualized rate of growth in July 2005 was 5.2 percent, well above the rate recorded in December 2004 (0.6 percent).

Table 29

EVOLUTION OF FOREIGN CURRENCY FINANCIAL SYSTEM LOANS TO THE PRIVATE SECTOR

	Balances in millions of US dollars			Rates of growth	
	Jul04	Dec04	Jul05	Jul.05/ Jul.04	Jul.05/ Dec.04
Banks 1/	9,611	9,465	10,114	5.2	6.9
Banco de la Nación	22	22	22	-0.4	-0.2
Microfinance institutions	**567**	**665**	**714**	**25.9**	**7.3**
Banks (microfinance loans)	101	126	153	52.2	21.6
Local savings and loans	217	250	271	24.8	8.4
Rural savings and loans	48	55	54	12.5	-2.8
Cooperatives	130	154	151	16.5	-1.6
Edpymes	43	49	51	19.5	5.7
Finance companies	29	32	33	15.5	5.7
Institutional investors 2/	**1,158**	**1,333**	**1,246**	**7.7**	**-6.5**
Pension funds	572	729	648	13.3	-11.1
Insurance companies	68	89	95	40.2	6.4
Mutual funds	518	515	503	-2.9	-2.3
Leasing companies and others	**621**	**639**	**648**	**4.3**	**1.4**
Total for Financial System	**11,979**	**12,125**	**12,744**	**6.4**	**5.1**

1/ Excludes microfinance loans.
2/ Mainly securities issued by the private sector.

II. FORECASTS 2005 - 2006

II.1 International context and external accounts

Growth prospects for the world economy remain favorable, although at lower rates than the previous year as the FED's interest rate increases have withdrawn monetary stimulus from the U.S. economy. In this context, an increase in the average prices of the main commodities is envisaged, especially oil, which could result in a bigger drop in the terms of trade (6.1 percent) and a lower trade balance surplus (US$ 3,015 million) in 2006.

The international panorama

63. The world economy is growing at lower but more sustainable rates because of the moderate and gradual withdrawal of monetary stimulus, particularly by the United States and China.

64. Forecast growth of our principal trading partners for 2005 remains at 3.5 percent (compared to 4.6 percent last year) with significant rates for China and the United States, which compensate for the sluggishness of the euro zone and Japan, even though forecast growth for the latter country has been revised upwards.

    It should be noted that growth of 3.6 percent in the United States and 9.1 percent in China explains around 15 percent and 25 percent of growth in the world economy, respectively[1/].

65. Growth forecasts for the **United States** in 2005 have improved from 3.4 percent in May to 3.6 percent in August as a result of favorable growth indicators in certain economic sectors. Thus, the North American economy grew 3.4 percent in the second quarter of 2005, the ninth consecutive quarter in which the economy grew at a rate above 3 percent. To this can be added, among other indicators, an improvement in consumer confidence in the second quarter of the year (after successive falls associated with high oil prices) and an improvement in employment indices, particularly for non-farm jobs.

1/ According to IMF estimates (World Economic Outlook, April 2004) the shares of U.S. and China in the world economy adjusted by the purchase power parity are 20 and 13 percent, respectively.

In this context the FED has gradually increased interest rates, also aimed at containing inflationary pressures caused, in part, by higher oil prices.

66. The FED's interest rate changes differ from those in other economies, including developed ones. The European Central Bank kept its rate at 2 percent, while the central banks of the United Kingdom and Sweden reduced their rates by 25 and 50 bps respectively.

The central banks of Brazil and Mexico have kept their interest rates unchanged in recent months, after making significant adjustments in the early part of the year. The Central Bank of Chile, on the other hand, continued to tighten its policy stance, increasing rates on six occasions, to 3.75 percent, within a context of inflationary pressure and accelerated growth in domestic demand.

Graph 48
CENTRAL BANKS' INTEREST RATES AS OF AUGUST 2005
(%)

* 12 - month CPI - Aug 2005; ** 12 month CPI - Jun 2005.

Table 30

COMPARATIVE CENTRAL BANKING DECISIONS IN 2005 UP TO NOW

Country	Interest rate	Committee meets	Direction	Last meet	Dec.04	Actual
United States (FED)	Federal funds	5	5 rises	9-Aug-05	2.25	3.50
ECB	Minimal auction	8	unchanged	4-Aug-05	2.00	2.00
Japan 1/	liquidity target (bills. of yens)	10	unchanged	9-Aug-05	30 - 35	30-35
United Kingdom	Repo	8	1 fall	4-Aug-05	4.75	4.50
Brazil	Selic	7	5 rises	20-Jul-05	17.75	19.75
Chile	Monetary policy	8	6 rises	11-Aug-05	2.25	3.75
Colombia	Repo (reverse)	7	unchanged	22-Jul-05	6.50	6.50
Mexico 2/	Corto (mill MXN average daily)	15	3 rises	12-Aug-05	-69	-79

1/ Mexico and Japan have influence on their interest rates through liquidity changes.
2/ An increment of "corto" implies less liquidity.

67. Similarly, **Japan** has increased its growth forecast for 2005 from 1.0 percent in May to 1.6 percent at present. In the second quarter of the year the Japanese economy grew at an annualized rate of 1.4 percent, benefiting from the depreciation of the yen against the dollar and more robust domestic consumption.

68. In **Europe**, growth forecasts remain modest, particularly in the main economies of the euro zone such as Germany and Italy. The United Kingdom also experienced a deceleration, for which reason the Bank of England decided to reduce interest rates (from 4.75 to 4.50 percent). It should be pointed out that high oil prices and low levels of consumer confidence continue to entail a risk of deceleration in the euro zone.

69. **China** experienced higher than expected growth in the first half of the year. Consequently, the government revalued the yuan by 2.1 percent against the dollar and announced a new floating exchange rate regime to be managed within a band of +/-0.3 percent, which also addresses international pressure to reduce U.S. trade imbalances.

Table 31

GROWTH IN PERU'S MAIN TRADING PARTNERS 1/

		Forecasts				
		2005			2006	
	2004	January	May	August	May	August
Trading partners	**4.6**	**3.5**	**3.5**	**3.5**	**3.4**	**3.4**
North America	**4.3**	**3.6**	**3.4**	**3.5**	**3.3**	**3.3**
USA	4.4	3.6	3.4	3.6	3.3	3.3
Canada	2.7	2.8	2.6	2.7	3.0	2.9
Europe	**2.4**	**2.0**	**1.9**	**1.6**	**2.1**	**2.0**
United Kingdom	3.2	2.5	2.5	2.0	2.3	2.2
Germany	1.7	1.2	0.8	0.9	1.4	1.3
Asia	**5.6**	**4.2**	**4.4**	**4.6**	**4.6**	**4.4**
Japan	2.9	1.1	1.0	1.6	1.7	1.5
China	9.4	8.2	8.8	9.1	8.0	8.1
Latin America	**6.9**	**4.7**	**4.9**	**4.9**	**4.2**	**4.2**
Chile	5.8	5.5	5.8	5.9	5.0	5.2
Brazil	5.1	3.8	3.7	3.0	3.7	3.4

1/ Data of Consensus Forecast in the month.

Table 32

INFLATION IN PERU'S MAIN TRADING PARTNERS 1/

		Forecasts				
		2005			2006	
	2004	January	May	August	May	August
Trading partners	**3.4**	**3.2**	**3.3**	**3.6**	**3.2**	**3.4**
North America	**3.1**	**2.6**	**2.8**	**3.5**	**2.6**	**3.3**
USA	3.0	2.5	2.8	3.6	2.5	3.3
Canada	1.8	1.9	2.0	2.1	2.0	2.0
Europe	**1.8**	**1.8**	**1.9**	**2.0**	**1.9**	**1.9**
United Kingdom	1.3	1.7	1.8	1.9	1.9	1.9
Germany	1.7	1.3	1.4	1.7	1.3	1.5
Asia	**2.1**	**1.8**	**1.7**	**1.4**	**1.8**	**1.6**
Japan	0.0	0.0	-0.1	-0.2	0.2	0.2
China	3.9	3.4	3.2	2.5	3.1	2.6
Latin America	**6.9**	**7.0**	**7.0**	**6.9**	**6.8**	**6.7**
Chile	2.4	2.8	2.6	3.1	2.9	3.0
Brazil	7.6	6.0	6.3	6.0	5.5	5.3

1/ Data of Consensus Forecast in the month.

70. As far trading partners in the region are concerned, growth rates are among the highest in recent years. The region is expected to grow 4.9 percent in 2005, similar to the growth forecast included in the May Inflation Report. These economies should continue to benefit from high raw materials prices and still low international interest rates. In this context, the Chilean economy stands out, with growth in 2005 at 5.9 percent, contrasting with 3 percent growth in Brazil.

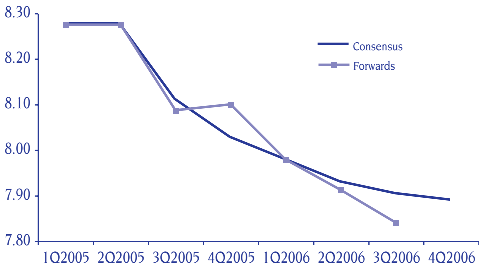
BOX 5

IMPACT OF THE REVALUATION OF THE YUAN

After maintaining a fixed exchange rate since 1994, in July China revaluated the yuan by 2.1 percent and announced that it would let the currency float within a band of +/-0.3 percent against a basket of currencies. It later said that this basket would consist of the currencies of countries whose bilateral trade is worth more than US$ 5 billion or which have direct investment or significant debt with China (such as the dollar, euro, yen and Korean won). The Chinese authorities have not ruled out future additional adjustments to the yuan.

The Chinese government has thus responded to international criticism that the yuan was undervalued and that this was contributing to imbalances in the world economy, reflected mainly by the United States' record current account deficit. The revaluation of the yuan also has a domestic objective, which is to avoid an overheating of the economy, which grew 9.5 percent in the first half of the year.

Forecasts: yuan per U.S. dollar



Source: Consensus Forecast (August 2005) and Bloomberg.

Nevertheless, several analysts and investors have said that the yuan should be more flexible and appreciate further; indeed, the forward markets and Consensus Forecast expect an additional appreciation of 3.0 percent over the year to December 2005 and 1.7 percent to December 2006. This position is backed by academic research that concludes that the yuan's undervaluation could be higher; Goldstein (2005), for example, estimates the appreciation at between 15 and 25 percent[1/]. Under this light, the July revaluation was modest and should not seriously affect financial markets or trade. As far as trade is concerned, Goldstein (2005) says that any fluctuation in the dollar will be of little significance if there is no participation by the Asian currencies (including Japan's), which together amount to 40 percent of the United States' foreign trade.

Thus the revaluation of the yuan has had a short-term effect on raw material prices, as these products have become cheaper in yuan terms. For this reason, metal prices at the London Metal Exchange (LME) rose to reflect China's increased purchasing power. According to the International Monetary Fund, China represents around 20 percent of world demand for copper, 19 percent of that for aluminum and 27 percent of demand for iron ore. Peru, on the other hand, provides 95 percent of exports to China of products such as copper, fishmeal, lead, iron ore and molybdenum.

Nevertheless, this impact is likely to be moderate because the appreciation of the yuan was very small, and other supply and demand factors play a much more significant role in determining prices.

1/ Goldstein "What might the next emerging-market financial crisis look like?", July 2005, IIE, WP05-7

The dollar in international markets

71. Between January and August 2005 the dollar appreciated against the main world currencies because of the FED's continued interest rate rises, which have lifted the interest rate differential between the United States and Europe in favor of the former, and increased demand for variable yield securities given favorable prospects for the U.S. economy in general and companies in particular. The rejection of the European constitution by France and the Netherlands in May and June this year, respectively, also contributed to the strengthening of the dollar. Thus the dollar appreciated 8.7 percent against the euro, 7.5 percent against sterling, and 6.5 percent against the yen.

72. The May forecasts remain valid and few variations are envisaged for the rest of the year, though with a certain dispersion. Recent forecasts (August Consensus Forecast)

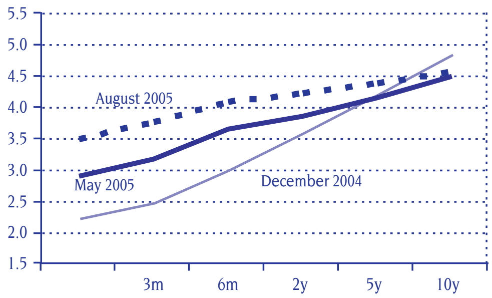
Table 33

TRADE BALANCE AMONG PERU'S MAIN TRADING PARTNERS 1/
(Percentage of GDP)

	2004	2005	2006
United States of America	-5.7	-5.8	-5.7
United Kingdom	-2.2	-2.3	-2.4
Chile	1.5	0.9	-1.3
Japan	3.7	3.3	3.5
China	4.2	4.1	4.0
Brazil	1.9	1.1	0.4
Germany	3.6	3.8	3.4
Colombia	-1.1	-2.6	-2.6
Spain	-5.0	-4.8	-5.4
Venezuela	13.5	12.0	8.4
Korea	3.9	3.6	2.9
Mexico	-1.3	-1.4	-1.6
Argentina	2.0	-1.2	-2.9
Italy	-1.5	-1.3	-0.9
Canada	2.6	2.6	2.5
France	-0.3	-0.4	-0.1
Belgium	4.2	4.3	4.2
Taiwan	6.2	6.6	5.9
Bolivia	2.7	2.6	2.4
Netherlands	3.4	4.2	4.5

1/ Source: WEO, April 2005.

Graph 49
U.S. FINANCIAL STOCKS YIELD CURVE
(%)



have the dollar depreciating slightly towards the end of 2005 and in 2006. This scenario assumes that there will be no sudden changes in U.S. external accounts nor significant additional adjustments in China's exchange rate regime.

International interest rates

73. United States interest rates have been rising since the second half of 2004 when the FED began a cycle of controlled increases in its monetary policy rate. Since that date the rate has been increased ten times, rising from 1.0 percent to 3.5 percent.

74. These successive increases in the United States' monetary policy rate have not been evenly transmitted to longer term rates, for which reason the slope of the yield curve has flattened compared to that described in the May Report. 30-year United States Treasury bond yields fell from 4.48 percent in May to 4.46 percent in August (a fall of 39 bps compared to December 2004), an insignificant change. This behavior could be associated with the demand from foreign central banks, mainly in Asia for United States Treasury securities.

BOX 6

"INVERTED" YIELD CURVE FOR UNITED STATES TREASURY BONDS AS AN ADVANCED INDICATOR OF ECONOMIC ACTIVITY

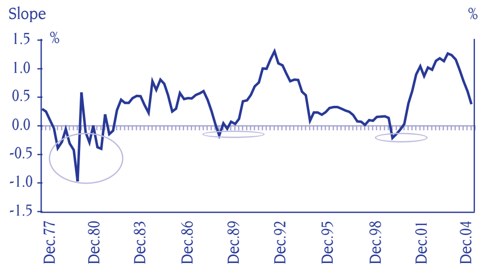
Since June 2004 the FED has been raising interest rates gradually (by 250 bp, from 1.0 to 3.5 percent) and the market expects that this will continue at future meetings. Nevertheless, between June 2004 and August 2005 long-term interest rates remained relatively stable and have even fallen (the 30-year rate fell from 4.85 percent in December 2004 to 4.46 percent in August 2005). For this reason the yield curve has started to flatten for maturities above 2 years (the long term section).

If short-term rates continue to rise and long-term rates remain relatively stable, an "inverted curve" could result. The fear of an "inverted curve" has attracted the attention of investors and market analysts because past experience associates this problem with later periods of recession or slower growth.

As can be seen in the following illustration, inverted yield curves have existed four times in the last 30 years in the U.S.: Aug. 78 - Aug. 80, Jan. - Sept. 89 and, more recently, Feb. - Nov. 2000. Each of these episodes of inverted yield curve [1/] (lasting 6 quarters approximately) was followed by a period of slower growth, as can be seen in the following figures.

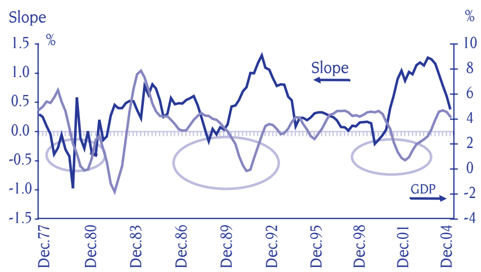
Nevertheless, recent variations in long-term interest rates for U.S. Treasury bonds could reflect other factors and may not necessarily lead to an economic slowdown. In the first place, there is a high

Yield curve slope



demand for long-term securities from foreign buyers (especially in Asia) and pension and investment funds. Today, according to U.S. Treasury statistics (information to April 2005) foreigners hold Treasury bonds worth US$ 1,990 billion, of which 62 percent are official holdings (foreign central banks, particularly those of Japan and China). Certain changes in regulations and preferences on the part of institutional investors (basically investment and pension funds) may also be having an influence by preferring long-term bonds. Parallel to this demand, issues of bonds have been limited in that the U.S. Treasury has consistently reduced long-term bond issues.

Slope of the yield curve and quarterly economy growth in the U.S. (%)

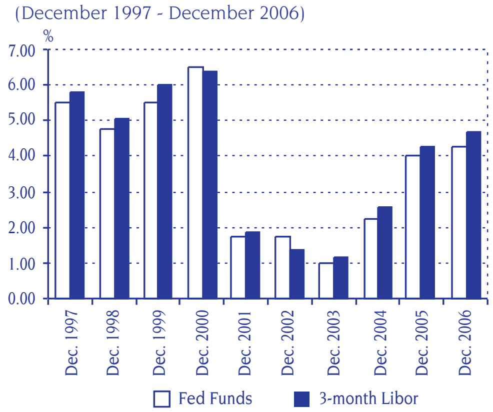


Long term rates also reflect expectations of future short-term rates. For this reason, long-term rates rose sharply in the first half of 2004, when the market was expecting the FED to start increasing interest rates. Thus, towards the end of January 2004 the 10-year rate increased when the FED withdrew from its press release for that month the phrase when qualifying the maintenance of a relaxed monetary policy "for a considerable period". The same occurred in May, when the FED added that "if interest rates are increased the adjustment will be gradual". Therefore, when the FED began its cycle of rate increases in June 2004, the market had already assimilated the change in policy. Later decisions by the FED were in line with expectations, the rates increasing gradually in increments of 25 bps. These rate rises have not therefore had a major influence on long-term rates.

These factors help to explain the flattening of the yield curve and reduce the possibility that this flattening could precede a slowdown in the United States' economy. In recent months at least, there have been no significant changes in growth expectations, which remain favorable. Indeed, given the changes in indicators of the U.S. economy during August, growth forecasts have been revised upwards.

1/ The "inverted curve" analysis covered the section between the 10-year bond and the 2-year bond.

Graph 50
USA: FED INTEREST RATES
(December 1997 - December 2006)



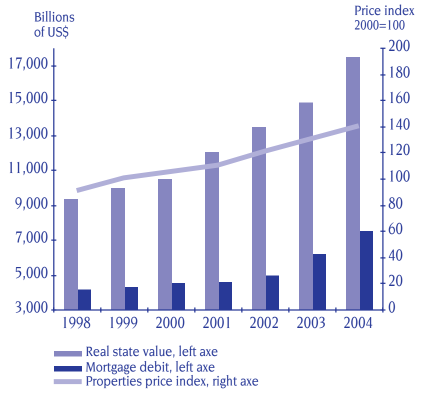
75. 3-month and 12-month LIBOR rates shadowed the changes in the FED interest rates. It is estimated that the FED will make most of its interest rate changes in what remains of this year (4.0 percent at the end of 2005) and will make only an additional adjustment of 25 bps in 2006.

BOX 7

RISK OF REAL ESTATE MARKET OVERHEATING

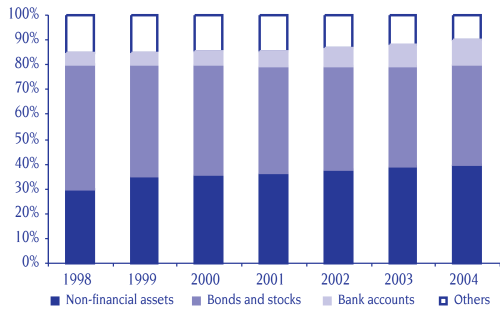
During the economic slowdown at the beginning of the decade, the real estate market was one of the most dynamic sectors, partly favored by low interest rates that encouraged refinancing and new mortgages. The boom in this market is a phenomenon that has been observed not only in the United States but also in the

Real estate value and mortgage debt



Source: Global Financial Stability Report, April 2005.

Overall composition of U.S. wealth by assets



Source: Global Financial Stability Report, April 2005.

majority of the developed countries. According to different sources, house prices have risen around 65 percent since 1997 in the United States while in the United Kingdom property has risen 75 percent since 2001. According to the Federal Real Estate Companies Office, prices throughout the United States have risen on average more than 11 percent in the last year alone.

There is no consensus over whether there is a speculative bubble in this market. Nevertheless, in a context of rising interest rates there is a risk of a downward correction in house prices. Among other effects, this would affect wealth, because real estate is increasing as a share of total wealth in the United States. Non-financial wealth (the principal component of which is real estate) currently represents around 40 percent of total wealth in the U.S. and 50 percent in Europe. This reduction in wealth would reduce consumption and cause investment to withdraw from the sector, which would translate into an eventual fall in aggregate demand and, therefore, a slowdown in world growth.

Terms of trade

76. High prices, above international forecasts, have been sustained by the strength of world demand for basic commodities, principally because the Chinese economy has been growing faster than the market expected and because supply and demand for commodities are nearly balanced, while inventories are low.

77. Future prices in the main world exchanges indicate that the market expects a gradual correction in international prices. This could continue during 2006 as the world economy grows modestly, associated with less monetary stimulus, particularly in the United States, and the correction of the yuan, which is seen as the first step towards a more flexible currency.

78. Metal prices are forecast to fall gradually with copper reaching US$ 1.58 a pound, gold US$ 432 per ounce and zinc US$ 0.59 per pound on average in 2005, after copper reached a historic high in August, while gold and zinc prices have been rising since June 1988 and October 1997 respectively.

BOX 8

FORECASTING THE TERMS OF TRADE

The terms of trade express the relative prices of exports compared to imports and therefore measure the purchasing power of our exports. Better terms of trade improve Peru's external and fiscal accounts, and increase national disposable income, and consequently have a positive effect on economic activity. In order to predict the terms of trade, Fisher’s chain-linked index was used. Building the index required the monthly linking factor to be calculated using the geometric mean of the Paasche and Laspeyres indices.

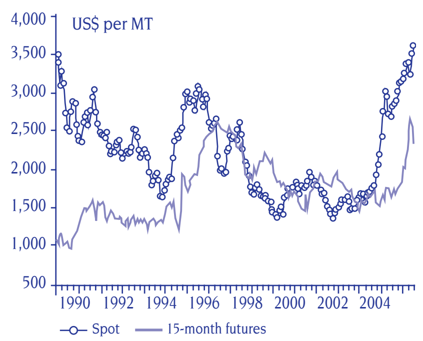
The export prices index was calculated as the weighted average of Peru's main traditional export products and a basket of prices of our main trading partners for the remaining traditional exports and all non-traditional exports. The import prices index was calculated as a weighted average of the main foodstuffs and fuels and the same basket of external prices for the rest of the country's imports. This basket of external prices was based on the variation in the retail prices indices of Peru's principal trading partners, as well as the variation of their currencies against the dollar.

The forecast of the terms of trade was based on future contract prices of commodities traded on the world's main exchanges. In the specific case of oil, the price of WTI crude was used as a reference.

These prices were calculated using weighted averages of the last thirty observations before the date of the estimate, and these were compared with values estimated by multilateral entities (such as the International Monetary Fund), international agencies (such as the International Energy Agency), and private estimates. If there were no future contracts for a given product, the estimates provided by these bodies were used as the basic input.

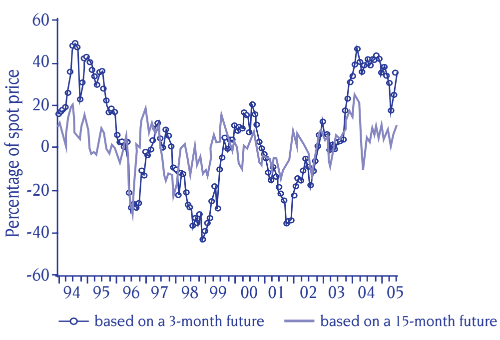
Copper futures have reflected the market's belief that between this year and the next there will be a modest recovery in inventories, which have been run down in recent years. It is expected that the price trend for copper will reverse over the next few months. This is due in part to more moderate growth in China compared to the first semester caused, among other factors, by the Summer energy shortages that have occurred in previous years. Similarly, the forecasts of world supply for 2005 and 2006 indicate growth in excess of an accumulated 10 percent, compared to 2004 according to reports from Cochilco (11 percent) and private institutions[1/], and growth in demand of up to 7 percent[2/] over the same period. The high price of copper in recent months was due in part to stronger than expected demand for the metal, resulting in lower inventories, which exacerbated the effects of short-term disruptions in supply caused by stoppages in Peru, Chile, the United States and Zambia.

15-month Copper spot and futures



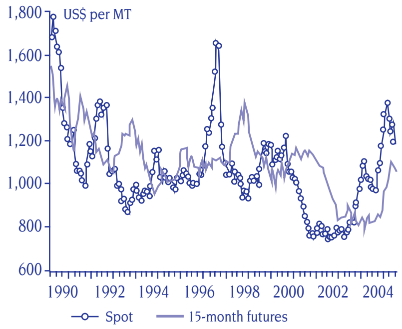
Oil, on the other hand, has long overtaken the band imposed earlier by OPEC, principally because of demand from China and, in the first quarter, Japan, which is expected to persist despite record prices. On the supply side, high prices have also been influenced by stoppages caused by U.S. refineries operating near to capacity and the inability of OPEC countries to increase production significantly in the short term. In the second semester and next year it is expected that consumption will be driven by growth in demand from China and the countries of the former Soviet Union[3/]. The Atlantic hurricane season is expected to be very active[4/] and this could affect the supply of crude at certain periods.

Cooper price: gap between spot and forecast prices

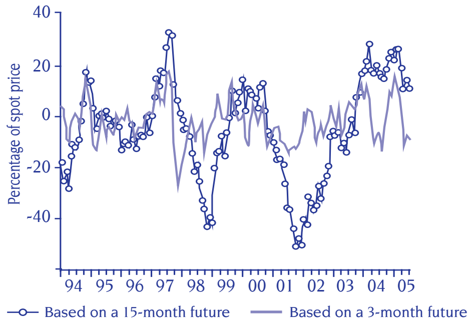


As far as **gold** is concerned, the dollar's fluctuations and depreciatory tendency, as well as the effect on inflation of the high oil price

15-month Zinc spot and futures



Zinc price: gap between spot and forecast prices



provoked an increase in the price of gold to levels not seen since the end of the nineteen eighties.

In the **zinc** market it is currently thought that prices will stabilize in the second half of the year due, among other factors, to a reduction in the price of copper. Nevertheless, this effect will be temporary because it is also expected that there will continue to be a shortage of the metal for the next two years5/.

For this reason, forecasts based on future contracts are subject to error in periods of high volatility and severe market imbalances. This is the case now, when the markets for precious and base metals and energy suffer from imbalances on both the supply and demand sides. It is possible that, despite the fact that futures incorporate all available market information, the error in estimation in a period marked by increased speculation and market imbalances could be considerable.

It should be pointed out that over the last 10 years absolute margins of error between 15-month futures and prices paid were 19 percent for copper and 15 percent for zinc.

Notes

1/ The Metal Bulletin Research gives partial forecasts of the growth in supply of 17 percent, while the International Copper Study Group suggests growth of 15 percent for the period 2006 - 2004.

2/ Chilean Copper Commission. Copper Market Report 2005, 2nd quarter, July 2005.

3/ Energy Information Administration. Short Term Energy Outlook. August 2005.

4/ Predictions of the NOAA (National Oceanic and Atmospheric Administration). August.

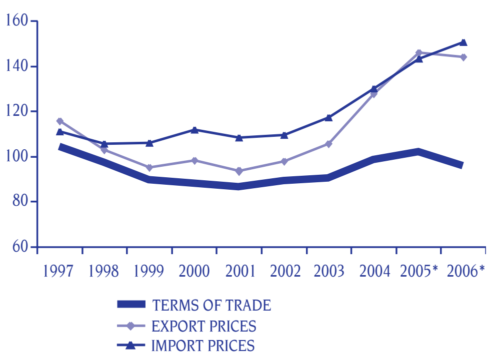
5/ Metal Bulletin Research. July 2005.

79. The price of oil could remain at around US$ 65 a barrel to the end of the year. It is therefore forecast that the average price of WTI crude could rise from an average of US$ 41 a barrel in 2004 to US$ 57 a barrel in 2005. The price has remained above the May forecast because of low inventories within a context of interruptions in the supply caused by the weather, tension in the Middle East, and strikes in certain important producer countries.

80. It should be said that in a context of highly volatile commodity prices the dispersion in the forecasts is relatively high, as can be seen from table 34.

81. Using data from the first semester and a gradual price correction, forecasts for **2005** have been revised upwards because of an improvement in the terms of trade, of 3.5 percent compared to the reduction of 2.3 percent forecast in the May Report. This would be the result of an increase in export prices of 14.1 percent, higher than the 10.2 percent increase in import prices. The level of both the terms of trade index (101.9) and the export prices index (146.0), could be significantly higher than the average for the last five year period (90.4 and 104.8, respectively).

Graph 51
TERMS OF TRADE INDEX AND EXPORT & IMPORT PRICES: 1997 - 2006



* Forecast.

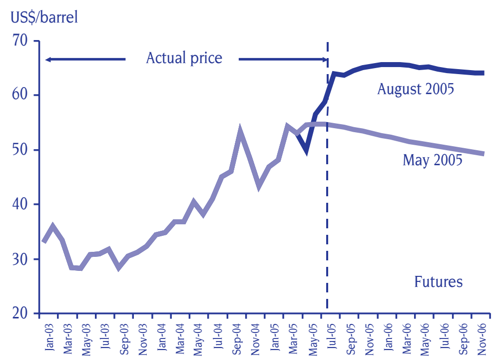
Table 34

COMMODITIES PRICES

		2004 [1/]		2005		2006	% var. 2005	% var. 2006
		Dec.	Average	Jul.	Average	Average	Average	Average
COPPER (cUS$/lb)	Inflation report [2/]	142.7	130.0	163.9	157.8	142.3	21.4	-9.8
	COCHILCO [3/]	---	---	---	146.0	120.0	12.3	-17.8
	REUTERS average [4/]	---	---	---	143.6	121.6	10.5	-15.3
	REUTERS median	---	---	---	143.6	120.0	10.5	-16.4
	REUTERS maximum	---	---	---	157.0	155.0	20.8	-1.3
	REUTERS minimum	---	---	---	132.0	99.8	1.5	-24.4
GOLD (US$/oz.tr)	Inflation report [2/]	442.2	409.8	425.1	432.3	445.5	5.5	3.0
	REUTERS average [4/]	---	---	---	432.0	441.6	5.4	2.2
	REUTERS median	---	---	---	433.3	450.0	5.7	3.9
	REUTERS maximum	---	---	---	462.0	500.0	12.7	8.2
	REUTERS minimum	---	---	---	412.0	385.0	0.5	-6.6
ZINC (cUS$/lb)	Inflation report [2/]	53.5	47.5	54.2	59.4	60.2	25.0	1.4
	REUTERS average [4/]	---	---	---	58.3	59.3	22.7	1.7
	REUTERS median	---	---	---	58.0	60.5	22.0	4.3
	REUTERS maximum	---	---	---	68.0	70.0	43.1	2.9
	REUTERS minimum	---	---	---	52.6	44.5	10.7	-15.4
MOLYBDENUM (cUS$/lb) [5/]	Inflation report	21.5	13.6	34.1	26.9	20.0	111.8	-25.6
	COCHILCO [3/]	---	---	---	30.0	16.0	136.4	-46.7
WTI (US$/b)	Inflation report [2/]	43.2	41.4	58.7	57.4	64.8	38.5	12.9
	CONSENSUS [6/ 7/]	---	---	---	---	51.6	34.4	-7.4
	EIA [8/]	---	---	---	55.0	56.8	32.7	3.3

Note:
1/ Internationals prices carried out except for molybdenum.
2/ Forecast based on last 30 forward contracts to August 16, 2005.
3/ Chilean Copper Commission. Cooper Market Report 2005, Second Quarter. July 2005.
4/ Commodity Pool Reuters. Survey to Between 24 and 30 Investment Banks and Specialized Publications.
5/ Molybdenum prices belong to the concentrate prices. The carried out values are average export prices to June 2005.
6/ Consensus Forecast. August 2005.
7/ The information is available for November 2005 and August 2006.
8/ Energy Information Administration. Short Term Energy Outlook. August 2005.

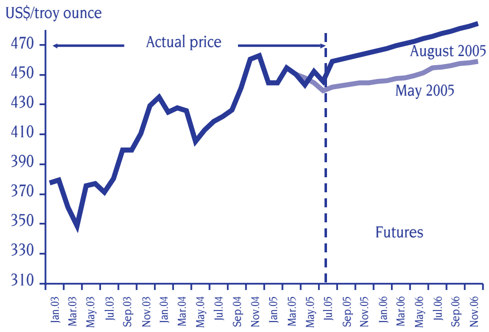
Graph 53
PETROLEUM WTI PRICE:
ACTUAL PRICE AND FUTURES



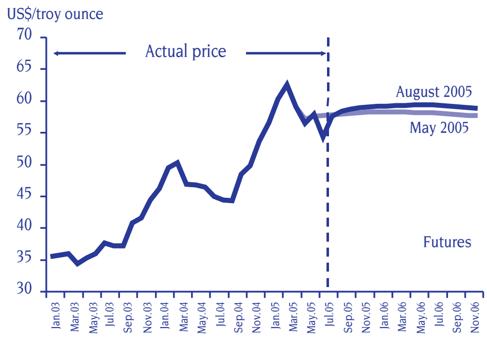
82. The terms of trade in **2006** are forecast to fall 6.1 percent compared to the May Report's forecast of a 2.8 percent reduction. In this regard, the forecast reduction in average export prices remains the same (a fall of 1.3 percent in this Report versus a 1.4 percent reduction in the May Report) but the increase in import forecast prices is greater (5.1 percent versus 1.4 percent forecast in the May Report) because of **higher forecast oil prices**. It is worth emphasizing that even with a forecast fall of 1.3 percent in export prices, particularly because of lower expected mineral prices, the average index remains well above the levels recorded over the last two years, including 2004.

GRAPH 52
FORECASTS OF COMMODITY PRICES
January 2003-December 2006

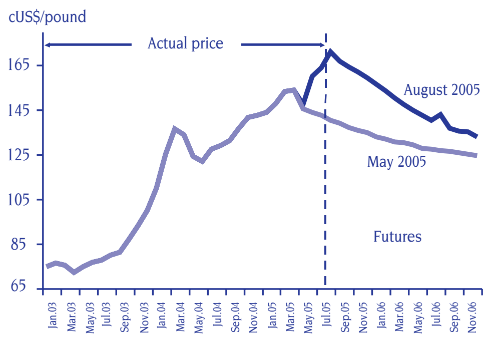
GOLD PRICE: ACTUAL PRICE AND FUTURES



ZINC PRICE: ACTUAL PRICE AND FUTURES



COPPER PRICE: ACTUAL PRICE AND FUTURES



SILVER PRICE: ACTUAL PRICE AND FUTURES

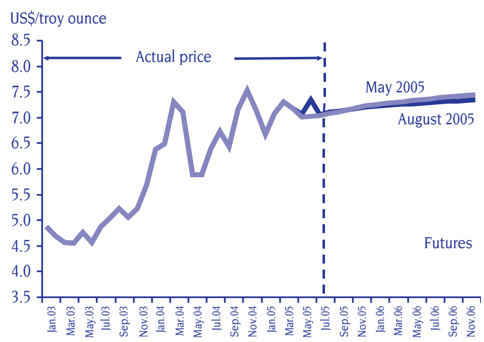


Table 35

TERMS OF TRADE
(Annual % change)

	2004	Forecasts				
		2005			2006	
		IR Jan.	IR May	IR Aug.	IR May	IR Aug.
Terms of trade	**9.0**	**-2.6**	**-2.3**	**3.5**	**-2.8**	**-6.1**
Export prices index	20.8	0.4	4.4	14.1	-1.4	-1.3
of which international prices:						
- Gold	12.7	1.7	5.3	5.7	3.8	4.9
- Copper	61.1	0.7	12.0	21.4	-10.4	-9.2
- Zinc	26.6	9.8	22.0	22.5	0.0	1.5
Import prices index	10.8	3.1	6.9	10.2	1.4	5.1
of which international prices:						
- Oil	33.2	3.8	27.5	38.5	-0.5	12.9
- Wheat	12.4	-5.3	-9.9	-10.0	8.8	12.1

IR: Inflation Report.
Source: CRBP.

BOX 9

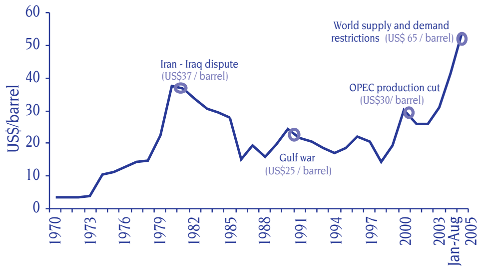
OIL PRICES

Oil prices in recent months have remained high and in excess of all predictions, because of the rigidity of the oil market and high demand from the principal consumer countries. In this context oil prices remain highly sensitive to any change in the delicate balance between supply and demand, such as expectations on inventories, the effects of the weather, or sociopolitical events having an unexpected effect on normal supply. WTI reached a record price of US$ 67 a barrel on the 12th of August. Nevertheless, it should be mentioned that in order to equal the price reached in real terms during the Iranian revolution and the Iran - Iraq war of 1979 to 1981, WTI would have rise to around US$ 80 a barrel.

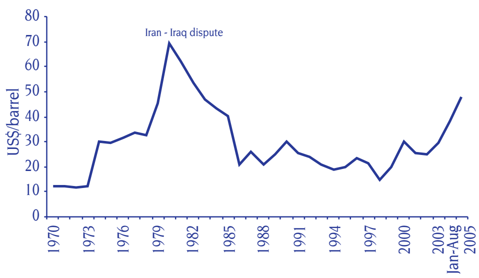
The forecast in this Inflation Report is for a price of US$ 65 and US$ 64 a barrel in December 2005 and 2006 (US$ 57 and US$ 65 annual averages, respectively), based on the average future prices in the last 30 days. Nevertheless, many factors are affecting the market's expectations of higher prices.

On the demand side, the forecast for 2005 and 2006 is for a rate of increase of around 1.9 - 2.1 percent to be maintained in 2005 (3.2 percent in 2004) and 2.0 - 2.1 percent in 2006[1/]. According to the EIA (Energy Information Agency), supply from non-OPEC countries is not expected to rise significantly; instead, it is expected to grow at a rate below the average for the last three years. Idle production capacity is at its lowest since 1951 and is not expected to increase significantly in the next few years. In addition, the fact that U.S. refineries are operating at their maximum capacity has led to a number of technical stoppages over the last month, while international tanker capacity is also near to full use. Geopolitical

International nominal price of petroleum



Real international price of petroleum



conditions and social tension in important producer countries is also a source of increased uncertainty over supply.

Finally, according to the NOAA (National Oceanic and Atmospheric Administration) the following months could be one of the most active hurricane seasons. In a context of limited capacity to increase production, U.S. refineries operating at maximum capacity and low inventories, oil prices are likely to be highly volatile in the event of any interruption in supply or damage to petroleum infrastructure.

1/ Ranges based on estimates by the IEA Monthly Market Report (July 2005) and EIA Short Term Energy Outlook (August 2005), respectively.

Trade balance

83. In a context of improved terms of trade and exports, a trade surplus of US$ 3.8 billion is forecast for 2005, the fourth consecutive year. This forecast is based on exports at the higher average prices predicted for the main base metals as well as higher forecast volumes of fishmeal, gold, zinc, molybdenum, and oil. In 2006 the trade surplus could fall (US$ 3.0 billion) because of the forecast correction in the terms of trade, although such a level would be higher than in 2004.

84. For **2005** forecast export growth has been revised upwards (28 percent compared to an estimated 17 percent in May), because of an average increase in export prices of 14.1 percent (versus 4.4 percent in the May Report). Growth in volume should be similar to that included in the May Report (12.0 percent). Traditional exports should increase by 30

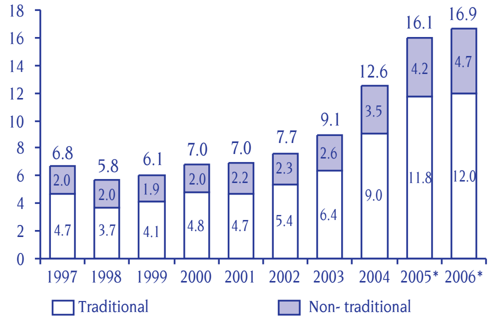
Table 36

TRADE BALANCE
(Millions of US$)

	2 004	2005 1/			2006 1/		2005 % change			2006 % change	
		IR Jan.	IR May	IR Aug.	IR May	IR Aug.	IR Jan.	IR May	IR Aug.	IR May	IR Aug.
1. EXPORTS	**12,617**	**13,652**	**14,729**	**16,097**	**15,003**	**16,856**	**8.2**	**16.7**	**27.6**	**1.9**	**4.7**
Traditional products	9,028	9,583	10,673	11,775	10,473	11,960	6.2	18.2	30.4	-1.9	1.6
Non-traditional products	3,476	3,937	3,921	4,178	4,393	4,738	13.3	12.8	20.2	12.0	13.4
Others	113	132	135	144	137	157	16.4	18.9	27.4	1.5	9.1
2. IMPORTS	**9,824**	**10,633**	**11,617**	**12,258**	**12,495**	**13,841**	**8.2**	**18.2**	**24.8**	**7.6**	**12.9**
Consumer goods	1,973	2,109	2,267	2,310	2,458	2,560	6.9	14.9	17.1	8.4	10.9
Raw materials	5,356	5,700	6,398	6,784	6,642	7,505	6.4	19.5	26.7	3.8	10.6
Capital goods	2,365	2,719	2,837	3,064	3,289	3,669	15.0	19.9	29.5	15.9	19.8
Other goods	130	104	115	101	106	106	-19.9	-11.3	-22.0	-7.7	5.0
3. TRADE BALANCE	**2,793**	**3,018**	**3,112**	**3,839**	**2,508**	**3,015**					

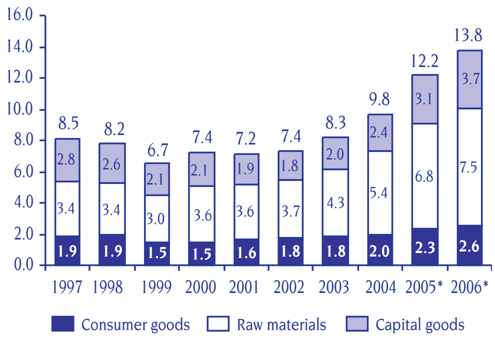
1/ Forecast.
IR: Inflation report.

Graph 54
EXPORTS
(Billions of US$)



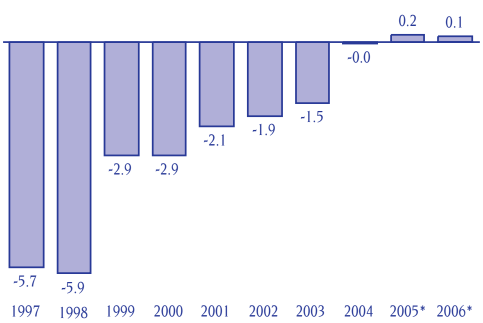
Note: Exports figures include other exports.
* Forecast.

Graph 55
IMPORTS
(Billions of US$)



Note: Imports figures include other imports.
* Forecast.

Graph 56
CURRENT ACCOUNT BALANCE
(Percentage of GDP)



* Forecast.

percent and non-traditional exports by 20 percent. This forecast growth in exports is explained by: higher world prices for basic products, higher exports by Antamina (copper and molybdenum), the beginning of the Alto Chicama project (gold) in the second half of 2005 and the impact over the whole year of the Camisea project (hydrocarbons), which came on stream in the second half of 2004, as well as the moderate effect of the elimination of textile quotas and buoyant exports of agricultural and fish products.

85. Imports in 2005 are estimated at US$ 12.3 billion (25 percent compared to 18 percent in the May Report), which is consistent with higher GDP growth (0.5 percentage points more than in the May Report) and higher oil prices compared to the May forecasts. Imports of raw materials (27 percent), especially fuels and industrial inputs and capital goods for manufacturing (30 percent) could explain this greater dynamism.

86. The positive trade balance forecast for **2006** is lower (US$ 3 billion), based on a more moderate rate of export growth (4.7 percent) reaching US$ 16.9 billion, associated with less favorable international prices. Imports should grow by 13 percent (to US$ 13.8 billion) given the still high oil price, while the rest of the country's imports are related to the dynamism of economic activity and the impact of commercial agreements on investment plans.

87. In **2005** a **current account** surplus of 0.2 percent of GDP is predicted, based on data from the first semester and in a context of higher export prices, compared to the 0.1 percent deficit forecast in the May Report. In **2006** a current account surplus of 0.1 percent of GDP is expected, considering real growth in exports of 6.2 percent and taking into account future contracts with the principal world exchanges, leading us to forecast a gradual reduction in the prices of the principal commodities, except for oil.

88. The **financial account** for **2005** should be positive to the tune of US$ 1.2 billion, half the figure for the previous year. The private sector should record a level of US$ 2.2 billion, US$ 809 million more than in the previous year, as more non-residents participate in local issues of sovereign bonds, more profits are invested directly rather than remitted abroad, world prices remain favorable and investments abroad by the financial system increase. Public capital should reach a negative level of US$ 1.0 billion, considerably less than for 2004. This is attributable to higher debt repayments (US$ 3.0 billion) due to early repayments to the Paris Club (US$ 1.6 billion) in the third quarter, which was financed by an issue of sol-denominated sovereign bonds valued at US$ 805 million, and an issue of global bonds valued at US$ 750 million in international markets.

89. In **2006** a current account surplus of US$ 116 million or 0.1 percent of GDP is forecast because of a lower trade balance associated with lower terms of trade. In an international context of rising world interest rates, the net flow of private capital is forecast to fall while the public sector should show a lower negative net flow because of lower amortization due to the early repayment to the Paris Club this year.

II.2 Economic activity

90. In a context of better global conditions than those predicted in earlier inflation reports, economic activity forecasts have been revised upwards. Thus, for **2005** the GDP growth forecast of 5.0 percent published in the May 2005 Inflation Report has been changed to 5.5 percent because of increased private investment and consumption, public investment, and exports. In this scenario, domestic demand should increase by 5.4 percent.

91. These modifications to the forecasts do not imply any inflationary pressure, given the productivity gains that have been experienced by companies in a more competitive environment, economies of scale arising from higher production and sales volumes, exchange rate appreciation and expectations of inflation agreeing with the Central Bank's inflation target, which can be confirmed from data collected by the CRBP's Macroeconomic Forecast Survey.

92. **Private consumption** should increase by 4.4 percent this year. This figure is consistent with the increase in national disposable income (5.4 percent) and higher consumer confidence measured by INDICCA. The indicator reached a

Table 37

GLOBAL SUPPLY AND DEMAND
(Real percentage values compared to same period in previous year)

	2004	2005*			2006*	
		IR Jan.	IR May	IR Aug.	IR May	IR Aug.
I. GLOBAL DEMAND (1+2)	5.6	4.7	5.5	6.3	5.2	5.3
1. Domestic demand 1/	3.9	4.5	5.3	5.4	5.2	5.2
a. Private consumption	3.4	3.8	4.4	4.4	4.5	4.4
b. Public consumption	4.1	3.8	6.1	10.0	2.1	2.8
c. Fixed private investment	9.0	8.0	9.6	12.5	10.2	11.3
d. Public investment	5.5	9.0	12.1	21.3	3.2	6.5
2. Exports	14.7	5.5	6.6	10.8	5.2	5.9
II. GLOBAL SUPPLY (3+4)	5.6	4.7	5.5	6.3	5.2	5.3
3. GDP	**4.8**	**4.5**	**5.0**	**5.5**	**5.0**	**5.0**
4. Imports	10.4	5.5	8.0	10.7	6.6	7.0

1/ Includes changes on inventories.
IR: Inflation report.
* Forecast.
Source: INEI and CRBP's forecasts

Table 38

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

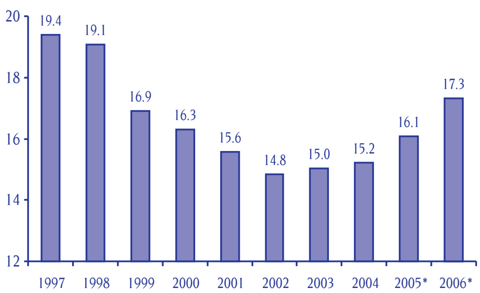
	2004	2005*		2006*	
		IR May	IR Aug.	IR May	IR Aug.
I. Gross domestic product (GDP)	4.8	5.0	5.5	5.0	5.0
II. Gross national product (GNP) 1/	3.2	4.9	4.6	5.7	6.4
III. Gross national income (NI) 2/	5.3	5.1	5.4	4.9	5.0
IV. National disposable income (NDI) 3/	**5.5**	**5.0**	**5.4**	**4.9**	**5.0**

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.
IR: Inflation report.
* Forecast.

level of 41 points in the second quarter of 2005 and peaked in July and August at 43 and 44 points respectively. This confirms the upward trend of the indicator that has been evident since the first quarter of 2004.

93. According to the CRBP's monthly expectations survey, GDP growth in 2005 is expected to be 5.3 percent by financial entities and 5.5 percent by economic analysts. Growth expectations for 2006 are 4.6 percent among economic analysts and 4.9 percent among financial entities (see tables 42 and 43).

Graph 57
FIXED PRIVATE INVESTMENT RATIO
(Percentage of GDP)



* Forecast

94. Growth in private investment should enable it to increase its share of GDP from 15.2 percent in 2004 to 16.1 and 17.3 percent in 2005 and 2006 respectively, regaining the share it had at the end of the last decade.

95. In 2005 it is expected that **exports** will continue to increase as they did in the first semester to make an annual increase of 10.8 percent, principally through higher volumes of gold and molybdenum and increases in non-traditional exports such as chemicals, agricultural & livestock products and engineering products.

96. It is expected that in 2005 **public spending** will grow 10.0 percent, mainly through higher wages and salaries and goods and services for central government, while **public investment** should increase by 21.3 percent.

97. During **2006**, economic activity should grow by 5.0 percent driven by increased domestic demand (5.2 percent) and exports (5.9 percent) within a favorable economic environment both nationally and internationally. Exports, whether traditional (particularly gold, molybdenum, and iron ore) or non-traditional (principally agricultural & livestock products and non-metallic minerals) will continue to increase.

Sector performance

98. GDP growth of 5.5 and 5.0 percent is forecast for 2005 and 2006, respectively. In 2005 this growth may be due principally to more buoyant non-primary manufacturing driven by solid domestic demand. In 2006, dynamic non-primary manufacturing should be accompanied by a more robust construction sector.

99. The **agriculture & livestock sector** could grow 4.3 percent in both 2005 and 2006, based on better weather conditions and more rainfall than in the previous year. The principal growth products will be rice, potatoes, agricultural exports, beef, and poultry. In 2006 plenty of water should be available and Peruvian farm produce will strengthen their position in foreign markets.

100. The **fishing sector** is expected to grow by 1.6 and 2.1 percent in 2005 and 2006, respectively. The increase in 2005 may reflect a recovery in the canning industry and continued higher landings for freezing and fresh consumption. Peruvian anchovy catches could increase slightly from 8.6 to 8.7 million metric tons compared to 2004. In 2006 greater diversification of species caught for canning is predicted, together with more activity in the freezing sector. Peruvian anchovy landings could decline slightly compared to 2005.

Table 39

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

	2004	2005*			2006*	
		IR Jan.	IR May	IR Aug.	IR May	IR Aug.
Agriculture & livestock	**-1.1**	**3.4**	**3.7**	**4.3**	**4.2**	**4.3**
Fishing	**30.5**	**1.8**	**1.9**	**1.6**	**2.6**	**2.1**
Mining & fuel	**5.4**	**7.0**	**6.7**	**6.4**	**4.4**	**4.3**
Metals	5.2	5.7	5.0	4.4	3.6	3.7
Fuel	7.1	26.2	21.3	24.8	14.7	12.1
Manufacturing	**6.7**	**5.0**	**5.2**	**6.4**	**5.2**	**5.2**
Based on raw materials	4.6	3.4	1.1	-0.4	3.1	2.5
Non-primary	7.2	5.5	6.0	8.0	6.0	6.0
Electricity & water	**4.6**	**4.0**	**4.1**	**4.2**	**4.4**	**4.4**
Construction	**4.7**	**6.0**	**6.5**	**6.5**	**8.3**	**8.0**
Commerce	**4.8**	**4.6**	**4.5**	**6.2**	**4.9**	**4.9**
Other services	**4.7**	**4.1**	**5.1**	**5.2**	**4.9**	**5.0**
GROSS VALUE ADDED (GVA)	**4.6**	**4.6**	**5.0**	**5.6**	**5.0**	**5.0**
Taxes on products and import duties	6.4	4.5	5.0	5.1	5.0	4.9
GLOBAL GDP	**4.8**	**4.5**	**5.0**	**5.5**	**5.0**	**5.0**
Primary GVA	**2.8**	**4.7**	**4.3**	**4.2**	**4.0**	**3.9**
Non-primary GVA	**5.1**	**4.5**	**5.3**	**5.9**	**5.2**	**5.3**

* Forecast.
IR: Inflation report.
Source: INEI and CRBP forecast.

101. The **mining and hydrocarbons sector** could expand by 6.4 percent in 2005 and 4.3 percent in 2006. Growth in both years will derive from higher gold and hydrocarbons production. Increased gold production reflects the beginning of the Alto Chicama project (La Libertad) in July 2005 by the Canadian company Barrick Gold. Production of natural gas and natural gas fluids in Camisea will also drive growth in the hydrocarbons sub-sector.

102. The **manufacturing** sector is expected to grow 6.4 percent because of an increase in non-primary manufacturing (8.0 percent) in 2005, which should offset a 0.4 percent contraction in the primary resources processing industry. The increase in non-primary manufacturing is a response mainly to increased domestic and foreign demand for chemical products, rubber and plastics; structural steelwork; food, beverages and tobacco; knitted textiles and the paper and printing industry.

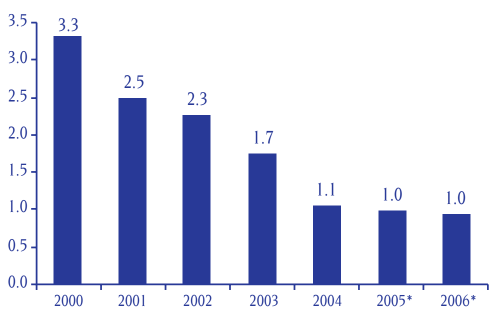
In 2006 the manufacturing sector is predicted to grow 5.2 percent. The primary resources processing industry should grow 2.5 percent, reflecting increased production of canned and frozen fish, sugar and oil refining. Increased non-primary manufacturing (6.0 percent) should be driven by increased production of non-metallic minerals, the paper and printing industry and chemical products, rubber, and plastics.

103. The **construction** sector should grow 6.5 and 8.0 percent in 2005 and 2006, respectively. The MiVivienda housing program will continue to drive the sector this year. During 2006 growth will respond to more buoyant private investment, building of the Southern Inter-ocean Highway and a number of large mining projects (especially completion of the Ilo smelter modernization project, and construction of the Cerro Verde sulfides and gas liquefaction plants).

II.3 Public finances

Fiscal forecasts predict a deficit of 1.0 percent of GDP for the period 2005 – 2006, in line with the Revised Multiannual Macroeconomic Framework (MMM) published in August, which assumes that public spending will be consistent with the predicted evolution of domestic demand and the inflation target.

Graph 58
NON-FINANCIAL PUBLIC SECTOR DEFICIT
(Percentage of GDP)



* Forecast

104. The **deficit in the non-financial public sector** for 2005 could amount to 1.0 percent of GDP, a figure 0.1 percentage point lower than that for 2004. Such an improvement would be the result of a 0.6 percent of GDP increase in tax revenue arising from increased economic activity and higher world prices for Peruvian commodities, which would be used to increase non-financial expenditure by 0.5 percent of GDP.

105. The **fiscal deficit for 2006** is estimated at 1.0 percent of GDP, similar to that forecast for 2005 and in line with the limit set in the Fiscal Responsibility and Transparency Act (FRTA) and the predictions of the Revised MMM, which implies an increase in the primary balance of 0.2 percent compared to 2005. This

Table 40

NON-FINANCIAL PUBLIC SECTOR
(Million of nuevos soles)

	2004	2005 *			2006*	
		IR Jan.	IR May	IR Aug.	IR May	IR Aug.
1. Current revenue	**35,381**	**38,112**	**39,121**	**39,800**	**41,390**	**42,016**
(% of GDP)	15.1	15.3	15.5	15.7	15.4	15.6
Real % var.	8.1	5.5	8.2	10.5	3.2	3.2
2. Non-financial expenditure	**-34,165**	**-36,055**	**-37,301**	**-38,250**	**-39,200**	**-39,920**
(% of GDP)	-14.6	-14.5	-14.8	-15.1	-14.5	-14.8
Real % var.	4.8	3.3	6.8	10.0	2.5	2.0
Current	-29,870	-31,493	-32,685	-33,250	-34,265	-34,364
(% of GDP)	-12.8	-12.7	-13.0	-13.1	-12.7	-12.8
Real % var.	5.3	3.3	7.1	9.3	2.3	1.0
Capital	-4,295	-4,562	-4,616	-5,000	-4,935	-5,556
(% of GDP)	-1.8	-1.8	-1.8	-2.0	-1.8	-2.1
Real % var.	1.5	3.6	5.2	14.4	4.3	8.6
3. Others	**1,184**	**898**	**1,245**	**1,127**	**1,475**	**1,378**
(% of GDP)	0.5	0.4	0.5	0.4	0.5	0.5
4. Primary balance	**2,400**	**2,955**	**3,066**	**2,677**	**3,665**	**3,474**
(% of GDP)	1.0	1.2	1.2	1.1	1.4	1.3
5. Interest	**-4,865**	**-5,405**	**-5,486**	**-5,153**	**-6,229**	**-6,036**
(% of GDP)	-2.1	-2.2	-2.2	-2.0	-2.3	-2.2
Of which: External (Millions of US$)	-$1,159	-$1,346	-$1,336	-$1,280	-$1,450	-$1,337
6. Overall balance	**-2,465**	**-2,450**	**-2,420**	**-2,476**	**-2,564**	**-2,563**
(% of GDP)	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0
Millions of US$	-$754	-$732	-$735	-$759	-$772	-$777

* Forecast.
IR: Inflation report.

forecast assumes that the increase in central government non-financial expenditure in real terms will not exceed the legal limit of 3 percent.

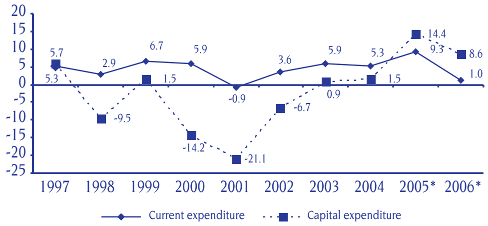
106. Central government **current revenue** in 2005 should amount to 15.7 percent of GDP, a figure 0.6 percentage points higher than that for 2004 and 10.5 percent higher in real terms.

Tax revenue should increase by 9 percent in real terms because of increases in income tax (18 percent) import duties (15 percent) and value added tax (7 percent). The first item principally reflects higher world and the lag following the increase in company income tax from 27 to 30 percent this year. As far as import duties are concerned, increased revenue derives from a 25 percent increase in imports. Improved revenue from value added tax is associated mainly with increased imports and, to a lesser degree, tax administration measures implemented in the second half of 2004. These factors could be partially offset by lower revenue from excise tax (8 percent in real terms) because of reductions in the tax rate on fuels aimed at attenuating the impact of higher world prices.

Non-tax revenue could increase by 19 percent in real terms because of increased income from the hydrocarbons levy and royalties arising from higher international prices and the Camisea operation; as well as mining royalties received this year.

107. Central government **current revenue** in 2006 could fall by 0.1 percent of GDP compared to 2005, although in real terms it would be 3.2 percent higher. This reduction will be the result of lower extraordinary income from regularization of income tax and a gradual fall in world mineral prices. It should be mentioned that the rate of the financial transaction tax (FTT) should fall from 0.8 to 0.6 percent while the value added tax will remain at 19 percent.

Graph 59
CENTRAL GOVERNMENT NON-FINANCIAL EXPENDITURE
(Real percentage change)



* Forecast.

108. Central government **non-financial expenditure** in 2005 should amount to 15.1 percent of GDP, a figure 0.5 percent of GDP higher than in 2004, equivalent to a 10 percent increase in real terms. This figure is in line with that forecast in the Revised MMM and includes the effect of the Supplementary Credit approved by Congress in June and amounting to S/. 1.3 billion (Law Nº 28562).

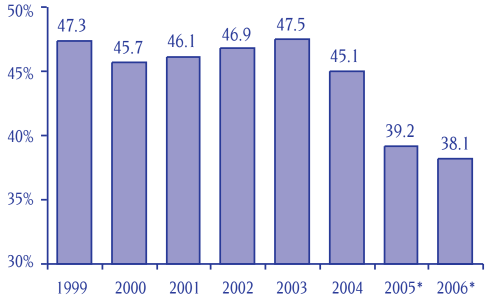
Given the annual provision for non-financial expenditure contained in the Revised MMM, this item should increase in the second half of the year, implying a 12 percent increase in real terms compared to the second half of 2004 (7 percent in real terms in the first semester) creating a fiscal deficit of 1 percent.

Current expenditure could increase 9.3 percent in real terms because of the effect of salary increases awarded in the second half of 2004 and the first half of this year (teachers, health professionals and others), as well as higher transfers to local governments as a result of the effect of higher world prices on income tax, the mining and hydrocarbons levy, and royalties.

Capital expenditure could increase by 14.4 percent in real terms, for which expenditure in the second semester would need to rise 19 percent in real terms (3.6 percent in the first semester).

109. Central government **non-financial expenditure** in 2006 should increase by 2 percent compared to 2005 (S/. 1.7 billion) after a real increase of 10 percent this year, in line with the Revised MMM. The supplementary credit authorized in June generated an increase in permanent expenditure estimated at around an additional S/. 600 million for 2006. An increase in transfers to local governments is predicted due to a lag in the effect of world prices on the mining levy. Finally, the 2006 expenditure figure already include payments of US$ 63 million from initial commitments associated with transport project concessions.

Graph 60
OUTSTANDING PUBLIC DEBT
(Percentage of GDP)



* Forecast.

110. **Interest** payments should amount to 2.0 percent of GDP in 2005, a figure 0.1 percent lower than in 2004 because of the effect of lower inflation on the interest accruing to bonds and an appreciation of the exchange rate on debt denominated in foreign currency. It should be mentioned that the early payment of debt to the Paris Club will generate a saving in interest of US$ 29 million this year, but an increase of US$ 37 million next year caused by extended public debt maturities.

111. **Interest** should amount to 2.2 percent of GDP in 2006, 0.2 percentage points higher than in 2005. This is because of higher payments on domestic debt resulting from a higher balance of sovereign bonds at longer maturities and the effect of inflation on bonds, as well as higher interest payments on foreign debt amounting to US$ 57 million.

Table 41

NON-FINANCIAL PUBLIC SECTOR FINANCING
(Millions of US$)

	2004	2005 *			2006*	
		IR Jan.	IR May	IR Aug.	IR May	IR Aug.
1. Overall balance (Millions of nuevos soles)	**-2,465**	**-2,450**	**-2,420**	**-2,476**	**-2,564**	**-2,563**
(% of GDP)	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0
Millions of US$	-754	-732	-735	-759	-772	-777
2. Amortization (Millions of US$)	**-2,068**	**-2,295**	**-2,267**	**-3,695**	**-1,910**	**-1,550**
Redemption of pension reform bonds	-215	-194	-196	-197	-69	-94
Internal	-505	-571	-573	-588	-314	-306
External	-1,348	-1,529	-1,497	-2,909	-1,527	-1,150
3. Borrowing requirement (Millions of US$)	**2,822**	**3,026**	**3,003**	**4,454**	**2,682**	**2,327**
External financing	2,474	1,523	1,673	2,223	1,799	1,000
Free disposal funds	2,158	1,023	1,173	1,723	1,299	500
Investment projects	315	500	500	500	500	500
Domestic bonds	766	1,027	1,030	1,803	600	1,150
Privatization	114	87	97	97	24	24
Others	-532	389	203	331	259	153

* Forecast.

112. The **borrowing requirement** should amount to US$ 4.4 billion in 2005, of which US$ 1.6 billion arises from the pre-payment to the Paris Club excluding this amount. The borrowing requirement is US$ 78 million higher than in the previous year.

Foreign disbursements should amount to US$ 2.2 billion, of which US$ 1.2 billion come from global bonds (US$ 750 million in July to cover the rescheduling operation with the Paris Club), US$ 546 million in freely available loans, and US$ 500 million from investment projects.

Domestic bonds should amount to S/. 5.9 billion, equivalent to US$ 1.8 billion, a figure that includes an exchange of maturities of Public Treasury bonds issued as part of the Financial System Consolidation Program and amounting to US$ 389 million (of which US$ 262 million have already been exchanged in May), as well as the equivalent of US$ 805 million issued in July and August to complete the rescheduling of debt with the Paris Club.

The operation to exchange dollar-denominated debt for debt denominated in domestic currency has reduced the exchange rate risk to public debt. It is estimated that the ratio of dollar-denominated debt to total debt will have been reduced from 85 percent in 2004 to 80 percent by the close of 2005.

113. The **borrowing requirement** for 2006 should amount to US$ 2.3 billion, reflecting a reduction of US$ 345 in foreign debt payments due caused by the early payment to the Paris Club.

Foreign disbursements should amount to US$ 1.0 billion, of which US$ 500 million will come from investment projects and US$ 500 million in the form of freely available loans. No global bond issues abroad are envisaged.

Issues of domestic bonds are estimated at S/. 3.8 billion, equivalent to US$ 1.2 billion. It is worth mentioning that this figure is higher than that included in the Revised MMM (US$ 650 million), which should allow more prudent treasury management, maintaining public sector deposits equal to one quarter's foreign debt service requirements. This will be in line with the Central Bank's recommendations to the Ministry of Finance on the Revised MMM.

II.4 Expectations

114. The Macroeconomic Expectations Survey carried out by the CRBP in May and August of Peru's financial entities and a group of economic analysts produced the following results:

Between May and August expected GDP growth rose from a range of 4.8 to 5.0 percent to between 5.3 and 5.5 percent for 2005. In 2006, economic analysts expected real GDP growth of 4.6 percent, while financial institutions forecast growth of 4.9 percent.

As far as inflation was concerned, both economic analysts and financial institutions reduced their inflation forecasts from 2.5 to 2.3 and from 2.5 to 2.4 percent respectively. Nevertheless, both groups thought that inflation would be around 2.5 percent in 2006.

Table 42

MACROECONOMIC EXPECTATIONS SURVEY
Economic Analysts

		January	May	August
GDP growth (%)				
	2005	4.5	5.0	5.5
	2006	4.1	4.5	4.6
Inflation (%)				
	2005	2.5	2.5	2.3
	2006	2.5	2.5	2.5
Foreign exchange (Nuevos soles per US$)				
	2005	3.34	3.29	3.26
	2006	3.45	3.34	3.30
Interbank interest rate (%)				
	2005	3.8	3.3	3.2
	2006	4.0	4.2	3.5

Table 43

MACROECONOMIC EXPECTATIONS SURVEY
Financial System

		January	May	August
GDP growth (%)				
	2005	4.5	4.8	5.3
	2006	4.5	4.2	4.9
Inflation (%)				
	2005	2.5	2.5	2.4
	2006	2.5	2.6	2.5
Foreign exchange (Nuevos soles per US$)				
	2005	3.30	3.27	3.26
	2006	3.35	3.32	3.30
Interbank interest rate (%)				
	2005	3.9	3.5	3.3
	2006	4.5	4.5	3.8

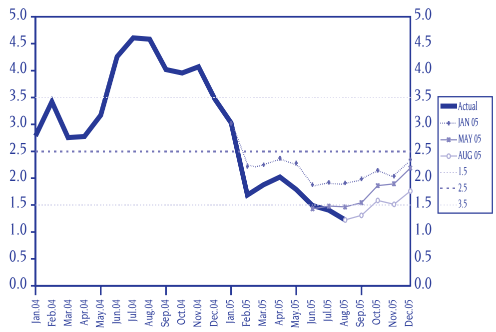
With regard to the exchange rate, both groups thought the nuevo sol would appreciate in 2005, falling from a range of S/. 3.29 and S/. 3.27 to the dollar in the May Report to S/. 3.26 to the dollar. In 2006 both the economic analysts and financial institutions expect a lower exchange rate than that given in the May Report, a fall from S/. 3.34 and S/. 3.32 to S/. 3.30 to the dollar.

II.5 Inflation

It is expected that the twelve month inflation rate will continue near to the lower limit of the target range (1.5 percent), closing the year at 1.8 percent. Throughout next year, the twelve month inflation rate should continue to converge on the target (2.5 percent), which assumes a reversal of the appreciatory tendency of the nuevo sol and an economy that continues to grow at a rate of 5 percent.

115. The central inflation forecast assumes that monetary policy will continue stable in the near future, but that throughout 2006 current monetary stimulus will be reduced gradually in line with the inflation target. As the Central Bank collects new information on the state of the economy, the monetary policy stance will be adjusted in a manner consistent with the CRBP's inflation target.

Graph 61
INFLATION 2005: ACTUAL AND FORECAST
(CPI 12-month accumulated change)



116. Throughout 2005 inflation has remained in the lower half of the target range and has been near to the lower limit in recent months. Graph 61 shows that inflation in 2005 has varied in line with the forecasts included in this year's reports. These reports predicted that inflation would be below the middle of the target range in the first part of 2005 before rising somewhat towards the end of the year.

117. The central inflation forecast for 2006 is below that envisaged in the May Report. In contrast to the previous report, twelve-month

inflation should still be below the target, although gradually converging to the 2.5 percent target.

118. Future variations in inflation will depend on the aggregate macroeconomic conditions described above, such as oil prices, the prices of Peru's principal exports, world economic activity, Federal Reserve interest rates, supply and demand, etc. Three macroeconomic factors have a significant influence on the behavior of the CPI:

a. The balance between supply and demand of consumer goods.

b. Labor costs and the cost of domestic and imported inputs.

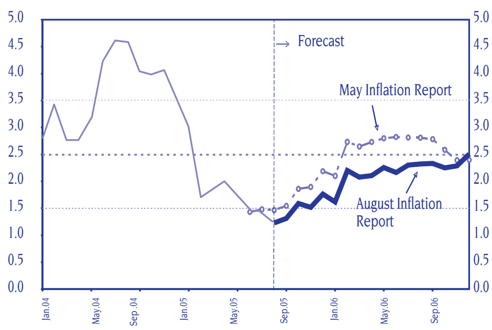
c. The price setting mechanism, which is influenced by the inertia inherent in inflation and by expectations of future inflation.

119. As far as the balance between supply and demand is concerned, the GDP indicator shows sustained growth in recent years that has not put pressure on inflation. It can be deduced, therefore, that growth in both supply and demand has been equal. The dynamism of economic activity over the forecast horizon is consistent with inflation converging from its current level of 1.2 percent with the 2.5 percent target by the end of 2006.

120. Another factor influencing inflation is the cost of producing final goods and services, particularly imports. The baseline scenario incorporates the transfer of higher fuel costs over the forecast horizon. It also assumes that the appreciatory pressure on the nuevo sol will be reversed. This evolution is explained by a reduction in the terms of trade, a lower interest rate differential between the sol and the dollar, and uncertainty caused by the proximity of elections in countries in the region. We also assume that there will be no upward pressure on wages and salaries in excess of increases in productivity.

121. The economy's price setting mechanisms are influenced by the inertia of past inflation and by expectations of future inflation. The announcement and publication of the 2.5 percent, target, as well as the CRBP's actions to ensure its attainment, have kept inflation expectations in line with the target. It is assumed, therefore, that over the forecast horizon these expectations will be around 2.5 percent.

Graph 62
INFLATION FORECAST
(CPI 12-month accumulated change)



III. BALANCE OF RISKS

122. As in previous Inflation Reports, the CRBP complements its central inflation forecast with an evaluation of the uncertainty and risks involved in each forecasting exercise. The balance of risks enables us to see how the behavior of the main determinants of inflation could affect the inflation forecast. An upward or downward balance of risks creates an asymmetric distribution, while a neutral balance of risks implies a symmetrical distribution.

123. In this Report the principal risk that could affect the inflation forecasts are:

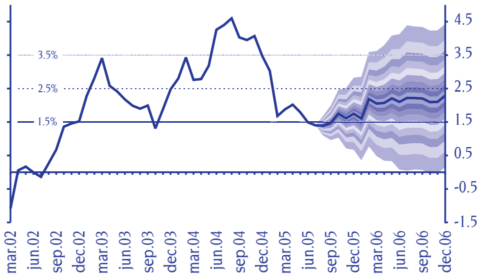
- **Further increases in the price of oil.** This Reports uses a baseline scenario in which the price of WTI is around US$ 65 a barrel over the forecast horizon. Any further increase in this price over and above the central assumption would imply higher pressure on domestic prices. In such a context, it is necessary to promote increased use of gas as this would lessen the effects of high oil prices, reducing costs, and increasing productivity.

  Should such a situation occur, the CRBP would not react to a temporary rise in inflation and would only do so if faced with a general rise in prices.

- **Higher export prices.** The central forecast scenario assumes that during 2006 the average prices of Peru's exports will fall 1.3 percent. Nevertheless, it is likely that the drop in export prices will be less or that, indeed, prices will not fall at all, which would have a more favorable effect upon the terms of trade than that contemplated in the baseline scenario. This would have two effects on the economy: on the one hand, there would be a boost to economic activity and demand; on the other, better terms of trade would strengthen the Peruvian economy and therefore contribute to maintaining an appreciatory pressure on the nuevo sol.

  Depending on the magnitude and persistence of both factors on inflation, monetary policy will be adjusted so as to achieve the inflation target.

Graph 63
INFLATION FORECAST
(CPI 12-month accumulated change)



- N.B. The illustration shows the central inflation bands over the forecast horizon. The darkest band around the central forecast represents a 10 percent probability of occurrence while all the colored bands represent a 90 percent probability of occurrence.

- **Deterioration of the world economy.** A higher than expected increase in federal fund rates caused by higher inflationary pressure in the United States and the possibility of a depreciation of the dollar beyond what has been assumed in the baseline scenario. In that case, the increase in Federal Reserve rates would be mirrored by Libor rates and domestic interest rates in dollars, which would in turn cause the sol to depreciate against the dollar. Given the proximity of the general election, the financial markets could also be subject to uncertainty and volatility.

  The CRBP has a high level of international reserves in order to address such a situation.

124. The assessment of the risks, both downward and upward against the baseline, gives as a result a neutral balance.

CONCLUSION

125. Forecast inflation for 2005 and 2006 described in this Report should be 1.8 percent, near to the lower limit of the inflation target range (1.5 - 2.5 percent). Throughout next year the rate of inflation should rise from its present level to the 2.5 percent target. This is consistent with growth in economic activity of around 5 percent and the expectation that appreciatory pressures on the nuevo sol will recede next year.

STATISTICAL ANNEX

INFLATION REPORT FORECASTS

	2004	2005 [1/]			2006 [1/]	
		IR January	IR May	IR August	IR May	IR August
	% real change					
1. Gross Domestic Product	4.8	4.5	5.0	5.5	5.0	5.0
2. Domestic demand	3.8	4.5	5.3	5.4	5.2	5.2
a. Private Consumption	3.4	3.8	4.4	4.4	4.5	4.4
b. Public Consumption	3.8	3.8	6.1	10.0	2.1	2.8
c. Fixed Private Investment	9.3	8.0	9.6	12.5	10.2	11.3
d. Public Investment	5.5	9.0	12.1	21.3	3.2	6.5
3. Exports of goods and services	15.0	5.5	6.6	10.8	5.2	5.9
4. Imports of goods and services	10.1	5.5	8.0	10.7	6.6	7.0
5. Main trade partners' growth	4.6	3.5	3.5	3.5	3.4	3.4
	% change					
6. Consumer price index	3.5	2.3	2.2	1.8	2.4	2.5
7. Nominal exchange rate [2/]	-5.5	1.8	-0.1	-0.6	1.5	1.2
8. Real exchange rate (multilateral) [2/]	-1.5	0.5	0.3	-0.9	1.3	1.8
9. Terms of trade	8.5	-2.6	-2.3	3.5	-2.8	-6.1
a. Exports price index [3/]	17.6	0.4	4.4	14.1	-1.4	-1.3
b. Imports price index	8.3	3.1	6.9	10.2	1.4	5.1
	% of GDP					
10. Balance of Payments' current account	0.0	0.5	-0.1	0.2	-0.4	0.1
11. Trade balance	4.1	4.0	4.1	4.9	3.1	3.7
12. Gross external finance of the private sector [4/]	3.2	0.9	1.4	3.7	2.3	2.1
13. Non-financial public sector primary balance	1.0	1.2	1.2	1.1	1.4	1.3
14. Non-financial public sector overall balance	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0
15. Tax revenues of the central government	13.3	13.2	13.4	13.7	13.4	13.6
16. Outstanding public debt	45.1	40.6	40.8	39.2	39.5	38.1
17. Outstanding external public debt	35.6	31.5	31.9	29.5	30.6	27.9
	% nominal change					
18. Central government non-financial expenditures	8.6	5.5	9.2	12.0	5.1	4.4
19. Monetary base (annual average)	18.8	11.0	22.0	26.3	12.0	14.5
20. Banking system credit to the private sector	-0.5	4.7	4.7	9.4	5.0	6.5

1/ Forecast.
2/ Exchange Rate Expectations Survey to Economic Analyst.
3/ August Inflation report includes molybdenum price index as part of exports prices index, before molybdenum was included in minor metals group.
4/ Includes foreign direct investment and long-run disbursements of private sector.
IR: Inflation report.

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